THE POWER OF GROUPS

A guide to balancing market power through the establishment of Farmer Controlled Businesses

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INTRODUCTION

A large fresh produce processor once remarked that: "Ninety per cent of our produce is supplied by 40 farms and the last 10% is supplied by 100 farms".

Farmers continue to lose market power in a world where agri-processors and food retailers continue to grow their market power. The question is: How can this continuing imbalance be countered from a commercial farming point of view?

The English Farming and Food Partnerships or EFFP (2004), is an organisation based in the United Kingdom which helps farmers, through collaboration, to work together in a growing market organised in a structured and professional farmer controlled business (FCB). Their mission is one where farmers have a profitable and sustainable future – where working together in a group is the focal point.

The EFFP compiled a document stating that farmers can capture more value from the food chain if they have a better understanding of consumer needs and have the ability to work with others to supply those consumer needs in the most cost-effective manner possible.

The main goal of collaboration is the sourcing of inputs, achieving production and business efficiencies, and the effective marketing of outputs. Farmers can enjoy many benefits when they form an FCB, for example: Doing business in a more secure market where new opportunities can be created, farmers will be able to supply the quantity that the retailers require and this supply can be more consistent and of better quality.

But balancing market power more evenly, is the underlying objective. The problem is that farmers still do not position themselves correctly and diminish their market returns to levels that are determined primarily by processors and retailers. This guide can help to assist farmers to understand why forming an FCB is important, which steps to take in forming an FCB and how to manage it successfully and profitably in the South African market.

In short, farmers need to regain marketing power of their product and gain economies of scale to afford them greater bargaining power. And with collaboration seen as a possible solution, it follows logically that **a business model should be structured in which farmers are the owners, managers and beneficiaries.**

CHAPTER 1

Background and history of the dairy industry in South Africa

The industry has changed in terms of production areas and production/ consumption fluctuations, nationally and internationally.

1.1 Background and history of milk production in South Africa

Over the last 15 years or so, the South African dairy industry has gone through many changes. According to Marais (2007), the market environment has not only changed from a highly regulated one to a free-market system, but there has also been a decline in the number of producers, leading to a sharp increase in the size of farm enterprises, shifts in the important production regions and huge improvements in technology that have influenced dairy production remarkably.

Dairy farms were mainly founded in the Witwatersrand, Durban, Cape Peninsula and other large consumer areas prior to the 1950s. The reason for this is that land was relatively inexpensive. In those days cream farming was a comparatively low-cost activity, seeing as farming was based on crop residues and natural veld with relatively minimal, if any, supplementary feeding. As time went by the milk production regions eventually shifted from inland to coastal grazing areas (Marais, 2007).

According to *Agri Review 2007*, South Africa has been experiencing milk shortages since 2005. These shortages were expected to increase substantially during 2007/08. Production of milk increased at an average of 1% per year, well below the growth in demand at 4% per annum (*Figure 1*). Demand has increased due to the increase in disposable income of South Africans and consumers are moving away from starch products, choosing to embrace diets higher in protein, thus increasing the demand for dairy products.

One of the factors that caused a decrease in production, included a decrease in the price which the producer receives – a result of conflict in the supply chain, as milk producers lack market power (*Lacto Data, 2007*). The South African Milk Producers' Organisation (MPO) reports that South Africa is no longer a producer of surpluses. This shows an opportunity in the market for milk producers, as the shortage is not just national but also international.

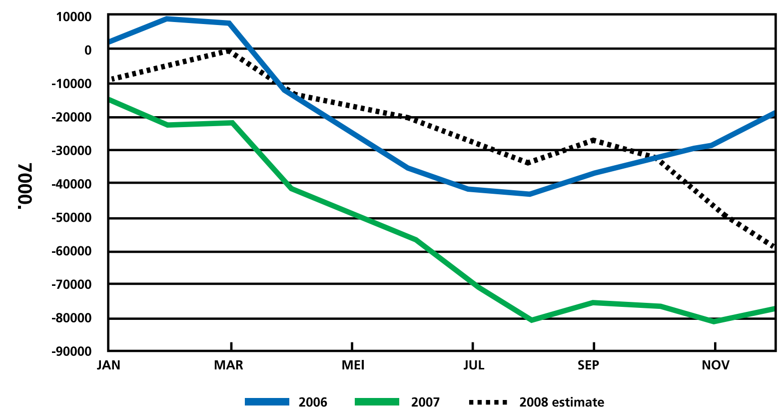

FIGURE 1: **Monthly cumulative difference between production and consumption (2006-2008)**
Source: Lacto Data, 2008

Feed costs make up between 60% and 80% of milk producers' direct production costs. Increasing maize and feed prices result in higher feed costs, adding pressure to producers' profit margins, as they lack the market power to pass on the increasing costs. As a group, though, farmers will have the economies of scale to be able to negotiate better prices for their product.

Table 1 sets out the number of milk producers per province from 1996-2007. These figures illustrate a total decline of 47% in the number of producers in the country. The Northern Cape shows the highest decline in milk producers, namely 74%. With such a decrease in the number of milk producers, one would normally expect the quantity of milk produced to also decrease.

However, looking at *Table 2*, it is evident that the percentage of producers producing on small scale (meaning less than 500 litres a day) has decreased. It is also clear that the percentage of producers producing more than 3 000 litres a day, has increased. This means that economies of scale are becoming increasingly important for producers to remain in business.

This state of affairs once again confirms the fact that producers are becoming bigger and that smaller farmers are finding it increasingly difficult to compete in such a market environment.

The quantity of milk produced, had increased between 1997 and 2007. To be exact, the average daily production of milk increased from 774 litres per producer in 1997 to 1 288 litres per day in 2004. Calculated in percentage terms, the average daily production per producer has increased by 66% (*Lacto Data 2007*). Yet this proves to be insufficient in meeting the needs of consumers and the growing market for dairy products in South Africa.

PROVINCE	NUMBER OF PRODUCERS PER PROVINCE				% CHANGE 1997-2007
	DEC 1997	JAN 2006	JAN 2007	JUL 2007	
Western Cape	1 577	878	827	809	-49%
Eastern Cape	717	422	420	411	-43%
Northern Cape	133	39	37	35	-74%
KwaZulu-Natal	648	402	385	381	-41%
Free State	1 204	1 067	987	924	-23%
Northwest	1 502	649	596	577	-62%
Gauteng	356	275	245	226	-37%
Mpumalanga	866	407	357	324	-63%
Limpopo	74	45	45	40	-46%
TOTAL	**7 077**	**4 184**	**3 899**	**3 727**	**-47%**

TABLE 1: **Number of milk producers per province 1996-2007**
Source: Lacto Data, 2007

DAILY PRODUCTION LITRES PER DAY	% OF PRODUCERS		% OF PRODUCTION	
	1995	2004	1995	2004
0 to 500	58	23	19	6
500 to 1 000	21	21	20	16
1 000 to 2 000	13	23	24	35
2 000 to 3 000	8	12	27	30
> 3 000	0	21	10	13

TABLE 2: **Distribution of milk producers, 1995-2004**
Source: MPO, 2004

1.2 International dairy industry

The international dairy industry has changed since the mid-1980s, in the sense that there has been a move away from bulk products (skimmed milk powder and butter/butter oil) towards value-added products (cheese and specialised milk powders) in the non-quota segment of the world market. While the bulk market still dominates the international market in terms of volume, it doesn't require too much imagination to see a future scenario where this will not be the case (Griffen 2001).

