

1

# Can Local Cooperatives Survive the Impact of Farmland's Bankruptcy?

2003 Annual Meeting  
NCR-194 Research on Cooperatives

October 29, 2003  
Fairmont Hotel  
Kansas City, Missouri

Prepared by:  
David Barton      Chuck Mickelsen  
Kristine Keil      Kendra Robben

ACC

---

---

---

---

---

---

---

---

2

## Agenda

- Farmland bankruptcy impacts: loss of investment, income and market access
- Loss handling is a burning and complex issue for local co-ops.
- Overview of history and issues
- Basics of cooperative finance (skip slides: 7-25)
- Basics of loss handling
- Local co-op survey results (skip slides: 40-42)
- Case study results (skip slides: 53-64, 67-72)
- Summary and discussion

ACC

---

---

---

---

---

---

---

---

3

## Overview

- History and General Context
  - 1986 Farmland writedown: 30.5%
  - 2002 Farmland bankruptcy, expected writedown: 100% ?
  - Today is different than 1986
    - Bankruptcy severely restricts flexibility
    - Local co-op profitability is lower
      - ROLA (Figure 5-1)
      - ROE (Figure 5-3)
- Concepts
  - Begin with the end in mind
    - Choose what is best for members
    - Protect and enhance your co-op's assets and future
    - Manage the balance sheet first to achieve preferred liquidity and solvency
    - Then manage patron accounts and cash flows to patrons (owners get what is left over)
    - Manage operations to achieve adequate, if not high profitability
  - Case co-op has a history of high profitability

ACC

---

---

---

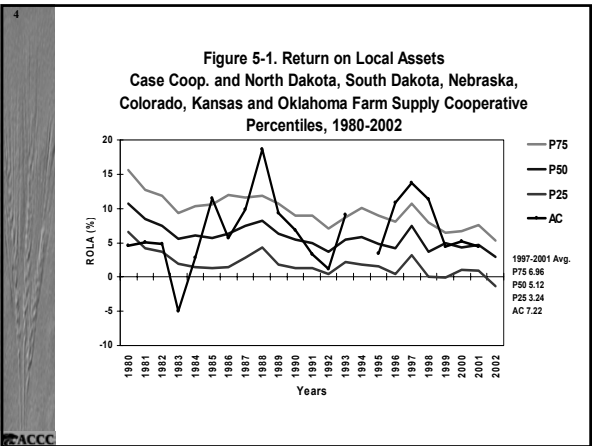
---

---

---

---

---




---

---

---

---

---

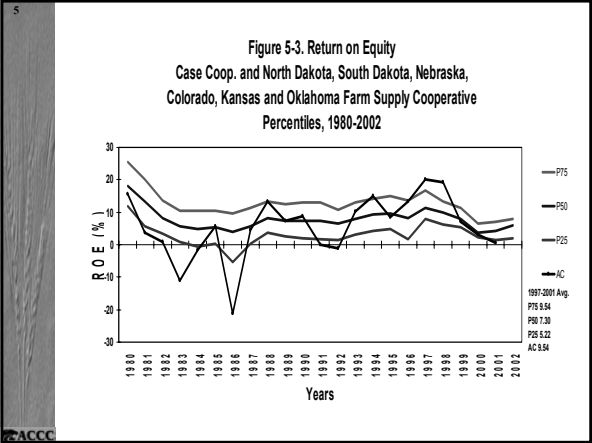
---

---

---

---

---




---

---

---

---

---

---

---

---

---

---

6

**Overview (continued)**

- How are other co-ops dealing with this problem?
  - Many different situations exist
  - No one best solution for everyone
  - Apply the basics to your situation
- How can you choose a strategy?
  - Evaluate alternatives, choices and consequences
  - Communicate with members and get their feedback
  - Select the best alternative (or combination)
  - Understanding before action (“seek first to understand”)

ACCC

---

---

---

---

---

---

---

---

---

---

## Basics of Cooperative Finance

- Finance decisions and interrelationships
- Balance sheet issues and illustration
- Income statement issues and illustration
- Income distribution alternatives
- Balance sheet management and equity management process
- Redemption budget calculation

---

---

---

---

---

---

---

---

## Principles of Finance

- Cornerstones of success
- Investment decision
- Financing decision
- Income decision

---

---

---

---

---

---

---

---

## Four Cornerstones of Financial Success

1. Be a profitable business
  - Manage income generation
2. Return profits to patrons
  - Manage income distribution
3. Provide sufficient equity financing
  - Manage balance sheet
4. Require patron equity investment proportional to use
  - Manage patron equity accounts

