COOPERATIVES CONSOLIDATE

Response to the Changing Structure of the U.S. Food Industry

BY DARREN HUDSON AND
C.W. HERNDON, JR.

Signs of the times: This crop input supply business in Hazen, Arkansas flew the colors of Terra International in 1999. Later that same year it became an Agro Distribution LLC outlet owned by Cenex. Now it is part of a pending deal that would bring it under the Royster-Clark banner.

photo courtesy Clear Window

The U.S. food and fiber system continues to evolve, driven by globalization, technological change, stagnant demand for food, and other political and economic forces. As a result, actors in the food system — processors, wholesalers, input dealers, and the like — have had to be creative in order to sustain their growth and maintain their value. One consequence has been increased consolidation.

Farmer-owned cooperatives have been caught up in this trend. Cooperatives comprise an important part of the overall agricultural sector, marketing 37.5 percent of all farm products and handling about 20 percent of all farm supplies in 1999 (USDA/RB-CS 1999). Given their present and historical importance, it is relevant to inquire how agricultural cooperatives are responding to, or participating in, the changing structure of agriculture.

Let's Get Together: M&A Activity in Cooperatives

Merger and acquisition (M&A) activities are changing the structure of agricultural cooperatives. Two recent studies by Parks and Manfredo and by Hudson and Herndon provide perspectives on the extent of these activities. Both studies examined the use of mergers, acquisitions, joint ventures, and strategic alliances. The increasing use of M&A strategies is clear (Figure 1); Parks and Manfredo suggest that total M&A activity among agricultural cooperatives increased about 142 percent over the 1991-1997 period — a figure similar to merger activity in other parts of the economy.

In our survey of 99 responding agricultural cooperatives, we found that about 79 percent had been offered an opportunity to participate in an M&A activity between 1995 and 2000. About 81 percent of those receiving an offer accepted at least one M&A activity. Approximately 60 percent of these participated in more than one activity over the five-year period. While the proportion of large agricultural cooperatives engaged in M&A activity is greater than the proportion for the smaller firms, it is clear that M&A activity is widespread among smaller cooperatives.

Behind the Urge to Merge

A variety of motivations prompt M&A activity, but two primary motivations appear to be capital constraints and concerns about the costs of doing business. The Parks and Manfredo study utilized time series data from M&A activity among the largest 100 cooperatives to highlight the importance of capital constraints on M&A. They conclude that the inability to raise equity capital sometimes forces cooperatives to merge or coordinate activities if they wish to expand. However, the Parks and Manfredo data set prevented the study of other microeconomic factors such as management control and diversification, which could mitigate the importance of capital constraints.

A cursory look at our survey suggests that capital constraints are not primary motivating factors. Only seven percent of the respondents cited "financial constraints forced the M&A activity" as the first or second most important reason for their most recent M&A activity. However, "increasing the size (scale) of the cooperative to cover increasing fixed costs of operation" was cited by about 25 percent of the respondents, suggesting that cost considerations were at least a part of the motivation. Parks and Manfredo's study worked with time series while this study used cross-sectional information, so the two are not entirely comparable. In spite of this, the two studies suggest that capital constraints pose a challenge to cooperatives and may drive M&A activity.

In our study, the most common reason (34 percent) given for becoming involved in M&A activity was to "streamline operations (reduce costs) by eliminating duplicated services and personnel between firms." This suggests cost reduction as a primary factor for M&A activity. For many cooperatives, sales growth has been slow due to stagnant demand for food and declining farm numbers. Additionally, publicly traded food marketing companies report low growth in sales (between one and seven percent) over the past five years.

These factors, coupled with the rise of large national and multinational companies and increasing numbers of contract farming operations — most of which bypass agricultural cooperatives — may all serve to decrease sales. Thus, the only means available for many cooperatives to increase or even maintain shareholder value is to reduce costs.

The need to reduce costs is emphasized by the two thirds of respondents who reported that their most recent M&A

