Support for Farmers' Cooperatives

Case Study Report
HKScan hybridisation

Perttu Pyykkönen
Petri Ollila

European Commission

The 2011-2012 project „Support for Farmers' Cooperatives (SFC)" has been commissioned and funded by the European Commission, DG Agriculture and Rural Development.

Contract Number: 30-CE-0395921/00-42.

The SFC project is managed by Wageningen UR's Agricultural Economics Research Institute LEI and Wageningen University. Project managers: Krijn J. Poppe and Jos Bijman.

Other members of the consortium are:

- Pellervo Economic Research PTT, Finland: Perttu Pyykkönen
- University of Helsinki, Finland: Petri Ollila
- Agricultural Economics Research Institute, Greece: Constantine Iliopoulos
- Justus Liebig University Giessen, Germany: Rainer Kühl
- Humboldt University Berlin, Germany: Konrad Hagedorn, Markus Hanisch and Renate Judis
- HIVA Katholieke Universiteit Leuven, Belgium: Caroline Gijselinckx
- Rotterdam School of Management, Erasmus University, The Netherlands: George Hendrikse and Tony Hak

How to cite this report:

Pyykkönen, P. and P. Ollila (2012). Support for Farmers' Cooperatives; Case Study Report HKScan hybridisation. Wageningen: Wageningen UR.

Support for Farmers' Cooperatives
Case Study Report
HKScan hybridisation

Perttu Pyykkönen

Pellervo Economic Research PTT, Finland

Petri Ollila

University of Helsinki, Finland

November 2012

Corresponding author:

Perttu Pyykkönen
Pellervo Economic Research PTT
Eerikinkatu 28
00180 HELSINKI
Finland
E-mail: perttu.pyykkonen@ptt.fi

Preface and acknowledgements

In order to foster the competitiveness of the food supply chain, the European Commission is committed to promote and facilitate the restructuring and consolidation of the agricultural sector by encouraging the creation of voluntary agricultural producer organisations. To support the policy making process DG Agriculture and Rural Development has launched a large study, "Support for Farmers' Cooperatives (SFC)", in order to provide insights on successful cooperatives and producer organisations as well as on effective support measures for these organisations. These insights can be used by farmers themselves, in setting up and strengthening their collective organisation, by the European Commission, and by national and regional authorities in their effort to encourage and support the creation of agricultural producer organisations in the EU.

Within the framework of the SFC project, this case study report on hybridisation of a cooperative (LSO, HK Ruokatalo, HKScan) has been written.

Data collection for this report has been done in the spring of 2012.

In addition to this report, the SFC project has delivered 33 other case study reports, 27 country reports, 8 sector reports, 6 EU synthesis and comparative analysis reports, a report on cluster analysis, a report on the development of agricultural cooperatives in other OECD countries, and a final report.

The authors would like to thank the directors and managers of HKScan and LSO Osuuskunta for their willingness to collaborate in this project and to share information on structure and strategy of their cooperatives.

Table of contents

List of abbreviations

CAP	Common Agricultural Policy
HK	HK Ruokatalo, HKScan
LSO	LSO Osuuskunta
IOF	Investor Owned Firm

1. Introduction

1.1 Objective and research questions

The imbalances in bargaining power between the contracting parties in the food supply chain have drawn much attention, also from policy makers. The European Commission is committed to facilitate the restructuring of the sector by encouraging the creation of voluntary agricultural producer organisations. DG Agriculture and Rural Development has launched a large study, "Support for Farmers' Cooperatives", that will provide the background knowledge that will help farmers organise themselves in cooperatives as a tool to consolidate their market orientation and so generate a solid market income**.**

Different kinds of hybrid structures have become more and more common among cooperatives. The different structures and converging towards IOF-type structure seems to be related to the growth of the cooperative (especially to financing the growth) and to the internationalization of the cooperative (see Chaddad and Cook 2004). In the framework of this study, this report provides information on the hybridisation process of LSO Osuuskunta to publicly listed company HKScan. This research issue is studied also in another case study of this SFC project. The other case concerns Dutch Vion that is the number one meat company in Europe.

In this case study, the following research questions have been guiding the research. First, how and why has the "hybridization" happened? Second, how are the producers' ownership, control and benefits (key elements in our definition of a cooperative) affected by hybrid structures? Third, what is the relationship between members and outside investors?

1.2 Analytical framework

There are at least three main factors that determine the success of cooperatives in current food chains. These factors relate to (a) position in the food supply chain, (b) internal governance, and (c) the institutional environment. The position of the cooperative in the food supply chain refers to the competitiveness of the cooperative vis-à-vis its customers, such as processors, wholesalers and retailers. The internal governance refers to its decision-making processes, the role of the different governing bodies, and the allocation of control rights to the management (and the agency problems that goes with delegation of decision rights). The institutional environment refers to the social, cultural, political and legal context in which the cooperative is operating, and which may have a supporting or constraining effect on the performance of the cooperative. Those three factors constitute the three building blocks of the analytical framework applied in this study (Figure 1).

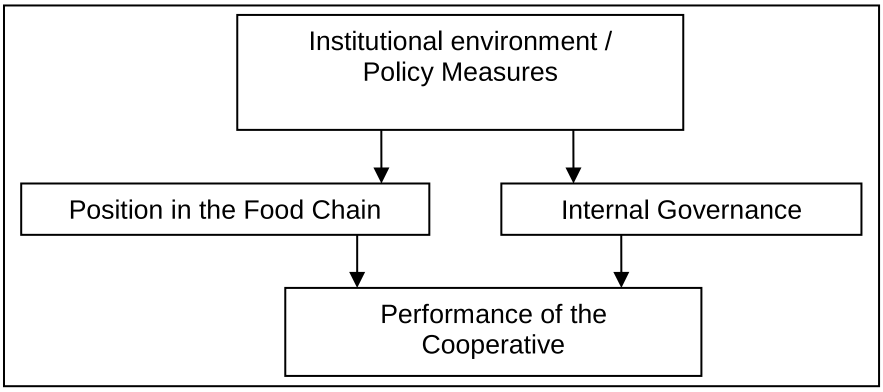

Figure 1. The core concepts of the study and their interrelatedness.

1.3 Method of data collection

The case study is based on multiple data sources. First of all, secondary data was used such as academic literature, country reports of the Support for Farmers' Cooperatives project, popular press and electronic media, various archives and other sources of information. Secondly, the annual reports and company histories are utilized in describing the path of the cooperative to the current hybrid structures are defined. If possible a brief comparison to other firms in the sector is made.

Additional information has been collected through personal interviews with various co-operative stakeholders. The key persons behind the path that has led to the current structures are interviewed. For this particular study, board members and managers of both HKScan and LSO Osuuskunta have been interviewed. There are both former and current members of the bodies among interviewees. In order to strengthen the producer view some producer suppliers that have not been involved in internal governance were also interviewed. Furthermore, the LSO Osuukunta was established in 1913 and thus, the cooperative is celebrating its 100th anniversary in 2013.There is history project going on and the authors of this case report were kindly offered an opportunity to use this material concerning hybridisation.[1] Standard techniques and approaches used in case study research were used in order to maximise reliability and avoid biases.

