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THE STRATEGIC CHALLENGES CONFRONTING AGRICULTURAL CO-OPERATIVES IN SOUTH-AFRICA: THE GROWING NEED FOR TRANSFORMATION INTO AGRICULTURAL COMPANIES

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1. INTRODUCTION

South-African agricultural policy has taken major steps towards liberalisation in the past seven years. This has had two immediate effects on the sector. First, agricultural co-operatives have lost their institutional role. Second, most of the sector is now confronted with fundamental changes in the competitive environment in which they operate. As a consequence, agricultural co-operatives should consider whether or not there is any economic argument for their survival within this emerging competitive environment.

We could rephrase the question as follows: can or will the agricultural co-operative survive in the new, competitive environment? If so, with what kind of activities? And what about the activities that are no longer performed by the agricultural co-operatives? How will they be organised in the future?

The bottom line of the discussion is purely economic: is there any managerial or economic reason to have agricultural co-operatives performing major economic activities within the sector?

2. CONTEXT: CHANGES AND IMMEDIATE CONSEQUENCES

The main argument for the change in policy was the need for South-African agriculture to be internationally competitive. Subsidies would cease and an efficiency drive was imperative. The shocks of the liberalisation policy would trigger the necessary adjustments, inducing greater efficiency within the sector. The main elements of the liberalisation policy were:

- the overhaul of the regulated marketing system: deregulation of agriculture and liberalisation of prices;

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- change in the tax system; and
- reorientation of government spending with regard to agriculture.

Managers of agricultural co-operatives (De Wet Goosen, 1999; Gouws, 1999; Du Toit, 1999; Joubert, 1999; Ras, 1999 and Schulze, 1999) confirm that the following changes have had the greatest impact on the position of their organisations.

- deregulation of the marketing system.
- abolition of subsidies;
- abolition of internal borders as far as the activities of individual co-operatives are concerned;
- opening of the market to international competition;
- loss of participation in the policy formulation process.

The deregulation of the marketing system, more precisely the abolition of the 1968 Marketing Act, has undoubtedly had a considerable impact on commercial agricultural co-operatives. Owing to deregulation, member farmers are no longer obliged to sell their products through agricultural co-operatives, and thus become competitors. Another result of deregulation is that the incomes of agricultural co-operatives come under pressure, since their sales through control boards are no longer guaranteed. In addition, the members of co-operatives have high expectations, which results in even greater pressure on agricultural co-operatives (Lubbe, 1994).

The government has suspended all forms of subsidies to the agricultural sector. It is clear today that commercial agriculture was strongly dependent on the government's financial support. The abolition of this support will sanitise the sector, and only efficient farmers will survive in the future (Vink, Kirsten & Van Zyl, 1998).

A positive change is that agricultural co-operatives are no longer bound to their borders of operation. They can now enter into mutual alliances, associations and other forms of cooperation so as to be better able to cope with the challenges and the risks of the free market (Lubbe, 1994).

As part of the liberalisation process, South Africa has opened its borders. As a result, agricultural imports have increased. For commercial co-operatives, this means that they have to sell their products at international market prices, which decreases their income. (Joubert, 1999). Another consequence of the opening of the market is the arrival of multinationals such as Monsanto and Parmalat. Compared to these companies, South Africa's agricultural co-operatives are in a weaker position. Given the fact that agricultural co-operatives could and needed to do little in terms of marketing and sales before, it is possible that they lack the knowledge and skills required in these areas. They will have to remedy this if they wish to compete with multinationals (Lubbe, 1994).

Another change for commercial agricultural co-operatives is that they no longer participate in the policy decision-making process. Whereas they used to have influence before through all kinds of channels such as control boards, and the policy favoured commercial agricultural co-operatives, this is now no longer the case.

The liberalisation of South Africa's agricultural policy has enabled the country's agricultural producers to sell their products in international markets. This actually means that they have to become internationally competitive. Another consequence is that international companies are going to investigate the South-African market. Thus, it is clear that commercial co-operatives have to become efficient and competitive, if they want to saveguard their place in the market in the future. In other words, agricultural co-operatives have had to develop strategies applicable to the new market.

The ultimate consequences of these changes have been that the agricultural co-operatives

- have lost their economic rent stemming from their institutional role; and
- are confronted with increased competition in their markets, urging them to aim for greater cost efficiency.

Hence, the economics have altered fundamentally for them, to such an extent even that their viability might be in question.

