

# IOWA STATE UNIVERSITY

Extension and Outreach / Department of Economics

## Pressing Issues of Ag Cooperatives and their Producer-Members

### **Management Options for Lenders and Agribusinesses**

ISUEO Pro-Ag Meeting

Fort Dodge and Mason City, Iowa

November 16 & 17, 2017

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Iowa Institute for Cooperatives Endowed Economics Professor

# Current Economics and Outlook

- Short term conditions
- Longer term positions
- Regionals' roles
- Sec 199
- Consolidation trends

*Producer Impacts*

## Local Savings

Local savings are key to member value, equity growth, and continued capital expenditure.

There are the profits generated from the co-op's own operations.

	<u>2015</u>	<u>2016</u>
Sales		
Grain	\$110,898,520	\$72,721,940
Farm Supplies	<u>\$36,995,170</u>	<u>\$40,077,100</u>
Total Sales	\$147,893,690	\$112,799,040
Cost of Goods Sold	<u>\$140,314,000</u>	<u>\$105,545,570</u>
Gross Margins	\$7,579,690	\$7,253,470
Other Income		
Service Income	\$5,527,810	\$5,142,900
Finance Charges	<u>\$702,040</u>	<u>\$566,220</u>
Total Other Income	\$6,229,850	\$5,709,120
Gross Income	\$13,809,540	\$12,962,590
Expenses		
Personnel Expense	\$4,497,100	\$4,589,870
Fixed Expenses		
Interest	\$1,628,210	\$1,758,740
Depreciation	\$1,813,240	\$1,740,870
Insurance	\$261,130	\$251,400
Property Taxes	\$504,100	\$565,500
Variable Expenses	<u>\$2,066,520</u>	<u>\$3,338,980</u>
Total Expenses	\$10,770,300	\$12,245,360
Local Savings (Loss)	<u>\$3,039,240</u>	<u>\$717,230</u>
Patronage Refunds Received	<u>\$239,900</u>	<u>\$477,700</u>
<b>Net Savings (Loss)</b>	<b>\$3,279,140</b>	<b>\$1,194,930</b>

## Regional Patronage

Local co-ops receive patronage allocations from regional co-op partners (e.g. CoBank, AGP, CHS, LOL, CIPCO, etc.)

This is recorded as income, though typically a portion is received as cash and a portion is issued equity (paper).

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	<u>2015</u>	<u>2016</u>
<b>ASSETS</b>		
Current Assets		
Cash on hand	\$1,542,630	\$4,971,560
Accts Receivable	\$5,792,150	\$4,178,530
Inventories	\$6,090,410	\$4,697,820
Others	<u>\$2,362,500</u>	<u>\$777,560</u>
<b>Total Current Assets</b>	<b>\$15,787,690</b>	<b>\$14,625,470</b>
Fixed (Long Term) Assets		
Land	\$1,751,110	\$1,751,110
Building & Equipment	\$35,245,720	\$35,608,220
Less: Accum Depreciation	<u>\$13,930,270</u>	<u>\$15,605,890</u>
<b>Total Fixed Assets</b>	<b>\$23,066,560</b>	<b>\$21,753,440</b>
Other Assets		
Investments in Co-ops	<u>\$8,774,160</u>	<u>\$9,078,390</u>
<b>Total Assets</b>	<b>\$47,628,410</b>	<b>\$45,457,300</b>

	<u>2015</u>	<u>2016</u>
<b>LIABILITIES</b>		
Current Liabilities		
Accts Payable	\$1,887,010	\$82,530
Operating Line	\$0	\$0
Current portion of long-term note	\$1,420,000	\$1,420,000
Accrued Expenses	<u>\$2,118,930</u>	<u>\$2,945,680</u>
<b>Total Current Liabilities</b>	<b>\$5,425,940</b>	<b>\$4,448,210</b>
Term (Long Term) Liabilities		
Mortgages / Term Notes	\$9,219,800	\$7,799,800
Member Notes	\$0	\$0
<b>Total Long Term Liabilities</b>	<b>\$9,219,800</b>	<b>\$7,799,800</b>
<b>EQUITY</b>		
Common Stock	\$156,500	\$156,500
Deferred Patronage Refunds	\$24,046,010	\$23,980,270
Retained Earnings	<u>\$8,780,160</u>	<u>\$9,072,520</u>
<b>Total Equity</b>	<b>\$32,982,670</b>	<b>\$33,209,290</b>
<b>Total Liabilities and Equity</b>	<b>\$47,628,410</b>	<b>\$45,457,300</b>

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## Regional Investments

- Investments in co-ops: this is the paper value of your co-op's equity in the regional (e.g., CHS, AGP, LOL, CoBank, CIPCO, etc.)
- No control over when it is redeemed
- Lenders discount this when calculating borrowing capacity
- Recall from income statement the "regional patronage?" This nets the newly allocated part and the annual redemption (if any).

- **Equity**
- Member-provided
- Results from profitability
- Retained savings – no individuals' names on it, permanent equity
- Member equity – capital in an individual's name, will eventually be paid back (redeemed)
  - Revolving equity
  - Age of patron
- How much should member equity be (%)?
- Redemption strategy options
- Section 199 increases retained earnings

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## LOCAL Equity

- The amount of equity that the co-op controls
- Calculation:
- Local Equity = Total Equity – Investments in Other Co-ops

2016

\$82,530  
\$0  
\$1,420,000  
\$2,945,680  
\$4,448,210

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## Section 199 (Domestic Production Activities Deduction)

- Deduction on qualifying activities up to 50% of wages but not to exceed AGI
- Co-op can keep (not pay taxes on income), or pass it through to members.
- Has resulted in significant equity accumulation to date.
- If this deduction goes away, real impacts on co-ops and members
  - Risk to equity redemption going forward
  - Risk to accumulation of equity

# Some State Impacts of Section 199

<u>State</u>	<u>Total DPAD Value</u>
Illinois	\$41,241,056
Iowa	\$67,121,336
Kansas	\$26,416,837
Minnesota	\$131,145,613
Nebraska	\$60,290,156
North Dakota	\$72,459,816
South Dakota	\$79,904,534
Wisconsin	\$65,274,664



