EMBARGOED UNTIL 12 NOON TUESDAY 9 NOVEMBER 1999

1999 NEW ZEALAND AGRIBUSINESS AND FOOD CONGRESS

COOPERATIVES VERSUS CORPORATES

ROGER KERR EXECUTIVE DIRECTOR NEW ZEALAND BUSINESS ROUNDTABLE	CHRISTCHURCH 9 NOVEMBER 1999

COOPERATIVES VERSUS CORPORATES

It is important to be clear what we mean when we talk about competition between supplier-owned cooperatives and investor-owned corporates. The competition between forms of business organisation is not like a sporting competition where there is only one prize and one winner and players are not allowed to switch teams in the middle of a game. Business competition may take place between firms that are organised in different ways and result in changes from one form of business organisation to another.

Although investor-ownership is the clear winner in a large swathe of economic activity, cooperatives and non-profit firms have important advantages in some situations. There is likely to be ongoing competition in industries or markets where cooperatives and investor-owned firms are fairly evenly matched. An important issue is whether changes occurring in agricultural processing and marketing are more likely to favour cooperatives or investor-owned firms.

It should go without saying that cooperatives and investor-owned firms ought to be allowed to compete on equal terms, without the government intervening to favour one way of doing business relative to the other. Unfortunately, as recent restructuring proposals for the dairy industry have shown, our government still bends to pressure to favour cooperatives relative to investor-owned firms in the processing and marketing of agricultural products. The strong ideological attachment to cooperatives in some quarters in New Zealand is arguably holding the sector back.

What is so special about cooperatives?

It is difficult to understand why this ideological attachment to cooperatives lingers on. Cooperation is a good thing in any business, but there is not necessarily anything more cooperative about the business organisations that we call cooperatives than about investor-owned firms. Some advocates of cooperatives like to think of them as "people-centred businesses". This conveniently overlooks the fact that all inputs to firms – including capital – are provided by people. In addition, like the owners of investor-owned firms, the owners of cooperatives benefit from any profits made by them. In neither case is the primary purpose of the business altruistic, as may be the case in non-profit firms.

The chief executive officer of the New Zealand Cooperatives Association, Ian Reid, has defined a cooperative as "a collection of individuals or businesses that decide to operate together for advantage". People also operate together for advantage in investor-owned firms – indeed they are a type of producer cooperative. This is the view of Henry Hansmann, a Yale law professor who has made significant contributions to economic analysis of the ownership of firms. Hansmann points out that in any producer cooperative, the suppliers of one of the factors of production receive any residual earnings after suppliers of other factors of production have been paid. An investor-owned firm is a type of producer cooperative in which suppliers of capital have the rights to residual earnings after suppliers of raw materials, labour and other inputs have been paid.

In practice, because the cooperatives owned by farmers in New Zealand do not obtain all their capital by borrowing, farmers have had an important role as suppliers of equity capital to these firms in addition to their role as suppliers of raw materials. The growing requirement for equity in value-added processing poses a critical issue for the farmers who own these firms, namely how to raise sufficient capital at least cost when their ownership rights stemming from their role as suppliers of capital are fused with their rights as suppliers of raw materials. As discussed later, it is becoming increasingly untenable to attempt to avoid this issue by bundling returns on the capital supplied by farmers together with payments for the raw materials they provide.

Why is investor ownership the norm?

Ownership of firms by the suppliers of equity capital is the norm in capital-intensive industries in New Zealand, as in most other economies. This is evident from the fact that investor-owned companies are frequently referred to as corporates and the system of private ownership is often referred to as capitalism.

Investor ownership has not become the norm as a result of an accident of history. There are good reasons why ownership of firms by specialised suppliers of capital is superior to the alternatives, particularly when the capital requirements of the firm are beyond the capability of its managers and suppliers. Although some of these reasons are familiar, it is worth listing them to make the point that only in special circumstances are other forms of ownership likely to be more efficient.

