Canadian Food Manufacturer and Retailer Review and Outlook 2015

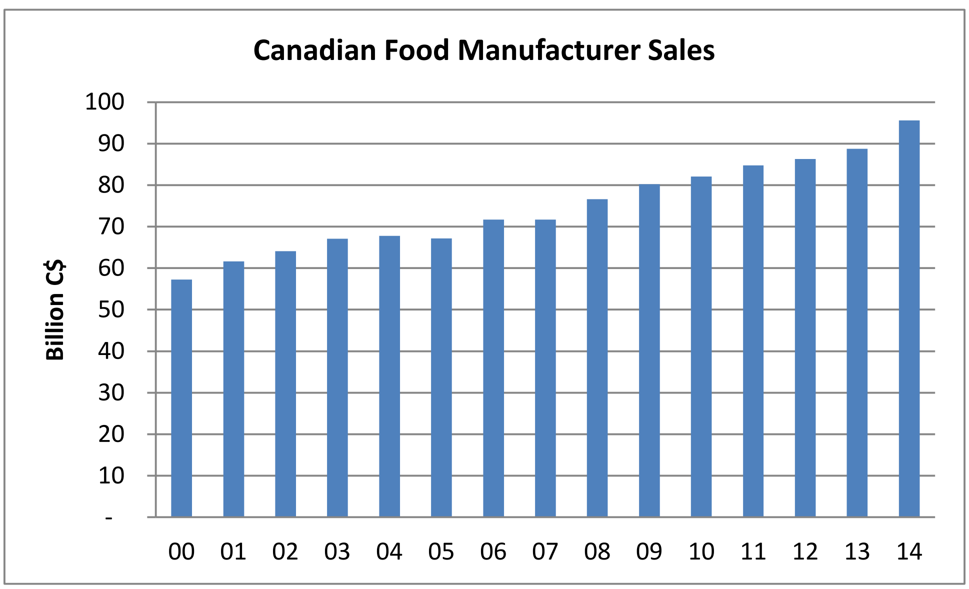
by Kevin Grier, January 2015

This paper provides a review of the performance and trends in the Canadian food manufacturing and grocery industry during 2014. It also provides a commentary on some of the issues and challenges that will face the industry during 2015.

Canadian Food Manufacturer Review

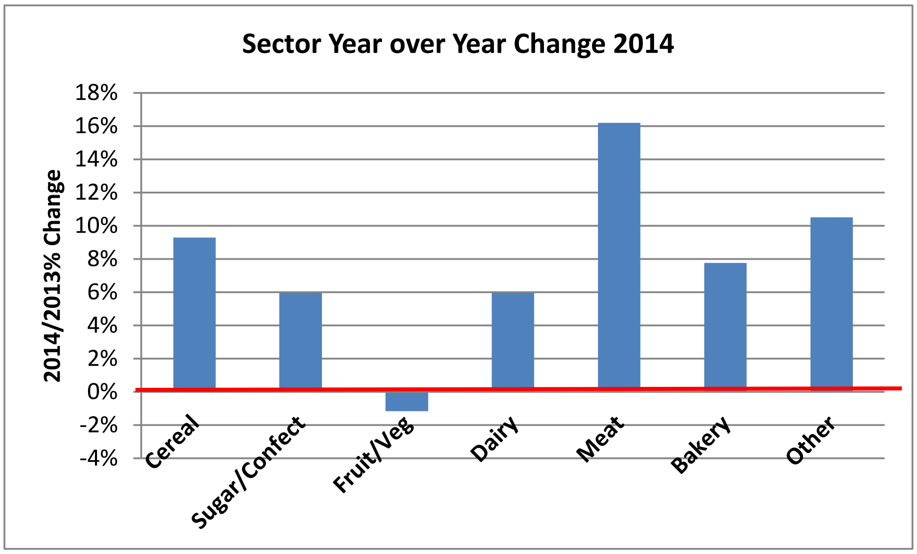
Sales

Canadian food manufacturer sales will total about $95.6 billion in 2014 based on StatsCan data through October 2014. The sales tally amounts to an 8% increase over 2013 and compares to a 3% compound growth rate in the 13 years from 2013 through 2000. As a further point of reference, it is noted that total Canadian manufacturing activity likely will have grown by 6% in 2014.



