

IOWA STATE UNIVERSITY

Extension and Outreach / Department of Economics

Co-op Finance and Equity Basics: Generating Value

Mid Iowa Cooperative Leadership Team

Conrad, Iowa

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Keri L. Jacobs, Assistant Prof & Extension Economist
Iowa Institute for Cooperatives Economics Endowed
Professor



HISTORY

The Problem

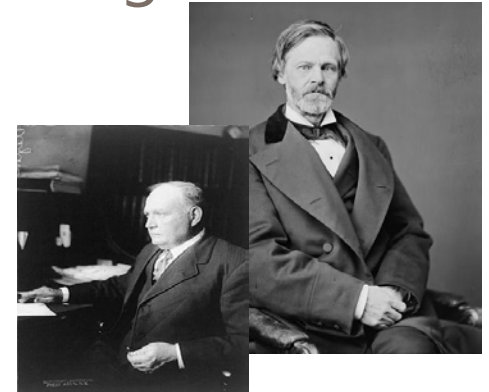
- Railroad movement (1840s – 1870s) led to rapid expansion and fueled the industrial revolution
- Farmers were largely left behind
 - little representation in Washington D.C.
 - no mechanism for organizing formally

Producers had no way to be on even footing with their trade partners, and no options.

The Solutions

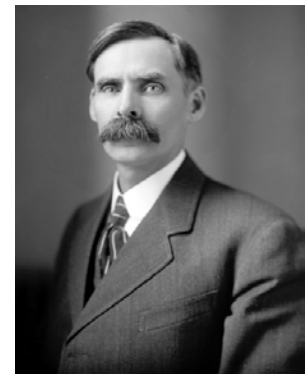
Beginning in 1850s, farmer associations began to form, but these came under attack.

- Sherman Antitrust Legislation, 1890
- Clayton Act, 1914



It wasn't until 1922 that producers could form organizations to act collectively, legally.

- Capper-Volstead Act



Capper-Volstead Requirements

- One member one vote OR limit dividends on non-farmer equity to 8%
- Member business must be greater than non-member business
- All voting members must be agricultural producers
- Association must operate for the benefits of its members

Allows producers to organize voluntarily to produce, handle, and market farm products to improve their terms of trade.

In Iowa

- IA has had a cooperative associations statute since 1915, the current version dates back to 1935.
- **Chapter 499** is primarily used
- Gives producer organizations the authority to engage in “any lawful purpose” and to exercise any power “suitable or necessary, or incident to, accomplishing any of its powers”
- Can have voting and non-voting members
- Voting rights limited to persons “engaged in producing a product marketed by the co-op; or who use the supplies, services or commodities handled by the coop”.

