CPA Info #96 August 2004

Thoughts for Farmers Considering Membership/Investment in a Processing Cooperative

Rob Holland
Center for Profitable Agriculture
A Proud Partnership of UT Extension and the Tennessee Farm Bureau Federation

Middle Tennessee Experiment Station
P.O. Box 1819
Spring Hill, Tennessee 37174
931-486-2777
rwholland@utk.edu
http://cpa.utk.edu

This educational fact sheet has been developed as part of the Center for Profitable Agriculture's priority program titled "Cooperative Development Emphasis" during 2004. The project was funded in part by the Tennessee Department of Agriculture, the Tennessee Farm Bureau Federation, the Kentucky Center for Cooperative Development and UT Extension.

Table of Contents

Introduction

The "Tennessee Processing Cooperative Law" provides new opportunities for Tennessee farmers. These include new market opportunities for farm commodities and the opportunity for investment in a value-added processing business. The new law is intended to enhance business formations that will add-value to farm commodities and agricultural resources in Tennessee.

Basically, the new law provides for the establishment of a new business structure specifically for businesses that will add value by processing or marketing agricultural commodities. The new business structure can be described as a hybrid between a traditional cooperative and a Limited Liability Company (LLC).

A business organized under the new law can raise start-up capital from farmers (patrons) and investors (non-patrons) with both having membership rights in the cooperative. Patron members are those who "conduct business" with the cooperative by delivering a predefined quantity of raw input commodities to the business for processing. Nonpatron members do not have an obligation to deliver commodities for processing. So, a patron member of a "processing cooperative" has potential benefits from selling commodities to the business plus possible financial returns on investment in the business from the value of the processed product. Non-patron members seek to benefit from their capital investment by dividends and appreciated stock value.

The initial start-up costs for many, large-volume agriculture processing businesses often exceed the investment capacity for even a large number of cooperating farmers. The new law provides a legal business structure that allows farmers to cooperate with each other to obtain the required quantities of agricultural commodities for a processing operation and to supplement their capital investment with capital investment from outside investors. Because the start-up costs associated with many large value-added processing businesses is often very high, under the new law, a "processing cooperative" can raise start-up capital from both farmer and non-farmer members.

It is important for farmers who are considering membership/investment in a new processing cooperative to understand that their involvement will be from three different perspectives: member, capital investor and obligated supplier of commodities for processing. Patron membership brings with it various responsibilities and opportunities for leadership, direction and decision making in the business. Patron members also provide a cash investment in the start-up capital of the business. Additionally, patron members become commodity investors because they must commit a specified amount of their annual commodity production as raw input for processing by the business.

Chicken or the Egg?

Successful processing cooperatives in Tennessee will likely result from business ideas that are well formulated, planned, organized and lead. Because a processing cooperative has similar organizational characteristics to traditional farmer cooperatives, strong farmer leadership in the business is essential. In fact, some processing cooperatives may only achieve success if they are farmer driven from the beginning. However, since a processing cooperative can have both patron an non-patron investors, some processing cooperatives may be initiated by investor leadership. Because the processing cooperative law provides majority control to the patron membership and because patron members have both a cash investment in the start-up costs and an obligation to deliver a specified amount of raw commodity for processing, strong patron-member leadership is suggested.

Likely Patron Members

The results of some interesting research by the North Dakota State University and Kansas State University helps identify some common characteristics of farmers more likely to become members/investors of new cooperative ventures.

The North Dakota study found that members of new generation cooperatives were younger than non-members and members tended to have higher levels of education. Members also farmed more acres, had more net income from farming and had a stronger financial condition (debt-to-asset ratio) than non-members. Members felt more strongly than non-members that their role in the agriculture industry extends beyond production agriculture and into the food processing and distribution businesses.

The Kansas State study looked into the factors underlying a producer's decision to invest a portion of their production in a closed-membership food processing cooperative. The study found that producers require knowledge of the risks and potential returns for the commodity that they may consider investing in a processing cooperative. In addition, the relative perishability of the commodity and the end food product has a significant impact on the amount of production that an individual producer will invest in the cooperative. That is, as the perishability of the commodity or end product increase, the portion of the farm-produced commodity committed to the business decreases.

Organizing Steps

There are a variety of phases and organizational steps that most cooperative processing ventures will encounter. Despite the many developmental and implementation steps and phases that successful cooperative processing ventures may take, two key components must be present early: a good idea and appropriate leadership.

