April 1, 2024

AGRICULTURAL FINANCE

Bullish on Beef:

Cattle Industry Outlook

Key Takeaways

Record-setting beef and cattle prices are here, and we think they're going even higher. Beef and cattle price levels will likely remain high through at least 2026, and new record prices may come as early as later this year. Inventories continue to decrease, and once cow-calf producers begin expanding their herds, we believe beef and cattle prices are likely to go even higher.

Cow-calf operations are taking over the beef value-chain. Cow-calf operations are currently receiving their biggest share of the beef retail dollar in nearly a decade,[1] and their share may get even larger as meat packers and feedlots compete over a decreasing supply of cattle. The market for beef is built from the bottom up; cow-calf operations are the most profitable that they've been in recent memory; and we think that profitability will likely continue through at least 2026.

Profit today or profit more tomorrow: the power of strategic growth. The most successful cow-calf producers may not be those taking profits today, but the cow-calf producers that are strategically rebuilding their herds. While some are cautious to avoid the negative consequences of an overzealous expansion similar to what was observed in 2014, skilled cow-calf producers who carry their herds and effectively manage drought conditions will position themselves for growth and greater expected long-term profits.

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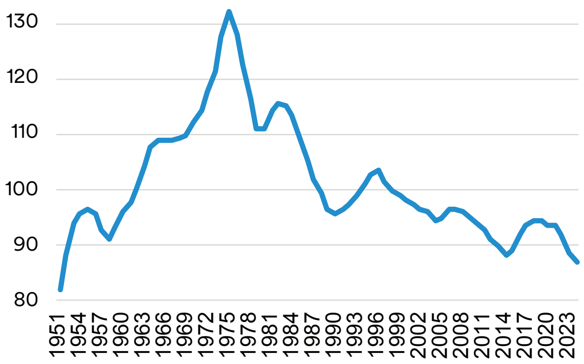
How We Got Here

U.S. Cattle Herd Approaches the Bottom of a Contractionary Cycle

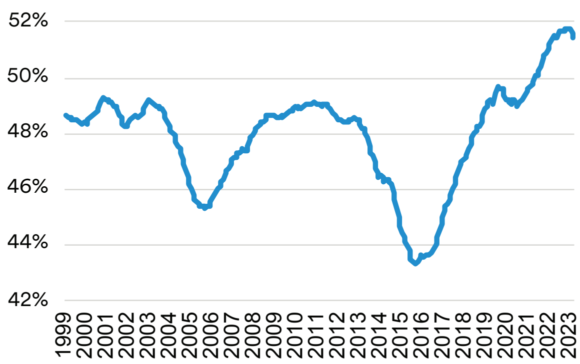
A key driver of the cattle industry's current situation and outlook is the herd cycle. While cattle herd inventories have generally trended downward since peaking in 1975, herd inventories ebb and flow and are currently at their lowest levels since 1951. Indicators suggest that the current herd cycle has yet to bottom out (Figure 1). Over the last two years, the ratio of cows and heifers being slaughtered has exceeded 50% of all cattle slaughtered, the highest on record since data collection began in 1986 (Figure 2). Unlike swine or poultry production, cattle production has minimal leverage, and inventories are slow to change. This supply dynamic will likely keep cattle prices high over the next few years, as it will take multiple years for herd inventories to meaningfully increase and put downward pressure on cattle and beef prices.

Figure 1 | Cattle & Calf Inventory (Million Head)



Source: MIM, USDA, March 2024

Figure 2 | Cow and Heifer Slaughter as% of Cattle Slaughter (12-month rolling average)

