Future State and Opportunities in Ontario

November, 2007

ONTARIO PORK

The challenge

Canada's pork industry is currently facing its greatest challenges of the past 15 years. The industry is being hit by several negative forces simultaneously with no simple answer in sight.

Broad globalization forces are pressuring the Canadian industry to improve its competitiveness amid a substantial appreciation of the Canadian currency against many foreign currencies. Trade frictions between Canada and the US continue to be a very real threat to the overall stability of the business environment. After a series of costly dumping investigations and countervailing actions during the last 25 years, the US government is now proposing to implement Country of Origin Labeling (COOL) to effectively segregate the US and Canadian meat supply chains.

Farm fall-out

Canadian hog producers are struggling with pork prices in Canada being at the lowest they have been since the 1998 pork financial crisis. But this time, the losses per finished hog marketed are much steeper than they were 10 years ago. The strong Canadian dollar and skyrocketing feed prices have sent losses through the roof. The hog/corn price ratio in Ontario was only 14.3 in July 2007, well below the 10 year average of 23.3. A similar situation exists in Western Canada with the hog/barley ratio.

Processor pains

The Canadian processing sector is in turmoil across the country. Longstanding structural inefficiencies in the processing sector have been unveiled largely by the strengthening of the Canadian dollar relative to the US dollar. This has played a principal role leading up to the crisis the industry faces today. Additionally, labour shortages, tight commodity margins, expansion moratoriums and supply chain issues have exacerbated the situation and are forcing processors to implement radical reorganization, including the closure of several plants.

Olymel, the country's largest processor, has over 17 plants in Quebec and Western Canada. This producer-owned cooperative processes 58% of all hogs produced in Quebec. Maple Leaf Foods is the second largest processor with key plants in Burlington, Ontario and Brandon, Manitoba. Each of these two plants is capable of processing over 1,000 hogs an hour.

Olymel threatened to close its biggest plant if it could not obtain wage concessions from its workforce. Olymel's argument was that market conditions called for a radical shift in their business model and their labour costs were too high compared to their competitors at home and abroad. While the company successfully negotiated labour cost savings with the workers' union, its struggles in Quebec are not over. A full industry reorganization is currently being considered.

There has been a reduction in the number of pork processing plants in Quebec following the merger between Supraliment, owned by the Groupe Brochu, and Olymel. This merger, combined with the current closure of mid-sized Quebec-based Qualiporc and Viandes Kamouraska, is putting pressure on packing capacity in Quebec. For the first time in many years, Quebec has insufficient capacity to slaughter all hogs produced in Quebec.

Using the July 2007 six month moving average of hog marketings in Quebec, it is estimated that 148,000 head are marketed per week. This amounts to insufficient capacity of around 7,500 head per week.

In Western Canada, Olymel has made significant investments in its Red Deer plant which could potentially raise its capacity to about 80,000 head per week. However, the company had to shut down its second shift at the plant more than a year ago due to labour shortages and overall market conditions. While Olymel's capacity in Alberta is listed as 80,000 head per week, a more accurate estimate at this moment is around 40,000 head per week.

As of June 1, 2007, production at Maple Leaf Foods Mitchell plant in Saskatoon was shut down, leaving Saskatchewan with no slaughtering capacity.

Maple Leaf Foods is reconfiguring their hog production, slaughter, primary processing and secondary processing operations in an attempt to create what they describe as a 'balanced pig' approach to their pork supply chain activities.

The company plans to concentrate its western operations in its Brandon plant to be able to start-up a second shift. The single-shift packing capacity is estimated at around 45,000 hogs per week. The company also operated a plant in Winnipeg but has since closed this plant.

The current challenges faced by both producers and processors can only be overcome through cooperation among all industry supply chain participants and governments.

An economic analysis done a year ago showed the closure of the Burlington plant would result in the Ontario economy losing $3.49 billion and 21,000 jobs.

The numbers speak for themselves

Total estimated impact on the Ontario economy of closing the Maple Leaf Foods Burlington, Ontario processing plant

Every dollar lost from a primary industry = $7 to the rest of the Ontario economy

Increase in exports will cause market hog prices to fall by at least transportation and border crossing costs to the US of $15/hog

Losses due to falling market prices

6.2 million market hogs produced in Ontario x $15/hog	= $93 million
Losses to the rest of the Ontario economy	= $651 million
Value of hogs processed by Maple Leaf at Burlington Plant 2.3 million hogs x $150 / hog	= $345 million
Losses to the rest of the Ontario economy	= $2.4 billion
Total dollar value lost to the Ontario economy	**= $3.49 billion**

Total Ontario jobs lost due to closing the Maple Leaf Foods Burlington, Ontario processing plant

*Estimated farm jobs lost due to decline in farm revenues of $651 million	= 4,500 jobs
*Other Ontario jobs lost due to loss of $2.4 billion in economic activity at the Maple Leaf Plants	= 16,500 jobs
Total	**= 21,000 jobs**

**Economic Impact of the Ontario Pork Industry, K. McEwen, U of G, 1997*

Ontario Pork leads the charge

Just over a year ago in October 2006, Maple Leaf Foods announced a major restructuring plan that included the sale or closure of their Burlington plant which processes 2.3 million hogs, half of Ontario's market hog production and 21% of Canada's production.

In response to their announcement, Ontario Pork – supported by the government of Ontario – commissioned an unprecedented $1 million research study to obtain an in-depth analysis of the current crisis. We hired the world's leading agri-food consultancy, Informa Economics, in addition to experts in business intelligence, economics, international trade, engineering, agri-business, real estate and others to answer a set of critical questions designed to find solutions to the issues faced by Ontario's hog industry.

Over 40 critical questions were developed and researched. The report exceeds 2,000 pages and required in excess of 4,000 person hours to generate.

The research evaluated Maple Leaf Foods' corporate restructuring strategy to determine its impact. The study team analyzed Maple Leaf's plans, their probability of success and the most probable future of the Burlington plant.

If the business fundamentals suggest that Ontario's production industry would have to undergo significant restructuring, what would that look like and how can we minimize the damage?

A comprehensive analysis of the North American hog and pork sector within a global context was prepared, including Ontario's position within that dynamic.

Researchers carefully appraised Olymel's situation and its call for a radical change in the hog production and slaughter environment.

An analysis was completed to determine the relative competitive positions of each province in expanding existing processing capacity. Specifically, it looked at where Ontario's industry sits within the competitive framework of the rest of Canada, North America and globally.

This booklet provides a high level overview of this vastly complex analysis. Some of the details must remain confidential to protect the integrity of our final competitive strategy. The document also outlines the next steps Ontario Pork is taking to address the current challenges and find workable solutions.

Restructuring of Maple Leaf Foods – Is it for real?

Over the past six months, researchers evaluated the business, financial, operational, marketing and management aspects of the corporate restructuring of Maple Leaf Foods as described by the company. This period of intensive research, analysis and business intelligence gathering included a review of the infrastructure and general economic environment within which the strategy will be implemented.

The research concluded that Maple Leaf Foods has both the financial and structural resources to implement its strategy, however, implementation does present significant challenges and obstacles they must overcome and successfully manage. While success is possible, it is by no means guaranteed.

Maple Leaf's main market strategy is to shift from the production and sale of fresh commodity primal products for the domestic and export markets to value added fresh products that would be merchandised in combination with their further processed, branded meat items. If the proposed strategy is implemented, Maple Leaf will be transformed over time into a different company with a radically different marketing focus.

What is likely to happen to the Burlington plant?

It is the study team's opinion that Maple Leaf will not sell or close the Burlington plant prior to the third quarter of 2009. By that time, the Brandon plant is scheduled to be operating on a full double-shift basis.

Differing opinions have emerged as to the probable future for the Burlington plant. Some believe that it is unlikely a buyer for the Burlington plant will be found. Current opinion suggests the plant, in its current state, is inefficient compared to contemporary standards.

Additionally, as structured, the economics of the hog processing sector in Canada are presently bleak at best, creating a significant barrier to market entry for any new owner. Such unfavourable market conditions would cause any prospective buyer considerable pause before signing an agreement to purchase.

On the other hand, its location is excellent, given its proximity to the largest consumer population in Canada and prime markets in the eastern US.

135 million people live within a day's drive of southern Ontario, representing approximately 44% of the US population and 48% of total US income.

Ontario itself is Canada's richest market with a population of 12 million and the country's highest personal incomes.

Less competition coming from Quebec for Ontario market hogs would be viewed positively by prospective buyers. And fewer competitors supplying the fresh market with Maple Leaf's withdrawal from this sector is another advantage.

Can Ontario's hog industry restructure?

Quebec's estimated weekly slaughter capacity has decreased from 189,000 per week in 2006 to 164,000 per week currently. This has boosted their slaughter capacity use rate to 91% from 79.1% previously.

