Challenges and Opportunities for Producer Companies in Capital Markets

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Abstract

The Producer Company section was first introduced in the Companies Act in 2002 and retained in the 2013 Act as well. Lack of access to capital has held back the growth of these companies. It is important to find ways to integrate them with the capital and debt markets like other countries have done. We suggest some ways forward based on our need and the experience of other countries. All these methods would allow outside investors who are not primary producers to contribute share capital in different forms. This would require some amendments to existing laws and regulations. Producer Companies can enable primary producers to significantly increase their incomes and help over 10 crore families.

Introduction

The Companies Act 1956 was amended to add a newchapter titled 'Producer Company' under Part IX, Section 581 in 2002. This section has been retained as it is in the 2013 Act. Producer Companies are essentially cooperatives and this new section allowed genuine member owned businesses to be set up anywhere in the country. Cooperatives under various State laws suffer from Government and political control, as well as various restrictive regulations,and are usually not viable. Primary producers, including farmers, fishermen, those in animal husbandry and poultry, craftsmen and so on can now form a company without this interference. Producer Companies can enable such primary producers to significantly increase their incomes.

This was widely welcomed by those working in the field of Cooperatives. Several eminent persons with knowledge and experience of cooperatives including Dr. Kurien, Amrita Patel, LC Jain, Mohan Dharia, Rama Reddy, Shashi Rajagopalan and others had played a role in getting the Producer Company section inserted in the Company Act. It was hoped that like AMUL, Nandini, Milma and Sudha dairies in Gujarat, Karnataka, Kerala and Bihar, profit making cooperatives would come up in various other non-dairy sectors of Agriculture, horticulture, fisheries, poultry and so on. But that has not happened. The US, Western Europe, Japan and other countries/ regions have several large and successful cooperatives running even today for decades. Some are in the Fortune 500 list. They run outside the Government system and are genuine member owned, member run business entities. For instance, in the US, there were about 30,000 coops in 2011. They had "more than $3 trillion in assets, more than $500 billion total revenue, and more than 2 million jobs, according to the National Cooperative Business Association."[1] Europe's Coops are equally impressive, with the top 10 Agriculture coops in 2010 having a combined turnover of $110 billion, the largest with a turnover of $17.7 billion.

India has one in the Fortune 500, namely IFFCO, which is run by Government appointed officers with little or no member participation. It enjoys subsidy as well. The Gujarat Cooperative Milk Marketing Federation (GCMMF), the flagship cooperative network in India with the AMUL brand, has a turnover of around $3.2 billion. With 32 lakh members it has the largest membership base in the world. This is a genuine farmer owned and farmer run cooperative giving significant benefits for decades to dairy farmers. It passes on about 85% of sales to farmer-members, which an investor owned company cannot.

There has been a lot of focus recently on actively promoting Producer Companies. Various non-financial aspects have been discussed elsewhere in different reports, and in development seminars and papers. However the financial aspect of it, which has hardly ever been touched upon earlier, is examined here.

Challenges for Producer companies

A company needs capital to be set up and to grow. There are three sources of this – capital from promoters, capital from other investors, and loans and various other types of debt. But for a Producer Company this route of raising capital is blocked since the law does not permit their shares to be traded on the exchanges. This is partly in line with the laws in other countries. The logic is that with only outside investors, the entire profits go to the investor and the farmer merely gets the value of the raw produce.

It is important to understand one specific characteristic of the Food Processing business. Let us look at the top companies listed on BSE and NSE that process rice, dal, wheat and edible oils. They are all high debt companies with average debt equity ratio on average of 204% in the 5 years between 2010-11 and 2014-15. The result is that the interest costs are much higher than PAT, with the ratio of interest to PAT being 191.6%. Most of it is short term borrowing. They have to purchase their raw material from primary producers and pay cash up front. When

selling their products, they have to give credit to the trade. In spite of this, the ROCE averaged 12% in the last 5 years and 12.77% in the last 3 years.The lesson for Producer Companies is that they not only need share capital, but more than twice that amount in loans.

In contrast, the most successful IT Companies enjoy a debt equity ratio of less than 20%. They are also able to raise capital from the market at a substantial premium during an IPO.

A typical case is that of a listed food processing company. It started off as a small private limited company in 1998, which by 2003had gradually built up its share capital to Rs. 3 crore. By the time it was listed in 2008, it had Rs. 7 crore share capital and only Rs.53 lakhs in reserves. Immediately after the IPO, its net worth was Rs. 45 crores with share capital of Rs.22 crores and reserves shooting up to Rs. 23 crores, coming from the premium paid on shares. This was sufficient for the next few years and they did not borrow from Banks. As loans built up, they obtained another round of preference share capital recently. This capital or net worth was used to leverage over Rs.120 crores in debt. Their turnover today is around Rs.600 crores. A Producer Company will find it impossible to replicate this since they cannot raise share capital in the market. They will find it difficult at first to even raise the initial small share capital from members.

How did NDDB succeed in setting up a $3.2 billion company like AMUL without raising funds from the share market? They had a corpus of about Rs.2800 crores obtained through grants. The District Milk Cooperative Unions received loans from NDDB for setting up dairy plants. The Dairy Unions neither raisedsignificant share capital nor went to Banks for loans. Only small token amounts were raised as share capital from farmers. Unlike crop based commodities, the working capital cycle for milk is very short as it is sold and consumed daily. So working capital needs are also much lower. Today's Producer Companies do not have the big corpus that NDDB had. Agri commodity processing and marketing of rice, wheat, dals and edible oil has longer working capital cycles. The lack of capital is one major reason for the lack of growth of Producer companies in India.

Lessons from Other Countries

How did other countries manage this problem? By one simple innovation – they allowed two classes of investors. First are the primary producers. Second are outside investors who contribute only capital but not farm produce to the cooperative. The specific details vary from country to country and in the US, from State to State. Some allow joint ventures between Cooperative businesses and corporate businesses. Others allow both classes of investors in the same company. Protection to outside investors in the case of sale, merger, closure etc. is given. New laws have been passed to address this problem in Italy (1988, 1991), Canada (1997), Portugal (1998), France (2001), and amended in Germany, UK, Belgium and Denmark [1].Some form of tax incentives are also given on amount paid in dividends in UK, Sweden and Finland, on profits derived from transactions with members in Cyprus, and trading taxes are reduced by 95%in Spain [2].

However, the Indian law does not permit outside investors. It however does permit joint ventures to a limited extent of 30% of reserves. The relevant part of the Act says "Any Producer Company may subscribe to the share capital of, or enter into any agreement or other arrangement, whether by way of formation of its subsidiary company, joint venture or in any other manner with any body corporate, for the purpose of promoting the objects of the Producer Company by special resolution in this behalf… for an amount not exceeding thirty per cent of the aggregate of its paid-up capital and free reserves".

While this provides some flexibility, the real problem is at start up time with low share capital mobilization from members. No other company will be interested in a joint venture at this time. Without adequate share capital the Producer Company finds it almost impossible to raise working capital loans which are vital for its business operations, just like loans are vital for publicly listed profitable companies in food processing. The RBI has issued a welcome circular that loans up to Rs. 5 crores given to Producer Companies, and new generation self-help and mutually aided Cooperatives (not to be confused with self help groups or SHGs) will be treated as priority sector lending. But the obstacle is the lack of adequate share capital, and hence Banks don't come forward to lend.

A way forward

One obvious way forward is to allow outside investors to have equity share capital. Some important issues while working out details are

- who controls the company (or joint venture) – the primary producers or the outside investors.
- allowing one class of shares to be traded only between primary producers, and the other in the open market.
- distribution of surplus. In the case of cooperatives the world over, the distribution is based on amount of business transacted by a producer. This usually means the quantity of raw material supplied by the producer. It is not based on shares owned. For the other class, distribution would have to depend on number of shares.
- rights of the two classes of owners, especially during closure, sale or merger

Even this is not enough at start up time. Adequate share capital can eventually be put in by farmers into Producer Companies. But it will not all come in on day one before operations start. It will be built up over time, typically three to eight years, just as it was in the example of the food processing company described earlier. In regular start-ups, this is handled by treating early and later investors slightly differently, where the former get shares at much lower prices before the IPO.

Later investors have to buy at much higher values – often several multiples of the face value. This recognizes the fact that the company's value has gone up significantly. This facility needs to be incorporated into the Producer Company as well. This should be for both classes of investors. A provision to allow the cooperative to buyback shares from outside investors at a later date on a mutually negotiated price should also be built in.

A specific example will make the principle more clear. A processing unit that decorticates groundnuts (i.e., removes the shells) may require only Rs.75 lakhs in capital investment in year 1. But it will require something like Rs. 5 crores in working capital to purchase raw material of Rs.10 crores. If the plant does not operate at or near full capacity, it will incur higher fixed cost and depreciation per unit of groundnut processed and become unprofitable. Banks would expect share capital and net current assets of around Rs.1.5 crores to give any working capital loans or provide collateral. But to expect farmers to pool this before operations start or provide collateral is unrealistic. However for farmers, the combined benefit of fair purchase value, profits, and lower input costs obtained through bulk purchases by the Producer Company adds up to something like Rs. 80 lakhs per year. Within 3 years the requisite capital from farmers will be available in the Producer Company by retaining part of the surplus.

So long term bridge financing is required. Outside (i.e., non-farmer) investors can be allotted shares at much lower prices than later investors after IPO. The risk taking ability among farmers is also different. Here again share prices for this class of owners can be differentiated. For outside investors, the lower priced initial shares can deliver value after a few years when the Producer company's valuation goes up.

Reducing the loan amount and interest cost can also significantly raise profits. They raise deposits year on year from members and use it for working capital. This reduces interest costs. This is true of one of India's very few non-dairy successful cooperatives in Mulkanoor, Telengana. If we recall that on average publicly listed companies of this type pay 191% of PAT as interest, it makes the Producer company much more successful. This in turn gives better returns to outside investors.

Conclusions

The capital markets have recently introduced IPOs for start-ups with various checks and balances. A similar innovative approach is needed for Producer Companies as well. The concept of social investing is vital. With credible rating agencies providing information, investors will come forward. Such shares can generate decent returns for investors. A more detailed study is required to give a complete plan for the growth of Producer Companies using share markets. For most farmers, farming is a low margin, risky business. Producer companies can however raise incomes by 25% to 75% year on year, depending on the crop and prevailing prices. At a time when the nation is debating the Land Acquisition Bill, we need to look for alternate ways to benefit farmers. Enabling Producer companies to access capital markets is one way. The benefits to about 10 crore farmers and their families are tremendous.

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