- First, the corporate structure permits the separation of investment and ownership from the management role. It allows the firm to tap into capital markets, now global in nature, for equity capital rather than having to rely an internal resources or on debt.
- Secondly, providers of capital are commonly in a much better position to bear the risks associated with the role of residual claimant because they are able to reduce firm-specific risk. Investors can hold a diversified portfolio of investments rather than having a high proportion of their capital invested in one firm. The capital market provides greater liquidity for small investors, which reduces the cost of capital to firms.
- Thirdly, as owners, investors generally share a single well-defined objective: to maximise the net present value of the firm's earnings. Sharemarket listing provides visible and independent valuations of future profits. This tends to reduce the costs of collective decision making in investor-owned firms.
- Fourthly, open capital markets provide mechanisms and disciplines that limit the problem of the separation of ownership and control. Owners and managers can have different interests. This problem arises with both corporates and cooperatives. Sharemarket listing, however, helps owners to monitor the performance of firms' managers. Large block shareholders have particular incentives and, typically, expertise to perform this role. They may also bring other benefits such as operating synergies,

technology and access to markets. Remuneration arrangements involving share parcels and options can help align the interests of managers with those of owners. Sharemarket listing provides greater potential for the threat of takeover to act as a spur to managerial efficiency.

There are some circumstances in which cooperatives may offer efficiency benefits that more than offset the advantages of investor ownership. (For convenience I use the term 'cooperative' in the conventional way from here on to refer to ownership by some class of patrons other than investors.) For example, where transaction-specific investments are involved, farmers may suffer a capital loss if the processing firm decides to obtain supplies from some other source, or the processing firm may suffer a capital loss if farmers decide to sell their produce elsewhere or to produce something else. Such problems can be serious, but control of the firm by some group of patrons other than investors is not necessarily the best solution. In many instances this type of problem can be handled adequately through contractual arrangements.

The strongest argument that cooperatives are efficient is their ability to operate successfully in a competitive market. If both investor-owned firms and cooperatives are doing so at a point in time, the efficiency of both forms of organisation must be roughly equal. This seems to be the case, for example, for retailer-owned wholesale cooperatives, such as Foodstuffs. This type of cooperative has also been able to compete successfully in the United States and Australia.

Agricultural supply cooperatives are also common in dairy processing and some other industries in the United States and Australia, as well as New Zealand. It is not always clear, however, that this implies that cooperatives are as efficient as investor-owned firms in these industries. Several factors need to be taken into account:

- In New Zealand, single desk exporting has virtually precluded entry of investor-owned firms to compete with cooperatives in the processing of dairy products for export. Overseas evidence that some dairy cooperatives have been able to hold their own in competitive environments has little relevance to the performance of cooperatives in a situation where competition is precluded. The proposed linking of the removal of the Dairy Board's export monopoly to the establishment of a mega-cooperative could result in the industry remaining protected from competition from investor-owned firms. The Business Roundtable has opposed the mega-coop proposal because of its potential to impede the access of competitors to milk supplies by denying its shareholders the right to exit with the full value of their equity.

- The overseas evidence on the competitiveness of agricultural supply cooperatives is not clear-cut. It is arguable that the exemption of cooperatives from antitrust law, in combination with regulatory advantages, has tended to favour cooperatives relative to investor-owned firms in the dairy industry in the United States. In addition, the corporate tax regime in the United States has tended to disadvantage investor-owned corporates relative to cooperatives.
- There seems to be a tendency for successful agricultural supply cooperatives to behave less like cooperatives and more like investor-owned firms, the further they extend their range of activities or add value to raw materials. If the cooperative is engaged solely in bargaining and the equity of owners is negligible, there is no reason why the owners of the cooperative cannot exercise their ownership rights solely with regard to their role as raw material suppliers. However, where the firm is engaged in value-adding activities which require substantial capital, the cost of capital to the firm is likely to be prohibitive unless the owners have substantial equity. As the value of owners' equity increases, the 'custodial' concept of ownership tends to get left by the wayside. It becomes increasingly untenable to allow new members to purchase shares at a nominal price and to provide retiring members with nominal compensation for the surrender of their shares.

Despite these qualifications, it is probable that agricultural supply cooperatives would have been able to survive open competition from investor-owned firms in some industries without government assistance. However, this is not necessarily a good guide to the future competitiveness of cooperatives in these industries.

Is there a trend away from cooperatives?

Some advocates of agricultural cooperatives seem to delight in pointing out that the New York Stock Exchange functions as a cooperative. If this is relevant, it is perhaps also worth noting that the Australian Stock Exchange (ASX) converted last year to become a listed company owned by investors. Other stock exchanges, including Wall Street and the New Zealand Stock Exchange, may follow suit. There has also been a trend toward investor ownership in other areas where the cooperative or mutual form has traditionally been important, including insurance and health services.

