Do Cooperatives Create or Destroy Value?

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The answer depends on what VALUE PROPOSITION a cooperative seeks to fulfill and how well it manages to fulfill it.

Consider three value propositions:
- **Traditional**: Mutual Benefit
- **Strictly Business**: Economic Value
- **Theory-based**: Maximize Joint Cooperative-Member Returns

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Benefits of Mutual Benefit

- **Member Preference: Fair Dealing!**
  - Member is on both sides of the transaction → Co-op has no incentive to cheat or behave as a monopoly.
  - One member, one vote & limited return on capital → Members have no incentive to cheat each other.
  - Critical assumption: Members are alike!
- **Public Policy Preference**
  - Limited exemption from anti-trust (Capper Volstead)
  - Single taxation (benefit blunted by LLC)
  - Access to "agency-like" debt capital (CoBank)

Problems with Traditional VP

- What if needed investment exceeds internal capital generation or is needed up front?
- What if member capital gets out of whack?
  - No or very little redemption ever occurs
  - "Retired" members vs. existing members
  - Big members vs. little members
  - "Temporary" equity capital
- What if mutual benefit is not enough?
Strictly Business Value Proposition

- **Value Proposition**: Economic value created by the cooperative enterprise.
- **McKinsey Study** (2002 based on 1999 data)
  - Agricultural cooperatives collectively destroyed over $1 billion of value in 1999.
  - Call to action:
    - Leverage horizontal scale
    - Pursue operational excellence
    - Drive customer integration
    - Exploit vertical opportunities
    - Create performance obsession

Value creation is key financial metric

\[
\text{Value created} = \frac{\text{Return on invested capital}^*}{\text{Cost of capital} \times \text{Invested capital}}
\]

- Annual return of investment above that expected given risk level
- Rate of return required to compensate investors for risk

* Impact of extraordinary items excluded

What Happened?

<table>
<thead>
<tr>
<th>Cooperative</th>
<th>1999 ROIC (McKinsey)</th>
<th>2006 ROIC (Estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farmland</td>
<td>-0.6%</td>
<td>Bankrupt</td>
</tr>
<tr>
<td>DFA</td>
<td>5.2%</td>
<td>6.1%</td>
</tr>
<tr>
<td>CHS</td>
<td>4.1%</td>
<td>19.1%</td>
</tr>
<tr>
<td>Land O'Lakes</td>
<td>1.6%</td>
<td>8.9%</td>
</tr>
<tr>
<td>Agrilink</td>
<td>5.2%</td>
<td>Majority private</td>
</tr>
</tbody>
</table>

Theory-based Value Proposition

Cooperative membership is a joint decision to patronize and to invest.

\[
\begin{align*}
\text{Farm Returns with Co-op} & > \text{Farm Returns without Co-op} \\
+ & + \\
\text{Investment} & \text{Investment} \\
\text{Returns from Co-op} & \text{Returns w/o Co-op}
\end{align*}
\]
Both Co-op & Farm Returns Matter!

- Cooperative-level returns (net income)
  - Patronage Refunds
  - Dividends on Capital
- Member farm-level returns
  - Price differentials
  - Service differentials
  - Existence
  - Risk reduction

Theory-based Value Proposition

\[
\text{Member's Return} = \frac{\text{Dividends} + \text{Cash Patronage Refund} + \text{PV of Retained Patronage} + \text{Price Differences} + \text{Service Differences} + \text{Value of “Existence”} + \text{Value of Risk Reduction}}{\text{Member’s Equity}}
\]

Challenges with T-B VP

- Cooperative-level returns are suspect
  - Co-op accused of not making them in the marketplace, but rather off the members
- Member-level returns can make the co-op returns look worse than they are.
- Member-level returns are subjective, specific to individual members, and yet real!
  - The co-op must “measure” them.
  - They are part of the value proposition.
  - Do members give the co-op credit for these???

Other Value Creation Options

- Evolution and experimentation
  - New Generation Cooperatives
  - Mix pure investors & patron-members
    • Joint Ventures, Alliances, Subsidiaries, LLCs
  - Wyoming Cooperative Law
  - Extreme: Sell the co-op or take it private
- Each of these trades off market access and opportunities for member control.
  - Isn’t a share of something better than all of nothing?

The Value Creation Challenge

- Traditional “mutual benefit” is not enough.
  - Yet it earns us special public policy treatment.
- Strict “economic value” is not enough.
  - It ignores the member level returns
  - Yet highlights the need for co-ops to perform
- Theory-based “cooperative plus member level returns” is not enough.
  - Co-op level returns are suspect
  - Member-level returns difficult to measure meaningfully
- What will work?
  - A value proposition meaningful to members that keeps the cooperative relevant to the marketplace of customers and partners.

NCFC Study and Findings

- IS THE COOPERATIVE MODEL OUTM ODED?
- NCFC study committee
  - CEO survey and financial executive survey
- Findings
  - Despite the challenges of globalization, unpredictable consumers, and system consolidation, those cooperatives nimble enough to respond to marketplace changes were thriving.
  - And, yes, they found creative ways to raise capital without abandoning the cooperative model.
Do Cooperatives Create or Destroy Value?

- **Yes!**
  - *Create* when the value proposition fits the members *and* the co-op performs
  - *Destroy* when the value proposition doesn’t fit or the co-op doesn’t perform.

- **Always challenged by:**
  - What is the mutual benefit?
  - What are the member level returns?
  - How do co-ops remain relevant to the game?