While the 2014 growth appears impressive relative to history and relative to the total manufacturing, as always it needs to be recalled that the food industry is comprised of many sectors. In that regard, the meat sector which comprises about 28% of total food sales saw total sales increase by 16% in 2014. In other words, the meat industry performance had a big impact on total sales in the food industry.

In that regard, it is noted however, that while the meat industry might have seen the biggest growth, other sectors also saw impressive, or above average gains during 2014. The "Other" sector on the graph below contains important industries such as snacks and prepared meals. Overall consumer packaged goods manufacturing in Canada, defined as those food sectors not including meat, seafood, dairy, feed or intermediate goods, saw sales gains in the 6% range. The only sector of the food industry that saw declines was fruit and vegetable processing. Other components of the StatsCan definition of the food industry include animal food and grain & oilseed milling. Those sectors also saw declines which were associated with the grain price fall. Those sectors however, are not typically considered part of the food industry directly.



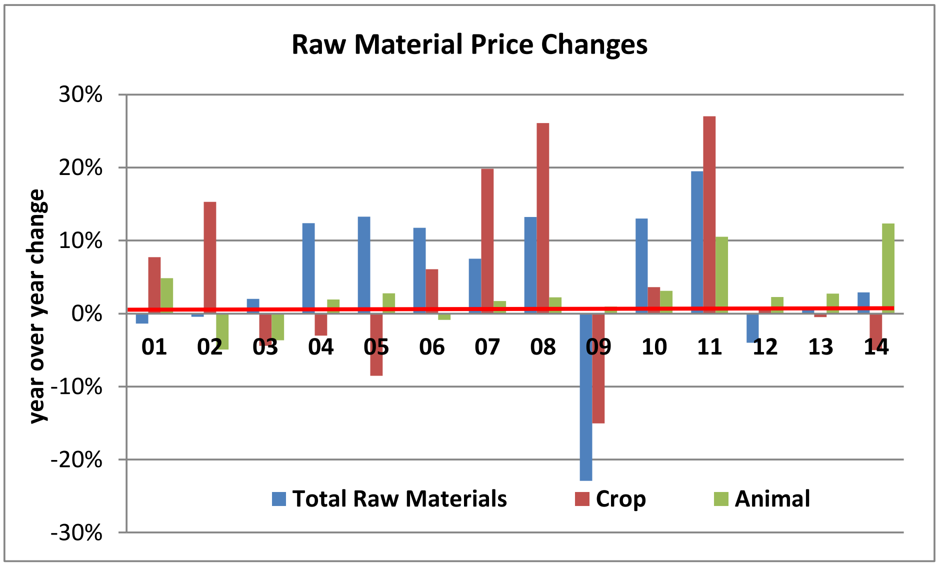
As such, in general apart from Fruit and Vegetable, 2014 should be considered a good year at least from a sales perspective for Canadian food manufacturing.

Costs

On the cost side of the equation, the experience of the manufacturer was totally dependent on the raw material requirements. If the raw materials were crop or grain based, it is likely that the food manufacturer experienced a profitable year in 2014. If on the other hand the raw material was animal or meat based, then the year would have been challenging.

