Make Informed Decisions
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Leverage Change Coming When?

Beef packer margins have been fantastic for 2-3 years. In a nutshell that is because beef demand has been very good while cattle supplies have been ample. Packers can have it both ways now. In contrast to the packer margins, rancher and cattle feeder returns have been generally poor or disappointing over these same 2-3 years. A constant refrain is that producers lack market leverage necessary to partake in those superb packer margins. They lack the leverage now because of supply and demand; the supply of cattle and the capacity driven demand for those cattle. The question then is when will supply and demand change to allow for greater producer leverage. The second question after when, is how will it happen? Will it come due to increased packing capacity or will it come from a rationalization, downsizing of the North American cattle herd.

The Case for Capacity

Rabobank recently publish a paper entitled, “The Case for Capacity.” The following is an excerpt:

> Despite the U.S. beef industry’s cyclical nature and its current contractionary phase, packing capacity expansion must play a role in rebalancing cattle supplies if the U.S. hopes to maintain or increase herd size over the long term. If the U.S. can avoid major herd liquidation in the current cattle cycle, the beef industry will be well-positioned to capitalize on growing global protein demand. Furthermore, improved industry stability will allow the beef sector to invest more focus and capital in its ongoing shift from an historically supply-driven market to one driven by consumer demands. Adding packing capacity would result in both a larger U.S. beef industry over the long run and more balanced profitability throughout the supply chain.
>
> An additional daily packing capacity of 5,000 to 6,000 head of fed cattle could restore the historical balance of fed cattle supplies and packing capacity and still allow for positive packer margins. Technological advancement poses the most viable option for capacity expansion in existing plants, while 1,000- to 2,000-head plants with product differentiation and strong vertical relationships offer the greatest opportunity for new construction.

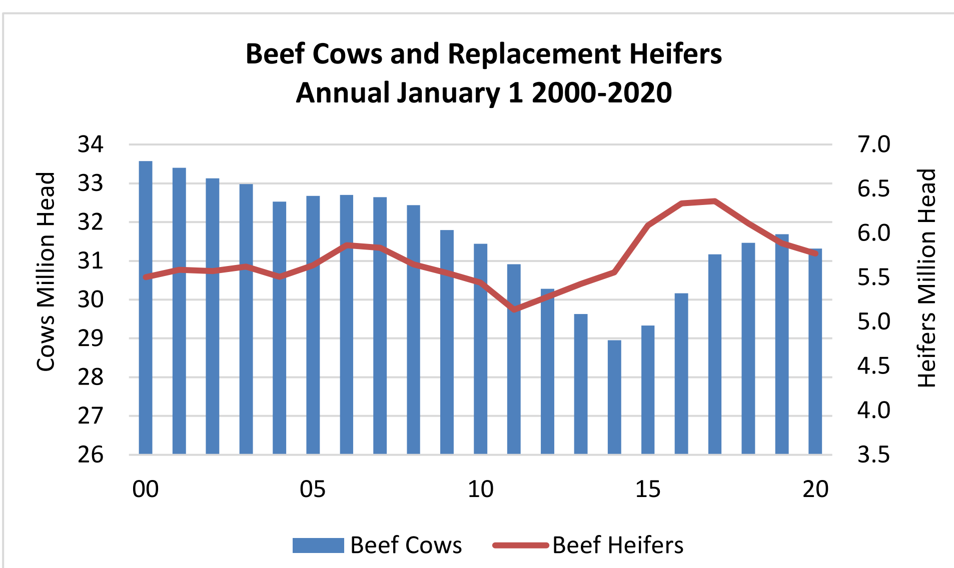
Regarding capacity expansion, Meatingplace.com, October 16 noted that vertically integrated beef processor FPL Food LLC announced that it has secured an initial round of financing to begin a multi-phased expansion of its Augusta, Georgia, slaughterhouse.

The first phase of the project is scheduled for completion in September 2021, and all phases will be completed within the next three years. The initial phase, when completed, will allow the company to process up to 2,500 Black Angus and Akaushi fed cattle weekly. With the completion of all expansion phases the throughput will increase by more than 5,000/week. These numbers will supplement the company's current cow and bull processing and take total production to more than 10,000 head weekly.

That expansion is in addition to the Agri Beef announcement of a new plant. Cattle Buyers Weekly (CBW), August 10 noted that the company has plans for a new beef processing plant in Jerome, Idaho, that will process 500 head per day and is being designed as an alternative model to the industry that is dominated by large plants. Agri Beef will be the majority owner of the plant, but cattle producers and feeders in the region will also be equity owners. Agri Beef, based in Boise, Idaho, is already the industry's 11th largest beef processor with a capacity of 1550 head per day at its plant in Toppenish, Washington. Agri Beef hopes the Jerome plant will open late next year or in early 2022. Once it reaches its 500 head of capacity, Agri Beef will become the industry's eighth largest beef processor, says CBW.

The Need to Increase Herd Size

Rabobank talked of the need to maintain or increase herd size. The paper also referred to the historical balance between fed supplies and capacity. Regarding the herd size and the potential to increase, the U.S. beef cow herd declined by 1% January 1, 2020. The July inventory has declined for two years in a row. The January 1, 2020 heifers for beef replacement tally has been declining for three years in a row. In addition, the Livestock Marketing Information Center (LMIC) estimates that cow-calf operations will be in a loss position this year for the fourth time in the last five years. Furthermore, total beef cow slaughter this year is up by 2% on top of last year. This year's beef cow slaughter will be the largest since 2012. Based on beef cow slaughter and inventory levels, I expect the January 1, 2021 beef cow inventory to be down by 2%.