In agricultural processing and marketing activities in New Zealand, Australia and some other countries, there seems to be a fairly clear trend toward investor ownership. One important New Zealand example is AFFCO, a major meat processing firm, which converted from a cooperative to a listed company in 1995. In Australia, PLC industries, a major egg marketer and feed miller, also converted to a public company in 1998, with 83 percent of shareholders voting in favour. By providing for shares to be traded on a restricted basis, recent reform proposals for the dairy, apples and pears, and kiwifruit industries may be interpreted as step in the direction of investor ownership, albeit a small and reluctant step.

In Australia, the trend in recent years toward stock exchange listing of farmer cooperatives has been attracting headlines like: "Bush goes on the bourse". In the dairy industry, early moves in the direction of investor ownership were made when Dairy Vale, a dairy products group based in South Australia, was floated on the ASX in 1995. Despite an elaborate structure designed to avoid takeover, a successful takeover occurred last year. Since the purchasing firm, Dairy Farmers, is a major cooperative, this might be thought to have levelled the score. However, Dairy Farmers is itself now considering a restructuring proposal that involves listing on the sharemarket within three years.

Meanwhile, Parmalat, a privately owned firm that is a major player in the international dairy market, has made a merger offer to Dairy Farmers. Some of the shareholders in Dairy Farmers clearly consider this offer to be more attractive than the restructuring proposal that their board has put to them. The Supreme Court of New South Wales has recently found that some of the material that the board of Dairy Farmers sent to its shareholders urging them to ignore Parmalat's merger offer was misleading or deceptive. Whatever the outcome of this particular merger proposal, it is clear that Parmalat would like to further expand its Australian operations, following its purchase last year of Pauls Ltd, a Queensland dairy company. It is interesting that one of Parmalat's reasons for expanding in Australia is to obtain access to dairy products to sell to Asia. I expect that many Australian dairy farmers agree with the chief executive of Parmalat's Australian operations, Alberto Ferraris, when he says that supplying Canadian cheese to Asian clients, as his firm has done in the past, is "sub optimal".

The large Victorian company, Bonlac Foods, has moved a considerable distance in recent years in the direction of becoming an investor-owned food and beverages company, rather than a traditional dairy cooperative. Through the acquisition of Spring Valley, it has expanded its activities beyond dairy products to include fruit juices and other beverages. Although Bonlac's core business has not been listed on the ASX, it launched a $100 million issue of listed capital notes in mid-1988 to reduce debt and fund acquisitions.

The introduction by the ASX in 1997 of more flexible listing guidelines covering cooperatives and former cooperatives has led to the listing of several firms. Farm Pride Foods Ltd, formerly the Egg Industry Cooperative Limited, was the first company to be listed under the new rules. The New South Wales grain handling company, Graincorp, was listed in March last year. Grain handling cooperatives in other states are reported to be considering similar moves. The national wheat marketing firm, AWB Ltd (formerly the Australian Wheat Board), is planning a stock exchange listing for the middle of next year.

Turning to fibres, Namoi Cotton was listed in 1998. Woolstock Australia Ltd, the private farmer-owned company that owns the remnants of the wool stockpile – which was accumulated under the infamous reserve price scheme that collapsed over eight years ago – is also reported to be considering listing on the ASX. It is possible, however, that the stockpile could be sold in a single deal before ASX listing occurs.

It is easy to overlook the fact that Wesfarmers, an industrial conglomerate with an annual turnover of around $3 billion – which makes it one of Australia's largest public companies – is controlled by the Westralian Farmers Co-operative Limited. This cooperative owns a 'founders share' in Wesfarmers as well as nearly half of its issued capital. Despite this, the management of Wesfarmers has been characterised by a strong focus on improving shareholder value. It is not surprising, therefore, that the chairman of Wesfarmers has publicly flagged the possibility that, as part of some future merger of the agricultural activities of Wesfarmers with other agricultural companies – such as AWB Ltd – the cooperative that currently has a controlling interest in Wesfarmers might cease to exist.

There is also a strong trend toward conversion of agricultural cooperatives to public companies in some other parts of the world. Three major Irish dairy cooperatives led the way about 10 years ago. The Kerry Group is often held up as a model of the benefits of corporatisation. Since its public listing in 1986, Kerry Group has grown into a major international food business with interests extending into areas such as meat products, convenience foods, home baking products and food ingredients. As in the case of Wesfarmers, a cooperative structure initially held a majority shareholding in Kerry Group but with the rapid expansion of the company the proportion of shares owned by the farmer cooperative has fallen substantially. The success of Kerry Group's operations has led to around a 20-fold appreciation in the company's share price.

