Research article

Innovative Institutional Arrangements and Shareholding Schemes Adopted by Producer Groups Servicing Smallholders in Myanmar

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Abstract Smallholder producer groups are vulnerable to institutional problems when they pursue value-adding enterprises requiring capital and predictable deliveries. This paper provides insights into effective shareholding arrangements introduced by two producer groups to upgrade their business strategies from 'transactional' to 'value-adding' status. The first group offered machinery services to reduce production costs and improve the quality of smallholder paddy. The second group focused on taking advantage of a domestic niche market for non-traditional, high-value, paddy varieties. Members and directors of these producer organizations were wary of free-rider problems that undermine collective efforts to finance assets and meet supply contracts. This study draws on the New Institutional Economics concepts of ill-defined ownership rights to analyze the innovative shareholding schemes devised by these groups to prevent free riding. It treats the producer groups as case studies, and the research is both exploratory and applied set within the framework of action research. Both groups issued non-redeemable, tradable, class B shares. Class B shares are appreciable but confer no or limited voting rights, allowing members to benefit as investors and as patrons while maintaining democratic control of their organization. The key, however, is to align investment with patronage as this prevents free-riding and mitigates conflicts of interest that discourage member investment and compliance with supply contracts. The first group linked member investment to progressive discounts on the cost of machinery services, thereby creating a strong incentive for larger patrons to buy more shares. The second group treated each share as a tradable obligation to deliver a specific quantity of high-value paddy, thereby requiring larger patrons to invest in more shares. This research adds to a small pool of literature that examines the attributes of well-defined ownership rights in smallholder organizations that pursue value-adding business strategies.

Keywords small-scale farmers, value-adding producer organizations, free-rider problems, institutional arrangements

INTRODUCTION

Demand for safe food has been increasing in developing countries due to rising consumer incomes and greater awareness of product attributes and their impacts on health (Minten and Reardon, 2008). Consequently, vertical linkages between producers and markets have become increasingly coordinated (Shepherd, 2007). This change has created both opportunities and challenges for smallholders. On the one hand, burgeoning supermarkets and hospitality chains generate opportunities for smallholders to benefit from prices seldom found in traditional wet markets. On the other hand, smallholders lack the scale needed to meet the quantity expectations of premium buyers at low costs. Many smallholders do not know the standards required for the farming practices they need to meet these standards, are unable to finance new technology and value-adding assets, and have no reputation as reliable food suppliers. (Markelova et al., 2009).

Collective marketing can mitigate these challenges, allowing smallholders to access markets that value quality (Markelova et al., 2009). Producer groups can purchase inputs in bulk and secure bulk discounts. They can coordinate members' production schedules, monitor their farming practices, and pool their output to meet large and consistent orders for quality products, lending visibility and credibility to the group as a reliable supplier (Narrod et al., 2009). Product pooling also mitigates idiosyncratic risk and lowers the unit cost of information, transport, storage, and transacting. Moreover, producer groups can finance value-adding assets by pooling member resources to leverage additional capital from strategic business partners, donors, and lenders (Kaganzi et al., 2009; Mwayawa et al., 2019; Yooprasert, et al., 2017). Indeed, interventions aimed at increasing smallholders' shares of added value usually involve producer groups (Sjauw-Koen-Fa et al., 2016).

While the role that producer groups can play in linking smallholders with high-value markets is widely recognized, the literature seldom distinguishes between producer groups that operate at a transactional level and producer organizations that need to finance value-adding business strategies. Regrettably, the literature reports many examples of failed producer organisations, particularly those operating as, or like, traditional cooperatives (Esnard et al., 2017). Failure has been attributed mainly to poor management, inadequate capital, and opportunistic side-selling by members (Rosairo et al., 2012). The New Institutional Economics (NIE) views these setbacks as symptoms of deeper challenges created by ill-defined voting and benefit rights that discourage farmers from investing in their organization and from complying with supply contracts (Cook and Iliopoulos, 1999; Hariss et al., 1996), and weak governance practices that undermine the ease and extent to which directors and managers can be held accountable for their decisions (Cornforth, 2004).

