

COMPANY DEEP-DIVE

Former Partner Believes Supply Constraints Will Significantly Reduce Growth in the Pasture-Raised Egg Market

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OTHER COMPANIES

PETE & G...	HAPPY EG...	CALM	WMT	EGG INNOVATIONS, LLC	MID STAT...	AMZN
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Transcript Highlights

- The expert thinks competition in the pasture-raised egg market is increasing and will likely result in a significant decline in VITL's market share and pricing power over the next ~3 years.
- In the expert's opinion, supply constraints will put a ceiling on the long-term share of the category.
- The expert believes avian influenza is increasingly becoming an endemic issue that is particularly problematic for free-range and pasture-raised egg producers.

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Expert Bio

Expert was a Vice President at Herbruck's Poultry Ranch, responsible for overseeing sales and marketing. Expert reported to the C-suite.

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 that you do not have a non-disclosure agreement or any other type of agreement or arrangement that will 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 and we'll move on. Finally, you agree not to discuss specific details of your current employer. Do you agree with this?

Expert

I do.

Analyst

All right. Excellent. Just to recap real quick for the transcript, today we're going to be talking about Vital Farms and really just running the full gamut in terms of their operations, competitive dynamics, industry trends, that kind of stuff. Before I get into my questions, why don't you just go ahead and give me a little bit of background about yourself, your experience in the industry?

Expert

Sure. I've been involved in the egg industry specifically for 22 years. The perishable business in the retail industry for just over 40, so about 41 years, my 42nd year. In terms of my roles that I played, specifically in the egg industry, have ranged from sales to category management to marketing. I have held titles from sales and marketing expert to CEO of a coop we recently started about two years ago in the Western states. I'm familiar with the players in the market. I'm familiar with the production aspects, costing, etc. I can provide general insights if you want to talk numbers without revealing any specific information. That's a nutshell of what I've been doing.

Analyst

Yeah. That's excellent.

Expert

Where would you like to start?

Analyst

I think let's start just a quick, high-level background piece and just maybe talk to me a little bit about the differences between a pasture-raised egg and a conventional, or really, I think, free-range is probably the most comparable ones just in terms operationally what the differences look like.

Expert

We'll run the gamut from conventional to pasture-raised. When you think from a standpoint of the hen itself, the biggest difference between conventional and pasture-raised is the hens housing. In a conventional, they're confined to a cage typically about the size of a sheet of paper but 8 ft. x 11 ft. Actually a little smaller, about 0.67 sq. ft. As you move up to cage-free, which would be the next change in housing and change in what you see in retail packaging, that is where the hen has 1 sq. ft. of space and has the ability to roam freely, free access to food and water 24/7. You then move to organic, and these also are reflected in price points at the stores.

Expert

Organics are, in essence, cage-free birds with an organic feed component and access to outdoors. Those are typically what most consumers buy. They make up the bulk of the market. When you get into free-range, as you move from cage-free to free-range, the difference is the outdoor access. They have a minimum of 2 sq. ft. of outdoor access. That's a fenced area with a cage-free environment within the house.

Expert

Typically, on a free-range, the barn size is about 20,000 birds. Some have been as high as 30,000, but typically 20,000 bird house is there. You have pasture-raised. Again, free-range and pasture-raised, the biggest difference is the amount of space. A pasture-raised bird has, by definition, 108 sq. ft. of outdoor space available. Quite a big difference between what a free-range bird gets or is, by law, has a 2 sq. ft. of outdoor range to 108 sq. ft. Does that make sense...

Analyst

[inaudible]. Yeah.

Expert

It's all about the size.

Analyst

Sure. Free-range versus pasture-raised, obviously, there's a difference in terms of the amount of outdoor space they have, but is there a difference in terms of how much time they spend outdoors?

Expert

No. Actually, as you look from organics all the way through pasture-raised, they do have the ability to confine the birds indoors due to weather, if it's too cold or too hot, or if you have thunderstorms, etc., going through. There's no difference in the time they have to be outside. There are no minimum set. With **the recent rise in HPAI**, you are actually seeing some free and pasture-raised farms or contract farms locking the birds in to keep them away from the wild birds outside.

Analyst

Interesting. Okay. I think it was HFAC that does the Certified Humane. I could have sworn I thought they said they had to have a minimum of six hours outside for the pasture-raised. Am I misunderstanding that or is it just because there's exceptions?

