

Declining Economic Linkage: SWP Share Conversion Story

NGERA-194 Annual Meeting
Minneapolis, MN
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November 2, 2006

Overview

- Background on SWP
 - Share Conversion
 - Market Performance post-conversion
- Economic Linkage
- Research Question
- Analysis
 - Interview Evidence
- Concluding Remarks

SWP History Lesson

- Centralized co-op established in 1924
- Once the largest grain handler in western Canada
- >60% provincial market share for 20 yrs
- 78,000 members in early 1990s
- Diversified business lines
- Served as a policy voice for farmers



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SWP Capital Shortage

- Being discussed as early as mid 1980s
- Earnings were declining
- Industry-wide belief: need to value-add
- Modernize and upgrade grain handling network
 - 14,000 mi branchlines protected until 2000
- 50% of members to retire in next 10 yrs
 - \$100 million equity repayment



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1996 Share Conversion

- UGG became publicly traded in 1993
- July 1994 vote to amend Act
 - 110 in favour (80.3%); 27 opposed
- Pool chose A-B dual share structure
 - Each farmer received one A share (voting)
 - Only farmers could be board members
 - \$305 million equity converted to B shares
 - 10% ownership limit on B shares



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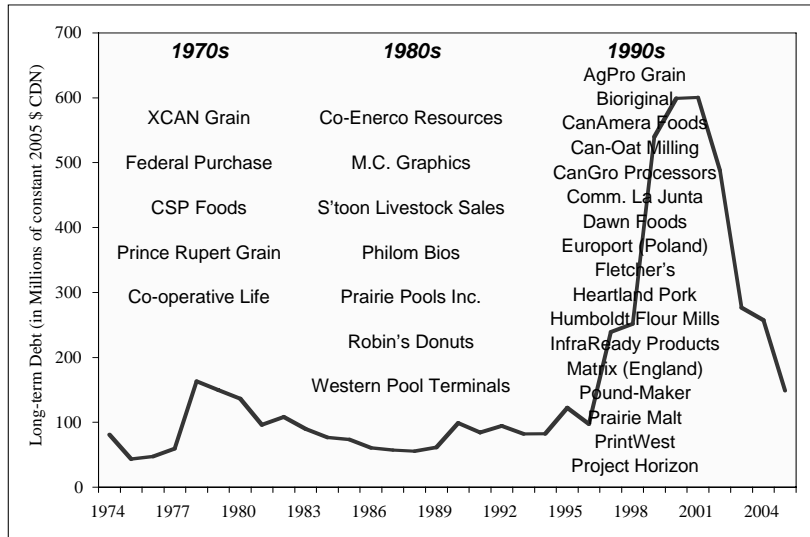
1996 Share Conversion

- Increased access to debt capital
- Shares opened April 2, 1996 on TSE
- Ambitious capital investment followed
 - First Foreign Direct Investment
 - \$270 million Project Horizon
- 1996-99, long-term debt \uparrow 5.8x
 - \$81 to \$469 million



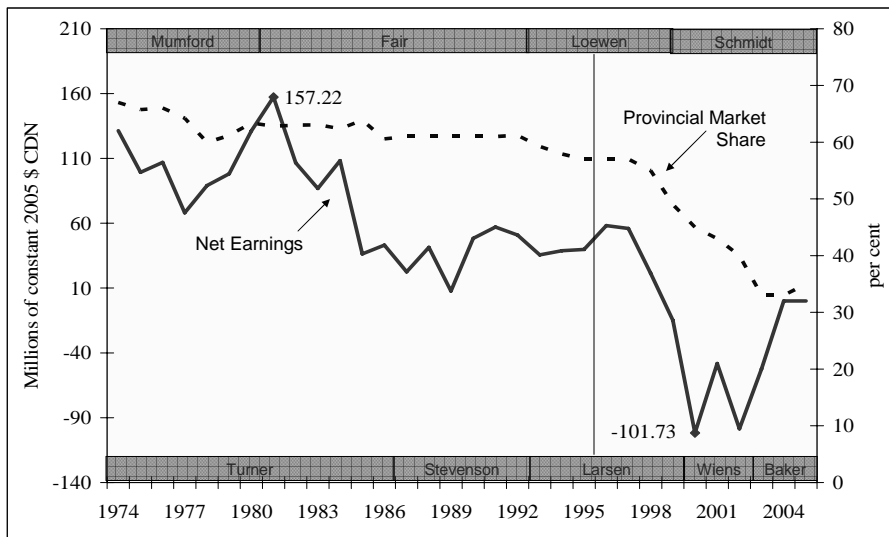
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SWP L-T Debt & Acquisitions, 1970-2005



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SWP Net Earnings & Provincial Grain Handling Market Share, 1974-2005



