ADDING VALUE – THE INVESTMENT IMPERATIVE

The Organisational Structure of Cooperatives

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DISCLAIMER

The views expressed in this report are entirely my own and do not necessarily represent the views of the Nuffield Farming Scholarships Trust, or my sponsor, or of my employers, or any other sponsoring body.

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1. EXECUTIVE SUMMARY

Farmers in the UK are going through a period of great change. This provides many opportunities which give powerful reasons to be optimistic about the future of the agricultural industry. There is great potential within the supply chain for farmers to generate value, but if farmers hope to appropriate any part of this they must become more involved by integrating themselves into the supply chain in ways that they have not done before. It is imperative that farmers become more closely connected to their markets, suppliers and customers; the challenge is finding a structure or mechanism that will allow them to do so.

There are many ways in which such integration can be achieved, indeed there are many examples of entrepreneurial farmers connecting with the market place and benefiting from doing so. However, for most the answer must be to work more closely together, to collaborate, in order to gain the scale necessary to invest into marketing and processing capacity.

Farmers can collaborate in a number of different ways, but lessons and observations from other countries around the world show that in the majority of cases the mechanism used to facilitate this is the Farmer Controlled Business (FCB). In general the scale of collaborative activity and benefits generated in other countries are significantly greater than that seen in the UK In the U.S., whilst the number of farmers who trade through FCBs is not dissimilar to the UK, across the board U.S. FCBs are adding more value to their members' production than those in the UK. In Ireland the figures are more compelling; Irish FCBs are generating circa €11.9 billion of sales (2003) compared to the estimated output of the agricultural sector at the farm gate of €4.9 billion (2005).

However, whilst examples from overseas make a persuasive case for the FCB, applying the model itself will not achieve success. Like any other business an FCB needs to have in place a robust strategy, together with the capability and capital to deliver it. Whilst it is accepted that the development of strategy and capability is crucial to the success of the FCB sector, it can be argued that the most fundamental restraint to FCB development in the UK is likely to be access to capital.

It is the issue of capitalisation that forms the basis of this study. Traditional cooperative structure is limited in its ability to raise capital from both members and 'outside' sources. In addition, the UK has little history of developing FCBs. In other countries FCBs have been able to develop into significant national and international businesses over many decades. This means that for the UK to achieve a similar position, not only will significant investment be required, but it will be required over a short period of time. Therefore there is a risk that some FCBs will fail to raise the capital required to deliver their strategy to the full.

If the development of a successful FCB sector is to be encouraged then there is a very real need to consider and embrace new cooperative models that firstly encourage rather than restrain investment from members and secondly, where necessary, facilitate investment from other, non member, sources.

One such model is the New Generation Cooperative (NGC), which developed in the U.S. during the late 1980s and early 1990s with the intention of attracting greater investment from farmers by effectively extending the investment horizon beyond immediate returns on product price. The NGC has, without doubt, reinvigorated the U.S. cooperative sector since that time, passing substantial value back to farmer members. However, the NGC model is not perfect, in some cases the demand for capital and issues over liquidity have led some NGCs to convert to other investor orientated forms. Nevertheless is it a structural model that could provide significant benefit to farmers in the UK.

It should be recognised that in the U.S. considerable support, such as loan guarantees and tax credits is available to both NGCs and to their member investors, primarily from Government. It is evident that this support has played a crucial role in the development of the NGC in the U.S.

The Irish Cooperative/PLC hybrid model provides persuasive examples of the success that can be achieved if the cooperative capital shackles are released. The performance and growth of Kerry Foods in particular is phenomenal. However, there is a debate as to whether the Cooperative/PLC hybrid actually benefits agricultural producers today and whether they are still indeed cooperatives. Given the success achieved it is very difficult to argue that this approach is wrong and that it has not been in the best interest of farmers. The question is whether the better option is relinquishing ownership and control rights but having a share in a successful business or retaining full ownership and control rights in a failing cooperative.

The greatest challenge to the development of the UK FCB sector and to the ability of farmers to take a greater stake in the supply chains in which they operate is the ability of the FCB to raise the capital it requires to deliver its strategy. It is imperative that existing FCB organisational structure is challenged and new innovative models and sources of finance are considered if the change necessary to transform the UK farming industry into one that is able to compete successfully in the global market place is to be carried out.

2. INTRODUCTION

2.1 Background

The agricultural world is changing. Reform of the Common Agricultural Policy, globalisation and consolidation within the food chain are putting significant pressure on the UK farmer. However, whilst the farmer can do little to stem the tide of globalisation and consolidation, the reform of the CAP and in particular the decoupling of payments from production, will for the first time in many years encourage the farmer to become market facing and to produce what the customer and markets actually want.

The bottom line is that the industry has moved, and will continue to move, from being a protected industry with all its key drivers coming from Government to one where it is the market that drives what happens. Moreover it is increasingly a global market that is setting the drivers that shape our industry. There is a political and economic imperative for agriculture to become more competitive, to be able to survive in the absence of production subsidies at world commodity prices. Both Defra's *Sustainable Farming and Food Strategy* and HM Treasury's *Vision for the CAP* have made it clear that agriculture must become more aligned to consumer needs and become capable of surviving in an environment with less direct support.

However, there are powerful reasons to be optimistic; agriculture is on the edge of a major turning point in its history determined by global drivers such as climate change, fuel security and rapid growth in population and affluence.

On a national scale the potential within the UK food market is vast. Between 1990 and 2004 the amount of money that the UK consumer spent on food in both retail and food service sectors has increased from £64 billion to £111 billion per annum, reflecting an enormous increase in the growth of 'added value' in our food sector. However, over this same period agricultural turnover has remained relatively static at approximately £15 billion, indicative of the fact that most of this value has been created and captured downstream from the farmer.

It is imperative to realise that the growth in value within the food industry has taken place and will continue to take place downstream from the farm gate. Therefore, if farmers hope to capture any of this value they must become more involved and integrate themselves into the supply chain in ways that have not been seen before. In addition, farmers must drive these changes; no one else will do it for them. In simple terms, farmers must become involved in the process if they want to share the rewards to be gained from it.

The challenge for farmers is that the fragmented structure of the agricultural industry leaves farmers in a weak strategic position within the market place. To capture greater value from the supply chain farmers will need to become more closely connected to their markets, suppliers and customers and whilst there will always be opportunities for individual entrepreneurial farmers to connect with the market place, for most the answer must be to work closer together, to collaborate.