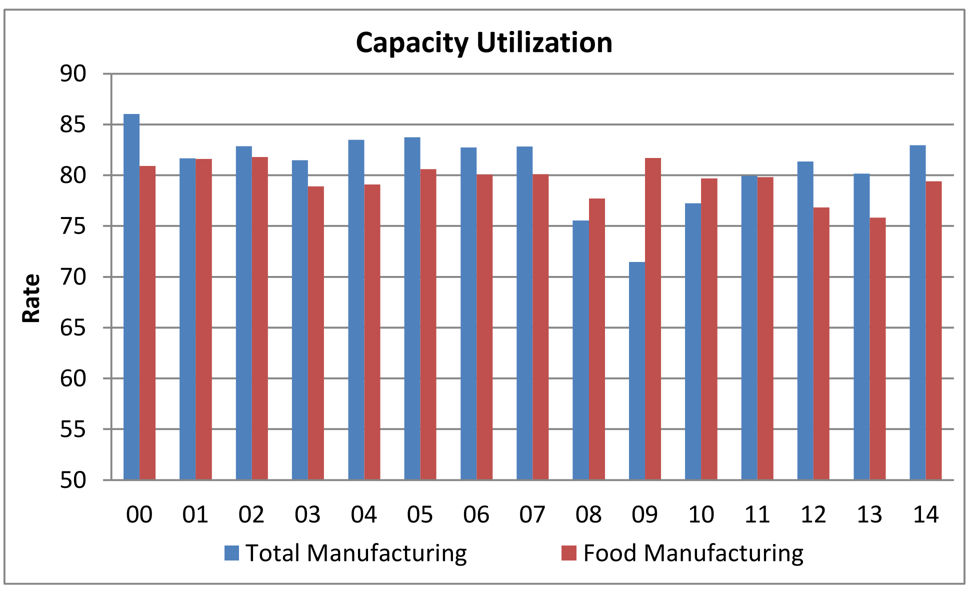
Based on the StatsCan raw materials price index, total raw materials cost increases amounted to about 3% in 2014. That compares to a more typical compound annual growth rate of 4% from 2000-2013. Crop based raw materials actually declined by 5% in 2014 compared to a compound annual growth rate of 5% from 2000 to 2013. Animal based raw costs increased by 12% in 2014 compared to a more normal 2% over 2000 to 2013.

Food manufacturers that have crop based raw materials have struggled significantly from 2007 through 2011. From 2012 to 2014 however, the costs increases have been either non-existent or in fact declining. Food manufacturers that required animal or meat products as their raw material in 2014 would have struggled significantly.



Capacity Utilization

The food manufacturing industry saw 2014 capacity utilization rate of 79% during 2014. That was a sharp improvement over 2013 but below the 80-82% rates seen earlier in the 2000's. By contrast total manufacturing utilization rates stood at about 83% in 2014, an improvement over the 80% rate in 2013.



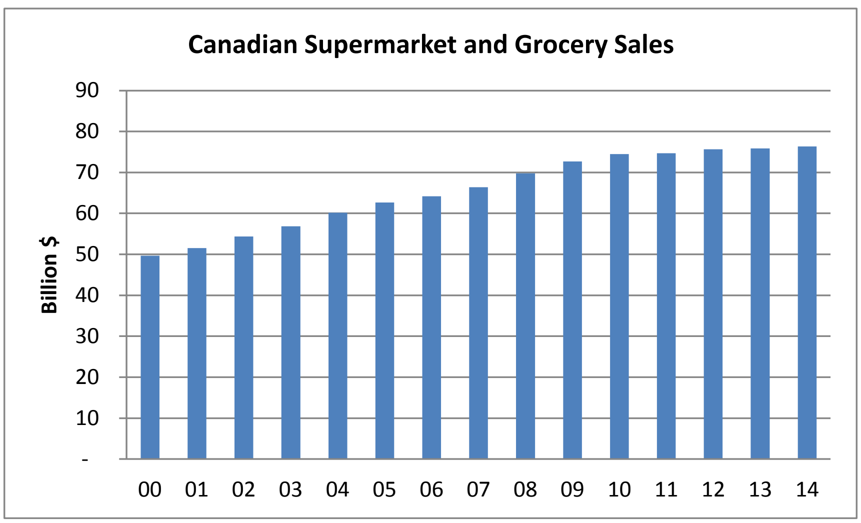
Over the past three years, Canadian capacity utilization in the food manufacturing sector amounted to 77%. That compares to over 80% during 2000-2010. The overall trend has been lower from 2009 to 2013. The increase in rates during 2014 was likely more due to plant closures as opposed to more effective utilization.

