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Developing New Generation Co-ops: Getting Started on the Path to Success

by Cindy Thyfault

Editor's Note: Cindy Thyfault is president of Westar Trade Resources, a strategic marketing and new business development company in Amarillo, Texas. The company has been instrumental in organizing several value-added manufacturing operations. This article is an excerpt from a book Thyfault is writing on the organization of "new generation" cooperatives.

The rise of "new generation" cooperatives in value-added agriculture has fueled the fire among farmers and farm organizations to investigate, develop and build companies owned primarily by farmers. The term "new generation" in this article is used to describe cooperatives which are producing their own value-added products, often non-food products. In many cases, stock sale to members is financing construction of processing facilities and members are contracting all or a large portion of their crop to the cooperative.

The changes and tensions caused by the 1995 Farm Bill, global market conditions, the declining number of farmers, the rising median age of farmers and economic stress in many rural communities have encouraged farmers to look for nontraditional opportunities to restore prosperity to themselves and their communities. Four factors in particular have widened the window of opportunity for further development of value-added agricultural projects. The first factor is the declining prosperity of many rural communities. A new focus on rural economic development to provide new jobs, protect existing businesses and create economic vitality has given new life to many rural areas. Projects can be tailored for specific economic areas. Value-added processing is a natural fit in this environment and can take advantage of specific crops and complementary industries in each community.

The second factor is the change in direction of farm programs and the new directives of the 1995 Farm Bill. These changes indicate a winding down of traditional federal farm price and income support programs, continuing policies aimed at creating a more market-driven farm economy. This puts farmers at a greater risk from price and income volatility. To provide more stability, many farmers and farmer co-ops are pooling marketing efforts and developing other forms of group purchasing activities.

The third factor is rising worldwide demand for processed food products. Rapid and sustained economic growth, rising incomes and standards of living (especially in the urban areas), steady transition to a market-based economy and gradual relaxation of trade restrictions are combining to create unprecedented opportunities for American exporters. These positive factors are leading to the development of a larger middle class in many emerging markets (notably China), where food purchasing and consuming habits are changing.

The fourth factor is the development of new technologies. Whether improving the quality of the environment or adding more nutritional value to the foods we eat, agricultural research is constantly opening new fields of opportunity across all sectors of industry. There is an increasing interest in developing non-food uses for agricultural raw materials. Particle board, paper and composites are a few

examples. Evidence of the need to band together to develop new value-added production opportunities is compelling. However, after the first burst of enthusiasm, two questions must be answered honestly and objectively, says David Barton, director of the Arthur Capper Cooperative Center at Kansas State University.

1. Why should we do this?
2. Why shouldn't we do this? A thorough examination of these two questions is critical to the success of any new company.

The success/failure rate of new business ventures is also pertinent to this discussion. Recent research (John A. Hall, "Bringing New Products to Market: The Art of Creating Winners") indicates that, of all new product concepts that emerge from the product planning process, only about 15 percent ever come to the market as new products. Among new products marketed by established firms, about 65 percent are judged to be successful. But for small, entrepreneurial and start-up companies, the failure rate in the first five years is 90 percent.

The eight steps outlined below can greatly reduce the risk of new business failure, protect community resources and develop an action plan for a new generation/value-added cooperative.

Why **SHOULD** we do this? The first phase examines the reasons the new business could work.

Step One: Assess competitive advantages. Examine what your community or agricultural organization has to offer. This assessment should include an objective analysis of crop patterns, type of products and services native to your area, service industries, available buildings, availability of water and other natural resources (current and future) and availability of waste facilities.

Remember, most manufacturing operations require large amounts of water. If your area does not have sufficient water reserves to support agri-industrial uses, you will probably have to select another site. This must be an up-front consideration in your planning process. Other environmental considerations-including solid waste and wastewater disposal are also very important.

Analyze the human resource potential in your community and organization. Don't ignore the talents of older, experienced businessmen who could help in this planning process.

