Co-operative capital

A new approach to investment in co-operatives and other forms of social enterprise

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Commissioning editor and principal author

Abbreviations

AIM	Alternative Investment Market
BCV	Bridges Community Ventures
BES	Business Expansion Scheme
CAT	Centre for Alternative Technology
CDFA	Community Development Finance Association
CDFI	community development finance institution
CIC	Community Interest Company
CSR	corporate social responsibility
DTI	Department of Trade and Industry
EIRIS	Ethical Investment Research Service
EIS	Enterprise Investment Scheme
FLO International	Fairtrade Labelling Organisations International
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act
FTSE	Financial Times Stock Exchange (Indices)
ICA	International Co-operative Alliance
ICO	Industrial Common Ownership
ICOF	Industrial Common Ownership Finance
ICOM	Industrial Common Ownership Movement
ILO	International Labour Organization
IPO	initial public offering
IPSs	industrial provident societies
IPSA	Industrial and Provident Societies Acts
LSE	London Stock Exchange
Ltd	limited
NCB	National Coal Board
NUM	National Union of Mineworkers
OECD	Organisation for Economic Co-operation and Development
plc	public limited company
REDF	Roberts Enterprise Development Fund
SiRi Group	Sustainable Investment Research International Group
SRI	socially responsible investment
SROI	social return on investment
VCT	Venture Capital Trust
WSC	withdrawable share capital

Introduction

Co-operatives have been in existence for at least 160 years. They are equitable businesses with a social purpose, democratically owned and controlled by their members. There are nearly three-quarters of a million co-operatives worldwide, providing jobs for over 100 million people – more than are employed by all the multinational corporations in the world[1].

The UK is the birthplace of the modern co-operative movement. Its founders, the Rochdale Pioneers, were the first to codify co-operative values and principles. Today, these values and principles are expressed in the International Co-operative Alliance's (ICA) statement on the identity of co-operatives – the definition of co-operatives used throughout the world. Appendix 1 contains a full copy of this statement, an abridged version is presented below. The ICA is the world's largest non-governmental organisation recognised by the United Nations.

The ICA statement on the co-operative identity

Definition
A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

Values
Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.

Principles
1. Voluntary and open membership
2. Democratic member control
3. Member economic participation
4. Autonomy and independence
5. Education, training and information
6. Co-operation among co-operatives
7. Concern for community

There are two main types of co-operative: consumer co-operatives and provider co-operatives. Consumer co-operatives are owned and controlled by the customers or service users of the enterprise, and include retail co-operatives, housing co-operatives and credit unions. Provider co-operatives are owned and controlled by those who provide labour, goods or services to the enterprise, such as workers' co-operatives, marketing co-operatives and some forms of agricultural co-operative.

Promoting new co-operative ventures

In the UK, the best-known form of co-operative is the consumer co-operative society, popularly referred to as The Co-op. In 1958 there were 932 independent consumer co-operative societies in the UK. By 2003, following a prolonged period of mergers and restructuring, there were 34 consumer societies with a combined turnover of £13.4 billion and reserves of £4.2 billion. During the same period, particularly in the 1970s and 1980s, there was a growth in the number of workers' co-operatives, credit unions and housing co-operatives. More recently there has been a resurgence of interest in consumer co-operatives, with the formation of co-operatives such as The Phone Co-op and Baywind Energy Co-operative. Current estimates of the number of co-operatives of all types in the UK range from 2,000 to 3,500, including some very small micro-enterprises and the Co-operative Group with a turnover of £8.9 billion.

It is widely accepted that the number of co-operatives in the UK belies the potential contribution this form of enterprise could make to the national economy. Many of the values and principles underpinning the co-operative form of enterprise are nowadays accepted as good business practice. Social responsibility, participation, equality and democracy are the foundations of modern society and, potentially, of a modern enterprise culture.

The 2001 Co-operative Commission report into the future of the consumer co-operative movement highlighted numerous issues including the old-fashioned image of retail co-operatives, their poor commercial performance and the lack of re-investment. Over the past three years the consumer movement has done much to address these issues. Among its many recommendations the Co-operative Commission called for the creation of a New Ventures Panel with a remit to identify new and fledgling sectors of the economy where opportunities might exist for a co-operative solution.

From its outset, the New Ventures Panel expressed concerns about the problems new and rapidly growing co-operative ventures face in raising long-term finance. These problems are particularly pronounced for smaller and younger co-operatives that need more than £1 million.

All businesses need long-term finance for their growth, development and sustainability. By far the best source of this long-term finance is the business itself: generating profits which are reinvested in the business. But reinvested profits are not always enough. The other main sources of long-term finance are debt and equity.

Historically, co-operatives have favoured debt over equity. This reflects the fact that the owner–members of co-operatives are primarily consumers or providers, rather than investors. Many co-operatives allow and even encourage their members to buy equity stakes, but there are usually limits on how much money individual members can invest, as well as limits on the returns they can receive on their investments. Investment by non-members has nearly always been in the form of loans. But a handful of UK co-operatives have experimented with raising equity capital from non-members. These experiments have been stimulated by the success of other forms of ethical businesses and social enterprises in raising significant amounts of equity capital from ethical investors. They have demonstrated that it is possible to align the interests of investors with the interests of other stakeholders in the enterprise.

A new approach to co-operative capital

The purpose of this publication is to promote a new approach to co-operative capital. It proposes a new form of multi-stakeholder relationship in co-operatives where the competing interests of employees, customers, suppliers and investors can be reconciled in pursuit of a common purpose. This new approach is possible because of the growing number of investors that want to invest in ethically guided businesses. Ethical investors are not interested in maximising their wealth at the expense of others. They want a fair return on their investment and, like other investors, they need to be rewarded for taking risks. But these rewards are not purely financial; they also want a social return on their investment. This social return may be expressed in the way the business is run, as well as in the products and services of the business.

Chapter 1: Opportunities for new ventures, identifies promising new business opportunities for co-operatives across a broad range of product and service sectors. It describes five areas where co-operatives have a competitive advantage over private sector firms, and the five main starting points for new co-operative ventures. It uses this information to establish a framework for identifying the most promising opportunities for new co-operatives.

The key to unlocking interest in the co-operative form of enterprise lies in demonstrating that co-operatives can serve the mutual interests of all stakeholders. Employee-owned businesses are more productive when the entrepreneurs and employees have a financial stake in the growth of the enterprise. Customers are more loyal to businesses they have a financial interest in, which in turn can lead to faster growth. But most successful high-growth co-operatives reach a stage where their investment needs are greater than can be met by their primary members. At this stage co-operatives need external investors who support their values and principles, and share an interest in their development. These processes are explored in Chapter 2: The stakeholder life cycle. This chapter argues that co-operatives will benefit from opening their doors to ethical investors who share their passion for their products and services.

A small number of co-operatives and social enterprises have already pioneered new relationships with investors, using a range of different legal models and financial instruments to raise between £1 million and £5 million of equity capital. Chapter 3: Current investment practices, examines the cases of four such enterprises, which illustrate how practices have changed over the years. The Centre for Alternative Technology (CAT) raised £1 million in preference shares from investors who were keen supporters of their work. Investors in CAT have never received a dividend, have no voting rights, and have to wait for prolonged periods to sell their shares. Traidcraft adopted similar practices in its early days of equity fundraising. But by the time Traidcraft launched its fourth share issue in 2002, which more than doubled the total equity to just under £5 million, it had introduced voting rights and made a commitment to pay dividends in the future. In contrast, Baywind Energy Co-operative has always paid shareholders a dividend, which investors have now come to expect. The ability to reward investors with a fair financial return on their investment, in addition to the social returns, is important if institutional investors are to be attracted to invest. The fourth case study in this chapter describes how Poptel, a workers' co-operative, attracted venture capital, and their experiences of working with this type of investor.

The issue of what constitutes a fair return for an ethical investor is one the subjects of Chapter 4: The ethical investor. This chapter examines trends in the UK ethical investment market. Although still very small when compared to the size of the UK capital investment market, the ethical investment market is growing fast. Over 20 years it has grown from virtually nothing to being worth more that £3.5 billion. However, very little of this capital is invested in co-operatives and other forms of social enterprise. In the past this was because institutional investors found it difficult to invest in co-operatives and social enterprises on terms that met their responsibility to focus on financial returns alone. But changes in the regulations governing the management of pension funds, which came into force in July 2000, have encouraged more funds to take ethical issues into account when making investment decisions. There is also mixed evidence about whether the application of ethical investment criteria results in a poorer financial performance. Co-operatives can appeal to ethical investors by offering a triple dividend: good financial returns from democratically managed businesses producing socially purposive products and services.

The remaining chapters look at the practicalities of engaging ethical investors in co-operatives. Chapter 5: Investing in co-operatives, examines mechanisms for investing in co-operatives and methods for calculating a fair return on investment. It explains how the co-operative principle of common wealth can be used to reconcile the competing interests of stakeholders by providing a basis for rewarding long-term investment with capital gains. The chapter also describes how co-operatives can achieve a balance between equity and debt finance that maintains the democratic rights of members, and explores the options for creating hybrid forms of co-operative capital that combine the attributes of debt and equity. As Chapter 2 recognises, the stakeholders in a co-operative can change as the enterprise grows and develops. And the investors in a co-operative can change too, creating an investor life cycle whereby new investors provide exit routes for earlier generations of investors. Chapter 5 describes how this process can be aided by developing highly transparent valuation techniques that can be used to establish a fair price for co-operative capital.

Investors need a market place where co-operative capital can be bought and sold according to ethical principles. Chapter 6: An ethical exchange, describes what would be involved in creating an ethical exchange. It explains why it is necessary to establish a market and how ethical trading would work, including the mechanisms for pricing traded capital. It also investigates the possible criteria for membership of an ethical exchange.

The proposals in this publication are radical and far-reaching. Chapter 7: An equity model for co-operatives, shows how all the ideas can be implemented within the spirit of existing co-operative principles. It presents the legal formats and organisational structures for enabling external ethical investors to invest in co-operatives. None of the developments proposed require fundamental changes to existing legislation.

Translating these radical proposals into action will require the full and active support of the UK co-operative sector. Chapter 8: Next steps, highlights ten key areas where work can begin on implementing the ideas in this publication.

[1] International Co-operative Alliance. *Co-operatives for fair globalisation: Creating opportunities for all*. 82nd International Co-operative Day, 3 July 2004.

Chapter 1: Opportunities for new ventures

> This chapter provides an analytical framework for identifying opportunities for new co-operative ventures. Section 1 identifies five main starting points for new co-operatives. Section 2 describes five areas where co-operatives have a competitive advantage over private sector firms. Section 3 proposes revitalising the co-operative brand and identity by developing it as a social brand, alongside other social brands such as fair trade and sustainability. Section 4 draws together the ideas presented in this chapter in a framework that identifies the most promising new business opportunities for co-operatives.

The supply of co-operative capital will only be improved if there is demand for that capital. Financial institutions have to be confident that there will be sufficient demand before they develop new products and services. This chapter examines the potential demand for co-operative capital from new co-operative ventures.

Identifying new business opportunities with the potential for growth and good returns for all stakeholders is extremely difficult. Highly innovative ideas all too often end in business failure, while more mundane ideas can sometimes be the basis of highly successful businesses. A survey of the fastest growing new businesses in the US[1] found that most had started with mundane business ideas, had very limited financial resources and faced severe capital constraints. The most promising start-ups tended to occupy small niches in unsettled market conditions and were highly dependent on the personal abilities of the entrepreneur to satisfy unclear customer needs. Does this apply to new co-operatives too? If it does, it means that attention should focus on the starting points for new co-operatives, examining what can be done to persuade highly talented entrepreneurs to adopt the co-operative business model. It would also be helpful to develop techniques for identifying the most promising market niches for these new co-operatives.

The New Ventures Panel considered three different approaches to the task of identifying new business opportunities[2]: the pragmatic, the theoretic and the entrepreneurial. The pragmatic approach focuses on opportunities that are most immediate and accessible to the co-operative movement. Examples of such opportunities include elderly care, childcare, renewable energy sources and affordable social housing. Work is already well advanced in investigating opportunities in these areas. The theoretic approach consists of developing analytical tools to identify, test and evaluate new business propositions, and through a process of elimination arrive at the most promising ideas. The entrepreneurial approach concentrates on the processes of new business development rather than the product or service idea itself. This approach addresses the weaknesses and limitations of the methods used to develop new co-operative ventures. One of the main limitations identified by the New Ventures Panel was the difficulties new and rapidly expanding co-operatives face in raising long-term finance to develop new business opportunities.

This chapter develops a framework for identifying promising business opportunities for new co-operatives. This framework will strengthen the theoretic approach being developed by the New Ventures Panel, and will combine with the pragmatic and entrepreneurial approaches the Panel is already developing to provide a powerful new method for creating new co-operative ventures.

1. Starting points for new co-operative ventures

Like all small businesses, co-operatives are more likely to seek external finance when faced with business growth opportunities in the early stage of their development, typically three to seven years after they have been established. But as Chapter 3 will show, very few UK co-operatives have sought to raise finance from the public. Over the last decade only 13 social enterprises have issued bonds or shares to the public, and this is more than double the number that did so in the previous decade. On the basis of this evidence, even if the supply of capital is greatly improved it is unlikely to unleash much extra demand from established co-operatives.

The demand for co-operative capital is more likely to come from newly established co-operatives. Outlined below are the five main starting points for such co-operatives. The first two entail the development of wholly new businesses, the rest involve the conversion of existing organisations into co-operatives.

Entrepreneurial new-start co-operatives

Chapter 2 highlights the low formation rate of co-operatives compared with private sector businesses. In order to encourage more entrepreneurs to choose the co-operative model, Chapter 2 proposes a new deal for entrepreneurs that financially rewards them for establishing co-operatives. All new-start businesses need start-up capital, and most would benefit from more capital than the entrepreneurs themselves can provide. Ideally this start-up capital should be in the form of equity, invested with an interest in the growth of the business rather than its ability to pay an immediate return on that investment. A co-operative capital fund providing equity finance to new-start businesses could encourage more entrepreneurs to consider the co-operative option. Co-operative business angels could play a similar role. It would be the duty of these investors to ensure that the new-start business becomes and remains a co-operative.

Managerial new-start co-operatives

Another way of developing new-start co-operatives is for a parent organisation to give birth to a new venture. Parent organisations could include voluntary and public sector organisations, as well as older, established co-operatives. The new venture might be a spin-off from an existing activity within the parent organisation, a new activity filling part of the parent organisation's supply chain, or a new complementary product or service targeted at the parent organisation's customer base. In all of these cases the parent organisation would be responsible for the initial feasibility work, and for recruiting a manager or managerial team charged with creating the new-start co-operative. While these new-start co-operatives might sometimes be the product of a single parent, more often they will be joint ventures involving two or more parents with a mutual interest and investment in the new venture.

Transformation of voluntary and charity sector organisations

There are strong links between the co-operative movement and the voluntary and charity sector. Both are parts of the social economy and, with the rise of interest in social enterprise, many voluntary organisations are beginning to examine their organisational structures. Over the last two decades there has been a steady shift away from grant income towards a contract culture in which voluntary organisations and charities compete with the private sector to deliver publicly funded services. More than 42% of UK based charities' total income is now earned from trading.[3] Trading is not compatible with charitable status or with a governance model that relies on volunteer trustees without the business acumen to make hard business decisions. Helping voluntary organisations that already obtain more than half of their income through trade to transform themselves into co-operatives may well become one of the most important starting points for new co-operative ventures over the next decade. There is evidence that this shift is already happening. For instance, the National Housing Federation is rebranding its member housing associations as social businesses.[4] One of the reasons for this rebranding is that some housing associations want to explore the possibility of introducing equity finance into their capital structures.

Externalisation of public services

The creation of Greenwich Leisure Limited was a landmark in co-operative history. Formed in 1993, it was the first large-scale externalisation of a public service. Since then many other local authorities have followed Greenwich's example, externalising their leisure service departments as co-operative enterprises. Other areas of public service provision could follow. Writing in The Guardian newspaper shortly after the 2001 general election victory, Patricia Hewitt said "*there is no reason why the partners in public service provision should come only from the private sector. In a second term we should be seizing the opportunity to promote social enterprises, not-for-profit businesses, committed to social goals as an essential part of a modernised public service.*"[5] The co-operative movement is already engaging with this important starting point for new co-operatives by working with government and its agencies to identify the most promising opportunities for externalisation.

Buy-outs of private sector firms

Employee buy-outs of private sector firms have always been an important source of new co-operative ventures. The main limiting factor has been the ability of employees to raise sufficient finance on an equitable basis. Co-operative–friendly funds, such as Baxi Partnership Ltd, have made a difference in a handful of cases, but most private equity funds will only back management buy-outs with strong growth potential. This has resulted in succession failure – a growing problem within the private sector. Succession failure is when a private business is forced to close because the owner cannot find a buyer or successor for the business. Recent research for the Small Business Service[6] suggests that the number of small and medium-sized private sector firms vulnerable to succession failure is growing rapidly, up from 27% in 1992 to 35% in 2000. It estimated that there are over 54,000 private firms, employing a total of one million people, vulnerable to succession failure. Co-operatives^UK^, together with a range of partners, has been developing co-operative solutions to the succession problem, demonstrating how the transfer of ownership to a co-operative structure can be achieved in a range of situations.[7]

2. The co-operative advantage

The Co-operative Commission called its report "*The Co-operative Advantage*" to focus attention on its central premise that co-operatives have a competitive advantage over the private sector. It argued that "*in successful co-operatives, the ethical values of honesty, openness, social responsibility and caring for others, can give an edge over businesses driven simply by the profit motive*".[8] It suggested that co-operatives could create a virtuous circle, within which the attainment of social goals results in commercial success, which in turn reinforces the ability to meet the social goals.

On the surface, this interest in a virtuous circle appears to be very similar to the enlightened self-interest of corporate social responsibility. All firms are now being urged by the government to accept their broader responsibilities to society. Many larger companies are keen to publicise their good deeds, providing information in their annual reports about their environmental performance and social impact. But this public relations emphasis on social performance is a poor counterbalance to the social consequences of the profit motive. Corporate social responsibility is too often played out on the periphery of companies where it cannot influence the profit-driven decision-making of the core business. If the virtuous circle of co-operation is to mean anything more than corporate social responsibility window dressing then it must be apparent in the core business behaviours and activities of co-operatives.

This means pursuing social goals directly through the trading activities and business practices of the co-operative. The Co-operative Bank is a powerful example of what this looks like in practice. It has achieved commercial success by adopting ethical standards and practices in its core business activities. It will not trade, for instance, with organisations involved in human right violations, tobacco products, the arms trade or the development of genetically modified organisms.

This chapter explores the following five areas where co-operatives may have a competitive advantage over private sector firms:

- **A values-based approach to new business development –** where co-operative values and principles are used to design and develop innovative new products and services and establish new niche markets;
- **Public interest activities –** where the product or service is purchased by local or central government agencies on behalf of the public;
- **High trust products and services** – where a high degree of trust is required between the stakeholders in the enterprise, particularly between its customers, employees and investors;
- **Higher productivity** – where the value-added or output per employee is higher because all the stakeholders have a shared interest in the success of the co-operative;
- **Mission-oriented businesses –** where the pursuit of profit is secondary to the social purpose or mission of the co-operative.

A values-based approach to new business development

Co-operative values and principles can be used as a toolkit for designing and developing new products and services. Good examples of areas where this has already been done include the ethically-guided approach to banking adopted by The Co-operative Bank and the fair trade products developed by the workers' co-operative Equal Exchange. Both illustrate the principle of using the co-operative values of democracy, equality, equity and solidarity to determine the choice, nature and design of their products and services.

The fair trade market is growing rapidly in the UK, albeit from a small base. Retail sales of fair trade products are estimated to have grown from £16.7 million in 1998 to £63 million in 2002. Fair trade ground coffee now has more than 14% of the UK ground coffee market. [9] In common with other social brands, fair trade is developing its own regulatory systems through the Fairtrade Foundation certification scheme and the international umbrella body the Fairtrade Labelling Organizations (FLO) International. The Co-operative Group is the leading retailer of fair trade products in the UK.

Ethically-guided business practices have made most progress in the field of personal investment and financial services. Chapter 4 presents an analysis of this market, charting its growth over the last two decades to its current size, with over £3.5 billion invested in ethical funds. However, as Chapter 4 makes clear, the ethical investment market is currently orientated towards the private sector, and is very underdeveloped in the co-operative sector. Major opportunities exist for developing a range of co-operative businesses offering ethical investment products and services, including ethical investment opportunities in the co-operative sector.

Some entrepreneurs have developed new niche markets based on co-operative values. The women who created the co-operative Letterbox Library were driven by the values of equality and solidarity to challenge the values presented in children's books. They set up a co-operative selling multicultural and non-sexist books for children and, over the years, have influenced the mainstream market to address these issues. As society becomes increasingly multicultural and diverse, there are many more opportunities for establishing co-operatives which serve niche markets that celebrate diversity and equality.

The third co-operative principle of member economic participation can provide a niche for co-operatives in markets where consumers or suppliers feel they are exploited or subject to unfair levels of competition. For instance, The Phone Co-op was established to provide consumers with a fairer deal in the telecommunications market. Customers of The Phone Co-op are encouraged to become investors too, and have so far provided the co-operative with all its capital requirements.

Business opportunities exist for developing new consumer co-operatives in other utilities markets such as gas and electricity, or in other energy markets such as vehicle fuels. Insurance markets could be another area of opportunity for consumer co-operatives, representing a back-to-basics approach for an industry that started out in the mutual sector.

Concern for community is the seventh principle of co-operation and can be used as a guiding principle for developing locally orientated products and services. Farmers' markets are an illustration of this principle at work. Co-operative village stores, where communities invest in their local store, thereby reinforcing their incentives to shop at the store, are another example of localism at work. Localism can be extended to a wide range of products and services that would benefit from greater customer involvement and influence. Health and education are two areas where the principle of localism could be used to design new services. Neighbourhood nurseries and healthy living centres are good examples of localism at work. Both of these examples also illustrate another area where co-operatives have a competitive advantage over the private sector, namely public interest activities.

Public interest activities

Over the last ten to fifteen years, profound changes have taken place in how public services are provided. Increasingly, local and central government are the purchasers rather than the providers of these services. This shift was initiated by the Conservative Government in 1988 in the form of Compulsory Competitive Tendering, and continued under the subsequent Labour Government through the vehicle of Best Value. In recent years the process of contracting out public services has intensified and become more complex, with the introduction of Public Private Partnerships and the Private Finance Initiative. This has brought public services such as health, education and transport into the private domain by establishing new approaches to capital investment in these fields.

Political concerns about these trends have led the government to seek the involvement of co-operatives, social enterprises and the voluntary sector in its drive to modernise public services. So far, co-operatives and other parts of the social economy have only secured a small proportion of new public service delivery contracts, with the bulk of the work going instead to the private sector. For instance, in the field of domiciliary care, local authorities, which used to employ their own direct labour to provide this service, now contract out the majority of this work, with more than three-quarters of it going to private sector contractors. [10]

There are two possible explanations why so few co-operatives have involved themselves in public service provision on any scale. First, co-operatives may have lacked the capital resources to invest in these new opportunities. Secondly, co-operatives and co-operative entrepreneurs may have been wary of engaging in competitive tendering that demanded cost cutting in services where employees were already poorly rewarded. Compulsory Competitive Tendering developed a bad reputation because some private sector firms used it as a vehicle for expanding their businesses, pushing up profits by cutting staffing levels and providing worse terms and conditions for workers. Best Value is meant to shift the emphasis from cost cutting to competition, productivity improvements and better quality services.

Co-operatives can establish a major competitive advantage over the private sector in the provision of public services by engaging stakeholders on a more equitable basis. Co-operative values and principles can be used to redesign public services. Local services could be democratically owned and controlled by the public service users, who could also become investors in the service. This could be coupled with employee involvement in the delivery of services, using the multi-stakeholder structures described in Chapter 7.

Opportunities for establishing new co-operatives in public service provision are likely to be concentrated in areas where one or more of the following conditions prevail:

- The service users are already actively involved in governing the service.
- A significant level of capital investment is required, some of which will come from the public purse if there are guarantees that it will not end up in private hands.
- An established co-operative is prepared to be a partner in the new venture.
- The current service providers support the proposals and are engaged as stakeholders.
- The service in question entails a high degree of trust between stakeholders.

While most of the opportunities will involve the modernisation of existing public services, there may also be opportunities to develop new public services. Community regeneration initiatives often involve the development of new public services in pursuit of social goals that are aligned with co-operative values; examples include waste management, community transport and complementary health services.

Another area where co-operatives could find new opportunities based on the public interest is the focus of the government's Wider Markets Initiative.[11] This initiative is designed to encourage the public sector to adopt a more entrepreneurial approach to the use of public assets. It promotes the commercial exploitation of underused assets through joint ventures with partners. A sister initiative provides advice and assistance to universities to help them commercialise the outputs of publicly-funded research in science and technology. Co-operatives could prove to be the perfect vehicle for these new ventures.

High trust products and services

Some products and services require the customer to have a high degree of trust in the supplier. This can be the case where the customer lacks the knowledge or expertise to determine whether the service or product being offer by the supplier is necessary or appropriate. Examples include health services, professional advice, and technical services such as vehicle maintenance or building work.

Trust can also be an issue where one group of stakeholders stands to benefit at the cost of another group of stakeholders, or where market conditions give one group of stakeholders more power than other stakeholders. Firms trading in near monopolistic conditions can force customers to pay high prices for the benefit of their shareholders. Similarly, businesses located in areas of high unemployment can recruit staff on lower wages and poorer conditions than elsewhere.

Another situation in which trust can be a major issue is where negligence, incompetence or abuse by one party can result in inordinately large losses for the other party. Health services are an obvious example of such a situation, along with other services such as personal care of the elderly, children or disabled people, where a service user's survival might be in the hands of the service. Financial services such as investment, savings and insurance can also fall into this category, as demonstrated by the endowment policies mis-selling scandal.

The profit motive of private sector firms can undermine their customers' and their employees' trust in them. This provides co-operatives with a competitive advantage. A survey of the customers of two co-operative and mutual societies found that they had remarkably high levels of trust in these businesses because there were no external shareholders expecting profits to be maximised for their private gain.[12] The same study found that this high level of trust in co-operatives was not just based on their different ownership structures but was also because of their broader co-operative principles.

Higher productivity

The ability to achieve higher productivity could be a very important competitive advantage for co-operatives. In theory, co-operatives should be more productive than private sector firms because productivity is in the interests of all stakeholders, unlike profitability, which only serves the interests of investors. And there is some evidence to support this theory. A study in the US of employee-owned firms found that productivity improves by an extra 4% to 5% on average in the year employee ownership is adopted, and is maintained in subsequent years.[13] This is supported by evidence in the UK which shows that companies and workplaces which adopt shared compensation practices, such as profit sharing, have higher productivity than other firms.[14] The same study found that productivity was even higher where there were shared information and decision-making practices.

Higher productivity is partly achieved through the labour of employees but is also dependent upon investment in machinery and equipment. Therefore, it would be reasonable to expect that a new co-operative model that aligned the interests of employees and investors would result in even higher levels of productivity.

Mission-oriented businesses

Research by Bristol University found that there are a growing number of businesses where profitability is secondary to another aim or mission that is ethical, creative, or innovative.[15] These mission-oriented businesses are passionate about their products and services. Profitability is important because it enables the business to achieve its mission, but it is not the mission itself. Instead, the motivation of mission-oriented firms comes from three interrelated sources. First, the business owners might be motivated by a desire to make a difference, to make the world a better place, informed by an ethical stance. Secondly, the owners may experience a need to satisfy their creative urges and want to be the best practitioners in their profession. Thirdly, some owners create businesses so that they can pursue a personal interest or belief, in the company of others.

The businesses studied by Bristol University included co-operatives and other forms of social enterprise, but most were private businesses owned by the founder or team of founders. Their strong focus on product and service development meant that all these businesses could be characterised as innovators. They were all engaged in the development of new markets, new products or new services.

Mission-oriented entrepreneurs do not fit the conventional theories of entrepreneurship or conform to the principles of capitalism and the pursuit of wealth maximisation. Instead, their behaviour might be explained by the ideas of Abraham Maslow[16]. He suggested that people are motivated by unsatisfied needs, and that there is a hierarchy of needs. Lower order needs must be satisfied before higher order needs become important. These lower order needs include physiological needs and the need for safety, which are usually satisfied by material possessions. Higher order needs include needs for belonging, love, esteem and self-actualisation. Mission-oriented entrepreneurs appear to be motivated by a need for self-actualisation, expressed through the development of their products and services. This is not to deny that self-actualisation can also be satisfied by the pursuit of private wealth, where money becomes a symbol of success. But, for the mission-oriented entrepreneur, success is measured by the acknowledged excellence of their products and services.

The range of products and services developed by mission-oriented entrepreneurs is very broad, but is largely consistent with the ethics of co-operation. Some engage in the same type of values-based business development processes described earlier in this chapter. Others focus on such issues as professional standards, creativity and innovation. The common factor appears to be that they all have high levels of competence in their chosen field of activity.

The fact that most of the businesses in the Bristol University study were private businesses provides clear evidence that mission-orientation is not something that is exclusive to co-operatives. This raises the question of why their founders had not thought of establishing these businesses as co-operatives. This question was put to a seminar for mission-oriented firms organised by Bristol University. The response was that co-operatives are old-fashioned and unattractive. Changing such attitudes requires an overhaul of the co-operative brand and identity.

3. The co-operative brand and identity

The co-operative brand and identity in the UK has been undernourished for decades. The Co-operative Commission described "*The Co-op"* as being "*burdened with an unfortunate, old fashioned image*". It recommended the creation of a Co-operative Brand Panel to "*develop a common national Co-operative branding approach for the movement*".[17] The challenge facing this Panel is to rethink the purpose of branding and identity in the context of co-operation.

Brands are among the most valuable but least tangible assets many businesses possess. The rise in the importance of brands mirrors the growing influence of marketing over the future performance of businesses, which in turn reflects the shift from supply-side to demand-side problems in the arena of global trade.

The problem facing the world is no longer one of production, but of consumption. The technical know-how exists to meet the basic material needs of everyone on the planet. But the failure of the global market economy to ensure that everyone has their basic needs met, points to the inherent weaknesses and inequalities of this system of distribution. While rich people and nations consume more than they need, others are left without enough. Meanwhile, businesses compete for market share by devising marketing campaigns designed to create needs among consumers through the development of brands.

Brands work by developing recognition and identity for the product or, more typically, for the business and the brand itself. Recognition is the first stage and relies on the exposure of the brand to its market. Recognition leads to the development of identity through association with information and ideas. Increasingly, the products being marketed are less important than the brands which represent them in the marketplace. There is a shift taking place in marketing, from a utilitarian approach, with its emphasis on the product, its price and its performance, to a new, lifestyle approach, where the consumer is invited to identify with the lifestyle and values embodied by the brand.

The lifestyles and values promoted by many brands are those of private sector capitalism. Exclusivity, high status, individualism and personal wealth are the staples of many brand values. But there are exceptions. The Body Shop, whose founder, Anita Roddick, prides herself on having established the company not to maximise her wealth but to promote her "*political philosophy about women, the environment and ethical business*"[18], has built a brand that has become an icon for corporate social responsibility.

While some consumers appear to be willing to pay premium prices for the privilege of becoming human billboards for the brands with which they identify, other consumers are trying to fight brand power. In her best-selling book *No Logo*[19], Naomi Klein presents an eloquent analysis of the power of brands to camouflage unethical business practices. But the problem is not with brands but with the underlying values, principles, ethics and lifestyles some brands represent and promote.

