

An Overview of the rapidly Changing Beef Industry

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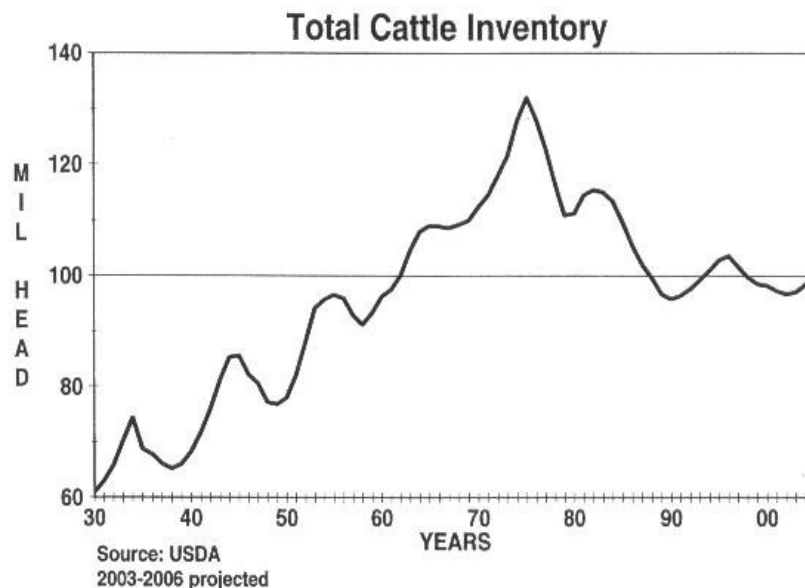
AN OVERVIEW OF THE RAPIDLY CHANGING BEEF INDUSTRY

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Today, I want to explore and discuss some of the changes that have and are taking place in the beef industry. Webster's dictionary has many different definitions for the word change. The best definition as it applies to our industry is this one – to become different; to alter. The beef industry is different now, when compared to its past. There are many reasons why this has happened.

Change has occurred in the beef industry in response to different needs of the beef consumer. Competition from pork and particularly poultry has created change. The economics of the business have caused consolidation in all segments of the industry. Consumer concern about the healthfulness and safety of consuming beef have forced modifications to the way we sell products.

Rapid change would be the headline for the beef industry over the past 20 to 25 years. One of the most drastic changes has been the sharp increase in total beef production while the size of the cattle herd has declined dramatically.



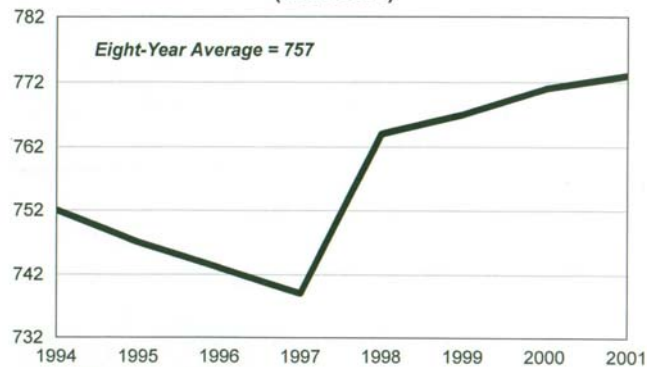
	Year	Commercial Beef Production (bil lbs)	Fed Steer Price	500-lb Steer Calf Price
	1970	21.5		
	1971	21.7		
	1972	22.2		
Cycle Low	1973	21.1	\$44.63	\$61.58
	1974	22.8		
	1975	23.7		
Cycle High	1976	25.7	\$39.62	\$39.26
	1977	25.0		
	1978	24.0		
Cycle Low	1979	21.3	\$68.42	\$92.71
	1980	21.5		
	1981	22.2		
	1982	22.4		
	1983	23.1		
	1984	23.4		
	1985	23.6		
Cycle High	1986	24.2	\$58.93	\$67.14
	1987	23.4		
	1988	23.4		
	1989	23.0		
Cycle Low	1990	22.6	\$78.32	\$99.14
	1991	22.8		
	1992	23.0		
	1993	22.9		
	1994	24.3		
	1995	25.1		
Cycle High	1996	25.4		
	1997	25.4		
	1998	25.7	\$61.73	\$84.70
	1999	26.4		
	2000	26.8	\$69.65	\$104.36
	2001	26.1		
	2002*	26.6		
	2003*	25.9		
	2004*	25.6		
	2005*	25.9		
	2006*	26.3		

