National Co+op Grocers

LEADer

Spring 2015 • Issue 27

Leadership Education and Development Newsletter

A publication designed to promote visionary and forward-thinking discussions between and among the leadership of NCG co-ops

A Study Guide for Co-op Leaders

A Deeper Dive into Co-op Finances

IN THIS ISSUE

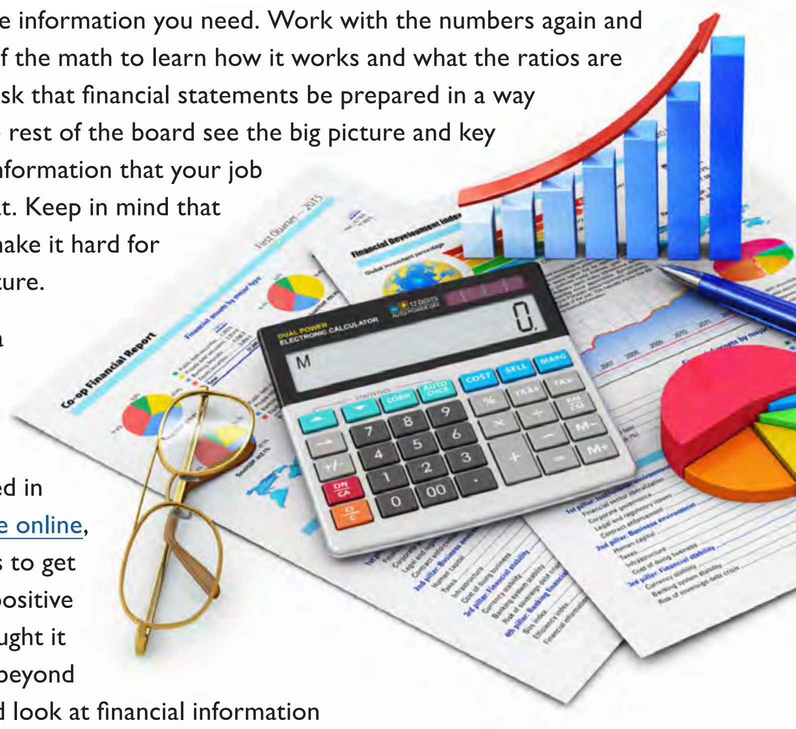
STUDY GUIDE

A Deeper Dive into Co-op Finances

Financial statements offer a wealth of information. Yet all too often, board members find statements intimidating. The formatting can vary; the terminology can be overwhelming. And not all of us have confidence with numbers.

But we're here to say: Don't be intimidated! Financial statements are simply reports showing the co-op's financial status at a particular point in time. Taken in doses and framed within the kinds of questions that good directors need to have answers for, the information is there for you to see.

Break it down into terms you can understand; relate the statements to your own life and finances. If you don't understand something, ask for an explanation, and keep asking until you get the information you need. Work with the numbers again and again; even do some of the math to learn how it works and what the ratios are showing. Most of all, ask that financial statements be prepared in a way that helps you and the rest of the board see the big picture and key trends—the type of information that your job requires you to look at. Keep in mind that too much detail will make it hard for you to see the big picture.



In this issue, we take a deeper dive into key financial analysis. Our first issue about financials was published in Winter 2010. Available online, the material continues to get lots of attention and positive comments, so we thought it might be useful to go beyond the beginning level and look at financial information a little more deeply. Here we offer an article about quartile reports, which some boards find helpful. We also offer articles about budgeting, cash flow, and developing a financial strategy for your co-op.

Also in this issue we introduce a new feature: a series called "Stronger Together." The articles deal with aspects of NCG that will be of interest to co-op directors. In our first article of the series, we explain NCG's system of risk management. Watch for something from NCG each issue, and let us know what topics you'd like to hear more about.