Brands can embody social values, principles and ethics. The Body Shop is a highly visible example of how this can be achieved. But The Body Shop still promotes its own private brand and ultimately aims primarily to benefit The Body Shop shareholders. A far more radical approach is to promote what can be called a social brand. Examples of social brands include organic food, fair trade, ethical investment, renewable energy, recycling, sustainability, ecology and the environment.

Social brands are the common property of social movements, which are composed of consumers, producers, suppliers and activists. Definition and regulation are important for social brands: they are like the membership rules for the social brand in question, and determine what products and services can use the social brand label. For instance, organic food as a social brand is regulated by certification schemes operated by organisations such as the Soil Association.

Co-operation already has many of the features of a strong social brand. It is the common property of a social movement with a coherent set of values and principles, maintained by a system of global self-regulation that both defines and defends the brand from appropriation by private interests.

But the biggest problem facing the co-operative brand is how to overcome its old-fashioned image. The best way of doing this is to associate co-operation with other social brands. The new workers' co-operatives of the 1970s and 1980s demonstrated how powerful this sort of association can be by becoming market leaders in organic food distribution, recycled paper and renewable energy. The Co-operative Bank managed to do the same thing in the 1990s by developing its ethical principles and associating itself with ethical investment.

Co-operation should be, but unfortunately rarely is, the business model of choice for entrepreneurs developing products and services based on social brands. The co-operative movement needs to become more attractive to budding entrepreneurs, and capable of responding to the development needs of successful social brand operators.

4. Identifying new business opportunities

The co-operative movement is already taking steps to reposition itself as a social brand and to encourage entrepreneurs and others to establish new co-operative ventures. The work of the New Ventures Panel, Co-operative Action and the Co-operative Brand Panel testifies to these efforts.

The New Ventures Panel has been investigating new business opportunities in the following areas:

- childcare
- health and social care
- rural broadband
- student accommodation
- renewable energy
- waste management.

The New Ventures Panel has also been examining the type of support framework that will stimulate the creation of more co-operatives. Attention has focused on promotional strategies, the provision of a first point of contact, and support brokerage for people and organisations establishing new co-operative ventures. It also looked at how it could facilitate investment and networking arrangements between investors, entrepreneurs, established co-operatives and other organisations that may have an interest in new co-operative ventures. A further element of the support framework is the development of a knowledge database of the opportunities, expertise and processes for establishing new co-operative ventures. Table 1.1 identifies a range of promising opportunities based on the analysis presented in this chapter. It demonstrates that opportunities are to be found in virtually all market sectors.

Table 1.1: Identifying opportunities for new co-operative ventures

Market sector	Co-operative advantage	Best starting points	Promising opportunities
Communications & IT	Values-based Mission-oriented	Entrepreneurial start-ups	Digital media Phone & broadband
Finance & Insurance	High trust	Entrepreneurial start-ups Managerial start-ups	Ethical insurance services Co-operative business angel services Co-operative venture capital funds Investor co-operatives
Food & Drink	Values-based Mission-oriented Higher productivity	Entrepreneurial start-ups Managerial start-ups Succession & buy-outs	Localisation of supply networks Fair trade products Organic food production
Healthcare & Pharmaceuticals	High trust Mission-oriented Public interest Higher productivity	Externalisation of public services Transformation of voluntary organisations	Floating care services Drug treatment Residential care Alternatives to day care
Industrial Manufacture	Values-based Mission-oriented Higher productivity	Entrepreneurial start-ups Succession & buy-outs	University spin-offs Environmental technologies
Leisure & Media	Values-based Mission-oriented Public interest	Externalisation of public services Entrepreneurial start-ups Succession & buy-outs	Sports & leisure centres Narrowcast media Spectator sports
Energy	Public interest	Entrepreneurial start-ups Managerial start-ups	Combined heat-power schemes Sustainable energy farming Electricity generation
Property & Construction	High trust Public interest Higher productivity	Externalisation of public services Transformation of voluntary organisations	Multi-functional community buildings Social housing Student housing
Forestry & Mining	Mission-oriented	Entrepreneurial start-ups Transformation of voluntary organisations	Carbon-lock initiatives Materials recycling
Retail, Distribution & Packaging	Values-based Mission-oriented Higher productivity	Entrepreneurial start-ups Succession & buy-outs Transformation of voluntary organisations	Local distribution networks Waste management
Transportation	Public interest Higher productivity	Externalisation of public services Transformation of voluntary organisations	Low energy transport Local transport networks
Professional services	Values-based Mission-oriented High trust	Entrepreneurial start-ups Succession & buy-outs	Investment services Business services Architecture
Other services	Higher productivity Values-based Mission-oriented High trust	Entrepreneurial start-ups Transformation of voluntary organisations	Childcare & nurseries Education & training Innovations in funeral care

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Chapter 2: The stakeholder life cycle

> This chapter examines how the stakeholders in a co-operative change as the enterprise grows and develops, and how this affects the life cycle of the co-operative. Section 1 highlights the low birth rate of co-operatives in the UK and investigates whether this is because the co-operative model in its current form is unattractive to entrepreneurs. Section 2 describes the growth patterns of co-operatives. It highlights the success of co-operatives in identifying niche markets, but the problems many of these co-operatives face when these niche markets grow more quickly than they do. Section 3 proposes that co-operatives should invite potential investors to become stakeholders and secondary members of their enterprises. Section 4 argues that co-operative founders should have an equity stake and should benefit from the capital growth of the enterprises they create. Section 5 discusses sustainable alternatives to unlimited growth and what this means for investors in co-operatives. Section 6 presents a model of the stakeholder life cycle, demonstrating how ownership and investment can be transferred between stakeholders during the lifetime of a co-operative.

Chapter 1 showed that there is a large range of promising business opportunities for new co-operatives. This chapter argues that these opportunities are not being fully exploited because of the way in which capital and investment is treated in co-operatives. At the heart of the matter is how stakeholders in co-operatives relate to each other.

All enterprises need employees, customers and investors in order to function in a market economy. These stakeholders have competing economic interests in the enterprise: employees want higher wages, customers want cheaper products and investors want bigger returns. The aim of co-operatives is to reconcile the competing interests of stakeholders by operating within an ethical code of values and principles, where interests are aligned in pursuit of a common social purpose. Co-operatives must also produce wealth that can be shared by all the stakeholders. The best measure of this wealth-creating ability is productivity not profitability. Higher productivity benefits all the stakeholders.

In co-operatives, investor interests are usually secondary to the primary interests of members, either as consumers, employees, suppliers or producers. Co-operatives were born as a reaction to the excesses of capitalism and the power of capital to exploit employees, customers and smaller-scale producers. In order to counter the power of capital, investors were denied any primary interest in co-operatives. But enterprises cannot function without investors, just as they cannot function without customers and workers.

This chapter argues that a failure to recognise the legitimate interests of investors inhibits the birth rate and growth of co-operatives. It presents ways of recognising and improving the rights of a range of different types of investors, both internal and external to the co-operative. Internal investors are primary members of the co-operative, usually customers, employees or suppliers. External investors have no other role in the co-operative. The best mix of investors for any given co-operative will change during its life cycle, providing earlier generations of investors with an exit route from investment.

1. The birth rate of co-operatives

Compared with private businesses, the birth rate of co-operatives and social enterprises in the UK is very low. It is estimated that there are 5,300 social enterprises of all types in the UK[1], compared with over 3.8 million private businesses. There is no national data on the number of new co-operative registrations, but it is probable that no more than 200 co-operatives are created each year. This compares with a birth rate in England and Wales of approximately 380,000 new businesses in 2002.[2]

In the early 1980s there was great optimism about the birth rate of new workers' co-operatives. The number of new co-operatives mushroomed from only 75 in 1977 to 1,476 by 1986.[3] But this relatively high birth rate was short-lived. The number of UK co-operatives of all types is thought to have peaked in the late 1980s at between 2,000 and 3,500 and has remained at this level ever since. Accurate data on the number of co-operatives formed each year is difficult to compile because there is no requirement in the UK for co-operatives to register with a central authority. In 2002, Co-operatives^UK registered 62 new co-operatives, but this is thought to be only a fraction of the co-operatives formed that year in the UK.

Even though accurate data is unavailable, it is clear that only a very small proportion of new businesses are established as co-operatives. Why is this the case? Does it reflect a lack of awareness and understanding about the co-operative option? Or is there something about co-operatives which entrepreneurs find unappealing?

It is hard to believe that entrepreneurs do not know about the co-operative option, given the promotional work of Co-operatives^UK and all the local co-operative development bodies throughout the country. It is also difficult to accept that co-operative values and principles only appeal to a tiny minority. The stereotypical contrast between profit-driven private entrepreneurs and social entrepreneurs who "*are driven by a mission, rather than the pursuit of profit or shareholder value*"[4] is contradicted by numerous studies of entrepreneurial motivation. According to a survey of small businesses in the South West of England[5] only 4% of owner–managers aimed to make their fortune. A recent study by Bristol University[6] has shown that many private businesses, as well as co-operatives, place mission before profit.

The reasons why so few new businesses are set up as co-operatives probably have more to do with the processes of business start-up, and how new businesses are financed. Most entrepreneurs start their businesses with very little financial capital, much of which is obtained from personal sources. They rely on using their own cars, computers and other equipment, and operate the business from home. No records are kept of these transactions because the entrepreneur owns the business outright and expects eventually to be able to reap the financial rewards of their investment. During the first few years of developing their businesses most entrepreneurs work very long hours and minimise their cash drawings from the business, usually to avoid having to borrow money from external sources. This non-monetary investment far outstrips the value of any cash investment, but entrepreneurs are prepared to do this because they own their businesses. Their unpaid labour enhances the value of their enterprises, so that some time in the future they may get a financial return on this investment.

Most co-operatives also benefit from the non-monetary investment of their founders and entrepreneurs, but unlike private entrepreneurs, co-operative entrepreneurs and founders rarely get a return on their investment of unpaid labour. Current practices in co-operatives do not recognise or reward entrepreneurs for increasing the value of their co-operatives. Equity is a word with a double meaning: it means fairness as well as having a share in the ownership of an enterprise. Current practices in co-operatives are unfair to the entrepreneurs who create them because they do not receive any return on their non-monetary investment, even when the business is successful. This could be why so few entrepreneurs choose to set up co-operatives.

Problems obtaining start-up capital might be another reason for the comparatively low birth rate of co-operatives. The vast majority of new private enterprises are one-person businesses, but most co-operatives start life as larger businesses, employing more people and requiring far greater initial capital investment. When larger businesses are launched in the private sector, entrepreneurs are expected to make large cash investments and are rewarded with substantial equity stakes in the business. Private equity investors are usually reluctant to invest in start-ups unless the entrepreneur has also made a substantial investment. Loans above £250,000 are difficult to obtain unless the entrepreneur can offer personal guarantees to secure the loan.

It is unreasonable to expect co-operative entrepreneurs to invest cash or provide personal guarantees for large loans unless they are properly rewarded for taking these financial risks. Equally, it is unreasonable to expect investors to invest in new co-operatives unless there is some financial incentive. Unless and until entrepreneurs and investors can share in the benefits of establishing successful co-operative businesses, most will opt for private business structures.

2. Growth patterns of co-operatives

There has been very little research on the growth patterns of co-operatives. Mike Hudson, in his book *Managing without profits* [7], describes five distinct phases in the development of third sector organisations, using the analogy of a life cycle: birth, youth, adulthood, maturity and decline. Hudson describes how organisations shift from an entrepreneurial culture to a managerial culture and eventually to a governance culture. In their mature phase organisations are in danger of being overtaken by younger organisations. Hudson notes that third sector organisations seldom die, even though some become smaller and slide into ever-increasing mediocrity.

Hudson based his ideas on the work of Larry Greiner[8] whose landmark paper, *Evolution and Revolution as Organizations Grow,* was published in the Harvard Business Review more than twenty years earlier. Greiner illustrated his ideas with a graph showing organisations on a trajectory of unlimited growth, consistent with the ambitions of capitalism. He assumed that all businesses want to grow, and will continue to grow, unless they fail.

Co-operatives occupy the space between Greiner's vision of unlimited growth and Hudson's life cycle thesis for the third sector. They operate in a market economy, where competition is the driver of change, but they are not in pursuit of wealth maximisation. Profitability may be important but it is not their sole purpose. In common with other types of third sector organisation, co-operatives and social enterprises are also driven by their social aims, which, when aligned with profitability, define their distinctive mission.

In academic circles the debate about the growth patterns of co-operatives has focused on the degeneration thesis. This argues that over time co-operatives will degenerate by reverting to capitalist structures or goals. Evidence to support this argument is provided by the rash of demutualisations of building societies and insurance firms in the 1990s. But the new workers' co-operatives of the late 1970s and 1980s provide a counterexample, as does the consumer co-operative movement. Despite the fact that many of the remaining consumer societies have large reserves, none have been demutualised. The survival rate of these new workers' co-operatives has been remarkably high. For example, nearly a third of the 26 Bristol-based co-operatives listed in a national directory published in 1986[9] are still trading after 18 years.

Many of these workers' co-operatives have an extraordinary track record for identifying and developing new niche markets in the British economy. Internet services, recycled office stationery, wind energy, multicultural children's books and organic wholefoods are all markets pioneered by these co-operatives. Some of these niche markets have grown into mainstream multi-billion pound industries. But the co-operatives that established these markets have not grown at the same rate. All have lost their market share in rapidly expanding markets.

There are many possible reasons why these new co-operatives have not grown with their markets. Business growth is difficult. It requires additional investment which, in turn, demands greater profitability and productivity, and reduces the amount of money available for wages, price discounts or dividends. Bad investment decisions can threaten the survival of the enterprise, leaving the employees without a job, customers without a supplier and investors without their money.

The Co-operative Commission was critical of the co-operative retail sector for its poor growth rate[10], which is reflected in the exceptionally low returns on capital achieved by the sector compared to its private sector competitors. In the private sector, where investors own the capital, very poor returns would be unacceptable. In the co-operative retail sector most of the capital is held in indivisible reserves, so it makes little immediate difference to members whether the return on this capital is high or low.

Poor commercial performance is one of the main reasons why an enterprise may find it difficult to raise external finance. When the return on capital employed falls below prevailing interest rates it is usually impossible to obtain debt finance and no investor will risk purchasing equity. There is a danger that mature co-operatives will encounter these difficulties unless their stakeholders have an interest in profitability. In employee-owned firms and other types of business where workers receive a share of profits, productivity is higher.[11]

In recent years the term ‘sustainability’ has entered the co-operative lexicon. It is a term borrowed from environmental activists, which refers to the use of natural resources in ways that can be continued indefinitely. In a business context, aspirations for limitless growth are clearly not sustainable. But enterprises that fail to change or adjust to new conditions in a competitive market can become equally as wasteful of resources. Sustainability means growing to an optimal size, large enough to achieve economies of scale but small enough to remain participative and engaging. It also means being prepared to reconsider the fundamental purpose of the enterprise, and to renew this purpose if it becomes obsolete. Older, more mature co-operatives should give birth to a new generation of enterprises as part of their sustainable life cycle.

If co-operatives are to challenge conventional enterprises in the twenty-first century, three major changes need to be made to the long-term financing arrangements and the life cycle of co-operatives. First, co-operatives need to form new relationships with ethical investors. These new relationships must be founded upon the belief that economic self-interest can be aligned with social purpose rather than detracting from it. Secondly, there should be a fair deal for entrepreneurs in order to encourage more of them to establish co-operatives. Thirdly, co-operatives need to adopt new development practices that offer sustainable approaches to growth at the same time as encouraging greater competitiveness with other forms of enterprise and greater co-operation among co-operatives. Alternatives to growth include spin-offs from existing co-operatives, cross-ownership, joint ventures and co-operative franchising.

3. A new relationship with ethical investors

Co-operatives should forge a new type of relationship with ethical investors based on the values of democracy, equality, equity and solidarity. Chapter 7 addresses the legal and constitutional issues involved in developing this new relationship, and describes what is required to make this new relationship successful.

The main aim of this new relationship is to create structures within the co-operative that will enable all the stakeholders, including investors, to reconcile their self-interests in pursuit of a common purpose. Each type of stakeholder has an economic self-interest which competes with the self-interests of the other types of stakeholders. But sharing power in a democratic setting can reconcile these interests by focusing on the common purpose of all co-operatives – creating wealth by producing excellent goods and services that enhance the quality of life for all.

Stakeholder roles are not mutually exclusive. Investors in a co-operative may also be its employees, customers and suppliers, as well as financial institutions and individual investors. Encouraging employees, customers and suppliers to become investors can improve the liquidity of the investment by increasing the numbers of buyers and sellers of shares. The engagement of these stakeholders as investors is linked to the life cycle of the enterprise itself, a process described in greater detail in the final section of this chapter.

When setting out to build a new relationship with investors, the first step is to enfranchise them. External investors should be offered secondary membership rights alongside the primary members of the co-operative. In the interests of equality and equity, the competing interests of stakeholders must be recognised. External investors should have the power to protect their primary interests in the enterprise, as should any other stakeholder with secondary membership. Where appropriate, separate bodies or councils should be established to address the interests of these secondary membership groups of investors, employees, customers or suppliers. Investors are being asked to risk their savings and should be rewarded fairly for this risk. But investors are not the only stakeholders who bear a risk. Employees and suppliers are risking their income and livelihood, and customers have to trust the honesty and openness of suppliers.

An investors' council would grant investor members the powers to influence, or perhaps even veto, any decisions made by the board of directors that affect their primary interests as investors. These include decisions to:

- issue new co-operative share capital
- raise other forms of external finance
- buy or sell major assets, shares or subsidiary companies
- change the constitution affecting the powers of investors.

The board of directors should retain responsibility for deciding how the surpluses of the co-operative are used, the level of dividend to be paid on investments, and the proportion of reinvested surplus to be allocated to the indivisible reserves. These decisions will affect how easy or difficult it will be to attract new investors and investment.

Each member of a co-operative, regardless of their stakeholder role, has a shared interest in the indivisible reserves of the co-operative. The requirement to establish indivisible reserves is set out in the third principle of co-operation (see Appendix 1). These reserves are the common property or common wealth of the co-operative. They are the product of the commitment made by all stakeholders, past and present, to the common purpose of the co-operative. In order to protect this common wealth from the sectional interests of any single class of stakeholders, it may be necessary to establish a secondary body to the main board of directors – a common wealth council.

The purpose of the common wealth council would be to act as trustees of the common wealth of the enterprise. It alone should hold the power to determine whether the co-operative should be sold, transferred to another co-operative or cease trading. It should be responsible for ensuring that any residual assets or proceeds resulting from the sale or disposal of the co-operative are transferred to the indivisible reserves of another co-operative.

The allocation of profits to common wealth reserves does not prevent shareholders from realising a capital gain on their equity stakes, especially if the shares are tradable on a secondary market. The capital value of shares is dependent upon the current and future dividends payable on those shares. Chapter 5 explores these issues in more detail.

Allowing investors to become members of an established co-operative will call for a great deal of care and sensitivity towards the interests of other stakeholders, especially the founders. Before allowing investors to purchase rights over part of the capital value of the co-operative, consideration should be given to the ownership rights of existing members and whether any of these members need to be compensated for the dilution of their financial interests.

4. A fair deal for co-operative founders

A fair deal for co-operative founders is necessary to increase the birth rate of co-operatives. Two different approaches could be developed, the first of which promotes an entrepreneurial approach, designed to encourage more entrepreneurs to establish co-operatives rather than private enterprises. Alternatively, a managerial approach, where a manager is recruited and paid the market rate to establish the business, might be more appropriate when new co-operatives are being launched by another organisation.

The entrepreneurial approach is best suited to new-start co-operatives where the enterprise is being established by an individual or team, and has no prior connections to any other organisation. This approach is based on the early recognition of the non-monetary investment made by the founders. This is achieved by establishing an equity structure for the co-operative and granting the founders rights over the full value of the enterprise. In line with the practices of all co-operatives, part of any retained surpluses should be allocated to the indivisible reserves or common wealth of the co-operative, but the remainder of the retained surplus should enhance the value of the equity held by the founders. The founders can realise the value of their equity stakes by selling their shares to new members or to external investors as the co-operative grows and develops.

The managerial approach to establishing co-operatives requires a sponsor to promote the proposal for a new co-operative, and an external investor who would be prepared to take the financial risks involved in start-up. The sponsor and external investor may well be the same person or organisation. This approach involves recruiting a manager (or management team), paying them the market rate, and giving them performance incentives to achieve a series of development targets. The sponsors and investors divest themselves of ownership and control of the enterprise by selling their shares to members of the co-operative, drawing on the retained surpluses of the enterprise.

The managerial approach is similar to top-down development methods, which were used by a few co-operative development agencies in the 1980s without much success. In most of these cases grants were used to finance new co-operative ventures created by managers recruited for that purpose. But if the funders had invested equity, they would have been responsible for protecting their investment. Equity is a far more socially responsible form of investment than grants, requiring the funder to retain responsibility for their decisions. However, as many grant-giving bodies are charities, they are not allowed to invest in high-risk ventures.

5. Investment to support sustainable development

The private sector has a voracious appetite for growth. Competition between firms pushes forward the search for new efficiencies, productivity gains and innovation. Co-operatives cannot turn their backs on these dynamics without risking their own survival. Yet the private sector imperative to pursue unlimited growth sits uncomfortably with the co-operative sector for a number of reasons. There are ethical objections to the pursuit of unlimited growth, especially when it results in monopolies or near monopolies. There are environmental objections to growth when it involves the unsustainable consumption of resources. And larger co-operatives can face organisational issues which require sophisticated approaches to maintaining the active involvement of their members.

Is the adage, grow or die, really true? Can sustainable development be an alternative to growth? While there is no conclusive evidence to back this assertion, co-operatives do appear to survive longer than private businesses. This is not because they have grown to become larger businesses but, perhaps, because there is a greater resolve to sustain the enterprise – there may be a willingness to accept a lower rate of return and lower rewards.

If co-operatives shun growth they are in danger of losing their influence over markets which become shaped by economic interests at the cost of social objectives. For example, there is a trend within the organic food market led by the large supermarket retailers towards high-value processed organic meals, which limits the health benefits of organic produce. Co-operatives need to be able to influence how markets develop if they are to fulfil their social objectives. This may be an imperative for growth. While many of the new co-operatives of the late 1970s and 1980s have survived, too many have lost their ability to influence the markets they created.

There are alternatives to growth that enable co-operatives to compete with the private sector while promoting co-operation between co-operatives. These alternatives include spin-offs, joint ventures, cross-ownership arrangements and franchising. The development of these alternatives requires long-term finance, which more mature co-operatives may be in a position to supply, as well as the expertise and experience of their longer-serving staff.

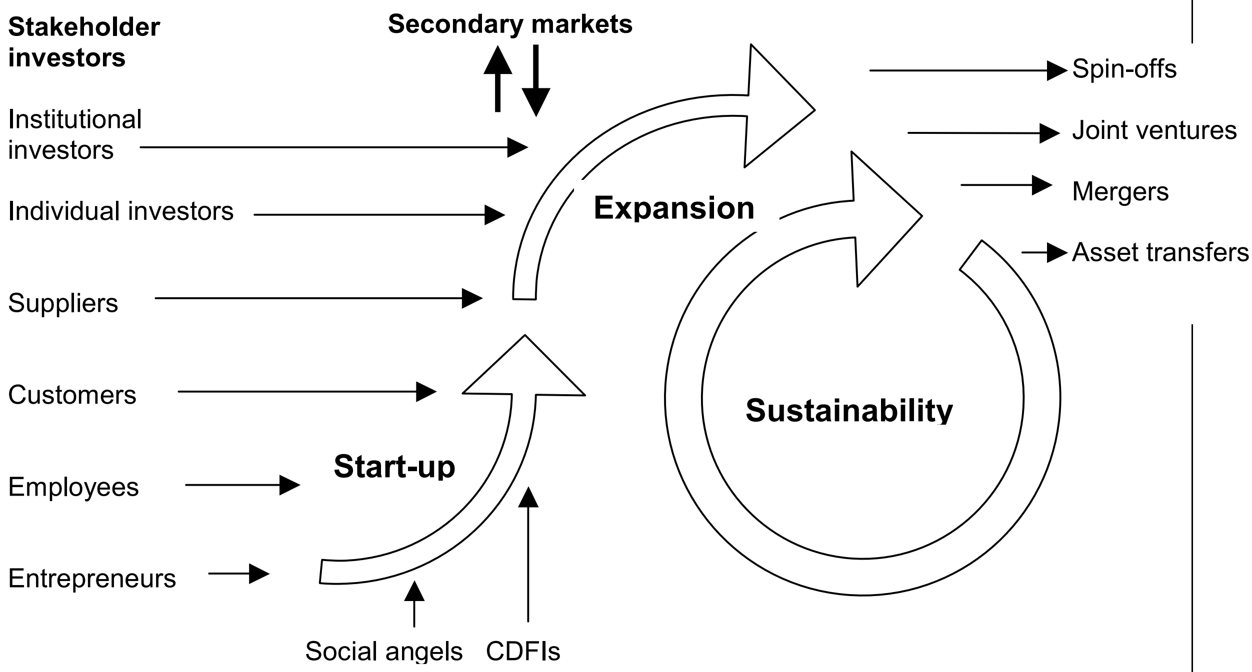
These new co-operative ventures can strengthen the stability of their parents. For instance, by spinning off non-core activities, an established co-operative can focus on what it does best and, at the same time, support the development of a new co-operative. Cross-ownership can help to cement relationships in supply chains. This is the basis of relationships within the Mondragon group of co-operatives. Franchising can be an excellent way of enabling communities to serve their own local markets whilst providing economies of scale for the parent co-operative. Joint ventures with other co-operatives can open up new markets by combining complementary skills and knowledge.

The key to these initiatives is access to long-term finance. All of them require risk capital, which makes them unsuited to debt finance. Investors are more likely to feel confident about investing in new co-operative ventures if they have the backing of established co-operatives, especially if the established co-operatives are investors too.

6. The stakeholder life cycle

This chapter has focused on the life cycle of co-operatives. It has suggested some reasons why so few new co-operatives are formed, and why so few of them grow to be large organisations. It has argued that the low formation rate and growth rate can be attributed to the nature of the stakeholder relationships underpinning the provision of long-term finance to the sector. These relationships can be changed by encouraging investors to become active members in co-operatives and by encouraging other stakeholders to become investors too. Figure 2.1 is a model of the stakeholder life cycle, identifying three key stages in the development of co-operatives: start-up, expansion and sustainability.

Figure 2.1: The stakeholder life cycle



Equity investors usually focus on three financial considerations: risk, reward and liquidity. Ethical investors might accept marginally less reward, but might also be more risk averse. Liquidity, the ability to sell equity for cash, is just as important a consideration as the risk–reward balance. Traditionally, co-operatives have provided liquidity by making shares withdrawable; this means that the co-operative is obliged to buy back the shares at the request of the investor. This type of equity investment has many of the same characteristics as an unsecured loan. At any time the co-operative could be faced with some or all of its shareholders wanting to withdraw their capital.

It is far better for co-operatives to make their shares non-withdrawable, but this means developing other ways of providing investors with liquidity. The stakeholder life cycle does just that. By opening up the membership of co-operatives to all its stakeholders, and encouraging these stakeholders to invest in the co-operative, a co-operative can create liquidity, with one generation of stakeholder-investors selling their shares to the next generation. The ultimate solution to the liquidity problem is to establish a secondary market in co-operative capital. Chapter 6 describes how such a market could be developed.

Setting up structures that acknowledge the non-monetary investment of entrepreneurs can stimulate the birth rate of co-operatives. Entrepreneurs who may otherwise set up private businesses, could be encouraged to set up co-operatives if external risk capital is to be available at start-up. By investing risk capital and becoming active members of these co-operatives, external investors can provide the finance and support entrepreneurs need in the early stages of developing a new co-operative.

Providing external equity finance at start-up not only offers immediate relief from interest charges and debt repayment but also broadens the stakeholder base of the enterprise. This has the effect of socialising the ownership of the co-operative – ensuring that the entrepreneurs become used to sharing power with other stakeholders at an early stage in the life of the co-operative. One of the main reasons private enterprises do not grow is because the owner–managers are reluctant to give up their independence. The same may be true of co-operative entrepreneurs unless they are introduced to external investors at an early stage.

Sources of this external risk capital could include community development finance institutions (CDFIs) and regional venture capital funds, as well as the growing number of specialist social venture funds. Launch Pad,[12] a Phoenix Fund project initiated by Sheffield Enterprise Agency, has identified the potential for CDFIs to invest a combination of debt and equity finance in fledgling enterprises, rather than only providing debt finance. Other potential sources of start-up equity could include grant-giving bodies, although this would probably require them to establish separate commercial funds. ‘Social angels’ are another potential source, proposed by the Bank of England. Social angels would be similar to business angels in the private sector: wealthy individuals with a business background who become active investors in a chosen enterprise. The amount of equity investment funding required at the start-up stage would normally be quite low, typically £50,000 to £100,000.

The alternative approach to financing start-ups is for a parent organisation to invest equity and employ a manager to research, develop and launch the new co-operative. This equity would provide a mixture of seed-corn and start-up capital. Parent organisations could include established co-operatives pursuing sustainable alternatives to growth (as outlined in the previous section of this chapter), and voluntary organisations that want to establish trading subsidiaries or divest themselves of non-core activities. Public sector organisations may adopt a similar approach in response to a Best Value decision to mutualise a service. If the parent organisation invests equity finance in the new co-operative it will be easier to raise debt finance from other sources.

The next stage in the co-operative life cycle is a period of rapid expansion as the enterprise grows to its optimum size. By now the enterprise will have proved its profit potential and demonstrated market demand for its products and services. One of the main factors holding back growth is the availability of long-term finance to increase the scale of its operations. It also has to secure the commitment of new stakeholders to become members and possibly investors in the co-operative. Typically, these new investor–members will be employees, customers or suppliers. These new investors also provide the first opportunity for the original investors to sell their shares.

Investing at the expansion stage of the life cycle is far less risky than investing at start-up because the co-operative will now have a proven track record. It is at this stage that external investors with no other stakeholder interests in the co-operative may be prepared to purchase an equity stake in it. As the co-operative matures and reaches its optimal scale some of its earlier investor–members will want to cash-in their shares. The business strategy of co-operatives at this stage will be to make themselves more attractive to institutional investors. Employee investor–members may want to transfer their investments to a broadly-based institutional pension fund that invests in their co-operative as well as other co-operatives. All of this creates ideal conditions for listing the co-operative on a secondary market. This would increase liquidity and provide opportunities for raising additional capital to reach the target of optimal scale.

The final stage in the stakeholder life cycle focuses on the goal of sustainability. It is at this point that more mature co-operatives may complete the cycle by investing in the formation of new co-operatives as an alternative to growth.

Not all co-operatives will be successful. Some will reach maturity only to discover that their markets are in decline and profitability is falling. In such situations co-operatives need the support of all their stakeholders to decide whether they can renew their fortunes, or whether they should protect their common wealth by merging with other co-operatives.

Other highly successful co-operatives will reach this stage in the life cycle having accumulated substantial indivisible reserves. Co-operatives with a large common wealth capital base will be attractive to equity investors because any distributable profits will be shared between fewer shareholders. These co-operatives can use their common wealth to invest in new co-operatives or to further strengthen their own capital base.

