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# Support for Farmers' Cooperatives

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*Case Study Report*  
**Cooperative Dairy  
Processor Valio –  
structural  
development to its  
present stage**

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# Support for Farmers' Cooperatives

## *Case Study Report*

# **Cooperative Dairy Processor Valio – structural development to its present stage**

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## **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.

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

In addition to this report, the SFC project has delivered 32 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 interviewees for their willingness to collaborate in this project and to share information on structure and strategy of their cooperatives.

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## List of abbreviations

CAP	Common Agricultural Policy
PO	(recognized) Producer Organisation



# 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. In the framework of this study, this report provides information on development of the Finnish dairy processing cooperative Valio into its present form. Because the span of the development has been long, the report describes Valio’s operating environment already from 1980’s up to the present.

In this case study, the following research questions have been guiding the research. First, what kinds of explanations are there for Valio’s organizational evolution (i.e. how and why has the “hybridization” happened)? Second, how has the internationalization affected the organizational structures? Third, how are the producers’ ownership, control and benefits (key elements in our definition of a cooperative) affected by growth, internationalisation and hybrid structures?

## 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).

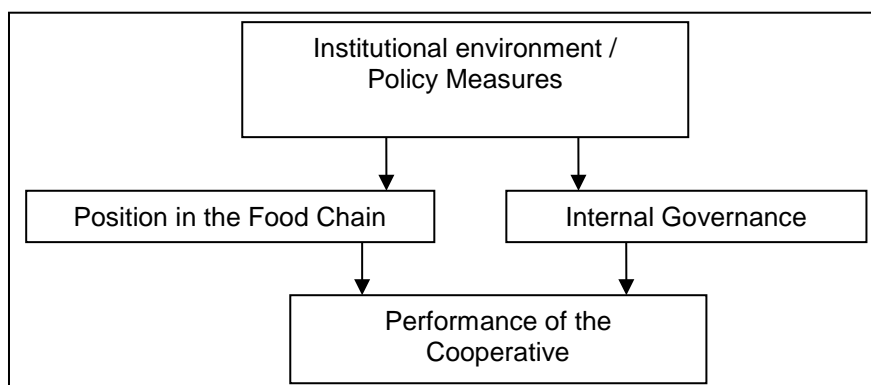


Figure 1. The core concepts of the study and their interrelatedness.

### **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.

Additional information has been collected through personal interviews with various co-operative stakeholders. For this particular study, board members and managers have been interviewed.

### **1.4 Structure of the report**

Chapter 2 is aimed to provide a picture about the dairy processing subsector as well as related industries with respect to Valio. Chapter 3 discusses about questions analysed in interviews. In chapter 4 conclusions are presented.



## **2. Development of dairy industry in Finland**

### **2.1 Agriculture and cooperative movement in Finland**

#### **2.1.1 Finnish Agriculture**

Finland is the northernmost country in the world engaged in agriculture in its traditional form. For example, wheat can only be grown on its southern coast. The major part of fields is used for hay growing, pasturing and growing other feedstuffs. Agriculture represents 3.4% of employment and 1.2% of the GDP.

Agricultural production takes place on 63,000<sup>1</sup> farms. The number of farms has decreased by 30% over the last ten years. The average field area is 36 hectares. 3,800 farms own more than 100 ha arable land having about 25 per cent of total field area. Most Finnish farms also own forests, about 50 hectares on average. Private persons, mostly farmer families, own about 90% of farms.

Milk production includes about 285 000 dairy cows on less than 10,200 dairy farms – thus the average dairy farm has 29 dairy cows. The size and number of large dairy farms has grown significantly during the past decade. However, the number of dairy farms has decreased by 6-7 per cent per year. The total yearly milk production in 2010 was 2,200 million litres. Average production per cow was 7,900 litres. Altogether 99.5% of milk production was further processed on dairy processing plants.

#### **2.1.2 Co-operative movement in Finland in general**

Scandinavian interest in co-operatives began in the late 1800s because of the problems of small farm holders and rural landless. Co-operatives were seen as means of generating needed changes in the rural areas<sup>2</sup>: “Merchants often sell to farmers falsified goods, the state of which the latter are not able to examine, and the use of which, in the carrying of agriculture, brings them considerable losses, which have their effect for many years... In addition to its development of capitalism has drawn away from the country districts, and especially from agriculture, intellectual labour, thus decreasing the influence of the country districts and the ability of farmers to watch over their interests”<sup>3</sup>.

In Finland co-operatives also had another function. In the beginning of the 1900s Finland was under the Russian rule and national political life was very restricted. However, there was a strong will toward independence. Co-operatives were systematically used as training organisations for democratic decision-making. This training turned out to be very important during the process and after independence was achieved in 1918.

From independence up to the 1990s the co-operative movement has had political dimensions, although not exactly party-political ones. Agricultural co-operatives did have connections to rural political parties, labour-rooted consumer co-operatives to the labour movement, and Swedish-speaking co-operatives to Finland's Swedish-speaking parties. However, the co-operative movement in Finland did not have a direct connection to central decision-making nor

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<sup>1</sup> The figures in this paragraph are based on Elintarviketalous 2010, TNS Gallup (2011a).

<sup>2</sup> Ollila, P. 1984

<sup>3</sup> Gebhard, H. 1916

has the government had a direct influence on co-operatives. It is not possible for the government to intervene cooperatives' affairs otherwise than modifying cooperative legislation.

## **2.2 Structure of dairy product consumption<sup>4</sup>**

Dairy products are often divided into four categories: liquid milk, fresh dairy products, cheese and butter, and milk powder

Finns consume 180 litres of fresh milk per capita per year. Milk consumption is slightly diminishing now that consumers are shifting to other, often also milk-based drinks. There is a clear trend from high-fat milk products to low-fat or fat-free products. A specifically Finnish phenomenon is the high consumption of buttercream (13 litres per capita per year).

The most important product in the category of fresh dairy products is yoghurt. Finns eat yoghurt about 20 litres per capita per year. Consumption is increasing, especially in the categories of fat-free and sugar-free products. Finns also have a special product called 'viili', which is a kind of processed sour milk. Its per capita consumption is about four litres, mostly unflavoured, but the consumption of flavoured products is also growing. Items in the fresh dairy product categories are increasing as well, such as desserts, snacks and food preparation products like Crème Fraiche.

Finns eat 13 litres of ice cream per capita per year. Consumption varies considerably from year to year depending on the weather conditions. The largest single segments are home packages, which represent about half of total consumption. The second largest categories are ice cream cones and ice cream sandwich products (20%). Light alternatives are increasing their share.

Cheeses are a large product category. Per capita consumption is still rising by about 2% yearly, being about 20 kg at present. The market share of imported cheeses has increased considerably, being at present close to 40 per cent. The consumption of butter has been diminishing since the 1970s. However, now the decrease has been levelling. In 2004 the per capita butter consumption was about 7 kg. During the last years the consumption of butter has gone up and the consumption of margarine has gone down.

Milk powder can be regarded as residual that is left when all the other products have been processed. About 6% of milk is processed into milk powder.

Liquid milk packages (Pure Pak) are brought in carriages mostly packaged already at the deliverer's storage. Earlier it used to be that the deliverer took care of milk packages up to the shelves. At present the deliverer's responsibility stops at the retailer's platform.

## **2.3 Development and structure of dairy processing**

### **2.3.1 Early development**

Dairy processing became common in Finland in around 1870. Among the reasons was the invention of the milk separator. The first dairies were established on large farms, and butter was exported to a large extent, large amounts to Great Britain. When the price of milk separators sank, the era of village dairy plants began.

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<sup>4</sup> Consumption figures are from Food Facts 2009 (TNS Gallup 2011b).

In the mid 1890s there were about 3,500 village dairies in Finland<sup>5</sup>. They were not 'dairies' in the present sense. They were man-powered and concentrated on buying raw milk. These dairies were owned by groups of farmers.

In 1895 the company law was revised so that it also allowed farmers and dairy producers to own shares in processing plants. This initiated the era of dairy shareholder companies. In ten years the number of village dairies decreased into one quarter of the earlier number.

The new co-operative law in 1901 allowed the establishment of co-operative dairies. During the first year about 30 dairy processing co-operatives were formed. It should be stressed that the initiative for the establishment came entirely from dairy producers. Both individual producers and public authorities were active in advancing co-operation between the dairy co-operatives. Regional organisations were established. These organisations had extension experts to advise how to improve the quality of dairy products as well as persons whose task was 'to increase the mutual unity of the membership'. By 1908 already 332 co-operative dairies had been established<sup>6</sup>. An overview of the Finnish dairy sector is found in Table 1.

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<sup>5</sup> Hokkanen, K. 1980, p. 36, Maidon Tie, Helsinki.