1.4 Structure of the report

Chapter 2 of this report is aimed to provide a picture of structure respectively in the primary production and meat industry in Finland as well as on meat industry in EU. Chapter 3 provides comprehensive description of the development and the hybridisation process of LSO Osuuskunta into HKScan (plc.). The development is also related to our building blocks of the SFC project in this Chapter. Chapter 4 provides additional information and views into these processes through interview results. Concluding remarks and the answers to the hypotheses to be tested are drawn in Chapter 5.

[1] This is referred as Åberg and Puro 2012. They have had an access to minutes of the different governance boards of LSO and HK and in addition they have documented more than 30 interviews during last year.

2. Meat sector structures in Finland and in EU

This chapter first provides an overview of the Finnish meat production and meat industry. Secondly, we provide a brief overview of the European meat industry.

2.1 Meat production in Finland

Pig meat consumption has increased quite steadily during the last decades in Finland. The domestic production has increased as well even though during the last couple of years the trend has changed (Figure 2.). Pig meat consumption is ca. 37 kg per capita whereas the poultry and beef consumption respectively only half of that.

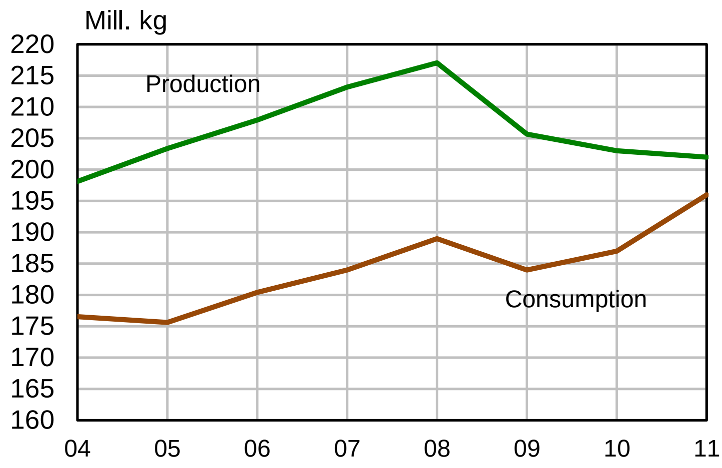

Figure 2. Pig meat production and consumption in Finland in 2004-2011. Source: Ministry of agriculture and forestry, data service.

The pig meat production much more concentrated both regionally and by size of farms. The most intensive production regions are in the South Western and Western Finland where also the largest meat companies' (HKScan and Atria) slaughterhouses are located (see Pyykkönen et al. 2010). The pig farms are also larger than farms in average in Finland. Still, there are a lot of quite small farms (Figures 3 and 4).

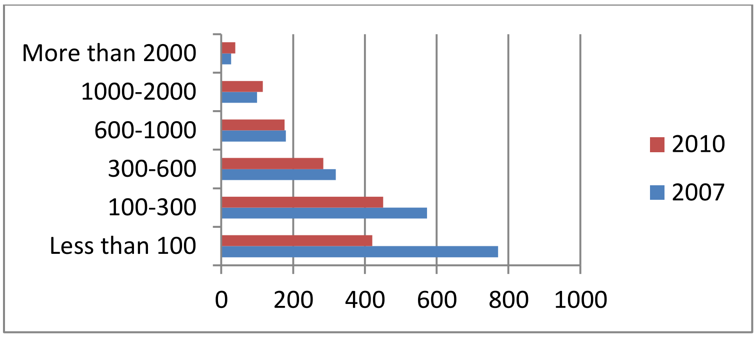

Figure 3. Pig meat producing farms according to their size.

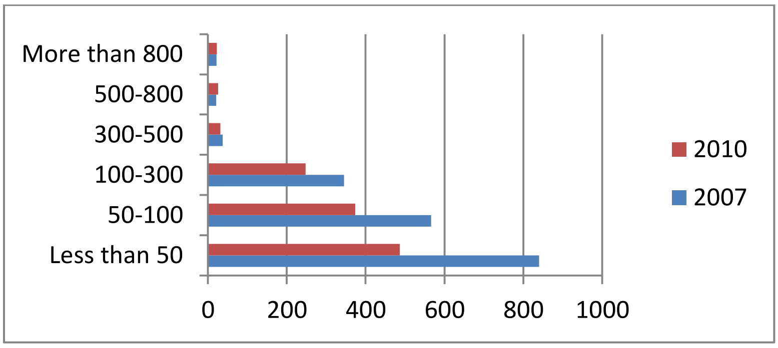

Figure 4. Pig farms that have sows according to their size.

However, structural change among pig farms has been quite fast and the number of farms is decreasing. The total number of pig farms was in 2010 around 2.000 but it is forecasted to decrease to less than 900 in 2020 (Pyykkönen et al. 2010). This change also affects the cooperatives in several ways. Firstly, the number of members in cooperatives decreases since the aim of cooperatives is to have only active producers as members. Secondly, the capital input per member increases. These changes may also affect the governance structures of the cooperatives.

2.2 Meat industry in Finland

The industry is quite concentrated in Finland. There are two large companies, our case HKScan and Atria that is also cooperative controlled publicly listed company. In addition, there are two medium sized family owned companies that have quite a strong position in Finland. In addition to these there are several smaller privately owned companies of which only few has slaughtering activities. They base they production on meat bought from domestic slaughterhouses and by importing their raw material. Some basic figures concerning the four largest companies are presented in Table 1.

Table 1. Finnish meat companies in 2009-2010.

	HKScan		Atria		Saarioinen		Snellman	
	2010	2009	2010	2009	2010	2009	2010	2009
Turnover, mill. €	2114	2125	1301	1316	327	340	191	173
Change in turnover, %	-1	-7	-1	-3	-4	-1	10	17
Share of foreign operations, %	66	66	41	41	3,4	1,8		
Net Profit, mill. €	31	32	-4	7	7	9	9	7
Net Profit, % of turnover	1,5	1,5		0,6	2,1	2,6	4,9	3,8
Equity/assets, %	34	37	40	40	56	55	39	33
Members in holding cooperatives	1810	2024		8014				
Number of employees	7491	7429	5812	6214	2098	2138	811	788

The joint market share of the two largest companies is 81% on slaughterings and around 60% on domestic production value. All these companies base their production mainly on domestic raw material and on their own slaughterings. They all also offer whole line of products (pork, beef, poultry) and all sortiment from cutted meat to convenience food.

Finnish companies have exported pig meat quite a lot. At largest the exports were 40 mill. kg (consumption around 180 mill. kg) in 2010. HKScan and Atria were responsible for almost totally for this export. In beef Finland has been net importer whereas in poultry the production and consumption are more or less in balance. Some export and import occur in any case due to the fact that the most valuable carcass parts (fillet) are consumed more than produced whereas the cheaper carcass parts are exported.

The two largest companies have taken huge steps during the last decade by foreign acquisitions. The two smaller companies have concentrated on domestic markets. The turnover of HK has almost quadrupled in a decade and Atria's doubled (Figure 5).

