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AGRICULTURAL COOPERATIVES AS EFFECTIVE MARKETERS OF VALUE-ADDED PRODUCTS

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EXECUTIVE SUMMARY

The ability of agricultural marketing cooperatives to compete with investor-owned firms (IOFs) in the food processing industry was assessed through a literature review and interviews with cooperative lenders and top managers at various cooperatives. The findings are discussed in this report and its companion, *Cooperative Principles and Regulations: Aiding or Hampering Cooperatives' Efforts At Value-Added Marketing?* This report contains a broad literature review identifying the requirements for being an effective marketer of value-added products and suggestions regarding how cooperatives can fulfill these requirements.

There are four basic requirements which cooperatives must satisfy to form the foundation for an effective marketing program. First, they need a well thought-out strategic plan which utilizes a niche strategy and has a competitive orientation. Second, the plan and its supporting programs should be market-oriented, rather than producer-oriented. Marketers of food products have achieved a high degree of product differentiation; thus, the third requirement that cooperatives must satisfy is the substantial financial capital needed to overcome this barrier to entry. Fourth, cooperatives must have management experienced with value-added products in order to broaden their expertise and perspective as they strive to be value-added marketers.

Thus far, cooperatives are strongest in the commodity-oriented segment of the food processing industry. Their competitiveness may be constrained by cooperative principles and various regulations which reinforce these principles. The most obvious limitation imposed by these institutional factors is that they constrain cooperatives' access to various sources of capital, including equity from their members. Cooperative principles and regulations can also impair cooperatives' abilities to be effective strategic planners, have a market orientation and have management experienced with value-added products.

Many cooperatives have implemented a variety of nontraditional financing programs, such as nonqualified allocations, preferred stock, and limited partnerships, to finance their value-added ventures. In some cases, they have compromised the cooperative principles to overcome their financing constraints. Cooperatives also need to address the other requirements for being an effective marketer of value-added products; these requirements are not as quantifiable as financial capital and can be easily overlooked.

There are thirty-four programs suggested in this report which cooperatives can implement to aid them in fulfilling the four basic requirements for being an effective marketer of value-added products; they are listed on page12. They include a broad range of activities, such as Board and member education of the financing requirements associated with the cooperative's strategic plan, joint ventures with IOFs and other cooperatives, a transferable delivery rights program, and management evaluations based on trends in the cooperative's performance. Each suggestion is described and evaluated for its consistency with cooperative principles and regulations, applicability to cooperatives of varying sizes and commodity groups, and ease of development and implementation. The suggestions regarding the financial capital requirement are also evaluated with respect to their funding potential. Some of the programs can be implemented relatively easily while others require considerable effort.

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Agricultural Cooperatives as Effective Marketers of Value-Added Products

I. INTRODUCTION

Approximately thirty percent of the farm production in the United States is now marketed through cooperatives. While agricultural production remains the major source of raw material in food manufacturing, it continues to decline as a proportion of the value of the end product. Many agricultural marketing cooperatives have opted to engage in continued vertical integration by marketing value-added products and are competing with investor-owned firms (IOFs).

A firm needs an effective marketing program to be a successful marketer of value-added products. One of the elements forming the foundation for an effective marketing program is the capital needed to finance product and market development activities. The other elements will be identified and discussed in this report.

Cooperatives have a unique institutional structure. Many cooperatives were formed in response to market failures. Unlike IOFs, they are essentially nonprofit enterprises operating for the mutual benefit of their members. They are governed by special federal and state regulations and guided by cooperative principles. These institutional factors may limit cooperative's access to debt and equity capital, and consequently constrain their ability to finance new products. They may also impose less obvious constraints on cooperatives' abilities to fulfill the other requirements which must be satisfied to be an effective marketer of value-added products. Nevertheless, some agricultural marketing cooperatives have become well-known for their food products and have had successful new product introductions.

The specific objectives of this study are to:

1. identify the requirements that a firm must fulfill in order to be an effective marketer of value-added products; and

2. develop a list of practical programs which agricultural marketing cooperatives can use to enhance their abilities, specifically, to finance their product and market development activities, and in general, to be effective marketers of value-added products.

A literature review of various topics—strategic management, the economics of food processing, cooperatives' performance as value-added marketers, the effects of cooperative principles and regulations, and cooperative financing programs—provides the background for this study. This information is integrated with the findings from interviews conducted with various cooperative lenders and managers and presented as a list of practical suggestions which cooperatives can implement to enhance their abilities to raise financial capital and fulfill the other requirements for becoming effective marketers of the value-added products. These suggestions are evaluated for their consistency with cooperative principles and regulations, applicability to cooperatives of varying sizes and commodity groups, ease of development and implementation, and funding potential (where appropriate).

II. LITERATURE REVIEW

In this section, the literature on strategic management and the economics of food processing is reviewed briefly to identify the requirements which firms must fulfill to be effective marketers of value-added products. This is followed by a discussion of cooperatives' comparative performance in the food processing industry. The effects of cooperative principles and regulations are then examined. The final section of the literature review is a description of the nontraditional financing programs which cooperatives are utilizing.

A. Strategic Management

Management principles are applicable to cooperatives as well as IOFs. Most management texts begin by emphasizing the importance of strategic planning. A strategic plan provides the firm with a blueprint for organizing and managing its resources. Cooperatives striving to be value-added marketers must understand the requirements of the strategy which they have selected.

Kotler defines strategic planning as "...the managerial process of developing and maintaining a viable fit between the organization's objectives and resources and its changing market opportunities. The aim of strategic planning is to shape and reshape the company's businesses and products so that they combine to produce satisfactory profits and growth" (p.33). Strategic planning did not surface in the United States until the early 1970s when companies began encountering a rapidly changing marketplace.

According to Porter, firms must develop their strategies within a competitive framework. Competitive moves by one firm have a noticeable effect on competitors and may incite retaliation, such as in-

creased price competition, new product introductions or advertising battles. He identifies three strategic approaches which a firm can utilize to cope with competitive forces and outperform other firms in an industry: 1) overall cost leadership; 2) differentiation; and 3) focus (or niche). Overall cost leadership requires sustained capital investment and access to capital, process engineering skills, etc. Differentiation requires strong marketing abilities, product engineering, creative flair, strong capability in basic research, and a corporate reputation for quality or technological leadership. The niche strategy means focusing on a particular buyer group, segment of the product line or geographic market; the firm achieves either differentiation from better meeting the needs of the particular target, or lower costs in serving this target, or both. A niche strategy may be the only option for a firm with limited resources. Porter emphasizes that effective implementation of a strategy usually requires total commitment to the strategy; procedures and staffing appropriate to one strategy can be detrimental to another strategy.

Plante's comments amplify the need for solid strategic planning by cooperatives. He states that cooperatives can no longer afford to attempt to achieve the following mutually exclusive objectives: 1) market member products at competitive prices; 2) return sufficient cash to members through patronage refunds and retirement of equities to permit members to pay their taxes; and 3) build equity capital in the business sufficient to finance the investments needed to keep the cooperative competitive. It usually has been more politically expedient for management to attempt to satisfy the first and second objectives while forsaking the third, which, in the long term, is the most critical of the three. Plante concludes that cooperatives need to change their legal, capital and operating policies if they are to survive and prosper.

Both the differentiation and niche strategies require a market orientation. Levitt is credited as being the creator of the market-oriented concept, which he describes in the following statement: "Selling is preoccupied with the seller's need to convert his product into cash; marketing with the idea of satisfying the needs of the customer by means of the product and the whole cluster of things associated with creating, delivering, and finally consuming it...a truly marketing-minded firm tries to create value-satisfying goods and services that consumers will want to buy" (p.50). A market-oriented firm must adapt and respond to a continuously changing marketplace in order to successfully implement a successful differentiated or niche strategy.

Kotler expands on Levitt's concept. He states that "...the marketing concept is a market-focused, customer-oriented, coordinated marketing effort aimed at generating customer satisfaction as the key to satisfying organizational goals" (p.17). All functions of the firm must work together to sense, serve and satisfy the customer. Firms must continually offer new products, which will have varying product life cycles.

Stern and Anderson specifically address agricultural marketing cooperatives' need to be market-oriented in their extensive analysis of successful marketing cooperatives. They conclude that "...successful marketing cooperatives are highly market-oriented and their primary goal is long term profitability" (p.67). They interviewed top managers of cooperatives and asked them to identify factors inhibiting the adoption of strong marketing programs at cooperatives. The most frequently cited reason (by 77% of the respondents) was lack of a brand franchise; this is actually the effect, rather than the cause, of a weak marketing program. Sixty-six percent mentioned unwillingness to invest in marketing and 44% stated that the focus of the cooperative was on members and moving quantity, rather than on the market and consumers.

Several of the cooperatives in Stern and Anderson's study facilitated their firm's market orientation by maintaining dual boards of directors; one board concentrated on producer-member issues and the other on processing and marketing issues. This structure enabled the cooperatives to devote sufficient attention to the strategic and policy issues associated with value-added marketing. In a few cases, the processing and marketing operation was an incorporated subsidiary of the cooperative.

Thus, two of the basic requirements for being an effective marketer of value-added products are having a sound strategic plan and a market orientation. Agricultural marketing cooperatives, as well as other firms, need to engage in strategic planning in order to accomplish their goals and utilize their resources most effectively. They have to choose between two basic strategic directions—being a low-cost producer or a value-added marketer. Both require developing a strategic plan; the latter also necessitates implementing programs which focus on the needs of customers, rather than producers.

B. The Economics of Food Processing

The concept of vertical integration is frequently mentioned in the cooperative literature. Agricultural cooperatives involved in vertical integration must un-

derstand the economics of food processing. There is a large body of theoretical literature regarding barriers to entry into high margin industries, such as food processing.

Sexton and Iskow discuss optimal vertical integration in a cooperative. They state that "a successful cooperative must integrate to the stage or stages in the production flow where the market failure is occurring" (p. 23). Dunn, et al. comment that "...use of cooperatives to integrate vertically continues to provide excellent opportunities for farmers to reduce costs and increase returns to their products through added value. Cooperatives should continue to carefully explore opportunities in consumer product and input markets, both individually and as partners in a multi-cooperative effort" (p. 44). Sporleder adds that the greatest potential for ensuring market access and control by producers lies with the growth of vertical integration by marketing cooperatives. His rationale for this statement is that the domestic food production and distribution system increasingly is becoming industrialized with fewer but larger processing and marketing firms with increasing market power.

