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Current and Future Issues for Directors and Managers of Local Cooperatives

Abstract
Cooperative managers and directors will be confronted with a number of changes as we move forward into the coming decade. I am going to touch on four developing trends which I feel are important. Trends that are likely to create forces for change in local cooperatives. They will raise difficult issues to be settled in the boardrooms of Iowa’s local cooperatives now and later in the decade of the 1990s. The list of trends includes the following: 1. Fierce competition among locally owned agribusiness firms. 2. Declining population and economic activity in rural communities. 3. Development of more consumer-oriented less commodity-oriented market channels. 4. Trends toward integrated and industrialized agricultural production.

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CURRENT AND FUTURE ISSUES FOR DIRECTORS AND MANAGERS OF LOCAL COOPERATIVES

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Cooperative managers and directors will be confronted with a number of changes as we move forward into the coming decade. I am going to touch on four developing trends which I feel are important. Trends that are likely to create forces for change in local cooperatives. They will raise difficult issues to be settled in the boardrooms of Iowa's local cooperatives now and later in the decade of the 1990s.

The list of trends includes the following:

1. Fierce competition among locally owned agribusiness firms.
2. Declining population and economic activity in rural communities.
3. Development of more consumer-oriented less commodity-oriented market channels.
4. Trends toward integrated and industrialized agricultural production.

FIERCE COMPETITION AMONG LOCALLY OWNED AGRIBUSINESS

The industry has at this time emerged from a sustained period of heavy demand for grain storage. This period provided good profits for elevators of all sizes and elevators in all locations. The 100 Iowa elevators in the 1988 ISU financial standards sample were in a stronger financial position than they had been in a decade. Debt levels

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had declined markedly and cash flow measures showed a great deal of strength. Many elevators were able to carry these benefits forward into 1989 through purchase and hedging of CCC grain.

There can be little doubt that this strength came from the high levels of storage income earned through the period 1986-1988. Directors will understand this—a parallel situation has occurred on their farms during this same period.

However, in 1990, the situation has changed dramatically. Differences in earning capacity emerged among local cooperatives. Elevators in a position to merchandise grain effectively continued to show good profits. Elevators not in a position to merchandise as effectively began to experience earnings pressure in 1989 and 1990. Excess capacity at the origination level has spawned fierce competition for grain at the country elevator level. The market forces currently favor those in a position to assemble large quantities of grain rapidly and to ship that grain at a freight advantage. Margins for many others have been squeezed.

A by-product of a fiercely competitive market is the tendency for those very firms being squeezed to cut margins. This comes in the form of aggressive grain bids, below-market prices on farm supply products and service concessions to customers. But too often this kind of action simply cannot be sustained or justified based on costs. It is done as a last ditch effort to gain control of business volume in the short run. For some locally owned elevators on the financial brink this choice is one of last resort. To support this strategy either extraordinary risks must be taken or operating losses must be endured. For those with deeper pockets, the choice to follow or not to follow can be
made more freely. But the effect in both cases on net worth is the same. It will be eroded.

Directors and patrons of cooperatives must understand that they are owners of the business as well as customers. Pricing at below cost is simply liquidating the equity in the business to current customers.

One effect of such a squeeze is to create tension in many of our local cooperatives. Tension between the patrons and their cooperative. Tension between the board of directors and the cooperative’s management. It is tempting to assume that the competitors are buying at lower cost, or have found better markets. Such possibilities can’t be totally ruled out. But it is extremely unlikely that similar firms selling or bidding in the same local market would have very different opportunities to buy and sell. There simply aren’t many deals in these commodities. If no fundamental business advantage can be identified, its time to ask questions about how it is possible to cut price significantly.

One of the serious near term challenges for coop boards and managers will be to deal with these tensions in a positive manner and direct them toward a positive solution. Finger pointing, laying blame or sniping will not solve the problem. Positive solutions must come out of joint efforts by the board and management to address the problem head on. Such solutions will almost always involve difficult decisions. Efforts must be focused on (1) the changes taking place in the industry, (2) what the patrons really expect from the coop, and (3) what the patrons are willing to pay for.
The 1990 Census figures did not bring good news to Iowa and, in particular, Iowa's rural communities. Iowa's population declined during the decade 1980-1990 and rural counties experienced the largest decline. Beyond that the portion of older Iowans and retired Iowans has increased. This is not a new trend but it has reached a critical point in many of our rural communities.

