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Farmer Brothers Company Proxy Contest: A Corporate Governance Case Study*

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ABSTRACT

In 2019, Farmer Brothers, a coffee and tea producer and distributor, was facing its second challenge to its board of directors from dissident founding family shareholders, who no longer held a controlling interest in the firm. Farmer Brothers defeated its first proxy contest in 2016, with shareholders and a major shareholder advising firm, International Shareholder Services, endorsing management. Since then, the performance of the company had declined, and its CEO replaced in May 2019. A new set of dissenting shareholders included the granddaughter of founder Roy Farmer and a former board of director member. The dissident shareholders were accusing Farmer Brothers' management of failure to create firm value and of poor financial and operating performance from 2017 to 2019. Farmer Brothers shareholders needed to decide whether to support Farmer Brothers management's slate of directors or director candidates promoted by dissident shareholders. This case study combines financial analysis (ratio and financial statement analysis, stock price performance, and firm valuation) with a close look at corporate governance.

Keywords: *Agribusiness finance; corporate governance; financial analysis, firm valuation, case study*

* This case study was prepared using publicly available information only. The case was prepared solely to provide material for class discussion. The authors do not intend either to illustrate effective or ineffective handling of a managerial situation.

1 Introduction

The December 2019 shareholders' meeting for Farmer Brothers Company was coming up soon. Shareholders needed to choose between management's slate of directors or director candidates promoted by dissident shareholders. This seemed to be a repeat of a proxy contest[2] three years earlier in 2016. Management defeated the dissidents then. Now some of the same dissidents, members of Farmer Brothers founding family, were trying again. The bitter 2016 fight certainly seemed to shake up management. Had management made the necessary changes back then that would enable them to defeat this year's dissidents? Or, was Farmer Brothers facing the same issues that led to the 2016 proxy contest? Which way should a shareholder vote? Were the dissidents right this time, or was current management doing a good enough job to continue supporting them?

2 Farmer Brothers

Founded in 1912, Farmer Brothers Company was a coffee roaster, coffee wholesaler and distributor, along with tea and other food products in its portfolio. Founder Roy E. Farmer managed the firm until his death in 1951, when his son, Roy F. Farmer, took control. The firm was incorporated in 1952 in California. Farmer Brothers changed its incorporation to Delaware in 2004 and in 2017 moved its corporate headquarters, product development and manufacturing and distribution operations from California to Texas. The firm's customers included restaurants, department and convenience stores, hotels, casinos, healthcare facilities, grocery chains, and coffee houses.

Farmer Brothers produced both private brand and their own brands of coffee and tea. Products included organic coffees and teas, iced and hot teas, cappuccino, spices, and other food products. The firm also provided services such as beverage planning and equipment and service. While coffee and tea of all types were Farmer Brothers' main products, the firm also produced puddings, soup bases, dressings, sauce mixes, baking mixes, jellies, coffee filters, sugars and creamers, spices, and cocoa. Table 1 contains information about sales in each of the firm's food categories.

3 Focus on Cost Reduction

In Farmer Brothers' June 2019 fiscal annual report (2019 10K), management highlighted their focus on cost reduction (Securities and Exchange Commission 2019b). Moving from California to Texas in 2017 was a major decision, involving the construction of new facilities, which the firm called state of the art. Management contended that California was a more expensive state, both in terms of real estate, labor costs and supply costs. The move itself, however, was costly, requiring the firm to build expensive new facilities. The facility was expanded in 2019 to increase production, with more emphasis on premium and specialty coffee. In addition, because Farmer Brothers serviced commercial brewing equipment as well, in 2019 the firm opened a dedicated equipment manufacturing center in Oklahoma City, which restored used equipment to "like new" condition. Cost reduction goals included more efficient acquisition integration and greater efficiency at its new facilities. Supply chain efficiency goals included outsourcing trucking, using vendor-managed inventory arrangements, and using third-party warehouse management.

[2] Shareholders vote for directors at a firm's annual meeting. Many shareholders submit their "proxy" rather than attend in person, which states which directors they support. Many times, there is a single slate of directors, with no controversy about their election. If some shareholders are dissatisfied with the way a firm is run, they may mount a proxy contest, naming different potential board members to challenge the current directors. Dissidents may solicit proxies (votes) through email, direct mail, ads in business journals, etc. This conflict is called a proxy contest, with both management and dissidents hoping to attract enough votes to elect their chosen director candidates.

Table 1.
Farmer Brothers sales by product categories in $ million by fiscal year

	FY 2016	FY 2017	FY 2018	FY 2019
Coffee (roast and ground)	332.53	339.36	379.95	378.58
Coffee (frozen liquid)	35.93	32.83	34.79	34.54
Tea (iced and hot)	25.10	29.26	32.48	33.11
Culinary	54.04	55.59	64.43	64.10
Spice	35.79	24.90	25.15	24.10
Other beverages	57.69	56.65	66.70	58.37
Sales by category	541.08	538.58	603.50	592.80
Fuel surcharge	3.31	2.92	3.04	3.14
Net sales	544.38	541.50	606.54	595.94

Assembled by authors using information reported by Farmer Brothers each fiscal year (FY) in the 10K reports. 10K reports obtained from the U.S. Securities and Exchange Commission's Electronic Data Gathering, Analysis, and Retrieval System (SEC's EDGAR 2021).