The underlying challenges faced by Canadian food manufacturers are best seen in the capacity utilization rates. Most of the big brands familiar to consumers are now sourced from US company plants. These brands are increasingly being featured on the front of flyers due to very intense grocery competition in Canada. Canadian producers typically make the second and third tier brands, or private label; all of which suffers as a result of big brand, front page feature tactics. These are Canadian manufacturer products, mostly private label, that have fallen sharply in recent years because of this dynamic. In the face of this activity which penalizes Canadian producers they are faced with falling production and thus declining capacity utilization.

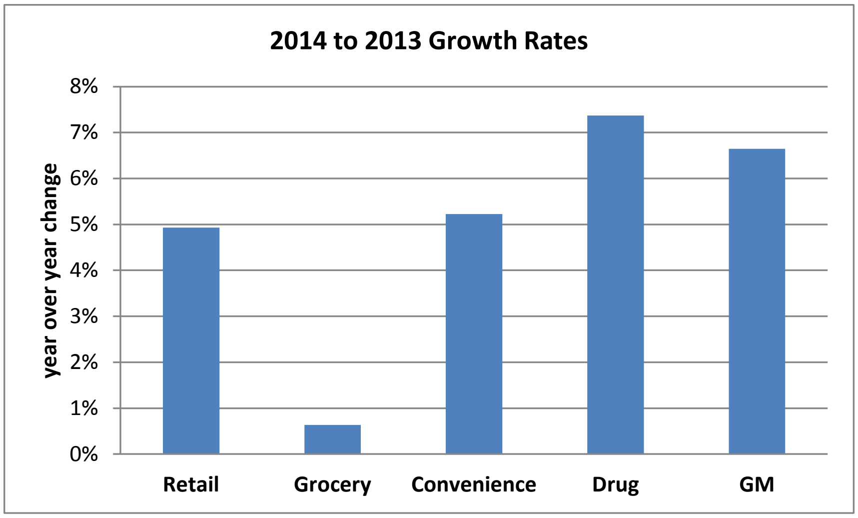
Canadian Grocery Review

Sales

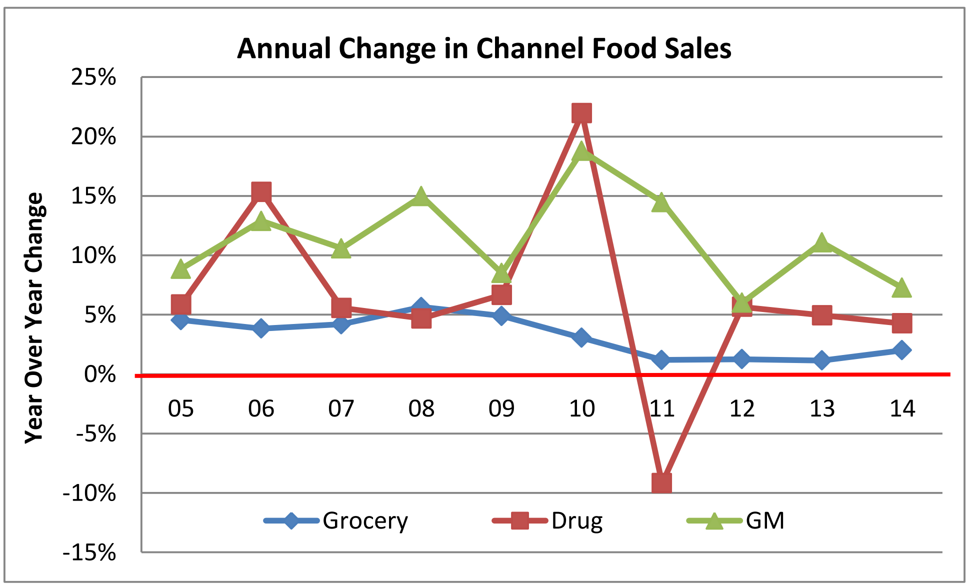
Canadian supermarket and grocery sales will hit about $76.3 billion in 2014 according to preliminary StatsCan data. That is a paltry 0.6% growth rate over the 2013 tally. The industry has grown by a grand total of just 2.5% from 2010 to 2014. That compares to a compound annual growth rate of 4% a year during the 2000-2010 period. Clearly the industry has been struggling to generate sales during the past four years.



