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## The Restructuring of Dakota Growers Pasta Company

Michael Boland\*

Gregory J. McKee†

\*Kansas State University, [mboland@k-state.edu](mailto:mboland@k-state.edu)

†North Dakota State University, [gregory.mckee@ndsu.edu](mailto:gregory.mckee@ndsu.edu)

# The Restructuring of Dakota Growers Pasta Company

*Michael Boland and Gregory J. McKee*

The decision discussed in this case is to examine the advantages and disadvantages of restructuring Dakota Growers Pasta. Cook's life cycle taxonomy of cooperatives is used to explain how the cooperative moved throughout its life until it restructured as a closely-held organization. The organization does not appear to have changed greatly in its operation since the conversion.

## Introduction

Durum wheat is produced by growers in North Dakota, eastern Montana, and the Prairie provinces. Producers are price takers in this industry and the wheat is shipped to demand points (including exports) where pasta production occurs. Prior to the late 1980s, there was no vertical integration for grinding durum wheat into semolina flour, which is used to manufacture pasta. The pasta manufacturers were primarily regional competitors who purchased semolina flour. Since the 1990s, however, vertical integration has occurred in this industry on a broad scale.

Dakota Growers Pasta Company (DGPC) organized as a cooperative in 1991 and is generally recognized as one of the first to use the new generation cooperative structure (Cook & Iliopoulos 1998). This new structure clarified the property rights issues identified by Cook and Iliopoulos (2000) and helped account for members' willingness to make original and resulting investments in DGPC. The users were the voting members who control the co-op, the owners who provided the equity capital, and the patrons who received the benefits of use, including: (1) a market or buyer for their durum wheat; and (2) a share of the profits based on use or patronage. Profits or net income were usually distributed as patronage refunds per bushel. In DGPC's case, durum wheat producers were the users.

In 1991, producers paid US\$125 to join the cooperative as a member and US\$3.85 (par value) per share, which represented an obligation to deliver one bushel of durum wheat. The US\$3.85 price was based on the historical per bushel average for North Dakota durum wheat. Producer-users or members were required to purchase

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*Michael Boland is a professor of agricultural economics at Kansas State University and associate director of the Arthur Capper Cooperative Center. Gregory McKee is a professor in the Department of Agribusiness and Applied Economics, North Dakota State University.*

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one share of stock for each bushel of durum wheat that they want to sell annually to DGPC (Cook & Iliopoulos 1998). Each share conveyed a right and an obligation to deliver durum wheat as specified in the Growers Agreement. The total number of shares sold matched the capacity of the semolina mill owned by DGPC.

If members could not supply the wheat with the desired quality from their own production, DGPC purchased the wheat on behalf of that member and charged them the current market price. Quality is a significant concern with durum wheat, as noted by Troccoli et al. (2000), because pasta manufacturing requires semolina flour made from disease-free durum. Members were exposed to price risk because they had to purchase durum wheat to be delivered to the company on their behalf. Growers agreements gave DGPC a competitive advantage because it allowed them to source high quality durum wheat.

Holding stock was important to the members not only because of the delivery right, but also because it was an asset. The stock could be traded or exchanged between members at a privately negotiated price. This meant that the stock price could appreciate or depreciate in value from the initial issue price or subsequent exchange price. However, DGPC always carried the stock on its books at its nominal issue or book price.

Dakota Growers Pasta Company became successful in a very short time as seen in tables 1 and 2 (U.S. Securities and Exchange Commission, n.d.). Members received patronage refunds (sometimes called patronage dividends) from 1996 to 2000. In addition, a three-for-two equity stock split was declared in July 1997. The company had been relatively profitable over time by increasing the value that members received for their durum wheat relative to non-members in North Dakota who did not invest in DGPC.

This rapid change resulted in the grower's original investment significantly appreciating in value. However, under the DGPC's cooperative structure, it was not possible to realize this value. Some members who were also leaders of DGPC recognized this issue and ultimately voted to convert the cooperative into a limited-liability company. The objective of this case, then, is to apply Cook's (1995) taxonomy of a cooperative life cycle to DGPC.