I passionately believe that farmers can realise great benefit from working together and investing into the food chain but to do so will require a much greater change in investment orientation and mindset than we have seen to date. This change will be from investment 'on-farm' to investment 'off-farm' downstream into the food chain, in most cases by means of Farmer Controlled Businesses (FCBs).

2.2 Why is the Organisational Structure of FCBs Important?

The first point to make is that the Farmer Controlled Business is not the only collaborative business model that works; there are many different ways in which farmers can work more closely together, particularly at production/farm level. However, around the world it is the Farmer Controlled Business model that dominates the collaborative sector and as such is the model that is explored in this study.

We already have in the UK a relatively buoyant FCB sector; in England alone there are approximately 300 FCBs with an aggregate turnover of £4.7 billion. In fact we have seen an increase in aggregate turnover of £1 billion over the last two years, but we are still a long way behind the FCB sectors in other parts of the world. For instance, the largest FCB in the United States, CHS Inc (formerly known as Cenex Harvest States) operating in the grain, energy and food sectors has an annual turnover of approximately £6 billion. The top 10 FCBs in the U.S. have an aggregate turnover of £21 billion. In Europe, the largest FCB is Metsäliitto, a wood marketing cooperative owned by 130,000 Finnish forest owners, which also has an annual turnover of around £6 billion, but, the scale of European FCBs is greater than in the U.S. with the top 10 having an aggregate turnover of £38 billion. These include FCBs such as Arla and Danish Crown that have a significant operational and market penetration within our own market place. In fact, Arla is the biggest milk processor and Danish Crown the second biggest meat processor in the UK.

Examples from overseas show quite clearly that if UK farmers are going to secure more value downstream in the food chain then there will be a need for their FCBs to shift away from the defensive cooperative model set up with risk averse policies and low levels of capitalisation to a more offensive and risk oriented form, structured to operate and compete in an existing market place but requiring significantly greater amounts of investment to do so, particularly from its members.

2.3 FCB Capitalisation

It is the issue of capitalisation that forms the basis of this study. The traditional cooperative structure is limited in its ability to raise capital from both members and other 'outside' sources. In addition, the UK has little history of developing FCBs. In other countries FCBs have been able to develop into significant national and multinational businesses over many decades, very often within a traditional cooperative structure. This means that for the UK to achieve similar positions and remain competitive, not only will significant investment be required, but it will be required over a short period of time, which in some cases will require amounts over and above the immediate return realised on product price.

If we expect and want to encourage our farmers to invest greater amounts in the supply chain, via their FCBs, then there is a very real need to consider and embrace new models that encourage rather than restrain capital investment. The crux of course, is to retain the balance between cooperative principles where equity investment is provided only from members and earnings are distributed according to use, and investor led structures where investment can be provided from various sources and earnings are distributed on the basis of the number of shares held. Often the consensus is that the two models are fundamentally opposed to each other, but there are examples from around the world that have managed to bring together the benefits of the cooperative and the investor led structure. The bottom line is that if we do not give serious consideration to sources of FCB finance, there is a real risk that some FCBs will become under capitalised, which at best means that they will stagnate and at worst, fail.

2.4 Capital Restraints

Our understanding of FCB capital structure in the UK is fairly limited, perhaps reflecting the relative infancy of our FCB sector as compared to other parts of the world. Fortunately there is a wealth of research and practical examples available, predominantly in the U.S. and Europe, from which we can learn.

To understand why different organisational structures have developed, it is important to understand how a FCBs capital structure can potentially restrain investment from members. In addition, it is important to understand the implications of bringing 'outside' equity investment into an FCB.

Taking member investment first, in the majority of cases FCB financing methods provide for little or no liquidity. Either the capital that the farmer invests into the business cannot be withdrawn or where a mechanism does exist for the farmer to withdraw his investment it can only be taken out at par value, for example if he put in £5 twenty years ago he can only withdraw £5 today. In other words he is unable to capture the current value of the FCB or the expected future earning potential of the FCB as and when he leaves. The disincentive arises when the member is unable to realise the full return on any investment in his life time within the FCB, a problem that is particularly prevalent when an ageing membership exists. This creates an unwillingness for members to contribute to growth opportunities and pressurises the FCB to increase payments today, though product price, relative to investment even if that is to the detriment of the business in the long-term.

In addition, where there is a lack of liquidity in an FCB, particularly when coupled with an older membership there is a risk that for members to realise the asset value, the FCB is pressurised into winding up, selling the business or demutualising.

It is these two issues, lack of liquidity and the ability to capture capital growth that I believe will provide the greatest restraints to the FCBs ability to raise capital from its members going forward.

Alongside the issue of liquidity is the issue of fair and equitable investment, commonly referred to as the free rider (or founder member) problem. A free rider occurs when a member (internal free rider) or non member (external free rider) takes advantage of a resource that they themselves have not created or fully invested into. In the case of an external free rider, an example would be when a farmer refuses to join an input supply cooperative, but is able to take advantage of the fact that the cooperative exists in the market place. An internal free rider on the other hand would occur, for instance, when a new member joins a milk cooperative and they are entitled from day one to receive the same milk price as the original members but they have not contributed the same level of investment. From the existing members' point of view, a free rider dilutes their rate of return as they are receiving a benefit at lower or nil cost, thus creating a disincentive for members to invest.

The implications of bringing in 'outside' investment primarily revolve around the issues of conflicts between cooperative members, those that are looking for a return on product price, and investors who are simply looking for a return on investment; together with issues over ownership and control rights. It is often cited as being difficult to meet the expectations of both users and investors, unless they are one and the same.

2.5 The Aims of the Study Tour

To:

- Investigate different cooperative organisational structures in the United States, Canada and Europe in order to understand how and why these models have developed.
- Focus on the New Generation Cooperative – a model developed in the United States to provide capital orientated attributes to attract farmer investors whilst still adhering to cooperative principles.
- Assess the impact of different organisational structures on member ownership, control and benefit.
- Assess whether the organisational structures from other parts of the world can or should be implemented in the UK.