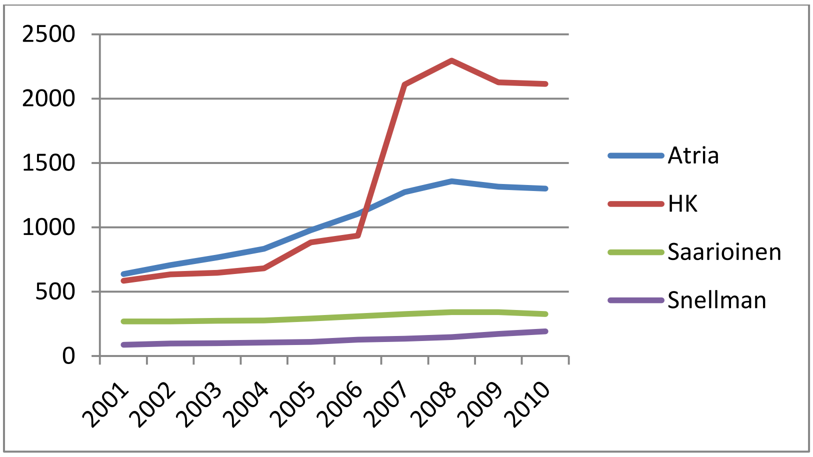

Figure 5. Turnover of Finnish meat companies in 2001-2010.

The growth has also had its price. The profitability of the two large companies has been quite weak during the last couple of years. This is not only due to the acquisitions but also the world market situation has been very tough especially in pork. However, the Swedish Meats acquisition and the reorganising of Swedish processes have been costly. Similarly, problems in Atria's Russian investments have been challenging. When we add the unprofitable export during the last years, the gap in the profitability compared to the domestic operators has been clear (Figure 6).

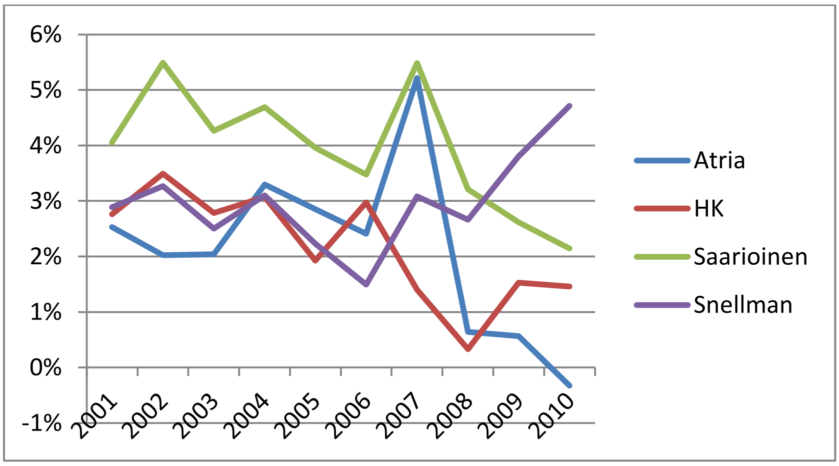

Figure 6. Net profit (% from turnover) of Finnish meat companies in 2001-2010.

The growth has also meant increased indebtedness. Debt to equity ratios are much poorer among companies that have grown fast. This is a challenge for every growth-oriented company but especially for cooperatives (even to cooperative controlled companies) if the owners' willingness to finance the investments is restricted. These financial issues have an utmost importance in hybridisation processes.

The producer prices in Finland follow changes in other EU member countries. However, the producer prices are not necessarily fully comparable, especially in beef, since the quality classes produced differ so much. Another distinguishing feature of the Finnish market is the milder price fluctuation. This can be seen especially in pork prices that are well comparable to the other EU countries (Figure 7).

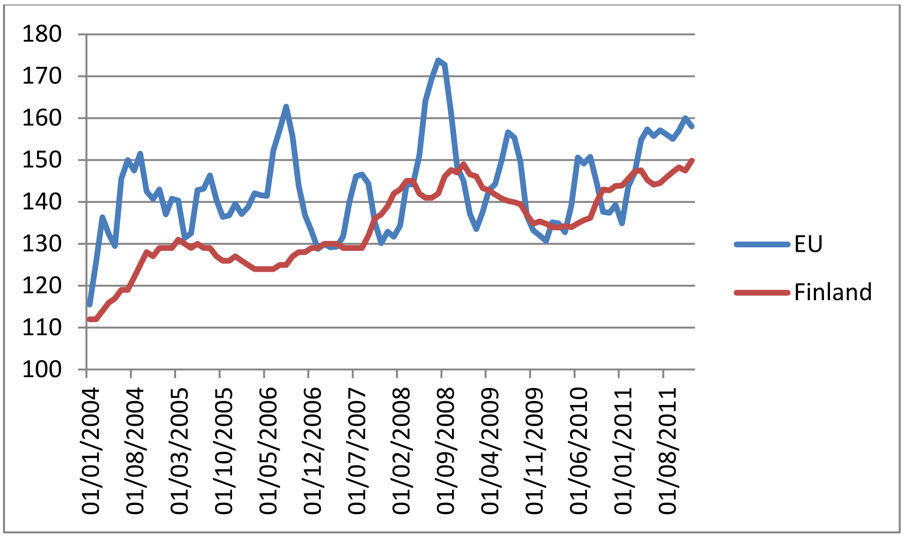

Figure 7. Producer price of pig meat in Finland compared to EU average.

The milder fluctuation is based on the very concentrated structures not only in the industry but even more in the retailing sector. According to the latest figures, the largest retailer's (S-Group) market share is ca. 45% and the second largest's (K-Group) respectively 35%. This makes it possible to agree on quite long lasting delivery contracts. Typically contracts are 3-4 months and prices are set for this whole period. This gives on the other hand some stability in the market but on the other hand it is inflexible if e.g. the costs at farm level increase and the producer prices cannot be increased according to the international market. This is also a question of market power and there are some evidence about possible problems in this sense (see Arovuori et al. 2011, Niemi and Xing 2011).

Compared to the Finnish dairy sector the pricing systems are totally different to the meat industry. In thedairy industry every milk producer is paid exactly according to the same quality principles and exactly the same price not depending on the size of the farm and the location of the farm. In meat industry, there are several cost based differences in pricing. Among farmers there have also been doubts that not all the existing differences are fair. Thus, there is obvious lack of transparency in pricing system.

2.3 Meat industry in the EU

Firstly, based on our database the structure (operational and governance) of these case companies are compared to the 20 largest cooperatives' structure. In addition, we also compare the case companies' position in the food chain and market performance with this Top 20 group as well as with the most relevant IOF arrivals in the sector.

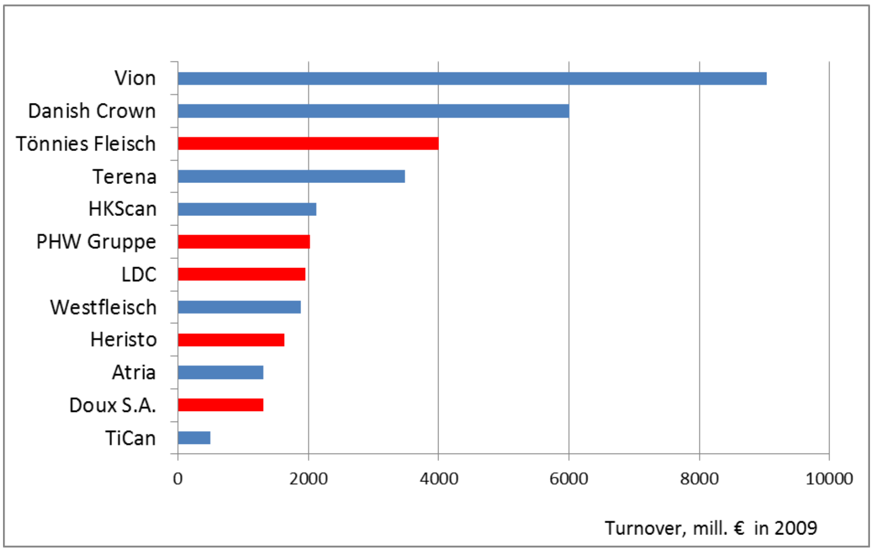

Figure 8. Turnover of the largest meat companies in Northern Europe.

