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Rabobank Pork Quarterly

Outlook for Global and Regional Markets

Rabobank International

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- Chinese imports are set to slow but remain strong
- Prices off-peak but still supported at high levels
- Flat to slightly increasing feed prices a welcome break for the industry
- Disease continues to play an important role
- Europe a wild card for 2012 pork outlook
- Stronger margins expected in 2012

Global Overview

Prospects for the pork industry in the first months of 2012 remain bright. Rabobank expects moderate seasonal price pressure in the first part of the quarter as demand falls from peak year-end holiday levels followed by a temporary increase in beef supply that will work its way through the system by the middle of 2012. Nonetheless, pork prices are expected to recover strongly. On average, prices will remain at elevated levels as high costs and disease problems in some regions prevent significant production growth. This will help both producers and processors as they look to margin recovery in 2012.

Chinese imports are set to slow but remain strong China increased its pork and variety meat imports in 2011 by 80 percent-90 percent and 20 percent, respectively, driving a global surge in prices. Rabobank expects Chinese imports to continue to be the main force behind future price strength. Chinese pork imports are likely to fall 18 percent-35 percent in 2012 relative to year-ago levels as domestic production regains its footing, lowering prices and reducing the need for imports. A key indicator will be if China imports pork in February after the New Year celebrations.

Prices are off-peak but continue to be supported at high levels. Slight price erosion is expected to continue in the first month or two of 2012 following the year-end holiday season. However, flat supply and seasonally stronger demand are expected to reverse the softening trend by the end of Q1 *(see Figures 1 & 2)*.

Flat to slightly increasing feed prices offer a welcome break for the industry. Rabobank's outlook for grain and oilseed markets in 2012 indicates a slightly declining price trend, but it all depends upon the weather. Grain and oilseed fundamentals have improved in recent months but remain tight, especially for corn, with ongoing low stocks-to-use ratios. The supply of wheat in international markets has improved following the return of Russia as an exporter. Increased production volumes are also expected in other parts of the world, including the United States (US) and Australia. Soybean prices have remained high due to ongoing strong demand for vegetable oil as the world stocks-to-use ratio is at an historic low.

Disease continues to play an important role. Disease outbreaks in China and Russia will continue to influence the global pork market in 2012. There continue to be clear signs of foot-and-mouth disease (FMD) in China and African swine fever (ASF) in Russia. According to Russia's chief veterinary inspector, Nikolai Vlasov, the ASF situation has worsened with the spread of the disease to a modern, 39,000 head breeding complex in the Timashevsk district of Krasnodar in early January.

Europe a wild card for 2012 pork outlook. Continuing strong exports, supported by a weakening euro relative to the US dollar, are expected to tighten EU domestic supply, supporting the European Union (EU) pork industry in early 2012. However, the effect of the ongoing credit crisis on European and possibly global GDP growth hangs over the market and places a ceiling on prices.

Stronger margins are expected in 2012 as many segments of the pork industry returned to profitability in 2011. Rabobank expects the industry to continue to build on recent gains as stable feed prices and strong pork prices make room for margin expansion. This will provide the industry, especially in the US and the EU, with an opportunity to continue to rebuild balance sheets. Key for long-term profitability will be whether or not the industry can maintain a disciplined supply/demand balance and position itself for future volatility.

