

A LEGAL PERSPECTIVE ON CO-OP INNOVATION

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Cooperative Innovation
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Producer Owned Businesses Are Unique

- ⌘ Producer owned processing and marketing businesses require producers to be participants and investors
- ⌘ Producers face weather and foreign supply risks beyond their control
- ⌘ Capital needs of business are often mistimed and mismatched with producers' capacity to invest
- ⌘ Aging of producers places stronger focus on liquidity rather than investment

Those with marketing power typically extract concessions and profits from those without

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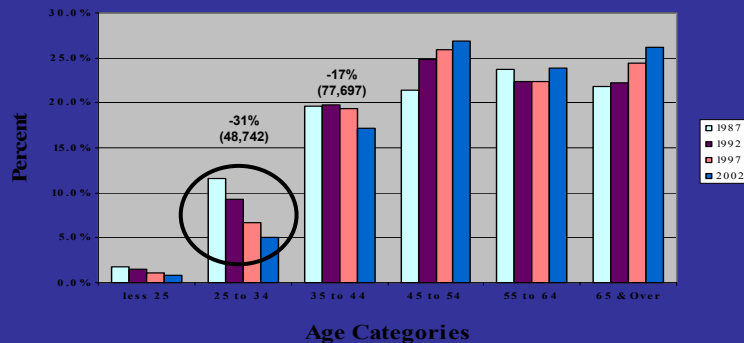
Cooperative Business Structure Challenges

- ⌘ Cooperative business structure developed 80 years ago and institutionalized by federal law
- ⌘ Structure based on commodity marketing model without capitalized processing
- ⌘ Structure designed as income and not growth business structure
- ⌘ Structure was adopted and adapted by processing cooperatives
- ⌘ Capital provided by patrons
- ⌘ Current patrons return capital of former patrons

Requires greater profitability and growing patron base to succeed, works best when members relinquish ties to patronage equity

Age of Farm Ownership

**% Farm Operators by Age Category
(1987, 1992, 1997, 2002)**



- ⌘ Current patrons provide the capital for ongoing business needs and to retire the capital of former patrons.
- ⌘ Where will the patrons come from?
- ⌘ Who will revolve former patronage equity?

Some Cooperatives Are Converting to Corporations or LLCs. Why?

- ⌚ Corporate cooperative business structure generally doesn't facilitate capitalized business structures – capital not tied to growth, capital revolvment without gain
- ⌚ Tax efficiency, opportunities (growth) inhibited by structure, capital requirements, liquidity, failure of members to capture **enterprise value**

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Enterprise Value: Examples

- ∞ More cooperatives are looking and are being forced by the marketplace and their owners to look at enterprise value; e.g.,
 - ❖ **Rabobank → Farm Credit Services of America**
 - \$600 million to shareholders, \$800 million to Agribank
 - ❖ **Ocean Spray → Northland, Pepsi**
 - Northland \$800 million → Ocean Spray; Pepsi \$100 million to growers, beverage joint venture
 - ❖ **Goldkist → IPO**
 - Retirement of patronage equities \$360 million (conversion to shares)
 - Additional cash distribution to members \$88 million (\$4,000 to \$120,000 per member)
 - Additional supplemental stock to members \$66 million (\$3,300 to \$99,000 per member)
 - ❖ **U.S. Premium Beef**
 - Majority owner of National Beef Packing Co., \$3.5 billion sales
 - Growth projected to significantly increase share value
 - Conversion to widely held LLC: A Units cattle delivery, B Units investment growth
 - ❖ **Golden Oval Eggs**
 - Large liquid egg producer; expansion capital not available from owners; share value reflective of area corn producer prospects
 - Conversion to widely held LLC: Single class of units, patronage equities plus common stock converted into units, no further corn delivery
 - ❖ **Dakota Growers Pasta**
 - Top three pasta producers
 - Conversion to corporation: Common stock (farmer member and delivery), delivery privilege Class D stock
 - Liquidity, outside investment capital, sourcing durum from new growing areas

Cooperators Will Drive Change To Face Market, Economic Challenges When State and Federal Legal Structures Impede Opportunities

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Failure to Capture Enterprise Value

