

Pondering When to Hold Them and When to Fold Them

AE16021Dec 2016

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Farmers United Cooperative

Farmers United Cooperative is a diversified cooperative with activities in grain marketing, cotton ginning and farm supply. The cooperative has 5 locations and in 2013 they handled 8.6 M bushels of grain, and ginned 150,776 bales of cotton. As is typical of the cotton supply chain, the producers retained ownership of the cotton bales which were transferred to a cooperative cotton warehouse. Farmers United purchased and merchandised the cotton seed totaling around 50,000 tons. The cooperative also had agronomy department sales of \$23.3M and sold \$12.2M of fuel. Farmers United was moderately profitable with a return on assets of 9.2% and a return on equity of 17%.

The ginning department has always been a mainstay of Farmers United accounting for over 45% of total sales and 43% of total gross margins in 2013. The cooperative competes with 6 other gins, all cooperative. The nearest gin is located 20 miles north and the others are 60 to 120 miles away to South and Southwest. Despite the competition the cooperative's ginning volume has been steadily increasing. Farmers United has 5.6M bushels of grain storage and the grain department provided 28% of gross margins in 2013. The cooperative competes with 2 other cooperative grain elevators and one independent, which are somewhat located fairly uniformly around the cooperative averaging 30-40 miles away. Cargill's export terminal located approximately 80 miles away is also an indirect competitor. The cooperative's grain market share has been somewhat erratic due to local weather patterns but appears to be stable.

Agronomy Competitors

Farmers United has always been involved in agronomy but aside from the fuel department which provided 6% of gross margin, the agronomy department provided the lowest share of the total gross margin at 23%. In contrast to the other departments, the agronomy department faces stiff competition from large multi-national firms including Agrium, Helena, J.R. Simplot and Willbur-Ellis. Agrium is the largest retail agronomy dealer in the U.S. operating 1,450 locations 44 states and internationally. Helena has 348 locations in 39 states while Simplot has 85 locations in 18 states. Even the smallest of the investor-owned competitors, Wilbur-Ellis has 175 locations over an 18 state area. In comparison, Farmers United operates 5 locations and a 20 county trade territory. The cooperative sources seed and chemicals, through Winfield and purchases and warehouses fertilizer from a number of sources along the Texas Gulf.

Due to the competitive environment the agronomy's department profits have been modest. The agronomy operations also involve substantial fixed assets and large investments in inventory. In

2010 fertilizer prices fell dramatically between the time that the cooperative purchased and re-sold the nutrients leading to large losses for both the department and the entire cooperative. The agronomy department also involves large investments and risk in accounts receivable. Sales volumes (when measured in dollars) have been increasing over time for all of the agronomy product categories (Table 1). However the department has shown an operating loss in 2 of the last five years. A departmental profit analysis (Table 2) revealed that the agronomy department had a return on assets of only 1.5% in 2013 which was much lower than the ginning departments performance of 18.8% or the overall cooperative's performance of 9.2%. The agronomy department has therefore been subsidized by the other operating divisions. The board was convinced that their agronomy division was operating as efficiently as possible. The financial performance was due to the competitive environment and the members' willingness to defect to a competitor for the slightest price advantage.

Table 1: Agronomy Department Sales and Margins

	2008	2009	2010*	2011	2012	2013
Seed sales	\$2,341,717	\$2,589,594	\$3,015,852	\$3,005,660	\$3,702,926	\$4,052,151
Chemical sales	\$4,508,049	\$2,932,477	\$3,576,759	\$4,036,703	\$3,754,324	\$5,929,434
Liquid Fert.	\$7,045,386	\$5,441,858	\$5,366,066	\$8,155,556	\$9,315,242	\$11,954,906
Dry Fert	\$431,959	\$980,460	\$664,929	\$530,996	\$864,060	\$949,124
Other	\$53,918	\$163,185	\$149,327	\$50,223	\$420,484	\$1,452,180
Total	\$14,381,029	\$12,107,574	\$12,772,933	\$15,779,138	\$18,057,036	\$24,337,795
						\$
COGS	\$10,721,997	\$11,690,141	\$13,750,861	\$13,568,390	\$14,541,023	\$20,541,023
Gross Margin	\$3,659,032	\$417,433	(\$977,928)	\$2,210,748	\$3,516,013	\$3,796,772
						\$
Expenses	\$3,662,001	\$1,891,733	\$1,662,250	\$1,736,521	\$2,872,653	\$3,656,170
Other income	\$219,752	\$975,152	\$175,152	\$75,152	\$175,152	\$975,152
Net Margin	\$216,783	(\$499,148)	(\$2,465,026)	\$549,379	\$818,512	\$1,115,754

* in 2010 fertilizer prices dropped by more than 40% between the time of inventory purchase and sale

	Ginning	Grain	Agronomy	Fuel	Total
Sales	39,251,819	15,919,593	23,387,069	12,257,270	90,815,751
Gross Margin	4,604,722	3,005,030	2,846,046	668,978	11,124,776
Allocated Expense	3,046,808	2,843,688	3,656,170	609,362	10,156,027
	2,409,207	955,883	211,428	229,875	3,806,393
Allocated Assets	11,920,445	11,125,749	14,304,534	2,384,089	39,734,817
Profit Margin	6.1%	6.0%	0.9%	1.9%	4.2%
Asset Turnover	3.3	1.4	1.6	5.1	2.3
ROA	20.2%	8.6%	1.5%	9.6%	9.6%

The Offer

In the fall of 2013 representatives from Pinnacle Agricultural Holdings LLC met Farmers United's CEO and board of directors and made an offer to purchase the cooperative's entire agronomy division. Pinnacle operated 160 locations in 26 states and was pursuing an aggressive expansion strategy. During the last year Pinnacle has purchased 28 local locations. Pinnacle had clearly been expanded toward Farmers United trade territory and would soon become a competitor. The deal would require the cooperative to sign a five year non-compete agreement. Pinnacle would purchase all of the physical assets (none of which were co-located with the ginning and grain infrastructure) at \$3.5M over book value.

