



WEEKLY OUTLOOK



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PORK INDUSTRY ON LAST LEG DOWN, BUT FUTURES PROVIDE A WAY UP

Bankruptcy is a terrible word, but one that indicates the pork industry is entering the “last leg down” in this cycle. Attorneys for several large producers have posted the “out of business” sign in recent months. Lenders to hog operations are increasingly facing the facts for their poorest performing loans—if the producer quits now, what can the lender recover? The bleak answer, in some cases, is not much since foreclosed hog buildings may have little value if forced on the market right now.

Why did it have to come to this? The answer has many dimensions, but in general there were just too many major demand and cost shocks in the past two years for an industry that had become too inflexible to downsize. That downward adjustment is now a forced adjustment with bankruptcy for a few just revealing the “tip of the iceberg” of the lost equity across the sector. The industry will now likely drop another three to five percent of the breeding herd to get small enough to return to breakeven.

Hog prices have improved from their lows in August, but the \$40 live price in the final quarter this year is more than offset by production costs estimated at \$48 per live hundredweight. In September there was some optimism that feed costs would be moderate for 2010, but that optimism has faded with a \$.90 per bushel increase in corn prices. Now the anticipation is that hog production costs next year for farrow-to-finish operations will be around \$50. This seems to be an insurmountable climb for prices from \$40 today.

The outlook is for hog prices to average about \$46 to \$47 next year, moving from about \$44 in the first quarter, to near \$50 in the second and third quarters, and back to the mid-\$40s in the final quarter. Given the assumption of \$50 costs, this would still leave \$10 of loss per head, the third year in a row of losses. However, the current financial reality likely means the herd will decline, demand will improve, and hog prices will be higher than the current forecast.

There are others that believe hog prices will be higher, most importantly futures traders. Using lean hog futures at the close on November 20 and the average Eastern Corn Belt basis level over the last five years, the futures market is suggesting \$50.50 for a farm level price next year, suggesting a breakeven price for 2010. If there is an unfortunate side to these higher prices it is that it may increase producer/lender optimism, resulting in a smaller than needed reduction of the breeding herd. If so, selling lean futures now will be positive.

Those producers and lenders facing the difficult decision of whether to continue or call it quits should consider these futures market pricing opportunities. Most lenders want their hog operations to at least cover cash outflows. That is to say, they do not degrade their current financial situation. What about the overhead costs such as depreciation and debt service on buildings and equipment, taxes, etc.? As stated earlier, hog buildings and equipment probably have little value right now in a forced liquidation. The lender may be better off to continue to work with hog producers if they do not worsen their financial situation over the next year. If they make it through, then the value of the buildings and equipment may be positive in another year.

Clearly some operations must reduce production, or shut down, to reduce total production. There are still operations with high costs, have low efficiency, are dramatically undercapitalized, or no longer willing to risk more equity erosion. That is where the additional downsizing will come.

Producers in a weak financial position who decide to hedge lean hogs with a live equivalent near \$50 must cover feed costs as well.

As bleak as the outlook seems, it is ironic that the futures market provides a way to at least get through 2010. Old timers use to say that you don't want to be short lean hog futures when the price cycle is ready to turn up, and that has been true in the past. When prices turned up, they tended to go much higher than anticipated, providing handsome rewards to those who stayed unsold on hogs.

But, this is a new era and old maxims may not hold. In addition hedging today may enable some operations to continue over the next year when the lender is ready to give up. For them the new maxim may be, survive in 2010 for an opportunity to be around in 2011.

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