# The Necessity of Reinvesting in the Co-op

As competition in the natural and organic market has intensified, one of the most difficult results has been the closing of several much-loved co-ops across the country. In 2016, GrassRoots Cooperative and East Lansing Food Co-op closed their doors. In 2017, three co-ops—Dubuque Food Co-op, Amazing Grains, and Good Earth Market—closed. Thus far in 2018, we've lost Company Shops Market and Harvest Co-op Markets. Although most co-ops are healthy, others continue to face significant challenges.

Co-ops are not alone; both independent natural foods stores and chain retailers have closed stores in markets across the country. Although store closings are not unique to co-ops, the loss of a co-op is painful for its entire community and a sobering event for our sector.

As we reflect on the co-ops that have closed and work to support those that are struggling, we've identified a few common factors contributing to poor performance. Chief among these is chronic underinvestment in the infrastructure of the physical plant—the building and equipment—sometimes going back decades. Our goal is to help co-ops understand the warning signs so they may recognize and respond to them earlier. We will address other common factors that can lead to a co-op's decline in future issues.

## Reinvestment is not optional

In the face of increased costs, declining sales growth, and the need to meet important financial obligations (interest from bank and member loans, for example), reinvesting is an easy expense to defer. After all, co-ops can work with old and worn equipment for quite a while before it fails entirely. While understandable, this reasoning has proven to be dangerous.

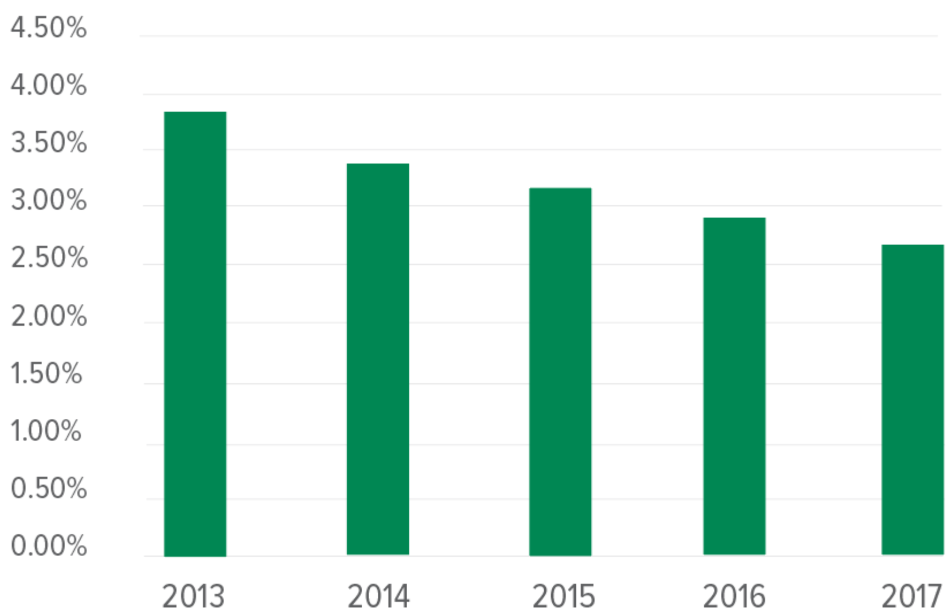
Often, the decision to forgo reinvestment isn't a decision at all; reinvestment simply isn't part of the co-op's culture unless it's unavoidable. For these co-ops, the prevailing sentiment is, "If it ain't broke, don't fix it."

**Key stakeholders—board, management, and staff—need to see reinvestment not just as a best practice, but as a vital aspect of the co-op's long-term viability.**

For other co-ops, underinvestment is the result of anxiety and uncertainty in the face of incoming competition. A common instinct when facing a competitive threat is to hunker down, conserving cash until the market improves. Unfortunately, as many co-ops have learned, the market rarely get easier. One incoming competitor is often followed by another, each one syphoning co-op shoppers and reducing basket size.

It is critical that all co-op stakeholders be aligned behind the belief that reinvestment in the operations and physical plant of the co-op isn't optional. It can be deferred, but often at the co-op's long-term peril. Underinvestment can become cyclical and fuel a downward spiral: sales declines often lead managers to defer needed improvements, which then exacerbates eroding sales. In facing significant sales declines—unless the co-op very carefully controls expenses—before long the co-op starts covering operating losses with equity that was built by prior earnings and investments. Once a co-op depletes its equity and cash reserves, it closes.