NATIONAL COUNCIL OF FARMERS

**Source: Chuck Connor, NCFC, November 2, 2017.**

Local Return on Sales

Working Capital

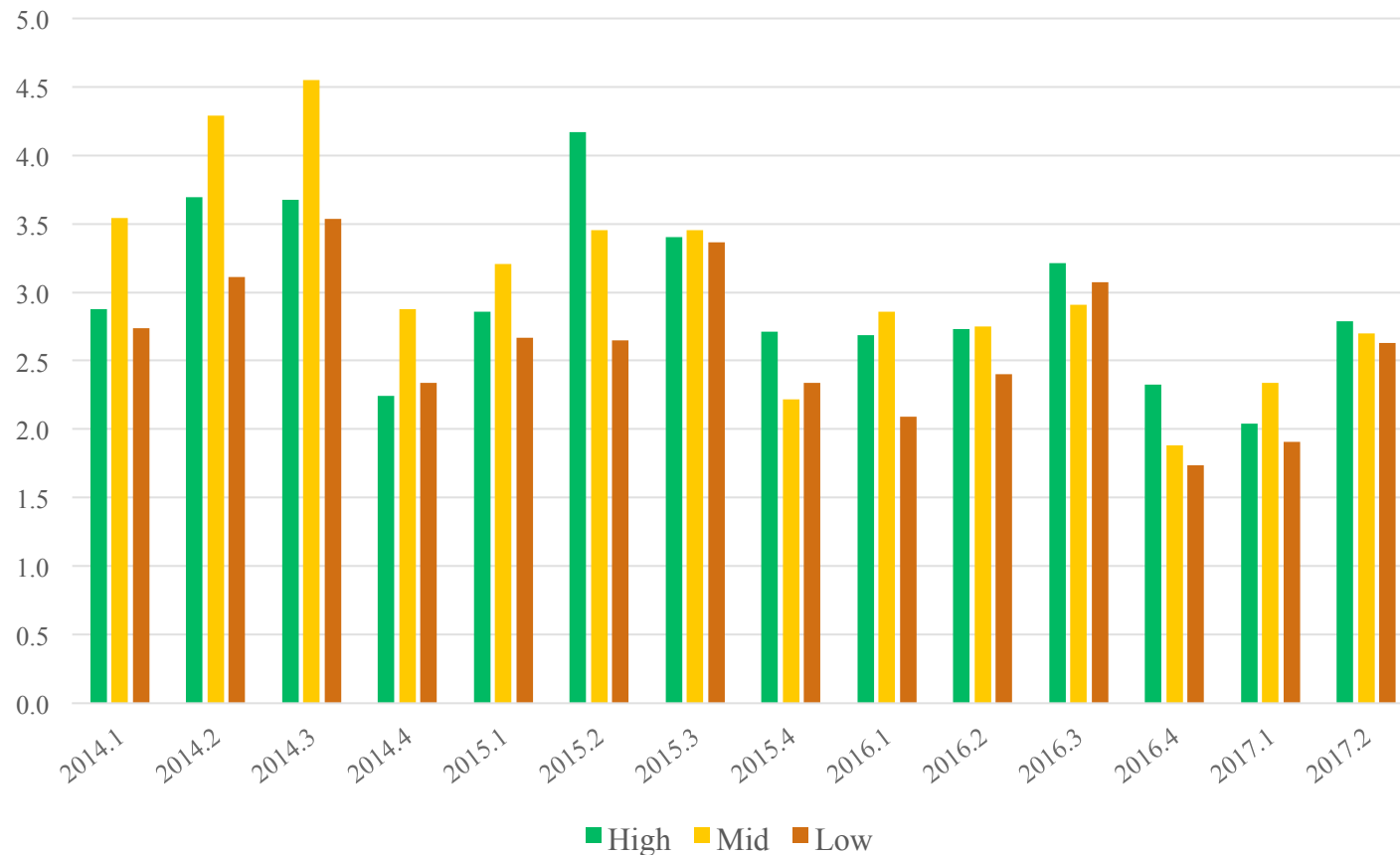
Account Receivables

Return on Equity

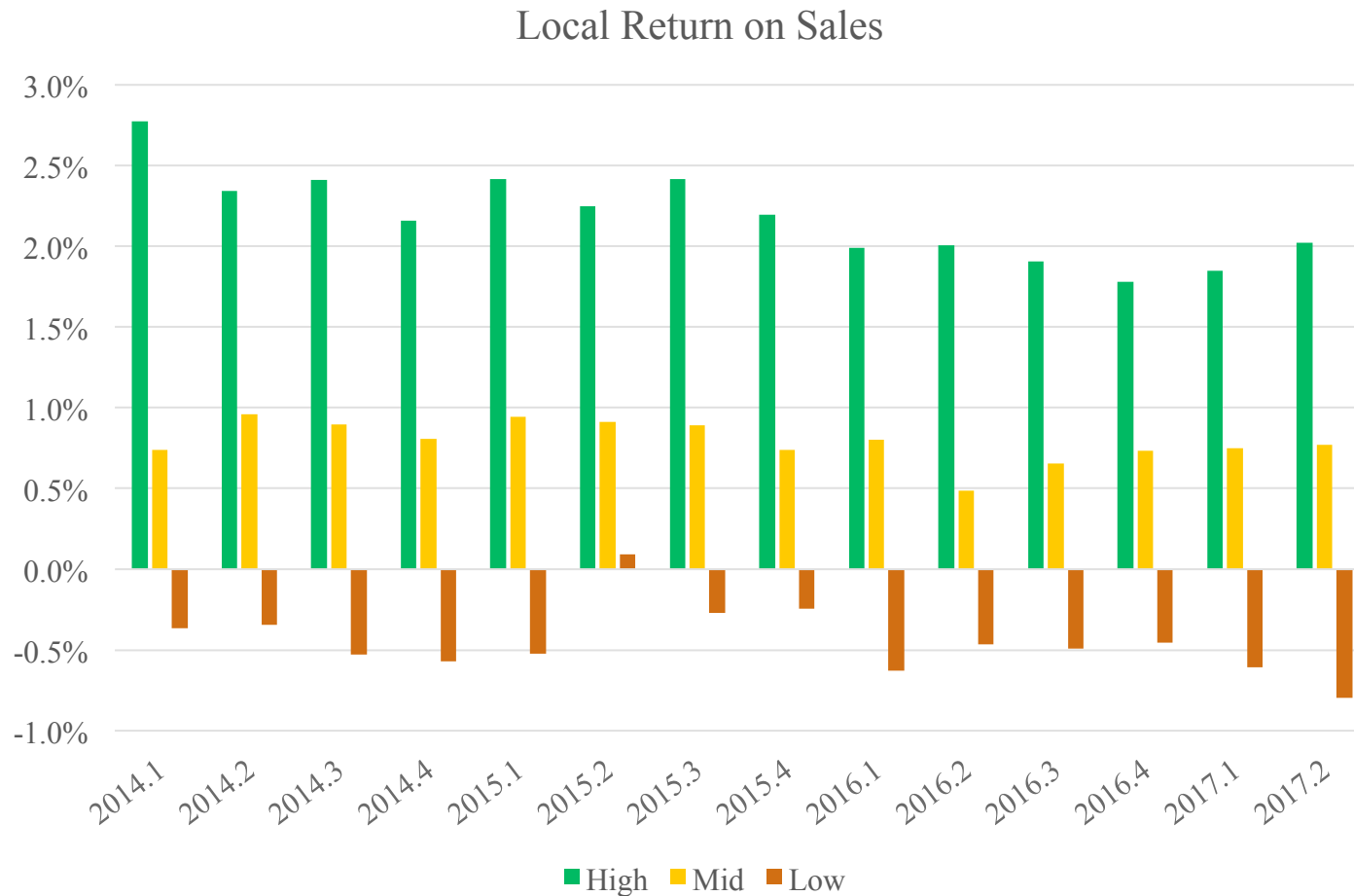
Profit Margins

## **SHORT TERM CONDITIONS**

# Sales to Local Assets – excess capacity in the system

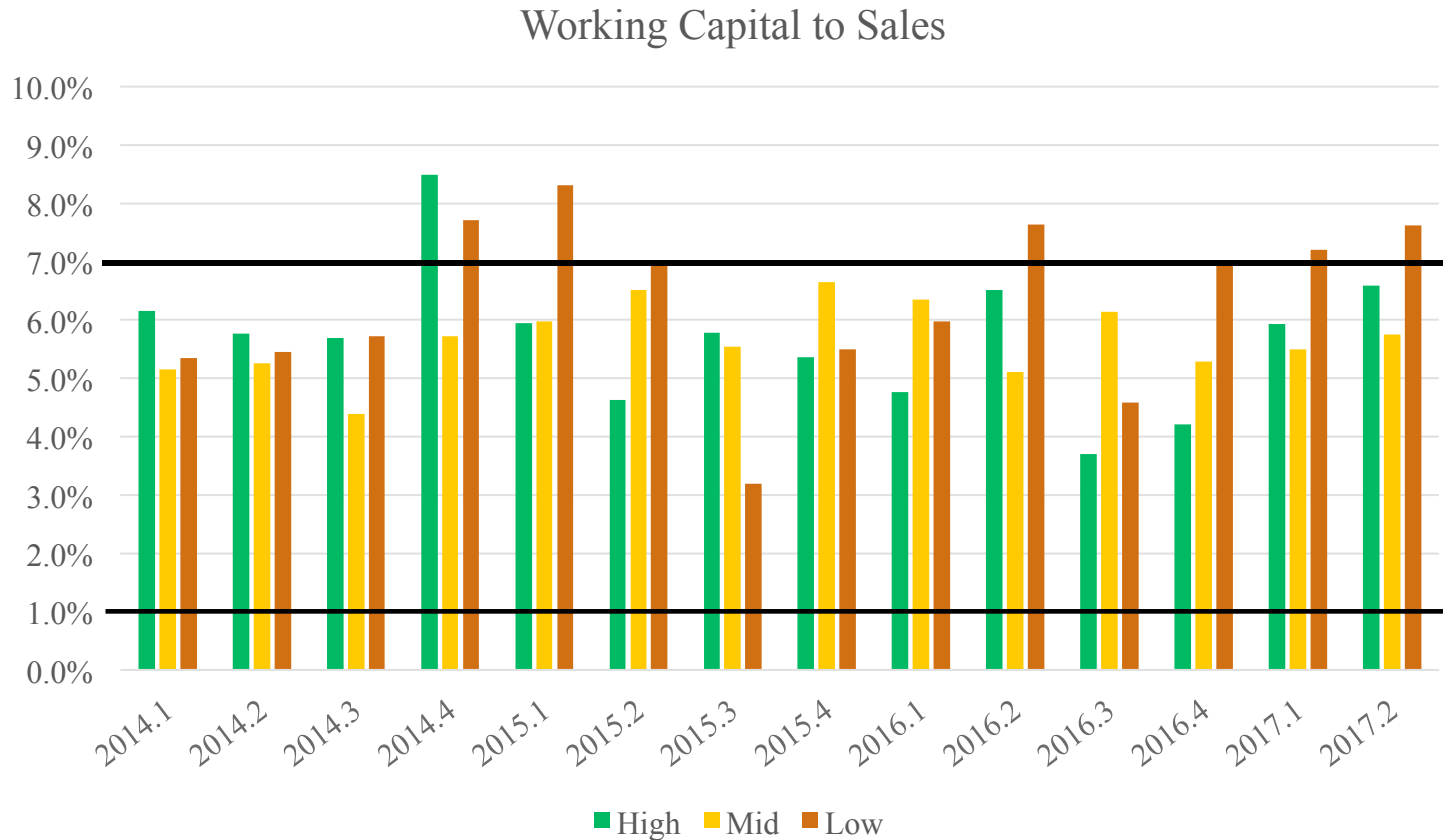


