Structure, Strategy, and Finance in Changing Markets: the Case of Pro-Fac Cooperative

Annual Meeting of NCERA-210 Committee: Research on Structure, Strategy, and Finance
November 19-20, 2008 in St. Paul, MN

Brian M. Henehan and Todd M. Schmit
bmh5@cornell.edu
Dept of Applied Economics and Management
Cornell University

Acknowledgements

- Co-author, Dr. Todd Schmit, Asst. Professor, AEM, Cornell University
- Gail Malone, graduate student in AEM, Cornell University
- Jenna VanLieshout, undergraduate student in AEM, Cornell University
- Kevin McAvey, graduate student, AEM, Cornell University
- Steve Wright, General Mgr. Pro-Fac Cooperative
- Kevin Murphy, Member Relations, Pro-Fac Cooperative
Why Study Pro-Fac Cooperative?

- Original Formation Based on Highly Innovative Business Structure
- Pro-Fac Has Effectively “Re-Designed” Itself Throughout It’s History
- Useful Case for Understanding How A Cooperative Strategically Re-positioned During Times of Significant Change
- Case Includes Review of Structure, Strategy and Finance Dimensions

Why Study PF in New York

- Economic Impact on NYS – 60,000 acres of high value crops and processing plants
- Ongoing Relationship – hosted BOD on campus, previous member survey, advised on organizational structure options
- Attended all annual meetings since 1985
Pro-Fac Cooperative

Pro-Fac Cooperative is an agricultural marketing cooperative of 488 members who provide fruits, vegetables and popcorn for processing facilities across the country. These commodities are marketed as branded, private label and food service products, primarily through its main customers, Birds Eye Foods and Allens, Inc. The total value of crops delivered in 2007 was $61.1 million.

Map of Pro-Fac Member Crops

Source: PF web site – www.profaccoop.com
### Pro-Fac Member Crops by State

- **California**: Peaches
- **Delaware**: Limas, Peas
- **Florida**: Potatoes
- **Illinois**: Popcorn
- **Michigan**: Apples, Asparagus, Blueberries, Carrots, Dry Beans, Peaches, Potatoes, Tart Cherries
- **Nebraska**: Popcorn
- **New York**: Apples, Beets, Butternut Squash, Carrots, Corn, Kraut Cabbage, Peaches, Peas, Red Cabbage, Snap Beans, Tart Cherries
- **Oregon**: Cucumbers, Potatoes
- **Pennsylvania**: Potatoes
- **Washington**: Cucumbers, Dry Beans, Potatoes

### Agenda

- Review Relevant Literature
- Discuss Why the Transformations Took Place
- Present Strategies and Structures Utilized for Redesign During Each Phase
- Review Financing Approaches
- Areas for Further Research
Relevant Literature

- Chaddad and Cook (2004) – Understanding new cooperative models “cooperative with capital seeking entities”
- Anderson (1986) – evolution of cooperative management strategies during phases of the cooperative life cycle
- Seeking input from this group – economic value of information, equity and risk management strategies

Three Phases of Redesign: Will Concentrate on Third Phase

1. First Phase starts with the Formation of the Cooperative in 1961 and runs to 1994
2. Second Phase Starts with Acquisition of Curtice-Burns Operations in 1994 and ends in 2002
3. Third Phase Begins with Inclusion of Vestar Capital, an Equity Partner Who Becomes Majority Owner of Processing and Marketing Assets in 2002 to today
Phase 1.

- PF Formed to Help Salvage Fruit and Vegetable Processing in New York
- This Period Saw Dramatic Restructuring in the Industry in U.S. and NY
- Post WWII Saw Dramatic Decline in Number of Firms and Plants
- Two Such Firms Located in W.New York – Curtice Brothers and the Burns-Alton Corp. Came up for Sale

