Written Testimony to
U. S. House of Representatives Committee on Agriculture

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Chairman Scott, Ranking Member Thompson, and members of the committee, thank you for inviting me to join the discussion today. I have been working in the beef packing industry since 1980. I was one of the founding partners of National Beef in 1992 and have been Chief Executive Officer since 2009. As CEO, I am actively engaged in the day-to-day management of National Beef and lead a team of industry veterans that procure more than 3.5 million head of fed cattle and produce and sell more than 4.5 billion pounds of beef and beef by-products annually.

The U.S. beef industry enjoys the reputation of producing the highest quality beef in the world and demand for U.S. beef continues to grow both domestically and across the globe.

Profitability in the beef industry is cyclical and highly dependent upon the cattle cycle and the resulting availability of fed cattle. For the reasons described below, in recent years National Beef has experienced exceptional financial results. We are pleased with our success and look forward to future opportunities to grow and improve our business. Our financial success directly benefits our employees, cattle suppliers, vendors, and the communities where we operate.

National Beef Background

National Beef was founded in 1992 by three partners, including me. Our vision was to develop a niche by creating a unique alliance with cattle producers and linking them with beef customers to provide a consistent supply of the highest quality beef available. Until that time, most cattle were traded in the cash market and brought the same price, regardless of quality. There was no clear economic incentive for cattle producers to invest in genetics or to change their feeding regimen to improve the taste and tenderness of beef. To compete against larger beef packers, we aligned our beef packing, marketing, sales, and distribution expertise with progressive cattle producers who were interested in earning a premium price for high quality cattle. Our strategy has proven successful. National Beef has grown from a small single-shift plant harvesting 1,500 cattle per day, which accounted for less than 1% of the total U.S industry slaughter in 1992, to a diversified beef processing company with more than 9,500 employees. We process more than 13,000 head per workday in three plants, accounting for approximately 14% of the U.S. fed cattle market. We also operate further processing plants, a leather tannery, and a refrigerated and livestock trucking fleet. Our facilities are located in Kansas, Iowa, Missouri, Pennsylvania, Georgia, Ohio, and Texas.

The ownership group of National Beef includes me, U.S. Premium Beef, LLC and Marfrig Global Foods, SA, a publicly traded company.

U.S. Premium Beef, LLC (USPB) became our partner in the ownership of National Beef in 1997. Its membership includes more than 2,400 cattle ranchers, farmers, and feedlot owners across 38 states.

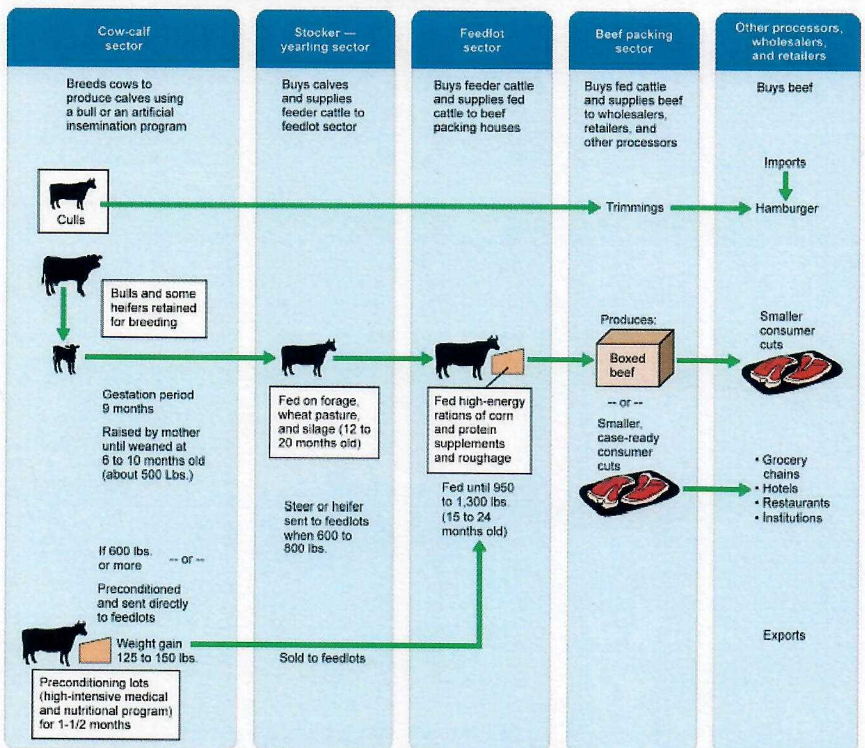
Over time, using data provided by us and our customers, USPB members have steadily improved the quality of their cattle. Today, USPB members provide National Beef with over one million head per year of the highest quality cattle in the U.S., earning a premium for those cattle and sharing in the profits of National Beef.

