



Co-operative Capital Units as a Solution to Co-operative Financing



Sustainable Co-operative Enterprise Project

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CO-OPERATIVE CAPITAL UNITS AS A SOLUTION TO CO-OPERATIVE FINANCING

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ABSTRACT

A major issue for many co-operative enterprises is the ability to raise capital to fund growth. Considerable attention has been given to facilitating access to non-member capital sources and managing and accommodating such financing. This paper examines the merits of a new financial instrument known as the Co-operative Capital Unit (CCU), introduced in Australia to increase the co-operative sector's flexibility in raising capital. Using a Delphi Panel approach the likely attractiveness of alternative CCU structures in terms of ownership rights, profit distribution, market facilitation and governance options were examined. We conclude that a CCU is likely to be of most value as an equity (rather than debt) instrument and propose CCU taxonomy depending on co-op ownership rights. We further propose an equity capital structure for a newly funded co-op to illustrate how CCUs could best be used to address some of the generic challenges facing co-ops.

Key words: co-operative enterprise, financing, equity, co-operative capital unit, Delphi panel, conjoint analysis.

INTRODUCTION

A co-operative (co-op) is a unique type of non-government, member-owned business entity that is owned and controlled by its members. Co-operative organisations are major contributors to local, national and international economies. In 2007 some 800 million people were members of co-ops worldwide (UN 2007) and the world's top 300 co-ops had a combined annual turnover of 1.1 trillion USD, a figure equivalent to the 10th largest economy of the world (ICA 2008). In Australia, the top 100 co-ops, credit unions and credit mutual firms have a member base in excess of 13 million people and a combined annual turnover of AUS\$14.7 billion (Co-operatives Australia 2011).

A major issue for co-ops can be the ability to raise capital to fund growth and considerable attention has been given to finding alternative capital sources, managing and accommodating such financing. The distribution of shareholder control is a fundamental point of differentiation between co-ops and investor owned enterprises, as co-ops do not allow concentration of shareholder power. Shareholder benefits are also more likely to be delivered via patronage (members' proportion of trade) rather than dividends, and this can limit the ability of the co-op to raise external capital (Bacchiega and de Fraja 2004; Roy 1976; Staatz 1987).

In some legislative environments a co-op is required to maintain all ownership vested within active members (members that are trading or have traded with the co-op within a defined period of time, generally a maximum period of 3 years). In this case any external capital can only be raised through financial instruments

that do not attract the conventional voting rights of an investor owned business. In addition, the co-op is commonly required to buy back the share capital of members that retire or become inactive; introducing a potential, and in some cases substantial, liability for the organization. An example can be found in the agricultural industry where farm consolidations over the past decade have placed financial pressure on co-ops in Australia and internationally, as large numbers of retiring farmers concurrently seek to have their shares bought back by the co-operative.

Furthermore, Australian co-ops law requires Co-operatives to adhere to the “one-member-one-vote principle”, which in some cases acts as a disincentive for member investment in their co-op on a long term basis. When combined with a lack of transferability, liquidity and appreciation of member equity, members are unable to capitalize on their investment or adjust their personal holding in the co-op and associated investment risks. Pressures therefore emerge to streamline co-op investment portfolio according to members’ risk profiles. Many hybrid forms of co-op have emerged over the years seeking to overcome some of the inherent weaknesses of co-ops without losing their fundamental strengths (Nilsson 1999; Chaddad and Cook 2004).

This study aims to explore the potential of the Co-operative Capital Unit (CCU), introduced in Australia under various State Co-operative Acts to increase the flexibility of capital raising and alleviate some of the above challenges faced by the co-operative sector in Australia and internationally.

LEGISLATIVE REQUIREMENTS FOR CCUs

This study took place within the context of the proclamation of the Co-operatives Act WA (2009). This replaced the previous Co-operatives legislation and introduced a number of new measures including the ability for co-ops to issue CCU. An interesting feature of the Act is the inclusion of the seven co-operative principles as outlined by the International Co-operative Association (ICA), which are now enshrined in this legislation (Part 1, Division 3).

Prior to the passing of this Act, Co-operatives in Western Australia were able to raise capital from non-members only through the issue of subordinated debt or debentures. A major impact of the new legislation is the introduction of the CCU, which is intended to provide a flexible instrument for capital raising without compromising the integrity of the co-op.

A Co-operative Capital Unit (CCU) is defined within the Co-operatives Act WA (2009) as:

“An interest issued by a co-operative conferring an interest in the capital, but not the share capital, of the co-operative” (Co-operatives Act 2009 (WA), Division 2, s257(1)).