4 Financial Performance of Farmer Brothers and The Industry

Coffee production and distribution was highly competitive, with competition based on price, quality, service, convenience, technology, and innovation in products and marketing. The US Census Bureau and IBIS*World* independently forecasted that industry revenue will grow between 0.8% and 1.2% annually between 2020 and 2025, consistent with low historical industry growth since 2005 (STATISTA: US Census Bureau 2020; Butler 2020). Industry revenue was mainly affected by the highly volatile world price of coffee beans and stable-to-low growing coffee per capita consumption in the US. Coffee consumers surveyed by the National Coffee Association reported consuming two cups of coffee per day on average in 2019, an amount that was stable during the last decade (STATISTA: National Coffee Association 2020).

Farmer Brothers' competitors included Folgers Coffee and Maxwell House Coffee. However, unlike Farmer Brothers, which was a focused coffee and tea company, Folgers and Maxwell House were part of highly diversified agribusinesses J.M. Smucker and Kraft Heinz. Farmer Brothers' coffee-focused competitors included the Coffee Holding Co., Key Coffee Inc., S&D Coffee and Tea, Massimo Zanetti Beverage, Trillian Food and Nutrition, Gavina & Sons, Royal Cup, and Ronnoco Coffee. With the exceptions of the Coffee Holding and Key Coffee, all coffee-focused companies mentioned above were privately held firms, for which no financial information was publicly available. Table 2 provides financial ratios of Farmer Brothers and its publicly traded coffee-focused competitors from 2016 to 2019. Farmer Brothers also competed in a minor degree with specialty coffee providers including Starbucks, Rogers Family Co., Distant Lands Coffee, Mother Parkers Tea & Coffee and Peet's Coffee and Tea.

Farmer Brothers experienced a decline in sales in fiscal 2019, both in direct store delivery (DSD) and direct ship sales. Management attributed the losses to changes in routes that had been consolidated for efficiency reasons, lower sales from two major customers, and loss of two brands where the customer chose an in-house brand, rather than Farmer Brothers'. On top of that, Farmer Brothers saw its cost of goods sold increase because of scrapped inventory and markdowns, higher coffee brewing equipment cost, and higher labor and manufacturing costs, some resulting from problems in integrating the firm's newest acquisition, Boyd Coffee. Farmer Brothers had purchased Boyd Coffee on October 2, 2017, paying $38.9 million in cash (71.61% of total value) and $11.8 million in Series A preferred stock.

Management noted the need to focus on cash management, customer retention, and making coffee production and distribution more efficient. Details of Farmer Brothers' revenue performance over time can be found in Table 3. Selected income statement, market, and balance sheet data for Farmer Brothers are provided in Table 4. Table 5 provides Farmer Brothers statement of cash flow data. Figure 1 provides Farmer Brothers stock prices and Figure 2 shows buy-and-hold returns for Farmer Brothers, stock market indices, and coffee competitors from January 2016 to December 9, 2019, one day before Farmer Brothers 2019 shareholders annual meeting. Table 6 shows descriptive statistics of financial analysts' recommendations regarding Farmer Brothers' equity.

Table 2.
Median values of selected financial ratios for Farmer Brothers and competitors from 2016 to 2019

	Farmer Brothers Inc.					Coffee Hold.	Key Coffee
	2016	2017	2018	2019	Median	Med. 2016/19	Med. 2016/19
ROA	19.5%	5.5%	-3.8%	-17.3%	0.8%	2.9%	1.0%
ROE	39.3%	9.8%	-8.0%	-46.5%	0.9%	4.4%	0.9%
ROI	2.1%	4.4%	2.3%	-0.8%	2.2%	3.4%	1.4%
EBIT margin	1.1%	3.2%	1.8%	-0.5%	1.5%	2.1%	1.2%
Net income margin	13.2%	4.2%	-3.0%	-12.4%	0.6%	0.9%	0.8%
Total asset turnover	1.5x	1.3x	1.3x	1.4x	1.4x	2.2x	1.3x
Fixed asset turnover	4.6x	3.1x	3.3x	3.1x	3.2x	37.1x	4.4x
Current ratio	2.7x	1.4x	1.0x	1.7x	1.6x	2.8x	2.5x
Total debt to equity	0.1%	12.0%	39.1%	59.4%	25.6%	27.4%	1.5%
Net debt to EBITDA	-1.7x	0.5x	2.0x	2.9x	1.3x	1.9x	NM
Times-interest-earned	-5.0x	2.5x	1.2x	-0.3x	0.4x	4.7x	73.6x
CFO to CAPEX	0.5x	0.5x	0.2x	1.0x	0.5x	1.9x	0.8x
CAPEX to D&A	2.4x	3.7x	1.1x	1.0x	1.8x	0.9x	0.7x
Altman Z score	4.23	4.26	3.17	2.70	3.70	4.67	4.58

Estimations by authors from financial data obtained from Standard & Poor's Net Advantage Capital IQ database (Standard and Poor's 2021). NA and NM mean "not available" and "not meaningful". Coffee Hold. refers to The Coffee Holding Company (ticker: NASDAQ JVA) and Key Coffee refers to Key Coffee Inc. (ticker, TSE 2594).