<sup>6</sup> Ibid., p. 39.

Table 1. Dairy production in Finland. Sources: Ministry of agriculture and forestry, Finnish Customs

<i>Domestic production</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>
Milk production ('000 t)	2396	2450	2362	2268
Milk intake ('000 t)	2296	2371	2293	2222
Number of dairy farms	32161	22225	15844	10923
Yield per cow (kg/yr.)	5982	6786	7505	7896
Number of milking cows ('000 heads)	399	364	319	289
<hr/>				
<i>Production of dairy products ('000 t)</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>
Fresh milk products	743	715	710	709
Butter	45	55	50	46
Cheese	91	93	91	101
Skim milk powder	14	24	21	17
<hr/>				
<i>Consumption (per capita, kg/yr.)</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>
Liquid milk products	146	138	134	128
Yoghurt	15	17	19	23
Cheese	15	18	19	21
Butter and butter-vegetable oil mixtures	8	7	5	6
<hr/>				
<i>Imports ('000 t)</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>
Cheese	7	20	31	45
Yoghurt	12	8	12	37
<hr/>				
<i>Exports ('000 t)</i>	<i>1995</i>	<i>2000</i>	<i>2005</i>	<i>2010</i>
Cheese	29	35	38	51
Butter	19	36	37	31
Yoghurt	10	16	19	28
Skim milk powder	..	20	14	14

Because butter export was from the beginning an important function of dairy co-operatives, there was an on-going discussion about a joint organisation for exports of dairy products. This discussion led to the establishment of Valio in 1905. Valio, which was later to become the leading organisation of Finnish dairy processing, was initially the export organisation of Finnish co-operative dairies. Thus, Valio became a second tier cooperative for dairy farmers.

Finland has a Swedish-speaking minority living mainly in the coastal areas. These Swedish-speaking milk producers wanted to establish their own co-operative organisation. It is interesting that the Finnish consumer co-operative movement also established its own dairy processing organisation and had altogether 22 dairy processing plants in 1955.

In 1984 Valio had 134 co-operative member dairies processing 92% of all milk received by plants. The Swedish speaking co-operative organisation Enigheten had 10 processing units processing about 4% of all milk received. 15 units were shareholder companies processing the

remaining 4%. In 1984 Valio also had direct ownership of nine processing plants. Valio's member dairies were not happy with Valio's own processing plants because they were competing with the member dairies.

### 2.3.2 Valio, the Central Organisation of Co-operative Dairies<sup>7</sup>

#### *Development until 1985*

After its establishment Valio underwent many difficult times, including the civil war in 1917 and the Second World War, after which about 20% of Finland's field area was overtaken by the Soviet Union.

After the Second World War, dairy processing was steered by the national agricultural policy up to the end of the 1980s. From the 1950s food imports and agricultural product prices were regulated by the policy. Because of structural policies, small agricultural production units were favoured. Subsidised prices led to surplus production, which was then exported with government subventions.

All this regulation allowed Valio to grow and develop without significant competitive disturbances. Some internal conflicts arose, e.g., between the northern co-operatives producing cheese and milk powder, and the southern co-operatives producing mainly liquid milk to nearby cities.

The size of dairy processing units was beginning to increase. In 1955 Valio had 337 member co-operatives receiving 1,300 million litres of milk, 3.8 million litres per dairy co-operative. In 1965 the respective figures were 287, 2,600 and 9.05. By 1975 Valio's dairies were receiving 2,500 million litres, corresponding to 16 million litres per co-operative. In reality the development was even more dramatic because second-degree co-operatives were also developing rapidly<sup>8</sup>.

Valio's market share measured by the raw milk received remained between 80 and 90%. Table 2 describes the development between 1965 and 1990.

Table 2. Structural development of milk production in Finland 1965-1990. Source: Perko (2005).

<i>Year</i>	<i>Milk producers 1,000</i>	<i>Number of dairy cows 1,000</i>	<i>Dairy cows per farm</i>	<i>Average production n l/cow</i>	<i>Milk to dairies mill. l/yr</i>	<i>Valio's share %</i>
1965	240	1,116	5	3,277	2,902	83
1970	190	874	5	3,680	2,801	86
1975	128	767	6	3,997	2,722	87
1980	91	709	8	4,479	2,949	92
1985	66	621	9	4,812	2,808	92
1990	45	492	11	5,547	2,600	91

As shown in Table 2 the number of milk producers fell to one sixth in 25 years. The number of dairy cows declined to less than half while the average dairy herd size more than doubled. Because the average production per cow increased by 1.7% the total milk production decreased only by about 10%. These dramatic changes led to changes inside Valio as well. Table 3 describes this development.

<sup>7</sup> This section draws from Nilsson and Ollila (2009).

<sup>8</sup> Hokkanen, p. 242.

Table 3. Valio's structural development 1963-1984. Source: Perko (2005)<sup>9</sup>

	1963	1973	1984
No. of Valio's member dairy co-ops	292	203	134
No. of co-ops processing milk	198	140	74
No. of functioning processing units	235	169	91
No. of Valio's own dairy plants	25	16	9

### ***Structural alternatives after 1985***

In the mid-1980s the rapid change in the dairy sector led to active discussion about Valio's future development. By 1987 the discussion and the top trustees' working group produced guidelines for actions. The goals of the development were as follows:

- Milk processing costs must be decreased.
- Market power must be increased without increasing costs.
- Division of duties between the federal co-operative and the member co-operatives must be better defined and the role of the central organisation must be reconsidered.

The working group presented three alternatives for what they called 'controlled structural development':

1. Development of the present dairy plant structure including larger units (30-40 first degree co-operatives).
2. Establishment of a regional dairy structure (only a few first degree co-operatives).
3. Only one national co-operative for the entire country (Co-operative Finlandia).

Three alternatives were also proposed for the division of work between the co-operatives and the federal organisation in marketing:

1. All marketing to be conducted by the federal co-operative. (alternative A)
2. Marketing and managerial operations to be totally shifted to the member dairy co-operatives. (alternative B)
3. The present model where the federal co-operative and liquid milk dairy co-operatives had their own roles. (alternative C)

As the discussion was going on, the operating environment was facing growing challenges. The rest of society increased its criticism of agricultural subsidies. At the end of the 1980s also the first signs of possible membership in the European Union were becoming evident. Valio's Board of Directors appointed a committee for structural change in late 1987, which listed the major challenges in the near future as follows<sup>10</sup>:

- The agricultural support system will be changed so that the subsidy level will decrease.
- Milk production will be reduced to correspond to a self-sufficiency rate of 115% instead of the prevailing 125%.
- Gradual liberalisation of international trade.
- Changes in the competition and price legislation (e.g., no price agreements of cartel pricing between processors).
- Rapid changes in the food system and in consumption patterns.

<sup>9</sup> Perko, T. 2005, p. 79, Valio ja suuri murros, Keuruu

<sup>10</sup> Perko, T. 2005, p. 83, Valio ja suuri murros, Keuruu

The challenges presented by the committee produced three alternative organisational models:

1. The federal co-operative would be changed into a shareholder company owned by the member co-operatives.
2. The entire organisation would form one co-operative.
3. The organisation would consist of regional co-operatives and a federated co-operative.

The first alternative turned out to be too 'radical at the time, and members turned it down because of 'membership policy reasons'. The second alternative meant that all the member co-operatives (at that time 120 co-operatives, 70 with milk processing) would merge into one national co-operative. The third alternative meant a system with a few strong regional co-operatives, which would then be members of the federal co-operative. The committee listed the pluses and minuses of alternatives 2 and 3 as shown in Table 4.

Table 4. The principles of single co-operatives versus federated co-operatives.

<i>One co-operative</i>	<i>Regional co-operatives and federal co-operative</i>
+ Centralisation of marketing eliminates competition between co-operatives	+ Managerial and operational efficiency is assumed to be better
+ Problems of multiple organisations will be eliminated	+ Possibilities for members' influence are better
+ The entire production and processing can be arranged as efficiently as possible and investments can be planned based on general needs	+ Regional co-operatives have a regional image
+ Co-ordination of raw material and products will be easier	+ Compared to the prevailing situation, many significant improvements: co-ordination of raw material, flexibility in pricing, differences in producer pricing become smaller
+ Pricing of milk products becomes easier, products can be priced according to demand and so the profits can be maximised	
+ Unified producer milk price could be realised	
- Bureaucracy may increase	- Mutual competition in the market is reflected in producer prices and makes it more difficult to conduct marketing policy
- The power of producer-members and their influence in decision making may decrease	- National co-ordination of production is more difficult than in the one co-op model. Regional co-ops keep their own raw material base and market areas. Switching products between co-ops becomes more difficult and the interest to market other co-ops' products may be low because of envy.
- Possible bad management may be reflected to the entire milk system	- Co-ordination of investments based on general needs is more difficult when a regional co-operative invests in a way that is inappropriate from the point of view of the whole.
- Personnel's commitment to work for the co-operative may be lower than in the regional co-operative model, the same may concern milk producers	
- The marketing function's ability to respond regional demand changes may be lower	
- A monopoly-like corporate image may become stronger. The negative attitude in the society may become stronger.	

