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BANKRUPTCY OF A SUPPLY COOPERATIVE: THE CASE OF AGWAY, INC.*

by

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Introduction

Agway, Inc. headquartered in Syracuse, New York has played a pivotal role over the years in the food and agricultural industry of the Northeast. With the largest membership, expansive operations, and the highest number of employees, it became the dominant cooperative in the region. Agway also played a very prominent role in regional and national organizations of cooperatives as well as in international cooperative development.

In it's day, Agway and it's predecessor organizations were highly innovative and helped commercialize many valuable new feed and fertilizer products developed through research conducted at Land Grant Universities as well as through work conducted at Agway owned research farms.

On October 1, 2002 Agway, Inc. filed for Chapter 11 bankruptcy. The filing involves a select group of Agway holdings including: Feed and Nutrition, Agronomy, Seedway, Feed Commodities International, Country Best Produce, CPG Nutrients, CPG Technologies and the Agway General Agency.

Various stakeholders – members, employees, and members of the agricultural community in the Northeast are asking what went wrong and what warning signs of problems were missed that might have helped avoid the severe financial difficulties that arose. There is also concern over whether the financial problems experienced by Agway are endemic to agricultural cooperatives in general.

Objectives

Given the scope of operations and the resulting impact on the agricultural industry in the Northeast, it is important to gain a better understanding of what were the underlying factors leading to Agway's financial failures. Specific objective include the following:

1. Determine the strategies that led to financial difficulties.

2. Identify potential warning signs that could have indicated increasing financial stress.

3. Analyze factors leading to financial difficulties that could be useful to other organizations facing similar challenges.

4. Determine unique aspects of a supply cooperative filing for bankruptcy under Chapter 11. and the associated implications for members.

It must be noted that this paper reports only preliminary results for this case study. Given that Agway's reorganization plan has not been filed and approved, it is premature to assess the full impact and result of this bankruptcy. The authors would have more access to data and information following completion of the bankruptcy proceedings. A more in-depth is planned for the future.

HISTORIC FACTORS

Historical Perspective

Agway was formed in 1964, the result of a merger between GLF (Grange League Federation) and Eastern States Farmers' Exchange. A year later the Pennsylvania Farm Bureau Cooperative merged into Agway. The result was a very large agricultural supply and marketing cooperative that covered 13 states, spanning from Maryland to Maine to Eastern Ohio. It is useful to understand that some of the strategic directions taken by Agway can be traced back to decisions made and a corporate culture that evolved a number of years ago.

A Tradition of Providing Members A Secure Market

Cooperatives are often formed to provide members a secure source of inputs and markets for their products. However, sometimes this motive can be taken to extremes.

GLF (i.e. Agway), together with other New York agricultural organizations, provided the leadership in establishing a radio network, Rural Radio Network, in 1946 to serve the radio needs of farmers and rural residents. It was sold in 1959 when it had an accumulated deficit of $970,000 and total debt to GLF (i.e. Agway) of $1.36 million.

In 1946 GLF also bought approximately a 40 percent share of Mohawk Airlines, the forerunner of USAirways, in the name of providing air transportation to Upstate New York. In this case, the value of that investment more than doubled before it was sold.

Another example was Agway's attempt to provide services to members, was its operation together with Southern States Cooperative of Texas City Refining, which owned and operated an oil refinery. The purpose was to provide members a secure source of petroleum products. This proved extremely advantageous and profitable during the oil shortages of the early 1970's. However, the petroleum market eventually changed and Texas City proved a costly investment. It was sold in 1988 at a loss of $110 million.

In 1961, GLF helped to form Curtice-Burns Foods, Inc., a vegetable and fruit processing company, headquartered in Rochester, N.Y. Curtice-Burns was a combination of what were at the time two struggling vegetable processing companies. Over the years, the company was very successful. But in 1993, Agway announced that it's controlling interest in Curtice-Burns was up for sale. The sale brought in a solid return, and this was one of the first indications that Agway needed cash to fund its other operations.

Emphasis on Size

In the 1970's and 1980's, Agway became the largest cooperative in the U.S., with sales of over $4.1 billion in 1984. In 1983, Agway was ranked 97th on the Fortune 500 list employing close to 18,000 employees.

During this time, there was an emphasis on cooperative size. Agway being on the *Fortune 100* list of U.S. companies was often mentioned in publications and meetings. We believe that any organization that places primary importance on size over profitability can likely run into problems. We would argue that this is a malady that also eventually contributed to the financial problems of Farmland Industries, a large Midwestern supply cooperative which also filed for bankruptcy and Ocean Spray, a large cranberry products marketing cooperative struggling with financial difficulties.