*projected

Note that total cattle numbers declined from near 130 million head in 1975 to just under 100 million head in 2000, but beef production has increased from 23.7 billion pounds in 1975 to 26.8 billion pounds in 2000. It now appears total beef production in 2002 could be equal to or greater than 2000. Fed steer and heifer slaughter is up 300,000 head through late July 2002, compared to the same time in 2001. Also, note the dramatic increase in fed steer and heifer carcass weight since they bottomed in 1997.

Average Annual Steer and Heifer Carcass Weight Numbers for Eight Years

(1994-2001)



Source: USDA Market News Service and National Agricultural Statistics, Des Moines, Iowa.

It appears fed steer and heifer carcass weights will average 20-25 pounds higher in 2002 compared to 2001. Low priced corn, good cattle performance in feedyards, premium structured futures in the distant months, and a lack of profitability has all contributed to heavier carcass weight this year. More cattle sold on a grid basis is also contributing to the increased weight.

Another significant factor related to increased carcass weight is improved genetics in the beef cattle herd in the U.S. Heavier weaning weights have led to a big jump in the amount of beef produced per cow. Cow/calf producers had to make this change to get more income in the face of increased costs of production. If this trend of increased production per cow continues, it will likely cause a continued decline in the size of the cowherd in this country. There is a good possibility the total cattle numbers in the U.S. may decline to 90 million head or less, sometime in the future.

Another dramatic change in the business is the way fed cattle are marketed. We are quickly moving away from a cash based system to a carcass merit marketing system. More and more fed cattle are being marketed where premiums and discounts are being paid based on the merits of each individual carcass. This is a long-term positive trend for the beef business. This is the only way the proper signal can be sent through the entire beef system to stimulate the production of more of the right kind of cattle.

This change has not occurred without a great deal of pain within the industry. There are some in the industry that yearn for a return to the cash market where almost all cattle sell for the same price.

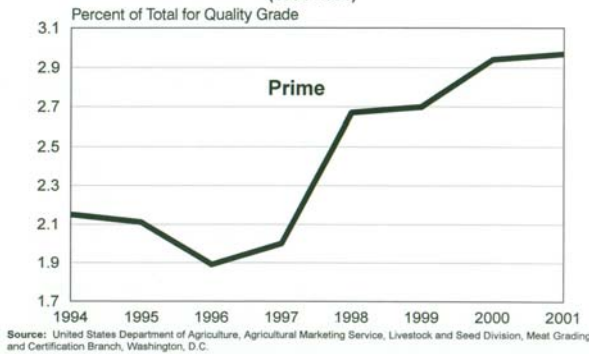
The downfall of the current value based marketing system is there is limited price discovery. Most are based on the cash live cattle prices, but less than half of the cattle are now sold that way, and they tend to be the plainer less

desirable cattle. So the situation we have, is that the price paid for the lower half of the fed cattle population is pricing the best cattle. This must change.

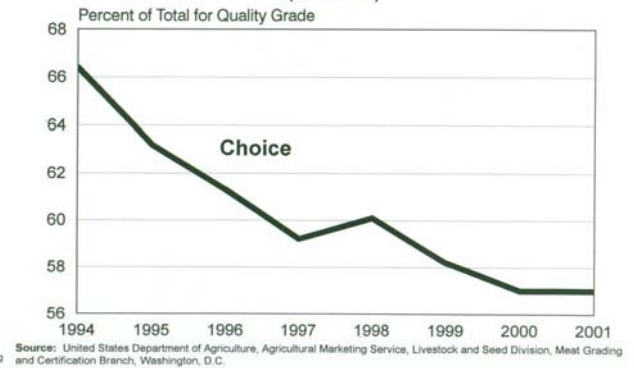
One of the most pressing challenges facing the beef industry is to develop a new and better price discovery system. If we are truly in the beef business, then some combination of various beef prices (possibly at the wholesale and or retail level) could form the basis for a better way to determine the value of a fed animal.