# Are Co-ops Generating Income from Their Ops Locally?

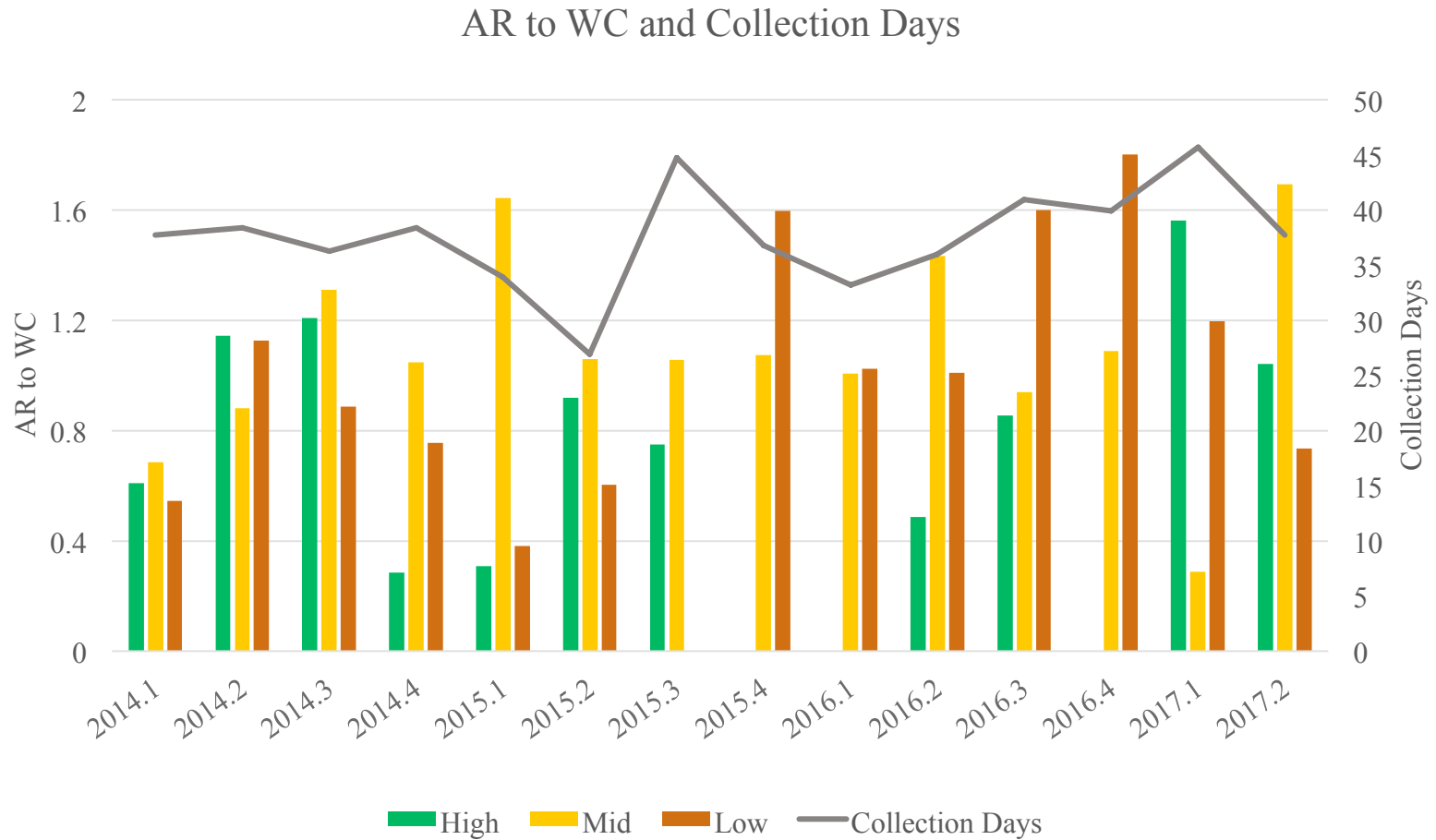


# “Excess” Working Capital?

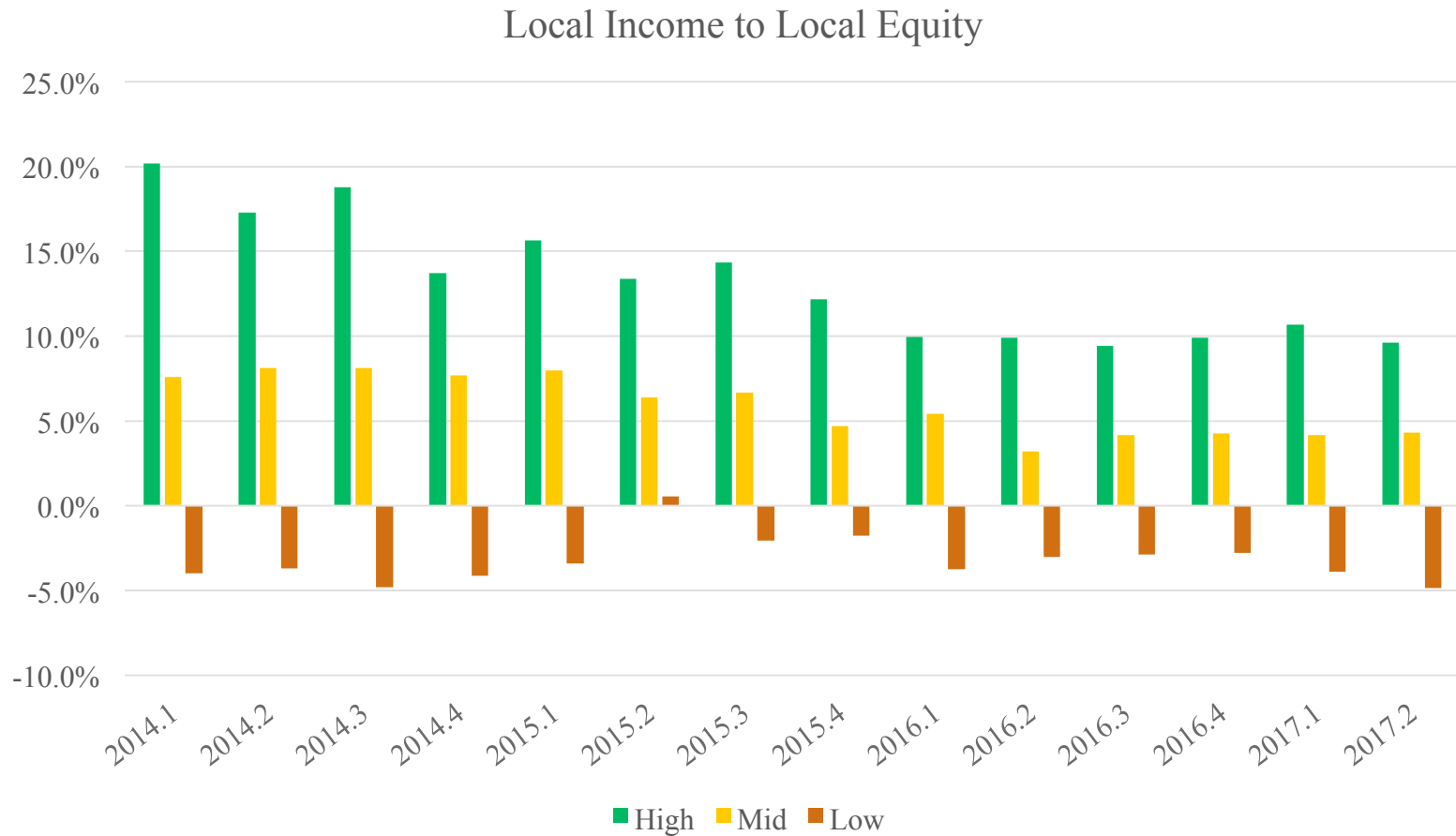
Putting debt on B.S. to  
bolster W.C.



# Accounts Receivable

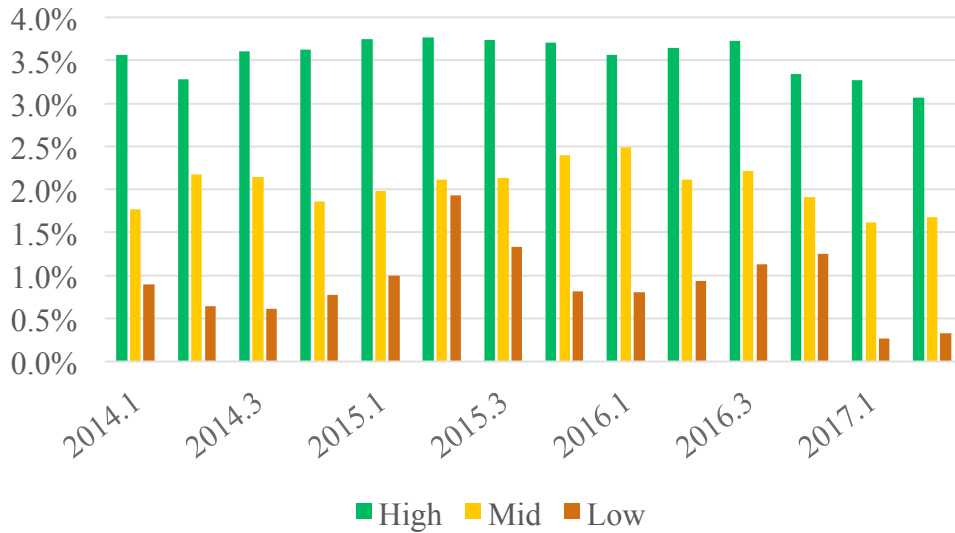


# Return on Equity (Local)





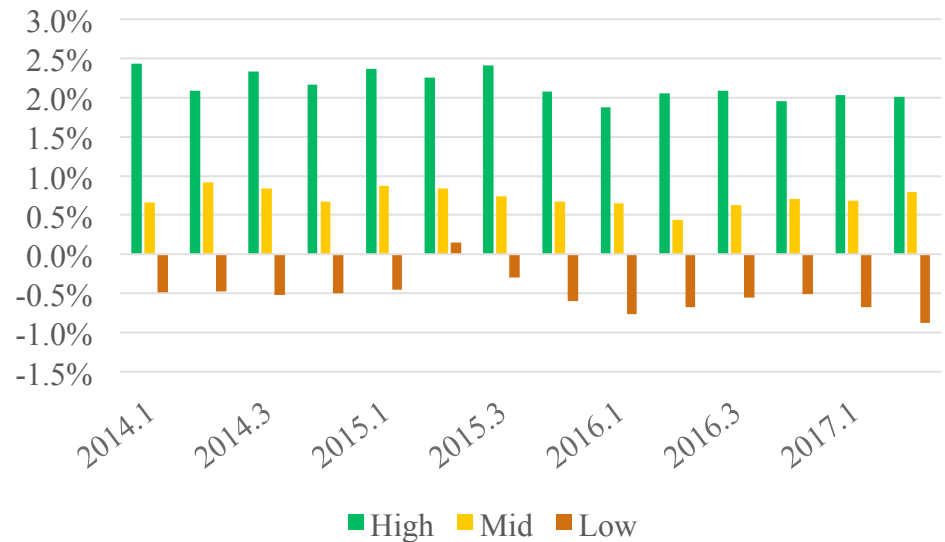
Net Profit Margin (w/ Patr)



Local co-ops get patronage from regional partners annually, and they report this as income, not included in “local savings.” It is taxable (in most cases) even if it is not received as cash (qualified).

Local performance can be masked by support from regionals, but it’s not all cash.

Net Profit Margin (w/o Patr)