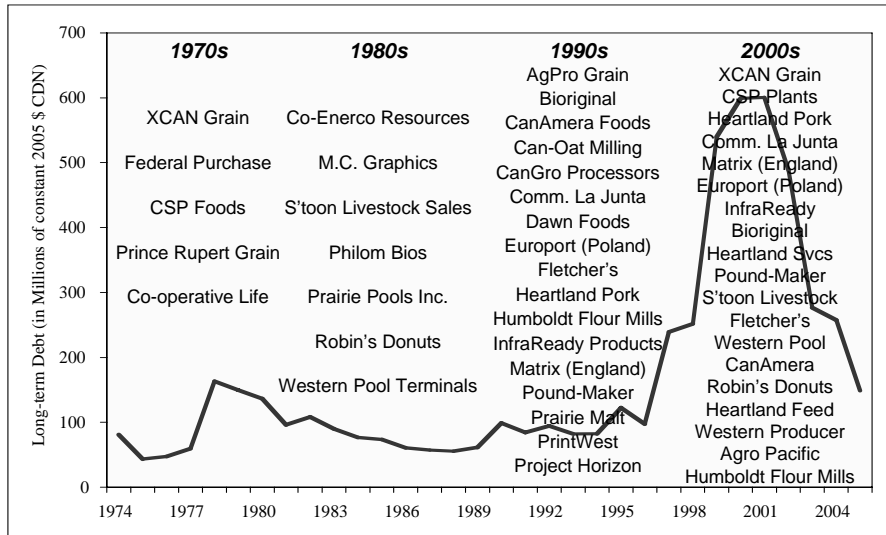
SWP Share Price on TSE, Apr 2/96 - Dec 31/05



SWP Post-Conversion

- By 2000, total debt ~ \$1 billion
- Market share dropped to <35%
- Multi-million net losses started in 1999
- CEO & COO released in 1999
- Major divestment occurred
- 2000-03: long-term debt ↓\$270 million

SWP L-T Debt & Acquisitions, 1970-2005



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Pool Financial Failure

- \$407 million debt restructuring Jan 2003
- Board structure changed again
 - 4 appointed; 8 farmer-elected
- Became federal corporation Feb 2005
 - Ownership limit fully removed
 - Board structure: 8 appointed; 4 farmers
- After 80 years, Pool no longer a co-op



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Explaining Financial Failure

- Lang and Fulton (2004) linked declining market share to member commitment erosion
- Member commitment highly correlated with economic linkage
- Economic linkage is the degree to which members' interests are linked to co-op's interests (Fairbairn 2003)



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Economic Linkage

- Ways to form close linkage:
 - Share operating success
 - Products to meet specific needs
 - Convenient format or location
- Need investor/member confidence for investment to occur
- Proper corporate governance helps to build confidence



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SWP Economic Linkage

- Patronage repayments no longer used
- Typically, shareholders have right to:
 - Share of profits
 - Provide a degree of control
- B Shareholders not eligible to vote for board members
- Dividends ceased after 1999



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Research Question

- Was maintaining economic linkage with members compatible with creating Class B shareholder confidence?
- Could either group exert enough control over the management to have their particular interests met?



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Analysis: Interview Evidence

- 21 personal interviews conducted with:
 - Past SWP board members
 - Past SWP management
 - Industry affiliates
- Interviewees remain anonymous
- Common set of questions focused on 1980-2000 period



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Lead-Up to Share Conversion

- Vertical integration key to survival
- “Have to be big enough to take on the multinationals...we were preparing ourselves for that day”
- Belief that Pool could be “ConAgra of the North”
- Pool became more commercially-oriented post-conversion



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SWP Decision-Making

- Three investments mentioned in nearly every interview
- Project Horizon
 - Did not understand “competitive dance”
- Mexico, Poland and England
 - No expertise in international arena
- Humboldt Flour Mills
 - Raised flags on Pool’s spending habits



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SWP Culture Change

- Urgency: “diversify or die”
- Industry dominance became increasing objective for investments
- Loewen “was going to push through the vision...[and] stop internal dissent”
- Loewen “had the confidence of the board of directors...no impediments in his path”



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SWP Power Shift

- As business moved away from farmgate it got tougher for board
- “as we got more external, we had to rely more and more on our CEO & CFO”
- Information shared with President, but not always shared with entire board
- Board members “were a little out of their league”



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Governance Problems

- “Senior management are always in a better position information wise...”
- Board became dependent on management to tell them what to do
- “would have been difficult even for a competent board to stay abreast...”
- “management running astray with the company” (Gatin 1999)



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SWP Economic Linkage

- Management's well-defined vision did not necessarily link up with member/investor interests
- Limited checks on management's power due to lack of information and experience among board members
- Culture change and power shift meant interests not being met



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Declining Economic Linkage

- Loss in market share
- Heartland Pork initiative missed target level for community investment
- Share price decline
- Neither group had widespread trust in decisions being made by Pool



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Concluding Remarks

- Share conversion not to be blamed
- Management focus on grand vision rather than serving interests of members/investors
- Perhaps slow managed process would have built and maintained confidence
- Under pressure of rapid change, decision-making patterns broke down
- Eroding trust and severing economic linkage



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