Porter's work provides insights regarding the concentrated structure of the food industry. He states that differentiation creates a barrier to entry by forcing entrants to spend heavily to overcome existing customer loyalties. Other entry barriers cited by Porter include access to distribution channels (e.g., brokers and retail shelf space), economies of scale (in production, research, marketing and customer service), and cost disadvantages independent of scale (e.g., the learning curve and proprietary production technologies). Overcoming these barriers usually involves losses during the start-up period and can take an extended period of time. Porter emphasizes that a firm must include the cost of overcoming entry barriers when calculating the potential returns from entry, rather than just considering the returns being earned by incumbents. Scherer also identifies differentiation as an entry barrier. He equates product image advantages with consumers to unit cost advantages since they both create a spread between a product's market price and the dominant firm's own unit costs. It is necessary to achieve a certain minimum threshold level of advertising or other promotional activity to have much effect on consumer behavior. The firm with a large market share can spread these costs over more volume than a new entrant. Large firms have well-established marketing channels and may enjoy certain economies of scale in promotion and physical distribution. Furthermore, large firms can use profits from other products to subsidize new product introductions. Scherer also notes that there are economies of scale with regard to research and development. Large firms can have a balanced portfolio of R&D projects, while a small firm does not have the resources to fund many such projects. He hypothesizes that in industries amenable to strong image differentiation (such as consumer food products), marketing strategies tend to emphasize the introduction of new products and the concomitant use of heavy advertising regarding special product features.

Kotler addresses promotion economies by discussing the S-shaped sales response function. A low level of advertising will not generate consumer awareness and sales. A threshold level must be reached before sales increase in response to the advertising.

Stern and Anderson note that in order to achieve long-term profitability, the successful cooperatives in their study have made large investments in market research, development of new products, plants, advertising and promotion and people. However, they state that since cooperatives "...depend primarily on their members, they have limited sources of equity. Limited equity means less money available for investment in research and development, advertising, etc." (p.36).

Similarly, Connor and Wills analyze the U.S. food processing industries and find that large, often diversified manufacturers emphasized consumer advertising, new product development and other methods to maintain differentiation. They do not find economies of scale to be a barrier in consumer foods industries. They identify large capital requirements and product differentiation as the primary entry barriers faced by agricultural marketing cooperatives and other firms attempting to enter this industry.

French, et al. note that cooperatives have historically lagged behind the rest of the private sector in research to develop new products. They comment that cooperatives need to engage in more vertical integration in food processing to survive. They hint at market-oriented strategies by mentioning that agricultural marketing cooperatives need to enhance their share of the consumers' dollar.

Vitaliano comments that marketing of differentiated food products can lead to higher average returns than does marketing of agricultural commodities. He cautions, however, that the failure rate for new products is high and that launching a brand is very costly. Thus, he concludes that cooperatives' costs and benefits of vertical integration "...must be examined in

light of investment analysis as it applies to the special characteristics of the cooperative form of business organization..." (p. 66). These characteristics are reviewed later in the discussion of cooperative principles.

Caves and Peterson are even less optimistic about cooperatives' prospects with vertical integration. They state that cooperatives "...are ill-suited to entrepreneurial tasks that are complex or entail activities far removed from the direct interests and experience of the cooperatives' members...[Their market] shares should be larger in activities involving immediate service to farmer-members than in those farther removed in the chains of marketing or supply" (p. 5).

According to Porter, vertical integration involves differing management requirements. He cautions that "...management capable of operating one part of the vertical chain very well may be incapable of effectively managing the other" (p.314). Cooperatives need the expertise and perspective which managers experienced with value-added products have. In particular, manufacturing and marketing are fundamentally different and it is unwise to turn a plant manager into a vice president for marketing. A vice president of marketing and his or her staff must be experienced at addressing customer's needs. It is also helpful to have other key management officers who are experienced with value-added products.

The majority of the cooperatives in Stern and Anderson's study reported that they usually recruit marketing officers from other food companies with strong marketing programs. They pay competitive salaries and have some form of a bonus program. However, they reported difficulties in attracting and keeping the talent they wanted, which they attributed to the low profiles, low margins and low marketing budgets of cooperatives.

Numerous economists, including Scherer and Porter most recently, have noted that firms enter into new businesses either through internal development or acquisition. Internal development requires the firm to confront directly the two sources of entry barriers into an industry—structural entry barriers and the expected reaction of incumbent firms. The costs of overcoming the former are upfront investments and startup losses. Existing firms can retaliate by lowering prices and escalating marketing costs. These barriers may be avoidable if entry occurs through an acquisition. Cooperatives may also gain management experienced with value-added products through an acquisition. However, cooperatives should not automatically conclude that they have a unique ability to operate an acquired business because they have been a supplier.

Porter suggests sequential entry (e.g., production for a private label or buying a brand with only regional distribution when the target group has national distribution) as a means of reducing barriers to entry. The firm may lower its costs and risks of entry by accumulating knowledge and brand identification in the industry through entry into the initial group and then using this knowledge to enter into the ultimate target group. Also, managerial talent can be developed in a more measured way in this fashion.

An effective marketing program is essential to being a successful marketer of value-added products. The research findings reviewed in this section indicate that there are four elements which form the foundation for an effective marketing program. In addition to having a solid strategic plan and market orientation, cooperatives pursuing a value-added strategy must satisfy two other requirements to be successful: 1) substantial financial capital; and 2) management experienced with value-added products. They face product differentiation as a major barrier to entry into the highly processed food market and the capital required to overcome this barrier can be substantial. They need the expertise and perspective which management experienced with value-added products have. An acquisition may be a more attractive means of entry than internal development for a cooperative.

C. Cooperative Performance in Value-Added Marketing

Despite the significant requirements which a firm must satisfy, agricultural marketing cooperatives are active in food processing industries. Welch's, Ocean Spray, Land O'Lakes, SunMaid and Sunkist are some cooperative brands that are well-known to consumers. The president of an East Coast dairy cooperative recently reported the introduction of five new major items into the retail and food service markets (Davis). The products are targeted at consumers' convenience and nutritional concerns. Nevertheless, cooperatives appear to be lagging behind IOFs in the food processing industries.

In discussing agricultural cooperatives' activity in food manufacturing, Torgerson notes that "...cooperatives do not have a major presence in industries characterized by heavy product differentiation...it is in basic agricultural commodities that cooperatives appear to be most active. In short, cooperatives have a

respectable presence in parts of the food processing sector, but nowhere near the domination of investor-owned counterparts. Cooperatives continue to have a challenge to grow and better strategically position themselves in the food processing system" (p.44).

Torgerson's statement related to a study by Rogers and Marion. Using 1982 Bureau of the Census data, Rogers and Marion found that the 100 largest agricultural cooperatives accounted for 6.9% of the value-of-shipments and 3.6% of the value-added in all food and tobacco manufacturing industries. Cooperatives have a low ratio of value-added to value-of shipments; this reflects the fact that cooperatives tend to operate in first-stage food manufacturing industries with lower value-added. When they separated 45 national industries in food and tobacco manufacturing into groups by the degree of product differentiation (based on industry advertising-to-sales ratios), the percentage of value-added controlled by cooperatives declined as product differentiation increased. The top 100 cooperatives held 8.0% of the value-added in the no product differentiation group, 4.9% share in the low product differentiation group, 6.2% share in the medium product differentiation group, and only a .3% share in the highly differentiated group. The opposite was true for the top 20 food and tobacco companies. Rogers and Marion found that cooperatives have substantially lower advertising-to-sales ratios than IOFs. They conclude that "...cooperatives typically had their strongest positions in those food manufacturing markets that are more commodity oriented, less differentiated, with low value-added to sales ratios, and low margins" (p.69). Combs and Marion obtained similar findings using 1977 Census data.

Rogers and Marion present the following hypotheses regarding why cooperatives are largely active in food manufacturing industries that appear to have little market power: 1) since cooperatives are a vertical extension of the farmer-member asset base, the greatest amount of activity will be closest to the integrator—first-stage marketing & processing; 2) cooperative boards tend to be very homogeneous, member-oriented and production driven; 3) cooperatives' primary mission is to assure a market for their members' output; 4) cooperatives are undercapitalized and successful product differentiation requires substantial investments in R&D and advertising; and 5) the amount of processing and value-added is much greater in later processing stages than in earlier ones. The first and third hypotheses suggest that cooperatives' objectives are inconsistent with a value-added strategy. The second and third hypotheses indicate that cooperatives are not market-oriented. Cooperatives' difficulties with fulfilling the financial capital requirement is identified in the fourth hypothesis.

Using grocery warehouse withdrawal data, Wills found that market share and advertising had less price-enhancing effects on cooperative brands than on proprietary brands. He suggests the following explanations for this result: 1) there are differences in the characteristics of markets in which cooperatives are the leading brand; 2) large cooperatives have less unified management objectives than do large IOFs; 3) traditionally-structured cooperatives are unable to issue stock to raise funds for capital improvements, market development and promotion; and 4) cooperatives have higher costs than IOFs because they absorb and store surplus commodities or divert them to other markets. These hypotheses could not be tested with Wills' econometric model. They suggest that cooperatives have difficulty satisfying the strategic planning, market orientation and financial capital requirements, as did Rogers' and Marion's hypotheses.

Schraeder, et al. conducted comparative studies of cooperatives and IOFs. They found that the profitability and rate of return on total assets of large agribusiness firms were more than three times higher than those for large cooperatives. In addition, cooperatives' advertising rates (the ratio of advertising expenditures/product sales) were substantially below those for IOFs.

Lerman and Parliament compared the financial performance of cooperatives and IOFs in the fruit and vegetable and dairy industries during 1976-87. They found that both groups of cooperatives in their study performed as well or better than comparable IOFs on profitability, leverage, and interest coverage. Fruit and vegetable cooperatives had poorer performance than IOFs with regard to sales/fixed assets, inventory turnover and current assets/current liabilities; the dairy cooperatives performed at least as well as their IOF counterparts on these measures. Lerman and Parliament note that fruit and vegetable cooperatives are locked into an existing product mix, unlike IOFs. They conclude that cooperatives and IOFs have similar fixed asset growth rates. They also found that cooperatives' lower debt levels were not due to the lack of investment opportunities or externally imposed restrictions on borrowing and suggest that the lower debt levels may be due to differences in tax treatment which enhance cooperative's equity capital per dollar of net margin.

