



TEACHING NOTE

**United Agricultural Cooperative: considering the sale of the agronomy
division**

John W. Siebert^a, John L. Park^a®, and Roy B. Davis^b

*^aProfessor, and ^bChair, Department of Agricultural Economics, Texas A&M University, 600 John
Kimbrough, College Station, TX 77843-2124, USA.*

Teaching Note for United Agricultural Cooperative: Considering the Sale of the Agronomy Division

This case is designed primarily for use in a college course which covers the management of agricultural cooperatives, particularly agricultural supply cooperatives. The case can also be used in a college finance course or a more general management course. Another application for this case would be a training workshop for either cooperative board members or for cooperative executives.

In all the above applications, the case provides a platform to discuss which enterprises a cooperative should undertake, versus which enterprises might best be discontinued. The case also provides a means to consider how such a decision might be made and also who might best make the decision. This case shows the actual circumstances of one cooperative; that of United Ag. While other cooperatives certainly face different circumstances, the case can serve to illuminate the issues which need to be considered during the making of such decisions.

The Decision to Sell

Did United Ag sell the agronomy division? The answer is yes. The transaction agreed upon is summarized by Roppolo (p.13):

One of our primary concerns for management and directors was to take care of our existing [agronomy] employees and the employees of Winfield who had worked so closely with us the last few years. In our negotiations they would all be offered jobs with the new company with raises and better benefits than they had with United Ag.

Another part of the negotiations was that they [Pinnacle] would lease offices at El Campo with an option to buy these offices and the old gin buildings that we use as warehouses for chemicals and seed. They would also lease office space and warehouse space at Danevang, Edna and maybe Eagle Lake.

After running the numbers it was clear that agronomy department supporters would share \$3,700,000. To decide how to allocate this, we looked back at all the agronomy sales [i.e., purchases] done by a member over all the years of stock outstanding and what percentage their purchases were of all the agronomy sales. This was the percentage of each member's use of the agronomy department. That percentage was then multiplied by the \$3,700,000 of gain on sale of fixed assets to figure how much each producer would get back... the \$3,700,000 would be paid out to those members who supported their agronomy department at a rate of 100 percent cash.

Teaching Strategy Statement

This case enables students to see a successful cooperative continue to evolve. The case is aimed at junior or senior level undergraduates or master's degree level students.

A solid case teaching strategy begins by instructing students to read the case prior to its discussion in class. To ensure student preparation is thorough, consider requiring the submission of typed answers to the *questions for discussion*. These questions appear at the end of the case. In lieu of a written paper, an alternative is to simply administer a quiz at the start of class.

The following discussion concerns the key questions, or teaching points, appearing at the end of the case. This discussion is designed to help professors provide a great learning experience for their students.

Teaching Point #1. The main goal of an agricultural supply cooperative

Have your students suggest the main goal which they feel an agricultural supply cooperative must pursue. Royer suggests several possible main goals such as: (i) maximize net earnings in the same manner as an investor owned firm (IOF); (ii) minimize the net price paid by members; (iii) maximize the combined return of a members' own agricultural firms and the cooperative; (iv) maximize the quantity which the agricultural supply cooperative produces or sells.

Goals (ii) and (iii) above appear close to United Ag's goals. In the agronomy divestiture discussion, management is very concerned that United Ag has not been capable of offering sufficiently low agronomy product sales prices so as to maintain members' purchasing loyalties. All United Ag's IOF competitors own very large retail sales networks backed up by proprietary brand names and also manufacturing facilities. Several competitors also own fertilizer mining operations. In this environment, United Ag is not cost competitive. Goal (ii) seems particularly evident as a point of frustration when General Manger Roppolo states, 'we have seen many of our loyal agronomy customers go elsewhere, and when we inquire why, it is never service, but always price.' (Roppolo, p. 12)

Goal (iv), on-going sales expansion, does not appear to be an objective. Roppolo states, 'We have worked hard to be efficient in our recommendations and have the integrity to not sell a product is if it's not needed or if the growers will not get a return on their investment [in the product purchase].' (Roppolo, p. 12)

Goal (i), net earnings maximization, does not match the culture of United Ag. The cooperative operates several pool pricing arrangements for grains and does not emphasize merchandising grain on its own account. United Ag is a member of the Texas Agricultural Cooperative Council. Also CFO, April Graves, is a member of the National Society of Accountants for Cooperatives. Further, United Ag does not make use of outside capital, other than simple financing through CoBank.

Related to goal (i), if one examines tables 3 and 4, three key 2013 financial ratios can be computed for United Ag. These are,

$$\begin{aligned} \text{Return on Assets} &= (\text{Net Earnings} / \text{Total Assets}) \\ &= (\$6,811,308 / \$39,734,817) \times 100 = 17.14\% \\ \text{Leverage} &= \text{Total Assets} / \text{Total Equity} \\ &= \$39,734,817 / \$21,317,490 = 1.86 \\ \text{Return on Equity} &= (\text{Net Earnings} / \text{Total Equity}) \times 100 \\ &= (\$6,811,308 / \$21,317,490) \times 100 = 31.95\% \end{aligned}$$

Here we can see that United Ag's return on equity (ROE) is relatively high. However, members do not mention ROE as an objective to maximize. Instead they seem to seek transactions on favorable price / quality terms.

