# The demutualization of a cooperative – Swedish Meats

**Lena W. Lind**
Swedish University of Agricultural Sciences
Department of Economics
P.O. Box 7013
SE-750 07 Uppsala
Sweden
Phone: +46(0)18-671716
E-mail: Lena.Lind@slu.se

**Paper prepared for presentation at the EAAE 2011 Congress**
**Change and Uncertainty**
Challenges for Agriculture,
Food and Natural Resources

August 30 to September 2, 2011
ETH Zurich, Zurich, Switzerland

**Abstract:** This study gives a theoretical explanation to why the slaughter cooperative Swedish Meats demutualized in 2007. The hypothesis is that the problems related to the vaguely defined property rights of the cooperative raised the members' agency costs to an extent that these costs exceeded the members' perceived benefits from trading with the cooperative. To test this hypothesis, interviews with key stakeholders in the former Swedish Meats were conducted. The findings indicate that the problems of vaguely defined property rights made it impossible for the members to improve the cooperative's profitability. Due to poor member governance, urgent long-term investments, for instance in marketing and product development, were not undertaken. Additionally, the persistently low profitability caused members to leave the cooperative, whereby economies of scale in the production could not be attained.

**Keywords**: Cooperative, slaughter, vaguely defined property rights (VDPR)

## 1. Introduction

### *1.1 The cooperative Swedish Meats*

Cooperatives have traditionally been the dominating organizational form in all the agricultural sectors in Sweden. This is due to the characteristics of the agriculture products. Agriculture products are specific in the sense that they are produced in other locations than where they are consumed (Ritson, 1997). The products have to be moved through marketing channels to reach the end-consumer. That creates opportunities for actors within the supply chain to act opportunistically towards the farmers, especially since agricultural products are perishable. Hence farmers may end up in hold-up situations where information asymmetry enhances the advantages of downstream actors within the supply chain. When a cooperative exists in the market, opportunistic behavior is avoided as the cooperative will become a yardstick to the competition (Sexton, 1986). For instance, the Swedish pig farmers used to be subject to opportunistic pricing from private slaughterhouses before forming slaughter cooperatives in the 1930s.

Additionally, agriculture products are bulky and costly to transport. The products also need to be processed. When undertaking these activities there are considerable advantages in large-scale operations (Padberg, 1997). Hence, it is beneficial for farmers to create cooperatives as marketing channels for their products.

A cooperative business is owned and controlled by its users (Barton, 1989). The user of a cooperative is a member of the cooperative. The members own the cooperative and receive advantages such as patronage refund based on the scope of their transactions with the organization. In traditional cooperatives, all members pay the same amount of equity.

Forming a cooperative is not costless to the farmers. Compared to transacting through the market, they have to take on costs for controlling and monitoring the cooperative. There will be agency costs associated to the separation of ownership and control.

In 1999, all but one Swedish cooperative slaughterhouse merged into the nationwide Swedish Meats (Swedish Meats, 1999). This was an attempt to improve the profitability of the slaughterhouses. During the period between 2000 and 2007, the number of pig farmers decreased from 4 384 to 2 055 (Statistics Sweden, 2009). At the same time, the whole slaughter industry experienced a decrease in number of slaughtered pigs from 1 877 138 to

1 609 289. This decrease affected Swedish Meats more than the investor owned competitors. The investor owned slaughterhouses rather increased their operations. The cooperative did not manage to improve the profitability and fell behind the investor owned firms regarding prices offered to the farmers. In 2006, an internet-based spot market was established.

During this period, Swedish Meats remained the dominating slaughterhouse and meat processor in the Swedish market. In 2007, however, the members decided to sell the operative part of the cooperative, Scan, to the Finnish firm HK Ruokatalo. This firm is listed at the Helsinki Stock Exchange but the majority of the voting stock is held by LSO, a society of Finnish animal breeders. Swedish Meats continued to exist as a cooperative with only one task, namely to own a minority share of HK Scan, which is the new name of HK Ruokatalo. The subsidiary firm that HK Scan runs in Sweden is named Scan AB.

The aim of this paper is to give a theoretical explanation to why Swedish Meat was demutualized. The hypothesis is that the inherent problems of the cooperative organizational structure, i.e. problems related to vaguely defined property rights (VDPR), had become too severe for the members to solve the problems. In order to study this, interviews have been conducted with key stakeholder of Swedish Meat.

