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NATURAL BEEF IN THE FEEDLOT: RISK & RETURN TO FEEDER CALF PREMIUMS

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Significant premiums can be realized in producing and marketing cattle through natural beef programs. However, if not executed with caution, the premiums can be quickly replaced with losses. "Natural" has been one of the hottest buzz words in feeder cattle sales over the last several years. The challenge is to make sure that everyone defines the term "natural" the same way. The "never-ever" programs seem to have been adapted as the industry's gold standard. This standard requires natural cattle to "never-ever" have been given antibiotics or hormones of any kind from birth to harvest. Thus if you treat a calf for scours with an antibiotic, that calf cannot be represented as "natural". It's important to note that for most natural beef programs products such as Rumensin® and Bovatec® are considered antibiotics while MGA is also disallowed since it is a hormone. Remember, VACCINES ARE NOT ANTIBIOTICS and have a significant negative impact on the value of natural cattle if NOT used. Any producer has the ability to produce and market natural cattle. The key element that has kept a vast number of ranches from participating in the natural market is their failure to identify and record calves that have been treated with antibiotics due to sickness within a group of otherwise "naturally" managed cattle. This unique identity can be anything such as an ear mark, special tag, tag #; etc, along as treated cattle and natural cattle can be identified and separated for market differentiation. Many ranches already choose not to implant their calves but then fail to identify and record the calves they have treated with therapeutic antibiotics. In these cases, simple record keeping would allow the ranch to access the natural market with their calves. But, what is the ranch giving up if they quit implanting? You will get multiple answers for many different reasons, however the most common answers is *"I don't know for sure"*. Everybody will say "pounds" but not many will know how many pounds for their specific operation.

The most important questions are always,
"Will I receive a premium for natural calves?" and "How much?"

If you look at any auction, private or public, natural cattle will generally always realize a premium over non-naturals of the same type and class. However these premiums will fluctuate with time and/or the premiums might not even exist and this why:

RETURN

Obviously, no one would be interested in participating in any program unless there were opportunities for higher returns. In the terminal markets, natural programs create many unique opportunities for selling finished cattle that can be very lucrative while mitigating risk (sometimes). The industry has introduced many new natural programs in the past couple of years to add to the roster of the veteran natural programs that have been the flagships to supplying and creating the natural trends. Some of these programs would include Coleman Natural Meats, Meyer Natural Angus, Premium Gold Angus, Creekstone Farms, Tyson, Maverick Ranch, Niman Ranch, Montana Legend, Montana Ranch Brand and others. One of the biggest incentives these programs provide to fat-cattle owners, which is equal to or greater than the actual premium, is the opportunity for "un-traditional" and unique pricing schemes. Forward contracts with window premiums, in-the-beef plus premiums, live plus premiums, grids with premiums to the base-price, forward contracted base-prices, premiums against the futures price, basis contracts, flat pricing and the list goes on. Some veteran fat-cattle buyers will probably not agree that these methods are "un-traditional" because this is how many of the fat-cattle were bought and sold in the old days, not the "Coca-Cola" buying (everything priced the same) of today. Thus these pricing mechanisms assist the feedlot buyers in making better decisions in addition to assisting retained-ownership customers make better decisions on selling or feeding. An average premium over the cash-market will be between $5/cwt to $15/cwt and yes, it sometimes can be $0/cwt. Consequently, the natural beef trend continues to grow and at different times of the year it is a battle to find and procure the "right" kind of natural feeders that will fill the "right" programs. Thus the fat cattle premiums are high causing the feeder cattle premiums to be high. This is key information producers need to have in order to make wise decisions regarding market timing. Of course, this is the question everyone is trying to answer. A great example is buying natural yearlings during the late summer of 2005. Natural yearlings are always in demand however the plants started gearing up for exports and were sending significant incentives for natural yearlings that would be harvested less than 21 months of age for December through February delivery. Huge feeder premiums (925 lbs steer @ +$110/cwt, respectfully) were paid for yearlings. The next big natural-type program gaining speed today is supplying product to the European Union. There is limited supply and great opportunity for some cattlemen. Even though premiums can vary, natural beef programs have attracted many cattle owners to chase some of the largest cattle premiums in the industry.

RISK

Any business investment that has a high return potential always is accompanied with a level of risk. The better risk can be managed and predicted, usually the more risk an investor is willing to take. Each person is willing to risk a different value of the potential return. *Natural cattle arguably have the highest value at risk compared to most of the branded beef programs*. When you quantitatively measure the Value at Risk (VaR), you measure the loss potential to manage the worse case scenario if things were to go wrong. Natural beef production generates a lot of operational risk concentrated in health, feedlot performance and identity preservation, which are summarized by the following.

Health. Total health management on the ranch level becomes crucial to the success of natural beef in the feedlot. There are no "silver-bullet" short-cuts when it comes to health. Vaccines are important, mineral is important, weaning on the ranch is important and it works best when it is all coupled together. *The reason preventive health is so important prior to the feedlot level, is* *because the cost of a treated calf is very high in natural beef programs*. The health assessment on feeder cattle is the biggest risk a feedlot will gamble and has major influence on buying decisions. The "true" cost of a treated natural calf in the feedlot is constantly debated between packers and feeders. This treat-cost can fluctuate between the occurrence of multiple variables: *Salvage Value* (Buying feeders with a natural premium and selling them on the commodity cash market), *Opportunity Cost* (The time of treatment during the feeding phase – can the animal be put into another fallout program – what could have been the animal's opportunity in another program), and *Lost Performance* (how do you justify the lost performance while being fed under natural protocols). *Health management and assessment is one of the main drivers of feeder calf premiums when comparing natural cattle to conventional cattle of the same class and type.*

Cost of Gain. Feedlot performance suffers from the absence of implants, MGA, and ionophores resulting in an average $0.10 per pound increase to the cost of gain (COG). This does not include the effect of poor health. Natural rations also require more management due to the inability to use ionophores causing a tendency to have a higher occurrence of metabolic disorders, directly increasing the COG.

Mishaps. Natural feeders risk messy transactions when buying cattle. Although purchase agreements state "natural with a natural affidavit to accompany the cattle", sometimes the paperwork never comes. The feedlot only lets that happen once for that source, and won't buy cattle there again. Or a ranch forgets to mention until late in the feeding period that a "few" treated cattle were shipped on a load of natural calves. Not to worry because they have sent the ear-tag numbers with a few of the treated cattle marked as "no-tag". Thus, all animals in the group that have lost a tag must be assumed to be ineligible for the natural market. At no point will the feedlot sell natural cattle with the chance that they might have been treated.

Value at Risk. All of these variables combined together add up to how much value you are putting at risk to the natural beef return potential. For example, using health as a variable, if cattle are assessed to be a health risk then the feedlot is putting more value at risk and should pay less. If the cattle are assessed at a very low health risk then the feedlot is putting less value at risk thus has the ability to pay more. Hence, this is why you see natural yearlings that have had multiple rounds of modified-live vaccines bringing tremendous premiums. First of all, these cattle are hard to find, but the main reason is that you are purchasing a product that has a comparatively low value at risk to the return potential when evaluated against natural bawling calves with no pre-conditioning. *Natural feeder premiums are relative to the feedlot's overall assessment of how much value they are putting at risk*. All feedlots or natural buyers have different comfort levels of how much value they are willing to risk and will most likely have different models of managing risk. Different scenarios also add into the risk equation. Is the feedlot buying the cattle to fill pens, are they buying cattle for a customer who wants to own them or advising a retained-ownership customer? These

scenarios can be completely different. As a result, natural feeder-cattle premiums will have a lot of variance due to the value at risk of the buyers' situation.

CLOSING

Not all sets of cattle were meant to be natural. Not all cow/calf operations fit the natural beef protocols successfully. However the operations that realize the risks involved with natural beef production and minimize the feedlot's value at risk will consistently receive substantial premiums for their natural feeder cattle. As natural feeder buyers, be true and honest about your risk assessment of natural feeders and stick to your own risk model. Managing your value at risk is not meant for "hitting the home run" but managing the worse-case scenario and preventing a disaster. The industry is at the dawn of higher demand for natural cattle while new major players come to the table, creating new markets domestically and abroad. It will be the progressive cattlemen that will reap these rewards at a sustainable rate by assessing their risk while meeting supply demands.