Expert

It's the certification. There's various certifying bodies and they all have different requirements to outdoor access. For example, a cage-free bird has what they call pop holes for them to pop outside into a cage or a confined area with outdoor access. You can see minimums depending on the certifying agency of six hours all the way up to 10. Some obscure ones have 12. That's all dependent on weather, dependent on outside factors.

Expert

Even though there is a minimum [inaudible] requirement of six hours, actually is null and void if it is too hot or too cold out. That also explains why you see most of these flocks anywhere from very southern Indiana through Missouri, because the weather is much more conducive to having outdoor flocks. They produced the ability to suspend outdoor access because of the recent AI outbreaks.

Analyst

Okay. Let me just ask real quick on the certifying bodies. Is there one in particular that tends to be more common? I've seen the Certified Humane around a lot, which I think is HFAC. Is that the most popular or is it a mix of different bodies?

Expert

It's the most popular. I would say, by far, most use it. Actually, most retailers or food service operators require it, but there are multiple others that are used. Trying to be very kind when I say this. If you decided to start your own certifying body, you could. You could write your own rules and whoever wanted to follow those could use your certification. It's all about the acceptance within the community of retailers and foodservice operators.

Analyst

Okay. On the temperature piece, is there any way to just ballpark what HFAC classifies as too hot versus too cold just like temperature range-wise?

Expert

Yeah. Typically, you will not put birds outside unless it's above roughly 60°C and you'll pull them in when it gets in the 90°C+ range. It's not a written rule. That's just when the birds will actually want to go outside.

Analyst

Interesting. Okay. That gets to something that Vital Farms talks about a lot which is this whole notion of the pasture belt and having this sweet spot of geography that is ideal for raising pasture-raised birds. That's why that sweet spot.

Expert

Yes. That is exactly why. Typically, the birds are all put in at night and then during the day, the doors are open for them to go out of the barns or whatever housing unit they use. However, the hens won't go outside if it's too cold or too warm. They'll stay inside. If it's raining out, you'll see them out in light rains. If there are thunderstorms, **that causes own set of problems** as they're called chickens for a reason. They tend to pile in corners and you get high death rates.

Analyst

Interesting. Okay. Is it true then that you can't really do pasture-raised chickens outside of that, call it, Southern Indiana and pasture-raised area because I've heard other people suggest that there's not that much truth to it, that you do pasture-raised birds anywhere in the U.S.?

Expert

That's a yes and no answer for me. Based on the industry, you can do pasture-raised birds anywhere you want. Think about your average backyard chicken. Your average backyard chicken, if they expanded the fenced area to the entire yard, you could probably have a flock of 20 or 30, depending on the size lot you have. They would be considered pasture-raised. You see those all over the country. When I was in Michigan, few farms down had birds out. You see them on just about every farm in the Midwest. You see them in California, not as many in Alaska. I'll be there next week.

Expert

The issue you have is being able to scale that. When the weather turns, when it's either too hot or too cold, the production drops. A pasture-raised bird is the least productive bird simply in terms of the number of eggs laid on an annual basis. When you throw in the weather factor, once you get outside of that call it the pasture belt, that's when **you see production drop to where your costs just skyrocket** and it's not worth raising on a commercial scale.

Analyst

Interesting. Okay. Most of the major producers in this market all operate in that cash route for more or less?

Expert

When you say operate, Pete & Gerry's has a processing facility in Pennsylvania. They'd be considered operating out of Pennsylvania. Most of their producers are further south but most of the farms that provide free and pasture-raised eggs do operate in that region. There's a large population in Indiana around the Shipshewana area, where it's mainly Amish and Mennonites. Those tend to be actually the larger producers or contract farmers that folks like Vital and Happy Egg use.

Analyst

Okay. That's actually a perfect lead into what I was going to ask. It's just who the farmers are. Vital certainly makes it sound like it's a bunch of small family farms that they're working with. I was just curious how accurate of a picture that is or what kind of scale they're usually working with.

Expert

Remember Vital Farms in their business model they're a marketing company. They don't own any birds. They contract with farmers. The same thing with Happy Egg. Pete & Gerry's owns a very small amount of birds in comparison to their total needs. The average farmer is someone who has two to three barns of 20,000-30,000 birds per barn. That's the average producer that contracts with the Vital Farms.

Expert

I personally know of a few groups that have banded together down in the Southwest Missouri area. While they'll have 600,000 birds mixed between free and pasture-raised, I think there's 12 in this group. Let me rephrase that. There's 12 different families in this group, that total 600,000 birds. They tend to be small. If you're thinking of that beautiful image of mom and dad and the kids chasing birds around the yard, that's not what it is. It's a barn with 20,000 birds in it.

