With this newsletter, we offer our stakeholders an update on the activities of the University of Wisconsin Center for Cooperatives, and perspectives on issues in the cooperative world at large. The newsletter is targeted to a broad range of perspectives, from policy makers to academics, cooperative business leaders to cooperative and community developers, and the interested public.

Cooperatives are unique in their structure and orientation. Operating in the marketplace, cooperatives strive to balance value equations that include both financial and service components for their member-owners. Cooperatives engaged in ongoing operations must solve this equation repeatedly as member requirements and market conditions change. And when the market fails to adequately serve a particular set of economic needs, the promise of the cooperative business model is often looked to as a vehicle for collective entrepreneurial efforts that can create jobs, fuel wide-ranging community economic impacts, and foster the growth of both tangible and intangible community assets.

These issues have ongoing relevance across the worlds of policy, business and academic research, and underlie our research, education, and outreach activities.

**NEWSLETTER FALL 2011**

**Innovative Co-op Solutions for Minority Ag, Community Health Center**
When the Farley Center, a local incubator farm, began to explore how a small group of independent vegetable producers could work together more profitably, they looked to the University of Wisconsin Center for Cooperatives for assistance.  *Page 2*

**Cooperatives and Human Capital in Agriculture**
Center Director and Associate Professor Brent Hueth presented research on board behavior in agricultural cooperatives at the Joint Annual meeting of the Agricultural & Applied Economics Association and the Northeastern Agricultural and Resource Economics Association in July.  *Page 3*

**Farmer Cooperatives Conference Returns to Twin Cities November 3-4**
The Center presents the 14th Annual Farmer Cooperatives Conference, a national conference that offers strategic thinking on current agricultural cooperative issues and trends. This year’s event will be held in Minneapolis on November 3-4.  *Page 3*

**Center Builds Connections with Business, Law Schools**
While cooperatives play an important role in a variety of economic sectors, most professionals in the legal and business sectors have only a passing familiarity with the cooperative business model and how it compares with other business and organizational structures.  *Page 4*

**Managing the Cooperative Life Cycle**
*This article summarizes a new staff paper by Brent Hueth, Associate Professor and Director of UW Center for Cooperatives. For the full essay, visit www.uwcc.wisc.edu.*
To function successfully over time, organizations must adapt to changing circumstances, both internal and external. Cooperatives share “life cycle” adaptations that are common across business organizations, but also face challenges that are unique.  *Page 4*
Innovative Co-op Solutions for Minority Ag, Community Health Center

When the Farley Center, a local incubator farm, began exploring how a small group of independent vegetable producers might work together more profitably, they looked to the University of Wisconsin Center for Cooperatives for assistance.

The producers come from diverse Hmong and Hispanic farming traditions, and had been individually cultivating plots at the incubator farm in rural Dane County, WI. The farmers had been successfully selling their produce to farmer’s markets, restaurants, and grocery stores, and were looking for ways to grow their operations.

Recognizing that some type of cooperative arrangement might be effective in supporting the individual goals of producers, Farley Center staff contacted Anne Reynolds, the Center’s Assistant Director, for guidance in exploring the cooperative option. Possible benefits that the cooperative could provide to the grower members included joint pooling and marketing, equipment sharing, a possible greenhouse purchase, training in organic certification, as well as a forum for sharing their diverse expertise with one another.

Spring Rose Growers Cooperative was incorporated in 2010. Anne encouraged the co-op to apply for the USDA’s Socially Disadvantaged Farmer and Rancher Cooperative Grant program, and in September 2010, the cooperative was awarded a $197,400 grant. Aimed at technical assistance for and by socially disadvantaged growers in southern Wisconsin, the grant supported a series of practical courses about increasing the profitability of grower operations. The workshops were presented collaboratively by the Spring Rose Growers Cooperative, a second area producers’ co-op, and other independent growers. Anne is continuing her advisory role with Spring Rose Growers on cooperative organization and governance issues, and provides linkages to other resources as needed.

