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STRUCTURING CO-OPERATIVE CAPITAL UNITS – SYMPOSIUM FINDINGS



Sustainable Co-operative Enterprise Project



CEMI
Centre for
Entrepreneurial Management
and Innovation

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STRUCTURING CO-OPERATIVE CAPITAL UNITS- SYMPOSIUM FINDINGS

Outcomes of CCU Symposium 11 May 2012

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About CEMI:

CEMI was founded in November 2002 as part of the Graduate School of Management at the University of Western Australia (UWA). Its focus then was on being a focal point for research, education and industry engagement with the primary goal of developing and enhancing the entrepreneurial skills of managers from both small and large organisations.

CEMI operated as a centre at UWA from 2002 to 2007 when it was decommissioned. During that time it developed a strong multi-disciplinary approach to its research, as well as undertaking a wide range of applied research projects for government and industry. It also developed leading-edge management development programs for small business owners and those seeking to commercialise new technologies.

In 2010 the Centre was reformed by its founder Professor Mazzarol as a private initiative designed to be a focal point for the exchange of ideas, knowledge and research into entrepreneurship and innovation. It is also a mechanism through which relevant projects designed to benefit the WA business community can be pursued with a view to enhancing entrepreneurship and innovation within the state.

Centre for Entrepreneurial Management and Innovation (CEMI)

www.cemi.com.au

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INTRODUCTION

This report summarises the findings from a symposium held at the University of Western Australia (UWA) on 11 May 2012 to investigate the use of Co-operative Capital Units (CCU) within co-operative businesses. It is part of a wider investigation into the sustainability of the co-operative enterprise business model being undertaken by UWA as part of a Linkage Project funded by the Australian Research Council (ARC), CBH Group Ltd, Capricorn Society Ltd and the Ravensdown Fertiliser Co-operative.

A total of 39 people participated in the symposium. The attendees were primarily co-operative board members, legal, financial and accounting professionals, co-operative executives (CFOs and others), and representatives from the Department of Commerce (WA).

Participants were presented with an overview of the Co-operative Capital Units (CCU) provisions of the Co-operatives Act 2009 (WA) (the Act) and the outcomes of a UWA Business School research project that used a Delphi Panel of experts to assess the way CCUs could be structured. They were then organised into six focus groups, where they developed CCU structures for several hypothetical cases.

The aim of the workshop was to reflect on research outcomes to date, seek confirmation (or otherwise) of the experts' opinions and further develop a framework of CCU structures in terms of ownership, governance, market facilitation and distribution options.

BACKGROUND INFORMATION

LEGAL DEFINITION AND REQUIREMENTS

CCUs are:

- An interest in the capital but not share capital of a Co-op;
- Personal property;
- Transferable or transmissible as provided by the Act and the rules of the coop, subject to the terms of issue of the CCU; and
- Subject to the rules of the coop, capable of devolution by will or by operation of law.

CCUs are a financial instrument only available to entities registered as a co-op. They can be issued to distribute the surplus of a distributing co-op, according to patronage. Co-ops are capable of issuing CCUs to non-members. CCU issues need to be consistent with the seven Co-operative Principles enshrined in the Act, and require membership and Registrar approval of their terms of issue.

CCUs are an interest in the capital but not share capital of a Co-op

A CCU holder has none of the rights or entitlements of a member of the co-op (unless otherwise a member). Each holder of a CCU is entitled to one vote per CCU held at a meeting of the holders of CCUs. Rights of the holders of CCUs may be varied only in the way and to the extent provided by their terms of issue and only with consent of 75% of holders of CCUs who vote at a meeting.

A CCU holder is entitled to receive notice of all meetings of the co-op and all other documents in the same manner as the holder of a debenture of the co-op. The issue of a prospectus for investors is required unless issues are made solely to members, members and employees, or inactive members who have their share capital converted to debt/CCUs. Further exceptions for certain issues apply (Part 6D of the Act).

Directors are entitled to take into account that the holders of CCUs have none of the rights and entitlements of, and are not entitled to be regarded as, members of the co-op.

