MODELS OF GROWTH IN AGRI AND FOOD COOPERATIVES

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Abstract

Growth is a major strategic goal for many agri. and food companies all over the world, and growth is necessary to maintain and enhance international competitiveness. For years, growth through mergers among national cooperatives has been rather uncomplicated. However, growth through international mergers and acquisitions is much more demanding and difficult for cooperatives. Mergers with - or acquisitions of - foreign capital owned companies are often rather capital intensive, and cooperatives do not have the same options and instruments to attract equity capital from the stock markets as shareholding companies.

This makes it necessary to define and develop new models for growth of cooperatives. The models can range from sophistication of the present cooperatives to a total showdown with the idea of cooperatives in agri. and food business.

In this article, eight different models are presented and discussed. Furthermore, some examples of how the models are implemented and used by farmers and cooperate members in order to be able to generate more growth in agri. and food industries, are described.

Finally, a number of crucial factors and preconditions, which should be taken into account when considering new corporate structures, are discussed.

Keywords: Growth cooperative merger acquisition driver

Introduction

Growth obtained through mergers and acquisitions (M&As), or organic growth (increasing market shares) is a major goal for many agri. and food companies all over the world. Growth is in many cases a necessary instrument to increase international competitiveness and the utilisation of resources. Furthermore, a significant number of technological and economic drivers will continuously enhance growth in agri. and food companies.

Achieving growth requires several strategic considerations. First of all, market growth within agricultural and food products is fairly low, because food demand is rather income inelastic. So if a company wants a high growth, it may be forced to increase its market share in a tough competition, or it may have to merge or acquire another company. M&As with capital owned companies might impose a financial burden, which cooperatives are unable or unwilling to fulfil.

Secondly, obtaining growth on a mature and consolidated market is almost impossible, and this means you have to grow through globalisation. Globalisation through foreign direct investments in itself means that companies embark on a new stage of their strategic development. However, for cooperatives, growth through foreign direct investments means specific challenges due to their funding abilities and due to their close linkage to domestic producers and farmers.

It must be stressed that cooperatives play a major role in the agro-industrial sector in many areas. In several countries, cooperatives are dominating companies in key agricultural markets. During recent years, cooperatives have been undergoing rapid structural development in which growth and consolidation have been significant trends. Though it may be challenging to continue this trend in future, it is still the assumption that cooperatives are able to create growth even in a more competitive and globalised world. In this article, different models for this growth in agri. and food cooperatives are introduced, and cases illustrating the use of some models are presented.

Drivers behind growth of agri. and food cooperatives

The overall motive behind growth in agri. and food cooperatives is rather obvious: Higher profit. Growth in itself is not a goal, but an instrument to create increased profit in the short, or long run.

Growth through mergers, acquisitions and structural development can directly and indirectly result in higher profit: directly because increased scale and a constant margin will mean increased profit, indirectly because companies will be able to increase efficiency, utilise synergies, exploit increased market power etc., as a result of an acquisition of another company, and this will normally lead to higher profits.

However, in some cases a merger or growth can be a goal in itself, and in other cases growth might be a milestone together with other goals.

In general, growth through mergers and acquisitions is aimed at achieving higher profit - either through higher sales prices for the members of a cooperative, or through a higher profit to be shared by shareholders or members of a cooperative.

There is a number of explanations behind the growth of agri. and food cooperatives - explanations that are important drivers, and that are crucial factors in an industry strategy based on growth. In each case, the company must decide whether the drivers are essential for the future, and whether the potential and advantages of growth are attractive - compared to the increased risk that is often linked to growth.

The basic motive is often to utilise the resources in such a way that it creates increased profit - in the short or long run. In many cases, growth leads to an investment or an extra cost, which will only be profitable after some years.

Basically, we can identify four different types of drivers behind growth in the agri. and food industry:

Internal drivers in a company or external drivers on the market create growth. At the same time, we can distinguish between active offensive (proactive) drivers, whereby a company predicts and seeks to utilise new opportunities, and more passive and defensive drivers, whereby the company seeks to reduce risks and threats.

The different drivers behind growth - ordered in the four groups - are shown in table 1.

