

***Innovative Financial Strategies That Work:
MKC***

**Financial Strategy Case Study
of
MKC
Moundridge, Kansas**

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Introduction

MKC (formerly Mid-Kansas Cooperative) is one of the largest retail or local grain marketing and farm supply cooperative in the state of Kansas. It serves more than 4,800 farmer-members in 11 counties in South-Central Kansas. Grain elevators receive grain at 35 locations, fuel service is available at 14 locations and agronomy services are available at 23 locations. Feed products are available through Countryside Feed, a joint venture with three other cooperatives. MKC was founded in 1965, as a result of the consolidation of three small local co-ops (Moundridge, Buhler and Groveland). Since that time it has grown and expanded in the south central area of the state through mergers with four other neighboring cooperatives. They occurred in 1992 (Farmers Union Equity, Lindsborg), 1995 (Farmers Grain Cooperative, Haven), 2002 (Farmers Grain Cooperative, Walton) and 2007 (Farmers Cooperative Association, Talmage). MKC also acquired grain and agronomy assets formally owned by many cooperative and non-cooperative businesses during the last 46 years.¹

MKC has also entered into several joint ventures, primarily with neighboring cooperatives. The largest is a grain marketing joint venture company, Team Marketing Alliance, LLC (TMA), currently owned in partnership with three other local cooperatives. TMA was organized in 2000. TMA serves as the grain marketing division for all four local cooperatives.² MKC now owns a majority interest, about 75 percent, of TMA. A grain terminal joint venture, Hutchinson Grain Terminal, was organized in 2003 with ADM and TMA but was discontinued in 2009. A fertilizer hub joint venture, Hutchinson Fertilizer Terminal, was organized in 2006 with ADM, Cairo Cooperative Equity Exchange and Farmers Cooperative Elevator (Cheney/Garden Plain).

MKC presents financial information on a consolidated basis that includes the TMA joint venture results, but nets out the earnings of the minority interest holders from net income. Financial results for 2005-11 are shown in Exhibits 1 and 2. In the seven years, 2005-2011, MKC's sales ranged from \$225 million in 2005 to \$315 million in 2011, but reached a high of \$453 million in 2009. Net income ranged from \$3.0 million in 2005 to \$8.9 million in 2011, but reached a high of \$10.8 million in 2009.

Financial performance has been relatively high and is expected to be high in the future. Return on equity was 16.0% in 2005 and 17.2% in 2011 but has ranged from a high of 30.2% in 2009 to a low of 12.6% in 2008. It has averaged about 18% over the last seven years.

Most of MKC's profits have come primarily from local earnings, not regional cooperative patronage refunds or other income. In 2011 about 80% of total before tax income came from local or operating income. MKC did have significant other income in 2009 due to a gain of \$1.9 million on its FCStone investment.

¹ Information about the history and operations of MKC is available at: <http://www.mkcoop.com>.

² Information about the ownership and operations of TMA (Team Marketing Alliance) is available at: <http://www.tmagrain.com>.

Non-current asset growth for three types of assets has been strong, supporting the rapid sales increases. The three types of assets are (1) local fixed assets, (2) outside investment in regional co-ops and (3) outside investment in joint venture companies (excluding TMA) Net fixed assets have increased from \$10.7 million to \$25.3 million over this time. Regional co-op and joint venture investments (excluding TMA) have increased from \$6.4 million to \$18.5 million. Fixed asset and investment growth have been financed primarily with new equity investment created by retaining earnings as allocated retained patronage refunds and unallocated retained earnings. Total equity increased from \$18.9 million in 2005 to \$51.5 million in 2011, an increase of \$32.6 million while fixed assets and outside investments increased \$26.7 million.

Balance sheet liquidity and solvency have also been strong. Working capital increased from \$6.3 million to \$22.4 million in 2010 (but had negative working capital of \$16.8 in 2011), and long-term debt to equity was 28.0% in 2005 and ended up at 31.8% in 2011.

MKC expects to continue growing even if it does not expand its marketing footprint and trade area through mergers and acquisitions. Corn production is growing in the area as it is in much of the Great Plains region of the country. It believes there will be a need for greater grain marketing and agronomy marketing capacity in the future.

The challenge for MKC will continue to be to sustain or improve profitability, maintain a strong balance sheet by financing growth with high proportions of new equity, and improve its income distribution and equity management programs as much as possible. It is clear to the leadership team, namely, the board of directors and executive management, the future will be more risky but filled with opportunity. MKC expects to rely on its core businesses, marketing grain and supplying agronomy inputs, for future profits.