Figure 1: Global average hog prices including QoQ and YOY growth, Q4 2011

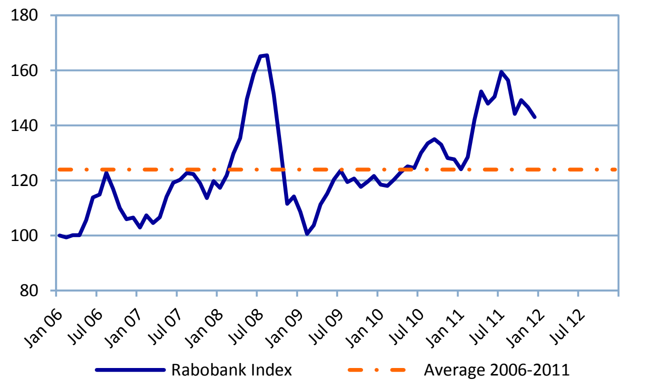
USD/kg, percent

Countries	Q4'11	Q3'11	QoQ	Q4'10	YoY
Brazil	1.98	1.96	1.0%	2.44	-18.9%
China	2.69	3.00	-10.3%	2.04	31.9%
US	1.89	2.16	-12.5%	1.47	28.6%
Canada	1.71	1.81	-5.5%	1.28	33.6%
EU	2.12	2.21	-4.1%	1.88	12.8%

Source: Bloomberg, USDA, EU Commission, 2012

Figure 2: Rabobank 5-nation finished hog price index, 2006-2012

Jan 2006 = 100



Note: Average finished hog prices weighted by share of global exports (Brazil, China, the US, Canada and EU).

Source: Rabobank, 2012

Regional Updates

China

- China encountered record high pork prices in 2011. Prices peaked at USD 4.78 per kg in September, driven by tight supply and disease. Chinese pork prices were the driving force behind the elevated Chinese CPI as well as global pork price increases.

- The hog herd, which started to recover in spring 2011, surpassed the 2009 pre-crisis level of 469 million head in Q3 2011. At about 475 million head as of November 2011, the herd is 5 percent larger than it was at the end of 2010, but only 2 percent better than at the end of 2009. Rabobank expects that the hog herd will continue to expand, but the pace will slow in 2012.

- Although there have been some signs of herd rebuilding, a lack of enthusiasm from farmers to replenish the herd could jeopardise the 2012 outlook. Volatile piglet and pork prices will continue to force small Chinese hog farmers to shrink faster than large operations can expand. Additionally, disease remains a risk factor for the size of the recovery, as reports of FMD outbreaks continue.

- Q1 pork demand will remain strong until after the Chinese New Year celebrations which begin the week of 22 January and last about two weeks. The festivities are typically followed by seasonally weaker demand and prices for the remainder of the quarter, though that was not the case in 2011. Sluggish pork prices may continue until Q3 of 2012, due to weak demand and recovering supply.

- Total 2011 Chinese pork and variety meat imports are estimated to be 360,000 tonnes-380,000 tonnes and 850,000 tonnes, 80 percent-90 percent and 20 percent higher than 2010 levels, respectively. The US was the largest beneficiary of the gain in imports, increasing its direct export to China fivefold with an estimated total export of 180,000 tonnes-200,000 tonnes. This accounts for about 50 percent of market share.

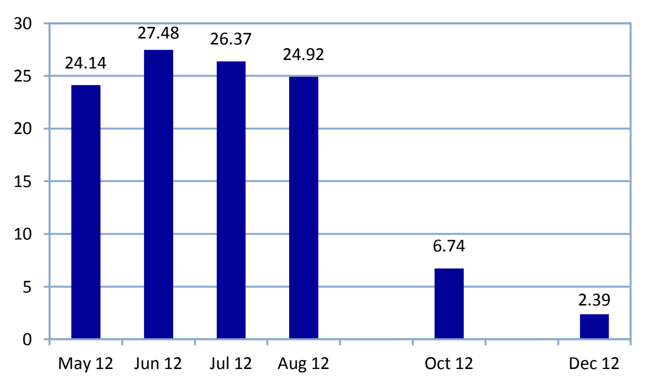
- We expect pork imports in 2012 to slow as lower prices in the domestic market decrease the competitiveness of imported pork. However, imports are still expected to be above 2005-2007 levels, given that the supply has not fully recovered. Rabobank forecasts total imports to be 0.8 million tonnes-1 million tonnes in 2012, a decrease of 18 percent-35 percent compared to 2011. In addition, with Brazil having access to the Chinese market, competition between exporting countries will intensify. According to the Brazilian Pork Industry and Exporter Association (Abipecs), China could import 50,000 tonnes of Brazilian pork in 2012.