The next night, after the meeting with the Pinnacle representative the board held a special meeting. Their initial reaction was that they would never consider selling a key portion of the cooperative. However, as the meeting wore on they did have to admit that there were arguments for the sale. The move would allow the cooperative to eliminate all of its long term debt and redeploy capital into its ginning and grain infrastructure. Even accounting for the overhead costs which would have to be absorbed by other departments, the cooperative's profitability and the member's patronage would increase. The cooperative would be divesting of an unprofitable department and exiting a competitive environment dominated by much larger firms. If the board did not accept the deal they would clearly soon be facing yet another competitor.

The discussion quickly focused on what was in the member's best interest. The cooperative's profits and patronage would likely decrease. The deal would bring another competitor into the trade territory which, in the short run, could improve prices to Farmers United members. The disadvantages of the deal were more strategic. By divesting of its agronomy department the cooperative would be giving up on one dimension of relevance to its members. Perhaps the agronomy department had an unrecognized benefit in maintaining ginning and grain volume. It has also long been recognized that cooperatives provide an "invisible benefit" in keeping the market place honest. Despite the current completion in agronomy, the investor-owned firms could consolidate or exit the regional market. Without the cooperative in the mix, Farmers United members were dependent on competition between the independents to keep margins reasonable.

Questions:

1. Farmers United members are clearly not willing to pay the level of prices necessary for the agronomy department to achieve an acceptable return on assets. Given that fact, how should the board evaluate the department? Is it fair to members when one department is in effect being subsidized by other areas?
2. Can the strategic benefits of maintaining more points of contact with the members justify maintaining an underperforming function? In the long run is it more important for a cooperative to be a one stop solution for all of the member's need or the least cost supplier of a limited number of services?
3. If the cooperatives legal documents give the board the authority to make this decision, should the board make the decision or take it to a vote of the membership? What are the advantages and disadvantages of either course of action?

Farmers United Income and Expense Statement 2013

	Sales	COGS	Gross Margin
Ginning	\$ 3,356,184		\$ 3,356,184
Cottonseed	\$ 12,365,011	\$11,286,224	\$ 1,078,787
Other	\$ 198,398	\$ 28,647	\$ 169,751
Total Cotton	\$ 15,919,593	\$11,314,871	\$ 4,604,722
Milo	\$ 19,610,067	\$18,773,078	\$ 836,989
Wheat	\$ 532,238	\$ 504,840	\$ 27,398
Corn	\$ 17,029,891	\$16,302,513	\$ 727,378
Soybeans	\$ 2,079,623	\$ 2,057,968	\$ 21,655
Storage Income			\$ 1,391,610
Total Grain	\$ 39,251,819	\$37,638,399	\$ 3,005,030
Seed	\$ 4,052,151	\$ 3,654,111	\$ 398,040
Chemicals	\$ 5,929,434	\$ 4,772,434	\$ 1,157,000
Fertilizer	\$ 13,303,615	\$12,114,478	\$ 1,189,137
Application	\$ 101,869		\$ 101,869
Total Agronomy	\$ 23,387,069	\$20,541,023	\$ 2,846,046
Fuel	\$ 12,257,270	\$11,588,292	\$ 668,978
Total	\$ 90,815,751	\$81,082,585	\$ 11,124,776
Operating Expenses			\$ 10,156,027
Other Income			\$ 182,115
Local Savings			\$ 1,150,864
Regional Patronage			\$ 2,655,529
Profit before Patronage			\$ 3,806,393

Balance Sheet December 31, 2013			
Assets		Liabilities and Owners Equity	
Accounts Receivable	\$ 6,881,293	Notes payable	\$ 5,719,735
Inventory	\$ 11,232,462	Accounts payable	\$ 5,107,457
Other	\$ 1,797,478	Cash Patronage Payable	\$ 2,625,615
Total Current Assets	\$ 19,911,233	Equity Retirement Payable	\$ 899,595
		Other	\$ 1,260,405
		Total Current Liabilities	\$ 15,612,807
Long Term Assets		Long Term Liabilities	\$ 2,814,520
PPE	\$ 11,663,838	Total Liabilities	\$ 18,427,327
Land	\$ 2,769,771	Qualified Equity	\$ 13,081,630
Investment	\$ 5,289,975	Unallocated Retained Earnin	\$ 6,348,250
other	\$ 100,000	Other	\$ 1,887,610
Total long term assests	\$ 19,823,584	Total Equity	\$ 21,317,490
Total Assets	\$ 39,734,817	Total Liabilties and Equity	\$ 39,744,817