During the course of this study I visited the United States, Canada, Southern Ireland, Brussels and the Netherlands. The majority of the study took place in the United States as my focus was on the New Generation Cooperative. I wanted to visit Canada to understand cooperative development in a country that is heavily influenced by the U.S. but operates in a policy and support framework more akin to that found in the UK. Lastly, Ireland provided an excellent opportunity to understand 'extreme' cooperative models where significant external investment has driven phenomenal organisational development.

3. UNITED STATES OF AMERICA

3.1 Background

The United States has 2.11 million farms, an average farm size of 443 acres with 936 million acres in production. Farms with annual sales over $100,000 (~ £50,000) account for 16% of all farms and 59% of land. In 2003 the U.S. farming sector generated $212 billion in receipts from marketing. In comparison, agricultural marketing cooperatives generated $70 billion of sales. There are 3,140 cooperatives in the U.S. operating on behalf of 2.8 million members representing 28% of farm supply sales and 29% of all commodities marketed.

Overall and somewhat surprisingly the structure and penetration of the FCB/cooperative sector in the U.S. is not that dissimilar to the UK, i.e. around 30% of farmers trading through FCBs, more within the dairy sector and far less in the red meat sector. But of greater interest is that across the board, FCBs in the U.S. are adding more value to their members' production than those in the UK. The New Generation Cooperative model has certainly played an important role in the generation of this value over the last two decades.

Also surprising and somewhat enviable is the extent to which the FCB sector is supported in the U.S. by a significant number of different organisations including, and very positively, Government. A number of key elements make up this support:

- The U.S. Government has supported and championed the case for collaboration and in particular the role of collaborative businesses for many years across many industry sectors, including the farming and food sector. This assertion can be evidenced in many different ways.

  - In the 1920s the Capper-Volstead Act was passed which in simple terms provides farmer cooperatives with exemption from anti-trust laws in the U.S. This Act provides limited antitrust exemption for agricultural marketing associations who if they meet a number of defined characteristics can agree on prices, terms of sale, select the extent of their joint marketing activity through their association, agree on common marketing practices with other cooperatives, and achieve substantial market share and influence. Essentially, as long as a cooperative adheres to a defined set of criteria and does not abuse its market position it is able to become a dominate leader in any given sector. Some cooperatives in the U.S. have market shares of 60% to 80%.

    Given the nature of the Act, it is reviewed by Congress every few years; whilst I was in the U.S. it was currently under review by Congressional Committee. Incredibly during an open consultation no one argued against the Act. Moreover, having been given copies of the United States Department of Agriculture's evidence to the Congressional Committee, it is clear that the USDA supports the continuation of the Act and argues strongly that given the structure of the food chain in the U.S. that the Capper-Volstead Act is not to the detriment of consumers.

- The USDA has had in place for many years a whole department, the Rural Business-Cooperative Services, focused specifically on cooperation and cooperatives. This has devolved in recent years to a more regional approach, but nevertheless still retains a Washington based department of administrators, tax, legal and other experts to support and champion work in this area.

- In the 1930s the Government set up the Rural Electrical Administration (REA) to provide support in setting up rural electrical cooperatives. As a result of this involvement, the majority of rural utilities remain in cooperative hands today and successfully supply services to the majority of rural areas in the U.S. A hugely important factor in the development of agricultural cooperatives is that many of these rural service cooperatives employ dedicated rural developers who provide support to the development of new and existing cooperatives. The most dynamic example is that of Bill Patrie who was the Rural Development Director at the North Dakota Association of Rural Electric Cooperatives, he is credited as being the man who 'sparked coop fever' in North Dakota which led to the development of well known New Generation Cooperatives such as Dakota Growers Pasta Co and North American Bison.

- On both a federal and state basis there are a whole range of grant and support schemes available to cooperatives and cooperative members. For instance, the Missouri Agricultural and Small Business Development Authority offer a number of programmes, the most enviable of which is perhaps the tax credit scheme. In Missouri, farmers are able to claim up to 50% of any investment into a cooperative back as a tax credit. Moreover, there is a buoyant secondary market for these tax credits, from banks to machinery dealers, which allows credits to be easily converted to cash. In many cases when new cooperatives are negotiating terms with the banks, part of this negotiation will be a commitment from the bank to purchase tax credits from members at par value.

  Interestingly and reassuringly, in the case of the Missouri Agricultural and Small Business Development Authority the receipt of any support, whether grants, loans or tax credits is conditional on the prerequisite that the steering group, committee or board undertake a programme of training and development.

▪ Following on from direct Government support and intervention outlined above, a whole series of regional support and development centres have been set up across the U.S. to provide on the ground support to new and developing farmer controlled businesses. These appear to have been set up on a competitive basis and as a result operate in a variety of ways in different states.

▪ There are a number of Universities that have both departments and chairs specifically focused on cooperatives and the development of farmer controlled businesses. This interest and support from the academic sector is both long standing and of high quality having attracted a wide range of academics with a knowledge and experience in this area. Just as I was leaving the U.S., the USDA held a series of open meetings inviting academics and cooperative support and trade associations to contribute to setting the department's research agenda for the forthcoming years. In most cases this agenda will be delivered by the universities.

- A number of trade associations exist whose sole remit is to represent the cooperative sector. These organisations, based in Washington DC are able to exert considerable influence over Government policy.

- A significant factor underpinning the development of farmer controlled business is the existence and development of the farm credit system in the 1930s, a scheme sponsored by Government that has resulted in the development of both Farm Credit Banks and more significantly the CoBank, which is a cooperative bank that is owned by and services agricultural cooperative businesses.

3.2 The Organisational Structure of Cooperatives in the U.S.

During my studies in the U.S. various different types of cooperatives were visited. However, the focus of the study was on the New Generation Cooperative, a model which developed in the U.S. during the late 1980s and early 1990s with the intention of solving the issues of capital liquidity, referred to above. Without doubt it has reinvigorated the U.S. FCB sector since that time, passing significant value back to their farmer members.

3.3 The New Generation Cooperative

The name ‘New Generation Cooperative’ is a term used in the U.S. to describe a particular type of cooperative that adheres to certain structural criteria as follows:

New Generation Cooperatives (NGCs) tend to be used where significant capital investment is required to build processing and/or marketing capacity in order to convert commodities into higher value-added products. Typically this investment is required up-front so that there is sufficient equity to build or purchase the assets required.

