Rising Equity and Retained Earnings for U.S. Farmer Cooperatives

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Since 2008, total equity levels have surged for U.S. farmer cooperatives. Higher profitability, mergers, acquisitions, and tax deductions utilized by U.S. farmer cooperatives have contributed to a 4X increase in average total equity. These equity generation sources have also shifted the composition to more retained earnings than allocated equity or equity tied to members. Given a board of directors and senior management do have some control over their respective cooperative's equity composition, the implications of the rise and compositional changes of equity should be considered. The objective of this fact sheet is to explore the changes in equity for U.S. farmer cooperatives across various states.

Equity is critical for any business, and its composition is unique to cooperatives. Equity capital is used to fund growth investments, finance inventories, or offset unexpected losses. An age-old challenge for the cooperative model is equity generation. Cooperatives do not have access to publicly traded equity markets, which means many cooperatives must primarily generate equity from retaining profits from member business. These profits can be retained as allocated equity or the member that generated those retained profits has a claim to that equity in the future. Member profits can also be distributed to retained earnings, and in that case, the cooperative has the claim to those retained member profits.

Cooperatives can also generate equity from non-member sources. Some sources of non-member proceeds are profits from non-members, income from joint ventures, outside investment returns, and tax deductions like Section 199. These proceeds increase retained earnings for a cooperative, which in turn increases total equity. Retained earnings are not subject to the cooperative's equity retirement program and can only be accessed by members if the cooperative is sold.

Regardless of the composition of equity, it is incumbent upon the board of directors and senior management to use equity in a manner to deliver value to the membership. Having higher levels of allocated equity does show more direct ownership by the membership, but it does mean less retained earnings to offset unexpected losses. Having higher levels of retained earnings does provide more direct equity for the cooperative, but it can result in ownership issues with the membership. It is important for a board of directors and senior management to understand how their equity is composed, its implications, and how equity is used to deliver value to the membership.

While each farmer cooperative is unique, it is beneficial to look at national and state trends in the evolution of cooperative equity. The remainder of the fact sheet looks at equity levels and composition using a unique data set of grain marketing and farm supply cooperatives' financial statements from CoBank.