Therefore, a CCU holding does not carry the rights of co-operative membership. A CCU can be structured as debt or equity and can be issued to both members and non-members. In order to issue such an instrument, a co-op must have rules which authorize and govern the issue of CCUs. The rules must contain the requirements outlined in section 261 of the Act as a minimum. These requirements state that:

- Each CCU holder is entitled to one vote per CCU only at a meeting of CCU holders;
- The rights of CCU holders may be varied according to their terms of issue with the consent of at least 75% of the holders;
- The holder of a CCU has none of the rights or entitlements of a member of the co-operative; and
- A CCU holder has the same rights as the holder of a debenture in respect to receiving notice of all meetings and other documents.

The terms of issue of a CCU must include details of entitlement to repayment of capital, entitlement to participate in surplus assets and profits, entitlement to interest on capital including whether interest is cumulative or non-cumulative, details of how capital and interest on capital are to rank for priority of payment on a winding-up, whether there is a limit on the total holding of CCUs for non-members of the co-operative and what that limit is (section 262).

FIGURE 1: FEATURES OF A CCU

A CCU:

- Can be structured as a debt or equity instrument;
- Can be issued to both members and non-members;
- Does not carry the rights of co-operative membership;
- May only be redeemed out of profits or the proceeds of a fresh issue of shares or CCUs.

CCUs are not to be issued unless the terms of issue are approved by a special resolution of the co-op and the Registrar, who is not to approve the terms of issue unless satisfied that they will not result in a failure to comply with co-operative principles and are not contrary to the rules of the co-op or the Act (section 262).

CCUs may only be redeemed out of profits or the proceeds of a fresh issue of shares or an approved issue of CCUs (section 264). The Act further allows for the conversion of CCUs held by an active member of the co-operative into shares of the co-operative, if there is such a provision in the terms of issue of the CCUs (section 266).

CCUs were first introduced in NSW in 1992, however only a small number of NSW Co-operatives have since made a CCU issue. In NSW a non-distributing co-operative can only redeem CCUs using proceeds from a fresh issue of shares or a new issue of CCUs made for the purpose of the redemption. This restriction may have attributed to the small uptake of CCUs. The WA Act does not have the same limitation with WA non-distributing Co-operatives able to use profits to redeem CCUs.

The West Australian and Victorian Acts also allow for one vote per CCU whereas the current NSW Act restricts voting to one vote per holder whenever a vote by CCU holders is required. The WA and Victorian Acts are therefore more favourable to an investor as their voting entitlement reflects their investment holding in line with conventional investor expectations. Not until the current draft Co-operatives National Law is adopted will the current NSW Act restriction be removed. There is no provision for issuing CCUs in either the SA or QLD Act. The issue of CCUs by Co-ops in those states will only be possible once they adopt the Co-operatives National Law. The Western Australia government has advised industry, in line with the wishes of the WA co-operative sector, that the Co-operatives Act 2009 will be maintained although amendments will be considered where necessary to have the WA legislation “corresponding co-operatives law” for the purposes of the Co-operatives National Law.

METHODOLOGY

Financial and legal experts in the co-operative sector were sourced nationally and internationally to form a Delphi Panel of experts. The Delphi method was developed in the 1940s by the RAND Corporation for the United States military with the aim of drawing together a consensus of opinion from a cross-section of experts

in a timely and controlled manner (Dalkey and Helmer 1963). It involves an iterative process of building a consensus view across the panel. The anonymity of the panel is important because it is desirable that the views of each individual are kept separate in case they should bias the views of the others.

The Delphi approach has been used as a research methodology with acceptable levels of validity across a wide range of social science disciplines for many years (Landeta 2006). Its characteristics involve a series of repeated rounds in which the experts are asked for their opinions on a given set of questions at least twice. In the first round they provide their opinion, then the results are collated and the composite view of the panel is fed back to panel members who are asked to reconsider their response. Panel members are then in a position to either stand by their first judgment or revise it in the face of the wider group opinion if their original position is at variance with that of the panel. The number of rounds required depends on the speed by which a consensus position is reached. The benefit of the Delphi approach is that the opinions of the panel are controlled for potential bias whereby one dominant individual might otherwise influence the views of others. The feedback to the panel is controlled by the researchers who act as panel coordinators. All opinions across all rounds form part of the final result.

The Delphi panel was asked to evaluate how CCUs can be utilised by a co-op to raise and retain capital. Panel members provided opinions on ownership rights, profit distribution, market facilitation and governance options in terms of their attractiveness for investors, members and co-op managers alike. It should be noted that due to the complexity of the subject of enquiry and thus the need for a high level of expertise, we targeted a panel of 6 to 9 members which resulted with the successful employment of 8 panel members for Round 1 and 7 of those members for Round 2. Therefore the results from the Delphi Panel method can only be assessed qualitatively as the sample size restricts us from applying statistical methods of analysis.

