# Industry Perspectives

A MONTHLY RESEARCH ANALYST SERIES

DIAMOND HILL CAPITAL MANAGEMENT

## The Shift to Cage-Free Eggs: Will Companies Crack Under the Pressure?

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If you're like most American consumers, you buy eggs at your local grocery store and never ponder the competitive dynamics of the U.S. egg industry. However, occasionally there are investment opportunities in basic, everyday industries that are experiencing a secular change and the companies investing in that change. Cal-Maine Foods, the U.S.'s largest egg producer, is an example of this and is well-positioned, in our view, to benefit from a notable industry transition to cage-free eggs over the next 12 to 18 months.

By way of background, it has been a tough couple of years in the egg industry. Prices for conventional caged eggs, which still represent the majority of the market, have been a bit weak due to elevated hen numbers, while cage-free egg prices have remained roughly flat due to the current cage-free supply/demand dynamics. Feed costs are currently relatively high compared to historical standards, and COVID-related demand changes have been challenging for the industry as demand shifts back and forth between grocery and foodservice.

Unsurprisingly, these challenges have led to a weak egg industry from a balance sheet perspective. This is a normal fact of life in a cyclical industry—in times of less-than-ideal conditions, balance sheets tend to weaken. However, what makes the current situation somewhat unique is that the cage-free shift—the most capital-intensive evolution in the history of the U.S. egg industry—is taking place now amidst the backdrop of weak industry balance sheets.

There has been a lot of talk in the egg industry over the years about the shift to cage-free eggs, but the first major regulation officially goes into effect on January 1, 2022. California, the most populous state with 12% of the U.S. population, will require ALL eggs sold in the state to be cage free starting in 2022, with orders for this transition to start in late 2021. In addition to California, Massachusetts will require its eggs to be cage-free in 2022, and seven other states (Colorado, Nevada, Utah, Michigan, Oregon, Washington and Rhode Island) have passed cage-free legislation that is scheduled to be implemented over the next three to four years.

There are currently 86 million cage-free hens in the U.S., accounting for 27% of the total U.S. egg-laying hen flock. The nine states mentioned above comprise roughly 25% of the U.S. population. Even if one excludes the reasonable likelihood of additional cage-free legislation in the next few years, when considering both the time/capital intensity of developing cage-free facilities and consumer demand for outside of these nine states, we believe cage-free supply will fall notably short of demand over the next three to four years. (It's worth noting that the data above excludes commitments made by large national retailers such as Walmart and Kroger, who have pledged to be cage-free by 2025.)

These dynamics are well-known by egg industry participants. However, the majority of the participants in the conventional egg industry are smaller, family-run businesses. Taking out large loans for meaningful cage-free expansion is a high-risk proposition —especially for those who lack long-term succession plans for the family business.

When combined with weak industry balance sheets, this uncertainty has led to underinvestment by many of Cal-Maine's competitors. Cal-Maine, on the other hand, has invested nearly $500 million in cage-free production while remaining in a net cash position. Two of its major projects are a large cage-free facility in Delta, Utah, which is expected to be operational by early 2022 (the same timeframe the California law goes into effect) and the purchase of the remaining 50% of the cage-free Red River Valley Egg Farm in Texas a few months ago.

In short, there is a major industry shift happening and, while the cage-free market is a bit oversupplied in the near term, it does not seem like the capacity is there to fully absorb the upcoming cage-free demand over the next 12 to 18 months. Cal-Maine has been reinvesting in its business to capitalize on this transition when a significant percentage of the industry is unwilling or unable to do so.

In commodity industries, the old adage "the cure for high prices is high prices" rings true time and time again, and if forgotten can lead to woe and misery. However, in this case, given the time and capital it takes to add new cage-free facilities, as well as the expense and uncertainty involved in moving to a cage-free operation, there are some barriers to a near-term supply response. No one knows how the transition will play out, but it doesn't seem unreasonable to think that companies who invested in cage-free before state regulations go into effect will reap the profits of higher cage-free prices, while those who have not invested in cage-free may see shrinking opportunities for their conventional eggs over time and be unable to build up the balance sheet to compete long term. In our view, these dynamics could potentially lead to a more consolidated egg market over the next five years.

All that said, there are clearly risks and Cal-Maine's opportunities are in shades of grey, not black or white. There are a lot of political dynamics to this transition—if cage-free egg prices spike and/or egg availability in grocery stores is hampered, it's not out of the question for politicians to attempt to push back the cage-free timeline or propose updated regulations. In addition, if cage-free egg prices get too expensive during the transition, national egg consumption could decrease and new consumer eating habits could emerge involving fewer eggs, which is a risk.

Another risk we monitor in cyclical businesses is the threat of new entrants in times of rising prices, but in the egg industry there haven't been any material new entrants to the industry in a long time and imports are not competitive. Additionally, it is less likely new entrants emerge at this point given the higher capital intensity of cage-free production (absent elevated cage-free prices for an extended period of time). There are admittedly barriers to exit in cage-free (i.e. it's costly to build a new cage-free facility so after you build it you want/need to keep operating it) but there currently aren't enough cage-free facilities to handle the upcoming demand, so we are not overly worried about the supply side as of now.

Cal-Maine's valuation is undemanding at current levels, and while we can't foresee the ultimate outcome of the transition to cage-free, we do believe Cal-Maine's management is making the best decisions it can with the information available and is putting the odds of success through this transition in its favor.

As of July 31, 2021, Diamond Hill owned shares of Cal-Maine Foods, Inc.