

PIPESTONE System



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MAY 2011

ANNUAL PERFORMANCE REPORT

BY LUKE MINION

Our recent Shareholder Summit gave me the opportunity to deliver my first-ever annual report to owners, and I was glad for the chance. I love this job, so I'm not shy about describing what we've accomplished for Pipestone System shareholders.

When I joined the System in 2000, there were 70,000 sows. Today, we have over 130,000 sows, and we employ over 600 staff. That's growth, for sure, but how are those sows and those people performing?

First, you should know we are positioned to compete long-term. Last year, we weaned an average 25.7 pigs per sow. Before long, 30 PSY won't be that uncommon in our sow barns—and without making genetic compromises. Our best performing farm achieved 13.6 pigs per litter born alive in 2010.

Today our female genetics are 82% PIC genetics, 14% Genetiporc, and 4% Danbred. We evaluate genetics all the time, but these three sources consistently rise to the top. Our boar lines are currently 58% PIC327, 35% PIC359, and 5% PIC410. Danbred sire lines account for 2%.

WHAT ABOUT PERFORMANCE AFTER THE SOW FARM?

Wean-to-finish numbers continue to improve, thanks to porcine circovirus vaccine, which has made a world of difference since 2008. We trust our wean-to-finish data, because you participate in weekly calls from our Information Bureau to assure we have accurate numbers.

We continue to monitor health performance constantly. That shouldn't surprise you, yet you may be interested in some of the ways we're measuring the effectiveness of our health programs.

- We're doing a trial to determine the impact if mycoplasma pneumonia vaccinations were stopped. For now, I'll say let's **not** stop vaccinating for Mycoplasma Circovirus.
- We're applying definitions of PRRS control and elimination throughout Pipestone System. Level One is PRRS-free and Level 5 is PRRS active. Of our sow farms, 41% have achieved Level 2 and 20% are at Level 3. Level 2 is negative commercial production, and 3 means a farm is using PRRS vaccine.

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We're fortunate to have a recognized expert in PRRS research in our corner as the newly named Director of Research for the Pipestone Veterinary Clinic. More at PipestoneSystem.com.

SWINE LINE

THE CIRCLE OF LIFE, PIPESTONE SYSTEM STYLE

Joe Thoma likes to compare Pipestone System ownership to the Circle of Life. “We own the sows and the pigs. We own the land. We use the manure to grow the corn on that land to feed the animals.” Then his brother, Matt, continues the thought adding there’s one link in the chain this Jesup, IA family doesn’t own. Yet.

“Eventually we hope to own the finishers, too,” says Matt. “You could say we want the whole thing!”

Here’s how the road to all-encompassing ownership began for the Thoma brothers. Matt and Joe grew up on a farrow-to-finish operation with 300 sows. After college, each entered the hog business in his own way. In 1992, Matt started with 100 sows of his own. Meanwhile, Joe and their dad, Jim, started buying feeder pigs.

Healthy pigs were always the goal of their business. When Dr. Cameron Schmitt began consulting with the Thoma brothers, their new veterinarian told them about Pipestone System. “We wanted a consistent pig source that offered healthy pigs.” That’s how Joe explains their 2007 decision to purchase shares in a System sow barn.

That barn, Grassland Pork, provided their first pigs that same year. The Thoma men were pleased because, “We got the steady flow of healthy pigs we were hoping for.” So, in 2009, they put up more finishers!

Though they still rent some pig spaces, “We now own most of our own facilities, all of which are concentrated around Jesup,” Matt adds.

Each Thoma brother raises corn and soybeans—farming together



The Thoma brothers

and separately. “We also feed cattle with Dad,” Matt continues. “Six hundred head per year.” Managing all of these enterprises is easier with help from two full-time employees in the hog operation.

Joe is married to Jennifer, who also works on the farm. They are parents of Audrey, 13; Blake, 11; Jared, 9; and Sydney, 6. Matt and Stephanie, a full-time mom, also have four children: Jacob, 16; Amber, 14; Jamie, 7; and Peter, 6. Eight children are good reason to think about the future.