### *1.2 Literature review*

The demutualization of cooperatives has received attention from researchers during the last decades. A variety of theories have been used to explain this development. Fulton (1995) uses the property rights theory to explain the demutualization of cooperatives. It is assumed that the actor controlling the outcome, the residual, of the activity undertaken should be the residual claimant. Traditionally, farmers have been this actor in the agricultural supply chains as they control the quality of the farm products, determining the quality of the processed products. Farmer cooperatives have therefore been formed as that enables the farmers to be residual claimants of the process of which they possess the residual control. Due to various technological changes, the variety of quality in farm products has decreased, lowering the need for farmers to be residual claimants of the processing stage. Hence, the need for farmer cooperatives decreases. Additionally, Fulton states that increased individualism has caused cooperative members to question the collective ownership, which is a challenge for cooperatives.

The change of culture and attitude is also emphasized by Hogeland (2006). She states that cooperatives have evolved from being a means for farmers to ensure their independence into becoming organizations with objectives of their own, whereby the difference between cooperatives and investor owned firms (IOFs) are erased and the loyalty of the farmers diminish.

Bager (1996) uses population ecological theory to explain that when cooperatives grow in size and complexity they become increasingly influenced by non-cooperative firms. The growth of cooperative firms is a consequence of the members' raising demands on the cooperative, which implies that cooperatives have to enjoy economies of scale (Nilsson, 1997). In the old days there was a sub-population of cooperatives in many industries, and so these developed a culture of their own. Nowadays the cooperatives have grown to the extent that they are similar to non-cooperative business firms. Nilsson et al. (2009) use socio-psychological theory to explore the components of the changing cooperative culture and find

that members increasingly exhibited low satisfaction, low involvement and low trust when the cooperative becomes large and complex. This alienation causes members to perceive that there is no remedy for restoring their satisfaction, involvement and trust.

Holmström (1999) compares corporate governance of traditional cooperatives with that of IOFs. As cooperatives' stocks are non-tradable, neither members nor financial analysts scrutinize the investments of cooperatives resulting in suboptimal investment portfolios. Moreover, the collective decision-making in cooperatives contributes to less efficient portfolios and conflicts between member categories will hamper good investments.

Cook (1995) uses the neo-institutional economics framework to explain cooperative development. Cooperatives are created to counteract market failure and to offer better prices than other market actors. They lower the members' transaction costs. However, market failures may disappear. Thereby the farmers' need for vertical integration is reduced and cooperatives might demutualize. This is especially likely if the members experience short-term transaction costs in dealing with the cooperative. These costs appear because of the vaguely defined property rights (VDPR). As the decision-makers face these problems, they will compare the benefits of exit with the sunk costs, competitive yardstick arguments etc. This analysis of tradeoffs may lead to a choice of exiting the cooperative business form, or the cooperative might undergo some kind of transition. Hence the VDPR bear a good deal of the blame when cooperatives have problems. These findings are supported by Hart (1997) who claims that today's markets are less characterized by market failures and that the costs for monitoring vertically integrated organizations have become too high for many farmers. Fulton and Hueth (2009) find that the VDPR problems create member ignorance, which give rise to poor management.

### *1.3 Problems of vaguely defined property rights*

When the residual control and the residual rights are aligned, there are no problems regarding the property rights of an asset. Due to the separation of ownership and control, agency costs will emerge. The separation of ownership and control will result in the need of contracts between the principal and the agent to make sure that the agent's interests are in accordance with the interest of the principal (Nilsson, 2001). As contracts always are imperfect, VDPR problems will appear.

In cooperatives, problems of VDPR may be severe. Firstly, cooperative residual claims are not openly tradable (Nilsson, 2001). Secondly, the members have no individual ownership rights to the cooperative, only to their individual share in the cooperative society. This share is not appreciable and all decisions regarding the equity are made collectively, i.e. by the board of directors or the general assembly. Thirdly, the existence of unallocated equity enhances collectivism in the decision-making. The result is that the members hardly have any individual property right to the cooperative, giving raise to problems of VDPR.