As always, we welcome your thoughts and experiences, as well as your suggestions on other topics or resources you'd like to learn about in the *LEADer.*

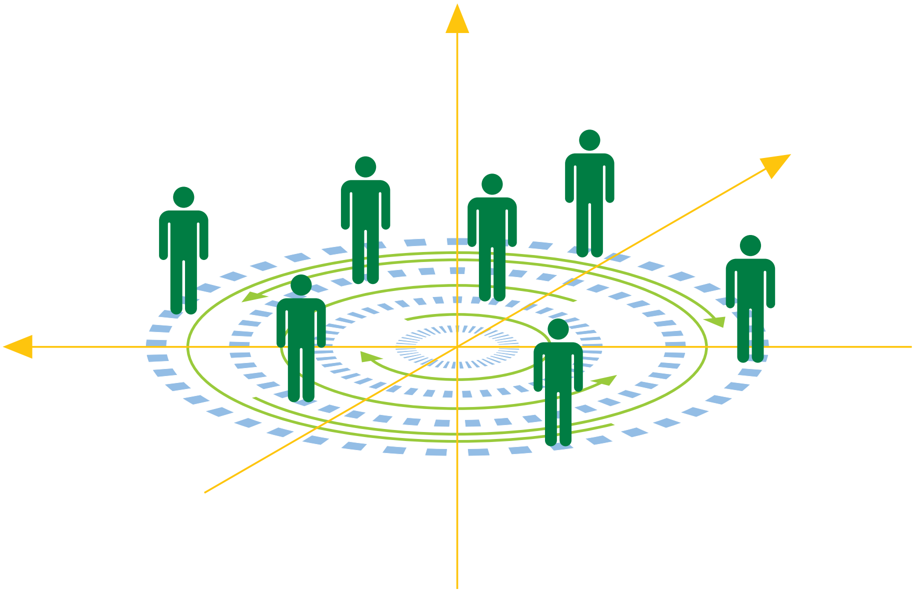
More about the LEADer

The *LEADer* is a quarterly study guide designed to foster visionary and forward-thinking discussions between and among co-op leaders. The *LEADer* is a publication of National Co+op Grocers (NCG; formerly National Cooperative Grocers Association) and strives to incorporate experiences and voices from all co-ops affiliated with NCG. Each issue is produced by the Board Effectiveness Support Team (BEST), a voluntary committee made up of board leaders and general managers from co-ops around the country. We welcome those who would like to join us in this project.

The *LEADer* is available to all interested co-op leaders. This issue and all back issues are available online. Those wishing to subscribe to the *LEADer* and have issues sent directly by e-mail as soon as they're available should contact Karen Zimbelman.

We welcome your reactions, suggestions, and contributions, as well as questions for us to answer in future issues. For more information about NCG, the *LEADer,* or the BEST, or to send along comments or questions, contact:

Karen Zimbelman
National Co+op Grocers
P.O. Box 399 · Arcata, CA 95518
866.709.2667—ext. 3150
karen.zimbelman@ncg.coop



Meet the BEST!

Board Effectiveness Support Team

Lucinda Berdon —
General Manager, Quincy Natural Foods (Quincy and Portola California)
gm@qnf.coop

Gail Graham —
General Manager, Mississippi Market Co-op (St. Paul, Minnesota)
gail@msmarket.coop

Paige Lettington —
Former Chair and Director, Sacramento Natural Foods Co-op (Sacramento, California)
paigelyn@comcast.net

Cindy Owings —
Former Chair and Director, Community Food Co-op (Bozeman, Montana)
petunias@3rivers.net

Marcia Shaw —
Consultant, Intentional Management (Corvallis, Oregon)
shawm@proaxis.com

Martha Whitman —
Vice President, La Montañita Co-op (Albuquerque, Santa Fe, and Gallup, New Mexico)
marthawhitman@comcast.net

Program Support

Karen Zimbelman —
Director of Membership and Cooperative Relations, NCG (Arcata, California)
karen.zimbelman@ncg.coop

Building a Member-Based Financial Strategy for the Co-op

by Paige Lettington

One of the board's most important jobs is strategic planning, and no plan is viable without a financial strategy to see it through. It's the board's job to look at where your co-op is going next and to work with your general manager to figure out how to get there. This work includes making short-term plans as well as envisioning long-term dreams. And, of course, your co-op's long-term dreams need member-owner support to come to fruition.

Every board inherits a financial situation. Yours may be difficult. Perhaps your co-op has had a setback, and you need to repay major debts, regroup, and determine how to rebuild equity. Maybe a recent expansion has financially stressed the co-op. Or perhaps your co-op has been doing well for several years without taking on a big project and is sitting on a big pile of cash and investments. Each situation requires strategic thinking.

As an individual, you might go into debt to invest in your future by buying a house. You might go into debt to buy a car if your current one is not meeting your needs. In the same way, sometimes the co-op needs to go into debt to make an investment in its future. As a board member, you may feel most comfortable when debt is low or nonexistent. Co-ops, as a reflection of their member-owners, tend to be conservative with finances. Your members might think it's better for the co-op to be debt-free than to take on a loan.

But taking risks and going into debt is generally a strong and sound business strategy and might be the path to better serving your membership. Co-ops often need to take on significant debt to improve their operations—perhaps for a relocation, to improve sustainability practices (with new coolers or solar power, for instance), or to offer new products or services, such as prepared foods or catering, requiring the addition of a production kitchen.

Your members are likely to be keenly interested in what you are doing with the co-op's money, so building member-owner awareness for an expensive project, especially if it involves debt, is essential. Even better is when the co-op uses member equity or member loans to build a base of capital that can be leveraged for a big improvement project.

The majority of member-owners will get behind projects if they are explained within the context of a bigger picture and vision. Here are some ways to get members on board with major projects and financing discussions:

- Clearly tie the project to short- or long-term goals that support the co-op's mission. For instance, if your goals involve sustainability, explain that investing in solar power or energy-efficient lighting and equipment will help the co-op reduce energy costs and the store's carbon footprint.
- Explain how the project will pay off in the long haul. For example, a remodel of the deli kitchen or the expansion of back-stock areas will likely increase staff efficiency while also reducing labor costs.

Co-ops that have strong member support can successfully raise funds for major improvement projects through member loans, through new-member drives, or by encouraging current members to complete their fair-share payments. Give your members a chance to live the "Stronger Together" motto by achieving something as a cooperative that they cannot achieve alone.

The Capital Budget: A Great Board Tool

by Lucinda Berdon

Forecasting the business needs of your co-op requires careful consideration by the board and management. A capital budget will outline and estimate your co-op's investments and plans for the next few years. It will identify upcoming capital expenses, such as an expansion, equipment upgrades, or standard equipment replacement. The capital budgeting process will help the board evaluate capital spending opportunities and will provide the board with information it needs to make important investment decisions. While they are never 100 percent accurate, capital budgets help directors and managers prioritize spending and evaluate essential improvement needs. Think of the capital budget as a guide to the future.

What's the difference between the operating budget and the capital budget? The operating budget involves single, day-to-day operational issues. It projects what the co-op's profit-and-loss statement will look like in the coming year.

In contrast, a capital budget involves two important decisions at once: what improvements and investments will be needed, and how will they be financed? We're talking about the big stuff here: fixtures and equipment, property, leasehold improvements, facilities improvements, acquiring assets, and building value to the business.

Comparing needs to long-term plans and business growth goals helps the board and management prioritize and plan for capital asset purchases. Our co-op lists all capital expenditures on a spreadsheet, with a five-year depreciation schedule and forecasts for the remaining useful life and replacement cost of each item. Attached to our capital budget is a sources-and-uses outline, which describes where the money will come from and how it's going to get used.

We then identify projects in order of priority. But prioritizing is not always cut and dried. For example, upgrading an IT infrastructure might involve a series of stages spanning months or years. Resetting the store may also happen in increments over months or years. Adding a new store may be a five-plus-year process.

Sometimes steps in the process are driven from the bottom up. For instance, our department managers often start the process by identifying a need. They might point out that a slow network and outdated computer equipment are creating inefficiencies. They would then make a capital expenditure request, which might later get inserted into the capital budget and evaluated.

When the board approves the capital budget, its takes two important steps. First, it empowers the GM to make investment and spending decisions within the context of the priorities of the entire budget. Second, it provides a larger context for planning what investments are needed and how those investments will be financed—whether via operations or via borrowing—to ensure that the co-op can afford them. Thus the GM won't need to consult with the board each time an expenditure comes up or an unforeseen opportunity arises.

Some boards require the GM to seek approval prior to spending anything over a designated amount, such as $5,000. This approach can slow down needed improvements, limit the co-op's ability to take advantage of unexpected opportunities, and trap the co-op in short-term thinking. Slow reaction time in the grocery business can be deadly. A good GM knows the business's needs and knows the benefits of specific investments, just as the GM is aware that selling off assets can strengthen the organization's position or situation.

