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Who owns the cooperative?

by Keri Jacobs, cooperatives economist, kljacobs@iastate.edu, 515-294-6780

Who owns the cooperative? The question of ownership is, in theory, easy to answer. Cooperative corporations, like other corporations, are owned by those who contribute equity to the firm. Yet an individual's investment in a cooperative – equity contribution – is tied directly to his or her use of the cooperative. This is perhaps the primary characteristic that distinguishes the cooperative business form from other organization structures. For example, one need not invest in Apple, Inc., to buy an iPad and, similarly, could invest in the company by purchasing stock without ever buying a single product or service from Apple. Not so with a cooperative; it is owned by those who use it currently or have used it in the past. In the case of the agricultural grain and supply cooperatives in Iowa, the producers who sell grain to and buy inputs from the cooperative own it. Or do they?

Today, Iowa is home to approximately 58 grain and farm supply cooperatives, less than 10 percent of the 710 cooperatives that existed in 1951. While some of the reduction in numbers is attributable to cooperative failures or sales, much is the result of co-ops merging with other co-ops. In 1951, a majority of the cooperatives were single location; today, very few single-location cooperatives exist.

Instead, cooperatives have grown into multiple-location firms spanning several counties. Cooperatives needed to grow to keep pace with and be able to service the growth in farm size and complexity of operations. As cooperatives have grown in size – and as they have experienced recent record-profitability years – the producers who do business with them (their owners) have, not surprisingly, begun to question whether they own the cooperative or whether the cooperative owns itself.

To understand ownership in a cooperative, its equity composition needs to be examined. In the simplest sense, a cooperative can build equity in two ways: by direct initial investments from the producers who use it and by earning profits. The initial investment piece is small. In most cases, producers in Iowa become a member of a cooperative by purchasing a single voting share for a relatively modest sum, perhaps \$25 to \$1,500. The majority of equity then is accumulated when the cooperative earns a net income, typically called “savings” or “local savings” in co-op jargon. With each year of positive savings, a cooperative allocates a portion to its members in the form of patronage based on an individual's proportional “use” of the cooperative – his or her share of the total business conducted. Often 20–30 percent of

this allocated equity is paid out as cash to the members who used the cooperative. The rest of the allocated

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Handbook updates

For those of you subscribing to the handbook, the following new updates are included.

- Historical Costs of Crop Production** – A1-21 (2 pages)
- Lean Hog Basis** – B2-41 (1 page)
- Live Cattle Basis** – B2-42 (1 page)
- Feeder Cattle Basis** – B2-43 (1 page)
- Feeder Steer-Heifer Price Spread** – B2-45 (1 page)
- Computing a Cropland Cash Rental Rate** – C2-20 (4 pages)
- Flexible Farm Lease Agreements** – C2-21 (4 pages)

Please add these files to your handbook and remove the out-of-date material.

