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Maintaining a Healthy Equity Structure: A Policy Change at Producers Cooperative Association

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Abstract

Within its sales territory, Producers Cooperative Association of Bryan, Texas is a dominant feed, fertilizer, and farm supply business. This case study enables students to understand the operating philosophies of this cooperative as it faces over twenty-one different major competitors. The case is designed to give students an understanding of the equity financing of a cooperative; a greater appreciation for creating member value within a cooperative; and an illustration of a successful board decision-making process. This case is intended for use in junior or senior level cooperative management or strategic management classes. Alternatively, the case can also be used in board of director and/or manager training. A separate teaching note explains the authors' desired case learning outcomes and also answers student questions.

Keywords: board of directors, cooperative, retains

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***“You participate in the profits as you participate in generating the profits”
– Bobby Kurten, Chairman of the Board***

Serving an area within a one hundred mile radius of Bryan, Texas, Producers Cooperative Association (Producers) provides feed, fertilizer, fuel, and supplies to agricultural producers. As of 2003 this single-facility cooperative's membership totaled 9,591. Such a large membership exists due to the vastness of the surrounding farming and ranching area in combination with a diverse economy capable of supporting both full and part-time agricultural producers. The large membership is also a result of this cooperative's philosophy regarding quality products, excellent service, and a dedication to making a profit.

A Change Considered - 1999

When measured on the basis of return on sales (i.e., profit ÷ sales), General Manager James Deatherage understood that Producers' feed and supply departments were more profitable than either its fertilizer or fuel departments. However, each cooperative patron's allocation of year-end stock was based upon their total purchase dollars regardless of the department patronized. Therefore, in 1999, Deatherage proposed that the Board consider paying out net margins at different rates depending upon each individual department's own profitability. Deatherage thought that if Producers' stock were allocated according to a patron's purchase mix (and hence patron contribution to profits), this would always insure that patrons received the most accurate patronage dividends. As a result several benefits would occur. First, individuals doing business with the most profitable departments would be less likely to take this business to a competitor. Second, individuals doing the vast majority of their business with the less profitable departments would not be receiving profits earned in the more profitable departments. Third, the change would accurately maintain Board focus on those businesses best suited to new investment and sales growth. The seed of an important idea was thereby planted. Namely, Producers needed to be careful not to subsidize its less profitable departments by taking away from its more profitable departments. Such cross-subsidization could ultimately make Producers' profitable departments vulnerable to losing customers.

The Board of Directors was interested in this change, but a motion for the change was not made. One reason was that Producers faced numerous competitors in its twenty county (17,000 square mile) service area. Furthermore, different competitive market structures are faced by each department. For example, feed sales competition comes from Purina, Cargill, and Lone Star. Two of these companies are nationwide, and all three support numerous local feed dealers. Fertilizer competition comes from Helena, Wilbur-Ellis, and American Plant Food. Producers faces online competition in animal health products from Jeffers, Valley Vet, Walco International, Ag Med Supply Company, and Lextron Animal Health. Tractor Supply Company is a broadline farm supply competitor with eight stores in the area. McCoy's sells farm and ranch supplies and has three locations in the area. Producers face five different petroleum suppliers capable of delivering to farm and ranch locations. In addition, since Producers operates a large retail fuel location, they face countless fuel retailers (although not all of these sell farm diesel). In terms of the home and garden product category, Producers faces three major competitors. These are Lowes, Home Depot and Walmart, all of whom have tremendous buying power. Within

Producers' service area, Lowes has three locations, Home Depot has five locations, and Walmart has nine locations.

The Cooperative Business Model

Barton states that a cooperative can be

...distinguished from other businesses by three concepts or principals: First, the user-owner principle. Persons who own and finance the cooperative are those that use it. Second the user-control principle. Control of the cooperative is by those who use the cooperative. Third, the user-benefit principle. Benefits of the cooperative are distributed to its users on the basis of their use. The user-benefits principle is often stated as business at cost. (p.1)

Barton goes on to state that user-benefits, "occur in the form of patronage refunds, more favorable prices, services that would otherwise be unavailable, and access to markets and assured sources of supplies" (p.2) He adds that, "the primary purpose [of a cooperative] is economic benefits for members." (p.8) A glossary of selected cooperative terminology is provided in Table 1.

