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Value-Added Business Ventures Through Producer Alliances

New Ventures IN FOOD AND AGRICULTURE FOR INDIANA

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More and more farmers are investing in value-added business activities with other farmers through producer alliances. Often these producer alliances are structured as new generation cooperatives (NGC), but they can also take the form of a limited liability company (LLC), a partnership, a corporation, or a buying or marketing group.

In some cases, the driving force behind the formation of a producer alliance is farmers' desire to move along the value chain and capture profits from other stages. In other situations, farmers find themselves without a marketing or processing plant when agribusiness firms consolidate and close local facilities. Iowa turkey farmers are one example. When Oscar Mayer was closing a processing plant and feed mill, the producers formed Iowa Turkey Growers Cooperative and purchased the facility. Producer alliances have the common characteristics of producers working together towards common business goals and desiring to capture additional value from the commodities they produce.

This publication identifies the factors that producers should evaluate when considering investment in producer alliances. The success of a value-added business depends upon the answers to three important questions:

1. Is the alliance a good business investment?
2. Will the organizational structure work?
3. Are there other goals for the alliance, and do they compete with or complement the goal of business profitability?

Is the Alliance a Good Business Investment?

There are two important questions to consider when evaluating whether an opportunity represents a good business investment. First, what are the returns and risks associated with the business venture? Second, is this a good business opportunity from the perspective of long-term strategic positioning?

Returns and Risks

Because any business venture is risky and has the potential to make either positive or negative profits, potential investors must do their homework before investing. This homework should include a complete market analysis and a feasibility study to evaluate the project's potential. If the project appears to have potential, then the interested investor should develop a complete business plan before making a significant investment. While each specific project is different and should be thoroughly evaluated, research recently conducted at Purdue suggests some general conclusions.

Purdue researchers considered three subsectors of agriculture—pork, corn, and beef—in the evaluation of the returns and risks associated with producer investment in value-added business activities. In each case, they identified alternative strategic business decisions for producers. In particular, they made comparisons between producers having: all of their equity investment in the farm, distributing their equity investment between the farm and the producer alliance, and distributing their equity investment among the farm, the producer alliance, and stocks and bonds.

This research suggests four important conclusions:

- Producers will benefit from diversifying,
- Producers will benefit from a balanced portfolio,
- Producers will benefit from leveraging into more profitable areas, and
- Producers' behavior will be influenced by government subsidies and programs.

Diversifying

The Purdue research shows that diversification beyond the farm or ranch into diversified business activities or stocks and bonds may result in both an increase in expected return and a decrease in the variability of returns (or a decrease in risk) when compared to a 100% investment in the farm or ranch. Just as nonfarm businesses place a high priority on having a diversified portfolio, farmers and ranchers should diversify, too.

A Balanced Portfolio

With respect to a balanced portfolio, diversification into a value-added business related to a farmer's commodity can be a particularly good investment in those times when farm income is high if processor income is low and vice versa. For example, when a product is characterized by volatile commodity prices and relatively stable wholesale/retail prices, there tends to be a high degree of negative correlation between farm income and processor income. This situation exists in the pork industry, and the Purdue research reveals that there is the potential for hog producers to diversify beyond the farm into processing and increase expected return and decrease risk.

It is important for farmers to understand that if final consumer demand is the source of price and income variability, vertical integration may increase rather than decrease risk. In addition, achieving the potential rewards when there is a high degree of negative correlation depends upon finding an appropriate business organizational structure for successful implementation. Particularly in the case of the processing of livestock, scale economies may make it impractical for a producer alliance to directly own the entire processing plant because the alliance may not be able to support a large enough operation to achieve economic efficiency.

Leveraging into More Profitable Areas

Some subsectors of agriculture do not yield as high a rate of return as outside investments. In these instances, it is often argued that individuals place value on the lifestyle of farming or ranching and thus are willing to accept the lower rate of return on their equity. Historical data on the profitability of cow-calf operations provide a picture of a sector of agriculture that often earns a lower rate of return than other investments. In these situations, with low rates of return, the diversification scenarios are attractive because the other investments yield higher returns.

Producers' Behavior Influenced by Government Subsidies and Programs

This conclusion is highlighted in the results of the Purdue study of corn producers investing in ethanol production. In particular, the business scenarios involving investment in an ethanol project were only worth considering when subsidies for ethanol production were in place. Thus, producers must evaluate all relevant government programs as part of the evaluation of a new business venture.

Long-Term Strategic Positioning

A strategic business analysis that carefully and systematically identifies all assumptions and evaluates the potential actions and reactions of competitors is an important step in the evaluation of investment alternatives. A typical framework for this analysis is to examine the five competitive forces set out by Michael Porter:

- Barriers to entry,
- Rivalry among competitors,
- Substitute products,
- Power of buyers, and
- Power of suppliers.

Barriers to Entry

Barriers to entry, the first of Porter's forces, relates to the ease with which other firms can enter the industry. When it is relatively easy for other firms to enter the industry, producer alliances must be careful. Profits that they may enjoy initially could be short lived if other firms enter and bid down the price.

