

IOWA STATE UNIVERSITY

Extension and Outreach / Department of Economics

Co-op Profits and Equity Basics

Mid Iowa Cooperative Associate Board Program

Conrad, Iowa

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HISTORY

The Problem

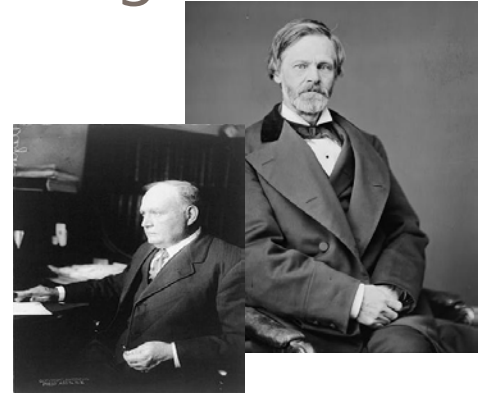
- Railroad movement (1840s – 1870s) led to rapid expansion and fueled the industrial revolution
- Farmers were largely left behind
 - little representation in Washington D.C.
 - no mechanism for organizing formally

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

The Solutions

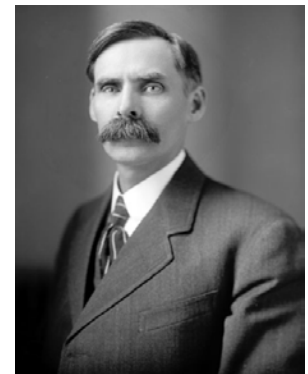
Beginning in 1850s, farmer associations began to form, but these came under attack.

- 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 (2016: 88% 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's first co-op statute was 1915, current version is 1935.
- Chapter 499 is primarily used (Mid Iowa is a 499 co-op organized in 1907 – perpetual stock company)
- 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”.

