Pork: Its Future in the Food Industry

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It's an honour for me to speak to you today at this association's 30th annual meeting. Clearly you have demonstrated a history of knowledge sharing and leadership in the Canadian industry and I applaud your initiative and ongoing efforts in that regard.

As one of your keynote speakers, I appreciate the opportunity to kick off this conference and maybe even some food for thought - ideas to think about and discuss amongst yourselves over the next few days. On the one hand, I hope that this session is a bit thought provoking, on the other, a bit controversial. For those of you who don't know me well, I do love a great debate. As well, I hope to use this platform to share the strategies of Maple Leaf since they stand to affect so many of you. To make sure we are all on the same page, I thought I would start by reviewing the objectives of our 45 minutes or so together. Questions to follow. My theme today is the Future of the Pork Industry: maintaining a competitive advantage in a face of revolution.

The global industry today is clearly facing more turbulent times than it ever has in its history, and maintaining competitive advantage is central to our success. Being a futurist can be a bit of a fool's errand some days. One observation that I would make is that, as you have heard, the more things change, the more they stay the same. There was a recent article in the Wall Street Journal by a Daniel Pearl who quoted the following item, and I read, "A new century is at hand and a fast spreading technology promises to change society forever. We will let people live and work wherever they please, create dynamic new communities linked by electronics and improve the lot of the poor and re-invent government, unless its use for elicit purposes sparks a crackdown." Now that sounds like the new world of the internet and cybernetics but that was all written a century ago about the telephone and that's right, I did say revolution. I believe we are in the midst of one today and I want to talk about it by reviewing the major trends in the industry - not that you are not familiar with them. Undoubtedly you are, but sometimes we see them from different perspectives. I also thought it would be some benefit from sharing our point of view on how the different players in the industry are reacting to those developments and to wrap up, I'll share what I refer to my "call to action" in the face of these revolutionary environments.

I'm sure the thoughts on this slide aren't any surprise to any of you. We have all seen the broad tends across the pork industry in North America over the last several years. There is likely not a single one amongst us that hasn't felt the challenges of the euphoria, of the historical hog price cycle at one time or another. Certainly changes in the demand pattern in North America as well as the continued growth in consumption from Asian markets have been under the watchful eye of every seller of pork around the world. Canada is 39% surplus in pork - 39% - so our knowledge of these markets globally is the essence of our long-term prosperity. This is particularly true knowing that virtually every single kilogram of product coming from growth in our Canadian industry needs to be sold outside this country. I've made the statement many times before: "Consolidation in the industry is like debating the law of gravity whether you like it or not, it exists, so we better figure out how to deal with it and make it work for us because we sure can't stop it." Lastly, there is the ever-increasing intensity around the environmental matters throughout the industry and in every segment of the value chain. Undoubtedly each sector in the value chain has developed appropriate responses to these broad trends and generally speaking the processes are no exception to this. Because time limitations today preclude a full discussion on each item on this chart, so I have chosen three areas to talk more about in this revolution in this fast paced pork industry. In our view, these three are the mission critical factors defining the future of our industry. First the impact of consolidation in the industry. Second, branding and value added product trends and finally, a detailed look at vertical integration and the Maple Leaf response to this, referred to as vertical coordination.

Consolidation in the Industry

I would assume everyone in this room has somewhat strong feelings about the announcement of Tyson acquiring IBP. The strategic rationale for this investment is quite clear.

- Tyson was experiencing what they refer to as chicken fatigue. Due to lack of increase in consumption after multiple decades of continuous growth they defensively needed to cover all species.
- Retail consolidation required a matching of scale with customers.
- Tyson's acclaimed marketing skills could be leveraged in pork and beef.
- And finally the price was right. IBP was trading at ridiculous low multiplies at the time this transaction occurred.

Tyson has now created a meat-processing company with annual revenues of 24 billion dollars US, which is seven times larger than Maple Leaf. Now that's daunting. I get asked everyday by one stakeholder or another, can we compete and my answer is resolute, absolutely. We can compete because of years of restructuring and investment in world scale, world class operations. We have the ability to keep pace but make no mistake about it, it will require continued vigilance and effort to make sure we stay in that position. We cannot fall behind or they will eat our lunch and we will not let that happen.

Sometimes we think that our customers are the only ones that are consolidated, obviously this is not the case and as I referred to earlier, retail concentration was a central driver in the Tyson transaction. Let me take you to a few statistics. In Canada the top three retailers have grown from 35% market share in 1984 to 52% in 1998 and this is expected to be 70% in 2004. Similar stories exist in the US and Europe with the top five capturing an expected 50% market share south of the border and 78% in Europe by 2002. We do significant business today with the largest retailer in America. This one single retailer is greater than the entire Canadian retail industry. Obviously we've kept pace in Canada with consolidation and kept ahead of the consolidation curve here in this country as well, at both the processor and producer levels of the value chain.

Our conclusions of consolidation are quite straightforward:

- Critical mass is important;
- We are not alone;
- It will likely continue all around us;
- In a consolidating world, it's more important to build closer relationships with your supply chain partners, than it is to build fences; and
- Finally, picking the right partner is critical to success.

Branding and Value Added

I will now turn my attention to one of the more exciting trends in the industry, the increase in branding and value-added marketing processes. Being essentially a packaged goods marketer at heart, and knowing that our company has great skills in that area, I feel very good about this direction. Certainly the Tyson take-over of IBP in the United States will enhance this as Tyson has a worthy reputation of being a skilled marketer. This raises the high bar for everyone in a way that I personally view as a positive. The trends towards branded fresh meat is quite clear. IBP launched their Thomas E. Wilson™ brand in the US with a significant marketing investment. Driving forces behind this direction include an increase in the consumer confidence of brands for safe, perishable foods, the ability of brands to lead innovation and the opportunities for category management using brand leaders in the retail case.

Maple Leaf Foods has significant competence in the field of brand development and brand management - particularly in fresh meat. Our best example is in the poultry industry. Maple Leaf Prime, our line of value added poultry products, sold at a premium price in the market place has been consumer tested to be simply a better product in all respects. The growth curve has been extraordinary. Up from $40 million in 1995 to $197 million in 2000, a compound annual growth rate over that period of time of 33% per year, making it one of the most significant brands in the Canadian retail store today. We have developed a true skills based competency in marketing branded fresh meat. Some people mistakenly have believed that simply applying a label on a product makes it a brand - a very naive assumption. Brand development and brand management is an organizational competence that takes decades to develop. It starts with a very deep knowledge of the ultimate consumer for your products. For example, did you know that in any given week, about 34% of households have at least 1 serving of pork at home. On the other hand, 63% of households eat at least one serving of chicken at home every week and 76% eat beef. Pork is obviously behind but look at the opportunity. 73% of households bought pork in the last 12 months, making exactly 7.4 trips on average to the category. That is about one trip every 7 weeks. Of this group, 20% of the pork buyers account for more than half of the total purchases - a very relevant statistic. 20% of the consumers of pork, consume more than half of the pork purchases. What this says, is that we have a very strong but small group of pork lovers who are driving consumption. Who are they? Well pork buyers are typically larger families, older families, higher income and they eat all types of meat. In fact, they are meat lovers. They are also heavy buyers of chicken and beef. What is it about pork that people like? Consumers tell us most frequently the good taste is the preferred purchase criteria. Whereas for chicken and beef, a good taste is not mentioned as often as versatility and good price. This tells me that if we make this product more interesting, with more variety, make it easy and fast to prepare for customers around the world, while maintaining the message of great taste, we can grow this market within our geography and everyone around the world. Here's a little brainteaser for you. Why do people disproportionally eat pork on Tuesday's as compared to every other night of the week? The fact is that 21% of pork is eaten on Tuesday's while the other days of the week average about 13%. Both chicken and beef are relatively flat and don't seem to have the same type of spike. We're not quite sure why this is yet, so I'll leave that up to you to ponder in the course of this seminar. We're only just starting to understand our consumers and quite frankly it's a long time overdue. Branded products, and competition based on differentiation not sameness, has been and will continue to be revolutionary in our industry and we believe this will add economic value for the entire value chain.

