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CURRENT CHALLENGES IN FINANCING AGRICULTURAL COOPERATIVES

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A review of JSTOR, an online system for archiving academic journals, reveals 1,921 unique citations—articles, proceedings papers, book reviews—for the word "cooperatives" in the American Journal of Agricultural Economics and Review of Agricultural Economics. Of these 1,921 citations, 620 are in the area of finance, more than any other category. This body of research suggests that cooperative finance is a critical challenge for agricultural cooperatives' survival and growth. Our engagement with industry cooperative leaders also suggests that the income distribution decision and the equity management decision, including equity investment and redemption, and the balance sheet management decision continue to be on their priority list. This article summarizes the results from a survey of cooperative leaders to better understand current challenges in financing agricultural cooperatives.

Elements of Cooperative Finance

A cooperative is a business operated primarily to provide benefits to members through marketing transactions, including input buying and output selling, and through a distribution of patronage earnings from these transactions; in return, members have a responsibility to provide equity capital—ownership—and exercise member control—governance. Members are quick to seek out the benefits of the cooperative business model but often reluctant to accept the corresponding responsibilities of ownership and control. Three functions underlie broad cooperative principles today. These are benefits, control, and ownership. Benefits include both market access at fair prices and other terms of trade and a claim on the income from these marketing transactions, usually distributed to patrons as patronage refunds proportional to use or patronage.Control is exercised through voting by members on governance issues including bylaw approvals, business mergers and dissolutions and election of directors. Voting power may be one-member, one-vote, sometimes championed as democratic control, or proportional to patronage and/or equity.

Ownership is obtained by the investment of equity capital by patrons either through cash purchase or through the retention of income from operations. Income may be retained in allocated form as per unit retains or retained patronage refunds, or in unallocated form as retained earnings. The cooperative business model is unique because it is user- or patron-oriented instead of investor-oriented.

In general, there are four unique and separate roles of users: customers, patrons, owners and members. Those who engage in buy or sell marketing transactions with the co-op are customers. Patrons are customers who are granted a claim on the patronage income proportional to use, as a patron and customer. The claim is not based on ownership unless ownership is managed to be proportional to patronage. This is the core difference between patron-oriented and investor-oriented business models. Patrons also own the cooperative. They have ownership rights derived from providing equity capital. Patrons who qualify as voting members are granted control through their voting power. In a pure cooperative with no nonmember or non-patronage business a customer or user is also a patron, owner and member. Many cooperatives prefer to use the term member instead of patron to convey the primary role.

Figure 1

Cooperative Business Model Is Unique.

The cooperative business model is unique. Its advantages include:

1. ability to better understand key customer needs because the customers own and control the cooperative and thus are motivated to align the business on customers or users who are also patrons, owners and members;
2. recognition of cooperative's unique business form by policy makers through special legislation; and
3. demonstrated success when the principles of cooperation are used effectively in conjunction with sound finance and other business principles.

The disadvantages of the cooperative business model include:

1. limited access to capital compared to publicly held firms,
2. inability to efficiently transfer ownership rights among owners, and
3. control rights are typically not aligned with or proportional to patronage or ownership. The asset growth, revenue growth and market share gains of agricultural cooperatives since 1950 suggest that the advantages outweigh these disadvantages.

The selection and implementation of an effective financial strategy is critical to the long-term success of any business, especially a cooperative business. Some of this is attributable to the uniqueness of the cooperative business model and its relationship to standard business finance. The uniqueness of the cooperative business model results from its focus on the role of the patron and the relationship of this role to the other roles of owner, member and customer. Cooperatives; fraternals—Knights of Columbus, Thrivent, Modern Woodmen of America, Ancient Order of Hibernians, and so on; mutual societies—State Farm, New York Life, American Family, and so on; and financial services firms—Nationwide, Vanguard, for example—share this uniqueness compared to investor-oriented types of businesses such as proprietorships, partnerships and corporations.

Financial Keys to Success of Cooperatives

Cooperatives must be competitive like any business. The cooperative business model is unique but it is still a business that is subject to the principles of business finance, business management and economics. It must be managed as a business that can compete in a capitalistic and highly competitive market economy. The primary economic justification for organizing and operating a cooperative is to correct and prevent market failures that are present or could be present. Other related justifications include providing missing services, reducing costs of service, and being price and service competitive in the marketplace—known as the "competitive yardstick" role. Some cooperatives also attempt to increase the value of patrons' incomes by bargaining for higher prices or better terms of trade rather than accept "market prices."

Irrespective of its purpose and role, a cooperative should strive to be as profitable as possible and then distribute those profits to its patrons. A cooperative should implement the core principle of the cooperative business model, service or operation at cost, by being competitive in the marketplace, making as much profit as possible, and then distributing profits and residual cash to patron-owners. Distribution should be done in a way that maximizes the long-run benefits to the group, keeping in mind that the group has heterogeneous interests at any one time due to their unique place in their business and personal life cycle. This distribution of patronage refunds or patronage income implements the service at cost principle of cooperatives. The payment of patronage refunds for a "non-pooling cooperative", or net margins for a "pooling cooperative", is the primary way cooperatives implement the service at cost principle. Patron-owners get what is left over through a combination of cash patronage payments, cash equity redemption payments and cash payments of net marketing proceeds.

Cooperatives should use balance sheet management when making income distribution and equity redemption payments. A cooperative must position and protect the business for short-run and long-run sustainability by adhering to a balance sheet management philosophy that manages both liquidity and solvency. Adequate risk capital must be provided by establishing and following liquidity and solvency guidelines as an element in the overall business strategy. Then the cooperative should pay out in cash to patron-owners any residual cash as cash patronage refunds or equivalent, and allocated equity as equity redemptions for cash not needed to meet the guidelines. Owners always get what is left over in any business, as residual claimants, and patron-owners of cooperatives are no different.