Even though the regional model was preferred, small dairy co-operatives especially regarded the model as too radical for them. The discussion lasted about two years during which period development in the operating environment was very fast. Valio's management was especially worried about developments in commercial policy; international trade barriers would rapidly become lower and the quantitative import restrictions would gradually disappear. Also it was regarded probable that the export subsidies would disappear in the near future.



At the same time the fear started to emerge that the regional dairies might become so strong and independent that the federal organisation would grow useless and the competition between dairies would increase. This had already happened in the co-operative slaughtering sector. Also developments abroad, e.g. in Denmark, France and the USA, had produced dairy co-operatives that were larger than the entire milk supply in Finland.

The director of Valio, Mr. Iikka Haka, was worried that changes in the environment would develop faster than the internal discussion about Valio's future structure. In 1989 he decided to propose again the model of Valio becoming a shareholder company, Dairies' Ltd. The majority of company shares would be owned by the member co-operatives, but also the federal co-operative Valio would own shares. The aim of this rearrangement was to cut operating costs by improving the organisation's structural efficiency and by diminishing duplicate activities. According to the calculations, about 20% savings in costs were possible<sup>11</sup>. The aim was that Valio would be lifted 'directly to an international level'.

The pluses and minuses were as follows<sup>12</sup>:

- + Production co-ordination becomes simpler. With the strategy proposed earlier of eight regional dairy co-operatives, co-ordination of production would not succeed because milk reserves and milk consumers are situated in totally different areas.
- + The producer price level can be unified when Dairies' Ltd. would pay the same price to all member co-operatives. "If this cannot be realised, the pressure among membership will increase significantly in the near future."
- + The rationalisation of production activities will be possible through specialisation. It is possible to optimise investments because the problem of duplicate operations will be eliminated.
- + Marketing and material operations will become more efficient and economical when the multi-level structure is eliminated.
- + Price competition between co-operatives will be eliminated. The probability of price competition will increase when cheap products from abroad enter the market.
- + It is possible to optimise pricing according to changing consumer preferences without it having any effect on producer prices in various regions.
- + One large enterprise always has more negotiating power than a group of smaller enterprises. Also this aspect will become more important when international competition increases.
- + New product development becomes more important all the time. It will be more important to direct sufficient resources to product development and this can best be done in a one-enterprise model.
- + Liberalisation of international trade is not just a threat but also an opportunity. However, the prerequisite for success is that the dairy industry is 'fully competitive all the way'.
- Increasing bureaucracy and heavy governance.
- Increasing distance between the enterprise and the membership.

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<sup>11</sup> Perko, T. 2005, p.93, Valio ja suuri murros, Keuruu.

<sup>12</sup> p. 93-94.

- Insufficient understanding of local markets.

In 1990 the model of Dairies' Ltd. was approved. The model follows the theoretical argument that the relative advantage for the co-operative form diminishes after the first stage of collecting of milk and getting it safely stored (Ollila 1989). The economic performance of complex operations is easier to control in a shareholder company form than in a co-operative form.

### ***Development in the late 1990's (domestic competition and "reaching the balance")***

The structural change initiated the development that was called the "milk war". The fight for domestic milk markets took place in a worst possible period. In addition to the burden of old, the heavy structure there was the challenge of adjusting into opening European markets. In addition to this, the consumption of milk and butter was going down. Foreign importers were attempting to enter to the market. Valio did not have particular allies abroad. In this kind of a situation Valio was in a difficult situation to cope with simultaneous increasing domestic competition.

In 1993 when Valio was negotiating about given three alternatives A, B and C (see chapter 2.2.2). At that time Valio was owned by 51 cooperative dairies. About ten of them did not accept any proposed changes because they were worried about loosing their production plants. Those ten dairies separated from Valio and took the name "Ten Dairies" (Kymppimeijerit) under which they took care about their own marketing. They even made a movement never experienced in the cooperative community by making a contract with an IOF dairy Ingman (at present bought by Arla Foods).

Ten Dairies wanted to believe that in the competition with larger dairies their independence and regional emphasis were advantages among their customers. During that time the customers were, indeed, still very regionally-oriented. The belief about the right decision was reinforced because of new concurrence legislation attempting to stop cartels and exploitation of excess market power.

Ten Dairies defined their collaboration as to increase the efficiency of the utilization of raw material and dairy processing as well as joint collective activities.

Ten Dairie's separation from Valio was an important thing. That reduced Valio's milk intake by 14 per cent. Valio's market share in the raw milk market dropped from 90 per cent to about 75 per cent.

The separation of those dairy cooperatives created a critique by the cooperative community and the Farmers Union. They were afraid that the cooperatives would outcompete each other and break the former solidarity among the community members. Ten Dairies defended themselves by saying that all the dairies have the right to fight for their own members, dairy personnel and their customers. This was very new in the cooperative community.

One of Ten Dairie's first tactical operations was to challenge Valio through competition authorities arguing that Valio exploited its decisive position in the market. According to the document left to the authorities Valio priced liquid milk products as "monopolistic" in regions that had no competition. However, in regions having competition Valio attempted to eliminate its smaller competitors by using aggressive pricing.

Competition authorities took the complaint seriously. After about one year's investigations the competition authority issued the decision according to which Valio had broken the legislation in two ways: Valio's price schedules had privileged large distributors and Valio had paid "marketing fees" in an illegal manner.

Separation from Valio continued. In 1997 two large South-Western dairy cooperatives, Maito-Aura and Maito-Pirkka started their separation. Those two dairies were important for Valio. Valio stopped this process through starting to pay from milk more than to the other dairies. However, those two dairies continued threatening to leave even after the agreement.<sup>13</sup> This behaviour irritated other member dairies because they thought that such behaviour is against the equal treatment principle. Valio's board of directors decided that the extra bonus paid to those two dairies was a one-time operation. This decision has prevailed up to the present.

One of the two mentioned dairies, Maito-Aura, decided to continue with Valio whereas Maito-Pirkka did not. Thus, it had to create from scratch its own product labels and the entire marketing organization. What helped was that the cooperative was economically in a good shape, and it had Helsinki region within 200 km to buy Maito-Pirkka's products processed from its 90 million litres milk intake.

For help to the market entry to competitive Helsinki region markets Maito-Pirkka got a companion, Kainuu Cooperative Dairy from North-Eastern Finland. In the end of 1997 a new company Aito Maito Finn Oy was presented. The company was leaning of Kainuus Aito (=Original) brand, and Maito-Pirkka's Finnmilk.

Aito Maito Finn started in 1998. Milk collection remained in dairy cooperatives, but processing was conducted jointly<sup>14</sup>. The total yearly milk intake was about 200 million litres.

Aito Maito Finn took the entire Finland as marketing area. In contract negotiations it offered milk a little cheaper than Valio, which increased the competition considerably. One of the most significant "victories" was that Aito Maito Finn concurred Valio out from cooperative SOK retail chain in Helsinki region, which meant about 13 million milk litres per year.

By 1999 Aito Maito Finn was in the position that the price competition had required so much resources that the group could not survive without an alliance with someone. After negotiation with many possible candidates both member dairies decided to rent their processing facilities and product labels to Valio. That was a difficult process for those two dairies and their decision-makers to save their faces.

This merger increased Valio's market share again up to 70 per cent, which awoke the question about decisive market share. In 2000 it was expected that the competition authority would not accept the merger. However, the authority had no choice. Both merged dairies were economically in a so bad shape that they would be in the bankruptcy if they wouldn't have joined to the Valio group. However, the question about the availability of raw milk for Valio's competitors had still to be solved. After long discussions the competition authority issued a long list of conditions that made the merger possible.

According to many researchers (e.g. Pohjonen 1985) the loss of the milk war was substantial for the farmers. The only winner was the retailing industry.

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<sup>13</sup> In a heterogenous membership it is difficult to follow the equal treatment principle. If the large members do not get the advantages corresponding their strategic position they may leave. And the small ones cannot survive without those large ones (Ollila 1989).

<sup>14</sup> According to Williamson's "Hierarchical decomposition principle" the relative advantage of the cooperative form diminishes after milk is collected, stored and pasteurized (Ollila 1989).

