Make Informed Decisions

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Canadian Food Manufacturer Exchange Rate Advantage?

Dollar Volatility Impacts Through the Food Chain

By Kevin Grier
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Key Points

- The depreciation of the Canadian dollar over the past ten months and in particular since the beginning of 2015 has important ramifications for the food industry and consumers.
- The depreciation provides margin, cost and price advantages for Canadian manufacturers versus U.S. manufacturers both at home and in the United States.
- Grocery retailers are caught in the middle with higher costing and the need to increase pricing to consumers.
- For consumers, its full impact is already on the shelf for fresh meats and produce, it will work through on packaged goods over the course of 2015. In other words, the depreciation impact on food prices is going to be in force through the year.

The big question is whether Canadian food manufacturers can and will take advantage of the situation competitively. This is a time for the hard fought battle to survive during the years of appreciation to bear fruit in terms of margin and market share gains.

Introduction

The trends and movement of the Canadian dollar (CAD) are always in focus for both consumers and businesses, but in recent months the focus has intensified due to its volatility. Scotiabank's May 2015, Foreign Exchange Outlook observes that the Canadian dollar is in the midst of massive swings, large intraday moves and rising volatility. The shifts in CAD are complicated and extreme. Between July 2014 and March 18th CAD depreciated 21% against the US dollar (USD), from mid-March until the end of April it had rallied back by a third, almost 7%.

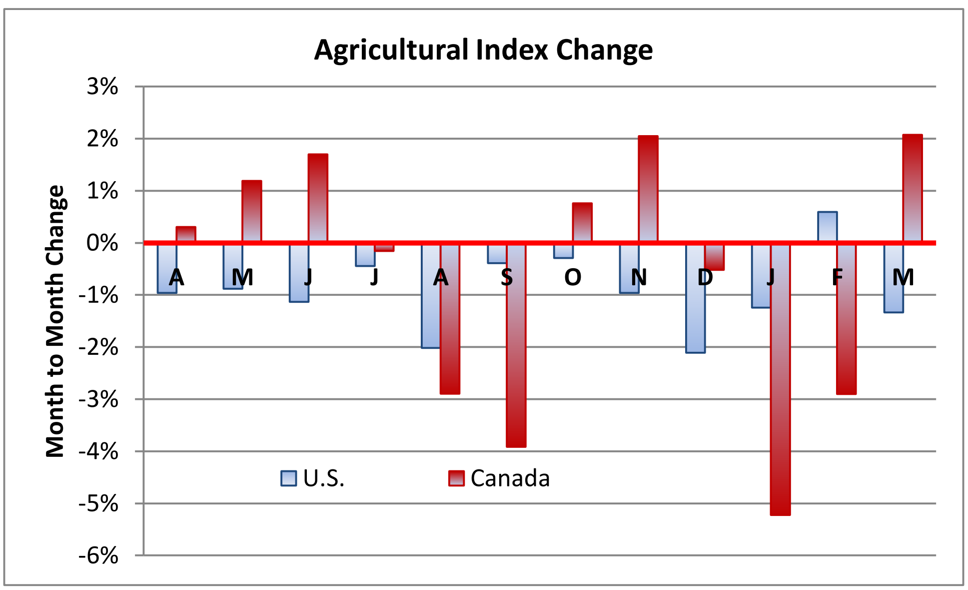
Within that context, the depreciation of the Canadian dollar over the past ten months and in particular since the beginning of 2015 has important ramifications for the food industry. Generally the depreciation makes Canadian food prices increase for consumers, but it also provides advantages for Canadian manufacturers both at home and in the United States. For their part, retailers are in the middle with higher costing and the need to increase pricing to consumers.

