Aim Higher Than Low Choice

The rebuilding phase of the cattle cycle represents an opportunity.

by **KATY KEMP,**
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The USDA Choice-Select spread is a traditional barometer of the payoff for premium beef. In recent years though, that boxed-beef price spread has varied from $15 per hundredweight (cwt.) to barely positive, leading to questions about whether it pays to aim for quality.

The answers point to an evolution beyond the line between Choice and Select, which has been blurred by feeding to heavier weights. Premium-Choice and Prime premiums are exerting more influence on today's cattle markets, observers say.

"In today's differentiated market, producers who are only paying attention to the Choice-Select spread are missing some of the more significant signals," says Mark McCully, vice president of production for the *Certified Angus Beef*® (CAB®) brand.

Licensed packers pay $50 million in annual grid premiums for cattle that qualify for that brand. There are other branded programs that pay for quality.

Ted Schroeder, director of the Center for Risk Management Education and Research in agricultural economics at Kansas State University, agrees there's more to the quality beef market than the Choice-Select spread.

"Low Choice is not as valued as high Choice," he says, "but there's still some distinction between Choice and Select in eating quality. Most private-label brands have quality-grade requirements that do not distinguish between Choice and upper Choice, and those will continue to be premium-priced products."

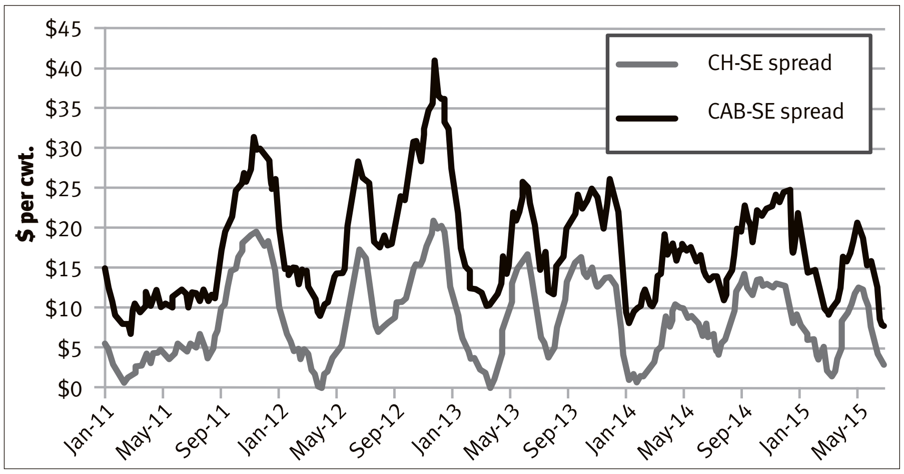
McCully says buyers of boxed beef have learned that what's left on the market after branded programs like CAB take most of the upper Choice is "a bit of a leftover."

Data from USDA and the 2011 National Beef Quality Audit (NBQA) indicate branded-beef programs reduce that upper two-thirds of Choice (Modest or higher degree of marbling) from 36% to just 11% after sorting for brands. What remains in the Choice box is 89% Small degree of marbling — and quality is further reduced after branded programs rail off the low Choice that is at least Small[50] marbling.

Brands that do not require premium Choice will, by default, source primarily low-Choice beef.

Consumer demand for beef from branded programs has grown in the last 10 years, Schroeder says. Responding to market signals for branded Choice has

Fig. 1: CAB® and Choice cutout — premiums over Select



Source: Urner Barry.

Beef demand index shows consumers crave quality

More of the best at higher prices — beef consumers demanded it in 2014, and they're still on track through the first quarter of 2015.

That's according to Kansas State University (K-State) economist Ted Schroeder and CattleFax analyst Lance Zimmerman, who created a demand model as a graduate project under Schroeder in 2010 and recently updated it.

Demand for the *Certified Angus Beef*® (CAB®) brand kept up a strong pace of growth, especially in the last five years, adding 112 percentage points to reach 229 on a 100-point base. That 129% increase in 12 years was up by more than 20 points from the 2013 mark (see charts).

The K-State model uses 2002 as the base year, and showed demand for commodity USDA Choice beef near the 110 level for most of the following years. It jumped to 120 in 2010 before eroding for three years to fall below 100 and recovered to 108 last year.

Zimmerman says Choice demand held up well in early 2015, too.

"The Choice spot market in April was $31 over a year ago with demand up 9%," he says. "Select beef was up $15, but volume has fallen so much in 2015 that it equates to a decrease in demand of more than 30% from the first quarter of 2014."

He notes much of the increase in Choice grading, as cattle are finished at heavier weights, just moves marbling up a few points and lifts up what would have been Select carcasses.

"We're at a point at these price levels where any apparent strength in prices is driven more by a decline in supply than by a demand base," Zimmerman says.

