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Membership is Ownership: The Cooperative Advantage

BY MARILYN SCHOLL

Interest in food cooperatives is growing, due both to increased interest in local, natural, and organic foods and to increased awareness of our economic vulnerability. More and more communities want the stability and accountability that a cooperative can offer.

Cooperative ownership is an economic model that can create great benefits for our communities and member-owners. The cooperative model is powerful if we focus proper attention on the owner side of that compound word, “member-owners.”

Typically, members pay fees or dues and get something, such as purchase discounts, in exchange. Owners invest and benefit if the business prospers. Cooperatives must create economic linkages with their member-owners by undertaking activities that make clear the close connection between the prosperity of the co-op and the prosperity of the member.

For cooperatives, owner equity and patronage refunds are tried and true tools that create and maintain a mutually beneficial relationship between the cooperative and its owners.

Owner equity fundamentals

Cooperative businesses require capital, and they generate capital in part through the share investments of member-owners. Debt and earnings are the other primary sources of capital.

A member share program has two essential goals: Member shares provide the co-op with an adequate capital base, and they create a sense of ownership. The co-op’s purpose is to meet member needs, and members need to understand that fulfilling that purpose takes capital.

Members own and invest in their cooperative because they trust that doing so is in their best interest. Because our culture does not have many examples of democratic ownership, member share programs must include adequate education so that owners understand how co-op ownership works.

Advantages and disadvantages: All types of capital have advantages and disadvantages, and member shares are no exception. Member shares can be limiting and slow to accumulate, especially for co-ops that are looking to expand. In a few states, however, laws allow co-op investment options that help overcome this disadvantage in capital formation.

In meeting the co-op’s needs, member shares have the advantage of being a low-cost way to build capital, since the co-op doesn’t typically pay interest on member shares as it does on debt capital. And member investments are more dependable and less risky than relying on earnings as the primary source of capital.

Cooperatives demonstrate the advantage of being community-based businesses, where a relatively small amount of investment from a large number of people can create a sizable base of funds from which to leverage larger amounts of capital. The share investments demonstrate member-owner commitment to banks and other lenders.

Finally, member share investments are also advantageous because shares are not considered taxable income for the co-op.

Equity share investments, unlike fees or dues, are refundable if the member no longer wants to use the cooperative. If a member leaves, the co-op repurchases the share within pre-established limits and restrictions that protect the co-op. It also is important to have a plan for dealing with abandoned equity, so that it doesn't have to be turned over to the state due to escheatment laws.

Determining share amount: In determining the amount of the share investment, co-op leaders should first consider the co-op's long-term capital needs. Then, determine how much of that capital should come from member equity, and divide by the potential number of members. Reassess the co-op's capital needs and member equity investment amounts as needed, and do so at least every five years.

Some co-ops implement an equity plan that requires an annual investment from each member. In this way, the capital base grows year by year and member by member. Whether your co-op uses a fixed fair share or requires an annual investment, note that determining the equity requirement does not begin with the question of what we assume the member-owners can afford. Affordability can be addressed by offering payment options that allow members to meet the investment requirement through smaller payments over a longer time period.

The co-op should offer a single class of membership with the same investment requirement and the same rights and benefits for each member. For co-ops that use patronage refunds, member courtesy cards can be issued to other people in the same household so that those purchases can be included in the patronage refund calculation. Multiple tiers and classes of membership can complicate communication and lead to perceptions of unfairness.

Annual fees or dues rather than share investments have some important disadvantages. First, fees and dues do not provide true ownership; you don't own Sam's Club or Costco just because you are a member. Second, fees and dues are taxable income for the business. Third, fees and dues are not refundable to the member. Administrative fees, if any, should be minimal, keeping the focus on equity and ownership.

Best words, best practices: Careless language can interfere with member-owners understanding the distinct advantages of cooperative ownership. Whatever words you use for owners and owner investment, choose and use your terms carefully and consistently. Communicate the true meaning of ownership with terms such as invest, investment, your share, refundable, and equity. Avoid inaccurate and potentially misleading terms such as cost, fee, pay, lifetime, one-time payment, and total. Member equity is not a fee, and it will likely change over time as the capital needs of the co-op change.

We carefully tell the story of ownership and cooperation so our members will understand and will be more likely to become active participants in that story.

Benefits fundamentals

Equity is one side of the ownership coin, and member benefits are the other side. The owners provide tangible support for the business with their equity investments, and in return the cooperative provides benefits to member-owners. The most important benefit for the member is the existence of the co-op itself. People invest in a co-op because they want to use its services. In addition, members receive benefit from being a part of the community, supporting the mission of the co-op as well as the community it serves.

Members should also receive some individual, tangible benefit because of their ownership investment in the cooperative. Any benefits program should be sustainable even if 100% of sales are to members – benefits should not be so costly to the cooperative that they become a disincentive to promoting membership. Member benefits also should be simple and easy to explain.