When faced with the task of establishing producer groups able to progress from transactional to value-adding business strategies, the NIE literature advises these groups to adopt constitutions that embed good governance practices and, importantly, do not constrain their choice of investor-friendly shareholding arrangements. 'Structure follows strategy' (Chandler, 1962) is a well-established business principle that receives scant attention in the literature dealing with smallholder marketing groups and their transition to value-adding organizations. This gap in the literature contrasts starkly with a growing emphasis on inclusive business models to leverage private sector finance, expertise, and intangible assets in pursuit of key Sustainable Development Goals (UNDP, 2015).

Our research seeks to narrow this information gap by examining and documenting case studies of two well-functioning producer groups located in the Myeik district of southern Myanmar's Tanintharyi Region. The case studies focus on institutional arrangements implemented by these groups to support their value-adding initiatives. While the primary purpose of this paper is to offer insights into shareholding arrangements that producer groups can use to incentivize investment and patronage, we also present nuanced findings and messages for development agencies uncomfortable with the idea of bringing investor-oriented structures into smallholder organizations.

RESEARCH METHOD

This research was both exploratory and applied and consequently used multiple case studies (Yin, 2018) set within the framework of action research (Reason and Bradbury, 2001) to meet its objectives. Exploratory case studies are guided by arguments or more specific propositions (Yin, 2018). The proposition central to this research is that investor-friendly institutional arrangements create opportunities for transactional producer groups to pursue business strategies that deliver greater value to their members.

Twenty producer groups were established in the neighboring districts of Myeik and Palaw between August 2018 and May 2019 as part of a value chain project funded by New Zealand's

Ministry of Foreign Affairs and Trade. All of these groups were functional two years into the project but were operating at only a transactional level. They placed bulk orders for inputs, took advantage of training and extension services offered by public and private agencies, and negotiated price discounts, credit terms, and transport arrangements with reputable suppliers. Their capital requirements were modest and adequately addressed by collecting membership fees. Two of these groups were purposefully selected by the project's action research team as candidates for upgrading to producer organization status because their business plans demonstrated financial feasibility but differed with respect to their value-adding strategies. This created an opportunity to design and pilot institutional arrangements for different, yet typical, smallholder value-adding strategies. The project's action research team shared its theory-informed ideas about appropriate institutional arrangements with the directors of each of these two cases between January 2020 and March 2021 and found a strong propensity within these groups to devise practical, investor-friendly shareholding schemes. During this time, some of the project's other producer groups developed sound business plans and adapted these shareholding schemes to support their value-adding strategies. The following section describes the shareholding schemes adopted by the two initial cases to launch their value-adding enterprises.

CASE STUDY FINDINGS

Machinery Service Provider

Producer Organization One (PO1) specialized in paddy (unmilled rice) and its members perceived value in its machinery services for land preparation and transport. Machinery services reduce labor costs and help farmers to plant and harvest on time improving the quality and consistency of paddy delivered to millers. Savings in labor costs coupled with higher prices paid by millers for a paddy of improved and consistent quality were expected to add significant value to members' deliveries. A business plan developed by the directors with the help of technical specialists, the action research team, and prospective partners including a machinery supplier and a microfinance company, projected a positive net present value and feasible cash flow for an investment of USD 27,857 in a tractor and implements. Of this total, USD 20,714 was to be financed with equity capital and the remaining USD 7,143 with a loan from a microfinance company to help cover installments on a three-year hire-purchase agreement offered by the machinery supplier. PO1's members agreed to contribute USD 12,714 of the equity capital from their funds with a further USD 8,000 from a grant awarded to them by the project. The directors shared the grant-funded equity capital equally between members to ensure that every founding member had a meaningful financial interest in the business regardless of their ability to pay for additional shares. Apart from promoting inclusivity, the grant provided PO1 with the additional equity capital that the microfinance company required to approve a loan of USD 7,143.