The Delphi panel surveys were delivered online using “Limesurvey” software, which allowed quick and cost-effective communication with panel members and data collection with a fast turnaround time (Gordon and Pease 2006). A combination of closed-ended and open-ended questions were used and upon the completion of two rounds we achieved a satisfactory consensus as to the most likely combination of CCU characteristics, depending on the purpose that the CCU is intended to serve.

The first round of the survey was exploratory in nature. Eight examples of potential CCU issues were presented and the panel members were asked to evaluate the terms of issue and each CCU instrument as a whole in terms of its attractiveness for the organisation, members, member-investors and external investors. Open ended questions allowed panel members to provide detailed comments on each CCU instrument, raising any concerns and proposing alternative structures.

The second round included two sections. The first section provided an overview of the opinions that were presented in the first round, allowing panel members to provide further comments, benchmarking their input against the information gathered to-date. A conjoint survey formed the second part of this round, focusing on alternative structures of equity-like CCU instruments, as these seemed to pose greater challenges as opposed to debt-like structures.

Conjoint analysis is a research method for eliciting respondents’ preferences that has been used extensively in marketing and health care research (Green et al. 2001; Ryan 2000). Sixteen hypothetical, multi-attribute models were shown to respondents in a sequential fashion and respondents were asked to rate their preference for each model (profile). Four attributes were used: ownership, governance, profit distribution and market facilitation of the CCU instrument. Each attribute was broken down into a number of levels (see Table

1). Each model was a combination of levels from all attributes, similar enough that respondents would see them as close substitutes, but dissimilar enough that they could clearly determine a preference. The analysis of respondents' preferences revealed trade-offs between various levels of the four key attributes, as well as the most preferable combination.

TABLE 1: CONJOINT DESIGN

ATTRIBUTE	LEVEL	OPERATIONALISATION
Ownership	Inside	<ul style="list-style-type: none"> The buyer must be either an active member of the Co-op or the Co-op itself (past members and their beneficiaries can retain their holdings)
	Outside	<ul style="list-style-type: none"> Subsequent to their issue can be traded between members and non-members alike
Governance	No Control	<ul style="list-style-type: none"> CCU holders have no representation on the board of the Co-op
	Some Control	<ul style="list-style-type: none"> CCU holders elect a predefined number of directors to the board of the Co-op (less than half)
Market Facilitation	Private	<ul style="list-style-type: none"> Sold privately at a price agreed by the seller and buyer
	Coop	<ul style="list-style-type: none"> Sold in a market operated by the Co-op at a value determined by an annual sworn valuation
	Third Party	<ul style="list-style-type: none"> Sold on a secondary market operated by a third party
Profit Distribution	100	<ul style="list-style-type: none"> 100% of new venture profits distributed annually as dividend
	50	<ul style="list-style-type: none"> 50% of new venture profits distributed annually as dividend
	Bonus	<ul style="list-style-type: none"> Fixed dividend referable to market rates plus bonus dividend at the discretion of the board
	Discretion	<ul style="list-style-type: none"> Variable dividend as determined annually by the board

RESULTS

Data from Round I included: i) quantitative ratings of alternative CCU instruments in terms of their attractiveness for the organisation, members, member-investors and external investors; ii) comments justifying the quantitative ratings; iii) answers to open ended questions; and iv) propositions for alternative CCU structures not captured by the survey. Two panel directors (researchers) processed the information and filtered out irrelevant content. The following views in relation to CCU ownership rights, returns and redeemability clearly emerged from the first round of the Delphi survey. When presented to the panel in the second round, further clarifications and a general consensus emerged.