MKC has had a long-time, on-going interest in improving its financial performance and strategies, especially those related to equity management. The CEO and directors have participated in many educational programs offered by Kansas State University and the Kansas Cooperative Council related to cooperative finance such as KSU's annual Symposium on Cooperative Issues, and KCC's Director Development Program (DDP) courses on governance, finance and strategy. The leadership team, including the board and top executives, has also focused on financial strategy issues at many board meetings and board retreats. MKC commissioned three major financial planning studies by the Arthur Capper Cooperative Center (ACCC) and Kansas State University to evaluate current financial strategies and investigate alternative strategies. Those studies were in 1990-91, 1996-07 and 2003-04. As a result, the team improved its knowledge and understanding of cooperative finance and strategy formation and implementation and subsequently implemented several new policies to improve the financial strategies of MKC based in part on these studies.

Early Times: Formation in 1965 to 1996

MKC used a very common equity management program following its formation in 1965. It obtained new equity investment by retaining part of the patronage income as a qualified, retained patronage refund and usually paid a cash patronage refund of 30% cash. Allocated equity was redeemed by using two

methods, estate settlements and age of patron, oldest first at the youngest age it could afford. By 1990 the age had been reduced to age 67.

The initial interest in changing current strategies began in the late 1980s due to education programs attended by MKC's leaders. The KCC began offering its four course educational program, DDP, in November 1986 which included a one-day course on cooperative finance. Most of MKC's directors attended this course in the late 1980s. In 1988, the ACCC offered its annual Symposium on the topic of equity management. Research on equity management conducted by Dr. David Barton, Director of the ACCC and a faculty member at KSU, was reported at the symposium. It suggested co-ops could improve the performance of their equity redemption programs by shifting away from using an age of patron redemption and using other methods, including a revolving fund or base capital method. Some cooperatives, who then used a revolving fund or had changed their equity management programs by dropping age of patron and introducing a revolving fund, also reported on their experience with superior programs using a revolving fund.

MKC initiated the first of several studies of its own equity management program following attendance by many leaders at these educational programs. Dr. David Barton worked with the General Manager, Bob Nattier, and the board during 1990 and 1991. The 1990-91 project included educational presentations and extensive analyses that evaluated several alternative strategies including dropping the age of patron redemption method. The board decided to stay committed to the age of patron redemption and no change was made in the equity management program at that time.

First Major Changes: 1996-2003

A new director, Neal Beam, was elected to the board in 1990 and became board chair in 1995. Neal attended the KCC's DDP course on co-op finance in December 1991. It was taught by Dr. David Barton, and Lynn Rogers, a loan officer of CoBank, MKC's primary source of short- and long-term loans. Professor Barton encouraged cooperatives to stop using the age of patron redemption method and switch to a superior method, such as a revolving fund or base capital. He also encouraged cooperatives to manage equity directly on the co-op's balance sheet by selecting a solvency target, such as 50 percent equity to assets, and then derive a redemption budget given the solvency target. Redeeming to those who became an age, such as 67, caused highly variable cash flows from year to year and caused solvency to vary up and down, year to year. It was like the tail wagging the dog.

Neal became interested in how to improve MKC's equity management program following the 1991 course on co-op finance. His interest intensified after MKC merged with Lindsborg in 1992 and then with Haven in 1995. It was not clear how to manage the equity of MKC in combination with the equity of Lindsborg and Haven. For several years MKC had been redeeming equity to the MKC patrons when they turned age 67 (if requested by the patron) and to the estates of patrons who died. Their long-run objective with each merger was to redeem the old equity of the former Lindsborg and Haven patrons on the same basis as the MKC patrons as soon as practical. However, in the merger agreements it was stipulated redemption of old Lindsborg and old Haven equity was expected to be dependent on profits

from the Lindsborg and Haven business units. This added the new wrinkle of additional equity classes whose redemption was tied to the profitability of selected business units.

Prior to the merger, Lindsborg has been struggling just to redeem the equity of patrons who died as estate settlements. In other words, agricultural producers had to die to get their equity investments redeemed. These equity investments were not cash purchase investments, like buying stock in a company such as IBM or ADM. They were created by retaining a portion of patronage refunds, usually 70 to 80 percent, in a retained patronage refund account for each patron. Patronage refunds are distributed to patrons at the end of each fiscal year as the patrons' share of net income or profits, divided between patrons on the basis of individual patronage.