### ***The present situation, structure and governance***

The last seven years the operating environment of the dairy industry has had many large and unexpected changes. In 2006 the world market price of milk suddenly raised. For example the price of milk powder increased 250 per cent in 2006. Among reasons for such an increase were the drought in Australia that decreased the supply, and increased demand especially in China and other Far-Eastern countries.

During 2006-2008 the financial position of dairy processing industry improved significantly. However, in 2009 the milk markets become worse again. The reason was to a large extent internal to Europe. Compared to Australia, the US and Southern America the European dairy industry's competitive ability is not very good. This forced the European dairy industry to look for market inside Europe. Thus, the competition increased and prices dropped, mostly by 20 per cent. Cheap dollar value had an effect, too. In Finland cheap Russian ruble and Swedish crown made the situation even worse.

Cheap Swedish crown made it advantageous to import raw milk from Sweden. This situation was fully exploited by Arla Foods who also managed to gain market share in Finland. All this affected also the payment ability of Finnish dairies leading to decreased producer prices.

The development has facilitated further consolidation of Valio structures. Among other regional dairies the two above-mentioned Maito-Aura and Maito-Pirkka have merged so that there are five large dairies left. They together with Valio thus set the price target also for the rest of smaller cooperatives (see Figure 2).

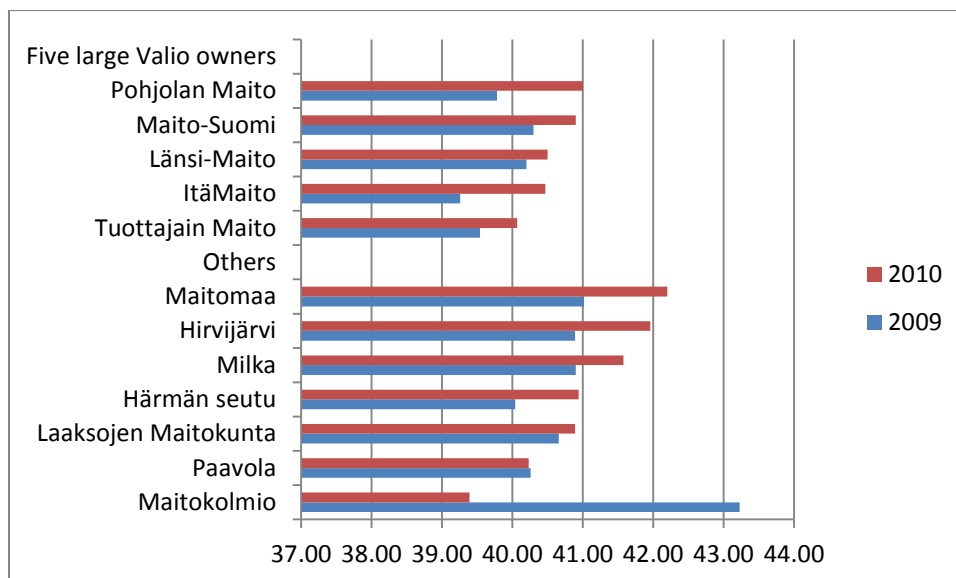


Figure 2. Producer price of milk in different dairy cooperatives in 2009-2010.

Valio's main goal is still to keep its position in the domestic Finnish markets. In order to be strong in Finland the strength has to be reinforced through international operations. There is no sign that foreign producers will be Valio's members similarly that the members in the owner cooperatives.

Current situation in the nutshell:

- Valio Ltd. owned by 18 member co-operatives

- About 9,000 milk deliverers in 8 cooperatives (i.e. those cooperatives that have business relation with Valio and no own milk processing)
- Market share measured by received milk 2010 about 86%
- 15 own processing plants in Finland. In addition to this, two processing plants in Estonia and a cheese packing plant in Belgium as well as a distribution terminal and melted cheese processing plant in Russia

The present governance structure of Valio Ltd. is presented in Figure 3. The 18 member co-operatives have their own membership meetings where they choose the Board of Directors and also the Board of Trustees in most co-operatives.

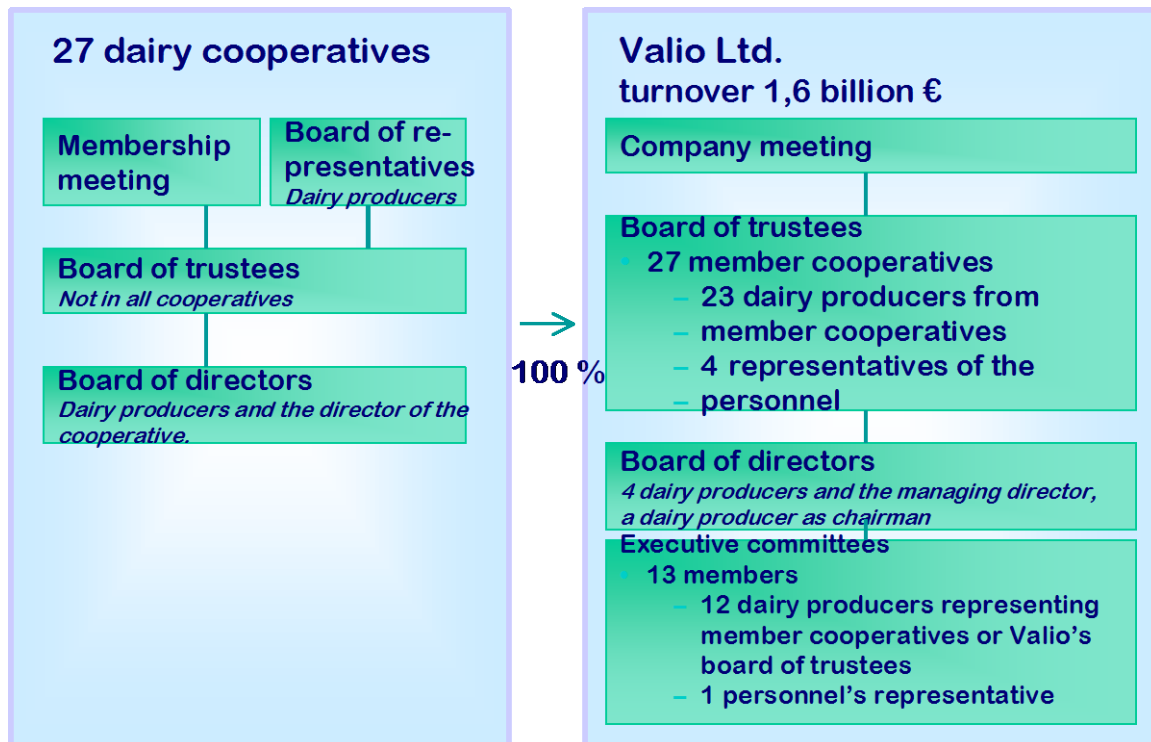


Figure 3. Governance structure of Valio Ltd. Source: Annual Report 2004. (Currently the same with exception that the number of shareholder cooperatives after mergers is 18.)

As shown in Figure 3, representatives of Valio Ltd's 18 member co-operatives gather once a year to a company meeting where they select 23 trustees to control company governance. Valio's personnel select four representatives. The Board of Trustees elects the chairman and vice chairman and appoints the producer members to the Board of Directors. The Board of Trustees also appoints the members to various boards in various fields of operations. Valio's Board of Directors consists of four milk producers and the managing director of Valio Ltd.

Relations between Valio's various governing bodies are as follows:

#### ***The company meeting***

- Discharges the members of the Board of Trustees and Board of Directors from liability
- Decides on remunerations for the members of the Board of Trustees
- Decides on the number of members to the Board of Trustees
- Elects the members of the Board of Trustees

#### ***The Board of Trustees***

- Monitors company governance managed by the Board of Directors and the managing director
- Prepares a statement about the closing of books and auditing report for the company meeting

- Decides on the number of members to the Board of Directors
- Elects the members of the Board of Directors and decides on their remunerations
- Elects the chairman of the Board of Trustees

***The Board of Directors***

- Decides on the company’s strategic goals and budget
- Appoints and dismisses the top management (incl. the managing director) of the company and decides on their salaries
- Prepares matters for the Board of Trustees’ meetings

***The managing director***

- Manages the day-to-day operations of the company following the Board of Directors’ guidelines and decisions

The Board of Trustees appoints the *executive committees*, whose task is to monitor the owners’ interests at the operational level of activities. At present there are three committees: the production committee, domestic sales and marketing committee, and material operations committee.

As presented above, Valio has gone through extensive changes in developing its governance. The governance structure has become more vertically integrated in strategic decisions. However, most of operational decision-making takes place at operational level<sup>15</sup>. As a result of this development Valio belongs to the best performing dairy processing companies in Europe, for instance, measured by the price paid to the milk producers.

**2.3.3 Present product portfolio**

Valio’s product portfolio includes around 1,100 products. The breakdown of total turnover into various categories is presented in Figure 4.

