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Agricultural Outlook Forum

Presented: February 17, 2006

A LENDER'S PERSPECTIVE ON CONTRACT POULTRY PRODUCTION

Kenny Bounds
Vice President
Chief Development Officer
MidAtlantic Farm Credit

2006 USDA Agricultural Outlook Forum



Contract Procurement in the Poultry Industry

Grower-Integrator Relationships

"Serving all of rural America"



MidAtlantic Farm Credit

Kenny Bounds

MidAtlantic Farm Credit
Vice President
Government Affairs Officer

Delmarva Poultry Industry, Inc.
Past President



"Serving all of rural America"



MidAtlantic Farm Credit

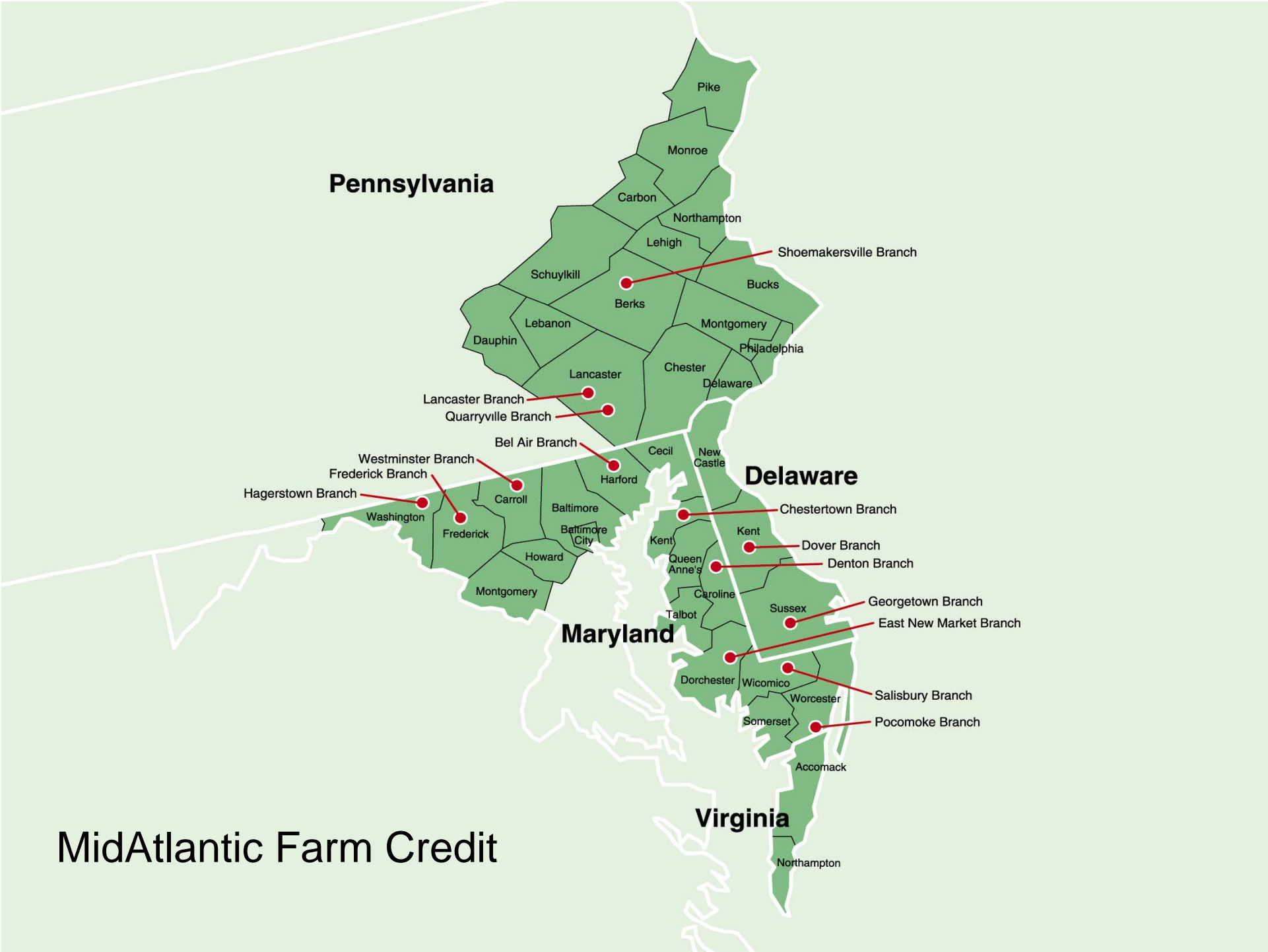


\$1.68 billion in loans
outstanding to more than
10,300 members in the Mid
Atlantic region

21 % of our loan portfolio is
poultry

"Serving all of rural America"





MidAtlantic Farm Credit

Poultry Dominates Agriculture on Delmarva



Poultry is the largest segment of agriculture in Delaware, Maryland & Virginia

36% of Maryland cash farm income

71% of Delaware cash farm income

20% of Virginia cash farm income

2004 DPI Facts and Figures



The Delmarva Peninsula consists of all of Delaware and the Eastern Shore of Maryland and Virginia

561 million birds

3.3 billion pounds

5,500 chicken houses

128 million bird flock capacity

2,000 Delmarva growers

"Serving all of rural America"

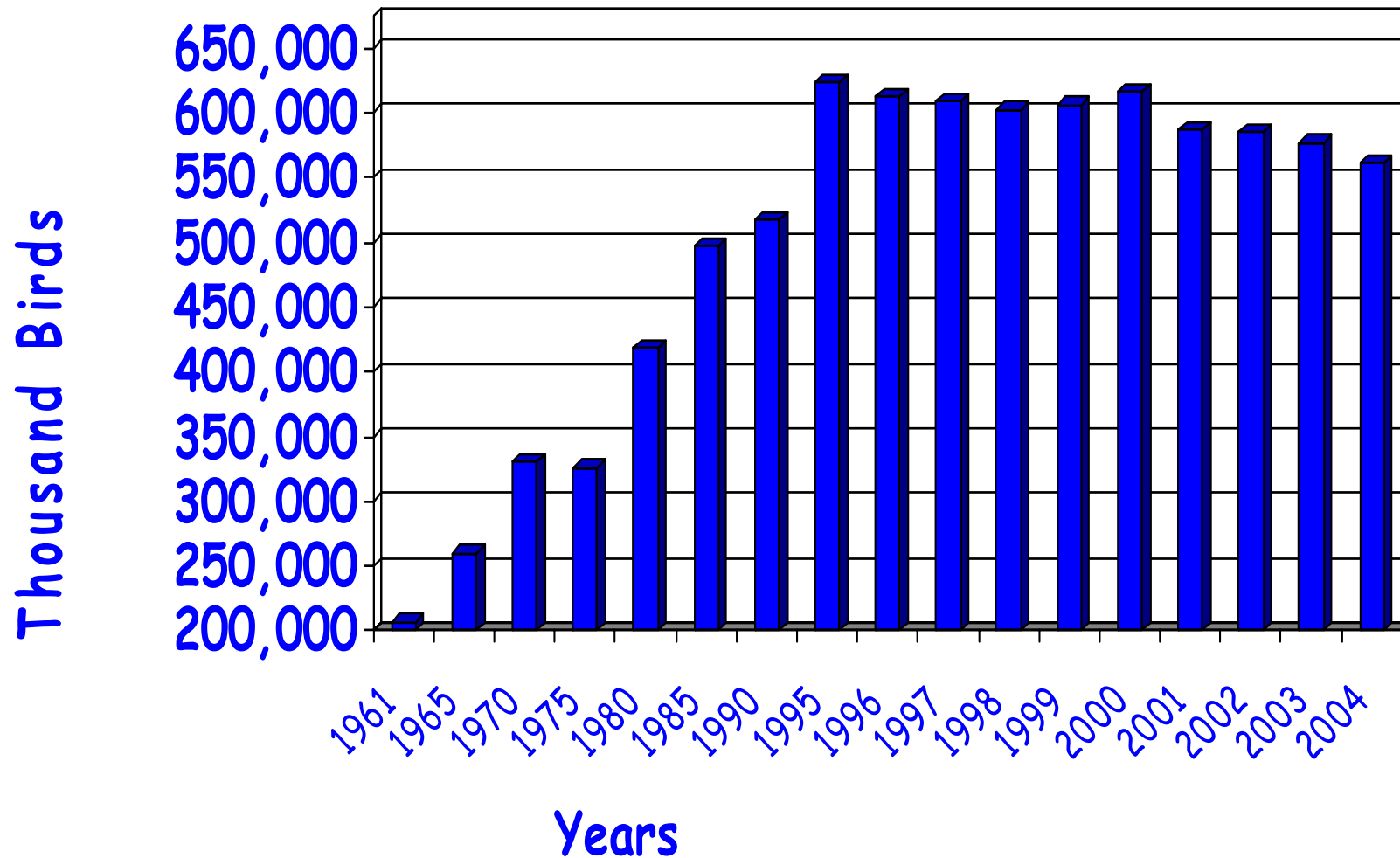
 **MidAtlantic**
Farm Credit

2004 DPI Facts and Figures



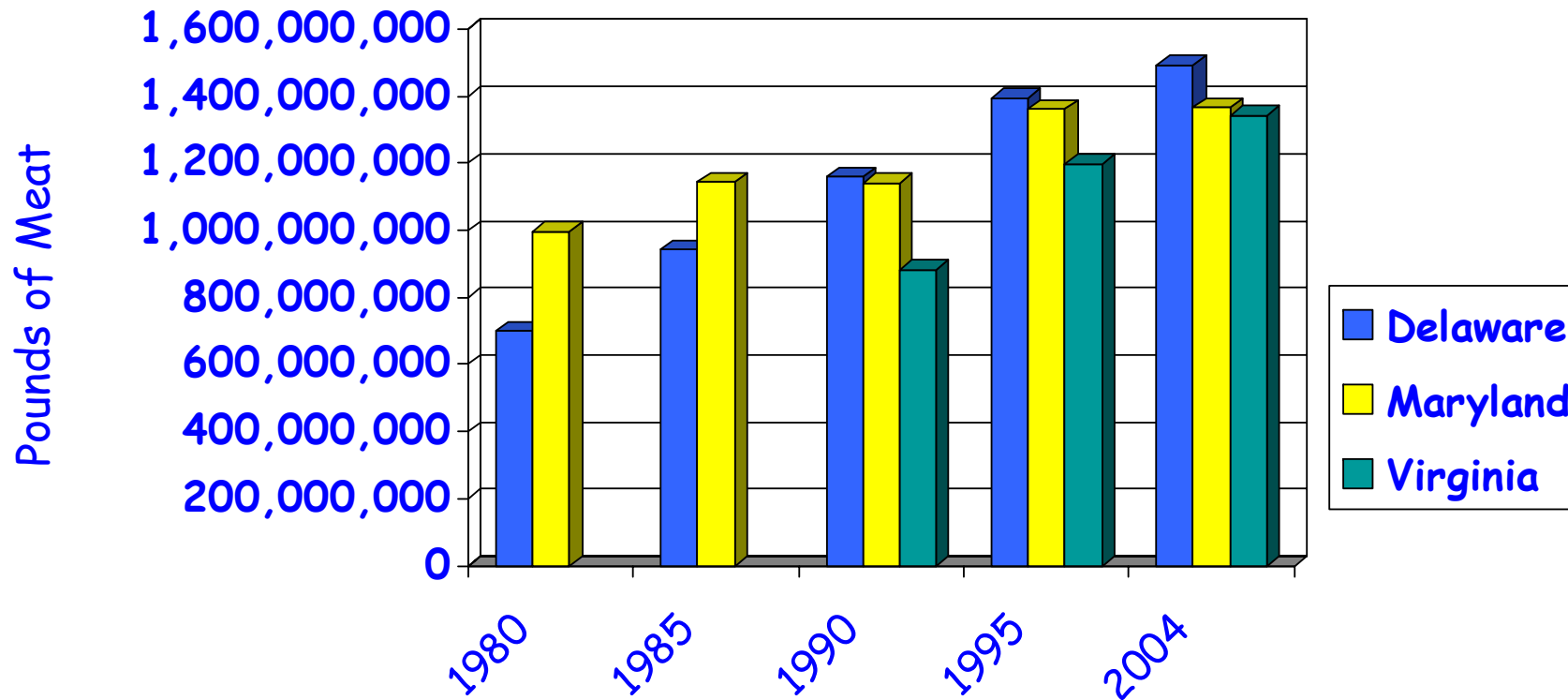
14,000 company employees
\$159 million grower pay
\$337 million integrator
payrolls
\$1.7 billion wholesale value
of Delmarva birds

Number of Broiler Chickens Produced on Delmarva



Source: DPI

Broiler Chicken Weights In Delaware, Maryland, and Virginia



Source: United States Department of Agriculture
Prepared by: Delmarva Poultry Industry, Inc.



DPI Delmarva Grower Data

	# of Growers	Capacity	# Birds	# Pds
1970	4611*	83 M	330M	Not Avail
1980	7175*	90 M	418M	Not Avail
1990	6817*	97 M	517M	2.4 B
1994	2800	113 M	605M	3 B
2002	2320	123 M	585M	3.2 B
2004	2000	128 M	561M	3.3 B

*Includes growers and their on-farm employees
Data from Delmarva Poultry Industry, Inc.

Contract Animal Agriculture



- Growing animals on contract for an integrator adds diversity and stability to cash flow of many farmers raising grain, vegetables, and other crops.
- Livestock production is the sole income source for many others.
- Loans for contract animal production have historically been among the best in our loan portfolio.

Contract Animal Agriculture



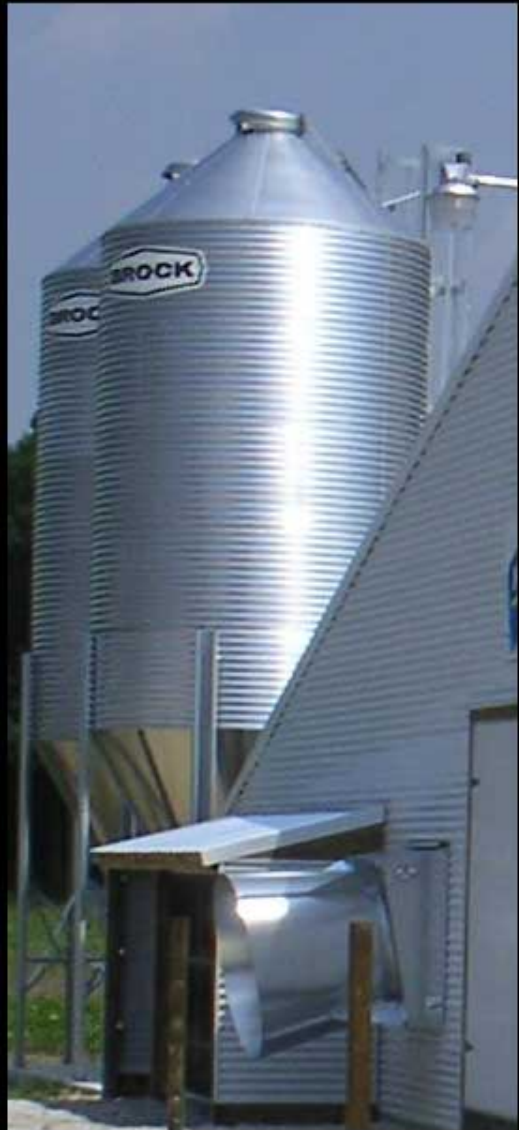
- Contract animal operations can be leveraged 100% and still cash flow.
- With the many financial tools and credit enhancements (loan guarantees, etc.) that we have to supplement loan packages, people with a sound plan and a good credit history are likely to be successful in obtaining financing.

Contract Animal Agriculture



- Growers have varied goals and objectives when they approach us for a loan.
- Some want to leave a job and have poultry income replace a portion of the salary, needing longer loan amortizations.
- Others want loan payments to equal net poultry income and pay the loan off as quickly as possible, planning for a future cash flow stream.

Contract Animal Agriculture



Poultry has been the primary tool used by many young and/or beginning farmers on the Delmarva Peninsula to succeed their parents on a farm operation or establish a new operation of their own

Housing Trends



- Demand for and interest in new housing remains strong.
- Best estimates are that we will build over 5 million square feet of new house capacity in the coming year. This amounts to 150-175 houses; most being wide type housing 60 or 66 feet wide.
- Approx 1/2 million square feet will go out of production or the equivalent of 17 new wide houses.

Trend in Housing Costs

YEAR	NUMBER	SIZE	COST SQ FT
1993	3	41 X 501	\$6.26
1995	2	43 X 501	\$6.38
2002	4	46 X 560	\$6.49
2003	3	51 X 501	\$7.39
2004	4	51 X 501	\$8.72
2005	3	66 X 600	\$9.48

*Includes generator and non cost-share portion of manure shed

New house incentive not included

Contract Animal Agriculture



- The trend to larger farms to gain economies of scale is necessary to remain profitable.
- Larger capacity spreads the high cost of land, equipment and new technology over more animal units.
- But, how large is too large?
 - Management issues
 - Biosecurity
 - Resale of large capacity farms
 - Perception – “Factory” Farm vs Family Farm

Construction Challenges



- Rapidly increasing cost of construction
- Inability to lock in construction costs- everyone at risk, builder, grower, lender.
- Large cost-overruns are a problem, especially with young farmers and leveraged beginning farmers.
- When state or government agencies are involved with loan guarantees, it not easy to restructure the deal midstream.

Poultry Cash Flow



- With acceptable performance, grower income is relatively assured.
- Companies offer an up-front incentives to build new houses.
- New house “guaranteed minimum payment” is good for the life of the loan.
- Contract guarantees minimum payment per flock but not number of flocks per year, so income can vary.

New Poultry House Cash Flow



3 – 60' x 500'

Recirculating pads, tunnel ventilated,
with generator and grower portion
of manure shed

\$162,000 gross @company avg. pay
-29,000 farm expenses

\$133,000 Net farm income

\$ 95,817 Total payments

\$ 37,183 Net to Producer

\$853,200 15 years, 7.6%

*Farm Credit patronage refunds not included

Risk Factors



- Extended layout time between flocks due to market conditions, diseases, etc.- thus lowering income.
- When the new house guarantee runs out there can be a significant reduction in guaranteed income. Typically, however, minimum and company average pay increases to cover most of this.



Risk Factors

- Indemnification of loss due to catastrophic animal disease such as AI is not assured.
- Need Risk Management Agency animal insurance product to provide a safety net or clear policy from APHIS on indemnity for growers.

Risk Factors



Accelerated write-off versus life of the loan on a single purpose ag building

- House 10 year depreciation
- Equipment 7 year depreciation
- Life of loan is typically 15 years

Uncle Sam Becomes Your Partner

Risk Factors



Obsolescence

- Repairs necessary to remain competitive and up to industry standards.
- Companies often offer cost-share, zero or low interest loans, and incentives such as an increase in minimum guarantee.
- Adds significantly to debt service, lowering margin.

Risk Factors



- Renovations often come at a time when depreciation has run out – 10 year range.
- If the producer has been living off the depreciation or has little margin for added debt service there could be a cash flow problem.
- Restructuring of debt may be necessary.

Risk Factors



- Energy costs are increasing rapidly. Some companies added an energy incentive this past fall.
- LED lighting promises to lower energy consumption.
- Power with solar panels?

Contract Production



- Way to manage production and marketing risks for producers. Big swings in income and much more risk prior to vertical integration and contract production.
- Allows expansion without huge capital outlay for companies.
- Competitive “tournament” contracts are favored by Delmarva growers.

Contract Production



In a DPI survey of growers, taken in 1998 at a time considered to be the bottom of grower – integrator relationships, three quarters of the growers were satisfied with their poultry company and their business as a poultry grower

Contract Production



- As a result of the survey and increased communications between companies and growers, many companies added or enhanced grower committees.
- New grower programs and training added.
- Problem identification and resolution addressed . Most companies now have grievance boards made up of growers.

Contract Production



“I want to make sure they cash flow and not get them into something where it does not meet their expectations. We do need the capacity but I want to be sure things are done the right way.”

Mark Patterson
Perdue Farms, Inc.

Contract Issues



- Weight, feed conversion and fuel are the competitive contract parameters.
- Feeds are charged at the standard rate and calculated each settlement week.
- Fuel is charged at the same standard rate for all.

Contract Issues



- Chick quality has always been an issue.
- Most companies allow a “tremor” adjustment to account for excess mortality.
- With the size of today’s farms it is not possible for all the chicks to come from one breeder flock. There is a mix of genetics on each farm.

Contract Issues



- Binding arbitration is required in most, if not all, contracts and is expensive if the peer group resolution process does not work.
- Most contracts are flock to flock contracts.
- Some are longer term contracts but with termination provisions.

Before Signing Contracts



- Meet with company representatives as many times as necessary to clarify all items.
- Meet with existing growers. Choose some who are very successful and some who are less than so.
- Meet with a lending institution to gain a financial perspective.

Before Signing Contracts



- Get copies of all documents that you will be asked to sign.
- Review all documents carefully and have them reviewed by your attorney.
- Ask for an explanation of how you will be paid and what expenses you will be accountable for.

Before Signing Contracts



- Take a step back and do an independent assessment of the proposal.
- Does it make sense for you and your family? Can you handle the labor, the lifestyle?
- Do you have a plan to address adversity?

Other Issues



- Manure – an asset when used according to a proper nutrient management plan.
- Co-Permitting was an ill conceived concept. Growers and companies alike opposed it.
- Companies have provided alternatives to land application.