It would not be correct to imply that the advantages of the corporate form are seeing an inexorable trend toward conversion of agricultural cooperatives to public companies. There is the potential for conflict between public shareholders and cooperative members when cooperatives attempt to maintain the business practices of a cooperative while raising equity capital from the public. Some agricultural cooperatives that have experimented with public listing, including a subsidiary of the large US dairy cooperative Land O'Lakes, have subsequently reverted to 100 percent ownership by a cooperative.

What are the pressures on agricultural cooperatives?

In a paper I gave a couple of years ago, I observed that the same factors that had been driving demutualisation in the insurance industry were also placing agricultural cooperatives under pressure to convert to publicly listed companies. These factors were: an increase in the range and diversity of activities of cooperatives; growing capital requirements; and the pressures for greater accountability for performance in a more competitive environment.

Range and diversity of activities

There are strong economic pressures for firms engaged in processing and marketing of agricultural products to undertake a wider range and diversity of activities. Traditional specialisation on commodity lines is under challenge. There is often potential to achieve economies by selling a range of beverages, for example, rather than just dairy products, or a range of horticultural products, not just apples and pears or kiwifruit. In addition, the increasing demand for convenience foods can often be met more readily by diversified food manufacturing firms.

As cooperatives attempt to meet this challenge by diversifying and adding more value, the returns flowing to farmers come to depend to an increasing extent on investments in activities that are a long way removed from the farm gate. As this trend continues, it is likely that more members of cooperatives will question why their capital is being placed at risk in investments that are not directly related to the processing and marketing of their produce. Cooperatives are likely to find it increasingly difficult to compete with firms like Kerry Group and Nestlé that are not similarly constrained.

The problems are exacerbated by the practice of bundling the dividend component of the return paid to farmers in the price they are paid for the produce they supply. Sending out separate cheques for dividends and produce will not solve the problem. The problem will remain as long as suppliers of produce are required to own shares proportional to the quantity of raw materials they supply. In other words, the bundling problem will only be solved when those farmers who wish to do so are free to sell their shares while continuing to supply raw materials to the firm.

Access to capital

Capital raising is likely to become an increasing problem as cooperatives get further involved in additional value adding. As residual claimants, farmers alone must assume nearly all the investment risk associated with cooperatives. As the amount invested in cooperatives by individual farmers increases relative to the level of their total assets, the risks involved in further investment must ultimately rise sharply. Although some external finance can be borrowed by farmers or cooperatives or both, prudence dictates that debt be kept in balance with the equity available from retained earnings.

What this means is that the ability of cooperatives to fund expansion is limited by the willingness of farmers to accept lower payouts in order to establish reserves. This can prevent cooperatives from becoming involved in major new investment projects, including the acquisition of major international brands, other than through joint venture arrangements with investor-owned firms.

Accountability

Accountability for performance tends to become an increasing problem as cooperatives become larger and as they diversify their activities. It is arguable that supplier shareholders in a small, local cooperative have common interests, are well placed to monitor its management, and have a fairly strong incentive to be well informed about its activities. As the membership of cooperatives increases and their activities become more diverse, the interests of members tend to diverge, individual members have less influence over decisions and it becomes much more difficult for them to monitor performance. Where a cooperative is heavily involved in further value-adding activities, members are likely to be less well placed to monitor the efficiency of the firm than are professional investors such as fund managers. In addition, in the context of a regulatory environment that has discouraged entry of investor-owned firms, the amalgamation of cooperatives in an attempt to achieve size economies tends to eliminate competitive benchmarks that could be used to assess the relative efficiency of different firms. This means that where members of a cooperative suspect that the firm may be poorly managed they are often unable to withdraw their investment unless they are prepared to change their occupation. The problems of dispersed ownership and the absence of benchmarks are likely to be serious in the case of the proposed dairy mega-coop if it proceeds.

When regulations that have discouraged entry of investor-owned firms, particularly single desk exporting, are finally removed, agricultural cooperatives will come under increasing pressure to lift their performance. Many may conclude that the advantages of investor ownership listed earlier are compelling reasons for converting to publicly listed companies.

Transferability of shares

An additional factor that is likely to place agricultural cooperatives under increasing pressure is the desire of members to ensure that they and their families can obtain access to the capital built up in cooperatives without having to sell their farms.

Under the traditional custodial concept of ownership of cooperatives, the benefits of the cooperative were capitalised in land values and accrued whether or not farmers actually supplied produce to the cooperative. There was no requirement to make a substantial investment in share purchase on entry to the cooperative and no compensation on exit for capital left behind. In those circumstances, investments made by the cooperative conferred benefits to current members that were more or less equivalent to an increase in the price received for farm produce.

