CoBank Knowledge Exchange

April 2018

Shifting Ground: Mega-Mergers to Realign Farm Retailers

by Will Secor

Economist,
Knowledge Exchange

Inside...

Key Points:

- Seed and crop protection rebate programs will change over the coming years due to mergers in the seed and crop protection industry.
- Agricultural retailer margins in the seed and crop protection segment can be thin, and often hinge on manufacturer rebates. Thus, many retailers will face critical operational decisions.
- Potential strategies in response to manufacturer rebate changes include exiting aspects of the crop protection or seed segment, developing retailer-branded products, or partnering with one manufacturer.
- Crop protection and seed industry mergers, and the resulting rebate program changes, could accelerate consolidation in the farm supply sector.

Summary

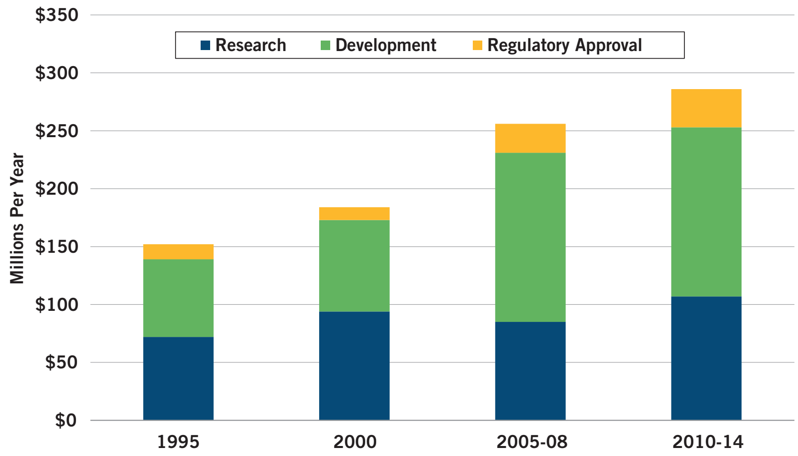
Crop protection and seed segment margins remain compressed for many agricultural retailers and agronomy divisions of combined grain and farm supply companies (the farm supply sector). The stressed farm economy and intense competition have driven gross margins to near- or below-breakeven levels in these segments. Rebate programs are the only mechanism for many in the farm supply sector to eke out a profit.

The struggling farm supply sector is keenly focused on price and rebate program changes resulting from crop protection and seed company mega-mergers. While cost savings may accrue through these mergers, they may also provide the merged companies with enhanced market power. To combat potential market power gains, anti-trust regulators have required extensive divestments in each of the mergers. Accordingly, the mergers' short-run impacts will likely be limited.

Rebate programs remain a concern despite these divestments because they are so critical to profitability. These programs can be very complicated and dependent upon factors outside of the seller's control. The merged companies are expected to require larger volumes for rebates and tie together discounts for seed and crop protection products.

EXHIBIT 1: Research, Development, and Regultory Costs

Crop Protection Products



Source: CropLife International

Those in the farm supply sector may evaluate options that include the following because of these changes:

- **Exiting** some business lines associated with seed and crop protection and devote resources to other areas.
- **Reducing** the number of brands they offer and partner with one manufacturer to maximize rebates.
- **Offering** competing products to increase bargaining power with manufacturers.
- **Cooperating or consolidating** with other agricultural retailers to gain bargaining power while preserving variety and maximizing rebate program discounts.

Mergers redefine the industry

The crop protection and seed industry is being reshaped by three mega-mergers: Dow-DuPont, ChemChina-Syngenta, and Bayer-Monsanto. While each merger has its own unique reasons, the major driving force has been cost reduction through economies of scale and scope. The downturn in agricultural commodity prices that hurt farm financials incentivized these companies to seek ways to reduce costs through mergers.