Table 1. Drivers behind the growth of agricultural cooperatives

	Internal	External
Proactive	• Economies of scale • High productivity • Synergy • Growth ambitions • Managerial urge • Utilise know-how and technology • Marketing control • Diversification • Focus • Attract qualified labour • Specialisation	• Access to cheap resources • Vertical integration • Being close to market • Market share and dominance • Access to know-how • Liberalisation of capital markets • Position on emerging markets (first mover) • Favourable options • Economic growth • Investors expect growth
Passive	• Risk diversion • Protection of know-how • Excess capacity • Seasonal adjustment • “Merge or die”	• Low market growth • Matching of customers • Larger assortment • Eliminate competitors • Secure supply of raw materials • Entry barriers • Legislative policies on competition • “Eat or be eaten”

The drivers in table 1 are identified by use of literature studies, consultancy reports, interviews with agri. and food companies and through opinions from agri. and food companies, which have recently experienced major mergers or acquisitions. As shown in the table, there are quite a few drivers, which can create growth in the agri. and food industry to a greater or lesser extent.

Among the most important drivers we will find ʽeconomics of scale’, ʽutilising synergies’ and ʽmatching of customers’.

Economics of scale means that if a company increases production, then the cost per produced unit will decrease. Naturally, this will lead to larger companies until economies of scale diminish, or even become negative.

Synergy basically means that 2 +2 = 5. It says that by adding two functions, you will achieve extra benefits.

The matching of customers means the retail customers merge and become more and more powerful. If you want to be an equal trading partner, you will have to grow in order to balance the market power.

All together it can be concluded that growth is an important strategic goal; that growth is promoted by a number of drivers, and that continuous growth is crucial for the future international competitiveness of agri. and food companies. This is the case for all agri and food companies (regardless of ownership). However, certain challenges - problems and advantages - are specific to the growth of cooperatives.

Growth: Potential and barriers

In highly developed economies, in many instances, cooperatives have been able to grow relatively unproblematically for years: Mergers among national or regional cooperatives have been implemented without transfer or the demand of capital, as the assets from the merging companies were added, and no external owners needed to be paid or compensated.

In several countries, the structure is now so mature that it is now difficult, or even impossible, to grow as a result of domestic mergers. The next step is international mergers and/or acquisitions, but this step is in itself a demanding and difficult challenge.

Firstly, mergers among cooperatives from different countries are challenging, as a transnational cooperative may be difficult, as cultural, structural and linguistic problems may arise.

Secondly, mergers with - or acquisitions of - foreign capital owned companies are often rather capital intensive, and cooperatives do not have the same options and instruments to attract equity capital from the stock markets, as those available to shareholding companies. Little equity together with poor instruments to attract external capital limits the opportunities for further growth in cooperatives.

Agri and food cooperatives all over the world have been forced to grow continuously, in many cases, in order to maintain or improve their international competitiveness. Also, the very biggest cooperatives have been under pressure for increased growth, because medium sized cooperatives also tend to grow substantially. This means that the competitive advantages enjoyed by the biggest companies decreases slightly, unless they continue their growth race.

The entire technological and structural development among cooperatives' customers necessitates growth. Economies of scale cannot be utilised without growth, and for this reason insufficient growth results in reduced competitiveness.

Growth, economies of scale, matching of the growing retail chains, and increased critical mass in order to invest in research and innovation will therefore be crucial strategies for agri and food companies in order to improve their international competitiveness. There will also be a relentless pressure on the companies to create new growth.

Cooperatives operating in a nationally consolidated agri and food sector, will foresee a growth pressure, whereby growth through mergers and acquisitions and organic growth will be more and more difficult to achieve. This will necessitate the definition and development of new models of growth for cooperatives. The models can range from sophistication of the present cooperatives, to a total closure of the idea of cooperatives in agri and food business.

The foundation for developing growth models

For centuries, cooperatives have proved to be unique companies with significant competitive strength. Cooperatives play a major role in several countries, and in several markets cooperatives are obtaining increasing market share.

Cooperatives have passed through a remarkable structural development towards fewer and fewer companies. In this way, a competitive advantage, in terms a economies of scale, market power and the utilisation of synergies, has been established.

The structural development among agri and food cooperatives in many highly developed countries is now so mature that further growth and structural development can only happen in cooperation with foreign cooperatives, or by the acquisition of capital owned companies. This presents new challenges for cooperatives.

