Pork Information Gateway

Financing hog operations

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Introduction

To look at financing swine operations, I think we have to look at where we have been in the past and what we will do in the future. Historically, swine production has been a profitable enterprise. However, the market collapse of 1998 has caused many producers to re-evaluate their position in the industry. Only those producers that are willing to respond and adapt to an ever changing marketplace will prove to be successful. I hope this paper gives you an outline to what we will look at as lenders providing capital into the swine industry.

Objectives

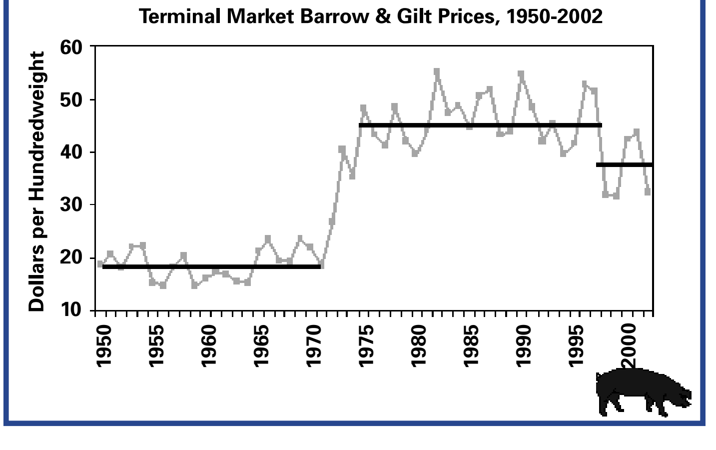
- Inform producers about changes in the industry that will affect financing of operations
- Describe factors which affect capital availability
- Explain the criteria that agriculture lenders use to make financing decisions

Past

In the early 90's vertical integration and processors providing packer agreements fueled the explosion and growth of the swine industry. If we were to summarize how lenders looked at providing capital to a swine operation it was based on the following parameters:
- Past historical prices of swine
- Past historical performances of swine operations
- Past trends on commodity and feed prices
- Cash flow on the enterprise and earning potential
- Capital structure of the facility and operating debt

Prior to 1998, if you looked at average hog prices from 1977 to 1998 as this chart illustrates they would average $46 live per cwt.

As you can see, there has been a fundamental shift in what the average price of pigs has been after 1998. The average price for pigs for the last five years has been much closer to $40 per cwt.

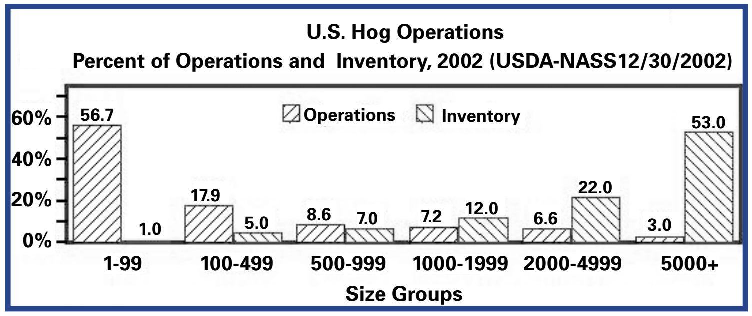


This holds true for 2003 as the average price received for the year was about $55.25 per 100 lbs. of carcass or about $40.89 per 100 lbs. live weight. These average net prices came from the mandatory price reporting data. This is also why there has been little liquidation in the industry during 2003.

