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THE CHANGING FOOD AND FIBER INDUSTRIES: IMPLICATIONS FOR COOPERATIVES

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THE CENTER FOR COOPERATIVES

WORKING PAPER SERIES

The Working Paper Series is designed to fulfill part of the less formal communications objectives of the Center for Cooperatives. The series presents papers dealing with cooperative issues or topics of interest to cooperative members, employees, elected officials, and others having an interest in cooperatives. Papers in this series express viewpoints and opinions about a fairly broad spectrum of cooperative topics, but are not intended to be finished-reports of formalized research by the authors. Some papers are informative only, while others are, in addition provocative. We intend for them to be educational.

Working Papers are published at irregular intervals, reflecting the financial position of the Center, as well as the interests of authors and availability of papers. They are intended to be brief in nature because they most frequently will not be exhaustive of their subject, but no editorial limit is imposed. Likewise, because the papers reflect opinions and viewpoints of the authors, there is only minor editing involved.

We hope the papers contribute to a better understanding of cooperatives, and lead readers to other more comprehensive publications on topics where further information is desired.

Because the mandate from the California Legislature, when it established the Center, intended that research and educational activities include both agricultural and mutual benefit cooperatives, the Working Paper Series may include papers of interest to both sectors. However, at times the emphasis may be stronger with only one of the two cooperative audiences. To help readers to identify the intended orientation, we follow a numbering system that distinguishes the intended audience by major orientation. Though papers are numbered consecutively during each year; those with primarily an agricultural orientation have the suffix A with the number, and those primarily oriented to mutual benefit cooperatives are suffixed by MB.

Leon Garoyan
Director

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by
C. O. McCorkle, Jr.

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THE CHANGING FOOD AND FIBER INDUSTRIES: IMPLICATIONS FOR COOPERATIVES*

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In a recent seminar organized for executives of California's leading agricultural businesses to examine strategies for competing in a changing environment, I was struck by the similarities and contrasts the implications of these changes hold for California's agricultural cooperative organizations. Whether cooperative or proprietary, however, in the turbulent and uncertain business environment of today there were opportunities for strengthening the competitive position of nearly every firm studied in that seminar.

My remarks are organized around four concurrent sets of changes that are influencing agriculture today and that will likely be at the forefront for the next several years:

1. Broad economic changes often referred to as macoeconomic changes, since they are national or international in scope and beyond the ability of any single firm or industry to influence significantly.
2. Changes in public perceptions and policies affecting agricultural industries and firms.
3. Changes in U. S. and foreign market structures.
4. Changes in technology and other inputs in production and marketing as firms strive to remain efficient, reducing their costs, and ensuring their competitive positions.

MACROECONOMIC CHANGES

Broad economic determinants of the business environment are not sufficiently understood nor adequately incorporated into the decisions of too many agricultural business executives. These forces transcend political boundaries and permeate all segments of our national economy. Three of these determinants — interest rates, inflation, and management of government debt — are of particular current importance.

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For the business firms — they establish the cost of borrowing money and the real cost of repayment and they influence the prices paid for inputs and prices received for products. They influence the purchasing power of businesses and individuals. They influence where investments are made and when, irrespective of whether we are talking about a domestic, foreign, or multinational company. For example, there are good reasons why foreign investment in the U. S. companies was only $80 billion in 1980 and is now over $300 billion and growing at an increasing rate: a strong relatively stable U. S. economy, an undervalued dollar, and a perception that American production assets are both undervalued and not used as efficiently as they could be. These three economic forces exert strong influences on currency exchange rates. They also affect national agricultural and trade policies both internally and externally for every major agricultural producing , exporting and importing country.

A fourth macroeconomic variable is real growth in productivity in the U. S. and in other countries. Productivity changes affect the relative rates of real growth in product demand, a critical force in determining growth in U.S. export markets as a result of increases in demand abroad. It is also a critical influence on input prices and production costs, thus helping to establish the relative strength of a nation in world trade. Real growth is related directly to such factors as public and private investment in research and development and human capital, rate of adoption of technology, and quality of the labor force. National policy of any nation, over time, can shape the productivity growth rate.

Every firm in American agricultural industries, whether proprietary or cooperative must assess the possible current and longer term impacts of these variables on their business performance and decisions for the future.

For example, it is critically important to every firm in the country how Congress and the Administration handle the current federal deficit issues. The Administration seems to be continuing with the position that economic growth is going to be of major assistance in lowering the deficit — a strong bet on rising real productivity. The Congress is stalemated on whether and how much to reduce expenditures on social programs or whether to press for tax increases. There seems to be little ground for compromise at the present time among these various perspectives.