Vertical Integration

Finally, today I would like to describe the Maple Leaf response to what is likely the most pressing need in each of your minds, vertical coordination. You've likely seen this chart before and are very aware of these facts. I would argue this is singularly the most significant change this industry has seen in the last several decades. In fact in it's history. The largest processor became the largest producer in an 18-month time frame. As you can see, in December 1998, Smithfield owned just 13% of their hog requirements. By May 2000, just 17 months later, their ownership increased to 60% by acquisition and growth. We believe the North American industry is only just beginning to see the effects of this strategy and its impact on everyone else. First, lets take a look at a bit more closely at some of the facts. This chart is a little bit busy. What it shows is the earnings per hog, before interest and tax, based on the models we have created for the last two economic cycles in the hog industry. What you can see is probably something that each of you probably know:

- The industry has a definite cycle;
- The cycle for production is much more volatile than the cycle for processing;
- The cycle for production is exactly the opposite of the cycle for processing.

My assumption is that most of you are aware of this. Certainly this is the basic reason why the advocates of vertical integration have moved in that direction, because they see blending these curves makes for a more stable business. A great objective, but not so good strategy in our view.

Additionally, one trend that we are seeing with the hog cycle, is that the velocity in pricing has been increasing since the mid 90's shown here using the CNE index. Before that time, we always experienced pricing swings but by and large the price movements were predictable within a fairly well understood range. In the last few years, we are seeing a trend that has increased volatility because more hogs are bought on a contract basis, and the cash market becomes more and more thinly traded, resulting in larger swings. All of us in the industry who use the cash market for contract pricing experience those wild moves. You can expect in the future that the volatility of the cash markets will continue, if not increase, as more and more production moves to fixed pricing and less and less remains for price discovery in the cash markets.

This graph shows us that the percentage of long term hog supply contracts has increased from 2% in 1960 to 1980 time frame, to 11% in 1993 and then explosively to an estimated 70% this year. So basically, this year 30% of the hogs will be purchased without a contract and will affect the pricing for the majority 70%. What a radical change in such a short time, but something isn't right with this picture. The vast majority of these contracts are not in my terms really contracts. They are supply agreements, with spot prices, based mostly USDA three area lean. What the majority of these contracts don't do is they don't stabilize the economic relationship or transfer a price risk from the producer to the processors. These is no economic transfer in the form of a fixed price for the hogs which is exactly what vertical integration does do and blends those curves. These formula price contracts are nothing more than simulated spot markets with a guaranteed outlook for your hogs. Again, not a bad thing, but simply not enough. I would suggest to you that this is one of the most important charts for you to consider today. It describes what we outline as the degree of fixed pricing that exists in the industry by each of the major processors in the market place. Today we have a story of extremes. From the old world of IBP which is very low in fixed price arrangements, all the way to companies like Premium Standard Farms that are totally 100% fixed priced, by virtue to the fact that they are 100% vertically integrated. Smithfield is shown here at around 60%, we believe that the industry average in North America is in the vicinity of 20%, including the vertical integration ownership. Now where do I believe this is headed. I'll be bold today and say 80%. We believe that 80% of the supply hogs at some point in the future will be marketed with a fixed price agreement which totally transfers market based risk, not production risk, but market based price risk from the producers to the processors. How do I feel about this for Maple Leaf Foods? Great. I'd ask you all to use your imagination. Can you imagine a world where 80% of the hogs in all across North America were sold at a fixed price that gives producers a reasonable return on their investment. I would say to you, what a sane place that would be. Interestingly, we are convinced that there would be reduced volatility in fact, not increased but reduced volatility, for the processors as well. Certainly an increased volatility for the remaining 20% of the spot market, so you wouldn't want to be left behind. There would be less focus on the buy side activity for processors, maybe a lot of field buyers in the US would be out of jobs. There would be an increased focus on the sell side activity of processors - a very good thing. Most importantly, there would be an increase in stability in the production sector. So you would like that. I would think so, but you may have to ask how we get there from here. Well, certainly Smithfield has chosen the vertical integration model. As I said previously, great objectives, and good idea but bad strategy in our view. There are many alternatives in how we could accomplish this but broadly speaking there are two primary ways to achieve a fixed price world. Either through vertical integration and ownership that blends those curves, the Smithfield way - an "I own it all" approach; or through vertical coordination, where long term contracts and partnerships provide the same benefits as vertical integration without actually integrating. This is what we mean by vertical coordination - a coordinated approach to the supply chain. Maple Leaf has chosen this 'Made in Canada' solution of vertical coordination. This is our primary economic transfer mechanism to match the economic effects of vertical integration in the cost of production contract. We believe this is a superior approach.

I have been alluding for some time to the underlying thinking behind our strategy at Maple Leaf, well here it is in the black and yellow. To be the number one pork protein company in the world, creating maximum value for Maple Leaf stakeholders, and all stake holders through effective vertical coordination of the pork value chain. It's important to understand that this vision impacts our strategy at all levels of our business in the pork value chain. Or, to say it in a different way, we have seven operating companies in the Maple Leaf Foods group that all participate in the supply chain to some degree or another now share this vision which is rooted in vertical coordination, not vertical integration. Stated very simply, the goal of vertical coordination is to gain all of the benefits of vertical integration without being vertically integrated. Let me say that again, the goal of vertical coordination is to gain the benefits that truly do exist of vertical integration without integrating. At Maple Leaf, the business model we have chosen to follow is quite different than those for Smithfield or IBP. It's based on our partnerships in the value chains; closely aligned partnerships but independently owned producers. We support this with an internal organizational structure that allows each of the separate entities in the Maple Leaf group to operate as independents, not demanding a relationship with producers but rather earning one. We believe that the benefits of vertical coordination over vertical integration are clear.

- We value the role of independent owner/operator producers;
- We can mutually achieve economic risk transfer of fixed price relationships to long term cost of production contracts, not ownership;
- We believe and the facts show that it is more efficient, independent producers historically have and will continue to do better work, more efficiently with a better product than corporate farming.
- There is greater flexibility to meet the demands of a changing market place around the world.

I'd like to briefly review the basic principles behind the cost of production contract. I won't go into the detail specifics, but in broad terms here are its features. The COP contract is available through our Signature Medallion program. The contract is based on the principle of equality of opportunity, not necessarily the equality of results. Contract term must run at least one hog cycle, defined as five years. Maple Leaf has some direction over genetics, nutrition, bio-security, construction and management practices under that choice. Obviously, it's your choice and we offer financial incentives that depend on the level of contract. Some producers in this environment would feel a loss of control. We simply don't look at it this way. We see it as gaining the benefits of vertical integration without integrating. There is a producer mix of market formula priced at COP contract options. As prudent risk managers, we would recommend an appropriate mix of COP and market based contracts. Recognizing that it is reasonable to expect that a market place risk yields slightly higher returns based on averages over time where as a COP contract on the other hand offers a lower risk and a risk adjusted return. This is logical and normal. Higher risk, higher return, lower risk, lower return. While that is something that you need to manage, we would encourage a balanced approach. There is an old Japanese quotation about conservative investing and it goes something like this. "Enjoy the party but dance near the exit." What this means is that it is appropriate to hedge your bets. The Maple Leaf Foods cost of production contract is designed as a true risk management tool that offers for the 90th percentile of producers a way to achieve, on a stable basis assuming they meet the targeted production performance, a return on equity of 15% and for the best producers over 20%. We have some signed up now and we will open up specific sign up windows at certain points in the future. If any of you have an interest in learning more about the details behind these long term agreements, we would be happy to talk to you about it at any time at your convenience.

So wrapping up, in times of revolution, there is limited tolerance for stand-by observers, its time for action. In Africa, they say it like this "when elephants fight, it's the grass that suffers." Let me wrap up my comments today with a specific call to action for each of you to consider. I believe that we should:

- Get to know the Maple Leaf vertical coordination strategy and how it can work for each of us in the industry. The notion of control is a relic of the past. This is about winning together, it's about the producers and the processors making money with the least amount of risk.
- To the producers in the group, I would suggest that you investigate a blended approach to the Maple Leaf cost of production contract. When the next window opens, hedging your bet is a good thing to a conservative investor.
- To the other processors in the room, I would encourage you to duplicate the Maple Leaf cost of production contract. We believe it's good for the entire industry and is better when the entire industry embraces this.
- Think of consumers and customers as our friends not our enemies and get to know them because brands and supply chain relationships will absolutely rule in the future.
- Size matters and pick you partners carefully.

I've covered a lot of ground. I know it's early in the day and early in the conference, however I would appreciate and enjoy taking any questions which you may have about the content of this presentation or in fact any other issues I may not have addressed to your satisfaction in my remarks this morning. Thank you for your patience and for listening to our view of the industry.

Questions

Bryan Perkins, Perkins Farms, AB *- Michael, a very interesting presentation for an industry in transition. You talked about the importance of your company establishing relationships with independent producers rather than the strict vertical integration route. I would be interested in knowing your definition of an independent producer and do you consider that there may be a range in that category.*

McCain - I would say in the strictest sense that the definition of an independent producer is one who owns his operation. This is certainly if you cut to the heart of the matter. Some people would believe to the extent that Maple Leaf, as the coordinator of a supply chain, makes the decision to chose it's preferred genetics or nutrition programs or what have you, or maintains control over those certain types of contracts, this by definition means the loss of independence. I simply don't look at it that way. I appreciate the perspective but I don't see it that way. I see it as gaining the clear, obvious and fact based advantages of vertical integration without integrating. I give up control to some of my customers every day, to food service customers and what they see as what's important to them in their business and to that extent I can survive and thrive as the processor meeting their needs. I couldn't care less if they want yellow widgets, they are going to get yellow widgets. So that clearly seems to be a focal point of debate of whether that constitutes a loss of independence and I don't believe it does.

Having said that, we designed our programs in Western Canada around the notion of choice, free choice, and we're not going to make that choice for our partners. We have programs that go the full spectrum. We could have said that's the direction we want to go. We could have said let's go there with a stick or a carrot. The stick would be - you have to do this as a producer. The carrot is, here are some incentives to do that, there are gains and benefits, and we'd be happy to share those. We're not going there with a stick, we're going there with a carrot. There are benefits to coordination, and we're willing to share those benefits. Having said that and I reiterate it, I've said it before, I'll say it again, I'll say it ten years from now, that's a choice that the producers have to make themselves and there will be room in the Maple Leaf procurement programs for all of those choices. I personally believe the smart one is the vertically coordinated approach, but if some people are so wedded, absolutely married to making that nutritional or genetics call or barn design call, what have you, does that mean you can't sell pigs to Maple Leaf? Absolutely not, I don't think it's the right choice, but we have a lot of room, lots of contract available to do that.

As Gary Stott said, our programs are designed so that people can't suck and blow. I guess is the way he put it. Is this right Gary? I want all the incentives, but I don't want to do this. I want to share the benefits of vertical integration, but I don't want to be coordinated. Some days these are the trade-offs you make. Is that helpful?