Integration of the swine industry

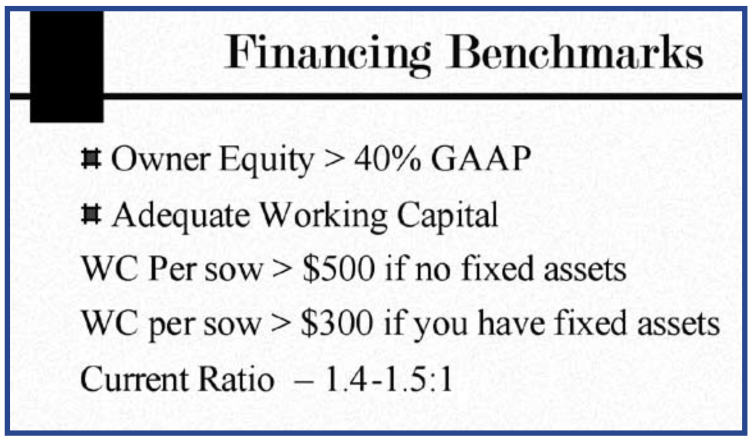
The swine industry has become a much more aligned and integrated industry. The swine industry currently is 20% vertically integrated with Smithfield, Premium Standard Farms and Seaboard. Also, with the evolution of packer agreements, up to 80-85% of all hogs are not purchased on the spot market as you will see later on in this presentation.

As illustrated by this chart, 3% of the operations account from 53% of all production. The industry continues to contract with the expectation that the trend will continue in 2004.



Present status of capital availability

At right are some basic lending benchmarks for producers to understand when they are looking at financing their swine operations.



These are core guidelines that producers will need to have as they look at financing their swine operations. Also a couple of other observations about the industry:

1. If you are not in the swine business today, don't try to get in. Lenders will be very wary of any new business trying to get into the swine industry. In reality, we probably need less people in the industry instead of anybody new trying to get in.

2. The days of highly leveraged transactions are over. There were many operations that were funded with low capital infusion (below 30% capital) and lenders will be very wary of any low capital swine deals in the future. Why is this?

There is no room for error and problems always arise. We have worked many swine operations that have PRRS breaks, production problems and with low capital to begin with lenders will be unwilling to put any more capital in. From what we have seen with a PRRS break on a 2500 sow unit, it will cost a minimum of $500,000 in lost production for that time period and that equates to $10 per pig if this unit produces 50,000 pigs per year. This equates to your breakeven increasing by $3.85 per cwt. on a 260# pig. If this operation had a net worth of $3 million on $6 million of total assets, for every $500,000 in losses that equates to a drop in owner equity by 8% and all of this is loss in working capital will we will discuss later.

Price variability. In the last five years we have seen prices from $8 per cwt to $55 per cwt and there is more uncertainty in the market. Uncertainty in any marketplace brings much more caution to the lending standards that are established.

Packer contracts. Currently packers are also less willing to provide contracts that always ensure profitability. Packer contracts in the past had a higher degree of certainty of repayment capacity on their loans that were provided versus what is currently being offered. Agreements in the past helped recapitalize the industry, and also improve the quality of the product.

Marketing alternatives. With producers fulfilling obligations to Packer contracts, there are other alternatives to look at aside from or along with Packer contracts. They are: Futures and Options marketing strategy.

Livestock Risk Protection (LRP). With the alternative marketing strategies, our producers need to be working with professionals that understand the futures market and can advise their clients on how to hedge hog futures as well as protecting feed inputs.

Mandatory price reporting. Producers and the industry also need to understand what is actually being paid for hogs during the year. Below is some detail concerning packer agreements and what producers have been paid for 2003 and through April 26, 2004. It is my belief that producers need to understand what producers are being paid and maximize revenue for their operation.

This data is from 1-1-03 through Dec. 31, 2003. It is only on the producer owned hogs and does not include packer owned hogs. The bottom line on these two charts is that you can see the value of selling hogs more with some form of an agreement versus the spot market. The difference can be up to over $7 per head in revenue. The last point is that the weighted National average for all hogs last year was $55.25, on a 200# carcass that equates to $110.50 per hog. This equals $41.36 per live cwt. and producers are not losing a lot of money at these levels and the very low cost efficient producers will want to expand. That is why we are not seeing any reduction of the US sow herd.