> *Dakota Growers Pasta Company, a NGC based in Carrington, North Dakota, was formed in 1991 by durum wheat growers in North Dakota, Minnesota and Montana to add value to their grain. 1040 growers raised $12 million to build a processing plant to convert durum wheat into quality dry pasta products. The $12 million formed 30% of the capital required to build the initial plant, with the remaining 70% debt financed. The plant became operational in 1993 and very rapidly reached full capacity. In 1996, needing to expand, the company made a second stock offering which raised another $11 million for further investment, again from members.*
>
> *Today the company is supplying premium pasta products to retail, foodservice and ingredient markets throughout North America, with reported net revenues of $171 million and a net income of $4.4 million in 2006.*

As well as requiring significant capital, the type of activity that the NGC is engaged in tends to require a regular and guaranteed supply of commodity product. Therefore the NGC assigns ‘delivery rights’ to the capital invested, so that prospective members are effectively purchasing the right, in fact obligation, to deliver product to the business. In simple terms the delivery right keeps investment in proportion to use. In addition, membership to the NGC is limited, effectively closed, because it is directly tied to the delivery rights, the numbers of which reflect the processing capacity and market needs of the business.

Alma Meats is a NGC cooperative in west central Missouri. It was established in 1944 as a 'traditional' cooperative to provide its members access to small scale meat processing and a locker plant. During the late 1960s and 1970 a decline in the locker business meant that new directions in marketing needed to be explored; by 1990, they had secured a stable marketing base in west central Missouri and continued throughout the 1990s to develop a significant market presence into the high end restaurant trade in Kansas City, St Louis and Wichita.

However, a disconnection with members and the need for major reinvestment led the group to consider ways in which they might raise more capital. In 2002 the decision was made to restructure the business as a NGC and instigate an equity drive. Members were invited to invest up to 2 x $15,000 shares (units). Each unit equated to a delivery right (obligation) of either 15 head of cattle or 50 head of hogs. 198 investors raised $3 million, which was used to buy out the members of the 'traditional' cooperative and invest into new facilities.

The most interesting aspect of the NGC, and the crux of their organisational structure, is that the investment/delivery right is tradable and can be sold from one producer to another and furthermore the value of this trade is a matter between the seller and the buyer which means that the price reflects the "value" of the business today as well as the potential for future earnings. This means that the farmers' investment can appreciate (or depreciate) in value and is liquid – the investment can be redeemed as real cash as and when a member decides to downsize their involvement or leave the business.

South Dakota Soybean Processors have been in operation since late 1996, processing soybeans on behalf of their members and allowing farmers to purchase soybean meal without the cost of added freight. Their goal is to provide high quality meal and oil at competitive prices to producers whilst providing added-value payments to their members.

The original share offering raised $21 million from 2,100 producers to build the first soybean crushing facility in the U.S. since 1978. After only three years of operation soybean prices in the region had lifted by 25 cents per bushel for all producers and members had been paid $9.2 million in dividends. But the really fascinating part is that the original shares/delivery rights sold at an average price of $2.19 per bushel were four years later selling for an average of $3.10, a 30% increase.

The type of activity that NGCs are involved in and the markets that they serve often leads to the claim that they only operate in niche markets. Depending on the definition of a niche market, this may be true. However, it does not mean that NGCs are necessarily small businesses.

Mid Missouri Energy is a NGC based in Malta Bend, Missouri. It is a 100% farmer owned bio-ethanol plant producing 40 million gallons of ethanol per annum from 380,000 tonnes of maize corn.

The project was a $60 million investment, 40% of which was farmer equity the rest being debt financed. Within a space of months they raised $26 million from 720 farmers (an up front investment of $36,000 each).

Within 7 months of operation and by their first year end, they had effectively paid a 30% dividend to members. In addition the original shares that sold for $10,000 per unit are now trading, 18 months later, at between $18,000 and $20,000 a unit! Finally, they announced in March 2006 plans to double production at a cost of $50 million to be funded by internal equity. This example is indicative of the rapid growth and success of the bio-fuels sector in the U.S. a significant proportion of which has been structured as NGCs owned by farmers.

The NGC is a model which has been able to attract considerable investment from farmers as it effectively extends the investment horizon beyond the immediate returns on price because the farmers' investment is both liquid and appreciable. However, the NGC model is not perfect, in some cases their demand for capital and issues over liquidity have led to structural changes that, arguably, have not always been in the best interest of members.

3.4 Problems with the New Generation Cooperative

It became apparent during the course of my studies that the NGC was not always the perfect model. The type of activity that the NGC tends to be involved with, the type of management employed and the liquidity mechanisms implemented can drive the business in a direction that was not necessarily intended at its conception. However, the following observations have to be put into context, in that they relate to a relatively small number of NGCs as compared to the 200 to 300 that are estimated to exist in the U.S.

3.4.1 Aggressive Need for Capital

As outlined above, NGCs tend to be used where significant capital investment is required to build processing and/or marketing capacity in order to convert commodities into higher value-added products. It appears that in some cases, particularly if the NGC is successful, there becomes a need to grow capacity in order to meet a growing market demand. In the majority of cases this will require additional investment and often, particularly as a NGC is restricted to raising equity from members, the NGC will go back to their members with another stock offering to achieve this. However, aspirations for further growth can lead to a situation where the need for capital becomes greater than farmers are prepared to commit to. At this point the NGC may consider alternative structural options that enable it to raise additional finance.

In 2002 Dakota Growers Pasta Company converted from a NGC to a common stock corporation. It was widely reported that members, who had already invested significant sums into their cooperative, approved by an *overwhelming majority to this conversion as by becoming a corporate business with stock that can be publically traded, the group would be able to attract new investors and additional capital to take advantages of new opportunities that arise.*

Opponents to the conversion believed that the cooperative had sold its members short, and that conflicts between investors looking for a return on their shares and producers looking for an enhanced product price would ultimately compromise the return to growers.

However, it appears from a conversation with Tim Dodd, President and CEO of the group, that part of the rational behind the conversion was that since the formation of the NGC disease and weather pressure had created conditions in which members were unable to grow durum wheat to fulfil their delivery obligations to the cooperative. This situation led to the cooperative having to purchase wheat on behalf of members, threatening the cooperative status of the business and creating potential tax implications from carrying out non-member trade. In a situation when growers are no longer providing product to the NGC, a return on investment rather than a return on product price becomes the priority, in which case perhaps the conversion was in the best interests of members.