Analyst

Would you say that average producer only, I don't know if only's the right word, but primarily raises chickens? Is it a farmer who has some other crop or something else or livestock that are focused on and then does this to supplement their income?

Expert

Typically, they have more than just birds. For example, if you're in the Amish and the Mennonite country down in Indiana, I'll use that as an example, they will have other livestock. They'll also have cattle. They also raised crops. The folks down in Missouri have birds and typically crops. Some have actually branched out into looking at their own processing facilities as a value add. Rarely are they just chickens. It's not sustainable.

Analyst

Okay. That impacts my next question. I was going to ask what kind of upfront cost or ROI or break-even time farmers have when Vital is onboarding them into the supply chain? It sounds like a lot of these farmers will already be chicken farmers. Maybe there's not as much an upfront cost that I might have thought.

Expert

No. Yeah. The upfront cost, if you are a free or a pasture, it's the building itself, and that can run because they don't have the typical systems that a cage free operation will have. If you're greenfielding a cage-free operation, you're looking at about \$75 a bird to greenfield a new barn that'll hold 150,000 birds. Typically, the farmers at Vital, they're not building barns to Vital specs because Vital simply follows the HFAC or that type of accreditation firm.

Expert

They do have the bird costs but in terms of infrastructure, the largest chunk is simply land. When you have to, on a pasture-raised, have 108 sq. ft. per bird and you have 10,000 birds, 10 or 15 is usually on the pasture-raised, 10,000 birds at 108 sq. ft., that's a lot of land that you have to, in essence, lay fallow because you can't plant crops on it. You can't use insecticides or herbicides. It's simply fallow pasture land that you throw a fence up around.

Analyst

Okay. Just make sure I understood that. Essentially, the land would be the big piece but I imagine those have the land and the barn. It's not hugely expensive to do it for a pasture-raised as it might be for a more cage-free aspect.

Expert

Correct. You really don't have equipment in the barn besides the central water lines, feed, and the laying area. You don't have the multiple levels that you see in a cage-free house. You don't have that type of equipment. Literally, you're almost at the mom, dad, and kids providing the feed. It's not as extensive. There still is a sizable chunk of an investment if you don't have a barn. You have to put a cooler in. There is \$20,000-\$40,000 for a cooler to store your eggs before they're picked up. You do have some equipment but very minor compared to a cage-free operation.

Analyst

I don't know if this will be too difficult to ballpark, but you mentioned \$75 per bird for a cage-free operation. What would you estimate it at for a pasture-raised one?

Expert

If you're greenfielding, you had to put a new barn up and equipment. You're still going to run \$30-\$40 a bird.

Analyst

Okay. All right. The question I had was just, from the farmers', perspective, how attractive is doing pasture-raised relative to maybe free-ranging or cage-free? Is it more or less profitable? Does that depend on if you're working specifically with Vital or working with a different pasture-raised marketer?

Expert

It is profitable but it has become less so in recent years. As you've seen, the egg market tightened up. It depends on the farmer's expectations. To give you an example, and these are ballpark numbers, if you are raising a free-range bird under contract for one of the major marketers like a Happy or Vital, you're being paid roughly \$1.40-\$1.50 for a nest of egg, per dozen. If you're doing the same thing on pasture-raised, you're looking at ballpark about \$1.70 for that same egg.

Expert

On average feed costs, conventional is about ballpark 90¢ a dozen, and about 60¢ a dozen for an inorganic product. You have to add in your labor, your investments, etc., your infrastructure. Your production costs in that free-range egg, you're getting \$1.54, are going to be somewhere in the neighborhood of \$1.30-\$1.35 for you to produce that egg to sell for \$1.50...

Analyst

That's specifically for the free range. If I get that right, that's the free-range cost.

Expert

We were talking about the profitability for the farmer or the producer. Their margin ranges is 10%-15% on what they're selling. When they're getting the \$1.50 for free-range, it's not huge. The scale of having 20,000 birds on a free-range laying at a 70% rate, the dollars add up.

Analyst

Okay. That costs you said, maybe like \$1.30-\$1.35 per egg. Would that be the same for pasture-raised too, so **your margin would be a little bit higher** than on the pasture-raised since you thought it from \$1.70-ish?

Expert

Yes. It increases a bit not in terms of labor, but in terms of the land allocated for it. **That \$1.30-\$1.35 cost will go up by 5¢-10¢ ballpark.** It all depends on how much land they just have sitting there. **They're typically not factoring in the loss potential** if they were row cropping it or something like that.