---

---

---

---

---

---

---

---

## Finance Decisions and Interrelationships

- 1. Investment
  - Assets
- 2. Financing
  - Liabilities
  - Equity
    - Investment
    - Redemption
- 3. Income
  - Generation
  - Distribution



**Balance Sheet**

**Income Statement**

---

---

---

---

---

---

---

---

## Balance Sheet Issues

- 1. Asset Investment
  - Total assets
  - Asset mix
- 2. Debt and Equity Financing
  - Liquidity: Working capital
  - Solvency: Equity to assets
  - Equity Structure
    - Allocated
      - Permanent
      - Semi-permanent
      - Revolving
    - Unallocated (permanent)

---

---

---

---

---

---

---

---

### Beginning Balance Sheet Illustration

Assets	%	\$	Liabilities and Members Equity	%	\$
Current Assets	30%	\$3,000,000	Current Liabilities	20%	\$2,000,000
Cash	10%	\$1,000,000	Accounts Payable	5%	\$500,000
Receivables	5%	\$500,000	Loans Payable	10%	\$1,000,000
Inventories	15%	\$1,500,000	Patronage Refunds Payable	3%	\$250,000
			Equity Redemptions Payable	3%	\$250,000
Investments	20%	\$2,000,000	Long-Term Liabilities	20%	\$2,000,000
Regional Stock	20%	\$2,000,000	Bank Loans Payable	18%	\$1,750,000
Other Stock	0%	\$0	Contracts Payable	3%	\$250,000
Net Fixed Assets	50%	\$5,000,000	Members Equity	60%	\$6,000,000
Land	15%	\$1,500,000	Allocated		
Buildings	15%	\$1,500,000	Common Stock	10%	\$1,000,000
Equipment	20%	\$2,000,000	Preferred Stock	0%	\$0
			Retained Patronage Refunds	40%	\$4,000,000
			Unallocated		
			Retained Earnings	10%	\$1,000,000
<b>Total</b>		<b>\$10,000,000</b>	<b>Total</b>		<b>\$10,000,000</b>

### Financial Structure

<b>Liquidity</b>		<b>Solvency</b>	
Working Capital (CA-CL)	\$1,000,000	Equity to Assets (ME/A)	60%
Current Ratio (CA/CL)	1.50	Debt to Equity (LT/LME)	33%

---

---

---

---

---

---

---

---











## Basics of Loss Handling (continued)

- Balance sheet and patron account equity management
- Selected profit and loss outcomes
- Loss distribution choices
- Loss distribution incidence
  - “Who suffers the loss?”
- Decision criteria

---

---

---

---

---

---

---

---

## Selected profit and loss outcomes

Case	Net Operating ("Local") Income	Other ("Regional") Income	Total Income
1	1,000,000	0	1,000,000
2	(1,000,000)	500,000	(500,000)
3	1,000,000	(500,000)	500,000
4	1,000,000	(2,000,000)	(1,000,000)
5	(1,000,000)	(1,000,000)	(2,000,000)

---

---

---

---

---

---

---

---

## Loss Distribution Choices

- First, choose extent will net among patronage pools.
- Second, choose how to distribute the income (positive) or loss (negative) of each pool. If a loss, use one or more of the five loss distribution alternatives.

---

---

---

---

---

---

---

---

# Loss Distribution Choices

1. Direct bill current year's patrons (or owners)
2. Create account receivable for current year's patrons (or owners)
3. Cancel allocated equity of current owners
4. Retain to (reduce) unallocated equity then recover carryover from past or future patrons
5. Retain to (reduce) unallocated equity, don't recover carryover

---

---

---

---

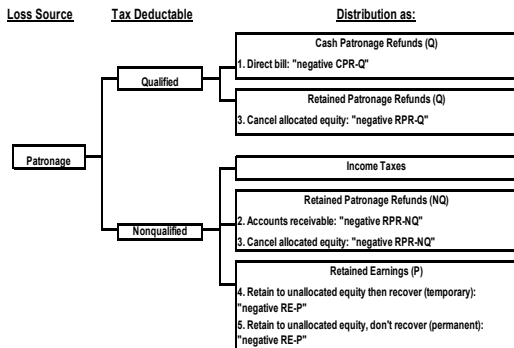
---

---

---

---

# Patronage Loss Distribution Alternatives




---

---

---

---

---

---

---

---

# Loss Distribution Alternatives

1. Direct bill current year's patrons (or owners)
  - account receivable, payable in cash
  - "negative cash patronage refund"
2. Create account receivable for current year's patrons (or owners)
  - account receivable, payable in future equity
  - "negative nonqualified retained patronage refund"