At the Shareholder Summit, a presentation on shareholder transitions by attorney David Naples resonated with the Thoma brothers. Now that they’ve increased their finishing capacity, they’d like to own corresponding Pipestone System shares to fill those buildings. “We’re still buying pigs from other Pipestone System shareholders...frankly, we’d like to own those shares, too.” Whether it’s eventually owning Dad’s shares in the Grassland Pork sow unit or purchasing shares in a new barn, Matt and Joe look forward to the day their control of the life cycle extends full circle. ■

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- Filtering sow barns is the next level of PRRS protection to prevent entrance of the virus. So far, 30% of our System-managed sow farms are filtered. We fund and cooperate with University of Minnesota Swine Digest Eradication Center. By the end of 2011, we expect to filter 50% of our sow farms and have fewer farms at Levels 4 and 5.

SETTING A VERY IMPORTANT GOAL

Our industry has been fighting PRRS for 30 years. We believe filtering is an essential step to control the disease along with vaccinating and placing new sow farms at a distance from other swine facilities. That’s why we’re launching an ambitious campaign to eliminate PRRS across the entire System.

We believe you make more money with PRRS-negative pigs. Our goal is PRRS-negative sow farms System-wide—every single barn—by 2013! Then, by 2015, our goal is for all System shareholder grow-finish barns to be PRRS-negative.

Those are two important objectives with corresponding performance outcomes. Imagine gaining one weaned pig per sow by keeping all sow farms PRRS-negative. If we control this one factor, we’ll be reconfiguring the output of all farms,

the numerical equivalent of adding thousands of sows! This isn’t a dream; it’s something we have the ability to accomplish, and we’re excited about it.

THE REASONABLE COST OF SUCCESS

Pipestone System expenses per sow are also down. How did we do it? In a number of different ways. Spending on gilts has been going down, because we’ve lowered replacement rates and we also monitor labor costs.

System labor costs are dropping due to better control of staffing. We find fewer employees can work more efficiently than a large staff. Whenever we have raised the bar for staff performance, they have responded. As we build new sow farms, we’ll aim for labor-efficient designs.

And finally, do not rule out new System farms. Though we’ve held back for a while, we’ll be floating the idea of new sow operations based on your level of interest—one in Iowa and one in South Dakota. We decided to put together a couple of good options for shareholders. If there is interest, we’ll move ahead with plans for new farms in 2011. ■

DO YOUR HOMEWORK BEFORE PLANNING SHAREHOLDER TRANSITIONS AND EXIT STRATEGIES

Everyone who owns shares in a Pipestone System sow farm needs to make a decision about the eventual disposition of those shares, according to David Naples, attorney at law. Soon-to-be retirees need to know the rules for passing shares and financial interest forward. So do families of shareholders and current shareholders who hope, ultimately, to acquire additional shares in a sow farm. “You might want to pass along more than the law and governing documents allow,” David points out.

Attorney Naples deals with those rights of succession frequently. At Leonard, Street, and Deinard, a Minnesota law firm of which he’s a shareholder, David works in the Mankato office, where he focuses his practice on advising “closely held businesses,” such as Pipestone System, on a variety of business, tax, and estate and succession planning matters. Daily, he helps those in family-owned businesses successfully transfer ownership and assets to a new generation.

He stresses plans that allow shareholders to relinquish their interest in a business in ways that make sense for both those owners and the company. “First, there’s not a large market for closely held business shares. Also, state laws will impose some restrictions. For example, you might want to pass along more than the law allows. You’ll want to consult with an attorney to make sure you can achieve the outcome you intend.”

David continues, “Ask yourself, ‘What do I want to happen?’ If your Pipestone System shares currently give you the right to buy pigs, will you need that right when you retire? Will your heirs need or want that right?” You won’t want to burden your estate with the obligation to continue buying pigs if no one in your family intends to stay in the pork business. Then, too, ask yourself how this ownership interest relates to the rest of your farm business, or your retirement needs for liquidity, or your farm succession plan.

TAKE YOUR SHAREHOLDER AGREEMENT ALONG TO ESTATE PLANNING SESSIONS

For all the reasons he’s listed, David Naples advises anyone in a closely held company to know what’s in the governing documents, such as a partnership agreement, member control agreement, or bylaws. “You need to get the governing documents and understand them,” he says. “Then find out how state law limitations could affect it. In most states, there are not a lot of restrictions to transferring stock. However, with ownership interests in partnerships and limited liability companies, you may be able to transfer only the economic rights (the right to receive distributions) but not the voting and management rights.”

Lack of voting rights could put heirs in a negative position of not having a voice in management or when to make distributions if other owners vote never to include them in profits. David also knows there will be times when a group of investors functions smoothly with a given owner but would prefer not to work with that person’s heirs.