Analyst

Right. Okay. All right. That's really helpful. Just to make sure I understand this correctly. When you contract with Vital, they're basically saying like, "We're going to pay you an X price per egg or per dozen eggs or whatever." Is there any other component? I've heard there's like a feed cost adjustment index or something like that.

Expert

Yes. The typical contract will be a flock-by-flock contract. Vital will contract for the flock. It's not, "We'll contract for a year, 18 months or two years." It's a flock-by-flock contract. Vital owns all of the eggs coming out of the birds. That's what's called a nest run. There are quarterly feed adjustments that run off the Board of Trade on corn and soy meal, as well as the organic if you're running organic corn and soy for those birds. It doesn't help them because it's not like they're making any money with a feed adjustment. It simply hopefully covers the additional costs that they have.

Analyst

Right. **It's basically trying to keep that margin for the farmer roughly flat.**

Expert

Correct. Yeah. It's like a cost-plus contract for the farmer.

Analyst

Okay. On the flock-by-flock contract basis, let me just make sure I understand that. I had heard that they were doing exclusive contracts for four to five years. You're saying it's a per flock basis and just for the length of time that that flock is producing.

Expert

Yeah. Typically, it's a flock-by-flock contract, but they're layered. They'll do two to three flocks. You have to remember, a bird starts really coming into full production as a pullet at about 26 weeks. They'll be laying on a free and a pasture all the way into 80+ weeks. If you're doing a two-flock contract or three-flock contract, that's what you see. They may say a four to five-year contract. What they're actually contracting is a series of, "We'll contract for three-flock rotations." That's important to understand.

Expert

If you're a producer, if you have a flock, it's somewhere between six and up to 12 months advanced to get the eggs hatched and get your check delivery scheduled. When I was working for a major producer with 13 million birds, you're laying out your flock rotations 18 months in advance. As a producer, you are more willing to do a three-flock contract versus a single because you can start planning the rotation of the birds out in new birds and to keep your cash flow continual.

Analyst

Okay. I'm trying to decide which way I want to go with this first. One of the questions **that pops into my mind then is how difficult or easy it may be** for competitors to either convert existing Vital Farms suppliers to their network or maybe just bring on entirely new supply in general? Maybe you could speak to that a little bit.

Expert

Sure. Let's start with the brand and new supply in general. For Vital to bring on a new supplier, there are a lot of hoops to jump through to make sure that they're completely vetted on their facilities, etc., to meet Vital standards. For Vital to go and capture or

take away a contract or a producer from one of their competitors is probably easier because they already are certified. It's a matter of running their audits and getting them into the fold.

Expert

Right now, there's **a lot of unrest with these producers** because they're still seeing \$1.40, \$1.50, \$1.60, sub \$2 for a nest or an egg when they're seeing \$6.99, \$7.99, \$9.99 retails in that same product in the stores right down the road. They know their eggs are going into those products. They're all wondering, "Why am I getting \$1.50 and I'm seeing that same egg on a shelf in a carton for \$6.99?" A lot of them are scratching their heads on why are they doing this? In particular, with the AI coming in right now, if **they lose a flock**, it's a big investment to get one back in because they have no cash flow coming from that house, and they don't have the balance sheets that the larger producers have.

Analyst

Do **you think this issue is more specific to Vital Farms' supply chain, or do you think it's a broad industry issue that everyone is facing?**

Expert

It's a broad industry issue. If you look at the industry overall, the Midwest will most likely stay conventional forever. They're so entrenched with huge farms, and the demand isn't there for cage-free. If you're sitting in a farm in South Dakota and you're supplying eggs to the West Coast, which is very common, and your customers are coming to you saying, "We need you to convert the cage-free because," for example, Colorado, it is mandatory, cage-free as of January 1, they have to decide whether they want to invest \$75 a bird to convert their flocks.

Expert

If you have 3 million birds, you want to convert your flocks over to cage-free, is the money there to justify that type of investment? You have smaller farmers of 1 million birds going, "Well, it's going to cost me \$75 million to go cage-free. Do **I want to saddle my kids with that type of debt?**" **It is an industrywide issue** as you see more cage-free laws coming in, which will, in turn, drive incremental sales on free-range and pasture-raised because that price gap dissipates.

Expert

Now, the consumer who sits in the middle and waffles on, "Well, I believe in this," but then they see the price point and go, "Well, I'm not going to pay that for it." Now, we're going, "Well, it's only an extra \$1. My pocketbook will now match what I'm saying." I see more of it coming in, and you'll see more consolidation within the industry because of that. Look at Cal-Maine and what's happening with them. Look at every large producer or private egg company, such as Rose Acre. You've seen them buy up other folks. **The consolidation is here and just puts more and more pressure** because you simply can't compete as a small producer with these companies. Sorry. That's my soapbox, but neither here nor there.

Analyst

Yeah. That's okay. I do want to get to the consolidation piece in a second. One more question really on Vital's supply chain. I think the way that it's described with having their home base in the pasture belt and having a network of farmers to have on these relatively multiyear contracts because they're doing multiple plots over that period, I could see how that might come across as, for lack of a better word, a bit of a competitive mode. Meaning, maybe **it's difficult** for other players to get in there because **they'd have to break up these contracts or break up this network**. There's only so much great land for pasture-raised. Is that the right way to think about it, or is **it more competitive** than it might seem?

Expert

It's more competitive than you see on the surface. In reality, if you're an outsider looking and you're going, "Well, they have all of the good farms locked up. There are long term contracts. There is a limited supply of folks who are willing to do this in this particular area that can support it." **We have to realize the pressure on the other side from the Happys and the Pete & Gerry's** and the smaller firms that are starting up in private label. **The demand for that product is growing.**

Expert

The **fastest**-growing category in the egg space are free and pasture-raised. It's the smallest category, but **it's the fastest growing**. There's a very finite amount of resources to fill that pipeline. It's a very competitive category when it comes to getting that producer locked up. There will be folks who are willing to step away from their contracts, whether it's at the end of it, in the beginning of it, or in the middle, for the right price point. You have a limited supply with players trying to get into it because **it is a growing** category. For folks like Vital and Happy, **it is a profitable piece of business for them.**

Analyst

Okay. Let me ask about the consolidation piece. This is something I've heard from other people as well. I'm curious on two pieces of that. One being, I would assume that **a consolidated operation is going to have a lower cost** to produce than somebody with a more asset light model, like Vital Farms. Would that be the right way to think about it?

Expert

That would be the right way to think about it. Correct.

Analyst

Okay. Do you think that at some point then Vital Farms is going to need to transform into a consolidated, into a vertically integrated operation as they scale, or to get behind the margins or compete or something?

Expert

From a business standpoint, it would make the most sense. You saw it happen on different products with retailers. **Costco, for example, had issues on their hotdog and their rotisserie chicken business**, so they simply went out and became vertically integrated. That makes perfect sense. You see, it would make sense for Vital to do that. If I was running that company with something, I would be looking at right now. The question is, do you want to get into the live animal business? There are **a lot of pitfalls** when you start owning birds.

Expert

Right now, **Vital and every other egg company faces a lot of complaints from PETA and Cornucopia Institute**, etc., in dealing with animal abuse, animal cruelty. You see all of that out there. They're targeting these farms. They're on the precipice of, **'We're about to potentially lose our supply** if we don't figure out a way to fix it or do we jump at this other side of the fence and become vertically integrated and then deal with all of these other risks?" They're, I'm sure, analyzing it as we speak. I don't know why they wouldn't be looking down that path. That's something I believe they should be doing. **It's a scary thing** if you don't have control over your raw materials. It can cause massive issues.

Analyst

The other thing that comes to mind then is if they go down that path, they're essentially just doing what Cal-Maine does but just specifically focusing on pasture-raised. Wouldn't Cal-Maine be better positioned to do that given their scale and expertise and everything?

Expert

You would think they would. You have to remember, the large players like a Cal-Maine are very good at what they do. **They're good at driving costs** out and working the supply chain logistics portion of it. When you start dealing with a relatively small volume and small farms, it falls outside of their bandwidth. It's not something that they find appealing or appetizing when there's still other players to gobble up in the segment they're prolific in.

Analyst

I see. Okay. The other thing along these lines of consolidation that I want to ask about was cooperatives. This is something that really I don't have a great understanding of. I've never really seen this before until I started looking at eggs. I was just struck by how many cooperatives there appeared to be. I'm curious why that's so common in the industry and how that impacts, what exactly that cooperative does and provide for farmers, how it changes competition maybe?

Expert

Typically, if you think of a farm cooperative like a Land O'Lakes, they start out with the intent of providing a larger leveraging point to bring food to market. That is the main intent of a cooperative is you gather a group of producers of like items, like a sugar cooperative, to have better bargaining powers and better pricing powers with their customer. The egg cooperatives it's interesting.

Expert

Most farmers have some type of cooperative arrangement. Your typical 1 million-2 million bird operator doesn't have customers. I'm not sure where you're based, but if you're in Chicago, if you're in the Illinois, Indiana, Iowa markets, you typically don't have access to the Jewels, to the Cub Foods, to the Walmarts, etc. You don't have access to that. They typically form with another competitor who has access to those customers and they simply are supplying them. That's a cooperative arrangement.

Expert

It's my prediction. You will see cooperatives pop up on the East Coast. You'll see a big one coming in the northeast, the Mid-Atlantic up. You'll see another one coming in the southeast to help give them leverage as the retailers consolidate, particularly with Kroger and Albertsons, with what's about to happen there.

Expert

You will see the same thing form on the egg side as they need to be able to stand up and have some more leveraging power against the retailers. Cooperatives are coming. Right now, egg cooperatives, they're there, but they're very small in nature and typically producer. The egg industry, **they don't have a path to market.** Most farmers do not have a path to market. That's why cooperatives exist.

Analyst

Okay. How does that impact Vital Farms? The two things I was thinking of were, one, would farmers **that are previously in Vital supply chain be more incentivized to join a cooperative like an Organic Valley** or something that does have a pasture-raised brand or would a cooperative maybe sell to Vital Farms?

Expert

You would see producers more incentivized to join a cooperative than for the cooperative to sell to Vital simply because the monetary aspects of it are more beneficial to join a cooperative. There's power in mass, and that's what the cooperatives provide. Right now, Vital really has three things that they should be very scared of. It should keep their CEO up at night. Number one is the potential diminishing supply. If you think about the typical farms, **they're exposed to pressure from all of Vital's competitors.** That's the first thing.

Expert

The second thing they should be scared of is AI. AI is becoming an endemic, not a pandemic. It's going to be here and the categories are in and free and pasture are exposed to the outdoor elements. They're exposed to the wild birds. They're now also exposed to cattle. Most of their producers are within a stone's throw of a cattle or dairy operation. That's the latest wrinkle on AI. The third thing is private label. Even though pasture and free-range are relatively small categories, are fast-growing, **they command a high price and they are high margin for the retailers.**

Expert

For retailers making 10%-15% on a conventional egg, at the end of the day, they're making 35%+ on a specialty egg. As retailers continue to expand their portfolio, the so-called Kirkland effect will happen. If it's successful, they will figure out how to private label it and sell it to the consumer. Those are the three things that would keep me up at night.

Analyst

That's helpful. Actually, this is a bit off topic, but I completely forgot to ask earlier. I'm just curious. I don't know. Have you seen any data or any evidence or anything that would suggest that a pasture-raised egg is more nutritional than a conventional egg or maybe there's some noticeable differences in the quality of the product or the taste or something?

Expert

You're getting in one of my favorite subjects. A chicken is a remarkable animal, and egg is truly nature's perfect food. A chicken itself, whatever you put in that bird goes right into the egg. There is a difference in the yolk color. If you have a chance, go pick up the cheapest egg on the shelf, which is typically conventional, although it may be cage-free in the market you're in, and compare it to an organic or a pasture-raised, you will see a more vibrant colored yolk.

Expert

Are there any nutritional differences? No. You can add like [inaudible], or some of the other omega-3 products. You can add various ingredients to their feed to add to the nutritional value, but they all contain the same amount of protein, the same amount of fat, cholesterol, etc. The only change you will see will be in the taste of the egg. You can alter the taste by altering the feed or the yolk color itself, again, by altering what you put into the bird. If you want to see some wild-colored yolks, I wouldn't suggest eating any of these. Go to your typical backyard chicken. You'll see some funky things coming out of those because, again, they're eating whatever out of the ground, and it goes right into the egg.

Analyst

I'm glad you brought the yolk color because that is something that I have noticed. One of the things I have heard was that, how to say it, Vital Farms is artificially supplementing their chicken feed like marigold petals and turmeric, paprika, that kind of stuff to get a certain dark orange, golden orange color. Is that the case?

Expert

Yes, it is the case. Again, it's a natural feed. It's something the birds could potentially eat if they were wandering around in a field of flowers. They do add those natural type ingredients to their eggs or to their feed to alter the yolk color. They have a beautiful orange color. It's very vibrant. If you think about it, they're bringing eggs in from multiple producers. What are the odds that producers spread across a three-state swath serving one of their processing facilities all the yolks look the same?

Analyst

Right. No. Of course. The reason **I asked for the yolk color, and certainly pushback** if you disagree with this, but from everyone I've talked to that eats Vital Farms eggs, the thing they always bring up is the yolk color. That seems to be the thing that gets them to buy Vital Farms eggs. I'm curious if you would push back on that at all.

Expert

I personally would. The yolk color is not any indication of the quality of the egg. The yolk color is simply an indication of what the bird is eating. **I would be challenging the folks** that are saying that to go pick up another egg product and crack them side by side. Take the raw eggs, put them on a white cutting board or white plate, and crack the eggs and look at how the yolk stands, how the albumen stands, how much, I just call it, the watery leftovers coming out of the eggs.

Expert

That will tell you the quality or the freshness of the egg. The yolk color, because it can be altered so easily, really doesn't do anything for me. It is what it is. Now, if I crack open an egg and the yolk just runs and it's a very watery looking egg, you're either looking at an old egg or one **that is getting inferior feed.**

Analyst

Right. Okay. One of the things I had noticed is that most of the pasture-raised brands I tested did not have the same yolk color as Vital, but a couple did. I even found a couple of privately owned pasture brands, which just got me wondering. Are you seeing more of that coloring happening in the market on both the branded side and the private label side?

Expert

Yeah. It's happening. The other thing you're seeing is a bleedover of the producers and eggs. If they have an excess of eggs, I'm not saying this is a Vital or Happy-type thing. If they're contracting an egg with a certain feed and they have excess, it gets sold off of the market. That's why you're seeing potentially the same egg that is **a Vital egg being downgraded to a cage-free brown.** You are seeing people trying to differentiate. On an egg itself, the only differentiation externally is the shell color. You see the Heritage eggs coming out. Vital has one. Happy has one. It's simply a different breed of bird but the yolk color is something that they can plant their flag in and go, "This is uniquely ours. This is what makes us different."

Analyst

Okay. Let me just ask. Vital Farms, I think they said that they really don't really do much of any wholesale unless they have extra. I'm just curious. Do you think at any point that they might go down a wholesale path where they're doing more private label? If so, would I be right to assume that **that would be a lower margin business** than doing just purely branded?

Expert

Significantly lower margin business. I do not see Vital getting into that. **Vital, right now, has the ability to downgrade or downpack any of their products.** I'm not sure if you're familiar with that term but if you have an egg that's produced with cage-free brown egg, it can be downgraded into a brown egg, a conventional brown. A pasture-raised organic brown egg, which is the most expensive egg you'll find out there, can be downgraded all the way to a conventional brown. Within Vital's portfolio, you have pasture-raised organics all the way down to a conventional feed free-range. They have no need to sell outside because **they can downgrade their eggs** all the way down.

Expert

Typically, that's why eggs are sold into the market as there's no way for **them to downgrade them.** I don't see Vital wanting to help their private label competitors by going to the wholesale market. The way they're built, their balance sheet really wouldn't like it if they started selling an egg for what would equate to probably \$1-a-dozen discount. If you look at the price gap, typically on a private label, the price gap on a pasture-raised is about \$1-a-dozen on shelf. That translates to 70¢-80¢ less paid for that product carton into their warehouse.

Expert

I don't see Vital doing that versus simply downgrading a product where **they'll take a 40¢ a-dozen hit to downgrade it from an organic** to a pasture-raised. It doesn't make sense. Also, there's not enough product right now. At times, you'll see Egg Innovations selling load here or load there but there's not enough of a sustainable product to be able to fill those markets.

Analyst

Okay. The other players in the space, like Pete & Gerry's and Egg Innovations and whoever, are those purely doing just branded? Pete & Gerry's just doing branded or all these other guys are doing a mix of both?

Expert

The only folks, if you think about the major players in the market, you have Vital, Happy, Pete & Gerry's, Egg Innovations, NestFresh. Vital, Pete & Gerry's, and Happy Egg, focus solely on their own brands. Egg Innovations, NestFresh, the next two down in Mid-States, which is a major supplier to Kroger and others on specialty eggs, they do private label as well as their own brands. If you think about a lot of the brands that are marketed out there, some have their own farms, most do not. Mid-States is a large supplier of those folks. If you're not contracted to one of the big three, you're contracted to Mid-States or Egg Innovations.

Analyst

Okay. I don't know. Maybe the last year or two, there's been **a lot more pasture-raised competition** showing up, at least from what I could tell on the retail side of things. I'm curious if you would agree with that characterization. If so, how would you expect market share in this category to play out over the next, call it, three years with the background that, I think, Vital says right now they have 90% of the pasture-raised segment?

