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The US swine industry: What does the future hold?

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How we got here

I would be remiss if I did not begin by explaining how we got to where we are today. Vertical integration and processors providing packer agreements fueled the explosion and growth of the swine industry in the early 1990s. If we were to summarize how this was done, capital was provided to a swine operation based on the following parameters:

- Historic prices of swine
- Historic performances of swine operations
- Past trends of commodity and feed prices
- Cash flow of the enterprise and earning potential
- Capital structure of the facility and operating debt

Hog prices from 1977 to 1998 averaged \$46 live per cwt. (see **Figure 1**).

As you can see, there has been a fundamental shift in what the average price of pigs has been after 1998. The average price for pigs for the last five years has been much closer to \$40 per cwt. I would speculate that if all of the proposals that we would have seen in the mid-90s had forecasted \$40 per cwt live, we would have not seen many new facilities built in the 90s. Why did this occur?

Integration of the swine industry

The swine industry has become a much more aligned and integrated industry. The swine industry currently is 20% vertically integrated with Smithfield, Premium Standard Farms, and Seaboard. Also, with the evolution of packer agreements, up to 85% of all hogs are not purchased on the spot market, as outlined in **Table 1**.

The point is, from a lender's perspective, we have had a fundamental shift in the industry, and how lenders view the swine industry has changed.

Present status of the swine industry

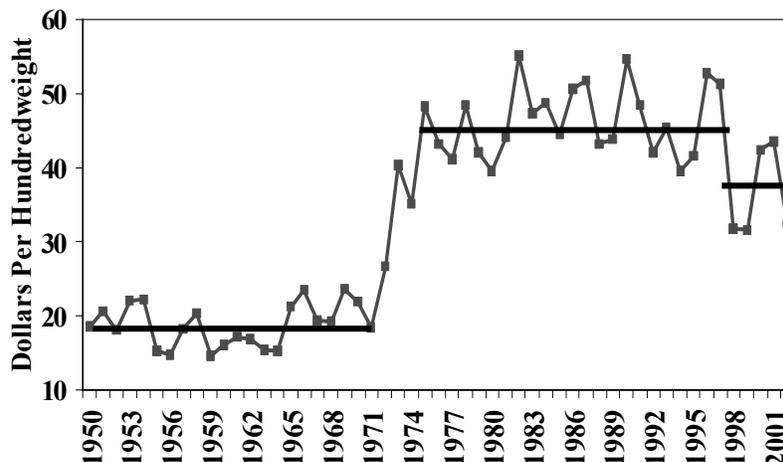
If you are not in the swine business today, don't try to get in. Lenders will be very wary of any new business trying to get into the swine industry. In reality, we probably need fewer people in the industry.

Table 1: January-March 2003 hog sales.^A

	Marketings (%)
Negotiated hogs	13.62
S/P market formula	41.04
Other market formula	5.46
Other purchase agreement	19.37
Packer sold	2.18
Packer owned	18.33

^ASource: USDA/AMS Prior Day Slaughter Reports

Figure 1: Terminal Market Barrow & Gilt Prices, 1950-2002



The days of highly leveraged transactions are over. There were many operations that were funded with low capital infusion (below 30% capital), but lenders will be very wary of any low capital swine deals in the future. Why is this?

First, there is no room for error; however, problems inevitably occur. We have worked with many swine operations that have PRRS breaks and production problems with low capital. Lenders are no longer willing to extend additional capital. In our experience a PRRS break on a 2500 sow unit will cost a minimum of \$500,000 in lost production which equates to \$10 per pig if this unit produces 50,000 pigs per year. The breakeven increases by \$3.85 per cwt. on a 260 lb pig. If this operation had a net worth of \$3 million on \$6 million of total assets, every \$500,000 in losses equates to a drop in owner equity by 8%. This is a loss in working capital, which I will discuss later.

Second, in the last five years we have seen prices anywhere from \$8 per cwt. to \$55 per cwt., and there is more uncertainty in the market. Uncertainty in any marketplace brings much more caution to current established lending standards.

Third, currently packers are also less willing to provide contracts to ensure profitability. Packer contracts in the past had a higher degree of certainty of repayment capacity on their loans that were provided versus what is currently being offered. Agreements in the past helped recapitalize the industry while improving the quality of the product. **Table 2** outlines how producers under contracts are selling hogs of higher quality than hogs sold on the spot market.