CCU STRUCTURE – DEPENDENT ON PURPOSE

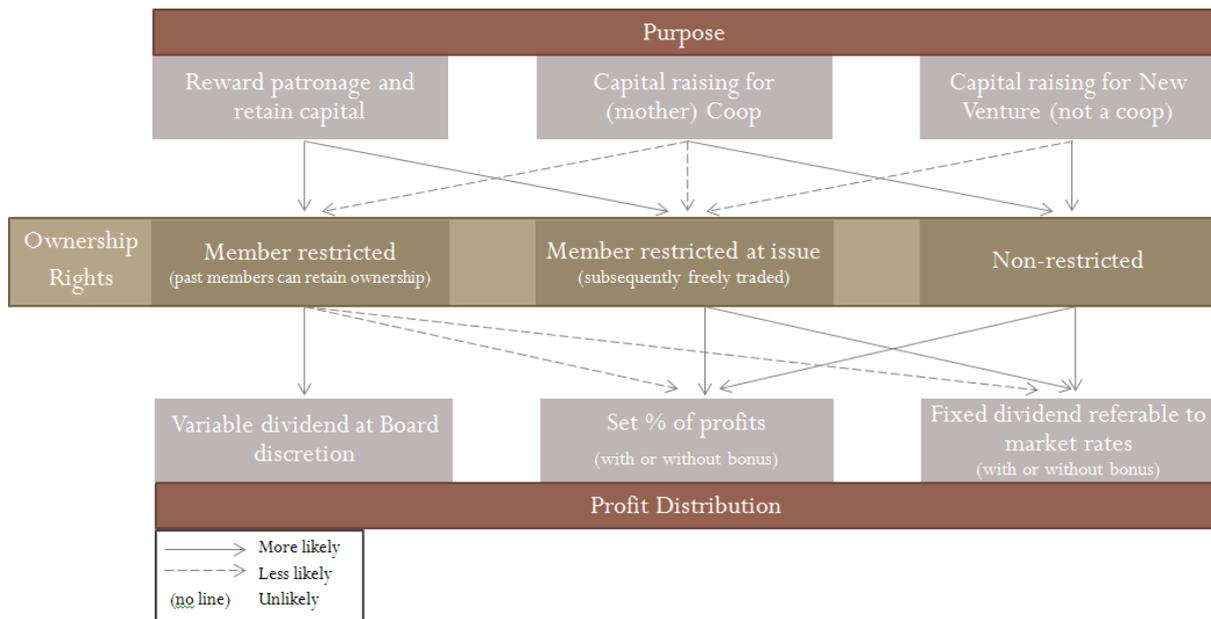
The CCU structure is found to be highly dependent upon the purpose that a CCU is designed to serve. The Delphi Panel identified at least three distinct CCU purposes:

1. Reward patronage and retain capital in the co-op.
2. Raise capital to be invested within the co-op.
3. Raise capital to be invested in a new venture (an investment project or a subsidiary entity that is set up as a corporation).

Figure 2 provides a conceptual framework of a CCU instrument, illustrating the most attractive combinations of terms of issue regarding ownership structure and profit distribution depending on CCU purpose. Continuous

lines connecting two boxes indicate “more likely” combinations, dotted lines indicate “less likely” combinations and if there are no lines connecting two boxes then it was regarded as an unlikely combination.

FIGURE 2: CCU PURPOSE, OWNERSHIP RIGHTS AND PROFIT DISTRIBUTION



A CCU with the purpose of rewarding patronage and retaining capital in the co-op is distinctly different to CCUs issued to raise new capital. In the former case the co-op will award CCUs to its active members as part of its allocation of retained earnings policy. By default members become the initial owners of those instruments, ownership is therefore either member restricted or restricted at issue and subsequently freely traded to increase instrument liquidity (Figure 2). It should be noted that even under member restricted purchase it was deemed appropriate to allow past members and their inheritors to retain ownership in order to reduce co-op financial stress and allow for retaining capital upon member retirement.

On the other extreme side of the diagram if the purpose of the issue is to raise capital for a new venture, then it is more likely to pursue non-restricted ownership to raise funds that are not otherwise readily available. A possibility within the non-restricted ownership structure would be to offer members the first right to ownership/refusal. It is also possible that ownership may be restricted to members initially, however subsequently becoming freely traded to increase liquidity. It was regarded unlikely to pursue member-only ownership for this purpose as it would severely impact on CCU liquidity.

When a CCU issue is for the purpose of raising capital for the mother co-op entity (e.g. to be invested in growth or expansion) it is similar to the previous example with non-restricted ownership more likely. Noting that CCU owners do not have voting rights, non-restricted ownership would increase instrument liquidity and attractiveness.

The last row on the diagram (Figure 2) examines distribution options. Offering a variable dividend at board discretion would only be appropriate for member restricted ownership. This assumes that as all CCU owners are members they have a level of trust and influence on the board and are therefore comfortable that the board would make a fair dividend distribution. This distribution option does not commit the co-op to a specific

dividend distribution and it is therefore the simplest and most likely distribution option for a CCU with member restricted ownership.

A set percentage of profits or fixed dividend/interest referable to market rates are likely distribution structures for capital raising CCUs (Figure 2). The choice between these options is a matter of management preference according to the nature of the investment opportunity. A co-op may choose to share the investment risk with the investors and offer a higher return linked to investment success (e.g. a high % of profit distributions) in the case of higher risk investments. Alternatively a co-op may choose to pay a set dividend/interest on the capital from the beginning and reap the majority of the investment returns. A floating interest/dividend was regarded a very appropriate distribution structure by the majority of the Delphi Panel, when it comes to a longer-term or ongoing investment.