For additional perspective, it is noted that while grocery grew by less than one percent in 2014, total retail grew by 5%. Convenience, Drug and General Merchandise grew by 5%, 7% and 7% respectively during 2014. As such, relative to history but also relative to other retailers, it can be seen that 2014 was not a strong year for Canadian grocers, at least from a sales perspective.

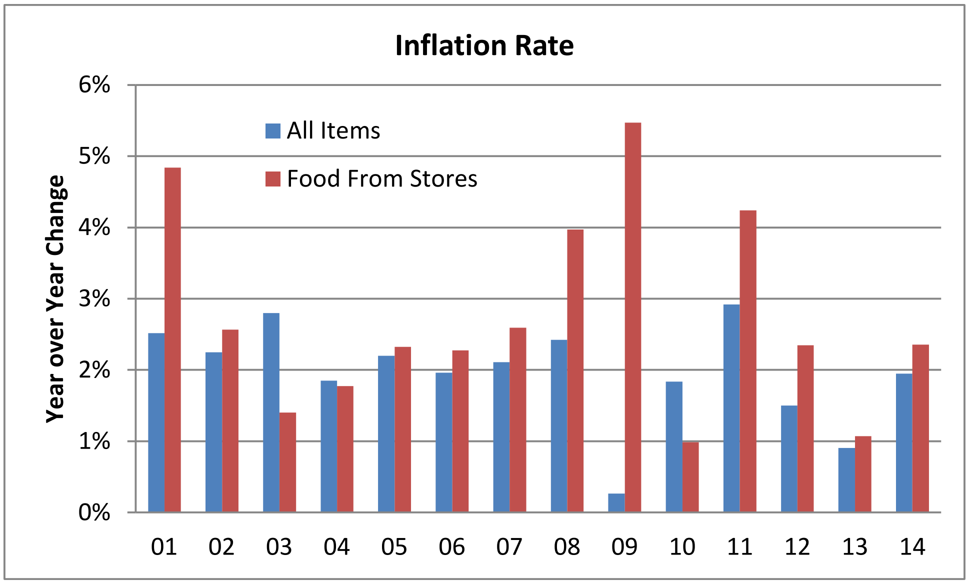


Not only are total sales suffering for grocers but the competing channels are increasingly taking away food sales from grocers. During the past ten years, as grocers food sales slowed general merchandisers such as Walmart and Costco regularly saw double digit gains in food sales.



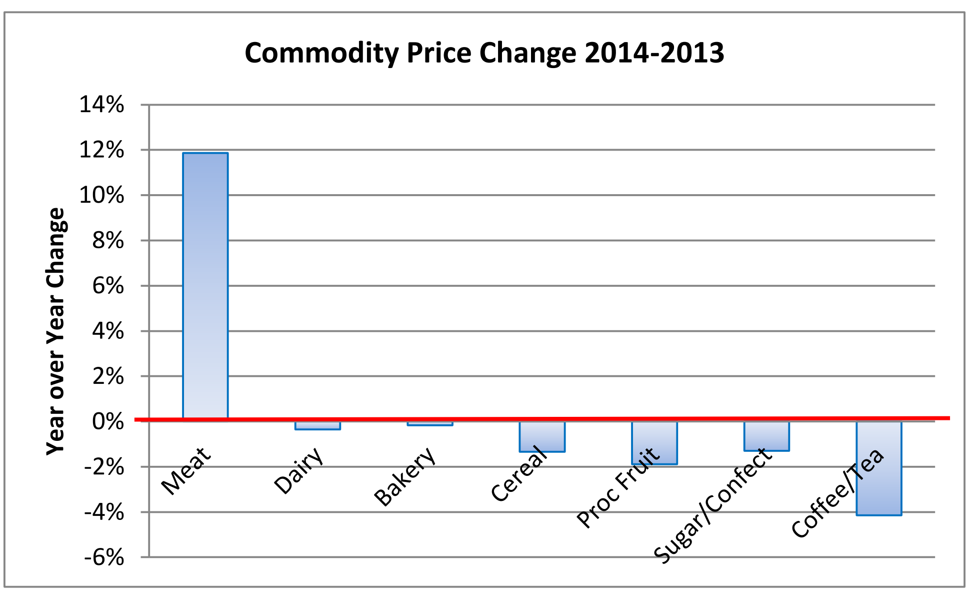
Prices

The prices of food purchased from stores increased by about 2% in 2014 which is right in line with the overall rate of inflation based on the Statistics Canada Consumer Price Index. Prices of food purchased from restaurants also increased by about 2% in 2014.



