

Risk Management

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Risk Management

- Managing your business to meet your long term financial expectations and obligations.
 - Measuring and Understanding Risk.
 - Identifying risk scenarios.
 - Applying the appropriate tools.
 - Develop, execute and refine the strategy.

Long term vs Short term Risk

- Long term risk –
 - Change in industry structure.
 - Over expansion of production capacity.
 - Structural cost increases.
 - Increased input demand.
 - Legislated production practices.
 - Change in industry dynamics.
 - Price discovery failure.
- Short term risk-
 - Change in industry conditions.
 - Outside market influence.
 - Stock market, Euro, Energy Markets, Elections
 - Competing proteins
 - Pork Export Restrictions.
 - H1N1, “drug residues”, GMO, anything that scares a consumer, bureaucrat or politician
 - Crop failures.
 - Domestic, International

Current Long Term Risks

- Price Discovery.
- Anti-Pork activist have reached critical mass.
 - Sow Housing
 - Antibiotics
 - Environmental
 - Transportation
- Permanent shift in feed costs?
- Structural shift in hog production.
 - Good times lead to expansion.
 - How much pork can the world absorb?
 - Imbalances in supply take 18-36 months to cure.
 - Prepare your balance sheets for the next imbalance.

Short and Long Term Risk - Price Discovery

- Virtually all hogs produced today are valued on some kind of a formula based on prices reported by the USDA.
- Price volatility has reached an unprecedented level.
 - Symptomatic of a “market failure”.
- Markets need reliable price discovery to allocate supply and demand.
- Volatility leads to uncertainty. Uncertainty is always bearish.

Long Term Risk - Anti Pork Activists

- HSUS, PETA, Waterkeepers, Others....
 - Sow Housing
 - Antibiotics
 - Environmental
 - Transportation
- Their agenda is to insure that your agenda fails.
 - Immediate consequences?
 - Long term consequences?
- How are you going to manage this risk?

Managing Long Term Risk

- Adopt a permanent low cost mentality.
 - We live in a commodity world. Only the lowest cost producers will survive.
 - It's not enough to achieve "low cost" to you have to always look to get better.
- Define your value statement.
- Don't confuse low price for low cost.
- Understand what "unintended consequences" mean to you.
- Influence your industry.
- Produce to the highest standard.
- Prepare and invest for extra scrutiny.
- Get ahead of the change.

Low cost vs Low Price

- Low Cost means having the most economically efficient operation producing to the highest quality standards.
 - Adopt a continuous cost improvement mentality.
- Low price means buying and producing cheap.
 - Sacrifice quality for price.
 - Taking shortcuts.
 - Feeding “cheap” rations.

Value Statement

$$\text{Value} = (\text{Quality} + \text{Service}) / \text{Cost}$$

- **Increase value by:**

- Improving quality and service at the same cost.
- Maintain quality and service and lower the cost.
- Improve quality and service at a lower cost.

- **Destroy value by:**

- Reducing quality and service at the same cost.
- Maintaining quality and service at a higher cost.