Panel members expressed concern in relation to variable dividends tied to organisational success. Potential governance challenges could be intensified in the case of a CCU that raises capital for the formation of a subsidiary entity with a distribution plan linked to the subsidiary's performance, as transfer pricing can take place. The following recommendations were made by the panel to ameliorate such concerns:

- An independent audit of profit calculations should take place where transfer pricing or overhead calculations are involved.
- A dispute resolution process should be established with expert determination provisions, to ensure that dispute resolutions can be arrived at quickly and inexpensively.
- The definition of profit and the profit calculation formula should be sufficiently robust to adjust for events that neither party anticipated (e.g. carbon tax costs).

An issue not expressly addressed by Panel members but recorded as a matter requiring investigation is the taxation consequences for both an issuer and a holder of a CCU of the way in which the return on a CCU is structured.

CCU STRUCTURE – RIGHT TO OWNERSHIP

Taking into consideration that CCUs do not attract voting rights; the panel experts agreed on three key issues. First, limits on the rights attaching to CCUs are likely to reduce take up, so fewer limits are recommended. Second, tying eligibility for an allocation of CCUs to a prospective member-investor's existing holdings seems inconsistent with the purpose of CCUs as a vehicle to raise capital. There should, therefore, be no cap on investment. Finally, allocations based on patronage could be attractive for some co-ops that have strong views about the alignment of member and co-op interests and could also be more attractive to larger members; while it should not be opposed by smaller members given the instrument would not attract additional voting rights.

CCU STRUCTURE – RETURNS AND REDEEMABILITY

There was consensus amongst the panel experts that a floating interest/dividend rate at a fixed margin referable to market lending rates (e.g. x% higher than the 5-year government bond rate) for longer-term or ongoing investments would be appropriate. It was felt that this provides certainty for the investor and for the co-op in terms of funding costs.

There was also support for CCUs to be traded amongst members on a secondary market (to increase liquidity and reduce Co-op financial stress). Plus, upon liquidation of the enterprise, CCUs should rank ahead of

ordinary share capital. Further, there was consensus that the variable dividend tied to enterprise success is likely to give rise to corporate governance issues in terms of potential conflict of interest at board level. Finally, it was agreed that early redemption by the board is not commercial unless a premium is paid on redemption. It should be noted that these views were expressed by the Delphi panel without a full understanding of the taxation consequences given the novelty of the CCU as a financial instrument.

Although some panel experts were in favour of a variable dividend component related in some way to the enterprise's success, others raised concerns over decision making. There may be a continued push by member-investors for dividends over re-investment which would be opposed by members that don't have CCU holdings. This could introduce political pressures at Board level, potentially reducing the ability of the organisation to retain capital for future investment opportunities and for working capital purposes.

Some panel experts regarded redemption at the option of the board as a very unattractive feature for investors unless there was a sizable premium paid to compensate for lack of liquidity. Some were in favour of redemption at the option of the investor upon reasonable notice for fixed term debt instruments, while others raised the concern of increased financing stress for the co-op, especially as CCU's cannot be repaid from debt, only from profits or another share or CCU issue

CCU STRUCTURE – MARKET FACILITATION

The research findings suggest that the issue of market facilitation would need careful consideration. Panel members tended to agree that private sales agreements between sellers and buyers are a viable option only in the case of member-restricted ownership of CCUs. However, a secondary market facilitated by a third party was deemed more likely to increase take-up of CCUs by non-member investors.

The panel suggested the idea of ownership being open only to members of other co-ops, creating a market where co-op members can invest in each-other's co-op in line with the 6th international co-operative principle "Cooperation among co-operatives". Such a market could be facilitated by the co-ops representative body or another independent party

CCU STRUCTURE – GOVERNANCE

Finally the issue of investor control concerned the panel members, and they were unable to reach a consensus on this issue. The panel was consulted on whether CCU holders should have representation on the board of the co-op by way of being entitled to nominate up to Y independent directors (where Y is less than half). Some panel members expressed the view that CCU holders should not have (additional)¹ representation on the board of the Co-op, as the directors cannot represent a class of investors and must adhere to their fundamental directorship responsibility of making decisions with the interests of the corporation of which they are a director as their primary concern. According to this view, the establishment of representative arrangements will likely place directors in a difficult position and could give the CCU investor a false sense of security. Other panel members were of the view that such a representation arrangement should be considered as it is likely to increase the attractiveness of the instrument for investors.

¹ "Additional" refers to member-investors that already have a voting right as members and under this term they would be acquiring additional representation on the board as CCU holders.

