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The Bankruptcy of Tri Valley Growers: What Went Wrong and What Can We Learn From It?

by

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Many questions have been raised regarding the causes of the demise of California's leading food-processing cooperative. A recently completed UC Davis study provides some answers.

Tri Valley Growers (TVG) was a California agricultural cooperative owned by more than 500 member-growers who delivered primarily tomatoes, peaches, pears and olives to the cooperative for processing and marketing. In fiscal year 1998, TVG's sales revenue reached $782 million, and its members' equity was $125 million. TVG hired more than 9,500 seasonal and 1,500 annual employees. Severe financial difficulties forced TVG to file a voluntary petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code, in July 2000. Its assets were sold subsequently to various buyers. TVG's bankruptcy caused ripple effects across much of the state's agricultural sector.

Essentials of TVG's Operations

In the mid 1990s, TVG operated ten processing plants, nine in California and a tomato-reprocessing facility in New Jersey. TVG procured raw products from growers on both a membership and a cash-contract basis and converted them into a wide variety of processed products. As time passed, the percentage of product, especially tomatoes, procured through cash contracts increased. Prior to 1983, TVG operated a single pool for products procured on a membership basis. All revenues and costs flowed into a single account, and surplus in excess of each commodity's "established value" (EV) was returned to members in proportion to their EV. Established value, in turn, was set in accord with industry prices that were discovered through bargaining between the commodity bargaining associations for tomatoes, peaches and pears, and the major independent processors of those commodities.

In 1983, TVG established the "50/50" pooling concept, whereby commodity-specific pools were established, and 50 percent of revenues derived from each commodity flowed into its own pool, while 50 percent went to the general pool. In 1996, TVG restructured itself as a "new-generation cooperative," members' equity was converted to capital stock, and the 50/50 pooling concept was replaced by a complicated alternative that essentially represented a return to the single-pool concept.

TVG's Tomato Operations

Tomatoes comprised about 40 percent of TVG's revenues in the 1990s. Tomato production had relocated from coastal areas to the central valley, causing a mismatch between production and processing capacity. Also, the processing technology had come to emphasize low-cost bulk paste manufacturing undertaken in the producing areas, with remanufacturing into specific products done elsewhere.

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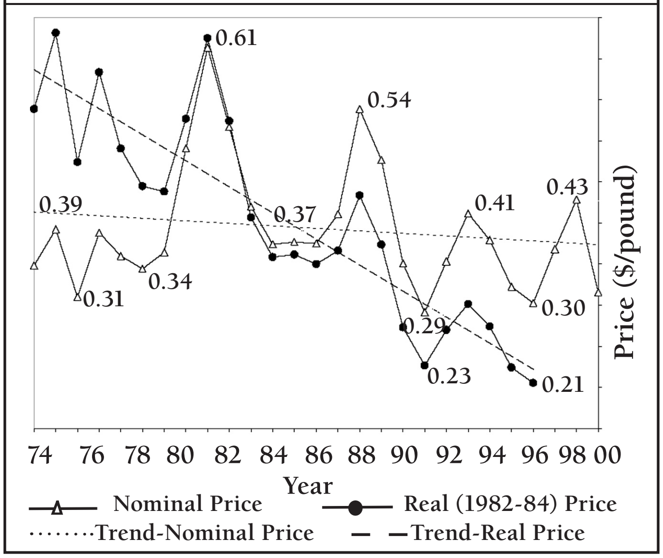
Figure 1. Price Trends of Industrial Tomato Paste (Fancy 31%, 55 Gallon Drum), 1974-2000



Processed tomato products sell in a global market, and prices are subject to wide fluctuations and are strongly influenced by inventories carried forward from the prior crop year. On both a nominal and a real basis, prices declined on average during the period 1974-2000 (Figure 1).

