South Central Cooperative
Case Study

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A major challenge for cooperative boards it to balance competing uses of funds in a way that is best for members while maintaining the long-term financial stability of the cooperative. This case study examines these trade-offs in a set of decisions facing an actual cooperative board.

The Setting

South Central Cooperative is a large diversified farm supply and grain marketing cooperative located in South Central United States. South Central has 4 branch locations and in normal years handles over 3M bushels of grain and has farm supply sales of $3-4M. In 2010 the cooperative set strategic goals to increase liquidity and reduce leverage, both of which were at levels which began to concern their lender. This year the cooperative has generated local savings of around $380,000 and total net savings (before any cash or stock patronage dividend and taxes) or $508,000. The cooperative has been receiving large patronage refunds from its fuel business. As part of their financial strategies, South Central has been retaining 50% of savings as unallocated equity and then paying 35% cash and 65% stock patronage refunds on the allocated portion.

That Pesky Balance Sheet

During their 2010 strategic planning retreat their CoBank representation conducted a financial fitness profile and discussed weakness in liquidity. The board had always prided themselves on the financial soundness of the cooperative so they immediately set goals to address the issues. by retaining a greater portion of profits as unallocated equity, keeping cash patronage low, and delaying equity retirements. Liquidity has now improved (current ratio went from 1.3 to 2.7) and the ratio of long term debt to member equity has fallen from 41% to 18%. Now the board wonders if it has been overly focused on leverage and liquidity ignoring both the equity structure and the impact on the members. The amount of unallocated equity now exceeds allocated equity. Local equity (total equity less the value of stock in regional cooperatives) represents less than 75% of total equity. One board member wonders whether those ratios are problems.

Equity Redemption

The cooperative is on an age of patron equity redemption program with a target age of 70. However in the past two years the cooperative has only retired estates and equity redemptions are current only back to age 72. The cooperative has several members with large equity balances approaching age 70. The board has considered transitioning to an age of stock redemption system. A consultant suggested maintaining the age of stock redemption and phasing in additional redemptions of the oldest stock in order to transition to an age of stock system. A redemption budget for the age of member system will require $150,000 while it will take roughly $225,000 to transition to the age of stock.

Fixed Assets

The board has been trying to maintain a fixed asset investment budget of around $250,000/year. They had hoped that this would keep equipment on a on a 3-4 year replacement cycle. The oldest fertilizer is now four years old and is beginning to experience significantly higher repair expenses. The manager is recommending replacing the floater at a cost of $300,000. The elevator superintendent would like to replace the leg in the elevator at a cost of $500,000. A new leg would improve handling speed and reduce waiting lines at harvest which can peak at over 1 hour wait. Some of the board are reluctant to go backwards on their goals to strengthen the balance sheet while other board members question "why have a strong balance sheet if you can't use it?"

Incentives and Bonus

The cooperative has 22 full time employees and a total personnel and benefits cost of around $645,000. Retaining employees at all levels of the organization has been a continual challenge. The board would also like to take proactive action to prevent them from losing their general manager to another cooperative. A board subcommittee was formed to investigate possible bonus and profit sharing systems. The committee has suggested a bonus pool averaging 5%. If implemented, the committee recommended that the board set the manager's bonus and allow the manager to allocate the remainder among the branch managers and employees. The bonus plan would push the ratio of personnel costs to gross margin well above the board's goal of 40%.

Profit Distribution

The cooperative has historically paid 35% cash dividend on allocated profits. A number of members have approached the board about increasing the percentage to 50%, which would be in keeping with surrounding cooperatives. The board is also re-examining their decision to retain 50% of profits as unallocated equity, essentially to take 50% off the top before splitting the remainder in cash and stock patronage.

Wind Energy Opportunity

The cooperative has an opportunity to invest in a large scale wind energy project which will be located in their trade territory. The minimum investment amount is $500,000. The cooperative should receive a return of about $30,000/year. However the return is scheduled to increase as the project pays down debt. The return is up to 10% in five years and the return over the life of the project averaged 16%. In ten years the cooperative could receive over $85,000/year which could be used to help boost the equity retirement budget.

Questions for Discussion

1. What is the right amount of unallocated equity for South Central? What are the dangers from having too little or too much unallocated equity? How does channeling funds to unallocated equity effect the members?

2. What percent of cash patronage do the members need to pay the taxes on their allocated retained equity? Should a cooperative attempt to match the neighboring cooperatives or focus on its own financial situation?

3. Does a cooperative have a commitment to retire equity according to specific schedule or should the redemption budget be based on balance sheet goals? Given the competing needs for funds how quickly should a cooperative retire equity?

4. Do members care more about infrastructure and service than cash patronage and equity retirement? Should a cooperative make sacrifices in those areas for "speed and space"?

5. Should cooperatives offers bonuses and performance pay and if so what is the proper measure of performance to link them to?

6. Should a cooperative invest in projects outside of its key areas for diversification or should they stick to the core areas and return any excess funds to the members?