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MENDELU Working Papers
in Business and Economics
32/2013

Does horizontal cooperation create value? A residual income approach application on Czech agricultural data

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MENDELU Working Papers in Business and Economics
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Citation

Ruzickova, K., Korab, P. (2013). Does horizontal cooperation create value? A residual income approach application on Czech agricultural data. *MENDELU Working Papers in Business and Economics* 32/2013. Mendel University in Brno. Cited from: http://ideas.repec.org/s/men/wpaper.html

Abstract

Kamila Ruzickova and Petr Korab: **Does horizontal cooperation create value? A residual income approach application on Czech agricultural data**

In the context of current competitive environment the companies in agriculture are forced to find a path towards the improvement of their business competitiveness. One of illuminating examples may be the horizontal cooperation in the form of cooperative entity. Naturally, as the economic performance of the group rises, the economic performance of members should rise, too. However, the crucial point is whether these members create a value for the owners, as this is the primary company objective. In this paper, we provide unique comparison of application of a residual income valuation method to empirically verify the assumptions which lead to grouping agricultural enterprises in cooperative entity.

There are two objects of research: firstly, the alliance of winemakers, their individual members cooperating in marketing and sales management with the aim of boosting their economic performance, and secondly, their business rivals, who decided not to enter the alliance and cooperate. Alliance V8 is a newly-established NGO grouping top Moravian winemakers, the only of its kind in the Czech Republic. Contrasting the results of the case study research of both objects of research reveals whether joining the alliance altered the value of their members and also examines the applicability of the valuation method.

Key words

company value, co-operative entity, horizontal cooperation, residual income

JEL: G32, Q13

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Acknowledgements

This paper was elaborated thanks to the international project “Human Resource Development - Science Education & Research in Faculty of Business and Economics in the Mendel University in Brno (2011-2014, MSM/EE)”, ID code: EE2.3.20.0006.

Introduction

The global business environment of today presents great opportunities, as well as potential threats. Companies not only in the Czech Republic, but also globally, have witnessed dramatic changes arisen from the world's economic crisis. Moreover, those changes are experienced throughout the industries and alternative management strategies need to be explored and employed. One of re-established solutions is represented by business cooperation of enterprises within different sectors of the economy, not excepting the agricultural sector.

Since the role of agricultural sector indisputably belongs to the most important and irreplaceable (Fleischer, Tsur, 2000; Randall, 2002; Chavas, 2011), the economic performance of agricultural companies presents rather unsatisfactory results (Kopta and Marsik, 2009; Cechura, 2010). Moreover, this sector of economy is typical with the joint role of uncertainty and exogenous influences (Chavas, 2011). Albert et al. (2001) therefore introduce several scenarios of potential future development of this sector and they claim that the answer for unfavourable development can be the cooperative initiatives. This phenomenon is evident within the EU context: there were 30,000 agricultural cooperatives in 2000, whilst in 2009, the number of cooperatives rose to 250,000 entities (COGECA, 2000, cited in Arcas-Lario, Hernández-Espallardo, 2003; Pascucci, Gardebroek, Dries, 2011). The relevance of cooperatives is then confirmed not only by practice (Co-operative facts & figures, 2012), but also by theory (Sarris et al., 1999; Arcas-Lario and Hernández-Espallardo, 2003; Bogetoft, 2005; Wolz, Fritzsch and Pencakova, 2006; Amadieu and Viviani, 2011; Feng and Hendrikse, 2012; Pascucci, Gardebroek and Dries, 2011; Pennerstorfer and Weiss, 2012).

This paper studies two samples of enterprises in agricultural sector: firstly, the individual member companies in the alliance of winemakers, which decided to cooperate in marketing and sales management with the aim of boosting their economic performance, and secondly, their business rivals, who decided not to enter the alliance and cooperate.

The economic effects of entering the alliance will be examined by member-company value measurement, and later on compared with the company value development of the non-member competitors. Since both samples have the same external unpredictable factors and exogenous influences, any increase or decrease in value may be connected with the fact of entering the alliance. Comparing and contrasting the motives of cooperation of cooperatives and alliance of winemakers may serve as the basis for potential improvement, especially in terms of the economic performance of the alliance. This perspective of comparing the individual wineries grouped in the alliance with

their business rivals from the same background has not been studied and published yet, according to the conducted literature review.

