Financial Trends and Needs of Cooperatives and Implications of Consolidation in the Farm Credit System

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The objective of this report is to discuss the cooperative's perspective on the current and future structure of the Farm Credit System, and its ability to deliver financial services that meet the cooperative industry's need. To address this objective, it is important to first understand the financial state of agricultural cooperatives (ag co-ops). Knowing the state of ag co-ops provides insights into their future financial needs. Finally, the report concludes with some thoughts on what would consolidation in the Farm Credit System mean for cooperatives and their farmer-owners.

Financial State of Agricultural Cooperatives

Recently, the agricultural cooperative sector has benefited from a sustained period of financial success. Much of this financial prosperity is due to the recent improvements in the overall agricultural economy. Furthermore, these positive trends are reflected in a sub-group of agricultural cooperatives, farmer cooperatives (grain, oilseed and farm supply cooperatives). This is of particular interest for this report because farmer cooperatives are the primary customer of CoBank, and these farmer co-ops are owned by Farm Credit association borrower-members.

Along with U.S. agriculture, the agricultural cooperative sector has experienced a significant boom. Most notably, real net incomes for agricultural cooperatives or ag co-ops have surged. According to USDA data from 2000 to 2012, the broad ag co-op sector's real net income has nearly quadrupled. In 2000, real net income was $1.6 billion in constant 2009 dollars and by 2012, it had risen to $6.1 billion (Figure 1 below). In fact, the 2012 real net income is above the 1976 historical high of $5.2 billion.

Soaring incomes have also strengthened ag co-op's balance sheets. Ag co-ops have invested significantly in improving infrastructure for their members. These investments range from keeping up with technological improvements in equipment to maintaining or building new storage facilities. Coupling these investments with sizable net income gains, assets and wealth of ag co-ops have also risen significantly over the last decade. From 2000 to 2012, the ag co-op sector's asset value more than doubled and net worth increased more than 50 percent (USDA).

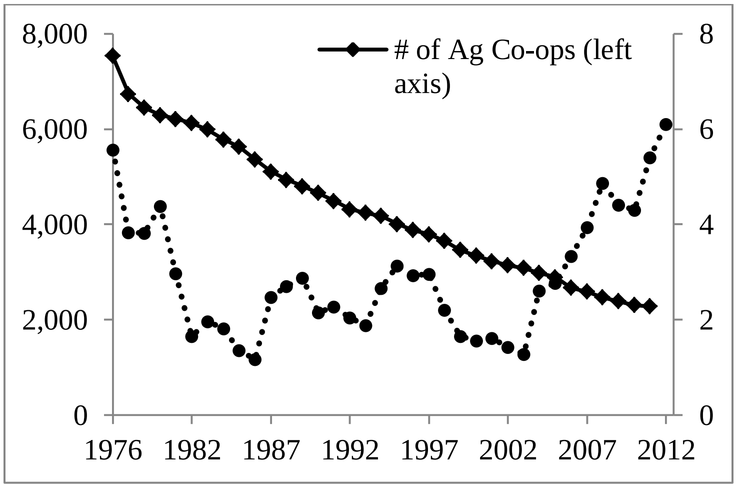

Figure 1. U.S. Agricultural Cooperatives Statistics – USDA Data

Another trend in the ag co-op industry is significant consolidation. Since 1976, the number of ag co-ops has fallen from about 8,000 to about 2,000 (Figure 1). Some of the drivers for this consolidation include the tumultuous 1980s in agriculture; government programs in the mid- to late-1980s ending their purchasing or storing grain program; and inefficient cooperatives merging or being acquired by other cooperatives or businesses.

Steep consolidation in the industry has led to many ag co-ops growing significantly in size. Today, there are fewer small ag co-ops, and large ag co-ops make up a significant portion of total sales volume. From 2000 to 2012, the percent of ag co-ops with less than $100 million sales (small ag co-ops) has dropped from 97% to nearly 80% (Figure 2 left chart). At the same time, ag co-ops with more than $1 billion in sales make up the majority of total sales in the industry (Figure 2 right chart). Even though there are only 31 of these very large ag co-ops, which amounts to about 1 percent of the sector, just over 50 percent of total gross sales are generated by these very large ag co-ops.