Ability to Manage Many Types of Businesses

There was a longstanding attitude at Agway, and predecessor organizations, that they could manage any type of business, even when other people had failed. Two major examples come to mind in Agway's history.

The first was an effort in 1941 to get into the retail food business by starting the Cooperative Producers and Consumers Markets, today a Northeast grocery retail chain called P&C. The purpose was to assist New York farmers market meat from their livestock production. Ownership interest in P&C was finally sold in 1961 following several years of unprofitable operations.

A more recent example was the purchase of H.P. Hood, a fluid dairy company, bought in 1980. A driving motivation was to help members of Northeast dairy cooperatives maintain a reliable and stable market for their milk, which was at risk. The fluid milk business has always been very competitive, and operates much differently than an agricultural supply company. Agway had no prior experience running a fluid milk business. In 1995, H.P. Hood was sold due to less than projected returns on their investment and mounting financial losses. Another interesting aspect of this example was that right up to their purchase of H.P. Hood, Agway had a strict policy that they would not become involved in dairy processing to avoid competing with dairy cooperatives in the region.

Corporate Culture

We are sure some readers are already wondering why several of the above examples date back to the 1940's. We firmly believe there is significant historical momentum in all types of organizations. This is often embodied in what today is called "corporate culture". Agway's history helped create a corporate culture that permeated their directors, management, and employees. At every Agway meeting or at any meeting that an Agway representative spoke at, started with a recitation of the Agway mission. However, many of Agway's old traditions and strategies may have out-lived their usefulness or detracted from their willingness to change.

Minimal Equity Investment

To become a member of Agway, all a farmer needed to do was buy one share of common stock for $25. And that is all the investment many members continued to have in the cooperative. There is a strong link between how much money members have at risk in a cooperative, and the interest they take in their cooperative, as well as the overall success of the organization.

Use of Tax-Paid Retained Earnings

Since equity was not able to be raised from members, Agway used tax-paid retained earnings as their primary source of equity. Depending on this source of equity means that a cooperative needs to consistently generate positive net income. It is also an expensive source of equity, because corporate taxes must be paid by the cooperative reducing the total funds available to build equity. In addition, when a cooperative becomes dependent on tax-paid retained earnings, there is a greater tendency for the cooperative to become "management controlled" rather than "member controlled", because the share of member equity does not grow and most members end up having have little equity at risk. (Anderson, 1987)

Heavy Use of Debt

Agway has always been highly leveraged. If compared to their competitors in almost any business, they would likely be one of the most heavily leveraged companies. During the entire 1984-2002 period Agway's highest equity to total asset ratio was 20.6%. (in 1987, see Table) From 1998-2001 equity to total assets averaged 12.6%. A general rule of thumb is that when equity to total assets drops below 15%, an organization is suffering severe financial problems.

At one point it time, Agway had a financing goal of using one-third debt, one-third subordinated debentures and one-third equity, primarily from tax paid retained earnings. During the entire 1984-2002 period, this goal was never achieved.

Use of Subordinated Debt

Most of Agway's debt, especially in latter years, was subordinated debt, also known as "junk bonds" because it is not secured by assets. While the level of the company's subordinated debt remained relatively level over the past 5 years, operating cash flow to support that debt deteriorated and became inadequate.

As of the bankruptcy filing, the largest single class of owners of these subordinated debentures was Agway's employees through pension fund and 401-K investments. They total approximately $35 million out a total of $425 million in subordinated debt. Members and public security holders own the remaining amount.

Limited Patronage Refunds

Except for 1987 and 1988, Agway has not paid a patronage refund to members since 1980. The primary reason is that sufficient earnings were not being generated from the patronage business, i.e. their agricultural supply operations. Most of net income came from non-patronage businesses such as petroleum, leasing, insurance and produce distribution.

Excess Capacity

With the largest market share for feed and many other input supplies in the Northeast, Agway has been prone to carrying excess capacity, which is typical of a market leader. At the same time, there was a major change in market conditions. In terms of feed, more farmers started mixing their own feed using direct purchased commodities, and moved away from the use of pelletized feed. This meant that many of Agway's feed, and other input supply plants, were operating significantly below capacity. This has a negative impact on per unit costs and can often lead to cut throat price competition.