Table 3.
Revenue-related performance measures for Farmer Brothers

	FY 2017	FY 2018	FY 2019	2018 vs 2017	2019 vs 2018
Units sold					
Coffee (roasted)	76,399	85,943	86,478	12.5%	0.6%
Coffee (frozen liquid)	403	407	427	1.0%	4.9%
Tea (iced and hot)	2,482	2,706	2,755	9.0%	1.8%
Culinary	9,071	9,227	7,932	1.7%	-14.0%
Spice	1,101	933	792	-15.3%	-15.1%
Other beverages	3,986	5,932	4,631	48.8%	-21.9%
Total	93,442	105,148	103,015	12.5%	-2.0%
Unit Price					
Coffee (roasted)	$4.44	$4.42	$4.38	-0.5%	-0.9%
Coffee (frozen liquid)	$81.46	$85.49	$80.89	4.9%	-5.4%
Tea (iced and hot)	$11.79	$12.00	$12.02	1.8%	0.2%
Culinary	$6.13	$6.98	$8.08	13.9%	15.8%
Spice	$22.61	$26.96	$30.43	19.2%	12.9%
Other beverages	$14.21	$11.24	$12.60	-20.9%	12.1%
Average unit price	$5.80	$5.77	$5.79	-0.5%	0.3%

Source: Farmer Brothers' 2019 10K report (Securities and Exchange Commission 2019b). Columns 2018 vs 2017 and 2019 vs 2018 show the percentage change between the noted years.

5 Company Management

Until 2012, Farmer Brothers was largely managed by members of the Farmer family, with an outside chief executive officer, Michael Keown, hired that year. While the firm never officially made an announcement of why they sought an outside CEO, the stock price tells a story. In early 2010, the stock traded at about $19 and by September 2011, the price had slipped to about $5.50. Many descendants of the founders held significant wealth in their stock ownership. While some of the Farmer family worked many years in the family business, the firm was not growing as it had in the past and an outside CEO, with experience in the overall industry, was sought to improve the company's fortunes.

Table 4.

Farmer Brothers selected income statement, market, and balance sheet data in $ million (except per share and beta data)

Selected financial items	FY 2016	FY 2017	FY 2018	FY 2019
Revenue	544.38	541.50	606.54	595.94
Cost of goods sold	373.21	354.65	399.16	416.84
Selling, general and admin. expenses	165.23	169.52	196.17	182.29
Operating income (EBIT)	5.94	17.33	11.22	-3.19
Net interest (expenses) gains	1.19	-7.00	-9.70	-12.00
Net Income	71.79	22.55	-18.30	-73.60
Normalized basic EPS	0.27	0.33	0.09	-0.64
Stock price (median of daily stock prices)	30.83	32.80	28.90	17.05
Firm beta	0.86	1.02	0.81	0.51
Weighted avg. basic shares outstanding	16.50	16.67	16.82	17.00
Cash and short-term investments	46.69	6.61	2.44	6.98
Receivables	44.61	46.76	58.80	56.35
Inventory	46.38	79.79	104.43	87.91
Total current assets	153.37	140.70	173.51	159.91
Net property, plant, and equipment	118.42	176.07	186.59	189.46
Other long-term assets	97.21	90.38	115.43	75.24
Total assets	368.99	407.15	475.53	424.61
Accounts payable	23.92	39.78	56.60	72.77
Current portion of long-term debt	0.11	27.62	89.79	0.25
Other current liabilities	3.64	5.78	7.88	5.97
Total current liabilities	56.84	97.27	178.46	96.07
Long-term debt	0.00	0.00	0.00	93.60
Other non-current liabilities	40.71	9.26	6.85	6.59
Total liabilities	186.40	177.60	246.16	266.50
Total equity	182.59	229.55	229.37	158.11

Sources: (1) financial statement items selected by authors from the Standard & Poor's Net Advantage Capital IQ database (Standard and Poor's 2021), (2) stock prices are the median of daily prices from the Center for Research in Security Prices (CRSP), obtained in the Wharton Research Data Services (WRDS) data collection (WRDS 2021a), (3) firm's betas are from the Beta Suite module by WRDS (WRDS 2021b). Normalized earnings per share (EPS) is an adjusted EPS value after removing unusual expenses.

Keown previously had worked in sales and marketing management for Procter & Gamble, E&J Gallo Winery, and the Minute Maid Company. Keown developed plans to modernize Farmer Brothers' California and Houston plants, hedge coffee purchasing, reduce inventory, close unprofitable parts of the business, improve truck delivery services, and increase communications to investors. According to Seeking Alpha contributor Mitchell Sacks, Farmer Brothers held its first ever conference call with outside investors in 2014 (Sacks 2016). Keown led Farmer Brothers' major move from its California headquarters and production facilities to its current home in Texas.

The stock price was trading around $20 per share by May 2019, when Keown chose to take a director role and stepped down as CEO. Keown was replaced by interim CEO Christopher Mottern, then a member of Farmer Brothers' board of directors. Mottern was the former CEO of Peet's Coffee & Tea, president of the Heublein Wines Group, and CEO of Capri Sun. In November 2019, Deverl Maserang replaced Mottern, who remained a member of the board of directors. Maserang was named president, CEO, and member of the board of directors. Previously, Maserang was CEO of Earthbound Farm Organic and held senior positions at Starbucks, Chiquita Brands, and Pepsi Bottling Group. Appendix 1 contains Farmer Brothers' board members and directors up for election —with a brief description of their experiences— in December 2019.

