

*11th Annual
Farmer Cooperatives Conference
November 18-19, 2008*

Cooperative Strategy, Structure, and Finance

POST CONFERENCE SUMMARY

Introduction

Equity and capital management issues continue to drive major strategic decision-making by today's farmer cooperatives. Against a backdrop of volatile markets and global competition, cooperatives must develop strategies that balance growth imperatives against risk and supply chain cost management. Over 170 cooperative board members, CEOs, and others doing

business with agricultural cooperatives gathered in St. Paul, MN last November to discuss "Cooperative Strategy, Structure and Finance" at the 11th annual Farmer Cooperatives Conference, sponsored by the University of Wisconsin Center for Cooperatives.

Strategies for Growth in a Competitive and Complex Environment

Upstate Farms Cooperative and Niagara Milk Producers Cooperative, Inc. had discussed a merger in the past. As value-added marketers of raw milk, they both shared a similar orientation toward product and quality, and operated in the same geographic area. Both were part of O-AT-KA Milk Products Cooperative, which was created to guarantee markets for member milk.

Their decision in 2006 to form Upstate Niagara Cooperative, Inc. was a win-win decision for both, said Dan Wolf, president of the board of the new cooperative. The

merger provided an effective way to achieve operational consolidations, and has provided strategic growth opportunities that position the cooperative favorably for the future. Similar earnings and member benefits meant that there was no need to adjust member equity shares in the merged cooperative. A board representation proposal that integrated the boards and the delegate structure from Upstate is in the process of being phased in. The merger included 90% ownership of O-AT-KA, which continues to provide security by guaranteeing markets and providing value-added products.

Managing Strategy Formulation and Implementation Risk

Michael Boland, Professor, Kansas State University, reviewed the process that underlies any effective corporate strategic plan. Strategies are not just ratified by the board, but should be formulated in concert with a general manager or CEO. Boland differentiated strategic planning, which relies on an analysis of the parts of business, from strategic thinking, which is a synthetic process of seeing the big picture. A strategic perspective can exist on multiple levels, from a conceptual perspective of the business, to its pattern of conducting business over time, to its position in the market, to strategic action plans to achieve an objective.

Larry Swalheim, CEO of Landmark Services Cooperative, and John Blaska, Chairman of the Board, presented the strategic planning and risk assessment process that allows Landmark to meet short and long term goals. Key assignments from an annual strategic planning retreat focus management effort on top strategic initiatives. Verity Resources, a joint venture with AgQuest that will provide in-house producer financing, is another result of the past year's strategic goal setting.

At Landmark, board committee meetings are effectively used to push the strategic agenda forward, and are not simply opportunities for division managers to "lobby for cash." The equity committee assures that the program is synchronized with the long term capital needs of the cooperative.

An internal audit committee has been formed to insure the identification, reporting and management of risk. Regular risk management reports in eight different areas are used to assess risk exposure; these

reports mean that "the Board knows exactly what our exposure is".

This framework has allowed Landmark to move quickly on new opportunities as they arise. The cooperative was able to act quickly and put together a merger with Grand River Cooperative in just three months this year. Both Blaska and Swalheim agreed that it is strong and effective communication between the board and management that allows this framework to operate.

Tim Lindgren, President and CEO of Sunkist, and Nicholas Bozick, Chairman of the Board, also discussed the need for good communications between the board and management. Lindgren noted that they use committee work and place an emphasis on teamwork to avoid close, divisive votes.

Sunkist has undertaken a variety of strategic initiative to maintain its competitive position and to improve returns to its members. Today, Sunkist's extensive marketing network supports a widely recognized brand. Its global licensing program and other non-patronage sourced business generate significant unallocated retained earnings that supply the majority of Sunkist's equity needs. This allows the cooperative to revolve member equity out on a 5-year plan.

Sunkist has undertaken several initiatives to meet buyer demand and to achieve operating efficiencies with its facilities. Sunkist Global, LLC sources counter-seasonal, complementary non-member fruit, and Sunkist/Taylor markets fresh pre-cut fruits and vegetables. The 2007 freeze provided an opportunity to consolidate processing operations into two plants that can meet the

changing product demands of the Sunkist

customer.

Managing Human Resource Risk

Bob Broekelman, Vice President, Recruitment and Selection, FCCServices, Inc., pointed to the looming retirement of the baby boomer demographic as another risk that cooperatives must develop strategies to manage. This group will be difficult to replace given the next

generation's smaller number, and the dwindling number of those with a background in agriculture. He discussed "Gen Y", the group now entering the workforce for the first time, and how to recruit and retain this future generation of workers.

