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INNOVATIONS



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IN COOPERATIVE FINANCE

Proceedings of the
December 1990
Conference

Sponsored by
University of California, Davis,
Center for
Cooperatives

\$6.00

INNOVATIONS IN COOPERATIVE FINANCE

Proceedings of the conference
sponsored by

University of California • Center for Cooperatives
December 1990

PARTICIPANTS

Richard P. Castanias

Associate Professor, Graduate School of Management
University of California Davis

Rick received his Ph.D. from Carnegie-Mellon University in financial economics. He had formerly worked as an industrial engineer for U.S. Steel Corporation. His expertise is in accounting, finance and economics. Rick contributes to top academic journals in areas of financial accounting, corporate financial policy and economics. He is a frequent reviewer and member of the editorial board for top professional and academic journals. He was presented the Outstanding Teacher Award for 1984-85 by the students in the Graduate School of Management. In 1990, Rick received a grant from the Center for Cooperatives to fund the project, *A Survey of Cooperative Capitalization and Financing Problems and Innovations*.

Robert A. Collins

Naumes Family Professor, Institute of Agribusiness
Leavey School of Business and Administration
Santa Clara University

Bob held a position as professor in the Agricultural Economics Department at UC Davis from 1978 to 1985 which he left to accept an appointment at the University of Arkansas. In 1989 he joined the faculty at Santa Clara University. He received his B.A. from Graceland College and his M.A. and Ph.D. in Economics from the University of Missouri. In his role as professor at UC Davis, University of Arkansas, Northwest Missouri State University and Columbia College, he has served on a number of academic and research committees including the Giannini Foundation Board of Directors. He has authored more than 24 publications in refereed journals. In 1990 Bob was awarded a grant from the Center for Cooperatives to work on a project titled *Conversion of Cooperatives to Corporations: Etiology and Deterrence*. An article resulting from this effort has been submitted to the *Western Journal of Agricultural Economics*. A publication by the Center for Cooperatives is pending.

George Crispin

Vice President of Production Planning,
Copacks and Procurement
Agripac, Inc., Salem Oregon

George received a B.S. in business administration from California State University Hayward in 1974. Prior to joining Agripac, he was employed by Del Monte Corporation in various positions in corporate planning and business development. George

joined Agripac in 1984 in his present position. Headquartered in Salem, Oregon, Agripac is a grower-owned cooperative engaged in the canning and freezing of fruits and vegetables. The company has annual sales in excess of \$150 million.

John M. Howland

President and Chief Executive Officer
American Rice, Inc., Houston, Texas

Prior to joining American Rice, John received his BA from the University of Alabama and MBA from the University of North Dakota. He served at the rank of Captain in the United States Air Force from 1970-1974 and was associated with Kearney Management Consultants and Touche Ross & Co. In his present position, John is President of a public corporation engaged in the marketing, processing and trading of rice. Approximately seventy-five percent of ARI's business is exported worldwide to over twenty-eight countries. The Company's sales volume last year was in excess of \$170 million. The company was reorganized in April of 1988 to a publicly owned corporation from a farmer-owned cooperative.

Donald Shulak

Executive Vice President & Chief Financial Officer
Tri Valley Growers, San Francisco, California

Don joined Tri Valley Growers as a consultant to the Vice President of Finance in 1971. He was named Senior Vice President in 1974 and Executive Vice President and Chief Financial Officer in 1983. A graduate of Ohio State University, he received a law degree from the University of Toledo, College of Law in 1960. He is a licensed attorney and a Certified Public Accountant.

Randall E. Torgerson

Administrator of Agricultural Cooperative Service
U. S. Department of Agriculture, Washington, D.C.

In 1974 Randy came to the USDA as a staff economist to the administrator of USDA's Agricultural Marketing Service. Prior to that time he had been a faculty member at the University of Missouri-Columbia and helped organize the Missouri Institute of Cooperatives where he served as executive secretary from 1969-73. He also helped form and served as executive secretary of the Graduate Institute of Cooperative Leadership, University of Missouri, 1971-74. As Administrator at ACS, Randy directs the research and technical assistance efforts of a staff of 69 people, primarily agricultural economists and cooperative specialists. He lectures frequently and is a prolific writer of articles, speeches, editorials and position papers on group action in agriculture.

PREFACE

These papers were presented at a conference sponsored by the Center for Cooperatives in December 1990.

In recent years there has been a number of cooperatives in the United States that have significantly modified their basic structure by either selling out to an investor owned firm (IOF), or organizing a subsidiary where the cooperative retains a majority share of the stock and sells the remaining stock to the general public. Professor Collin, following Schrader's initial work, lists three possible motives for these actions. First, the desire of the cooperative to increase its equity base in order to expand market share through asset expansion. Second, the liquidation motive where members of the cooperative nearing retirement wish to liquidate their share of the equity including the market value of the assets. The third motivation is a takeover bid from an IOF because it fits into the expansion plan of a competing corporation.

The first paper in these proceedings is John Howland's presentation of the "American Rice International Story." Howland draws a picture of the environment in 1988 when the membership of ARI voted to form a new firm and sell out their equity share to an IOF while retaining 52 percent of the voting stock in the new corporation.

The second paper in the series is Professor Collin's paper "An Economic Evaluation of Cooperative Restructuring" where he looks at the experience of several cooperatives that have recently gone through a restructuring. The third paper is by Professor Castanias, who reports on "Problems and Issues in Cooperative Financing."

The fourth paper by Randall Torgerson, Administrator of the Agricultural Cooperative Service is a rebuttal of the trend towards privatization titled "Why Cooperatives Should Stay Cooperatives". The last two papers are cases in point where cooperatives have attempted to satisfy the liquidity motive by creating secondary markets in either their base capital plan or transferable delivery rights. These two papers are by Don Schulak, CFO of Tri Valley Growers and by George Crispin, Vice President of Agripac.

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ARI STORY

John Howland

I'm going to talk about not how we went public, but why the decision was made to go public. Going public is a very mechanical kind of thing. There is a whole mirage of SEC and IRS problems to contend with, but it's very mechanical in nature. It can be done, but I think what I would prefer to dwell on this morning is why the farmers or the members of American Rice made the decision to go public.

What I want to talk about first is what American Rice was as a cooperative. We were the largest international marketer of branded rice products in the world who marketed rice in 28 countries. We had a 50% ownership in a joint venture called Comet American Marketing (CAM) that marketed branded products in the U.S. We had approximately a 10% US domestic share. We had a competitive edge over the industry for a number of reasons, that we will talk about shortly. We were privately owned as a cooperative by 2300 rice farmers in the states of Texas, Louisiana and Mississippi and a few in Arkansas. That's kind of how we were postured. Sales volume—We did about \$233 million dollars a year, \$176 million of that was international business, the balance of it was through the CAM joint venture. Employees—we had about 455 employees between the two. We were a very typical cooperative. We were operating on a pooled marketing basis. The members were committed to deliver a 100% of their crop to ARI every year.

The competitive edge we had over some of the others in the rice industry, particularly in the south was that we were a branded organization. Approximately 75% of our products went into brands either internationally or domestically. And as cooperatives go, that is a fairly high proportion. Most cooperatives in the rice business did not have that kind of brand orientation. They were a more commodity type operation. We were farmer supplied. As I mentioned earlier, the producer had to commit 100% of their crop to ARI. We had very strong government relationships. The rice industry has historically had a very strong government support program. We were very active in that. The producers were legislatively very active in Washington.

We have a brand new facility in Freeport, Texas—a state of the art type facility that had just been constructed the year before. It could export as well as import rice. We owned 40 acres of land in downtown Houston. Those things we all felt gave us a very strong base as a cooperative.

Now I'd like to talk a little bit about the rice industry in general so that you all have a feeling of the competitive trends that are out there. That's important in understanding why this decision was made. If you look at world production in Figure 1, you'll notice that the US in that little wedge is 6.1 million metric tons. We're insignificant in the scheme of things. A 5% crop change in China, for instance, is bigger than our whole crop. It's a very thin position we hold in the world. Very small. If you look on the chart you'll see China is huge and India is huge. Some of the lesser countries, like Thailand, are the biggest exporters of rice in the world. The US with the small crop we have, is the 2nd largest exporter in the world. There are wide swings in the price of rice because it's such a thinly traded commodity. Prices can go from \$4 to \$13 in a couple of months time and we've seen that happen in the 1980s. If you look at the major importers in the world, there aren't very many of them. China used to import, now they are exporting.

One thing I should have pointed out earlier on is that these figures were the same figures that were used at grower presentations back in 1988 when they made the decision to do this transaction. So if this data looks dated, it's that way intentionally because I wanted you to see the same facts that the growers were looking at when they made this decision.

Most of the numbers you will see in these slides have not changed since 1987 or 1988 and those that have I'll try to point out as I go along. In 1987 the biggest customer for US rice was Iraq with 25% of US exports. Of the southern crop, even a higher percentage went to Iraq. We were not able to export to Iran for political reasons. The Common Market shows up as an importer of rice (see Figure 2), but you'll see in Figure 3 they are

WORLD PRODUCTION
MILLION METRIC TONS

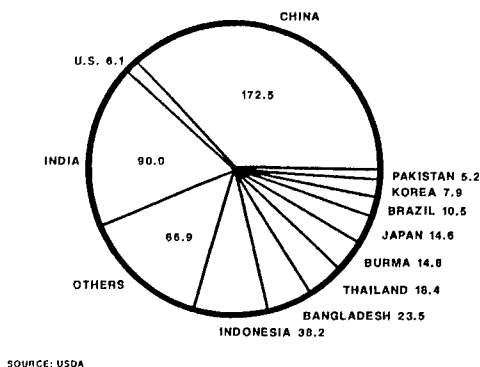


figure 1

WORLD IMPORTS
MILLION METRIC TONS 1987

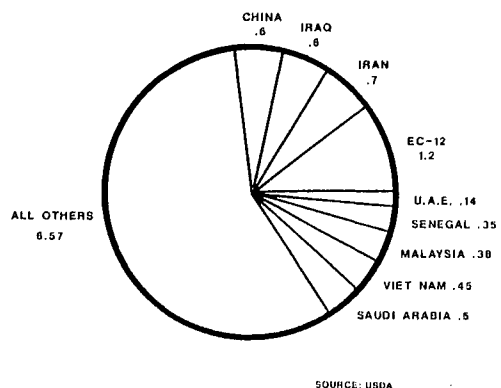


figure 2

also one of the biggest exporters. They import rice under a tariff structure they have that in effect allows them to bring in a semi-processed rice and turn around and re-export rice under what you would call an export enhancement program. In the US that gives them an unfair advantage in terms of markets they can get to that we cannot. So they show up as an importer, but they are also a large exporter of rice. The Arab Emirates imports are very small. The only other big market is Saudi Arabia and ARI has dominated that market. We have about an 80% US market share there. It's the best rice market in the world. They pay cash in advance and purchase lots of rice. We ship about 3 million 100 pound bags of rice a year to Saudi Arabia. It's all branded and the leading consumer size package there is 100 lb. bag. In the parboiled rice category, 6 million people in Saudi Arabia eat more of that type of rice than everyone in the US combined. That's how big a rice market it is. ARI has historically dominated that market. We have about an 80% market share of the branded type product. As you can see on Figure 2, there were not many markets the US could get to. Vietnam shows up as an importer. They are now the third largest exporter of rice and growing very rapidly. In terms of where we could go, we were very limited. We could not get to Vietnam, Malaysia, Senegal, Iran, or China and all the rest of those markets were so small that they don't bear mentioning.

If you look at the major exporters in Figure 3 and where they were in the ranking, it's very similar today with one exception. Thailand was number 1, the US was number 2 and then we had the Common Market which you saw is an importer—we'll they imported and exported as I mentioned before. China also goes both ways. China will import low quality rice to feed their people and export their high quality to earn foreign currency. Pakistan, Burma and Australia are all exporters. Today, Vietnam is sandwiched in between the US and the Common Market. Now if you look at world production of rice in Figure 4 and what has happened between 1981 and 1987 on an annualized basis, you'll notice that all the major countries in the world have increased their production significantly with the exception of the US. The US has experienced a significant reduction in production compared to the rest of the world. When you look at a 4% increase—it doesn't look like a huge percentage increase, but when you put that on China's base as you recall earlier, that's a huge amount of rice and the same with India and some of the other countries. Now, they have very fast growing populations. Notwithstanding that, when you put that percent-

MAJOR EXPORTERS

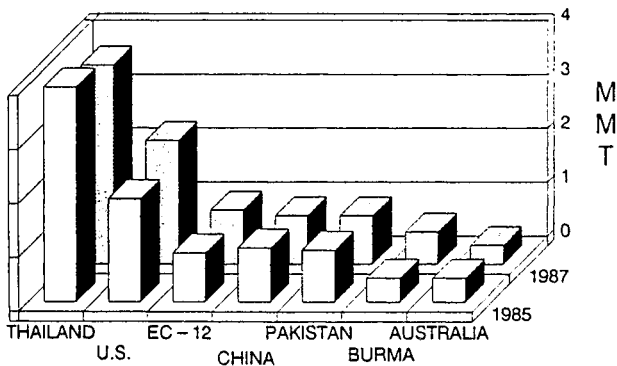


figure 3

age increase on those basis—on an annual basis over that period of time, it's a very large number. What is significant is that the US production on a comparative basis is going down.

WORLD PRODUCTION

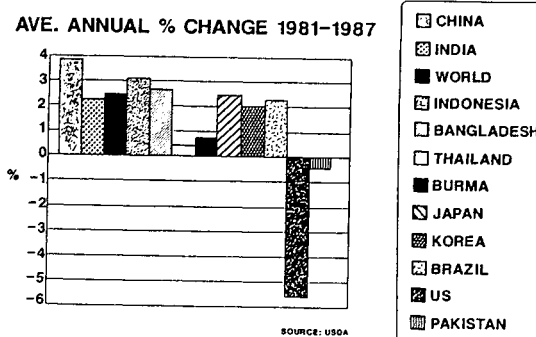


figure 4

The marketing record of ARI, if you were to look at it over a period of time from 1976 when it started till 1986, looked pretty much like this (Figure 5). As a cooperative it was very successful. It historically paid its patrons considerably more on a per unit basis than the average US price of rice. The average price of rice is in white, what the ARI member received is in black. On a pure commodity basis, which a cwt of pure rough rice is, that's a fairly significant spread. What should be noticed is not how much ARI beat the average price, but the significant decline in prices to rice growers as you approach 1986.



figure 5

A fundamental thing, I believe, is that a cooperative is only as healthy as its underlying membership base. A cooperative is very difficult to take on in the market place, but when a cooperative becomes very weak, very quickly its membership base starts decaying for many reasons. It's the membership base that is the underlying strength of the cooperative. You will see in this presentation why the ARI membership base was becoming much weaker and that is something you should focus on.

ARI marketed in 28 countries, around the world. ARI marketed rice almost everywhere that US rice was sold. The predominant market was Saudi Arabia. Domestically we marketed much like a US food company would. We had three domestic groups. We had a grocery products group, which markets the products you see on the food store shelf. The brands; Blue Ribbon brands, Comet brands, Family Recipe brands. Those brands are all owned by ARI and were marketed very

much like anyone else markets a brand and a product through the grocery store. The domestic institutional group marketed food products institutionally to hospitals, schools and other institutional customers. We had a very large market share in the Caribbean market because of our proximity to the gulf coast. Examining market shares, (Table 1) the numbers on the left represent the highest per capita market consumption in the country and on the right you see what ARI's market share was in those markets. For instance if you look at Houston, we had over a 50% market share, Charleston/Savannah interestingly is the number one per capita market in the country. We had over 50% market share there. The only thing I would point out is about 80% of the rice is sold in 13 states in this country and it's all your coastal states. So you can start in Boston, then go right down the coast around the south, Louisiana, Texas, California and up through Washington. That's where most of the rice is sold. The people who eat rice in this country are largely the ethnic minorities, the blacks, hispanics, and the Asians. In the US, the typical US Caucasian who has European roots is not a rice consuming individual. They eat potatoes. We could sell all the rice that the state of Nebraska consumes for instance, and it wouldn't run our rice mill for one day for a whole year's worth of consumption. We sell a surprising amount of rice in this country in 100 lb. bags on super market shelves in different ethnic markets. The markets for large volumes of rice domestically is very limited essentially the large seaboard cities.

COMET AMERICAN MARKETING RETAIL SALES		
U.S. Rank Consumption	City	Market Share-Major Markets 52 Week 1/1/89
4	Houston	52.1%
17	Dallas/Ft. Worth	12.0%
12	El Paso, Albuq. & Lubbock	34.8%
8	San Antonio/Corpus	49.6%
24	Oklahoma City/Tulsa	7.4%
2	New Orleans	4.4%

6	San Francisco	5.2%
7	Los Angeles/San Diego	8.8%
21	Salt Lake City/Boise	22.2%

15	Atlanta	2.7%
10	Charlotte, N.C.	40.3%
1	Charleston/Savannah	50.8%
16	Greenville/Spartanburg/Ash	28.8%
25	Louisville/Lexington	3.1%
9	Raleigh/Grnb/W.S.	38.0%
20	Richmond/Norfolk	23.8%

3	New York	0.9%
13	Boston/Providence	6.1%
11	Hartford/New Haven/Spngfld	1.5%
22	Buffalo/Rochester	9.4%
19	Albany	1.1%

Table 1

ARI has a relatively new facility in Freeport, Texas. I'm not going to go through all the numbers on this facility except to tell you that it's a huge facility (See Table 2). It's one of the biggest of its kind. Those numbers if you know anything about rice processing, are huge in comparison to most facilities around the country. The facility produces most rice products including parboiled rice, white rice, brown rice and instant rice. It's a big rice processing facility and it's designed to both import and export rice. The facility dominates much of the Port of Freeport. It has about 180,000 square ft. of warehouse space on the deep water. The rice comes out of the mill through the warehouse and on to the ships. It's fairly economical and fairly effective. If you were to build that facility today and the accompanying docks and the warehouses, it would likely cost approximately a hundred million dollars.