Farmer Cooperative Equity Changes from 2008 to 2019

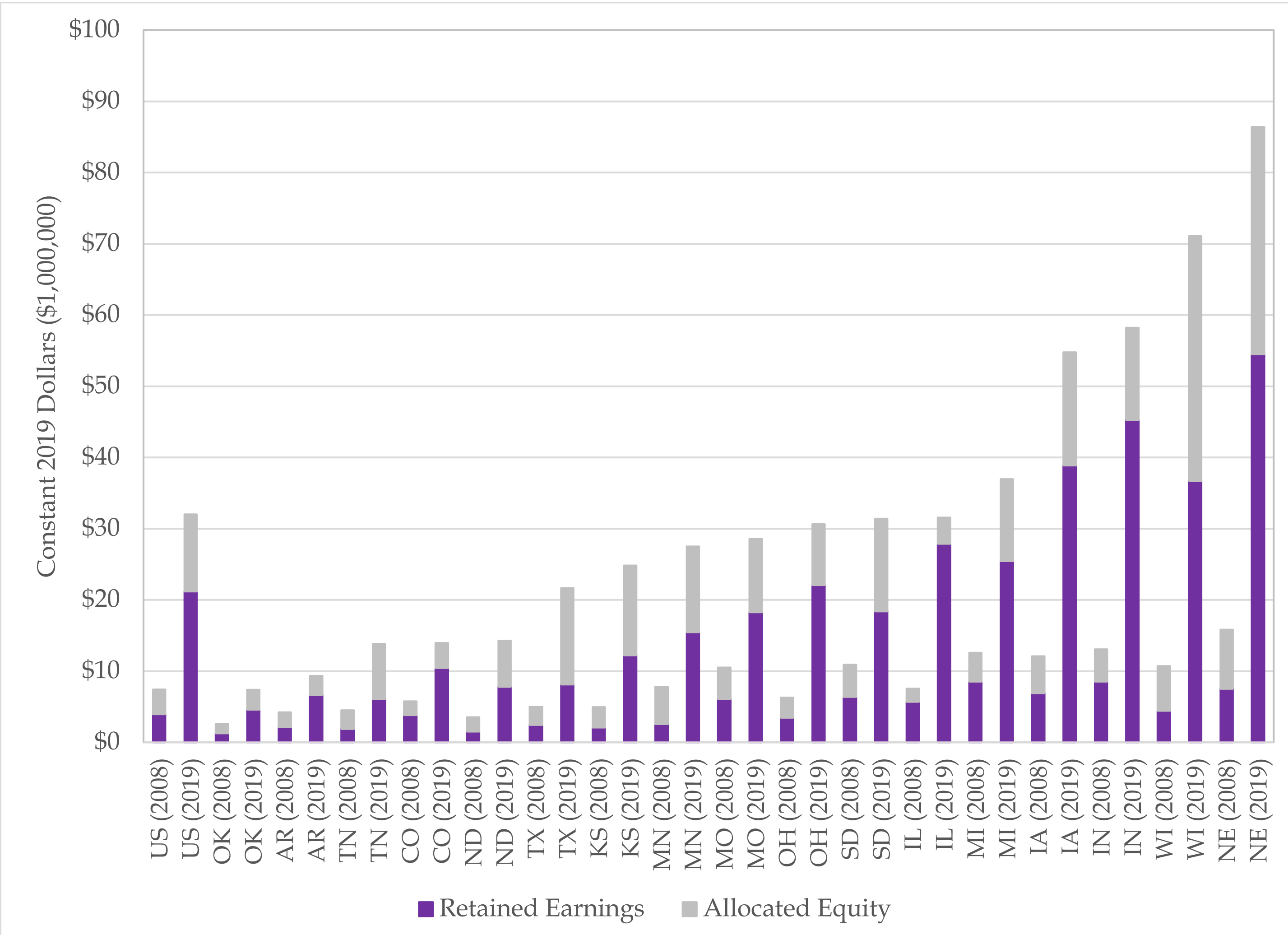

Figure 1. Grain and Farm Supply Cooperatives Average Retained Earnings and Allocated Equity Across States (2008 and 2019)
* Data is from CoBank financial statement database

On average, farmer cooperatives' total equity has surged. Figure 1 shows the inflation-adjusted, average total equity, and breakdown of equity into retained earnings and allocated equity for U.S. farmer cooperatives. From 2008 to 2019, the average total equity for U.S. farmer cooperatives increased from $7.4 million to $32.0 million. Much of this increase is driven by rising profitability, tax deductions like Section 199 and bonus depreciation on eligible assets, and mergers/acquisitions.

Every state shows an increase in average total equity, with equity skyrocketing in some states. Farmer cooperatives in Oklahoma, Arkansas, Tennessee, Colorado, and North Dakota saw their average total equity more than double. But Iowa, Indiana, Wisconsin, and Nebraska saw their equity levels increase by more than

4.5X, with Nebraska leading the way with a staggering increase of $70.6 million or 5.5X. The large increases in equity are likely driven by accelerated consolidation within their geographic area.

A significant driver for the rise in average total equity is an increase in retained earnings. As shown in Figure 1, from 2008 to 2019, U.S. farmer cooperatives' average retained earnings increased by $17.2 million, and allocated equity increased by $7.4 million. Given the significant increase of retained earnings, the average farmer cooperative's equity now consists of more retained earnings than allocated equity.

To more easily show this equity composition change, Figure 2 reports the average retained earnings-to-total equity ratio for 2008 (purple bar) and the subsequent change in the ratio from 2008 to 2019 (gray bar). The average U.S. farmer cooperative's ratio went from 51% in 2008 to 62% in 2019, which shows that retained earnings is rising faster than allocated equity for many farmer cooperatives.