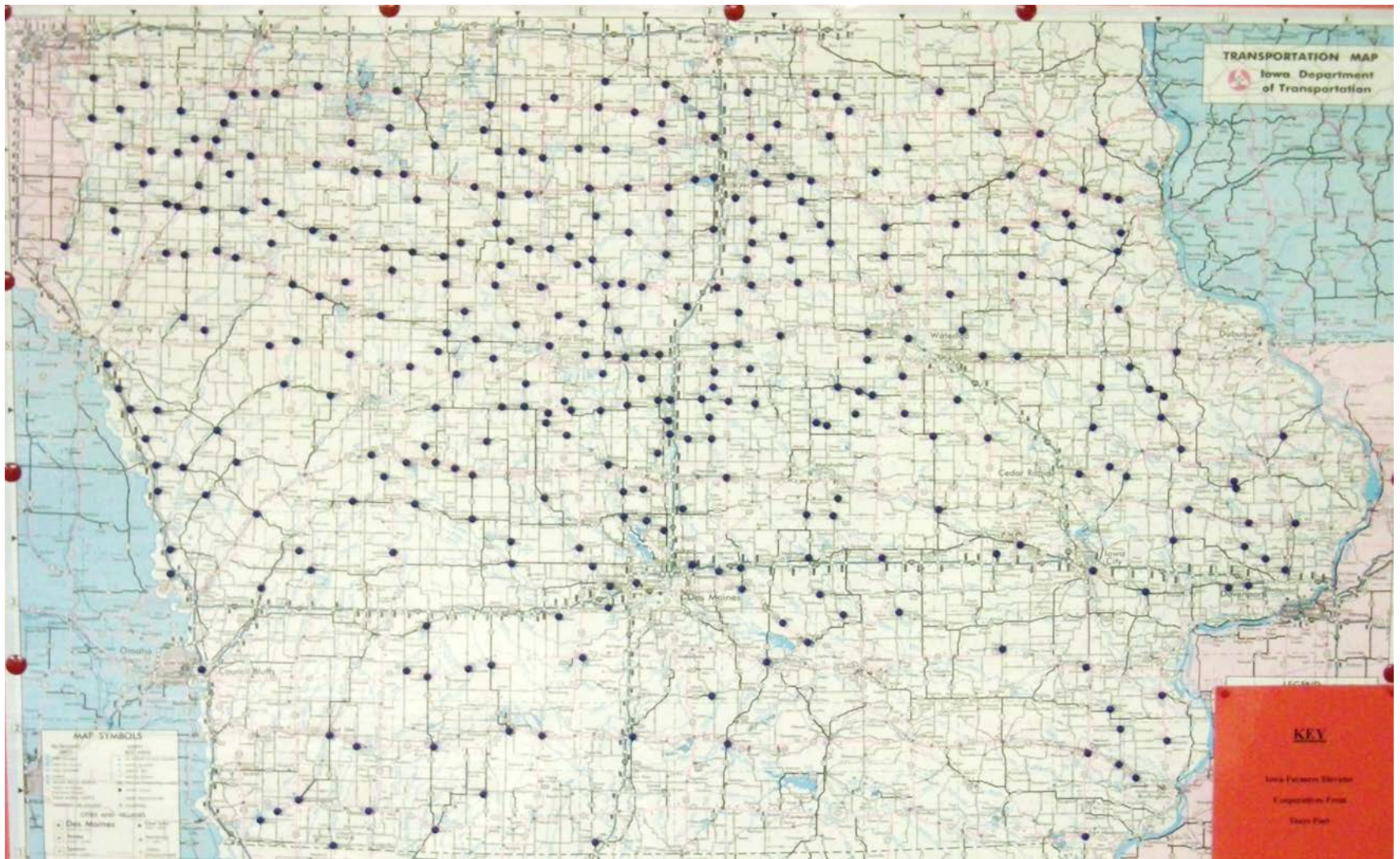
In Iowa – Other Statutes

Chapter 501 – “New Generation” cooperative

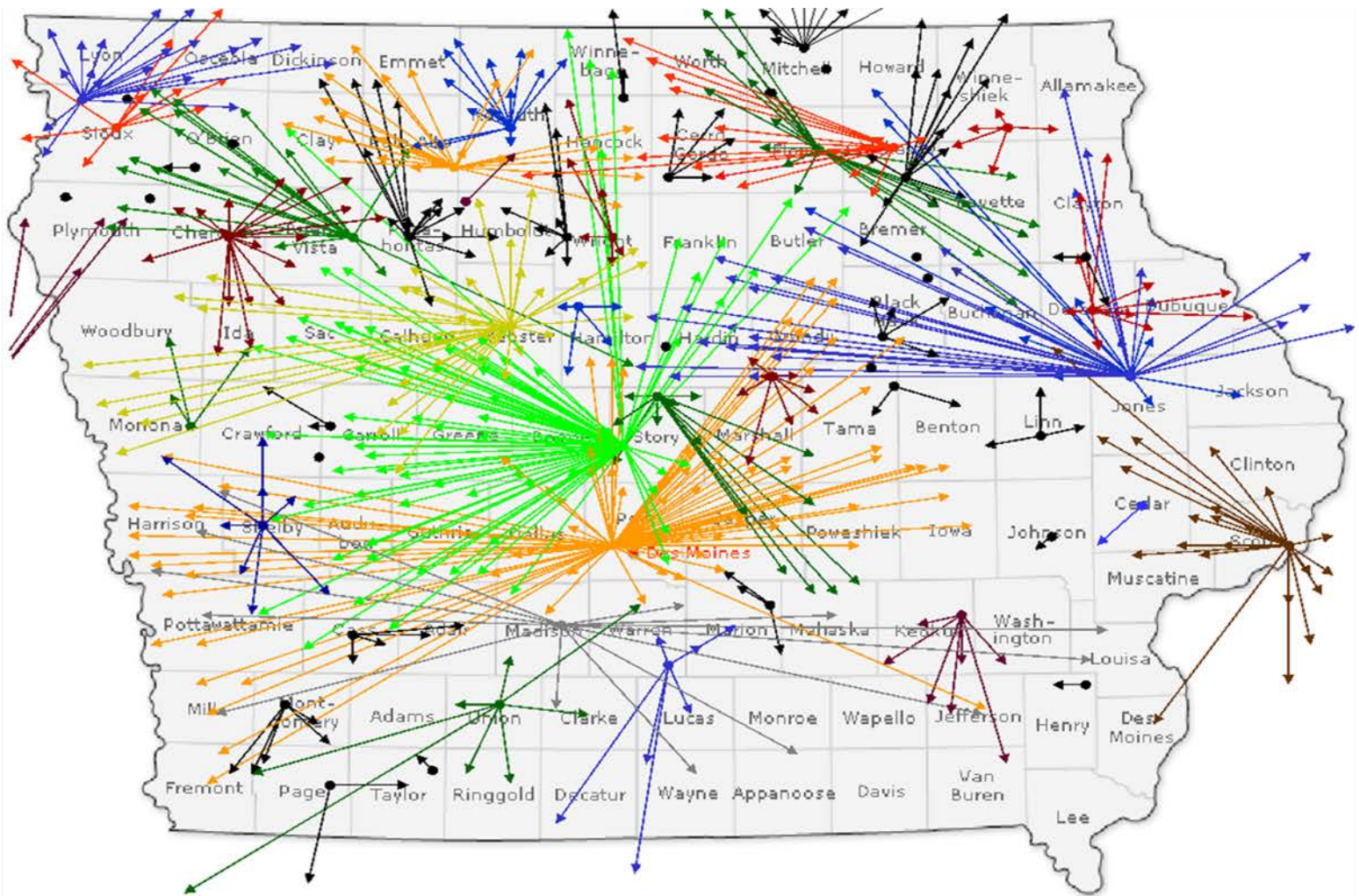
- “Closed membership” – members are only those that provide equity capital
- Often for value-added processing
- Members buy the right to delivery obligations – these are their equity shares (addresses undercapitalization problem)

Chapter 501a - combines LLC and co-op model

- Ability to raise capital from non-patron members and give them voting rights
- Addresses limiting capacity of traditional model



Iowa Grain and FS Co-ops 30+ Years Ago



Iowa Grain and FS Co-ops Today

Source: Iowa Institute for Cooperatives, Jan 2017

ECONOMIC JUSTIFICATION

A Fundamental Difference

“By construction, cooperatives put the economic interests of a particular class of patron in front of all other stakeholders and look to patron owners for risk capital and leadership...”

Economic Benefits to Members

Producers recognized the need for and benefits to acting collectively to:

- Get fair prices for their outputs
- Access products and inputs at market prices
- Reduce their joint costs of selling and buying through economies of coordination and size
- Pool risk
- Risk diversification
- Benefit from increased market power through profits

Cooperatives are the “competitive yardstick”

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Other Benefits To Producers

- Improve or standardize product quality
- Form a community of like-minded producers
- Favorable tax treatment
- Pooled skills

How To Talk About “Value”