For example, if net income earned marketing wheat is 5 cents per bushel, patrons receive 5 cents per bushel in patronage refunds for the total bushels sold to the co-op. If a 20 percent cash patronage refund is paid then 1 cent is paid in cash and the remaining 4 cents is retained and not received until it is redeemed at some future time. In the case of Lindsborg this was only redeemed after the death of the patron.

The merger improved redemptions substantially. Old Lindsborg equity allocated to patrons was specified as a separate class of equity, Common Stock Class B, on MKC's balance sheet and equity records following the merger. New equity (retained patronage refunds) earned by Lindsborg patrons after the merger was placed in the same equity class as MKC had always used for its patrons, Preferred Stock (PS). In 1996 holders of Common Stock Class B (CS-B) received an equity redemption if they died and those age 78 and older received a redemption of all of their CS-B equity.

Haven had been redeeming only to estates. The old Haven equity was designated as Common Stock Class C (CS-C) following the merger. In 1996 MKC was able to redeem to those age 84 and older as well as to estates.

Neal thought maybe now, 1996, was a good time to evaluate MKC's entire approach to equity management. He decided to visit with the General Manager and CEO, Bob Nattier, about his ideas. Bob had been the CEO since 1978 and was very familiar with the equity management issues facing their co-op. Bob informed Neal that just before Neal was elected to the board, MKC had studied its equity management alternatives in detail with the help of Professor Barton in the 1990-91 project but the board decided to continue the current equity management program. Bob agreed that it would be a good time to re-evaluate the current program and other alternatives.

Together they decided to discuss it with the board of directors. The board decided another study of their alternatives was needed and the 1996-97 project was initiated. A committee of four directors and the CEO was appointed by Neal, and Professor Barton was invited to prepare a study proposal and to meet with the committee. The committee asked him to conduct an analysis and prepare a report. They provided specific direction to Professor Barton on what they wanted to evaluate.

All member-patrons held Common Stock Class A which was only redeemed as an estate. Classes B, C and PS each had a unique redemption program consisting of estate settlements and an age of patron

redemption. Classes B and C were assigned a redemption budget with the expectation that the ages would be reduced over the next 10 years until they reached age 67, the lowest acceptable age since it matched the age currently used for PS equity. Class PS received the residual distribution of funds that would achieve the liquidity and solvency targets. The intent for PS was to phase-out the age 67 redemption and phase-in a revolving fund. Two phase-out rates were evaluated, fast, at a reduction of 20% per year (following a series of 100%, 80%, 60%, etc.) and a slow phase-out rate, at a reduction of 10% per year (following a series of 100%, 90%, 80%, etc.).

Over the next several months, three successive reports were prepared. The Phase 1 report was presented to the equity management committee on December 23, 1996, the Phase 2 report was presented to the board on January 31, 1997 and the Phase 3 report was presented to the board on March 7, 1997. Modifications in the assumptions were made to refine the income projections, to refine the balance sheet management assumptions and to refine the equity redemption strategies. The projects made a 10 year projection for 1997-2006. Profit generation, income distribution, and equity management projections were made based on liquidity and solvency targets, fixed asset growth assumptions and redemption program strategies.

MKC decided it was too complicated to implement the intended policy of setting a redemption budget for Class B and Class C based on the earnings of those original assets. Instead MKC decided to reduce the age of redemption between the current age of redemption for class B and C stock to the target age of 67 at a steady rate. Lindsborg Class B stock was redeemed using estate settlements (ES) and age of patron oldest first at age 77 in 1997 (AP/O"XX" where XX, such as 84, declines to use up the assigned redemption budget) and declining to age 67 in 2006 by applying a uniform budget per year equal to 10% of the outstanding equity held by those ages 77-67 at the beginning of 1997. Lindsborg Class C stock was redeemed in a similar manner but the age range was started at 83 and reduced to 67.

One major concern expressed by the board was the cash flow impact on those PS equity holders becoming age 67. Would they object to the phase-out because they would not receive 100 percent of their equity account as in the past? Would a phase-out of age of patron and phase-in of a revolving fund end up providing less cash flow to those patrons than the current program? Cash flows to all birth groups were measured for each alternative strategy and compared to the current strategy. The goal was to construct a strategy that was viewed as win-win by those becoming age 67. A win-win was achieved if the discounted cash flow for the alternative strategy was as much or more than the cash flow for the current strategy of redeeming at age 67.

