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Managing the Cooperative Life Cycle

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1. Introduction

Organizations arise out of a need to coordinate the energies and efforts of multiple people toward a specific purpose. Effective adaptation to changing external and internal circumstances is essential to organizational growth and success. Organizational scholars have identified specific adaptations that occur commonly enough in business organizations to label them collectively as an evolutionary process or "life cycle."

This essay presents the concept of a **cooperative life cycle** and discusses managerial challenges that are specific to life cycles in cooperative business organizations. We begin by discussing components of a life cycle that are common to all organizations. We then briefly indicate how the purpose of a cooperative is distinct from other business organizations, and how cooperatives achieve their mission by imposing operational constraints on their financial and governance structure. Three unique life-cycle challenges emerge directly from these constraints: communicating value to patron owners; managing economic diversity among members; and managing intergenerational equity. We discuss each challenge in turn, and suggest strategies for dealing with each.

2. Organizational life cycles¹

Organizations are created to realize a purpose that no single person can realize individually. The central day-to-day function of an organization is to coordinate the efforts of multiple persons on specific projects and activities that are part of this larger purpose. Management is the art and science of coordinating efficiently, or minimizing waste. For most business organizations, whether cooperative or otherwise, there are no simple managerial recipes. Projects are complex, and the people in a given organization have diverse talents, information, behavioral idiosyncrasies, and internal missions. It is impossible to plan a fully efficient coordination of these diverse resources toward a common purpose. As a consequence, the

process by which an organization develops an operational framework for accomplishing its purpose is part design and part trial and error.

This evolutionary process typically has a number of stages that characterize an organizational life cycle. The beginning or **entrepreneurial phase** of an organization is creative. There is cohesion and excitement among participants and coordination occurs almost spontaneously. A **collectivity phase** normally emerges to reign in creative spirits and achieve focus. One or more leaders emerge to articulate a common purpose under which members of the organization agree to operate. During this phase, differences in beliefs and values among the organization's participants must be reconciled.

Organizations start simple, but generally become more complex over time with growth in the number and scale of projects that are undertaken to achieve a given mission. Inevitably, a language and set of operational procedures emerge to communicate, coordinate, and motivate task assignments. To the extent that these language and procedural elements develop absent intentional design and documentation, they can be characterized as *organizational culture*.

The means by which an organization operates internally can be formalized and intentionally communicated to new members, but doing so requires an investment in capacity for human resource development. Operating rules must be identified, codified, and organized into a coherent package. New employees must be hired to act as trainers. When an organization grows sufficiently large, it makes sense to undertake this **formalization phase** because the cost of doing so can be spread across a large number of people. When only one new person is brought into an organization, he or she can learn how to get things done by watching others and gradually acquiring the relevant knowledge.

Of course, formalization can go too far, even to the point of inhibiting effective coordination. Bureaucracy does not have to be a bad word, but often it is used that way. Rules and regulations serve a purpose when, by indicating how things should be done, they economize on thinking and deliberation. However, rules and regulations get in the way when special circumstances arise, or when persons with vested interest in the status quo use them to stifle innovation. Organizations that allow excessive formalization and operational rigidity to develop put the organization's survival at risk. Thus, organizations need continually to enter an **elaboration phase** where fundamental operational procedures are reevaluated in light of changing internal competencies and external forces.

Long-lived organizations continually scan for ways to adapt and improve their organizational structures. Doing so requires systematic information gathering to identify potential problems and opportunities; managers must then act promptly on these and identify effective solutions and subsequent organizational adaptations.

As a result of their unique purpose and organizational structure, cooperatives are subject to life-cycle and managerial challenges beyond those described so far. Before describing these further challenges, it will be helpful first to recall why cooperatives exist in the first place.

3. Cooperative purpose

Market failure is a broad term used by economists to reference any deviation from the outcome characterized by the ideal notion of "perfect competition." In perfectly competitive markets, consumers know what they want and what is being sold; producers know everything about what *consumers* want and are consumers themselves in perfectly competitive markets for all of their production inputs; there is no disagreement about the relative likelihood of alternative potential future states of the world; contracts are perfectly enforced; and, moreover, no individual consumer or producer is large enough to recognize the potential influence of their decisions on equilibrium market prices. Because perfect competition is an idealized state, market failure is pervasive; all markets function imperfectly. The question is to what degree.