---

**Phase 1. Integrated Operations    PF & CB**

--- Farm Product Value Chain ---

- Food Service
- Retail
- Specialty Products
- Production Planning

---

**CB Functions**

**PF Functions**
### Summary of Curtice Burns and Pro-Fac Cooperative Integrated Agreement, 1961-1994

<table>
<thead>
<tr>
<th>Curtice Burns</th>
<th>Area</th>
<th>Pro-Fac Cooperative</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Net proceeds derived from total sales; shared with PF 50/50</td>
<td>Finance</td>
<td>- Financed ownership of plants, leased facilities to CB</td>
</tr>
<tr>
<td>- Common stock listed on AMEX, 1973</td>
<td></td>
<td>- Equity loaned to CB, seasonal &amp; term loans from Bank for Coop’s</td>
</tr>
<tr>
<td>- Conducted all marketing activities</td>
<td>Marketing</td>
<td>- Recruited members from new acquisition farming areas</td>
</tr>
<tr>
<td>- Owned brands, made acquisitions</td>
<td></td>
<td>- Reserved first right to purchase brands upon dissolution</td>
</tr>
<tr>
<td>- Developed new products</td>
<td></td>
<td>- Farm products provide basis for new products</td>
</tr>
<tr>
<td>- Supervised and managed business and properties of PF</td>
<td>Management &amp; Governance</td>
<td>- PF and Agway had access to books and financial information</td>
</tr>
<tr>
<td>- Maintained relations with lenders, kept books for joint venture</td>
<td></td>
<td>- 1 CB and 1 Agway director on PF board</td>
</tr>
<tr>
<td>- One PF director on CB board</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Phase 2. Begins in 1994

- Agway is Forced to Sell Its CB Majority Interest to Raise Cash
- The Long Standing Integrated Agreement Venture with CB Came to an End in 1994 as PF Purchases Agway’s Interest
- CB buyout creates Initial Leverage on PF’s Balance Sheet (Debt financing at 50% in ’96)
- BE acquisition results in highly leveraged position in 2000 (Debt financing at 80% in 2001)
Phase 2. Developments

- PF Becomes the First Farmer Cooperative to Acquire a Publicly Traded Company
- Later Becomes the First Farmer Cooperative with a Security (cumulative preferred stock) Listed on a Major Exchange – NASDAQ (symbol PFACP)
- To Signify It's Role in Linking the Agricultural and Marketing Segments, CB Changed It’s Name to Agrilink


- CB/AF/BE wholly-owned subsidiary of PF (1994)
- Pro-Fac Board & CB/AL/BE Board meet jointly as a single board, separate votes as necessary
- Agrilink controlled brands, including acquisition of Birdseye & other brands from Dean Foods Vegetable Co. (1998)
- Dean's acquisition effectively doubles size of Birds Eye Foods
- Birds Eye Foods finds itself in a highly leveraged position
Number of Pro-Fac Members, 1974 - 2008

Pro-Fac shareholder and member capitalization and investment, 1974-2008.
Commercial market value (CMV) of raw product deliveries, total and per member, 1962-2008

Pro-Fac debt levels and debt ratio, 1974 - 2008
Phase 3. Begins in 2002

- Agrilink is in a Highly Leveraged Position
- Thin Margins Limit Earnings
- Capacity of Members to Provide Needed Equity is Being Tested
- Board Explores Other Sources and Reviews Many Options
- Accepts Proposal from Vestar Capital Partners and Approved by Member Vote
Pro-Fac Cooperative, Vestar, & Birds Eye Foods Organization, 2008

**Grower-Members Elect Directors**

- **Pro-Fac Cooperative (PF) – 41%**
  - Board of Directors
  - 12 - Elected by Membership
  - 3 - Independent, appointed by elected directors

- **Vestar Capital Partners**
  - Private Equity Firm

- **Vestar LLC**
  - Capital Investment - 56%

- **Management - 3%**

**Birds Eye Holdings LLC**

- Board of Directors
  - 9 – Vestar
  - 2 – Appointed by PF board

**Birds Eye Foods, Inc.**

- Management & Staff

**Notables:**

- Vestar holds controlling interest in Birds Eye Holdings LLC
- Birds Eye Holdings owns facilities (assets) and Birds Eye brands
- Allens Inc. purchased NY plant facilities and private label brands in 2006
- PF received $120 million distribution from Birds Eye Holdings in 2007, used primarily for equity redemption and dividend payments

---

**Need for Capital Infusion**

- Non-cash goodwill impairment charge of $179 million results in negative income for FY 2002 and reduces equity
- Increased debt to finance acquisition of large, national branded business
- Exhaust members capacity to supply more equity
- Increased interest expenses

