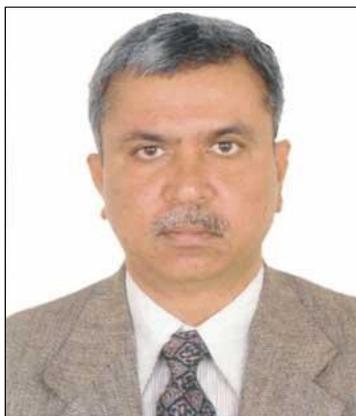


# Financial Inclusion in Capital Markets: Challenges and Opportunities for Producer Companies



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## Abstract

In recent times, there has been a major thrust on financial inclusion. Starting with Self Help Groups (SHGs) and the SHG-Bank linkage model, it has moved to Micro Finance Institutions (MFIs), NBFCs, and now small finance banks. The poor have been recipients of loans. But is there an opportunity today to include them not merely as customers for loans, but also as owners or shareholders and participants in the capital markets? Beyond that, can the

marginalized become significant players in this market – not merely as investors in the stock market, but as promoters and owners of business? What does International experience tell us about this type of initiative?

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

## Introduction

The Companies Act 1956 was amended to add a new chapter titled 'Producer Company' under Part IX, Section 581 in 2002. This section has been retained as it is in the 2013 Act. Producer Companies are essentially cooperatives and this new section allowed genuine member owned businesses to be set up anywhere in the

country. Cooperatives under various State laws suffer from Government and political control, as well as various restrictive regulations, and are usually not viable. Primary producers, including farmers, fishermen, those in animal husbandry and poultry, craftsmen and so on can now form a company without this interference. Producer Companies can enable such primary producers to significantly increase their incomes.

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

India has one in the Fortune 500, namely IFFCO, which is run by Government appointed officers with little or no member participation. It enjoys subsidy as well. The Gujarat Cooperative Milk Marketing Federation (GCMMF), the flagship cooperative network in India with the AMUL brand, has a turnover of around \$4 billion. With 32 lakh members it has the largest membership base in the world. This is a genuine farmer owned and farmer run cooperative giving significant benefits for decades to dairy farmers. It passes on about 85% of sales to farmer-members, which an investor owned company cannot.

The potential for Producer Companies is immense. Operation Flood raised 1.5 crore dairy farmers to prosperity and converted India into the world's largest producer of milk. This kind of potential exists in the agriculture sector where India has even more farmers than in the dairy sector.

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

### **Challenges for Producer companies**

What is a Producer Company? It has primary producers as shareholders, typically farmers, artisans, fishermen, poultry breeders and so on. As per law, in a farmer producer company, only farmers who supply their agriculture produce to the company are shareholders. Passive investors who can provide capital are not allowed by Law to invest or buy shares. A Producer Company's shares cannot be listed on the share market. The Producer Company in reality is a Cooperative disguised as a Company (without the regulations and control that Cooperatives suffer from in India), and the restrictions on outside capital and on listing in the share markets in fact follow traditional best International practice.

The primary reason for permitting Producer Companies was to allow producers in States that do not have a progressive Cooperative Law to register as a Producer Company. Since Cooperatives are a State subject in our Constitution, the Producer Company section was inserted in the Company's Act which is under the Central Government. The logic for not allowing outside capital is that with only outside investors, the entire profits go to the investor and the farmer merely gets the value of the raw produce. Since the gap between farm gate prices and the retail value of many food products is well over 500% and in many cases over 1000%, it is felt that outside investors with more capital will take over the Producer Companies and enjoy all the profits as well as any wealth increase due to capital gains. This was precisely the logic that was used in Western democracies when they framed laws for Cooperatives.

However, small farmers do not have adequate capital to set up really competitive Producer Companies. Outside capital is not accessible. Also investors do not have an exit option since the shares are not allowed to be listed in capital markets, and no IPO is possible.

Beyond share capital, other financing is also crucial for the agriculture and food business. It is important to understand one specific characteristic of the Food Processing business. Let us look at the top companies listed on BSE and NSE that process rice, dal, wheat and edible oils. Many are high debt companies with average debt equity ratio on average of 204% in the 5 years between 2010-11 and 2014-15. The result is that the interest costs are much higher than PAT, with the ratio of interest to PAT being 191.6%. Most of it is short term borrowing. They have to purchase their raw material from primary producers and pay cash up front. When selling their products, they have to give credit to the trade. In spite of this, the ROCE averaged 12% in the last 5 years

and 12.77% in the last 3 years. The lesson for Producer Companies is that they not only need share capital, but more than twice that amount in loans.

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

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

How did NDDDB succeed in setting up a \$4 billion company like AMUL without raising funds from the share market? They had a corpus of about Rs.2800 crores obtained through grants. The District Milk Cooperative Unions received loans from NDDDB for setting up dairy plants. The Dairy Unions neither raised significant share capital nor went to Banks for loans. Only small token amounts were raised as share capital from farmers. Unlike crop based commodities, the working capital cycle for milk is very short as it is sold and consumed daily. So working capital needs are also much lower. Today's Producer Companies do not have the big corpus that NDDDB had. Agri-commodity processing and marketing of rice, wheat, dals and edible oil has longer working capital cycles. The lack of capital is one major reason for the lack of growth of Producer companies in India.

### **Lessons from Other Countries**

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

are also given on amount paid in dividends in Cyprus, UK, Sweden and Finland, and on profits derived from transactions, as well as on trading where taxes are reduced by 95% in Spain [2].

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

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

### **A way forward**

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

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

To start with we can consider 70% ownership by farmers and 30% by outside investors. The company should also be allowed to go for an IPO at a suitable time. Later at some appropriate time, if the collective of farmers so choose, they can offload another 10% shares and get the benefits of capital gains.

However we need to go back to the startup phase of a Producer Company. Adequate share capital can eventually be put in by farmers into Producer Companies. But it will not all come in on day one before operations start. It will be built up over time, typically three to eight years, just as it was in the example of the food processing company described earlier. In regular start-ups, this is handled by treating early and later investors slightly differently, where the former get shares at much lower prices before the IPO. Later investors have to buy at much higher values – often several multiples of the face value. This recognizes the fact that the company's value has gone up significantly. This facility needs to be incorporated into the Producer Company as well. This should be for both classes of investors. A provision to allow the Company to buy back shares from outside investors at a later date on a mutually negotiated price could be considered.

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

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

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

### **Where is the money?**

Where is the money for the poor? Is it in loans taken from NBFCs at 24% to 30%? Is it in traditional cooperatives?

Is it in the Producer Companies? Is it in profits as is the case in AMUL and other successful farmer owned companies or cooperatives? Or is it in wealth creation through capital markets?

Let us compare profits and capital gains in the food industry. Investopedia says "In May 2015, the P/E ratio for food and beverage companies with positive earnings ranged from 2.7 to 1,124 and the average ratio was 51.8."<sup>2</sup> In the US, the Food Processing sector has a PE ratio of about 32.<sup>3</sup> In India it is about 44, with a dividend yield of 0.36%.<sup>4</sup> So Producer Companies, if they do as well as professionally run listed food processing companies will get very little in terms of dividend.

Investopedia says "In May 2015, the profit margin for companies in the food and beverage sector ranged from -24.1% to 24%. The average profit margin was 5.2%.<sup>5</sup> In the US it is about 11.6%.<sup>6</sup> In India it is about 8% for the top companies and less for others.

In short, when we compare the profits to the P/E ratios, it is clear that the money is in wealth creation through capital gains rather than through profits. So in a Producer Company, farmers no doubt are better off, but the real money is in the capital markets. To put a number to it, AMUL's gross margin is about 20% and its net margin is not a good measure. That's because AMUL pays a higher procurement price to farmer-members, and this shows much lower net profits. On a comparable basis, if we take a net profit margin of 8%, AMUL would have had a market cap of about Rs.89,000 crores. Nestle with one third the sales and similar margins has a market cap of Rs.63,000 crores – in that sense the Amul estimated market cap is very conservative. If 30% of the shares are allowed to be off loaded into the capital markets, the value is about Rs.26,000 crores, or the annual turnover. That would more than double their current reserves of around Rs.10,000 crores. (It is important to note that Amul does not increase its reserves and surpluses through retained earnings beyond what is required as it is better to give much higher benefits to farmers on a year to year basis). Meanwhile the farmer income is about Rs.23,00 crores from the milk purchases by AMUL from its members.

The Amul financial analysis is at best approximate. But it illustrates a very important point: how to make small producers partners in wealth creation. That goes beyond being customers of microfinance loans or the owners of dairy cooperatives or Producer Companies. While there are benefits in the latter, the real money is in wealth creation through capital markets.

### **An Innovative Example**

A recent start up called India Farm Foods (IFF) Private Limited (see [www.farmveda.in](http://www.farmveda.in)) was set up with social investors getting preference equity shares at 0.1% dividend on face value. In essence it is free capital for a private limited company. The investors' motivation is to create an economic engine that provides profits to farmers in perpetuity rather than give annual grants that are spent on charity. In the medium to long term, the

farmers' organizations will buy shares in IFF. That either provides an exit option to the investors or in case they decide to write it off, a cushion of reserves for the company to grow further. Since this is a start-up, the jury is out on how much wealth it will create.

### **Beyond Producers**

Large number of the poor are wage earners – rural landless so called "unskilled labour", drivers, cooks and so on. Today there are organizations of rural wage earners, most recently set up in Raichur District of Karnataka with over 1.5 lakh members and several crores in savings. They have a rural cooperative Bank. An earlier one is there in Maharashtra, and there is the well-known SEWA Bank. These were created by aggregating small savings of a large number of people.

Even here a judicious mix of people's savings-capital combined with outside capital can create wealth for the poor. With NBFCs having PE ratios of well over 15, and a few with ratios of over 25, the potential for creating wealth is there.

### **Conclusions**

The capital markets have recently introduced IPOs for start-ups with various checks and balances. A similar innovative approach is needed for Producer Companies as well. The concept of social investing is vital. Such shares can generate decent returns for investors. A more detailed study is required to give a plan for the growth of Producer Companies using share markets. For most farmers, farming is a low margin, risky business. Producer companies can however raise incomes by 25% to 75% year on year, depending on the crop and prevailing prices. At a time when the nation is debating the Land Acquisition Bill, we need to look for alternate ways to benefit farmers. Enabling Producer companies to access capital markets is one way. It will require small changes in the law. Appropriate package of incentives will give it a further boost. – not so much that the incentives become the primary reason for financial success, but enough so that the usual risks of business are overcome. There is much to learn from the start-up environment with respect to financial incentives.

It is important to note that though small producers and the poor may not have the managerial talent to run businesses, neither does the average shareholder in capital markets know how to run large corporations. Professional managers run the companies, and same will have to be true in this case as well. Amul is certainly the biggest example of how this is done.

A kick start is required to integrate small producers and the poor into financial markets. Amul and its associated partner, NDDDB got a corpus of nearly Rs.3000 crores as grants and succeeded. Since that kind of money may or may not be available, a similar leg-up is required for small producers beyond the dairy sector as well as for wage earners. Allowing them to partner with outside capital to create businesses where the small members retain majority control is just one way forward we have explored

here. The benefits to the poor – the major focus of financial inclusion, then progresses from the poor-as-loan customers (Micro finance), to the poor as owners (Producer Companies) to the poor as partners in wealth

creation. The potential benefits to about 30 crore people living below the poverty line are tremendous – as well as to the nation as a whole.

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