This article aims to answer the question, whether joining a group in agricultural sector influences the individual member-company value. The residual income approach was employed for empirical verification of fulfilling the economic motives of cooperation: improvement of the company credit, trustworthiness and viability by increase in company value for owners. We examine the value of both entities before joining and the value as a member of the group, and try to provide arguments whether the assumptions from the literature on motives of grouping and benefits of membership, may be, on the sample observed and verified.

1 Review of the literature: Agri-business and the agricultural cooperatives

In most central and eastern European countries (CEECs), the model of cooperating entities was employed during the Communism era. The original collective or state form of ownership was transformed into producer co-operatives, small family farms or newly established forms as limited liability and joint stock companies (Csaki and Lerman, 1997; Swinnen et al., 1997, both cited in Sarris et al., 1999). Sarris et al. (1999) consider the commercial cooperation of small farmers with unexploited potential, as important viable option for the future in CEECs, even though there are severe technological and financial constraints.

However, in this paper, we focus on agricultural enterprises in the Czech Republic, which are strongly affected by historical development during the last 30 years. The historical events caused immense changes in their business strategies, together with the development of new media and political environment: companies have to deal not only with globalization or rapid evolution of new technologies, but also with increasing bargaining power of retailers, post-harvest hold-ups, or increasing demand for food (Viaene and Gellynck, 1995; Hendrikse and Bijman, 2002, both cited in Arcas-Lario and Hernández-Espallardo, 2003).

Those enterprises were forced into the informal cooperation within the commodity vertical but also into adding other business activities to stay viable and competitive, so called sideline. Today, Czech agricultural companies are finding a path towards economic prosperity via modern managerial tools and consistent cost management, due the fact, that their business activities are according to Cechura (2010) rather ineffective. Moreover, these companies still remain unprofitable with steep fluctuations of cash-flow (Kopta and Marsik, 2009) and profits of these companies became directly dependent on public subsidies (Strelecek, Lososova and Zdenek, 2007). On the other hand, this type

of funding is inevitably related with any company enhancement within this sector of economy (Strelecek, Lososova and Zdenek, 2007). Therefore, the potential for becoming a beneficiary of these financial sources rises with concentration of capital, knowledge and experience, i.e. in co-operative entity.

Based on aforementioned facts, many agricultural enterprises are grouped into the cooperating entities, or groups of individual producers (Sarris et al., 1999; Arcas-Lario and Hernández-Espallardo, 2003; Bogetoft, 2005; Amadieu and Viviani, 2011; Feng and Hendrikse, 2012; Pascucci, Gardebroek and Dries, 2011; Pennerstorfer and Weiss, 2012). A cooperative is a company collectively owned by the independent primary agricultural producers as input suppliers within a production vertical and simultaneously, they are the partial owners and controllers (Bogetoft, 2005; Feng and Hendrikse, 2012; Hernández-Espallardo, Arcas-Lario and Marcos-Matás, 2012). The importance of these producers' groups within the agri-food chain is verified by the substantial market shares in most EU Member States (Pennerstorfer and Weiss, 2012) and their active role for a very long time in many countries all over the world, not only in the agricultural sector (Arcas-Lario and Hernández-Espallardo, 2003; Hansmann, 1996, cited in Feng and Hendrikse, 2012).

On the basis of mutual agreements between agricultural co-operators, most of these farmers deliver their production to that cooperative. Pascucci, Gardebroek and Dries (2011) proved on the Italian dataset, that those farmers, members of cooperative, do not deliver their production only to the mother-cooperative, but also elsewhere. Moreover, there are also non-members, delivering their production to the cooperatives. They introduce the soft and shadow memberships, the former involves membership without delivering, and the latter involves delivering but not membership. Their findings confirmed that different strategies even within the cooperative sectors may be employed. Pennerstorfer and Weiss (2012) highlight the fact, that each individual member can decide whether and how much to deliver to the cooperative and hence the cooperative cannot control the quantity supplied to the market. Moreover, the increase in production lowers the final price on the market. The fact that the cooperation entity cannot control the volume of production causes the negative externality of joint ownership of such entity.