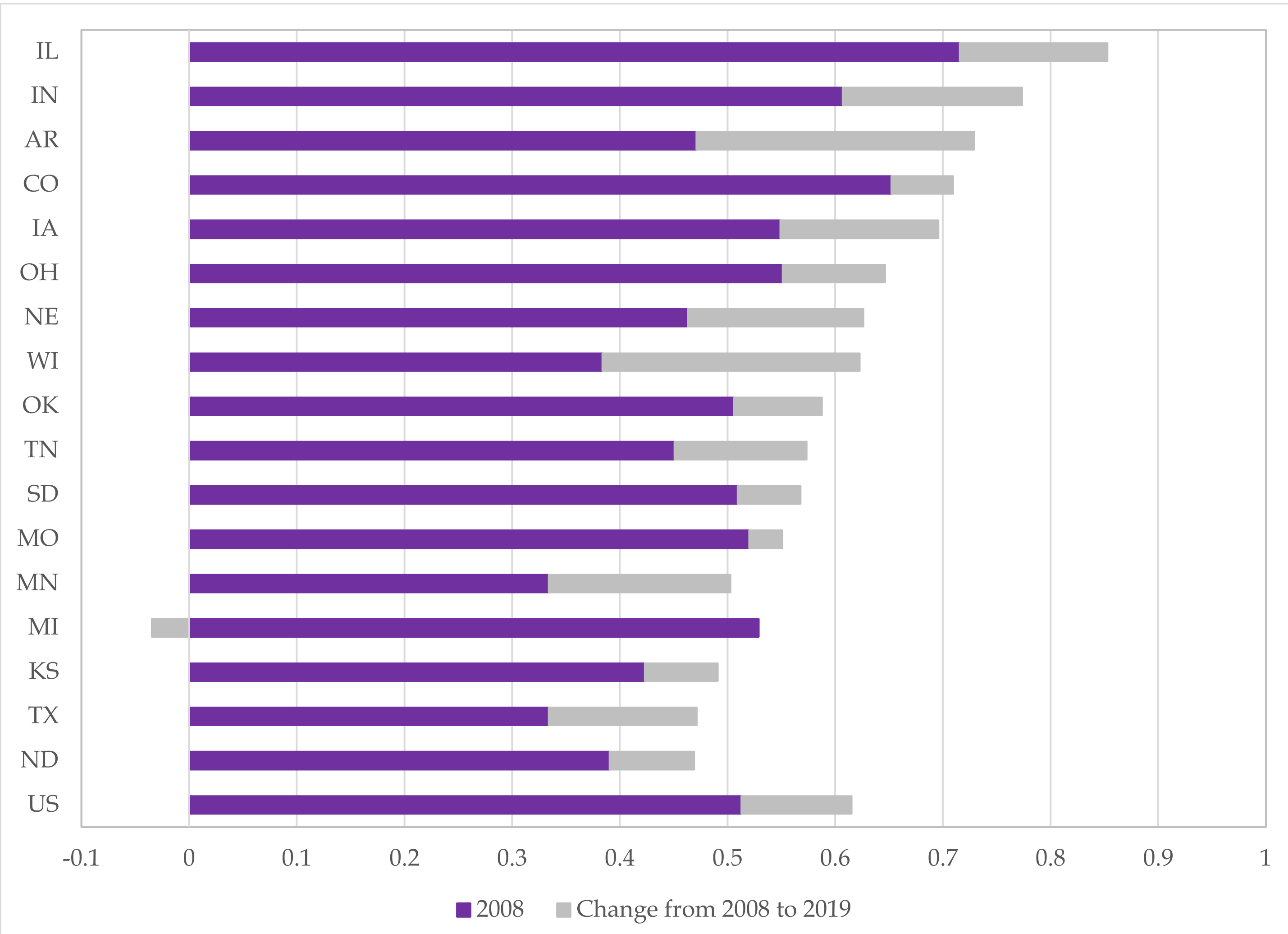

Figure 2. Grain and Farm Supply Cooperatives Average Retained Earnings-to-Equity Ratios Across States (2008 and Change from 2008 to 2019)
* Data is from CoBank financial statement database

Nearly every state reported an average increase in the ratio of retained earnings-to-equity. Arkansas and Wisconsin experienced the largest ratio increase with both states having their ratios increase by approximately 25%. So the average cooperative within these two states experienced a very significant rise in retained earnings relative to allocated equity. However, one state, Michigan, did experience a decrease in the ratio so allocated equity rose faster in that state. In fact, the average farmer cooperative in Michigan now has more allocated equity than retained earnings (2019 ratio equals 49.5%).

Implications of the Retained Earnings-to-Equity Ratio

The 50% ratio represents an interesting point because it indicates how the cooperative board of directors distributes profits back to the membership through patronage. If a cooperative's retained earnings-to-equity ratio is less than 50%, it is an indication that the cooperative allocates a larger percentage of profits back to the members in the form of allocated equity. A ratio greater than 50% suggests a larger share of profits is held by the cooperative as retained earnings.

As you can see in Figure 2, there is a fair amount of variation across states on how cooperatives distribute member profits. One state, Kansas, has an average retained earnings-to-equity ratio less than 50%, which suggests these cooperatives tend to allocate profits back to members. However, Kansas cooperatives still had a sizable gain in retained earnings. From 2008 to 2019, retained earnings increased by $10.1 million, and allocated equated increased by $9.5 million.

Another state, Illinois, has a retained earnings-to-equity ratio well above 50%. From 2008 to 2019, the average Illinois farmer cooperative saw retained earnings increase by $22.2 million while allocated equity went up $1.8 million. This suggests more member profits are held by the cooperative as retained earnings.

So what is the optimal retained earnings-to-equity ratio for a farmer cooperative? Answering that question is going to vary across cooperatives. Just as we saw in Figure 2, there is a fair amount of variation across states. Kansas tends to have lower ratios, while Illinois tends to have higher ratios. The point of examining these ratios is not to argue a higher or lower ratio is good or bad. Rather, it is for a cooperative board of directors to recognize the differences and understand how it fits into their approach to delivering value to their membership.

Higher retained earnings-to-equity ratios indicate a cooperative has more risk capital for the cooperative to absorb unforeseen losses. But members will not receive as much future allocated equity redemptions. Lower retained earnings-to-equity ratios indicate the membership has more direct ownership of future claims to a cooperative's equity. But if an unforeseen loss were to occur, then members will likely have to absorb some of that loss with a reduction in their allocated equity.

In short, retained earnings and allocated equity are both important for any cooperative. Knowing the tradeoffs between these two types of equity should be discussed by the board of directors to ensure the composition allows them to meet their long-term goals. Ultimately, the objective of every cooperative should be to use equity to create value for the membership.