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A Local Cooperative's Financial and Strategic Analysis of the Evaluation of Potential Merger Partners

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Abstract

This is a two-part teaching case developed through in-person interviews which were conducted with the managers of locally owned farm supply/grain marketing cooperatives in Indiana and Colorado in the spring of 2000. The case has been written so that each part can be used individually or together and can also be used in either the undergraduate classroom or in extension programming with cooperative managers and directors. Part I focuses on how to use financial analysis in business reorganization decisions and Part II focuses on how to analyze alternative business reorganization possibilities from a strategic management perspective.

Key Words: cooperatives, mergers, evaluation of alternative business strategies

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Part I: The Financial Case Analysis

Sam Potts and Leo Wingate are the general manager and chief financial officer, respectively, of Alton Valley Co-op and are responsible for preparing a recommendation for the Board of Directors. The issue at hand involves deciding with which of two neighboring cooperatives Alton Valley should merge: Sedgewick Farmers Cooperative or NorthStar Ag. Both merger possibilities have strong and weak points. Either choice would mean a great deal of change for all involved, but a merger seems inevitable, as the agribusiness world is becoming a tougher place in which both farmers and cooperatives operate.

It was during a recent strategic planning retreat that Alton Valley's Board of Directors had come to the decision to pursue identifying a merger partner. The Board of Directors had gone into that retreat with the objective of first gaining a better understanding of how current industry changes were affecting local cooperatives, and second, identifying plans for the future that would ensure a viable cooperative presence for their farmer members. Alton Valley finds itself challenged by its limited market territory.

The position of the neighboring agricultural cooperatives was another important aspect of Alton Valley's limited market territory. The neighboring agricultural cooperatives both have a strong presence in the areas surrounding Alton Valley's traditional market area, limiting market territory expansion opportunities. The members of the Board of Directors had come to the conclusion that they needed to seek a merger with another cooperative.

When Alton Valley had made its interest in a merger known, two neighboring cooperatives quickly expressed interest. Mr. Wingate was responsible for preparing financial assessments for each potential partner. He had started with the annual reports including balance sheet and income statement information for Sedgewick Farmers Cooperative and NorthStar Ag. See Financial Data.

Alton Valley Cooperative

Alton Valley has been paying patronage and revolving equity on a regular basis, but as the Board of Directors had recognized at the recent retreat, it is a small cooperative, surrounded by urbanization and facing competition from neighboring agricultural supply companies, both cooperatives and investor-oriented firms. In spite of this, Alton Valley has a very loyal customer base, due to the fact that it has always cultivated a customer service philosophy, particularly for the agronomy division. The energy division had been able to capture some new business as a result of the urban development in Alton Valley's market territory. In particular it had acquired a significant share of fuel business for construction firms as well as LP (liquid propane) to the residential customers. However, the cooperative realized that the changing marketplace had left its grain business in a position that was no longer viable. The urbanization had resulted in a loss of crop acreage and fewer bushels of grain flowing through the elevators each year. The business also had no rail loading elevators and many of the facilities were getting older[2].

Alton Valley has moved into some nontraditional lines of business in recent years including: pet food, horse feed, lawn and garden business and bird feed. Alton Valley has been considering a C-store but hasn't made the investment up to this point.

Merger Possibilities

NorthStar Ag

Both potential merger proposals have some good and bad points. NorthStar Ag is a large cooperative, the product of a merger five years ago. Its agronomy and energy divisions are large. NorthStar is a big player in regional grain trade, with two rail-loading elevators and several smaller elevators with truck-only service that feed into the rail facilities.

NorthStar Ag would bring a great deal of business diversity to a merger, since it does not rely heavily on one single line of business.

Sedgewick Farmers Cooperative

Sedgewick Farmers Cooperative is also a large cooperative, and the product of a merger. However, the merger that resulted in Sedgewick Farmers Cooperative was nine years ago. The agronomy division is Sedgewick's core business. Sedgewick Farmers Cooperative's grain division has some rail facilities and focuses on traditional commodity grain marketing. Sedgewick's feed division is virtually nonexistent. Sedgewick's energy division holds over 60% of the bulk petroleum and bulk LP market. Alton Valley's general manager is concerned that Sedgewick Farmers Cooperative tends to focus on charging the lowest price rather than service.

