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DEBT OR EQUITY IN THE FINANCING OF CO-OPERATIVE ENTERPRISES

Elena Mamouni Limnios¹, John Watson, Tim Mazzarol and Geoffrey N. Soutar
University of Western Australia

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ABSTRACT

A major issue for co-operatives is their ability to raise member or investor capital to fund growth. A financial instrument, termed Co-operative Capital Unit (CCU), has been introduced in Australia to increase the sector's flexibility in raising and retaining capital. CCUs are loosely defined in the legislation and can take the form of debt or equity. A Delphi Panel of experts was used to examine CCU structures in terms of their intended purpose and their likely attractiveness to investors. CCUs were more likely to be attractive as equity than debt investment instruments, with the potential to attract capital investment without diluting control. The challenge of achieving investor attractiveness is discussed and a new equity and control structure is proposed to address identified challenges.

INTRODUCTION

The difficulty co-ops have in raising capital is seen by many as a major problem (Henry 2005). Being traditionally solely-owned by transacting members (patrons), co-ops are less focused on growth and profit distribution and commonly return value to their member-owners through patronage as a combination of low cost transactions and cost rebates. Co-operative legislation in various countries has recently been adjusted to allow for non-patron ownership. However, this has not necessarily resulted in equity infusions, as the patron-focused nature of co-operative enterprises reduces their attractiveness to investors. In addition, a significant external equity infusion can be unattractive from the co-ops perspective, as it could result in a hybrid co-op structure with significant governance and control challenges. Third party debt from conventional banking sources remains the most commonly sought form of external financing for co-ops. The major challenge co-ops face in this process is the classification of member capital accounts as debt on their balance sheet. Traditional banking institutions do

¹Corresponding author contact details:
UWA Business School, University of Western Australia
M263, 35 Stirling Highway
CRAWLEY WA 6009 Australia
TEL: +61-404-554-854 EMAIL: elena.limnios@uwa.edu.au

not understand the nature of co-operative enterprises and co-op members' roles as patrons, owners and investors (Nilsson 2001).

Co-ops also face difficulties in attracting additional member capital, due to poorly defined ownership rights, a lack of appreciation in the value of shares and a lack of transferability of these shares (Cook and Iliopoulos 1999). The one-member-one-vote principle also acts as a disincentive for member investment in their co-op, as additional capital investment does not attract additional voting rights. In some countries (including Australia) the one-member-one-vote principle is enshrined in the legislation, whereas in other countries (including New Zealand) co-ops can translate the principle of democratic governance with a proportional voting system in which members have voting rights in proportion to their shareholding that commonly reflects patronage (a cap on the maximum voting power of a member is usually applied). Raising additional member equity is often not an option for a co-op unless its rules allow for appreciation and the transferability of member equity. Member capital can be raised through short and medium term debt instruments, which has historically taken place when bank financing was not available or preferred. Co-ops that perform well commonly encourage their members to leave part of their annual rebate or distribution in a member account in the co-op. This is another form of debt financing often referred to as "contingent capital". It relies on member trust and loyalty, as members choose to support their co-op by leaving their rebate in their co-op account, in some instances without receiving an interest on the capital retained in this account. In situations where the co-op requires additional injections of equity these member accounts are converted from debt to equity (usually via preference shares), hence the term "contingent capital".

The consolidation of the agriculture industry worldwide has placed a liability on agricultural co-ops with a shrinking member base. Retaining member capital is a major challenge, especially in cases where co-op shares have appreciated in value and non-active members are unable to retain equity in the co-op. In cases where co-ops redeem their shares at par value the financial risk is less. However, governance challenges can emerge, as retiring members may see privatisation as the only way to extract value from their investment.

Co-operative Capital Units (CCUs) have been introduced in Australia as a way to increase the flexibility of capital raising within co-ops. Although introduced in New South Wales (1992) and Victoria (1996) and, more recently in Western Australia (2009), CCUs are vaguely defined in legislation and poorly understood by co-op managers and consultants. This study examines the range of alternative CCU structures in terms of their intended purpose from the co-ops' perspective and their likely attractiveness to investors. It should be noted that CCUs are an international first and are established in an Australian legislative system that otherwise restricts ownership to active members and requires adherence to the one-member-one-vote principle. Nevertheless, CCUs were also examined outside this legal framework, to determine their potential as a financing instrument in the co-op sector worldwide.