Discounts or patronage refunds? While both discounts and patronage refunds are tangible member benefits, and both generally benefit the owner in proportion to how much they spend, patronage refunds are a best practice for providing benefits, superior to a discount system in a number of important ways. First and foremost, patronage refunds are directly tied to the health and profitability of the business and to the essential dual role of the consumer-owner. The cooperative's board decides to allocate earnings to the members only after ensuring that the business has actually made money. And since the business is more likely to show a profit if the members use the business, patronage refunds support a mutually beneficial relationship.

With discounts, the "earnings" are given away whether or not there are any actual earnings, because the decision about how much discount is offered is made before the sales are known. If the discount amount was set too high, then the co-op can lose money; if set too low, members may not receive as much benefit as they should. Members often have a hard time seeing how much benefit they accumulate through discounts, and shelf prices are often artificially inflated to make the discounts affordable, thereby weakening the co-op's price image. Everyday discounts can be costly and unsustainable, while discount days are not equitable for all members.

Even with all these disadvantages, the worst thing about register discounts is that they create a sense of entitlement, which makes it harder to create a sense of ownership. Surcharges to non-members, on the other hand, can be a powerful incentive to join, but they are also very off-putting to first time customers or those who prefer not to join.

Too often discounts provide an unrealistic return on investment. If a member were to invest the same amount of money in a savings account or the stock market, they might expect a return of 2-10% a year. A $200 investment might provide an acceptable return of $5-20 a year. These returns should be kept in mind when considering the amount of return co-op owners should receive annually through discounts.

Patronage refunds, on the other hand, create a mutually beneficial relationship, one that encourages and rewards member investment. Members can trust that the co-op is not unduly profiting from their purchases, because surpluses are returned in proportion to those purchases. The co-op can trust that the members support the business and will wait for their benefit until after all sales and costs for the year are accounted for.

Members pay attention to patronage refunds: there is nothing like a check in the mail to remind one of the meaning of ownership! Some cooperatives time patronage refunds so that members receive their checks before Thanksgiving, near the end of the year, or right before April 15, as one way to enhance the value of the refund.

The management and board of the cooperative pay attention to patronage refunds because such refunds can create appropriate pressure for the co-op to generate net income, one sign of a healthy business. Patronage refunds, whether distributed or retained, reduce the co-op's tax obligations and keep more money circulating in the local economy. Since the IRS allows the co-op to retain up to 80% of the allocation, the retained portion provides a tax free and interest free way to capitalize the business. (For more information, see *Cooperative Grocer* #134 January-February 2008, "Planning Patronage Refunds," by Bruce Mayer.)

While patronage refunds provide the primary economic return on owner investment, food co-ops use an array of other member-owner benefits and incentives to attract new owners, show the value of membership, and thank owners for their patronage. Member appreciation events, special prices on selected products, coupons, special orders, free or reduced class fees, discounts from community businesses, and case discounts all can provide incentives to join and economic benefits for members. These benefits are usually determined by the co-op's management and should be structured and communicated carefully so they are sustainable and flexible over time.

Time to make a change?

If your co-op has not been emphasizing ownership and equity or has created a sense of entitlement with discounts, it will be a challenge to create an ownership culture. But this problem will not get easier with time. Begin by building understanding of the issues among the co-op's leaders. Plan how to educate and engage owners in the conversation.

Overcoming resistance to change must include a clear vision of the value the co-op brings to its members and the community. When making structural and difficult change, it is preferable to make all the changes at the same time. Dragging it out with incremental changes makes communication more challenging, increases the cost, and adds to resistance. (See other *Cooperative Grocer* articles for stories of co-ops that have made membership system changes.)

Summary

In our society, we are programmed to look out for number one; we are not taught how to create, maintain and share the ownership of community assets and common wealth. The cooperative structure offers us an economic means to meet our common needs through democratically owned businesses. When many of today's food co-ops were established, we wanted to create an alternative to the capitalist society, but many of us threw out the baby with the bath water. Rejecting concepts equated with capitalism – profit, equity, ownership, and management – too many food co-ops went out of business clinging to their idealism.

Fortunately, we can look to the cooperative principle, along with the generations of businesses that existed before us throughout the worldwide cooperative movement, to establish effective and sustainable structures that balance the needs of individuals and of business, so both can prosper. If co-op members only look at personal gain, they miss the power of cooperation. The opposite is also true: if cooperatives don't offer meaningful benefits to its owners, cooperative leaders have missed the point. Cooperatives must balance the needs of the owners and the needs of the business they own. Owner equity investment and patronage refunds are effective tools to create the right balance.

Cooperatives do offer an alternative – a business model in which no one benefits at the expense of others, that builds a community rather than drains its resources. The owners of any type of business provide capital, and in return expect some control and some return on their investment. In investor-owned businesses, those with the most money to invest have the most control and get the greatest share of the benefits. In a cooperative, owners provide capital equitably, have only one vote regardless of amount of investment, and receive their benefit or return based on how much they use the co-op. Ultimately a co-op's success is dependent on its understanding and effectively implementing the economics of ownership within the principles of democracy.

The notions of ownership and patronage refunds are embedded in the 3rd cooperative principle: "Member Economic Participation." Rising from the successful innovations first realized by the Rochdale Pioneers some 160 years ago, this principle outlines the way cooperators contribute to, control, and share the wealth created by their business. This distinctly cooperative advantage has proved itself for generations, and it is even codified in our current tax laws and IRS rules.