Table 1. Glossary of selected terms pertaining to agricultural cooperatives

Term	Term Definition and Synonyms
Cooperative	A business owned by its customers (referred to as a <i>supply and/or service cooperative</i>) or owned by its suppliers (referred to as a <i>marketing cooperative</i>). Producers is a supply cooperative.
Dividends	The portion of year-end profit paid to cooperative members. In the case of Producers, dividends are paid 30% in <i>cash</i> and 70% in <i>stock</i> .
Equity	The net asset value of the cooperative, less the liabilities owed by the cooperative to non-members.
Patron	Someone who purchases from a cooperative and is an owner of the cooperative. Also called a cooperative <i>member</i> .
Patron Equity	The equity of a cooperative which is specifically identified with an individual member(s). Synonymous with stock.
Profit	Total revenue less all costs and expenses. Also called <i>net income</i> or, in a cooperative, <i>net savings</i> .
Redemption	The repayment of stock to patrons. Also called <i>revolving, retiring, or redeeming</i> stock.
Revolving Cycle	The number of years elapsing between when a cooperative issues stock and when that stock is redeemed. Producers is currently on a five-year revolving cycle.
Stock	Also called <i>capital stock</i> and sometimes <i>preferred stock</i> . Stock is allocated to individual patrons.

Peterson and Anderson emphasize this when they state, “a cooperative maximizes [member] value when it produces an optimal differential return to members over what they would receive in the absence of cooperative membership.” (p.372) When it comes to measuring member satisfaction, Deatherage knows that you cannot take a cooperative member’s loyalty for granted. What gives members a valued experience are the things that cause such loyalty: “Run it like a business. Rotating stock [i.e., paying profits as dividends to members] is one of the things that give our members a feeling of ownership value. A managed, consistent rotation of stock will, in itself, create loyalty.”

Producers History

Producers was founded in 1943 by seventeen members who purchased railcars of grain in order to bag the grain for use as livestock feed. Beginning in 1948 and spanning a period of 26 years, local rancher Woody Humphries served the cooperative. Mr. Humphries was initially a board member, holding the position of Secretary. In 1951 he was elected Chairman of the Board. In many ways his pragmatic focus set the modern direction of the cooperative: “Priorities are important. You must figure out the difference in what you want to do and what you should do. If you figure that out, you will be successful” (Clifton et al.). Over the years this mantra has manifested itself through Producers philosophy of serving members’ needs and doing so at a profit.

Potential members of Producers must be in production agriculture with the intent to earn a profit. They can only join subject to board approval and must pay \$10 for one share of preferred stock. As members purchase products from the cooperative, they simultaneously contribute to the cooperative’s capital. This occurs because a percentage of the profit generated by each member’s dollar purchases is retained in the form of capital stock. Capital stock is redeemed (i.e., paid back to each member) at the discretion of the board. Since the late 1980s, the Producers board has been able to maintain a five-year revolving cycle. Even though members must wait five years, they often refer to their stock as a dividend. Because this capital stock can only be awarded through patronage in the cooperative, a virtuous cycle exists whereby members’ on-going purchases fund the cooperative’s equity and secure its future growth and operation.

Recent benchmarks show that Producers leads their peers in promptly revolving patrons’ capital.¹ A survey was made of ninety-six Texas marketing and/or supply cooperatives working in such areas as cotton, grain, chemicals, fuel, feed, supplies, garden, and/or other (Baros). Seventy-one of these cooperatives replied to a question concerning the “age of their oldest patronage stock outstanding.” The average age of the oldest stock was 17.6 years compared to Producers’ average of only five years.

The physical assets of Producers feature a modern feedmill, a dry fertilizer manufacturing plant, a self-service fueling station, a 24,000 sq. ft. farm supply store, and a home and garden center. Deatherage explains the financing of Producers growth: “We have grown out of hip pocket. It is nice to be able to say that we are debt-free. However, we cannot let this keep us from being progressive. What is important is the quality of facilities. We take on a new project every single year. You have to keep growing.”

¹ The words member and patron are used interchangeably.

Producers Financial Performance

Table 2 provides recent benchmarking statistics for 2007. It presents both balance sheet and income statement information for Producers as compared to the average amongst a peer group of seventeen supply cooperatives (USDA). All of these cooperatives have annual sales between \$50 to \$100 million. In the balance sheet portion it can be seen that Producers has greater equity as a percentage of total assets, 83.89% versus the group average of 54.51%. Producers' equity

Table 2. Financial statement comparison of Producers Cooperative to the average of similarly-sized U.S. supply cooperatives, 2007^a