Since USPB partnered with National Beef in 1997, we have paid more than $1.6 billion in profit distributions and $650 million in cattle-quality premiums to USPB and its cattle producer members.

Beef Industry Segments

The infographic below shows that the cattle and beef production industry begins with the cow/calf sector. This is where key decisions regarding herd size expansion or contraction, quality genetics, and animal health are made by hundreds of thousands of individual farmers and ranchers. According to USDA data, in 2021 there were approximately 30.1 million beef cows in the U.S. held in more than 700,000 herds; the average size of a cow herd was about 43 cows.

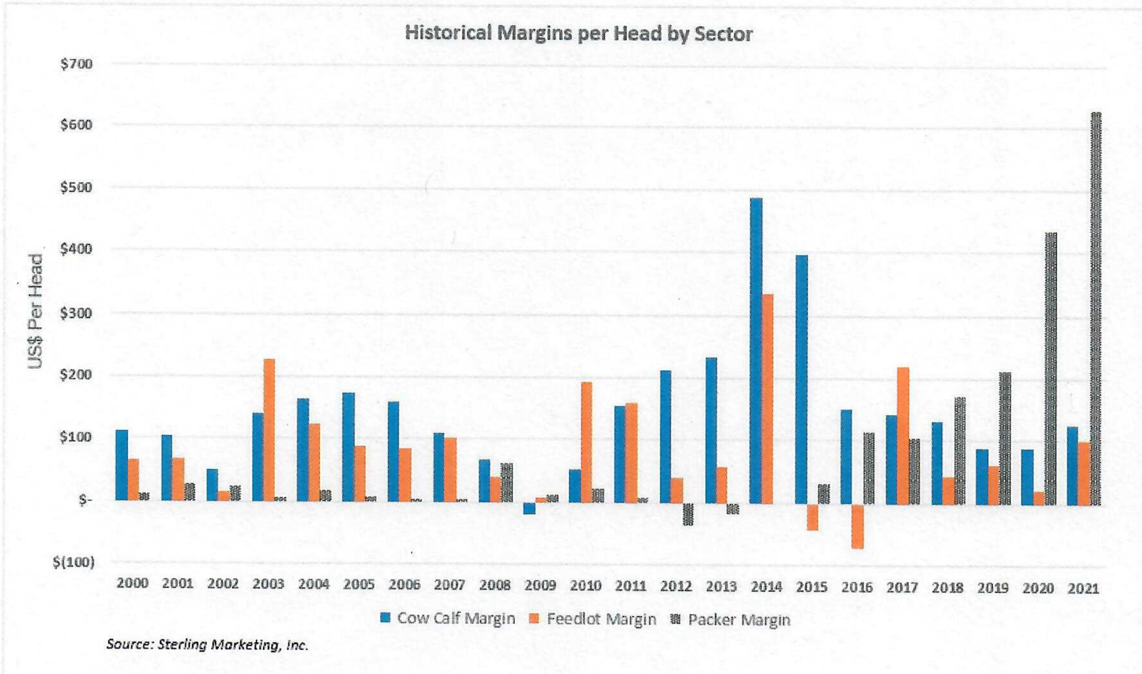
Figure 1: The Beef and Cattle Industry from Animal Breeding to Consumption



Source: GAO analysis of U.S. Department of Agriculture and industry information. | GAO-18-296