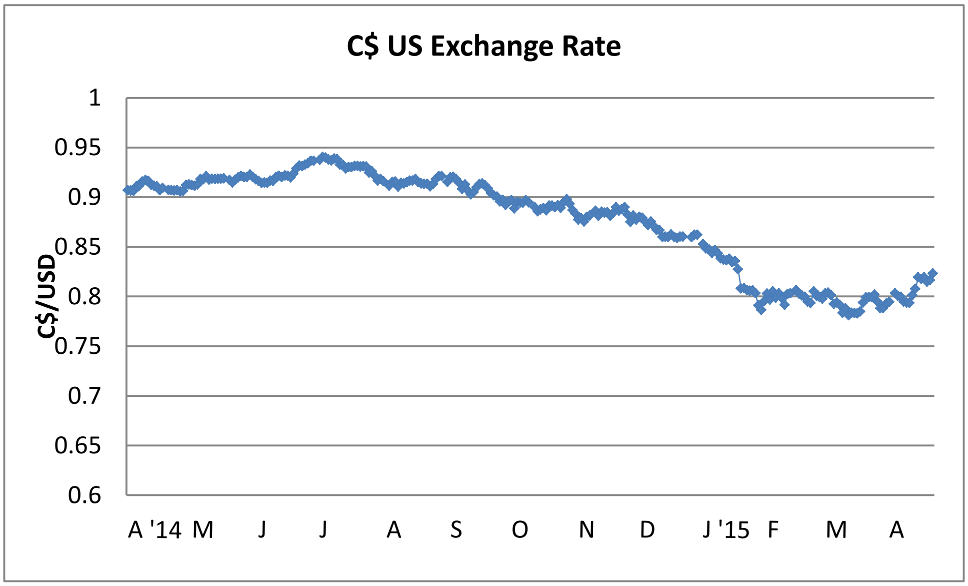
This report examines how the exchange rate impacts costs and prices through the food chain. It also explains the winners and the losers in the exchange rate driven cost-price volatility.

Contributes to Volatility

Canadian grocers and manufacturers face a volatile commodity cost environment. The volatility is magnified by fluctuations in the value of the Canadian dollar. For example, over the past year on a month to month basis, the U.S. "Commodity Agricultural Raw Materials Index Monthly Price" as reported by Index Mundi had a standard deviation of 1%. The Bank of Canada Agriculture Index had a standard deviation of 2%. While the indexes do not allow an "apples to apples comparison", given open borders for most commodities, agricultural commodities should change the same magnitude in both countries. The greater volatility in Canada is at least partially due to the relative fluctuation in the Canadian dollar relative to the USD.

Further to that point, during the past 12 months, the Canadian dollar hit a US low of $0.7991 on March 18 this year and a high of $0.9416 on July 3 last year with the average at about $0.874. As such, while the exchange rate did appreciate notably during April, as of the end of the month, it was not close to its 12 month average.





Fresh vs Manufactured Impact

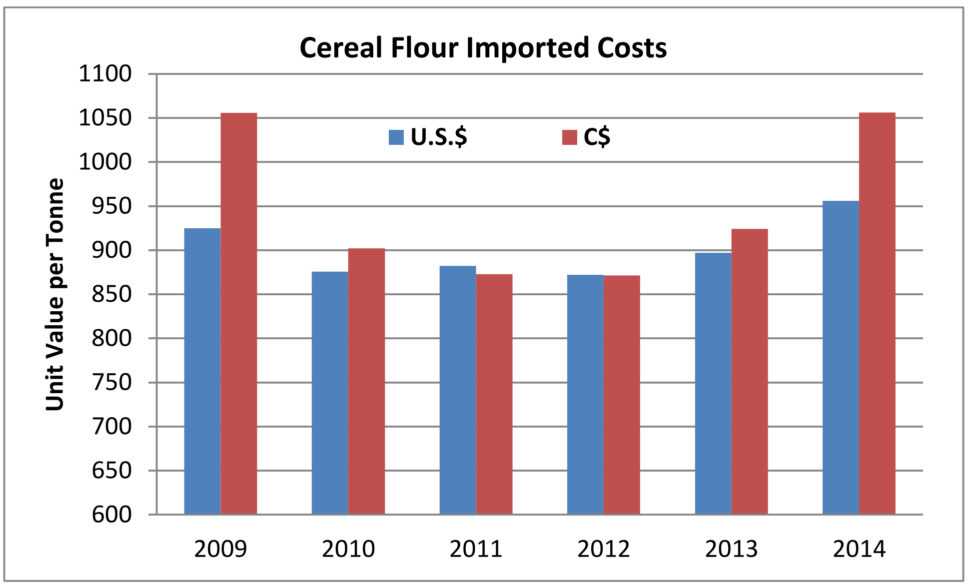
The impact of the changing dollar on fresh meat, fruits and vegetables is immediate for grocery procurement departments. That is because most of those commodities are procured on either a spot negotiated basis or on some formula tied to U.S. prices. That is, appreciation or depreciation is reflected in grocer's costing at the time of procurement, which in the case of meat and produce is often weekly. As such, the depreciated dollar of recent months immediately becomes a higher cost for grocery distributor fresh buyers.