LEGAL DEFINITION

A co-operative capital unit (CCU) is defined as “an interest issued by a co-operative conferring an interest in the capital, but not the share capital, of the co-operative” (Co-operatives Act 2009 (WA), Division 2, p. 152). Therefore, a CCU holding does not carry the rights of co-operative membership.

A CCU can be structured as a debt or equity instrument and can be issued to members and non-members. A co-op must have rules that authorise and govern the issue of CCUs in order to issue such an instrument. In Western Australia, the rules must ensure each CCU holder:

- Is entitled to one vote per CCU only at a meeting of CCU holders.
- Has rights that can be varied according to their terms of issue with the consent of at least 75% of the holders.
- Has none of the rights or entitlements of a member of the co-operative.
- Has the same rights as the holder of a debenture in respect to receiving notice of all meetings and other documents.

The current NSW Act restricts voting to one vote per holder whenever a vote by CCU holders is required, whereas the WA and VIC Acts allow proportional voting. The WA Act is, therefore, more favourable to an investor, as their voting entitlement reflects their investment holding in line with conventional investor expectations. It should be stressed that CCU holders do not carry the rights of co-op membership and, thus, do not attract member voting rights.

The terms of issue of a CCU must include details of entitlement to repayment of capital, entitlement to participate in surplus assets and profits, entitlement to interest on capital including whether interest is cumulative or non-cumulative, details of how capital and interest on capital are to rank for priority of payment on a winding-up, whether there is a limit on the total holding of CCUs for non-members of the co-operative and what that limit is (Co-operatives Act 2009 (WA), section 262).

CCUs may only be redeemed out of profits or the proceeds of a fresh issue of shares or an approved issue of CCUs (Co-operatives Act 2009 (WA), section 264). The Act further allows for the conversion of CCUs held by an active member of the co-operative into shares of the co-operative, if there is such a provision in the terms of issue of the CCUs (Co-operatives Act 2009 (WA), section 266).

METHODOLOGY

National and international financial and legal experts in the co-operative sector were contacted to form a Delphi Panel of experts. The Delphi approach has been used as a research methodology with acceptable levels of validity across a wide range of social science disciplines for many years (Landeta 2006). The panel was asked to evaluate how CCUs can be used by co-ops to raise and retain capital. Panel members provided opinions on ownership rights, profit distribution, market facilitation and governance options in terms of their

attractiveness for investors, members and co-op managers. The Delphi panel surveys were delivered using online survey software. A combination of closed-ended and open-ended questions were used and, on the completion of two rounds, a satisfactory consensus as to the most likely combination of CCU characteristics was reached.

The second round of the Delphi panel survey included a conjoint experiment. Conjoint analysis is a way to elicit people's preferences that has been used extensively in marketing and health care research (Green, Krieger, and Wind 2001). As can be seen in Table 1, four attributes were included in the design that had two to four aspects (or levels). This led to a 16-option partial factorial design, each of which was a combination of levels from all attributes, similar enough that respondents would see them as close substitutes, but dissimilar enough that they could clearly determine a preference. The analysis of respondents' preferences revealed trade-offs between various levels of the four key attributes, as well as allowing an assessment of the most preferred combination.

Table 1. Conjoint design

ATTRIBUTE	LEVEL	OPERATIONALISATION
Ownership	Inside	<ul style="list-style-type: none"> The buyer must be either an active member of the Co-op or the Co-op itself (past members and their beneficiaries can retain their holdings)
	Outside	<ul style="list-style-type: none"> Subsequent to their issue can be traded between members and non-members alike
Governance	No Control	<ul style="list-style-type: none"> CCU holders have no representation on the board of the Co-op
	Some Control	<ul style="list-style-type: none"> CCU holders elect a predefined number of directors to the board of the Co-op (less than half)
Market Facilitation	Private	<ul style="list-style-type: none"> Sold privately at a price agreed by the seller and buyer
	Coop	<ul style="list-style-type: none"> Sold in a market operated by the Co-op at a value determined by an annual sworn valuation
	Third Party	<ul style="list-style-type: none"> Sold on a secondary market operated by a third party
Profit Distribution	100	<ul style="list-style-type: none"> 100% of new venture profits distributed annually as dividend
	50	<ul style="list-style-type: none"> 50% of new venture profits distributed annually as dividend
	Bonus	<ul style="list-style-type: none"> Fixed dividend referable to market rates plus bonus dividend at the discretion of the board
	Discretion	<ul style="list-style-type: none"> Variable dividend as determined annually by the board

FINDINGS

A key finding from the study was that, if structured as a debt instrument, a CCU was not likely to offer much that was not available to co-ops through existing subordinated debt instruments. CCUs have potential as equity instruments that de-couple co-op funding and ownership from control, the latter remaining vested with active members.

