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Journal of Cooperatives

Volume 21

2008

Page 1

Cass-Clay Creamery: A New Direction for an Old Brand

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Cass-Clay Creamery: A New Direction for an Old Brand

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Consolidation and industrialization are increasingly important factors affecting the level of membership in cooperative businesses. This article presents information about the development of the dairy industry in North Dakota and its effect on Cass-Clay Creamery, a farmer-owned dairy cooperative. Students are asked to analyze decisions about branding and being acquired by another larger cooperative.

Key words: Dairy, cooperative, acquisition, North Dakota, Cass-Clay, AMPI

Acknowledgement

The authors gratefully acknowledge the assistance of the following in helping to prepare this manuscript: Keith Pagel, J.W. Schroeder, Alan Qual, Gary Hoffman, John Ringsrud, Mark Furth, and Sheryl Meshke. This study was funded in part by proceeds from an endowment to the Quentin Burdick Center for Cooperatives and the Arthur Capper Cooperative Center.

Introduction

North Dakota was not known for being especially warm in December and 2006 was no different than any other year. Keith Pagel, general manager of Cass-Clay Creamery (Cass-Clay) was preparing for a board meeting. For several years, the board had been discussing the future of Cass-Clay. In recent years, it had developed a successful regional brand by co-branding its products with upper Midwest professional and collegiate sports teams. The brand marketing efforts had been successful but it had not enabled the cooperative to offset the long-term trends in the upper Midwest dairy industry of declining membership, excess capacity, and increased costs for energy and transportation. The cooperative incurred losses in net income in 2004, 2005 and 2006; this poor financial performance was partially attributable to the inefficient use of its assets.

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The primary challenge Cass-Clay faced was to maintain its cooperative business culture while trying to improve its financial performance. The board and Keith considered several options, including generating more income from its value-added brand marketing (option one), reducing its asset base as a means of reducing costs (option two), finding another partner who would provide equity by buying into the cooperative (option three), or considering a unification (e.g., acquisition) with another dairy cooperative (option four). Option one had worked but Keith and his management team believed their negotiations had resulted in the best possible sale price. Option two had already been tried and the remaining assets were valuable due to the integrated nature of their business. Option three was not feasible since an outside investor was not likely to emerge because of Cass-Clay's financial position and because the membership was not willing to relinquish its governance rights. Keith was now seeking unification opportunities with other dairy cooperatives. One such partner, Associated Milk Producers, Inc., had emerged and Keith was prepared to discuss the proposal with the board tonight. Regardless of what it decided to do, Cass-Clay's future was going to take a new direction.

Background on Cass Clay Creamery

Cass-Clay Creamery (Cass-Clay) is a dairy cooperative which both bottles milk and process it into other dairy products. Established in 1934, it originally marketed milk produced by members farming in the Cass County, North Dakota and Clay County, Minnesota area. These adjacent counties lie along the middle of the eastern border of North Dakota and western border of Minnesota, respectively. Today, Cass-Clay markets milk from members farming in North and South Dakota, Montana, and Minnesota. In recent years, its revenues have been at or above \$100 million.

Cass-Clay processes milk into a broad line of products. Fluid products include traditional skim, 1%, 2%, and whole milk products and chocolate milk. Other products include cottage cheese, chip dips, Romano and Parmesan cheeses, ice cream, yogurt, butter, and sour cream. All of its operations occur at facilities in North Dakota (ND), Minnesota, and South Dakota, with its headquarters at a facility in Fargo, ND. Given the location of these facilities and associated transportation costs, Cass-Clay has traditionally marketed its products to consumers in North Dakota and western Minnesota.

Keith Pagel has been general manager of Cass-Clay since 2000. During his tenure, he and his management team have developed strategies to generate economic benefits for the cooperative's membership. These efforts have been made with a goal to maintain strong ties to its membership and to grow in economic size over time. Keith works with a board of directors. The

board is comprised of dairy farmers operating in North and South Dakota, Minnesota, and Montana. This nine-member board makes general business policy decisions and represents all members (who are the patrons, members, and owners of Cass-Clay) investors in making decisions about investment policies for new equipment, milk purchasing incentives, and quantity and timing of giving financial benefits to the general membership. Due to changes in North Dakota and Minnesota's dairy industry during Keith's tenure, the number of members in the cooperative has declined from a high of approximately 1,300 members to fewer than 200 today. The volume of milk produced by the membership has, however, increased during his tenure.

