

10th Annual

Farmer Cooperatives Conference

November 5-6, 2007

## Valuing the Cooperative Business in the 21<sup>st</sup> Century

### POST CONFERENCE SUMMARY

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#### Introduction

The Farmer Cooperatives Conference celebrated its 10<sup>th</sup> anniversary with a record attendance, as over 180 participants from U.S. and Canadian cooperative leadership gathered in St. Paul, MN to explore the issue of cooperative value

The University of Wisconsin Center for Cooperatives (UWCC) established the Annual Farmer Cooperatives Conference in 1998 with seed money from the Farm Foundation, which has generously continued to provide funding for the annual conference in each year since. The conference objective is to provide co-op directors and managers,

professional organizations, government representatives, and academics with information on major trends and issues affecting agricultural cooperatives.

Brent Hueth, Associate Professor and Director of the University of Wisconsin Center for Cooperatives, opened the conference. Mary Thompson, Director of Communications, Farm Foundation, reviewed the Foundation's priorities for the conference, which include an examination of the long-term economic viability of the cooperative, and a focus on issues related to access to capital.

#### Do cooperatives create or destroy value?

Chris Peterson, Professor at Michigan State University, provided a solid framework for the conference with his presentation on the question, "Do cooperatives create or destroy value?" Each cooperative is built around a value proposition, said Peterson. Whether value is gained or lost is determined by how well the cooperative fulfills that proposed business arrangement.

Value propositions can be used to categorize cooperatives; each category brings its own challenges in measuring the value it proposes to create. The traditional value

proposition, in which the cooperative business is organized and run for the mutual benefit of its members, provides market access and fair dealing to its member-patrons, as well as some public policy preferences. The priority is on patronage transactions – either buying or selling – and the member equity needed to invest in the business can be "earned" and paid through patronage transactions. Problems with this model occur when capital needs for either investment or member equity redemptions exceed equity generation from members. And, as market conditions evolve, the co-op

may not be the only avenue for “fair dealing”.

Another type of value proposition is based on the economic value that is created by the cooperative enterprise. In this case the annual return of investment, adjusted for a given risk level, is the key metric for assessment. It was on this basis that the 2002 McKinsey report concluded that agricultural cooperatives had destroyed over \$1 billion of value in 1999.

The study jolted the agricultural cooperative sector into action, and fostered a stronger focus on business performance. However, assessing value creation strictly on financial measures does not encompass the mutual benefit provided to members, nor does it reflect whether members have benefited from this type of value creation. Under this proposition, there is no value added by the use of the cooperative business structure.

A third type of value proposition is what Peterson calls a theory-based value proposition, which recognizes that a cooperative can create value at both the member farm level, which was not included in the McKinsey study, and at the level of the co-operative business. Returns at the cooperative business level can be measured by the net income used for patronage refunds and dividends on capital.

But the returns at the member farm level are more difficult to quantify. The value of these benefits, which include price and service differentials, risk reduction, and the market existence provided by the co-op, accrue to each individual’s farm operations, and member perceptions of these returns will vary. Quantifying and establishing the appropriate balance between individual and cooperative returns is a subjective, challenging process.

There are other variations of the cooperative structure that are being used to create and capture value, but these structures use trade-offs in member control to gain broader market access, alternative equity sources, or other opportunities.

Peterson concluded that value is created when the cooperative both offers a value proposition that fits member needs, and performs well as a business. Some cooperatives have accomplished this, but remaining relevant to the marketplace while providing mutual benefit and returns at the member level will continue to be challenge for co-ops.

Doug Sims, retired CEO of CoBank, focused on economic valuation. He stressed that a cooperative must first function successfully as a business before it can deliver the other benefits that are also associated with the cooperative business model.

Sims said he believed that cooperatives had historically coasted on the value of member refunds without addressing inefficiencies within the business, and that the co-op’s value proposition must be able to generate a return on investment that meets or exceeds the cost of capital. Given that ability, however, a member-owned and controlled cooperative can be an exceptionally strong model for a customer-oriented business.

