

INDUSTRY OVERVIEW

# Former CEO of a Competitor Believes Legislative and Consumer Shifts Toward Cage-Free Eggs Will Further Consolidate the Industry as Small Producers Shut Down or Sell to Scaled Producers

DATE PUBLISHED	INTERVIEW DATE	EXPERT PERSPECTIVE	ANALYST PERSPECTIVE	PRIMARY COMPANIES
12 Aug 2024	05 Aug 2024	Competitor	Investor-Led (Buy-Side)	CALM

OTHER COMPANIES

ROSE ACR...	HILLANDA...	EGGLANDS...	HERBRUCK...	KR	VITL	HAPPY EG...	PETE & G...	WMT	TGT
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## Transcript Highlights

- The expert believes premium egg categories will become more attractive as cage-free Pricing and HPAI reduce the spread between conventional and premium.
- The expert thinks CALM will continue to get larger over time, including penetrating the premium eggs category.
- In the expert's opinion, VITL's recent distribution expansions are indiscriminate and may pose risks.

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## Expert Bio

Expert was the CEO at ProEgg Cooperative.

## Interview Transcript

Analyst 00:00:00

First, this call will be recorded so that it can be transcribed. Second, you understand the definition of material non-public information and agree not to disclose any such information or any other confidential information during this interview. Third, you confirm that you do not have a non-disclosure agreement or any other type of agreement or arrangement that would prevent you from speaking about any of the companies that may be discussed during this call. If you can't answer any question I ask, please feel free to let me know and we'll move on. Finally, you agree not to discuss details of your current employer. Do you agree with this?

Expert 00:00:32

I agree.

Analyst 00:00:36

All right. This call is primarily going to focus on the egg industry. I'll actually be, just given your background, more interested in, I don't know what the right term is, I think some of them are calling classic egg segments and some of the big players in the landscape there.

Expert 00:01:02

Sure.

Analyst 00:01:02

It would be helpful to get started if you could just provide a very brief overview of your background.

Expert 00:01:18

Yeah. My background in the food industry spans 40+ years. I spent the first almost 15 years of my career with Michael Foods, at the time known as Crystal Farms, selling shell eggs, liquid eggs, egg products, and dairy products. I then spent 20 years in the meat business with Sara Lee, Hormel, in a private equity firm doing sales and marketing, management of people, international and domestic sales, category management, new product development, etc.

Expert 00:02:06

I've spent the last six years back in the egg industry with Herbruck's up in Michigan, running their sales and marketing department, doing new product development, category management, sales team management, customer management, pricing, production interface, etc. Recently left ProEgg Cooperative, which is the nation's largest egg cooperative with nearly 25 million birds. That was a start-up. That's my background in two minutes.

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Analyst 00:02:50

Yeah. No, that's great. I'm actually interested in the co-op side of the business, just understanding how that works. In the scheme of the U.S. Market, I think people point to Cal-Maine obviously as the largest producer. What is the rest of the market look like beyond Cal-Maine?

Expert 00:03:17

Cal-Maine is the largest producer in the world and the U.S. Once you move outside of that, you get into companies that are still family-owned or family-run, and they tend to be very regional. Companies like Rose Acre, which is expanding nationally, but they're mainly Midwest and the West. Companies like Hillandale, which are based in the Eastern Midwest and the Northeast. Other companies such as Sonstegard up in the Dakotas. You have multitudes of companies spread throughout.

Expert 00:04:03

Once you get outside of Cal-Maine where they have 40+ million birds, you drop all the way down to about 25 million or 30 million, depending again on rotation, with the Rose Acres, etc., it becomes very fractured, very regional. It's an interesting set of dynamics. Typically, if you're a producer with under that 5-million bird mark, you tend to not have a market. They're relying on the larger players such as Cal-Maine, Rose Acre, or Hillandale, etc., to market their eggs for them because they have the relationships and the ability to get those eggs to the customer.

Analyst 00:04:54

Yes. That makes sense. What does Egglan's Best fit in?