A Triple Delivery System

For most of it's existence, Agway had a triple delivery system with: 1) Agway Inc. owned corporate stores, 2) independent local cooperative stores, and 3) franchise representative stores. There was a period when Agway tried to convert their corporate stores into representative stores. Then in the early 1990's a decision was made to buy out all the independent local cooperatives to consolidate the delivery system. Financial performance did not improve because market conditions continued to change. Beginning in 1999, Agway sold or closed all its remaining company owned stores and sold their warehouse system to Southern States Cooperative. These moves were made because returns on these assets were chronically inadequate. Today most store customers do not realize that the cooperative no longer owns any assets related to the store distribution system. However, Agway remains a supplier to dealers and retains rights and revenues related to use of the Agway name.

Shrinking and Increasingly Heterogeneous Farm Population

The Northeast has seen an ongoing decline of farm numbers at higher rates than other regions of the U.S. There has also been a widening gap between farm sizes, with an increasing number of larger farms and increasing number of smaller farms. Agway's traditional customers and members were the middle-sized group, which is shrinking.

Attempting to serve an increasingly heterogeneous farm base can be a unique challenge for a cooperative, especially one operating in the supply industry. Investing in assets that are flexible enough to economically serve a diverse customer base can be a challenge. Agway's feed production facilities, which might have been state of the art for a given decade, quickly became antiquated requiring significant changes in processing technology and distribution logistics. Making the best economic decision in a cooperative with a heterogeneous member base can be hindered by a lack of understanding the differential economic impact of decision made on various member groups, (Henehan and Anderson). Achieving profitability can revolve around the capacity to understand all of the costs associated with serving various members groups and effectively allocating those costs across member segments as well as focusing on serving the members of the future.

WARNING SIGNS

Potential "Red Flags"

Several, more recent events should have signaled red flags to members and others that Agway was experiencing significant financial distress. These events include: continuing losses, scaling back of annual meetings, changes in director nominating procedures, resignation of directors, and raising cash by selling profitable businesses, suspension of subordinated debt repurchases, and delayed filing of financial reports. More details on each of these potential warning signs are presented.

Continued and Large Losses

Between 1984 and 2002 Agway had losses in eight out of 19 years, (see Table). Over that nineteen-year period, total losses exceeded profits by $138.2 million. The largest losses can be attributed to the write-downs of major businesses or restructuring activities, i.e. Texas City Refinery (1988), the Customer Driven 1995 repositioning (1992), and disposal of four businesses (2002). Continual restructuring and write-downs can be a sign of a changing marketplace as well as ineffective strategies.

Scaled Back Annual Meeting of Members

Until recently, Agway hosted one of the most impressive annual meetings in the U.S. cooperative community. It was a 2-3 day event with thousands attending, and several big names providing entertainment at a significant cost.

As earnings deteriorated, this meeting format became a luxury the cooperative could no longer afford. Over the past few years the size and scope of annual meetings were significantly scaled back, including when and where it is located. While all members receive a "call to the annual meeting" there is little or no publicity. And, as a result, member participation has dramatically declined.

Director Nomination

In January 2001, Agway changed the way it would nominate and elect directors to the board. One rationale given was to get more "business-oriented" directors on the board. At the same time they downsized the board from 15 to 12 member directors. They adopted a very radical nominating system for cooperatives, which has since been changed slightly. Agway wanted more directors with a "big picture view" and "sound business skills". When the new nominating and election procedures were adopted, it resulted in a significant change in the composition of the board of directors. This may be viewed as a signal that the previous governance system did not provide all the skills set required of a contemporary cooperative board.

Outside Directors Resign

Also in January 2001, the Agway board changed director election policies and brought two non-member professional business people onto the board. In June 2002, both outside directors notified the board they were resigning from the board. "In their letters of resignation to the Board, neither outside director expressed any disagreement with the Company on any matter relating to the Company's operations, policies or practices". (8-K SEC filing, June 17, 2002)

However, it can be an indicator of financial problems when two or more directors resign from any organization simultaneously, especially outside directors. Also, there was no press release from Agway announcing their resignation.

Limited Cash Availability

In Agway's 2001 Annual Report, the cash and cash equivalent reported in the current assets section of the balance sheet amounted to exactly $0. We understand this happened because it was a practice to "sweep" their cash account daily, applying the proceeds against lines of credit to reduce interest costs. It is rare to find a company of any type, report $0 Cash. It is more common when cash accounts are swept for the funds be carried as cash equivalents, and specifically marketable securities. This should have been a signal to any member, stockholder or debenture holder that there were cash flow problems.