The only way to know if you will have enough money to do what you want to do is to plan ahead for needed investments, study your capital reserve needs, and identify where the money will come from to meet those needs. Keep in mind that projects can run into delays and cost overruns. Also remember that screaming deals shouldn't be passed up. If you don't seize investment opportunities, you might regret it later.

Cash Is King: Reviewing Cash-Flow Statements

By Martha Whitman

To read your co-op's financial statements is to decipher different aspects of its financial health. The income statement, with its comparisons to budget, last year's numbers, and line items as a percentage of sales, tells us if the co-op is growing or shrinking, if the co-op is profitable or not, and if expenses are hitting industry standards. It provides data for the entire period covered, whether that's a month, quarter, or year.

The balance sheet is a snapshot of the co-op on a specific day (last day of the month, quarter, or year) and lists the dollar value of everything the co-op has—assets such as cash, inventory, and real property—along with a breakdown of how those assets were financed, whether by a bank, vendors (liabilities), or members (equity).

As the name suggests, the cash-flow statement focuses on cash and whether the co-op has enough money to pay bills and keep the doors open. The income statement shows noncash expenses such as depreciation and estimates of taxes due. Additionally, the income statement shows the equal allocation of some expenses through the year, even if one big check is written for the whole expense. The balance sheet reflects the cost value of assets but not necessarily the cash you would receive if you sold the assets. That is, the market value of your building or inventory might be quite different from the book value, and you won't know that until a transaction actually takes place. But the cash-flow statement is all about hard, cold cash. The dollars on the statement show the exact amount of cash coming into and going out of the co-op.

Here's the thing: It's possible to be profitable on paper but still fail due to a shortage of cash. It's also possible to be unprofitable yet to manage to pay the bills (at least for a while). The cash-flow statement explains how either situation can happen. Even if you aren't dealing with a financial crisis, you can still learn a lot about your co-op by understanding this statement. If the cash from operations is consistently greater than net income, then earnings are considered solid. But if cash from operations is consistently less than net income, you will want to know why net income is not turning into cash.

At this point it might be helpful to pull out one of your co-op's cash-flow statements and to follow along with our example. First, notice how the statement is organized. Generally, cash-flow statements are broken into three segments: cash from operations, cash from investments, and cash from financing. Notice how this information is presented. Cash from operations begins with the net income of the reporting period (in this example $4,164) and then adjusts for noncash expenses such as depreciation ($4,725). Further adjustments are made based on increases and decreases in various balance sheet accounts, such as inventory ($2,551), prepaid expenses (-$9,451), and accounts payable ($824). The resulting sum is the net cash provided by operations ($1,764).

The next section shows adjustments from investments, such as purchases of equipment (-$174), buildings, or property improvements. The final section, cash adjustments from financing, includes such things as principal payments of long-term debt (-$2,286) or funds received from a new loan. Again, activities that increase cash are listed as positive. Those that decrease cash are listed as negative.

The sum of these three segments results in a net increase or decrease of cash for the period. This amount is added to the total cash at the beginning of the reporting period ($107,825), resulting in the co-op's total cash at the end of the reporting period ($107,078). Your co-op's statement probably includes two more columns, "year to date" and "last year to date." For simplicity's sake, these column were excluded from this example.

With time, the cash-flow statement becomes easier to understand, and remember that you can focus on the trends rather than the details. Is the cash level consistently going up or down? Why? Have your general manager report the days-cash-on-hand ratio. It tells you how many days the co-op would be able to pay its bills if disaster were to strike and the co-op were to close. How does this ratio stack up against industry standards or your comfort level? Do you have too much cash? How well is your co-op leveraging its cash and member equity? All these questions make for great discussions and lead to a better understanding of what's possible for your co-op. Being able to review and analyze the co-op's financial statements is a duty of each board member. With practice, you might find the process interesting and empowering.

