JBS slaughter cuts – good or bad for the market?

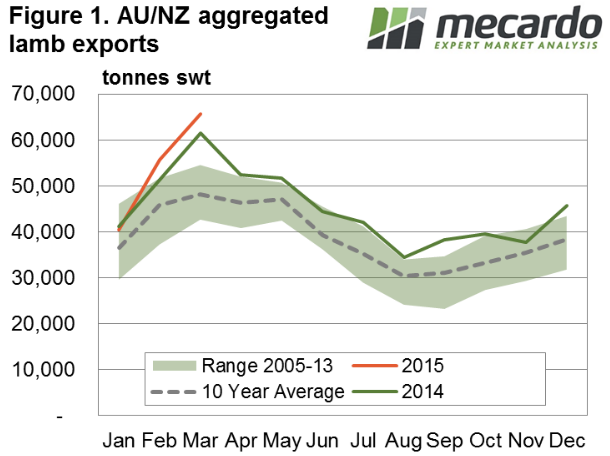
6 May 2015

Author: Augusto Semmelroth, Mecardo

The recent move by JBS to cut weekly lamb and sheep slaughter capacity on the back of "domestic and international market conditions" has hit the media channels like a bombshell. Many producers are now left wondering what the ramifications for prices will be going forward. This article assesses the potential drivers behind JBS's decision, and further investigate the current supply and demand factors impacting the market.

The key issues raised by JBS have been described as "poor export demand conditions" and a general view that export supply is currently outstripping demand. While the first statement should be taken with a grain of salt, as any structural shift in demand patterns seems unlikely, the latter is a valid point and has surely impacted the market over the last couple of months.

Figure 1. AU/NZ aggregated lamb exports



Source: DAFF, Stats NZ www.mecardo.com.au

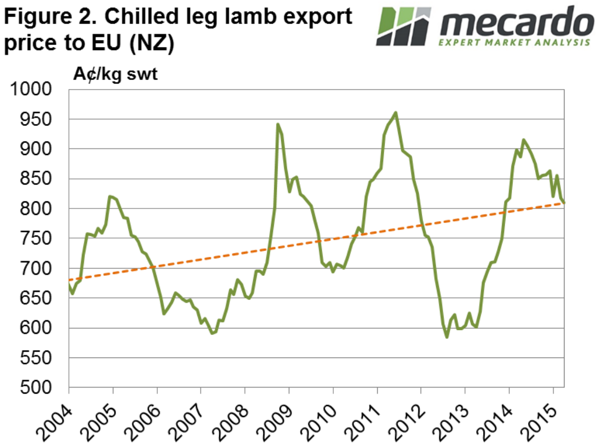
The supply side of the story is fairly easy to measure. Eastern states lamb slaughter levels have tracked around 6% higher year-on-year since January. Moreover, despite the reported "soft overseas demand", year-to-date lamb shipments (to April) are still running 7.5% above the previous record set in 2014, and a whopping 38% above the 5-year average. Essentially, this means that overseas markets have been able to absorb unprecedented volumes of Aussie lamb meat.

Key points

- Supply glut from Australia and New Zealand pressuring export prices and, consequently, putting a lid on saleyard prices.
- Expectations of tighter winter supplies have prompted processors to start cutting slaughter capacity.
- JBS's 20,000 head cut in sheep and lamb processing capacity only represents 4% of total east coast supply.
- This recent events reinforce our view that a supply squeeze is looming, which will support firmer lamb and mutton prices.

That said, to get a more accurate picture of the state of exportable supplies available to overseas markets, it's of critical importance to also include the volumes from New Zealand, the largest lamb exporter. Figure 1 shows the aggregated lamb exports from Australia and New Zealand until March. During Q1 2015, total lamb exports were 5% higher year-on-year and 24% above the average shipments seen between 2005 and 2013.

Figure 2. Chilled leg lamb export price to EU (NZ)



Source: MLA, Agrifax www.mecardo.com.au

JBS slaughter cuts – good or bad for the market?

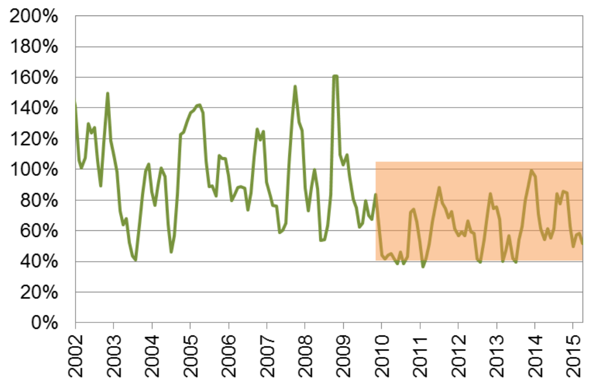
6 May 2015

These stubbornly strong export levels have taken most market participants by surprise, and surely created a short-term supply glut in the market.

However, while the impact on export prices was clear in March and April, it's far less alarming than many may contemplate (figure 2). To put things into perspective, the price for key export products has only fallen by around 5% since February but remains historically strong.

This leads us back to the claim of "tight margins" in lamb and sheep under the current market conditions. And that's a pertinent claim. However, using the spread between the Eastern States Trade Lamb Indicator (ESTLI) and the Chilled Export Leg to EU as a rough gauge for processor margins, things don't look any worse than any time since 2010, allowing for seasonality (figure 3).

Figure 3. Spread between ESTLI and Chilled leg EU



Source: MLA, Agrifax www.mecardo.com.au

What does this mean?

At first glance, the move by JBS to cut supply capacity by a reported 20,000 head of sheep and lamb per week may sound like a lot. Yet, it only accounts for roughly 4% of the eastern states supply on the east coast. As such, we believe that this reduction in slaughter capacity won't have a significant impact on prices, particularly considering that supplies will get tighter going forward and processors will have to cut capacity anyway. There is no doubt that processors' margins in lamb and sheep are not as lucrative as they were before 2010, when looking at the lamb prices versus export values. With that in mind, running a "tighter margin" business only makes sense when operational capacity is fully utilised and fixed costs are diluted. In a scenario of scarce supplies and higher lamb prices, as expected for the coming months, processor margins will be undoubtedly squeezed. To conclude, adjusting slaughter capacity in anticipation of a supply gap in winter seems like a sound strategy for many processors. This move also supports our view that sheep and lamb numbers will contract considerably over the coming months to see the current "supply glut" from Australia and New Zealand finally abating to support firmer lamb and mutton prices in the short to medium-term.

Want more Mecardo information?

Visit www.mecardo.com.au/rawlinson-brown to receive Mecardo for free for 3 months.

Prepared by mecardo EXPERT MARKET ANALYSIS