ASSESSMENT OF NEEDS AND ISSUES RELATED TO FINANCING OF AGRICULTURAL CO-OPERATIVES

A Report to the Co-operatives Secretariat

By

Farm Business Consultants

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Executive Summary

The Co-operatives Secretariat, Government of Canada, mandated Farm Business Consultants to undertake a capitalization needs assessment of agricultural co-operatives with a particular focus on debt financing. More specifically, there was a need to get information from co-operatives and lenders to identify where problems in accessing capital exist and why. Also an analysis of availability of debt financing and of capital requirements by sector, by stage of development, as well as by size, with a particular focus on small and medium size co-operatives was performed.

This study was intended to complement previous studies which indicated that the ability to raise capital is an impediment to both the development of new co-operatives and to the expansion of existing co-operatives. This study was completed by surveying both co-operatives and financial institutions.

Survey of Agricultural Co-operatives

The study found that existing co-operatives have very few problems borrowing capital, and in many cases they did not need to borrow as they are able to finance their expansion through retained earnings. However, there are established co-operatives that are experiencing significant market competition resulting in reduced income which then results in problems with financing. Ontario, as a region, had the highest level of existing co-operatives experiencing financial difficulty and consequently reduced access to debt capital.

The co-ops having difficulty accessing debt financing had a host of issues such as lower profitability, higher risk of their market sector, competition, management and insufficient retained earnings. Their business structure was not found to be the cause of credit limitations.

Special analysis was completed on newly formed co-operatives to determine whether they encounter issues related to debt financing. They report that the FIMCLA program was very helpful, and in some cases essential for their start up. They also report that having access to specialists capable of guiding them through all of the issues of establishing a new co-operative is an area where additional assistance would be beneficial. They report many benefits of choosing the co-operative structure, one of which was the loan guarantee program, and another is the preference of the farmers for this type of business structure. However, where a new co-operative wishes to establish a large business, there are difficulties in raising investment capital.

Survey of Lenders

The financial institutions surveyed treat co-operatives the same way as “broadly held” corporations. A few identified issues around how co-operatives manage their business as an area where risk is sometimes increased, as some co-operative's return too much profit to members leading them to be vulnerable to market volatility. Farm Credit Canada has been financing co-operatives although this portion of their portfolio is not large compared to corporations.

The FIMCLA loan guarantee program was one of the key issues the majority of the co-operatives in this sector identified as an area where a government program has been helpful. The level of awareness of the existing federal loan guarantee program (FIMCLA) was found to be very low, as several co-ops who are planning to expand were unaware of the program, and the few co-ops that were having difficulty with their financial institution were also unaware of the program. The level of support for the continuation of a loan guarantee program was very high amongst both co-operatives and financial institutions. The level of use of this program would have been much higher if the level of awareness was increased.

The study identified a need to provide more training for co-operative boards as an area where both the financial institutions and co-operatives surveyed found an opportunity for improvement. This is not because the individuals do not have suitable business skills; the issue is one of understanding board governance and the role of a Board member.

Identified needs coming out of the study

- Assist in strengthening existing co-op training. The study identified a need to provide more training for co-operative boards as an area where both the financial institutions and co-operatives surveyed found an opportunity for improvement. This is not because the individuals do not have business suitable skills; the issue is one of understanding board governance and the role of a Board member.
- Assist in the start up process; government support in the key phases of early stage development – in business planning and human resources that have co-op expertise to help develop the project.
- Help in building a financial plan and raising start up capital. There is a need to facilitate initial co-op structuring and to enable it to be properly capitalized, complying with provincial statutes and regulations.
- Investigate options to facilitate co-op access to equity from members, and to obtain outside investment through both tax measures (the co-ops mentioned the Co-op Investment Tax credit which was advocated by the sector organizations) and other non-tax measures.
- Enhance the FIMCLA loan guarantee to assist co-ops in accessing debt financing. The current eligibility requirements are considered too restrictive.

Project Summary as outlined by the Co-operatives Secretariat

This project will consist of undertaking a capitalization needs assessment of agricultural co-operatives with a particular focus on debt financing. More specifically, there is a need to get information from co-operatives and lenders to identify whether problems in accessing capital exists and if so why. Also an analysis of availability of debt financing and of capital requirements by sector, by stage of development, as well as by size, with a particular focus on small and medium size co-operatives will need to be performed.

Background

Numerous studies have been completed in the past where the focus has been on issues related to co-operatives. One of the more recent and more detailed studies was completed by Ernst & Young. This study determined that access to capital is a problem for co-operatives and recommended that additional assessments be carried out to determine the extent of the problem and to identify possible solutions. This study had not been carried out through extensive surveys of co-operatives.

The Ernst & Young Study was titled: "Canadian Agricultural Co-ops Capitalization, Issues and Challenges: Strategies for the Future". The key recommendations from this study that relate to capital are as follows:

1. Determine why co-operatives are not benefiting as much as they should from current federal government support programs.
2. Assess the level of participation in these programs by co-operatives in relation to the participation by other business structures.
3. Determine the capital requirements of the various size co-operatives in various sectors, with a focus on determining what are the future capital requirements.
4. Once the capital requirements are known, determine the gap if any exists between the requirements and the capital which may be available to a co-operative.

Our discussions with provincial government agencies and universities have indicated there have been a limited number of recent studies on this issue. Thus there is no known study project underway which may duplicate the work completed in this study.

The study focused on small and medium-sized co-operatives, which would normally have assets less than $50 million, however a number over this level where included. The study completed by Ernst & Young indicated that the large co-operatives have other alternatives for raising capital that are not cost-effective for small and medium-sized co-operatives. Therefore it was deemed there is a lower level of need to study larger co-ops, and a risk that it would be more difficult to maintain confidentiality of the results due to small sample size of the large co-operatives. The study team excluded livestock co-operatives, which had as a primary function to provide farmer-members access to special government loan guarantees, as this group is not reflective of other co-operatives.

In other words, we did not want to have their high success rate at obtaining credit influencing the results of the study.

Overview of Debt Capital Requirements

Due to insufficient data on existing co-operatives, it is not possible to utilize the survey results to calculate the potential demand for capital from this type of survey. Thus the survey team utilized Informa's multi-client North American study on demand for agricultural capital and sources of agricultural finance. This study focused on the need for capital at both the farm and agricultural processing levels, and then assessed where capital would be sourced in the future.