Sample Cash-Flow Statement

Statement of Cash Flows for Month Ending January 31, 2015		
Cash Flows from Operating Activities		
Net income		$4,164
Adjustments to net income	Depreciation	$4,725
(Increase) decrease in assets		
	Receivables	-$6,331
	Inventory	$2,551
	Prepaid expenses	-$9,451
Increase (decrease) in liabilities		
	Accounts payable	$824
	Accrued payroll payable	$5,570
	Payroll tax payable	-$340
	Gift certificates	$52
Total adjustments to net income		-$2,400
Net cash provided by operations		$1,764
Cash Flows from Investing Activities		
Purchases of equipment and improvements		-$174
Investment in vendor co-ops		-$50
Cash Flows from Financing Activities		
Principal payment, long-term debt		-$2,286
Net increase (decrease) in cash		-$746
Cash at beginning of month		$107,825
Cash at end of month		$107,079

How Are We Doing? Let's Look at the Numbers

by Gail Graham

If you haven't yet seen it, check our Winter 2010 issue called "Monitoring Financials." You'll find it packed with excellent information about finances for new directors. See, especially, the article called "Eight Key Financial Indicators for Co-op Boards," which distills the key numbers that boards need to pay attention to and gives a good explanation of why they matter.

The article refers to benchmarks that will help you evaluate your co-op's performance. Benchmarks also provide context by allowing you to compare your co-op's financial results to those of other co-ops. NCG makes this work easy for its member co-ops by publishing the semiannual *Trends Supplement Report*, which shows performance compared to key indicators. The report shows at least 12 quarters of information for participating stores. Your general manager has access to this information and can create a report for your review.

There are a number of ways to look at comparative data. As a general manager, one comparison I find particularly helpful is the "four-quarter identical-co-op rolling average." Looking at an average of data smooths out seasonal bumps. And in this case, expansions and new stores are considered in a different group, so those results don't distort the picture.

To understand a comparative report, board members need information on the baseline group. For example, note that in the fall of 2014, there were 117 co-ops in the "identical store" category. You'll want to further identify how many of these stores were in the same size category as your co-op. This information makes the comparison more meaningful.

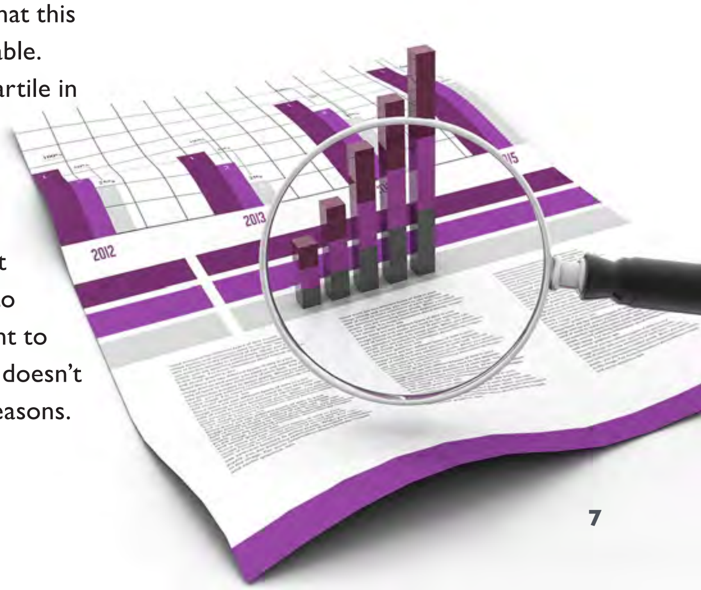
Board members have different levels of comfort when it comes to reviewing financial information. For most, it isn't part of their regular jobs. And if you are looking at reports only four times a year, you'll want a few paragraphs of background information. For example, you might need a reminder on the difference between quartile results and average results.

A quartile report provides comparisons of your co-op's data against the upper, middle, and lower quartiles. For instance, if you were comparing 100 co-ops and were to rank them all in terms of sales growth, the upper quartile would be marked by the growth rate achieved by the co-op in the 25th position (one-quarter below the best), and the lower quartile would be marked by the growth rate achieved by the co-op in the 75th position. When reviewing a quartile report, remember that this data is calculated on each variable. So the co-ops in the upper quartile in sales growth may not be the same as the co-ops in the upper quartile in gross margin.

Quartile results can help us set our sights on where we want to be. However, it's also important to remember that upper quartile doesn't always mean better, for two reasons. First, with some ratios, such as labor and operating expenses, the lower quartile reflects the more desirable result. And of course, a major limitation of quartile reports is that they give you a comparison to results from peers, not necessarily to best practices.

You'll find the quartile report for two anonymous co-ops in this issue's study guide. Use these samples to get to know this report and to practice reviewing its data. Then ask your GM for your own co-op's quartile report using selected financial indicators.

