



REVOLVING COOPERATIVE EQUITY - A GENERATION OF MISUNDERSTANDING

About mid-semester each fall, I introduce to my undergraduate students the general topic of “cooperative finance.” By this time, the students have already been exposed to cooperative principles and have a basic-level grasp of operational practices. As I begin my lecture on revolving cooperative equity, one can tell by the perplexed expressions on the students’ faces that my message is not being clearly received. Forgetting for the moment my instructional deficiencies, one presumes that the subject is unusually complex or confusing. As college sophomores and juniors, these students associate with the terms “equity capital” those monies generated by corporations through their direct sale of common/preferred stock to prospective private investors. As these students soon discover, the acquisition and maintenance of adequate equity capital by cooperative businesses is quite a different matter. The cooperative peculiarities are both numerous and varied. They comprise the basis for a generation of misunderstandings with regard to cooperative operations and they account, in large part, for the confused looks on the faces of my agricultural economics students. The objective of this discussion is to point out those major cooperative peculiarities as they relate to the generation and maintenance of equity capital. We shall discuss reasons why a cooperative’s equity capital base must continue to grow and alternative means for securing this growth. Finally, we shall address a basic cooperative conflict that ultimately evolves between a cooperative’s operational needs and its philosophical underpinnings.

Cooperative Peculiarity

Very little cooperative stock is sold to private investors and little, if any, finds its way into the commercial markets for the transfer of such securities. That equity generated directly through the sale of cooperative stock is usually confined to

member-users of that cooperative business and normally comprises a very small proportion of that total equity base upon which the firm operates. Conversely, the bulk of equity capital used by cooperatives evolved from their use of, and dependence upon, the revolving capital program (RCP). As a means for generating equity capital, RCP has probably been used by virtually all agricultural cooperatives at one time or another.

Under the RCP, current cooperative patrons contribute each year to the capital base through the cooperative’s retention of a portion of current savings or a per-unit retain. The capital thereby generated each year is retained and used “temporarily” by the cooperative and returned (revolved) to the contributing patron at some future time when it can be supplanted by new capital similarly generated in a subsequent year.

Revolving Capital Attributes

As originally conceived and implemented, the RCP contained a number of attractive features for financing cooperatives’ operations on an ever-revolving pool of equity capital funds. Among the more attractive attributes of the program were the following:

1. The fulfilling of working capital needs and the financing of *modest* facilities or equipment expansion could be accomplished largely from current savings and/or per-unit retains. This did not present cooperative patrons with a direct out-of-pocket cash expense and all equity generated in this manner was assigned to the patron through the issuance of revolving capital certificates (the face value of which the patron could assign to the asset side of his personal accounts).
2. Insofar as RCP-generated equity certificates were non-interest bearing and not due-dated, the cooperative gained access to a low cost and relatively unconstrained pool of funds to underwrite their operations.

- Perhaps the most attractive alternative of RCP was that it functioned in a manner that was philosophically compatible with the so-called cooperative principles. The revolving feature, itself, meant that as long as the revolve period remained relatively short, the current patrons of the cooperative would bear the primary burden of financing its current operations. Moreover, the distribution of this burden would approximate closely the degree to which each patron used or was reliant upon the cooperative enterprise.

A Weakness Overlooked

Implicit in the successful use of RCP were the basic assumptions that agricultural cooperatives would experience modest but gradual growth, savings generated and retained would be sufficient to support a disciplined growth in the equity capital base, and inflation or other economic distortions would not create imbalances in the capital revolve cycle. Through the mid-1960s, these assumptions remained relatively valid. But, the converse has occurred in the past decade.

In keeping with the basic philosophy underlying cooperative activity, agribusiness cooperatives have always placed a high priority on service to its member-patrons. Non-cooperative enterprises, during this same period, have operated more directly in search of the financial betterment of their stockholder-owners. While both forms of organizations went in search of equally meritorious goals, the basic difference in their search has led cooperatives to provide extra benefits and services to their patrons ... oftentimes to the extent that the entities' financial performance has been adversely impacted. In other more serious cases, in their search of the ideological aspects of cooperative activity, management and directors have occasionally subverted the firms' operational efficiency. As the ability to generate savings deteriorated, so did the cooperative's ability to accumulate capital through retains. At the same time, this continued search for diversity and an expansion of services provided comprised the basis for the need of an accelerated rate of growth in capital accumulation. The divergence of these trends soon became apparent as cooperatives were forced to rely more heavily on debt capital to underwrite their expansion.

