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Revolving Fund May Provide Alternative for Nebraska Cooperatives

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Market Report	Yr Ago	4 Wks Ago	4/13/07
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight	$83.93	$98.68	$98.33
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb	132.11	126.02	127.05
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb	106.06	109.00	110.33
Choice Boxed Beef, 600-750 lb. Carcass	140.01	165.50	168.89
Western Corn Belt Base Hog Price Carcass, Negotiated	53.17	58.68	65.29
Feeder Pigs, National Direct 50 lbs, FOB	53.44	70.38	70.88
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean	59.07	67.08	66.98
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct	68.00	84.75	88.50
National Carcass Lamb Cutout, FOB	224.30	241.94	244.27
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu	3.98	4.43	4.61
Corn, No. 2, Yellow Omaha, bu	2.07	3.75	3.42
Soybeans, No. 1, Yellow Omaha, bu	5.34	7.12	6.78
Grain Sorghum, No. 2, Yellow Columbus, cwt	2.89	6.13	5.50
Oats, No. 2, Heavy Minneapolis, MN , bu	1.98	2.89	2.82
Hay			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton	130.00	*	135.00
Alfalfa, Large Rounds, Good Platte Valley, ton	65.00	*	92.50
Grass Hay, Large Rounds, Good Northeast Nebraska, ton	55.00	*	90.00

* No market.

Most Nebraska marketing and farm supply cooperatives use age-of-patron plans for managing the investments their members make in the organizations. Under an age-of-patron plan, equity allocated to an individual member from retained patronage refunds is held in the cooperative until that member reaches a particular age, often 65 years. At that point, all the member's equity is eligible for redemption.

Because many of the largest equity holders in these cooperatives are nearing the age at which their equity will become eligible for redemption, directors and managers anticipate that attempts to continue redeeming equity according to an age-of-patron plan will place their cooperatives under enormous financial pressure within the next few years. Consequently, cooperative decision makers are expressing renewed interest in alternative plans for managing member equity.

Figure 1 (on next page) represents the distribution of equity by member age for a representative Nebraska grain marketing and farm supply cooperative capitalized with $3.5 million of member equity. This figure demonstrates two important aspects of the financial situation facing many Nebraska cooperatives. First, a large proportion of the cooperative's equity is held by older members. Over $1.4 million, or about 40 percent, of the equity is allocated to members 55 years of age or older, suggesting that equity redemption will soon place a tremendous financial burden on the cooperative. Second, there is a considerable amount of variation in the equity held by older members. For example, members who are 60 years old hold over $174 thousand in equity capital while members who are 61 years old own only about a third as much. This suggests that if the cooperative attempts to adhere to an equity redemption schedule dictated by an age-of-patron plan, it will face widely fluctuating burdens from year to year, seriously complicating financial planning.

Many cooperatives that currently operate age-of-patron equity plans have considered adopting the revolving fund plan in an effort to make financial planning easier and to avoid the

