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## **South Dakota Soybean Processors Conversion Overview<sup>1</sup>**

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## Company Overview and History

**Organizational history.** South Dakota Soybean Processors (SDSP) converted from a co-op to an LLC on July 1, 2002 following a member vote on June 20, 2002 in which 94 percent of the votes cast favored the conversion. SDSP was first organized as a South Dakota new generation, or closed cooperative, in 1993. Over 2,100 members, primarily farmers in South Dakota and neighboring states, purchased stock during 1994-95. Members were required to purchase one share of stock for each bushel of soybeans that were to be delivered to the plant, with a minimum purchase of 2,500 shares. Each share purchased obligated the producer to deliver one bushel of soybeans annually. However, since not all of the equity shares (called equity units by SDSP) had been sold, producers were required to supply soybeans at some prorated rate. For example, in 2001, 14,129,250 shares had been sold, which would mean that only that many bushels were committed to the plant if the 1 share to 1 bushel ratio held. Instead, producers would supply 27 million bushels or about two bushels per share of stock.

Over nine million shares were sold originally, with an average investment of 10,000 shares per producer and an average price of \$2.19 per bushel. Stock shares were sold in three different early offerings at a price of \$2.00, \$2.25, and \$2.50 per share. Since these offerings there have been two stock splits, a 3 for 2 split in 1997 and a 2 for 1 split in 2003. One original share is now equal to 3 shares. Therefore, the average cost basis per original share is \$0.73. The most recent share price in the third quarter of 2007 was \$1.33.

**Present business.** They own and operate a soybean processing plant, a soybean oil refinery, and a bio-based polyurethane production facility in Volga, South Dakota. They began producing crude soybean oil, soybean meal and soybean hulls in late 1996, and since then have expanded the business to include the development of new, vertically integrated product lines and services. In 2002, they began refining crude soybean oil into a product known as refined and bleached oil. In 2003, they became the majority owner and assumed management control of Urethane Soy Systems Company (USSC), which produces Soyol, a bio-based polyurethane product made from soybean oil. They also offer and provide construction, management and consulting services to soybean processing facilities. These services were provided to Minnesota Soybean Processors during their formation and start-up periods.

Their core business consists of processing locally grown soybeans into soybean meal and soybean oil. Soybean meal is primarily sold to resellers, feed mills, and to livestock producers as livestock feed. Soybean oil is sold in crude and refined form. Since the completion of their refining facility in 2002, they process most of their crude soybean oil into refined and bleached oil. They sell this oil to a manufacturer of various retail and bulk food products where it is further processed for human consumption. Oil is also sold to the biodiesel industry.

**Operations and financial performance history.** Basic performance information is reported in Table 1. One key metric is bushels of soybeans processed. Bushels processed were 21.7 million bushels (MBU) in 1998, increasing to 26.8 MBU by 2000. Between 2001 and 2006 bushels processed were fairly consistent, ranging between 26.8 and 28.3 MBU. Sales or revenues were

more volatile because of commodity price changes. Sales were \$157.3 million in 1998 and increased to \$212.7 million in 2006. Net income was a record high in 2001 at \$9.6 million and has been positive every year except 2005 when a loss of \$3.6 million was incurred. Net income improved substantially in 2006 to \$7.7 million, an improvement of \$11.3 million from 2005. Net income in 2007 through six months is down from 2006 at about \$0.8 million.

The soybean crush margin is viewed by many as a good proxy of industry performance. The crush margin is reported in Table 1. However, SDSP's performance does not correlate closely with the crush margin. CEO Rodney Christianson does not view it as a credible measure of industry performance.

Equity to assets, or solvency, has declined from about 60 percent in 1998 to 52 percent in 2002, prior to conversion. Since conversion, equity to assets has declined slightly to 49 percent in 2006. Profitability, as measured by return on equity, has ranged from a high of 29.1 percent in 1998 to a low of negative 11.1 percent in 2005.