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<sup>15</sup> This follows the “Hierarchical Decomposition Principle” presented by Williamson (1985).

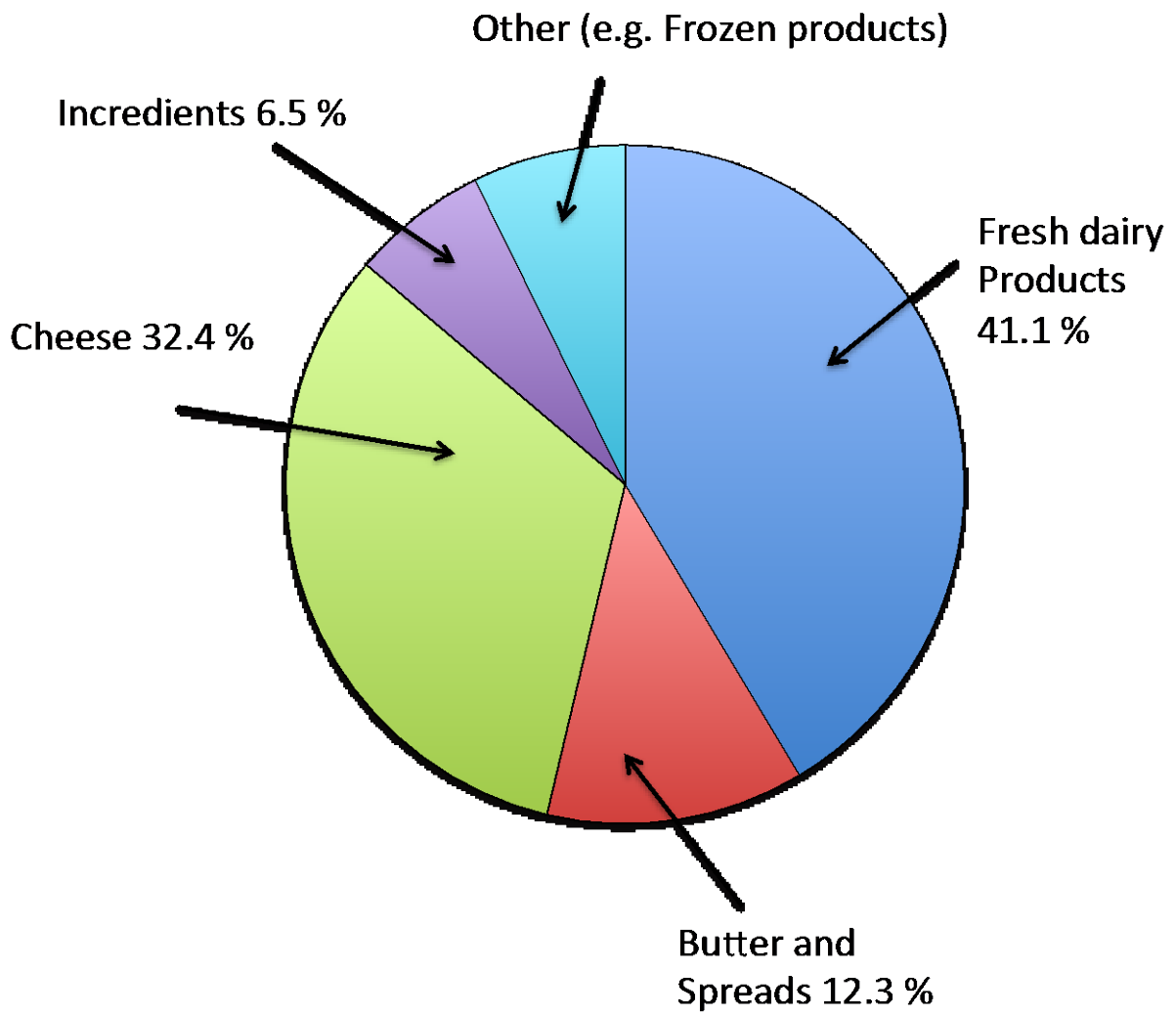


Figure 4. Division of Valio's turnover into product categories in 2010. Source: Valio Annual Report 2011

**2.3.4 Research and new product development<sup>16</sup>**

Valio’s research and new product development department has about 120 employees. The department’s yearly budget is approximately 10 million EUR. The strategic emphasis areas are milk-acid bacteria and separation techniques. Research on milk-acid bacteria has produced functional foods such as Evolus drink (decreases blood pressure) and Gefilus cheese (positive effects on children's allergies, infections and diabetes risk). Other products are lactose-free liquid milk products, yoghurts and food cream.

In 2011 Valio launched a total of 78 new products in (2010: 66), plus a number of new products in Russia, Sweden and Estonia. Seven new patent applications were submitted in 2011 (2010: 1).

R&D and quality control costs totaled MEUR 27.3 (MEUR 27.3), or 1.4% of net sales (1.5%).

**2.3.5 Economic performance<sup>17</sup>**

The total milk production has declined in Finland during the last decade. Currently it is more than 5% below the quota. However, the Valio’s share has increased since it has managed to maintain the quantity of received milk pretty much at the same level during the last years (Figure 5).

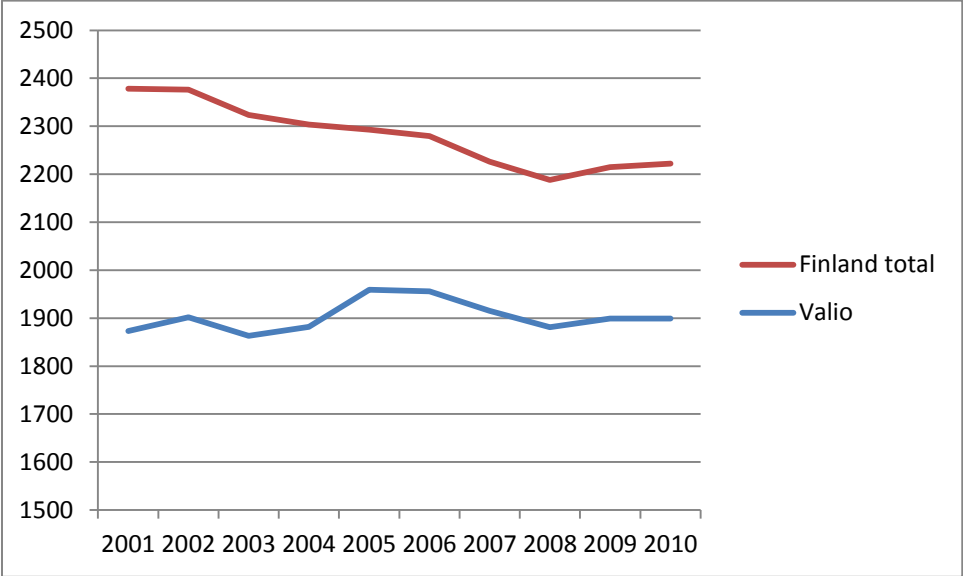


Figure 5. Milk production (mill. litre) in Finland and Valio’s share in 2000-2010.

Some key figures about Valio and its performance are presented in Table 5.

<sup>16</sup> The figures are from Valio’s home page, red May 14., 2012.

<sup>17</sup> The figures in this section are based on Valio’s Annual Report 2011.



Table 5. Key economic figures of Valio in 2007-2011.

	2007	2008	2009	2010	2011
Received raw milk (milj. L)	1915	1881	1899	1899	1870
Turnover (mill. €)	1713	1844	1787	1822	1929
Total assets (mill. €)	875	919	949	986	1011
Investments	94	118	79	68	85
Turnover/received milk from owner members (€/l)	0,89	0,96	0,94	0,96	1,03

Turnover shows however, an increasing trend being 1 929 million € in 2011. This is mainly because of Valio's own brands' success. Valio's investments were 85 million € in 2011. More than 90 per cent were domestic investments. A considerable part of the investments were improvements in environment-friendly processing and improvements in energy efficiency, for instance in recapturing the waste warmth.

In Figure 6 can be observed that low net profits during 2001-2007 indicate that Valio has used its net profits for higher milk producer prices. In 2008 net profits were used for investments. After 2008 Valio is obviously redirecting its net profit scheme. In 2009 Valio's net profits were almost 20 million € and in 2010 almost 40 million corresponding almost 2 cents per litre in producer price. As seen in Figure 6 this is a clear change to the previous period. This indicates the preparation of own financing for future investment needs.

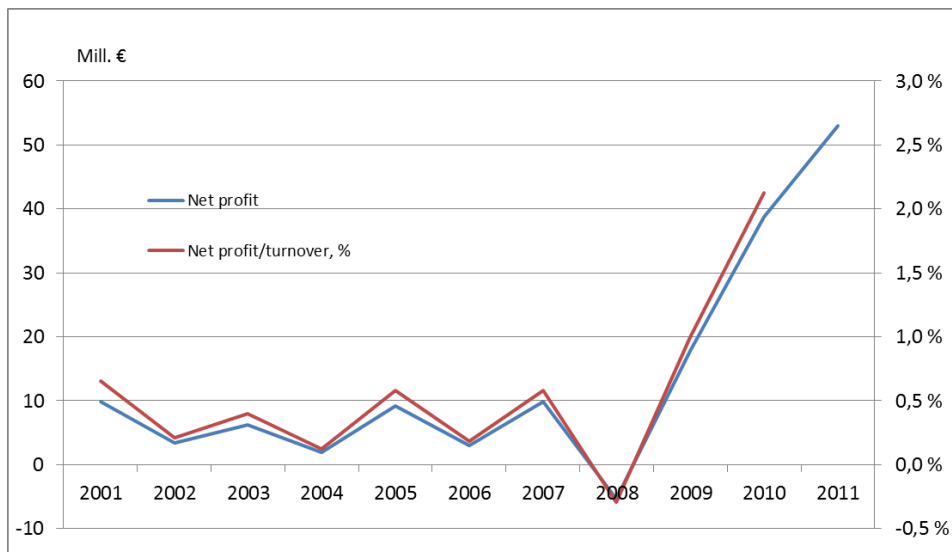


Figure 6. Valio's annual net profits 2001-2011

### Valio's performance 2011<sup>18</sup>

Valio uses milk return as its main performance measure. Milk return is calculated from milk margin, which is:

$$\text{Milk margin} = \text{net sales} - (\text{other costs excluding depreciation} + \text{the price paid for raw milk} + \text{interest on shareholder loan paid to owners})$$

<sup>18</sup> [www.valio.fi](http://www.valio.fi) read 17.5.2012

By milk return is meant:

$$\text{Milk return} = \frac{\text{milk margin} - \text{depreciation} - \text{financing for investments}}{\text{milk volume supplied by the producers}}$$

The used performance measure is quite unique. We know that even though many cooperative enterprises use net profit it does not reflect anything else but the difference between initial and final price paid to the producers. Even being a share company, Valio uses a very “cooperative-like” performance measure.

Valio Group milk return\* for 2011 hit its highest ever level at 44.9 cents/litre (2010: 41.1 c/l).

The price paid to producers for raw milk was raised by 2.5 cents/litre as of the beginning of April and by 2 cents/litre as of the beginning of August, paid over the whole year at 44.1 cents per litre, which is 3.2 cents up on the previous year, and the second highest in Valio’s history.

The increase in the price paid to milk producers was enabled by the increased demand for products highly valued by consumers in Finland and Russia. The volume and profitability of basic milks in Finland decreased due to extensive imports from Sweden, but operating profit nevertheless stood at 11 million €.

Valio Group net sales for 2011 increased to 1,929 million €, which is 5.9 per cent higher compared to the previous year. Net sales increased at the same rate in both international markets and in Finland. The Valio Group milk margin\*\* stood at 961 million € (2010: 901 million €). Valio Group’s book profit for 2011 after taxes rose to around 54 million € (2010: 39 million €).

Loans from financial institutions at the end of 2011 totaled 90 million € (2009: 114 million €). Valio Group’s equity/assets ratio rose to 48% (2010: 45%). Investments totaled 85 million € (2010: 68 million €).

The milk volume taken in by Valio from its owners totaled 1,870 million litres, down 1.5% on the previous year.

The biggest risk challenging the development of the milk return is related to the instability in the global economy and the rapid fluctuations in exchange rates that may result from that.

## **2.4 Valio’s international markets**

### **2.4.1. International dairy product markets**

Finland’s self-sufficiency rate in the dairy sector is about 110 %. In 1990’s it used to be about 130 %. The decrease has concerned especially liquid products. Part of the surplus is not purposeful expansion of export markets but a remainder from the era of closed markets with tight price control and import restrictions. As already mentioned, despite the rapid reduction in the number of milk producers and the number of cows, the total amount of produced milk has remained rather stable or declined only slightly (taking into account quota restrictions).

A real challenge is to maintain the (already low) profitability and still pay the highest producer milk price in Europe (inevitably for producers having the highest-cost production environment). Valio is by far the largest exporter of Finnish milk products.

In spite of discussions about an international merger, especially with the Danish-Swedish Arla, Valio has decided to stand alone, at least for the time being. One hindrance to a merger with Arla is that the direction for their interest in exports markets differs about 180 degrees: Arla has been interested in expanding to the West while Valio's interest has been in the East in addition to especially Sweden.

Valio's primary strategic focus is on Finland and the nearby countries Sweden, Estonia and Russia. The EU countries and the United States also represent key markets.

The Valio Group comprises the parent company, Valio Ltd, and its subsidiaries in Russia, the United States, Sweden, Estonia and China.

Valio Group takes in around 2,000 million litres of milk per year, which includes procurement for Valio dairies in Estonia. Some 40% of all milk processed by Valio is used to manufacture products for international markets. These products are sold in more than 60 countries and account for one third of Valio Group's 1.8 billion € turnover<sup>19</sup>.

All Valio fresh dairy product exports go to the consumer sector and are produced either in Finland or Estonia for sale in nearby markets. For example, around 85 per cent of all Valio cheese products sold abroad are consumer items.

Valio maintains contact with its international customers either through its local subsidiaries or direct sales.

Valio International Operations focuses on selling consumer products through its subsidiaries, particularly in Russia, Sweden and the Baltic States. Cheese sales are developed in selected markets in Europe and the US. The highest volume export products are cheeses, butter and fresh dairy products.

Ingredients Sales is responsible for all of Valio's ingredient sales both in Finland and abroad. The main product categories are milk powders, demineralized whey powders (DEMI) and butter in Finland, the EU and other selected markets such as China.

Another idea has been for Valio to invest in milk processing abroad to prevent potential import from other countries by being a strong actor itself in potential importing countries. This is especially true in the case of Valio's activities and investments in Estonia. Some highlights of Valio's export activities in various countries are presented below:

- Valio's Alma brand has a 30% market share in the Estonian fresh dairy product markets. In 2003 Valio bought Võru Juust, the leading cheese manufacturer in Estonia.
- Valio has a 40% market share in fruit yoghurts in Sweden.
- Valio's products are among the leaders in food imports to Russia. Valio's market share in butter is 35% in Moscow and 55% in St. Petersburg. Valio's processed cheese brand Viola has been in the Russian market for 70 years already and has a market share of 44% in Moscow and 53% in St. Petersburg in its product category.
- Valio's Emmental cheeses lead import statistics in the USA. In Northeastern USA Finlandia Emmental is the second largest brand in its category.

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<sup>19</sup> Figures are from [www.valio.fi](http://www.valio.fi), 14.5.2012

- In 2003 Valio began exports to China with butter and processed cheese. Currently the export is mainly demineralized whey powders (DEMI).

In 2011 Valio's international sales increased by 18 per cent. Sales in Russia increased by 43 per cent and in Sweden by 29 %. During the same time domestic sales decreased by 5 per cent

Also can be added that globally Valio is putting effort on health and wellness products, for example, commercialisation and market-based conceptualisation of functional milk acid bacteria (LGG®) and lactose -free products. In addition to this, the role of industrial products is important. Industrial products comprise 11 per cent of Valio's total sales.

It has been discussion about the meaningfulness of investing Valio's resources abroad. A part of the membership thinks that it does not make sense to waste member's and member dairies' money abroad especially because those investments have not been very successful. Others, including the management in turn argue that investments especially to the neighboring countries are strategically important for preventing other countries' dairy processors from using those countries as stepping stones to Finland. However, according to the survey among farmers<sup>20</sup> they seem to be surprisingly ignorant towards their cooperatives' international activities.

## 2.4.2 Sales of Technologies, Licences and Patents

In addition to wellness products and functional Foods Valio sells product ingredients, research and production know-how and brand labels related to functional foods. The business is based on long-range licence contracts with enterprises all over the world, the most being dairy processing firms.

Technologies licenced are<sup>21</sup>:

- LGG® - the most researched functional milk acid bacteria. Used e.g. in GEFILUS products.
- Evolus® - the first soured milk product that helps to reduce blood pressure (Valio's Patent)
- Zero Lactose™ - processing capabilities of lactose-free liquid milk (Valio's Patent)
- LGG® Extra - probiotic combination product patented by Valio. This ingredient affects positively on digestion.

The major part of this category's sales is know-how. Every technology also includes ingredients that Valio sells as part of the licence only available from Valio. The income from licence and technology sales was about 200 million € in 2011. In addition to this Valio thinks that the exports of technologies improve Valio's mark in the world as well as the reputation as forerunner.

