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# AGRIBUSINESS MANAGEMENT

## FINANCING AND CAPITALIZING THE FUTURE OF AGRIBUSINESS COOPERATIVES

### Background

Agricultural cooperatives have comprised a major portion of this nation's agribusiness industry for several decades. Indeed, many would argue that at the time of its origin, the industry was comprised of more cooperatives than any other form of business organization. It matters little how one would react to this view. Moreover, it matters little whether you are a strong proponent of agricultural cooperatives or whether you ascribe more to the corporate or private ownership forms of business organization. The facts are that agricultural cooperatives have been around a long time. They do comprise a major segment of the agribusiness industry. They have contributed much to the viability and economic stability of our agricultural economy. And, while the number of operating cooperatives and cooperative memberships are now declining, the economic prowess of our agricultural cooperatives appears to be growing.

Most of us recall 1973-75 as a "boom period" for the agribusiness industry. Prices for production supplies and agricultural commodities rose dramatically. Farm incomes improved in almost all categories except for the dairyman and the cattle feeder. The overall financial position of agribusiness enterprises here in the Pacific Northwest showed significant improvement. Survey results are now showing that agricultural cooperatives shared in this period of prosperity. A more literal interpretation of these data would suggest that as of the period ending 1975, agricultural cooperatives had actually improved their position vis-à-vis other organizational forms

of business<sup>1</sup>. For example, during the fiscal year 1972, the 7,797 agricultural cooperatives operating at that time generated a total business volume of \$21.7 billion. By fiscal 1975, the number of cooperatives had dropped to 7,645 but their combined total business volume had nearly doubled to \$42.3 billion. Statistics show that at least five out of every six farmers are members of at least one agricultural cooperative. Total cooperative membership reached an all-time high of 7.7 million in 1955-56, but declined steadily to 6.1 million in 1974-75. Agricultural marketing cooperatives handled commodities valued at \$6.4 billion in 1950-51, or about 20 percent of total commodities marketed at that time. By 1974-75, marketing cooperatives volume had grown to \$32.7 billion or 31 percent of the total U.S. value. A similar result is found when viewing data on farm supply cooperatives where volume grew from \$1.7 billion in 1950-51 (12 percent of U.S. total) to \$8.7 billion (18 percent of U.S. total) in 1974-75. Service cooperatives (those providing transportation, storage, testing, etc.) also experienced a growth in sales from \$100 million to \$954 million during this same time period<sup>2</sup>. These business volume data have not been adjusted to reflect price inflation, but they would be affected no differently than would similar data from the alternate forms of business organization.

### Future Problems?

The data summary provided above would suggest that agricultural cooperatives have fared quite well in recent years. No doubt they have. In my opinion, their overall economic position has improved and they retain a very healthy share of

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<sup>1</sup> "Statistics of Farmer Cooperatives 1972-73, 1973-74, and 1974-75." *Farmer Cooperative Service*, USDA, May 1977, Washington, D.C.

<sup>2</sup> FCS, USDA. "Farmer Cooperatives Volume Nearly Doubles in Three Years." *Farmer Cooperatives*, FCS, USDA, June 1977, pp. 12-14.

total commerce within the agribusiness industry. Yet one must not allow a composite set of favorable statistics to lull oneself into a false sense of complacency. The occurrences of the “boom period” of 1973-75 brought much needed relief to many cooperatives resting on the brink of financial insecurity. These occurrences also contributed to a rise in cooperative members’ incomes to a level never before achieved -- and a tax bracket never before confronted. While these two features are of a positive nature, each has created an area of concern with regard to the future financing of cooperative organizations.

### **Temporary Respite Only**

The first area of concern revolves around the uncertainties attached to those cooperatives whose financial viability was only temporarily sustained by the two-year boom period. As already noted, some cooperatives had reached a point of near financial insolvency by the early 1970’s. Their future was doubtful as internal inefficiencies, management deficiencies, or loss of market were contributing to an environment where additional external financing was in doubt. Additions to the financial base via internal membership financing was rendered no more promising as a result of an extended period of deteriorating performance. In particular, many grain-storage and fertilizer-supply cooperatives had found the going difficult in the early 1970’s. But alas, \$5 per bushel wheat and \$300 per ton ammonia prices during 1973-75 provided a respite for their difficulties.