CONJOINT MODEL

The conjoint analysis examined panel members' preferences in terms of various operationalisations of ownership, control; market facilitation and profit distribution (refer to Table 1 for attribute level operationalisation). The analysis of responses resulted in the following utility factors shown in Table 2.

TABLE 2: CONJOINT UTILITY FACTORS

ATTRIBUTE	LEVEL	UTILITY FACTORS	ATTRIBUTE'S IMPORTANCE
Ownership	Inside	-0.24	13.2%
	Outside	0.24	
Governance	No Control	0.08	19.8%
	Some Control	-0.08	
Market Facilitation	Private	-0.39	15.4%
	Coop	0.06	
	Third Party	0.33	
Profit Distribution	100	0.63	51.6%
	50	0.35	
	Bonus	0.64	
	Discretion	-1.62	

When the utility scores are examined more closely, it can be seen respondents had greater preference for a CCU that was governed by the following terms:

- Subsequent to their issue can be traded between members and non-members alike (0.24)
- Sold on a secondary market operated by a third party (0.33)
- Fixed dividend referable to market rates plus bonus dividend at the discretion of the board (0.64)OR 100% of new venture profits distributed annually as dividend (0.63)
- CCU holders have no representation on the board of the Co-op (0.08)

Negative utility factors were attached to the following terms which were viewed unfavourably:

- The buyer must be either an active member of the Co-op or the Co-op itself (past members and their beneficiaries can retain their holdings) (-0.24)
- Sold privately at a price agreed by the seller and buyer (-0.39)
- Variable dividend as determined annually by the board (-1.62)
- CCU holders elect a predefined number of directors to the board of the Co-op (less than half) (-0.08)

In terms of the relative attractiveness of the four attributes that were examined it is concluded that distribution (51.6%) is the major determinant of investor attractiveness. The other three factors were also deemed attractive with governance 19.8 per cent, facilitation 15.4 per cent and market 13.2 per cent. When examining preferences within this important attribute (Distribution) we find that respondents differ in opinion, which may mean that the most preferable terms of distribution will depend on the specifics of the CCU offer. If for example the new venture is not expected to require capital for expansion then distribution of 100 per cent of profits may be the most attractive option. The risk associated with the venture/investment could also make a fixed dividend with bonus (Bonus) option more attractive than a set percentage of profits and vice versa

DISCUSSION

Let us now overview these findings and consider what they mean in relation to the use of CCU within co-ops as a future funding mechanism.

IS THE CCU A PROMISING EQUITY INSTRUMENT?

One of the key conclusions of this study is that in our view CCUs have little to offer co-ops as a debt-like instrument in comparison to conventional debt instruments that are currently available to co-ops. Although a CCU could be structured as a conventional debt instrument the new terminology would only generate uncertainty for investors and it is therefore unlikely to be used as such. CCUs could however be a promising new form of equity for co-ops that could achieve the following goals:

- De-couple co-op ownership from control (as CCUs do not attract voting rights), and thus
- Attract external equity, additional member investment or reward patronage while maintaining democratic member control; and
- Allow for members to retain equity upon retirement.

Whereas non-member shareholders can pose a risk to the co-op as they retain voting rights, this limitation is overcome as CCU holders have no voting rights. The challenge is to structure a CCU in such a way that investors still find it an attractive proposition despite their lack of voting rights and thus co-op control. Examining the proposed distribution options in Figure 2 we note that by attaching a fixed dividend/interest referable to market rates a CCU is effectively transformed to a debt-like instrument. Paying a set percentage of profits can be an effective distribution structure when the CCU is linked to an investment project or entity. The real challenge is to develop a CCU structure that would enable paying a variable (and potentially “franked”) dividend at board discretion (which would be preferable from the co-op’s perspective), while still remaining an attractive investor proposition.

A VARIABLE DIVIDEND CCU STRUCTURE

The following CCU structure is proposed as a way to maximize attractiveness from the perspective of the co-op and the investor:

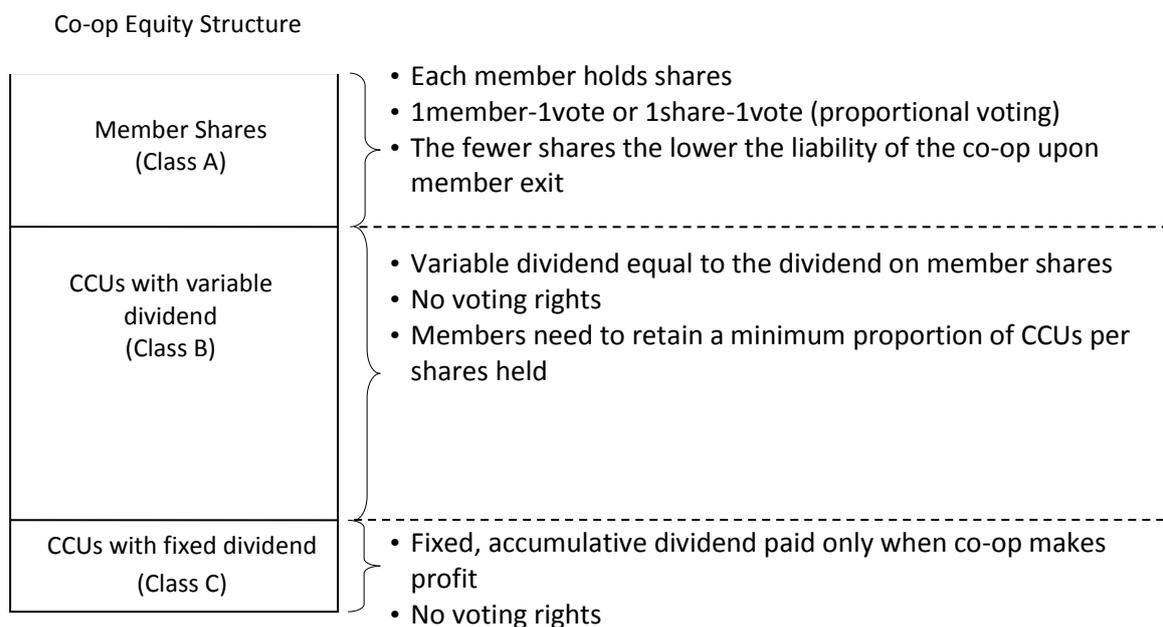
1. CCUs to be equity instruments that attract no voting rights and can be owned by member-patrons and non-members alike.
2. The dividend paid on CCUs and member-patron shares is the same and is variable upon board discretion.
3. Member-patrons need to retain a minimum proportion of CCU holding against their member-patron shares until retirement (e.g. 1000 CCUs per 1 member share).

By linking CCU and member share dividend one ensures that CCU investors’ and member-patrons’ interests are streamlined. This is further strengthened by the requirement for member-patrons to retain a proportional holding of CCUs to their member shares, ensuring that members will have a continued, strong interest in the value of CCUs. This structure cannot eliminate investor concern that co-op members may have a preference to extract benefit via patronage rather than share distribution, which can place less emphasis on co-op profitability and share distribution. If however the proportional holding of CCUs vs. member shares is such that

members are required to have a significant capital investment in their co-op, this would ensure that members share a strong investor interest in their co-op in addition to their patron interest.

Figure 3 illustrates the proposed equity structure. In addition to the variable dividend CCUs (class B), the co-op may choose to issue fixed dividend CCUs (fixed dividend referable to market rates or a set percentage of an investment's profit) (class C). It is proposed that the latter (class C) is structured as a preference share that is paid only when the co-op makes a profit and accumulates over time.