Strategies for Cooperatives in Turbulent Times

Amy Gales, Central President, CoBank, outlined strategic guidelines that cooperatives might adopt in these turbulent times. In her succinct review of the current financial crisis leading up to the present situation, Gales noted that the losses of \$1 trillion have pulled \$10 trillion from the market, and the global de-leveraging has led to a crisis of liquidity, capital and confidence.

Commercial banks have responded to current credit market conditions by pricing to risk. There has been a flight to quality and a reluctance to extend new credit, although the first quarter of next year may see a freeing up of credit if the market begins to settle down. Farm credit institutions are positioned with quality portfolios oriented to longer-term growth instead of quicker, higher – and more risky – returns. These institutions are reserving their liquidity for core borrowers. As a government-sponsored entity (GSE), CoBank continues to balance its mission with sound lending practices, although it is not immune from the current situation. As interest rates continue to rise, loan structures will be more important. Increasing need for

credit will make market partners more difficult to find.

Gales offered a "top 10" list of strategies that cooperatives can adopt to cope with a volatile financial landscape. She noted that "cash is king" in times like these, and it is important to improve working capital and manage debt so that resources are available for inevitable bumps in the road. To maintain a strong emphasis on profit, there can be no "sacred cows", and the cooperative must be willing to act when margin objectives are met. Refining short-term and long-term planning by understanding the cost of doing business is another useful strategic focus. Leverage is good, but only up to a point: the 1980's were an example what happens when highly leveraged farming is faced with asset devaluation. Capital expenditures should be made with an understanding of where they fit in on the planning timeline, and preferably should be made without the money to back them up. Managing the day to day financial operations – cash flow and accounts receivable – bring benefits as well.

Risk management is an increasingly critical piece of cooperative strategy, and new levels

of procedures and controls to manage price risk must be implemented. Expertise is now more important than ever, and a CEO/CFO strategic perspective, rather than a GM/Controller operational perspective, can prepare a cooperative for future challenges.

A board that really understands its responsibilities and adds value to the

organization can bring another crucial perspective. Effective communications with all stakeholders, both internally and externally, makes strategic implementation possible. While these are economically challenging times, Gales reminded the conference that there would be many opportunities for those that were watching for them.

Managing Supply Chain Risk

Bruce Vernon, Vice President of Marketing, MKC, and Cheryl Schmura, Vice President, Crop Nutrients, CHS, Inc. examined today's substantial challenges of managing risk in the fertilizer supply chain.

Vernon described the sometimes discontinuous relationship between inputs and corn, and the substantial fluctuations in both. Former correlations in prices between inputs and natural gas are not holding firm. The impact of global competition is profound. Cooperatives now face volatile supply and demand pricing rather than one grounded in production costs, and a more uncertain supply.

Regardless of recent price volatility, said Vernon, the cooperative must assume some measure of risk to service its customers. To mitigate the risk, MKC is stressing reciprocity on the part of both cooperative and customer: the buying and selling of grain is linked to the buying and selling of inputs.

Schmura described how a complex interplay of factors, including equity market and dollar valuations, a decline in the

skyrocketing price for grain and fertilizer, foreign trade tariffs, weather events, and collapsing freight rates, have contributed to an overall market situation in which market players have lost trust in one another.

Smoothing out the extreme ups and downs of the fertilizer supply chain is a challenge. Farmers are hesitant to place orders in a volatile market, and cooperatives can't assume the risk by importing product without customer orders in place. The lack of demand has hampered movement in the supply chain that would free up inventory space, allow dollar averaging on the value of existing inventory, and support new production and imports. Next spring may see stresses on the system.

Cooperatives can address supply risk by finding partners with multiple sourcing options, having a good relationship with a bank, and planning based on "what-if" scenarios. Price risk can be managed by locking in margin and not letting greed take over the decision-making process. A good cash position and reputable partners can support cooperative performance.

Trends in Cooperative Structure, Strategy, and Finance

Several case studies looked at the structural changes that agricultural cooperatives have adopted to meet particular challenges. Brian Henehan, Senior Extension Associate, Cornell University, and Kevin Murphy, Pro-Fac's Vice President of Member Relations, discussed how Pro-Fac Cooperative has strategically repositioned itself several times in response to changing market conditions. Pro-Fac has used innovations like transferable delivery rights, multi-commodity pools, and equity conversion to publicly traded securities to create liquidity for member investment.

Murray Fulton, Professor, University of Saskatchewan, provided a cautionary tale about the need for monitoring and oversight in his description of the events leading up to the conversion of the Saskatchewan Wheat Pool in 2005 to a business corporation. Overconfidence by senior management, and the lack of effective oversight by the board of directors, led to major investment strategies that increased long-term debt five-fold over three years. Substantial internal funds from the 1996 IPO meant that new ventures were not subject to the more dispassionate analysis of outside equity markets. SWP's aggressive new business strategies ultimately failed, which led to the loss of its cooperative status.