Raising Cash by Exiting Profitable Businesses

In March 2002, Agway announced it was exiting several businesses. A major one being Telmark, their leasing unit which had been very profitable over the years. Why exit a profitable business? Typically, the primary reason is to generate needed cash from selling a business that has built up substantial equity over the years in order to reduce the parent company's debt.

Agway also announced on September 12, 2002, that they were selling their Sunflower Processing plant and business in North Dakota to CHS Cooperatives. Management had always indicated that sunflower seed processing had been a profitable business and Agway was "the largest U.S. processor and a worldwide distributor of sunflower" products. Perhaps, it made less sense to keep this business after Agway exited the retail store system.

In a March 2002 announcement of businesses to be sold, the sunflower plant was not included. This unplanned sale of assets became another attempt to generate cash flow by selling additional profitable businesses.

Difficulty in Selling Businesses

The March 2002 announcement to sell four businesses included Telmark, Agway's profitable leasing company. On May 23, 2002 Agway announced "after lengthy negotiations, Agway and a potential buyer were unable to reach final agreement on a sale of Telmark. (8-K SEC filing) As reported in a subsequent 8-K SEC filing on June 17, 2002, it became apparent that Agway's immediate liquidity situation would not be corrected without the sale of Telmark. The failure to sell one of a company's most valuable assets, causing it to violate its loan covenants, was another signal of severe financial distress.

Suspension of Debt Repurchases

On June 14, 2002 Agway announced that subordinated debt would no longer be repurchased early. Up until that time, even though subordinated securities had due dates of up to fifteen years, Agway was willing to convert them to cash any time a holder submitted these securities for redemption. As a result, it was a very liquid asset for Agway investors.

It should be noted that annual reports plainly stated that: "Agway is under no obligation to repurchase such debt when so presented, and may stop or suspend this repurchase practice at any time." This was a preemptive action taken to avoid default on senior lenders' loan covenants.

Delayed Annual Report and SEC Filings

In past years, Agway always reported their annual sales and earnings following the close of the fiscal year via a press release in mid-August to early September. This year the annual report was posted via a 10-K filing with the Security and Exchange Commission (SEC) on September 30, 2002, the last possible day for filing if a company's fiscal year ends on June 30 yet another warning sign of financial problems.

THE BANKRUPTCY OPTION

Cooperative Reorganization under Chapter 11

Reorganizing a supply cooperative under Chapter 11 of the Bankruptcy Law offers some unique challenges. Most companies (cooperative or otherwise) who file under Chapter 11 do not end up reorganizing but liquidating all their assets and closing the books.

In Agway's case, many of the members were operating with a limited understanding of the Bankruptcy Laws and were not necessarily aware of the dramatic shift in orientation and control that takes place when the focus changes from being "member driven" to "creditor driven". The decision making center moves from the board of directors to the bankruptcy court and creditors committee.

A long, drawn out bankruptcy proceeding can be both time consuming and costly. Any cooperative considering reorganizing should understand the dynamics and potential costs involved. In Agway's case, the lack of stock as a potential financing mechanism for refinancing reorganization limits the options available to convince creditors to convert outstanding debt into equity.

The largest class of unsecured creditors in Agway's case are employees and pensioners, a group who might be less patient and willing to stay the course with members who might prefer some type of reorganization. The creditor pressure to receive cash payment underlies the decision to sell all of Agway's assets including those businesses, which were not initially included in the original filing. And so, members who were hoping for some sort of reorganization resulting in continued supply cooperative operations may be disappointed.

There also is a very specific "pecking order" that put member equity holders at the bottom of the pile. Members should not necessarily count on getting any of their equity back. In Agway's case the members who hold additional subordinated debt securities may not receive their face value or any deferred interest.

Conclusions

A number of historic factors underlie some of Agway's poor financial performance including: serving as a "White Knight" to provide members with market security, overemphasis on achieving size at the expense of profitability, management resources spread out too thinly across a highly diversified business portfolio, a corporate culture unwilling to change, minimal equity investment by members, use of tax-paid retained earnings, too highly leveraged, use of "junk bond" financing, limited patronage refunds, excess capacity, inefficient delivery systems, and a shrinking increasingly diverse customer base.

A number of warning signs could have helped those monitoring performance to foresee a deteriorating situation including: ongoing and large losses, scaling back of annual meetings, director nomination and resignations, limited cash availability, increased sales of profitable businesses to support ongoing marginal operations, suspension of securities repurchase, and delayed filing of SEC and annual reports.

