

Cutting back, trading down

Processors respond to consumer purchases based on absolute price

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by Steve Kay

According to many reports, SPAM and macaroni and cheese are two of the hottest-selling food items as of late. That's enough to upset anyone in the meat and poultry industry, unless they happen to work for Hormel Foods or Kraft.

Despite the doom-and-gloom news, however, Americans are still eating mountains of beef, pork, chicken and turkey. Yet, there are significant shifts going on. As the economic crisis deepens, consumers continue to trade down in their meat purchases. Absolute price has largely replaced relative value, as consumers make purchasing decisions based on how much protein they can buy for a dollar.

This is the biggest challenge facing the meat and poultry industry. The economy is still under siege and any real signs of recovery are unlikely to show until 2010 at the earliest, economists say. Consumer spending accounts for 67 percent of gross domestic product (GDP). But Americans have seen a massive erosion of equity, by some accounts more than \$14 trillion in the past year. They are saving more and spending less, hence, the trading down in meat purchases.

Restaurants nationally are also suffering and this is hurting beef demand, particularly for middle meats. OSI Restaurant Partners, which operates Outback Steakhouse and Fleming's Prime Steakhouse chains, reported sales for its 2008 fourth quarter were down nearly 10 percent on the year before. Outback's sales were down 9.5 percent and Fleming's were down 19.6 percent. Outback has now rolled out 15 meals under \$15 to lure back customers. Most of these items aren't beef.

Beef's predicament

Boxed-beef prices in early March were 10 percent below last year's levels. Pork cutout values were 5.5 percent lower than last year. But pork and chicken were still much cheaper than beef, which is why consumers continue to trade down in their purchases. This trend began last year and has accelerated. The wholesale beef market for months has reflected the shift. The price differential between tenderloins and ribs relative to end meats (chucks and rounds) and grinding beef has been at historically narrow levels. Retailers say customers are even trading down from the highest-priced (leanest) ground beef to the cheapest or fattiest.

"The Power of Meat," an annual joint study by the American Meat Institute and the Food Marketing Institute, confirms the trend. The latest study, which details the findings of a national online poll of 1,059 consumers conducted last November, says the recession is being felt throughout the grocery store, especially in the meat department. Economic woes are affecting where people shop for meat, as well as the kind of cut, brand and quantity purchased, it says.

While shoppers are eating out less and cooking at home more, they are also trading down, substituting and eliminating, resulting in overall food spending remaining roughly the same as a year ago at \$91 per week, says the report. But while grocery expenses may be relatively unchanged, the way shoppers are spending most certainly is not. The study found at least half of consumers are using coupons whenever possible, buying only what they need and switching from national brands to store brands.

When it comes to the meat case, 51 percent of the respondents said they have changed their purchasing habits. Popular ways to save money in the meat department include greater preparation before going to

the store and a longer selection process when in the store ♦ 71 percent said they read the grocery flyers looking for meat and poultry deals more often and more carefully than a year ago. Sixty-nine percent stock up on meat when it is on sale, and 67 percent purchase less-expensive cuts either frequently or every time they shop. Others cook more casseroles or pasta dishes to make the quantity go further or buy and cook meat and poultry less often, the report indicates.

Beef and pork demand are suffering as a result. Overall beef demand declined about 2 percent in 2008 from 2007. But the decline accelerated in the fourth quarter from the third and has continued to slide in the current quarter. Pork demand declined 3 percent in 2008 and has also fallen more drastically this year. Both will decline more in 2009 than in 2008. A key factor is the amount of total meat and poultry that will be consumed. USDA♦s latest forecast is for beef disappearance to be up 28 million lbs. in 2009 from 2008. Pork disappearance will be up 519 million lbs. while broiler and turkey disappearance will be down 118 million lbs. Beef will face even more competition from pork.

A more challenging environment

Meat and poultry processors thus face a market environment in 2009 that is more challenging than forecast only three months ago. They will somehow have to sell their products at a price that attracts consumption yet allows them to make a profit. While 2008 was a profitable year for most beef and pork processors, it was a deeply negative year for chicken processors. Beef margins during the first two months of 2009 were positive but then turned negative. Pork margins were red for seven out of nine weeks. In the week ended March 14, fed beef and pork processors lost a combined \$46 million. Conditions will remain challenging throughout 2009 so margin management will be more vital than ever, say observers.

