

Financing Issues and Challenges Facing U.S. Producers

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■ Introduction

I appreciate the opportunity of providing a US perspective on the financial situation of the US hog industry; on how hog producers have approached and/or handled equity issues that have developed over the past decade or so and to point out some of the potential mechanisms or tools that have been utilized to manage equity within the production sector.

■ Impact of Structural Change

There can be no question that the North American hog industry is totally different today than what it was 8-10 years ago. Vertical integration and the broad use of packer contracts were the two key features that fueled the expansion and structural change in the industry during the 1990's. As the industry has undergone this rapid structural change, the economics of the industry has changed dramatically.

Based on the profitability of hog production for much of the 1980's and early 1990's, capital was provided to hog production units based on several key parameters:

- Historic hog prices
- Historic feed (corn and soybean meal) prices
- Historic productivity of the industry and/or specific performance of individual operations
- Expected operation earnings potential and cash flow of the operation
- Current or expected capital structure of the facility and its operating debt

Since economic returns in the hog production sector had been generally favourable in the 10-15 years preceding the 1998 price meltdown, capital available to the sector was relatively easy to obtain either through traditional lenders or from venture capitalists. Unbeknownst to those financing the 1990's expansion were the hazards that lied ahead.

■ New Realities Require Change

A look at **Figure 1** demonstrates the magnitude of change that has occurred in recent years and also points out very dramatically why hog producers **NEED** to manage their businesses differently today than they did in the past. Figure 1 provides a historical representative of profit margins for commercially oriented farrow to finish margins based on a model that Sparks has maintained for a number of years. The solid line distribution reflects the historical range of profit margins for the 1986 to 1997 time period. You will note that during this historic time frame, the vast majority of months reflected profits for commercial hog operations with monthly returns ranging from in excess of \$75/head US to losses in excess of \$30/head. The majority of the observations from 1986 to 1997 were positive and the average margin for that time period was \$23.57/head.

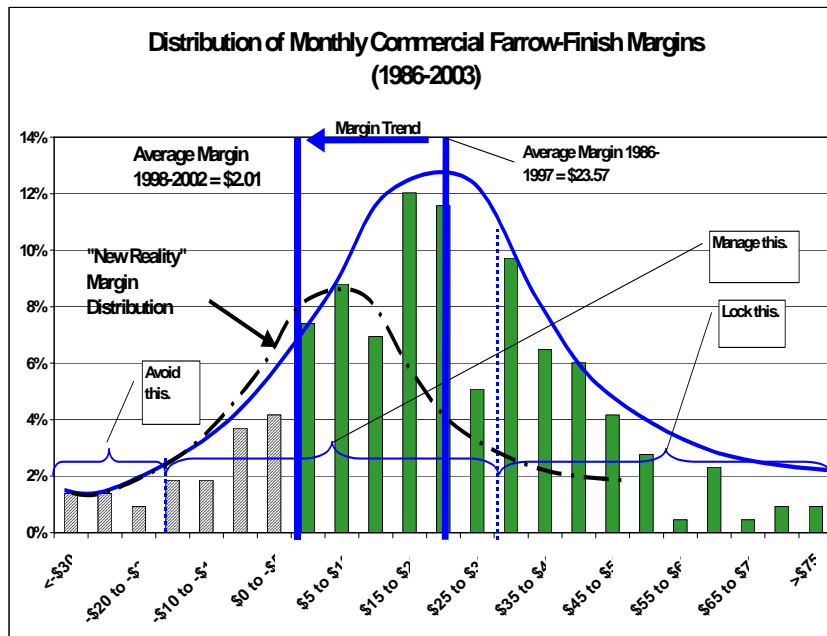


Figure 1. Distribution of monthly commercial farrow-finish margins

■ A New Economic Profile Emerges

As the US hog industry went through dramatic growth and structural change during the early/mid 1990's, the economic profile of the industry changed. For the five-year period spanning 1998-2002, there was a very distinct shift in the profit distribution curve (broken line). The percent of observations still reflects solid periods of profits but the percentage of observations reflecting losses has grown significantly relative to the previous time period. The average hog profit margin for 1998-2002 was only \$2.01/head so in a very short period of time, one can identify a tempering of profits and a shifting of the distribution reflecting nearly as many months of losses as profits. Certainly, managing a business in the "new reality" hog industry presents challenges that were non-existent or at least, not nearly as critical back in the 80's and 90's.

■ Proactive and Tough Decisions

At Sparks, we spend a great amount of our time trying to anticipate where hog producers are going to fall on the profit distribution chart. To do this, one has to have a forward expectation of key input costs, forward hog prices and production performance. While productivity of the hog operation is subject to factors that may or may not be predictable, most can be managed and therein lies one of the key components of success in the hog business; top notch management.

There are two aspects to future feed costs and hog prices that create the potential for being proactive in managing the operation's financial volatility and success. One can certainly build future price forecasts based on rigorous supply/demand analysis but such forecasts should only be used as a guide to managing equity in the firm. The best forecasts in the world will do you absolutely no good if you, as the manager of the operation, are not prepared to make risk management decisions that turn profit expectations into realized results. The futures market and to a lesser extent, other risk management tools must be utilized to capture the economic results that are typically provided to those that are able to identify and execute.

In Figure 1, you will note that we have identified profit levels that should be locked in (at least on a portion of the operations production) when the futures market is providing the opportunity to do so. There are times when profit expectations can be very bleak and it is our contention that when looking ahead, producers should never sit idly by and allow themselves to absorb more than \$15/head loss. When future supply/demand conditions raise the threat of losses of this magnitude, producers should move quickly to prevent such potential losses from becoming reality. This is easier said than done and at times, factors enter the market and create shocks that either were not or could

not have been forecast. My point is that the onus is on today's manager to be on top of market conditions at all times and have a plan in place that can be executed quickly when warranted. Many times, the market has adjusted before action can be taken and this almost assures heavy losses and maybe business failure if the equity does not exist to ride through the severe market down turns.