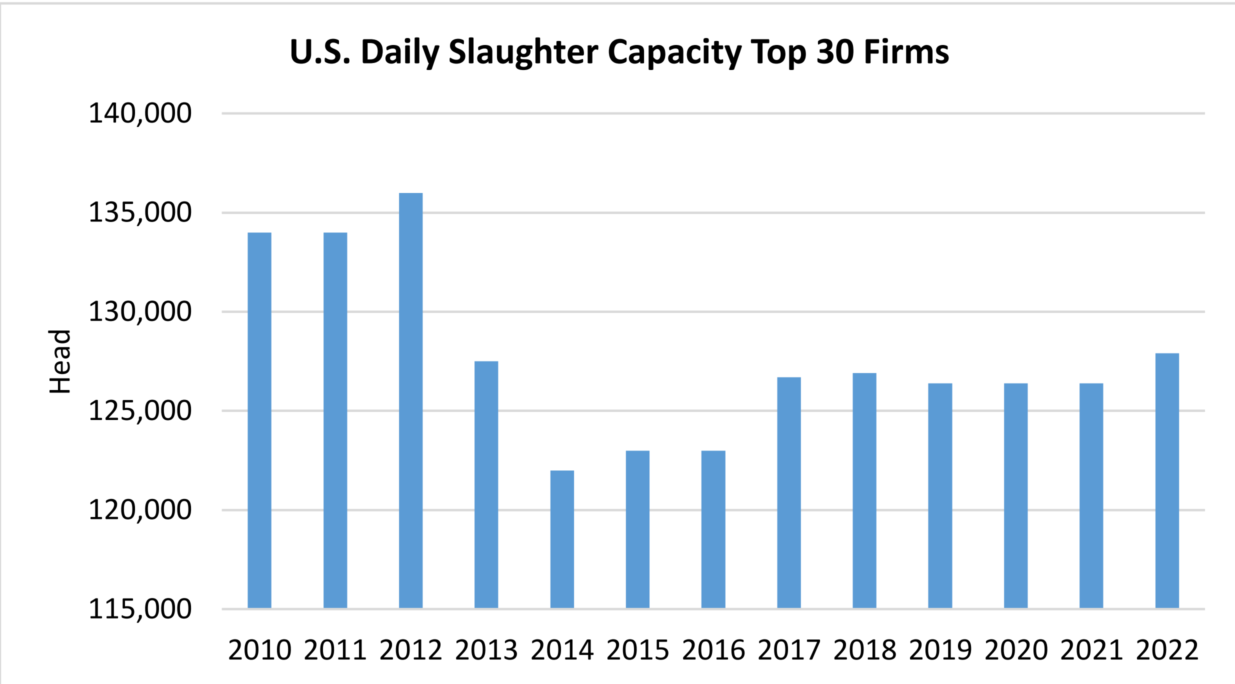


Add to the above the fact that there has been a drought in parts of U.S. cow country and sharply rising feed costs. There is little obvious evidence that there is going to be an expansion of the beef cow herd in the next two years, at least.

The question then is when and how there will be the “historical” balance between fed supplies and capacity.

Capacity and Supply

Based on CBW listing of U.S. packers, the top 30 companies in the U.S. had a one-day capacity of about 126,400 in 2019. It is likely modestly higher in 2020. With the addition of the new plant and expansion, the industry should be at about 128,000 by 2022. Even with this expansion and organic growth, capacity will be much less than 10 or more years ago. As can be seen on the graph, there was serious plant rationalization in the 2012-2014 period. That time saw notable closures by Tyson, Cargill and National.



There are many ways to measure “balance” in the market. Certainly, in recent years the huge expansion in packer margins has been seen as a sign of imbalance. The view is that producers have been unable to share the exceptional margins generated from beef. Whether that is a right way to look at it or not, it is a good starting point. In the five years prior to 2018, the average gross margin was about $200/head for packers. After 2017 packer gross margins increased sharply. Even without the wild vagaries of the Finney County fire or the virus disruptions, gross margins of $400 have been common.

The CBW top 30 listing noted above is for all cattle, not just fed. Taking 80% of that top 30 totals can be used as a gauge for fed cattle slaughter capacity. The next step is to examine capacity against fed cattle supplies. The ratio of steer and heifer inventory January 1 compared to the annual top 30 slaughter capacity from 2010 to 2017 was about 97%. That is fed supplies to start the year were about 3% less than annual capacity. The ratio of the inventory to capacity in 2018-2020 was 102%. The inventory or supply against capacity demand has grown in recent years. The current inventory shows supplies greater than the capacity compared to less than capacity prior to 2018. That can help to explain the lack of leverage that feeders note in the market each week.

Leverage Change in 2023?

By 2022, I expect to see the steer and heifer inventory down about 3% from the January 2020 total. That coupled with the increase in capacity at Agri Beef and FPL should get that supply-capacity ratio down to 98%. In other words, the balance that Rabobank is looking for might start to appear by 2022. That is due to the combination of increased capacity and a herd reduction. The bottom line is that cattle feeders cannot be expected to gain any leverage until 2022. Given likely decline in the herd, that leverage may turn solidly in the feeders favor by 2023. From a cattle feeders' perspective, at the very least it means that there is still a tough going in 2021. Furthermore, it also means that one path that is certain to get to a stronger leverage in 2023, is through a rationalization from 2021-2022.

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