Griffen states that, in terms of demand, the section of the world dairy market falling outside the ambit of import quotas, has always been a volatile place. In the past, swings in the levels of a country's imports of dairy produce, were often associated with changes in government intervention in the market. Structural reform in a number of countries has meant that such direct involvement by governments, has been substantially reduced.

This process can be illustrated by the case of the former USSR. Following the post-1990 economic reforms, imports to the USSR were no longer performed by a single state agency, but rather by a myriad of small traders. This resulted in a change in the dynamics of the import market and large state-run agencies operating periodic tenders for substantial volumes of dairy products, are increasingly being replaced by private importers. In such cases where the suspension of state importation is also often associated with the curtailing of government subsidies to domestic consumers, this means that, at least initially, the change is often accompanied by a drop in total import demand. The consequence has been that all exporters, and in particular those that do not subsidise their exports, have had to move from bulk products and become more focused on consumer needs.

Such an approach opens the way for branding and national marketing reprocessing. Those countries that have, in the past, based their export industries on the use of subsidies, now show indications that their dairy industries are reorientating themselves towards value-added niche markets in areas where consumption is increasing or the cost of milk production is low. This process can be seen as both an adaptation to the reduction in export subsidies agreed to under the Uruguay Round Agreement (URA) and, in the longer term, as preparation for possible further reductions in any future rounds of multilateral trade negotiations.

As for the future, limitations on export subsidies under the URA and subsequent rounds of multilateral trade agreements, could effectively limit supplying the international market for bulk dairy products to those countries which can produce such commodities cheaply, for example Oceania, the Southern Cone countries of South America, and possibly India and some countries in southern Africa. One could assume that if these countries were given the chance, they would prefer to rather supply higher valued products. This tells us that the international dairy market is changing, both as a result of the URA disciplines and wider developments in the world economy.

Both factors are leading to a market which is more complex than that which existed previously. This complexity is reflected in the trading and distribution system, the range of products available, and the increased emphasis on meeting the demands of the consumer. Consumers are many and varied. The South American markets will become more export-orientated, but as a whole, the developing countries will remain substantial net importers of dairy products.

In the dairy market of the future, some will demand low-priced products, while others will pay a premium for quality and uniqueness. The challenge for dairy export countries, is to identify which markets they can profitably supply to and to focus their efforts on meeting the needs of consumers in these markets.

CHAPTER 2

Domination of retailers and price-fixing among milk processors

2.1 Milk industry: Competitive issues

There are currently four dominating food retailers in South Africa: Pick n Pay, Shoprite/Checkers, Spar and Woolworths hold the majority market share in South Africa. Together they have a market share of 94% and seeing that they are the link between the consumer and the product, they will have a substantial influence on the price of the product (Botha et al 2006).

The South African Competition Commission over the past few years investigated claims of price fixing in raw and retail milk prices among the major milk buyers/processors in South Africa. In some cases price information was exchanged and deals were made to sell surplus milk to other companies, rather than to the consumers.

"Excess" milk was removed from the market and producers were compelled to sell all their milk to specific buyers (Competition Commission, 2006). The same also happened in the United Kingdom, where dairy and supermarket groups were also heavily fined because of price-fixing with milk, butter and cheese prices. The cost to the consumers was £270 million because of this (MPO 2008).

Figure 2 is an illustration of the balance of power in the market. Farmers (producers) are at the bottom of the ranking, with consumers at the top. Consumers have the most power to determine market trends in terms of quality, prices and quantity. The processors and lastly the farmers (producers) have to respond to these trends via the retailers.

Many retailers have minimal direct contact with producers, seeing that they mostly communicate via processors, packers and intermediary marketing organisations. Indirectly, though, they have a considerable influence on the producer through specification of product and production standards. These trends in turn cause producers to suffer under vast commercial pressure (EFFP 2004).

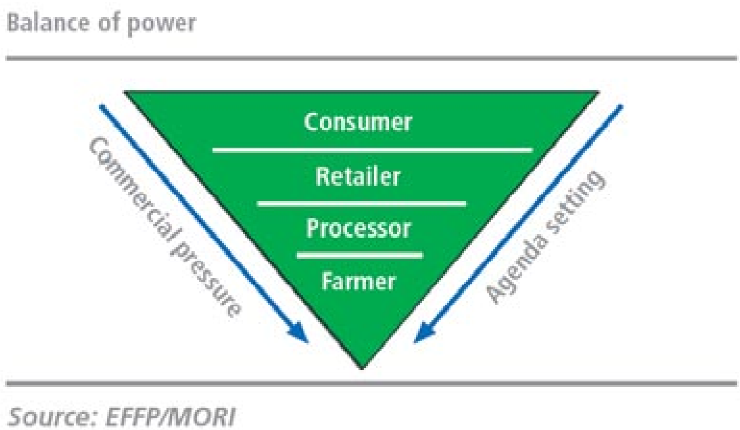

FIGURE 2: **The balance of power in the industry**
Source: EFFP, 2004

2.2 The influence of supermarkets

The South African supermarket sector is currently dominated by four big food retailers, namely Pick n Pay, Shoprite/Checkers, Woolworths and Spar. Together they have a market share of 94% and, seeing that they are the link between the consumer and the product, they will have a substantial influence on the price of the product (Botha et al, 2006).

According to Weatherspoon and Reardon (2003), supermarkets in South Africa have a 55% share of the national food sector retail turnover and form only 2% of the 70 000 stores in the formal sector (see *Figure 3*). While so-called superrettes (store sized between supermarkets and convenience stores) also make up 2% of the 70 000 stores, their share of the formal retail sector turnover is only 10%.

The remainder are convenience stores (2,3% of the 70 000 formal sector stores), with a share of 4,1% of retail turnover; small stores, where the customer asks for the goods at the counter (25% of all the formal sector retail stores and 4% of turnover); rural self-serve (6% of formal retail sector and 8% of turnover); and lastly "rural counter" and self-serve (62% of stores and 19% of turnover).

