



## EXTENSION

# Understanding Cooperative Equity

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Equity is the investment member-patrons make in a cooperative. According to cooperative principles, members have a key responsibility to provide equity. Cooperative equity can be allocated (issued in the specific name of a member) or unallocated (a general reserve fund that is collectively owned). Cooperative equity can also be revolving, semi-permanent or permanent and qualified or nonqualified. The distinction between qualified and nonqualified equity relates to the taxation of the patronage distributed as equity.

There is little incentive for members to invest equity capital because cooperatives distribute equity based on use, not in proportion to equity ownership. Open membership cooperatives often create equity out of the profit stream by issuing a portion of patronage in the form of equity. Closed membership cooperatives often link each unit of equity with a usage right.

Equity in any firm is risk capital. Equity holders have the right to the residual returns. In other words, the owners of any firm have a claim on what is left over after all of the creditors have been paid. When a cooperative is profitable and retains a portion of the profits as equity, then the equity value of the cooperative increases, otherwise the value decreases. Lenders like to see a strong equity base because it enhances their collateral position and makes the loan less risky. The cooperative equity is the basis for its borrowing capacity. Agricultural cooperatives have historically financed between 40 and 50 percent of their assets with equity.

## Direct Investment

Direct investment is equity created when a member makes a cash contribution or investment in exchange for equity. Direct investment is allocated equity since it is held in the names of specific patrons. Direct investment is semi-permanent. It is typically not redeemed by the cooperative until the death of the member. The most common form of direct investment is the membership share of stock that a member must purchase as a condition of joining the cooperative. For new generation cooperatives, the vast majority of their equity is in the form of direct investment.

Direct investment is usually the only option available to raise the equity to start a cooperative. The equity drive to obtain the direct investment helps determine if there is enough interest and commitment to establish the cooperative. In terms of existing cooperatives, direct investment or membership stock ensures that members have some personal stake before they are granted the right to vote and use the cooperative's assets. As the amount of direct investment is increased, the cooperative has less need to retain profits as equity and can issue

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a higher portion of cash patronage. The major disadvantage of direct investment is that because cooperative profits are distributed in proportion to use, there is no return linked to investment. In an open membership cooperative, equity does not appreciate and it cannot be bought and sold. Because of that, members have little interest in investing in cooperative equity. In a closed cooperative, there may be a limited market for the cooperative equity because of the usage rights. Direct investment is not generally a recurring source of equity capital as it takes a special effort to develop an equity drive, which often requires careful compliance with laws and regulations.

## Retained Patronage Refunds

Retained patronage refunds are portions of the net income allocated to members but paid in the form of equity rather than cash. Retained patronage refunds create allocated equity since it is held in specific patron accounts. Retained patronage refunds are typically revolving equity, meaning that it is eventually redeemed for cash by the cooperative at its original face value. Traditionally, open membership cooperatives have raised the majority of their equity through retained patronage refunds.

The advantage of retained patronage from the member's perspective is that it is created from the profit stream and members do not have to make a cash investment. Members essentially earn their way into ownership. Retained patronage is a systematic method for the cooperative to build equity and one that it is relatively painless for the member. The disadvantage of retained patronage from the cooperative's standpoint is that it is dependent upon the profitability of the cooperative. If the cooperative has a loss year, the equity value of the cooperative is reduced. Revolving equity creates a complex balancing act for the board of directors. Another disadvantage of retained patronage and revolving equity is that members may expect the cooperative to revolve equity regardless of its financial condition. Members only realize value for the share of profits distributed in the form of equity when that equity is redeemed for cash. That causes members to want the cooperative to revolve equity as rapidly as possible and to keep the revolving cycle constant or increasing.