TVG joined the paste revolution in 1974, when it built a paste-manufacturing facility near Volta and secured a favorable ten-year, cost-plus paste contract. However, TVG also adopted a nonstrategic approach to expansion in the 1980s through acquiring the membership and facilities of failed co-ops Glorietta and Cal Can. As a result, TVG's tomato facilities were not well-aligned geographically with its production, causing it to have higher shipping costs than the competition. Also, in some cases, its facilities lacked state-of-the-art technology and their production capabilities were not well-aligned with the market's needs.

Thus, circumstances suggest that TVG needed to make investments in plant modernization and relocation. However, it was constrained during the late 1980s and 1990s from doing so because it was already carrying a high debt-to-equity ratio and its members were themselves suffering from adversities in the raw-product market, making it difficult to collect more equity from them.

TVG's inability to compete in the growing but cost-driven bulk-paste segment of the market caused it to refocus on producing peeled products and branded product sales in the 1990s, but this strategy was constrained because TVG's brands were weak and the value-added strategy brought it into direct competition with larger, financially stronger rivals. Overall, TVG produced a wide variety of low-value and/or low-margin products. During this period it manufactured 435 tomato product items or labels, including 154 peeled products, 148 remanufactured products, 61 paste items, 22 sauce products and 17 puree items. TVG mostly missed the explosion in demand in the 1990s for pasta sauces, Mexican salsas and barbecue sauces.

Very low raw-product prices in 1991-92 caused reduced grower shipments to TVG in subsequent years, leading to underutilization of plant capacity—tomatoes processed in five plants could have been consolidated into three. Poor alignment of production with processing capacity, inefficient technology and underutilization of plant capacity combined to make TVG a high-cost tomato processor relative to most competitors. Stagnant processed-product sales in the early 1990s also led to high inventory costs (Figure 2).

Tomato market adversities led to low grower returns and persistent subsidization from fruits to tomatoes under the 50/50 pooling arrangement. Most TVG growers were multi-cannery growers and lacked loyalty to TVG. TVG lacked strong membership contracts that would have required delivery and instead was forced to offer tomato growers special deals—cash contracts, accelerated payments and low rates of equity retention—to retain the patronage of tomato growers in the 1990s. Only 54 percent of tomatoes were acquired on a membership basis in 1996. Its severe problems and limitations in the tomato market caused TVG to actively contemplate a tomato exit strategy in 1994, but a new board and management team took over soon thereafter and recommitted TVG to the tomato market.

TVG's Fruit and Olive Operations

Fruits comprised about 53 percent of TVG's revenues in the 1990s, with the lion's share representing canned peaches and fruit cocktail. Prior to its bankruptcy, TVG was the largest fruit processor in California, with about a 40 percent aggregate market share. TVG operated its own brands, such as Libby and S&W, but sold a majority of its product under private labels.

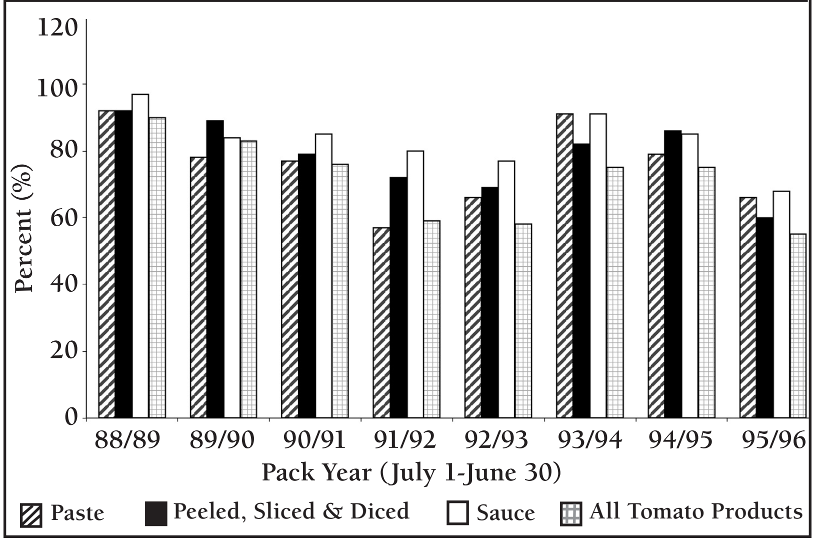
TVG was better positioned in fruits than tomatoes, and fruit products on average generated a higher margin than did tomato products. On the downside, per capita consumption of canned peaches and pears declined rather consistently from 1970 through the 1990s, as fresh-fruit alternatives became increasingly available. Despite its large share of California production, TVG lacked large national market shares or dominant brands for any of its processed products and was essentially a price taker in these markets.