Unlike Lerman and Parliament, Chen, et al. found cooperatives had lower profitability, lower degree of diversity, higher leverage, and higher growth rates than comparable IOFs in the U.S. aggregated food sector. They also determined that cooperatives used much less advertising than IOFs. The Chen analysis was not separated into industry groups, unlike the Lerman and Parliament analysis.

The accounting firm, Deloitte & Touche, has been conducting annual studies comparing the financial performance of investor-owner food processors, dairy cooperatives and other agricultural marketing cooperatives. The average sales of the nondairy cooperatives have consistently been the lowest and they have also been the most highly leveraged group. However, the IOFs have the lowest asset turnover ratio. The IOFs and nondairy cooperatives have had similar before-tax returns on equity, while the dairy cooperatives have been earning substantially lower rates of return.

These analyses of market shares indicate that cooperatives typically are not major players in highly processed sectors of the food industry; they are strongest in more commodity-oriented markets with low value-added to sales ratios. Some of the authors hypothesize that cooperatives lack the financial capital and market orientation and that their strategic objectives are inconsistent with being a value-added marketer. The results of studies comparing the financial performance and production efficiency of cooperatives and IOFs are inconclusive. Neither organizational form appears to have a clear cut advantage with regard to their performance.

D. Cooperative Principles, Regulations and Statutes

Although cooperatives and IOFs are competitors in the food manufacturing industry, cooperatives are subject to special tax provisions and other statutes. The regulations which are most commonly mentioned in the cooperative framework include Subchapter T and Section 521 of the Internal Revenue Code, the Capper Volstead Act, Securities Registration requirements and state statutes. Cooperatives are also governed by the cooperative principles—"user-controlled, user-financed and user-benefit." These principles are designed to promote the basic purpose of a cooperative, which is to provide economic benefits to its members. Many of the cooperative regulations reinforce the cooperative principles. Cooperatives' limited presence in highly processed food products markets may be partially attributable to cooperative principles and regulations. The effects of these institutional factors on cooperatives' abilities to be effective marketers of value-added products are evaluated in detail in the companion report to this study, *Cooperative Principles and Regulations: Aiding or Hampering Cooperatives' Efforts At Value-Added Marketing?* The findings in this report are summarized below.

Cooperative regulations and principles block access to capital from certain sources and inhibit the retention of existing equity capital. Cooperatives' competitiveness can also be undermined in less obvious ways. The user-controlled principle constrains cooperatives' abilities to be market-oriented and to engage in solid strategic planning. The fact that cooperative members earn returns on the basis of their patronage, rather than their investment, can cause reluctance to invest in advertising and product development needed to become market-oriented. The requirement for management experienced with value-added products can easily be overlooked because there is no secondary market for members' equity and managerial control is subsequently left to a producer-oriented board.

E. Cooperative Financing Programs

Despite the financing constraints imposed by cooperative principles and regulations, numerous cooperatives have developed a variety of innovative financing programs. In this section, cooperatives' financial planning issues are reviewed briefly, followed by descriptions of numerous financing sources. These financing sources are listed in Table A. The consistency of various financing programs with cooperative principles is reviewed at the end of this subsection. The financial profile of cooperatives is described in Appendix A.

1. Financial planning

The National Council of Farmer Cooperatives-Legal, Tax and Accounting Committee (NCFC/LTA) Subcommittee on Capital Formation (Subcommittee) 1988 report notes that a cooperative's organizational goals and long range plan must first be clearly developed in order to develop an effective financing program. Then alternative financial structures should be investigated to fund the capital needed to execute the plan. In its 1987 report, the Subcommittee states that some cooperatives have taken a holistic approach to the strategic management of financial resources and have opted for fewer plant investments and greater market investments.

In a similar strategic framework, Korzan and Gray discuss the characteristics of the financial structure needed by a growth-oriented cooperative. They note that the weakness in using patronage retains to fund all permanent facilities and expansion is that the source cannot be controlled to match any long-range plan of expenditures. A period of declining or negative margins is often the time when additional funds for expansion are most needed. They conclude that member education is a vital part of a cooperative's overall financial program; members must be aware of the need for invested capital and the benefits which could accrue to them as owners and patrons of a well-financed cooperative.

Dylla states that cooperatives generally have available to them all forms of debt and equity capital available to IOFs. He then qualifies this statement by noting that most cooperatives' equity has a temporary character and that they have very limited access to public securities markets through debt or equity issues. Consequently, many cooperatives rely heavily on long-term debt for capital. He emphasizes that "...[c]ooperatives, like other business enterprises, must rely on equity to provide the most important source of their ongoing capital needs to support growth, expansion and working capital" (p. 32). Dylla also comments that the stronger, well-managed cooperatives have substantial member loyalty which enables them to be more comfortable with a higher debt ratio than a comparable IOF.

Cotterill emphasizes that members' risk/return preferences should be considered when developing the cooperative's financial structure. Using the Capital Asset Pricing Model to evaluate a cooperative's financial structure, he notes that maximizing the net present value of the cooperative's net cash flow does not necessarily increase its value to its members. Some members may prefer lower average returns with more stability. Thus, a cooperative may find it beneficial to its members to employ a buffer stock approach, drawing down its retained earnings in bad years and adding to them in good ones, to reduce the riskiness of the cooperative's payments to its members. The members' required rate of return on equity capital could thus be lowered, thereby reducing cash patronage refund amounts on average. Cotterill concludes that cooperatives utilizing this approach may expand more rapidly than other cooperatives.

2. Cooperatives' equity financing sources

Members provide most, if not all, of cooperatives' equity financing. Except where noted otherwise, the descriptions of various financing sources cited in the remainder of this section were obtained from the annual reports filed by the NCFC/LTA's Subcommittee on Capital Formation. The year of the particular report is noted in parenthesis.

Cooperatives can utilize nonqualified allocations to raise additional equity from their members (1985). Nonqualified allocations allow members to defer their tax liability on the retained equity until they actually receive cash payment of the retains. Ocean Spray doubled its sales between 1980 and 1985 while tripling its equity capital. The growth was partially funded by the cooperative retaining large amounts of equity from its members by issuing these retains as nonqualified allocations. The resulting tax liabilities were offset with investment tax credits and accelerated depreciation deductions.

Nonexempt cooperatives are also accumulating equity from nonpatronage earnings. There are four major ways of generating such income: 1) royalties from trademark licensing programs; 2) part/full ownership of a profitable proprietary corporation; 3) development of a nonpatronage division within the cooperative; and 4) using the cooperative's capabilities to handle both member and nonpatronage business (1984). Most cooperatives have chosen to retain nonpatronage earnings on an unallocated basis, and view it as their most permanent form of equity capital. This capital is not taxable to the members until and unless it is distributed—usually at the cooperative's dissolution. Various cooperatives have developed nonpatronage business to fund tax-paid retained earnings, including Citrus World, Mid America Dairymen, Sun Diamond, Sunkist and Ocean Spray. Sunkist derives most of its nonpatronage earnings from licensing revenues and retains them on an allocated basis. Citrus World and Sunkist have generated enough equity from nonpatronage earnings to permit significant reductions in traditional member retains. Ocean Spray generated most of its unallocated tax-paid nonpatronage earnings from nonmember operating profits (1986).

Direct member investment is another equity source; that is, a cooperative can require new members to invest a minimum amount of cash in the cooperative. This capital is redeemed, retired or repurchased by the cooperative only at the death of the patron, and only then at the discretion of the board of directors. Sporleder

TABLE A
COOPERATIVES' FINANCING SOURCES

I. EQUITY CAPITAL
- A. Member and/or patronage related:
  1. qualified allocations
     - a. patronage dividends
     - b. per unit retains
  2. nonqualified allocations
     - a. patronage dividends
     - b. per unit retains
  3. unallocated equity
  4. delivery rights
  5. preferred stock
  6. common stock
- B. Nonmember related:
  1. unallocated equity (nonpatronage earnings)
  2. preferred stock
  3. venture capital

II. DEBT CAPITAL
- A. Member/employee relatedMember/employee related:
  1. certificates of indebtedness
  2. subordinated debt
  3. demand deposit programs
- B. Nonmember/employee related:
  1. CoBank—secured/unsecured
  2. commercial bank—secured/unsecured
  3. commercial paper
  4. private placements
  5. industrial development bonds
  6. public offerings
  7. capitalized leases
  8. Eurobonds

III. ALTERNATIVE RESOURCE STRUCTURES
- A. Operating leases
- B. Limited partnerships
- C. Joint ventures with IOFs and cooperatives involved in functions such as:
  1. copacking
  2. marketing agency in common
  3. new product development
- D. Mergers

suggests that cooperatives implement atransferable delivery rights system which allows for rewards to the original providers of risk capital. The delivery rights can be bought and sold among existing members; presumably, older members will earn capital gains as a return on their original investment. Such a program should be supported by stringent delivery restrictions. It would be separate from the equity supplied by members under the cooperative's capital plan.

Nontraditional financing structures for cooperatives have their roots with the founder of the California school of cooperative thought, Aaron Sapiro. As reported by Wallace, Sapiro developed a program which involved cooperatives forming stock subsidiaries and selling nonvoting preferred stock in these subsidiaries to outside investors (typically banks) while the cooperative held the common stock in the subsidiary. A portion of the nonvoting preferred stock was retired each year because the cooperative's bylaws require it to do so; some patronage refunds were withheld for this purpose. Eventually, the cooperative acquired complete ownership of its asset base.

Cooperatives have also sold preferred stock to members. Such issues are usually used to engage in a venture which has greater than usual risks and which benefits less than all of the cooperative's patrons (1986). When a cooperative is in a financially distressed situation, it should consider issuing stock which is preferred (at liquidation) to all other membership and patronage capital in order to increase its attractiveness to investors. The dividends reduce net earnings available for patronage allocation. Such stock issues may be exempt from securities registration requirements. Landmark and Farmland Industries have issued preferred stock (1985). Landmark sold preferred stock to the public prior to 1981, raising $12 million. Farmland sold $25 million of 8% preferred stock to its local members in 1983.

