SMITHFIELD FOODS INC
Form 10-Q
March 08, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended January 27, 2013

COMMISSION FILE NUMBER 1-15321

SMITHFIELD FOODS, INC.

200 Commerce Street
Smithfield, Virginia 23430
(757) 365-3000

Virginia	52-0845861
(State of Incorporation)	(I.R.S. Employer Identification Number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o	Smaller reporting company	o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

At March 1, 2013, 138,763,415 shares of the registrant's Common Stock ($.50 par value per share) were outstanding.

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PART I—FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMITHFIELD FOODS, INC.
CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(in millions, except per share data)

	Three Months Ended		Nine Months Ended	
	January 27, 2013 (unaudited)	January 29, 2012	January 27, 2013 (unaudited)	January 29, 2012
Sales	$3,583.3	$3,478.3	$9,900.4	$9,885.1
Cost of sales	3,254.5	3,098.5	8,862.1	8,678.6
Gross profit	328.8	379.8	1,038.3	1,206.5
Selling, general and administrative expenses	198.9	187.3	605.7	626.8
(Income) loss from equity method investments	(6.4)	22.0	(13.8)	11.3
Operating profit	136.3	170.5	446.4	568.4
Interest expense	40.6	42.3	124.6	134.6
Loss on debt extinguishment	—	4.6	120.7	12.2
Income before income taxes	95.7	123.6	201.1	421.6
Income tax expense	14.2	44.6	47.0	139.8
Net income	$81.5	$79.0	$154.1	$281.8
Net income per share:				
Basic	$.58	$.49	$1.04	$1.73
Diluted	$.58	$.49	$1.03	$1.72
Weighted average shares outstanding:				
Basic	140.3	161.0	147.7	163.1
Effect of dilutive shares	1.2	1.8	1.3	1.1
Diluted	141.5	162.8	149.0	164.2

See Notes to Consolidated Condensed Financial Statements

SMITHFIELD FOODS, INC.
CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(in millions)

	Three Months Ended		Nine Months Ended	
	January 27, 2013	January 29, 2012	January 27, 2013	January 29, 2012
	(unaudited)		(unaudited)	
Net income	$81.5	$79.0	$154.1	$281.8
Other comprehensive income (loss):				
Foreign currency translation	54.1	(55.9)	19.5	(189.1)
Pension accounting	8.0	3.5	24.2	10.6
Hedge accounting	(39.6)	5.1	(9.3)	(33.5)
Total other comprehensive income (loss)	22.5	(47.3)	34.4	(212.0)
Total comprehensive income	$104.0	$31.7	$188.5	$69.8

See Notes to Consolidated Condensed Financial Statements

SMITHFIELD FOODS, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
(in millions, except share data)

	January 27, 2013 (unaudited)	April 29, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$138.6	$324.3
Accounts receivable, net	694.0	624.7
Inventories	2,390.7	2,072.4
Prepaid expenses and other current assets	215.4	277.6
Total current assets	3,438.7	3,299.0
Property, plant and equipment, net	2,295.4	2,277.2
Goodwill	785.4	768.2
Investments	536.5	522.6
Intangible assets, net	392.0	381.8
Other assets	173.0	173.4
Total assets	$7,621.0	$7,422.2
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	$511.1	$63.5
Accounts payable	452.4	415.8
Accrued expenses and other current liabilities	552.1	657.0
Total current liabilities	1,515.6	1,136.3
Long-term debt and capital lease obligations	1,852.4	1,900.9
Other liabilities	1,038.8	995.0
Redeemable noncontrolling interests	12.3	2.0
Commitments and contingencies		
Equity:		
Shareholders' equity:		
Preferred stock, $1.00 par value, 1,000,000 authorized shares	—	—
Common stock, $.50 par value, 500,000,000 authorized shares; 138,763,415 and 157,408,077 issued and outstanding	69.4	78.7
Additional paid-in capital	1,383.9	1,561.0
Stock held in trust	(68.5)	(67.9)
Retained earnings	2,292.9	2,326.4
Accumulated other comprehensive loss	(476.5)	(510.9)
Total shareholders' equity	3,201.2	3,387.3
Noncontrolling interests	0.7	0.7
Total equity	3,201.9	3,388.0
Total liabilities and equity	$7,621.0	$7,422.2