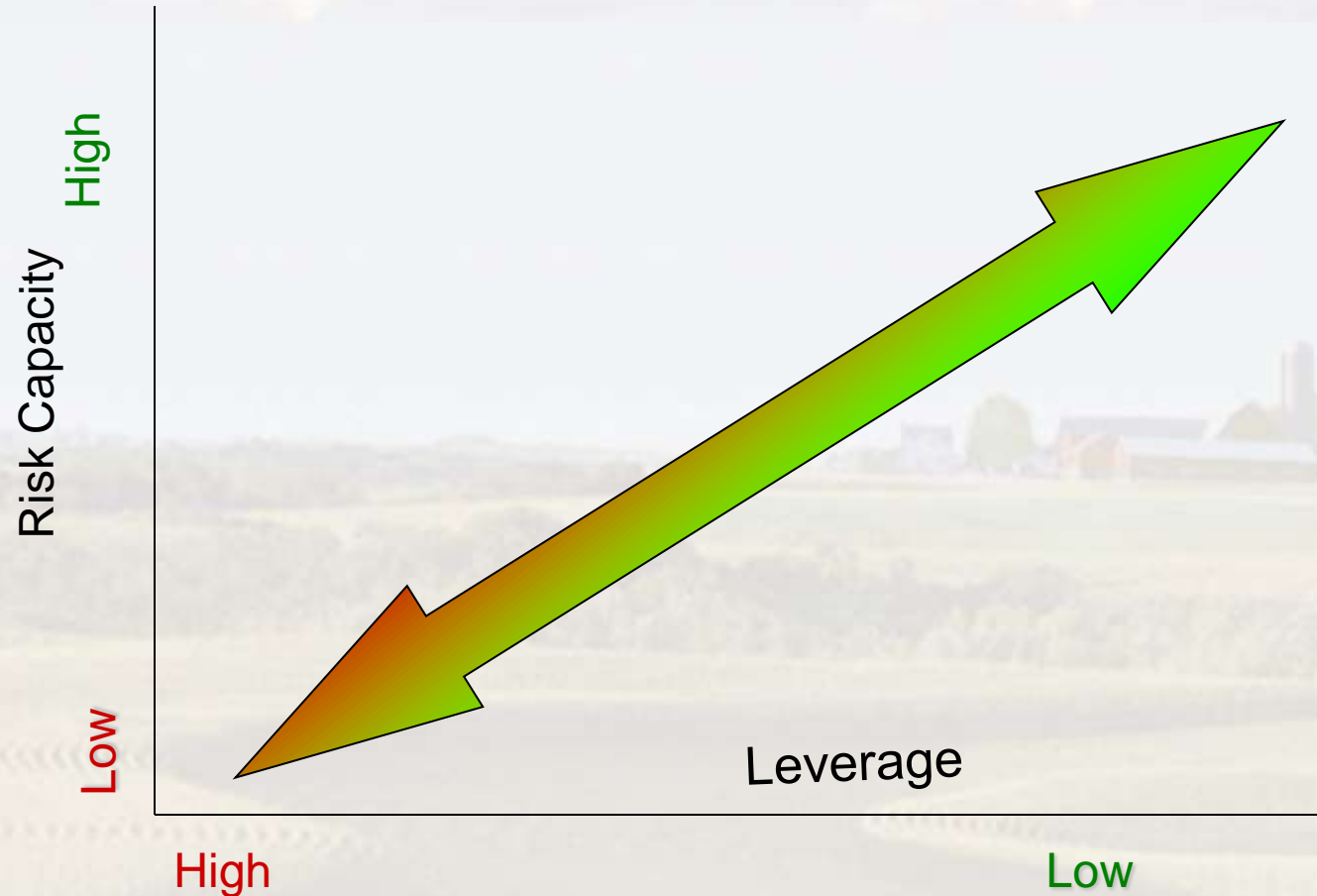
Where is Value Created?

- The customer always defines when value is created and what that value is worth.
- They vote with their pocket books, they have unlimited information and they are fickle!
- Value creation is not the same thing as “value added”.

Short Term Risks

- Current Production Cycle
 - Hog supply situation.
 - +Tighter supplies.
 - =Demand Recovery.
 - -Reduced slaughter capacity.
 - Demand questions.
 - \$Dollar.
 - Volatility fatigue.
 - Feed Costs.
 - Corn is planted, could be record large.
 - Beans are on their way.
 - When was the last time a crop was “made” in June?
 - Hog Crush Margins

