

COMPANY DEEP-DIVE

CEO of a Competitor Thinks VITL Will Lose Market Share in Pasture-Raised Eggs Over the Next ~3-4 Years

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OTHER COMPANIES

- PETE & G...HAPPY EG...TRADER J...EGGLANDS...ROSE ACR...CALMORGANIC ...CIRCANAMID-STAT...HELLMAN & FRIEDMAN LLC

Transcript Highlights

- The expert believes the pasture-raised category will continue to grow as Millennials and Gen Z become larger consumer segments.
- The expert thinks competition in the pasture-raised egg category is increasing and will likely reduce VITL's pricing power.
- In the expert's opinion, the biggest source of cost pressure going forward will be farm/egg acquisition costs, in part because competition for pasture-raised egg sourcing is increasing.

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Expert Bio

Expert is the CEO at Pete and Gerry's Organic Eggs.

Interview Transcript

Analyst

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 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, just let me know we'll move on. Finally, you agree not to discuss specific details of your current employer. Do you agree with this?

Expert

Agree.

Analyst

All right. Excellent. Just to recap for the transcript, today we're going to be talking about Vital Farms and competitive dynamics, market trends, all that good stuff. Before we get into my specific questions, why don't you just go ahead and give me a quick background on yourself and your experience in the industry?

Expert

Sure. I've been around consumer products my whole career, since the mid- to late-'80s when I started with Procter & Gamble. I specialized more in food and beverage the last couple of 15, 20 years. I joined Pete & Gerry's as CEO in August of 2022. Did not have prior egg experience or anything really this close to the farm.

Expert

When I joined, we were just working through a lot of the grain hyperinflation that occurred when Russia invaded Ukraine. **That just blew the whole world grain markets into turmoil.** We implemented, as did **others, other premium egg players a number of price increases** to get on top of that. Had been through two cycles of avian influenza now, which have actually a bit of a different effect on us than both the commodity players, which we can talk about.

Expert

We have two brands. Pete & Gerry's and Nellie's. We play in a broader footprint than some of the other players where pasture-raised and free-range and both organic and conventional fed. Vital, as you probably know, is purely pasture-raised, and then Happy Egg with the other premium player is solely free-range. That's a bit of a background on our business and some of our competitors.

Analyst

All right. Perfect. Maybe just to start out, I was wondering if you could give me, to the extent you can do numbers, rate otherwise, just ballpark is helpful but just a sense of what the egg market looks like in terms of market share and growth rates in different segments. Cage-free, free-range, pasture-raised, and how those compare, if that makes sense.

Expert

Yeah. I can give you a rough numbers. **The total U.S. egg market has been actually pretty flat in terms of volume.** It's about \$9 billion U.S. in revenue and about 3 billion dozen. It is about 2/3, maybe 63%, 64% cage. This is in volume. The remaining 30-odd percent, 36%, 37% is going to be cage-free and up. That number has shifted quite a bit.

Expert

Cage has been declining for a couple of reasons. I think probably five years ago, that number might have been 80% of the total. **They've been declining** both because of the animal welfare concerns that consumers have and shifting away from cage, as well as a number of big markets mainly California and Massachusetts have outlawed anything in a cage, whether it's eggs or pork or whatever cages before, and other states are coming. Colorado, New Mexico, others are coming.

Expert

There's definitely a shift to awaken cage-to-cage, free and up. Big difference in our world between cage-free and free-range in that cage-free, the birds are not in cages, but **they're not actually getting outdoor access**, whereas all of our birds are free-range and up about their access.

Expert

Cage-free has been because of a lot of the shifts **I just talked about is growing in the low single-digit range, whereas free-range, depending on whether it's conventional or organic, has been growing in the high single, low-double digits.** Pasture-raised has been the star, and that's really credit to Vital and what they've done in the industry.

Expert

That's been growing mid-teens volume, maybe even low 20s in some years in volume to the point now where I believe pasture-raised is bigger than free-range. They're both, of that 36%, 37%, I think it's roughly 21%. 20-odd percent is cage-free, and then the remaining what, 15%, 16% is going to be shift as we share between free-range and pasture-raised, but that expect to continue to shift more in favor of the larger players.

Expert

In dollars, it's a different story. It's because we in the premium, free-range, and up have taken price because of those input costs that I mentioned, less because of avian influenza, but labor, grain, diesel, all those are big cost drivers for our business because we're not in-line processors. We've taken price and as a result, if **you looked at that growth, the growth numbers, it's going to favor** some of the more premium players.

Analyst

That's really helpful. This is probably a tricky question, but I'm curious if you have a sense of where the growth in pasture-raised is coming from. Is it more coming from free-range, perhaps, or is it coming from the other segments?

Expert

It's certainly going to come from free-range. Again, it's tough to talk about hen treatment and feed simultaneously because they do obviously intermingle, meaning organic free-range has probably been a bigger contributor to pasture-raised growth than conventional free-range.

Expert

There's certainly a migration from organic where that used to be the premium expression of an egg, an organic free-range egg. Now, Vital has, again, just done a nice job of shifting the consumer kind of calibration to the premium expression being pasture-raised.

Expert

That's a piece of it. I'd say another piece of it's going to come from where they've been able to convince consumers that branded pasture-raised is a better egg than private label. In some cases, it might be if **the private label players are molting their flocks** or the eggs are a little bit older, they're not going to seem as fresh and the experience isn't going to be as good. There could be some foundation there moving just from private label pasture over to branded pasture.

Analyst

I do want to get to that in a second. Let me ask, I'm curious if you have a sense of where pasture-raised is in its growth curve. Would you expect that it'll sustain the recent, I don't know, let's call 15%, 25% CAGR it's been going over the last couple of years. Do you think that's close? Do you have a sense of where the ceiling might be?

Expert

We just reentered the pasture-raised.

Expert

We reentered with just a pure conventional pasture about two years ago. We have seen, as we've entered the category, we've taken share from Vital, which I'm sure you'll want to talk a little bit about later, but also have expanded the categories. We see pasture-raised continuing as a category to grow.

Expert

The other driver, though, the growth in the category has been Vital's entry into organic pasture. That's their gold box. It's premium both in terms of hen welfare and feed. You don't have to talk about regenerative farming practices. With that one, they do have a regen product, which doesn't really do all that well. **Their organic pasture has really done quite well and has continued to grow the overall pasture category**, even while conventional continues to grow.

Expert

We're seeing more and more consumers care about that hen welfare expression. It's been like that in Europe for quite a bit longer. Whereas you're looking at **purely just generational shifts in the U.S. from boomers sunseting and Gen Xers dialing it back and also feeling some economic pressure** as dealing with all sorts of inflations. Their kids are going to college and everything else, versus where millennials and Gen Zs are who care. They're much more receptive to the animal welfare message.

Expert

They're about the same size. If you take those four cohorts and you lump boomers and Gen X into one and Gen Z and millennials into the other about the same size, roughly 130 million, 140 million. One's on its way up with increasing buying power, meaning millennials and Zs and one's on its way down. We actually see the groundswell for that hen welfare expression to be in the early, whatever you want to call it, days, innings, whatever early stages.

Analyst

Okay. Let me just ask to make sure I understand that. The difference between pasture-raised and free-range, is it really just come down entirely to hen welfare or is there any other, I don't know, nutritional component or very noticeable product quality component?

Expert

First of all, there's the definition. There's two definitions for free-range. One is the bird has to have an average of 2 ft² per bird outside. The European standard is 21 ft² per bird. You can put a free-range barn of 20,000 birds. If you're doing 2 ft², you can put it on about 3 ac. If you're going to follow the European definition, it needs about 8 ac.

Expert

Contrast that with pasture-raised is only one definition. It's 108 ft² per bird. Don't ask me how they come up with that number, except that a typical premium barn is about 20,000 birds. If you do the math on how much land you need for 20,000 birds to have 108 ft², it's 50 ac, which is a round number.

Expert

There's a big difference when you just look at the amount of access that those birds have to the outdoors, which does a couple things. One is they can just forage more for a more natural diet of grubs and grasshoppers and whatever else they eat when they're out there, and they peck for constantly pecking the ground for food. The other is that the more the bird is outside, the more sun it gets, the more vitamin D it gets. The healthier the bird, the healthier the egg.

Expert

Now, there is no, not that we're aware of, whatever you want to call it, nutritional difference in an egg laid sadly, by a bird sitting in a cage versus a bird that's out on 108 ft², nutritionally. When you look at the yolk, when you look at the thickness of the shell, crack the egg, there's a difference. You can feel and see the difference.

Expert

The other difference, which is not anything to do with whether it's free-range or pasture-raised is just purely time. Meaning if the bird is older and still laying eggs and is forced to lay more eggs, those eggs are going to have thinner shells. We don't do that. I don't believe Vital does that, but some of the cage or some of the conventional players will do that.

Expert

The other is how long the egg sits in cold storage, in refrigeration before it actually gets graded. If you look at the date stamp on the side of a package of eggs it's either 30 days if it's California or 45 days from the date it was graded if it's most other states. That only happens when you grade the egg. You can keep the egg in cold storage for 30, 60, 90 days, and then put a date stamp on it. The older that egg gets, the less the quality is, but that's not a difference between free-range and pasture that'll be the case no matter.

Analyst

Interesting. Okay. I wanted to ask about the yolks because that is something that I've noticed. I bought a whole bunch of different brands of pasture and whatnot, and the yolks definitely did strike me, particularly, the ones that Vital has and Pete & Gerry's actually has. One of the things that I have heard is that that is partly a result of adding marigold petals, paprika, turmeric, that kind of stuff to the chicken feed to get that rose color scale that they're looking for. Did I understand that correctly?

Expert

It can be. I will tell you that it's not something we do. It is something others in the market do to get that gold or whatever orange color. It can go too far. I'm not going to name competitors, but I've seen [inaudible] natural. I mean, they're practically red because there's so much turmeric in there.

Expert

There are definitely some additives that you can put in. You got to remember that the birds when you do a feed mix for birds, there's corn, there's soybean, but then there's everybody uses a different proprietary nutrient packet. Those will include those different items, could be vitamins, could be other supplements. Could be the things you're talking about.

Expert

There's definitely a difference, but I would chalk that difference up more to the fact that the bird is getting more exercise, more vitamin D from the sun, etc. It's going to make their output just healthier. Again, not healthy to the point where you can make a nutritional claim, but just look better, feel better, taste better when you eat it, feel better when you whip it into a scrambled egg.

Analyst

Of course. How important do you think the yolk coloring is driving the consumer's perception of this is definitely a different product? Would **you expect more competitors** to start one way or the other, trying to get a yolk color that really maps as Vital? It struck me that some of their private label, for example, where they didn't and then it doesn't feel the same.

Expert

Yeah. Did you buy private-label, pasture-raised?

Analyst

Yeah.

Expert

Yeah. A bird, typically a layer lives about, they are what are called pullets when they're about 16 weeks old. By the time they get to about 24 weeks, they're starting to be productive hens. They go from that kind of 23-week-old, 24-week-old up until, they'll lay for about a year to maybe 60 weeks, mid-80s. Mid-80s, that's an old bird.

Expert

Typically, what ends up happening at that point is **you're going to depopulate the flock**, which is you euthanize the birds or bring them off somewhere else. They're not meat birds. You can't do anything really with them. If you prolong the life of the flock, you can stretch out the laying cycle for that bird. You'll get more eggs out of her. It's pretty inefficient. You start feeding her too much grain. You'll start to notice the shells are thinner. **The yolks don't look as good.**

Expert

That's one factor and the other is just how much are you willing to invest in feeds and that nutritional packet. Feed is roughly half the cost of a dozen premium eggs. If you think about the corn, soybean meal's more expensive than corn or there's more corn in the mix, but it's roughly 1/3, 1/3, 1/3 between the corn, the soybean meal, and that ingredient packet in terms of cost.

Expert

If you really want to try, and this is a game of pennies. I mean pennies, 1/2 pennies per dozen because it's just such massive volume at 3 billion dozen, that you can pick up a half a penny or a penny. If you're a conventional player, you can make a lot more money. You could do that by putting a lower-cost ingredient packet in there, which will make the bird less healthy.

Expert

The other piece, I don't know what Vital does, but you're spending a lot of money on these birds.

Expert

All those things contribute to a healthier bird and a better experience, but also a better egg. That's the best way I can describe it, and you end up with a better product.

Expert

There is definitely a barrier to entry, and you have to make all those investments. Some are willing to do it and some aren't.

Expert

We haven't seen anybody really mount a charge to either us or Vital in the space. There are plenty of players out there. Kirkland sells a lot of pasture-raised organic eggs. Trader Joe's sells a lot in that. Where do you live?

Analyst

Southeast Florida.

Expert

Okay. Are there Trader Joe's by you? Probably not.

Analyst

Yeah, there is one.

Expert

Is there? Okay. It's worth going into Trader's to try. Have you tried their private label?

Analyst

I looked at them. I didn't actually buy them.

Expert

Okay. Worth trying theirs to see if you see the same thing in the yolks because they're going to be different than, say, a Publix private label, which is where I'd imagine you've got more Publix or Whole Foods around. Whole Foods and Trader Joe's' private labels are going to be, I think, a little higher quality because they're willing to pay a bit more.

Expert

For them, in particular, for Trader Joe's and for Costco, they absolutely believe that **eggs are a loss leader traffic driver**. **They're not as nearly worried about their margin in that section** as they are about being a leading price point that's going to drive people in there to buy everything else that's higher margin.

Analyst

Interesting. Okay. This is actually a good lead into what I wanted to shift to which is the competitive landscape. Maybe just give me a sense of who the major players are and how their business models differ. Are they more branded or private label? Are they more vertically integrated or more asset-light like Vital?

Expert

Yeah. We can spend time talking about Vital specifically if you want or you want to talk about other competitors first?

Analyst

The other competitors are really what I'm interested in.

Expert

Yeah. In the premium space, the other big national player is Happy Egg. Happy has a much different business model, they're privately owned. Their model differs mostly in that it's a really asset-light model. They don't own farms. They might own a few of their, I can't remember what they call. They call them Heritage eggs. They're blue and brown eggs. They're more heirloom-like.

Expert

They own some of those birds, but for the most part, they historically had contracted with some growers like Mid-States to supply both the eggs and the grading. They didn't have processing facilities. Are you familiar with how the supply chain works for premium eggs?

Analyst

Yeah.

Expert

Okay. They don't have any farms that they contract with, that they will have an ongoing relationship with. They just really have a relationship with that grower Mid-States, and then they don't process Mid-States' processes. They're truly just taking a packaged dozen eggs and they are doing the marketing for it.

Expert

They're doing the brand building, the traffic building to the shell or to the retailer, and then getting it on shelf. That's their model. Not huge, but not insignificant.

Expert

You have a bunch of, I'll call it smaller regional players like Farmers Hen House, which is out of Iowa. You have Hidden Villa, which has Country Hen and a few other smaller regional brands. I mentioned Kipster and some others, and they all have varying models. Some have captive birds and will outsource processing. Some will have a fully-integrated model.

Expert

There's Eggland's Best as well. Eggland's Best is a different model. Eggland's Best is a franchise model. What they do is if you're an integrated player like Cal-Maine or Rose Acres, you will have a region of the country where you have Eggland's Best distribution. It's up to you to supply the eggs to be able to get on shelf.

Expert

They do the marketing a bit like a Taco Bell's going to do the national marketing, and then you're going to be the regional player. In Cal-Maine's case as with some others, they also do the DSD distribution. They'll literally get it all the way to the shelf, or in some cases, they'll deliver to the warehouse if that's how the retailer wants to do it.

Expert

Those are the big players. You have your conventional private-label players that are again going to be regional, whether it's Herbruck's, which focuses more on organic. Hidden Villa, Hillandale, Rose Acres. I mentioned Cal-Maine, they're all folks that have massive farms, birds in the millions. Vital, talk about having I think roughly, [inaudible] 300+ farms, so they're probably in the 6-million- to 7-million-bird range. Maybe 6 million.

Analyst

Okay, that's very helpful. Let me ask just to summarize. The branded players like Vital, like yourselves Pete & Gerry's, and Happy Egg, though Happy Egg's not really in pasture, you guys exclusively do branded. Vital doesn't do any wholesale private label, I believe. You have the other players that are smaller or like a Rose Acre or a Cal-Maine that are even larger and they'll do a mix of branded or private branding?

Expert

Correct. My understanding is that Vital does not do any private label either. Again, most others are a mix. Happy doesn't do any private label just because they don't have any farms.

Analyst

Right. All right. The other thing I want to ask about was Vital has this concept of the pasture belt, this narrow strip of U.S., that's the only place where you can raise pasture-raised birds. I just was curious. A) How true is that statement? B) If it is true, does that give them, I don't know, for lack of a better word, a competitive moat where they've locked down the farms in that area?

Expert

They're actually contradicting that a little bit now because they have announced, as I understand it, a second Egg Central Station that I think they're going to do in Indiana if I remember right.

Expert

We don't want that geographic concentration because one, we want to have a diversity of farmers, but two, it's more of an installation to avian influenza, which tends to follow migration patterns of wild birds. **The more concentrated you are, I guess the higher the likelihood is you get a devastating hit.**

Expert

Maybe not a hit because if it's happening in the Upper Midwest, which is where it happened last spring and you don't have birds there, then you're fine. **If you do, you could risk losing multiple farms.** Now, they haven't had a big hit, nor have any of the premium players. **It's a more insulated model.** If you do get an outbreak in a region, you're more at risk.

Expert

You asked about this farm availability. Look, Vital is very well known in that area. Part of the thing to remember, by the way, is the reason that that's such an appealing area is it's cheaper to move finished eggs than it is to move grain. Grain has a fairly high cost to relocation. You're almost always going to find barns closer to the grain.

Expert

You can literally move the eggs in a nest from farms 300 mi, 400 mi to a processing facility. That's why they located their Egg Central Station and the cold storage right there. Now, they're banking on the Midwest and Indiana for their next location. There are farmers that are willing to switch.

Expert

For some, it's a financial decision. For others, it's the way they feel they're partnering or not with their egg company. We've been able to pick up farmers that used to be Vital farmers, and then they come over to us and Vital's picked up our farmers. **One's not exclusive versus the other, but there's a constant kind of churning.**

Expert

The other piece that will happen is it's not that hard to put up an egg farm, and it costs about a million dollars to put up a barn. If you have the land, then great. If you don't have the land, the lands are quite expensive. Chicken farms tend to be not in primary agrarian areas. You're not going to have a premium field that could be used for corn or wheat or something else. It's a more lucrative crop.

Expert

You tend to find stuff on the outskirts that has a lot of wooded area. If you can find 50 ac with 30 ac of it's in the woods and you can put up a barn, you can do a pasture-raised farm. The better the economics get in pasture-raised, and they are improving, continuing to improve, the more farmers you're going to attract into that space, which is just that's the way supply and demand in agriculture has worked forever. It just becomes more appealing to people to join that.

Expert

There a lot of farmers that get of dairy, for example, and they'll get into egg farming; it's a hell of a lot easier. You don't have to milk cows at 3:00 A.M., you don't have to worry about where your herd is. It's a lot less land-intensive. I think there's going to be an increasing supply of farmers out there that are willing to put up these barns and put up layer hens.

Analyst

Okay. **On the same topic, a couple of different pieces.** One of the things that I've heard is that maybe call it **5% of Vitals farmers are churning** out every year. The company is trying to add, I think, another 300 or 250-300 farms over the next three or four years.

Analyst

It sounds like at the same time, at least from a retail perspective, **it looks like there's a real explosion in the amount of competitors** in pasture-raised in particular. I'm just curious for your sense of how that impacts things. Does it seem relatively achievable for them to add that many new farms? Is **the competition for those farms, and therefore the prices they're paying for eggs getting a little bit more intense?**

Expert

Yes. I don't know, and yes, the short answers to your question. I don't know if it's realistic to think they can add that many more farms. Just so you have some numbers you can do some math with. A typical bird, a bird that is not stretched should lay about 27 dozen eggs in her lifetime, about 21 dozen in the first 52 weeks, and then the remainder for the part-year that she'll be around.

Expert

If you look at Vital's growth aspirations to be \$1 billion by 2027, that means that if they're going to do that and shell egg, they're not going to do that with getting into the broiler business or something else. That means that they need to be roughly 200 million dozen. Barring any major pricing moves, we think there are roughly 100 million dozen today.

Expert

Yeah. If they have 300 farms today and they're doing 100 million dozen, they're going to have to pick up 300 more farms, a comparable size to double. That's 60 farms a year, it's not five years to 2027. Obviously, it's going to be three cycles. Three and a half cycles. You've got to pick up basically 100 barns or 100 farms a cycle between now and the end of 2027 to get to that number.

Expert

Now, they could have pricing up their sleeve. If organic pasture continues to grow, that shifts their mix, which takes some heat off of the number of farms they have to put on. Organic pasture is even harder to bring birds on.

Expert

Those farms are, you have to basically make sure that you're on your 50 ac. There are no pesticides used, there's nothing in there that's not an organic fertilizer or anything like that, which it's harder to do on 50 ac and there's only 5 ac. That raises the bar even more, but again, consumers are willing to pay for that, so it might be worth it.

Expert

Look, I will tell you, **they continue to amaze and impress us in their ability to constantly put up good numbers, big numbers.** They're constantly picking up share points, a 10th of a share point at a time. They just march along. I'm not sure I'd bet against them. I know the market's been pounded the last few days. Their stocks are almost below 40. I don't know where it closed the other day, 37.

Expert

Cal-Maine's actually taking a bit of a dip, too, but not as much of a dip as they have, which I find interesting. The run, you're closer to this than I am which is what you do, but their run in the last six months has been phenomenal.

Analyst

Let me ask you one other piece from the competition side of it. One of the things that I noticed is there's a lot of cooperatives in this space, like Organic Valley and a bunch of others. It was surprising to me to see that. **I was wondering how that impacts competition, maybe both on the marketing side, but also on the supply side.** Really, what I was wondering is from a farmer's perspective, is it maybe more attractive to work and sell your pasture-raised eggs through a cooperative as opposed to selling them to Vital Farms? Is that a risk in any way?

Expert

I don't know. I've always wondered why there hasn't been something that feels more like a milk co-op in the egg space. I realize that both we and Vital, even though we're the largest in the premium space, we're tiny compared to Cal-Maine and Rose Acres and the others.

Expert

I do believe **they had some collusion issues** a couple of years ago with some of the, [I don't know, it was] retailers brought the suit or somebody brought the suit that they were colluding to when the price of conventional eggs really spiked from AI, which I don't think there was really any merit to that, but I'm not going to get into that.

Expert

Those are the groups that would really form a true co-op. My understanding of the way, for example, a milk co-op works is they are there for the benefit of the farmers or Ocean State for cranberries. You're there to make sure the farmers have an outlet for their crop, for whatever their output is at the highest price per unit.

Expert

Milk co-op is going to say it's a better, higher use of milk right now to sell it to ice cream or to cheese than it is to whole milk, gallon milk in the stores. They'll direct it that way, and that's what you're paying them for. I don't see that ever being the case for eggs. Right now, the players are finding the best use for their eggs out in the marketplace, and the individuals are doing that.

Expert

Organic Valley's business model, I don't really understand, and don't know how much better off those farmers are. You have to remember the farmers in Organic Valley, I believe **they're taking all the grain risk**. If grain doubles and the price that they can get for their eggs doesn't, **they're going to take a huge margin hit**, where we will insulate our farmers. They're purely just as I mentioned before, the labor and the land, to collect the eggs, put them on 30-count flats, and put them in a cold storage waiting for us to pick them up. It's risky.

Analyst

Is **it an advantage for farmers** if they're considering between you guys and Vital. At least my understanding is that with Vital, they're responsible for putting up more of the cost really per feed and for [inaudible] as opposed to, it sounds like you guys are putting that cost up for them. Does that make it more attractive, you think?

Expert

For our model?

Analyst

Yeah.

Expert

Yeah, we think it does. You got to remember that, and I don't know this, I haven't talked to a lot of Vital farmers, but my understanding is that they're not 100% on the hook for the grain cost. What they do is we actually buy grain and supply the feed to our farmers. We'll create the mix to farmers where we're direct. We'll supply the mix to them from different mills that we contract with.

Expert

Vital will allow the farmer to go do that. Literally, my understanding is they just send them the bill, which is not a very efficient way to operate because you can get, obviously, the scale benefits to buying more grain if you can do that and mix that once rather than mixing it for 50 different farmers 50 different times. For us, we tend to try to just be upfront with the farmers say, "This is what we're willing to pay you per dozen." There's not a lot of performance clauses in there.

Expert

Again, I've never seen a Vital contract. This is just purely what I hear is that there's more performance-related. You can make more money, but it's a bit like a pro baseball player signs a \$30-million-year contract, but only \$5 million of it's guaranteed. The rest of it is you have to win the batting title, you have to win the World Series, you have to win this, you have to win that. Yeah, you can make \$30 million, but it's pretty hard.

Expert

For a Vital farmer to get everything is difficult, but they do put it out there. That's the risk of that sort of model.

Analyst

This is a bit of a speculation, but just zooming out a little bit over the next, call it three or four years. I'm curious what your sense would be in terms of how market share shapes up. What I've seen Vital claims they have like around 90% market share. Certainly, whenever I see them in the store, they seem to carry a pretty meaningful price premium over the other pasture-raised eggs. How would you think their market share would shape up and that price premium would shape up?

Expert

Yeah. I assume you're talking market share of pasture.

Analyst

Yeah.

Expert

We expect them to be about a 70-share player. We're not going away. You've already highlighted how others are coming into the space, some with, I call it good eggs, some with not-so-good eggs. I would say that their volume can continue to grow because the category is growing, but their share of total premium eggs and pasture in particular, I would expect to continue to decline.

Analyst

Just to make sure I'm not [saying clarification. You're talking in volume not in share numbers?]

Expert

Yeah.

Analyst

Okay. Not to put you on the spot too much, but how much of a decline would you expect? [What do you expect] from 70% to 50% or is that too aggressive?

Expert

What period of time?

Analyst

[I could call it four years, three, four years.]

Expert

Three, four years, I could see them coming down to a 60-share player over that period of time, but of a bigger category. It doesn't mean that they can't achieve their objectives. The commitment to pasture-raised is a bit of a double-edged sword for them. It's great because they're singularly focused, their message is on point. Consumers, they don't have to confuse consumers. They're talking about, "Well, free range isn't so bad." **The problem** is there's a big chunk of the market.

Expert

We see three different consumer segments out there, there's a consumer that is an organic egg consumer. There's a consumer who really cares primarily about hen welfare, which is the pasture-raised consumer. Obviously, there's overlap between organic and pasture for those two.

Expert

There's a third group, though, who wants the best for their family, but they're, we'll call them box checkers that want to do everything from hen welfare to meeting their budgetary needs to healthy lifestyle for them and their families, and clean labels and all that stuff. They just have a long list of boxes and we believe that's our Nellie's shopper.

Expert

Vital launched as we understand it, we saw a Vital free-range item in Sprouts in Denver, literally, one store, one item. It might still be there or it hasn't, but we certainly haven't seen them expand. As committed as they are to that kind of animal welfare and humane treatment of birds, they can't backslide to free-range.

Expert

In their mind and for their consumer, they view that as backsliding. That limits their ability to grow. All their growth has to be in pasture-raised or above. Again, I don't think regenerative, which is all about farming practice is not about hen welfare. It is because the birds are still outside, but it's more about just how you're treating the land with pollinators and all the other stuff.

Expert

That's not a place where they can go. I don't know what better or what higher treatment or expression of animal welfare there can be than pasture-raised. **I could be wrong, but that to me just feels like they've run out of runways or ways to express themselves, and that can be a little scary.**

Analyst

Right. **I'm sure you would agree that they have a pretty strong brand.** I'm curious, I guess how you think that brand translates into their ability to keep a price premium over pasture-raised players? How much of a premium, if any, do you think they can consistently capture versus Pete & Gerry's or whoever else in the space?

Expert

As we've come in, they're promoting more, we're promoting more. They seem to have plenty of supply, but as you promote more, that brings down the average price. They'll always be a premium player.

Expert

When you have competition, the retailer, they're going to work you up against one another and they'll come after us, they'll come after them, they'll come after whoever else is in the space to continue to promote, because the retailer knows the importance of pasture as well. To answer your question, I always see them being premium, but I don't see their price point remaining constant. Same thing will happen on organic pasture, by the way over time.

Analyst

Yeah. Of course. One of the things that I wanted to touch on real quick here at the end is just obviously Vital has reported exceptional numbers, which a big reason why **their stock is up so much**. I'm curious **a big piece of that seems to be the rise in pricing and decline in input costs**. How do you see that playing out and that evolving over the next, I don't know, six, 18 months? Would you expect **input costs to keep going down or flatline and margins to stay exceptional or maybe [inaudible] a little compression?** How would you paint that picture?

Expert

Yeah. Again, there's three or four major inputs to our business model. The first is feed and grain, the second is diesel because we have to get the eggs back from the farms. The third is labor, and the fourth is going to be basically our farmer payments. They even acknowledged in their first quarter call that Kellogg's said, "Don't expect these 40%+ gross margin to sustain because things couldn't be any better in terms of grain prices and everything else aligning."

Expert

Now, having said that there's a good crop. There's been **some areas have experienced a little bit of drought**, but then they've seemed to be getting some rain now. Right now we're seeing it looks like to us both in South America and in the U.S., that the grain futures don't seem to be showing any sign of a big spike over the next couple of six or 12 months.

Expert

That one you could say, "Yeah, it probably sustains." Don't see diesel going crazy from here, unless there's another global event. That should stay pretty steady. Labor, **I think a lot of the inflation** is baked in. It's not going backwards. We're not [inaudible] it back, but **I think the days of 5%-8% annual inflation and labor**, those are probably behind us. Those are locked in.

Expert

To me, the big wild card is going to be what you have to pay the farmer to produce your eggs. The numbers and I know we're paying more now to be competitive for both free-range and pasture. We're having to pay, some upfront fees for building barns and getting barns up front in the tens of thousands of dollars per farmer to help offset that cost. All that stuff factors into your COGS. Where that ends up, I don't know. If you think about it, it's an extra nickel **a dozen isn't going to put you in the poor house**, but it adds up.

Expert

That could put some pressure on margins. The other piece for them is I don't expect them to be able to maintain their price points. I think they're going to start to promote more. They're going to have to start to promote the gold box more and continue to promote the black box. That's just a gross-to-net walk. **That should put some pressure on the margins** as well.

Analyst

Tying this all together, I'm sure you've probably seen the targets they put out there for 35% gross margin, 12% to 14% of just EBITDA. Just give me your sense of how achievable that is. Is that something that you think they can consistently pull off every year for their sustainable future, is that aimed too high even in the long term, what's your sense?

Expert

Historically, they were a low 30% margin player. That sees them picking up over the long term a couple of points, **I mean, again, down from the 40% that they did in the first quarter**, but that's for reasons that I don't think are sustainable. They spend a lot on marketing, but that's controllable. Can they steer to a 12% to 14% gross or EBITDA margin? Yes. I think that's a reasonable target in our space. Yeah, I think those numbers are doable for the foreseeable future for them.