Cooperative membership is cooperative ownership. Our owners and directors, staff and management, should all understand that this economic model offers us many advantages, including the ability to serve members, build equity, and share in the common wealth.

Sidebar 1:
Building Blocks for an Owner Investment Plan

Following are critical considerations for a cooperative owner investment plan:

- **Ownership:** a mutually beneficial relationship exists between the member-owners and the co-op.
- **Investment:** the money belongs to the member and is invested to help the co-op better meet the member's needs.
- **Fair Share:** the co-op's overall capital needs are divided equitably among all members; the equity requirement is based on a member's "fair share."
- **Flexibility:** because the equity requirement is based on the co-op's capital needs, this requirement may change as the needs of the business change.
- **Values:** member equity investment helps to accomplish the co-op's mission and create a cooperative economy.

Sidebar 2:
Developing Best Practices

The best practices discussed in this article are a result of a three-year project to analyze and learn from what has worked and what hasn't. In 2001, a small group of experienced cooperators from successful food cooperatives met in Northampton, Mass. to help our friends at newly organized River Valley Market Co-op set up their member-owner policies and practices. Rosemary Fifield from Hanover, Elizabeth Archerd from the Wedge, Lisa Malmarowski from Outpost, Peg Nolan of National Cooperative Grocers Association, and Marilyn Scholl of Cooperative Development Services set about to create an ideal membership program. A year later, over 200 people attended the "Let's SOAR" conference in the Twin Cites to share experience, knowledge and insights. Together we developed a set of best practices for member programs that any food co-op can implement and gain from. (For more, see http://www.cdsfood.coop/bestpractices)

Sidebar 3:
Administration of Membership Programs

For co-ops and members to properly benefit from the decisions concerning profits and patronage refunds, the operational practices must keep pace with the desired outcomes. Membership records are the official record of corporate ownership. To maintain and use these records requires adequate resources: labor, computer hardware and software, backup systems and support, even desk space.

Both the computerized database and the individual entry forms (paper or electronic) should have fields for:

- member name and number;
- all communication avenues (e.g., address, phone numbers, email).

In addition, the database itself should include:

- a record of equity payments, including the amount and dates paid, as well as the next payment due;
- the ability to import and update members' purchase data daily from your POS system;
- a record of each member's purchase amounts for the current and past fiscal years;
- a record of patronage refund distributions (both paid out and retained) for each member;
- notes of communications made to the member about membership-related issues.

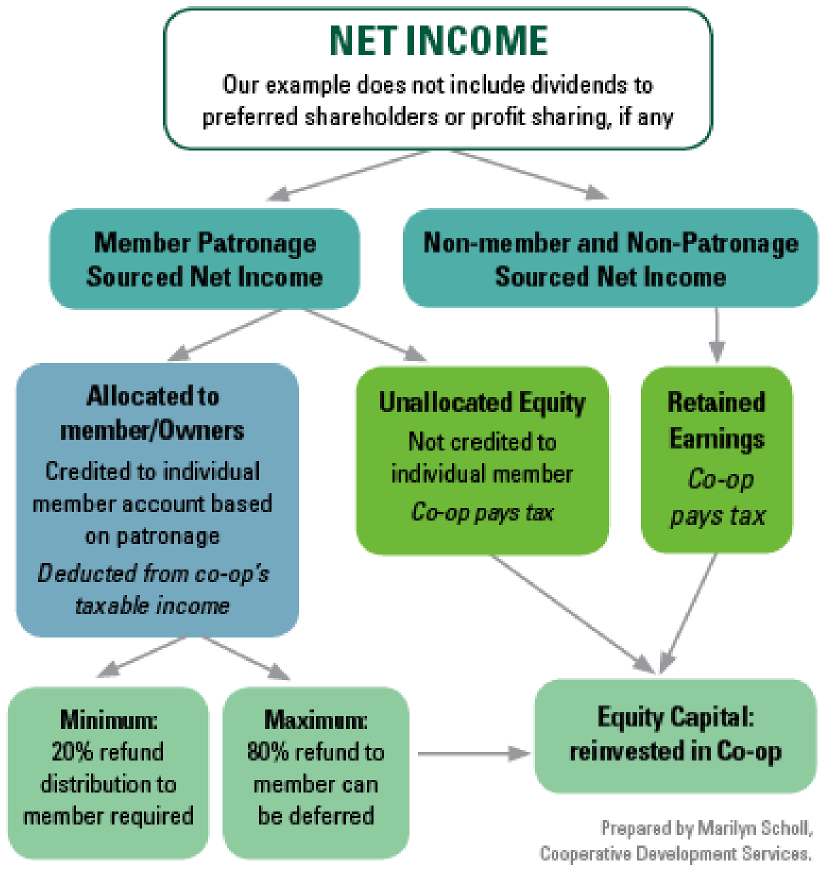
As with all operational systems, the collection of members' equity and patronage data should be as seamless and simple as possible. Talented and professional staff, using appropriate technology and software, make it possible for our cooperatively-owned businesses to take advantage of the patronage refund method and provide excellent member-owner services.