In the meantime there is upward pressure on interest rates brought on by continued federal borrowing and demand for capital by the private sector for expansion. The Federal Reserve, recognizing the pivotal role of rising interest rates in triggering recessions, has tried to stabilize these rates. All responsible participants recognize the serious impact a recession would have on the ability to manage the federal deficit on the well-being of American business, and on the health of the international economy.

Agricultural businesses, and particularly farms, are in a particularly awkward position as interest rates rise and the economy softens. The cost of borrowing goes up, obviously. More important, costs of inputs tend to be maintained or fall very slowly since farms inputs are purchased in industrial type markets where price maintenance is considered important and output is adjusted to maintain those price levels. The prices farmers receive for most farm products, in contrast, are far more volatile as farmers continue to produce in the face of falling prices. California farmers, particularly those producing specialty crops are accustomed to this phenomenon, but it still results in wide income swings and occasional prolonged periods of relatively low returns on assets, periodic serious vulnerability to excessive debt load, and a high degree of uncertainty.

The individual firm manager must engage in longer term strategic planning, given the importance of these macroeconomic variables over which he or she has little influence. Consider their impact on such fundamental management questions as these:

1. What types and amounts of long term investment, if any, are acceptable? What are the potential gains as weighted against the financial exposure over the life of the investment?
2. What type of financial arrangement is most advantageous to undertake technological upgrading in an agricultural firm? Is there one that is adequate, yet minimizes exposure? Is it better to lease or purchase? Should one borrow or equity finance?
3. What is an appropriate level of flexibility to maintain in agricultural business and what are the ongoing costs of attaining that flexibility to provide greater freedom of action in the future? What level of reserves should be targeted and what is the opportunity cost of achieving and maintaining that reserve? In what form should it be held?
4. How are the competitors positioned for the future and what advantages might your firm gain as a result of changes in general economic conditions? Are they undercapitalized and thus more vulnerable and less able to move quickly to take advantage of new opportunities? Are they over-extended and likely to be targets for acquisition? If they are foreign competitors, are they willing to undersell for an extended period in order to weaken or break what they consider their competition?

When cooperative management wrestles with these hard strategic questions, the problems take on some additional complexity. A cooperative is "user owned", "user controlled" and "user benefitting", an expression I recently heard from one of California's cooperative managers that frames the problem. Each "user" is also responsible for another

business entity — his farm — with economic objectives that do not necessarily match those of the cooperative manager. Nor is there necessarily a match between the planning horizon of the "user" toward his farming operation and his cooperative.

The "user" expects short term results from his cooperative and if he doesn't get them he considers other market outlets. The cooperative manager is required to develop longer term strategies to compete successfully in an environment frequently dominated by proprietary firms that are investor oriented and typically looking for longer term growth possibilities.

Cooperative managers and governing board leaders must recognize the challenge this dichotomy presents and (1) learn to live with, (2) educate the membership to the special challenge it presents, and (3) grow in sophistication to be able to act like a proprietary firm in its business decisions, yet retain and take full advantage of the flexibility the cooperative structure provides, particularly in financial management.

CHANGES IN PUBLIC PERSPECTIVES AND POLICIES TOWARD AGRICULTURAL INDUSTRIES

Public perspectives on a number of issues are often ill-defined and initially diverse, but if they contain substance, they tend to gain momentum and emerge as new law or regulations. Once this occurs, those perspectives take on a lasting character that affect nearly everyone in some way.

The complex food safety issue is in the process presently. Society is in general agreement that a problem exists but there is no consensus as to what it is, how serious it is, or what should be done about it. Agricultural interests have a major stake in the outcome because their livelihoods are involved. Food processors are cautious because they are not sure of their exposure under current regulations. Most producers see no attractive alternative to conventional production technology, though there are signs of change. The early pioneers with "organic farming" were small and few. Many larger farmers are experimenting partly out of fear of consumer reaction, partly in response to possible opportunities to capitalize on consumer concerns in the market place. The 30,000 "organically" farmed acres in California in 1988 will more than double in this year. Retailers who must face consumers want to shift the responsibility for guaranteeing food safety elsewhere.

The laws on the books at present are in major part flawed and conflicting to the point where there is serious challenge to the integrity of our testing processes. And individual firms are not sure at any given time exactly what standards they are being held to. Delaney, de minimus, FIFRA, Proposition 65? Therefore, what constitutes compliance is not very clear.