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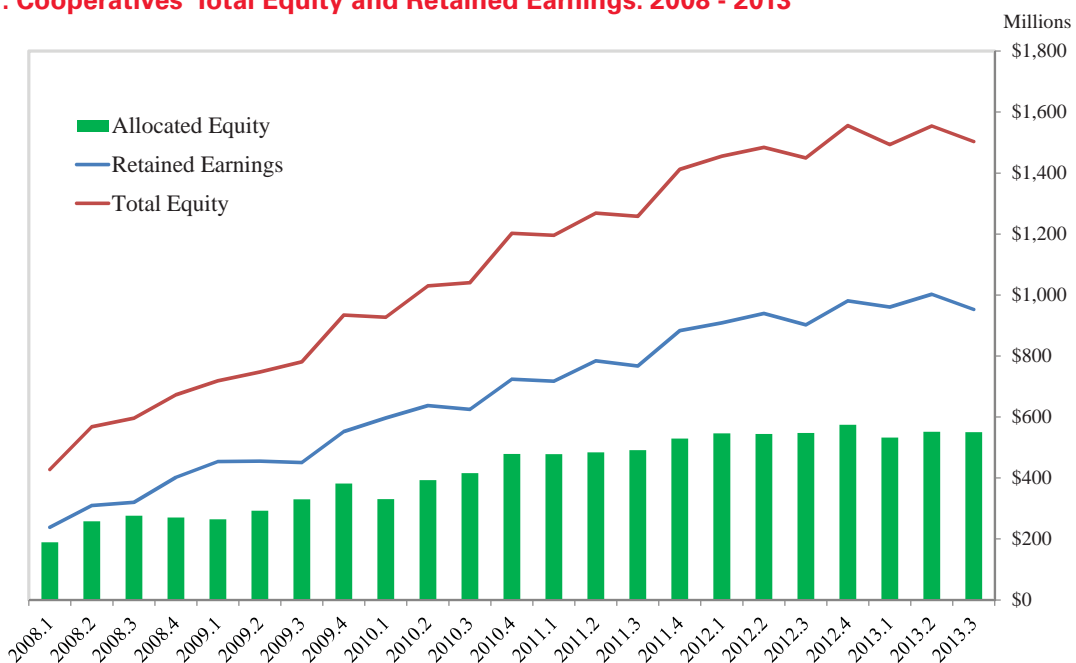
equity stays on the cooperative's balance sheet as equity in the member's name. This is retained patronage or retained allocated equity, and it will eventually be redeemed or paid out to the members over the normal course of business. In Iowa, many cooperatives are redeeming allocated equity 7–12 years after it was allocated to the members. The rest of a year's savings – that which is not paid out as cash to members or placed into members' retained allocated equity – is designated as retained earnings: equity in the cooperative with no one's name on it. This is where the issue of ownership gets blurred: whose equity is that? Importantly, equity that has not been allocated to a member is members' equity because members control and own the cooperative. However, it is not designated to be redeemed to members as retained patronage is. Practically speaking, it is only accessible to the members if the cooperative is sold or dissolved.

Recent record profitability years coupled with tax deductions – like Sec. 199 (the domestic production activity deduction) – have led to significant increases in cooperatives' retained earnings. Adding to retained earnings benefits the cooperative in a number of ways. The most often cited benefit given by cooperative managers and directors is that it is permanent equity. Conversely, retained patronage is not viewed as permanent equity because of the expectation that it be redeemed to members at some point in the future. A cooperative board ultimately has control over whether and how much of that is redeemed, but the expectation of redemption exists. Having a significant share of the co-op's equity as permanent equity is favorable to the cooperative when working with lenders who evaluate the risk profile of a cooperative on their permanent equity. Another benefit of retained earnings is

that it acts as a cushion to absorb losses (negative savings) when they occur. Without retained earnings to absorb the loss, the co-op would be required to reduce members' equity or "bill" members for their share of the loss in that year. Even though reducing retained earnings does reduce members' equity, most members do not perceive it as a direct loss because the equity against which it is charged was not allocated to them initially. Finally, retained earnings provide a readily available pot of equity to use for investments (asset acquisitions, replacements, etc.) without taking directly from the members' allocated equity, which, as a reminder, is expected to be redeemed to them. This gives the board and management more flexibility in the timing of the investment activities and often permits them to make decisions more quickly.

Just as there are benefits to retained earnings, there are drawbacks. Perhaps the greatest of those is the question at hand. A large share of equity as retained earnings creates uncertainty about the cooperatives ownership and the reason for its existence. Members incorrectly perceive that they do not own the cooperative because the share of equity with members' names on it is relatively small in comparison. A potentially negative disincentive exists because members understand that the only way to "get" that equity is to sell or dissolve the cooperative. Consider a cooperative that has 75 percent of its equity as retained earnings and 25 percent as retained patronage and membership certificates. If a private firm were to approach the board of the cooperative and make an offer to buy the cooperative for "balance sheet" value, the members in aggregate would stand to earn four times their retained equity. When members do not perceive the retained earnings as "members' equity," then the threat of

Figure 1. Cooperatives' Total Equity and Retained Earnings: 2008 - 2013



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an outside firm buying the cooperative becomes very real. Further, because members' equity accumulates over time, this situation is made more likely because the members with the largest equity share are the older members who are perhaps no longer farming or are contemplating retirement. Do they have the same incentives as the beginning or younger farmers to ensure that the cooperative is around for the next 10–40 years? Generally speaking, older members prefer to get the equity out of the cooperative; younger members want the permanent equity left intact because it supports capital investments, which benefit their own farming operations.