**Table 1. Selected income statement data for Dakota Growers Pasta Company for year ending 31 July, in thousand dollars.**

|  | <b>2008</b> | <b>2007</b> | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>2002</b> | <b>2001</b> | <b>2000</b> | <b>1999</b> | <b>1998</b> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Net revenues                           | 280,199     | 191,062     | 171,509     | 155,619     | 144,679     | 136,806     | 152,465     | 135,921     | 136,862     | 124,869     | 119,621     |
| Cost of Goods Sold                     | 246,709     | 165,575     | 148,904     | 136,179     | 132,245     | 125,160     | 130,502     | 124,811     | 116,890     | 106,062     | 100,229     |
| Gross profit                           | 33,490      | 25,487      | 22,605      | 19,440      | 12,434      | 11,646      | 21,963      | 11,110      | 19,972      | 18,807      | 19,392      |
| Marketing, general and admin. expenses | 17,450      | 12,973      | 14,190      | 16,507      | 8,345       | 9,816       | 9,382       | 9,631       | 9,713       | 7,866       | 6,754       |
| Asset impairment loss                  |             |             |             |             | 704         |             |             |             |             | 0           | 0           |
| Operating income                       | 16,040      | 12,514      | 8,415       | 2,933       | 3,385       | 1,830       | 12,581      | 1,479       | 10,259      | 10,921      | 12,638      |
| Other expense-net                      |             | (2,199)     | (2,143)     | (1,817)     | (2,835)     | (2,364)     | (3,365)     | (3,574)     | (3,929)     | (2,434)     | (3,264)     |
| Non-controlling interests              | 202         | 52          | 894         | 3,003       |             |             |             |             |             |             |             |
| Income(loss) before income taxes       | 14,671      | 10,367      | 7,166       | 4,119       | 550         | (534)       | 9,216       | (2,095)     | 6,330       | 8,487       | 9,374       |
| Charge for deferred taxes*             |             |             |             |             |             |             | 6,105       |             |             |             |             |
| Net income (loss)                      | 9,291       | 6,608       | 4,373       | 2,513       | 336         | (429)       | 1,834       | (1,784)     | 7,628       | 7,988       | 9,374       |

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**Table 1. Selected income statement data for Dakota Growers Pasta Company for year ending 31 July, in thousand dollars.  
(Continued from previous page.)**

|  | 2008   | 2007   | 2006   | 2005   | 2004   | 2003   | 2002   | 2001    | 2000   | 1999    | 1998  |
|--|--------|--------|--------|--------|--------|--------|--------|---------|--------|---------|-------|
| Inventory valuation adjustment <sup>†</sup>            |        |        |        |        |        |        |        |         |        | (3,429) |       |
| Dividends on preferred stock                           | 283    | 113    | 451    |        |        | 3      | 10     | 15      | 4      | 143     | 15    |
| Net earnings(loss) on common/equity stock              | 9,008  | 6,495  | 3,922  | 2,513  | 336    | (432)  | 1,824  | (1,799) | 7,624  | 4,559   | 9,374 |
| Weighted average common/equity shares outstanding      | 10,192 | 12,501 | 13,169 | 13,169 | 12,265 | 12,355 | 11,382 | 11,253  | 11,166 | 8,603   | 7,356 |
| Net earnings(loss) per common equity share outstanding | 0.88   | 0.52   | 0.30   | 0.19   | 0.03   | (0.03) | 0.16   | (0.16)  | 0.68   | 0.53    | 1.27  |
| Cash dividends declared                                |        | 0.14   | 0.04   |        |        |        |        |         |        |         |       |

\*Charge to record deferred taxes upon conversion from a cooperative to a corporation.

<sup>†</sup>Cumulative effect on prior years of changing to a different inventory valuation method.

Source: U.S. Securities and Exchange Commission

## Conceptual Framework

Ownership structure determines whether businesses can be identified as cooperatives. In the case of new generation cooperatives such as DGPC, users serve as owners. Owners contribute equity by participating in an initial sale of equity stock and then periodically purchase common stock as it is made available. Cooperative owners, therefore, are primarily responsible for providing equity capital.

DGPC, as originally incorporated, is characterized as a Sapiro II Cooperative. Cook (1995) developed a taxonomy to describe the life cycle of a cooperative. While Cook did not have any data to provide evidence for his life cycle theory, his taxonomy is useful for explaining the behavior of DGPC over the first ten years of its existence.

Cook hypothesizes that a cooperative's life cycle can be explained in six stages. Stage One in Cook's life cycle taxonomy of cooperatives involves durum wheat growers seeking to bypass an investor-owned firm, enhance prices, increase margin, and avoid market power. In Stage Two, the cooperative sustains itself economically as opposed to exiting quickly due to an inadequate business model. In Stage Three, Cook argues that members more closely scrutinize the cooperative's transacting costs. In this stage, the members begin to consider all transactions with the cooperative and analyze the associated benefits and costs.

In table 4 of his article, Cook (1995, p. 1157) shows that the portfolio problem and control problem are the two major transactions costs issues with a Sapiro II cooperative like DGPC. The portfolio problem is that a member's investment decision is tied to their patronage decision. Vitiliano (1983) suggests that this issue results in a further fractioning of commonality of interest and a general tendency to favor decisions that reduce risk. The control problem is that the members have a divergence of interests between members and the board of directors. Vitiliano argues that this control problem results in decisions that seek to reduce the value of residual claimants in the cooperative. These residual claims tend to be exchanged for capital resources whose owners, in turn, bear the financial risk.

During Stage Four, cooperative decision makers become more aware of the unique property rights issues associated with owning the capital resources of the cooperative and conclude that there are three options available for enhancing returns from their investment: exit, continue, or transition. In Stage Five, the cooperative leaders choose between these three options. Cook and Chaddad (2002) provide more information on these options. Hendrikse and Bijman (2002) show that, in certain cases, the more important the investment for the processor relative to the farmer's investment, the greater the likelihood that the cooperative may not be an efficient ownership structure.

**Table 2. Selected balance sheet data for Dakota Growers Pasta Company for year ending 31 July, in thousand dollars.**

|                            | <b>2008</b> | <b>2007</b> | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> |
|----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Cash                       | 125         | 89          | 343         | 229         | 589         | 5           |
| Working Capital            | 21,351      | 20,800      | 23,273      | 20,156      | 16,586      | 13,429      |
| Total Assets               | 162,698     | 143,166     | 134,249     | 135,130     | 119,415     | 122,390     |
| Long term debt*            | 31,174      | 40,681      | 28,545      | 25,385      | 21,087      | 28,263      |
| Redeemable preferred stock |             |             |             | 7           | 20          | 33          |
| Stockholders' equity       | 56,687      | 49,150      | 64,592      | 61,132      | 58,619      | 53,818      |
|                            | <b>2002</b> | <b>2001</b> | <b>2000</b> | <b>1999</b> | <b>1998</b> | <b>1997</b> |
| Cash                       | 2,866       | 3           | 1,725       | 3,425       | 182         | 5           |
| Working Capital            | 23,013      | 14,420      | 25,089      | 31,065      | 22,813      | 6,329       |
| Total Assets               | 125,541     | 128,658     | 131,857     | 135,873     | 124,537     | 68,739      |
| Long term debt*            | 38,274      | 47,594      | 51,626      | 59,116      | 66,056      | 27,131      |
| Redeemable preferred stock | 54          | 113         | 126         | 53          | 253         | 453         |
| Stockholders' equity       | 56,090      | 54,267      | 60,533      | 58,982      | 36,875      | 29,956      |

\*Excluding current maturities.

