Equity Management

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Objective of Equity Management

- Attract new members
- Keep current members
- Satisfy member needs
- Maintain cooperative profitability
- Allow for growth
Equity Management Process

1. Determine income generation and distribution
2. Determine desired assets
3. Determine desired financial structure
   1. Debt/equity
   2. Working capital
4. Determine equity redemption budget
5. Determine equity redemption program
Debt/Equity Mix
Questions:

- Does co-op have the ability to repay the debt incurred?
- Does co-op have adequate financial flexibility?
- Does the rate of return on additional assets justify additional debt?
- Are management and board comfortable with the debt/equity level?
### Calculations for Redemption Budget

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Equity</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>+ Additional investment</td>
<td>$200,000</td>
</tr>
<tr>
<td>=Maximum equity</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>-Ending equity (target)</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>=Redemption budget</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
Why Equity Redemption?

- **Equity Redemption** is the process of returning equity in cash to member-patrons who have previously invested.

- Over invested or inactive members should not be responsible for financing a cooperative they do not use.

- Failure to redeem equity reduces member realized ROE.
Equity Redemption Programs

- Defines the way that one or more classes of equity are treated for redemption
- The redemption policy is used for everyone in a particular equity class
- The overall program should be consistent with the cooperatives equity management objectives
Conflicting Views

- Patron-”I have to die to get it” (wants it as quick as possible, combine local and regional
- Local-”Producers expectations are unreasonable”, regional redemption is too low, segregate into local and regional components
- Regional-”local’s want too much”, regional’s redemptions should be limited
Factors affecting Equity Redemption

- Does the plan treat members fairly?
- Does the plan promote member equity contribution?
- Does the co-op have cash flow and/or financial stability to sustain plan?
- Does the plan match federated co-op redemption plan?
- Does the plan meet lender requirements?
Criteria (continued)

- Popularity with patrons
- Administrative costs (simplicity)
- Compatibility with bylaws, articles and mission statement
Alternative Redemption Methods

- Special Programs (uses trigger event)
- Age of patron (oldest first)
- Age of patron (pro-rated)
- Age of stock plan
- Base Capital plan
- Percentage of all equities plan
Special Situation Plan

- Entire member equity is due at one time
- Some event must trigger redemption:
  - Member death (most common)
  - Age of patron (60 to 90 years; 72 is avg.)
  - Retirement from farming
  - Move out of trade area
  - Hardship (financial &/or disability)
Special Situation Plan

Advantages:

- Low financial burden on co-op
- Easy to understand
- High priority cases get attention when other plans not working
- Works well for co-ops offering favorable prices
Special Situation Plan
Disadvantages

Does not tie equity base with current patronage

Co-op financial planning can be difficult

Member gets poor realized return
Age of Patron (oldest first)

- Redeems when the patron reaches a specific age
- Assumes that patrons are natural persons (not LLCs or Trusts)
- Requires patron birth date information
Age of Patron
Oldest First

- Advantages
  - Simple-easy to understand
  - Works well for cooperatives with favorable prices

- Disadvantages
  - Little incentive for younger farmers
  - Equity investment not proportional to patronage
  - Members expect redemption regardless of financial condition
Age of Patron (pro-rated)

- Redeems a portion of each patron's account for patrons past a set age (example 55)
- Coop established redemption budget (example $100,000)
- Determine total equity of members older than 55 (example $1,000,000)
- Establish redemption percentage (10%)
- Some coops use a fixed percentage
Age of Patron (pro-rated)

- Advantages
  - Easier to integrate with the redemption budget
  - More members receive redemptions
  - More popular with members that AOP

- Still not proportional
  - Redeems at a decreasing rate but never completely redeems
  - Fixed percentage limits flexibility
Age of Stock Plan

- Redeems based on the age of the stock
- Redeem on “First In => First Out” basis
- Ranges from 18 months to 30 years
- Some co-ops have multiple revolving funds
## Age of Stock

<table>
<thead>
<tr>
<th>Total Equity (beginning)</th>
<th>Allocated Equity</th>
<th>Redeemed Equity</th>
<th>Year redeemed</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>500</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>$500</td>
<td>$500</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>$1000</td>
<td>$500</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>$1500</td>
<td>$500</td>
<td>$500</td>
<td>1</td>
</tr>
<tr>
<td>$1500</td>
<td>$1000</td>
<td>$1000</td>
<td>2,3</td>
</tr>
<tr>
<td>$1500</td>
<td>$500</td>
<td>$500</td>
<td>4</td>
</tr>
</tbody>
</table>
Age of Stock Plan

Advantages:
- Easy to understand and administer
- Equities somewhat proportional to use for short revolving periods
- Co-op can adjust equity by adjusting length

Disadvantages:
- Good year/bad year problem
- Disparities can occur between equity and use
- Members may expect fixed revolving regardless of financial conditions
Base Capital Plan

- A base equity is established.
- Under invested members continue to increase investment, while over invested members get partial or total redemption.
- Can be combined with a variable cash patronage refund plan (over invested member receive larger cash refund).
<table>
<thead>
<tr>
<th>Mem.</th>
<th>Beg. equity</th>
<th>Patronage</th>
<th>Share of business</th>
<th>Equity Obligation</th>
<th>Over or under invested</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1,685</td>
<td>120,208</td>
<td>11%</td>
<td>2,035</td>
<td>-350</td>
</tr>
<tr>
<td>B</td>
<td>3,345</td>
<td>207,631</td>
<td>19%</td>
<td>3,515</td>
<td>-170</td>
</tr>
<tr>
<td>C</td>
<td>2,805</td>
<td>152,991</td>
<td>14%</td>
<td>2,590</td>
<td>+215</td>
</tr>
<tr>
<td>D</td>
<td>5,515</td>
<td>327,839</td>
<td>30%</td>
<td>5,550</td>
<td>-35</td>
</tr>
<tr>
<td>E</td>
<td>4,550</td>
<td>284,127</td>
<td>26%</td>
<td>4,810</td>
<td>-260</td>
</tr>
<tr>
<td>F</td>
<td>350</td>
<td>0</td>
<td>0%</td>
<td>0</td>
<td>+350</td>
</tr>
<tr>
<td>Total</td>
<td>18,250</td>
<td>1092796</td>
<td>100%</td>
<td>18,500</td>
<td>-250</td>
</tr>
</tbody>
</table>
Base Capital Plan

Advantages

♦ Considered most equitable
♦ Allows management to alter equity requirements
♦ Only plan which requires under-invested members to pay an interest fee to over-invested members

Disadvantages

♦ New or under-invested members may not be able to provide required equity immediately
♦ Board members do not like to increase base level
♦ Complex to understand and administer
Percentage of All Equities

- Reduces member equity by %
- Retiring a % of outstanding equity, regardless of issuance.
- Used by a limited number of cooperatives
### Percentage of All Equities (cooperative’s calculation)

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning equity</td>
<td>2000</td>
</tr>
<tr>
<td>Retained equity</td>
<td>500</td>
</tr>
<tr>
<td>Equity available</td>
<td>2500</td>
</tr>
<tr>
<td>Equity required</td>
<td>2300</td>
</tr>
<tr>
<td>Redeemable</td>
<td>200</td>
</tr>
<tr>
<td>Percentage redeemed</td>
<td>10%</td>
</tr>
</tbody>
</table>
## Percentage of All Equities

<table>
<thead>
<tr>
<th>Member</th>
<th>Beg. Equity</th>
<th>% redeemed</th>
<th>Redemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>750</td>
<td>10%</td>
<td>75</td>
</tr>
<tr>
<td>B</td>
<td>250</td>
<td>10%</td>
<td>25</td>
</tr>
<tr>
<td>C</td>
<td>250</td>
<td>10%</td>
<td>25</td>
</tr>
<tr>
<td>D</td>
<td>500</td>
<td>10%</td>
<td>50</td>
</tr>
<tr>
<td>E</td>
<td>250</td>
<td>10%</td>
<td>25</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>10%</td>
<td>200</td>
</tr>
</tbody>
</table>
Percentage of All Equities

Advantages:
- Rewards new patrons
- Easy to understand and administer
- Works well for cooperatives with a stable membership and patronage

Disadvantages:
- Poor transfer of ownership
- Transfer of ownership cannot be completed without additional provisions.
Proportionality

#1 Base Capital
#2 Age of Stock
#3 Percentage of all equities
#3 Age of Patron (prorated)
#4 Age of Patron (oldest first)
#5 Special (estates)
Conclusions

- Don’t let the tail wag the dog
- Principle should be proportionality
- Age of patron is the least desirable
- Best plan for most cooperatives is age of stock combined with estates
- Regional-local conflict can be solved with local/regional segregation
- No simple strategy is best for everyone
Alternatives to Redemption

- Partial Redemption (Discounting)
- Conversion to Debt or Preferred Stock
- Exchange of Equity Between Members
- True Secondary Markets
Partial redemption or discounting:

Members get paid discounted value of future equity redemptions

- Difficult to choose discount rate
- Income tax consequences are not well established
- Members may not understand Net Present Value concept
Conversion to Debt or Preferred Stock

- Improves co-op cash flow, but it changes co-op’s balance sheet
- Gives members more return
- Allows exchange of equity between members
- Limited market of members
- Purchase price may not be realized value
- Member income tax issues are unclear
Exchange of Equity between Members

- Most cooperatives restrict these transactions
- Some allow transfer to family members
- Price is privately negotiated
- Must be board approved and recorded by the cooperative
Exchange of Equity between Members

**Advantages**
- Immediate cash for equity sold
- Reflects true market value
- Cooperative does not provide cash for the transaction

**Disadvantages**
- Limited markets among qualified members
- Purchaser faces risk of depreciation of stock.
Secondary Markets

- Allowing cooperative equity to trade in a secondary market …
  - Member control is compromised
  - Relieves cooperatives of liquidating equity for members
  - Compromise of Power must be made
    - Voting stock for producer-members
    - Public non-voting stock for non-producers
Putting It All Together

- **Equity Programs**
  - Equity Investment Plan
  - Specific Method For Raising Equity
  - Provide For Redemption
  - Specify How Returns Are Paid

- Programs chosen depends on the circumstances of the cooperative
Putting It All Together

- Specific Equity Plans Should…
  - Raise Adequate Equity
  - Minimize Redemption Burden
  - Assure Fair Treatment
  - Generate Adequate Returns Over Time

- A Cooperative Should Choose an Equity Plan That Meets Their Own Circumstances