Managing Coop Equity- Problems on the Horizon?

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Abstract
Cooperative patrons have come to expect great deal from their organizations. They not only expect their cooperative to provide competitive price and market access benefits but they also expect to receive financial returns in the form of cash patronage refunds and equity retirements. In many cases patrons maybe expecting more than can realistically be delivered. This is not news to many cooperative directors. They are continuously being confronted with requests from patrons for higher cash patronage payments, equity revolvement, better equipment and facilities, lower prices for inputs and higher bids for grain.

Disciplines
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MANAGING COOP EQUITY - PROBLEMS ON THE HORIZON?

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MANAGING COOP EQUITY - PROBLEMS ON THE HORIZON?

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Cooperative patrons have come to expect a great deal from their organizations. They not only expect their cooperative to provide competitive price and market access benefits but they also expect to receive financial returns in the form of cash patronage refunds and equity retirements. In many cases patrons may be expecting more than can realistically be delivered. This is not news to many cooperative directors. They are continuously being confronted with requests from patrons for higher cash patronage payments, equity revolvement, better equipment and facilities, lower prices for inputs and higher bids for grain.

These are clearly competing demands on the organization. An improvement in one area will nearly always come at the expense of improvement in one or more of the others. Cash patronage, fixed assets, prices and bids are usually more visible and immediate. They have tended to get the greatest patron attention leaving equity retirement with lower priority. But the equity issue is always lurking in the background. Although some cooperatives are capable of generating sufficient cash to cover all these competing demands many are having increasing difficulty. Changes shaping up at the farm level and member expectations may make it even more difficult in the future.

A declining number of entering farmers and a chronic build-up of equity in the hands of older patrons is nothing new to cooperatives. It is a more or less natural consequence when either a first-in first-out revolving fund or the member's age is used as the basis for retiring equities. However, the rapidly accelerating concentration of
production into the hands of a very small number of farmers has magnified the consequences of these policies. Large blocks of equity allocated in the late 1970s and mid-1980s will need to be revolved.

But the concentration of equity in the hands of older producers is only part of the problem. The other part of the problem is in the patron’s perception of what cooperative equity really is. To most patrons it is their patronage refund. They earned it and they have a right to get back the exact amount they put in no matter how the coop performs. In the minds of most coop members their coop equity has taken on the status of a debt -- at least, in terms of receiving face value with near certainty. Very few patrons see it as "risk" capital provided to their cooperative which may be lost or diminished if the coop doesn't perform well.

Boards will be faced with more difficult questions from patrons about equities as current trends continue. Individual board members will need to have a clear understanding of cooperative equity themselves and be able to explain the tradeoffs, the unique problems of cooperative capitalization, the effects of operating performance on the coop's equity to the membership. Beyond that boards will need to manage the equity issue in a way that will permit their cooperative to compete against corporations with very different equity structures. It may be useful to review the similarities and differences between cooperative and corporate equities as a starting point.

**COOP EQUITY VERSUS INVESTOR CORPORATION EQUITY**

Both cooperatives and investor oriented business firms are financed with two types of capital -- debt capital and equity capital. Debt capital is usually understood to
have the following characteristics: (1) It has a fixed principal face value that neither increases nor decreases. (2) It carries a defined interest rate or charge for its use. (3) It has a fixed repayment schedule or expectation. (4) It has a priority claim on assets of the firm in liquidation. These characteristics are the same for both cooperatives and investor corporations.

In contrast, there are important differences between coop equity and equity in investor owned corporations. Equity capital in investor oriented corporations must be purchased with cash. Most cooperative equity is earned through patronage refunds from doing business with the cooperative at market prices. A portion of the refund is typically retained and the remainder (at least 20%) is paid in cash. Thus the patron’s equity investment in the cooperative is generated from funds that the patron would not have received if he or she had done business with a non-cooperative competitor.

Earning equity in this way is very different than purchasing it with cash up front. The patron is financing the cooperative with capital that would have been kept by the corporate competitor rather than capital which could have been used in the farming operation. Only when the cash patronage is insufficient to cover the tax liabilities on the refund is there a negative cash flow to the patron’s farm operation. When the cash portion is insufficient, the negative cash flow is still usually less than the equity value even after a fairly long revolving period. Passively accumulating equity while doing business at market prices is radically different from having to accumulate the hard cash before investing it.