3.4.2 The 'Thin' Market

The basic principle of the NGC is that the delivery rights/investment are tradable from one producer to another; the model is reliant on there being an active secondary market for trade in order to provide liquidity and a market value. However, the market for trade is limited because only farmers producing the same commodity are eligible to buy delivery rights. The market is further limited by geographic implications; there will be an optimum distance for delivery of product into the NGC, after which it is no longer cost effective to deliver. In addition, the members of a NGC are all involved in the same activity thus if the NGC is performing well, members will be reluctant to sell their delivery rights and conversely if the NGC is under performing, there will be plenty of sellers but few buyers. The result can be a 'thin' market for trade.

The impact of a thin market on a NGC can be acute because members are often persuaded to invest on the basis that they will be able to capture any capital growth as and when they leave. If they then discover that liquidity is limited due to a thin market they are likely to rebel and either pressurise the cooperative to increase product price at the expense of future investment or call for structural change, which in extreme cases can force a sale of the business to completely liquidate the assets. According to Professor Michael Cook from the University of Missouri, this is exactly what happened to Minnesota Corn Processors, one of the original NGCs, who in 2002 sold out to ADM as a consequence of a virtual absence of any secondary market for their stock.

3.4.3 Motivated and Aggressive Management

One of the key factors that makes a NGC successful is that they tend to employ motivated, skilled and aggressive management to drive the businesses forward. This is without doubt a positive attribute. However, it seems that in some cases a consequence of this was that once the original objectives of the NGC had been achieved, this type of management was unlikely to sit back and consider the job well done, they were more likely to continue to push the business in new directions, even if this was ultimately to the detriment of the members. It also appears that if management had been successful to date, the members were prepared to go along with them.

To use South Dakota Soybean Processors as an example: A number of years ago they started to sell soy oil into a company that was converting the oil into plastics. Seen as an opportunity they decided to invest into this facility and became the majority owner. However, the demand from this facility was soon to outstrip their available supply of soy oil, which meant that they would have to buy oil from other sources. As this would be non-member trade they formed a subsidiary business as a Limited Liability Company (LLC) to carry out this trade, but, as a wholly owned subsidiary it is taxed in its own right before funds are carried back into the NGC, where they were taxed again. Therefore, to become more tax efficient they made the decision to convert the whole organisation to an LLC which meant that all income generated is only taxed once. Once they had converted to an LLC they undertook an equity drive to raise the capital required to invest into the plastics facility.

According to the CEO, converting to an LLC was an expensive process and they had under-estimated the costs of doing so. In addition, to facilitate an equity drive as an LLC meant that they had to register a prospectus with the Securities and Exchange Commission at considerable cost (cooperatives in the U.S. are exempt from the need to raise a prospectus).

The conversion to an LLC also meant that the 'delivery rights' were no longer valid. Members do continue to sell soybeans to the plant but this is very much at true market values, and the lack of commitment means that members can (and do) sell to other outlets if the price is better. Conversely, free of the obligation to purchase members' soybeans the group strive to buy from the cheapest source possible.

It appears that the whole premise of this conversion is that the plastics business will be successful, otherwise the conversion process and the costs involved would have been a waste of time. At the time of the visit, it was not clear whether this was the case or not. However, whilst the results of the investment may be extremely successful, it seems that South Dakota Soybean Processors have become an investment vehicle rather than being a cooperative intent on enhancing its members' price for soybeans.

3.4.4 Driven by Support Schemes

It emerged in conversations with the managers of two recently formed NGCs, that the decision to structure the business as a NGC was driven entirely by the availability of specific support for NGCs from both federal and state sources, including the 50% tax credits available to members. It was clear that neither group adhered to NGC principles and one group actually admitted that if they had formed after 2003, when

State legislation was changed to allow other cooperative models access to grants and support, they would have formed as a Limited Liability Company.

3.5 The Federal Structure

Another common structure in the U.S. is the Federal Cooperative owned by a number of smaller (local or regional) cooperatives providing greater scale and often a national presence to better fulfil a function over and above that which can be achieved on a local basis. Some of the largest Cooperatives in the U.S. operate on a federal basis, such as Land o' Lakes and Ag Processing Inc.

> *Ag Processing Inc. (AGP) is a farmer-owned cooperative based in Omaha, Nebraska that specialises in the procurement, processing and marketing of grains and grain products, principally soy beans. It was formed in 1983 through the merger of two regional cooperatives and today is owned by over 200 local cooperatives representing over 250,000 farmers throughout the Midwest and six regional cooperatives representing farmers throughout the U.S. and Canada. AGP is the largest 'cooperative' soy bean processing company in the world and the leading supplier of refined vegetable oil in the U.S.*

It is clear that the federal structure can provide significant benefits whilst retaining the identity of local cooperatives, a factor that is often very important to local farmer members. However, the fact that the members of the local cooperatives are effectively disconnected from the federal group can lead to problems of transparency. Many local cooperatives do not openly show the contribution provided by its federal group as ring fenced income. This means that their farmer members will not always appreciate the value being generated by the federal and in some cases will not appreciate that the value provided by the federal group is actually covering up the poor performance of a local cooperative.

In addition, and as a result of poor performance, many local cooperatives are now consolidating with others resulting in organisations that have generated significant scale in their own right leading them to question whether they need the federal cooperative structure anymore. AGP are addressing these issues to some extent by forming, where possible, relationships directly with farmers.

3.6 Base Capital Plan

An important principle of the cooperative model is keeping investment in proportion to use, the rationale being that if the investment is not aligned to use, conflict can potentially occur between those who are looking for a return on product price and those who are looking for a return on investment.

In many cases, when members invest capital into their cooperative the criteria for such investment is based on their current usage. For instance, in UK milk cooperatives capital is accumulated from members via a levy on every litre of milk produced. However, this can potentially lead to problems in the future because whilst the accumulation of investment is in proportion to a members' use of the cooperative today, over time as a member's use increases or decreases, the investment will effectively become disconnected from use, unless a mechanism exists to maintain proportionality on an ongoing basis.

A base capital plan is a capital management technique that encompasses both accumulation and redemption of capital from members and keeps capital investment in proportion with members use. The base capital plan is used by numerous U.S. cooperatives, including CoBank and Dairy Farmers of America (DFA).