Globalisation seems to be continuing - despite economic recession - and international mergers, acquisitions and investments are becoming more and more important in the strategic process of companies. Foreign direct investments and production in foreign subsidiaries is becoming the dominant source of globalisation and growth.

Cooperatives have a limited ability to attract and accumulate equity funds to use for investments in:
- International activities and foreign production
- Processing at a great distance from members' production in the value chain
- Strategic and long term research and innovation etc.

Simultaneously, there is a trend towards fewer cooperative members, increasing pressure for investments in cooperatives, but also increasing pressure for investments among farmers and members in agriculture.

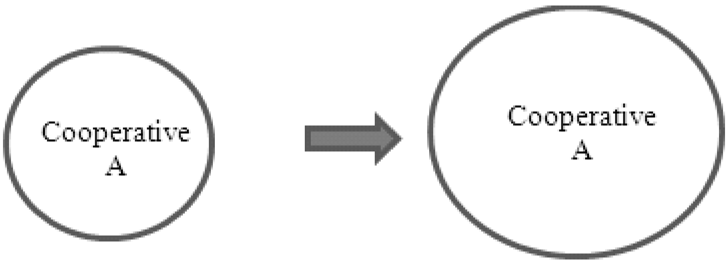
Agri and food cooperatives are mostly based on the principle that all farmers have the right to become a member, and they can become members and owners of a cooperative without having to buy a share in the company. Similarly, resigning members leave the cooperative without their part of the shared capital. This principle is important for the benefit of future generations. For this reason, we must avoid a situation in which major parts of the assets in a cooperative are capitalised and distributed amongst members of cooperative.

Models

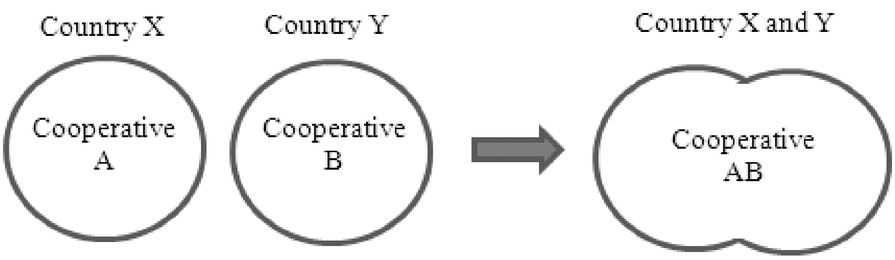
It will be crucial to develop adequate models of growth in agri and food cooperatives, which will enable the cooperatives to generate further growth despite the barriers and obstacles previously mentioned. In this section, eight different models are presented and discussed.

Model 1: Status quo.

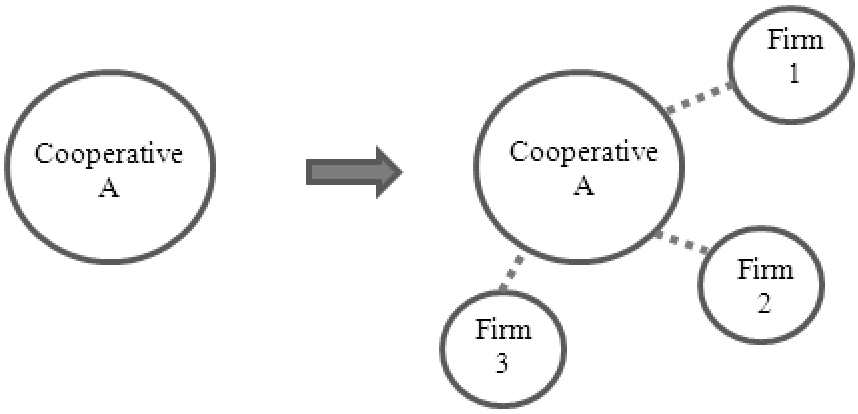
The cooperative model remains unchanged, and no major structural changes or changes in ownership are introduced. The cooperatives are able to create growth through self-financing and loan finance.



