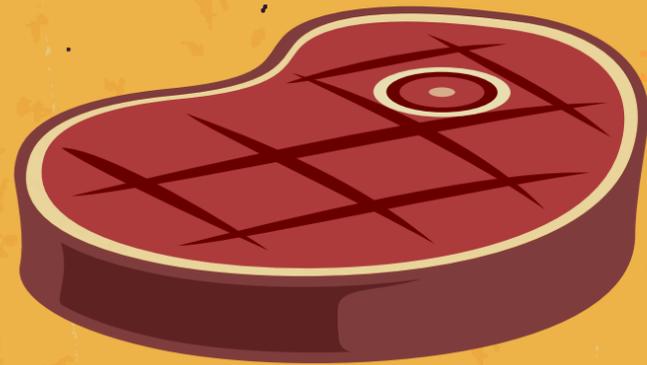


PREMIUM WAGYU QUALITY



STEAK

ALWAYS FRESH

Protecting an Asian treasure in America

The impact of Japanese cars on the American auto industry is well known. Not so well known are the regulatory and intellectual property issues faced by beef producers in the introduction of Japan's esteemed Wagyu beef herd to U.S. pastures and tables.

By Jeffrey Andrien

Japan is known globally for its meticulous attention to quality standards and consumer standards, often offering the most differentiated and intricate products. In no industry is this more apparent than in the cattle industry in the U.S., where Japanese brands are considered to be the gold standard for the world's finest meats, and where beef producers are now continuing the trail-blazing branding efforts of Toyota and Honda that commenced more than four decades ago.

In 2014, it is Japanese cattle breeders that are poised to have a profound impact on the American beef industry. However, distribution agreements, partnerships and legal challenges threaten to derail American efforts to fully adopt Japanese cattle-raising methods, and protect the genetic and intellectual property that serves as its very basis of distinction.

When one thinks about the best beef in the world, Wagyu beef invariably comes to mind. The word, Wagyu, is made up of two parts 'wa' and 'gyu', which refer to 'Japanese' and 'cattle', respectively. Wagyu can refer to any of four indigenous Japanese breeds of cattle, Kuroushi (Japanese Black), Akaushi (Japanese Brown or Japanese Red), the Japanese Polled and the Japanese Shorthorn.ⁱ The distinctions among the four breeds of cattle are important because they produce beef with different characteristics and quality.

Wagyu are considered to be national treasures of Japan, with the Kuroushi and Akaushi strains reputed to produce the highest quality beef. While it is Kuroushi cattle that produce the world renowned Kobe beef,ⁱⁱ it is the Akaushi breed, from the Kumamoto prefecture in Japan, that is currently struggling to maintain its pure lineage and unique

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identity in the U.S.ⁱⁱⁱ Like Kuroushi, Akaushi (pronounced 'akka-ooshē'), produce some of the world's best beef; typically grading two to three levels above U.S. Department of Agriculture (USDA) Prime.^{iv} This is exceptional as only from one to three percent of U.S. beef grades out at USDA Prime and above. And because Akaushi cattle are considered national treasures, the Japanese government has banned their export, making authentic Akaushi beef virtually impossible to find outside of Japan, and when one can find it, the retail price of the product is often three or more times that of prime beef.

The Japanese way to building a treasure

Japan's success in developing two breeds of cattle that produce superior quality beef is based, in large part, on the adoption of a 'closed system'. In contrast to the West, where breed development is left to individual ranchers and breeders, the Japanese have established a central authority that collects and analyses data, and regulates breed development. For example, the Japanese Akaushi Association (JAA) was created over 50 years ago in order to 'collect, manage and process all Akaushi data', and JAA has collected 'carcass performance, breeding pedigrees and economic data for every animal in the entire breed'.^v Master geneticists and scientists have analysed the data for multiple traits, such as maternal, structural, fertility, carcass and palatability, and used them to develop a breed that is uniform to the extreme and consistent throughout its genetic lines.^{vi} New bloodlines are only released for general production after they have 'been proven meritorious by extensive and accurate statistical analysis, using a sophisticated progeny-testing model'.^{vii} The Japanese data tracking system is so rigorous that for Kobe beef, which has the most stringent requirements, a consumer ordering a steak can request a certificate of authenticity that provides, among other things, the lineage of the animal that the steak comes from, the

date of slaughter of the animal, and the weight of the animal at slaughter.^{viii} This data-driven approach is what helps make Akaushi cattle superior to Western breeds in virtually every aspect.