In total, six unique equity redemption strategies were evaluated for Class PS equity held by all patrons. MKC also was interested in using a combination of age of patron oldest first at age 65 (AP/O65) and age of patron prorata at age 55 with a variable percentage redemption to those age 55 and older. S0 was the base plan that represented the current program. S1-S5 represented alternatives that practiced strict balance sheet management and were capable of achieving both liquidity and solvency targets. The liquidity target was a current ratio of at least 1.25 and a solvency target series starting at 53% equity to assets in 1997 and ending at 47% in 2006 for Phase 2. Phase 2 reduced solvency and created a large redemption budget, which attempted to address the concern about achieving a win-win cash flow to

those becoming age 67 over the next 10 years. The projected cash flows of all the strategies were much better than win-win.

However, in the end the board decided to put higher priority on strengthening the solvency of the balance sheet going forward than on win-win cash flows. Phase 3 increased the solvency targets by 0.5% each year from 53% in 1997 to 57.5% in 2006 and constructed six alternative redemption strategies to evaluate.

The six strategies were expressed algebraically as:

1. $S_0 = SP + AP/O67$
2. $S_1 = SP + AP/O65 + AP/P55xx\%$
3. $S_2 = SP + RF$
4. $S_3 = SP + AP/O67(\text{slow phase-out}) + RF$
5. $S_4 = SP + AP/O67(\text{fast phase-out}) + RF$
6. $S_5 = SP + BC$

The board chose the slow phase-out rate, strategy S3, as the strategy of most interest. The projection indicated the ten birth years becoming age 67 (1930-1939) had cash flow ratios ranging from a high of 107% for the 1935 birth year to 88% for the 1938 birth group, compared to the current strategy, S0.

In 1997 MKC implemented the transition plan described by strategy S3 by gradually phasing out the age of patron redemption to the PS stock holders and phasing in the revolving fund redemption. When Walton merged into MKC in 2002 the same framework used for Lindsborg and Haven equity was used to include the old Walton equity in the redemption program.

Financial conditions between 1996 and 2003 ended up being substantially different than the 1997-2006 projections, a common occurrence with financial plans. In May 2002 Farmland Industries declared bankruptcy and the investment MKC and other co-ops had in Farmland was valued at zero. MKC was forced to consider how to distribute a substantial loss, due to the write-down of its Farmland investment, and how to modify its financial strategies including its equity redemption program. In September 2002 the Arthur Capper Cooperative Center held a special symposium on loss handling options for local cooperatives like MKC. Most of the leadership team of MKC attended that meeting. At the end of the 2003 fiscal year MKC reported a loss of \$4.6 million, due in large part to a write-down of their entire investment in Farmland Industries, totaling \$5.6 million.

Total profitability of most co-ops, including MKC, declined in the 1990s and into the early 2000s. MKC still performed at a relatively high level with return on equity dropping from around 15% in the 1980s to 13% in the 1990s. Except for the loss year in 2003, due to the Farmland write-down, profitability still averaged around 12% in 2000-2002. But the financial uncertainty caused by lower profit trends and by the Farmland bankruptcy persuaded MKC to be cautious in redeeming equity. As a result, the original equity management plan was not fully implemented between 1997 and 2003.

In January 2003 the MKC board conducted its annual board retreat to consider future strategic direction. Two topics discussed were (1) how to handle the expected write-down of its investment in Farmland Industries due to Farmland's bankruptcy and expected liquidation and (2) how to improve its current equity management program in light of its current and expected financial situation. The CEO, Bob Nattier, invited Professor David Barton, Director of the Arthur Capper Cooperative Center at Kansas State University, to provide information on (1) loss handling options when an investment write-down in a regional cooperative leads to an overall loss and to provide information on (2) equity management alternatives in this context.

Additional Changes Considered Due to Expected Transition to New CEO

In early 2003 the CEO, Bob Nattier, announced he intended to retire at the end of 2003 and the board of directors began a search for a new CEO. In May 2003 Bob Nattier asked Professor Barton and the ACCC at K-State to conduct another in-depth study of their equity management alternatives and have a report ready to present to the new CEO and to the board, once the new CEO was satisfied with the report. A preliminary report was reviewed with Bob Nattier and the new CEO, David Christiansen, in February 2004 and a final report was completed April 15, 2004.

The 2003 financial planning project made a financial projection for 2004-2013. The income projection projected income generation with return on sales of around 1.5% and return on equity of around 15%. Income distribution assumed non-patronage income of 20% and patronage income distributed as qualified patronage refunds with 30% paid in cash. Fixed asset purchases equaled depreciation expense resulting in no net growth. Balance sheet management targets were set for liquidity and solvency. Liquidity was managed with three targets: current ratio, cash and working capital. Solvency had declined since 1996 and equity to assets was 27.8% in 2003. The equity to assets target was set at 28% in 2004 and increased by 0.5% per year ending up at 32.5% in 2013.

The equity structure had changed from the previous structure due to the 2002 merger with Walton and the addition of old Walton equity as Class D common stock. Five allocated equity classes were actively managed. Enhancements were added to the financial simulator to more accurately estimate the impact of several policies in use by MKC.

Class A, Class B, Class C, and Class D Common Stock were redeemed using the traditional estate settlement. Class A stock, the membership stock of all MKC members, was maintained at \$300 per member. Participating stock and stock credits were combined into class A stock for the financial analysis since they are equivalent in terms of financial analysis. Classes B, C, and D also used an age of patron redemption program at the designated ages in all strategies. Class B stock (Lindsborg) age of patron redemptions was maintained at age 68 (birth year 1936 after fiscal year 2004). Class C stock (Haven) age of patron redemptions were then at age 69 (birth year 1935 after fiscal year 2004) and were reduced to age 68 in 2008 and then maintained thereafter. Class D stock (Walton) age of patron redemptions were then at age 74 (birth year 1930 in fiscal year 2004) and were reduced to age 68 by 2013.

Class A common stock was required of all patrons, voting members and non-voting patrons. A minimum of a \$50 cash purchase for one share of stock was required of all new patrons. An additional 5 shares or

\$250 was required but could be “earned” by the distribution of retained patronage refunds. Class A stock could only be redeemed as an estate settlement. The amount of retained patronage refunds needed to bring patrons up to their \$300 investment goal was estimated by the simulator.

A base plan strategy was constructed to represent the current redemption program for the PS equity class. The PS equity redemption program was expressed as:

$$S0=SP+AP/O68(\text{phase-out})+RF$$

The birth year to be redeemed in 2004 was 1935 but the fiscal year ended in February so this was re-interpreted to be an age 68 instead of age 67 redemption, like in the 1996-97 studies. The phase-out rate to be used in 2004 was 50%, picking up where they left off in the previous phase-out, and the rates were scheduled to decline by 10% each year, reaching 0% in 2009. The revolving fund had been successful in redeeming some old equity but equity from 1980 and after remained. It was decided the base plan, S0, would redeem all old equity to the year retained of 1984 in 2004 (20 years old) and then they would implement a 10 year revolving fund in 2005 and after without regard to managing the solvency target. Then S1 would more strictly manage the balance sheet with a calculated redemption budget without regard to controlling the exact year retained or length of the revolving fund at 10 years.

The first issue to be evaluated was the choice of how to recover the Farmland investment write-down or loss. Variations of strategy S1 were used. S1 did require strict balance sheet management and the achievement of the liquidity and solvency targets, resulting in a redemption budget and a revolving fund redemption that could vary in length from year to year. The recovery choices considered were, no recovery (N), slow recovery (S) over five years and fast recovery (F) over the shortest time possible, which was one year. The faster the recovery the lower the patronage income and patronage refunds in the year of recovery. The slow recovery amounted to \$230,000 per year for five years and fast recovery amounted to \$1,150,000 in one year.

The three PS equity redemption programs were expressed as:

$$S1N=SP+AP/O68(\text{phase-out})+RF$$

$$S1S=SP+AP/O68(\text{phase-out})+RF$$

$$S1F=SP+AP/O68(\text{phase-out})+RF$$

Patronage refunds were \$2.09 million under S1N in 2004 and only \$0.91 million under S1F in 2004. Fast recovery provided the biggest ultimate cash flow benefit to patrons since taxes were reduced and retained earnings increased by the recovered amount of \$1,150,000, allowing for larger equity redemptions than would have otherwise been possible.

Four additional strategies were constructed to evaluate other equity management alternatives and were similar in assumptions to one or more of the S1 strategies.

S2 evaluated the impact of using a base capital (BC) redemption method instead of a revolving fund method. Three variations evaluated were:

$$S2N=SP+AP/O68(\text{phase-out})+BC$$

$$S2S=SP+AP/O68(\text{phase-out})+BC$$

$$S2F=SP+AP/O68(\text{phase-out})+BC$$

S3 evaluated a high retained earnings strategy by distributing the same cash patronage refund dollars as in S1 by distributing the equivalent to the retained portion of patronage refunds to retained earnings. Only the fast recovery option made sense with this strategy. For the PS class of stock it was expressed as:

$$PS:S3F=SP+AP/O68(\text{phase-out})+RF$$

The redemption budgets to the Class B, C and D stock were increased since less PS equity was created and more old equity could be redeemed. Each class had a percentage pool redemption to absorb the additional budget available.

S4 was similar to S1S except it evaluated the impact of moving to a higher common stock requirement by increasing common stock from \$300 to \$2,000.

S5 was similar to S1F except it emphasized high retained earnings but splits the 70% of patronage income being retained on a 50-50 basis between allocated retained patronage refunds and unallocated retained earnings. The consequence was expected to be a slower increase in retained earnings than S3.

Extensive comparisons of these strategies were made in terms of the cash flow impact on patrons and the impact on the equity structure of the balance sheet. The new CEO, David Christensen, and the board used this information to help formulate changes in the future equity management program of MKC.

Equity Management Simplification: Post 2003

David Christensen decided to propose a simplification of the existing equity management plan to the board, after consulting with financial advisors and the board. The proposal was adopted by the board in 2004. The changes included:

1. The retained patronage refund type of allocated equity was consolidated from four separate classes into one new class of allocated equity called "deferred patronage" or "Revolving Fund." The old MKC preferred stock class, PS, the Lindsborg class B, the Haven class C and the Walton class D were all consolidated into this one class in 2004. All classes had received substantial redemptions due to the age of patron phase-out and the introduction of the revolving fund redemption.
2. The age of patron redemption was dropped and only estate settlement redemptions and revolving fund redemptions would be made from the new "revolving fund" class in the future. All new retained patronage refunds would be distributed to the new class. Not much

equity was expected to be redeemed through age of patron redemptions from the old classes in the future so patrons turning a target age, such as 67, were not expected to be upset.

3. The new program was expressed as SP+RF. This also simplified balance sheet management since only one major class had to be managed. This resulted in an acceleration of the phase-out of the age of patron redemption.

This simplification was proposed as a way to reinforce the philosophy of being “one company” not several legacy companies with differences between them, including those reflected in multiple equity classes.

The financial strategies also included making more fixed asset investments, financed as much as possible with equity. MKC leadership stressed the need to improve profitability to create more new equity. Industry profitability increased from 2004 to 2011 and MKC was able to improve its profitability as noted previously.

Substantial equity redemptions were made using the revolving fund method. The revolving fund often redeemed at least two years of old equity each year and the revolving fund is now redeeming 1990 equity, resulting in a revolving fund of about 21 years in length. High priorities in the 2004-2011 period was facility improvements (high fixed asset growth) and keeping the balance sheet strong. Revolving fund equity redemptions were the residual use of available funds so there was no attempt to reach a certain length of revolving fund by a date certain.

MKC’s equity structure changed between 2005 and 2011. One prominent change, common to many local co-ops, is the relative increase in unallocated equity compared to allocated equity. Unallocated equity increased from \$7.7 million, 40.9% of total equity, to \$23.9 million, 46.4% of total equity. This increase in dollars is the result of retaining after-tax earnings from non-patronage business as retained earnings not from retaining patronage income as retained earnings. In other words, MKC has operated as a pure co-op by allocating all patronage income to patrons as cash patronage refunds or retained patronage refunds. Higher levels and proportions of unallocated equity make it possible to redeem more allocated equity, all else equal.

In 2007 Talmage co-op merged into MKC and their allocated equity eligible for a revolving fund redemption was not separated out as a separate class even though it had been redeemed in the past only as an estate settlement. It was combined with the MKC revolving equity after some special restructuring to make it fair and equitable to both Talmage patrons and MKC patrons. The equity was restructured or spread out over previous years (“years retained”) in a way that resulted in Talmage patrons receiving equity redemptions equivalent to what they would have received had they remained an independent cooperative. This also was a win-win outcome for MKC patrons. The advantage of this approach was that only one class of equity need be maintained and a revolving fund could be used to redeem equity from that class.

Section 199 Utilization

MKC has utilized the Section 199 deduction or tax benefit in some past years and did pass some deductions through to producers one year. They did not use it in 2010 and do not plan to use it in 2011 because of the possible risks of doing so, if the deduction was denied by the IRS after an audit.

Only grain volume has been used in the past as the basis for the deduction. MKC has not used business volumes from agronomy or other business units to try to justify larger deductions.

Most advisors talked to by MKC suggested a conservative strategy in claiming the Section 199 deduction. This meant grain volume could be claimed if the purchase from the patron and payment to the patron was made by the co-op. However, MKC uses the TMA grain marketing company, an LLC, to purchase and pay for grain. This business structure is a problem. Many financial and legal advisors have expressed concerns about being able to claim those grain purchases by the LLC as co-op "per unit retains paid in money" (PURPIM), a requirement to claim the deduction.

MKC retained George Benson, a nationally respected tax accounting lawyer and expert on Section 199, as well as their auditor, Ken Hamby, to advise them. Based on this professional advice they have chosen to forgo using the Section 199 deduction due to the LLC business structure they utilize.

Business structure alternatives that could safely utilize Section 199 have been considered, including dissolving TMA or merging TMA into MKC. No acceptable alternatives have been found so far. They have concluded the TMA business structure is very cost efficient and off-sets the disadvantage of not being able to utilize the Section 199 deduction. They have also considered trying to get a Private Letter Ruling from the IRS that might enable them to use the LLC business structure as an eligible party but have chosen not to do so.

Summary of Finance Innovations

MKC was an early pioneer among local co-ops in making several types of changes that improved its equity management program. Those changes included:

1. MKC phased out a popular but inferior equity redemption method, age of patron, and phased in the revolving fund method. This facilitated more effective balance sheet management including the ability to achieve liquidity and solvency targets. It also treated patrons in a more fair way by significantly increasing the proportionality of investment, keeping the equity investment in the hands of active patrons as much as possible. Also, a much larger group of patrons received a redemption of equity each year with a revolving fund redemption.
2. MKC restructured the allocated equity in individual patron accounts to make the revolving fund redemption more fair and equitable, given that the historical year retained information in some equity classes was not accurate. The restructuring action was also used with Talmage equity to account for the fact Talmage had much older equity than MKC at the time of the merger. An adjustment was necessary to treat both Talmage and MKC patrons in a

- win-win way. Otherwise Talmage patrons would get a much bigger redemption with a revolving fund than they would have received in their old program and MKC patrons would get a much smaller redemption than they would have received.
3. MKC maintained separate equity classes for the legacy companies after a merger up until 2004 to manage each equity class in a fair and equitable way, relative to each of the other classes. They was implemented by calculating a total redemption budget for all classes combined and then splitting this total into parts by assigning a redemption budget to each equity class in a way that implemented this win-win concept.

Exhibit 1

MID KANSAS COOPERATIVE ASSOCIATION
Moundridge, Kansas

CONSOLIDATED STATEMENT OF OPERATIONS

For Years Ended February 28

	FYE 2011	FYE 2010	FYE 2009	FYE 2008	FYE 2007	FYE 2006	FYE 2005
TOTAL SALES	314,821,398	337,611,406	452,535,819	281,059,170	225,257,225	217,165,077	225,464,992
GROSS MARGINS	31,110,034	23,351,032	28,086,593	18,385,640	15,544,674	15,384,008	12,917,351
TOTAL OTHER OPERATING INCOME	13,035,647	13,639,706	13,068,472	7,189,513	6,632,709	8,056,797	8,492,594
GROSS INCOME FROM OPERATIONS	44,145,681	36,990,738	41,155,065	25,575,153	22,177,384	23,440,805	21,409,945
TOTAL OPERATING EXPENSES	32,351,234	28,033,176	29,230,283	24,344,952	19,139,237	18,542,145	17,912,246
EARNINGS FROM LOCAL OPERATIONS	11,794,447	8,957,562	11,924,782	1,230,201	3,038,146	4,898,660	3,497,699
TOTAL OTHER EARNINGS	2,893,816	4,266,008	5,559,770	4,731,898	3,356,619	1,773,426	1,260,667
NET EARNINGS BEFORE INCOME TAXES	14,688,263	13,223,570	17,484,552	5,962,099	6,394,766	6,672,086	4,758,366
TOTAL PROVISION FOR INCOME TAXES	1,101,734	615,105	2,214,910	1,004,140	862,558	508,117	269,240
INCOME BEFORE NON-CONTROLLING INTEREST	13,586,529	12,608,465	15,269,642	4,957,960	5,532,207	6,163,968	4,489,126
NON-CONTROLLING INTERESTS	(4,715,124)	(4,176,808)	(4,431,980)	(1,283,102)	(2,340,345)	(1,839,154)	(1,456,044)
NET EARNINGS	8,871,405	8,431,657	10,837,662	3,674,858	3,191,862	4,324,815	3,033,082
Profitability							
Return on Sales (NE/TS)	2.82%	2.50%	2.39%	1.31%	1.42%	1.99%	1.35%
Return on Local Assets ((LE)/(TA-TI))	4.16%	6.44%	10.81%	0.59%	2.89%	7.17%	5.96%
Return on Equity (NE/ME)	17.22%	18.69%	30.20%	12.57%	13.80%	20.18%	16.04%
Efficiency							
Gross Income to Personnel Expense (GI/PE)	2.98	2.72	3.19	2.85	2.76	2.68	2.45

Exhibit 2

MID KANSAS COOPERATIVE ASSOCIATION
Moundridge, Kansas

CONSOLIDATED BALANCE SHEETS

February 28

	FYE 2011	FYE 2010	FYE 2009	FYE 2008	FYE 2007	FYE 2006	FYE 2005
TOTAL CURRENT ASSETS	257,270,638	119,729,630	92,287,894	194,489,457	92,057,884	57,497,644	47,228,571
TOTAL INVESTMENTS	18,510,368	16,711,144	15,172,678	13,143,813	10,220,501	7,857,579	6,401,850
TOTAL OTHER ASSETS	863,914	993,927	905,571	937,191	963,541	832,982	785,972
NET PROPERTY, PLANT AND EQUIPMENT	25,306,856	18,397,606	17,075,444	13,613,996	12,043,868	9,952,850	10,687,931
TOTAL ASSETS	301,951,776	155,832,307	125,441,587	222,184,457	115,285,793	76,141,055	65,104,325
TOTAL CURRENT LIABILITIES	234,076,825	97,315,049	78,614,982	185,510,750	84,953,516	50,112,055	40,882,999
TOTAL LONG- TERM LIABILITIES	16,368,716	13,413,628	10,940,283	7,432,087	7,210,724	4,602,006	5,306,449
MEMBERS' EQUITY							
Preferred stock	-	-	-	-	-	-	5,742,372
Common stock	4,100,950	3,998,450	3,932,350	3,856,550	3,526,150	1,027,200	5,029,819
Participating stock	934,750	940,700	712,850	702,550	147,000	67,350	68,900
Revolving fund and other ledger credits	17,633,856	15,021,162	13,398,966	10,166,681	8,661,324	11,121,574	28,883
Retained earnings	23,873,453	20,744,184	16,776,721	12,630,394	10,461,692	8,897,784	7,731,748
Noncontrolling interests	4,899,505	4,374,647	1,086,577	463,600	325,388	313,085	313,156
Accumulated other comprehensive income	63,721	24,487	(21,142)	1,421,845	-	-	-
TOTAL MEMBERS EQUITY	51,506,235	45,103,630	35,886,322	29,241,620	23,121,554	21,426,993	18,914,878
TOTAL LIABILITIES AND MEMBERS EQUITY	301,951,776	155,832,307	125,441,587	222,184,457	115,285,793	76,141,055	65,104,325
Liquidity							
Working capital (CA-CL)	23,193,813	22,414,581	13,672,912	8,978,707	7,104,368	7,385,589	6,345,573
Current ratio (CA/CL)	1.10	1.23	1.17	1.05	1.08	1.15	1.16
Solvency							
Equity to Assets (ME/TA)	17.06%	28.94%	28.61%	13.16%	20.06%	28.14%	29.05%
Adjusted Equity to Assets ((ME/(TA-CL))	75.88%	77.08%	76.64%	79.73%	76.23%	82.32%	78.09%
Debt to Equity (LTL/ME)	31.78%	29.74%	30.49%	25.42%	31.19%	21.48%	28.05%
Retained Earnings to Equity (RE/ME)	46.35%	45.99%	46.75%	43.19%	45.25%	41.53%	40.88%