Bankruptcy can be a more onerous option than members may initially realize and should be avoided at all costs. This point argues for more vigilance by members and an increased understanding of the warning signs of financial distress before the situation worsens.

Limitations of Study

Of course it is risky using the experience of a single supply cooperative to draw too many conclusions that apply to other supply cooperatives or agricultural cooperatives in general. On the other hand, we are convinced that there are some valuable lessons to be learned from this case that can increase the understanding of how bankruptcies occur as well as critical warning signs to be aware of. The authors also hope to have access to more extensive data and interviews to develop a more in-depth analysis.

Areas for Further Research

In addition to pursuing a more in-depth study of Agway's experience, one must have concern about the financial stress that other U.S. supply cooperative have been experiencing who have in the past been very successful organizations. Are the current changes in farm structure creating more significant challenges for supply cooperatives? Are the costs of innovation in supplying farm inputs–research, biotechnology, etc. - too great for farmer cooperatives to afford? Have supply cooperatives, not able to generate enough earnings for the farm-input side, become too diversified?

Summary

There were several signs over the years, and of late, that Agway was having significant financial difficulties. Certainly Agway has accomplished much over the years, and many farmers indicate that they regret seeing its presence in the Northeast diminished. One point many farmers do not realize is that Agway remains a major competitive force in input supplies and agricultural products marketing in the Northeast. Put differently, they continue to make inputs that Northeast farmers purchase cheaper and commodity prices received higher. Unfortunately for Agway, these benefits accrue to all farmers and not just those that belong to Agway.

There are no simple, easy answers to the question of what went wrong with a business that ends up in bankruptcy. Determining what went wrong for cooperative businesses must involve all of the key players who have an influence on determining financial success: members, directors, and managers. Members, at times, asked Agway to do too much on their behalf without thoroughly understanding the costs involved. Directors did not always demand profitable results. Members can influence directors to opt for the status quo rather than making the tough strategic decisions needed to compete in today's marketplace. Managers too often selected, and poorly executed the wrong strategies to achieve profitability. Accelerated change in the structure and fabric of production agriculture in the Northeast over the last 30 years, in some cases "pulled the rug" out from under Agway's plant and store operations. There are a number of lessons to be learned. Further study is needed to conduct a more in depth analysis.

Agway Financial Results Summary: 1984-2002*

Year	Total Revenue (million)	Net Income (million)	Net Margin percent	Equity (million)	Total Assets (million)	Equity/ Assets percent
1984	$4,101.5	$11.8	0.29	$296.9	$1,515.8	19.6
1985	$4,067.2	$14.1	0.35	$306.0	$1,483.4	20.6
1986	$3,510.5	$14.0	0.40	$319.5	$1,488.6	21.5
1987	$3,264.7	$9.1	0.28	$326.7	$1,586.7	20.6
1988	$2,935.5	-$91.6	-3.12	$233.2	$1,496.8	15.6
1989	$3,296.8	$11.1	0.34	$255.3	$1,700.9	15.0
1990	$3,607.1	$8.1	0.22	$261.7	$1,837.1	14.2
1991	$3,486.5	-$6.4	-0.18	$253.4	$1,880.4	13.5
1992	$3,261.2	-$58.8	-1.80	$190.5	$1,829.3	10.4
1993	$2,278.8	$19.8	0.87	$195.5	$1,352.1	14.5
1994	$2,187.2	-$3.3	-0.15	$203.9	$1,400.3	14.6
1995	$1,592.1	-$15.9	-1.00	$172.4	$1,224.8	14.1
1996	$1,662.5	$12.7	0.76	$172.7	$1,245.9	13.9
1997	$1,671.1	$10.7	0.64	$177.8	$1,300.3	13.7
1998	$1,562.9	$41.1	2.63	$206.3	$1,417.3	14.6
1999	$1,221.5	$1.8	0.15	$198.9	$1,437.2	13.8
2000	$1,426.9	-$9.4	-0.66	$182.6	$1,572.7	11.6
2001	$1,548.3	-$8.9	-0.57	$169.3	$1,599.9	10.6
2002 a	$1,269.9	-$98.2	-7.73	$64.1	$1,574.4	4.1
2002 b	$899.9				$519.8	
Total Net	**Loss for Period**	($138.2)				

a 2002 Continued and discontinued operations
b 2002 Continuing operations only

SOURCE: Agway Annual Reports 1984-2001 and Securities and Exchange Commission 10-K report September 30, 2002.

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