When markets work sufficiently poorly, there is the possibility that some kind of non-market institution can be designed to correct or improve market performance. Insurance against health risk, and physician service, are two products that nearly every person wants at some point in their life, but which are not provided well by free and unfettered markets. The problems in these markets are mostly informational. Insurance providers cannot easily detect the relative riskiness of potential consumers. They also cannot easily observe the treatment efficacy provided by physicians. Likewise, patients know little or nothing about the quality of service provided by a given physician. Remedies for dealing with these informational problems vary across countries, but they all involve some form of intervention in the marketplace.

Cooperatives are seen by economists as a non-governmental remedy for market failure.² And the reason they provide a remedy is precisely because they are constrained to operate on behalf of some class of patron. It is this patron focus that gives cooperatives their distinctive role in the economy, but also what presents a unique set of life-cycle challenges.

4. Unique life cycle challenges

It is self-evident that cooperatives exist because their patrons do not receive satisfactory service from conventional business organizations. In this sense, cooperatives provide a clear benefit to patrons. The irony, however, is that in order to operate strictly in the interest of patrons, cooperatives must impose on themselves operational constraints that limit their ability to compete with investor-oriented companies. Indeed, one can envision the cooperative business model as an additional layer of organizational rules, or constraints, layered *on top* of those under which a conventional investor-oriented business operates.

First, according to most statutes under which cooperatives operate, board members must come from the population of individuals who patronize the organization. In principle, an investor-oriented firm could do the same (except in cases of conflict of interest), but chooses not to in part because it seeks business knowledge and talent that may not exist within the patron population. Similarly, an investor-oriented firm could use some form of democratic process for selecting new directors. The fact that investor-oriented firms generally choose not to operate this way suggests an organizational advantage in granting control of the process to management.

Second, and likely more important, cooperatives acquire their equity capital mostly from patrons, and, if they do use outside equity, limit the returns they pay to some maximum amount. This constraint severely limits the liquidity and risk-bearing services that are normally provided by capital markets, and arguably raises the cost of capital for cooperatives.

Taken together, these two constraints represent a handicap for cooperative businesses that generates at least three unique life-cycle challenges for managers and patron owners.³

4.1 Communicating value

Perhaps the most obvious challenge a cooperative faces is communicating its value to patron owners. Consider the following example: a population of farmers currently purchases all of their fertilizer from ABC Farm Supply, Inc. ABC does not have much competition in the area so it is able to charge a fairly high price. To be concrete, let's say there are 100 farmers, and ABC currently charges \$1/unit for its fertilizer.

Now imagine that half the farmers get frustrated with the price they are paying and decide to form a fertilizer purchasing cooperative. They estimate that, by hiring a manager who will purchase for them on a wholesale basis, they will acquire fertilizer \$.10/unit cheaper than they are currently paying. If they could recruit more farmer members into their group, they could perhaps earn even greater savings. Let's assume the cooperative forms and that farmers members are able to acquire fertilizer at \$.90/unit. Assume moreover that ABC now must lower its price to keep its remaining customers, who otherwise would seek membership in the cooperative.

Now imagine trying to value the cooperative business that these farmers have formed. What is the cooperative worth? Assume that each farmer needs just one unit of the fertilizer input and that the current interest rate is 10 percent.

There are at least two issues to consider in this example. First, the cooperative firm itself has nothing to show on its financial statements. It has no assets or liabilities. It generates cash-flow to pay for managerial service, but otherwise passes earnings on to members in the form of a lower price for fertilizer. Because its competitor matches the price it charges, ultimately it is unable to retain any earnings (with no capital assets to improve, there is no reason to retain

earnings in any case). Because there is no cash flow beyond what is used to pay the manager, the cooperative is worth nothing! Does this make sense? Is the cooperative really generating zero value for its owners?

