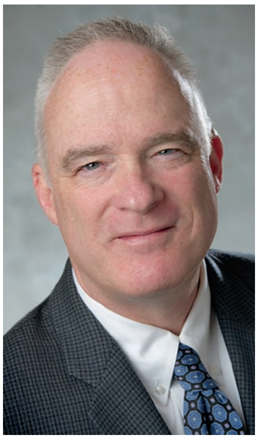
OPINION The View from Grier

A Fall to Remember



By Kevin Grier

The fall of 2016 should be remembered as one of the most fascinating and positive periods for the pork industry in many years. I know it seems strange if not callous to say that considering Canadian hog producers were losing about $20-$30/head this fall. Furthermore, with pricing trending down to the $110 range, it seems peculiar to talk about this being a positive period. With all of that acknowledged, I still say it was a very positive fall and early winter.

On one level I say this because it could have been worse. On another level is say this because I see that the industry accomplished an exceptional feat.

Take the first point: For months I have been pointing out in my bi-weekly report, the *Canadian Pork Market Review*, that the industry in the United States was in danger of marketing hog volumes that were in excess of industry capacity. The last time that happened at a sustained level was in 1998 and it led to a complete hog price collapse. The concern was the same for this fall if the industry consistently breeched capacity with unyielding numbers of hogs.

The concept of plant capacity is fluid, but it basically means the maximum throughput in terms of hogs per hour or per day or week. The fluidity comes in the definition of a day, or a week. Most U.S. plants do a double shift and the midnight shift might be a time of clean-up and maintenance. But that does not mean there cannot be overtime on a given day. There is some flexibility on what can be done in a day. Even if there is no overtime, and even if union rules put a cap on hourly throughput, there is still the issue of what constitutes a week.

Most companies are glad to work on a Saturday. Saturday work helps defray the plant overhead. If a company is working Saturday, it usually means that demand is strong and margins are good, otherwise they would not bother with Saturday overtime pay rates. If a mid-sized Canadian plant of 9,000 head per day has weekly overhead of $400-500,000 and its per head kill costs are $30 on five days, it can reduce its per head costs by $2-3/head by putting in a Saturday kill. One extra day helps reduce the entire kill for the week by a couple dollars. As such the idea of working a Saturday is not a problem. In addition, Sundays are unusual in the industry, but they can be done as well with the same economies of scale noted.

The downsides of overtime and weekends is that workers and plants get tired. Even with overtime pay there is only so much overtime work that employees will want to do before absenteeism comes into play. Plants need maintenance, and continual overtime and weekend work leads to breakdowns and slowdowns.

All of that is a long way of saying that plant capacity is not easily defined and its definition can vary based on circumstances.

No matter how capacity is defined, I expected that a good number to use for capacity in the United States would be about 2.4 million a week. That number had been blown away almost every week since September with no problem (well that might be an exaggeration if you talk to plant supervisors and union reps). Weekly kills of well over 2.5 million head have been common.

The point of course is that when I said, "It could have been worse," that is exactly the case. If capacity had indeed been fixed at what I thought it was, then packers would not have been able to procure those hogs and prices would have tanked by far more than they did in the fall.

Another exceptional feat is that despite the historic kills and production this fall, packers managed to keep the pork cutout value strong. The pork cutout value is the composite value of the carcass taking into account the yields and value of each of the primal cuts such as hams, bellies, etc. It is very noteworthy the as of the beginning of December, the cutout value had actually increased over the fall. Packer marketers were able to maintain and increase the value of the cutout in the face of huge production volumes. That is impressive.

The higher cutout value, efficient plant operations and of course lower hog prices meant that packers had a fantastic fourth quarter in terms of profitability. That of course made them all the more willing to run at full speed.

The other point of credit should be given to producers. Hog farmers knew it was going to be a tough fall. In like of declining futures prices, hog farmers made sure that they stayed ahead on marketings. Producers stayed current and even marketed hogs ahead of schedule. Weights did not build and there was no back up. That also kept this fall from deteriorating.

Demand Continues Strong

Part of the reason the cutout stayed firm, as noted above, is that pork demand continues to be a positive force in the industry. If demand had been weak, packers would not have been able to keep the cutout firm. If demand was weak packers would not have wanted to keep kill schedules as robust.

Looking specifically at Canadian demand in 2016, the Agriculture Canada Red Meat Section calculated that Canadian pork disappearance (consumption) increased nearly two per cent in the third quarter this year (latest). Canadian consumer pork prices, as measured by the Statistics Canada Consumer Price Index, increased by about one per cent in the third quarter. When you combine the fact that Canadians ate more pork with the fact that pork prices increased, it says very good things about pork demand. In other words, despite the higher pricing, Canadians continued to step up to the meat case and purchase pork products.

Price Formula

The discussion of pricing formulas that is taking place in Alberta this fall is sometimes centred on which is the right U.S. reference point. In other words, which is the most appropriate U.S. price in which to base Canadian hog price formulas. The merits of the Iowa-Southern Minnesota or the CME index or the pork cutout are central to the debate.

Currently the industry prices off the U.S. hog through a formula that includes a division or multiplication factor, in addition to premiums and discounts. Those factors are ultimately the local or regional pricing basis which reflects local or regional supply and demand. To me, this is the real issue. While the choice of U.S. reference is central, the most important pricing component is the local basis as reflected

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in the factors and premiums. This reflects packer demand and local supplies.

In the case of Alberta, if Olymel decided that it made sense to change the reference from ISM to the U.S. cutout, the most critical issue then would be the factor to bring the price back to Alberta hogs.

Ultimately it is up to the packers to decide the price that they need to attract enough hogs to the plant. This is within the context of their own supply base, which in the case of Olymel Red Deer is material in the 50-60 per cent range. Producers then decide whether that is enough money to make the investment in the business worthwhile. The decision is whether they will ship weaners south, finish hogs for the prairie competitors or leave the business.

As I have noted in the *Canadian Pork Market Review* many times, it seems to me that the packers have determined that making pricing more attractive on the prairies would be a zero sum game. Based on their actions they must consider that higher prices would not result in more production and greater supplies. Instead it would simply mean packers get into a battle with each other with no net gain. Whether that is right or not is beside the point.

Recent actions however, are indicating that the packers are starting to use price to compete more vigorously. Olymel's signing bonus, Maple Leaf's Sig 3&4 blending and top up, as well as the new formulas from Donald's Fine Foods are testimony to that. Whether this is enough to generate more production or simply results in shuffling numbers between packers is the critical issue.

For their part, producers must also consider the prairie barriers to expansion. These barriers are just as important or more important than price. Construction costs on the prairies far exceed those in the U.S. That plus the environmental regulations and the animal welfare changes make every producer's expansion plans much more challenging, in addition to the pricing issue.

The reality is that the industry now has so few players that it is necessary for both packer and producer to address all barriers to expansion and growth, including price. Packers need to have producers on board more than ever and vice versa. ■

Kevin Grier Market Analysis and Consulting provides industry market reports and analysis, as well as consulting services and public event speaking. You can reach him at kevin@kevingrier.com to comment or to request a free two-month trial of the Canadian Pork Market Review.