# WHAT WENT WRONG AT AGWAY

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On October 1, 2002 Agway filed for Chapter 11 bankruptcy. Many people are asking what went wrong. This is a hasty attempt by the authors to analyze the situation. We hope that this short article will provide valuable lessons for other cooperatives and organizations.

First, a little history. Agway was formed in 1964, the result of a merger between GLF (Grange League Federation) and Eastern States Farmers' Exchange. A year later the Pennsylvania Farm Bureau Cooperative merged into Agway. The result was a very large agricultural supply and marketing cooperative that covered 13 states, spanning from Maryland to Maine to Eastern Ohio.

We have divided our discussion into historic and recent issues.

## **Historic Factors**

### Provide Members A Secure Market

Cooperatives are often formed to provide members a secure source of inputs and markets for their products. However, sometimes this motive can go to extremes.

GLF (i.e. Agway), together with other New York agricultural organizations, provided the leadership in establishing a radio network, Rural Radio Network, in 1946 to serve the radio needs of farmers and rural residents. It was sold in 1959 when it had an accumulated deficit of $970,000 and total debt to GLF (i.e. Agway) of $1.36 million.

In 1946 GLF also bought approximately a 40 percent share of Mohawk Airlines, the forerunner of USAirways, in the name of providing air transportation to Upstate New York. In this case, they fortunately saw their investment more than double before it was sold.

Another example was Agway's attempt to provide services to members was its operation, together with Southern States Cooperative, of Texas City Refining. The purpose was to provide members a secure source of petroleum products. This proved extremely advantageous and profitable during the oil shortages of the early 1970's. However, the petroleum market eventually changed and Texas City proved a costly investment. It was sold in 1988 at a loss of $110 million.

In 1961, GLF helped form Curtice-Burns, a vegetable and fruit processing company, headquartered in Rochester, N.Y. Curtice-Burns was a combination of what were at the time two struggling vegetable processing companies. Over the years, the company was very successful,

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but in 1993 Agway announced that it's controlling interest in Curtice-Burns was up for sale. The sale brought in a solid return, and this was one of the first indications that Agway needed cash to fund its other operations.

Emphasis on Size

In the 1970's and 1980's, Agway was the largest cooperative in the U.S., with sales of over $4.1 billion in 1984. At the time there was an emphasis on cooperative size. Agway being on the Fortune 100 list of U.S. companies was often mentioned in publications and meetings. We believe that any organization that places primary importance on size over profitability can likely run into problems. We would argue that this is a malady that also eventually caused Farmland Industries and Ocean Spray their financial problems.

Ability to Manage Many Types of Businesses

There was a longstanding attitude at Agway, and predecessor organizations, that they could manage any type of business, even when other people could not. Two major examples come to mind in Agway's history.

The first was an effort in 1941 to get into the retail food business by starting the Cooperative Producers and Consumers Markets, today a Northeast grocery retail chain called P&C. The purpose was to assist New York farmers market meat from their livestock. Ownership interest in P&C was finally sold in 1961 following several years of unprofitable operations.

A more recent example was the purchase of H.P. Hood, a fluid dairy company, bought in 1980. A driving motivation was to help members of Northeast dairy cooperatives maintain a reliable and stable market for their milk, which was at risk. The fluid milk business has always been very competitive, and operates much differently than an agricultural supply company. Agway had no prior experience running a fluid milk business. In 1995, H.P. Hood was sold due to less than projected returns on their investment and mounting financial losses. Another interesting aspect of this example was that right up to their purchase of H.P. Hood, Agway had a strict policy that they would not become involved in dairy processing.

Corporate Culture

We are sure some readers are already wondering why several of the above examples date back to the 1940's. We firmly believe there is significant historical momentum in all types of organizations. This is often embodied in what today is called "corporate culture". Agway instilled a lot of corporate culture in their directors, management, and employees. In fact, we remember when every Agway meeting or at any meeting that an Agway representative spoke at started with a recitation of the Agway mission. However, many of Agway's old traditions and strategies may have out lived their usefulness or detracted from their willingness to change.

