Financing Agricultural Co-Operatives

AN OVERVIEW › UPDATED JUNE 2018

CANADIAN AGRICULTURAL PARTNERSHIP

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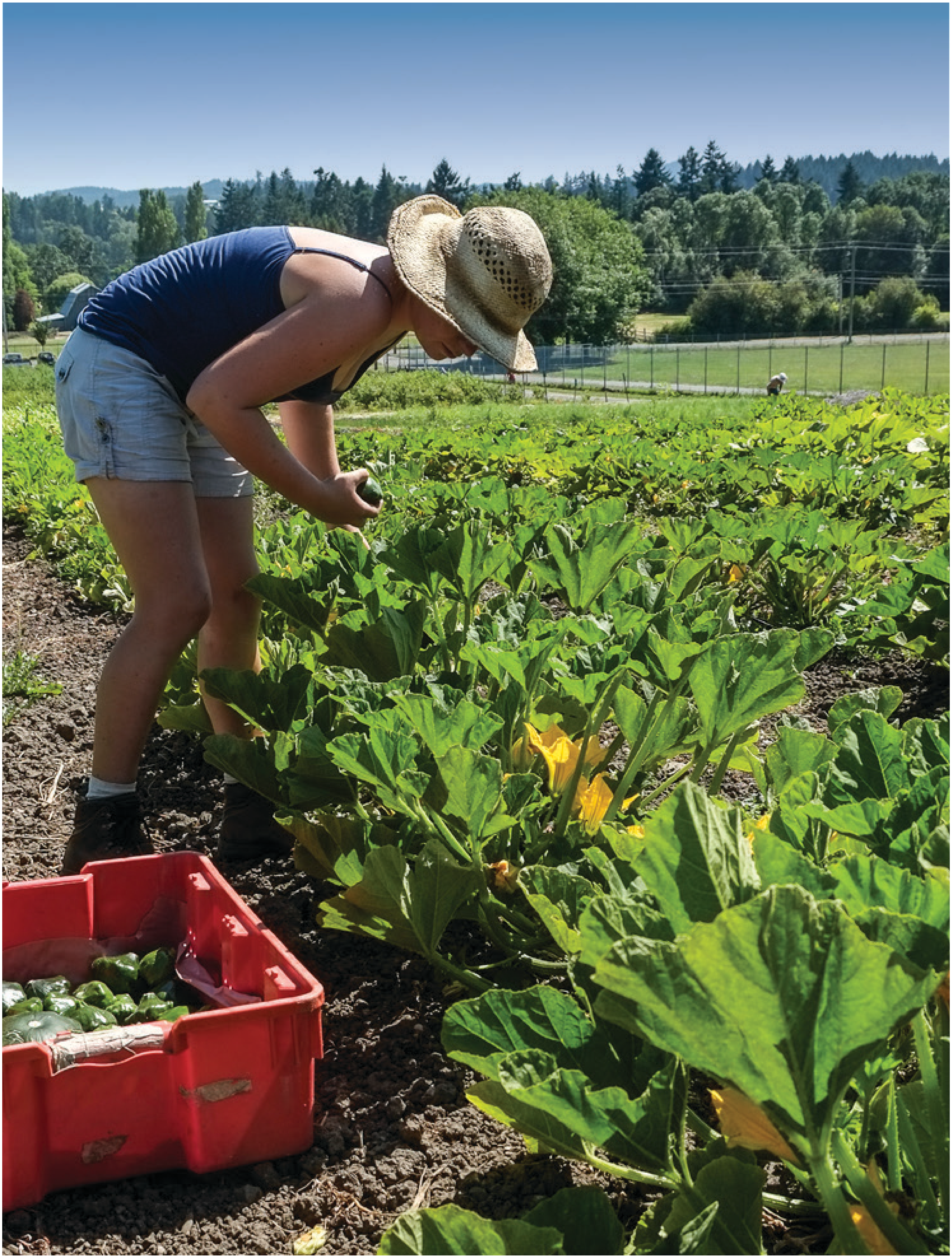

Contents

Acknowledgments

The material in this booklet draws heavily from and builds upon earlier works published by various organizations and government agencies in Canada and the United States. Without the leadership offered in these works, this booklet could not have been produced. A partial list is as follows:

- *Cooperative Financing and Taxation. Rathbone, R. C. United States Department of Agriculture.*
- *Base Capital Financing of Cooperatives. Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture.*
- *New Generation Co-operatives: Revitalizing Rural Communities. B. Stefanson, M. Fulton and Harris. Centre for the Study of Co-operatives, University of Saskatchewan.*

A complete citation of these works as well as additional references are provided at the end of this booklet.

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Both booklets were updated in January 2018 by Greenchain Consulting, a Vancouver-based local food and agriculture consulting form that has worked extensively with Co-ops in developing local food enterprises.

The responsibility for the content and all opinions in this document are the author's alone. The report does not necessarily reflect the opinions of the federal and provincial governments which funded the project.