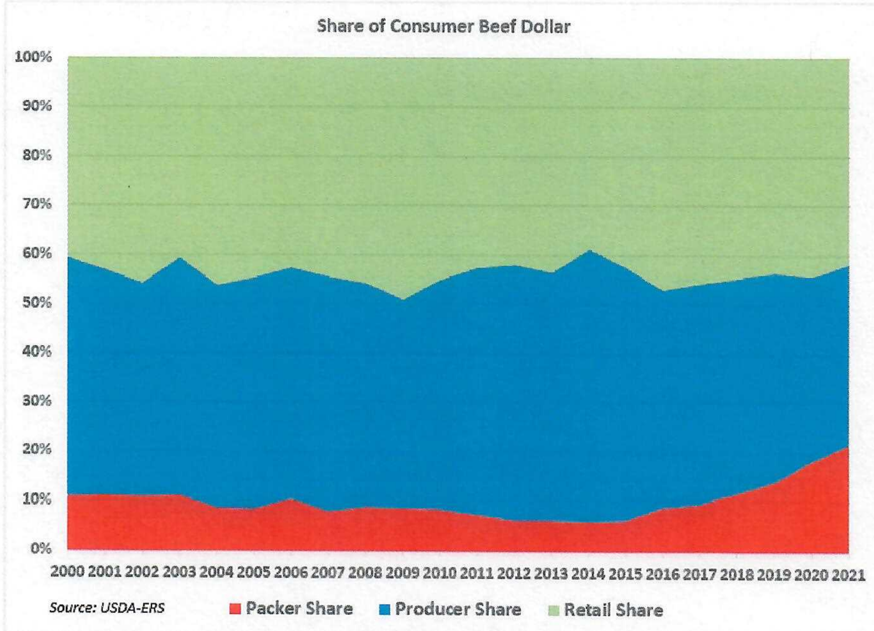
After calves are weaned from the cow, they are typically sold to a cattle producer that grows the calves on pasture or other high-roughage feeds before selling them to a feedyard where they are fed a high-energy diet for approximately 180 days. When the cattle are finished and ready for slaughter, the feedyard sells the fed cattle to a packer. Cattle often change ownership multiple times throughout the process. Except for the cow/calf producer, all parts of the production chain derive their profitability from the margin difference between the buying cost and the selling price less the cost to produce.

As shown in the following chart, the profitability of each part of the cattle and beef production chain fluctuates cyclically. As one considers the relationship between cattle prices, beef prices and relative profitability it is important to note that the supply and demand dynamics are different for each segment of the industry. While the key raw material for the beef packing segment, fed cattle are not the only input – labor, packaging, transportation, technology, regulatory compliance, capital, and risk are all required to convert fed cattle into beef and beef by-products products.



Each head of cattle processed in our plants yields over 100 different beef cuts and beef by-products. Wholesale prices fluctuate daily based on each product's unique supply and demand dynamic and move independently of each other. Each day, beef packers are required to report selling prices to the USDA for many beef and beef by-product items. In turn, the USDA reports aggregated pricing data daily.

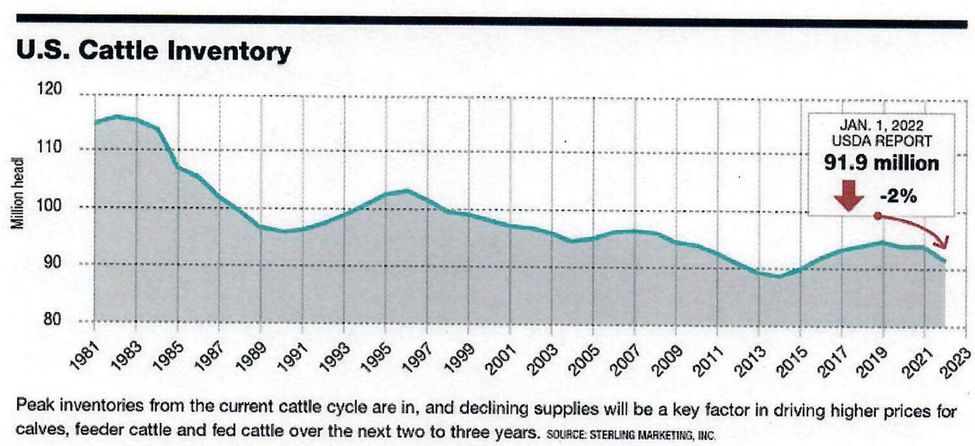
The prices that consumers pay for beef items at the retail level are determined by the retailer, not by the National Beef. Retail prices tend to be less volatile than wholesale prices. As shown in the following chart, most of the total retail value of beef flows to the cattle production and retail sectors, in contrast to the packing sector which gleans a significantly smaller percentage of the total value.