Part II: The Strategic Management Case Analysis

While Leo Wingate was responsible for preparing the financial recommendation for Alton Valley's board of directors Sam Potts was responsible for the strategic management implications. He wanted the board to look beyond "just the numbers"

[2] In this way Alton Valley is similar to many locally owned cooperatives, across the United States, who have and are continuing to find themselves challenged by a lack of rail loading elevators and aging elevator facilities. The capital investment necessary to construct rail loading facilities and update aging facilities is often extremely high so businesses put off the investment and soon find themselves in a less than competitive position.

because qualitative issues such as management relations or customer service can make or break a business. NorthStar Ag and Sedgewick Farmers Cooperative both have good and bad aspects so the decision will not be clear-cut.

Sam Potts reminded himself that the Board of Directors had gone into their recent retreat with the objective of first gaining a better understanding of how current industry changes were affecting local cooperatives and second identifying plans for the future that would ensure a viable cooperative presence for their farmer members. However, its limited market territory is a major challenge with urban development quickly identified as an important structural change. Even though many of the board members still thought of the city as “a long way away” urban expansion was resulting in land being converted from crop production to housing developments. Sam Potts also noted that as the general standard of living in the economy improved, more people were becoming “hobby farmers.” They were seeking out the “good life of the country” by buying up 40 to 80 acre plots where they could raise a few horses, enjoy the peace and quiet of rural life, and commute to the city for their day job.

The neighboring agricultural cooperatives both have a presence in the areas surrounding Alton Valley’s traditional market area, limiting market territory expansion opportunities. Alton Valley was losing important grain marketing and agronomy business because of decreased crop acreage in the region. It is well known in this industry that margins are low in grain marketing and agronomy so volume is essential. While Alton Valley had started to adapt to the increased suburban influence with new products and services such as a lawn and garden center and recreational animal feed the changes had not been significant enough. The Board of Directors had come to the conclusion that they needed to seek a merger with another cooperative.

Alton Valley Cooperative

Alton Valley Cooperative has been paying patronage and revolving equity on a regular basis, but as the Board of Directors had recognized at their retreat, it is a small cooperative, surrounded by urbanization and facing competition from neighboring agricultural supply companies, both cooperatives and investor oriented firms. In spite of this, Alton Valley has a very loyal customer base, due to the fact that it has always cultivated a strong customer service philosophy, particularly for the agronomy division.

One sign of this was the fact that service for agronomy customers had been so good that the cooperative’s customers had not felt the need to jump on the technology “bandwagon” as quickly as in some other regions. Alton Valley had been able to hold off making investments in GPS (global positioning system) technology during a time that their competitors were offering GPS services. Alton Valley’s customers had remained loyal because they had not perceived the need for the expensive technology when they were getting such good service. However, another factor in the decision to seek out a merger partner was the realization that their member customers' needs were changing and good service alone might not be sufficient for them to remain loyal in the future. Thus, Alton Valley is now at a point of needing precision agriculture products and services like GPS and soil nutrient mapping. The directors and management team at Alton Valley realized that investment in GPS equipment and personnel training would take a significant amount of capital.

As Alton Valley's energy division manager had pointed out, any change brought good and bad effects. "Sure, urban development is reducing the number of acres we serve in agronomy, but fuel sales have increased. All that development has increased the demand for bulk fuel in the area, and we've been able to capture a large share of that business. Customer service is a big selling point when selling fuel and other products to construction firms and we're good at it. And," he added, "those people who want their forty acres in the country are using LP (liquid propane) to heat their homes. We need to try to look for the good in these situations."

"True," Sam Potts had answered, "but the loss of crop acreage also makes investment in our elevators questionable. Loss of crop acreage means fewer bushels of grain through our elevators. We have no rail loading elevators, only larger truck facilities, and many of them are starting to show their age. In addition, the current trend to ship grain larger distances from the farms on semi-trucks makes investment to upgrade the elevators very risky. You can only expect so much from even the most loyal members! We've already shut down our feed mill."