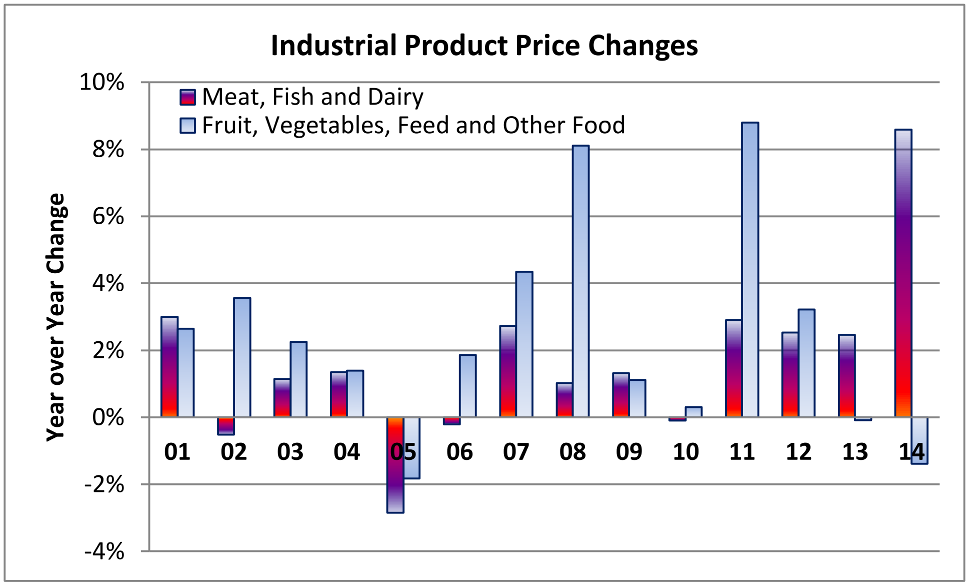
Looking at the overall numbers, however, seriously hides what is happening at the grocery store. The surging price of meat during 2014 has been well documented and discussed. As noted above, meat is a big part of the food industry. Furthermore there have been rather robust 5% increases in the prices of fresh fruit and vegetables. Those fresh meat and produce prices would also be impacted by the depreciating currency.

The reality of the grocery store is that grocery merchandisers have faced a massive challenge in gaining meaningful price increases in the interior of the store. While meat and produce on the store periphery were driven higher by cost increases, the key items in the grocery aisle were either stagnating or declining. In fact on average, the consumer packaged goods items were lower in 2014 by about 1%. That means that the entire dry grocery department saw pricing declines.