A limited number of cooperatives have publicly issued stock to generate equity. Land O'Lakes formed Country Lakes Foods to which it transferred its fluid milk and ice cream businesses to be operated on a for-profit basis, with public ownership (1989). As a public stock corporation with the ability to raise capital in

public markets and offer its securities in acquisitions, it was thought that Country Lakes Foods would have more flexibility to grow during a period of industry consolidation. Land O'Lakes retained 70% of the stock of Country Lakes Foods. Country Lakes Foods had acquired, and expected to acquire for the foreseeable future, over 75% of its requirements for raw milk from Land O'Lakes; however Country Lakes Foods did not have any long term purchase contracts with Land O'Lakes for milk or other agricultural products and intended to purchase raw milk at the lowest available cost. Nevertheless, the relationship between Land O'Lakes and Country Lakes Foods as a majority-owned subsidiary on the one hand, and supplier-purchaser with outside public owners on the other hand, creates obvious potential conflicts of interest.

GoldKist undertook a public offering by forming Golden Poultry (1988 NCFC/LTA Subcommittee on the Use of Subsidiaries). The motivation was threefold: 1) obtain risk capital in order to remain competitive in a fast changing and capital intensive industry; 2) enhance profitability by achieving economies of scale; and 3) improve the quality of Gold Kist's equity by creating permanent equity. Gold Kist created a holding company, Agri-International, to hold the stock of its noncooperative subsidiaries and to provide the possibility of raising capital through the sale of minority interests. The public offering was preceded by two private stock offerings. After the September, 1986 public offering, Gold Kist owned 72% of Golden Poultry. It also had a management service contract with Golden Poultry under which GoldKist provides management guidance and corporate staff services for a fee.

Venture capital is an alternative source of equity financing not usually considered by cooperatives. Samsel, et al. recently surveyed venture capitalists regarding their interest in investing in agribusiness firms in general (not cooperatives specifically). Venture capital firms usually are interested in more than just one or two industries. Thirty percent preferred investing in the western United States. Thirty one percent indicated they would consider investing in a specialty food company and 26% would do so in the food processing industry.

3. Cooperatives' debt financing sources

Cooperatives traditionally have relied heavily on debt financing; however, their debt financing sources have been changing. As the size of the cooperative increases, funding from the Banks for Cooperatives and commercial banks tends to decrease while funding from alternative sources (e.g., leases and industrial development bonds) increases (Royer, et al.).

Sunkist was the first cooperative to successfully market a fixed rate Eurobond issue, and Ocean Spray became the first cooperative to successfully complete an unsecured fixed rate private placement. Ocean Spray was soon followed by Sunkist and California Almond Growers Exchange (now Blue Diamond Growers). Ocean Spray, California Almond Growers Exchange, Sun Diamond, American Rice, Welch Foods, C & H Sugar and Sunkist also have obtained capital through the commercial paper market (1985). Even after the 1986 Tax Reform Act, numerous cooperatives are using financing from industrial development bonds to construct new production facilities (1987).

Member/employee demand deposit programs can provide short-term financing for cooperatives, as noted by Craycroft. The program can be structured such that the participants received a rate of return one to two percentage points below the cooperative's short-term debt rate. Such a rate would be attractive to the depositors because it would exceed the rate they could earn on certificates of deposit of comparable maturity.

Capitalized leases can free up working capital and result in improved cash flow for a cooperative (compared to debt financing). However, capitalized leases usually are higher cost than debt financing when interest rates are relatively low (Martin). Although most of the tax provisions which made capitalized leases attractive have been repealed, large cooperatives continue to negotiate leases and lease-purchase deals (Pederson and Gill). A few cooperatives use capitalized leases in conjunction with limited partnerships.

Subordinated debt is viewed by most banks and rating agencies as equity, but it is considered debt for tax purposes (1984). It may be structured with any combination of features, such as fixed or variable interest rates, intermediate or long term maturities, interest reinvestment options, and redemption or exchange options. It provides an attractive way for members and others to invest in the cooperative and is usually less expensive to the cooperative than bank debt. However, the interest expense associated with subordinated debt is a legal obligation which can create liquidity problems, whereas preferred stock dividends or other returns on member capital can be foregone. Subordinated debt issues may require registration with the Securities and Exchange Commission.

4. Alternative resource structures

Alternative resource structures can reduce or eliminate the financing needed by a cooperative to gain access to the assets required to produce value-added products. The following forms of alternative resource structures are described below: operating leases; joint ventures; limited partnerships; and mergers.

Operating leases are used as a source of off-balance sheet financing (1988). They can be an attractive source because they do not tie up working capital in long-term assets; payment may be deferred over a long term and residual values are not amortized.

Joint ventures are a nontraditional source of financing for new products (1984). They encompass a variety of legal structures. They may be the only way a cooperative can afford to own part of an expensive facility, with full or fuller utilization. A joint venture may allow the cooperative to market a new product nationally, "lock in" access to a marketing capability and prevent competitive inroads (1984). Copacking agreements are a form of a joint venture; such arrangements reduce upfront capital requirements and reduce the risk of new products (1985).

Based on case studies of four joint ventures, Frederick developed guidelines related to the following aspects for joint ventures among cooperatives: adequate background information; economic compatibility; trust among participants; respect of business performance; facility convenience; control of venture structure; and confidence that the venture will not adversely impact other operations. Cooperatives should recognize that one of the venture partners must be in control for a successful joint venture; otherwise, the venture simply creates another layer of management and slows or impairs decisionmaking.

Cooperating Brands (CBI) is a joint venture started by four cooperatives (Citrus World, Tree Top, Welch Foods and Ocean Spray (1985). The participants retain their brand name identities. CBI provides buyers with single-source access to a full line of single serving, thaw- and-serve juices. Similarly, Sun Diamond Growers was formed to provide combined sales representation and certain support services to SunMaid, Diamond Walnut, Sunsweet, Valley Fig and Hazelnut Growers of Oregon. Unlike CBI, Sun Diamond Growers performs all of the sales activities for its member cooperatives. This structure produces economies in sales management and order processing. The size of combined product line also provides Sun Diamond Growers with leverage with its brokers and the retail trade.

Numerous cooperatives are engaged in joint ventures with IOFs. TriValley has such a joint venture to explore the creation of new markets for its products. Landmark had a joint venture with two proprietary firms for egg processing and marketing, operating profitably until one of the partners sold out. Growmark is involved in a joint venture with Archer Daniels Midland (ADM). In 1990, Growmark offered its grain member cooperatives the following choice with regard to grain patronage refunds: (1) all cash; or (2) a combination of cash (at least 20%) and ADM common stock (1990). Another joint venture between a cooperative and an IOF involves a smaller cooperative in the Rocky Mountains whose members can provide a grain source for a process which has been owned and patented by an IOF. The joint venture has enabled the cooperative to gain the financial benefits of vertical integration through the joint venture. Without the joint venture, the cooperative would not have had access to the patented process nor the capital needed to originate the process or to purchase and construct the processing facilities.

Craycroft notes that limited partnerships can be viable source of equity capital for cooperatives. The limited partners would normally be comprised of members (and sometimes, employees) of the cooperative. The partnership acquires and leases back facilities and/or equipment to the cooperative. The lease payments can provide the limited partners with a rate of return above that which they could earn on certificates of deposit of a comparable term, but less than the rate the cooperative would pay if it had to obtain long term debt financing.

Mergers can also provide additional financing capacity to cooperatives. Some cooperatives have retained their cooperative structure after a merger. Recent examples include Riceland Foods/Arkansas Rice Growers Cooperative Association, and Landmark/Ohio Farmers (Countrymark) (1985). In other cases, cooperatives have merged to become part of IOFs. American Rice was bought out by Successor American Rice, a newly organized for-profit enterprise. The purpose of the transaction was to attract additional capital through equity investments by new investors and to thereby strengthen its capacity to raise capital.

5. Consistency of financing programs with cooperative principles

Cooperatives may be reluctant to utilize some financing alternatives which they believe are inconsistent with cooperative principles. Dunn, Knutson, and

Dunn, et al. review the compatibility of some financing programs with cooperative principles. Dunn, et. al. note that investment-based (as opposed to patronage-based) equities can be an important source of capital, particularly if issued under equity reinvestment programs or employee stock ownership programs. Such investments should carry no voting rights and should have a fixed return rate or one based on broad financial market measures.

However, investment-oriented equity capital violates the user-financed principle. Dunn, et al. note that public stock issues also compromise the user-benefit principle (and are therefore detrimental to cooperative members' welfare), even when the stock is issued by a subsidiary. They comment that "...there is an inherent conflict in the objective of providing the highest possible return to investors and in the long-term goal of serving the needs of farmers" (p. 47). If the investors have voting rights, the user-controlled principle is also violated. However, Dunn concludes that flexibility is essential and that cooperative principles should be viewed as guideposts or goals, not as absolute acid tests.

Dunn, et. al. caution that, although joint ventures with IOFs enable cooperatives to have access to markets, capital, technology and to pool risk, these "...benefits must be weighed against the inherently conflicting objectives of the two types of organizations and the potential for loss of control..." (p.46). Although unallocated reserves can be a source of permanent capital or risk capital, Dunn, et. al. and Knutson state that such programs can undermine the user-controlled and user-financed principles. From a purely theoretical standpoint, they find that equity capital gained from patronage assessments is preferable; they note, however, from a pragmatic standpoint, cooperatives must look at all financing alternatives.

Thus, a cooperative should clearly define its organizational goals before revamping its financial structure. As indicated in Table A, cooperatives have been expanding their sources of debt and equity capital and undertaking alternative resource structures to raise the capital they need to be effective marketers of value-added products. Some of these programs are not consistent with cooperative principles; however, the principles should be used as guidelines rather than absolute behavioral requirements. Such compromises may be essential to cooperatives striving to generate the substantial capital required to be an effective marketer of value-added products.

There are four basic requirements which cooperatives must satisfy in order to be effective marketers of value-added products. First, they need a well thought-out strategic plan which utilizes a niche strategy and has a competitive orientation. Second, the plan and its supporting programs should be market-oriented. Marketers of food products have achieved a high degree of product differentiation; thus, the third requirement that cooperatives must satisfy is the substantial financial capital needed to overcome this barrier to entry. Fourth, cooperatives must have management experienced with value-added products in order to broaden their expertise and perspective as they strive to be value-added marketers.

Thus far, cooperatives are strongest in the commodity-oriented segment of the food processing industry. They engage in many longstanding practices which are attributable to the cooperative principles—user-financed, user-controlled and user-benefit. Their competitiveness in the food processing industry may be constrained by these principles and various regulations which reinforce them. The most obvious limitation imposed by these institutional factors is that they constrain cooperatives' access to various sources of capital. The fact that cooperative members earn returns on the basis of their patronage, rather than their investment, reduces the attractiveness of cooperatives to outside investors and diminishes their members' investment incentives. Cooperative principles and regulations can also impair cooperatives' abilities to satisfy the other requirements for being effective marketers of value-added products.

