



Lakeside Sale Should be Positive for Cattle Feeders

By Kevin Grier
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Tyson's Choice

Tyson Foods, Springdale, is selling the packing, feedyard and fertilizer assets of Lakeside Farm Industries Ltd, and its subsidiary Lakeside Packers, to XL Foods, Calgary. The C\$107 million transaction includes C\$57 million, which will be paid at closing. The remaining C\$50 million, plus interest, will be paid over a five-year period following closing. Both companies anticipate completing the sale by the end of September.

After the initial disappointment of not having a third domestic bidder pass, cattle feeders will generally be pleased that XL purchased the Brooks operation. The bottom line was that Tyson was going to get out, and at least cattlemen can be assured that the operation is in good hands.

US stock analysts have been eying Brooks and have been questioning Tyson management regarding its future status. On January 28, Tyson CEO Dick Bond was essentially asked how he could keep Brooks open when he had already decided to shutter Emporia, Kansas. A secondary argument was that he did not need Brooks since he had the Pasco plant nearby in Washington. He acknowledged the problems in Canada such as the exchange rate, high barley pricing and the resulting feeder cattle loss. He said, however, that their goal was to keep the product they processed in Canada and be able to sell it in Canada. They did not want to rely so much on the US market for sales from that plant. He went on to say that he thought they were competitively positioned to keep operating at Lakeside, despite some short term problems. At the time, he said "what we are doing in Canada is viable for the long term".

As such, we see that the "viable for the long term," meant that it was viable for about five months. In the Tyson news release June 25, Bond was quoted as saying "Lakeside no longer fits the long-term strategy of our company..." In its last quarterly report on April 28, Tyson stated that "operating results for the second quarter and six months of fiscal 2008 were negatively impacted by higher operating costs and losses at our Lakeside operation in Canada". It is never a good sign when a Canadian operation is negatively cited in a US financial report.

Already the US stock analysts are weighing in favourably. In a June 25 Credit Suisse report entitled, *The Incredible Shrinking Beef Business*, the company said, "In the short-run..., the closure helps reduce losses that we suspect the company was incurring both in terms of cash flow and earnings. [The Long Run] We think Tyson made the right decision to sell this facility. Labor shortages have plagued Lakeside for years as workers in the Alberta province have migrated to the higher-paying oil industry. In addition, the Canadian cattle industry as a whole is

in the midst of a massive liquidation having never fully recovered from the taint of mad cow disease.”

XL Moves Forward

Lakeside currently employs 2,300 people and has the capacity to slaughter and process 4,700 cattle per day according to Tyson. Cattle Buyers Weekly, however, says that Lakeside’s actual capacity is just 4,000 per day.

For its part, XL Foods plans to continue operating the Lakeside facility after the sale is completed. “We believe the Lakeside plant and cattle feeding operation will complement our other beef operations in Alberta and Saskatchewan, said Brian Nilsson, co-chief executive officer of XL Foods Inc. “In addition, it will help strengthen our ability to meet the needs of our North American customer base. We intend to make the transition of ownership as smooth as possible,” said Nilsson. At the appropriate time, this will include informational meetings with members of the Lakeside staff. (Tyson News Release, June 26).

XL is part of the Nilsson Bros. Group, a Canadian cattle feeding and marketing company. Nilsson Bros. entered in the meatpacking business in the late 1990's with the purchase of Edmonton Meat Packing and XL Foods. The business currently includes packing plants in Edmonton and Calgary, Alberta; Moose Jaw, Saskatchewan; Omaha, Nebraska and Nampa, Idaho.

There have also been several opinions expressed suggesting that the purchase price of C\$107 million was a very good deal for the Nilsson’s. That is especially the case with C\$57 million paid at closing and with Tyson financing the \$50 million, plus interest, paid over a five-year period following closing. Certainly, if compared to replacement costs, it is a deal. The view is that it was sold cheaply as a reflection of the limited prospects for the industry. I am not so sure, however, that the sale price was so cheap. The first point to note is that Tyson likely paid about \$45 million for the plant in 1994, according to Steve Kay of Cattle Buyers Weekly. Kay also estimates that they spent up to \$90 million in upgrades. Over the 1990’s and early 2000’s, the plant was one of the better plants in the IBP regime. Of course, with the border closure from the second half of 2003 through mid-2005 the plant was generating exceptional returns. I don’t think the plant owes Tyson anything.

As a final point regarding the purchase, it is important to note that despite the fact Tyson is financing part of the price for five years, the company will not be involved in Lakeside at all. In response to my question in that regard, a Tyson spokeswoman said, “We will not be involved in the management of the plant after closing.”

I think both sides have something to be pleased with in terms of the deal. From the Nilsson’s perspective, their reputation for being shrewd buyers remains well intact. For Tyson, they were going to get out anyway, and they got \$107 million for doing so. A Tyson spokeswoman told me that as of June 27, “We have heard only positive comments about the deal.”

Capacity and Competitive Bidding

There are two key questions cattle feeders will be asking. The first will be regarding the future of the two main XL kill plants in Calgary and Moose Jaw. The second will relate to the competitive bidding situation.

Nilsson's quote that "the Lakeside plant and cattle feeding operation will complement our other beef operations in Alberta and Saskatchewan" suggests they are planning to keep both kill plants open. In fact, Nilsson has stated directly that they do not plan to close Calgary. They do, however, plan on accessing other synergies as a result of the Lakeside acquisition.

