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## A LIFE-CYCLE PERSPECTIVE ON GOVERNING COOPERATIVE ENTERPRISES IN AGRICULTURE

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If there is one organizational attribute that differentiates cooperatives from other organizations, it is the way they are governed. By construction, cooperatives put the economic interests of a particular class of patron in front all other stakeholders, and look to patron owners for risk capital and leadership on elected governing boards. More commonly, the interests of investors, working partners, or sole proprietors are primary, and patron interests are protected through competition in the marketplace. Membership on governing boards, if they exist, is heavily influenced, if not chosen directly, by management.

These differences create challenges and opportunities for effective governance in cooperatives. On the one hand, patron board members have good information, and strong economic motive, to perform the monitoring role normally ascribed to governing boards. Electing board members from among patrons can also help maintain strong patron relationships. On the other hand, patrons may lack the business expertise that is needed to advise management regarding strategy. Similarly, patrons who contribute capital might show greater purchase loyalty to their cooperative, but relying on retained earnings as the sole source of risk capital can limit firm growth. Effective cooperative leaders manage these trade-offs to a net advantage.

More fundamentally, however, are the unique consequences for governance that arise from the root cause of cooperative enterprise, and from the special life-cycle issues that emerge as a result. These consequences become more important as cooperatives mature and grow, particularly in market settings where they are one option among many for patronage.

### Why Cooperatives?

There are a handful of industrial sectors where cooperatives account for a significant fraction of economic activity. In each of these sectors, there is a unique story to tell about how markets failed to satisfy patron needs.

Arguably, the story for the agricultural sector is about market power (Taylor, 1953). Spatial and temporal features of farming severely limit opportunities to achieve region-wide scale economies. Despite significant consolidation in farming over time, relatively small, autonomous, and typically familial, production units still supply the vast majority of primary farm-level output. In contrast, relatively large agribusiness firms supply the majority of inputs that farmers use, and control the processing, marketing, and distribution of farm output to final consumers.

The market power that farmers face as individuals provides strong motivation for collective action. Acting together, farmers can improve market performance in the aggregate, and generate redistribution of economic surplus from input-supply and intermediation sectors to the farm sector. Many of the cooperatives that exist today in agricultural markets were created decades ago to achieve exactly these outcomes.

This history is important for governance because the pro-competitive effect of cooperative enterprise, while apparent to the initial generation of cooperators, is mostly invisible to the current generation. The short-run effect of successful cooperative formation is transformative, providing balance and opportunity in the marketplace to a formerly disadvantaged group. In the long run, however, competitors respond to generate new market dynamics. As time

passes, established cooperatives can be taken for granted and viewed as indistinguishable from their competitors in the eyes of patrons.

And yet, where would the market be without a cooperative presence? If there is any reason for using the unique governance and financial structure of a cooperative business, it is to move the market in favor of patrons. As a consequence, it is impossible to understand and communicate cooperative value without recognizing how cooperatives affect outcomes in the marketplace.

### **Communicating Cooperative Value to Members**

Assuming that cooperatives exist in the agricultural sector to level the economic playing field for farmers, let's think for a moment about how to value a cooperative business. In doing so, it will become clear why it is so difficult to communicate value to members.

For a publicly traded company, its stock price reflects the expected discounted value of future cash flows—dividends and capital gains—to stockholders. At any given moment, equilibrium stock price reflects investor beliefs about what these cash flows will be in the future, which implicitly provides a well-informed estimate of firm value to investor owners. There is no stock price for a cooperative business, but in principle it is still possible to estimate firm value for patron owners in terms of expected discounted future cash flows.

In practice, however, if we look just at the expected discounted value of cash flows provided to patrons directly through prices and earnings—or savings—distributions, we will miss most of the value provided by a cooperative, which instead accrues indirectly through a shift in market equilibrium.

Consider the following example. A group of farmers currently purchases all of their fertilizer from ABC Farm Supply, Inc. ABC faces limited competition in the area so it charges a high price. To be concrete, let's say there are 100 farmers, and ABC currently charges \$1/unit for its fertilizer. Now imagine that half the farmers in the area form a fertilizer-purchasing cooperative. They estimate that, by hiring a manager who will purchase for them on a wholesale basis—but with direct delivery to individual farms so there is no need for investment in plant and equipment—they will acquire fertilizer at \$0.90/unit, \$0.10 cheaper than they are currently paying. If they could recruit more farmer members into their group, they could perhaps earn even greater savings. Let's assume the cooperative forms with 50 members and that each farmer member can now acquire fertilizer at \$0.90/unit. Assume moreover that ABC matches this price to keep its remaining patrons.

Now imagine trying to value the cooperative business that these farmers have formed. What is the cooperative worth? 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. Moreover, because ABC matches the cooperative price, patron members do not experience a savings relative to the market price for fertilizer. For this cooperative, financial statements significantly under report value.

Clearly the cooperative has created value, but where, and how does management measure it? The cooperative established a new market equilibrium that serves all patron interests. To measure cooperative value fully, management must estimate cost savings relative to market equilibrium without the cooperative. Taking this value into account, the firm generates an earnings increase of \$0.10 for 50 members in perpetuity. Using a discount rate of 10%, this amounts to a present discounted value of \$50. But that's not all the value the cooperative creates. There are also the cost savings that nonmembers receive as a result of improved competition. This savings generates an additional \$50 in aggregate value for nonmembers, resulting in a total firm value of \$100. Will patron owners of this cooperative understand that their cooperative is worth \$50—and that it generates a further market-wide benefit of \$50? Perhaps they would if market competition was this simple, but of course it is not. In the messy day-to-day challenges of managing cooperatives and competing in real-world agricultural markets, it is easy to lose sight of the unique impacts that cooperatives generate for members and other market participants.

