CO-OP CONSOLIDATION

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Number of ag cooperatives declines, co-op influence does not

By Dan Kowalski

AGRICULTURAL COOPERATIVES HAVE BEEN in a steady state of consolidation for decades. But despite the decline in the number of cooperatives, the influence of co-ops in rural America is not shrinking. However, it is changing. Fewer, larger co-ops have changed the competitive landscape in agriculture and have also affected the role of the co-op in rural communities. The first segment of this report identifies the trends behind consolidation and offers a snapshot of how co-ops have evolved over the years.

Why co-ops are consolidating

The number of farmer cooperatives has been declining steadily since at least the 1950s. This largely follows the trend of farm consolidation in the U.S., which has led co-ops to think about growth to better serve larger and more sophisticated member/owners.

One of the significant changes in consolidation over the last 40 years has been the cause. From the 1980s through the 1990s, co-ops were consolidating for defensive reasons as the agricultural sector reeled

Key Points:

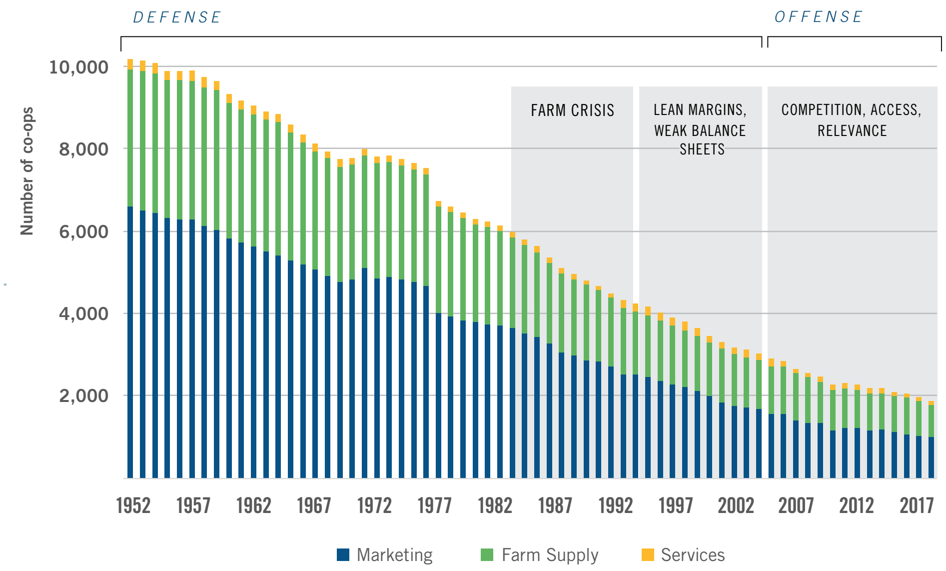
- *For decades, the consolidation of farms, farmers and co-ops trended together. Since the 1990s, the three have diverged.*
- *The pace of co-op consolidation has quickened during the current downturn, averaging 4 percent annually in 2016 and 2017.*
- *Since 2014, bankruptcies and dissolutions have surged as causes for consolidation.*
- *As co-ops continue to consolidate, staff sizes have grown despite a recent decline in business volume and net income.*
- *Average cash patronage fell sharply in 2017, but remained above levels prior to 2013.*

from the farm crisis and attempted to shore up balance sheets. Demand for agricultural goods improved in the 2000s, as did margins, ushering in a new period of offensive consolidation *(Exhibit 1)*. To compete in an increasingly global industry, many co-ops recognized a need for larger and more costly infrastructure and more insightful market information. Fewer, larger farmers were also demanding better and more diversified services from their co-op. Consolidation for the purpose of scale and relevance had begun. Over the decade from 2007 to 2017, on average, 70 co-ops were consolidated annually.

Exhibit 2 shows that co-op consolidation and farm consolidation diverged, however, starting in the early 1990s. From 1992 to 2017, farm numbers declined by 3 percent and the number of farmers increased 35 percent, while the number of co-ops and co-op membership fell by more than 50 percent.

EXHIBIT 1: Agricultural Co-op Consolidation by the Numbers

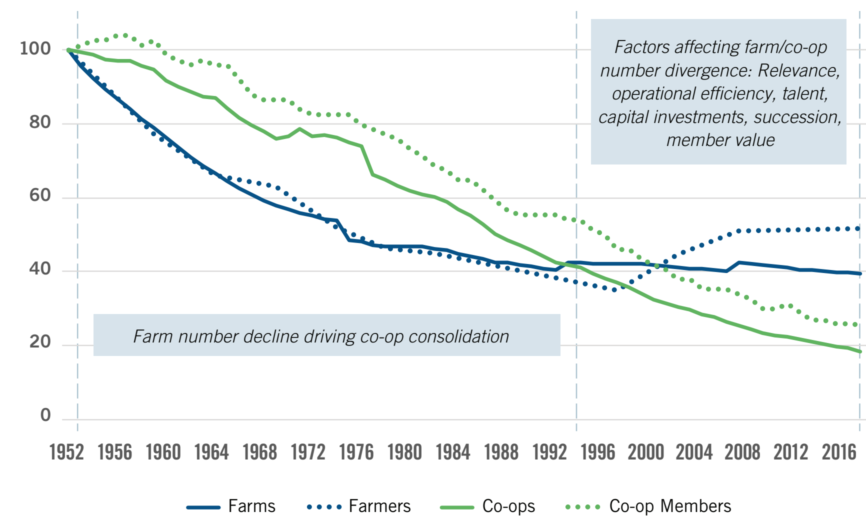
Consolidation has been happening for decades, but driving forces have shifted from defensive to offensive.



Source: USDA Rural Development, CoBank, Keri Jacobs

EXHIBIT 2: Index: Number of Farms, Farmers, Co-ops and Co-op Members

Farm numbers have stabilized, but co-ops and membership continue to decline.

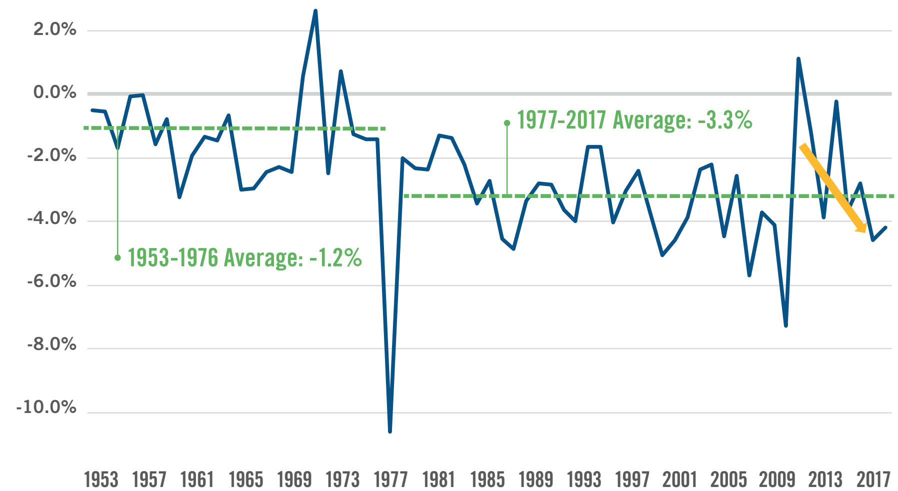


Source: USDA Rural Development, USDA Ag Census, CoBank

The pace of co-op consolidation has also quickened in recent years *(**Exhibit 3**)*. From 1953 to 1976, the number of co-ops declined by about 1 percent annually. From 1977 to 2017, co-op numbers fell by more than 3 percent annually. This further illustrates that "offensive" factors led to just as much, if not more, M&A activity compared to "defensive" factors. The recent farm economy downturn also accelerated the consolidation from 1.2 percent in 2011 to more than 4 percent in 2016 and 2017.

But while co-op numbers continue to shrink, the number of co-op owned facilities/locations seems to be steady or growing. Keri Jacobs of Iowa State University recently found that despite consolidation of more than 80 percent of co-ops in Iowa since 1979, the number of co-op locations/facilities are up more than 20 percent over the same period *(**Exhibit 4**)*. M&A activity may cause the closure or seasonalization of some facilities, but the larger co-ops may also purchase or build other facilities in different locations.

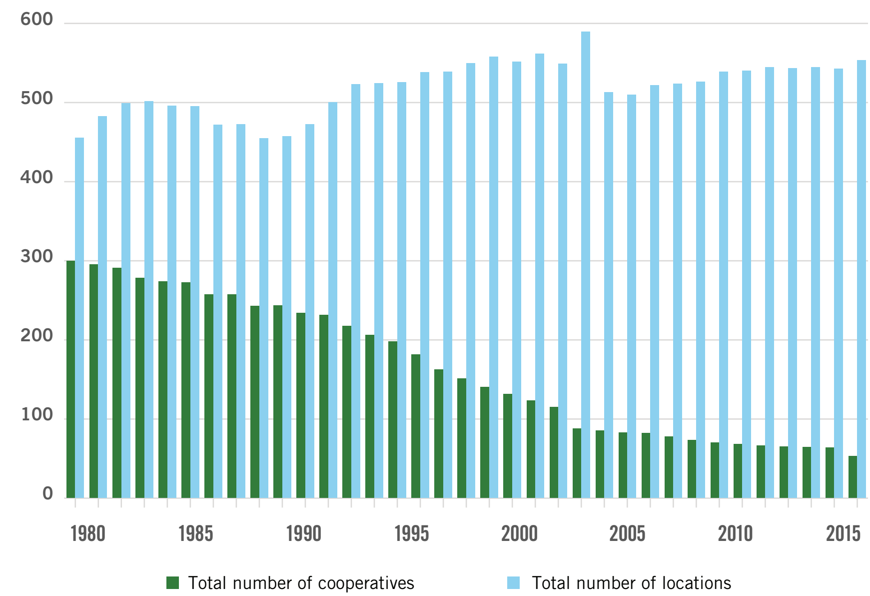
EXHIBIT 3: Annual Percentage Loss of Agricultural Cooperatives



Source: CoBank, USDA Rural Development

EXHIBIT 4: Iowa Cooperatives and Locations

Iowa is representative of other states. Co-op numbers have declined but facility numbers have not.

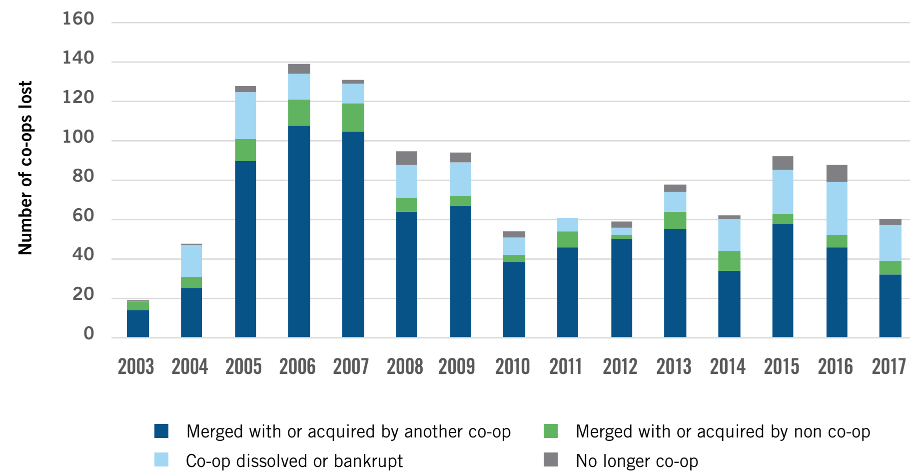


Source: Briggeman, Jacobs, Kenkel, McKee. "Current Trends in Cooperative Finance"

Consolidation comes in many forms. Co-ops merge with other co-ops as well as non-co-ops, while others dissolve and some restructure into non-cooperative businesses. From 2003 to 2013, on average more than 70 percent of co-op consolidation resulted from co-ops merging with or being acquired by another co-op *(**Exhibit 5**)*. Beginning in 2014, the share of disappearing co-ops that dissolved or went bankrupt surged. Over the four year period from 2014 to 2017, nearly 3 out of every 10 co-op consolidations resulted from bankruptcy or dissolution.

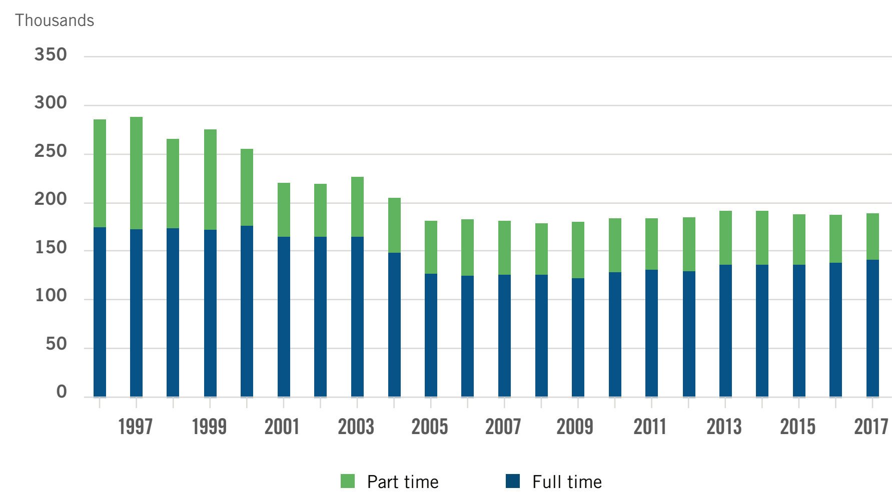
Co-op numbers may continue to fall, but the number of people employed by co-ops has actually been increasing for over a decade *(**Exhibit 6**)*. Ag co-ops added roughly 7,700 employees between 2005 and 2017. As co-ops have grown, they have also increased the proportion of full-time employees from 61 percent in 1996 to 74 percent in 2017.

EXHIBIT 5: Reasons for Cooperative Decline



Source: Data generated by James Wadsworth of USDA, Interpretation by CoBank

EXHIBIT 6: Ag Cooperatives Employees



Co-op employment has increased marginally since 2005.

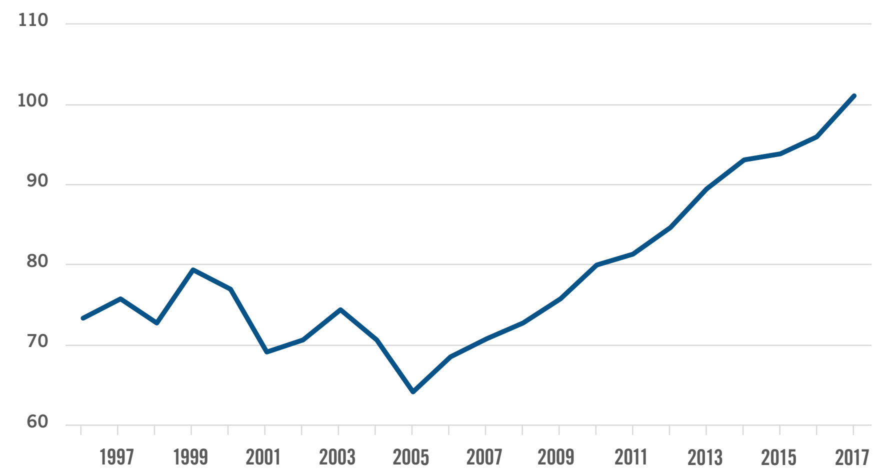
Source: USDA Rural Development, CoBank

The average co-op now employs more than 100 people, a 33 percent increase in two decades *(**Exhibit 7**)*.

Co-op business volume has also diverged from co-op numbers. Since 1952, co-op business volume has grown at a compound annual growth rate (CAGR) of 4.3 percent *(**Exhibit 8**)*. Volume grew at a much faster rate between 2007 and 2013 (7.5 percent CAGR), but has since fallen by 20 percent from the 2014 peak, reflecting lower commodity prices and the cyclical downturn experienced across much of agriculture.

EXHIBIT 7: Average Number of Employees per Co-op

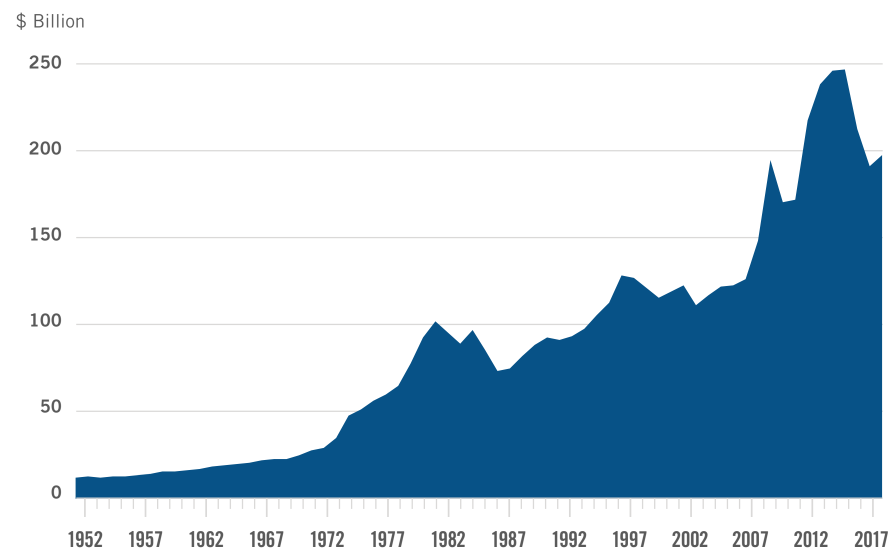
As co-ops have grown in size, so have their staff numbers.



Source: USDA Rural Development, CoBank

EXHIBIT 8: Ag Co-op Gross Business Volume

Ag co-op business volume has increased by more than 15x since 1952.