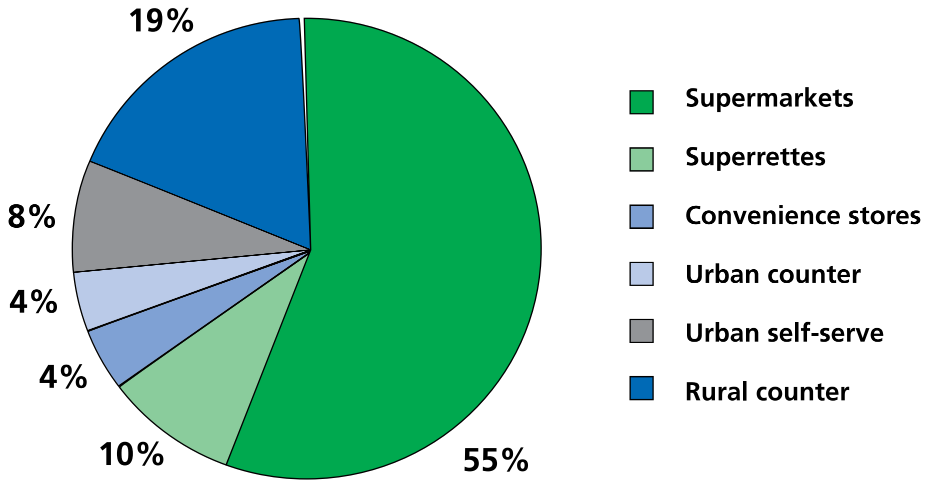

FIGURE 3: **Percentage of formal retail sector turnover**
Source: Weatherspoon and Reardon, 2003

The supermarket sector is growing at a rapid pace, which means they will continue to influence and dominate the structure of the agri-food system. Urbanisation and the increase in income of the population, are contributing factors. Supermarkets are diffusing and then rapidly consolidating their procurement systems in order to gain economies of scale. This requires producers to deliver larger volumes.

The only way that this is possible, is through tight coordination among many small producers, who combine their supply to meet the high-volume demand over an entire year (Weatherspoon and Reardon, 2003).

The current free-market structure in South African agricultural industries, resulted in primary producers left without farmer-controlled structures, as most previous cooperatives converted into companies, with primary producers becoming minority shareholders and outside controlling shareholders having a profit motive.

CHAPTER 3

The importance and contribution of FCBs internationally

3.1 Overview of international FCBs

The EFFP (2004) defines a farmer controlled business (FCB) as a legal entity, which is commercial and is managed and controlled by farmers or farmers' organisations. An FCB enables its members to buy inputs in bulk, share machinery and assist members in negotiating better prices for their products.

The problem is that producers have lost control over their product. Buyers' milk tankers fetch the product from the producer, the buyer tests the samples, issues the invoice and decides which price he will pay the individual producer. It is also quite common for buyers to pitch producers against each other, in order to keep control of the buying of milk.

But this is not how things should be done, and producers need to regain power over their product and become price-makers – not price-takers. Therefore the farmers should collaborate on issues such as transport, sample testing and invoicing. These actions and exercises will always cost money, but doing it in a group will possibly bring the costs down, while at the same time increasing the market power of the group, thus putting them in a better position to negotiate the best price for their product. This again leads to the group being the price-setters and not the price-takers (Midlands Milk, 2008).

Figure 4 illustrates the level of value that is added by different countries' FCBs, through processing and service delivery. The EFFP (2004) found that England's total FCB output is only 30-35% of the country's gross agricultural output. In Sweden and Denmark FCB output is twice that of their agricultural output.

Comparative figures are not available for South African agriculture, but the consensus among industry leaders is that it is below the English number.

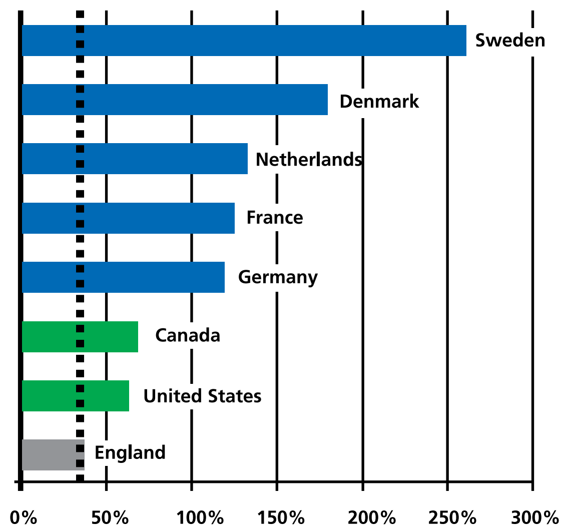

FIGURE 4: **Cooperative turnover compared to agricultural output**
Source: EFFP, 2004

3.2 The importance of FCBs internationally

The EFFP conducted a study in 2003 in the United Kingdom, where they asked their study group what they regard as collaboration and how important they think collaboration will be in the future. They found that, although farmers have collaborated to buy inputs (almost 60% of the larger farms), they do not consider this as collaboration.

In the group, 76% of the farmers believed that collaboration (*Figure 5*) will become increasingly important in the future, while only 4% thought it will become less important (EFFP, 2004). The increases in input prices have caused farmers to form groups that buy inputs together. By doing this, they do not need to buy machinery as individuals and they can negotiate a better price because, as a group, they can buy in larger volumes. These groups are usually informal, loose arrangements, with no formal contract between the members.

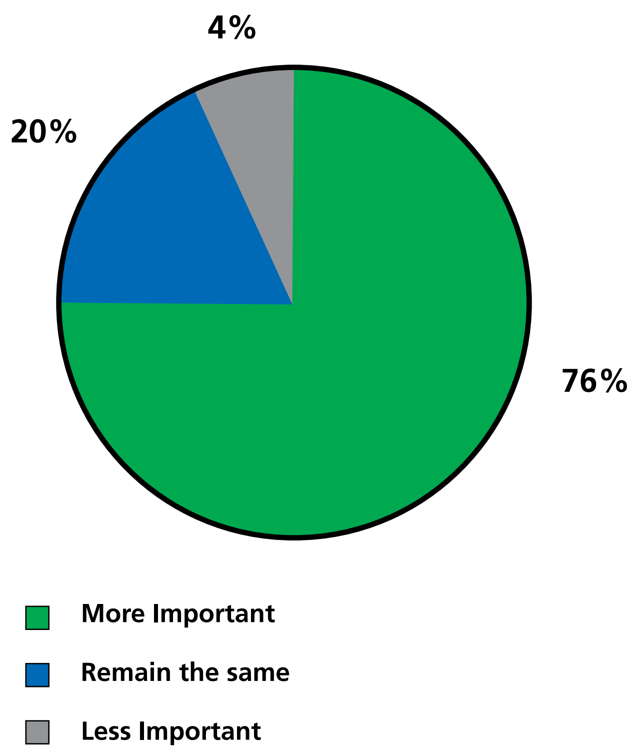

FIGURE 5: **Future importance of collaboration**
Source: EFFP, 2004

CHAPTER 4

A guide to and comparison of the various forms of agri-business

Forms of business can vary from a loose association (buying inputs) to a formal entity (cooperative/business)

4.1 Forms of business

There are different forces continually at work in the market place, and requiring change. There are also different debates surrounding businesses in South African agriculture. These debates are increasingly gaining momentum, because more and more farmers realise that if they collaborate, they can increase their market power and most probably be able to better protect and manage their own survival as a business. This can only be accomplished if the market power of all the participants is balanced.

Milk producers have known this for some time now and the findings of the Competition Commission confirmed this at the beginning of 2007. The question is: How do you balance the market power in an environment where the market concentration is increasing on the processors' and the offset (supermarket) side.

