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## High Yield Research

### Food & Beverage – Overweight

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## Poultry Industry Collusion Lawsuits: Our Perspective

On Jan. 30, 2018, the two largest foodservice distributors in the U.S. filed lawsuits against 18 poultry suppliers and Agri-Stats, a subsidiary of Eli Lilly and Co. (LLY). In early January 2018, retail chain Southeastern Grocers (BILOLF), owners of Winn-Dixie and BI-LO grocery stores, filed a similar lawsuit. These lawsuits follow another similar lawsuit filed in September 2016 by regional foodservice distributor Maplevale Farms. The lawsuits contend that the industry colluded to control production and manipulate pricing to achieve abnormally high profits. We believe the industry has enjoyed a longer-than-normal period of profitability that may be explained by a multitude of factors. While we are not privy to any of the discovery issues within the lawsuits filed against the poultry industry or information turned over by Fieldale Farms to investigators, we believe we can provide some context around some of the accusations in the various court documents.

- Renewable fuels legislation led to increased corn use for fuel. This change in trend consumption, combined with a drought from 2010 to 2012 led to historically high corn prices and volatility, which resulted in financial stress for the poultry industry.
- Analysis of historical Georgia dock pricing data for skinless boneless breast meat reveals that pricing failed to keep pace with the CPI over the alleged period of collusion and volatility in prices remained virtually unchanged from the prior period. These characteristics seem to reflect unchanged market dynamics period to period.
- While we are not lawyers, based on our analysis of pricing dynamics, factors contributing to cost inputs, capacity additions, financial stress, and industry evolution, we find it difficult to definitively affirm an environment of collusion.

### Relevant Period 2008-2016

The lawsuits contend the relevant period of coverage was from 2008 until 2016. We believe this period is very important in the evolution of the poultry industry for several factors, including the rapid acceleration in the use of corn for fuel (ethanol) combined with drought stress (2011-2012), multiple financial restructurings within the industry, and finally a material movement to value-added products (e.g., all natural, antibiotic free – ABF, organic, free range, fully-cooked, etc.) from more commodity-oriented products.

### Corn in Ethanol Leads to Fuel Corn Correlation, Higher Prices and Volatility

The economic environment for the livestock and poultry sector changed dramatically, starting in 2006 as the Energy Policy Act (EPAAct) 2005 was phased in. EPAAct 2005 created the renewable fuel standard that mandated annual ethanol production of up to 7.5 billion gallons by 2012, which escalated to 15 billion gallons by 2015 under the Energy Independence and Security Act (EISA) of 2007. Despite healthy corn crops, feed costs

Please see page 7 for the rating definitions, important disclosures and required analyst certifications.

All estimates/forecasts are as of 02/06/18 unless otherwise stated.  
02/06/18 at 3:35 p.m. ET.

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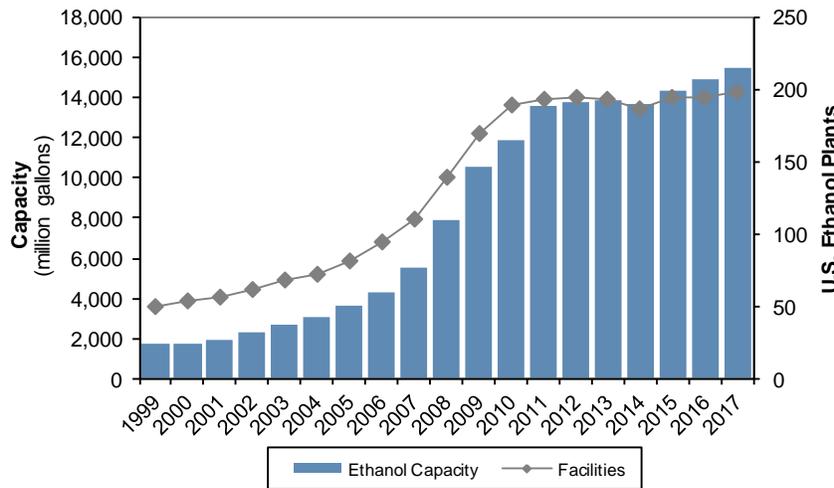


**Feed prices and drought led to the apparent decline in cattle and hog production in similar periods.**

more than doubled and feed price volatility increased sharply over a very short period due to the inevitable and perhaps unintended correlation between corn and oil. From the spring of 2005 to the spring of 2008, the farm price of corn more than tripled. Corn prices more than doubled again from late 2010 to 2011 and remained elevated through the summer of 2013. The double-digit growth in corn processing for ethanol—combined with a multi-year drought—was the major element behind the rapid increase and volatility of feed costs. Not only did high feed and volatile feed costs temporarily affect broiler industry production (2009 and 2012), but the cattle herd peaked in 2006 at 106 million head and recently returned to inventory levels above 100 million for the first time on June 30, 2017. The hog herd also peaked in 2008 at 68.2 million before plunging to 63.6 million merely two years later. The hog herd did not recover until 2015.