From #134, Jan - Feb 2008

Patronage Dividends: A Primer

BY BRUCE MAYER

Should your cooperative consider patronage dividends to owners? If you are already issuing patronage dividends, is your cooperative following the rules? If your cooperative receives patronage dividends from other cooperatives, do you understand what the rules are?



Prepared by Marilyn Scholl, Cooperative Development Services.

Patronage dividends represent a unique opportunity for retail food cooperatives to avoid taxation at any level on some or all of the cooperative's earnings. The tax laws allow patronage dividends to your individual members to be exempt from taxation. Since these are deductible by the cooperative and not taxable to members, the patronage dividend amount is not taxed at eitherlevel. While there are potential under-capitalization problems if a cooperative distributes 100 percent of the patronage dividend, avoidance of taxation is a significant advantage to patronage refunds for retail food cooperatives.

Patronage dividends originated with the Rochdale Society cooperative principles that included "net margins distributed according to patronage." Since cooperatives had a long history prior to the enactment of the U.S. income tax laws, cooperatives were accommodated in the tax code. The Internal Revenue Service (IRS) rules formalize the procedures that result in a tax deduction. These rules treat a cooperative as having the option of operating as a pass-through entity where profits are considered an overcharge to be returned to patrons.

Subchapter T

The IRS rules for patronage dividends are outlined in Subchapter T of the Internal Revenue Code. The five code sections comprising Subchapter T are: * 1381-what is a cooperative under Subchapter T? * 1382-how are income and patronage dividends calculated? * 1383-what is nonqualified patronage? * 1385-how are patrons taxed on the dividend? * 1388-what do the terms mean?

These rules apply to non-exempt cooperatives. There are exempt cooperatives, normally only agricultural, which must apply for exempt status and follow somewhat different rules. All cooperative accountants and their outside accounting advisors should be familiar with Subchapter T, even if the cooperative only receives patronage dividends from other cooperatives. Accountants should also utilize the accounting guidance available in the American Institute of CPAs (AICPA) Audit and Accounting Guide, Agricultural Producers and

Agricultural Cooperatives. Additional information on accounting and tax issues is available by joining the National Society of Accountants for Cooperatives (www.nsac.coop). Your accountant on staff and your outside advisor should both be members of NSAC in order to keep up on cooperative tax and financial issues.

Subchapter T lays out three basic criteria for patronage dividends. To be deductible the patronage dividend must be paid:

1. "on the basis of quantity or value of business done with or for such patron,
2. "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount paid, and
3. "which is determined by reference to the net earnings of the organization from business done with or for its patrons."

Item 1 requires the cooperative to specify the basis for calculating patronage. For a consumer-owned cooperative it will be sales. For a worker-owned cooperative it will be hours worked by workers or dollars paid to workers. We will use consumer-owned cooperatives in the examples below. The patronage dividend must be proportionally allocated based on business done with everyone, including non-members.

Item 2 requires that the cooperative operate under a pre-existing obligation to pay patronage dividends. This is normally part of the bylaws but may also be in the form of a written agreement with the members. State law normally allows a board of directors to determine that some or all of income be set aside as a reserve not to be paid out as patronage. This tempers the pre-existing obligation. But patronage dividends are not allowed if there was not an obligation established at the beginning of the tax year from which patronage is paid. Part of establishing the obligation is informing members that they may receive a patronage dividend. This is one reason cooperatives should distribute their bylaws to new members. Be sure you consult a qualified attorney on the precise wording of your bylaws, since they must be in accordance with the IRS rules and with applicable state laws.

Item 3 specifies that the base for patronage is net income. The IRS prefers taxable income as the patronage base. This is what most cooperatives use, although book income may also be used. The basis for patronage should be used consistently and should be specified in the bylaws.

Determine amount eligible for patronage dividend

The starting place in allocating patronage is to determine net income for tax or for book purposes. Using this, most cooperatives simply apply a percentage of sales to members and to non-members to determine the net income generated by members (patronage income) and the net income generated by non-members (non-patronage income). A more detailed analysis might allocate revenue and expense items such as member discounts, member only sales, advertising, member communications, and non-member mark-ups to the appropriate member or non-member calculation of net income. The member (patronage) net income is then allocated to each member based on the percentage of that member's purchases of total member purchases. The non-member (non-patronage) net income is not allocated to members and will potentially be subject to taxation.

The practical method of determining the patronage allocation to each member is to download the annual sales by member from your point of sale system to a spreadsheet. This can then be sorted from largest to smallest. A ratio of each member's sales to all sales is then an easy calculation, as is multiplying this percentage times net income to calculate the amount of patronage that could be allocated to each member. A mail merge can then be used to generate the actual notices to members of their patronage. Most cooperatives apply a minimum dividend amount that they will process. For instance, anyone who would receive under $2 could be cut out of further processing. This does mean that the cooperative will pay tax on those earnings of members who would have received under $2.

The board will determine the actual dividend payout. The maximum dividend amount will be the net income earned from members. The dividend may be paid out with a minimum of 20 percent either as cash or as a store certificate, with the balance being held by the cooperative as equity in the name of the member.