2003 YTD Info

Producer Owned Hogs

- 70.288 M producer sold hogs (12 -31-03)
- 12.342 M sold on spot or 17.6%
- 6.775 M sold on other Mkt formula – 9.6%
- 34.82 M sold on Mkt formula – 49.5%
- 17.386 M other agreements – 24.7%

2003 YTD Info

Producer Owned Hogs - Net Prices received

- Spot - $53.53 / cwt
- Other Mkt formula – $56.03
- Mkt formula – $54.65
- Other agreements – $57.20
- WTD Avg. - $55.25

We are currently in a changing marketplace and producers must be aware of the changing industry. Demands for pork products are very good but we cannot be lulled into the fact that pork prices will remain high for ever. We also need to aware of the increase of breakeven prices because of higher feed prices. The following page includes two charts, one will look at the average cost of production for 2003 and the next will look at breakeven prices with corn at $3.00 per bushel and soybean meal at $300 per ton.

2004 YTD Info

Producer Owned Hogs - Net Prices received

- Spot - $61.33 / cwt
- Other Mkt formula – $57.43
- Mkt formula – $61.89
- Other agreements – $61.91
- WTD Avg. - $61.41

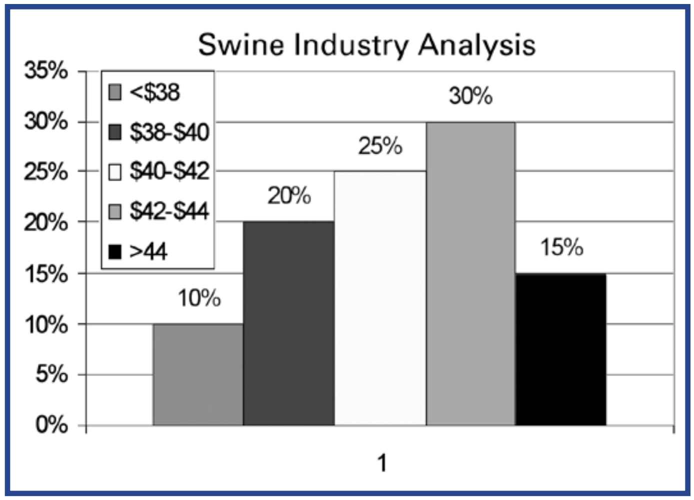
2004 Pricing Information: This is from 1-2-04 through 4-26-04.

As you can see we went from a 2003 breakeven price of $41 per cwt. or $106 for a 260# animal to today we are at $121 for a 260# animal or $46.50 breakeven. Producers that can manage feed costs and maximize efficiencies will separate themselves from the rest of the industry. Lenders will want to understand producers feed price risk strategies as we go forward. It will be very important for producers to convey this information to their lenders.

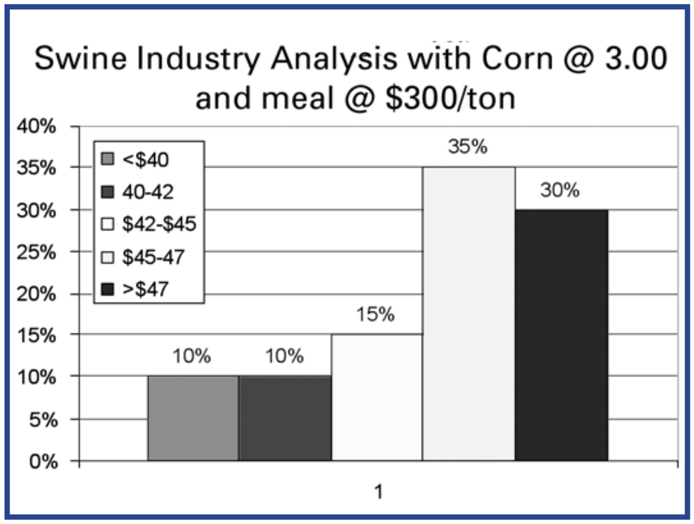
What will AgStar look for from swine producers that they are looking to provide capital for?