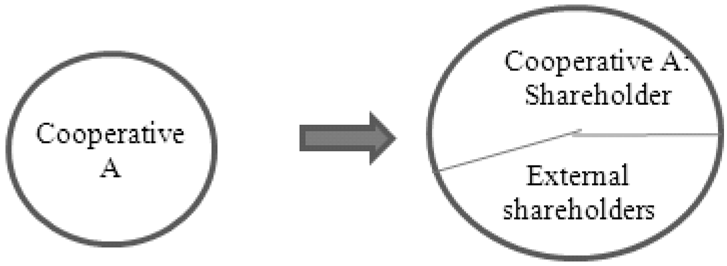
Model 2: Mergers with foreign cooperatives



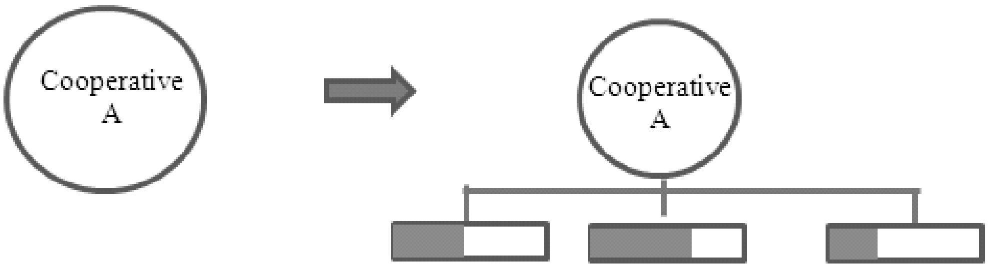
Model 3: Global strategic alliances
Cooperatives generate growth, critical mass and market power through cooperation with other national or international companies.



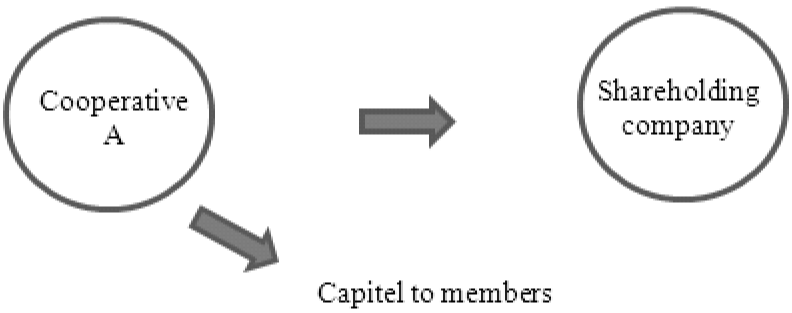
Model 4: The cooperative is transformed into a shareholding company. The cooperative members maintain the majority shares through a common ownership in the shareholding company.



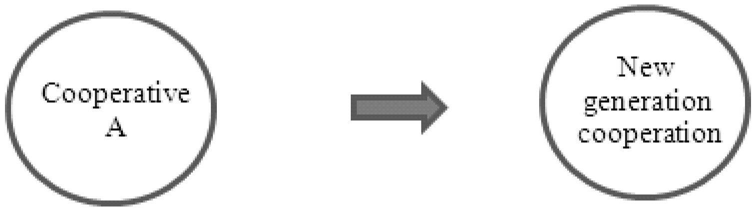
Model 5: Core business units are maintained in the cooperative, while other business units are separated, or developed into shareholding companies with external investors.



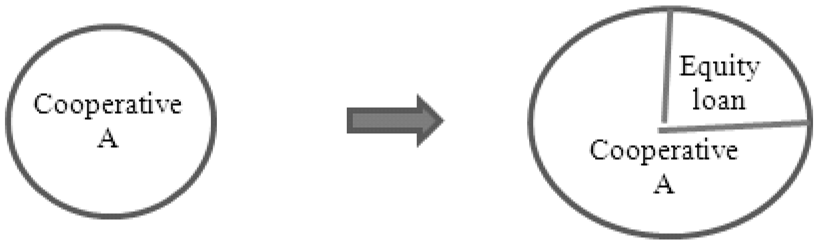
Model 6: The cooperative is sold and transformed into a shareholding company.
The assets are distributed to the former cooperative members - as capital or as shares in the new shareholding company.



Model 7: New Generation Cooperation (NGC).
In general, new members of a NGC will have to make a capital contribution to the company to pay for the right to deliver. This right to deliver is often a tradable asset, which means that members will get a part of the added value in the company. Therefore, the members will have an incentive to take part in long term investments in a NGC.