Purpose, ownership rights and profit distribution

The appropriate CCU structure was found to be highly dependent on the purpose the issue was intended to serve. Three distinct purposes were identified:

1. To reward patronage and retain capital in the co-op;
2. To raise capital for investment within the co-op; or
3. To raise capital for investment in a new venture (an investment project or a subsidiary entity that is set up as a corporation).

The first purpose is fundamentally different to the other two, as CCUs in that instance will be rewarded to members in proportion to patronage. Such CCUs can be a mechanism for rewarding loyalty and allowing members to retain their capital in the coop on retirement without diluting control from active members (as CCUs can be held by non-members but do not attract voting rights). In the second and third cases, investors (who can be members only and/or non-members) will need to be presented by an attractive proposition to invest their funds in the form of CCUs. Likely combinations of ownership rights and profit distribution options dependent on CCU purpose can be seen in Figure 1.

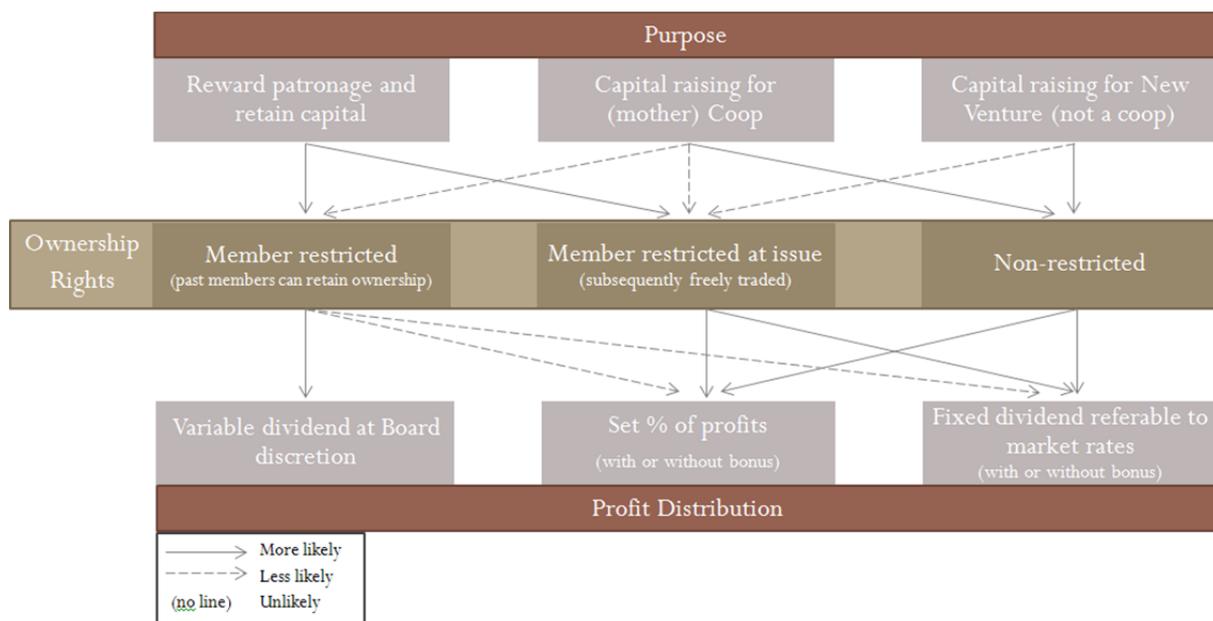


Figure 1. CCU Purpose, Ownership rights and Profit Distribution

The use of a fixed dividend referable to market rates when trying to attract external (non-member) investors (Figure 1) can minimise the governance challenges associated with a variable return. Such a structure provides certainty to investors and attracts low-risk investments, in which case CCU attractiveness will be highly dependent on the agreed rate of return. By attaching a fixed dividend/interest referable to market rates, a CCU is effectively transformed into a debt-like instrument.

Paying a set percentage of profits can be an effective distribution structure when the CCU is linked to an investment project or entity. CCU attractiveness will depend on the business plan and forecasted profits of the investment project or entity. If CCU return is linked to the profit

of the co-op entity, attractiveness will depend on the historical focus of the co-op on the generation of profit or providing member rebates and rewards. In this case the question of investor influence over co-op governance emerges as an important determinant of the attractiveness of the investment proposition.