International competition in the local market is increasing as well. This situation is not unique to South Africa; many studies are currently being done in England on how to improve the market power of the producers and also how they can effectively and profitably be part of the value chain. FCBs in Europe are quite large via their share-holding in primary cooperatives; they have a market share of 45-99% in processing and value adding businesses in the dairy industry (EFFP, 2004). This is definitely not the case in South Africa.

Therefore the question is how farmers as a group can increase their participation and market power in the supply chain. FCBs can play an important role in bringing producers together to guarantee the traceability, critical mass and requisite levels of service delivery, and thereby meet the changing demands of consumers (EFFP, 2004).

Different business structures can be used as a vehicle for an FCB. These can differ from a loose agreement through to cooperatives and companies. The structure will be determined by the producers involved in the initial phases, but normally will evolve from an informal cooperation into formal business structures. The revised *Cooperatives Act* in South Africa, remains a useful business vehicle and continues to be used successfully in the USA and Europe.

4.2 Cooperatives Act

The following is an extraction from South Africa's new *Cooperatives Act, 2005*:

"The *Cooperatives Act* was renewed in 2005, with the objective to make it more usable as a business form among smaller groups of like-minded people. The purpose of the revised Act is to establish sustainable cooperative principles, thereby increasing the number and variety of economic enterprises operating in the formal economy.

"The membership of a Cooperative is voluntarily to persons who accept the rules and responsibilities of the Cooperative. In Primary Cooperatives the members are allowed one vote each. Secondary and Tertiary Cooperatives may

OWNERSHIP	SOLE PROPRIETARY	PARTNERSHIP	COMPANY	COOPERATIVE
	INDIVIDUAL	TWO PEOPLE	SHAREHOLDERS	MEMBERS
Management	The owners are responsible for management and take all the major operational business decisions.	Partners share the management and take joint business decisions. Some business decisions are made taking into account the senior partner, who will have a greater say in the matter.	Management is controlled by the board of directors and associates, who is elected by the shareholders. Each shareholder usually has as many shares as voting rights.	The board of directors elected by the members, manage the cooperative. Each member only has one vote when electing directors, irrespective of how much equity the member has in the cooperative.
Capital	The owner invests capital in the business and is held responsible for any debt.	Partners provide the equity. Usually, every partner is responsible for the partnership's debt, which is equal to the net worth of his/her property.	Equity is obtained through the sale of shares to investors who want to make a profit. The company is liable for its own debt. Each shareholder can lose the amount of his/her investment, should the business fail.	Equity comes from members. It is obtained through direct contributions in the form of membership fees or the sale of stock or by saving a share of the income made from the selling of each unit stock marketed through the cooperative. Each member is responsible for the quantity that they invested, should the cooperative fail.
Profit	Profit belongs to the owner.	Profit (or loss) is shared among the partners, in accordance with the partnership agreement.	Profit is paid out to the investors as dividends, according to the amount of shares that he/she owns or it can be used to expand the business.	Profit is expressed as the use that the members could derive from the cooperative.
Tax	Income is taxed only once, as an income of the owner.	Income is taxed once; as an income of the partners.	Income is taxed twice; first as the income obtained by the company, and then as the income received by the shareholders through dividends.	An agricultural co-op with a turnover of less than R16 million, is classified as a Small Micro Enterprise for tax purposes, subject to two requirements: (1) The cooperative must be a non-profit organisation and (2) members may not have shares in another company. If any of these requirements are not met, then for tax purposes the co-op will be classified as a company and will pay tax accordingly. Dividends paid out to co-op members are exempted for individual tax.
Lifespan	The lifespan of the business is directly related to the owner.	The lifespan of a partnership is determined by the partners. If one dies or leaves the business, the business should be closed and a new partnership formed.	Companies can continue to operate indefinitely, irrespective of what happens to the ownership.	A cooperative will still be able to operate, even when members leave.

TABLE 3: **Different business models**
Source: Land O'Lakes

adapt their constitution so that a member can have more than one vote, on condition that it should not exceed more than fifteen per cent of the vote of all the members of the Cooperative.

"One of the objectives of the new *Cooperatives Act* of 2005, is to specially assist emerging farmers to form cooperatives. The reason for this is that the government understands the importance of cooperatives to help in rural areas with not only service delivery but also to provide food in those areas."

The Act is divided into different sections, with the following titles:
- Application to register the cooperative
- Constitution and powers of the cooperative
- Registered office and record-keeping by cooperative
- Membership of cooperatives
- General meetings
- Management of cooperatives
- Capital structure
- Audit of cooperatives
- Amalgamation, diversion, conversion and transfer
- Winding-up or de-registration of cooperatives
- Judicial management
- Admission of the Act
- Cooperatives advisory board
- Miscellaneous provisions
- Special provisions relating to certain kinds of cooperatives

The Act gives an outline of the process to be followed, but also the key business principles that should be embodied in the structure and conduct of the business. It can play an important role in bringing producers together to guarantee the traceability, critical mass and requisite levels of service delivery, and thereby meet the changing demands of consumers (EFFP, 2004).

4.3. Network association

This model allows a group of farmers to join forces and function within a formal business structure. This is the first step to working together in a contract form. The volume, price and quality of the products are decided upon beforehand. The business manages aspects such as product volume, quality control and price negotiation. One of the requirements is that a clear description should be given of the products with which the members want to trade.

In some cases it is possible to have standardised contracts between members and also the business structure and their members, as well as guidelines in respect of operational requirements to be part of the network (net) association. A very good example is a group of producers that are in a partnership, who sell their milk to a processor. They negotiate the requirements regarding quality, quantity as well as delivery date beforehand.

The contracts can be flexible and changes can be made within any business period. This will result in a high-value final product because of better coordination in the chain. Demand can be more closely correlated with supply within a flexible, yet agreeable framework, allowing closer contact with the first buyer in the chain.

Later it will also be necessary to set up a legal framework. Information shared among members as well as the price basis of the contract, will be more transparent. The level of organisation can vary, meaning that members can be closely managed or they can be externally managed in a flexible way (Gonzalez-Diaz et al, 2007).

There are no barriers to entry, except that members should accept the basic rules of the net association. A barrier to exit can be that the member should first deliver on his binding contract. The members can decide among one another if they would like to tender for a contract. If they are successful, they are encouraged to appoint a professional coordinator. Another option could also be to position them in such a way, that they can share any overhead costs.

Because of this, the net association helps to bring supply and demand closer together. Another purpose of a net association should be to enhance independence, communication and flow of information and create an environment where there is mutual trust among members. Although the entity operates in a contractual legal framework, it is very flexible. As the net association becomes bigger and more successful, the members can decide if they wish to form a cooperative.

4.4 Cooperatives

Remember: A cooperative is a business and should be run like a business. Therefore it requires:
- Careful market analysis
- Sound business planning
- Competent management
- Adequate capital for start-up and growth

A cooperative as a business entity is regaining popularity worldwide; the main reason being that it is based on the principle of cooperation. However, South African producers will have to move away from the notion of old-generation cooperatives, where decisions were politically and emotionally motivated, and not necessarily in the best interest of the larger group in the business. In this regard, it is a prerequisite that members should be very clear on the business goals and annual business targets.