Beef Cattle Cycle

Beef cattle production is a cyclical business similar to other boom-and-bust production agricultural enterprises. The number of beef cows tends to increase when there is ample pasture availability and good profitability and tends to decline when profits lessen or when drought leads to less abundance of pasture and roughage feeds.

As shown in the chart below, the cattle cycle tends to run about 10 to 12 years from peak to peak and trough to trough. While this periodic cycle has been persistent for more than a generation, each cycle high has been lower than the previous cycle's high. This shows that the U.S. cattle herd has been declining for many years. The decline in cattle production and historically low profitability in the beef packing segment explains why there has been no meaningful amount of new beef packing capacity added to the industry for many years.



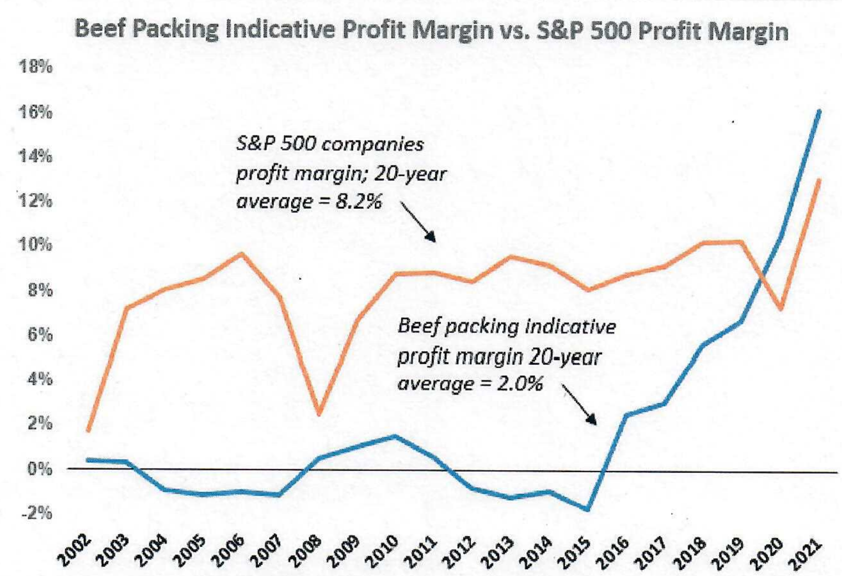
Peak inventories from the current cattle cycle are in, and declining supplies will be a key factor in driving higher prices for calves, feeder cattle and fed cattle over the next two to three years. SOURCE: STERLING MARKETING, INC.

Due to reproductive biology and production constraints, the availability of fed cattle harvested and processed into beef lags the beef cow cycle by about three to four years. Therefore, the peak in cow herd numbers that occurred in 2017 was expected to result in a peak in fed cattle numbers in 2020-21. The subsequent decline in beef cow numbers that began in 2018 and is continuing at an accelerating pace today will result in fewer fed cattle being available for harvest for the next several years until the cow/calf segment halts liquidation and begins rebuilding the herd.