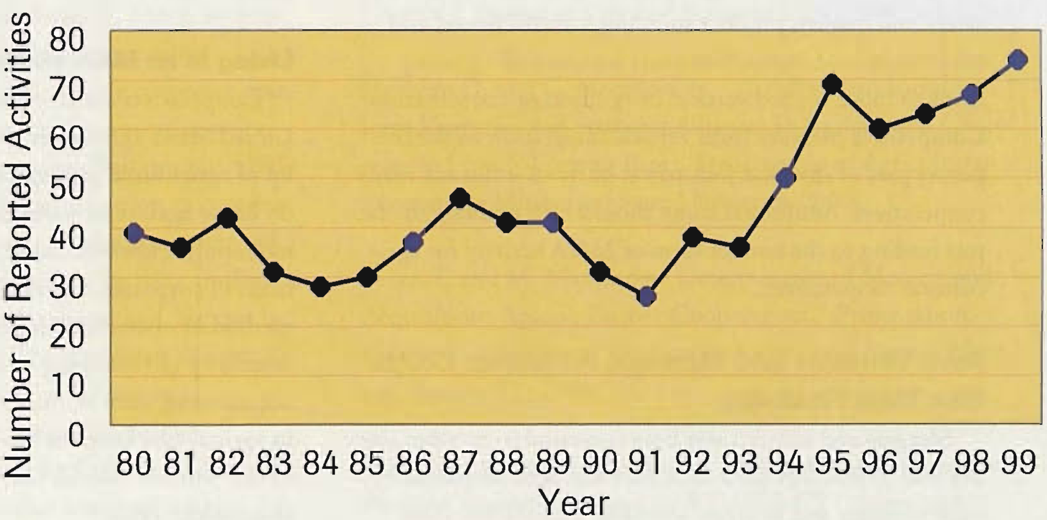

Figure 1. Number of Reported Mergers, Acquisitions, Joint Ventures, or Strategic Alliances in Agricultural Cooperatives, 1980-1999.

activity was horizontal in nature. Horizontal integration involves expanding while staying within present market channels and the present range of activities. This outcome appears to be consistent with cost reduction strategies, but the implications for cooperatives' abilities to compete in the future are unclear.

The other third of the M&A activity among cooperatives was vertical in nature. Noel Estenson, former Chief Execu-

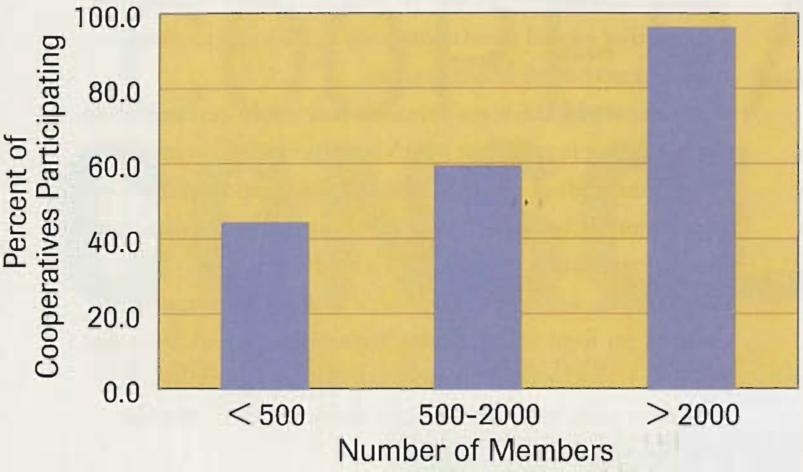

Figure 2. Proportion of Cooperatives Participating in M&A Activity by Number of Members of the Group (N=99).

tive Officer of Cenex/Harvest States, suggests that many cooperatives are attempting to become "food centers." That is, many cooperatives are trying to move into vertically integrated or coordinated value chains that deliver food from "field to plate" using highly integrated services. Food safety and quality, product sourcing, control issues, and other sources of transaction costs are compelling many firms to move toward vertical integration or coordination. Competitive pressure from vertical integration in the corporate part of the food industry is likely to influence many cooperatives. Additional study should help evaluate the factors leading to the correct form of M&A activity for agricultural cooperatives.

Joint Ventures and Strategic Alliances: Coops Flex Their Flexibility

Mergers and acquisitions have increased in number since the mid-1990s, but their incidence has been surpassed by joint ventures and strategic alliances. The shift to these forms of business organization (Figure 3) may stem from perceptions regarding the flexibility associated with the two types of organizational structures. About 60 percent of responding cooperatives agreed with the statement: "In general, a joint venture or strategic alliance with another cooperative offers more flexibility than a merger or acquisition." The importance of flexibility depends on the situation. However, in a world of rapid changes in consumer demand, flexibility is an important aspect of a cooperative's ability to adapt.

A cooperative that has developed a new line of food products without having access to appropriate market channels could merge with a distributor in order to gain the needed access. However, the merger may result in the cooperative losing its identity and options for subsequent changes in its business. The cooperative could acquire the distributor, assuming capital constraints do not prevent it. The cooperative could choose to exit this new type of business, but to do so it would need to divest newly acquired assets.

Alternatively, the cooperative could form a joint venture or a strategic alliance with the distributor. Although the cooperative might encounter contractual problems with joint ventures and strategic alliances, this action allows access to market channels without the permanency or the cost of a merger or acquisition.

Rapidly changing consumer demand has increased the risk associated with ownership through mergers and acquisitions, so many cooperatives are favoring the flexibility of joint ventures and strategic alliances. However, this may simply be a capital constraint story in which cooperatives are utilizing joint ventures and strategic alliances to play the consolidation game at somewhat lower cost.

Living in an M&A World

Cooperatives are an economic and cultural mainstay in United States agriculture. Historically, they have been made up of agricultural producers who have banded together to do battle against an unforgiving market or a corporate monopoly. However, many cooperatives now resemble firms in corporate America. This change in organization or method of operation has been required, at least to some extent, by the changing structure of agriculture. Mergers, acquisitions, joint ventures and strategic alliances abound in agricultural cooperatives for many of the same reasons as in the "outside" world: increasing or maintaining shareholder value.