Trends as we move ahead

Before I look to the future to see how the industry might evolve, I would like to review where I see the industry today and future trends in the swine industry in relation to who is left producing pork. I have illustrated where I believe the industry is in terms of cost of production and what those costs are. **Figure 2** indicates the current state of the industry.

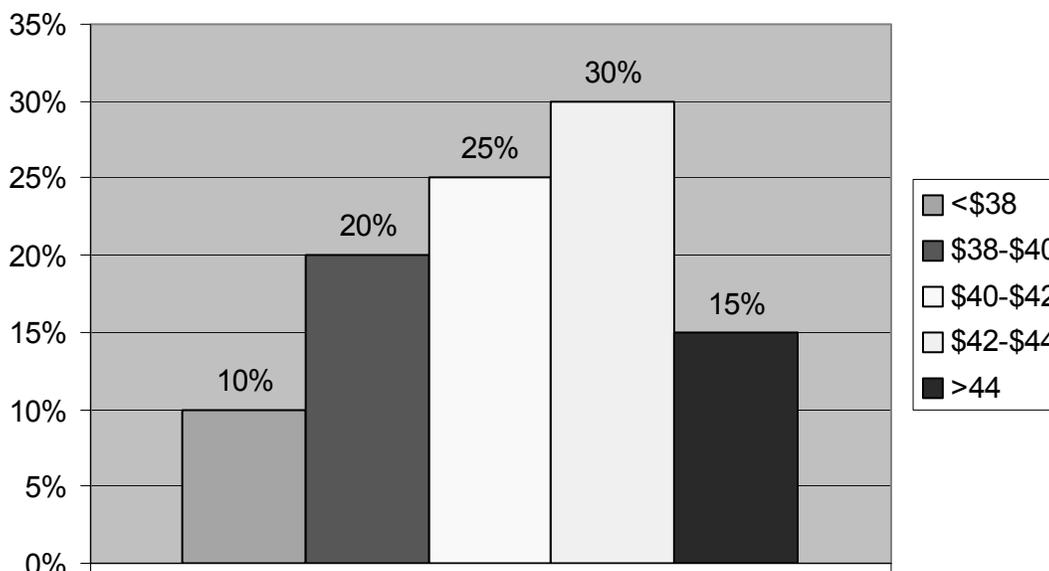
I believe the average cost to produce pork is very close to \$41 per live cwt. This is with average corn cost at \$2.30 per bushel and soybean meal at \$190 per ton. For every \$0.10 increase in corn per bushel, this will increase

Table 2: Carcass traits of January-December 2002 hog sales.^A

	% Lean	Carcass wt (lb)
Negotiated hogs	53.20	193.81
S/P market formula	54.14	196.82
Other market formula	53.69	199.16
Other purchase agreement	54.27	196.44
Packer sold	52.70	194.42
Packer owned	53.49	198.14

^ASource: USDA/AMS Prior Day Slaughter Reports

Figure 2: Swine Industry Analysis



breakeven costs \$1 per pig. Also, with every \$10 per ton of soybean meal increase or decrease this will affect breakeven costs by \$0.70 per pig. As you can see, there is a segment of close to 10% of the industry today with costs under \$38 per live cwt. Now let's go to the year 2006 and let's see how this situation might look (see **Figure 3**).

It is my opinion that with feed costs remaining constant, the graph's peak will shift to the left. The number of producers raising hogs under \$38 has more than doubled and only a very small percent of the industry is operating near breakeven cost of \$42-\$44 per cwt. These producers also have a niche market with a processor to fill a market need for the industry. Keep in mind that their profit per cwt. will not be any greater than the low cost producer. The buyer of this product will not allow this to happen. The

reason for this is that, whether you are raising a niche market-type animal or straight commodity-type of animal, the buyer of the product will only allow so many dollars of margin. The consumer will pay more for it but only a limited amount. Again, you are in a commodity market, but you are competing against fewer people for that market.

If feed costs remain constant, I believe the cost structure of the swine industry will look something like that pictured in **Figure 4** by 2010. There will be a very narrow difference between the 80% of the marketplace. There might be a difference of less than \$2 per cwt. The margin for error will be much less, but the production supply to fill the marketplace will be larger.

