An Introduction to Cooperative Financing Strategies

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Learning Objectives

1. To become familiar with examples of strategies used to finance cooperatives
2. To recognize that choice of governance structure impacts financing options for member-owned ventures

This article provides a general introduction to address the question of how cooperatives are financed. In this context, a discussion of cooperative financing strategies includes examples of strategies cooperatively owned ventures use to raise initial funding, sources of risk capital for continued investment in assets, and alternative mechanisms for distributing benefits and losses (Peterson 2011). Cooperatives and other organizations operated for the joint benefit of their members employ a wide variety of financing strategies. And, in addition to the general strategies explained here, cooperative policies and bylaws result in many variations to the examples presented. While this discussion of cooperative financing is not exhaustive, it provides an introduction to relevant options and considerations to be made when selecting among financing alternatives.

Some financing strategies may not be legal or feasible for cooperatives with a particular governance structure. Therefore, it is important to consider the challenges and benefits of various equity strategies in relationship to governance structure as part of the cooperative development process. In addition, it is helpful to consider how financing and governance needs may evolve over time. Existing cooperatives reconsidering their equity strategy may be interested in exploring changes to governance structure or membership arrangements to facilitate employment of alternative equity strategies. The following sections address ownership rights, initial funding strategies and continued financing options.

1. Who owns?

Ownership rights are often linked to control rights and residual claimant rights[1]. Who might be eligible to exercise these rights, or become a member of the cooperative, is a fundamental question cooperative developers may need to address when designing capital structure plans. Various types of funding are available through such avenues as member patron relationships, non-patron investors, venture capital organizations, private organizations, government programs, and financial institutions. Stakeholders often decide to support a cooperative with a specific objective in mind. To enhance cooperative success, it is helpful to understand stakeholders' objectives and ensure their incentives for involvement in the cooperative venture are in alignment with cooperative goals and objectives. The following examples explore possible members, investors and stakeholders.

[1] *Control rights* refer to the right to make decisions concerning the cooperative and the use of its assets. Control rights are often stipulated as part of the governance, or voting, structure of the cooperative. However, given that contracts cannot specify every possible contingency, there are often control rights which are left unassigned and may be assumed by certain parties. These unassigned control rights can be referred to as residual control rights. *Residual claimant rights* refer to the right to receive net income the cooperative produces after contractual obligations have been met. For further discussion of control and residual claimant rights, see Milgrom, P., and J. Roberts. 1992. *Economics, Organization and Management*. Englewood Cliffs: Prentice Hall.

1.1 Member Patron Relationships. The cooperative will face many decisions in the implementation of its vision. The transactions involved in pursuing cooperative goals often affect individual members differently (Hansmann 1996). Therefore, cooperatives can design their membership structure in an attempt to align member interests. Cooperatives may consider whether it is appropriate to have 1) a voluntary, non-binding membership agreement or a more highly defined membership structure, 2) a minimum level of transaction frequency or equity contribution, or 3) various membership classes.

1.2 Non-patron Investors. Non-patron investors are often seeking a financial return when considering investment in a cooperative. In contrast, member patrons may be willing to accept weaker financial returns in light of the benefits they gain through membership. Employees, another potential class of non-patron investors, may tend to favor job security or employment benefits over patron services. Cooperative leaders need to address whether potential divergence of interests within the organization may be adequately resolved through selective incentives[2] when considering whether to seek equity capital from non-patron investors (Olson 1965).

1.3 Venture Capital Organizations. Angel investors or venture capitalists may be interested in investing in cooperative organizations. Alternately, cooperative and investor-owned businesses operating in related industries may seek to act as venture capitalists to the cooperative or engage in a joint venture with the cooperative organization. Incentives these investors have may include financial returns on the investment, cost savings to their existing business, and improvements to the operation of their business which result in a net gain to be shared among the investors.

1.4 Private Organizations. Private organizations such as non-profit agencies, foundations or community development programs likely do not intend to become owners, per se, of the cooperative organization. These entities are often involved in assisting with fundraising, donating funds or granting funds. They may also reduce cooperative costs by providing services such as training or assistance in conducting a feasibility study. Even though private organizations may not seek ownership rights within the cooperative, their organizations continue to have a separate mission and are responsible for furthering this mission. Therefore, it is important to determine whether funds or assistance from private organizations necessitate compliance with certain practices, reporting requirements, or stipulations that detract from the cooperative's original purpose.

1.5 Government Programs. Government ownership may be rare in the case of cooperatives that originate from the bottom up: i.e. through the interaction of potential member patrons.