United States

- Rabobank expects US pork production to rise about 2 percent in 2012, primarily on productivity gains and possible herd rebuilding. Sow slaughter levels averaged 4.5 percent above year- ago levels for the entire second half of 2011, which suggests that producers' interest in expanding is low. With the futures curve presenting hog producers with an opportunity to lock in positive margins for most of 2012, incentives are in place for reduced sow slaughter and possible modest expansion (*see Figure 3*).

Figure 3: US hog production futures curve, May 2012-Nov 2012

USD/head



Source: USDA, Bloomberg, 2012

- USDA's December Quarterly Hogs and Pigs report showed the swine breeding herd up 0.4 percent over year-ago levels and the market hog inventory up 1.7 percent (*see Figure 4*). US producers are not expanding rapidly despite a profitable 2011 and the prospect of good returns in 2012 that is implied by the futures curve. Memories of sharp losses from late 2008 to the beginning of 2010 are eliciting conservative business planning on the part of hog producers. Another factor may be the high dependency on exports, especially to China, as a driver of high prices.

- Much of the outlook for 2012 will depend on pork export demand. Accounting for 22 percent of production in 2011, exports have become the incremental source for demand and a primary driver for prices. Exports by volume for the year through November were up 23 percent over year-ago levels. China in particular has emerged as a major export customer this year. With year- to- date shipments up 357 percent over year-ago levels, China is now our third largest export customer, accounting for 12 percent of total export volume. Rabobank expects strong exports to China to continue in 2012, though perhaps not at 2011 levels.

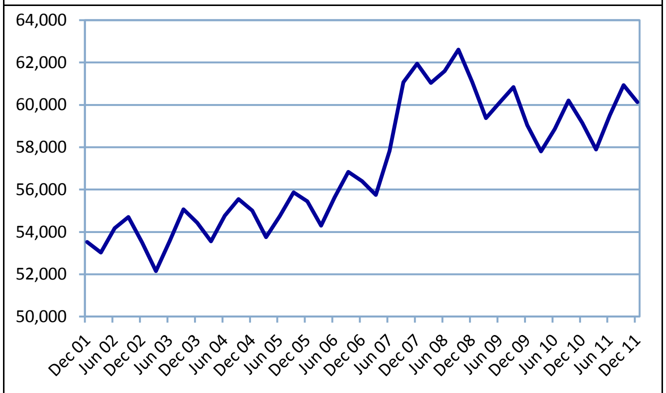
- Also supporting the outlook for US pork prices in 2012 are significant reductions in beef and poultry production, as well as supplies. Rabobank expects beef production to be up in Q1, but down 6 percent by the second half of 2012. Rabobank also expects chicken production to be down 4 percent-5 percent in 2012. Reduced beef supplies are expected to result in record high beef prices that will provide an umbrella for pork prices.

- Retail prices and spreads are signalling strong consumer demand. USDA's monthly retail/wholesale pricing data are showing a record USD 1.96 per pound difference between retail and wholesale prices for pork. It is no coincidence that the data also show a record USD 5.00 per pound retail price for beef. The data supports our beef price umbrella theory and, to the extent that retail pork can maintain its historical 28 percent discount to retail beef, the situation bodes well for pork in 2012. Moreover, wide margins at the retail level mean that grocers have a strong incentive to feature pork and that they have room to pay up.

- USDA issued a scaled-back final version of its Grain Inspection, Packers and Stockyards Administration (GIPSA) rule in December. The original June 2010 version proposed highly controversial restrictions on marketing agreements between producers and processors, limiting producers' ability to negotiate price premiums. The final version does not include these provisions.