Their study is forecasting a 3% capital growth requirement in the agricultural processing sector. The survey indicates that co-operatives are competitive and are either stable or in expansion. Thus, although the study did not segregate co-operatives, the best indication we have of future capital needs for co-operatives is an annual requirement for 3% per year.

Availability of Debt Financing – The Co-operatives Experience

Financial institutions treat most co-operatives as “broadly held” corporations. A broadly held corporation has multiple individuals involved in ownership and often has a management team rather than major investors as managers. A “closely held” corporation is normally a small number of individuals where the major shareholders are often involved in managing the corporation.

Financial institutions do not identify the type of business structure in their client database, and as a result the study was not able to obtain data comparing co-operatives to corporations. The survey of financial institutions indicates that they do not undertake marketing initiatives to source new clients by business structure. Portfolio risk management strategies result in financial institutions selecting certain enterprises they focus on for new business development, and other enterprises they may select to limit new lending activity. Therefore where a new co-operative may experience difficulty sourcing debt capital, the issue was most often the type of enterprise not the business structure. See page 15 of the study for information on financial institutions.

FIMCLA is a loan guarantee program which provides up to $3 million of loan guarantee to qualifying co-operatives. This program had a very low level of awareness amongst existing co-operatives, and in particular a limited level of awareness amongst newly established co-operatives. As a result, the study found numerous situations where the program would have been able to assist in the start up of new co-operatives or prevent financing problems for existing co-operatives. See page 20 for more information on FIMCLA.

Survey of Co-operatives

There are regional differences with Ontario experiencing a higher level of debt access problems than other areas. We looked at the issue of whether the few having difficulty would have had easier access if they were corporation. In other words, did the structure of their business create the reason that they had some difficulties obtaining financing? Because of the regional differences we are reporting the results by the following regions: Western Canada, Ontario, Québec and Atlantic. Small and medium-size cooperatives where selected for the vast majority of the survey candidate's.

WESTERN CANADA SURVEY RESULTS

Sales for Co-Ops Surveyed ($million)

0 to 5	29 co-ops
5 to 20	8 co-ops
20to 50	11 co-ops
50 plus	3 co-ops
Total	**51 co-ops**

Type of Co-op Surveyed	
Marketing	11
Supply	28
Service	12

Fifty one co-operatives were surveyed. A high level, over 92% of the co-operatives reported “no problems” in obtaining adequate debt capital. The majority of this group is able to finance expansion from internal operations. There was a very high initial survey response rate, in that every co-op contacted was willing to indicate whether or not access to credit was a problem or not. Due to the high number reporting “no problems” and the timing of the survey, many did not want to take the time to complete the full survey, for the following reasons:

◊ Some felt that since they did not have a problem they could not comment on the subject, as they do not take the issue to their Boards, do not have business plans done (as they do not need them), and they haven’t talked to a financial institution.
◊ Some felt that advising the study team that they have no current and future borrowing problems was enough assistance, given they are very busy with other work.

Western Canada Co-operatives reporting “some” problems

In one case, the co-op had to restructure their credit a number of years ago. It was implied that the board of directors came to the realization that all profit could not be returned to the members. To grow, it is necessary to reinvest the profits. In effect, the board shifted their focus from just satisfying the members, to satisfying the business needs of the co-operative. This co-operative now enjoys a “preferred credit rating”.

A co-operative that processes products for members had credit problems 2 years ago when they reported losses on their operations. Their bank provided them with formal notice that they would have to correct this problem in the coming year. They made arrangements with their members to reduce the payments made to members that year. This solved the problem with the bank and they are very profitable today. They are in the process of an expansion and are still with the same bank. The manager indicated he would have expected the same reaction from the bank if they were a corporation. They were unaware of the FIMCLA program and indicated that it may have helped them deal with the bank.

A co-operative that was starting up in specialized sector had to raise more capital from members than expected as they could not obtain normal loan to security levels for the land they purchased. The surveyor has had direct experience with sole proprietors in the same sector who have had similar experiences, thus it is the enterprise that is the limit on capital not the co-operative structure. They reported they are profitable and planning on expanding. They were unaware of the FIMCLA program and this could have resolved their financing problems. We have put them in touch with the FIMCLA manager. Another organic co-operative reported no problems in the past and they are currently expanding without problems. Therefore, the co-operative with problems would have had the same problems with a corporate structure.

Of the co-operatives reporting problems, one would be considered large and the others small with all three types, marketing, supply, and service reporting problems. Thus the co-operatives were not segmented into one particular area.

Western Canadian co-operatives reporting “no” problems

The majority of these co-operatives did not have an issue that was top of mind in terms of an area where they felt they need assistance. This is a sign that they are feeling very much in control of their destiny, and yet many of them reported constraints on future expansion. That key constraint on expansion of their current business model is that they would have to take market share away from a neighboring co-operative in order to expand. The majority reported they are in an expansion mode, and that they are looking at the services they can provide in their geographic area. The influx of very large box stores within several hours distance was reported as a constraint on some of the services that some provide in the rural areas. A significant number of co-operatives indicated that they have no competition because no one else is prepared to provide their service in their area. Therefore if it was not for the existence of the co-op, members would have no service. None of the co-op's of this nature reported problems accessing credit, as they have very strong local support. One co-op of this nature has had a multimillion dollar credit facility in existence for a number of years without ever using it.

One outcome of this survey is that we have found the co-op sector to be financially sound, stable, in many cases able to finance expansion with internal resources, and in most cases not worried about whether they need to have access to credit. This fact was a major constraint on collecting additional detail in the survey as we had an extremely high rate of managers who responded to the survey, but very few who would take the time to comment on financing structure, human resources, business plans, etc.

With regard to those co-operatives that did respond about business plans, the expanding co-ops had business plans, the holding steady co-ops didn't and most likely they don't need a business plan. . Where formal business plans are prepared, the assistance of professionals is used to help management prepare the plan.

Staff recruitment varies. Where possible, well trained staff is the preferred choice however competition is fierce from the oil industry. In the case of the steady co-ops, the reliance seems to be on knowledge of the co-op and clients served by the co-op. In one case, the co-op strives to hire high school students as part of their training role to the community. The work earns school credits, provides spending money for the young persons and awakens them to the need for better education. This co-operative is indeed fulfilling its role to the community it serves. Staff turn over didn't suggest any significant difference from other sources of employment however no comparison could be made to industry norms.