Beside the uncontrolled delivery volume, there are also other limitations of cooperatives, for example: their governance structure, which is rather decentralized, may cause a problem in decision-making. Second area includes the problems with new members, who benefit from the work of the old members; or finally, there might be a lack of interest in the long-term investments if the membership period is shorter than the potential benefits (Bogetoft, 2005; Feng and Hendrikse, 2012; Pennerstorfer and Weiss, 2012). Stewart (1993) even states that it is not possible to efficiently run

this kind of business since the customers and suppliers have direct interest in running it and calls it conflict of interest (Stewart, 1993, cited in Feng and Hendrikse, 2012).

On the other hand, there are various advantages of cooperatives, even though the overall economic evaluation is often undervalued or missing (Sarris et al., 1999; Arcas-Lario and Hernández-Espallardo, 2003; Bogetoft, 2005). Pennerstorfer and Weiss (2012) present the major advantages of cooperatives: the attractiveness for capturing the fruits of large farming enterprise compared to small family farms, or higher market power and improved market position. As far as the short-lived products as milk or fruit and vegetables are concerned, the cooperatives are trying to actively market this production and reduce the risk of post-harvest hold-ups (Staatz, 1984; cited in Bogetoft, 2005). Nevertheless, Tirole (1988) states, that these hold-ups issues can be effectively handled also by using hedging or long-term contracts (Tirole, 1988, cited in Bogetoft, 2005).

As a consequence of the aforementioned facts, agricultural cooperatives are being forced to change the orientation from a supply-driven to a demand-driven, in other words, from selling what has been produced to produce what can be sold (Kyriakopoulos and Van Bekkum, 1999, cited in Arcas-Lario and Hernández-Espallardo, 2003). Agricultural cooperatives have to respond with different strategies in order to remain viable and competitive in quality (i.e. differentiation) and in prices (i.e. production costs). In Germany or Denmark, agricultural cooperative chose merging as a route, however, in Spain, collaboration among cooperatives was preferred (Perrot et al., 2001; Julia and Mari, 2002, cited in Arcas-Lario and Hernández-Espallardo, 2003), so called second level of cooperating. The major driver of those entities performance is surprisingly not the financial investment of individual members, but the intangible investments, instead (Amadieu, Viviani, 2011).

Beside the agricultural cooperatives, many companies employ the strategic alliances having the form of mutual integration. According to Wu et al. (2009), strategic alliances are relationships based on formal agreements between companies willing to agree upon certain objectives; however, remaining independent companies. This kind of business cooperation is typical for international activities within the global field of business (Isoraite, 2009) since strategic alliances can be considered as a response to the competitive environment (Dickson and Weaver, 2011). These alliances are phenomenon of today (Gulati, 1998); they became even more popular due their ability to draw the greater value from the marketplace regardless the industry (Shah and Swaminathan, 2008).

The reasons for entering strategic alliances are closely reviewed in the following table (Tab. 1) along with summarisation of the so-far presented facts on motives of cooperatives.

Table 1: Motives of cooperation in strategic alliances and cooperatives, a review of literature

Motives of cooperation	
Strategic alliances	Cooperatives
Reaching new markets	Improved market position
Technology improvement	Sale of the production
Distribution channels sharing	Economies of scale
Equipment and knowledge sharing	Higher market power
Risk sharing	Services provided for the input
	Reduced risk of post-harvest hold-ups

Source: own compilation based on Isoraite, (2009), Pitts and Lei, cited in Wu et al., (2009), Dickson and Weaver, (2011), Elmuti and Kathawala (2001), Wu et al., (2009), and Pennerstorfer and Weiss (2012)

The essence of these alliances is when benefits exceed the costs (Wu et al., 2009). Elmuti and Kathawala (2001) state, that through strategic alliances companies can penetrate markets that would otherwise be uneconomical, since these alliances present a part of global networking process (Dickson and Weaver, 2011). On the other hand, the success of the whole alliance is directly dependent on the individual strategic partner selection (Shah and Swaminathan, 2008).

Based on the fact, that a cooperative is an autonomous group of persons who decide voluntarily to meet their economic needs through a separate enterprise which is owned and controlled by single members, it can be concluded, that strategic alliances share the same principles.