Source: U.S. Securities and Exchange Commission

## Description of the Conversion

The late 1990s saw changes that affected durum wheat production in eastern and central North Dakota. Wet weather enabled scab to spread from eastern North Dakota to central North Dakota. Changes in U.S. agricultural policies also enabled growers to change their portfolio of crop mixes. Some chose to produce less durum wheat and increase their production of soybeans and corn. This meant that many of the producers who owned DGPC were physically unable to deliver high quality durum wheat, as required by their Growers Agreement. These changes jeopardized DGPC's status as a cooperative because its members were no longer patronizing the cooperative with their durum wheat (Nelson and Olson 2002)

Financial constraints associated with being a cooperative corporation also affected the membership (U.S. Securities and Exchange Commission 2002). Restricting the sale of ownership shares to members of the cooperative sometimes made it difficult for members to sell their stock. Some producers wanted a more liquid market for their shares in DGPC. Additionally, DGPC realized that access to public debt and equity markets was necessary if the cooperative were to expand because the members were no longer able to provide equity capital. Tables 1 and 2 suggest that DGPC was successful in accomplishing its original mission of increasing the margin on durum wheat. DGPC quickly advanced through Cook's Stage Two and into Stage Three because its benefits far outweighed the growers' costs. Specifically, the original equity that DGPC members contributed provided far greater than that of their farm-level investments in a relatively short period of time.

These production and financial conditions motivated the DGPC board of directors to begin discussing the future direction of the cooperative. This was Stage Four. In late 1999 and early 2000, DGPC's directors considered a report by a large regional investment banking firm concerning various available options for corporate structure and capital sources (Pates 2002). The board began to explore the advantages and disadvantages of remaining a cooperative, converting to a limited liability company (LLC), or becoming a publicly traded corporation. The advantages of remaining a cooperative included being member-controlled and not incurring the transaction costs of conversion. The notable disadvantages of remaining a cooperative included an inability to access capital markets beyond member-owners, a lack of liquidity for stock shares, and an inability of some members to deliver durum wheat.

The advantages of converting into an LLC included producers retaining governance. However, this structure would incur a significant tax liability because the transition would involve liquidating the cooperative and redistributing the assets into the LLC. These assets had appreciated in value, which would result in a tax liability to members. An additional concern was that an LLC structure would



not provide the desired level of liquidity or access to capital as would a publicly traded corporation. The board of directors recommended that members vote to convert to a publicly traded corporation (Dakota Growers Pasta Company 2002). This structure would allow additional individuals to become equity holders, including non-producers, which would create liquidity for the stock shares. Allowing non-producers to become equity holders would also mean increased access to capital. A third advantage was that members would no longer be required to deliver durum wheat, a requirement of their membership in the DGPC cooperative. The conversion would allow them the privilege, but not the obligation, of delivering the durum wheat. One disadvantage was that there could be an increase in the tax obligation of the equity holder. Conversion meant that both DGPC and the equity holder would pay corporate and personal income tax, respectively, on any distributions.

In December 2001, the DGPC board voted unanimously to initiate the conversion. The producer-members of the cooperative would become shareholders of the North Dakota corporation. The cooperative's equity (membership stock, common equity stock, preferred stock, and non-qualified allocated equity) would be converted into equity in the corporation. Each share of common stock would represent one vote for any issues presented to the stockholders. Each share of common equity stock would be converted into one share of common stock with voting rights and one share of Series D Delivery Preferred Stock. The preferred stock had no voting rights.

The non-qualified allocated equity was non-cash patronage income earned by the members but not yet allocated by the board of directors. Non-qualified meant that the members were not taxed upon receiving notice that this patronage income had been earned but not yet allocated as cash. Each US\$7.36 of non-qualified allocated equity would convert to one share of common stock. A mechanism was provided so that, if DGPC announced it was purchasing durum wheat, members could still deliver supplies after the conversion if they so desired. Provisions were also made to protect shareholders in the event of a hostile takeover. A membership vote on 22 May 2002 favored the conversion. This represented Stage Five in Cook's taxonomy.