For consumer packaged goods (CPG) or manufactured food products, the impact of the exchange rate on grocery distributors is indirect or less immediate than for fresh products. Another point of note is that the grocery buyer of consumer packaged goods deals with both domestic manufacturers as well as affiliates of U.S.-based firms. The Canadian affiliate is an importer of finished product from a U.S. factory, while the domestic manufacturer produces products from raw materials in Canada. It is important to note that the impact of an appreciation or depreciation is felt differently depending on whether the Canadian CPG supplier is a domestic manufacturer or Canadian affiliate firm.

The domestic manufacturer or the Canadian affiliate branch office of a U.S. based manufacturer is impacted through the cost of inputs or the cost of imported final products respectively. The grocer is impacted when the changes in the Canadian dollar becomes part of the trade negotiations. In the case of depreciation this is either a push for higher prices or reductions in promotional support or both. With regard to manufactured products, some perspective is in order. As CIBC Institutional Equity Research has noted in numerous reports, 80% of produce, the majority of private-label ingredients, and about 60% of finished CPG products are produced/manufactured outside of Canada. So clearly the dollar is crucial to both domestic or affiliates.

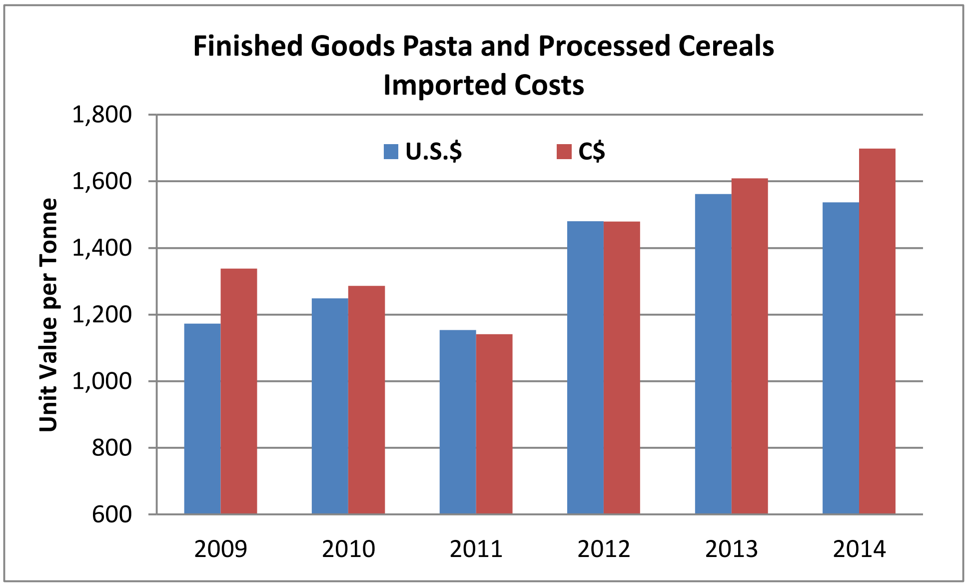
Domestically manufactured product is first impacted through input costs, which in turn impact margins. Depending on the manufacturing and sales cycle, the exchange related increases in cost of goods could pressure prices or margins immediately. A depreciated dollar resulting in higher costs is going to be front and centre in the manufacturer-grocer pricing and trading negotiations. Further to that, private label transactions have become much more transparent, with producers required to reveal their input costs. Again the dollar is key.