The benefits of ownership accrue more directly to members when compensation is paid for shares relinquished when members leave the cooperative. However, the compensation payable is generally determined according to the value of the tangible assets of the firm. The value placed on a firm by the sharemarket reflects the present value of the expected future earnings of the firm as an ongoing concern. The market value of listed companies is usually substantially greater than the value of their net tangible assets.

In addition, farmers have to cease to be suppliers in order to obtain access to their share of the capital that accumulates in cooperatives. In some respects this is similar to a form of compulsory superannuation that can only be accessed on retirement, no matter how much the owner of this asset may prefer to use the funds for other purposes such as repayment of debt or education of children. The situation is actually much worse than this, however. A well-designed superannuation fund would not require farmers to put all their eggs in one basket by investing large sums in a single firm, particularly when returns from that investment are likely to be highly correlated with returns from the farm itself. Nor would such a fund treat particular classes of investors such as long-established savers and new savers in an arbitrary manner, as cooperatives commonly do.

While many farmers now recognise the benefits of being able to transfer ownership rights, there is still some concern that unrestricted share transfer could disadvantage them by resulting in a loss of farmer control. It is common for some restrictions on share transfer to be retained in initial public share offerings in order to ensure that farmer control of firms is not threatened.

It is possible that these restrictions may deny shareholders of poorly performing firms the potential to achieve higher future earnings through transfer of control. Even with these restrictions, however, successful takeover offers can still be made when large numbers of farmers are prepared to sell their shares.

The main cost of restrictions on share transfer takes the form of a lower market price for farmers' shares because liquidity is reduced. When there is a requirement that a certain class of shares must be owned by farmers, any farmer selling shares has to sell at a price at which it is attractive for some other farmer to buy. In order to induce farmers to hold more of these shares in their portfolios the yield must be higher (or the share price must be lower) than on shares that are freely tradeable. Shareholding restrictions also reduce the threat of takeover, which in turn depreciates share values.

Restrictions on share transfer may substantially depress the market price of shares owned by farmers. It is of interest in this context that the requirement that Air New Zealand 'A' shares can only be held by New Zealanders has resulted in that class of share trading below the unrestricted 'B' shares by a margin of more than 20 percent. A requirement that a particular class of share could only be owned by a relatively small group of people in New Zealand could depress the price of that class of shares to an even greater extent.

Conclusion

In considering competition between cooperatives and corporates, the most important point to keep in mind is that both forms of business organisation are perfectly valid. The choice between cooperatives and corporates should not be a public policy issue. It should be determined by competition in the marketplace in an environment in which tax and regulatory regimes are neutral between types of organisation.

It is likely that cooperatives will continue to have important advantages in some activities. When we look at the agricultural supply cooperatives, however, the benefits that they are alleged to offer in terms of allowing farmer control to be maintained seem to be vastly overrated. Although benefits may exist in some circumstances, they are likely to be increasingly overshadowed by the benefits that farmers can achieve by exercising their ownership rights in these firms in their role as shareholders. As shareholders, farmers have a strong interest in ensuring that the firms are able to adopt profitable diversification strategies; that access to the capital market is not constrained; that management is accountable; and, if they wish to sell shares, that the price is not depressed by restrictions on who may purchase them.

In the New Zealand environment today, the weaknesses of the cooperative structure are most apparent in the dairy industry. The problem of the price distortions arising from the bundling of raw material and investment returns is most acute in this industry, and cannot be effectively solved in a cooperative structure. The separation of investment and supply, in conjunction with an end to the statutory export monopoly, would allow a contestable market to develop for raw milk, boosting farm-gate prices once cross-subsidies are eliminated. It would also allow dairy companies to access a wider range of investors, lowering the cost of capital to the industry and making company management more contestable. The current proposal to form a single large cooperative is therefore a poor solution to the dairy industry's problems.

The extent to which New Zealand farmers decide to make further moves toward the conversion of cooperatives to investor-owned firms in the near future is likely to hinge on their perceptions of the balance between benefits and costs of maintaining organisational structures that are intended to preserve farmer control. Perceptions seem to be most optimistic about the benefits of farmer control where single desk exporting arrangements have hitherto discouraged the entry of investor-owned firms into processing and marketing activities. I believe they are likely to change rapidly when investor-owned firms are able to enter these industries and compete on equal terms with cooperatives.