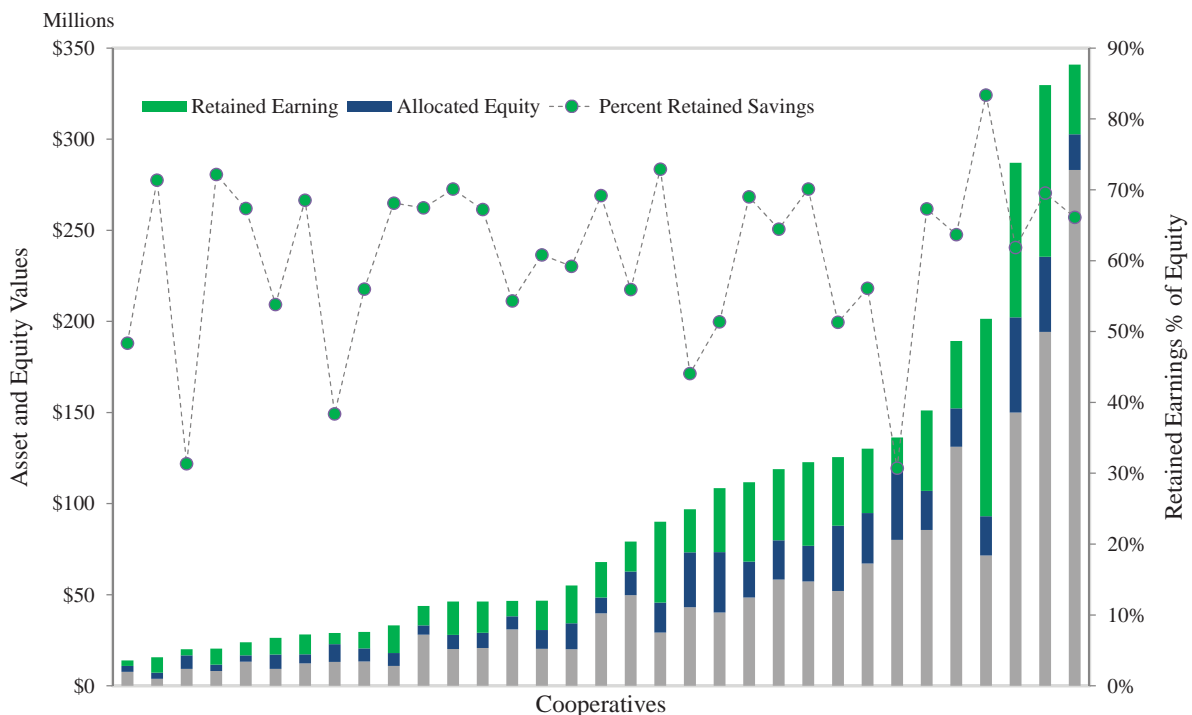
How real is this situation? Does it exist locally? Firm-level equity data from 33 cooperatives in Iowa and surrounding states indicates that it may. Figure 1 shows the aggregate quarterly value of these cooperatives' total equity and retained earnings since 2008. Allocated equity has increased even as cooperatives have paid out older equity to members and retained earnings has also increased over this time period; however, the largest increase has been in retained earnings. On average, these cooperatives have approximately 65 percent of their equity as retained earnings.

Farmers anecdotally perceive that as the co-op has grown in size, farmers actually own less of the cooperative. Interestingly, the largest cooperatives are not necessarily the ones with the highest proportion of retained earnings. The disaggregated data for these same individual cooperatives during 2013 is illustrated in Figure 2. The cooperatives here are arranged smallest to largest in asset value, given by the total height of the vertical bars. The

colored portions of those bars indicate the amount of retained earnings and allocated equity in each. Green markers (top portion of bar) identify the percentage of these cooperatives' total equity that is in retained earnings. While some of these cooperatives are operating with approximately 40–50 percent of their equity in retained, most have retained earnings at 55–75 percent of total equity, with a few as high as 90 percent. The perception of members of larger cooperatives is often that they feel the members no longer own the cooperative, but as this shows, cooperative size has little to do with its equity mix.