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Chapter 3: Current investment practices

This chapter presents a series of case studies describing how co-operatives and social enterprises have raised equity capital from external investors. Section 1 describes how the Centre for Alternative Technology raised £1 million through the issue of non-voting shares. Section 2 describes how Traidcraft has raised more than £5 million over a period of twenty years through a series of share issues, the most recent of which granted voting rights to all shareholders. Section 3 describes how Baywind Energy Co-operative has raised nearly £2 million from investor-members through the sale of IPS shares and bonds. Section 4 explores the issues involved in attracting institutional investors and venture capital. Section 5 describes how Poptel raised capital by forming a joint venture with a private equity investment company. Section 6 describes the work of Baxi Partnership, an institutional investment fund specialising in employee-owned businesses. Section 7 presents a brief review of external investment practices in other parts of the world.

Over the last twenty years a small but growing number of UK co-operatives and social enterprises have experimented with new forms and sources of external finance. Most of these experiments have involved the sale of shares or bonds to private individual investors, although more recent experiments have also involved the sale of equity to institutional investors and venture capital funds. Table 3.1 lists the more significant share and bond issues since 1984. (Only issues of more than £100,000 are listed.)

This chapter features four case studies that chart the development of these external investment practices. The first two case studies, on the Centre for Alternative Technology and Traidcraft, illustrate how the early experiments concentrated on investors who wanted to support the work of the enterprise and who were prepared to accept non-voting shares and risk forgoing any return on their investment. The Centre for Alternative Technology has never paid investors a dividend. Traidcraft has also not paid dividends for most of the years since its first share launch. But more recently Traidcraft has introduced voting rights for shareholders, and plans to pay a dividend in the near future. This mirrors a general trend towards engaging external investors in the enterprise, and efforts to offer a real and fair return on investment. The third case study describes how the Baywind Energy Co-operative raised nearly £2 million from member-investors, many of whom live locally. Investors, who are full members with democratic voting rights, have always received a competitive return on their investment, ranging from 5.6% to 6.6% gross in recent years.

The first three case studies all describe situations where the external investors are private individuals. In recent years co-operatives and social enterprises have begun to turn their attention towards institutional investors. One of the earliest examples of institutional investment in an ethical share issue is Henderson Global Investor's purchase of £0.5 million of shares in the Ethical Property Company's first issue of 1999. At about the same time, Poptel, the subject of the fourth case study, was completing a deal with a private equity investment company, Sum International. This involved creating a new joint venture, which was majority owned by Poptel, a workers' co-operative. However, the new venture, which had taken on most of the operational activities of the co-operative, struggled to achieve viability. Despite obtaining fresh investment from Baxi Partnership, an investment fund dedicated to employee ownership, Poptel was eventually taken into ownership by Sum International in 2002.

All four case studies illustrate the benefits of engaging external investors, but also the inadequacies of current practices and the problems associated with the lack of investment liquidity and, in some cases, the difficulties of sharing control with investors. The UK is not alone in exploring equity finance for co-operatives and other forms of social enterprise. The chapter concludes with a section reviewing practices in other countries, including attempts to develop social venture capital.

Table 3.1: Share and bond issues (over £100,000) by co-operatives and social enterprises 1984-2003

Organisation	Date	Structure	Type of investment	Target to raise	Amount raised
Traidcraft	1984	plc	Share	£0.3m	£0.3m
Mercury Provident	1985	plc	Share	c£1m	£0.5m by 1990
Traidcraft	1986	plc	Share	£1m	£1m
ICO Fund	1987	plc	Share	£0.5m	£0.5m
Shared Interest	1990	IPS	WSC*	N/a	£17.8m by 2003
Centre for Alternative Technology	1990	plc	Share	£1m	£1m
Mercury Provident	1991	plc	Share	£0.5m	£0.4m
Traidcraft	1991	plc	Share	£0.6m	£0.4m
Ecological Trading Company	1993	plc	Share	£0.75m	£0.2m
ICOF Community Capital	1994	IPS	WSC*	N/a	£0.45m
Out of this World	1995	IPS	Share	£1m	£1m
Shared Interest	1995	IPS	Bond (5 year)	£1m	£0.65m
Triodos Renewable Energy Fund	1995	plc	Share	£1m	£1m
Shared Interest	1996	IPS	Bond (5 year)	£1m	£0.85m
Baywind	1996	IPS	IPS share	£3.1m	£1.2m
Out of this World	1996	IPS	Bond	£0.2m	£0.2m
Shared Interest	1997	IIPS	Bond (5 year)	£1.3m	£1.3m
Out of this World	1997	IPS	Bond	£0.2m	£0.2m
ICO Fund	1997	plc	Share	£1m	£1m
Aston Reinvestment Trust	1997	IPS	WSC*	N/a	£0.41m
Triodos Renewable Energy Fund	1998	plc	Share	£1.5m	£1.5m
The Phone Co-op	1999	IPS	WSC*	N/a	£0.4m by 2003
Shared Interest	1999	IPS	Bond (5 year)	£1m	£1m
Ethical Property Company	1999	plc	Share	£1.32m	£1.32m
Baywind	1999	IPS	IPS share	£0.67m	£0.67m
Citylife (Sheffield)	1999	IPS	Bond (5 year)	£5m	£0.8m
Citylife (Newcastle)	2001	IPS	Bond (5 year)	£2m	£2.0m
Shared Interest	2001	IPS	Bond (5 year)	£1m	£1m
Citylife (East London)	2002	IPS	Bond (5 year)	£50m	£1.9m
Shared Interest	2002	IPS	Bond (5 year)	£1m	£1m
Ethical Property Company	2002	plc	Share	£4.2m	£4.2m
Traidcraft	2002	plc	Share	£3.25m	£3.25m
Unicorn	2003	IPS	Loan stock	N/a	£0.3m
Shared Interest	2003	IPS	Bond (5 year)	N/a	£0.7m
Golden Lane Housing	2003	Charity	Bond (10 year)	£4m	£1m (est)
Cafédirect	2004	plc	Share	£5m	£5m
Shared Interest	2004	IPS	Bond (5 year)	£1m	£1m

* WSC = withdrawable share capital

1. Centre for Alternative Technology

The Centre for Alternative Technology (CAT) occupies the site of an old slate quarry near the mid-Wales town of Machynlleth. Since the 1970s the Centre has been offering a practical demonstration of the benefits of alternative technologies, both to day visitors to the site and through its programme of educational work, training and consultancies.

In the late 1980s the Centre planned a major development programme to improve facilities for tourists. The centrepiece was the development of a water-powered funicular railway to carry visitors up to the quarry. In order to fund the railway and other infrastructure work, the Centre for Alternative Technology plc issued a £1 million share issue. The shares (which were eligible for Business Expansion Scheme [BES] tax relief) were taken up quickly, by about 2,000 investors. Investments ranged from £100 (the minimum) to a few larger holdings (around £12,000-£14,000). There are currently about 1,800 shareholders.

CAT has operated from its earliest days as a worker-managed venture, and although not legally a co-operative it continues to operate according to collective working principles (all permanent staff have wage parity, for example). The relationship between CAT's staff and its shareholders may be particularly relevant to workers' co-operatives.

The share issue was arranged to protect the element of worker control of CAT: investors were allocated class B non-voting shares, while 50,000 class A voting shares were acquired by an employee share-ownership trust which raised £50,000 to pay for their purchase via a loan from Unity Trust. There are also two guardian shares, held by a registered charity (the Society for Environmental Improvement Trust). This essentially provides a mechanism to protect the original vision of the Centre; the Trust is controlled by a number of key people associated with the Centre in the early days. Through the guardian shares, they have a veto over proposed changes to the plc's memorandum and articles.

The current structure of CAT is made up of the plc, which runs the commercial trading aspects of the Centre, and the associated Centre for Alternative Technology Charity Ltd, which undertakes the charitable educational work of the centre (including work with schools, residentials and information services). The plc has a turnover (2001) of £1.7 million, of which about £300,000 is from visitors' admission fees; the charity turnover is about £1 million. The plc directors are appointed by an employee benefit trust (which has taken over the class A shares from the original employee share-ownership trust). Since employees are not permitted to be charity trustees, the charity has independent external trustees who nevertheless work closely with the Centre's management. However, these formal structures co-exist with more informal arrangements which maintain the traditional principle of collective working and which are coordinated through an elected management group meeting on a weekly basis.

There have been no dividends paid since the share issue. The original prospectus made it clear that dividends would have relatively low priority in terms of profit allocation, and since then CAT plc has made either trading losses or only relatively small profits in most years. A good trading period in the mid-1990s was used to allocate £10,000 to buy back shares, enabling some investors who wished to sell their shares to do so. Dividends might have been considered after another good year, 2000, had it not been immediately followed by the Foot and Mouth emergency. Most of the profits were used to build reserves, with 20% going for a staff bonus, and 10% for a new stakeholder pension scheme for staff. (Wages at CAT continue to be well below the national average, with full-time permanent staff paid £14,000 a year in 2003.)

Partly to assess shareholder attitudes to (the lack of) dividends, a questionnaire was sent out in 2002. 677 of the 1,800 shareholders replied. Among the findings were:

- The main reason for buying the shares:
    - potential dividend (6.4%)
    - capital appreciation (8.9%)

    - a type of donation (28.6%)
    - support for a good cause (87.2%)

- Views on wanting to receive a dividend:
    - yes (17.2%)
    - no (49.7%)
    - ambivalent (13.3%)
    - if profitable (7.7%)

- If a dividend were paid:
    - would keep it (31.7%)
    - would waive it (21.1%)
    - would donate to CAT Charity (37.2%)
    - "it depends" (10.5%)

The problems and delays facing shareholders wishing to sell (particularly in cases where the investor has died and the shareholding has become the responsibility of executors) have clearly caused some worries for CAT. The problem was only partially resolved by the £10,000 share buy-back. Currently about £20,000 shares await new purchasers.

The plc's company secretary keeps a list of would-be sellers, and arranges share transfers when purchasers come forward. Sixteen share transfers were arranged in 2002 compared with 33 transfers in 2001 and 55 transfers in 2000. A larger number of transfers were made in 2000 and 2001 because existing shareholders offered to buy significant numbers of further shares, allowing several smaller holdings to be transferred to a single existing shareholder. All transfers up to now have been at par (£1), which for shareholders who benefited from the original BES tax relief amounts to de facto capital appreciation. On legal advice, the Centre does not advertise that investors have shares to sell; a further problem is that would-be new investors want to support the Centre's work directly, rather than buy 'second-hand' shares.

Some investors have chosen to donate their shares to the CAT Charity (Gift Aid relief is not available, unfortunately). A further number have indicated that they intend to bequeath their shares to the CAT Charity.

CAT encourages supporters of its work to become members (£16 a year). Members receive, among other things, a quarterly magazine *Clean Slate* and an invitation to an annual conference. Whilst some shareholders are also members, there is no automatic overlap. Shareholders receive fund-raising newsletters and details of CAT's publications, and can also attend the AGM (this is a separate event to the annual conference). Last year about fifty attended, an increase on much poorer turn-out in previous years. Shareholders also have their own representative as an observer (without voting rights) on the plc Board; the current representative was chosen by election some years ago.

Since 1990, CAT has undertaken further significant capital developments through grant support and fund-raising, and this route is now clearly preferred as an alternative to further share issues. (The cost of meeting the legal obligations towards its shareholders is also a burden on the plc.) There is a sense, in fact, that the share arrangements are something of a left-over from a previous period of CAT's development, and that – despite its best intentions – the Centre has never quite been sure how best to relate to its investor-supporters. The 2002 questionnaire to shareholders can be seen as an attempt to tackle this and to find out more about investors' attitudes and requirements.

2. Traidcraft

Traidcraft is one of the leading fair trade organisations in Britain, selling an extensive range of products (including fair trade foods and drinks, crafts, clothing and paper products) primarily from developing countries. The company is based in substantial premises in Gateshead.

Traidcraft's turnover in 2002-3 was £12 million. Almost half of these sales came from Traidcraft stalls run by volunteers, and held typically in churches or in workplaces. Wholesale trade (particularly to supermarkets) has grown considerably in recent years, and brought in £3.3 million in 2002-3 (27%). Mail order sales accounted for £1.4 million (12%). The company also sells to independent retailers (£1.6 million in 2002-3, 13%). Pre-tax profits were £416,000, post-tax profits £321,000.

Traidcraft has a history which goes back to 1974, to early moves to import craft goods direct from producers in developing countries as a way of helping poverty relief and economic development. Traidcraft plc has been trading since 1979. The company's first share issue in 1984 was a landmark in the development of this kind of direct ethical investment in Britain, and was highly successful: the full offer of £300,000 was fully subscribed, with many would-be investors disappointed. Two years later, a second share issue, this time for £1 million in share capital, was also very successful and was fully subscribed. This was followed by a third share issue, in 1990-1991, when 600,000 shares were offered and about £400,000 was raised. (The third issue, unlike the first two, was not eligible for tax relief for investors under the Business Expansion Scheme.)

More recently, Traidcraft has gone back to its supporters a fourth time, with the ambitious aim of raising a further £3,250,000 in capital. This share issue, which opened in October 2002, was also fully subscribed.

Traidcraft is run according to a set of 'Foundation Principles'. There are eighteen principles, under five main headings:

- Traidcraft is a Christian response to poverty
- Traidcraft's mission is fighting poverty through trade
- Traidcraft respects all people and the environment
- Traidcraft abides by and promotes fair business practices
- Traidcraft strives to be transparent and accountable.

Traidcraft plc, the trading company, is one of three closely-linked organisations. Traidcraft Exchange is a registered charity which works to raise awareness of fair trade and ethical business principles and which provides training, consultancy and information services. The Traidcraft Foundation, also a charity, is the vehicle which ensures that both the plc and Traidcraft Exchange remain true to the Foundation Principles.

Until the 2002 share issue, Traidcraft plc was effectively under the direct control of the Traidcraft Foundation, which owned 100% of the voting (A) shares in the company. Shareholders who invested in 1984, 1986 and 1990/91 received non-voting B class shares. They had the right to elect a single director, but otherwise they had very little direct power.

This has now changed. Since 2002, Traidcraft plc has had a single class of voting ordinary shares, bringing together all previous and new shareholders. However, the Traidcraft Foundation continues to own a single guardian share, which gives it a range of powers designed to protect the Foundation Principles and the original Traidcraft vision.

The reason for this move was explained in the 2002 share prospectus as a desire to make the company more transparent and accountable to all stakeholders, including shareholders:

"The Directors believe that this new structure is more appropriate for Traidcraft plc's future development because it should make the Company more accountable to its shareholders for the effective application of their capital to its mission. At the same time, Traidcraft's Foundation Principles and the Company's commitment to social accounting (both defended by the Traidcraft Foundation through the guardian Share and the Deed of Mutual Covenant) will continue to ensure that the Company works in the interest of wider stakeholders and, in particular, in the interests of its suppliers from poor communities in the developing world."

The original 1984 share issue attracted 845 shareholders, the majority of whom invested £200 or less. The vast majority were individual investors, though some shareholdings were acquired by church groups. The 1986 and 1990/91 issues increased the number of investors, and by the time of the 2002 issue the company had approximately 3,600 investors. This has now risen to about 5,500, still primarily individuals.

Traidcraft has sought to find out more about its new crop of investors through a questionnaire, which has achieved a 50% response rate and which is currently being analysed. The company's chief executive Paul Chandler says that the average shareholding (£1,250) is considerably larger than previously, and that shareholders are somewhat younger than in the past. 75% declare themselves to be Christian. There is also a strong correlation with supporters of organisations such as Oxfam, Christian Aid, Amnesty International and the National Trust. Perhaps significantly, half appear to be completely new supporters, not previously known to Traidcraft as mail order customers or volunteers.

Traidcraft plc's share prospectuses have always been honest about the financial returns on offer to investors. As the 1986 prospectus put it, "*Dividends will be low… and the directors do not envisage a substantial appreciation in the share price*". At that stage, the company declared that dividends above 6% would not be paid. Subsequently, the memorandum and articles have been changed so that they set a maximum dividend on shareholder funds at no more than 2.5% above Bank of England base rate (paying more requires the specific agreement of the holder of the guardian share).

In practice, no dividend to shareholders has been paid since 1987, a consequence partly of difficult trading circumstances in the late 1980s and early 1990s. However, this issue was revisited at the time of the 2002 share issue, and the current intention of the directors is to recommence modest dividend payments, probably from 2004. The company's profitability has improved markedly in the past two years, and both 2001-2 and 2002-3 have seen best-ever pre-tax profits. Corporation tax was paid for the first time in many years in 2002-3.

The 2002 prospectus states:

"Maximising the financial return for shareholders is not a principle aim of the Company. However the Board believes that, in order to demonstrate the viability of fair trade, it is important that it does seek to pay a reasonable level of dividends. In deciding on the allocation of future distributable profits the Board has indicated its intention to consider paying dividends up to the prevailing rate of inflation…"

In actual fact, a significant number of shareholders have waived their rights to future dividends, in favour of the Traidcraft Exchange charity.

The 2002 prospectus is also honest about the illiquidity of the shares ("*Over the 23 year history of the company, it has been difficult for individuals to sell their shares when they want to").* Indeed, before the 2002 issue there was a backlog of previous shareholders wanting to sell, some of whom had been waiting a considerable time. The Board has arranged for the stockbroker Brewin Dolphin to coordinate a matched bargain service, although Brewin Dolphin says that this has been used only on a modest basis. The firm charges its minimum commission rate of £25 for this service.[1]

In terms of capital appreciation, the 1990/91 share issue attempted to factor in a small element of growth by offering £1 par shares at £1.10p. Subsequent to this, the company's substantial trading losses meant that, in relation to net asset value, Traidcraft shares fell in value. Currently, Brewin Dolphin recommends a £1 share price for the matched bargains it coordinates.

Judging from the success of the 2002 issue, these possible drawbacks are clearly overridden in the minds of many investors by the opportunity to support a pioneering and high-profile fair trade organisation. Traidcraft's overtly Christian background also undoubtedly helps in this respect. However, it is interesting that the Board has recently addressed the role of shareholders within the company, and has recognised the need to involve them as stakeholders in the company – something which arguably did not occur in the 1990s. The 2003 AGM, held in September in Newcastle, for the first time gave shareholders a formal role in the company, including voting on directors' appointments and directors' remuneration. Traidcraft also encouraged shareholders unable to attend the AGM to submit questions, which were then answered via the website, to create a kind of 'virtual AGM'.

Looking further ahead, Traidcraft plans to bring shareholders together with other stakeholders (particularly its suppliers in developing countries) in 2005, at the time when the company will be developing its next strategic plan.

3. Baywind Energy Co-operative

Baywind Energy Co-operative, the community-based co-operative set up to support the development of wind energy in Cumbria, is often cited as a model of how new co-operative businesses can be established. Baywind represents a venture by a co-operative into the area of energy generation, identified as a promising area for growth. Baywind has also been profitable: the co-operative has experience of running two successful share offers (the first in 1996/7 raised £1.2 million, the second in 1998/9 the full £670,000 on offer), and since then has been able to pay significant returns to its investors: 6.07% gross in 2002, for example. Perhaps not surprisingly, there are many would-be shareholders queuing up, waiting to acquire shares.

Baywind chose the traditional Industrial and Provident Society (IPS) route to incorporation, structuring itself as a community co-operative. The members are the shareholders (only investors can be members), limited to the standard IPS £20,000 investment maximum. Each investor receives one vote, regardless of investment size (the share issues imposed a £300 minimum holding). Baywind today has about 1,300 member-investors, of whom approximately 40%-45% live in the south Cumbria/north Lancashire area, close to the location of its wind turbines.

Baywind's origins are somewhat unusual. It was effectively created in a top-down manner by Wind Company, a UK operation of the Swedish wind energy developers Vindkompaniet, who at the time were developing a five turbine site at Harlock Hill, Cumbria. Vindkompaniet, whilst a commercial enterprise, had experience of working with community groups in Sweden to support wind energy generation. The first share issue raised the capital to purchase (at market price) two of the Harlock Hill turbines erected by Wind Company. Subsequently, Baywind raised capital in its second share issue to purchase (again at a commercial price) one of four turbines at the Haverigg II wind farm, also developed by Wind Company.

Unlike most co-operatives, therefore, Baywind's investors found themselves coming in as members of an embryonic organisation which, whilst legally a co-operative, was heavily dependent on the expertise of its 'godparent' Wind Company/Vindkompaniet. When Vindkompaniet subsequently decided to withdraw from the UK market, the co-operative urgently needed to find its own management expertise and develop administrative structures. Baywind was fortunate in that, following an appeal, a number of member-investors with business experience came forward to strengthen the co-operative's board.

One decision taken was to acquire complete control of the Harlock Hill wind farm by purchasing the remaining three turbines there. This acquisition was made in 2001, though not through a third share issue. The cost was met partly from the co-operative's reserves (members had previously agreed that money allocated to a depreciation fund could be utilised in this way) but chiefly via a business loan from The Co-operative Bank. The cost of acquiring the turbines in this way was calculated to be cheaper than using share capital.

The issue of share interest payments to investors has been discussed several times by the co-operative's members, most recently in a long debate at the last AGM. When the first payments were made, several investors were clearly surprised ("We got lots of letters saying 'I never expected to see any returns, in fact I didn't expect to see my money again'", recalls Andrew King, Baywind's chairman). However, other investors clearly do welcome, and indeed have come to expect, these financial returns. The AGM discussion clearly demonstrated a considerable spread of opinion in this respect.

The co-operative policy is that trading surpluses (after development costs and depreciation) are distributed in full to members. This has resulted, given current low interest levels, in what can be considered to be relatively high returns. (In fact, returns in 2003 are expected to be lower than in 2002, because summer wind levels were much lower than usual.)

Baywind's strategy now is to seek to replicate its model by helping other locally based community wind energy generation co-operatives become established. Co-operative Action has helped fund a development worker at the co-operative, and Baywind has identified prospects for community groups to acquire a number of wind turbines on wind farms currently being developed, particularly in Scotland. At the same time Baywind has established Energy4All, currently a wholly owned subsidiary established as a limited company. The idea is that each new co-operative will contract to receive management and administration services from Energy4All, which will be converted into a company jointly owned by each participating co-operative (in other words, in operation if not in legal structure, Energy4All will be a secondary co-operative).

There is no recognised market in the shares but a number of Baywind investors (or, frequently, the executors of their wills) have sold shares since the original share issues, having been given the names and addresses of potential investors by the co-operative. Although the high demand for shares might suggest that the shares could be sold at a premium, in fact shares appear to have changed hands either at par (£1) or at 80p (representing the fact that most original investors benefited from EIS [Enterprise Investment Scheme] tax relief, so that £1 shares effectively only cost them 80p). Baywind's shareholders are almost exclusively individuals; Andrew King says that the £20,000 maximum investment acts as a strong deterrent to institutional investors.

4. Institutional investors and venture capital

So far, much of the emphasis in this chapter has been on individual investors. What of institutional investors, however? What experience do values-driven businesses have of accessing capital held institutionally, and what are the particular issues which then arise?

The next chapter examines the development of the ethical investment movement in Britain. This has created a sizeable (although still small in relative terms) pool of money managed by institutional fund managers, where there is an express objective of achieving social as well as financial returns. However, almost none of this money up to now has been channelled directly into the sort of co-operatives or social enterprises who have sought capital through ethical public offerings.

The Ethical Property Company is one of the first social enterprises to have institutional investors among its shareholders. Henderson Global Investors is able to justify its holdings primarily because the funds raised have been reinvested in the relatively secure home of property. They can also point to the fact that the Ethical Property Company has a track record of paying dividends.

In summary: Ethical Property Company

- Established in 1998 *"to meet the property needs of the social change sector"*
- First share issue in 1999 raised £1.72 million, and was over-subscribed. Six properties were acquired, for rent to charities and campaigning bodies
- Second share issue in 2002 raised a further £4.2 million, also invested in property for use by groups working for social change
- Share price increased to £1.05 for second share issue
- Ethical Property Company has a policy of paying dividends. Dividends of 3p per share paid in 2000 and 2001
- Institutional investors invested £881,000 in second issue
- Ethical Property Company discussing creation of an ethical exchange for buying and selling its shares

To a limited extent, the lack of direct institutional investment in individual co-operatives and social enterprises may be the result of the particular legal constraints imposed by IPS legislation where – as is the case with Baywind – the maximum investment is currently £20,000. A more substantive reason, however, is that historically those who have responsibility for other people's money have tended to be highly cautious in their investment decisions, concerned that they could be operating outside their legal powers if they choose investments on any grounds other than financial returns. This point is explored in more detail in the next chapter.

There is, however, another potential source of capital. For smaller and medium-sized start-ups and developing businesses in need of equity capital, one common route is to look for venture capital from external investors.

The operation of the venture capital industry is well known. Venture capital investments are typically made in high-risk, high-return enterprises. Investors expect to have a significant shareholding in the business, granting them the right to nominate directors of the company. Venture capital is restless money, and investors typically look for an exit route after a few years, to enable them to sell their holdings. This is usually provided through a flotation on a secondary market, a management buy-out or a trade sale to another company.

The difficulty in reconciling the operation of the venture capital market with co-operative and other types of social enterprise is also well-known. For co-operatives, there are both structural and philosophical problems. Because of their legal structures, co-operatives do not have the same share mechanisms as plcs through which venture capitalists can arrange their investment. There are potential problems, too, in reconciling co-operative members' interests with those of the investor. For example, employees may be better served if a business expands very gradually; by contrast, venture capitalists are likely to be looking for very rapid growth.

But without risk capital structured as equity, young businesses face a heavy burden of debt. Are there possibilities, therefore, of translating the basic venture capital model into the particular circumstances of co-operatives?

Towards the end of this chapter, there is a description of how the concept of 'social venture capital' is being developed in the US. This concept is now also being developed in Britain. The idea of a community development venture fund was one of a number of proposals made by the UK Social Investment Task Force in 2000.[2] The idea can be seen as a development of the community-based loan and grant fund schemes available for social enterprises.

It is also worth noting the launch of the first self-described 'ethical' Venture Capital Trust (VCT), the Pennine Downing Ethical VCT. This seeks to invest in companies which "*make a positive contribution to society through the provision of useful products and services, by the creation of jobs and through good management, without compromising expected returns on investment*".[3] The financial performance of this fund has been disappointing. (VCTs, established in 1995, are fully quoted companies very similar to investment trusts in concept; they provide a tax-efficient way of investing in a portfolio of emerging companies.)

Any discussion of venture capital in relation to values-driven businesses such as co-operatives has to look at the experience of the workers' co-operative Poptel, which turned to conventional venture capital to aid its development.

5. Poptel

Poptel was one of the relatively small number of workers' co-operatives established in the 1980s which developed from small roots into more substantial commercial ventures. It had a high profile in the broader co-operative movement, and the company was instrumental in establishing the international .coop suffix for co-operative business web addresses. It helped provide internet facilities for many campaigning organisations, NGOs and trade unions.

Poptel continues to trade but is no longer a co-operative, ownership having effectively passed in 2002 to the primary venture capitalist investor Sum International. A small web design spin-off, Poptel Technology, remains co-operatively run. Poptel's former internet service provider business has been passed (along with some former Poptel staff) to another co-operative business, The Phone Co-op.

For many years, Poptel was simply the trading name of Soft Solution co-operative, originally established in 1983 as a common ownership workers' co-operative. Employees were invited to join Soft Solution after they had worked for Poptel for six months (originally one year).

In the late 1990s, in the context of the dot.com boom, the internet expansion and the high degree of competition in the IT sector, Poptel faced an urgent need for more funds, both to update its core IT capital equipment and for working capital. It approached financial institutions in the co-operative sector, but in the end negotiated a £1.5 million facility with the private equity organisation Sum International. The deal involved the creation of a new holding company, in which the investor held 25% of the shares and the Soft Solution co-operative held the remaining 75%. Sum International took up a number of places on the board of the new company, and also, by agreement, arranged for the company to have a new managing director. One of Poptel's founders remained chair of the board. At the time, employee directors argued that the new arrangements, especially the presence of non-executive directors on the board, strengthened the management of the business. Subsequently, they have admitted that there were tensions between old and new board members over the direction of Poptel's development.

Following the injection of venture capital, Poptel was able to invest in a new Network Operation Centre (the IT hub of the business). The business also set its sights on rapid expansion, with the number of staff increasing from around 20 to about 55. Major resources were invested in developing a Professional Services division, offering design and build services for websites for organisations. This business grew fast, but income was dependent on individual contracts and was therefore lumpy. Poptel also invested heavily in developing the .coop idea, for which it was to operate the international registry service.

Poptel had originally operated on a wage parity basis. This was changed early in the co-operative's life, partly to reflect market realities in the IT sector. Unlike most IT businesses, however, staff did not hold shares individually, and therefore did not have access to the sort of share option schemes common elsewhere in their sector. The co-operative had a number of discussions about moving from collective towards individual shareholding in the business. However, this debate became purely theoretical as Poptel hit further financial turbulence.

Among other problems, the .coop project encountered unexpected delays and in 2000-01 Poptel found itself facing a series of further cash-flow difficulties requiring more capital injections. A further £3 million was obtained: £1 million came from Sum International and £2 million from the Baxi Partnership, an investment vehicle established to promote employee-owned businesses (see Section 6 below).

Had the market valuation of IT companies continued in the way seen in the late 1990s, Poptel could have successfully brought in further venture capital without diluting too much the percentage of shares held by the workforce. But unfortunately the market in IT-related shares had crashed, as the dot.com bubble imploded. The new investment therefore took the external shareholders' share in Poptel up to 49%.

Poptel's staff were conscious of the importance of maintaining their co-operative status by holding at least a bare 51% majority ownership in the business, and had devised a way to finesse the share ownership arrangements to try to make this possible. The device involved utilising a Soft Solution Employee Benefit Trust. Part of Baxi's investment would be in the form of a loan to this body, which in turn would hold some of the parent company's shares. According to Malcolm Corbett, Poptel's corporate affairs director at the time, the net result was that by 2001 Soft Solution owned 44% of Poptel's shares and Soft Solution Employee Benefit Trust owned a further 7% of the shares, with the remaining 49% of the shares held by external investors. It was a solution which, just about, allowed the workforce to claim that they maintained overall control.

However, this device could not be utilised a second time. It was clear by 2002 that Poptel would not be able to continue trading without further capital injections. As Malcolm Corbett has put it, *"The only people at the table were Sum"*. The end result was that Sum International took majority control of Poptel, a solution which certainly left some key players with a bitter taste. The former worker-appointed board members stepped down and Sum's founder partner Yoram Amiga became non-executive Chairman. Sum International has also appointed a new managing director, who has adopted a US-style of management designed to encourage employee participation.

The Poptel story might be read as a Faustian bargain by a workforce with private capital which unreeled to the inevitable outcome, when the investors were left in full control. The co-operative's former senior managers do not accept however that this was inevitable. Rather, they say, it was the result of an unlucky combination of external factors over which they had little control. It is true that the trading situation for all IT companies in recent years has been highly challenging, and many conventional businesses have also foundered.

It should perhaps also be added that Yoram Amiga from Sum International claims to be a strong supporter of the idea of co-operative business and has even suggested that Poptel could be reconverted in the future to a co-operative.[4]

6. Baxi Partnership

The Poptel story brings in, though not in the happiest of circumstances, the work of the Baxi Partnership, an equity fund dedicated to supporting the concept of worker-ownership. Baxi Partnership, which when created was worth £20 million, is highly unusual and is perhaps the closest in the British context to anything representing a genuine co-operative capital investment fund. Unlike a traditional venture capital fund, Baxi Partnership offers 'patient' capital. It is managed by David Erdal, and – apart from its unfortunate foray into Poptel – has successfully invested to date in a number of employee-buyouts of existing businesses.

The Baxi Partnership fund was extricated from the remains of the central heating and boiler company Baxi, which had previously been run as a fully employee-owned business but which had, through trading difficulties, been taken over in the late 1990s and had lost its employee-ownership structure. Baxi, previously a privately owned business, had been sold to the workforce by its owner Philip Baxendale in 1983 for a fraction of its market value. The fund, therefore, enables the impulse behind this original action to be maintained, though now in a different way.

The Baxi Partnership invests by providing long-term loans to enable employee buy-outs. All the shares in the employee buy-out are held by an employee benefit trust: at least 50% of the share capital will be held in perpetuity by the trust. The other shares are held by employees, with an employee share incentive plan acting as the distribution and market mechanism.

Baxi Partnership Ltd itself is owned by a trust which was established by a 2000 Act of Parliament. This sets down that the trust must make its decisions for the benefit of employees of the companies in the Baxi Partnership – in other words, the beneficiaries of the trust are the employees of the companies in which it has invested. The trust is also committed to the aim of business success and of a partnership culture in the workplace.[5]

The Baxi Partnership has identified four key scenarios when it may be able to assist businesses:

- family owners who want to take their capital out

- corporate owners who want to sell a non-core subsidiary
- venture capitalists who are looking for an exit
- entrepreneurs who want to move on.

Its first two investments were in the Scottish engineering company Woollard and Henry (£1.3 million), a family concern which was contemplating selling out to a competitor, and in the Lancashire container manufacturer UBH International, as a phoenix bid to rescue a company in liquidation (about £1 million). More recent investments by Baxi Partnership have included a £2 million loan to Loch Fyne Oysters, the seafood and game company, as part of an employee-buyout following the death of the founder of the business.[6]

7. The wider picture: Practices in other countries

What of the situation elsewhere in the world? The debates and experiences in Britain which have been described in this chapter in many respects mirror very similar developments elsewhere in the world.

In the United States, the vast bulk of socially responsible investment remains invested in conventional companies. However, one notable development in recent years has been the interest among charitable foundations, public pension funds and private equity funds in the possibility of social venture capital.

One interesting example is the Investors' Circle, which describes its objective as *"venture capital for a sustainable future"*. The organisation currently has about 100 members, made up of individual investors, venture capital fund managers and foundation representatives who *"believe in the power of venture capital to act as a tool for social change"*. Each month about 15-20 vetted business proposals are circulated to members of the organisation, who can then choose, if they wish, to negotiate directly with the individual companies. The Investors' Circle says that, since 1992, it has helped facilitate the investment of $85 million in almost 150 companies. Investors' Circle works closely with an 'ethical' venture capital fund, Commons Capital, and has also spun off its own non-profit foundation, IC Foundation.[7]

A similar approach is taken by Vancadia Capital Corporation, based in Vancouver and Arizona. Vancadia is a merchant banking operation which specialises in investing in socially responsible companies, generally those which have advanced beyond the start-up stage and have reached a development and expansion phase. Among others, Vancadia has recently provided venture capital to a company producing fruit juices, a renewable energy business and a service provider in the IT sector.[8]

As well as these examples of social venture capital, the large mutual fund manager, Calvert, which specialises in ethical funds, has begun to channel a very small share of money invested in two of these funds into individual businesses, on a venture capitalist basis. The Calvert Special Equities program invests in *"high-risk, socially and environmentally responsible enterprises… [which] provide market-based solutions to some of the more difficult social, environmental and health problems"*. Currently some 30 investments, ranging from $100,000 to $1 million, have been made.[9]

The development of social venture capital in the US has been the subject of a recent academic study which looks at tentative steps by charitable foundations and pension funds in this direction. It makes the observation:

"*Foundations have clearly had mixed results from their involvement in social private equity, and it is too soon for many to ascertain whether it was a success. Currently, small foundations invest small percentages of their endowments, which means there is limited capital available and a limited number of investments to evaluate*."[10]

Even social venture capital, however, requires a similar level of investor intervention in a business as conventional venture capital, which as we saw in the case of Poptel can lead to difficulties for co-operatives.

A number of north American co-operatives have attempted to get round the difficulties of attracting risk capital from external sources in creative ways, including establishing separate legal entities which are wholly or partly owned by the parent co-operative. One example is the walnut growing co-operative, Diamond of California, which was motivated by the desire to reduce the burden on co-operative members of financing the co-operative's development. Diamond's solution has been reported in a recent Ernst and Young report for Canadian co-operatives as follows:

"*The co-operative took advantage of a recently available tool, known as Cumulative Recourse Offered Preferred Shares (CROPS), which offers a method to raise money in the private market, with the best characteristics of both equity and debt. A key consideration for this capitalization method is that the co-operative did not want to lose control of the co-operative. The main financial advantages offered by CROPS are that it strengthens a co-operative's balance sheet by raising equity-like capital on a cost effective basis; rating agencies regarded CROPS as equity for rating purposes since the shares are subordinate to bank debt; it enhances a co-operative's creditworthiness; and the new financing tool is competitively priced.*"[11]

In outline, Diamond established a wholly owned limited partnership, which raised $15 million as a loan and lent it on in turn to the parent co-operative as preferred stock.

Another similar example is that of Capital Desjardins, a wholly owned subsidiary of Fédération des Caisses Desjardins du Québec (a federation of co-operative savings banks/credit unions). This was set up in 1994 with the aim of obtaining external capital and in turn investing it in the individual savings banks, in order to help them improve their capital ratios and financial position. Capital Desjardins successfully raised US$200 million in 1995 in debenture stock and a further $800 million in 2002.

The Ernst and Young study mentioned above also looks at examples from elsewhere in the world where co-operatives have chosen to seek direct external capitalisation. In Australia, a number of agricultural co-operatives have developed classes of share with subordinated voting rights which are traded on the Australian Stock Exchange. One example is the cotton marketing co-operative Namoi Cotton, which raised A$35 million in 1998 through Co-operative Capitalization Units. These quasi-shares attract dividend payments, as decided by the co-operative board, and would share in the distribution of surplus assets in the event of dissolution. Holders of the units can nominate up to three independent directors, but do not have conventional shareholder voting rights. Other

Australian co-operatives to have issued Co-operative Capitalization Units include Norco Co-operative, a dairy food manufacturer, and Walgett Special One Co-operative, a grain handling business.

In Canada, a number of provincial governments have made changes to co-op legislation to permit non-member investment, unequal voting rights and the transferability and appreciation of shares. One agricultural co-operative which has used these powers is the Saskatchewan Wheat Pool, which issued non-voting class B shares in 1996 as a means of funding its growth strategy. Class A shares (voting shares) are held by co-operative members and are non-transferable and non-appreciable, with no entitlement to dividends. Class B shares bring no voting entitlements, have restricted ownership rights, but do receive dividends and can be transferred (they are traded on the Toronto Stock Exchange).

The Ernst and Young study notes "*Since the share issue, the co-operative has suffered financially and attracting and retaining members has been difficult. Those that hold true to the traditional co-operative model criticize the co-operative's share issue and feel that it has contributed to the financial problems of the company, since they have betrayed their members with outside interests*".[12]

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[1] Personal communication with author. February 2003.
[2] UK Social Investment Task Force. 2000. *Enterprising Communities: Wealth beyond Welfare*. UK Social Investment Task Force.
[3] Pennine Downing Ethical VCT <<www.rathbones.com >> Accessed 16 July 2004.
[4] For further information, see the more detailed case study on Poptel written by Andrew Bibby (2001), available at <<www.andrewbibby.com/socialenterprise>>. See also *Financial Times*. 2003. Investors 1, Workers 0 in the capitalist stakes. Andrew Bibby. 8 July.
[5] *Financial Times*. 2002. Evangelist for employees as owners. Mark Nicholson. 21 November. *Financial Times*. 2002. The challenge when labour employs capital. Andrew Bibby. 31 October. See also <<www.baxipartnership.co.uk>> Accessed 16 July 2004.
[6] *Financial Times*. 2003. Loch Fyne Oysters to be owned by staff. Mark Nicholson. 4 March.
[7] Venture capital for a sustainable future. <<www.investorscircle.net>> Accessed 19 July 2004.
[8] Vancadia Capital Corporation <<www.vancadia.com>> Accessed 19 July 2004.
[9] Social Venture Capital <<www.calvertgroup.com>> Accessed 19 July 2004.
[10] Fleming, Dennis. 2002. *Social Private Equity Investment.* INSIGHT Philanthropy Services.
[11] Ernst and Young. 2002. *Canadian Agricultural Co-ops, Capitalization Issues and Challenges: Strategies for the Future.* Ernst and Young.
[12] Ibid.

Chapter 4: The ethical investor

This chapter examines recent trends in the UK ethical investment market in order to understand what ethical investors may expect from an investment in a co-operative. Section 1 charts the birth and growth of the ethical investment movement in the UK. Section 2 describes how institutional investors have responded to the growing interest in ethical investment. Section 3 examines the financial returns achieved by ethical investments. Section 4 looks at what an ethical investor might accept as a fair return on investment, and describes methods of accounting for the social return on investment. Section 5 discusses the scope for strengthening the ties between ethical investors and co-operatives.

There is considerable interest today, among both individual and institutional investors, in the idea of ethical or socially responsible investment. About £3.5 billion is held by individuals in the UK in collective investments which, to a greater or lesser extent, impose ethical constraints on investment choices.

At the same time, institutional investors – insurance and pension funds, charities and churches – have begun, on a much more frequent basis than in the past, to take ethical considerations into account when making investment decisions. One recent analysis suggests that, if the totals in all these types of investment are added up, as much as £220 billion is held in the UK in some form of socially responsible investment.[1]

The bitter irony, of course, is that almost none of this money is currently channelled into the co-operative sector. Instead, the vast bulk of 'ethical' money ends up invested conventionally, in large measure in public limited companies quoted on the London, or other major world, stock markets. This is also true of the significant funds – both ethical and otherwise – managed by the two arms of Co-operative Financial Services. In other words, 'ethical' money is going almost exclusively into conventional private sector firms.

There are reasons why this is currently the case. But, if the co-operative sector is going to move forward and find the capital it will need for new initiatives, this is an issue which must be addressed.

1. The ethical investment movement in the UK

Recent years have seen the development of what can fairly be described as a distinctive movement, both in the UK and in other western countries, committed to promoting 'ethical investment'. (Increasingly, the alternative term 'socially responsible investment' is also being used; this chapter, for convenience, will stick with the traditional term.)

The ethical investment movement is a broad-based one which brings together a diverse group of people. It includes, for example, both those coming from an activist political background on the liberal left and those with a committed Christian set of beliefs. More specifically, the ethical investment movement has over recent years appealed to those with an interest in world development issues including fair trade, in environmental issues, in animal welfare, in the peace movement, and in many other causes. To the extent that there has been any relationship with the traditional co-operative movement in the UK, the main point of contact has been through The Co-operative Bank's highly successful ethical banking initiative. Co-operative Insurance Services has been a rather more modest player in the ethical funds market.

It is convenient to begin the account by going back to the early 1980s. One place to start would be with the launch in 1984 by Friends Provident of Stewardship, the first so-called 'ethical' unit trust in the UK. This idea (though becoming familiar in north America) was considered threateningly radical at the time in the conservative culture of the City.

During the rest of the 1980s, Stewardship grew modestly in size, and was gradually joined by a number of competitors. By 1989, fourteen ethical funds had been established, which together held about £42 million of investors' money.

At the time of Stewardship's launch, there was a growing campaign against western companies' complicity in supporting the apartheid regime in South Africa. Early ethical funds like Stewardship attracted people who wished to avoid their own money being used indirectly to reinforce apartheid. In addition (and primarily to attract Christian investors), the funds tended to avoid companies connected to the alcohol and tobacco industries, gambling and the military sector. From the early 1990s, the situation changed as environmental and ecological concerns became more central.

Mainstream ethical investment funds are not the only manifestation of the ethical investment movement. The Ecology Building Society, established in 1980 and incorporated in 1981, has successfully developed as a specialist mortgage lender with a commitment to environmental and social objectives. Shared Interest, established in 1990 and legally incorporated under IPS legislation as a society for the benefit of the community, is effectively a savers' co-operative, borrowing from UK savers and offering loans and capital to Third World producers. Triodos Bank, which describes itself as an ethical bank which "*enables money to work for positive social, environmental and cultural change"*, has broadened its appeal from its original roots in the Rudolf Steiner movement (the Dutch-based Triodos parent bank took over the UK's Mercury Provident bank, first established in 1973, in 1995). Among other initiatives, Triodos has begun to develop its Ethical Exchange (Ethex) (see Chapter 6).

The growth of all these initiatives has been a success story, even if the total amount invested in the ethical funds, about £3.5 billion, is still only a tiny percentage of the overall total of investment funds under management in the UK.[2] There are currently about fifty-five self-proclaimed ethical investment funds. While they have similarities with each other, there are also considerable differences. For example, some funds are much more active in positively seeking out companies to invest in, in contrast to those who simply screen out companies with undesirable practices. There are also significant differences in terms of the issues covered; these now can include a range of disparate concerns, from animal testing to pornography, labour rights to nuclear power, greenhouse gases to motorway building. Some funds are much more responsive to investor input and participation than others.

These developments are not unique to the UK. By December 2001, there were reported to be 280 green, social and ethical funds in Europe, representing a 78% increase over a 24-month period.[3] After the UK, the largest markets in Europe are Sweden, France and Belgium (the UK's relative position in Europe has declined from 33% of the whole European market in 1999 to 21% in 2001).

Despite recent growth, however, European ethical funds in general remain a long way behind the US in terms of the sheer size of the ethical investment market. Table 4.1 shows the number of ethical and mutual funds in 2000 in Europe and the US. The UK market is still less than 25% of the total size of the US market in terms of numbers of funds and just over 4% of the total size of the US market in terms of ethical assets under management.

Table 4.1: Overview of the ethical mutual fund market on 31 December 2000

	Number of ethical mutual funds	Ethical assets under management ($m)	As a % of total mutual fund assets
Belgium	26	602	0.80%
France	14	371	0.01%
Germany	22	1,317	0.04%
Italy	5	2,077	0.45%
Sweden	42	1,190	1.46%
Switzerland	22	1,011	1.12%
The Netherlands	11	1,309	1.20%
United Kingdom	55	6,390	1.35%
United States	230	153,000	2.26%

Source: Bauer, R and Otten, R. (2002)[4]

The largest ethical funds in Europe are given in Table 4.2. It will be seen that the greatest concentration of assets is in three UK funds and two Italian funds.

Table 4.2: Largest European ethical, green and social funds (€ million)

Ranking Dec 2001	Ranking June 2001	Asset management company	Name of fund	Nationality	Assets €m
1	2	Friends Ivory & Sime plc (now ISIS Asset Management)	Friends Provident Stewardship Unit Trust	UK	919
2	1	Sanpaolo-IMI Asset Management SGR	Sanpaolo Azionario Internationale Etico	Italy	775
3	3	Framlington	Health Fund	UK	700
4	5	ABN AMRO Asset Management	ABN AMRO Groen Fonds	Netherlands	463
5	4	Sanpaolo IMI Asset Management SGR	Sanpaolo Obbligazionario Etico	Italy	462
6	-	UBS Asset Management	UBS (Lux) EF Eco Performance	Switzerland	445
7	7	Dexia Asset Management	Stimulus Invest Stimulus European Balanced Medium	Belgium	410
8	9	SNS Asset Management	ASN Aandelen Fonds N.V.	Netherlands	292
9	6	Henderson Global Investors	NPI Global Care Growth	UK	274
10	-	ING Fund Management E.V. and ING Bank Fondsen Beheer BV	ING Bank Duurzaam Rendement Fonds	Netherlands	254

Source: SiRi Group (2002)[5]

Where are ethical funds investing? Table 4.3 analyses the twenty most popular stocks held by these funds.

Table 4.3: The most frequent stocks in SRI portfolios on 31 December 2001

Ranking Dec 2001	Ranking June 2001	Most common stock
1	2	Nokia
2	4	Johnson & Johnson
3	1	Vodafone
4	3	GlaxoSmithKline
5	8	ING
6	New entry	Vivendi
7	16	Royal Dutch Petroleum Shell
8	6	Pfizer
9	11	BP
10	New entry	Home Depot
11	14	Intel
12	17	Lloyds TSB
13	20	Fannie Mae
14	New Entry	Ericsson
15	New entry	Aventis
16	New entry	Sanofi Synthelabo
17	5	Royal Bank of Scotland
18	13	Microsoft
19	New entry	BNP Paribas
20	New entry	L'Oreal

Source: SiRi. (2002)[6]

Like their orthodox investment counterparts, then, the largest ethical investment funds are taking their assets into relatively safe and chartered waters. The list of portfolio companies here would not present any difficulty for ordinary institutional investors and illustrates the inherent risk aversion of the financial markets.

2. Ethical investment and institutional investors

So far this chapter has focussed on collective mutual funds, which primarily appeal to individual investors. But what about institutional investors themselves?

Historically, those who have responsibility for other people's money (including trustees of insurance and pension funds, charities and private trusts) have tended to be highly cautious in their investment decisions, concerned that they could be operating outside their legal powers if they chose investments on any grounds other than financial returns.

A landmark pensions case in 1984 appeared to reinforce this message. The case was related to attempts by NUM-appointed trustees of the pension fund of the NCB (subsequently British Coal) to cease to invest, among other things, in companies in competing energy industries – investments which, it could be argued, threatened the jobs of the very people who were in the pension scheme. The court judgment was a complex one, but nevertheless suggested that trustees had little room to manoeuvre if they wished to introduce non-financial criteria into their investment decisions.[7]

The overall climate has, however, changed in recent years, helped by the growth of interest in corporate social responsibility (CSR) and by evidence that ethical investment policies do not necessarily mean that returns will automatically be lower. One key factor (Russell Sparkes, author of the book Socially Responsible Investment,[8] went as far as to call it a *"historic"* step forward) has been the decision by the UK government to require pension fund trustees to state whether or not they are taking social, environmental and ethical considerations into account when fixing their investment strategy. This new requirement, announced in 1999, has been operative since July 2000.

Another change has come with the passing of the Trustee Act 2000, which encourages charity trustees to ensure that their fiduciary responsibilities are in line with their charity's broader aims and objectives. Investments need to be 'suitable', and not only in terms of their financial performance.

Recent years have also seen a number of other regulatory and commercial changes. For example, the Myners report[9], published in 2001, among other things laid down guidelines for shareholder activism in institutional funds. Among other changes in corporate governance practice, all companies are now required to report on their social, environmental and ethical risk management practices.

Partly as a consequence of these various developments, the last few years have seen a dramatic increase in the numbers of institutional investors engaging in forms of ethical investment. According to Russell Sparkes, an overall total of £224 billion in assets in the UK was invested in 2001 according to some form of socially responsible investment (SRI) criteria. This comprised £13 billion from church investors, £25 billion by charities, £80 billion from pension funds and £103 billion from insurance companies, together with the £3.5 billion held in ethical funds. This compares with a total of just £22 billion in 1997.[10]

There are strong reasons to believe that there is the potential for quite considerable further growth. For example, one recent survey of 100 of the UK's largest charities and foundations found that 60% still had no written ethical or socially responsible investment policy.[11]

The experience of the United States also suggests that that the UK SRI investment market can grow. According to the most recent (2001) report by the (US) Social Investment Forum[12], some $2,340 billion of assets out of the total US investment assets of $19,900 billion are in 'socially screened investment portfolios' – or in other words, more than 10% of the total under professional management. Within this amorphous total the Social Investment Forum distinguishes between three broad categories of socially responsible investment. The largest category consists of investments which are screened according to certain ethical criteria: in 2001, this comprised $2,030 billion. Secondly, there are investments which are used as a basis for shareholder advocacy, or in other words where investors attempt to use their investment to encourage or discourage certain practices by the company (in 2001, this comprised $903 billion, including about $600 billion where funds are also ethically screened). Finally, a small share of the total ($7 billion) is represented by the 'community investing' category, such as that undertaken by community development financial institutions in the US. There are now over 360 of these institutions in the US. They play a valuable role in supporting community economic regeneration, particularly among lower-income and ethnic minority communities.

3. Does ethical investment affect financial returns?

One of the enduring questions which has been asked since the early days of the ethical investment movement is the extent to which, if at all, financial performance is adversely affected by introducing non-financial criteria into the investment decision.

It would be fair to say that, certainly initially, the investment community felt that ethical selection of stocks must involve higher risk and poorer returns – if only for the reason that the universe of possible investment options was restricted. To an extent this sceptical view still applies today in conventional fund management circles.

However, the significant number of research studies into this area suggest that this view is simplistic, and that ethical investment need not mean reduced financial returns – indeed in some circumstances it can lead to improved returns. For example the researcher John Guerard, in a 1997 study, compared the returns on an unscreened universe of 1300 US equities with the returns on an SRI screened reduced universe of 950 companies and found *"no statistically significant difference"* in their performance over an eight year period to 1994.[13]

In the UK, a detailed study by the Ethical Investment Research Service (Eiris) in 1999 also appeared to suggest that there was little difference in performance returns from ethically screened shares, compared to the FTSE All Share Index. Eiris examined five 'ethical indices', based on the criteria given in Table 4.4.[14]

Table 4.4: Criteria used by ethical indices

	Exclusion/Inclusion Criteria		Performance in relation to FTSE All Share Index
Charities' Avoidance Index 56% of FTSE All Share	**Exclusion by:** • Alcohol/tobacco production, gambling • Alcohol or tobacco sale • Military involvement • Pornography		400% increase over 10 year period 0.08% annual return over FTSE All Share
Environmental Damage Avoidance Index 54% of FTSE All Share	**Exclusion by:** • Greenhouse gas production • Intensive farming • Nuclear power • Supply/use of ozone depleting chemicals • Manufacture/marketing of pesticides • Pollution convictions • PVC manufacture • Road-building, fuel retail & vehicle use • Tropical hardwood use, retail or extraction • Water pollution		450% increase over 10 year period 1.61% annual return over FTSE All Share
Responder's Index 74% of FTSE All Share value but only 235 companies	**Inclusion by:** • Community involvement • Disclosure • Equal opportunities • Environmental initiatives • Training • Trade union recognition		425% increase over 10 year period 0.53% annual return over FTSE All Share
Ethical Balanced Index 47% of FTSE All Share 340 companies	**Exclusion by:** • Animal testing • Gambling • Weapons production, nuclear weapons, arms export • Nuclear power stations • Manufacture of ozone-depleting chemicals • Pornography • Irresponsible Third World marketing • Tobacco production • Tropical hardwood extraction/use **Negative screen:** • Advertising complaints, alcohol, animal testing etc	**Positive screen:** • Community involvement • Disclosure • Environmental initiatives • Equal opportunities • Positive products & services	400% increase over 10 year period 0.34% annual return over FTSE All Share
Environmental Management Index 117 companies, 57% FTSE All Share	• Corporate environmental progress • Environmental reporting • Environmental reporting awards • Adoption of environmental management systems • Alternative energy development		375% increase over 10 year period - 0.61% annual return below FTSE All Share

As can be seen, the only index to under-perform the FTSE All Share index over the same time period was the Environmental Management Index. All others were above the performance of the FTSE All Share, with the Environmental Damage Avoidance Index showing the best return. In terms of volatility, the Environmental Damage Avoidance and Ethical Balanced Indices were marginally more volatile than the FTSE All Share over the period, but all other indices were substantially less volatile.

However, other studies are somewhat less positive. One US study of 24 ethical funds conducted in the mid 1990s suggested that only four were above average compared with conventional funds. Over the ten years to 1995, US mutual funds on average lagged behind other funds, although only by a relatively modest 1% a year.

These surveys, and several others, have been analysed in depth by Russell Sparkes in his recent book on SRI. He offers his own assessment, stating that "*On the whole, UK SRI unit trusts seem to have produced long-term investment returns slightly below those of comparable unit trusts*."[15] This debate can perhaps be summarised by concluding that the evidence is mixed, but that if it is indeed true that ethical funds collectively do under-perform non-ethical funds, the difference does not appear to be particularly significant.

Recent research has also considered whether a company's performance is linked to its willingness to look at issues of corporate social responsibility. Evidence is emerging to support the contention that firms with a strong CSR base out-perform their competitors with a weak or no commitment to CSR.[16] It is argued that CSR-minded companies are potentially more innovative (because innovative capacity may be enhanced by a requirement to be sustainable and responsible), have a stronger reputational base, have better internal and external strategic relationships, and have a stronger and more varied strategic asset base.

In other words, it is no longer necessarily adequate to view a strong CSR profile as a cost – it can actually be an asset to a business. An environmentally, socially and ethically based strategy should mean that a company is more rigorous in its attention to the management of its reputation and its practices across its range of activities and hence is more attractive as an investment proposition.[17]

4. A 'fair' return?

The issue of whether ethically-screened investment involves a reduction in investment returns has been the focus of much research activity. Formulating the question in this way, however, implies that ethical investors share with conventional investors an overriding concern with a single indicator, that of the financial return on their investment. But, as the last chapter demonstrated, ethical investors may have different expectations of what constitutes a fair return on investment.

Individual ethical investors' approach to the question of returns on their investments can be charted on a spectrum, ranging from at one end a conventional desire to maximise financial returns to, at the other end, a 'quasi-donation' approach to the money in question. Where on this spectrum a particular investment decision falls is likely to depend not just on who the individual is who is making the investment but also on how much and why they are investing. It is possible to imagine, for example, that the same individual would be more cautious if they were investing a large lump sum towards a retirement pension than, say, putting aside a small amount of capital which they could afford to lose.

The attitudes of ethical investors to their investment decisions have been the subject of a recent research project, *Morals and Money*, led by Professor Alan Lewis at the University of Bath, and summarised by him in his book *Morals, Markets and Money*. These research findings are based on analysis of over 1000 questionnaires completed by investors with ethical unit trusts as well as a series of focus group discussions and a computer based investment simulation exercise.

As Alan Lewis points out, the vast majority of investors with ethical investments also hold non-ethical products. Despite this, there is a reluctance to shift out of the ethical investments held even if performance in them is markedly worse. He summarises the research findings as follows:

> *"…Although there is a certain pragmatism in holding a morally mixed portfolio in the first place, investors are loyal to the ethical investments they have. Ethical investors are clearly not all the same, those who endorse ethical motives enthusiastically and those most concerned about nuclear power, ozone-layer degradation, the Third World, armament production and animal testing are more prepared to take financial losses. This willingness to accept losses is not, however, a function of the proportion invested ethically – investors with the most to lose stick with 'ethicals' just as much as people whose investments are 'spare cash'.*
>
> *"There could be two systems at work here: those with smaller proportions invested ethically can in some senses 'afford' to lose some money as the effect on their overall financial position will be marginal; for those with a larger proportion invested ethically, the financial losses would certainly hurt, but they persist, perhaps because the proportion invested ethically is an indication of the strength of their moral commitment.*"[18]

Alan Lewis's research reinforces the view that many ethical investors are much more prepared to accept reduced financial performance than the investment industry, with its own particular obsessions and interests, currently realises. Admittedly, this may not be the case with institutional investors, where the requirement to meet fiduciary responsibilities is likely to mean a much greater focus on maintaining financial returns.

One attempt to move beyond simple financial indicators when assessing investments has been made in the United States where work around the concept of 'social return on investment' (SROI) has been undertaken in recent years, led by the Roberts Enterprise Development Fund (REDF), a private charitable foundation. REDF has attempted in particular to develop a sophisticated set of indices by which charitable trusts can assess the value of their own engagement with social enterprise and community development.

As Cynthia Gair of REDF has explained:

> *"At a basic level, concepts of social return on investment, like their business predecessors, compare some measure of the resources invested in an activity to some measure of the benefits generated by it…On a deeper level, SROI may posit real, sometimes radical departures from traditional concepts of financial return by broadening the "who" a return may accrue to, and by expanding the "what" that can be considered part of an activity's return. REDF has pioneered this broadening of concepts of return. In our approach to SROI, we recognize and attempt to quantify the "return" that accrues to a whole community, rather than just those returns that accrue to a specific set of investors. We believe that "return" may take the form of a wide range of changes, including those that can be monetized, such as community tax savings, decreased social service costs, and individuals' increased income; as well as changes that have distinct effects on individuals and communities but are hard to translate into dollars, such as individuals' increased housing stability or self esteem."* [19]

One difficulty with this approach is that some social returns on investments are not amenable to quantification; REDF tends to focus on what it calls 'socio-economic' and 'economic' value, rather than pure 'social value'. Another difficulty, as REDF readily admits, is the considerable resources which have to be devoted to undertaking each specific social rate of return calculation. In this respect, the problem is not dissimilar to that facing companies which attempt to carry out accurate social and environmental audits to complement their financial audits.

As it currently has been developed, the SROI concept is also more appropriate to the work of charitable foundations supporting community regeneration and development than to the wider area of ethical investment. Nevertheless, this is an area where further work might well be of value.

Even more difficult than any discussion of the social return on investment is the fundamental question of what constitutes a 'fair' return on investment. The issue can be stated very simply: what share of the profits generated by an enterprise should rightly belong to those who have invested, as opposed to those who are other stakeholders, including those who are employees?

One way to approach the answer to this question is to consider the degree of risk to which investors are exposing themselves. It is a familiar principle that, in general, the higher the risk involved, the greater the potential returns which need to be on offer. Investors who make money available on a venture capitalist basis, for example, will expect high returns from those businesses which are successful, in part to compensate for the large numbers of businesses which can be expected to fail. So perhaps what constitutes a 'fair' return to investors will be higher during the early years of an enterprise than later in its life cycle.

On the other hand, this argument isn't necessarily altogether convincing, since the other stakeholders in an enterprise – including most notably the workers – are also likely to be exposing themselves to a greater level of risk when a business is just starting out. Employees, for example, may have to work hard for relatively little pay, in jobs which are by definition less secure than those in a more established concern. (The issue of risk and reward is looked at in more detail in the next chapter.)

It is tempting, in fact, to respond to our question about a fair return on investment by asserting that ‘fairness’ is not a concept which is recognised in the way in which the markets are currently structured. Conventionally within private sector businesses, the share of an enterprise’s wealth generation which goes to investors depends not on any logical or equitable distribution between stakeholders, but rather on how well business costs (including labour costs) can be controlled. Investors have the right to enjoy whatever they manage to get.

It is true that this sort of attitude may be coming under increasing pressure, with the growth of interest in corporate social responsibility, with its emphasis on a triple bottom line (of social and environmental as well as financial returns), and with corporate scandals such as Enron and Worldcom. Institutional shareholders are beginning to show themselves much more prepared to intervene in the internal management affairs of the companies whose shares they hold.

If the ethical investment movement is to move forward, it may want to address in more detail some of the questions that have been posed here. In particular, it will surely be necessary to challenge the short-term approach towards maximising financial returns and to emphasise instead the need for lower, but more sustainable financial returns, over the longer-term.

5. Co-operatives and ethical investment

At the start of this chapter the point was made that despite the sizeable sums now invested ethically in the UK, almost all of these funds are currently held in conventional private-sector businesses. Almost nothing is invested in co-operative enterprises.

One of the major themes of this publication is that a rejuvenated co-operative movement must ensure that it has access to the capital it needs for its development. The growing pool of ethical and socially responsible capital is one obvious place to look.