> *For example, DFA have established a base capital plan over 10 years where members have to achieve a target investment of $1.75 per hundred weight of milk delivered. In order to achieve this target, DFA retains 10 cents/cwt from under funded members until their base capital reaches $1/cwt, after which members are entitled to receive 20% of earnings in cash and 80% as DFA capital account credits until the base target is achieved. Once the base capital target is achieved in full, members receive earnings in full. If a member's production increases they are required to increase their target investment and conversely if production decreases their investment is redeemed to meet their new target.*

3.7 Observations and Conclusions from the United States

- The New Generation Cooperatives have without doubt re-invigorated the cooperative sector in the U.S. since the late 1980s, providing a vehicle that has encouraged investment and as a result has enabled farmers to create and capture significant value from the rest of the supply chain. In particular, the impact of NGCs in the bio-ethanol sector is phenomenal, returning extraordinary benefits back to their farmer members. With such returns being generated it is interesting to speculate on how important the supply of feed stock is to their members now as opposed to the generation of returns on investment.

- The capital investment in a NGC is not redeemable, it can only be traded out; therefore it is permanent equity capital which provides distinct financial advantages when compared to the quasi equity/debt that exists in many cooperatives.

- The NGC, whilst providing significant benefits to the farming sector, is not without its problems. The potential and impact of these issues should be understood by the executive, board and, most importantly, the members.

- The NGC is a model that has encouraged significant capital investment in the U.S. and is a model that could provide significant benefit to farmers in the UK. Both the English Farming & Food Partnerships (EFFP) and the Scottish Agricultural Organisation Society (SAOS) have key roles to play in promoting and assisting in the development of the NGC structure within the UK.

- The amount and level of support offered to cooperative businesses and to members of cooperatives in the U.S. is considerable. Support aimed specifically at the NGC has clearly encouraged the development of this model.

- Scale of cooperatives is important; comparisons of the UK FCB sectors compared to the U.S. and Europe is stark, the UK is a long way behind other parts of the world. The federal cooperative structure is one way in which the advantages of scale can be captured whilst still retaining localised recognition and ownership.

- It is apparent that the U.S. cooperative sector has a much greater understanding of organisational issues that can effect cooperative businesses and as a result have developed models that are able to overcome some of these issues. It is important that cooperative businesses and those that provide support to cooperative business improve their understanding of cooperative organisational structures.

4. CANADA

4.1 Background

According to the latest data there are 247,000 farms in Canada with 89.9 million acres in production. Average farm size is 676 acres and farms with annual sales over CA$250,000 account for 14% of all farms. In 2001 the Canadian farming sector generated gross receipts of CA$38 billion. In comparison, agricultural cooperatives generated CA$14 billion of sales. There are 1,331 cooperatives in Canada operating on behalf of 390,000 members creating CA$1.2 billion in net value added per annum.

4.2 New Generation Cooperatives

Akin to the U.S. the Canadian Cooperative sector is providing greater benefits to their members compared to the UK. Across the board they are adding more value to their members' production. The uptake of the NGC model has been somewhat slower than in the U.S. a factor which Murray Fulton, an economist at the University of Saskatchewan, puts down to the lack of Government and industry support for FCBs compared to the U.S. However, there is a feeling that they are on a cusp of change and that Canada will see a rapid development of NGCs over the next few years.

> *LeRoy Agri-Pork Cooperative is a NGC located approximately 100 miles east of Saskatoon. It is unusual because local arable farmers invested into the cooperative to build four hog finishing barns which they rent to a local large scale hog producer. However, this is not as strange as it first appears because by doing so they were able to sustain the production of hogs within the region which guaranteed them a secure market for their grain. In fact the delivery rights linked to the investment of the NGC provide the members with a contract to deliver feed barley or wheat to the hog producers feed mill. In addition the arrangement has provided economic stability for their community; the combined operation employs over 100 people and has an annual payroll of CA$3 million.*

One of the founding members of LeRoy Agri-Pork is also a member of his local cooperative grain store and retail store. He believed passionately that collaboration was vital to provide the infrastructure required to retain social cohesion within the small community in which he lived. He wanted to farm, but he also wanted to live in a vibrant community.

Murray Fulton believes that the development of the cooperative sector requires various aspects to line up, including: Government support, a passionate facilitator, an enabling environment, an understanding of cooperative structure and a crisis to actually motivate the industry to act, leading to the assertion that perhaps a lack of cooperative development is due to that fact that life is not quite hard enough yet!

4.3 Observations and Conclusions from Canada

- A network of support and understanding from Government, financial institutions and support networks can make a significant difference to cooperative development. Cooperatives will develop where there is a market need without intervention, but where intervention, particularly from Government, is observed there are greater levels of collaboration, increased benefits and more innovative cooperative structures.

- The impact of cooperatives and collaborative activity on rural economic and social development is considerable. A factor that is relatively easy to measure in both Canada and the U.S. as the divide between rural and urban economies is clearly defined compared to the UK where the rural and urban economies are intrinsically mixed. The Canadian cooperative sector appears to put great emphasis on the social benefits of collaboration when lobbying Government and other bodies in order to generate greater support.

5. IRELAND

5.1 Background

There are 140,000 farms in Ireland with 10.6 million acres in production. Average farm size is 78 acres and only 55% of farmers describe farm work as being their sole occupation. In 2005 the estimated output of the agricultural sector was €4.9 billion. In comparison, agricultural cooperatives generated circa €11.9 billion of sales (2003). There are approximately 60 agricultural cooperatives in Ireland operating on behalf of 130,000 members.

Most of the large cooperatives in Ireland are multipurpose, dominated by the milk sector. Today there are 32 dairy/multipurpose cooperatives, but 4 to 5 of these control 60 to 70% of milk processing and supply of inputs to farms. These top 4 to 5 include organisations such as Kerry Foods, Glanbia and Dairygold that have all become multinational food businesses.

The development of cooperation in Ireland is different from other parts of the world, in that the cooperative movement was initiated by one person, Horace Plunkett, who began to develop cooperatives in the 1880-1890s. By the turn of the century there were over 400 cooperatives across Ireland. Over the years for various reasons cooperatives have merged and consolidated to the relatively small number seen today. A key driver in the establishment and role of cooperatives in Ireland is their reliance on an export market for their products; this reliance has also perpetuated a need in some cases to diversify into other market segments and to establish an operational presence in other countries. It has been this drive that has led some cooperative businesses to seek external equity, by floating the business on the stock exchange, as a way in which to finance their growth strategies. As Kerry Foods succinctly puts it, a successful business requires a robust strategy, the capability to deliver and capital – if any one of these factors is missing the business at best will stagnate and at worst will fail.