Of course not. Our analysis so far ignores that the cooperative has value embedded in each of its farmers' operations in the form of higher profits that result from paying a lower price for fertilizer. Taking this value into account, the firm generates an earnings increase of \$.10 on 50 members in perpetuity. This amounts to a present discounted value of \$50. But that's not all the value the cooperative creates. There is also the cost savings that non-members receive as a result of improved competition. This generates an additional \$50 in aggregate value for non-members, resulting in a total firm value of \$100. Would it be rational for an investor to pay this amount for the cooperative? Will patron owners understand that their cooperative is worth \$50 (and that it generates a further market-wide benefit of \$50)?

Making sure that patron owners *do* understand the worth of their cooperative is central to effective cooperative management. Unfortunately, there is no easy way to do so. To the extent that competitors of a cooperative match the cooperative price (as in this example), there will be no savings that can be demonstrated, relative to competitors. This is a common predicament for cooperative managers. To the extent that a cooperative generates value that does not show up on its financial statements, the onus is on management and the board to demonstrate value. Without doing so, a cooperative risks becoming irrelevant and "just another business" to its owner patrons.

4.2 Managing economic diversity among members

Suppose that two individuals—to be concrete, let's call them Tom and Jerry—each have \$50 to invest. The pair identifies two attractive investment opportunities that are available for their \$100 with expected payoffs presented in the following table:

Year	Project A	Project B
1	0	0
2	0	0
3	0	0
4	0	0
5	200	0
...	0	0
20	0	2000

Assuming that each investor can safely earn a 5% annual rate of return on their capital, project net present values are given by $\$56.71 = 200/(1.05)^5 - 100\$$ and $\$653.78 = 2000/(1.05)^{20} - 100\$$.

Both projects generate positive net present value, but clearly project B should be chosen instead of project A.

Whether Tom and Jerry will agree to this choice depends on what we assume about the relative "time patience" of the two, and on whether or not there is a market for ownership in project B. To see why, assume that Jerry is relatively young, but that Tom is approaching retirement. Assume further that there is no market in ownership. Under these two assumptions, it is reasonable to imagine that Tom will discount the value of project B at a much higher rate than the 5% we assumed. Once the investment is sunk, Tom will have to wait 20 years for a payout, and by this time he may be dead!

But consider what happens if instead we suppose that there is a market for ownership in project B. In this case, Tom can sell his ownership stake at any point after making the initial investment and earn its full net present value.⁴ Although this is a simple example, it demonstrates clearly and simply one important function of a market for company ownership: to limit the influence of owners' liquidity preferences on investment choices. To the extent that the value of a company is the sum total of net present values of the investment projects it represents, such a market ensures that decisions are taken that maximize firm value. The structure of a cooperative limits opportunities for creating an ownership market. With the restriction that only patrons can be owners, the potential number of traders in such a market is severely limited and markets only function well when there are large numbers of traders.

The upshot of this finance lesson is that diversity among cooperative owners can lead to poor corporate investment decision making. It is essential that boards operate in the interests of the firm. When a decision that clearly is in the interest of the firm is likely to benefit some members at the cost of others, arrangements should be considered to compensate losers in the deal so that they will be willing participants.

4.3 Managing capital structure

Equity is an essential component of finance in any business organization. Inevitably, there are gaps between the revenue a firm generates and the expenditures it must incur to sustain and grow its business. This can happen over short periods like weeks and months (working capital), and over longer periods of years, even decades (investment capital). Using bank loans (debt) is one way to fill these gaps. However, banks are willing to lend only so much in relation to the amount of liquid assets a firm has; and from a firm's perspective, debt is risky because it **must** be repaid at regular intervals. If there are unexpected decreases in earnings (or unexpected increases in input costs), a firm may be unable to meet its repayment obligations. Complementing debt capital with equity (risk) capital is one way to satisfy lenders and reduce this risk.