Not all co-operatives had affiliations with other co-operatives. Most co-ops that were affiliated, relied on supplies and training from Federated co-op as well as financial advice from their local Credit Unions.

Only one co-operative thought the popularity of co-operatives was increasing. The rest thought the co-op movement was steady. Most agreed that co-operatives play an important role as an alternative in the event that corporations don't fairly respond to their needs. They also agreed that co-operatives offer a good solution to niche marketing needs to communities too small to attract corporate service providers.

Three quarters of the supply co-ops indicated that they where expanding, and that they had suitable internal resources to manage this expansion. Some indicated they had recently expanded without any difficulty in obtaining financing. The remainder of the supply co-ops that are not expanding indicated that a saturated market was the key constraint on expansion, and in many cases for them to expand they would have to take business away from a neighboring co-op.

Most of the service co-ops were providing seed cleaning services; they have a very loyal customer base, and described themselves as stable or slowly expanding. The balance were feed mills which described themselves as stable in a sector that has over capacity, however in some cases, no competitor is trying to service their market due to distance.

The marketing co-ops surveyed were diverse as nearly every type of production marketed was surveyed. They were all in a very strong financial position and described themselves as stable. They generate their income from activities associated with marketing their member's production, thus they do not experience as much market volatility as co-operatives which must buy and hold inventory until it is sold. However, one did report problems in a year where volumes were low, but there was no risk of long-term financial difficulties as they did have a captive market

Federated Co-op

The co-operatives in western Canada cited unanimous praise for the efforts of Federated Co-op in assisting them with managing financial issues. This was not a question structured in the initial survey however it was mentioned on numerous occasions, and there is no doubt that as one of the managers put it "having a mother ship to guide you tends to keep you off the rocks". There is also no doubt that having the support of an experienced, financially sound, co-operative like Federated Co-op has increased the access to credit for those co-operatives which fall under their umbrella.

ONTARIO SURVEY RESULTS

Sales for Co-Ops Surveyed ($million)

0 to 5	8 co-ops
5 to 20	6 co-ops
20to 50	5 co-ops
50 plus	4 co-ops
Total	**23 co-ops**

Ag Supplies	10 co-ops
Marketing	8 co-ops
Processor	3 co-ops
Services	2 co-ops
Total	**23 co-ops**

Twenty-three co-operatives were surveyed. The sample selected is considered to be very representative of the different types and sizes of co-ops that operate in Ontario in the target group, and also represents a sizeable percentage of those co-ops. Most co-ops in Ontario have been in business for a long time, but 4 co-ops in operation less than 15 years were surveyed.

A lot of amalgamation has taken place in the supply co-op sector in the past 20 years. Many of those supply co-ops are also dealers in grains and oilseeds, which may represent up to half of their total business. There have been some recent failures of co-ops of significant size. In addition, about 10 years ago United Co-Operatives of Ontario (UCO), the main supplier for the supply co-ops, entered into bankruptcy. The assets were acquired by US based Growmark, which now carries on the role of the former UCO. Although this survey was not designed to analyze the profitability of co-ops, it is evident that some sizeable co-ops in the supply-grain dealer group are going through financial difficulty. This was freely admitted by those particular co-ops.

About half (52%) of the Ontario co-ops surveyed indicated that they have had no problems with accessing capital, and occasionally they changed financial institutions to obtain a more favourable arrangement. It should be noted that 1 co-op, representing 4% of the 52%, does have some anxiety regarding an upcoming large essential capital project. No formal loan application has been made. This will be a relatively big borrowing step for this co-op, but it is considered premature to state that they will not be able to obtain suitable capital for this project.

The survey results revealed minor difficulties with 26% of the survey group with issues such as reduced loan amount or repayment period, greater security requirements, stringent loan conditions, or higher than market interest rates. These were considered to be only minor issues for the co-ops involved, and upon further questioning, it was evident that these factors only had minor impact on their business.

The remaining 22% (5 co-ops) did indicate that they are having more serious difficulties meeting their credit requirements. Before reaching any conclusions, it is necessary to carefully look at each of these 5 co-ops to explore the reasons for their concerns:

1. This co-op was declined by its financial institution. It has not defaulted on any loans, but is attempting to restructure its loans. There were valid business reasons for the bank's position; losses for the past few years and a need for better management of the business.

2. This co-op has not been declined, but has not been able to obtain the quantity of credit, the length of payback period, interest rate, security requirements, and loan conditions it felt applicable to their situation. The individual surveyed felt that the reason was sector risk and low equity.

3. A start-up co-op with limited equity. It was not declined for credit, but could not obtain the amount of credit, interest rate, security requirements, nor loan conditions that it felt it deserved.

4. This co-op reported problems with interest rates higher then the market rate and security requirements greater than anticipated. No formal application was made for more credit, as their banker did not appear receptive, and they have had weak financial results in recent years.

5. In this situation, the co-op experienced problems with the amount of loan offered being less than applied for, and loan conditions that negatively impacted the co-op. The co-op readily admitted to cash flow problems and some management problems.

By examining each of the 5 co-ops individually, it is considered that there were issues related to profitability, equity or management that resulted in those particular co-operatives having problems.

Co-ops in Ontario are expanding, over 30% of the co-ops surveyed indicated that they are expanding, while over 50% consider themselves as holding steady. The remaining state that they are consolidating or most likely will be, in the near future.

The survey indicated that co-ops considered "competition" as the number one impediment in the development of co-operatives in Ontario. The second factor was various government regulations, including environmental issues and reporting issues. Availability of credit was a distant third factor followed by human resources and then other issues, which included declining numbers of farmers in the area serviced. Only 2 co-ops reported availability of credit as their main impediment and a further 2 ranked it as their second most important impediment.

In Ontario, only 4 co-ops (17%) were aware of FIMCLA. One of these is using it and a second is now applying. The other 2 thought that they were either not eligible, or were told that the amount was not enough and there would be too much paperwork. Five of the co-ops who did not know about it were interested in knowing more about the FIMCLA program.

Five of the 23 co-ops (22 %) surveyed in Ontario have loans outstanding with FCC. Several others have discussed financing with FCC staff. It would appear that most Ontario co-ops, who have term loans with sources other than their own members, have some knowledge of the lending programs of FCC. Five of the co-ops (22%) in the completed survey category, in Ontario, have loans outstanding with Credit unions. None of the Ontario co-ops surveyed had obtained Venture Capital to assist in meeting their financial needs.