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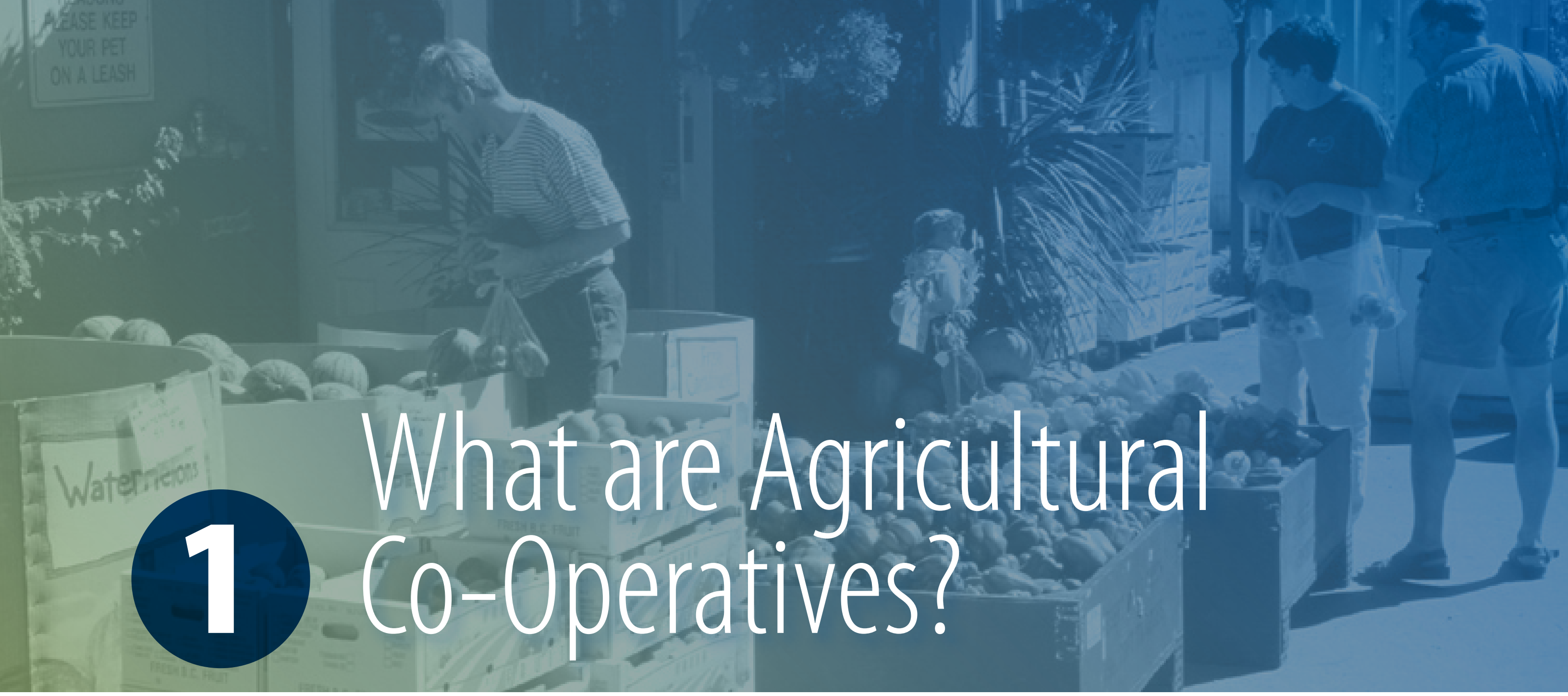


1 What are Agricultural Co-Operatives?

A co-operative is a type of enterprise that is owned and democratically controlled by members—the people who use and benefit from its services.

Almost any type of business can be organized as a co-operative and co-operatives operate in almost every sector of the provincial economy. Agricultural co-ops give agricultural producers an opportunity to own and control businesses related to the products they produce, allowing them to share their costs or combine their marketing efforts to achieve greater financial success than they could achieve on their own.

Types of Agricultural Co-operatives

Two main types of agricultural co-operatives operate in B.C., which are designed to help producers either reduce the cost of production or increase the demand for their end products. A third type, New Generation Co-ops, operate in other provinces and in the US. Each is briefly described below.

SUPPLY CO-OPERATIVES

Supply co-operatives are focused on using their collective buying power to access product inputs, materials, equipment or land at competitive rates. This allows them to reduce their operating costs and gain access to inputs that they could not access on their own. Supply co-ops can range from simple buying clubs organized by producers to access bulk or volume discounts, to large wholesale and retail operations which provide a wide variety of goods and services to a broad range of producers.

MARKETING CO-OPERATIVES

Agricultural producers create marketing co-operatives to jointly market and distribute their products. By aggregating the production of a number of smaller producers, a marketing co-operative can meet the order minimums of larger commercial or institutional buyers. By pooling their resources, producer-members can hire professional marketing specialists to promote them and create a single ordering portal so that buyers can place one consolidated order for all the member producer products, have it delivered on one shipment and pay one invoice.

NEW GENERATION CO-OPERATIVES

New Generation Co-operatives (NGCs), which are not that new any more as they have been operating since the 1990's, are co-ops that use a unique share structure to raise large amounts of money for value-added processing activities. All three Canadian Prairie Provinces have introduced new laws or modified their legislation to allow for NGCs. However, no NGCs have been established in B.C. and the British Columbia Cooperative Association Act does not include any mention of NGCs. As a result, they are not discussed further in this guide.

Governance Options for Agricultural Co-operatives

Prior to 2007, only for-profit co-ops were permitted under B.C. law. However, following amendments to the B.C. Co-operative Association Act in 2007, non-profit organizations can incorporate as community service co-ops. Each governance approach is briefly described below.

FOR-PROFIT CO-OPS

For-profit co-ops can offer investment shares to help fund the operations of the co-op. While all co-op members must purchase membership shares, which gives them membership privileges, investment shares are optional. Members (or non-members that purchase investment shares in for-profit co-ops) are entitled to receive dividends in proportion to the amount of their investment.

NON-PROFIT CO-OPS

Non-profit co-ops are not allowed to issue investment shares but can be eligible for charitable status. Also, on dissolution, their assets cannot be returned to the members. They must be transferred to another non-profit co-op or charitable organization.

Types of Shares offered by Agricultural Co-operatives

Most agricultural Co-ops are controlled by producers and therefore have only one class of shares that are issued to producers. However, some agricultural co-ops have multiple classes of shares so that different types of shareholders can have an ownership stake in the co-op. These are called multi-stakeholder co-operatives and, in addition to producer shares, they may issue worker shares, consumer shares, and/or supporter shares. Multi-stakeholder co-ops are often considered for food hubs, where control of the co-op may be shared with both producer members and consumer members. Multi-stakeholder co-ops can be more challenging to operate because the interests of the different types of shareholders may not always be aligned. These issues can generally be overcome by creating effective processes to resolve conflicts before they arise.

More information about Agricultural Co-ops and how to start them is provided in the companion guide to this document: Agricultural Co-ops in B.C.: A Start-Up Guide.

2 Overview of Agricultural Co-Op Financing

Like all revenue-generating enterprises, agricultural co-operatives must maintain sufficient levels of equity capital to ensure the financial viability of their operations.

However, in a co-operative, membership shares and equity capital also provide the basis for member ownership and control. This makes some of the financial characteristics of co-operatives different from other forms of business.

The following considerations factor into the financial decisions and policies of for-profit co-operatives:

- *The members must maintain a controlling ownership stake in the co-operative so the majority of the co-operative's equity capital needs to be obtained from members.*
- *The benefits that members receive from their membership (e.g. annual dividends) will be proportional to the amount of capital they have contributed and all members are generally required to provide a minimum amount.*
- *It is generally expected that the majority of member contributions should be from active members that currently use or benefit from the services of the co-op. Non-active members are encouraged or required to sell their shares so that they can be made available to active members.*

These considerations influence the ways in which co-operatives finance their operations and handle equity in the business. Some of the methods used to acquire capital, accumulate equity, and redeem member equity are presented below.