As a national treasure of Japan, the Japanese government forbids the exporting of live animals and other genetic material such as bull semen or embryos for transplant. However, as the result of a loophole (which has since been closed) in the Trade Act of 1992 between the U.S. and Japan, a breeding nucleus of 11 Akaushi cattle was brought to Texas in a custom-designed Boeing 747 in 1994.^{ix} Perhaps even more fortunately, the importers of these 11 prized cattle recognised the benefits of the Japanese method of developing and protecting the breed. They resisted the urge to exploit the cattle for short-term profit, which would have come at the expense of diluting the breed's genetic characteristics. Instead, with a focus on maintaining the distinctiveness and integrity of the breed, HeartBrand and its producer partners have bred the Akaushi herd in America to approximately 10,000 head of cattle over the past 20 years.

Remarkable results and health benefits

From a consumer's standpoint, the most celebrated trait of Akaushi is that it produces extremely flavourful, tender and juicy beef with high intramuscular fat or marbling. And in one of those rare win-win situations, where something that tastes better is actually good for you, Akaushi beef has an extremely high ratio of monounsaturated fat to saturated fat and cholesterol, as well as a high amount of Conjugated Linoleic Acid (CLA). HeartBrand reports that studies have shown CLA to help control insulin levels (thereby reducing diabetes), help increase weight loss, and slow the growth of a wide variety of tumours, including some kinds of cancerous tumours. Additionally, the high ratio of monounsaturated fat to saturated fat has

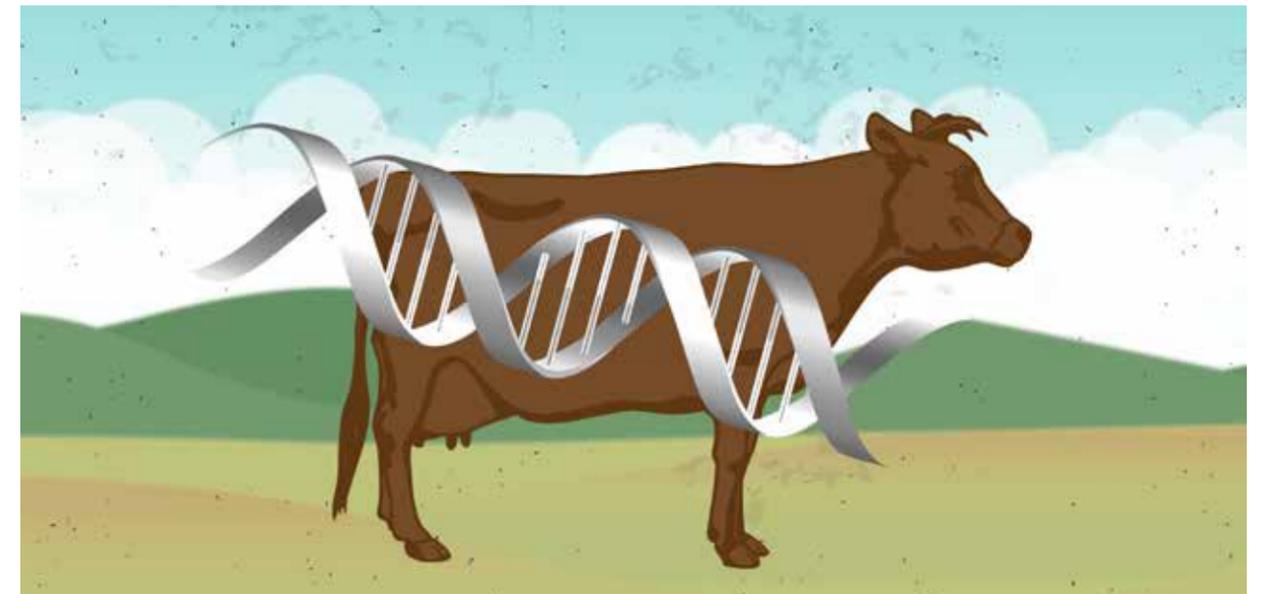
been demonstrated to lower levels of low-density lipoprotein (LDL), which is the harmful cholesterol, without decreasing high-density lipoprotein (HDL), which is the good cholesterol, thus lowering the risk of heart disease.^x

From a rancher's perspective, however, health benefits are only one of the many attributes of Akaushi. Amazingly, the cattle have better carcass yield and transfer their genetic components significantly faster than their Western counterparts. Moreover, Akaushi require no special feed or care compared to Western breeds, have fertility

rates that are comparable to or better than western breeds, and can adapt to different climates better than most other cattle (Akaushi are being raised throughout the U.S., in disparate climates such as Texas, Colorado, Montana and Florida).^{xi}

While the cost and complexity of raising Akaushi are low compared to the best American breeds, it is the grade and potential yield that is of greater interest. According to HeartBrand, full-blood Akaushi yield over 95 percent of USDA Prime grade beef on a typical carcass. In contrast, Angus, a widely popular and

distinguished cattle breed in the U.S. and Europe, yields from six to eight percent USDA Prime beef. These high-grade yields command significant premiums at slaughter. In fact, even half-blooded Akaushi, when crossed with domestic U.S. breeds, yield over 50 percent USDA Prime beef, and do so after only one generation of crossbreeding. This type of genetic transfer, in which ranchers attempt to increase yields or improve genetic characteristics by introducing new bloodlines into their herds, typically takes 10 to 12 years (three to four generations) with other breeds.



Following in Japanese footsteps

Since receiving the original 11 cattle in 1994, HeartBrand has carefully and diligently built and protected the Akaushi brand and avoided the short-term oriented decisions that could irreparably harm the distinction of the Akaushi product.

Dr. Antonio Calles, a master geneticist and former executive at HeartBrand, is perhaps the most authoritative figure in the U.S. on Akaushi cattle. It was through his devotion to the breed and to the Japanese methods of raising cattle and protecting Akaushi genetics that the U.S. Akaushi herd grew to a self-sustaining size of approximately 10,000 head of cattle.

From the beginning, Calles and HeartBrand have strived to follow the Japanese model to protect and maintain the integrity of the Akaushi breed. For example, they established the American Akaushi Association (AAA) to perform a role similar to the one the JAA performs in Japan. The AAA's mission is 'to change beef production through tracking, maintaining and verifying the purity of the breed, the performance of the offspring and the

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quality of the final retail product'.^{xii} To this end, the AAA has adopted a whole-herd reporting system, which collects DNA data, carcass performance, breeding pedigrees and economic data for every Akaushi animal in the U.S. that registers with the association.^{xiii} HeartBrand, in turn, requires ranchers that purchase its Akaushi cattle ('Producers') to become members of the AAA and to participate in the whole-herd reporting system. The ability to track progeny performance across different climates and geographies is essential in evaluating and improving the yield of herds.

Additionally, HeartBrand maintains a closed system, similar to that in Japan, by placing certain restrictions on its Producers. One such restriction is that Producers can only sell live Akaushi cattle to HeartBrand or to other Producers, thus ensuring that the supply of Akaushi cattle is kept within the HeartBrand network. Such customer resale restrictions are generally used when the good or service needs to be protected to maintain the distinctiveness of the offering. This distinction serves as a basis of differentiation and allows the product to avoid being commoditised. Further restrictions involve how Producers can market beef derived from Akaushi cattle and what portion of their harvested cattle must be sold back to HeartBrand for sale to the public. Much like

a bottling relationship with a carbonated soft drink producer, the cattle producers have contracted margins and known purchase arrangements. This type of contract is referred to as a vertical restriction in which a producer or the owner of a mark specifies the manner, territory, types of customers or prices, etc. that those who wish to deal with them must abide by; in some cases it might be all of these managerial actions. Such vertical restraints have been a cornerstone in developing brands and protecting intellectual property.

Together with these restrictions and requirements, HeartBrand's closed system of growing the Akaushi herd in the U.S. enables tracing of the lineage of every animal within the system back to its Japanese ancestors, thereby authenticating it as full-blood Akaushi. This attention to process has earned some goodwill within the Japanese cattle industry. While initially HeartBrand and the AAA had a strained relationship with the JAA, primarily because the JAA was unhappy that the 11 animals were exported from Japan and was concerned about stewardship of its national treasure, the relationship has improved over time. By fully embracing Japanese methods and protecting the integrity of the Akaushi breed, these organisations now share an excellent relationship and work cooperatively with one

another.^{xiv} One advantage of this cooperation is that it creates redundancy. Having herds in different locations ensures that independent bloodlines can be established and used to rebuild either herd—in the event that disease or some other natural disaster decimates the Akaushi population in one country. This has happened in other agricultural sectors, as was the case with some popular European wines, crops of which were killed by disease. Eventually, Californian vines needed to be re-imported to rebuild the diseased vineyards of Europe.

Litigation

HeartBrand's closed system has recently come under attack, facing legal challenges from one of its producing partners, Bear Ranch. Owned by billionaire Bill Koch of the high profile Koch family, Bear Ranch became a Producer in HeartBrand's system when it purchased 400 Akaushi cows and 24 Akaushi bulls from HeartBrand in 2010. Duly impressed with the quality of the cattle, Bear Ranch management continued purchasing additional Akaushi cattle from other HeartBrand's Producers between 2010 and 2013, and grew its herd through purchases and breeding to approximately 4,000 head of cattle.

However, Bear Ranch soon found the restrictions and requirements of HeartBrand's full-blood contract onerous and sued HeartBrand, claiming the contract was anti-competitive and, therefore, illegal. Flouting of any of the precepts that ensured the integrity of the cattle would mean dramatically reducing the authenticity and distinction of the brand not just in the U.S. but on the global stage.

HeartBrand countersued Bear Ranch claiming that the latter engaged in fraud when purchasing its Akaushi cattle and that Bear Ranch had breached the contractual obligations of a HeartBrand Producer. The lawsuit has been ongoing for more than two years now, and although HeartBrand won a major victory during a recent jury

trial, the verdict still faces judicial review and potential appeal. In short, HeartBrand's ability to continue employing the Japanese systems that are designed to protect the integrity of the Akaushi breed is at high risk.

The challenges ahead

Despite winning a jury verdict in its litigation with Bear Ranch, HeartBrand did not emerge completely unscathed, and the company still faces some difficult hurdles enroute to achieving its goal of transforming the U.S. cattle and beef business and delivering the highest quality beef to the market. Most notably, one of the court's rulings in the litigation eliminates HeartBrand's ability to control inter-Producer purchases. In other words, the court ruled that while the contract restrictions apply for the purchases a Producer makes from HeartBrand, if a Producer purchases cattle from another Producer, the HeartBrand restrictions no longer apply. One can only imagine the potential for intra-firm sales via cross-holdings, which would circumvent the spirit of the initial agreement.

Depending on how this plays out in practice, this ruling could devastate HeartBrand, as well as its ability to control the Akaushi genetics outside of Japan and apply the Japanese principles that are the foundation for building the Akaushi brand in the United States. Producers could potentially circumvent the DNA testing and whole-herd reporting that enables authentication, data collection and optimal genetic performance of Akaushi cattle. Moreover, they could sell live Akaushi cattle to ranchers outside of the current system without restrictions, which would undoubtedly result in the proliferation of cross-bred animals that are marketed under the term Akaushi, thus diluting the breed's brand. The fact that HeartBrand does not have (and cannot acquire) a trademark on the term, 'Akaushi', further complicates its development of the Akaushi brand in the U.S., and strengthens its need to maintain a

closed, Japanese-style production system. In conclusion, the prospects of another Japanese revolution in a quintessential American industry, although off to a strong start, remain (for the time being) at the mercy of the U.S. legal system. Stay tuned.

Jeffrey Andrien
is a Managing Director at The Claro Group, a financial advisory and management consulting firm in the United States. He is also a visiting professor at Thammasat University, Bangkok and frequently lectures at other academic institutions

Reference

- ⁱ Kobe beef, "FAQ", <http://www.kobe-niku.jp>.
- ⁱⁱ Much like the term 'Champagne', a designation for sparkling wine that is produced from grapes grown in the Champagne region in France, the term 'Kobe' is a designation for beef produced from Kuroushi cattle born and raised in the Hyogo prefecture in Japan. In order to be classified as Kobe, the beef must also satisfy a number of additional requirements.
- ⁱⁱⁱ HeartBrand Beef, <http://heartbrandbeef.com>.
- ^{iv} Sarah Harris, "A Breed all its Own", Farm Credit Bank of Texas, Summer 2007.
- ^v HeartBrand Beef, <http://heartbrandbeef.com>.
- ^{vi} Ibid.
- ^{vii} Ibid.
- ^{viii} Olmsted, Larry, "The New Truth About Kobe Beef: Scarce Amounts Now Available In The U.S., But Not In Europe", Forbes, July 1, 2014.
- ^{ix} HeartBrand Beef, <http://heartbrandbeef.com>.
- ^x Ibid.
- ^{xi} American Akaushi Association, <http://www.akaushi.com/>.
- ^{xii} Ibid.
- ^{xiii} American Akaushi Association, Whole Herd Reporting system, <http://static.squarespace.com/static...Whole-Herd-Reporting-II-1.pdf>.
- ^{xiv} Sarah Harris, "A Breed all its Own", Farm Credit Bank of Texas, Summer 2007.