In downtown Houston, ARI owns a block of land that is approximately 40 acres in size. That's where the old mill was historically, today it stores milo for the US government. Most of the surrounding land is park. So it's a very attractive piece of real estate. As the Houston market gets stronger, which it is today, that land should be very valuable to the company.

FREERPORT FACILITY

- * Newest/Most Efficient In Industry
- * Capacities
 - Parboil 5,000,000 cwts.
 - White 7,000,000 cwts.
 - Instant 10,000,000 lbs.
 - Shipping 300,000 tons
- * 360,000 Square Feet Shipping Warehouse
- * Only Rice Mill On Deep Water
- * Logistical Capabilities
 - Deep Water
 - Rail
 - Truck
 - Barge
- * Replacement Value - \$101,000,000
- * Foreign Trade Zone
- * Non-Union Port

Table 2

You ask yourself, with all those things going for it, why did these rice producers want to unload it and stop being a cooperative? In 1987 the Board of Directors hired Touche Ross out of San Francisco. They devised a strategic plan for the Board of Directors of ARI. They went out and they talked to the growers and they asked the growers, what do you want out of this cooperative? What do you want from ARI? If you look at this, they wanted their cake and to eat it too. They said, take all my rice, give me the highest price you can get for it, let me get all of my cash out of ARI and let me maintain control of ARI. That's what we want. And they were very sincere about this. I think that if many of you went out and asked your patrons what do you want out of your cooperative, you'd get a list that looks somewhat like this. If you think about it, it's not a bad deal if you can get it, but there is no Santa Claus. Many of those things are in conflict with each other. By and large that's what they said across the entire membership.

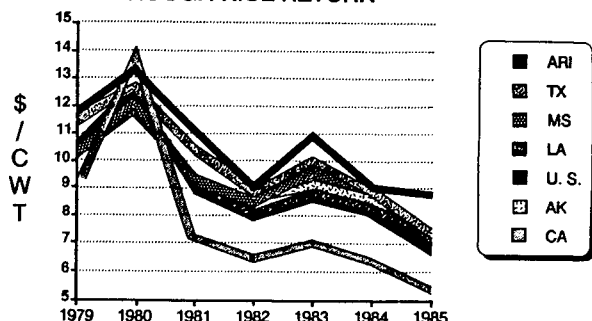
One of the first things Touche Ross did in the strategic plan was to examine the world rice situation. Touche Ross said the importance of the US would continue to decline. We are not going to increase rice production significantly and when you look at the subsidies being paid to rice, I think you will see why. Rice, historically has been a very highly subsidized crop on a per acre basis. I think we're fooling ourselves, if we think that we are going to increase rice production significantly with our water problems. US rice companies must pursue new world markets if we're going to stay in business. That's kind of how things looked in the world and you saw the background for that on some of the other charts. In the US, in terms of what's happening in the US rice industry, Touche Ross said increased competition and the lack of capital will make ARI non-competitive. ARI had about \$20 million in capital that the growers had put up. Federal budget deficits will put downward pressure on farm subsidies. Now keep in mind the time frame we're talking about right now is 1987—1988. If you look at the rice industry prices in Figure 6, it parallels a chart I showed you earlier on the

return to ARI growers. This chart does it just on a rice per cwt. basis across the different states. You notice California is lower. California is by and large a medium grain market and it has a dollar per cwt support less than long grain markets, so when you see that line lower for California, you almost have to take them out of the equation when you look to the south. The south is the basis for comparison. In the south when you see the states are all fairly close to each other. You notice ARI's return was higher than the southern average for all of those years, but the unmistakable trend is downward.

The federal farm subsidies paid on a per acre basis to various crops is shown in Figure 7. The rice industry has been very effective legislatively. I mentioned before we were strong politically and this is no accident. Rice is a very highly subsidized crop, always has been and to be effective in the future, probably always will be. You can grow rice in Thailand for about \$5.00 per hundred pounds, you can grow rice in the

If you look at the rice acre comparison in Figure 10 depicting where the acreage is being lost in various states, you'll notice the greatest acreage reduction is in Texas. The water cost in Texas is higher than the other states in the south. Additionally the farms were larger in Texas than in the other states and the new farm programs came in the mid 1980s were skewed to be more advantageous toward the smaller farms in terms of the way the marketing loan program worked for rice. The average size farm that could max out in terms of benefits was about 180 acres. The average Texas farm was 560 acres resulting in a great amount of acreage being lost in Texas thus going out of production. About 60% of the members of ARI who held most of the equity in ARI on a patronage basis were in the state of Texas. Louisiana was next and Mississippi was the 3rd state that came in most recently. But about 92% of the patrons came from Texas—Louisiana and Mississippi made up the balance. When a cooperative is liquidated or goes public, the IRS says the equity has to go back on a patronage basis from day one. A minimum of ten years, but preferably back to day one. If you looked at ARI acreage historically, Texas controlled most of it, then Louisiana and then Mississippi. Texas farmers looked at their acreage as being the acreage going out of production first.

RICE INDUSTRY PRICES
ROUGH RICE RETURN



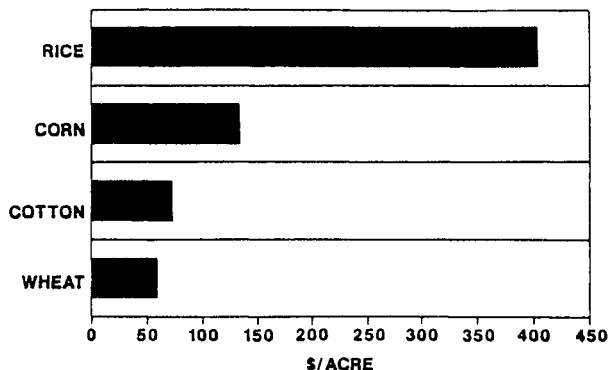
SOURCE: USDA & ARI DATA

figure 6

south at \$8.00 to \$9.00 per hundred pounds. To compete in the world it's going to take subsidies for US rice. Effective as the south has been legislatively on rice, I think maybe the producers felt that they could not sustain this long term. I think it's a very valid judgment. These subsidies are down somewhat on rice, but by and large they are still much higher than they are on other crops on a per acre basis.

FEDERAL FARM SUBSIDIES

(EST. FY 1987)

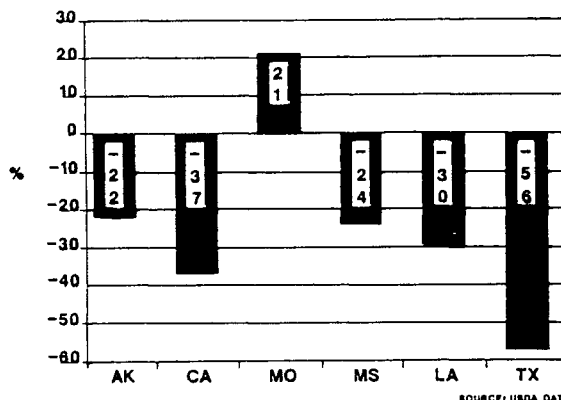


SOURCE: INSIGHT MAGAZINE

figure 7

RICE ACREAGE COMPARISON

(1980-1987 INDICATED CHANGE)



SOURCE: USDA DATA

figure 8

Touche Ross said the value added to rice will continue to move from producer to the retail level and competition for branded rice markets will increase due to well capitalized food markets. Here is a slide (Figure 9), that compares a period of time - 1975 to 1986. This is at a per \$1.00 value in terms of where the percentage amount of that dollar went, either to the farm level, the mill level (the middle man level if you will) or the retail level. You will notice that today a smaller amount of the dollar is going to the producer level. I don't think that will surprise any of the producers in this room. A growing amount of the dollar is going to the retail level. It has a lot to do with the new products coming out, quick cook products, microwave product, those products that are adding considerable amount of value over the commodity side. You see a greater amount of the return coming from downstream processing. If you look at some significant events in the rice industry, in 1986 Quaker purchased Golden Grain which owns the Rice-a-Roni line. Heinz purchased Near East Foods and ADM purchased two rice mills. These were all new companies to the rice industry in 1986. In 1987, ARI completed the Freeport facility for about 40

million dollars in cash. If you will compare ARI to the other big rice cooperatives in the south (See Figure 10), you will see Producers was the smallest of the three, ARI was kind of in between with Riceland Foods being the largest. Compared to some of the people we competed with, particularly ADM and Con-Agra, We were insignificant in terms of size to either equity or revenues.

If you examine the value added marketers (see Figure 11), that we had to compete with, you notice that in terms of either equity or revenues, we were very small. What is significant, three of those companies, Heinz, Quaker Oats and Lipton, all entered the rice market in about 1985 to 1986. Prior to that we did not have to compete with them. In the late 70s, the rice

in the branded business per se, as you would think of a company having large branded markets. ARI was 75% in the branded business, but we did not compare ourselves with the branded marketers on the right. The companies on the right all had national branded distribution. We were more pocketed in high consumption rice markets. The companies on the right had the capital and had the funds it took to compete on the supermarket shelf. We were caught kind of in the middle of never-never land. We couldn't go back and be a commodity processor, but we couldn't compete with the capital on the right side. We were caught in the middle.

**VALUE ADDED TO RICE
(FARM TO CONSUMER)**

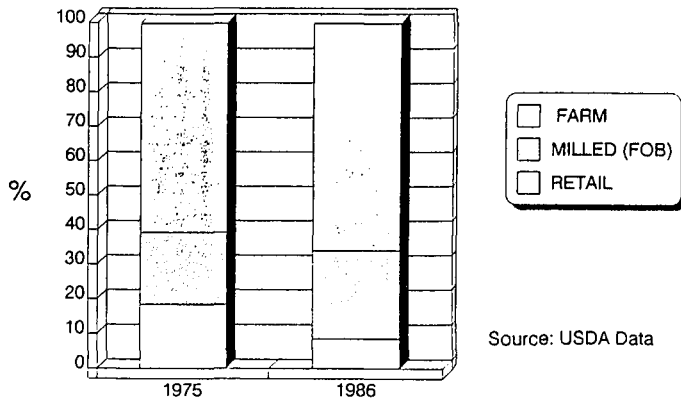


figure 9

Source: USDA Data

COMPARISON OF COOPERATIVES

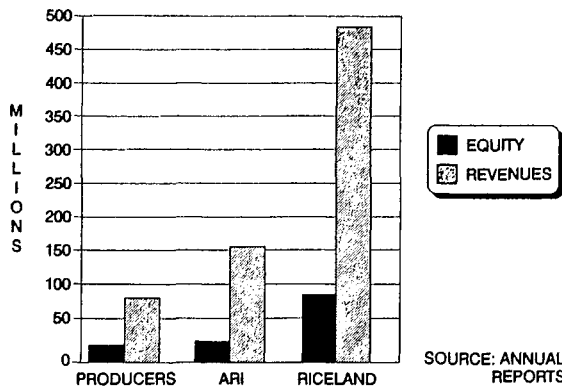
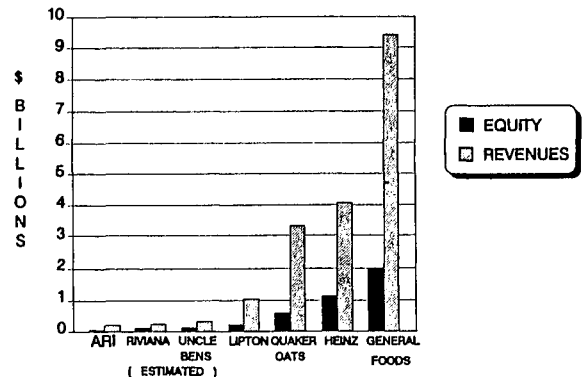


figure 10

SOURCE: ANNUAL REPORTS

industry was a nice clubby little group. We had a couple of big co-ops out here in California, 3 big co-ops in the south, Riviana Foods, Uncle Ben's and Comet. Everyone had a place. When the big food companies decided to get in, Heinz, Quaker Oats and Lipton, it changed the equation radically on the supermarket shelf. Things became much tougher. The industry changed dramatically after that. If you look at the percent of revenue spent on advertising (see Figure 12), you'll notice that ARI did not even compare with these other companies. If you look at ARI in terms of where we were postured as a company, (see Figure 15) the commodity processors are on the left and in that group are included Riceland, Producers and Comet. Comet was more of a commodity type processor, P&S and ADM, were not

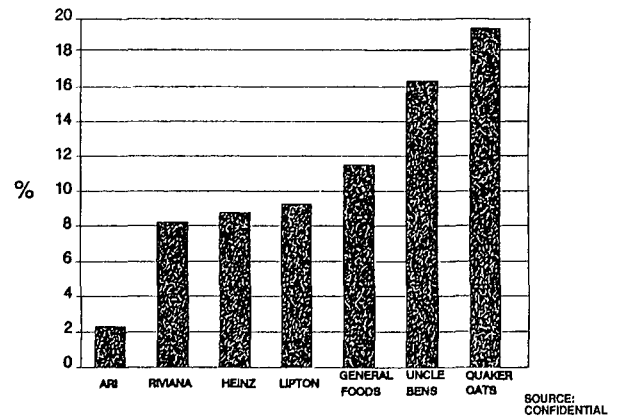
VALUE ADDED MARKETERS



SOURCE: CONFIDENTIAL

figure 11

% OF REVENUE SPENT ON ADVERTISING



SOURCE: CONFIDENTIAL

figure 12

ARI IS INBETWEEN

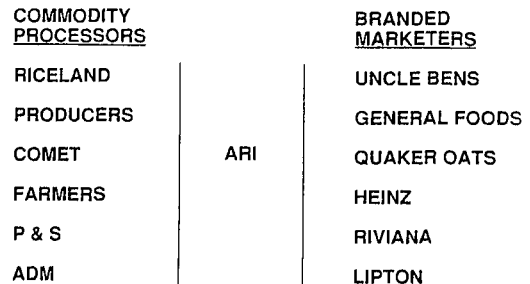


figure 13

It is important to look at farmer cooperative trends, back in this period of time and put yourself in the producers position in terms of what was happening to farmer cooperatives in the mid 1980s. The Touche Ross study came out and said the importance of farmer cooperatives as a business structure will continue to decline and limitations on capital may force many cooperatives out of business. Figures 14-17 appear in *Farmer Cooperatives*, published by the Agricultural Cooperative Service, USDA. I'm sure many of you are familiar with these. These were slides that were published by USDA in terms of what was happening through 1986. Since then I suspect some of these have turned around and are trending the other way, but keep in mind that this was through 1986 at the point in time where ARI producers were evaluating this decision. Some of these cooperatives have shaken out in the mergers that have taken place. In terms of membership being lost, the trend was down. If you looked at the numbers of co-ops, it was also trending down. The sales volume in cooperatives was decreasing. The net margins were on a downward trend. There was a significant amount of consolidation going on in the food industry (See Figure 18). The markets were requiring new products