Perkins *- Well, obviously I hit a bit of a nerve there. You did an excellent job of answering the question that someone may have asked you at sometime with a different intent that I had. My intent was that, and you did a dandy job. I'm really interested in how you define an independent producer. Do you define an independent producer as someone who owns and operates their own farm, or can it in fact be a system, or what sort of definition are you suggesting when you are talking about establishing a relationship in which you establish some criteria for operation of a independent producer?*

McCain - I don't know a strict definition exists. My guess, off the top of my head, I'd say if you were to draw a line in the sand, it would be about the notion of owning and operating. I own a piece of Maple Leaf Foods and I've owned businesses that I owned and operated, that business. But I have worked with customers who have told me exactly what they wanted in the form of product but I still own and operated my business. If there were definition, that would probably be it.

Florian Possberg, Big Sky Farms Inc, SK - *Michael, we are seeing significant consolidation in all industries and all sectors. My question has two parts. Number* *one, in your opinion, in five years, how many significant players will we have left in the meat protein processing sector in North America and the second part is, in your opinion, how much room is there in Western Canada, specifically, in five years for players in Western Canadian processing?*

McCain - How much room in Western Canada? *(Yes)* In five years, I don't know. That a tough call for me. I'll give you a little bit of a different answer, because I don't know. I will tell you that if you walk down a grocery store, and there are hundreds of categories in a grocery store, from cereal to peanut butter to milk, dairy, any type of product, frozen, grocery, perishable, otherwise. If you walk into a grocery store, of the hundreds of categories in that grocery store, the average category leader of all the hundreds of categories has a 39% market share. The average category has three to five participants in it in North America. I ask you ultimately, why would our industry be much different. That's where it seems the ball lands; three to five leaders, scale players. To the second part of your question, is there room for smaller operators? Absolutely. You look at category after category. There will be room for those niche players in any industry. The difficulty for them will be to define what they are, who they are, and how they want to play. If they try and be a small guy and play toe to toe with the big guy, that's a tough thing. So they have to figure out that it's like when WalMart comes to town, there is room for the independent drug store, but the successful ones have concluded they can't be mini copy of WalMart. They have got to be something different. So there will be room for them, but they can no more be this big guy, than the big guy can try to be a niche player. Does that make sense?

Possberg *- I think so, but the question that more specifically, we are asking ourselves in Western Canada, we had four significant players and now there is three. Five years time are we going to be down to one or two and of course, we are asking you for a guess.*

McCain - I don't know that. I will tell you that the Canadian industry continues at large to be hugely over capacity and consolidation is continuing. Where that ball is going to land, I don't that anymore than you do.

Possberg *- Are you wishing to make a gut feeling guess?*

McCain - No, the bottom line is, that people should bank on the fact that consolidation is going to continue in the industry. I look at that from our customer base on that basis. It's doesn't frighten me, as you say, it's a reality. I have to deal with that. I try and develop closer relationships with customers we are working with, and I know if I'm performing, that won't matter. I think you can suggest that it's going to continue.

Possberg - *I guess producers are asking themselves - you have put a lot of effort into developing a program that is the basis of how you want to see hog procurement in the next while. As producers, it's going to be significant whether we have a choice of dealing with three options, two options or one option. If it's one option, we probably need to realize that up front, be realistic and if there is only room for that number of* *players in our particular region, if that's reality, I guess we need to get our minds around how we are to deal with reality.*

McCain - Florian, the only council that I suggest is that while I won't put a number, now I think it's going to end up here, I do believe it will be more than one. It's inevitably more than one. A third of the market hogs in Manitoba are still going to the US. If we look at it from a market share prospective, if you consider the three Prairie Province, in the eight mid western states of the northern mid west, we have exactly 6% market share - six - in that trading region. We view that as largely our catchment area from a supply perspective. That means 94% of the hogs are going to somebody else in that region and that's where the competition is going to continue. The one thing I do believe is factual, is that there will be more than one processor, even in Western Canada.