Risk Balance



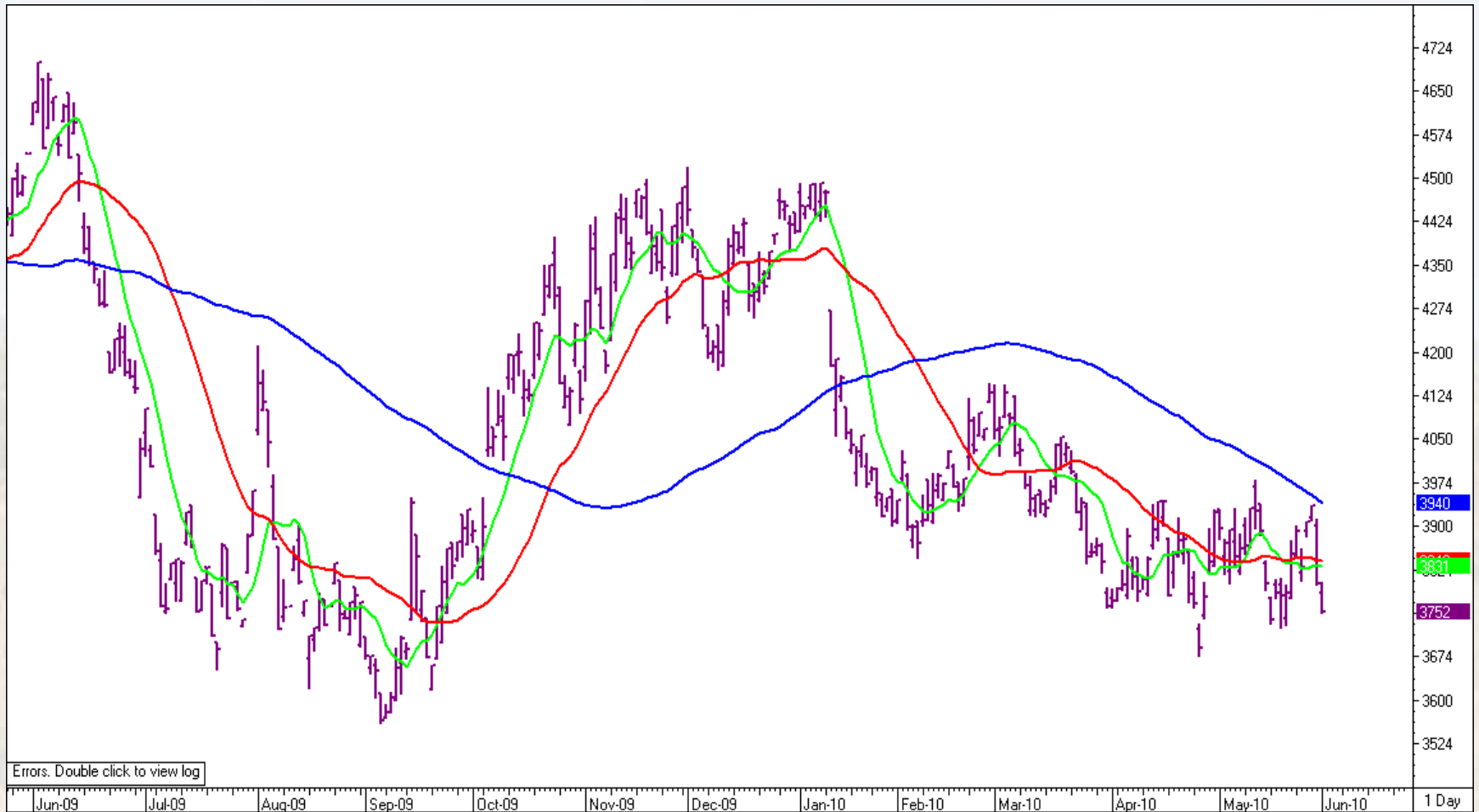
Margin Risk Management

- Strategy needs to Complement the balance sheet.
 - High leverage – more conservative risk management program.
 - Less leverage – more aggressive risk management program.
- Margin Management is more important than cost or price management.