Expert 00:05:03

Egglan's Best is a cooperative, if you want to call it that. They have multiple members throughout the country who own marketing regions throughout the country. There're exclusive areas where they have the ability to sell a branded product. The difference between Egglan's cooperative and a traditional cooperative is Egglan's is truly a marketing company. They don't do anything with production. They don't own any birds. They don't own any distribution points.

Expert 00:05:41

They simply act as the branding and marketing support for the producers. The producers themselves own the selling to the customers, own the distribution piece, own the production piece. Egglan's simply steps in on the larger national accounts. They actually do the calls or joint calls with the local producer or the franchise owner, if you want to put it that way, but Egglan's strictly controls all the national accounts and most of the regional accounts.

Analyst 00:06:19

Cooperatives, with Egglan's that you also handle some of the distribution capabilities, the sorting, the packaging.

Expert 00:06:31

Correct. When you think about a cooperative, a cooperative will handle not only the marketing, the sales, they'll also handle the entire order-to-cash process. Egglan's doesn't do that. That's all handled at the producer. In a co-op, they handle the entire order-



to-cash process, and they also deal with logistics, freights, etc.

Analyst 00:07:06

Does that mean that Egglan's Best, their farmers, are they typically larger entities that have the scale to do the logistics and those admin functions themselves?

Expert 00:07:25

Yeah. If you think about Egglan's Best, some of the larger members or franchise owners would be Hillandale, Cal-Maine, folks like Herbruck's up in Michigan. Those are the ones that they have the distribution capability. Egglan's is going to go out and partner with the various producers that have the market. They're not going to partner with a producer who doesn't have a relationship with an account or a way to get that goods to market.

Expert 00:08:18

You may have 2 million birds you want to put on Egglan's feed, but they're not going to grant you a territory unless you have a relationship with a particular retailer, in most cases, large retailers. That's why you see Hillandale up in the Northeast because they have relationships with all of those accounts. You see Herbruck's in the Midwest out on the West Coast up in the Northwest. You now have Versova management which handles Morning Fresh and a few others that they bought up there that have the relationships with the customers already established.

Expert 00:09:02

That was an easy way for Egglan's to get into the customer base. It's funny, Cal-Maine and Hickman's out of Arizona, they have a joint business relationship with Southwest Specialty that supplies eggs in California in that neck of the world. It's quite interesting. They won't bother with someone just because they can produce eggs. They won't bother with them unless they have a way to get them to market.

Analyst 00:09:37

**What's interesting about Egglan's to me is given their position as purely a marketing-based entity, implicit in that is, is there some benefit to having that marketing entity and a branded egg in terms of relationships with the distribution channel** and ultimately maybe the price you receive for the eggs on the shelf were from are wholesale?

Expert 00:10:13

For Egglan's, they set the price going to the national retailers. The cost going into that national retailer and the producer for the accounts that aren't controlled by Egglan's, they will set the price but typically it's either equal to or slightly higher just because of the cost of doing business with that account.

Expert 00:10:40

There are restrictions to what that producer can sell. They also have to pay a penalty if it is in conflict. If they sell another omega-3 product or an organic egg, that is considered competition to the Egglan's Best product, **they have to pay a penalty or rated cents per dozen to Egglan's Best** to be able to sell that into the accounts.

Expert 00:11:13

For the producer, it really doesn't help them to get a better price on, say, their organics because they sell an Egglan's Best organic. If anything, they're already selling an organic to that account. Let's say Kroger, for example, and this covers a lot of companies, a producer could, in theory, sell to Kroger their private label product under an organic. An organic private label, they also could sell their own branded. Whatever the producer brand is organic and an Egglan's Best organic. The same egg is sold under three different labels.

Expert 00:11:59

There is a huge discount for the Simple Truth product, which is the organic compared to the Egglan's Best, and that can be as much as 75¢ a dozen. That Simple Truth will be cheaper than Egglan's Best. There is room for, for example, a person to put out their organic eggs by X to play in the case, but **their sales will obviously suffer** because Egglan's is putting out their promotions and the customer is obviously handling their information.

Analyst 00:12:41

I will attack this one other way just to make sure I understand all the ins and outs here.

