Mid America Cooperative Council

November 10, 2016

Co-op Equity Management

Proud Member of the
Farm Credit System

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CoBank's Equity Plan

- Target Equity = 8% of clients average loan balance's over 10 year period.
- Patronage Payments = 1% of clients average loan balance during the year.
- Patronage Payment = 75% cash & 25% equity
  - This has been as low as 50% cash & 50% equity when CoBank was first formed.
- CoBank's target return on equity is 20%.

CoBank's View of our Clients Equity

Regional Agribusiness –

Local Leverage %

((Long Term Debt + Capital Lease Obligations + Subordinated Debt) / (Total Net Worth – Investment in CoBank – Investment in Other Coops – Investment in Subsidiaries)) * 100

- Essentially we are measuring total debt to core net worth.

- This shows how a borrowers finances their organization (% of Debt vs. % of Equity).

- 80% is considered minimally adequate by CoBank Credit Division
- 50% or less is my personal recommendation
- 35% or less is considered strong by CoBank Credit Division

CoBank’s View of our Clients Equity

Utility Lending Division -

Equity / Total Assets (Total Net Worth / Total Assets)

- Measures % of assets financed by equity vs. debt

Generation & Transmission Coops

- 2.5% is considered minimally adequate by CoBank Credit Division
- 6.5% or more is considered adequate by CoBank Credit Division
- 10.5% or more is considered strong by CoBank Credit Division

Electrical Distribution Cooperatives

- 12.5% is considered minimally adequate by CoBank Credit Division
- 20% or more is considered adequate by CoBank Credit Division
- 27.5% or more is considered strong by CoBank Credit Division

Allocated vs. Unallocated vs. Retained Earnings

Allocated Equity

- Cooperative receives the benefit of reduced tax liability.
  - Member pays the taxes but also the expectation of future payout of the equity.
  - Expectation that active users of the cooperative should hold the bulk of the equity.
  - If equity is not actively revolved it losses it’s value for the member.

Allocated vs. Unallocated vs. Retained Earnings

Unallocated Equity

- Cooperative pay’s the taxes upfront on the equity but receive tax refund if equity is distributed to the membership.
  - No expectation of future payout of the equity.
  - Flexibility to utilize the equity to grow the cooperative or retire equity back to the shareholders.
  - Some view this as a violation of cooperative principles.
    - “Ownership in relationship to utilization”

Retained Earnings

- Cooperative pays the taxes on the earnings.
- Used to grow cooperative, repay debt, or build balance sheet strength.
- Most patient source of equity for the cooperative with no expectation of disbursement.

Current Equity Levels vs Historical

Regional Agribusiness Averages (1170 Borrowers)

2011

- Total Net Worth = $32,926,371
- Debt to Net Worth = 1.52 : 1.00
- Local Equity = $27,730,449
- Local Leverage = 57.23%

2015

- Total Net Worth = $43,550,248
  - Average Net Worth increased $10.6MM
- Debt to Net Worth = 1.18 : 1.00
  - Average debt only increased by $410k
- Local Equity = $36,703,735
- Local Leverage = 52.58%

Analysis

- Borrower's took advantage of historically profitable years to significantly increase equity levels (and working capital).
- Allocated Earnings increased by $400k.
- Retained Earnings increased by $10.6MM.
- Preferred Stock decreased by $78k to $340k. (18% decrease)

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Risks of having too little equity

- More debt needed to finance operating needs.
- Higher risk profile from lenders.
  - Leads to higher interest rates.
- Higher interest expenses due to higher debt levels and higher rates.
- Ripe for hostile take over bids.
  - Member that has low amount of equity and/or no equity revolvemer could be tempted with sweet cash offer.
- Other risks?

Risks of having too much equity

- Member resentment.
- Low ROE.
- Hurting members profitability / growth potential?
- Other risks?

Thoughts on Equity

- How closely to do you look at ROE?

- Does your cooperative have a target ROE?

- One potential way to increase ROE is via leverage – would you consider taking out a loan to retiring equity and therefore increase ROE?

Thanks!

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