In this paper, we consider the company value improvement after accession to the group as the evidence of cooperation efficiency, and confirmation of fulfilling the individual motives of cooperation. Even though there are several conceptions of company value according to the valuation purpose etc. we prefer the value conception presented by Kislingerova (2001): *"exchange value of company based on willingness of both transaction partners but closely related to the future economic performance of the company, i.e. to the positive cash flow"*. This conception is based on the market value definition introduced by the TEGoVA (The European Group of Valuers' Associations) and European Valuation Standards (EVS): *"The estimated amount for which the asset should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion"* (EVS, 2012, p. 15). The essence of this idea is: the higher the value of a company, the higher the price if the exchange is the case, i.e. the information for investors what is the benefit they may receive if invest in a company (Kislingerova, 2001).

2 Materials and methods

In the pilot study, the unstructured interviews are employed to find motives of cooperation. These motives are examined and empirically verified in the primary research. The economic efficiency of cooperation is verified by the financial valuation framework, where the company value is calculated as the present values of future expected quantifiable benefits (Tsay, Lin and Wang, 2008). The efficiency is proved if there is a positive difference between before and after entering the cooperating entity. The model of residual income (RI) valuation, also known as the Edwards-Bell-Ohlson (EBO) model (Mishra and O'Brien, 2005), is employed in two points in time: firstly before and then after the entering the grouping. Since the alliance was established in 2006, the first valuation was conducted for the year 2005 (t) and the second valuation was calculated as at 2008 (t+3). This comparison serves as the evidence of economic effectiveness of individual group's member. The residual income valuation model (RIVM) and its empirical usefulness was presented by Lee et al. (1999, cited in Mishra and O'Brien, 2005). Various authors present the calculation of RIVM, for example Skogsvik (2002), Bild et al. (2002), Landsman et al. (2006), Stubelj, et al. (2009), or Elsner et al. (2012); however, Plenborg (2002) expresses the RI approach in terms of financial ratios, as:

$$P_0 = BV_0 + \sum_{t=1}^{\infty} \frac{(ROE_t - r_e)BV_{t-1}}{(1+r_e)^t} \tag{1}$$

where P is the firm value, BV the book value of equity, ROE the return on equity, and re the cost of capital (equity holder). The RI is defined as the difference between ROE and re, known as spread, multiplied by the BV (Plenborg, 2002).

The cost of equity capital is calculated according to the Neumaierová's dynamic scorecard INFA, since this method is more appropriate for individual company's risk assessment. This method is dedicated to the monitoring of key company financial indicators incorporating them into the formula:

$$r_e = r_f + RP \tag{2}$$

where rf is the risk-free rate and RP stands for additional risk and is calculated as:

$$RP = r_{LA} + r_{POD} + r_{FINSTAB} + r_{FINSTRU} \tag{3}$$

where all rs stand for additional risks associated with company size, business risk, financial stability and financial structure, respectively (Neumaierová et al., 2005).

The sample consists of two groups of companies: firstly, the alliance of winemakers and its individual members, secondly, comparable competitors as non-members of any kind of horizontal-cooperative entity. Both entities are founded and operate in the Czech Republic, without any foreign investments. The financial reports serve as the primary information source drawn from Czech Business Register, together with the unstructured interviews with the representatives of those entities. The dataset consists of three members of the alliance of winemakers and three comparable competitors (see Tab. 2). All observed entities are legal bodies according to the Czech law and order. According to keeping the business secret, all the responders are labelled with capital letters A-F, where A-C stand for members of the alliance and D-F stand for their main business competitors, non-member companies.

Table 2: Description of the sample

	V8: strategic alliance	**Competitors: non-members of cooperative**
Company labelling	A-C	D-F
Sample size	3	3
Total members	6	-
Founded	2006	-
Commodity	Wine	Wine
Production area	600 ha	206 ha
Overall turnover	4 mil EUR	1,9 mil EUR

Source: own work based on Czech Business Register (2012), unstructured interviews with research responders (2012) and corporate database Amadeus from Bureau van Dijk (2012)

As the V8 alliance is the only alliance of winemakers in the Czech Republic and for the three remaining members we faced a lack of data, the research sample for the Czech Republic cannot be larger.

