

Do Cooperatives Create or Destroy Value?



Dr. Chris Peterson

Nowlin Chair of Consumer-Responsive Agriculture
Michigan State University

© Dr. H. Christopher Peterson, Michigan State University, 2007

Do Cooperatives Create or Destroy Value?

- The answer depends on what **VALUE PROPOSITION** a cooperative seeks to fulfill and how well it manages to fulfill it.
- Consider three value propositions:
 - **Traditional:** Mutual Benefit
 - **Strictly Business:** Economic Value
 - **Theory-based:** Maximize Joint Cooperative-Member Returns



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Traditional Value Proposition

- **Cooperative:** A business organization run for **mutual benefit**.
 - Member benefits
 - Motive is to patronize (sell through or buy from).
 - Returns paid to patronage (not capital).
 - Member ownership
 - Only source of common equity
 - Member control
 - Traditionally one member, one vote



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Benefits of Mutual Benefit

- Member Preference: Fair Dealing!
 - Member is on both sides of the transaction → Co-op has no incentive to cheat or behave as a monopoly.
 - One member, one vote & limited return on capital → Members have no incentive to cheat each other.
 - Critical assumption: Members are alike!
- Public Policy Preference
 - Limited exemption from anti-trust (Capper Volstead)
 - Single taxation (benefit blunted by LLC)
 - Access to “agency-like” debt capital (CoBank)



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Traditional Value Proposition

- Guarantee members have market access.
- Guarantee fair dealing.
- Open membership (all comers; limited upfront investment).
- “Earn” your equity contribution through retained patronage refund (or retain).
- Redeem equity as cooperative was able.



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Problems with Traditional VP

- What if needed investment exceeds internal capital generation **or** is needed up front?
- What if member capital gets out of whack?
 - No or very little redemption ever occurs
 - “Retired” members vs. existing members
 - Big members vs. little members
 - “Temporary” equity capital
- What if mutual benefit is **not** enough?



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

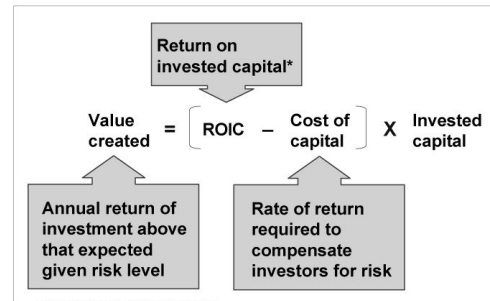
Strictly Business Value Proposition

- **Value Proposition:** Economic value created by the cooperative enterprise.
- **McKinsey Study (2002 based on 1999 data)**
 - Agricultural cooperatives collectively **destroyed over \$1 billion of value in 1999.**
 - Call to action:
 - Leverage horizontal scale
 - Pursue operational excellence
 - Drive customer integration
 - Exploit vertical opportunities
 - Create performance obsession



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

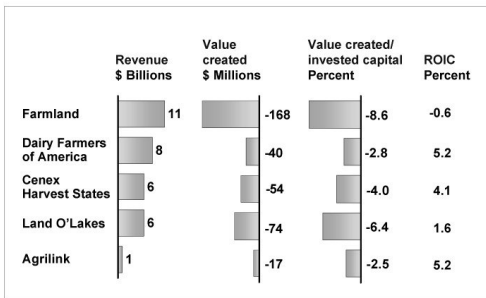
Value creation is key financial metric



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Regionals struggled to create value in 1999...

ESTIMATE



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

What Happened?

Cooperative	1999 ROIC (McKinsey)	2006 ROIC (Estimate)
Farmland	-0.6%	Bankrupt
DFA	5.2%	6.1%
CHS	4.1%	19.1%
Land O'Lakes	1.6%	8.9%
Agrilink (Birdseye)	5.2%	Majority private 8.4%



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Strictly Business Value Proposition

- Economic value takes into account the cooperative level performance.
 - But is that all members want?
- Is strictly business value creation enough for a cooperative?
 - What happened to mutual benefit?
 - Why be a cooperative at all?
 - How do members reap the benefit?



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Theory-based Value Proposition

Cooperative membership is a **joint** decision to patronize and to invest.

$$\begin{matrix} \text{Farm Returns} \\ \text{with Co-op} \\ + \\ \text{Investment} \\ \text{Returns from} \\ \text{Co-op} \end{matrix} > \begin{matrix} \text{Farm Returns} \\ \text{without Co-op} \\ + \\ \text{Investment} \\ \text{Returns w/o} \\ \text{Co-op} \end{matrix}$$



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Both Co-op & Farm Returns Matter!

- Cooperative-level returns (net income)
 - Patronage Refunds
 - Dividends on Capital
- Member farm-level returns
 - Price differentials
 - Service differentials
 - Existence
 - Risk reduction



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Theory-based Value Proposition

$$\begin{array}{rcl}
 \text{Member's} & & \text{Dividends} \\
 \text{Return} & = & +\text{Cash Patronage Refund} \\
 \text{on Equity} & & +\text{PV of Retained Patronage} \\
 & & +\text{Price Differences} \\
 & & +\text{Service Differences} \\
 & & +\text{Value of "Existence"} \\
 & & +\text{Value of Risk Reduction} \\
 & & \hline
 & & \text{Member's Equity}
 \end{array}$$



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Challenges with T-B VP

- Cooperative-level returns are suspect
 - Co-op accused of not making them in the marketplace, but rather off the members
- Member-level returns can make the co-op returns look worse than they are.
- Member-level returns are subjective, specific to individual members, and yet real!
 - The co-op must “measure” them.
 - They are part of the value proposition.
 - Do members give the co-op credit for these???



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

Other Value Creation Options

- Evolution and experimentation
 - New Generation Cooperatives
 - Mix pure investors & patron-members
 - Joint Ventures, Alliances, Subsidiaries, LLCs
 - Wyoming Cooperative Law
 - Extreme: Sell the co-op or take it private
- Each of these trades off market access and opportunities for member control.
 - Isn't a share of something better than all of nothing?



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

The Value Creation Challenge

- Traditional “mutual benefit” is not enough.
 - Yet it earns us special public policy treatment.
- Strict “economic value” is not enough.
 - It ignores the member level returns
 - Yet highlights the need for co-ops to perform
- Theory-based “cooperative plus member level returns” is not enough.
 - Co-op level returns are suspect
 - Member-level returns difficult to measure meaningfully
- What will work?
 - ***A value proposition meaningful to members that keeps the cooperative relevant to the marketplace of customers and partners.***




Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University

NCFC Study and Findings

- ***IS THE COOPERATIVE MODEL OUTMODED?***
- NCFC study committee
 - CEO survey and financial executive survey
- Findings
 - Despite the challenges of globalization, unpredictable consumers, and system consolidation, those ***cooperatives nimble enough to respond to marketplace changes were thriving.***
 - And, yes, ***they found creative ways to raise capital*** without abandoning the cooperative model.



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University



Do Cooperatives Create or Destroy Value?

- Yes!
 - **Create** when the value proposition fits the members and the co-op performs
 - **Destroy** when the value proposition doesn't fit or the co-op doesn't perform.
- Always challenged by:
 - What is the mutual benefit?
 - What are the member level returns?
 - How do co-ops remain relevant to the game?



Nowlin Chair of Consumer-Responsive Agriculture • Michigan State University