U. S. FARMER COOPERATIVES
(TOTAL SALES IN 1980 DOLLARS)

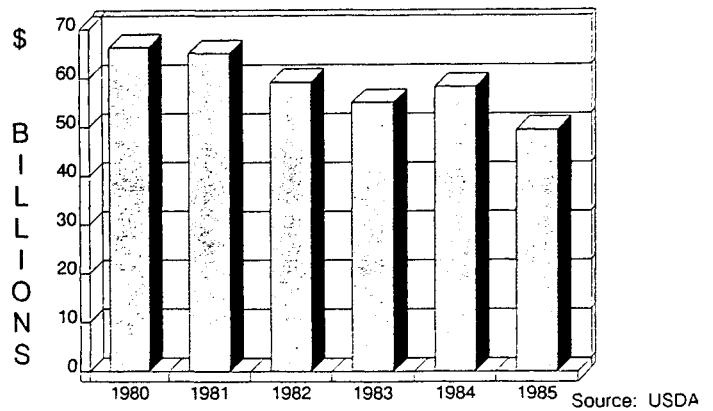


figure 16

MEMBERSHIPS IN FARMER COOPERATIVES

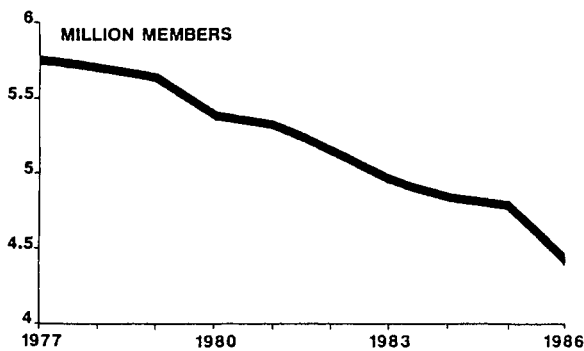


figure 14

U. S. FARMER COOPERATIVES
(NET MARGINS IN 1980 DOLLARS)

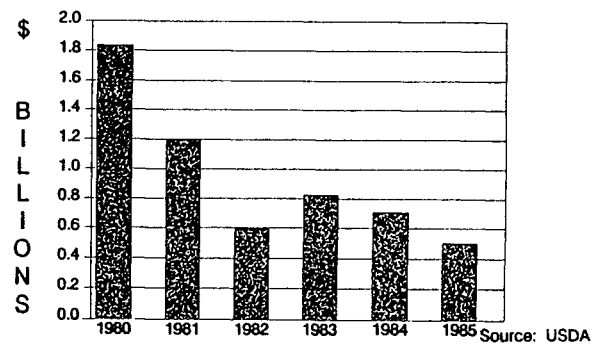


figure 17

U. S. FARMER COOPERATIVES
(NUMBER OF CO-OPS)

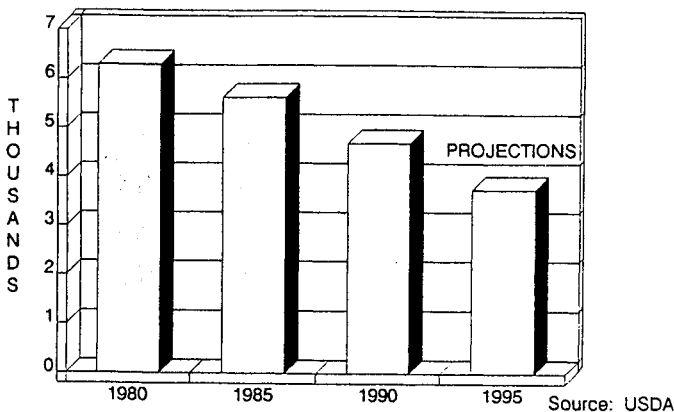


figure 15

(See Figure 19), the profit margins of these food companies were increasing and low margin commodity operations were being phased out (See Figure 20). The big food companies were getting out of the commodity processing business, concentrating their capital on the supermarket shelf and downward processing and there were a number of mergers going on in food marketing companies in that period in time. There were a large number of new product introductions on a national basis. Keep in mind it takes almost 20 million dollars to roll out a new product on a national basis and that includes all the advertising, the product development and the slotting allowances you have to pay on the supermarket shelf. Those numbers are large and for a small cooperative to try to compete in that game is difficult. If you make one mistake, you're out of business. The risk is very high. The operating margins of food companies were going up and the one thing driving that by the way were these new product introductions that were coming out. If you remember the shift in the dollar return, from the grower level, up to the retail level, that's what these food companies were participating in more and more. The sales volumes were much larger (See Figure 21). You'll notice almost all these charts are just the opposite of the cooperative trends at that point in time. If you look at return on equity for farmer coops (See Figure 22) through 1985 it was down and for food companies it was going up during the same

**FOOD MARKETING COMPANIES
(NUMBER OF MERGERS)**

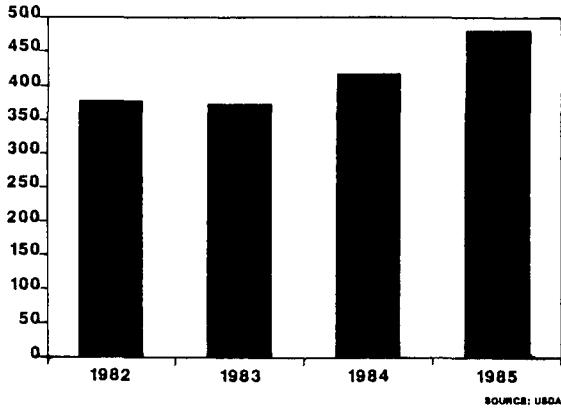


figure 18

**FOOD PROCESSING COMPANIES
(SALES)**

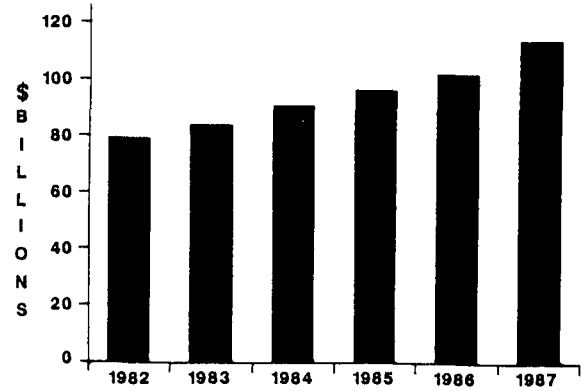


figure 21

**FOOD MARKETING COMPANIES
(NUMBER OF NEW PRODUCT INTRODUCTIONS)**

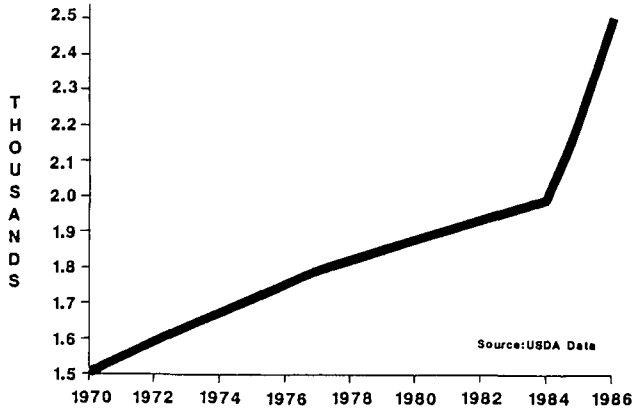


figure 19

**U. S. FARMER COOPERATIVES
(RETURN ON EQUITY)**

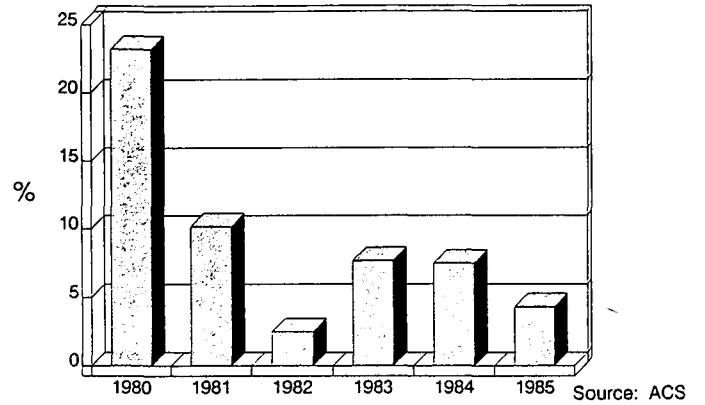


figure 22

**FOOD PROCESSING COMPANIES
(OPERATING MARGIN)**

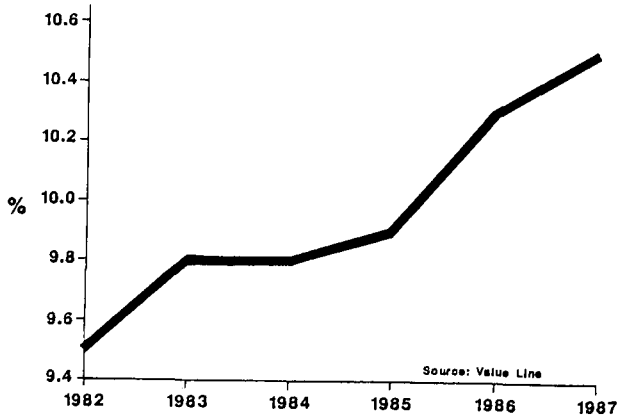


figure 20

**FOOD PROCESSING COMPANIES
(RETURN ON EQUITY)**

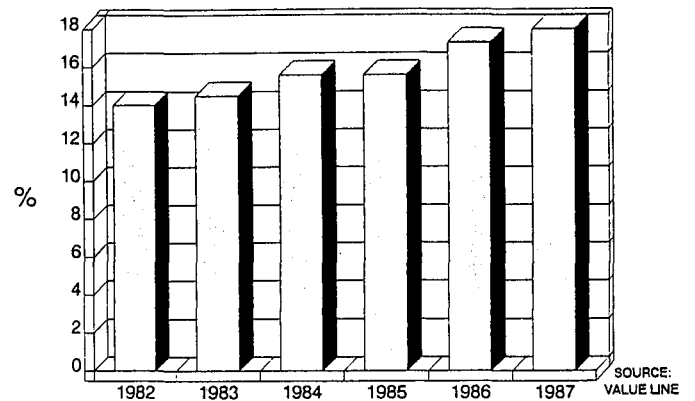


figure 23

time period (See Figure 23). The comparison of average sales of the average size coop was about 250 million dollars and the average size sales of a big food company was 2 billion dollars (See Figure 24).

It's hard to find stand alone products on the supermarket shelf today, except for cooperatives. For instance, rice is a stand alone product. You'll find coops trying to expand into other products that their members don't grow. You find cooperative management quite often going to the cooperative board of directors saying, "We've got to get into these other products" and the owners will often say, "Why, we don't grow those things." One of the reasons is, you need more clout on the supermarket shelf. It's very difficult to deal with supermarkets if you're a one product company. The supermarkets have you over a barrel. When a company can come in like General Foods or the Mars group for instance, with Uncle Ben's rice and Mars candy bars, they have a lot more influence over supermarkets than do one product cooperatives.

Figure 25 shows the one problem in the cooperative that we could never find a solution to. In the inventory turn-over ratio, there is something a lot more insidious than what these two lines show. Food companies turn over their inventory 7 1/2 times a year with an average marketing cooperative doing it about 4 times a year. Now, what does that mean? What really happens is that your food processing companies are concentrating their capital on the supermarket shelf in the downward processing of rice or whatever the product is. They are focusing their capital on marketing. Farmer cooperatives are focussing much of their capital on getting the product out of the field, storing the

shelf. As long as our capital is tied down here in low return operations, its hard to get up on the top. The thing many of the growers in cooperatives think about first is getting their crop out of the field and how its stored and how its taken care of. That's what they relate to. It's something they very much understand, that's very important to them. It was very difficult and ARI could not see a way to get over this hump. We just had a fundamental problem with it and spent hours discussing it and studying it, but were never able to come up with what we felt was a workable solution. It's a problem I feel that many cooperatives face.

The members of ARI reviewed all of this information and all of these trends and decided now was the time to get their money out of the rice cooperative. There was a considerable amount of controversy among the members of ARI. Not among the Texas members, or Louisiana members, but among the Mississippi growers that had only been in ARI a couple of years. The reason was that when the cooperative paid its equity back and it allocated the stock out, it had to do it on a patronage basis which meant the Texas and Louisiana members were going to receive the largest amount of equity and the Mississippi growers were going to get the very least amount of equity out of the transaction. Well it went to a vote of the membership and 92% of the members voted for the transaction. If you characterized it, almost all of the Texas and Louisiana members voted for it and almost all the Mississippi members voted against it. The members voted to do the transaction.

If you look at the balance sheet (See Table 3) of ARI before the transaction, we had about 25 million dollars in total equity, about 5 million of that had been earned on non-member business and had about 44 million in long term debt that was largely used to build the Freeport facility. The transaction was accomplished with a company named Erly Industries. The reason it was done with Erly is that they owned the other half of ARI's marketing joint venture and were prepared to pay off all of the ARI growers equity. Erly contributed \$40 million dollars in capital to the transaction with \$20 million of it in cash. The cash was used to refund ARI grower returns. For that Erly received 48% of the common stock which represented voting control. The rest of the

COMPARISON OF AVERAGE SALES

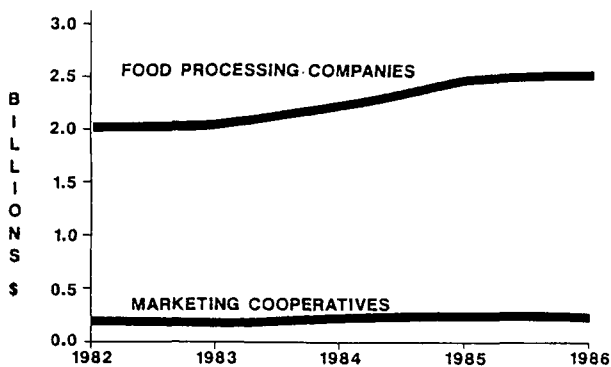
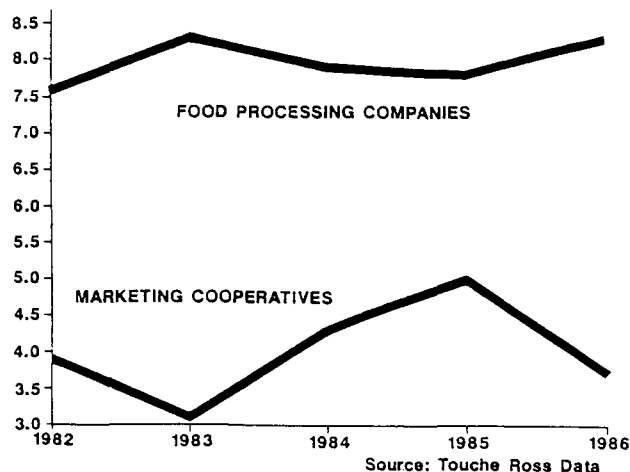


figure 24

product, and carrying the inventory and financing it for the grower which is the lowest return on the economic scale. We are trapped into a position of having to keep our product where the lowest return is on the percentage of the dollar you can extract from the market place.

The food companies that we compete with are keeping their dollars in the market place where the highest return is. In fact you are finding more food companies today wanting to buy their raw materials from cooperatives, letting the cooperatives perform the lower return operations. The economics are simple, the highest return comes out of those activities on the supermarket

INVENTORY TURNOVER RATIO



Source: Touche Ross Data

figure 25

stock, 52%, was allocated to all the growers on a patronage basis, since day one of the cooperative. Most of it went to the Texas and Louisiana producers. A very important part of this transaction was that the new company agreed to buy from the old company the ending pool inventories at \$9.46 per cwt. The market value of the rice was about \$6.43. The producers received an additional 12 million approximately, in cash, besides their equity value, that went back to them as part of the pool.

In summary, the producers received all their equity, another 50 million in cash on their marketing pool and they also received long term contractual rights with ARI as long as they wanted to deliver their rice to ARI. The way these contracts work is that ARI has to pay a minimum of 90% of whatever the average market value was of rice is in a given year. What ARI does is buy the rice at harvest and pay an up front price of say \$7.00. Whatever the market escalates to during the next five months above that, we pay them 90% of that amount.

The way the transaction worked out was that the members lost the control of the cooperative. The 48% shareholder has effective control because the rest of that stock is spread across 5,500 accounts, but they did get their equity out and they did end up with a home for 100% of their rice on a long term contractual basis and they are guaranteed at least 90% of whatever the market is on that rice. So the producers received most of the options they wanted.

The thing the producers wanted most was to get their equity out. They decided that to have control was just not that important to them. They believed the industry was changing. It was transitioning from a period of where there was excess rice to a period now where there is more capacity than there is raw product. That is exactly what has transpired.

What happened to the stock that went out in terms of market value? There was no underwriter in the transaction, the stock was just passed out to the growers. About 8 million shares or thereabouts went out to all of the growers. There was no market value on the stock. ARI said it would list on NASDAQ exchange and that market would find its own level. As soon as the stock was passed out, probably about 8 different brokerage firms immediately started trading the stock. They were putting a value on it around \$3.50. In the first few weeks they were prepared to buy stock at that amount.

The stock today probably sells between \$.50 a share and a \$1.00 a share. The market is very thinly traded. I'd say the producers sold about 20% of their shares up front at around the \$3.00 range. The rest of that stock is still held by the producers. To many, this was the first stock they ever owned.

Keep in mind the stock value was not the main reason they did the transaction. A lot of cooperative managers ask me the question, "How did you go public?" "Did you make a whole pot of money?" That was not the reason these producers wanted to go public. Their reason was very narrow, they saw their industry changing and they saw that rice production in their historical state was not going to be there long term. They felt their competitive advantages were going away and they decided now was the time to get their money out and shift the risk of ownership to someone else. That's why they did the transaction. It was very simple. They wanted to shift the risk of ownership right now while they thought that there was the ability to do so. They found a company who was willing to take that risk and that's why the transaction happened. It was not to make a whole pot of money. It was to get their equities out, have a home for

BALANCE SHEET — June 30, 1987
(Millions)

ASSETS	
Current Assets	\$28.2
Investments	7.0
Property, Plant, Equipment	59.2
TOTAL	\$94.4
 LIABILITIES & EQUITY	
Current Liabilities	\$19.3
Long Term Debt	44.7
Retained Earnings	5.2
Equity	25.2
TOTAL	94.4

Table 3

AN ECONOMIC EVALUATION OF COOPERATIVE RESTRUCTURING

Robert A. Collins, Ph.D.

In the last decade, several large agricultural cooperatives have either become publicly-held corporations, formed corporate subsidiaries or have allowed themselves to be acquired by a corporation. Their actions have created concern that the cooperative form of organization may be failing to meet the needs of modern agribusiness and that changes in the structure of cooperatives may be necessary.

Today, I will discuss some possible economic motives that may make members want to dissolve their cooperative and examine the limited evidence from recent conversions of cooperatives. Finally, I will suggest some possible changes in organization that could reduce the economic motivation for dissolving cooperatives.

First, I would like to briefly discuss the way economists think. For theoretical economic analysis, the subject is homo economicus, which translates roughly as "economic person". In other words, we assume that a person's economic choices result from careful analysis of only economic factors. The possible effects of ideology, loyalty, tradition or search for self actualization are ignored. Practical people often dismiss such simplistic theories of behavior as absurd. While this may be true for explaining the choice of any one person, economic factors do appear to be important for explaining aggregate economic choice. Therefore, I will proceed as if non-economic factors are totally unimportant in the choice calculus of groups of cooperative members.