Other Issues



- Perdue Manure Pelletizing Plant
- Allen's Hatchery initiative to burn litter for steam to power their rendering facility
- Manure to energy projects such as Fibrowatt

Ways to Partner



- Companies and growers have found many ways to cooperate for their mutual benefit.
- Team approach to environmental issues, regulations, challenges.
- We have many new neighbors to mutually address.

Urban Encroachment/Neighbor Relations



“As someone who now has a CAFO poultry operation 300 feet from our property, we can tell you first hand that 300 feet is not acceptable to neighbors of poultry growers”

Charles E. and Betty Schelts
Queen Anne Record Observer

Urban Encroachment/Neighbor Relations



“Perhaps the Queen Anne’s County Commissioners, poultry grower mortgage lenders and the chicken integrators themselves would like to put their money where their mouth is and purchase our now worthless property.”

Charles E. and Betty Schelts
Queen Anne Record Observer

Humane Society of the United States



“These farm animals—sentient, complex, and as capable of feeling pain and joy as those dogs and cats we welcome into our families—are viewed by industrialized agriculture as mere meat-, egg-, and milk-producing machines. They suffer immensely when profit outweighs their well-being”



“The interface between farming operations and the rapidly developing areas across the state is creating new challenges. We are confident that we have capability in Maryland to develop creative and effective solutions.”

MDA Secretary Lewis Riley

Impact of zoning change on profits



Example: proposed Queen Anne's County change from 300' to 750' setbacks, land at \$7,000/acre, 25 year amortization on the land, 15 years on 3 poultry production facilities.

Current Zoning

Positive net cash flow margin \$27,225
Cash flow coverage 123.59%

Proposed Zoning

Negative net cash flow margin (**\$10,811**)
Cash flow coverage 92.95%

Challenges for Delmarva



DPI Best Management Practices for Good Neighbor Relations Adopted 9/13/05

***Voluntary practices offered in
lieu of government
intervention to improve
relationships among poultry
growers and their neighbors.***

Challenges for Delmarva



DPI Best Management Practices for Good Neighbor Relations

House location
Manure handling
Carcass disposal
Vegetative buffers
Odor prevention and control
Contact with neighbors

The Good News



- Environmental groups, many of which were former adversaries, now see merit in working cooperatively.
- Many news media outlets are running positive stories, including, recently, the Wilmington News Journal and the Baltimore Sun.

No longer under attack

VIEWPOINT

'Our industry is under attack': Bounds

EDITOR'S NOTE: The following is an abbreviated text of Mr. Bounds' speech at the DPI Booster Banquet, held April 20, in Salisbury, Md.

By **KENNETH M. BOUNDS**
President
Delmarva Poultry Industry Inc.

I would like to start by thanking you for your support of DPI. It has been amazing to me how many dollars, how many hours, how much effort is needed to run this organization. I am very proud of the job that everyone is doing.

Since last year's banquet, your organization has been working hard for all of you. No one group dominates DPI. Growers, employees, companies, allied and community businesses are all represented and represented well. Many of you in the audience have participated in the numerous meetings, hearings, testimony

the personnel, nor do you want them, to police what you are doing with your nutrient management plans and crop production. If Gov. Glendening and Secretary Nashida are successful in this effort, you and the companies can be fined under the Clean Water Act, which covers point sources of pollution.

Agricultural nutrients are non-point sources of pollution and you, as growers, are not currently subject to these harsh fines.

What does it mean to you? I will tell you — significant fines levied on a daily basis, more government intrusion into your lives, and the increased likelihood that the companies would have to drop you as a grower for nothing related to poultry performance. If you were the least bit negligent in implementing the requirements of your nutrient management plan, the company could be fined into bankruptcy



At the annual Delmarva Poultry Booster Banquet in Salisbury last week, DPI President Ken Bounds, right, chats with Delaware Gov. Tom Carper.

rather than the stick approach despite EPA's call for a heavy-handed regulatory program.

In Virginia, the law that was en-

ally. Through billboards, beach airplane banners, and radio advertisements and other things, we will send them a message that our farm families

"Serving all of rural America"

 **MidAtlantic**
Farm Credit

New Found Friends



"Given a choice between an acre of farmland and an acre of residential development, the best thing for the bay is farmland, without a doubt"

Kim Coble
Maryland Executive Director
Chesapeake Bay Foundation



The Good News

- Poultry remains profitable. Young farmers are entering the business.
- Politicians are coming to see that we are smart enough to have agriculture and a healthy environment.
- Sound science, public commitment, and cooperation now seem to be the norm-ag must live up to our commitments to keep it that way.



Thank You!!!