In European context the HKscan is the 5th largest. Vion and Danish Crown are in their own class and then privately owned German Tönnies Fleisch and French Terena (a multipurpose cooperative) are larger than HKScan. HKscan also processes the meat much more than for example Danish Crown. The role of more processed products and so called convenience food is increasing all the time (Figure 9).

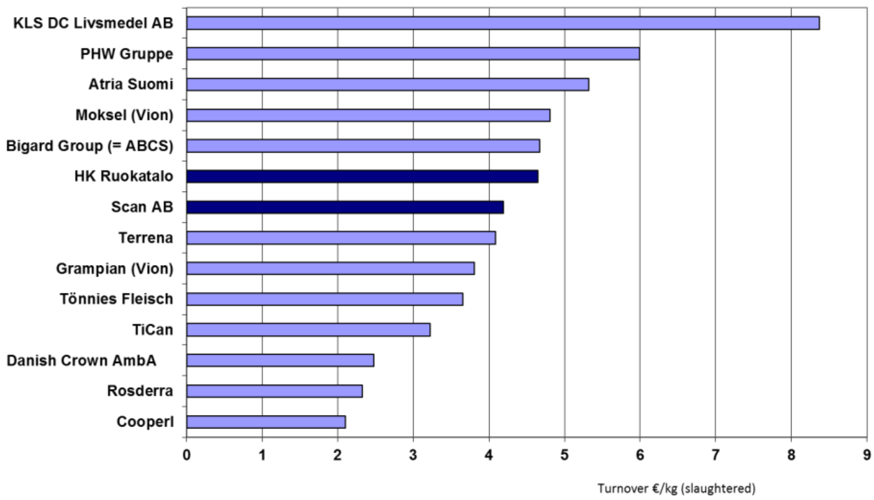

Figure 9. Turnover per slaughtered amount.

The consolidation development in European meat sector has also been very rapid during the last decade. In the following some/most of the largest acquisitions and mergers during the last five years are listed:

2007: HK – Swedish Meats 2007
2007 Danish Crown – KLS, Ugglarps
2008: Terrena – Unicopa (pork and poultry)
2008: Cooperl - Arca merger
2009: Cooperl Arc Atlantic - Broceliande
2010: Elivia (Terrenan beef/pork division) bought 4 plants from Bigard

2010: HKScan - Rose Poultry
2010: DC - D&S Fleisch
2011: Tönnies - Tummel
2011: Cooperl - Defi Viandes

The consolidation seems to be ongoing all the time. Our case company HKScan also seems to be very actively involved in these processes.

3. Development and hybridisation of LSO into HKScan

This chapter provides, first, a description of development phase of the cooperative (3.1) and secondly, relates the phases to our building blocks.

3.1 Development phases of the company

HKScan is a company that has been shaped by many corporate takeovers and mergers. The company developed and grew in south-western Finland, where agriculture and cattle farming have traditionally been strong. We can define three different phases in the cooperative's/company's history. The first phase is the establishment of the cooperative, the second concerns domestic consolidation and the last (and still on-going) phase is the internationalisation process.[2]

3.1.1 Beginning of the cooperative

The origin of the company can be considered as dating back to Lounais-Suomen Osuusteurastamo (nowadays LSO Osuuskunta), a slaughterhouse cooperative founded by some 20 cattle farmers in 1913. This was one of the 23 cooperative slaughterhouses in Finland that have ever existed.

The LSO was already in the beginning at least in some sense internationally oriented. The cooperative engaged in extensive wholesale operations, beginning to export meat towards the end of the 1910s. The first exports were naturally to Sweden. Later in the 1930s, it exported millions of kilos of bacon to the United Kingdom and, towards the end of the decade, beef to Central Europe.

The processing of meat started already in early stages of the cooperative. Sausage manufacturing was started namely already in 1915. At that time most of the slaughterings (around 60%) were cattle, one third pigs and the rest horses and mutton. The pigs exceeded cattle slaughtering in 1930's. However, the total annual amount slaughtered was less than 10 mill. kg the first 40 years. In 1950's the slaughtered amount finally exceeded 10 mill. kg.

In 1920's the cooperative had 8 slaughterhouses even though more than half of the marketed meat was slaughtered on farms. Only the cutting, processing and marketing were taken care of by cooperative. The quality of home slaughtered meat, however, was poor and thus, in order to foster a proper slaughtering practices cooperative established new plants. In the end of 1930's there were 16 slaughterhouses and the share of home slaughterings had decreased to 12%.

The cooperative remained local and even though it increased its share in the region it was still very small company. However, due to the large number of very small farms in Finland (after the land reforms in 1918 and in the beginning of 1920's) the number of cooperative members exceeded 1.000 already in the beginning of 1920's.

The local meat cooperatives started to cooperate in export already in the very beginning of their history. Later on the consumer cooperatives were accepted as members to this 2nd tier

[2] The basic description relies very much on HKScan Internet pages. In addition, the LSO history written by Suistoranta (1989) is used as a reference as well as the more recent history by Åberg and Puro 2012 which is in progress but of which the authors have kindly shared the information.

cooperative. And a bit later they got the power and the seeds for the long lasting dispute between producer and consumer cooperatives were sown. After this regional producer cooperatives established their own 2nd tier cooperative (Tuottajain lihakeskuskunta TLK).[3]

One of the important stages in the Finnish meat sector is the enlargement of pig meat production that started in the end of 1950's (and was accelerated in the end of 196's) when the mechanisation in agriculture really started. Tractors displaced the horses and the land that was not anymore needed to feed horses was put into grain production and for pig fodder. This development also meant that the share of pig meat became much more important to LSO than to its counerparts in other Finnish regions. The number of LSO members had increased to more than 3.500 in the end of 1950's.

3.1.2 Domestic consolidation

In the beginning of 1960's the number of farms in Finland was more 300.000. The background for the increased number of farms was in the settlement operations after the Second World War. The mechanisation of agriculture, the change from lack of food to overproduction, industrialisation of the entire society also meant that the structural change in agriculture started in 1960's. The farm number started to decrease and farms started to specialise. The slaughtering business felt a similar kind of pressure. The business units were small and need to concentrate production and processing was obvious. Thus, the need for consolidation and industrial cooperation increased as well. The MTK (Finnish Farmers' Union) also had an active role in order to trying to foster this development. In the end of 1960's MTK set an ultimate goal of uniting all the regional cooperatives into one national cooperative. That never succeeded. The local cooperatives did not want to "take orders" from above and wanted to stay independent and decide themselves of their own businesses.

However, the poor profitability and obvious need to improve industrial structures led to a situation where there were in the beginning of 1970's only eight regional cooperatives left in Finland. At most there had been 23 cooperative slaughterhouses in Finland in 1920's.