Many cooperatives have broadened their access to capital and now finance their value-added ventures using such diverse sources as nonpatronage income, public stock offerings, industrial development bonds, leases and joint ventures. In some cases, they have compromised the cooperative principles to overcome their financing constraints. Cooperatives also need to address the other requirements for being an effective marketer of value-added products: a sound strategic plan, a market orientation and management experienced with value-added products. These requirements are not as quantifiable as financial capital: consequently, they can be easily overlooked.

TABLE B
SUGGESTED PROGRAMS FOR COOPERATIVES STRIVING TO BE EFFECTIVE MARKETERS OF VALUE-ADDED PRODUCTS

A. Suggested Programs for Fulfilling the Financial Capital Requirement
   1. Develop a long-range strategic plan prior to implementing a new financing program.
   2. Provide continuing education to the Board regarding the financing requirements associated with the cooperative's strategic plan.
   3. Provide continuing education to members regarding the financing requirements associated with the cooperative's strategic plan.
   4. Seek its debt financing from a variety of sources.
   5. Retain unallocated equity.
   6. Organize its value-added business as a non-cooperative subsidiary and publicly issue stock for a portion of the subsidiary.
   7. Utilize operating and capital leases to obtain facilities and equipment for processing value-added products.
   8. Engage in joint ventures/shorter-term agreements with other cooperatives and IOFs.
   9. Defer certain product and market development expenses.
   10. Form limited partnerships using member/employee investment programs.
   11. Implement a transferable delivery rights program.
   12. Implement a base capital equity program structured to prevent deferrals of equity payments.
   13. Establish a clearinghouse for members wishing to redeem their equity.
   14. Issue nonqualified retains.
   15. Forfeit Section 521 exemption.
   16. Develop a mechanism for collecting member equity through direct payments, rather than deductions from patronage payments.

B. Suggested Programs for Fulfilling the Strategic Planning Requirement
   1. Adopt or continue formalized strategic planning process.
   2. Continually educate the Board on strategic planning issues.
   3. Review basic strategic planning issues with the membership.
   4. Appoint (more) outside directors to the Board.
   5. Implement a transferable delivery rights program.
   6. Report trends in cooperative's performance.
   7. Restrict itself to one strategic orientation.
   8. Multiple-commodity cooperatives should have a single pool.

C. Suggested Programs for Fulfilling the Market Orientation Requirement
   1. Emphasize its market orientation in its strategic plan.
   2. Continuously educate board members on marketing issues and apprise them of the progress of the cooperative's marketing program.
   3. Develop a diverse product line.
   4. Engage in joint ventures to market products.
   5. Defer certain product and market development expenses.
   6. Expand the product line through acquisitions, as well as internal development.
   7. Expand the commodities delivered by members.

D. Suggested Programs for Fulfilling the Qualified Management Requirement
   1. Provide competitive salaries and benefits to management.
   2. Evaluate management on trends in the cooperative's performance.
   3. Limit the size of the board to twelve or fewer members.

III. SUGGESTED PROGRAMS FOR COOPERATIVES STRIVING TO BE EFFECTIVE MARKETERS OF VALUE-ADDED PRODUCTS

To gain further understanding of the requirements and constraints cooperatives face as value-added marketers, interviews were conducted with three different types of business professionals—the Chief Financial Officers (CFOs) of thirteen cooperatives involved in value-added marketing, the CFOs of four small- to medium-sized IOFs similar to the cooperatives interviewed in this study, and five lending officers who have worked with cooperatives. These interviews covered topics discussed in the literature review. They examined how well the cooperatives were meeting the four basic requirements for being successful marketers of value-added products. The interview responses are summarized and analyzed in the companion report to this study, *Cooperative Principles and Regulations: Aiding or Hampering Cooperatives' Efforts at Value-Added Marketing?*

The findings from these interviews are integrated with insights from the literature review and presented as suggested programs which cooperatives can undertake to satisfy the four basic requirements to be effective marketers of value-added products. These suggestions are listed in Table B. Almost half of them relate to the financing requirement. There have been numerous developments in this area which cooperatives should consider. However, the other requirements for being an effective marketer of value-added products are equally important and should not be undermined by implementation of only the financing programs.

The suggestions included in this report should not be considered to be mandatory or comprehensive. A cooperative does not need to implement all of these suggestions in order to be an effective marketer. Furthermore, there are other ways that cooperatives can satisfy the four basic requirements.

Many of the suggestions listed below have been implemented by the cooperatives interviewed for this study, or were mentioned in the literature review. Some are listed more than once, because they address more than one requirement. The suggestions under each requirement are listed randomly. Some of the suggestions will require major effort by a cooperative, while others can be implemented with relative ease.

Each suggestion is described and justified briefly in outline form. It is evaluated for its consistency with cooperative principles and regulations, applicability to cooperatives of varying sizes and commodity groups, and ease of development and implementation. The suggestions regarding the financial capital requirement are also evaluated with respect to their funding potential.

A. Suggested Programs for Fulfilling Financial Capital Requirement

1. Develop a long-range strategic plan prior to implementing a new financing program.
   a. Description and justification:
      As previously noted, a firm should have its strategic plan and know its resource requirements before it develops its financing program. Its financial plan should support the strategic plan, rather than drive it.
   b. Consistency with cooperative principles and regulations:
      No inconsistencies with developing a strategic plan prior to implementing a financing program. Intent is to maximize efficiency of user financing.
   c. Applicability to cooperatives of varying sizes and commodities:
      Important to all cooperatives.
   d. Ease of development and implementation:
      Larger cooperatives will have better staff support for developing plan. If consultants are used, several management officers should work closely with the consultants.
   e. Funding potential:
      Intent is to maximize efficiency of the use of existing funds, rather than generating new funds.
2. Provide continuing education to the Board regarding the financing requirements associated with the cooperative's strategic plan.
   a. Description and justification:
      As noted by Korzan and Gray in the literature review and reiterated by lending officers, cooperatives' board members need to have a comprehensive understanding of the financing required to carry out its strategic plan. A first-stage commodity processor needs less capital than a value-added marketer who must finance product and market development and advertising, in addition to its processing facilities. Some cooperatives are currently unwilling to invest in new products that generate losses the year that they are launched. When a value-added marketer initiates its value-added strategic

direction, it is likely to incur low or negative returns until its program begins to build. It must have working capital to finance these losses.

b. Consistency with cooperative principles and regulations:
Promotes the user-financed principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives.

d. Ease of development and implementation:
Requires continual attention by management. Boards with limited knowledge of financial management will require more education. Information regarding the cooperative's financing requirements and their connection to the strategic plan should be presented frequently at Board meetings and during strategic planning sessions.

e. Funding potential:
The Board's better understanding of its cooperative's financing requirements will build its support for the cooperative's financing programs.

3. Provide continuing education to members regarding the financing requirements associated with the cooperative's strategic plan.

a. Description and justification:
Although detailed information regarding the cooperative's financing requirements cannot be presented to its membership without compromising confidential business plans, a cooperative's members should be provided with a realistic projection of the cooperative's long-range financial needs. They should be advised if their capital requirements are expected to increase or remain stable. Information regarding the cooperative's financing requirements and their ties to the strategic plan should be presented at all member meetings and member publications. Members who disagree with the value-added strategy or lack the financial capacity to invest in the cooperative may wish to withdraw.

b. Consistency with cooperative principles and regulations:
Promotes the user-financed principle.

c. Applicability to cooperatives of varying sizes and commodities:
Important to all cooperatives.

d. Ease of development and implementation:
Requires continual attention by management, particularly among cooperatives with a diverse membership.

e. Funding potential:
The membership's better understanding of its cooperative's financing requirements will build its support for the cooperative's financing programs.

4. Seek its debt financing from a variety of sources.

a. Description and justification:
As noted in the literature review, many cooperatives still obtain their debt financing only from CoBank and/or commercial banks. Possible debt financing sources which may be available at lower cost include: industrial development bonds, member/employee demand deposit programs, private placements, subordinated debt and commercial paper.

b. Consistency with cooperative principles and regulations:
Debt financing is not considered to compromise the user-financed principle; some programs involve voluntary member investment. Some of the programs may involve securities registration requirements.

c. Applicability to cooperatives of varying sizes and commodities:
All cooperatives may benefit from diversifying their debt financing sources. However, certain instruments, such as commercial paper, are used only by larger cooperatives because of the size of the issue and the name recognition needed.

d. Ease of development and implementation:
Larger cooperatives have more financial staff members to assist in such efforts. However, smaller cooperatives may find that the reduced interest costs justify adding an additional staff member.

e. Funding potential:
Could locate sources willing to lend when traditional sources will not. Some programs could have relatively limited funding potential, such as a membership demand deposit program. Others, such as a private place-

ment with an insurance company, could provide most or all of the cooperative's long-term financing.

