

Who Will Retire Member's Equity?

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Structural Change, Board Decisions and Membership Control

Structural change in agriculture is creating unprecedented challenges for cooperative boards and could threaten the value equities in the future. Radical changes in the structure of agriculture are affecting the farm level as well as the cooperative level. In both cases, the trends have been in the same directions - fewer - larger - greater technological complexity - greater management intensity - heavier capital investment - increased risks - and the list goes on. Large differences have emerged among local cooperatives and among their producer members in the process. The greater diversity creates some knotty problems for cooperative boards and cooperative memberships as they attempt to define what activities the cooperative should perform, how it should approach markets, how it should price its products and services, and how it should relate to its members.

The cooperative system's ability to return the equity to the members who have provided it will (to a large extent), depend on how well cooperative boards and members address these questions. Cooperatives (especially the open membership variety) are by nature intergenerational organizations. There has been an unwritten contract that the current generation of members will finance the coop with equity while the next generation gradually assumes ownership. The dominant means of capitalization used by open membership cooperatives to accomplish intergenerational transfer has been the retained patronage refund. Net margins are allocated to current members based on their business volume and a significant fraction of the refund is typically retained as allocated equity.

Since patronage refunds are allocated on the basis of business volume, the equity retained is roughly proportional to a member's use of the cooperative. Those members, who do large amounts of business, receive larger patronage refunds and build larger amounts of equity retained as allocated patronage refunds. Patrons who do little business

with the coop provide little equity. Over time, each member builds an equity stake in the cooperative that is related to the amount of business they do with the coop.

This method of capitalization is attractive because there is no requirement for the beginning patron to put cash into the cooperative up front. In essence, prior members provide the equity capital to finance the cooperative while the beginning member builds equity. As younger members do business, cash is generated to retire the equity held by those prior members. Perhaps the most attractive feature of this method of capitalization is the fact that it capitalizes the cooperative with money that the member would never have received had he or she done business with a non-cooperative firm rather than the cooperative.

The net earnings of the non-cooperative corporate competitor would be distributed to its shareholders based on how much stock they owned rather than the farmer customers based on how much business they have done. For this reason, the equity in a cooperative has been called “found money” by some. Since the members finance the cooperative with money that would not otherwise be available to them, there is minimal competition for capital with the member’s need for capital to invest in his or her farm enterprises.

Because the ownership of the cooperative is intergenerational, and because ownership must transfer by way of younger members doing business with a profitable cooperative, *it is critical* that the cooperative rapidly adapt to structural changes. ***It must provide relevant products and services to beginning and future members as well as current members.*** When a cooperative fails to provide relevant products and services at a competitive price, profits disappear and the ownership will not transfer. Like any other business firm, a cooperative’s equity value will erode if it becomes irrelevant and/or non-competitive in the marketplace. It is the speed and magnitude of the structural changes now occurring (and the increasing diversity among members born out of those structural changes) that represents a huge challenge for coop boards. As the board attempts to keep the cooperative profitable and make the ownership transfer work for the whole cooperative, the different interests of a more diverse membership tend to impede its progress.

MEMBER DIVERSITY REQUIRES CHANGE AT THE COOP

Cooperatives are created by members and cannot be insulated from the structural changes that occur at the farm level. The farm level changes have been profound over the past 3 decades. From the time most locals were formed until the 1970s, farm operations of typical coop members grew in size but were otherwise quite uniform. Today, they are most assuredly not as uniform. Farmers now differ more than ever before in (1) size, (2) production technologies, (3) degree specialization, (4) financial position and strategies (5), and age or time horizon.

INCREASING DISPARITY IN SIZE AND PRODUCTION TECHNOLOGIES

The differences in farm size are most apparent and most often used as a gauge of member diversity. Member cropping operations now fall into a very wide range from 100 acres or less to more than 10,000 acres for members of some cooperatives. Hog operations may vary from 25 sows to more than 2500. Size differences of this magnitude are certainly stark and bear little resemblance to the differences existing in the 1960s and 1970s. But important differences other than size now complicate the board's efforts to serve member needs.

Member farm enterprises are also becoming more diverse from a technological standpoint. As recently as 20 years ago, crop and livestock production technologies, methods, and practices were quite uniform. Successful "one size fits all" cooperative programs could be developed to serve the needs of virtually all members. Today the cropping enterprises vary widely in the production practices used and technologies used. Hog operations vary from moderate sized conventional operations to large specialized three-site units. Successful programs and products can no longer be developed for all "crop patrons" or "livestock patrons" as a group. They must instead be tailored to far more individualized patron needs.