**Ethanol industry capacity doubled from 2007 to 2011.**

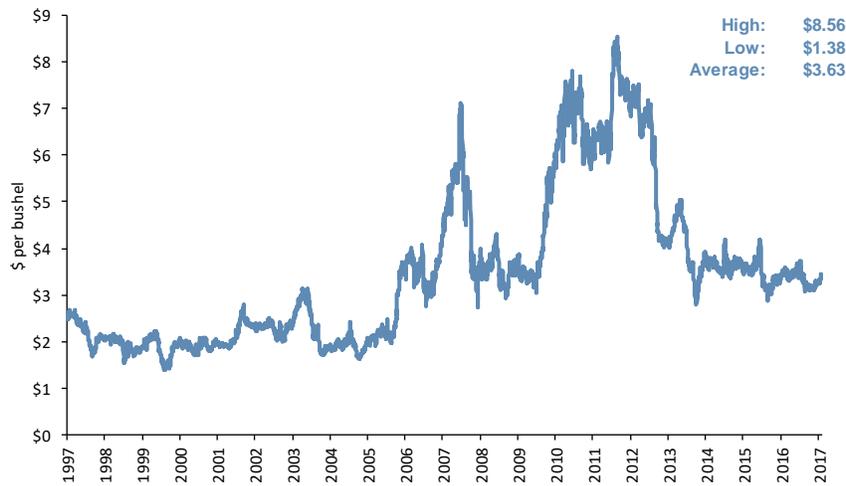
**Exhibit 1: Ethanol Industry Capacity and Facilities**



Source: Renewable Fuels Association

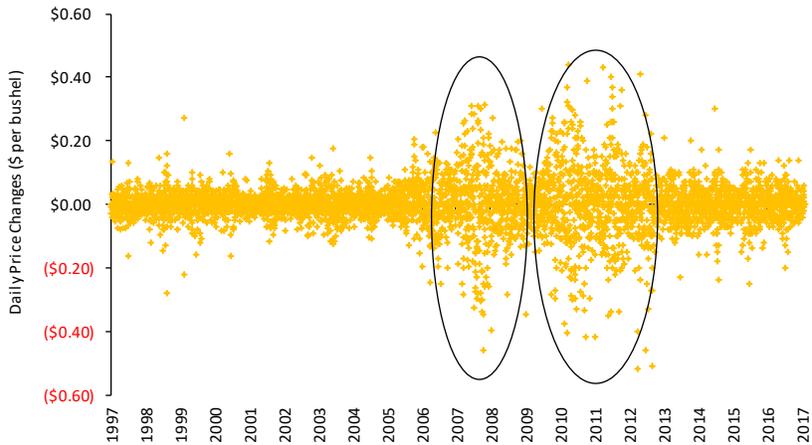
**Corn is the largest variable cost input for the poultry industry.**

**Exhibit 2: Daily Illinois South Central Corn Prices**



Source: Bloomberg and Wells Fargo Securities

**Exhibit 3: Daily Illinois South Central Corn Price Volatility**



**Corn price volatility increased with ethanol industry growth and drought in 2011-2012.**

Source: Bloomberg and Wells Fargo Securities

**Profit Woes Lead to Bankruptcies, Balance Sheet Repair and Evolution**

From the period 2008 to 2011, there were multiple bankruptcies in the broiler industry. Based on our profit calculations, 2008 and 2011 were the most difficult profit periods for the industry in the past decade. According to *Reuters*, William Snyder, a managing partner at turnaround firm CRG Partners, who acted as chief restructuring officer at Pilgrim's Pride said, "We were not just reshuffling the balance sheet. We actually restructured the company." Pilgrim's Pride closed six facilities in 2009 (Douglas, Ga.; Dalton, Ga; Athens, Ga; Athens, Ala.; El Dorado, Ark.; Farmerville, La.). Douglas, Ga., was reopened in 2010 and the Farmville, La., facility was sold to Foster Farms for \$80 million. On a net basis, approximately 3%-4% of industry capacity was shuttered from 2009 to 2010 by Pilgrim's alone. According to the *Atlanta Journal-Constitution* on Oct. 21, 2011, "The [poultry] industry has been under heavy economic pressure in the past year," said John McKissick, an agricultural economist at the University of Georgia. "Feed prices, which represent half or more of the price of chicken on market shelves, doubled and fuel prices rose as prices for chicken fell and consumption dropped slightly," he said.