The accompanying charts show very clearly that the largest reward in the market as it currently exists is to produce more pounds of beef.

The Annual Average Percentage Distribution of the USDA Quality Grades for Prime, Choice, Select and Standard for a Period of Eight Years (1994-2001)



The Annual Average Percentage Distribution of the USDA Quality Grades for Prime, Choice, Select and Standard for a Period of Eight Years (1994-2001)



The charts clearly show that while we have given lip service to improving carcass quality, both from a yield grade and quality grade, it is not happening as it needs to. Note the decline in the percent of cattle that have a choice quality grade, and the increased number grading select and standard. Also note the decline in the number of yield grade 1 and 2 carcasses, and the increase in the number of yield grade 3,4, and 5 carcasses. Until we develop a better system of premiums and discounts for the right kind of carcass, the industry will continue to respond in the way it has the past several years, that is to produce more pounds.

The only way for the beef industry to grow and be profitable is to offer higher quality, more consistent products that the beef consumer is willing to buy at a higher price. This is the primary reason for the development of many of the new coordinated beef production systems in the United States.

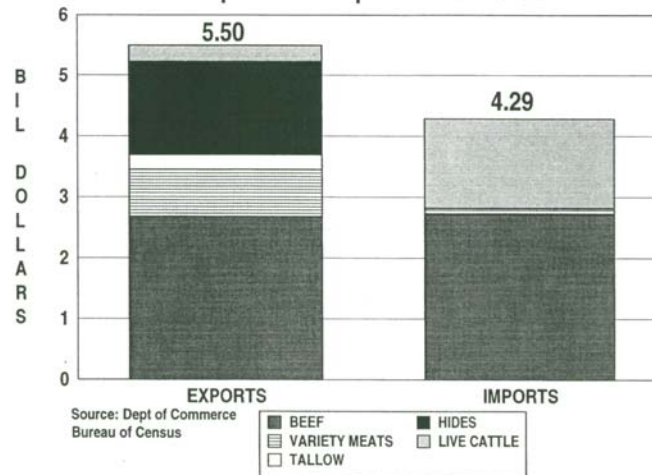
These coordinated production systems are all designed to send a better signal throughout the system about the products the beef consumer wants to buy and what the industry must produce to meet that demand. These vertically coordinated systems should also help keep supply and demand in better balance, as well as, help distribute the profit throughout the system based on the bottom line contribution made by each segment of the system. Are we there yet? No, but I am confident that as we go forward, our industry is innovative enough to develop a price discovery and beef marketing system that will result in long term stable profitability for all involved.

Some current successful beef programs are already in place:

- U.S. Premium Beef (a closed coop)
- Various Breed Alliances
 - Gelbvieh
 - Charolais
 - Red Angus
 - Certified Hereford Beef
 - Certified Angus Beef (probably the most successful)

Branded programs such as the Hormel Fully Cooked Beef Products, IBP's Thomas E Wilson, and Excel's Cattleman's Collection are succeeding very well. As the quality and consistency of the beef supply improves, more companies will be willing to sell it as a branded product and guarantee it to taste good every time. Branded beef, grids, formulas, alliances, coordinated production systems, and closed coops were not part of beef industry until a few years ago. They have only come on the scene as the beef industry tries to respond to the beef consumer's desires.

2001 Live Cattle, Beef, and Beef Byproduct Exports vs. Imports Total Value



Operating in a global market is another dramatic change for the beef industry. Beef exports make up a large and growing market for high quality U.S. fed beef. Beef exports used about 8 percent of the total U.S. beef production in 2001 and total exports equaled \$5.5 billion in value. Japan imports more U.S. beef than any other country, followed by Korea, Mexico and Canada.