3. SOME EARLY RESPONSES

The early responses to these emerging challenges were mixed. A considerable number of agricultural co-operatives – an estimated 70 out of 246 -

transformed themselves into companies. Leading figures within the Agricultural Business Chamber favour such a transformation as it allows a more pro-active stance vis-à-vis the strategic challenges posed by the changing environment. But we can also observe a counter-movement, promoting a return to the original co-operative principles.

3.1 Transforming into a company

Both interviews and the relevant literature (Cilliers, 1997; De Villiers, 1993; Gouw, 1999; Schulze, 1999; Ras, 1998; Du Toit, 1999; Joubert, 1999; Van Zyl, 1997; Ras, 1999; Luttig, 1999; Welgemoed, 1997; and De Wet Goosen, 1999) reveal that the main reasons for opting for such a transformation are:

- the need for attracting additional capital
- the wish to unlock value for members/investors
- concern regarding political intervention

The comfortable financial position of many co-operatives was threatened by the abolition of subsidies, price liberalisation and the loss of access to low interest loans from the Landbank. These loans were essential to the co-operatives in order for them to be able to balance their capital structure, which was often overloaded with debt. The case of Senwes is not exceptional: their debt ratio (D/D+E) was about 60% (Senwes, 1996). The loss of access to cheap debt induced a need to drastically change the capital structure (Ras, 1998). However, co-operatives can only do this, if their members are willing to increase their financial stake in the organisation. For companies, a capital increase is in principle much easier, as they can attract funding from outside investors as well.

Compared to companies, co-operatives often receive tax benefits. As a consequence, they accumulate wealth more rapidly. Most of this wealth is retained within the co-operative and added to reserves. In most countries there are strict rules and even – in the case of liquidation of the co-operative – a ban on the distribution of these reserves among its members. The argument is that the accumulated wealth has been acquired thanks to the community's contribution through tax benefits allowed for social reasons. Hence, the obligation of the co-operative under liquidation to transfer its reserves to a not-for-profit organisation with similar objectives.

Co-operatives became increasingly concerned about these reserves. Moreover, the change in the political regime could also lead to a 'confiscation' of reserves. As Co-operative Law did not easily allow the unlocking of these

reserves and their distribution to members, transforming the co-operative into a company, for which the rules were more flexible, seemed to be the only option. An additional advantage is that, for the individual member too it becomes easier to unlock his investment in the organisation by simply selling his shares. Hence, the transformation into a company made the capital investment in the former co-operative much more liquid.

In 1994, the Land and Agricultural Policy Centre (LAPC) was established. The LAPC advises the government on agricultural policy. In 1996, the LAPC published a report on agricultural co-operatives, in which the following recommendations were made:

- abolishing tax benefits;
- granting every farmer the right to join the co-operative; and
- imposing equal treatment of new and old members regarding voting rights and access to services.

The ultimate objective of the proposals in the report was to break the dual structure of South Africa's agriculture. The Co-operatives Policy Task Team (CPTT) voiced a similar opinion. This has caused growing concern regarding the possible loss of independence. Many white farmers concluded that the best way to protect their independence was to transform the co-operative into a company.

3.2 Revamping the original co-operative principle

The changes in the political and economic environment are leading to greater uncertainty and mixed feelings. Both sides – farmer members and the management of the co-operative – are starting to blame each other. The situation is increasingly viewed as *a conflict of interest.* Competitive pressure forces co-operatives to pay lower prices to farmers, while farmers traditionally counted on the co-operatives for safeguarding their commercial interests. But the management of co-operatives are also blaming farmers for their reduced loyalty. Farmers look for better opportunities and sometimes tend to sideline co-operatives. It is within this context that some favour going back to the basics of the co-operative movement and revamping the original co-operative principles.

This reveals a major *mind-set problem* that may prevail in some cases and may even haunt some co-operatives, blocking the necessary restructuring. All of the changes are impacting on the economic viability of the agricultural co-operatives as economic organisations. A refusal to engage in this line of thinking, with arguments based on tradition, group interests, and so on, will probably lead to missed opportunities and block the way to badly needed restructuring. At the core of the mind-set problem is the persistent traditional view of co-operative principles, whereas what is needed strategic economic and investment thinking.

If the above hypothesis is correct - namely that the economic viability of the current way of organising commercial agriculture is under threat and that restructuring and new institutional or organisational arrangements are needed - then certainly this mind-set problem is one of the crucial challenges of (institutional) change management that the managers of agricultural co-operatives are confronted with.

