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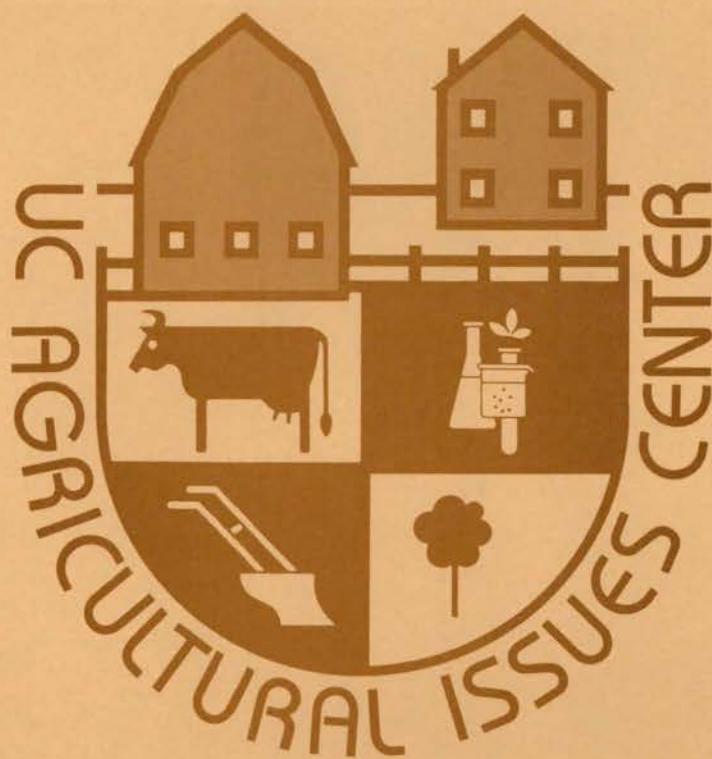
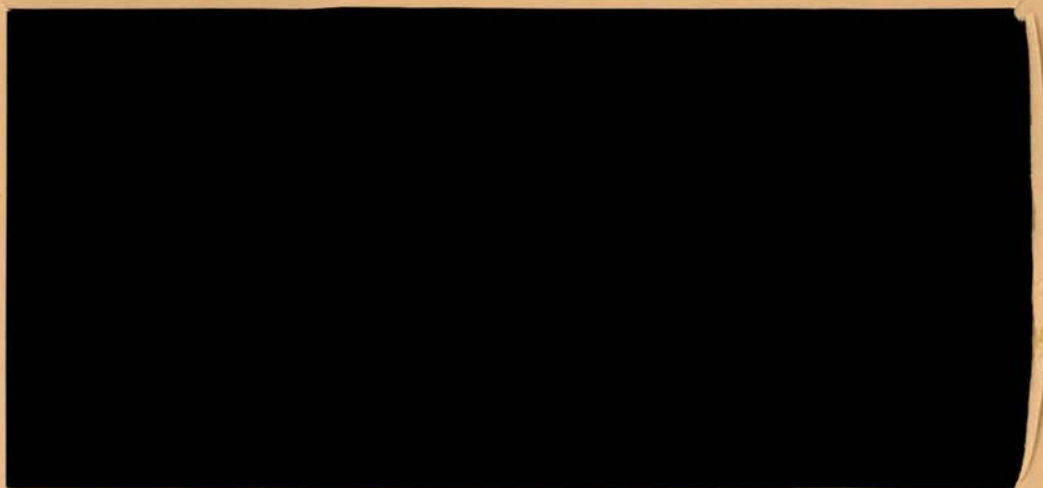
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Agricultural Cooperatives: Are They Still Relevant?

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It is in the highest order of the duties of a chief executive officer to ceaselessly question the relevancy of the enterprise entrusted to his leadership. This is a vital part of the process of staying in touch with the many competitive, demographic and institutional influences on the market place for a company's products or services. No matter how successful a business may be at a given moment in time, its long term survivability rests upon its ability to recognize influences for change in its environment and to adapt to that change in a manner that exploits any new advantage or minimizes any harmful development.

Over the course of the nearly 40 years of my experience in the food industry, the winds of change have blown constantly, forcefully and seemingly from every direction. Today, these forces for change seem to be quickening their pace and intensifying in their complexity. Thus, the issue of relevancy is of greater concern than ever for any industry participant.

At the outset of my career, the dominant market forces were:

- a rapidly expanding world market for commercial sales of food products;
- an explosive series of technological innovations that dramatically improved productivity in each stage of food delivery systems; and
- the beginnings of the continuing trend away from recipe prepared meals to convenience foods, snacks, and meals away from home.