The loss of acreage to development made each customer more critical, but that loss also limited growth opportunities along traditional lines. During the retreat, the general manager had summarized Alton Valley's nontraditional businesses. "We branched out into more non-traditional lines of business by trying to serve the suburban customer base that has been growing in the area. First, we ventured into the pet food and horse feed for hobby farmers in the feed store. I am pleased to report that the decision to expand into a separate storefront has been successful. Choosing to locate in the new shopping center was a big part of that success."

"The pet and hobby feed was followed by an expanded lawn and garden business. We started with some grass seed in the farm store and lawn chemical application by the agronomy division. When water gardens became so popular, we added supplies for building ponds in another corner of the store. Next came a separate lawn and garden center with nursery stock two years ago. We've been lucky enough to have our own gardening enthusiast already on staff, who was willing to move from full-time agronomy consulting and chemical application to managing the nursery inventory on a seasonal basis. But where we've hit a bit of a snag is in inventory management. Inventory for a retail business is very different from what an agricultural cooperative usually manages and the lawn and garden center is a lot of work. It is a good thing that the margins are positive. Now, that bird food shop, on the other hand, might just be more trouble than its worth…but the margins are so good! We need to get a better handle on it. What started as some bird food on the shelf next to the bagged fertilizer and grass seed in the farm supply store is quickly turning into a gift shop and bird-feeding store. Definitely not what we are used to dealing with! Now we're thinking about C-stores, and they are going to have similar issues for us."

Sam Potts also felt a responsibility for the cooperative members and employees. The members of Alton Valley Co-op had always valued the high level of customer service that was a trademark of the cooperative. Potts was proud of the fact that he had fostered a group of employees at Alton Valley that was loyal and dedicated. Potts felt it was important that these employees not be left without jobs following reorganization. For himself, Sam had recently been invited to apply for a general manager position of a local cooperative in another state. However, his family was settled in school and extra curricular activities so he liked the idea of staying in the area.

Merger Possibilities

NorthStar Ag

Both potential merger proposals had some good and bad points. NorthStar Ag is a large cooperative, the product of a merger five years ago. NorthStar Ag recently realized that it had to pay greater attention to equity redemption, so devoted a whole board retreat to that issue. By the end of the retreat they had developed a plan that would have all equity paid to members who are 65 years and older within 5 years. They are currently redeeming equity to those aged 70.

Their agronomy division has already entered into the GPS arena, but is not very far on the learning curve. They still have people in training and are just now getting the ball rolling. The management of NorthStar Ag made a conscious decision to move into GPS in a slow and methodical manner. They had always prided themselves on excellent customer service and wanted to make sure that their employees had the necessary training to deliver that same quality of service with this new technology.

The energy division's sales have been rising. NorthStar is currently operating two C-stores, which are proving to be successful business ventures. In particular, they are enjoying economies of scale in the management of the stores. They recently hired a C-store manager with good retail experience who is managing the personnel and inventory for both C-stores.

NorthStar is a big player in regional grain trade, with two rail-loading elevators and several smaller elevators with truck-only service that feed into the rail facilities. In fact, NorthStar's rail elevators are one destination for grain moving out of Alton Valley's elevators on semi-trucks. NorthStar is aggressively getting involved in the identity preserved (IP) grain market in order to offer greater marketing alternatives and revenue potential for its members. This interest in IP markets has also been an incentive for investing in the GPS services. NorthStar is hoping to eventually offer their buyers a package including information on such things as production practices and handling procedures along with the IP grain in return for a higher price. This could give NorthStar Ag an edge in the market place with a product that could rapidly become highly differentiated from the grain sold by other grain companies.

Since there is still quite a significant level of livestock production in NorthStar Ag's market area, they have recently invested in a new, state-of-the-art feed mill. Alton Valley had been an important player in that venture. In order to serve their feed customers better, Alton Valley had entered a joint venture with NorthStar Ag on the new feed mill. NorthStar Ag built the feed mill, with Alton Valley contributing a share of the capital. In exchange, NorthStar Ag agreed to process and distribute feed to Alton Valley's customers. In addition the new feed mill manufactures Alton Valley's pet food line. While the contribution from Alton Valley had helped lighten the financial burden of this investment, it had not eliminated it. On a positive note, the quality of feed is excellent resulting in high sales and high throughput.
The general manager and the four division managers of NorthStar Ag range in age from 45 to 53 and are all working very well together. It is expected that a merger with Alton Valley would not result in any of Alton Valley's management team being incorporated into the new cooperative. However, virtually all of the other employees would be brought into the new cooperative.