Qualified notices

In order for the cooperative to retain part of the patronage dividend, members must receive a qualified notice of allocation. This notice indicates that by cashing their check, or using their certificate, they also accept the non-cash portion retained by the cooperative. This notice must specify a deadline to cash the check/certificate of at least 90 days after issuance. The IRS allows the cooperative, through the issuance of a qualified notice of allocation, to deduct the non-cash portion of the patronage dividend.

Food cooperatives will normally only use qualified patronage dividends. The non-qualified patronage dividend is non-deductible at the time it is issued but is deductible when cash is paid. The National Cooperative Grocers Association issued non-qualified patronage dividends on 2005 income as a tax-planning tool.

Form of payment

The minimum 20 percent paid out portion of a patronage dividend may be in the form of a store certificate that is redeemable in the store for purchases. You must also allow members to ask for cash if they prefer that option. This is much easier than issuing checks and limits the problems with un-cashed checks. Using a certificate also encourages members to use the dividend on groceries and keep the funds in the cooperative.

Anyone who does not cash a check or use a certificate by the deadline you specify in the written allocation notice gives up his or her claim to the patronage dividend including the non-cash portion. The cooperative will then need to pay tax on the entire patronage allocation to that member. Due to timing and practicality many cooperatives adjust for the unclaimed patronage in the next year, paying the tax at that time.

Some patrons may deliberately not cash their patronage check/certificate, thinking they are making a contribution to the cooperative. One way to encourage cashing the checks/certificates is to set up a donation fund either to the cooperative or as part of the community contributions program of the cooperative. If the person gives the cash portion back, it is taxable to the cooperative in the next year, but the retained portion of equity would still be held in that member′s name and would not be taxed.

Payouts to members from the income of a given tax year must be made no later than 8.5 months after that year-end. This allowable timeframe is called the payment period. The deadline for cashing the check/ certificate must be no later than 90 days after the end of the payment period. The IRS is very particular about this and will classify any payment made outside of the allowable payment period as an ordinary corporate dividend-nondeductible for the cooperative and taxable to the recipient. A 1099-DIV would need to be issued to each member. Any non-cash portion held by the cooperative would also not be deductible.

Filing 1099-PATR forms Is not required

Food cooperatives should file IRS form 3491 to elect not to issue the 1099-PATR form. Form 3491 is filed in the first year patronage dividends are paid and does not need to be filed again. This exemption is allowed for cooperatives that have at least 85 percent of gross receipts from the sale of "personal, living, or family items." The tax code allows persons who purchase such items from a cooperative to exclude any patronage dividend from taxable income even if they receive a 1099-PATR. The reasoning is that individuals may not deduct personal use items and therefore any dividend on them is not taxable. Not issuing the 1099-PATR does not relieve members who are required to claim the patronage dividend as income from doing so. Examples of some possible members who should claim a patronage dividend as income are restaurants and day care centers.

One more issue with patronage dividends is the financial statement presentation. There is no definitive requirement for treating patronage as a deduction from income or as an equity transaction similar to corporate dividends. The guidance from the AICPA in the Audit and Accounting Guide mentioned earlier is that patronage is an equity transaction. The reporting examples given in the AICPA Guide follow that format. On the other hand, the CoCoFiSt format uses the income statement treatment.

In considering your cooperative′s treatment, a question to ask is: we are retaining 80 percent of the payment, so why should it be expensed? Showing patronage dividends as an expense reduces net income, which may make your cooperative look weaker to a banker or other evaluator who does not understand cooperatives.

Related issues include the balance sheet presentation of the retained patronage dividend and the policy for eventually paying it out to members. The retained portion of a patronage dividend is equity of the cooperative and should be presented along with retained earnings and member shares in the balance sheet. This retained patronage is only paid out by the decision of the board. Most cooperatives do not return the retained patronage even if a member requests it back. This is also generally the case in agricultural cooperatives.

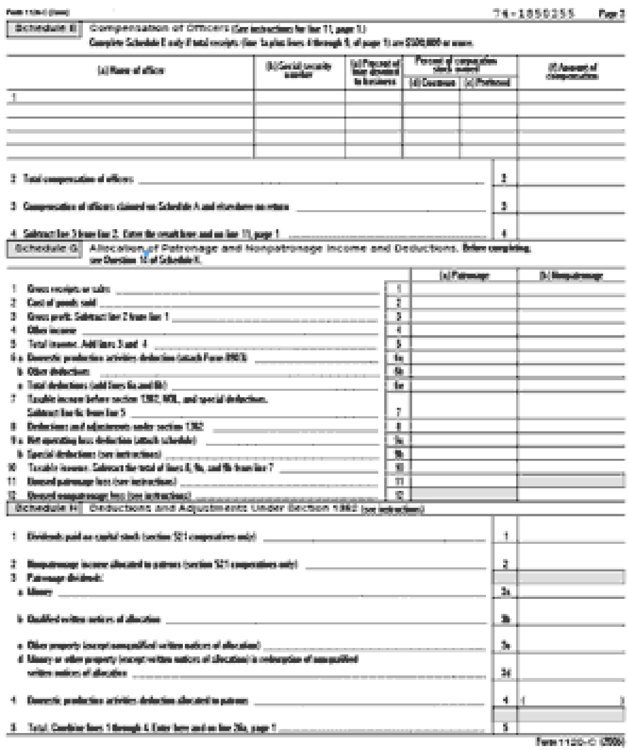
One advantage food cooperatives have in withholding retained patronage is that almost all members never paid tax on it and already received some cash. This removes the basic fairness argument that agricultural cooperatives must face since their members normally did pay tax on the retained patronage. If your cooperative does plan to revolve back this equity, it should lay out a plan for it. If it does not plan to revolve it back, that should be made clear. Most cooperative members should be receptive to the idea that they get some cash back and the rest is an easy way to avoid paying taxes and keeping the money in the cooperative working for them.

