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Premium Standard Farms' strategic approach

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Premium Standard Farms

Company overview

Premium Standard Farms (PSF) is the only 100% vertically integrated provider of pork and pork products to the wholesale and retail food markets in the United States and abroad. PSF uses modern, efficient building designs; sophisticated genetic methods; and strict control of animal health and diet to produce premium pork and pork products. PSF has approximately 132,000 sows total, with 110,000 sows in production operations located on over 44,000 acres in northwest Missouri and 22,000 sows located on approximately 54,000 acres located in the Texas panhandle area, with an aggregate capacity to produce approximately 2.4 million hogs annually. PSF operations include hog production facilities, a pork processing facility capable of processing in excess of 7,000 hogs per day (on a single shift), feed mills, genetic improvement facilities, office and training facilities, and additional production infrastructure. PSF's Milan, Missouri pork processing facility is among the most modern facilities of its kind, capable of processing the approximately 2.0 million hogs expected to be produced annually by PSF's Missouri operations.

PSF's products include fresh pork; we currently markets these products to a variety of wholesale and retail customers in the United States and abroad. PSF's fresh pork—which includes loins, tenderloins, hams, butts, picnics, bellies and other products—are sold to supermarket chains, meat distributors, further processors, food service companies, institutional food customers, and the export market. PSF's operations also include the sale of live hogs and the sale of processed pork products in the variety meat industry, the feed processing industry, and the pet food industry.

Industry overview

The pork industry experienced a very challenging year in 1998, which was disastrous for some and advantageous for others. After experiencing near record profits in 1997, pork producers saw live hog prices tumble from highs in the low- to mid-\$40s to a low of \$8 with the average price for the year settling around \$32. 1998 was the first time since 1955 that hog prices dropped below \$10. Adjusted for inflation, prices were lower in December than they

were during the Great Depression. The average price for December was \$15, compared to the 5-year average price of \$47. It is estimated that pork producers lost \$2.6 billion in equity during 1998 (University of Missouri). On the processing side of the pork industry, packing plants benefited by lower hog costs and produced very attractive profits. Although wholesale meat prices were also at historic lows, packers were able to obtain high margins due to the low price of live hogs.

Many factors played a role in the live hog price decline. During 1998, pork producers expanded pork production an estimated 9% over 1997. While pork production continued to increase, packing plant capacity actually declined owing to the closing of four plants since 1997. Capacity went from 419,000 head per day during 1997 to approximately 392,000 head per day during 1998.

The primary factor in the decline of live hog prices in 1998 was overproduction by the industry following high prices in late 1996 and 1997. In addition to a large supply of hogs from the domestic industry, hog imports from Canada rose 830,000 head from 1997 to a record 4 million head in 1998. The increase in Canadian supply was attributed to the strength of the U.S. dollar and a third major Canadian packing plant strike.

Overall, the pork industry in 1998 witnessed many positive signs, including the continued increasing demand for pork products. Packing plants set record slaughters during 1998. In the history of the pork industry there have been weekly slaughters in excess of 2 million head only 28 times. Of the 28 times, 14 were recorded during 1998 with 12 being in the fourth quarter.

Domestic pork demand increased over 7% with per capita consumption estimated to have increased by 5 pounds per person since 1997. Despite the financial situations in Asia and Russia, pork exports increased for a seventh consecutive year with an 18% increase over 1997, exporting 1.23 billion pounds. Pork exports represented approximately 6.5% of the pork production volume.

Pork industry consolidation will continue to play a major role, especially coming out of a disastrous year for producers. The low hog prices of 1998 have curbed herd expansion and accelerated consolidation. Currently, the top 50 producers are responsible for half of the pigs produced

in the United States. This percentage will continue to increase as the pork industry moves closer to a supply chain structure. The success of the pork industry is dependent upon its ability to transform its production processes from commodity-driven marketing and pricing to a highly coordinated production process in which each step of the production chain is aimed at producing a final consumer product. This type of production process ensures quality and consistent products that consumers expect and are willing to buy. Once this production process is finally complete, pork prices will remain more consistent and less volatile than they are at present.

As for expansion in the pork industry, it will primarily be seen in the west and southwest United States. Only five states had increases in pig breeding herds by more than 3,000 head during 1998: North Dakota, Oklahoma, Colorado, Texas, and Utah. According to Ron Plain, University of Missouri—Columbia, this shift is occurring as producers search for isolation from other pigs and from people.