---

---

---

---

---

---

---

---

### Loss Distribution Alternatives

- 3. **Cancel allocated equity of current owners**
  - pass through to owners, usually past patrons
  - “negative qualified or nonqualified retained patronage refund”
- 4. **Retain to (reduce) unallocated equity, then recover carryover from past or future patrons**
  - retain at co-op level to “patronage” retained earnings
  - offset past patronage income in reserve (carryback)
  - offset with future patronage income (carryforward)
  - “negative patronage retained earnings”

---

---

---

---

---

---

---

---

### Loss Distribution Alternatives

- 5. **Retain to (reduce) unallocated equity, don't recover carryover**
  - retain at co-op level to “patronage” retained earnings
  - don't offset past or future patronage income
  - “negative patronage retained earnings”

---

---

---

---

---

---

---

---

### Loss distribution incidence

- **“Who suffers the loss?”**
  - current patrons
  - past patrons
  - future patrons

---

---

---

---

---

---

---

---



## Financial Analysis Survey Profile: Fiscal Year 2001

<u>Measure</u>	<u>Average</u>	<u>Low</u>	<u>High</u>	<u>You</u>
<b>Liquidity</b>				
Current Ratio	1.39	0.97	7.88	
<b>Solvency</b>				
Equity to Assets (%)	54.15	35.08	93.04	
Equity to Adjusted Assets (%)	84.33	69.61	100.00	
<b>Profitability</b>				
Return on Local Assets (%)	4.50	(9.77)	19.05	
Return on Equity (%)	6.54	(14.30)	15.83	

---

---

---

---

---

---

---

---

---

---

## Financial Analysis Survey Profile: Fiscal Year 2001

<u>Measure</u>	<u>Average (%)</u>	<u>Low (%)</u>	<u>High (%)</u>	<u>You</u>
<b>Equity Structure</b>				
Unallocated to Total	30.36	(15.21)	68.32	
<b>Investment Structure</b>				
Farmland to Total Inv.	54.84	10.77	91.68	
Farmland to Total Equity	19.20	3.82	39.97	
Farmland to Allocated Equity	27.51	4.59	55.64	
Farmland to Unallocated Equity*	63.23	22.58	193.89	
Total Inv. to Total Equity	35.01	16.83	54.33	
Total Inv. to Unallocated Equity**	115.30	31.59	388.05	

\*Actual low is -215.70

\*\*Actual low is -323.11

---

---

---

---

---

---

---

---

---

---

## Financial Analysis Survey Profile: Fiscal Year 2001

<u>Measure</u>	<u>Average</u>	<u>Low</u>	<u>High</u>	<u>You</u>
	<u>(millions of dollars)</u>			
<b>Size</b>				
Total Sales	20.03	1.92	80.91	
Total Assets	10.51	0.86	38.10	
Total Investment	1.99	0.13	8.03	
Farmland Investment	1.09	0.10	4.13	
Total Equity	5.69	0.80	19.23	

---

---

---

---

---

---

---

---

---

---

## Loss Expectations and Handling

- **Loss expectations**
  - Only 25% expect local loss “very likely”
  - Only 25% expect overall net loss “very likely”
- **Loss handling**
  - 32% expect to pass loss through, cancel allocated equity
  - 34% expect to retain loss at co-op level
  - 13% expect to do a combination
  - Point: many different approaches will be taken

---

---

---

---

---

---

---

---

## Changes to Income Distribution

- 50% expect to make changes
- 50% expect to stay the same
- In past, 90% distributed all patronage income as patronage refunds
- In future, 35% plan to change by distributing some or all patronage income to retained earnings
- How will you change your income distribution and equity management?