Patronage involves a simple set of rules but you need to actually learn them and keep them in mind so your cooperative can follow the applicable laws and make sound decisions.

Form 1120-C

New for 2006 wa a specific IRS income tax form for cooperatives, the 1120-C. This will be mandatory for all cooperatives starting with the 2007 tax form. The primary difference from the 1120 is the addition of Schedule G that specifically requires the allocation of all income and expense items into patronage and non-patronage columns for all cooperatives with over $250,000 in gross receipts. Previously such an allocation was only explicitly required for cooperatives over $10 million in gross receipts. This allocation has always been required for all cooperatives but has generally been ignored by smaller entities.

One result of allocating income in Schedule G is that net operating losses stay segregated by patronage and non-patronage sources. The IRS rules prevent patronage losses from offsetting non-patronage income. This can result in some pitfalls as a cooperative uses up a net operating loss. In loss years the loss is normally not allocated to members, resulting in an accumulation of patronage and non-patronage net operating losses. When the cooperative begins generating a positive net income, it may issue patronage dividends before its patron net operating loss is used. This can result in a situation where it will not be able to use up its patronage net operating loss and will pay more tax on its non-patronage income than would be expected by only looking at the overall net operating loss carry-forward.



Schedule E Compensation of Officers

Schedule G Allocation of Patronage and Nonpatronage Income and Deductions.

		(a) Patronage	(b) Nonpatronage
1 Gross receipts or sales	1		
2 Cost of goods sold	2		
3 Gross profit. Subtract line 2 from line 1	3		
4 Other income	4		
5 Total income. Add lines 3 and 4	5		
6a [illegible]	6a		
b Other deductions	6b		
c [illegible]	6c		
7 [illegible]	7		
8 [illegible]	8		
9a [illegible]	9a		
b [illegible]	9b		
10 [illegible]	10		
11 [illegible]	11		
12 [illegible]	12		

Schedule H Deductions and Adjustments Under Section 1382

Form 1120-C

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From #129, march - april 2007

Capitalization Strategies

for new

BY BILL GESSNER

Where we gonna get the grubstake? The 300 food co-op stores in the United States, owned by more than 400,000 consumers, face the continuing challenge of building capital if they are going to continue to grow and develop to serve their members and communities. As much as we might want to ignore this challenge, co-ops need to find ways to acquire more capital as a means to fulfilling their mission.

Capital is defined as money or property used to produce more wealth. Traditionally, businesses require talent and capital to develop and flourish. The Food Co-op 500 program for creating new food co-ops has put forth a "Four Cornerstones" model, surrounding talent and capital with vision and systems.

Food co-ops have most often been chronically undercapitalized. There has been a continuing lack of education that focuses on a member's responsibility to help capitalize their co-op. System-wide, food co-ops have been weak in the area of ongoing capital planning. In this article, we will feature the cornerstone of capital and describe both traditional and creative approaches to building capital for existing and new food co-ops.

Member capitalization

Member capital is often assumed to be equity, but it really is a combination of equity and debt (liabilities). Member share investments are equity, while member loans are liabilities. As part of a capitalization plan, member equity and member loans are different creatures but equally important. Together they represent the owners' direct investment in the cooperative.

Member equity dollars are raised in small amounts from all members, coming in over a period of time. Member loans are significantly larger dollar amounts coming from a smaller number of members, secured over a relatively short period of time. Raising member equity is commonly an ongoing effort, while member loans are most often raised in a 4–6 week period, usually to help finance an expansion project.

Member equity represents the grassroots ownership of a cooperative business. As we look back over the past 35 years of food co-ops, we can see a slow crawl toward making real the ideal of member equity signifying ownership. Many of us can remember lifetime memberships for $5; annual dues of $5 in exchange for a 20 percent everyday discount; then the painful, confusing transition from dues to equity; and reducing or eliminating everyday discounts so that members aren't greedily getting a 300 percent annual return on their capital investment.

Now many food co-ops are increasing the member share requirement and/or moving towards annual equity infusions (with a higher cap or no cap), including the retained portion of patronage dividends. We are thankful to have co-op history and the co-op principles to guide us through this maze.