Valio's R&D is a globally respected product development unit. Valio's functional products GEFILUS® and Evolus® are carefully researched. Valio is said to be the pioneer in functional food's product development in the whole world.

Lactose -free milk is processed using a technology that maintains the milk taste. The technology is said to be unique and better compared to any other.

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<sup>20</sup> Ollila, P. 2011.

<sup>21</sup> [http://ammattilaiset.valio.fi/portal/page/portal/valiocom/valio\\_worldwide/innovations](http://ammattilaiset.valio.fi/portal/page/portal/valiocom/valio_worldwide/innovations), 14.5.2012.

## 2.5 Co-operative development

### 2.5.1 Member-producer relations

A dairy producer wanting to become a member of Valio's primary co-operatives must first send an application to the Board of Directors of the primary co-operative. After processing the application the Board gives its decision. When becoming a member the producer agrees to fulfil certain quality criteria (see below). In practice, entirely new members are applying membership very seldom. Usually, new members apply for membership after the generation change and thus, it is only a continuum of the farm's membership. Of course, in some regions there is competition in milk collection and then you can change the cooperative.

The membership contract says nothing about milk price or quantity, but the co-operative promises to receive all the delivered milk and promises to pay as a good price for it as possible. Typically, it is stated in the cooperative's statute that the producer has to deliver all his/her milk to the cooperative except the amount that is used at his/her own or employees' households and except the amount that BoD of the cooperative allows to sell elsewhere. Thus, in principle the producer has no obligation to deliver all his or her milk to the co-operative. However, in practice it is. The amount that is allowed to sell elsewhere is usually small-scale direct selling of milk or processed products to consumers. In order to be able to get support for that the producer must have so called direct selling quota.

Co-operative members follow the principle of 'one member one vote' in primary co-operatives' elections. The vote is independent of the milk quantity delivered.

Despite the fact that the core of Valio is today a shareholder company, the significance and influence of its member-owners has not diminished. This relation is reciprocal. Throughout its entire history Valio has emphasised the importance of good quality milk<sup>22</sup>. All producers delivering milk to Valio must commit themselves to a quality contract, which includes five days' training in milk quality. It also requires documenting on the animals' medication, antibiotic testing, acquisition of new animals, maintenance and testing of milking machinery, and an insurance against salmonella. The highest level of dairy farms' quality contract requires ISO 9001 (quality) and ISO 14001 (environment) quality certificates.

Some activities in Valio's milk quality monitoring are presented in Table 6.

Table 6. Activities in Valio's milk quality control. Source: Annual Report 2004

	<i>Dairy farmer</i>	<i>Raw milk from the farm</i>	<i>Milk trucks</i>	<i>Quality requirement</i>
Aroma and taste	Daily	Every batch	Every batch	Faultless
Temperature	Daily	Every batch	Every batch	< 6°C
Microbial drug residues	As necessary	2 times/year	Every batch	Negative
Bacteria	-	2 times/month	2 times/week	<100 000/ml
Cells	Daily/weekly	2 times/month	2 times/week	<400 000/ml
Freezing point (added water)	-	2 times/month	2 times/week	<-0.512 °C

As Valio manufactures milk also abroad the position of foreign milk producers compared to domestic member-producers is different. There is a potential conflict between those two groups.

<sup>22</sup> In earlier times when production units were small, transport distances long and cooling technology undeveloped, the poor quality of milk used to be a real problem.

## 2.5.2 Personnel relations

Rapid and profound changes in the organisation of Valio have posed a challenge to Valio's personnel. Even though the number of personnel, 4,000 employees, has not changed to any major degree, the staff positions, contents of work as well as locations have. About 400 persons work abroad.

In 2003 Valio's management realised that the ability of its personnel to continuously adjust to new situations was coming close to its limit. Valio hired an employee welfare director<sup>23</sup>. Her assignment was to work together with the training and personnel departments towards a better synchronisation of the management's speed of change and personnel's capacity to change. Efforts to improve the working environment have included development discussions with personnel, development of work, stress management, ability to give feedback and prevention of mobbing. Measures have further been taken to develop the middle management's skills of communication with their subordinates.

## 2.5.3 Relations with the retailing industry

In addition to milk collecting and processing, Valio's logistical ability is a major strategic advantage. Still ten years ago Valio was increasingly taking care of the milk product departments of the retail stores. At present Valio's responsibility generally stops at the retailers' platform.

Most of the orders arrive through the retailers' electronic systems at Valio's ordering and logistics system. Valio implemented its new SAP-based ordering system in spring 2005. This is said to be one of the most sophisticated systems in the world. It combines the ordering systems of the retail chains with its own system using synchronised standards. Orders are based on storage data, shelve monitoring system and data coming in from cash registers. Valio's delivery system follows the ECR principle. System development is in continuous contact with the retailers.

However, the smallest retailers are still outside the electronic ordering system. Around 20% of the total number of orders arrive either through the daily telephone contacts of Valio's own sales force or through the Internet-based ordering system specifically designed for small customers.

Valio's deliveries are made on six days per week from four distribution centres. Usually the orders come in by 10 o'clock in the morning. At this time the software starts to plan the routing and the orders will be delivered on the same day in the afternoon. Orders arriving after 10 a.m. will be automatically postponed to the next day.

Thus, Valio's fresh products are delivered six times a week and mostly on the same day as they are ordered. 'Hard' milk products like cheeses are delivered within a 48-hour time frame and often as a supplement load in the lorries.

The lorries have a delivery time window for retail stores. If there are no disturbances, punctuality is within minutes. Punctuality is also frequently monitored. The most challenging days are the days just before public holidays and the first days right after them.

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<sup>23</sup> Castrén 2005.

## 2.5.4 Ownership and control

Valio's ownership is solely in the hands of milk producers. This holds both in financial and governance structures. There are only cooperative shareholders and all the shareholders are cooperatives that have only supplier members. There are no other equity in Valio and in owner cooperatives than suppliers' shares and accumulated profit and surpluses.

Moreover, as noted in section 2.2.2 the controlling bodies (BoD, Board of Trustees) consist almost only of milk producers. In Board of Trustees there are also personnel representatives. In contrast to especially publicly listed companies, there are no professionals from other sectors in governance bodies.

This emphasizes the fact that even though Valio is a limited liability company it pretty much operates like a 2<sup>nd</sup> tier cooperative. Ownership, control and patronage are fully united according to our definition of cooperatives.<sup>24</sup> This structure also emphasizes the supplier role based on patronage instead of investor role.

Valio's domestic operations are in turn solely in the hands of Valio itself. It has no active subsidiaries in Finland that have food processing activities. Moreover, the international operations are taken care of by subsidiaries registered in concerned countries. All Valio's subsidiaries are currently solely owned by Valio. It does not have any partners anywhere. Thus, the ownership structure is in every sense very simple and straightforward.

These elements are also emphasized by the company strategy. The mission of Valio is defined "to promote the business of Valio milk producers". Moreover, the Valio Group financial goal is: "milk margin is on a par with the best European dairy companies". There are no direct goals concerning growth, net profit or equity to asset ratio that are usually expressed in company strategies.

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<sup>24</sup> User owned, user controlled, user benefited.

### 3. Survey results

Interviewees: CEO of Valio, Chairman of BoD of Valio, CEO of the third largest owner cooperative, Chairman of BoD of the largest owner cooperative, milk producer active in cooperative organisations.

The most important decisions concerning the ownership structure of Valio were made in the end of 1980's and in the beginning of 1990's. They have also been documented quite well and they have been analyzed in previous chapters. The ownership structure issues were thus dealt only briefly in interviews. Instead, we concentrated in the interviews on the internationalization, growth and supplier relations in foreign countries. These issues are, of course, related to ownership structure and to the mission and goals of the company.

#### 3.1 Ownership issues

Valio's growth strategy is obviously autonomous, based on high value products and niche markets in Finland and in the neighboring countries. If a company is not very active in mergers or acquisitions it does not need so much excess capital. This need for capital in foreign investments has very often been the reason to think about ownership structures (compare e.g. meat processing industry, see Pyykkönen and Ollila 2012).

With this growth strategy Valio has not had the need to think about changing ownership structure and/or seeking for outside investors. Even if the internationalization were possible without outside investors it would probably need capital from owners or debt financing. These both would probably not be very high in owners' wishes when they need their own capital for restructuring their own farms.

Thus, this growth strategy that relies more on R&D than acquisitions seems to be very suitable from cooperative owners' perspective. Especially, when it seems to be working. If we look at the financial goal of Valio (milk margin among the best in Europe, i.e. producer price among the highest) it has succeeded very well. Moreover, the cooperative structure of Valio (even though it is a limited liability company) does not hinder this strategy. On contrary, it may even promote it.

