DEFINING THE VALUE OF THE COOPERATIVE BUSINESS MODEL: AN INTRODUCTION

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Introduction

People who are unfamiliar with the cooperative business model often define cooperatives in relation to the dominant model of a firm: investor ownership. There is a rich body of knowledge and shared understanding regarding the value of investor-owned firms. Although stock prices and financial metrics don't reflect the entire value of a firm, they are readily available and easily comparable across firms. They can be used by a wide variety of factors in the economy, including investors, potential merger partners, customers and analysts.

Lacking transferable shares and other standard indicators of firm value, cooperatives require a more complex assessment. The source of the complexity is embedded in the cooperative ownership model. Cooperatives are owned by their patrons, and cooperatives create value by successfully translating and aggregating information about their members' needs into valued products and services. Successful cooperatives must find a balance between maximizing the current well-being of the owners and maintaining the long-term economic sustainability of the firm.

The standard definition of the term value combines two concepts: monetary worth and importance to the possessor. This definition is consistent with a discussion of the value of the cooperative business model. Important strands of thought regarding cooperative valuation include the economic value of the firm, the value of cooperative's presence in the marketplace, and the value of the firm to its owners, which may include both concrete and intangible benefits.

In the following discussion, we will discuss how the value of cooperatives is expressed and defined. We will begin by considering cooperatives' complex economic value, which is the value of cooperatives as an influence on prices and/or services within the economy, the value of cooperative business assets at the enterprise level, and members' assessment of value. This will be followed by a discussion of the value of cooperatives' distinctive ability to aggregate and align member needs while generating trust, loyalty and mutual commitment. In an increasingly complex and globalized business environment, cooperatives are positioned to gain significantly from their special relationship with their member-owners.

Value of Cooperatives in the Economy

Cooperatives are often formed in response to a problem in the market, usually due to an imbalance of power between a supplier of goods and the customer. By pooling members' purchasing power, a cooperative may serve as a force to lower prices or raise the quality of service, or influence the market in other significant ways.

The cooperative's positive impact on prices or services will eventually be met by competitors, and the cooperative's beneficial influence may fade from memory (Hueth, 2011). Credit unions, which are consumer owned financial cooperatives, provide a good example of this phenomenon. Credit unions began offering savings and lending services to consumers in the 1920s, at a time when many banks did not offer these services to ordinary working people. In Wisconsin, for example, 85% of the citizens did not qualify for bank credit. An early version of today's payday lenders offered credit at rates of 200–1000%. A statute establishing credit unions was passed in 1931, and by 1939 there were over 500 credit unions operating in Wisconsin, meeting the market demand for fair consumer loans. In 2013, almost 75 years later, banks and credit unions offer fairly standard consumer credit products. In order to compete, credit unions must differentiate themselves through qualities like price, access and service.

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Value of Cooperative Business Assets

Cooperative firms are evaluated based on their business assets, with the same tools used to value other firms. As with other closely-held businesses, where there is no public market for stock, analysts use financial metrics and estimated revenue projections to assess cooperatives.

Business valuation tools include the balance sheet method, EBITDA (earnings before interest, taxes, depreciation and amortization) and estimated future cash flows. The balance sheet method of valuation looks at net book value (total assets less total liabilities); liquidation value; and replacement value (what would a willing buyer have to pay to replace assets at current prices?). EBITDA is a financial metric used to value and assess the performance of companies across industries. It focuses on how much profit is made on the products that a firm buys and sells, under present operations and assets. The goal of estimating future cash flows is to accurately understand the projected value of an investment, based on future costs of money and revenue projections.

Cooperatives have adopted industry expectations for return on investments, using the same benchmarking tools. For example, value creation is defined by the return on invested capital minus the cost of capital times the amount of invested capital. This financial metric shifts attention from revenues to return on investment, providing a critical tool for analyzing use of capital. Like their competitors, cooperatives have increased profits by focusing on strongly performing sections of their business and maximizing their strengths.

Member Assessment of Value

In order to fully understand the value of their cooperative to their life or business, cooperative members must estimate several things: the economic value of the prices and services offered by the cooperative; the future value of the investments made by the cooperative, the value of annual cash patronage distributions, and the value of their investment in the cooperative. The cooperative model depends on collective investment in a firm that delivers most of its value through use of the cooperative.