Cooperative and corporate equities do share some common characteristics
even though they are obtained in quite different ways. Cooperatives and investor
corporations are similar in that neither are obligated to pay dividends on their equity
capital. Although some corporations and a few cooperatives do pay dividends on their
stock or equity there is typically no legal obligation to do so. Likewise both
cooperative and corporate equities have a lower priority than the debt capital used. If
the firm is liquidated stockholders would be paid only after all debts had been paid.
Thus both corporate and cooperative equities are at risk and may be lost if the firm
performs poorly or fails. Unfortunately this possibility is not often pointed out to
cooperative patrons and over the years an expectation (sometimes an unrealistic one)
has been built in patrons minds that their equities can be paid out at face value in the
future no matter how poorly the coop performs.

Cooperative equity differs from corporate equity in other important ways.
Corporations have no obligation to redeem their equities once they have been issued.
It is unusual for an investor corporation to use it’s cash flow to repurchase the equity it
has issued. Generally, corporations are free to reinvest cash flow in the business to
replace fixed assets and expand. By retaining profits in the company the market value
of the stock is increased and provides benefits to stockholders. Cooperatives on the
other hand must redeem their equities and the overwhelming member expectation is
that the equities will be redeemed at face value. This expectation persists even where
the true value of the equities may have been eroded through poor operating
performance or changes in the economic value of the fixed assets. The redemption
requirements when coupled with the expectation of redemption at face value creates a
hybrid form of equity which is more like debt capital than corporate equity.

Corporate and cooperative equities also differ in terms of their transferability. Corporate equities are usually transferable but cooperatives typically do not permit their equities to be freely transferred to other owners. If transfer is permitted at all the board usually imposes strict limitations on such transfers. Investor corporation equities can usually be sold to another buyer at any time the stockholder wishes to convert them to cash. Redemption of cooperative equities typically requires board action and cannot be done unilaterally by any one patron.

Both cooperative and investor oriented corporation equities are affected by financial performance. But the equities are affected in different ways. In the corporation good performance provides benefit to stockholders through appreciated market values of the stock they hold. Poor performance may result in reductions in market values and the loss of part of their equity investment.

Since cooperative equity is usually nontransferable and does not appreciate or depreciate the effect of operating performance is not visible through the market value of equity. Where operating performance is good it is possible to revolve equity more promptly and where performance is poor equities revolve more slowly or sometimes not at all.

The unique features of cooperative equities make it necessary for boards to consider some strategies that are different from those used in corporations as they address equity management. Several alternative approaches can be taken to deal with the equity challenge now developing. These include:
1. Improved Operating Performance
2. Improved Fixed Asset Deployment and Management
3. Improved Equity Retirement Plans and Policies
4. Different Earnings Allocation Strategies
5. Equity Write-Downs to Reflect Large Losses
6. Better Member Understanding/Knowledge/Awareness Programs

In most cases it may be necessary to combine several of these approaches. No one approach provides the entire solution to the equity puzzle by itself. Each one brings the cooperative closer to its ultimate goal.

IMPROVED OPERATING PERFORMANCE

The first and foremost factor in dealing effectively with the cooperative equity problem is better operating performance. Equity value in either a cooperative or investor corporation hinges on the ability of the firm to generate cash flows. Good net income and net cash flow from operations are the ultimate source of patron equity value. If operating performance can be improved enough there should be little problem in maintaining the value of equities. Improvements in operating performance, however, do not come automatically and they do not come without continual change and adaptation to emerging customer needs and market conditions. Customer needs and market conditions have changed radically over the past decade and will change even more in the next decade.

Cooperatives now having difficulty with operating performance need to carefully evaluate their current structure and operating practices. In today's competitive market some cooperatives simply lack the size, structure, or trade area to generate good operating results. Many cooperatives in this situation can continue to survive and limp along with the lackluster or poor operating performance for years. But this strategy
carries a hidden cost.