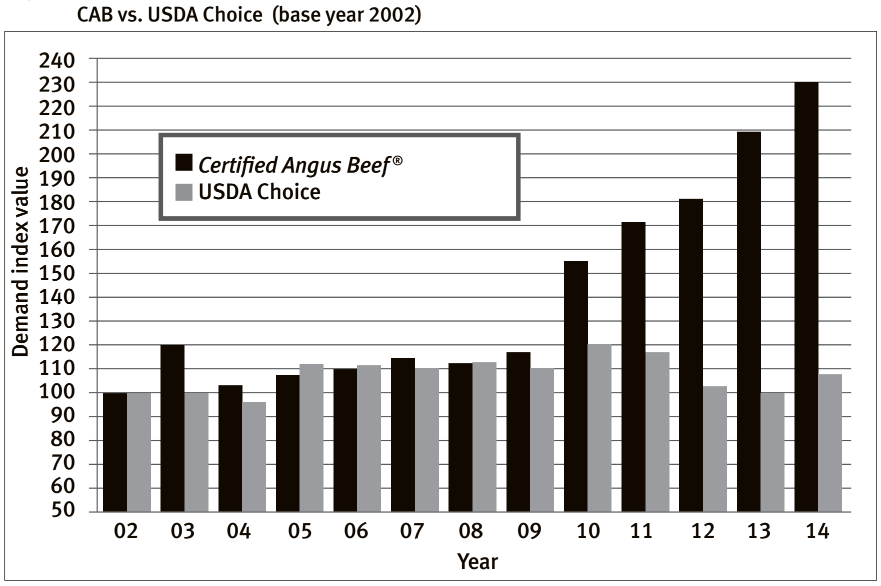
Schroeder says the soaring demand for CAB is actually volume-driven, for the brand has seen 10 consecutive fiscal-year increases in pounds sold.

"It's a market-share growth brand, with sales volume up some 11% since 2010, while Choice volume declined by 16%," he points out.

At prices much higher than 2010, the percentage CAB wholesale beef price premium over Choice declined from 4.5% to 3.5% last year, Schroeder says.

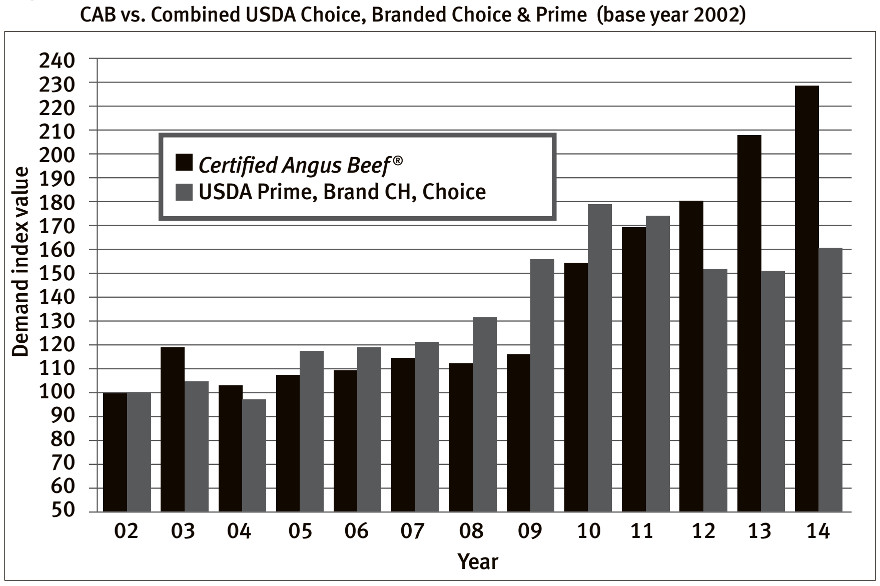
However, Zimmerman notes CAB is an increasing subset of Choice (now

Fig. 1: Wholesale beef demand index values
CAB vs. USDA Choice (base year 2002)



Source: USDA, Urner Barry and Certified Angus Beef LLC.

Fig. 2: Wholesale beef demand index values
CAB vs. Combined USDA Choice, Branded Choice & Prime (base year 2002)



Source: USDA, Urner Barry and Certified Angus Beef LLC.

resulted in less Select product over that time span. The shift in the supply ratio might suggest a narrower Choice-Select spread.

"There is a lot less Select product out there today than Choice, or even upper two-thirds Choice and Prime on a percentage basis," McCully says. "Typically, when our supply of Choice increases, the Choice-Select spread has decreased, but that really hasn't happened. It has been relatively constant over the last few years, averaging around $7 per hundred."

In the first six months of 2015, the spread widened by 41¢ per hundred, with an average Choice cutout $24.06 per cwt. greater than a year ago, according to USDA figures. Other spreads may be more telling: The CAB-Select spread is often twice as wide as the Choice-Select quote (see Fig. 1).

"CAB demand and volume have continued to increase," Schroeder says. "Branded programs will continue to expand as we see strength in consumer demand for high-quality beef."

The trend of more branded programs and greater Choice supply is counterintuitive to premiums, unless there's a shift in demand. Research says that is exactly what has happened.

"As we continue to put out a better product, we shouldn't expect premiums to retrace," McCully says. "Rather, meeting the expectations of our brand, and as we differentiate our beef from other protein options out there, the value increases."

That reality of growth and demand for branded-beef programs has bolstered the Choice-Select spread and added more value to high-quality beef, Schroeder says.

"If we did not have these private-label programs with so much prominence and apparently growing in importance, the Choice-Select spread would be narrower," he says. To the extent that any brand adds value to Choice beef, it widens the spread, "but the relative supply of Choice and Select beef will continue to be an important driver."

Brands inspire confidence

Higher costs come with higher expectations. With record-high prices for all beef, differentiating quality becomes more important. Consumers need more confidence and have turned to branded programs to provide some of that assurance.

"The industry as a whole benefits when consumers have a more desirable eating experience with beef because it increases overall beef demand," Schroeder says. "CAB

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accounting for more than 15.2% of it), so the brand's higher cutout value is helping to lift wholesale Choice prices, as well.

Schroeder says grid and formula premiums paid for CAB-qualifying cattle are up by more than 35%, compared to those in 2010-2011.

"That's consistent with this growing demand for CAB, and it suggests packers make sufficient money on the program to where they have become more aggressive about targeting and attracting CAB cattle," he says. Some of that relates to the option of marketing the 74% of non-qualifying black cattle into other programs "that carry some of the Angus value banner," he adds.

The demand model shows a combined category of Choice, Branded Choice and Prime, for which demand increased more than 10 points in 2014 to reach 161 on that 100-point index. That was obviously buoyed by the rise in CAB demand, but Zimmerman points out Prime beef has also increased in both price and supply — the latter continuing up 15% in the first quarter of 2015.

Global demand is represented in the model by its use of world per-capita consumption.

"A huge percentage of it is

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picked upper two-thirds Choice instead of all Choice, because all Choice did not have sufficiently predictable eating quality.

"Now, with most of upper two-thirds Choice going to these branded programs, I think the incentives are pretty clear," he says. "My best recommendation to producers is strive for high quality."

Once retail beef prices rise, they are slow to subside. Consumers have made the shift to paying and expecting more, says McCully. That says demand for high-quality beef will remain strong, and that's a key point as producers begin to rebuild their herds.

"With an eye on the long-term trends, the decisions we make today in breeding and genetics will impact supplies within a couple of years and build from there," he says. "Now is the time to better position your herd and your operation for the future."

Editor's Note: *Katy Kemp is an industry information intern for Certified Angus Beef LLC.*

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domestic demand, but there are global implications," Zimmerman says. "Beef prices are up all over the world, and they are value-conscious, too, looking at pork and chicken. White-marbled, grain-fed U.S. beef competes at the higher price point only by virtue of its quality."

Does retail or foodservice demand play the larger role now?

Schroeder says today's beef consumers are less price-sensitive, after a few peeled away to settle on pork or chicken at lower prices. Demand at the retail level may depend on better consumer education so that they accurately discern the value of CAB vs. lower-quality Angus brands.

On the foodservice side, he sees the overall business recovery boomlet leveling off, "with fewer big steak dinners paid for by corporations," leading that area of demand to plateau.

Zimmerman gives more of an edge to dining out.

"When I first wrote the paper in 2010, retail had led us out of the recession," he notes. "But foodservice led the way in 2014 and that sector had the best first quarter in 2015 in a long time. With slow and steady growth in consumer buying power and the greater flexibility of menu pricing, I think the tables are turned in favor of restaurants now."

They agree that overall, demand for CAB can rise again in 2015.

"Recovery in beef demand across the industry started in 2013 with primarily end meats, and not really the cuts we typically hang our hats on," Zimmerman says. "But CAB demand growth has been for all of the cuts and the brand is positioned well for another good year."

Schroeder says, "As long as CAB continues to have growing sales volume, and price premiums do not suffer too much relative to Choice, there is no reason CAB cannot continue to have a demand index similar to recent years, though growth may slow in the next year or two."

The related white paper, "Defining and Quantifying *Certified Angus Beef®* (CAB®) Brand Consumer Demand," updated in 2013, can be viewed at *www.cabpartners.com/news/research.php*.

— by Steve Suther, industry information director, Certified Angus Beef LLC