A $25 Equity Investment

To become a member of Agway, all a farmer needed to do was buy one share of common stock for $25. And that is all the investment many members have in the cooperative. We firmly believe there is a strong link between how much money members have at risk in a cooperative,

and the interest they take in their cooperative, as well as the success of the organization.

Use Of Tax Paid Retained Earnings

Since equity was not coming from members, Agway used Tax Paid Retained Earnings as their primary source of equity. Depending on this source of equity means that a cooperative needs to consistently generate positive Net Income. It is also an expensive source of equity, because corporate taxes must be paid by the cooperative reducing the total funds available to build equity. In addition, when a cooperative becomes dependent on Tax Paid Retained Earnings, there is a greater tendency for the cooperative to become "management controlled" rather than "member controlled", given that member equity does not grow and most members have little equity at risk. (Anderson, 1987)

Heavy Use of Debt

Agway has always been highly leveraged. If compared to their competitors in almost any business, they would likely be one of the most heavily leveraged companies. During the entire 1984-2002 period Agway's highest Equity to Total Asset ratio was 20.6%. (See Table) From 1998-2001 Equity to Total Assets averaged 12.6%. Our general rule of thumb is that when equity to total assets drops below 15% an organization is suffering severe financial problems.

At one point it time, Agway had a goal of using one-third bank financing, one-third subordinated debentures and one-third equity, primarily tax paid retained earnings. During the entire 1984-2002 period, this goal was never achieved.

Subordinated Debt

Most of Agway's debt, especially in latter years, was subordinated debt, also known as "junk bonds" because they are not secured by assets. While the level of the company's subordinated debt has remained relatively level over the past 5 years, operating cash flow to support that debt became inadequate and deteriorated.

As of it's bankruptcy filing, the largest single owner of these subordinated debentures was Agway's employees through pension fund and 401-K investments. They total approximately $35 million out a total of $425 million in subordinated debt. Members and public security holders own the remaining amount.

Limited Patronage Refunds

Except for 1987 and 1988, Agway has not paid a patronage refund to members since 1980. The primary reason is that sufficient Earnings were not being generated from the patronage business, i.e. their agricultural supply operations. Most of Net Income came from non-patronage businesses such as petroleum, leasing, insurance and produce distribution.

Excess Capacity

With the largest market share for feed and many other input supplies in the Northeast, Agway has been prone to carrying excess capacity, which is typical of a market leader. At the same time there was a major change in market conditions. In terms of feed, more farmers started mixing their own feed using direct purchased commodities, and moved away from the use of

pelletized feed. This meant that many of Agway's feed, and other input supply plants, were operating at significantly less than full capacity. This has a negative impact on per unit costs and can often lead to cut throat price competition.

A Triple Delivery System

For most of it's existence, Agway had a triple delivery system with: 1) Agway Inc. owned corporate stores, 2) independent local cooperative stores, and 3) franchise representative stores. There was a period when Agway tried to convert their corporate stores into representative stores. Then in the early 1990's a decision was made to buy out all the independent local cooperatives to consolidate the delivery system. Financial performance did not improve because market conditions continued to change. Beginning in 1999, Agway sold or closed all its remaining company owned stores and sold their warehouse system to Southern States Cooperative. These moves were made because returns on these assets were chronically inadequate. Today most store customers do not realize that the cooperative no longer owns any assets related to the store distribution system. However, Agway remains a supplier to dealers and retains rights and revenues related to use of the Agway name.

## Recent Issues

There are several more recent events that should have signaled red flags to members and others that Agway was experiencing significant financial distress.

Continued and Large Losses

Between 1984 and 2002 Agway had losses in eight out of 19 years, see Table. Over that nineteen-year period, total losses exceeded profits by $139.2 million. The largest losses can be attributed to the write-down of major businesses or restructuring activities, i.e. Texas City Refinery (1988), the Customer Driven 1995 repositioning (1992), and disposal of four businesses (2002). Continual restructuring and write-downs can be a sign of a changing marketplace as well as ineffective strategies.

Scaled Back Annual Meeting of Members

Until recently, Agway hosted one of the most impressive annual meetings in the U.S. cooperative community. It was a 2-3 day event with thousands attending, and several big names providing entertainment. The cost must have been enormous.