Most Ontario co-ops (77%) indicated that the popularity of co-operatives is holding steady. The others generally felt that they were decreasing in popularity. Only one co-op surveyed expressed the opinion that they thought they were increasing in popularity.

Clearly the number one recommendation for government assistance to help remove potential borrowing constraints that are faced by co-ops was for loan guarantees – 52% of the co-ops surveyed. Interest rate subsidies (30%) ranked second. It was generally felt that subsidies should not be provided to co-op agri-businesses and the 30% may reflect wishful thinking. As for the various choices in the area of Management and Training assistance, Board of Directors Training and assistance with business planning, were mentioned by 22% each. Growmark does offer various Training and Management assistance programs to its member co-ops.

QUÉBEC SURVEY RESULTS

Sales for Co-ops Surveyed ($million)

0 to 5	8 co-ops
5 to 10	6 co-ops
10 to 15	5 co-ops
15 to 20	6 co-ops
20 plus	5 co-ops
Total	**30 co-ops**

Type of Co-op Surveyed

Marketing	3 co-ops
Supply	27 co-ops
Service	1 co-ops
Total	**30 co-ops**

Thirty co-operatives were surveyed. Co-operatives (co-ops) are at various stages of development, 10 % were incorporated in the past 4 years. A small majority report that they are at an expansion stage, and a minority reports that they have reached a maturity stage. This minority is mainly made up of co-ops with an annual income smaller than $10 million.

Access to Credit–Québec

The majority (± 80%) of co-ops surveyed say that they did not encounter any roadblocks while applying for financing in the past. However, a large number of co-ops with an income lower than $15 million experienced numerous difficulties such as greater security required, reduced loan amount, higher interest rates.

Of all the participating co-ops, none knew the exact amount of the credit rating allocated by their financial institution. A very small number (14%) of co-ops had to restructure their loans during the last few years. For the most part, those co-ops had an income above $10 million. Overall, the capital of co-ops is made up of: one third (1/3) in equity and two third (2/3) in loans.

Surveyed co-ops find that most of the financial institutions understand their financial needs; however, they mention that some constraints still exist such as: additional security requirements requested by some financial institutions, lack of knowledge regarding co-ops business cycle, securities appraised at lower value, etc.

Les Caisses populaires (Credit Unions) are the main source of credit for most co-ops. Participating co-ops also mention that they do not use multiple financing institutions in order to obtain funding.

Without being major obstacles, some concerns have been expressed regarding some financial institutions practices such as: limiting access to financing, requesting additional securities and increasing interest rates, profitability ratios, the nature of co-ops operations, credit standards, etc.

The majority participating co-ops do not know about the different loan products or venture capital offered by Farm Credit Canada.

Finally, none were aware of the Farm Improvement and Marketing Co-operatives Loans Act (FIMCLA).

A small number of co-ops surveyed have a business plan and reviews it on a regular basis. This business plan is more likely used as a management tool by co-ops with an income over $10 million. Amongst co-ops using their business plan, several indicated that actual results were often below the projections outlined in the business plan. Finally, a few co-ops (5%) indicated that their Caisse Populaire assisted them in the preparation of the business plan.

The main selection criteria used to hire managers vary according to co-op income level. Co-ops with income below $5 million state that the main selection criteria used to recruit management staff is knowledge of the co-op and its business. On the other hand, as the co-op income increases, post-secondary degrees become the main selection criteria. Generally, the management staff turn over rate varies from 0 to 15%. It is higher for co-ops with an income below $10 million.

During the last few years, a small amount of co-ops has used assistance programs, more precisely human resources training programs. Co-ops highly value these programs and find them beneficial.

Co-ops are facing heavy competition in their respective area. This situation is due to factors such as prices, the variety of products offered and the size of the competition.
These co-ops believe that some internal factors such as their size and capital availability play a limiting role. A small number of co-ops (5%) indicated that they had merged during the last five (5) years with another co-op. This situation is mainly found amongst co-ops with an annual income above $15 million.

Finally, the main factors co-ops view as obstacles to their expansion include funding availability and human resources. Only a few co-ops mention competition and governmental intervention as obstacles.

Co-ops as a management structure was viewed as increasing in popularity. In the event of governmental involvement, co-ops would like to see the implementation of programs focusing on loans guarantees and interest rate subsidies.

In addition, the vast majority of co-ops surveyed, believe that a federal government assistance program (régime canadien d'investissement coopératif - RIC) aimed at promoting and strengthening co-op investment would be the best form of governmental assistance. They also recommend the development of federal tax measures to encourage members or other investors to invest into co-ops.

La Coopérative Fédérée de Québec

This federation was recognized by both co-operatives and lenders as having created an environment to enhance the availability of debt capital. They provide management training, training for Board members and assistance with the development of financial reports and business plans. A very important function is that if a co-operative does experience financial difficulty, this organization will send in resources and make arrangements to turn around the situation. As a result, the financial institutions have a great comfort level in lending to co-operatives in Québec.

ATLANTIC PROVINCES

Sales for Co-ops Surveyed ($million)

0 to .5	4 co-ops
.5 to 1	1 co-op
1 to 5	3 co-ops
5 plus	2 co-ops
Total	**10 co-ops**

Ag Supplies	3 co-ops
Marketing	5 co-ops
Processor	0 co-ops
Services	2 co-ops
Total	**10 co-ops**

Ten co-operatives were surveyed. The sample is considered to be very representative of the different types of co-ops that operate in these 4 provinces in our target group. The Atlantic co-ops were found to be relatively small with sales in the 10 co-ops surveyed averaging about $3 million and assets of $1.6 million. Forty percent actually had assets of $200,000 or less.

Forty percent of the co-ops surveyed reported that they are expanding, although only 1 (10%) reported more than modest expansion in process. Another 40% reported they are holding steady while 1 co-op (10%) mentioned it is consolidating and 1 (10%) mentioned it is getting smaller due to fewer farmers in the sector involved.

The survey revealed very few with access to credit issues in Atlantic Canada. Only 1 (10%) reported any issues as it had its operating line of credit reduced because their profits were too low. Another co-op advised that it had issues with its financial institution, when it approached another financial institution and all of its needs were met.

The survey indicated that availability of credit ranked well down on the list of impediments in their development. Human resources and declining numbers of farmers in the area serviced were the primary concerns. Competition and government regulations also were greater concerns than access to credit. Only 1 co-op (10%) indicated availability of credit as the most important impediment to the development of the co-operative.

