Critical Decision Making: Lessons Learned From the Saskatchewan Wheat Pool

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Key Events

- April 1996 – Pool shares began trading on the Toronto Stock Exchange
- January 2003 – $405 million debt restructuring plan that saved SWP from bankruptcy and altered board governance
- February 2005 – SWP’s board of directors approved a recapitalization plan that transformed the Pool from a co-operative to a business corporation
- August 2007 – SWP officially renamed as Viterra.
- May 2012 – Viterra shareholders vote to accept takeover bid by Glencore
SWP Net Earnings and Market Share, 1974-2005

Net Earnings

Provincial Market Share

Millions of constant 2005 $ CDN

Key Period – 1996-2000

- New CEO appointed in 1994; removed in 1999
- Project Horizon – $270 million investment in 22 new large inland grain terminals
- First foreign direct investments
- Major investments in grain processing, farm input supply, and hog processing and production
- Long-term debt rose from $93.6 million in 1996 to more than $518.7 million in 1999
- Grain handling market share in SK fell from 61% to 33% in the ten-year period 1993-2003
What Went Wrong?

- Two key factors dominated
  - Overconfidence of the senior management
  - Agency problems and a lack of effective oversight by the board of directors

- Both of these factors are particularly important when management has access to internal funds for investment and hence does not have to subject itself to monitoring of the equity market

- Share conversion in 1996 provided this access; with the conversion of retained member equity to permanent equity, banks were willing to lend considerably more money than they had previously
Overconfidence

- Large literature that shows that overconfident managers/CEOs routinely pay too much for acquisitions and make poor investment decisions
- Selection bias plays a role
- Important psychological reasons – managers routinely make common cognitive errors
- Managers suffer from competitor neglect
- Organizational culture is important
- Problem is made worse if sufficient oversight is not provided
Cognitive Errors

- Mistakes in the way that information is processed (Lovallo and Kahneman 2003). These include:

- Propensity for people to overstate their ability – to see themselves as above average

- Attribution errors – people underestimate the role of luck and attribute positive outcomes to things they have done, while attributing negative outcomes to outside events

- One of the consequences is hubris – the belief by managers that they can do anything, even in situations where others have not succeeded
Business Planning and Cognitive Errors

- Most business plans start with a proposal which, by its nature, stresses the positive.

- Starting with a proposal that is tilted towards the positive virtually ensures that the final plan is tilted that same way. The reasoning is anchoring – the cognitive tendency to put too much emphasis on the starting point.

- Furthermore, information acquired to test the assumptions and claims in the proposal will often be chosen to support the initial beliefs that underlay the proposal – the so-called confirmation bias.
Competitor Neglect and Organizational Culture

- Most business plans are developed without considering what competitors are planning.

- If competitors are considering the same sorts of proposals, the result can easily be over capacity, price wars, or product duplication.

- Manager competition can create revenue inflation and underestimation of costs and delays. Makes anchoring worse and can generate “winner’s curse.”

- Situation is made even worse if there is a culture of developing goals that stretch the organization, and if purveyors of pessimistic information are shunned.
Agency and Lack of Oversight

- Since an agent typically has more information than the principal who hired him/her, and since it is costly for the principal to obtain this information, the opportunity exists for the agent to behave in a manner that is not in the principal’s interests.

- This problem further complicated in SWP case:
  - Two principals were present – the farmer-members and the investors. One agent – the CEO/executive team.
  - Since farmers no longer owned SWP, they had little incentive to monitor its performance.
  - Investors had no legal means to influence the board.
Agency and Access to Funds

- Agency problems are likely to be greater in firms that have excess cash available for investment and acquisition purposes (Jensen 1986).

- Managers that have access to internal funds do not have to subject themselves to the monitoring that external capital markets provide or, in the case of co-ops, the demands by members for proper use of their funds. As a consequence, managers are better able and more likely to make investments that benefit them personally rather than add shareholder value.
Agency, Overconfidence and Source of Funds

- The combination of a lack of oversight and hubris/overconfidence is particularly important.
- If CEOs have excess cash available, they will tend to over-invest in new ventures or acquisitions. And if they are overconfident they will tend to overpay, thus making it even more likely that the investment will turn out poorly.
- As well, oversight will be lacking because of the use of internal funds.
Summary

- Co-ops that are at the greatest risk of overinvesting and having investments turn out poorly are likely to:
  - Be large and diversified
  - Be publicly traded
  - Have highly confident leaders
  - Have excess internal funds available for investment

- The SWP possessed all of these characteristics

- Next section presents results from published material, as well as from 21 personal interviews conducted from Sept 2004 to April 2005
What Interviewees Had to Say – A Belief of Urgency