But the benefits of a much closer relationship between co-operatives and the ethical investment/SRI movement go further than this. For the co-operative movement, there is an opportunity to promote its democratic and socially-orientated business credentials to a potentially sympathetic audience who, perhaps, have up to now been not been made properly aware of the ‘co-operative difference’. The success of The Co-operative Bank’s ethical banking policy and of the retail movement’s commitment to own-brand fair trade coffee and chocolate shows the potential here.

The co-operative movement also has much to offer in the developing debate of what constitutes corporate social responsibility. Historically, the ethical investment movement has been more concerned with monitoring the sort of products companies make and with the environmental effects of their operations, rather than with questions of internal corporate governance or employment practices. But this is changing. As business becomes increasingly global, there is growing interest in assessing the extent to which multinational companies are adopting good practice in their worldwide operations. The two major codes and guidelines which are being used are those drawn up under the auspices of the International Labour Organization (*The ILO Tripartite Declaration of Principles* concerning multinational enterprises and social policy) and the OECD (*Guidelines for multinational enterprises*, and *Principles of corporate governance*).

But co-operatives have – or at least should have – a head start here. For over 150 years, co-operative businesses have attempted to develop their own form of corporate social responsibility, by creating forms of enterprise which are not obsessed simply with maximising short-term profits or with maximising shareholder returns. The unique position of co-operatives in this respect has been recognised by the ILO in its 2002 Recommendation for the Promotion of Co-operatives. The text of the Recommendation praises the "*co-operative values of self-help, self-responsibility, democracy, equality, equity and solidarity, as well as ethical values of honesty, openness, social responsibility and caring for others*".[20] This international endorsement of co-operatives is of considerable value, not least because of the ILO's tripartite nature (governmental, business and workers' representatives have equal weight in drawing up ILO conventions and recommendations). Together with the ICA's seven co-operative principles, it offers the platform on which the co-operative sector can engage with the debate on CSR and on ethical investment.

To summarise, the growing ethical investment movement has brought to light quite considerable sources of socially-minded capital which are potentially of use to co-operatives; co-operatives need to consider what changes they need to make to their structures and ways of operating in order to access this capital. The benefits from a closer engagement between co-operatives and the ethical investment/SRI world, however, go well beyond the particular question of the accessibility of capital.

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Chapter 5: Investing in co-operatives

> This chapter examines the process of long-term investment in co-operatives. Section 1 categorises the different types of investors in co-operatives. Section 2 analyses what investors want from their investments and how this affects their investment decisions. Section 3 proposes that productivity is a better measure of the financial performance of a co-operative than profitability. Section 4 analyses the impact of common wealth on the value of shares. Section 5 examines the factors determining the balance between debt and equity investment and describes some hybrid forms of finance. Section 6 describes four main methods of valuation and the circumstances in which each method might be appropriate. Section 7 describes the investor life cycle; showing how new investors provide exit routes for previous generations of investors.

Up to now this publication has concentrated on the reasons why co-operatives might want to change their relationships with investors and investment. It has argued that opening up co-operatives to external investment will increase the birth rate and growth rate of co-operatives, and it has shown that there is an interest and willingness among ethical investors to invest in co-operatives and social enterprises. This chapter and the following two chapters concentrate on the practical arrangements for enabling co-operatives to develop their relationships with investors.

If a co-operative is to raise additional capital, it needs to develop a long-term strategy towards investors and investment. A good starting point is to identify the full range of investors in co-operatives and their motives for investing. Co-operatives need to know what each type of investor wants from their investments and where the balance lies between social and financial returns.

The concept of common wealth is central to the proposition that investors' interests can be reconciled with the interests of the other stakeholders in co-operatives. However, the practice of accumulating common wealth in the indivisible reserves of co-operatives has an impact on the financial returns to investors and how investments in co-operatives should be valued. This chapter examines this impact and outlines a range of valuation techniques that could be used to determine a fair value for equity in co-operatives.

1. Who are the investors and why do they invest?

The previous chapter focused on the behaviour and interests of ethical investors. It noted that ethical investors are a large and relatively untapped source of finance for co-operatives. However, it is important to remember that the ethical investor will not be the only type of investor in the co-operative. In addition to these external investors, who might have secondary rights in the co-operative, the primary members of the co-operative might also be investors. Primary membership is usually based on a stakeholder role or relationship other than that of investor – typically, that of customer, employee, tenant or supplier.

Primary members and external investors may have different reasons for investing in the co-operative. The investment interest of primary members may be secondary or instrumental. For instance, employees, in a workers' co-operative, may be prepared to forgo the more immediate and secure reward of wages in return for a share in the future revenues and capital growth of the co-operative because they believe that this will help the enterprise grow more quickly, provide them with more interesting jobs and work opportunities, and help the co-operative achieve its broader mission. This contrasts with the interests of external investors who will be chiefly concerned with the investment risk and rewards, although these rewards may include the social achievements of the co-operative.

Liquidity is an important issue for all investors. The reasons why investors sell their investments are as significant as their reasons for investing in the first place. While it is unlikely that investors in co-operatives will indulge in speculation, they will still need to sell their investment at some stage. There are a number of reasons why they may wish to sell. First, they may have ceased to be a member, in which case they are obliged to withdraw their investment. For instance, if they were an employee member of a workers' co-operative they may have retired or got a job elsewhere. Secondly, they may want to pursue other options with their investment funds. The third possibility is that they have changed their assessment of the investment. They may feel that the investment has become riskier, or is under-performing financially or socially. All of these reasons are important because they will affect the attitudes of the potential new investors to whom they might sell their investments.

There is a big difference between investing in an expanding co-operative where the investment is new and additional finance, and investing in a mature co-operative where the investment is replacing existing funds and providing an exit route for old investors. New investors in this situation are likely to be more cautious and want to know why the old investors are selling. But it is also important to recognise that different investors may want different things from their investment in co-operatives.

2. What do investors want from co-operatives?

The main factors investors will consider before deciding to invest in a co-operative are:

Social return on investment: The social objectives and social performance of the co-operative will play some part in the investors' decision to invest. The extent to which investors will forgo a financial return on their investment in favour of a social return will vary, as demonstrated by the case studies in Chapter 3 and the analysis of ethical investors in Chapter 4.

Financial return on investment: For most investors there is a trade-off between risk and reward. The greater the risk presented by an investment opportunity, the greater the reward needs to be to encourage this risk to be taken. Conversely, investors will accept lower rewards on lower risk investments. If a co-operative offers low rewards it seems reasonable to assume that the investor will expect the investment to be low risk.

Revenue versus capital growth: The individual circumstances of the investor will usually determine whether they want a financial return in the form of a revenue stream of dividends or interest payments, or through the cumulative growth in value of their original capital investment. Some investors may want and expect a combination of both.

Security: One of the major risks faced by all investors is the possibility of losing money on an investment. Some forms of investment are safer than others, and some enterprises represent a higher risk of default than others. There are ways of improving the security of an investment, but these usually come at a cost, which brings the investor back to the issue of how they balance risk with reward.

Exit route: Every investor will eventually want or need an exit route to divest from the co-operative. In the case of loans, bonds and preference shares a repayment date or schedule is usually established at the time of making the investment. Share capital is different. Traditionally, co-operatives have made their shares withdrawable, which can have major implications for liquidity and cashflow. The alternative is to make shares transferable between investors, and to allow the development of a secondary market in these shares.

Co-operatives can make themselves more or less attractive to different types of investors according to how they address each of the above factors. Other factors include:

The development phase of the co-operative: Early stage investment will only appeal to certain types of investors, while older co-operatives with a more established track record will be attractive to a far broader range of investors. The life cycle of investors is explored in greater detail later in this chapter.

Confidence in the management team: This is a crucial factor when risk is involved. A strong track record and good business plan can allay the fears of some investors if they demonstrate that the management team has contingency plans and can react positively to unexpected events. In the private sector, investors usually expect the management team to share the risks by investing in the business themselves. Employee investment in co-operatives could be seen in the same light by some investors.

Scale of investment required: Most investors have an upper limit on the level of investment they will make in a single enterprise. The scale of investment required will also influence the type of investor who is able and willing to invest.

While all of these factors influence the investment decision, the valuation of the enterprise is probably the single most important decision-making factor governing equity investment. Unlike debt finance, where the co-operative is committed to repaying the capital it has borrowed, non-withdrawable equity capital is only worth what someone is willing to pay for it. The indeterminate value of equity is the basis of speculation in most stock markets. Speculation and ethical investment are uneasy partners. Therefore it is essential to develop transparent techniques for placing a fair value on equity capital in co-operatives.

The value of equity capital ultimately depends on the financial performance of the enterprise, and what it does with its profit. Co-operatives treat profit and reinvestment differently from private enterprises, and this has consequences for the valuation of co-operative capital. The next two sections examine the effectiveness of using profitability as a measure of financial performance in multi-stakeholder co-operatives, and the impact on the value of equity capital of retaining profit in indivisible reserves.

3. Profitability and productivity

Measuring the financial performance of a co-operative might appear to be a straightforward task. Most people think that profit calculations are the best and simplest way of doing this. Profit is calculated by comparing the income and expenses of a business over a given period of time. But on closer inspection, measuring profit can be a highly complex task, which encompasses a series of assumptions about the relationship between different stakeholders in the enterprise, their ownership rights, and the fundamental purpose of the enterprise. And, given the limitations on the distribution of profits in co-operatives, is profit the best tool for measuring the financial performance of a co-operative?

In private enterprises profit is the individual property of investors, but in co-operatives members collectively own the surpluses, of which only part can be distributed to individual members. Profit can be stated as a formula linking the key stakeholders of the co-operative:

Profit = Income from **customers** minus the cost of **employees, suppliers, tax** and **debt**

So why would a co-operative want to increase its profit, especially when its members, whether they are customers, employees or suppliers, have to pay for that profit and cannot distribute it all among themselves? It would be more economically rational for consumer co-operatives to charge customers lower prices, for workers' co-operatives to pay employees higher wages, and for marketing co-operatives to pay suppliers higher prices. Some academics have used this logic to underpin a degeneration theory, which argues that co-operatives are unsustainable forms of enterprise.[1] Others argue that co-operative members don't pursue narrow economic self-interest in the same way as investors do in profit-maximising firms. But there is scant evidence for either of these assertions.

A debate about self-interest is less relevant in a multi-stakeholder co-operative, where the enterprise faces the challenge of reconciling the competing interests of its stakeholders. If they accept the legitimacy of each other's interests, and believe they share an overarching mutual interest or common purpose, then it may be possible to satisfy all the stakeholders. The key to a fair relationship between competing stakeholders may be provided by market principles.

The laws of supply and demand suggest that there is an equilibrium point in all perfectly functioning markets, expressed in the form of an agreed price, which aligns the interests of buyers and sellers. To achieve the condition of a perfect market, all parties to the transaction, in other words, all the stakeholders, must have full knowledge of the market, and a free choice of alternative buyers and sellers. For co-operatives this means they must share power and control fairly among all the stakeholders, including investors.

All stakeholders have a mutual interest in the financial success of their enterprises, but measured as productivity not profitability. Productivity measures the output of the enterprise, usually expressed as the gross value added per unit of labour. Chapter 1 has already explained why co-operatives might be more productive than private enterprises. The two key ingredients of high productivity are investment and efficient work practices. High productivity is in the interests of both employees and investors. It is also in the interests of customers and suppliers if it results in a higher volume of sales or more competitive prices.

By focusing on productivity rather than profitability co-operatives can unite the interests of their stakeholders. This provides a basis for making fairer decisions about how profits or surpluses are used.

4. Profits, growth and common wealth

The ICA principle of accumulating common wealth or indivisible reserves is unique to co-operatives, setting them apart from private enterprises. This has a major impact on investors in co-operatives in ways that are not immediately evident until transferable equity investment is introduced.

According to ICA principles, at least part of the reserves of the co-operative should be indivisible. This acknowledges that not all of the profit created by a co-operative can be attributed to a single stakeholder group or owner. Instead, the indivisible reserves or common wealth is the collective property of the co-operative's members and stakeholders. Common wealth cannot normally be distributed to members. If the co-operative is wound up or sold, a proportion of the proceeds corresponding to the indivisible reserves must be transferred to another co-operative enterprise, or donated to a charity or similar beneficiary identified by the constitution of the co-operative.

The effect of common wealth is to discourage members from selling their co-operatives. It limits the benefits to investors of a trade sale, in which the co-operative is sold as a going concern to a new owner. Trade sales are one of the principal exit routes for private equity and venture capitalists. Another effect of common wealth is to restrict the benefits to investors of mergers or take-overs by a private sector firm. However, common wealth does not adversely affect the benefits to investors of a co-operative merging with another co-operative enterprise.

All of this has an impact on how some investors will value co-operatives. Section 6 of this chapter describes four main valuation techniques. Two of these techniques, net asset value and earnings multiples, are partly based on the assumption that the co-operative, or its assets, could be sold. A third technique, discounted cash flow, enables investors to factor in an allowance for indivisible reserves, although even this technique does not take into account the fact that investors are unlikely to have the power to sell the co-operative.

From the financial perspective of the investor, the principle of common wealth may seem like bad news but, paradoxically, it can be of benefit to investors and enhance the capital value of their shareholding. This is because common wealth is free capital, which carries no costs to the co-operative and does not attract interest payments or dividends. Assuming that the reinvested profit in the indivisible reserves results in a growth in profit the following year, and that the investors' share of the profit remains the same, then the investors will benefit from this growth. Table 5.1 shows how dividend growth can result from increased common wealth, using the example of a co-operative where 40% of profits are distributed to investors, 40% are reinvested in indivisible reserves and the remaining 20% are allocated to other social and co-operative purposes. Assuming that the co-operative is able to achieve a 10% return on its reinvested profits, then the dividend per pound share will grow as shown in the table.

Table 5.1: Impact of common wealth on dividends

	Year 1	Year 2	Year 3	Year 4
Investor capital	5,000,000	5,000,000	5,000,000	5,000,000
Common wealth capital	1,000,000	1,240,000	1,489,600	1,749,184
Net profit (10% return on capital)	600,000	624,000	648,960	674,918
Investors' dividends (40% of net profit)	240,000	249,600	259,584	269,967
Dividend per £ share	4.80%	4.99%	5.19%	5.40%
Reinvested profit (40% of net profit)	240,000	249,600	259,584	269,967
Social purposes (20% of net profit)	120,000	124,800	129,792	134,984

If the investors' capital is in the form of transferable shares, then they should be able to sell their shares for more money to reflect the increase in dividend. However, this assumes that there is a market for co-operative capital and other investors believe that the co-operative will be able to maintain its performance. This example also illustrates why equity capital in co-operatives needs to be transferable rather than withdrawable, and why it is important to develop a secondary market for co-operative capital.

Table 5.1 shows all the reinvested profit being treated as common wealth capital and none going into distributable reserves, which shareholders could access if the co-operative was liquidated. None of this matters if the dividend continues to grow and shareholders can sell their shares through a secondary market. But if the financial performance of the co-operative starts to flag, dividends fall and with them the value of shares, then investors might want some form of remedial action.

Chapter 7 describes how co-operatives can give investors the right to protect their interests while still retaining democratic control by the primary members. There are a number of areas where investors should have the right to influence decisions that affect their interests, including:

- the raising of additional investment capital (debt or equity)
- the purchase or disposal of major assets
- changes to the constitution which affect the rights of investors.

5. Types of investment: Debt versus equity

This publication has focused on the development of equity finance, in contrast to debt finance or loans. Both types of finance have their advantages and disadvantages, and it is important that co-operatives, like any other type of business, establish the right mix of long-term finance. There are a number of factors influencing the best mix of long-term finance. These include:

The cost of raising finance: It is generally acknowledged that the initial cost of raising finance through an initial public offering (IPO) of equity is more expensive than any other method, and can be as high as 10% of the amount raised. The cost of joining and remaining on a secondary market or stock exchange can also be high. In contrast, the cost of raising withdrawable share capital from members of an IPS co-operative can be relatively small, although the amount raised is highly dependent on the scale and wealth of the co-operative's membership. The cost of raising loan finance depends on the amount, the arrangement fees charged by the lender and how long the money is being borrowed for, but usually falls within a range of between 1% and 5% of the total amount borrowed. However, over the long-term, the cost of regularly renewing medium-term loans could outstrip the one-off cost of raising permanent equity finance.

The cost of servicing capital: The cost of servicing equity finance is usually higher than the cost of servicing loans. This is because equity finance is more at risk than loan finance. Equity holders are usually the last in the line of creditors if a co-operative is declared to be insolvent. The size of the equity risk premium is hotly disputed, but a figure of 3% to 4% above prevailing interest rates is often quoted.[2] However, interest rates on loans can also be very high if the lender perceives the borrower to be a high risk. Furthermore, the cost of a loan is determined by the lender and is usually a variable rate over the medium-term, whereas the dividends on equity are determined by the co-operative and can vary substantially from one year to the next.

The impact on control: Raising finance in the form of equity usually dilutes the control rights of existing members and/or shareholders. There are ways of limiting the control rights granted to external equity investors in co-operatives (described in Chapter 7), although these limitations may also limit the attractiveness of the equity offer to investors. In contrast, lenders are not usually granted any control rights, although they may still exert a strong influence over the co-operative if they are able to recall borrowings at short notice, which is typically the case with overdrafts.

Liquidity and cashflow: The ability of investors to convert their investment into cash, otherwise known as liquidity, is a major influence on the investment decision. Debt finance is temporary and is usually subject to a fixed repayment schedule with major negative consequences for the cashflow of the co-operative. Equity capital can either be temporary, if shares are withdrawable, or permanent, if they are non-withdrawable. In most IPS co-operatives share capital is withdrawable, which means that the co-operative must be able to refund shares according to the terms of the share agreement. This can have a serious impact on the co-operative's cashflow, especially if there is a loss of confidence in the co-operative by member-shareholders. If equity capital in co-operatives is non-withdrawable, alternative arrangements must be made to enable investors to sell their shares to a third party. This issue is addressed in detail in the next chapter.

Gearing: Gearing is the ratio of debt to equity or, strictly speaking, the ratio of debt to the net asset value of a co-operative including its indivisible reserves. Lenders will be interested in this ratio because the higher it is, the more exposed their loans are to risk that would otherwise be borne by equity holders. But loan finance is usually cheaper to service than equity, not least because the interest paid on loans is a pre-tax expense, so most co-operatives will prefer to borrow money if they can. However, there may come a point when the co-operative cannot raise additional debt finance because it is already too highly geared and equity finance will be its only option.

Because of the lack of any tradition of raising equity finance, most established co-operatives will rely on debt finance or retained profit. Retained profit is often thought to be a free source of capital but, as was made clear earlier in this chapter, making higher profits might conflict with the other financial interests of primary members, who may prefer higher wages (in a workers' co-operative), or cheaper prices (in a consumer co-operative).

While superficially there may be a clear distinction between debt and equity finance, it is possible to arrange forms of finance that blur these distinctions. Some of the main alternatives to conventional debt or equity are:

Preference shares: This type of equity capital has no voting rights attached to it, and may have a fixed dividend rate. Preference shares are so called because they are preferred ahead of ordinary shares in the line of creditors. Dividends on preference shares must be fully paid before ordinary shareholders receive any dividend. The dividend on preference shares can be cumulative, meaning that a dividend not paid in one year is rolled forward to the next year.

Loan stock, debenture stock and bonds: This is a type of debt finance where the co-operative issues a bond confirming the amount of the debt, the amount and timing of interest payments on that debt, and the redemption date when the debt will be repaid in full. It is also possible to issue undated bonds, which pay interest in perpetuity. Debenture stock is where the loan or bond is secured against an asset owned by the co-operative, which reduces the level of risk for the bondholder. Bonds can be made transferable and therefore tradable, and some large UK mutual societies use bonds to raise money on the London Stock Exchange.

Convertible debt: This is where a lender is given the option of converting loans into equity at some future date. Meanwhile, interest is paid on the loan but none of the capital is repaid. The conversion price of debt into equity is preset at a rate favourable to both the co-operative and the investor, based on the co-operative performing well in the future.

Mezzanine finance: This type of finance is half way between equity and debt finance, hence the name mezzanine finance. In the line of creditors it comes after loans but before shareholders. Mezzanine finance is usually tailor-made to suit the enterprise but its typical ingredients include deferred repayment until maturity, and an element of profit sharing on top of interest payments, which are typically higher than the rates paid on more conventional loans. The profit-sharing element may take a variety of forms, including options to convert the loan into equity at a pre-determined price.

There are legal and regulatory controls governing the issue of these different forms of finance and investment, most of which are contained in the Financial Services and Markets Act 2000. Specialist legal advice should be sought in most cases, which, of course, will add to the cost of raising finance.

Whatever the type of financial instrument used to raise finance, investors will usually want to assess the value of a proposed investment before deciding to invest. In the case of debt finance this is relatively straightforward. Investors will set an interest rate that reflects prevailing market rates, the period of the loan and the risks associated with the debt. In the case of equity finance the investor must resort to valuation techniques.

6. Valuation techniques

Valuing equity is an imprecise art. Four different approaches are outlined here, together with an analysis of their respective strengths and weaknesses. Co-operatives should aim to make the process of valuation as transparent and fair as possible. But, ultimately, buyers and sellers will decide whether or not the valuation is mutually acceptable. Valuation techniques cannot determine the future; the future will always be unpredictable, which is why some investors pay a lot of attention to evaluating the quality of the management team and its ability to deal with the unexpected.

Price of recent investment
This method is different from the three other valuation techniques described in this section, which are all based on the performance of the enterprise, using historical, current and/or forecast data. In the case of new enterprises, including those still at the pre-trading stage, a more reliable way of valuing the enterprise can be to use the actual price of the investment as the basis for the valuation. So, if it is estimated that £100,000 is spent (invested) in setting up an enterprise, this is taken to be its value. As long as the estimate is based on a recent investment, and not an investment made some time ago, then it is generally considered to be a fair value. But the greater the length of time between the actual investment and the valuation, the more danger there is that it will not reflect fair value because market conditions may have changed.

This method closely reflects how entrepreneurs often approach the task of launching a business. They invest what it takes to get started, with the price of the investment treated like the cost of an entry ticket to that market sector. In a co-operative context, investors using this method of valuation are likely to want the fairly high level of control over financial decisions which is usually associated with primary membership. However, there may be some investors who use this method but do not want any control. This is most likely to be the case when the social performance of the co-operative is more important to the investor than the financial return on the investment.

Net asset value
The net asset value of an enterprise can be calculated using the following data from its balance sheet:

Net asset value = total assets – total liabilities

$$\text{Share price} = \frac{\text{Net asset value}}{\text{Number of shares issued}}$$

This is a very simple technique and, on the surface, would seem to be highly accurate. It uses data from the audited accounts, which, by law, are required to state the value of assets and liabilities as accurately as possible. But this seemingly simple task is fraught with problems. The book value of assets is not necessarily the same as their resale value or replacement value. It is extremely difficult to value intangible assets such as the reputation of an enterprise with its customers, or the accumulated wisdom of its workforce. And if the co-operative retains profit in indivisible reserves, this has to be taken into account when calculating the net asset value of the co-operative.

Net asset value is used to value shares in the Ethical Property Company. Given that the major assets of this enterprise are highly tangible, and are subject to periodic revaluation, then this may be a fairly accurate way of valuing the business. But it will not be so useful for co-operatives with few physical assets or with large holdings of indivisible reserves.

The ICA principles require that all co-operatives should make at least part of their reserves indivisible, although there are no guidelines on how large or small this part should be. Instead of using net asset value to price shares, co-operatives should use net distributable asset value, subtracting the value of indivisible reserves from the net asset value.

Earnings multiples
This technique is based on comparing the earnings of the enterprise with other enterprises in the same trade sector. At its simplest, the technique relies on a trade sector comparison of dividend yields. The dividend yield can be calculated by dividing the dividend paid on shares by the share price. The dividend yields of enterprises in the same trade sector can be compared with each other to provide a benchmark for new co-operative enterprises entering the sector.

Dividend yields can also be compared with prevailing interest rates to determine how attractive investing in the enterprise might be. However, this is not a wholly reliable comparison. Some enterprises might offer very small dividends but still attract a lot of investors because the capital value of the shares is increasing. A rising share price depresses the dividend yield, and vice versa. The share price of an enterprise is affected by factors other than the dividend it offers investors, including its long-term trading prospects, the level of retained profits and its distributable reserves.

A more reliable but more complex technique uses price-earnings (p/e) ratios or earnings multiples. This is based on the earnings of the enterprise and not just the proportion of earnings that is paid out in dividends. What makes this technique complex is the range of different ways of measuring the earnings of an enterprise. The simplest method is to use pre-tax profit, but some would argue that this doesn't give a reliable enough picture of the enterprise's performance. Some prefer to use the profit or earnings of the enterprise before interest, tax, depreciation and amortization have been deducted (known by the acronym EBITDA), which is thought to more accurately reflect the operational performance of the enterprise

Earning multiples is not a wholly reliable technique for co-operatives where the value of shares does not reflect the value of the enterprise or the residual value of the enterprise to shareholders. It relies too much on comparing the current performance of different enterprises and takes no account of how the enterprise itself is likely to perform in the future. A way of overcoming this weakness is to determine the future flows of cash the enterprise might generate for the investor.

Discounted cash flow
This valuation technique is based on measuring the cash flow of an investment by taking into account how much money is invested, how much money the investor receives back (in terms of interest payments or dividends), and the timing of these payments.

A very simple version of this technique is to calculate the payback period, which is the length of time the investor has to wait before getting their money back. The longer the payback period, the less financially attractive the investment will be to an investor. But this technique has many flaws, chiefly that it does not take into account the effect of time on the value of money. This is based on the notion that £1 in your hand now is worth more than the prospect of receiving £1 in one year's time, because if you have £1 now you could invest it in a deposit account and in a year's time it would have accrued interest.

One way around this problem is to discount the value of money received in the future, compared to its present value. There are several different methods of doing this. One method is based on calculating the net present value of an investment, where the value of money received back on the investment in the future is discounted at a given rate. This allows a fairer comparison to be made between investments that offer a quick but smaller return, with those that offer a slower but larger return.

Calculating the net present value of an investment provides a quantitative technique for comparing the financial returns on a range of investment options. Investors choose a discount rate that represents their minimum acceptable rate of return on an investment, also known as the hurdle rate. One way of establishing a hurdle rate is to identify an easy and safe alternative to investing in an enterprise, such as a government bond.

Another variation of the discounted cash flow method is to calculate the internal rate of return of an investment. The internal rate of return is the discount rate required to generate a net present value of zero. The internal rate of return is a popular method of valuing investments because it aggregates all the net income flows into a single figure which is equivalent to the interest rate on the investment.

The advantages of using discounted cash flow as a valuation technique are that it is based on the future not the past, and it takes capital growth into account as well as interest or dividend income from the investment. Both net present value and the internal rate of return provide quantitative data for comparing investment options.

However, as with all valuation techniques, discounted cash flow depends on the accuracy of the underpinning assumptions and input data used in the calculations. It also depends on the ability of the enterprise to meet or exceed its performance targets, as well as on the transparency of the board's financial strategy and its commitment to this strategy over the medium-term.

Which technique?
Which of these four valuation techniques is fairest to both parties in an equity transaction will depend on a range of factors including the market sector of the business, its age and stage of development, and the rights and restrictions attached to the equity. For instance, net asset value calculations are less effective if the business has few tangible assets compared to its earning potential, which is typically the case in many knowledge-based industries. Earnings multiples calculations are not so reliable for younger enterprises, or for businesses trading in volatile sectors. Discounted cash flow techniques assume that investors will sell their investments when it best suits their financial interests, which may not be true of ethical investors.

Furthermore, none of these techniques are capable of measuring the social value of the investment to the investor and how this affects the price they are willing to accept. Ultimately, the test of any valuation technique is whether both buyers and sellers are willing to accept the valuation and are prepared to trade at the valuation price. This issue is explored further in the next chapter.

7. The investor life cycle

Chapter 2 introduced the concept of a stakeholder life cycle. It described how stakeholders become involved at different points in the development of a co-operative, focusing on three distinct phases: start-up, expansion and sustainability. It identified the different types of stakeholders who might be attracted to becoming investors at each of these different phases of development.

Table 5.2 analyses the investor life cycle in more detail: it identifies 13 principal types of investor and their most likely entry point into the life cycle of the co-operative; the range and scale of the cash investment they are likely to make; the type of investment vehicle they prefer; and their expectations and/or requirements as investors. The table also lists the most appropriate valuation techniques for each type of investor and their probable exit route.

Inevitably, some of the details in Table 5.2 are based on supposition rather than fact because equity investment in co-operatives is still very underdeveloped. Some of the different types of investors, such as co-operative business angels, do not yet exist, and there are very few actual examples of others, such as co-operative capital funds.

Appendix 2 presents a hypothetical investment case history, which demonstrates how investors and stakeholders might interact during different stages in the life cycle of a co-operative. It illustrates how, in this fictional example, the value of equity depends on the distributable earnings of the co-operative, which in turn is assisted by the growth in common wealth.

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[1] Cornforth et al. 1988. *Developing successful worker co-operatives*. Sage.
[2] Dixon, Hugo. 2000. *The Penguin guide to finance*. Penguin.

Table 5.2: The investor life cycle

Investor type	Entry point in life cycle	Scale of investment	Type of investment	Investor expectations &/or requirements	Valuation technique	Exit route
Founders-entrepreneurs	Pre-start	£0 - £20K	Equity	Long-term reward for short-term risks, effort & time investment. Capital growth opportunity	Price of recent investment	Buy-back by co-operative or new stakeholder &/or external investor
Managers–key employees	Start-up & beyond	£0 - £20K	Equity	Profit-sharing incentive to offset low salary. Capital growth opportunity	Not applicable if part of profit-sharing	Buy-back by co-operative or new stakeholder &/or external investor
Corporate customers	Start-up & beyond	£1K - £50K	Member shares Bonds Preference shares Equity	May be linked to primary membership or trading relationship with co-operative	Price of recent investment Net asset value	Buy-back by co-operative or new stakeholder &/or external investor
Corporate suppliers	Start-up & beyond	£1K - £50K	Member shares Bonds Preference shares Equity	May be linked to primary membership or trading relationship with co-operative	Price of recent investment Net asset value	Buy-back by co-operative or new stakeholder &/or external investor
CDFIs	Start-up & beyond	£5K - £50K	Debt Bonds Mezzanine finance	Security of loan guarantees, cash flow	Net asset value Earnings multiples Discounted cash flow	Buy-back by co-operative. Sale of any equity to co-operative capital or ethical investment fund
Social banks	Start-up & beyond	£10K - £1M	Debt Bonds Mezzanine finance	Security of loan guarantees, cash flow	Net asset value Earnings multiples Discounted cash flow	Buy-back by co-operative. Sale of any equity to co-operative capital or ethical investment fund
Employees	Early stage & beyond	£0 - £10K	Member shares Equity	May be linked to primary membership &/or profit-sharing incentive in addition to salary	Not applicable if part of profit-sharing	Transfer to ethical investment/pension fund
Private individual customers	Early stage & beyond	£25 - £25K	Member shares Bonds Preference shares Equity	May be linked to primary membership. Investment to support co-operative. Scale of investment in proportion to personal wealth	None (sentiment) Price of recent investment Net asset value	Buy-back by co-operative or new stakeholder &/or external investor
Co-operative business angels	Early stage & expansion	£10K - £100K	Equity	Capital growth opportunity	Price of recent investment Net asset value Earnings multiples	Public offering of equity &/or listing on market
Co-operative venture capital funds	Expansion & sustainability	£50K - £5M	Equity	Capital growth opportunity	Net asset value Earnings multiples Discounted cash flow	Public offering of equity &/or listing on market
Other co-operatives	Expansion & sustainability	£50K - £5M	Debt Bonds Preference shares Equity	Joint venture, merger or acquisition of one co-operative by/with another co-operative	Price of recent investment Net asset value Earnings multiples Discounted cash flow	Spin-off, trade sale to another co-operative
Private individual investors	Sustainability	£250 - £50K	Bonds Preference shares Equity	Ethical investment opportunity, requirements depend on scale of investment in proportion to investor's personal wealth	None (sentiment) Price of recent investment Net asset value	Listing on market Buy-back by co-operative
Ethical investment funds	Sustainability	£50K - £5M	Bonds Preference shares Equity	Part of portfolio of investments with aim of achieving best social & financial performance for their investors	Earnings multiples Discounted cash flow	Maintain market listing

Chapter 6: An ethical exchange

This chapter sets out a proposal for the creation of an ethical exchange trading in co-operative and social enterprise capital. Section 1 explains why it is necessary to establish an ethical exchange. Section 2 describes what an ethical exchange would do. Section 3 sets out the options for the structure of the exchange. Section 4 explores what criteria should be used to determine whether an enterprise can join the exchange and become a listed co-operative or social enterprise. Section 5 explains how the exchange would work. Section 6 examines the strengths and weaknesses of five options for pricing shares and suggests which of these options should be used by the exchange. Section 7 discusses the potential limitations of the proposals in this chapter.

Creating a market for co-operative capital is essential if co-operatives are to issue shares and bonds that can be traded between investors. A market is any mechanism that brings together buyers and sellers. These mechanisms range from private transactions between individuals, possibly brought together by a broker or another type of intermediary, to public trading on stock exchanges. This chapter proposes the development of an ethical exchange, trading in co-operative capital and in the stocks and shares of other social and ethical businesses.

A genuinely ethical exchange, which works in the interests of all the stakeholders may seem like a pipe dream. But with an increasing number of co-operatives and social enterprises now raising capital through share and bond issues, such a market could become a reality. And should it succeed, it could open up new horizons in ethical investment, presenting a direct challenge to the ethical investment market and providing a new benchmark in ethical standards for other markets to live up to.

1. Why is an ethical exchange necessary?

There are currently three main trading markets in the UK: the London Stock Exchange (LSE), the Alternative Investment Market (AIM) and OFEX. These markets form a hierarchy, with companies graduating from one to the next as they grow in size. Indeed, AIM was established by the LSE for companies at an earlier stage of development. The markets higher up in the hierarchy offer greater liquidity, but are more expensive for companies to join and the listing requirements are more stringent.

OFEX is the most junior of these markets. Typically, a new share issue on OFEX will aim to raise between £0.5 million and £1.5 million, but the fundraising costs are proportionately high, often between £100,000 and £150,00 in fees alone, and it costs around £10,000 a year to maintain the listing.

Although many companies go straight to AIM, a listing on OFEX is often a first step towards an AIM listing. It becomes possible through AIM to attract major institutional and other investors. However, fees for an initial listing on AIM are likely to be between £300,000 and £500,000 even before marketing costs. The larger of the AIM companies move to the LSE. Some have a balance sheet value as little as £10 million, but most are much larger.

Although a number of building societies, mutual societies and even one co-operative society – the Co-operative Group – have issued bonds on the LSE, the mainstream markets are not generally suitable for co-operatives and social enterprises for two main reasons. First, these markets are dedicated to the principle of maximising the wealth of shareholders and would not countenance some of the restrictions on share capital proposed in this publication. Secondly, these markets allow and even encourage speculation, which many people would argue is out of keeping with ethical investment. Of particular concern are arrangements that enable stocks and shares to be rapidly bought and sold, with a view to making money out of short-term stock price changes, even over just a few hours.

However, the purpose of a market is to encourage the trade of stocks and shares, and to create liquidity for investors. Improved liquidity comes at the price of more opportunities for speculation. The challenge facing an ethical exchange is how to achieve a balance between liquidity and speculation.

The main reason for creating an ethical exchange or market is to provide investors in co-operatives and social enterprises with a mechanism for disinvesting when they decide to. However, properly constructed, such a market could achieve much more, eventually becoming a vital support service for all public share and bond issues of an ethical nature. As well as generating liquidity in shares listed on the market, it could also provide a focal point for the marketing of new and existing ethical investment products, and undertake new issues, as well as raising financial standards within the companies listed on the market, thereby increasing transparency and investor confidence.

As Chapter 3 has already shown, the number of ethical share issues taking place in the UK has been steadily increasing, as has the amount of money raised through these issues. The largest amount raised by any single share issue has increased from £1 million in the period 1984-89 to £5 million in 2004. This is significantly more than is normally raised on OFEX.

An ethical exchange would be of most interest to social enterprises that have used the plc format to issue shares to the public. This is because it is difficult to redeem plc shares. It is legally complex for companies to buy back their own shares, and it would place a great strain on most companies' cash flow to do so. Because of the asset lock on residual assets, trade sales, management buy-outs, mergers and takeovers by private sector firms would be out of the question. So a market would be of great help to investors who want or need to disinvest from a plc-format co-operative or social enterprise.

A market would be of less interest for co-operatives and social enterprises undertaking bond issues. Social enterprises that have issued bonds usually have a very loyal following, with investors reinvesting in new issues when the bonds are repaid. However, most of these bonds have short redemption periods of only five years. Long-term bonds, which provide enterprises with long-term security, can be unattractive to investors if they have no way of redeeming their investment before the end of the term. A market would overcome this problem, making long-term bonds more attractive to investors.

A market is of no immediate interest to co-operatives issuing withdrawable share capital, because withdrawable share capital cannot be traded. However, this type of co-operative may still be interested in a market where it could raise capital by issuing bonds.

An ethical exchange has the potential to offer more than the secondary trading of shares and bonds. An ethical exchange could enable more co-operatives to raise capital through share or bond issues by supporting them in coming to market in the first place, and also by allowing them to take on new investment on an ongoing basis. For co-operatives issuing withdrawable share capital or other non-transferable investments, this would be a very useful function.

Creating an ethical exchange would have a major impact on the thinking and behaviour of co-operatives and of ethical investors. An ethical exchange would probably attract proportionately more individual investors than would the mainstream markets. For example, Traidcraft has over 2,400 shareholders and the Ethical Property Company over 1,200. This is more than most AIM companies, where the average is around 800 investors.

While most private sector companies would see having a large number of shareholders as a burden, as each one needs to be serviced however small their investment, ethically directed enterprises tend to see it as a strength. This is not only because of a general commitment to inclusivity, but also because it helps to prevent a handful of shareholders from controlling the enterprise, thereby helping to protect its ethical values and purpose. A wide shareholder base also helps with liquidity, in that small holdings are easier to trade than large ones, and having more investors would mean that the demand to sell shares would be more evenly spread over time.

2. What would an ethical exchange do?

An ethical exchange should be capable of assisting co-operatives and social enterprises in a number of ways, by being able to:

Generate liquidity in investments: The primary role of an ethical exchange would be to generate liquidity in ethical shares and bonds once an issue has been undertaken. This would not only help investors to disinvest when they need to, but would also be likely to attract more investors in the first place, as they would be more confident that they would eventually be able to disinvest. However, liquidity can only be created if there is a steady stream of new investors wishing to buy shares. To be successful, then, an ethical exchange would need to market to new investors.

Bring new issues to market: An ethical exchange should be able to assist enterprises in coming to market, and ensure that the costs of undertaking an issue are minimised. In addition, the fact that these enterprises have gone through a due diligence procedure would give investors greater confidence in the investment. This would encourage them to invest larger sums. Although it would be unreasonable to require social enterprises to undertake an issue through the exchange, doing so would indicate that the enterprise meets the exchange’s ethical and financial criteria and that the necessary due diligence work has already been undertaken. However, social enterprises that do not launch their share issues through the ethical exchange should still be able to list, even though extra expense is likely to be involved.

Attract new investors: An ethical exchange would increase the pool of ethical investors available to social enterprises, as there would be one well-known port of call for those looking to invest ethically. It is also likely to be of particular interest to institutional investors. An ethical exchange would also give investors greater confidence that the investment they are making is at a fair price, that it will be settled efficiently, and that a level of due diligence has been undertaken.

Market investments collectively: This would reduce the cost of marketing, the high cost of which is the main barrier to raising share and bond investment for small companies. Collective marketing could take place through a number of vehicles such as a website, a newsletter, regular open days for investors and through general publicity for the exchange. The establishment of an ethical exchange is likely to generate substantial media coverage, which would in turn reduce marketing costs. In the longer-term, it might even be possible to persuade some newspapers to list an ethical exchange's share and bond prices.

Support smaller enterprises with start-up finance: Although public share and bond issues would not be appropriate for most new social enterprises, it would be possible to produce guidelines on the advisability of undertaking an issue and the minimum level of investment that the exchange might undertake to raise.

Create new financial opportunities: In the longer term, an ethical exchange might find that it can develop a number of the financial mechanisms used by the mainstream markets. Perhaps the most useful of these would be funds established to hold several or all of the ethical investments on the exchange. These funds would be similar to mainstream ethical unit trusts and would be particularly attractive to institutional investors that are looking for ways to invest large amounts of funding in small companies.

Offer training in financial and compliance issues: An ethical exchange could play an important role in helping to develop the financial and compliance capacity of the social enterprises listed on the exchange. This would also help to raise financial standards in the market, thereby improving investor confidence. Training in compliance issues would also help to ensure that listed enterprises could meet the stringent requirements of the Financial Services and Markets Act 2000 and understand how to factor these requirements into their business planning. A certain level of financial compliance would anyway be necessary for an organisation to be able to list on an ethical exchange, both in terms of the Companies Acts requirements, and the rules imposed by the exchange.

3. The structure of an ethical exchange

There would be three main stakeholder groups within an ethical exchange: social enterprises who wish to list on it; investors who wish to invest in the enterprises listed; and those responsible for the execution, regulation and legal compliance of the market. Market brokers would be a welcome fourth category of stakeholder, providing a professional opinion on the value of, and a suitable price for, shares.

Co-operatives and social enterprises would need to meet ethical and financial criteria laid down by the exchange in order to win membership. Individual and corporate investors could also become members of the exchange, receiving regular information in exchange for a membership fee.

The functions of the exchange fall under three headings:

Trade and new investment execution: This would involve maintaining lists of buyers, sellers and enquirers; providing them with the necessary information on how the market works; carrying out the trading and issuing of shares; collecting stamp duty and transaction fees; and the execution of the paperwork necessary to support these activities. This role could be extended beyond a passive matching service to include an active opinion from a broker on the value of shares, as well as an active match-making service designed to improve liquidity through buyers being encouraged to buy more shares if they are available and sellers being encouraged to take a lower price if it enabled the sale to take place.

Compliance with the Financial Services and Markets Act 2000 and the Companies Acts: This entails ensuring that the practices of the enterprises listed on the exchange and of the exchange itself meet the requirements of the Financial Services and Markets Act 2000 and the Companies Acts. While the responsibility for compliance would remain with the directors of the enterprise, the exchange would seek to maintain certain standards through its rulebook. Enterprises may be required to provide information at certain times and would be subject to sanctions should they fail to comply.

Marketing: This is the business of attracting new enquirers to the exchange through publicity and marketing.

The first two of these functions would need to be conducted by an FSA registered body with the appropriate approvals to manage an exchange, which would in effect be the market operator. Marketing could be carried out by the listed enterprises, the market operator, the broker, or all three of these stakeholders working together. Investor members could also support marketing initiatives. Careful attention would need to be paid to possible conflicts of interest for the market operator and the broker in this area.

The choice of market operator would be critical to the success of the exchange. Currently, there are two bodies with both the approval and the credentials to act as market operators. These are Triodos Bank and Brewin Dolphin.

Triodos Bank has the most experience of working with social enterprises on ethical share issues. They have, to date, acted as sponsors of share and bond issues on behalf of four organisations. This has involved extensive due diligence work and business advice. Triodos has also been providing a matched bargain market called Ethex for shares in Cafédirect, the Ethical Property Company and Triodos Renewable Energy Fund, and for bonds issued by Golden Lane Housing.

Brewin Dolphin is a broker that acts for over 200 FTSE and AIM listed plcs. They were brought in to advise Traidcraft on share price matters at their last issue and have gone on to run a matched bargain market in Traidcraft's shares. Brewin Dolphin is keen to be more actively involved with other social enterprises.

The market operator would have to determine the ownership and control of the exchange. There are three main ways of structuring the ownership of an ethical exchange. First, the exchange could be a project of the market operator, in the way that Ethex is currently a project of Triodos. Under this model, the market operator has the freedom to set the terms on which a social enterprise joins the exchange, and a social enterprise chooses to join if it considers those terms attractive. The market operator would execute the trades and would also hold the list of investors and social enterprises that are members, dealing with each directly. Marketing would be undertaken collectively by the market operator and by the individual companies for their own investments.

The second option would be for the exchange to become a trade body, either a co-operative or a company limited by guarantee, controlled by its members. The market operator would deal with compliance and market execution, and the trade body would deal with the market operator on behalf of members and would negotiate the fees collectively. The trade body would hold the list of investors and enterprises that are members and would provide them with marketing information. The market operator would ensure that the trade body complies with the FSMA and the Companies Acts. Members would pay fees to the trade body, and the trade body would appoint the market operator in much the same way as a company appoints an auditor.

The final option is for the exchange to be a project of the market operator; but a trade body would also be formed, though with fewer powers than outlined above. In this case, the market operator would hold the list of members, collect fees and deal directly with the social enterprises; however, all parties would be required to join the trade body which would be assigned certain powers and activities, such as co-ordinating members' meetings, inputting into strategic development, and undertaking some publicity and marketing. Under this model the trade body would be able to influence the market operator but would not be able to transfer the exchange from one market operator to another.

Of these options, the first would be preferable from the point of view of the market operator as it allows them the greatest freedom of operation. Some social enterprises might also prefer this model because it is the simplest and requires the least commitment on their part. The second option conveys advantages, however, as it allows for limiting the market operator's potentially monopolistic position. But it would require a substantial commitment from the enterprises listed on the exchange as well as requiring them to undertake more of the financial risk of running the market. The third option is a compromise position that might offer the best starting point, as it is a pragmatic option that allows for the formation of a trade body without that body having to take on significant responsibilities. Alternatively, a more powerful trade body could be a safer long-term option, with initially many of the responsibilities of that body delegated to the market operator. This leaves open the possibility of moving towards either the first or the second option as matters progress.

4. Membership criteria

In order to be listed on an ethical exchange, an investment product must be transferable. This means that it can legally be sold on to another investor without having to be redeemed. Shares are usually fully transferable, although many smaller companies have articles of association that restrict the transfer of shares. Any such restriction would need to be reviewed and most likely removed.

Bonds are sometimes transferable, sometimes not. However, research would indicate that most if not all of the enterprises discussed here have issued their bonds on a transferable basis, and so could be listed on an ethical exchange. Depending on the repayment terms specified in the original investment, even those bond investments that are not transferable could be repaid and new bonds issued to a new investor, meaning that the social enterprises could not list on the market but could still attract new investment through it.

Withdrawable share capital is usually not transferable between third parties, which means that it could not be listed on an ethical exchange. An ethical exchange could still act as a marketing vehicle for withdrawable share capital, with investors purchasing shares directly from the co-operative, but this share capital could not then be traded on the ethical exchange.

Only social enterprises issuing transferable shares and bonds would be able to list on the market. In order for an ethical exchange to offer a comprehensive service to all ethical investments, enterprises should be offered the opportunity of either a full or a partial listing. The difference would be that a full listing includes listing of the existing investment on the exchange as well as marketing of the investment to investors, while a partial listing only allows for marketing of the new investment. Both a full and a partial listing would bestow membership of any trade body, and access to training and advice services. For the investor, this would mean that all ethical investments would be available to them on the one market. Table 6.1 provides a summary of the kinds of investment, the kind of business entity issuing them and whether they could achieve a full or partial listing.

Table 6.1: Investments and listings

Type of investment	Type of company	Full/partial listing
Share	plc	Full
Bond (transferable)	plc or IPS co-operative	Full
Withdrawable share capital	IPS co-operative	Partial
Bond (non-transferable)	plc, Ltd or IPS co-operative	Partial

According to Malcolm Lynch of Wrigleys Solicitors, it is possible under FSA rules for an IPS co-operative to issue equity in the form of co-operative share capital that cannot be withdrawn, but instead can be transferred to another owner. This makes it possible for a co-operative to list on an ethical exchange, although matters of pricing and, in particular, the voting rights of this type of stock would still need to be resolved. In essence, the question is whether it is possible to design a package suitably attractive to the investor, relative to the risk they are taking, which would also satisfy the members of the co-operative.

Social enterprises which wanted to become members of the exchange would need to meet certain criteria. These criteria would be designed to offer comfort to all stakeholders. Investors will want their investments to meet certain financial and ethical quality standards; the market operator will want to know that member-enterprises can meet the demands of the FSMA and Companies Acts; and existing member-enterprises will want to know that new members will uphold the aims and standards of the exchange. These criteria fall under three broad headings:

> **Financial criteria:** In order to be able to join the exchange, the applicant enterprise should be able to meet two financial requirements. First, it should have an established track record of paying investors a return on their investment or be able provide evidence to support its future policy on investor returns; if it does not intend to offer any return to investors this should be clearly stated. The second requirement should be to have a mechanism in place for calculating an appropriate share price for the investment.
>
> **Social and environmental criteria:** Any organisation seeking a listing should be a dynamic social enterprise making a positive contribution to society and the environment, and with a strong and sustainable future. It should also meet ethical and corporate governance standards. Although it is very difficult to specify criteria of this nature, it is important for an ethical exchange to have a written policy for the sake of transparency and of offering a standard of ethical performance to share or bond holders. However, these criteria need to allow for a degree of flexibility in their application. This is not a difficult balance to achieve (the legal system manages to do it by striking a balance between the setting of the law and its later interpretation) but it does require considerable thought and development, as well as a responsible body to apply the rules.
>
> **Transparency and the provision of information:** It would be necessary for each enterprise to make available information about its ongoing business to the ethical exchange, particularly if this information is price sensitive. The provision of this information and the due diligence required to confirm it would be essential in order to avoid mistakes being made and the market being exploited by scams. Any enterprise should also be able to prove its ongoing practical commitment to social aims. This is best done through a social audit, and an enterprise should in due course develop one once listed. In general, however, a commitment to a high standard of transparency would be essential.

Table 6.2 below sets out a summary of the proposed criteria for listing. These would have to be applied judiciously by the body responsible for admission.

Table 6.2: Criteria for listing on an ethical exchange

Positive criteria	Negative criteria
Essential criteria (Must have/be) • A tradable investment • A financially sustainable business with a realistic dividend policy and a means of valuing the business • A defined social purpose that accords with the exchange's overall objective of building a sustainable society and a sustainable environment • Committed to transparency in its business dealings	**Preventative criteria (Cannot have/be)** • An unethical business
Desirable • An annual social audit • A business with long-term prospects and opportunities • A commitment to honesty and transparency • An innovative social enterprise	**Undesirable** • An enterprise paid by unethical businesses for its services or knowingly receiving grant funding from an unethical business • An enterprise that is in any way undemocratic or discriminatory towards its employees, volunteers or clients • An enterprise that lacks the support of the community it serves
Preferred • Corporate governance policy and practice • Equal opportunities policy and practice • Environmental policy and practice	**Discouraged** • Excessive salaries

For the purpose of the above table, an unethical business can be described as: a business which causes damage to the environment through its activities; is engaged in arms sales, pornography, tobacco or animal testing; or which has a poor human rights or employment rights record.

Social enterprises that lack essential criteria or which possess preventative criteria would not be eligible for listing. Desirable characteristics would weigh in favour of a listing, while undesirable characteristics would weigh against. There would be very few cases in which the 'preferred' and 'discouraged' criteria would determine whether or not an organisation was granted admission; rather, the exchange would wish to engage with the enterprise to develop the preferred criteria and to lose the discouraged criteria once it is listed.

The ethical criteria would be applied by the body responsible for running the exchange. This would either be the enterprises that are already members, the market operator, or both working together. This body could also adjust and improve on the criteria as it sees fit. If the exchange were to grow significantly and to have sufficient companies listed to be divided into sectors, it might then be desirable to introduce additional criteria for each sector.

5. How the exchange would work

The principal attraction of an ethical exchange is that it offers a positive alternative to the mainstream markets. As well as playing a key role in developing investment in the broader social enterprise sector, the exchange would challenge the mainstream markets by setting an ethical standard for them to be compared with. It is important therefore that the ethical exchange should be structured to avoid the perceived social and environmental inadequacies of the existing markets. These inadequacies include:

- excessive speculation and profiteering
- no or limited social or environmental priorities among the majority of companies listed
- a lack of transparency and accountability among those who operate the exchanges.

Trading mechanism

The exchange would function as a matched bargain market. This would mean that at least initially there would be no market-makers or brokers profiting from the purchase and sale of shares at differing prices (known as the bid-offer spread). At a later stage, if the volume of trading were to increase, it may prove beneficial to introduce market-makers. However, at all times, transactions taking place on the exchange would be transparent, with no hidden charges. Annual accounts would be produced and made publicly available, showing how funds earned by the exchange had been used. Ideally, a social audit of the ethical exchange according to agreed performance criteria would be carried out each year.

Pricing

Pricing stocks and shares is a highly complex task. Inevitably, the ethical exchange would suffer from limited liquidity, particularly in the early stages, which would in turn place pressure on any pricing mechanisms it adopted. A range of pricing models is discussed in more detail in the next section of this chapter.

Membership

Enterprises joining the exchange would need to meet the criteria outlined above. In addition, the market operator would need to go through a due diligence procedure prior to listing an enterprise in order to ensure that the requirements of the Financial Services and Markets Act 2000 and the Companies Acts were met. This procedure would also determine the price at which an investment is listed. In addition to the enterprises listed becoming members of the exchange, potential investors should be asked to join before receiving information on the investments opportunities, making the ethical exchange more like an ethical investment club. This could help with compliance issues. In addition, these members could be charged an annual fee to help pay the costs of marketing. A higher fee could be charged to institutional members. Enterprises listed on the exchange would be expected to encourage their existing investors to join the exchange. In addition, the exchange could be marketed to the customers of ethical financial institutions such as Triodos and The Co-operative Bank.

The ‘Rule Book’

The market operator would need to devise a rule book – akin to the LSE’s Purple Book and AIM Rules – which sets out the listing requirements for companies in order for them to comply with statutory regulations and ensure that the quality of enterprises listed on the market is maintained.

Trading Days

Trading would take place on recognised trading days, when all buyers and sellers listed on the market are matched. Trading days would be likely to take place fortnightly, although this could be more or less frequent if required.

Communications with investors

Investors could be kept informed about the performance and development of the companies listed on the exchange through a variety of media. These could include a dedicated website disseminating price sensitive information, a bi-annual newsletter, copies of the annual reports of all the co-operatives and social enterprises listed on the market, and circulars providing information on events that are required to be reported to shareholders (for example, significant acquisitions). In addition, the market operator could provide a dedicated enquiry line for servicing investor enquiries and investment requests. This would only be able to provide factual information, not advice on investments.

Charges

Investors would be charged an annual membership fee as well as transaction charges on purchases and sales. Enterprises listed on the exchange would be charged an annual membership fee together with further charges for transactions and advice services.

Costs

Although some grants and sponsorship funding might be available to launch an ethical exchange, it would need to be self-financing in the long-term through income generated from membership and listing fees. It is important to keep these fees as low as possible in order to make the cost of raising capital through the exchange competitive with other sources. However, the costs of running an exchange can be substantial. In addition to the trade execution costs for each listed enterprise there are three major cost activities that would have to be covered by the exchange:

> **Handling enquiries:** The exchange must be capable of dealing with large numbers of enquiries from investors, potential members and actual members of the exchange. Enquiries would range from requests for an initial outline of the market, through to detailed information about listed enterprises and their investment activities.

Compliance: Compliance costs would consist of an initial health check, checking of share price declarations, and approval of all investor communications. Basic compliance costs should be covered by the annual membership fee from listed enterprises. Additional one-off compliance payments may also be required as the work can vary greatly from company to company. Where a share issue is undertaken, this should be done with future compliance issues in mind. Compliance costs can then be paid from the proceeds of the share issue as a share premium cost.

Marketing: Marketing is also a very costly exercise, but it is also an area in which the ethical exchange shows the greatest potential for both saving enterprises costs and achieving improved results. The cost of raising new capital for ethical investments usually ranges from 5% to 10% of the money raised. Of this, well over half consists of marketing costs. An ethical exchange would offer the opportunity to pool marketing costs to maximum effect. It would also create a focal point for ethical investment.

6. Pricing shares and bonds

Although bonds can vary in price on the mainstream markets, their price could be fixed on an ethical exchange or subjected to strict pricing rules. For instance, the price of ethical bonds could change marginally, to reflect changes in prevailing interest rates.

However, the pricing of shares is a highly complex task. Chapter 5 addressed the valuation of enterprises which, though related to the pricing of shares, is not quite the same thing. Unlike the mainstream markets where share price is determined by supply and demand, a pricing mechanism would be necessary for an ethical exchange, especially if price speculation is to be avoided.

Five options on how the price of a share on an ethical exchange could be determined are set out below. These form a continuum between fixed pricing and open market pricing. Each option has its strengths and weaknesses but, in summary, fixed pricing is more open to criticisms of unfair price determination and poor liquidity, while open market pricing is more prone to profiteering through speculation.

Option 1 – Fixed-price trading: Trades take place on the exchange only at a fixed price, which is the price at which the shares were first issued. Buyers and sellers can trade at other prices, but these trades would need to take place off market. This is the model used by the Centre for Alternative Technology.

Option 2 – Set-price trading: Prices on the market can vary, but are set by either the company itself or the market operator. An independent broker might also make an assessment of this price, which would be desirable as it implies greater scrutiny and may reassure the investor that the price is fair. Again, buyers and sellers could trade at different prices, but these trades would need to take place off market. This is the model used by Traidcraft and by the Triodos Renewable Energy Fund. Traidcraft uses a broker, while Triodos makes its own assessment of price.

Option 3 – Set-price trading, but with the addition of a liquidity fund: This is the model currently used by the Ethical Property Company. The Company has formed an employee benefit trust into which a number of individuals have loaned money at a favourable interest rate. The trust then becomes a player on the market, buying the shares of those wishing to sell quickly and selling them on to new investors in order to release cash back into the fund. While other investors trade at a fixed price, the trust's purchases and sales are made at a premium price, realising a small profit to the trust. These funds are used to support an employee share purchase scheme. The trust then acts as a market-maker, but one where any profits made are for the benefit of the company's employees. A further elaboration of this model is to issue the employee benefit trust with options to purchase shares. If there is a surplus of buyers over sellers, the trust then exercises some of its options, selling the shares to buyers. This brings new share capital into the company even if no share issue is open.

Option 4 – Variable-price, order-driven trading: In this model a guide price for the shares is put forward by a broker, the company or the market operator. Buyers and sellers then place orders, according to the price they would like to achieve, which might be at, above or below the guide price. They can either place a 'best price' order, asking for the best price available at that time, or they can place a 'target price' order, asking that the trade should only be executed at a target price. If the target price is not available by a certain date, the order either expires or becomes a 'best price' bid. This model extends Option three, as the offer to purchase at a price different to the set price is open to all investors rather than only to the employee benefit trust. It introduces a bid-offer spread set by the investors, but still leaves them the option of buying and selling only at the guide price. It also leaves scope for the liquidity fund outlined in Option 3 to be introduced into the market. This would be highly effective because the employee benefit trust would have to be more price-competitive.

Option 5 – Variable-price, quote-driven trading: This model is similar to the approach used in parts of the mainstream markets for shares with limited liquidity. There is no guide price for the shares. Instead there is a market-maker whose role it is to buy and sell shares in the enterprise, offering investors a sale price and a purchase price based on a bid-offer spread. Market-makers pay for their work through the profit made on purchases and sales, although they run the risk of making a loss.

Which model?

The most mature pricing model for enterprises listed on an ethical exchange is Option 4, with the liquidity fund outlined in Option 3 available where possible. Option 4 is the most flexible model as it allows room for Options 1, 2 and 3 still to operate within it. Options 1 and 2 may be the best models for some enterprises when they first list on the ethical exchange, and it is only once their trading has matured that they should open up to the possibility of a variable price. Option 5 is not appropriate because it is more of a speculative, profit driven model, unsuited to an ethical exchange. In the long term Option 1 is an unsatisfactory model because the share price does not reflect the fortunes of the enterprise, although it may be appropriate for the initial period of trading. Probably the best approach for an enterprise is to enter the market using Option 1, move quickly to Option 2, and then progress to Option 3 or Option 4 as it matures.

Rules for setting price

On an ethical exchange, directors of the enterprise would at least initially set the price of their own shares, in some cases with the opinion of an independent broker. This mechanism could open up the ethical exchange to criticisms of price fixing. However, this would be dealt with by determining prices according to pre-set rules, approved by the market operator, which investors can easily understand. This combination of cross-checking and transparency would ensure that the launch price is not artificially high or low, while still allowing the directors and members of the co-operative the right to determine what this price should be.

The rules would also set a frequency for the review of the price. On the review date, the enterprise would propose a price to the market operator who would check that it is fair and accords with the rules before listing the new price on the exchange. In the interest of transparency, the rules should be presented at an AGM and a vote held to win acceptance from shareholders. Changes to the pricing rules, allowing the co-operative to progress to more mature pricing options, would require the approval of the AGM and the co-operative's investor council, if there is to be one.

It is important that the pricing mechanism used by a co-operative or social enterprise should remain highly transparent to investors. The rules for calculating the share price should be published on the organisation's website and referred to in other communications with shareholders (such as the annual report). Details of any price review should be posted on the organisation's website within seven days of the review, and communicated to all investors registered on the exchange.

Social enterprises offer both social and financial returns. Although offering a social return would be a requirement for all enterprises listing on an ethical exchange, it is arguable that ethical investors are looking for both a social and a financial return, and that the social return should be factored into the share price. In a similar vein, ethical investors would assess the both the financial and social risks of an investment before making it.

7. Potential limitations of an ethical exchange

One of the main problems facing the development of an ethical exchange is attracting a sufficient number of co-operatives and social enterprises to become founder members. Economies of scale would apply to the running costs of the exchange: the more members it attracted, the lower its membership fees would be.

The idea of an ethical exchange will not appeal to all social enterprises or ethical investors. IPS co-operatives that have withdrawable share capital, or even transferable bonds, would be unlikely to benefit from an ethical exchange. Other co-operatives and social enterprises might feel that the costs of admission to the exchange, and of maintaining a listing, would not be outweighed by the benefits.

Some social enterprises might feel that listing on the ethical exchange would only serve to encourage their investors to disinvest, where previously there had been no apparent demand for disinvestment. This might particularly apply to social enterprises that have already undertaken share or bond issues and do not plan to raise additional capital. Other social enterprises may also fear a degree of loss of control over their affairs, although the appropriate drafting of rules should enable enterprises to retain their individual character. They may also perceive the exchange as creating new competitive demands for higher profitability and dividends.

Much of the long-term strength of the exchange would depend on the willingness of member enterprises to work together in marketing the exchange and in maintaining high standards of compliance. It would need to be highly transparent in its functioning, especially in the way in which shares and bonds are priced.