Marvin Wiens, former Chairman of the Board, Saskatchewan Wheat Pool, provided his perspective as a board member during

that time. He resigned in 2004, when both board and management agreed that SWP could not longer survive as a cooperative. He cited several reasons for this outcome: the board did not persist with hard questions and exert financial control; the cooperative did not work to maintain member loyalty during a competitive period; and a lack of shared vision.

Clarifying the objective of a strategic initiative – is it to manage risk? Share investment cost? Provide market entry? – will aid in determining the structure to be used, said Gregory McKee, Professor, North Dakota State University. North American Bison Cooperative chose to form an alliance with North Dakota Natural Beef, LLC (NDNB) after it declared bankruptcy in 2005, to reestablish itself in the market. Dieter Pape, who is the CEO and General Manager of both firms, described how the cooperative, formed in the 1990's, built a processing plant, but encountered severe financial problems because the market for bison had not been adequately developed. The alliance with NDNB has provided the co-op with needed marketing expertise as well as cost efficiencies. The cooperative began paying patronage refunds for the first time in 2007. A strategic alliance with North Dakota State University has also provided NDNB with resources for to differentiate its products, a key advantage of a new market entry.

Cooperative Finance: Principles versus Practice

David Barton, Professor, Kansas State University, provided a comprehensive review of the principles and practices of cooperative finance. While profitability is absolutely critical to success, a focus on

services to members and patrons is still required.

Barton recommended that cooperatives consider replacing traditional qualified

patronage distributions with nonqualified ones, practice strict balance sheet management, and using a base capital redemption program.

Chris Peterson, Professor, Michigan State University, stressed that the goal of cooperative finance decisions is to deliver the cooperative's value proposition, and to assure that the cooperative can maintain operations, make investments and pay members appropriate returns. The total

profit in the system, on both cooperative level and member level, must be considered when assessing cooperative performance and making investment decisions.

Peterson noted that a recent National Council of Farmer Cooperatives study showed that those cooperatives that can respond to changes in the marketplace continue to do well, and that the cooperative model had not prohibited them from finding creative ways to raise capital.

Equity and Capital Management Strategies

CVA faced a complex set of equity management issues that it assumed in a series of mergers. Doug Derscheid, CEO of CVA, described how the cooperative has worked to create a fair and equitable approach for dividing the total redemption budget between simplified equity classes. CVA is moving toward a revolving equity fund by using nonqualified retained patronage refunds to pay down equity debt, and cautiously using unallocated retained earnings to contribute to capital reserves.

The leveraged balance sheet of the recent past, with only adequate working capital, will not work in today's economic climate, said Tom Houser, Vice President,

Agribusiness Banking Group, CoBank. Higher levels of operating capital will be needed to manage the risk associated with record grain prices and crops input costs.

Cooperatives face several challenges in establishing permanent capital. Many members see cooperative profitability translating to member loss. But permanently retaining more equity can position the co-op to revolve the allocated equity more quickly. While there is a common mindset that equates a tax on cooperative income as a negative, a co-op tax liability may benefit the member in the long run.

Legal Challenges and Solutions

Legal perspectives on strategic planning and capital management issues were provided by attorneys Mark Hanson, Stoel Rives LLP, David Swanson, Dorsey & Whitney LLP, and Michael Weaver, Lindquist and Vennum PLLP. Swanson suggested that a long-term contractual relationship is better than a transactional arrangement when times are tough, but warned against assuming that

a contract party is solvent. Hanson encouraged cooperatives to review their business operations to minimize capital needs while adjusting equity programs to build a permanent capital base to address capital risks. Weaver discussed the need for cooperatives to recapitalize, given the aging of both assets and patrons. Former owners may be a source of outside capital. Another

approach to build equity was the use of an unqualified per unit retain, which acts as a

pretax contribution to capital, as opposed to the nonqualified allocation.

Observations, Challenges, and Opportunities

Michael Cook, Professor, University of Missouri, provided an insightful wrap-up to the conference, noting that the risk and volatility that characterizes the current economic landscape was part of every presentation. He summarized the questions that every strategic analysis should address: What is the arena of business operations? What vehicles are used to achieve in that arena? How does the cooperative differentiate itself with patrons and supplier? What is the timing and staging of business

activities? Is there economic logic to support these answers?

Strategic thinking must also take the behavior of others, especially rivals, into account. Furthermore, the structures used to carry out business strategies are not neutral with respect to benefits and distributions, and ownership and control. The board has a critical role in considering all of these questions.