As earnings deteriorated, this meeting format became a luxury the cooperative could no longer afford. Over the past few years the size and scope of annual meetings were significantly scaled back, including when and where it is located. While all members receive a "call to the annual meeting" there is little or no publicity. And, as a result, member participation has dramatically declined.

Business Oriented Directors

In January 2001, Agway changed the way it would nominate and elect directors to the board. One rationale given was to get more "business-oriented" directors on the board. At the same time they downsized the board from 15 to 12 member directors. They adopted a very radical nominating system for cooperatives, which has since been changed slightly. Agway

wanted more directors with a "big picture view" and "sound business skills". We completely agreed with their motivation. When they adopted their new nominating and election procedures it resulted in a significant change in directors. We viewed this as a signal that the previous governance system did not provide all the skills set required of a contemporary cooperative board.

Outside Directors

Also in January 2001, the Agway board changed director election policies and brought two non-member professional business people onto the board. We had encouraged such a move for several years and understand their "outside directors" made a significant contribution in many areas, but were not as familiar with the agricultural industry.

In June 2002, both outside directors notified the board they were resigning from the board. "In their letters of resignation to the Board, neither (outside director) expressed any disagreement with the Company on any matter relating to the Company's operations, policies or practices". (8-K SEC filing, June 17, 2002)

It should be a "red flag" when two or more directors resign from any organization simultaneously, especially outside directors. Also, there was no press release from Agway announcing their resignation.

Limited Cash Availability

In Agway's 2001 Annual Report, Cash and Cash Equivalent in the Current Assets section of the Balance Sheet stood at exactly $0. We understand this happened because it was their practice to "sweep" their cash account daily, applying the proceeds against their lines of credit to reduce interest costs. It is rare to find a company of any type record $0 Cash. It is more common when cash accounts are swept for the funds be carried as cash equivalents, and specifically Marketable Securities. Certainly this should have been a signal to any member, stockholder or debenture holder that there were cash flow problems.

Raising Cash by Exiting Profitable Businesses

In March 2002, Agway announced it was exiting several businesses. A major one being Telmark, their leasing unit which had been very profitable over the years. Why exit a profitable business? The primary reason is to generate needed cash from selling a business that has built up substantial equity over the years in order to reduce the parent company's debt.

Agway also announced on September 12, 2002, that they were selling their Sunflower plant and business in North Dakota to CHS Cooperative. Management had always indicated that sunflowers had been a profitable business and they were "the largest U.S. processor and a worldwide distributor of sunflower" products. Perhaps, it made less sense to keep this business after Agway exited the retail store system. In their March 2002 announcement of businesses to be sold, the sunflower plant was not included. Again, we saw this as an unplanned attempt to generate cash flow by selling another of their profitable businesses.

Failure to Sell Telmark

The March 2002 announcement to sell four businesses included Telmark, Agway's leasing company. On May 23, 2002 Agway announced "after lengthy negotiations, Agway and a potential buyer were unable to reach final agreement on a sale of Telmark. (8-K SEC filing) As reported in a subsequent 8-K SEC filing on June 17, 2002, it became apparent that Agway's immediate liquidity situation would not be corrected without the sale of Telmark. The failure to sell one of a company's most valuable assets, causing it to violate its loan covenants, was another signal of severe financial distress.

Suspension of Debt Repurchases

On June 14, 2002 Agway announced they would no longer repurchase subordinated debt early. Up until that time, while their subordinated securities had due dates of up to15 years, Agway was willing to convert them to cash any time a holder submitted these securities for redemption. As a result, it was a very liquid asset for Agway investors. It should be noted that in their annual reports it has been plainly stated that: "Agway is under no obligation to repurchase such debt when so presented, and may stop or suspend this repurchase practice at any time." This was a preemptive action taken to avoid default with its senior lenders' loan covenants.

Delayed Annual Report and SEC Filing

In past years, Agway always reported their annual Sales and Earnings via a press release in mid-August to early September. This year their annual report was posted via a 10-K filing with the Security and Exchange Commission (SEC) on September 30, 2002, the last possible day for filing if a company's fiscal year ends on June 30.