Not all cooperatives took advantage of this period by rectifying their operational deficiencies. By late 1976, grain and fertilizer prices had returned to pre-1973 levels. Sales volume data ending in fiscal 1975 do not, of course, reflect the economic conditions which followed the boom. By 1976, many cooperatives found themselves in a financial position not greatly different than that posted in the pre-boom years. Even worse were those grain storage cooperatives who were now forced to construct new or additional facilities to handle the record 1976 crop. A near record carryover of these 1976 grain stocks has not much brightened their prospects for 1977. In brief, those cooperatives which failed to “mend their ways” during the good times of 1973-75 will likely find it most difficult to secure needed financing for the late 1970’s.

Quoting Mr. Gail N. Brown, “Cooperatives are a definite part of the American capitalistic system: but a capitalist without funds is in trouble<sup>3</sup>.” So our cooperatives may have amassed some impressive economic statistics, but emerged from the boom period cash-starved and financially weak. Mr. Brown also notes that the rate of real growth of American Business is slipping, and his analysis of California cooperatives shows their operations are, “no better and, in fact, may be worse<sup>4</sup>” than their earlier positions.

The California analysis suggests that working capital available to cooperatives is very low, compared with that for corporations. Cooperatives are now more highly leveraged than their corporate competitors. It would also appear that cooperatives are now more vulnerable to continued inflation than are corporations. The future of some of these cooperatives may well depend on their ability to secure debt-financing from such nontraditional sources as insurance companies, investment banking groups, private placement of debentures, and the sale by large cooperatives of their own paper. Several cooperatives have already explored some of these alternatives. Regardless of your views toward such debt capital sources, we would probably all agree that their increased use would dramatically affect the future of cooperative financing.

### **Membership Equity Threatened**

The second area of concern revolves around the impact which membership tax bracket has upon a cooperative’s ability to generate capital via patronage retains and equity revolves. Recently, Mr. Gerald Dryer acknowledged that, “Farmers facing an increasing income tax burden would like to receive a larger percent of cash as part of their patronage refund<sup>5</sup>.” Tax law requires farmers to pay taxes on the full amount of patronage earned in a given year regardless of the portion received

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<sup>3</sup> Brown, Gail N. “Coop’s Fiscal Facts a ‘Must’ for Members in Times Ahead.” *Farmer Cooperatives*, July 1977, pp.12-15.

<sup>4</sup> Op. cit., p. 14.

<sup>5</sup> Dryer, Gerald. “Individual Members Receive Variable Cash Patronage Refund Tied to Member Equity Level.” *Farmer Cooperatives*, FCS, USDA, June 1977, p. 9.

as cash. Larger farming operations and the greater incomes generated in 1973-75 resulted in many cooperative members confronting a 22-40 percent tax bracket for the first time ever. If their cooperative paid only the required 20% cash patronage, retaining the remainder for operating capital, these farmers then faced a “real tax” rate on the discounted net present value of cooperatives patronage equal to 60 to 90 percent! Under this situation, it’s understandable why cooperative members may rapidly lose their enthusiasm for membership equity capital programs as now practiced.

Adding to this concern are some research findings by Dahl and Dobson<sup>6</sup> showing that cash patronage refunds could be increased by over 90 percent and finance costs reduced by 6 to 9 percent by employing a capital acquisition program based more heavily on permanent member certificates of indebtedness and less heavily on revolving fund capital.

All the above would suggest that in the future, cooperative financing would be secured by permanent equity capital much like that provided by agribusiness corporations. Cash patronage paid could be dramatically increased and farmers would be pleased with a reduction in their tax burden. But as the saying goes, “Life is not always that simple.” First of all, permanent equity capital is not always available in the amounts desired. Second, member control, as cooperatives grow in size, becomes an issue of great importance. Loss of revolving capital may transfer membership control to those who are no longer patronizing the organization. That users of a cooperative are also the owners of that organization is a very basic cooperative principle. Adjustments to this principle would surely cause repercussions to other areas of cooperative operation. So let’s look a little closer at each of these possibilities.

In the work conducted by Dahl and Dobson, the researchers reviewed the record of annual growth

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<sup>6</sup> Dahl, Wilmer A. and W. D. Dobson. “An Analysis of Alternative Financing Strategies and Equity Retirement Plans for Farmer Supply Cooperatives.” *American Journal of Agricultural Economics*, 58:2, May 1976, pp. 198-208.

in the value of certificate of indebtedness held by Wisconsin cooperatives. They found that this annual growth rate reached a high of 14.2 percent one year. The researchers then hypothesized what might happen if such a growth rate could be achieved every year. Since the certificates represented a low-cost source of capital, increased reliance on them released funds from the equity capital revolve program and facilitated dramatic increase in the cash patronage levels paid. But just how realistic is it to expect a cooperative to achieve a 14.2 percent annual increase in its permanent certificates of indebtedness and do so for each consecutive year? According to the Farmer Cooperative Service<sup>7</sup>, the nation’s farm-supply cooperatives actually decreased their proportionate use of certificates of indebtedness from 1962 to 1970 as a source of capital. Further, this same source suggests that cooperatives within the St. Paul Farm Credit District (of which Wisconsin is part) increased their proportionate use of certificates of indebtedness during this period, but only modestly, i.e., by a total of 19 percent over the eight-year period.

