Equity Composition of Kansas Grain, Oilseed and Farm Supply Cooperatives

ACCC Fact Sheet Series – Paper #4 (Updated Data)

Original Research Article using CoBank's Risk Analyst Database

June 22, 2016

Brian C. Briggeman, Ph.D.
Associate Professor and Arthur Capper Cooperative Center (ACCC), Director
Department of Agricultural Economics
Kansas State University

Chuck Mickelsen
Arthur Capper Cooperative Center (ACCC), Computer Information Specialist
Department of Agricultural Economics
Kansas State University

Krishna P. Pokharel
Ph.D. Candidate and Graduate Research Assistant
Department of Agricultural Economics
Kansas State University

Equity generation and composition are important topics for any cooperative. Generating equity capital is critical because it can be used to finance growth through capital investments, absorb any business losses, help secure a loan as well as be used for other business purposes. For cooperatives, equity levels are primarily boosted by retaining a portion of member and/or non-member income. Once the income is retained, it must be designated as either allocated equity (i.e., the equity has a member's name on it and will be redeemed to that member in the future) or as unallocated equity (i.e., the equity is held at the cooperative level and not owed to a specific member). For the cooperative's board of directors, it is critical to determine the appropriate level and proportion of allocated and unallocated equity for their cooperative.

While equity levels and composition will vary from cooperative to cooperative, there are some general trends that have developed throughout the industry. Specifically, Boland (2012) found that for a national sample of grain, oilseed and farm supply cooperatives' equity rose, especially unallocated equity. Thus, the objective of this fact sheet is to examine equity trends but focus specifically on Kansas grain, oilseed and farm supply cooperatives (hereafter, Kansas co-ops).

Data for this analysis was provided by CoBank's Risk Analyst database, and is made available to the researchers per a confidentiality agreement. The data are a panel of 45 Kansas co-ops with the necessary financial variables that span the years of 1999 to 2014. Averages of all reported financial variables are adjusted in a 2014 constant dollar value using a Bureau of Labor Statistics (BLS) GDP price deflator.

To understand the evolution of Kansas grain, oilseed and farm supply (agricultural) co-ops' equity position, we must first start with an examination of where the equity is primarily generated, total net savings or total net income. Kansas co-ops' total net income has experienced some fairly wild swings. From 1999 to 2003, average total net income fell from an inflation adjusted \$855,863 to -\$552,538 (figure 1). Non-member income was negative in 2002 and 2003 primarily because of Farmland Industries bankruptcy.[1] Similarly, average member income was negative in 2003 (- \$161, 808) and 2004 (\$ -17,494). Furthermore, 2003 was especially stressful

[1] Due to data limitations, non-member income is estimated as the difference between year *t* retained earnings and year *t* – 1 retained earnings.

for Kansas co-ops due to huge negative member income because of drought conditions that spread throughout the state.