The equity mix of cooperatives results directly from board decisions. A cooperative's board decides how its income will be allocated to meet its members' needs and the cooperatives' future strategic plans. The board, which is elected by the membership and who are also producers with production at risk, has a responsibility to direct the cooperative in a manner that is consistent with the best interests of the members and to ensure the continued operation of the cooperative for the benefit of its members. Whether a board targets a relatively high proportion of retained earnings or a high proportion of retained allocated equity, it is all members' equity, and it exists to benefit the members either through eventual equity redemption or through investment in the assets, technology, and services that benefit its members. As a co-op's retained earnings grow relative to allocated equity, it becomes increasingly important that the cooperative board and management communicate with members the value proposition of this permanent equity so that members correctly perceive its value to their own continued use of the cooperative.

Figure 2. Cooperative Equity Composition by Asset Size, 2013





Making the right crop insurance choices for 2014

by Steven D. Johnson, farm and ag business management specialist,
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Buying crop insurance and making coverage decisions will be one of the most important risk management decisions farmers will make this winter.

The 2012 drought and 2013 drop in corn prices emphasize the need to manage revenue risk. Crop revenue coverage to insure against both yield losses and price declines the past two years has kept most farm operations financially viable. With lower corn and soybean projected prices forecast for 2014, crop insurance's ability to protect against loss of revenue will be critical.

With lower crop insurance revenue guarantees, many farmers may need more revenue coverage. For example, at the 75 percent coverage level, 2014 ratings for premiums are projected to be between 2 and 5 percent lower than those in 2013.

However, revenue guarantees are tied to new crop futures prices, which will likely drop 10 to 20 percent from those in 2013. A farm level revenue protection or revenue protection (RP) coverage this year with the same actual production history (APH) as last year may fall below the cost of production for many farm operations. Meanwhile, most crop production costs will remain high in 2014, lagging the decline in commodity prices, putting a squeeze on margins.

Having a crop revenue insurance protection policy, along with using a well-prepared and properly executed grain marketing plan, will allow farmers to protect the majority of their revenue.

Revenue guarantees lower

Farmers should consider moving to higher coverage levels to offset a portion of the risk with lower crop revenue guarantees. Revenue guarantees this year are calculated using the average futures price in the month of February for the December 2014 corn contract and the November 2014 soybean contract. These prices are called "crop insurance projected prices."

The first step to using a crop insurance RP policy as part of your risk management strategy is to choose the right level of coverage. Farmers who insured at 75 percent with RP last year might consider increasing to 80 or 85 percent levels of coverage for 2014.

For example, say a farmer's corn APH is 180 bushel per acre and he is insured at the 75 percent level. With 2013's \$5.65 per bushel projected price level, the per-acre guarantee was \$763. This year's guarantee may only be \$4.50 per

bushel, however, which means revenues of \$608 per acre are protected. That's a revenue guarantee decline of \$155 per acre compared to last year.

Trend-adjusted (TA) option

Farmers should nearly always take the TA option. That's the cheapest way to increase revenue guarantee without paying additional premium. By choosing the TA yield option, farmers can protect a higher level of yield than their 10-year APH yield average for a very small increase in premium. In fact, they might get an extra 8 to 10 bushel per acre for corn above their 10-year APH for the least amount of additional premium cost.

Enterprise vs. optional units

For most farmers, enterprise units make the most economic sense. At the 75 percent level of coverage, enterprise unit premiums are subsidized at 77 percent; for optional units, the subsidy is only 55 percent.

USDA's Risk Management Agency increased subsidies for enterprise units beginning in 2009 because when farmers use enterprise units, similar crops are combined across the county to determine indemnity loss. In contrast, using optional units provides coverage for similar crops within the section of land. Farmers take more risk when using enterprise units but receive a larger percent subsidy.

If farmers have insured acres in more than one section of land, they should look at using enterprise units; they'll get the largest premium discount. Optional units insure crops at the section line. With enterprise units, they're combining all of their cornfields together in the county and all their soybean fields together in the county. This is where adding supplemental coverage fits in.

