**Understanding Cooperative Returns**

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One of the fundamental characteristics of a cooperative that distinguishes it from other forms of business is that the customers (patrons) are also the owners of the firm. Members are really making a joint decision to invest in the cooperative as owners and to patronize the cooperative firm. That creates the possibility that the member can benefit at both the farm level and at the cooperative level. Farm level returns could include more favorable prices, reducing risk through pooling or the access to services that are otherwise unavailable. The cooperative may also be creating an invisible benefit by keeping the market more competitive. None of those benefits show up on the cooperative’s income statement and they are separate from the patronage distributed to members.

Both levels of the returns (farm level and cooperative level) are potentially important to a potential member. In theory, a producer would invest to join a cooperative when the perceived returns at the farm level plus the projected returns from the cooperative were higher than alternative investments. For most producers the relevant alternative investment is investing in their farm operation. So, a producer would be expected to join a cooperative when the benefits from the cooperative at both the farm and cooperative level were greater than investing in their farming operation.

As you might recall, one of the original Rochdale principles was “good sold at market prices” and as we will see in later chapters, cooperatives are encouraged to set the prices for both farm supplies and farm commodities at the prevailing market price. In other words, the best practice is typically for the cooperative to price at market levels and concentrate on generating returns at the cooperative level which can be passed on to the members as patronage. When a cooperative tries to benefit members through favorable prices it runs the risk that it mist-estimated costs and ends up making a loss. The cooperative’s competitors also often match favorable prices so the strategy ends up benefiting non-members as much as members. Still, the broader point is that members can potentially benefit at both the farm level and the cooperative level and the cooperative board and manager must consider both effects. This is a unique aspect of the cooperative firm.

There are some instances where the potential for member level returns are particularly apparent. Some marketing cooperatives, particularly those marketing specialty fruits and vegetables, operate on a pooling basis. Under that structure, the cooperative does not purchase the commodity but rather gives the member an advance on the final pool distribution. The advance payment serves as a partial payment of the final pooled value of the commodity. Eventually all of the commodity in the pool are sold and the residual amount is distributed to the members in proportion to volume. One can think of the first payment as relating to the commodity value and the second payment as a profit distribution but there is really no clear separation. The pooling cooperative is operating entirely as an extension of the farm. The final value of the commodities combines the value created at the farm level (growing and harvesting the fruit or vegetable) and the value created at the cooperative level (processing, packaging and marketing). However, there is no separation between those values. The advance payment does not necessarily reflect the value of the crop it is simply an advance on the final projected value of the final product. In a pooling cooperative all of the return comes at the member level. Members may appreciate the importance of their pooling cooperative but they really have no measure of the value created at the cooperative level.

Another instance where member level value is important occurs when the existence of the cooperative allows the members to grow a more profitable crop. For example, in the northern plains, sugar beet production has historically been more profitable relative to corn or soybeans. There has been instances where an investor owned sugar beet processing facility has decided to close and farmers have formed a cooperative to purchase the facility or built a processing plant. That raises the question as to why the producers came to a different conclusion over the feasibility of a sugar beet processing plant relative to the investor owners. It is possible that the producers had a lower hurdle for an acceptable rate of return. What is more likely is that the producers were considering the additional farm level returns that the processing plant would create by allowing them to grow a more profitable crop. In the case of a sugar beet processing cooperative, the members can monitor the returns created at the cooperative level and will receive a share of those returns through patronage. They also receive a farm level benefit by being able to grow a more profitable crop. The cooperative board and management would need to consider the farm level returns that are created by the cooperative’s existence in addition to the cooperative level returns.

A more complex example of farm level returns occurs in farm supply cooperatives when they provide products or services that are important to members but only marginally profitable. A classic example is a cooperative tire shop that fixes flat tires on vehicles and implements. The tire department is frequently not profitable. Members might argue that the access to tire repair services is important at the farm level. Cooperative leaders face the dilemma in determining whether the possibility of farm level returns justifies maintaining a service which is not generating returns at the cooperative level. One challenge is that while members might be opposed to closing the tire shop they may not consider the farm level value when they evaluate the cooperative performance. It is not unusual to see a situation where members are dissatisfied the their cooperative’s profitability while at the same time they support the cooperative maintaining unprofitable products and services due to the value they provide at the farm level.