---

**Cornell Cooperative Enterprise Program**
Options the PF Board Considered in 2002

- Increase public stock offering
- Seek strategic investor
- Find synergistic partner, LLC
- Seek private equity firm
- “tough it out”
- Sell the company

Pete Call, PF Chairman and BEF Board Member

- “PF’s expertise lies in producing raw products not in operating processing facilities, so a partnership with an operating entity is an option that will be actively pursued”
Selecting a Private Equity Partner

- Good fit with portfolio
- Worked with current management
- Acceptable Terms:
  - Option for individual members and management to invest
  - Termination payments
  - Line of credit
  - 10 year supply agreement
  - Representation on BEF board

Public Stock Offering vs. Private Equity Placement

Publically Traded Offering
- ST Horizon
- 1/4ly earnings driven
- Market Volatility
- Broad Stockholder Interests
- High Cost of Listing & SEC Compliance
- SOX requirements

Private Equity Investment
- Longer Horizon (7yrs)
- Driven to improve firm performance
- Less volatility
- Narrow Investor Group
- Possess management talent
- Ultimately sell acquired businesses for gain
Phase 3. Developments

- In August 2002, Vestar Becomes Majority Owner of Agrilink (approx. 56%)
- Agrilink Name Changed to Birds Eye Foods, BEF
- PF:
  - Maintains significant minority ownership of BEF (approx. 40%) with management accounting for (approx. 4%)
  - Has 10 year supply agreement
  - Receives $10 million annually for 5 years
  - Can secure $1 million line of credit for each of 5 years

Phase 3. Developments

- Bird Eye Foods Rolls Out Successful New Products
- Vestar Sells Processing Plants and Private Label Business to Allens, Inc. in 2006
- Vestar Subsidiary- BEF Holdings Distributes 120 Million to PF in 2007
- PF Uses Distribution to Redeem Equity and Pay Dividends on Selected Securities
Financing Through Each Phase

Phase 1.
- Innovative diversification of sources – members, loans from BC, and publicly traded securities
- Relatively strong, consistent earnings supported use of retained earnings
- Upfront member purchase of stock tied to deliveries raised additional member equity

Financing: Phase 2

- Maintained diversification of sources – members, loans from BC, and publicly traded securities
- High costs of acquisitions eroded equity
- Weaker earnings reduced use of retained earnings
- Limited new member purchases of stock tied to deliveries raised additional member equity
- Increased Debt Level to Support Buyouts Results in Highly Leveraged Position and Increased Interest Expense
Financing: Phase 3.

- PF Accepts Proposal from Private Equity Firm
- Vestar Investment Significantly Reduces BE Debt (approx. $175M)
- Agreement with BE Holdings Generates Annual Payments for 5 years
- Annual Payments Used to Support PF Operations and Pay Dividends on Preferred Stock

Research Questions

- Does a Private Equity Firm Do a Better Job Managing Member Equity than a Cooperative?
- Are Specialty Crop Producers Gaining Market Power that Minimizes Market Risk (and need to own plants & brands)?
- How Do We Measure the Value of Market Intelligence and Information that Cooperatives Generate for Members?
Summary

- The PF story presents a unique case in the world of cooperatives.
- A Number of “Firsts” for a farmer cooperative:
  - Leveraged buyout of publicly traded company,
  - Having a security listed on a major exchange.
- Continue to Change and Adapt to New Players and Markets.

Summary, cont’d

- Utilized a number of innovative strategies to overcome potential constraints encountered by traditional agricultural cooperatives:
  - Transferable delivery rights
  - Multi-commodity pool
  - Diverse set of crops and products
  - Board geographic membership base
  - Conversion of equity to publicly traded securities to create liquidity for member investment
  - Partnering with successful firms and capital groups.
Current Situation for Most Members

- Significant Increase in Prices for Most Crops (Input costs also increasing)
- Growing Demand Results in Increased Acreage for Most Crops
- $120M Distribution in 2007 Generated Higher ROE
- Situation Varies Across Crops and Regions
- It Remains to Be Seen, How Long It will Last