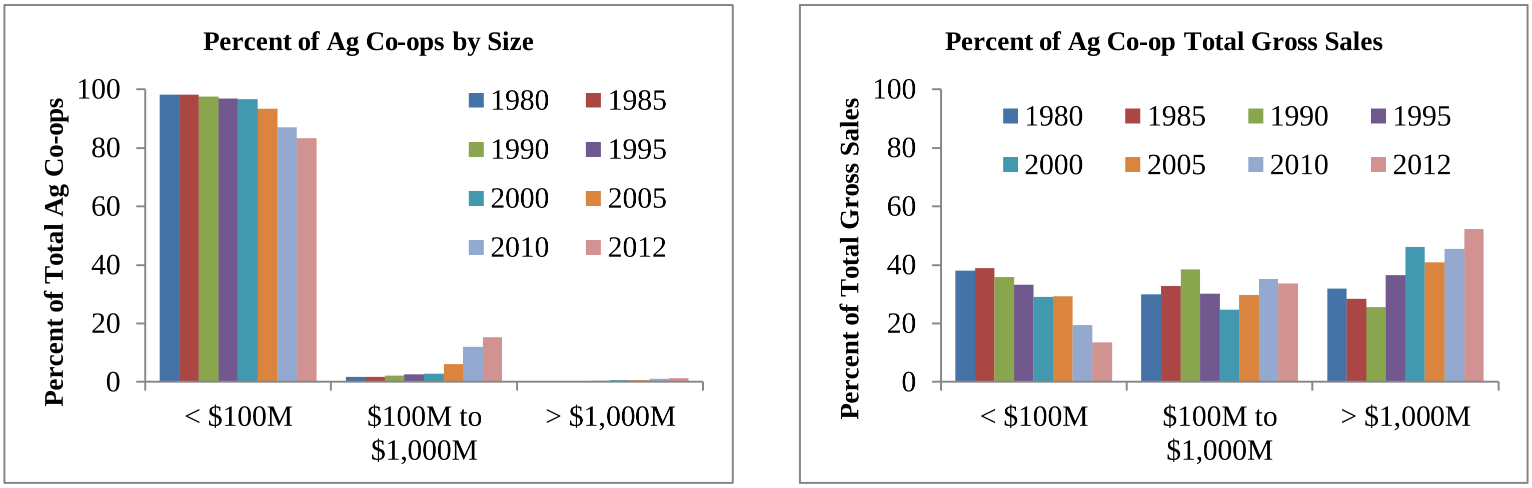

Figure 2. Percent of Ag Co-ops and Total Gross Sales by Size – USDA Data

Many of these same trends for the overall ag co-op sector, the trends of financial prosperity and consolidation, have been experienced for farmer cooperatives (farmer co-ops). That is, many farmer co-ops from across the U.S. have (1) reported record local savings to their membership; and (2) invested significantly in infrastructure such as grain storage, equipment, and facilities as well as in technological improvements in equipment. These two trends have provided many benefits back to the farmer-owner.

Another similar trend for farmer co-ops is significant consolidation. To illustrate this consolidation, consider the state of Kansas. From 1993 to 2012, the number of farmer co-ops in Kansas fell from 172 to 91 (USDA). Other states have experienced more significant consolidation. For example, in the past, Nebraska had a similar number of farmer co-ops as Kansas, but today has a few more than 30 farmer co-ops. There is no clear reason why consolidation has happened more rapidly in some states than others.