To further determine your community's competitiveness, examine its strengths and weaknesses and various external opportunities and threats. What businesses in your area are growing/declining? What factors could change in the next five to ten years?

Don't ignore the economic impact of your business on the schools and the tax base of the county. Value-added manufacturing industries are typically capital and labor intensive. A project which is too large can overwhelm the resources of a county, city or school district in the first three to five years.

Finally, will the majority of the community support new or expanded industry? What help or assistance can local banks and financial institutions contribute?

Step Two: Identify a project. This step builds on the information compiled in the first step. One of the best ways to develop creative ideas is a community brainstorming session. Let ideas flow among the members and record each idea. Look for new and improved products that could compete with those currently on the market and could be manufactured as locally produced commodities. Is it something that you would like to buy?

Network with government agricultural and commerce officials and university research departments. Do some research in the library to look for new technologies and trends. Narrow your potential product list to the best two or three which show a pattern of growth, increasing demand and potential in the marketplace.

Step Three: Organize a development team. There are two very important elements of this step. One is to make certain that a high level of commitment exists among all members of the cooperative. Most value-added manufacturing projects take at least five years of intense commitment to complete the investigation, planning, organization, start-up, development and first-stage operations. All members of the team must be able to devote the time and energy necessary to get through these trying first years.

The second element of the team is diversification and expertise among members. Gary Boyd, partner with AgriInitiatives, an Austin, Texas-based consulting firm, stresses the need for involvement of consultants from outside the community -private or public (such as advisors from a university, USDA, etc.)who can lend a greater degree of objectivity to a project. In some cases, outside directors with special skills (finance, legal, etc.) may help achieve this. "Otherwise, the whole community can get so caught up in a project that there can be a lot that is overlooked during the due diligence and planning process," says Boyd. "Some questions just won't get asked unless there is that diversification."

New businesses will be competing in a highly competitive global marketplace characterized by constantly changing markets. Total-quality manufacturing and efficiencies of scale will determine the success or failure of operations. Use university personnel and successful professionals in manufacturing and marketing as your advisors. Now is the time to meet with companies which may be interested in buying your products and forming strategic alliances. Use contacts at local and area chambers of commerce and economic development organizations.

Selection of a qualified first board of directors is critical for the success of the venture. Formation of a nominating committee which can recruit candidates who bring special skills to the board can help accomplish this all-important task. Co-op bylaws may provide guidance on director selection, and some state statutes also have provisions relating to director selection. (For more on this topic, request CIR 14, "What Co-op Directors Do," from USDA by calling (202) 690-0357.)

Keep the board size reasonable - 12 or fewer is usually advisable. All members should be able to devote enough time to meet frequently and be totally committed to making the company successful and profitable. The board should maintain objectivity throughout the entire planning and start-up process.

A new cooperative that will be producing a value-added product and which expects to tap export markets will need expertise in many areas. This expertise includes agricultural production, technical manufacturing, national and international marketing, business management and new product development.

A board comprised primarily or exclusively of farmer-producers may acquire this type of expertise through the use of one or two outside directors, through the management it hires to run the cooperative, or through consultants hired to work with management and the board in developing business and operational plans.

Selection of the CEO is the next major step. Qualities to consider include: entrepreneurial style, familiarity with the industry, management experience, management style, experience in new product development and the ability to integrate oneself and family within the community. The first CEO of any organization has the unique opportunity and responsibility to develop the management style and corporate culture of the organization.

Step Four. Raise seed capital. These are the funds that will be needed for travel, consultants, research, due diligence, attorney's fees and accountant's fees. For a project of any size, this can easily require \$150,000. If this amount seems out of reach for your group, take a deep breath and look at broadening your region to include other communities or organizations. Investigate the availability of research grant opportunities, contact your local economic development organization and/or develop a joint venture partnership with an established company which may contribute research and development capital.