Figure 2

Snapshot of Agricultural Cooperative Equity Management Programs

USDA Rural Business Cooperative Programs surveyed agricultural cooperatives in 2008 (Eversull, 2010) and found that 50% were redeeming equity based on a revolving fund and 28% based on age of patron. Compared to earlier studies, it is apparent that revolving fund programs have increased over time relative to age of patron. For example, a revolving fund redeems the oldest equity first regardless of the age of the member while an age of patron program redeems equity only when a member reaches a certain age such as 70 years.

The evaluation and choice of alternative strategies must be done within an integrated and comprehensive finance, strategy and risk management framework. For an agricultural cooperative, that framework should include both the patron-producer perspective and the cooperative business perspective. In other words, a cooperative can be viewed as an extension of the patron's business, such as a farm, or as an independent firm that attempts to prosper in a market economy. Both perspectives are important.

Critical Challenges

Based on the survey results cited above, there are three particularly critical financing challenges facing cooperatives. They command much attention from cooperative boards of directors and the members.

Financing Asset Growth for Members

The most mentioned critical challenge identified by the survey respondents was the need to acquire and maintain adequate equity capital to help finance growth and provide increased working capital. Production agriculture is experiencing a boom, especially in the crop production sector. This has resulted in the need for agricultural cooperatives and similar agribusiness to add assets to service the needs of production agriculture. In addition, prices of farm inputs and outputs have become more volatile, increasing the price risk to producers and agricultural cooperatives. Increases in crop yields, coupled with the ability of seed genetics to grow crops in geographic regions where they had not been grown before, and advances in irrigation technology have created a need for new grain and agronomic assets.

Maintaining Sufficient and Consistent Profitability

The second most mentioned challenge was the need to be profitable in order to finance much-needed assets and maintain a strong balance sheet. This finding is consistent with research showing that cooperative investment is tightly linked to its ability to generate cash flow through operations. Since most equity capital is obtained from earnings, this implies maintaining and improving profitability is also critical. Another challenge related to profitability cited by many respondents was the increased need for equity capital to improve liquidity and solvency so that the cooperative could offer risk management tools to producers, such as locking in a net margin per acre, by executing a grain selling decision in conjunction with agronomy and energy purchase decisions.

Managing Business Risk While Maintaining Ownership

The third most mentioned challenge was balancing or managing the trade-off between adhering to the ideal principle of proportionality of equity investment with the urgent need to provide more equity risk capital. Members want the cooperative to invest in assets that increase profitability and reduce business risk, requiring more equity investment to finance the assets and strengthen the balance sheet, but at the same time do not want the cooperative to slow down the rate at which equity is redeemed to the members as a way to increase equity investment. In other words, members want the benefits of the cooperative but don't want to accept the corresponding ownership responsibility. This puts even more pressure on boards of directors and managers to assure that the cooperative is profitable, to create more equity investment, and to use higher leverage to finance assets.

A recent USDA study on equity management by Eversull (2010) reported that 21 cooperatives were using a base capital plan linking equity capital to current users of the cooperative. That is the best plan in traditional "open" cooperatives for maintaining proportionality of equity capital investment with use by current patrons of the cooperative. It is also the most complex equity management system and is more difficult to communicate to members. It is clearly evident that many crop farmers are very profitable as found in state farm management association records and in the dramatic increases in land prices. Thus, it may be easier for cooperatives to improve profitability by increasing net margins to pay for the much-needed improvements in assets, if cost efficiencies and competition permit.

Balance sheet management that selects liquidity and solvency targets and only redeems excess equity as the residual distribution of cash is considered the best way to manage aggregate patron equity investment and manage balance sheet risk. Equity management that selects equity redemption methods which maintain equity investment of individual patrons as close to proportional to use is considered the best way to manage individual patron ownership. The revolving fund and base capital redemption methods are the preferred methods.

Figure 3

Key Topics for Further Research in Cooperative Finance

1. Understand and critique nontraditional cooperative business models.
2. Understand various innovations and their relationship to cooperative principles in the United States. and other countries.
3. Identify a range of options that cooperatives can use to address specific financial management issues raised by leaders and members, such as building permanent equity capital or accelerating equity redemption.
4. Develop a list of best practices to communicate cooperative and business finance principles and their most effective implementation to directors and managers.

Need for Education about Cooperative Finance

It is evident that education of leaders and members about cooperative finance is critical if leaders and members are to understand why a cooperative must be profitable and why cooperative finance practices must be aligned with the cooperative's business model. These are tenets of effective income distribution and balance sheet management. If members view the cooperative as the vertical extension of their farming enterprises, then the ultimate objective is to maximize after-tax discounted cash flow back to the producer-member. A list of key topics for further research and education was identified by the industry leaders.

Concluding Comments

Alignment of a financial business strategy on cooperative principles and the cooperative's business model, including equity management, are critical issues for the success of an agricultural cooperative. Financing and managing the asset growth needed to meet member needs, and keeping equity proportional to usage are two critical issues for financing agricultural cooperatives.Cooperative finance has been an important topic for agricultural economists and continues to be an important topic today as evidenced by the comments from these cooperative leaders. Land grant university economists have long conducted extension education programs for managers and directors of cooperatives. Such programs remain relevant today, especially those addressing cooperative finance.

For More Information

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