To maintain an economic focus, it is critical for the board to set measurable standards for assessing how well the cooperative meets its value proposition. These may include non-financial benchmarks that reflect other ways that a cooperative can create value, but they must not overshadow the development and execution of a successful business plan.

## Valuing Assets during Changing Times

A cooperative may assess the changing marketplace, its business plan, and its own value proposition, and decide that the cooperative structure can meet both economic and member benefit criteria.

A change in market conditions was compelling enough for a group of Michigan Sugar Company (MSC) beet producers to buy the company and create a producer-owned enterprise. When the parent company went into bankruptcy and put up MSC for sale, sugarbeet growers were faced with the possibility of losing demand for their crop, which produced a higher net return per acre than other crops they could grow. Mark Flegenheimer, CEO of MSC, described how this potential loss provided the incentive for producers to raise equity and take on substantial debt to buy the company, which was an established company with a well-known brand. Producers bought shares based on acreage, committed that acreage to beet production, and raised \$24 million in equity to start this new generation co-op.

United Producers, Inc., a livestock marketing co-op that also offers risk management and production management services, decided to maintain its core cooperative structure after a lawsuit wiped out the co-op's equity, forcing it to reorganize.

CEO Dennis Bolling noted that economic performance was paramount for the business to survive, but it was initially unclear whether the value proposition for members would support those priorities. The livestock industry is a mature one; perhaps the cooperative structure was not the most economically appropriate at this stage in the

business's life cycle. The cooperative previously had been structured so that the risk to farmers was limited to their retained earnings, but the future of the business required greater equity participation. But farmers were willing to continue to both patronize the co-op and provide equity for refinancing cooperative operations because they recognized the value that the co-op brought to their individual operations.

With this commitment, as well as strong assets in its local facilities and a sound loan portfolio, UPI is implementing cooperative-based solutions to meet its capital requirements through new capital retains and preferred membership programs. It has created a community markets program to organize new cooperatives around its local facilities, in which the new co-op will buy the UPI facility in the area, but contract UPI to manage the facility.

While these efforts are not sufficient to meet all capital needs, they have provided significant member value while addressing financial requirements. Any future structural changes will be made in the context of meeting members' needs.

In other cases, the evaluation of the cooperative's value proposition has led to the conversion to other business structures. FCStone CEO Pete Anderson described the rationale and the process of converting from a cooperative to a public corporation. As a cooperative it provided risk management services to its members through its commodities business, but the business began rapidly to expand as it developed an integrated risk management program that was marketed to a larger, non-member customer base. FCStone needed increased

capital to finance this expansion while maintaining member service levels, but annual member payouts limited the company's ability to raise and retain equity. The cooperative structure also did not provide liquidity or a means for members and employees to benefit from the company's growth in both market value and income generation.

The board did not want to sell the mature, developed company. Taking on subordinated debt did not seem viable, and the board did not want to give up control by taking on equity partners. After a comprehensive strategic assessment process, management recommended a conversion to a stock company controlled by existing members, with an implementation of an ESOP and increased investment opportunities for members, and the plan was carried out in 2004. Two years later the company converted from a private to a public corporation, with an initial public offering of common stock.

David Barton and Michael Boland, Professors, Kansas State University, compared in their accompanying case study the member benefits under the two structures. It appears that access to risk management services by members/customers remained about the same pre- and post conversion.

The value of members' investment in the company is a second metric for conversion evaluation. FCStone's redemption rates and cash patronage refunds were high by cooperative standards. But the IPO generated unparalleled multiples of book value that provided the possibility of large equity payouts to co-op and producer owners, a scenario that was unique to this conversion and its business position.

The last point of member benefit comparison is in governance and control of the business. For the next few years at least, it is expected that the original local co-op CEOs will maintain control of the board.

Rodney Christianson, CEO of South Dakota Soybean Processors (SDSP), described how SDSP began as a new generation or closed cooperative in 1995, and its members purchased stock that required delivery of soybeans to the processing plant. As the cooperative grew and the industry matured and consolidated, SDSP developed plans for expanding its non-member business to compete in the burgeoning field of vegetable oil technologies.