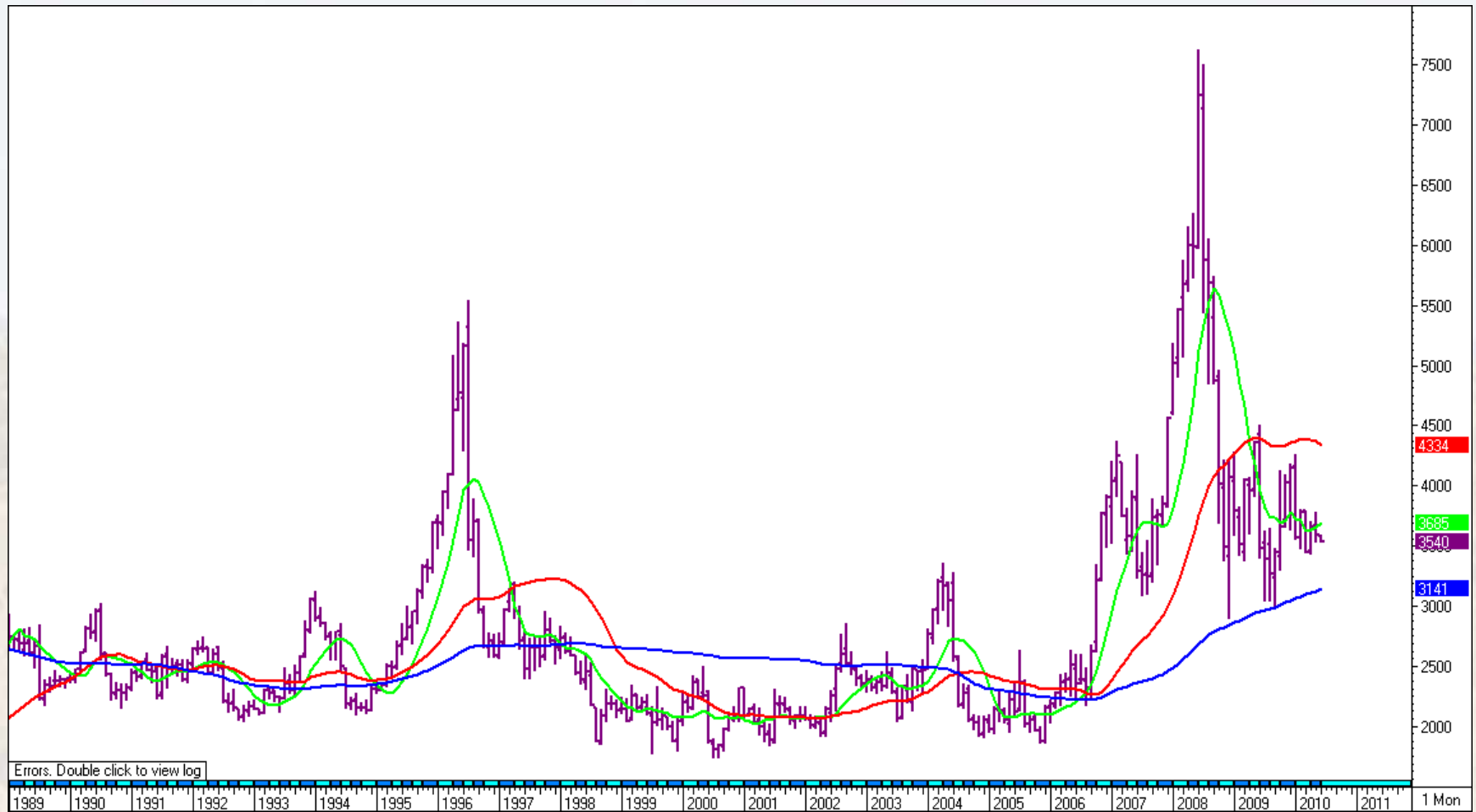
October Hog Futures



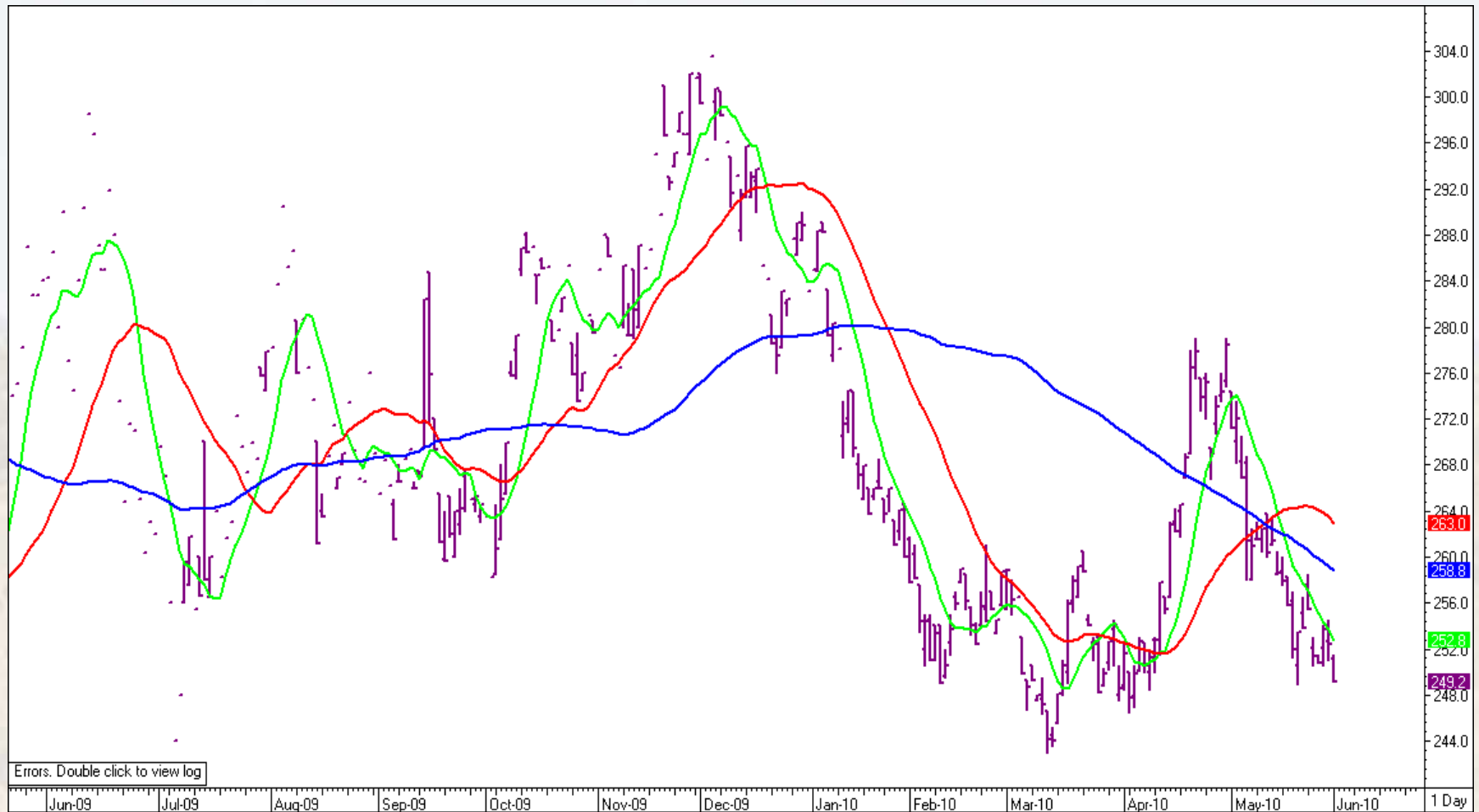
December Corn



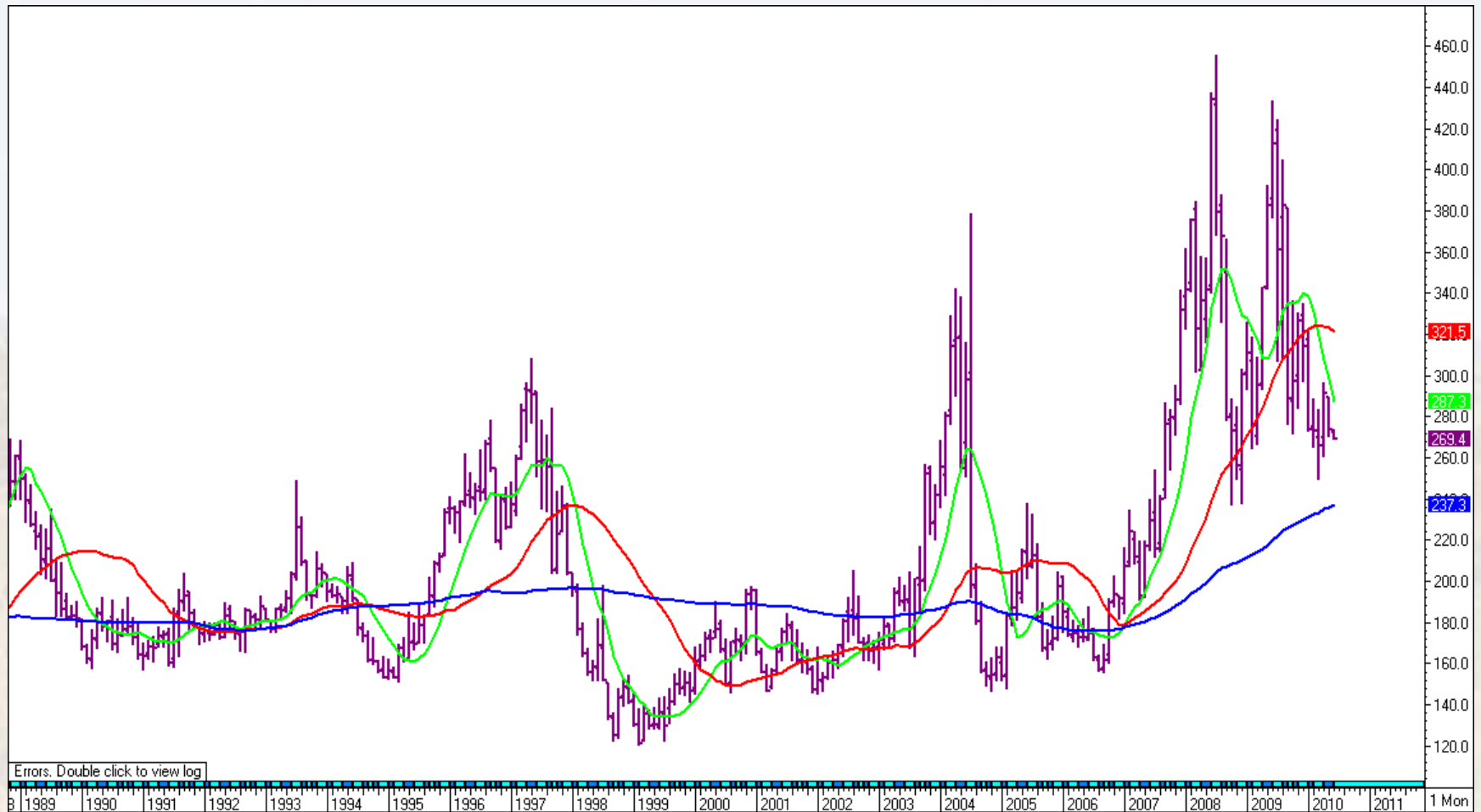
Nearby Corn Futures



