Testimony to the Democratic Hearing on the Crisis in the American Livestock Sector

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Pork producers are experiencing the largest losses in modern history. They are more efficient than ever before, but prices they receive dropped to some of the lowest post-war levels in December. Prices have stabilized, and based on the USDA December 1998 report are expected to increase beginning in February and return to break-even levels by mid-summer. Break-even prices will be a welcome sight to producers, but the damage caused by the losses that began in November 1997 will leave a lasting legacy on surviving producers and the industry. I will attempt to explain why prices have fallen to these low levels, provide my forecast of how quickly they may recover, and explore the possible implications for future industry structure.

Why the Low Prices?

The basic reason for extremely low hog prices is that the supply of market ready hogs is larger than the capacity to process them. Weekly slaughter has exceeded 2.0 million head since Labor Day with the exception of the holiday shortened weeks. Slaughter hit 2.2 million in the two weeks prior to Christmas and may do so again in January.

Packers are running double shifts, over-time, and six days a week were possible and there have been limited Sunday operations, but supplies continue larger than processing capacity. Paying more over-time, taxing equipment and cooler space, storing or merchandising extra product drive up the cost of processing. There is a “kink” in the packer's demand curve at approximately 2.0 million hogs. Prior to Labor Day and 2 million head a week, each 1,000 additional hogs resulted in a price decrease of $.03/cwt (100,000 head => $3/cwt). Since Labor Day at levels over 2 million head a week each 1,000 head increase resulted in a $.09/cwt price decline ($9/cwt for each 100,000).

I believe that farm level prices will rebound as quickly once slaughter levels begin to decline. Based on the December Hogs and Price report, weekly slaughter could return to the 2 million head level in early February. A 200,000 head reduction in weekly slaughter is forecast to boost hog prices $18/cwt and return them to the upper $20s.

This packer bottleneck can be traced to a similar situation in the fourth quarter of 1994. Packers were quite profitable and some reinvested their earnings in 1995 in additional packing capacity at the same time pork producers cut production. Facing tight hog supplies, and reduced profit the packing sector began to reduce capacity in 1996. Over 200,000 head of weekly capacity has closed since the end of 1995. It will be interesting to see if packers reinvest current profits into additional capacity without some assurance that hog supplies will be available.

What are the Implications for Industry Structure?

The current losses experienced by pork producers are expected to change the face of the pork industry. In one regard, the current low prices are an indication that the hog cycle is still

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alive and that the liquidation occurring will result in higher hog prices in 2000. Historically, firms that weather the losses are rewarded with profits later in the cycle. While I am not ready to declare the hog cycle dead and buried, I am cautious about how profitable the next revolution of the cycle may be. I am also concerned about who is able to weather the current losses long enough to enjoy the better prices in the future. The following is a synopsis of different segments of the industry and a scenario that may develop to dramatically change the pork industry.

**Diversified Family-Farm Hog Enterprises:** 1996-97 were two very good years for hog farms that produced their own grain. These farms face a cash flow crisis today, but in many cases their balance sheet is strong enough to restructure the short-term debt into a longer-term repayment plan that will allow the operation to continue. Based on an analysis of the Iowa Farm Business Association Records approximately 75 percent of diversified operations with a significant hog enterprise are good candidates for debt restructuring. Due to either high debt levels or high cost of production the financial position of the remaining farms has moved into the “severe” category. Debt restructuring will result in 5-10 higher cost of production. However, these losses have already been incurred and will have to be recouped in some fashion.

**Specialized Pork Production Businesses:** This group has invested heavily into pork production and expanded production in 1997 that hit the market in 1998 at a loss. These producers are also the most likely ones to have a packer contract as many lenders required some type of risk management plan as part of the financing package. Some of these contracts have a large negative ledger balance today, and thus the producer owns the packer rather than the lender. Many lenders are committed to working with this class of producers because they have a successful proven track record, have adopted modern technology, and are well positioned for the future as low cost producers. However, these producers have a cash flow crises and are at risk of asset devaluation (explained below).

**Large-Scale Producer:** As with smaller producers it is difficult to characterize large-scale pork producers. These operations are often highly leveraged and have expanded rapidly in recent years. The 1998 pork industry structure study indicated that many of these producers were not involved in risk-sharing contracts with packers and are suffering the same cash flow crisis as much of the industry. Some of these operations may be able to attract additional equity capital or new buyers to stay in operation. They operations have obligations to suppliers, creditors, and contract growers that may be regionally concentrated and significant to local economies.

Ironically, there is a concern to the entire industry of forced liquidation of the large-scale operations at “fire sale” prices. If these operations are sold for a fraction of their book value two shock-waves will be felt throughout the pork industry.

First, facilities sold at these reduced prices may be viewed as the market value for pork production facilities. Appraisers, lenders, and bank examiners may begin to re-evaluate production assets and devalue them on balance sheets. Producers that are solvent today may be teetering on bankruptcy after a devaluation of their facilities. Next, their facilities may be forced onto the market further feeding a downward spiral of asset values as we saw in the 1980s.

Second, and more important for the structure of the pork industry, is that the buyer of fire-sale priced assets will have a significant cost of production advantage over other producers.
The buyer of assets at 50 percent or less of their new value would see cost of production decrease 10 percent. This differential will continue to pressure the surviving producers.

There is also concern about who the new buyer may be. Most existing producers are not in a position to buy as they may be for sale themselves. The low hog prices that have created large losses for producers have created large profits for others in the pork value chain. Seven packers already own hogs or are closely related to hog production operations (Smithfield, Lundy, Clougherty, Seaboard, Excel, Premium Standard Foods, and Farmland). Packers may be interested in securing a hog supply as liquidation take their traditional suppliers. There is a rumor that one of these has bought an operation on the "Top 50" list recently.

There may be other buyers such as agribusiness firms interested in becoming a major stake-holder in the pork industry, but they are not readily apparent at this time. The mounting losses resulting from volatile prices are not likely to attract uninitiated outside investors that have had limited interest in the pork industry in the past.

Summary

The recent low hog prices have generated the largest losses in history during December. The red ink that started in November 1997 is expected to end in mid-summer 1999. The liquidation that is occurring will result in higher hog prices particularly in 2000. However, many the surviving producers will need to restructure the accumulated short-term debt over a longer period of time and their cost of production will increase. Loan guarantees or interest buy-downs will be helpful (and possibly necessary) for survival of many independent pork producers.

The hog production sector of the pork industry is expected to continue the trend to fewer and larger producers. Smaller, diversified producers will likely quit hog production but remain in agriculture as they have in the past. Larger producers that have grown rapidly in recent years are not likely in a position to continue their recent pace of expansion. However, the production sector may be on the verge of a period of consolidation through acquisition. Most existing producers are not financially capable of buying competing firms. However, large agribusiness firms or pork packers may decide to expand their holdings in the pork industry through the purchase of large-scale operations at fire-sale prices.

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1 See accompanying materials for more information on packer contracts.