In another innovative application of the model, a cooperative of neighborhood organizations has been formed to more effectively coordinate a broad range of health and wellness-related services. The cooperative development process was initiated by the Allied Wellness Center, a nonprofit that was established to provide health services and prevention education programs to a low income neighborhood in Madison, WI. The organization’s director saw an opportunity to more effectively build programs to support community health by working with other neighborhood organizations. As a long-time nurse, she also saw the need to encourage client participation in decision-making around their own health and wellness issues.

Allied Wellness Center met with several other neighborhood organizations to explore possible cooperative opportunities, including resource sharing for administrative functions. Assistant Director Anne Reynolds was asked to be part of these discussions as a resource on the cooperative model. Several small joint projects emerged from this process, and were successfully funded by grants. These successes provided momentum to continue the development of a wellness cooperative that would also include the neighborhood population as one group of stakeholders.

Through the Wisconsin Partnership Program, a grant for the next stage of cooperative development work was awarded to the Allied Wellness Center in April. The grant program supports projects that both improve the health and well-being of the public and that develop strong community-academic partnerships. The Center for Cooperatives agreed to serve as the academic partner for the project. The Center sees it as an opportunity to contribute to the development of an innovative cooperative model. Anne will serve on the Advisory Committee and will be primary liaison for the project.

Steps to bring community residents into the cooperative development process are underway. Initial meetings have been held to identify neighborhood needs that could be addressed by a wellness cooperative. Possible projects might include child care services, services to support individual entrepreneurial efforts, healthy foods education and a community center. Projects such as these respond to broader economic and social needs that significantly influence individual health. The grant-funded education and training to support neighborhood participation is also
expected to provide long-term wellness benefits to residents through increased social capital – the capacity of a group to effectively work together to solve common problems.

Cooperatives and Human Capital in Agriculture

Center Director and Associate Professor Brent Hueth presented research on board behavior in agricultural cooperatives at the Joint Annual meeting of the Agricultural & Applied Economics Association and the Northeastern Agricultural and Resource Economics Association in July. His presentation was part of a session on “Human Capital: Competing on Capabilities in Agriculture”.

Although agribusiness research regularly explores topics such as markets, competition, and the internal resources requirements for firm success, literature on human resource capabilities within agribusiness firms has been lacking. Agribusiness cooperatives in particular face unique human resource issues. Structurally, cooperative governance is dependent on member-elected boards to monitor the balance between patron value and the return-on-investment considerations that are part of the management perspective. These potentially diverse sets of interests present both the board and the management team with challenges in cooperative decision-making.

Brent’s research empirically examines the interactions between boards and managerial teams in a large sample of agricultural cooperatives. Preliminary findings show significant variability in board structure, board participation in strategic planning, and board monitoring of managerial behavior. Continued research will identify those factors correlated with this decision-making variability. These results will provide insight into why cooperatives choose different business strategies that significantly affect and influence cooperative performance. An evaluation of these differences will generate a better understanding of effective governance practices in cooperatives.

This research is based on data being collected through a longitudinal cooperative business survey, which is part of the Center’s multi-year Research on the Economic Impact of Cooperatives project being funded by USDA.

Farmer Cooperatives Conference Returns to Twin Cities on November 3-4

For 14 years, the Center has presented the Farmer Cooperatives Conference, a national conference that offers strategic thinking on current agricultural cooperative issues and trends. This year’s conference will be held in Minneapolis on November 3-4.

The event will provide an opportunity to hear cooperative leaders assess the current business environment. Speakers will explore the challenges that consolidation in the global agricultural markets presents, and examine innovative structural and financial approaches that some cooperatives are adopting to stay competitive. More information on the program is available on the Center’s website: http://www.uwcc.wisc.edu/

The annual conference is attended by agricultural cooperative business leaders, academics and public policy makers. Program development is led by Anne Reynolds, with assistance from a national planning committee of business and academic experts. The conference is made possible through the strong support of leaders in the agricultural cooperative sector: CoBank, CHS, Dorsey & Whitney LLP, Farm Foundation, GROWMARK, Land O’Lakes, Lindquist & Vennum, NCFC Education Foundation, Stoel Rives LLP, Clifton Gunderson, and the Ralph K. Morris Foundation.
Center Builds Connections with Business, Law Schools

While cooperatives play an important role in a variety of economic sectors, most professionals in the legal and business sectors have only a passing familiarity with the cooperative business model and how it compares with other business and organizational structures. The Center is reaching out to the University of Wisconsin Law and Business schools to build relationships that, over the long run, will foster opportunities for teaching and learning about cooperatives within those disciplines.

