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U.S. Poultry Outlook: This Time Things Are Different

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Key Points:

- The U.S. chicken industry has experienced an unprecedented run of historic profitability since 2012 and responded with a significant increase in production and processing capacity.
- Six new poultry processing plants are expected to be operational by 2020. The new chicken production capacity, though, is coming online in the midst of continued supply expansion among competing animal proteins.
- Profitability across the poultry sector is now under pressure as meat prices decline amidst growing supplies, bringing to mind the last major downturn a decade ago which resulted in severe financial losses across the sector.
- With the industry now more responsive to demand – while also enjoying strong balance sheets following years of strong profits – the outlook for the next downturn in the chicken cycle is much brighter.
- The spread of African Swine Fever, or ASF, in major markets like China could significantly alter poultry's export demand and industry profitability in the short term.

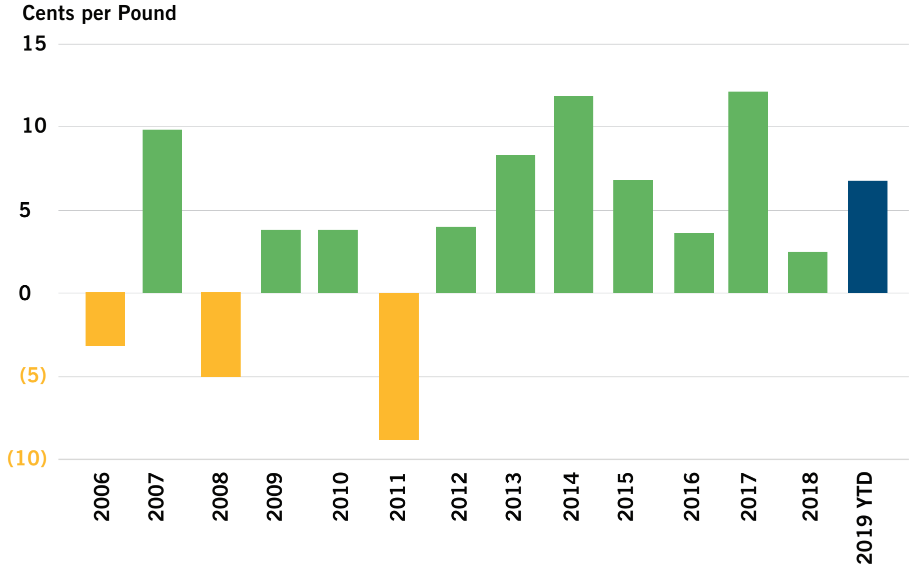
Introduction

The U.S. poultry sector's recent history can largely be divided into two periods: before 2012 and after. 2012 is the demarcation point *(Exhibit 1)* because feed costs set a historic peak that summer as drought spread across many grain-producing regions, including the U.S. Since that time, feed costs have normalized and global economies have rebounded – and animal protein demand has followed suit. The result: a period of climbing U.S. consumption of animal protein, including chicken, and a prolonged run of elevated profitability for the chicken industry.

The five-year period prior and including 2012 is in many ways a dark ages for the U.S. chicken industry and animal protein in the U.S. in general. From 2008 through 2012 more than a dozen chicken companies changed hands as industry profitability tested historic lows on more than one occasion. Factors driving this challenging period included:

- Passage of the Renewable Fuel Standard in the U.S. The country developed a large ethanol industry consuming approximately one-third of U.S. corn production.
- The entrance of China onto the global stage for imports of both feed grains and animal protein.

EXHIBIT 1: Spot U.S. Chicken Industry Margins



Sources: Weekly USDA Northeast chicken prices and CME near-term futures for corn and soybean meal.

Notes: Represents CoBank estimate for spot chicken industry profitability based on U.S. industry production of big bird, retail tray pack and whole bird channels. Margin does not represent any individual producer.

The global supply of feed stocks has rebounded now that demand growth for ethanol and demand from China has slowed dramatically. With that change, feed costs have not only fallen dramatically but have been far less volatile. This has allowed animal protein producers to plan and develop supply chains far more effectively. With capacity having subsequently grown across the poultry sector, fears are now growing of a looming correction.

Lessons Learned

What was learned during the downturn a decade ago has strengthened the U.S. chicken industry for the future. These lessons have driven important changes within chicken companies and also improved how they interact with their customers both domestically and internationally. Here are five things that are different now:

1. Improved pricing

Industry pricing is likely the biggest structural shift in U.S. chicken production. It has allowed producers to more quickly pass on changes in feed costs, which allows them to more effectively manage the primary driver of earnings volatility.

The expansion of cost plus and other pricing contracts that incorporate a component where chicken prices can quickly reflect changes in input costs has been significant. Today, chicken companies are able to focus on the efficient conversion of feed into animal protein instead of being expert predictors of where grain and meal markets are heading.

