

## **Evolving Credit Needs of Cooperatives and Producer-Owned Businesses**

### **Invited Paper for:**

“Serving the Changing Financial Needs of American Farmers and Ranchers,  
2005 – 2016”: A project of Farm Credit Horizons

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February 11, 2005*

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## Introduction

Supplying capital to farmer-owned businesses has always been an important aspect of the Farm Credit System's mission. CoBank (and formally the various Banks for Cooperatives) has been a primary source of credit for farmer-owned cooperatives for over 70 years. Despite the prevalence of cooperatives in agricultural industries, the U.S. banking industry struggles to understand the cooperative business model and has been reluctant to lend to producer-owned businesses (Hazen, 2003). CoBank has had a fundamental understanding of the cooperative business model, which allows it to provide a source of specialized expertise. The bank's cooperative structure results in lower interest costs to farmer cooperatives and, ultimately, to their producer members. In recent years the structures of farmer-owned business and landscape of rural America has changed. As the Farm Credit System positions itself for the future it is important to understand the evolving financing needs of cooperatives and farmer-owned businesses.

## The Changing Agricultural Landscape

Before examining changes in the cooperative model, it is useful to note two major trends in the agricultural environment: the changes in farm structure and the increased focus on value-added activities. Agriculture lenders are aware of the changing structure of production agriculture. Farms and ranches are getting larger and more specialized and are accounting for a greater share of overall production. Small and part-time operators

represent an increasing share of overall farm numbers. Middle-sized farms and ranches have declined both in numbers and in share of total output. Both large and small farm operations are adopting new structures.

As large farms become more industrial, they have adopted new organizations. Large operations tend to use rental arrangements, leases and contracts to control assets as opposed to outright ownership. They also tend to involve multiple operators. In many large commercial farming operations, management has been separated from land ownership and equipment operations. One farm operator (or corporation) may own the land, another individual will serve as a professional manager, while another set of operators provides machinery services on a custom basis.

Large farms and ranches are impacting traditional cooperatives. These operators may demand discounted pricing as well as specialized services such as precision agriculture, direct shipping, contracting services and direct shipping (Campbell, 2003). Cooperative managers are particularly sensitive to the needs of large producers because they account for the bulk of business volume and often have access to alternative market channels. Positioning a cooperative to efficiently serve large members may require investments in additional assets.

Large producer members also tend to be an unenthusiastic source of cooperative equity. They often have higher marginal tax rates, higher expectations for cash patronage refunds (as opposed to qualified stock refunds) and have higher liquidity expectations. These expectations place pressure on equity revolvment . The result for many

cooperatives has been a shortage of equity capital and increased interest in permanent (as opposed to revolving) equity sources.

The growing number of smaller farms is also impacting cooperatives. The growth of small and part-time producers has encouraged cooperatives to diversify into non-traditional product lines, after-hours services, and smaller scale application equipment (Campbell, 2003). Smaller operations are more likely to be involved in the production of alternative or specialty crops, sustainable agriculture and organic production. They are also more likely to pursue alternative market channels such as direct marketing, and community sponsored agriculture. Cooperatives, particularly those near metropolitan areas, are struggling to reposition their asset bases to take advantage of these opportunities.

Another important trend in the agricultural environment is the growth of value-added activities. Producers may pursue value-added activities to gain more direct access to markets and, ultimately, a greater share of the consumer's food dollar (Holland and Ziehl, 2005). By pursuing value-added activities, farmers hope to assure themselves a place in the food supply chain, which is increasingly reliant on vertical integration and coordination of production, marketing, and/or processing to deliver products with attributes that meet specific end-user needs (Ellerman, McFeeters, and Fox 2001).

Producer-owned value added efforts cover a wide range of activities from U.S. Premium Beef, Golden Oval Eggs, Dakota Growers Pasta, and Crystal Sugar to small projects like Grown Locally, an eleven member Iowa cooperative supplying locally grown and processed produce to institutional and restaurant customers. Regardless of the

scale of the project, producers have discovered that processing activities are capital expensive. Lack of capital, both equity and debt, are key constraints to the development of farmer-owned processing projects (Hazen, 2003). The high capital requirements of value-added business projects have been the major force driving the development of new cooperative structures.

### Development of New Cooperative Structures

Acquiring equity capital has long been recognized as a problem for cooperatives (Cook, 1995, Cook and Iiopoulos, 2000). Traditional U.S. cooperatives (farm supply and marketing) have obtained capital primarily through retained patronage (retaining profits) and per-unit retains (volume based assessments). Most traditional U.S. cooperatives have been formed under an open membership system allowing a producer to join at any time by making a small initial investment. Under this cooperative structure, a member's equity is essentially created out of the firm's profit stream. Traditionally, cooperative equity has lacked a secondary market and is redeemed at book value (face value) regardless of the value of the cooperative. Under this structure members receive no return on their investment in the cooperative and receive no benefit from the growth in the value of the firm unless the cooperative is liquidated.