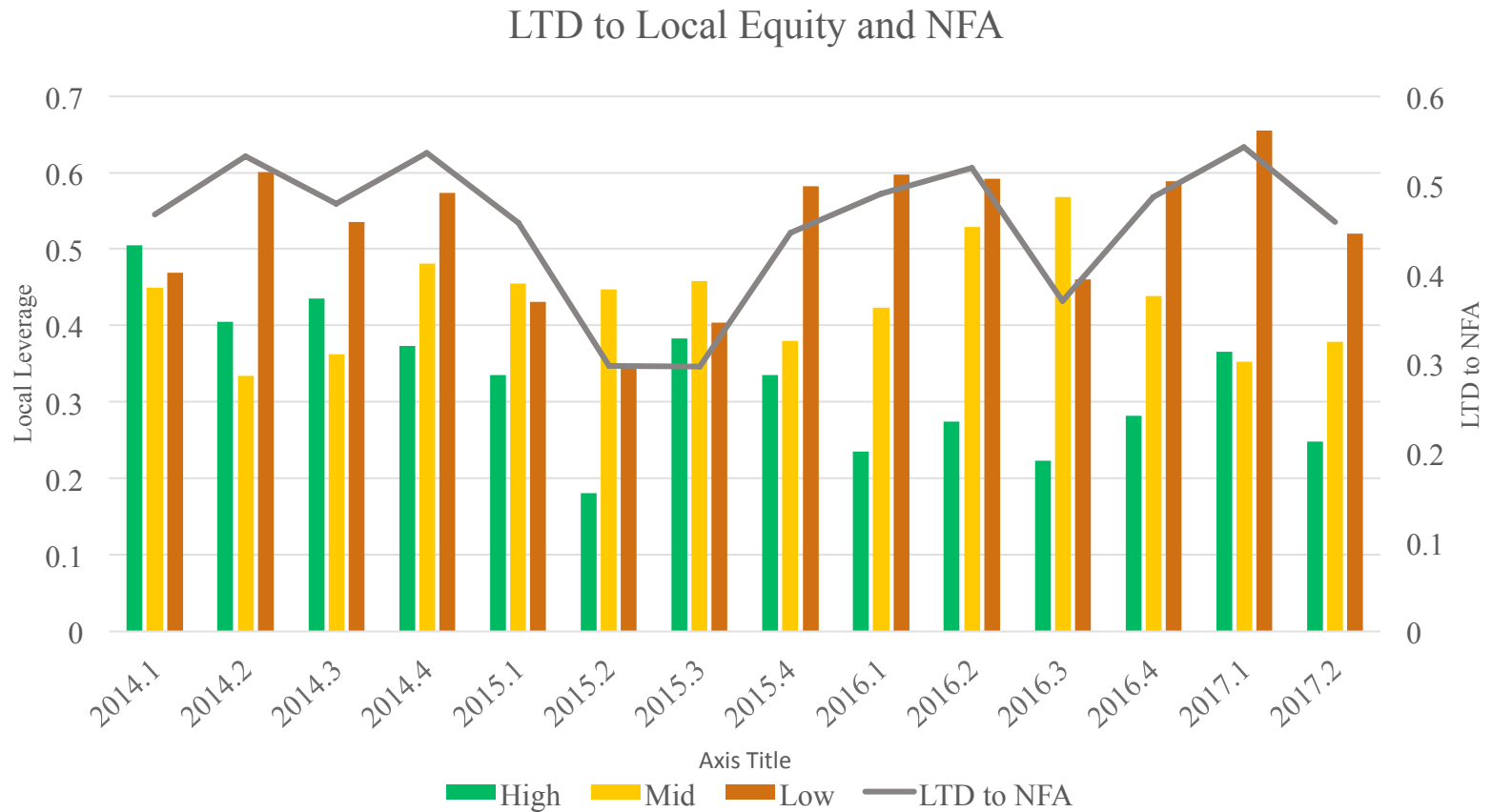
Leverage and Asset Financing

Equity Positions

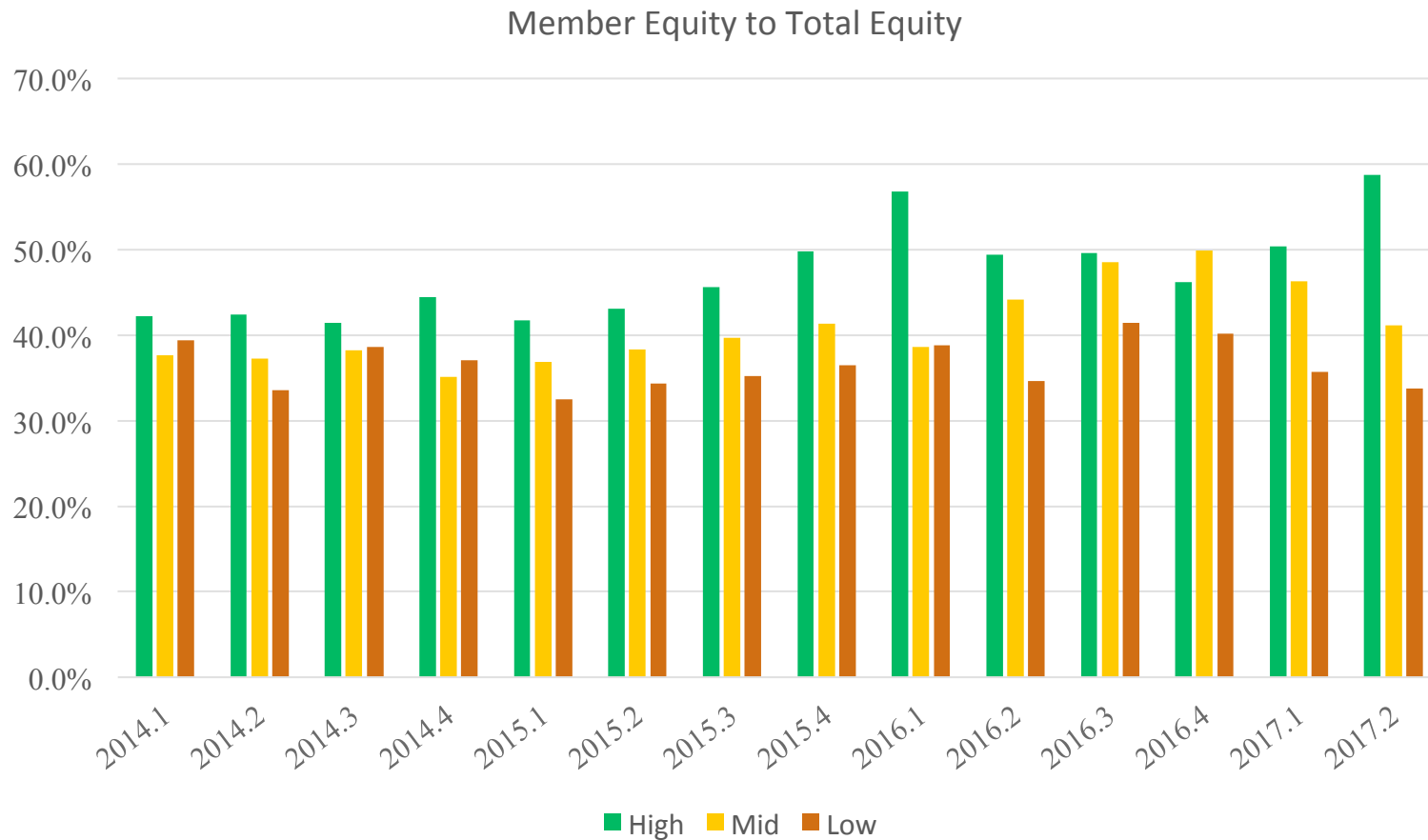
Expense Management

**LONGER TERM POSITIONS**

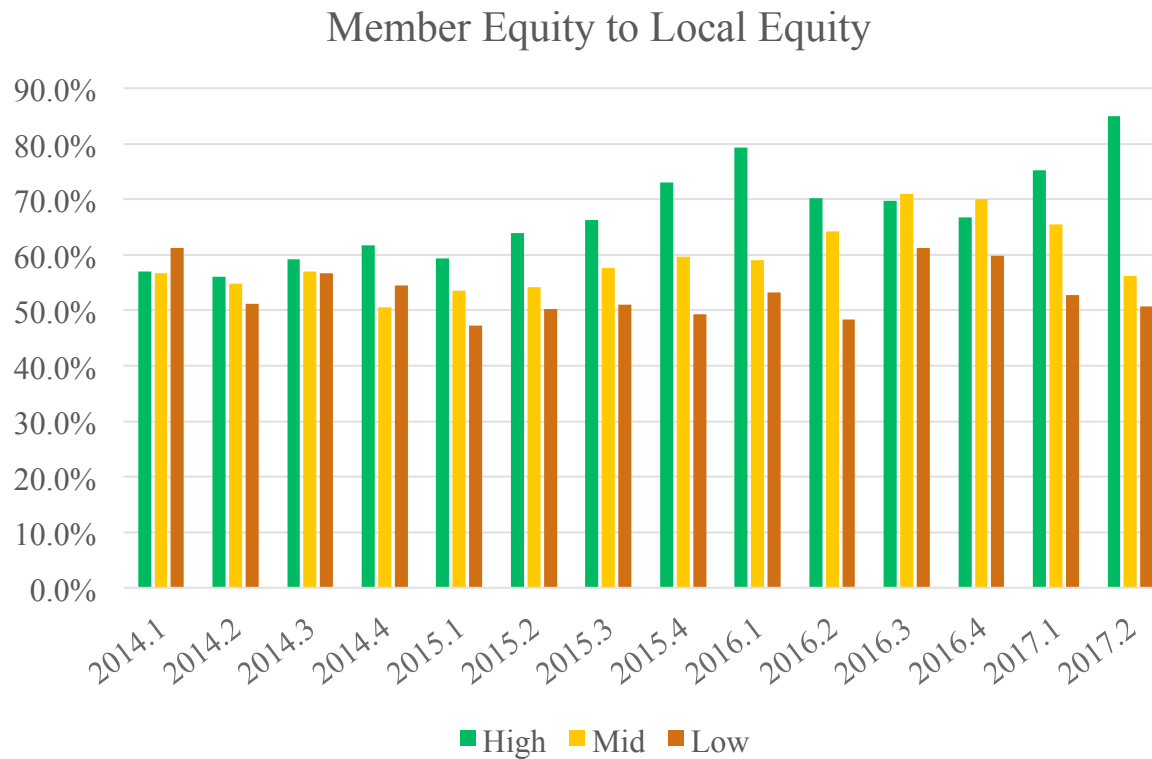
# Local Leverage and Fixed Asset Financing