Expert

I would expect **Vital to lose some market share** simply because, right now, I was taking a peak yesterday at the last four weeks, on pasture-raised and free-range. **You will see private label making inroads.** You will see a lot of smaller companies start to expand into pasture-raised. A lot of the smaller brands that you may never have heard of just go into a smaller store outside of the mainstream FMCG retailers. They will start their own brands, or you'll have someone break off and get tired of dealing with Vital Farms.

Expert

There's a group I know of right now that is moving away from Vital Farms and started their own brands. There will be **a lot of dilution in that category.** You will not see **the category have the ability to grow beyond in three years, more than 10% on a CAGR just because of the lack of supply.** **The consumer willingness to purchase at that price point will actually outstrip the supply.** You'll see a Demand Index of probably a 1.15. Just again, theoretical number with about a 1.10 supply index happened in three years. That will only attract more people into the market because that will drive the price up.

Expert

That and cage-free becoming the new floor in probably half the country, half the population, whether it's legislated laws or consumer demand. It becomes an invitation for everyone to jump in. In three years, I'd see **Vital losing about probably 20% of their total market.** That's my crystal ball is telling me. The balance, there'll be people just fighting it out and the ship will turn. At some point, they're going to have to turn to price as a lever to get consumer acceptance or get on retailer shelves. You'll see **prices drop** not substantially, but you'll probably see a 50¢-\$1 a dozen drop in three years.

Analyst

The pricing was the other piece I was going to ask about because right now when I was looking, it seems that Vital had pretty significantly higher prices compared to their pass rate competition. I was seeing anywhere from \$2-\$4 a dozen in some places. Assuming **their brand is good enough to give them some pricing advantage,** what kind of pricing premium do you think they might be able to hold over these categories?

Expert

It all really depends on what happens with the retailers' shift. Their stronghold is obviously with Whole Foods. There is a discount between a Whole Foods and a Walmart 2 mi away in terms of what their price levels are. It all depends on how they play their marketing and where the consumer is shopping at.

Analyst

Yeah. No. All right. I do want to be respectful of your time here. Let me just finish this thing off. Is there anything that I haven't asked about that is important that I should be focusing on or anything that's maybe misunderstood or overlooked?

Expert

If you had to dive into a few other areas, I would look at the consumer trends and combine that with the cage-free legislation and cage-free actions coming up in the next five years. If you layer that on top of the trends we're already seeing within Vital's performance metrics, it would give you a better idea of what to expect if you're looking at a three- to five-year horizon.

Expert

A significant amount of the population on either coast, **which is where the free and pasture-raised tend to have the highest sales per capita,** those shifts consumer. What's going on with legislation will actually assist that category as the floor of pricing in the stores rises with the elimination of a conventional product. Those are the two areas I would look at if I was you. I'd better estimate what will happen to Vital in the future.

Analyst

Awesome. If I could just ask a quick clarification about that. On the one hand, if I heard correctly, you're suggesting that due to supply constraints, **you would expect growth of the pasture-raised category in three years to come down to high-single digits**, low-double digits, about 10% or so. On the other hand, you're implying that with cage-free becoming more prevalent and required, that the floor goes up, that reduces the price cap and therefore, makes pasture-raised a little bit more attractive. Help me reconcile the two things.

Expert

You're going to see a squeeze on the supply as the price cap shrinks on the coast. You will see that happen. That will draw more people into investing into producing a free and a pasture-raised product. It won't bring them in fast enough to cover that gap. **You will see a shortage of eggs on the pasture and free-range.** Not a shortage where **you can't find them on the shelf, but a definite squeeze in the supply chain, which tend to reset when you think of the floor coming up and that price gap diminishing that will drive more people into buying a free and pasture-raised, which puts pressure on supply chain.** More people will come in.

Expert

It takes time to get that and they can't turn it on overnight. Where it bodes well for the Vitals, the Happys of the world is, it will allow them to raise their prices for the retailers even as **that price gap is shrinking.** They'll be able to raise their prices to help their bottom line. It doesn't have anything to do with supply. Until they get that supply, they'll be able to raise prices over the next two to three years because the demand will be there. You're really playing on almost a three-dimensional axis here and trying to balance supply-demand and the pricing pieces.

Expert

A whiteboard is the best way to lay this out, but it bodes well to be in free-range or pasture-raised as you move forward in the future. **It will never be as big a piece of the category as organic, simply because of the supply constraints because of the limitations** with where you have to raise the birds. Also, and think about this, if you did have pasture-raised grow as big as cage-frees right now, you would literally need most of the western U.S. to put the chickens out just because of the space requirements.