Effects Of Alliances On The Beef Cattle Market

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Introduction

Beef cattle alliances have become the most talked about alternative to the open market for marketing cattle. Much of this discussion is due to the promises made by alliance promoters. However, there are some significant economic factors that make alliances worth examining. This paper will explore some of the economic characteristics of beef alliances and the potential effects they may have on the cattle market in general.

The beef industry has lost considerable market share to the poultry and pork industries over the past couple of decades. Some of the decline can be attributed to the changes in consumer preferences, but a significant portion is due to marketing structures. The vertical integration and coordination in those industries has allowed information transfer to be internalized and nearly complete. The open market system, still prevalent in the beef industry, does not allow information to be easily shared from one production stage to another. This creates inefficiencies in transmitting end consumer preferences back to the early stages of production. In addition to the information transfer, the poultry and pork industries have also produced several consumer-aimed products. These products include simple brand-identifiable packaged meat, such as GoldKist® boneless thighs, and ready-to-eat meals. The beef industry has been slow to get such items to the table, but steps are being taken by programs such as the Certified Angus Beef® and Farmland Beef®. Alliances have contributed to development of these branded consumer products. In addition to consumer product development, there are implications alliance participation may have on the overall cattle market.

Examples From Other Markets

The poultry industry is representative of the extreme effect of an alternative marketing structure on a traditional market. Open markets for broilers are nearly non-existent. With the poultry packers owning nearly all of the broilers in production, there are very few buyers that could be targeted by independent broiler producers. Thus, producers are forced to contract with poultry packers in order to stay in the poultry business.

There have, nonetheless, been positive effects for those producers who do contract with the poultry packers. Income has become more stable as market risk has been removed by the contracts, and most of the production risk has been absorbed by the packer as well (Martinez, 1999). These producers have seen benefits in financing their operations as well. Lenders that understand the contracts are generally more willing to provide financing because of the reduced default risks that a contracted producer possesses (Featherstone and Sherrick, 1992; Roberts and Barry, 1998).

A similar effect has also significantly impacted the pork industry. The pork industry was sent into shock in late 1998 when the market hit bottom. Many producers found it much cheaper to dump their hogs on other producers rather than continue to finish them to market. Much of this was due to adjustments in the market as well as uncertainty about the future of the markets due to the rapid adoption of contract production in

the industry. While the pork market has not totally gone the direction of the poultry market, the market has changed.

For the pork producer participating in contract production, the effects on income and financial viability has been quite the same as with the poultry example. Income streams have become more stable, and the risk-reducing nature of the contracts has been favorably received by lenders. The result has been an overall improvement in the financial performance of many operations (Roberts and Barry, 1998).

Beef Alliance Initiatives

The alliances in the beef industry attempt to accomplish many of the same goals as the contract production of the poultry and pork industries. They attempt to increase the amount of information transfer, improve the producer's financial returns, and create a brandable quality image around a specific product or product niche. However, the beef alliances use the principles of vertical coordination in an entirely different way. Much of this difference is generated by whom is coordinating the market. In the poultry and pork industries, the integrators and coordinators have been the packing companies. With the beef cattle alliances, there have been a few different coordinators such as marketing groups, cooperatives, breed associations, and other producer groups. The effect has been an entirely different risk structure, but the market effect has potential to be very much the same as in the other industries.

Market Effects

As participation in alliances increases, the likelihood of noticeable market effects increases. The most obvious potential effect is a decline in the quality of animals available on the open market. With many alliances being loose in their contractual arrangements, many producers can opt to take cattle they feel will not do well on the pricing grids to the traditional market. Such a strategy does require intense management and forecasting skill suggesting considerable risk. Additionally, the attempt to avoid the discounts arising from poorly performing cattle would bring will eventually be counter balanced by the adjustment of the market to the lower quality of cattle on the market.

The nature of the pricing grids becomes a bit of a concern for many as the traditional cattle markets become thinner. Most grids are market based and would have to adjust as the market adjusts to the changes in the animals sold through the market. Without these adjustments, the returns from participation would decline potentially leading to a collapse of the alliance structure. However, another argument is that producers will find ways through intensive management to decrease the number of low grading cattle. This situation will improve the overall quality in the market, but it would also decrease the number of cattle sold on the open market. The result would then be a thin market where prices could decline for lack of demand.

The most significant effect of increased alliance participation would be with the smaller producers who are not currently able to participate in alliances due to their inability to produce truckloads of cattle. Their cattle could be seen potentially as lower quality animals. However, cooperative arrangements between producers are an attempt to avoid such a situation by creating a large producer-like entity that can produce consistent truckloads of cattle.

The consumer market is most likely to benefit from increased participation in alliances. The information transfer facilitated in coordinated markets allows consumer preferences to be efficiently transferred back though the production chain. The result is a higher quality product which consumers will desire and for which they will be willing to

pay a premium. This effect, in conjunction with the gains in cost efficiency through the coordinated market, allows for the continuation of rewarding pricing grids.

Financial Effects

In both the poultry and pork industries, the packers are able to remove some, if not all, of the market risk exposure on producers. Additionally, a considerable amount of production risk is contracted away. In contrast, the fact that packers are not the coordinators in the beef industry alliances creates a much different financial risk scenario for the beef producer participating in an alliance.

The nature of the alliance pricing grids creates an exposure to additional income variation unless a producer can maintain a consistent non-fluctuating distribution of carcass grades throughout the herd. The increased income fluctuation, however, comes with an expected higher overall return if the producer has carefully matched his/her alliance of choice with his/her herd profile. With a good match, there is potential to improve the overall financial performance of the enterprise. Significant improvements in returns on equity and term debt coverage along with the market certainty may provide opportunity for more favorable financing terms for the participating producer in lieu of the increased income variability. Much of this result comes about in the form of risk efficiencies which a well matched alliance to herd pairing can accomplish.

Summary Remarks

If every beef producer participated in an alliance, the effect on the traditional cattle market would be extreme. Pricing grids would have to be adjusted as the open market base would become irrelevant. Even without complete participation, there will be effects on the cattle market as a result of increased alliance participation. The potential exists for the traditional market to become a "hamburger" market where only low quality animals are marketed. The most likely significant effect will be on the average open market price. As fewer high quality cattle are marketed on the open market, the difference between the high and low prices paid on the open market will shrink.

The overall effects of alliance participation on the cattle industry are beginning to materialize. Branded products are being introduced to the market. Ready-to-eat beef products are being made available to consumers. Information is being transferred more efficiently through the production system. Incentives are becoming more focused on the production of beef and less on the production of cattle. These are the ultimate drivers that will alter the beef cattle market in the future as the beef industry positions itself to be more competitive with the poultry and pork industries.

Literature Cited

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