But above all else, an ethical exchange would be judged by its performance and the performance of its member enterprises. The failure of listed enterprises, especially in the early life of the exchange or when the number of listed enterprises is small, could have a devastating effect on investor confidence.

Chapter 7: An equity model for co-operatives

This chapter presents a legal and organisational model for external investors to participate in co-operatives. Section 1 describes how co-operatives decide which stakeholders are their primary members and the role of investors in co-operatives. Section 2 describes how the legal format of a co-operative's constitution determines its status as a co-operative and the mechanisms for engaging investors. Section 3 explores what co-operative principles have to say about the treatment of investors in co-operatives. Section 4 highlights the main design features of an equity model for co-operatives. Section 5 describes how external investor participation in co-operatives would work in practice. Section 6 explores the governance issues associated with these proposals.

This publication has made a series of radical proposals about investor participation in co-operatives. At first glance these proposals might seem like a major departure from the traditions of co-operation, requiring major changes in the legal formats of co-operatives. But great care has been taken to protect the fundamental characteristics by which co-operatives are defined, which are embodied in the International Co-operative Alliance's statement on the co-operative identity. Furthermore, none of the proposals in this publication require a change in corporate legislation. This chapter presents a legal and organisational model for co-operatives that want to promote investor participation. The basic features of this model are that:

- investors will be offered both profit-related dividends and capital gains on their investments – provided that not all of the co-operative's trading profits are available for this purpose;
- investors may be offered voting membership of the co-operative – provided that they cannot thwart the democratic wishes of the participating members who are there by reason of being users or providers of the service.

1. Stakeholders as members

Co-operatives historically have been owned and controlled by a membership drawn from a single stakeholder group. Co-operatives are member-based organisations. Membership confers constitutional rights, in particular voting rights and preferential or exclusive access to services or facilities. The criteria for membership define the nature of the co-operative. Broadly, co-operatives fall into two main types: those that sell things to their members (consumer model), and those that buy things from their members (provider model).

Examples of the consumer model include:

Retail co-operatives: Co-operatives that operate shops, supermarkets and associated services (such as pharmacies, funeral directors, travel agents). Membership is open to all customers, although most retail co-operatives will happily sell to non-members.

Housing co-operatives: Co-operatives that provide housing for their members. Dwellings may be owned by the co-operative, or managed by the co-operative on behalf of some other owner (known as tenant management co-operatives). Membership is open to all tenants and only to tenants.

Credit unions: Financial services co-operatives based on a 'common bond'. Members save money with the credit union and may borrow from it. Membership is open to individuals who share the common bond (such as working for the same employer or living in the same neighbourhood).

The most prevalent example of the provider model of co-operative is the workers' or employee-owned co-operative, where the co-operative buys its labour requirements from its employee-members. There are also co-operatives in other sectors that purchase products from their members for processing and selling on, for example in agriculture and fisheries.

Childcare is an example of an industry in which either type of co-operative may thrive. There are dozens of childcare co-operatives owned and controlled by the parents and guardians of the children being cared for (consumer model) and dozens more run as workers' co-operatives (provider model). A co-operative's choice of structure will be a result of the motive for establishing the enterprise rather than its field of activity.

It is not uncommon for someone to perform a dual function with regard to a co-operative. For example, an employee of a consumer co-operative may also shop there and thus be eligible to become a member – but as a consumer rather than as worker. Similarly, in a childcare facility structured as a workers' co-operative, some of the employee-members may themselves have children who are cared for by the co-operative. These dualities of function do not generally cause problems provided the membership does not become dominated by people who may have conflicting interests in the business – a simple example of which might be a desire for higher wages (as an employee) versus cheaper prices (as a customer).

The role of investors in co-operatives

Investors have never been seen as a valid stakeholder group in terms of co-operative ownership, and the language of co-operation has historically been anti-investor. Examples include phrases such as *"rewarding participation rather than investment",* or in the case of worker co-operatives *"labour hiring capital rather than capital hiring labour".* One of the defining characteristics of co-operatives has long been their principled commitment to a limited return on capital. This is discussed in more detail later in this chapter.

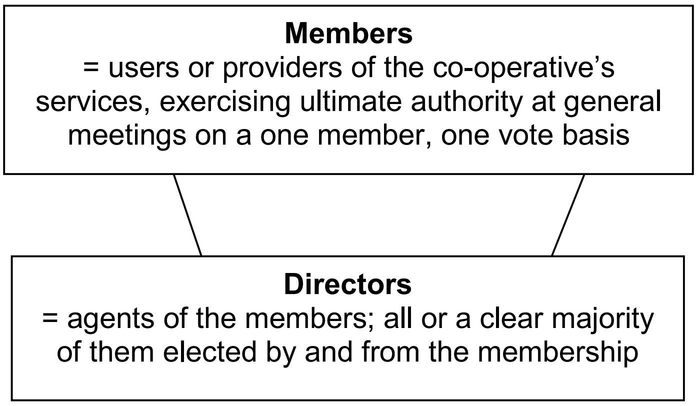
The principle here is clear. A co-operative should be run primarily or exclusively for the benefit of its members: those who either use or provide its services, according to its nature. Money is merely a tool to achieve this end, to be acquired as cheaply as possible and without giving up any constitutional powers to the providers of finance*.

* In practice this division is not always quite so clear-cut. Some of the largest institutions modelled on co-operative lines are providers of financial services: the mutual building societies and their close relatives, the friendly societies. Here, of course, the members are by definition investors and one of the key benefits offered to members is a competitive return on their capital.

The historical norm within co-operatives has been self-capitalisation by the members. In many parts of the world, though not in the UK, co-operative law requires a minimum investment by members as a condition of membership. Self-financing is seen as one of the main ways of ensuring independence, an important principle of co-operation (especially in economies where there is a high degree of state influence over business). Although there are limits on the return payable on members' investments, it remains the case that, in most co-operatives, members have dual roles: they are investors as well as users or providers of its services. The traditional legal form for co-operatives in the UK is the Industrial and Provident Societies Acts (IPSA), which permits each member to hold up to £20,000 worth of shares.[*]

What is being considered here, however, is something new for UK co-operatives: the possibility of giving investors enhanced financial rights, and some control rights, as investors and not because they are already members of the co-operative as users or providers.

Figure 7.1: The structure of a co-operative



The general structure of a co-operative follows that of a conventional share-based company. At the top of the hierarchy are the members (equivalent to company shareholders), who hold ultimate power in the enterprise but delegate authority for nearly all governance and management matters to a board of directors (who may be known as 'the committee of management', or similar, in a co-operative). The members may call the directors to account if they are dissatisfied with the performance of the co-operative, and the directors are required to report to the members at least once a year at the annual general meeting.

Responsibility for certain decisions may not be delegated to the directors, in particular amending the co-operative's governing document, in which the fundamental rights of the members will be enshrined, and winding up the co-operative. These decisions can only be made at a general meeting, where all members have the opportunity to vote.

[*] This statutory ceiling on the value of a member's shareholding is reviewed from time to time and, at present, consideration is being given to doing away with an upper limit altogether.

In a larger co-operative the governance structure may appear more complex than this simple division between the members and the board of directors (for example, members may come together in a number of regional general meetings rather than in one all-inclusive meeting), but the same basic principles apply.

2. The legal status of co-operatives

The conventional legal form for co-operatives in the UK is registration under IPSA.[*] Two types of society may register under these Acts: bona fide co-operatives, and societies for the benefit of the community. In essence, the former are member-benefit organisations and the latter, as the name implies, are community-benefit organisations, often charitable in nature.

IPSs (Industrial and Provident Societies) grew out of Friendly Societies in the mid nineteenth century. Registration under IPSA confers corporate status on a society and limited liability on its members. If the society should become insolvent, each member stands to lose no more than the value of their shareholdings, currently limited to a maximum of £20,000 per member (except where a member is itself another IPS).

IPS shares are unlike company shares, in that:

- Voting rights are held on a one member, one vote basis, regardless of shares held.[**]
- If allowed by the society's rules, shares may be withdrawn at any time, whereas a company's shares may usually only be redeemed from profits or the income from a new issue of shares.
- Most IPS shares are par shares in that they never vary in value: a share purchased for £1 will eventually be redeemed for £1.
- As a consequence, a member's share account may contain fractions of shares. For instance, if a member holds 100 x £1 shares and the society pays out 2.25% in interest[***] that year, the member's account will stand at £102.25 – technically, 102¼ shares. Taken along with the par value and the withdrawable nature of the share capital, this makes 'shares' in an IPS look suspiciously like a savings account, although of course a member does stand to lose their capital if the society should go bust.
- An IPS may only pay limited interest on members' share capital. (This issue will be discussed in greater detail later.)

[*] There is a move to change the name of this legislation to the *"Co-operatives and Community Benefit Societies Act"* and one Act of Parliament has already been passed with this name: the Co-operatives and Community Benefit Societies Act 2003. However, the primary legislation at this time retains its rather archaic name.

[**] One member, one vote is the norm in primary societies. In secondary organisations (such as a federal body), voting rights may be held on some other democratic basis such as a formula that takes account of the number of individual members each society represents within the secondary body. A few societies operate in a different way: some agricultural co-operatives, for example, allocate voting rights on the basis of the number of acres farmed. The key point is that voting rights are never tied to the level of investment in the society, as would normally be the case in a company.

[***] In IPS terminology, it is conventional to speak of 'interest' on shares and not 'dividends'.

Until February 2001, IPSs were regulated by the Registry of Friendly Societies within the Treasury. The Financial Services and Markets Act 2000 shifted responsibility for IPSs to the FSA (Financial Services Authority). The FSA and the Treasury are committed to the modernisation of IPS legislation and regulation. The legal services team within Co-operatives^{UK} is working closely with the FSA and the Treasury to ensure that this process of modernisation continues.

Chapter 8 urges Co-operatives^{UK} to extend this dialogue with the FSA to include the proposals for equity-based structures described in this publication. Four main proposals should be considered: the introduction of different classes of shares within IPSs, the power to issue transferable investor-only shares, changes to the limitations on the scale of dividends, and the raising or removal of the £20,000 upper limit on shareholdings.

Section 5 of this chapter presents a blueprint for an equity-based model for co-operatives using the Companies Acts as the vehicle for incorporation. The Companies Acts have been used by many co-operatives in the past 30 years because this legislation is generally considered to be a flexible, cheap and quick method of incorporation. For the same reasons it has been chosen as the format for the model presented in this chapter. This does not preclude the possibility that IPS legislation could be used to achieve the same or better effects.

This chapter assumes that the equity investment put into a co-operative will take the form of shares. This need not necessarily be the case: a co-operative may make use of debenture stock, or some sort of invented financial vehicle such as a 'co-operative bond', but shares are the common currency of business investment and are widely understood. Thus the type of company envisaged is a company limited by shares (rather than a company limited by guarantee).

3. Co-operative principles

As noted in Chapter 5, in order to attract equity investment it is necessary to offer terms that are sufficiently attractive to the potential investor. The question here is: In order to attract equity investment, how far may one go in rewarding that investment without offending co-operative principles?

In this respect it is necessary to review these internationally recognised principles, and it may be instructive to look at changes made to them in 1995.

The status of these principles is very important to the co-operative movement. Because co-operatives see themselves as part of a worldwide homogenous family, but one made up of fiercely independent entities, it has long been considered desirable to have a universally recognised definition of a co-operative that can be applied regardless of local variations in legal frameworks or practice. A set of replicable co-operative principles was established by the Rochdale Pioneers in the nineteenth century, and these have been regularly reviewed and updated. Stewardship of these principles rests with the International Co-operative Alliance, and amending them is a serious business.

Enhancing the financial returns to investors

The last revision of international co-operative principles took place in 1995, and one area that saw significant change was that of rewarding investment. Prior to 1995, the relevant sections read:

> "*The interest paid on shares and other invested capital should be strictly limited. Any surplus arising from the operations of a co-operative belongs to its members and should be distributed in such manner as would avoid one member gaining at the expense of another. This may be done by decision of the members as follows:*
>
> *a) by provision for development of the business of the co-operative;*
>
> *b) by provision of common services; or*
>
> *c) by distribution among the members in proportion to their transactions with the co-operative."*

Here we can clearly see the principle, discussed earlier, that investors should be paid as little as possible for their capital, while the participating membership should enjoy the fruits of any trading surplus generated.

Co-operatives in the 1980s and 90s had to come to terms with a changing economic environment, reflected in a change of emphasis in the 1995 principles:

> *"**Third Principle: Member Economic Participation***
> *Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."*

Comparing this with the pre-1995 version, we may note that members now usually receive limited compensation on capital subscribed, suggesting that on occasion that return need not be limited. Further, this Principle says nothing at all about limiting the return on capital subscribed by non-members.

It seems clear the overall intention and effect of these changes was to give co-operatives much greater freedom to raise capital as best they can in a complex and competitive financial and commercial environment. Close analysis of this revised principle suggests the following:

- co-operatives can pay commercial rates for external capital, including the payment of profit-related dividends, and can allow capital gains to be made by investors;
- this should not normally apply to investors who are also members of the co-operative by virtue of their being providers or users of the services of the co-operative (i.e. traditional co-operative members), who should continue to accept a more limited return on their capital, or at least on the capital they are required to subscribe as a condition of membership;

- co-operative members should continue to enjoy and exercise the power to apply trading surpluses for the benefit of the co-operative and its members, even if some of those surpluses now are available to reward investors;
- non-participating investors, who may not be bound by the "*limited compensation"* rule, may become members of a co-operative – hence the need to insert *"usually"* in the third sentence. This will be subject to the Fourth Principle, which is discussed later.

It is likely that much of the stimulus for the 1995 changes came from Italy, with its huge and influential co-operative sector. Changes to Italian co-operative legislation in 1992 (Law No 59) introduced provisions very similar to those outlined above.

Involving investors as stakeholders

Post-1995 ICA principles have rather more to say about control within a co-operative than they do about rewarding investment:

> *"**Second principle: Democratic Member Control***
> *Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote), and co-operatives at other levels are also organised in a democratic manner."*

> *"**Fourth Principle: Autonomy and Independence***
> *Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy*."

That's clear enough: co-operatives are controlled by their members and any arrangement with external investors must not compromise this control – though this principle clearly does countenance some constitutional impact of agreeing terms with external investors. So who qualifies for membership?

> *"**First Principle: Voluntary and Open Membership***
> *Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination."*

"...persons able to use their services" makes perfect sense in a consumer co-operative. In a workers' or producer-controlled co-operative the phrase has to be understood in the context that the service offered to its members is employment or providing a market for their products.

The principle of open membership requires that the rules of a co-operative specify a particular economic relationship with the co-operative which qualifies someone for membership. All who share that economic relationship with the enterprise are entitled to become members: employees in a workers' co-operative, customers in a retail co-operative, tenants in a housing co-operative, savers/borrowers in a credit union.

What the first ICA principle fails to clarify, however, is whether or not anyone else may be eligible for membership. In other words, it does not state that membership is only open to all persons able to use their services. This omission leaves the door open for investors to be admitted provided they don't swamp the membership and divert the co-operative from its primary purpose.

Once again, this reflects what has happened in Italy, where up to 33% of a co-operative's membership may be drawn from investors ("contributing members" as they are called) rather than from the primary stakeholder group ("ordinary members"). Law 59/92 also states that contributing members may serve as directors provided that ordinary members are in the majority.

The monitoring of co-operative principles

The above sections have been concerned with exploring the extent to which a co-operative might engage investors of equity finance while maintaining co-operative principles. In the UK there is no effective monitoring of co-operatives in respect of their adherence to international principles. Some, but by no means all, co-operatives may come under scrutiny in the following circumstances:

- If an enterprise wishes to register as a bona fide co-operative under the Industrial and Provident Societies Acts – the traditional legal form for co-operatives – it must fulfil certain conditions for registration. These conditions mirror international co-operative principles and are subject to interpretation by the Financial Services Authority (as the registering body for Industrial and Provident Societies). A co-operative so registered will not be permitted to make any changes to its rule book that would render it ineligible for registration under the Acts. However, a significant number of co-operatives register under the Companies Acts, where they are legally indistinguishable from any other type of company. Any claim by a company to be a co-operative rests on the provisions of its articles of association, and is not subject to any independent scrutiny at the point of registration.[*]
- If an enterprise wishes to join Co-operatives^UK, the national apex body for co-operatives (or one of the smaller sector-specific federations), it will need to demonstrate its co-operative credentials. However, membership of Co-operatives^UK or a federation is not compulsory. (One possibility is that such membership might be made a requirement by a new co-operative investment institution, or to secure a listing on the mooted ethical exchange.)
- If an enterprise wishes to borrow from one of the specialist co-operative loan funds, such as ICOF (Industrial Common Ownership Finance), it may be required to demonstrate its co-operative credentials before receiving financial support. If the co-operative movement itself were to establish an equity fund to invest in co-operatives along the lines proposed in this study, then that fund might adopt its own criteria for recognition as a co-operative.

[*] Unless it wishes to use the word 'co-operative' within its registered name, in which case it must meet certain criteria laid down by the DTI. At present, co-operatives adopting the model described here probably would not so qualify, and this issue may need to be raised with the DTI with a view to amending their guidelines.

Consequently, the motive for ensuring that equity-accepting co-operatives do not breach international co-operative principles is not, at present, the fear of some penalty or disadvantage, but rather a desire by the co-operative movement to remain true to its principles and to avoid dilution of the co-operative ethic. It is, essentially, a self-regulation issue.

4. Designing an equity model for co-operatives

It is almost certain that any large-scale co-operative venture looking to attract significant equity will have a legal structure designed especially for it. The particular features of an investment mechanism may depend on the source from which it is hoped to attract investment;[*] but a general-purpose blueprint of an equity model may be useful either as a starting point or for default use.

As indicated earlier, the two major variables for consideration when designing such a blueprint are:

- the extent to which investors may have access to the co-operative's trading profits to reward their investment through dividends and/or capital gains;
- the degree of influence extended to investors, primarily through voting rights within the co-operative.

It should be noted that there is nothing inherent or automatic about the rights attached to an equity investment. While there are certain conventions surrounding share capital in companies, for example the differential rights and risks attached to ordinary shares and preference shares, these are by no means immutable. In essence, the rights and risks attached to any investment amount to a contractual agreement between the investor and the investee, and the terms of this agreement may be written into the company's memorandum and articles of association or in a shareholders' agreement.

In designing an equity vehicle for investment, these two major variables: investors' access to profits and their control rights, may be represented by sliding scales.

Figure 7.2: Investors' rights

←NO ACCESS TO PROFITS – 50% – UNLIMITED ACCESS TO PROFITS→

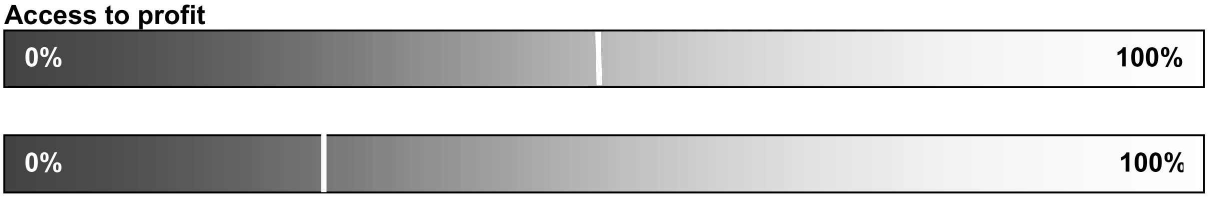
←NO CONTROL RIGHTS – 50% – UNLIMITED CONTROL RIGHTS→

Essentially, the further to the left of the scale the investment opportunity lies, the less is being offered to potential investors, while the further to the right it lies, the more it may be considered to undermine co-operative principles and independence.

[*] Compare this with the findings of Le Conseil Canadien de la Coopération and The Canadian Co-operative Association, in their 2002 report on investment strategies for Canadian agricultural co-operatives: *"we have concluded that no 'perfect' capitalization model exists, as each co-op is unique in how it structures itself. Therefore, one cannot assume that one of the tools is best for all co-ops. Additionally co-ops generally use more than one type of capitalization tool and often change their capitalization method depending on the needs and future direction of the co-op."*

It would be quite possible to design different equity vehicles for different markets, and different co-operatives might feel more or less comfortable with investors' rights placed at different points on the scale. Equally, different investors may have different views regarding the balance between financial and social returns required on their capital. For the purpose of offering a blueprint for a general-purpose equity model co-operative, the limits proposed are: a maximum of 50% of profits and a maximum of 25% of voting rights available to investors.[*]

Figure 7.3: Investors' rights in an equity-based co-operative



Before describing this proposed model in more detail, it may offer some reassurance that other countries have reached similar conclusions. Reference has already been made to Italian co-operative law and the distinction between contributing members and ordinary members. Another example is the worker co-operative legislation of the Valencia region of Spain. Features here include:

- at least 55% of members must be employees, with a maximum of 45% of members being investor-members – though investor-members may not control more than 30% of votes at a general meeting;
- at least 20% of annual profits must go to non-distributable reserves, and 10% to a fund for co-operative training and promotion; the remainder may be available for distribution to employee-members and investor-members.[1]

Thus it can be seen that, while the numbers may vary, others trying to resolve the equity problem in co-operatives have reached the same general conclusions.

5. How it would work

Membership and shares

It is proposed that there should be two classes of membership in an equity co-operative model: ordinary members (users or providers of the service), and investor-members. There will be at least two classes of shares: ordinary (or co-operative) shares, which will carry a limited return, and investment shares held by investor-members, who will be entitled to a maximum of 50% of profits and a

[*] It would be possible for a co-operative to issue a range of different investment vehicles (classes of shares), each crystallising degrees of control and access to profits at different points along these scales, but there is no need to delve into such complexities here.

maximum of 25% of voting rights at general meeting[*]. Some co-operatives may also wish to issue conventional non-voting preference shares etc.

With few exceptions, ordinary members should not also be able to hold investment shares (and thus become investor-members). To permit them to do so would lose the distinction between members' capital (meaning traditional co-operative members) and external capital, and the special privileges attached to each; and could also result in some co-operative members having more than one vote at general meeting, which is a clear breach of the co-operative ethos.[**] However, exceptions may be made when a co-operative is transforming from one form of ownership to another, with special arrangements to cope with the transition.

Individual co-operatives may wish to use some other term to describe their ordinary members, one that better suits the nature of their enterprise. For example, a workers' co-operative may prefer to distinguish between employee-members and investor-members, and a housing co-operative between tenant-members and investor-members.

Application of profits

ICA principles have the following to say about profit distribution:

"Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership."[***]

Members' limited return on capital

This has long been an essential feature of co-operatives, emphasising that members benefit from their participation in the business of the co-operative primarily as consumers or providers, rather than as investors. That benefit can be financial: "*benefiting members in proportion to their transactions with the co-operative"* allows for profit distribution to members, but calculated by reference to the volume of what they have bought from or sold to the co-operative, not how much they have invested. The limit on the return on members' capital is, or should be, two-fold: a ceiling on the interest[****] that is normally paid annually out of trading profits, and a restriction on

[*] It has to be said that the 50% limit on profits available to investors is a somewhat arbitrary figure, based on the principle of sharing profits equally between investors on the one hand and the co-operative and its participating members on the other. The proportions available to both parties could be varied without fundamentally affecting the model. The 25% limit on voting rights is not so arbitrary, as will be explained later.

[**] It may be possible to establish a 'member benefit trust' to hold some investment shares collectively on behalf of the ordinary membership, probably purchased out of profits, but the implications of this would need to be carefully thought through.

[***] See Appendix 1

[****] What would normally be called a 'dividend' on shares is often referred to in UK co-operatives as 'interest', while the term 'dividend' is reserved for the share of profits allocated to members by virtue of their participation in the business.

the capital gains a member may make on the sale or redemption of their shares (most co-operative shares are par shares: they never vary in value, so a share purchased for £1 will eventually be redeemed for £1).

Consequently, any decision by a co-operative's members to allocate profits to reserves is essentially a decision to deny themselves access to those profits, as the increase in the value of the business will not be reflected in the value of their shareholding. The only unfettered access to profits that members have is the annual 'dividend' paid on their transactions with the co-operative, and once profits have been allocated to reserves that opportunity is lost.[*]

A successful co-operative will therefore experience a growing gap between the value of members' (par) shareholdings and the asset value of the business. A decision needs to be made on what can happen to this 'spare' reserve in the event that the co-operative is wound up while solvent. In the UK there are two primary models, usually referred to as common ownership and individual ownership.[**]

- In a common ownership co-operative, members receive nothing on dissolution other than the par value of their investments (loans or shares) – any residual assets must be given to another common ownership co-operative, or to charity. The aim of this model is to discourage members from winding up a successful co-operative as they have nothing to gain from so doing. These dissolution provisions are similar to those to be found in the governing documents of voluntary, community and charitable organisations.
- In the individual ownership model, residual assets may be transferred among the members, but again in proportion to their contribution to the business as user or provider and not in proportion to their investment. Most such co-operatives require that assets are distributed amongst all those who have been members within the past six years, and not just the members at the date of deciding to wind up.[***]

In most other parts of the world, co-operatives operate on the basis of a hybrid of these two approaches. Some of the assets are available to members on winding up, while some are not. Those that are not available are called 'indivisible reserves'.

Indivisible reserves

The concept of indivisible reserves is common to the co-operative legislation of many countries and is often protected by statute. As suggested by the name, it is a pool of reserved profits which cannot be distributed (or divided) among the members or investors, either during the lifetime of the co-operative or upon winding up. While many UK co-operatives have adopted the principle of common ownership of assets, which similarly cannot be distributed to members or investors, there is no statutory

[*] This is a somewhat over-simplified analysis as in practice the members might in future be able to create an artificial profit from the sale of assets and then make a large transaction-related distribution to themselves from that profit, thus accessing reserves. This is rare though not unknown.

[**] At one time the individual ownership model was sometimes described as 'co-ownership' but this was misleading as some of the earlier common ownership enterprises also used the term co-ownership.

[***] Some older-established co-operatives in fact permit residual assets to be distributed among the members in proportion to their shareholding, but this has been recognised as not being in keeping with ICA principles and co-operatives retaining this provision are encouraged to amend their rules.

protection for such reserves*. Continuing non-distribution of the asset pool depends on the good faith of each generation of members. The nearest equivalent to indivisible reserves that the UK is likely to see in the foreseeable future is the ‘asset lock’ feature of the proposed CICs (Community Interest Companies). CIC status will be an overlay on one of the existing company forms and is intended to reassure potential funders and supporters that their contributions to a CIC will be used for the benefit of the community in perpetuity, without the possibility of assets being sequestered at some future time by the members of the company. Some co-operatives may qualify for CIC status but only if they:

- are registered under the Companies Acts;
- have purposes that the CIC regulator consider are sufficiently for community interest, which might include childcare or environmental services, but are unlikely to include, say, light engineering or agriculture unless the co-operative particularly employs people with disabilities or otherwise demonstrates direct social benefits;
- are essentially not-profit-distributing; the DTI team working on details of the CIC proposals have indicated this will be a defining characteristic of the CIC. CICs that pay dividends on shares will have to cap these at a relatively low level of return.

Consequently, the type of co-operative that will be seeking equity investment will not be eligible for CIC status and the statutory protection of the asset lock this will provide.

Meanwhile the Co-operatives and Community Benefit Societies Act 2003 introduced a similar asset lock for community benefit societies registered under Industrial and Provident Society legislation, but not for co-operatives.

Thus for the foreseeable future, at least, any desire by UK co-operatives to maintain indivisible reserves (as recommended by ICA principles) will continue to rely on the good faith of the members and internal governance processes, and not on any statutory protection. It is assumed that most co-operatives will wish to maintain indivisible reserves and so the equity model must allow for this.

Profit and asset distribution in the equity co-operative model

To summarise all the above, it is proposed that the following provisions should appear in the equity co-operative model:

> **Application of profits**
> Profits of the co-operative shall be applied as follows, in such manner and such proportion as may be recommended by the directors and approved by the common wealth council**:

* The Industrial Common Ownership Act 1976 recognised the principle of non-divisibility and offered a degree of protection to the assets of co-operatives that had been issued with an ICO certificate under the Act. However this Act only applied to employee-owned co-operatives, and the Act, which effectively had a five-year lifespan, has now expired.

** The composition and role of the common wealth council will be discussed later in this chapter.

a) To a general reserve for the continuation and development of the co-operative;
b) To paying co-operative dividends to ordinary members, on the basis of some equitable formula that recognises each member's contribution to the co-operative's business during the period in which the profit was generated and which may make allowance for such relevant factors as length of membership;
c) To paying investment dividends to investor-members in proportion to their shareholding, provided that no more than 50% of profits are available for this purpose;
d) To paying interest on ordinary members' shares at a rate not exceeding 3% above the base rate of the co-operative's bankers from time to time[*];
e) To making payments for social or charitable purposes.

Meanwhile the dissolution clause in a common ownership model would read:

In the event of the solvent winding up or dissolution of the co-operative the liquidator shall first, according to law, use the assets of the co-operative to satisfy its debts and liabilities. In the event that any assets remain to be disposed of after its liabilities are satisfied, these assets shall be applied as follows:
a) first, not more than 50% of the value of the residual assets shall be distributed amongst the investor-members in proportion to the shares each holds within the co-operative at the time of dissolution;
b) second, shares held by ordinary members shall be redeemed at par value if sufficient funds are available;
c) third, any balance shall be transferred to some other common ownership enterprise(s), or to some non-profit organisation(s) promoting and supporting co-operative and common ownership enterprises, as may be decided by the members at the time of or prior to the dissolution.

In the event that for whatever reason any residual assets cannot be transferred as described above, they shall be given for charitable purposes.

The equivalent clause in an individual ownership model co-operative would read:

In the event of the solvent winding up or dissolution of the co-operative the liquidator shall first, according to law, use the assets of the co-operative to satisfy its debts and liabilities. In the event that any assets remain to be disposed of after its liabilities are satisfied, these assets shall be applied as follows:
a) first, not more than 50% of the value of the residual assets shall be distributed amongst the investor-members in proportion to the shares each holds within the co-operative at the time of dissolution;
b) second, shares held by ordinary members shall be redeemed at par value if sufficient funds are available;
c) third, any balance shall be distributed amongst those persons who have been members of the co-operative during any part of the period of six years immediately preceding the date of the commencement of winding up or dissolution proceedings, in accordance with some formula which equitably rewards each such member and past member of the co-operative for their contribution to the business of the co-operative during their period of membership, as may be agreed by the co-operative in general meeting at the time of or prior to the winding up or dissolution.

In the event that for whatever reason any residual assets cannot be transferred as described above, they shall be given for charitable purposes.

[*] This is a common ceiling rate in co-operatives but could be varied within reasonable limits.

Value of members' shares

While shares held by ordinary members will be par shares, never increasing in value and only reducing in value if the co-operative's assets are insufficient to redeem them, shares held by investor-members may vary in value for the purposes of redemption or assessing their market value. The valuation of shares is dealt with in Chapters 5 and 6, but it is worth noting that the proportion of residual assets available to investor-members will affect such valuations.

Control and voting rights

In keeping with international co-operative principles, ordinary members will hold voting rights on a one member, one vote basis. Meanwhile the co-operative's governing document may permit investor-members to hold, collectively, up to 25% of total voting rights within the co-operative.

The 25% threshold

This 25% threshold is significant under company law. While most management and governance decisions are delegated by the members to the directors, certain fundamental decisions may only be made by the members at a duly convened general meeting. The Companies Acts specify certain of these decisions, and the company's articles of association may specify additional ones. For example, disposal of major assets might be made subject to a decision made in general meeting.