Cooperatives as a business entity, is not only gaining popularity internationally, but also locally. This was emphasised with the publication of the new *Cooperatives Act, 2005* and also by the work that the American cooperative, Land O'Lakes, is doing. Land O'Lakes is not only actively involved in the establishment of cooperatives in Africa, but is also presenting cooperative training courses in association with the University of the Free State.

Land O'Lakes is one of America's premier farmer-owned cooperatives. They are the leading marketer of dairy-based products and their brand is recognised not only nationwide, but also internationally.

In America, cooperatives make a large contribution not only to the communities that they serve, but also to the economy. This is proven by the fact that the 250 purchasing cooperatives offer group buying-in shared services to more than 50 000 independent businesses. The 270 telephone cooperatives provide services to two million households. Putting this into perspective: Cooperatives in the US serve 120 million members, or four in every ten Americans (Land O'Lakes website).

One of the objectives of the South African government, is that cooperatives should assist with service delivery in the rural areas. Looking at cooperative statistics, these entities can very well be a means to help the government achieve that objective.

A cooperative is usually founded by a group of individuals who want to work together to reach a common goal. They buy shares or pay a membership or joining fee to be part of the cooperative. The shares give the members voting power, which they can trade, thus giving them profit gains.

The members vote for at least three directors, who are responsible for the daily running of the business. The directors must report back to the members. A very important principle is that a co-op is a democratic entity which is controlled by the people who work in it. Their primary goal is not to make a profit from the business, but to gain market power and in the process be financially viable to stay in business.

Co-ops are classified according to the reason for their existence. There are two levels of co-ops: A primary level and a secondary level. There has to be at least five members in a primary co-op. Close partnerships and providing essential services to gain economies of scale and market power, are some of the main objectives. There can also be other goals, for example to provide certain goods and services to its members. The members of a primary co-op can later form part of a secondary co-op (Department of Trade and Industry, 2004).

How it works, is that the members deliver their product to the co-op and the quantity of the product they intend to trade, will be determined by the rights that they have bought. This encourages member loyalty and gives the members a sense of loyalty towards the co-op.

Members receive market prices for their product, as well as additional incentives which prove the ability of the co-op to add value to their inputs. This emphasises the clear distinction that can be made between the products that the farmer delivered and how successful the co-op is as a business.

In a co-op, the members decide at the end of the financial year, whether they should divide the profits among themselves. This is different from a closed corporation or company where the members receive dividends. The profits are divided among the members based on a ratio of how much business the member has done with the co-op. The higher the ratio, the higher the amount received by a member. The main reason for the establishment of co-ops in South Africa, is to assist in improving infrastructure and service delivery in the rural areas. Not only do they provide financial assistance to farmers, but can also be used as a vehicle to increase market power (*www.seda.org.za*).

The marketing co-op business model is known to producers in South Africa and can be developed as a business structure to increase farmers' market power.

The previous directorate of the Department of Agriculture was moved to the Companies and Intellectual Property Registration Offices (CIPRO) on 1 April 2005. This was done to allow the office to become much more business orientated than it had previously been. The numbers of cooperatives traditionally registered in respect of agriculture, were already being overtaken by the numbers registered for trading co-ops.

The number of new registrations for the financial year, 2005/2006, showed an increase of 55, 4% compared to the 2004/2005 financial year. This sharp increase is, among others, attributed to the fact that provincial governments have attractive incentive schemes in place, and that government has initiated awareness campaigns explaining the advantages of co-ops (*CIPRO Annual Report,* 2006).

According to the *CIPRO Annual Report* for 2006/2007, a total of 6 765 new cooperatives were registered for the 2006/2007 financial year, taking the total number of registered cooperatives in South Africa to 13 496.

CO-OP STATUS	2003/2004	2004/2005	2005/2006	2006/2007
New registrations	532	511	2 829	6 765
Deregistrations	220	79	135	200

TABLE 4: **Cooperative statistics, 2003-2007**

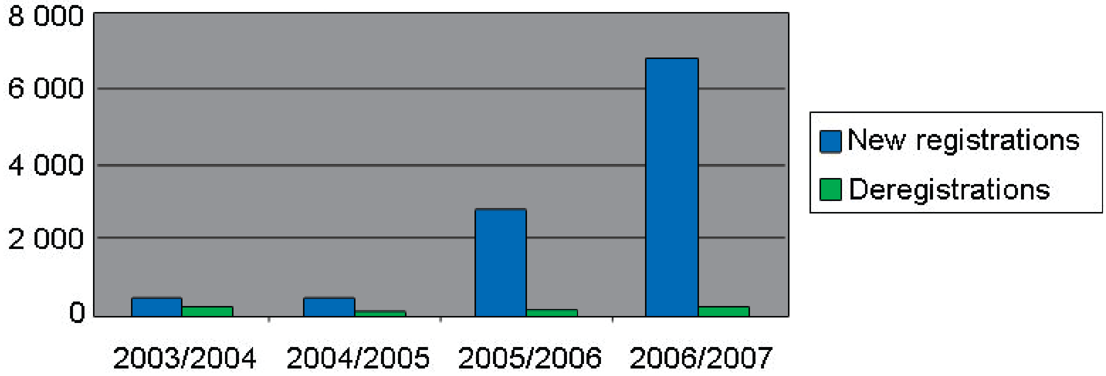

FIGURE 6: **Cooperative statistics, 2003-2007**

4.5 Net business

This type of business model was named by Gonzalez-Diaz et al (2006), but it is based on the same principles as a traditional registered company. The main difference is that the shareholders are now companies that are active in a specific supply chain. Every member company or co-op owns shares in the overarching net company and it is therefore to their advantage to share information and make sure that every level of the business is successfully managed.

The structure can be organised horizontally or vertically, which means the shareholders can be a group of primary producers (FCB), processors, input companies, traders, financial institutions and a supermarket or a specific retail outlet, to mention but a few. The business contracts only the best supplier which complies with the high quality standards and business goals required. This encourages excellent service and increases the dividends which the shareholders can earn.

A way to create an even bigger incentive for the shareholders to improve their performance, is to issue different types of shares that will give members different profits and determine their voting power.

This business structure is also suitable to enhance a trademark, with specific product qualities. The promotion of the trademark and increasing of market share, will be shared by all the members in the group. This will enhance further cooperation in the specific supply chain and give rise to a better competitive position in the market, and distinguish the group’s product from others in the market place.

CHAPTER 5

Principles and guidelines for business operations

The following information was derived from interviews with persons who are currently involved in successful farmer controlled businesses in South Africa. These interviews were done on-site and according to a structured questionnaire during late 2007 and early 2008. Irrespective of which business entity you are involved in, the basic criteria or checklist remains the same. The objective was to determine the basic principles according to which businesses operate and to establish guidelines for others in the primary agricultural industry who wish to follow suit.