### **After the Conversion**

The conversion to a publicly traded company addressed the financial concerns of the membership and eliminated the requirement for producer-members to provide durum from their own production. Additional liquidity for the shares has occurred since the conversion, but trading volumes for the stock have been minimal according to DGPC's most current annual report. Two companies, Variable-Investment Advisors and Alerus Securities, facilitate trading of the DGPC common

stock. The change, as expected, also improved access to capital as outside investors could now purchase stock in DGPC. MVC Capital of New York provided US\$5 million in equity to DGPC in August 2004 and received common stock shares totaling 6.8 percent of common equity (909,091 shares of stock with a US\$5.50 value per share). They also have a representative on the board of directors (Pates 2004).

In 2005, DGPC issued its first dividend since the conversion, paying US\$0.04 per share payment to holders of both Series D Delivery Preferred Stock common stock. In 2006, DGPC paid US\$0.01 per share dividend to holders of Series D Delivery Preferred Stock and US\$0.14 per share to holders of common stock. It also constructed a new short goods pasta line at the New Hope, North Dakota facility in 2005, which increased its pasta-manufacturing capacity to 230 million pounds.

Further increases in capital occurred in February 2007. At this time, DGPC entered into a stock purchase agreement with MVC Capital, Inc. and La Bella Holdings, LLC. MVC acquired one million shares of convertible preferred stock and La Bella acquired one million shares of common stock valued at US\$10 per share. The cash was used to tender an offer to DGPC common stockholders. In May 2007, DGPC purchased 3,917,519 shares of common stock from its shareholders at an average price of US\$10 per share. Dividends were paid in 2007 and 2008. Furthermore, DGPC purchased all the outstanding shares in DNA Dreamfields, which markets pasta with a low glycemic index and fewer carbohydrates than any other pasta on the market (Pates 2005).

## Conclusions

The main questions asked by stakeholders in DGPC centered around three main issues: control, ownership, and benefit. Control issues are linked to the importance of being solely owned and controlled by producers in a certain geographic region, performance of a producer-controlled board vis-à-vis an investor-controlled board, and changes in capital structure due to an investor-controlled board. For example, prior to the conversion, the board of directors represented 2.2 percent of the members and votes. After the conversion, the board of DGPC controlled 11.2 percent of the common stock, which resulted in greater influence on items submitted to the membership for a vote.

Ownership issues were primarily linked to the role of outside equity and its impact on common stock price volatility, costs of debt capital vis-à-vis member capital, and whether it was possible to find outside equity holders to invest in DGPC through preferred stock without voting rights. Benefit issues included changes in tax liabilities due to the conversion and whether the pattern of income distribution would change after the conversion, such as DGPC retaining more earnings rather than pay cash dividends.

Prior to the conversion, only durum wheat producers who patronized DGPC could own common stock with voting rights. After the conversion, anyone who owned common stock gained voting rights. The conversion allowed an outside equity holder to acquire stock and a seat on the board of directors. After the conversion, dividends were paid on the preferred stock before the common stock. The company incurred a loss in 2003, but in 2005 the board declared a dividend on both common and preferred stock. Furthermore, shares of common stock could be transferred to any person, whereas before the conversion shares could only be transferred to active producers.

There have been no outward signs that the conversion has changed DGPC's long-term strategy. It still uses durum wheat from the region in its semolina grinding and pasta manufacturing plants. However, the external capital has allowed it to expand and DGPC is well-positioned to take advantage of changes occurring in the U.S. pasta industry. In the end, the capital requirements to farmers may have been too large, liquidity too low, and producer delivery rights too risky for the cooperative. As a result, the DGPC membership proceeded through all the stages in Cook's life cycle and followed the sequence of events suggested by Cook and Iliopoulos (1998) to conclude that another form of ownership was required.

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