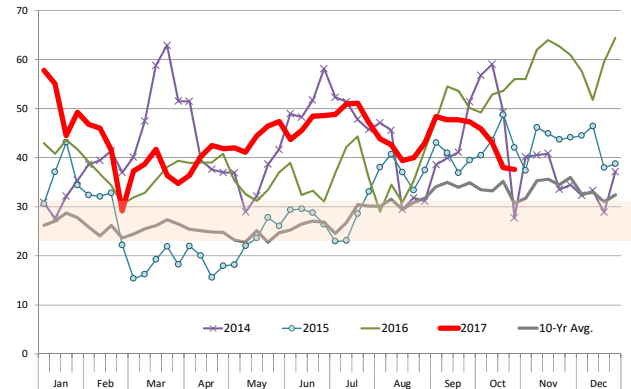


With cattle and hog prices moving higher recently, one of the questions market participants are pondering is the impact this is having on packer profitability. The short answer is that higher livestock costs have squeezed profits but those profits remain above the long run averages. Before we look at the specifics of each sector, one thing to consider when talking about long run averages is the dramatic shift in the labor cost structure. Escalating labor costs have been a hot discussion topic for a while and the situation is getting increasingly more difficult as the country approaches full employment. We urge you to keep this in mind when we talk about long run average margin calculations since today the packer needs to cover a more expensive labor force than ten years ago. The shaded area in each chart is where we think the packer needs to be to breakeven but it's a very uncertain number and one that changes over time.

We think the gross margin for processing hogs last week was around \$38/head and it is expected to be around \$37.5 this week. This is about \$10/head less than what the packer was getting just a few weeks ago in September and down 33% from the very lofty margins that the pork packer was getting last year. There is no question that the margin has gotten squeezed the last few weeks as hog purchasing costs have escalated. However, according to our calculation, the gross margin is still above the 10year average for this time of year. We also think that tighter as these margins are, the pork packer is still in the black, just that they likely are falling short of what they probably budgeted for Q4. The margin calculation is made up of two components. How much is the packer making by selling the meat and how much is the packer making from the offal products (drop credit). The meat margin, the spread of cutout minus hog price, is what's been affected the most recently. Current spread between cutout and net hog price is around \$9/cwt or \$19/head. The by-product or offal value is a bit trickier to calculate since the numbers on this are all over the place. USDA reports a drop credit calculation but over the years we have opted to use the one calculated by LMIC. That calculation also is based on USDA data but it makes a different set of assumptions on yields, etc. This is the reason for the difference between our current calculation of the drop credit, which is around \$18.7/head and what you would get from the USDA calculation. The second chart to the right shows the longer term trend in both components of the pork packer margin. It is interesting to note how unusually large the premiums were last year on the meat side, with the packer benefiting from the lack of processing capacity but also because extra weekend shifts were required and which are more costly. **In the case of beef, the current gross margin is around \$330/head, a little under the lofty margins of last year but still well above what we think is needed to breakeven and long run averages.**

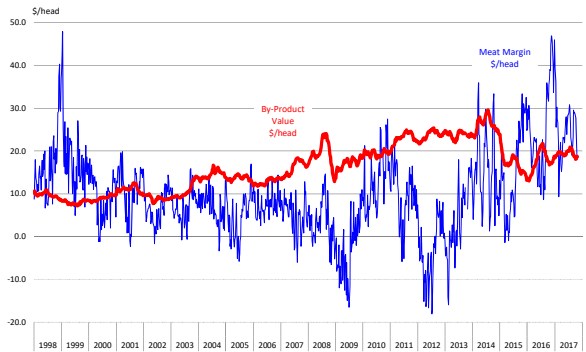
PORK PACKER CALCULATED GROSS MARGIN. \$/HEAD

Calculated Using the Weekly Pork Cutout Value, Number of Head Processed, and Drop Credit Value. Data Source: USDA, Steiner & LMIC Drop Credit



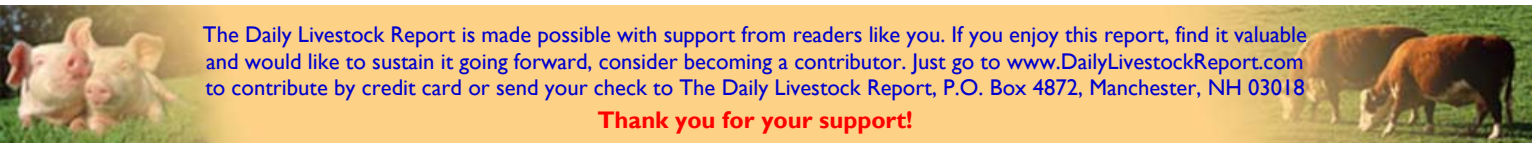
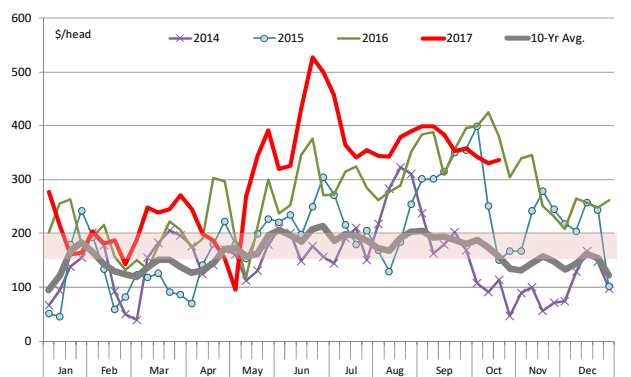
PORK PACKER MARGIN COMPONENTS. \$ PER HEAD.

Calculated Using USDA Price Data for Cutout & Hogs. LMIC Data Used for By-Product Value



BEEF PACKER CALCULATED GROSS MARGIN. \$/head

Calculated using the Comprehensive Cutout, Drop Credit and Negotiated Fed Cattle Prices



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