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Analyst 00:12:52

You mentioned some of these very significant producers, these very large integrated producers, Hillandale, Rose Acre, Herbruck's, they actually will co-brand or go under the Egglan's brand for some portion of their eggs in certain regions. I just wanted to understand why they would choose to do that rather than just going to the retailers themselves.

Expert 00:13:24

In today's environment, most of them are thinking, "Why are we doing this?" because they do pay a fairly hefty premium to Eggland's Best to be able to sell their products. When Eggland's Best started, you have to understand, the market at that time when Eggland's Best rolled out, the organic eggs were specialty store only. Cage-free eggs didn't exist. 90% of the eggs sold in the country were a conventional egg or your generic white egg or a generic brown and they were all market-based items.

Expert 00:14:06

I'll give you a bit of information here. Back when I was selling eggs in the late '80s, the market offset off of Urner Barry, a high market offset was 10¢ or 12¢. At that point, when Eggland's Best started, you had most producers working off markets making minimal returns on their conventionals, and you have Eggland's Best come in as the first true premium egg out there on a large-scale basis, and they were offering margins that were 4X and 5X what you were getting on conventionals. That's why producers jumped all over it.

Expert 00:14:56

If you fast-forward it to 2020, the average offset on a Midwest market is probably closer to 25¢-30¢. Their margins have again are tiny, but the margins for Eggland's Best, because **they're facing additional competition from the Vital Farms, the Happy Eggs, Pete and Gerry's, all the national or some super regional branded, especially players in the specialty category has grown, the Eggland's Best pricing has come down.** At the same time, what Eggland's Best is charging the producers for the right to sell the eggs has gone up, so they're caught in a squeeze.

Expert 00:15:55

Right now, their margins are limited and decreasing at Eggland's Best. Today, ever since **AI reared its ugly head** a few years ago, the markets have risen much higher than the historical norm. **They're making more money selling a white egg as a cage-free or conventional egg they would be selling as an Eggland's Best.** **They're downgrading Eggland's Best eggs** and selling them as a cage-free or a caged egg and making more money. It's an interesting challenge.

Analyst 00:16:41

Yeah. That's interesting. I know when I go to the grocers, EB does not look like a premium brand to me where I am.

Expert 00:16:49

No, it doesn't. They haven't updated their packaging. Most of the countries sell a foam package and consumers think foam is bottom of the barrel. It's lost their panache, if you want to put it that way.

Analyst 00:17:12

Yeah. This is pretty fascinating. All right. You mentioned AI. I'd love to hear what your thoughts are on the big trends we should be thinking about for the industry for the next few years.

Expert 00:17:33

The big trends you're going to see in terms of the overall market, first and foremost, with HPAI becoming endemic and now spreading, and the first outbreak in 2015 was one thing, the next outbreak was another, but now it's sticking around, it's changing its cycle, you will see the producers pushing back against retailers and food service operators for increased costs to cover what they need to protect themselves against AI.

Expert 00:18:24

You will also see the smaller farmers, the smaller producers, so the million birds and under, they will start to either go out of business or sell to larger producers such as Cal-Maine or even some of the larger regional producers because they simply can't afford to put in the biosecurity measures. In terms of AI, that will elevate the overall conventional market, so the base market, whether you're Midwest, South Central, etc.

Expert 00:18:59

That market which typically would dip into the 90s¢ and sometimes into the 80s¢ will probably hover around that \$1.20-\$1.30 mark as the bottom line, and we'll bump up against \$2 with the cyclical holiday needs. That's what AI will do to the market. It's going to bring it up from 90¢ summer market into the \$1.20s just because of supply concerns.

Expert 00:19:31

On the other hand, you will also see with the overall consumer demand, in Western 13, about 75% of those consumers that live in the Western 13 states are under either a legislative action or a voter action for cage-free. The cage-free flocks, I'm going to start with California, it's rolling through, by the time January 1 of 2025 hits, **75% of the consumers will be forced** to buy cage-free eggs because of state laws, however, they were [re-nacted]. You will see a big push on cage-free.



