GEORGE MORRIS CENTRE

Food and Beverage Sales and Pricing Challenges

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The Canadian grocery sector is exceptionally competitive. In fact, grocery chains continue to lose share to alternative retail channels, to the tune of almost $900 million over the past two years. At the same time, rising commodity prices are impacting grocers' costs. The challenge for grocers trying to compete is that they won't be able to offset all of their rising costs in the form of higher food prices for consumers.

This report reviews data on food and beverage sales, identifies drivers of cost increases and concerns about retail price increases, and outlines future challenges in the grocery sector.

Retail Sales Channel Developments

Statistics Canada recently released their Quarterly Retail Commodity Survey for the fourth quarter 2007, in which they assert that retailers had a strong 2007 with sales increases in all major commodity groupings. Canadians spent $413.4 billion on goods and services in retail stores last year, up 5.8% from 2006.

Statistics Canada says more than half of spending in retail stores focused on transportation, food and beverages. Proportionately, of every $100 spent in retail stores in 2007, consumers spent about $21 on food and beverages, $21 on motor vehicles, parts and services, $10 on automotive fuels, oils and additives, $9 on furniture, home furnishings and electronics, $9 on health and personal care, $8 on clothing, footwear and accessories, $7 on hardware, lawn and garden products, $3 on sporting and leisure goods and $2 on non-electric housewares. The remainder, about $9, was spent on all other goods and services, such as tobacco and pet food.

Total food and beverage sales increased by 5% in 2007 compared to 2006. Food and beverage sales sold by food and beverage stores (grocery and specialty) increased by 4% last year while food sold through drug stores and general merchandise stores increased by 7% and 10.5% respectively. Sales through food and beverage stores represent continuation of a longer term trend of lost share for these channels. The bulk of the lost share is going through general merchandisers like Wal-Mart and Zellers. Figure 1shows the share of food and beverages sold through food and beverage stores compared to the share sold through general merchandise stores.

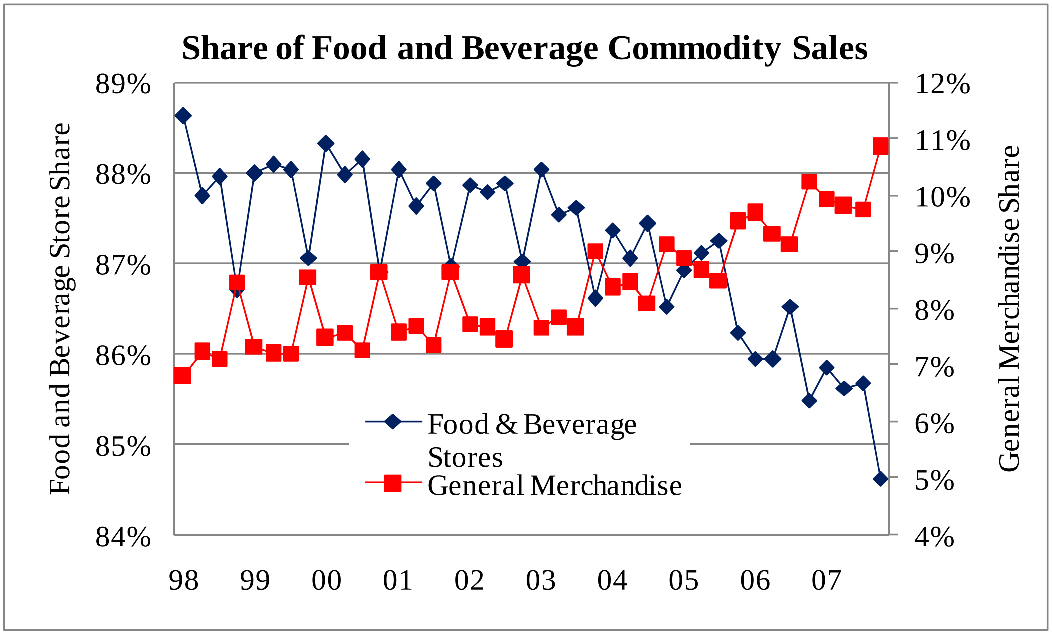

Figure 1 **Source: Statistics Canada**

Grocery store share has declined from nearly 89% in 1998 to less than 85% as of the last quarter of 2007. Meanwhile, general merchandise share is now near 11% compared to less than 7% in 1998. Drug store share does not change much at around 1-2%.

What is of particular interest is the rate of decline in grocery share over the past two years, with the average quarterly rate of decline amounting to nearly a quarter of a percent. In the previous two years, 2004 and 2005, the rate of decline was only 0.05% per quarter. Between 2006 and 2007, grocery stores lost 1% share of the food and beverage sales. That one percentage of lost sales amounts to nearly $900 million.

Assuming that Statistics Canada keeps Wal-Mart's Supercentres in the General Merchandise category, there is no doubt that the erosion in grocery share is going to continue for the next several years. Conversely, the protection of share against Wal-Mart is going to be the focus of grocer attention for the next several years.

