

SMITHFIELD FOODS INC
Form 10-Q
August 11, 2014

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 June 29, 2014

COMMISSION FILE NUMBER 1-15321

SMITHFIELD FOODS, INC.

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

Virginia
(State of Incorporation)

52-0845861
(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 No

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 No

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	<input type="radio"/>	Accelerated filer	<input type="radio"/>
Non-accelerated filer	<input checked="" type="radio"/>	Smaller reporting company	<input type="radio"/>

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

At August 11, 2014, 1,000 shares of the registrant's Common Stock (no 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 and unaudited)

	Successor Three Months Ended June 29, 2014	Predecessor June 30, 2013	Successor Six Months Ended June 29, 2014	Predecessor June 30, 2013
Sales	\$3,814.0	\$3,337.8	\$7,236.1	\$6,664.7
Cost of sales	3,345.5	3,031.6	6,370.9	6,099.5
Gross profit	468.5	306.2	865.2	565.2
Selling, general and administrative expenses	219.2	213.9	434.6	421.9
(Income) loss from equity method investments	(10.9	) 2.5	(26.0	) (5.3
Operating profit	260.2	89.8	456.6	148.6
Interest expense	40.4	44.9	81.2	87.7
Non-operating gain	—	—	(1.1) —
Income before income taxes	219.8	44.9	376.5	60.9
Income tax expense	76.9	12.5	128.3	10.3
Net income	\$142.9	\$32.4	\$248.2	\$50.6

See Notes to Consolidated Condensed Financial Statements

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

	Successor Three Months Ended June 29, 2014	Predecessor June 30, 2013	Successor Six Months Ended June 29, 2014	Predecessor June 30, 2013
Net income	\$142.9	\$32.4	\$248.2	\$50.6
Other comprehensive income (loss), net of tax:				
Foreign currency translation	2.2	(14.7)	1.5	(42.5)
Pension accounting	—	(49.4)	—	(41.4)
Hedge accounting	30.5	(43.1)	(100.8)	(75.7)
Total other comprehensive income (loss)	32.7	(107.2)	(99.3)	(159.6)
Comprehensive income (loss)	\$175.6	\$(74.8)	\$148.9	\$(109.0)

See Notes to Consolidated Condensed Financial Statements

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

	June 29, 2014	December 29, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 109.4	\$ 193.4
Accounts receivable, net	870.9	810.9
Inventories	2,319.5	2,274.7
Prepaid expenses and other current assets	204.2	225.1
Total current assets	3,504.0	3,504.1
Property, plant and equipment, net	2,728.7	2,745.9
Goodwill	1,629.8	1,622.5
Investments	522.6	496.5
Intangible assets, net	1,401.4	1,405.8
Other assets	158.8	180.0
Total assets	\$9,945.3	\$ 9,954.8
LIABILITIES AND EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 85.0	\$ 48.5
Accounts payable	453.7	614.4
Accrued expenses and other current liabilities	680.1	632.7
Total current liabilities	1,218.8	1,295.6
Long-term debt and capital lease obligations	3,034.4	2,997.4
Other liabilities	1,263.6	1,381.4
Redeemable noncontrolling interests	48.2	48.6
Commitments and contingencies		
Equity:		
Shareholder's equity:		
Common stock, no par value, 1,000 shares authorized; 1,000 issued and outstanding	—	—
Additional paid-in capital	4,156.9	4,157.4
Retained earnings	282.9	34.7
Accumulated other comprehensive income (loss)	(60.3	) 39.0
Total shareholder's equity	4,379.5	4,231.1
Noncontrolling interests	0.8	0.7
Total equity	4,380.3	4,231.8
Total liabilities and equity	\$9,945.3	\$ 9,954.8