**Exhibit 4: Industry Bankruptcies**

Company	Filing Date
Zacky Farms	Oct-2012
Cagle's	Oct-2011
Lady Forest Farms	Jul-2011
Allen Family Foods	Jun-2011
Custom Poultry Processing	Apr-2011
Townsend's	Dec-2010
Pilgrim's Pride	Dec-2008

Source: Court filings

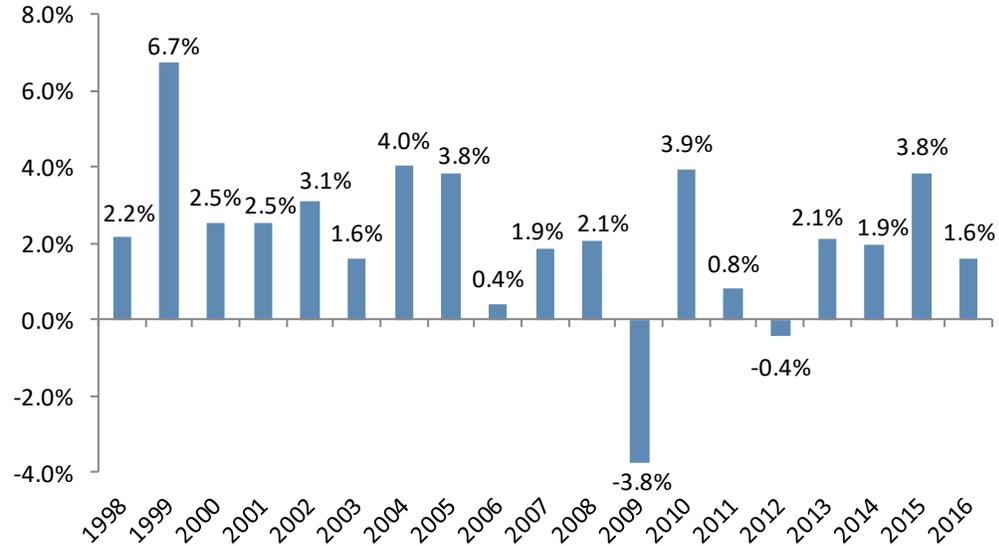
**Bankruptcies led to facility closures and reduced capital availability.**

Considering the damage done to industry balance sheets from 2008 to 2011 from the doubling of feed costs, it would take time for balance sheets to be repaired before the industry could make commitments to major capital projects. Many early capital projects (2012-2016) involved adding new capabilities as opposed to additional commodity

pounds. Companies including, Pilgrim’s Pride and Tyson Foods, have converted facilities to antibiotic free, organic, and prepared foods. According to Pilgrim Pride’s earnings call on Feb 9, 2017, CEO, Bill Lovette said, “I think over the next five years, you can see that the percentage [of prepared foods] has a chance to double from where it is currently.”