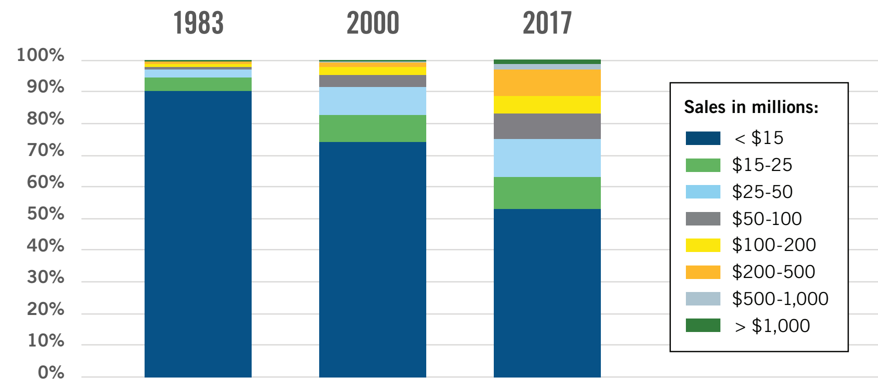
Source: USDA Rural Development, CoBank

Sales volume is another indicator of how co-ops have grown more diverse in size and capacity as a result of consolidation. In 1983, 90 percent of marketing co-ops generated $15 million or less in sales *(**Exhibit 9**)*. In 2017, roughly half of marketing co-ops generated those sales in nominal terms. Perhaps the most notable change from 2000 to 2017 is the expansion in share of co-ops that generate between $200 and 500 million in sales. The number of co-ops in this sales range now exceeds those in each of the two ranges just below it ($50-100MM and $100-200MM). Altogether, the data indicates that marketing co-ops are more diverse in size than ever, but the larger co-ops continue to control more of the volume.

Perhaps one of the most significant impacts of consolidation has been the increase in co-ops' average net income. From 1993-2017, average co-op net income grew by a 9.7 percent CAGR *(**Exhibit 10**)*. But income really began to surge in 2003. Between 2003 and 2017, net income grew at a 15.9 percent CAGR despite declines in income in 2016 and 2017. The boost in income has strengthened co-op balance sheets, enabled co-ops to better weather downturns, and made capital investments possible for many.

EXHIBIT 9: Breakdown of Marketing Co-ops by Sales Volume

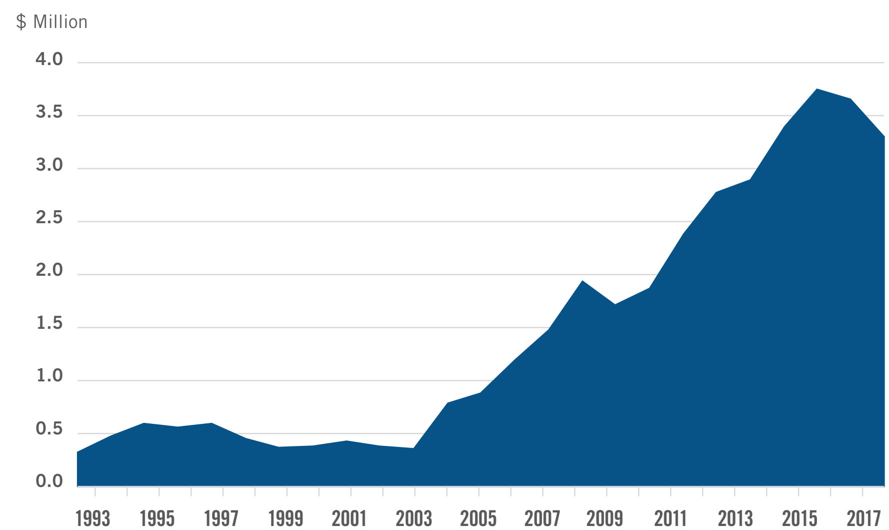
In 1983, 90% of co-ops had sales of less than $15 million. Today, that figure is only 50%.



Source: USDA Rural Development, CoBank

EXHIBIT 10: Average Co-op Net Income Before Taxes

Co-op income is much stronger and more stable today than in the past, making co-ops more sustainable and adding a boost to local tax bases.

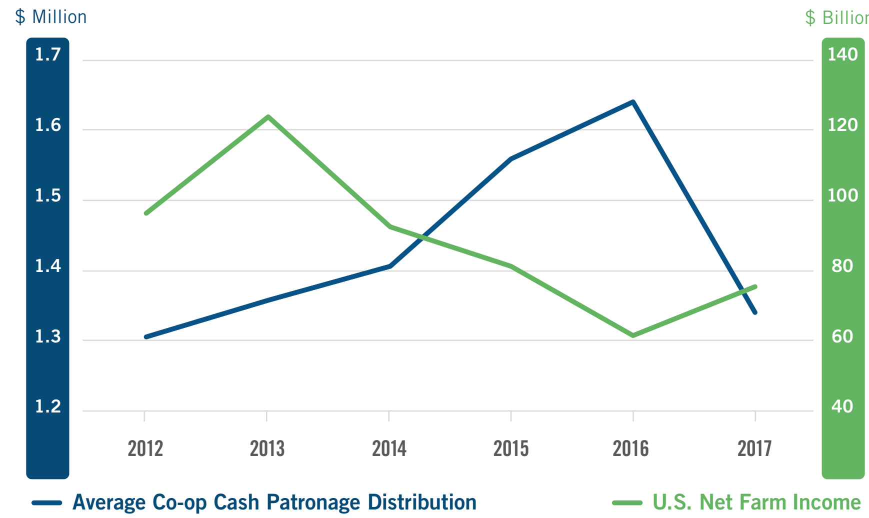


Source: USDA Rural Development, CoBank

Cash patronage distributed from co-ops to their farmer owners also remained above average through the first few years of the farm economy downturn *(**Exhibit 11**)*. This provided somewhat of a hedge against commodity price declines. Patronage distribution fell 18 percent from the 2016 peak to 2017. In contrast, net farm income peaked in 2013, and fell 39 percent through 2017.