The shareholding scheme adopted by the directors required members to purchase non-redeemable, tradable, class B equity shares. The shares were issued at a low price of USD7.14 per share to encourage investment by poorer members and to promote liquidity in the market for shares. Tradable shares provide an entry mechanism for newcomers and allow members to adjust their shareholding or exit with capital gains. Proportionality between investment and patronage is a key success factor in producer organizations. It mitigates free-rider problems by aligning the interests of members seeking dividends and capital gains on their investment in shares and those seeking favorable prices for their patronage. However, this proportionality is difficult to achieve when the business strategy is to sell machinery services. To promote proportionality between investment and patronage, the shareholding scheme offered larger investors progressively higher discounts on the price of machinery services. Apart from encouraging larger patrons to purchase more shares, this arrangement allowed PO1 to grow its business by selling services to non-members at market prices.

The directors favored a three-tier discount scheme to foster proportionality between investment and patronage (Fig. 1). In terms of this scheme, members received a share certificate along with either a personalized bronze, silver, or gold discount card entitling them too progressively greater discounts on the price of hiring machinery services depending on the number of shares purchased. Directors retained the right to revise the discount rates and thresholds in response to changes in the organization's performance and the number of shares issued.

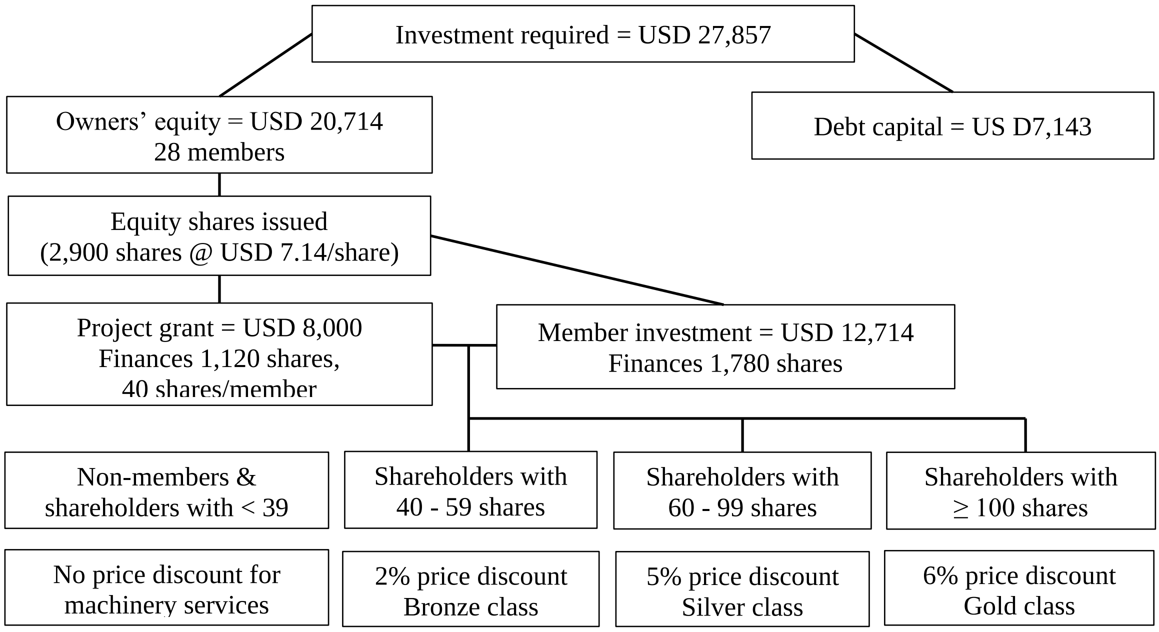

Fig. 1 Share scheme with price discounts for machinery services

Members were issued a single share certificate that included a table recording the initial number of shares purchased and subsequent transactions approved by the directors. If a transaction shifts a member into a higher or lower discount category, the directors simply issue the member a replacement discount card of the appropriate color. The shares do not confer voting rights as PO1's constitution[1] assigns one vote to each registered member. Membership is not restricted to patrons, nor is it restricted to natural persons. The directors can, therefore, solicit investment from strategic business partners, individuals, or firms, who see value in building long-term trading relationships with PO1. Non-patron shareholders are not issued discount cards but can benefit from capital gains, dividends, and mutual interests in value chain performance. To safeguard against a potential loss of patron control, the constitution included a bylaw allowing patron shareholders to nominate the candidates contesting at least six of the ten seats on PO1's board of directors. At the same time, this bylaw allows the directors to offer strategic business partners some seats on the board if they make substantial investments in the organization.

Members met their financial commitments within the expected timeframe and purchased 1,780 shares raising USD12,714 in equity capital. This covered the first three of five installments on the tractor and implements, which the producer organization purchased at the end of 2020. The project's grant was intended to finance another 40 shares for each of PO1's 28 members, raising a further USD 8,000 to help meet the final two installments, which were due in 2022. Unfortunately, the grant was delayed as PO1 was not viewed as an 'approved supplier' by the in-country NGO. The delay resulted in a year-long postponement owing to work disruptions caused by COVID-19 pandemic travel restrictions in 2020 and the civil unrest following a military coup in February 2021. Despite these setbacks, PO1's business grew much faster than expected. By the time the grant was disbursed in February 2022, the directors had already purchased a second tractor financed entirely from retained earnings and additional equity capital invested by existing and new members, not all of whom were farmers. No loans were required or taken. Similar shareholding schemes were subsequently adopted by two of the project's hybrid pig producer organizations to finance the equipment needed to manufacture affordable and good quality animal feed using locally procured ingredients.

[1] See https://www.worldvision.org.nz/campaigns/resources-myanmar-livelihoods/ for a template used by the producer groups to draft their own constitutions.

Marketing Service Provider

Producer organization two (PO2) did not require additional capital to implement its value-adding strategy. Their strategy relied on members meeting the terms of a contract to supply a niche miller with a specific quantity of a non-traditional paddy variety, Sin Thu Ka, that satisfied its mandated good agricultural practices and the product quality requirements of the miller's brand. Both parties hoped to establish a long-term trading relationship built on a predictable supply of high-quality paddy for the miller and a significantly higher and less risky price for PO2's members. Reaching an agreement on a price that would meaningfully add to the value of members' crops was critical to the success of the strategy, and the action research team played a vital role in brokering a pricing mechanism accepted by both parties[2]. The pricing mechanism reduced farmers' downside risk by specifying an agreed floor price that would be paid if market prices fell sharply after planting but allowed farmers to benefit from rising prices by benchmarking the price of Sin Thu Ka paddy against the price of a well-traded local variety. The miller recognized that this pricing mechanism would discourage PO2's members from side-selling and therefore, reduce the risk of a shortage in paddy supply.

In addition, PO2's directors issued tradable delivery rights[2] to members who wished to participate in the paddy supply contract. A tradable delivery right is a class B share that is tied directly to patronage. Each right obliged its owner to deliver 795 kilograms of Sin Thu Ka paddy produced in compliance with the agricultural practices and standards specified in PO2's contract with the miller. The directors and the miller monitored these practices and standards, which related primarily to the use of safe inputs and the moisture content of paddy when harvested. New Generation Cooperatives (Hariss et al., 1996) usually sell tradable delivery rights to their members to raise equity capital in direct proportion to patronage, but PO2 issued its delivery rights free of charge to participating members as its business strategy did not require additional capital.

One hundred delivery rights were issued to 45 of 63 members who agreed to supply the miller with a total of 79,500 kilograms of Sin Thu Ka paddy. The number of rights taken up by individual participants ranged from one (795 kgs) to four (3,180 kgs). The contract concluded successfully at harvest time in December 2020 despite severe flooding that prevented some participants from harvesting their paddy. These farmers leased their delivery rights to other participants who produced paddy in excess of their rights, allowing PO2 to fulfill the terms of its supply contract and maintain its good relationship with the niche buyer. Participants benefitted from a more certain and higher paddy price than non-participants, making ownership of the rights an attractive proposition. When tradable delivery rights generate benefits, they acquire a market value that their owners can realize by leasing or selling their rights to other members of the organization. Participants therefore have an incentive to meet their delivery obligations because compliance encourages the buyer to offer better terms that increase the market value of their delivery rights. Like other class B shares, tradable delivery rights are non-redeemable. A change in the quantity of paddy contracted by the miller in future years will be accommodated by adjusting the amount of paddy defined by each right and not by redeeming them or freely issuing new rights.

DISCUSSION

Efforts to help smallholders access preferred markets by improving the safety and quality of their food products invariably require collective action and producer groups which function well as conduits to deliver training and procure seasonal inputs in bulk at discounted prices. Groups operating at this level have little need for investor-friendly institutional arrangements but do benefit from good governance practices. Institutional arrangements, particularly those defining benefit rights, become important when producer groups seek to provide value-adding services and establish durable supply relationships with premium buyers who require consistent quantity and quality to support their brands.

[2] See https://www.worldvision.org.nz/campaigns/resources-myanmar-livelihoods/ for the template used to negotiate terms of the paddy supply contract, and for an example of the tradable delivery rights that PO2 issued.

In practice, smallholder producer groups typically start their business operations transacting seasonal inputs, and they usually express a strong preference for democratic control of their organization. Implementing agencies sometimes confuse democratic control with collective decision-making. The groups discussed in this study were all too familiar with the hindrances of collective decision-making and understood the importance of embedding good corporate governance practices in their constitutions to promote transparency and accountability in their elected leadership. Groups also understood the importance of attracting investment from strategic business partners, and they purposefully avoided constitutional clauses that would prevent them from investing, but did so inadvertently by opting for democratic voting rights. When the action research team pointed out that strategic business partners were unlikely to make significant investments if they had no voice on the board of directors, the groups approved constitutional bylaws allowing external investors to fill some seats on the board while maintaining majority control in the hands of candidates nominated and democratically elected by producers.

This study focused on two producer groups that introduced value-adding enterprises. The first case (PO1) required significant capital to finance machinery and equipment, and the second (PO2) had to meet a niche buyer's strict quantity and quality requirements. In both cases, the directors issued non-redeemable, tradable, non-voting, class B shares to launch their new enterprises. Share tradability offers investors the prospect of realizing capital gains, provides a mechanism for members to enter and exit the organization, and avoids the threat of redemption risk. However, issuing tradable shares does not create proportionality between investment and patronage, a critical success factor for producer organizations that require members to invest, and for producer organizations that need members to comply with their delivery obligations. The directors were acutely aware of these weaknesses and devised innovative schemes to address them.

In PO1, where the business strategy made it impractical to enforce direct proportionality between patronage and investment, the directors offered larger investors progressively greater discounts on the cost of value-adding services, so encouraging larger patrons to buy more shares while allowing the organization to profit from trade with non-members who did not qualify for price discounts. In PO2, the class B shares were issued as tradable delivery rights, creating direct proportionality between patronage and shareholding. Although these rights were issued free of charge, a successful business strategy gives them market value, which in turn, encourages members to meet their delivery obligations because non-compliance undermines the strategy and reduces the value of their rights. The market for these rights also facilitates compliance because members who cannot meet their delivery obligations can sell or lease their delivery rights to other members who have surplus products, which is precisely what occurred when some members of PO2 suffered crop damage due to excessive flooding.

Smallholder producer groups that require value-adding assets to realize their business strategies are inevitably constrained by inadequate capital and require some grant funding to make their business plans profitable, cash flow feasible, and hence more attractive to investors and lenders. Donors can, and should, provide grants in ways that promote inclusivity in business models. The grant awarded to PO1 was injected as equity capital, adding an equal number of shares to each member's existing shareholding. Although modest in size, accounting for less than half of the equity capital needed to finance PO1's investment, the grant ensured that even the poorest members had a meaningful financial interest in their organization's future performance.

CONCLUSIONS

Smallholders seeking market opportunities understand the potential benefits of collective action but also understand that success is unlikely without accountable leadership and rules to mitigate free-rider problems that emerge when a group calls on its members to contribute capital and supply quality products. The cases analyzed in this study revealed a propensity for smallholder producer groups to design and implement institutional arrangements that encourage investment and patronage without compromising producer control. Development agencies that facilitate producer organizations should not impose structures that prevent them from issuing classes of non-redeemable, tradable, shares to patron and non-patron investors.

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