Processing volumes have been relatively stable from 2000 through 2007 but net income has been highly variable, primarily due to the volatility in soybean crushing margins in the U.S. industry. Because of the industry volatility multi-year average performance measures are more meaningful. Three performance measures are shown in Table 1: equity to assets, return on equity and return per share. In the pre-conversion period, 1998-2002, the average return on equity was 19.2 percent. In the post-conversion period, 2002-2007, the return on equity averaged 5.9 percent.

**Pre-conversion situation.** They were originally organized as a South Dakota cooperative in 1993 with 521 tax status, limiting the amount of non-member business to no more than 15 percent. Their member-owners were, and continue to be, primarily farmers in South Dakota and neighboring states. As a South Dakota cooperative, they were entitled to single-level, pass-through tax treatment on income generated through their members' patronage. This allowed them to pass their income onto their members in the form of qualified patronage refund distributions without first paying taxes at the company level, similar to a partnership. However, as they grew, the continuing availability of the advantageous tax treatment became less secure. They expected to grow into business lines that would generate significant non-patronage income and may require acquisition of more soybeans and more equity capital than members wanted to provide. This income, if distributed to members, would incur double taxation. Accordingly, in 2001 the cooperative's board of directors approved a plan to reorganize into a South Dakota LLC with more financial and operating flexibility.

## **Conversion Rationale and Proposal Overview**

**Stated reasons for conversion.** There were four main reasons stated in the 2002 Prospectus. They are:

1. *Provide more tax efficient distribution of income to owners.* Due to potentially costly long-term tax consequences to our members of continuing to operate as a cooperative corporation, the Board of Directors is recommending that we reorganize our business as a LLC. The primary reason for this is to avoid double taxation of non-patronage

- income from our operations and investments that have the potential to increase substantially.
2. *Provide more operating flexibility by eliminating patron delivery requirements.* The LLC organization eliminates the requirement that the members do business with the cooperative in proportion to their equity holdings to qualify for patronage income distribution.
  3. *Improve liquidity of current allocated equity.* By allowing non-producers to become investor members we expect this will give our members more liquidity if they want to sell their interests since membership will not be restricted to agricultural producers.
  4. *Improve access to new equity capital.* By completing the reorganization, and eliminating the agricultural producer requirement, we may increase our potential investor pool to raise additional capital if we ever need to.

**Conversion proposal description.** The conversion was from a new generation, or closed cooperative, to an LLC. The cooperative members were told the following in the 2002 Prospectus:

1. You will receive one capital unit of the new LLC for every equity unit of the Cooperative that you own now, so your percentage equity interest in the new LLC will be the same as it is currently in the Cooperative.
2. Your voting rights and rights to cash distributions as an owner of capital units of the new LLC will be similar to your rights as a member of the Cooperative. Each member of the new LLC will be entitled to one vote on each matter brought to a vote of the members, regardless of the number of capital units owned.
3. You will no longer have a soybean delivery requirement. Membership in the new LLC will not be restricted to agricultural producers.
4. We do not expect that you will have to pay self-employment tax on distributions that are based on your capital unit ownership.
5. The reorganization will be a taxable event, and members may recognize a gain or loss as a result. We expect that most members will incur a small capital loss as a result of the reorganization; however, the actual tax effect on you will depend upon your adjusted tax basis in your shares of equity stock and the final determination of the fair market value of the liquidating distribution. Although the basis of equity stock will vary among the members, the value per unit of the distribution will be the same for all members. Based upon a June 30, 2001 appraisal of our plant, property and equipment and certain investment assets and our December 31, 2001 balance sheet, the per share value of the distribution upon liquidation would have been \$1.89 per share if the reorganization had occurred on December 31, 2001. If you purchased your shares in our initial equity offering at a price of \$2.00 per share, your adjusted tax basis would have been \$1.97 as of December 31, 2001; accordingly if the reorganization had occurred on Dec 31, 2001, you would have incurred a capital loss of \$0.08 per share. If you did not purchase all your shares in the initial offering, the tax effect will be different for you. [Note: These values are adjusted for the 3 for 2 stock split in 1997.]

The plan of reorganization was approved by the members at a meeting held on June 20, 2002, and the reorganization became effective July 1, 2002. The transaction was an exchange of interest whereby the assets and liabilities of the cooperative were transferred for capital units of

the newly formed LLC, Soybean Processors, LLC. The capital units were distributed to their members upon dissolution of the cooperative at a rate of capital of one capital unit of the LLC for each share of equity stock owned in the cooperative. The distribution of capital units to their members was registered under the Securities Act of 1933, as amended. For financial statement purposes, no gain or loss was recorded as a result of the exchange transaction. Upon completion of the reorganization, the name of the LLC was changed to South Dakota Soybean Processors, LLC. As an LLC, which may elect to be taxed either as a partnership or a corporation, they elected to be taxed as a partnership in order to retain their historic single-level income tax treatment at the member level.

## **Post-Conversion Overview**

**Company performance.** One major driver behind the conversion was the expectation of high non-patronage income and the need to provide a more tax efficient method of income distribution. SDSP continued to perform well overall after conversion on July 1, 2002 as indicated in the metrics shown in Table 1. Non-patronage type business was expanded through their relationship with Minnesota Soybean Processors, initially as an investor as well as a managing member, and now as only an investor with 6.95 percent ownership. Small losses on this investment were incurred in 2004-05, totaling about \$125,000, but income of about \$668,000 was incurred in 2006. Returns from the Soyol business are also primarily non-patronage in nature and have not been as good as expected but are expected to improve in the future. Since cash distributions to member-stockholders were suspended in 2005 and 2006 and the level of non-patronage income has not been as great as expected so far, this potential benefit from the conversion has not been as great as anticipated.

A second major driver was operating flexibility gained by eliminating the delivery requirements. This expected benefit has been realized. Both SDSP and the growers are free to acquire or sell soybeans in the manner that is most advantageous to their individual operations. In reality, CEO Rodney Christianson reports, most member operations have not changed much as a result of this new flexibility. However, the increased use of soybeans by the plant, whether through delivery agreements or not, is estimated to have increased local prices or lowered the basis by as much as 25 cents per bushel. This price improvement was one of the reasons for the initial creation of SDSP by producers and this benefit continues, but is shared by all producers in the area, not just the original members.

A third major driver was an improvement in the liquidity of current allocated equity. This was achieved. Stock exchanges between owners have increased and are now facilitated by a third party, AgStockTrade.com. Members can buy and sell their shares in a relatively efficient way, although the market is thin compared to large publicly held offerings. Trading was stopped during an equity drive in 2004. Associated with liquidity is the appreciation or change in value of stock. SDSP's stock price averaged \$2.19 in the initial three offerings. On a post-split adjusted basis the \$2.19 price converts to \$0.73. The post-split adjusted stock price averaged as high as \$1.52 in 2000 and as low as \$1.25 in the first quarter of 2006. The third quarter 2007 average price was \$1.33. Therefore, stock price has appreciated in value by at least \$0.60 per share. See Table 2.

A fourth major driver was improved access to new equity capital. SDSP had one major equity offering approved in 2004 that ended June 30, 2005. They attempted to raise up to \$11.25 million to fund capital improvements, complete the buyout of the other partners in the polyurethane business unit, Urethane Soy Systems Company (USSC), and enhance their research and development efforts. The offering had two phases. In the first phase, first scheduled to last 45 days, they offered stock to existing members at \$2.00 per share. It closed on April 11, 2005 and raised \$3,922,000. In the second phase they offered stock to the general public at \$2.50 per share. It closed on June 30, 2005 and raised about \$1.0 million, bringing the total raised to about \$4.9 million.

**Member benefits.** The ultimate test of a conversion is the benefits it actually provided compared to the benefits that would have been achieved if the co-op business form had continued. This is difficult to measure because economic conditions and firm performance are always changing in unforeseen ways and the basis for income distribution changed from bushels delivered to share of stock owned.

One key metric is whether grower members are able to market soybeans as well or better after conversion. It appears they did get paid competitive or market prices and had several choices of buyers to sell soybeans to, both before and after conversion.

A second key metric is the impact on member investment in SDSP and the income received. The original co-op members continued to be the predominant member-owners of the LLC, before and after conversion. The measures of interest are (1) the cash received (roughly equivalent to the cash patronage refunds), (2) the return on equity, and (3) the change in stock price. These values are reported in Table 1.

Cash received in the pre-conversion period, 1998-2002, was \$21,088,508, or 71 percent of total income. Average cash per year was \$4,363,140, assuming 4.8333 years. Cash received in the post-conversion period, 2002-2007, was \$14,770,456, or 121 percent of total income. Average cash per year was \$2,954,091, assuming 5.0 years.

It is not clear if cash received would have been significantly different if the co-op had not converted. However, the best measure, from the member's perspective, is after-tax cash flow. This has not been calculated since we do not have estimates of SDSP's income components, including non-patronage income before and after conversion, their precise income distribution strategies, and the impact on producer cash flows.

The return on equity performance was described earlier. In summary, ROE averaged 17.3 percent while a co-op in 1997-2002, and averaged 5.9 percent while an LLC in 2002-2007. There is no clear evidence business form choice was a factor in the returns since the LLC operation was very similar to the co-op operation.

Stock prices have gone up from the original purchase price, adjusted for the stock splits. Purchase prices have ranged from \$2.00 to \$2.50 and averaged \$2.19 in the initial equity drive ending in 1995. Stock prices have always been above these prices and have been as high as \$3.14 in the third quarter of 2005. Recent prices in third quarter 2007 were \$2.66.

A third key metric is governance or control. The membership base did not change significantly and producers continue to control SDSP. The board of directors continues to be composed entirely of producers. The CEO has been the same person throughout their history.

**Table 1. SDSP Operations and Financial Performance, 1997-2007.**

	Pre-Conversion: FYE of August 31						Average
	1997	1998	1999	2000	2001	2002-(10 mo.) <sup>6</sup>	
Bushels Processed	N/A	21,722,885	24,553,153	26,250,016	26,803,782	N/A	
Revenue	\$105,607,666.00	\$157,344,377	\$134,167,994	\$134,669,671	\$147,746,720	N/A	
Net Proceeds/Net Income	\$567,218	\$8,511,477	\$4,623,436	\$1,883,493	\$9,558,728	\$5,237,360	
Cash Paid to Members	\$0.00	\$5,822,558	\$3,436,451	\$579,302	\$5,731,197	\$5,519,000	
Total Assets	\$53,554,833	\$48,391,882	\$48,400,001	\$52,319,061	\$56,849,530	\$69,454,194	
Total Equity	\$20,712,386.00	\$29,234,713	\$28,040,589	\$26,492,282	\$35,475,907	\$35,924,341	
Equity to Assets	38.7%	60.4%	57.9%	50.6%	62.4%	51.7%	
Return on Equity	2.7%	29.1%	16.5%	7.1%	26.9%	14.6%	17.3%
Shares Outstanding	9,419,500	14,219,500	14,219,500	14,219,500	14,129,500	14,129,250	
Return per share	\$0.06	\$0.60	\$0.33	\$0.13	\$0.68	\$0.37	\$0.38
Cash return per share	\$0.00	\$0.41	\$0.24	\$0.04	\$0.41	\$0.39	\$0.26
Average Share price	N/A	\$2.49	\$2.86	\$3.03	\$2.67	N/A	
Adj. Pre-Split Yearly Average Price <sup>2</sup>	N/A	2.49	2.86	3.03	2.67	N/A	
US Crush Margin	N/A	N/A	0.40	0.67	0.78	0.74	