Professor Schrader of Purdue University has summarized several economic factors that may motivate homo economicus to reorganize a cooperative. He lists the equity access problem, the liquidation motive and the corporate take-over motive. The first two of these are motives of the cooperative members and the last involves motives of people external to the cooperative.

The equity access motive arises from the need for cooperatives to expand in order to maintain market share and their competitive position. Since the return on member's equity is limited, they may be reluctant to provide additional equity to finance growth. This leaves managers in the position of financing growth with debt, which can be risky in a volatile business environment. Conversion of the cooperative to a corporation eliminates this problem since corporations have access to national equity markets.

The liquidation motive may arise when a substantial portion of a cooperative's members are near retirement. Since members usually receive only the book value of their equity when they leave the cooperative, a strong motivation may exist to convert the cooperative to a corporation when the market value of equity greatly exceeds the book value. Market value of equity may exceed the book value simply because of accounting rules that require assets to be valued at the lesser of cost or market, and arbitrary depreciation rules. After a decade of double digit inflation, these rules may produce a book value of equity that is only a fraction of its liquidating market value. The natural operation of capital markets may also create this difference

for successful cooperatives. Since the market value of equity is the capitalized value of the expected earning stream, a cooperative that is capable of producing a substantial stream of earnings with low systematic risk may also have a market value of equity in excess of book value. In either of these situations, members who have a fairly short time horizon may have a strong incentive to sell the cooperative or convert it to a publicly held corporation.

A third motivation for converting cooperatives may come from the expansion desires of corporations. A cooperative may have markets, facilities, sources of supply or expertise that happen to fit the expansion plans of a competing corporation. It is also possible that cooperatives may be "sitting ducks" for takeovers even if their operations are only peripherally related to the corporation because of the same factors that created the liquidation motive. That is, since members can only get book value upon liquidation, a corporation may only need to bid above book value to get member approval. This may make cooperatives a "bargain" compared to attempting to take over an alternative similar corporation or proprietary firm.

An additional factor that may affect both the unwillingness of members to provide equity to the cooperative and their potential motivation to convert their cooperative to a corporation involves risk management. The primary rule of risk management is "don't put all your eggs in one basket." Since the economic well being of a cooperative may be very highly correlated with the member's economic situation, member equity may be regarded as another egg in the same basket.

Some evidence is available to evaluate these various motivations. Several of the cooperatives that have changed their form of organization have produced a public record which provides the data necessary to see which of these factors may have been important motivators.

The most popular hypothesis for the conversion of cooperatives is the equity access motive. It also has the least evidence supporting it. After the reorganizations of American Rice and Rockingham Poultry, they had more debt and less equity. The Land O' Lakes Cooperative has not realized any equity infusion from the formation of Country Lake Foods, Inc. It appears that Gold Kist poultry is the only cooperative so far that has realized any substantial equity infusion from the formation of a publicly-held subsidiary or the direct conversion to a corporate form. It appears, therefore, that the equity access motive may not be a general explanation for these reorganizations.

There is more support for the liquidation hypothesis. In the case of American Rice and Rockingham Poultry, members may have expected to receive from 2-3 times the book value of their equity from the conversion to the corporate form. There is less evidence that the creation publicly-held subsidiaries by Gold Kist and Land O' Lakes were related to the liquidation motive. In fact, Gold Kist may have created substantial problem in this area due to the success of Golden Poultry, Inc. The market value

of the roughly \$6 million of members equity used to start Golden Poultry has now grown to about \$77 million. It is possible that members of Gold Kist may not be happy when they discover that their share of this \$71 million gain is not available to them when they liquidate their membership.

Both of the cases that exhibit elements of the liquidation motive also have the strong appearance of corporate take overs. One could view the reorganization of American Rice as a take over by ERLY Industries and the conversion of Rockingham was an outright acquisition by Wampler-Longacre, Inc. The coincidence of these two motives supports the assertion that they may reinforce each other.

While the number of well-documented cases of cooperative restructuring is too small to permit any solid conclusions, it appears that all three of Schrader's motives may find some support in the data. At this moment, it appears that the equity access problem has the least support while the synergism between the liquidation motive and the buy-out motive has the most supporting evidence. This is especially true for cooperatives that become corporations. The motivation for the creation of publicly-held subsidiaries of cooperatives is less clear. In fact, it appears that when these enterprises are successful, a substantial motive may be created to liquidate the parent cooperative.

This discussion of the economic motives for restructuring has been leading up to a discussion of how innovations in cooperative finance can be used to mitigate these motives and maintain the viability of the cooperative structure. In a moment I will discuss potential financial innovations that may be used for mitigation of specific motives, then I will mention possible packages of these innovations that might be used as a comprehensive approach. But first a caveat. The general classes of innovations below have not been thoroughly evaluated for legal and taxation implications. They only are suggested as general concept that would require substantial research prior to implementation. In some cases, legislation may be required to allow needed changes.

Cooperatives frequently have problems financing expansion. When expansion is necessary but prudence requires that no more debt be used, and members are reluctant to contribute more equity, there may be an alternative to converting a cooperative to a publicly-held firm. There are several potential methods of raising capital without the perils of fixed interest payments while still maintaining the cooperative form of one person, one vote control. This type of capital has the benefit of functioning much like equity in that a few years of hard times would not bankrupt the firm. This financing could take several forms. One is the "equity sharing" loan. In this case the lenders(s) or bondholders could be guaranteed a below market rate of or 4%, but in addition receive a share of the cooperative's profit. While the total expected cost of this financing would be no less than conventional debt, it would allow the cooperative to receive external financing without loss of control, and greatly enhance their ability to survive hard times. Similar arrangements could be made by using a non-participating preferred stock, or like Ford Motor Company, with different grades of common stock. For example, members could be entitled to one share of voting stock while non-voting stock could be sold to the public in return for a share of the income. This could create a true cooperative-corporate hybrid which might be better than having

cooperatives form publicly-held subsidiaries and then attempt to maintain the fiction that they are separate entities.

A third possible alternative is something similar to the Irish public limited company (PLC). These companies are formed by creating a corporation that receives substantially all the assets of the cooperative and a portion of the shares are transferred to the members of the cooperative, in return the remainder of the shares are sold with a public offering. The cooperative owns a controlling interest in the corporation but the role of the cooperative is reduced to raw product acquisition from farmers. Therefore, forming a PLC essentially amounts to converting all of the processing and distribution functions of the cooperative to a corporate form while maintaining the cooperative for product acquisition. While this business form does not really prevent cooperative conversions, it does solve the equity access problem.

It appears, however, that the more pressing problem may be dealing with the factors that jointly create the liquidation motive for numbers and the acquisition motive for corporations.

A method of mitigating these problems is to modify the process by which cooperatives accept new members and liquidate positions of retiring members. Most cooperative memberships are not transferable and the board has no power to regulate the acceptance of new members and place a value on the share of a retiring member. This type of arrangement creates arbitrary valuations that have the effect of distorting incentives. An alternative method would allow either free transferability of membership rights or transferability subject to board approval.

One possibility is the creation of an "open outcry" market for membership shares. This could be accomplished by establishing a time and place for a membership market and requires that all exchanges of memberships occur in this setting. This would create a competitive market for membership shares, where the shares would presumably reflect product volume. Membership could be closed or the cooperative could also sell shares in this market if a decision is made to expand capacity. This institutional arrangement preserves the cooperative principle of being controlled by its users, but makes ownership proportional to use. If board approval of buyers of membership rights is a concern, potential bidders could be approved or disapproved prior to the auction.

An alternative to the "open outcry" auction to transfer membership rights is to allow a private broker to make a market for membership rights. This method would create a bid-asked spread, however, that would reduce the value of the membership shares. If the broker was a cooperative employee, however, the spread could be controlled, and the approval process for new members could be incorporated with the transfer process.

Since it appears that there is substantial synergism between the corporate acquisition motive and the equity liquidation motive, it is possible that a market for membership would eliminate much of the advantage that cooperative takeovers have for corporations. That is, if the corporation had to bid more than the market value of the equity in order to get members to approve a sale, corporate takeovers of cooperatives would only occur when the combined value of the two organizations exceeded the sum of the two individual firms. When no market exists for member equity, the corporate bid only must exceed

the book value of equity for rational members to approve the sale. This suggests that the current structure of successful cooperatives makes them easy prey for corporations.

In the absence of a market for membership, it is possible that a "poison pill" could be incorporated into cooperative by-laws. This is a provision that makes a takeover unprofitable if it is attempted. There are various ways of accomplishing this objective, but it is not clear that the membership would benefit from such an arrangement unless the objective of maintaining the cooperative structure outweighs all economic motives.

In some cases, it may make sense to combine these actions to achieve multiple objectives. For example, it may make sense to offer a class of non-participating preferred stock to the public and create a market for membership. These combined changes could allow orderly financing of growth, create a fair method for intergenerational transfer of membership and eliminate any advantage that corporations have for taking over cooperatives. □

PROBLEMS AND ISSUES IN COOPERATIVE FINANCING

Richard P. Castanias, Ph.D.

1. Introduction

The topic of long-term financing continues to be of growing importance to cooperatives. The importance results in part from the growing competition that many cooperatives face from well-capitalized domestic and foreign investor-oriented firms. Another factor is that business risk has increased for many cooperatives in recent decades. The past long-term financing and investment decisions of cooperatives, themselves, may also have a significant bearing on the financing situations that many currently face. All of these factors have contributed to a substantial increase in the concern that cooperative managers and academics alike have expressed about past, present, and future trends in cooperative financing. This paper adds one more to the list of factors; namely that, when it comes to raising long-term financing, cooperatives may be at a distinct disadvantage relative to investor-oriented firms (IOFs). This result stands in contradiction to the widely-held idea that a cooperative should be able to do just about anything an IOF can, and do it as well as an IOF can.

Another widely-held idea in the theory of IOF financing decisions is that capital expansion requires "at-risk" equity funding. For most successful IOFs, "at-risk" equity funding for expansion and growth comes primarily from internally-generated cash flows; that is, from retained earnings. Furthermore, IOFs with consistent flows of retained earnings available to service debt, find that the raising of long-term debt financing is made easier and less costly. Capital-expansion-oriented cooperatives, on the other hand, traditionally raise "at-risk" equity funding through revolving grower retains.

The problem with patronage retains as a source of cooperative "at-risk" equity funding for working capital and fixed asset expansion is that they are not permanent in the sense that retained earnings for an IOF are permanent. There is implicitly, if not explicitly, the understanding between patrons and cooperative management that the patronage retains will be 'revolved' back, usually over a fixed period such as five years. Although the decision to 'revolve or not to revolve' is retained by the cooperatives' boards of directors, most patrons view unfavorably cooperative failure to revolve as scheduled, in much the same manner as lenders view missed interest pay-

ments. The problem is exacerbated, we argue, by two additional factors. First, the absolute levels of patronage retains is considerably smaller (about one-third as large over the period from 1954 through 1981) than the average retained earnings of a comparable IOF. Second, patronage retains tend to be more volatile than comparable retained earnings streams for IOFs. These factors are discussed in greater length below. As a result of them, however, IOFs that are otherwise identical to cooperatives seem to have a distinct advantage when it comes to financing and maintaining fixed asset expansion.

Bad Decisions and Bad Luck

The argument to be presented is not specifically about the efficiency of cooperative management. Neither is it an argument about the marketing advantages that cooperatives may or may not provide their members. Nor is it an argument about "bad luck" with exchange rates, inflation, competition, dumping, or any of a list of unfortunate occurrences that are often presented to explain the demise of cooperatives since the 60's. Unexpected exchange rate changes, energy cost increases, and foreign competition may have made things worse but the seeds of the problem facing cooperatives were there before any of these phenomena occurred.

The idea that cooperatives are not as well suited as comparable IOFs are for obtaining and maintaining the kinds of permanent long-term "at-risk" financing that are needed by businesses that invest in long-lived assets, is developed in Section 2. There, financial theory and the differences in financing methods available for IOFs and cooperatives are also discussed.

In Section 3, we examine the history of cooperative financing over the last four and a half decades. We see that many cooperatives chose to grow by expanding vertically into related processing, merchandizing, and distribution activities, or alternatively by increasing their focus on processing and/or distribution activities. This can and has meant increased investments in long-term, and often fixed assets over the past four decades. The result was significant increases in 'operating' leverage for cooperatives by 1980. We then ask; how were these fixed asset

expansions financed? The answer is debt. Cooperatives had relatively more debt, and relatively less net worth to secure the debt and relatively less internally generated cash flow to service the debt. The by-product of the higher debt levels was relatively greater 'financial' leverage for cooperatives by the 1970's. The end result of greater operating and financial leverage was greater exposure to risk. Unfortunately, business risk was also increasing in the 70's.

After we have examined the arguments and the evidence, we discuss what cooperatives can do to solve the problem. Specifically, in Section 4, we discuss whether cooperatives can restructure their financing so as to alleviate the disadvantages that they face in raising stable, permanent, "at-risk" long term financing. The paper "Innovations in Debt and Equity Management," by Castanias and Castanias, examines in more detail the financial restructuring options available to cooperatives.

2. A Look at the Theory of Financing: Investor-Oriented Firms versus Cooperatives

In order to identify financing innovations that have a chance of solving the financing problems cooperatives are facing, one must understand why cooperatives have a problem in the first place. We will begin not by discussing financing for cooperatives, but financing for IOF's, and not even necessarily just those IOF's which happen to be competing with cooperatives.

The "Pecking-Order" Approach to Long-Term Financing

How do firms typically raise long-term financing? Especially, how do they obtain the long term financing needed to fund fixed asset expansion? The prevailing theory among academics as well as practitioners is that firms use the "pecking-order" approach to funding long-term investments. The pecking-order approach maintains that most firms finance investments with funds in the following order, from:

1. retained earnings,
2. divestiture of marketable securities,
3. secured debt,
4. unsecured debt, and finally
5. new issues of equity.

Thus, retained earnings is the first and, as it turns out, foremost source of funds for internal investment. Examination of sources and uses of funds statements reveals that on average 80.2% of new investment by U.S. Industrial firms came from internal cash flows between 1965 and 1985. The balance came from borrowing (14%) and new issues of common stock (6%). This is true in almost all periods, although there is variation from

Table 1
Internal Financing as a Percent of Total Financing

Year	Percent
1965	76.6%
1979	78.7%
1985	86.8%

period to period. For example, in 1983, 96.1% of all long term financing needs came from internally generated cash flows, while in 1984 internal cash flows generated only 74.4% of the funds required for capital expenditures.

These data are consistent with the results of numerous other studies, which demonstrate that the first form of financing used by firms is internally generated cash flow. This finding is generally true for most lines of business, although financing from retained earnings is more likely for firms with:

- Riskier cash flows from operations
- Greater proportions of fixed to total costs
- Relatively less securable assets
- Greater ratios of intangible to tangible assets
- More ambitious fixed-asset investment plans
- More start-up activities, i.e. younger firms¹

These observations are not independent. Both younger firms and firms with high percentages of fixed costs will tend to have riskier cash flows, all else held constant. Firms that are capital intensive will tend to have higher fixed costs, and relatively more ambitious fixed asset investment plans, yet may have relatively more securable assets. The first two factors will favor retained earnings financing, while the third factor, securable assets, raises the possibility of debt financing. The pecking-order approach, however, suggests that firms with securable assets will still prefer, if they can, to finance with retained earnings since assets available to secure loans in the present should still be available to secure loans in the future.

Several arguments are put forth generally to explain the preference for retained earnings as a source of long-term financing, including:

- Managers and boards have more control over retained earnings.
- Managers and boards have less need to justify/document use of retained earnings.
- Retained earnings are cheaper, since there are no flotation costs.²
- Retained earnings do not obligate the firm to make fixed interest payments.

The desire to have retained earnings available to fund capital expenditures and other forms of long-term asset investment is sufficiently strong that it is often argued that paying the funds out as a dividend is wasteful for firms in the early growth phase of their life cycles. Excess cash flow above current investment needs for a firm early in its life cycle should be stored, instead, as marketable securities - providing the firm with a store of investment funds for future periods. When a firm has insufficient cash flow from internal sources to fulfill its investment plan, it draws down its investment in marketable securities, presumably purchased in earlier years from excess cash flows.

As a last resort a firm will raise funds by issuing debt and equity. First secured debt is issued. Obviously, firms that make more investments in securable assets have a greater capacity to issue secured debt. But less generally recognized is the fact that firms that average larger and/or more stable retained earnings flows, will have lower costs of secured debt borrowing even if all retained earnings in a particular period are committed to new investment. This is because the expectation of relatively high

and stable levels of retained earnings in most years provides security for debt service in occasional bad years. Thus, the greater is a firm's capability to generate retained earnings, the greater is its borrowing capacity and the lower is its cost of borrowing even for secured debt.

When securable assets (existing as well as new) have all been pledged, the firm can turn to unsecured debt and/or equity issues. In fact, most firms can't do much unsecured debt financing, and prefer to leave some securable borrowing capacity unused. Firms that borrow in unsecured debt markets and then try to borrow again later under distressed circumstances, usually find that they are unsuccessful in obtaining funds at reasonable rates, if at all.

Outside equity seems to be a relatively unimportant source of funds for expansion. In fact, the market appears to value efforts by firms to raise stock for expansion purposes as a negative signal about the firm's financing policy, resulting in a negative price reaction to new stock issues. Surveys of managers indicate that they prefer to issue new equity:³

- when their stock price is too high, or
- when they have too much debt and need to adjust debt/equity ratios.

In short, equity financing is by far the most important source of long-term financing for industrial firms, but the equity financing is from retained earnings, not from new issues of common stock. The equity capital raised this way is "at-risk" capital. The greater the risk of the firm, the greater its need to rely on "at-risk", or equity, capital to fund fixed-asset investments. The empirical evidence on industrial firm financing suggests that retained earnings are relatively more important for more capital-intensive firms. As we will see in the next section, when data for firms in lines of business more comparable to those of cooperatives are examined, the results are much the same.

The reasons for following a pecking-order approach to financing decisions are both intuitive and theoretically sound. The pecking-order approach is consistent with business entities trying to maximize the value of owners' investment. Under most circumstances, it also maximizes the probability of the business entity's survival.

Sources of Cooperative Long-Term Financing

In principle, Cooperatives should be just as concerned as comparable IOF's are with the security and value of owners' investment and with the organization's probability of survival. Thus, following a pecking-order approach to making long-term financing decisions should make as much sense for a cooperative as it does for an IOF. Cooperatives should benefit, just as IOFs do, by financing with "at-risk" capital. Cobia, in the "Equity and Debt" chapter of his seminal book on cooperatives agrees, when he observes:

"Equity is risk capital; it exists to serve as a buffer during periods of economic misfortune. Any losses experienced by the cooperative are subtracted from the cooperative's equity pool until it is exhausted. Thus, a strong equity base provides security for lenders and makes it possible for borrowers to receive more favorable interest rates."⁴

Thus, we would expect that cooperatives should try to raise more "at-risk" equity funding:

- as the proportion of fixed to total assets increases, perhaps due to more ambitious fixed-asset investment plans, and
- as business risk increases.

During the 1960's and 1970's many cooperatives were characterized by increasing ratios of fixed to total assets and faced increasing business risk. But, as we will see below, expansion-minded cooperatives which relied on patronage retains as a source of "at-risk" capital historically did not and, in fact, simply could not retain earnings at the same rate as comparable IOFs. In this one regard, cooperatives were at a distinct disadvantage relative to IOF competitors.

Cooperatives are not, however, identical to IOFs. Attending to the security of and the rate of return on patrons' capital, and to the probability of the organization's survival, while important, may not be the only objectives of a cooperative. The cooperative may not even be primarily concerned with the return on patrons' equity investment. The primary objective of the cooperative may be to provide economic and, perhaps, noneconomic, benefits to its members.⁵ These benefits may include return on patrons' equity investments as a relatively minor factor along side, for example, creating a stable and liquid market for the patrons' product. Having said this, it is also important to observe that a cooperative that risks the very existence of the organization by making very poor financing decisions, is probably putting at risk most, if not all, of its objectives.

Similarly, the patron, when deciding whether to 'invest' in cooperative 'equity', will be concerned with more than just the marginal rate of return relative to the return on other investment alternatives. A part of the return to the member may be the intangible and indirect benefits associated with investment in the cooperative (access to markets and reliability of source of supply). But members must understand that equity capital is risk capital and subject to loss.

Traditionally, cooperative equity is different from IOF equity in many ways, including:

- Only 'qualified' persons may be members.
- Control of the cooperative is 'democratic' (one member one vote, rather than one share one vote).
- Net Income is returned as patronage refunds, in proportion to patronage.
- Patrons provide equity (allow a percentage of Net Income to be retained) in anticipation of benefits arising from patronage, rather than in expectation of capital appreciation or dividends.
- Equity is often revolving; that is, it is scheduled to be redeemed over a period of time, such as five years.
- Equity is redeemed at book value, or par value, whichever is less.⁶
- Cooperative equity holders cannot (or can rarely) sell their shares for cash.

These factors affect the capabilities of a cooperative to raise equity capital from members. We list below the most common approaches traditionally used to raise equity capital (retain equity) from members:

- Retained patronage refunds
 - Based on Net Income, and patronage
 - Accounted for 50 to 90% (average 77%) of cooperative equity funding during the period since 1954
- Per unit capital retains
 - Based on value of number of units of patronage
 - Accounted for up to 40% of cooperative equity funding since 1954
 - Commonly used in marketing cooperatives
 - Quantity dependent on income (cooperatives actually lost equity in 1982)
- Direct investment
 - Limited or no return linked directly to investment
 - Transferability limited
 - Limited returns
 - Accounted for less than 10% of cooperative equity funding since 1954
- Unallocated equity - permanent retention from members
 - Reserves for bad debts, capital expansion, litigation, debt repayment, general financial strength, etc.
 - Larger members are insisting on "equitable, not equal, per unit investments in the coop"⁷. That is, a lower per unit investment for the larger member versus the smaller member.

In summary, cooperative equity funds have mostly been of the revolving type. The problems with patronage retains as sources of "at-risk" equity funding include:

- Retains are a much smaller percentage of Total Revenue than are retained earnings for a comparable IOF.
- Not only are retains flows to cooperatives relatively smaller, they are also considerably more volatile, and are more 'temporary' in nature than IOF retained earnings. Thus, these funds may appear deceptively easy and too reliable a source of equity and thereby lead to unwise expansion or expenditures.
- The member's risk capital has limited and very low expected return. If the cooperative must go back to the member for more capital, then the chances are that the member is already in a very risky environment.
- Trends in all industries have been toward increasingly larger economic units, with greater proportions of fixed to total assets; thus the cooperative if it moves in this direction will need more members and more capital to sustain the larger economic entity.⁸

Cooperatives may raise equity financing in other ways as well. In fact, many of the most interesting innovations in cooperative financing have to do with new and more effective ways to raise equity. Many of the equity financing innovations involve redefining the nature of the patron's investment. These include:

- Special assessments
- Base-capital plans

- Front-end equity requirements
- Pools
- Patron loans

Other innovations change even more radically the nature of fixed asset investment to the point where the patron-owned cooperative is a shell owning yet another entity that is often legally separately defined. These include:

- For-profit subsidiaries
- Joint ventures
- Limited partnerships
- Employee stock ownership plans
- Equity from non-members and nonpatronage activities

Many of these innovations are very promising. The degree that each alleviates the cooperatives' "at-risk" equity problems is discussed in Castanias and Castanias, "Innovations in Debt and Equity Financing Management." For our purposes here, it is important to note that these financing innovations have not played a prominent role in cooperative financing until recently, and even now the application of many of these innovations is far from wide spread. The primary sources of long term financing for cooperatives in the post World War II era have been patron retains and long-term debt. In the next section we take a closer look at trends in cooperative financing in recent decades.

3. The History of Cooperative Financing since 1954.

In order to get an idea of what has been happening to cooperatives in recent decades, let's look at some of the available data.

Total Assets and Sales Volume

The period from 1954 through the late 1970's was one of substantial growth for cooperatives. Total Revenues, or Sales Volume, increased substantially from \$11.6 billion in 1954 to \$101.5 billion in 1981. Total Assets increased substantially for cooperatives from \$3.3 billion in 1954 to \$29.4 billion in 1980. The ratio of Total Assets to Sales Volume increased steadily at a rate of about \$500 million per year between 1954 and 1981. The growth in Total Assets as a percent of Sales Volume reflects the increased investment in fixed assets throughout this period.

Since 1980 Total Assets have decreased slightly, and Sales Volume have decreased 30%. The decade of the 80's has been one of retrenching and reorganizing for cooperatives. The total number of cooperatives fell by over 20%, partly due to combinations and partly to dissolutions.

Total Liability and Net Worth

Several interesting ratios can be calculated from available data. Two rough measures of the amount of liability financing include:

- TL/NW - the ratio of Total Liabilities-to-Net Worth (TL/NW), and
- TL/TA - the ratio of Total Liabilities-to-Total Assets.

Rough measures of Liability and Net Worth to the size of the firm as measured by Sales Volume (Volume) include

TL/V - the ratio of Total Liabilities-to-Volume, and
 NW/V - the ratio of Net Worth-to-Volume.

A rough measure of the rate of equity accumulation is

NW/TA - the ratio of Net Worth-to-Total Assets.

The data come from several sources, including primarily Richardson, Volume 8 of the Major Statistical Series of the U.S. Department of Agriculture, 1988. The composition of sampled cooperatives changes over this period, unfortunately, but since 1950 is broadly representative of different regions and farm product groups.⁹

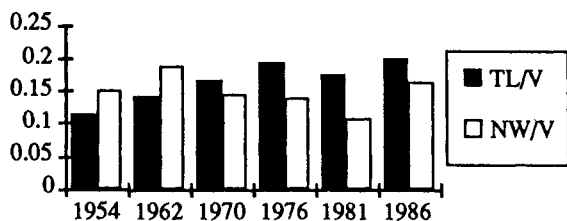
Also unfortunate is the fact that total Liabilities is not broken down farther into its components, including short and long-term debt. A working assumption is that increases in total liabilities associated with increased working capital needs is likely to be proportional to increases in volume, during normal growth periods of length at least that of a business cycle. This implies that changes in total liabilities as a percent of volume are likely to be associated with increased short and long term debt. Similarly, changes in the ratio of net worth to volume reflect the cash flows that might have been retained in operations as "at-risk" equity capital, and thus available, on average, to help fund fixed asset expansion.

In Figure 1, TL/V and NW/V are plotted for a sample of cooperatives for the years 1954, 1962, 1970, 1976, 1981, and 1986. We see that:

- Total Liabilities-to-Volume is sharply increasing for the period from 1954 to 1976, and relatively level thereafter.
- Net Worth-to-Volume increases through 1962, sharply decreasing through 1981, and slightly increasing thereafter.

These findings, which we find repeated in other data, lend themselves to the following interpretation: cooperatives were accumulating larger quantities of fixed assets throughout the 1960's and 1970's. This required cooperatives to raise long-term financing. Prior to 1962, the funding came about equally from debt and retained equity. But the fact that Net Worth was falling through the period from 1962 through 1981 suggests that that funding was no longer coming from equity accumulation, as with retained earnings. The increases in Total Liabilities suggest, in fact, that the primary source of long-term funding

Figure 1
Cooperatives
Total Liabilities and Net Worth to
Volume Ratios



from 1962 through 1981 was debt.

Leverage ratios were increasing for cooperatives for the period from 1962 through 1981. Figure 2 shows the ratios of Net Worth and Total Liabilities-to-Total Assets for the same years. Again, this figure shows clearly the increased reliance on debt financing from 1962 through 1981. In order to get a feel for how wide spread the phenomenon of increased leverage was, we calculated and plotted in Figure 3 the Net Worth and Total Liabilities-to-Total Assets ratios for:

- the 100 largest farmer marketing and supply cooperatives,
- the 18 largest fruits and vegetables cooperatives, and
- the 23 largest Sacramento marketing cooperatives

for the years 1962, 1970 and 1976¹⁰. Again, it is clear that Total Liabilities is a significantly increasing and Net Worth a decreasing proportion of Total Assets during this period.

Comparable Investor-Oriented Firms

A comparable sample of IOF firm data was collected from the Standard and Poors Compustat data base by identifying Standard Industrial Classification (SIC) codes that correspond to cooperative lines of business. Firms in the Compustat data base that had matching SIC codes were included in the IOF sample used here. IOF data was available from 1970 through 1989. During the period 1970 through 1981 IOF Total Assets nearly doubled, as did Sales Volume. Total Assets as a percent of Volume were about constant, increasing through 1976 and declining thereafter. These are approximately the same patterns

Figure 2
Cooperatives
Net Worth and Total Liabilities to Total
Assets Ratios

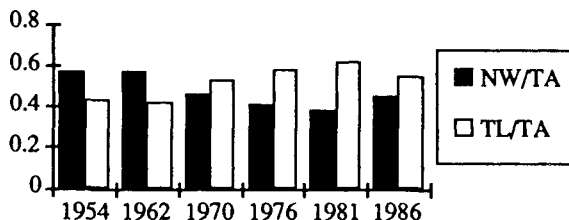


Figure 3a
100 Largest Farmer Marketing and Supply Cooperatives
Net Worth and Total Liabilities as a Percent of Total
Assets

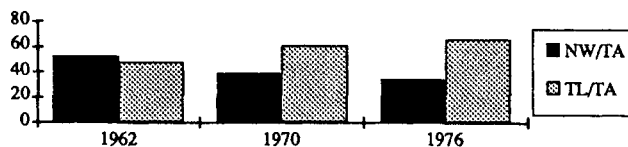


Figure 3b
Largest Fruits and Vegetables Cooperatives
Net Worth and Total Liabilities as a Percent of Total
Assets

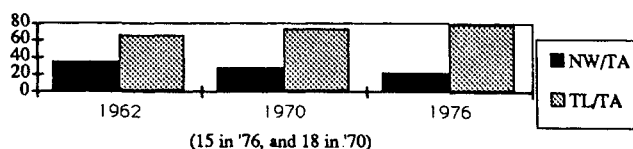
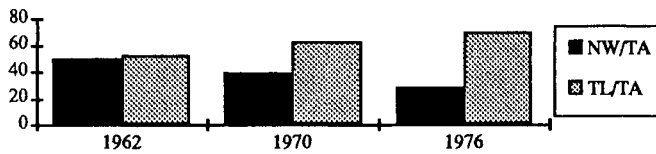


Figure 3c
23 Largest Sacramento Marketing Cooperatives
Net Worth And Total Liabilities as a Percent of Total Assets



as were observed for cooperatives during the 1970's.

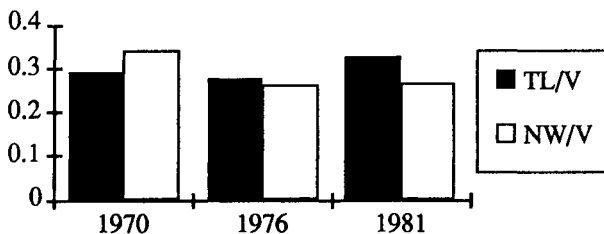
Figure 4 presents Total Liabilities and Net Worth-to-Volume ratios for the IOFs. Figure 5 presents IOF Net Worth and Total Liabilities-to-Total Assets ratios. Figures 6 and 7 present cooperative and IOF Total Liabilities-to-Net Worth and Net Worth-to-Volume ratios, respectively. We see in these figures that

- Total Liability-to-Volume is increasing for IOFs, but not as fast as for cooperatives.
- Total Liabilities-to-Net Worth is greater for cooperatives than for IOFs, but is increasing at about the same rate.
- Net Worth-to-Volume is substantially higher for IOFs than for cooperatives.

These data suggest that:

- Cooperatives tend to have a substantially lower rate of equity accumulation when compared to IOFs.
- Cooperative Net Worth was substantially decreasing as a percent of Sales Volume throughout the period from 1962 through 1981.
- Cooperative asset expansion during the period from 1962 through 1981 was substantially through debt expansion.
- Cooperatives had higher debt-to-equity levels than comparable IOF's throughout the period from 1954 through 1980.

Figure 4
Investor-Oriented Firms
Total Liabilities and Net Worth to Volume Ratios



Other data, not reported here, also suggest:

- Both Net Worth and Cash flows from operations for cooperatives tended to be more volatile than cash flows from comparable IOF's during the '70s, and tend to be more volatile than those for firms in capital intensive industries even in the 1980s.
- Although Cash flows from operations is higher in the middle '80s than earlier, it is still below that of IOF's in comparable industries, and substantially below that of capital intensive firms in general.
- Limited evidence suggests that the difference in cash flow behavior between cooperatives and comparable IOF's is even greater for privately held IOFs.
- The Total Liability and Net Worth ratios of cooperatives resemble IOF retailers more than IOF agricultural industry firms and certainly more than IOF fixed asset capital intensive firms for the 1960's and 1970's.
- The effects discussed above are greater for marketing cooperatives than for supply cooperatives.

Figure 5
Investor-Oriented Firms
Total Liabilities and Net Worth to Total Assets Ratios

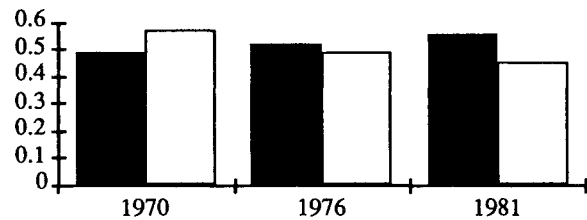


Figure 6
Cooperatives and Investor-Oriented Firms
Total Liabilities to Net Worth Ratios

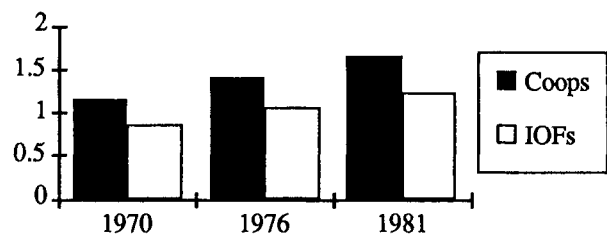
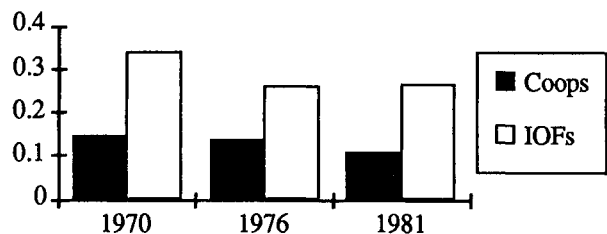


Figure 7
Cooperatives and Investor-Oriented Firms
Net Worth to Sales Volume Ratios



Interpretation of the Data

What are the implications of the asset expansion for cooperatives during the period from 1954 through 1976? The data suggest the following story:

- Some of the increases in total assets may have been associated with working capital increases because of increased marketing of members' products. But much of the increase was due to investments in fixed assets.
- Increases in fixed assets will tend to increase the volatility of earnings from operations (by increasing 'operating' leverage).
- Increased borrowing will also tend to increase the volatility of earnings (by increasing financial leverage). Increases in the volatility of earnings from operations increases the borrowing costs and risk to the cooperative. Increased possibility that an unfortunate exogenous event (inflation, an economic down-turn, exchange rate changes, overseas dumping, whatever) will leave the cooperative with a cash shortfall.
- But a cash shortfall could mean that planned grower revolves may have to be postponed in order to generate the needed "at-risk" capital.
- Cancelled revolves may mean disenchanted growers, who may leave the cooperative, lowering patronage in future years.
- Lower patronage may result in a lower future stream of equity funding for the cooperative when, perhaps, it most needs its cheapest and most stable form of long-term financing.