This year, Center staff will conduct a training session on cooperatives for third year law students participating in the UW Law and Entrepreneurship Clinic. At the clinic, students with a background in business law provide legal and business planning advice to new entrepreneurs under the supervision of faculty and private sector lawyers. The collective entrepreneurship inherent in cooperative start-ups is often not recognized and supported by services geared toward entrepreneurial support. The goal of the training session is to provide an overview of how cooperatives are used in a variety of sectors, and the benefits and challenges that characterize cooperative development. Law students will gain a better understanding of the cooperative model, and the situations in which it might support an entrepreneurial effort effectively.

The Center, in a joint program with the Wisconsin School of Business, held the first Cooperative Executive Leadership Program in June 2010. Fifteen cooperative executives, from across the country and across economic sectors, participated in an intensive 4.5 day residential program held on the campus of UW-Madison. Participants rated the program, which was taught by both School of Business faculty and Center staff, very highly.

In addition to the quality of the instruction and content, participants also valued the interactions with other successful cooperative executives. However, the program was not offered this year due to insufficient enrollment; program cost and scheduling were major factors.

The faculty at the School of Business has expressed strong interest in continuing to collaborate with the Center. Program ideas continue to be explored for 2012, and a shorter program is under consideration. Building these relationships may also help foster other teaching and outreach possibilities with the School of Business.

Managing the Cooperative Life Cycle

This article is a summary of a new staff paper by Brent Hueth, Associate Professor and Director of UW Center for Cooperatives. For the full essay, visit www.uwcc.wisc.edu.

Organizations are created to realize a purpose that no single person can accomplish individually. To function successfully over time, however, organizations must adapt to changing circumstances both inside and outside the organization. Some of these adaptations are common across business organizations, and organizational scholars have identified them as characteristic of a business “life cycle.”

While cooperatives share many of these life-cycle stages, a cooperative life cycle includes adaptations to challenges that are specific to the cooperative business model. Cooperatives use distinct financial and governance structures to meet their purpose of providing benefit to their patron owners.

Organizational life cycles

All organizations are faced with the challenge of managing the specific projects and activities that contribute to their larger purpose. For most business organizations, whether cooperative or otherwise, there are no simple managerial recipes. The life stages of an organization are reflected in this evolution of an
operational framework, a process that is part design and part trial and error.

The beginning or entrepreneurial phase of an organization is creative. It is typically followed by collectivity and formalization phases, as the organization achieves focus and develops coherent operating rules. Successful organizations need to continually maintain an elaboration phase. Fundamental operational procedures are systematically reevaluated for potential problems and opportunities, and managers can act promptly to identify effective solutions and subsequent organizational adaptations.

Cooperative purpose

Cooperative organizations share these life-cycle characteristics. However, they also are subject to life-cycle and managerial challenges that grow out of their unique role as a response to the “market failure”\(^2\), a broad term used by economists to describe the reality of imperfect competition that exists in most markets. Producers and consumers must conduct their transactions without full knowledge about demand, supply, costs, alternatives, and how contractual promises made today will translate into realities tomorrow.

Cooperatives respond to market failure by operating on behalf of some class of patrons that did not receive satisfactory service from conventional business organizations. However, in order to operate strictly in the interest of patrons, cooperatives must impose on themselves operational constraints that sometimes can limit their ability to compete with investor-oriented companies. In particular, cooperatives acquire most of their equity capital from patrons, and limit the returns paid on any outside equity to some maximum amount. This constraint severely limits the liquidity and risk-bearing services that are normally provided by capital markets, and arguably raises the cost of capital for cooperatives.

It is this patron focus that gives cooperatives their distinctive role in the economy, but also what presents a unique set of life-cycle challenges for managers and patron owners\(^3\): communicating value to patron owners, managing economic diversity among members, and managing capital structures.

Unique life cycle challenges

1. Communicating value

Perhaps the most obvious challenge a cooperative faces is communicating its value over business options to patron owners. Consider the following example: A group of farmers are purchasing all of their fertilizer from ABC Farm Supply, Inc. ABC does not have much competition in the area so it is able to charge $1/unit for its fertilizer.

Now imagine that half the farmers get frustrated with the price they are paying and decide to form a fertilizer purchasing cooperative. The farmer members hire a manager who purchases for them on a wholesale basis, and now members are able to acquire fertilizer at $.90/unit, a $.10/unit savings. Assume, moreover, that ABC now must lower its price to keep its remaining customers, who otherwise would seek membership in the cooperative.

Now imagine trying to value the cooperative business that these farmers have formed. What is the cooperative worth? There are at least two issues to consider in this example.

It is difficult for cooperative managers to demonstrate savings relative to competitors when competitors match the cooperative price. The cooperative has generated a higher profit for each of its farmers’ operations that result from paying a lower price for fertilizer, but the improved competition also has provided cost savings for non-members. In both cases, there is additional long-term value created by increased farm-level profit as it is reinvested and generates income.

Secondly, the cooperative firm itself has nothing to show on its financial statements. It has no assets or liabilities. It generates cash-flow to pay for managerial service, but otherwise passes earnings on to members in the form of a lower price for fertilizer. Because there is no cash flow beyond what is used to pay the manager, the cooperative is worth nothing! Does this make sense? Is the cooperative really generating zero value for its owners?

Of course not.

Making sure that patron owners do understand the worth of their cooperative is central to effective cooperative management. Unfortunately, there is no easy way to do so. Management and the board must find ways to demonstrate the value that doesn’t appear on financial statements. Without doing so, a
cooperative risks becoming irrelevant and “just another business” to its owner patrons.

2. Managing economic diversity among members
Suppose that two individuals—let’s call them Tom and Jerry—each have $50 to invest. The pair identifies two attractive equity investment opportunities that are available for their $100. Project A has an expected payoff of $200 after 5 years, and Project B has an expected payoff of $2000 after 20 years. Assuming that each investor can safely earn a 5% annual rate of return on their capital, Project B generates a higher expected net present value, and would appear to offer a better return.

Whether Tom and Jerry will agree to this choice depends on the relative “time patience" of the two, and on whether or not there is a market for ownership in project B. Assume that Jerry is relatively young, but Tom is approaching retirement, and that there is no market for ownership. Under these assumptions, Tom will have to wait 20 years for a payout, and by this time he may be dead! If there is a market for ownership shares in project B, however, Tom can sell his ownership stake at any point after making the initial investment and earn its full net present value. 4

This simple example clearly demonstrates one important function of a market for company equity shares: to limit the influence of owners' liquidity preferences on investment choices. The market provides entry and exit opportunities for individuals to make decisions based on their own individual planning horizons. In the aggregate, this effectively maximizes firm value over time, to the extent that the value of a company is the sum total of net present values of the investment projects it represents.

The structure of a cooperative limits opportunities for creating an equity ownership market. With the restriction that only patrons can be owners, the potential number of traders in such a market is severely limited. Markets only function well when there are large numbers of traders.

The upshot of this finance lesson is that diversity among cooperative owners’ individual planning horizons can lead to poor corporate investment decision-making. It is essential that boards operate in the interests of the firm. When a decision that clearly is in the interest of the firm is likely to benefit some members at the cost of others, arrangements should be considered to compensate losers in the deal so that they will be willing participants.

3. Managing capital structure
Inevitably, there are gaps between the revenue a firm generates and the expenditures it must incur to sustain and grow its business. Both equity and debt capital can be used to finance this gap.

Debt levels are limited by the amount of a firm’s liquid assets that can be offered as collateral. Furthermore, loans must be repaid at regular intervals, regardless of business performance. Equity, or at-risk capital, which confers some level of ownership, does not carry the same obligation, and is one way to satisfy lenders by reducing the risk that debt poses to the business.

Business organizations can generate equity capital by retaining and accumulating earnings, which increases the equity stake of existing owners, or by seeking capital directly from existing and new owners. For public-stock companies, there is an external equity market in which any individual owner can easily liquidate his or her ownership shares, or purchase a greater number of shares.

For a cooperative business, the inability of owners to easily liquidate their ownership shares creates unique challenges for sourcing and managing equity capital. Retained earnings can be a major source of equity capital for the cooperative business, which uses its administrative and accounting systems to keep track of the identity of each owner and their accumulated equity contributions over time. However, there are some inherent dilemmas with the relative capital contributions of individual members in relation to their patronage contributions.

From a life-cycle perspective, it is often argued that a cooperative should strive to maintain rough proportionality between an individual's current-period patronage and his or her contributions to current-period equity capital. Although simple in principle, there are complications even with this practice. First, to the extent that earnings on a member’s patronage is retained and identified as a capital contribution, why should a member who contributes a given amount of patronage in a high-return year be credited with a greater capital contribution than a different member who contributes the same patronage level in a low-return year? In other words, on what basis should members' capital contributions be measured?
Second, forcing proportionality between patronage and capital contributions ignores differences across members in their demand for liquidity. That is, there may be years in which one member would effectively be willing to loan to another member by contributing relatively more capital—and it may be in everyone’s interest for this to occur. Following a strict proportionality rule eliminates this possibility for mutual gain.

There is another, and perhaps even more critical, challenge that arises from tying capital contributions to the identity of individual patrons: sometimes patron members (and even managers!) forget that capital contributions are equity, and as at-risk capital, cannot be “repaid” if the cooperative performs poorly financially.

For a public-stock company, poor financial performance affects all current owners equally through two channels: stock values decrease, reducing the wealth of each owner, and the company may choose to reduce its dividend payment rate, further reducing owner wealth. In a cooperative company, management chooses (even if only implicitly) to distribute losses across generations of owners when it designs a program for “revolving” capital contributions, i.e., retiring the contributions of past patrons, and seeking contributions from current and new patrons. For example, by extending the period of revolvement, a cooperative effectively reduces the capital contributions of current-generation patrons by choosing not to return the capital contributions of previous generations. “Intergenerational equity” is thus a double entendre of sorts for cooperative business organizations! Managing this issue requires understanding and communication to members about the true nature of capital contributions.

**Conclusion**

While all organizations tend to follow a “life cycle”, there are life-cycle challenges that are unique to cooperatives. Given the unique purpose of cooperatives as means of regulating imperfect markets, communicating the value provided to members is critical to success. Often, the value provided by cooperatives is difficult to measure because it is embedded in the behavior of other market participants, who must react to competition from cooperatives with lower prices and better service.

Similarly, the patron-owner structure of cooperatives generates unique challenges for management. Diverse economic interests of owners must be balanced with the interest of the cooperative business itself, and the burden of equity capital contributions must be spread efficiently and fairly across patron owners.

Managing these challenges effectively in response to changing external circumstances and internal competencies is critical to long-run cooperative survival.

**Endnotes:**

1. Organizational life cycle theories have been articulated by a large number of authors. Here I briefly summarize a synthesis of these theories presented by Richard Daft in his textbook, *Organization Theory and Design*, Chapter 9.

2. Of course, there are also historical, sociological, political, and perhaps even psychological, causes of cooperative economic activity. The point here is not to deny other possible explanations for cooperatives to exist, but rather to focus on one explanation that seems to have sound empirical grounding, and that helps to understand common pitfalls in cooperative life-cycle management.

3. Cooperatives exist and thrive despite this handicap because patrons (including non-member patrons!) benefit from the corrective function provided by patron ownership. Moreover, there are offsets benefits—for example, patron loyalty and relatively “patient” capital—but the fact that other organizations do not adopt the cooperative structure except when a specific class of patron is dissatisfied suggests the net effect is an operational handicap, rather than advantage.

4. Assuming that each investor can safely earn a 5% annual rate of return on their capital, project net present values are given by $56.71 = 200/(1.05)^5-100$ and $653.78 = 2000/(1.05)^5-100$. Both projects generate positive net present value, but clearly project B should be chosen instead of project A.

The astute reader may question how Tom and Jerry managed to find such fantastically priced investment opportunities. If there was a market for ownership in the investments at the time of purchase, they should have been priced at their economic worth ($156.71 for project A and $753.58 for project B).