Most of TVG's fruits were procured on a membership basis and, perhaps because they had fewer selling options than the tomato growers, TVG's fruit growers were generally loyal to the co-op. However, the persistent subsidies from peaches to tomatoes through the 50/50 pooling arrangement from the mid 1980s through the mid 90s caused discontent among the peach growers.

Although olives were a high-margin item for TVG, they caused many problems. Movement as a percent of production was consistently the lowest of any TVG commodity, the percent of nonmember purchases increased rapidly to 71.5 percent in 1996, and in excess of $10 million in costs were incurred due to environmental contamination of the olive-processing plant in Madera.

Unlike its major competitors Pacific Coast Producers, a peer co-op that focused on low-cost, private-label production, and Del Monte, which focused on value-added brands, TVG tried to perform in both market segments. However, despite many problems, TVG's fruit operations (excluding olives) were competitive to the very end.

Figure 2. TVG's Percent of Tomato Pack Sold 1988/89-1995/96



The "New-Generation" Restructuring

In April 1995, Joseph Famalette was hired as CEO and president of TVG. Famalette had been the architect of a restructuring plan for American Crystal Sugar, and presented a similar plan to TVG members in June 1996. TVG's equity base was hemorrhaging at this time due to loss of members and increased use of cash contracts.

The restructuring plan included converting existing equity to a capital stock issued by commodity class. The capital stock conferred both a delivery right and obligation and could be transferred, with board approval, only to another California producer of the commodity. For example, 1.8 million shares of tomato stock were authorized, implying delivery of 1.8 million tons, but less than 800,000 were issued. The 50/50 pooling concept was replaced with a "profitability-target" concept that was closely akin to the old single-pool concept. The restructuring included a purge of many employees who were replaced with executives who had little prior experience with cooperatives or food processing. A retired TVG executive noted wryly, "They fired everyone who knew where the light switch was at."

The Final Downward Spiral

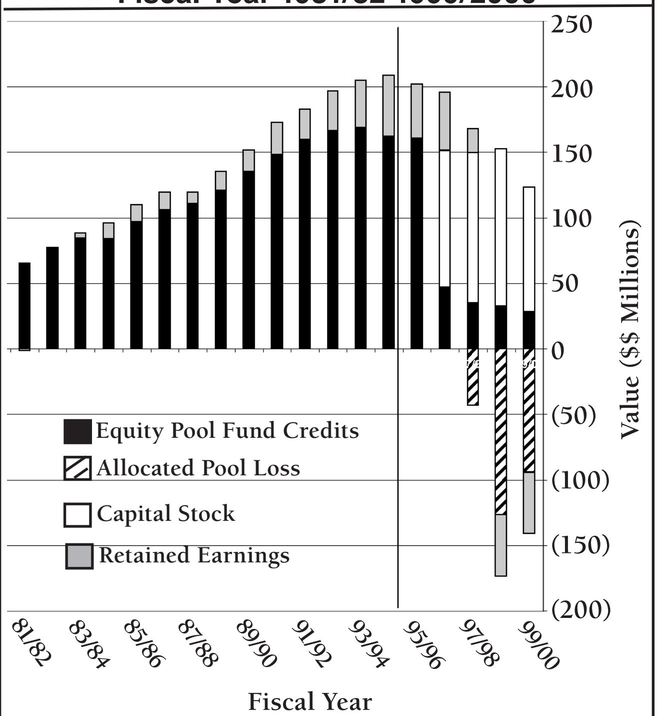
In 1996, TVG changed its definition of operating income and redefined its fiscal year. The new management also raised prices after the 1996 pack, in market conditions that were not supportive of higher prices. This move resulted in declining sales and rising inventories. Long-term debt rose from $30.1 million in fiscal year 1995/96 to $145.6 million in fiscal year 1996/97. In August 1997, TVG's auditor, Deloitte & Touche warned TVG of an increased risk of inaccurate financial reporting, in part because the position of chief financial officer had been eliminated in the downsizing.