See Notes to Consolidated Condensed Financial Statements

SMITHFIELD FOODS, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(in millions)

	Nine Months Ended	
	January 27, 2013	January 29, 2012
	(unaudited)	
Cash flows from operating activities:		
Net income	$154.1	$281.8
Adjustments to reconcile net cash flows from operating activities:		
Depreciation and amortization	176.1	182.4
Loss (gain) on sale of property, plant and equipment, including breeding stock	11.0	(25.3)
(Income) loss from equity method investments	(13.8)	11.3
Pension expense	72.0	42.9
Pension contributions	(8.6)	(132.1)
Changes in operating assets and liabilities and other, net	(335.8)	(150.3)
Net cash flows from operating activities	55.0	210.7
Cash flows from investing activities:		
Capital expenditures	(194.9)	(199.0)
Business acquisition, net of cash acquired	(23.1)	—
Net (expenditures) proceeds from breeding stock transactions	(14.4)	4.3
Proceeds from the sale of property, plant and equipment	14.9	5.6
Other	—	(0.1)
Net cash flows from investing activities	(217.5)	(189.2)
Cash flows from financing activities:		
Proceeds from the issuance of long-term debt	1,019.2	—
Principal payments on long-term debt and capital lease obligations	(714.6)	(149.7)
Net proceeds from revolving credit facilities and notes payable	72.1	18.4
Repurchase of common stock	(386.4)	(110.6)
Change in cash collateral	—	23.9
Debt issuance costs and other	(16.7)	(9.9)
Net cash flows from financing activities	(26.4)	(227.9)
Effect of foreign exchange rate changes on cash	3.2	(4.7)
Net change in cash and cash equivalents	(185.7)	(211.1)
Cash and cash equivalents at beginning of period	324.3	374.7
Cash and cash equivalents at end of period	$138.6	$163.6

See Notes to Consolidated Condensed Financial Statements

SMITHFIELD FOODS, INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. You should read these statements and notes in conjunction with the audited consolidated financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended April 29, 2012. The information reflects all normal recurring adjustments which we believe are necessary to present fairly the financial position and results of operations for all periods included.

Smithfield Foods, Inc., together with its subsidiaries (the “Company,” “we,” “us” or “our”), is the largest hog producer and pork processor in the world. In the United States, we are also the leader in numerous packaged meats categories with popular brands including Farmland®, Smithfield®, Eckrich®, Armour® and John Morrell®. We produce and market a wide variety of fresh meat and packaged meats products both domestically and internationally. We conduct our operations through four reportable segments: Pork, Hog Production, International and Corporate, each of which is comprised of a number of subsidiaries, joint ventures and other investments.

The three months ended January 27, 2013 correspond to the third quarter of fiscal 2013 and the three months ended January 29, 2012 correspond to the third quarter of fiscal 2012.

Net Income per Share

We present dual computations of net income per share. The basic computation is based on weighted average common shares outstanding during the period. The diluted computation reflects the potentially dilutive effect of common stock equivalents, such as stock options and performance share units, during the period. We excluded stock options for approximately 1.4 million and 1.4 million shares for the three months ended January 27, 2013 and January 29, 2012, respectively, and 2.1 million and 1.7 million shares for the nine months ended January 27, 2013 and January 29, 2012, respectively, from the diluted computation because their effect would have been anti-dilutive.

Recently Issued Accounting Pronouncements

In July 2012, the Financial Accounting Standards Board (FASB) issued new accounting guidance on testing indefinite-lived intangible assets for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If it is not, no further analysis is required. If it is, the previously prescribed test is required. The new guidance is effective for fiscal years beginning after September 15, 2012 with early adoption permitted. The adoption of this guidance is not expected to impact our consolidated condensed financial statements.

NOTE 2: ACQUISITION

American Skin Food Group, LLC

In September 2012 (fiscal 2013), we acquired a 70% controlling interest in American Skin Food Group, LLC (American Skin) for $23.3 million in cash. The purchase price is subject to post-closing adjustments for differences in American Skin's calendar 2012 earnings and working capital at closing from agreed-upon targets.