---

---

---

---

---

---

---

---

## Case Study Results

- **Co-op description**
- **Loss handling strategies**
- **Loss handling projected results**

---

---

---

---

---

---

---

---

## Co-op Description

- Small, Midwest co-op, mostly farm supply
- Long-time Farmland member with \$1,127,725 investment
- Assume 100% write down in 2003
- Retained earnings of approximately \$1.3 million and total equity of \$3.4 million
- Equity to assets of 46% with desire to grow to 55%
- Last five year average ROE of 10-12%
- Future ROE average of 10%
- Cash patronage rate is 30%
- Non-patronage business is 20%
- Equity redemptions are by estates and revolving fund; projected to achieve 9-10 year length

---

---

---

---

---

---

---

---

---

---

## Loss Handling Strategies

- Based on revolving fund strategy (SP + RF)
- If No FI Equity Cancellation
  - LHS1: No Loss and 2003 net income of \$192,000
  - 2003 regional patronage refunds of \$133,125 (FI = zero)
  - Revolving fund length is 9 years
- If FI Equity Cancellation of 100% and 2003 net loss of \$930,000
  - LHS2A: Cancel active patron allocated equity
  - LHS2B: Cancel active and inactive patron equity
  - LHS3: Retain, fast recovery (retain temporarily)
  - LHS4: Retain, slow recovery (retain temporarily)
  - LHS5: Retain, no recovery (retain permanently)

---

---

---

---

---

---

---

---

---

---

## Loss Handling Incidence by Strategy

- LHS2A: Cancel active patron allocated equity
  - Targets active past patrons
  - Shortens or speeds up revolving fund to 6 years
  - Maximizes “tax benefit” to active patrons
  - Unfair if inactive patron found later and equity is redeemed at par
- LHS2B: Cancel active and inactive patron allocated equity
  - Targets future patrons (lower patronage refunds)
  - Shortens revolving fund to 7 years (less than LHS2A)
  - Inactive patrons don’t get “tax benefit”

---

---

---

---

---

---

---

---

---

---

## Loss Handling Incidence by Strategy

- **LHS3: Retain, fast recovery**
  - Targets future patrons (lower patronage refunds)
  - Shortens revolving fund indirectly to 6 years
- **LHS4: Retain, slow recovery**
  - Targets future patrons
  - Indirectly shortens revolving fund to 8 years
- **LHS5: Retain, don't recover**
  - Indirectly targets past patrons by slowing down revolving fund to 10 years
  - Indirectly targets future patrons by reducing future patronage refunds

---

---

---

---

---

---

---

---

---

---

## Loss Handling Projected Results

- General overview
- Operating statements with income distribution
- Balance sheets with structure and performance ratios
- Cash flow summaries
  - Paid out by corp
  - After tax to patrons

---

---

---

---

---

---

---

---

---

---

## General Overview: Projected Results

- Strict balance sheet management means no redemptions for 1-2 years
- **LHS2A: Canceling allocated equity of active patrons ("pass through")**
  - Reduces 2002-2011 patron after tax cash flow by about \$30,000
  - equals 2.6% of total write down of \$1,127,725
  - Equals 4.0% of allocated equity write down of \$744,113.
- **LHS2B: Canceling allocated equity of both active and inactive patrons**
  - Reduces 2002-2011 patron after tax cash flow significantly more than \$30,000 since inactive patrons won't receive tax benefit

---

---

---

---

---

---

---

---

---

---

## General Overview: Projected Results

- **LHS3: Retain, fast recovery**
  - Reduces 2002 011 patron after tax cash flow by about \$24,000
- **LHS4: Retain, slow recovery**
  - Reduces 2002 011 patron after tax cash flow by about \$36,000
- **LHS5: Retain, no recovery**
  - Reduces 2002 011 patron after tax cash flow by about \$253,000

---

---

---

---

---

---

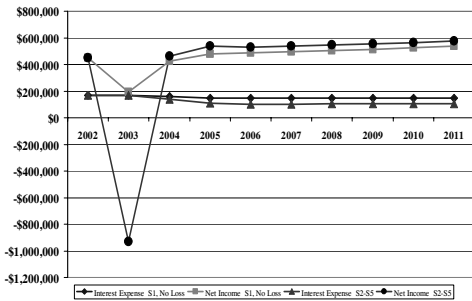
---

---

---

---

Net Income and Interest Expense



Conclusion: Net income goes up with writedown because total assets, total long term debt and interest expense go down.