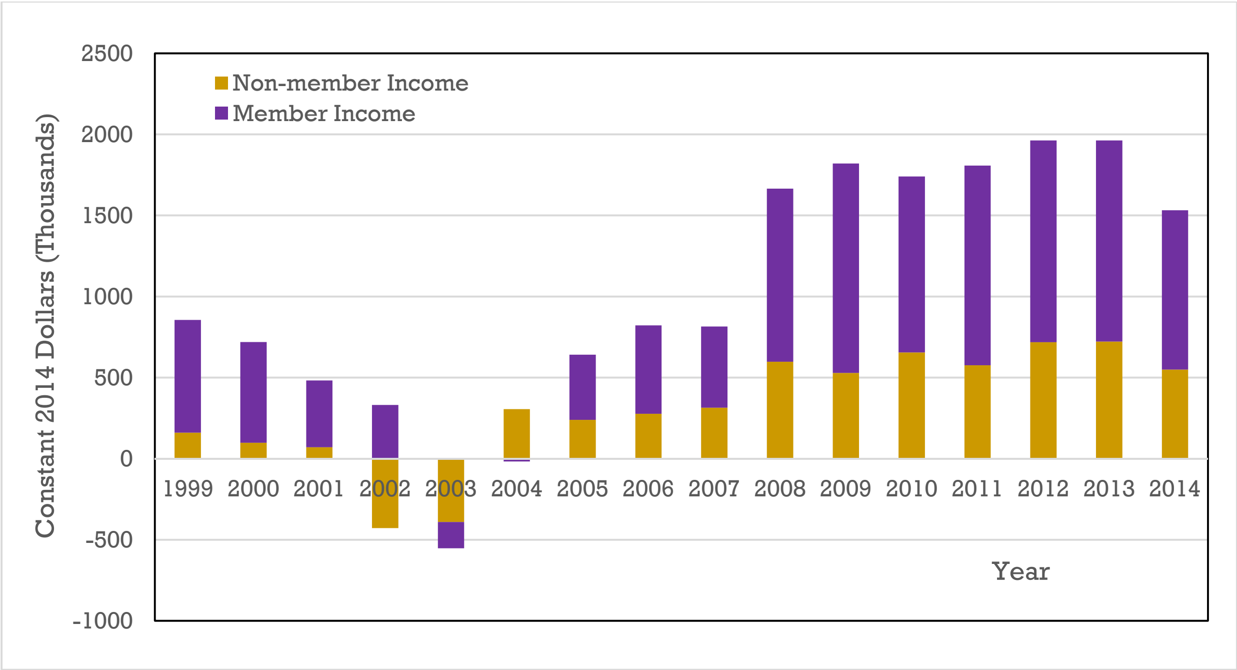

Figure 1. Average Real Net Income for Kansas Grain, Oilseed and Farm Supply Cooperatives

Total net income has soared since 2004. For Kansas co-op, the average total net income was nearly $1.96 million in 2012 and 2013, which is far better than the negative income experienced in 2003! These strong gains were led by a boost in member income. For example, the percentage of member income was 63% in 2012 and 2013. In fact, from 2008 to 2014, member income was larger than any early *total* net income. Similarly, non-member income experienced significant gains, which contributed to the steep rise in Kansas co-ops' profitability. However, total income was slightly decreased in 2014. If the decrease in total income (non-member and member income) continued in the future, it could create stress in agricultural cooperatives.

With rising income, Kansas co-ops have bolstered their balance sheets by boosting equity levels. While total members' equity fell from 2001 to 2005, it rebounded sharply thereafter (figure 2). In fact, the average total equity for Kansas co-ops is $13.8 million in 2014, which is more than 3 times the low experienced in 2003. Furthermore, this lofty equity level is comprised of record setting inflation adjusted allocated and unallocated equity levels of $7.7 million and $6.1 million, respectively in 2014.

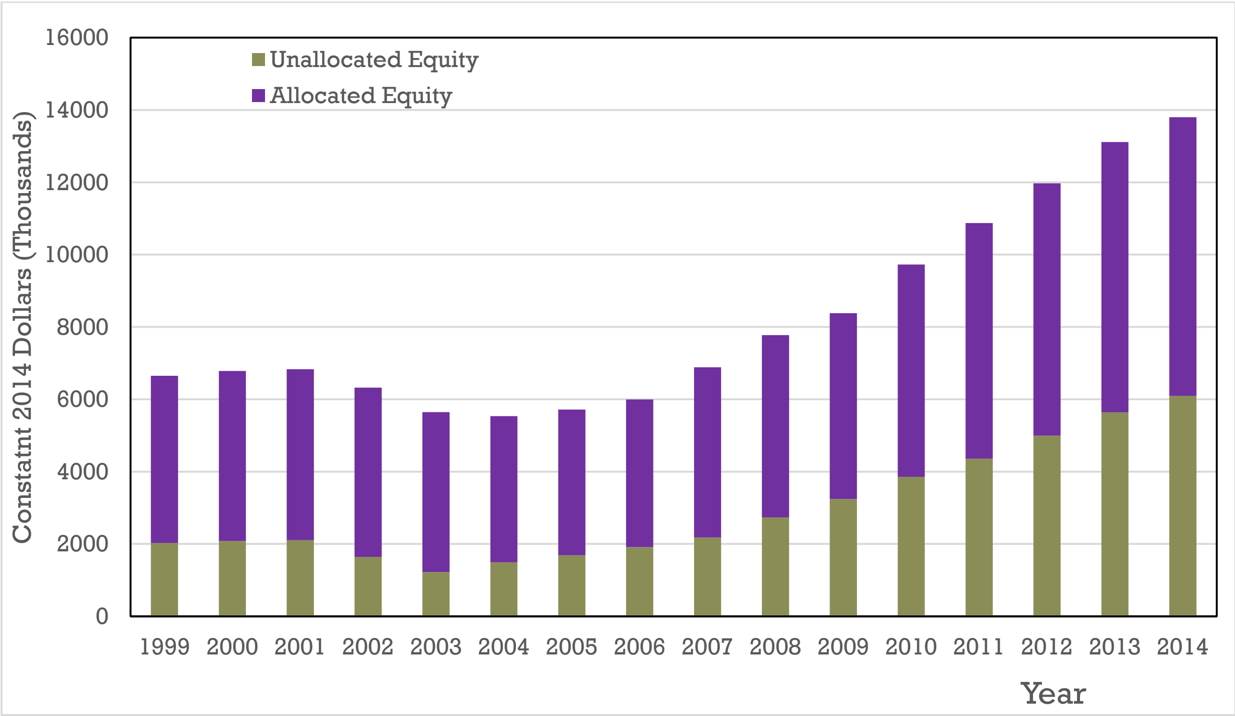

Figure 2. Average Real Members' Equity for Kansas Grain, Oilseed and Farm Supply Cooperatives

The equity composition for the average Kansas co-op has changed throughout time. One trend has held firm, Kansas co-ops tend to have more allocated equity than unallocated equity. Before 2007 except 2003, on average, Kansas co-ops' percentage of allocated equity set at a fairly constant 70 percent, and unallocated equity set at 30 percent (figure 3).