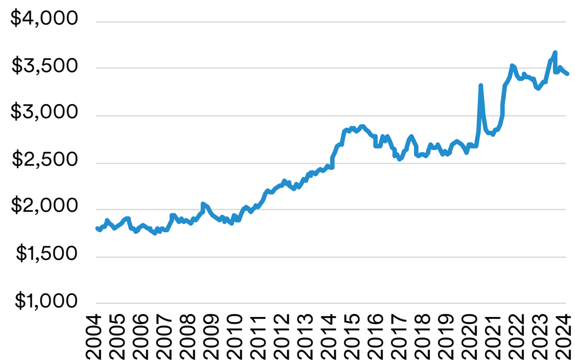


Source: MIM, CattleFax, USDA, February 2024

Strong Demand for Beef From the Pandemic and Onward

Some might be surprised that beef demand is so strong, and that consumers are still hungry for beef despite record-high retail prices. This can be explained, in part, because demand curves are not linear, and consumers become increasingly insensitive to supply shocks. At these high prices, most consumers who would be priced out of the market have already substituted beef for chicken or pork. Another reason for the strong demand for beef is because American beef is increasingly of the highest quality and value. Beef quality coming out of the packing plant as measured by USDA grades continues to improve over time, and cow-calf producers are increasingly participating in value-add practices such as certified organic, grass fed, sustainably sourced, hormone/antibiotic free, etc. The result is that the overall value of the typical animal destined for slaughter is increasing, and consumers are willing to pay a larger premium for it (Figure 3). While consumer demand is sensitive to macroeconomic shocks and the conditions of the broader economy, the pandemic proved the resiliency of U.S. demand for beef, and the demand for beef seems unlikely to materially decline in the immediate future.

Figure 3 | Total Retail Value of a 1000 lb Steer



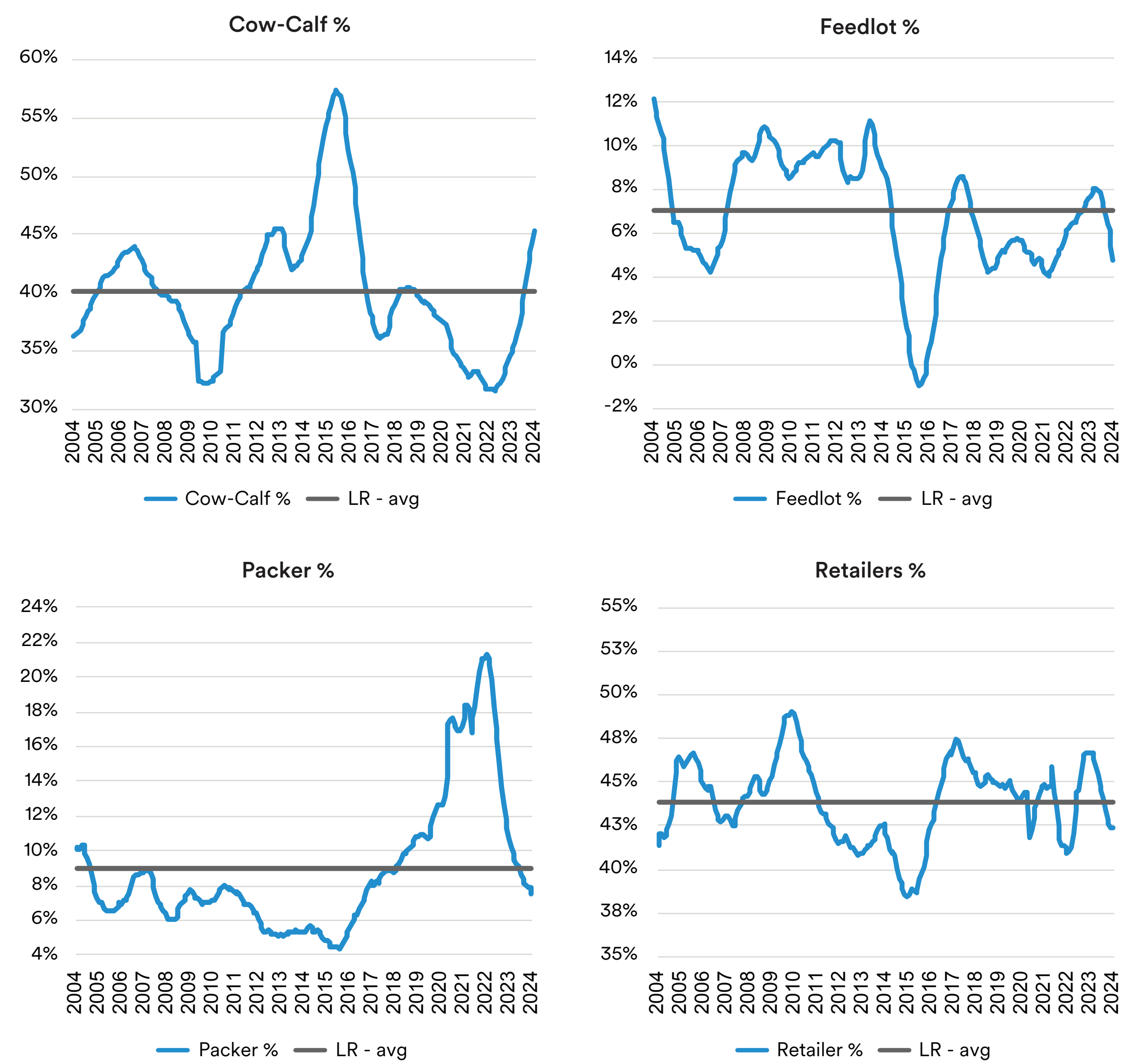
Source: MIM, LMIC, March 2024

What's Next?