Concerning LSO, the most important domestic consolidation phases took place in 1964, 1971 and 1989 when LSO took over other provincial meat cooperatives (Länsi-Uudenmaan Osuusteurastamo, Etelä-Suomen Osuusteurastamo, Satahämeen Osuusteurastamo SOT) that were the closest neighbours to the LSO region. The merger with SOT was interesting also therefore that the cooperatives have started their collaboration already more than ten years earlier by establishing a joint limited liability company Broilertalo Oy to take care of broiler slaughtering and processing. In the 1980's the cooperative was part of a more extensive national reorganisation within the industry, with consumer cooperatives (OTK 1981 and SOK 1985) winding down their meat operations.

After these and some other mergers elsewhere in Finland there were five cooperative slaughterhouses left in Finland (LSO, Itikka, Lihakunta, Pohjanmaan Liha as well as Karjaportti[4])

[3] TLK's history ended in 1991 after an attempt in 1980's to join most of the forces in the meat sector. As part of this process the consumer cooperatives' role in slaughtering business disappeared. However, not even this attempt was very successful. The end of TLK also meant that the large cooperative operators LSO and current holding cooperatives of Atria Itikka and Lihakunta shared the heritage of TLK and became market leaders in Finland.

[4] Karjaportti, later Portti had serious financial problems already in the 1990's that continued in the new decennium. Finally, after different development stages and cooperation HKScan bought the company in 2010 and currently Portti Oy is HKScan's subsidiary.

in the end of 1980's. The domestic consolidation had become to the end. After these mergers there were more than 20.000 members in the cooperative.

New structures

The next important phase was in the end of 1980's when the lack of capital due to the decreasing number of supplier members (and increasing burden to a single member) as well as increased indebtedness due to the former acquisitions meant that the cooperative started to think over the business model. Similarly to the slaughtering cooperatives in the Northern Finland[5], the LSO cooperative established a limited liability company LSO Food Oy in 1988 that was firstly entirely owned by the cooperative LSO but soon after that it looked for private investors (but only producers at that time). The slaughtering, processing and marketing were moved to the company whereas collecting and supplier services were left to the cooperative.

In the beginning of 1990's the company LSO Food Oy acquired privately owned Helsingin Kauppiaat Oy (in 1991 as part of the demolition of TLK) and Kariniemi Oy's poultry division (in 1993). These acquisitions strengthened the cooperative's presence in the consumer market and gave it some of the best-known brands in Finland. After these processes the new company name, HK Ruokatalo Oy, was introduced at the beginning of 1997. Few months later the company was listed on the Helsinki stock exchange (Nasdaq OMX). As part of this process the collecting and supplier services held by cooperative were moved to LSO Foods Oy that was now reorganised as a daughter company of HK Ruokatalo. The role of LSO cooperative has since that been only to act as a holding cooperative.

This is a very similar path as has been in the other Finnish large cooperative based slaughterhouse, Atria. The consolidation process among Finnish cooperative slaughterhouses has led to the current situation where there are four cooperatives of which three (LSO included) are only holding cooperatives and one is also involved in collecting business.

3.1.3 Internationalisation

The changed structures were obviously made due to the changed policy environment. Finland has joined EU in 1995 that meant a tremendous change in the agricultural and food policy. Before the EU membership the border protection was so tight that in fact there was no foreign competition in the Finnish market. This held in every product where there was domestic production.

The new competitive situation forced the Finnish food industry to further develop their operations. In the protected world the need to increase productivity was neglected and the economic situation of the companies was poor at that time. This was the situation especially in the meat sector and in LSO. The threat to import competition was in meat sector much harder than e.g. in the dairy sector. Very concentrated retail sector made it possibly to use imported products as "price fighters" against domestic production. Thus, firstly, in order to be competitive the industry needed to increase domestic productivity and efficiency of the production. Secondly, they had to be prepared to increased export due to the increased import if he production in Finland was to be maintained. Thirdly, the need to learn the international operators' manners increased the need to internationalise their operations from traditional export with help of export subsidies.

[5] In Northern Finland the cooperatives publicly listed the newly established limited liability companies at once whereas LSO took these steps a bit slower.

HK Ruokatalo embarked on an internationalisation process with the acquisition of a majority holding in Estonian-based AS Rakvere Lihakombinaat in summer 1998 and AS Tallegg in 2001 and a minority holding in Sokolów S.A. of Poland in 2002. In 2004 HK Ruokatalo and Danish Crown started a strategic co-operation in Poland and finally in 2006 they had acquired Sokolów's entire share capital.[6] In January 2007, HK Ruokatalo Group went to Sweden by acquiring Scan AB, which is the largest meat company in Sweden. The substantial expansion of the group's international business caused a need to re-name the company from HK Ruokatalo Group to HKScan Corporation. As part of this purchase, the Swedish meat cooperative, currently Sveriges Djurbönder ek. för. became a co-owner of the new company. In 2010 became Rose Poultry A/S, the largest poultry company in Denmark, a part of the group through an acquisition. The group is now active in nine Northern European countries.

3.2 Relations to our building blocks

In this section we briefly look at the building blocks of our entire project. The aim is to find out whether there are reasons e.g. in institutional environment that may have affected the development and which need more clarification in interviews.

3.2.1 Institutional environment and policy

As Cholupkova (2002) has noticed the Finnish producer cooperation has been founded from top down in contrast to almost any other country in Western Europe where the most common way has been the opposite. The cooperative law in Finland came into force very early (1901) and the central organisation Pellervo had a major role in promoting cooperation among Finnish producers (and consumers as well). This created a very strong position for Finnish cooperatives (see also Kuisma et al. 1999).

However, the Finnish cooperatives have been very business oriented throughout their history. The purpose has been to improve their members' welfare. The consolidation development is one example of the business orientation. In the 1980's when the first steps in hybridisation process was taken the overall atmosphere especially in business world was perhaps a bit changed. The younger generation that was recruited to the banking sector was not any more so tight to old traditions and to rural background. When cooperatives became larger the cooperative business form looked perhaps a bit old-fashioned from financial perspectives. There were doubts of e.g. slowness of decision making process. This might have affected the hybridisation process.

On the other hand, due to this business orientation there have been no policy measures that would have given any advantage to any of the business forms. There are some differences in taxation rules but they affect the members' taxation not the company' or cooperative's taxation that are basically similar (see Pyykkönen et al. 2011).

The Finnish EU membership was a fundamental change in policy environment. It did not affect the business units as such except in primary production. However, the change in competitive situation of the food industry was remarkable when Finland became part of the EU internal market instead of being protected from foreign competition. The agriculture has had a special position in Finnish policy and the need to protect it and maintain domestic production remained after the EU accession. Finland negotiated the right for national support that has maintained the production in Finland. It has also affected to the position of domestic producer owned food

[6] The purchase of Sokolow and collaboration with Danish Crown have been described and analysed in another SFC Case study (Pyykkönen et al. 2012).

industry since it has been able to rely on domestic raw material. This policy is choice Finland has made differs essentially from the choice e.g. Sweden made in EU access. Sweden chose a much more liberal policy and this is partly the reason why Swedish food industry has been in trouble.

