

Agricultural Outlook Forum 2001

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## U.S. PREMIUM BEEF SELLING MEAT AND MEALS INSTEAD OF CATTLE

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Thank you for this opportunity to come before you once again to provide an update on the success of our Company and plans for the future. As many of you are aware, U.S. Premium Beef (USPB) was formed back in July of 1996 as a closed marketing cooperative made up of cattle producers who organized with the common mission to “sell meat and meals instead of cattle”.

Winston Churchill once observed, “No revolution was ever fought and won behind the battle cry, we must reach consensus.” As producers we must break out of the commodity mold and move toward the marketing of value-added products. This movement of developing creative marketing practices is at times neither popular nor easy. For USPB, our shareholders not only risked their hard earned equity, but withstood political fall-out from the very people who have been the most vocal against our current marketing practices.

I urge USDA and our lawmakers to listen to a broad sampling of producer input regarding such issues as limiting marketing arrangements between packers and producers and producer contract protection. We risk inadvertently squelching the very opportunities innovative producers have been fostering to move into a value-added category.

It is important to realize up front that not every producer-owned venture has reached fruition or succeeded. In fact, we as producers have historically experienced limited success in owning businesses outside of the ones we manage daily. The reasons range from over-optimistic feasibility analysis, lack of practical vision, lack of expertise, improper Board/Management roles, becoming too political, improper or limited due diligence, too many chiefs and lack of lender support. It takes a tremendous amount of discipline

in order to avoid these pitfalls. As we were developing USPB, we even resorted to such economic disincentives as fining an individual \$100 each time planning discussions deteriorated to a political focus. There are a thousand ways to put a producer owned cooperative venture together wrong and only a handful the right way.

The founders of USPB were motivated to pursue our venture by one thing; FEAR. Fear is a great motivator. The fear of being a highly invested participant in an industry that had lost market share for 20 consecutive years. The awareness that under the current marketing system, the economic signals were to buy the cheapest, poorest animal that walked the face of the earth and feed him until a feedlot bundled him with entire showlist and sold at one price. If the consumer paid General Motors the same price for Chevys as Cadillacs, they would stop manufacturing Cadillacs. The beef industry has too many Chevys because of our broken marketing system. We also feared that under an extremely segmented marketing system that independently, we lacked the ability to realize a competitive price.

Our fear motivated us to identify several keys to a successful beef industry. First, we must implement a value-based pricing system where there is economic incentive to produce an animal that the consumer wants. Second, the producer must have the knowledge, carcass data, to effect change. And thirdly, the producer must have ownership beyond the pen gate. We must move the price discovery point where the consumer purchases our product. Only then will the producer realize full value for their product.

From this, we developed a mission. Our mission in USPB is to profitably sell meat and meals instead of cattle.

The USPB concept was evolving into an integrated strategy. Historically, producers have viewed vertical integration with much skepticism due to the model developed in other species such as poultry and pork. In these industries, vertical integration was typically top-down. However, by contrasting the beef industry to other species you see a dramatic difference in the ability to concentrate production. In swine and poultry, concentration is feasible because the cheapest feed source, small grains and concentrated protein sources, is mobile. However in beef, cattle are most efficiently grown through the utilization of the grass roughage that is geographically dispersed throughout the United States. Therefore there is a limited ability to efficiently concentrate beef production. This results in a tremendous

difference in capital investment in production assets. Universities estimate that the average investment in production assets per cow/calf unit is between \$2000 and \$4000. This is substantially higher than the cost of processing, which could run as high as \$200 per carcass unit. Contrast this once more to pork and poultry where due to the ability to concentrate, the per-unit cost of production is comparable to per unit cost of processing. It is more likely in these species that vertical integration would occur top down. Now, how likely is it that a processor will vertically integrate downward into livestock production ownership in the beef industry? It is highly unlikely a processing would make this level of investment. However, if you are a producer with over \$2000 per animal unit invested, how likely is it that given the opportunity, you would invest an additional \$200 to sell meat and meals instead of cattle? This was the point when we decided, USPB could and should work.