GREATER SPECIALIZATION

Equally significant cooperative members have tended to become more specialized in either grain or livestock production. What were diversified family farming operations with grain, hogs, cattle or perhaps dairy in the 1960s and 1970s have evolved toward

more specialized large scale cash grain, hog or dairy operations. Despite the obvious risk management advantages of diversification, competitive pressures have tended to create more specialized farms. Capital, management, technical knowledge and skilled labor requirements for each of the traditional enterprises has ballooned and forced greater specialization.

With greater specialization, members have come to expect different products and services from the cooperative. These programs allow farm businesses to maintain some level of diversification while managing their more specialized crop and livestock enterprises. Livestock producers are faced with heavy capitalization and time requirements in the livestock enterprise. Some livestock farmers look to the cooperative to provide custom application for fertilizer and chemicals as well as crop monitoring and scouting. In a few cases, cooperatives even provide custom planting or harvesting to permit those producers to reduce time demands during peak crop seasons as well as the capital demands for equipment.

Cooperatives can also provide crop farmers programs which permit them to concentrate investment and time into the cropping operation while achieving some level of diversification. Cash grain producers may not wish to invest capital and labor in farrowing or nursery operations but may be willing to invest in finishing activities and operate them. Cooperatives offer two types of programs for these producers. Aligned feeder pig farrowing activities provide feeder pigs to producers who wish to take a market and ownership production risk. Contract production opportunities are offered for still other producers who may not wish to invest the capital required in an aligned system, but who want to earn a return for labor in the form of a contract payment.

CHANGING FINANCIAL POSITIONS AND STRATEGIES

From the dawn of U.S. agriculture there have been differences in the financial position of U.S. farmers. Some were able to finance primarily with equity while others have used more debt capital. In general, older more established producers used more equity and younger producers used more debt as they started farming. Traditional cooperative products and services developed around this progression in financial structure and are well adapted to it. While this progression still holds true today for most

operators, the capital requirements have grown so rapidly that even many established producers find it difficult to maintain sufficient equity to finance farm growth and technological demands.

To a great degree this has come about as a direct result of the ever-increasing capital requirements in the agriculture production sector being spread across fewer farm operators in the sector. The increasing size and technical complexity of a modern farm operation requires continuously increasing equity. At the same time, there is a consistently declining number of farmers. In other words a larger total capital burden required to produce the U.S. supply of crops and livestock must be shared by fewer and fewer farmers. The net result is that each individual farmer is responsible for providing ever-increasing amounts of risk capital. The on-farm capital burden for each individual farmer will continue to increase as the number of farmers continues to decline and as the adoption of more capital intensive farm production technologies continues.

To provide financing for production assets farmers have traditionally relied on both debt and equity capital and have taken on all the ownership risks of production. However, new financing patterns have been emerging. Leasing farmland has long been a common way for farmers to gain control of production assets, but equipment has traditionally been owned. Some producers now routinely use farm equipment leasing plans as a means to obtain the needed equipment while using the equity normally tied up in equipment elsewhere in the operation. Leasing programs are also available for dairy cows and other livestock as a means to stretch limited equity capital. Other producers are using contracting in parts of their operation to reduce the need for risk capital and reduce lender concerns about price volatility. Contracts come in a wide variety of forms and run the full gamut from production contracts to contractual marketing arrangements such as the ledger contracts or window contracts used in the pork industry.

Both the leasing programs and the contract programs bring outside capital into production agriculture and as a result reduce the capital burden on farmers. While not all cooperative members are using one or more of these financial strategies, nearly all cooperatives have some members who do use them. Those members use and expect different programs than traditional producers. In many cases, they require different credit arrangements and carry different types of risks than those encountered with more

traditional members. The future is likely to bring even more diversity among members' financial strategies. Boards will need to wrestle with the problems of meeting the new patron needs while serving the traditional producer and protecting the financial health of the cooperative.

DIFFERENCES IN AGE AND TIME HORIZON

The final type of variation among cooperative members is in the age and time horizons of the farm businesses they operate. Differences in time horizon and age among cooperative members is not a new situation. Since cooperatives were first formed, their membership has always included farmers of all ages and at all points in the life of their farm businesses. But in the past, greater uniformity in size, enterprises, farming methods, financial strategies and other key structural variables made the age and time horizon issue far less pressing. In the current climate of rapid (and many would argue undesirable) structural change, the time horizon issue becomes far more important and divisive.