5.1 Background on the organisations

5.1.1 Founding

Most were formed in the last two years and wanted to improve their market power and ability to negotiate better prices for their product.

5.1.2 Reason for establishment

FRBs need to find common ground on which to base their establishment. Judging from the interviews and the reasons given, it is cheaper to collect the milk in bulk, than to collect small quantities at a time. The entity can contract its own transport to collect the milk from members and deliver it to the buyer. The location and concentration of the members are very important for the optimisation of logistical factors. Price advantages on bulk deliveries are also given to groups, which creates the incentive for farmers to buy inputs as a group.

The following were areas recognised as sources requiring improvement or providing an opportunity:

- Lack of transport
- Buying in bulk
- Communication
- Marketing
- Sharing costs.

5.1.3 Number of members

- The number of members vary between five to 50
- The important thing to consider is that members should be located fairly close to one another or along a similar route. This will make the collection of samples and milk easier and cheaper
- Restricted membership leads to stability for producers and for the entity
- Because the shareholders come from different backgrounds, they ensure that the interests of the community are protected.

5.1.4 Member responsibilities

- Elect and remove committee members
- Adopt and amend constitution as well as resolutions and motions presented at meetings

- Approve changes in capitalisation and major expansions
- Require the officers, directors, employees to carry out the provisions of the constitution
- Require an accounting at least annually
- Assist in financing the organisation
- Support the organisation through patronage and, if possible, get others to do so
- Pay your account on time
- Become active in the cooperative's affairs by attending meetings, serving on committees, accepting special assignments, and genuinely backing the organisation
- Abide by the decisions of the majority
- Criticise constructively and suggest new ideas without requesting special favours
- Remain informed about the cooperative by reading minutes of meetings, and conversing with directors or employees
- Defend the cooperative and its management when attacked or criticised unjustly
- Cease being a member if thoroughly dissatisfied with the cooperative, and before ruining the cooperative for others.

5.1.5 Management

- The directors are voted for by the members
- The board of directors is responsible for setting the cooperative's strategy, goals and objectives, and for hiring a manager (when necessary) or contracting members to perform specific tasks in the business
- The manager (or specific members) is again responsible for following through the objectives, strategies and goals that the board or group has set
- The manager should also report back to the group and the board
- The board of directors and management must benefit the FCB as a whole
- The inspiration and driving force should come from within the group and not an external source, because the business can collapse when the external source leaves the group
- The success of the co-op/FCB is directly related to the trust and confidence the members have in those who manage the co-op (which can be the members or an outside individual)
- It is also an added advantage if the management can be performed by group individuals with specific expertise (Katz and Boland, 2000). One example is where there is a veterinarian on the board of directors - he will be able to assist with animal health problems. The same goes for lawyers or accountants.

5.1.6 Asset management

- Each farmer manages his own assets
- The members pay a premium to the entity and the money is used for buying necessary equipment for the entity (e.g. milk testing equipment, transport vehicles).

5.1.7 Shareholding

- Each member is issued one share
- Profits can be paid out in the form of dividends
- By law the receiver of those dividends (paid out after 1 October 2007) is required to pay 10% tax on the amount received.

5.2 Contract between producers and FCB

5.2.1 Volume

- Most businesses or co-ops have a minimum volume requirement that producers should comply with. In some cases the flow of volumes within specific guidelines can also be agreed on, which will make future contracting to a buyer easier
- Seeing that there are shortages in the milk market at times and a producer may deliver more than what is expected of him, the business should have some guidelines in place as to how this will be handled or the produce sold within or outside of the business.

5.2.2 Grade and quality

- The FCB only accepts milk according to pre-specified quality criteria, for example a temperature of 4°C
- Most FCBs collect the samples themselves (as it is still their product) and send it to an independent laboratory in Pretoria, where it is then tested. The results are verified with the buyer and used as a basis for payment
- When the company has evolved, it can acquire its own laboratory to perform tests. An effective way to do this is to hire someone (family member in the group) who goes around to members, collecting their milk
- A person can also be employed to help individual producers to enhance and maintain the quality of their milk.

5.2.3 More considerations

- The milk should be kept at 4°C
- The producer must take his own sample; this enhances accountability and instills a sense of responsibility
- The producer should receive a weekly report on the quality of his milk. This allows him the opportunity to correct any errors or improve on his current quality status
- A good example is a company which requires its producers to take their own samples. Someone else will collect the samples, tests are done on a weekly basis and the results are then posted on the group's own website. No names are disclosed. Rather, each producer is represented by a number.

5.2.4 Payment terms

- This depends on negotiations with the buyer
- Supply contracts are used to regulate the flow of milk/produce that can easily attract premiums from the buyer and leads to much better coordination within the supply chain, and more effective marketing and profits. This will result in an incentive to the farmer to produce in the months when supply is low. This pushes the milk price up
- The producers get paid according to the volumes and quality they deliver
- Major suppliers (producers that supply the biggest percentage of the co-op's milk) can be paid more than smaller suppliers
- Producers can have their own invoice books, sending the invoices out on a regular and agreed-to basis, to the financial manager/member of the company who does the payouts
- In other cases the producer can be paid directly by the buyer and they can then pay a premium to the FCB they belong to.

5.3 Contract between organisation and buyer

5.3.1 Volume

- The buyer and FCB can negotiate the volume that they require beforehand
- If the FCB produces surpluses, it can be sold to their buyer or a sale can be negotiated with another buyer
- In many cases the volume that the buyer would purchase from the FCB is not flexible, except when there is a shortage of milk in the market.

5.3.2 Grade and quality

- The grade of milk and quality is based on a set determinant.

5.3.3 Payment terms

- The buyer can either pay the producer directly according to the invoices received or pay the FCB and the FCB will then pay the producer according to the volumes sold
- The members pay a certain amount to the FCB, which is then used for administrative expenses and to pay the manager's salary.

5.4 The functions of an FCB

- Bargaining for better and fairer prices with processors and distributors on behalf of producers, based on volume, etc
- Guaranteeing producers a market for their milk
- Checking the weight and test results of producer's milk
- Collecting market information which is then passed on to producers, thus assisting with business planning at farm level
- Gaining access to technology, marketing channels, technical expertise and vital market information
- Providing access to capital and equipment
- Reducing production costs and increasing production efficiencies
- Collective decision-making and the sharing of marketing and transport costs, thus contributing towards reduced costs
- Helping the producer to handle market shocks better, because the risk is now divided among the members and with better flow of information from the buyer/market place
- Putting the producer in a stronger bargaining position
- Acting as a network linking producers, resources, funding, government and others.

5.5 Disadvantages of forming an FCB

- Loss of individual autonomy
- Additional costs because of the coordination of the production process and other business issues
- Having to work in a group, where you are not necessarily the leader
- Many of the farms that are too small to be included in an FCB, could be put out of production.

CHAPTER 6

Adopt the right habits

6.1 Habits of a successful FCB

When the decision has been made to start the FCB, there are certain elements that the FCB has to comply with to ensure a better than average chance at succeeding.