5.2 The Cooperative/PLC hybrid

Ireland pre 1973 was a very poor country; agriculture formed an important part of the economy but was reliant on exporting 80% of product produced. However, in 1973 Ireland joined the Common Market and this was hugely significant as it opened up access to the European markets. The impact on the dairy industry was phenomenal, massive increases in milk prices and therefore milk volumes (10% per annum). But in 1984 quotas were introduced which effectively capped further growth.

By the mid 1980s there were only five major cooperative groups operating in the dairy sector and these essentially had two options, to stagnate or do something different, but to do something different would require capital.

Kerry Foods was the first group to consider the hybrid model. They had developed a strategy to become an international food company, a plan that would require significant capital to achieve, capital that they believed members would be unable to provide. In 1996 following a period of lobbying to change the laws in order to make the necessary changes, the Kerry Group PLC was formed. This conversion paved the way for others to follow.

5.2.1 Kerry Foods

In 1986 Kerry Cooperative was issued with £90 million worth of shares from the Kerry Group PLC in return for its assets and undertakings. However, before this issue was made, Kerry Cooperative made a 2 for 1 share split of cooperative shares – effectively doubling the number of cooperative shares.

Members were then invited to purchase 1 Kerry Group share for each cooperative share that they held for 35p. In addition, they were invited to purchase 1 Kerry Group share for every 80 gallons of milk supplied for the same price. Then in October 1986 the Kerry Group floated on the stock exchange at a launch price of 52p. The members of the Kerry Cooperative became shareholders both through their interest in the cooperative and also as direct shareholders of the PLC. At this stage 90% of the PLC was owned by the cooperative and 10% floated. There is not room in this report to chart the incredible growth of the business from this beginning except to note that today the Kerry Group has a market capitalisation of €3.6 billion and a share price of €19.66.

When Kerry Foods went public, it was written into the cooperative rules that the cooperative share of the group could not fall below 50%. However, over time, this rule became restrictive in that it prevented the Kerry Group from raising any further funds from the market place. In addition members of the cooperative were beginning to raise concerns that the value of the group which resided in the cooperative was not liquid; they could not get their hands on it. As a result it was agreed in 1996 to change this rule to state that the cooperative share could not fall below 20%. At the same time the cooperative instigated a share exchange program, which in simple terms distributed the PLC shares held by the cooperative directly to members, effectively liquidating the value locked up in the cooperative. It is said that during the first share exchange 100 Kerry farmers were made millionaires over night!

Today the Kerry cooperative only owns 28% of the plc, but it is estimated that at least half of the plc is still owned by farmers either through their cooperative shares or as individual Kerry Group shareholders. Incredibly, since the share exchange programme began in 1996 the proportional residual value of the cooperative's holding has increased from €312 million (with a 52% holding) to €825 million today (at the current 28% holding).

Undoubtedly, the Kerry Group has been remarkably successful. Since the floatation revenue has increased from €337 million to €4.4 billion in 2005 and earnings per share have increased from 7.6 cents to 132 cents over the same period. However, there is a question whether the Kerry Group has moved too far away from its roots; how important are its current milk producers to its overall strategy? As a PLC business can it justify to its shareholders, the majority of whom are not current dairy producers, paying an above market price for milk. It appears that all the while the group is performing and generating a healthy cash flow, that it is able to pay (or slip under the radar) an acceptable milk price and keep its shareholders happy as the impact of milk price on the bottom line is not significant. However, this strategy is reliant on continued growth, as and when the group's performance begins to falter, it is likely that attention will turn to milk price as a way in which to cut costs within the business

5.2.2 Glanbia

Glanbia is the result of a merger between Avonmore and Waterford in 1997, both of which were already hybrid cooperatives/PLC. But as compared to Kerry, the Glanbia cooperative still retains the majority shareholding of the PLC, and it seems that they are determined that this remains the case. The farmers realise that the cooperative is nothing without the PLC, and therefore there is little point in liquidating their PLC shares for a short term gain. Apparently, it was recently suggested that the cooperative sold 3% of its shareholding to raise funds to prop up the milk price, but members refused, indicative of the fact that members do take the long term view. However, the same issues of milk price versus shareholder returns still remains, an issue that is perhaps more acute for Glanbia than Kerry as performance has lagged since the merger.

5.2.3 Dairygold

Dairygold was formed in 1990 through the amalgamation of two large cooperatives, Ballyclough Cooperative Creamery and Mitchelstown Cooperative Agricultural Society. Up until very recently they were a traditional Irish multipurpose cooperative with a portfolio that included milk processing, consumer foods and input supply. However, over a number of years they had also accumulated a significant property portfolio and chain of home stores.

Last year, in answer to concerns over the risks that ‘non core’ cooperative business could have on the group and to enable members to unlock some of the wealth in the cooperative, they went through a major structural change (only a third of Dairygold members are active dairy producers). The ‘non core’ activities (property, home stores and consumer foods) were separated off into a subsidiary company called Reox Holdings plc whilst the traditional cooperative activities remained in the cooperative. Twenty five percent of the subsidiary shares are held by the cooperative and the rest were spun out to members on the basis of three Reox shares for every four held in the cooperative. Currently the shares have not been listed but are tradable on a grey market.

This change appears to have worked well; the cooperative has been able to focus on core activity for the benefit of its members, whilst Reox holdings has been able to concentrate on the maximisation of profits. The two tier structure has reduced the level of potential conflict between trading and non trading members. Surprisingly, the consumer foods division has been included within Reox holdings when it might have been expected that this division remained within the cooperative particularly where the product portfolio relates directly to the marketing of milk.

5.3 Observations and Conclusions from Ireland

- In stark contrast to the UK, the agricultural sector in Ireland is dominated by cooperatives, many of which offer a wide portfolio of services. To a large extent the growth of the cooperative sector has been a result of Ireland's reliance on the export market, a phenomenon also seen in countries such as New Zealand and Australia.

