



SWINE INDUSTRY CRISIS

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Pork is a vital part of American history, economy and everyday life. Behind this longstanding agricultural industry are the producers, processors, and allied industries that all work together to produce what has become the highest quality, safest and most affordable supply of pork and pork products in the world.

Demand for U.S. pork continues to grow and provide opportunities for U.S. producers and processors. The index of U.S. consumer-level demand calculated by Professor Glenn Grimes of University of Missouri rose 2.5% in 2007 and was 5% higher than one year earlier for the period of December 2007 through February 2008. 2007 marked the 16th consecutive record year for U.S. pork exports.

Today the U.S. pork industry is the number one exporter of pork worldwide. This position has been achieved through decades of commitment to improvement in the industry's practices, including quality, food safety, animal care, and the environment. China, Russia and South Korea accounted for the greatest growth in 2007. The growth is due to increasing incomes in importing countries, the weakening U.S. dollar which makes U.S. pork products cheaper relative to those of competing countries and various animal disease issues that reduced domestic protein supplies and increased demand for U.S. pork. The 1st qtr of 2008 brought record-high monthly shipments as well, with February exports accounting for over 20% of the total US pork production.

Given these success stories, one would think this would be a time for celebration in the U.S. pork industry. Sadly, nothing could be farther from the truth. Today, the pork industry finds itself in an severe financial crisis; one not caused by overproduction or lack of product demand, or slaughter capacity or disease, or any of the traditional reasons that traditionally were in the control of the industry.

Situation Analysis

The U.S. swine industry is in a state of crisis as a result of two major forces – completely outside of industry control - that have converged to significantly drive up cost of production. Simply put input costs have doubled in the last year.

1. A dramatic direct impact on feed costs. Feed represents 65% of the cost of producing a hog, and pork producers' feed costs have more than doubled in the past year. As a result, producers in the recent weeks are losing as much as \$30 to \$50 per head and it is difficult to see an end in sight. (Attachment A)
2. A dramatic increase in the amount of capital needed to produce pigs. Higher feed costs have caused a "double whammy" in that not only are producers losing money on every hog they sell, but they also must invest significantly more working capital to get animals to market weight. Cash reserves and lines of credit are being quickly depleted at a time when difficult economic times and a tight credit market are causing banks to actually tighten their credit terms.

Input Costs

The unintended consequence of using bio-fuels to meet the ever increasing energy demand has driven up not only corn and soybean costs, but all feed input costs. Logically, anything that is grown on the soil (and competes for acres) or generates energy, has seen hyper inflation. And the once-predictable relationship between our primary input costs and hog price is anything but predictable, or manageable.

Had the input costs not added 40% to 50% to the cost of producing each hog carcass, the next twelve months would have been profitable. The magnitude of the projected financial losses is such that many producers will be forced out of business.

This is not a market hog price issue...this is an input – specifically corn - price issue.

Pork producers could once depend on the historical "hog/corn" ratio to know that corn ultimately would be rationally priced relative to the price of pork. They are now faced with an "oil/corn" ratio that is impossible to predict with any degree of certainty, and creates a sense of helplessness.

The ethanol industry is also feeling the impact of increased corn prices. However, unlike the livestock industry which is forced to respond in a delayed, free market manner as markets rationalize, the ethanol industry is benefiting from a blenders' tax credit, a tariff on imported ethanol and federally mandated usage. This puts other users of corn, particularly the livestock production sector which has for many years been the largest customer of corn producers in the U.S., at an unfair disadvantage.

Current US ethanol production capacity is about 8 billion gallons per year. Plants currently under construction will add another 5 to 6 billion gallons to bring the total to 13 to 14 billion gallons by the end of 2009. With record high crude oil prices, ethanol production seems likely to exceed the mandated amount of 15 billion gallons by 2015. This means that the 15 billion gallons of corn ethanol will provide a market floor that reduces the perceived risk of ethanol production. Actual corn-based ethanol production could easily rise to 20 to 30 billion gallons so long as the ethanol subsidy and tariff applies to all the ethanol that is produced.

Why Increased Production?