The Beef Value-Chain Is Shifting as Packing Plant Capacity Utilization Decreases

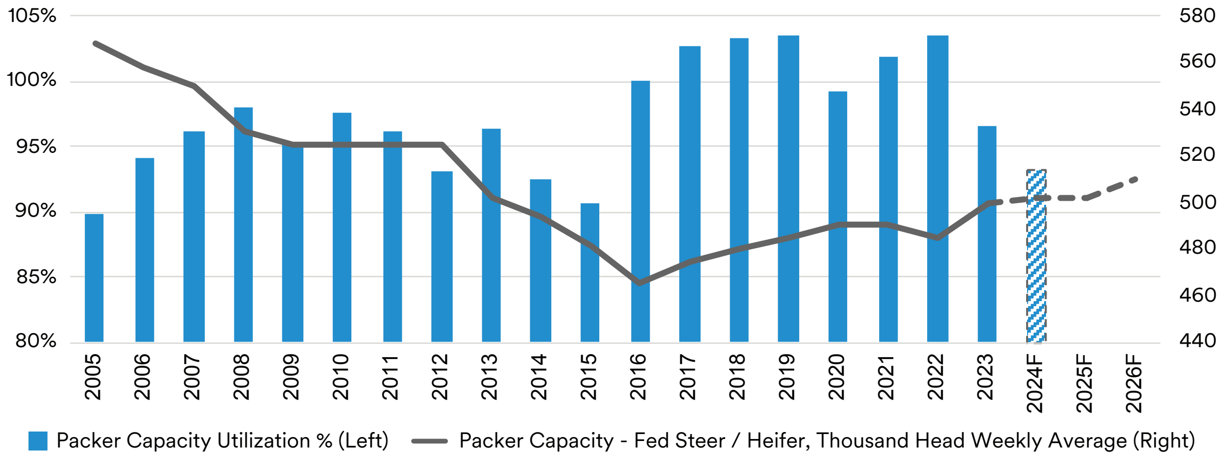
The beef value-chain can be broken into four distinct segments: cow-calf producers; feedlots; meat packers/processers; and retailers. Cow-calf producers breed feeder cattle that are placed into feedlots; feedlots then market fed cattle to meat packers/processors; and meat packers/processors then market boxed meat to retailers. The share of the retail dollar that goes to each of these four market participants varies over time (Figure 4). During the pandemic, meatpacker capacity utilization often exceeded 100%, which squeezed the profit margins of cow-calf producers and feedlots upstream of the packers. Today, cow-calf producers have been choosing to continue shrinking their herd to capitalize on higher cattle prices. Now, packing capacity utilization is down to pre-pandemic levels because of the smaller herd size and continued growth in packing capacity (Figure 5). As a result, cow-calf operations are collecting the largest share of beef's retail dollar in nearly a decade. Meanwhile, feedlots', packers' and retailers' shares of the retail dollar

Figure 4 | Beef Value-Chain Shares



Source: MIM, CattleFax, LMIC, USDA, March 2024 have all crossed below their respective long-term averages. Commercial dairies across the country are increasingly diversifying their operations and using beef genetics.[2] Currently, this has been very helpful in assuring the profitability of individual dairies, but in the future, this will likely become more prevalent and have broader impacts on the cattle industry. Unless something unexpected occurs such as a major reduction in packing plant capacity, it seems cow-calf producers will likely continue to capture a larger share of the beef retail dollar through 2026.

Figure 5 | Meat Packer Capacity and Utilization Rate



Source: MIM, CattleFax, LMIC, March 2024

Decisions To Be Made

Cow-calf producers will have to face their age-old trade-off; sell one now at high prices or hold off and sell two at potentially higher prices later. Beef production is a one-to-one trade-off, and having one more head to slaughter tomorrow means foregoing slaughter of a cow today. Therefore, beef prices and cattle inventories are slow to change. In 2022 and 2023, many producers were choosing the first option, drawing down inventory to take profits now.