Further, company law requires that some decisions (or 'resolutions') require higher majorities of votes cast than others. The main types of resolution are:

> **Ordinary resolution** – requires a majority of 50% of votes cast plus one in order to be passed;
>
> **Special resolution** – requires a majority of 75% of votes cast in order to be passed;
>
> **Elective resolution** – requires a unanimous vote from the company's members in order to be passed.

Company law specifies that changes to the company's memorandum or articles, and decisions to wind up the company, require a special resolution. Consequently, if the investor-members were to control more than 25% of the votes in the co-operative, they could block an attempt by the ordinary members to pass a special resolution even when every single ordinary member voted in favour. With 25% of the votes, however, the investor-members only need to secure the support of a single ordinary member to prevent a special resolution from being passed. Thus it can be seen that this 25% figure is significant in maintaining democratic member control while giving the investor-members some reasonable and meaningful influence at general meetings.

Again, it is possible for a company's articles to add to the list of decisions requiring a special resolution, which would have the effect of enhancing the investor-members' potential influence.

Investor-members will always be able to block elective resolutions. These are required if a company wishes to exempt itself from the requirement to hold annual general meetings, to present accounts to the members, and similar AGM-related matters.

The control of votes

There are a number of different ways in which the investor-members' votes might be controlled, depending on the nature of the co-operative and the number and nature of the investors. To reiterate a point made earlier, the minutiae of corporate governance are likely to be a part of the negotiations that will be required prior to receiving an injection of equity finance, and thus will vary from one concern to another.

However, the model should offer maximum flexibility to deal with as wide a range of circumstances as possible, for example: very small and very large co-operatives; only one or two equity investors or a larger number of them; individual or corporate investors.

The following provisions are proposed:

- All investor-members shall be entitled to attend and speak at general meetings of the co-operative (via an appointed representative in the case of a corporate investor).
- Investor-members between them shall hold that number of votes that is equal to one-third of all other voting rights held within the co-operative, rounded down (i.e. if there are 15 ordinary members, the investor-members between them will hold 5 votes; if there are 250 ordinary members, the investor-members between them will hold 83 votes). This formula ensures they always control 25% of the total votes, or fractionally less than 25%.
- Where there are two or more investor-members, they shall be offered a choice of methods of casting their collectively-held votes:
  a) convening a meeting of investor-members prior to each general meeting of the co-operative and agreeing how to cast their block vote on each resolution to be decided; or
  b) allocating the total number of votes held by the investor-members among those members in proportion to the size of their investments. For example: the investor-members between them are entitled to 83 votes. There are three investor-members, one holding 45% of the equity, one 40% and the other 15%. They would be allocated respectively 37, 33 and 13 votes to cast as they think fit.
- Proxy voting at general meetings should be permitted.

Altering shareholders' rights

The investor-members shall have a power of veto over any decisions that affect their rights as shareholders. This power would be exercised by convening a separate meeting of investor-members, where the principle of one share, one vote would apply on a ballot, and where any proposal to alter the rights attached to shares would require a 75% majority vote in favour to be adopted.

Financial underperformance

The ultimate control in a co-operative lies with the members making decisions through general meetings, and of course investor-members will always be in a minority in this forum. There may thus be concerns about remedies available to the investor-members if the co-operative repeatedly fails to make the financial returns investors expected.

The preferred option is to give investor-members significant influence over specific decisions via the medium of the common wealth council, which will be discussed later. However, in some instances equity investors may require a sturdier means of intervention to protect their investment. In such cases it might be necessary to introduce triggers for increasing the rights of investor-members.

6. Governance

Although the proportion of votes controlled by investor-members at general meetings is of great importance with regard to maintaining co-operative integrity, this is not the sole governance issue in an equity co-operative model.

Board of directors

Investor-members (or their representatives, in the case of corporate investors) will be eligible to serve as directors. Directors will be elected by and from the membership in general meetings, and the members should be free to elect whoever they believe is best able to manage their business effectively. The fiduciary duty attached to directorship means that all directors should act in the best interests of the enterprise and not in their own interests, so securing a place on the board would not be an appropriate way for an investor to protect their investment at the expense of the ordinary members. Furthermore, section 303 of the Companies Act 1985 makes it clear that any director may be removed at any time by a simple majority vote of the members, regardless of any agreement between the company and that director, so the ordinary members can ultimately control the composition of the board anyway. The role of the board will essentially be the same as in a conventional company.

The common wealth council

When members of a co-operative retire from membership, they do not take with them their share of the full value of the business, as do exiting shareholders in a conventional company. This gives rise to a common wealth, a pool of assets which are the collective property of past and present members. This common wealth, recognised in international co-operative principles, is one of the key features that distinguishes co-operatives from other business forms[*].

Conventional governance mechanisms do not cater for the supervision or protection of this common wealth, a function that will have additional importance in this proposed new generation of co-operatives which aim to reconcile the interests of different stakeholder groups. For this purpose it is recommended that the equity co-operative model should feature a common wealth council in addition to the board of directors. A

[*] The common wealth discussed here is almost, but not quite, synonymous with the indivisible reserve described earlier in this chapter. Indivisible reserves, as utilised by co-operative sectors in other countries, are strictly realisable assets that can be given a reasonably precise financial value. The common wealth envisaged here certainly includes such assets but may also be considered to include less tangible common property such as the business's principles, ethos and history.

primary responsibility of the council will be to avoid excessive benefits accruing to present members, both ordinary and investors, to the detriment of a common wealth that has been created by past members, by community goodwill towards the enterprise, and by support from the co-operative movement, or otherwise.

As well as ensuring the maintenance and proper application of the common wealth, there will also be a function to protect the interests of other stakeholders from excessive regard to the common wealth at the expense of their legitimate expectations – for example, of a fair return on their investments in the case of investors or on their labour in the case of employees.

Composition of the common wealth council

Membership of the common wealth council should comprise the following, with no sectional interest holding a majority of places:

- ordinary members of the co-operative;
- investor-members;
- past members of the co-operative;
- employees (except in the case of a workers' co-operative, where the employees will be represented by ordinary members);
- representatives of the wider co-operative movement – for example, other well-established local co-operatives or co-operative development bodies;
- any other key stakeholders appropriate to that particular enterprise – for example, major suppliers, local community representatives, industry specialists, key customers.

The composition of the common wealth council may well vary from one co-operative to another. For example, Chapter 2 proposes the idea of supplier councils, employee councils, customer councils and the like to address the interests of key stakeholder groups. A multiplicity of councils is perhaps more likely to be found in larger enterprises, while in other instances a single common wealth council may endeavour to unify all these interests.

Role of the common wealth council

The common wealth council will be free to consider any matter affecting the co-operative, and may challenge or express a view to the directors on any matter. Formal approval on the following matters will be required from the common wealth council before the directors may take action on them:

- issuing additional share capital;
- procuring other significant investments;
- selling assets worth more than a certain predetermined value;
- investing in or buying other businesses;
- amending the constitution of the common wealth council;
- paying dividends or interest to members;

- amending the terms and conditions of employees;
- approving budgets and business plans, with the proviso that the directors may proceed to implement a budget or business plan if in their opinion prolonged negotiations with the common wealth council could be damaging to the business.

The following table shows in which forum certain types of decision may be made. Where two forums are indicated, both must ratify a decision.

Table 7.1: Decision making in an equity-based co-operative

	BD	CWC	GM	IM
Amend the memorandum and articles of association (other than shareholders' rights)			✓	
Wind up the company			✓	
Amend the constitution of the common wealth council	✓	✓		
Sell major assets	✓	✓		
Amend the rights attached to investor-members' shares			✓	✓
Issue additional shares	✓	✓		
Adopt budgets and business plans	✓	(✓)		
Buy or invest in other businesses	✓	✓		
Set dividend and interest rates	✓	✓		
Decide the proportion of profits to go to reserves	✓	✓		
Approve directors' reports & accounts			✓	
Amend employees' terms & conditions	✓	✓		
Appoint and remove directors			✓	

BD = board of directors
CWC = common wealth council
GM = general meeting
IM = meeting of the investor-members

[1] ICOM. 1998. *Developing Social Enterprise – comparing policy and practice in five countries of the European Union*. ICOM.

Chapter 8: Next steps

> This chapter describes ten actions the co-operative sector should take to implement the ideas presented in the preceding chapters of this publication. Action 1 is to promote co-operation as an ethical business model. Action 2 is to promote social ownership as a defining feature of social enterprise. Action 3 is to develop new model rules for co-operatives. Action 4 is to encourage new-start co-operatives to use equity-based structures. Action 5 is to encourage established organisations to create new co-operatives. Action 6 is to promote new thinking among business service professionals about equity investment in co-operatives. Action 7 is to create a co-operative venture capital fund. Action 8 is to support the development of an ethical exchange. Action 9 is to promote new business opportunities in the financial services sector. Action 10 is to commission further research.

This publication sets out a radical agenda for the transformation of stakeholder relationships within co-operatives. It promotes a new approach to ethical investment and suggests new ways in which capital can be rewarded, valued and traded. This chapter describes the next steps. It lists ten actions the co-operative sector can take to drive this agenda forward.

1. Co-operation as an ethical business model

Chapter 1 showed that there are plenty of market opportunities for establishing new co-operative ventures based on an ethical business model. Chapter 2 underlined the importance of engaging all the stakeholders, including investors, in the development of co-operative enterprises. Stakeholders will have competing interests, but are united by their shared ethical values and principles.

Co-operation already has a strong ethical imperative. Any co-operative that applies to be a member of Co-operatives^{UK} or any other national co-operative body affiliated to the International Co-operative Alliance (ICA), must agree to uphold the ICA Statement on the Co-operative Identity. This statement commits all co-operatives to the ethical values of honesty, openness, social responsibility and caring for others, and it requires all co-operatives to be jointly owned and democratically controlled. Enabling ethical investors to invest and participate in co-operatives strengthens this principle of democratic social ownership by broadening the range of stakeholders to which co-operatives are accountable.

Ethical investment funds tend to focus on what businesses do and don’t do. So far, the ownership and control principles of businesses have not featured in the selection criteria of ethical investment funds, even though these principles determine what businesses do and don’t do. Ethical investors are beginning to realise that, as shareholders, they have a say in the policies and practices of the businesses they invest in. Shareholder activism is on the increase, but all too often fails because control is based on the principle of one-share-one-vote, concentrating power in the hands of a few large shareholders. Democratic social ownership offers ethical investors the opportunity to participate in the pursuit of a shared social purpose with other stakeholders.

There is an urgent need to promote the concept of social ownership to ethical investors and to explain how, as investors, they can participate in the development of co-operatives and other forms of social enterprise. Chapter 4 described how ethical investors use negative and positive screening criteria to select investment opportunities. Currently, none of the ethical indices use social ownership criteria in their positive screening measures. One obvious reason for this is the lack of opportunities for ethical investors to invest in socially owned enterprises. Creating investment opportunities for ethical investors must go hand in hand with a campaign to establish social ownership as a major ethical issue. Democracy, fairness and the rights of all stakeholders to influence enterprises in areas that directly affect them, must be key aspects of this campaign.

The Co-operative Bank has shown that it is possible to align co-operation with ethical values. The promotion of co-operatives as an ethical social brand is the responsibility of the whole co-operative movement, but especially that of the Co-operative Brand Panel, which has been established for just this purpose.

2. Social ownership

The aim of this publication is to develop new forms of multi-stakeholder relationships which reconcile the competing interests of employees, customers, suppliers and investors, in pursuit of a common purpose. These new forms are relevant not only to co-operatives but also to other forms of social enterprise that have similar values and principles to those of co-operatives. The co-operative sector has a leadership role to perform in the social enterprise sector, demonstrating how social and financial interests can be aligned in a business through the principle of social ownership.

Social ownership has four defining features. The most important of these features is open membership which determines who can participate in the ownership and control of the enterprise. The other three features are democratic member control, social equity in the use and distribution of profits, and the commitment to protect the common wealth of members.

The term ‘social enterprise’ lacks an agreed definition that binds it to a particular set of values and principles. It encompasses a broad spectrum of organisational models, including co-operatives, development trusts and social firms. Most promoters of social enterprise, including the Social Enterprise Coalition[1], say that social ownership is an important characteristic of social enterprise; but this is not always reflected in the legal formats of social enterprises. The proposed regulations for Community Interest Companies (CICs) contain some of the features of social ownership, but do not require CICs to have a defined and open membership structure.

Not all forms of social enterprise have embraced social ownership. At one end of the social enterprise spectrum there are businesses that have adopted a private ownership model. They use a plc structure to issue ordinary share capital that operates on a one-share-one-vote basis. There are no restrictions on the distribution of profits or residual assets to shareholders, and there is nothing to prevent the accumulation of the majority of the shares in the hands of a minority or even a single person or entity.

Co-operatives^UK should encourage further debate about the definition of social enterprise and work with other national social enterprise bodies such as the Social Enterprise Coalition, the Development Trust Association, Social Firms UK and the DTI Social Enterprise Unit, to establish a definition of social enterprise that incorporates social ownership. A distinction should be made between social enterprises that have social ownership structures, and ethical or social businesses that have private ownership structures.

3. New model rules for co-operatives

Co-operatives^UK should develop and promote model rules for new co-operative ventures based on the ideas presented in this book. It needs to develop models for each of the main legal formats including IPSA (the Industrial and Provident Societies Acts), the Companies Acts and the new CICs, taking into account the developmental issues outlined below.

Some co-operatives already issue share capital using models of democratic employee-ownership, customer-ownership or supplier-ownership based on IPSA legislation. If these types of co-operatives want to raise capital from external investors, they should know how to make the transition from one legal form to another. The new legal form should distinguish between the ownership rights of the primary members–workers, customers or suppliers – and the ownership rights granted to external investors. If the primary members are to continue to be investors in their own co-operative then it is important to ensure parity in financial rewards with external investors and, at the same time, not allow primary members to use their voting powers to favour their own financial interests over those of external investors.

Chapter 7 put forward the case for using the Companies Acts to incorporate new co-operatives, arguing that this legislation is far more flexible and adaptable than IPSA. However, IPSA legislation and regulation are being modernised, with the introduction of new legislation to protect the principle of mutuality and the transfer of regulatory powers to the FSA (Financial Services Authority). It is important to continue this process of modernisation by exploring with the FSA how equity structures can be developed within IPS (Industrial and Provident Society) co-operatives. Four modernisation proposals should be considered: the introduction of different classes of shares, the power to issue transferable investor-only shares, changes to the limitations on the scale of dividends, and the raising or removal of the £20,000 upper limit on shareholdings.

Similar issues affect the development of CICs. The proposed regulations allow social enterprises to be incorporated as companies limited by shares, with shareholders investing capital in the enterprise. The regulations provide an asset lock, which is similar to the principle of common wealth. The proposed regulations will also introduce a ceiling to the dividends paid on share capital, which may severely restrict the appreciation rights of external investors. A better alternative to this might be to place a limit on the proportion of profits that can be distributed to shareholders. This would encourage greater reinvestment of profits in the enterprise and improve the appreciation rights of investors, assuming that the shares held by investors can be traded on a secondary market.

4. Equity-based structures for new-start co-operatives

Big ideas, such as the proposal to create an ethical exchange, can distract attention from the starting points for stimulating demand for co-operative capital, which begin with the birth of new co-operative ventures. Initial public offerings (IPOs) and floatation on an ethical exchange are more suitable for expanding co-operatives. Co-operatives are far more likely to adopt this development route if they embrace equity-based structures at birth, because the founding investors will eventually want an exit route, which an ethical exchange would provide. The hypothetical example in Appendix 2 demonstrates how this might work when a team of worker-entrepreneurs creates a co-operative. Other founders could be corporate bodies such as charities, voluntary organisations and co-operatives. If the founders have equity stakes in their new ventures they will welcome the introduction of external equity investors at a later stage, because it will enable them to sell their investment without threatening the internal capital base of the co-operative.

Co-operative development bodies have a major role to play in promoting equity-based structures to entrepreneurs and organisations creating new co-operative ventures. They need to be experts in equity-based financial and legal structures and know the best local sources of professional services. They should act as conduits to CDFIs, co-operative business angels, The Co-operative Bank and other social banks, helping new-starts to construct appropriate funding packages.

CDFIs should be encouraged to invest a mix of debt and equity in co-operatives and social enterprises. Co-operative Action should solicit the support of the Community Development Finance Association (CDFA) for the principle of investing equity finance in fledgling social enterprises. ICOF, as the principal CDFI for co-operatives, should take the lead in this area by developing a co-operative equity investment fund.

Several bodies, including the Bank of England, the DTI Social Enterprise Unit and the Social Enterprise Coalition, have suggested establishing a network of social business angels, but no work has yet been done to find out what the true potential of this idea may be. Social business angels could be important supporters of equity-based structures for new-start co-operatives.

5. The role of established organisations in creating new co-operatives

There is a tendency to assume that most new enterprises are created by entrepreneurs. Chapter 1 highlighted four other starting points for new co-operative ventures which, taken together, represent far more fruitful territory for high growth ventures. Three of these starting points could be rich sources of such ventures.

Older, established co-operatives should create and invest in new co-operative ventures. Chapter 2 describes a managerial approach to establishing new co-operatives which consists of older, established co-operatives acting as lead investors in the creation of spin-off co-operatives. These spin-offs would benefit from access to the customer base and from the expertise of their parent co-operative. They could attract other partners and investors, reducing the risk exposure of the parent co-operatives.

Many organisations in the voluntary and charity sector that obtain most of their income from trading would benefit from equity investment. Chapter 1 described how housing associations, many of which are heavily debt financed, also receive capital grant funding from the government which would be jeopardised by the introduction of private equity capital, whereas co-operative capital, provided by ethical investors, might not jeopardise government investment, especially if social ownership principles are in place. Further research is necessary to establish how voluntary and charity organisations could be converted into co-operatives.

The government is committed to modernising public services. Chapter 1 noted that many local authorities have already converted their leisure services departments into co-operatives or other forms of social enterprises. Opportunities exist in many other sectors of public service where the co-operative advantage of enjoying high levels of public trust is important. The introduction of co-operative capital to finance these new initiatives, raised through local or sub-regional co-operative capital funds, could result in a new form of local stakeholder involvement.

Co-operative Action and Co-operatives^UK should develop a promotional campaign targeted at established co-operatives, voluntary and charity organisations, and local public services, to raise awareness about the concept of co-operative capital, the importance of social ownership and the practicalities of establishing new co-operative ventures incorporating these ideas. The regional development agencies and their counterparts in Scotland, Wales and Northern Ireland, could be effective partners in such a campaign.

6. Promoting new thinking among business services professionals

Professional business services providers such as accountants, Business Link advisers, bankers, consultants, lawyers, investment managers and corporate finance experts have a vital role to play in the dissemination of new business models to their clients. Many of these professionals are already aware of the growing importance of ethical issues in society, and will welcome the opportunity to explore and develop new forms of ethical equity investment in business. The Co-operative Bank could contribute to a promotional campaign targeted at the professional business services community. The campaign should target professionals that already provide business services to established co-operatives, voluntary and charity organisations, and the public sector. It might also be possible to develop joint promotional events aimed at professional business services providers and their clients, focusing on practical examples of how they can develop new ventures together.

7. A co-operative venture capital fund

Chapter 5 identified a range of investment vehicles that could be developed for co-operatives. The most important of these vehicles at this stage in the development of the field, is the co-operative venture capital fund. Such a fund would act as a powerful catalyst, encouraging other investors, especially founders, entrepreneurs, co-operative business angels and CDFIs, to acquire equity in new-start and early stage co-operative ventures, and as a consequence, improve the birth rate of co-operatives.

The government has already supported the creation of nine regional venture capital funds in England and the creation of Bridges Community Ventures (BCV), the UK's first community development venture capital company. These funds each have about £25 million to invest in small firms with growth potential. The government has provided half of the money for these funds on a subordinated basis to encourage the private sector to provide the other half. With the exception of the BCV fund, these funds are under the control of the regional development agencies in England, which sub-contract fund management to specialists in this field. In order to stimulate demand for regional venture capital funds, the government has also supported the development of the Early Growth Fund in each English region.

Up until now BCV has promoted enterprise in communities rather than community enterprise by focusing on private sector firms operating in disadvantaged communities. It has recently launched an exploratory study into the development of equity-like capital for social ventures, which it defines as revenue-generating social enterprises or for-profit socially driven businesses[2].

The co-operative sector, including Co-operatives[UK], ICOF, The Co-operative Bank, the Wales Co-operative Centre and the Co-operative Party, should seek the support of government to develop a co-operative venture capital fund with a launch size of the fund should be in the region of £20 million. This fund should be used for investing in established high-growth co-operatives. Fund management could be sub-contracted to an organisation with experience in investing in co-operatives. The fund should be able to lever in investment from other sources. It will be important to build relationships with the regional venture capital funds and BCV, as well as other social or ethical venture capital funds that may have an interest in co-operatives and social enterprises.

8. An ethical exchange

The development of a secondary market for co-operative capital is essential for the long-term future of this field. It would be extremely difficult to persuade investors to purchase non-withdrawable capital without an established secondary market. An ethical exchange will act as a beacon for ethical investors and ethical businesses alike.

Chapter 3 noted that Triodos Bank has already started to develop an ethical exchange service. It currently has four members: Cafédirect, the Ethical Property Company, Golden Lane Housing and the Triodos Renewable Energy Fund. All trades are conducted on a matched bargain basis, with Triodos Bank acting as an intermediary in the transaction. The brokers Brewin Dolphin provides a similar service for Traidcraft.

Chapter 6 set out in detail what is involved in developing a secondary market. It proposed a set of ethical criteria for enterprises wishing to be listed on an ethical exchange. These criteria cover financial, social and environmental aspects of the enterprise, but not how the enterprise is owned and controlled. Careful consideration must be given to all these criteria. There is a very strong case for including elements of social ownership in the criteria, which would limit the liquidation, voting and income rights of investors. However, if such criteria are mandatory, it could deter some ethical businesses from joining the exchange and limit the appeal of the market to some investors. A better approach might be to develop an ethical exchange with a selection of criteria addressing different ethical issues.

9. New financial services business opportunities

The development of equity-based investment for co-operatives and social enterprises will create a range of new business opportunities in the financial services sector. These include opportunities to create an ethical exchange and a co-operative venture capital fund, which have already been described in this chapter, as well as the opportunities described below. Co-operative development bodies and new and established co-operatives should be encouraged to take up these new opportunities.

Relationship brokers: Co-operatives and social enterprises that achieve early stage growth but are not ready to be launched on an ethical exchange, need to form relationships with individual and corporate investors, including co-operative business angels, venture capital funds, investment trusts, and other co-operatives and social enterprises. Relationship brokers would specialise in building networks of investors and professional advisers who can support high growth co-operatives. First Tuesday is an example of this type of service in the private sector.

Training services: There is a need to educate co-operative business advisers, entrepreneurs, managers and directors in the legal and financial processes involved in designing equity-based financial structures. Initially, the training should focus on the broader vision of co-operative capital, helping practitioners understand how equity finance is able to enhance the values and principles of co-operation. In the longer term there will be a demand for training in the governance and management skills required by co-operatives with external investor members. The Co-operative College is well placed to provide such services.

IPO sponsors/advisers: Undertaking an initial public offering (IPO) of equity is a highly specialised activity, especially if it is an IPO of equity in a co-operative or social enterprise designed to attract a large number of small investors. An IPO calls for the co-ordination of a range of services including those of corporate lawyers, reporting accountants, share registrars, brokers and financial public relations advisers.

Share registration services: This is an essential service for all enterprises making a public offering of shares. Services include the data processing of applications in IPOs, the creation and maintenance of a register of shareholders, the registration and certification of share transfers, the dispatch of share dividends, annual reports and AGM invitations, and the management of polling arrangements.

Ethical investment co-operatives: There are already a number of financial services co-operatives in the UK which provide advice to individuals on ethical opportunities for savings, investment and pensions. There is an opportunity to extend this work by forming investment clubs or co-operatives that focus exclusively on the co-operative and social enterprise sectors.

Research and media services: If investment in co-operatives and social enterprises is to develop a presence in the ethical investment field it will need to raise its profile in the media. Institutional investors expect enterprises to provide them with price sensitive news and often employ analysts to monitor the performance of enterprises in order to assist with investment decisions. There could be opportunities for researchers to provide this information on an independent basis.

Co-operative investment funds: In the longer term there may be the scope to develop co-operative investment funds that invest in a range of co-operatives and social enterprises. These funds could specialise in specific trade sectors such as affordable housing, or in selected communities, localities or sub-regions. Other options include funds that focus on shares traded on the ethical exchange, and tracker funds which spread investment across all the enterprises listed on the exchange.

10. Further research

A publication of this nature inevitably raises many important issues that are simply beyond its scope and resources to investigate, develop or resolve. Chief amongst these are the implications for the governance of co-operative ventures, viewed from the perspective of non-investor stakeholders. Co-operativesUK is already engaged in a major review of co-operative governance. A future review should include the development of functional governance models for multi-stakeholder co-operatives with secondary member investors, drawing on the lessons to be learned from co-operatives in other countries where equity-based models have already been developed.

Another important issue requiring further research is the tax treatment of equity investment in co-operatives and social enterprises. This is a complex area which involves many different schemes and initiatives including Venture Capital Trusts, the Share Incentive Plan, Community Investment Tax Relief, the Enterprise Investment Scheme, the Corporate Venturing Scheme and Enterprise Management Incentives.

Taking the next steps

Co-operativesUK is responsible for promoting the growth and development of the co-operative sector. It has close links with co-operative development bodies throughout the country, which help new and established ventures to adopt the principles and practices of co-operation. Clearly there are resource implications, but Co-operativesUK and others in the sector should work together to establish a new way forward for co-operative development based on the ideas in this publication.

However, it is the estimated 9 million co-operative members in the UK[3] that have the biggest part to play in moving these ideas forward. By embracing new forms of co-operation that incorporate investor interests, the UK co-operative sector can demonstrate that it is committed to radical new manifestations of co-operative principles.

[1] Social Enterprise Coalition. 2004. *What is social enterprise?* <<www.socialenterprise.org.uk>> Accessed 26 July 2004.
[2] Bridges Community Ventures. 2004. *Exploratory study: Equity-like capital for social ventures*. Research summary circulated by BCV, June 2004.
[3] ICA. *ICA membership statistics, 1998*. <<www.ica.coop/statistics>> Accessed 16 July 2004.

Appendix 1: The ICA statement on the co-operative identity

Taken from : Ian MacPherson, Co-operative Principles for the 21^{st} Century (Geneva: International Co-operative Alliance, 1996). Adopted at the 1995 ICA Centennial Congress in Manchester, England.

Definition
A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

Values
Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.

Principles
The co-operative principles are guidelines by which co-operatives put their values into practice.

First Principle: Voluntary and Open Membership
Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.

Second Principle: Democratic Member Control
Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives, members have equal voting rights (one member, one vote) and co-operatives at other levels are also organized in a democratic manner.

Third Principle: Member Economic Participation
Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

Fourth Principle: Autonomy and Independence
Co-operatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

Fifth Principle: Education, Training, and Information
Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of co-operation.

Sixth Principle: Co-operation among Co-operatives
Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional, and international structures.

Seventh Principle: Concern for Community
Co-operatives work for the sustainable development of their communities through policies approved by their members.

Appendix 2: ABC Co-operative: A hypothetical investment case history

ABC Co-operative is a workers' co-operative with four founder members. It is registered under the Companies Acts using a model constitution prepared by Co-operatives[UK]. Each member invested £1,000 in return for a 25% capital stake, issued in the form of 1,000 £1 shares. The shares were transferable, but carried no voting rights. It borrowed £50,000 at 6% interest from a CDFI for six years, with a capital repayment holiday until year three. When the co-operative was launched it produced the following projections:

ABC Co-operative	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6
Loans at year end	50	50	37.5	25	12.5	0
Profit before dividends and interest	-10	0	10	20	30	40
Interest	3	3	2.6	1.9	1.1	0.4
Dividend	0	0	0	0	0	0
Reinvested profit	-13	-3	7.4	18.1	28.9	39.6
Net assets	-9	-12	-4.6	13.5	42.4	72
Investor capital	4	4	4	4	4	4
Common wealth	-13	-16	-8.6	9.5	38.4	68

All figures are £'000s

The co-operative decided to expand in year four. It needed to raise an additional £250,000 capital and to recruit four more employees. It forecast that it would earn 10% return on the additional capital invested. A Co-operative Capital Fund agreed to buy 5,000 new shares at a premium price of £25 each. In return, ABC agreed to introduce annual dividends distributing 50% of its profits, with the remainder reinvested in the common wealth of the co-operative. The remaining £125,000 was borrowed from a CDFI at 6% interest over five years.

The deal with the Co-operative Capital Fund, which in year four owned the majority of the investor capital shares, netted a paper profit of £24,000 for each of the founder members, based on the new share value. The founders also received a profit share of £2,000 each, which was forecast to rise to £3,870 by year six.

ABC Co-operative	Yr 4	Yr 5	Yr 6
Loans at year end	150	120	90
Profit before dividends and interest	45	58	70
Interest	9	8	6.3
Dividend (50% of profit after interest)	18	25	31.8
Dividend per share	2.00	2.78	3.53
Reinvested profit	18	25	31.9
Net assets	138.4	163.4	195.3
Investor capital	129	129	129
Common wealth	9.4	34.4	66.3

All figures are £'000s

In year five it was agreed that the four new employee members should be offered 250 shares each at the original issue price of £1, in return for agreeing to establish an investors council, which would have veto rights over future share issues. This resulted in a small drop in the dividend payable per share.

ABC Co-operative	Yr 5	Yr 6
Loans at year end	120	90
Profit before dividends and interest	58	70
Interest	8	6.3
Dividend (50% of profit after interest)	25	31.8
Dividend per share	2.50	3.18
Reinvested profit	25	31.9
Net assets	164.4	195.3
Investor capital	130	130
Common wealth	34.4	66.3

All figures are £'000s

In year seven the investors' council supported proposals by the main board to launch a public share offering and list on a co-operative capital market with the aim of raising £5 million. 100,000 shares were to be issued at a premium price of £50 per share. A dividend forecast of £2 per share was made for the first four years, even though this meant reducing the proportion of reinvested profits. The return on capital was predicted to be 5% in year seven, rising by an additional 1% per annum for the next four years. The table below shows that by year 11 the co-operative would be able to reintroduce the 50% retained profit principle and increase the dividends paid on shares.

ABC Co-operative	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11
Loans at year end	90	60	30	0	0	0
Profit	70	256.5	314	372	438	512
Interest	6.3	4.5	2.7	1.4	0	0
Dividend	31.8	220	220	220	220	261
Dividend per share	3.18	2.00	2.00	2.00	2.00	2.37
Reinvested profit	31.9	32	91.3	150.6	218	261
Net assets	195.3	5,228.3	5,319.6	5,470.2	5,688.2	5,949.2
Investor capital	130	5,130	5,130	5,130	5,130	5,130
Common wealth	66.3	98.3	189.6	340.2	558.2	819.2

All figures are £'000s

In year ten the Co-operative Capital Fund decided to sell all 5,000 shares for a market price of £50 per share. It calculated that for an initial investment of £125,000 it would receive a total income of £328,400, or a net gain of £203,400, representing an internal rate of return of 22%. This was better than its own forecast of 20% internal rate of return. The income would more than compensate the Fund for the cost of developing the co-operative.

Two of the four founder members left ABC in order to launch another co-operative. They both sold half of their shareholdings in ABC, raising £25,000 each, which they invested in their new co-operative.

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To be supplied.