

## **Innovative financing for entrepreneurial and market-oriented agricultural cooperatives**

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## Introduction

The environment of the cooperatives is currently undergoing a rapid change. Public policy as demonstrated in the reformed CAP, trade liberalisation under the GATT agreement, and the EU enlargement are to bring *more competition* and *less support* to commodity markets. At the same time, biotechnology, information technology, and the rising power of retail chains and MNEs push for more *co-ordination in the agri-food* chain in order to deliver value to customers. The *differentiation of demand* brings new requirements as food consumption is increasingly related to non-consumption utilities like *social referencing, health, environmental friendliness and regional origin*. The combined effect is the emerging need for *entrepreneurial, adaptive and market-oriented structures* for every type of institution.

One could, then, well ask “are the coops ready to compete in the new competitive environment?” and if not “what are their organisational, financial arrangements that impair their competitiveness and efficiency and eventually, legitimacy within the society at large?”. Which, then, direction should re-engineering with respect to financing/ownership, if and when necessary, follow and what is the scope and relevance of collective action today?

## Financing in Traditional Cooperative

Traditionally the members are the exclusive financiers of the cooperative as a way of maintaining patron ownership and control. Cooperatives in the past they resorted to participation shares, retained patronage refunds, and per-unit capital retains. Through their *participation certificates* patrons buy their membership and gain access to the assets of the cooperative.

Another source is in the form of retained *patronage refunds*: net income is kept in proportion to the transaction done via the cooperative. Cooperatives also resort to *per-unit capital retains* which are related to the value or number of units processed.

These unique financial tools reflect the unique ownership structure of cooperatives as conceived in a era where the needs in investments were limited. As a result, dividends on capital stocks are low while the equity is forbidden to be appreciated to reflect changes in the value of cooperative.

## Developments in Financing cooperatives

Cooperatives have been introducing innovative financial instruments in an effort to cope with increasing needs in investments. The reason is that the existing financial regulations have often been proven to be insufficient when cooperatives needed to respond to market opportunities. Table 1 summarises novel financial tools put into effect by cooperatives in the EU countries.

### *Subsidiaries and Strategic alliances*

- The last twenty years many cooperatives have operated subsidiaries as a means to acquire international focus, to develop innovating products and to become more nimble in the marketplace. The organisational advantages of subsidiaries for an agricultural co-operative are linked to: better risk management of the holding cooperative enterprise, easiness of sourcing raw material from competitive markets, and market-oriented product development which results in competitive strength in the marketplace over multinational and retailers. For example, Danish cooperatives have used subsidiaries with the intent to get better clout on foreign markets e.g. MD Food in British market.
- The last years many companies relate to one other in the multitude of roles of competitor, customer, collaborator. Collaboration takes the form of strategic alliances either to develop a new product, or market each other products in more markets. For instance, Arla and MD Foods have entered into collaboration in the vending machine market.

### *Bonds*

- Many cooperatives have experimented with non-member equity capital issuing bonds. Bonds do not bear control right e.g. voting but in return they have fixed yield usually more attractive than

governments bonds. Campina Melkunie issued bonds to both members and external investors in order to acquire its Belgian subsidiary Comelco.

**Proportional tradable shares**

- Many cooperatives are willing to keep the members involved with investing in the cooperative. As a result, they have established a secondary market for membership shares allowing for trade of shares among members. Every share carries a delivery right of a number of units of raw material. Members can trade their shares at conditions that reflect the value of market performance of the cooperative enterprise. Avebe, the potato starch cooperative has introduced proportional tradable shares, as new generation cooperatives have pioneered in USA.

**External participation shares**

- Non-member equity capital is used in many countries. Spain and some of its provinces has coined the concepts of supporting members, collaborating members and associates. Italian cooperatives may have financial backing members. In France, there is a special legal form for cooperatives (SICA) with up to 50% of the equity in the hands of non-members. In the ordinary co-operative form in France, the cooperatives can invite external financiers to buy participation shares, investment certificates and bonds.

**Public quoted shares**

- Some cooperatives have opted for becoming public listed companies so as to broaden their financial basis. Stock quoted cooperatives, mainly in Ireland, have released their control rights by permitting majority of their equity to be in the hands of non-members.