In Atlantic Canada, 3 co-ops (30%) were aware of the FIMCLA program. Only 1 co-op is using it. Another inquired, but was told it was not eligible, while the third found that FIMCLA was not useful to it, as it has better options.

The number one recommendation for government assistance to help remove potential borrowing constraints that are faced by co-ops was for loan guarantees, 6 co-ops (60%), and another 6 mentioned assistance in the planning and preparation of effective Business Plans, as the main items recommended. Four co-ops (40%) recommended that interest rate subsidies be considered.

Survey of Recently Established Co-operatives

Atlantic	4
Québec	3
Western Canada	2
Sales $0-5M	6
Sales GT$5M	3
Marketing	5
Supply	4

Twenty seven recently established co-operatives where identified and 9 of them were contacted in addition to those surveyed above. The purpose was to determine their experience with raising investment capital and borrowing debt capital. The results show that the FIMCLA loan guarantee was essential for the co-operatives which succeeded in getting established with very little startup problems. There where several recently established co-operatives that were not aware of the FIMCLA loan guarantee and this would have assisted them in reducing the complexity of arranging guarantees from individuals in the co-operative. Where new cooperatives need to raise significant amounts of equity capital, there are sometimes problems and this is an area where assistance could be provided.

Two of the co-operatives in this group where established by individuals with experience in establishing several co-operatives. They stated that the FIMCLA loan guarantee made the process very easy for them, and in one case this was one of the reasons they chose the co-operative model.

A large start up co-operative which has not yet completed its requirements to establish their business indicated they have received reasonable offers of debt and investment capital. They chose the co-op model because it is a better structure for the following reasons:

- they felt it was easier than establishing a publicly traded company
- they had concerns about a large player coming in and buying of the shares of a publicly traded company

- the structure was quite appealing to members
- they could raise a certain amount of capital without as much regulatory compliance as they would have had with a Corporation.

One of these co-operatives did not achieve their start up goals, because they did not receive adequate advice on issues related to provincial securities regulations. Due to the seasonal nature of their operation this was a critical factor and they missed a start up deadline. This co-operative was unaware of the loan guarantee program, and the program could have provided significant assistance. They did not get to the stage of applying for debt capital because of the securities problems.

Awareness of the FIMCLA loan guarantee is a problem, as those co-operatives who where aware of the program utilized the program, and those who were not would have benefited from the program. All 9 of these co-operatives strongly support the continuation of the loan guarantee program as an area where the government can play a key role in helping established co-operatives.

The majority (66%) of the co-operatives in this group struggled with all of the issues associated with developing a new business, largely due to a lack of individuals with experience in establishing new co-operatives. A third of the co-operatives in this group had either the availability of an experienced consultant or an experienced individual who guided the producer groups through the process. Therefore a recommendation from all of the co-operatives in this group was that assistance from the government in facilitating the availability of knowledgeable individuals would enhance the ability of new co-ops to get established. One of the co-operatives indicated this would have made a dramatic difference in their results.

Two co-operatives identified the limitation on RRSP investments to 10% of an investors portfolio was a factor which hindered their ability to raise investment capital.

Survey of Financial Institutions

Western Canada

The survey was completed after 80% of the co-operatives have been surveyed, so that any of the issues, which developed out of talking to the co-operatives, could be dealt with when talking to the bankers.

Every bank and credit union reported that they do not segregate data on their co-operative loans. In other words, they do not have the ability to compare the quantitative results of their loans to co-operatives versus loans to corporations. In every case, the financial institutions reported that they handle co-operatives the same as "broadly held" corporations.

Several bank managers reported that they felt many co-operatives tend to prefer to deal with credit unions, as some co-operatives view them as a similar organization, which sometimes has some of the same people on the local board. However these bank managers also indicated that they will provide aggressive loan pricing in order to compete for the co-operative's business.

When asked if their financial institution targeted co-operatives as a market they wish to pursue, all respondents indicated they target certain enterprises, and do not focus on what the business structure is. Portfolio risk management is the science of measuring the amount of risk your financial institution has in certain sectors, and most of the financial institutions are following similar systems for managing risk. Thus it is not surprising that the response was a focus on enterprise, and this would explain why some businesses, which may not have had a problem in the past might find their financial institution reluctant to continue to do business at previous risk levels. In other words if a financial institution finds it has too many loans of a certain type, they will cease making loans in the sector or will take actions to reduce their portfolio exposure to that sector.

Ontario and Atlantic

The Lender's surveyed indicated a willingness to lend to co-ops, although, as expected, this represents only a small portion of their agricultural business. The FIMCLA Program was considered a factor which would cause a bank to prefer a co-op structure, but it does not apply to all co-ops. It seems to be known and liked by lenders but not used very often. One lender mentioned that another advantage that co-ops offered to them is that audited financial statements were also always provided. As far as processing and assessing a loan application is concerned, no significant difference from corporations was revealed.

The main weakness mentioned is related to the fact that the members/owners are also the main customers. Co-ops who sell farm supplies may keep prices down for their members, rather than strive for high profits. This does concern lenders as businesses need profits as reserves for poor years and capital investment. One lender expressed concern with aging facilities, with questionable re-sale value which puts their security at risk. Another lender indicated co-ops sometimes have difficulty shutting down an unprofitable location as it serves their members located nearby. The lack of personal guarantees is also considered a weakness. Half of the lenders surveyed indicated that co-ops represent a higher risk with the other half indicating that lending to co-ops is a similar risk to lending to corporations.

Québec

The results clearly indicate that financial institutions exercise the same care and apply the same procedures in approving and administering a co-operative (co-op) loan as making a loan to corporations. They neither require different criteria nor follow a different process when approving loans to co-ops than to corporations.

Generally according to financial institutions, both the information provided and the business plan (when required) are of the same quality as those provided by other corporations, except in the case of a few small co-ops which sometimes provided insufficient and incomplete information.

When comparing the gap between actual results versus projected financial results, financial institutions indicate that both co-ops and corporations obtain the same results.

The portion of agri-loans portfolio of financial institutions varies greatly from one institution to another. In terms of number of loans and dollars outstanding, agri-loans represent less than five (5%) of their portfolio; however, there are considerable variations depending upon the geographical location of the same financial institutions and depending upon the different types of institutions. Credit Unions (les caisses populaires) report making a higher portion of loans to co-ops.