1. Cost of production – not only do you have to know your cost of production but you have to be better than the industry average. The benchmark today with current feed cost is $46-$47 per cwt. (THIS HAS BEEN CHANGING ON A DAILY BASIS). You have to be at least this level and preferably lower than this number. The biggest question that we always hear is what do you mean by cost of production. From our

standpoint, that is all costs of operations, which includes depreciation, debt service and also general and administrative expenses. If you do not include this in your total costs you are not being totally honest with your true cost of production. If you are a smaller producer you need to include family living and what it takes for your family to live on. Again this is part of running the business. This is the most critical component to success. The swine industry is a commodity business. You need to do better than the average if you are to survive.



2. Adequate working capital – this, from an operations standpoint, is critical to survivability. We also realize that over the last two years it has been difficult to maintain and keep working capital. The producers that have it can survive and probably grow through acquisitions. In having a benchmark for working capital on a farrow to finish operation, to me it depends on the type of operation that you have. If you own a lot of your facilities the working capital that we would use would be a lower number than the producer that doesn't own any facilities because he does not have current portion of term debt in that equation. If you own your facilities we would like to have a working capital number of at least $250-$300 per sow. If you don't own any of those facilities, that number should be doubled or $500-$600 per sow. If you are below these numbers, what should you do?



- If you have some facilities and have been paying down on these, try to refinance and fix your working capital situation. Many barns should have only less than five years left to pay and with rates where they are at this is as good of time as any to try to help fix this issue. The only case that we would consider this would be for a farrow to finish operator that has low cost and also has an alignment with a packer. If the producer is a contract grower this should not be done. As we look into the future it is our belief that contract grower rates will also continue to be pressured on lowering their grower rate. The only case that AgStar should consider this option would be in the case of a very efficient low cost aligned farrow to finish producer.
- If you have debt on your sows, structure a note to pay this off in less than three years. This cost also needs to be calculated in your total cost of production. Many times we will see sows on the operating notes and it is all on current portion. Pushing this down to intermediate term debt does help with the working capital equation. Also with prices now on the profitable side this forces you to pay debt off when you should be and don't think about expanding.
- Exit the business or get rid of your non-performing units. This is probably the biggest obstacle that most producers are faced with. Maybe it is time to get out, cull sows are at a higher value and you can capture a higher value today than you might at a later date. Also if you have 20,000 sows, get rid of your bottom 10-20%. These are the ones that are causing you a higher cost structure. You need to run your business like any other business. Many companies are faced with cutting back on employees and operations to stay in and stay profitable. You should be no different.
- Risk mitigating marketing arrangements. With the increased volatility in the live hog market price, lenders are not very interested in financing producers who are heavily exposed to this risk. If a producer insists on being exposed to this risk, the lenders will tend to require an even stronger working capital position and a more sustained and lower breakeven level.

What does the future hold for available capital?

In order to get capital for your business, this is what it will require:

- Low cost of production
- Integration or coordination with a packer (you can't go it alone)
- Equity
- Strong working capital
- Strong management skills

The people that have these in their operations will have great opportunities in the future to grow and be profitable. They also will be able to negotiate very favorable terms from lenders because people will want to do business with them. If your business fits this category, you will have many choices or capital to choose from.

Summary

From a lending standpoint, those producers that have strong working capital, reduced costs of production and sound management practices stand the best opportunity for financing from agriculture lenders. The recent upswing in market hog prices seen during 2004 have helped to improve producer margins and increase working capital. However, the continued instability of the swine industry demands that producers take necessary measures to protect themselves from this uncertainty. Alleviating this risk makes those producers more appealing to agriculture lenders for financing opportunities in the future.

Literature Cited

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3. USDA Livestock and Grain Market News, Des Moines, IA. 2003 and 2004 swine pricing information. Available from: www.ams.usda.gov/mnreports/lm_hg201.txt.

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