How this issue will be resolved also is not clear. What is clear is that in the absence of better scientific information, the claims of concerned citizens are going to receive a great deal of attention. Unfortunately, the leading spokespersons have been calling for the continued use of Delaney standards which are unreal and unenforceable. Proponents have been afraid to compromise for fear of losing too much control. In the meantime, this issue stands in the way of rational progress toward solving this difficult problem.

As our society continues to evolve from a rural to an urban industrialized society, perspectives on agricultural programs change. The generation that is leading industry, government and the service trades today has lost most of its connection with its agricultural heritage. As a result, we see challenges and changes to our traditional policies. The dairy price support program, once sacrosanct politically, is undergoing great change, marketing orders and agreements, particularly the supply control provisions are being challenged vigorously, and the public subsidies for such a key input as water in California agriculture are increasingly criticized. For the agricultural firm, the question of how it communicates with, at best, an uninformed public and, at worst, a hostile public on such matters as food safety, resource use and pricing, subsidy programs, and the interaction of agriculture and the environment is not very well answered. Are cooperatives able to engage effectively in the public's education? Many of the most vocal critics on food safety and environmental issues are philosophically attuned to cooperative organization.

A few California cooperatives are in a particularly sensitive position with respect to marketing orders where supply control or distribution mechanisms are involved. When a single large cooperative dominated the market for a commodity, the marketing order allowed control over volume and flow of a commodity to the benefit of cooperative members and indirectly to the industry. As structure in these industries change, consumer or proprietary sector pressure against these devices seems to grow. As the absence of government support for marketing orders seems to expand, the future of supply control provisions appear to be in some jeopardy. It is only realistic to ask, "Can some of our major cooperatives compete effectively without the assistance of the supply control provisions of the marketing orders?" Stated alternatively, "What changes might they have to make to be competitive in the absence of supply control provisions?"

Can these organizations continue to operate effectively in markets with greater price variability within and between seasons? Can they further differentiate their products and possibly give up some segments of the market in order to concentrate on the most profitable part? Or should the commodity business be their major focus? Are there value added niches

that have promise for substantial expansion? Is there a place for the smaller firm or firms that can move quickly to optimize market position?

Another area of changing public policy is in foreign trade. Many agricultural markets — some argue most — are rapidly becoming internationalized. This is not new to California but the ground rules seem to be changing as the trade balances and relative economic strength of nations changes. What has been emerging at an increasing rate are import and export subsidies, tariff and non-tariff trade barriers, and food security policies and programs.

California specialty crops are seeing stronger competition than at any time in recent history. Foreign nations are subsidizing production and exports to the U. S. as a means of obtaining hard currency earnings. These and other nations are restricting entry of U. S. products to protect domestic producers or to limit currency export. Some nations are encouraging development of competing production elsewhere in the world as a part of an international aid/market development program. The U. S. engages in retaliatory actions in the short term with an avowed goal of freer trade in the longer run. A firm selling on a significant scale in foreign markets and restricted from sourcing and processing abroad may find itself at some disadvantage if the terms of trade continue to develop as they have been in recent years, the recent GATT agreements notwithstanding. Are there possibilities in joint venture or contractual arrangements for cooperatives to improve their ability to compete on more equal terms in both foreign and domestic markets?

CHANGES IN U. S. MARKET STRUCTURES

The primary focus continues on consolidation and concentration of market power in the processing and retail sectors. A recent paper by Leon Garoyan titled "The Market for Corporate Control" provides much food for thought on this topic. In agriculture the need grows to supply products year round and to guarantee quality if one is to remain competitive. There is also interest in developing countervailing power to resist further shouldering of excessive risks pushed onto agricultural firms by retail giants and to contain costs inflicted on them for slotting allowances, promotions and margin reductions. The aggressive processing cooperative, if nimble and financially strong enough to respond quickly should be able to cope as well as a proprietary firm of comparable size, provided management is in position to do so.

The implications of these consolidations (and spin-offs in some instances) are mind-boggling. We have seen some major firms in the food businesses such old line firms as Del Monte, Hunt-Wesson, Beatrice, Safeway, Nabisco, and Stop and Shop, to name but a few — all the victims, directly or indirectly, of one firm, Kolberg, Kravis, and Roberts.

These acquisitions were financed mostly by debt, rather than equity. For example, the acquisition price of $25 billion paid for RJF-Nabisco by KKR was financed by $24 billion of new debt.