Expert 00:20:14

When California went cage-free, there was this, "Oh no, California, it's going to suck up every cage-free egg in the U.S." It didn't. **The demand was a little softer.** With what's going on in the West Coast and then with the consumer demand shifting and the consumer preferences shifting in the East Coast, you will see the Midwest, and they're already doing it and they've started doing it a few years ago, the producers will be shifting their conventional production to cage-free production to be able to meet the demands of the consumer.

Expert 00:20:53

You will see **the cage-free market continue to rise.** We just saw the Northwest market, in essence, merged with the California market to represent **what will be a national cage-free market.** That spread will be roughly 50¢-60¢ above the Midwest market, which is the barometer for everything conventional.

Expert 00:21:22

The other thing you will see is the cage-free production will not be enough to meet the demands in the next year, year and a half with everything changing, so you'll see the cage-free market rise even more. That will be interesting. What that does overall in the stores is now you have cage-free as the new baseline. It used to be conventional whites or conventional browns, now cage-free is a new baseline egg in the market. That will give a lower price gap to a free-range organic pastured raised.

Expert 00:22:08

It used to be consumers either fell on one end of the spectrum on price and they bought the cheapest in the case, the other end of the spectrum was they bought a specialty egg, be it organic, cage-free at the time, etc., and then you had about 50% of the market in that **murky** middle, which they were undecided. They made the decision at the shelf. That group in the middle is now going to be pulled more towards the specialty end of the higher-priced end because the price gap between the baseline egg and an organic egg will start to shrink.

Expert 00:22:53

If you think about it now, the average price on an organic egg across the country is roughly \$3.99 on average. The average price on a cage-free egg in the states where it's mandated based on the market going up and the bulk of those eggs still on the market formula, there's under a 50¢ price discrepancy or disparity between a cage-free and organic. The people that weren't buying organic because even though they believed in it but they didn't have the financial wherewithal to buy them will now start buying organics or will start buying free-range or pasture-raised.

Expert 00:23:43

There aren't enough organic eggs right now to supply the consumer demands. If the demand jumped by 15%, you wouldn't have enough organics to supply the consumer demand. If you're a specialty producer, you'll have now have the ability to raise prices, **which will slow some of the consumer demand** to bring it back in equilibrium.

Expert 00:24:09

Between now and, say, 18 months to 24 months from now, you will see organics be the potential cheapest on the shelf. I personally just bought an organic brown that was cheaper than Eggland's Best and was on par with cage-free.

Expert 00:24:31

You put all of that for all those points out there and then look at the producers in the Midwest because they still do rule the roost on producing conventional eggs, are they going to start moving towards a potential higher profit margin and convert flocks to cage-free or some to organic or will they simply say, "We can't afford to invest \$50-\$75 a bird to transition them into a cage-free and stay conventional?"

Expert 00:25:09

It will be interesting to see what those smaller producers do. If you have 1 million birds, let's say you're a 1-million bird farmer, you have three choices. You either align with a producer to sell your current conventional eggs. You align with the producer and transition to cage-free eggs, which on 1 million birds will cost you \$75 million, and saddle your kids with that because they're all family-owned farms, or do you go out of business or sell? Those are their three choices.

Expert 00:25:47

They will face that relatively quickly because **all egg farmers, in general, operate on very thin margins** and they live on cash flow. If you don't have a market, you rely on someone else to market your eggs, you're eating into your cash flow and your margin just to stay in business. It's very interesting. The dynamics will change quickly.

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Analyst 00:26:22

Can you help me understand the economics of a producer? It sounds like it might bifurcate between small producers and large producers in terms of spending CapEx and shifting production from conventional to cage-free in respect of the total earnings return. To put it another way, you have this offset **which is much more profitable** for cage-free.

Analyst 00:27:01

Put aside the legislative mandates for now, but just for the Midwest guys that can serve [mid-lower] markets out there as they evolve and put aside the consumer preferences and all that, just on a pure economic basis, is it better for them to spend the money and go to cage-free or is it better just on a pure economic basis for them to stay doing conventional eggs if they have a choice?