	Post-Conversion: FYE of December 31						Average <sup>5</sup>
	2002-(6 mo.) <sup>4</sup>	2002-(12 mo.)	2003	2004	2005	2006	
Bushels Processed	N/A	27,963,507	28,384,272	26,823,093	28,003,640	27,775,724	N/A
Revenue	N/A	\$159,497,284	\$207,256,575	\$238,211,056	\$210,370,966	\$212,721,926	\$111,518,770
Net Proceeds/Net Income	\$3,306,363	\$6,612,726	\$3,394,824	\$688,612	(\$3,640,170)	\$7,651,359	\$824,308
Cash Paid to Members	\$2,540,000	N/A	\$2,539,827	\$3,290,629	\$0	\$0	\$6,400,000
Total Assets	\$70,284,896	\$70,284,896	\$81,617,064	\$72,499,888	\$73,630,296	\$82,070,372	\$81,461,651
Total Equity	\$33,875,593	\$33,875,593	\$34,730,590	\$32,122,573	\$32,768,497	\$40,409,808	\$33,828,321
Equity to Assets	48.2%	48.2%	42.6%	44.3%	44.5%	49.2%	41.5%
Return on Equity	9.76%	19.5%	9.8%	2.1%	-11.1%	18.9%	4.9%
Shares Outstanding	14,129,250	14,129,250	28,258,500	28,258,500	28,228,500	30,419,000	30,419,500
Return per share	\$0.23	\$0.47	\$0.12	\$0.02	-\$0.13	\$0.25	\$0.03
Cash return per share	\$0.18	N/A	\$0.09	\$0.12	\$0.00	\$0.00	\$0.21
Average Share price	\$3.00	N/A	N/A	N/A	\$1.54	\$1.37	\$1.45
Adj. Pre-Split Yearly Average Price <sup>2</sup>	3.00	N/A	N/A	N/A	3.09	2.81	2.92
US Crush Margin <sup>3</sup>	0.34	0.68	0.72	0.98	0.80	0.66	N/A

<sup>1</sup> First 6 months of data

<sup>2</sup> 3 for 2 Stock split in 1997 and 2 for 1 Stock split in 2003

<sup>3</sup> Only 10 months of data for 2006

<sup>4</sup> Assigned 50% of 2002 12 month values

<sup>5</sup> Excludes 2002 12 month values

<sup>6</sup> 2002 10 month net income estimated from last 6 months of \$3,142,416

**Table 2. SDSP Stock Price History, 1998-2007.**

Period	Low Price	High Price	Average Price	# of Capital Units Traded	Adj. Pre-Split Average Price	Adj. Post-Split Average Price
1997 <sup>1</sup>	N/A	N/A	N/A	N/A	N/A	N/A
1998	2.25	3.50	2.49	246,500	2.49	1.25
1999	2.00	3.25	2.86	184,250	2.86	1.43
2000	2.50	3.52	3.03	126,750	3.03	1.52
2001	2.50	3.12	2.67	180,250	2.67	1.34
2002-6 months	2.91	3.13	3.00	110,000	3.00	1.50
2003 <sup>2</sup>	N/A	N/A	N/A	N/A	N/A	N/A
2004 <sup>3</sup>	N/A	N/A	N/A	N/A	N/A	N/A
First Quarter 2005	N/A	N/A	N/A	N/A	N/A	N/A
Second Quarter 2005	N/A	N/A	N/A	N/A	N/A	N/A
Third Quarter 2005	1.54	1.75	1.57	37,000	3.14	1.57
Fourth Quarter 2005	1.50	1.54	1.51	23,500	3.02	1.51
First Quarter 2006	1.22	1.27	1.25	21,000	2.50	1.25
Second Quarter 2006	1.29	1.32	1.30	76,000	2.60	1.30
Third Quarter 2006	1.32	1.60	1.45	152,250	2.90	1.45
Fourth Quarter 2006	1.43	1.49	1.46	92,000	2.92	1.46
First Quarter 2007	1.45	1.50	1.47	120,000	2.94	1.47
Second Quarter 2007	1.46	1.60	1.53	60,500	3.06	1.53
Third Quarter 2007	1.25	1.40	1.33	44,500	2.66	1.33
Fourth Quarter 2007					0	0.00

<sup>1</sup> 3 for 2 Stock split in 1997.

<sup>2</sup> 2 for 1 Stock split in 2003.

<sup>3</sup> No trading in 2004 and up through June 2005 during an equity drive.