Beef Packing Segment Profitability

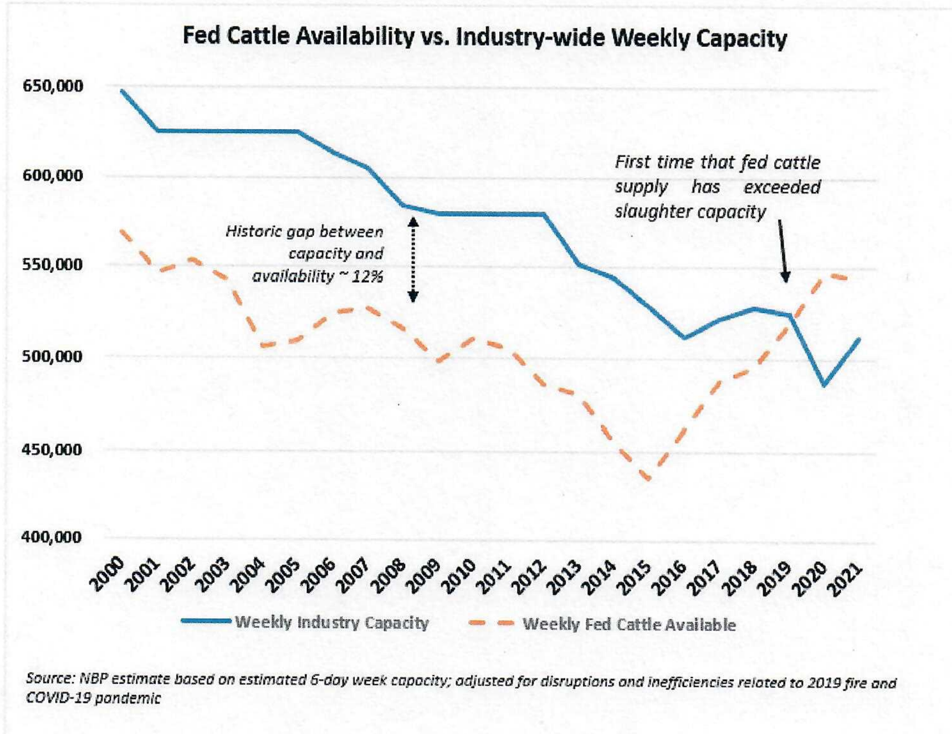
The U.S. beef packing industry has at least 30 participants operating more than 50 cattle slaughter and processing facilities. This number does not include the many very small "locker plants" operating under state inspection. As the fourth largest participant, National Beef operates approximately 14% of the total fed cattle slaughter capacity.

In 1998, the five largest beef packers accounted for 86% of fed cattle slaughter capacity compared to 84% today. Thus, any discussion about beef packer concentration and its impact on prices or profitability should be framed by the fact that the beef packing industry has been operating at about the same degree of concentration for more than 20 years. As shown in the below table, during this period, beef packing profits have varied based on the cattle cycle and have averaged 2% of revenue. All else being equal, when more fed cattle are available for harvest, National Beef's profits tend to be higher; when fewer cattle are available, our profits tend to be lower.



Source: NBP management estimate of Industry average beef packing net income margin versus net income margin of S&P 500 companies; based on internal and publicly available information.

As described above, the U.S. cattle inventory has been trending lower for more than 40 years. Beef packing capacity has also been declining, although at a slower rate. For many years, industry capacity has exceeded the number of cattle available for slaughter. As a result of this excess capacity and the overall decline in the cattle inventory, the packing segment has been a historically low-margin business, typically earning about two cents for every dollar of revenue generated. The imbalance in processing capacity versus cattle availability became particularly severe in 2014 and 2015 when fed cattle supplies dropped to the lowest level in 60 years – even lower than expected due to back-to-back widespread droughts that impacted the key cattle growing areas of the United States. Fed cattle and calf prices rose to record levels, and capacity utilization in the beef packing industry dropped to nearly 80%. Several poorly located and inefficient plants were closed. In the case of National Beef, we experienced record losses and closed our Brawley, California plant. Since 2016, fed cattle supplies have increased sharply while processing capacity in the industry increased only slightly. At the same time, customer demand for beef has been improving, both in the U.S. and in key export markets. By early 2019, capacity utilization had increased to more than 95%, an efficiency level not seen in the beef packing industry for decades. As cattle supply and beef demand increased, National Beef's profits increased accordingly, just as the laws of supply and demand would predict.



The demand for fed cattle and the supply of beef was abruptly disrupted in August 2019 when one of the nation's largest beef slaughter and processing facilities, accounting for approximately 5% of total industry capacity, suffered a major fire that resulted in that plant going offline until early 2020.