# Do the Best Performers Allocate More, or Do Those That Allocate More Perform Best?

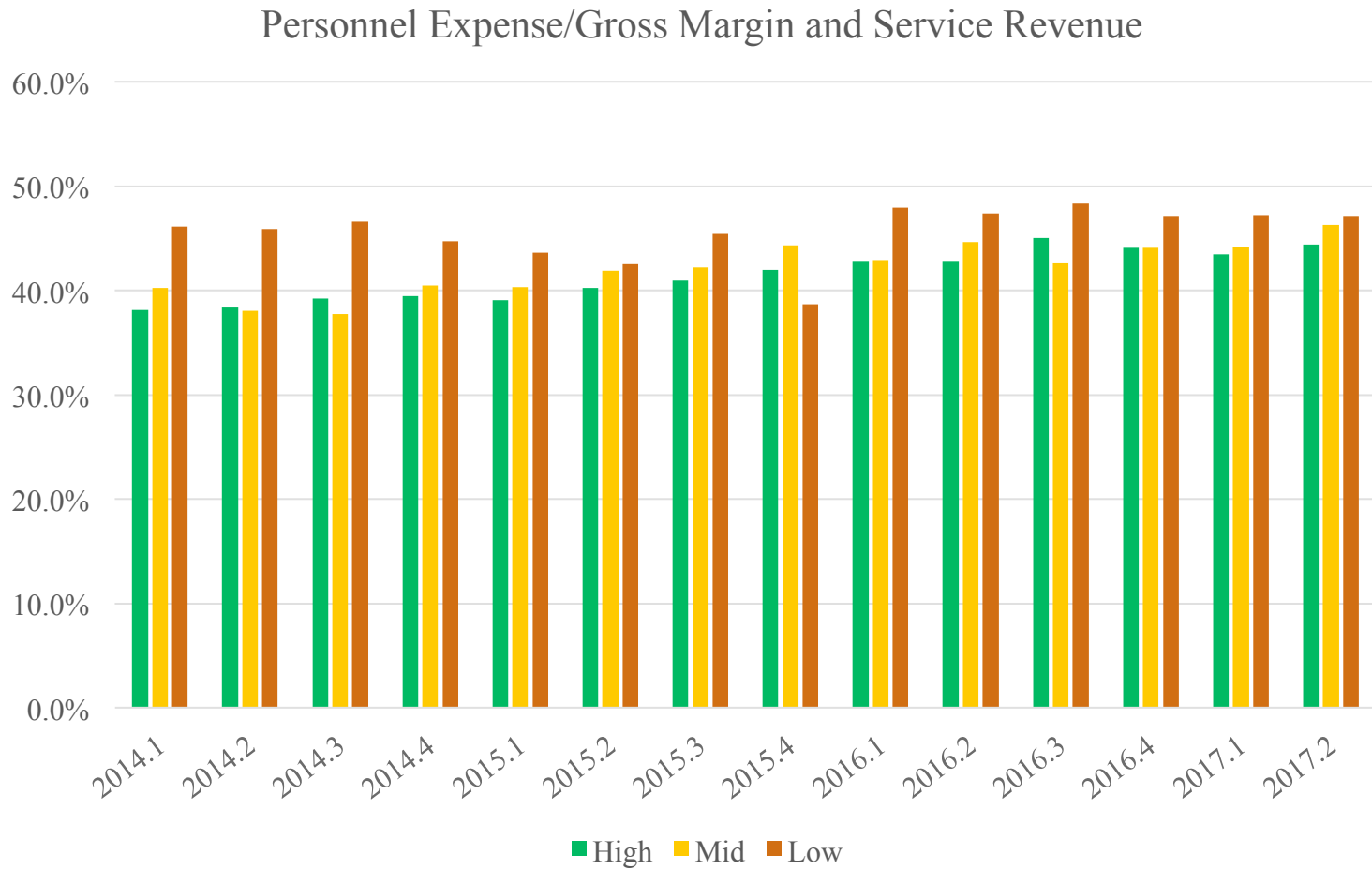


# Equity – Do We Have “Too Much” Member Equity?

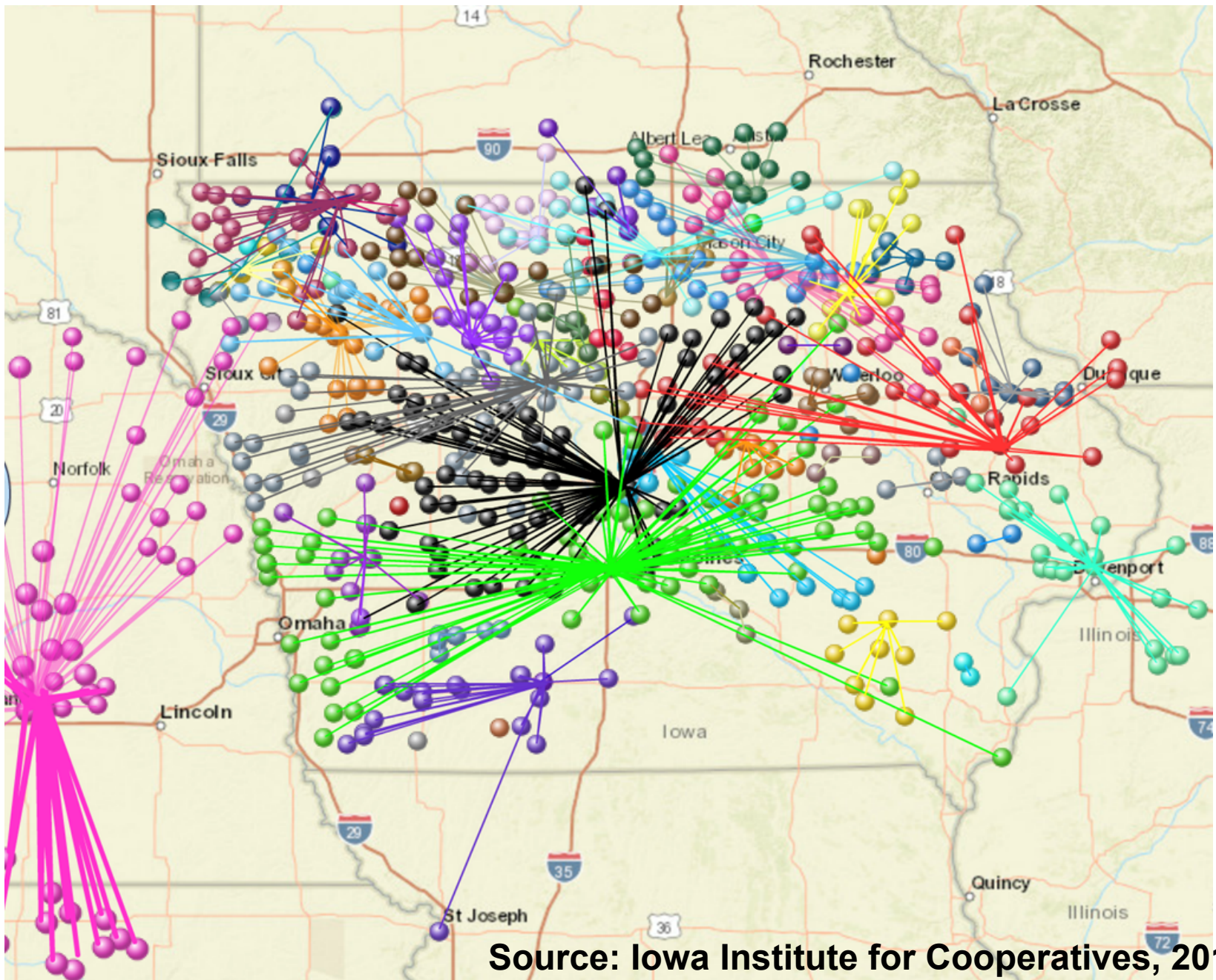


If the increase is due to growing use of NQ allocations by locals, then OK. Otherwise, signals a future management issue with equity redemption.

