AGRICULTURAL
GUIDE
Published by the University of Missouri-Columbia Extension Division

Cooperatives

# Securing equity capital for farmer cooperatives

JUN 24 1986

C. Brice Ratchford and Brian Griffith
Department of Agricultural Economics
College of Agriculture

Archive version - check for updates

Most Missouri farmers belong to and patronize one or more cooperatives. One feature that differentiates cooperatives from investor-owned firms (IOFs) is that cooperatives are owned by the members who are also the patrons. Cooperatives are identical to competing IOFs in terms of capital requirements. They are also similar in that total capital requirements are met through some combination of borrowed funds and equity funds provided by the owners. While the optimum combination varies from firm to firm, the average optimum should be essentially the same for all types of firms.

Most cooperatives have had difficulty raising equity capital. As a result, they have depended heavily on borrowed funds. The high real interest rates that have prevailed for the past five years reveal the weakness of this approach.

One reason cooperatives have difficulty raising equity capital is they can only provide limited return on it. Limits of 10 percent are set by Missouri statutes[1] and the Federal Capper Volstead Act. They are reinforced by the Internal Revenue Service code.

In reality, almost no cooperatives pay any return on equity capital, as such. Furthermore there is no chance for capital appreciation of co-op equity. The members and owners must get benefits by using the cooperative.

This publication describes the sources of equity capital that cooperatives can use in Missouri. It also outlines a few problems with the approaches.

## Sources of equity capital

The sources of equity capital are essentially the same for all Missouri farm supply and marketing cooperatives with the exception of Mid-America Dairymen, Inc. Most agricultural cooperatives in Missouri are incorporated under Chapter 274 or Chapter 357 of the Revised Missouri Statutes. Chapter 274 dictates the formation and operation of a nonstock cooperative, while Chapter 357 dictates the formation and operation of a stock cooperative. In this guide we will use the term 274 co-op to describe cooperatives incorporated under Chapter 274 and 357 co-op to describe cooperatives incorporated under Chapter 357.

### 1. Initial payment by members

Many Missouri cooperatives require prospective members to pay a one-time entrance fee. For 357 co-ops, the fee is usually one share of common stock; for 274 co-ops, it is the purchase of a membership. In Missouri cooperatives, the initial fee is modest, ranging from $10 to $25. A few require fees as high as $100.

In many established cooperatives, the membership fee is deducted from a patronage refund. Thus, farmers could become members of a co-op without asking to become members.

Regardless of the method used to secure the entrance fee, the amount of capital raised is small in absolute terms and in relation to total capital needs. Many 357 co-ops offer members and nonmembers shares of preferred (nonvoting) stock. This approach could raise a lot of capital. It has not done so in Missouri, perhaps because it has not been encouraged.

Many marketing cooperatives around the United States raise substantial capital through a large entrance fee. For example, rice cooperatives often require a $100-per-acre investment. Sugar co-ops require $1,000 or more per acre. Some dairy co-ops require a minimum $100-per-cow initial investment. Such approaches not only raise substantial capital, but also provide strong incentives for members to support the cooperative.

### 2. Retained allocated earnings

Retained allocated earnings are the major source of equity capital in Missouri co-ops. They are accumulated by allocating co-op net earnings to members based on their business with the co-op. These allocations are called patronage refunds. The cooperative pays the member some percent in cash (usually 20 to 50

[1]Mo. Rev. Stat. Section 357.130.

percent) and retains the balance—retained allocated earnings. The part not paid in cash is shown on the records as members' equity. In a 357 co-op, evidence of ownership may be preferred stock. In all 274 co-ops and some 357 co-ops, the evidence of ownership is a *notice of allocation*.

This approach is a fairly painless way to raise capital, but there are several problems with it. First, the co-op must make net earnings. Furthermore, annual earnings may not be highly related to capital requirements at a given time. Finally, a member relations problem can occur because, as most co-ops currently operate, the individual member has a tax liability on both the cash and the retained patronage refund.

### 3. Per unit capital retains

Many marketing co-ops require that a small per unit (bu., cwt.) "retain" be added to equity capital. The only co-op in Missouri using this approach is Mid-America Dairymen, Inc.

There are a number of advantages to this approach. It is more dependable than retained earnings because volume changes less than earnings. The co-op can change the amount of the per-unit retain to reflect capital needs. It also tends to keep the capital provided by members consistent with current use. Farm supply and grain marketing co-ops have never used this manner of obtaining equity capital, although they could.

### 4. Unallocated earnings

Cooperatives may retain earnings that are not allocated to patrons. Most Missouri cooperatives have been conservative in using this approach for securing capital. Most have kept only earnings from non-member business or non-business related activities in this category. Recent troubled financial times have added pressure to depend more heavily on this method for accumulating capital.

Several problems with the approach exist. The cooperative must pay income taxes on such earnings. Before a co-op can use the method, it must have earnings. The approach also violates the co-op principle "operating at cost."

## Most equity capital is not permanent

Individuals are discouraged from investing in co-ops because co-ops can only provide limited returns on capital. A major problem for the cooperative corporation is that none of the capital, except unallocated earnings, is "permanent." At some time, all other equity must go back to the owners.

In an IOF, equity raised through sale of stock and retained earnings is permanent in the sense that the corporation has no obligation to ever redeem this paper. The owner of the paper is free to sell it to anyone, at either the price quoted on a stock exchange or at an individually negotiated price. The corporation simply changes the name of the owner on its books.

In a cooperative, equity is redeemable only by the cooperative and, unless there are bylaw provisions, it is redeemable only at the discretion of the board of directors. Therefore, most cooperatives have developed plans for redeeming equity. Some co-ops plan to retire equity on a regular basis. For example, they return all equity that has been in the cooperative for a certain number of years. Farmland, Inc. and some of its affiliated local cooperatives retire equity in five installments after a member reaches 65 years of age and retires. All co-ops must settle a member's equity account upon death and settlement of the estate of a member.

There are two major problems with equity retirement or revolvement plans. First, the ability to revolve "out" or redeem member equity depends on having current earnings or new capital retains. Second, the co-op needs to secure new capital constantly to replace any equity that is retired or is needed for expansion.

## Equity vs. debt capital

Many co-ops have borrowed from members and issued bonds or certificates of indebtedness. Such instruments carry a maturity date and usually a stated rate of return. Any instrument with a stated maturity date is debt capital, regardless of source, and must be shown as such on the balance sheet.

## Conclusion

Cooperatives have served farmers well. They differ in fundamental ways from IOFs. Emphasis should be placed on the word *differ.* Because of the differences, the cooperative corporation has some advantages and some disadvantages over IOF corporations. The unique features of equity capital in a cooperative tend to be a disadvantage.

Co-ops can overcome the weakness by applying some combination of a large front-end investment, capital retains, and a steady stream of current earnings. They can use concepts such as the base capital plan, relating capital needs to current patronage.

■ Issued in furtherance of Cooperative Extension Work Acts of May 8 and June 30, 1914 in cooperation with the United States Department of Agriculture. John W. Oren, Director, Cooperative Extension Service, University of Missouri and Lincoln University, Columbia, Missouri 65211. ■ An equal opportunity institution.