Rivalry Among Competitors

The second force, rivalry among competitors, refers to the competitive pressures that exist in the marketplace. The wet corn milling industry provides an interesting example of this force. In wet corn milling, industry concentration is very high, with the top three firms having almost 80% market share in the corn sweetener market and the top three firms having over 86% market share in the lysine industry. These firms control a large percentage of the market and along with that have a significant amount of market power. From the perspective of competitive rivalry, the wet corn milling industry is not a good prospect for any firm to enter and certainly not one for a producer alliance or new generation cooperative to try and enter.

The advantage of hindsight from a real-world example confirms this. An interesting meeting took place in 1994 during which Dwayne Andres, then CEO of ADM, urged Joe Famalette, then CEO of American Crystal Sugar, not to build the ProGold high fructose sugar plant. American Crystal Sugar did proceed with the ProGold plant, but it experienced financial difficulties and is now owned and operated by Cargill. A second farmer-owned cooperative, Minnesota Corn Processors, is now owned and operated by ADM.

Substitute Products

Substitute products, the third force, refers to whether there are firms that produce different products but ones that could substitute for the product the producer alliance is producing. These firms are potentially competitors, and it is important that the producer alliance evaluate the chance that they could become a threat to the profitability of the operation.

Power of Buyers and Power of Suppliers

The final two forces are power of buyers and power of suppliers. A producer alliance's position in the marketplace and profitability will depend upon how much market power it has compared to its buyers and its suppliers. If the producer alliance is one of many firms selling to a single buyer or small number of buyers, the balance of market power is in favor of the buyer. In other words, the buyer will have more control in price and other negotiations than the producer alliance has.

Will the Organizational Structure Work?

As discussed earlier, producer alliances can be structured under a variety of different business forms, including: new generation cooperative, limited liability company, partnership, corporation, buying or marketing group, joint venture, strategic alliance, and unique ownership arrangement with a regional cooperatives. There are advantages and disadvantages associated with each of these different business structures, and those advantages and disadvantages depend upon specific business conditions. So investors in a producer alliance must get legal and accounting advice and then evaluate their specific business to determine the most appropriate organizational structure.

There is a second set of issues associated with establishing an organizational structure that will work. Will the members cooperate with each other and work towards a common goal, or will they become competitive, which will result in the alliance falling apart?

First, the larger the benefits from working together in the alliance, the more likely producer alliances are to be successful. With significant benefits, members are more likely to overcome the challenges associated with working together in an alliance. Also, producer alliances are more likely to be successful when the membership is relatively homogenous and financially stable. It is easier to organize an alliance around common goals if the individuals involved are in similar situations. In addition, an alliance made up of producers who are financially stable is more likely to be successful because the ability to withstand difficult financial times will be greater.

The stability—and therefore success—of a producer alliance also depends upon having a mechanism for penalizing any members who defect, because it is inevitable that members will attempt to defect or renege on their agreements with the alliance from time to time. Penalty mechanisms can be written into contracts and have financial consequences, or they can be social in nature. Finally, producer alliances involve significant interaction among the members, and they are more likely to be stable and successful when the members trust each other, are committed to the alliance, and communicate with each other.

Are There Other Goals for the Alliance?

It is important to identify and evaluate all of the goals that members, or potential members, of a value-added business or producer alliance have for the business. Examples of goals that members may have include:

- Generating new markets for the commodities they produce,
- Increasing member income,
- Generating new jobs in the rural area, and
- Enhancing rural development in the area.

Certainly, some value-added producer alliances will generate additional economic activity in the rural area, generate new jobs, enhance the local tax base, and strengthen local demand for retail goods and services. However, investors and lenders judge the success of the producer alliance on the profitability of the business. If a producer alliance becomes too focused on some of the secondary objectives, it may not be able to achieve a level of profitability that is needed to sustain the business.

Thus, potential investors in a producer alliance must first explicitly identify all of the goals for the value-added business. Then they should determine whether these goals are complementary or competing. Finally, they can proceed with the project, focusing on the goals that are most important to achieve.

Conclusion

Value-added business activities through producer alliances have the potential to increase incomes for producers. However, new business ventures are risky and can result in investors losing money. Farmers who are interested in producer alliances must do their homework before making a significant investment. Important components involved in evaluating the potential of a producer alliance are:

- Determining market potential,
- Preparing a pre-feasibility study,
- Conducting a strategic business analysis using Porter's 5 forces model,
- Developing a business plan,
- Comparing the various alternatives for the business,
- Determining whether the members of the producer alliance can work together, and
- Determining whether there are other objectives associated with the project and whether the business can be profitable.

Investors should only proceed forward with the producer alliance if they are comfortable with both the risks and potential returns associated with the new business venture.

Reference

Porter, Michael. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. The Free Press, A Division of MacMillan Publishing Co., Inc., New York, 1980.

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