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The Curious Case of Cooperative Capital

(Or, Why Your Co-op is Worth More Than You Know)

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Are retained earnings an "investment"?

- "A cooperative is operated for the mutual benefit of its members. Advantages accrue to a member in relation to patronage **not** financial investment."
 - *Randolph Paul, "The Justifiability of Exempting Cooperative Organizations from Federal Income Taxes", Minnesota Law Review, 1945 (9).*
- "The only methods by which farmers' cooperatives may obtain capital are borrowing and **investment** [via retained earnings] by farmers."

Words matter

- "Words are the vehicles by which ideas are conveyed...words are merely the audible or visible skins of human thoughts."
 - *Ladru Jensen, T.H. Hedgepeth and F.R. Olmstead, "Report on Classification and Terminology," The Business Lawyer, 1948 (4)1, American Bar Association*
- "Cooperative corporation law has borrowed from private-corporation law...clarification and standardization of terminology of cooperative associations is sorely needed."

Why this word matters

We are taught to measure value with ROI.

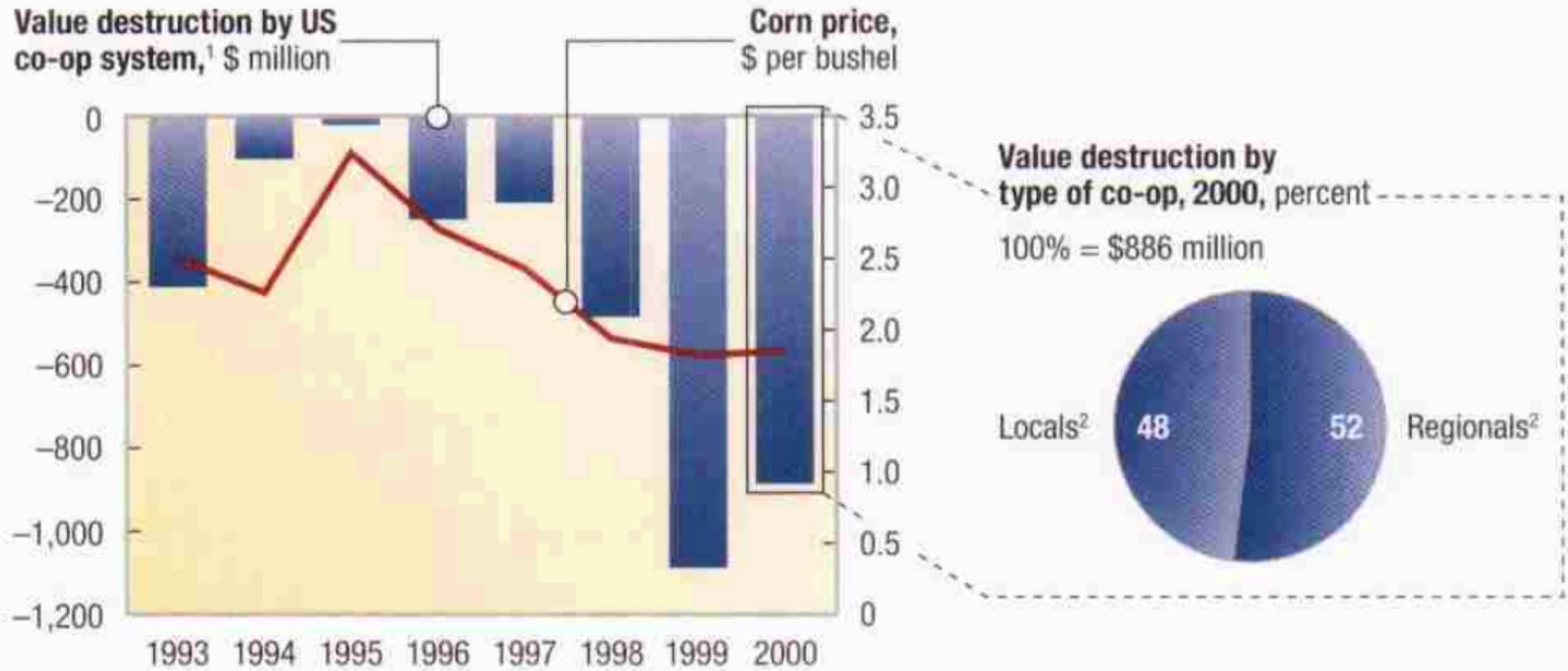
Not knowing how to credibly value a cooperative is
dangerous

The McKinsey Quarterly, 2002, Number 3

"Despite the \$1.5 trillion a year that agriculture and the activities associated with it bring to the US economy, much of the industry is destroying value. The problem is...one of the industry's traditional business models: agricultural cooperatives. With few notable exceptions, **co-ops destroy value.**"

EXHIBIT 2

Value blight



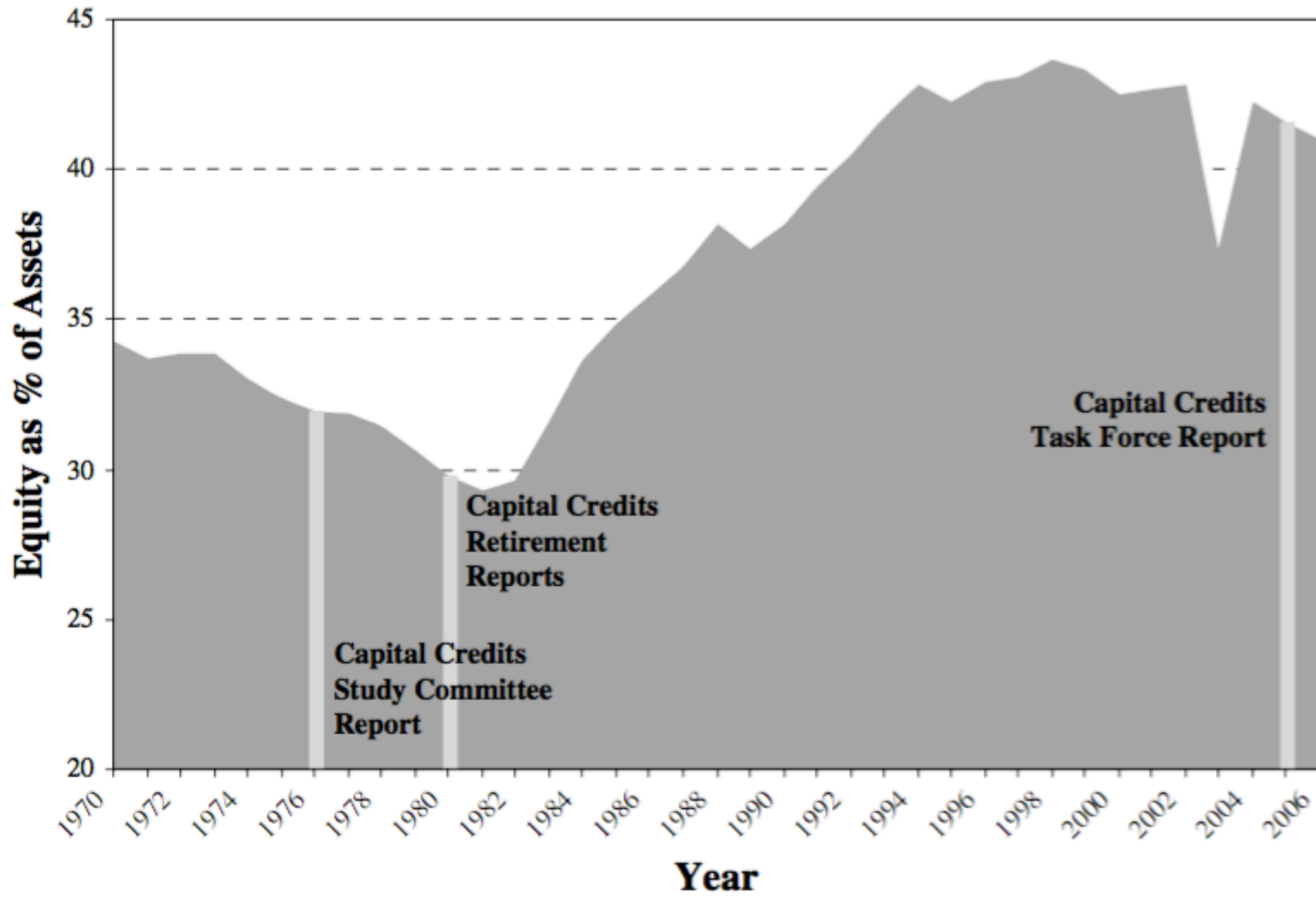
Harvard Law Journal, 2008, Volume 5

POLICY ESSAY

**ELECTRIC CO-OPERATIVES: FROM
NEW DEAL TO BAD DEAL?**

REPRESENTATIVE JIM COOPER*

FIGURE 3: DISTRIBUTION SYSTEM EQUITY (PERCENT OF ASSETS)¹¹³



Acquirer

FAIR VALUE APPRAISAL OF CERTAIN INTANGIBLE ASSETS OF Acquiree PURSUANT TO THE ACQUISITION METHOD AS DEFINED IN ASC 805 – BUSINESS COMBINATIONS

As of

Acquisition Date



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eNews from Thursday, August 16, 2007 [print view](#) | [email to](#)

AGP Rejects Buyout Offer from Omaha-Based Investors

Omaha World-Herald (NE) (KRT) -- Aug. 15 -- Directors of Ag Processing Inc. (AGP), an Omaha-based agricultural cooperative, rejected a purchase offer by a group of investors Tuesday, calling it a hostile-takeover attempt.

The DCF is comprised of components in addition to Management's forecast. These are:

- An estimate of the company's cost of capital
- An estimate of the company's net working capital requirements in response to the changes in its operations indicated in the forecast
- An estimate of value of the cash flows for the period beyond the forecasted annual cash flows, based on a perpetuity model

Business enterprise value is defined as the combination of all tangible assets, normal working capital, and intangible assets of a continuing business. Alternatively, it is equivalent to the invested capital of the business; that is, the combination of the value of the stockholders' equity and long-term debt.

...
value was assigned to the Acquiree trade name.



- Customer relationships: At the date of acquisition, Acquiree had significant relationships with its patrons. However, the cash flow from the existing customer base is insufficient to cover contributory asset charges on tangible and intangible assets resulting in no value to the customer relationships.

The sum of the present value of the excess earnings was calculated to be less than \$0. The fair value of the Customer Relationships as of the Valuation Date is \$0.

Puzzle

Cooperatives do not pay for equity

Evidence

- CUs and many consumer cooperatives generally may pay a patronage refund, but many do not
- Farmer cooperatives and utilities often use some form of "revolving equity" with an implicit *negative* return
- Mutual insurers pay below-market returns on equity
- Sense among practitioners that cost of equity is "too low"

Questions

- Does this mean co-op members do not value financial capital?
- Where do the dividends go?

Possible answers (hypotheses)

1. Members are ignorant, or ambivalent
2. Co-ops are inefficient and wasteful
3. Co-op leaders earn "rents" (or steal!) from members
4. Something else is going on

"You can fool some of the people all of the time,
and all of the people some of the time,
but you can't fool **all** of the people **all** of the time."

--Abraham Lincoln (1858):

An "equity discount" puzzle?

- Investor-owned firms pay for equity capital (too much, it seems) because equity holders *demand a premium* for risk bearing
- By analogy, cooperative firms do not pay for their capital because equity holders are willing to accept a *discount* for their equity?
- Why? Is this something that can be accounted for in a "standard" economic model?

Yes, of course!

MINNESOTA LAW REVIEW

Volume 39

January, 1955

No. 2

MULTIPLE CONTRACTUAL ASPECTS OF COOPERATIVES' BY-LAWS

CHARLES E. NIEMAN*

Valuing cooperative enterprise

- Measure patron (consumer surplus) **and** cash-flow benefits
- Consider effects on **non members**
- In many cases, largest component of value is not on the balance sheet, and not earned by members

Are retained earnings an "investment"?

- Often referred to as such because they are a **mandatory capital contribution**, agreed to prior to their creation:
 - Co-op obligated contractually to allocate earning to patron as **income**
 - Patron in turn obligated to **invest** income in co-op
- Wonderful legal construct
- But obscures what's really happening, and causes confusion

What is the return on this
"investment"?

Absence of return through "investor channel" is evidence of implicit (or "revealed") return through patronage channel.

And in an economic model with rational behavior, this return must be **at least** the market return on capital (and likely much more)