5. Retain unallocated equity.
   a. Description and justification:
      This important source of permanent equity was identified in the literature review. It can provide the stability in equity needed when a cooperative makes the long-term investments in marketing and production for a value-added program.
   b. Consistency with cooperative principles and regulations:
      Some cooperative specialists contend that overuse of unallocated equity can result in member complacency and can undermine the user-control and user-financed principles. Cooperatives exempt under Section 521 must allocate nonpatronage earnings to their nonmembers on the same basis as to their members; having unallocated equity is a violation of one of the requirements of Section 521.
   c. Applicability to cooperatives of varying sizes and commodities:
      Applicable to all cooperatives. Even smaller cooperatives can generate nonpatronage income from sales of nonmember commodities and/or nonproducer items, and sales of capital assets.
   d. Ease of development and implementation:
      Nonpatronage earnings are the most likely source of unallocated equity. A cooperative may have to develop the nonpatronage business or make an acquisition. Management may encounter resistance from members who are protective of management's attention to their commodities; they should be reminded that the unallocated equity benefits them by reducing the capital required from them.
   e. Funding potential:
      Should be significant. The goal of one cooperative interviewed in the study was to build its unallocated equity such that it represented one-third of its total equity.
6. Organize its value-added business as a noncooperative subsidiary and publicly issue stock for a portion of the subsidiary.
   a. Description and justification:
      Some cooperatives have used this approach to gain substantial equity to finance its value-added program.
   b. Consistency with cooperative principles and regulations:
      Some cooperative specialists contend that such programs compromise all of the cooperative principles. The user-financed principle is undermined because of the nonmember equity capital. The user-benefit principle faces conflict because the subsidiary will want to obtain its raw product (the members' deliveries) at the lowest cost while the members want the highest price. The stockholders will share control of the value-added program; this compromises the user-control principle. The stock may have to be registered. The noncooperative subsidiary's sales would not be included in determining the cooperative's compliance with the fifty percent nonmember revenue limits under Section 521 and Capper Volstead.
   c. Applicability to cooperatives of varying sizes and commodities:
      This program is not for every cooperative. Only cooperatives large enough to have substantial name recognition can expect to raise capital in this manner.
   d. Ease of development and implementation:
      Public stock issues require substantial management effort. Compliance with registration requirements is time-consuming and the stockholders' interests need to be recognized. Some cooperative members may protest that the stockholders benefit unfairly at the members' expenses.
   e. Funding potential:
      This costly financing mechanism is used when it is the only way a firm can raise large amounts of capital.
7. Utilize operating and capital leases to obtain facilities and equipment for processing value-added products.
   a. Description and justification:
      Operating and capital leases can be used by cooperatives in order to have access to production resources without tieing up large amounts of working capital. Since cooperatives frequently cannot (fully) utilize their depreciation deductions, such leases can be

less costly than debt-financed purchases.

b. Consistency with cooperative principles and regulations:
No inconsistencies noted.

c. Applicability to cooperatives of varying sizes and commodities:
Cooperatives of varying sizes and commodities in this study utilize lease financing.

d. Ease of development and implementation:
There are numerous firms that provide lease financing to cooperatives. The lease contract should be carefully reviewed.

e. Funding potential:
Moderate; some of the cooperatives in this study financed approximately ten percent of their assets with leases.

8. Engage in joint ventures/shorter-term agreements with other cooperatives and IOFs.

a. Description and justification:
As noted in the literature review and CFO interviews, joint ventures/ shorter-term agreements can reduce the amount of financing needed and can enable cooperatives to achieve significant cost reductions in acquiring access to facilities for producing value-added products. The cost-sharing can often make a project financially feasible. The cooperative can use a copacker with such an agreement to produce items for the cooperative; this provides production capability to the cooperative without the high ownership costs. Conversely, the cooperative can be the copacker and reduce its overhead by obtaining fuller utilization of expensive equipment.

b. Consistency with cooperative principles and regulations:
No inconsistencies noted.

c. Applicability to cooperatives of varying sizes and commodities:
Cooperatives involved in extensive value-added processing will have greater opportunity to be involved in such agreements; however, virtually any cooperative involved in food processing needs production capacity that can be shared with another firm.

d. Ease of development and implementation:
Equipment manufacturers can facilitate the identification of potential partners. The contractual agreement should be carefully reviewed by both parties.

e. Funding potential:
Such arrangements are designed to provide cost savings, rather than being a direct financing source.

9. Defer certain product and market development expenses.

a. Description and justification:
The deferral of certain product and market development expenses can also improve the feasibility of a new value-added product. Since cooperatives operate in a fiercely competitive environment, they are often forced to maintain competitive returns even while developing a value-added program. The deferral of certain product and market development expenses over a three to five year period may preserve a competitive return.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that such deferrals violate the service-at-cost aspect of the user-benefit principle. However, the cooperative accrues the benefits from the expenses over an extended period; thus, it can be argued that the expenses should also be spread over an extended period. Deferrals are strictly regulated by the Financial Standards and Accounting Board.

c. Applicability to cooperatives of varying sizes and commodities:
All cooperatives with product and market development expenses can benefit from deferrals; the extent of the benefit will depend on the amount of the expenses.

d. Ease of development and implementation:
The cooperative should review its proposed deferral practice with its audit firm, prior to making the expenditures.

e. Funding potential:
Enhances a product's feasibility, rather than generating new funds.

10. Form limited partnerships using member/employee investment programs.

a. Description and justification:
Limited partnerships can be formed to acquire and lease back equipment and facilities needed to produce value-added products. The limited partners could be members (and possibly, employees) who would earn a

rate of return higher than that which they would receive on comparable investments, but lower than that which the cooperative would pay for long-term debt capital.

b. Consistency with cooperative principles and regulations:
The major drawback to this arrangement is that some nonparticipating members could feel that the limited partners are earning an unfairly high rate of return at the cooperative's expense, thereby compromising the user-benefit principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives. The size of the limited partnership could vary with the size of the cooperative.

d. Ease of development and implementation:
The contractual agreement should be carefully reviewed by all of the participants.

e. Funding potential:
Some cooperatives have funded assets in excess of $10 million with such programs.

11. Implement a transferable delivery rights program.

a. Description and justification:
A delivery rights program would enable the payment of premium returns only to product delivered with delivery rights. The delivery rights could involve a tiered premium structure. The delivery rights could be issued (either sold or given) to members when a cooperative initiates its valued-added strategy. They would appreciate in value as the cooperative's program flourished and could provide capital gains to the members who initially financed the program. Subsequent holders of the delivery rights could also achieve capital gains.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that such a program undermines the user-benefit principle by paying different returns to different members. The program would effectively provide a return on the members' investment, which is inconsistent with the user-benefit principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives with value-added programs. Acreage with perennial crops could be sold with the delivery rights.

d. Ease of development and implementation:
Easy to implement. Requires significant member education. Slightly difficult to administer for commodities with widely variable yields from year to year. Prospective members may object because the program increases their cost of entry into the cooperative.

e. Funding potential:
Most delivery rights are issued initially without payment to members; they are intended to provide a capital gains mechanism for the members and therefore enhance their willingness to invest in the cooperative. However, delivery rights could initially be sold to raise equity capital.

12. Implement a base capital equity program structured to prevent deferral of equity payments.

a. Description and justification:
Since most cooperatives distribute their earnings on the basis of members' patronage rather than their investment, there is little incentive for members to invest in the cooperative. A base capital program can be structured to effectively pay members on the basis of their investment, as well as their patronage. Members' capital requirements for the program would be proportionate to their patronage. They would only be eligible to receive a member's return on the portion of their deliveries which were fully funded by their investment in the cooperative; their remaining deliveries would be treated the same as those of nonmembers.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that such a program violates the user-benefit principle in the same way as would a delivery rights program. The program clearly supports the user-financed principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives.

d. Ease of development and implementation:

Simple to develop. Requires significant member education. Slightly difficult to administer for commodities with widely variable yields from year to year. Relatively new members may protest the lower returns that they will receive until they are fully funded.

e. Funding potential:
The rate at which equity would be collected from new and expanding members could be faster than from a standard revolving program. Thus, the cooperative would have an overall increase in its equity, unless it chose to redeem retiring members' equity quickly.

13. Establish a clearinghouse for members wishing to redeem their equity.
    a. Description and justification:
    Several of the cooperative CFOs in this study remarked that the lack of liquidity was the factor that contributed most significantly to their members' reluctance to invest in the cooperative. The clearinghouse would enable members to sell their capital stock at a discount. If combined with the base capital program described above, members would have no incentive to disinvest. However, if financial conditions forced them to sell, they could cash out all or part of their equity investment and could then deliver their product to the cooperative as a nonmember. Retiring members could presumably redeem their stock sooner with this market, rather than waiting for redemption by the cooperative.
    b. Consistency with cooperative principles and regulations:
    Could be viewed as violating the user-financed principle. May involve securities registration requirements.
    c. Applicability to cooperatives of varying sizes and commodities:
    The size of the market will increase with the size of the cooperative's membership; the market could be too thin if the cooperative is small.
    d. Ease of development and implementation:
    Simple to develop. Requires member education, particularly to ensure that they realize the implications of selling their stock. Monitoring each member's investment level would be easy since the cooperative is operating the clearinghouse.
    e. Funding potential
    Although such a program would not directly generate equity capital, it would do so indirectly by enhancing the liquidity of the members' equity investments.
14. Issue nonqualified retains.
    a. Description and justification:
    Equity retains can create financial hardships for some cooperative members by producing negative after-tax cash flows on patronage dividends issued as nonqualified retains. This situation can be remedied if the cooperative issues nonqualified retains, thereby delaying the taxation of the members' retains until after they are paid in cash by the cooperative. Since the cooperative is taxed on such retains, the practice of issuing nonqualified allocations is most attractive when the cooperative has unused tax benefits. This situation is less common since the repeal of the investment tax credit.
    b. Consistency with cooperative principles and regulations:
    Promotes the user-financed principle.
    c. Applicability to cooperatives of varying sizes and commodities:
    Could be applicable to any cooperative.
    d. Ease of development and implementation:
    It may be difficult for a cooperative to have unused tax benefits to offset its tax liability from the nonqualified allocation. Requires explanation to the membership that it is a tax *deferral*, not a tax exemption.
    e. Funding potential:
    Potentially moderate; will ease financial hardships for some members; thereby making them more receptive to investing in the cooperative.
15. Forfeit Section 521 exemption.
    a. Description and justification:
    Many cooperatives have found it beneficial to forfeit their Section 521 status. By doing so, they are taxed on nonpatronage income and capital stock dividends; however, they also have considerably more financial flexibility. A nonexempt cooperative can have unallocated equity and it does not have to treat members and nonmembers equally in the distribution of patronage dividends. It also faces less stringent requirements re-

garding the composition of the capital stockholders.

b. Consistency with cooperative principles and regulations:
Section 521 status is voluntary; a nonexempt cooperative can file under Subchapter T.

c. Applicability to cooperatives of varying sizes and commodities:
Any cooperative pursuing a value-added strategy is likely to feel constrained by the requirements of Section 521. Most of the larger cooperatives have forfeited their Section 521 status.

d. Ease of development and implementation:
Very easy to change the status; however, a cooperative cannot continually change its status.

e. Funding potential:
The ability to have unallocated equity and not be severely constrained regarding the composition of its capital stockholders can have a significant impact on the cooperative's equity capital.