Business organizations can generate equity capital by retaining and accumulating earnings (increasing the equity of existing owners), or by seeking capital directly from existing and new

owners. Of course, for public-stock companies there is an external market for ownership rights in which any individual owner can easily liquidate his or her stake (or purchase a greater stake). For a cooperative business, the inability of owners to easily liquidate their ownership stakes creates unique challenges for sourcing and managing equity capital. From an administrative and accounting perspective, a cooperative business must keep track of the **identity** of each owner, and track their accumulated equity contributions. Doing so then raises questions about the relative capital contributions of individual members in relation to their patronage contributions. This is a complication that does not arise in public-stock companies because the identity of individual owners does not matter.⁵

From a life-cycle perspective, it is often argued that a cooperative should strive to maintain rough proportionality between an individual's current-period patronage and his or her contributions to current-period equity capital. Although simple in principle, there are complications even with this practice. First, to the extent that earnings on a members' patronage are retained and identified as a capital contribution, why should a member who contributes a given amount of patronage in a high-return year be credited with a greater capital contribution than a different member who contributes the same patronage level in a low-return year? In other words, on what basis should members' capital contributions be measured? Second, forcing proportionality between patronage and capital contributions ignores differences across members in their demand for liquidity. That is, there may be years in which one member would effectively be willing to loan to another member by contributing relatively more capital—and it may be in everyone's interest for this to occur. Following a strict proportionality rule eliminates this possibility for mutual gain.

There is another, and perhaps even more critical, challenge that arises from tying capital contributions to the identity of individual patrons: sometimes patron members (and even managers!) forget that capital contributions are **equity** that cannot be "repaid" if the cooperative performs poorly financially. For a public-stock company, poor financial performance affects all current owners equally through two channels: stock values decrease, reducing the wealth of each owner, and the company may choose to reduce its dividend payment rate, further reducing owner wealth. In a cooperative company, management chooses (even if only implicitly) to distribute losses across generations of owners when it designs a program for "revolving" capital contributions, i.e., retiring the contributions of past patrons, and seeking contributions from current and new patrons. For example, by extending the period of revolvment, a cooperative effectively reduces the capital contributions of current-generation patrons by choosing not to return the capital contributions of previous generations. "Intergenerational equity" is thus a double entendre of sorts for cooperative business organizations! Managing this issues requires understanding and communication to members about the true nature of capital contributions.

5. Conclusion

This essay discusses the notion of an organization "life cycle" and discusses life-cycle challenges that are unique to cooperatives. We argue that given the unique purpose of cooperatives as means of regulating imperfect markets, communicating the value provided to members is a key to success. Often, the value provided by cooperatives is difficult to measure because it is embedded in the behavior of **other** market participants who must react to competition from cooperatives with lower prices and better service. Similarly, the patron-owner structure of cooperatives generates unique challenges for management in balancing the diverse economic interests of owners with the interest of the cooperative business itself, and in spreading the burden of (equity) capital contributions efficiently and fairly across patron owners. Managing these challenges effectively in response to changing external circumstances and internal competencies is key to long-run cooperative survival.

Endnotes:

¹ Organizational life cycle theories have been articulated by a large number of authors. Here I briefly summarize a synthesis of these theories presented by Richard Daft in his textbook, Organization Theory and Design, Chapter 9.

² Of course, there are also historical, sociological, political, and perhaps even psychological, causes of cooperative economic activity. The point here is not to deny other possible explanations for cooperatives to exist, but rather to focus on one explanation that seems to have sound empirical grounding, and that helps to understand common pitfalls in cooperative life-cycle management.

³ Cooperatives exist and thrive despite this handicap because patrons (including non-member patrons!) benefit from the corrective function provided by patron ownership. Moreover, there are offsetting benefits—for example, patron loyalty and relatively "patient" capital—but the fact that other organizations do not adopt the cooperative structure except when a specific class of patron is dissatisfied suggests the net effect is an operational handicap, rather than advantage.

⁴ The astute reader may question how Tom and Jerry managed to find such fantastically priced investment opportunities. If there was a market for ownership in the investments at the time of purchase, they should have been priced at their economic worth (\$156.71 for project A and \$753.58 for project B).

⁵ Except in the case where one or a small number of owners seeks to concentrate their ownership stake for the purpose of exercising greater voice in managing the firm's affairs.