See Notes to Consolidated Condensed Financial Statements

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

	Successor Six Months Ended June 29, 2014	Predecessor June 30, 2013	
Cash flows from operating activities:			
Net income	\$248.2	\$50.6	
Adjustments to reconcile net cash flows from operating activities:			
Depreciation and amortization	113.8	125.5	
Income from equity method investments	(26.0)	(5.3))
Changes in operating assets and liabilities and other, net	(410.2)	(262.9))
Net cash flows from operating activities	(74.2)	(92.1))
Cash flows from investing activities:			
Capital expenditures	(98.5)	(149.9))
Business acquisitions	(11.0)	(32.7))
Net proceeds (expenditures) from breeding stock transactions	9.7	(11.2))
Proceeds from the sale of property, plant and equipment	2.3	3.4	
Other	3.4	(0.3))
Net cash flows from investing activities	(94.1)	(190.7))
Cash flows from financing activities:			
Proceeds from the issuance of long-term debt	13.0	200.0	
Principal payments on long-term debt and capital lease obligations	(27.7)	(59.7))
Proceeds from Securitization Facility	185.0	200.0	
Payments on Securitization Facility	(135.0)	(30.0))
Net proceeds on revolving credit facilities	48.3	204.3	
Other	(0.5)	2.1)
Net cash flows from financing activities	83.1	516.7	
Effect of foreign exchange rate changes on cash	1.2	(1.6))
Net change in cash and cash equivalents	(84.0)	232.3)
Cash and cash equivalents at beginning of period	193.4	322.2	
Cash and cash equivalents at end of period	\$109.4	\$554.5	

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

Organization

Smithfield Foods, Inc., together with its subsidiaries ("Smithfield," "the Company," "we," "us" or "our"), is the largest hog producer and pork processor in the world. We produce and market a wide variety of fresh meat and packaged meats products both domestically and internationally. We conduct our operations through five reportable segments: Fresh Pork, Packaged Meats, Hog Production, International and Corporate. See Note 12—Reportable Segments for additional information about changes to our reportable segments during the current quarter.

On September 26, 2013 (the Merger Date), pursuant to the Agreement and Plan of Merger dated May 28, 2013 (the Merger Agreement) with WH Group Limited, formerly Shuanghui International Holdings Limited, a corporation formed under the laws of the Cayman Islands hereinafter referred to as WH Group, the Company merged with Sun Merger Sub, Inc., a Virginia corporation and wholly owned subsidiary of WH Group (the Merger Sub), in a transaction hereinafter referred to as the Merger. As a result of the Merger, the Company survived as a wholly owned subsidiary of WH Group.

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 Transition Report on Form 10-K for the eight months ended December 29, 2013. 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.

The Merger was accounted for as a business combination using the acquisition method of accounting. WH Group's cost of acquiring the Company has been pushed-down to establish a new accounting basis for the Company. Unless the context otherwise requires, all references to "Successor" refer to Smithfield Foods, Inc. and all its subsidiaries for the period subsequent to the Merger. All references to "Predecessor" refer to Smithfield Foods, Inc. and all its subsidiaries for all periods prior to the Merger. Purchase price allocations resulting from the Merger affect the comparability of results of operations for the Successor and Predecessor periods.

The consolidated condensed balance sheets, as of June 29, 2014 and December 29, 2013, reflect various preliminary fair value estimates and analyses resulting from applying the acquisition method of accounting as of the Merger Date, including preliminary work performed by third-party valuation specialists, which are subject to change within the measurement period as valuations are finalized. The Company expects to continue to obtain information to assist in determining the fair value of the net assets acquired at the Merger Date during the measurement period. Measurement period adjustments that the Company determines to be material will be applied retrospectively to the Merger Date.

Change in Fiscal Year End

On January 16, 2014, the Company elected to change its fiscal year end from the 52 or 53 week period which previously ended on the Sunday nearest April 30 to the 52 or 53 week period which ends on the Sunday nearest December 31. The change in fiscal year was made effective as of December 29, 2013. Therefore, the three and six

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months ended June 29, 2014 correspond to the second quarter and first half of 2014 and the three and six months ended June 30, 2013 represent the comparable periods for 2013.

Recently Issued Accounting Pronouncements

In July 2013, the FASB issued Accounting Standards Update 2013-11, Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss or a Tax Credit Carryforward Exists (ASU 2013-11). This update does not have a significant impact on our consolidated condensed balance sheet.

In May 2014, the FASB issued Accounting Standards Update 2014-09, Revenues from Contracts with Customers (ASU 2014-09). The new guidance is effective for fiscal year and interim periods within those years beginning after December 15, 2016 and early adoption is not permitted. The guidance is not currently effective for us and has not been applied in this Form 10-Q. We are currently in the process of evaluating the potential impact of future adoption but at this time do not anticipate it will have a material impact on our consolidated financial statements.

NOTE 2: INVENTORIES

Inventories consist of the following:

	June 29, 2014	December 29, 2013
	(in millions)	
Fresh and packaged meats	\$ 1,114.9	\$ 956.7
Livestock	932.6	1,054.8
Grains	149.4	134.5
Manufacturing supplies	77.1	69.3
Other	45.5	59.4
Total inventories	\$ 2,319.5	\$ 2,274.7

NOTE 3: 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.

Changes in commodity prices could have a significant impact on cash deposit requirements under our broker and counter-party 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 June 29, 2014, 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 counter parties under financial instruments. Although our counter parties 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 counter parties 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 counter parties is based upon a number of factors, including

credit ratings and our evaluation of their financial condition. As of June 29, 2014, we had credit exposure of \$11.6 million on non-exchange traded derivative contracts, excluding the effects of netting arrangements. As a result of netting arrangements, we had no significant credit exposure as of June 29, 2014. No significant concentrations of credit risk existed as of June 29, 2014.

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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 on a gross basis.

	Assets		Liabilities	
	June 29, 2014 (in millions)	December 29, 2013	June 29, 2014 (in millions)	December 29, 2013
Derivatives using the "hedge accounting" method:				
Grain contracts	\$24.2	\$ 5.5	\$20.0	\$ 16.2
Livestock contracts	3.4	0.7	198.4	1.1
Foreign exchange contracts	0.4	0.6	—	—
Total	28.0	6.8	218.4	17.3
Derivatives using the "mark-to-market" method:				
Grain contracts	1.7	0.6	1.2	1.1
Livestock contracts	7.8	2.8	14.9	9.5
Energy contracts	2.1	2.9	—	—
Foreign exchange contracts	0.1	0.6	0.1	0.2
Total	11.7	6.9	16.2	10.8
Total fair value of derivative instruments	\$39.7	\$ 13.7	\$234.6	\$ 28.1

The majority of our derivatives are exchange traded futures contracts held with brokers, subject to netting arrangements that are enforceable during the ordinary course of business. Additionally, we have a smaller portfolio of over-the-counter (OTC) derivatives that are held by counterparties under netting arrangements found in typical master netting agreements. These agreements legally allow for net settlement in the event of bankruptcy. We offset the fair values of derivative assets and liabilities, along with the related cash collateral, that are executed with the same counterparty under these arrangements in the consolidated balance sheet. The following tables reconcile the gross amounts of derivative assets and liabilities to the net amounts presented in our consolidated condensed balance sheets and the related effects of cash collateral under netting arrangements that provide a legal right of offset of assets and liabilities.

June 29, 2014					
	Gross Amount of Derivative Assets/ Liabilities	Netting of Derivative Assets/ Liabilities	Net Derivative Assets/Liabilities	Cash Collateral	Net Amount Presented in the Condensed Consolidated Balance Sheet
(in millions)					
Assets:					
Commodities	\$39.2	\$(33.7)	) \$ 5.5	\$64.5	\$70.0
Foreign exchange contracts	0.5	(0.2)	) 0.3	—	0.3
Total	\$39.7	\$(33.9)	) \$ 5.8	\$64.5	\$70.3
Liabilities:					
Commodities	\$234.4	\$(33.7)) \$ 200.7	\$(187.7)) \$13.0
Foreign exchange contracts	0.2	(0.2)) —	—	—

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Total \$234.6 \$(33.9) \$ 200.7 \$(187.7) \$ 13.0

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	December 29, 2013		Net Amount		
	Gross	Netting of	Presented in	Cash	Net Amount
	Amount of	Derivative	the	Collateral	
	Derivative	Assets/	Condensed		
	Assets/	Liabilities	Consolidated		
	Liabilities		Balance		
			Sheet		
	(in millions)				
Assets:					
Commodities	\$ 12.5	\$ (7.4	) \$ 5.1	\$—	\$ 5.1
Foreign exchange contracts	1.2	—	1.2	—	1.2
Total	\$ 13.7	\$ (7.4	) \$ 6.3	\$—	\$ 6.3
Liabilities:					
Commodities	\$ 27.9	\$ (7.4	) \$ 20.5	\$ (15.6	) \$ 4.9
Foreign exchange contracts	0.2	—	0.2	—	0.2
Total	\$ 28.1	\$ (7.4	) \$ 20.7	\$ (15.6	) \$ 5.1

See Note 10—Fair Value Measurements for additional information about the fair value of our derivatives.

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 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 June 29, 2014, we had no cash flow hedges for forecasted transactions beyond December 2015.

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. The ineffective portion of derivative gains and losses is recognized as part of current period 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 (SG&A) 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 six months ended June 29, 2014, the range of notional volumes associated with open derivative instruments designated in cash flow hedging relationships was as follows:

	Minimum	Maximum	Metric
Commodities:			
Corn	42,575,000	87,375,000	Bushels
Soybean meal	346,500	827,300	Tons
Lean hogs	103,280,000	1,847,680,000	Pounds
Foreign currency ⁽¹⁾	15,144,435	33,405,406	U.S. Dollars

⁽¹⁾ Amounts represent the U.S. dollar equivalent of various foreign currency contracts.

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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 periods indicated:

	Gains (Losses) Recognized in Other Comprehensive Income (Loss) on Derivative (Effective Portion)		Gains (Losses) Reclassified from Accumulated Other Comprehensive Loss into Earnings (Effective Portion)		Gains (Losses) Recognized in Earnings on Derivative (Ineffective Portion)	
	Successor Three Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013	Successor Three Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013	Successor Three Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013
Commodity contracts:						
Grain contracts	\$ (20.8)	\$ (17.6)	\$ 7.7	\$ 34.3	\$ (2.7)	\$ 1.7
Lean hog contracts	(12.5)	(18.0)	(90.9)	(0.6)	(2.3)	(1.0)
Foreign exchange contracts	0.2	(0.7)	0.2	0.7	—	—
Total	\$ (33.1)	\$ (36.3)	\$ (83.0)	\$ 34.4	\$ (5.0)	\$ 0.7
	Successor Six Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013	Successor Six Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013	Successor Six Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013
Commodity contracts:						
Grain contracts	\$ 37.5	\$ (57.6)	\$ 6.3	\$ 80.5	\$ (0.3)	\$ (0.5)
Lean hog contracts	(310.1)	21.2	(116.6)	4.5	(17.8)	(0.8)
Foreign exchange contracts	0.5	(0.1)	3.2	2.1	—	—
Total	\$ (272.1)	\$ (36.5)	\$ (107.1)	\$ 87.1	\$ (18.1)	\$ (1.3)

For the periods presented, foreign exchange contracts were determined to be highly effective. We have excluded from the assessment of effectiveness differences between spot and forward rates, which we have determined to be immaterial.

As of June 29, 2014, there were deferred net losses of \$103.7 million, net of tax of \$66.1 million, in accumulated other comprehensive income (loss). We expect to reclassify \$10.3 million (\$6.3 million net of tax) of deferred net gains on closed commodity contracts into earnings within the next twelve months. We are unable to estimate the amount of unrealized gains or losses to be reclassified into earnings within the next twelve months related to open contracts as their values are subject to change.

Fair Value Hedges

We enter into derivative instruments (primarily futures contracts) that are designed to hedge changes in the fair value of live hog inventories and firm commitments to buy grains. When fair value hedge accounting is applied, derivative gains and losses are recognized in earnings currently along with the change in fair value of the hedged item attributable to the risk being hedged. The gains or losses on the derivative instruments and the offsetting losses or gains on the related hedged items are recorded in cost of sales for commodity contracts.

During the six months ended June 29, 2014, the range of notional volumes associated with open derivative instruments designated in fair value hedging relationships was as follows:

	Minimum	Maximum	Metric
Commodities:			
Corn	450,000	8,200,000	Bushels

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The following table presents the effects on our consolidated condensed statements of income of gains and losses on derivative instruments designated in fair value hedging relationships and the related hedged items for the periods indicated:

	Gains Recognized in Earnings on Derivative		Losses Recognized in Earnings on Related Hedged Item	
	Successor Three Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013	Successor Three Months Ended June 29, 2014 (in millions)	Predecessor June 30, 2013
Commodity contracts	\$2.9	\$1.3	\$(2.7)	\$(1.3)
	Six Months Ended		Six Months Ended	
	June 29, 2014 (in millions)	June 30, 2013	June 29, 2014 (in millions)	June 30, 2013
Commodity contracts	\$2.0	\$		