The necessary emphasis on short term financial performance and the bottom-line which follows takeover, changes the philosophy, product lines, and relationships with those with which they do business. The heavy debt load and service costs often force reorganization to raise cash. Strategies to extract more cash from suppliers by various means and from consumers in the form of higher prices and/or less service begin to dominate. Agricultural firms supplying these giants or competing with them are strongly challenged.

The fundamental questions are, "Can cooperatives compete effectively in these changing market structures?" "Are they able to change fast enough to meet the changing demands imposed on them in new structures?" "Are they strong enough financially to withstand the pressures they are increasingly confronting?"

THE CONTINUING DRIVE TOWARD COST REDUCTION AND IMPROVED EFFICIENCY

This is certainly not a new issue nor is a lasting "optimum" position ever reached. The objective however, is simple — be the low cost producer in the industry. This goal has always meant capital investment in cost reducing technology. This has meant greater concern for profit maximization and has generally increased optimum firm size. In recent times it has also meant reduced consumer or account service. It has also meant stricter quality control to avoid any interruption in market relationship.

While all firms had to be conscious of the need for cost reduction and greater efficiency, for cooperatives the issue takes on some different dimensions. In a technological sense, cooperatives have kept pace if not led their industries. But, cooperatives have not been able to control raw product cost as successfully simply because they have not been able to exercise the same selectivity in membership that the proprietary firm has done with its suppliers.

Cooperatives in California have traditionally been dominant players in their respective industries. Can they continue to carry the major economic burden of market development and still remain competitive across the market as they have tried to do?

Given these two facets of the historical cooperative environment, can cooperatives continue to compete even if they aren't low cost producers? Or to achieve the competitive level of efficiency and low cost, will they be forced to eliminate the high cost raw product supply (poor quality, long

hauling distances, low volume pickups, etc.) which means eliminating some members. Are these hard choices compatible with the concept of the cooperative form of organization?

CONCLUSIONS

1. To survive in the future, cooperatives are going to have to act even more like the best of the proprietary firms in their management and marketing activities. They are going to be forced to make earlier payment for the raw product. They are going to have to be more selective in their sourcing and the markets they choose to serve.

2. Cooperatives will need to fully exploit their financial flexibility as a competitive strategy. They have the opportunity to take a longer term perspective than those of their proprietary competitors who are burdened with excessive debt. They have a broader financial base, given the options they have for raising working capital and financing debt.

3. Cooperatives will have to work harder to close the gap between the user's perspective on the role of the cooperative and what is in the longer term best interests of the cooperative as a competitive entity in a rapidly changing market place.

4. Boards of Directors of cooperatives have a very special role to play in developing understanding among the membership and support for the strategies, policies and decisions the boards and managers must make. Management by consensus of the membership is not a viable option today nor was it ever.

5. Management of the cooperative will be tested, as never before, in meeting the challenges outlined above with the added responsibility, as compared to its proprietary counterpart, of satisfying constituents with far more vested interest than the corporate stockholder has in his equity holding. The former is not only an owner, but a supplier. When he moves, not only is ownership affected, but the competition might be strengthened at the same time since the more business-oriented suppliers are likely to move first. When the latter moves, his equity position merely changes hands.

6. Most of all, management and directors must increase their understanding of the economic realities of the world in which they do business. If they find this too complex, they had better find ways of availing themselves of the necessary expertise. Outside members of boards and competent consultants are two possible approaches.

ABOUT THE CENTER FOR COOPERATIVES

The Center for Cooperatives was established by the California Legislature in 1987 as a center in support of research, education, and extension activities to "advance the body of knowledge concerning cooperatives in general and address the needs of California's agricultural and nonagricultural cooperatives."

The Center's objectives are to promote:

1. EDUCATION. The Center offers formal and informal educational programs to those involved in cooperative management and develops teaching materials for all levels of interest.

2. RESEARCH. To help the state's cooperatives reach their objectives, research is conducted on economic, social, and technical developments. A practical aspect of this research: the provision of competitive research grants, and studies for government agencies on how cooperatives can help achieve public policy objectives.

3. OUTREACH. The Center is prepared to inform the public on cooperatives and their significance to the economy of California.

While the University of California is responsible for its administration, the Center is intended to serve statewide. Its teaching and research resources are drawn from interested professionals from all UC campuses, the State University System, other colleges and universities, and sources indigenous to the cooperative business community.

The Center is prepared to receive gifts and contributions from the public, foundations, cooperatives and other like sources.

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