4. THE NEED TO MEET STRATEGIC CHALLENGES

Most of the early reactions were not responses to the changes in the economic environment, but to the changes in the institutional and political environment. A long-term vision would need a more in-depth analysis of the economic implications and the strategic challenges of the changing environment.

Two levels of analysis are required. First, the impact of the change in the competitive environment on the value chain has to be assessed. Then, the consequences this may have for the management of the agricultural co-operatives have to be identified. More particularly, the intrinsic constraints of this organisational form when confronting the new strategic challenges should be considered.

4.1 The impact of the change in the competitive environment on the value chain

An explorative analysis of the value chains of some major agricultural commodities in South Africa and the impact of deregulation makes it possible to identify the following strategic options. The results of the study are discussed in D'Haese, (2000) and D'Haese and Bostyn (2000). The following tendencies can already be detected, for example, in sub-sectors such as corn, wheat and oilseeds, which are very much dependent on the world market:

- bottlenecks and hence, value opportunities shift in the value chain away from primary production towards processing;
- competition becomes much more global and is increasingly dominated by multinational players; and

- to be in a position to compete in this market, companies need to be fairly sizeable and have to be able to meet huge capital requirements.

4.2 Emerging management constraints while confronting the new strategic challenges

There are several indications in history that co-operative principles work much better in small-scale initiatives than in large-scale economic activities. If this is confirmed, one would expect the co-operative organisational structure to come under pressure if the management of agricultural co-operatives confront the new strategic challenges as outlined above. There are two main reasons why co-operatives may underperform in scale-dependent industries. The first relates to the difficulties in raising additional capital to fund large-scale economic activities. The second reason has to do with the governance structure based on co-operative principles.

4.3 Constraints in raising additional capital

Several managers in agricultural co-operatives have already drawn attention to this argument. As long as the co-operative can finance its growth with internally generated funds, the constraint is not felt. This means that the path of sustainable growth limits the growth of the co-operative. When for reasons of competitiveness, accelerated growth is needed, a capital increase remains the only option. Members of the co-operative are not always willing or in a position to come up with the money. Extending the base of membership is hardly an option. For a company, the situation is in most cases much easier to deal with. If the company has a convincing story and strategy, additional capital can be drawn from the capital market.

The underlying reason for this constraint is the principle of solidarity and equality on which the co-operative movement builds. This brings us to the issue of corporate governance.

4.4 Managerial and governance constraints

To clarify the nature of these constraints, we refer to Alchian and Demsetz's thesis (1972) regarding the nature of the firm and its basic management challenge.

Firms can be considered as instances of team production. There is however no clear sequence of separate activities by the employees, but rather a continuous process of activities leading to the creation and delivery of value. This leads to two complications from the point of view of effective management and management control:

- the contribution of each employee is not directly identifiable; and
- the productivity of each employee is dependent on the input provided by others in the chain of actions.

Alchian and Demsetz (1972) showed that these challenges cannot be overcome without a monitor or effective management control. However, teamwork within a group of equal partners does not immediately allow for this effective control.

The picture sketched above leads to an open window of moral hazard. The overall result of the team can be considered as a public good, while the production input of each member is marginal and difficult to perceive. Hence, there will be a natural tendency towards free-riding. Agreeing on a *primus inter pares* scheme, in which a team member is appointed in the role of monitor, is not a lasting, effective solution, as he/she will have similar incentives to opt for a free ride. The way out is to grant the monitor property rights on the output of the team, combined with remuneration obligations towards the other members of the team. In that scheme, the monitor becomes the *residual claimant*, and control is linked to the residual claims of the monitor 'as owner of the firm'. Alchian and Demsetz's thesis claims to prove the superiority of the capitalist firm as an organisational device, over other organisational structures of production.

Applying Alchian and Demsetz's argument to co-operatives would lead to the following conclusions :

- The principle of solidarity and equality leads to a situation similar to the starting position of team production. Hence, information and co-ordination costs are very important. The threat of free-riding and other forms of moral hazard is real.
- This results in a tendency towards separating management and sheer membership. As the co-operative remains small, mutual control remains more or less possible, although it is costly in that the project is time-consuming. The logical format of this separation of management and membership is elected management.