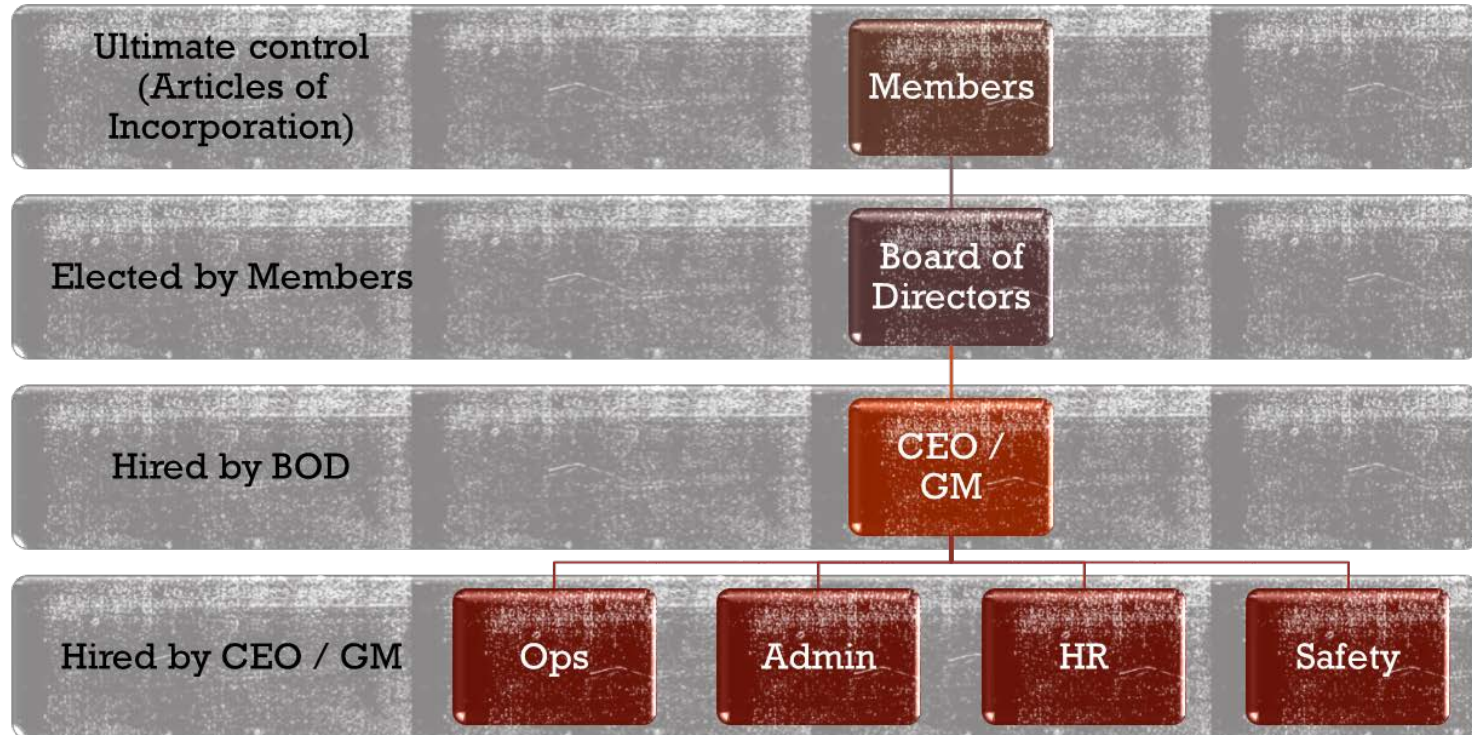
- **Price** – an important component, but not the only one, and perhaps the co-op does not intend to be a price-leader. That is OK.
- **Service** – are you ‘high touch, high service?’ This costs money.
- **Existence Value** – what are the producers’ options without their co-op? Would those competing companies behave in the same manner on price and service absent the co-op?

How To Talk About “Value”

- **Patronage** - do your members understand it, and where it comes from? Why CAN'T they have their patronage up front?
- **Governance** – perhaps the least-appreciated and most over-looked component of value. Are you prepared to respond to the objection, “My vote means less now since there are so many members”?
- **Community** – are you telling the story about the impact of the co-op in the community? Taxes, wages, education support, etc.

GOVERNANCE & CONTROL

Chain of Command



Members are ultimately responsible

Members elect the board

- This happens on an annual basis
- Each member gets equal vote
- The board is responsible for creating the **strategic** vision and plan and overseeing its implementation.

The Board hires the GM / CEO

- The GM is responsible for **operational** vision and planning.

“Locals” and “Regionals”

Centralized (aka, “local”)

- members are individual, families or private businesses
- they elect the board
- usually one central office, 1 board of directors, can have many locations
- members receive patronage – mix of cash and equity

Federated (aka, “regional”)

- “co-op of co-ops”
- members are other cooperatives
- board is managers or board members of member co-ops
- Member receive patronage – mix of cash and equity

The decision to use a cooperative, is the decision to invest in one. The two cannot be separated.

CAPITALIZATION, OWNERSHIP & PROFITS

What is the co-op's objective?