---

---

---

---

---

---

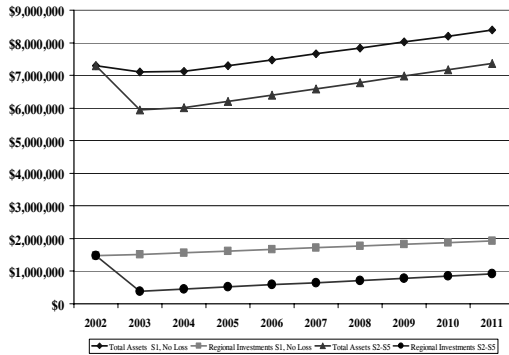
---

---

---

---

Total Assets and Regional Investments




---

---

---

---

---

---

---

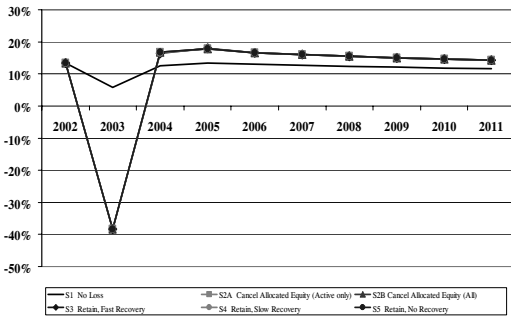
---

---

---



Return on Equity



Conclusion: ROE is higher because net income increases and total equity decreases.

---

---

---

---

---

---

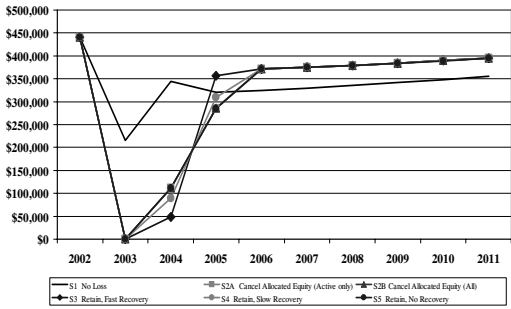
---

---

---

---

Total Cash Flow to Patrons



Conclusion: Total cash flow is lower in 2003-2005 because there are no or lower cash patronage refunds and/or equity redemptions. It is higher in 2006-2011 because of higher cash patronage refunds.

---

---

---

---

---

---

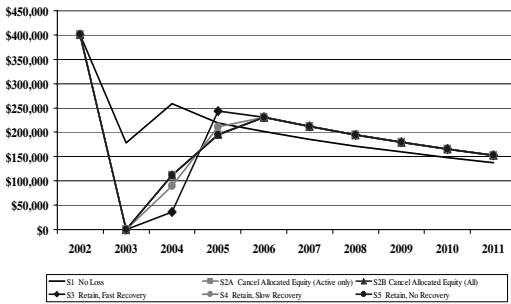
---

---

---

---

Present Value of Total Cash Flow to Patrons



Conclusion: Total cash flow is lower in 2003-2005 because there are no or lower cash patronage refunds and/or equity redemptions. It is higher in 2006-2011 because of higher cash patronage refunds.

---

---

---

---

---

---

---

---

---

---

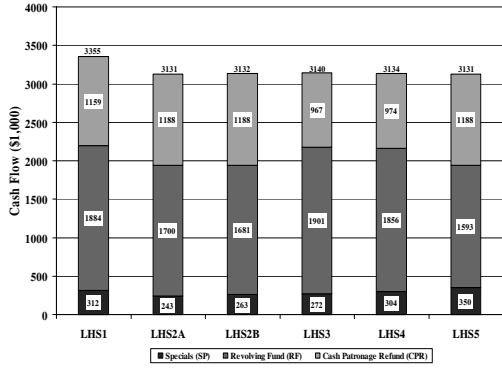








Total Cash Flow to Patrons by Strategy by Source, 2002-2011




---

---

---

---

---

---

---

---

---

---

## Summary and Discussion

- Complex issue
- Begin with the end in mind
- Decision guidelines
- Loss distribution incidence

---

---

---

---

---

---

---

---

---

---

## Begin with the End in Mind

- Choose what is best for members
- Protect and enhance your co-op's assets and future
- Manage the balance sheet first to achieve preferred liquidity and solvency
- Manage operations to achieve adequate, if not high profitability

---

---

---

---

---

---

---

---

---

---

## Decision Guidelines

1. Be fair and equitable to patrons
  - based on "business at cost" principle
2. Be legally feasible
3. Be financially feasible, efficient, expedient
4. Be strategically effective
  - evaluate your company's situation and direction
  - evaluate your competitors, their response
  - evaluate your members' response

---

---

---

---

---

---

---

---

## Loss Distribution Incidence

- Consider who pays: past and/or future patrons
- Canceling members allocated equity
  - Can be positive for members
  - Can be positive for co-op
- The co-op system is strong, especially locals

---

---

---

---

---

---

---

---

**"Destiny is no matter of chance...  
it is a matter of choice."**

*William Jennings Bryan*

---

---

---

---

---

---

---

---

# Questions and Discussion

---

---

---

---

---

---

---

---