Adding supplemental coverage

Farmers need to look at having some supplemental crop insurance products, in addition to revenue protection. Various supplemental policies can be added to multi-peril RP policies. The supplemental policy choices include crop hail, wind and greensnap coverage, weather products and projected price discovery products.

If a farmer decides to use enterprise units and the TA option, he can add supplemental insurance products such as hail, wind and greensnap policies.

By using enterprise units, farmers will save more on the premium, but they're exposed to risk when hail hits one of their farms, but doesn't hit the other corn fields in the county.



Farm lease types have different risks and rewards

by William Edwards, retired extension economist, wedwards@iastate.edu

The proportion of Iowa farmland operated by the owner has stabilized at about 37 percent, according to the most recent farmland ownership and tenure survey conducted by Iowa State University (see table). What has changed, however, is the popularity of different types of farm leases. From 2007 to 2012, traditional crop-share leases stayed steady at 12 percent of total farmland, but flexible cash leases increased from 5 to 8 percent while fixed cash leases fell by the same amount. To put it another way, 19 percent of Iowa's cash leases now have provisions by which the rent automatically adjusts up or down each year, compared to only 12 percent in 2007.

Rent values by type of lease

How have fixed, flexible and crop-share leases compared in recent years? Figure 1 shows estimated rents per acre for the past 10 years for a corn-soybean rotation. Of course, actual rents will differ for each farm. The fixed rent value is the average cash rent paid in Iowa based on Iowa State University Extension and Outreach's annual survey. The flexible cash rent values are estimated at 25 percent of the gross revenue per acre from corn and 35 percent of the gross revenue per acre from soybeans. Gross revenue is calculated by multiplying the state average yields for each year by the state average cash prices in October, November and December of the same year. The USDA direct payments and multiple peril crop insurance payments received each year are also included. The value of the crop-share rent is estimated as one-half of the gross revenue minus one-half of the costs typically shared by the landowner, based on ISU Extension and Outreach typical budgets.

From 2004 to 2006, all rents were very stable. However, in 2007 a period of higher and more volatile crop prices began. Crop-share and flexible rents rose immediately because they were directly tied to current prices. Fixed cash rents lagged behind for about two years, then caught up. In the most recent years, all three rents have been very close. Crop-share and flexible rents have been slightly higher than fixed cash rents, which is justified by the increased risk borne by the landowner in each case. In 2013 the crop-share and flexible cash rents both nosedived in response to the lower corn and soybean prices for the 2013 crop, whereas most cash rents were negotiated before the price decline was apparent.

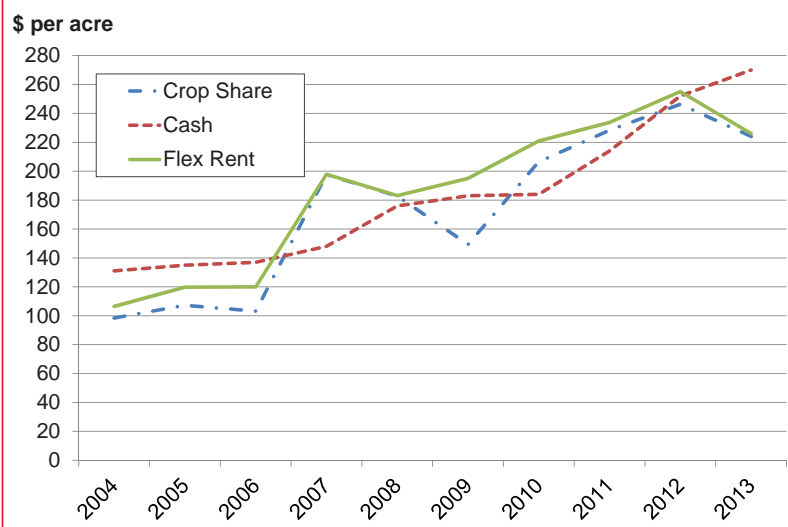
Sharing financial risk

Another recent ISU study examined the amount of variation in net returns to the landowner and tenant under different lease arrangements, based on yield, price and production cost patterns in Iowa over the past several decades. Because cash rents are based on expectations of yields and prices for the coming year, rather than actual results, they change more slowly than flexible cash or crop-share leases. Many fixed cash rents are not renegotiated each year. This results in a more stable, albeit slightly lower, average rent over time. The landowner knows with certainty at the beginning of the year how much the rent will be. Any variation in net returns caused by unexpected changes in yields, prices and production costs is borne by the tenant, as shown in the first bar in Figure 2.

Land Tenure Arrangements, % of All Iowa Farmland		
Land Tenure	2007	2012
Owner-operator	37%	37%
In government programs	7%	5%
Custom farmed	2%	3%
Fixed cash rented	37%	34%
Flexible cash rented	5%	8%
Crop-share rented	12%	12%
Rented, other types	0%	1%

Source: ISU Extension Ag Decision Maker file C2-15

Figure 1. Rent for 50-50 Corn/Soybeans Rotation



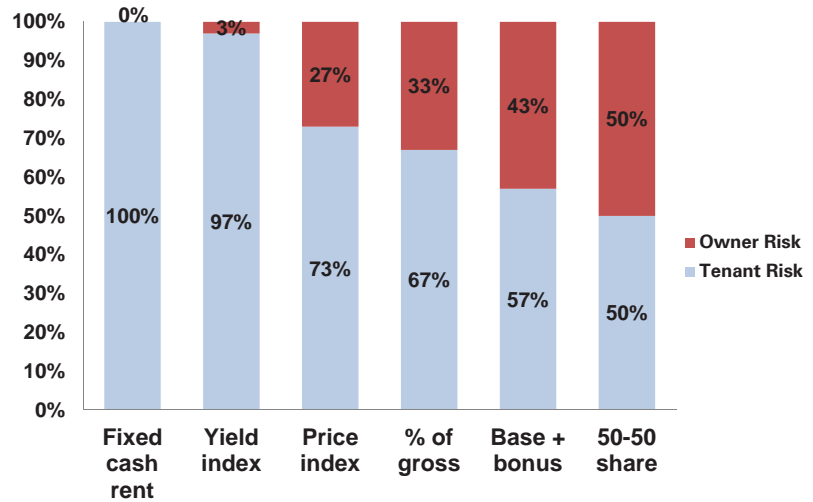
Farm lease types have different risks and rewards, continued from page 5

Flexible leases share risk differently

At the other extreme, under a 50-50 crop-share lease the tenant and landowner share financial risks equally, as shown in the bar on the far right in Figure 2. The other bars show how financial risk is shared under several types of flexible cash leases. The “yield index” bar represents a lease for which the rent paid each year depends on the actual yield attained, only. The “price index” bar represents a lease for which the rent varies with year-to-year prices, only. The yield index lease transfers very little risk to the owner because in Iowa, at least, yields have been more stable than prices in recent years.

Some flexible leases set the rent each year as a fixed percent of the gross crop income each year. As shown by the “% of gross” bar, this reduces the tenant’s net income variability even more because the rent automatically adjusts up or down with both prices and yields. The “base plus bonus” bar represents a flexible lease in which rent is equal to a fixed base rent plus a percent of the tenant’s return over production costs. By incorporating costs into the rent equation, the tenant’s net return varies even less, and the sharing of risk approaches that of a 50-50 crop-share lease.

Figure 2. Relative Financial Risk Born by Tenant and Owner



It is important to note that as landowners take on additional financial risk, their returns will increase in years of higher than expected profits as well as decrease when overall returns decline. Both owners and tenants should select a lease type that reflects their individual abilities and desires to bear risk and reap rewards, versus their needs for more stable income.

Updates, continued from page 1

Internet Updates

The following information file and decision tools have been added on www.extension.iastate.edu/agdm.

Net Present Value of Beef Replacement Females – B1-74 (1 page)

Net Present Value of Beef Replacement Females – B1-74 (Decision Tool)

ACRE Payment Estimator (Average Crop Revenue Election) 2013 – A1-45 (Decision Tool)

Current Profitability

The following tools have been updated on www.extension.iastate.edu/agdm/info/outlook.html.

Corn Profitability – A1-85

Season Average Price Calculator – A2-15

Soybean Profitability – A1-86

Ethanol Profitability – D1-10

Iowa Cash Corn and Soybean Prices – A2-11

Biodiesel Profitability – D1-15

... and justice for all

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