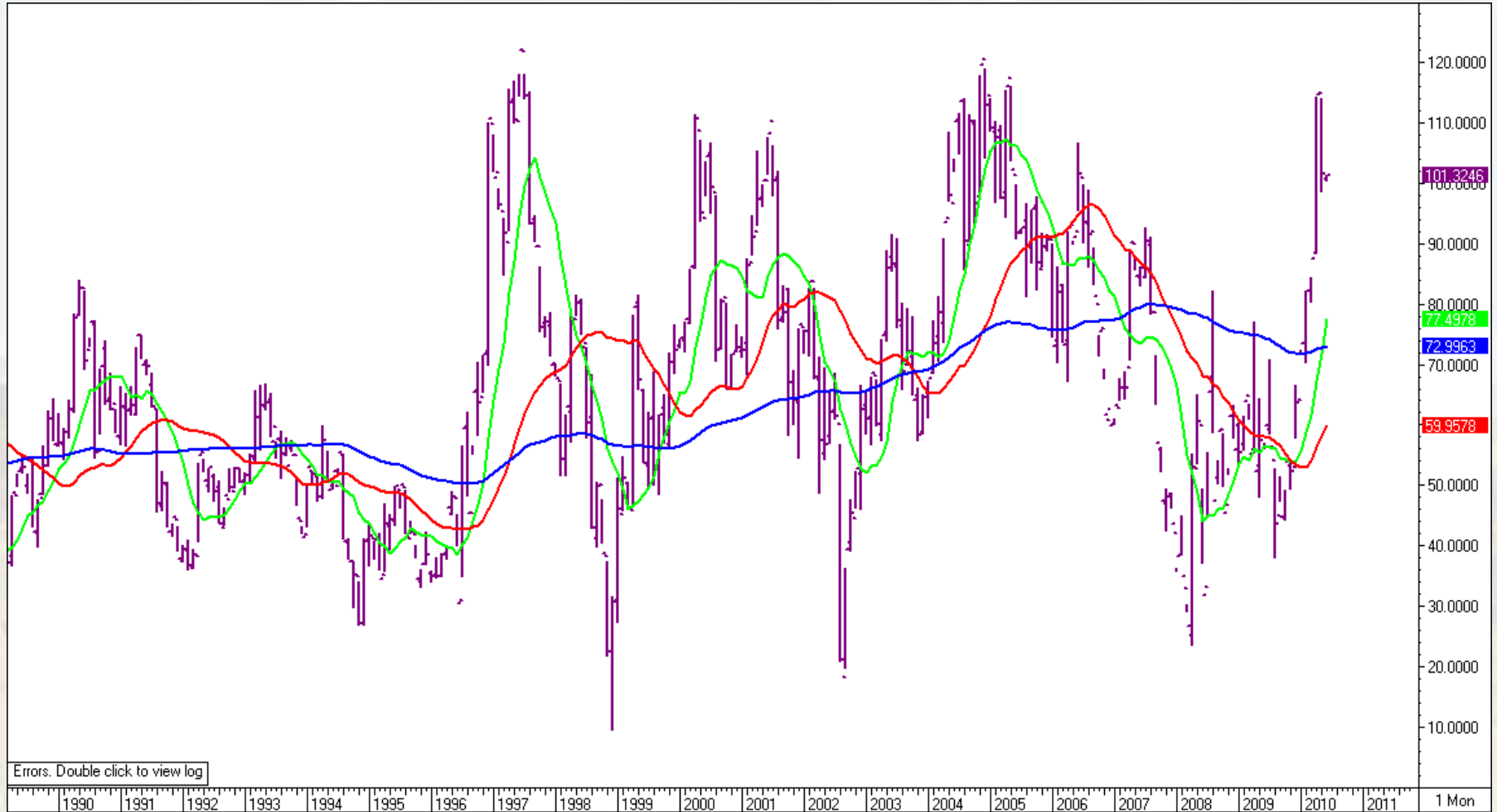
December Soybean Meal



Nearby Soybean Meal



Nearby Hog Crush



Packer Risk Management Tools

- Market Hog Supply Agreements
 - Price Discovery/Market access.
 - Not a risk management tool.
 - Windows.
 - Cost/Plus.
 - Ledger.
- Hedging Programs
 - Basis
 - Some packers offer hedging programs in conjunction with Market Hog Supply Agreements.
- Expected Producer Return = Average Market Price minus transaction costs and risk premium.
- Expected Packer Return = Average Market Price plus risk premium.