Owners already in the company also have an interest in how estates are passed along. They should consider whether they care who their future partners are. The company and owners might need to draft some sort of buy/sell agreement, according to David.

“An agreement might say, ‘We will allow current shareholders the right of first refusal to buy shares before they can be transferred to others (including family).’ Or it could say the company will buy back an owner’s shares upon certain events, such as death. Maybe you just want to know the company will buy you out when the time comes. A buy/sell agreement can also address how to value shares—and whether all decisions have to be agreed to by all owners, a majority, or some other percentage. The buy/sell agreement can prevent unwanted owners and sets a predictable method for determining share value.”

Some of these issues may have been addressed in the original agreement you signed, but David Naples suggests you and your legal adviser take another look. “What may have worked some years ago might not make sense now. I’d suggest reviewing your arrangement with Pipestone System and with the owners in your particular barn. Then owners can determine if the arrangement is consistent with how they wish to pass along their System shares in conjunction with their other farm business.”

David mostly hears from people who need to know where to start. So he reiterates: begin by looking at your Pipestone System agreement; then see if that is consistent with what you want your transition plan to accomplish. When you’ve answered those questions, it will be easier to determine what to do next.

At the Shareholder Summit, David heard questions from owners in their fifties who were interested in succession issues. He’d encourage them to start preparing now. “If you don’t create your own plan, someone else’s plan will come into play. A good succession plan is a gift to your family that gives them a chance to succeed and promotes family harmony.” ■



Attorney David Naples and Dr. Gordon Spronk discuss Naples’s presentation on effectively transitioning System shares to new owners.

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HOW YOUR LENDER SEES YOU

Mark Greenwood is Vice President, Commercial Lending for AgStar® Financial Services, ACA in Mankato, MN. He's responsible for \$1.4 billion in loans and leases that make up the AgStar swine portfolio. It stands to reason he's faced plenty of pork producers across the desk. At our System Shareholder Summit in late March 2011, he offered meeting attendees the chance to see themselves through his eyes—and by extension, their own lender's eyes.

"New sow units have to be capitalized correctly and proposed at the right size," Mark explained. "It used to be easy when corn sold for two or three dollars and the cost of production was predictable. But the new reality, from the lender's view, is an awareness of the extreme market moves in all commodities."

Mark went on to underscore the importance of confronting today's increasingly dominant risk factors. "It takes a lot of money to manage risk...and a strong stomach! Good banking partners are critical, because a producer buying or marketing in this climate will find it very difficult to be right all the time."

For the past few years, Mark has heard young financial analysts, new to the ag business, wonder out loud whether anybody ever makes money in the swine industry. "As pork producers, you know people in ag put everything they own into their operations (even the cash value of life insurance)." With that much hinging on success, Mark realizes the danger some producers were in until recently. He says the more proactive you were—the more actively you managed the relationship between costs and income—the better you protected your assets.

"Does everybody know what a loan covenant is?"

A loan covenant restricts the borrower's ability to do certain

things—acquire more debt, for example. "As a loan client, your role in that covenant agreement is to be proactive. (1) Make timely financial reports. By that, I mean warn your lender of what you see on the horizon. (2) Do a self-assessment. Ask yourself whether you can honestly compete in the current climate. (3) Have a plan B or C ready for times of financial stress. (4) Find partners who will help you ride out the storm. (5) Improve your forecasting and budgeting by thoroughly understanding your cost of production.

"Get better at managing your business—every aspect of it," Mark stresses.

What about capital availability going forward?

"You survived. Now you're attracting better lending rates. That's especially true if you're a Pipestone System shareholder. Lenders are comfortable with the System model," says Mark Greenwood.

As for your assets, Mark reports finishing barns and wean-to-finish barns have held value in lenders' eyes while nurseries have not. Assets aside, Mark asserts a pork producer can never have too much working capital, knowing market and input volatility will be the new normal.

"Is land overpriced? We're probably close to the high end, but the upswing isn't quite finished," Mark contends. "Current land values may hold as long as interest rates stay put, but rising interest will take land costs down."



Mark Greenwood

When advising clients, Mark "gets nervous when you're spending that kind of money on land. If I were you, I'd use my capital to rent land. But if you have more money than you know what to do with...go ahead and buy." ■