EXHIBIT 11: Average Co-op Cash Patronage vs. Farm Net Income

Patronage payments have increased as farm income has declined by half.



Source: CoBank, USDA

Conclusion

The trend of consolidation among agricultural co-ops has remained relatively steady for at least seven decades. Co-ops have continued to consolidate even as the number of farms and farmers has stabilized, signaling a transition from "defensive" consolidation to "offensive" consolidation. The rate of consolidation slowed from 2010 to 2013 as agriculture experienced a boom period, but the rate has since returned to the longer term average, and is now exceeding that average. Despite the market challenges, though, co-ops on average maintain much stronger balance sheets, employ more people, manage a larger number of facilities, and remain a valuable source of cash for farmers through patronage distribution.

We expect consolidation among agricultural cooperatives to continue as the industry confronts persistent challenges in agricultural markets, evolving farmer demographics and management style, and the steady pressure to gain scale in pursuit of competitive advantage.

CO-OP CONSOLIDATION

Drivers of consolidation: Some old, some new

By Catherine Merlo

Spurred by both old and new drivers, mergers and acquisitions are reshaping the nation's farmer-owned businesses.

IN 2016, LEADERS OF TWO longtime Minnesota agricultural cooperatives reached the same conclusion.

"We realized we would be stronger together than alone," says Dave Stuk, then CEO of Harvest Land, one of the two co-ops.

A year later, on September 1, 2017, Harvest Land and Co-op Country Farmers Elevator merged, creating a diversified farm co-op with 1,500 farmer-members, $350 million in annual sales and a new name, Farmward Cooperative. It was the first merger for either co-op in more than 30 years.

The Farmward merger is part of a significant and ongoing consolidation trend among U.S. agricultural cooperatives. Between 2013 and 2017, 262 ag co-op mergers occurred, according to James Wadsworth, agricultural economist with the U.S. Department of Agriculture (USDA). Co-ops that dissolved or no longer operate as a cooperative totaled 118, raising the five-year consolidation number to 380.

Mergers and other consolidation ventures aren't a new phenomenon among agricultural co-ops – a wave, for example, took place in the 1970s and again in the late 1990s. In fact, there hasn't been one year since 1979 when at least one ag co-op merger did not take place, says Keri Jacobs, assistant professor at Iowa State University. But some believe farm co-ops are consolidating at a rate not seen since the late 1990s.

It's difficult, however, to quantify the number of ag co-op consolidations because no national database is kept on them. USDA is perhaps the most comprehensive data-gatherer. Every year, it

The potential for combining forces is an ongoing topic of discussion at co-op offices and on member farms across rural America.

publishes its "Agricultural Cooperative Statistics" report, an overall summary of co-op numbers.

USDA's latest report, reflecting 2017 numbers, shows there were 1,871 U.S. agricultural cooperatives. What's significant about that is not only were there 82 fewer ag co-ops than in 2016 but that USDA largely attributes the drop to increased merger activity.

Still, in some cases, USDA can only assume that consolidation is the reason for fewer ag co-ops in its database, says Wadsworth. Co-ops don't always report the reason they've ceased operation. "The numbers aren't perfect because co-ops don't always respond to our annual survey," he says.

Consolidation's farm foundations

What is clear is that mergers, acquisitions and other consolidation activities remain in full swing, while the potential for combining forces is an ongoing topic of discussion at co-op offices and on member farms across rural America.

"We're always looking for opportunities for merger and acquisition growth," says Nick Breidenbach, general manager of Central Dakota Frontier Co-op, a 1,400-member ag supplier based in Napoleon, North Dakota. "It's part of our strategic plan to grow for the benefit of our patrons."

In recent years, Central Dakota Frontier has pursued that growth by acquiring area competitors, including Alliance Ag in 2016, AgVantage in 2014 and Farmers Union Oil Company in 2013. In the past two years, Central Dakota Frontier has discussed consolidation with at least four other ag co-ops.

The consolidation push among farm cooperatives reflects a dynamic seen throughout production agriculture. Farming operations are consolidating to increase efficiencies in input purchases, management and operations. As a result, they're growing larger in acreage while declining in individual farm numbers. U.S. farms averaged 444 acres in 2017, up from 418 in 2007, according to USDA. Meanwhile, the number of U.S. farms in 2017 dropped to 2.05 million, down from 2.20 million in 2007. Moreover, farms reporting the greatest amount of annual sales – $1 million or more – increased the most of all classes, rising by 400 farms to 83,000 between 2016 and 2017.

