Red Meat Market Assessment

Toma & Bouma Management Consultants
and George Morris Centre, October 2008

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Canada

What does the future hold for Canada's red meat industry?

It is important to pose this question yet again

Much has changed in both the Canadian and global red meat industries since FCC conducted the North American Red Meat Market Assessment study in June 2006. FCC returned to its original research partners, Toma & Bouma Management Consultants in partnership with the George Morris Centre, to update the 2006 study. This new study examines global developments and emerging trends impacting Canada's livestock and red meat industries, including current challenges, global red meat trends and Canada's place in international markets.

Feed costs

Competitive feed grain costs are the most important component in the livestock and red meat industries. The cost of feed grains has increased dramatically for many reasons (including ethanol demand) and livestock producers across North America are facing losses and exceptional cost pressures. Canadian producers have faced higher feed costs than their U.S. counterparts for several years and consequently have experienced either reduced profits or greater losses.

The net impact is a loss of feeder animals to the U.S. in both the cattle and hog industries. This has created exceptionally low use of feedlot capacity in Alberta and a significant loss of finishing activity in Ontario and the Prairies. In summary, the net impacts are as follows:

- Feeder cattle, calf, market hog and weaner pig pricing is lower in Canada than the U.S.
- Canadian livestock feeder margins are lower than their U.S. counterparts due to higher grain costs.
- Canadian cattle and hog livestock feeders are not competitively bidding for feeder cattle or weaner pigs, which forces exports of both livestock categories to the United States.

Canadian dollar appreciation

The rapid appreciation of the Canadian exchange rate in 2007 and 2008 was a key factor affecting the livestock and red meat industry. Since changes in the exchange rate are immediately reflected in the price of livestock and meat, the impact is dramatic. Appreciation in the exchange rate immediately results in lower prices. When the currency depreciates, as was the case between 1976 and 2001, the opposite occurs. Changes in the exchange rate are intrinsic to pricing.

The appreciation of the Canadian dollar from 2002 to 2008 has created reductions in red meat and livestock pricing and gross margins. Over the past 10 to 20 years, depreciation of the Canadian dollar has made for a gradual increase in profits to Canada's industry, relative to the U.S. On the other hand, rapid appreciation triggered rapid decreases in profits.

These fluctuations raise a fundamental question: did Canada's livestock industry expand because of competitive factors including superior performance and lower cost, or was it primarily due to declining currency value? Regardless, it is clear that Canada's industry is no longer competitive in the U.S. marketplace, the U.S. being Canada's major competitor in both the domestic and international markets. The declining Canadian dollar was a significant factor contributing to the expansion of the industry and the reverse is also true. A higher Canadian dollar significantly reduces the competitiveness of the livestock and red meat industry.

Livestock spreads and basis

Livestock and red meat pricing in Canada is based on the U.S. price, the exchange rate, transportation costs and local factors. Higher transportation and logistics costs result in an increase in the cost of moving livestock to the U.S. and a lower pricing structure in Canada. If there is an increase or decrease in local demand for livestock, there will be an increase or decrease in local pricing relative to the U.S.

The rising cost of fuel, logistical challenges and regulatory requirements related to BSE and problems in the Canadian pork and beef packing sectors have caused spot market price spreads and basis to decline in the cattle industry while formula contracts have been reduced in the pork industry. Lower local pricing for market or finished animals means less competition for cattle feeders and hog finishers, contributing to a record flow of feeder cattle and hogs out of Canada.

Pork and beef packer challenges

Pork and beef packers are challenged to find and keep labour, resulting in reduced capacity use, lower production, decreases in value-adding and subsequent erosion of domestic and export market share.

Labour costs, second only to the cost of livestock, are a major challenge for Canadian packers. Even small differences in wage rates create cost-per-head differences that are crucial to the survival of a plant. Generally, Canadian plants must pay higher wages and this contributes to increased operating costs when compared to their U.S. counterparts.

Canadian beef packers have been impacted by regulations resulting from the BSE crisis. The

Expanded Feed Rule on Specified Risk Materials (SRM) is a major concern and constraint for Canadian packers. Under this regulation, a permit is required to transport, accept and dispose of certain cattle tissues that can transmit BSE. The regulation went into effect in July 2007 and was implemented to further ensure food safety. The Canadian Food Inspection Agency (CFIA) tracks and maintains continuous control over SRM and ensures that it does not enter livestock feed, pet food or fertilizer. The change is estimated to have cost beef packers between $5 and $6 a head for younger cattle and from $10 to $15 a head for older cattle. U.S. packers do not face the same rules and processes.

COOL

Country of Origin Labeling (COOL) became U.S. law on September 30, 2008. Strict enforcement of the legislation will occur following a six-month phase-in period. COOL requires retailers of covered commodities to inform consumers of the country of origin. There are uncertainties and many unknown impacts about the ultimate results of COOL. At the very least, the impact will be neutral. However, it is more likely that COOL will result in a modest negative pricing impact for Canadian livestock.

Global trade

Global competition is emerging on two fronts:

- Low-cost competitors such as Brazil and Argentina are building production capacity. These products move to market as frozen pork because of distance, leaving the fresh category open to Canadian exporters.
- Integrated systems led by operations such as Smithfield and Danish Crown are capable of rapidly locating and establishing integrated production, processing and marketing capability within a target market.

There is good news. Income growth and urbanization in developing countries is an important factor driving current and expected growth in global red meat demand. It is widely expected that global demand for meat proteins will continue to grow over the next decade. Canadian beef and pork sectors will benefit from this increased demand.

The future picture that emerges is that of a bigger pie in which the growth of certain producing regions does not come at the expense of other producing regions. In other words, growth of South American beef exports or Eastern European pork exports does not mean fewer opportunities for Canada.

