GEORGE MORRIS CENTRE

2009 Food Industry Financial Results

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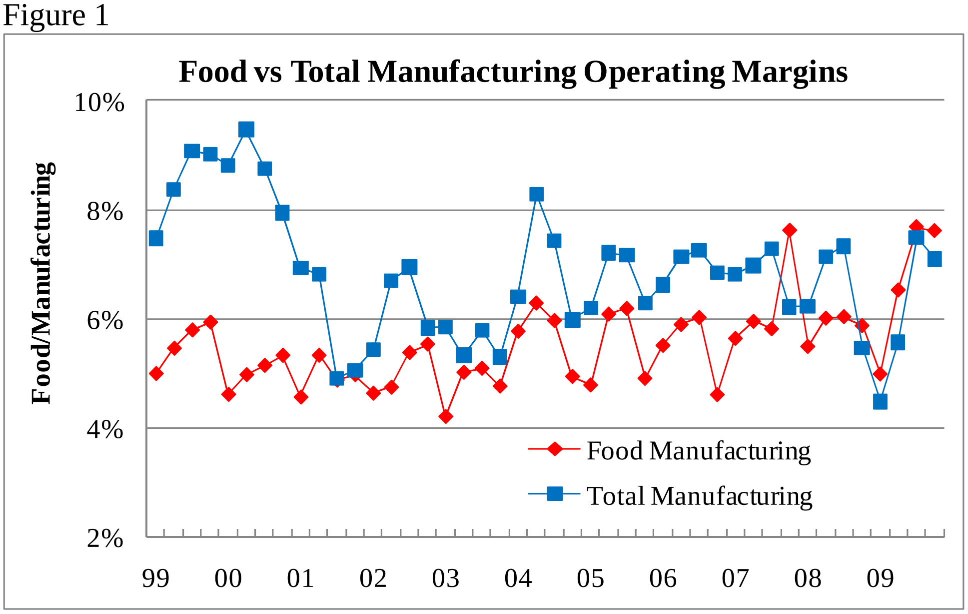
The following is a summary of food manufacturing and distribution financial returns as reported by Statistics Canada's Industrial Organization and Finance Division. The George Morris Centre receives a special statistical order from Statistics Canada, focused exclusively on the food industry.

Canadian food manufacturers enjoyed a strong 2009 as a number of cost and revenue factors were working in the industry's favour. In 2010, the industry is going to see a much more challenging year as those same factors begin to align not so favourably. This paper looks at results from 2009 and some of the challenges for 2010.

In 2009, Canadian food manufacturer's operating profits increased by 13% over 2008. Operating profits were boosted by an exceptionally strong 28% increase in the fourth quarter. Figure 1 shows operating margins for food manufacturing and total manufacturing on a quarterly basis, from 1999 through the end of 2009. Operating margins are operating profits divided by operating revenues.