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[2] Olson defines a selective incentive as "an incentive that operates, not indiscriminately, like the collective good, upon the group as a whole, but rather selectively toward the individuals in the group. The incentive must be 'selective' so that those who do not join the organization working for the group's interest can be treated differently from those who do. These 'selective incentives' can be either negative or positive, in that they can either coerce by punishing those who fail to bear an allocated share of the costs of the group action, or they can be positive inducements offered to those who act in the group interest." Selective incentives, whether tangible or intangible, can be used within the group to stimulate individuals to act in a group-oriented way. Examples of selective incentives include 1) varying cost or payment structures for members meeting certain criteria, 2) feelings of solidarity gained through membership, or 3) fines to individual members for non-compliance with cooperative regulations.

However, even in instances where government ownership is not a consideration, government programs can affect the capital structure options available to cooperatives. For example, stipulations regarding membership eligibility and governance structure may be placed on organizations accepting funding from federal, state and local programs. Eligibility for government programs may be further restricted by the cooperative's choice of incorporation status or tax status.

1.6 Financial Institutions. A variety of financial institutions provide debt financing to cooperatives, including traditional banking institutions, credit unions, and specialized banks serving cooperatives. In the U.S., examples of lenders with a history of lending to cooperatives include NCB (National Cooperative Bank) and Farm Credit Services. Financial institutions do not seek ownership rights; their incentive for provision of funds is in collecting interest on the loan. However, it must be noted that interest payments may not be the only drawback to seeking debt financing. Loan covenants may also be put in place which could restrict the cooperative's strategy set.

2. Initial Funding

Without a proven track record, securing start-up funding may be challenging. In the case of purchasing cooperatives, if for example, storage facilities or other significant investments are not necessary, cooperators can simply contribute funds for the joint purchase of items. However, when larger investments are necessary for cooperative operations, many alternative financing arrangements are available. Cooperatives may utilize seed capital contributions, non-redeemable shares, development loans and grants, government programs, venture capital financing, and loans as sources of start-up funds. Tax credits may also offset initial capital requirements for cooperative businesses.

2.1 Seed capital contributions. For cooperatives that emerge from the bottom-up, through a group of individuals interested in pursuing a common interest, seed capital contributions allow potential cooperators the availability of funds to determine whether their initial concept is viable. Seed capital contributions may involve a series of small resource contributions. For example, an initial contribution of five dollars may be taken to judge interest and develop a draft proposal. Then, a one hundred dollar contribution may be sought from all still interested to put toward future feasibility studies or seeking legal counsel. While seed capital contributions to cooperatives are often not large enough to begin operations, they can be tied to future ownership rights or benefits within the organization. For example, if the cooperative chooses to incorporate non-redeemable shares into their structure, seed capital contributions may be counted toward future share purchases.

2.2 Non-redeemable shares. Non-redeemable shares refer to financial contributions which will not be returned to the member. At the most basic level, many cooperatives require a membership share to join the cooperative. Local food cooperatives may sell consumer membership shares for ten to fifty dollars. Membership shares oriented toward producers can be more costly: ranging from one hundred to one thousand dollars. Typically, membership shares cannot be redeemed when the member leaves the cooperative. However, membership shares are unlikely to be a significant source of financing for the cooperative.

An example of a type of cooperative that uses non-redeemable share equity as a significant source of financing is the New Generation Cooperative (NGC). Shares in an NGC are non-redeemable, appreciable, and linked to a right and obligation to do business with the cooperative. This means shares are often linked to a delivery obligation. For example, a producer may buy a certain number of shares that corresponds to the amount of raw product he will be contracted to deliver to the cooperative (Burress, Cook and Klein 2008). Some incorporation statutes also allow for non-producer members to buy shares in a cooperative (Iowa Cooperative Associations Act 2005; Minnesota Cooperative Associations Act 2003; Nebraska Limited Cooperative Associations Act 2007; Oklahoma Uniform Limited Cooperative Association Act 2009; Tennessee Processing Cooperative Law 2004; Utah Uniform Limited Cooperative Association Act 2008; Wisconsin Cooperative Associations Act 2006; Wyoming Processing Cooperative Law 2001). Non-producer members are primarily seeking a return on their investment, rather than the benefits of cooperative membership.

2.3 Development Loans and Grants. Loans or grants may be sought through public or private channels for initial funding. Some organizations offering development support include the United States Department of Agriculture, the Cooperative Development Foundation, and local economic development offices. Typically, a formal proposal accompanies a request for development funds. In addition, development funds are often linked to specific objectives: for example, funding a feasibility study, seeking technical assistance, or providing training. Additionally, some funding programs are targeted toward a specific purpose or group of cooperators: biofuels, healthcare or socially disadvantaged populations (U.S. Department of Agriculture 2011b; U.S. Department of Agriculture 2011c). It is important to ensure cooperative and funding agency objectives are aligned.