I have been involved in working with pork industry supply chain participants for the better part of 30 years now and I can assure you, you can not be right about the markets all of the time. I can also assure you that some of the "best" hedges I have ever been involved with, were hedges that were placed at small loss levels. One might say that locking in a loss is a prescription for failure. I tend to disagree and if done at times when a real "margin" threat exists, it may actually be the prescription for success. In our experience, the most difficult hedging decision for a producer is one that locks in a \$5-10 per head loss for a period of high uncertainty; normally the 4th quarter of the calendar year. But there have been several recent examples where making this tough decision has gone a long ways to maintaining the equity of an individual farm. The huge losses in the late months of 1998 and most of 1999 could have been mostly avoided through timely execution of a hedge program. Dealing with an equity crisis once you are already into it is comparable to closing the barn door after the horse has run out. You still end up with an empty barn.

Of course, understanding your operations risk exposure and managing it can be addressed in other ways. I know in this session last year, a lot of time was spent discussing various types and forms of packer contracts and packer integration. There are viable reasons why the US (and Canadian) hog industry has re-structured itself and I think the economic drivers behind the re-structuring of the industry and the development of contractual business relationships can be seen in **Figure 2**. This chart provides an extended history of the level and volatility of both packer and hog producer margins. One can easily see that there is a strong cyclical component to hog production margins over time and a very strong trend in overall producer margins to lower levels. Back in the 80's and most of the 90's, the biggest unknown for hog producers was just how much money they would make; not whether they would or would not make money. That has changed in the last 5 years, so the question now is IF money is going to be made or lost; a totally different operating environment.

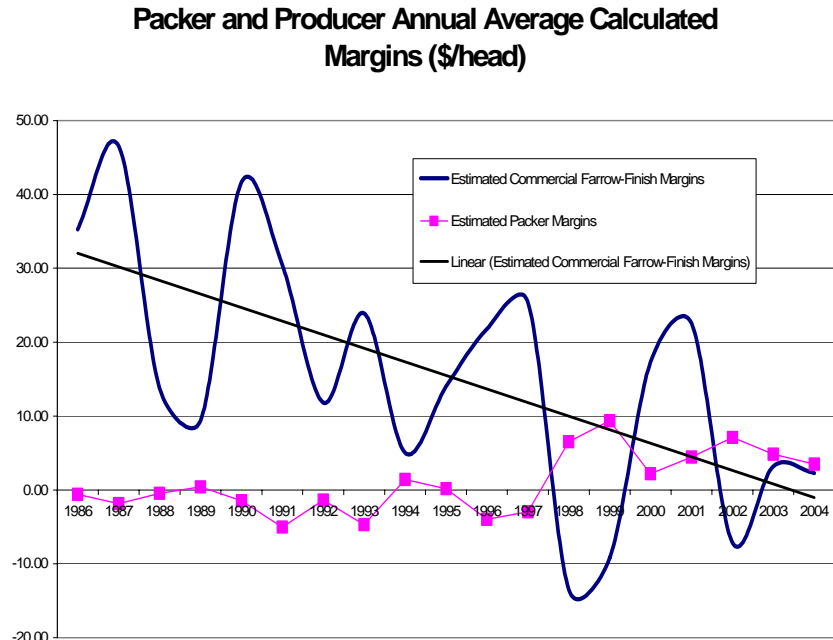


Figure 2. Packer and producer annual average calculated margins

■ **Packer Influences**

For the packer, the 80's and most of the 90's were years of relatively tight margins. Since we do not have a way of fully representing the total industry in terms of packer margins, let's just say that at best, it was an industry of tight margins and being successful had plenty of challenges. During the period of tight packer margins, the US industry went through major consolidation and during the early/mid 1990s integration became a new feature in the market. As a result of these efforts, it would appear that packers were able to establish a new margin level and one could certainly draw an implication from the chart that some of this may have come at the expense of the hog producer. Coincidentally to these changes in producer/packer margins was the rapid acceleration in packer contracting; some of this initiated by the packer to assure a predictable supply flow and some by the producer to guarantee access to shackle space. While not evident in Figure 2, which is based off market returns, the development of many of these packer contracts had an element of margin protection for the producer so those that had risk sharing elements did take out some of the margin depression that developed in 1998/99 and again in 2002.

The point that I'm trying to make is that changes in the industry during the 1990's accelerated both packer and producer consolidation and also fostered a rapid shift to industry integration. Today, integrators account for about 20% of US production and when lumped together with hogs that are also under various forms of supplier contracts, about 85% of hog production is operating in a new business environment. Changes that have taken place will keep hog prices (returns) at long-term average levels not significantly above long-term average costs. Investment in hog production from outside capital sources will be constrained by the lack of return on that investment so it is likely that current integrators will continue to expand their numbers base (probably through acquisition of existing sow facilities) and at the same time, there will likely continue to be efforts on the part of producer groups to integrate into the processing segment of the industry. I think efforts on the part of politicians to legislate against packer ownership of hogs will continue to fail and those operations that are well run and forward looking will be the long-term survivors.

■ Conclusions

I know I have delivered a sobering message today on the equity challenges facing US producers, and probably by extension, Canadian producers as well. But it is important to face up to the fact that the "golden" age of commercial pork production is history. In the new reality of hog production, top production management and a low cost structure are no longer optimal. Vertical integration both through direct ownership or contracting/coordination will continue, and is on a path to help reduce margin volatility; but it is not without its own unique challenges. Finally, unless they are low cost AND high equity, producers will need to become much more proactive in risk management than they have been historically.