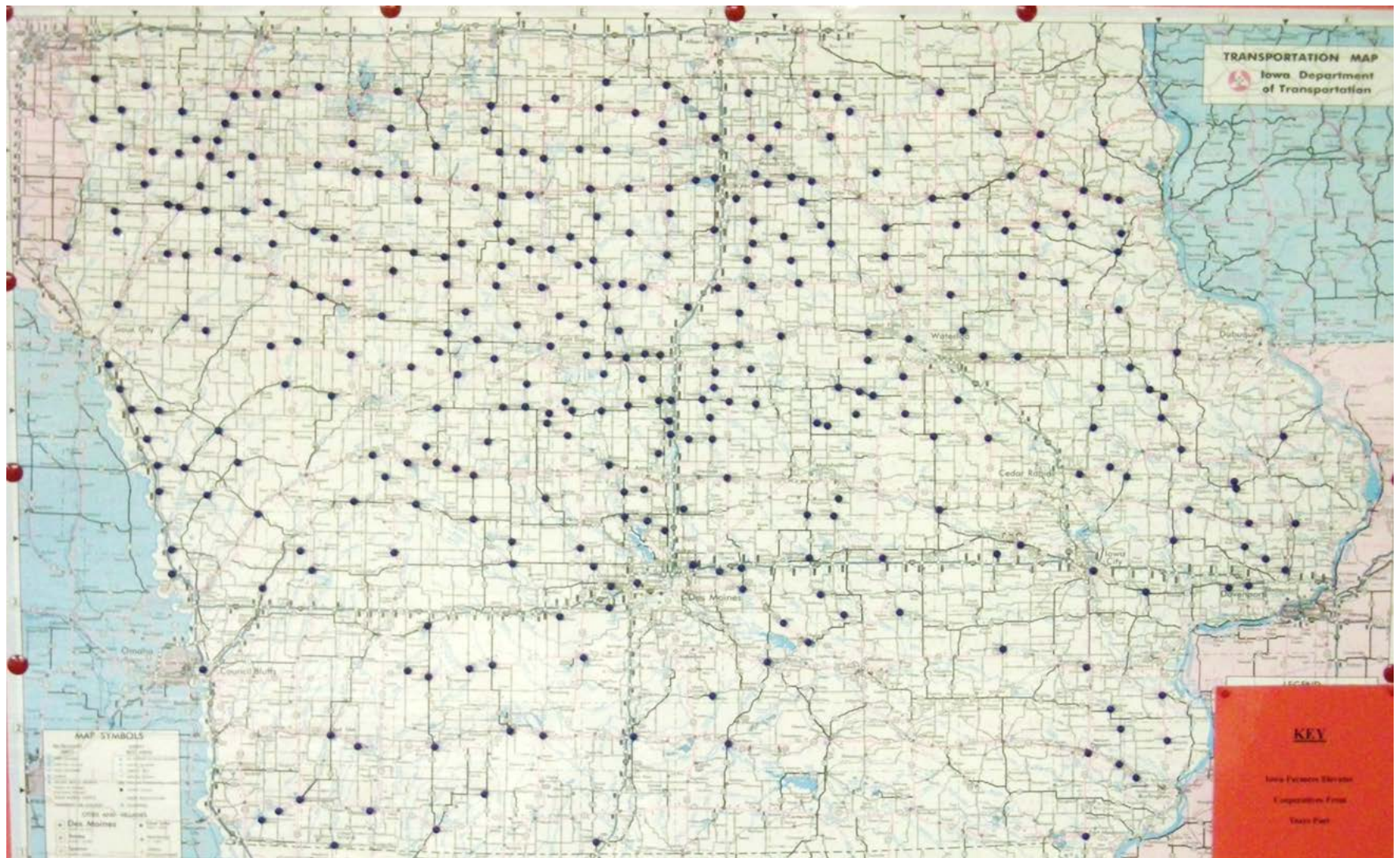
In Iowa – Other Statutes

Chapter 501 – “New Generation”

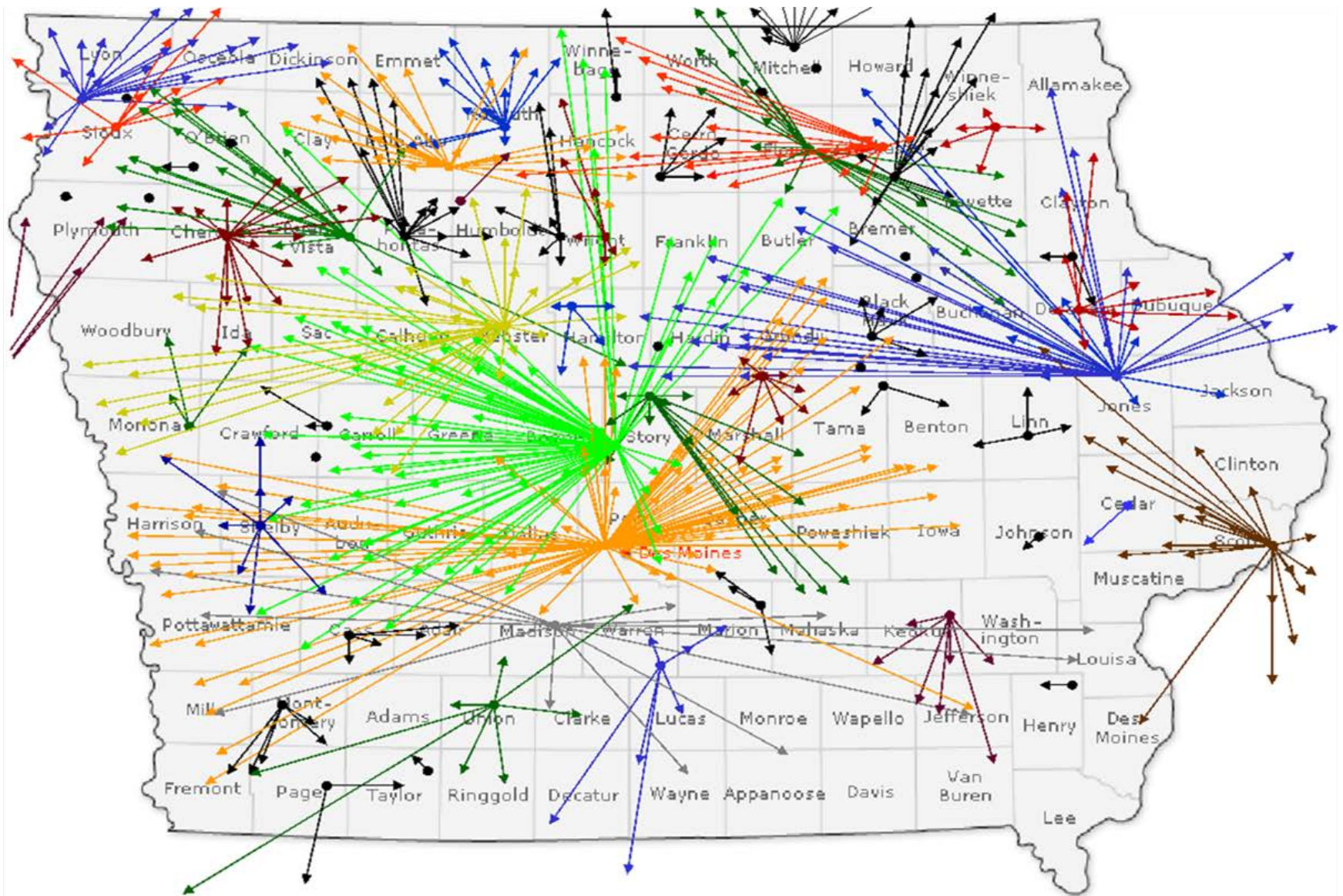
- Closed - members are only those that provide equity capital
- Often for value-added processing (ex: ethanol)
- Members buy the right to delivery obligations – these are their equity shares (addresses undercapitalization problem)