CCUs are redeemable only out of profits or proceeds of a fresh issue of shares or of CCUs made for that purpose. CCUs are convertible into shares instead of redemption, or by paying up unpaid shares held by the member/CCU holder. CCUs do not attract a fixed nominal value and financial market provisions of the Corps Act apply equally to any market for CCUs.

KEY PROPOSITIONS CONFIRMED

The workshop confirmed the following key research propositions:

- CCU structure is highly dependent on purpose, with key differences between CCUs that aim to reward patronage/retain capital versus CCUs that aim to raise capital for investment.
- In terms of **ownership structure**:
 - **When seeking to reward patronage, retain capital and unlock member value:** CCUs to be member restricted (with past members able to retain ownership) or member restricted at issue and subsequently freely traded/transferred.
 - **When seeking to raise capital for investment:** CCU ownership to be open to members and non-members, with members possibly offered a first right of refusal (and even some form of preferential offer terms).
- In terms of **profit distribution and governance**:
 - **When ownership is restricted to members and past members:** CCUs to pay a variable dividend at Board discretion, CCU holders to have no additional representation on the Board of Directors.
- In terms of **market facilitation**:
 - **When ownership is restricted to members and past members:** CCUs to be sold privately at a price agreed by the seller and buyer, or to be sold in a market facilitated by the co-op (co-op to act as a broker but not set price).
 - **When ownership is open to members and non-members:** CCUs to be sold in a market facilitated by the co-op or by a third party, with the potential for a specialist CCU exchange to be developed.

EXTENSION OF PREVIOUS WORK

GOVERNANCE

A key challenge that focus groups explored was whether a CCU issued for the purpose of raising capital should offer investors some form of representation on the Board of Directors to counteract their lack of voting rights. The Delphi panel of experts (previous research) were divided on this issue, as concerns were raised that board members can not represent a class of investors.

The workshop clearly illustrated that the co-operative sector in Western Australia understands investor need for reassurance that the co-operative is professionally managed and efficiently run. The idea that CCU holders could vote or nominate a number of Board members was seen as plausible. These directors would act as independent board members (non-member directors), and although bound by their fiduciary duty to act in the best interest of the organization, they could provide some reassurance to CCU holders that the board has the necessary management expertise and ability to consider CCU related issues. Workshop participants saw the following as feasible alternatives:

- **When seeking to raise capital for investment:** CCU holders to elect a predetermined number of independent directors to the board of the Co-op
- **When seeking to raise capital for investment:** CCU holders nominate a predetermined number of independent directors to the board of the Co-op, which would be approved (and would be liable to removal) by members

It was further suggested that the Trustee structure available under the Corporations Act could be adopted.

Attracting external CCU investors without any control over co-op governance was regarded less likely, although it was noted that it could be feasible in the case of a highly successful co-op with a strong history of member share dividend payments.

OWNERSHIP AND DISTRIBUTION OF PROFITS

CCUS TO RAISE CAPITAL

There was a general consensus that CCUs aiming to raise capital (and thus available to members and non-members) should offer a dividend comprised of a fixed and variable component. The variable component should be significant enough to ensure that CCUs could be classified as equity in the co-op's balance sheet.

Workshop participants did not favour the option of a set percentage of profits being distributed to CCU holders (even where CCUs were related to a specific project or investment opportunity). This could be because of governance challenges associated with profit definitions and transfer pricing that can take place.

The general opinion was that CCUs are less likely to be attractive to non-member investors if they do not offer some certainty through a fixed dividend component.

CCUs TO REWARD PATRONAGE

Participants debated the value of closed ownership (members and past members only) versus awarding CCUs to members initially with the ability to then transfer to non-members.

Closed ownership enables the co-op to lock-in its capital, especially if CCUs are redeemed at board discretion. The aim would be to provide an attractive return, therefore making CCUs an attractive investment proposition for current and exiting members, encouraging them to leave their capital in the co-op. The downside of closed ownership is that members as investors would have low liquidity with a limited ability to unlock the value of their investment. It was noted that members may be discouraged from increasing (or even maintaining) their patronage due to their inability to unlock the full value generated by their investment.