Sedgewick Farmers Cooperative

Sedgewick Farmers Cooperative is also a large cooperative, and the product of a merger. However, the merger that resulted in Sedgewick Farmers Cooperative was nine years ago. Sedgewick Farmers Cooperative has not been revolving equity and the current philosophy is to pay out estates and keep the rest of the money in the cooperative for upgrading and expansion purposes.

The agronomy division is Sedgewick's core business. They currently offer consulting and customer application services, including extensive precision agriculture services, such as soil nutrient mapping, GPS-guided variable application, data storage for customers with yield monitors, and analysis of maps for future planning. They have been one of the first cooperatives in the region to invest in GPS equipment and, as a result, now have experienced personnel and established systems. Alton Valley has found Sedgewick to be an aggressive competitor for agronomy business, focusing largely on price competition. Sedgewick Farmers Cooperative has an agronomy plant right at the edge of their market territory, on "the line" they share with Alton Valley. For the last three years, Alton Valley has shared an agronomic consultant with Sedgewick Farmers Cooperative, who is based at that plant.

Sedgewick Farmers Cooperative's grain division has some rail facilities, but the cooperative does not offer IP grain production contracts to growers. They have instead chosen to focus on traditional commodity grain marketing. Sedgewick's feed division is virtually nonexistent. Their market area favors more grain-only farms and recreational feed has not been an important product.

Sedgewick's energy division holds over 60% of the bulk petroleum and bulk LP market. Sedgewick would have little trouble incorporating Alton Valley's energy division into its own operations, although customer service might not be at the level that the Alton Valley members are used to.

Sedgewick Farmers Cooperative has experience in agronomy and energy, but it has no experience in non-traditional businesses. In addition, Sedgewick tends to focus on price rather than service. However, Sedgewick's involvement in precision agriculture services would mean a huge jump in those services for Alton Valley's customers.

The management team at Sedgewick is in a state of transition. The general manager is currently 63 years old and starting to think about retirement. The assistant general manager just left to become general manager of another local cooperative. Two of the four division managers are currently interviewing for other jobs. A merger with Alton Valley would most likely result in Sam Potts being named the assistant general manager in the short term and general manager upon the retirement of the general manager. The opportunities for the employees are less clear. Sedgewick has the reputation of running a "lean operation" and Potts is concerned that following a merger with Alton Valley, the new cooperative would try to operate with the same number of employees that Sedgewick currently has.

Financial Data for Northstar Ag, Sedgewick Farmers Cooperative, and Alton Valley

Table 1: Income Statements for Northstar Ag and Sedgewick Farmers Cooperative

	Northstar Ag	Sedgewick
Sales		
Supplies	$20,000,000	$29,920,000
Marketing	80,000,000	28,000,000
Total Sales	100,000,000	57,920,000
Gross Margins		
Supplies	5,000,000	7,480,000
Marketing	1,520,000	532,000
Total Gross Margin	6,520,000	8,012,000
Add: Service Revenue	2,500,000	3,100,000
Less: Operating Expenses	8,178,000	10,216,000
Net Operating Income	842,000	896,000
Add: Misc. Income	250,000	325,000
Less: Other Expenses	500,000	315,000
Saving before Patronage Refund	592,000	906,000
Add: Patronage refund received	85,000	67,500
Total Savings	677,000	973,500
Less Extimated Taxes	80,000	83,000
Savings to be Distrubited	*$597,000*	*$890,500*