Expert 00:27:34

Let's look at the two different profit structures. Right now, the cost to produce a naked egg, that is an egg that's gone through the processing and it is not packaged, is running about 95¢. That's the cost of produce. If you take an average 25¢ offset of the market, it means for them just to break even on that naked egg, it's \$1.20. The market has to be Urner Barry and the Midwest has to be at \$1.20.

Expert 00:28:12

To produce that same naked egg, and this is before you add packaging labor, getting a truck, getting it to a customer, on a cage-free egg is running about 30% higher. You're adding another, to keep the math easy, 25¢ a dozen. Now, that same egg is costing you \$1.20 to produce because the birds eat more feed, they produce less eggs, it takes more labor to handle cage-free of higher bird mortality, etc. It costs them \$1.20, that means the cage-free market average is about a 30¢ discount. If you get into your entry-level accounts, the cage-free market has to be \$1.50.

Expert 00:29:10

If you're talking about investing \$75 a bird over the flock lifespan, that adds about another 5¢. That bird costs about 5¢ a dozen. Now, your true cost with investing \$75 a bird in CapEx is \$1.25. That's what they need just to break even. The market has to be right around \$1.55 average. If you're sitting in today's climate, the cage-free market is much higher than that. They have to shift that product to the West Coast if you're sitting in the Midwest, so now you're adding another roughly 20¢-25¢, on top of your cost.

Expert 00:30:08

As you can see, it starts escalating. The market for them to break even is now pushing roughly \$1.70-ish, somewhere in the \$1.70s. That's the break even. They have to make an assumption that the market will be over, say, the \$1.90 mark for the next two years for **them to recoup their capital investment at a decent enough rate of return** to invest in the next flock.

Expert 00:30:46

When you're a farmer, when you're a producer and you're moving to your next flock, you're planning your flocks anywhere from nine to 18 months in advance. The larger folks, like a Cal-Maine, a Rose Acre, a Hillandale, they're planning their flock rotation 18 months in advance. The smaller guys are planning at nine months in advance. You're taking a lot of risk is what I'm saying.

Expert 00:31:20

Yes, from an economics point of view, if you simply put pen to paper, it makes sense, you have a higher rate of return to go cage-free, but **you also have a higher risk** because it's a \$75-bird CapEx investment to be able to get into the cage-free or you look at it and go, "Well, I'm not going to invest \$75 a bird. I'll stay with conventional."

Expert 00:31:53

You also face the risk there, but it's a lesser risk because you know that the production of conventional, the non-cage-free egg producer or non-cage-free flocks will eventually diminish as people are moving the ones that can afford it and want to take a gamble and moving to cage-free. **You're taking a risk into their ends** right now.

Expert 00:32:18

If I was a farmer, if I was a producer, I had 1 million, 2 million birds, I would be looking to sell. That's what I think will happen. You will see all of these smaller producers selling. By the time we look at the business in 2027, January 1 of 2027, I would be surprised if you had more than 20 egg companies representing 80% of the market. Right now, there are about 300 out there that makeup 1 million birds and over. That'll shrink to, I'm saying, 20-25.

Analyst 00:33:20

That is a great perspective. I'm not sure, even if you have 20-25, it's a very regional business. Eventually, let's say by 2028, the Cal-Maines of the world and the Hillandales and Rose Acres, does **that give them even better pricing power** because now it's an even more consolidated industry or even when you're dealing with 20, 25, is it still very much a commodity business?

Expert 00:33:52

It does give the larger producers more negotiating power. You have on one hand the consolidation not only in the egg industry but in every other agriculture industry, be it grains, protein production, etc. On the other side, you also have consolidation, talking about retail or food service operators, that is the pool of national operators. They're all getting bigger.



Expert 00:34:28

Look at the Kroger-Albertsons merger, which I know they're going to court should come through. Look at Walmart, look at Target. You can tick off on two hands, there's 10 grocery operators that control the bulk of the market. You have to get bigger. Hence, the reason you will see more co-ops start. Hence, the reason you will see the Cal-Maines of the world get bigger. They need to do it to be able to have the ability to get price out of the buyers. It's a classic case of guns and butter if you remember your Econ 101. That's what's happening. I haven't used that phrase in 40 years.