Because of the fire, there was an immediate reduction in demand for fed cattle, but the available supply of cattle did not change. As would be predicted by a simple supply/demand equation, this resulted in a significant drop in fed cattle prices. At the same time, the supply of beef immediately declined while the short-term demand for beef increased as wholesale buyers scrambled to secure their product needs. This resulted in a significant increase in beef prices. Lower cattle prices and higher beef prices led to a temporary upward spike in National Beef's profits.

The coronavirus pandemic in March 2020 further disrupted the supply and demand balance for fed cattle and beef. But instead of just one plant, the entire industry that was impacted. In April and May 2020 many beef packing plants were closed or running at severely reduced capacity due to workforce absenteeism. The supply and demand dynamics were much the same as with the 2019 fire, but the overall impact was significantly greater and lasted longer.

As a result of coronavirus-related reductions to the labor force, industry capacity was significantly reduced, thereby lowering the demand for fed cattle, resulting in lower cattle prices. At the same time, overall consumer demand for beef increased – while restaurant demand declined, retail grocery demand surged and prices for typical retail cuts like ground beef and roasts reached record highs as consumers increased their at-home dining.

The production cutbacks resulted in a backlog of approximately one million head of fed cattle. These extra cattle negatively impacted cattle prices in 2020 and for much of 2021 before being cleared from the supply pipeline late last year.

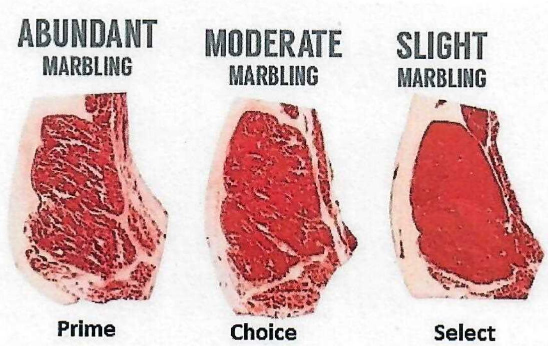
Beef Quality

It is important to understand the basics of beef quality because it is fundamental to why National Beef has been successful and why Alternative Marketing Agreements – often called "grids" – have been so important to the product quality improvements made by the U.S. beef industry over the past 15+ years.

National Beef introduced grids in the 1990s. Before that time, fed cattle were bought using pricing methods whereby fed cattle purchased on a given date, regardless of quality, were obtained at the same approximate price. This method of selling cattle provided no economic incentive for a cow/calf producer to invest in improved genetics or for a feedyard operator to invest in a more robust feeding regimen that could be expected to increase the percentage of cattle that would grade Choice or Prime. Thus, beef quality was stagnant, contributing to a decline in consumer demand for beef.

The amount of marbling (intramuscular fat) in beef is the primary determinant of taste and tenderness. USDA graders inspect each carcass and assign a quality grade based on the amount of marbling visible in the meat.

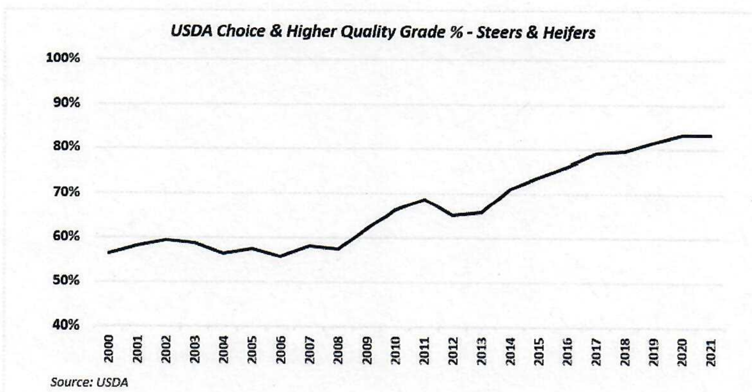
Increased marbling leads to higher quality grades, improved taste and tenderness, and higher product value. The highest USDA grade is USDA Prime, followed by USDA Choice, then USDA Select. Cattle carcasses that grade Prime and Choice have a higher value and command premium prices from packer buyers versus those carcasses that grade Select.