The purpose of the loans covers all the stages of development of co-ops, with maybe an emphasis on operating loans. Finally, financial institutions rarely make venture capital investments in co-ops because due to the structure of most co-ops, as with out the use of investor class shares, there is limited ability for the investor to take advantage of the growth in the business.

Generally the financial institutions give the same risk rating to co-op loans as corporation loans. They also do not require additional collateral if co-ops meet the usual rating standards used by lenders. Finally, defaults on loans by co-ops are the same as other corporations.

These financial institutions, however, mention that co-ops have unique characteristics which must be taken into account, such as inefficient management in small co-ops, lack of additional funding, under capitalization, limited access to liquid assets, and sometimes a board of directors that are too entrepreneurial.

The number of loans made to co-ops should remain firm during the next few years, according to financial institutions surveyed. Some institutions, however, believe that some changes could occur following the merger of some co-ops, thus creating new needs and business opportunities.

Financial institutions would also favour the introduction of a federal government assistance program aimed at encouraging investment in co-ops (régime canadien d'investissment coopératif - RIC) and new tax measures in order to increase the number of external investors.

Farm Credit Canada

Farm Credit Canada (FCC) is the largest agricultural lender in Canada, with a mandate to ensure capital is available for the Ag sector. FCC is a crown corporation with offices across Canada. FCC was able to do a special analysis of their data to assess how many co-operatives there are in relation to the number of corporations in their portfolio. This data could potentially understate the number of corporations due to the method of selecting accounts. The accounts were selected based on the name of the client thus the following data represents the number of clients with either corporation or co-operative in the name.

Asset Level	Corporations	Co-operatives
0 to $5 M	4232	36
$5 - $20 M	579	10
$20 to $50M	49	5
+$50M	14	2

Venture Capital

None of the co-operatives contacted in the study have utilized venture capital. Three co-operatives indicated they investigated utilizing venture capital however the level of returns requested by the venture capital companies where higher than the co-operative was willing to undertake. One co-operative that is in the process of getting established indicated they may utilize venture capital and they have received a proposal from a venture capital company.

The Vice President of FCC Ventures stated that they have made 10 investments for a total of $22 million since the establishment of their venture capital group three years ago. FCC has not made a venture capital investment in a co-operative. He indicated that a typical co-operative structure does not facilitate a venture capital investment, as in many cases the venture capitalist is looking for an increasing share value. Co-operatives have the capability to create value; however in most cases the co-operative passes the value on to members rather than increase share value.

In the United States, CoBank which is the largest co-operative financial institution stated they have been able to utilize a venture capital partner in states that have established special laws allowing a co-operative to have “investor” shares. Additional information on CoBank can be found in this study.

The study group did not find any other venture capital group in western Canada, which made investments in a co-operative. Discussions with a venture capital fund in Québec indicated that their minimum expected return on capital would be a barrier to co-operatives as it is much more expensive than raising investment capital from members.

Investment Capital - Canada

Discussions were held with a number of the provincial government representatives whose responsibility it is to assist in the development of co-operatives. These discussions revealed that the legal framework exists to develop co-operatives, new generation co-operatives, or hybrid co-operatives that have the capability of attracting investor capital.

The focus of this discussion was to determine why it is so rare to have venture capital invested in a co-operative. The consensus is that more work needs to be done in this area to develop the skills needed to put deals together. In other words, a new group of producers proposing to develop a business would find it much easier to find consultants, lawyers, accountants, and venture capitalists, who would encourage them to use the corporate model rather than the co-operative because that process is well understood. The study group recommends that consideration be given to developing resources available across Canada to help new groups form co-operatives and successfully raise investment capital. There are very few legal firms positioned to provide advice on this topic at the present time, so additional work in this area would be beneficial.

Consideration should be given to developing a coalition of mature large co-operatives that work with a special group to raise start up capital for new co-operatives. In other words, the co-operative system has a lot of the required resources to increase the amount of investment capital available for new co-operatives however there is no lead mechanism for doing this at the present time.

Saskatchewan's ANGen Program

Saskatchewan has new generation co-operative legislation that permits an investor type of share in a co-operative; however the investor share is limited to 20% of the capital compared to 50% permitted in the State of Minnesota. The Minnesota model requires that a minimum of 60% of the profits flow through to the patron members, Therefore it is not likely investors would invest beyond 40%.

The Saskatchewan ANGen program pays up to $100,000 of the following:

- Market assessment: identify the market potential and the market trends for the proposed product.
- Feasibility study: analyze the viability of the project and evaluate the chances of success.
- Business planning: develop the marketing, management, human resource, operating and financial elements of a sound business plan.
- Organizational development: develop the legal framework involved with formalizing the New Generation Co-operative organizational structure and developing the bylaws and articles of incorporation.
- Prospectus: preparation and approval of a prospectus required by Saskatchewan regulations
- Securities Commission to offer securities to potential shareholders.
- Pre-design of facilities: design specifications of facilities.
- Assistance can not be used for operating costs or the purchase of land, buildings or equipment.

We were advised that only two or three potential co-ops have used this program per year.

Alberta New Generation Co-operatives

New generation co-operatives (NGCs) in Alberta can have any level of investor shares as a part of the co-operative. The government representative for assisting NGCs advised that 9 new generation co-operatives have been formed, however some of them are not active.

A new meat processing co-operative is proposing to use both a corporate and co-operative structure in order to raise capital and manage some issues such as capital gains exemption. This hybrid business structure would see a new generation co-operative formed consisting of farmers who would have delivery rights and obligations to the co-operative. The co-operative would then invest in the Corporation, which would own the processing facility. The rationale for this dual structure is that it makes it easier for the non-farm investors and for the members of the co-operative. Venture capitalists and other investors are familiar with the corporate model, while the members of the co-operative would retain the rights of the majority investor in the new processing facility.

Loan Guarantee Program – FIMCLA

The initial meeting with the project steering committee revealed that a study is underway for this program to determine the effectiveness of the assistance and to suggest areas of improvement. As this FIMCLA study did not focus specifically on co-operatives, this study team was asked to include questions to solicit response on FIMCLA utilization by co-ops.

100% of the co-operatives responding to the question in Western Canada and Québec were unaware of the FIMCLA program. There was limited awareness in Ontario and Atlantic. Those who were not expanding or using cash to expand did not have any interest in the program; however the others did want details on the program in case it could be of assistance. The survey of credit unions and banks indicated that some are aware of the program but the majority are not. (This will be partly due to the fact that most of their co-operative clients are extremely strong, and concerns about risk are not top of mind, Therefore they tend to forget a program if it is not used).