Table 5.
Farmer Brothers selected statement of cash flow data in $ million

Financial statement item	FY 2016	FY 2017	FY 2018	FY 2019
Net Income	71.79	22.55	-18.30	-73.60
Depreciation & Amortization	20.77	22.97	32.86	33.67
Change in accounts receivable	-3.50	0.00	-4.60	2.76
Change in inventories	10.06	-8.00	-15.50	16.19
Change in accounts payable	-3.30	8.89	3.86	16.55
Cash from operating activities	27.63	42.11	8.86	35.45
Capital expenditure	-50.50	-84.90	-37.00	-34.80
Sale of property, plant, and equipment	10.95	4.08	1.99	2.40
Cash acquisitions	0.00	-25.90	-39.60	0.00
Cash from investing activities	-39.50	-106.70	-74.60	-32.40
Total debt issued	19.83	136.79	85.32	50.64
Total debt repaid	-3.50	-87.70	-24.10	-48.60
Repurchase of common stock	-0.20	0.00	0.00	0.00
Cash from financing activities	17.84	49.76	61.98	1.46
Net change in cash	5.94	-14.90	-3.80	4.55

Source: Cash flow statement items selected by authors from the Standard & Poor's Net Advantage Capital IQ database (Standard and Poor's 2021).

6 The 2016 Proxy Contest

The first proxy contest began with a letter to all Farmer Brothers shareholders in August 2016 from Save Farmer Brothers group, led by Carol Farmer Waite, granddaughter of founder Roy Farmer[3].At the time, Ms. Waite's siblings, board member Jeanne Farmer Grossman, Emily Farmer, and Richard Farmer did not participate in Save Farmer Brothers. The letter from Ms. Waite highlighted issues with Farmer Brothers' performance and management, including their belief that: (1) Farmer Brothers employees considered upper management to be toxic, (2) management lied and misrepresented facts about Farmer Brothers, (3) management's record of operating performance, capital allocation, and value creation was poor, (4) Farmer Brothers' board needed to begin a strategic review process, and (5) directors Charles Marcy and Chris Mottern needed to be replaced.

[3] The Save Farmer Brothers group letter can be found at: https://www.prnewswire.com/news-releases/save-farmer-bros-commences-solicitation-of-proxies-for-farms-upcoming-annual-meeting-and-delivers-letter-to-stockholders-300358279.html

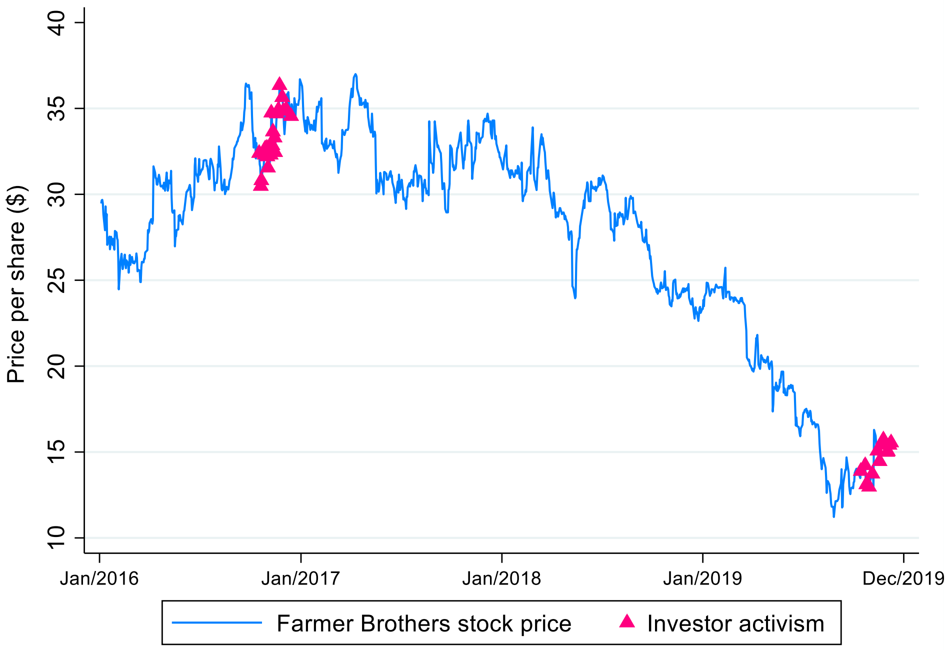

Figure 1. Farmer Brothers daily stock prices from January 2016 to December 9, 2019.
Source: Standard & Poor's Net Advantage Capital IQ database, annotated price chart module (Standard and Poor's 2021).
Triangles in pink indicate investors' activism related events.

On November 25, 2016, Farmer Brothers issued a press release noting that International Shareholders Services (ISS) supported management. ISS was a major shareholder services firm that advised companies and shareholders about proxies and proxy contests. ISS endorsed management's candidates for the board of directors, calling the directors "highly qualified" (Farmer Brothers 2016b). ISS stated that the dissident shareholders failed to make their case noting that Farmer Brothers stock had appreciated from $11.83 in 2012 to $34.10 in 2016 (Figure 1). The ISS report further said that Directors Marcy and Mottern had improved Farmer Brothers' corporate governance and that the dissidents' proposed directors did not have sufficient industry experience and were not proposing a better plan of action for Farmer Brothers. Shareholders voted with management and Marcy and Mottern remained directors.