Even though the cooperative continues to survive, its ability to retire equity promptly and systematically is lost. If the coop has a series of years with poor operating performance equity value can be seriously eroded without patrons (or in some cases the board itself) realizing that the loss has occurred. Even though the face value of patron equity may not be reduced, the cooperative does not have the cash available to retire it promptly. In the more serious cases there is insufficient cash to retire anything but estates. Boards have an obligation to make sure the cooperative is structured appropriately so that losses in equity value do not occur simply because the cooperative is not competitive enough to generate net savings.

EQUITY RETIREMENT PLANS AND POLICIES

Boards can also help to meet the equity challenge by choosing equity retirement plans and programs more carefully. An ideal equity retirement program would coordinate the cooperative's need for equity financing and cash flow patterns with member demographics and members use of the cooperative. Using such a coordinated approach can generally improve the long run value of the cooperative's equity. Planning equity retirement decisions over a longer run time period and harmonizing the equity decisions with operating cash flow, the cooperative's capital requirements and member characteristics places much needed discipline on the equity program. It is almost certain to increase the ultimate value members receive from the cooperative.

Few cooperatives now overtly attempt to harmonize their equity program with
either the cooperative's internal capital needs and financial performance or its member use patterns and demographics. In most cooperatives there is little long term planning done about either equity retirement or whether patrons provide equity in proportion to use. Equity retirement decisions tend to be made one-by-one at the end of each year. They tend to be based on the cash available after all other needs for cash have been met or, in some cases, the level of estates due.

More often than not return on equity is not high enough to revolve equity as promptly as it should be. Boards do not generally examine the rate of return on existing equity and ask whether that rate of return is high enough to revolve the equity they have already issued. Nor do they attempt to determine the level of equity that the cooperative must have and the rate of return that is necessary to revolve it in a timely way. One serious consequence of delayed equity retirement has been the concentration of equity into the hands of older and sometimes retired members.

In the future, it will be necessary to put greater effort toward concentrating ownership in the hands of those who are actively using the cooperative. "Base capital" plans are one possible approach that hold promise. Base capital plans attempt to keep a patron's equity holdings in proportion with the amount of business the patron does with the cooperative. Patrons receive no revolvement until their equity is in proper proportion to their use of the cooperative. Retirements are begun when a patron has provided the right share of total equity for the amount of business done.

These plans appear to keep equity in the hands of current users more effectively than some of the more traditional equity retirement programs such as
revolving by year, percent of the total equity pool, or the age of the member. Revolving by year the patronage was earned can also keep ownership in rough proportion to use, but it is effective only if the revolving period is not too long. Revolving out some percentage of the total equity pool is also somewhat less effective in maintaining proportionality between ownership and use of the cooperative. Beyond that it can result in younger patrons building their equity levels more slowly than is desirable.

Revolving by age of member has tended to build up large blocks of equity in the hands of older patrons. A large percentage of the equity is now held by members over 70 years of age in many local cooperatives. While some of these members may still be doing business with the cooperative, their equity stake is nearly always completely out of proportion with the amount of business they do with the coop.

Changing the basis of an equity revolvement plan is never an easy task. It is especially difficult when the cooperative is already behind in retirement of equities and operating cash flow is low. Nevertheless, it will be necessary for boards to strive for greater proportionality between patron’s ownership stake and their use of the cooperative. Given the kinds of member demographics in production agriculture today there is simply no alternative.

**IMPROVED FIXED ASSET DEPLOYMENT AND MANAGEMENT**

Cooperatives--especially at the local level--have placed a heavy emphasis on ownership of fixed assets. Board decisions on the deployment and management of fixed assets can play a critical part in avoiding future equity retirement problems. On
the other hand, poor decisions on fixed asset deployment can reduce equity values in several ways. Excess or poorly located fixed assets hurt current operating performance by increasing costs and making the cooperative less competitive with others in the market. Beyond that they absorb cash flow that could be more productively employed elsewhere in the cooperative. This rations the amount of capital available for the cooperative to pursue more promising activities. Finally, when poor fixed asset decisions are made the book value of assets on the balance sheet is nearly always overstated. Overstating asset values in relation to their ability to generate cash flow (or the value the assets could fetch on the market) results in overstated equity values.