The lack of use was due to a lack of awareness, not a lack of need. The availability of a loan guarantee was the most often suggested recommendation by the existing co-operatives responding to the survey.

Eligibility for a loan guarantee can be a problem if there is a requirement that 100% of the members be engaged in farming. This limits access to investor members, can prevent memberships from being sold to people in the community who might use the service, and can prevent management from being rewarded with shares. Therefore eligibility criteria might be based on the majority control by farmers.

Experience in Other Countries

The United States has a co-operative sector which is very similar to Canada, along with a similar agricultural and business environment. Thus the study team focused on research with the key agricultural co-operatives who provide financing to co-operatives within the United States.

An interview with one of the senior bankers in one of the largest agricultural financial institutions in United States revealed some issues which are causing a shift towards more limited liability corporations (LLC's) as the structure to choose for start up agricultural businesses.

He cited one of the major law firms which have assisted the development of co-operatives is now counseling many groups of farmers who wish to establish new businesses to use the limited liability corporation or LLC business structure. One of the key reasons for this is that an LLC will have an easier time raising capital than a corporation, not because the financial institutions favor them, but because many of the investors favor them. The reasons he cited for investors preferring and LLC is that the investor can sell their shares in the future as a means of exiting the investment. He stated that more of his farming clientele are looking at their non-farm investments as part of their retirement strategy, and in this strategy the ability to receive a capital gain and have liquidity are key issues. (One must note that laws regarding business structure have recently been changed in several states to bring co-operatives on to an equal footing with corporations.)

Many co-operatives in the United States are required to certify that every member is a farmer every year. This is a constraint on the ability to attract management, and he cited a number of the ethanol facilities that they have financed as an example. They have invested in over 15 facilities, all of which have the majority of shares owned by farmers, however the management of the ethanol facility has shares and is rewarded with options to purchase shares in the future. This results in a management team that is very committed to increasing the value of the facility, resulting in the farmers receiving a good return on their investment.

His financial institution has passed on the opportunity to finance two new ethanol facilities because of a lack of local investor support. As he puts it, the existing facilities are having a phenomenal year with the price of fuel being so high and price of corn being so low. Thus, the ability to attract local investment capital is the key constraint on the proposed two new facilities that they will not finance. Therefore in this situation, if the business model was proposed to be a co-operative, and if in this state the lack of "investor" shares resulted in a lower level of local investment, then it would be reasonable to state that co-operatives have less access to capital. At the banking level, they are only prepared to finance a certain percentage of an ethanol facility no matter what the business structure is.

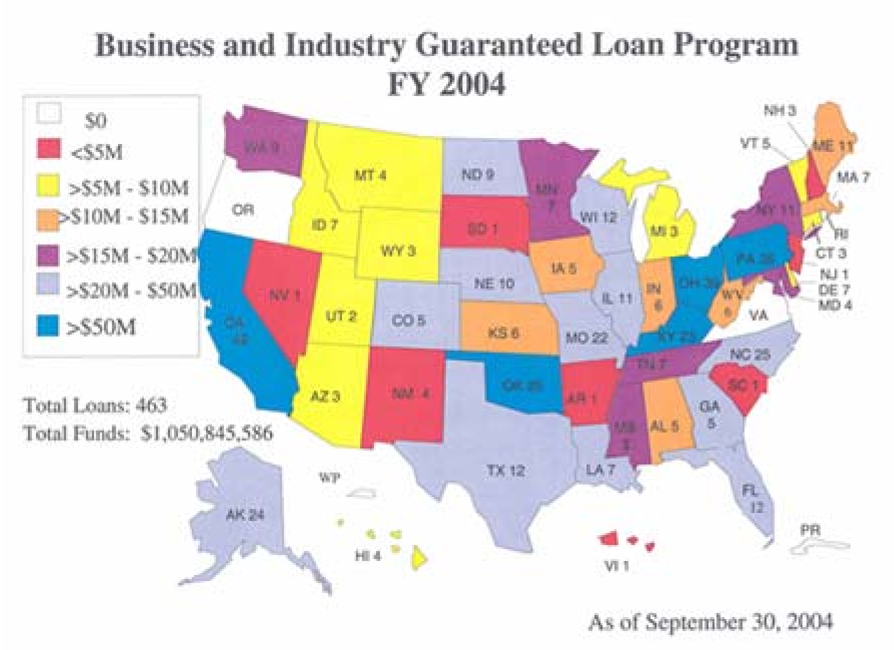
In summary, this experienced Ag banker who started his career financing a large number of co-operatives is seeing a shift away from the co-operative model, **in some states**, due to the increased flexibility that shares in an LLC offer versus having stock in a co-operative. Another key point he made is that good projects get funded, no matter what the structure. He also stated that in their marketplace farmers have made good money by investing in their own farm operation, and thus there has been some reluctance to invest beyond their farm. He indicated that many projects have been pushed by local economic development officers, who are trying to develop jobs in their community, rather than being pushed by strong farmers who have a good business case for developing a value added business. Therefore some of the projects, which have not received funding, have been an attempt to build a business in the wrong agronomic area. This has led to the failure of a number of co-operatives in the United States, and he cited several examples, some of which they have invested in.

CoBank has been very successful and financing co-operatives, however due to some changes in regulations, more financial institutions are able to compete with CoBank. Therefore co-operatives in United States have more choice and more competitive interest rates, and as a result US co-operatives have better access to borrowed capital than in the past.

The key message for Canadian co-operatives is that having flexibility for how you structure shares in a co-operative may prevent a similar trend from developing here. This co-operative banker admitted that in all honesty he would advise a group to look at using an LLC versus a co-operative structure, and this is what is occurring in their marketplace. **Note:** his territory does not include the states, which have passed legislation to permit up to 50% **investor class** co-op shares.

US Loan Programs for Co-operatives

The Business and Industry (B&I) Guaranteed Loan provides guarantees up to 80 percent of a loan made by a commercial lender. Loan proceeds may be used for working capital, machinery and equipment, buildings and real estate, and certain types of debt refinancing. Assistance under the B&I Guaranteed Loan Program is available to virtually any legally organized entity, including a co-operative, corporation, partnership, trust or other profit or nonprofit entity. The maximum aggregate B&I Guaranteed Loan(s) amount that can be offered to any one borrower under this program is $25 million. A maximum of 10 percent of program funding is available to value-added co-operative organizations for loans above $25 million to a maximum aggregate of $40 million. Thus a co-operative has a higher available loan guarantee than other business structures.