This is especially true for the traditional producers who have well established farm business and have a five or ten year time horizon. It is this group that now holds a great deal of the equity in local cooperatives. In many cases, these farm businesses have made sufficient investments in assets and have selected technologies which will carry them through. They want and expect more traditional cooperative programs for inputs and marketing and tend to be less concerned about the longer time horizons. Most would prefer to have their cooperatives resist the structural changes now occurring and continue operations much as they were in the past at least until they retire or exit farming.

Such expectations run counter to the demands for new programs and services placed on the cooperative by other groups in the more diverse membership who may have longer time horizons and feel a need to adapt to rapidly changing industry structure. This places a board of directors in a very difficult position. Today's board is confronted with not only rapid structural change but also vastly different expectations in their membership body about how the cooperative should respond to these changes. And it must balance these conflicting expectations while at the same time protecting the financial health of the cooperative and the value of its equity.

MEMBER CONTROL, BOARD DECISIONS AND EQUITY VALUES.

A basic tenant of cooperation is that the cooperative is controlled by members (presumably active users of the cooperative) through an elected board of directors. It has long been recognized that direct control and decision making by the membership is too time consuming and cumbersome to be practical in a dynamic business environment. Instead members delegate the authority to make major policy and investment decisions to boards democratically elected from the membership. It is expected that boards will protect and enhance the value of the cooperative's assets and make informed business decisions for the members. It is also expected that the board will invest the capital of the cooperative in assets and programs that will benefit members.

But the tough questions today are: (1) What programs and investments will protect and enhance the value of the cooperative? (2) What are the member benefits? (3) Which kinds of members will benefit? (4) How will they benefit? The increasingly diverse cooperative membership combined with rapid changes in the structure of production agriculture makes it extremely difficult to answer these questions. Should the cooperative concentrate exclusively on the traditional members who now account for significant business volume but who may have a limited age horizon? Or should the cooperative offer products, programs and services for the younger and/or nontraditional members who appear likely to account for an increasingly high fraction of the business volume in the future?

At least part of the answer is found in the intergenerational nature of the cooperative noted in first part of this article. The cooperative must provide value to both groups or the transfer of ownership will not occur and the value of the cooperative's assets and equity will dwindle. It cannot afford to lose relevance to significant groups of current or future producers. On the contrary, it is critical for the cooperative to have programs and services that are important to future producers if it is to generate the positive net savings to retire the equity of current members.

This is more easily said than done. Structural change is creating a great deal of financial pain and turmoil for some members. Anger and frustration are understandable. Attempts to halt structural change are a natural response. Member pressure to use the cooperative as a tool to prevent or attempt to reverse structural change is already building

in some cooperatives. Board members are often criticized for developing and offering non-traditional programs and services geared to their more diverse memberships. In a few cases groups of members have made attempts to limit the authority of the board and force more favorable treatment for groups of members perceived to have been harmed by structural change. The easiest path for the board would be to concentrate on the traditional segments and avoid the headaches associated with the changing structure of production agriculture. But this is done at the risk of being non-competitive and irrelevant to producers in the future.

Cooperatives are an excellent tool for helping farmers to adjust and adapt to structural change, but they are not an effective tool to halt or prevent structural change. Cooperatives are not immune from the market forces. They must meet the same market test that investor-oriented firms meet. Only massive federal government intervention or the regulation of agricultural production as a public utility could completely stop the structural changes now underway. Well-meaning efforts by members to attack the problem of structural change by limiting the activities of their cooperative have little chance of success in a competitive setting where other firms are free to operate and expand with impunity. The only lasting effect will be to reduce the cooperative's ability to meet the evolving and future needs of their more diverse membership. The equity value and the cooperative's ability to redeem it will be reduced as a direct consequence.

Back to the opening question: Who will retire member's equity? Of course there have never been any guarantees that cooperative equity will be redeemed at all. It is, after all, risk capital and it is the first to be lost when unforeseen disaster or extremely adverse market conditions arise. But if we presume that no such unforeseen factors are involved --Who will retire it?

The answer really hasn't changed much. It will be retired by future cooperative members who are doing business with a profitable cooperative. It will be retired by a more diverse membership utilizing cooperative products, programs and services that are geared to their needs. It will be retired by cooperatives whose members and directors understand that their cooperative can aid members in adjusting to structural change but who do not expect their cooperative to magically stop structural change or just pretend that it is not happening.