Additionally, the members receive their surplus from participating in the cooperative in the form of improved terms of trade, including patronage refunds (Nilsson, 2001). When the members evaluate the performance of their cooperative they have substantial difficulties. The members get no market signals concerning the value of their invested shares in the cooperative. Hence, agency problems are more severe than in an IOF. The problems of VDPR are the free-rider, the horizon, the portfolio, the control and the influence cost problems (Cook, 1995).

As all members receive benefits of the assets that a cooperative has accumulated over the years, new members will be *free-riding* on the efforts of the old. The unallocated capital makes it possible to members to reap benefits without contributing accordingly (Cook, 1995). Due to the possibility to free-ride, members do not like to invest in the cooperative. Especially not since members will not get part of the unallocated capital when they leave the cooperative.

Since members have no property rights to the cooperative's capital a *horizon problem* occurs. The fact that members have different time horizon for their investments implies that the cooperative's investment decisions become suboptimal for most members (Cook, 1995). A member will oppose to investments that bring benefits after this person's membership period has expired. This limits the strategic decision-making of the cooperative.

The lack of tradability, liquidity and appreciation of the residual claims also cause a *portfolio problem* (Cook, 1995). With no other ties to a business than the equity investment, the owner can create a portfolio that matches his or her risk preferences (Sykuta and Cook, 2001). The members of cooperatives are tied to the cooperative because of the farm activities requiring this outlet. The cooperative can be regarded as an extension of the farm. The risk preferences of the farmer will therefore have to be met by the diversification of operations within the cooperative. As the memberships are heterogeneous, the cooperative can only meet the preference of the average members or a specific group of members. The composition of the portfolio is likely to cause conflicts between the principal (the members) and the agent (the manager) (Nilsson, 2001).

An agent has to be controlled and monitored by the principal. In a cooperative, a *control problem* arises as no information regarding the performance of the agent is provided through the stock market (Cook, 1995). Hence, a cooperative's board of directors will have to undertake the monitoring and controlling without this evaluation instrument. The agent will have large opportunities to act opportunistically. The information asymmetry and the divergent interest between the agent and the principal will create problems in monitoring the cooperative.

Additionally, the heterogeneity within cooperative memberships may lead to some groups acting to promote their interests on behalf of other members' (Cook, 1995). This causes an *influence cost problem*. If individual members are to engage themselves in monitoring the cooperative, they will face huge costs, which have to be borne by themselves but the benefits of their efforts will be shared with all other members. Hence, such monitoring efforts are not likely, which is to say that the management will have great opportunity to act opportunistically. Furthermore, if the management would like to be informed about the opinions of the members there would be major problems and costs, as well.

## 2. Methodology

To investigate why the cooperative Swedish Meats was demutualized empirical data was necessary. Due to the complexity of the problem, qualitative data was needed. Personal interviews were conducted to make two-way communication possible. Key stakeholders within Swedish Meats at the time for the decision to sell were interviewed. That is both those who took active part in the decision process (directors) and those who were subject to the decision (rank-and-file members). As it was impossible to know beforehand what information

could be obtained from different persons, the chosen approach was the Grounded Theory (Glaser and Strauss, 1967). Thus, interviews were conducted until the point was reached where no more information was acquired, i.e. when so-called theoretical saturation was accomplished. Hence, a gross list of potential interviewees was compiled before the data collection started. As the data collection was based on the principle of triangulation (Jick, 1979; Yin, 2003), i.e. information about a certain issue should be achieved by two or more interviewees so as to corroborate the data, a variety of persons were interviewed – managers, board members, farmers, procurement officers, etc.

All interviewees were or had been members of the cooperative. Two were members of the board of representatives when Swedish Meats business operations were sold. Another respondent was a director. The present and the former chairman of the Association of the Swedish Pig Producers were interviewed as they had insights into what went on among the cooperative members, as these were also members of professional association. The present chairman of Swedish Meats was interviewed while the person who was chairman at the time of the decision declined to answer any question.

In order to ensure that all aspects of the problems were covered, semi-structured interviews were conducted following a question guide. During the interviews, the respondents could speak freely. The interviewer made sure that all items in the question guide were answered. The interviews were conducted over telephone and lasted between 30 and 75 minutes. All interviews were recorded and the recordings were transcribed. Before the interview, the respondents were asked if they agreed to participate and if they would accept the recording. They all accepted recording. They had the opportunity to read the question guide before the interview and to correct the transcript of the interviews.