This means that cooperative firms must anticipate the needs of their members, in order to be relevant to current and future demands. As they assess strategic decisions, they should have a long-term time horizon. This is where cooperatives have an important advantage over public companies, which are increasingly challenged by their focus on quarterly reports. On the other hand, cooperatives, as member-driven organizations, must consider members' differing time horizons for active participation in the cooperative. Cooperatives may be pressured to return high cash patronage refunds, preserve under-utilized services or revolve equity, rather than investing in valuable future. Leadership must educate members to make the connection between present investments and future gains, with both short- and long-term advantages.

Cooperatives price their products and services competitively, and then use patronage refunds (and occasionally dividends) to return a portion of the profits to members after the completion of the financial year. When the cooperative is competitive within a market, patronage and equity may differentiate it from competitors. Members may view cash patronage distributions as a significant incentive to patronize the cooperative.

Cooperatives also have the option of using patronage distributions strategically, to reward members for patronizing profitable business units, or to increase loyalty by easing difficult conditions for their members. Badgerland Financial, a Wisconsin-based farm credit association, used a special patronage distribution to help members with post-drought financial burdens in October 2012. Producers Cooperative of Bryan, Texas, offers differential cash patronage allocations to encourage use of profitable divisions. After an annual analysis of each unit's financial results, the cooperative gives patrons of top performing areas higher cash allocations. In 2008, when fertilizer prices were high, this allocation system rewarded fertilizer patrons, who might otherwise have left the cooperative for the competition. The additional cash patronage contributed significantly to members' perception of the cooperative's value. Cooperative Group UK uses a similar system to encourage members to patronize its various retail locations. With 4,800 retail outlets offering members banking, grocery, insurance and utility services, the Cooperative Group offers one membership card, which tracks patron usage. The card allows the Cooperative Group to distribute patronage refunds based on a strategic formula. Members are encouraged to patronize the various retail outlets through a system of rewards and "bonus" points, all related to annual patronage distributions.

Except for the membership share, the other equity owned by cooperative members does not require an upfront investment. As Michael Boland writes in another section of this website, cooperatives are continuously innovating in the way that they handle member equity and capital. Several cooperatives, including West Central and Organic Valley, convert member equity into preferred stock, which is not tradable but earns an annual

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dividend. The innovative model of "new generation cooperatives" was developed to solve problems of liquidity and market value. These cooperatives are capitalized through a high level of tradable membership stock, but the stock is based on use of the cooperative, and only tradable among members. As many of these cooperatives have continued to operate, they have evolved toward traditional cooperatives, returning patronage refunds and retaining earnings, with limited stock trading.

Value of Aggregating and Aligning Members' Needs

When a group of people creates a cooperative, they want it to return value based on their use of its products or services. Profits retained by the firm are invested in assets to support future services or earnings, with limited returns to investors.

Increasingly, cooperatives return value by strengthening their members' ability to anticipate and adapt to changing markets, economies and environments. Cooperatives strategically invest in systems, research, assets, marketing and new ventures that will provide long-term value for their members.

FrieslandCampina, a Dutch dairy cooperative, evaluates each new business opportunity using two criteria: the expectation that it will deliver profits to members and the expectation that it will help boost members' regular income. Investments that meet both criteria are prioritized. Its "Route2020" strategy includes significant investments in marketing, research and assets to support the growth categories of infant and child nutrition products, dairy-based beverages and branded cheese. It believes that these categories will provide increased market share, higher premiums to members, and higher profitability for the firm.

Spanish farmers need to constantly adopt new technologies in order to retain their position in the competitive export market. The Association of Fruit and Vegetable Producers of Almería (COEXPHAL), a federation of 100 small marketing cooperatives, adds value by helping farmers comply with both market forces and regulatory changes. COEXPHAL markets 65% of the exports and 70% of fruit and vegetable production in Almeria, a highly productive region in southeast Spain. With 8,100 farmer members and sales of almost $2 billion, they can ship consumer-ready product directly to large customers, and comply with the growing demands for food safety and quality preservation, and increased use of biological controls.

The cooperative model provides a powerful mechanism for organizational alignment and employee motivation. A study by McKinsey & Company found that cooperatives outperform similar investor-owned organizations in these areas. Since members participate in setting the direction of the firm, business strategies tend to be well aligned with key stakeholders. This sense of shared purpose, and a service-oriented mission, appeals to employees and provides a powerful motivational tool (Borruso, M, 2012).