Consult experts in the field of FCB development: It is good to consult with experts in the field of FCB development, such as lawyers and other advisors. It is also not unusual to rely on outside help in the start-up phase of the cooperative.

Always consult and inform the members: It is management's responsibility to communicate regularly with members. A good idea is an own website with a link where members can exchange ideas and find the latest news pertaining to the FCB.

Maintain good relations between the board-management: The board is responsible for developing a policy, employing a manager and providing adequate financing for the FCB. Each board member should have a clear understanding of what their roles and responsibilities are.

Meetings should be conducted in a professional and business-like manner: Meetings should be planned in advance and conducted in a business-like manner. This means that there should be a set agenda. It will be an added advantage if the chairperson has some experience in conducting business meetings.

Follow sound business practices: Standard accounting procedures should be followed where financial reports are compiled, audited and presented to the board, who will then inform members accordingly. Management should monitor finances to decrease costs.

Build links with other FCBs: It is good to form alliances with other FCBs; they may be valuable as sources for supplies or marketing opportunities. Try to learn from their mistakes or good practices.

The benefits of joining the FCB must be clear: If the FCB sets out the advantages of joining its ranks in a clear, transparent manner, then potential members will be more inclined to join the FCB.

Binding agreements are encouraged: A big mistake that participants can make, is to try and take advantage of all the benefits, while trying to avoid the cost of joint efforts (they avoid giving up their independence and don't want to abide by group decisions). Therefore a binding agreement is encouraged that includes the level of participation which each entity has to comply with (Rapp G, 1995).

6.2 Factors critical to the success of an FCB

Positive	Negative
• Education about FCBs • Shared vision of the business's goals • Should have realistic goals	• Lack of shared vision • Hidden agendas
• Trustworthy/honest members • Management should have a variety of skills • Must be hard-working and motivated	• Only want the benefits and not willing to put in the time or effort
• Examine your target market	• Failure to properly explore market
• Success will depend on the commitment of each member's time and the final resources available	• Proceeding with the business idea when it is not economically feasible • Not enough member participation
• Appoint a proper consultant with good references to help prepare a business plan • The consultant should be familiar with the industry	• Appointing a consultant who is not knowledgeable about the industry
• An extremely sound and well-constructed business plan will assist in obtaining financing	• A poor business plan will not interest investors to invest in the business • If the members don't trust the management, they will invest less of their own money, which means that more capital will have to be sourced

TABLE 5: **Factors critical to the success of an FCB**
Source: Land O'Lakes, 2007

CHAPTER 7

It's decision time

So, you think that an FCB might be the option for you? Then take a good look at the following questions. If you can answer yes to each of them, then you will know that an FCB is the right answer. These questions are listed as steps, and represent a logical process on which to base your decision.

STEP 1
Is there an economic need?

↓

STEP 2
Is there member interest?

↓

STEP 3
Can an FCB offer a solution?

↓

STEP 4
Is the FCB plan feasible?

↓

STEP 5
Are resources available?
Are members committed to the FCB and their contracts?

Source: Rapp G, 1995

CHAPTER 8

Compiling a business plan

8.1 Agri-business plan

8.1.1 Business profile and summary

Here an overview of the business's profile should be discussed to give a general impression of what you have in mind and how you propose the business should work.

8.1.2 Mission objective

The mission of the business is three-fold, each being as integral to your success as the next. These objectives should also include the business's long-term and short-term goals. It puts into perspective where the business is now and where it wants to be in the future.

Product mission: Provide customers with the finest quality product.
Community mission: Provide community support as an entity owned by the community it plans to serve.
Economic mission: Operate and grow at a profitable rate through sound economic decisions.

8.1.3 Business activities and targets

Marketing plan
- Here you should include what the business plans to market, if there are possibilities for expansion and any new marketing ideas (new buyers, new product developments)
- Increase sales and market share by developing a brand name
- Improve packaging and promotional activities.

Production plan
- Describe what the business plans to market
- Produce alternative products
- Produce value-added by-products and materials.

Management and labour plan
- Share workload internally
- Train and upgrade to handle new products
- Minimise hired help.

Financial plan
- Pay off debt according to payment schedules
- Investment strategy
- Build equity.

8.2. The business organisation

8.2.1 The company

- This should include the type of business you are starting (cooperative or public company)
- Your target market and how you plan to be successful in the market you are serving, should also be included.

8.2.2 Mission statement

The mission statement is a short-term goal for the business; it explains what you stand for and how you plan on differentiating yourself from other agri-businesses. A mission statement is important in that it gives the members a sense of direction and clarity on what the business wants to achieve. The mission statement forms the basis for the vision statement.

8.2.3 Vision statement

The vision statement explains what the business wants to achieve in the future. The vision statement is more of a long-term goal for the business and is important because the vision statement will be achieved when the business feels that the mission statement was successfully achieved.

8.2.4 Principles to achieve goals

These principles are important to the success of the business and should be the principles of all the members, as the members are part of the ownership and management of the agri-business.

8.3 Products

Here the following should be included:
- Delivery
- Volumes
- Quality standards.

8.3.1 Competitive advantage

This should include what the business plans do to differentiate itself from other agri-businesses. This can be in terms of the product, and the marketing or delivery of the product.

8.3.2 Technology

This heading includes research of new technologies, which can be done in association with your buyer or within the business. The objectives should be to minimise costs and improve the quality, volumes or method of marketing.

8.4 Market analysis

This should include the target market (food, service delivery) and the recognised need within the community. The need within the community can be in terms of the transport of their product, buying inputs or having economies of scale to profitably market their product.

8.4.1 SWOT analysis

The following entails a SWOT analysis of the agri-business

Strengths
Look at the strengths that the agri-business will have – this can be in terms of lower costs or taking more of the responsibility for the product in terms of delivery, quality control, marketing or improved technologies. Here you should impress your buyer.

Weaknesses
Here you should take an honest look at the weaknesses of the business. This has its advantages in terms of which it will assist the members in pinpointing how and where they need to improve the business.

Opportunities
This is also aimed at assisting the members to pinpoint where the opportunities are in the market. The more the opportunities, the better it is for the business, because this shows how much potential the business has to be successful.

Threats
Here the threats to the success of the business should be discussed. The following can be threats:
- Member participation/loyalty
- Management
- Natural disasters (floods, droughts)
- Economic instability (politics, inflation, interest rates)
- Government (instability, policies).

8.5 Marketing plan

Based on the SWOT analysis, the marketing strategy for this project will aim at capitalising on the strengths of the agri-business. Discuss how you plan on marketing your agri-business and how you plan on selling your product to your buyer.

A reliable pricing model should be developed to ensure that you negotiate the best price for the inputs you are purchasing and for the product you are selling.

8.6 Management and personnel

Management should be elected by the members. It can be an outside organisation, but the ideal is that the FCB should be owned and managed by the members that belong to it. This will encourage members to ensure the success of the business, as they will also be the beneficiaries at the end.

8.7 Financial plan

Here forecasts should be made to predict the financial viability of the entity. This also determines how much capital is required. The ideal would be that the members should invest the initial capital, which will ensure that they are the sole owners of the agri-business.