Informal comments made by the CEOs of several of the largest agricultural cooperatives in the U.S. indicate that the compelling reason for participating in M&A activity is "fear:" fear that their cooperatives will not be able to compete effectively with corporate and cooperative counterparts who are actively pursuing M&A activities. As their competitors increase in size and market power, these CEOs feel obliged to seek opportunities to respond by enhancing their own size and market power.

The challenges for cooperatives appear to be twofold. First, capital constraints and the need for M&A activity has increased the complexity of the environment in which cooperatives must operate. Perhaps it is time to reconsider the rules for financing cooperatives to allow such things as the limited issuance of equity capital. There are many challenges to creative financing, but gaining flexibility for adaptation appears to be an essential ingredient for the long-term survival of cooperatives.

Second, cooperatives appear to be adjusting in much the same manner as their corporate relatives. However, cooperatives are producer-owned organizations. The increasing size and organizational complexity of cooperatives stemming from mergers and other joint efforts only serves to increase the detachment between ownership and management, creating potential agency conflicts and a potential skepticism on the part of producer-owners that their cooperative is really "working for them."

Most cooperatives were formed with the goal of enhancing producer welfare either through increased market power or decreased input costs. The current M&A wave may serve to undermine confidence in the linkage between these goals and the activities of the cooperatives. At the same time, survival and growth is essential to achieving and furthering the original goals of the cooperative. Exhibiting adequate sales growth and enhancing shareholder value in an environment of stagnant demand for food is challenging. M&A activity may be the only avenue open to achieve those goals.

As cooperatives are forced to operate in a corporate manner, the incongruence of corporate and cooperative objectives is likely to become more apparent. Will this ultimately lead to producer withdrawal from participation in cooperatives? We cannot say for certain, but producers are shrewd and will demand alternative motivations for their continued participation in these restructured cooperatives. Success in enhancing shareholder wealth will help mitigate distaste for "corporate" behavior, but the slightest failure may undermine producer motivation for participation.

Our work, along with that done by Parks and Manfredo, and by others, provides evidence that cooperatives are responding to the changing structure of agriculture. Nonetheless, challenges abound. Will cooperatives successfully realign themselves? We cannot be sure. However, it appears that many cooperatives are aggressively pursuing a strategy of realignment. One thing seems clear: the face of agricultural cooperatives is changing rapidly. With that change, the days of most small, local, user-friendly cooperatives are likely numbered.

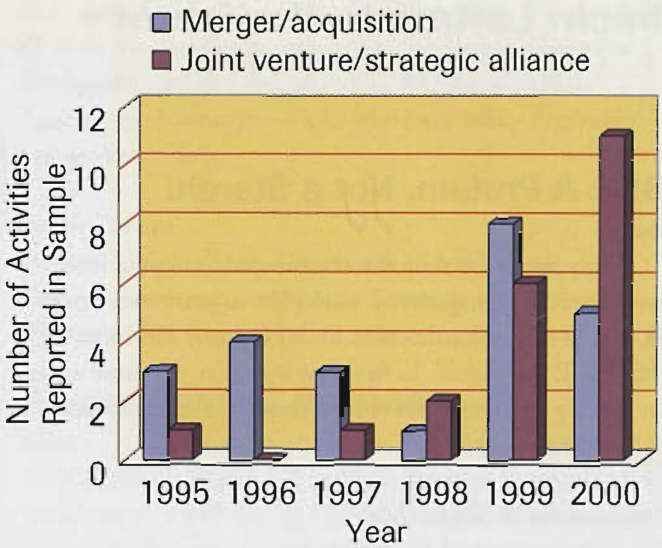

Figure 3. Number of Mergers and Acquisitions (M/A) and Joint Ventures and Strategic Alliances (JV/SA) Engaged in by Agricultural Cooperatives, 1995-2000 (N=99).

For More Information

Estenson, N. "Challenges and Issues Facing Cooperatives in a Consolidating and Integrating Environment." Presentation to the Second Annual Conference on the Future of Agriculture, Athens, GA, 10-11 August 2000.

Fama, E. and M. Jensen. "Separation of Ownership from Control." *Journal of Law and Economics,* 26(1983):301-325.

Hudson, D. and C. Herndon, Jr. "Mergers, Acquisitions, Joint Ventures, and Strategic Alliances in Agricultural Cooperatives." Staff Working Paper, Department of Agricultural Economics, Mississippi State University, 2000.

Parks, T. and M. Manfredo. "Determinants of Mergers and Acquisitions Among Farmer Cooperatives." Presentation, American Agricultural Economics Association Annual Meeting, Tampa, FL, 2000.

U.S. Department of Agriculture. *Understanding Cooperatives: Farmer Cooperative Statistics.* USDA/RB-CS Cooperative Information Report 45, Section 13, Washington, DC, December 1996.

Darren Hudson is Associate Professor in the Department of Agricultural Economics at Mississippi State University. C.W. Herndon is Professor in the Department of Agricultural Economics at Mississippi State University.