Beef packers also face considerable erosion in by-product values. These were 45 percent lower the second week of March than for the same week last year. Most of the decline has come in hide values. A steer butt branded hide that week sold for only \$29 versus a high of \$64 in the summer of 2008, reflecting a global glut in hides and weak leather demand. The value averaged only \$5.88 per cwt. the first week of March, which meant \$61 per head less than a year earlier. By-product values are how packers cover their variable costs. That♦s why beef margins went red in early February when boxed beef prices fell, even though packers bought cattle cheaper.

Ways to improve margins

Packers are already implementing several ways to improve their margins without relying on the price spread between live cattle and boxed beef. Many are considering running only five days per week and not operating at all on Saturdays, except occasionally this spring and summer. Reduced kills though can be difficult to achieve. Packers face labor-contract issues involving guaranteed hours to workers. They might have to short regular customers. In particular, reductions increase overheads on a perhead basis.

Weak demand at home and abroad have already forced beef packers to run reduced hours. Cattle slaughter from January 1 to March 10 (46 days) was down 1.9 percent from the same period last year, with fed steer and heifer slaughter down about 4 percent. Yet it did little to stabilize wholesale fed beef prices so deeper production cuts appeared necessary before spring demand began to kick in. Hog slaughter was down 1.5 percent, which analysts said was not enough to boost wholesale pork prices.

In addition, beef and pork processors will have to deal with smaller numbers for the next several years. The national cattle herd might shrink in 2009 by another 1.5 million head, after declining 1.544 million in 2008. Canadian cattle numbers are declining as well, and mandatory country-of-origin labeling has made it more difficult to import Canadian and Mexican cattle and Canadian hogs into the U.S.

Imports in the first two months of the year were down dramatically. Cattle imports were down 37.5 percent while hog imports were down 48 percent. Feeder cattle imports to February 28 totaled 64,017 head,

versus 122,129 head for the year earlier period, according to USDA data. Steer and heifer slaughter imports totaled 99,299 head versus 163,631 head. Slaughter cow imports totaled 31,540 head versus 26,166 head. Both feeder pig and slaughter barrow and gilt imports declined sharply. Feeder pig imports totaled 835,559 head versus 1,371,580 head. Barrow and gilt imports totaled 109,010 head versus 538,347 head.

All this might force a plant closure or two. The cattle and hogs won't be available in North America to sustain the amount of capacity the industry still has, say analysts. Packers will have to cut fixed costs as much as possible. They will have to return to running "bare bones" operations without compromising food safety and product quality. JBS showed after it bought Swift & Company in July 2007 that it is possible to save a lot of money. It reduced cattle processing costs from \$212 to \$168 per head in the first year alone. But such cost cutting often means the elimination of salaried staff and has an effect on suppliers to the industry, say observers.

Packers will also need to find new ways to improve meat yields and not give anything away. For example, one packer with a very large ground-beef operation has started using a European fat-detector machine. It measures the fat content of ground beef so accurately that, after being stalled, it saved the packer \$75,000 a day at one plant. The plant was giving away too much lean (meat) in its grind. The machine paid for itself in less than two weeks.

Packers are also looking at ways to reduce their exposure to commodity market fluctuations. They are starting to employ computerized-pricing systems that do everything from calculating how to price meat at the start of the week to helping determine at what level to run plants.

Beef packers are also considering more supply programs with cattle feeders to gain a more consistent flow of cattle and to improve the overall quality of their raw material. A key element of National Beef Packing's success is its relationship with majority owner U.S. Premium Beef, whose members provided National with 19 percent of its cattle in fiscal 2008. National has other key suppliers who provide high-quality cattle. Just 25 suppliers, excluding USPB members, supplied 42 percent of all its cattle in 2008.

Future concerns

Given the somewhat bleak outlook for the next 12 months, concerns will remain about the ability of some companies to weather the economic storm. Several major players have already announced plans to downsize their operations. Of the biggest companies, Cargill Inc. (with interests in beef, pork and turkey processing) and Hormel Foods (in pork and turkey) look to be financially strong.

JBS (in the U.S. in beef and pork) is on a sound financial footing right now and has strengths in its global production platform, its solid balance sheet and its focus on being a leastcost processor. But its beef operations in Brazil and Australia are unlikely to deliver the same kind of profits they did in 2008. And U.S. beef and pork margins, as noted, have deteriorated so far this year. However, JBS on March 10 said it plans to double its 2008 dividend to 102.3 million reais (US\$42.9 million) from a previously planned 51.1 million reais (about US\$21.5 million). The amount is six times more than what it paid in 2007, it said.

As the world's largest meat and poultry company, Tyson Foods has taken various steps so far this year to improve its performance and financial strength. In March it completed the sale of its Canadian beef operations in Brooks, Alta., to XL Foods. Tyson received C\$55.5 million at closing. Another C\$50 million, plus interest will be paid over a five-year period. On March 9, Tyson announced it had entered into a \$1 billion senior secured credit facility with JPMorgan Chase Bank. Tyson also closed a previously announced offering of \$810 million in unsecured notes due 2014. It intends to use the proceeds to repay borrowings and terminate commitments under its accounts receivables facility, repay and/or refinance other indebtedness and for other general corporate purposes, it says.

"Given the current financial market, we believed it was prudent for us to proceed with these measures now," said Dennis Leatherby, Tyson's executive vice president and chief financial officer. "The offering and new credit facility provide Tyson with continued financial flexibility, giving us the option of paying off some existing debt early, as well as funds for future financing needs."

Meanwhile, Pilgrim's Pride Corporation may be in the process of ceding its No. 1 position in poultry processing back to Tyson. Operating under Chapter 11 bankruptcy protection, Pilgrim's is closing three plants, in Douglas, Ga.; El Dorado, Ark.; and Farmersville, La.

It subsequently announced plans to sell the Farmersville facility to Foster Farms for approximately \$80 million. The firm says the closures, which involve the loss of 3,000 jobs, will create \$110 million in annual net savings. The closures mean it will cut production by nearly 10 percent. Pilgrim's says it remains confident it will emerge from Chapter 11 in calendar 2009.

Smithfield Foods, the nation's and world's largest pork company, appears to have strengthened its balance sheet. It took steps in February to close six plants and eliminate 1,800 jobs. It is also significantly restructuring its business model of independent operating companies by reducing these to three from seven. The move will save Smithfield about \$55 million in fiscal 2010 and \$125 million by fiscal 2011, it says.

Smithfield ended its fiscal 2009 third quarter (ended February 1) with \$960 million in available liquidity. It has reduced its overall debt by \$700 million since the fourth quarter of fiscal 2008, including more than \$320 million in the third quarter. Debt to total capitalization has been reduced to 53 percent, it says. However, some financial analysts remain cautious about Smithfield because of the debt it has coming due in October, its heavy hog production losses (\$254 million in the third quarter) and the state of the credit markets.

Corn-price threat

Also hanging over the industry is the likelihood of higher corn prices. Cash prices in mid-March were \$3.50 per bushel, basis Omaha. These were 32 percent lower than the \$5.18 being paid a year earlier. But prices are still well above the average \$2 to \$2.25 seen for years up until 2007. Corn futures in early March were anticipating that prices would creep up to \$4 by late summer. Prices could go higher if the Obama Administration pushes ahead with an increase in the percentage of ethanol-based fuels to be blended with conventional fuel, say analysts.

The Administration wants to raise the percentage to as much as 13 percent from the current 10 percent. Right now, USDA has corn farmers planting about the same number of corn acres as last year. .

Last year's record-high corn prices caused most poultry processors, and Smithfield and others on the hog side, to incur heavy financial losses. Increased prices again this year could put some companies more at risk, given weak domestic demand for meat and poultry and a sharp decline in pork and poultry exports.

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