Successful cooperatives take advantage of this deep organizational alignment. Many cooperatives have multiple relationships with their member customers, giving the firm a deep knowledge of their members' attitudes and business requirements. Cooperatives can capitalize on this knowledge, especially if they integrate information systems across operations and divisions to fully track their relationship with each member.

Cooperatives can take advantage of their multiple connections with their members to understand and anticipate their fundamental needs, and then invest in high quality and stable systems to fulfill these needs. CHS has invested to mitigate risk in a volatile marketplace through ownership of facilities and global partnerships. Investments in origination and export infrastructure have been made to ensure long-term access to global grain markets for members. CHS looks at investments that will position owners to take advantage of future opportunities. For example, it is investing in soy sourcing and processing, as a key nutrition source for a growing world population.

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The Value of Trust and Loyalty

Research on consumer attitudes has found that quality and price are only two of the factors that create a perception of value. Other important components include institutional reputation, associations, and the psychological benefit derived from bonds shared with other customers/members. Perceived value combines tangible and intangible components of a relationship (Dacin, 1995).

One of the critical intangible components of a relationship is trust. The cooperative model creates trust through a tacit understanding that a member-owned business will operate in the best interests of members. As a cognitive concept, the definition of trust varies among individuals, but it has some very concrete benefits in the marketplace. Trust is a quality that has three advantages to a firm: it creates loyalty, encourages sharing of valuable insights, and reduces the need for costly contracts and adversarial negotiations.

A 2013 survey found that only 59% of Americans trust institutions and their leaders, and that the public perceives that the wrong incentives are driving decisions in major institutions. The Edelman Trust Barometer is an annual global survey that reports trust levels in institutions like business, media, non-profits and government. In its years of research, Edelman has found that the essential building blocks of trust are engagement, integrity and high quality/innovative products and services. Engagement is described as "places customers ahead of profits, communicates frequently and honestly on the state of its business."

These attributes closely mirror the qualities that consumers value in cooperatives. A 2012 study by the Consumer Federation of America reported that consumers believe that cooperatives have the best interests of customers in mind, that they can be counted on to meet customers' needs and are committed to providing the best service to their customers, and that they outrank for-profit businesses in these vital areas.

Trust may be particularly critical in market niches where the consumer of a product or service is particularly vulnerable to the consequences of poor behavior. Everyone can agree on the value of trust, but the concept of trust may be very individual. This is because trust is directly related to the belief that another person or institution will not exploit personal vulnerabilities. If the relationship involves multiple contact points, deals with a core element of the member's livelihood, or requires a long-term commitment, the importance of trust rises substantially.

The first modern cooperatives, British retail groceries, provide an early example of cooperatives successfully operating in a niche that was vulnerable to negative behavior. During the Industrial Revolution, people moving from farms to urban areas were suddenly dependent on purchased food. Long before government regulation of food safety, adulterated milk and mealy flour was a huge problem. The British consumer-owned cooperatives built their astonishing success on a reputation for providing safe and high quality food. Within 30 years they grew from one small store in Rochdale, England, to more than 1,000 stores throughout the British Isles. In order to ensure safe and reliable products for consumers, these stores created federations that aggressively built and bought food-manufacturing plants. They created a food system that used local products and imported items like high quality butter from the United States and tea from India. These products were distributed within a cooperatively-owned supply chain, and created a highly trusted cooperative brand (Webb, 1891).

Trust is vital to economic transactions, which always involve some form of cooperation and exchange. A study of Missouri corn and soybean producers found that they viewed cooperatives as more honest, competent and trustworthy than investor owned firms. One question asked respondents to assess the "honesty and integrity of the people (in the cooperative or agribusiness) who explained the contract to you and who paid you and took delivery of your grain." A perception of honesty and integrity contributed to trust, which was a significant factor in producers' choice of firm to use in marketing their crop (James, 2005).

Trust can lower the costs of creating and maintaining global relationships. CRI, which markets cattle genetics internationally, has intentionally built partnerships with other cooperatives in order to increase its global market share. This strategy has created stronger market relationships and increased margins. Since trust is an important factor in marketing relationships, shared farmer-ownership has helped reduce cultural boundaries and jumpstart relationships.

