GEORGE MORRIS CENTRE

Food Industry Financial Review and Update

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The following article utilizes data from the Statistics Canada quarterly report entitled, "Financial Statistics for Enterprises." The food industry information is sourced as a special run for the George Morris Centre by Statistics Canada.

Food industry news reports have been focused largely on soaring grain and wheat pricing and the impacts on food pricing. The purpose of this note is to assess the performance of food manufacturer and retailer profitability during this period of rapid grain price increases. The note starts with an overview of the total Canadian industry performance, followed by food manufacturing and food retailing. The profit focus is on the first two quarters of 2007.

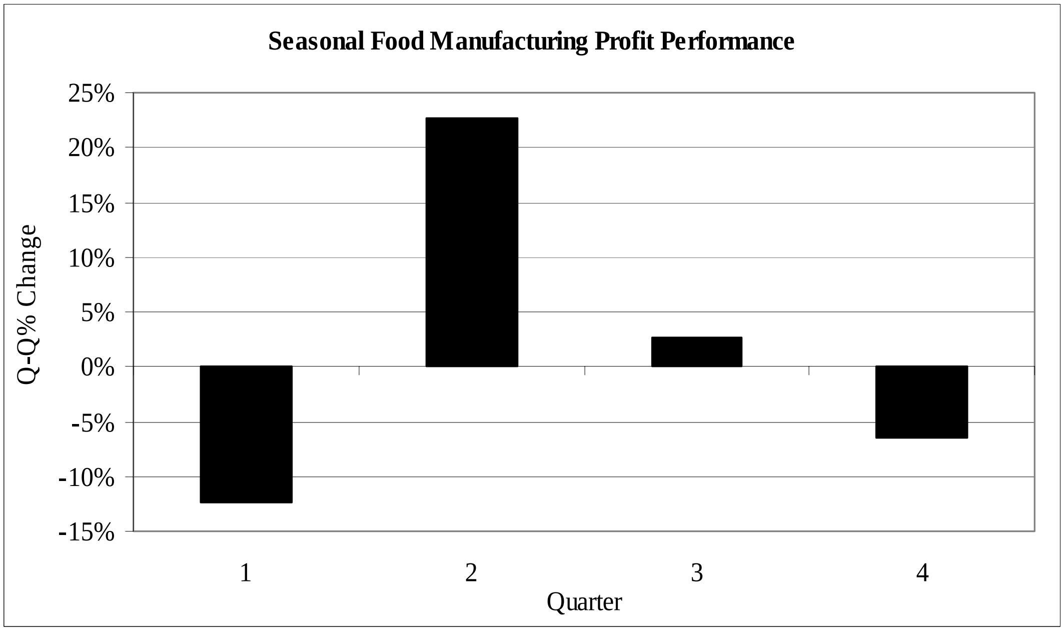
Profit Overview

Canadian corporate profits eased back in the second quarter, following four quarters of modest growth. Profits of $62.1 billion remained near their record high, at 0.7% below first-quarter levels. Declines in the manufacturing and insurance sectors were partially offset by gains from wholesalers, retailers and real estate companies. Overall, losses in motor vehicle, wood and paper industries overshadowed gains in the petroleum and coal, chemical, plastic and rubber products industries. Motor vehicle and parts manufacturers' profits tumbled $770 million to a loss of $50 million for the quarter, despite a 4.4% growth in domestic new motor vehicle sales. Profits have been volatile and on a downward trend since peaking at $2.5 billion in the second quarter of 2000. Wood and paper producers also fared poorly, reporting a loss of $130 million, partially due to declining lumber prices on the world market.

On the positive side, petroleum and coal producers benefited from swelling exports, propelled by strong global demand and rising oil prices. Operating profits jumped 14.2% to $3.2 billion, just shy of the $3.6 billion peak reported in the fourth quarter of 2005. On a similar note, high prices for inorganic industrial chemical products and fertilizers helped profits for chemical, plastic and rubber product manufacturers rebound 16.5% to $1.6 billion, following a decline of 13.6% in the first quarter. Continued strong consumer spending boosted retail profits 4.1% to a record high of $4.0 billion. Clothing and department stores reported a 6.2% increase in operating profits. Other retailers boosted their profits by 5.5%.

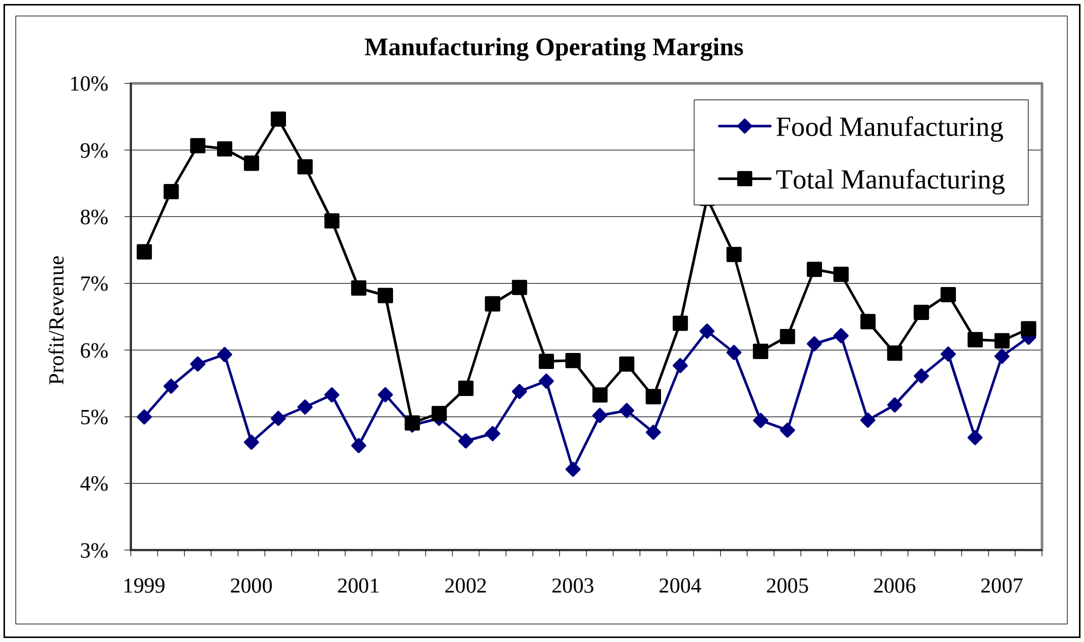
Food Manufacturing

In the food industry, food and soft drink manufacturers' second quarter profits increased by 18% over the first quarter of this year and 18% over the second quarter last year. The graph below



shows the seven-year average changes in quarter-to-quarter profits (4th to 1st, 1st to 2nd, etc). As can be seen on the graph, it is not unusual to see a big jump in profits in the second quarter over the first quarter. In fact, this year's first to second quarter 18% jump in profits was a little below average. It is likely, however, that the lower than average increase in second quarter profits was due to the above average profits in the first quarter of this year. As can be seen on the graph, profits normally decline from the fourth to the first quarter. This year's profits actually increased by 19% from the fourth to the first quarter.

The following graph shows operating margins (operating profits/operating revenue %) from 1999 through the second quarter of 2007. As can be seen from the graph, food margins have been fluctuating mostly between 5 and 6% for most of the past eight years. In fact, from 1999 through 2002, margins averaged 5.1%. From 2003 through 2006, margins averaged a little higher at 5.3%. So far, 2007 is turning out to be a very strong year with regard to margins. In the first two quarters of 2007, margins have averaged 6%.



Another point that can easily be seen from the graph is that while food margins have been relatively stable, the total manufacturing sector has been much more volatile. While food margin standard deviations are just about one half of a percent, total manufacturing standard deviations are over 1.2%. Stability of margins, in comparison to other industries, is one of the long standing characteristics of the food industry.

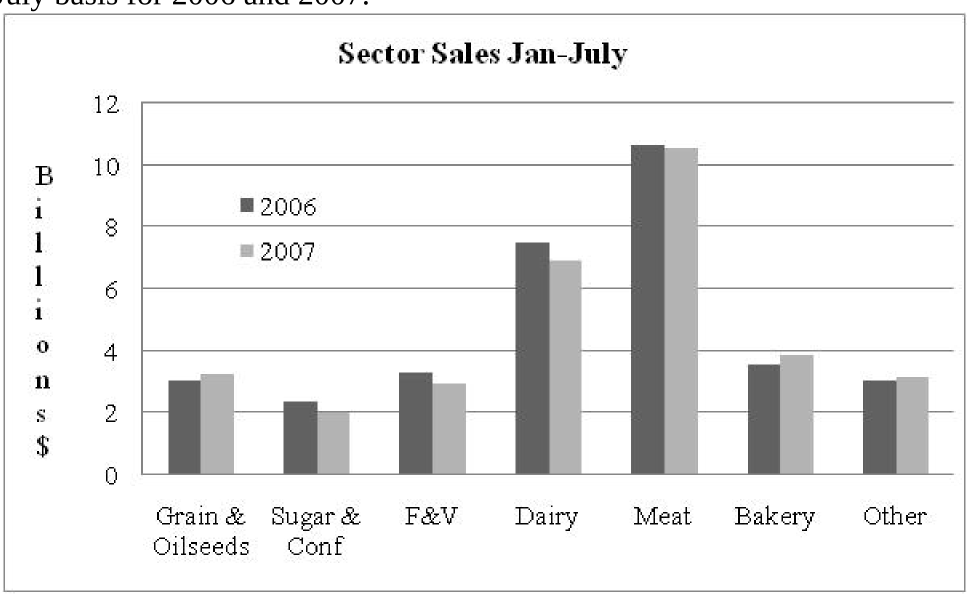
While food manufacturer profits have improved in the last two quarters, the question naturally arises as to whether there is a connection between profits and food industry pricing. The graph to the right shows the performance of food industry pricing relative to the total manufacturing sector. The graph shows the Industry Price Index, which measures changes in wholesale pricing between manufacturers and distributors. The graph shows monthly changes from 2006 through August 2007.

There are three basic messages from the graph:

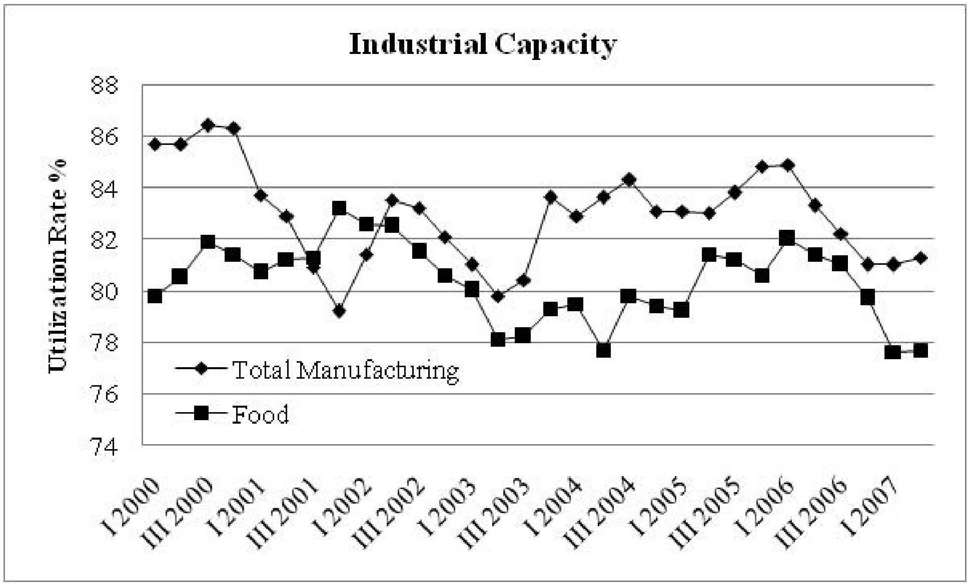
1. Food manufacturing pricing has stabilized in 2007, while total manufacturing pricing has declined.
2. Overall pricing levels in the food industry are higher (4%) in 2007 than in 2006.
3. Food manufacturers have been unable to push along pricing increases for most of 2007. In fact, pricing actually declined in August.

As noted, food manufacturing pricing is about 4% higher in 2007 than it was in 2006 over the same time frame. That, coupled with the overall reduction in total sales, means that real sales volumes have declined fairly dramatically in the Canadian food industry. Of course, there is a danger in generalizing about the "food industry." The meat industry led the move to overall higher pricing levels in the latter half of 2006. Furthermore, the main reason for the flat overall food price trend in 2007 was the decline in meat pricing. Meat pricing has been declining from the spring through the summer. Meat, which is the largest food industry sector, comprises a material portion of the total food industry sales base. Bakery product pricing has been fairly steady. Dairy product prices have been on a slow, steady increase over the last two years. Fruit and vegetable prices have been steady for most of 2007, after jumping sharply late last year. Sugar prices have been on the decline for most of 2006 and 2007. Each sector experiences its own market factors, which get reflected in the total "food industry" index.

With regard to the individual food manufacturing sectors, Sugar and Confectionary sales declined the most at 16 %, while Fruit and Vegetable processing declined 11 %. Dairy declined 7 % while Meat declined 1 %. The following graph shows selected food sector sales changes on a January-July basis for 2006 and 2007.



Real sales declines in the food industry are being reflected in plant capacity utilization rates. As can be seen on the graph below, the food industry tends to have lower plant utilization rates than the manufacturing sector in general. This is likely due to the seasonal nature of much of the industry.



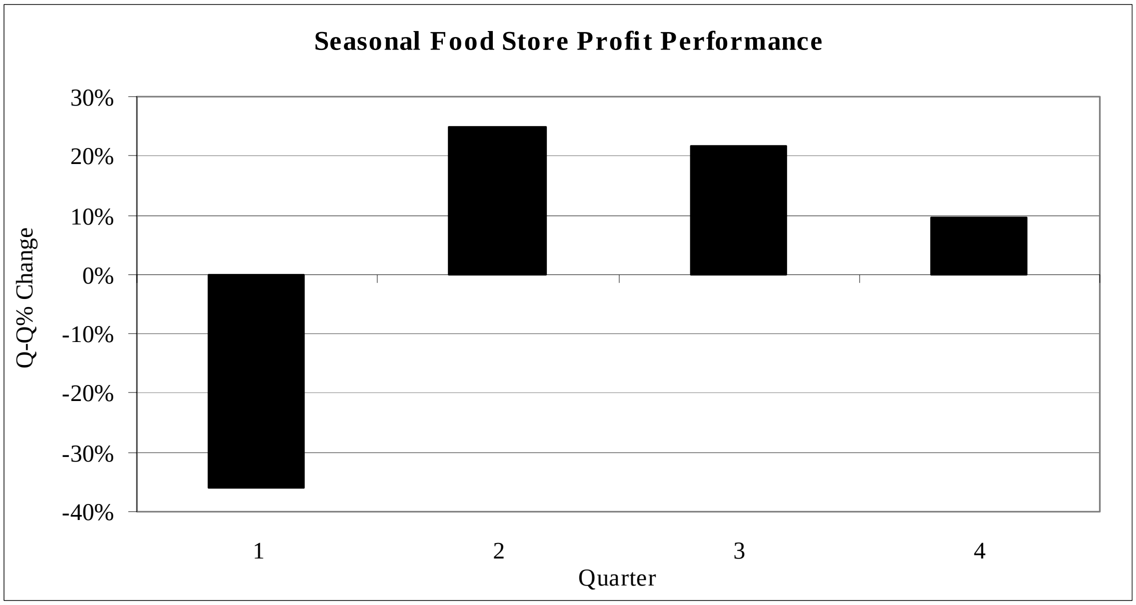
It is also likely due to the need for extra capacity in a sector that manufactures a largely perishable product. Perishable production needs to be more flexible regarding capacity. Nevertheless, as can be seen on the "Industry Capacity" graph, the capacity utilization rate of the food industry is trending very low relative to "normal levels" of over 80%.

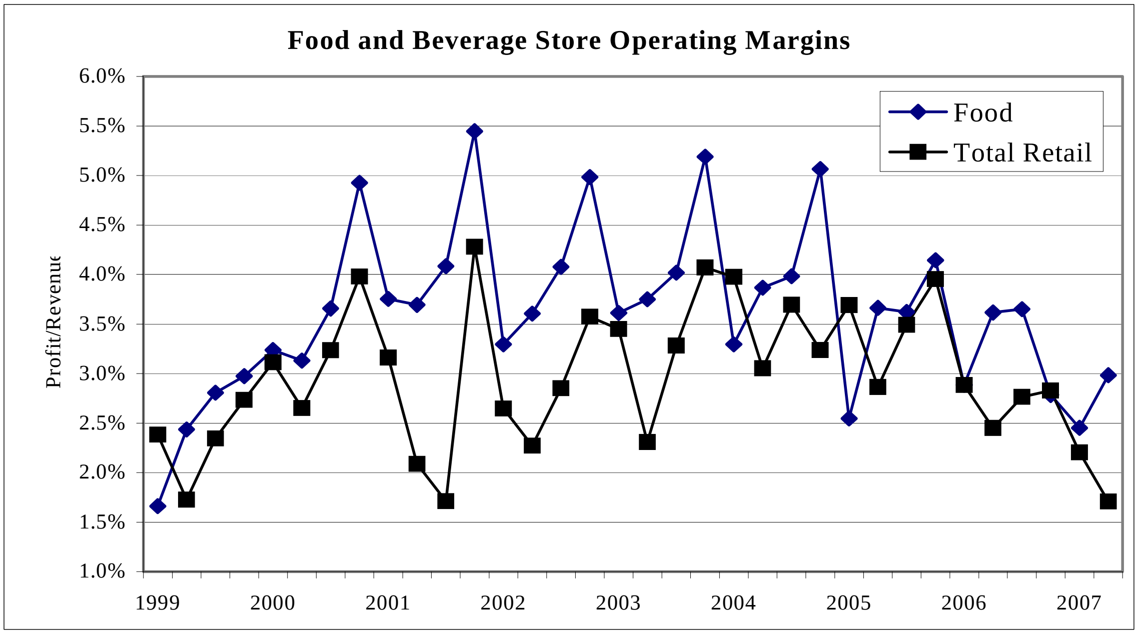
It is interesting to note that, despite the dramatic appreciation of the Canadian dollar, the export/import balance in the food sector is not changing dramatically. Preliminary data show that Canada's food trade surplus expanded this year through July, compared to last year. In other words, Canadian food manufacturers are not losing domestic or export share to international competitors, yet.

Food Retail

Food retail stores saw their second quarter operating profits increase by 26% over first quarter profits. Second quarter profits, however, are down by 15% compared to the second quarter of 2006. The first of the following two graphs shows the six-year average seasonal quarter-to-quarter changes in profits. As can be seen, the 26% second quarter increase in profit from the first quarter is not necessarily unusual. That is because, as can be seen, the first quarter is typically a very poor profit quarter. The other side of that observation, however, is that while first quarter profits normally decline by over 30% from the fourth quarter, this year's first quarter profits only declined by 16-17%.

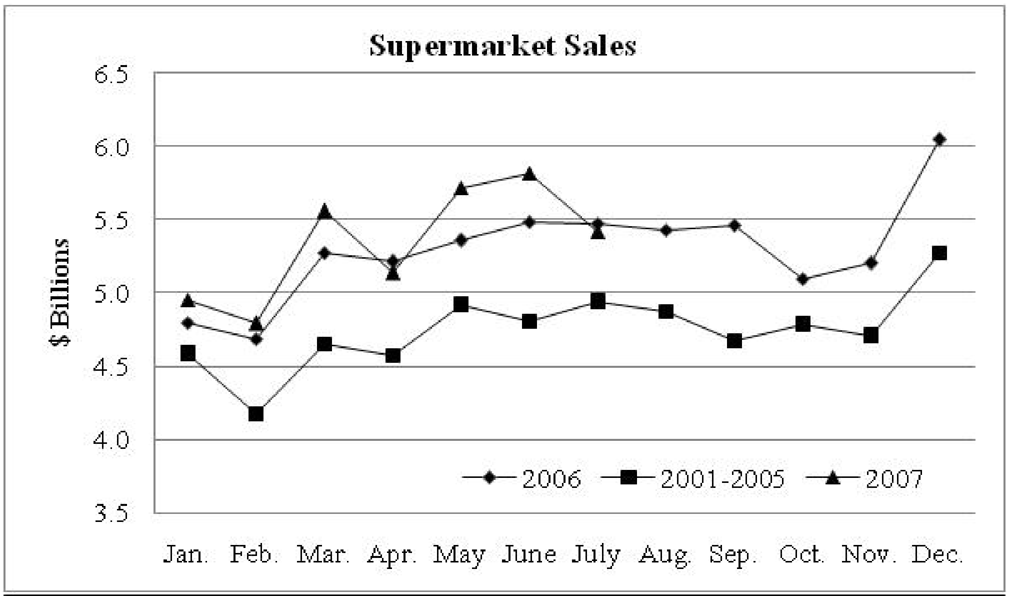
The second graph below shows the quarterly operating margins from 1999 through the second quarter of 2007 for total retail and for food stores. As can be seen, food retail profit performance has been volatile over the past six years. The general trend in the last three years, however, has been lower. In 2004, margins averaged over 4% while in 2006 margins were just over 3%. For the first two quarters of 2007, margins have been just 2.7%.

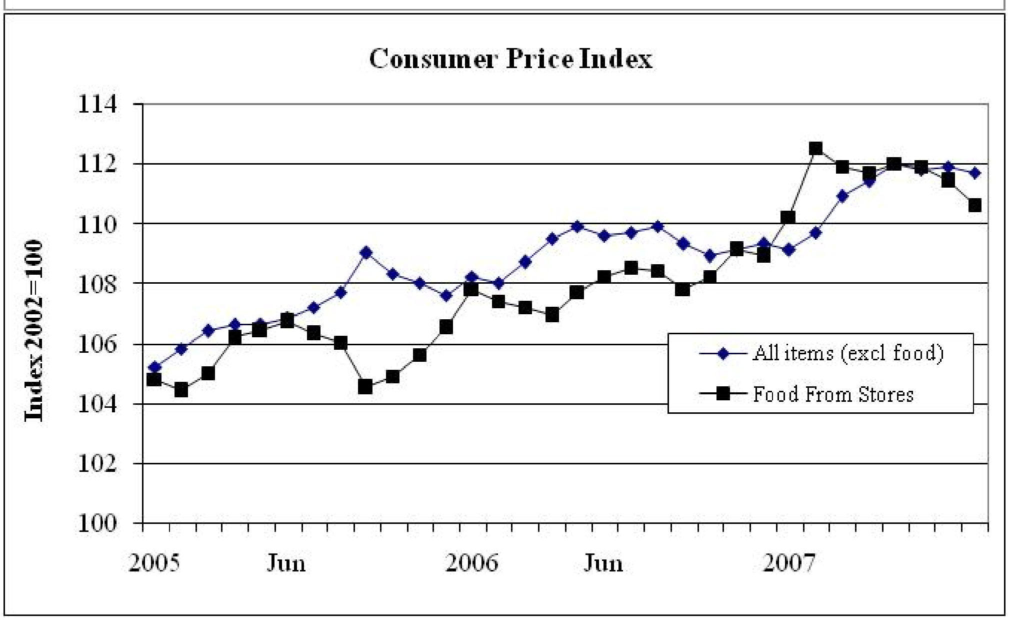




To get behind the profit numbers it is worthwhile to take a look at sales and pricing, as illustrated on the next two graphs. Supermarket sales dipped below year ago levels during July, but the seven month total remains 3% greater than last year. The first graph below shows the monthly trend in supermarket sales for 2007, 2006, and the previous five year average.

The good news regarding the supermarket sales increase is the fact that it was generated by real volume gains. The bad news is also that it was generated by real volume gains. That is, supermarkets do not appear to be able to make any moves on increasing pricing. The second graph below shows the consumer price index for all items (excluding food) and for food purchased from stores. As can be seen, after making some gains in late 2006 and early 2007, pricing slid sideways to lower. Furthermore, the pricing increases earlier in the year were mostly due to fresh produce and meat pricing as opposed to packaged goods.





Pricing challenges are reflective of a tough retail environment. Grocers are going to compete on price and that is not likely to change. That is particularly the case given the pending entry of the Wal-Mart Supercentres into an increasing number of markets across Canada. As such, while there is a focus on the impact of higher grain pricing on food prices in Canada, the competitive realities of the market mean that price increases will be hard to achieve,

Information from this paper first appeared in the George Morris Centre publication, Grocery Trade Review. If you are interested in a free two month trial to Grocery Trade Review, please e-mail Kevin Grier at kevin@georgemorris.org