Governance

The issue of investor control concerned our panel members, who were unable to reach a consensus on this issue. The panel was consulted on whether CCU holders should have representation on the board of the co-op by way of being entitled to nominate up to Y independent directors (where Y is less than half). Some panel members expressed the view that CCU holders should not have (additional)² representation on the board of the co-op, as the directors cannot represent a class of investors and must adhere to their fundamental directorship responsibility of making decisions with the interests of the corporation of which they are a director as their primary concern. According to this view, the establishment of representative arrangements will likely place directors in a difficult position and could give the CCU investor a false sense of security. Other panel members were of the view that such a representation arrangement should be considered as it is likely to increase the attractiveness of the instrument for investors.

Most preferable combination of CCU terms

The conjoint model suggested respondents had a preference for CCUs that permitted transferability between members and non-members and that could be traded on secondary financial markets by third parties. The most desirable form of returns to CCU holders was that of fixed dividends with reference to market rates, plus bonuses at the discretion of the Board or 100% of new venture profits distributed annually as dividends. As noted already, representation on the Board was a controversial issue among respondents.

DISCUSSION AND CONCLUSIONS

Although a CCU can be structured as a conventional debt instrument, the new term would only introduce uncertainty for investors and it is unlikely to be used in this way. A CCU issue could be an attractive equity instrument for a traditional co-op and, as such, it could:

1. De-couple co-op ownership from control.
2. Attract external equity, additional member investment or reward patronage while maintaining democratic member control.
3. Allow for members to retain equity upon retirement.

However, the issue of voting rights and Board membership makes the CCU a special class of share capital, in which dividends (fixed and/or variable) become the key source of investor attraction. While stock market investors rarely execute their voting rights, co-op investors

² “additional” refers to member-investors that already have a voting right as members and under this term they would be acquiring additional representation on the board as CCU holders

will be wary of a co-op's tendency to reward patronage versus report profits and will, thus, have strong preference for a fixed return, debt like instrument. The real challenge lies in developing a CCU structure that pays a variable dividend at board discretion (which would be preferable from the co-ops perspective), while remaining an attractive investor proposition.

A variable dividend CCU structure

The following CCU structure is a way to maximise attractiveness from the perspective of the co-op and the investor.

- CCUs should be equity instruments that attract no voting rights and can be owned by member-patrons and non-members alike.
- The dividend paid on CCUs and member-patron shares is the same and is variable upon board discretion.
- Member-patrons need to retain a minimum proportion of CCU holding against their member-patron shares until retirement (e.g. 1000 CCUs per 1 member share).
- CCUs are traded on secondary financial markets operated by third parties.
- On liquidation CCUs to rank ahead of share capital.

By linking CCU and member share dividend, a co-op ensures CCU investors' and member-patrons' interests are integrated. This is further strengthened by the requirement for member-patrons to retain a proportional holding of CCUs to their member shares, ensuring members will have a continued, strong interest in the value of CCUs. This structure cannot eliminate investor concern that co-op members may have a preference to extract benefit through patronage rather than through share distribution, which can place less emphasis on co-op profitability and share distribution. If, however, the proportional holding of CCUs and member shares is such that members are required to have a significant capital investment in their co-op, this will ensure members share a strong investor interest in their co-op in addition to their patron interest.

CCU potential beyond the Australian context

In countries in which co-op ownership is not restricted to active members, the CCU concept is still valid and could take the form of a special class of shares that does not attract voting rights. All of the combinations suggested in Figure 1 are applicable in an international context. However, their appropriateness will depend on the nature of co-op business model. A CCU-like equity structure would be more applicable to co-ops that have not introduced non-member investors with voting rights.

A multiple class equity structure with active member shares and non-member shares can be implemented in the same way as proposed in the previous section; linking the dividend of the two share classes, while requiring active members to have a minimum holding of non-member shares. This structure aims to compensate for non-member investors' lack of direct control by streamlining active member interests with non-member investor interests.

A traditional co-op can make a gradual transition to this hybrid co-op form by initially rewarding this special class shares to their active members as part of their rebate structure

until a critical mass of allocated shares is reached to allow for trading amongst members and non-member investors. From that point onwards the co-op can issue non-member shares to raise capital from within and outside the member base.

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