# Personnel Expense Management (target 40%)



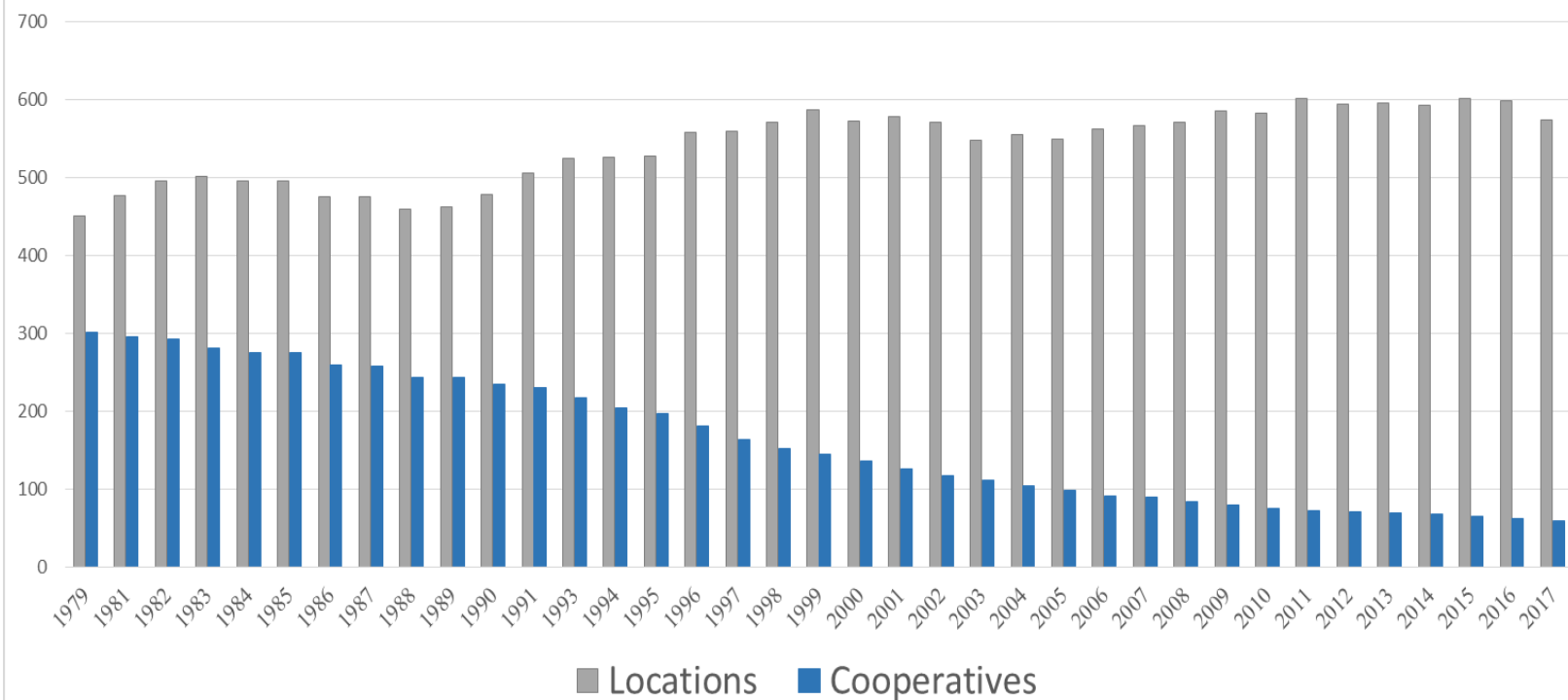
# MERGERS / CONSOLIDATION

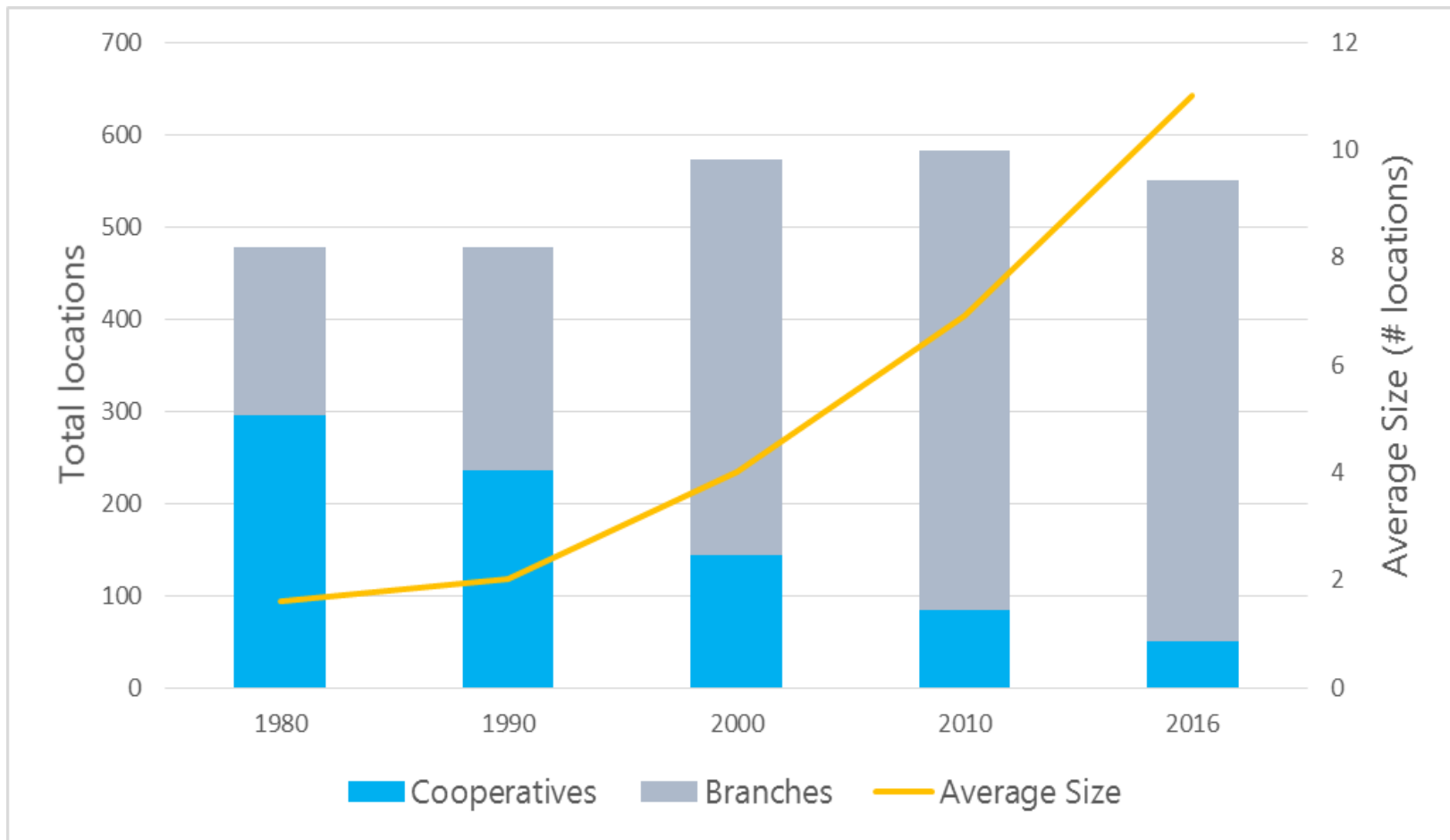


Source: Iowa Institute for Cooperatives, 2017

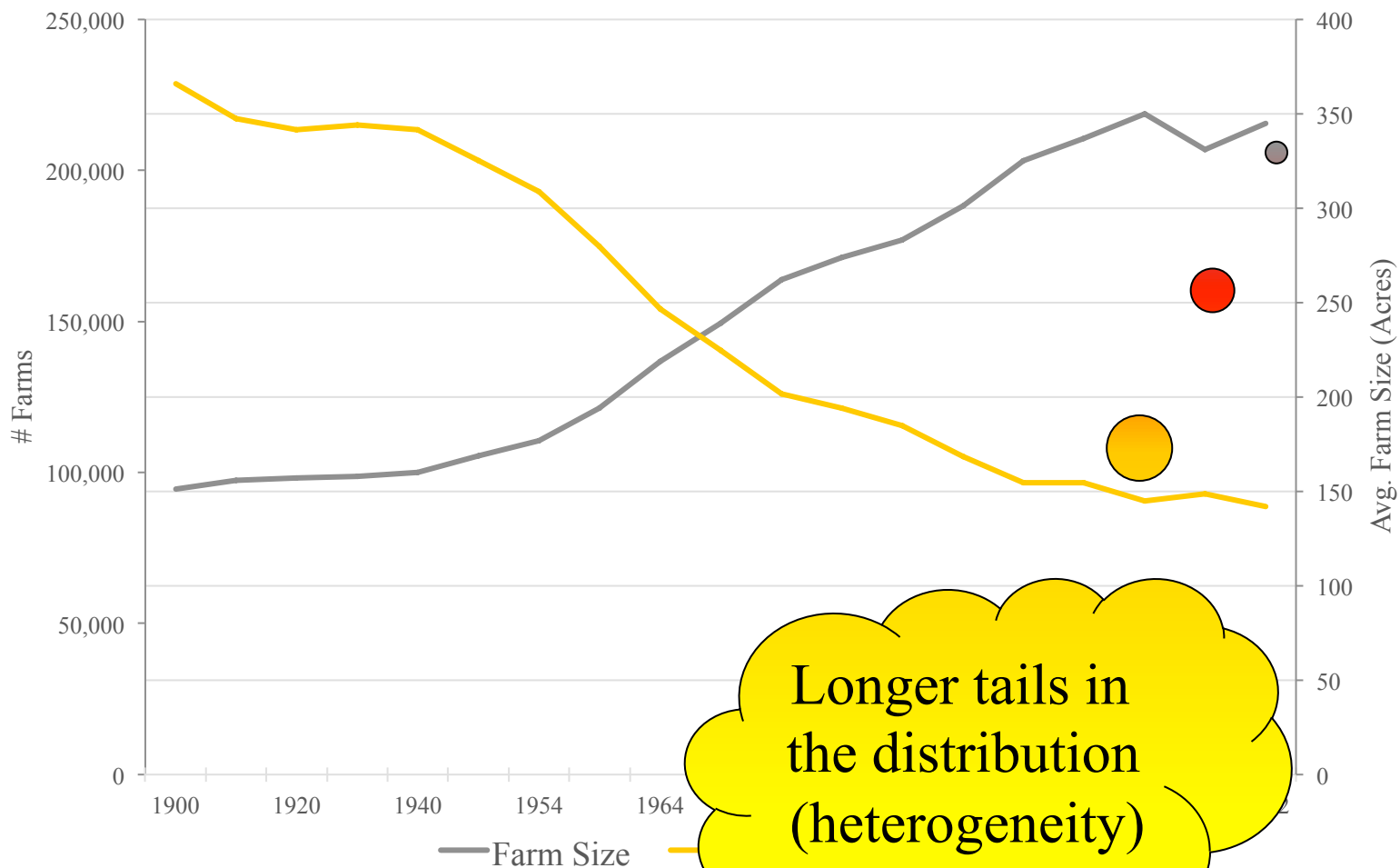


## Consolidation of Iowa's Grain & Farm Supply Cooperatives 1979 - 2017





# Iowa's Producers Are Getting Bigger



Data Source: National Agricultural Statistics Service, USDA

# Co-op “Partners” Are Getting Bigger

- Bayer – Monsanto
- Dow – DuPont
- ChemChina – Syngenta
- John Deere
- Agrium

# What Are The Justifications by Co-ops in Iowa?

- Enhanced cost efficiency in admin and operations (economies of size)
- More 'output' with fewer inputs (economies of scale)
- Access to strategic assets (location specificity)
- Access to and retention of talent
- Value creation in the eyes of producer-members

# What About Beyond Iowa?

## Kansas

- 74 g&fs, approximate 588 branches
- Retiring managers a catalyst
- Co-ops bypassing merger vote through L.L.C. structures
- How will they deal with governance issues?

## Minnesota

- Most g&fs are 1 – 3 locations
- Uptick in mergers but some voted down
- Farmers value choice of doing business with many co-ops