We conclude that it is partly the very structure of and the potentially short-lived nature of the revolving retain arrangement that is the source of the cooperatives long-term financing problems. If the cooperative tries to depend on grower retains to finance long-term investment in quantities that are easily financed by its IOF counterparts, the cooperative takes on risk that its IOF counterparts need not take on.

The cooperative cannot easily get around the problem by borrowing. Borrowing costs should be higher for coops than for its IOF counterparts because of the impermanent nature of its equity, or "risk-capital" investments. Furthermore, borrowing to finance fixed assets will doubly magnify the volatility of cooperative cash flows (by increasing both operating and financial leverage).

It may very well be that the equilibrium financial strategy for a cooperative will involve considerably less debt than for a comparable IOF, if the cooperative must rely on a considerably smaller and a potentially more volatile retained earnings financing associated with patronage retains. Since fixed asset investments tend to exacerbate the problems, it may also very well be that cooperatives should be doing a lot less long-term asset investing than its IOF counterparts.

What, then should a cooperative do, if it believes, as is commonly espoused, that it must expand fixed asset investment in order to compete with IOFs?

4. The Implications for Cooperative Financing

We consider three possible solutions: Cooperatives might:

1. Bite the bullet and convert into an IOF, with permanent long-term equity financing, and the potential to generate much more of the same over time (all other things held equal). The newly converted IOF should also enjoy lower borrowing costs.
2. Consider a more nostalgic alternative; they might consider going back to their roots, and resist the temptation to expand up (down) stream into capital-intensive activities such as processing, transportation, etc., that are far removed from the cooperatives' original function.
3. Continue doing business as they have, but restructure financially to obtain a more permanent, more stable source of long-term financing.

The companion paper by Castanias and Castanias discusses some of the many alternatives that we have found cooperatives trying, including:

- For-profit subsidiaries
- Joint ventures
- Limited partnerships
- ESOPS
- Preferred stock (or other securities) issued to members, or possibly nonmembers
- Loans from members
- Plans for restructuring the grower retain programs, including:
 - Special assessments
 - Base-capital plans
 - Front-end equity requirement
 - Pools

Some of these are more promising than others as far as creating a more permanent, less elastic pool of equity financing, and some, of course, have features that make them attractive (or unattractive) completely aside from their impacts on the permanence of the cooperative's long-term financing.

Some have been tried extensively. For example the base-capital plan has been tried by Tri-Valley Growers, American Crystal Sugar, National Grape, Agripac, and Farmland, to name a few. Recent experience also suggests that a properly planned and executed for-profit subsidiary business can be an effective way for the cooperative to take a portion of its business public (e.g. Land O'Lakes and Gold Kist). Joint ventures and limited partnerships have been successfully employed by a number of cooperatives (Land O'Lakes, Pacific Coast Producers, and CENEX). Each of these, if properly executed can have the effect of increasing the supply of "at-risk" equity capital available to the cooperative, and permit the kind of growth that many feel is needed if the cooperative is to compete profitably on behalf of its members with IOF farm supply and marketing companies. □

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Footnotes:

¹ These data are from Ross and Westerfield (1990). See also Donaldson (1961), and Myers (1984).

² We are speaking specifically of established companies that are expanding in a new and perhaps untested directions. That is, we are not referring to true start-up firms. Start-up firms may have negative earnings for years. But the need for equity financing is still valid and typically comes from the entrepreneur and/or a venture capital source.

³ But the cost of retained earnings is still the equity cost of capital, meaning that cost of retained earnings is likely to be greater than the marginal cost of long-term debt.

⁴ Similarly, managers repurchase when they feel share prices are too low. See Wansley et. al (1989).

⁵ Cobia (1989), p. 244.

⁶ See Cobia (1989), Chapters 1 and 2 for a discussion of social value of the benefits that may be provided by cooperatives.

⁷ Tax court precedents have been established to get around this problem, albeit with some difficulty and with less clear property rights than would be the case for an IOF.

⁸ Weber (Fall 1989).

⁹ Weber (Fall 1989), p. 13.

¹⁰ Richardson (1988).

¹¹ See Richardson (1988) Department of Agriculture report for detail on sampling procedures.

¹² These are the only years for which we have comparable data.

WHY COOPERATIVES SHOULD STAY COOPERATIVES

Randall E. Torgerson

Growers and ranchers have organized cooperatives for some very fundamental reasons:

- They felt exploited over prices paid for products delivered or prices charged for goods and services provided by other market channel participants;
- they needed services that were unavailable to them from other sources;
- the structural disparity in size and scope of activities between many producers acting individually and other market channel participants required producers to develop balancing market power of their own;
- they could gain efficiencies and scale economies through jointly conducted business activity that would benefit their individual farming operations;
- they could capture value-added margins from advanced stages of marketing; and
- growers could enhance market coordination and therefore the competitiveness of the entire marketing system to their benefit through group action initiatives.

In short, properly structured, capitalized and managed, cooperatives improve the profitability of growers' on-farm business enterprises and the performance of markets.

There have been two processes occurring in agriculture that are having profound influence on how the food industry is organized: more integration and coordination. Cooperatively owned businesses are a natural vehicle for implementing these two processes to growers' benefit. Through joint ownership of marketing, farm input or service assets, cooperatives become the off-farm or rancher's business — the business beyond the fence line in an integrated sense. The key is that the driving force behind this integration is the entrepreneurial business unit — the growers' operation and not some outside dominating force.

Secondly, coordination is growing through ownership and/or contractual integration as a response to the inefficiencies of more open markets. While this has taken place first in the handling of perishable crops, there is evidence of closer market coordination in the handling of non-perishables including basic commodities and livestock. Again, cooperatively owned businesses and/or bargaining associations are a natural vehicle for maintaining producer control and influence over these processes.

Changes in Capital Structure

Capital structures of the Nation's largest agricultural cooperatives have changed dramatically over the last 30 years. In 1962, equity capital supported over 52 percent of total capitalization for the largest 100 cooperatives. In 1980, this ratio had decreased to 28.6 percent as major cooperatives relied increasingly on debt to finance asset growth (Table 1). Cooperatives' highly leveraged position left them exposed to the ravages of the agricultural depression of the 1980's. As a result, most regionals took corrective action and increased owner-equity to reflect more prudent and conservative management of their balance sheets. This action has reduced debt servicing costs and has allowed larger and more stable earnings to members.

Table 1 - Net Worth Trends of the Top 100 Cooperatives, Fortune Corporations, Selected Years, 1962-1989

	Equity Capital as a Percent of Total Assets					
	1962	1970	1976	1980	1986	1989
Top 100 cooperatives	52.4	39.1	34.0	28.6	35.9	36.7
Top 100 corporations	65.3	54.5	49.5	44.9	40.7	29.7

All agricultural cooperatives combined in 1989 had the second highest net income and the third highest sales in history. (See Table 2.) Data for 1989 indicates that net income after deduction of losses was \$1.9 billion or 12.3 percent higher than the \$1.7 billion in 1988. Combined business volume was \$70.4 billion or 6 percent above 1988 levels. Equity capital also grew by nearly 4 percent to \$13.3 billion. This solid performance shows that cooperatives are entering the 1990's in considerably better condition financially than when they entered the 1980's.

Table 2 — Performance of all Farmer Co-ops

Item	1980	1985	1989
	Billion \$		
Sales	66.3	65.6	71.1
Assets	29.4	27.8	29.6
Net Income	1.9	0.8	1.9
Net Worth	10.6	12.1	13.3

It is interesting to note that as we come in to the decade of the 1990's, the comparative position of cooperatives and investor oriented firms (IOF's) has flip-flopped. IOF's are more highly leveraged today than cooperatives — the exact opposite situation faced in the early 1980's. It suggests that the chickens have come home to roost regarding the junk bond syndrome. The situation also suggests that cooperative leaders should be alert to acquisition opportunities as IOF's adjust their portfolios and attempt to shed enterprises not meeting return on investment expectations.

Many cooperatives serving rural America today show excellent overall financial health. Balance sheets are conservatively maintained; close attention is being paid to producers'

changing needs; economies of size have been realized to spread costs and be a least-cost operator. Facilities, equipment, and services have been kept technologically up-to-date. Marketing programs for specialty crops such as fruits, vegetables and nuts are industry leaders and often regarded by critics as the envy of the food industry.

These circumstances show the results of following sound business practices that permit the organization to achieve tangible benefits for members. It might appear strange to some that this conference on cooperative finance is addressing alternative sources of risk capital. Are growers looking for a free lunch? Are some seeking growth while at the same time attempting to abdicate their membership financial responsibilities? Do growers really think they can have the benefits of both worlds? These questions and challenges must be put to members on a straight forward basis.

The purpose of our discussion is to address some fundamental business issues relating to organizational form that growers use in meeting their needs in the market place. In recent years it has been fashionable in some circles to advocate creative ways to attract outside risk capital in cooperatives. While still in embryonic or experimental stages in a number of cooperatives, some of these "creative" ways raise a number of critical issues that must be addressed directly in a forum such as this. These issues get at the heart of what a cooperative is and how it can sustain itself over the long pull. To ignore them or to remain silent is to have complete disregard for growers' interests.

What are the Advantages of Operating as a Cooperative

The essential argument relating to maintaining cooperative status of organizations focuses on the "benefit for whom" question. Cooperative theory posits that all things being equal in a cooperative and IOF's production functions, the objective of a cooperative is to maximize returns to the producers' product being marketed by the cooperative or the goods or services purchased by them. In contrast, the IOF seeks to maximize returns to investors. This often means minimizing costs for inputs including those purchased from producers, i.e., the exact one on which the producer is trying to maximize returns through cooperative marketing. As a result, the orientation of the business is fundamentally different and may be entirely opposite.

The cooperative investment for a producer is his product and equity. The producer seeks to maximize returns on that product rather than a return on investment per se. This can and often does lead to different ideas on what types of investment the business makes. Business results will be viewed differently depending on whose perspective is taken, the producers' or investors'.

These differences in orientation and purpose are recognized in the tax code and in the limited antitrust immunity provided growers using cooperatives by the Capper-Volstead and Clayton Acts. A number of critics point to this treatment as being different from investor-oriented firms. In point of fact, it is different because the law recognizes cooperatives as a distinctive, alternative way of conducting business.

As noted in our 1987 Senate report Positioning Farmer Cooperatives for the Future, a cooperative is a business owned by and operated for the benefit of the users of its services. The key features distinguishing its method of doing business are as follows:

Control—The cooperative is controlled by its users through democratic or proportional voting;

Ownership—it is capitalized by those using its services and returns to capital are limited;

Benefits—it is obligated to return net margins to users on the basis of patronage.

In a presentation to the Graduate Institute of Cooperative Leadership in 1989, the imminent cooperative legal scholar, Robert G. Taylor, identified the following advantages of operating through the cooperative form of business.

1. Combining growers marketing or purchasing power to increase muscle in the market place is the classic reason for a cooperative.

- (a) Public policy has traditionally favored agricultural cooperatives to reduce the disparity in bargaining power between producers and their customers or suppliers.

- (b) The limited antitrust exemption is provided for this purpose.

2. Existence of a vigorous producer oriented business may contribute to the long term interests of producers generally, including keeping noncooperative competitors more competitive.

3. Patronage distributions receive single tax treatment.

- (a) not a privilege.

- (b) a necessary advantage to reflect the obligation to distribute patronage margins.

4. Other benefits reflect stated public policy to encourage self-help among farmers by use of agricultural cooperatives:

- (a) Access to credit on favorable terms through the cooperative Farm Credit System.

- (b) Limited privileges of Federal income tax exemption for agricultural cooperatives that comply with Section 521 of the IRS code.

- (c) Limited exemptions for Federal securities laws, and favorable Securities Exchange Commission precedent and practice regarding not treating true patronage paper as requiring registration.

These are some very cogent legal/economic advantages to operating on a cooperative basis. There are others that have become apparent in recent years, some of them recognized belatedly by growers who lost their organization. As an example, cooperatives increasingly act as the producers' voice in their industry. This is especially true as producer numbers continue to dwindle. Representation of growers' interests through their economic organizations substitutes for the strength in numbers formerly held whether it be on trade, environmental, marketing order or other issues.

Another example is in the soundness of decisions generally reached by cooperatives. While cooperative structure may lead

to slower decisions due to the deliberative process, these decisions are often well thought through and thoroughly debated.

Cooperatives retain a dispersed ownership agriculture by their very nature. This is increasingly important to the future economic organization of American agriculture.

As self-help regionally or locally-based, private sector rural enterprises, cooperatives provide development and growth that is sensitive to local business conditions and responsive to the needs and service of rural people. Cooperatives represent a rural development success story that can be a model for other sectors serving rural America.

Managers who claim that cooperatives can't operate as well as IOF's just haven't done their homework. They haven't learned to manage in a co-op setting. If a manager uses only IOF management tools when dealing with a cooperative, then naturally the co-op won't be as successful — an incomplete set of tools is being used. It's like trying to tighten a bolt with a hammer.

I would also emphasize that there is nothing in a cooperative's purpose, structure, method of operation, or financing that makes it a less effective or beneficial player in a competitive, market oriented economy. Those who make free and unfettered competition the centerpiece of economic activity cannot say cooperatives are anachronisms made possible only because some refuse to accept the real business world in which we all live. Cooperatives can and do compete as effectively as any IOF when they are properly managed and controlled, and in so competing make the market system work. It is no more accurate to say cooperative conversion to an IOF is just one more step in their organization maturation process than it is to say the dramatic and destructive collapses and bankruptcies of IOF's so common today (often for the very same reasons leading to cooperative conversions) is just one more step in their maturation process. Such an observation begs the real question—what must be done during the life of either organization to prevent its demise? From an economist's viewpoint, either process is not an answer nor a conclusion, but an invitation to find out what went wrong.

As we observe various proposals to convert or otherwise deviate from received cooperative methods of operation, there appears to be a persistent myth that producers can retain producer control when trying to attract outside capital. What isn't fully appreciated or scrutinized is that outside equity interests create a different fiduciary responsibility in an organization, and that income maximization for producers' benefit is therefore sacrificed. In short, producer orientation is diluted and often lost. So are the benefits that go with producer ownership. The experiences at ARI and Rockingham provide some lessons in this regard that puncture the myth.

Who's Promoting Outside Equity?

It's perhaps useful to identify elements promoting the conversion of cooperatives to IOF's, or the use of outside equity by cooperatives. In his article identifying conversions, Lee Schrader at Purdue University overlooked mentioning these promoters or what motives might be encouraging them. Here is a list for your consideration.

1. security firms, accounting firms, law firms, financial houses, and consultants who would profit from handling such transactions, and who have little appreciation for what cooperatives are and what they do;
2. over zealous managers who would convert the organization for their own aggrandizement such as controlling ownership interest, high pay and benefit rewards;
3. certain manager cults who are more concerned with "keeping up with the Jones" or "bandwagon" attitude by taking assets out of producer control through public offerings thereby disenfranchising producers from future benefits;
4. Selfish growers who want to cash out and don't care about what happens to their peers;
5. Boards and managers looking for an "easy" way out of problem resolution in the short run without examining long run consequences; and
6. Managers or management teams who have failed to manage the cooperative effectively and would blame failure on some inherent weakness in the cooperative form of business.

What Are Long Term Consequences of Conversion?

The longer term consequences of converting cooperatives to IOF's is important to consider and understand because it helps others think through the cause and effect relationships, i.e., long run implications. Among these are the following:

1. Producers maintaining equity interest in IOF's find that they are minority shareholders and have no say or control as was true when they were owner-users of a cooperative. Producer interest and influence is vastly diminished.
2. Producers no longer have the benefit of the yardstick role of cooperatives as a dimension of market structure.
3. the cooperative is no longer there as an institution to protect and enhance farmers' interests for the next and succeeding generations. Most producers have that interest in mind.
4. Need for a cooperative often continues, however, at a much higher capitalization price than the assets just given up through a conversion, i.e., it will cost a lot more to get a new one going.
5. Development of markets for farmers' products takes a long term commitment to build a consumers' franchise for products. Cooperatives are never adequately compensated for the value of the market development effort.
6. In many cases, sale of assets is playing right into the hands of growth-oriented IOF's that may be seeking to displace farm operators as well as their cooperatives (Castle & Cook's Dole acquisition of citrus groves and packinghouses)
7. Cooperative/public stock company or ESOP mixed ownership arrangements will likely be challenged on grounds of violating the intent of the Capper-Volstead Act. Besides, its difficult to serve two masters.