3.2.2 Ownership and internal governance

In the end of 1980's there were 25.000 members in LSO Osuuskunta. The governance was such that instead of General Assembly there was (and still is) Member Council, Supervisory Board and Board of Directors. Currently (in 2011) there are 1.670 members. The cooperative has had an active policy during the last decade that only active producers can be members in the cooperative.

After the first hybridisation step in 1988 the established LSO Food Oy was owned by LSO Osuuskunta (90% of the shares, and 99% of the votes).[7] The division of shares into two series (A and K) was made already in the beginning in order to be able to maintain the majority of votes even in a possible situation that the company will be publicly listed and there will be outside investors. Thus, the cooperative prepared for future steps in hybridisation.

The ownership structure of HK Ruokatalo after the establishment of the concern (in 1995) but before public listing in 1997 was such that the LSO Osuuskunta owned around two thirds of the shares and more than 90% of the votes. After public listing and emissions to institutional investors in the end of 1998 the LSO Osuuskunta's share of the shares was 39% and of the votes still almost 90%. One of the most important outside investors was LRF (Swedish Farmers' Union) whose share was around 10%. LRF had at that time a Baltic Sea Strategy and it made investments in food industry not only in Sweden but also in Finland and Poland for example.

These LRF shares were later on sold to Danish Crown which still owns part of them. Interestingly, after Danish Crown becoming shareholder (that was connected to a start of the collaboration of DC and HK in Poland, see Pyykkönen and Ollila 2012) CEO of DC was nominated to BoD of HK Ruokatalo. The reason for Finns was to learn from Danish experience in the international markets. Thus, at that time DC and HK felt themselves more as collaborator than competitors.

After the internationalisation process and especially the acquisition of Swedish Meats meant restructuring of the ownership. In addition to LSO Osuuskunta, the Swedish producer cooperative, currently Sveriges Djurbönder ek. för. became a large owner of the company. Currently, the major owners of the publicly listed company HKScan are listed in the Table 2.

Table 2. Ten largest owners of the HKScan, Situation 31st March 2012.

	Share (%) of the	
	shares	votes
LSO Osuuskunta	34,88	69,25
Sveriges Djurbönder Ek. För.	12,54	12,39
Keskinäinen työeläkevakuutusyhtiö Varma	6,82	2,38
Keskinäinen Eläkevakuutusyhtiö Tapiola	1,87	0,65
Fim Fenno Sijoitusrahasto	1,58	0,55
Maa- ja metsätaloustuottajain Keskusliitto MTK ry	1,52	0,53
Sijoitusrahasto Alfred Berg Finland	1,39	0,48

[7] The shares that were not owned by the cooperative were in the beginning owned by cooperative members.

Sijoitusrahasto Taaleritehdas Arvo Markka Osake	1,18	0,41
Danish Crown A/S	0,98	0,34
Valtion Eläkerahasto	0,91	0,32

The shares are divided in two series: the A shares that are publicly listed, and the KII shares that are owned by mother cooperatives LSO osuuskunta (87,7% of KII series and Sveriges Djurbönder (12,3% respectively). The KII series gives twenty times as much voting rights as A shares. Therefore, the largest owner, LSO Osuuskunta, has an absolute majority of the voting rights. Of the other eight largest owners six are Finnish institutional investors, mainly insurance companies. The last two in the "Top ten" list are the competitor/collaborator Danish Crown and Finnish Farmers' Union MTK.

In the mother cooperative LSO Osuuskunta there are 1,670 members of which almost half are cattle farmers (of which 80% are dairy farmers), another half pig farmers and the rest poultry producers. Instead of General Assembly there is Member Council which consists of 40 representatives elected from 8 election districts. Every member has one vote in elections. Member Council appoints the members of the Supervisory Board which again appoints the Board of Directors.

LSO Osuuskunta as a major owner has an important role when appointing the members of BoD of HKScan. Currently, there are six members in the BoD of HKScan. In fact, the members are nominated based on LSO's proposal. Currently, there are three suppliers (two Finnish and one Swedish) and three professionals (two Finnish and one Swedish). The relationship between LSO Osuuskunta and HKScan governance structure is currently such that same persons cannot be in both companies governance.[8]

The interesting issue concerning the cooperative's governance is the decreased number of members and changed structure in agriculture. The members used to be much more homogenous group than they are currently. For example, the pure meat producers' invested capital into the cooperative is much larger than their share of votes. The capital to be invested is related to the value of the marketed meat production such that a member has to invest 2.000€ for every 20.000€ production value. An average LSO pork producer in Finland has thus to invest around 20.000€ into his/her own cooperative. At the same time a typical dairy producer's investment obligation is only the minimum share, i.e. 2.000€.

In the long run, this imbalance between producers (especially when the pork is the most important for HKScan) may cause a challenge to the governance of the cooperative. Even though the cooperative doesn't anymore have any business operations but acts only as a holding cooperative there still exists a connection between membership and patronage. It is in LSO's as well as in HKScan's interest that members would be active producers. Thus, the LSO statute orders that the membership in LSO requires production contract with HKScan (or actually with its subsidiaries or partnership companies). The Statute of Sveriges Djurbönder does not require patronage to Scan AB (HKScan's Swedish subsidiary) even though most of the members are probably Scan suppliers.

3.2.3 Position in the food chain

[8] This change in practice is related to ongoing process concerning suspected insider trading where LSO Osuuskunta bought HKScan shares.

The company's home market consists of Finland, Sweden, Denmark, the Baltics and Poland. HKScan produces, sells and markets pork, beef and poultry meat, processed meats and convenience foods to retailers, the HoReCa sector, industry and export customers.

Since the beginning of 2007, the company's business was divided into four business segments: Finland, Sweden, the Baltics and Poland. Denmark became the fifth segment in autumn 2010. HKScan's business in Finland, Sweden, Denmark and the Baltics is carried out mainly through wholly owned subsidiaries while the business segment of Poland consists of the company's 50 percent indirect holding in Sokolów S.A. (see Pyykkönen and Ollila 2012). The turnovers and the most important subsidiaries by market areas are presented in Table 3.

Table 3. The operational structure of HKScan.

The company has very large market shares especially in Finland and in Sweden. Compared to many other European competitors the HKScan sortiment is larger (including both red and white meat). Also the processing level is higher than average. The company takes care of the entire chain from farm to wholesaler. The cooperative LSO Osuuskunta acts only as a holding cooperative.

3.2.4 Growth and internationalisation (relates to performance)

The company HKScan has set its strategic goals such that HKScan's mission is to be a responsible food company which creates economic value added for its stakeholders through its meat-based product portfolio, food concepts and tasty products designed to contribute to the lives of consumers by making cooking easy and enjoyable. The vision of HKScan says that HKScan is a responsible food company which sets the standard for best practices in the meat industry in Europe through strong brands, innovative products, an efficient and transparent production chain and skilled employees. They call themselves as "meat industry shaper".

The role of internationalisation is thus clear (has been since mid-1990's). Moreover, the value added to its stakeholder evidently refers to the Finnish producers through LSO Osuuskunta.

The financial targets and dividend policies HKScan tries to achieve are as following:

Operating profit:	over 5 per cent of turnover
Return on equity:	over 15 per cent
Equity ratio:	over 40 per cent
Dividend distribution:	at least 30 per cent of net earnings

Currently, these goals have not been reached. A couple of recent years have been very tough to the company. Especially, the Swedish operations and the development there has been problematic.

