COOPERATIVE EXTENSION SERVICE
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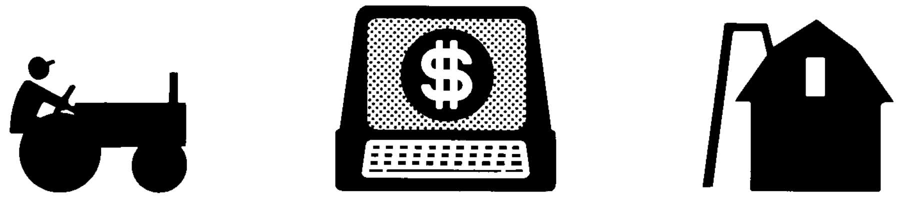

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The Farmers' Cooperative Yardstick

Financing Agricultural Cooperatives Alternative Capital Sources

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So you and your neighbors have decided to organize a cooperative. You have identified the functions the cooperative will perform and, based on meetings of interested producers, you have appointed a survey committee to determine the economic feasibility of organizing the cooperative. One important function of the survey committee is estimating the co-op's capital needs. An accurate estimate of these capital needs is important in determining whether the cooperative will be feasible. Improper estimates of capital needs and uncertainties about input and market prices for product output often bring the co-op patron negative net margins. Further, failing to provide necessary capital, often needed in a co-op's early stages, can lead to a decision not to invest in a cooperative, which may have profit potential after a few years operation.

This fact sheet identifies a co-op's potential capital needs and available capital sources.

Determining Capital Needs

Capital refers to durable or long lasting inputs such as machines, buildings, equipment, land, vehicles, etc. Capital also means cash needed by the cooperative for day-to-day operations.

A co-op's capital needs can be divided into: **(1)** long-term or fixed capital; **(2)** short-term or operating capital; and **(3)** organizational funds.

Long-term Capital is for land, buildings, equipment and vehicles needed by the cooperative. It also includes stock investments made in other cooperatives or corporations, such as membership in a federated buying or selling co-operative.

Short-term Capital is for making crop and/or livestock advances, inventories, supplies, wages and other current expenditures. If the cooperative plans to extend credit, it should finance accounts receivables. The co-op may also need large amounts of operating capital if it engages in contracting and vertical integration.

Organizational Funds are for legal and recording fees, business permits, incorporation fees, promotional supplies, and other expenses incurred in organizing a cooperative.

The exact amount of capital necessary depends on: **(1)** The type and size of cooperative to be organized; **(2)** the extent of ownership or rental of fixed facilities; **(3)** the pledges of business volume; **(4)** the availability of borrowed funds and the ability of members to subscribe capital; and **(5)** the type and extent of services to be provided.

Sources of Co-op Financing

Cooperatives can get the financing to organize, operate, and expand from two sources: equity capital and borrowed capital. In a cooperative, equity capital is the portion of assets owned by members. It is also described as the risk capital because all other obligations must be met in case of liquidation before any equity capital is returned to members. Borrowed capital is capital borrowed through the member's equity in the cooperative.

Equity Capital Sources

Members most commonly provide equity capital to their cooperative by: **(1)** purchasing capital stock or other types of equities; **(2)** leaving a portion of the co-op's net savings in the cooperative; and **(3)** authorizing the co-op to deduct from proceeds made through sales of member's farm products—usually called per unit retains.

Equity capital may be divided into two classes: **(1)** initial capital investments consisting of common stock, preferred stock and membership fees; and **(2)** capital obtained through operations that result in member or patron investments. These investments consist of patronage refunds and per unit capital investments made by members in their cooperative, and stock or other types of equity certificates sold to members and patrons.

Common Stock is an important source of initial equity capital in the cooperative. Generally, common stock is fixed to voting rights. The cooperative may issue several kinds of common stock (i.e., classes A, B, and C) and designate one class as voting stock. For example, Class A common stock may be voting stock and may be limited to one share per member. Class B stock may represent other initial investments of members. In some instances, per unit capital investment and deferred patronage refunds are identified as common stock C.

Preferred Stock is a second source of initial equity capital. As the name implies, this stock is preferred over common stock because it has fewer risks and dividends are assured. Usually preferred stock is non-voting. Preferred stock is more like an investment than other equity capital issued by cooperatives, and in many instances, it may represent capital raised from the general public or non-patron groups.

Membership Fees are a third source of initial equity capital when cooperatives are organized on a non-stock basis. Paying the membership fee is thus equivalent to purchasing a share of voting stock. Some cooperatives expect fees to be paid yearly in proportion to the business the member does or will do with the cooperative.

Membership Certificates are issued by non-stock cooperatives to members when membership fees are paid. These funds pay all or a part of the costs associated with operating the cooperative.

Capital Certificates, also issued by non-stock cooperatives, are similar to preferred stock certificates in that they may bear interest, have due dates, usually have no voting rights, and can be issued to both members and non-members.

Deferred Patronage Refunds. Cooperatives can retain 80 percent of net margins and pay member-patrons the remaining 20 percent in cash. The 80 percent of net margins, which could be paid to members as patronage refunds, are accumulated by the cooperative until sufficient capital is accumulated to finance needed facilities and operations. They may then be redeemed under a revolving capital plan.

Retention of Unallocated Reserves. Some capital reserves are retained by the cooperative on an unallocated basis. These reserves are generally designed to absorb possible operating losses and are sometimes established to comply with state laws.

Per-unit Capital Retains, used primarily by marketing cooperatives, are invested in cooperatives through deductions from sales proceeds on a physical unit basis. Cooperative bylaws may place such retains in a revolving capital fund, providing that when the cooperative has adequate finances, the fund will be revolved.

Revolving Fund Financing allows cooperatives to constantly renew their capital structures, to provide an unending source of member capital, and, at the same time, assure that the oldest equities would be paid back first. Under this financing method, members' revolving equities are allocated to them on the cooperatives' books, and these equities are used to conduct the business.

Sources of Borrowed Funds

Cooperatives may often find equity capital sources are not adequate either to begin or to maintain a sound and stable financial structure. As a result, many co-ops must find permanent external sources. Some cooperatives raise external funds from non-member investors and creditors. Raising funds this way gives the cooperative greater leverage; that is, it can borrow additional capital on a smaller percent of net worth. The member thus has a lower investment and the creditors share a greater portion of the risk.

Sources of borrowed funds for cooperatives include:

- CoBank
- The National Rural Utilities Cooperative Finance Corporation (NRUCFC)
- Rural Telephone Bank
- Government agencies
- Individuals
- Commercial banks and insurance companies
- Regional cooperatives
- Municipal bonds
- Foundations and private grants

CoBank is part of the Farm Credit System, a $78 billion nationwide network of banking institutions created by Congress in 1916. CoBank offers its customers a wide variety of products and services at competitive interest rates in part because it is a federally chartered and regulated Farm Credit Bank. Most of the bank's customers are agricultural cooperatives that process, market, transport, and export agricultural products as diverse as beans, fruits, vegetables, grains, cotton, dairy, livestock, and fish. At year-end 1997, loans to these 1,500 cooperatives made up 60 percent of the bank's loans.

The National Rural Utilities Cooperative Finance Corporation was established in 1970 to meet rural electric cooperatives' critical financial needs. It makes both long-term secured loans and short-term operating loans to rural electrification administration distribution systems, to power systems and to statewide rural electric associations.

Rural Telephone Banks were established in 1971 to meet the increasing needs of rural telephone systems.

Commercial Banks and Insurance Companies have played only a minor role as a capital source. Their interest rates tend to be higher than the rates offered through the bank for cooperatives.

Municipal Bonds are sometimes issued by municipalities interested in stimulating business and industrial development. Through such bonds, money is raised from the general public to build facilities and purchase necessary operating equipment.

Foundations and Private Grants. Individual and private foundations occasionally give funds to cooperatives. These grants primarily have been to limited resource cooperatives that provide opportunities for special groups or promise to furnish new and needed services.

Depreciation Reserves. A cooperative's yearly net savings includes depreciation of buildings and equipment as a non-cash expense. The amount is credited to a "reserve for depreciation" account. Cash funds equal to the annual depreciation then become available to finance other fixed assets or operating needs. Many cooperatives rely on funds from depreciation expense to help make annual payments on notes or mortgages used to finance new facilities or services.