## 3. The problems of vaguely defined property rights within Swedish Meats

The interviews with the Swedish Meats representatives reveal that the cooperative was suffered from problems of VDPR. The cooperative had experienced low profitability during all its existence and it could not offer as high prices for the members' animals as the IOFs. That resulted in low trust among the members. It was no longer considered to be disloyal behavior to trade with an IOF. Rather, defection was considered to characterize a good businessman. This made it easier for members to leave the cooperative. The cooperative then ended up with inefficient operations, not being able to enjoy economies of scale.

The stated reasons for low profitability were lack of possibilities to sell meat to the lucrative Swedish market; the retailers offering better terms to competitors; Swedish Meats not responding to market trends (such as local production); too little product and market development; and too much focus on cutting costs in the production. One may wonder why the members did not take action. The reasons stated in the interviews can be connected to the problems of VDPR. The reasons to the low profitability and to the problems of governing the cooperative are presented below.

### *3.1 Free-rider problems*

The *free-rider problem* became severe for the cooperative as the low profitability and the focus on lacking patronage refunds resulted in low member loyalty. The low performance by

the cooperative in the past discouraged the members to invest in the cooperative. That resulted in a vicious circle where needed investments were not undertaken.

> *"It is so much history and if you haven't delivered (profits) in the past, the cooperative hadn't… then it is really hard to ask (the members) for a favor stating that you will deliver" (Interviewee 5)*

The members took advantage of the situation without contributing. Instead, the poor loyalty resulted in many members trading with IOFs, further lowering the profitability of the cooperative due to low capacity utilization. The members enjoyed the cooperative's role as a competitive yardstick but they did not contribute.

### *3.2 Horizon problems*

The members and the management focused on short-term investments to streamline the slaughtering. No long-term investments in marketing and product development were undertaken, leading to difficulties in sales.

> *"We didn't undertake product development. That is because it cost money. And no marketing. This is short term saving and a long-term disaster" (Interviewee 5)*

There was no money for long-term investments. The members cared about the cooperative potential to benefit their farm operation but did not regard the cooperative's survival. There was a *horizon problem*. This prevented the long-term investments in marketing and product development as the farmers wanted the profits as patronage refunds rather than invested in the cooperative.

### *5.3 Portfolio problems*

The larger members had more to lose due to the cooperative's inefficient operations. Therefore they put more effort into monitoring and controlling the cooperative and to ensure that the smaller members voted according to their interests. This created a *portfolio problem* as the smaller farmers might not have the same risk preference. Due to differences in risk preference, more risky strategic investments, such as marketing and product development, was not undertaken.

> *"They (Swedish Meats) should have thought about what (information) to have on the package, to tell where the meat came from – they should in an early stage joined to the local, the locally produced trend. Because we could. It would not have been expensive. We already could trace the meat. It was the will lacking. But mostly, the strategic thinking." (Interviewee 1)*

### *3.4 Control problems*

The members perceived the cooperative to be too large and complex, making it hard for the member representatives to monitor and control the management. There was no quality assurance in the organization and no flexibility, compared to the IOFs. The members and

elected representatives perceived that they only received information that the management wanted them to have.

> *"There is a culture within the slaughter industry (the cooperative)… that the management staff only presents the information it likes to give to the board of directors and that the board of directors is too incompetent, or too unused to run large companies… that the management gets an information advantage…" (Interviewee 2)*

This increased the agency cost and worsened the *control problem*. Additionally, as the directors are full-time farmers they could not involve themselves in all complex issues. They lacked knowledge regarding the strategically important issues of markets and product development for the cooperative. Furthermore, the members did not perceive the directors to be competent, i.e. the agency costs increased. The member found the cooperative's structure too complex and they perceived that they could not monitor the directors or the management. The members were weak as owners, afraid of conflicts. They continuously demanded changes to improve the profitability of the cooperative, but they never followed up whether the management or the directors fulfilled their promises. A culture emerged of management and core directors scratching each others' backs.

### *3.5 Influence costs problem*

There were also problems related to the *influence cost problem*. If members were critical to the current running of the cooperative, they were silenced.