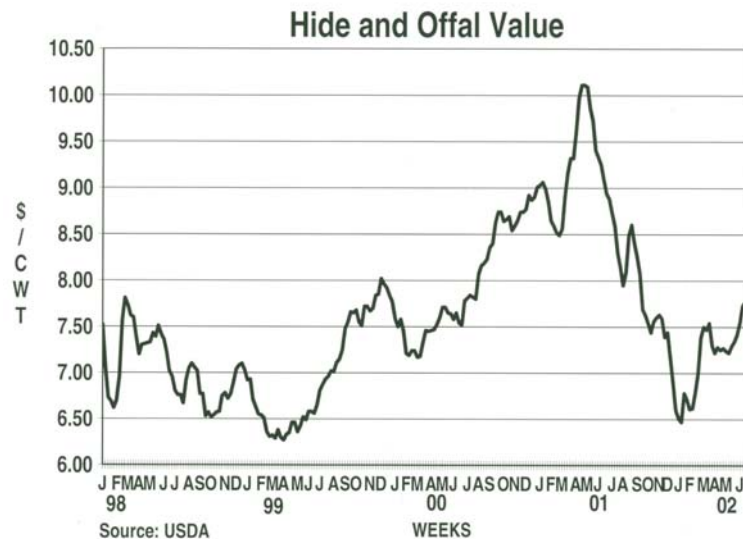
One of the pitfalls of relying too heavily on the export markets came into play on September 10, 2001. That was the day BSE was found in the cattle herd in Japan. As most of you are aware, U.S. beef exports to Japan dropped dramatically. In March of this year, Russia imposed a ban on importing U.S. poultry into that country. While not directly affecting beef exports, all of a sudden there was an excess amount of cheap poultry on the market in the U.S. which had a negative effect on beef demand and prices.

Foreign currency values compared to the U.S. dollar also have an impact on the volume of U.S. beef exports. Australia and New Zealand currently are competitors for U.S. beef exports. However, several South American countries, particularly Argentina and Brazil pose new threats to the U.S. beef export markets.

Another threat to the U.S. beef export market comes from within the beef industry itself. There is a segment of the industry who want to erect walls around our borders and restrict beef trade with other countries. Trade is a two-way street, and if we are to have a viable beef export business, we also have to allow some imports of lower quality, lean foreign beef into this country. Fortunately, in total value, beef and cattle exports from the United States were \$1.25 billion greater in value than were the imports into the U.S. last year.

Recently, a new challenge was presented to the U.S. beef industry. McDonald's, the largest buyer of beef, (over one billion pounds per year) told the

industry they can not purchase enough domestic lean beef to meet their demand. Consequently, McDonald's decided to begin using imported lean beef in some of their stores. This development has caused a great deal of concern within the beef industry. It would appear there may be an opportunity to develop a new system to provide lean domestic beef to meet McDonald's demand. There also appears to be an opportunity to export more fed beef trimmings for McDonald's to use in their stores in other countries around the world.



Another component of the export market that is extremely important to our industry is hide and offal. Hide and offal values have ranged from a low of \$6.40 per hundred in 1999 to a high of over \$10.00 per hundred in 2001. The 1999 low was caused by slow exports due to the decline of the Asian economy particularly in Korea. The high in 2001 was created by the Foot and Mouth Disease crisis in Britain. The world market grew worried about a potential shortage of hides, resulting in an increased demand for cattle hides from the United States.

Getting the Trade Promotion Authority bill passed should be a high priority for the U.S. beef industry. This bill would give the president of the United States the authority to negotiate trade agreements with other countries without the approval of Congress. Despite all of the challenges of selling beef in the global market place, there continues to be many opportunities to grow this segment of our market. These are opportunities we could only dream about fifteen or twenty years ago.

Government and the accompanying regulations are playing a large and more important role in our business than ever before. Environmental regulations of parts of our business have been around for some time. However, environmental regulations are becoming more numerous, far-reaching, and expensive every year. Later this fall, the U.S. Environmental Protection Agency will release a new set of Confined Animal Feeding Operation Regulations. They

will regulate more producers than ever before, will cause some producers to exit the business, and will cost the rest of us large amounts of money to comply with the new rules. The industry must be vigilant to ensure that future government regulations are balanced and cost effective relative to the benefits they provide.