However, when significant stress occurred in the cooperative industry, the percentage of allocated equity shot up. In 2002, Farmland Industries, the largest agricultural cooperative in North America, filed for bankruptcy. As a result, Kansas co-ops had to write off sizable losses.

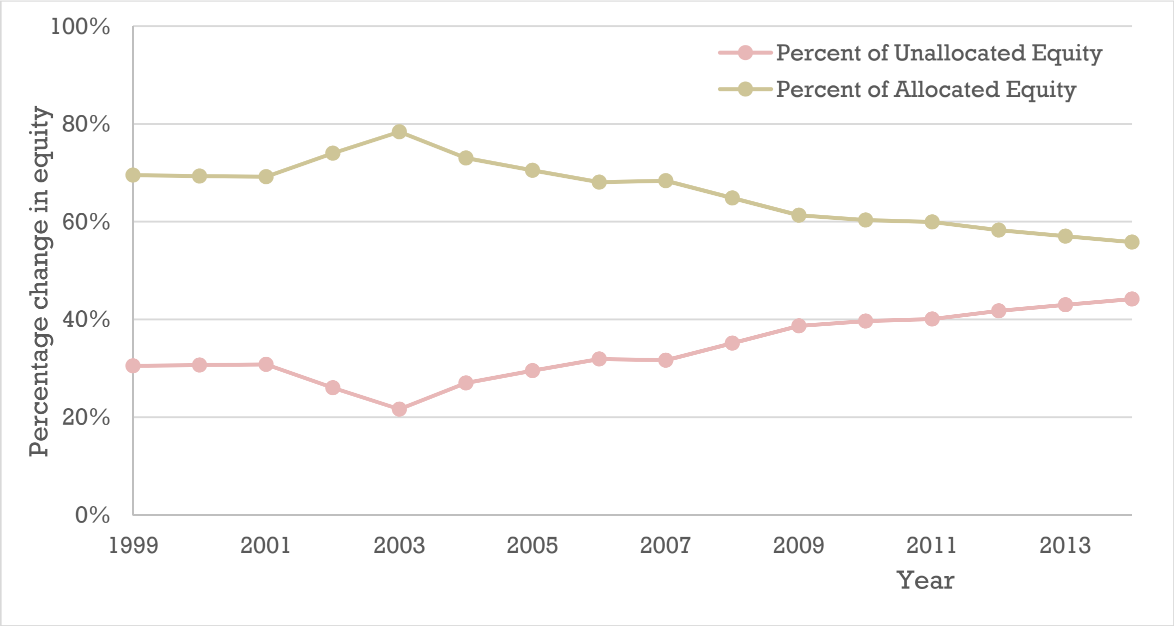

Figure 3. Percentage of Total Members' Equity for Kansas Agricultural Cooperatives

To pay for these losses, unallocated equity was primarily used, which pushed the percentage of unallocated equity down to approximately 20 percent (allocated equity approached approximately 80 percent) in 2003. This strategy is much more palatable for cooperative members to accept because the equity being used to fund the losses, unallocated equity, does not have their name on it. Still, some Kansas co-ops chose to and/or were forced to use some if not all allocated equity to fund the losses experienced in the Farmland Industries bankruptcy.

Today, Kansas co-ops' total member equity has a much larger percentage of unallocated equity. Since 2007, the percent of unallocated equity has risen from 30 percent to 44 percent today. The rise in unallocated equity is likely attributable to increasing non-member business income, usage of the section 199 Domestic Production Activities Deduction (DPAD), and/or assignment of member income to unallocated equity. Boland's findings do support this statement. In 2014, the percentages of allocated equity and unallocated equity were 56 percent and 44 percent, respectively (figure 3).

So, what is the appropriate amount of unallocated equity within a cooperative? Answering this question is complicated and should be left to a cooperative's board of directors. That is, the board needs to weigh all factors as to why the cooperative would want to boost unallocated equity and why they may want to reduce it. In general, a primary reason to hold more unallocated equity is it provides risk based equity that can be used to pay for unexpected losses. On the flip side, having too much unallocated equity can create ownership issues. In short, the ramifications of the apparent trend of rising unallocated equity must be discussed by each individual cooperative board directors to ensure their own trend is meeting the needs of their members and ensuring the long-run viability of the cooperative.

References

Bureau of Labor Statistics (BLS, 2015): http://www.bls.gov.

Boland, Michael, "Cooperative Finance and Equity Management," *CHS Center for Cooperative Growth White Paper*, accessed on January 4, 2013 at: http://www.chscenterforcooperativegrowth.com/images/PDF/Boland_WhitePaper.pdf