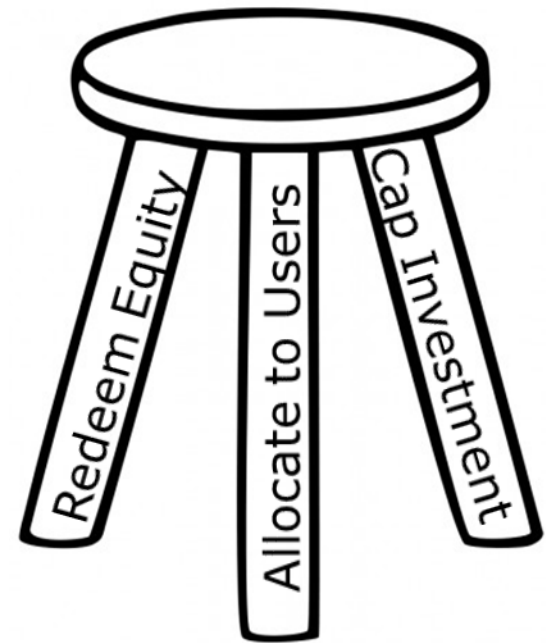
- Co-op profit maximization?
- Member profit maximization?
- Minimize selling price of inputs to farmers?
- Maximize purchase price of farmers' outputs?
- Maximize total system benefits?
- Maximize the total amount of business conducted?

Whatever the objective, it aligns directly with the co-op's pricing, patronage, and equity decisions.