Figure 3: Swine Industry 2006

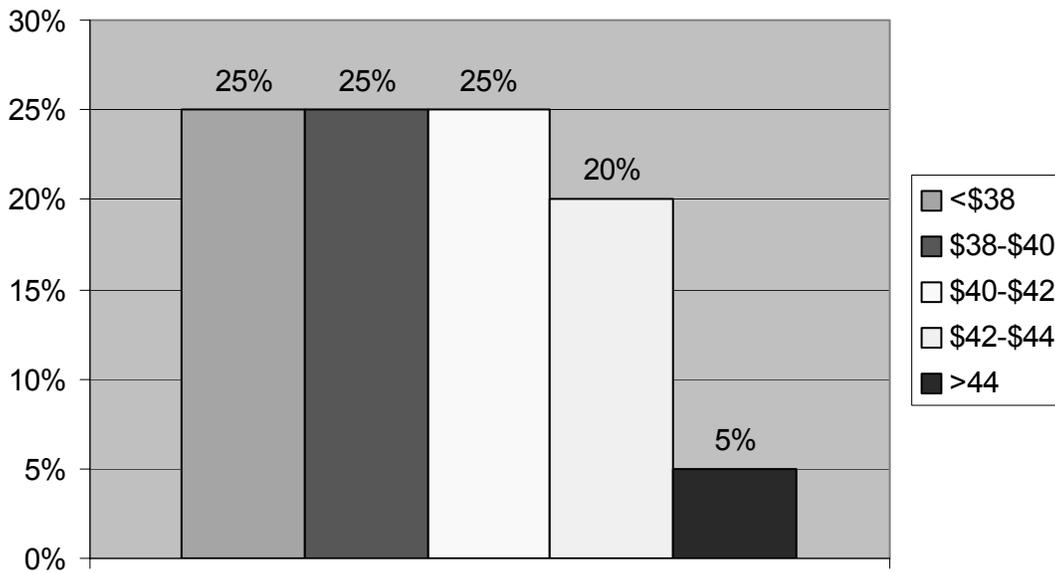
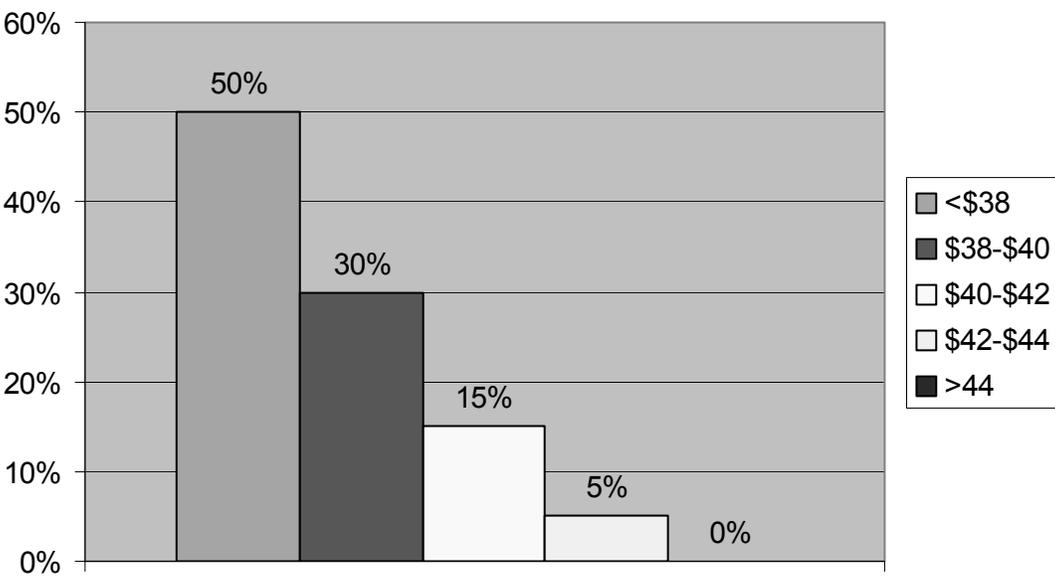


Figure 4: Swine Industry 2010



Strategies to thrive

Cost of production

Not only do you have to know your cost of production, but you also have to be better than the industry average. The benchmark today with current feed cost is \$41 per cwt. You have to be at least this level—and preferably lower. The biggest question that we always hear is, “What do you mean by cost of production?” From our standpoint, it is all costs of operations, including depreciation, debt service, and also general and administrative expenses. If you do not include this in your total costs, you are not being totally honest with your true cost of production. If you are a smaller producer, you need to include family living expenses. Again, this is part of running a business. This is the most critical component to success. The swine industry is a commodity business. You need to be better than the average if you are to survive.