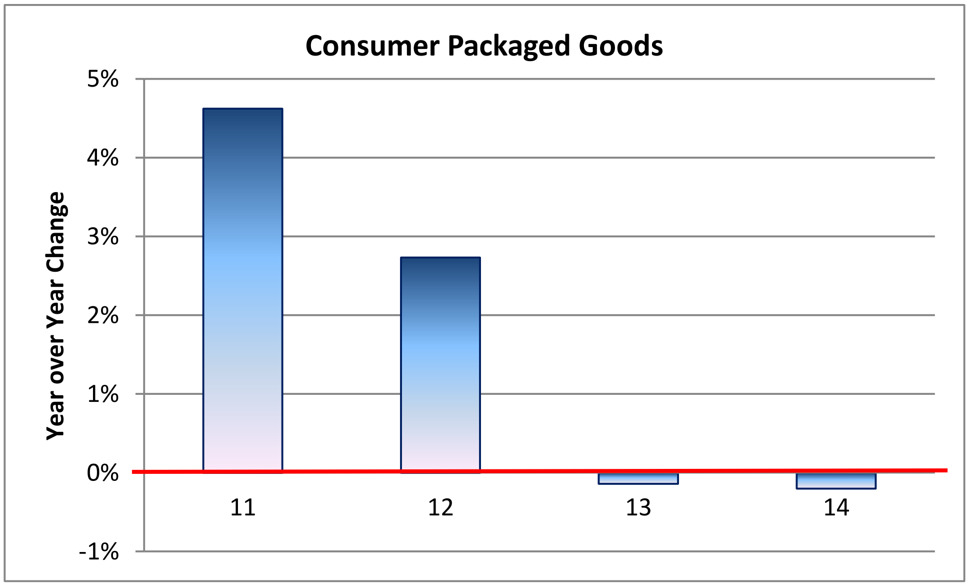


Costs

Costs for grocers can be measured by using the Statistics Canada Industrial Product Price Index. That is the index that measures the price changes at the manufacturer to retailer level or wholesale. As always, it is difficult to generalize about pricing direction because the breakdown between the animal-base versus crop or other product-base is stark. In 2014 the costs of meat, fish and dairy based products increased to grocers by about 9%. Crop and other food products actually declined by about 1%. The crop and other food product performance stands in sharp contrast to the performance of the past several years of strong pricing increases. The animal cost increases are running historically high.

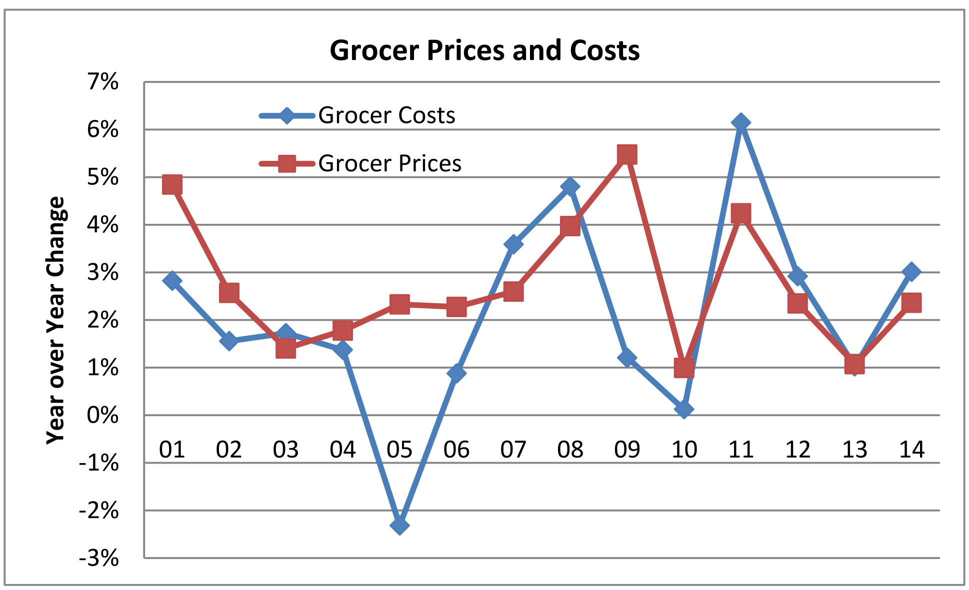


Within the Fruit, Vegetables, Feed and Other Food Products is the consumer packaged goods items of the grocery department. That is the cereals, breads, condiments, snacks etc. are all consumer packaged goods located in the middle of the store in the grocery aisles. Those products have not seen cost increases at the wholesale level for the past two years. In fact those consumer packaged goods sold by food manufacturers in Canada have declined in price in 2013 and 2014.