At my mid career, government activism began to re-shape the business climate of the food industry and seems certain to persist as one of the dominant influences on how we produce and deliver food. Government intervention now impacts a host of food industry issues as wide ranging and diverse as:

- agricultural subsidies
- water management
- food labeling and packaging

- international trade
- fiscal and monetary policy
- air and ground water quality
- food safety
- immigration law

And finally, we are now well into a new period in which the commercial world market for food is maturing--at least in quantitative terms--while world food production continues an irrational expansion. In the cruelist of ironies to the American farmer, this rapid growth of foreign capacity coincided with the sharp rise in the dollar's exchange rate during the first half of this decade. Largely because of a currency basis that made our products less competitive, the force of rising world surpluses almost exclusively hit U.S. farm producers, forcing back their historic market shares and driving down true commodity values perilously close to cash costs for many crops. And specialty crops certainly have not been sheltered from these developments.

Brazil is awash with surplus orange concentrates, products of massive conversions in recent years of former jungles to citrus groves. Because of these marketless supplies, American markets have been unaffected in terms of price or product availability by the unprecedented series of killing frosts that have occurred in Florida since the turn of this decade. Boat loads of substitutable Brazilian concentrates have flowed readily to the United States to fill the voids caused in Florida by a capricious Mother Nature.

With processed tomatoes, world capacity has increased by at least 50 percent since 1975, a year which many identify as capping off a long upward trend in worldwide consumption. As with orange concentrates, any drop in local production can be quickly offset by a draw down from surplus stocks distributed literally throughout the world.

Wine grapes are still another commodity example of the worldwide stresses of overproduction. Our local industry has experienced a modest measure of relief this past year as the result of the marketing success of new products and the dollar's declining attractiveness to imports. Nevertheless, supply pressures are intensifying in the European Economic Community, where the wine industry is the centerpiece of the Common Agricultural Policy. Under this program, diversions of surplus stocks to nonbeverage uses

have failed in recent years to keep pace with declining consumption as young Europeans turn more and more to alternatives. The building inventories are an enormous multiple of California's annual production.

With these and many similar examples that can be drawn of the buildup of foreign capacity to produce both basic commodities and specialty crops, it seems evident that the world supply conditions that have triggered the ongoing farm depression in the United States may be long lasting. Foreign governments--including the EEC--continue to develop increased production capacities for both basic and specialty crops. To some degree this assistance reflects understandable strivings for self-sufficiency. In the main, however, it is evident that the motivation is to convert otherwise idle land and labor to exportable agricultural products.

It is not the purpose of this discussion to pass judgment on the economic merits of these foreign schemes. However, it seems to me compelling that we understand that the objective of these economic alliances between our foreign competition and their home governments is to obtain larger shares of world markets. To a major degree this means further erosion of world market shares for American produced commodities and the persistence of world surpluses, irrespective of the levels of future American farm production. This, then, is the competitive context for an examination of the contemporary relevancy of agricultural cooperatives.

I have often heard it said that agricultural cooperatives are the same as any other business enterprise except for their statutory charter. This ordinarily is followed in the notion that all that is needed for successful performance are competently drawn policies and competent business management. Such vacuous thinking very probably explains why some cooperatives are formed to carry out economically foredoomed missions and why others labor for years under marginal performance with rotating boards of directors and management. In fact, cooperatives are profoundly different from for-profit businesses. Let me discuss what I believe are the two most significant of these differences.

First: By the very nature of their charter, the corporate purpose of cooperatives is to provide a service to members. In absolute contrast, the corporate purpose of all for-profit businesses is simply to reward invested capital.

Second: The only source of equity capital for a cooperative is pro-rata retains from the income stream to members. Again, this constraint derives from its charter. For-profit businesses, of course, have unlimited access to capital markets for equity investments.

These are much more than subtle differences.

To some degree, most cooperatives provide services to members that are without economic justification. In worst cases, these can sustain otherwise obsolete products or activities to the point of fatally impairing operating results. Meanwhile, the for-profit company faces no such dilemma for it is obligated to simply terminate any activity that does not support its return on capital objectives. Obviously, these differences can result in one type of management that is demoralized by marching orders that conflict with terms of accountability and another type that is accountable only to precisely drawn marching orders.