In turn, the businesses that serve American farms are combining forces to compete and better serve these larger customers. Consolidation has taken place among global seed and chemical companies – Dow-DuPont, Bayer-Monsanto and ChemChina-Syngenta – as well as local and regional farmer-owned co-ops that provide farm inputs and services.

Why ag co-ops are joining forces

For co-ops, several merger drivers remain unchanged from decades ago. These farmer-owned businesses want greater market power. They're seeking increased economies of scale. They're consolidating to gain the capital needed to compete and acquire

assets and sophisticated technology that will aid them in better serving members. Consolidation also can capture synergies between two organizations that create greater opportunities here and abroad.

That was the case for Agtegra Cooperative of Aberdeen, South Dakota. The grain-handling and agronomy services co-op launched operations Feb. 1, 2018, after a unification of two long-time organizations, South Dakota Wheat Growers and North Central Farmers Elevator. The new cooperative serves more than 6,800 farmer-members in over 60 communities in North and South Dakota. Annual sales approach $2 billion.

"We merged to gain size, scale and efficiencies," says Agtegra CEO Chris Pearson. "Those will allow us to pass on savings to our members and build a stronger business."

Agtegra represents another aspect of today's consolidation trend: The largest number of ag co-op mergers and other consolidation activity is occurring among grain and oilseed marketing co-ops and farm supply co-ops, Wadsworth reports. In 2016, 20 grain and oilseed co-ops merged, consolidated or were acquired by another cooperative – the highest number since 2013. Eight farm supply co-ops did the same, although that was a sharp drop from the 19 that combined forces in 2013.

Iowa's Jacobs agrees the high number of mergers among grain and farm supply co-ops stems from a desire for efficiencies and competitiveness on the ag inputs side. "The need for reducing costs through aggregated purchasing is a significant driver," she says.

From 2013 to 2017, 96 percent of consolidation endeavors occurred among centralized co-ops,

Consolidation terms defined

MERGER:

Two or more co-ops combine assets, membership volume and established markets to give them broader reach than before. Often, one co-op survives legally as the dominant corporate entity while the other gives up its former corporate identity.

CONSOLIDATION OR UNIFICATION:

Two or more co-ops come together, combining assets, membership and customer base, and consolidate into a newly established business. Both organizations lose their legal identity and a new co-op identity is established. Changes in accounting standards have made this alternative less prevalent.

ACQUISITION:

Co-op acquires the assets of an investor-owned firm or another co-op, or one in another line of business to diversify its portfolio.

JOINT VENTURES:

Strategic alliance arrangement generally created to provide a key step in the value-added chain.

MARKETING AGENCY IN COMMON:

The coordination of just the marketing activities of multiple cooperatives under a single entity. These arrangements are specifically authorized in the Capper-Volstead Act.

which are comprised of individual farmer members. These significantly outnumber federated co-ops, or those whose members are other cooperatives. For 2016, USDA counted 1,750 centralized co-ops and 28 federated. Another 93 were "mixed," meaning co-ops whose memberships include both individual producers as well as associations. USDA further notes that grain and farm supply cooperatives make up nearly 67 percent of centralized co-ops.

More merger motivation

Another impetus for co-op consolidation may be the struggling agricultural economy, says Brian Briggeman, professor and director of the Arthur Capper Cooperative Center at Kansas State University. "Depressed incomes and tight margins for farmers can make things financially tough for co-ops," he says. "That can raise the incentive to merge or create an alliance before things get too bad."

In addition, smaller farmer-owned businesses "may consider a merger to make sure they stay of the size and scope to be relevant to the large producer who has the most ability to bypass the cooperative," says Phil Kenkel, Regents professor and Bill Fitzwater Cooperative Chair at Oklahoma State University.

Other motivations are spurring ag co-ops to consolidate.

"Some may want to become regional powerhouses," Kenkel notes. "Many of those cooperatives are already the product of successful mergers, so they may have incorporated continued mergers into their strategic planning process."

Mike Boland, Koller professor of agricultural economics at the University of Minnesota, has seen that as well. "The reality is that farm input supply and grain/oilseed marketing co-ops have merged together over the decades to form mixed co-ops, and those are consolidating," he says.

CEOs of large cooperatives are more exposed to regional and national industry events, adds Kenkel, so they may have more opportunity to develop relationships with other CEOs and board members of similar-sized cooperatives.

A question of weak or strong merger partners?

Do co-ops pursue mergers with weaker businesses? In some cases, yes.

Central Dakota Frontier was a strong and healthy co-op seeking size, scale and efficiency when it chose to acquire floundering businesses. "The companies we acquired were suffering financially and had eroded their capital enough that they were no longer able to make necessary improvements," Breidenbach says. "We were not equal merger partners."

Even so, Central Dakota Frontier believed it could turn the struggling acquisitions around by managing them differently. Picking up additional locations also would bolster the co-op's profitability. Moreover, the acquisitions would help with overall expense

control, especially through administration costs, interest and insurance.