Finally, findings from both samples are summarized and compared. The motives of cooperation are challenged with the theory and the empirical evidences are provided. All the findings are supported with the literature review on cooperatives, alliances of winemakers and company valuation as for example Amadieu and Viviani (2011), Arcas-Lario and Hernández-Espallardo (2003), Bogetoft (2005), Cassia and Vismara (2009), Chavas (2011), Plenborg (2002) or Pennerstorfer and Weiss (2012).

3 Results and discussion

Firstly, results of unstructured interviews with representatives of member enterprises of V8 are presented. The aim of interviews was to detect motives of firms for joining the group, which in other words means how members benefit from participation. The outcomes of interviews are then compared with motives from the literature on cooperatives' motives to see whether there is a possibility of generalisation.

Table 3: Results of unstructured interviews with research respondents

Economic motives of cooperation	
V8	
Coordination of marketing activities in the Czech Republic and in foreign markets	Common sales policy in foreign markets
Know-how sharing	Smoother sale of production
	Quality improvement

Source: own work

In the case of Alliance V8, the motives of joining and participation in the group are in accordance with the literature review. Moreover, the alliance shares the same principles as cooperatives (see Tab. 3).

The research results of residual income valuation approach on the research sample are summarized in the contingency table (Tab. 4). The total number of value creating companies has increased from 4 to 5, from the year *t* and year *t+3*. Moreover, almost all companies have improved their values.

Table 4: Research results summarized in contingency table

		Value creation after accession to group		
		Created	Not created	Total
Value creation before accession to group	Created	4	0	4
	Not created	1	1	2
	Total	5	1	6

Source: own work

Besides, we identified one company which value has even decreased, as further shown by table 5. All the member companies of co-operative entity have improved their values significantly (companies A, B and C). Whereas non-member companies, their business rivals, have experienced less significant rise in values (companies D and F) or even decrease in company value (company E).

Table 5: Value improvement

	Company	Relative difference in values in time *t* and *t+3*
Member companies	A	235%
	B	42%
	C	287%
Non-member companies	D	13%
	E	-24%
	F	175%

Source: own work

The individual value drivers are according to the residual income valuation method (RIVM) company equity, in the form of asset value, and discounted future profit in the form of future performance value. This future performance is estimated on the basis of so called spread, the difference between return on equity (ROE) and costs of equity capital (re), and equity as at the previous year. Therefore, the main value drivers are company's equity per se, historical performance reflected by ROE and financial risk depicted by re. The higher the net income, the higher the ROE, and similarly, the better the financial situation in a company, the lower the costs of equity capital (re), according to the Neumaierova et al. (2005) INFA methodology. Companies in the co-operative entity have enhanced their sales, therefore, their profits have arisen and as a consequence, the overall company financial situation has improved.

On the contrary, non-member companies have experienced the same business environment, with the same business background, opportunities and threats, but due the fact they did not join the co-operative entity their sales have not been enhanced as the member companies' sales and therefore, their values rose more slowly.

Conclusions

In this paper we have examined the impact of horizontal cooperation on company value of enterprises which joined an alliance of winemakers and their main business rivals who did not enter the cooperative entity. Measuring the company value using residual income approach to company valuation before joining and as a member of cooperative entity and comparing the results with non-member business rivals, we identified different results for both examined groups. For the member companies the results clearly confirmed that the company value increased after each enterprise entered the group. However, in the case of non-member business rivals, the results are not as clear and indicate increased as well as decreased company value within the same time frame. We see the reason of the differences in entering the group and starting mutual cooperation.

Since the comparison of cooperating entities within the agricultural sector with those who do not cooperate has not been discussed often by the other authors identified in the literature review; we find this topic relevant due to the irreplaceable role of agriculture in each world economy. We are convinced that by analysing the company value and by verification of cooperating motives in economic terms the overall economic situation of agricultural companies can be enhanced and improved.

Further research on this area, i.e. testing the hypothesis whether horizontal cooperation leads to higher company value, should be done with a larger dataset of horizontally cooperating firms and in a larger market than the Czech Republic offers. A special attention should be paid to identification of determinants of company value for each member of the alliance.

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