

Financing Issues and Challenges Facing Canadian Producers

Michael L. Deutscher

905 Fifth Avenue Box 610 Humboldt, Saskatchewan, S0K 2A0

Email: mdeutscher@bigsky.sk.ca

■ Introduction

My involvement in the hog industry is relatively short lived. Although I have been involved as an advisor to grain, cattle and hog farmers for all of my professional life, I didn't get into the hog business until 1995 and have been full time with Big Sky Farms since 1998 as CFO. I have seen good times – 1996 to mid 1998 and 2000-2001 - and the bad times – 1998/1999 and the last two years.

During the years spent at Big Sky, the growth rate of the industry has been phenomenal. However, it became apparent two years ago that the industry was reaching a crossroad. Would the focus remain on expansion or would the industry face a period of rationalization? I think the answer is now apparent.

■ The Twenty-first Century – Huge Opportunity

It appeared that the Canadian hog industry had a lot going for it in the year 2000:

- A top quality, safe product.
- Access to growing international markets.
- Abundant low cost feed ingredients.
- Top quality research.
- An abundant land base particularly in Western Canada.
- Excess slaughter capacity.

There was an opportunity to grow and the hog industry responded. The Western Provinces, with Manitoba leading the way, has increased production by 30% since 1999. We are now producing over 15 million hogs annually, approximately 4 million more hogs than Western Canada's current slaughter capacity. Excess production is shipped to the U.S. for slaughter and finishing.

■ Challenges We Now Face

The opportunity for expansion we saw in 2000 has slipped away from us at least in the short term. There are a number of challenges we have to resolve:

- **Average Price.** We thought that if we produced more hogs, packers would become more efficient and our average price would move up. Although we produce top quality hogs and in sufficient quantities to meet packers needs, the extra value and efficiencies at the packer level is not reflected in the price we receive.
- **BSE.** BSE was a wake-up call for the Canadian meat industry. We rely on the export of up to 70% of our production either as meat or live animals, a significant amount of which goes to the U.S. With the border closed to cattle, Canada had to work its way through a mountain of meat protein.
- **Slaughter Capacity.** Mandatory country of origin labeling (COOL) and Homeland Security in the U.S. We can increase exports of pork over time but with our limited slaughter capacity we will not be able to slaughter all of the hogs that would be available if the U.S. border is effectively closed to live hogs by the enactment of COOL. Packers have indicated that it will take one to two years to reach double shift capabilities and find markets for the extra pork produced. It will also take two to three years to construct new slaughter capacity. There will be a slaughter problem when COOL comes into effect in September 2004.
- **Competition for Shackle Space.** As recently as 2001, expansion was necessary for the Canadian hog industry. But now that we have more hogs than slaughter capacity, there is competition for available shackle space. **Canadian Dollar.** The strength of the Canadian Dollar has impacted exporters and those whose price is based on the U.S. Dollar. Canadian hogs are usually priced on formulae that are U.S. price adjusted.
- **Lower Cyclical Prices.** The average price we received in the 1999 to 2003 hog cycle was lower than the previous cycle. Retailers are receiving a higher percentage of the money spend on food. Packers are closer to the average with producers taking the big hit, receiving approximately 17% of the consumer dollar. In the past, the producer received approximately 30% of the consumer price.

Most producers have put expansion on hold while the challenges facing the industry are worked out.

■ How to Meet the Challenges

- **Differentiating our Product.** We will have to be more aggressive in identifying and differentiating our product. Otherwise, we will have to accept a commodity-based price. We must be able to offer hogs that are high health and fed rations free of meat and bone meal by-products. Also, Canada's CQA program should be front and center in developing markets that pay premium prices.
- **Increase Slaughter Capacity.** We will have to increase slaughter capacity in Western Canada. Hand in hand with increasing slaughter capacity is finding markets for the pork produced.
- **Control Price Swings.** We have to learn how to control price swings through forward pricing and agreements with packers. Since forward pricing is difficult to control beyond six months, long-term supply agreements will have to be negotiated with packers.
- **Source Equity Investment.** With the past eighteen months of poor performance, financial resources of most producers are stretched to the limit. We have to source equity investment not so much for expansion but to survive the current downturn. And the equity must be "patient equity" that understands the hog cycle. To do this we have to find solutions to the issues the industry is facing.

■ Equity and Debt Providers

It is difficult to discuss financing issues given the challenges the industry is facing. Most producers have shelved expansion plans but must still maintain communication with their debt and equity providers. Equity and debt providers require adequate assurance that they will receive a return on their investment and that they are investing in producers that will be able to repay their loans. This is an obvious statement, but one that is a good introduction to the next paragraph.

Producers will have to develop business plans and actions that address the industry's challenges. Developing a plan that uses historical pricing, costs and market data that indicate the potential for profit and sustainability is now just the starting point. New components will have to be added to the model that will at a minimum:

- Provide comfort that risks can and will be managed.
- Address marketing concerns. Long-term agreements/vertical coordination with packers will have to be developed. Producers will likely have to invest in packers and packing facilities.

- Show that you will be in the top 10% of the industry in production and cost control.
- Address environmental and animal welfare concerns.

Big Sky recognized in 1998 that the Company would have to develop and maintain a significant hedge program. In 1999 a “production margin” forward pricing program was developed which has contributed significantly to the Company’s viability.

■ Summary

Raising capital, both equity and financing, has now become a major issue for the Canadian hog industry. In the past producers could prepare business plans based on strong industry performance – performance that provided a healthy return and an adequate buffer to lows in the relatively predictable four-year price cycle.

In the last three years, we have seen a shift in the hog industry outlook. What was once a buoyant positive attitude has become one of constraint. There are just too many negative issues to resolve going forward. A few years ago, it was said that our industry had to mature to compete in the international community. Well, we have matured if maturity meant producing large quantities of hogs.

The Canadian hog industry has reached a crossroad. The old saying that if we produce it, someone will buy it is now out of date. Focus now has to be directed to increasing Canada’s shackle space and export markets. We can no longer rely on the U.S. to take excess production. How do we reduce and eventually eliminate our dependence on the U.S.? We can do so by moving to the next level through partnerships and joint ventures with companies higher in the value chain. Producers with vision have realized this and have or are working towards a more stable production system that includes packer and marketing initiatives.