Projected growth would threaten the cooperative's single taxation treatment, and required more equity for expansion and a larger pool of producers. The board of directors in 2001 approved a plan to convert to an LLC to meet these challenges. The LLC would maintain the single-tax treatment for its members, and was expected to provide operational efficiencies by eliminating the member delivery requirements, which were needed to qualify members for patronage distributions. The LLC structure would also provide liquidity for producer members' allocated equity because sale of shares would be allowed to investor members. It was also expected that new equity capital for expansion would be more readily available under the new structure.

In Barton and Boland's case study, expectations that drove the conversion were compared to the results. Because the growth in non-patronage-sourced business has not been as strong as expected, the business's single tax status was not jeopardized to the extent projected. Business growth has been sufficient to increase the demand and the

price for soybeans in the area, however. While producers and the plant are now both free to pursue the best respective buy/sell relationships, the actual transactions continue to follow the preexisting pattern. All producers in the area, not just the original members, have benefited from the price increase. Equity liquidity has increased, as has access to new equity capital.

The changes in cooperative member benefits as a result of the conversion are mixed. The membership base did not significantly change with the conversion, so producers continue to control the board. It appears that members' ability to sell soybeans competitively was not significantly changed by the conversion; members had flexibility both before and after.

Changes in member investment since the conversion have varied, but it is not clear whether the co-op structure would have produced any different results. Stock prices have fluctuated, but have remained above the original equity drive purchase price.

The Gold Kist transformation from cooperative to public company to takeover target was described by Dan Smalley, past board chair of the cooperative. Gold Kist had evolved into a major poultry production and marketing enterprise with a homogeneous board and membership. The financial success raised member expectations for payouts at the same time that the cooperative began to lose market share, faced large equity redemption obligations and needed access to capital.

Serious board conflict ensued, and after exploring strategic alternatives, the board recommended converting to a public company with an IPO. The proposal would allow Gold Kist to be a financially stronger

and more flexible company, and create liquidity for equity holders. Cooperatives have life cycles, and the growing capital needs that Gold Kist encountered to maintain its success in the food industry were difficult to meet within the cooperative structure.

Smalley also noted that the difficulties Gold Kist encountered with its homogeneous board might have been avoided had the perspective and expertise of independent directors been allowed under the cooperative structure.

The membership approved the conversion, Gold Kist went public, and a new board with a majority of independent directors was formed. But the now-public company was soon sold to Pilgrim's Pride, a privately held enterprise that had been tendering offers throughout the conversion process.

Smalley felt that the outcome ultimately benefited the cooperative member, because the sale and takeover allowed cooperative members to capture the full market value of their company, which would not have been possible under the cooperative structure. Former members continue to be contract producers for Pilgrim's Pride, but have no investment or control over the company.

The issues that commonly lead to conversion were described by John Schmitz, CHS executive vice president and CFO, as the lack of equity liquidity, lack of a means to capture enterprise value, lack of equity capital for growth or acquisitions, and the conflict of cooperative customer and owner interests. Schmitz said that a cooperative can capitalize on its strengths to strategically address these conditions, and described the advantages of CHS's cooperative structure as four-fold: a single level of income taxation, an orientation toward long-term

planning, potentially closer customer ties, and the earnings benefits ultimately received by the customer. CHS equity and enterprise valuations are similar to an average of

publicly held agribusiness corporations: earnings are the most important source of capital for creating value for the shareholder and the business, regardless of structure.

### **Trends in Financing Bioenergy**

Tom Houser, Vice President, CoBank, provided an update on developments in bioenergy, a sector in which agricultural producers have used a variety of cooperative and non-cooperative structures to capture value. Houser stated that the sector will continue to be volatile, especially with the disconnect between corn and ethanol prices. Location, access to capital, and low production costs are critical for project success as the ethanol and biodiesel industries continue to consolidate. He predicted that capital will not be available for new ventures, but will be channeled to plant expansions, or to new plants undertaken by companies with a proven track record in the business.

Capital formation and access to equity capital continue to be primary requirements for participation in biofuels opportunities, and Michael Weaver, Lindquist and Vennum, examined how this is influencing trends in business structures. Tax and governance considerations, investment liquidity and balance between income and investment appreciation goals are further considerations. Weaver noted that preferred

stock and active equity revivment programs are methods that traditional cooperatives can use to manage the built-in tension between patron expectations and business needs; new generation cooperatives, LLCs, or public corporations are other structures that producers have used to facilitate capital formation. Weaver also discussed the legal and tax implications of recent cooperative trends including recapitalizations and mergers and acquisitions.

### **Outlook for Agriculture**

Ross Anderson, senior vice president of Agribank, provided a context for future business decisions with an outlook on agriculture, which is in excellent financial condition at present. The development of ethanol markets has raised farm income in the U.S, and global demand for food will continue to strengthen exports as the dollar declines. However, future strategies should encompass the many uncertainties surrounding ethanol, which is largely dependent on subsidies and governmental policies, and its impact on the livestock and transportation industries.

### **Valuing Assets and Measuring Performance**

The conference program also included presentations on performance measures and asset valuation, which are key to assessing the cooperative value proposition. David Holm, Executive Director for the Iowa Institute for Cooperatives, began this

segment of the conference with a description of the cooperative benchmarking project he is piloting. Participating cooperatives will be able to compare their own cooperatives performance to other similar ones on a company, department and location basis

over time, using reporting that trends income and balance sheet ratios, and provides other critical ratios. Using this type of benchmark analysis can be a powerful tool for assessing results of management decisions.

Harry Fehrenbacher, president of Effingham Equity, pointed out that cooperatives are just one of many opportunities competing for farmer capital in today's market, and the high-dollar, long-term nature of capital projects, coupled with the trend of early obsolescence through technology, makes capital asset decisions difficult. These decisions are the most crucial that the co-op can make; Effingham Equity, primarily providing farm supply services, has required substantial capital investment over the last 10 years to provide the information, capacity and service quality levels that make up its value proposition. Fehrenbacher described his co-op's capital asset decision-making process as based on how well the investment will profitably support core business strategies while reflecting a customer focus,

improvement in business practices, and integrity. Cash flow must be simultaneously managed to protect the balance sheet and revolve old equities. The cooperative has instituted a systematic evaluation of the return on assets by facility and department, so that it can regularly assess how well capital assets are contributing to the cooperative's goals.

Amy Gales, regional manager of CoBank, reviewed financial perspectives on valuation. Value can be determined using different methods, but all must establish a present value for relevance and viability both now and in the future. Gale reviewed balance sheet, income statement and discounted flow methods, in contrast to SWAG (Scientific (or Silly) Wild-Ass Guess) approaches, which can be driven by non-financial consideration. To paraphrase Warren Buffet, companies need to make money, have an understandable business proposition, have favorable, long-term prospects, and be operated by honest, competent people.

### **Member Value Proposition**

The value proposition for members was key to Swiss Valley Farms' reassessment of itself when a 50-year sunset clause in the bylaws required it to reincorporate. The cooperative had grown through mergers and acquisitions and expanded its focus to include value-added cheeses as well as the fluid milk market, so the opportunity for reevaluation was timely. Gordon Toyne, co-CEO, and Don Peterson, Director, provided their perspectives on the process of reincorporating under the new Iowa cooperative law as a stock cooperative, rather than a membership one. The board used committees and outside expertise to tackle the reincorporation

challenge, and worked to assure that the best interests of member-owners and employees were preserved in the process. In considering the new cooperative structure, the board had to compare the limits of traditional bank lending practices against the impact of new sources of equity, from retired members, employees and outside investors, to provide the additional capital needed for maintenance and growth. The board also considered the impact of outside directors, who would be allowed under the new law and could provide needed expertise in such areas as finance, and mergers and acquisitions. The governance committee and the attorney worked to define and codify

these different interests in the new articles and bylaws; member voting rights and producer-member majority on the board was written into the bylaws. The new structure will give the co-op the flexibility to meet changing equity requirements through its ability to issue preferred stock, which also provides a way for both employees and co-op members to invest in the co-op. The co-op's mission statement has been broadened to recognize its commitment to its workforce and customers, as well as to its owners and members.

Because the change was so significant, extensive membership communications on this issue began five months before the vote to allow for questions and explanations. Peterson felt that this step was critical to member engagement and the eventual success of the reincorporation effort.

Michael Cook, Professor, University of Missouri, noted the many different member value propositions that were described in the earlier presentations. He emphasized that the definition of value to the member can change over the course of a single cooperative's life cycle. The range of member value propositions reflect the complexity of the cooperative structure,

while value created by the investor owned firm is assessed by just a few measures. Cook pointed out that co-op value propositions treat members as patrons or as investors, and the cooperative should understand where along the patron-investor spectrum their membership wishes to be.

Traditionally, farmer cooperatives have been formed to secure producers a larger portion of the proceeds from the sale of their product, or "a larger piece of the pie", and the co-op supported their efforts as individual entrepreneurs. The current shift in cooperative business strategy is to "create more pie" by enlarging markets through value added efforts. Members look to the cooperative to serve a more "collective entrepreneur" function, and capital formation becomes a larger issue.

Because there are many ways to create value, cooperative members need to share a common interest. Cooperative life cycles can be seen as a process in which divergent interests develop within the membership as the result of growth, and the subsequent actions the co-op takes is a process for realigning the members' common interests. From this perspective, Cook said, a cooperative can have multiple life cycles.

### **Branding and Corporate Responsibility**

A broader perspective on the cooperative value proposition was provided by Jean-Marie Peltier, President and CEO, National Council of Farmer Cooperatives, in her presentation on cooperative branding and corporate responsibility. Peltier pointed out that traditional cooperative values – farmer ownership and control, economic viability of farm businesses, stewardship of natural resources, and rural community – fit in well with the current emphasis of sustainability

and social responsibility in the corporate realm.

NCFC is developing a cooperative stewardship initiative, the NCFC Code of Sustainable Practices, to promote these values by working with Wal-Mart on their producer score card program, and by exploring other tools for self-regulation rather than using a third-party certification process for sustainability compliance.

To market this initiative, NCFC is developing a communications program that will capitalize on the desire by consumers to buy products that are values-based. Because cooperatives are associated with sustainability and have “feel good” associations with farmer ownership, community, integrity and resource stewardship, cooperatives are well-positioned to offer the sustainability-based products that consumers are seeking.

Peltier urged farmer cooperatives to create a vision of sustainability that is aligned with grower needs; stating that “you can’t go wrong by doing good!”

Kevin Sexton, Manager, discussed how River Country Cooperative redefined its

member value proposition in response to the changing marketplace. Population growth and suburban development had caused demographics of the co-op customer to change, and by the mid-80’s business had fallen by half and members’ equity was gone. Farmers Union Cooperative Oil Association changed its name and repositioned itself as River Country Cooperative, serving both consumer and farmer needs, and saw sales growth from both urban and rural business segments.

Almost half of its earnings are now from petroleum, with the remaining earnings from farm supply activities. The co-op is attempting to maintain its program of cash refunds to members while building its unallocated reserve to support its growth.

## Conclusions

It is clear that the ability of a cooperative to create economic value, as measured by standard financial metrics, is critical to the ongoing viability of the business. But the value proposition for members can encompass a wide range of benefits that may be difficult to accurately assess. Benefits may have a patron or an investor orientation, which may change over the life cycle of the

cooperative, and may be further complicated by market valuation increases that are difficult for members to capture. Cooperatives continue to explore structural alternatives that can support the value proposition for members and meet capital formation challenges, while weighing the potential impacts of the trade-offs in member control.