Business strategy

PSF's business strategy is to produce and market high quality pork and pork products at low cost by combining state-of-the-art hog production with modern and efficient pork processing, located together in geographic regions that provide strategic access to key inputs and attractive markets for pork and pork products. PSF's large scale hog production operations use modern, efficient building designs; sophisticated genetic methods; strict control of animal health and diet; modern animal husbandry practices; aggressive feed cost management; and well-trained employees. As a result, management believes PSF generates a high volume of lean hogs of more consistent size and quality and at a lower cost than our typical competitor. Management also believes that, based on cut-outs of over 2.5 million hogs, PSF hogs have more lean meat per pound of live animal, better meat quality, and higher realizable product value compared to hogs raised by the typical hog producer.

Marketing and customers

PSF primarily markets its products as fresh pork; those products are sold to:

- certain retailers and retail distributors in the form of chilled and boxed bone-in or boneless tenderloins, loins, hams, picnics, butts, and bone-in ribs;
- further processors, in the form of containers of chilled bone-in or boneless hams and picnics, boneless Boston butts, trimmings, and other products used by these customers to make processed pork products;
- institutional food customers in the form of large containers of chilled bone-in or boneless loins; and,

- export customers—particularly Japan—to whom PSF ships, in chilled form, boneless tenderloins, loins, hams, shoulders, and bellies for the Japanese retail market and—in frozen form—the same cuts as well as offal items.

PSF's marketing strategy is to capitalize on the quality of the pork produced by PSF's controlled supply of high quality, consistent hogs and its modern processing facility, by selling its fresh and processed pork at prices which reflect a premium. Due to its management of genetics, feed, and animal handling, PSF believes that its products generally have better and more consistent color, flavor, nutrition, and consumer appeal than do products made from typical market animals. PSF's Milan pork processing facility has been designed to enhance the realization of this quality by converting standard pork cuts to value-added products through boning, trimming, and other further processing. Furthermore, PSF may realize additional incremental value by targeting specialty, export, and ethnic markets with undervalued cuts.

In order to take advantage of what management believes to be a differentiated product, PSF markets its products with the Premium Standard Certified label to retail and other customers. Currently all of PSF's fresh pork including that sold to third parties for further processing receives the Premium Standard Certified label. PSF intends to broaden its labeling to include products packaged and sold by further processors who process PSF fresh pork.

International sales

In 1997, PSF renewed a three-year contract with Marubeni America Corporation to be their exclusive trading partner for the Japanese market. PSF and Marubeni are contractually bound to increase export volumes to Japan over the three-year period. Management believes that the Japanese market generally has provided a premium value for the fresh and frozen further processed pork items because of PSF's vertical integration. PSF also exports offal items to Japan because of the generally higher value placed on certain of these items than can be obtained in the domestic market.

PSF is actively pursuing export opportunities in the Korean market. A principal area of focus of PSF will be to replace domestic sheet ribbed belly sales with export single ribbed belly sales. The main risk will be a flooding of the market by low cost competitors. PSF believes it will be able to use its vertical integration and production flexibility to develop this market niche.

PSF also exports fresh or further processing raw materials to Canada and Mexico.

PSF has attempted to establish relationships with domestic trading partners to avoid market risks such as foreign

currency valuation, government controls, tariffs, duties, and unpredictable economic and political conditions.

Production operations

General

Efficient commercial hog production is a science- and management-intensive process that requires modern genetics, insemination methods, feeding, animal husbandry, and management methods. In PSF's operations, the production of a pig takes place in five steps:

- breeding,
- gestation,
- farrowing,
- nursery, and
- finishing.

Genetic improvement facilities

PSF uses AI technology to further improve and control key production parameters, reduce the time necessary to incorporate new genetics, improve product uniformity, increase protection from disease transmission, and enable PSF to implement more rapid product changes. Management believes that the advantages provided by the use of a genetic improvement facility and AI methods will result in higher consistency and higher quality pork and processed pork products.

Breeding stock

Currently, most of the breeding stock used by PSF to stock new sow units and to replace culled sows is purchased from PIC. PSF has also developed an internal "multiplier" herd, which uses a portion of PSF's female production as a PSF-owned and -controlled source of sows at substantially lower cost. This internal multiplier herd is continually improved through the purchase of enhanced genetics. In addition, both to enhance the quality of its genetics and to diversify its sources of genetic supply, PSF has an agreement for the exclusive use and distribution to third parties in the United States of all genetic lines of a leading European pig genetics firm.

Biosecurity

The ability to maintain health and control disease is a crucial factor in the productivity and profitability of a hog operation. Disease may reduce the number of pigs weaned per sow, increase mortality rates, and hamper the growth of pigs to finished size. Diseases can be spread in a variety of ways including transmission from other infected pigs, feed, trucks, rodents or birds, people visiting the farm, or through the air. PSF attempts to reduce the risk of disease transmission through a multiplicity of methods, including geographic separation of—and restricted access to—production facilities, cleanliness procedures,

high health genetic stock, and monitoring and response. All units are restricted access, "shower in/shower out" facilities. If it is necessary for a manager or worker to enter a unit other than their designated unit, a mandatory 24-hour layover period is required. Feed and trucks are inspected and monitored. Procedures within the facilities are designed to stop the spread and lessen the viability of infectious agents during all phases of the production process. The impact of disease is also controlled through the selection of healthy, disease-resistant sows and through herd-breeding procedures which help pass along antibodies to young pigs. When disease is found, prompt treatment is implemented to lessen its impact on the affected animals and to prevent its spread to other facilities. PSF believes that its biosecurity practices and large number of dispersed units reduce the likelihood and economic impact of the outbreak and spread of disease.

Feed mills

PSF derives a number of advantages from milling its own feed. The Missouri and Texas operations are located in areas with access to substantial corn and other feed grain production which is in excess of local demand. As a result, PSF can typically access feed grains on a cost-effective basis without incurring undue shipping expense. In addition, PSF can manufacture and deliver feed to its facilities at savings relative to a commercial feed mill. As a large consumer of grain and feed additives, management believes PSF possesses buying power that gives it an advantage over smaller feed manufacturers. Furthermore, unlike third party feed mills that operate on a cost plus basis and must provide feeds for many types of customers and animals, PSF has substantial incentives and the capability to procure grain cost-effectively. PSF develops "least cost" formulations based on available feed components to create customized diets which are designed to optimize animal performance.

Animal waste treatment

PSF's operations have been designed to handle hog manure in a manner that attempts to preserve the health, cleanliness, and well-being of the animals; provide an acceptable working environment for the employees; reduce odor around the production facilities; and to provide high quality natural fertilizer which is applied to surrounding farmlands. Many of the buildings incorporate a flushing system that removes animal waste periodically throughout the day. In the Missouri operations, this waste is collected in lagoons that are located at each site. In these lagoons water is added and the waste is broken down by naturally occurring bacteria. The effluent, which is mostly water, is drawn through a system of pipes to irrigators, which distribute it on farmland owned by PSF and on neighboring landowners who desire the fertilizer value of the effluent. In the PSF Texas operations, the location of large numbers of units in close proximity on the same

property and the climate allow PSF to treat its waste without the use of lagoons. Instead, waste is pumped to centralized waste treatment centers where solids are mechanically separated for use as high quality fertilizer on PSF's land. The separated liquid effluent is treated in aeration tanks and then used to irrigate PSF's surrounding land.

The effluent provided by PSF's waste treatment systems is a high quality irrigant that enhances the economic value of PSF's acreage. The crops growing on this acreage absorb the specific nutrients contained in the effluent. PSF maintains a staff of land management specialists comprised of farming and animal waste experts and consultants who constantly monitor and model waste production, farming activity, and nutrient levels to ensure that waste is promptly and properly applied and that nutrient uptake by the crops is sufficient to use all amounts applied. PSF believes this emphasis on waste management provides a benefit to its local communities by offering opportunities for cropping arrangements on PSF land and reducing odor and environmental impact.

Processing operations

PSF's highly automated processing operations have been designed to enhance the company's ability to capitalize on the value of its hog supply by achieving the significant benefits of vertical integration that are not available to other non-integrated hog producing or pork processing competitors. First, PSF, by processing its own hogs, can capture all of the incremental carcass value of its hogs through processing rather than passing this value on to other processors. Second, the proximity and integrated management of production and processing operations allow PSF to streamline logistics, transportation, and production schedules to enhance asset use and reduce PSF's cost structure. Third, control over the key factors—genetics, nutrition, and environment—that affect the leanness and meat quality of each hog allows PSF to improve the realizable value of its hogs. Fourth, control of both production and processing generally allows PSF to provide a higher level of quality and safety assurance to its customers.