As one example of the exchange impact on input costs, consider cereal flour, a basic processed food ingredient. North American trade values per tonne are reported by the USDA's Foreign Agricultural Service. In 2011 and 2012, with a comparatively robust CAD, cereal flour was less expensive in Canadian dollars. The gradual depreciation of 2013 and then the more rapid depreciation of 2014 forced ingredient costs to be higher in Canada. This costing impact would be the case regardless of whether the source of the ingredients was the United States, Canada or anywhere else in the world.



Imports Impacted Immediately

While it takes time for ingredient costs to filter through the chain, the imported cost of finished goods from the United States by affiliates would reflect the changed value of the exchange rate immediately upon purchase or transfer. The transaction from the U.S. base to the Canadian affiliate immediately requires more C$'s. For example, products such as pasta and processed cereals, which use the flour noted above, would have seen the trading price of the finished goods move from very little difference between Canada and the United States in 2011 and 2012 to a major costing increase in late 2014. Importers of finished pasta and cereals, as well as all other processed products for that matter, would have seen C$ costs increase dramatically and immediately in 2014. The differential due to the exchange rate would have exceeded C$150/tonne last year versus no difference in 2012.



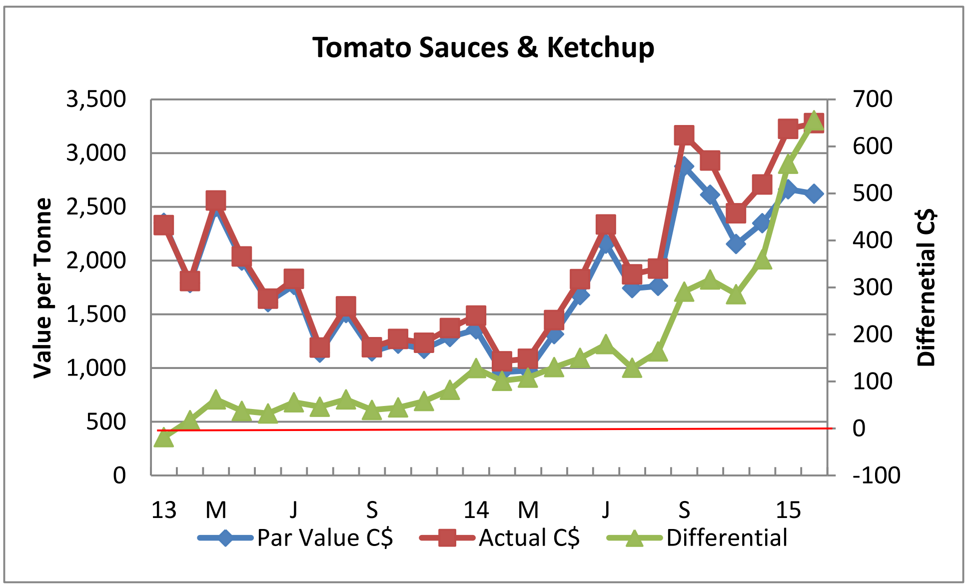
That increase in imported finished goods costs or prices would have provided a pricing umbrella for Canadian based manufacturers. In other words, regardless of whether the increased costs of the C$ depreciation could be passed along by the affiliate, the fact is that Canadian based manufacturers would gain a windfall advantage on price. That is because while the Canadian based manufacturer's cost of raw materials went up due to the dollar depreciation, the cost of the finished CPG based on the same exchange rate movement would significantly outpace the ingredient cost increase. The potential net margin results, at least on paper are positive for domestic manufacturers with a depreciated currency.