As these trends continue, rural communities are faced with greater difficulties in maintaining (1) an acceptable level of employment, (2) an acceptable level of public services, and (3) keeping the level of taxes reasonable. Each business in these communities is an important part of the community fabric. None can be lost without noticeable damage. This includes the local cooperative.

In most communities the cooperative is not just a significant employer. It is also a significant taxpayer and a significant user of goods and services from the local economy. Beyond these benefits the cooperative manager and top level employees are very often a major source of leadership in the community—in its churches, schools, and organizations.

All these benefits are threatened as the grain marketing and farm supply industry adjusts to changes occurring at the producer level. It is no secret that the number of farmers is declining and operations are getting larger. It is not uncommon for a single operator to replace two or three who retire. These larger scale farmers have much different expectations from their cooperative than those they replace. Competitive grain
bids and low input prices are near the top of the list. Only the most cost efficient firms can provide them.

Cooperative boards and patrons are placed in a situation where they must choose between making the necessary adjustments to remain competitive in the industry and living up to the expectations of the local community. In the vast majority of cases these goals are incompatible. What must be done to accomplish one of them dooms any chance of accomplishing the other. This leaves the board with the terrible dilemma of choosing which group to disappoint.

Conditions for merchandising bulk grain now favor firms that (1) handle large volumes of grain, (2) have good transportation access to several alternative markets, (3) have capable grain merchandising personnel, (4) have strategically located facilities capable of meeting buyer's needs and (5) have a management system in place to coordinate it all. Such firms in the cooperative sector are difficult to build and operate without sustained conscious effort on the part of directors and management. Beyond that, a decision to do so almost certainly means that some of the community focus must be traded off in favor of a grain business focus.

There may be alternative strategies a board can take to maintain greater community orientation but they generally do not involve concentrated focus on large scale bulk grain marketing. Some cooperatives are focusing more on the farm supply side of the business. Others are becoming involved in value-added activities such as egg production or broiler production. These and similar strategies can permit a cooperative to maintain a greater community focus.
But I must emphasize that such strategies are not without their own set of risks. Nor do they allow the cooperative to ignore business realities and sound business principles. To make these strategies work well still requires careful business planning and execution by boards and managers. I must make the further caution that not all local cooperatives can use the same strategy and be effective.

MORE CONSUMER ORIENTED LESS COMMODITY ORIENTED MARKET CHANNELS

The decade of the 1990s will bring a change in the markets for agricultural products and the way agricultural production decisions are made. Traditionally production decisions for Iowa agricultural products have been centered at the farm level and very decentralized. It has been a commodity oriented system where one producer's product has been considered to be the same as another producers product within the broad constraints of quality and grade. Total supply of most products has been determined through decentralized decisions made by independent producers acting in response to cost of inputs and prices of products farmers produce.

The role of processors and consumers in the market channel has been a rather passive one. It has been one of responding to and making adjustments to whatever quantity and quality of the commodity has been produced. In this way total supply has been determined through the collective effects of decisions by individual farmers acting independently. Genetics have been determined by individual producers acting
independently. Physical characteristics have been determined by individual producers acting independently.

There are cases where genetics and physical characteristics have been adjusted by producers to meet consumer demand. In the case of livestock, significant adjustments have already been made in some species. Independent producers of hogs, for example, have made big adjustments in the type of animal produced over the past 30 years. They are now producing much leaner hogs. But, by-and-large the processor and consumer have more or less passively accepted the amount and type of product produced.

During the decade of the 1990s, the market channels for hogs, cattle, and sheep will become much more consumer oriented. The trends toward adapting the final meat product to consumer tastes and preferences will accelerate during the 1990s. Consumers are aging. The average age of the population will continue to increase during the decade and into the 21st century. Average income of older consumers is higher. They are willing to pay for quality and convenience. They often seek foods that conform to dietary restrictions.

Trends toward consumption of convenience foods are likely to continue. American's eating patterns are now biased toward fast preparation and consumption and will continue to be. In the words of marketing expert, Roger Blackwell, "Fast food is no longer good enough. Americans now want instant food!" The microwave oven has found its way into more than 70% of American homes. Along with the microwave oven has come a myriad of processed foods -- many of them packaged in individual portions. These highly processed specially packaged products bear less and less resemblance to the
wholesale and retail cuts of the past. Their success with consumers depends on uniformity, consistency and high quality.