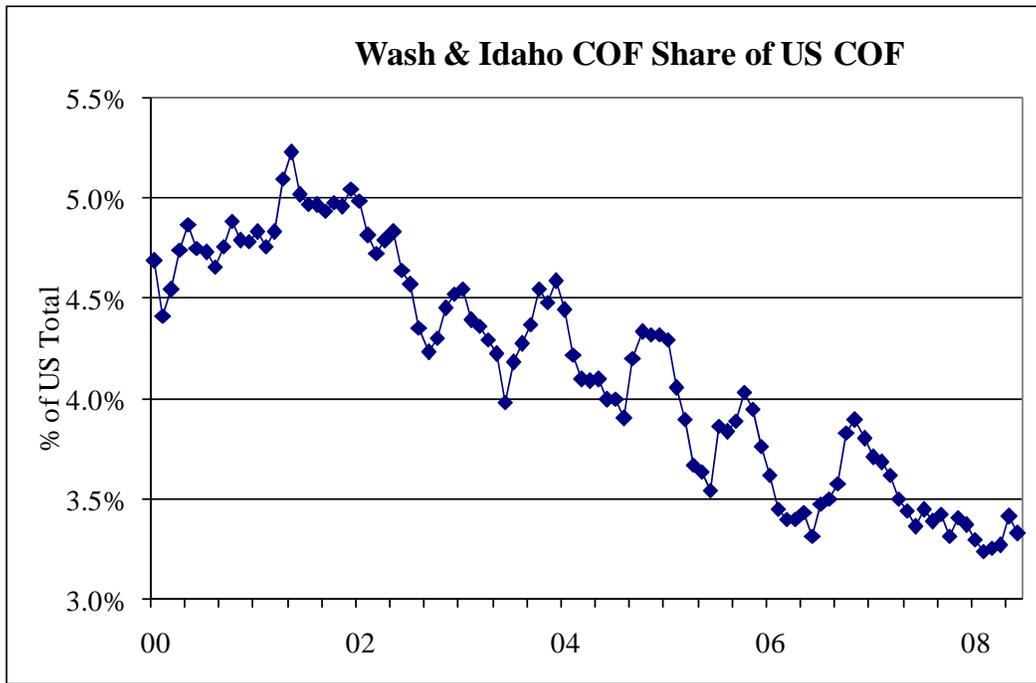
From my perspective, however, keeping the two XL kill plants open in addition to Brooks would be surprising. There are 4 plants in Alberta and Saskatchewan: Cargill, High River; Lakeside, Brooks; XL, Calgary; and XL, Moose Jaw. They have a combined capacity of about 64-65,000 head per week. Total kills have been averaging fewer than 47,000 head in the two provinces, meaning capacity in the region is less than 75%. Often, capacity is much less than 75%. Previous George Morris Centre research has shown that a change in capacity from near full capacity to 70% resulted in increased costs per head of \$26. This is a very conservative estimate but it needs to be recognized that even a \$10/head differential is a huge competitive disadvantage.

If XL were to close the Calgary plant, capacity in the region would decline by 5,000 head per week. At the same time, however, capacity utilization rates would increase to about 80%, assuming that kill levels remain the same. It makes more sense to close Calgary, given its small size and real estate value. Moose Jaw, on the other hand, is in the heart of cow country. While it is generally regarded by cattle feeders as positive to have plenty of capacity, it is much better to have plants running efficiently. Nothing is more detrimental to the industry than its current rate of capacity utilization, which is likely the main reason Tyson left. In other words, it is better to have efficient plants running near capacity than to have unused capacity.

With regard to competitive bidding, there is no doubt that from the cattle feeder's perspective, it is better to have XL and Tyson competing for Alberta-based plants. Nevertheless it also needs to be remembered that long before IBP bought Lakeside in 1994, IBP was an important presence in the Alberta market. IBP's Pasco, Washington plant saw southern Alberta as part of its supply region. Even after the Lakeside purchase, Pasco was a regular bidder, often competing with its sister plant in Brooks. In addition, this action may even heighten the competition in Alberta between Agri-Beef in Toppenish and Pasco. Toppenish, which kills about 7,000 per week, is about hour away from Pasco. As such, it is reasonable to expect that Tyson will continue to be very active in southern Alberta.

In fact, if Tyson has decided they are going to ride the Pasco horse, it is expected that Tyson would be a formidable competitor in Alberta. They have not, however, been making moves in that regard. They are not openly attempting to tie up Alberta cattle for the fall once they are out of Brooks and they are not reassuring current suppliers. Alberta cattle feeders need to keep an eye on Pasco more than they need to worry about XL Calgary.

Furthermore, I am not certain that Tyson actually made the right decision to abandon Brooks and stick with Pasco. The following graph shows the number of cattle on feed in Washington State and Idaho as a share of the total US cattle on feed since 2000.



Source: USDA NASS and George Morris Centre

These numbers do not look encouraging from the perspective of Tyson. While it is true that the Canadian prairies are going to see more cow liquidation, there will still be a massive herd when the liquidation is through. Furthermore, grain is the most important factor in the cattle and beef industry. In that regard, again there are current challenges but, long-term, Alberta has the advantage.

The fact that the beef packing industry in Canada is down to two major players in Canada and three in the US should help to dispel the myth that the sector is a lucrative profit machine. Within that context, the loss of Lakeside had long been feared by cattle feeders. Now cattle feeders can go forward with the knowledge that the plant is in strong hands.