That means that some of the Canadian-based manufacturer competitive advantages of the exchange rate exist with or without passing the exchange rate cost or price impacts to Canadian grocers. The Canadian based manufacturer begins the grocery negotiation process with a margin advantage over an U.S. based affiliate supplier. That is because Canadian raw material cost pressure is less than the affiliate purchase price pressure as described above. Nevertheless the C$ depreciation must eventually be passed along by both domestic and U.S. based manufacturers in order to protect margins. As for passing along these costs, that means a battle with Canadian retailers. The leverage is still retailer advantaged. Typically a wide industry move is necessary to force retailers to capitulate.

This can often mean that U.S. based producers become less interested in the Canadian market as this market brings back fewer U.S. dollars. This will also make them less likely to play ball with Canadian retailers' demands. Canadian manufacturers can thus gain market share in Canada while their U.S. competitors are less interested north of the border.

Export Benefits

Of course, a depreciated C$ also provides margin and costing improvements for exports to the United States. Product pricing that might not have been profitable at a par dollar can become profitable at a C$0.80 dollar. For example Canadian exports of tomato sauces and ketchup to the United States generally traded a C$ value that was very similar to the USD value for most of 2013 and the first half of 2014. By the second half of 2014, however, the C$ return per tonne was C$200-400/tonne more than the return would have been at par. By the first two months of 2015 the depreciated C$ brought back over C$600/ tonne more than would have been the case at par.



In addition to those variables, the depreciated dollar gives Canadian manufacturers a costing advantage in the United States. At a par dollar, Canada's food industry average wage rate of about C$19/hour in 2014 would be USD $19/hour. At an 0.80 CAD, the USD equivalent wage becomes USD$15. The same sort of conversion would occur at all costs from energy to packaging as well as labor.

Further to that big exchange driven movement on exports to the United States, experience has shown that U.S. retailers are completely indifferent to USD/CAD exchange. In other words they are not going to seek lower prices from Canadian supplies simply because the transaction is now more lucrative for Canadian suppliers. That means that Canadian manufacturers should take advantage of the situation while the opportunity presents itself.

Why it Matters

The depreciated dollar provides a pricing umbrella in the domestic market and more profitable alternatives in the United States. Of course the argument has its limits. If a 0.85 cent dollar is good, isn't a 0.65 cent dollar even better? The answer is no. The cheaper dollar not only increases the Canadian cost of living, but it also reduces incentives to invest as it increases the cost of capital. The depreciation of the early 2000's led the Canadian industry to be uncompetitive in terms of plant efficiency and scale. When the dollar appreciated the Canadian industry downsized, particularly the food industry, because it was not competitive at a par dollar. Smart manufacturers used the time of appreciated dollars to invest in plant, equipment and scale. Their belief is that if you can't compete at a par dollar, then you can't compete. To them, the current depreciation is a bonus to be used to re-invest.

Based on Scotiabank and other forecasters, the Canadian dollar is going to stay at current levels for at least 2016. That should provide Canadian food manufacturers competitive opportunities and improved margins. It should also provide a window in which to continue to invest in plant and equipment in order to prepare for an appreciation.

For consumers, the impact of the depreciated dollar is still working its way through the supply chain. While its full impact is already on the shelf for fresh meats and produce, it will work through on packaged goods over the course of 2015. In other words the deprecation impact on food prices is going to be in force through the year.

A version of this report first appeared in the Kevin Grier Market Analysis and Consulting publication, Grocery Trade Review, April 2015. For a free trial subscription to this publication please email kevin@kevingrier.com or visit www.kevingrier.com