Practices like open communication and member participation in governance help to create a perception that a firm is fair. Fairness is a powerful human preference, and organizations that can capitalize on this preference have an advantage in the marketplace. If members assume that the cooperative has treated them fairly, and dealt with them honestly, they may accept a competitive price that is not the absolute best price in the market. One long-time member of a marketing cooperative made this comment when comparing private brokers to his co-op: "In a cooperative, you may not be happy, but you're content."

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The Value of Member Participation in Decision-Making

When the Cooperative Group UK was planning to make a large investment in a significant number of new locations, it turned to its members for on-the-ground local knowledge. Using a simple online survey, it asked the 6 million members to suggest new sites, and then used technology to map the responses, creating very useful intelligence for store locations. Presumably, Cooperative Group members were willing to share their insights because they had a stake in the results and believed that their input would be influential. They trusted that the outcome would be beneficial to them.

In order to reap the rewards of member input, cooperative leadership must spend time mobilizing members around a common vision. The dialog is multi-faceted. Businesses and governmental institutions that have relied on a top-down power dynamic are confronting the power of consumers and activists to shape public opinion. Surveys report that other consumers are trusted twice as much as CEOs, forcing firms to develop a new model of engaged management. Cooperative leaders have the advantage of experience with dealing with many stakeholders, so this dynamic isn't new to them. One national agricultural cooperative asks its large delegate group to discuss and answer three to four carefully chosen questions at its fall meetings. The questions range from strategic to operational, with the responses forwarded to the board and management. The cooperative makes every effort to close the feedback loop, so that delegates know how their input affected decision-making.

Cooperatives are well positioned to take advantage of members' collective knowledge. For example, a cooperative owned by 75 licensed fishermen in Chignik Bay, Alaska, was faced with dwindling catches and low prices for its salmon. It conceived of a fairly radical plan to pay a small number of its group to fish extremely efficiently, while the rest of the fleet stayed home. Profits were shared equally at the end of the season, with everyone benefitting from substantially lower costs, higher quality catches, and efficient resource management (Deacon, 2005).

The pioneers of organizational psychology found that people will accept major changes if they feel they have been able to influence the decision. Although this isn't a universal trait, members who value democratic control of the cooperative are more likely to have a positive attitude toward the firm. A study of members of large Swedish agricultural cooperatives found that members' attitudes towards governance were more significant than volume of use or age in determining their loyalty to their cooperative (Osterberg, 2009).

Cooperatives may benefit from members' perception that there's a value to self-governance, but at least some of them must also participate in self-governance. Although they can be costly, cooperative annual meetings provide a valuable opportunity to encourage dialog among members and leadership. According to preliminary findings from research conducted by the University of Wisconsin Center for Cooperatives, average attendance at agricultural cooperatives' annual meetings is about 32%, with 35% of members voting in board elections. Although some people might say there is room for improvement, these numbers are similar to the average turnout for U.S. federal elections in non-presidential years.

Cooperatives are owned by people who have something in common. This has value in the public policy arena. Two-thirds of the cooperatives responding to a recent survey said that their firm engages in public relations efforts to influence external stakeholders regarding their members' interests. Efforts vary from participating in social media to event sponsorship and hosting community workshops to employing full-time government affairs staff. Interestingly, there are significant differences in the ways that cooperatives describe their value to external audiences. Some emphasize impact on local economies, others their positive effect on members, and a few reported talking about the cooperative principles and how they differ from investor-owned firms (Bond, 2011).

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Summary

A classic assessment of the value of the cooperative model for members looks at the discounted value of member equity, value of patronage distributions, value of any dividends, and the value of the products and services in supporting a member's life or business. The value equation for a member of a cooperative includes their use of the cooperative, their patronage distribution, the value of their investment, and any dividends. Successful cooperatives invest in activities that will return profits to their members and support their future success.

As with any business relationship, the cooperative and members must successfully navigate the intangibles that create a sense of trust. Trust is a valuable and rare quality in the marketplace, but the cooperative model engenders internal institutions that build trust and confidence in the firm. Although cooperatives are primarily economic organizations, they have a social aspect that allows them to call on members' willingness to share valuable competitive information. Successful cooperatives are taking advantage of their close connection to members to fully understand their present needs and use this understanding to position them for the future.

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