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Analyst 00:35:35

Yeah. Let's switch gears a bit. Let's go back to HPAI because there's something that I'd be interested in talking through. There are some discussion out there that this outbreak of HPAI is much less seasonal. It's lasting throughout summer. There's human and mammalian transmission. What does that mean in the industry? What does that mean for this outbreak versus past history?

Analyst 00:36:03

**Fake orders are obviously very high.** I think backlogs are five months out, but it also creates potential for oversupply in time depending on what happens with flocks that need to be cleaned, removed. I'm curious how you characterize this current situation and maybe scenarios for what happens six months from now, a year from now.

Expert 00:36:47

Yes. On one hand, as the flocks are being repopulated, if AI does not hit, if **you're not losing birds to AI**, there is a possibility of being oversupplied on the bird side. However, with that said, you will also see people getting out of the business and the flock size shrinking that way. AI is endemic at this point. It is passing on to humans, which is even scarier. The latest outbreaks of AI have really occurred with cattle passing it onto birds. That is something that nobody expected.

Expert 00:37:47

Herbruck's, when they got hit, this is recently, theirs came from cattle because the folks that worked in the barns had cattle at home or their neighbors had cattle, so they brought it into the barns. They didn't have an effective biosecurity policy against cattle. Everyone has a biosecurity policy against owning birds, but with cattle coming into play, everyone is scrambling right now to figure out how to change that.

Expert 00:38:20

In Herbruck's example, **they lost 6.5 million birds in a week.** With the large complexes that are out there right now and more coming as a consolidation hits, in theory, if it hits in Northern Iowa again as it has in the past, **you could lose 20 million birds with one outbreak.** I do not believe there'll be an oversupply. **Farmers are more cautious at this point.**

Expert 00:38:56

The typical farmer mentality is, "Oops, we can make an extra 5¢, let's plant more corn. Let's put more birds on. **It is so expensive now and the cost of capital is very prohibitive.**" You see less of them putting on more than they need and less are going to take the risk because they're seeing neighbors and acquaintances going out of business.

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Analyst 00:39:38

Is there any offset to that sort of impetus to repopulate flocks just from the grain futures and feed costs should continue to push downward? Does that change the equation for the big guys at all?

Expert 00:39:57

No. The grain costs don't change the equation. Yes, grain costs are important. They can typically pass some of those along as grain costs go up or as grain costs go down. If the grain costs go up, they can most of the time pass that along. There are some provisions in their contracts for grain adjustment.

Expert 00:40:28

As **grain costs go down**, it works the same way, and the retailers come back for that as well. They'll come back and actually ask for concessions because they do a quarterly grain cost review. You also are seeing cost-plus contracts or grain-based contracts becoming a bit more prevalent. Walmart, for example, they have about half of their annual supply locked up on market. The other half is locked up on grain-based. That's fairly common knowledge.

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Analyst 00:41:13

Interesting. All right. In terms of Cal-Maine, how far are they pushing into cage-free if you have any sense?

Expert 00:41:31

If you've looked at the recent builds they've announced, they're all cage-free. **Cal-Maine has a reputation** of being a bit of a gambler. They like to play the market. When it comes to their movement towards cage-free, they've publicly stated **they're cautious about it.**

Analyst 00:42:04

Publicly, they said **they're cautious**, but yet they're building and buying a lot of cage-free capacity. Are they making a sneaky gamble in cage-free?

Expert 00:41:51

I would say when it goes to cage-free conversions, if you've looked at their returns, looked at their quarterly filings, they had a huge year when the market was high. **They had a horrible year** when the market was low. I think their annual return over two years is about 4¢ or 5¢ a dozen. Actually, probably 2¢ or 3¢ at the end of the day.

Expert 00:42:46

They're willing to invest, but they only have so much capital to go around. I would say they're cautious. I believe their public statement reflects what they're actually doing. I don't think they're going whole hog into cage-free. With that said, I do believe that their next acquisitions will be in the specialty market.

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Analyst 00:43:16

Interesting. Do you think **they have any advantages** competing against the Vitals, the Happys, the Pete & Gerry's of the world? Do you think a branding advantage can persist in the premium market? That's been a question that's been on my mind.