**Table 1: Equity formation methods for the EU Cooperatives**

Country	Memberships hares/retained profits	Bonds /member shares	External participation shares	Proportional tradable shares	Joint-stock (external equity)	Public listed shares
Belgium	+	+		+		
Denmark	+				+	
Germany	+					
Greece	+				+	
Spain	+	+	+			
France	+	+	+			
Ireland	+				+	+
Italy	+		+		+	
Luxembourg	+	+				
Netherlands	+	+		+	+	one
Austria	+	+				one
Portugal	+	+	+			
Finland	+		+		+	
Sweden	+				+	
United Kingdom	+	+				+

**Ownership rights structure for entrepreneurial cooperatives.**

Though different financial tools have been put into effect we are able to discern some similar dimensions in re-engineering process that revolves around ownership rights. The idea that common property exists is hardly novel or peculiar to cooperatives. Both cooperatives, partnerships and IOFs, and many other legal forms of economic organisations are based on common property. Yet, the public domain of common property, that is to say, incomplete determination of attributes of common property can justify a distinction among cooperatives and IOFs. In fact, the public nature of the assets

in cooperatives can cause a series of problems, according to agency theory, in conjunction with the following factors:

### ***Size of the membership and free-riding***

As the number of individuals that share the common assets increases, the return on assets is to decline for two reasons as Olson has shown. Firstly, the larger the group, the smaller the reward for any individual that could receive from supplying the good on his own. Secondly, the larger the group, the greater the organisational costs for providing the collective good. Only small groups can provide collective goods as face-to-face communication can motivate the individuals. Contrariwise, large groups can't notice let alone exclude free riders from consuming the collective good.

Cooperatives face this problem due to increase, internationalisation, and diversification of membership the last thirty years. Cooperatives usually adopt open membership which simply means that a new member does not have to contribute to the value of a cooperative assets, and he can have equal rights to the decision process. Thus, the property of a cooperative becomes public good and the free rider behaviour arises. This is identified as a *common property problem*.

### ***The horizon of residual claims***

Another troublesome consequence of the collective property of cooperatives is that are used to be tied-equity firms in which residual claims on the enterprise's income stream are contractually tied not to the capital that members have invested but to their volumes of transactions with the firm. Thus benefits from investments can be captured only over the time of membership/use and not over the productive life of the assets giving rise to the *horizon problem*.

### ***The tradability of residual claims***

When the size of membership grows the risk behaviour of patrons varies and aggregate synthesis of risks is aggravated due to lack of secondary market for shares. Patrons can not acquire a portfolio of investments which reflects their risk preferences due to lack of tradability of ownership rights: thus the *portfolio problem* arises. The result of such a restriction is risk aversion of members towards investments.

### ***Output variation of collective assets and structure of residual claims***

According to property rights theory, if a party can influence the return on an asset, the greater the proportion of the residual claims this party will be assigned. The following example will clarify the point. Say, that one production process uses two inputs: farm output and processing services. If the farm output is highly unpredictable, this was the case in the past, and the quality of processing service is stable the most efficient method is to make the owners of the farm output the residual claimants.

In this respect cooperatives are well suited to conditions of unpredictability of farm output. Quality improvements in farm produce through a more rigorous grading system has been attributed to cooperatives because the weather caprices and the biological nature have rendered impossible to pre-empt the quality and quantity. However, the last decades advances in agricultural knowledge, techniques and technology have brought in a degree of certainty in the farm output. In addition, consumers are willing to buy tailor-made food with functional features explaining why processors surpass spot markets to co-ordinated direct chains.

The most profound implication of these developments is that not farmers but input suppliers or processors are to be the residual claimants since farmers are not in a position to influence the quality of farm produce. If farmers, hence, are willing to continue playing a role in the food chain, they should be able to invest on subsequent stages of the food chain. As a matter of fact, the scope for cooperative action is not at the commodity segment but closer to the end consumer.

### ***The decision attributes of property***

One of the fundamental rights that a owner carries upon the property is the right to decide on its use. Yet, what we evidence in the world of organisations is a sharp separation of ownership from decision making. The residual claimants of corporations, shareholders, receive the proportions of organisational income after deducting fixed claim contracts e.g. labour as a reward to their capital resources provide. Yet, the use of their property is controlled by a handful of professional managers. The link between ownership and decision control is of vital importance to collectively owned

organisations such as cooperatives. Separation of residual risk-bearing from management in corporations has led to refinement of the decision process: *decision management* (initiation and implementation) is exercised by the management and *decision control* (ratification and monitoring) by the residual claimants, that is, the shareholders. But then the question is how owners secure efficient and profitable use of their property: stock market provides the signals for evaluating management performance functioning as a control mechanism on behalf of shareholders.

In contrast with IOFs, decision rights are more complex in cooperatives making necessary members' interference. The decision control can not be exercised since shares are not tradable. Thus, members' involvement with cooperative decision control is necessary and it is demonstrated by restricting membership on the cooperative board to farmers-members only. The redemption of residual claims, the prices of raw material relative to competitors, and the decision to dissolve a cooperative can exercise a control function although they can only partially approximate the stock market. Decision management tasks are also ill-performed. As we know appropriate reward system preconditions acquisition of skilful management. However, cooperatives are not allowed to use share ownership or share options to reward successful management. Overall, both decision management and decision control functions in cooperative organisations are underperformed giving rise to the so-called *decision problem*.