In August 1998, TVG announced a net loss of $78 million and fired CEO Famalette. About 50 percent of this loss resulted from paying growers 129 percent of the established value, versus the 90 percent that was guaranteed. Fiscal year 1998/99 closed with a loss in excess of $120 million. These losses were carried forward on TVG's books, effectively depleting the cooperative's equity (Figure 3), and making it functionally bankrupt even before the official filing in July 2000.

Analysis of TVG's Demise

The seeds of TVG's demise were in place prior to the 1990s in the form of high inventories, low productivity of assets, high operating and transportation costs relative to the competition, and a high debt-to-equity ratio, which inhibited needed investments in modern plant and equipment. TVG was competitive in fruit

Figure 3. TVG Members' Equity, Fiscal Year 1981/82-1999/2000



processing, but not in tomato processing. TVG either needed to become competitive in tomatoes by finding a market niche where it could thrive or jettison its tomato line. Using fruit revenues to subsidize tomatoes was not a viable long-term strategy. It will never be known whether TVG could have survived as a fruit processor, if it had divested its tomato lines in advance of the disastrous last years of its operation.

The new-generation restructuring was largely unsuccessful, in that it failed to stabilize either the equity base or the base of raw product, but it had little per se to do with the bankruptcy. Rather, the restructuring was a desperate response to severe problems that were already in place. The cost-reduction measures implemented at that time were counterproductive because they were too radical and ill-targeted, so as to negatively impact TVG's ability to generate revenues. The long-standing problems of poor internal controls and lack of a centralized information system were never addressed.

Some have viewed TVG's bankruptcy as a sign that co-ops are ill-suited to succeed in twenty-first century markets. One way to evaluate this concern is to ask which of TVG's problems were due to its cooperative structure, versus due to market conditions or internal problems? We view the acquisition of inefficient capital from defunct co-ops as both a co-op (due to a misplaced sense of obligation to help fellow co-ops) and a management problem. The high debt-to-equity ratio that TVG experienced is common among cooperatives, and is due to the limited pool from which they can draw equity (namely, the members), and members' reluctance to contribute to long-lived projects, known as the "horizon problem." The unwillingness to terminate growers who were no longer viable producers for the cooperative and the dramatic grower overpayments in the final years probably also trace to the grower-ownership dimension of a cooperative.

Market problems were fundamentally twofold, but neither was insurmountable. The tomato market, though growing over time, was very volatile, and the canned fruit market was in decline.

Internal problems related to management and the board of directors were several, in our view. Nonstrategic acquisitions of failed competitors has already been noted, failure to adopt an integrated management information system was a critical error, so, too, was the Famalette-era purge of employees who were knowledgeable about the food-processing business. Other internal problems attributable to the co-op's leadership include failure to come to grips with the grower end of the tomato business, including over-reliance on cash contracts. Finally, TVG had a persistent lack of focus on the selling side—for example, whether to emphasize brand or private-label sales and whether to emphasize paste or value-added products in tomatoes.

Ultimately, we do not think that TVG's cooperative structure was the major factor in its bankruptcy. The fact that peer cooperative Pacific Coast Producers continues to experience success supports this view. We do think the TVG experience offers lessons for cooperatives. A multiproduct marketing co-op is desirable in the sense that modern markets prefer "full-line" suppliers, but marketing multiple products has the potential to create significant internal problems in terms of pooling and director loyalty and responsibility. TVG's experience with its tomato growers emphasizes the importance of long-term grower contracts to encourage member loyalty. However, loyalty to other cooperatives should not replace sound business judgments. Finally, TVG was probably slower in responding to changing market forces than its competitors, perhaps due to a cumbersome cooperative decision-making process.

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