Value-Added Producer Grants (VAPG) The maximum amount that can be awarded is $500,000, and all VAPG funds must be matched by an equal amount of funds from the applicant or a third party. In 2004, approximately $13.2 million was available for grant awards. Rural Co-operative Development grants are made for establishing and operating centers for co-operative development for the primary purpose of improving the economic condition of rural areas through the development of new co-operatives and improving operations of existing co-operatives. The maximum amount that can be awarded is $300,000, and recipients must provide matching funds at a level of 25% of total project costs. Approximately $6.3 million was awarded to 24 recipients on September 10, 2004.

Co-Bank

A Co-Bank representative did advise that recent changes to co-operative legislation in several states have made it possible to invest equity capital in co-operatives. This is the ability to use investor class shares. He advised that these changes did not result in any changes to their credit policies however it has made it much easier for a co-operative to raise investment capital in the local community, and their organization has partnered with a large venture capital firm and as a result they are financing more co-operatives in the states with this new legislative capacity. A chart showing a comparison of the growth of the corporate sector versus co-operative sector in Wisconsin shows this impact.

New Filings in Wisconsin

Year	Total Corporations	LLCs	LLPs	Cooperatives
1996	8,533	3,478	880	14
1997	7,952	5,567	962	12
1998	7,035	7,656	787	16
1999	6,767	9,785	596	8
2000	6,647	11,674	489	12
2001	5,828	13,953	424	22
2002	5,716	17,388	367	14
2003*	3,424	12,548	211	6

*First six months

Source: Bernice Smith, Wis. Dept. of Financial Institutions (608/264-7803)

PLEASE NOTE: No comparable Minnesota data is available from the Secretary of State

The above chart outlines the trend toward LLC's and limited liability partnerships (LLP's) in relation to co-operatives.

This is an excerpt from Minnesota's press release on new co-operative legislation:

The landmark new Chapter 308B statute was proposed to provide flexibility to Minnesota co-operatives attempting to raise equity for modernization or expansion.

Chapter 308B allows for the ability to raise equity from non-patron investors and patron members to meet the minimum equity requirements and pay more than 8% return on the investment.

Chapter 308B requires that patron-members hold at least 50% of the voting powers in "general matters of the co-operative." Patron members are guaranteed at least 50% of the voting power on the board of directors and patron member board votes are counted as a block. This 50% threshold is intended to encourage consensus decision-making with investor board members. However, patron members can set this minimum level higher.

Chapter 308B provides significant protections for patron members. Patron members have the financial right to no less than 60% of the 308B co-operatives' profit allocations and distributions unless patron members vote to reduce their financial rights. If patron members vote for a change that reduces their financial rights to less than 60%, the patron members must still receive at least 15% of the profits even if investor members *own more than 85% of the equity. Patron members can set significantly higher levels of patron member financial rights in the bylaws.*

Therefore, the research on access to capital in the United States does show that changes in how co-operatives can be structured with investor shares was needed to allow the co-operative model to compete for investor capital.

The Consulting Team

FBC is a private tax and business consulting firm that specializes in serving the needs of rural Canada. FBC has been in operation for over 50 years and has over 22,000 members who utilize our tax preparation services resulting in over 50,000 tax submissions being filed each year. In response to requests from our members, FBC is establishing one of the larger business consulting teams focused on serving rural Canada.

Ron Witherspoon P. Ag., VP Advisory Services, FBC. Mr. Witherspoon has over 30 years of experience in agricultural finance and investment. Most recently, he managed an agricultural venture capital firm that established over two dozen new businesses, all of which are in the agricultural value added sector. Ron has participated on the board of numerous profit and nonprofit organizations, and he was Saskatchewan's representative on the Federal Provincial investment attraction committee. Raised on a farm in Carberry, Manitoba, Ron graduated from the University of Manitoba and worked in four provinces with Farm Credit Corp. While at FCC, Ron held the positions of A.V.P. Business Development, A.V.P. Portfolio Management (responsible for risk assessment) in corporate office and then A.V.P. Lending, and A.V.P. Administration in the Saskatchewan region. Ron has led alliances with multinational companies and has extensive connections in the agricultural sector in the United States. Ron is also functionally bilingual.

John McGee - completed a 35 year career with Farm Credit Canada, and retired in 2003. During this time, he worked in most sections of this financial institution, including technical work and program supervisory positions in the areas of loan origination, administration of existing loans, problem solving with farmers in financial difficulty, public relations, advisory services and various special programs. John spent the last few years of his career working with clients facing serious financial challenges, in order to resolve their problems. In many of these cases, this involved a co-operative effort with the Farm Debt Mediation Services.
While with FCC, John acquired considerable survey experience. He was the coordinator for the Province of Ontario for one of the surveys, which involved training staff who completed the surveys, answering questions and coordinating and checking completed surveys. Also, John has completed surveys himself, at various farms in Central Ontario, for 2 of the other surveys completed by FCC.

Gary Shufelt - bilingual, managed the Business Planning for Agricultural Ventures project for Agriculture Canada, held a number of management and research positions with Farm Credit Corporation. Gary is capable of conducting interviews in both languages, has resided in both Eastern and Western Canada.
Gary was born on a farm in Québec, held a number of positions with FCC, while Executive Assistant to the Chairman, Gary developed a number of connections within Agriculture Canada and numerous farm associations including English and French speaking co-operatives. Gary was responsible for a number of significant research projects many of which relied on data that he helped compile from farm surveys. Gary arranged for the completion a survey of the participants in the Business Planning for

Agricultural Ventures project, with the result that this was one of the highest rated programs offered to date.

Gérald Tétreault, MBA – bilingual, has over 26 years of experience in the agricultural sector. Gérald is a consultant for the Farm Debt Mediation Service in Québec since 1986 . Gérald held a senior management position with Union des Producteurs Agricoles du Québec (UPA).

Gérald Tétreault provides consulting services to farmer organisations, government and private individuals. Gérald has participated in different studies for UPA, MAPAQ, KPMG and he has conducting interviews for Farm Credit Corporation, Bulletin des Agriculteurs, KPMG, IQOP, and SOM.