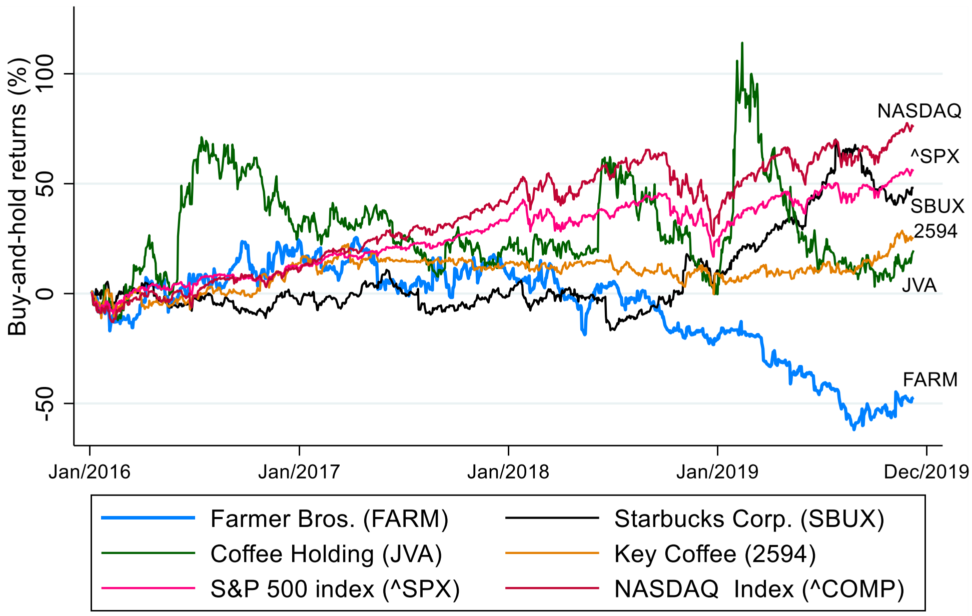

Figure 2. Buy-and-hold stock returns for Farmer Brothers market indices and coffee companies
Source: Standard & Poor's Net Advantage Capital IQ database, annotated price chart module (Standard and Poor's 2021). Market indices and coffee firms selected by authors.

Table 6.
Analysts stock trading recommendations for Farmer Brothers

	Mean	Median	% Buy	% Sell	% Hold
2016	1.81	2.00	100.0	0.0	0.0
2017	1.67	2.00	100.0	0.0	0.0
2018	1.88	2.00	100.0	0.0	0.0
2019	2.45	3.00	55.6	0.0	44.4

Source: IBES Consensus Recommendations, obtained from the WRDS database (WRDS 2021c).
Notes: Columns mean and median show the corresponding mean and median monthly recommendation values by financial analysts covering Farmer Brothers. Recommendations are provided in a 1 to 5 scale, where 1 is 'strong buy', 2 'buy', 3 'hold', 4 'underperform', and 5 'sell'. Columns % buy, % sell, and % hold show the percentage of monthly recommendation on those categories by financial analysts.

7 The 2019 Proxy Contest

"*Insanity: doing the same thing over and over again and expecting a different result.*"

From October 30 to December 9, 2019 (one day before Farmer Brothers' annual stockholders meeting), several documents were released and filed as proxies with the Securities and Exchange commission by "Concerned Stockholders of Farmers Brothers," a group of dissident shareholders[4].The quote above was the first line from a letter sent to all Farmer Brothers shareholders by Concerned Stockholders of Farmer Brothers, dated November 26, 2019, outlining their dissatisfaction with Farmer Brothers' performance. The complete letter is provided in Appendix 2. Jeanne Farmer Grossman, who owned 4.9% of outstanding shares, wrote the letter.

The letter urged shareholders to elect Mortensen and Waite to Farmer Brothers' board of directors and remove current directors Mottern and Marcy. The letter's primary concerns included: (1) a 59% decrease in share value over the previous three years, compared to a 45% gain in the S&P 500 index, (2) claims that directors Charles Mottern and Chris Marcy were in part responsible for Farmer Brothers' past problems, and (3) the need for directors experienced in operations, customer relations, and employee management to assist Farmer Brothers' newly hired CEO. CEO Deverl Maserang was also standing for election to the board of directors (Appendix 1), but he was not targeted by the dissident shareholders.

Farmer Brothers Response

Farmer Brothers' management had strongly supported Mottern's tenure as interim CEO and as a director, stating that he had provided the foundation for future profitability and growth, which would be continued by Maserang (Dworski 2019). In a letter supporting Mottern, management called attention to the firm's focus on financial flexibility, debt reduction, more efficient accounts receivable, restructuring the DSD business and right-sizing the company. (Appendix 1 provides management's list of qualifications for the three directors up for election.) Management said the dissidents' director candidates lacked the qualifications to be directors. Management said it met with Jeanne Farmer Grossman to better understand her issues with the firm, but she declined to engage.