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



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

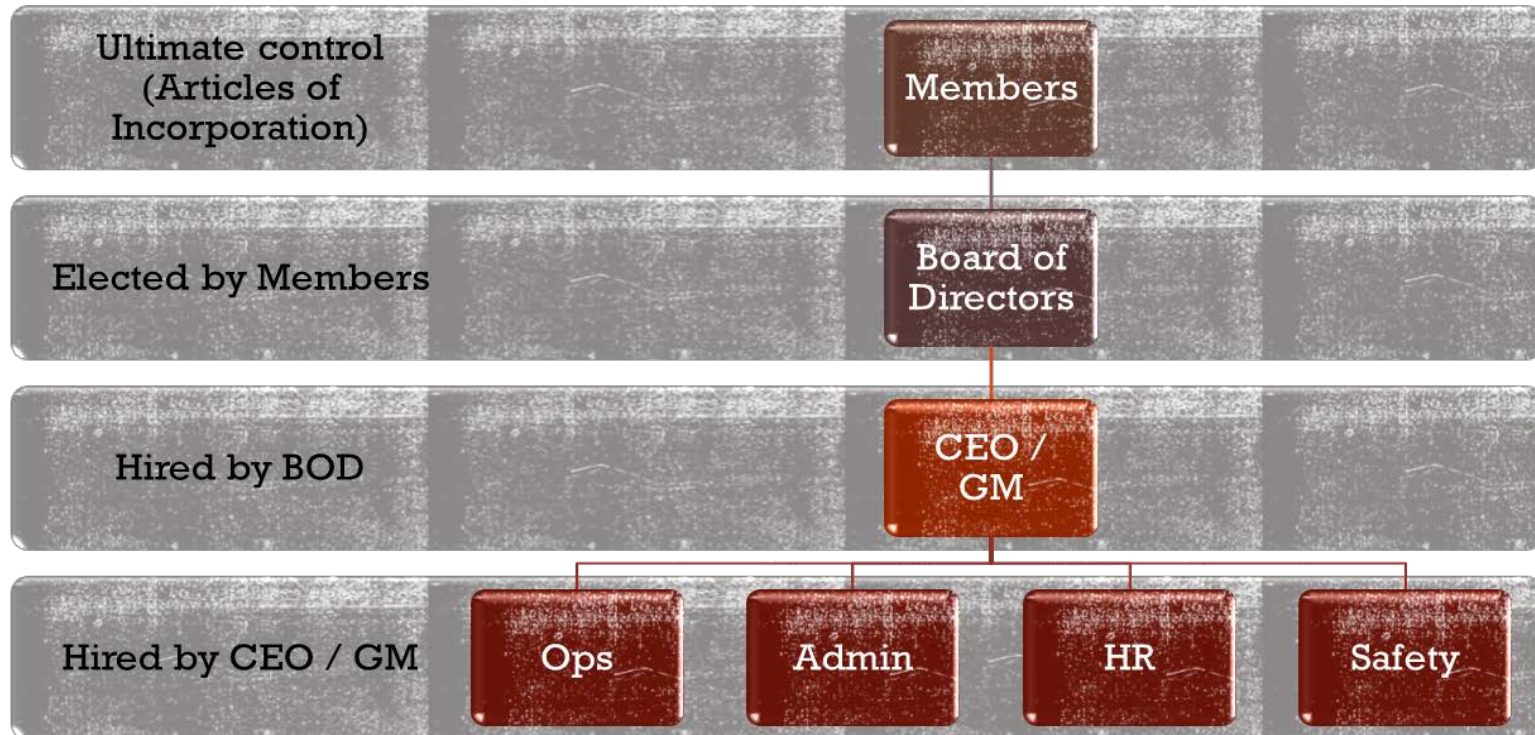
Producers recognized the need for and benefits to acting collectively to:

- 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
- Benefit from increased market power through profits
- Favorable tax treatment

Cooperatives are the “competitive yardstick”

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

WHAT IS MID IOWA'S VALUE?

The Mid-Iowa Difference

Growers are experts in making things grow. As a full-service cooperative, Mid-Iowa Cooperative provides the products, services, ag business resources, and technical expertise to help our local producers thrive in central and east-central Iowa.

Our diverse client portfolio reaches across the state to serve 850 members. We're also the largest direct-ship farm-to-market grain procurement company in the Midwest.



**Our mission is to create value to
maximize your profits.**

How Does Mid Iowa Define “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.

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

PROFITS, OWNERSHIP, AND CAPITALIZATION

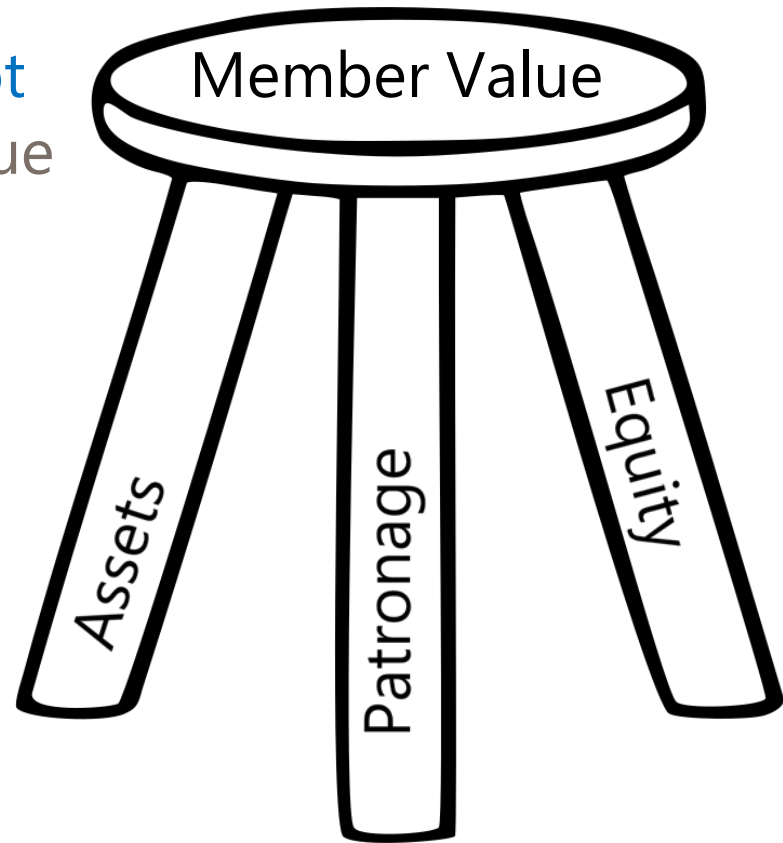
What is the co-op's objective?