> *"They were promoted if they agreed with the management and once part of leadership the representatives have had to 'get back in line'. If you were to think by yourself, you would know that it wasn't OK… At the same moment, you would not get any other position within the Swedish farmer cooperatives" (Interviewee 2)*

It was perceived that directors were elected for the wrong reasons. They were charismatic rather than competent for the task at hand. Too much politics were involved in the decisions, e.g. closing down plants in directors' own districts. The directors wanted to be popular. They raised the prices for the members' products even if the cooperative was not in a financial position to do so. They did not discuss strategic issues of importance to the long-term ability to pay a good price for the animals. On top of that, the cooperative had no strong leader who could make up for the heterogeneity of the membership and be able to communicate unpopular but strategically necessary decisions to the members.

## 6. Discussion and conclusion

The demutualization of Swedish Meats seems to be caused by the VDPR problems. The cooperative could not make the strategic decisions needed to raise the profitability. Swedish Meats had a very heterogeneous membership because the merger that created this cooperative comprised almost all of the country's slaughterhouse cooperatives. The diverging interests of the many small producers and the fewer larger producers seem to have had an influence on the scope of the VDPR problems. As a cooperative becomes more complex, the VDPR problems become more severe (1995). As smaller members are not as dependent on the cooperative's competitive yardstick role as much as the larger members are, they are not

willing to accept large agency costs. The smaller members have because of their limited production less to lose than larger producers. Many small members are not fulltime farmers or do not have slaughter animals as their main income, rather milk. Thus, there are good reasons why the smaller members opposed to many of the larger members and voted for a demutualization. Possibly many of the smaller members also had a horizon problem as they anticipated exiting their business in a near future, following the overall market structure (Fulton and Hueth, 2009).

This horizon problem resulted in no long-term investments. Rather, Swedish Meats focused on streamlining the slaughtering activities. These were activities that the members had more knowledge about. Theoretically, the larger members have more to lose from an inefficient cooperative than the smaller members. Hence they were prepared to take a leading role in governing the cooperative. The larger members would have preferred long-term investments to raise the profitability. That was prevented by the political culture of the cooperative.

The directors were not very skilled but rather charismatic and liked. They were liked both by the members and the management. Thus, many necessary strategic decisions were not made since they were uncomfortable. Instead of making sure that strategic long-term investments were made, the directors raised the prices for the animals or paid patronage refunds. Due to the large size of Swedish Meats and its complex structure, it is understandable that the CEOs had a dominating power position. The board had much less to say. There was thus a management style that did not satisfy the members (Fulton and Hueth, 2009). It is no wonder that the members in general became dissatisfied and lost trust in the cooperative (Nilsson et al., 2009). The members were of course also aware of the mismanagement of the firm (Bager 1996; Hind, 1997, 1999; Holmström, 1999).

According to the interviewees, the large members were divided into two groups. One was loyal, guarding the competitive yardstick role. The other one was disloyal, negotiating and trading with IOFs. The latter group, free-riding on the cooperative's competitive yardstick function, was growing larger. Possibly, this increase came about because they opposed to the political culture within the cooperative. The increased free-riding has occurred as the present generation of farmers does not remember the market failures of pre-cooperative days. The loyal group of members still remembers the market failures when private actors offered low prices and the farmers had to accept these as they had no options. Among the loyal group, there was a fear of falling prices when the competitive yardstick function is no more present.

The trend towards shrinking loyalty among the Swedish Meats membership supports Hogeland's observations (2006). She explains that the difference between cooperatives and IOFs are successively being erased whereby the loyalty of the farmers diminish. The Swedish Meats respondents state that the members were dissatisfied that the cooperative could not perform as well as the investor owned slaughterhouses.

One basic observation is that since the market has changed character there is no longer a market failure to be corrected by any cooperative. The number of farmers is decreasing and their operations are getting larger, whereby the farmers get more market power. Additionally, the capacity of the IOF slaughterhouses increases and the transportation systems is getting better, providing more options to the farmers. An Internet-based spot market for animals is currently improving the price information available to the farmers. Particularly in southern Sweden the need for cooperatives to correct for market failures has vanished due to possibilities to export the animals.

The present study fits into this pattern of previous studies. The Swedish slaughterhouse cooperatives had during the many years of national agricultural policy become large and complex (Nilsson, 1997). Some people even claim that they enjoyed governmental support so they could fight the IOF competitors successfully. Therefore it is no wonder that most members did not care about the efficiency of the cooperatives. There was little cooperative culture (Bager, 1996; Hogeland, 2006) and the cooperative could because of the inefficient operations not manage to reduce the transaction costs for the farmers (Harte, 1997). The collective structure of the cooperatives, stimulated by governmental support, created all the problems of VDPR (Cook, 1995; Harte 1997).