Industrial Structure of Milk Supply and Processing

Decline in Size of Dairy Industry in North Dakota and Minnesota

One factor which affects the financial performance of the cooperative is the volume of milk it processes. Milk volume growth has been affected by forces controlling milk supply and demand. First, the numbers of dairy farms and dairy cows have persistently declined in Cass-Clay's trade area. Some members have moved their operations to other states. Others have switched from dairy production to more lucrative grain-only or grain and beef farming. Still others have quit farming entirely.

In North Dakota, for example, the number of dairy cows declined from 375,000 head in 1950 to 32,000 head in 2006 (U.S. Department of Agriculture 2008). Total statewide milk production also declined during the same period (U.S. Department of Agriculture 2008). The number of dairy farms declined from 2,839 in 1987 to 633 in 2002 (U.S. Department of Agriculture 1992, 2002). Similar changes occurred in Minnesota, Montana, and South Dakota.

The declining numbers of dairy cows and farms increased the geographic spread of members in Cass-Clay's trade area. This affected the cooperative's freight costs. The cooperative acquires approximately 70% of its milk from only 12 farms. These are as far away as eastern Montana, over 350 miles west of Fargo; and Mandan, about 200 miles west of Fargo. The distances, coupled with increasing fuel costs, contribute to high freight costs. In an effort to attract large, distant members, the board had maintained a policy of charging all members the same rate for freight costs, but recently started charging in proportion to distance travelled.

The states in Cass-Clay's trade area have also had little success encouraging new producers to enter the dairy industry. Dairy industry leaders, such as Gary Hoffman of the North Dakota Dairy Coalition, attempt to grow the industry in Cass-Clay's trade area. Although a handful of new dairies will be started in North Dakota this year, efforts are hampered by lifestyle preferences of the next generation of farmers. Many prefer schedules which

permit vacations and pursuits outside farming. Other career opportunities, low profitability, and other similar issues are other reasons. The decline in cow and producer numbers in the region appears irreversible.

Consolidation of Dairy Processing Industry in North Dakota and Minnesota

These trends have contributed to the consolidation and shrinking of the dairy processing industry in the upper Midwest (Minnesota, Montana, North Dakota, and South Dakota). As the number of dairy farms and cows in the state declined, the need for processors decreased. For example, in 1977, 17 plants manufactured dairy products in North Dakota and 72 in Minnesota (U.S. Department of Commerce 1980). By 2002, only five remained in North Dakota, and 44 in Minnesota.

Production Costs, Milk Prices and Revenues

Cass-Clay provides a guaranteed market for member-produced milk. Declines in real raw milk prices in the market have contributed to the cooperative's declining financial performance. In 2006 and 2007, prices for milk received by farmers was relatively low (Table 1) having declined steadily since 1997 from \$13.34 to \$9.71 per hundredweight for milk types.

Table 1. Prices received by farmers, all milk

Year	Annual	Deflator	Real Price
		<i>Dollars per hundredweight</i>	
1997	13.34	100	13.34
1998	15.5	106.1	14.61
1999	14.35	109.7	13.08
2000	12.31	109.3	11.26
2001	14.97	114.1	13.12
2002	12.11	109.9	11.02
2003	12.52	117.5	10.65
2004	16.04	124.4	12.9
2005	15.14	127	11.92
2006	12.91	125.5	10.28
2007	13.61	140.1	9.71

Deflated to 1997 dollars

http://future.aae.wisc.edu/data/monthly_values/by_area/316?area=US&tab=prices&grid=true
<http://usda.mannlib.cornell.edu/MannUsda/viewDocumentInfo.do?documentID=1207>

Small dairy herds force North Dakota and Minnesota members to have relatively high milk production costs when compared with producers in other parts of the United States. A nationwide study of costs and returns in 2005 indicated that average dairy farms receive \$17.03 in gross production value per hundredweight of milk, but net returns of -\$1.43 after total production

costs and allocated overhead are considered. Net returns differ by herd size, however. Dairy farms with fewer than 50 head, for example, received net returns of -12.22 in 2005 per hundredweight of milk, whereas farms with more than 1000 head have positive net returns (Table 2) (McDonald et al. 2007). In 2002, of the 633 farms in North Dakota with dairy cows, 97% percent had fewer than 200 head (United States Department of Agriculture 2002), while 96% of the 6,474 farms in Minnesota had fewer than 200 head. Hence, since members of Cass-Clay which contribute relatively small volumes of milk had relatively small herds, they may experience negative net returns in some years. However, other indicators of profitability, such as the milk-feed price ratio, indicate the second half of 2007 may have been one of the most profitable periods for dairy producers nationwide since 2005. In 2007, Minnesota producers experienced milk-feed price ratios higher than the national average (University of Wisconsin 2008).