While cooperative leaders must consider farm level return, whenever possible the cooperative should try and generate most of the return at the cooperative level. Farm level returns are difficult to measure and sometimes accrue to non-members as well as members. Cooperative boards should scrutinize any investment or activities that are being justified solely on the basis of service differentials, value of existence or the value in reducing risks. Those farm level returns, while important, are also subjective and may vary from member to member. That does not mean that farm level returns should be ignored. It means that activities generating only farm level returns should be examined closely to assure that such value actually exists and is recognized by the members.

Return on Investment

In an investor owned firm the owners purchase stock or other form of ownership and receive a return through dividends on equity and/or appreciation of the stock value. In an investor owned firm there is no return to the users or customers. That makes the calculations of return on investment fairly straightforward. The owner’s investment and the owner’s return are readily apparent. As mentioned, cooperative members are both investors and users. That raises some interesting questions on measuring a members return on investment and in considering what the appropriate return should be. In theory a member’s return from a cooperative includes patronage refunds, dividends paid on equity and farm level returns such as price differential, service differential, value of existence and value of risk pooling). As we have discussed, farm level returns may be important but are difficult to measure. If we focus on the cooperative level returns we see that members benefit primarily through patronage refunds which are paid in a combination of cash and revolving equity. he member’s returns reflect the cash patronage and the present value of the revolving equity which will be redeemed for cash at a later date. As we will see in later chapters, dividends on invested equity are limited by law and only a minority of cooperatives pay any dividends on equity capital.

Ideally, a cooperative would provide fair returns to members both as users and as owners. Patronage payments (both cash and the eventual return from revolving equity) provide a return to use but the return to ownership in a cooperative is indirect. This can lead to a “free rider” problem where new members receive the benefits from the cooperative with very low investment. It can also provide a disincentive to support long run investment by the cooperative since the member will only benefit from future patronage. For example, we would not expect older members in a dairy cooperative to support investing to develop branded value added products. They will likely conclude that the will not be active in the cooperative long enough to receive the benefits through future patronage. They would instead push for the cooperative to increase cash patronage and not retain funds for re-investment in the cooperative.

Closed cooperatives (new generation cooperatives) solve the free rider problem and the problem of incentive for long term investments, by linking investment to usage rights. Members have the opportunity to sell their shares and usage rights to another eligible member with the approval of the board of directors. If the new generation cooperative is successful, patronage payments will increase and the usage rights will be more valuable. That structure provides the potential for an appreciation in stock price and provides an additional aspect of the return on investment. In traditional or open membership cooperatives the owners return comes entirely through patronage which implies that the member must continue to use the cooperative in order to receive a return. Open membership cooperatives cannot entirely eliminate the free rider problem but can minimize it by managing equity in a manner that keeps equity investment in proportion to use. Keeping member investment proportional to use helps to treat members fairly as owners.

The denominator of the return on investment formula (owner’s return/equity invested). As we will see in our later chapter on Capital Structure, the owner’s equity in a cooperative business also has some unique characteristics. Some of the most common forms of equity are the direct investment that a member makes in order to join the cooperative, the retain patronage (patronage issued in the form of stock) and unallocated equity. Unallocated equity is created when the cooperative retains funds without creating equity in individual patron names. Members have a collective claim on the unallocated equity but it is never redeemed and the member would only receive the value associated with the unallocated equity if the cooperative is liquidated.

What is the appropriate equity category to use in measuring the owner’s return on investment? The answer is not entirely straight forward. In a closed cooperative the vast majority of the equity comes in the form of the direct investment which was made to join and obtain usage rights. That makes if fairly easy to calculate the return on investment in a closed cooperative. In open cooperatives direct investment is only a small portion of total equity and members only make a nominal investment to join the cooperative. Most of the equity in an open cooperative is created out of the profit stream in the form of allocated revolving equity (stock patronage) and unallocated equity (general reserve fund). Most cooperative scholars agree that the cooperative’s return on investment should be based on the total member equity. It must be noted however, that much of that equity may have earned out of the profit stream and members may have made very little actual out of pocket investment.