Teaching Point #2. An agricultural supply cooperative's selection of business activities

In the early 1900s, particularly following World War I, U.S. farmers faced trends of both depressed sales prices for their products while simultaneously needing to purchase more farming inputs from the increasingly industrialized agribusiness sector. These two factors were important causes for the founding and growth of early farm supply cooperatives. These supply

cooperatives sold and/or manufactured such products as fertilizers, chemicals, petroleum and other supplies. 'It became evident to farmers that they could effect a much more economical distribution of supplies through pooling their own buying power. It would probably not be too far wrong to say that almost every successful purchasing cooperative has been built as a monument to the inefficient distribution of supplies that had existed in that community.' (American Institute of Cooperation, p. 563)

This countervailing market power or competitive yardstick view of cooperatives was advocated by Edwin Nourse. 'Nourse posited that cooperatives serve ... a yardstick role by which members could measure the performance of other firms dominating the marketing channel. This check and balance function provided a checkpoint on other business and forced them to be more competitive. If markets became more competitive by virtue of the role of cooperatives, Nourse argued, in an economist's rhetorical fashion, that their role was fulfilled and they could cease to exist.' (Torgerson, Reynolds and Gray, p.2)

This is, indeed, what happened with the agronomy division. Dunn points out that, 'implicit in the user focus of a cooperative is the requirement to serve the expressed needs of current users as those needs evolve. This requires continuing reorientation of the cooperative to members' needs rather than perpetuation of the organization as an autonomous and static entity. It demands the cooperative be a tool in the dynamic and evolutionary process of meeting farmers' needs given the changing institutions and practices of the market place.'(p.85)

Table 4 shows all the firms selling fertilizer, agricultural chemicals and seed in United Ag's service area. This area consists of twenty Texas counties. In this area, United Ag holds a twenty percent market share. The remaining eighty percent of the market is served by Crop Production Services, Helena Chemical, J.R. Simplot, and Wilbur Ellis. As shown in table 4, these large competitors operate with vertical integration stemming from their local retail outlets and product brand names, back through to product manufacturing, distribution, and even mining. In other words, the proprietary business community is no longer a 'monument to the inefficient distribution of supplies.'

In regard to evaluating the financial performance of different divisions, tables 1, 2 and 5 provide needed information. For 2013, table 1 presents sales, cost of sales, and gross margins for each of the cooperative's different divisions: cotton, grain, agronomy, hardware, and fuel. Here it can be seen that the largest total gross margin is associated with cotton; a total of \$8,854,452. Table 2, the 2013 statement of operations, shows that the cotton division also received \$3,356,184 in gin fees and allowances. Summing the above two amounts, cotton generated \$12,210,636 in gross margins and fees. This is slightly over one-half of the cooperative's total gross margins and other operating revenues. By this same measure, grain is the second largest division, creating \$1,653,450 in gross margins (see table 1) and \$3,005,030 in fees (see table 2) for a 2013 total of \$4,658,480 in gross margins and fees. In visits with United Ag staff, these numbers explain why the cotton and grain divisions are often the focus of conversations.

Table 5 provides detail for agronomy. Gross margin was \$2,846,044, expenses were \$2,759,841, patronage from other cooperatives was \$659,203, net margin was \$1,115,754, and other income and expense was \$333,628. Hence net margin was \$1,115,754. Adjusted net margin for agronomy was \$745,983. Consequently, in 2013 the performance of agronomy was very good.

In contrast to this performance, table 5 also shows that in 2010 agronomy lost \$1,974,955 for that single year. During 2010 fertilizer price declines created a large loss in inventory value.

The loss was due to an abnormally wet planting season resulting in steep price discounts amongst competitors; effectively a fight for market share. Summarizing over ten years, table 5 shows that agronomy had an average adjusted net margin of negative \$8,478 per year. This loss occurred despite patronage received from other cooperatives in the amount of 143,024. Hence United Ag did include patronage allocations from other cooperative in their accounting and decision making.

This average loss, when coupled with the future risk of another year like 2010, frustrated United Ag's leadership. United Ag's presence in this business needed to be reevaluated and Dean Williams' telephone call was the catalyst to set this process in motion.

With its exit from agronomy, the following firms would still be competing with one another in the local agronomy market, seeking farmers' business: Crop Production Services, Helena Chemical, J.R. Simplot, Wilbur Ellis and Sanders. Therefore it is evident that ample competition presently exists in the market place so that members can conduct their agronomy business on favorable terms. Consequently, at this time, there is no need for United Ag to re-enter the agronomy market. Were this to change, United Ag is prohibited from re-entering the agronomy market until its five year non-compete agreement has expired.