**Declining EBITDAP Percentage**
**Earnings Before Interest, Taxes, Depreciation, Amortization, and Patronage**



## Insufficient earnings

All businesses, whether conventional operations or co-ops, need to generate earnings. Earnings are often measured as EBITDAP: Earnings Before Interest, Taxes, Depreciation, Amortization, and Patronage. These are the funds remaining after the primary business expenses are accounted for, and must be sufficient to cover financial obligations. They should also be healthy enough to allow a business to both facilitate reinvestment and grow equity through retained earnings.

> **Co-ops that reinvest significantly in their stores before new competitors open can recover more quickly and with less impact to equity.**

Unfortunately, co-ops' system-wide EBITDAP has been declining since the emergence of the "new normal" market conditions in 2014. Between 2013 and 2017, NCG system-wide EBITDAP declined by more than a full percentage point. As of the 2nd quarter 2018, the downward trend continues, and national EBITDAP as a percent of sales is approaching just 2 percent. Each percentage point decline represents roughly $20 million per year that isn't available for co-op reinvestment

While EBITDAP performance will naturally vary somewhat among co-ops, on average we believe co-ops should be striving for at least 6 percent EBITDAP. This will allow most co-ops to generate adequate retained earnings and a net profit of 1–2 percent. In order to achieve this, most co-ops will need to generate 15 percent in margin minus labor (MML). The co-op system average for MML in 2017 was 13.4 percent.

The biggest barriers to improving MML and earnings are the continuing downward pressure on prices and continual increases to personnel costs. Many co-ops fail or struggle to implement the pricing strategies necessary to yield sufficient margin without worsening price perception. Some also struggle to control personnel costs in the face of declining sales.

If co-ops can't overcome these barriers, more will go into decline and may face closure in the years to come. Continued closures will impact all NCG co-ops—even the strong ones—as it will hinder our ability to leverage collective sales to secure lower costs and other benefits in the future.

## What can co-ops do?

Co-ops are wise to ensure key stakeholders—board, management, and staff—understand co-op finances and the need for reinvestment. Everyone needs to see reinvestment not just as a best practice, but as vital aspect of the co-op's long-term viability.

Both NCG and CDS Consulting Co-op offer resources to improve financial literacy for a variety of co-op stakeholders. Owners also need to understand the need for improvements, especially those that might disrupt their shopping experience. Co-ops should find ways to engage owners on specific changes and solicit input for future improvements.

Make sure financial goals allow for sufficient earnings. Growth in equity should be fueled mostly by retained earnings. If your co-op isn't budgeting to generate 4–6 percent EBITDAP, it is worth having a discussion about why and what the co-op can do to improve earnings.

Co-ops should generate a capital budget as part of a 3-year or 5-year budget cycle. Significant improvements should be built into long-range budget forecasts, so boards and staff can be aware of upcoming needs, anticipate how much improvements will cost, and how they will impact cash flow. NCG offers a multi-year operating budget template with projected income statements, balance sheets, and capital budgets. Users in co-ops report that the template is an effective tool without being too complicated or inaccessible to stakeholders.

Don't hunker down when facing new competition. Co-ops that reinvest significantly in their stores before new competitors open can recover more quickly and with less impact to equity.

Look for the signs of underinvestment:

- *Days of cash on hand*: NCG requires that co-ops maintain a floor of at least 10 days of cash on hand; however, having more than 30 days of cash on hand may signal that the co-op isn't reinvesting sufficiently.
- *Debt to Equity*: A low debt-to-equity ratio can be a sign that a co-op is under-leveraged and isn't adequately reinvesting in the business.
- *Depreciation*: Co-ops that report little or no depreciation are often due for reinvestment.

In challenging times, spending money may seem counterintuitive. However, reinvesting is necessary and is critical to co-ops' continued growth and success. •


PHOTO: Menomonie Market Food Co-op, Menomonie, Wisc.

Menomonie Market Food Co-op anticipated competition with a new store in 2015.