Looking forward, for operations that aren't well capitalized, still recovering from the pandemic era and reeling from years of drought, they may find it difficult to resist continuing to take profits now. And as other operations defer slaughtering heifers and choose to increase their herd size, that decrease in herd supply to market will put further upward pressure on prices that may bolster the short-term profitability of slaughter. Operations that are well capitalized and able to expand their herd are expected to profit even more in the near future, as prices and margins are expected to grow. Cow-calf producers who have herds that are slightly off-cycle compared to the market are likely the best positioned to profit. They will likely have calves to sell when everyone else is starting to rebuild, and packers and feedlots will be competing hardest.

The U.S. cattle industry will be built from the bottom up over the next few years, and cow-calf operations will likely be the most profitable segment of the beef value-chain. The margins of the feedlots and the packers will continue to be squeezed as they compete for fewer and fewer cattle headed for market, but large retail values will help them remain profitable as long as they're able to keep cattle moving through.

We used our network of borrowers to connect with feedlot operators, as we wanted to hear what they thought they can do to remain profitable over the next few years. Jordan Levi, CEO of Arcadia Asset Management, and Vice President of Five Rivers Cattle—one of the largest cattle feeding operations in the world, had this to say:

> *Generally, feedlots that have cattle ownership do well in this part of the cycle, as the tightness in supply results in an increase in prices. While this may mean that feedlots have to assume more risk, the payoff could be asymmetrical to the risk. Feedlots that rely on third-party cattle to fill up their facility will need to be overly mindful of cost and create additional value for their customer base, such as a competitive supply agreement or niche opportunities. This is an exciting time to be in the cattle business, as the leverage is shifting away from the packer down to producers, all the while the market is seeing tremendous demand for the product.*
>
> **—Jordan Levi**

Risks to the Outlook

Drought Continues To Be Problematic

One of the primary reasons the U.S. cattle herd is contracting is due to the prolonged drought across cattle-rearing regions, particularly the Southern Plains—exemplified by recent record-setting wildfires in the Texas panhandle.[3] Drought worsens forage conditions and increases the number of cattle that are put on feed, which is particularly painful for cow-calf producers when feed prices are high. While rains will eventually return, just the uncertainty of drought can be the deciding factor for an operator's herd management decisions.

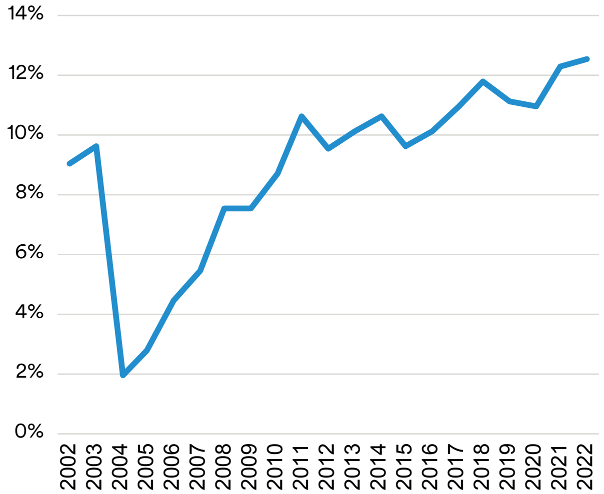
Input Prices Are Slowing Down but Will Remain Elevated

According to the USDA, input prices are forecast to continue increasing modestly. Interest expenses will continue to be a greater part of cow-calf producers' budgets, as loans mature and are refinanced at higher rates, but easing feed costs should help offset some of this expense. High input prices create an environment where efficient managers and producers can gain a competitive edge and emerge as market leaders.

The Cattle Industry Is Less Dependent on Exports Than Most AG Segments, but Things Change

The last several years have demonstrated how delicate our system of global trade truly is. While the U.S. beef industry is less reliant on export markets than much of the U.S. agriculture sector, its reliance on exports is increasing, and over 12% of beef production is exported (Figure 6). China imports 18% of U.S. beef exports and presents the largest geopolitical risk to U.S. beef exports. Increased trade restrictions or tariffs could have modest impacts on U.S. beef markets.

Figure 6 | Beef Exports as % of Production



Source: MIM, USDA, March 2024

Endnotes

1 USDA, March 12, 2024
2 Dairy Herd, September 11, 2023
3 NESDIS, March 7, 2024

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