In truth, I believe the farmer perceives his farm-supply cooperative to be an important vehicle for the near-cost, competitive, purchase of his resource needs. It would be presumptuous for us to expect that some farmers also perceive of their cooperatives as an alternative cash investment opportunity in much the same light as commercial corporate bonds. One must also recognize that the outright sale of certificates of indebtedness, the purchase of such certificates with patronage revolves, and the transfer of other patronage instruments have all become very “cloudy” practices as a result of some court decisions regarding the applicability of SEC rulings to cooperative operations. It is generally understood that nontaxable cooperatives are exempt from the filing and disclosure provisions of the 1933 and 1934 SEC acts while taxable cooperatives are subject to both acts. Of course, both taxable and nontaxable cooperatives are subject to fraud provisions in both acts. Some U.S. cooperatives have registered their debentures with the SEC. At least in one case, revolving fund certificates have

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<sup>7</sup> FCS, USDA. “A Financial Profile of Farmer Cooperatives in the United States.” FCS, USDA, *FCS Research Report*, No. 23, pp. 50-53.

been registered. It was generally thought that this latter procedure was not necessary, particularly where the instruments were nontransferable and nonnegotiable. However, the SEC has sought further legislative review of the matter. The uncertainties created by this cloudy environment do little to encourage the issue or purchase of certificates of indebtedness on an expanded scale.

Our second consideration involves the distribution of equity capital amongst cooperative member-patrons and the ability to adjust this equity base in light of the firm's financial needs, the turnover of membership, and a rising farmer income tax bite.

Most would agree that a good, member equity capital plan should facilitate the following:

1. Provide for the maintenance and/or improvement of the balance-sheet financial strength of the cooperative.
2. Provide an opportunity for the proper leveraging of the equity base to the ultimate advantage of the cooperative and its members.
3. Provide for a higher cash patronage refund percent and/or a shorter revolve period without impacting financial security; and, to make such adjustments in accordance with the proportionate use (patronage) each member has made of his cooperative, i.e., transfer cooperative ownership to current patrons.
4. Provide a means by which the redemption of inactive patron's equities can be facilitated quickly and easily.

The big question, of course, is exactly how can this "ideal" program be constructed and implemented? Over the years, numerous programs have been described in traditional cooperative literature. Recently, Mr. Gerald Dryer described one such program now being used by the Indiana Farm Bureau Cooperative Association<sup>8</sup>. The IFBCA program is worthy of further consideration for the following reasons: First, the board of directors establishes the equity fund level needed based on patronage generated and capital provided from general reserves, preferred stock, and other possible sources. Second, the cash refund percent received by

member-patrons is not fixed, but is allowed to vary from 20 to 50 percent depending on the percent of the needed equity fund currently owned by patrons. Third, individual patron cash patronage payments are then established via a statistical weighting of the amount of equity currently owned, volume of business the patron contributed during a base period (3 yrs.), and the patron's current year volume of the refund.

This program has several attractive features, most relating to the ability to keep cooperative ownership in the hands of those who use it most. But in addition, the cash patronage percent is no longer a rigid figure which penalizes the farmer in a high tax bracket year. The farmer now recognizes that his tax burden is no longer affected by arbitrary factors, but rather by a conscientious attempt at equitability amongst all cooperative patrons.

### Summary

Agricultural cooperatives continue to occupy a very prominent position within the nation's agribusiness industry. Some recent statistics would suggest that cooperatives actually improved their market and economic position vis-à-vis the other organizational forms of business as a result of the boom period in agriculture during 1973-75. While the statistics are, indeed, favorable ones, cooperative management should not become complacent about the future, particularly as it relates to needed financing and programs of capitalization. It can be shown that some cooperatives failed to make optimum use of the good years to improve their balance-sheet positions and debt-financing structure. Other cooperatives found that good times created some dissatisfaction amongst their members over existing equity capital programs. Permanent certificates of indebtedness have been proposed as one means to build the necessary equity base, increase cash patronage, and build an expanded base for future debt financing. This paper reviews several prospective means for future cooperative financing and capitalization and tries to uncover some of the limitation and attributes of each.

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<sup>8</sup> Ibid, Dryer, p. 9-10.