Several major problems have been identified with the traditional equity system. These are commonly described as the Free Rider Problem, the Horizon Problem, and the Portfolio Problem (Sykuta and Cook, 2001). The Free Rider Problem is a property rights issue caused by the nontransferability of cooperative stock and the fact that new members in open membership cooperatives receive the same profits as long-term investors. An

example of the free rider problem occurs when cooperative members provide the risk capital to develop a flour milling cooperative and find they receive the same return as other members that joined only after the project was successful. More subtle Free Rider Problems also occur between sub groups of members within a cooperative.

The Horizon Problem stems from the nontransferable and non-appreciating aspects of cooperative equity. Because members receive benefits only through use, there is a disincentive to invest in long-term projects particularly by members that do not anticipate long-term patronage. An example of the Horizon Problem occurs when older members oppose investment in a new rail-loading system, instead preferring that funds be channeled into redeeming equities.

The Portfolio Problem is created because cooperative members cannot withdraw and reallocate their equity investment to match their risk-return preferences and the fact that cooperative firm returns are often highly correlated with that of the farm business. The observation that cooperative members cannot access the going concern value of the cooperative firm (McDavid, 1995) is a manifestation of all three of these basic problems.

These issues with cooperative equity have been addressed both within traditional cooperative structures and through the creation of new structures. Traditional cooperatives have attempted to address the Horizon Problem by adopting shorter equity redemption periods and by using redemption systems that keep cooperative use and investment more proportional (Cook, 1995). However, rapid equity redemption requires high profitability and limits cooperative growth. In recognition of both the undesirability of cooperative stock and the difficulties in managing equity redemption with variable

profitability, many cooperatives have also attempted to build permanent equity (unallocated equity also called retained earnings). Non-patronage income has been a popular source of permanent equity. However, this approach does not alleviate the underlying property-rights issues and violates the underlying member-owner principle.

### New Generation Cooperatives

An evolution of the cooperative form that has been used extensively for value-added projects is the New Generation Cooperative. Members are required to make up-front investment in order to obtain delivery rights, and supply is controlled through marketing agreements. Cooperative stock (and associated delivery rights) can be traded among other producers eligible for membership. Because members must provide initial investment capital in order to ensure participation in the eventual value-added returns, the Free Rider Problem is minimized. The transferability and appreciability features of New Generation Cooperative stock reduce Horizon and Portfolio Problems.

While the New Generation Cooperative structure increases the attractiveness of cooperative equity, it has not eliminated cooperatives problems in acquiring equity. Because they are limited to acquiring capital from agricultural producers, many project organizers find that they are unable to attract sufficient equity funds. The limited nature of the market for New Generation Cooperative stock (agricultural producers who are eligible for membership and able to deliver the required commodity) can also make it difficult for members to sell their stock.

Successful New Generation Cooperatives find they are unable to finance expansion projects because they have exhausted available producer investment (Hazen,

2003). Because of constraints on additional equity and stock liquidity problems, several high profile New Generation Cooperatives (Dakota Growers Pasta, Minnesota Corn Processors, U.S. Premium Beef) have converted to stock corporations or limited liability companies (LLCs). These structures allowed investors other than farmers to buy stock in the ventures and provided more liquidity to shareholders who wanted to sell their stock.

### Investor/Cooperative Hybrids

Another evolution of the cooperative business model has been the development of cooperatives with nonmember equity. This structure provides two classes of ownership: outside equity investors and patron stockholders. The entity returns are split between the two classes with the outside investors receiving investment-based returns and the patron stockholders receiving patronage-based distributions.

A number of states, including Wyoming, Minnesota, Wisconsin and Tennessee, have enacted legislation enabling cooperative/LLC hybrids. Efforts to develop a uniform federal law for this structure are underway by the National Council of Farmer Cooperatives (Mott, Fredrikson and Byron, 2004). While there are differences in individual state statutes, this structure mandates control by farmer members but can allow the investor class to receive up to 85% of the profits (Hensley and Swanson, 2003). These entities are part of a broader classification termed “investor-share cooperatives,” which assess outside equity through preferred stock, non-voting common stock and participation certificates (Chaddad and Cook, 2003).