"We felt that in 12 months the acquired company would be contributing to our bottom line," Breidenbach says.

In the Farmward merger, however, the dynamics were different. The two co-ops had been partners in various joint ventures over the years but, by 2017, saw the need to grow. Although Harvest Land was the larger of the two, "the merger was treated as one of equals," says Stuk, who today is Farmward's CEO.

"We had a lot of respect for each other, and we had very complementary territories that fit but didn't overlap in core production areas," Stuk adds. "We wanted to make sure we would be the first choice of members."

In Iowa, the many recent consolidations represent mergers of equals, Jacobs says.

Newer consolidation drivers

More recently, a new merger driver has surfaced among the nation's rural cooperatives.

"Management succession is entering the equation," says Curt Pederson, general manager at Farmers Elevator Co-op in Bellingham, Minnesota.

At the same time that co-ops are becoming larger and harder to manage, increasing numbers of baby boomers are retiring, reducing the pool of experienced co-op managers. When a cooperative seeks an experienced CEO, it often finds itself competing with other cooperatives in a small candidate pool. Some smaller cooperatives decide to merge with a cooperative that has a successful CEO.

Many recent mergers are the result of manager retirements and the desire not to compete against another co-op for top manager talent.

In fact, many of Iowa's recent mergers are the result of manager retirements and the desire not to compete against another co-op for top manager talent, says Jacobs.

Management retirement is the reason Farmers Co-op is seriously considering its first merger. The Minnesota grain marketing and ag input co-op has 450 members and $68 million in annual sales. For years, it's passed on mergers with neighboring co-ops, unwilling to take on poorly managed or unprofitable organizations.

But Pederson was considering retirement after nearly 30 years as the co-op's general manager. Six miles away, Rick Nelson, the manager of Louisburg Farmers Elevator, a small but well-run grain marketing co-op, was close to retirement. The two co-op managers and their boards met to discuss a merger possibility. In December 2018, Louisburg Farmers merged with Farmers Elevator. Today, the merged co-op counts 475 members and $76.5 million in annual sales. Pederson remains general manager.

That's a situation Boland has seen before. "When CEOs or general managers are closer to retirement, they are more apt to look at a merger opportunity as a way to leave the co-op better than they found it," the Minnesota professor says.

Ag co-ops also are finding that even mid-manager positions require more sophistication. It can be a challenge filling key positions with people willing to move to the small rural towns where so many farm-related businesses are based. As a result, access to talent and succession planning has been a key merger driver in the Midwest.

"A larger company may be in a better position to attract and retain employees, particularly when potential employees and those just out of college want to work at larger companies that can show evidence of a desirable career path," Jacobs says. "Growth is a way to enhance the co-op's attractiveness to new employees."

A "what about us?" mentality also is emerging in consolidation considerations.

"When board members hear about other cooperatives merging, they wonder what the future landscape of surviving cooperatives will look like," Kenkel says. "Some feel that if they do not target a merger with a smaller cooperative, they might become a target for acquisition by a larger cooperative. More generally, some may just worry they are missing an opportunity."

Kenkel recalls several instances of board chairmen wondering aloud, after seeing other mergers, whether their cooperative should do the same. "When I follow up with questions on what they hope to achieve, they don't have any specific concerns about efficiency, member service or profitability," he says. "They just don't want to be left out of the trend."

Consolidation slowing or accelerating?

Opinions vary on whether the consolidation pace among the nation's agricultural cooperatives is accelerating or slowing.

Breidenbach of Central Dakota Frontier believes the consolidation trend "absolutely" will continue but, in his area at least, "the low-hanging fruit is gone."

Iowa's Jacobs does not believe mergers are accelerating in her state. "We peaked about two to three years ago in Iowa," she says. "There are still mergers, but the rate seems to have slowed. Perhaps this is because of the uncertainty in the ag economy. Also, members seem to be growing weary of discussing mergers, and we have had a few in Iowa voted down."

As Boland sees it, the pace of mergers will ebb and flow as co-ops adjust to their newly consolidated status. "It is going to take time, many years, to get the 'new' co-op organization built after a merger, especially in these larger ones," he notes.

Kenkel and Briggeman expect the merger trend to continue. Many on the front line, like Farmward's Stuk and Agtegra's Pearson, agree. In fact, there is "absolutely" the possibility of another merger in Agtegra's future, Pearson says.

"To stop looking at growth opportunities means we won't someday be a viable co-op," Pearson notes. "We have to grow to serve our members well."

But that strategy comes with issues of its own. "Our biggest challenge is whether our membership will let us grow fast enough," he adds. "They don't always like to see us get larger. We have to learn even more about being a large company but also keep a local touch. Without that, they will not let us grow."

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CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities.

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For more information about CoBank, visit the bank's website at www.cobank.com.