16. Develop a mechanism for collecting member equity through direct payments, rather than deductions from patronage payments.

a. Description and justification:
Intent is to reinforce the message to cooperative members that they are the investors in their cooperative. The cooperative CFOs in this study noted that members tend to consider themselves to be users rather than investors of their cooperative. Their equity retains should be considered to be investments, rather than user fees.

b. Consistency with cooperative principles and regulations:
Promotes the user-financed principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives.

d. Ease of development and implementation:
Simple to develop. Collection problems could result. Could be politically unworkable; members may resist being sent a "bill".

e. Funding potential:
Intent is to improve members' understanding of their financial responsibilities as cooperative members. Consequently, the program should build support for the cooperative's financing programs.

B. Suggested Programs for Fulfilling the Strategic Planning Requirement

1. Adopt or continue formalized strategic planning process.

a. Description and justification:
The importance of a sound strategic plan was discussed in the literature review and reiterated during the lender and CFO interviews. The process must be formalized because it is too easy for management to become immersed in day-to-day issues and continually delay their strategic planning efforts. The plan should be of a long-term nature and should be updated annually.

b. Consistency with cooperative principles and regulations:
A sound strategic plan will enhance user benefits and it can promote all of the cooperative principles.

c. Applicability to cooperatives of varying sizes and commodities:
Although larger cooperatives have more staff available to support the strategic planning process, all cooperatives should engage in the process. If consultants are used, several management personnel should work closely with the consultants because the process is more important than the document.

d. Ease of development and implementation:
The initial plan will require significant management time, and the revisions will be substantially easier. The long-range nature may be difficult to deal with for cooperatives that have been embroiled in day-to-day issues. Resources to implement the plan may be severely constrained. Despite these difficulties, all cooperatives will find the process to be beneficial.

2. Continually educate the Board on strategic planning issues.

a. Description and justification:
The cooperative will maximize the benefits from its strategic planning if it continually focuses on the plan to ensure that its day-to-day activities are consistent with it. Cooperatives' management staffs tend to have longer-term perspectives than their boards; consequently, their boards need continual exposure to strategic planning issues to shift their orientation. The long-term nature of

the cooperative's value-added programs (resource requirements and benefits) should be emphasized. Each board meeting should include a management presentation of at least one strategic planning issue in the abstract and an evaluation of the consistency of the cooperative's current activities with its strategic plan.

b. Consistency with cooperative principles and regulations:
Promotes the user-control principle by making Board members better policymakers and fosters a longer-term perspective of the user-benefit and user-financed principles.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all. Larger cooperatives are more likely to be involved already in such activities.

d. Ease of development and implementation:
Requires additional management effort. Board members may initially tend to stray to day-to-day issues; the strategic planning items should be placed on the Board's agenda. Board members should also attend strategic planning members sponsored by universities, banks and other cooperative-oriented organizations.

3. Review basic strategic planning issues with the membership.

a. Description and justification:
Cooperative members tend to have short-term perspectives. They need to be educated regarding the longer-term requirements and benefits of their cooperative without disclosing confidential details. This information should be presented at member meetings and in member publications. Members who do not agree with the cooperative's strategic direction may wish to withdraw.

b. Consistency with cooperative principles and regulations:
Promotes the user-control principle by making members more knowledgeable about policy issues and fosters a longer-term perspective of the user-benefit and user-financed principles.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all. Larger cooperatives are more likely to be involved already in such activities.

d. Ease of development and implementation:
Requires additional management effort. Members may tend to stray to day-to-day issues at member meetings.

4. Appoint (more) outside directors to the Board.

a. Description and justification:
Some of the lenders and CFOs interviewed in this study indicated that cooperative boards could benefit substantially by having outside directors. Cooperatives' board members tend to have little or no experience with the major strategic issues facing value-added marketers. Management needs the objectivity and expertise such individuals can provide.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that outside directors undermine the user-controlled principle. Outside directors are prohibited by some state statutes.

c Applicability to cooperatives of varying sizes and commodities:
All cooperatives could benefit from the broader experience base provided by qualified outside directors.

d. Ease of development and implementation:
The current Board and cooperative members may object to having outside directors because they can divert management's attention away from the members' commodities. They need to be reminded that outside directors can be beneficial to the cooperative by providing needed objectivity and expertise.

5. Implement a transferable delivery rights program.

a. Description and justification:
The delivery rights could be issued to members when a cooperative initiates its valued-added strategy. By offering the potential for capital gains, a delivery rights program promotes a longer-term orientation among the cooperative's members. The delivery rights program would also facilitate planning of the cooperative's production facilities and marketing program by controlling delivery volumes.

b. Consistency with cooperative principles and regulations:
As previously noted, some cooperative specialists may contend that such a program undermines the user-benefit principle by paying different returns to different members. The benefits should justify the compromise.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives with value-added programs. Acreage with perennial crops could be sold with the delivery rights.

d. Ease of development and implementation:
Easy to implement. Requires explanation to the members; prospective members may object because the program increases their cost of entry into the cooperative.

6. Report trends in cooperative's performance.

a. Description and justification:
Several of the cooperatives in this study report five- or ten-year trends in their performance and some compare their returns with their competitors' or the field price. Single year comparisons can be detrimental when a cooperative is newly implementing its value-added strategy. Product and market development costs can have a significant impact on the cooperative's return, particularly if they are not deferred. Once the cooperative's value-added program is off the ground, its returns should increase and eventually surpass its competitors. Trend reporting should foster a longer-term orientation in the Board and the membership.

b. Consistency with cooperative principles and regulations:
Intended to foster a longer-term interpretation of the user-benefit principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives.

d. Ease of development and implementation:
The information could easily be incorporated into a cooperative's Annual Report and presented at its Annual Meeting.

7. Restrict itself to one strategic orientation.

a. Description and justification:
Porter indicated that having more than one strategic orientation can be detrimental to a firm. Being a nicher requires different resources than being a differentiated marketer or a low-cost producer. For example, being a low-cost producer requires investment in production equipment; this need competes with the capital required by nichers and differentiated marketers for product and market development. A cooperative that operates as a low-cost producer of commodity-like products while developing a value-added program can send mixed signals to the marketplace and to its staff.

b. Consistency with cooperative principles and regulations:
Promotes the user-benefit principle by maximizing long-term benefits.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives.

d. Ease of development and implementation:
A cooperative may find it difficult to abandon one of its orientations, particularly that of being a low-cost producer. Management and the Board are used to the immediate benefits or returns provided by investment in more efficient production equipment. They need to realize that the differing orientations compete for capital, management time and other resources.

8. Multiple-commodity cooperatives should have a single pool.

a. Description and justification:
Intended to promote a broader perspective by the Board and membership of the cooperative's benefits. Separate pools can be divisive; members may complain that their commodity is not being allocated adequate resources. When a cooperative initiates its value-added program, it will probably not be able to extend it to all of its commodities at once. However, all of the members will be financing the venture and will all share in the returns.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that this structure undermines the user-benefit principle; some members will be subsidizing others. As previously noted, a cooperative marketing value-added products needs a broader view of this principle.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all multiple-commodity cooperatives.

d. Ease of development and implementation:
Some members may be resistant; members must be educated regarding the stabilizing effects of diversification on returns .

C. Suggested Programs for Fulfilling the Market Orientation Requirement

1. Emphasize its market orientation in its strategic plan.

   a. Description and justification:
   Most cooperatives have a long-standing objective of providing a home for their deliveries. A market-orientation is the reverse of this; it requires satisfying the needs of customers. The strategic plan of a cooperative marketing value-added products should address the needs of customers in its analysis of the marketplace, consumer trends, the cooperative's strengths and weaknesses, and its competitors, and in its product development, advertising and promotion programs. It should allocate funds for an appropriate advertising program. Although members may be convinced that the cooperative's products are wonderful, they should recognize that advertising is needed to generate consumer awareness.

   b. Consistency with cooperative principles and regulations:
   A market orientation requires investments in tangible assets, which some cooperative specialists may contend undermine the user-benefit principle. However, this strategic orientation is intended to maximize returns to cooperative members in the long run.

   c. Applicability to cooperatives of varying sizes and commodities:
   Applicable to all cooperatives striving to be effective marketers of value-added products. A multiple-commodity cooperative may have more difficulty than a single-commodity cooperative in incorporating a market orientation in its strategic plan. Some commodities have greater product development opportunities. A cooperative may not have the capital to finance the product and market development of several commodities simultaneously. Thus, members may claim favoritism and object to the development efforts dedicated to one particular commodity.

   d. Ease of development and implementation:
   It is difficult for a user-controlled firm to shift its orientation from its users to its customers. The members must be convinced that their returns are maximized when the cooperative's customers' needs are served first.

2. Continuously educate board members on general marketing issues and the cooperative's marketing program.

   a. Description and justification:
   Most cooperatives' board members do not understand marketing and do not have the business backgrounds to be aware of marketing issues. They tend to view marketing issues from their producers' perspective, rather than as policymakers of a firm engaged in marketing. They need to become sensitized to customer needs and market trends and to have an general understanding of marketing principles. They should be aware of the lengthy product development process, the costs and benefits of developing brand equity, and the difficulties and importance of product distribution. Although board members will expect to see the benefits too quickly, they should be apprised of developments in the cooperative's marketing programs. Through repeated exposure, they will develop realistic expectations and sensitivity of marketing issues.

   b. Consistency with cooperative principles and regulations:
   Intended to promote user-control by having a better-informed Board.

   c. Applicability to cooperatives of varying sizes and commodities:
   Applicable to all cooperatives striving to be effective marketers of value-added products.

   d. Ease of development and implementation:
   Will require substantial effort by the cooperative's marketing staff. Board members should attend marketing seminars sponsored by universities, banks and other cooperative-oriented organizations. Marketing items should be presented at every board meeting.

3. Develop a diverse product line.
   a. Description and justification:
      Market-oriented firms must address the needs of very diverse consumer groups with rapidly changing tastes. A limited product line will meet the needs of a small number of customers. IOFs generally expand their product lines to appeal to a larger consumer base. A broad product line also allows a firm to achieve marketing economies by gaining greater awareness of its brand among consumers. The increased sales volume will spread overhead and advertising costs further. As a bigger account, the cooperative will gain attention from its brokers, retailers and consumers. The cooperative may find it advisable to buy other commodities and/or have the new products copacked. The diversification may also make the cooperative's earnings less susceptible to price fluctuations for its commodities.
   b. Consistency with cooperative principles and regulations:
      Some cooperative specialists may contend that such diversification compromises the user-benefit principle. It is intended to maximize the members' returns in the long-run by strengthening the cooperative's market position. A cooperative's ability to market nonmembers' product may be constrained by the 50% restriction on nonmember sales in Section 521 and the Capper Volstead Act; Section 521 also limits sales of nonproducers' products to 5% of an exempt cooperative's sales.
   c. Applicability to cooperatives of varying sizes and commodities:
      Applicable to all cooperatives striving to be effective marketers of value-added products. Multiple-commodity cooperatives will find it easier to broaden their product lines without purchasing raw product on the outside.
   d. Ease of development and implementation:
      Some Board members and cooperative members may object to the use of management time and capital to develop and market products that do not utilize the members' commodities. They should be advised of the long-term benefits from broadening the product line.