A cooperative's desire to provide full and quality service to its membership is not the sole cause of

this dilemma. In many cases competitive factors and changes in economic conditions have become external factors contributing towards a cooperative's need to expand rapidly or otherwise change its method of operation. Technological changes, for example, have forced many cooperatives to expand large sums of money for modernization or revised marketing and distribution methods. Similarly, many marketing cooperatives, which for years merchandised their product at the wholesale level, are now finding it necessary to move into the retail market in order to secure a more dependable market for their patron's product.

This need for rapid cooperative growth or change, when coupled with a modest ability to generate internally the necessary equity capital, has set the stage for a basic conflict or weakness in the future financing of many cooperatives. The dilemma worsened when in 1962; the "consent" provisions of the Revenue Act were implemented. Under these provisions, cooperative patrons were required to report non-cash patronage distributions (retained savings) as taxable income. Patrons could no longer amass, tax free, assets in the form of cooperative equity capital. These changes generated the existing situation of patrons now seeking higher proportional cash patronage payments and/or a more reasonably current (shorter) capital revolve program.

New Financial Policies Required?

Because of the conflict just noted, by the mid-1960s most cooperatives were diligently searching for a new or improved means for accumulating and maintaining equity capital. A quick review of the literature suggests that a large variety of plans, programs, and schemes were devised and implemented.

Some early program changes included the creation of tax-paid retained earnings much like those generated by conventional corporations. Insofar as this program change was still linked to the cooperative's ability to generate savings, it comprised only a partial solution. Other program changes included the full or partial replacement of revolving capital with securities (preferred stock) bearing no implied or actual revolve obligation. While this program had some intuitive appeal, it proved to be operationally difficult for many cooperatives. First, these securities had to be freely transferable. Private investors were not accustomed to such issuances and specialized

markets for their sale never developed. Second, to be marketable, the securities had to bear dividends set at a competitive level. Insofar as such securities could be held by nonmembers, and insofar as these represented a prior claimant on the cooperatives' operations, they no longer had access to low-cost equity with which to operate. In addition, some concerns were expressed that these practices violated longstanding cooperative philosophy relating to "services at cost" and "exclusive member-patron ownership."

Indeed, for fifteen years cooperatives have searched for new financial policies that might supplant the RCP practices implemented by their founding patrons. Numerous variants in securities, unallocated reserves, and tax-paid retains have been attempted ... most have been found wanting. As one reviews the capital bases of cooperatives today, they are likely to be surprised by the extent to which these organizations still rely heavily on some form of RCP. Each cooperative's current use of an RCP may show some variation in the way retains are apportioned amongst its members. There may also be some variation in the policies under which such equity is redeemed by patrons. Because of these variations, and because of the important role fulfilled by RCP, the remainder of this discussion shall address the remaining misunderstandings still surrounding the practice of generating and maintaining cooperative equity.

Retained Equity Apportionment

One of the fundamental concepts of the cooperative way of doing business - one based on fairness and equitability suggests that each member's investment in the cooperative be proportionate to each member's use of that cooperative. Most recent adjustments in RCPs used by cooperatives have been designed to provide a convenient mechanism for apportioning each member's investment to most accurately reflect this concept. Were this not attempted, some members would become over-invested and, in effect, result in their subsidizing others.

There are many ways to estimate a member's "use" of a cooperative's services. Historically, this "use" has been tied to dollar business volume, units of business transacted, assets employed, and/or patronage generated. Overall, most capital apportionment systems are patronage-linked. With single product or service cooperatives, in particular, this is generally found to be an

acceptable procedure. For larger, multi-product cooperatives, the patronage basis may represent an erroneous measure of members' use.

For example, products that generate little or no savings as a result of their sale distort the true usage of the cooperative's assets. More simply, if a member purchased only relatively low margin products or services, that member's usage on a patronage basis could be well below that proportion of company assets actually employed to provide that product or service. Users of low-margin products or services are, therefore, subsidized by the users of high-margin products or services. In an attempt to correct this inequity, some cooperatives have designed a system for capital apportionment that reflects each member's employment of the firm's assets. Most of these systems weigh each member's volume of business by the assets required to provide the needed products or services and then apportion each member's required capital retain in accordance with each member's proportionate use of total firm assets employed. Equalization of equity held normally takes place under these systems by having the under-invested members purchase preferred stock from over-invested members - subject to some maximum cash limits. Other firms may rely on the entire revolve period to allow an over-invested member to recover his equities ... which are concurrently replaced by equities secured by under-invested members.