One final point on the financial trend of farmer co-ops is the considerable strength of farmer co-ops' balance sheets. Based on the most recently available CoBank data from 2005 to 2010, the average farmer co-op with more than $100 million in sales has boosted liquidity and equity. Both measures of balance sheet health nearly tripled as working capital shot up from $5.3 million in 2005 to $16.7 million in 2010. Over the same time period, retained earnings or unallocated equity rose from $8.5 million to $22.3 million.

Future Financial Needs

While farmer co-ops are in a solid financial position, they do face a number of significant current and future financial needs. First, market volatility has created an elevated need for short-term debt capital at competitive rates. Second, improvements in production agriculture has led to farmer co-ops updating infrastructure, which creates demand for longer-term debt financing. Third, farmer co-ops must also be cognizant of the increased need to manage their cash flows from financing. Finally, additional consolidation within farmer co-ops will only elevate the needs for debt capital.

Today's farmer co-op has experienced a surge in the need for short-term debt capital. During the 2008 commodity price run up and collapse as well as the persistence of market volatility since that time, farmer co-ops have an elevated need for seasonal loans. Rising margin calls and higher priced input inventories have boosted the farmer co-ops use of seasonal loans. From 2005 to 2010, the average farmer co-op with more than $100 million in sales had their seasonal loans payable nearly double. Furthermore, over the same time period, farmer co-ops' self-financing of margin deposit, prepaids, and other operating current assets nearly tripled.

Certainly, short term financing needs are great, but so too are demands for longer term debt capital. As production agriculture has experienced tremendous gains in technology and efficiency, farmer co-ops have had to respond with investments in infrastructure. Specifically, grain unloading and storage needs (the often referenced "speed and space" need) have risen exponentially. In addition, older elevators have been repaired or updated (note that these elevators may not be able to adequately address the "speed and space" issues of today's agriculture). Ultimately, these investments in storage facilities have been debt financed. From 2005 to 2010, the average farmer co-op's total non-current liabilities have more than doubled.

The demand for short-term and longer-term debt capital has transformed the primary source of cash flow for farmer co-ops. For any business, including farmer co-ops, total cash flow comes from three sources: business operations, net investments and financing. Using the CoBank data and estimating cash flows via the indirect method, the 2005 primary source of positive net cash flow for farmer co-ops was from operations. Given the aforementioned need for short-term credit to handle market volatility and the need for longer-term debt capital to finance investments, the primary source of positive cash flow for the average farmer co-op today is clearly financing cash flow.

As a result, farmer co-ops will likely need additional tools and information on cash flow management. Many lenders outside of the Farm Credit System have various programs aimed at helping their borrowers improve their cash flow management. That is, techniques on collecting accounts receivable, managing working capital and inventories, projecting cash flows, etc. This is not to say that farmer co-ops will need a lender to do this for them. Rather, lenders could share ideas of best practices in managing cash flow or facilitate training that comes from non-agricultural businesses that have experience dealing with cash flows in very large businesses. Given the consolidation within the farmer co-op landscape, more and more very large farmer co-ops will likely form, which would amplify the need to understand a co-op cash flows.

Furthermore, the growing size of farmer co-ops also means the need for larger amounts of credit. CoBank’s reported hold limits are high enough to meet all of their farmer co-op customers credit needs. However, the credit limits imposed on individual farmer co-op customers may be limiting, especially if consolidation continues. Significant growth and the continued consolidation of farmer co-ops may create a situation in the future where the individual credit limits, not necessarily the hold limit, may not be able to meet the needs of very large farmer co-ops. If this was the case, then farmer co-ops may look to other lenders for credit as well as other sources from capital markets or even private equity firms.

To date, there has been some interest from private equity firms and even foreign firms (such as Marubeni acquiring Gavilon) in investing in agriculture. The challenge for these firms investing in cooperatives is that private equity and/or foreign firms typically desire more control than they can get in the cooperative model. Furthermore, these equity investments would be quite illiquid and require a higher rate of return than what a farmer co-op could borrow from traditional lenders such as CoBank. So, these factors will likely deter major investments. However, if outside investors want to acquire a farmer co-op and the farmer-owners want to sell, then the investor will likely just buy the co-op and restructure it.

What Would Consolidation in the Farm Credit System Mean?

For farmer co-ops, consolidation within the Farm Credit System is already happening. The merger between CoBank and U.S. AgBank has created a “real time” case study for farmer co-ops. To date, all anecdotal and formal reports indicate the merger is moving along very well. The following quote from CoBank's 2012 Annual Report really does sum up all of these reports on what the merger has meant to farmer co-ops, "The merger with AgBank diversified CoBank's loan portfolio and enhanced our capital base and overall lending capacity."

Following the merger, CoBank remained in a very strong financial position. According to CoBank's 2012 Annual Report, net income is at $854 million (over $300 million higher than 2008), shareholder equity is at $6.4 billion (nearly $3 billion higher than 2008), and unallocated retained earnings is at $2.7 billion (over $1 billion higher than 2008). Furthermore, CoBank's 2012 permanent capital ratio is at 16% (7% is required) and its core surplus ratio is at 10% (3.5% is required). In short, farmer co-ops have a financially strong lender in CoBank.

Of course, the merger does heighten some risks for farmer co-ops through their lending relationship with CoBank. That is, if CoBank were to somehow experience additional stress or hardship through the merger, then the risk to farmer co-ops would be if this stress limited farmer co-ops access to credit or negatively impacted their terms of credit.

Heightened stress or additional risks stemming from the merger could come from a number of sources. While not an exhaustive list, here are some of these risks: (1) elevated credit exposures through a larger portfolio loans; (2) movements in interest rates impacting a larger market value of equity; (3) heightened demands for more credit are not able to be met because of lack of liquidity; and (4) increased need to manage more operational and reputation risks.

Fortunately, CoBank recognizes these risks and has implemented an extensive risk management program to monitor and manage these risks. The key risk areas of focus for CoBank are credit, interest rate, liquidity and operational and reputation risk. Not only are individual business segments within CoBank charged with monitoring these key risk areas, but there is a single risk management group, led by the Chief Risk Officer, that monitors and provides advice on these risks. In short, CoBank takes a very proactive approach to risk management.

Finally, it is important to remember that if consolidation within the entire Farm Credit System has an impact on farmers it can ultimately impact farmer co-ops. Why? The cooperative business model (user-owner, user-control and user-benefit) creates this situation. That is, a co-op's success is invariably linked to the performance of their farmer-owners. So, any change that positively or negatively impacts a farmer will likely flow through and affect the farmer co-op.

Conclusion

Farmer co-ops need a strong lending partner. While they have experienced a boost to their financial position recently, the needs to finance current operations and future growth opportunities are large. Clearly, the Farm Credit System, through CoBank, has been able to meet these debt capital needs through difficult times (the massive margin calls of 2008) and prosperous times (the 2011 and 2012 historically high real net incomes). The recent merger between CoBank and U.S. AgBank has brought additional benefits to farmer co-ops through an enhanced capital base and bigger lending capacity.

It is important to remember that farmer co-ops need a Farm Credit System to provide certain benefits. If the System were to undergo additional consolidation, then one farmer co-op CEO stated there are four key areas that should be enhanced.

1. Dependable agricultural lender. Agriculture is cyclical with good and bad times. This creates a need for a lender who understands and will be with the borrower through these cycles.

2. Competitive credit terms. From interest rates to term limits to collateral, creditworthy borrowers need a competitive lender in the agricultural marketplace.

3. Capacity to meet credit needs. The agricultural industry is capital intensive with significant demands for short-term and long-term credit to operate. Thus, a lender with significant capacity is needed.

4. Knowledge of agriculture. Change in today’s global agricultural landscape is significant and farmer co-ops need a lender who can provide insights into this change.

In conclusion, keeping these four key areas in mind should help the Farm Credit System continue to be an integral part of the agricultural and cooperative industry.