## Summary

The purpose of this article has been to point out issues and events members should be sensitive to concerning the performance of their cooperatives. We have tried to identify several "red flags" to hopefully assist in preventing similar problems in other cooperatives.

There were several signs over the years, and of late, that Agway was having significant financial difficulties. Certainly Agway has accomplished much over the years, and many farmers indicate that they regret seeing its presence in the Northeast diminished. One point many farmers do not realize is that Agway remains a major competitive force in input supplies and agricultural products marketing in the Northeast. Put differently, they continue to make inputs Northeast farmers purchase cheaper and commodity prices higher. Unfortunately, these benefits accrue to all farmers and not just those that use Agway.

Agway has achieved several other notable accomplishments. They created and developed Telmark; their profitable leasing subsidiary. Agway Energy Products is a large supplier of fuels to Northeast farms, one of the largest suppliers of fuel oil and propane in the U.S. and also a profitable operation. Their profitable produce distribution system is one of the largest on the Eastern seaboard. While their feed operations have struggled financially they remain the largest animal feed and nutrition company in the Northeast. Hopefully, after exiting several businesses and improving their financial structure, Agway will be a more viable, albeit

much smaller, cooperative.

There are no simple, easy answers to the question of what went wrong with a business that ends up in bankruptcy. Determining what went wrong for cooperative businesses must involve all of the key players who have an influence on determining financial success: members, directors, and managers. Members, at times, asked Agway to do too much on their behalf without thoroughly understanding the costs involved. Directors did not always demand profitable results. Members can influence directors to opt for the status quo rather than making the tough strategic decisions needed to compete in today's marketplace. Managers too often selected, and poorly executed the wrong strategies to achieve profitability. Accelerated change in the structure and fabric of production agriculture in the Northeast over the last 30 years, in some cases "pulled the rug" out from under Agway's plant and store operations. There are a number of lessons to be learned. In the limited time available, we have only been able to identify a few of the issues related to what went wrong at Agway. Further study is needed to conduct a more in depth analysis.

**Agway Financial Results: 1984-2002***

| **Year** | **Total Revenue** ($million) | **Net Income** ($million) | **Equity** ($million) | **Total Assets** ($million) |
|---|---|---|---|---|
| 1984 | 4,101.5 | 11.8 | 296.9 | 1,515.8 |
| 1985 | 4,067.2 | 14.1 | 306.0 | 1,483.4 |
| 1986 | 3,510.5 | 14 | 319.5 | 1,488.6 |
| 1987 | 3,264.7 | 9.1 | 326.7 | 1,586.7 |
| 1988 | 2,935.5 | -91.6 | 233.2 | 1,496.8 |
| 1989 | 3,296.8 | 11.1 | 255.3 | 1,700.9 |
| 1990 | 3,607.1 | 8.1 | 261.7 | 1,837.1 |
| 1991 | 3,486.5 | -6.4 | 253.4 | 1,880.4 |
| 1992 | 3,261.2 | -58.8 | 190.5 | 1,829.3 |
| 1993 | 2,278.8 | 19.8 | 195.5 | 1,352.1 |
| 1994 | 2,187.2 | -3.3 | 203.9 | 1,400.3 |
| 1995 | 1,592.1 | -15.9 | 172.4 | 1,224.8 |
| 1996 | 1,662.5 | 12.7 | 172.7 | 1,245.9 |
| 1997 | 1,671.1 | 10.7 | 177.8 | 1,300.3 |
| 1998 | 1,562.9 | 41.1 | 206.3 | 1,417.3 |
| 1999 | 1,221.5 | 1.8 | 198.9 | 1,437.2 |
| 2000 | 1,426.9 | -9.4 | 182.6 | 1,572.7 |
| 2001 | 1,548.3 | -8.9 | 169.3 | 1,599.9 |
| 2002 (continued & discontinued operations)<br>2002 (continuing only) | 1,269.9<br>899.9 | -98.2 | 64.1 | 1,574.4<br>519.8 |

SOURCE: Agway Annual Reports 1984-2001 and Securities and Exchange Commission 10-K report September 30, 2002.

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