These trends will put pressure on the traditional way the market channel has operated. As the food processing sector attempts to adjust to consumers’ demand for uniformity, consistency and high quality, changes in raw product and the timing of production will be necessary to deliver what the consumer expects.

Current practices of taking raw product with variable physical characteristics will become less acceptable to the processing sector. Processors will feel the need to acquire raw product that has been produced with the desired characteristics in mind. Characteristics such as protein content, fat content, texture, and consistent portion size will require a great deal more coordination than the traditional market channel has provided.

The current system where producers are making independent decisions about the type of genetics to be used and making the decision where and when their livestock will be sold after the animals have been produced does not fit as well. Uncertainty about supply of product and timing of product sales will make it difficult for processors to consistently provide desired characteristics to the consuming public. This will result in enormous pressures to change that system.

Nor will the effects stop at the producer level. Final product characteristics of the meat produced are also affected by the types of feed the animals consume, the facilities where they are raised, and the type of veterinary and animal health programs in place. The input supply and production service sector will have to adjust.
What does this mean for local cooperatives? It means that the drive for consistency in final meat product will affect the types of feed products their customers demand. It means that the feed programs will need to be carefully tuned to fit the production system required to produce a more consistent meat product that has the desired consumer characteristics.

To further complicate the matter, processors and marketers of convenience products may attempt to provide final products with different characteristics to different segments of the consumer market. This means that more numerous unique production systems will have to be served.

At this point those corn and soybean producers in the audience are perhaps breathing a sigh of relief that the products they produce are not facing such a fate. But the fact is the corn and soybean market channels will also be facing a more customer oriented market channel. Granted the changes are not likely to come as fast nor are the pressures likely to be as immediate. But the trend is beginning.

Changes in the corn and soybean sector to make them more customer oriented are now showing up in two forms. Both are talked about using the general term "grain quality" but they are really quite different ideas when viewed from the producer perspective.

The most widely held concept of grain quality is associated with grade, cleanliness, kernel integrity, and similar physical factors. At least one local cooperative has already begun pilot efforts of this kind in soybean quality. This involves efforts to reduce foreign matter and cracked beans. It involves working with producers in an effort to fine tune
variety selection, harvest practices, grain handling practices, and other production level practices. Similar programs for corn are being tried in other states. Once again, broken kernels, foreign matter and methods of drying at the farm level are the focus of these efforts. This concept of grain quality is not inconsistent with the present system. It fits very well in fact.

Another concept of grain quality (less well understood) involves the value of various components of the soybean seed and the corn kernel. Under this concept of "grain quality" the value of the commodity would be based on the value of the usable components of soybean seed and corn kernel to the processor or user.

Application of genetics and biotechnology to these commodities has the potential to change the ratio of various components in the grain. This would allow processors, feeders, or other users of grain to select grain with more of the components they need most and less of the component they need least. In this respect, the grain would be "tailored" to their specific use. Presumably, a buyer would be willing to pay more for products that provide more of the specific components they want.

This presents a serious problem to grain handlers and marketers. Our current grain bulk marketing system is designed to store and move grain as a bulk commodity at a very low cost per bushel. This implies that virtually all grain received can be co-mingled in storage. It implies that bulk shipping can be done frequently in very large quantities. It implies that any given inventory of grain can be sold to any one of several customers.
Significant investments have been made in bulk handling systems and in transportation facilities based on the ability to use co-mingling and frequent large volume shipment of undifferentiated commodities. It is a system where shipments may be made to a wide variety of markets and end users in the export market, the domestic processing market or the domestic feeder market.

Sale of smaller quantities of grain specially produced to meet the needs of specific end users is likely to require a much different set of fixed assets and marketing strategies. Handling costs per unit of product marketed in this way are almost certain to be higher. Additional testing is going to be necessary when grain is received and shipped. At present, there have been some small scale pilot projects but few, if any, are doing it on a commercial scale.