Research and development (R&D) costs have increased significantly as seed and crop protection technology has advanced and the regulatory demands have increased. Consider these statistics from studies by CropLife International:

- The average cost to bring a new crop protection product to market between 2010 and 2014 was $286 million, up 55% from 2000.[1] (*See Exhibit 1.*)
- It cost $136 million to bring a seed variety to commercial market between 2008 and 2012.[2]

Additionally, a crop protection product or seed trait must move through the regulatory process before it can reach an agricultural retailer's warehouse. CropLife International studies found:

- Registering a crop protection product between 2010 and 2014 cost $33 million, up from $11 million in 2000.
- From 2008-2012, completing the regulatory process for developing a new seed trait cost $35 million.

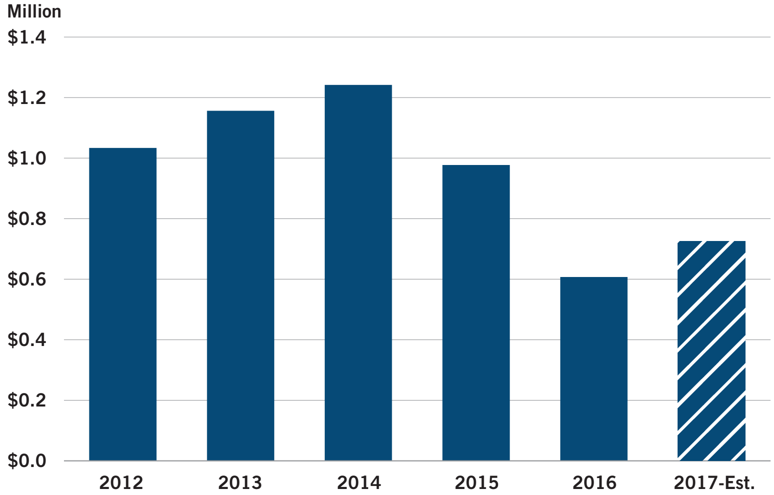
The merging companies are also hoping to gain economies of scope, not just scale. The economies of scope arise from significant complementary activities. The merging companies are now researching and marketing a "total package" to growers that covers seed, crop protection products, and farmer data management.

The U.S. companies involved in mergers have tied corporations that are strong in seed (DuPont and Monsanto) with leading crop protection companies (Dow and Bayer). Although Syngenta and ChemChina are known for their crop protection products, Syngenta also has significant strength in seed with ambitions to grow this segment.

As R&D costs for both seed traits and crop protection products increase, the need to link them also increases so that the company ensures a return on the R&D investment. Farm data service arms of merging companies, such as Monsanto's Climate Corporation and DowDuPont's Granular, add a complementary service

EXHIBIT 2: Net Operating Profit

CoBank Farm Supply Customers (Average)



Source: CoBank ACB

Note: 2017 is an estimate using preliminary data

to their parent company's offerings. Combining seed, crop protection, and farm data service lines enhances the products and services a single manufacturer brings to farmers.

This more complete portfolio of crop inputs will allow manufacturers to gain a larger share of the farmer's wallet by increasing cross-selling opportunities. It also allows manufacturers to construct rebate programs that promote sales of their portfolio rather than a particular product.

The impact on prices

Market participants rightly worry about increasing prices whenever a merger wave hits an industry. In general, mergers create two outcomes that at least partially offset each other in their impacts on prices: cost reductions and market power gains. Holding all else constant, cost savings pull prices lower, while increases in market power will push prices higher. Most mergers generate both effects, and therefore the net effect of the merger may raise or lower prices.

The mission of antitrust regulators is to ensure a merger or acquisition does not harm competition. In doing so, they analyze whether the resulting combined company will have cost savings that outweigh any gains in market power. If a newly merged company would control too much of the market, anti-trust regulators would likely require divestments or block the merger.

The mega-mergers in the seed and crop protection industry were initially projected to push the industry from a "Big 6" to a "Big 3." Early estimates showed seed prices might increase by around 5 percent in corn and soybeans to nearly 20 percent in cotton.[3] However, significant divestments will likely maintain important levels of competition in the industry. In particular, BASF emerges as a major seed and crop protection player, scooping up assets offloaded by Bayer.

Prior to the merger wave, most companies in the industry focused on either seed or crop protection, not both. Now, a "Big 4" set of companies are surfacing post-merger that are firmly rooted in both seed and crop protection.

As a result of the divestments and the new "Big 4" competition, any direct price impacts of the mergers will be relatively small in the short run.

Rebate program changes accelerate

Margins for seed and crop protection products have compressed over the past several years as farmer incomes declined and farm supply sector competition intensified. Farmers continue to haggle over prices for seed and crop protection products as they seek to reduce costs in the face of low commodity prices. Competition is fierce because of more price transparency brought about by online platforms like Farmer's Business Network (FBN) and Agroy, and increasingly large and cutthroat competitors. Net operating profit for CoBank's farm supply customers is estimated to rebound in 2017 from expense reductions rather than an increase in margins. Potential rebate changes will continue to put the spotlight on cost controls. (*See Exhibit 2.*)

Rebate programs often are the difference between a positive or negative seed or crop protection margin for many in the farm supply sector. These programs provide discounts to agricultural retailers based on the volume of seed and crop protection products they buy and sell. Typically, the discount per unit may increase if additional volume targets are met.

Seed rebate programs are often more straightforward than crop protection rebate programs. They are simpler because these programs are based on pre-paying for a certain volume, and most factors are known with a reasonable degree of certainty up front.

Crop protection programs are more complicated for several reasons. First, discounts often vary by product within a manufacturer's product line. Second, manufacturers stack rebates, providing additional discounts based on the sales of a combination of products. These first two factors create a matrix of rebates that are contingent on sales of multiple products simultaneously. This makes forecasting the end-of-year rebate check extremely difficult. As a result, many agricultural retailers view these rebate programs as "black boxes." Lastly, crop protection product demand depends on factors outside the agricultural retailer's control, such as weather and pest pressure.

More complex rebate structures are also emerging. Some companies base discounts on share-of-wallet and year-over-year volume growth, in addition to current year volume.

Mergers will bring changes to these rebate programs. Merged companies will want to capitalize on their size and greater link between seed and crop protection products. Rebate changes will likely incentivize larger volume thresholds and tie discounts together across seed, crop protection, and farmer data products. Manufacturers may develop "package" discounts that bundle these products rather than continuing down the path of a matrix rebate system. While many in the farm supply sector hold out hope that rebate programs will be simplified, the seed and crop protection mergers will likely make rebate programs more complex.

"Rebate changes will likely incentivize larger volume thresholds and tie discounts together across seed, crop protection, and farmer data products.

Retailers positioning to gain efficiencies and remain relevant

The grain and farm supply industry is going through a tremendous amount of change. Grain and farm supply companies have felt the downturn in the farm economy as much, if not more, than crop input manufacturers. They are facing new competitors and business models that challenge their success and way of doing business. Meanwhile, their farmer-customers are becoming larger and beginning to come from a new generation — factors that are changing what they need from their local grain and farm supply company. Because of this changing environment, grain and farm supply companies are consolidating, seeking internal cost savings, providing more services to farmers, and experimenting with new business lines.

Mergers in the seed and crop protection industry will likely further complicate business in the farm supply sector. Rebate structure changes would require agricultural retailers to adapt. However, the objectives will remain the same: gain efficiencies and remain relevant.

Agricultural retailers will likely experiment with several strategies when faced with changing rebate programs, with four potential options in particular.

1. Exit a part of the seed and crop protection segment and devote resources elsewhere. Exiting a part of the seed and crop protection segment is a worst-case scenario strategy. However, it also sets a baseline for analyzing the other strategies. This option specifies what the agricultural retailer can do instead of being in a particular area of the crop protection and seed segment. This may be the optimal strategy for some agricultural retailers if profitability is marginal or negative, margins are at risk of declining further, and competition from major competitors is increasing. In some cases, manufacturers may provide better rebate programs to their dealer network over their agricultural retailer partners. This indicates that exiting may be a good long-run strategy as it may show the intentions of the manufacturer's long-term distribution strategy of going direct to farmers.

2. Partner with a manufacturer to maximize rebates. Partnering with a manufacturer is attractive to an agricultural retailer as a way to reduce costs. By focusing on one manufacturer, an agricultural retailer could more easily maximize rebates through increased volumes within a given product and across the portfolio of products. This strategy will be especially important for smaller agricultural retailers that cannot optimize their use of multiple manufacturer rebate programs. The risk with this strategy is that they no longer provide as much variety to their farmer-customer. Variety is often a critical reason farmers buy through an agricultural retailer versus a manufacturer sales rep.

3. Offer retailer-branded, competing products. Large agricultural retailers may pursue the development or expansion of retailer-branded seed or crop protection products. As crop prices plummeted and remain low, farmers have shifted some crop input purchases to generic chemicals or retailer-branded seed because they have lower price points.

This strategy has its drawbacks. Creating a line of retailer-branded products adds complexity and cost to the agricultural retailer business because they are now a manufacturer, not just a distributor. Such a move also puts the agricultural retailer in direct competition with their suppliers, changing the relationship.

On the plus side, successful retailer-branded products can improve the bargaining power of agricultural retailers. Additionally, a new line of products can counter potentially reduced innovation at the manufacturer-level. Successful retailer-branded products will also contribute to the bottom line with positive margins that can sometimes exceed the profitability of major-branded products. This strategy can help lower costs on major brands while potentially increasing retailers' relevance to their farmer-customers by offering new seed and crop protection products.

4. Consolidate or cooperate with other agricultural retailers. Seed and crop protection industry mergers only reinforce the pressure for agricultural retailers to form alliances, cooperate, or consolidate. This was already an important avenue for agricultural retailers to reduce costs and maintain, or increase, their relevance to both farmers and suppliers. With fewer suppliers, agricultural retailers may lose bargaining position. To counteract this, they can work together or merge and obtain a stronger bargaining position. Additionally, becoming larger allows an agricultural retailer the opportunity to pursue its own brands. Finally, a larger agricultural retailer or an alliance of agricultural retailers can better maximize the benefits from manufacturer rebate programs without reducing the number of brands offered to its farmer-customers.

Conclusions

With slim margins in crop protection and seed segments, the farm supply sector is watching the impacts of the most recent merger wave in the industry closely. In particular, rebate programs will likely be changed in important ways in the years ahead.

Divestments in each of the three mega-mergers should keep significant competition in the seed and crop protection markets, easing concerns of price increases. However, the industry has changed significantly with important implications for agricultural retailers.

The farm supply sector was already responding to changes among its farmer-customers and within its own industry. Changes in the seed and crop protection landscape reinforce retailers' pursuit of lower costs and lasting relevance. Stronger partnerships and retailer brands can be potential strategies to explore. Agricultural retailers may also consider merging or forming alliances to gain more bargaining power and cost savings.

References

[1] *Phillips McDougall. The Cost of New Agrochemical Product Discovery, Development and Registration in 1995, 2000, 2005-08 and 2010-2014. CropLife International, March 2016. Available here.*

[2] *Phillips McDougall. The Cost and Time Involved in the Discovery, Development and Authorisation of a New Plant Biotechnology Derived Trait. CropLife International, September 2011. Available here.*

[3] *Bryant, Henry, Aleksandre Maisashvili, Joe Outlaw, and James Richardson. Effects of Proposed Mergers and Acquisitions Among Biotechnology Firms on Seed Prices. Working Paper 16-2, Agricultural and Food Policy Center, Texas A&M University, September 2016. Available here.*

CoBank's Knowledge Exchange Division welcomes readers' comments and suggestions.
Please send them to KEDRESEARCH@cobank.com.