For equity capital, cooperatives must compete for available funds with the farming operations of their member patrons. That's a tough contest even under the best of times for production agriculture. Because there is no tangible return to capital on cooperative equity, farmers tend to look at it as an unsecured, interest-free loan. Furthermore, longer term members are inclined to resent the lesser investments of newer members. All too commonly, this negative environment for equity financing leads toward excessive leveraging of a cooperative's business operations. This in turn can launch a cycle of extreme conservatism in such critical outlays as plant modernization, market and product development and research. Excessive leveraging has a chilling effect on any other policy decisions perceived as discretionary and involving risk.

Just after post World War II during the period of world market growth, we can observe conditions that enabled cooperatives to not just survive with these limitations, but to greatly expand their activities. The predominant positive force was the rising economic tide of growth markets. These tended to provide profitable returns at the farm gate rather reliably, and thus modest marketing margins from the cooperative were tolerable, particularly if the cooperative's services enabled increasing farm output of profitable crops. In turn, these growth markets served to liquidate the cooperative's inventories quite reliably. This comforted creditors of cooperatives who might otherwise have been troubled by their highly leveraged financing and their potentially volatile memberships.

By the late 1970s it was becoming vividly apparent all of this market environment would change for the worse as world markets matured and foreign production escalated. Despite these clear signals, many cooperatives were unable to adapt to these new conditions. They were too bound to their habits of the past, which had been shaped by their inherent operational and financial limitations. As the casualties began to mount after the turn of the 1980s, the most common victim profile was a capital intensive, highly leveraged firm that was heavily or totally dependent upon high volume sales of nondifferentiated commodities or materials. Whether organized as cooperatives or otherwise, firms that were so positioned when world competition intensified in the early 1980s were no more able to cope with a new market forces than would a raft on the high seas be able to manage changing tides.

What has emerged from this drastic change in the supply and demand configurations of world food markets is a dramatic ascendancy in the value of favorably differentiated food products and a downward trend in value for most commodities. It is a classic case of the rich getting richer, while the poor get poorer.

For most commodities, cash prices have dropped alarmingly since the decade's beginning. For starters, wheat is off more than one-third and corn is only worth half as much. For consumer product marketers, however, this decline in commodity values has meant a dramatic drop in their production costs. Indeed, these past few years have provided the answer to a marketer's prayer: Healthy profit gains have been made without incurring the risks inherent with price increases at the consumer level. As vigilant as the consumer may be in monitoring any change in shelf price from one purchase to another, few, if any, perceive or care about the influence of world commodity markets on manufacturer's costs.

It should not be assumed that these gains have come easily to differentiated products or that they are locked in for the future. As always, franchises will be vigorously contested, no doubt all the more because of the lowered commodity cost base. Thus, even though there are cooperatives who are among this enviable group of marketers of favorably differentiated products, it is clear they must commit to professionally managed and adequately funded marketing programs over the long run if they are to sustain or further exploit their invaluable advantages.

It is these kinds of cooperatives that I see as still relevant under contemporary and prospective market conditions, subject, however, to one major qualification: They must find the means to overcome the financial and operational limitations of their charter.

Farm equities have been heavily eroded in this decade. If cooperatives have suffered chronically from financial malnutrition in the past, it certainly does not seem reasonable to expect their farmer owners to improve internal financing in the near term. Furthermore the issue of member services overriding return on capital simply will not go away. In fact it likely will intensify as substitutable lower-cost foreign commodities become increasingly available. One must ask: What will be the cooperative response when a for-profit firm competes on the retail shelf with an identical consumer product that is cost advantaged by French prunes, or Israeli tomato paste, or Greek raisins, or Spanish olives, or Chinese walnuts? Clearly, cooperatives must constructively resolve these basic operational and financial issues if they are to remain viable under the market conditions now in place.

There is, I believe, a working blueprint available for the operational and financial structure of future cooperatives. It involves a kind of hybridization of corporate structures by separating the business operations of the cooperative into a management company for which public shares could be offered. Most fixed assets would remain with the cooperative. The two entities would be linked by a management services contract with profit sharing provisions.

This concept has been pioneered successfully over a quarter century period by Curtice-Burns, Inc. and the Pro-fac cooperative, New York-based operations with a diversity of national involvements. Their prolonged and successful testing has abundantly demonstrated the usefulness of this hybridizing of corporate structures. To me, it is a relevant form for the successful cooperative of the future. I don't presume it is the only form that will facilitate successful progress for surviving cooperatives, but I do believe that most, if not all of them could be challenged to apply and benefit from the adaptive qualities of this model.