In any event, don't try to proceed ahead on a shoe-string budget. Richard French of Quest Business Services in Hutchinson, Kansas, notes "a lot of start-up groups have a weak point in their organizations if they don't do the background work in a thorough way. They don't have a proper foundation. If you don't do it, it weakens your overall position."

If members of your cooperative are concerned about losing seed capital, they need to understand that if the business is started and fails due to lack of pre-planning, your group and others will lose a lot more than the seed capital. It is important at this stage to form a corporate entity to manage the funds. The group is now ready to proceed to the next phase.

Phase Two explores the question: "Why SHOULDN'T we do it?"

This phase is designed to look objectively and rationally at all of the pitfalls, including a thorough investigation of the markets, financial needs, economies of scale and the timeline needed to successfully carry the new business through the first five-year period, a time of high risk.

Step Five: Investigate. Use this step to challenge the validity of those two or three good ideas developed during the phase-one planning exercises. Identify every reason why your project WON'T work. Question everything. Does this product have an existing market? Where? Is it growing or declining? Does this product have good technology?

At this stage, use of a marketing and technical consultant is a MUST. An independent analysis is the best investment your cooperative or group will ever make. The consultants and members of the group may need to travel nationally and internationally to observe existing plants, conduct due diligence on the creditworthiness and service environment of the plant and equipment manufacturers, ask for marketing information and copious references, then talk to customers who are using the products.

The only dumb question at this stage is the one you do not ask. By this time, emotions are high and it is easy to get swept into the enthusiasm of the salesman or the thrill of the profit potential. Constantly look for warning signals that could signal potential problems. After feeling confident of the process and the product and making a commitment to one project, you are ready to move forward to the next step.

Step Six: Develop a comprehensive marketing plan. Most farmers are producer-oriented. However, the ability to produce large quantities of any value-added product does not guarantee that the bills are going to be paid. Now is the time to use the services of a professional marketing consultant. New market planning and new product entry are critical activities that should be entrusted to professionals skilled in the necessary disciplines of planning, research and analysis. Most important, they must relate to and have a feel for the products they are working with.

Lack of market research, or poorly planned or poorly executed market research, is a major cause of new product failure. Be prepared to commit the funds necessary for extensive market research and the development of a comprehensive marketing plan, which will become a major part of the business plan.

Your marketing consultant will need to develop a plan which answers a number of key questions. Who is going to buy this product? What are the specific reasons or motivations for them to buy it? What value does the new product provide that is not now available on the market? How much money are potential customers willing to pay for it? What is the message or the "hook" that must be used to get the attention of prime prospects so that they can be converted into customers? Is this a volume market, or will this product only appeal to a small "niche" market?

All new businesses in this international age should have a global marketing strategy, including export markets and a plan on how the company will handle import competition. Don't ignore domestic competition from established companies and potential new entrants. Explore new technologies that could make your product obsolete and develop a plan which includes new product development.

Step Seven: Develop the business plan. Don't fall into the trap of writing a plan just to get a bank loan. It is important to go slow at this stage-explore every detail. The assistance of your accountant and attorney is vital. Develop a plan that can become a road map for where you want to go, and stick to it. If your plan is conservative (based on less than ideal market conditions) there will be less stress and more probability of reaching the financial goals during lean times. Look at existing businesses in the same industry to establish an accurate time-line for development and growth.

Pat Helton, director of the International Trade Center in Lubbock, Texas, advises: "Come up with a plan, follow the plan and don't walk away from it." Plan for the unexpected, and don't take anything for granted. Write a plan that you can follow, and commit to it. "Most failures occurred because companies didn't follow the business plan, panicked, then veered away," states Robert Kennedy, deputy assistant commissioner for finance, Texas Department of Agriculture.