At times, cooperative CEOs and board argue that because the members did not make direct investment for the majority of their equity, it is not important to measure a cooperative’s return on equity. The counter to that argument is that the cooperative is owned and controlled by the members. All of those members have alternative uses for funds in their own farming operation. If the cooperative is unable to generate a return on the members’ equity there is an argument for liquidating the cooperative and allowing the members to invest the funds at the farm level. This suggest that one measure for the appropriate return on investment in a cooperative is that it should be comparable with returns from non-cooperative investment. The long-run return to the stock market has been 10-12%. Cooperative boards might consider that level as a goal for return on total equity. Of course, if the cooperative I less risky relative to the typical firm or is structured to help the members reduce risk, a lower return might be acceptable.

While this discussion has illustrated the complexities of understanding and measuring the owner’s return from a cooperative there are some general conclusions:

1. Cooperatives can generate return at both the cooperative level and the farm level. While cooperative leaders must consider farm level return, whenever possible the cooperative should try and generate most of the return at the cooperative level. Fam-level returns are difficult to measure and sometimes accrue to non-members as well as members. Cooperative boards should scrutinize any investment or activities that are being justified solely on the basis of service differentials, value of existence or the value in reducing risks. Those farm level returns, while important, are also subjective and may vary from member to member. That does not mean that farm level returns should be ignored. It means that activities generating only farm level returns should be examined closely to assure that such value actually exists and is recognized by the members.
2. In most agricultural cooperatives the owners return come primarily through patronage. That eliminated any direct incentive to hold equity and can make members with short time horizons oppose the cooperative’s investment in long term assets. All members can receive patronage benefits regardless of investment (the free rider problem) which can cause members not to support the cooperative’s actions in retaining funds and building equity. Closed membership cooperatives solve this “free rider” problem by linking investment with use and requiring substantial up front investment. Open membership cooperatives cannot eliminate the free rider problem but can reduce it by distributing an appropriate portion of profits in the form of equity (which helps members build equity investment) and by managing revolving equity to keep equity in proportion to use.
3. There are some unique issues in discussing the return on investment in a cooperative business. The member’s return may include farm level returns which are difficult to quantify. Additionally, some categories of member equity are created through retained profits and do not represent an out-of-pocket investment. Despite those unique features in measuring and benchmarking return on investment, cooperative leaders should strive to make cooperative level returns equal to or exceeding those from alternative non-cooperative investments. Regardless of how the equity was created, members will expect the cooperative to generate a reasonable return on those funds. A cooperative that continually fails to create a reasonable return on equity stands the risk of the members dissolving the cooperative to better deploy the capital in their own farming operations.
4. Cooperative performance cannot be measured solely on the basis of profitability. The member’s cooperative level return will also be affected by how the cooperative distributes profits and the revolving equity time cycle. In addition there are farm level returns such as service differentials and risk management. Finally, the cooperative may be generating a return through its very existence either by allowing the producer to grow a more profitable crop or by keeping markets competitive. Cooperative leaders must consider these other returns but not use them as an excuse for failing to generate adequate financial returns at the cooperative level.
5. Cooperative leaders should strive to treat members fairly both as patrons and as owners. The cooperative should allocate a high portion of the profits to patrons and distribute those profits in an appropriate mix of cash and equity patronage. The practice of retaining profits as unallocated equity (which is never revolved to the patron) should be used sparingly. Returning profits in proportion to use through patronage treats members fairly as users. In setting the appropriate mix of cash and equity patronage the cooperative should consider the cash needs of the cooperative as well as the need for patrons to build equity ownership. The board should attempt to manage equity revolvement so as to keep equity ownership in proportion to patronage. Keeping member investment proportional to use helps to treat members fairly as owners.

Summary

Understanding and measuring cooperative’s returns is complex. Members make a joint decision to invest in and patronize a cooperative. That means that they are both users and owners. The cooperative business model is focused on providing returns to use but the board and manager must strive to ensure that members are adequately invested in the cooperative. Most cooperatives do not provide a direct return on invested capital but by keeping investment in proportion to use they indirectly create a return on investment and treat members fairly both as users and owners.

Cooperative leaders should also strive for the cooperative to generate an adequate return on the member’s investment. One benchmark for an adequate cooperative level return would be a return comparable with the long-run return on the stock market or returns from other investment with a similar risk level as the cooperative. Cooperatives can also generate return at the farm or user level which can include price differentials, service differentials, risk reduction and a value of existence. Cooperative leaders must carefully weigh the impact of those returns but to the extent possible should work to maximize cooperative level returns. In the long run, members will choose to remain a member of a cooperative as long as combined returns from the farm and cooperative level exceed that of any alternative use of their equity capital.