8 Financing and Macro-Economic Conditions

As of the end of the 2019 fiscal year, according to Farmer Brothers' 10K, the firm's primary financing was $150 million senior secured revolving credit, with a provision to increase the credit line by $75 million if needed. Farmer Brothers paid an average commitment fee of 0.3% and paid an interest rate on funds borrowed of prime plus an average of 0.4%. At the end of fiscal 2019, Farmer Brothers had borrowed about $94 million long-term debt, significantly increasing long-term leverage and interest expenses (Table 4). Average interest expense was 3.98% in 2018 and 4.1% in 2019. Management believed the credit facility and cash from operations would be sufficient to fund working capital needs and capital

[4] Selected documents are concentrated in the following website: https://www.globenewswire.com/en/search/organization/Concerned%2520Stockholders%2520of%2520Farmer%2520Bros%C2%A7. Accessed on July 26, 2021.
Proxies could be accessed from the Securities and Exchange Commission's EDGAR website (SEC's EDGAR 2021).

expenditures for fiscal 2020 (Table 5). The credit facility required Farmer Brothers to have a ratio of debt minus cash to EBITDA of 3.5 or less and a ratio of EBITDA to interest expense of 3.0 or greater.

By late 2019, Farmer Brothers' weighted average cost of capital, also known as WACC, which depended on firm specific risk and the macro-economic situation, was estimated to vary between 3.5% to 4.5%. Treasury bill rates were around 1.5% and analysts expected risk-free governmental rates to further decrease in the near future. The average of Farmer Brothers' betas during the previous four years was 0.8 and it was 0.5 in 2019 (Table 4). When estimating the WACC, practitioners commonly used a market premium, defined as the difference between the expected stock market rate of return and the risk-free rate, between 5% to 6%. Long term US GDP growth rate was estimated at 2% annually by the Organization for Economic Co-operation and Development.

9 Farmer Brothers Shareholders

Farmer Brothers stock was traded on the NASDAQ exchange under the ticker FARM. Institutional ownership was high, at 55% of shares, particularly for a relatively small firm (compared to its behemoth food company rivals). Insiders owned about 14% of shares, meaning that no single shareholder, or even group of shareholders had control of the firm. Of these insider shares, 6.4% were held by employees, largely through its Employee Stock Ownership Plan (ESOP) and 7.5% held by individual insiders. Farmer Brothers had 17,042,132 shares outstanding in 2019 and 16,951,659 in 2018. Farmer Brothers had also set allocated shares as executive compensation. The firm paid a dividend in the past, ending its dividend in 2011, when the stock was performing poorly. Farmer Brothers had not re-instituted a dividend for common stocks at the time of the case.

Farmer Brothers had an ESOP which distributed shares to employees; however, that plan was paused as of January 2018. Employees' 401K retirement plans could have up to 4% of the employee annual compensation in Farmer Brothers stock. As of June 2019, 1,393,530 shares were awarded to employees' retirement plans.

Preferred Stock

Farmer Brothers had 14,700 shares of Series A convertible preferred stock, which had been used to purchase Boyd Coffee. Series A stocks paid a dividend of 3.5% and had an initial value of $1,000 per share, a price that varied based on dividends declared. The stock had a conversion premium of 22.5% and the firm had the right to convert the preferred stock to common one year after issue. Holders also had the right to convert 20%, 30%, and 50% of their preferred holdings at the end of the first, second and third year, respectively, from the date of issue.

10 Who Deserves Support?

A decision needed to be made concerning how to vote during the December 2019 Farmer Brothers' shareholders meeting. There were a number of considerations that could be clarified through financial analysis. First, a financial statement and ratio analysis would show whether Farmer Brothers had indeed been underperforming its peers, as the dissidents charged. Next, how had Farmer Brothers performed relative to the market and its close competitors? Finally, was Farmer Brothers under or overvalued or correctly priced? If undervalued, what steps could be taken for the firm to reach its potential? This was the second time in three years that management had been challenged by Farmer family stockholders. What did the dissidents want? Was the end of 2019 the best time for the proxy fight? Table 7 provides Farmer Brothers' most recent financial results —at the time of the case— corresponding to July to September 2019, filed with the Securities Exchange Commission on November 8, 2019. Table 7 also shows the corresponding quarter results of 2018 and 2017.[5]

[5] Instructors using this case study may choose to provide students some or all questions below.

1. Perform a ratio and financial statement analysis of Farmer Brothers for the past four years. What are the firm's weak and strong points? Have intracompany ratios and financial statements improved or declined over this time period?
2. The case provides stock prices for Farmer Brothers and index values for NASDAQ and S&P 500. Has Farmer Brothers outperformed or underperformed the market? Why do you think this is the case?
3. (Optional) Is Farmer Brothers underpriced, overpriced, or correctly valued? Use free cash flows discounted by weighted average cost of capital to value Farmer Brothers. Perform a sensitivity analysis to determine how robust your analysis is.

Table 7.
Selected quarterly financial items for Farmer Brothers from July to September 2017, 2018, and 2019 in $ million (except per EPS data in $)

	Sept. 2017	Sept. 2018	Sept. 2019
Revenue	131.71	147.44	138.60
Operating income	5.94	4.07	-5.70
Net income	0.84	-3.00	4.65
Basic EPS	0.05	-0.18	0.26
Normalized basic EPS	0.15	-0.18	-0.29
Cash from operating activities	7.10	1.08	-3.90
Cash from investing activities	-8.30	-7.70	11.34
Cash from financing activities	2.21	12.29	-7.00
Net change in cash	1.06	5.69	0.44

Source: Assembled by authors using Farmer Brothers 10Q reports filed with the Securities and Exchange Commission.

Acknowledgements

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Teaching note

Access to a teaching note can be requested from the authors.

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4. Assess the complaints of the 2019 dissident shareholders. Do they make valid points? What do the shareholders hope to accomplish with this second proxy contest? If you were representing either management or the dissidents, how would you make your case to the public and to the opposing side?