While slaughter capacity is being more fully used in Quebec, some imported pigs from other provinces will likely be required to top up kill lines from time to time. However, Ontario's exports to Quebec will decline substantially and Ontario Pork will not be able to rely heavily on Quebec for processing, given current conditions. Over the past two years, Ontario's exports to Quebec have already declined by 10,000 hogs per week. Ontario producers are in a precarious position when it comes to slaughter capacity, especially if the Burlington plant is closed.

Ontario's breeding herd has grown by almost 100,000 head since 1996, resulting in weekly finished hog marketings of 118,000 hogs, processed as follows.

- 90,000 per week in Ontario
- 12,000 per week in Quebec
- 16,000 per week exported to the US

It should be noted that while these are the most recent statistical figures available, it is recognized that the trend in the last three quarters has been downward.

In addition, Ontario markets a significant number of feeder pigs to the US currently around 22,400 each week.

Ontario's breeding herd is the fifth most efficient of any state or province in terms of pigs weaned per breeding animal per year. Research suggests the province has the scale and efficiency to become an even larger player in the North American feeder pig trade providing US import policies are favourable. In order to gain the attention of large integrated U.S. processors, Ontario will have to market large volumes of high health pigs. This has the potential to significantly increase the risk of hostile trade actions.

The research looked at how Ontario's hog industry could restructure from the farm through processing, to build a solid future for all stakeholders. It looked at developing a larger export feeder market, producing pork only for domestic demand and explored several niche market opportunities such as biomedical, natural, organic and specialty breeds.

While niche markets offer good prospects for producers, the potential is limited for the immediate future. The total pork niche market in the US represents approximately 900,000 head per year compared to Ontario's 5.2 million hogs marketed in 2006. Even if Ontario were able to capture the entire U.S. niche market, it would only account for about 17% of Ontario's production. An expansion of this market segment is possible with further innovation.

The study confirmed that an Ontario pork industry focused solely on the domestic pork market would be less than half the size of the current industry, about 43% of current size based on 100% domestic market share. It is likely that the size of an industry focused on the domestic market will decline further by 2012, given recent trends in Canadian pork consumption and Canadian pork imports.

The competitive positions of Ontario, Alberta, Saskatchewan, Manitoba, Quebec and the Maritimes were analyzed in terms of their comparative strengths and weaknesses in hog production activities. Ontario's producers compete handily with those in other provinces, landing in the top three or better for 11 of 19 significant performance factors. When it comes to pigs weaned per sow per year, Ontario's breeding herd has consistently been in the top five states or provinces for the past five years.

Where is an expansion of processing capacity likely to occur?

Five to seven years ago, Canada had a productivity advantage relative to the US and that gap has been closing fast. And here's why.

- Canada had a cost advantage in feed and that has been lost.
- The rapid appreciation in the Canadian dollar from 63 cents in 2002 to parity plus at present has had a dramatic impact on Canada's competitiveness for processing and production.
- The strong Canadian dollar has also greatly affected export sales of both live hogs and pork worldwide.

Canada has lost many of the advantages that stimulated growth in the pork industry during the 1980s and 1990s. Canadian producers have been losing money the past couple of years while US producers have had an unprecedented run of strong profits.

The net result is that the Canadian industry is in the early stages of a new round of rationalization and repositioning in both production and processing. As hog production declines, slaughter plant utilization issues will get worse, not better. And this will keep both producers and packers locked in a cycle of margin tightness.

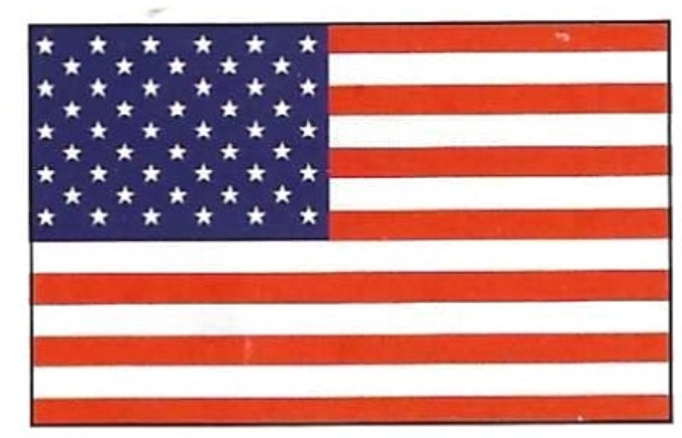
Evidence suggests processing capacity in Canada is likely to expand in the medium term of two to four years, especially given the bottlenecks in red meat trade that are likely to emerge at the Canada-US border due to the implementation of Country of Origin Labeling (COOL). Ontario Pork has been leading the charge on COOL in Ottawa and Washington to make sure that the US and the new COOL legislation honors their obligations under existing WTO and NAFTA agreements.

Ironically, profitability at the farm level is a prerequisite to expanding capacity at the processing level. Unfortunately, restricted access at the border will result in lower domestic hog prices. It is a gross understatement to say that export markets are vital for Canada's hog industry.

One important variable in analyzing performance and future expansion decisions is government willingness to provide assistance. Expanding capacity in Saskatchewan does not make the most economic sense, but this could change if the government determined it worthwhile to offer an attractive package to re-establish processing capacity in the province. It should be noted that the Brandon plant was attracted to Manitoba in part by provincial government incentives.

Alberta is not an attractive location for expanding processing capacity due to labour market conditions. Quebec is unattractive on two fronts. First, hog procurement rules are frustrating existing processors and secondly labour productivity is lowest in Quebec with one of the highest labour rates.

Expanding processing capacity makes the most sense in Ontario providing profitability at the farm level can be reached. Western Canada currently enjoys a slightly more favourable hog/barley ratio than the hog/corn ratio. It may be more profitable to raise and feed hogs in Manitoba and develop processing capacity in that province. The Manitoba government has shown their willingness to fund investments in the past and this is possible again – but current environmental constraints would need to be relaxed.



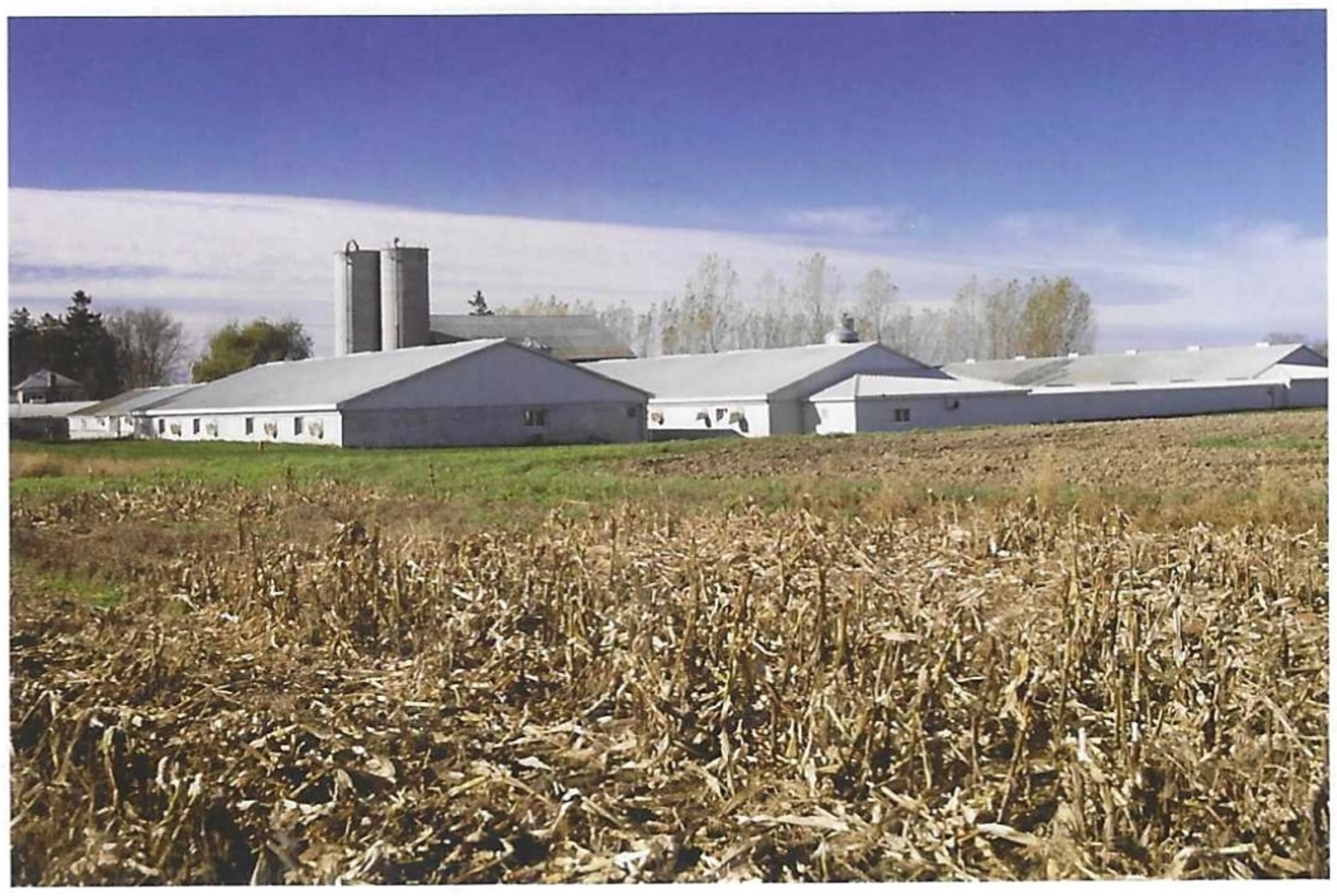
An analysis of the competitive positions of Canadian provinces in expanding existing or attracting new processing capacity was done. Ontario and Manitoba are well positioned to develop and expand current processing capacity. Ontario scores best in terms of industry performance parameters because of their positioning with respect to domestic and foreign consumption points, access to the labour market and potential economies of scale. From a financial support perspective, Manitoba scores best.