At the root of many situations that may lead to consideration of cooperative conversions to IOF's, are faulty cooperative practices. The best cooperative alternative is to identify these practices as problematic and to straighten them out rather than throwing the baby out with the bath water.

A Reaffirmation of Cooperative Fundamentals Needed

Recent focus and attention on cooperative finance is welcome because it provides an opportunity to reaffirm fundamentals or basics of cooperative finance. The key is that control follows finance and that growers and ranchers need to capitalize their organizations if they are to realize full benefits from operating on a cooperative basis. California leads the nation in the dollar volume of products marketed cooperatively. As a result, there is need to constantly evaluate financial needs to: (1) provide organizational stability, (2) keep ownership in the hands of current users, and (3) capitalize on growth opportunities.

In a talk on creative financing George S. May, former CEO of United Cooperatives of Ontario, identified ten ideas for creative financing. These included (1) A menu of flexible-innovative investment instruments such as preferred shares with an accumulative dividend feature or joint venturing with members in a federated system; (2) sale/lease back of existing assets taking advantage of investment interest by foreign interests, with rights to repurchase; (3) business integration back and forward with suppliers or buyers; (4) spin-out of specific business units through joint venture where a majority interest is retained; or use franchise turn-key package basis; (5) redevelopment of specific assets such as real estate that can be sold or converted to alternative uses; (6) combining with other co-ops to create "one-stop" financial centers" through linkages with the cooperative farm credit system, credit unions, or cooperative insurance companies; (7) pension fund manager leverages when over funding occurs; (8) looking at joint fiscal agency arrangements such as the Euro capital market through a multinational combining forces in the cooperative sector; (9) off-shore barter arrangements to enable sales of product abroad to countries with weak currencies; and (10) government capital sources such as regional development grant programs such as those found in Canada and the EEC to replace older facilities or build new ones.

Evidence indicates cooperatives can survive and flourish by sticking to sound basics of cooperative finance. Some innovations or creative ways can be adopted like those mentioned above without throwing the baby out with the bath water. It's important that when using subsidiary, joint venture or other arrangements that control always stays with the originating cooperative thus maintaining the user-owned nature of the business. Wherever possible, these arrangements should also be used with other cooperatives thereby strengthening the cooperative system.

While members cannot shirk their responsibility to finance their cooperatives, we probably need to reexamine how capital is rewarded as an input, i.e., revisit cooperative practices.

Summary

Producers need to take a long hard look before taking action to sell out their cooperative. While there is probably some wisdom in the verse from Kenny Rogers, Gambler song "Know when to hold them, and know when to fold them" producers have invested a lot of blood, sweat, equity and sometimes tears in establishing cooperatives as viable business

organizations. The need for such an alternative business form continues. As one cooperative leader has succinctly stated, farmers in our area have paid for many companies over the years, but this one we own.

Our orientation as resource people needs to be on a how to build upon cooperatives effectiveness and efficiency, not how to liquidate them. □

TRI VALLEY GROWERS CAPITAL FUND

Donald Schulak

Tri Valley Growers' capital fund and pooling practices have their roots in the formation of Tri Valley Packing Association in 1932. In 1920, Armour Packing Company signed a consent decree with the U. S. Government under the Livestock Act which provided that no meat packer could market produce unrelated to the meat business. The consent decree, though signed in 1920, gave the meat packers ten years to divest their fruit and vegetable canneries. After a court battle, the decree took effect in 1931, effectively closing Armour's fruit canning operations at its Visalia, Modesto and San Jose plants.

It is part of the folklore of Tri Valley that one of their five original fruit grower directors borrowed the \$100 which capitalized the cooperative under the California Food and Agricultural Code. Armour sold its plants to the cooperative for nothing down, no interest payments for three years and no principal payments for ten years. Spreckels agreed to supply sugar and Continental Can agreed to supply cans with no payment until the processed fruit was sold. Plant personnel made similar agreements. Regardless of what has been published, Drexel Burnham did not originate the highly leveraged transaction! TVG is leveraged but never as highly leveraged as at its inception.

The history of Tri Valley records that its first general manager, Mr. George Pfarr, the man who allegedly borrowed the \$100, had prior experience with a cooperative that had gone bankrupt. He emphasized the importance of the single pool concept. Referring to the grower problems that plagued the bankrupt cooperative's multiple pool method, he said:

"...we had constant bickering to adjust overhead to show results for these products. This did not lend itself to harmony...."

"To overcome this difficulty we established a value at which every ton of products delivered was credited on the books at the time of delivery. This value was established by the Board of Directors and was established at or as near as possible to the value our competitors were paying. We thereby established a total established value on all products delivered.

"We then operated our canneries just as our competitors did, sold our goods and paid our operation costs exclusive of the value placed upon the growers products. All the money left after paying the above was divided among our different products in the same ratio as that of its established value...."

"Three features made for harmony among our growers. First,

the pooling of all products into one pool. Second, the regular payment plan. Third, the almost guarantee of receiving the established price."

The original bylaws provided for an eight-year revolving fund with a maximum retention of 17.5% of the aforementioned established value. Eight times 17.5% equals 140%. We will come back to that number again. The Association was exempt from federal tax under a code section that preceded Section 521. Farmers were not particularly worried about income taxes in 1932. The retention was not taxable until redeemed in cash eight years later. This is still the state of California tax law if the proper elections are made.

In 1966, the federal tax law was changed to make retentions taxable when issued. Patrons would then be subject to tax for the refund of prior years' retentions as well as current retentions. By 1966, we were well past the great depression and our members were paying taxes.

In addition, the industry was changing. The Board correctly predicted that waste disposal costs in the San Francisco Bay Area would become excessive. Tri Valley had two plants in the Bay Area. Dole, the largest producer of fruit cocktail in the world, desired to sell their plant, also located in the Bay Area.

The plan adopted at this time comprised six main points:

1. TVG would buy the Dole facility and agree to a supply contract with Dole.
2. TVG would build a "super cannery" in Modesto large enough to replace the production of the three Bay Area plants which would then be closed.
3. The City of Modesto would build a modern waste disposal system to accommodate the new plant.
4. TVG would accept non-patronage tonnage from Dole's growers. Thereby, TVG would become taxed under Subchapter T rather than Section 521. The goal set in 1970 was to build after-tax retained earnings of 10% of members' equity from this non-member tonnage.
5. The equity program was changed to require a "permanent" equity base as determined by the Board. The plan adopted that year and still in place today requires a capital contribution of 140% of the last

eight-year average of established value, the numerical equivalent of eight years at the maximum retention of 17.5% per year. The maximum retention was continued at 17.5%. If there was a poor year and the cooperative retained less than 17%, the difference would be made up in years subsequent to the eighth year. The Board has discretion to change both the eight-year period and the 140% maximum.

- This program enjoyed the advantage of "locking in" pre-1966 untaxed retentions, which addressed the tax issue discussed earlier. Since TVG would only be retaining the amount necessary to bring a member up to the 140% requirement, there would not be a refund unless a member's established value fell. A member would be subject to tax for any incremental addition (his retain). Unless the value of his deliveries fell, he would not suffer a tax on his pre-1966 retains. This was advantageous for the \$20 million equity held at that time but is of little significance today when we have more than \$150 million in member-contributed equity.

In the early 1970's, the program was modified to allow a modest amount of liquidity. The bylaws were amended to allow retired and active members to sell equity to other active members not subject to delivery history or equity requirements. This enabled active members to acquire equity from another member and at times, a members' bank, at a discount, reducing the cost to the purchaser of meeting equity requirements.

Unfortunately, it worked too well. To slow down the sale and purchase, the program was modified to require active members selling their equity to pay interest at TVG's cost of funds plus 2.5% on any equity shortfall created by the sale. In recent years, the Board has capped these equity sales at \$2 million. Whatever an active member gained, the cooperative lost, but it did provide a means for retired members to redeem their equity early and aided current members in hardship cases to sell their equity and still maintain their membership rights. Again, this program has been capped at \$2 million and the Board, at its sole discretion, can reduce the cap to zero.

In 1983, the bylaws were amended changing the equity requirement base from established value to crop proceeds. That increased the equity requirements significantly. In addition, the method of allocating proceeds between crops was changed from the single pool method to a 50/50 method; 50% based on the separate return for a given crop and 50% based on the return of all crops. That is, if crop A earns 110% and the total is 120% for all crops, then crop A member will receive

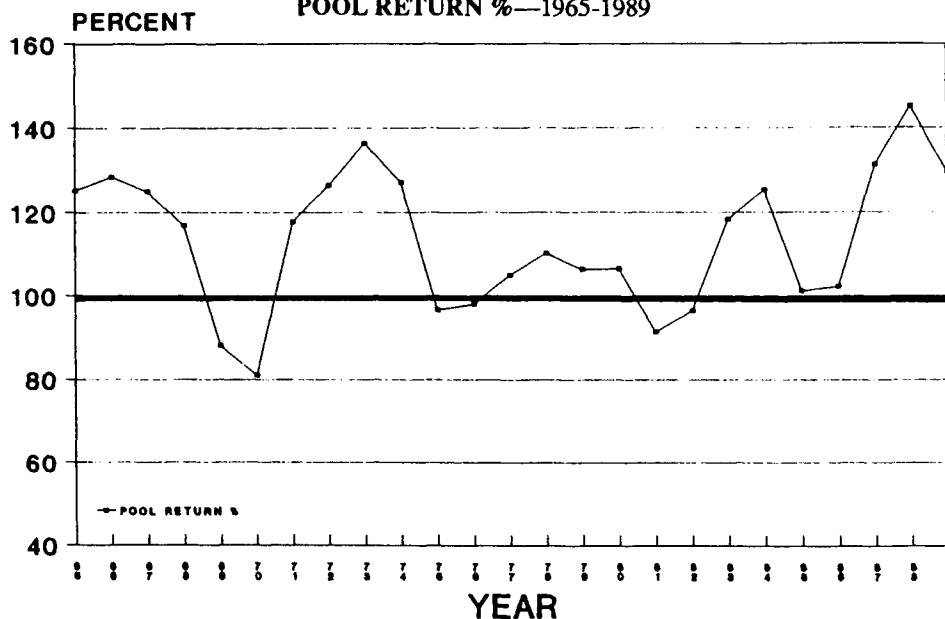
115%. If crop B earns 140% and the average is 120%, then crop B will receive 130%.

In an emergency, the cooperative can choose to refund equity with three-year promissory notes. This has been done about six times over the last 55 years. It can also fail to refund at all. That has been done only once. If the financing requirements increase, the Board could increase the equity requirement to an amount greater than 140% of the last eight-year average. In addition, the eight-year multiplier could be changed.

The goal today is to build permanent equity in the form of unallocated retained earnings. There have been a variety of mechanisms; two proprietary subsidiaries, S&W Fine Foods and Valley Forklift, have helped. S&W acquires TVG-produced products at cost. They pack dry-soak beans, potato chips, glace, coffee and other items in two plants. They also source fancy products worldwide. Valley Forklift procures forklifts for TVG and also sells and leases forklifts to the general public. Our can manufacturing division, the largest manufacturer of sanitary cans on the West Coast, sells a small portion of its production to other California processors. TVG recently incorporated a New Jersey corporation to process Eastern tomatoes and reconstitute our California tomato paste into products for the East Coast market. We market offshore-sourced products through our distribution systems. We also add to retained earnings unusual income such as the sale of tax credits and major gains on sales of fixed assets. And, of course, we process non-member raw product and retain the profits. All of these activities are subject to federal and state income taxes.

This after-tax retained earnings has provided cushions for unexpected losses such as the start-up of the previously mentioned "super cannery", the banning of products made with cyclamates, the discontinuance of certain products, retroactive FASB adjustments such as SFAS #96, a flood and now, last year's earthquake. Over the last 20 years, almost \$30 million has been charged against retained earnings from these events. This cushioning ability has helped to prevent valleys in our patronage pools.

Chart #1
POOL RETURN %—1965-1989



Tri Valley Growers Capital Fund

We have always kept separate our patronage losses carried forward under Section 277 from our non-patronage losses carried forward under Section 172. However, all of these losses were ultimately deducted for both federal and state tax purposes.

Earlier, I mentioned the statement made by TVG's first general manager that 100% pool returns could practically be guaranteed. Obviously, there is now much more volatility than we experienced prior to the 1960's. Chart 1 shows TVG's average pool return for the last 26 pools. Pools are closed after 90-95% of a crop is sold, normally in November of the following year.

Chart 2 shows our after-tax net proceeds by fiscal year. The fiscal year is far more volatile than the pool year because it cuts off at January 31 when less than 50% of the new pack is sold. Note that during the last agricultural depression in the early 1980's, when interest rates reached 20%, we lost over \$30 million in a three-year period. The next chart will show the lack of impact of these losses on our equity.

Chart 3 shows our equity growth over those same 26 years. We never failed to increase our equity even during the 1980's agricultural depression.

Chart 4 shows our total interest-bearing debt-to-equity ratio as of January 31. Normally, only 50% of the new pack is sold by that date so our debt is near its seasonal peak. There were significant increases when we built the "super cannery" and acquired the Oberti Olive Company and S&W Fine Foods, Inc., when Glorietta Foods was admitted as a member and when California Cannery & Growers was absorbed.

The latter was not an acquisition but rather the amalgamation of assets and growers into TVG when California Cannery & Growers, a cooperative larger than Tri Valley, went bankrupt. After each of these events, new equity contributed by new members subsequently reduced our leverage. We are now again near our long-term low.

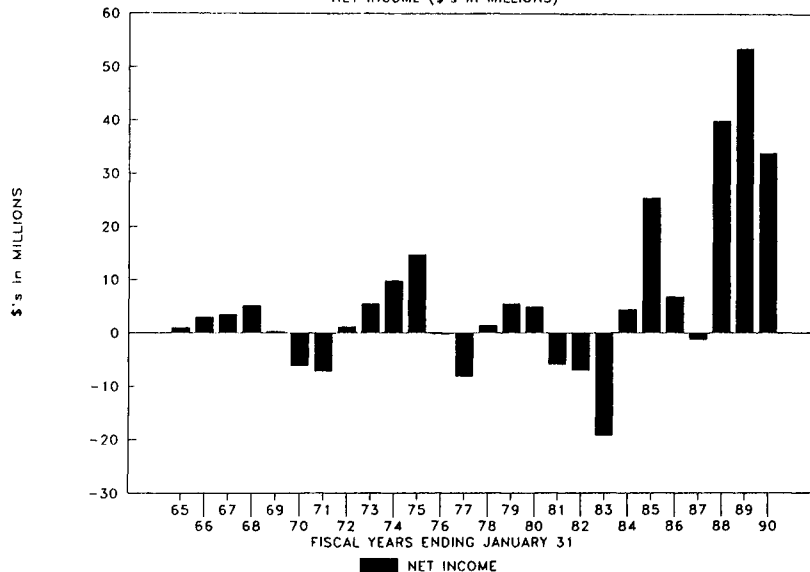
An internal control established to prevent an overpayment is the requirement that every monthly pool simulation (forecast) must be accompanied by a table showing the estimates made in that same month and the final result for each of the last ten years. If accounting seriously misses a forecast, then they must admit it for the next 120 months. We have had only trivial overpayments of progress payments in our 55-year history.

A secondary protection against overpayments is our Board of Directors. Recently, a Standard & Poor's analyst inquired if our Bylaws contained a provision placing the lender in front of the patron. I responded that we have something better. Our Board consists of nine grower members and two outside directors. We market eight patronage crops. It is unlikely that a director growing one crop would ever vote to overpay another crop.

Chart #2

TRI VALLEY GROWERS

NET INCOME (\$'s in MILLIONS)



In summary, TVG was born in the depths of the Great Depression. Its midwife was leverage. It has grown to be the largest canner of fruits and tomatoes in the State of California. We never could promise our lenders that we would always make a profit. We did promise that we would never pay out more to our members than we earned and that our equity would always grow. I believe that systems and traditions have been institutionalized so that we can keep that promise into the future. □

Chart #3

TRI VALLEY GROWERS EQUITY ANALYSIS

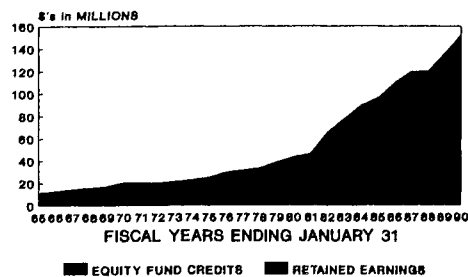
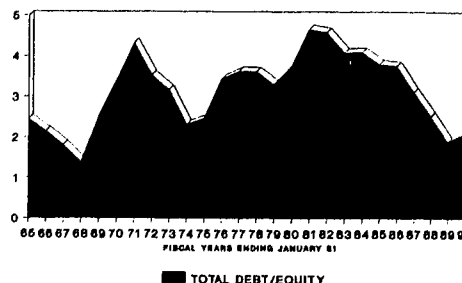


Chart #4

TRI VALLEY GROWERS TOTAL DEBT TO EQUITY RATIO



VALUING DELIVERY CONTRACTS

George Crispin

I am pleased to be here and have this opportunity to tell you a little about Agripac and our experience in valuing delivery contracts as a means to raise equity capital.

First, let me take a few minutes to present a brief history about Agripac and set the stage for the situation we faced that prompted action.