	Producers Cooperative 2007	Supply Co-op Average 2007
Balance sheet		
Current assets	66.99%	54.53 %
Other assets	0.08%	3.02%
Investments	2.86%	17.63%
Plant, Property and Equipment (net)	30.05%	24.82%
Total assets	100.00%	100.00%
Current liabilities	16.10%	36.64%
Total liabilities	16.10%	45.49%
Allocated equity	48.12%	30.55%
Retained earnings	35.77%	23.96%
Total equity	83.89%	54.51%
Total equity and liabilities	100.00%	100.00%
Income statement		
Total sales	100.00%	100.00%
Cost of goods sold	81.30%	86.45%
Gross margin	18.69%	13.55%
Service and other income	1.06%	3.45%
Gross revenue	19.76%	17.00%
Wages	6.05%	7.20%
Depreciation	1.56%	1.17%
Interest	0.00%	0.70%
Other	6.88%	4.56%
Total expenses	14.49%	13.64%
Income-own operations	5.27%	3.37%
Patronage income	0.67%	1.48%
Non-operating income	0.99%	0.13%
Net income before taxes	6.93%	4.98%
Taxes	0.78%	0.71%
Net income	6.14%	4.26%
Ratios^b		
Return on sales (net income / total sales)	6.14%	4.26%
Asset turnover (total sales / total assets)	2.55	2.49
Return on assets (net income / total assets)	15.65%	10.60%
Leverage (total assets / total equity)	1.19	1.83
Return on equity (net income / total equity)	18.66%	19.44%

^a Co-op average is for 17 U.S. farm supply cooperatives, all having between \$50 to \$100 million annual sales. Totals may not add due to rounding. **Source:** USDA-RBS.

^b Dollar totals used for the ratio calculations are as follows. Column one, Producers Cooperative: total sales = \$54,009,515, net income = \$3,320,863, total assets = \$21,208,203, and total equity = \$17,792,620. Column two, the aggregate of all 17 U.S. farm supply cooperatives: total sales = \$1,114,605,363, net income = \$47,524,239, total assets = \$448,289,903, and total equity = \$244,362,826.

consists of allocated equity (i.e., members' stock) in the amount of 48.12% of total assets versus the group average of only 30.55%. Producers' equity also consists of retained earnings in the robust amount of 35.77% of total assets versus the group average of 13.65%.

In the income statement portion of Table 2 it can be seen that Producers' gross margin is higher at 18.69% of sales versus the group average of 13.55%. Other factors contributing to Producers' performance include lower wages (6.05% of sales versus the group average of 7.20%), lower interest expense (0.00% of sales versus the group average of 0.70%), and higher non-operating income (0.99% of sales versus the group average of 0.13%). As a consequence, Producers' return on sales exceeds that of the group average. Ratios presented at the bottom of Table 2 show that Producers has higher return on sales (6.14% versus 4.26%), higher asset turnover (2.55 versus 2.49), higher return on assets (15.65% versus 10.60%), lower total assets to total equity (1.19 versus 1.83), and a slightly lower return on equity (18.66% versus 19.44%).

For accounting purposes, Producers is divided into four different departments: (1) feed, (2) fuel, (3) fertilizer, and (4) farm supply/home and garden. According to Deatherage, "all four of our departments are profitable. All four pay patronage back." Referring to individual products, Deatherage states, "there are some product lines we cannot be in. Our preference is not to match price just to sell something. Loss leaders are usually just that, a loss."

To paraphrase Deatherage's philosophy of financial management, one might describe him as saying: 'We want to run this cooperative like a business where we have made a good buy, run an efficient operation, and make a return. On the other hand, when it is difficult for us to match a price we prefer not to subsidize the sale of that product. We pay our profits back to the members at year end, yet I do not want our sales people to rely on this point. But I hope members recognize this point, on their own, and factor it into purchase decisions.'

To paraphrase Deatherage's product and service philosophy, one might describe him as saying, 'we want to provide the best products, programs and services with the most knowledgeable, service-oriented staff in our area. Patrons know we can be depended upon. Non-members do business with us for these same reasons.'

Deatherage realizes that debt is a tool to both grow and to multiply earnings. He does not rule out the idea of borrowing, but it would have to be a very special project. He knows his board and members like to say that their co-op is debt-free. Although Producers does grow aggressively, Deatherage cautions against growing just to be larger."

Table 3 shows Producers' steady sales growth over the period 1999 to 2003. Despite facing numerous competitors, Producers has remained a thriving business. The cooperative returned an average of 6.3% of all of the purchase expenditures made by its members. At the end of the year, 30% of these returns were paid to members in cash. The remaining 70% was issued as preferred stock with the Board's intentions being to redeem this stock (i.e., pay back in cash) five years from the date of issue. The cash-stock percentage split, common to many cooperatives, is intended to enable members to pay personal income taxes on cooperative earnings due in the current year. Such taxes are due because these profits have been allocated to the individual members. The relatively fast five year stock rotation cycle prevents owners' investment in the cooperative from being tied up for an extended time period.

Table 3. Total qualified patronage refund distributions, 1999-2003

Year	Total Qualified Distribution ^a	Total Member Purchases	Qualified Distribution Percentage
1999	\$1,796,455	\$24,747,659	7.25%
2000	\$1,853,624	\$27,435,778	6.75%
2001	\$1,610,180	\$28,004,075	5.74%
2002	\$1,450,521	\$28,174,811	5.14%
2003	\$2,012,159	\$30,443,372	6.60%
Average			6.30%

^aThe term total qualified distribution refers to the money paid back to cooperative members at year end in the form of cash and stock. Total qualified distribution *differs* from a cooperative's net savings (i.e., net income) due to factors such as: book-to-tax depreciation differences; losses on any stock the cooperative owns in federated cooperatives; cooperative earnings on non-member business; any retained earnings, and also the income taxes paid by the cooperative on such non-member business.

Board of Directors Meeting – 2003

After a successful 2003, the matter of allocation of year-end profits received board attention once more. The board had Deatherage research and prepare extensive exhibits about the topic. In the preparation of these exhibits, every effort was made to allocate General and Administrative (G&A) expenses to each department based upon direct use. However, some G&A proved to be un-allocable. Such categories included advertising, annual meeting expense, employee costs for the main office, postage, equipment, security, property taxes, telephone, credit card fees and a few more items, all of which are allocated equally against all sales dollars. Fixed costs, in so far as these can be measured by depreciation, are allocated to each respective department.

Table 4 is a Board exhibit that detailed individual departmental performance for the years 1999-2003. On a percentage of sales basis, earnings averaged 8.71% for Feed, 7.93% for Supplies, 3.33% for fertilizer and 1.55% for petroleum. Feed was the top department for the years 2000, 2002, and 2003 while Supply was the top department for the years 1999 and 2001. On the bottom end, Petroleum was the lowest performer in every single year. Because all members received dividends based on overall profitability, such numbers naturally led Deatherage to be concerned that petroleum customers might be subsidized by the customers of the other departments.

In order for the Board to understand this situation, Table 5 gives a 2003, department-by-department, profile for fourteen different patrons' purchases. Those shown purchased an average of \$11,682 in supplies, \$41,790 in fuel, \$17,915 in feed, and \$18,773 in fertilizer. In aggregate, these patrons' received a 2003 refund of \$5,960. This payment was the actual 6.61% dividend (based on average profit) for 2003. In contrast, by using the proposed new dividend rates by department, the aggregate payment received by these selected patrons would drop by \$2,356 to the new lower level of \$3,604. Deatherage had selected the fourteen patrons in Table 5, not as a random sample, but rather so as to profile which types of members would benefit, or lose, as a consequence of their particular departmental purchasing mix.

Table 4. Profits expressed as a percentage of departmental sales, Producers Cooperative

Year	Supply	Petroleum	Feed	Fertilizer	Sales Weighted Average
1999					
Profit	9.07%	1.87%	8.79%	5.49%	7.26%
Difference ^a	1.82%	-5.38%	1.54%	-1.76%	0.00%
2000					
Profit	7.91%	1.97%	9.41%	4.03%	6.76%
Difference ^a	1.16%	-4.78%	2.66%	-2.72%	0.00%
2001					
Profit	8.97%	1.81%	7.65%	2.78%	5.75%
Difference ^a	3.22%	-3.94%	1.89%	-2.97%	0.00%
2002					
Profit	5.46%	0.91%	7.87%	2.34%	5.15%
Difference ^a	0.31%	-4.24%	2.72%	-2.81%	0.00%
2003					
Profit	8.25%	1.21%	9.83%	1.99%	6.61%
Difference ^a	1.64%	-5.40%	3.22%	-4.62%	0.00%
5 Year Simple <u>Average</u>					
Profit	7.93%	1.55%	8.71%	3.33%	6.31%
Difference ^a	1.63%	-4.74%	2.41%	-2.98%	0.00%

^aDifference refers to the profit of an individual department minus the sales weighted average profit for the cooperative as a whole.

Once the board members looked at Table 5, a significant discussion ensued. Only five of the fourteen patrons shown in the Table would gain from the proposed policy change. The smallest gain was that of patron number twelve, in the amount of \$18. The largest gain was going to be that of patron number fourteen, in the amount of \$2,270. Patron fourteen's good fortune resulted from the fact that his/her purchases were mainly from the more profitable feed department. On the other hand, nine of those listed in the Table would receive less money due to the proposed change. The smallest of these would be the decrease in the dividend of patron number one, in the amount of -\$42. The largest of these would be the decrease in the dividend incurred by patron number eight in the amount of -\$21,537. This occurred because patron eight's purchases were all from the petroleum department.

Seeing these exhibits, a board member spoke up to say, "it simply does not seem right to make a change whereby many patrons would lose."

A second board member spoke up in response. "Wait a minute. Look at our average for all patrons shown on the bottom right corner of the Table 5. Our average patron does not win or lose from this change. If this is a more efficient way to price our products, then we need to consider making this change even though some patrons might lose."

Table 5. Impact of proposed profit allocation method based upon selected patron’s 2003 purchase history^a

Selected Patrons	Supply Purchases	Fuel Purchases	Feed Purchases	Fertilizer Purchases	Total 2003 Purchases	Profit Payment at 6.61%	Proposed New Payment^b	Gain (Loss)
	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>	<i>(\$/Yr.)</i>
#1	\$4,312	\$1,645	\$15,340	\$11,203	\$32,499	\$2,148	\$2,107	(\$42)
#2	\$658	\$0	\$11,457	\$0	\$12,115	\$801	\$1,181	\$380
#3	\$30	\$3,021	\$10	\$0	\$3,061	\$202	\$40	(\$162)
#4	\$19,964	\$90,593	\$5,757	\$0	\$116,314	\$7,688	\$3,309	(\$4,379)
#5	\$54,290	\$4,889	\$680	\$66,743	\$126,601	\$8,368	\$5,933	(\$2,435)
#6	\$575	\$16,866	\$7	\$0	\$17,447	\$1,153	\$252	(\$901)
#7	\$6,794	\$6,943	\$19,182	\$40,850	\$73,768	\$4,876	\$3,343	(\$1,533)
#8	\$0	\$398,828	\$0	\$0	\$398,828	\$26,363	\$4,826	(\$21,537)
#9	\$0	\$20,698	\$231	\$75,123	\$96,051	\$6,349	\$1,768	(\$4,581)
#10	\$21,742	\$19,999	\$29,186	\$23,980	\$94,907	\$6,273	\$5,382	(\$891)
#11	\$27,114	\$6,202	\$52,420	\$32,902	\$118,637	\$7,842	\$8,120	\$278
#12	\$9,734	\$4,992	\$16,736	\$8,899	\$40,361	\$2,668	\$2,686	\$18
#13	\$14,628	\$10,381	\$27,053	\$240	\$52,302	\$3,457	\$3,997	\$539
#14	\$3,710	\$0	\$72,747	\$2,888	\$79,344	\$5,245	\$7,515	\$2,270
Patrons #1 to #14 Average	\$11,682	41,790	\$17,915	18,773	\$90,160	\$5,960	\$3,604	(\$2,356)
Total Coop Patron Avg.	\$612	\$633	\$1,444	\$485	\$3,174	\$210	\$210	\$0

^aTotals may not add due to rounding.

^bCalculated based upon each patron’s department-by-department purchase volume according to the formula: Supply * 8.25% + Fuel * 1.21% + Feed * 9.83% + Fertilizer * 1.99%

A third board member said, “patron eight exemplifies what has hurt us in the past and what can also hurt us in the future. This patron is only a fuel customer. However, he/she receives the full benefit of profits earned in the supply and feed divisions. In effect, this patron is taking money earned by other patrons’ purchases. Of course, if we change this policy, we might lose this patron’s petroleum business all together.”

With that silence ensued. Board members turned their attention to the bottom line of Table 5. Sure enough, under this new policy the average cooperative patron did not gain or lose. With that the chairman spoke up, “it is best for the long term health of our co-op that you participate in the profits as you participate in generating the profits.”

Upon hearing that, the board member who had initially complained about making a change whereby many patrons would lose, spoke up. “Even though some may get a little less, we have to do what is best for the co-op as a whole. Therefore I will make a motion to the effect that this new policy is adopted to be effective for the year 2004.” A second was quickly offered and the motion passed unanimously, 9 - 0.

Questions for Students

1. What results did James Deatherage seek to achieve through having Producers Cooperative pay out annual profits differentially as determined by individual department sales? What do you think may have been some of the unintended consequences of this change?
2. What is the appropriate performance measure for a cooperative's success?
3. Why not simply reduce the cooperative's prices so that less of members' personal money would need to be tied up in cooperative stock for a period of five years?

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