## Per Unit Capital Retains

Per unit capital retains, also called per unit retains, are equity that is deducted from the member's commodity pay-

ment for each unit of commodity handled. Per unit retains are therefore based solely on the amount of commodity handled and not impacted by the profitability of the cooperative. Because of that, per unit retains create a stable source of equity for the cooperative. The disadvantage of per unit retains from the member's standpoint is that the cooperative deducts equity even when commodity prices are low. Some members also may feel that the stable source of equity, regardless of profitability, places less pressure on the cooperative to operate profitably and efficiently. Because per unit retains are deducted from the commodity payment, some members perceive that the cooperative is not price competitive. Per unit retains creates allocated equity and it can be allocated as either qualified or nonqualified equity. They are taxed in a similar way to patronage refunds except that a cooperative issuing qualified per unit retains does not have the requirement of issuing at least 20 percent cash patronage, which is a requirement for qualified patronage refunds.

## Unallocated Equity

Unallocated equity, also called unallocated retained earnings, is a general reserve fund that is collectively owned by the members. As the name implies, unallocated equity is unallocated and it is the only permanent category of equity in a cooperative since it is never revolved or returned to the members. One of the purposes of unallocated equity is to create a reserve fund that can be reduced if the cooperative experiences a loss. In the absence of unallocated equity, the cooperative would have to write down the value of the member's stock in any year that a loss occurred. If the cooperative returned to profitability, new retained equity would be created but the value of the stock that was written down would not change. Stock write downs create member communication challenges. Unallocated equity is often created from the profits on non-member business.

The disadvantage of retained member profits as unallocated equity (from the member perspective) is that unallocated equity is never revolved by the cooperative and the member never receives those profits. If a cooperative is liquidated, the residual value of the firm, after all creditors are paid, is distributed to members in proportion to past use during a defined period, typically around six years. Active members therefore still have a claim on the assets funded by unallocated equity. However, once a member becomes inactive, they eventually leave behind any claim on the unallocated equity. High levels of unallocated equity can therefore create an incentive for members to liquidate a cooperative to capture the value of the unallocated equity.

Unallocated equity reduces the member's return from the cooperative since the profits retained as unallocated equity are never returned to the member. It therefore violates the principle of distributing profits in proportion to use. It may also reduce the member's sense of ownership in the cooperative since it is not reflected in the stock amounts held in the owner's name. Despite those facts, the portion of unallocated equity

in agricultural cooperatives has been increasing. According to USDA cooperative statistics, allocated equity represented approximately 60 percent of cooperative equity in 2017, with 40 percent being unallocated. Many boards of directors are attracted to retaining profits as unallocated equity since it avoids the need for future equity redemption payments.

## Preferred Stock

Most cooperative bylaws permit the cooperative to sell preferred stock to either members or non-members. Preferred stock owners do not have voting rights. If the cooperative is liquidated, the preferred stock holders have a claim on the residual value ahead of the common stockholders. That is the origin of the term 'preferred.' There is typically no market for preferred stock in a cooperative and they typically carry a dividend rate. The maximum dividend is often limited by law to 8 percent. The board has discretion not to pay the dividend if the cooperative does not have the financial resources, making preferred stock equity and not debt. However, the board cannot pay patronage unless the preferred dividends have been paid.

In recent years, some progressive cooperatives have redeemed revolving equity by converting it to preferred stock. The effect is that after some period of time, the cooperative begins to pay dividends on patron equity. That can be beneficial to the cooperative since they don't have to expend the cash to revolve the equity (only to make the dividend payment). Many members may also be happy to hold the equity since they are receiving a dividend. The cooperative also can use the profits from non-member business to pay the dividend payment. The preferred stock dividend often is higher than the cooperative's interest rate. It is therefore not a cost effective alternative for the cooperative, but since the funds are going to members and to outside lenders, it may still be considered to be in the member's interest.

## Nonmember Sources of Equity

One limitation of the cooperative business model is that it generally does not lend itself to raising capital from non-member investors. Cooperatives can sell preferred stock to non-members. In times of low interest, cooperative preferred stock could be attractive to nonmembers. However when interest rates rise, investors have alternative investment choices that would be considered lower risk and providing a higher rate of return. Preferred stock is an illiquid investment, which also limits the interest from nonmember investors.

The hybrid member-investor cooperative form has two classes of members. Investor members receive a share of profits based on their ownership, while user members receive a share of profits based on patronage. That creates a direct incentive for nonmember investment and addresses some of the limitation in raising nonmember equity. The member-investor model has not been particularly successful as a vehicle for attracting nonmember investment.

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