Equity financing in cooperatives. Three case studies in dairy sector (*)

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Abstract
There is a general view in economic literature that cooperatives are under-invested. Currently the issue is on the International Co-operative Alliance’s agenda. To contribute to this topic we undertake three case studies from large dairy cooperatives to learn about how they have faced these alleged constraints. This raises questions because not all the successful cooperatives which have been studied have introduced changes to overcome the supposed limitations of cooperative ownership rights.

Keywords: Cooperative capital, cooperative financing, cooperative ownership structure, ownership rights.

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Introduction
The constraints on cooperative financing have for some time seemed pervasive; there is a general view in the literature that cooperatives are underinvested.

Chaddad and Cook (2004) characterise traditional cooperatives as having the following attributes: “ownership rights are restricted to member-patrons, residual return rights are non transferable non appreciable and redeemable; and benefits are distributed among members in proportion to patronage”. They sum these up as representing a “vaguely defined” property rights structure.

These vaguely defined property rights lead to conflicts over residual claims and decision control. These conflicts could explain the recurrent difficulty of cooperatives to attract capital. In this way, common ownership causes the free rider problem as new members pay a small quantity of capital to join the cooperative services diluting the capital between members. This discourages members from investing in the cooperative.

The purpose of this paper is to contribute to this issue. To this end, we undertake three case studies extracted from the dairy sector with the aim to learn how they have faced these alleged constraints. We have chosen dairy cooperatives because, i) it defines a subsector inside the agriculture, therefore the economic activity of the cooperatives is more similar than different agricultural cooperatives and, ii) the dairy sector is very competitive and dynamic and requires high investments in capital (industrial processing of the raw milk, and the subsequent marketing of the industrial products, R+D activities, brands, etc.).

The studied dairy cooperatives are Fronterra (New Zealand), Royal FrieslandCampina and Arla (from Europe). All of them ranked in the World Co-operative Monitor.

We also include in the study the equity accounting classification as an issue, which has not been addressed by economic literature. Finally, we conclude and propose possible work lines.


**Fonterra Co-operative Group**

Fonterra Co-operative Group Limited is a cooperative company incorporated and domiciled in New Zealand. Fonterra Co-operative is the parent company and presents consolidated financial statements in accordance with IFRS. We examine the annual report and financial statements of 2012 and 2013.

The number of shares held by the members is according to the level of transactions with the cooperative, exactly: “each shareholder supplying milk to the Company in a season is required to hold one Co-operative share (share) for each kilogram of milksolids obtainable from milk supplied to the Company by that shareholder, excluding milk supplied by that shareholder under contract supply or as unshared supply, in that season” (Fonterra, 2012).

The previous one is known as the share standard. In addition, each shareholder is able to hold further shares up to 20% of the share standard.

The rights attaching to shares include:

- voting rights of one vote per 1,000 kilograms of milksolids obtainable from milk supplied to the Company by a shareholder during the season preceding\(^1\);
- rights to any dividends\(^2\) declared by the Board; and
- rights to share in any surplus on liquidation of the Company.

Shares are valued on the basis of a Restricted Share Value, which is determined by the Board on an annual basis, for each season, after having regard to a value range determined by an independent valuer.

If a shareholder decreases supply during a season, the number of shares held will be re-apportioned between the number of minimum required shares (calculated using the share standard) and the number of any additional shares that may be held.

Shares held in excess of the number required to be held by the share standard can be surrendered at the election of the shareholder. However shares representing greater than 120% of the number required by the share standard will automatically be surrendered, at the then prevailing share price.

Payment for the surrender of shares may be made at the option of the Cooperative by cash; or the issue of Capital Notes.

Capital notes are unsecured subordinated borrowings which are quoted on NZX’s debt market (NZDX). They are classified as non-current liabilities in the financial statements.

Therefore, this system tries to keep equity in hands of shareholder supplier

From 2013 Fonterra has established the “Fonterra Shareholders’ Market”, where shareholder suppliers are able to buy the share that they need to supply milk or sell shares in excess directly. Consequently the shares are not redeemed.

Also from 2013, shareholders may elect to sell the economic rights\(^3\) of some of their Cooperative shares to the “Fonterra Shareholders’ Fund”, subject to an individual limit set by the Board within an overall individual limit set out in the Company’s constitution, but voting rights are kept by members shareholders.

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\(^1\) Less milksolids supplied under contract supply or as unshared supply.

\(^2\) Dividends are based on the number of shares, that is, based on capital

\(^3\) The economics rights are:

- the right to receive any dividends declared by the Fonterra Board;
- the right to any other distributions made in respect of Co-operative shares; and
- rights to share in any surplus on liquidation of Fonterra.
Fonterra is an example which merits a deep study. In few years Fonterra has change its equity structure, has removed the value return (returns to members according to the milk supplied), has introduced dividends on shares held, has introduced the “Fonterra Shareholders’ Market” and the “Fonterra Shareholders’ Fund” while the cooperative is under control of its members. Following the Chaddad and Cook (2004) models, Fonterra was a member-investment cooperative where distribution of profits were in proportion patronage to a distribution of profits according to the proportion of member shareholdings and after that to a cooperative with an internal market to transfer the shares and losing the characteristic of redeemable. Now it is a cooperative close to new generation cooperatives model.