An idea that blossoms into a successful business often addresses an unmet need, provides a competitive advantage and addresses an economic need that might be fulfilled by a cooperative effort. Successful business ventures also are well-rooted in strong leadership. Leadership for successful agricultural cooperatives should demonstrate a confident balance of expertise, vision, dedication and commitment to the project.

While the following is not a complete or comprehensive description of every phase that will be encountered in the development of a new cooperative processing venture, the following listing should help provide a guide to the development of a successful effort. In many cases, the development of a cooperative processing business can be categorized by the following phases:

- I. Exploration and assessment
- II. Feasibility analysis
- III. Planning
- IV. Implementation
- V. Operation

Some of the steps that organizing leaders will address include:

1. Organize and develop the business idea and the leadership team
2. Conduct exploratory meetings with potential member-users
3. Survey prospective members to determine potential and capability of delivery.
4. Discuss survey results at a general meeting and decide whether to proceed.
5. Identify a steering committee
6. Open an escrow account
7. Form corporate entity
8. Raise seed capital
9. Conduct a needs and costs analysis
10. Conduct feasibility study
11. Develop business plan
12. Contract for legal and accounting services
13. Prepare articles of incorporation, charter, by laws and legal papers for business organization
14. Elect board of directors
15. Organize and conduct a membership drive
16. Conduct an equity drive
17. Hire a manager
18. Acquire facilities
19. Begin operations

Collecting Initial Operating Funds

The primary organizers behind a processing cooperative venture often seek funds to assist in the initial consideration and organizational phases of a project. Sometimes this initial money will be used to help finance technical assistance, feasibility analysis and organizational functions. This type of money is often referred to as "at risk" funds and should be considered more as a contribution or a donation than an investment. Initial funds are normally used for operational expenses rather than investment in real property. Contributions to the initial pool of money may or may not be tied to any stock investment. Any unused initial money may or may not be returned to the contributors if the project is discontinued.

The need for initial operating money during the analysis and evaluation phases is practically unavoidable and project organizers are likely to have to solicit these types of funds. Soliciting and contributing initial operating money can be a difficult task for some organizers. Potential contributors should be well informed on how the funds will be deposited, how they will be managed and how/why they will used. Potential contributors should also be well informed whether initial operating money will relate in some way to stock allocations. Potential contributors must fully understand how the initial operating money will be used, and they should understand that these funds may not be returned.

The solicitation of initial operating money may be a very formal process involving escrow accounts and detailed contract-like procedures that describe its need, use and handling. However, the seeking of initial operating money is often a very informal process concentrating on verbal communications and possibly the use of personal bank accounts. Either of these scenarios can work as long as all individuals involved are informed and comfortable. However, the process for seeking and contributing initial operating money is normally handled differently from the equity drive.

Equity Drive[1]

1. The organizing committee should work with legal and accounting advisors to prepare a prospectus prior to receiving any investment funds or discussing investment opportunities. It is important to establish and follow strict guidelines for the format of "informational meetings" which are conducted prior to the distribution of the prospectus. There are state and federal restrictions on making public comments about a project before the prospectus is in the hands of the potential investor.

2. Equity investment in a cooperative may be exempt from both state and federal security exchange regulations. It is important to apply for exemption prior to the equity drive.

3. The purpose of the disclosure statement is to inform potential investors about the potential risks, rewards, legal terms and conditions of membership and delivery right interest and other information material to the decision to participate. Depending on the type of security exchange exemption or registration used, a specific format for the

[1] The "Equity Drive" section was provided by Dr. Philip Kenkel, Chair of the Bill Fitzwater Cooperative Center at Oklahoma State University, compiled from various sources.

disclosure material may be required. Regardless of the legal requirements, the value-added project should disclose all information that might be relevant to an investor's decision to participate. Well-written and comprehensive disclosure documents assist potential investors and help protect the entity, the directors, organizational committee and the manager from legal claims from disgruntled investors.

4. Avoid talking to potential investors until information is available to answer their questions. This will require information from the completed feasibility study and decisions on cooperative structure issues.

5. The business plan should always be considered a working document. Market prices, interest rates and other factors will fluctuate. In addition, not all elements of the business plan may be complete at the time of the equity drive. The organizers must be careful not to misrepresent the potential risks of the project or make definitive statements about issues that have not yet been decided.

6. Organizers should be particularly careful in making statements concerning the projected return on investment. ROI questions can best be addressed by discussing the range of returns identified in the feasibility study and sensitivity analysis and by discussing what factors will have the most critical impact on ROI.