- ⌚ Cooperatives traditionally burdened with “service at cost,” “return of equity” which has diminished expectations and thinking as to enterprise value
- ⌚ Many times cooperatives are thought of as permanent, perpetual entities rather than transitional business structures to more efficient markets
- ⌚ Enterprise value focuses on predictable excess cash flows from a business – many times a multiple of three to six times EBITA depending on business growth opportunities
- ⌚ Many times cooperatives can jointly own/operate processing and marketing functions with outside equity or other businesses

There are times when the future growth opportunities have much more value to others than to the cooperators. **The key is when cooperators figure out how to retain producer participation value and efficient markets without the complete burden of owning (capitalizing) processing and upstream marketing functions**

Conversion Impediments

- ⌚ Cooperator resistance to change
- ⌚ Tax consequences of conversion
- ⌚ Securities registration

Concerns for Directors and Management

- ⌘ Corporate scandals are increasing potential liability to directors and management
- ⌘ Capital structure should be analyzed by accountants, board, and management
- ⌘ Failing capital structure may impose liability if no plan to change
- ⌘ Capital revolvment policies need to be carefully reviewed
- ⌘ Emerging Communications
 - Directors with specialized knowledge or expertise can be held to a higher standard of liability
 - Directors
 - Board “undervalued” company in taking private
- ⌘ MCP
 - Sale of interest to ADM after member approval
 - Directors and management sued by disgruntled members over valuation, compensation, process
- ⌘ Valuation of Company is area of increasing liability

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Capital And Business Structure

Capital, owner liquidity, and business valuation will play a larger role in the development of producer owned and controlled businesses. The changing demographics of producers in the United States and elsewhere and the consolidations in the food industry generally will provide opportunities, nudge and even force changes in business structure.

Most businesses are focused on the bottom line which is important if the business desires to create its own path forward, however, proper capital and business structure are necessary to sustain the bottom line.

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Alternative Capital Structures – When They Work

⌘ Traditional Cooperative

❖ Characteristics

- Open membership based on patronage (limited membership fees)
- Capitalization through patronage
- No return on patronage equity
- Current patrons retire patronage equity of former patrons
- Pay out as much of the earnings as possible

❖ Best Conditions

- Low capital or fixed capital
- Focused product marketing
- Members not **attached to equity**
- Income not growth business model

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Alternative Capital Structures – When They Work

⌘ FONTERRA COOPERATIVE MODEL – ENTERPRISE VALUATION, RETURNS

❖ Characteristics

Fair Entry and Exit

- Farmer members own shares corresponding to production units
- Cooperative is valued annually
- New farmer members purchase shares at market; coop redeems shares of exiting farmer members at market
- Exiting farmer members paid with coop notes which are tradable on an exchange
- Board can stop redemption at 5% of shares

Pricing and Measurement of Returns

- Independent verification of commodity pricing relative to competing markets reported to members
- Total shareholder return reported as pretax return on an estimated value of business at the beginning and end of year
- Return separated into return based on commodity and return based on growth of business

Best Conditions

- Cooperative monopolizes business segment
- Sole source processing
- Large base of producers
- Business growth with modest per share (per production unit) capital requirements

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Alternative Capital Structures – When They Work

NEW GENERATION COOPERATIVE – TRADABLE SHARES

❖ Characteristics

- Business capitalized with producer investment shares on per unit of delivered product
- Production delivered under marketing contracts
- Shares tradable to other producers

❖ Best Conditions

Identified commodity patronage

- e.g., identity preserved grain, sugar beets, certain fruits and vegetables
- Business growth (capital appreciation)
- Large sustainable producer base

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Alternative Capital Structures – When They Work

NEXT GENERATION COOPERATIVE – PATRONAGE AND GROWTH CAPITAL

❖ Characteristics

- Pass through taxation (like LLC)
- No restriction on “patronage sourced” earnings
- Patron members receive allocated percentage of profits based on patronage, investment members receive profits based on investment
- Patrons receive allocated patronage based return, investors receive investment return
- Generally patron controlled, but may have up to 85% investment returns to investors if approved by patrons
- Capital gains tax on liquidation proceeds

❖ Best Conditions

- Identified patron transaction that has value beyond market price commodity transfer
- Capital requirements that exceed patron contributions
- Business growth beyond patronage business
- Growth that is attractive to outside investors or patrons as investors
- Growth that is independent of patronage transactions

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