Even though far short of break-even levels, hog prices are remarkably strong given that pork production has reached record levels in the past year. Production has increased for three reasons:

1. Profits. Iowa State University estimates that Iowa farrow-to-finish hog operations were profitable for 44 out of 45 months from February 2004 through September 2007. During that time period, the U.S. breeding herd grew by only 3.1% -- a very modest amount when compared to past hog expansion phases.
2. Increased imports of pigs and market hogs from Canada. Feeder pig imports increased by 11.8 % in 2007 while 19.4% more market hogs were shipped to the U.S. for processing in the wake of packing plant closures in Canada
3. Growing productivity. U.S. producers continue to improve the number of litters farrowed per breeding animal and the number of pigs weaned from each litter. But the big productivity driver since mid-2007 has been the use of effective porcine circovirus vaccines which have dramatically reduced postweaning mortality and improved growth rate and feed efficiency. These vaccines were adopted almost universally by U.S. pork producers in order to reduce economic losses and improve the well-being of the animals in their care.

Risk Management/Access to Capital

The weakness in our economy has created a sharp reduction in interest rates and uncertainty in our stock market, which in turn has created an unprecedented interest in the commodities markets. Due to the general sentiment that we are using up our scarce resources, commodity speculators have generally taken long positions (ownership in contracts) in these commodities.

As if the fundamental factors (energy demand and world demand for grains) have not been enough to drive feed prices significantly higher, this wave of speculative ownership in commodity markets has artificially driven prices even higher, and created yet another degree of risk and uncertainty that is perhaps even more difficult to predict or manage for producers than the "oil/corn" ratio.

Market volatility has made historic risk management tools less effective. Changing grain demands and volatile energy costs have increased basis. Some producers have faced significant margin calls on hedge positions as prices have moved far beyond their historic normal ranges. These margin calls have, in turn, added to short term credit issues with lenders. For example, initial margins have increased, making the credit requirements for hedging greater even if you're on the "right" side of the market. Market volatility is increasing and the absolute value of risk is higher. While long hedges on grains have paid off, there is significant exposure to the downside of prices if one places a long hedge (essentially locking in high feed costs). This is where hedge funds create a problem – if they can move prices \$0.50 to a dollar lower in the short run, the producer's ability to maintain a hedge given large credit requirements is a concern. Then the potential exists to lose on both sides – having lost the correct position (long) due to margins and then having prices rebound after the hedge is lifted. The basic issue becomes one of volatility rather than levels. Volatility creates its own unique set of risks for hedgers and the hedge funds, high crop prices, and global instability are creating this volatility which makes it difficult to effectively manage risk.

Bankers and lending institutions are also in a quandary regarding which risk management tools to recommend. With the price of commodities continuing to skyrocket, credit limits and exposure are at record levels.

Access/Availability of Grain

And concerns go beyond just high input costs, though such concerns are serious. Obtaining physical access to grain is of significant concern. Corn planting intentions are eight percent (8%) less than a year ago. There is also significant weather uncertainty due to a late/wet spring for planting the crop and the risk of drought. The U.S. corn belt has historically had a drought every 19 years, with the last major drought in 1988, 20 years ago. Further, drought in the Midwest is frequently preceded by one year by drought in the Southeast – which happened last year. Producers and their lenders are very concerned about having physical access to corn to feed their livestock.

As a result, many lenders are asking producers to have an adequate supply of grain on hand to guarantee availability and offset any significant upswings in the market. Though this is easier said than done for producers, it is an additional working capital requirement and credit exposure for producers.

Exports of grain continue to increase as world grain supplies remain tight and the weak dollar makes U.S. grains a good value for many buyers. Countries such as China are increasing their imports while others (most notably Argentina) are restricting exports of grain to assure domestic availability and lower prices.

Industry Structure

Due to the rate at which these economic challenges have taken place, a significant number of producers are being affected. The rate at which the cost of production has risen is staggering. More disturbing is the fact that there is no end in sight. Historically, these types of economic challenges were brought on by overproduction of hogs or shortage of a crop due to a weather condition. Either way, we were usually one year away from the economic challenge being reversed. Today, the magnitude of losses by producers is quickly eroding the equity built up over the last ten years and sadly there seems to be no indication of this trend changing.