Other recent changes in cooperative equity programs relate to the conditions and terms under which equity certificates may be redeemed. Some cooperative members are less than pleased by their inability to gain a refund on their equity whenever they wish. Others are unhappy that this capital does not earn a dividend during the period it remains with the cooperative. A recent study by the ESCS-USDA suggests there are sound reasons for this discontent as 29 percent of marketing and supply cooperatives had been operating in the complete absence of an equity redemption program. In addition, it was found that 10 to 48 percent of their total equities were held by persons who were no longer active in the cooperative organization. Another study by the General Accounting Office resulted in similar findings and contributed much towards a GAO report to Congress suggesting that redemption programs should be adopted quickly by cooperatives, either voluntarily, or under the threat of legislation mandating it.

Indeed, I believe those cooperatives with no form of equity redemption program should add such provisions to their RCP. Those cooperatives with specialized or limited plans should consider a more comprehensive program ... one incorporating the revolving concept, the base capital concept, or some other similar program that addresses the adequacy and equitability requirements. Should a cooperative's financial position be such that it cannot *regularly* revolve or adjust the capital base, then it should allow for the redemption of equities held by estates for members who retire from farming and/or who move away from the area or reach a specified age (post-retirement).

Revolving Equity and Capital Formation

Proponents of the free enterprise system argue that "control follows ownership." In privately held or publicly owned businesses, ownership and control rests typically with majority stockholders, many of whom are serving as managers or officers in the company. For the cooperative business, however, ownership is dispersed amongst all member-patrons and control is normally not a function of the number of shares of stock held. Control, therefore, rests with *all* the holders of equity capital and can be easily sacrificed if this equity capital is inadequate or inequitably distributed.

This discussion has shown that the RCP provides for both adequacy and equitability under conditions of modest cooperative growth and a stable economic or marketing environment. Within the past decade, these conditions have not prevailed and many cooperatives have begun to struggle with their existing capital programs. Rapid rates of growth and competitive pressures to adopt expensive technological equipment have resulted in some cooperatives' failure to maintain a healthy equity capital base. Given such an "exposed" position, the cooperative is ill prepared to deal with adverse economic conditions. They remain in a weakened state and could become easy prey to an attack by competitive forces or a recessionary economy.

All cooperatives should adopt equity redemption programs and adhere to their parameters. Such adaptation requires that the redemption impact be incorporated into a long-range financial plan. As more cooperatives establish such redemption programs, either voluntarily or under legislative

threat, there will be more and more need to build and maintain a healthy capital base.

Sky-high interest rates and sky-rocketing inflation have also impacted cooperative capital formation. The more highly leveraged an organization finds itself, the more adversely it is impacted by record-high interest rates. As inflation runs rampant, existing plant and equipment depreciation schedules become obsolete and replacement requires greater expenditure than that allowed for in previously existing schedules. Hence both of these phenomena argue in support of a stronger equity capital base.

As the agribusiness industry grows more complex and vertically integrated, cooperative members are asking their organizations to further expand their service offerings to include such things as expanding exports and underwriting the development of facilities for the production of alternative forms of energy. Quite obviously, such functions cannot be easily performed by cooperative organizations already short of equity capital.

Despite numerous attempts to replace revolving capital (or base capital) programs with various forms of permanent, dividend-generating equity, few have met with success. The search continues for some variation in the RCP that will meet the cooperative's requirement for capital adequacy and equitability. No miraculous discoveries are likely to be found, but the cooperative can no longer "low profile" the organization's need for equity capital supplementation. Strong capital programs do not evolve accidentally. They result from the long-term serious study of the cooperative's needs and its members' financial ability. During the past decade, cooperatives have relied on debt capital to fund those programs or functions which equity capital could not support. As creditors' investment in cooperative operations now approach two-thirds the value of all assets employed, it is easy to see why the trend cannot extend much further without a heavy infusion of member-equity capital. If cooperative members are going to retain control over their cooperatives, the necessary equity capital must be provided. For this, there are no alternatives.

Sincerely,



Ken D. Duft
Extension Marketing Economist