Some board members aren't comfortable reviewing financial statements. While it's incredibly valuable to have financial expertise on the board, all board members need to take responsibility for a basic understanding of the important numbers—the key indicators of the financial health of the co-op. Learning the basics and getting good, clear, simple explanations and good reports delivered regularly in a standardized fashion, with relevant background information, can help a board pay attention to what matters.



Stronger Together: Managing Risk within Our Co-op System

by Karen Zimbelman

NCG members participate in our national contract for product purchases from our primary distributor, United Natural Foods, Inc. (UNFI). One of the terms of that agreement is that NCG and its participating members share financial liability for payments of all co-ops' purchases from UNFI. In exchange, co-ops get preferred pricing, payment, and other terms.

This shared liability is managed by NCG at the corridor (regional) level. Each of the three corridors (eastern, central, and western) has a Risk Management Committee (RMC) that monitors financial performance and key indicators of all co-ops in the region to ensure continued financial health and to limit risk exposure by the rest of the corridor co-ops. The committees review key indicators and metrics on a quarterly basis to identify any potential risk based on negative trends. All participating member co-ops also deposit money into NCG's Joint Liability Fund (JLF), which serves as a self-insurance fund in the event of a payment default.

The corridor RMC has the authority to:

- Set the deposit rate, paid in as a percentage of average term payables due to UNFI by each co-op. The default rate for all participating co-ops is at least 8 percent, but it can be any amount above that up to 100 percent.
- Set payment terms—that is, how quickly the deposit requirement must be paid in to the JLF. The default is that JLF deposits are paid by the co-op within 6 or 12 months, depending on the situation. However, the RMC can ask for faster terms, including the requirement that funds are fully paid in before the co-op can start purchasing from UNFI on NCG's contract. (Payment up front, before purchasing from UNFI, is required of all start-up co-ops.)

In addition, an RMC can require that co-ops provide financial reports more often than quarterly. A committee can make this request with the primary purpose of encouraging and supporting operational improvements and to better support the co-op and its managers during times of change, volatility, or challenge. Corridor RMCs might require monthly reports for several reasons:

- **A Management Change.** If the co-op has a new GM or an interim manager, an RMC might want to review financial statements monthly for about a year or until it feels sufficiently familiar with the GM and is assured that the co-op's key indicators are stable or improving.
- **A New Co-op.** If a co-op has just joined NCG and is beginning to purchase goods as part of the national supply contract, an RMC might monitor its key indicators to ensure a successful adjustment to the contract's costs.
- **A Major Project or Expansion.** A major expansion or project often means increased debt, unusual and high expenses, volatile cash fluctuations, and increased risk, all necessitating RMC oversight.
- **Negative Trends.** If a co-op's financial indicators are trending in a negative direction, the RMC will closely monitor its financial statements to manage risk. NCG also provides a number of resources and tools to encourage improved financial performance.

The board will be notified by letter if a co-op goes on a corridor committee's "watch list." That's when the co-op must start submitting monthly financial reports. Such notification should never be read as a lack of faith in the co-op's management or ongoing viability. It just means that NCG is doing its best to actively manage risk and wants to be aware of the co-op's status at all times. In this way NCG can better know what resources would be helpful to the co-op and can help manage risk based on the most current information.

"Stronger Together" is a new series dealing with NCG topics that might be of interest to co-op directors. Send your questions or feedback about this issue's topic or suggestions for future topics to Karen Zimbelman.

STUDY GUIDE:
Financial Analysis Using a Quartile Report

by Karen Zimbelman and Cindy Owings

Notes:

Here's your chance to review a co-op's financial data and quartile comparisons. Keep in mind that it is impossible to know everything about a co-op's operations or financial status just from the numbers. The context of the co-op's operations is also important to understanding what the statements show. You must consider, for example:

- How long the co-op has been operating.
- How long it has been operating in its current location.
- How long it has been since a major expansion, relocation, or renovation.
- Market factors. For example, did a competitor recently open? How close is it to the co-op? What other competitors are operating in the market?
- Other factors that contribute to operations. For instance, did the co-op just open a new deli or renovate the store? Is parking limited? Does the co-op have extremely high sales per square foot?

In addition, it's often useful to know about trends in the key indicators being reviewed. For example, is sales growth up from the three prior quarters or trending downward? Finally, a board will want to know how current numbers compare to the co-op's projections (the budget). Is the co-op doing better or worse than expected?