On March 28, the inventory of US hogs was shown to be about 7 percent larger than year ago levels. USDA's March Cold Storage report showed that the amount of pork in cold storage was 6 percent larger than last year. As a result, hog prices are likely to decrease further in the short term even with strong demand.

In the absence of input costs being reduced or the market price paid for hogs increasing dramatically in the short term...we are left with only one option... downsizing the industry.

Hog manure is a valuable nutrient resource which substitutes for commercial fertilizer. A reduction in hog numbers will result in an increase in reliance on commercial fertilizers further exacerbating ethanol's impact on the environment from more intensive cropping systems.

The industry is currently experiencing a 4% to 5% equity drain per month placing it on the brink of significant loss of producers and production. This economic crisis will cause a significant structural change (versus a typical market swing) as it will hasten consolidation and tighten integration with pork processing companies. Ironically, a major underlying intention of the U.S. bio-fuels policy was to strengthen the independent Midwest farmer; the unintended consequence of this policy will be to hasten the departure of the independent pork producer from the business.

Expected Market Impacts: Producers

Eventually hog prices and profitability will return, but only after a substantial reduction in supplies either from reduced production by existing producers or producers being forced to exit the pork business. A simulation analysis of the market impacts is used to demonstrate how producers and ultimately consumers are affected. Feed costs have been estimated to increase the total cost of producing hogs by about 54 percent. These feed cost increases are assumed to increase poultry costs by an equal amount and beef costs by 25 percent. The lower percentage for beef costs is assumed because ruminants are better able to use alternative feedstuffs. These increased costs result in about a 12 percent reduction in pork production, a 10 percent reduction in chicken production and a 2.5 percent reduction in beef production.

As production is reduced meat product prices will increase. Hog prices are expected to increase by nearly 25 percent and retail pork prices will increase by about 17 percent. Beef and poultry prices will also increase. Factoring in production decreases and price increases, pork producers are estimated to lose a total of \$3.3 billion.

The analysis simply returns the market to its equilibrium condition (price/quantity) relationships before the cost increase. However, it suggests that at current cost levels, the sow herd in the U.S. would need to decrease about 10 to 12 percent. This number is somewhat lower than the pork production level, because some of the production decrease will occur due to expected decreases in market weights and because the Canadian pork industry which exports pigs to the U.S. is also shrinking. There are roughly 6.1 million sows in the U.S., so that we would need to decrease sows by about 600,000 head.

Expected Market Impacts: Consumers

Eventually, these cost increases will be passed through to consumers. Consumers will suffer a loss of \$8 billion due to reduced pork consumption and increased prices. For perspective, the pork industry farm value historically averages about \$12 billion and the consumer value of pork averages about \$50 billion. Consumers will also pay higher prices for other meats resulting in a total consumer loss for all meat of about \$20 billion due to higher feed costs. These losses do not include changes due to trade or the fact that other food product costs and prices are also increasing creating even greater stress on household budgets.

This will have several far-reaching effects on the U.S. government and economy, including increasing the rate of inflation, increasing the cost of social programs not only because food stamps are diminished in purchasing power, but because more people will be enrolled in these programs, and increasing health care costs as consumers shift their diets to less expensive, less healthy foods.

Attachment A

Breakeven Projections

Percent Contracted	0%	Lbs of Gain	270
Weight of Hog	260	Feed Cost per Lbs of Gain	\$ 0.352
Price of Isoweane Pig	\$ 35.00	Turns per year	2.00
Break-Even Price	\$ 60.44	Death Loss	7.0%
Cash Price	\$ 43.00	Corn	\$5.50
Grade Premium	\$ -	Price of Soymeal	\$325.00
Contract Price	\$ -	Price of Other feed	\$ 0.850
Contract Price with Premium	\$ -	Fixed Costs	\$ 27.00
Price Received Total Production	\$ 43.00	Feed Efficiency	2.65
Rate of Gain	1.48	Profit/Loss Per cwt.	\$(17.44)
Lbs of Corn	558	Profit/Loss Per Hog	\$ (45.35)
Other Lbs Feed	21	Lbs of Meal	136
Total Lbs of Feed	716	Cost of Feed	\$ 95.15
Total Cost	\$ 157.15	Break-Even	\$ 60.44

Based on available numbers as of 4-22-2008