Additional nuggets of wisdom that have emerged over the past 35 years include:

- Member capital should come in the form of equity investments, not dues or fees. (Dues and fees are taxable income and don't stay in the member's name.)
- Don't use the term "life-time membership." (Members may vote to increase the equity share requirement at some point in the future.)
- Develop ways to raise additional equity from current members—through retained patronage rebates or an annual equity investment requirement.
- Co-ops should base their member equity requirements on an examination of the co-op's long-term equity needs, not what they think they can successfully ask of their members.
- There should be an approximate balance between a co-op's member equity (symbolizing the cooperative) and retained earnings (symbolizing the business), roughly within a 1:2 or 2:1 relationship.
- Members should provide at least 50 percent of sales (a symbolic measure but indicating a truly consumer-owned cooperative).
- Find new ways to continuously educate members and potential members on the benefits and responsibilities of member ownership of consumer food co-ops.

With co-ops' pressing everyday operational needs, building member equity is often not a priority or a focus, though it should be. Setting and pursuing annual goals for new members and new equity is very important. If membership benefits are properly structured and promoted, a natural flow of new members and new equity into the co-op will develop. Periodic membership drives are not necessarily a best practice, although October as Co-op Month offers good opportunities for promotion and education. Membership recruitment should be ongoing, and it should flow naturally with an effective membership system. Look at other food co-ops to find examples of best practices.

New members and potential members are most often customers of the co-op who value the co-op and its services. What is an appropriate number of active members (defined as those who have shopped at the co-op in the last year)? There is no hard-and-fast rule. I suggest, given what members are typically buying from their food co-op, that 75 percent of the number of retail square feet would represent a near-capacity number of members for a mature co-op. (Maturity with regard to membership might be defined as 5 years in a location.)

Thus, a food co-op of 10,000 square feet of retail space, with at least half of its sales to members should have at least 7,500 members at maturity. If we examine our existing food co-ops, we might find quite a range in this ratio of square feet to active members.

New food co-ops should set goals for the number of members for the different stages prior to and after opening. For example: feasibility (300, depending on store size), launching a member loan drive (500), closing on financing (750), store opening (1,000), and one year after store opening (1,500). Again, membership maturity should be reached within five years.

There are a number of options for creating additional member equity, but remember the importance of keeping it simple in the eyes of the member and potential member. Having too many options make it more difficult for someone to become a member or invest additional equity.

Member Loans

For purposes of internal capital planning within the food co-op system, options include retaining a portion of patronage rebates, annual equity investments, developing more attractive preferred share programs for members, cultivating nonmember equity investors as strategic partners (as allowed by the new co-op statutes in some states), and developing best practices for dealing with abandoned equity.

Another important equity option, member loans, offers unique characteristics and advantages. Member loans represent commitment and engagement in the co-op. While not coming from all members, member loans are nevertheless a very strong indicator of member buy-in and support for the proposed future direction of the co-op. The member values the co-op and all its services and is willing to lend a sizable amount of money to the co-op, understanding the risks involved. Member loans typically range from $1,000 to $10,000 and upwards to $50,000. Member loans are unsecured and subordinated to senior and secondary debt (bank debt and other secured or higher positioned loans).

Member loans are a healthy ingredient in the cooperative's stew of assembled capital; they serve to leverage the bank financing. A bank will be impressed by a co-op's ability to raise member loans. Since they are subordinate to bank loans, member loans can be viewed as quasi-equity. When calculating debt/equity ratios, member loans can be added to equity and deducted from liabilities, so long as that is clearly stated. Member loans can also be viewed as a bridge to member equity. Member loans are most often raised intensively as part of an expansion project and repaid over a four-to-eight-year period of time, as member equity slowly flows in to replace the member loans.

Food co-ops are raising significant amounts of member loans as part of the capital for expansion projects. We are seeing successful member loan campaigns in the $300,000 to $1 million range for all sizes of food co-ops, including start-ups. The planning for a member loan drive typically takes at least four to six weeks and includes appropriate legal advice from attorneys experienced in co-op and securities law.

If the member loan drive is well- planned and organized, the drive can be completed in four to six weeks. Interest rates are in the range that will be attractive to a social investor as opposed to a speculative investor—generally somewhere between a money market rate and a 5-year CD rate. We recommend offering no more than two categories of interest rates: for example, setting a ceiling of 4 percent for all loans under $10,000 and 5.5 percent for loans of $10,000 or more. Creating a complex tier of interest rates and terms will only make it more difficult for a member to commit to making a loan.

The food co-op sector has only scratched the surface of the potential of member loans as a long-term source of capital. We have seen numerous examples where anywhere from one in 10 to one in four members is interested in making a member loan to their cooperative. A collaborative effort amongst food co-ops, perhaps through NCGA, could result in a complete system for planning, implementing, and administering member loan programs in all of our food co-ops. Such a system could likely be designed to conform with all state and federal securities regulations.

Bank debt

The food co-op sector has benefited greatly from a variety of financial organizations, but most specifically, NCB (formerly known as the National Cooperative Bank). NCB, in addition to making loans to a great number of food co-ops, has invested heavily in building the infrastructure and capacity of the food co-op system. Loan funds such as Northcountry Cooperative Development Fund (NCDF), Co-op Fund of New England (CFNE), and Local Enterprise Assistance Fund (LEAF), as well as a number of credit unions, and local banks, have been sources of capital for many food co-ops.