Packer Contract Issues

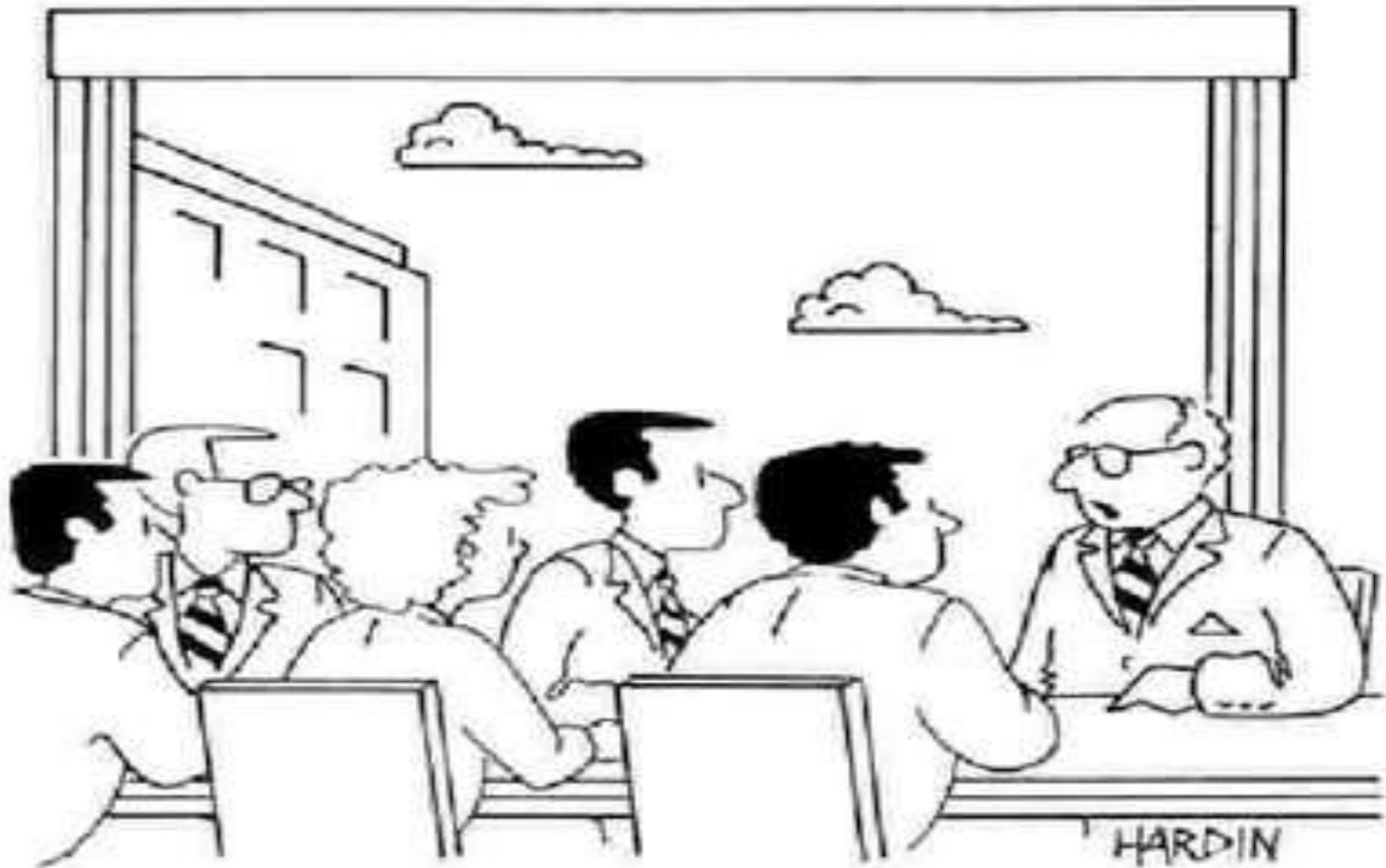
- Matching the strategy to the objective.
 - Market access.
 - Reduce risk.
 - Increase revenue.
- Price Discovery.
 - Liquidity of underlying market used for price discovery.
 - Matching base price to geography.
- Time Horizon

For Contract Examples

- All packers who purchase more than 100,000 head are required to submit example contracts to the USDA.
- USDA Packers and Stockyards Website
https://scl.gipsa.usda.gov/main_about_scl.html
- 80 contract types listed

Conclusion

- Our industry is not out of the woods. There is a tremendous amount of risk.
- Managing the long term risk of our industry is taking on greater importance.
- No one is smart enough to “out guess” the market.
- Your banker needs to be a part of your risk management plan.



"We've considered every potential risk except the risks of avoiding all risks."