Table 2: Balance Sheets for Northstar Ag and Sedgewick Farmers Cooperative

	Northstar Ag	Sedgewick
ASSETS		
Cash	$70,002	$133,050
Receivables	1,750,050	2,328,375
Inventories	5,040,144	4,124,550
Prepaid Expenses	70,002	33,263
Other	70,002	33,263
Total Current Assets	7,000,200	6,652,501
Total Net Fixed Assets	9,764,800	10,035,249
Total Assets	***$16,765,000***	***$16,687,750***
LIABILITIES		
Accounts Payable	4,500,000	2,857,000
Notes Payable	3,278,000	1,578,000
Total Current Liabilities	7,778,000	4,435,000
Non-Current Liabilities	2,354,000	2,354,000
Total Liabilities	***10,132,000***	***6,789,000***
NET WORTH		
Nonallocated	2,051,000	1,001,000
Allocated	4,582,000	8,897,750
Total Net Worth	6,633,000	9,898,750
TOTAL LIABILITIES AND NET WORTH	***$16,765,000***	***$16,687,750***

Table 3: Income Statement for Alton Valley

Sales	
Supplies	$10,000,000
Marketing	20,000,000
Total Sales	30,000,000
Gross Margins	
Supplies	2,601,000
Marketing	399,000
Total Gross Margin	3,000,000
Add: Service Revenue	1,950,000
Less: Operating Expenses	4,500,000
Net Operating Income	450,000
Add: Misc. Income	90,000
Less: Other Expenses	60,000
Saving before Patronage Refund	480,000
Add: Patronage refund received	60,000
Total Savings	540,000
Less Extimated Taxes	30,000
Savings to be Distrubited	***$510,000***

Table 4: Balance Sheet for Alton Valley

ASSETS	
Cash	$700,000
Receivables	1,000,000
Inventories	1,200,000
Prepaid Expenses	700,000
Other	700,000
Total Current Assets	4,300,000
Total Net Fixed Assets	5,700,000
Total Assets	***10,000,000***
LIABILITIES	
Accounts Payable	1,575,000
Notes Payable	1,575,000
Total Current Liabilities	3,150,000
Non-Current Liabilities	1,350,000
Total Liabilities	***4,500,000***
NET WORTH	
Nonallocated	1,010,000
Allocated	4,490,000
Total Net Worth	5,500,000
TOTAL LIABILITIES AND NET WORTH	***$10,000,000***

Table 5: Ratios for Northstar Ag and Sedgewick Farmers Cooperative

	Northstar Ag	Sedgewick
Net Profit Margin	0.60%	1.54%
Return on Assets	3.56%	5.34%
Return on Equity	9.00%	9.00%
Days Sales Outstanding	6.30	14.47
Fixed Asset Turnover	10.24	5.77
Total Asset Turnover	5.96	3.47
Current Ratio	0.90	1.50
Quick Ratio	0.25	0.57
Debt/Asset	60.44%	40.68%
Equity Multiplier*	2.53	1.69
Dupont Model ROE**	9.00%	9.00%

*Used in Dupont Model Calculations
**ROE=Net Profit Margin X Total Asset Turnover X Equity Multiplier

Table 6: Ratios for Alton Valley

Net Profit Margin	1.70%
Return on Assets	5.10%
Return on Equity	9.27%
Days Sales Outstanding	12.00
Fixed Asset Turnover	5.26
Total Asset Turnover	3.00
Current Ratio	1.37
Quick Ratio	0.98
Debt/Asset	45.00%
Equity Multiplier*	1.82
Dupont Model ROE**	9.27%

*Used in Dupont Model Calculations
**ROE=Net Profit Margin X Total Asset Turnover X Equity Multiplier

Table 7: Ratios for all Three Cooperatives

	Northstar Ag	Sedgewick	Alton Valley
Net Profit Margin	0.60%	1.54%	1.70%
Return on Assets	3.56%	5.34%	5.10%
Return on Equity	9.00%	9.00%	9.27%
Days Sales Outstanding	6.30	14.47	12.00
Fixed Asset Turnover	10.24	5.77	5.26
Total Asset Turnover	5.96	3.47	3.00
Current Ratio	0.90	1.50	1.37
Quick Ratio	0.25	0.57	0.98
Debt/Asset	60.44%	40.68%	45.00%
Equity Multiplier*	2.53	1.69	1.82
Dupont Model ROE**	9.00%	9.00%	9.27%

*Used in Dupont Model Calculations
**ROE=Net Profit Margin X Total Asset Turnover X Equity Multiplier

Discussion Questions for use in Teaching

Discussion Questions for Part 1 (Financial Analysis)

1. Consider the profitability ratios for Northstar Ag and Sedgewick Farmers Cooperatives. Identify the strengths and weaknesses of these two cooperatives from a profitability perspective.