Royal FrieslandCampina

Royal Friesland Campina is a Dutch cooperative whose members are dairy farmers from Netherlands, Germany and Belgium. Zuivelcoöperatie FrieslandCampina U. A. 4 (the cooperative) is the sole shareholder of Royal FrieslandCampina N.V.5, which is the parent company of the Group. Royal FrieslandCampina N.V (from now the Parent Company) presents the consolidated financial statements of the Group in accordance the International Financial Reporting Standards (IFRS). We examine the 2013 financial statements and annual report.

All milk supplied by the members is purchased by FrieslandCampina Nederland B.V., a subsidiary of the Parent Company.

FrieslandCampina’s milk price comprises the guaranteed price, the performance premium and the distributed registered fixed member bonds. The guaranteed price is the weighted average of the annual milk prices for raw milk paid by the reference companies (twelve German dairy companies, Arla Foods in Denmark, Bel Leerdammer, Cono Kaasmakers and DOC Kaas in the Netherlands and Milcobel in Belgium).

The equity of the parent company is formed by issued capital, share premium, perpetual notes, member bonds, cooperative loan, fair value reserve, other reserves6, retained earnings and non-controlling interest. Issued capital is formed by 10,000,000 shares all are held by Zuivelcoöperatie FrieslandCampina U. A. (the cooperative). Perpetual notes are perpetual subordinated loans with a 7.125% cumulative interest. There is not repayment commitment, but the notes can be repaid (that is, they are callable). All perpetual notes have been repaid in 2013, therefore there is not perpetual notes at the end of 2013.

The equity structure of Royal Friesland Campina could be seeing as like “member-investor cooperative”, where part of the patronage return is in form of registered fixed member bonds. Members cannot trade registered fixed member bonds, only on the termination of business activities and the termination of the membership they are automatically converted into unrestricted member bonds, which can be traded between member bondholders. Member bond is the most important instrument in the equity structure, representing almost the 50% of the equity. But this instrument has a ceiling in their remuneration (3%), therefore the main way to distribute benefits is by means of patronage.

The perpetual notes are so far less important (5.76% of the equity in 2012) and have been repaid in 2013, therefore the wholly owned by the cooperative is not a proper capital seeking entity.

The Royal FrieslandCampina case shows us the important effects of the accounting standard in the design of financial instruments in order to qualify to accounting classification as equity. Member bonds,

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4 Uitgestolen Aansprakelijkheid (U.A.)

5 Naamloze Vennootschap (N.V.)

6 Cash flow reserve and currency translation reserve.
perpetual bonds (and cooperative loan) are perpetual and subordinated instruments and their remuneration is not mandatory from contractual characteristics.

**Arla**

Arla Foods amba is a Danish cooperative with dairy farmer members from Denmark, Belgium, Germany, Sweden, Luxembourg and UK. Arla Foods amba is the parent company of Arla Group and presents the financial statements in accordance with IFRS.

The equity’s structure is formed by individual capital, common capital and supplementary payment. Collective capital comprises unallocated equity (capital account and statutory reserve for Special purposes), the individual capital comprises delivery-based owner certificates and contributed capital. The supplementary payment is the proposed profit appropriation, that is to say, the proposed portion of profit to be distributed to members when it is approved by the Board of Representatives. It is formed by the supplementary payment for milk and the interest on contributed capital (interest rate of CIBOR +1.5% on individual member accounts (paid in capital)).

As it is established in the Articles of association, the member, on termination of membership does not entitle to any share of the Cooperative’s property or assets. The member has only rights on individual capital, and this is paid “pursuant to the applicable provisions”, that is, the Board of Representatives shall decide on any payment of delivery-based ownership certificates, contributed capital or other individualised consolidation 7. Therefore, ownership rights in Arla are restricted to members, nonappreciable and redeemable but subject to the approval by the Board of Representatives, in order to qualify as equity accounting.

On the other hand, the farmer-member receives “on-account” price for the milk, which is paid monthly and a supplementary payment (which comprises the supplementary payment for milk and the interest on contributed capital) and the individual consolidation, which is the share of profit deposited in individual capital. The remuneration is not a mixed configuration of returns based on capital and on patronage, because of the remuneration of contributed capital is capped and only represents the 1.5 % of the Supplementary payment.

The cooperative structure of Arla as very close to a traditional cooperative in models identified by Chaddad and Cook (2004). This fact raises questions on how it can explained the expansion of Arla despite the supposedly limitations on its ownership rights.

**Conclusions**

The study of how some big dairy cooperatives face financing issues has shown different equity structures and how they can quickly change. Also it has showed that accounting classification as equity matters and it is a characteristic which is taken account.

Equity structures varies from more traditional as Arla Corporation with individual capital and common capital to more innovative as Fonterra with a market to exchange members’ shares in order to keep the required number of shares according to the transactions with the cooperative (milk supplied). The case of Arla raises questions to the traditional economic literature on how it can explained the expansion of Arla despite the supposedly limitations on its ownership rights. We think that an expansion of the study, adding new case-studies could be of interest in order to generalize the results.

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1 Article 5.
References