Located in Burgaw, North Carolina, American Skin manufactures and supplies pork rinds to the snack food industry. By leveraging our coordinated sales and marketing team, we believe American Skin can expand into new markets both domestically and internationally, which could substantially increase current sales of approximately $25 million and net income of $3 million annually over the next five to seven years with minimal additional plant investment.

The acquisition of American Skin was accounted for in the Pork segment using the acquisition method of accounting, which requires, among other things, that assets acquired, liabilities assumed and noncontrolling interests in the acquiree be recognized at their fair values as of the acquisition date. The following table summarizes the fair values of the assets acquired, liabilities assumed and noncontrolling interests recognized as of the date of acquisition for American Skin:

	(in millions)
Cash and cash equivalents	$0.2
Accounts receivable, net	2.0
Inventories	0.7
Property, plant and equipment, net	3.4
Intangible assets, net	12.4
Goodwill	15.1
Assets acquired	33.8
Accounts payable	0.5
Liabilities assumed	0.5
Noncontrolling interests	10.0
Purchase price	$23.3

Intangible assets acquired include customer relationship assets, contractual rights and trademarks with fair values of $9.7 million, $2.6 million and $0.1 million, respectively. The customer relationship assets and contractual rights will be amortized over useful lives of 15 years and 12 years, respectively. The trademarks are not subject to amortization.

Goodwill was recognized to reflect the amount of the enterprise fair value that exceeded the fair value of the identifiable assets acquired and liabilities assumed. The amount of goodwill that is expected to be deductible for tax purposes is $10.5 million.

The fair value of the noncontrolling interests was measured based on market multiples for similar public companies and consideration of the terms of the acquisition, which provide the noncontrolling interest holders the right to exercise a put option, which would obligate us to redeem their interests. The redemption amount is based on a fixed multiple of earnings, which is consistent with the formula utilized in determining the purchase price for our 70% interest.

Due to the potential post-closing purchase price adjustments noted above, the amounts recognized for goodwill, including the related tax deductible portion, and noncontrolling interests are subject to change.

NOTE 3: INVENTORIES

Inventories consist of the following:

	January 27, 2013	April 29, 2012
	(in millions)	
Livestock	$1,139.9	$962.8
Fresh and packaged meats	929.9	912.1
Grains	202.7	90.4
Manufacturing supplies	64.3	59.1
Other	53.9	48.0
Total inventories	$2,390.7	$2,072.4

NOTE 4: DERIVATIVE FINANCIAL INSTRUMENTS

Our meat processing and hog production operations use various raw materials, primarily live hogs, corn and soybean meal, which are actively traded on commodity exchanges. We hedge these commodities when we determine conditions are appropriate to mitigate price risk. While this hedging may limit our ability to participate in gains from favorable commodity fluctuations, it also tends to reduce the risk of loss from adverse changes in raw material prices. We attempt to closely match the commodity contract terms with the hedged item. We also periodically enter into interest rate swaps to hedge exposure to changes in interest rates on certain financial instruments and foreign exchange forward contracts to hedge certain exposures to fluctuating foreign currency rates.

We record all derivatives in the balance sheet as either assets or liabilities at fair value. Accounting for changes in the fair value of a derivative depends on whether it qualifies and has been designated as part of a hedging relationship. For derivatives that qualify and have been designated as hedges for accounting purposes, changes in fair value have no net impact on earnings, to the extent the derivative is considered perfectly effective in achieving offsetting changes in fair value or cash flows attributable to the risk being hedged, until the hedged item is recognized in earnings (commonly referred to as the “hedge accounting” method). For derivatives that do not qualify or are not designated as hedging instruments for accounting purposes, changes in fair value are recorded in current period earnings (commonly referred to as the “mark-to-market” method). We may elect either method of accounting for our derivative portfolio, assuming all the necessary requirements are met. We have in the past availed ourselves of either acceptable method and expect to do so in the future. We believe all of our derivative instruments represent economic hedges against changes in prices and rates, regardless of their designation for accounting purposes.