The fact that Valio acts in a very cooperative manner is indicated through its way of handling own capital. In addition to the milk margin goal, Valio pays dividend payments and interest on shareholders capital loans. Referring to the Figure 6 in Chapter 2.4, most of the Valios profits are paid in milk prices to the collecting cooperatives, owners of Valio. The owner-shares of the cooperatives are not entirely distributed according to the delivered milk. The structural change has affected the deliveries in different regions and there are also some other reasons why the shares and delivery shares are not the same. Thus, if Valio made profit and paid considerable dividends the producer price would probably differ quite a lot in different regions in Finland. However, the similar price in every region was one of the goals of restructuring the ownership structures 20 years ago (see section 2.2.2).

Thus, Valio pays similar price to every cooperative and the cooperatives pay exactly the same price (quality adjusted, of course) to every producer. Valio has two sources for individual equity financing. In addition to the shares the primary cooperatives have given shareholder loans to Valio. The dividends are paid for shares and the interest on shareholder loans. When summing up these two sources of capital returns from owner cooperatives' perspective the capital returns are also reflecting the patronage (i.e. quantity of milk delivered). Thus, in practice the cooperatives that have a smaller share of Valio compared to their share of deliveries have larger



shareholder loans to Valio and the interests Valio pays on these loans “equalize” the capital returns to correspond the deliveries.

### **3.2 Internationalization and growth**

Valio has its roots in international operations since it was originally established as butter exporting company. Still, export is in the core of Valio’s international operations. As described above, Valio has not been very eager to act as processor in foreign markets. Estonian market is the only exception.

The reason to acquire production in Estonia was mainly to protect the domestic Finnish markets.<sup>25</sup> Of course, Estonia offered also opportunities as such as a liberal and market-oriented country that also had relations to Russia. In Valio case the Russia connection through Estonia was, however, not that important since Valio’s own market channels to Russia were already in a good shape. Currently, Valio’s market share in Estonian fresh dairy product market is around 30%. With this market share Valio is at least able to prevent some share of possible export in Finland and thus, to protect Valio’s domestic production from foreign competitors. With this market share it also can to some extent affect the price level in Estonia. Thus, the Estonian operations are perfectly in line with the Valio mission.

In export markets Valio has concentrated on high value products. The structure of Valio’s exports differs from many other dairies in Europe. For example, the share of skim milk powder (SMP) that is a typical “tail product” and that produces very low “milk margin” is very small. The Swedish export, that together with Russia, is the most important export destination for Valio’s products, is a very good market. Valio has concentrated on high value products that are often so called functional food products. Furthermore, Emmental cheese has also a long tradition in Valio’s export portfolio.

Even though the domestic market has on average a better ability to produce high “milk margin” the exports are necessary because of seasonal variation, especially in production. When the production is the highest in spring, it is 13% higher than in November when it is the lowest. Moreover, the consumption structure does not entirely respond to the fat and protein contents of raw milk. If domestic market share is wanted to maintain as high it is necessary to have some excess production. Through R&D and looking for niche market this strategy has so far been quite successful.

The competition in domestic market has, however, increased both in basic products (fluid milk and import from Sweden) as well as in high value products. The most important import product that have effects on Valio’s performance is still however cheese.

### **3.3 Supplier issues**

What comes to the supplier treatment in Estonia where Valio has considerable processing industry the answer is very clear. It has never been considered a possibility that Estonian

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<sup>25</sup> There was an interesting attempt in 1990’s when Valio and Arla planned joint investment in Estonia. Together with Estonian state they would have established a company Eesti Piim whose market share would have been around 90% in Estonia. The Estonian state would have owned 65% and Valio and Arla together the rest 35%. However, the small state owned dairies were privatized before the plan was started to put in action. Thus, the plan was never accomplished (Perko 2005).

producers would be co-owners of Valio. Even if Estonian producers wanted to be the Finnish cooperatives would not allow that.

In theory, the Estonian producers could establish a cooperative that would acquire Valio's shares from an emission directed to this particular cooperative and accepted by its current owners. Among Estonian farmers there has been some willingness to become a member in Valio/respective cooperative. The hope has been to get the same price that is paid in Finland. In practice, even if this kind of arrangement was possible, it would be very improbable that Valio would pay the same price in Estonia as in Finland. Thus, the benefit for the Estonian owners would not come in a form of higher price. In a way this situation is comparable to the situation with Arla producers in Finland. Currently, Arla producers in Finland are paid according to the competitive situation in Finland and according to the same pricing system (including seasonal pricing) that other Finnish dairy operators use. The price level is considerably higher than in Sweden or Denmark where Arla has member-suppliers. If Finnish Arla suppliers were accepted as members in Arla they wouldn't accept the Swedish/Danish price.

Thus, the price level is not the issue. However, again the Valio's mission is very clear "to benefit its owners" and Valio's owners are Finnish. Valio wants, however, to be a responsible actor in all the markets and it is important to the company that they treat their foreign suppliers in a fair manner. Valio is perhaps not the highest paying dairy in Estonia but it is said to be the most secure payer.

The interviewees did not have a clear opinion about the possible Producer Organisations (PO) that are currently possible in milk sector after the approval of so called milk package. In Finland it is very probable that there will not be any considerable PO's due to the large market share of cooperatives that already take care of the responsibilities appointed to PO's. However, in Estonia it is possible that PO's will be established.<sup>26</sup> Are they established on regional or dairy cooperative basis and what could the effects on Valio's supplier relationships, had not been thought yet. One possibility in the future is that this kind of PO would act as a starting point to a cooperative that in some time in the future could be a Valio shareholder. This future prospect was not entirely excluded.

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<sup>26</sup> With the large suppliers (e.g. farms that have been established on the grounds of kolkhozes) Valio's Estonian subsidiaries have direct contracts. Smaller producers have already established an organization to work as middleman between the industry and producers.

## 4. Overall Conclusions

The hypotheses named to this case were H12, H13, H14 and H15. In the following we firstly answer to those hypotheses and secondly look at the other hypotheses whether we are able to add something on them too.

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

Based on Valio this hypothesis cannot be supported. Neither can it be entirely rejected since Valio's growth and internationalisation strategy has relied on R&D and high value export rather than mergers and acquisitions. However, the failed examples from the Valio's history (failed Arla/Valio merger, Estonian attempt) give us a hint that there are some willingness and capability to think over also the ownership issues in the company and especially among the owner's.

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

This hypothesis is strongly supported. In addition to acting as profit centres, the aim has often been in protecting domestic market and thus increasing the ability to increase "milk margin" in Finland. In addition to this, pursuing other countries' producers' benefits would be controversial to the priority of advancing initial members' benefits.

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.

Similarly to the previous hypothesis, strongly supported. Even though, the "milk margin" decides the producer price and the role of capital return is small compared to the producer price and even if the foreign suppliers were not paid the same price as in Finland the benefit of Finnish producers would be at least in the short run negative. Moreover, the value of Valio is not in fact known since it is not listed in the Stock Exchange. However, the net value would probably be much larger than the owner's equity invested in Valio through cooperatives. Thus, there is no reason to accept foreign members. If the situation were such that company wanted to grow through acquisitions and needed capital and this would be the way to increase equity the membership might be considered. But this would mean re-thinking of whole company strategy.<sup>27</sup>

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

This hypothesis is at least partly supported (compare H13 and H14). The situation in Estonia is different. Valio's subsidiary has contracts with producers whereas in Finland Valio has not direct contracts with suppliers.

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<sup>27</sup> Thus, our hypotheses H1: "Cooperatives going international will choose a different institutional arrangement in dealing with suppliers due to differences in the institutional environment" and H2: "Cooperatives going international will choose a different institutional arrangement in dealing with suppliers due to differences in the characteristics of the transaction (such as specific investments, environmental and behavioural uncertainty, and coordination needs)" as well as H4: "Second tier cooperatives that go international are less likely to establish member-relationships with their foreign suppliers" and H6: "Larger cooperatives are less likely to invite foreign suppliers to become member than small cooperatives." were not supported. The institutional environment or being 2<sup>nd</sup> tier actor did not affect the decision. The invitation does not seem to be related to the size of the cooperative but mainly on national interests.

One of our hypotheses to be tested was H7: “Larger cooperatives are more likely to see their members set up new associations.” This issue is partly connected to the “EU milk package” that came into force in March 2012. Since the cooperatives have a dominant role in Finland it is very probable that Producer Organisations that the package allows will not be established in Finland. Milk producers are still so homogenous group that this won’t happen in Finland, not at least in the near future. The producers appreciate e.g. the tradition of same price for every member in spite of the differences e.g. in size or distance from the processing plant.

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