The holding cooperative LSO Osuuskunta has respectively set their goals. The aim of LSO Osuuskunta is to support its members' meat production and marketing and to secure the coninuity of production. These goals are achieved by owning HKScan. LSO Osuuskunta supervises and controls HKScan business such that the business is developed in profitable and competitive manner. LSO Osuuskunta also foster the value of its investment in HKScan as well as produces value added for its members. The ownership ensures the company commitment to local raw material and development of the entire meat chain.

Taking into account these goals the growth is an obvious goal. And the growth is not possible without internationalisation.

4. Survey results

This chapter aims to add information concerning reasoning to moving into hybrid structures and the more complicated ownership/supplier relations than in traditional cooperative. These relations are according to the interviewees more and more challenging. This is the case not only in the Finnish meat sector but in all the other sectors everywhere in Europe.

4.1 Reasons for hybridisation

The structural arrangements in the meat industry in 1980's needed capital and the possibilities available for limited liability companies were not available for cooperatives. At the same time the farms were quite indebted and their ability to invest in their own cooperative was restricted even though they have been willing to do so. Thus, when the first step of hybridisation was taken the number of farms has been declining, there were no new members to be expected to share the capital needs cooperative certainly needed. However, equity should be raised in order to avoid expensive debt financing.

In this situation, the cooperative governance started to think about their options. The idea was to divide the operations into cooperative operated collecting of animals and limited liability operated slaughtering, processing and marketing. The limited liability company would then be able to attract capital from outside traditional farmer circles. The possible public listing was one option already at that time. The planning of these arrangements took two years. In 1988 the arrangement were decided according to this plan.

The cooperation between the cooperative LSO and established limited liability company LSO Food Oy was ensured by having the same CEO and same members in the BoDs. The main reason was the equity raising but another reasons can be find firstly from the company form as such and secondly from the need make certain operative decisions easier. The capital market was liberalised in Finland in the end of 1980's and the cooperative was seen as an old-fashioned form. Thus, it was a bit easier to negotiate also on debt financing with banking sector.

The limited liability company also offered a bit distance to the supplier governance. There was an obvious need to make structural arrangements also in the industry. This meant e.g. that some of the plants had to be closed and it was easier to make these decisions in company than in cooperative where others than business reasons might have affected the decisions (see Åberg and Puro 2012).

The equity raising was firstly sought only from members of the cooperative. The limited liability company has been established in April and in September there was an emission directed to LSO members. The emission was successful since the members' involved (5.700) share of production was 87%. Thus, the reasoning that the suppliers did not want to finance their own cooperative was at least partly wrong.

However, this reasoning of farmers' disability was certainly true few years later when the next steps in the hybridisation process were taken. In the beginning of 1990's the company indebted heavily and the profitability weakened. Even though the equity has risen the company did not manage very well. Thus, in mid-1990's company was almost in bankruptcy. The equity to asset ratio was positive only due to the fact that required depreciations had not been made but in fact the ratio was negative.

Thus, the decision had to be made quickly. But it needed a reliable plan. The first step was to hire a new CEO who at once changed the most important managers. Second step was to start to look for equity raising. Firstly, it needed some commitment from current owners. Thus, the first emission was directed to the LSO Osuuskunta, its members and company workers. This created the basis that the company could start to think about future public listing.

Finland had joined the EU and the farmers had a tremendous pressure to develop their own farms. In this situation, they would have not been able to invest more in their own cooperative or company. The situation concerning the future prospects (e.g. transition period was still going on) were uncertain. Thus, the only way to look for capital was outside the farming sector.

The third step, public listing took place in 1997. The operative businesses (collecting animals, primary production services) that have been left to the cooperative in 1988 had been moved into HK Concern already in 1995. Soon after public listing the fourth step of hybridisation and reorganizing the business was to seek outside investors. This was done in 1998 by organizing four emissions. These were targeted to institutional investors, stakeholders, employees and for some named companies. One of the investors was LRF.

One of the interviewees commented that if the cooperative/company had not managed in closed economy it had no possibilities in an open economy after EU access, either. Thus, the decisions made in the cooperative/company were absolutely necessary in order to be able to avoid the demolition of the company. With these arrangements the company's equity to asset ratio was increased from 15% in 1995 to 38% in 1998 after the emissions.

Thus, this reorganising made it possible to think about the future and the growth strategy and internationalisation. The largest ownership arrangements were made in 2006 when the Swedish Meats was acquired. This acquisition was financed mainly by debt financing and taking responsibility of the Swedish Meats debts (see Häkkinen and Raukko 2011). As part of this process renamed HKScan got a new cooperative owner, currently Sveriges Djurbönder ek. för. After this acquisition the equity to asset ratio collapsed to below 30% in 2007 having been around 45% in the years before. Still, the ratio is below 40% and the performance of the company does not satisfy the owners.

One of the key drivers behind the growth strategy has been to protect the domestic market. The growth as such may be a goal that brings value added to the owners. On the other hand, being active in the neighbouring market (for HK Estonia, Sweden, Poland too) may prevent foreign competitors to get good position and increasing competition at domestic market. Thus, there has been very considerable national interest in growth acquisitions.

4.2 Controlling power of producers

In order to be a reliable actor in the Exchange some of the interviewees were thinking that in the future the joining of the two series of HKScan shares (A and K) must be considered. The strong role of the cooperatives that exceeds the owner share may decrease the attractiveness of the company from institutional investors' perspective.
However, that difference in voting rights has probably been discounted in the market value of the shares. Thus, the investor, when making a possible investment decision is very well aware of this situation. Furthermore, some of the outside investors may appreciate if there is a one strong and clear owner. Therefore, in order to keep the investors happy company has to pay good dividends.

The problems may arise, however, if the suppliers' goals are not similar to the investors' goals. This may well happen when thinking about e.g. producer price based on patronage relationship and dividends and increase of the value of the share in Exchange from investors perspective. At least in the short run suppliers may appreciate highest possible producer price that contradicts the investors' interests. If the suppliers' representative LSO Osuuskunta would be too strongly for patronage goals (i.e. highest possible producer price) the reliability of the company as a publicly listed company would decrease. Obviously this does not seem to be the case. In the long run the goals of the supplier-owner and investor-owner should be the same.

From holding cooperatives perspective this customer/owner dilemma is very challenging. Even though the goal of success of the entire meat chain is clear for cooperative it is not similarly to all of its members. The larger and more professional suppliers understand this very well. However, the communication and education of the members, especially those involved in internal governance, is extremely important.

Due to the strategic goals of the LSO Osuuskunta (Chapter 3.2.4) it is also very understandable that the membership is at least at the moment mentioned to be restricted only to Finnish producers. The control of the company is an important goal in order to maintain the strong position of domestic production.

4.3 Benefits of the owner-suppliers

Another interesting dilemma concerns the double role of the farmer as supplier and owner. The membership in LSO requires patronage contract with HKAgri or Länsi-Kalkkuna (HKScan subsidiaries that take care of collecting animals), not the opposite. Membership in cooperative brings only owner's interest not supplying possibilities. Thus, the role of invested capital in own cooperative is much nearer the outside investor's role than in traditional cooperative where membership in cooperative brings the delivery right to the cooperative.