4. Engage in joint ventures to market products.
   a. Description and justification:
      In the literature review, it was noted that SunDiamond and Cooperating Brands provide buyers with single-source access to a full line of products of different brands. Alternatively, the joint venture could market the products under a single brand name. It could involve licensing with the cooperative as either the licensor or the licensee. Such joint ventures enable a cooperative to gain broader access to the marketplace without incurring the full costs (and returns) of doing so. They also provide marketing and production economies of scale and can be a good mechanism for cooperatives to advance on the learning curve for marketing value-added products.
   b. Consistency with cooperative principles and regulations:
      Some cooperative specialists may contend that such arrangements undermine the user-benefit and user-controlled principles. However, the potential increase in the members' returns can be substantial. The right of cooperatives to form joint marketing agreements is promoted by the Capper Volstead Act.
   c. Applicability to cooperatives of varying sizes and commodities:
      Applicable to all cooperatives striving to be effective marketers of value-added products. The parties involved in the Cooperating Brands venture are among the nation's largest cooperatives.
   d. Ease of development and implementation:
      Such arrangements should be considered to be long-term and the contractual documents should be reviewed very carefully by all of the parties involved.

5. Defer certain product and market development expenses.
   a. Description and justification:
      Will enhance the feasibility of diversifying the product line to become more market-oriented. The deferrals will spread the development costs over an extended period, thereby making the cooperative's returns more competitive as it initiates its value-added ventures.

b. Consistency with cooperative principles and regulations:
Promotes the user-benefit principle by tieing together more closely the costs and returns from new products. Deferrals are regulated by the Financial Accounting and Standards Board.

c. Applicability to cooperatives of varying sizes and commodities:
May be most helpful to smaller cooperatives that do not have the volume to spread high product and market development costs.

d. Ease of development and implementation:
Management should discuss this program with its audit firm prior to its implementation.

6. Expand the product line through acquisitions, as well as internal development.

a. Description and justification:
The acquisition of a value-added product line works in three ways to make a cooperative more market-oriented. First, it broadens the cooperative's product line quickly with relatively low risk. Second, the acquired firm can have management experienced with value-added products. The acquisition may be more viable than internal development because most of the cost of the acquisition (including goodwill) is depreciable.

b. Consistency with cooperative principles and regulations:
If the acquisition does not utilize the members' commodities, some may contend that it violates the user-benefit and user-financed principles. However, the intent is to increase user-benefits in the long-term. Using members' equity to acquire a firm that is not closely connected to the basic activities on an exempt cooperative is a violation of Section 521.

c. Applicability to cooperatives of varying sizes and commodities:
All types of cooperatives can benefit from the diversification provided by acquisitions.

d. Ease of development and implementation:
Larger cooperatives will be most likely to have the track record and equity base to obtain financing for the acquisition.

7. Expand the commodities delivered by members.

a. Description and justification:
The expansion could occur by merging with another cooperative or adding new commodities grown by its existing members and/or new members. The larger membership can also increase the cooperative's equity and enable it to spread its overhead costs.

b. Consistency with cooperative principles and regulations:
Such actions are usually protected by the Capper-Volstead Act.

c. Applicability to cooperatives of varying sizes and commodities:
The benefits of diversification will be most apparent to a small, single-commodity cooperative.

d. Ease of development and implementation:
Prior to initiating the program, the cooperative should closely evaluate the consistency of the new commodities with its strategic plan and their market potential. Some of the cooperative's existing members may be protective of management's attention to their deliveries and may not want to share their control with new members. They should be educated regarding the benefits of the action.

D. Suggested Programs for Fulfilling the Qualified Management Requirement

1. Provide competitive salaries and benefits to management.

a. Description and justification:
Cooperatives' difficulties in attracting management experienced with value-added products have been attributed to the low salaries that they have historically paid. As cooperatives strive to be effective marketers of value-added products, they need experienced management. In recent years, they have upgraded the quality of their management staff. Most of the cooperatives in this study paid some form of a bonus to their management. The size of the bonus was related to the cooperative's performance relative to its competitors' or to its stated business goals. Craycroft suggests that cooperatives pay bonuses in the form of a phantom stock plan instead of making cash payments, in order to reduce the cooperative's working capital requirements. Under the phantom stock plan,

"stock" would be issued to management with a certain base value. The base value is then adjusted annually based on the cooperative's performance. Each year, the managers can elect to: 1) continue their participation; or 2) cash out their shares and be precluded from reentering the plan.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that competitive management salaries and bonuses undermine the user-benefit principle by increasing the cooperative's costs. However, higher salaries may attract more qualified individuals who may earn higher returns for the members.

c. Applicability to cooperatives of varying sizes and commodities:
The salaries and bonuses should be commensurate with the qualifications required. Small cooperatives will not require managers with the same breadth and depth of experience as the larger cooperatives.

d. Ease of development and implementation:
Some board members may be reluctant to pay bonuses and raise salaries to competitive levels. The cooperative's audit firm may be able to advise the board on competitive salary levels. Management recruiting firms should be able to assist the board with its recruitment efforts.

2. Evaluate management on trends in the cooperative's performance.

a. Description and justification:
Management should be evaluated on trends in the cooperative's performance, rather than on a single year's results. As previously noted, a cooperative that is initiating a value-added strategy can incur high costs and generate low returns. The management involved in the development process should be judged on the basis of their improvement, rather than their comparative performance. There may be an exceptional year when returns in the commodity market exceed those of value-added marketers; on average, a cooperative with a well-developed value-added strategy will earn a premium return.

b. Consistency with cooperative principles and regulations:
The management's performance should be viewed in the context of accomplishing the strategic plan, which should be consistent with cooperative principles.

c. Applicability to cooperatives of varying sizes and commodities:
Applicable to all cooperatives striving to reward their management fairly.

d. Ease of development and implementation:
Board members may be reluctant to reward management when the cooperative is earning returns below those of its commodity-oriented competitors. However, the compensation should be viewed in the context of accomplishing the strategic plan; if the cooperative is progressing as planned, management should be rewarded for the success.

3. Limit the size of the board to twelve or fewer members.

a. Description and justification:
A cooperative can enhance its attractiveness to a potential management hire by providing a supportive structure. Large boards require more management attention and take valuable management time away from strategic and operational issues. As the number of board members increase, so does the likelihood that a board member will encroach into management's area of responsibility.

b. Consistency with cooperative principles and regulations:
Some cooperative specialists may contend that reducing the size of a cooperative's board violates the user-control principle because it decreases the amount of member representation.

c. Applicability to cooperatives of varying sizes and commodities:
Federated cooperatives and cooperatives handling numerous commodities are most likely to have large boards.

d. Ease of development and implementation:
Some members will resist the change. The cooperative's Articles of Incorporation or Bylaws will have to be changed.

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APPENDIX A
Financial Profile of Cooperatives

Royer identifies three ways members can contribute equity: direct investment through purchase of stock; reinvestment of net margins through retained patronage refunds; and deduction from sales proceeds in the form of per-unit capital retains. Direct investment is not very important—only 14.7% of new equity raised between 1980 and 1984 by the top 100 cooperatives was generated in this manner. Per unit retains seem best suited for cooperatives with marketing agreements. Cooperatives are also building equity from nonpatronage business. Unallocated retained equity grew from 10.8% of equity in 1962 to 16.8% in 1981 among top 100 cooperatives.

The report, *Farmer Cooperatives' Financial Profile, 1987* by Royer, Wissman and Kraenzle is based on the most recent study of U.S. agricultural cooperatives' financial structures conducted by USDA's Agricultural Cooperative Service. Marketing cooperatives have increased their use of unallocated equity. Among the marketing cooperatives surveyed, 19% of their equity was held as unallocated. They distributed 22% of their net margins in 1987 as unallocated equity, compared to 4% in 1970 and 6% in 1976. In 1987, they retained an additional 26% as allocated equity, while distributing 44% as cash patronage refunds. The cooperatives used 7% of their net margins to pay income taxes. Forty-one percent of the marketing cooperatives' assets were financed by equity, 27% by borrowed capital and 32% by other liabilities. Reliance on equity financing decreased as the size of the cooperative increased. The following equity capital sources will be described in detail: nonqualified allocations; unallocated equity from nonpatronage sources; delivery rights; public stock offerings; and venture capital.

In 1987, marketing cooperatives obtained 62% of the borrowed capital from the Banks for Cooperatives, compared to 73% in 1976. Leases, industrial development bonds, other cooperatives and other sources accounted for 20% of the cooperatives' borrowed capital. Ten percent of their debt financing came from commercial banks, and 8% from bonds and notes issued by the cooperative (usually as private placements with insurance companies.)

ABOUT THE CENTER FOR COOPERATIVES

The Center for Cooperatives was established by the California Legislature in 1987 as a center in support of research, education, and extension activities to "advance the body of knowledge, concerning cooperatives in general and address the needs of California's agricultural and nonagricultural cooperatives..."

The Center's objectives are to promote:

- EDUCATION. The Center offers formal and informal educational programs to those involved in cooperative management and develops teaching materials for all levels of interest.

- RESEARCH. To help the state's cooperatives reach their objectives, research is conducted on economic, social, and technical developments. A practical aspect of this research: the provision of competitive research grants, and studies for government agencies on how cooperatives can help achieve public policy objectives.

- OUTREACH. The Center is prepared to inform the public on cooperatives and their significance to the economy of California.

Located on the University of California, Davis campus, the Center is a University-wide academic unit. Its teaching and research resources are drawn from interested professionals from all University of California and state university campuses, other colleges and universities, as well as sources indigenous to the cooperative business community.

The Center is prepared to receive gifts and contributions from the public, foundations, cooperatives and other like sources and is establishing an Endowment Fund.

For information about the Center or its programs or publications, call 916-752-2408 — FAX 916-752-5451 or write: The Center for Cooperatives, UC Davis, Davis, CA 95616.