FIGURE 3: PROPOSED CO-OP EQUITY STRUCTURE



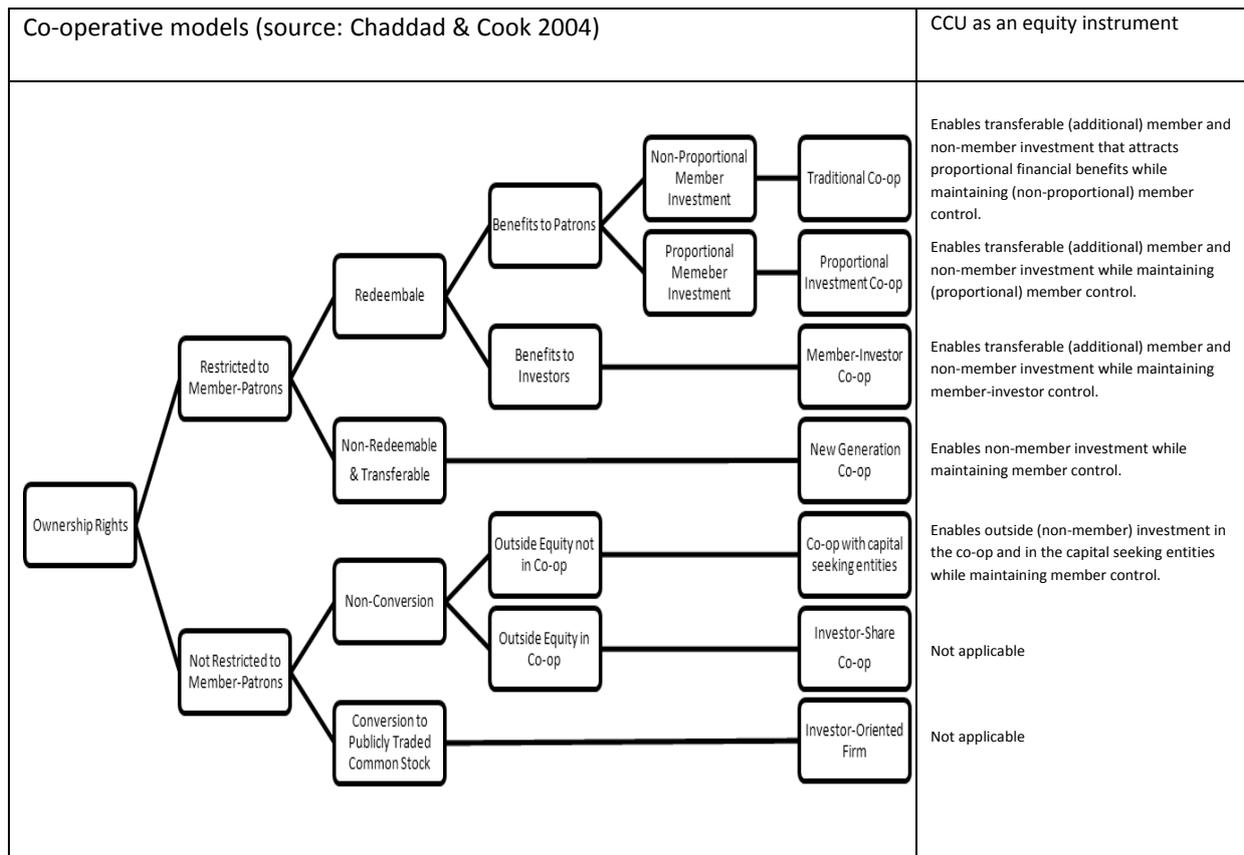
CCU AND ORGANISATIONAL DYNAMICS

Co-ops suffer from a series of generic weaknesses involving free-riding, short term horizons, conflicts over shareholder rights, misalignment of member and co-op interests, and agency costs associated with the management of a complex network organisation (Cook 1995). These challenges are due to vaguely defined property rights (Nilsson 1999), as well as the dual function of the co-op that is mirrored by the dual function of its members as patrons and investors. Nilsson (2001) points to the tensions that this dual role can generate and the impacts that this can have on the management of the co-op. Member and organisational needs can be competing at times, as retaining surplus operational capital or conducting investments to ensure the longer-term competitiveness of the organisation is commonly not well received by members with a shorter investment horizon, or members that prefer economic benefits through patronage (amount of trade) and thus put continued pressure for better prices and lower transaction costs.

Co-op members place varying degrees of importance on their patron and investor roles. At the two ends of the spectrum when more importance is clearly placed on patronage (traditional co-op) or investment (co-op that operates with an investor-owned firm model) co-ops seem to encounter only minor property rights problems (Nilsson 1999). When both investor and patronage interests are significant the co-op moves towards an "Entrepreneurial" model which may allow for proportional member investment, appreciation of equity and the

inclusion of non-trading investors through a multiple-class capital structure. The Proportional Investment Co-operatives, Member-Investor Co-operatives, New Generation Co-operatives, and Investor-Share Co-operatives (Chaddad and Cook 2004, see Figure 4) represent a range of ownership right structures that have been adopted by this type of co-op.

FIGURE 4: CCU IMPACT ON CO-OP OWNERSHIP RIGHTS



CCU as an equity instrument has the potential to be used by both traditional co-ops and more “entrepreneurial” co-op models to adjust the balance of patronage and investment interest among members.

The proposed variable dividend CCU equity structure (figure 4) provides a mechanism that enables the co-op to function in any spectrum from a traditional co-op (CCU and member-share dividend is low) to a co-op that is more investor oriented (high requirement of CCUs per member share, high dividends paid). CCUs increase transferability and liquidity of member equity and can attract external capital investment in the co-op without compromising member control. As such CCUs have the potential to impact on co-op ownership rights models as noted in Figure 4.

In the case of an existing co-op (e.g. a traditional co-op) that wishes to attract external capital, CCUs can initially be rewarded to members (e.g. based on history of patronage) in order to build up a critical mass of CCUs to cover the minimum holding per member share (refer to equity structure model in figure 5) and thus increase the investor interest of member-patrons. Subsequently, a number of CCU issues can be made to attract additional member investment and external capital, while maintaining the existing structure of co-op control (e.g. members have only one vote).

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