In the future, boards will need to give more careful consideration to both the amount and the type of fixed assets the cooperative owns. Serving smaller numbers of patrons with larger farm operations will require different kinds of fixed assets. But a more significant fixed asset issue may be determining what level of fixed assets that the smaller number of large volume producers will be willing (or able) to finance with equity. Answering this question will require boards to think about fixed assets differently than they have in the past.

It is a common belief that everything should be replaced and maintained. Most boards of directors presume that all or most of their cooperative's fixed assets should at least be maintained or replaced as they depreciate. In most cases, boards attempt to increase them. In reality, better operating performance could result if some facilities were to be closed or milked for depreciation. To be sure, the board should not let all
the cooperative's fixed assets fall into disrepair. However, attempts to maintain the status quo level, location, and type of fixed assets may be equally damaging to the cooperative's equity values.

It is not off base for a board to ask itself "should this facility be maintained or should we put the money somewhere else?" As markets and patrons change boards need to constantly reevaluate whether or not replacement is appropriate or whether the cooperative should redeploy the asset into another business activity or location.

A decision not to invest in some locations is difficult for a board to make and such decisions can be expected to upset some patrons. It will require that the board and management to be able to clearly articulate the business reasons behind their decision. Patrons sometimes resist decisions that could improve operating performance. This happens in part because they fail to associate current financial performance with their equity values. The fact that current users are not providing as much of the equity as older or retired users is also a factor. It is less painful to overinvest using the prior generations capital. Base capital where current users provide the equity help patrons understand the negative effects on equity values when unwise fixed asset decisions are made.

The fixed asset deployment and management problem goes beyond just replacing or upgrading the existing fixed assets their cooperative now owns. Structural changes in the industry are leading to more mergers, consolidations, and buy-outs. Perhaps one of the most difficult questions boards of directors will need to face involves whether the assets of neighboring cooperatives or proprietary firms should be
acquired. Boards should evaluate the ability of the assets to generate cash flow and their effect on the value of members equity before buying. Expenditures for acquisition of assets through merger, consolidation or acquisition need to be examined in the same harsh light as expenditures to maintain or enhance existing assets. Both kinds of investment can damage equity value if they are not measured against their cash flow potential and other alternatives. Not all acquisition opportunities are good ones.

DIFFERENT EARNINGS ALLOCATION STRATEGIES

The development of a good equity retirement program begins when the board makes its decision on how the cooperative’s earnings will be allocated. Much like revolvement decisions, allocation decisions tend to be made on an annual basis with little consideration for the long term consequences. To meet the future challenge of equity revolvement will require that boards take a second look at their allocation decisions and how these decisions affect equity retirement.

As a board approaches the allocation decision it has several choices. Net savings may be issued as cash, allocated equity or they may be retained in the cooperative in unallocated form. There is a great deal of pressure to pay out at least 30 percent in cash in order to cover the income tax liability patrons must pay on the refund they receive. Most of the remainder is typically allocated to members and a small fraction is usually placed into unallocated retained to cover non-member business. The cooperative must pay corporate income tax on the portion of its net savings the board places into the unallocated equity category. But the tax does not have a net negative effect on the coop’s cash position. Although paying taxes is a
cash drain the coop does not need to pay out cash at the time of allocation to cover member's tax liabilities. And the board will not have to revolve out of the unallocated equity at a future date. This is important if the cooperative is having a tough time retiring the equity it has already issued.

The long standing practice of issuing the vast majority of net savings as allocated equity has been popular with boards and patrons and it fits cooperative principle of operation at cost. However, if the cooperative already has large quantities of allocated equity and cannot revolve it in a timely way, the benefits to patrons from allocating more of net savings may be more illusory than real. If the cash flow from operations is inadequate to revolve existing equities within a reasonable time (or at least before they become estates), perhaps the board should consider putting more net savings into unallocated equity. Allocating more equity than the cooperative can retire is doing the patron no favor; especially when the patron has a tax liability on the allocation.