Agripac is a grower owned cooperative located in the Willamette Valley of Oregon. The company was created in 1971 through a merger of two predecessor cooperatives, Eugene Fruit Growers and Blue Lake Packers. Eugene Fruit Growers was formed in 1908 and Blue Lake Packers was founded in 1932. With these roots, Agripac has been a functioning cooperative for over 80 years. Our cooperative is a frozen and canned fruit and vegetable processing company. We sell our products to the private label trade in retail, foodservice, industrial, and export markets. At 46% of sales revenue, foodservice is our largest business segment followed by retail at 37%, industrial at 9% and export at 8%. (See Figure #1) These percentages exclude our Birds Eye business, which I'll discuss later.

Business Segment Analysis
% of Dollar Sales (Actual 1988 YTD)

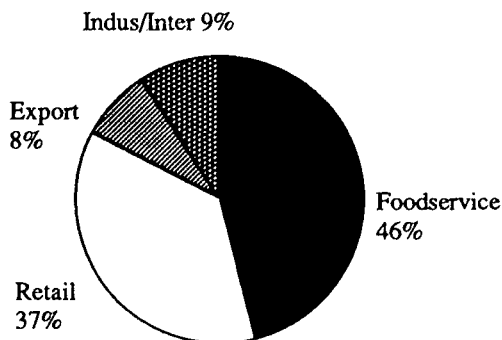


Figure #1

Agripac also markets canned vegetables and fruits under two regional brands. Our Diamond A brand is distributed primarily in the Western United States, including California. Jack and the Beanstalk is distributed primarily in the Southeast part of the country.

Now, before I go any further, I think I had better pause and say something about our location. We know that everyone knows where California is, but Oregon, usually pronounced Ora-Gone by most out-of-staters, is sort of thought of by many people as being "somewhere out west". Oregon is not only a very scenic state, but enjoys a diversified economy from agriculture to forestry products to High Tech.

Agripac's crops are grown in one of the most agriculturally varied and fertile soils in the United States, the Willamette Valley. The very ample winter rains and abundant summer irrigation water assure consistent production of high quality crops. Over the years, Agripac has been a leader in our industry. In 1923, Eugene Fruit Growers was the first U.S. Canner to

make a commercial pack of Blue Lake pole beans. The pole bean spurred the development of the northwest as a canning area and set the standard of quality for over 40 years, until the introduction of the bush bean in the mid 1960's.

Throughout the 1950's and 60's both predecessor cooperatives grew and prospered. Increased tonnage requirements necessitated new and improved methods of growing, harvesting and processing crops. New varieties were developed and the mechanization of harvesting reduced or eliminated the need for hand labor. In the processing plants, line speeds were increased with new equipment and procedures.

After the creation of Agripac in 1971, the company decided to expand production to meet the growing demand for frozen fruits and vegetables. Freezing tunnels were added to Agripac's plants in Salem and Eugene. In 1980, Agripac acquired another frozen vegetable processing plant in Salem from Delgetty Foods. With the acquisition of the Delgetty plant, Agripac's frozen business generated about half of its sales revenue. At the same time that its frozen business was expanding, Agripac also tried to expand its canning business. In 1981, Agripac purchased a canned green bean and pear packing plant from Castle and Cooke (Dole). In the same year a major capital investment was made to update and increase canned production in its other plants.

The expansion coincided with a major economic downturn and double digit interest rates. Agripac recorded its first loss in 1980. Four consecutive years of losses brought Agripac's growers to financial crisis and, for some, bankruptcy. In the midst of its financial troubles, a labor dispute arose and a major strike nearly brought Agripac to its knees. Accumulated losses for the four year period 1980 through 1983 exceeded \$15 million. (See Figure #2) Pool returns averaged 75% of the cash value of the crops delivered to the cooperative — before retains. To put this in perspective, it was equivalent to having every Agripac grower experience a total crop failure for one year. Needless to say, retains were insufficient in those years to maintain a strong balance sheet. The Company borrowed its way to survival.

1980 - 1983 Operating Losses

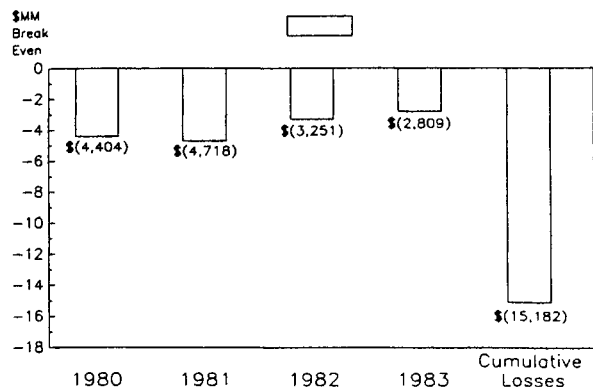


Figure #2

In late 1983, Agripac hired a new President & General Manager, Paul Solari. Paul was a seasoned veteran in the canning industry and experienced in turnaround situations. The mission mandated by the Board of Directors to Paul was simple and direct... "Stop the hemorrhaging and get things headed in the right direction". In assessing Agripac's predicament, Paul knew there was nothing that could be done near-term about the heavy debt load and that the Company lacked the capital to invest in cost savings projects. So, the focus had to be on direct and immediate action in three areas...cost reductions, margin improvement and accurate financial information. Paul quickly initiated a cost reduction plan. These programs, especially as they affected the elimination of jobs and created stricter controls in all facets of the business, were not easy. Many rumors abounded in the trade, among our suppliers and in our communities, sometimes with the encouragement of our competitors, that Agripac would not make it.

Addressing Agripac's marketing problems, Paul recruited an experienced sales and marketing professional and hired Dennis Delaye to take on this challenge. Last year, Paul retired as Agripac's President & General Manager and was succeeded by Dennis Delaye.

But for those that wished us ill, it was wishful thinking on their part. They did not count on the basic character and strength of Agripac's growers and employees...and their will to succeed. By 1984, Agripac was on the mend. (See Figure #3) The Company posted a modest profit in 1984 with a pool return just over 100%. Over the next couple of years, Agripac hovered around the breakeven point with pool returns at the 97 to 98% level. The hemorrhaging had stopped but the Company was not achieving pool returns that were adequate for the growers or to finance the Company's capital requirements.

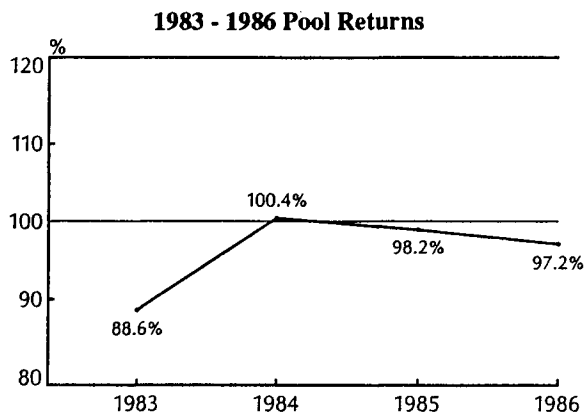


Figure #3

In late 1985, Agripac developed a three year strategic plan with the objective to bring pool returns to at least the 110% level and a goal of 115%. (See Figure #4) One of the strategies adopted was to balance the price instability related to private label sales with a strong brand. Since Agripac lacked the resources to build its regional brands to national prominence, the tactic that emerged was to seek an association or affiliation with a national branded food company. And, as fate would have it, in 1986 we read a news release in the local paper announcing General Foods intention to sell their Birds Eye frozen vegetable plant in Woodburn, Oregon and sign a supply agreement to buy Birds Eye products from whoever purchased the plant.

Woodburn, incidently is only 15 miles north of Salem. This is what we were looking for and we went after it. The purchase of the plant and multi-year supply agreement were completed in February, 1987. Although it entailed some risk, the opportunity provided an excellent fit with Agripac and was just what the doctor ordered.

Strategic Plan Pool Return

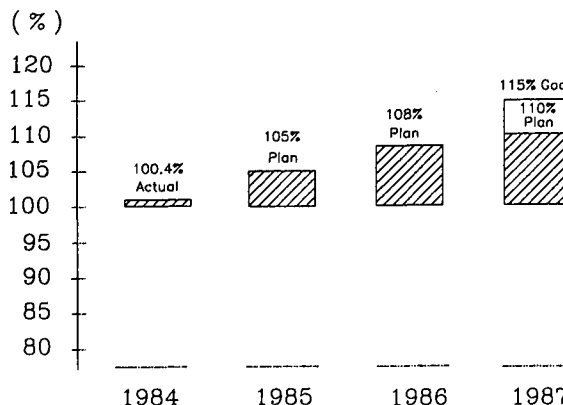


Figure #4

Convincing General Foods that we could operate a frozen processing plant more effectively than they could was an interesting challenge. After all, Birds Eye pioneered the frozen industry. But, due to Woodburn's close proximity to Salem, we identified significant synergistic cost savings that could be realized by Agripac. In fact, we proved that we could manufacture Birds Eye Products for General Foods, with a reasonable profit margin—at a lower cost than they were able to achieve. The supply agreement with General Foods was structured to minimize Agripac's financial risk. We were willing to put a cap on the upside profit potential in manufacturing Birds Eye products, but we insisted that there also be a floor, virtually insuring that we would breakeven after paying facility interest. Limited risk was a very important negotiating point.

The key hurdle we faced in pulling off the acquisition of the Birds Eye plant was financing. We were already over-burdened with debt and our growers were unable to finance the acquisition using traditional methods for raising equity capital. This chart (Figure #5) shows the rapid build-up of Agripac's long term debt during the early 1980's as a result of ill-timed expansion and borrowing its way to survival. You can see that Agripac's long-term debt in 1980 was only \$2.6 million, by 1985 long-term debt reached \$15.2 million- about a six-fold increase.

Another key issue was dealing with the existing growers that delivered their crops to the Birds Eye plant in a fair and equitable manner, and, at the same time, providing opportunities for Agripac's existing growers to deliver crops to the plant that they would own. This was a particularly thorny issue. One of the main considerations of the acquisition was the crops delivered to the Woodburn plant that were also grown by Agripac's growers for delivery to the Co-op's plants. The Common Crops grown were green beans, Italian beans, sweet corn and cauliflower. The other crops delivered to Woodburn further enhanced the value of the plant. The other crops grown were baby whole carrots, pearl onions, cabbage, strawberries and raspberries.

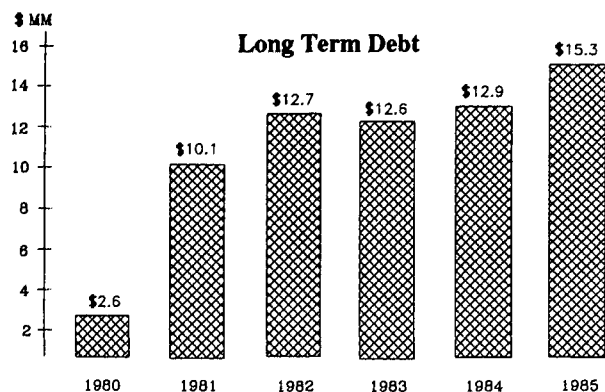


Figure #5

To respond to these issues, the Board created a "Grower/Equity Committee" and charged them with the responsibility of developing a plan to raise equity capital and deal with grower issues. The Grower/Equity Committee met many times to grapple with the issues and formulate a plan. It wasn't easy, but a solution was found. The committee recognized that it would be impossible to please both the old Birds Eye growers and Agripac's existing growers, but there was a way to handle the transition in a manner that addressed the concerns of each group. We called it the Grower Transition Plan. The grower transition plan was a three year program that enabled the Birds Eye growers to phase down their row crop farming operations, allowing them time to develop alternative crops. Agripac recognized that an immediate termination of Birds Eye grower's delivery contacts would cause severe economic hardship, not only to the growers, but to farm supply businesses, lenders and local communities. The total value of the crops they delivered to Woodburn was over \$8 million.

Over a three year period, Agripac growers would be given the opportunity to grow products delivered to Woodburn. In the first year, Birds Eye growers would grow two thirds of the Woodburn tonnage and Agripac members one third. In the second year, Agripac growers would grow two thirds, and in the third year, Agripac growers would grow 100%.

The next topic was quite controversial, but Agripac's Grower/Equity Committee felt appropriate. They decided to offer membership in the Cooperative to about 30 Birds Eye growers. These growers were fairly large and derived a high percentage of their farm income from their deliveries to the Birds Eye plant. These growers still would lose two thirds of their deliveries, but had an opportunity to join Agripac and keep one third.

Finally, we addressed the equity issue. Since all of the common crops to be grown for the Woodburn plant were incremental tonnage requirements for Agripac's growers, we decided not to just give them away to the members of the Co-Op. We would sell the right to grow this tonnage. We created Woodburn Base Acres and made them distinctly different than Agripac's original base acres. What are base acres? In 1982, Agripac allocated the acreage required to grow the crops it needed to its member growers as a way to control the acres planted and tonnage delivered to the Co-Op. Base acres gave

members the perpetual right to grow a specified number of acres of a specific crop. Further, the Co-Op allowed growers to transfer or sell their base acres to one another, subject to certain criteria. The original base acres that were given to Agripac's members quickly took on a market value. During the hard times of the early 1980's, some growers sold some or all of their base acres to generate cash. Other growers bought base acres, hoping that the Co-Op would turnaround and they would make a return on their investment. By 1986, Base Acres values had increased significantly. Demand for additional acreage far exceeded the annual quantity that became available. The Woodburn plant acquisition would create the need to grow additional acreage, and therefore, a source for new equity capital.

The values established for Woodburn Base Acres were determined by evaluating the prices that Agripac members were selling their original Base Acres within the membership. We then discounted these prices about 25% to arrive at the value we set for Woodburn Base. We created 1,200 acres of green bean base at \$750 per acre, 200 acres of Italian Beans at \$750 per acre, 3,900 acres of sweet corn at \$250 per acre and 600 acres of cauliflower at \$860 per acre. Overall, we determined that we could raise about \$2.5 million in new equity capital over a three year period, or approximately \$850 thousand per year during the three year grower transition program. (See Figure 6.)

Woodburn Base Acres and Equity Value

	Acres Available	Value Per Acre	Value Equity (000's)
Green Beans	1,200	\$ 750	\$900
Italian Beans	200	\$ 750	150
Sweet Corn	3,900	\$ 250	975
Cauliflower	600	\$ 860	516
			<u>\$2,541</u>

Figure #6

One provision we made on the Woodburn Base Acres, was that they could be redeemed at some future time by the Co-op at their face value. This was done so that if, for some reason, we no longer needed to grow this acreage, we could retire the Woodburn base, rather than dilute Agripac's original base. Armed with a grower transition plan, a means to raise \$2.5 million in new equity capital, tentative acceptance by General Foods of our offer to purchase their Woodburn Plant and manufacture Birds Eye Products under a multi year supply agreement, it was time to review our plan with the Bank of Cooperatives. So, we jumped in our brand new corporate jet and set our heading for Spokane. We knew that selling our proposal to the Bank would be difficult at best. But, with some friendly persuasion, the Bank's loan officer could see our point. The effect of the acquisition was a major step for Agripac, increasing sales by over 50% from \$77 million in 1986 to \$117 million in 1987. (See Figure #7.) Pool returns increased from 97% in 1986 to almost 116% in 1987. (See Figure #8)

Valuing Delivery Contracts

From 1987 to the present time, Agripac has continued to grow and prosper. Aided by the Midwest drought of 1988 and 1989 that drove up prices for canned and frozen fruits and vegetables, Agripac recorded its all time high pool return in 1988 at 185%. In our business, one growing area's disaster is another area's bounty. Our cooperative has suffered through some hard times, but the adversity has made the good times seem even better. With a little luck and a lot of hard work, today Agripac is alive and healthy. We are proud of our past and optimistic about our future.

As with many Co-ops, we continue to explore innovative ways to finance our Cooperative. The Woodburn acquisition provided a unique set of circumstances that enabled us to sell incremental delivery contracts, or Base Acres, to raise equity capital for a specific purpose. I think this conference is especially pertinent for cooperatives seeking innovative approaches to address capitalization issues. □

Agripac/Woodburn Sales

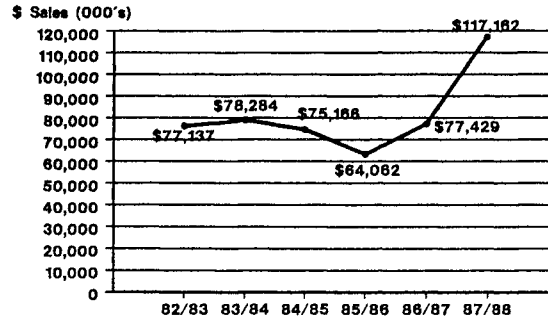


Figure #7

1982 - 1987 Pool Returns

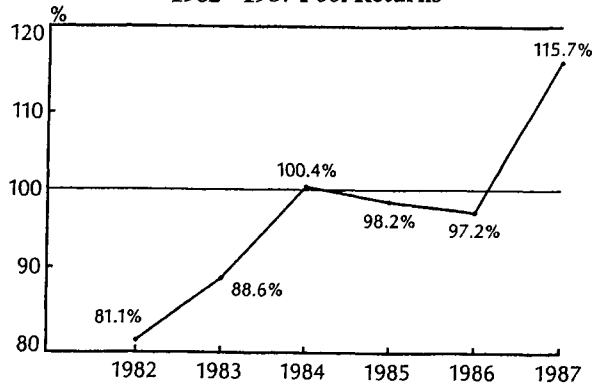


Figure #8