Determining Capital Needs

Before identifying where new sources of capital can be raised for a new co-op, it is important to first determine how much and what type of financing is needed. There are two major types of funding needs for any new co-op: pre-launch start-up funds and post-launch operating funds. Each are briefly described below:

PRE-LAUNCH FUNDING

At this stage, the goal is to identify all the equipment, vehicles, warehouse space, supplies and pre-launch labour costs that will likely be incurred to launch the co-op and to get them onto a list. The next task is to estimate the costs for each item on the list and determine the total costs. It is easy to view this list as somewhat fixed because most items on the list will seem very worthwhile and necessary. However, with a little effort it is generally possible to find a number of ways to drastically reduce those costs using the following techniques:

- **DETERMINE** *if any of the founding members own some of those assets and may be willing to contribute them on a short-term basis or for a modest rental fee.*
- **CONSIDER** *whether any of the more expensive items, like vehicles, can be rented or leased, instead of purchased. In the case of vehicles they may be able to be avoided altogether in favour of third-party distributors.*
- **IDENTIFY** *the opportunity to use a portion of an existing warehouse space as opposed to renting a dedicated space. Not only is the sublet space cheaper, but it often includes costs such as insurance, security, utilities, and so on. The most ideal option is a founding co-op member that has extra space to offer the co-op on a short term, rental basis.*
- **SEE** *if any items can be purchased second hand, instead of buying them new.*
- **ASK** *the local community to provide volunteer labour for certain tasks.*

Using a combination of these methods, it is surprising how much the initial startup costs can be reduced. The one place not to skimp, however, is ensuring that sufficient funds are allocated to hire a manager to coordinate all the pre-launch tasks. It is possible to avoid labour costs at the pre-launch stage, but this comes at a significant cost in terms of a much longer, pre-launch development period and much poorer co-ordination of tasks, both of which can wipe out the savings of not hiring a manager at this critical pre-launch phase.

POST-LAUNCH WORKING CAPITAL FUNDING

Almost every start up enterprise takes a significant time to build up a customer base before it reaches its financial breakeven. A good rule of thumb is to assume that the co-op will not reach this point until its third year of operations. This means that it will likely lose money every month for the first 24 to 30 months. The funds needed to keep the co-op operating during this initial growth period is called working capital funding.

To determine how much working capital funding is required, it is important to create financial projections for each month of operation until that magic financial breakeven point is reached. This involves making a number of assumptions about how fast the revenues will grow, what the net margin will be on those sales, and what the overhead expenses are likely to be. This may seem like guess work but by carefully identifying the assumptions that drive the projections, it should be possible to come up with a financial picture that feels reasonable to the members. Once that it is done, it is just a matter of adding up all the declining losses to the breakeven point. The resultant number is the amount of working capital funding needed. The goal should be to raise at least the first full year of working capital needs plus 100% of the pre-launch funding before making a final go:no:go decision on proceeding with the co-op.

Acquiring Capital

When forming a co-operative business, the founders must plan how they will acquire enough capital to cover the pre-launch start-up costs of the business as well as operating losses until the co-op reaches a financial break-even. Potential sources of capital for new for-profit co-operatives primarily include member investment and debt financing. Non-profit community services co-ops are generally restricted to debt financing and grants or donations. Provincial legislation prohibits co-operatives from accepting most types of venture capital. Unless otherwise indicated, this document focuses primarily on for-profit co-ops.

DIRECT MEMBER INVESTMENT

Investing risk capital in a newly formed co-operative is a basic responsibility of membership — it demonstrates the member's commitment to the successful start-up and continuing operation of the enterprise. Direct member investment can also be a way for established co-operatives to raise capital for a special need, such as purchasing new assets or expanding operations. Three types of direct member investment in co-ops include:

- *The purchase of membership shares;*
- *The purchase of investment shares;*
- *The payment of fees.*

Regardless of the amount of capital an individual member invests in a co-operative, he or she is entitled to only one vote when deciding on major policy issues and when electing the board of directors of the co-operative. This restriction is based on the control structure of co-operatives, which is linked to membership, not ownership.

MEMBERSHIP SHARES

Under the Cooperative Association Act of British Columbia, individuals are required to invest an initial amount of capital to become a member of a co-operative. To meet this requirement, all co-operatives must issue a class of shares specified as membership shares. Every member must purchase at least one membership share. The share value can vary, depending on the nature and mandate of the co-operative. Co-operatives do not usually pay interest on membership shares.

INVESTMENT SHARES

In addition to membership shares, co-operatives can issue investment shares to members or non-members to raise capital. Investment shares may be divided into different classes, with different values and conditions attached. The interest paid on investment shares is determined by the board of directors, and, unless otherwise defined in the rules of the co-operative, is limited to an eight percent annual return.

Some co-operatives require members to purchase investment shares in proportion to the amount of business they conduct with the co-op (e.g., the number of units of raw product they deliver to a co-op's warehouse or the amount of product they purchase from a supply co-op). In this way the member's investment in the co-op reflects his or her use of the services provided by the business.

MEMBER FEES

Co-operatives may charge an annual membership fee or a one-time fee when new members join the organization. The Board of Directors determines the amount and frequency of membership fees.

DEBT CAPITAL

Debt capital is money borrowed with a legal obligation to repay it under stated interest rates, terms, and conditions. Agricultural co-operatives use the same debt capital sources as other businesses. Primary sources include commercial banks, credit unions, and specialty lenders such as government agencies. Co-operatives may also borrow money from their members and, under certain circumstances, from non-members. Because of the structure of co-ops, raising equity is a better option because it only has to be redeemed when it is no longer needed whereas debt payments must be made regardless of whether the co-op has the funds to make those payments. Debt capital is divided into two general categories: short-term and long-term.

SHORT-TERM DEBT

Short-term debt is repayable in one year or less. Most co-operatives establish an annual short-term operating line of credit with a lending institution. This type of loan commitment helps the co-op manage day-to-day cash flows and gives it the flexibility to borrow and repay amounts as needed up to the limit of the credit line.

Short-term borrowing can be used to pay for purchases or to pay members for their products in advance of when the co-op receives payment. When the co-op receives payment, it then repays its operating loan. In addition to borrowing short-term capital from institutions, co-operatives may also borrow from members.

LONG-TERM DEBT

A co-operative typically acquires long-term debt primarily to finance the purchase of fixed assets. Long-term debt may also be used to increase working capital for general operating purposes.

Long-term loans can be structured in many different ways to meet the needs of the borrower and the lending institution. Generally, long-term loans are granted in an amount equal to 60 to 70 percent of the cost or value of the asset being financed. The co-operative finances the remaining amount from its equity capital. Repayment is usually scheduled in annual installments over the life of the loan. The repayment period depends on the type of asset being financed and its useful life. For example, equipment loans may be for ten years while a loan to construct a building may be repaid over 30 years.

Depending on the financial strength of the co-operative, the lender may require certain conditions as part of the loan obligation. Conditions can include:

- *A specified minimum level of working capital;*
- *Certain minimum financial performance standards;*
- *Limits on expenditures for fixed assets;*
- *The lender's approval to redeem, or pay-out, equity to members.*

These conditions protect the lender in case the co-operative's financial condition declines. They also affect the amount of control the members have over the business. A financially stronger co-operative (i.e. one with a larger level of member investment and stronger financial performance) may have fewer conditions imposed on it.

LEASING

Leasing is another form of debt and can be set up on a short-term or long-term basis. A short term operating lease can be arranged for the seasonal use of a piece of equipment such as a forklift. Longer-term leases involve a leasing company purchasing an asset and then leasing it to the co-operative for a specific period of time or for the life of the asset. The co-operative pays the lease company "rent" in the form of lease payments. At the end of the lease term, the co-operative either returns the asset to the leasing company or purchases the asset for a price set at the beginning of the lease.

Long-term leases generally range from three to seven years, depending on the type of asset involved. Financial leases can be used for such capital items as vehicles, computers, and equipment.

In deciding how to finance the acquisition of an asset, a co-operative needs to analyze the relative advantages of using traditional debt financing versus some type of lease arrangement. This cost comparison must consider the impact each alternative will have on the financial return to the membership, and the long-term impact on the co-operative's finances.

Some of the advantages of leasing include:

- *Avoiding having to use existing cash reserves to make a down payment of 30 to 40% to purchase the asset.*
- *Achieving a lower effective interest rate because the lessor can pass on to the lessee the tax savings realized from depreciation and other expenses*
- *Being potentially able to return the asset, such as a vehicle, before the repair costs become excessive.*

Crowdfunding: A new method of raising equity or debt financing

In recent years, a new avenue of funding has emerged that relies on enabling many people to make contributions to projects, typically through a website, that they really like. A wide range of agriculture and local food enterprise have successfully raised money through crowdfunding platforms. There are four primary ways that agricultural co-ops could raise money through crowdfunding (although not all platforms offer all four types), as follows:

- **DONATIONS –** *Local residents make a donation of $30 to $100 and, depending on the number of backers, this method could reasonably be expected to raise $5,000 to $8,000. This a good option for non-profit co-ops.*
- **REWARDS –** *In this case, the co-op would offer different rewards in return for contributions. Typical rewards could include 4 baskets of fresh produce for $100, a harvest dinner on a farm using on-farm ingredients, $100 worth of processed products for a $100 contribution, and so on. This method could raise $20,000 - $25,000.*
- **DEBT –** *The co-op would issue loans to buy equipment and repay the loans, typically over a 3 – 5 year period with interest. Under the new crowdfunding rules approved by the B.C. Securities Commission, a firm can raise up to $250,000 from un-accredited investors, that would normally not be allowed to do unless they were close friends, employees or business associates of the enterprise.*
- **EQUITY –** *The co-op could issue membership shares or investment shares (for-profit co-ops only) to new members. The same $250,000 limits apply for both debt and equity campaigns.*

While a co-op would typically pay a 5% commission and a 3% payment processing fee to list the campaign on a crowdfunding site, these platforms can generate very significant exposure for the co-op's products that can easily justify that expenditure. Crowdfunding sites that specialize in local/community projects are the best option for co-ops.

Accumulating Equity

Once the co-operative is operating, the goals are to accumulate sufficient equity through successful business operations to cover continued operations, to finance growth and to build up the net worth of the co-operative. Co-operatives accumulate equity by:

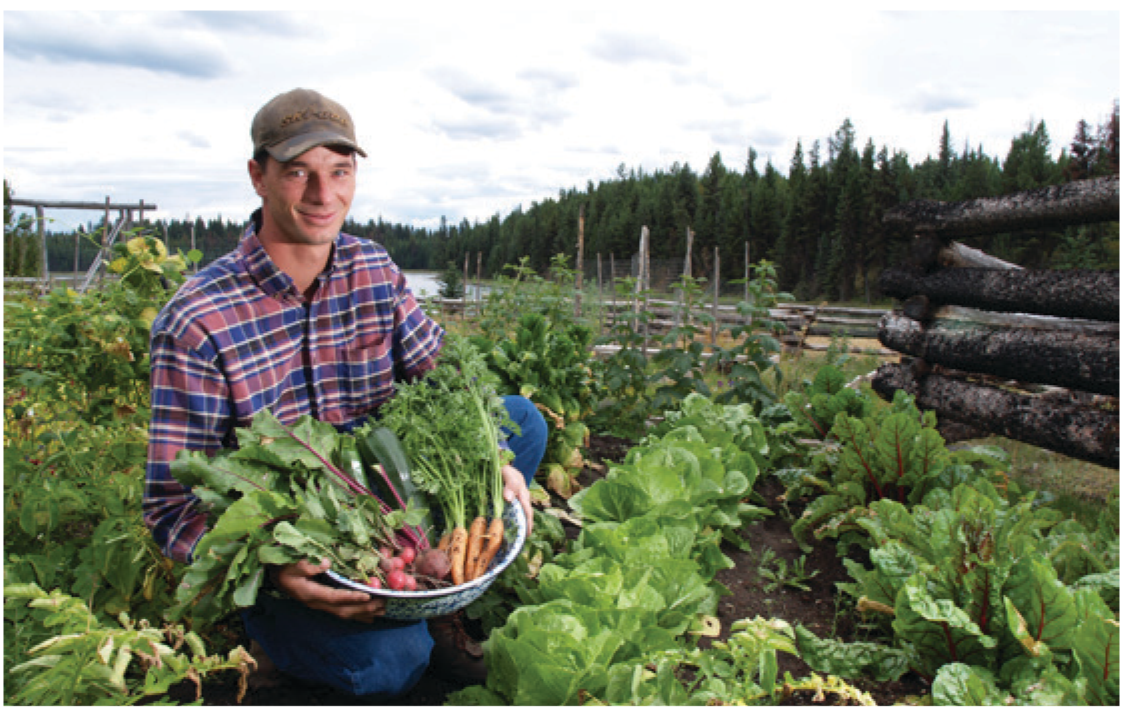
- *Retaining a portion of the patronage refunds declared in a given year;*
- *Retaining a portion of the net income generated by the co-operative as unallocated equity;*
- *Collecting capital contributions from members through per-unit retains (amounts collected in relation to their patronage).*

The above methods for accumulating equity can limit a co-operative's need for direct investment by members. However, members may be asked to invest in their co-operative under certain circumstances, such as a disaster or major expansion.

RETAINED PATRONAGE REFUNDS

Retained patronage refunds are an important source of financing for many agricultural co-operatives. At the end of a co-op's fiscal year, the co-op determines its operating profit. The profit can be either allocated to members on the basis of their patronage or it may be retained in the co-op as unallocated equity. The net earnings allocated to members on the basis of their patronage are called patronage refunds or patronage dividends.

The board of directors of a co-operative may choose to pay out in cash, all or a portion of, the patronage refunds declared in a given year to the members. However, co-operatives typically elect to leave a portion of the declared patronage refunds within the business as equity to finance continued operations and growth.



Allocated and Unallocated Equity

Two types of equity exist in a co-op – allocated and unallocated. Allocated equity is equity that corresponds to a particular member's accounts and includes the money they invested through their purchase of membership shares, investment shares or through retained patronage funds and per-unit retains. So long as the co-op is solvent, the co-op maintains an obligation to pay back the allocated equity to the member at some point in the future. The obligation to redeem member equity is unique to co-ops and stems from that fact that each member is an owner and has the right to have their equity paid back when they no longer use the services of the co-op.

Unallocated equity is the same as equity in a regular business in that it is non-allocated to any member and can be used to pay for any financial need of the enterprise. Unallocated equity is owned by the members collectively and can only be paid to members in cases where the co-operative is being dissolved or as refunds or dividends. Unallocated equity is typically built up from the net profits of the business, but can also be increased from the sale of assets, or an equity infusion from a merger with another co-op.

Adapted from Cooperative Financing and Taxation. Rathbone, R.C. United States Department of Agriculture.

Financing a co-op through the reinvestment of patronage refunds is a simple and straightforward way for members to carry out their obligation to finance the business according to their use of the services provided. However, retained patronage refunds are not always the most reliable source of capital because it is dependent on the co-operative's profitability. In good years, a co-operative may have a large amount of capital to retain. In poor years, little new capital is available.

ACCOUNTING NOTE: "Patronage refunds payable" is a current liability account unique to co-operatives. This amount is owed to members, in cash, based on the amount of earnings the co-operative's board of directors has decided to allocate to member accounts. In a marketing co-operative which operates on a pooling basis, this category may be called "due members." It reflects the amount owed for product delivered, if the amount earned exceeds the amount advanced.

UNALLOCATED EQUITY

In addition to distributing a portion of the co-operative's net earnings as patronage refunds at the end of the fiscal year, the board of directors may choose to retain a portion of net earnings as unallocated equity. Unlike retained patronage refunds, unallocated equity is equity capital that is not allocated to specific member accounts (see above).

In years when the co-op loses money, unallocated equity provides an alternative to charging losses against members' equity in the co-op. Some co-operatives (those that have not built up their capital reserves to a level specified in the B.C. Cooperative Association Act) are required to retain ten percent of net surpluses each year as a capital reserve in an unallocated account.

When deciding whether or not to retain a portion of the net earnings of the co-operative as unallocated income, directors must be mindful of removing the direct link between an individual member's ownership in the business and the co-operative's capital base. While unallocated equity is still owned by the members collectively, members do not have a specific ownership stake in it. If too much of a co-operative's capital base is made up of unallocated equity, members may become reluctant to patronize or invest in their co-operative, as the benefits from doing so become less clear.

Taxation of For-Profit Co-operatives

Like all businesses, for-profit co-operatives (including supply and marketing co-operatives) pay taxes. However, the amount of taxes paid by co-operatives can be different depending on decisions made by the co-op's board of directors. Co-operatives also tend to distribute their profits differently than corporations.

Consider the choices available to a co-op's board of directors at the end of the fiscal year. If the co-operative generates a profit, the board must decide how the profit will be distributed. If the co-op has issued preferred share, the dividends on those shares must be paid first. The board can then decide how to deal with the remaining funds (if any), which could include one or more of the following:

- *Distribute a portion of the surplus to the members in cash (as patronage refunds), generally on the basis of business done with the co-operative,*
- *Retain a portion of the surplus as retained patronage refunds,*
- *Retain a portion of the surplus as unallocated retained earnings.*

PATRONAGE FUNDS: A co-op's net surplus on business conducted with or for members is not taxable to the co-operative if this income is distributed or allocated to members on the basis of business done with the co-operative. However, those funds are taxable to members, regardless of whether the patronage funds are retained by the co-operative or paid out as cash in a given year.

It is relevant to note that any business can choose to give cash back to its customers based on the amount purchased and deduct those payments from their taxable income. However, most businesses do not do so because their shareholders expect returns based on their investment, not their patronage.

PER UNIT CAPITAL RETAINS

The amount of equity that can be retained in the co-operative as either retained patronage dividends or unallocated equity fluctuates according to the level of profit at the end of each year. An alternative method for accumulating equity that does not depend on the level of net earnings, and which is therefore considered more stable, is through per unit capital retains.

Like retained patronage refunds, per unit capital retains are collected from members in proportion to the amount of patronage or business they have done with the co-operative. However, unlike patronage refunds, per unit retains are based on the number, or dollar value, of units marketed or sold. For example, for each physical unit of product handled by the co-operative, a certain amount of capital is retained as a member's capital contribution to the business. Alternatively, a certain percentage of the dollar value from sales is retained.

Marketing co-operatives, particularly those that use the pooling method of accounting, typically use per-unit retains as a way of accumulating equity. Supply or service co-operatives frequently use retained patronage refunds to accumulate equity because their earnings are generally more stable from year to year. However, many marketing co-operatives also use retained patronage refunds as a source of equity, even though their earnings are generally subject to greater fluctuations.

Redeeming Member Equity

When a co-operative business acquires and accumulates equity that is allocated to its members, the co-operative is accepting the obligation to redeem, or payout, this equity to members sometime in the future. Allocated equity is equity that is assigned to individual members' accounts within the co-op and includes equity generated from direct member investments, retained patronage refunds, and per-unit retains.

A co-operative is not legally obliged to redeem allocated equity within a specific period, but there are advantages to having a structured plan in place to retire members' equity. As members patronize their co-operative, they assume the basic responsibility of providing capital to the business according to their use of the services and products provided. When patronage terminates, so does the financing responsibility.

Unless the co-op adopts a systematic plan to redeem allocated equity, an increasing amount of capital will be held by inactive members. Such a situation can lead to conflicting objectives among the membership. As an extreme example, inactive members may lobby for the dissolution of the co-operative to get their equity out of the business, at the expense of members who continue to rely on the services provided. The periodic redemption of equity also serves to demonstrate to members the value of their investment, encouraging member support through patronage and further investment.

Although there are advantages to having a structured equity redemption plan in place, many co-operatives retain member equity for an unspecified number of years and may only redeem members' equity under special situations, such as death or withdrawal of membership. At a minimum, a co-operative should have a specific policy for dealing with the timely return of equities when a member dies, reaches a certain age, or retires from farming. Such a practice allows for estates to be settled more rapidly. This type of policy also allows an older retired member to access the capital he or she has invested in the co-op when such access is likely to be beneficial.

Some co-operatives have policies for early equity retirement when a member's farming operation is liquidated by foreclosure or the operation is sold outright, regardless of the member's age. This keeps the investment in the hands of current members and, for the inactive member, provides the opportunity to have an out-of-the-ordinary transaction settled in a timely fashion. In some cases, a co-operative may agree to retire equities early, but at a discount from their face or book value in order to avoid weakening the co-op's capital position.

Two structured plans for redeeming member equity in a co-operative include revolving funds and base capital plans. Tradable equities provide an alternative to the redemption of equities.

REVOLVING FUNDS

Most agricultural co-operatives in North America that have structured equity redemption plans in place redeem members' equity through a revolving fund program. Revolving funds are based on a "first-in, first out" method of redeeming equity. This method simply requires the co-operative to establish a target period or revolving cycle for returning capital to members.

The cycle to revolve equity should be kept fairly short to assure members that their investment in the organization is worthwhile. For most co-operatives, a reasonable cycle for revolving allocated equity is five to ten years. However, actual cycles depend on the nature of the co-operative's operations, business cycle and the type of capital acquired.

Co-operatives with revolving funds can be subject to volatility in their equity levels, reflecting the volatility in commodity prices and output. When implementing a revolving fund program, the board and management of the co-operative must retain enough money in the revolving fund to adequately finance the business. This is an important consideration since the equity level must be sufficient to keep operating expenses, including interest expenses, low enough for the co-operative to be competitive. In addition, a co-op's lenders may establish specific equity levels to be maintained.

BASE CAPITAL PLAN

A modification of the revolving fund is the base capital plan. Base capital plans provide co-operatives with a structured method for both accumulating and redeeming equity on an ongoing basis. Under a base capital plan, members' equity investment in the co-operative is maintained in proportion to their patronage. The proportional relationship between members' investment and patronage is accomplished through an annual assessment of each member's use of the co-op over a "base" period of years. This assessment is used to determine if members are either over-invested or under-invested relative to their level of past patronage and the capital requirements of the co-operative.

Co-operatives may use retained patronage refunds, per-unit capital retains, direct member investment or a combination of methods to obtain the required amount of capital from members who are under-invested. Members who are over- invested in relation to their patronage are refunded a portion of their equity in the business.

A more detailed description of base capital plans and how these plans are implemented is provided in the following section.

TRADABLE EQUITIES

As an alternative to the redemption of equities, a co-operative may allow members to trade equities among themselves. This alternative is usually limited to co-operatives operating on a pooling basis and where member equity carries with it some type of delivery or purchase rights for the products sold by the co-operative. The advantage of permitting this type of trading is that the co-operative's total amount of equity is not reduced when a member decides to leave the co-operative.

Financial keys to success for co-ops

While co-operatives are generally set up to provide benefits beyond making a profit, they still need to be able to compete with traditional businesses and be well managed. Here are three financial keys to success for co-ops.

1. **STRIVE TO BE FINANCIALLY SELF-SUSTAINING –** *Agricultural co-ops should strive to make a large enough profit that they can easily cover their working capital needs without loans, make moderate capital investments in their growth and be able to pay patronage refunds. Some co-ops tend to focus on just achieving a breakeven profit to minimize patronage investments, but this significantly limits their ability to pursue new opportunities and means that they are always facing short-term cash flow issues.*
2. **PRIORITIZE CASH RESERVES OVER INCOME DISTRIBUTIONS TO MEMBERS –** *The goal here is to first make sure that the co-op has sufficient funds on hand to manage both liquidity and solvency before making any income distributions or equity redemption payments. While members always appreciate getting their equity redeemed, it is not worth it if they have to contribute those funds back on short notice because too much equity was redeemed.*
3. **USE AN INTEGRATED FINANCE STRATEGY AND RISK MANAGEMENT APPROACH –** *This approaches requires the co-op to strongly consider both the member-producer interests and interests of the co-operative. In other words, the co-op should view itself as both an extension of the member's business and as an independent firm that needs to be competitive in a market economy.*

Adapted from Current Challenges in Financing Agricultural Cooperatives. Choices 3rd Quarter 2011. A publication of AAEA

3 Base Capital Plans

What is a Base Capital Plan?

A base capital plan is a financial management tool that co-operatives can use to:

- *Acquire and accumulate equity in relation to the capital needs of the business;*
- *Manage member investments in the business according to their patronage;*
- *Ensure that ownership and control of the business is kept in the hands of members who actively use the services of the co-operative.*

In many co-operatives, the methods for accumulating and redeeming equity capital are not directly related to the co-op's capital needs. Usually, the amount of new equity capital available results from the organization's profitability or depends on the amount of product handled. For example, if the primary source of equity is from retained patronage refunds, operating results decide the amount of capital available for the business to use in financing capital needs. If a co-operative is using a per-unit retain, the amount of capital available depends upon sales generated or the physical volume of product handled during a given year. Under either method of equity accumulation, minimal financial planning can take place until the operating results are known at the end of the year.[1]

1 Material in this section is adapted from Base Capital Financing of Cooperatives, Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture, Rural Business/Cooperative Service.

Similarly, equity redemption decisions are often based on what is left over after other capital needs are met. The residual approach to equity redemption does not involve much financial management or planning. This approach also reduces a co-operative's ability to adjust its equity levels when faced with unforeseen capital demands in the event of operating losses, low volume of product, or demands arising from large capital expenditures.

With a base capital plan, however, the amount of equity needed is determined in advance by the board of directors, based on careful financial planning. The method for getting the needed capital from members is then established. A base capital plan also brings better control to the equity redemption process. The amount of capital to be redeemed by members during a given fiscal period is included as part of the capital requirements identified in the co-op's financial plan. Redeemable equity is set up as a capital need, similar to fixed asset purchases and long-term debt repayments.

How Does a Base Capital Plan Work?

The objective of a base capital plan is to make the members' equity investment proportional to their level of patronage. For example, if a member's use of the co-op represents four percent of total patronage, a base capital plan provides a method for ensuring that the member's equity investment represents four percent of the total allocated equity required by the business.

CHOOSING A STRUCTURE

To implement a base capital plan, some decisions must first be made regarding the plan's overall structure. Specifically, a base period and measurement unit need to be determined to calculate members' average use of the services provided by the co-operative.

DETERMINING THE BASE PERIOD

The base period is the length of time over which a member's patronage or use of the co-operative is measured in relation to all other members. Although base periods generally range from one to ten years, each co-operative must decide on the length of base period that is best suited to the products handled, the nature of production cycles, and the type of business.

A short base period (from one to four years) is effective in adjusting for rapid changes in levels of patronage. It is also easier to calculate average patronage levels for one-year versus multi-year periods.

A longer base period (from five to ten years) can help smooth out year-to-year swings in patronage and provides a more representative picture of the long-term average use of the co-operative. A long base period is important for co-ops that handle seasonal commodities such as fresh fruits and vegetables, where the year-to-year acreage and yield may change significantly.

As a rule, base periods should be as short as possible, making the program more responsive to changes in patronage levels and keeping ownership in the hands of current users. Shorter base periods also increase the co-operative's ability to adjust members' equity levels to meet the changing capital needs of the business and to address unforeseen circumstances.

DETERMINING THE MEASUREMENT UNIT

A unit is needed to measure each member's use of the co-operative's services over the established base period. The type of measurement unit used varies with the type of co-operative and the commodities handled or services provided. It can be a physical unit of product supplied or marketed, or it can be a percentage of the value of the products handled. The measurement unit selected should be the one that best represents each member's relative use of the co-operative.

A physical unit is easy to use and understand. For example, in a vegetable marketing co-operative, the measurement unit may simply be the number of cases of product delivered. Supply co-operatives can use a physical unit of product sold to its members, such as a ton of feed or fertilizer.

Under a percentage of value method, a member's use of the co-operative is measured by applying a set percentage to the price of the products purchased by, or delivered to, the co-operative for each year in the base period. The percentage value method is a little more complicated than using a per unit method, but it takes into account the possibility that higher commodity values may require more equity to support them.

CALCULATING MEMBERS' PATRONAGE AND INVESTMENT IN THE CO-OPERATIVE

Once the base period and the measurement unit are determined, the co-operative can then calculate each member's average level of patronage. This calculation is used to determine the relationship between each member's level of patronage and their level of investment in the co-operative.

For example, Table 1 illustrates a hypothetical co-operative of five members. A five-year base period is used to calculate average patronage. Member A's $10,000 investment represents ten percent of the total allocated equity in the co-operative. However, Member A's patronage over the five-year base period averaged 15 percent. This indicates that Member A's use of the co-op increased faster than his rate of equity investment. To reach an investment level that is proportionate to patronage, Member A would need to contribute $5,000, since he is under-invested by that amount.

Table 1. Example of current equity investment levels compared with the base period of patronage.

ALLOCATED EQUITY INVESTMENT LEVEL			AVERAGE 5-YEAR BASE PERIOD PATRONAGE	AMOUNT OVER (+) OR UNDER (-) INVESTED	
Member	Amount	Percent of Total	Percent of total patronage	Percent	Amount
A	$10,000	10%	15%	-5%	-$5,000
B	$30,000	30%	25%	5%	$5,000
C	$35,000	35%	20%	15%	$15,000
D	$20,000	20%	30%	-10%	-$10,000
E	$5,000	5%	10%	-5%	-$5,000
Total	$100,000	100%	100%	0%	$0

Source: Base Capital Financing of Cooperatives, Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture.

Member C, on the other hand, is over-invested by $15,000 because his patronage during the 5-year base period averaged only 20 percent of the co-op's total patronage, while the level of investment stands at 35 percent of total member equity. The difference in the level of patronage and investment may indicate that Member C has stopped doing business with the co-op. To achieve proportionality, Member C would be due an equity redemption of $15,000 from the co-operative.

IMPLEMENTING THE PLAN

Once the structure of the base capital plan has been determined, the plan is implemented by:

- *Determining the capital needs of the co-op;*
- *Calculating the investment obligation or equity entitlement of each member;*
- *Obtaining equity contributions from under-invested members; and*
- *Returning equity to over-invested members.*

DETERMINING THE CAPITAL NEEDS OF THE CO-OPERATIVE

One of the most critical components of any capital program, including a base capital plan, is determining the equity needs of the co-operative. The board of directors and the management of the co-op will need to establish the amount of capital required each year based on the organization's short and long-term financial plans. A typical planning cycle begins in the second half of the current operating year when the operating results for the year are fairly well known, and the preliminary capital requirements for the coming year can be identified. This involves a two-step process:

1. **ESTIMATE THE PROJECTED CAPITAL REQUIREMENTS –** *These include fixed asset purchases, long-term debt payments, and other special circumstances under which equity is redeemed separately from the base capital plan (for example, an allowance for the redemption of equities for members who may die or retire over the coming year).*
2. **ESTIMATE THE SOURCES OF CAPITAL FOR THE COMING YEAR –** *These include estimates of patronage and nonpatronage income to be retained, per-unit capital retains, new long-term debt required, and any other equity capital sources.*

The sum of these two estimates provides the total equity capital needed for the coming year.

CALCULATING MEMBERS' INVESTMENT OBLIGATIONS AND EQUITY ENTITLEMENTS

Using the estimate of equity capital needed for the coming year, the co-operative can calculate each member's investment obligation or equity entitlement. For example, Table 2 shows an extended version of the hypothetical example laid out in Table 1. In this case, it is assumed that the board of directors have determined that an additional $20,000 is required to meet the co-op's capital needs for the upcoming fiscal period (for a total capital base of $120,000).

Table 2. Example of required equity investment vs. existing investment level

MEMBER	SHARE OF REQUIRED EQUITY*	CURRENT FISCAL YEAR ALLOCATED EQUITY LEVEL	NEXT FISCAL YEAR ALLOCATE EQUITY LEVEL	AMOUNT OVER (+) OF UNDER (-)INVESTED	AMOUNT RETAINED OR ADDED	EQUITY REDEEMED	ENDING ALLOCATED EQUITY LEVEL
A	15%	$10,000	$18,000	-$8,000	$8,000	$0	$18,000
B	25%	$30,000	$30,000	$0	$0	$0	$30,000
C	20%	$35,000	$24,000	$11,000	$0	-$11,000	$24,000
D	30%	$20,000	$36,000	-$16,000	$16,000	$0	$36,000
E	10%	$5,000	$12,000	-$7,000	$7,000	$0	$12,000
Total	100%	$100,000	$120,000	-20,000	$31,000	-$11,000	$120,000

Based on average patronage levels over the 5 year base period
Source: Base Capital Financing of Cooperatives, Rathbone, R. C. and D. R. Davidson. United States Department of Agriculture.

As in the previous example, Member A's investment at the end of the current year is $10,000. However, the required investment to support the capital needs of the co-op in the coming year is $18,000 (15 percent of the co-op's total capital requirements). Member A will need to satisfy the $8,000 shortfall. Of the five members presented in this example, Member C is the only member who is over-invested relative to the co-op's required equity needs. Member C would, therefore, be due an equity redemption of $11,000. As illustrated in Table 2, if the co-operative collects $31,000 from under-invested members and redeems the $11,000 owed to Member C, the co-operative is left with the $20,000 of additional equity required for the new fiscal year.

OBTAINING AND REDEEMING MEMBERS' EQUITY CONTRIBUTIONS

For the co-op to obtain the required equity contributions from members, each member will need to be notified of their investment obligation. A statement should be prepared for each member showing his or her current year investment and the proportionate amount of capital needed to meet the required level of investment for the new fiscal period.

For the under-invested member, the statement shows how additional investments will be collected. For example, the co-operative's planned patronage retain or per-unit capital retain for the coming year may be sufficient to satisfy the new requirement. If not, the member may have capital retained at a higher rate than the member who is closer to being fully invested. Alternatively, members may be asked to make a direct cash investment to achieve parity. Over-invested members should be advised of the co-op's plan for refunding all or part of the over-invested capital.

The adjustment of members' equity investments will typically be made over some prescribed time period, instead of all at once. Spreading out the contribution burden for under-invested members helps younger or newer members who may have limited capital resources to invest. This practice also decreases the capital burden of the co-operative in satisfying redemption obligations to over-invested members.

Advantages and Disadvantages of Base Capital Plans

Like any capital program, base capital plans have their advantages and disadvantages. A board of directors should carefully weigh all aspects when considering the suitability of a base capital plan for their co-op.

The advantages of base capital plans include:

- *Member investments are linked directly to patronage and the plan provides a mechanism for maintaining this relationship.*
- *A base capital plan permits the co-op to systematically adjust capital requirements up or down to meet the changing needs of the business.*
- *Members are encouraged to view their investment in a base capital plan as a "true" investment, which they will have access to at some point in the future.*
- *A base capital plan gives the board and management a tool to manage the co-op's capital and requires that an annual budget and financial plan be developed. Comprehensive financial planning is key to the success of any business, including co-ops.*
- *A base capital plan allows members who are phasing out of farming or withdrawing from the co-op to have their equity returned over a reasonable period of time (depending on the flow of funds from current members).*
- *The ability to enhance member loyalty is increased because of the plan's equitable treatment and predictability.*

The disadvantages of base capital plans include:

- *Capital investment requirements can place a financial burden on new members. However, programs can be designed to help new members achieve required investment levels on an installment basis over multiple years. This could cause the further disadvantage of slowing the redemption of equity of over-invested members.*
- *The base capital plan does not work well if there is a constant and large membership turnover. This situation puts a strain on remaining members to provide the additional capital which is no longer being supplied by members who are withdrawing from the co-operative.*
- *A base capital plan is difficult to manage if there are widely fluctuating capital flows.*
- *A base capital plan is more difficult to understand than traditional capital programs such as the revolving fund method of redeeming equity. This aspect should not be considered an obstacle to adopting such a plan, because these difficulties can be overcome with effective, ongoing education and communication programs.*

Cooperative Marketing Agreements

A marketing agreement is a contract between the co-operative and its members, which can benefit both parties. Producers benefit by knowing that a portion of their production is "pre-sold". The co-op benefits because it can coordinate the volume of business with the size of available facilities and the level of customer demand. Marketing agreements may also enable the co-op to pre-sell member products on the basis of timing considerations included in these contracts. Marketing agreement should be prepared with the help of a lawyer and should include the following:

- *A description of the commodities to be produced, packed, processes, and/or marketed by the co-operative.*
- *The quantity of product to be delivered, specifying if it is by weight, number of cases, or acreage basis (if it is the latter, the co-op assumes the yield risk).*
- *A clause stipulating what happens to excess production. Some co-ops require that it be destroyed to avoid flooding the market and depressing prices, others require that the member delivers all they produce, while still others will allow the member to market the excess through other channels.*
- *The time and place where the legal title of ownership transfers from the producer to the co-op*
- *A description of how and when the producer will be paid and the method of determining the value of the commodity.*
- *A clause requiring the member to disclose any liens or claims against any products covered by the agreement.*
- *A clause stipulating the rights of the co-op and the obligations of the member in the event that the member fails to deliver the product in the quantity, level of quality, or at the required time specified in the agreement.*
- *The lifespan of the agreement and the notice periods required to either extend or cancel the contract.*
- *An "Act-of-God" clause that holds each party harmless in the event of natural disasters or events beyond human control.*

Adapted from Starting an Agricultural Marketing Cooperative. Center for Cooperatives. University of California.

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