2. Consider the management ratios for Northstar Ag and Sedgewick Farmers Cooperatives. Identify the strengths and weaknesses of these two cooperatives from a management perspective.

3. Consider the liquidity ratios for Northstar Ag and Sedgewick Farmers Cooperatives. Identify the strengths and weaknesses of these two cooperatives from a liquidity perspective.

4. Consider the debt ratios of Northstar Ag and Sedgewick Farmers Cooperatives. Identify the strengths and weaknesses of these two cooperatives from a debt perspective.

5. Consider the profitability ratios of Alton Valley Co-op. Identify the strengths and weaknesses of Alton Valley from a profitability perspective and evaluate how it would fit in with Northstar Ag and Sedgewick Farmers Cooperatives.

6. Consider the management ratios of Alton Valley Co-op. Identify the strengths and weaknesses of Alton Valley from a management perspective and evaluate how it would fit in with Northstar Ag and Sedgewick Farmers Cooperatives.

7. Consider the liquidity ratios of Alton Valley Co-op. Identify the strengths and weaknesses of Alton Valley from a liquidity perspective and evaluate how it would fit in with Northstar Ag and Sedgewick Farmers Cooperatives.

8. Consider the debt ratios of Alton Valley Co-op. Identify the strengths and weaknesses of Alton Valley from a debt perspective and evaluate how it would fit in with Northstar Ag and Sedgewick Farmers Cooperatives.

Discussion Questions for Part 2 (Strategic Management Analysis)

1. Complete the following SWOT Balance Sheet for Alton Valley Cooperative.

Strengths	Weaknesses
Opportunities	**Threats**

2. Complete the following SWOT Balance Sheet for Northstar Ag. Cooperative.

Strengths	Weaknesses
Opportunities	**Threats**

3. Complete the following SWOT Balance Sheet for Sedgewick Farmers Cooperative.

Strengths	Weaknesses
Opportunities	**Threats**

4. Compare the SWOT Balance Sheet of Alton Valley with the SWOT Balance Sheet of Northstar Ag. Identify the advantages and disadvantages of a merger with Northstar Ag.

5. Compare the SWOT Balance Sheet of Alton Valley with the SWOT Balance Sheet of Sedgewick Farmers Cooperative. Identify the advantages and disadvantages of a merger with Sedgwick Farmers Cooperative.

6. What is your recommendation? Why? (It is useful to have paper ballots for this vote.)

7. How would the membership of the cooperative view each of the advantages and disadvantages of the merger that you just voted on?

8. What issues still need to be worked out in the negotiation with the cooperative you are merging with (e.g. name of the new business, equity redemption policy, etc.)?

9. What steps would you, as members of the board of directors, have to take to "sell" the merger to the members?

10. What are the advantages and disadvantages of a three-way merger with Alton Valley, Northstar and Sedgewick?

11. What are the changes of a three-way merger being successful?

SWOT Balance Sheet

Example Characteristics Used in a SWOT Balance Sheet

Strengths	Weaknesses
1. A skill or important expertise 2. Valuable physical assets 3. Valuable human assets 4. Valuable organizational assets 5. Valuable intangible assets 6. Competitive capabilities 7. Achievement or attribute that puts the company in a position of market advantage 8. Alliances or cooperative ventures	1. Deficiencies in competitively important skills/expertise/intellectual capital 2. Lack of competitively important assets physical, organizational, intangible 3. Missing or weak competitive capabilities in key areas 4. COMPETITIVE LIABILITIES
Opportunities	**Threats**
1. Serving additional customer groups 2. Expanding product line 3. Using the internet and e-commerce 4. Integrating forward or backward 5. Acquisition of rival firms 6. Alliances/Joint Ventures	1. Entry of potent new competitors 2. Loss of sales to substitutes 3. Technological changes that undermine demand 4. Slowdowns in market growth 5. Shift in buyer's needs and tastes