Adequate working capital

From an operations standpoint, adequate working capital is critical to survivability. We realize that over the last two years it has been difficult to maintain and preserve working capital. Producers with adequate working capital can survive and probably grow through acquisitions. A benchmark for working capital on a farrow-to-finish operation depends on the type of operation. If a producer owns a lot of his own facilities, the working capital we would use would be a lower number than a producer who doesn't own any facilities—because he does not have current portion of term debt in that equation. For producers who own their own facilities, we would like to see a working capital number of at least \$250-\$300 per sow. For producers who don't own their own facilities, that number should be doubled. What can a producer do who falls below these numbers?

Refinance

If you have some facilities, try to refinance and increase your working capital situation. Many barns should have only less than five years left to pay, and with our current rate environment this is an excellent time for refinancing.

Restructure debt on sows

If you have debt on your sows, structure a note to pay this off in less than three years. This cost also needs to be calculated in your total cost of production. Many times, we see sows listed on the operating notes as current debt. Pushing this down to intermediate term debt improves the working capital equation. Also, with prices now on the profitable side, this forces you to pay debt down. Don't think about expanding.

Market proactively

Take a proactive approach to marketing. Producers in the future will not be able to rely on contracts. They will have

to be able to use all forms of marketing to compete. They will have to procure inputs, use forward contracts, utilize the Chicago Mercantile, and take advantage of profits when they arise. I believe there will be two forms of contracts in the future: a cost of production contract where producers rely on their production expertise and sell for a margin over costs. This contract will be for a small segment. The second contract will be more of an integrated model by the producer, processor, and food distributor and pricing products up the food chain. I believe this will occur in the next 2-3 years.

The above-mentioned points can be effective for a producer who has 500 or 50,000 sows. Size does not matter. A producer with 500 sows must be more hands-on, and his costs will have to be less than a 50,000-sow system to survive in the long term. Producers have a perception that size always means lower cost, but I beg to differ. In the swine industry, I believe it becomes much harder to keep controls in place once you reach 30,000 or more sows. From my experience, producers are able to handle much of the growth up to the 30,000-sow level; beyond that, there is a new layer of people and infrastructure that needs to be added to handle employee issues. This is a very key point as we move forward. I am not convinced that as consolidation continues and large producers expand we can keep costs down. I believe we would have a lower cost of production with 200-25,000 sow systems than 100-50,000-sow systems. I would take the smaller model. I am not saying you need to be at 25,000 sows, but I do believe that producers will need to market and coordinate their production systems much like a 25,000 sow pod to enhance their revenue. They must work together to maximize their revenue of pounds of pork.

Decision process for exit

This is a difficult decision for any producer and probably the biggest obstacle that most producers face. Maybe it's time to get out; cull sows are at a higher value today. This may be an opportunity not available in the future. If you have 20,000 sows, cull the bottom 10-20%. These sows are causing you a higher cost structure. You need to run your business like other non-ag businesses; many companies are faced with cutting back on employees and operations to remain profitable. You should be no different. The time to exit is not when hog prices are low. The best time to sell is when the market is high. From a sow herd example, this summer cull sows are worth over \$150 per sow; last fall they were worth less than at \$100. For a 2500-sow operation the sow herd alone is worth over \$125,000.

Profile of successful operations

In conclusion, the profile of a successful operation is “SIMPLE”:

- Staying power (You have to believe you can compete, regardless of size.)
- Integrate or coordinate (You cannot go it alone.)
- Management
- Production skills
- Low cost of production
- Equity

The operations with willpower have great opportunities to grow and be profitable. They also will be able to negotiate very favorable terms from lenders. People will want to do business with them.