Expert 00:43:36

Yes, it will persist. Again, remember, when you think about consumers, you can take any category, and if you do a deep dive, pick the ice cream category, for example, it's one of my favorite ones to look at and study, if you ever go into a grocery store on a Saturday, just go stand in front of the ice cream case or the egg case, the ice cream case is even better, you'll see people come up and about 25% of them will go right for the Breyers, the Edy's, or whatever the local premium brand is. They don't even look, they just zoom right to that spot.

Expert 00:44:13

You'll see another 25% that will scan the case and buy the cheapest thing in the case. You'll see about half the consumers that actually will spend about two minutes on average trying to decide what ice cream to buy. They're the ones that have on their list, "Get Rocky Road." They don't have a brand preference, but they know they don't want the cheapest, so they're literally studying that case. That's where branding is important.

Expert 00:44:46

The same thing in eggs. What branding also does for the producers is it allows them some pricing power with the retailers. All they're trying to do with branding on the egg side is thread the needle to be between the premium brands. Say a Vital Farms on a pasture-raised and the store brand on that same pasture-raised, they want to sit in the middle and then put enough out there, particularly on social media, digital efforts, and some in-store branding in terms of maybe some point of sale or point of purchase materials and the cartons themselves to stand out so **you'll see brighter cartons or different cartons.**

Expert 00:45:40

That's what made Vital Farms work was they're very unique. Nobody packed eggs in a black carton. It didn't scream fresh. You look at Happy Egg with their yellow carton with almost the circus tent stripes. That carton itself costs about 35¢. It's coming out of France. The Vital carton is mid-20s¢. It's not cheap compared to the other cartons out there. Branding is important. You will see Vital, you will see Happy Egg, you will see Pete & Gerry's continue to push.

Expert 00:46:19

So yes, branding is very important because the only way to survive in the egg category with commodity eggs going away and cage-free becoming the new norm is to get away from commodity-based pricing and a commodity-based mindset. You can look in the milk case. The only way to make money for a milk producer is to pack a brand. They can't live off of what store brands are paying.

Expert 00:46:53

That's why if you go just look at the gallon jugs of milk, 2% milk is 2% milk. There's no difference between the store brand and the Land O'Lakes' 2%. Why are people buying Land O'Lakes? Because they believe in the brand. Why are people buying the generic product? Because it's the cheapest. You need the brand in order to survive, and **margins are very thin.**

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Analyst 00:47:23

Since we've ventured into the premium segment, I actually had a question. I don't know if I've gotten a great answer too. Vital Farms puts out this number that their average buyer spends \$34 a year, which in my mind equates to about four to five cartons, four to five dozen. Part of me is surprised and part of me is not. Just given, in your example, and they're buying the category, but they'll price shop at the shelf or make the decision when they show up.

Analyst 00:47:57

I'm curious, why aren't people more loyal to, let's say, Vital Farms? If you're only buying four to five cartons a year, that sounds like a lot of trialing or maybe it's an episodic, opportunistic buying. It doesn't sound like, "I'm buying a case every week and that's all. I only eat Vital Farms eggs." Unless it's like a barbell where one side is buying Vital Farms day in and day out and only buys Vital Farms, and on the other side, there's people that are buying one pack a year or on average a quarter. They're buying one every two years or something just for the heck of it. What do you think's going on with that buyer behavior?

Expert 00:48:47

There's a few things going with the consumers, and there have been a few studies done on this. The consumers, you have heavy, light, and medium users. It's the typical light to medium user that is in the specialty category. The heavy user is having eggs every morning for breakfast. They're typically an older consumer.

Expert 00:49:18

The Vital consumer is, let's say, a mom in their mid-30s with a couple of kids at home. That's pretty good without getting deep into consumer insights and consumer profiling. It's a suburban mom and she goes to and shops about five stores on average to get their groceries. What's happening is they're going to Whole Foods which is our Vital's most prevalent to buy the perimeter of the store, the fresh products, and that's where they're picking up the bulk of their Vital.