It is doubtful that the industry will move away from an undifferentiated bulk handling grain marketing system with lightning speed. The premium that end users must pay will have to be large enough to offset the increased costs of testing, segregating, holding for longer accumulation periods and making smaller sized shipments. Still it is a change that will bear watching. There may be niches for some cooperatives in serving the more specialized needs of end users in the decade of the 1990s. In some respects, the fixed assets in these elevators could be well suited for this activity.

VERTICAL INTEGRATION AND INDUSTRIALIZATION

The final trend is the move toward vertically integrated (and in some cases totally industrialized) production systems for many of the farm products now grown in Iowa.
Because cooperatives are owned and controlled by independent producers this question becomes a very difficult one. It is a question that many of us would rather avoid.

Cooperatives are not leading the move toward either vertical integration or complete industrialization of what has traditionally been farm level production. Nevertheless, as we move into the coming decade both the cooperative and their patrons are going to find that the issue will become increasingly difficult to ignore for some Iowa commodities.

Many of the cattle and sheep now raised in Iowa are being produced under some type of contract or cost sharing arrangement. Although most Iowa hogs are still produced by independent farmers integrated production systems in the Southeastern U.S. appear to have significant cost advantages. The broiler production now moving into Iowa is contract integrated.

For some commodities such as eggs the production is becoming industrialized. The top 5 egg production firms now own 33% of the nation's total laying flock. The top 10 egg production firms own about 45% of the nation's laying flock. Greater numbers of turkeys are now being produced in company owned houses and cared for by company employees.

As the anticipated discoveries in biotechnology and genetics are brought to the market there will be increased incentive for vertical coordination among the input supply level, the production level and the output processing level in the market channel. As the market channels become more oriented toward specific needs of end-users and consumers there will be more incentive for vertical coordination among the levels in the
channel. Independent producers (even large ones) will need an effective trustworthy connection to the other levels in the channel.

Cooperatives can be a powerful tool in the hands of farmers in this kind of environment—an environment that calls for greater coordination between the production level, and the other levels in the market channel. But cooperatives will not accomplish their full potential unless their directors and managers are alert to changes in the industry. They will not accomplish their potential if their managers and directors fail to identify what is happening in the industry soon enough. They will not accomplish the potential if their managers and directors fail to identify what patrons expect from their cooperative and carefully focus the resources of the coop to achieve it.

In closing I would say that the 1990s will bring strong challenges to local cooperatives. Cooperatives are capable of meeting their challenges. But managers and directors must be alert, perceptive and open minded. Let me recap.

(1) Cooperatives must learn to survive in what promises to be a fiercely competitive local market. This will almost certainly require changes in operations. Sniping, complaining, finger pointing will not help. Careful evaluation, planning, and business-like execution are the only solution.

(2) Cooperatives must define more carefully the major emphasis and scope of their operation. In most cases this will involve choosing between alternatives that will allow the coop to operate as a low cost bulk grain merchandiser and other alternatives that will provide the coop with a business niche in more localized markets.
(3) Nearly all cooperatives must make the adjustments necessary to serve their patrons in a market channel that is becoming more end-user and consumer oriented. Greater end-user emphasis will be most apparent in the livestock sector. But will it also begin to show up in the crops commodities sector. This is especially true for the physical grain quality characteristics. But the intrinsic component value grain quality question can be expected to become a bigger issue as the decade proceeds.

(4) Cooperatives will be expected to assist producers as they attempt to survive in a more closely coordinated production system and market channel. As producer-owned organizations cooperatives are in a unique position to do so. They can be the critical connection between the production level and the input supply level and the output processing level.

To successfully meet these challenges will require boards and managers to work together as a team. The need for strategic planning cannot be ignored. The need to carefully define what the cooperative members expect and what they are willing to support is more pressing than ever. But I'm confident that the talent and commitment of Iowa boards and managers will be a potent enough force to successfully meet all the challenges the 1990s bring for local cooperatives. And I'm confident that Iowa cooperatives will find ways to successfully meet the changing needs and expectations of their patrons. The needed leadership capabilities reside in the same board rooms where you will find the challenges.
FOUR TRENDS OF THE 1990s

1. Fierce competition among locally owned agribusiness firms.

2. Declining population and economic activity in rural communities.

3. Development of more consumer-oriented less commodity-oriented market channels.

4. Trends toward integrated and industrialized agricultural production.