Figure 4: US market hogs, Dec 2001-Dec 2011

thousand head



Source: USDA, 2012

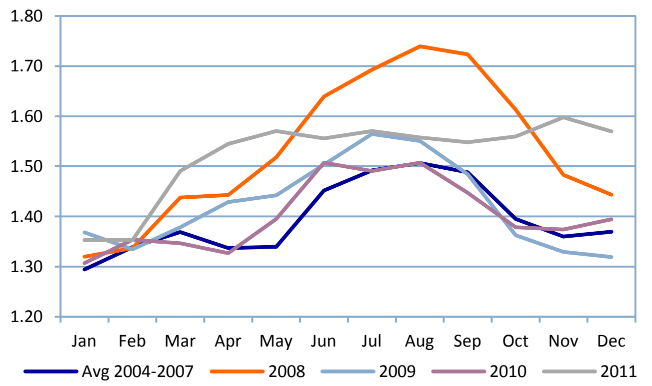
EU

- EU pig prices rose counter-cyclically in the last months of the year, driven by continuing strong export demand and slightly declining production despite lower domestic demand (see Figure 5). Exports from January through November increased 21 percent, mainly driven by soaring exports to South Korea (+99%), China (+92%), Belarus (+42%) and Hong Kong (+31%). Combined with stabilising/slightly declining feed prices since summer 2011, this resulted in positive margins at the farm level. Margins also improved at the processing level in the second half of the year, mainly due to relatively stable input prices.

- Indicators for 2012 profitability are looking positive for the EU pork sector. This is especially true at the farm level, where reduced production should help improve upstream pricing power. Following a 5 percent decline in May-June, Rabobank expects the EU sow herd to show a 9 percent decline in the December release, resulting in a total EU production decline of 3.6 percent.

Figure 5: EU pork prices, 2005-2011

EUR/kg*



*: Reference price

Source: European Commission, 2012

- Rabobank expects pig prices to remain at elevated levels, particularly in the first part of the year, with possible peaks above EUR 1.75 per kg. Prices will be supported by firm export demand, lower supply and possible further weakening of the euro.

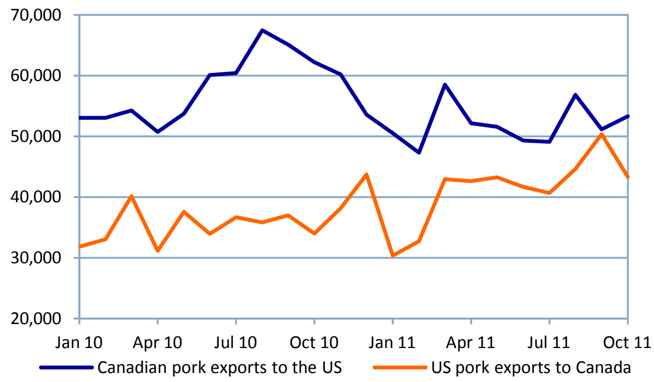
- However, the EU credit crisis remains unresolved. Future developments have the potential to negatively impact European and global GDP growth and therefore also pork consumption and prices. Fresh pork sales have already fallen in Spain (-9.1% Jan-Jun), France (-3% Jan-Sep) and Germany (-1% Jan-Sep) signalling the potential impact of an escalation in the crisis.

Canada

- Rabobank expects Canadian pork production to be flat to slightly up in 2012. Like pork producers elsewhere, Canadian hog farmers face high and volatile input prices and have consequently shown reluctance to expand. Canada's sow herd has stabilised at about 1.3 million head and Rabobank expects it to remain near this level for the foreseeable future. To the extent that slight gains in production do occur, they will be the result of production efficiencies and not significant herd expansion.

Figure 6: Canada/US pork trade, Jan 2010-Oct 2011

thousand lbs cwe



Source: USDA, 2012

- Rabobank also expects Canadian pork exports to be flat in 2012. Exports in 2011 benefited from increased volumes to China, South Korea and Russia. However, those gains were offset by reduced exports to the US, Japan and Hong Kong. Canada's pork trade surplus with the US was especially hard-hit. US pork exports to Canada were up 18 percent year-on-year through October, while Canada's exports to the US fell 10 percent over the same period, partly as a result of Country of Origin Labeling (COOL) in the US, and the stronger Canadian dollar (*see Figure 6*).