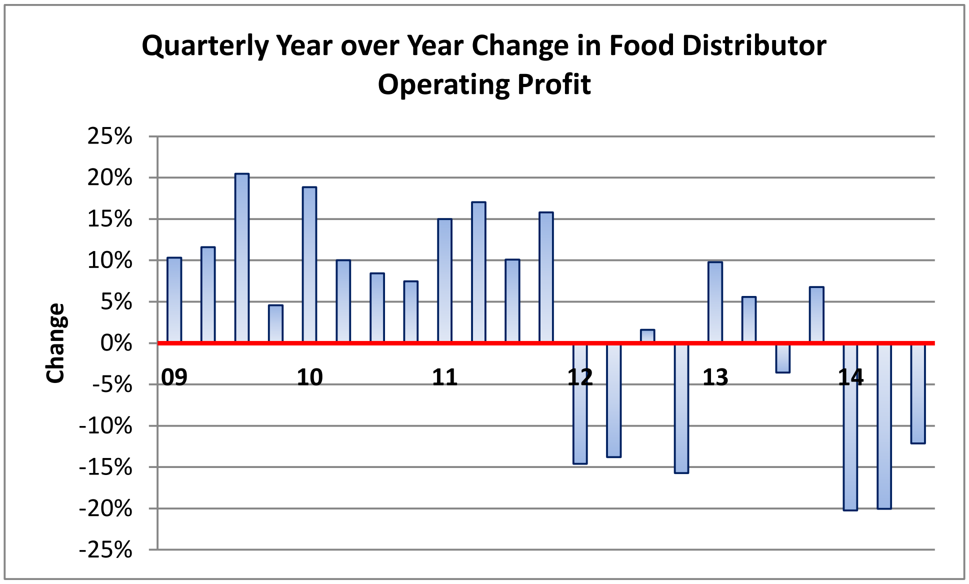


When the main commodity or product cost components are combined, the costs to grocers for all items except fresh fruits and vegetables likely increased by about 3% or more during 2014.

When the costs indexes are combined with the pricing indexes in 2014 it leads to the conclusion that grocers had a challenging year in 2014. Costs would have outpaced pricing gains throughout the year. In fact, over the past four years, grocer cost increases appear to have consistently outpaced pricing gains.



Further to that point, Statistics Canada publishes financial returns by industry and that data provides an indication of just how challenging 2014 has shaped up to be for grocers. During the first three quarters of 2014 for which data is available, operating profits for grocers declined sharply on a year over year basis.



2015 Outlook

- Grocers will get relief on pork and poultry costs as production increases in both those proteins but beef costs will continue to increase. Grocers will continue to play "catch-up" on meat pricing and will be pushing prices up throughout 2015.
- With the exchange rate at just over 0.84, Scotiabank is forecasting continued depreciation for the first six months of 2015 before stabilizing.
- The depreciated Canadian dollar will cause upward pressure on all raw materials but will have an immediate and direct impact on fresh meat and produce. Cost increases for grocers will take place immediately while follow-up pricing increases will lag. Margins will struggle for grocers due to the depreciated Canadian dollar.
- Lower gasoline prices will be beneficial to consumer spending on food.
- The robust growth in square-footage in the Canadian grocery industry is expected to slow according to CIBC's Institutional Equity Research team. This will at least partially ease back one of the dynamics that was stirring the competitive environment during the past two years in the Canadian grocery industry.
- The Canadian grocery industry will continue to be very competitive due to ongoing pressure from both Walmart and Costco. With that noted, the competitive heat is likely to ease back a notch or two compared to 2013 and 2014.
- Grocers should be able to ease prices modestly higher during 2015 compared to what they were able to achieve in 2014. Three percent inflation for food should be seen over the year.
- Food inflation will continue to be driven by fresh products as consumer packaged goods remain the competitive football in the middle of the store. Grocers will continue to use the middle of the store for competing.

- Canadian manufacturers of consumer packaged goods will face ongoing pricing problems due to the competition in the centre of the store.
- The federal government’s confusing and misguided claim to monitor U.S. versus Canadian retail pricing will place added burdens on Canadian consumer goods manufacturers.
- The question is whether excess Canadian food manufacturer capacity can be redirected to the US market to spread the risk, especially with a declining C$. Often those Canadian producers don't have the scale or resources to do so. There are only a few Canadian manufacturers who have faced that challenge and are winning.
- The weaker C$ will limit the growth in U.S. product incursions into the grocery store.

A version of this report first appeared in the January 2015 edition of Grocery Trade Review. If interested in a trial subscription to Grocery Trade Review, please contact kevin@kevingrier.com

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