At Diamond Hill, we take a long-term view of our ownership in businesses, but there are times when unforeseen events or crises can cause industry dynamics to rapidly shift. These periods of crisis can often lead to interesting potential investment opportunities.

In the protein industry, which includes beef, pork, poultry, eggs, and seafood, an example of this type of event is an outbreak of disease, which can cause dramatic reductions in supply, significant price moves, and/or industry consolidation. While disease itself is not unusual and is a fact of life in the industry, there is currently a disease sweeping through Asia and parts of Europe that we believe will have an unprecedented impact on the global protein industry: African Swine Fever (ASF).

What is African Swine Fever?
African Swine Fever is a disease that has a nearly 100 percent mortality rate, with pigs that catch the disease dying in just a few days. The disease can spread rapidly and spreads easiest in areas without strong farm biosecurity. People can eat ASF-infected meat, as the disease has no impact on humans.

The disease has been around for over 100 years in various parts of the world, but the roots of the current outbreak most likely began in 2007 in the Caucasus region. While ASF has impacted parts of Russia and Eastern Europe over the last decade, the disease did not have a dramatic impact on the global protein industry until last year.

In August 2018, however, ASF surfaced in China and has been spreading like wildfire throughout the country, as there is currently no vaccine for the disease. The entry of ASF into China is significant for several reasons:
- Pork is the most consumed protein in the world, with China accounting for 50 percent of both global pork production and consumption.
- Chinese pork production alone accounts for 20 percent of total global protein (beef, chicken, and pork) production.

We believe that protein prices around the globe will likely increase significantly over the next six to nine months, but the timing, magnitude, and geographical risks remain highly uncertain.

China
The Chinese ministry announced in mid-August that the country’s pig herd had shrunk by 32 percent year-over-year in July, significantly worse than the 26 percent year-over-year decline in June. While those percentages obviously indicate major losses, the Chinese government thus far has significantly underreported the extent of the spread. Many industry sources are now using 50 percent as an estimate for the loss in Chinese hogs, with some citing losses as high as 60 to 70 percent in certain regions.

It’s difficult to comprehend the numbers involved, but if roughly 50 percent of the Chinese hog herd has been wiped out that means that roughly 10 percent of total global protein production has disappeared in the last
year. The U.S. is the third-largest pork producer in the world behind China and the European Union and is a major global player, but if China were to lose half of its pork production, that would be equivalent to more than twice the entire annual U.S. pork output. Today, there simply isn’t enough available pork in the world to counteract China’s growing pork deficit.

Throughout most of 2019, Chinese pork prices remained somewhat benign, which is not what one would initially expect. However, it appears that Chinese hog farmers rushed their hogs to market in late 2018 and early 2019, selling them quickly before their pigs were infected. The resulting supply glut caused prices to remain stable throughout the spring and early summer of 2019. However, in mid-June, prices started moving upwards and are currently some 30 percent higher than in June, which leads us to believe that pork shortages are beginning.

Southeast Asia and Eastern Europe
From China, the disease spread south into Vietnam, the world’s sixth-largest pork producing country. Vietnam confirmed its first outbreak on February 19, 2019, and since then has culled about 5 million pigs, representing roughly 20 percent of its entire herd. ASF continues to spread throughout the region, with Cambodia, Laos, Myanmar, and the Philippines all confirming outbreaks this spring and summer.

Eastern Europe is also dealing with ASF, with cases reported in Serbia, Slovakia, Poland, Bulgaria, Romania, Ukraine, Lithuania, and Russia in 2019. While difficult for locals, the outbreaks in Eastern Europe are not expected to have a material impact on the global protein situation at this point, as the impacted countries are generally not large producers. However, the outbreaks in Eastern Europe are worth monitoring because if the disease spreads into Western Europe (particularly major producers Germany and Spain), the global impact could be material.

Potential Winners and Losers
Assuming the U.S. remains ASF-free, the U.S. companies who stand to benefit most from the spread of ASF are those that own and control protein production. We believe Seaboard Corporation is very well-positioned to benefit from ASF due to its strength in pork production and vertically integrated business model. Other significant beneficiaries could be chicken producers Sanderson Farms and Pilgrim’s Pride, as chicken will likely be a substitute for pork during a shortage. Tyson Foods is another beneficiary overall, but they have some segments of their business where they buy protein from other producers, so those segments could face some margin pressure. Egg producer Cal-Maine Foods could potentially be another winner, as egg demand may increase if other protein prices are too high.

It’s worth noting that despite the large impact ASF is likely to have, the traits we look for in a potential investment in the protein industry, including a long-term oriented management team, a solid balance sheet to withstand the inevitable cyclical downturns, and high levels of insider ownership, remain unchanged. While we are following ASF-related developments closely, we simply view ASF as a potential tailwind for our holdings and is not the sole reason we own these businesses.

The losers, we believe, are primarily businesses that buy raw meat as an input. This includes most restaurants, as well as other prepared food/meat companies that produce very little of their own meat and instead choose to buy the raw product from others and process it in their own plants. Additionally, the spread of ASF will probably be a negative for consumers around the world, as the price of food will likely rise.

It’s important to note that the above discussion is predicated on the assumption that ASF doesn’t enter the U.S. If it does, U.S. pork exports may shut down, which could cause the opposite effect for most of the participants listed above. Since the U.S. is a net exporter of pork, excess U.S. pork could end up stuck in the country, which may cause domestic protein prices to drop due to oversupply.

Internationally, ex-China, potential winners include JBS and BRF, two large Brazilian meat companies, as well as most European meat producers. Depending on how extreme prices become, various seafood companies, including Norwegian and Chilean salmon farmers, could also benefit.

In China, it’s likely that ASF will drive significant consolidation in the pork industry. Currently, a large percentage of farms are small, backyard hog operations, but it’s almost certain that the major pork producers with better biosecurity will consolidate and gain material market share over the next decade.

What’s Next?
Today, it remains to be seen how the spread of ASF will play out. We believe that protein prices around the globe will likely increase significantly over the next six to nine months, but the timing, magnitude, and geographical risks (i.e. if ASF enters the U.S.) remain highly uncertain. Either way, it’s likely that the next year will be a volatile one in the industry, and we remain alert and ready for any investment opportunities that may come our way.

As of August 31, 2019, Diamond Hill owned Cal-Maine Foods, Inc. (equity) and Seaboard Corp (equity). As of June 30, 2019, Diamond Hill owned Pilgrim’s Pride Corp. (debt). The views expressed are those of the research analyst as of September 2019, are subject to change, and may differ from the views of other research analysts, portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.