Model 8: Cooperative members contribute to the cooperative in the form of equity loans.
Cooperative members, and perhaps also other persons or investors with a special interest or connection with the cooperative, provide equity loans. The cooperative pays an interest rate - equivalent to the changes in average share price for a comparable shareholding company.



In models 4 and 5, it is assumed that the cooperative members do not have special preferences or advantages being suppliers to the company. The agricultural products delivered to the company are traded at the "market price" - which in itself may be difficult to quantify. Payments for other assets and values such as market competences, brands, security of suppliers etc., will not be given to the farmers as a price supplement. However, these assets will be priced and capitalised and the value will be reflected in the price of the shares, which new investors will have to pay for up front.

The aim is to ensure that the external investors are quite confident that the company works purely for profit maximisation, and that the profit is strictly shared amongst the owners, in relation to their share of capital invested in the company.

Cases: Models to create growth

All eight models are implemented today in several areas - and often parts of several models are used in a corporate structure. In this chapter we will see examples of how the models are implemented and used by farmers and cooperative members in order to be able to generate more growth in agri and food industries.

<u>Fonterra</u>
Fonterra was established in 2001 by a merger between New Zealand's two biggest cooperative dairies and the milk marketing board. Today, the company stands for 95 % of the milk production in New Zealand and it processes milk from 11.000 dairy farmers. It is the biggest company in the country and the 6th largest dairy company in the world. 95 % of its production is exported, which

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makes Fonterra the biggest actor on the international dairy market. 80 % of Fonterra's milk intake comes from New Zealand.

In 2007, Fonterra launched an ambitious growth strategy of which the aim was to expand in a number of international growth markets - including China and India. There was a strong demand for fresh milk in these markets, and Fonterra's strategy was to supply these markets through foreign direct investments in local production. To fulfil the strategy, it was urgent to attract a certain amount of capital from external investors.

In the autumn of 2007, the board of directors at Fonterra proposed to transfer all assets in the company to a new shareholding company and to list the shares on the stock market. The intention was that the cooperative should retain 65 % of the shares, members would receive 15 %, and the remaining 20 % would be sold on the stock market.

According to the plan, the members of Fonterra were supposed to vote for the first part of the proposal in May 2010. However, the cooperative members were rather against the plan, so the board of directors chose to postpone it. The resistance among the members was due to three major concerns:

1) Concern that the new corporate structure would have a negative impact on their milk price.

2) Concern that the cooperative members' share of 65 % would be reduced.

3) Concern regarding the question of how to pay for capital and milk in a fair way? There was no simple answer to this question.

Fonterra also has other instruments to attract equity capital. Cooperative members are invited to provide equity capital for the company, and the company has already succeeded in attracting a significant amount of money.

The Fonterra case shows that a transfer to a shareholding model might lead to both advantages and disadvantages for the farmers. Access to external and equity capital will be possible, but at the same time farmers will have to sacrifice influence and price premiums.

Arla Foods

In 2000, the Danish dairy, MD Foods, merged with the Swedish dairy, Arla. Both dairies were cooperatives, and the new cooperative, Arla Foods, became one of the largest dairies in the World. The creation of Arla Foods was a major example of a merger between two cooperatives from two different countries.

The increased concentration among both retailers and competitors was a major driver behind the merger. The fact that consumers' increasing demand for product innovation, marketing and processing would require larger companies in the dairy sector, was emphasised (cf. Danish Dairy Board, 2000).

Also, increasing liberalisation and competition on the dairy markets and the enlargement of the EU were major drivers behind the merger. Further, very low growth on the domestic markets made it advantageous to find a foreign partner.

Finally, it was also important that the two dairies would be able to supplement and complement each other. The cooperative model and the historical origin created a common platform, and through MD Foods' international position, common synergies could be utilised. Arla's export share was only 12 %, while MD Foods' was greater than 60 %.

Changing corporate structures and the transformation to a shareholding model has been thoroughly discussed in recent years at Arla. However, until now, farmers have decided to retain the cooperative model. Furthermore, at the end of 2010, the members decided to significantly increase the equity capital of the company in order to be able to cope with the corporate strategy, which implied an increase in turnover of 50 % within the next five years. The extra equity capital will be obtained by the farmers, who will double the share of the milk price, which they will leave as capital in the company.

DLF-TRIFOLIUM Ltd.

DLF-TRIFOLIUM Ltd is an example of a cooperative which is a completely dominant shareholder in a shareholding company.

