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Alberta's Future Beef Packer Landscape

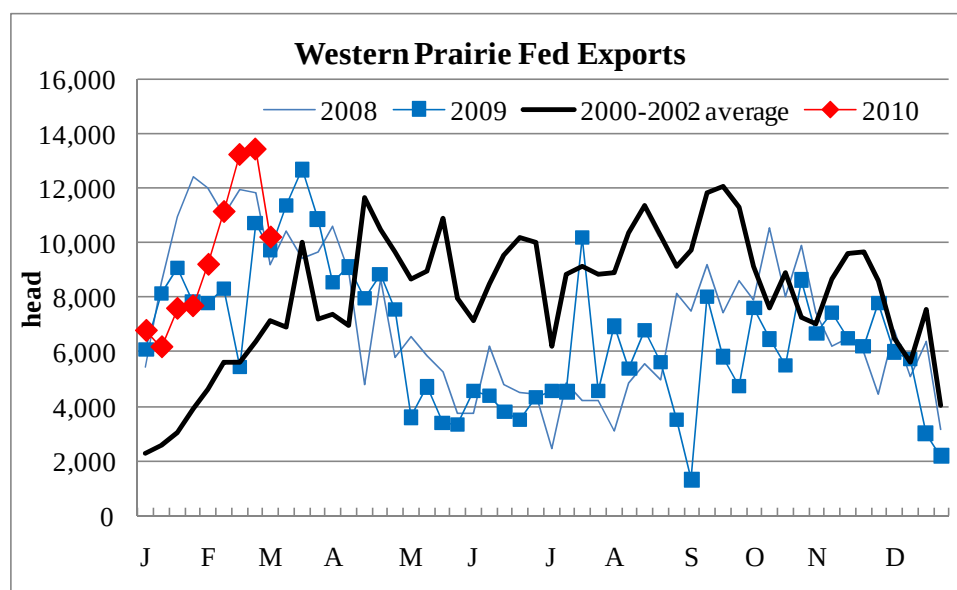
*Kevin Grier, Senior Market Analyst
March 2010*

There is an increasingly realistic argument that Alberta's cattle producers could lose one of their most important destination plants in the US Northwest. This paper examines why the loss is a realistic point of concern and the potential ramifications if it does occur.

Numbers and Perspectives on the US Northwest

So far this year, fed cattle exports off the western half of the prairies are 17% higher than last year at the same time. Figure 1 shows western prairie fed cattle exports on a weekly basis for 2008, 2009 and 2010, as well as the three year pre-BSE average. The export totals on the graph do not include those that would have exited the prairies through North Dakota. Only Idaho, Washington and Montana ports of entry are used from the USDA reports. Export totals are averaging about 9,500 per week compared to 8,100 per week last year. The combination of greater volumes and higher prices in the US Northwest this year compared to last year points to very strong US Northwest packer demand for cattle.