- Growth makes mutual control virtually impossible. Costs and time implications become prohibitively high. Management moves further away from its constituency. Frictions may emerge. Co-operatives evolve into pseudo-co-operatives behaving rather like companies.
- Control and pressure for efficiency, however, remain low, because, under the co-operative principle, the relationship between residual control and residual claimant is rather complex. Alchian and Demsetz showed that linking control to property rights is the core of the solution to the governance challenge.

Hence, one would expect co-operatives to perform less well because they cannot solve this governance challenge in a convincing and lasting manner. Capital providers are also involved in production and/or customer relationships. As such, they tend not to behave like investors or residual claimants. The lack of a residual claimant means that the institutional solution as identified by Alchian and Demsetz is not available.

The ultimate conclusion is that agricultural co-operatives have to transform themselves into companies in order to meet efficiency requirements and to remain competitive. The changing environment results in harsh competition and the main strategic responses require scale-dependent moves down in the value chain. Governance structures based on the principles of co-operative movement are less efficient in dealing with such situations.

Remarkably, the mind-set problem we referred to above reappears here. The absence of a residual claimant is due to the fact that the function of capital provider is not separated from that of producer and/or customer. Analytically speaking, the mind-set problem is then the inability to develop a straight-line investor attitude because the situation of a member-farmer is a mixed one, entailing producer and/or customer aspects as well as investor interests.

5. CONCLUSION

In this explorative study, we have shown that the change in agricultural policy has two immediate consequences for agricultural co-operatives:

- The semi-governmental role of agricultural co-operatives was abolished. Consequently, co-operatives are losing the rent associated with this institutional function.

- Deregulation and the opening-up of agriculture to international competition have led to a fundamental change in the economic environment of agricultural co-operatives, which is characterised by increased competitive pressure and a profound need for an efficiency drive.

The initial responses of agricultural co-operatives were more inspired by political than by economic changes. However, lasting responses should be based on the economics of the emerging competitive environment. Valuable strategic options need to be based on the sound analysis of the changes in the value chain of the industry. With value opportunities shifting away from primary production towards processing, and competition becoming more global, companies need to re-focus and restructure. Size and capital requirements become critical factors in this process.

The constraints of the co-operative form of organisation are clearly felt. They are two fold. The ability to raise additional capital is typically limited because of the membership-based funding of the business. The second constraint is perhaps even more fundamental. Governance structures based on co-operative principles do not allow for an effective separation of management and production/customer interests and this cannot solve the residual control/ residual claimant issue.

The so-called mind-set problem is also at the core of this challenge. It can now be specified as the inability to develop a straight-line investor attitude, because the position of a member-farmer is a mixed one, incorporating both producer and/or customer aspects as well as investor interests. However, in most cases, management will have to find ways to deal with this mind-set problem, as transforming the agricultural co-operative into a company will most probably be a crucial element in the newly adopted strategy of the organisation.

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COMPETING AT THE "CUTTING EDGE": OPPORTUNITIES FOR AGRIBUSINESS PARTNERSHIPS AND CO-OPERATION IN THE SOUTHERN AFRICAN REGION

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What are the opportunities for agricultural business, trade and co-operation in Southern Africa and, in particular, South Africa and Zimbabwe - two of the most significant economies in the SADC region? The competitiveness status of agribusiness - from a global viewpoint - in sixteen food and fibre supply chains in Zimbabwe and South Africa is determined in this study using the Revealed Trade Advantage method of Balassa. Based on this status, there is potential in certain agro-food chains for supply chain integration and co-operation between agribusinesses in South Africa and Zimbabwe. Such partnerships will improve competitiveness and will allow agribusinesses to compete at the "cutting edge" in the global environment.

1. INTRODUCTION

The current turmoil in Zimbabwe obscures the real opportunities for collaborative partnerships and co-operation between agribusiness firms in South Africa and Zimbabwe. Such partnerships and co-operation would enable the two countries to forge a development path for internationally competitive agro-food and fibre industries in the greater Southern African sub-continent. What are the real competitive advantages and opportunities for agricultural business, trade and co-operation in Southern Africa and, in particular, South Africa and Zimbabwe, two of the most significant economies in the SADC region?

Two major forces influence the strategic environment in which farmers and agribusinesses in Southern Africa operate, namely, the drive towards economic globalisation and the movement towards geo-political co-operation through trade blocs/agreements/common markets driven by multiple forces of technology, economies of size and specialisation (Tweeten, 1993 and Zuurbier, 1999); and socio-political forces which *inter alia* emphasise land reform and the integration of "historically disadvantaged groups" such as

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