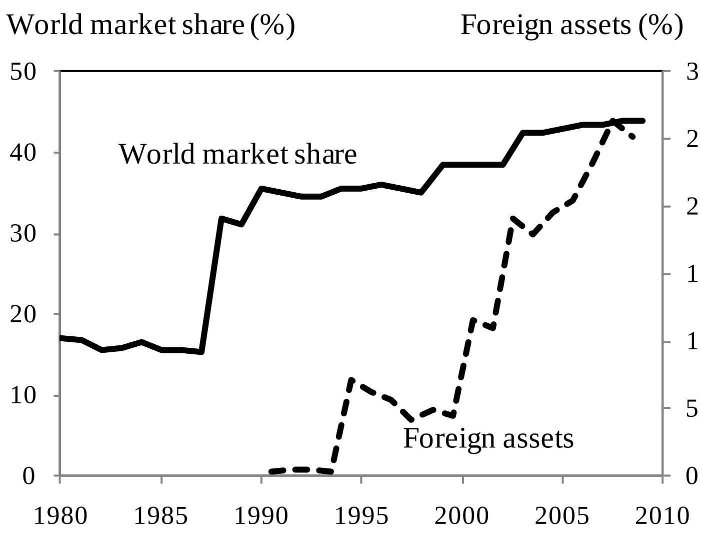
DLF-TRIFOLIUM Ltd. is the world's biggest seed company within the breeding, production, sale and marketing of cool season clover and grass seed species. The company is estimated to have a world market share of 20 %.

DLF-TRIFOLIUM is based in Denmark and owned by Danish seed growers through the cooperative DLF AmbA.

DLF AmbA was the main shareholder and the major driver behind the creation of DLF-TRIFOLIUM Ltd. The company was floated on the stock market in 1989 and the cooperative was able to buy up shares and increase its share in DLF-TRIFOLIUM Ltd. The company was then delisted and today the cooperative owns 95 % of the shares.

The farmers managed to obtain complete control and ownership and the company experienced significant consolidation and globalisation, as illustrated in figure 2.

Figure 2. DLF-TRIFOLIUM Ltd: Share of world market and share of foreign assets



Source: DLF-TRIFOLIUM (several issues) and Danish Seed Council (several issues)

The figure shows that the company's share of the world market has more than doubled since the mid 1980s. At the same time, the international activities of the company have increased remarkably since the mid 1990s and the foreign assets as a percentage of total assets have increased from zero to almost 50 %.

In the 1980s, acquisitions focused on increasing the domestic market share, but as consolidation in Denmark matured, a number of foreign acquisitions in Europe were carried out.

In 2002, the internationalisation of the company was strengthened, as the company acquired the third largest seed company in Europe, the Dutch Cebeco Seeds Group.

DLF-TRIFOLIUM Ltd. is now almost completely owned by a cooperative - and managed as a cooperative. This case illustrates that a mixed corporate model can succeed, and that farmers have been able to establish, manage and finance a company that has become the world leader within its business area within a relatively short time.