- A number of cooperatives in Ireland have restructured to facilitate external investment. This has without doubt led to some becoming major successful international businesses.

- There is a debate as to whether the Cooperative/PLC hybrid actually benefits agricultural producers today. Are they really still cooperatives? For instance, the business portfolio of Kerry Foods is a long way removed from dairy production in County Kerry.

- However, groups such as Kerry Foods and Glanbia have provided processing and marketing facilities in Ireland that would have been unlikely to exist without them. They have also made a lot of farmers (particularly founding members) very rich and lastly, the cooperatives still realise substantial value through their PLC shareholding, although lack of liquidity structure within the cooperative itself implies that members cannot directly access the wealth captured by the cooperatives.

- Given the success achieved, it is very difficult to argue that the cooperative/plc approach is wrong and that it has not been in the best interest of farmers. We have to consider what might have happened if they had not chosen to raise investment from external sources. A lack of capital may well have led to static or even failed cooperative businesses. Which is the better option, relinquishing ownership and control rights but having a share in a successful business or retaining full ownership and control rights in a failing cooperative?

6. CONCLUSIONS AND RECOMMENDATIONS

It is imperative that UK farmers work together to both create and capture greater value from the food chain. However, we have to recognise that compared to other countries we do not have a history of developing cooperatives such as Campina, Danish Crown or Ocean Spray into multinational businesses which took place over many decades. This means that for the UK to achieve similar positions, significant investment will be required over a short space of time, that in some cases will require amounts over and above the immediate return realised on product price.

The risk is that some collaborative businesses will be unable to access the finance that they need to implement their strategies to the full and as a consequence opportunities will be lost. Therefore, it is crucial that both farmers and their FCBs understand, consider and embrace organisational models that will provide the maximum opportunity to raise the levels of investment required.

In many cases this is likely to mean adopting structures that are more investor orientated than UK collaborative businesses have traditionally been in the past.

The New Generation Cooperative (NGC) is one such model which has been able to attract considerable investment from farmers as it effectively extends the investment horizon beyond immediate returns on price because the farmers' investment is both liquid and appreciable. The NGC model is not perfect, in some cases their demand for capital and issues over liquidity have led NGCs to convert to other investor orientated forms. Nevertheless it is a structural form that could provide significant benefit to farmers in the UK.

The attractiveness of the NGC model is that it has been able to introduce investor orientated mechanisms while still retaining fundamental cooperative principles, i.e. that investment, operational risk, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services, and that a cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative.

My study demonstrates that these principles should always remain as the starting point in any FCB development for the simple reason that once other 'outside' sources of capital are introduced or if a members' investment is not aligned with their use of the FCB then ownership and member benefit are likely to become diluted plus a conflict is likely to arise between those who are looking for a return on the service provided by the FCB (i.e. milk price) and those that are looking for a return on investment.

However, given the level of capital investment that will be required in some instances coupled with the short timescales in which UK FCBs need to deliver, if we rely solely on investment from farmers, who in many cases are unable to afford it, then there is a real risk that FCBs will be or will become under capitalised, which at best will lead to stagnation and at worst failure. Therefore, we must remain open minded to other solutions which in some cases are likely to include bringing in external investment.

However, bringing in external investment, whether through listings on public financial markets or through private equity, will impact on ownership and control rights and ultimately on the benefits realised. There is an argument that once a cooperative business embarks on this route it becomes inevitable that it will eventually evolve from a cooperative to an investor owned firm. For that reason it is imperative that the board and executive understand the medium to long term implications of whichever route a FCB takes in terms of its organisation of capital structure and communicates that understanding to their members.

My vision: is that if we can successfully introduce more innovative models into the UK, and I am already working with several FCBs as a result of my travels, then perhaps in ten years time UK FCBs will be leading the world.

Recommendations:

- Support for the collaborative sector in the U.S. and to a lesser extent in Ireland has had a major impact on the development of cooperatives. It is unlikely that farmers in the UK are any more or less likely to accept collaborative action than those in the U.S., yet the U.S. has a much more buoyant cooperative sector than the UK. Government and industry support through delivery bodies such as the English Farming and Food Partnerships (EFFP) and the Scottish Agricultural Organisation Society (SAOS) is imperative to drive the collaborative sector forward.

- Compared to other countries around the world, the UK lacks a research and knowledge base that is able to challenge the structure of FCBs and to provide innovative new thinking on the role that FCBs can play within the supply chain. There is a real need and opportunity for industry, academia and supporting bodies to collaborate through formalised groups to generate new ideas and encourage coordinated solutions which unlock value from supply chains.

- The interest, understanding and engagement of financial institutions with FCBs in the UK is relatively low compared to other countries. For example, the UK does not have cooperative banking facilities such as CoBank in the U.S., Rabobank in the Netherlands and Crédit Agricole in France that have undeniably played an important role in the development of FCBs in their respective countries. Given the investment imperative facing UK FCBs today, it is important that the finance sector is encouraged to engage further with them and that consideration is given to new innovative solutions to ensure that they are properly capitalised.

- The policy framework surrounding FCBs in the UK has some inherent advantages, particularly in terms of tax treatment. However, given the investment imperative, it is questionable whether the policy framework is now fit for purpose. Some progress has already been made by EFFP and SAOS in consultation with the Financial Services Authority and HM Treasury, but further change will be necessary to support the development of the UK FCB sector.

- In the U.S. the provision of support from government in the form of grants, loan guarantees and tax breaks/incentives has had a considerable and positive impact on the development of their cooperative sector. To drive greater farmer involvement and investment into UK supply chains, consideration should be given to the implementation of such schemes by UK government.

- It is essential that further growth and expansion takes place in the UK FCB sector. To enable this to happen UK competition policy must not unduly prevent such growth from taking place. Evidence in the U.S. indicates that cooperative exemption from anti-trust legislation has not led to any abuse in the market place. There is a real need to build an evidence base in the UK that can be used in inform and influence Government competition policy reform.

- Defra are currently developing the Rural Development Programme for England (RDPE) to 2013, and in conjunction Regional Development Plans are being constructed to set out how the RDPE will be delivered in each region. There is an opportunity to provide incentives within the delivery plans for producers who are considering collaborative activity. For example, an application for support could be considered more favourably if it includes an element of collaborative activity. There is also an opportunity to link governance and leadership training into the support schemes.

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