As a consequence, making sure that patron owners do understand the worth of their cooperative is central to effective cooperative governance. Unfortunately, there is no easy way to estimate and communicate this value. To the extent that competitors of a cooperative match the cooperative price, as in the example above, there will be no savings that can be demonstrated, relative to competitors. This is a common predicament for cooperative managers. To the extent that a cooperative generates value that does not show up on its financial statements, the onus is on management and the board to communicate this indirect value to members. Without doing so, a cooperative risks

becoming just another business to its patron owners, but straddled with the managerial handicaps associated with operating on a cooperative basis.

### **Implications for Board Governance**

The special value created by cooperatives points to a unique role for cooperative directors as ambassadors to patrons and the public at large. In addition to the standard roles of directors in noncooperative firms—monitoring and advising management—cooperative directors must also communicate unique impacts effectively.

Traditionally, the democratic governance process of cooperative enterprise is interpreted as a representational mechanism. Elected members whose responsibility is to protect local interests in firm-level strategic decisions represent regional interests on the board. However, this view clashes with the fiduciary responsibility each board member has to protect cooperative interests at the corporate level. It is easy to think of examples where preserving regional interests comes into direct conflict with corporate survival. From the perspective of managing a business, accommodating regional interests seemingly is a handicap that limits strategic flexibility.

However, there is a countervailing benefit: democratic governance with regional representation by patrons provides a unique capacity to seek maximal market share while offering a credible claim for protecting patron interests at the corporate level. If the patron population is represented on the board with full authority to direct corporate policy, members can be assured that any market power exercised by the cooperative is to their favor. Further, in instances where the market power exercised by a cooperative is not immediately apparent, patron board members can offer a credible insider view of industry competition. By explaining to members how their cooperative nudges the market in favor of patron economic interests, they can further establish patron loyalty.

Of course, there will always be limits to how far a given cooperative can push its market boundaries. Inevitably, expanding regional and sectoral coverage leads to more diversity among patron owners. To achieve maximal scale efficiency and market impact, cooperative leaders must recognize and justify differential treatment of patron owners based on their relative contributions to the firm. Attracting new members from a different region, for example, may require offering prices that are superior to those provided to existing members. When some existing members object that doing so is not fair, as inevitably they will, it is the responsibility of leadership to explain why fair can often mean unequal, and how current membership will benefit from adding new membership. Similarly, when closing a local supply or receiving facility increases aggregate scale efficiency, those who benefit directly might consider compensating former users of those assets for their loss. An effective board will not let local interests interfere with strategic initiatives that generate net gains—it will use local representatives to help identify mutually acceptable terms of trade among patron owners.

From this perspective, rather than view governance as a bottom-up representational process, perhaps it is useful to think of it as an effective organizational strategy to build and sustain patron loyalty. Under this view, cooperative leaders should take care to recruit board members who will be effective ambassadors, and then take the time to develop a corporate strategy collectively. If each board member contributes to that strategy, and feels ownership of it, collectively the board can be a powerful advocate for the cooperative among patrons.

Recruiting effective board members is a practical challenge for cooperative managers and directors. Elections for board seats often are not competitive (Reynolds, 2004). The panel of cooperative experts cited by others in this special theme identified recruiting new directors as the most important governance issue facing cooperatives. The additional data reported in Bond and Bhuyan in their article in this theme suggests that the problem is most acute among younger patrons.

Participating on a board requires significant time, and exposes members to financial and legal risk. Viewing board participation as an economic choice, there must be some compensation for these costs to attract new members. In public-stock companies, board members are normally salaried with benefits and performance-based pay. Further, there are substantial nonmonetary benefits that accrue from the opportunity to strengthen and expand productive social networks. Farmer cooperatives typically do not pay salaries to directors, and the potential networking benefits from participating arguably are more limited.

Individual farmers do have an economic interest in participating on the board as patron owners, but collectively they face a free-riding problem. One potential solution is greater pay. While seemingly an obvious solution, there are likely less obvious, but nevertheless good, reasons why most cooperatives do not choose to pay their directors significant salaries. Complementary with pay is investing significantly in recruitment, and providing public recognition for board

contributions. A formal director nomination and recruiting committee is one kind of investment. Some highly functioning boards also commit CEO and director time to farm visits of prospective board members. These visits can be used as opportunities to explain the unique impact of cooperative generally, and the special commitment required of individual members to on-going cooperative success.

### **Concluding Comments**

Cooperatives play an important, and arguably undervalued, role in agricultural markets. To the extent that market maturity masks their procompetitive effect, cooperative managers and directors lack quantitative evidence to document firm value to patrons and policy makers. Governing cooperatives in this context suggests a need to focus on recruiting and training directors who can credibly communicate unique cooperative value to patrons, and who understand the need to negotiate toward a value maximizing strategy. As researchers are able to better document and quantify the unique impact and importance of cooperatives, the organizations' leaders will have more tools at their disposal to explain value to their peers.

### **For More Information**

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