Table 2. Dairy costs of production, by herd size, 2005

	Enterprise size (number of milk cows)					
	<50	50-99	100-199	200-499	500-999	>999
Mean herd size	35	69	133	295	666	2,083
Output per cow (lbs)	15,055	17,149	18,228	19,487	20,719	20,195
<i>Dollars per hundredweight</i>						
Total operating costs	12.30	12.94	11.51	11.31	11.07	9.74
Purchased feed	3.60	3.75	4.12	5.00	5.64	5.99
Homegrown feed	5.02	5.07	4.06	3.01	2.58	1.47
Grazed feed	0.41	0.15	0.11	0.10	0.02	0.01
Allocated overhead	17.79	12.56	9.31	6.61	5.00	3.85
Hired labor	0.50	0.80	1.34	1.84	1.80	1.61
Unpaid labor	10.60	6.10	6.13	1.34	0.54	0.17
Capital recovery	5.26	4.56	3.89	2.55	2.03	1.66
Total costs	30.09	25.50	20.82	17.92	16.07	13.59
Gross value of production	17.87	17.56	17.20	17.25	16.56	16.54
Net returns	-12.22	-7.94	-3.62	-0.67	0.49	2.95

Source: McDonald et al., 2007

Revenues in any given region are also affected by sales of milk produced and transported from other regions of the country. Although data about the price effect milk supplied by regions outside Cass-Clay's geographic market are unavailable, quantities of milk produced outside of this region are sold in Cass-Clay's market. For example, in December 2003, producers from Idaho delivered more than 260 million pounds of milk to the area covered by the Upper Midwest Federal Milk Marketing Order, which covers eastern North Dakota, Minnesota, Wisconsin, and northern Illinois (Beitlich 2004).

Given that Cass-Clay members produced 345 billion pounds of milk in 2003 (Whitehill 2004), 260 million pounds represents almost 8% of Cass-Clay's total production. Hence, revenues are drawn away from Cass-Clay's trading area and income for its milk producers is reduced.

Competitors of Cass-Clay

Cass-Clay supplies dairy products in competition with several other producers (Table 3). These include cooperatives and investor-owned firms in the North Dakota and Minnesota geographical market. Bongards Creameries (Bongards MN) operates a plant in Bongards and owns a plant in Perham. This cooperative manufactures various dairy products and has 421 patrons.

Table 3. Name and size of dairy product producers selling in Cass-Clay's trade area, 2007

Name and Headquarter Location	Pounds of Milk (billions)
Dairy Farmers of America, Kansas City MO	37.599
Land O'Lakes Inc., St. Paul MN	12.260
Associated Milk Producers Inc., New Ulm MN	5.100
Foremost Farms USA, Baraboo WI	4.859
Swiss Valley Farms Co., Davenport IA	1.402
First District Association, Litchfield MN	1.246
Bongards Creameries, Bongards MN	0.807
Cass-Clay Creamery Inc., Fargo ND	0.352
Sunrise Ag Cooperative, Buckman MN	0.196
<u>Hastings Cooperative Creamery Association, Hastings MN</u>	<u>0.198</u>

Source: Hoard's Dairyman, October 17, 2007

First District Association (Litchfield MN) operates a plant in Litchfield. The cooperative has 803 patrons and ten member creameries in west central and northeastern Minnesota, northeastern Iowa, and western Wisconsin. It produces under the Fieldgate label. Swiss Valley Farms (Davenport IA) operates plants in southeastern Minnesota, northeastern Iowa, northern Illinois, and southwestern Wisconsin. It has 867 patrons and produces a broad line of differentiated dairy products under its own retail label, Swiss Family Farms, as well as private label and ingredient markets. Associated Milk Producers Inc. or AMPI (New Ulm MN) has 3,400 patrons in Iowa, Minnesota, Missouri, Montana, Nebraska, North Dakota, South Dakota and Wisconsin. It produces a broad line of dairy products for the private label market. Foremost Farms USA (Baraboo WI) has 3,697 patrons in Illinois, Indiana, Iowa, Michigan, Minnesota, Ohio and Wisconsin. Its retail brands include Golden Guernsey Dairy[®], Morning Glory[™] and Grip It, Sip It.[™] brands.