- The World Trade Organization (WTO) ruled in November that the US's COOL policy violates the US's WTO obligations. Canada has argued that the US's COOL policy burdens its pork industry with unfair costs on exports, hurting its competitiveness. The Canadian industry is heavily export-dependent, sending 65 percent of its production to foreign customers in 2011. The US, Canada and Mexico have until 23 March to respond to the WTO's ruling.

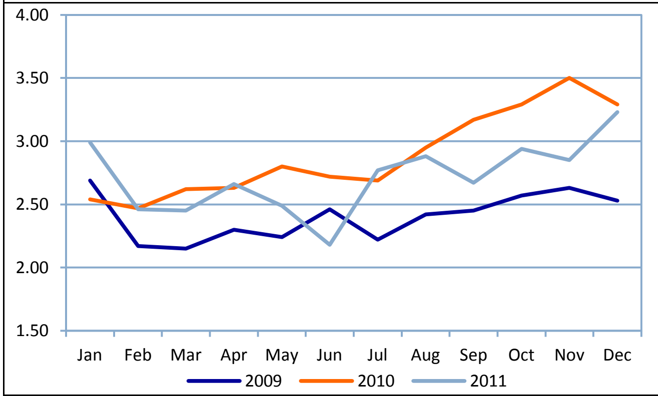
Brazil

- Brazilian hog prices rose 14 percent in Q4 2011 over Q3 2011supported by end-of-year celebrations and high beef prices (*see Figure 7*). These factors more than offset reduced pork exports, which fell by 3 percent quarter-on-quarter and 7 percent year-on-year. Brazil is still being hurt by Russia's ban on Brazilian exports.[1]

- Rising hog prices coupled with relatively stable grain prices provided for slight improvement in producer profitability after months of intense pressure that pushed many small, independent producers out of the market. However, small farmer herd liquidation was offset by expansion in integrators' sow herds along with further growth from larger independent producers. Overall, Rabobank expects that Brazil's pork production will grow by 2 percent in 2012.

Figure 7: Brazilian hog, live prices, 2009-2011

BRL/kg



Note: Prices as recorded in Patos de Minas, Minas Gerais

Source: CEPEA, 2012

- Pork and hog prices are expected to decline in Q1 2012 on a typical seasonal trend towards lower domestic consumption and exports. Even so, margins for both independent producers and packing companies should remain stable, as grain prices should ease locally as the corn and soy crops come to market. The downside risk lies in the expected seasonal decline in beef prices, which may be exacerbated this year as a result of the higher calf crop in 2009 and 2010. Longer term, the gradual opening of the Russian market could lift exports.

Japan

- Japan's overall pork demand remained steady in 2011 with a slight, positive substitution boost during the beef radiation scandal in Q3. For 2012 , the demand for premium meat will likely be weak, driven by the economic environment.

- Continuing focus on food safety and the positive perception of imported meat will support import volumes. Leading suppliers in 2011 were the US, Canada and Denmark. These countries accounted for 40 percent, 20 percent and 15 percent, respectively, of Japan's estimated 120,000 tonnes-130,000 tonnes of imports.

- Japan announced its intention to join the Trans-Pacific Partnership (TPP), a multilateral trade agreement which currently includes Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, the US and Vietnam. This could shake up the import positions of the leading players, with the biggest threat being posed to Denmark.

South Korea

- South Korea continued to recover from its Q1 2011 FMD culling, but Q3 2011 hog inventory at 7.8 million head is still 20 percent below the average 9.8 million head pre-crisis. Assuming the continuation of the last three quarters' 5 percent CAGR, South Korea will not reach its pre-crisis inventory level until Q3 2012.

- The combination of supply recovery and global economic uncertainty may continue to push consumer pork prices down, which is not encouraging for domestic herd replenishment.

[1] 85 Brazilian pork plants have been banned from exporting to Russia since June 2011.

- The narrowing supply gap suggests an import decline of up to 20 percent relative to the 2011 volume of 520,000 tonnes (65% meat, 35% by-product). Even so, a 20 percent decline would mean imports of 400,000-420,000 tonnes, which is still 33 percent-40 percent higher than 2010.

- After acquiring the leading import position in 2011 with an estimated volume of 160, 000 tonnes (+30%), the US will strengthen its position in 2012 with implementation of the Korea-US Free Trade Agreement (KORUS FTA). This is supported by a strong marketing effort from both USDA and the United States Meat Export Federation (USMEF). Additionally, Canada continues to maintain a 20 percent import tariff, which will redirect importers to the US.

- During Jan-Nov 2011, several new players entered the competition for South Korean import volume: Spain (30,784 tonnes; +73.5%), Germany (28,960 tonnes; +685%) and Mexico (≈10,000 tonnes; +34%).

Russia

- Russian 2011 pork production increased by about 100,000 tonnes to 2.4 million tonnes (+4.4%). This growth was almost totally from industrial producers at the expense of household and back yard farming. This represents a slowing in production growth from 18.3% in 2010.

- Total pork imports from January-October amounted to 597,000 tonnes (+5.8%) with imports of fresh pork increasing by 68.4 percent. This clearly shows the steady growth of Russian pork consumption and the impact that swine fever has had on supply.

- Current production and import volumes are likely to continue in Q1 2012. Impacts from new capacity coming on line and reduction of the import quota from 472,100 tonnes to 400,000 tonnes will not be felt until later in the year.

- The major risk in Russia is further outbreak of ASF. An outbreak was recently reported in a 39,000 head breeding complex located a few kilometres outside of Timashevsk, near Krasnodar. According to Russia's chief veterinary inspector, Nikolai Vlasov, ASF in Russia is 'progressively getting worse'. In addition, the spread of ASF 'is not rare but quite common which is an indicator of the existing structure, the result of the decentralisation of veterinary services of the country'. The recent developments forced Ukraine to impose strict border control including the installation of 'pig free' zones along its border with Russia.

Industry comments

Industry continues to face challenges

After a difficult first half of 2011, especially for companies active in the Northern Hemisphere, the global pork industry was able to regain some of its lost margins in the second half of the year. This resulted in, at best, an average year for most players in the industry, with some possible bigger winners in Asia and, to a lesser extent, the US and more underperforming companies in Europe

Rapidly increasing feed and hog prices pressured margins for all players in the global pork industry in the first half of 2011. The Rabobank hog price index surged by 23 percent between January-April followed by another 8 percent increase between May-August. Together with an increase of roughly 40 percent in feed costs between June 2010 and June 2011, it pressured the margins of pork processors, both independent and integrated, around the globe. Margins recovered slowly in the course of the summer with stabilising hog and feed prices, strong (import) demand in China and South Korea and companies renegotiating contracts to be able to carry higher prices.

However, for most processors this recovery was not sufficient to increase profitability throughout the year. Companies with large shares of sales in value added and further processed products that also have lean structures for optimal (internal) logistics have weathered the storm noticeably better than their competitors. In addition, companies which restructured their businesses with a clear focus on cost-cutting after the pressures of poor margins in 2008 and 2009,improved their competitive position, which paid off during the difficult first months of 2011. Rabobank expects that these companies might be in a position to make some add-on acquisitions to strengthen their positions in the near future. Mergers/acquisitions of lower-performance companies to cut costs and capacity through restructuring is likely across the industry as companies seek to increase competitiveness. Although 2011 was generally a year with limited M&A activity, some important transactions did take place, including:

- Merger of French pork cooperatives Porc Amor and Cofiporc to create Porc Amor Evolution, the fourth biggest processor with a yearly throughput of 1.8 million head,
- Belgium Westvlees acquired Lovenfosse and Detry, making it the undisputed leader in the Belgian pork industry,
- Irish Dunbia acquired UK-based Heathfield Foods to strengthen its foothold,
- Cargill purchased a hog production facility in Texas from Smithfield subsidiary Premium Standard Farms.

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