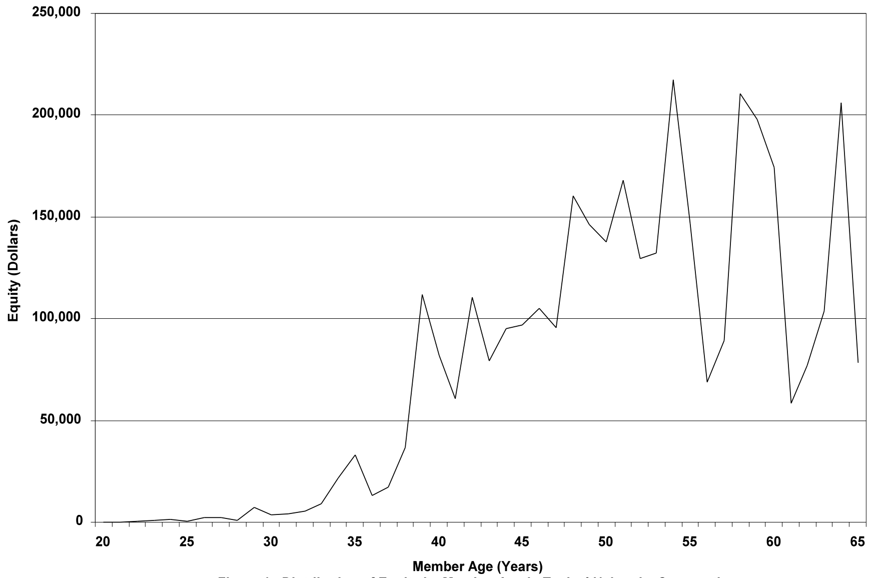

Figure 1. Distribution of Equity by Member Age in Typical Nebraska Cooperative

challenges presented by having to redeem very large amounts of member equity during the course of a few years. The revolving fund, or first-in/first-out, plan is the method of equity management used by most cooperatives in the United States that systematically plan for the accumulation and retirement of member equity. Under the revolving fund plan, a cooperative continues to retain a proportion of the patronage refunds it issues members each year. These retained patronage refunds are added to the revolving fund to provide equity capital and to be redeemed eventually in turn. The oldest equities are redeemed first, usually at the discretion of the board of directors and according to the financial needs of the cooperative.

Revolving funds offer younger farmers a greater incentive to conduct business with a cooperative and to invest in it because they normally can expect to begin receiving redeemed equity sooner than under an age-of-patron plan. In addition, research has shown that under a revolving fund plan, equity is usually maintained more in proportion to patronage. Thus those members who actively benefit from a cooperative are more likely to hold the greatest investments in it.

Cooperatives seeking to adopt a revolving fund plan may face opposition from older members who are in line to have their equity redeemed within the next few years under the existing age-of-patron plan. Consequently, a cooperative that chooses to convert to a revolving fund plan may need to conduct the conversion gradually during a transition period. For example, under a ten-year transition period, those members 55 years of age or older might continue to have equity accumulated and redeemed according to the age-of-patron plan. Both the existing and new equity of younger members would be placed in a revolving fund to be redeemed in the future on a first-in/first-out basis. Alternatively, the cooperative might choose to place any new equity of the older members in the revolving fund as well.

To analyze the effects that the length of the transition period and other variables might have on the performance of a revolving fund plan, we conducted a number of simulation experiments using the NebCAST computer software program developed by Darrell Mark, Jeffrey Royer, and Rik Smith of the University of Nebraska–Lincoln Department of Agricultural Economics. (For information about NebCAST, see "A New Tool for Analyzing Cooperative Equity Plans," *Cornhusker Economics,* April 19, 2006.)

According to our simulations, longer transition periods are associated with shorter revolving cycles in situations where older members hold a disproportionately large share of the cooperative's equity, such as the case represented by Figure 1. When equity is more evenly distributed across member age or younger members hold most of the equity, the length of the transition period usually does not have as important of an effect on the revolving cycle.

Other factors also are related to the length of the revolving cycle a cooperative can maintain. Our simulations demonstrate that practices such as paying a high proportion of patronage refunds in cash, diverting a large share of net margins to tax-paid unallocated reserves, or pursuing growth objectives not supportable by the rate of return are associated with longer revolving cycles. On the other hand, taking measures to improve the cooperative's rate of return can bring about more rapid revolvement of member equity.

For a revolving fund plan to work effectively, a cooperative must maintain a reasonably short revolving cycle. Otherwise, redemptions will not occur in a timely manner, equity will not be held in relationship to use of the cooperative, and retired members may find themselves holding substantial investments. To achieve a shorter revolving cycle, it may be necessary for a cooperative to reduce the patronage refunds it pays in cash to levels lower than its members are accustomed to receiving. The cooperative also may need to abandon strategies based on increasing unallocated reserves so it can focus on the effective accumulation and redemption of member equity.

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