### **Stimulating entrepreneurship in the cooperatives**

What compels the above mentioned adoption of new financial tools, is the need and willingness to cope with the new conditions prevailing in agribusiness. As a matter of fact, the developments in the cooperatives demonstrate that a spirit of entrepreneurialism pervades many of them. How can cooperatives, then, become more entrepreneurial?

#### ***Setting a clear objective***

While in IOFs, profit is the clear objective making easy to design the right incentives let alone to evaluate management performance, cooperative decision making has been plagued by confusion on the nature of their objective. Members have been concerned with *price of the raw material*. Management usually pursues *expansion* or optimisation of *net income* running the cooperative as an independent profit center. As a matter of fact both objectives are irrelevant as we already know from the 1940s. Maximising the *patron' welfare* is the only optimal solution: joint maximisation of benefits of members both as investors and patrons. Members should be provided with signals in order to evaluate their cooperative on this dual relationship. In addition measuring management performance accordingly and tying their reward to this objective can relieve cooperatives from the decision problem.

#### ***From Equal to Equitable***

For many years cooperatives have been associated with equal pricing, equal voting and so forth. As cooperative membership becomes diversified, cooperatives have to move from equal to equitable treatment. Pricing based on the volumes of transactions reflect accurately the costs as occur since the marginal cost varies according to the size of patronage. Cross-subsidies, in a systematic pattern, between various groups of members can endanger the cohesion of the cooperative. In addition, capital provision of members should be tied to their patronage as well. It is of vital importance to provide members with incentives to invest by establishing a secondary market for equity capital.

Equitable treatment recognises the different needs and contribution of various groups of patrons providing them incentives to remain within the cooperative. Other wise the cooperative can not keep its membership loyal and maybe some groups of patrons defect to form a new cooperative. Such an outcome can not be of value to farmers because organisational costs increase, and hence, relinquishing their operations to private firms will be inevitable. A stable and efficient solution, as the game theory has demonstrated, would be to organise cooperatives along homogeneous segments on the basis of location, product category or investments profiles to satisfy special preferences and needs, yet under common management.

### ***Flexible/market-oriented structures***

Cooperatives organised in the federated system suffer from certain drawbacks when they should take entrepreneurial decisions. Local cooperatives can make difficult changes to be implemented resulting in rigid decision making. Competition among local cooperatives-members of the federated cooperative is counterproductive impairing co-ordination of processing or marketing functions. These problems have rendered federated structures inappropriate to co-ordinate several stages of the agri-food chain due to swollen transaction costs.

This is the reason why many cooperatives have pursued cooperation via joint ventures whose advantage is clear market scope, flexible and skilful management, and better access to equity capital. Beneficial, though, in certain circumstances, this solution might be, inclination to confine co-ordination among cooperatives on ideological grounds can be detrimental to the interests of patrons. For instance, collaboration of cooperatives on strategic research is beneficial as risk reduction and cost sharing are achieved. In contrast, when penetration into foreign market is at stake a strategic alliance between an IOF and a cooperative may be preferable. Another structure with certain entrepreneurial advantages is forming ventures between the cooperative itself and those members that are willing to exploit market opportunities and assume the necessary risks. All in all, the importance of network relationships lies in the ability to reap benefits associated with responsive, market-oriented behaviour and developing new core competences.

### **Conclusions**

Overall, the most prominent challenge is being a cooperative. The pace of change in agribusiness has accelerated making change for cooperatives inevitable. Entrepreneurship, thus, is compelling raising serious questions on the suitability of existing structures. Many would doubt if cooperatives are of relevance today, while others will prefer to stick to tradition in order to defend the importance of cooperatives. The problem that underlies both these conflicting views is exactly the same: the established orthodoxy that prevails when we conceive, and explain cooperatives. Nothing could be far from truth than to define cooperatives based on the criteria, needs, and context that brought in the specific structures years ago. The cooperatives exist as a means to deliver on the mutual benefit of a group of persons that share individual though common purposes. If, a century ago, the scope of collective action was building countervailing power at the commodity level, nowadays, differentiated demand, and technological change call for a co-ordinated action of the food chain. If family farms are to continue playing a role in agribusiness they should be rewarded in return for the capital provided, and the risks assumed. Change is not a threat to the existence of cooperatives but an opportunity to demonstrate again the relevance, benefit and universal value of collective action and cooperation among individuals.

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