- The Pool believed it needed to “move rapidly to beat [the] U.S.” and it needed to “become more of a global player and expand beyond Saskatchewan borders”

- As one management person stated, “[there] was tremendous pressure to do things quickly and preemptively before someone else [did]”

- CEO Don Loewen quoted as saying “if we don’t become a strong, global force, we will just be eaten up by the American [multinationals]. Quite frankly, they’ll eat our lunch.”
What Interviewees Had to Say – Overconfidence

- A sense of confidence permeated the SWP; as Loewen stated, the Pool had “seen the changes coming better than a lot of companies”

- Interviewees recalled how Pool personnel believed the Pool could become “the ConAgra of the North” and become “one of four or five top grain companies in the world” with revenues of “$40 billion within 10 years”

- Industry observers indicated that industry changes would “leave few survivors. Saskatchewan Wheat Pool and Cargill will be the only ones – it’s a pretty safe bet.”
What Interviewees Had to Say – Overconfidence

- New CEO was “absolutely driven by the thought that [the Pool] had to move very quickly”. He had everybody “hooked on this idea of being the biggest and the best”.

- He “did a very commendable job running a division under the philosophy of a Milt Fair [the previous CEO]”. Previous investments had turned out well so the board “didn’t think he could do anything wrong”.

- Decision-making style described as “shoot from the hip” with good gut feelings determining a number of investment decisions.
What Interviewees Had to Say – Overconfidence

- One board member described the Pool as feeling “invincible and that was driven by Don Loewen’s personality and a number of people around him that just felt [the Pool] couldn’t be stopped”.

- Loewen’s strong leadership “was going to push through the vision...[and] stop internal dissent”
What Interviewees Had to Say – Hubris and Competitor Neglect

- One board member explained how “the argument that was being made was that if [the Pool] did it first, no matter what we paid for it, we would prevent our competition from doing it and then we would be successful”

- The Pool “firmly believed they were going to stop the competition literally by tying up all the construction capacity for these high throughput elevators in the short-run”
What Interviewees Had to Say – Oversight

- “You could see the gradual change where the board became almost dependent as opposed to being the final decision-making body. They basically became dependent on management to tell them, ‘Here’s what you should do and here’s why you should do it.’ ... you do not want a board to get into micro-management, but in terms of being able to make some of these major decisions around that, they pretty much had no choice but to go with what management put before them and as best as they could make decisions on it.”
What Interviewees Had to Say – Oversight

- According to one board member “there were a lot of things shared with the President that never got adequately shared with the rest of the Board. Getting things done became more important than sharing information”

- In contrast, senior management sees the situation differently – “the amount of information we supplied was information overload at times” and “it was more that the board did not know the questions to ask”
What Interviewees Had to Say – Oversight

- “The Board of Directors did not have the makeup or the people on it that would normally have served that check and balance to senior management.” As one senior manager commented, the Board seemed to be missing the “cynical eye on the thing that you really need”

- The move to a publicly traded company was “a quantum shift” and “as the business got more sophisticated, and more complicated, and moved further away from the farm gate it got tougher” for board members to assess proposals.
What Interviewees Had to Say – Oversight

- The volume of proposals and expected promptness for decisions to be made “would have been difficult even for a competent Board to stay abreast and do a fair job of assessing what was coming in”

- “Ideas did not get...proper and adequate evaluation, if Loewen wanted to do it everyone would find a way to make it happen.”
Overconfidence and Hubris: Cognitive Errors at Work

- Senior management, and with them the rest of the organization, clearly saw themselves as above average. Success was believed to have stemmed from their actions.

- Anchoring and the confirmation bias were both at work – investment analyses were constructed to be optimistic as goals were encouraged to be stretched, which in turn bred further optimism.

- Competitor neglect at work

- When the overconfidence and hubris were combined with excess internal capital, the result was a major spending spree.
Oversight Problems and Overconfident Leaders

- Agency was exacerbated by three factors:
  - Ownership and control were separated via the A-B share structure
  - Sheer volume of the investment and acquisition activity undertaken made it virtually impossible for a board to stay on top of what was happening;
  - As a result of the change in financial structure, the senior management had available an almost unlimited amount of internal funds.

- This excess supply of internal funds exacerbated the overconfidence and hubris that the CEO and senior management exhibited – new investments could be undertaken without having to be subjected to the scrutiny of the capital market or the members.
Concluding Thoughts

- SWP succumbed to the two classic problems associated with financial investment activity – agency problems and management overconfidence.

- The result was as expected – the Pool overinvested and made poor investments, the consequence of which was that its financial viability was severely challenged.

- What started as an attempt to keep the SWP competitive in a rapidly changing market ended with the SWP making bad business decisions, which in turn resulted in the loss of the Pool’s cooperative structure.