**Acknowledgements**

The Swedish Farmers' Foundation for Agricultural Research is acknowledged for the funding of the project. The Royal Swedish Academy of Agriculture and Forestry is acknowledged for enabling the presentation of the data at the XIIIth EAAE Congress 2011.

**References**

Bager, T. (1996). *Organisations in sectors – Explaining the dissemination of populations of formal organisation in economic sectors: bridging rational choice and institutional approaches,* Esbjerg, Denmark: South Jutland University Press.

Barton, D. (1989). Principles. In D. Cobia (Ed.), *Cooperatives in agriculture.* (pp. 21–34). Englewood Cliffs, NJ: Prentice-Hall.

Cook, M. (1995). The future of U.S. agricultural cooperatives: A neo-institutional approach, *American Journal of Agricultural Economics, 77*, 1153-1159.

Fulton, M. (1995). The future of Canadian agricultural cooperatives: A property rights approach, *American Journal of Agricultural Economics, 77*, 1144-1152.

Fulton, M. and Hueth, B. (2009). Cooperative Conversions, Failures and Restructurations. An Overview. *Journal of Cooperatives, 23*, i–xi.

Glaser, B. G. and Strauss, A. L. (1967) *The Discovery of Grounded Theory: Strategies for Qualitative Research*. Chicago: Aldine Publishing Company

Harte, L. N. (1997). Creeping Privatisation of Irish Co-operatives: A Transaction Cost Explanation. In: Nilsson, J. and G. van Dijk (editors), *Strategies and Structures in the Agro-food Industries* (pp. 31-53). Assen: Van Gorcum

Hind, A.M. (1997) The changing values of the cooperative and its business focus. *American Journal of Agricultural Economics, 79*, 1077–1082.

Hind, A.M. (1999). Co-operative life cycle and goals. *Journal of Agricultural Economics, 50*(3), 536–548.

Hogeland, J. A. (2006). The economic culture of U.S. agricultural cooperatives, *Culture & Agriculture, 28*(2), 67-79.

Holmström, B. (1999). The future of cooperatives: A corporate perspective. *Finnish Journal of Business Economics, 48*(4), 404–417.

Jick, T.D. (1979), Mixing Qualitative and Quantitative Methods: Triangulation in Action, *Administrative Science Quarterly, 24*(4), 607-611.

Nilsson, J. (1997). Inertia in Cooperative Remodeling, *Journal of Cooperatives, 12*, 62-73.

Nilsson, J. (2001). Organisational principles for co-operative firms, *Scandinavian Journal of Management, 17*(3), 329–356.

Nilsson, J., Kihlén. A. and Norell, J. (2009). Are Traditional Cooperatives an Endangered Species? About Shrinking Satisfaction, Involvement and Trust, *International Food and Agribusiness Management Review*, *12*(4), 103-123.

Padberg, P. D. (1997). The Global Context of Agro-food Marketing. In P. D. Padberg, C. Ritson and L. M. Albisu (Eds.), Agro-Food Marketing (pp. 11-28). Oxon, UK: CAB International.

Ritson, C. (1997). Food Marketing and Agricultural Marketing: The Scope of the Subject of Agro-food Marketing. In P. D. Padberg, C. Ritson and L. M. Albisu (Eds.), Agro-Food Marketing (pp. 11-28). Oxon, UK: CAB International.

Sexton, R. J. (1986). Cooperatives and the Forces Shaping Agricultural Marketing. *American Journal of Agricultural Economics, 68*(5), 1167-1172.

Statistics Sweden (2009). *Yearbook of agricultural statistics 2009*, Official Statistics of Sweden.

Swedish Meats (1999). *Årsredovisning 1999* (Annual report, 1999).

Sykuta, M. E. and Cook, M. L. (2001). A New Institutional Economics Approach to Contracts and Cooperatives, *American Journal of Agricultural Economics, 83*(5), 1273-1279.

Yin, R. K. (2003). *Case Study Research: Design and Methods, 3 ed.* Thousand Oaks, CA: Sage Publications.