Beef quality is driven by genetic choices made at the cow/calf level and feeding choices made throughout the life cycle of the animal. Certain beef breeds, such as Angus, tend to have higher marbling than other breeds, and the decision to feed a steer on a corn-based high-energy diet will produce beef with more marbling than from a similar steer fed a low-energy grass-fed diet. Different cultures prefer different degrees of marbling – the dominant preference in the U.S. and its key export markets is for a grain-finished high Choice or Prime graded product.

National Beef's strategy was, and still is, to provide economic incentives to cattle producers to invest in genetics, feed programs and other tools to increase the quality of their cattle. Our grids provide that incentive. Cattle producers who choose to sell their cattle to National Beef on a quality grid earn premium prices for their cattle that meet the quality specifications aligned with consumer preferences for premium beef. This quality-grid approach has become widespread across the industry. It has enabled professional, motivated cattle producers to create value and improve their profitability by earning higher than average prices when selling their cattle.

The chart below shows that quality incentives have also resulted in the average percentage of beef carcasses grading Prime or Choice increasing from 55% to 85% over the past 20 years. This dramatic improvement in quality has enabled a resurgence in beef demand in the U.S. and in our key export markets. Using current USDA-reported price data, this increase in grade is worth approximately $1.4 billion in additional value to the U.S. beef industry each year.



Summary

The U.S. beef packing industry is considered by many to be concentrated. This concentration is partly due to the historic low profitability that has forced weaker, inefficient participants out of business, and has discouraged new entrants. It is also a by-product of the scale that results in significant efficiencies in slaughtering, processing, and marketing globally, the beef and beef by-products that come from the more than 25 million head of fed cattle that American ranchers and farmers produce for slaughter each year. At National Beef, our unique business model and our scale has enabled us to access the capital necessary to invest in the people, equipment, and expertise needed to successfully navigate the intense requirements of our cattle suppliers, customers, and regulators.

Notwithstanding this concentration, beef packing remains a highly competitive business – every day National Beef seeks to outmaneuver its competitors to buy the best cattle, hire the best employees, and satisfy the most desirable customers. Our historically narrow profit margins are a testament to the highly competitive nature of the beef packing industry.

National Beef has benefited from increased profitability in recent years. This increased profitability has been driven by the cattle cycle and the continued growth and improvement in our operations. In the two most recent years, our increased profitability was due, in part, to powerful and unexpected external disruptions to the supply and demand of fed cattle and the distinctly separate supply and demand dynamics for many beef and beef by-products. A significant portion of our profits is being reinvested in expanding our beef processing capacity, which will benefit the entire industry going forward.

I appreciate the effort to understand the reasons for the recent increase in beef packing profitability and I respect the different points of view on this topic. The increase, however, should be viewed in the context of the history and the future of the cattle and beef industry.

Since 2016, we have been in an increasingly favorable part of the cattle cycle which was coming to a peak around 2020. Then, just as our margins were nearing cycle highs, the industry was impacted by the August 2019 fire and the 2020 coronavirus pandemic – both of which created supply/demand dynamics that favorably impacted and extended the peak in our profitability.

USDA data shows that fed cattle supplies have peaked and will continue to decline over the next several years. The cattle cycle has turned in favor of the cattle production sectors. Fed cattle prices are 15% higher than one year ago while wholesale boxed beef prices are 5% lower. We expect cattle prices to trend higher, beef prices to moderate and return to a more normal seasonal trend, and National Beef's profit margins to compress.

We also believe that because of the improved quality of U.S. beef cattle and the growth in demand for U.S. beef and beef by-products, profits across all segments of the industry will settle into a higher range than in previous cycles.

While National Beef's expected profits are not as attractive as those available in many other industries, they are sufficient to entice us to invest in additional new capacity. Last year, we announced the construction of a new beef packing and processing facility in Tama, Iowa. That project is underway with an expected completion date in 2025. Once operational, this new facility will have the capacity to harvest 2,500 head per day and will replace the much smaller, older facility that we currently operate in Iowa.

In addition to our new Iowa plant, several other groups have announced plans to build additional capacity. We believe this is an encouraging sign for the future of the U.S. beef industry.