CCUs that subsequent to their issue can be traded by members and non-members increase the liquidity of the instrument (and thus its attractiveness to investors) and can offer a resolution to the challenge of locked member value that has historically driven co-ops to demutualization. Such CCUs would not lock up profits in the co-op, however, in such cases it would be prudent for the Co-op to keep some of their capital reserves unallocated (best practice suggests 50% of profits allocated to a co-op reserve account on an annual basis). This structure resolves the co-operative challenge of having to pay out exiting members from co-op funds.

*As an equity instrument CCUs
have the potential to:*

- *Unlock member value*
- *Create permanent capital*
- *Attract capital investment*

*A CCU's structure is highly
dependent on its purpose*

CONCLUSIONS

The workshop highlighted the fact that the co-op sector in Western Australia recognizes the opportunity that CCUs represent as an equity instrument that can:

1. Unlock member value;
2. Create permanent capital, and
3. Attract capital investment.

The structure of a CCU is highly dependent on its purpose and the conditions and requirements of the issuing co-operative. This became evident as workshop groups raised questions and provided different perspectives when examining hypothetical cases.

Whilst recognising the individuality of each CCU issue the following framework has been developed to guide co-op managers and advisors in their choices.

Table 1 Framework to Guide CCU Structure

PURPOSE	OWNERSHIP	GOVERNANCE	MARKET FACILITATION	DISTRIBUTION
Reward patronage & retain capital	Inside <ul style="list-style-type: none"> Rewarded based on patronage The buyer must be either a qualified member of the Co-op (past members and their beneficiaries can retain their holdings) or the Co-op itself 	No control <ul style="list-style-type: none"> CCU holders have no representation on the board of the Co-op 	Co-op <ul style="list-style-type: none"> Sold in a market facilitated by the co-op Private <ul style="list-style-type: none"> CCUs to be sold privately at a price agreed by the seller and buyer Redemption <ul style="list-style-type: none"> Redeemed by the Co-op at board discretion 	Variable <ul style="list-style-type: none"> Variable dividend as determined annually by the Board
Reward patronage & unlock member value	Outside <ul style="list-style-type: none"> Rewarded based on patronage Subsequent to their issue (and build-up of critical mass) transferrable between members and non-members 	Some control <ul style="list-style-type: none"> CCU holders nominate a predetermined number of independent directors to the board of the Co-op (to be approved by members) No control <ul style="list-style-type: none"> CCU holders have no representation on the board of the Co-op (for Co-ops with attractive historical CCU performance) 	Third Party <ul style="list-style-type: none"> Sold on a secondary market operated by a third party Co-op <ul style="list-style-type: none"> Sold in a market facilitated by the Co-op 	Combined Fixed and Variable <ul style="list-style-type: none"> Dividend with a fixed component (fixed or referable to market rates) and variable component (at Board discretion or performance related) Variable <ul style="list-style-type: none"> Variable dividend as determined annually by the Board (for highly performing Co-ops with history of attractive dividend payments)
Raise investment capital	Outside <ul style="list-style-type: none"> CCU ownership open to members and non-members, with members possibly offered a first right of refusal 	Some control <ul style="list-style-type: none"> CCU holders to elect a predetermined number of independent directors to the board of the Co-op CCU holders nominate a predetermined number of independent directors to the board of the Co-op (to be approved by members) 	Third Party <ul style="list-style-type: none"> Sold on a secondary market operated by a third party Co-op <ul style="list-style-type: none"> Sold in a market facilitated by the Co-op (for smaller CCU issues/ Co-ops that cannot justify third party facilitation costs) 	Combined Fixed and Variable <ul style="list-style-type: none"> Dividend with a fixed component (fixed referable to market rates) and variable component (at Board discretion or performance related)

Notes to table 1.

- The above options are suggested as the most likely combination of terms that can result in an attractive proposition for the investor, the Co-op and its members.
- When multiple suggestions are provided under each purpose these are listed from more to less preferable for investors (top to bottom).