When we began exploring the development of USPB back in the fall of 1995, our hopes were to have a plan to take to producers within one year. We were wrong. We incorporated on July 1, 1996 and began developing a membership base, exploring processing options and lining up debt financing. We eventually reached a tentative deal with Farmland Industries in the form of a letter of intent on July 1, 1997. This led to the introduction of a stock offering on September 1, 1997. On November 1, 1997 we closed the first stock offering raising \$38 million in producer equity. We subsequently purchased a partnership interest in Farmland National Beef on December 1, 1997 and delivered our first animal on the very same day.

The acquisition can be broke down on a per-head basis as follows: The cost of acquisition was \$104 per head. We raised \$55 per head/share of producer equity and borrowed \$50 per head of capacity. One share held the right and obligation to deliver one head of finished cattle per year to the processing facility and a pro-rata share of company earnings.

While exploring processing ownership options, we considered all alternatives including building, a buy-out and joint venture. Our due diligence of the packing industry revealed many things. Many of which were in conflict with the producer perception. We discovered there was a difference in profitability, there was intense competition between players, there were failures even among large sound financial participants and profits were seasonal among many other things. Above all, we discovered that entering this business without an exiting participant as a partner was suicide.

Our decision to enter a partnership with Farmland was driven by the results of our investigation of the company's size, management, profitability and presence in the value-added product sector. As the nation's fourth largest beef processor, there existed the size necessary to realize economies of scale yet small enough whereby we could achieve a significant enough ownership to establish governance. Farmland National Beef has successfully built a company that was competitive in operational efficiencies and began establishing branded programs utilizing the Farmland brand. Over time, it became our first choice of processing partners.

The primary benefits to producers who participate in USPB are a competitive value-based grid, free carcass data, further processing earnings and guaranteed market access. After the following brief summary of the USPB program to date, I will relate our performance relative to the costs of participation:

- 1404 members in 33 states
- 360 stockholders in 20 states
- 780 feedyards have shipped cattle in 14 states
- 1.8 million cattle delivered
- \$24 million in cash grid premiums paid
- \$36 million in processing earnings
- \$1.5 billion in total sales

The foundation behind our value-based pricing system is the USPB grid. In industry terms, the USPB grid is considered a "white tablecloth" grid. As the name implies, we are attracting cattle that would produce a meat product in the higher quality categories of choice, upper choice and prime. For example, if a USPB producer delivered a prime carcass, they could realize a quality grade premium of \$150 per head. Since our program began, the AVERAGE premium per head has increased over 90% to \$14.34. The top 50% realize an average per head premium of over \$31. The top 25% now realize on average over \$41 per head premium.

Processing earnings continue to distinguish USPB from many other alliance programs in the industry today. To date, USPB has generated over \$36 million in earnings. In fiscal 2000 alone, USPB members realized \$27.59 in earnings on every head delivered, representing a three-fold increase from our first full year of operations.

The best indicator of success of our program is share value. As a shareholder in USPB, you have the ability to transfer or sale your shares on a private treaty basis to other cattle producers. We routinely assist our shareholders in selling and purchasing shares. Since our initial offering in the fall of 1997, our shares have increased in value 67%, from \$55 to \$92 per share.

While the early investors in USPB took a calculated risk in capitalizing and supporting USPB, the returns have far exceeded expectations. Their \$55 per head investment has realized on average a 200% return taking into account the grid premiums, company earnings and stock appreciation. To put it in cattle terms, in fiscal 2000, the top 50% of our cattle delivered earned their members over \$76 per hundredweight compared to an average \$69 market. That is over \$7 per hundredweight advantage by participating in USPB.

These opportunities exist for beef producers and other agricultural producers if the desire exists. Darwin said it best, "It is not the strongest of the species that survives, nor the most intelligent; it is the one that is most adaptable to change." Great words to ponder as producers, processors and legislators search for the path to the most efficient production of an abundant, better and safer food supply.

Thank you again for the opportunity to visit with you today.