CHAPTER 9

Case studies of successful FCBs

9.1 Mountain View Harvest

This American Cooperative was formed after their traditional cooperative, Farmers Marketing Association, went bankrupt in an attempt to save a market for the producers' wheat. The members of the Mountain View Harvest Cooperative became the first farmer-owned bakery, after they bought an established bakery.

They kept the management as it was when they bought the bakery, but were required to expand very quickly as the demand for their product increased. This expansion came at such a fast pace that, although they started with sufficient investment capital, they were kept on a tight financial budget.

The fact that they bought an already established bakery, allowed them to move rapidly into the production stage rather than struggling with the building of a new facility. The expertise of the employees was also a great help to the members of the cooperative and contributed to the success of the products.

9.2 Home Grown Wisconsin

This FCB was formed to help organic producers to increase their marketing area and profits. Farmers who were interested in sustainable agriculture, collaborated in a cooperative to enter new markets that, without the volume they produced as a group, they would not have been able to enter.

The cooperative had to pull through a few setbacks in their start-up phase. But not only have they increased the volume of high quality product that the members are producing – they are also making good profits and eventually expanded their market.

9.3 Midlands Milk (Pty) Ltd (KwaZulu-Natal)

Midlands Milk is managed by Allan Penderis of Tammac Consultants cc. Midlands Milk's mindset should guarantee them success: They see their milk buyer as their customer and although they respect their customer, they do not give control and decision-making power to the customer. The seller should provide the buyer with a product that is different from that of their competitors, so as to attract buyers and keep them as clients in the long run.

Traditionally the producer has been a price-taker in terms of both his inputs and his outputs. Midlands Milk, although in all cases taking the needs of the market and its customers into account, strives not to be pure price-takers when it comes to selling its product.

"Midlands Milk was started in 2006 by a group of dairy farmers in the Midlands of Natal, led by René Stubbs. The guiding principle of Midlands Milk (Pty) Ltd is "to ensure a continuous and sustainable supply of high quality milk, ensuring that the respective needs of both processing and retailing industries are met, whilst ensuring an equitable and reasonable share of economic benefit to all the participants in the value chain".

They currently have approximately 30 members, producing approximately 80 million litres of milk per annum or about 4% of South Africa's milk. The members are situated in relative close proximity of each other between Howick and Mooi River, making transport relatively efficient. The management of Midlands Milk consists of five directors and a manager.

They strive to provide their buyers with A-grade milk. Testing is done by Lacto Lab (Pty) Ltd in Irene, Pretoria. Midlands Milk members take their own milk samples for testing on a weekly basis. This is just another way in which producers take control of their product. Samples are delivered to a number of "sub-depots" from where they are collected, packaged and dispatched to the laboratory. Results are e-mailed to the farmers and posted on the Midlands Milk website, normally by the following afternoon. By reporting the results quickly, the producer is more likely to be in a position to take corrective action if necessary.

Since a relatively stable supply of milk is essential to ensure market and therefore price stability, Midlands Milk has a quota system in place. Producers earn quotas during the traditionally low production months from February to May each year. The quota is then applied between July and the following January. Quotas cannot be purchased, only produced.

Each producer has his own milk receipt book, which he uses to record milk sales. Milk producers also invoice the buyers directly. On the fifteenth of every month the buyer pays the producer directly. Prices are negotiated every three months. Midlands Milk has developed the Base Price Indicator Model, an aid in price negotiations. This is available on their website.

If the producers have surplus milk, the company will help the producers to sell the surplus or the producers can negotiate with their buyers to buy the surplus. Midlands Milk therefore also requires their producers to supply production forecasts every three months. This is done on an Excel template, provided by Midlands Milk, and available on their website.

Midlands Milk has a highly structured and well-managed system which makes them a great example to learn from.

(Case studies extracted from Waner, 1999)

CHAPTER 10

Agricultural Cooperatives and the Competition Act

At first glance, the promotion of cooperation might seem at odds with the *Competition Act*. However, collaboration among potential competitors is also possible through other arrangements such as joint ventures, business contracts and mergers and acquisitions, without necessarily falling foul of the Act.

Such collaboration may inter alia increase market access or even result in efficiencies that are beneficial. Where they do affect competition, they may be justified on the basis of efficiency or other gains outweighing anti-competition. Where it results in conduct that is prohibited under the Act, exemption may be granted if it meets the criteria set out in the *Competition Act* (Section 10 and Schedule 1 of the *Competition Act*).

The current free market structure in South African agricultural industries, has resulted in primary producers left without farmer control structures, as most farmer cooperatives converted into companies, with primary producers as minority shareholders and external controlling shareholders with a profit motive (Weatherspoon and Reardon 2003). In view of this, one must also bear in mind that many of the previous cooperatives changed to public companies.

Cooperatives and converted cooperatives, like any other business entity, can be assessed based on three dimensions: Collusion, abuse of dominance, and mergers and acquisitions (Competition Commission 2008).

10.1 Collusion

The Competition Commission does not see cooperatives as being negative in the market, as long as their structure does not lend itself to being anti-competitive. Thus conduct will be the focus of the competition authorities and therefore they will take an in-depth look at the structures, to ensure that they do not become a breeding ground for cartels and collusive behaviour (Competition Commission 2008).

10.2 Abuse of dominance

One of the reasons for establishing cooperatives, especially those focused on marketing, is the need to protect weaker players from powerful ones. Through amalgamations and internal growth it is, however, possible for a cooperative to expand at a formidable scale, resulting in the concentration of market power.

Further anti-competitive exclusionary arrangements with suppliers or customers may occur. The risk of market foreclosure exists in markets where there is vertical integration, increased barriers to entry and where access to cooperatives has grown to become an essential prerequisite for operating in those markets (Competition Commission 2008).

10.3 Mergers and acquisitions

Chapter 8 of the *Cooperatives Act 2005* provides for the combination of two or more cooperatives, provided that the new entity will still comply with the requirements of a cooperative in terms of the Act. Schedule 1(h) further provides for the takeover or acquisition of interests or shares by a cooperative in trusts, companies or other juristic persons or partnerships (Competition Commission).

CONCLUSION

Waner (1999) concludes that FCBs enable agricultural producers to compete in the global market place, by adding value to their farm products to help keep a greater proportion of the profit in the pockets of the members.

It was apparent in a study that the EFFP (2004) conducted, that producers will collaborate in a group if the FCB offers excellent business opportunities and, most importantly, if the producers were convinced that the benefits are proven and tangible. At the end producers must let go of the stereotype where it is said that they cannot work together in the long term. Through patience, determination and good leadership you will be able to commit and work effectively and profitably as a unit.

The FCB is a model that is gaining in popularity in a number of countries, as a way of enhancing producers' market power, in an era where economies of scale and the market power of processors and retailers continue to escalate. It also supplies a model in terms of which the product of a group of producers can be differentiated and promoted in the market place. FCBs give the producer a method to regain some control over his product and can be applied in various ways, according to the need and objectives of the group involved.

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