**Exhibit 5: Change in Domestic Broiler Production**

**Production growth was subdued by volatile input costs, financial stress and bankruptcies.**

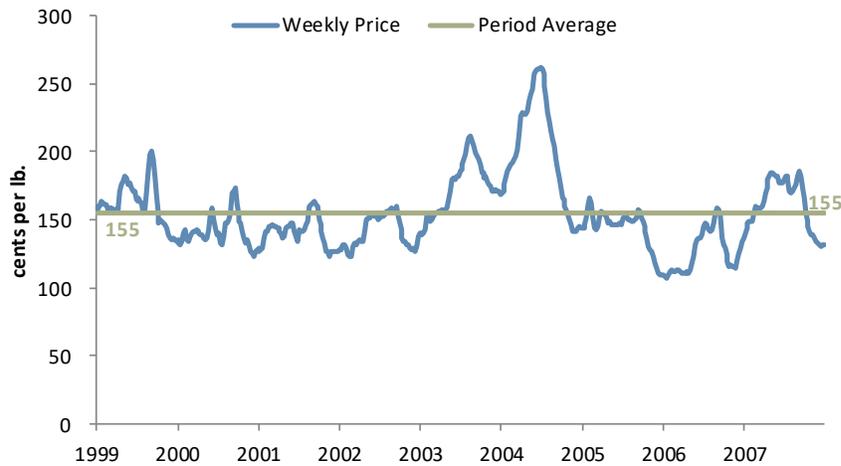


Source: USDA Economic Research Service

**Supracompetitive Price Accusations Not Evident as Breast Meat Inflation**

We decided to analyze the performance of skinless boneless breast meat (SKBS) prices over the period of alleged collusion relative to the eight years prior. We used SKBS in lieu of whole birds, as presented in the lawsuits, as the food service industry purchases more breast meat and wings (parts) rather than whole birds. Based on industry sales volume, more than 80% of the industry production is in parts rather than whole birds. Based on an analysis of skinless boneless breast meat prices from 1999-2007 and from 2008-2016, the average price increased from \$1.55/lb to \$1.69/lb, which implies 1.2% nominal annual price inflation. The CPI food away from home increased an average of 2.8% from 1999 to 2016 and 2.7% from 2008 to 2016, therefore the price inflation of breast meat failed to exceed the average inflation of food away from home pricing. Moreover, the standard deviation of breast meat prices from 1999-2007 relative to 2008-2016 varied by less than \$0.01 per pound. If there was collusion and price index control as alleged, the overall price changes and volatility hardly reflect that notion. A couple of the poultry companies we follow used the USDA Georgia dock as a reference for less than 10% of their sales and were more focused on *Urner Barry* market prices, therefore any potential liability associated with sales tied to Georgia Dock price manipulation may be limited.

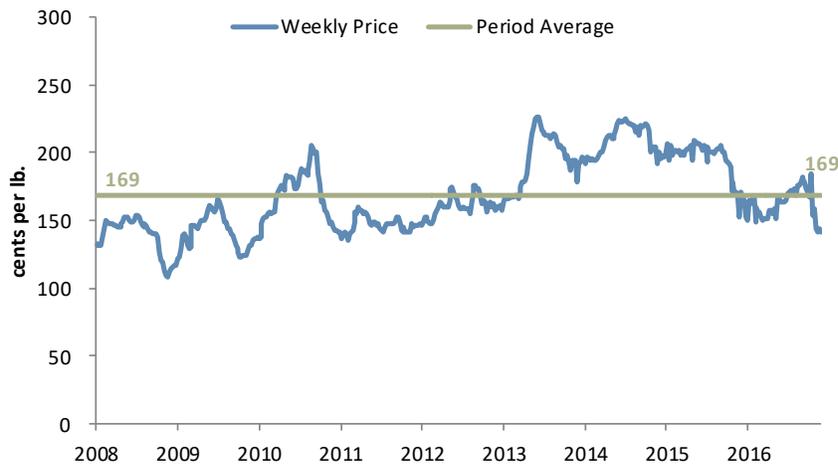
**Exhibit 6: Weekly Boneless Skinless Breast Prices (Jan. 1999 - Dec. 2007)**



Source: USDA Georgia Dock quote

*Industry price volatility remained virtually unchanged during the measured periods despite allegations of “controls.”*

**Exhibit 7: Weekly Boneless Skinless Breast Prices (Jan. 2008 - Nov. 2016)**



Source: USDA Georgia Dock quote

**Exhibit 8: Monthly Food Away From Home CPI %**



Source: Bureau of Labor Statistics

### **We Are Not Sure the Industry Structure Meets the Definition of Oligopoly**

According to *WATT Poultry USA*, there are more than 55 poultry processors in the United States and a multitude of others with further processing operations. The top five broiler processors control approximately 58% of the market, while the top 10 processors control approximately 78% of the industry volume. This amount of industry concentration hardly meets the definition of oligopoly, in our opinion. In oligopolistic markets, independent suppliers can effectively control the supply, and thus the price, thereby creating a seller's market, according to *businessdictionary.com*.

### **One Processor Succumbed to Legal Pressure, but Contends No Guilt**

On Aug. 7, 2017, Fieldale Farms, the 15<sup>th</sup> largest broiler company in the U.S., agreed to pay \$2.25 million to settle a putative class of direct purchasers in the Maplevale Farms lawsuit. The settlement agreement states that Fieldale Farms would provide material cooperation in the litigation, according to court documents. Fieldale's cooperation includes providing documents it produced to the Office of the Florida Attorney General in a related inquiry into broiler industry pricing practices. Fieldale agreed to provide Agri-Stats' reports, phone records, electronic sales information, and other documents, as well as make employees available for interviews and depositions. Fieldale Farms' management maintains it did nothing wrong in the motion, but wishes to avoid the uncertainty of trial.

### **Conclusion: Not Enough Information to Throw the Book, in Our Opinion**

There are a multitude of factors that explain the lack of industry capacity additions from 2008 to 2016. As such, we struggle to understand how the alleged collusion will be proven based on industry production, profitability and the price behavior of key outputs. The information provided by inside documents, communications and Agri-Stats reports could sway several ongoing investigations, but again, we find it difficult to understand how outright collusion will be proven based on the fallible conclusions in the cases presented by one food retailer and three foodservice companies.

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**Additional information is available on request.**

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