- 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.

Local Savings is the Key to Member Value

The co-op cannot exist if not profitable, and member-value does not exist without the co-op.



	2015	2016
Sales		
Grain	\$110,898,520	\$72,721,940
Farm Supplies	\$36,995,170	\$40,077,100
Total Sales	\$147,893,690	\$112,799,040
Cost of Goods Sold	\$140,314,000	\$105,545,570
Gross Margins	\$7,579,690	\$7,253,470
Other Income		
Service Income	\$5,527,810	\$5,142,900
Finance Charges	\$702,040	\$566,220
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	\$2,066,520	\$3,338,980
Total Expenses	\$10,770,300	\$12,245,360
Local Savings (Loss)	\$3,039,240	\$717,230
Patronage Refunds Received	\$239,900	\$477,700
Net Savings (Loss)	\$3,279,140	\$1,194,930

Local Income

- Before patronage from regionals and other investments
- Indicates the operational outcomes locally

Patronage Received (Allocated)

All *qualified* patronage allocated in the year is included here, but not all is received as cash. (Remember this for the balance sheet discussion)

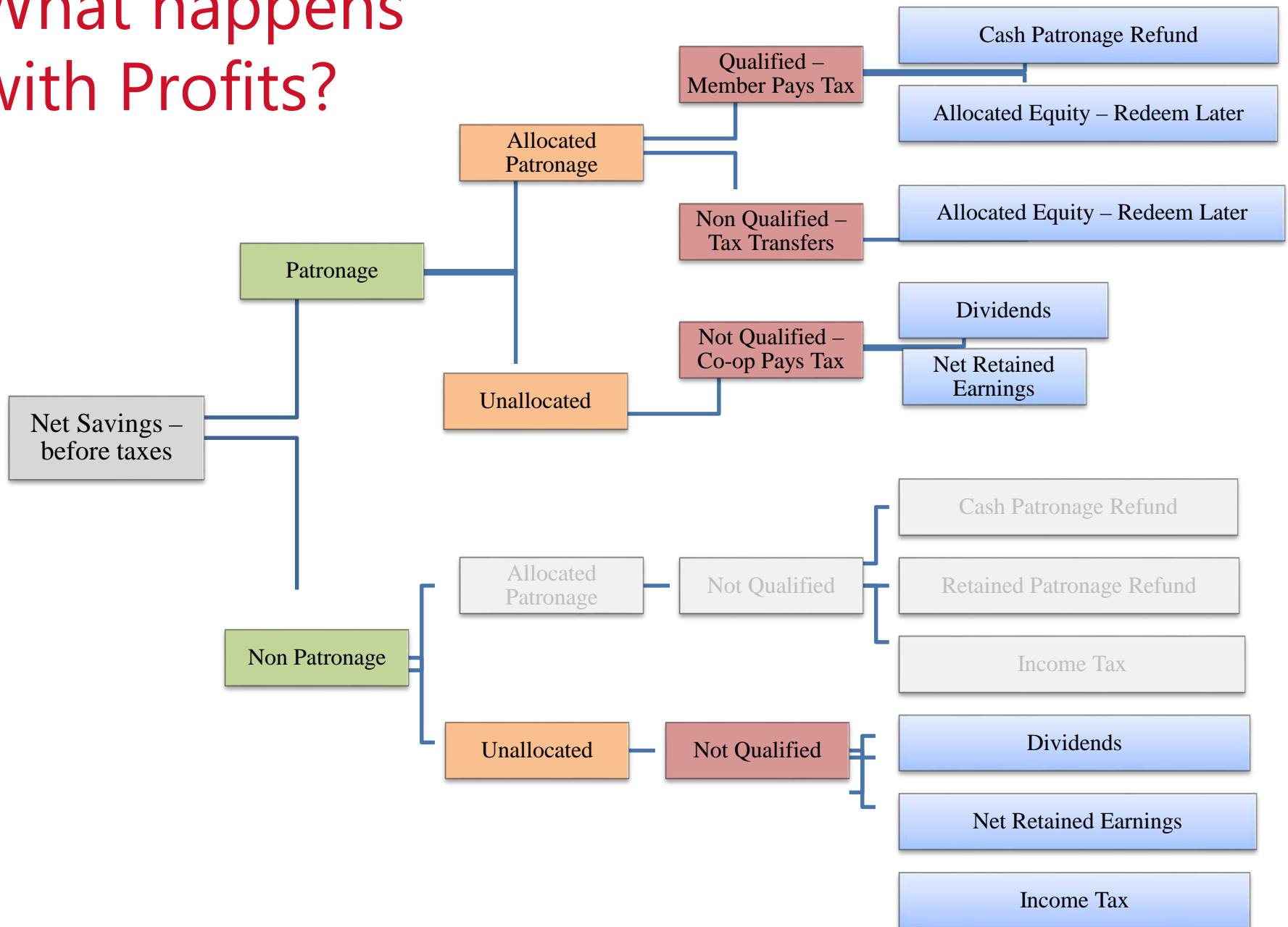
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Net Savings (before taxes)

This is the number from which the board will:

- Invest in new assets (or not)
- Redeem member equity (or not)
- Pay patronage (or not)
- Pay down debt

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)

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

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 (undivided interest)**.
- This amount will not be redeemed to patron-members as patronage in the future - **PERMANENT EQUITY**.

Equity

- Member-provided
- Results from profitability
- Retained savings – unallocated, and permanent equity
- Member equity – named equity, will eventually be redeemed

- Revoked
- Age

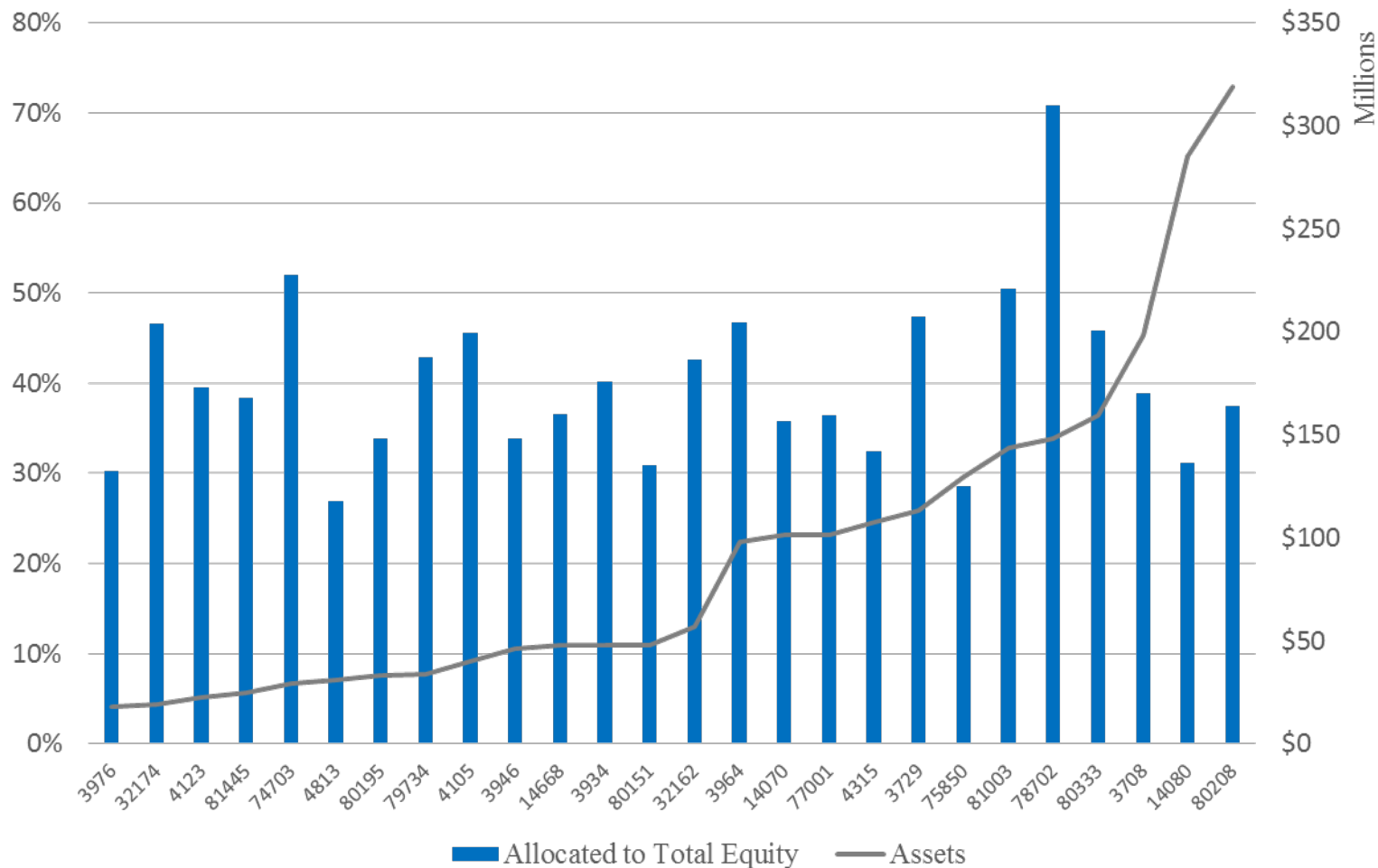
May see Q & NQ in deferred patronage

Notable Items

- How much should member equity be?
- What is the ideal redemption timing and strategy?
- What are tax implications?

	2015	2016
LIABILITIES		
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	\$2,118,930	\$2,945,680
Total Current Liabilities	\$5,425,940	\$4,448,210
Term (Long Term) Liabilities		
Mortgages / Term Notes	\$9,219,800	\$7,799,800
Member Notes	\$0	\$0
Total Long Term Liabilities	\$9,219,800	\$7,799,800
EQUITY		
Common Stock	\$156,500	\$156,500
Deferred Patronage Refunds	\$24,046,010	\$23,980,270
Retained Earnings	\$8,780,160	\$9,072,520
Total Equity	\$32,982,670	\$33,209,290
Total Liabilities and Equity	\$47,628,410	\$45,457,300

The proportion of total equity allocated to members is a board decision...but it has dropped dramatically in recent years at **some** co-ops due to **Section 199** in the tax code.



Equity & Value

- Members' risk capital
- What 'return' does risk capital provide to members?
- Do your members perceive the value their ownership is providing?

To increase members' capital and permanent equity, a co-op must be able to generate **local savings**.

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LOCAL Equity

- The amount of equity that the co-op controls

Calculation:

$$\text{Local Equity} = \text{Total Equity} - \text{Investments in Other Co-ops}$$

2016

\$82,530

\$0

\$1,420,000

\$2,945,680

\$4,448,210

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>
Total Fixed Assets	\$23,066,560	\$21,753,440

Other Assets

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Relationship between LOCAL equity and MEMBER equity

- When member (allocated equity) is **GREATER THAN** local equity, a situation exists in which the co-op's redemption liability outweighs the equity it controls.
- Put another way: if retained earnings and equity in regionals are equal, do you have a cushion of permanent equity? How does this impact the redemption timing?

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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

Revolving Equity

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)

Profit and Equity Management Qs:

- How dependent are you on regional patronage?
- Do you allocate regional equity – what are the policies?
- What is Mid Iowa's comparative advantage in the tax environment – allocate or retain?
- Do you have non-member business to increase retains?
- What is your mix of retained to total equity – target or just happens?
- Do you allocate 'too much' local equity?



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