Overall, Ontario scores highest in terms of performance factors that could support expanding existing or building new pork processing capacity. Manitoba comes second.

A discussion of profitability at the various levels of the market always generates discussion about producer-owned processing facilities. Historically, these ventures have underestimated the challenges processors face. If the business incentives are not there for existing processors, even though producer-ownership can improve supply chain coordination, research shows that this alone is not enough to tip the scale in favour of economic viability.

Processing capacity in Canada may have reached a stable equilibrium if the future implementation of COOL in the US does not have a significant impact on cross-border trade flows of live hogs and pork meat.

Following implementation of COOL, Canadian hogs may be priced at a discount in the US, leading to a price reduction for Canadian hog producers. However, the price discount in itself may not be enough to trigger expansion in pork processing capacity given the relative value of the Canadian dollar and global market opportunities.



Alternatively, if COOL results in restricted access to the US, the excess supply of slaughter and feeder hogs in Ontario and Manitoba could prompt private investments in pork processing capacity in those two provinces, providing a long-term steady supply of live hogs is assured. And that means profitability at the farm level would need to improve dramatically. The provincial governments' willingness to support the industry would be an important determinant to the location of any additional processing capacity.

What's next?

The amassed intelligence has put us in an excellent position to make sound business decisions. It's now time to answer the critical questions of:

If Maple Leaf Foods proceeds with its withdrawal from Ontario's production and primary processing industry, are the business fundamentals present to have an existing processor expand capacity?

Can we attract a new out-of-province processor?

Can we create a viable producer-owned processor?

Ontario Pork has put together a team of strategic business experts who are now charged with building a set of options, strategies and executable business plans. The team, led by Informa, the world's leading agricultural consultancy, includes such notables as:

- Dr. Clayton Yeutter, retired secretary of Agriculture and US trade representative. Dr. Yeutter negotiated the original free trade agreement between Canada and the US.
- Dr. David Rogers from the Harvard School of Business, 50 years of consulting experience with dozens of Fortune 500 and international companies.
- Dr. Frank Ingratta, retired Deputy Minister of OMAFRA, with over 30 years service to the Ministry.

The anticipated completion of the Business Plan is April 2008. Regardless of the chosen direction, we know it will require a partnership among the government of Ontario, the government of Canada and current industry participants, including existing Ontario processors. The plan must consider the interests of all stakeholders if a sustainable success is to be achieved.

We're facing a serious crisis today that poses a real threat not only to pork producers and processors but to the larger economy. The next stage of developing strategies will bring us one step closer to a long-term solution and a brighter future. We will keep you informed.

If you would like to provide feedback to this information, we would welcome written submissions. Please send your comments to:

Ontario Pork
Attention: MRS Project
655 Southgate Drive
Guelph, Ontario
N1G 5G6

This project has received funding support from the Ontario Ministry of Agriculture, Food and Rural Affairs and the Ontario Ministry of Economic Development and Trade. Such support does not indicate endorsement by these Ministries of the contents of this material. The views expressed in the materials are the views of the authors and do not necessarily reflect those of the Ministries or the Ontario Government.