2.4 Government Programs. In addition to the example of grants mentioned above, government programs may support cooperative development through loan guarantees or tax incentives. Loan guarantees are agreements to repay a designated percentage of a loan to the lender in the event the borrower defaults. A guaranteed loan lowers a lender's risk that the loan will not be repaid, making it easier for cooperatives to secure financing. The United States Department of Agriculture Rural Business-Cooperative Service is one organization that supports borrowers through guaranteed loan programs by acting as guarantor (U.S. Department of Agriculture 2011a).

There may be a wide range of tax incentives and legal considerations affecting member-owned organizations. Therefore, it is important to consult a cooperative accountant, attorney or local development specialist to become well informed of available options. Agricultural and horticultural cooperatives have a long history of supportive government policies regarding taxation (Frederick 2005a; Frederick 2005b). However, in recent years, government programs have also granted incentives to individuals investing in certain cooperative structures. For example, Missouri producers investing in NGCs processing agricultural commodities may be eligible for a tax credit of up to fifty per cent of their investment for a maximum fifteen thousand dollar credit (Missouri Department of Agriculture 2011).

2.5 Venture Capital Financing. Venture capitalist organizations are one class of investors that may wish to contribute risk capital to emerging cooperatives. Venture capitalists buy shares in start-up organizations, typically with the intent of retaining ownership of these shares

until the venture is established. Shares can then be sold to willing investors. It is also possible for established cooperatives, with business interests related to the emerging entity, to act as venture capitalists. In this respect, the established cooperative may become a major shareholder in the new entity as well as a producer or consumer of cooperative services. In other words, established cooperatives may be looking for a long term investment in the new entity as well as membership benefits. For example, a local grain cooperative may become a major shareholder in a newly forming feed milling cooperative (Burress, Cook and Klein 2008). This relationship allows a financial return on their investment as well as a potential outlet for cooperative grain.

2.6 Loans. Debt financing can also be obtained through a variety of lenders. It may be beneficial to work with lenders that have experience working with cooperatives. In the U.S., examples of lenders with a history of lending to cooperatives include NCB (National Cooperative Bank) and Farm Credit Services.

3. Continued Financing

Once the member-owned organization is established, additional financing sources are available. These sources might include retained earnings, base capital programs, share offerings, the issuance of debt or divestiture of assets.

3.1 Retained earnings. Often, the majority of funds for internal cooperative investment are derived from retained earnings (Castanias 1990). When a cooperative generates a profit, it must decide what portion of these profits will be 1) returned to members or 2) retained within the cooperative for operating expenses or continued development (Cropp 2005). Retained earnings may be assigned to the member as non-permanent, allocated equity or assigned to the cooperative as permanent, unallocated equity.

Equity allocated to members is not a permanent source of equity to the cooperative because this capital is to be returned to the member. Typically, equity is allocated to the member in proportion to their use of the cooperative. Examples of allocated equity include retained patronage refunds or so-called per-unit retains (Rathbone 1997). Allocated equity may be returned to the member on a revolving basis: meaning that the cooperative utilizes the capital as a no-interest loan from the member, returning these funds typically within a 3-18 year timeframe at the discretion of the board. Alternately, allocated equity may be scheduled to be redeemed by the member when exiting the cooperative. Allocated equity is generally returned to the member at par value unless specific arrangements for accrual of interest are stipulated (Cobia 1989).

Unallocated equity is non-redeemable; meaning this capital may not be returned to members unless the cooperative is sold or dissolved. In addition to retained earnings from member business, potential sources of unallocated equity include non-member business, subsidiary arrangements, joint ventures, or cooperative investments in other entities. Unallocated equity generated by non-member sources allows the cooperative to support member needs without extracting additional member investment.

3.2 Base Capital Programs. Base capital programs may be used as an additional source of funds for cooperative operations. Even though allocated equity may be retained in proportion to member patronage, over time, retains allocated to a certain member may no longer reflect

current patronage. For example, a member near retirement may have contributed substantial funds to the cooperative in the form of allocated equity; however, their current cooperative patronage is negligible. On the other hand, a new member may conduct a large volume of business with the cooperative but their short tenure as a member has not resulted in a substantial amount of capital being contributed to the organization. Base capital programs attempt to introduce a measure of equity by ensuring members have contributed a certain minimal level of investment in proportion to their current patronage. Before gaining the full benefits of membership, members may be required to build their individual capital base through greater retained earnings, direct contributions or the purchase of base capital units from other members. A base capital approach may be more adept at ensuring that current cooperative users finance the organization (Rathbone and Davidson 1995).

3.3 Share offerings. Depending upon their particular ownership structure, cooperatives may be able to access additional risk capital through subsequent share offerings or preferred stock offerings. Cooperatives with a structure that includes non-redeemable shares may conduct additional share offerings when in need of additional equity. It may however, be difficult to create enough enthusiasm among investors to purchase shares in subsequent rounds unless the additional offering is linked to a specific expansion opportunity likely to justify the investment. Another drawback to subsequent share offerings is the potential for dilution of current member or investor's shares and voting rights. If subsequent share offerings are not a viable option, the organization may consider issuing a capital call to shareholders. Capital calls may be voluntary or required. The calls are essentially requests for additional capital to be furnished by current shareholders. Shareholders not responding to voluntary capital calls may have their ownership rights reduced.

Cooperatives may also choose to issue preferred stock. Preferred stock is generally a fixed-dividend, often non-redeemable, non-voting stock issued to members or non-members (Boland and McKee 2009; Chaddad and Cook 2004). The option of offering preferred stock may be available to a wider range of cooperatives. One benefit of preferred, non-voting stock is this equity source does not dilute member voting rights (Van Bekkum and Bijman 2006).

3.4 Issuance of Debt. In addition to loans as discussed in the previous section, cooperatives may wish to explore additional sources of debt financing. One option is to look to members for debt financing. By issuing debt to members, cooperatives may be able to secure funds at a lower interest rate than a bank loan (Bartsch and Dahlgren 1997). Examples of debt issued to patrons include demand loan certificates and patron demand deposit accounts. Patron demand deposits act as a savings account. The account bears interest. And, patrons can generally withdraw deposits at any time. Cooperatives may also develop similar accounts for non-members (Hanson, et al. 1999). However, it can be risky for cooperatives to rely on demand deposits for financing. Especially during times of hardship, the cooperative is at risk for experiencing large withdrawals which put added strain on financial stability (Brueckner, Duft and McCluskey 2000; Duft 1998).

Bonds may also be used in cooperative financing (Chaddad and Cook 2004; Van Bekkum 2009; Van Bekkum and Bijman 2006). By issuing bonds, the cooperative essentially borrows

funds from bond holders for a specific time frame at a fixed interest rate. The issuance of bonds may be of interest to cooperatives seeking to maintain member control.

3.5 Divestiture of Assets. Cooperatives may also look to divest assets in search of liquidity. The first option may be marketable securities in which the cooperative has invested funds during times of prosperity. Examples of marketable securities include money market instruments or treasury bills. Alternatively, if seeking a shift in strategy focus, cooperatives may divest of larger assets, including the spinoff of a business unit or subsidiary.

4. Continuous Revision of Financing Strategies

After reviewing possible financing alternatives that align with the cooperative's mission, there is most likely a proposal, a prospectus, bylaws, or other documents to be written that share elements of the financing plan. If initial financing plans do not come to fruition, or at some point in the future no longer contribute to the overall goals of the cooperative, adapting cooperative structures and financial strategies may be necessary. Successful cooperatives may find the need to modify their financing strategy at several points throughout the cooperative life cycle (Cook and Burress 2009). Continuous revision of financing strategies may sustain the cooperative's ability to meet members' evolving needs.

5. Background reading

Brueckner, E. C., K. D. Duft, and J. J. McCluskey. 2000. "Patron Demand Deposit Account and Regional Patronage Financing Activities of Agribusiness Cooperatives." *Journal of Agribusiness* 18(3): 289-302.

Van Bekkum, O. F. 2009. "Cooperative Champions or Investor Targets? The Challenges of Internalization and Exteral Capital." Working Paper, The Netherlands Institute for Cooperative Entrepreneurship (NICE), Nyenrode Business Universitet.

6. Required reading

Castanias, R. P. 1990. "Problems and Issues in Cooperative Financing." Paper presented at Innovations in Cooperative Finance, University of California, Center for Cooperatives, December.

US Department of Agriculture- Rural Business and Cooperative Service. 1994. Understanding Cooperatives: Financing Cooperatives. Washington DC: Cooperative Information Report 45, Section 7, October.

7. Optional reading

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8. Exercise

Write a short description of 1) a cooperative you envision developing or 2) an established cooperative. Your description should include the cooperative's mission, objectives and operations. You must also address who will own the cooperative by indicating 1) who will have control in the form of governance or voting rights and 2) who the claimants are for any proceeds or benefits of the organization.

a. ***Choose three financing strategies***. Next, explain at least three financing alternatives to be used to finance the cooperative, either during start-up or in the future. If you choose an existing cooperative, you will need to look at financing options that may be viable but are not currently in use by the organization. Be sure to indicate why the strategies you have chosen are an optimal method for financing your particular cooperative. In addition, list any potential pitfalls you may see with the financing option you have chosen.
b. ***Exclude two financing strategies.*** To conclude, mention at least two financing alternatives that are not a good fit for your particular cooperative, explaining why these financing strategies may not be viable for your particular model.

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