Global system or organizational developments

A review of industry structures shows that the pork industry is further advanced in value chain or organizational development than the beef industry. Fundamentally, pork production lends itself to concentration and systems more than the beef industry. Six different pork value chains were examined. Each has a set of unique features and is an example of a well-organized and systematic approach to production, processing and marketing. They include:

- **Danish Crown** – a total industry sector strategy built on a co-operative model that has a long history in Denmark.
- **Smithfield** – the highly integrated industry model that has redefined efficiency and cost

competitiveness within the U.S. has proven to be financially very successful, although it may be facing environmental challenges due to livestock concentrations.

- **Seaboard-Triumph** – a contractual model in which six large-scale production groups built a large-scale plant and contracted all product marketing to an established food marketer.
- **Meadowbrook Farms** – a small, vertically integrated co-operative pursuing a value-added niche market strategy in Illinois.
- **Agrosuper** – supported by the Chilean government in the pursuit of bilateral trade agreements, this integrated Chilean model is based on a quality, disease-free platform and has been successful developing preferred supplier relationships in Japan, Korea and China.
- **Sioux Preme Packing** – a specialized custom processing operation that pursues specialized niche markets to serve dedicated customers and dedicated producers or producer groups requiring processing services to supply their customers and markets.

Within the beef industry, the following types of systems or value chains are identified:

- **Branded programs** – the most common approach includes a variety of programs such as the well-known Angus Beef programs (Certified Angus Beef and Canadian Certified Angus Beef). There are over 100 such programs in the North American industry, mostly packer-driven, that begin on the packer floor by selecting and sorting from the daily volume coming through the system.
- **Supply based** – programs driven by individual entities such as feedlots, ranches or a packing plant owned by a group of producers determined to develop their own position in the marketplace. Examples include Harris Farms and Creekstone Farms.
- **Organizationally driven** – programs that focus on organizing a critical mass of supply or producers to develop a unique brand and supply capability within the marketplace. Examples include Ranchers Renaissance in the U.S., SOVIBA in France and Peter's Farm in the Netherlands.
- **Regionally based** – there are several examples of regionally based programs that are driven by jurisdictional interests to create a differentiated product and appeal to local and regional customer loyalties including Nebraska Corn Fed, Ontario Corn Fed and Atlantic Tender Beef.
- **Focused marketing companies** – professional marketing and sales companies that specialize in developing a customer base, and in turn, contracting with processors and producers to supply these customers. They're most common in major exporters such as Australia and Brazil.

The most significant observation is the lack of development within the Canadian livestock industry with respect to organizational or value chain models. In large part, Canadian beef and hog producers are loosely connected to the processing sector because of the overwhelming commodity approach that persists in both sectors.

Conclusions

Expansion of livestock production in Canada will be driven by four key sets of factors that are interrelated:

1. Cost-competitive inputs

The key inputs are feed grains for production and labour for processing.

2. Macro-economic factors

A host of complex supply and demand factors where the relative value of the Canadian dollar compared to the U.S. dollar and other competitive suppliers' currency values is a critical component.

3. Marketing capability

The ability of an industry to develop differentiated supply strategies either by market, market segment or specific customer is a consideration.

4. Organizational capacity

The organizational infrastructures inherent to an industry and its ability to form supply chains that connect the market, the processing sector and the producing sector is a factor.

In light of these factors, it is the conclusion of the commissioned authors of this study that the potential expansion of the Canadian livestock industry is unlikely. Instead, it will be a challenge for the livestock industry to compete and operate at current levels.

It is critical to note that the expansion and success of both the Canadian beef and pork sectors since 1980 has largely been the result of two major factors:

- The availability of cheap feed grains – largely a default of the regulated Western Canadian food grain industry.
- A steady decline in the Canadian dollar (1976 to 2002).

These factors no longer favour the Canadian livestock industry. Now, both the beef and pork sectors face two additional competitive forces:

- Marketing as a core competency – led by major multinational companies with recognized brand names, marketing programs, dedicated supply arrangements, joint investments and dedicated sales forces, including international offices in target markets.
- Organizational strengths on the part of major competitors – within the past 20 years, well-resourced integrated systems, contractual arrangements and dedicated supply chains have emerged. By comparison, Canadian livestock systems appear less able to compete other than as a low-cost commodity supplier. At the same time, Canadian cost structure does not position the industry to compete as a low-cost supplier and expect to earn a return on investment.

The effects of the global financial crisis beginning in fall 2008 cannot be ignored. Immediate impacts for Canada's red meat industry included a decrease in the value of the dollar, accompanied by falling feed prices. Will the late summer decline in the Canadian dollar persist? Will the Canadian beef and pork sectors regain some of the ground lost when the currency appreciated? Will the additional competitive forces mentioned above now constrain the ability to recapture market share? In the longer term, consumer demand for red meats could also change as a result of a new world economy. The full consequences of the downturn remain to be seen.

The points of competitive strength in other countries are points that Canada also possesses in abundance. With regard to fundamental factors such as arable land, livestock densities, fresh water, animal health, climate and access to markets, Canada moves forward in an enviable position compared to most livestock-producing nations in the world.

The Canadian livestock and red meat industry does face daunting challenges. These challenges will likely result in downsizing. Afterwards, the competitive strengths noted will allow Canada to grow and move forward. This will require the industry to develop new organizational strategies and marketing skills while addressing fundamental cost challenges, such as feed grain costs and labour costs per unit of output.

In summary, although there are many significant challenges facing the livestock and red meat industry, there is room for optimism.

If you are thirsty for information that will help you manage your operation, give us a call. Our relationship managers and subject matter experts from coast to coast can help you.

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Notes

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09-067-021-01 E 10/23/08 AS

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