- Managers see clear ‘back office’ and safety cost savings and talent acquisition by merging
- Energy co-ops: risk, and difficult to scale up to get cost efficiencies

# What About Beyond Iowa?

## Missouri

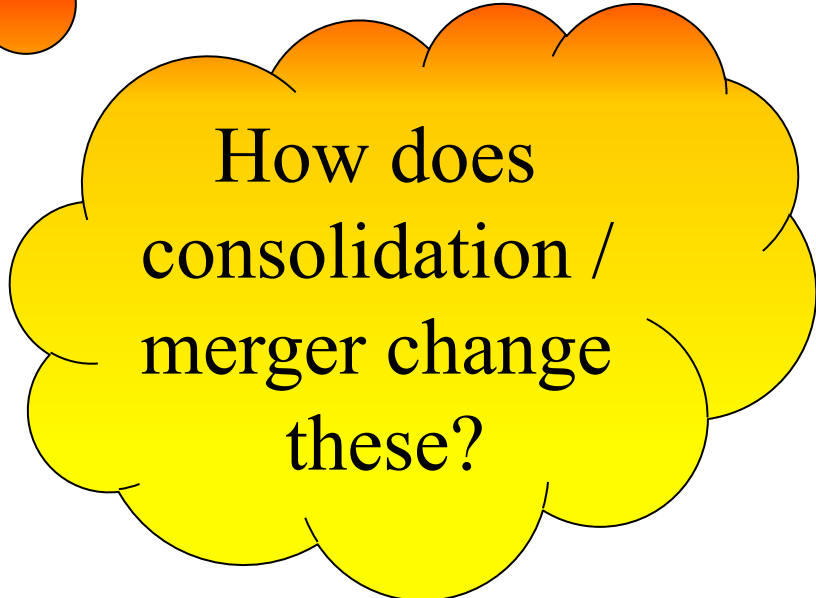
- Landscape dominated by MFA, Inc. (100, of which approx. 24 are independent)
- 20 – 25 independent local g&fs – most 1 location
- Very few ‘super locals’
- Increased importance of non-member business to generate permanent equity

## Oklahoma

- < 40 co-ops, merger is a big topic
- Financial stress (severe droughts, infrastructure issues)
- Cotton profitability driven by volume
- Grain alliances are major part of landscape (Equity Marketing Alliance merger with CoMark, L.L.C.)

# Co-op Value

- Price and market functions
- Patronage
- Service
- Existence Value
- Governance
- Community



How does  
consolidation /  
merger change  
these?



# The Crux

Consolidation is fundamentally putting at odds members' values and perceptions with leaderships' values and perceptions.

- “The co-op is just another big business.”
- “It’s not my co-op anymore.”

The frictions created through consolidation but have significant financial ramifications.



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