The role of food safety issues and their effect on our business are at the forefront like never before. *E-Coli* 0157H7, BSE, and Foot and Mouth disease are in the news and impacting our business almost on a daily basis. The cost of compliance with new food safety regulations has increased the slaughter cost of beef cattle nearly \$40-50/head.

The outbreaks of Foot and Mouth Disease in Great Britain devastated its animal agriculture industry. F.M.D. has not been found in this country since 1929. If it ever invades our shores, it would have an immediate and very drastic negative effect on the U.S. beef business. While F.M.D. poses no food safety concerns, it would cause us to immediately lose access to export markets in other countries.

Food safety issues are also high on the priority list of retail and food service beef users. Virtually all of these beef customers now require beef producers, in every sector of the business, to guarantee that beef animals under their care and control were not fed any mammalian derived protein products (i.e. meat and bone meal). Many of them are also seeking process verification regarding the use of vaccines, antibiotics, and cattle handling procedures. McDonald's, Burger King, and Applebees, as well as several retail chains, have been working with beef industry representatives to develop a proposed set of minimum cattle handling guidelines for animals that produce beef purchased by their company. The National Cattleman's Beef Association just recently released a proposed set of minimum animal handling guidelines developed to meet the needs of the earlier mentioned beef buyers. It is important that the beef industry be involved in developing these guidelines to insure they are reasonable and well thought out. Hopefully, this will satisfy the beef consumers desire to know how the beef they consume was fed and handled.

Consumers are also causing changes in the way beef is sold in retail markets and through food service businesses (restaurants etc.). Gone are the days of the butcher shop in the back room of each store. Today, there is a growing demand for pre-packaged, case-ready beef products. Research shows 70 percent of the consumers do not know at 4:30 p.m. what they plan to serve for dinner that night. In 1960, 2.5 hours per day were spent on meal preparation. Today, 80 percent of the meal preparers spend less than 45 minutes on meal preparation. Forty-eight percent of consumers say convenience is the most important factor when making a food buying decision. This emphasis on convenience has created demand for quick easy to prepare meal solutions, many of them pre-cooked.

An increasing number of meals are being eaten and/or prepared away from home. This is the most significant change in food marketing in the past twenty years. Foodservice now accounts for 48 percent of beef sales, while retail food stores sell 52 percent. Away from home food sales have grown 50 percent in the last ten years.

Hamburger sales are 51 percent of total beef sales. Hamburger is also the beef item that is the most challenging from a food safety standpoint primarily due to E-Coli 0157H7. In an effort to combat this problem, the industry was successful in getting a cold pasteurization (irradiation) process approved to kill E-Coli 0157H7 in beef products. I believe it will play an increasing role in food-safety procedures in the future.

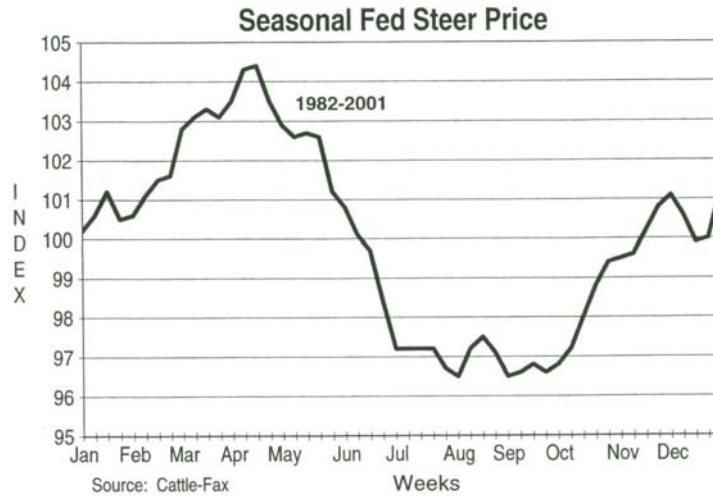
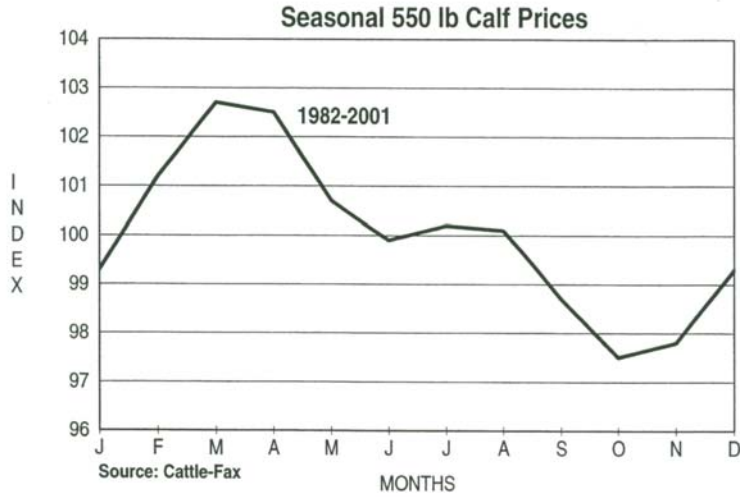
I predict, in the not to distant future, the United States will implement a mandatory individual animal identification program. This will facilitate the control of infectious animal diseases, as well as assist in identifying animals with superior genetics that will produce higher quality, more consistent beef products that today's beef consumers are demanding. Mandatory ID will also facilitate the implementation of the recently passed Mandatory Country of Origin Labeling Law that will go into effect in 2004.

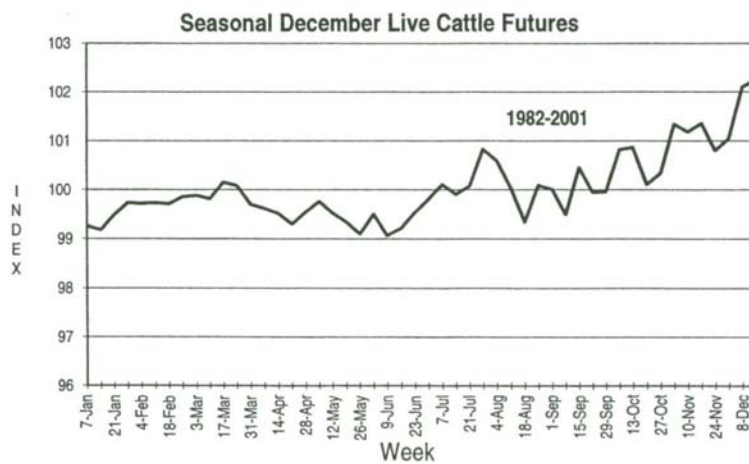
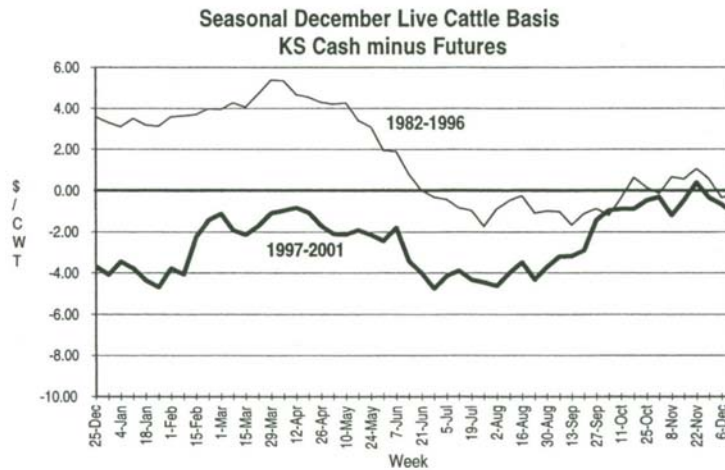
As this new beef supply system grows and develops, it will create a demand for calves and feeder cattle that are process verified and come with a known genetic package for feedyard performance and carcass characteristics. As a feedyard operator, I will be willing to pay a higher price for these cattle. Cattle that get sick and or die lose money. Texas A & M ranch to rail data clearly shows cattle that get sick have a marked decline in feedyard performance and also produce less desirable carcasses.

We live in a time of instant communication. This has had a large impact on our business, which will continue into the future. Markets are able to react much more quickly to industry news and happenings. World events are now only a click away. Market volatility appears to have increased as a result. Unfortunately, even unsubstantiated rumors can have a devastating impact on beef, live cattle, and futures prices (i.e. Kansas Foot and Mouth Disease rumor on March 13, 2002).

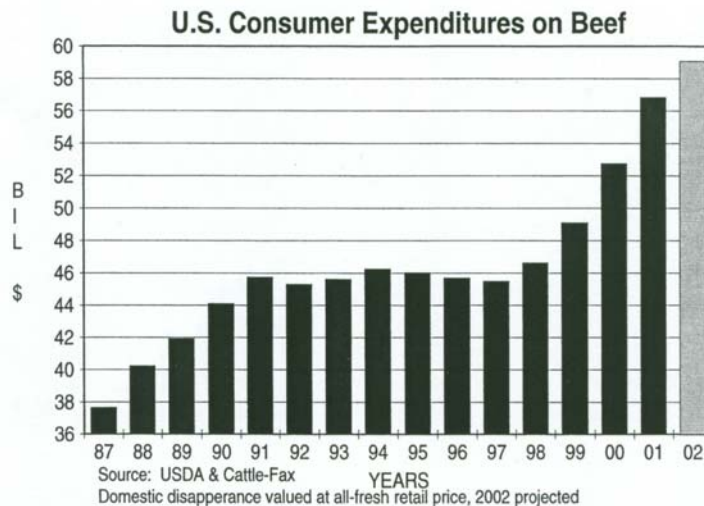
The increased market volatility and the many outside influences affecting beef and cattle prices created a renewed and increased emphasis for risk management strategies for the successful beef industry of the future. Had the industry done a better job of managing risk the past couple of years, losses could have been much smaller.

One simple risk management strategy is to understand the seasonality of prices of cattle and beef. The accompanying charts show the seasonality of calf, yearling and fed cattle prices. Cattle futures and basis also have a seasonal pattern.





An exciting and very positive improvement in beef demand is encouraging for the beef industry. I believe the changes that have and are occurring within the industry will keep beef at the center of the consumer's plate for many years. We will still face intense competition from pork and poultry. But beef is back with some new great-tasting, convenient healthful products.



I would be remiss if I do not mention the positive contributions the Beef Checkoff has made in repositioning beef as the protein of choice. The checkoff has heavily invested in helping develop many of the new beef products we now see on the market. Most of the recent new beef safety interventions were developed by research at least partially funded by the Beef Checkoff. There are some in the industry that want to do away with the only industry self-help program in existence. I would suggest that instead of debating the demise of the checkoff, we should be debating how much the checkoff should be increased.

In summary, we have covered a large number of topics today.

- Change is inevitable.
- Beef production will stay large and will be done with fewer total cattle.
- We are moving away from a cash based market system.
- We will develop a new price and value discovery system.
- Vertical coordination between all industry segments will increase.
- We operate in a global market system.
- Government regulations will increase.
- Food safety efforts are much more important than at any time in history.
- Mandatory individual identification will be implemented soon.
- Animal welfare concerns and the need to raise animals humanely is a reality.
- There will be increased demand for and higher prices paid for source and process-verified calves and feeder cattle.
- Events outside the industry will continue to have a large impact on the business.
- Increased emphasis on risk management is a must.
- Beef demand continues to be good.
- Pork and poultry will continue to offer stiff competition.
- The Beef Checkoff is positive for the Beef Industry.

Finally, the Beef Industry is on the verge of destroying itself from conflict from within. It is time to stop the internal bickering and focus on producing and marketing beef to meet increased consumer demand. The real enemy is poultry and pork, not other beef industry participants.