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Appendix 1 – Farmer Brothers Board of Directors by the end of 2019

Members of the Board of Directors

Source: Securities and Exchange Commission (2019a)

Randy Clark, Chairman of the Board
Independent Directors
Hamideh Assadi
Allison M. Boersma
Stacy Loretz-Congdon
Charles F. Marcy
David W. Ritterbush
Executive officers
D. Deverl Maserang, CEO
Christopher P. Mottern
David G. Robson

Directors Up for Election in 2019, Verbatim Excerpts from Management Letter

Source: Management letter to shareholders (Farmer Brothers 2016a)

Charles Marcy brings over four decades of experience as a senior executive, or advisor, of companies in the food industry, including multiple public companies. He has relevant expertise in the food industry as well as public company board, corporate governance, and executive compensation experience. He also has significant experience in marketing and strategic planning in the consumer products space. As the Chair of Farmer Brothers' Nominating and Corporate Governance Committee, Mr. Marcy led the effort to appoint the company's three newest directors. He also led the recent comprehensive CEO search process, which resulted in appointing Mr. Maserang —a highly qualified and seasoned leader. Mr. Marcy most recently served as Chief Executive Officer of Turtle Mountain, LLC, a privately held natural foods company. Prior to this, Mr. Marcy served in executive roles including President and Chief Executive Officer and a Director of Healthy Food Holdings; President, Chief Executive Officer and a Director of Horizon Organic Holdings; President, Chief Executive Officer and Director of the Sealright Corporation and President of the Golden Grain Company, a subsidiary of Quaker Oats Company.

Deverl Maserang was appointed President and Chief Executive Officer of Farmer Brothers on September 13, 2019. He brings to Farmer Brothers more than 30 years of leadership in turnarounds and global supply-chain transformations, along with deep experience in the food and beverage industry. Mr. Maserang most recently served as President and CEO of Earthbound Farm Organic. Prior to that, Mr. Maserang was Managing Partner at TADD Holdings, served for three years as Executive Vice President Global Supply Chain at Starbucks, in various operating and supply chain roles during his ten years at Chiquita Brands and in logistics management roles at Pepsi Bottling Group.

Christopher Mottern is an independent business consultant and served as Interim Chief Executive Officer of Farmer Brothers from May 7, 2019, until October 31, 2019. During the transition to the Company's permanent successor, Mr. Mottern clearly defined his key priorities, maintained continuity, and conducted a professional transition. His leadership during this critical period laid the foundation for the Company's turnaround. Mr. Mottern brings to the Farmer Brothers Board over three decades of senior executive experience in the food and beverage industry, spanning manufacturing, supply chain, consumer branding, risk oversight, along with financial and accounting expertise. He previously served as President and Chief Executive Officer and a member of the Board of Directors of Peet's Coffee & Tea, Inc. Prior to this, he served as President of The Heublein Wines Group and as President and CEO of Capri Sun, Inc.

Appendix 2 – Letter to Farmer Brothers Shareholders

Source: Proxy filed by "Concerned Shareholders" (Concerned Stockholders of Farmer Bros 2019)

"Insanity: doing the same thing over and over again and expecting a different result."

I am writing you on behalf of a group of concerned Farmer Brothers stockholders. Together we own 4.9% of the company's stock. Like you, we are frustrated by the value destruction that is a direct consequence of poor decisions made by our Board and Management over the last three years. Customers are confused, employees are disheartened, and our company is at a critical inflection point. In its recent communications to you, the company tried to hide their failures and ask for more time to get their multi-year "turnaround" off the ground —time, we believe, they should not be afforded without better, more experienced stewards elected to the Board.

This is why we are asking for your support in electing Thomas Mortensen and Jonathan Waite to the Board. Tom and Jonathan are directly aligned with your interests in seeing Farmer Brothers' success, have crucial on the ground experience and can effectively oversee and support our new CEO as he executes a turn-around plan.

We are asking you to elect our two director nominees and remove two of the principal architects of the company's failures, Directors Charles Mottern and Chris Marcy.

It is particularly revealing how the company has attempted to gloss over decisions that were made by, and indeed implemented at the behest of Mr. Mottern and Mr. Marcy that have led to disastrous results for us shareholders. The recent "plan" put forward by the company mirrors many of the priorities we have been advocating for as a shareholder and that I personally pushed for as a director of the company. What's missing today is proper oversight of and support for management by a Board of Directors intimately familiar with Farmer Brothers' operations, customers, and employees. Without this, we fear that the future will be no different than the recent past: a continued effort to cover up the issues of the past and not focus on the decisions and details required to ensure success. The success of Farmer Brothers now depends on execution, quarter by quarter, which we are confident is possible if our nominees are elected to the Board, given their past contributions during their time at Farmer Brothers.

Shareholders should take note of conclusions recently made by Institutional Shareholders Services, a leading proxy advisory firm, in its report on the election contest:

- "…if the turnaround is not executed with a sense of urgency, shareholders' remaining trust in the longer-tenured directors (Marcy, Mottern, and chairman Randy Clark) could erode rapidly."
- "As correctly highlighted by the dissident, FARM has effectively been in a state of perpetual turnaround under the longer-tenured directors. It will therefore likely take more than one quarter of results to convince shareholders that recent positive developments are in fact durable."
- "Several financial, operational, and leadership concerns developed during the latter half of the former CEO's tenure —a period during which FARM surrendered the lion's share of TSR gains reaped during the former CEO's first few years in office. While the board indicates that it was kept in the dark about the full extent of negative developments (which only came to light in 3Q FY19), there were warning signs that predated the initial public disclosure of concerns in 3Q FY18, such as steadily increasing debt, organic revenue decline, and turnover in key DSD leadership positions. Collectively, these issues should have prompted a deeper dive into FARM's condition, which in turn may have allowed the board to address mounting concerns more proactively."
- "The board's initial decision to provide the former CEO with the benefit of the doubt in 3Q FY18 may be reasonable in light of the value creation he oversaw during the initial stages of his tenure. However, there is minimal evidence to suggest that the board had a substantive contingency plan in place even a year on from the initial public disclosure of concerns."
- "The notion that there was insufficient succession planning prior to the former CEO's departure in May 2019 is supported by the fact that an ad hoc search committee was not formed until June 2019, and the fact that it took five months to appoint a new CEO."
- "A cynical mind might also view the former CEO as a convenient scapegoat, particularly since he was allowed to step down and remained entitled to receive severance, despite what the board characterized during discussions with ISS as questionable candor."

We can tell you that Directors Mottern and Marcy were central actors in the company's failures, principally in supporting a failing CEO, implementing programs and directing management over decisions for which they had no experience and displayed purely self-interested motivations as the performance of the company crumbled… In the last three years Mottern and Marcy bear significant responsibility for the state of Farmer Brothers and the general deterioration experienced since 2016, because they:

- Pushed for unproven, failing strategies,
- Supported the former CEO on the basis of personal relationships,
- Undermined company culture by supporting indiscriminate employee purges,
- Disregarded oversight responsibilities,
- Silenced dissent, and
- Implemented a strategy built on preconceived premises rather than the realities they encountered.

Since 2016, better management and Board leadership at Farmer Brothers would have taken greater advantage of the Company's market opportunities, produced far better operating results and unlocked more shareholder value, but the Board had no plan… for succession, talent development, strategy, or execution… that was tangible, measurable, and analyzable. **BUT NOW THEY SAY THEY HAVE A PLAN … AGAIN.**

What's changed since 2016?

In 2016, the Company claimed that it was successfully implementing initiatives toward positive growth — with very high expectations. By 2019, most have proven to be major mistakes and failing operating performance: poor leadership, poor management, problems with supply chain and operations, terrible capital allocation discipline, and declining customer relationships and employee value.

As an example, in 2016 the Company stated that it expected a savings of $18M-20M annually from the new Texas headquarters and annual savings of $3M of 3PL savings to date, with neither of these expected saving ever realized (and the prior CFO even declared that the numbers made no sense)

As another example, during the last three years, the optimization of the supply chain continued with no defined direction or results and no quantified optimization attained:

- The execution was never elevated because there wasn't a specific plan for how priorities were to be executed.
- Instead of enhancing service capabilities and equipment programs, the company downplayed service and equipment programs and devalued service by failing to provide the service and customer relationships that customers and vendors had come to expect.
- In striving to differentiate product portfolio through innovation, it failed to ask customers what products needed more differentiation and which did not.
- Decisions seemed arbitrary without explanation, and actions such as arbitrarily raising prices and downgrading coffee blends led to greater attrition.

Mr. Mottern re-organized direct-store-delivery, evidently without awareness of previous failed re-organization attempts, especially the massive failure of 2009-2010:

- He made many of the same mistakes that were made earlier and required the 2011-12 turnaround.
- He did not talk with employees doing the work nor with individuals who suffered through the bad times before the 2011-12 turnaround.
- Even after his initial reorganization failed, there still appears to be no defined plan or execution points to carry out a loosely stated list of priorities.

The same is true with Mr. Marcy's attempt to redefine marketing strategies, differentiate the portfolio and make acquisitions for the sole reason to improve financials by buying revenue through acquisitions.

- His marketing and acquisition attempts were costly failures.
- His differentiation of the portfolio through innovation did not bring the desired results largely because he did not attempt to find out what customers wanted in the portfolio.

Why would shareholders give Mottern and Marcy another chance when, under their Board leadership, the result could be the same —failure!

Our nominees are committed to helping this Board, Management and company succeed – for the benefit of each shareholder.

Tom Mortensen and Jonathan Waite have helped turn Farmer Brothers around before. And they are prepared to help do it again. They listen to those who do the work, they have deep knowledge of the company's past successes and failures. They have a different perspective than the rest of the Board because they have also done the work and know first-hand about the operations of the company.

Tom and Jonathan know how to optimize the supply chain and how to continue further optimization when appropriate. They know how to improve equipment placement and service to satisfy customers. They know how to differentiate the portfolio to meet the needs of customers and to innovate the portfolio when customers desire that innovation. And most of all, they already value the strong culture that Farmer Brothers had and know when changes need to be made.

Importantly, they already have a deep appreciation for the talented and experienced employees that have made the Company great in the past and are ready to do so for the present. Simply, they are the most qualified and experienced to help Farmer Brothers succeed.

We urge you to elect Tom Mortensen and Jonathan Waite. Once elected, they will work with the Board and new CEO Deverl Maserang to begin the process of returning Farmer Brothers to the values and principles upon which it was built.

Sincerely,

Jeanne Farmer Grossman