We do not offset the fair value of derivative instruments with cash collateral held with or received from the same counterparty under a master netting arrangement. As of January 27, 2013, prepaid expenses and other current assets included $20.2 million representing cash on deposit with brokers to cover losses on our open derivative instruments and accrued expenses and other current liabilities included $0.9 million representing cash deposits received from brokers to cover gains on our open derivative instruments. Changes in commodity prices could have a significant impact on cash deposit requirements under our broker and counterparty agreements. Additionally, certain of our derivative contracts contain credit risk related contingent features, which would require us to post additional cash collateral to cover net losses on open derivative instruments if our credit rating was downgraded. As of January 27, 2013, the net liability position of our open derivative instruments that are subject to credit risk related contingent features was not material.

We are exposed to losses in the event of nonperformance or nonpayment by counterparties under financial instruments. Although our counterparties primarily consist of financial institutions that are investment grade, there is still a possibility that one or more of these companies could default. However, a majority of our financial instruments are exchange traded futures contracts held with brokers and counterparties with whom we maintain margin accounts that are settled on a daily basis, thereby limiting our credit exposure to non-exchange traded derivatives. Determination of the credit quality of our counterparties is based upon a number of factors, including credit ratings and our evaluation of their financial condition. As of January 27, 2013, we had credit exposure of $23.4 million on non-exchange traded derivative contracts, excluding the effects of netting arrangements. As a result of netting arrangements, our credit exposure was reduced to $2.5 million as of January 27, 2013. No significant concentrations of credit risk existed as of January 27, 2013.

The size and mix of our derivative portfolio varies from time to time based upon our analysis of current and future market conditions. All derivative contracts are recorded in prepaid expenses and other current assets or accrued expenses and other current liabilities within the consolidated condensed balance sheets, as appropriate.

The following table presents the fair values of our open derivative financial instruments in the consolidated condensed balance sheets on a gross basis.

	Assets		Liabilities	
	January 27, 2013	April 29, 2012	January 27, 2013	April 29, 2012
	(in millions)		(in millions)	
Derivatives using the "hedge accounting" method:				
Grain contracts	$41.3	$35.3	$22.4	$9.6
Livestock contracts	8.5	22.9	3.9	—
Foreign exchange contracts	1.3	1.9	0.1	—
Total	51.1	60.1	26.4	9.6
Derivatives using the "mark-to-market" method:				
Grain contracts	10.5	9.1	3.0	1.0
Livestock contracts	1.4	7.4	1.0	7.2
Energy contracts	2.7	—	3.7	12.2
Foreign exchange contracts	0.8	2.4	0.3	0.7
Total	15.4	18.9	8.0	21.1
Total fair value of derivative instruments	$66.5	$79.0	$34.4	$30.7

Hedge Accounting Method

Cash Flow Hedges

We enter into derivative instruments, such as futures, swaps and options contracts, to manage our exposure to the variability in expected future cash flows attributable to commodity price risk associated with the forecasted sale of live hogs and fresh pork, and the forecasted purchase of corn, wheat and soybean meal. In addition, we enter into interest rate swaps to manage our exposure to changes in interest rates associated with our variable interest rate debt, and we enter into foreign exchange contracts to manage our exposure to the variability in expected future cash flows attributable to changes in foreign exchange rates associated with the forecasted purchase or sale of assets denominated in foreign currencies. As of January 27, 2013, we had no cash flow hedges for forecasted transactions beyond April 2014.

When cash flow hedge accounting is applied, derivative gains or losses are recognized as a component of other comprehensive income (loss) and reclassified into earnings in the same period or periods during which the hedged transactions affect earnings. Derivative gains and losses, when reclassified into earnings, are recorded in cost of sales for grain contracts, sales for lean hog contracts, interest expense for interest rate contracts and selling, general and administrative expenses for foreign exchange contracts. Gains and losses on derivatives designed to hedge price risk associated with fresh pork sales are recorded in the Hog Production segment.

During the nine months ended January 27, 2013, the range of notional volumes associated with open derivative instruments designated in cash flow hedging relationships was as follows:

	Minimum	Maximum	Metric
Commodities:			
Corn	30,885,000	114,525,000	Bushels
Soybean meal	273,496	755,444	Tons
Lean hogs	—	569,920,000	Pounds
Foreign currency [1]	15,922,580	71,979,138	U.S. Dollars

[1] Amounts represent the U.S. dollar equivalent of various foreign currency contracts.

The following table presents the effects on our consolidated condensed financial statements of pre-tax gains and losses on derivative instruments designated in cash flow hedging relationships for the fiscal periods indicated: