

Company establishing a cross-border pork production company

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ABSTRACT

Establishing a cross border swine production system is the focus of this thesis.

There are three basic sections to this project: 1) the business plan information 2) the study of economic principles and the state of the industry, and 3) the implementation of starting the business. First the project develops a basic business plan for Company, and then uses economic theory to evaluate business opportunities. The project incorporates basic business plan information such as establishing a business philosophy, that includes company goals and objectives. The process involved the creation of specific business entities and the analysis of different corporate structures: Limited Liability Corporation (LLC), Sub S Corporation, and Class C Corporation. Through this process of establishing this cross border swine production company the Partnership and Cooperative business structures are also evaluated and formed. Company, Inc was incorporated in State as a Sub S corporation.

Economies of size and scale are used as the background for developing this business entity. The Cobweb model is used to help understand and explain the existence of a hog cycle and the ramifications this has for Company, Inc. These economic principles are applied to current North American data to determine an entry point and to predict the best time to enter the swine industry. A study of the United States-Canada exchange rate is required to understand the dynamics of establishing a swine production company that crosses an international border. The study discusses global issues and possible threats that exist to an international corporation.

Finally the implementation phase used models to estimate asset values and incorporated tax planning methods to determine the final corporate structure. The

implementation phase includes pro-forma financial statements that were used to secure financing. The implementation phase also included renegotiating supplier contracts based on the data learned during the state of the industry analysis to establish a cost of production that could be profitable for the businesses going forward. The end result is an example of the process used to establish a cross border swine production company.

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INTRODUCTION

Company is a firm set up by three shareholders with the intention of finding the right opportunities to grow a pork production system. The shareholders already own, operate, and manage other business entities associated with the production of animal proteins. The concept was to establish a company, evaluate the state of the industry, find opportunities for business growth, and utilize the assets and experiences of the shareholders across more pounds of pork production. The first process was to develop the business plan for Company, the basics are explained in Chapter one. Once the corporation was established and in place, economic theory and the state of the industry were studied to determine an entry point for the business, a synopsis of this process is presented in Chapter two. A unique opportunity was uncovered in the southern part of the Province that led to an in depth process of establishing business structures and international financial management. In this process, influences outside of the norm such as legal issues, exchange rates, asset evaluation, and debt structure required evaluation and analysis. In the process Company, Inc. became a North American corporation with assets in both the United States and Canada. By crossing the border and establishing key relationships the company was able to capitalize on the current state of the industry and the economy in Canada. Chapters three, four, and five outline the timing, business structure, asset value advantage, and management processes that make this venture a unique business opportunity.

CHAPTER I: COMPANY, INC. BUSINESS PLAN

Company, Inc., hereafter referred to as simply COMPANY, is a State Corporation established to leverage shareholder assets and experiences in the production of pork as a protein source. COMPANY was incorporated as a Sub S Corporation in State for the purpose of conducting business operations in North America. Shareholders of COMPANY have other business assets based in that State. Some of the shareholders of COMPANY have established a similar model with livestock production, i.e., ownership and coordination from production to retail sales. Because of the shareholders assets and experiences, COMPANY was established to participate within the pork value chain, with an emphasis on production. The COMPANY model will be patterned after the livestock model already in place.

Shareholders of COMPANY, through membership in “A” Cooperative packing plant, established market access for their hog production. Ownership in a packing plant provides the ability to also participate in the retail marketing of pork products. “A” pork processing plant is a producer owned cooperative; COMPANY is a member of the cooperative and the shareholders of COMPANY hold positions on the board of directors and executive management team of the cooperative. COMPANY headquarters are located in State. Breeding animals for COMPANY production systems are available from Multiplier, a shareholder owned gilt multiplication company. Feed manufacturing and feed manufacturing expertise are available from a shareholder owned feed milling operation.

Grain inputs (corn) and land for manure disposal are available from shareholder owned farming operations. Financial management, hedging, and information systems are in place to support shareholder multi-business operations and are available to COMPANY.

1.1 COMPANY Vision Statement, Mission and Company Objectives

The vision of COMPANY is **Integration through coordination**: COMPANY will leverage its shareholders' assets, relationships, and experiences to provide growth opportunities. Opportunities will be analyzed and evaluated to determine if they are economically and strategically in line with the business objectives of COMPANY. The shareholders of COMPANY have previous experience and assets in both the production of livestock and pork; they also currently control and manage livestock production from on-farm production through retail sales. COMPANY will leverage its shareholders' assets and experiences in the swine and livestock industries to improve efficiencies through both economies of scale and economies of scope. COMPANY will grow as business solutions are available, strategic, and offer opportunity for shareholder return on investment. Business will be conducted on a best cost basis. Geographically, the business will focus in North America and specifically in and around the Great Lakes region. Figure 1.1 shows the company logo, which was designed to depict the company's geographical location without borders or boundaries and to focus on pork as the company's protein of choice.

The mission of COMPANY is **“to become a best cost producer of quality pork products that can be sold at premium prices while providing growth opportunities for its shareholders through investments or contractual arrangements in North**

America.” COMPANY will own assets as necessary and will enter contractual arrangements as available to maintain a best cost business model. COMPANY will conduct business in all aspects of the value chain to become vertically coordinated and integrated. COMPANY will enter either domestic or international markets as necessary and available.

The goal of COMPANY is to build equity for its shareholders. Each shareholder made an equal initial investment through the purchase of shares. Shareholders have the ability to borrow the corporation investment dollars at a predetermined rate of interest. Shareholders also have the ability to utilize their other business entities and resources as vendors and suppliers of COMPANY. The profits of COMPANY will be reinvested in the business for business growth and business efficiency through economies of scale. COMPANY business success will be measured by business growth and return on shareholder equity. Economies of scale allow COMPANY to improve efficiencies, improve negotiation positions, and spread fixed costs across more pounds of pork produced. The shareholders of COMPANY also believe in expanding business operations through economies of scope, i.e., as ancillary businesses become economically viable to acquire COMPANY will target such diversity if it is economically attractive. Certain business functions can be spread across other shareholder entities improving the efficiencies for all. The strategy for shareholders of COMPANY is to provide expertise and management to operate and grow; profits will be left in the corporation to reduce debt

and expand the business. The following objectives of COMPANY are based on achieving an ultimate goal of business growth:

Objective 1: Business Growth and Development

Identify business opportunities that align with COMPANY core strengths and business philosophy. Grow strategically without any hard or specific timeline. Grow based on market conditions, timing, and opportunity. Grow in a manner that does not have negative effects on the overall North American pork industry and that complements other shareholder assets. Expand into coordinated businesses as they become necessary, available, and economically viable. Utilize existing shareholder business functions to improve efficiencies across multiple business operations. COMPANY is not restricted to swine production; however, the business will remain focused in animal agriculture and pork as its core business and its core strength.

Objective 2: Human Resources

Identify relationships and key people to assist in the management and coordination of the business. COMPANY will expand and grow as it is able to align with the right people that have the resources, expertise, and share a common commitment to growth and animal agriculture. The shareholders of COMPANY believe that management and people are the key ingredients to business success. COMPANY will create ownership opportunities and/or partnerships with key people in order to create management and labor longevity and stability.

Objective 3: Global Marketplace

COMPANY will compete in a global market. Business management and cost analyses will be benchmarked against the North American market place. The products COMPANY produces will target global standards and be eligible to be sold world wide based on demand and profitability. The corporation may expand into branches and partnerships outside the United States. Geography, logistics, and political environments will be considerations in any business ventures of COMPANY. COMPANY believes that protein for human consumption should be produced and manufactured in the world areas that offer the safest and most economical production systems, but that animal protein should be available to the entire world population.

1.2 COMPANY Shareholders

COMPANY was created by three equal shareholders, each bringing different skills, experiences, and backgrounds to the business. In addition to his role with COMPANY, each shareholder has responsibilities outside of COMPANY. The following are the three shareholders and a brief description of their backgrounds:

President (Shareholder A):

Vice President (Shareholder C):

Livestock Secretary and Treasurer (Shareholder B):

LivestockLivestock Livestock

1.3 COMPANY Corporate Structure

COMPANY was incorporated with the intent of entering a pork production business with expansion expectations modeled after the shareholders' other business models. COMPANY incorporated with no specific business objective other than to

evaluate the state of the swine industry and determine an entry point and method for growing the company. The corporation was established as a Sub S Corporation after considering other corporate structures. The initial consideration was the Limited Liability Corporation (LLC) corporate structure. The advantage of setting the business up as an LLC in the United States is the limitation on owner liability. The main disadvantage to this structure is that other countries, such as Canada, do not recognize the same limitation on owner liabilities as are afforded in the United States. COMPANY determined that if the corporation was set up as an LLC that would potentially restrict the ability to operate in other countries, specifically Canada. Either a class C Corporation or a Sub S Corporation would allow the business to expand without international border restrictions. The Sub S Corporation was chosen because it provides similar limitations of owner liability, it is recognized by foreign countries as a corporation, and it does not have the adverse double taxation consequences on shareholders that a C Corporation can have.

COMPANY is uniquely positioned and was established to grow strategically in the North American market. When COMPANY was formed, the North American hog cycle was favorable or entering a favorable period for individual business growth in swine production. COMPANY had also been offered an opportunity to expand its scope by taking on an ownership position in the “A” Cooperative, a pork processing plant. Membership requires that market hogs be delivered to the plant – one market hog per year per share owned in the cooperative. This ownership opportunity in a packing plant for pork was a first step toward COMPANY’s integration through coordination vision. This

opportunity however required that COMPANY enter into swine production in order to meet its hog delivery obligation to “A”. This did not allow for a gradual ramp up of production as would be typical of a start-up business. Rather, the commitment to “A” required COMPANY to acquire an established production system. Acquiring a pork production system would be the next step toward this vision or business model of integration through coordination.

Figure 1.2 illustrates the current corporate structure of COMPANY. The Sub S, State based company has three shareholders that all participate in the management and hold positions in COMPANY. The business currently has two divisions; a Canadian Branch known as COMPANY-CND and a U.S. division which has an investment through membership in “A” pork processing plant and purchases feeder pigs and finishes market hogs in contract barns to fulfill its obligations to “A” Cooperative.

1.4 Economies of Size and Scope

Economies of size refers to expanding the business unit to spread fixed costs over more final product. In order for COMPANY to take advantage of economies of size, the company would look to acquire an existing system rather than starting small and growing to scale. The state of the hog cycle in Canada offered opportunity for this type of acquisition that either was not available in the U.S. or was not cost effective.

Economies of scope refers to linking common pieces of the production chain such as feed milling, labor, or information support systems (IT) across different business units to improve efficiency by sharing fixed costs thus reducing overall costs and individual

business unit costs. COMPANY with its shareholder's other assets is able to capitalize on these economies of scope.

The three shareholders in COMPANY own, manage, or operate related businesses in agriculture and the production of protein. These related businesses include farm land and the production of grains required to feed hogs, feed milling operations with enough capacity to feed additional hogs, a swine genetic multiplication business that would supply breeding animals for the business, and an ownership stake in a pork production packing plant that will process and market the pork products. In addition, shareholders have experience in owning and operating a vertically coordinated livestock other production system that owns the livestock, mills the feed, processes the meat, and adds value by further cooking the meat in a company owned multi-species smokehouse. The shareholders are also involved in other commercial swine, beef, and dairy production businesses. Prior to COMPANY, the shareholders' other business entities produced X market hogs per year and sold them either under contract or on the open market to U.S. packers. This diverse group of shareholder business entities brings economies of scope to COMPANY. As COMPANY expands into market hog production, the overall scale of pork production across shareholder business units expands and allows owners to capitalize by spreading fixed costs across more pounds. By combining certain management and labor tasks with other businesses, COMPANY and the other businesses are able to more fully utilize those resources and spread fixed costs out.

COMPANY's business philosophy is to coordinate with other organizations, partners, or business entities as necessary in order to maximize the efficiencies of COMPANY and take full advantage of potential economies of size and scope. This diversity and size allows COMPANY and its shareholders to focus on the production of proteins while spreading fixed costs across more total pounds. The business model is designed to reinvest profits into the organization for growth and return on equity. The shareholders are interested in developing assets and equity in the business, not creating pay checks for the owners. In the end, COMPANY is a long-term investment for its shareholders, they provided an initial upfront investment to establish the corporation. They provide leadership and economic decision making to the business. They also provide capital in the form of loans, goods and services on a contractual basis from their other business entities, and management that takes advantage of economies of size and scale across both COMPANY and their other entities. The COMPANY business is based on growth and as it grows the value of the shareholders original investment will increase. In the meantime the shareholders are able to capitalize on the value of COMPANY's size and scope.

Figure 1.1: COMPANY Logo

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Figure 1.2: COMPANY Corporate Structure

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CHAPTER II: STATE OF THE SWINE INDUSTRY AND OPPORTUNITY ANALYSIS

By the end of 2007, pork production costs were on the rise. The cost of corn increased to unprecedented levels due to the demand associated with ethanol production in the U.S. and strong global markets. The U.S. dollar compared to the Canadian dollar was as weak as any period in history. Even the pending implementation of Country of Origin Labeling (COOL) threatened to further increase the cost of production for North American swine producers. A more positive factor was that world consumption of pork and North America's ability to produce it efficiently remained strong as evident by the export market. Although these increasing cost issues would seem to encourage producers to exit the industry, these were the factors that COMPANY used to define the opportunity and decide to enter into pork production. The Cobweb model is an economic model that can be used to illustrate the opportunity and explain why a business would enter an industry that seems to be unprofitable.

2.1 The Cobweb Economic Model

The Cobweb economic model (Figure 2.1) illustrates and helps explain the dynamics of agricultural price cycles like the hog cycle. As the price and quantity fluctuate from high prices and low quantities to low prices and high quantities, a cobweb-like pattern is formed trying to reach equilibrium. Because price and quantity demanded change according to outside influences, equilibrium is never actually achieved. In its simplest form, the Cobweb hypothesis suggests that supply decisions are based on current price

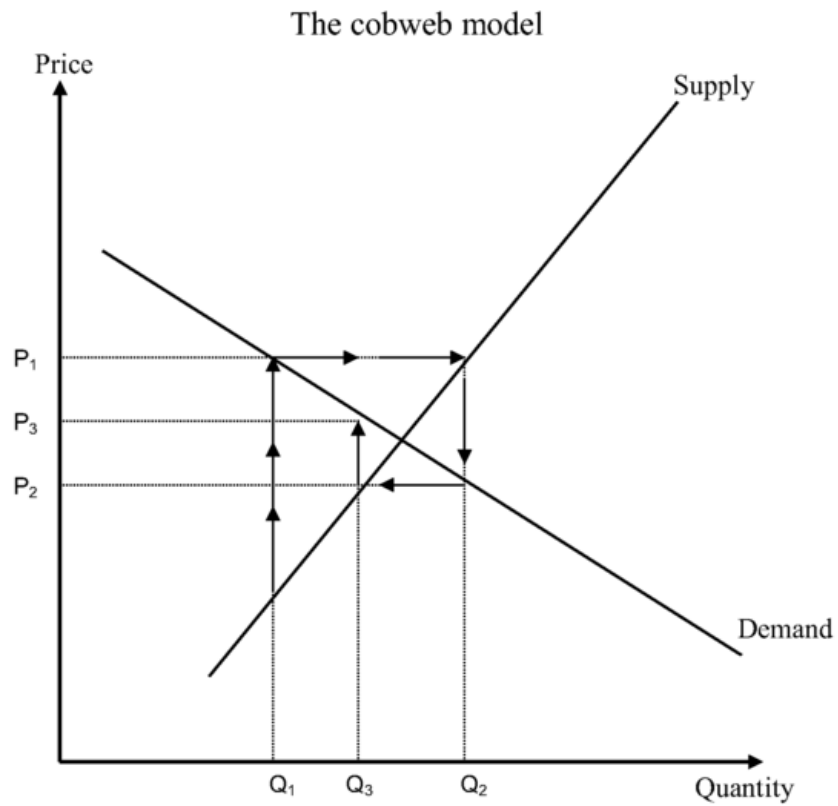
even though production lags. Thus production is increased when price is high, which in turn creates over production, driving price down; then, when price is low supply is decreased, which in turn creates a period of supply not keeping track with demand. Pork production has historically followed a Cobweb-type economic model. The biological production lag or time between when the producer intends to produce and when the actual production is available tends to lead to decisions based on current conditions or predictions as opposed to actual supply and demand. Thus, when prices are high swine producers tend to increase production creating an over supply, which drives price down leading to producers decreasing production, hence reducing supply and driving price up. This pattern has been referred to as the hog cycle. The Cobweb economic model in its simplest terms assumes that pork producers cannot figure this out and adjust their production practices to compensate. But, there are outside influences, such as pig health, that have an impact on supply or consumer spending that can have an impact on demand and these factors are not very predictable. The pork industry definitely has Cobweb-type tendencies and this has defined the economics of pork production.

A layman's example of the how the Cobweb model is closely related to agricultural markets is outlined on Wikipedia's website, (http://en.wikipedia.org/wiki/Cobweb_model). Agricultural markets are thought to be good examples of where the Cobweb model applies, since there is always a lag between planting and harvesting.

The Cobweb process is illustrated in Figure 2.1. The equilibrium price is at the intersection of the supply and demand curves. Lower production in period 1 means supply

falls to Q_1 , thus price rises to P_1 . Producers then adjust their period 2 production or new producers enter the business with expectations that this high price will continue. When the period 2 supply comes in higher at Q_2 levels prices fall to P_2 levels. This process repeats itself between periods of low supply with high prices and then high supply with low prices, the price and quantity spiral inwards and the economy converges to the equilibrium price.

Figure 2.1 Cobweb Model



The Cobweb model gets its name from the combination of the spiral and the supply and demand curves that oscillate back and forth “What the Cobweb example shows is that if supply decisions are based on current price, and there is a delay between the decision how much to produce and the sale of that production then prices can fluctuate even if supply and demand is stable. Will "rational" producers base their decisions on the current price?” (<http://william-king.www.drexel.edu/top/prin/txt/eqapps/cob4.html>). In agriculture, many of the factors that will impact future supply, demand, and price are not known at the time production decisions have to be made. Producers are left to make predictions regarding demand and price in order to determine supply intentions. The Cobweb theory simply suggests that lagged production and outside influences have an affect on price, supply, and demand, and because they are unpredictable there will always be fluctuations. This economic model provides the background and explains what has become known as the hog cycle in the swine industry.

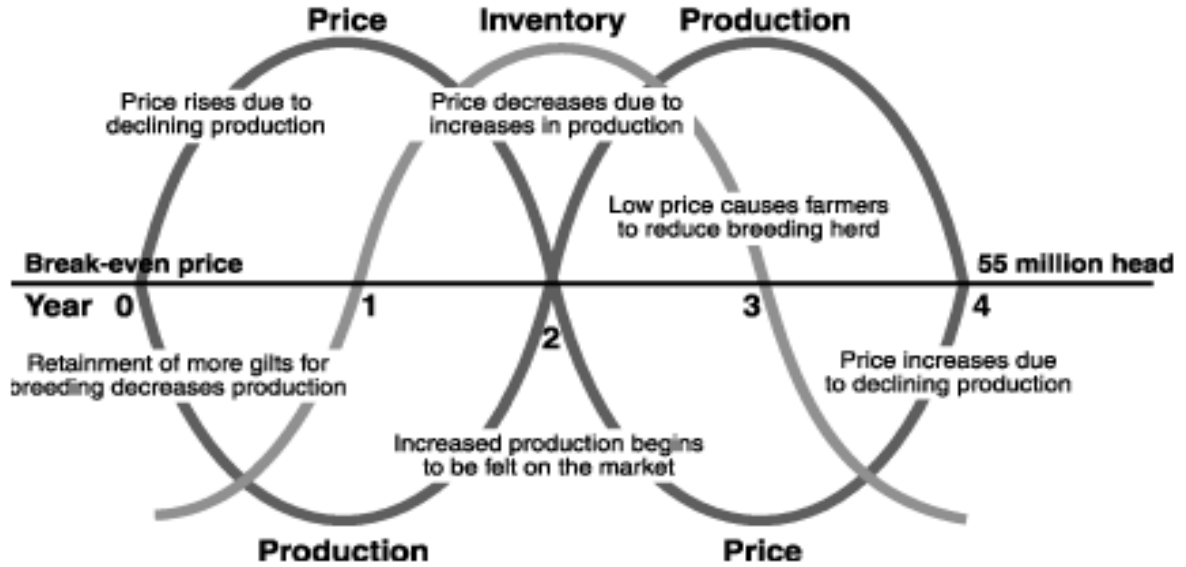
2.2 The Hog Cycle

In the swine industry, prices cycle due to influences other than just the U.S. supply and demand. In a January 1996 article (Hog Market Cycles), Stearns and Petry indicated that the U.S. hog industry historically cycles approximately every four years, averaging two years of accumulation followed by one to three years of liquidation. Just as the Cobweb model would suggest, Stearns and Petry indicate that the U.S. hog industry has historically been characterized by cyclical variations in hog inventories, pork production, and hog and pork prices. They define a cycle as “a production or price movement that tends to last a certain number of years and repeats that pattern over a long

period of years” (Stearns, Petry, January 1996, EC1101). Inventory cycles experience periods of increasing numbers or accumulation and periods of declining numbers or liquidation. Price cycles are either periods of increasing prices or periods of decreasing prices. “Price cycles tend to be the opposite of production cycles, but turning points may not occur at identical times.” (Stearns, Petry, January 1996, EC1101).

Figure 2.2 illustrates a theoretical four-year hog inventory, pork production, and hog price cycle with two-year accumulation, liquidation, increasing price, and decreasing price phases. This theoretical hog cycle as defined by Stearns and Petry (Stearns and Petry, January 1996, EC1101) assumes in year one that price is above costs of production which causes producers to decide to increase inventories. In year two increased production from the now larger breeding herd inventory and no overall change in demand forces prices to decline. By year three, production has increased to the level where prices fall below cost of production levels and producers decide to reduce herd inventories. As producers liquidate inventories an even larger supply is put on the market. During year four, production declines and prices increase to the break-even point where the cycle began and the process repeats.

Figure 2.2 Hog Cycle



This cycle has been well documented in the United States. In particular, “During the past 50 years, 12 cycles have occurred averaging 4.08 years in length, with a range of two to six years” (Stearns and Petry, January 1996, EC1101). Stearns and Petry go on to show that the 1989-1992 U.S. hog cycle consisted of one year of liquidation (54 million head) and three years of accumulation (54.5 million, 57.7 million, and 58 million).

The swine industry in the U.S. historically experienced these cyclical fluctuations in price and inventory because producers could easily enter and exit production. Their production systems were outdoor lots with minimal fixed costs while variable costs like the price of grain provided the incentive to exit or enter production. However, the swine industry in the U.S. has evolved and changed over time, producers today tend to have considerably more capital invested in fixed assets, meaning more of their costs are fixed and even as variable costs fluctuate there is less incentive to exit and reenter the business.

While there still are variations in farm size and types of production systems, the majority of the industry has invested in production systems that produce consistent hog numbers week in and week out. Swine production systems in the U.S. tend to be large to take advantage of economies of scale and often are diversified beyond just pork production to take advantage of economies of scope. Consider that the largest pork producers in the U.S. today would include companies such as Smithfield, Cargill, and Tyson, all large integrators that are diversified. In today's environment, consolidation seems more likely than liquidation since the assets are already in place. In the most efficient economic environment, older, less efficient production systems would be liquidated when prices are low to allow supply to decrease to meet demand.

Since Canada uses U.S. commodity markets for price discovery, international exchange rates can be an outside influence that creates hog cycle fluctuations. This means that the hog cycle will still occur, but now on a more global or regional scale rather than as a national cycle. Considering the North American landscape of pork production in 2007, input costs being higher than hog prices suggested a period of liquidation of inventory was due. Given that a period of liquidation is always followed by a period of high demand and high price, and given the time lag in production, the time to enter the industry or consolidate is during liquidation. Exchange rates were causing good, efficient Canadian production systems to be less competitive than some less efficient U.S. systems. Industry wide there needed to be some liquidation; however in this unique case newer more

efficient systems production systems were being devalued because of geography and trade issues.

In a 2007 article titled “Where has the hog cycle gone?” Steve Meyer of Paragon Economics, Inc. outlined the four factors that have historically driven the hog cycle: 1) easy entry with low capital requirements and a cost-free exit, 2) time lags, 3) atomistic production, and 4) resource availability. He goes on to suggest that things are different now mainly due to the size of hog operations and more limited market opportunities. Dr. Meyer argues that entry is now difficult and to exit the industry is expensive. Producers “are in the business to make money from selling carcass pork, not for adding value to excess corn.” (Meyer, 2007). These points are valid and in the U.S. it is difficult to understand why producers should expect to experience the same hog cycle in the future. Within the United States it is more likely that we will see the hog industry continue to consolidate with fewer and fewer larger producers. However, even the largest U.S. pork producers have begun to think globally and expand outside of the U.S.

In today’s landscape, corn, the major input cost for pork production, is being used to produce fuel as well as feed for hogs. This factor alone has changed the cost structure of raising a pig to market weight. It requires approximately 10 bushels of corn to raise a pig to market weight, implying that for every \$1.00 per bushel increase in the price of corn the cost of producing a market hog is increased by \$10.00 per head. The revenue per market hog must keep pace with such increased costs. North America has the best infrastructure, access to capital, and the natural resources available to producers, which allows it to

produce pork efficiently and export the product all over the world. Demand, in this case export demand, has kept U.S. prices high and reduced the incentive for cutting back production. In addition, for the first time since the 1960's the currency exchange rate in Canada has been at par with the U.S. dollar. These two factors are driving the North American hog cycle: higher input costs combined with at par exchange rates have increased export demand for U.S. pork and are causing Canadian production to contract.

The hog cycle is driven by supply and demand and there is a pretty clear price cycle depicted in Figure 2.3. A couple years of higher prices followed by a couple years of lower prices happens repeatedly, with three straight years of declining prices indications are that prices should be at or near the bottom and should begin to spike up. Figure 2.4 shows that U.S. hog slaughter has increased only recently in 2007 and 2008 compared to the previous five-year average. Figures 2.5 and 2.6 clearly show that the U.S. export markets have increased in recent years and 2.6 indicates that U.S. packers have not imported more carcasses. The Canadian industry as shown in Figure 2.7 on the other hand was built to export pork, in this graph exports are shown as a negative only to depict that they are leaving Canada. Canada expects to export pork and as long as the exchange rate is favorable the pigs get slaughtered in Canada. When they no longer have an exchange rate advantage, the pigs get shipped to the U.S. to be slaughtered and the U.S. exports the pork products. These charts might suggest that there really has not been any increase in demand for pork; although U.S. exports are up, Canadian exports are down and Canada is liquidating inventories because of over supply, high costs, and low prices. Low prices for

three years suggest over supply and given the hog cycle trends the industry needs some liquidation.

Figure 2.3 North American Hog Prices

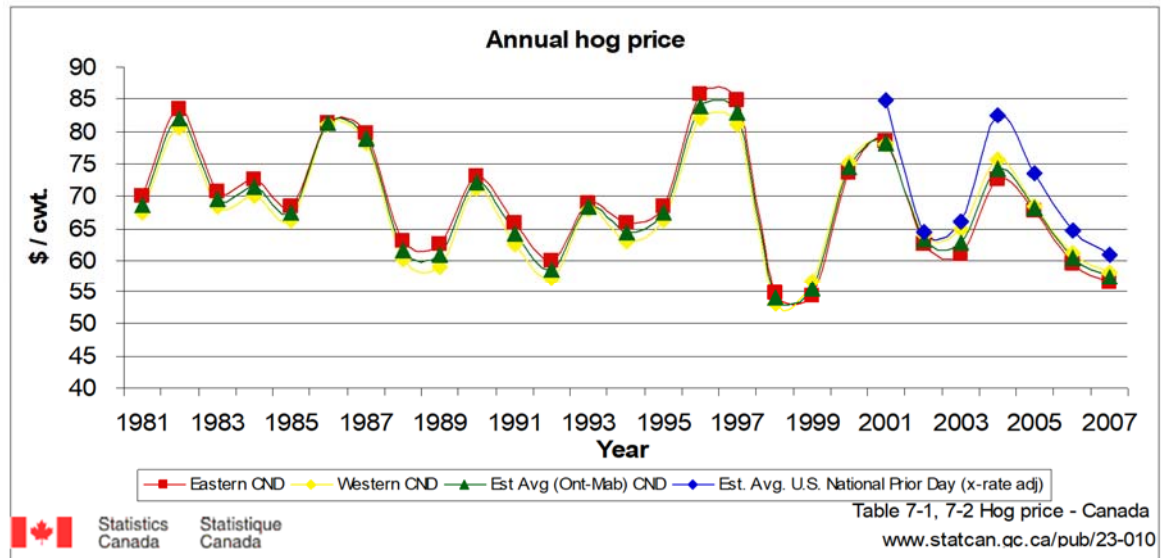


Figure 2.4 U.S. Hog Slaughter

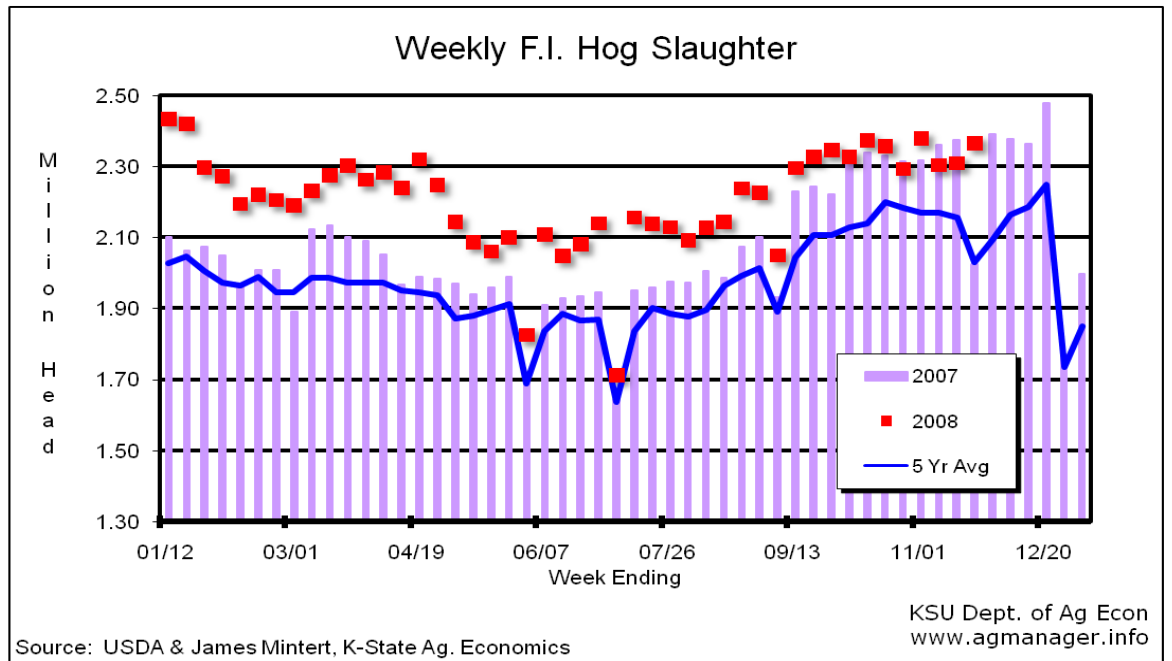


Figure 2.5 U.S. Pork Exports

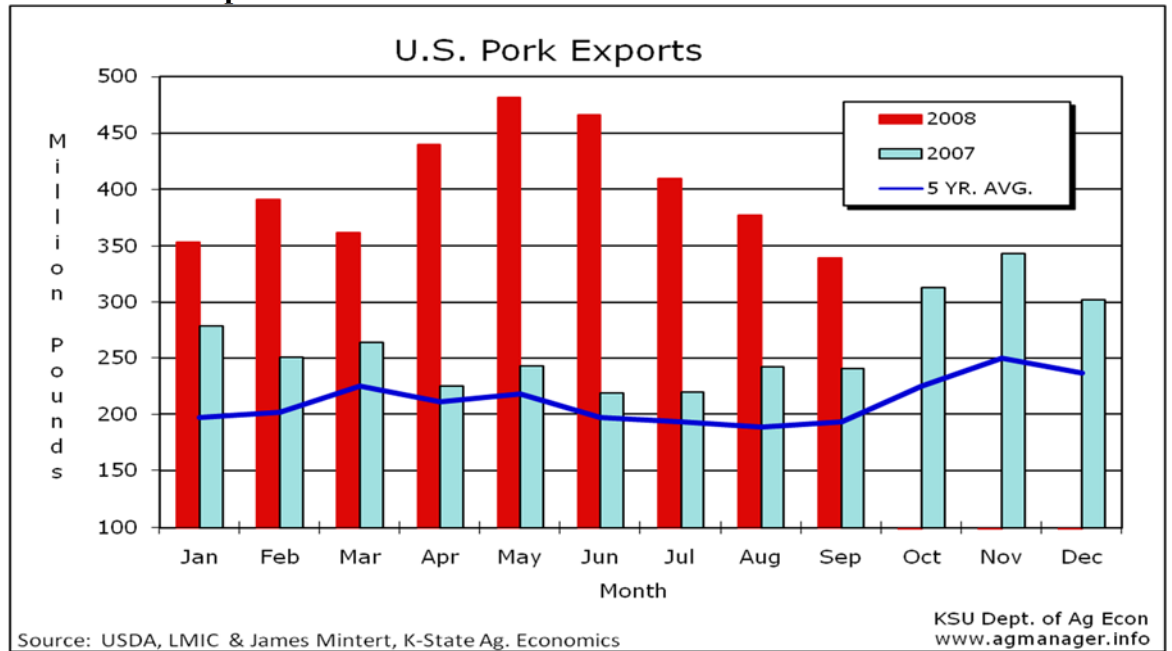


Figure 2.6 U.S. Import / Export Data

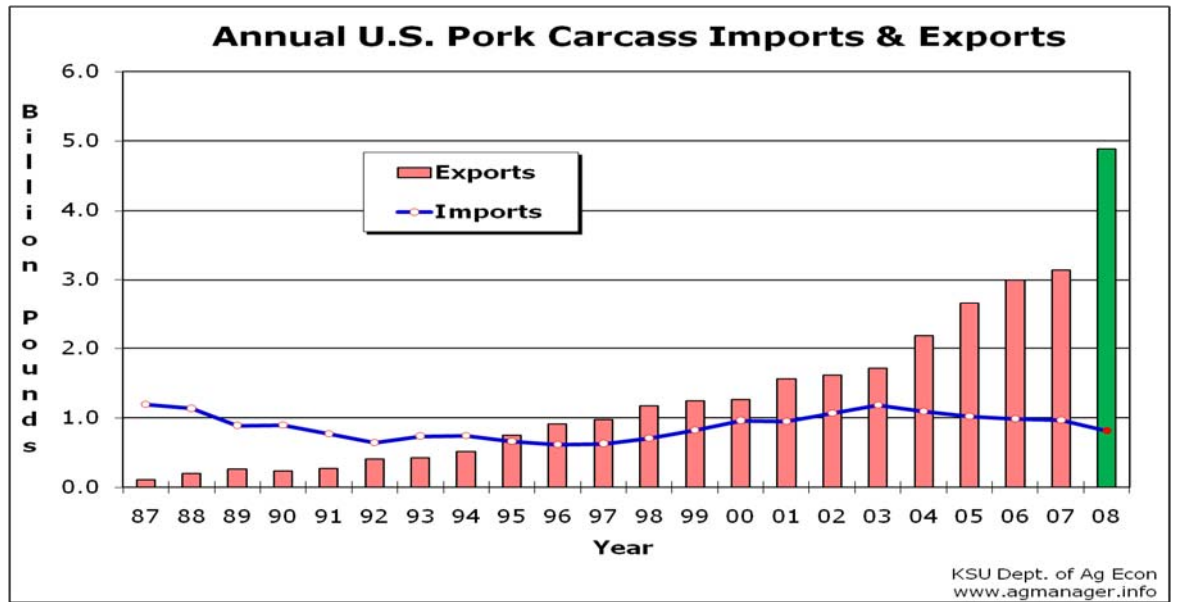
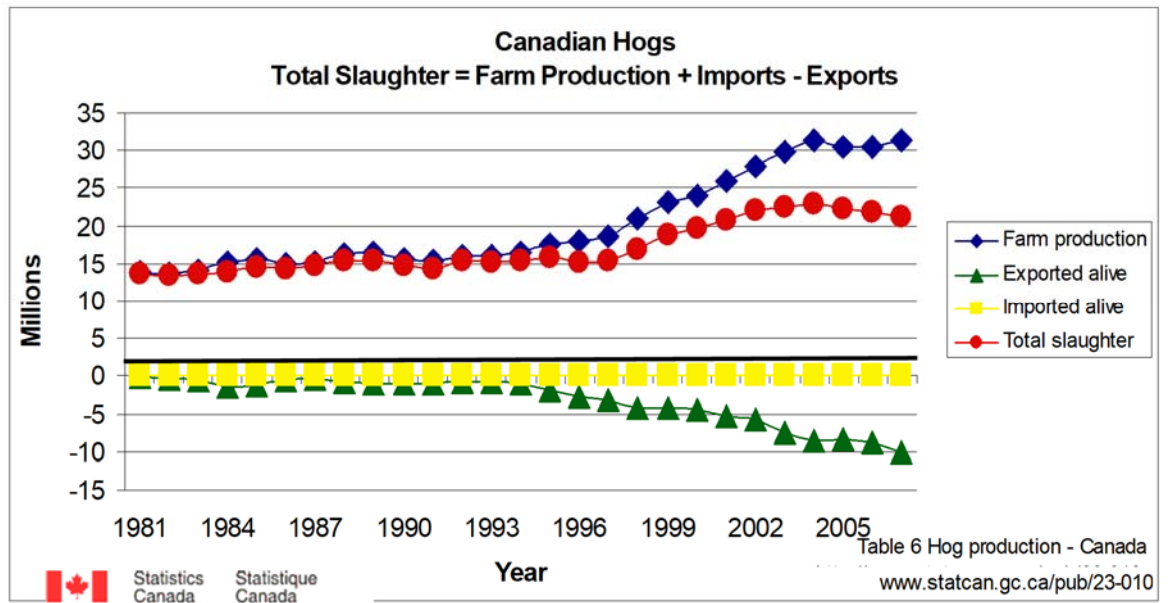


Figure 2.7 Statistics Canada



The typical low prices caused by over supply in the hog cycle have not been as noticeable to U.S. producers, mainly because the Canadian producers have taken most of the hit while U.S. exports have increased. In 2007 and 2008, the Canadian government offered producers financial incentives to liquidate sows. The program required that producers take sows out of production for a minimum of three years. During the same period (2007 – 2008), U.S. packers slaughtered above average numbers of hogs compared to the previous five-years (Figure 2.4) and exported above average amounts of pork during the same period (Figure 2.5). COMPANY believes that the hog cycle is actually tied to the markets used for price discovery not geographical borders. Because Canada bases their commodity prices on U.S. markets and then adjusts them using exchange rates, Canada's price should always be calculated into a North American supply and demand curve. In other words, the U.S. industry has historically viewed supply and demand based on U.S. inventories and prices; but, since Canadian production is tied to the same price discovery markets and since exports customers for both countries are similar, the hog cycle should be viewed as a North American cycle.

If supply exceeds demand for North American pork, price will go down until supply contracts and less pork is produced, thus driving price back up. Supply is influenced by both U.S. and Canadian production and inventories. Demand is also influenced not only by U.S. and Canadian domestic consumption but by global consumption of pork. When U.S. and Canada exchange rates favored Canadian pork, the net effect was higher Canadian export numbers. When the U.S. and Canadian dollars are

equal or favor the U.S., the net effect is increased U.S. exports. Even as cost of production fluctuates, it does so across North America, not just in one country. There may be variation, but overall, if commodity prices trend up or down they do so together. An example is a common formula used to establish the base price for market hogs in Canada:

$$\text{Base Price} = \text{Average Chicago Mercantile Exchange Constructed price} \times 1.8204 \times \\ \text{Average Bank of Canada noon hour Canada/U.S. dollar exchange rate.}$$

The CME Constructed price is the weighted average price calculated from the national Daily Direct Hog Prior Day Report – Slaughtered swine price published by the U.S. Department of Agriculture using the average net negotiated price. The 1.8204 is the industry standard calculation used to compare head-on versus head-off carcass weight. The noon hour Canada/U.S. dollar exchange rate is reported daily by the Bank of Canada.

The U.S. markets used for commodity price discovery influence the hog cycle as well as both U.S. and Canadian supply and demand. Based on historical trends and because there is a production lag in swine production, entering the industry when prices are at the bottom, and there seems to be an oversupply of hogs, should mean that prices will be better when pigs are ready to market. COMPANY believed that the liquidation occurring in Canada was due to an over supply of hogs across North America. As inventories declined, demand for North American pork would increase and thus price would increase.

2.3 The Exchange Rate

For most of the time since the 1970s it has cost more than one Canadian dollar to purchase one U.S. dollar. However, in September 2007 for the first time in more than 30 years the Canadian dollar was at par with the U.S. dollar. Figure 2.8 tracks the historical U.S. / Canadian exchange rates. This is an important change to Canada as a whole, because the Canadian economy, and especially the Canadian swine industry, is so heavily reliant on exports. Canada's main trading partner is the United States. According to an article published by the Bank of Canada, "When the value of the Canadian dollar is low, imported goods become more expensive, and we tend to reduce the volume of our imports, at the same time, other countries will pay less for some of our products and that will tend to boost export sales" (Bank of Canada, The exchange rate, April 2006). Figure 2.9 illustrates what has happened to the exchange rate in 2008. Since September 2007 it has only cost approximately one Canadian dollar to purchase one U.S. dollar. One would think that the ideal time for U.S. investment in a Canadian business would be when the U.S. dollar was strong; i.e., the dollar would have more purchasing power. However, when the U.S. / Canada exchange rate moved to par the swine industry in Canada suffered. The inputs are based on U.S. commodity prices, the hogs sold are based on U.S. price discovery and the Canadian costs structures had been established at much different exchange rates. The net affect of this was that Canadian assets were now being under valued as compared to U.S. equivalent assets. Even at a par exchange rate the value received versus the dollars required to acquire Canadian swine assets were not comparable. These assets could not have been acquired at this value when the exchange rate was at its normal levels. For

example a \$1,000,000 asset when the exchange rate is par is worth a million U.S. dollars and a million Canadian dollars. That same asset when the exchange rate was \$0.80 U.S. to \$1.00 Canadian would have cost 800,000 U.S. dollars (i.e., \$200,000 U.S. less). Because these assets were built to supply export product into the U.S. and because of the liquidation occurring in the swine industry, the exchange rate, and the overall state of the swine industry, Canadian banks were reluctant to value swine assets at all. Thus, the same \$1,000,000 asset could be bought for pennies on the dollar, assume \$0.30 on the par dollar, a savings of \$700,000 U.S. and \$500,000 CAD better than the previous exchange rate levels. One of Dr. Meyer's criteria for having a hog cycle was that producers could enter the industry with minimal capital requirement. The state of the Canadian swine industry in 2007 and 2008, along with the at par exchange rate, provided for just such an opportunity, with minimal capital investment and at levels far below what it would have cost in the United States.

After studying historical exchange rates, it is apparent that the U.S. dollar has either been at par or worth more than the Canadian dollar. Figure 2.8 shows that in nearly the last 100 years the Canadian dollar almost has never been worth more than the U.S. dollar. When it has occurred historically it did not last long and stayed very close to par. Thus, there is very little risk that the assets purchased at bargain prices during a par exchange rate will actually be worth less in either U.S. or Canadian terms in the future. In other words, there appears to be minimal downside risk.

Considering that COMPANY's business model is to plow dollars back into any business venture for growth and that the Canadian swine industry was liquidating due to over supply, the company set out to identify and acquire Canadian assets. U.S. swine assets had not experienced the same decline in value because U.S. pork export numbers were at record highs. Canadian assets were valued extremely low while new U.S. construction or the purchases of U.S. assets were considerably more expensive. Each U.S. dollar moved over to start the Canadian branch will still be worth one U.S. dollar but in Canadian terms that dollar will grow to be worth \$1.20 as the exchange rate goes back to historic levels. This is important because Canadian lenders will value the branches assets at higher values in the future which increases the branches access to capital and provides opportunity for growth. The buying power in Canada compared to the buying power in the U.S. at the time was completely opposite. There were few buyers in Canada and many sellers, while in the U.S. there were few sellers and many buyers wanting to expand. Moving investment dollars into a Canadian branch when the exchange rate was at par and the industry is in liquidation mode virtually guaranteed that in time that investment would appreciate in value for the branch. In addition, because commodity prices in Canada use U.S. markets multiplied by the exchange rate to determine price, every commodity sold when the exchange rate adjusts back to historical levels, will be at U.S. equivalent values for the branch.

Looking at the historical data in the last one hundred years the Canadian dollar has either been at par or worth less than the U.S. dollar (Figure 2.8). Starting in the fall of 2007

the two were basically equal or at par (Figure 2.9). The par exchange rate in 2008 created losses for pork producers that had built their business expecting an exchange rate adjustment for the hogs they sold. A hog worth 100 Canadian dollars at a par exchange rate would be worth 120 Canadian dollars at a more historical \$0.80 exchange rate.

COMPANY saw this exchange rate as an opportunity to invest in business assets in Canada that were currently under valued with the expectation that these asset values would correct over time. In addition, borrowing Canadian operating dollars to run the operations on either side of the border allowed for potential advantages that U.S. lenders could not offer. There is little risk of the Canadian dollar becoming worth more than the U.S. dollar and a strong historical precedence that it will actually weaken as compared to the U.S. dollar. Basically this allowed for the input costs and revenues for hogs to be locked into U.S. values and the assets to be purchased below U.S. standards.

Figure 2.8 U.S. - Canadian Historical Exchange Rate

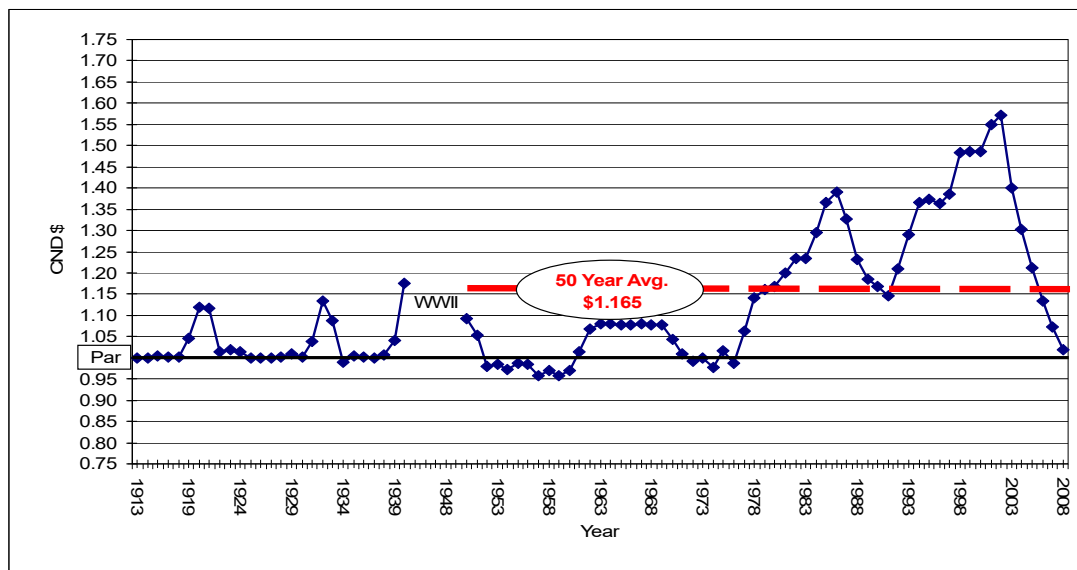
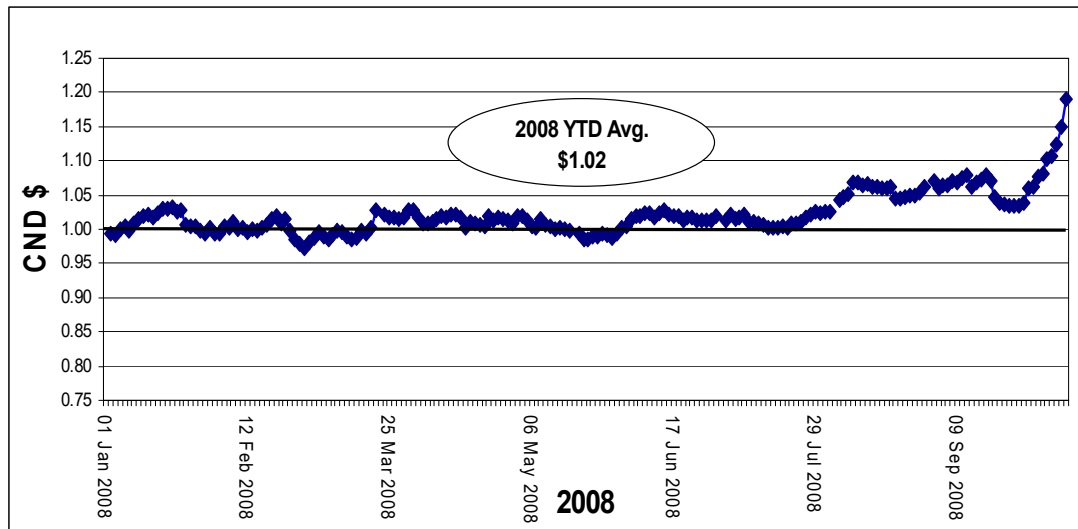


Figure 2.9 U.S. - Canadian 2008 Exchange Rate



2.4 COOL “Country of Origin Labeling”

Country of origin labeling (COOL) is potentially a threat to owning Canadian hogs since it has the potential of increasing costs across North America and may act as a trade barrier between U.S. and Canadian pork. COOL requires retailers to label pork products according to their country of origin. Four ways pork products could be labeled are: 1) U.S only (born, raised, and slaughtered in the U.S.), 2) U.S. – Canada (born in Canada, raised and slaughtered in the U.S.), 3) Canada – U.S. (born and raised in Canada, slaughtered in the U.S.), or 4) Canada (born, raised, and slaughtered in Canada). This will require producer affidavits, packer tracking and traceability of carcass parts, and proper retailer labeling. All of this will require investment and potential inefficiencies throughout the pork chain. In October 2008 COOL was implemented for all fresh pork products sold in the U.S., however, the requirements and penalties associated with implementation had been

relaxed compared to the original requirements. The form of COOL that was implemented has fewer label requirements and producers are able to sign affidavits that represent origin as opposed to animal identification and specific tracking systems. Canada and Mexico have already filed complaints with the World Trade Organization that suggest COOL is a trade barrier. Thus COOL may not have the major cost impact on the North American market as it once threatened to cause. COOL however does have the potential of restricting imports of Canadian hogs into the U.S., at least temporarily, even though there is no real evidence that consumers will pay more for U.S. only pork or that it is in any way safer than pork from Canada. Packers and retailers in the U.S. do not want to add inefficiencies into their systems. Thus, the only guarantee involved with COOL is that it will increase the cost of producing and processing pork across North America.

With the threat of COOL potentially restricting market access of Canadian hogs and if a reduction in supply is required to reestablish equilibrium in the hog cycle, then the expectation is that hog number reductions are more likely to come from Canadian producers than from U.S. producers. This makes the objective of COOL appear to be no more than an unfair trade barrier. In an effort to provide some “made in the U.S.” price advantage, COOL increases the cost of production for the entire value chain without a clear method for recapturing those costs. Thus COOL is an outside influence that will affect the hog cycle. However rather than reducing the number of less efficient and less productive swine producers, this legislation appears to intend to eliminate only non-U.S. producers. The shareholders of COMPANY believe that the economy itself and the hog cycle would

have achieved a more logical and similar result, liquidation of the least efficient hog numbers to reach equilibrium in the hog cycle. The way it stands COOL threatens to reduce the number of hogs coming in from Canada, because there will be fewer producers left in Canada. This shift has the potential of changing the hog cycle for North America. Either way, COMPANY positioned itself to deal with COOL as it unveils itself. As a member of “A” Cooperative, COMPANY has an ownership stake in a U.S. packer, thus solidifying its ability to at least market hogs in the U.S. and because of the geographic location in Southern Province, COMPANY has market access to four Canadian packers. This does not mean that all hogs produced in Canada will be destined to a U.S. packer; rather, it means that all options will remain open to COMPANY and economics will dictate where to market hogs and sell pork.

2.5 Globalization

The global demand for pork has kept export markets viable, while the infrastructure and resources available in North America keeps the production of pork cost effective compared to other parts of the world. The U.S. and Canada have the infrastructure and expertise to be extremely efficient in the production of pork. While other parts of the world may have similar resources, it is not likely that North American pork production will be replaced any time soon. Thus, the reason for creating COMPANY and setting it up as a North American pork producer was based on the shareholders belief that the economics of the industry are sound and that there is a long-term market for the products that it will produce.

The rationale for entering Canada was based on economics and opportunity. The Canadian swine industry expanded in the late 1990's following a major expansion and consolidation of the U.S. swine industry. Canada offered geographical separation and high health alternatives that were difficult to find in the United States. Canada grew its swine industry with the intentions to export much of the pork it produced based on an exchange rate of \$0.80 U.S. equaling \$1.00 Canadian. Canada bases its commodity price discovery on U.S. markets and because of the favorable exchange rate was able to spare little expense in the construction and management of the swine industry. Canada experienced years of growth and prosperity while the exchange rate favored Canadian pork for export.

However, when the U.S. dollar declined in value and the exchange rate moved to par, the Canadian producers struggled to adjust and thus their industry is in decline. Producers are exiting the business, packers struggle to compete with U.S. packers, lenders under value swine assets, and now input costs across North America are on the rise. The ethanol boom in the U.S. is having an affect on the costs to produce pork in North America, which may cause some liquidation of the U.S. production system. Canadian packers have already scaled back numbers and plants due to exchange rates and labor costs. U.S. packers have expanded their numbers to answer the increased export demands. The weak U.S. dollar has actually pulled export sales of pork products from Canada to the U.S. such that the U.S. has not experienced the downward portion of the hog cycle. On the other hand, Canada has taken on the entire burden of the down side of

the cycle. However if the hog cycle is a North American cycle driven by both domestic and international factors it will eventually affect the North American market as a whole.

In an article, “Pork Packing Sectors See Constant Change” by Steve Meyer, September 15, 2007, a significant decline in Canadian slaughter capacity with a steady to slight increase in U.S. capacity is documented. In the article, Dr. Meyer outlines the expansion of U.S. packing capacity from 2006 levels to 2007 levels, a 5,660 head per day increase, while the Canadian packing industry decreased during the same period by approximately 16,260 head per day. The net effect on producers is 10,600 fewer shackle spaces per day in North America. This reduction of space to slaughter hogs, in conjunction with the effects of COOL, as well as higher input costs driven by ethanol demand for corn, suggests that a down turn in production is inevitable. Even increased U.S. export demands as shown in Figure 2.5 will not overcome the potential over supply of hogs in North America. Based on these data, COMPANY believes that the hog cycle does exist and that consolidation will happen in the short term, where older less efficient production systems will be forced to shut down as the market attempts to reach equilibrium. Ultimately, despite COOL and given the historical exchange rates, it should be less efficient production that liquidates. Even with imposed barriers such as COOL, the hog cycle should be considered a North American hog cycle and over time economics will consolidate the industry. Continuing to see the industry defined by borders distorts the overall market and COMPANY expects to see continued consolidation of the swine industry across North America into more efficient systems.

The article “Perfect Storm Converges on Struggling Industry” by Kevin Grier, January 15, 2008, outlines the various factors facing the Canadian pork industry: exchange rate crunch, feed cost challenge, packer challenge, and now losses have taken a toll on producers. “Going forward, prospects for Canadian pork producers do not look promising, at least through 2008” (Grier, K. , January, 2008). In December of 2007, the futures markets were lined up against the already struggling Canadian producer. U.S. prices were projected to average \$X/cwt. on a carcass basis for 2008. At the projected par exchange rate, and using Canadian pricing formulas, that translated into below breakeven prices for Canadian producers. This article outlined why a North American Hog cycle exists and describes what is happening in the swine industry. Liquidation is occurring in Canada even though it may not be as evident in the United States.

Figure 2.7 shows how the Canadian swine industry grew rapidly in the late 1990’s, following a similar type of growth that had occurred in the U.S. The weak Canadian dollar allowed Canadian producers an advantage when they exported pork products. Figure 2.7 shows the total annual slaughter numbers in Canada compared against the on-farm production. Canada imports very few hogs each year. The number being exported or expected to be exported allowed for the Canadian expansion. This made for a profitable scenario so long as the Canadian dollar remained weaker than the U.S. dollar and the efficiencies of North American production were in place. However, as outlined in the Perfect Storm article by Grier, when the exchange rate went against the Canadian

producers, the entire industry felt the impact because profitability diminished and the industry contracted.

The opportunity therefore was for COMPANY to establish itself on both sides of the border and to enter the industry at a time when the hog cycle and exchange rate allowed the most favorable entry costs. Geographically, Southern Province offered some economic benefit compared to Western Canada, it also is more strategic for a company based in State. Entering the industry when the exchange rate was at par and the industry was in decline would allow COMPANY to renegotiate with suppliers to get costs more competitive with U.S. standards. All inputs costs, fixed costs, and marketing arrangements would be adjusted to be competitive across North America. Entering the industry at a low point in the hog cycle offered the opportunity to acquire assets at bargain prices compared to the U.S. market.

As everything is lined up in Canada to create the perfect storm, everything is also aligned to create perfect opportunity for growth. COMPANY positioned itself to enter the industry during low price and over supply and at point where the exchange rate was at par, this created an overall reduction in the asset valuation that provided upside assuming that when the exchange rate trends back to historical levels or near historical levels the business would be positioned to capitalize and grow. The perfect storm also allowed COMPANY to immediately reestablish cost structures to be competitive in the North American market.

CHAPTER III: SUB ASSET ACQUISITION

In the fall of 2006 COMPANY announced its intention to scale back its swine production operations, in part by selling the Province assets of its swine production company. The herd health, management, and location (Figure 3.1) of these operations in southern Province made it a viable option for COMPANY. The timing for entering the industry aligned with the historical hog cycle and industry study that was completed. Geographically, the locations of these operations are east of the COMPANY offices and other shareholder production systems. The offices and farm locations in southern Province are located near (Figure 3.1). The climate and communities are similar to that of State, and the management team in place was experienced with common goals and had a desire to remain in place. The current management team had been maintained from a storied Province pork and livestocklivestock production company that was acquired by the shareholders of COMPANY had previously worked together and had business relationships in both livestock and swine production. The previous management team made it clear to COMPANY that they wished to continue managing and operating the operations that had originally been.

This opportunity, while complicated with border issues including tax consequences, legal differences, and currency exchange challenges, offered COMPANY the ability to consolidate within the swine industry. That is, COMPANY could expand the size of its swine operation to capture economies of size without increasing the total number of hogs

produced in the North American industry. The cost to acquire similar assets in the U.S. would have made the same project unrealistic. Considering the state of the hog cycle, consolidation rather than expansion is better for the overall swine industry and thus would not negatively impact the other assets of the COMPANY shareholders. The geographic location of these operations is ideal; COMPANY is able to coordinate with some of the other shareholder business entities, thus capturing efficiencies associated with economies of size and scope. The management team that was in place offered stability and the confidence of knowing that the operation would be managed properly and perform at high levels. COMPANY would enter the Canadian swine industry at a par exchange rate and with a full understanding of the cost disadvantages facing Canadian producers.

Figure 3.1: Province Opportunity

Figure intentionally removed

COMPANY will be managed and benchmarked not against previous Canadian production levels and costs but rather against North American costs and other COMPANY shareholder entities. The at par exchange rate and the state of the industry meant that production input costs such as feed milling, rent, and labor could be renegotiated to be competitive with these standards. Genetic fees, management, and IT systems could be immediately adjusted to be volume based and discounts applied across X sows. Packer agreements would start from the “A” requirement and could now be based on X market

hogs per year. Shareholders would participate in the overall management of the business and utilize all aspects of their other business units and experiences to hedge and manage the business. The business model is to develop a best cost production system; this former CSF system had all the pieces to achieve that objective. In January 2007, COMPANY began a year-long process of creating an international business structure and acquiring the production assets.

3.1 The International Corporate Structure

This venture for COMPANY required the company to establish a Canadian branch under a license to operate a corporation in the province of Province. This Canadian branch of COMPANY is referred to as COMPANY-CND. The first and most critical step to getting this project to completion required that COMPANY add a Canadian resource that could represent the company and be available on a daily basis to coordinate and manage the process in Canada. In May 2007 COMPANY presented a proposal to the current management outlining an asset purchase plan for a portion of their Province swine operations.

3.2 The Asset Evaluation Model

A spreadsheet model was developed to estimate real asset values. Table 3.1 shows the summary page from the model that established an expression of value for the assets. The current state of the industry and exchange rate were not factored into this model; rather the model provided COMPANY an understanding of the real value of these operations. The model allowed for inserting or removing individual assets since the seller did not own

X% of all their production systems. COMPANY worked with local real estate agents, facility engineers, and farmers in order to establish standards for the model. COMPANY used standard and known production criteria for the operations. The model estimated values for three criteria: facilities, land, and animal inventory. Land values were developed using recent regional real estate comparable sales data. Facility values were estimated based on cost to build new, age of facility, type of facility, and a standard depreciation schedule to arrive at a current estimate of value. Hog inventories were broken into active sow and litter values, cull sow value, artificial insemination (A.I.) boar value, and replacement gilt value. No weaner, feeder, or market hog values were included in the estimate of hog inventory value. The parties had agreed that all inventories outside of the purchased assets would not be a part of the transaction. All growing hogs in contract barns would remain owned by the original owner. In addition, it was determined that only 100% owned assets would be part of the final transaction, this eliminated about some sows that were under some type of partnership or contract scenario. COMPANY used these model-estimated asset values to calculate and determine a potential sale price, and to begin to develop cost of production expectations. Once the model was completed and the asset values had been estimated, outside factors were applied to develop an initial purchase price offer. The model estimated the some sow's value to be about \$X million, the some acres of farmland value to be \$X million, and the eight sow farms value to be \$X million. All estimated values assumed the business operations as a going concern and included all equipment associated with running the farrow-to-wean operations.

This process did not include financial modeling or the development of financial statements for the business. The shareholders of COMPANY and the management team of already operate and manage swine production companies. It was understood that the costs and revenues would need to align with current practices or North American standards. The process was focused on the asset evaluation. The value of the asset would play a key role in determining to ability to operate these operations as a cross border entity.

Table 3.1 Estimate of Asset Values

Table intentionally removed

3.3 Multiple Business Entities Formed

Once the assets were identified and the values estimated, the next step was to develop the partnership with the management group that was currently responsible for the management of these farms. This partnership was determined to be a critical component to the transaction. Having management people in Canada allowed stability to maintain the labor force that was in place to keep the farms operating. In addition, the management team brought a history of the farms and assets. They have proven performance numbers and brought local community integrity to the process. COMPANY and its shareholders were not interested in trying to manage a production system from a distance, thus it was decided that COMPANY would partner with the management team in the purchase of these assets. This international partnership was formed and became Sub, (Figure 3.2).

The corporate structure in Canada (Figure 3.3) evolved into multiple structures. Sub is the result of the work that went into determining how to enter the business in Canada. Sub is a partnership between COMPANY-CND and the previous management group. The Canadian branch of COMPANY (COMPANY-CND) is the majority partner in the Partnership (Sub) and a majority shareholder of a Canadian Corporation#, Inc.#, Inc., and is under contract to purchase 100% of the weaner pig production from Sub.

COMPANY made it known through a public announcement that they intended to sell operations, that represented about X sow spaces on multiple farms in Province. #, Inc.#, Inc. would purchase eight farm sites, approximately X sow spaces on X acres of

farmland, and rental farm houses. Sub Partnership would own the livestock inventory and rolling inventories (approximately X sows and nursing piglets, along with numerous trucks, trailers, and farm vehicles). In addition, the partnership accepted the grower contract obligations and labor force for the entire operation (Farrow to Finish). Sub Partnership leases the facilities from #, Inc.# and sells its weaned pig production to COMPANY-CND, plus provides management services to COMPANY-CND for the grower phase of the approximately X pigs produced per year.

3.3.1 Province, Inc.

The shareholders of COMPANY are obligated under their shareholder agreement to hold management positions within Sub. COMPANY has minority ownership in Sub partnership and #, Inc.# made up of five shareholders; each has experience and a working knowledge of the assets and the business:

Each of the above-noted shareholders held management positions with Province or had a relationship with the management of these operations. The shareholders were crucial in establishing this business; without the leadership or desire to take on ownership from this group COMPANY would not have proceeded with the acquisition. The structure allows the Sub management team to oversee the entire structure of Sub, #, and COMPANY-CND.

3.3.2 Sub Partnership

Sub is a partnership between COMPANY-CND and COMPANY with responsibility for the sow farm management, production and sales of the weaner pigs to

COMPANY-CND, and to provide production management and business services. Sub leases sow farms from #, Inc. This lease agreement requires that all costs, utilities, and maintenance are the responsibility of Sub. Sub is also a management service company that provides management services to COMPANY-CND, #, Inc.#, . These management services are contractual, fee-based arrangements that include labor, financial support, manure management, production performance, and employee relations. Sub, because of its partnership status, pays no taxes in Canada, the two corporations that make up Sub are each taxed according to their percent ownership. The partnership structure was established as part of the corporate tax planning process.

3.3.3 Inc.#, Inc.

Inc.# Inc. is an Province corporation that owns and leases properties under contractual arrangements. Tax laws in Canada restrict certain tax benefits from businesses that are not controlled by Canadian citizens; however, these tax breaks are available to corporations that are controlled through voting rights by Canadian citizens. Inc.#, Inc. was established as part of the corporate tax planning process, two Canadian citizens hold voting shares in the corporation. Inc.# will operate as a breakeven corporation that provides a tax advantage to its shareholders COMPANY-CND and COMPANY

3.3.4 Company - Canada

COMPANY-CND is a branch of COMPANY that has a license to operate in Province. It will have its own financials and maintain business operations in Canada. COMPANY initially funded the Canadian branch but going forward COMPANY-CND will operate as a wholly owned subsidiary of COMPANY with its own profit and loss

statements. Any transactions that occur in the U.S. are done as a separate entity, including any sale of feeder pigs from COMPANY-CND to COMPANY. COMPANY year end financials will roll up any profits or losses of its Canada entity into the companies' overall financials. COMPANY-CND is a majority partner in Sub and a majority shareholder in #, Inc.#. COMPANY-CND is under contract to purchase 100% of the weaner pigs produced by Sub. COMPANY-CND is under contract to use Sub management services for its operations in Canada. COMPANY-CND is under contract to sell about a third of its feeder pigs per year to COMPANY in the U.S. to be finished in the U.S. and sold to "A" to fulfill its membership requirement.

Figure 3.2: Sub Partnership Logo

Figure intentionally removed

Figure 3.3: Sub Partnership Structure

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As illustrated in Figure 3.3, the corporate structure involved in setting this system up was complicated and required much study and understanding of corporate law and tax implications. This structure achieved the requirements of COMPANY, it allowed for business growth in the swine industry without expanding the North American total numbers as these hogs were already in place. It allowed COMPANY the opportunity to grow at a time that potentially takes advantage of the current hog cycle and allowed for growth at a time when the exchange rate allowed asset purchases at reduced rates. It provided the opportunity to partner with a group that is skilled in leadership and business management, that have a proven track record in production excellence, and that are committed to their local community.

Sub partnership allows COMPANY to strategically align with a sow base in Canada that has exceptional reproductive production performance, is known for its high health and sow productivity, and has market access to four local Canadian packing plants. Finishing production efficiencies have been negatively impacted by exchange rates and the cost of inputs. Grower contracts, feed agreements, and all vendor relationships will be benchmarked against North American standards. A strong sow base in Canada however provides for a consistent flow of high health weaner pigs. The ownership position of COMPANY in the Canadian businesses allows for security both in pigs and in management of the sow base. Sub will be run as the sow base with a clear focus on reducing the cost to produce weaner pigs; it will also provide management services to

COMPANY-CND and other production systems in Province. Sub will focus on becoming a best cost producer as compared to North American production standards.

CHAPTER IV: SUB INTERNATIONAL PARTNERSHIP

After months of planning and negotiating, the business was purchased and began operating as Sub partnership 2008. The due diligence process was completed in December 2007. There were multiple legal issues required to complete this process including corporate structure, human resource issues, payroll, taxes, grower contracts, and confidentiality agreements. The Partnership invested in attorneys, certified public accountants, and tax consultants on both sides of the border. The first year focused on startup issues and establishing best business practices. The process included renegotiating virtually every contract and agreement that was in place. Management has been focused on achieving North American costs standards as defined by other shareholder entities. The staff of Sub has been focused on herd health and production efficiencies. Ownership has worked to combine common business functions and establish strong business relationships.

On 2008 Sub and #, Inc.#,Inc acquired the assets that included sow farms, land, rolling stock, sow inventories, and the hiring of employees. Everything from the computer system to the office space needed to be converted to Sub. There were approximately X head of pigs in contract nursery and finishing barns still owned by COMPANY when the acquisition was complete. Sub was responsible for renegotiating all the contract grower agreements to align with North American standards. When the original grower contracts were signed in Province the exchange rate was at \$0.X and the industry was in a growth phase. This allowed the previous owners to agree to terms that were much higher than

similar agreements in the U.S. and across North America. The feed agreements were similar as they had excessive costs built in that put the average cost per ton out of standard compared to shareholder owned feed milling operations. COMPANY-CND established a Canadian line of credit for purchasing and building its inventory from 0 to X pigs on feed in nursery and finishing after the sale. This line of credit extended to pigs on feed in either the U.S. or Canada. Supplier and vendor agreements all were evaluated and compared against other shareholder standards and renegotiated as required. In the first year of production as much as \$X per pig marketed was removed from the total cost of production through these renegotiation efforts.

As start up companies, Sub and #, Inc.#, Inc both sought and received long-term loans on the assets purchased in January 2008. This financing was needed to acquire and run the on-going business operations of weaned pig production. This process involved creating pro-forma financial statements and making bank presentations.

4.1 Pro-Forma Financial Statements to Secure Financing

The original Sub pro-forma financial statements did not account for the final business structure that included #, Inc.. To begin the process it was determined that all weaned pig production from Sub would be sold under contract to COMPANY-CND. This established revenue for Sub immediately after the acquisition was complete. In addition, COMPANY agreed to use Sub management services for animals still owned after the acquisition, this provided a second immediate revenue stream for the partnership. It is unusual for a start-up swine production business to have immediate revenue with very little

upfront investment, thus the pro-forma financial statements are positive for Sub. These pro-forma financial statements were developed for lenders during the acquisition process. The financing of these operations and the financial statements focused on reducing costs compared to the previous ownership. Much thought and study was dedicated to corporate structure and tax planning and their impact on the final financial analysis of the businesses.

Prior to finalizing the corporate structure the pro-forma financial statements were prepared and presented to several Canadian banks to secure the long-term debt required to purchase the assets and start the business. Long-term debt for the project was originally estimated at approximately \$X million (Canadian dollars), or about X% of the estimated asset purchase value of approximately \$X million. These financial statements do not include any COMPANY-CND requirements, including a \$X million line of credit for growing the finishing pig inventory. The pro-forma financial statements were finished before the negotiations with COMPANY were actually complete and thus the actual financials look very different from these early projections. However, developing these pro-forma statements allowed Sub and #, Inc. to secure financing and complete the acquisition.

The pro-forma balance sheet (Figure 4.1) lists the inventory, land, and facilities all as assets, this overstates what actually transpired because #, Inc. actually purchased the land and facility assets and leases them back to Sub. There are two purchase price adjustments made that are shown as liabilities, these adjustments were made as part of the negotiations for accepting the COMPANY grower contracts and feed contract terms that were over priced, COMPANY adjusted the purchase price as an offset. The net income

and loss estimates were calculated using previous year's performance when the operations were part of COMPANY and include projected principal paid toward long-term debt.

The pro-forma income statement (Figure 4.2) has four forms of income, weaned pigs sold to COMPANY-CND, cull sows, maternal barrow market hogs, and rent. The rent does not account for #, Inc.. The income statement nets out the overhead, this was done because the revenues from management fees collected from COMPANY-CND and COMPANY offset any costs associated with the office staff and office management. This was necessary since Sub staff all came over to Sub after the acquisition even though COMPANY still had pigs on feed and COMPANY-CND has no employees to manage their pigs on feed. COGS are based on previous years data provided during due diligence. These pro-forma statements are summaries of the detailed financial analysis done to provide COMPANY-CND, COMPANY, and lenders confidence that Sub could operate the business profitably.

The pro-forma financial analysis provided a starting point for completing the acquisition; however, the actual values at closing were much different. The asset values were adjusted after the lender assessment of the properties, exchange rates, and the state of the swine industry was completed. Because of the state of the industry and the hog cycle, the lenders were reluctant to value swine assets at the model estimated rates. The land and facilities were devalued in the final negotiation with COMPANY to account for this "state of the industry" adjustment. The pig inventory was valued only at cull value. Thus the actual long-term debt, owner equity, and inventory values are greatly reduced from these

original pro-forma statements. The state of the hog industry changed the purchase price from the model-estimated values depicted in Table 3.1. In addition, using the futures markets and developing projected cost models allowed for purchase price offsets in lieu of accepting the feed contract and the grower agreements. This offset did not preclude Sub from also renegotiating these agreements immediately after the acquisition.

Table 4.1 Sub Consolidated Pro-Forma Balance Sheet

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Table 4.2 Sub Consolidated Pro-Forma Income Statement

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CHAPTER V: FIRST YEAR BUSINESS ACCOMPLISHMENTS

The first year of operation has seen the business begin to take shape. The financial reporting package used by the shareholders' other business entities is implemented. This financial package provides monthly reporting for each of the business entities and has moved the business to a cash based accounting program. The production monitoring record keeping system Pig Champ has been replaced with the web-based program Metafarms. This system was not only implemented in the Sub operations but across others in the State as well. One of the purchased sow farms was shut down and the inventory put into a federal sow cull program where the Canadian government paid Sub to reduce its inventory. The site has been approved and is now the operation's federal quarantine facility used to finish replacement breeding animals which are supplied by High Lean Pork, a State company owned by shareholders of COMPANY.

In addition to the purchase price reduction provided to offset excessive feed costs, a new feed milling agreement has been negotiated. This new feed milling agreement is comparable to the shareholder owned feed manufacturing costs in State. In addition to the purchase price adjustment for contract grower agreements, all growers agreements were adjusted, terminated, or renegotiated to be the same whether they are in Province or in the U.S. Approximately a third of the feeder pig production is now sold to COMPANY and finished in the U.S. to be slaughtered at "A". COMPANY established grower contracts in the U.S. at the same rates as grower contracts in Province and hired a service manager in

the U.S. to oversee this flow. Canadian packer contracts were negotiated and signed in Canada for the pigs finished in Province. The Province Pork Board fees were more than double what U.S. Check-Off fees are so Sub actively participated in hearings to restructure the authority of the Province Pork Board. Semen manufacturing has been evaluated and is being renegotiated to get costs comparable to High Lean Pork's internal semen manufacturing costs. Genetic contracts were bundled and renegotiated to encompass Sub, other, X sows. Land rent and manure contracts have been reopened with an emphasis on the value of the manure. Every contract, supplier agreement, and vendor relationship was evaluated in the first year of operation.

It is apparent already that the concepts and plans COMPANY projected for taking advantage of economies of size and scope already have had a positive impact. Systems that had previously been in place are now spread across more production with little to no additional cost. Phone systems and information systems were changed over to be consistent across the business units. But most noticeable has been the advantage of size, not only has Paragon reduced its costs but so have the other production systems. Genetic fees alone were reduced by \$X per year by reaching new volume discount thresholds.

Liquidation in Canada is occurring, the exchange rate has moved in a favorable direction for Canadian producers, both of which equate to improved profitability for the Canadian businesses. The timing for purchasing these assets allowed for low entry costs into the business. The purchase agreement included offsets for out-of-date contractual agreements and all major supply cost contracts have been adjusted in the first year. After

renegotiating supplier agreements Sub estimates that costs have been reduced by about \$X per pig marketed. Tax planning and corporate structure were used to set the business up for success. Moving the business to a North American cost structure with a par exchange rate was the main emphasis in year one.

The first year financial results will not be complete until year end; however, compared to the original pro-forma projections, they will be considerably more reflective of the actual business and corporate structure. The original pro-forma financial statements did not account for the final corporate structures that were implemented or were not adjusted with the final asset purchase agreement specifics. The final purchase price was less than the original asset value estimates. Because of the adjustments to corporate structure and asset revaluations, the initial owner investment and long-term debt are both less than initially expected. Production performance has met expectations for the first year, however with the emphasis on reducing costs and the success achieved in that area, the original financial estimates are much different than the actual numbers recognized. Many of these issues could not have been projected or even planned for; however, the basis for entering the business in the first place remains consistent with the overall strategy set up by COMPANY. The commodity markets, COOL, and other outside factors play a crucial role in overall profitability, but the business is now in a better position because its costs are more manageable.

COMPANY was formed to leverage shareholder assets and experiences to produce protein, specifically focusing on pork. The Sub partnership offers just such an opportunity

for COMPANY. The process required planning, careful analysis of the project and of the industry as a whole. Economic principles were used for financial planning, tax planning and asset value discovery based on industry trends and conditions created due to the hog cycle. Economic theories involved understanding the advantages of the economies of scale and scope. Pro-form financial planning was the tool originally used to secure financing; the business has now realigned its cost structure and implemented common financial packages. These changes will allow for financial benchmarks and comparisons across business units in the future.

The start up year for this business was about understanding the timing and entry phase into the industry. The partners in Sub all have experience and knowledge of managing swine production and the key financial drivers required to make swine production profitable are in place. Exchange rate, COOL, the hog cycle, asset purchase costs, interest rates, and tax planning all had to be evaluated as part of the process. The first year of business focused on establishing competitive cost structures. The asset purchase price was aided by the efforts put into understanding the industry and opportunity. The cost structures were adjusted according to experience and knowledge of the industry. Management was in place and allowed to continue with confidence.

The success of this business start up is due to careful and thoughtful planning, an understanding of the industry, sound negotiations, and the ability to implement the plans and cost structures across all aspects of the business. In no situation has the status quo been accepted, every contract and agreement has been updated. Although there is no way to

predict every twist and turn in commodity production, with the wealth of experience amongst the partners and shareholders involved in this business the companies are set up for success.

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