Although the cooperative would have to pay income tax on the unallocated retained earnings the level of allocated equities would grow at a slower rate. This helps the board avoid issuing more allocated equity than the cooperative can realistically expect to redeem in the future. Over time, issuing less redeemable equity can help to balance the amount of equity to be redeemed with the cash flow available for redeeming it.
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EQUITY WRITE-DOWNS TO REFLECT LARGE LOSSES

Cooperatives can incur large operating losses in relation to their equity base for a variety of reasons. Such losses are often not managed in a way that is consistent with uniform treatment of members and sound equity retirement practices. When a large loss (greater than 5% of equity, for example) occurs how the board chooses to recognize the loss can affect the rate of equity retirement, the ownership distribution among members, and the value of allocated equity to patrons. The operating loss must be reflected by an equity reduction on the cooperative’s balance sheet. The choice of which balance sheet equity category is reduced to reflect the loss is a board decision. The board may reduce either the allocated patron equity account or it may elect to recognize the loss by reducing unallocated retained savings.

Reducing unallocated savings is often preferred because it is less visible and does not require that patrons be notified individually that their equity claims on the cooperative have been reduced. The fact remains, however, that the cooperative has less equity and replacing the lost equity may require more borrowing. Additional borrowing will almost certainly further reduce the future operating cash flows available for equity retirement. Not only are earnings likely to be less but repayment of the loan will also absorb cash that could have gone for equity retirement or replacement of fixed assets. Finally, the ratio of unallocated equity to allocated equity has been further reduced. Thus a greater fraction of the cooperative’s total equity will eventually need to be revolved out in cash at some future time.
The reduced operating cash flow and the reduction in total equity usually lengthens the time period before the remaining allocated equity can be revolved out. Even though patrons have not been directly informed that a loss in the value of their equity has occurred they will nevertheless bear the consequences through slower revolvement.

Ownership proportionality with use may also be damaged in the process. If the cooperative uses the unallocated account to "carry the loss forward" and restores the unallocated equity account with net savings generated in the years following a loss, the transfer of ownership to younger patrons will be delayed. Because the net savings generated in the following years will be used to restore the unallocated equity account a reduced stream of net savings will not be allocated to younger producers currently using the cooperative. In cases where age of member is used to retire equity, this can freeze an ownership pattern already biased toward older members who as a group already tend to be overinvested. Worse yet, this approach can also discourage current users from patronizing the cooperative. Those who do business with the cooperative in the succeeding years immediately after the loss are bearing a disproportionate part of the burden of replacing the lost equity.

There are also member tax implications depending upon how the loss is handled. If the loss is passed to members by reducing allocated equity, most farmers can use it to offset federal, state, and self-employment tax liabilities. For some patrons this can create 40 - 50% of cash flow per dollar of loss received. If the loss is not passed to patrons, it is likely that the amount of time before equity is retired will be
longer and the benefit to patrons will be reduced.

Writing down member equity to reflect a loss is a serious decision and should not be taken lightly. It should not be done where losses are small relative to total equity or where the impact on the equity revolving period is insignificant. However, when significant losses occur and the revolving period will be materially affected, the board should seriously consider it. It is perhaps a better alternative to the "hidden" devaluation in equity that occurs when the loss is not passed to the membership.

**BETTER MEMBER UNDERSTANDING/KNOWLEDGE AND AWARENESS**

Part of the equity retirement dilemma boards now face is partly caused by unrealistic member expectations from the cooperative. It is natural for members to ask for more than the cooperative can deliver. It's human nature to look for a good deal. But patrons are much more likely to have unrealistic expectations when they are poorly informed about the trade-offs that must be made among prices, services, quality and equity revolvement. Cooperative boards and management must constantly remind the membership that the cooperative is a business entity and has to function in a very competitive environment.

Members must understand that their organization and their equity is at risk. They must understand that poor operating performance endangers not only their investment but the existence of a farmer owned and controlled business in the market. Members also need to understand that their patronage refunds are being earned with assets which were purchased and built by prior generations. If succeeding generations are to enjoy the same kinds of benefits, the current members must also
be willing to make realistic demands on the cooperative. Informed patrons with realistic expectations are much more likely to permit the cooperative to make the needed structural changes to be competitive.

CONCLUSION

It is not impossible to manage cooperative equity effectively and maintain integrity and value. But it is becoming more of a difficult job. The six approaches discussed above are a starting point. There is no single magic solution. In most cases, a combination of the approaches discussed above will be required. In all cases recognition of the need for better equity management by the board of directors is the critical first step toward getting the job done.