Without the benefit of a lot of context or knowledge of any trends, try your hand at reviewing the sample quartile reports on the following pages. You'll see the co-op's data and the value for each indicator for the upper, median, and lower quartiles. Remember that upper, median, and lower quartile designations fluctuate in terms of their desirability. For instance, being in the upper quartile for sales growth is generally a positive factor, while being in the upper quartile for labor expense is generally a negative factor. Remember as well that the quartile scores are supplied by other co-ops in the designated peer, or comparison, group; they do not necessarily represent best or desired performance.

For each of the following financial statements, start by indicating whether the co-op's data is in the upper, median, or lower quartile for each of the key indicators listed. Then determine whether the co-op compares positively (better than) or negatively (worse than) to the peer group in those areas. Review your thoughts and responses with others on your board.

STUDY GUIDE:
Sample 1

Co-op A operates in a small town with no major natural foods competitors. A strong regional chain has been adding more natural and organic products at very attractive prices, but no new competition has entered the market in the last five years. Co-op A has somewhat limited parking and is operating at high capacity for its current store. Sales per square foot are significantly higher than desirable.

Date: **4Q14**
Companies: **Co-op A**
Company Size: **Medium–Large Natural Food Co-op Companies**

Co-op A		Upper Quartile Percent — Rolling	Median Percent — Rolling	Lower Quartile Percent — Rolling	Is this indicator in the upper, median, or lower quartile?	Generally, is this better or worse than the peer group?
Income statement						
Sales	7,800,663	8,240,667	7,271,790	6,616,320		
Sales growth	4.41%	13.77%	5.02%	-0.15%		
Gross margin	36.08%	39.17%	38.17%	36.08%		
Operating expenses	34.82%	38.63%	36.75%	34.55%		
Net income	1.73%	2.78%	1.96%	0.22%		
Balance sheet						
Cash	374,865	759,265	509,887	374,865		
Days cash on hand	17.94	40.16	22.56	17.94		
Total debt to equity	0.67	3.69	1.62	0.53		
Current ratio	3.50	2.88	2.17	1.44		

Start by filling in the answers in the two right-hand columns, indicating whether Co-op A's performance is in the upper, median, or lower quartile for each category and whether it is better or worse than its peer group. Then discuss the following with others on your board:

- ❑ What more would you like to know about Co-op A to better understand its financial position and status?
- ❑ Based just on the information provided, what are your primary concerns about Co-op A's financial performance?

Notes:

STUDY GUIDE:
Sample 2

Co-op B operates in a major metropolitan area with strong population growth. A big regional natural foods chain has opened several stores near the co-op and is aggressively pursuing a strategy for growth. The competitor features local products as well as a full line of natural and organic foods. It carries lots of featured fresh items (in the deli, produce, and meat/seafood departments), along with some household, body care, and conventional grocery products. The co-op operates out of a small retail space with some back stock stored on adjacent property.

Date: **4Q14**
Companies: **Co-op B**
Company Size: **Medium Natural Food Co-op Companies**

Co-op B		Upper Quartile Percent — Rolling	Median Percent — Rolling	Lower Quartile Percent — Rolling	Is this indicator in the upper, median, or lower quartile?	Generally, is this better or worse than the peer group?
Income statement						
Sales	5,524,231	5,524,231	5,215,640	4,864,366		
Sales growth	0.15%	11.00%	6.47%	2.35%		
Gross margin	36.04%	39.40%	37.75%	36.85%		
Operating expenses	37.21%	37.99%	37.21%	35.87%		
Net income	-0.64%	1.82%	1.24%	0.20%		
Balance sheet						
Cash	817,862	477,187	380,466	191,782		
Days cash on hand	59.17	39.81	20.42	14.99		
Total debt to equity	0.13	1.42	0.92	0.49		
Current ratio	4.79	3.51	1.97	1.75		

Start by filling in the answers in the two right-hand columns, indicating if Co-op B's performance is in the upper, median, or lower quartile for each category and whether it is better or worse than its peer group. Then discuss the following with others on your board:

- ❑ What more would you like to know about Co-op B to better understand its financial position and status?
- ❑ Based just on the information provided, what are your primary concerns about Co-op B's financial performance?

Notes: