Grocery Trade Report

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Market Analysis and Consulting Inc.
Make Informed Decisions

November 2020

Canadian Food Industry Statistical Snapshot

Consumer Prices				
Change vs Prior Yr	CPI All Items	CPI Food from Stores	CPI Restaurants	Packaged Foods*
October	0.7%	2.3%	2.2%	0.4%
Latest 12-month YOY	0.9%	2.8%	2.2%	1.9%

Manufacturing Industry Raw Costs and Goods Prices				
Change vs Prior Yr	Raw Crop-Based Materials Costs	Raw Animal-Based Materials Costs	All Manufactured Food Costs	Packaged Foods* Price
October	7.5%	2.2%	5.0%	2.0%
Latest 12-mon YOY	2.9%	-2.1%	4.1%	1.2%

Retail, Foodservice Sales Revenue				
Change vs Prior Yr	Total Retail	Supermarkets	Convenience	Foodservice
September	8.0%	11.8%	9.1%	-20.2%
Latest 12-mon YOY	-2.6%	9.7%	4.9%	-19.6%

Manufacturer Sales Revenue				
Change vs Prior Yr	Total Manufacturing	All Food	Soft Drinks	Packaged Foods*
September	-4.1%	6.7%	1.0%	1.3%
Latest 12-month YOY	-10.3%	2.9%	1.1%	3.1%

* Packaged does not include meat, poultry, seafood, dairy, eggs or produce

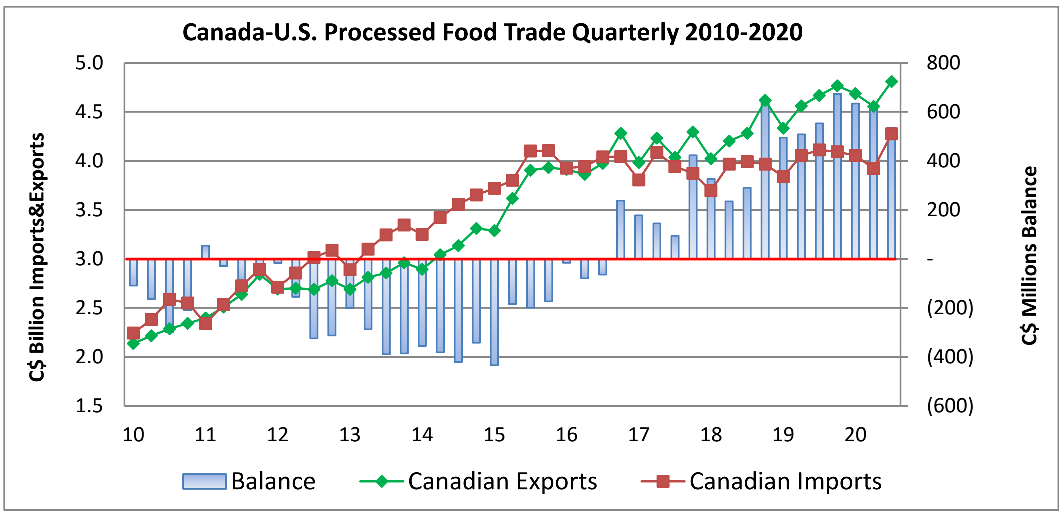
Executive Summary

- Canada continued to run a strong packaged food trade surplus with the United States in the third quarter.
- Canadian imports of packaged goods increased notably in the third quarter. The likely reason for the increase would have been supply chain re-stocking after the consumer hoarding of the second quarter.
- A firmer exchange rate is possible in the next year and that may result in greater imports by the second half of 2021.
- Retail food inflation increased modestly in October to 2.3% but it remains well below U.S. rates.
- CPG retail price increases have been very small. That could mean increased competitive intensity. Increased competition is also being asserted by BMO.
- During the last two months the Canadian rate of industrial CPG inflation has jumped ahead of the U.S. rate.
- Agricultural commodities continue to see underlying inflation, led by the most important commodity, corn. The trend is strong and does indicate upward pressure on food manufacturing costs.
- Corporate Profile: Metro.

Why More Imports?

Canada's processed food exports to the United States increased by 3% in the third quarter this year compared to last. Total packaged food exports to the U.S. were just over C$4.8 billion in the quarter. Canada's imports increased by 4% to hit $4.28 billion. This is according to the USDA's Foreign Agricultural Service (FAS) data. The FAS defines processed foods as the typical packaged goods in the grocery department of a supermarket, as well as margarine, processed meat, and dairy. Not included are alcoholic beverages, fresh meats, seafood and produce.

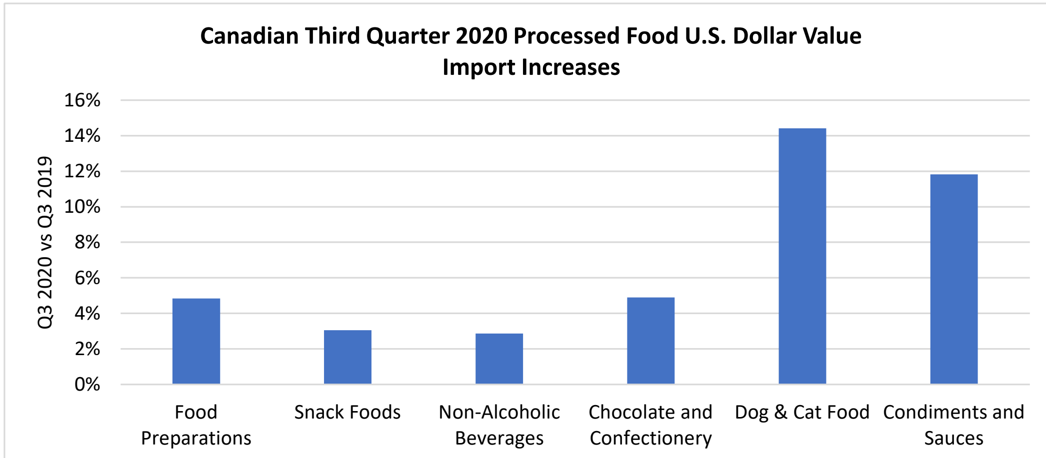
Interestingly, Canada's processed food trade surplus with the United States declined in the third quarter. That was the first decline in the surplus since the third quarter of 2017. Beginning with the fourth quarter of 2017 to the second quarter of 2020, Canada's trade surplus with the U.S. in processed foods has increased year over year.



Broad-Based Import Gains

As can be seen on the graph above, the import tally has been remarkably stable, trending sideways around $4 billion from 2015 through the first half of 2020. The steady trend is indicative of solid, dependable demand within the Canadian retail and foodservice sector. The third quarter of 2020 was noteworthy in its run-up to nearly $4.3 billion.

That Q3 2020 tally is not overly out of line with the trendline, but it does raise questions as to why. The initial temptation would be to question whether there were any virus-related reasons. It could simply be that the Canadian supply chains were being re-filled after the Q2 consumer hoarding. That may be the best reason. The import increase was across a wide range of products (see graph below). That indicates that the whole spectrum was being re-stocked. Another virus-related rationale is that the biggest sub-category, the Food preparations had a solid 5% gain. Food preparations are the baking and cooking ingredients. They likely got a large share of the panic buying in Canada during the second quarter as consumers increasingly cooked and baked at home.

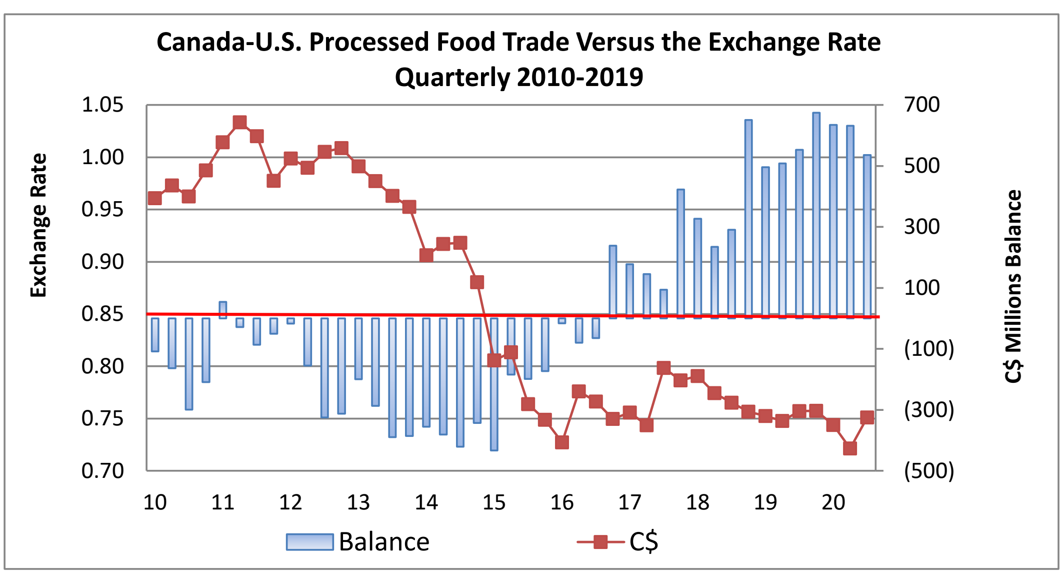


Another reason for the increase in imports may have been the stronger dollar. The dollar firmed in the third quarter to an average of 0.75 compared to 0.72 in the second quarter. That could have made U.S. product more attractive. Certainly, if that is the case, that trend could be continuing into the fourth quarter.

Exchange Impact

As noted here often when discussing trade, it is worthwhile to note that at least partial credit for the string of surpluses since 2016/17 must go to the weaker exchange rate. The decline in the C$, especially since 2014, coincides with a trend towards reduced deficits and eventual surpluses in processed food trade with the United States.

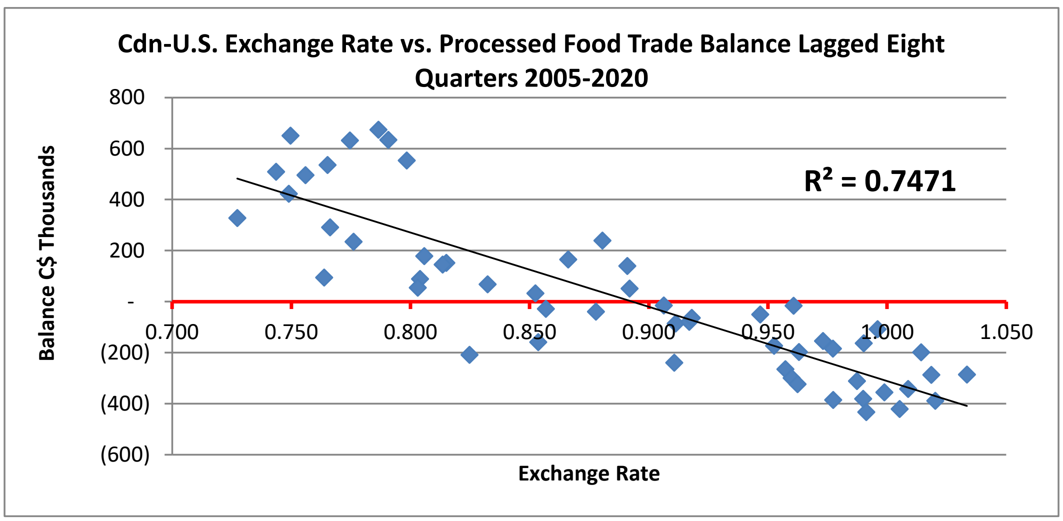
It is worth noting, however, that Canada's trade competitiveness is not necessarily fully attributable to the weaker C$. There was a near trade balance in 2011 when the C$ was ranging around par. Furthermore, in 2008 (not on the graph below) Canada had a small surplus despite a par dollar. That demonstrates that trade competitiveness is not solely due to a weak currency, but it helps.



Lagged Response

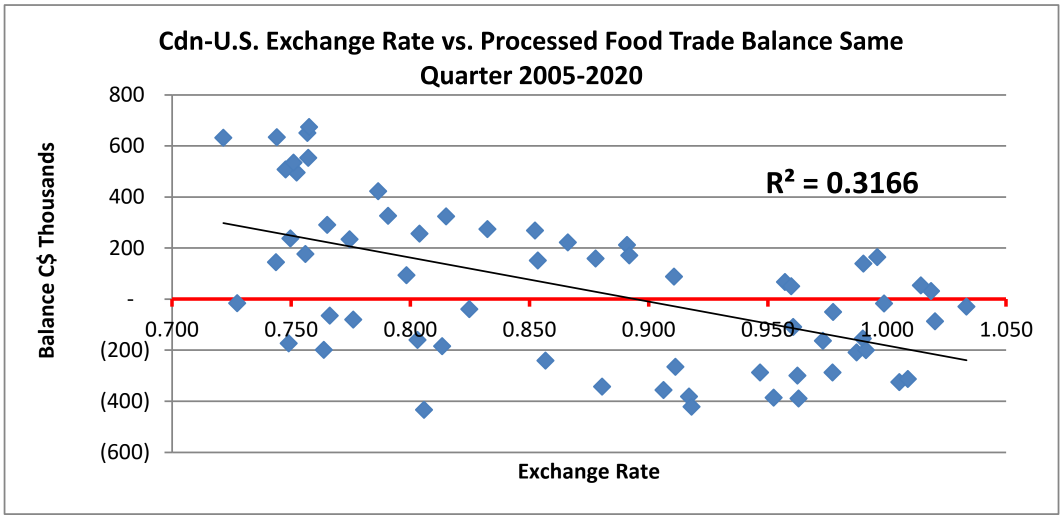
As a final point about the exchange rate, it was argued above that the stronger dollar may have had something to do with stronger Q3 imports. That is certainly possible but as argued here before, in non-commodity trade markets manufacturers take time to adjust to the exchange rate changes. Unlike commodity sellers, manufacturers need time to adjust to the marketing, costing and profit incentives created by the exchange rate changes. Manufacturing and marketing changes must be adopted once the impact of the exchange rate becomes apparent on costs and profits. Firms will want to ensure that the change is not temporary. Contracts may need to be negotiated with new partners in the United States. This all takes time to develop, hence the lagged trade response.

The following graph shows the quarterly statistical relationship between the exchange rate and the processed food trade balance. The graph shows a two-year lag between the exchange rate and the trade balance. This two-year lag is maybe indicative of the time frame that allows companies to adapt to the changing currency and its opportunities or its detriments, depending on direction. The lagged relationship is statistically strong between the two variables. The weaker the currency, the higher the trade surplus for Canada; with a two-year lag. The stronger the currency, the trade balance is lower or in negative territory, with a two-year lag.



Little Spot Market Impact

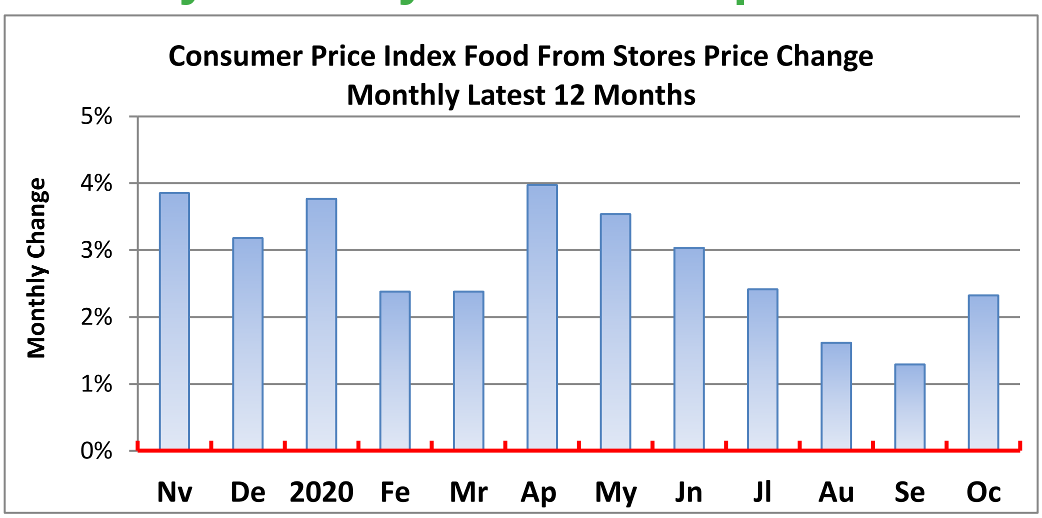
Contrast that relationship with the quarterly relationship with no lag; in other words, there is no time difference between the exchange rate and the trade balance. In this case there is some logical statistical relationship between the exchange rate and the trade balance, but it is not strong. The point then is that while the stronger exchange rate may have drawn some product into Canada in the third quarter this year, it was probably not the major factor. That is, the stronger currency may have resulted in some spot market or opportunity transactions. With that said, it is doubtful that the only reason for the Q3 jump was the firmer Canadian dollar.



<u>Why it Matters</u>

While the C$ firmed in the third quarter, it is on path for an even stronger fourth quarter. Global investors are under no illusions about the merits of Canada, or lack thereof. As such, the issue is not so much a stronger C$. Instead, the issue may become a weaker USD. In addition, it is likely that resources will catch more global investment which could be positive for the C$. The Canadian dollar has traded in a tight trading range for the last five years. Packaged goods traders should at least plan for it to trade in the upper end of that trading channel. There also must be an acknowledgement of the risk that it breaks out to the upside and finds a new trading range. If it does, then at the very least that trade balance will begin to narrow notably beginning in the second half of 2021.

Monthly Grocery Inflation Report



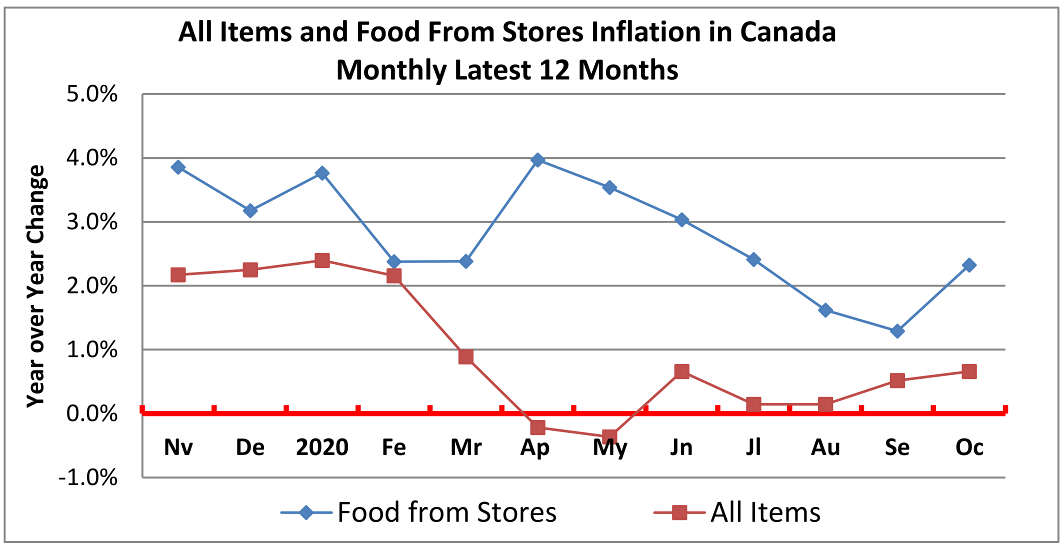
The following is a summary of the Statistics Canada Consumer Price Index (CPI) October inflation data (latest) versus the same month last year as shown on the table on the first page of this report:

- All items increased by 0.7% versus the same month last year.
- The rolling 12-month all items average inflation rate is 0.9%.
- Food purchased from stores increased by 2.3%.
- The rolling 12-month average inflation rate for food from stores was 2.8%.

All Items vs Food from Stores

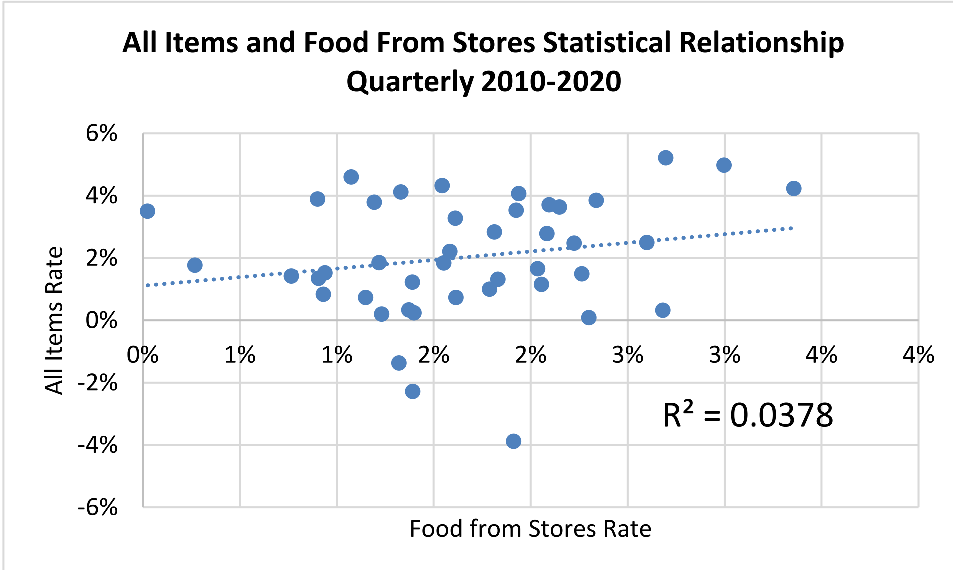
The "food from stores"[1] (FFS) inflation rate of 2.3% was the first increase in six months. For reference, that rate compares to the 2010-2019 average rate of 2.0% and the 2015-2019 rate of 1.7%. In other words, the increase was basically a typical or normal rate of increase for the food from stores rate. Meanwhile the inflation rate of all items, at 0.7% is slowly rising off-the lockdown and virus driven deflation that was seen in April and May. The all-item rate was less than half the rate seen between 2015-2019

The spread between all items in the total CPI basket and the FFS component widened modestly in October. The spread was 0.8% in September then more than doubled to 1.7% in October. That widening occurred because the food rate rose faster than the all-items rate. In any event the spread between the all-items and the FFS at 1.7% compares to almost zero difference for the long term 2010-2019 spread.



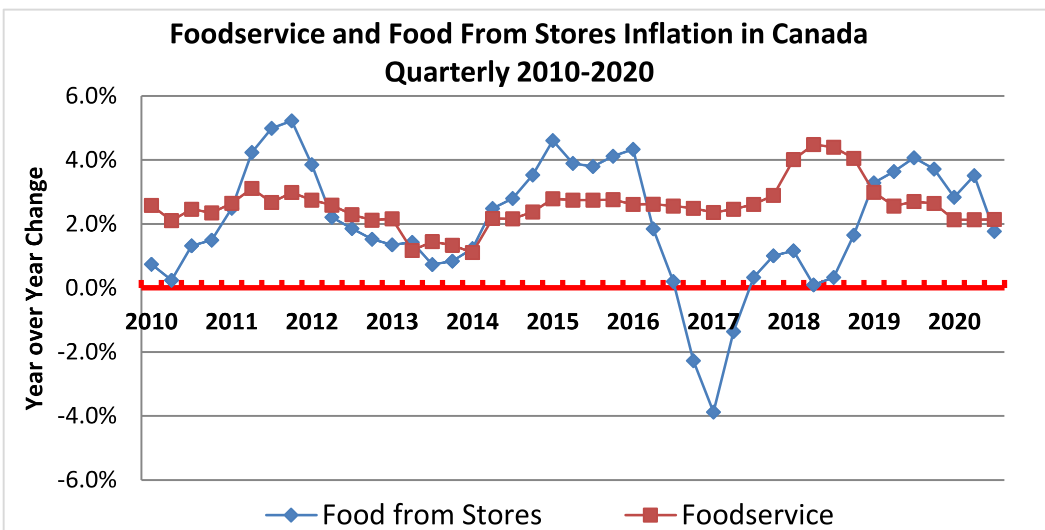
As noted last month in this report, there is very little correlation between all-items and the food from stores rates (see graph below). That is not unexpected. Food from stores comprises only 11-12% of the total CPI. In addition, the FFS has much more volatility. The food from stores standard deviation at 2% is double the all-items standard deviation on a quarterly basis from 2010-2019. That is not surprising given that the FFS is subject to wild commodity gyrations. Furthermore, the food component is subject to a variety of different factors that are independent of the total and the economy in general.

[1] The "food from stores" component of the StatsCan CPI comprises 11% (+-) of the total goods and services basket. The other big components are shelter at about 27%, transportation at 20% and recreation, education and reading at 10%. The foodservice component, which is separate from food from stores, is about 5% of the total basket.

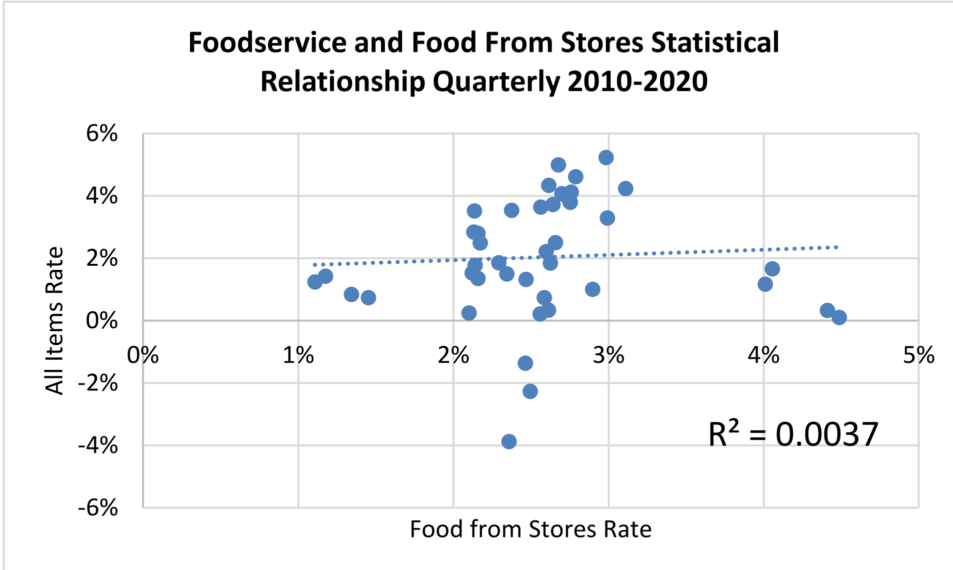


Foodservice Price Gains

Foodservice prices increased 2.2% in October, the same as September. The foodservice inflation rate for October is less than the 2.6% longer term 2010-2019 rate. The foodservice rate was very close to the FFS rate in October. Over the 2010-2019 period that FFS inflation rate has averaged about 0.6% less than the foodservice inflation rate. There is much more volatility in the FFS inflation rate compared to the foodservice rate. The standard deviation, a measure of variation from average, of the FFS inflation rate on a quarterly basis is 2%. The foodservice standard deviation was just 1%, over 2010-2019.



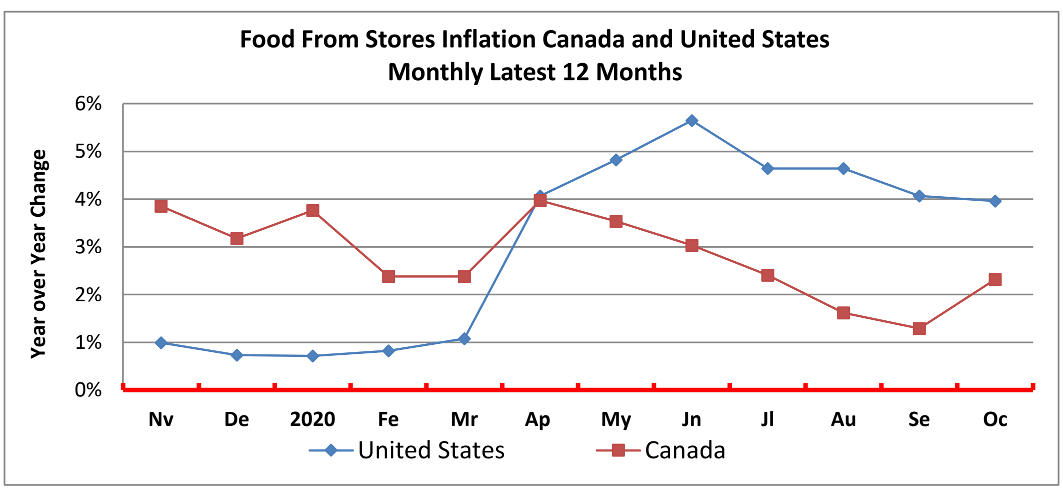
It might not be surprising that there is more fluctuation in grocery pricing than restaurant pricing. Menu pricing will tend to be fixed for longer periods of time for a variety of reasons. What is surprising, however, is that there is no relationship whatsoever between FFS and foodservice pricing.



Canada vs. U.S.

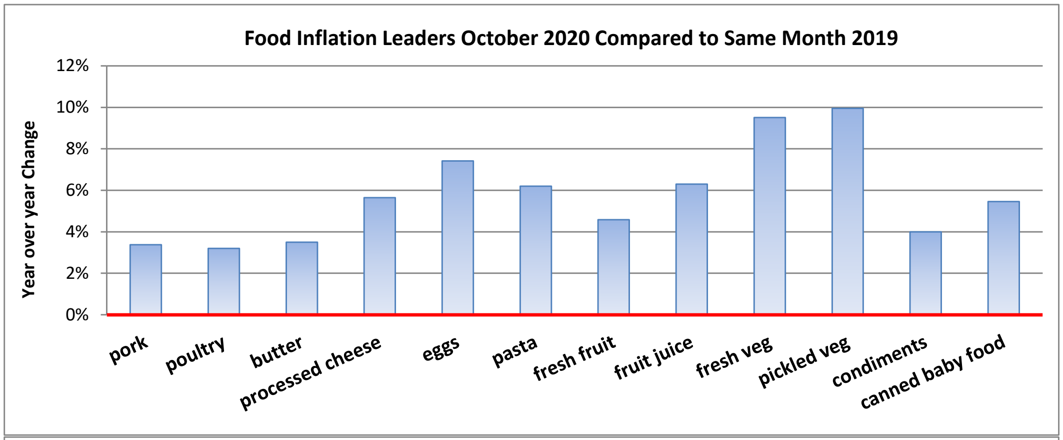
The U.S. food from store inflation rate was 4.0% in October. As noted here repeatedly in previous reports, it appears that U.S. grocers responded to consumer panic buying and loss of foodservice by hiking prices. In other words, the U.S. response was a rational reaction to a market opportunity.

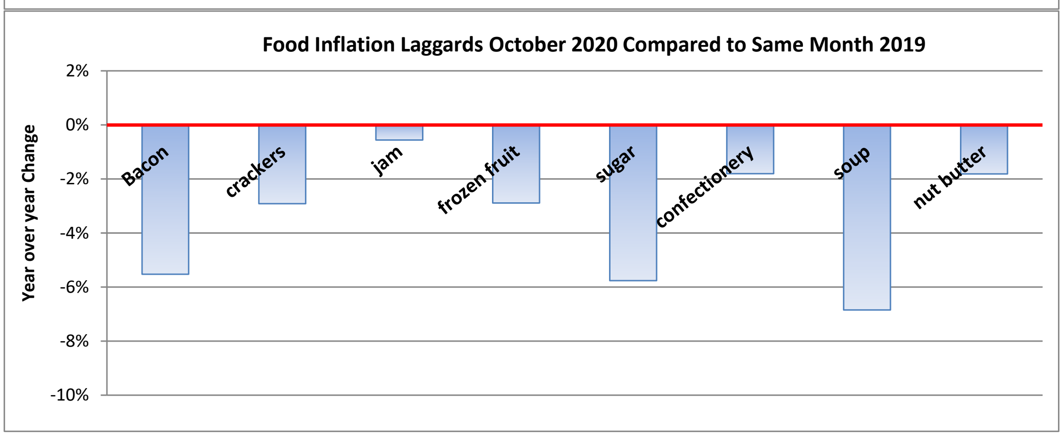
The pricing response since the pandemic in the U.S. and Canada completely reversed relative pricing positions. Prior to the pandemic, Canadian food from store inflation was consistently greater than the U.S. In the five years from 2015-2019, Canadian food from stores inflation averaged 1.5% more than U.S. inflation. In the ten years from 2010 to 2019 the Canadian rate averaged 0.8% more. Since April this year, the U.S. rate has averaged 2% more than the Canadian rate.



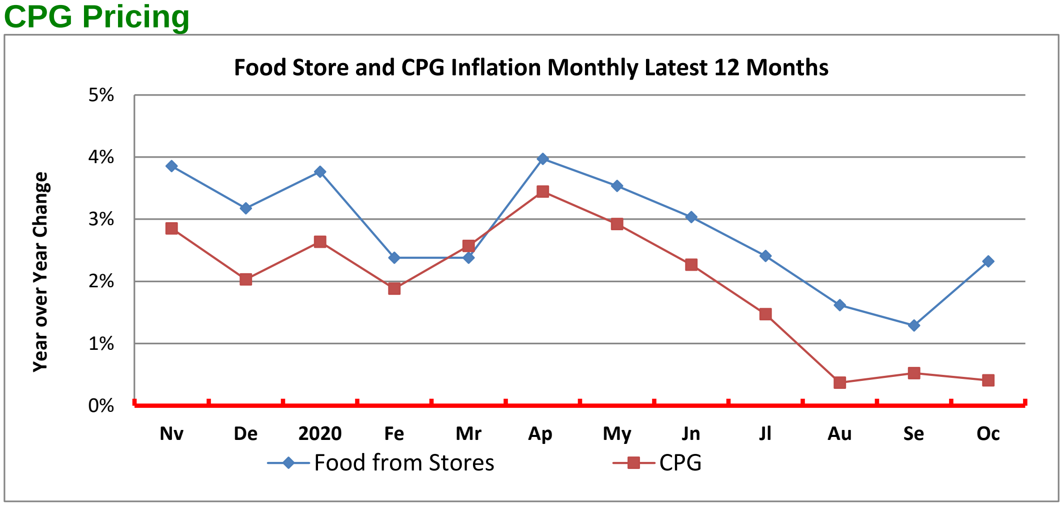
Key Product Price Trends

The following two graphs show some of the inflation leaders and laggards in the food store in October.





CPG Pricing

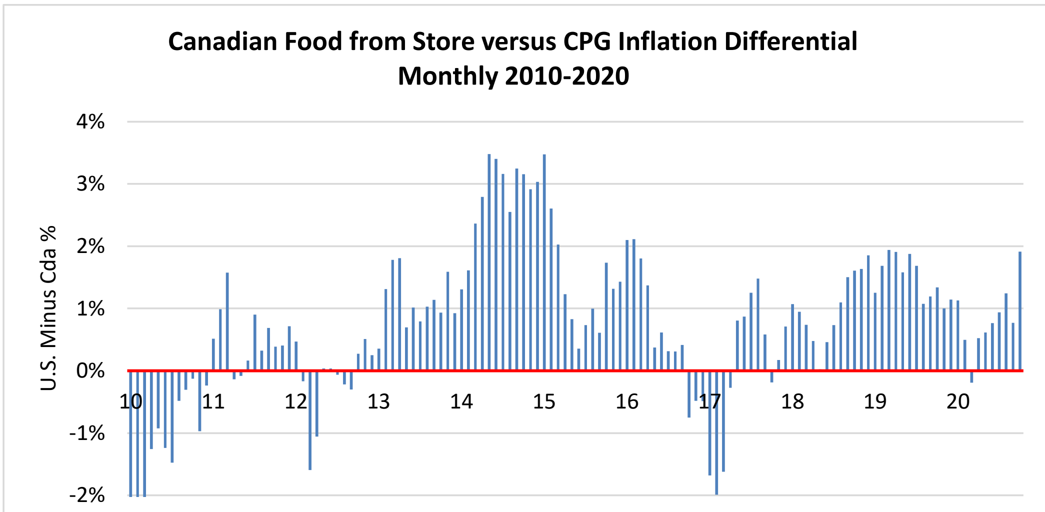


Consumer-Packaged Goods[2] (CPG) are those packaged processed products in the grocery aisles in the middle of the store. In October, CPG products saw price

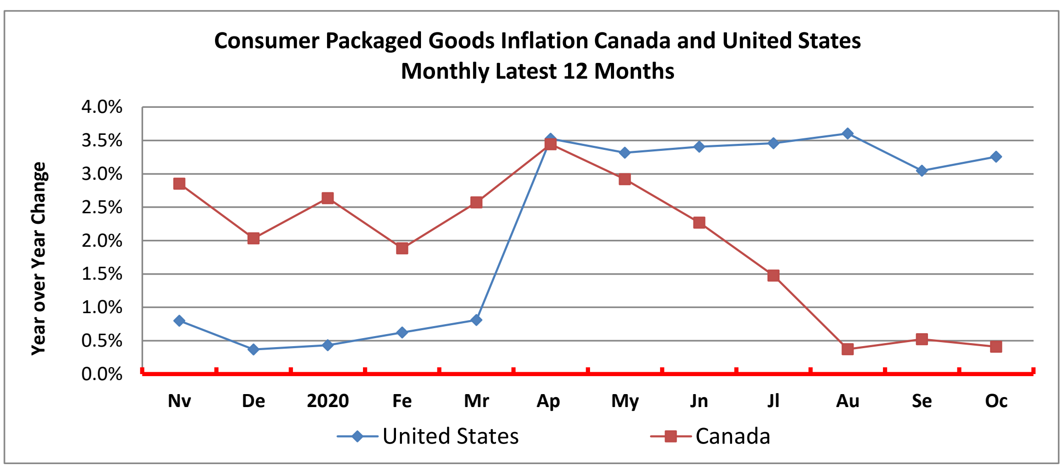
[2] CPG products make up about 44% of the weight of the StatsCan Food from Stores share. That implies that StatsCan considers the packaged goods in the grocery aisles to be 44% of the consumer basket in the grocery store. That is the biggest general component of the food basket by far.

increases of 0.4% year over year. That compares to the food from stores tally of 2.3% and the 0.8% CPG average of 2015-2019.

The fact that the food from stores inflation is greater than the CPG is normal. Over the ten years from 2010-2019, the food from stores rate was 1% greater than the CPG. That is the same differential as the five year 2015-2019 and the same for 2020.



Finally, as usual, it is instructive to compare pricing with the United States. The U.S. CPG prices rose by 3.3% in October. That 3.3% increase is 2.8% greater than the Canadian CPG increase.



The 2.8% difference between the U.S. and Canadian CPG pricing is a very significant difference from a historical perspective. From 2010-2019, there was almost no difference between Canadian and U.S. CPG inflation, on average. In the 2015-2019 period the U.S. CPG inflation rate was 0.4% lower than the Canadian rate. Since April, however, the U.S. CPG inflation rate was 1.7% more than Canada's CPG inflation rate.

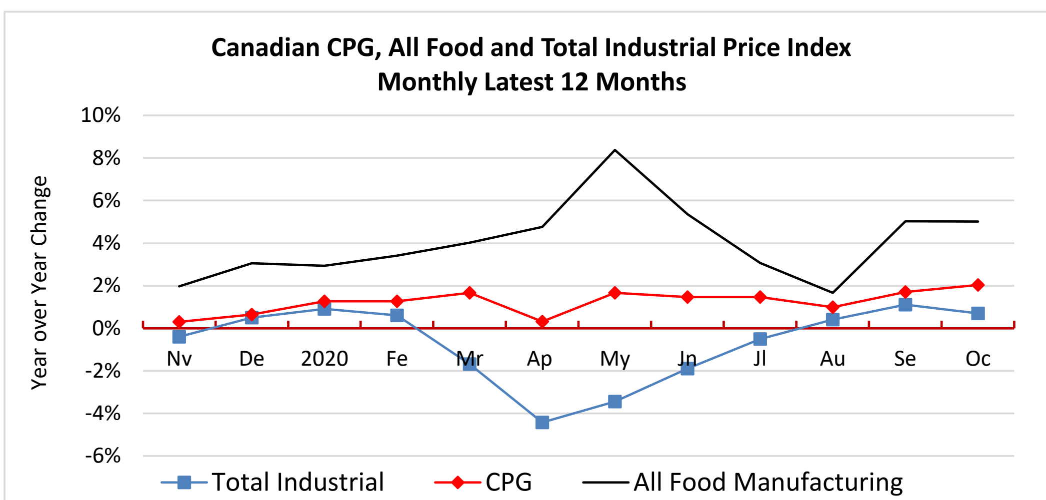
Key Takeaway

Researchers at BMO Capital Markets recently noted that they believe that competitive intensity in the grocery space had already returned to pre-COVID levels in the summer and has continued to intensify in recent months. That is based on analysis of digital marketing spending. BMO says that intense competition is firmly here. They conclude that grocers are investing in a meaningful level of promotional and marketing spend to sustain current sales levels and market share. That BMO assessment coincides with the very low inflation of the CPG items in store. As noted here often, CPG prices are a bellwether of competitive intensity.

If this increase in competitive intensity is true and if it is to be sustained, it portends to challenges for grocer margins in the coming months. That is due to clear threats of underlying agricultural commodity inflation as noted elsewhere in this report. It also means extra pressure on packaged goods suppliers to the industry.

Monthly CPG Manufacturer Price Report

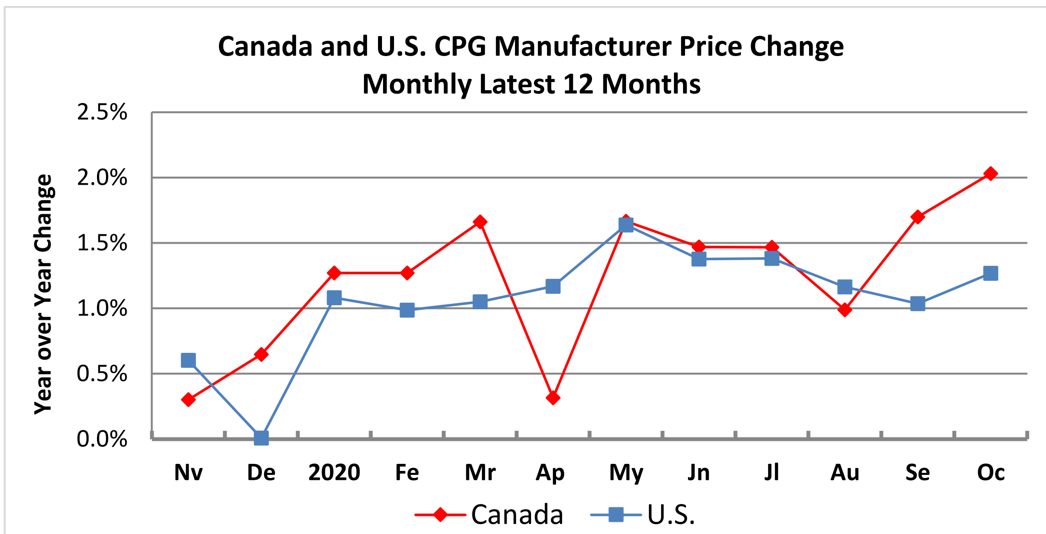
At the manufacturer level, Canadian consumer packaged goods food product prices, as measured by the Statistics Canada Industrial Product Price Index (IPPI)[3] rose 2% in October (latest). That compares to a 5% gain for all manufactured foods in Canada and the total industrial product spectrum of 1%. CPG are about 36% of total food in the StatsCan IPPI basket. The IPPI for CPG has risen at a 1.2% rate over the previous 12 months.



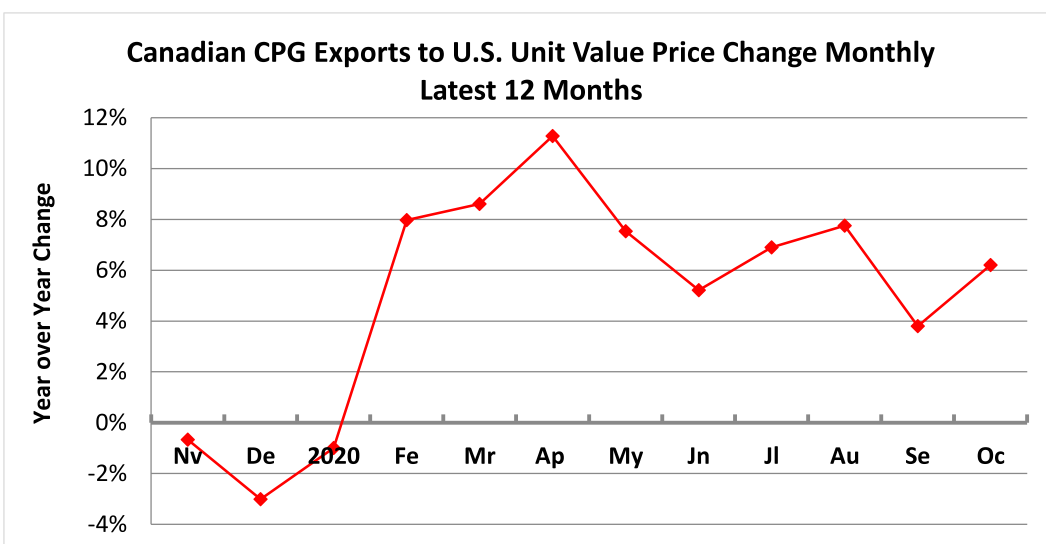
[3] The Industrial Product Price Index (IPPI) measures price changes for major commodities sold by manufacturers operating in Canada. The prices collected are for goods sold at the factory gate. The index measures the movement in prices for manufactured goods produced in Canada, destined for domestic or export consumption.

The increases in all food manufactured prices were led once again by the meat industry. Pork and beef prices increased sharply during October and that continued into November. The CPG manufactured products saw decreases for cereals and syrups as well as for flour mixes, dough and dry pasta. There were increases in the prices of confectionery and frozen foods.

In the United States, CPG prices at the manufacturer level increased by 1.3% in October. The 12-month rolling average increase in the U.S. was 1.1%. The 12-month Canadian and U.S. CPG rolling average are roughly the same. With that noted, during the last two months the Canadian rate of industrial CPG inflation has jumped ahead of the U.S. rate.



Recall that the IPPI includes products that are exported as well as sold domestically. As such, the Canadian IPPI is influenced by exports, particularly to the United States. CPG exports are important to manufacturers and may comprise up to 40% of total production. USDA processed food trade data can be utilized to estimate Canadian CPG price changes monthly. During October



(latest), Canadian CPG exports to the United States had a unit inflation rate of 6%. The rolling 12-month inflation rate of Canadian exports to the U.S. was 5%.

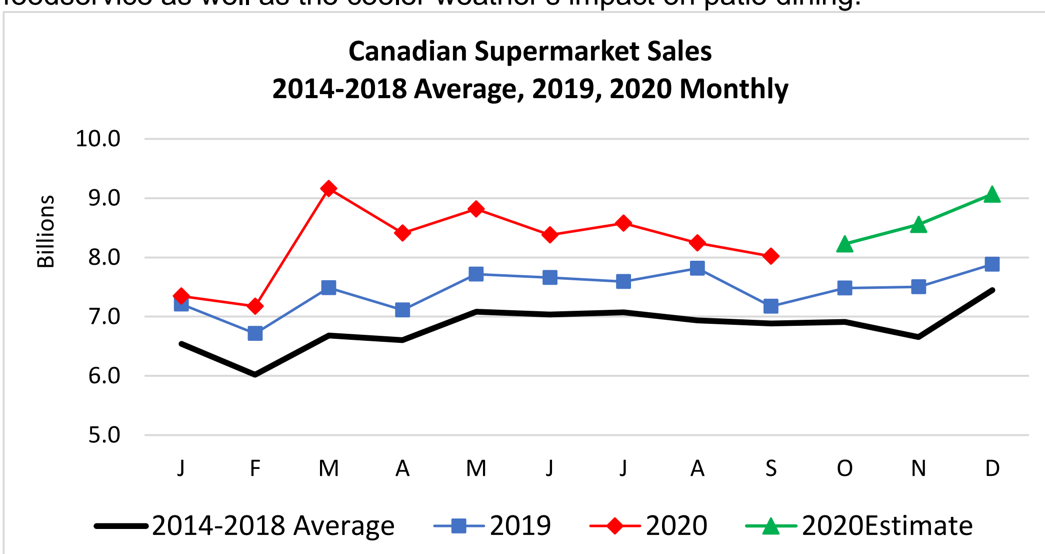
Key Takeaway
The Canadian CPG manufacturers are seeing some life on the pricing front. It is being driven, however, by export pricing. The stronger C$ will take the edge off that pricing.

Monthly Food Industry Sales

Supermarkets

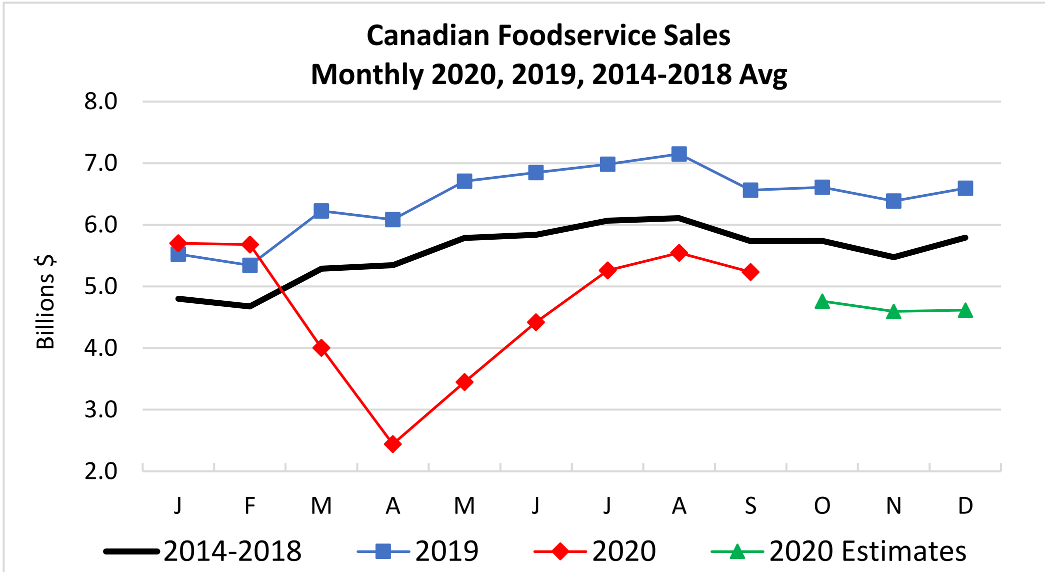
Canadian supermarket sales increased by 11.8% in September (latest) compared to the same month last year. Twelve month rolling average sales are up 9.7%. The biggest year over year increase was March at 22% followed by April at 18%.as consumers hoarded due to the virus. The August increase was just 5% which was the smallest since the virus became widely known in Canada.

Estimations of sales for October-November as well as the forecast for December are for greater sales again ranging from 10-15%. This is due to increased consumer hoarding again. It is also due to the increased lockdowns of foodservice as well as the cooler weather's impact on patio dining.

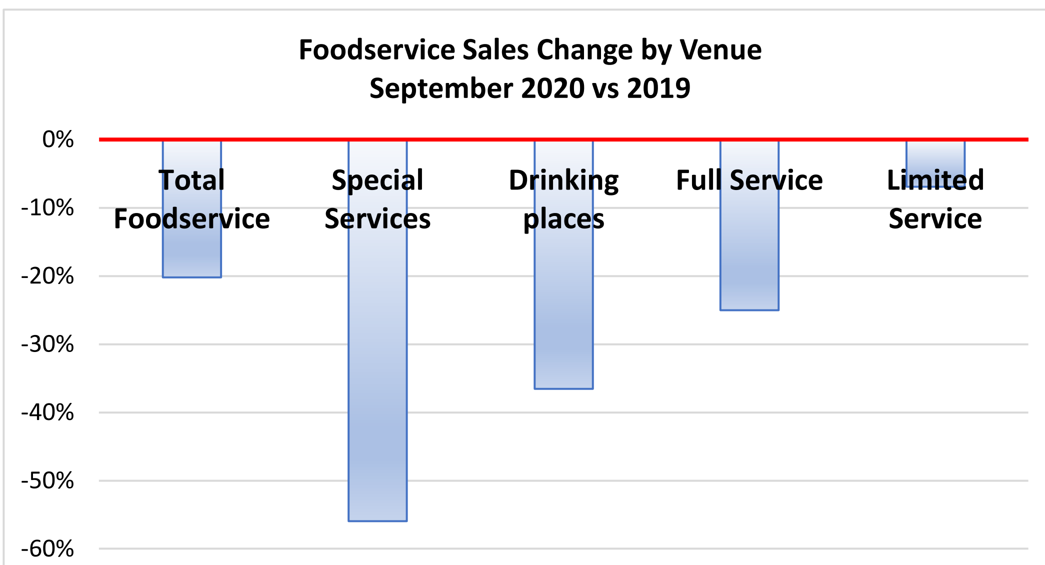


Foodservice

Foodservice, sales in September (latest) were down 20% compared to the same month last year. The 12-month rolling average sales were down 20%. The September sales decline was the smallest since the lockdowns began in March. In April sales declined by 60%. The September sales declines were lessened due to fewer government lockdown restrictions. Looking to the October to December period, the expectation is for increased sales reductions due to the cooler weather's impact on patio dining and increased government restrictions.

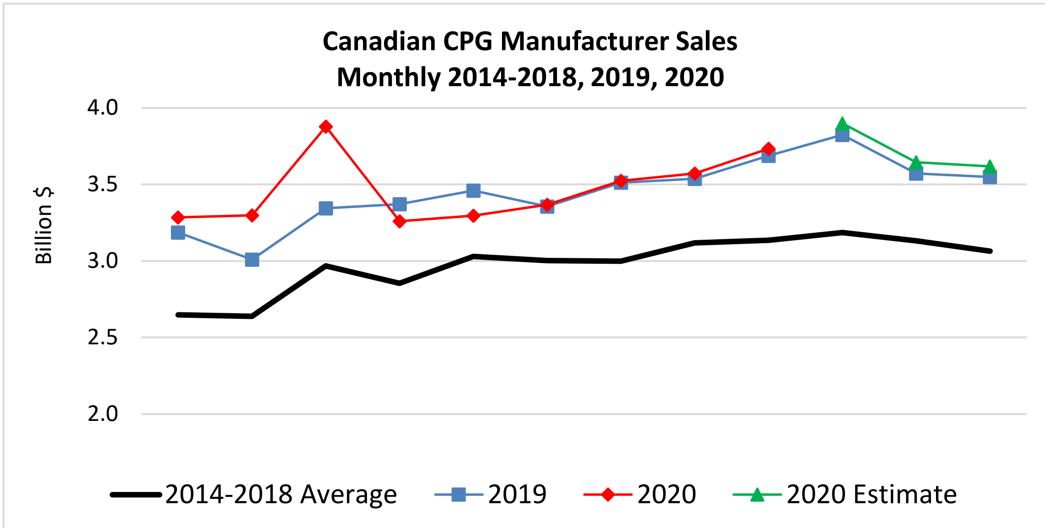


Full-service and limited-service venues normally comprise about 85-90% of foodservice sales. Those are the sit-down restaurants and fast-food. Bars and catering/food trucks are the remainder. Full-service declined by 25% in September while limited service declined by 7%. The expectation is that full-service sales will decline further in October to December. Limited service could be roughly equal to or greater than year ago in those months.



CPG Manufacturing

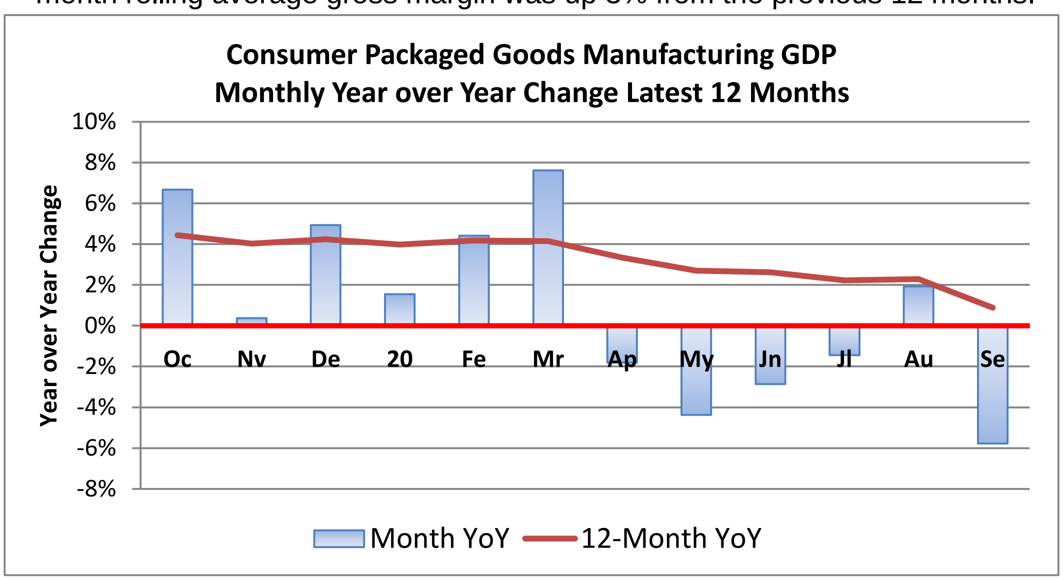
Consumer Packaged Goods Food manufacturers saw sales increase by 1.3% in September. The year-to-date increase was 3.1%. That compares to the 16.0% increase in March and a 3% decrease in April as the pandemic took hold on processing patterns. The expectation is for sales to increase by about 2% from October through December. The estimates reflect the impact of a firmer C$ and stronger retail purchases more than offsetting lost foodservice sales.



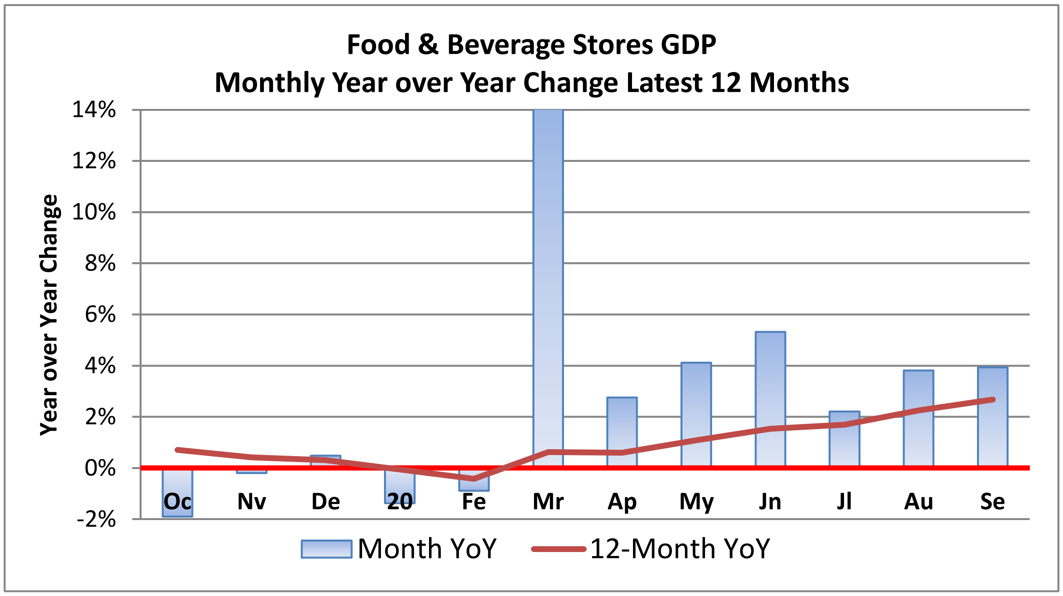
Monthly GDP Tabulation

Each month Statistics Canada publishes Gross Domestic Product (GDP)-by-industry.[4] The GDP of an industry is a general approximation of the gross margin

- During September (latest), the gross margin for consumer-packaged goods food manufacturers was down 6% from the same month the previous year. The rolling 12-month average GDP or gross margin increased 1%.
- Food retail gross margins were up 4% in September versus 2019. The 12-month rolling average gross margin was up 3% from the previous 12 months.

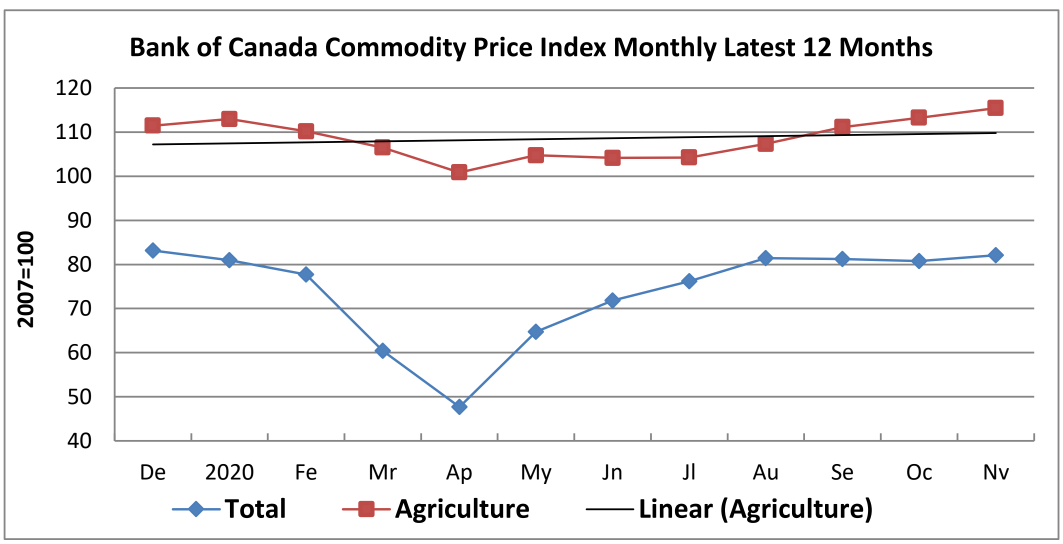


[4] GDP by industry is the value added of an industry according to the U.S. Bureau of Economic Analysis. It is the contribution of a private industry to overall GDP. The components of value added consist of employee compensation, taxes on production, imports less subsidies, and gross operating surplus. Based on that definition, the GDP by industry could also be regarded as a general approximation of the gross margin of an industry, plus employment income, before operating costs. The GDP-gross margin analogy is not perfect, but it suffices for discussion.



Commodity Watch

The Bank of Canada (BoC) Commodity Futures Index for all commodities was unchanged this November compared to the same month last year. The agriculture index was up 2% compared to the previous month and up 4% compared to November 2019.



In addition to the BoC index, the following are the latest trends in commodity futures over the month of November:

Cattle	higher
Cocoa	higher
Coffee	higher
Corn	higher
Hogs	steady
Sugar	steady
Wheat	lower

Agricultural commodities continue to see underlying inflation, led by the most important commodity, corn. Corn is seeing and is expected to continue to see very strong export demand from China. Corn often has an impact on most agricultural commodity costs. As noted last month, the trend is strong and does indicate upward pressure on food manufacturing costs.

Corporate Stock Focus: Metro

Metro (MRU) is a leading food and drug retailer with ~1,300 stores primarily in Quebec and Ontario. Brands include Metro, Super C, Food Basics, Jean Coutu, Brunet, Adonis and Premiere Moisson. Its main pharmacy banner, Jean Coutu, acts as franchisor to its pharmacists and benefits from the sale of pharmaceuticals and retail items, as well as through rent and royalty streams.

Researchers at CIBC Equity Research says that in its latest earnings report, Metro delivered balanced results with strong margin and cost discipline on an elevated top-line amidst a challenging environment. Its geographic and channel balance leave it well-positioned to navigate shifts in competitive and consumer behaviour, including more intense promotional activity. The researchers believe that the company has navigated the pandemic about as well as one could reasonably expect. Food-at-home will remain elevated for the next few months at least, and likely more. But at some point, tailwinds will turn to headwinds, and lapping stock-up sales and the heightened demand of lockdown periods will present challenges. Nonetheless, we expect Metro will execute with its hallmark discipline and deliver for its shareholders.

CIBC says that the explosion of e-commerce demand during the pandemic has challenged Metro's overall cautious approach to the online channel, but the company is acting. The company announced plans to open a 100,000 square foot facility at a cost of $15million. This is not really a dark store in the traditional sense, but it will fulfill demand solely for delivery orders in the Montreal-area. No financial details were shared beyond the up-front costs, but CIBC views this as a measured investment that will ease the burden on stores and ramp up over a few years to material revenue.

The researchers are concerned, however, that facility includes no automation. Clearly this reduces the up-front cost, but it also limits throughput and efficiency, they say. CIBC expects technology to be the primary lever to building a profitable online grocery business and deferring this step pushes off progress.

Another issue they see is that this spend highlights the challenge of adapting an existing business to a new channel that will ultimately cannibalize the legacy store network. For all intents and purposes this new facility is the same as adding new brick and mortar square footage to the Montreal market, a step that few grocers would likely entertain at this point. Lastly, CIBS believes the Ontario market is more competitive, and they are more cautious about MRU's ability to gain - or maintain - market share through the online channel in that region.

Conclusion

The CIBC researchers conclude that Metro continues to execute with balance and discipline, leveraging elevated demand to above-average earnings growth. Given the volatility and rapid shifts in consumer behaviour, this is no easy feat, and MRU has earned its position as the premium-valued grocer, they say. The company has taken a measured approach to ramping up e-commerce but the opening of a dedicated facility highlights flexibility and responsiveness, even amidst uncertainty.

The researchers' share price target rises to $63 (was $61).

Charting for Metro

Source: money.tmx.com, December 9

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