These cooperatives can be described as regional, meaning most of the membership and business activity is concentrated in a particular area, such as

the Midwestern United States. Two other cooperatives, Land O'Lakes, Inc. and Dairy Farmers of America, Inc., are national in scope. Land O'Lakes, Inc. (Arden Hills MN) is a diversified cooperative with 4,610 dairy producers. Its dairy products are sold under the Land O'Lakes label and much of its milk collection and processing operations are conducted through long-term supply agreements with different companies. Dairy Farmers of America, Inc. or DFA (Kansas City MO) has over 11,306 dairy producers, supplying almost a third of the domestic US fluid milk market. It owns the Borden and Golden retail brands.

Changes in Demand: Industrialization and Population

Cass-Clay also faces changes in dairy product demand in the Upper Midwest. One determinant of demand is the size of the geographic market in which products are marketed. Traditionally, retailers have purchased dairy products from regional producers and sold to locations nearby. Increasingly, vertical relationships between dairy product producers and retailers, such as grocery stores and institutional food outlets, govern the flow of these products. As retailers consolidate and serve larger geographic markets, improved coordination and flow of dairy products is sought by forming relationships with a single dairy processing company. Dairy cooperatives are forming some of these marketing relationships. For example, in 2002 Land O'Lakes Inc. and Dean Foods Company (Dean's) formed an alliance to allow the members of Land O'Lakes to market their milk throughout Dean's nationwide system of retail customers.

Another determinant of demand is population size. Although per capita milk product disappearance in the US has remained steady since 1982 (Table 4), steady population levels in North Dakota and population growth in Minnesota have increased total dairy product demand in the North Dakota and Minnesota region.

Table 4. US per capita consumption of all dairy products

Year	U.S. population, July 1 (Millions)	Total Disappearance (Million lbs)	Per capita consumption (lbs)
1995	266.557	153,597	576.2
1996	269.667	152,695	566.2
1997	272.912	154,794	567.2
1998	276.115	157,988	572.2
1999	279.295	163,139	584.1
2000	282.403	167,246	592.2
2001	285.335	167,351	586.5
2002	288.216	168,996	586.4
2003	291.089	172,895	594.0

2004	293.908	174,273	592.9
2005	296.639	178,146	600.5

Source: USDA/Economic Research Service. Data last updated Feb. 15, 2007.

Includes all commercial sales and USDA donations.

www.ers.usda.gov/Data/FoodConsumption/spreadsheets/dymfg.xls

Cass-Clay's Competitive Position

Updates to Physical Assets

Historically, the management of Cass-Clay responded to the industrialization of the milk market by updating its physical assets. As dairy processing facilities closed in its geographic market, Cass-Clay purchased the assets of other cooperatives or private companies in an effort to increase milk volume and enlarge the number of consumers served. During the 1970s and 1980s, Cass-Clay purchased assets in the North Dakota cities of Grand Forks, Jamestown, Minot, Mandan, Medina, Rugby, and Valley City, as well as in South Dakota and Minnesota. Updates to Cass-Clay's Fargo facility include a new freeze tunnel, which freezes ice cream more rapidly and preserves freshness better than older technology; high speed bottling lines and material handling equipment; and enlarging the cooler to three times its original size. Updates at its Mandan facility include a cooler and loading dock for speedier delivery truck loading. New boilers have been installed in its Hoven, SD cheese processing facility. These investments totaled more than \$5 million between 2002 and 2004. These improvements are coupled with commitments from the board of directors to encourage facility update expenditures of about \$1 million annually (Thompson 2004).

Branding

In order to increase margins from dairy product sales, Cass-Clay began an intensive brand marketing program. The fact that Cass-Clay chose to brand several of its products is interesting because of its cooperative business status. Both Beverland (2007) and Hardesty (2005) noted that because of the traditional cooperative principles of user-benefits, user-financing, and user-control, few cooperatives have nationally prominent brand names. For agricultural cooperatives, the user-benefit principle tends to contribute to seasonal product availability and inability to provide long-term returns to members who invest in brand building. The user-financing principle contributes to comparatively limited access for capital to invest in branding. The user-control principle may lead to a homogenous board of directors with no brand building experience.

Having a cooperative develop its own brand can benefit consumers, however. Haller (1992) found that cooperatives branding their own cottage cheese tended to price lower than competing brands, had higher sales volume

than other brands in areas where both products were sold, and merchandised more aggressively than all other brands, except in-store brands. Hence, branding may allow cooperatives to increase sales by increasing the distribution of their products within current markets.

Cass-Clay's branding efforts began in earnest in 1996, with the release of its current "sunburst" design logo. Since that time, the logo has been used on many of its products and on publicly-visible equipment. In total, 35% of the annual product volume produced by Cass-Clay is packaged in a branded container. By 2004, Cass-Clay spent about \$1 million annually in its advertising (Thompson 2004). This was expensive to maintain and with declining profitability and increased competition, it was doubtful whether Cass-Clay could continue such expenditures in the future.

Cass-Clay has been able to use its branding strategy to broaden its geographic product distribution. Cass-Clay brand products have obtained shelf space in stores where they hadn't sold previously, such as in SuperValu stores operating under the Cub brand in the Twin Cities market.

The brand has also gained significant recognition through its relationship with the Minnesota Vikings football team, which began in 2003. Cass-Clay worked with Gameday Sports Company to align its brand with the Minneapolis football franchise. Now several Cass-Clay products feature the official team logo, including ice cream flavors like Touchdown Toffee and Victory Vanilla, chocolate milk, and French onion snack dip. The relationship with the Vikings also enabled Cass-Clay to strengthen relationships with other clients.

Cass-Clay has formed relationships to promote its brand through other sports teams and venues. In 2005, Cass-Clay began selling products at the Xcel Energy Center, home of the Minnesota Wild. Other relationships exist with North Dakota State University and the University of North Dakota, featuring these schools in connection with ice cream flavors Bison Crunch and Championship Sioux, respectively. Alumni support exists for relationships with schools in western North Dakota and Minnesota.

Cass-Clay also enhanced its brand identity by offering products differentiated by packaging innovations. The company developed a 97 ounce container for chocolate milk, a unique volume among chocolate milk products. Other products are differentiated by containers which are more lively and colorful than previous designs. Cass-Clay also followed changes in ice cream packaging by promoting its line of "scrounds," ice cream containers with rounded edges. Together all of these efforts contributed to a well-respected brand by consumers in all geographic markets featuring Cass-Clay products.

Despite updates to its physical assets and these successful brand marketing efforts, in December 2006 Cass-Clay was still a regional dairy cooperative with a sports team niche. This niche, however, relied on contracts

which were renegotiable in the future. Other competitors were keen to have access to similar branding efforts and it was conceivable that Cass-Clay could lose these contracts to a competitor.

The Decision Faced by the Board

Keith had studied other dairy competitors in the Upper Midwest in order to find possible candidates for a unification. The board desired firms that had a similar organizational culture and would preserve Cass-Clay's brand marketing efforts. In addition, the board wanted to ensure that its members had representation on the board of directors. Finally, since the board was sensitive to the fact that its profitability had declined in recent years, it wanted to select a company which would improve its profitability and preserve the equity of its current and past members.

One company, Associated Milk Producers Inc. (AMPI) attracted Keith's attention. AMPI, based in New Ulm, Minnesota, is a dairy products cooperative which is owned by dairy farmers in Iowa, Minnesota, Nebraska, South Dakota and Wisconsin. Although it competed with Cass-Clay, AMPI did not have many members in Cass-Clay's trade territory. At the end of 2006, AMPI had approximately 3,400 members and processed 5.1 billion pounds of member milk. By contrast, Cass-Clay had 172 member farms and processed 0.3 billion pounds of member milk (Jackson 2007). Sales of AMPI are now approximately \$1 billion annually, making it one of the ten largest milk processing cooperatives in the country. AMPI markets a full line of dairy products and ingredients for the retail, food service and food ingredient sectors, including cheese, butter, instant milk, shelf-stable cheese and pudding, and other items. In addition to commercial and institutional sales, it also retails some of its products under numerous label customers.

As a cooperative, AMPI shares Cass-Clay's member-focused philosophy. As a result, Keith believed that if Cass-Clay's assets were sold to AMPI, AMPI would likely continue to operate existing facilities and to guarantee a market for milk produced by member dairies. Keith feared that acquisitions by other companies would lead to a splintering of the parts of the company into joint ventures with other firms. Such a division would tend to be confusing to the membership and remove any sense of member business control.

AMPI liked the idea of acquiring Cass-Clay for purposes of diversification. AMPI primarily produces products for private labels. Cass-Clay, in contrast, bottled fluid milk and produced several other branded dairy products. AMPI viewed the acquisition of Cass-Clay as an opportunity to expand its product line and expand its retail presence by using an already-developed and well-recognized name. Since significant expenses are required

to develop a brand, AMPI intended to take advantage of the already-existing value of the Cass-Clay brand.

The equity of Cass-Clay would be exchanged with AMPI, net of past losses from previous years which had not yet been allocated to Cass-Clay's members' equity. The acquisition would place Cass-Clay's equity under AMPI's equity management policies. The net result was that since equity for AMPI members was comprised of a 12 year revolving fund, and equity for Cass-Clay members comprised a 19 year revolving fund, Cass-Clay members would receive equity more quickly if they were to be acquired by AMPI than if they were to remain an independent company. Another benefit that the board liked was that AMPI would make lump sum equity payments over five years to any retired producer over the age of 65.

The acquisition would also generate economies of scale. Production costs would decline for Cass-Clay, by almost one-third in some cases, relative to costs prior to the acquisition. Lower costs would result in increased profitability and leave more income available to revolve equity and invest in new assets.

The acquisition would create other financial benefits. The acquisition would generate economies of scope, making available new and increased levels of professional resources, such as technical and financial expertise, which members of Cass-Clay did not previously have access to. The acquisition would also enable members to take advantage of selling whey, a byproduct of milk processing into dairy products. Sales into this market would add to the revenues of Cass-Clay members since dry whey sells for approximately \$0.44 per pound.

AMPI was prepared to create two temporary seats on its twenty-four member board of directors in order to accommodate two members of Cass-Clay. After two years AMPI's board will return to its original size and reallocate its seats based on the number of members within each of its divisions. Thus, membership would have representation in Cass-Clay's trade territory.

Acquisition Issues for the Board to Consider

AMPI's board of directors proposed acquiring Cass-Clay (beginning on May 1, 2007) and operating it as its Fargo division. There were many benefits to the proposed acquisition by AMPI.

Among these were:

- Economies of scale in production and associated cost reductions
- Enhanced use of the Cass-Clay brand
- Broadened geographic reach of Cass-Clay produc

- Shorter equity revolvment period
- Increased return on equity
- Continued governance presence on AMPI board

Keith had developed a list of issues to discuss with the board. These were

1. AMPI desired to maintain the Cass-Clay brand. However, now the brand might include milk from all AMPI members including those outside the new Fargo division.
2. Cass-Clay had a long-established corporate giving program in their member communities. However, this would now be part of AMPI's corporate giving program. It was likely that there would be changes in philosophy.
3. In order to best optimize the entire system of AMPI, the AMPI board of directors might decide to introduce changes in transportation allowances and pricing that might be advantageous and disadvantageous to producers in the new Fargo division.
4. The new 24 member board of directors for AMPI would include as many as two directors from its Fargo division. This was understandable since Cass-Clay was much smaller than AMPI.
5. Cass-Clay's success in recent years was due to its relationships and contracts with local sports teams, larger warehouses, and wholesale groups. This required marketing expenditures. However, Cass-Clay was losing money despite such branding. AMPI might decide to reduce such expenditures to increase profitability.

All of these issues were important to Cass-Clay's board of directors and the members it represented. It was important that the effect of these changes be analyzed since the welfare of the membership depended on the prospects of the acquisition improving the cooperative's financial performance.

Update

On May 21, 2007, the membership of Cass-Clay unanimously approved the decision to be acquired by AMPI. Cass-Clay was represented by two members on AMPI's board, which is expected to be reduced to one member in 2009. As of May, 2008, The Cass-Clay brand has not been removed from any of the products Cass-Clay was making at the time of the acquisition. The anticipated financial, personnel, and bargaining power benefits of joining with a larger company are beginning to be realized. Cass-Clay's physical assets increased AMPI's production capacity to fifteen plants and added fluid milk, ice cream, and cultured dairy products to its family of products. AMPI now markets more than \$1 billion of dairy products regionally

and nationally, and contributed to record earnings of almost \$25 million in 2007.

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