Expert 00:50:04

They're also going to the local Walmart. They're going to Target. They're going to the discount stores to buy the bulk of their dry goods and fill-in trips. They are buying other eggs and it's not because of they're ignoring Vital when they buy the other eggs, it's because when you go into Whole Foods, which is Whole Foods and specialty stores are still the primary outlet for Vital, those stores, Vital is priced at \$8.99-\$9.99 a dozen.

Expert 00:50:44

If you go to a Walmart, you can buy Vital for \$7.99 a dozen or \$6.99 a dozen. At Walmart, they're buying the rest of their groceries or shopping there because groceries are less expensive. They walk up to the egg case and they feel, "There's my favorite brand. It's Vital. It's \$5.99. Well, wait a second, Walmart has an egg at \$2.99. Am I going to spend \$3 more because I'm making breakfast for the kids?"

Expert 00:51:13

They know the difference now. **It's a financial compromise for them**, which is why you're not seeing Vital sales as strong in Walmart, even though they have a significant discount to the specialty retailers that sell that same product. It's because Walmart is all based on price and people are shopping at Walmart for price.

Expert 00:51:36

It takes a lot to overcome a \$2 or \$3 gap, whereas at Whole Foods, you can't buy a dozen eggs under \$4.99 or \$5.99, depending on which store you're in. That price gap isn't as large. The expectations are, "Well, I'm at Whole Foods, I'm going to spend all my paycheck there." It's not the biggest deal. When you have the Walmart mindset or Target mindset or even a Kroger mindset, you're there for price, not for the perimeter. **That's why their sales are falling off.**

Expert 00:52:18

There's also another phenomenon known as ghosting. It's fun. My daughter has friends that do this, and she's 32 years old. They'll buy Vital Farms and they'll buy it once or twice a year, but they'll buy other eggs and put their eggs in the Vital cartons. When their friends come over and open the fridge, they see all this premium product in the fridge even though it's not. I don't know if you've ever heard of that before, but it's pretty common among millennials, funny.

Analyst 00:52:50

That's hilarious actually. Ghosting is the dating term in my view. To ghost your eggs, I think the term is catfishing. They're catfishing their eggs.

Expert 00:53:09

They're doing that a lot because they want their friends to think they're buying the best.

Analyst 00:53:16

That is hilarious.

Expert 00:53:18

It's a weird thing, but it's happening. Overall, Vital and especially folks are poised to really be able to expand in the market with what's going on with cage-free assuming **they manage their supply chain correctly and don't run into issues with that.**

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Analyst 00:53:45

**You've got these opposing forces where on the bottom end, what will be the baseline egg will be cage-free, and then you've got HPAI pushing prices.** The spread to premium, free-range pasture, it gets smaller and that makes the buying decision easier. At the same time, you've got this buyer behavior and Vital puts out the numbers, they say **it's got another 25% of the market to penetrate in terms of shelf distribution.** They're more Walmart than they are Whole Foods and Sprouts. That makes **it tougher from a shopping mindset perspective** to price high as well. Where does that fall out for them? Maybe nobody knows yet.

Expert 00:54:38

Nobody knows yet, but they're looking at market share. They're looking at outlets to grow. I don't believe based on the distribution gains they've seen that they're putting their focus on the right end customer and outlet. They're taking the shotgun approach at this point because they know the only way to grow is to expand distribution.

Expert 00:55:13

They're taking a shotgun approach versus a rifle. It'll cause one or two things to happen. If they do it correctly and they maintain their price points and they grow slowly, they'll be able to keep their core outlet base happy. If, however, they have to bring their price points down to expand distribution and channels that their core customer doesn't shop at all the time and to grow market share and gain trial, that'll do nothing but annoy their core base.

Expert 00:55:59

There are plenty of competitors out there who would love to walk into Whole Foods and take Vital business at Whole Foods. **You're going to lose potentially. Whole Foods could lose some buyers** if they switched and didn't carry Vital Farms. That brand loyalty index for Vital is somewhere in the 80s percent if I recall the last time I saw it. Are **you willing to suffer a 15% loss in a customer base for an egg** when you can bring one in and have exclusivity? I don't know. It's a decision that will be made, but they have to be very, very careful in how they do it.