Most processing plants are large facilities with high capital investments and fixed costs. To operate efficiently, they require a large supply of hogs which they must purchase on the open market. Most of these operations are designed to produce a commodity product rather than high quality pork. As a result, the processing industry is highly competitive and has not been consistently profitable. However, PSF believes that by controlling its own high quality, consistent hog supply, it should be among the more efficient processors in the industry and capable of producing a consistent high quality product whose value will be recognized in the market.

The design of the Milan, Missouri processing facility reflects four key objectives of PSF. First, modern equipment and proven technology has been used to build what management believes to be one of the highest quality facilities in the industry. Second, the facility design emphasizes worker safety to ensure compliance with all regulations and to reduce worker injury and turnover. Third, the facility is designed to produce a product that is appealing to further processors and consumers and will be brandable. It employs identification and tracking technology to ensure quality control for the final pork product. Fourth, the facility is designed to reduce waste products and emissions and dispose of waste in accordance with applicable environmental standards.

The Texas facilities

In 1994, PSF's predecessor began the development of a hog operation located in the Texas panhandle. PSF selected this region for several reasons. First, the availability of large, flat tracts of land allows for efficient layout of units and reduced construction and operating costs. The size of these properties allows for large, three-site production buildings that can benefit from common infrastructure—such as waste handling and utilities—while preserving the separation needed for biosecurity. Second, this area has access to substantial amounts of water from the Ogallala Aquifer. Third, because of the historical presence of large cattle feed lot operations, the area has well developed and economical access is available to locally produced grain, as well as by rail and truck from the major Midwest grain producing areas. Fourth, this region's semi-arid climate is desirable for swine production because it provides a comfortable environment for hogs which both encourages feed efficiency and rapid growth and reduces airborne transmission of disease. Fifth, the region provides relative isolation from other hog operations, further reducing the risk of disease. Finally, management believes the economic and social climate in this region is favorable for large scale agribusiness operations, particularly livestock.

The first phase of the Texas Facilities was the June 1994 acquisition of the 16,800 sow Perico hog production operations and the 33,000 acre High Plains Ranch located nearby. The planned second phase of that expansion was to create a fully integrated production and processing operation in Texas through the construction of additional hog production facilities on the High Plains Ranch, a state-of-the-art processing plant (based on the Milan, Missouri, facility), and the acquisition of an adjacent 7,000 acre ranch. PSF made a substantial investment in the construction of additional hog production facilities on the High Plains Ranch and related infrastructure between June 1994 and May 1995.

However, beginning in the third quarter of 1994, PSF did not meet its operating plans as hog prices declined significantly and feed, labor, and other costs remained relatively fixed or increased; in May 1995 PSF suspended expenditures on the Texas Facilities. PSF initiated organizational and operational changes during and following the reorganization, which it believes—together with decreased debt service obligations and increased hog and pork prices—have resulted in PSF's improved performance since the effective date.

PSF resumed work on the Texas facilities in early 1997 through the planned investment of approximately \$5 million in hog production facilities. With the completion of construction, PSF's Texas operations have approximately 22,000 sows in production operations with the capacity to produce over 400,000 hogs per year. Hogs produced at the Texas operations generally are shipped to PSF's Milan facility for processing to the extent that that facility has available capacity. Texas hogs produced in excess of this capacity will be sold as market hogs to other processors. PSF intends to periodically evaluate the desirability of further expansion of its Texas operations based on production and processing needs, operating performance, capital requirements, and growth strategy. Current plans call for the project to be completed over a period of several years.

Community relations

Premium Standard Farms, and the employees who comprise the work force, are committed to the communities in which their operations are based. Besides being a major contributor to economic growth in north Missouri, many employees of the company contribute valuable resources to society by participating in many school, civic, industry, and church organizations.

Since 1999, PSF has formed a Citizens Advisory Panel comprised of proponents and opponents of the operation. The group meets monthly to discuss issues pertinent to the communities and the company. A community newsletter—mailed quarterly to more than 22,000 local residents—was also established. The newsletter highlights company information to keep citizens informed. A 24-hour hotline was established and provides a resource to contact Premium Standard Farms about any issue.

Premium Standard Farms has an 'open door' policy and has worked very hard towards honest and open communications with media representatives and the communities. Every media call is returned by the appointed company spokesperson and community leaders are urged to attend receptions that provide company updates.