Figure 1

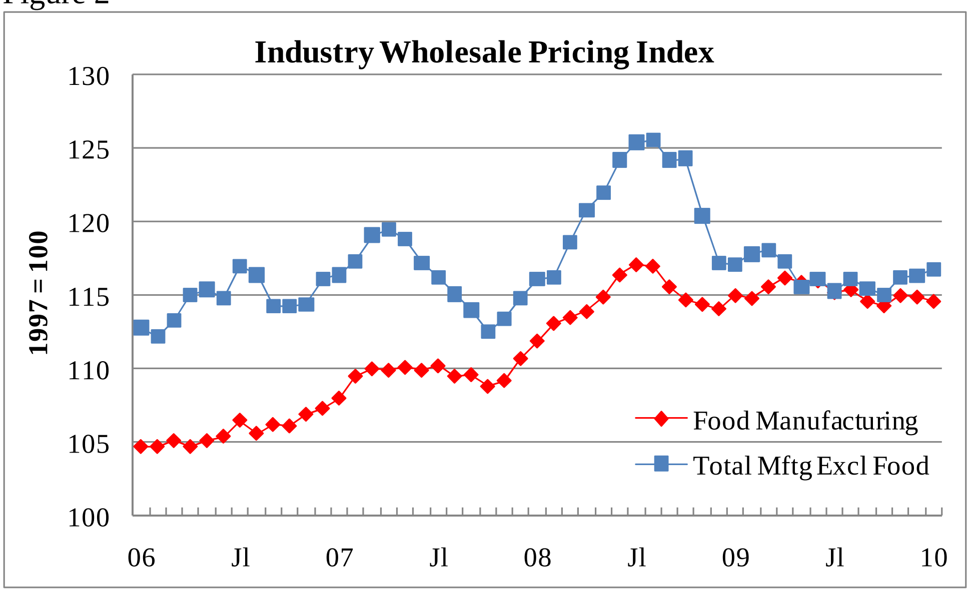


As can be seen, food manufacturing margins spent most of the past decade well below total manufacturing. Between 2000 and 2008, total manufacturing margins averaged 7%, while food manufacturing margins averaged just 5%. During 2009, however, total manufacturing margins averaged 6% while food manufacturing margins averaged 7%.

On the manufacturing side, it is easy to understand that during a recession, margins would be pinched. Recessions typically mean unemployment, unfilled orders, declining sales, inventory build-up and under-utilized capacity. These factors will all squeeze manufacturers' margins. On the food manufacturing side, however, it is often noted that the industry is recession-proof because "people have to eat." In fact, it is far from recession-proof, as consumers do tend to trade down to lower margin items and cut back on discretionary items. Nevertheless, the industry is less vulnerable to economic downturns than the manufacturing sector in general. While this makes sense, it is difficult to understand why food industry margins should actually increase during a recession.

As a starting point in trying to understand the numbers, it is instructive to look at prices and revenues. The StatsCan data show that food manufacturer operating revenue actually declined by 1% in 2009 compared to 2008. At the same time, operating revenues for all manufacturing declined by 11% in 2009. Looking at overall prices at the manufacturing level helps to explain the revenue picture. Figure 2 shows the Statistics Canada Industry Price Index (IPI) for Food Manufacturing and for All Manufacturing excluding food and beverages on a monthly basis, from 2006 through January 2010. The IPI shows the monthly change in pricing at the manufacturer level relative to the base period (1997 = 100). The prices collected are for goods sold at the factory gate. As a result, the prices covered by the IPI refer not to what a purchaser pays but to what the producer receives.

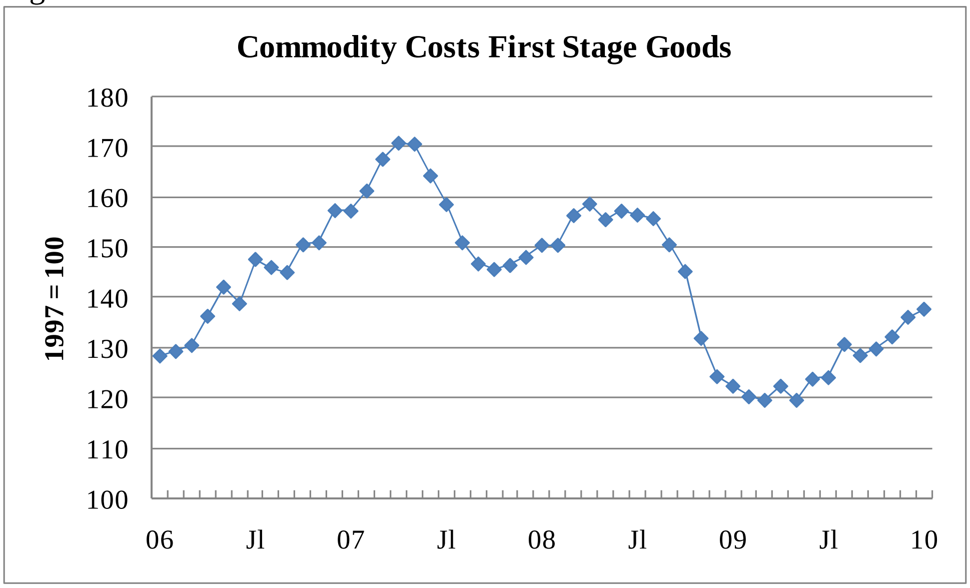
Figure 2



As can be seen on the graph, food manufacturing prices were relatively steady in 2008 and 2009. In fact, prices for 2009 were up by less than one half of one percent over 2008. Total manufacturing, on the other hand, saw 2009 prices decline by 4% versus 2008.

While revenues in 2009 were flat to just slightly lower, the expense side of the ledger saw operating costs decline by 10%. Statistics Canada does not break down the operating expenses into costs of raw materials and operating costs such as labour. In order to get a sense of the breakdown in costs, Figure 3 shows the Industry Price Indexes for commodities at the first stage of processing. That is, these products are crude commodity costs for food products, as well as an array of other commodities.

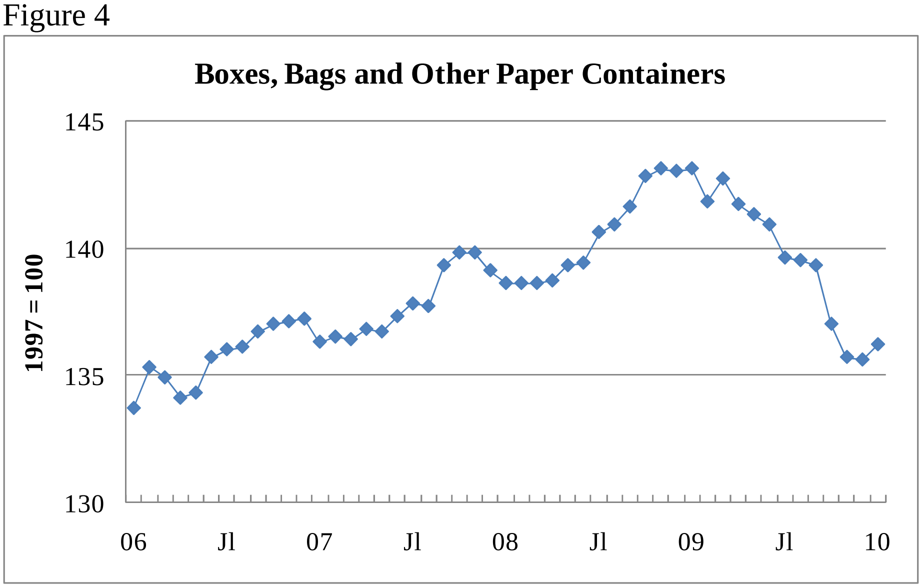
Figure 3



As can be seen, commodity costs increased on a month-to-month basis throughout 2009. Nevertheless, when compared to the previous year, these commodity costs declined by 16% from 2008 through 2009. This does not mean that all food manufacturers saw declines in raw material costs of that magnitude, but it does suggest that of the 10% decline in operating costs, a large share is likely going to be found in raw materials.

The performance of packaging costs also points to the raw materials costs as a source of the cost relief in 2009. Figure 4 shows the Industry Price Index for boxes, bags and other paper containers. These costs declined on a month-to-month basis through 2009 and were, on average, unchanged from 2008.

Figure 4



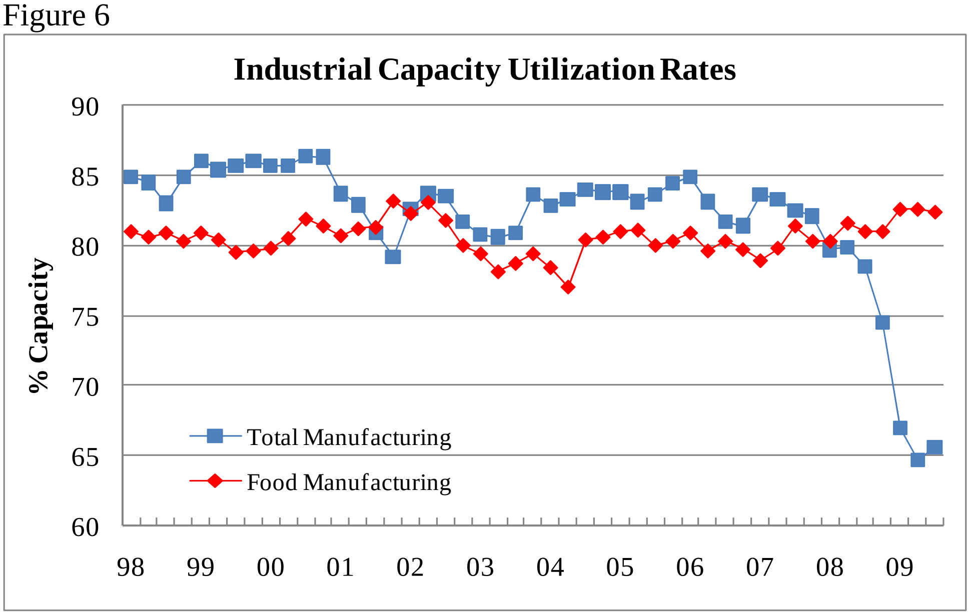
One final point on the cost side – Figure 5 shows average hourly earnings for employees paid by the hour, excluding overtime. The graph shows food manufacturing wages and wages for all goods-producing industries.

Figure 5

As can be seen, food manufacturing wages are significantly lower than all goods industries. Over the four year period on the graph, food manufacturing wages averaged nearly $6/hour less than all goods-producing industries. During 2009, however, all goods-producing industry wages were flat compared to 2008, while food manufacturing wages increased by nearly 2%. As such, some of the decline in raw material costs in 2009 was offset by wage increases.

Finally, as noted above, capacity utilization is impacted by economic growth. Figure 6 shows the Statistics Canada estimate of capacity utilization for all manufacturing and for food manufacturing on a quarterly basis, from 1998 through the third quarter of 2009.

Figure 6



As can be seen, the capacity utilization rates in total manufacturing have been severely impacted by the recession. In contrast, the utilization rates in food manufacturing actually increased during 2009. Underutilized capacity results in higher costs per unit of output. Increased utilization generally results in lower costs.

Generally, the profit performance and drivers for 2009 look to have been very favourable for food manufacturers. Looking ahead to 2010, food manufacturers are going to face challenges on the commodity front, as well as on the finished goods side. On the commodity front, as the graph above shows, costs appear to be trending back upward again. On the finished goods side, grocery distributors are going to be more reluctant than normal to absorb pricing increases. Wal-Mart appears ready to launch a more aggressive expansion and the pricing competition is likely to intensify.

As reported in the Wall Street Journal, February 26, pressure is building on food manufacturers to raise prices in part because their costs for everything from milk, meat, sugar and petroleum-based packaging are expected to climb this year. If food companies are able to pass along their higher costs, retail food prices will climb between 2.5% and 4% this year, according to a range of estimates by economists. If consumers resist higher prices, however, the food sector will struggle. Furthermore, as noted in the March 5 Wall Street Journal, manufacturers have been offering more coupons and other discounts to regain shoppers who have opted for less-expensive private-label products. Executives from food companies have said recently that they hope more promotions—not price increases—will help drive sales this year.

These factors all point to rising costs for food manufacturers, and an increased inability to force food pricing higher. This, in turn, points to margin pressure in 2010 which is, ironically, a time when total manufacturing should begin to see improvements.

A version of this report first appeared in the George Morris Centre publication, Grocery Trade Review, March 2010. If you would like a free two-month subscription to Grocery Trade Review, please e-mail Kevin Grier at kevin@georgemorris.org.