Students can be directed to Porter's Five Forces Model in Figure 1 in order to picture the competitive situation faced by United Ag's agronomy division. United Ag and the competing firms shown in Table 4 (Agrium, Helena, JR Simplot, and Wilbur Ellis) all are in a battle as depicted in the center box, namely *Competition between Firms in the Same Industry*. All of these firms faced the same *Threat of New Firm Entry* represented by Sanders impending arrival in the local market place. Because United Ag is the smallest and least integrated amongst this group of firms, they have a very difficult challenge successfully dealing with the *Bargaining Power of Suppliers*. *Customer Bargaining Power* is a problem for United Ag as well because United Ag appears to be a high cost provider of fertilizer, chemicals and seed. This then negates United Ag's ability to be a countervailing force in the market place. In fact, it makes United Ag a force restraining competition! This is the major reason for United Ag's sale of the agronomy division.

Teaching Point #3. Evaluating a division within a cooperative

United Ag is now looking at other business operations which it might enter. Part of the motivation is so that the overhead charges carried by the division, equaling \$184,573 in 2013, can be spread across a larger volume of sales, hence lessening the impact of agronomy no longer being able to cover such charges. One new business venture being considered is the milling and/or bagging of feed or grains. Although United Ag is a very large first handler of grains, the cooperative currently does not have the capability to produce bagged products. An opportunity exists because United Ag does purchase packaged feed and grain products which it currently sells to patrons.

Board Member Views

One board member we interviewed stated, 'we thought having the co-op in the [agronomy] business was a good thing. But we were actually keeping the price up for these other guys [i.e., retail agronomy sellers]. When we got out the price dropped the next day. It was a price drop, and then a price drop, and then a price drop.' Why did such price declines occur? The competing agronomy operations, owned by Agrium, Helena, J.R. Simplot and Wilbur-Ellis, now

had to face a new competitor. Consequently, the members of United Ag were now paying lower prices for seed, fertilizer and chemicals.

Another board member stated that the programs now being offered by all agronomy retailers in the market are very beneficial. ‘At \$3.75¹ corn, we need every advantage to get through this [low price period]. All we have left from the government is crop insurance. We have to look for everything we can get to put a crop in the ground.’

The lower agronomy prices offered to farmers seem to indicate that the cooperative was *inadvertently* holding up market-wide prices for chemicals, fertilizer and seed. This was due to the fact that the cooperative’s suppliers were also its local competitors, i.e., the vertically integrated and horizontally integrated firms listed in table 4. Once the cooperative sold its business to Pinnacle, a firm with capabilities similar to the other major firms listed in table 4, competition drove prices down, thereby benefiting United Ag members as well as all other farmers in the United Ag’s territory.

Future Issues

For the time, being it is somewhat difficult for the Sanders’ local office to share the same location with the United Ag main office. Plans are being considered to build a new headquarters office for United Ag. Admittedly, some tension does exist as not everyone wanted the cooperative to exit the agronomy business. As one board member stated, ‘we had to support our cooperative by purchasing from agronomy. But it cost us money to be loyal.’ Some cooperative members miss purchasing their agronomy supplies directly from the cooperative. For example, United Ag was able to directly bill landowners for a designated percentage of purchases made by members who were their tenants. After the sale, one board member stated, ‘I was worried about the way separate billing was handled for my landlords. The co-op had it set up for all landlords. I have twenty different landlords. This is a challenge for farmers.’

Teaching Point #4. Who Should Make the Decision?

The board made the decision to assume sole responsibility for the divestiture decision. The potential of lost agronomy sales, due to the publicity associated with a general membership vote, certainly influenced this choice.

Another board member stated, ‘we have one thousand members and only two hundred active members [meaning large scale commercial versus largely pet food members]’. This board member felt it would be easy for members without a customer experience in agronomy to want to stay in this business.

Another board member stated, ‘I was using every [agronomy] service.... I thought the business sale should have gone through the membership for a vote and then been sold in the market place.’

In regard to a public bid, or at least putting the matter to a vote of the membership, General Manger Roppolo commented, ‘if we would have put this sale out for public bid, our customers would have been picked off one-by-one. Then if we didn’t sell the business, we would have had no use for the assets.’

Teaching Point #5. Should United Ag Sell the Agronomy Division?

¹ This refers to the current market price of corn as measured in dollars per bushel.

Posing this question to students allows them to study the case so as to present their own recommendation along with the facts to back up their argument. For example, professors can use this question as a quiz taking place before case discussion occurs. When used this way, students are properly incentivized to study and professors are assured that students come to class prepared. Or, during class, this question can be used as a means to facilitate discussion and to create an interesting white board outline of the key facts and issues in the case.

Epilogue

Months after the new crop planting was completed in the winter of 2016, General Manager Roppolo was able to reflect that the sale of the agronomy division had, indeed, been a wise decision. Crop prices had now been declining for three years, thereby reducing farmers' earnings and ability to pay for their agronomy supplies. A local agricultural finance professional indicated that local agronomy accounts were past due at rates over 50% of sales.

The sale of agronomy allowed United Ag to focus on its better performing divisions – cotton, grain merchandising, and general store - thus ensuring that United Ag could provide the best possible prices and services to its membership.

Figure 1. Porter's Five Forces Model.