These pricing contracts also allow the chicken industry to hedge and, to some degree, lock in profit margin. A key risk management weakness of chicken production in the U.S. versus hogs or cattle is the lack of a futures market for the broiler industry. With the expansion of cost plus and other price contracts, chicken producers have shifted the conversation from one about outright chicken prices to how feed and other production costs are faring at a given time.

2. Stable feed costs

Cost of production is also a key variable making the outlook for 2019 and 2020 quite different than what the industry experienced in 2008, 2009, and 2011.

Feed costs comprising corn and soybean meal have moderated significantly from the run-up in the period of 2006 to 2012. Now that global feed stocks have rebounded, corn and meal prices have declined and have also become far more stable.

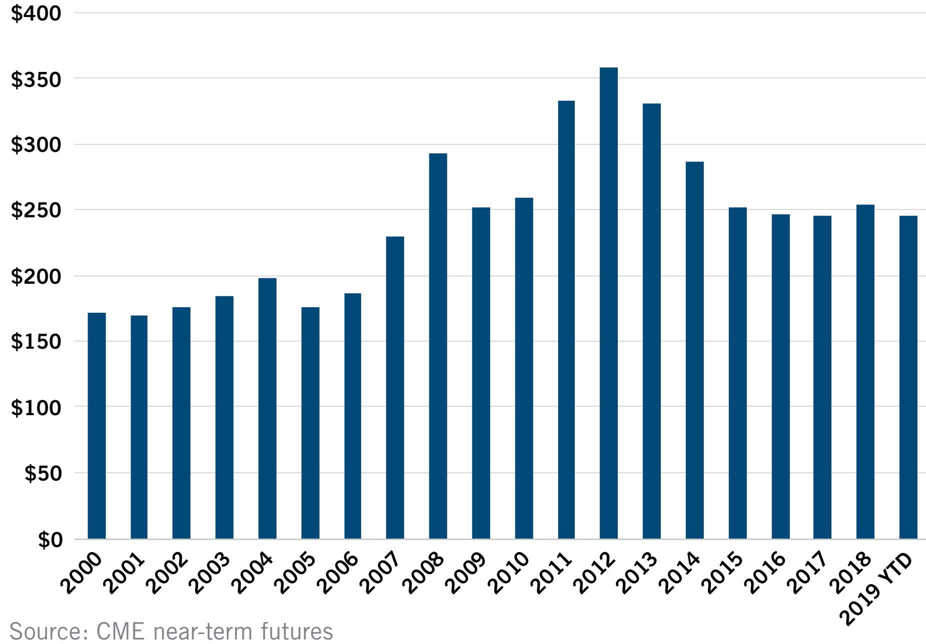
Feed cost per ton, which incorporates both corn and meal, has averaged approximately $250 per ton since 2015 *(Exhibit 2)*. During the run-up in prices a decade ago, they doubled in just a matter of five years.

3. **Managing non-feed costs**
   While feed costs have become much more manageable, non-feed production costs have become increasingly challenging.

   The lack of available labor for chicken processing, as well as those sectors that directly supply chicken production, have increased non-feed production costs significantly in recent years. Wages have climbed in chicken processing plants *(Exhibit 3)*. The costs of housing, feeding, and transportation have risen as well. In processing alone, we estimate costs have risen close to 20 percent in the last 10 years.

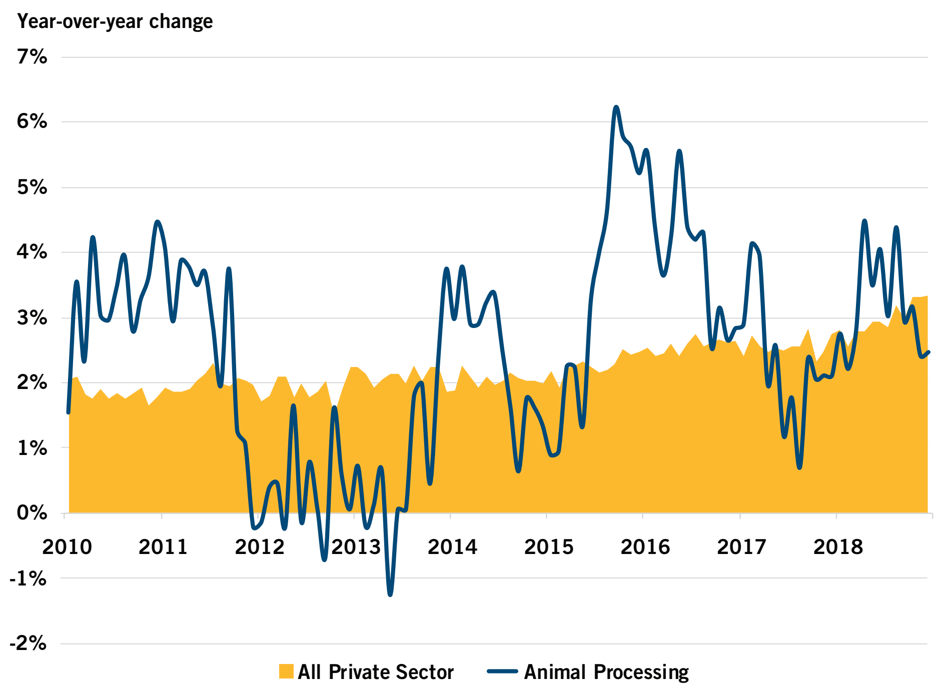
   Cost inflation is always a challenge to offset in a commodity business like agriculture. However, the steady and consistent level of inflation is a far more manageable position for chicken companies going forward than the extreme volatility of a decade ago.

EXHIBIT 2: U.S. Chicken Feed Cost per Ton



Source: CME near-term futures

EXHIBIT 3: Average Hourly Wage Inflation



Source: BLS

"We project 1.5 percent chicken production growth, which is well below the 2.5 percent average growth rate in the last five years."

4. **Improved capital structure**
   When feed costs and a weak U.S. economy drove the sales of many chicken companies 10 years ago, the remaining companies and management teams knew that the old way of operating couldn't continue. Not only did they change their pricing structure as detailed earlier, but they also changed their capital structures and their general outlook on production and profitability.

   Many chicken companies found themselves with burdensome levels of debt that became unsustainable when corn prices doubled and almost tripled in 2008 and 2009. Today, the average chicken producer has almost as much cash on hand as debt on their balance sheet, making them far more resilient to any downturn in chicken prices and margins.

5. **Smarter supply management**
   Today, the chicken sector responds to changes in demand far more rationally than it has in the past.

   One instance of this was the closing of U.S. export markets in 2015 during the outbreak of High Path Avian Influenza. This caused leg quarter prices to crash, falling by over 50 percent in a matter of just a few months. Producers were able to adjust supply to meet demand, giving export markets time to reopen and profitability to rebound.

Outlook

The outlook for the remainder of 2019 – and very possibly 2020 – has improved markedly over the last few months.

Production

There is significant new chicken production capacity coming online. This growth started last summer and will continue through 2020. At this point half of the six new plants are up and ramping up production, but this is yet to show up in weekly production. We view this as another example of rational industry behavior by producers as chicken breast prices fell to historically low levels in the fall of 2018. We expect chicken supply to not fully reflect the increase in capacity from new plants while the legacy plants curb production numbers.

With chicken prices under more pressure recently, producers should use this as an opportunity to optimize their labor needs and costs. We project 1.5 percent chicken production growth, which is well below the 2.5 percent average growth rate in the last five years.

Feed costs are also well managed. The range of prices we have seen for corn and soybean meal should continue through 2019.

With good visibility for production costs, the outlook for chicken producer margins is better in 2019 compared to 2018. Last year was a modestly profitable year as very weak prices in the fall eroded much of the profit the industry generated in the spring and summer.

Demand

The domestic and international demand environment looks favorable for U.S. chicken producers.

Chicken has been the less-favored protein in the last couple of years as heightened economic and wage growth has driven consumers to more luxury-priced proteins like beef and seafood. However, there is near-consensus expectation for a U.S. economic recession in the next two years. This environment has historically played well for U.S. chicken demand.

International demand is where U.S. chicken could see the biggest upside. Two factors that may influence demand:

1. **ASF outbreak limiting global pork supply** – The outbreak of African Swine Fever (ASF) in China and Asia is broadly wreaking havoc on hog herds and pork production. China's pork production may decline by 30 percent due to ASF, according to some estimates. Given China's massive share of the global market, this could result in a 15 percent decline in the world's pork supply. Chicken prices in China and other parts of Asia are already on the rise. In some markets, they have reached all-time highs.

   All indications are that the ASF outbreak is as widespread and as devastating as we had feared last fall. China has a limited number of options to source material volumes of animal protein. It seems likely that the U.S. will help fill the massive supply gap that the large and growing populations of Asia will be facing later in 2019 and very possibly for years to come.

2. **China may lift HPAI ban** – It is only a matter of time before U.S. chicken exports benefit with increased trade volumes, but it would be a reopening of China to U.S. chicken that could also change things. U.S. chicken has been banned in China due to an outbreak of highly pathogenic avian influenza (HPAI) for three years. However, as China's animal protein shortage becomes increasingly pronounced, it is likely the ban will be dropped.

The outlook for 2020 is predominately dependent on the impact of ASF in China and Asia broadly and what trade opportunities materialize for U.S. poultry, beef, and pork. Without sizable export volumes of all three major animal proteins, the U.S. poultry sector, and the protein sector in general, will be facing a significant glut of meat in the domestic market.

A look at the prices of meat and poultry in the summer of 2018, prior to the first news of ASF in China, shows U.S. consumers were beginning to reach a peak in animal protein consumption. That isn't to say that U.S. consumers stomachs are as full as they could get of meat and poultry, but each marginal pound of consumption would come at significantly lower prices. At these prices, producers would struggle to be profitable.

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