Figure 1

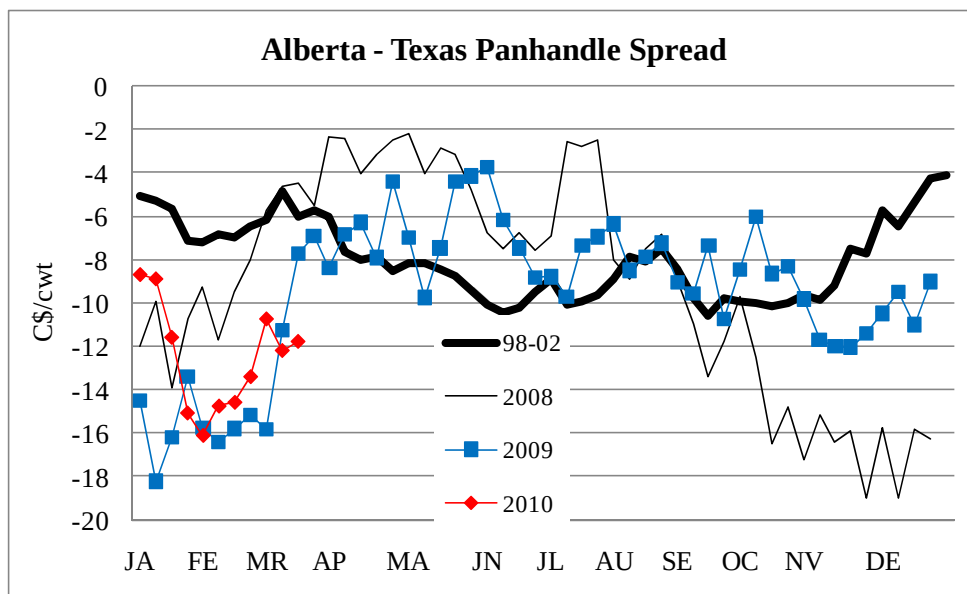


Source: USDA AMS WA_LS635

Price Spread Discussion

As can be seen from the graph, exports can ebb and flow throughout the year. The recent surge in fed exports can be explained, on the surface, by the fact that the Alberta market has been relatively weak. The strength or weakness of a local market can be illustrated by the spread between one market and another. In a region that has supplies greater than local demand, the spread is typically reflective of the cost of moving the cattle to the alternative market. Any move above or below that cost is generally reflective of changes in supply and demand locally. Figure 2 shows the spread between Alberta and the Texas Panhandle in Canadian dollars for 2008, 2009, 2010, and the pre-BSE average. As can be seen, in 2010, the spread has been much weaker than the pre-BSE average.

Figure 2



Source: Texas Cattle Feeders, Canfax

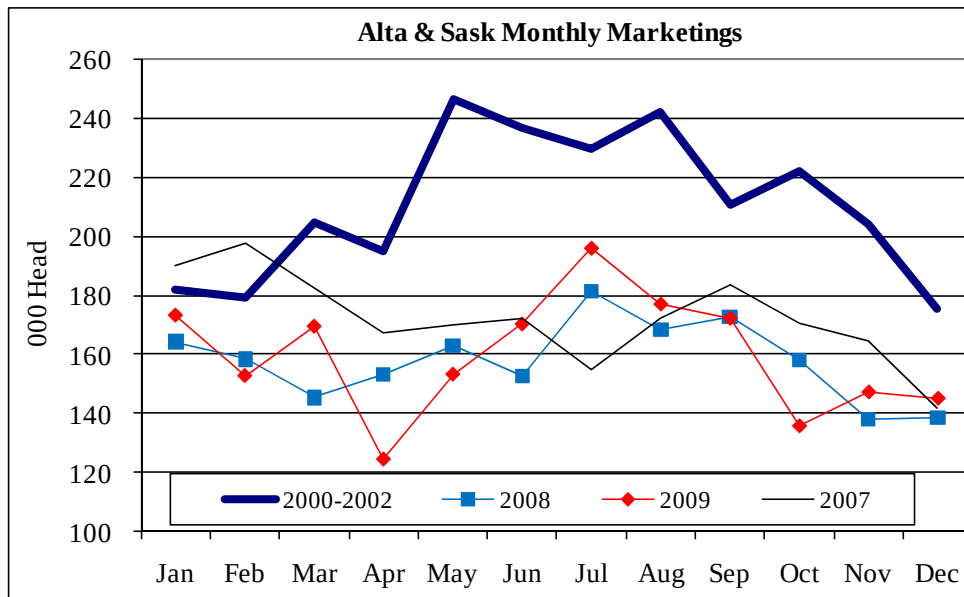
As of March, however, the spread has begun to tighten. This is not unusual given the time of year. Yearlings are beginning to run a little short and calves are not ready. In the post-BSE era, the industry has come to expect a spring and summer tightening of the spread. This is an interesting contrast to the pre-BSE era in which the spread would seasonally weaken in the spring and summer.

It is interesting because there isn't really a good explanation for the change in the spread pattern in the pre and post-BSE eras. Placement patterns have not changed. Peak placements are still in the fall with a bounce higher in late winter, just as they were in the pre-BSE era. The bottom line, however, is that marketing patterns have changed in the post-BSE era, even though placements have not changed.

Figure 3 shows Canfax marketing patterns for the three year pre-BSE average as well as for 2007, 2008 and 2009. As can be seen, marketings no longer seem to increase in the spring and

summer, as they did in the pre-BSE period. The flatter or even lower marketings in the summer coincide with stronger packer demand. This, in turn, helps explain the tighter basis or spread.

Figure 3



Source: Canfax

It is important to examine the spread within the context of US demand in order to address the issue of seasonality of US demand. When looking at the basis and weekly exports, there are certain times of year when the Alberta and Saskatchewan markets depend more upon US packers. In the post-BSE era, Canadian feeders look to the US during the early part of the year. During the summer, given the strong basis, there is less concern about US packer participation in Canada.

It is when the spread is weakest that the market will be most impacted by a loss in demand from US packers. The potential of loss of demand from US packers is the focus of the remainder of this paper.

Important US Northwest Packers

The bottom line is that the US Northwest is an important market for Alberta and Saskatchewan fed cattle. Statistics Canada reports 350,895 fed cattle were exported to the US from Alberta and Saskatchewan in 2009, which is 15% of their marketings

The key packers in the US Northwest are operated by Tyson Foods, JBS Swift and AB Foods. The Tyson plant in Pasco, Washington, is arguably the most important. According to US publication, "Cattle Buyers Weekly," the plant can slaughter about 2,200 fed cattle per day. It likely slaughters fewer than 500,000 head per year. Of this total, at least 200,000 come from southern Alberta. Pasco is about 594 miles southwest of Lethbridge. The plant has been an important participant in the Alberta market for decades.

If Pasco gets the 200,000 head, the remaining 150,000 or so head of cattle are split between AB Foods and JBS. AB Foods operates a 1,600 head per day plant in Yakima, Washington, 660 miles from Lethbridge. The company is an important participant in Alberta's fed cattle and feeder cattle markets. That is, while it likely sources about 75,000 head of fed cattle from Alberta, it also pulls feeder cattle off the prairies for its feedlots and eventual slaughter. Finally the other key fed cattle participant is the JBS plant in Hyrum, Utah, which is listed by "Cattle Buyers Weekly" as having a daily capacity of about 2,500. It is about 700 miles due south of Lethbridge. JBS has, however, recently scaled back production and is operating at significantly lower speeds. While Utah may not technically be a US Northwest state, that plant has also played an important role over time in the Alberta market.

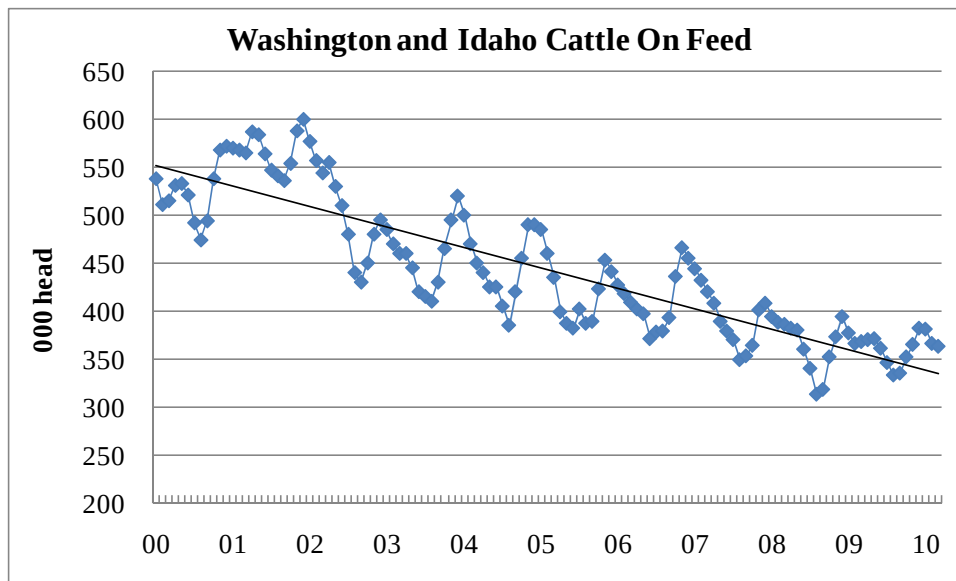
At the very least, the importance of these packers is that they provide an effective floor price to the Alberta market. Prices in the Alberta market can generally not fall below the US price less than cost of transport to these plants. These plants not only provide a floor, however, they also provide an added competitive balance to Cargill in High River and XL Foods in Brooks.

While these plants are important to Alberta, it is clear, based on the volumes and share of their kill, that Alberta is very important to these plants as well. The share of each of the three plant's kill that comes from Alberta probably ranges between 15% and 40% over the course of the year. Even on the low end of the annual share, at certain times of the year, the share from Alberta can be very important to the efficient operation of the plant. The premise then is that the US Northwest, Alberta and Saskatchewan are one regional market. This is the case, even when considering that the US legislation, Country of Origin Labeling (COOL), has resulted in higher costs of processing Canadian cattle and higher risks of selling the beef from the cattle. That is, COOL has hurt each individual plant's profitability and margins, but they are still active participants in Canada.

US Northwest Supplies

This leads to observations about the strength and vitality of the cattle and packing sector in the US Northwest. In that regard, the March 2010 USDA Cattle on Feed Report provides more evidence that the supply situation in the US Northwest is continuing to shrink. Figure 4 shows the cattle on feed inventories for Washington and Idaho, combined on a monthly basis from 2000 through March 2010. Washington and Idaho were chosen because they are the only two northwestern states that the USDA specifically lists in the Cattle on Feed Report.

Figure 4



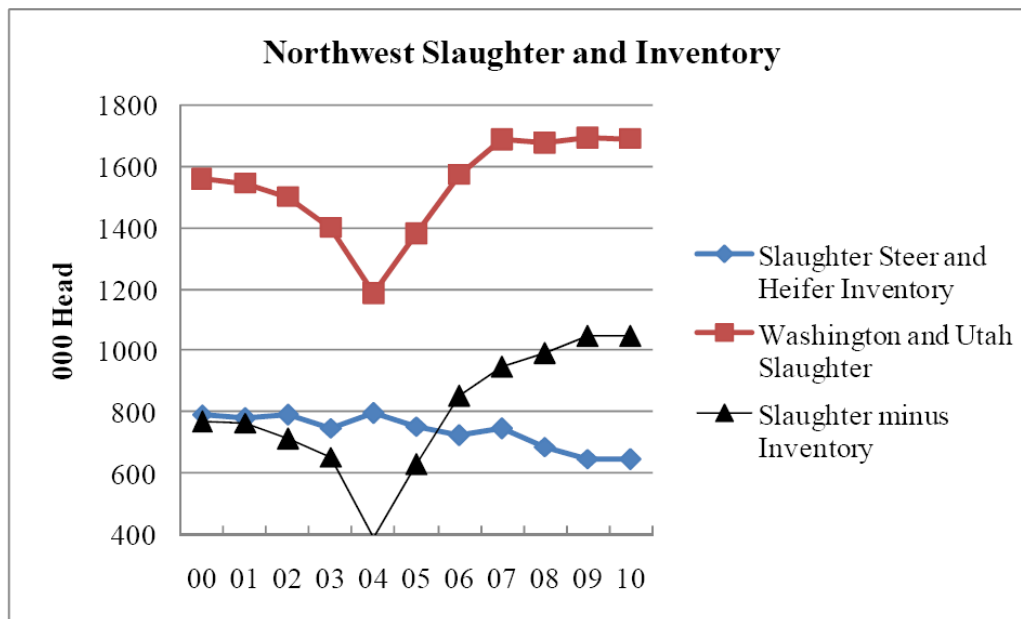
Source: USDA Cattle on Feed Reports

As can be seen, the on feed totals have been declining dramatically in these two states. In the first quarter of this year alone, the inventory has declined by 6%. The total has declined by 25% over the past five years.

In addition, the January 2010 US Cattle Inventory Report showed that the supplies of slaughter steers and heifers in three US Northwest states, Washington, Idaho and Utah, declined by 1% as of January 2010. This follows a decline of 6% in January 2009. Over the last ten years, the average year over year decline in the inventory of slaughter steers and heifers has amounted to 2% each year.

Figure 5 shows the relationship between the inventory of steers and heifers and total annual slaughter in Utah and Washington State. The 2009 slaughter data are estimated as opposed to actual as the USDA no longer publishes data for Utah. The 2010 slaughter data are forecasted. The graph shows the big drop in slaughter in these states during the BSE years when they could not access Canadian cattle. The main message of the graph is the increase in slaughter compared to inventory. That is, the deeper message of the graph is the dependency of plants such as Pasco and JBS Hyrum on cattle from outside the region.

Figure 5



Source: USDA NASS

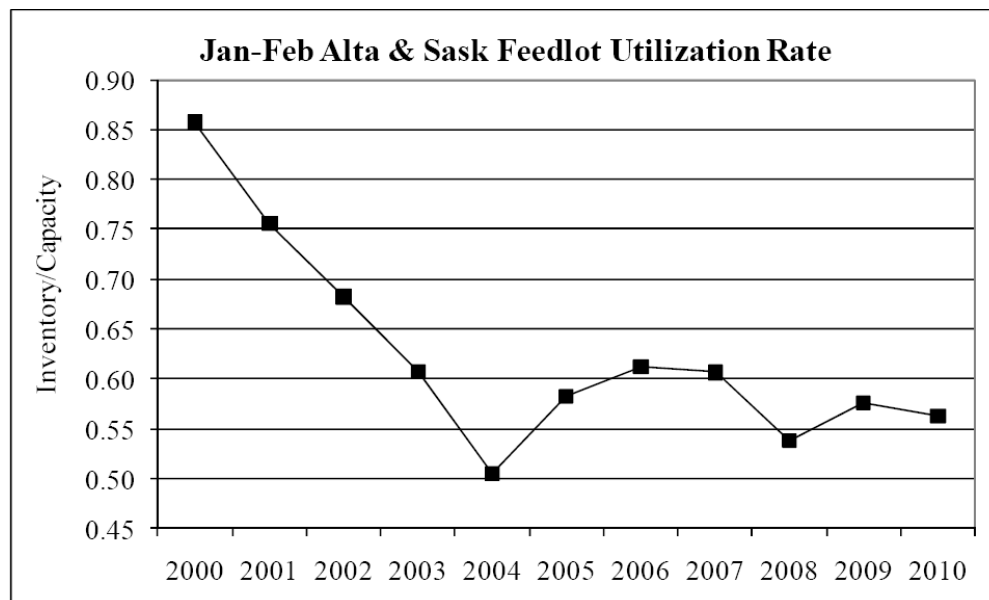
Alberta Supply Challenges

While there are supply challenges in the US Northwest, Alberta is also not without issues. The January 2010 Statistics Canada Canadian cattle inventory report showed that the western cow herd took another big drop in 2010, due largely to continued low margins and the drought in Alberta in the first half of 2009. The western herd dropped 4% this January compared to January 2009 and is now 16% lower than its BSE inflated total in 2005.

Supplies can be looked at in a number of ways including feedlot capacity. Each year, Canfax carries out annual estimations of Saskatchewan and Alberta feedlot capacities. The latest report shows that the total number of feedlots has stayed the same this January compared to last January. There has been, however, a slight reduction in total bunk capacity. In total, Alberta and Saskatchewan have a combined capacity of 1,696,950 head in 211 feedlots with a onetime capacity of 1,000 head or more capacity. This is down 1.6% from January 2009 says Canfax. Of that 1.7 million head capacity, 166,000 are in Saskatchewan, or just under 11%.

According to Canfax estimates, from the beginning of 2007 through February 2010, Alberta cattle feeders have lost more than \$35/head on yearlings. Given the performance of the past three years, it is surprising that the industry has not lost more capacity. This is doubly the case when considering that the feedlot sector is suffering from continued overcapacity. Figure 6 shows the feedlot capacity utilization rate for Alberta and Saskatchewan feedlots for 2000 through 2010. It is calculated using the Canfax estimation of capacity for each of the years. The calculation also uses the number of cattle on feed on average for those years for January and February.

Figure 6



Source: Canfax

As can be seen, the utilization rate was at its peak in 2000 and fell to its low during the BSE years. The utilization rate hit another low at the beginning of 2008. That was the period of time from late 2007 to early 2008 in which Alberta's grain price spread was at a severe disadvantage relative to the US. As a result, cattle moved south rather than to Alberta feedlots. In 2010, the utilization rate has taken another dip lower. This is a function of the severe financial stress in the latter half of 2009 and the first two months of 2010. It is also due to the fact that from July to October, Alberta was at a feed cost disadvantage relative to US feeders. The underutilization of the yards would only make the situation worse. Underutilized capacity adds to overall costs per head.

Again, it is surprising that more capacity has not been lost. Given the trend in herds in Canada and the US, feedlot capacity rationalization is going to be a more common fact of the business in the next few years.

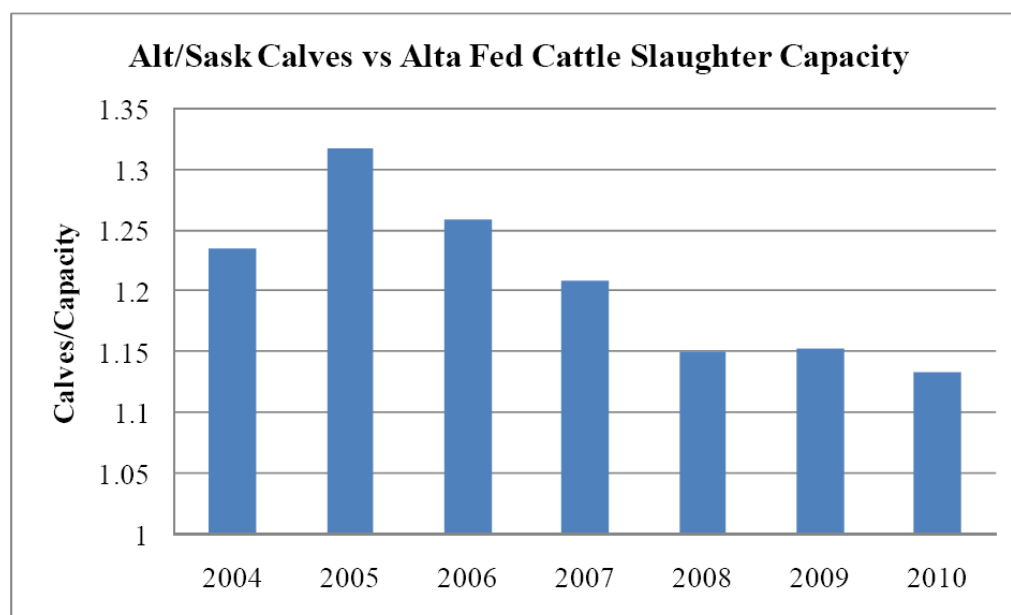
Slaughter capacity is another interesting variable in the overall market context. Alberta's slaughter capacity increased during the peak BSE years. Capacity has increased and then decreased somewhat since 2004. With that noted, the three main plants at Brooks, High River and Calgary have stayed reasonably steady over the past five to six years. A good working number for these three plants would be 53,000 per week, assuming a Saturday kill at the two big plants. This would put annual slaughter capacity at 2.7 million head in Alberta over the years from 2004 through 2010 for those plants. Again, while other plants have come and in some cases gone, this capacity number is a good reference to work with.

In that regard, it is interesting to look at cattle supplies relative to capacity. In Alberta and Saskatchewan, the combined inventory of calves hit a peak in 2005 at more than 3.2 million head. That number was inflated by the backlog of cows not being culled due to the border

closure. Since that time, the calf inventory has declined by 15% in the west and by 14% for Alberta and Saskatchewan combined.

The total calf number in 2005 was 19% more than the Alberta slaughter capacity. If it is assumed that Calgary is a cow-only plant, then the calf numbers were 32% more than the combined capacity in the two other plants. The combined total of 2.8 million head in 2010 is just 13% more than the Alberta fed cattle capacity, assuming Calgary stays with cows. Figure 7 shows the ratio of the combined Alberta and Saskatchewan calf numbers compared to Alberta's fed slaughter capacity.

Figure 7



Source: George Morris Centre

In 2005, calf numbers were 777,000 more than the slaughter capacity. By 2010 the numbers were 326,000 more than the capacity of the two big plants. Over the course of 2010, it should be anticipated that the herd will continue to decline. As such, by the beginning of next year, that surplus of calves over capacity could amount to less than 250,000 head.

Observations

There are several observations that can be drawn from the discussion above.

One point is that, based on the feedlot capacity utilization rates in Alberta and Saskatchewan, it can be reasonably argued that there is going to be rationalization in bunk space. It does not make sense that feedlot capacities can continue to be utilized at just 55-60% of capacity, especially with ongoing losses in the sector.

Another reasonable assertion is the likelihood that a plant will be lost in either Alberta or the US Northwest. Based on the relative supply situation, it is more likely that a plant in the US

Northwest will be closed. Of the three plants discussed above, it appears the JBS plant would be the leading candidate, because of its distance from Alberta and other major US feeding regions, as well as its recent downsizing.

Of course there is also the argument that the XL cow slaughter plant in Calgary could be a candidate for closure. The pros and cons of that plant have been discussed by cattle producers for years. For now, however, given the fact that XL Moose Jaw remains shut and that overall supplies still exceed capacity in Alberta, the Calgary plant is likely to remain open.

The loss of a US Northwest plant would not simply result in reduced demand for Alberta cattle due to the loss of a bidder. It would be much more important than that. The loss of a plant in the region would free up all the US domestic supplies for that plant. These domestic supplies would probably make their way to other Northwest plants. The loss of a plant would likely make the US Northwest self-sufficient or close to it. This, in turn, would have serious ramifications for Alberta price discovery and overall basis levels.

In any event, the situation is serious enough to suggest that Alberta cattle feeders need to plan or at least make contingencies for a market without the US Northwest as a backstop.

This is a compilation of articles and reports first outlined in the George Morris Centre publication, Canadian Cattle Buyer. If you are interested in a free two month trial subscription to Canadian Cattle Buyer, send an e-mail to kevin@georgemorris.org