Introduction to Balance Sheet Management and Evolution of Equity Management Programs

CHS Insight Meeting

Michael Boland
Koller Professor of Agribusiness Management
Director of The University of Minnesota Food Industry Center

E. Fred Koller endowed Chairholder in Agribusiness Management
(funded by CHS, Land O’Lakes, Agribank, CoBank, Country Insurance and Financial Services, Koller Family, University of Minnesota Foundation, and friends)

Schedule

• Morning Session
  – CHS Management Report
  – Introduction to Balance Sheet Management

• Lunch

• Afternoon Session
  – Evolution of Equity Management Programs
  – CHS Director Report

Session 1 Outline

• Understanding of cooperative business model
• Income distribution decision and board responsibilities
• Board responsibility on balance sheet
• Board responsibility for equity management
• Group Exercise

What are your issues?

• Let’s lay out the issues and questions you have on these two topics to begin with.
Some Key Board Responsibilities

- Governing body for cooperative
- Recruitment, hiring, evaluation, compensation, and retention of CEO / General Manager
- Decision of how much equity is on balance sheet
  - What to do with any “residual” cash or income

Links to Cooperative Business Model and Proportionality Concept

- Customers
  - Desire a transaction that leads to increased farm profits as co-op is vertical integration of farming operation
- Patron
  - Desire distribution of residual income in proportion to patronage
- Member
  - Desire to control the cooperative through its governance
- Owner
  - Desire for ownership, investment and redemption in proportion to patronage

Relationship of Income Decision and Balance Sheet in a Cooperative

Definitions

- Source of income
  - Patronage income arises from business done by members
  - Non-patronage income arises from non-member business
- Type of equity
  - Allocated income is subject to redemption by the board
  - Unallocated income is retained by the co-op and not redeemable
- Taxability of equity
  - Qualified
    - Excluded from co-op’s taxable income
    - 20% must be paid in cash
  - Non-qualified
    - Excluded from member’s taxable income
    - No minimum requirement for cash payment
- (Cobia textbook)
Cooperative Generates Income from Operations

- Board decision-making with regard to risk exposure.
  - What decisions has the board made in its strategic thinking process?
    - What does the industry analysis suggest for risk exposure?
    - What does the firm analysis suggest for risk exposure?
    - How much equity does board desire on balance sheet?
      - What type of equity? (member or non-member, allocated to the member or unallocated as retained earnings)
      - Note that the taxability issue is a decision to be made later
    - What is appropriate equity-to-assets ratio? (capital structure)

Key Board Decision: Appropriate Equity-to-Asset Ratio

- Dictated by need to maintain lender covenants
- Board strategic thought process and assessment of risk. An annual board retreat is often used to generate this information. This information feeds into the business plan required annually by most lenders.
  - Future farm policy?
  - Volatility in prices and implications for risk management strategies used by cooperative?
  - Other factors

Solvency, as measured by adjusted equity to assets (total equity divided by (total assets minus current liabilities)) varies widely from state to state and co-op to co-op in 2008.

Evans, E. “Cooperative Equity Redemption.” Rural Business Cooperative Programs Research Report 220, June 2010
**Key Board Decision: Decision to Acquire Additional Assets**

- What is the purpose of additional assets?
  - Generate future income
  - Meet members service and product needs
    - What is your mission statement?
  - Reduce costs
    - Acquire new technology or process
    - Acquire market share to deepen footprint or add geography
- This decision is predicated by board preference for
  - Greater debt on balance sheet
    - Seeing leverage among some larger co-ops right now
  - Greater equity on balance sheet by financing with
    - Working capital
    - Ask members to invest directly
    - Partner with another entity to acquire asset and share income/risk

**Evolution of Equity Management Philosophy Over Time**

- Brookings Institute Report (late 1940s, Koller)
  - Co-ops operating ‘at cost’ also unable to redeem equity (member unrest)
- Land grant university research (early 1960s)
  - Lack of consistent profitability (governance issues)
- GAO Report (1979) and USDA Report
  - Inability to redeem equity (governance issues)
- Merger studies, equity management and lack of performance (late 1980s and 1990s)
  - Mergers are not always the solution and equity must be valued at market rates rather than 1:1 to ensure success (Parliament, Barton).
  - Co-op life cycle must be known (Barton)

**Evolution of Equity Management Philosophy Over Time**

- Regional co-op bankruptcies and other write-downs (early 2000s)
  - Many co-ops unwilling to write down individual member equity accounts which suggests what about how those boards view allocated equity?
- Section 1099 Issue
- Why are more boards considering changes in equity management programs now?
  - Why is there a need for unallocated or permanent equity?
  - How is this linked to working capital?
  - How do we look at equity structure?
    - Need to operate the business day-to-day?
    - Thinking about takeover or dissolution?

**What have we learned about equity management over time?**

- Key Board Decision: Cooperative must be profitable.
  - Mission statements
- Key Board Decision: Pool all income from all sources because strategy and assets reflect risk tolerance and income diversity.
  - Non-member business is different
- Key Board Decision: Co-op should adhere to cooperative principles
  - High degree of allocated equity
  - If unallocated retained earnings are used, communicate why that method is being employed to members
  - Users of co-op should have greater investment
What have we learned about equity management over time?

- Key Board Decision: Think about communication with members and alignment with members
  - Need and desire for allocated equity
    - Users should be invested in co-op
    - Younger producers must understand their responsibilities as well
  - Discuss why members pay cash on non-cash patronage (qualified)
  - Consider having member pay tax on patronage paid in cash (nonqualified)

Equity structure, measured by retained earnings to total equity, varies widely from state to state and co-op to co-op in 2008.

Key Board Decision: Decision to Redeem Equity

- Patronage income allocation and distribution
  - High customer-patron ownership (allocated) or high retained earnings (unallocated).
  - Allocated implies (to members) some expectation of future repayment while unallocated as retained earnings implies no expectation of repayment.
- Taxes and Patronage refund
  - Qualified or nonqualified
- Qualified cash patronage refund rate
  - Low rates (below producer marginal tax rate) have been common in past in certain regions but are not desirable.
  - High rates reduce member investment in cooperative over time.
- Nonqualified cash patronage percentage rate
  - Low rates are likely to be more common since co-op incurs the tax liability.
  - High rates reduce member investment in cooperative over time.

Exercise

Here are the four perspectives of the cooperative business model and the member self interest. How does the board manage these four perspectives?

Customer (lowest price, highest level of service)
Patron (high cash patronage)
Owner (rapid redemption of equity)
Member (high level of influence)
Session 2: Introduction to Equity Management
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Exercise for You

• What is your co-op’s current equity management policy?
• How has it evolved over time?
• What are your biggest equity management challenges now?

Relationship of Income Decision and Balance Sheet in a Cooperative

Group Exercise

• You have $100 of assets.
  – $50 current assets
  – $40 fixed assets
  – $10 investments in other co-ops, LLC’s
• What should your capital structure look like?
  – How much debt?
  – What should the equity look like?
    • Allocated?
    • Unallocated?

Qualified distribution means patron pays all taxes on cash and non-cash in distribution year.
Non-qualified distribution means the patron pays taxes only when cash is received.
Allocated equity retains patron name on the equity.
Concluding Thoughts: Develop a Board Philosophy on Equity Management

- Easy to communicate to members
- Aligned on firm strategy
- Linked to best practices of cooperative finance
- Should not change much over time
- Understanding of psychology regarding present value and future value
- Avoid making decisions that result in rules
- Understanding of tax implications
- Communicate that cash for equity redemption is the residual claimant on net income.

Avoid making decisions that result in “hard and fast” rules

- Age of patron method – redeem equity when the patron reaches a specified age. The rule is the year (generally 65 years or older).
  - Midland Cooperative (“Midland M”) probably was first wide-spread user of this program in 1930s and 1940s.
    - Trade territory was eastern MN and northwestern WI which was poor profitability.
    - Difficult to get farmers to write checks
      - Producers understood per unit retains concept and this was farm supply co-op solution to that issue
    - Promoted age of patron as a social security program
- Revolving fund method - redeem equity based on oldest equity first. The rule is the difference between current year and the past year when equity was allocated.
  - Some flexibility if the rule is communicated as “oldest equity first” regardless of length of time.
- Rules like age of patron result in equity redemption being thought of as a current liability and hamper board ability to make strategic decisions.

Age at Which Equity is Redeemed and Length of Revolving Fund in 2008, Years

Understanding of tax implications

- Equity redemption programs developed in 1930s and 1940s recognized the implications of marginal tax rates for co-op and member.
  - Individual marginal tax rates were 5% in 1940.
    - Corporate tax rates were 19% in 1940.
  - This relationship has averaged from 1:3 to 4:1 over the 1940 to 1983 time period and begun narrowing with deductions and tax changes.
- Qualified distributions made sense tax-wise.
  - Do they today?
- Section 199 Issue and unused tax ‘credit’
What are more co-ops putting some income into unallocated income?

- Reasons often cited for permanent equity
  - Ability to handle losses
    - Farmland, Agway, Countrymark bankruptcies, CHS agronomy issue, local losses
  - Boards are sensitive to writing down the value of allocated equity
    - Operating losses are viewed different than losses in investments
  - Provides working capital for co-op to make asset investments
    - Many boards consider allocated equity as something that must be redeemed in the future
  - Lenders and other stakeholders advice

What are your questions?