7. The current wisdom is that the total time period from initial informational meetings to the close of the equity drive should be kept as short as possible. Many organizers believe that enthusiasm for a project erodes. However, the time frame often needs to include separate informational meetings for lenders, managers of existing cooperatives and other important audiences. Many producers will also need time to discuss the proposed equity investment with their lenders. The general rule of thumb is that only one out of every ten producers who attends an informational meeting will eventually invest. Successful equity drives often require multiple meetings in each location which may include both short informational meetings and more in-depth follow-up meetings.

8. Simplicity is important in a successful equity drive. Creating numerous classes of stock or specifying different alternatives depending on the number of shares of stock sold make sales more difficult.

9. Establishing low goals for the amount of equity raised generally becomes a self-fulfilling prophecy–it is generally more difficult to come back to investors for additional equity.

A Checklist for Potential Patron Members

People contribute and or invest in business ventures for different reasons and with different objectives in mind. The following questions should assist individuals considering patron membership in their evaluation of possible investment. Answers to these issues will vary and no correct pattern of responses is necessarily indicative of a decision to invest or not invest. However, consideration of these issues should assist potential investors in assessing their awareness, comfort and capabilities.

- ❑ Do you have a good understanding of the business venture proposed?
- ❑ Are the objectives of the proposed business consistent with the goals and mission of your farm operation?
- ❑ Does the business venture have valuable and respected farmer leadership involved?
- ❑ What advantages/disadvantages do the non-patron members provide?
- ❑ Has the project been well studied and planned?
- ❑ Do you have a good understanding of why the requested funds are needed and how the requested funds will be used?
- ❑ Will the requested funds be used for initial operating purposes or do they represent an equity investment?
- ❑ If the requested funds are for operating purposes, does the contribution create some type of priority or advantage for later capital investment?
- ❑ How will the requested funds be deposited?
- ❑ Who will have oversight and authority for the use of the requested funds?
- ❑ What will happen to the requested funds if the business idea is abandoned?
- ❑ Do the requested funds represent an equity investment or a start-up contribution?
- ❑ What are the potential returns from the invested funds?
- ❑ What are the potential returns from cooperative membership?
- ❑ What risks are the cooperative business exposed to?
- ❑ How will membership/investment in the cooperative influence your farm operation?
- ❑ How will cooperative membership impact your personal and business goals?

Summary

The “Tennessee Processing Cooperative” law creates a new business structure which combines some characteristics of traditional cooperatives with some characteristics of a limited liability company. This new business structure is for ventures that add value to agriculture commodities by processing or marketing them. A business formed under the law will follow traditional cooperative organization principles and will be exempt from state franchise and excise taxes, similar to traditional cooperatives, but will accommodate both patron and non-patron membership. Patron membership will include both capital investment and a pre-defined delivery commitment of commodities to the business for processing. Non-patron membership includes only capital investment. Membership and investment in a processing cooperative should be carefully considered and evaluated.

<u>Sources</u>

“A Guide To Value-added Cooperative Development.” William Patrie, Dakota Cooperative Development Center, North Dakota Association of Rural Electric and Telephone Cooperatives, September 2002.

“Developing New Generation Co-ops: Getting Started on the Path to Success.” Cindy Thyfault, University of Wisconsin Center for Cooperatives, Rural Cooperatives, July/August 1996, Vol. 63, No. 4.

“Factors Underlying Producer Investments in Processing Cooperatives.” Michael Boland, Jayson Lusk, David Barton, Department of Agricultural Economics, Kansas State University, August 2002.

“Five Questions to Ask Before Joining a New Processing Cooperative.” Frayne Olson, Quentin Burdick Center for Cooperatives, North Dakota State University, July 1996.

“Getting From Idea to Implementation” Ag Innovation Guide, A Publication of the Agriculture Business Development Division of the Missouri Department of Agriculture.

“How to Start a Cooperative” USDA Rural Business/Cooperative Service, Cooperative Information Report 7, Revised September 1996.

“New Generation Cooperatives – Who Invests?” Frayne Olson, Theron Kibbe and Gary Goreham, Quentin Burdick Center for Cooperatives, North Dakota State University, August 2002.

“Should I Join a New Processing Cooperative?” Frayne Olson, EB-67, Quentin Burdick Center for Cooperatives, North Dakota State University, July 1996.