Understand that no one wants to be the "guinea pign to test your product acceptance. Be prepared to attend trade shows and seminars, advertise and market to customers for an extended period of time without profitability. Finalizing joint venture relationships and strategic alliances at this stage is a must. Also, don't disregard the development stage, which can include ironing out bugs in the machinery, product testing and certification, product acceptance, salaries and other expenses.

Don't plan for a profit for at least two to three years. A large portion-probably most-profits realized during this period of time should be reinvested back into the cooperate for growth and expansion.

The financial statements are a very important part of the planning process and involve extensive input from technical consultants and industry officials regarding start-up costs and development-stage costs. Raw material procurement and storage are critical in a value-added agricultural enterprise, because raw materials are usually only available for purchase several weeks during the year. Extensive pre-planning is required to fund these types of massive raw material purchases.

Another part of the planning process is having a plan for dealing with drought or natural disasters that could destroy a crop. The cooperative must plan if it is to prevent these occurrences from shutting down the manufacturing production.

Other capital-intensive costs are plant and office equipment. Get bids on good equipment which will serve a growing company. Carefully examine warranties and service agreements.

Be sure to incorporate into your business plan any federal or state programs designed to help promote cooperative business activities. These programs may add dramatically to the feasibility of the new value-added project. Work with your federal and state officials to make sure you have structured your business correctly to take full advantage of these programs.

Step Eight: Raise the necessary capital. For any new business venture of this type, most financial institutions will require at least 40 to 60 percent equity from the owners. The amount required will vary depending on key factors. Is the market for the product well established? Have the risk elements been dealt with before? Is the company establishing a new product in the marketplace? Is the product high-tech?

A well-written business plan is a vital tool if farmer-producers are to invest capital. Many new generation cooperatives are raising capital through stock sales in which members also enter into a contract to supply the cooperate with a set percentage of their crop. Membership is often limited, so there is strong incentive to be among the initial stock owners.

Still, potential farmer-members are going to have to be thoroughly convinced of the efficacy of the project before committing their money and/or crop to it. Product demonstrations, town meetings and video presentations will help gain support. The initial planning stages again become very important in proving your concept to potential stockholders.

There are many ways to design the farmer-participation package. A \$5,000 to \$10,000 investment will usually allow more farmers to participate, and also spread the risk among a larger group. Don't discount the possibility of needing to raise additional capital at a later stage for expansion or for unexpected difficulties.

One concept that is hard for some farmer-producers to compare is the value of a return on equity vs. sale of raw product. Be prepared to show charts and graphs illustrating these benefits over a five- to ten-year period. Stress the length of time involved for developing these types of manufacturing projects.

Banks for cooperatives have been the primary financial institution in the last 50 years for helping to finance new cooperatives, but many commercial banks are also funding cooperatives. USDA has a number of financial programs that can assist cooperatives that meet certain criteria. Chief among these is the Business and Industry Loan Guarantee program of USDA's Rural Business-Cooperative Service (RBS), which can provide up to \$10 million (\$25 million in some circumstances) in loan guarantees for business projects that create and maintain employment opportunities in rural areas. The actual loans are secured through a local bank, which can have its lending authority expanded and its risk exposure reduced by partnering with USDA in this program. Call (202) 690-4730 for more information. The Alternative Agricultural Research and Commercialization Corporation, also affiliated with USDA/RBS, can also provide matching grants for cooperatives and other businesses which will produce non-food products from agricultural crops. (Call (202) 690-1624 for information on this program.)

Bankers must evaluate your new business concept independently on its own merits, not on the merits of any current business or cooperative organization.

Developing any start-up company can be very difficult and time-consuming, but can be very successful and rewarding if the planning process is followed carefully. Farmer-owned value-added agricultural enterprises are a much-needed addition to our nation's rural economy and will be even more important in the next century. Through hard work, commitment, and courage, farmer-producers can create new prosperity for themselves and their communities. It's a frontier with no limits and no boundaries and vast economic possibilities and opportunities available to those with the vision to see beyond the horizon.