Co-ops in search of bank financing have had to find lenders who are willing to look beyond a strict collateral coverage ratio, since most co-op expansion projects require more senior debt than a conservative interpretation of collateral allows. A co-op will need a bank that is able to be comfortable with the proposed expansion project and its projected cash flow, the cooperative's management, and the long-term viability of the cooperative. The bank will need to recognize that they will not be able to get personal guarantees from the owners of the co-op, nor will they be able to get an SBA loan guarantee, for which consumer co-ops are not eligible.

Expansion

Expansion projects for existing food co-ops, whether at the current store, a relocation, or an opening of a second or third store, have for the most part followed a rough formula for sources of capital:

At least 30 percent (the more the better) of the project costs should be covered by the owners' contribution (derived from the co-op's cash reserve, net proceeds from sale of real estate, new member equity, and member loans).

Not more than 45 percent of the project financing should come from bank debt (senior, first-position debt), but it can go as high as 55 percent and more if real estate purchase is involved.

The middle category, between owners' contribution and bank debt, is "external, subordinated," and should be as close to 25 percent as possible. Sources include landlord contribution, extended vendor credit, free fill (from manufacturers), and other subordinated funds from city/community sources, including grants and low-interest, long-term debt.

Start-ups

For start-up food co-ops, these percentages change somewhat. The owners' contribution may need to be as high as 50 percent of the project cost, and bank debt may be as low as 25 percent, with the middle category of "external subordinated" supplying the gap. The capitalization challenge for start-up food co-ops is very steep.

While many co-ops have been able to own their real estate and benefit from that, there are many other co-ops pursuing expansion projects that involve a lease rather than purchase of real estate. Usually there are substantial leasehold improvements in an expansion project, and these improvements don't provide much collateral value to a lender (although a lease assignment to the lender can help alleviate that). Expansion planning should include exploration of options that involve acquisition of real estate. The real estate can provide stronger collateral and might inspire a higher level of member loans.

In assessing financial feasibility in a proposed expansion project, long-term cash flow is perhaps most critical, demonstrating that all lenders, external and interna,l can be repaid. Measures such as the debt/equity ratio, the current ratio, and the debt-service coverage ratio are perhaps most important. Ratios do not provide carved-in-stone answers to questions of financial feasibility, but they provide a convenient way to focus the analysis.

Many co-ops have been adverse to utilizing debt as a source of capital. Realistically, it should be providing at least 50 percent of the capital system-wide, the most strategic way to leverage our member capital.

Summing up the grubstake

For a long time, "profit" was a dirty word in co-ops, but now we seem to recognize its necessity if we are to fulfill our mission. "Capital" has been a word that we've ignored, denied and not understood. However, it is encouraging to see recent efforts to gain a greater understanding of the food co-op systems' current capital position. How many members/owners do we have? How much member capital do we have? How much equity do we have? How can we best leverage the consolidated balance sheet of many food co-ops, while honoring the roots of local ownership and control?

The NCBA (National Cooperative Business Association) Equity Task Force will soon issue a report of their recommendations for the co-op sector. (See accompanying article.) What are the long-term capital and equity needs of the food co-op system, and where will that capital come from? The food co-op system should be prepared to begin a capital planning effort to identify sources and strategies for acquiring capital to support our long-term growth and development. What is the role of our National Cooperative Grocers Association in helping launch a capital planning effort?

Sources of capital that could be pursued more aggressively include:

- Strategic partnering with the social investment community to seek non-member equity investments.
- Exploring approaches to attract capital into co-ops from self-directed IRAs.
- Aligning with the green movement to bring more green design into our new store projects, resulting in greater appeal to social and environmental investors.
- Collaborating with USDA on loan guarantees and grant programs.
- Collaboration with credit unions.
- Planning and implementing a systematic member loan program, usable for all food co-ops.
- Developing best practice approaches to building member engagement/investment, including best practices for patronage rebates and/or annual equity investments.
- Lobbying to retract the restriction that prevents consumer co-ops from being eligible for SBA loan guarantees.
- Gaining greater support from city/community sources, including long-term low interest loans, grants, and opportunities for tax-increment financing.

Can we build a shared vision of 500 food co-ops that are fully capitalized? Can we implement that vision?

Suggested Reading:

1. Food Co-op 500: http://www.foodcoop500.coop/html/model_overview.shtm

1. "Financial Toolbox," available from Cooperative Grocer:

www.cooperativegrocer.coop/cg_special.html#financial

1. "Expansion Toolbox," available

from Cooperative Grocer:
www.cooperativegrocer.coop/cg_special.html#relocation

1. "Conducting Member Loan Campaigns,"

by Bill Gessner, CG Jan.-Feb. 2000:
www.cooperativegrocer.coop/articles/
index.php?id=298

1. "Leveraging Benefits for Producer and Consumer Co-ops," by Kevin Edberg, CG Jan.-Feb. 2006: www.cooperativegrocer.coop/articles/index.php?id=630