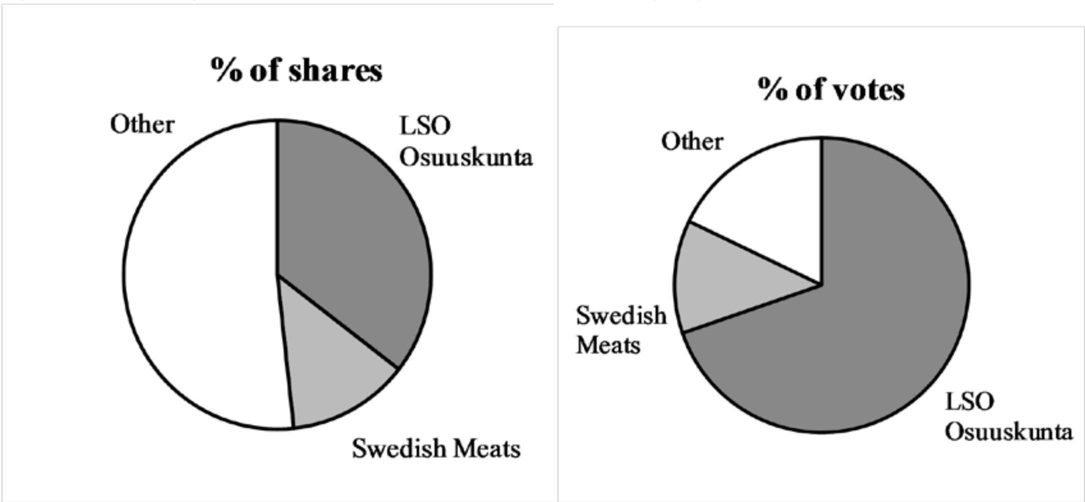
HKScan

HKScan is one of the leading meat and food companies in Northern Europe with a domestic market consisting of Finland, Sweden, the Baltic States and Poland. The company produces, sells and markets pork, beef, poultry meat, processed meats and convenience foods.

HK Scan is a result of a merger between Swedish Meats and the Finnish HK Ruokatalo, in 2006.

The largest shareholders are shown in figure 3.

Figure 3. The largest shareholders in HK Scab: Percentage of shares and votes



Source: HKScan (2010)

The figure shows that LSO Osuuskunta holds 35 % of the shares, but almost 70 % of the votes. LSO Osuuskunta is a cooperative owned by farmers, who deliver animals for slaughter at HK Scan.

In this case, the cooperative has maintained a decisive influence in the shareholding company - even with a rather small percentage of the shares. Similarly, the former Swedish cooperative members of Swedish Meats have managed to obtain 12 % of both shares and votes in HK Scan.

Furthermore, there are a number of smaller shareholders, including pension funds and insurance companies.

HK Scan is an example of farmers managing to maintain their decisive influence in a share holding company. Furthermore, the shareholding structure has facilitated mergers and investments both nationally and internationally.

Crucial factors and lessons to be learned

The eight models encompass a number of crucial factors, which need to be taken into account when considering new corporate structures. The cases discussed above illustrate this.

1) One major shareholder demanding majority

In several models, it is assumed that a group of cooperative members or farmers maintain a decisive influence in the company through a majority of the shares or votes.

Obviously, maintaining the majority of votes without holding the majority of shares requires some kind of concession or payment. However, if you obtain the majority of votes through acquiring the majority of shares, concessions may not be necessary. Often, external investors prefer to have one major industrial share holder.

2) The pricing of agricultural products

In cooperatives, the profit generated is returned to the members through a price premium on the commodities that the members deliver. In a shareholding company, the profit is returned according to the capital that the owners invest. Therefore, a crucial question is, how to pay for two very different inputs, capital and agricultural products, in a fair manner. This question may be very relevant in models 4 and 5.

Fundamentally, a ‘market price’ should be paid for the agricultural products. Afterwards, the company can decide to distribute the profit to the cooperative members as a price premium per delivered amount of products. In order to be able to attract external investors, there must be very strict procedures for pricing the agricultural products delivered by farmers.

However, it may be extremely difficult for large companies to estimate a market price. Increased vertical integration and very high market shares will blur the market prices.

3) Access to markets and to products

The farmers have an interest in ensuring the sale of their products. In the same manner, agri and food companies have an interest in maintaining their access to agricultural products as raw materials for their processing industry. This mutual interest, which is a cornerstone of cooperatives, can be fulfilled by the drawing up of contracts between farmers and companies. However, contracts of this type are a source of conflict.

4) The strategic development of the company

A cooperative group of farmers in a shareholding company may primarily strive to ensure optimal sales of their agricultural products. They also have a secondary interest in ensuring that the company generates a large profit. However, the company may decide to move its production and sourcing of agricultural products to a foreign country.

The company’s competences within quality, health, vertical integration, marketing etc. can be transferred to a foreign country and to a foreign plant, which is based on local agricultural products from foreign farmers.

Global off-shoring of agricultural production appears to be an obvious strategy to follow, but farmers and cooperative shareholders will probably oppose this. In any case, the shareholders must be prepared for this conflict in advance.

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5) Transnational mergers between cooperatives can involve cultural, linguistic and structural problems

Merging two cooperatives from two different countries is a challenge. Cooperative members are owners and suppliers, and they may depend heavily on the outcome of the cooperative company. In many cases, farmers and members take an active part in the strategic decisions of a cooperative. These democratic and economic dimensions imply that competing interests will often emerge if the group of members is too heterogeneous.

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