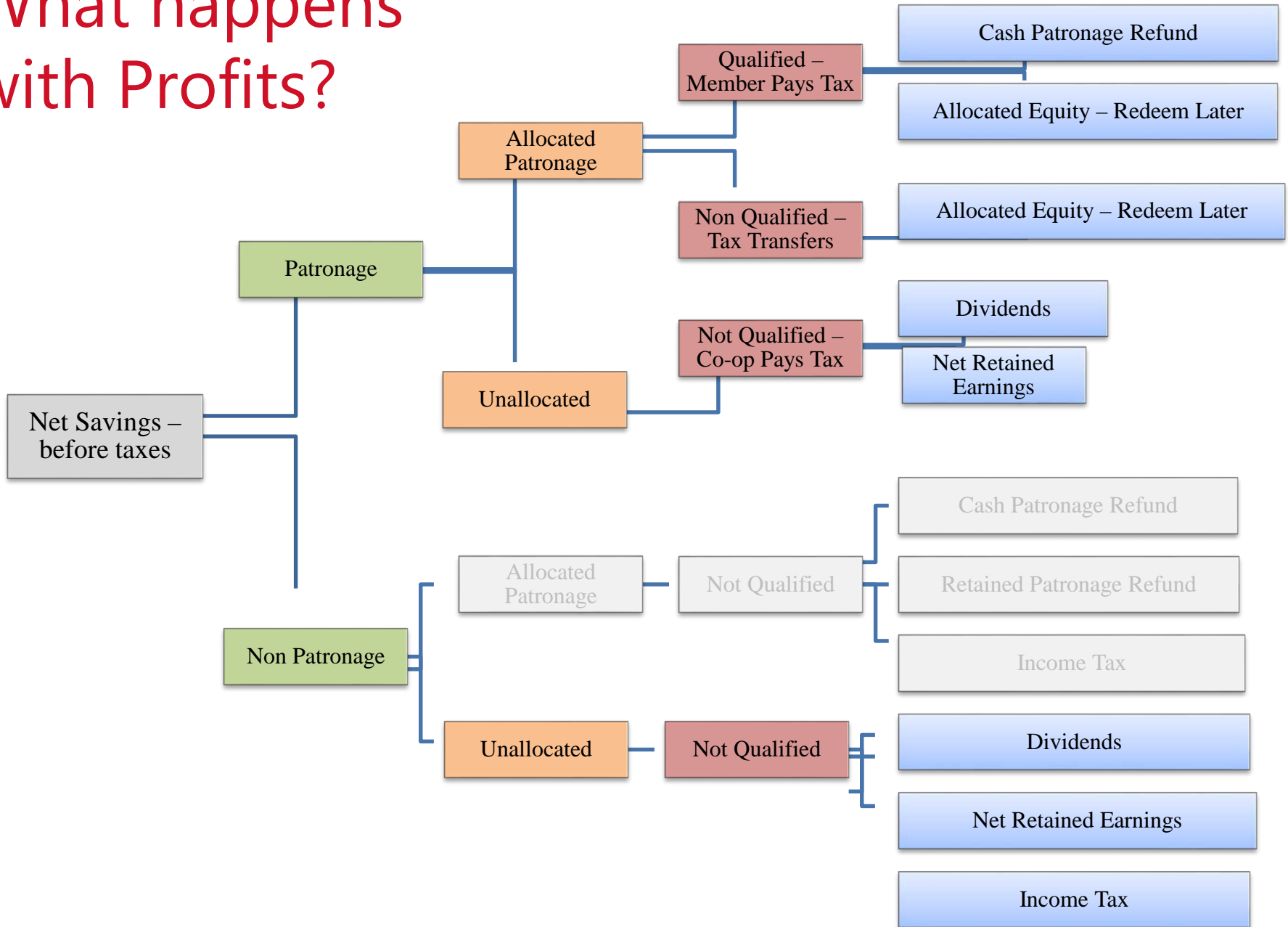
Cooperatives MUST be profitable

Profitability is necessary for...

- Financial sustainability of the cooperative
- Ability to reinvest in assets and productive resources
- Ability to revolve equity
- Funds for growth



What happens with Profits?



Profits Become Patronage to Members

Patronage is...

- ...a cooperatives adherence to the “service at cost” principle, and
- ...a distribution of co-op profits (aka “savings”) to those who did business with the cooperative.

How?

- Cash
- Allocated equity (retained by co-op temporarily)

Type of Equity

1. Stocks and Subscriptions

- The direct **initial investment** (cash purchase) made to join the cooperative (partial is subscription)
- The new member gets a **membership certificate** or **share of common stock**.
- This conveys voting rights and **Class A Membership**.
- A new member may **"earn" membership** by doing business with the cooperative, the patronage from which is applied to the stock subscription fee until it is satisfied.

Type of Equity

2. Allocated Equity

- The portion of a cooperative's equity that results from **member business** with the cooperative.
- Members are **allocated** a portion of the year's profits, some of which is **equity held in the cooperative** with the member's name on it until it is redeemed to the them – **NON-PERMANENT EQUITY**
 - This is the member's **allocated equity (allocated patronage)**.
 - The allocation of equity increases the member's **ownership**

Type of Equity

3. Unallocated Equity / Retained Savings

- The portion of a cooperative's equity that results from **member or non-member business**.
- A portion of the year's profits (net savings) are not allocated to members and instead **held as common equity**.
- This amount will not be redeemed to patron-members as patronage in the future - **PERMANENT EQUITY**.

Assignment of Savings (Income)

1. Allocate
 - a. Qualified Allocation
 - Cash
 - Retained allocated patronage / equity
 - b. Non-Qualified Allocation
 - Retained allocated patronage / equity

2. Retained Savings

Equity Redemption Options

1. Age of Patron – more cooperatives moving away from this; equity and estate ‘smoothing’ is difficult to achieve with this.
2. Age of Equity (Revolving Equity) – becoming most common; much flexibility, better able to smooth estate and equity ‘liabilities’ over time.
3. Base Capital - “efficient” approach, but more difficult to manage

Revolving Equity

Revolving equity is “FIFO” but can be accomplished in a number of ways:

- Redeem (retire) by year – e.g. from 2013 savings pay all of equity allocated in 2001.
- Determine the dollar amount to pay and redeem the oldest equity first up to that amount.
 - Let annual savings dictate amount?
 - Use historical average of equity holdings to determine amount

Equity Redemption Options

Pros

- Viewed as better than age of patron
- Allows flexibility in paying and structuring
- Keeps equity investment more proportional to a member's use

Cons

- May be difficult to achieve with swings in income and large allocation years
- Slippery slope if redemptions slow
- Challenge to explain and administer

Example: A Member...

...with 500 acres in corn, is the poster-child member, buying all her inputs and selling all grain through the co-op.

- Bushels marketed: 200 bu/acre
- Inputs purchased: \$308.35/acre

The co-op has released their annual report and announced patronage rates for the year:

- 3.70 cents per bushel of grain
- 3% of agronomy business

The co-op announces they will pay 60% as cash and the rest (40%) as retained allocated equity (this is the capitalization function).

Equity is Paid Back?

Equity is not marketable, not recallable, and requires a board decision to be redeemed.

When? (Depends...)

- If good profitability, the co-op can redeem old equity faster (10-12 years on average in Iowa)
- If not profitable enough: hopefully before the member dies (yikes, but it's true)

How?

- Age of patron
- Age of equity (revolving equity)