The investor (owner) expects returns to his/her invested capital. Normally there are two kinds of returns. Firstly, the dividends company pays and secondly, the expected increase in the value of the investment (market value of the share). In LSO case the holding cooperative is paid dividends from HKScan. The dividends (after discounting the costs of the cooperative) are paid to the members as interest on their invested capital. Thus, it is fairly comparable to the dividends paid to an investor. However, there is no instrument or possibility from cooperatives perspective to benefit from possible increase in market value of the HKScan shares that cooperative owns. Thus, in this sense the motives of the supplier to become a member are not so concrete than they are in pure investor's case in IOF-case.

According to Finnish taxation rules there are some possibilities to gain from the increase in market value of the share. When calculating the capital income share that is based on net wealth of the farmer he/she can use the taxable market value of the investment in LSO instead of real invested capital. In 2011 the taxable market value was around four times larger than the real invested capital. Thus, if the farmer is wealthy enough and his/her marginal tax of other than capital income is high he/she benefits from being able to have a larger share of his/her incomes taxed as capital income.

However, this benefit is not equal to each owner and is based on the farmers' economic position otherwise. Moreover, for majority of the current members the importance of this taxation benefit is rather small. The average amount of invested capital is around 12.000€ and many of the members have only one member share that is worth 2.000€.

However, the structural change in Finnish agriculture is rapid and based on Pyykkönen's et al. (2010) study one can estimate that in 2020 there are only 800 members in LSO and the largest 100 producers own around half of the cooperatives equity. Calculated with current figures this would mean that the average investment of these 100 largest producers were around 100.000€.

This is a major challenge to the cooperative for many different reasons. Firstly, is it still fair to have one-man-one-vote principle? The largest suppliers may require a larger role when making important decisions.

Secondly, do they still see their investment as a cooperative share without need to benefit from the possible increase in the market value of the share? They might demand the division of the LSO shares in HKScan to members. This would in fact mean the abolition of entire LSO as such. Another alternative would be that LSO cooperative was changed to a limited liability company and the cooperative shares were changed into company shares. This would maintain the controlling power of LSO but would that kind of indirect investing be enough attractive?

Thirdly, the largest suppliers may see themselves only as investors rather than cooperative members and are requiring more benefits. They might leave the cooperative and invest somewhere else or directly to HKScan the respective amount. When doing so, LSO should return the member his/her shares. If there were enough large members acting like this LSO should sell its HKScan shares or take some debt. In both cases the strategic position of LSO as major owner of HKScan weakened.

The big questions related to this issue are what are the benefits cooperative can offer and do the large suppliers need cooperatives? The farmer interviewees saw these questions more relevant than the cooperative managers.

4.4 Conclusions of survey results

Based on the interviews it is obvious that in LSO case the hybridisation was absolutely necessary. The financial position of the company in those critical stages was such that in fact there was no other way than try to attract capital from outside investors. Moreover, the growth/internationalisation strategy the cooperative/company had chosen in 1990's would not have been possible without being publicly listed company.

The hybrid structure brings however some challenges at least in the short run. The goals of farmer suppliers and outside investors are not necessarily similar. A supplier may appreciate the highest possible producer price and the investor is expecting high dividends and the increase in market value of the company. In the long run the goals are equal but especially in difficult market situation as seen during 2010-2011 the goals have been contradicting. There is no objective guide-lines for determining how much to pay to suppliers as higher price, compared to the interest paid to the investors.

The structural change puts also pressure on further development of cooperative structures. The hybridisation process may take new forms and have some effects also on the holding cooperative. For example, the one-member-one-vote principle might be reconsidered as well as the possible benefit from increase of cooperative's market value.

5. Overall conclusions

Hypotheses to be tested were

H12. Cooperatives going international are more likely to have diverse ownership structures.

This hypothesis got clear support. The strategic decisions concerning growth by internationalising the HK operations would not have been possible without outside investors. The public listing was also a natural continuum to this development.

H13. Foreign subsidiaries are more likely to be set up as profit centers, pursuing a profit objective and not a supplier benefit objective.

Similarly, this hypothesis was supported. The national interests while making strategic decisions are so strong that this is the case. Furthermore, in addition to acting as profit center the foreign investments were also made for protecting domestic production from foreign competition both at farm and industry levels.

H14. Cooperatives going international are not likely to invite their foreign farmer-suppliers to become members as domestic members fear a dilution of income rights.

Again, this hypothesis was supported (see also another SFC case by Pyykkönen and Ollila 2012). In case of LSO the market value of LSO shares in HKScan is more than four times as much as the members' invested shares in cooperative. If new foreign members were accepted they would get the share of this collective accumulated income and that would not be acceptable from domestic members' perspective.

H15. Cooperatives going international will apply different business models in their foreign operations, which will lead to a different relationship with foreign farmers.

This hypotheses is not so clear whether it was supported. Compared to H13 one might think that this is the case. However, neither in Finland the patronage is tight to the membership of the cooperative. The patronage is based on contracts the supplier and the company (HKScan subsidiaries taking care of collection) have agreed on. Similar kind of a contract production is in the company's wishes also in foreign operations. Thus far, the structures especially in Poland are not such that this would be possible. In addition to this, different business cultures, business practices, legislation, and even prejudice, may be affecting to this matter.

References

Arovuori, K., Karikallio, H. and P. Pyykkönen. (2011). *The development of power relations in the Finnish food markets*. PTT Reports 230. 47 p.

Chaddad, F. and M. Cook. (2004). *Undestanding New Cooperative Models: An Ownership-Control Rights Typology.* Review of Agricultural economics. 26:348-360.

Cholupkova, J. (2002). *European Cooperative Movement – Background and Common Denominators.* The Royal Veterinary and Agricultural University. Food and Resource Economic Institute. Unit of Economics. Working papers 2002/4.

Häkkinen, L. and M. Raukko. (2011). *Beefing up the meat market - The HK Ruokatalo – Swedish Meats acquisition.* Turku School of Economics. Series C-1:2011:19-32.

Kuisma, M., Henttinen, A., Karhu, S. and M. Pohls. (1999), *The Pellervo Story*. Pellervo Confederation of Finnish Cooperatives.

Niemi, J. and L. Xing 2011. *Market power in the retail food industry: Evidence from Finland*. Paper presented at the 21st Annual IFAMA World Symposium in Frankfurt on June 20-21,2011. 16 p.

Pyykkönen, P., Lehtonen, H. and A. Koivisto. (2010). *Structural change and investments in Finnish agriculture 2010-2020*. PTT Working Papers 125. 24 p.

Pyykkönen, P., Bäckman, S. and P. Ollila. (2011). *Support for farmers' cooperatives in the pork sector*. Wageningen: Wageningen UR.

Pyykkönen, P. Ollila, P. and P. Matczak (2012). *Support for Farmers' Cooperatives; Case Study Report Sokołów – collaboration of Danish Crown and HKScan*. Wageningen: Wageningen UR.

Suistoranta, K. (1989). *Lihan tähden kaikki työ.* LSO:n historia.

Åberg, V. and Puro, L. (2012). *Lihatalonpojat ja heidän yhtiönsä - LSO, HK ja liha-alan rakennemuutos.* Preliminary manuscript.

Websites:
www.lso-osuuskunta.fi
www.hkscan.com