## Other Legal and Tax Issues Facing Cooperatives

Evolving cooperative structures are also impacting and being impacted by other legal issues. New investor/cooperative hybrids do not appear to qualify under the narrow definitions of a cooperative under the Capper Volstead Act and would, therefore, not have exemption from antitrust regulations. Hybrid entities would also likely not qualify for exemption of registration under the Securities and Exchange Commission and could face an expensive and time-consuming registration process (Hanson, 2004).

New Generation Cooperative structures are also raising issues on patronage requirements. Several cooperatives with delivery right/obligation systems have also created a marketing pool that can buy the specified commodity in the name of members who cannot meet delivery requirements. Although originally designed to cover emergency situations such as drought or disease, this mechanism has allowed producer members to become pure investors and forgo delivery (Nelson, 2003). All of these issues highlight the broader question of what distinguishes or should distinguish a cooperative from other business forms (Nelson, 2003).

Traditional cooperative structures also face legal and accounting issues. Proposed standards by the Financial Accounting Standards Board would have reclassified the majority of traditional cooperative equity as liabilities. In arguing against the proposed standards, cooperative industry groups emphasized the differences between the cooperative and corporate structures. Similar arguments are being used to suggest that corporate-governance reforms contained in the Sarbanes Oxley Act (which currently apply only to entities offering publicly traded securities) are not appropriate for cooperatives. As evolving cooperative structures allow cooperative entities to take on

more of the characteristics of corporations, arguments for unique treatments may become more difficult.

### Implications for Cooperative Lenders

The most obvious implication from the ongoing evolution in cooperative structures is the need to modernize the Federal Farm Credit Act to allow CoBank financing for a broader scope of entities. Proposals for modernization include expanding eligibility to entities with 50% producer voting control (versus the current 80% limit), allowing continuing financing for cooperative firms adopting new structures as long as 50% farmer ownership is maintained, and providing transition financing for CoBank customers that restructure and no longer meet eligibility criteria (Jaeger, 2003).

Arguments for expanded lending authority are well founded. Current lending restrictions have obviously not impeded evolution of producer-owned business structures but have prevented many new entities from obtaining CoBank financing. However, even supporters of expanded eligibility (including Under Secretary of Agriculture for Rural Development, Thomas C. Dorr) have questioned at what point hybrid organizations cease being cooperatives (Jaeger, 2003). Hanson (2004) suggests that lenders and policy makers would be better served by defining a cooperative business in terms of producer benefit rather than “bright-line” limits on business structure. The question of how a producer-owned business should be defined will remain a key issue for the Farm Credit System.

Changing business structures and equity issues will also impact CoBank in its loans to traditional cooperatives. Trends toward local cooperatives involvement in

strategic alliances, joint ventures, and innovative business arrangements will likely continue. As cooperatives use alliances to combine similar business operations, lenders often find it more difficult to evaluate operational efficiency and to project how alliance activities will impact a cooperative's financial profile. The issue of permanent capital, which was highlighted by the proposed accounting standards change, will undoubtedly be revisited. Cooperative lenders have traditionally advised cooperatives in balancing revolving and permanent equity but have not distinguished between classes of patron equity in their loan underwriting standards.

Another implication of these evolving producer-owned business structures is the need for Farm Credit lenders to understand and be in a position to evaluate a much broader set of organizational structures and resulting property rights issues. Lenders providing funds directly to hybrid cooperative entities, traditional cooperatives involved in joint ventures and strategic alliances, or producers investing in new business as either patron or investor members, will have to understand the profit distribution systems and residual claimant structure of new business structures. It is obvious that cooperatives and other producer-owned businesses are becoming more interested in accessing outside equity capital. It is equally obvious that these outside investors are sophisticated and will demand structures that protect their interests.

The evolution of producer-owned business models also highlights a need for venture capital for producer-owned and/or rural-based business projects. Even after adopting business structures that make equity investment more attractive to producer members and/or allowing participation by investor members, many value-added projects are unable to meet the equity levels required by potential lenders. The mixed success rate

of new value-added efforts that include the failures of Spring Wheat Bakers, Prairie Farmers Cooperative pork processing plant, and Iowa Quality Beef Supply Cooperative suggests that lender caution is not entirely unfounded.

Venture capital for rural-based and agricultural related projects is scarce. Typical venture capital firm are looking for emerging markets and industry segments poised for rapid growth, and extraordinary profits with sufficient size (\$100 million in total equity) to facilitate a public sale at a latter date (National Venture Capital Association). Information technology and health care account for over two-thirds of venture capital dollars in 2004 (NVCA). The typical agricultural value-added project does not have the size or growth potential to interest venture capital providers.

Producer groups attempting to attract venture capital often struggle to understand and evaluate proposed structures and terms. Venture capitalist are interested in designing an exit strategy for the venture capital participants within a 3-7 year time period. This often involves preferred classes of equity with provisions for cumulative dividends and conversion to common equity. Exit provisions allow the developers to repurchase the venture capital equity at predetermined price formulas, often a multiple of the firm's profits. A venture capitalist typically requires representation on the governing board and/or participation in management.

Producer groups eliciting interest from multiple venture capitalists can find themselves (or their consultants) analyzing a confusing array of structures, contractual obligations and governance provisions. The resulting business structure is often quite different from the developers' initial concept. Value-added projects run into problems

when the developers attempt to “pull a business plan through a new business structure” (Hanson, 2002.)

New venture capital sources such as the proposed National Rural Business and Cooperative Equity Fund that was supported by CoBank would obviously address the void in agriculturally focused venture capital. Alternatively, if efforts to create rural focused venture capital sources are not successful, Farm Credit lenders could pursue better working relationships with venture capital sources. The specialized expertise of CoBank and other Farm Credit System lenders would be an invaluable service to producer groups negotiating with venture capital suppliers.

As farmers and farmer-owned businesses (both traditional structured and newly evolved) shift from commodities to value-chain participants, lenders will be forced to understand a broader range of market channels. For example, a lender servicing a natural beef alliance might need to evaluate the position of its supermarket partners, while the lender financing the producers might need to evaluate the differential collateral value of the cattle within the alliance versus traditional commodity outlets. As producers and producer organizations align into integrated supply systems, Farm Credit System lenders will be forced to evaluate loans and projects on the basis of strategic relationships and strengths rather than market price measures. Farm Credit System lenders have, heretofore, enjoyed an advantage in specialized industry knowledge and expertise. Future lenders will likely be forced to broaden their expertise.

As previous discussion has suggested, changes in producer-owned business models will impact suppliers of producer credit as well as cooperative lenders. Wilson et al. (1996) investigated the attitudes of North Dakota lenders (Farm Credit System and

commercial banks) toward lending funds for the purchase of cooperative stock. The authors found that decisions were based on the farmer's repayment capability and asset base and not on that of the new cooperative. Regardless of whether a producer seeks direct funding for cooperative stock, participation in producer-owned business structures will impact the liquidity, leverage and cash flow of the farm business. Future agricultural lenders will likely find a broader scope of investment assets on producer's balance sheets.

Tomorrow's Farm Credit lender may need to evaluate small group producer businesses. In order to gain further economies of scale, several large producers could join forces to purchase inputs, own machinery, build grain storage, cotton gins or pursue other jointly-owned projects. Multi-producer activities involving large producers can easily rival the size of yesterday's cooperative. The Farm Credit System has expertise in both production and cooperative lending and is uniquely positioned to service these types of enterprises. However, these new multi-producer enterprises, do not fit comfortably under either the lending criteria of either the cooperative or producer arms of the Farm Credit System. Unlike a traditional cooperative, the capital and cash flows are likely to be highly integrated with that of the producer's farming operations. On the other hand, the lender will need to evaluate governance, ownership structure and ownership transfer issues. Servicing these opportunities may require linkages between Farm Credit's cooperative and producer-based lending channels.

Similar small group enterprises involving small producers are also likely to emerge. While less attractive from a loan volume basis, these activities will also present new opportunities for Farm Credit lenders, particularly those with more urban trade territories where, paradoxically, small-scale agricultural opportunities tend to expand.

Despite their disadvantage in scale economies, smaller multi producer enterprises often enjoy strategic advantages stemming from their linkages to the final consumer. For example, the previously described Grown Locally cooperative in Iowa grew from a community supported agriculture project to a firm supplying institutional and restaurant customers using internet ordering, refrigerated transportation, further processing and freezing operations. In the future all Farm Credit System lenders, even those servicing small producers, may find themselves evaluating group business structures.

### Conclusions and Recommendations

American agriculture is becoming more industrialized. Cooperatives and producer-owned businesses are seeking more flexible business models. These changes highlight a need for regulatory changes expanding eligibility limits for Farm Credit System lenders. All aspects of the Farm Credit System will need to understand and analyze an increasing complex array of producer/investor-owned business models. System lenders will also need increased expertise and capabilities in analyzing markets, market channels, product categories, and strategic partnerships and relationships. Tomorrow's traditional cooperative borrower will represent a larger and more complex business. Value-added ventures will involve fluid mixes of producer and investor capital. Less formal multi producer enterprises involving both large scale and small scale producers are likely to develop. In servicing these groups, Farm Credit Systems lenders may find a need to link efforts of their producer and cooperative lending branches. Evolving cooperative business structures will present the Farm Credit System with new

opportunities and new challenges. Responding to these opportunities will require investment in human capital, information systems and business partnerships.

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