Pricing Tensions

The April 10 Wall Street Journal contained an article that is reflective of much of the media coverage of global food pricing. The Journal reported the following:

> After several years of relative stability, a wave of rising prices is washing over the world economy… Rising prices for food, energy and other raw materials account for much of the pickup in inflation rates. High food and energy costs hit developing countries -- where consumers spend a larger share of income on those necessities -- particularly hard. In recent weeks, protests over rising costs have shaken countries from Vietnam, where prices are up 19.4% from last year, to Egypt…. the World Bank estimated global food prices have risen 83% over the past three years, threatening recent strides in poverty reduction.
> But the fact that inflation is rising almost everywhere suggests some of its causes are global. As crops are sold for alternative-energy production, food prices have soared:

The price of rice, the staple for billions of Asians, is up 147% over the past year. Increasing demand for natural resources among developing economies such as India and China has pushed up prices for raw materials world-wide.

In Canada, the price of food purchased from stores has been steadily increasing since it bottomed for 2007 in October. According to the Statistics Canada Consumer Price Index, the price of food purchased from stores has increased about 2.6% since October. Within that context, however, the food from stores index is actually lower in February this year than it was in May of last year. Figure 2 shows the performance of the Statistics Canada consumer price index for Food From Stores, Restaurants and for All Items except food.

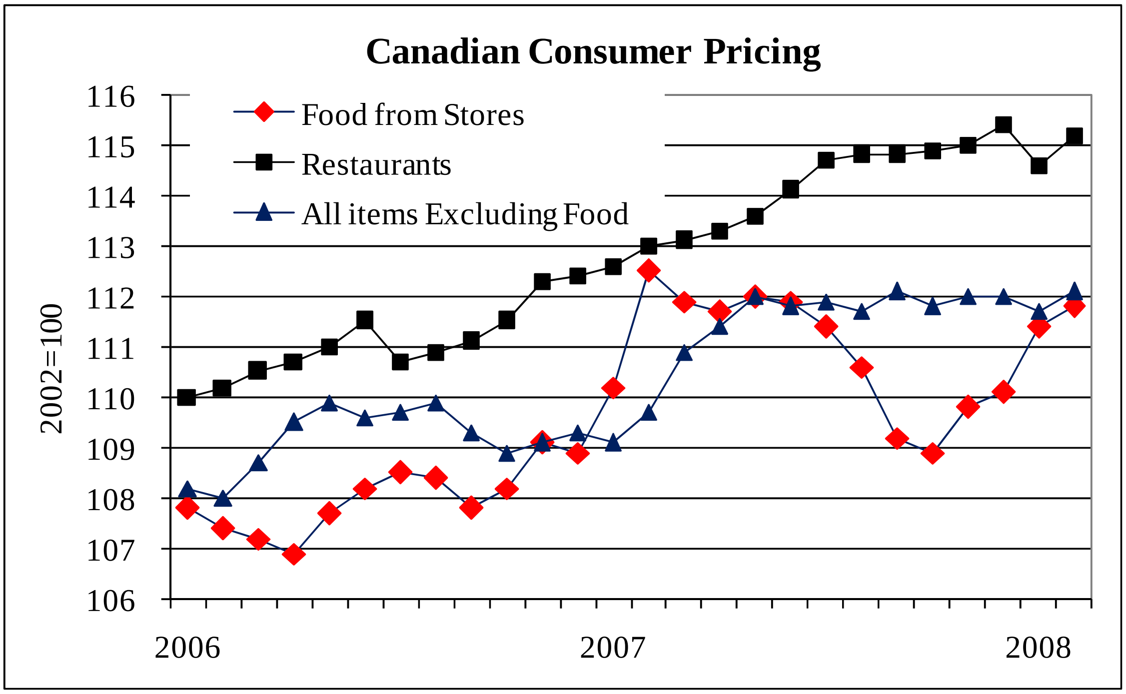

Figure 2 **Source: Statistics Canada**

For further context, it appears that the main drivers of upward momentum in food pricing are bakery products, dairy and vegetables. Specifically, from October through February, bread prices are up 9%, pasta is up 16% and fresh vegetables are also up 16%.

Looking specifically at the consumer price index in Canada, it is not clear that there is a food pricing problem. Fresh fruit and vegetable pricing is often characterized by volatility. In addition, dairy pricing, being protected by the supply management system is also characterized by a slow, steady increase.

As is often noted, the real driver of food pricing increases, or at least the concern about food pricing increases, has been increased grain costs. US ethanol subsidies have driven up the price of grain corn which, in turn, has driven up the price of other feed and food grains such as soybeans and wheat. While the efficacy and merit of subsidized ethanol is almost non-existent, there is no doubt about its buoyant impact on grain pricing.

In that regard, there are two main areas of consumer food pricing impact: wheat and grain-based products and meat. With regard to meat, the production process tends to delay the final product pricing impact. That is, eventually high grain costs are going to force meat pricing higher but that could take a year before it is felt in the meat case. In the case of wheat and grain based products, the process can take just as long due to manufacturing, inventory and other logistical factors.

With that noted, however, there are indications that grain costs are making their way through the food chain. The Statistics Canada *Industry* Price Indexes for flour and oil based products are up by 10% and 14% respectively in February compared to October 2007. Despite those big increases, food manufacturing prices are up by about 3% compared to their 2007 low in October of 2007, which is not much different than the increase in the consumer price index increase since last October.

Figure 3 shows the performance of the Statistics Canada Industry Price Indexes for food and for all manufacturing items. As can be seen, the industry index has been increasing since October as in a similar pattern to the consumer price index. Despite that similarity, there is one important point of difference between the Industry price index and the Consumer Price Index: February consumer pricing is not at its one year peak. The industry price index for February this year is at its one year peak. In fact, the February industry price index is at an all time high.

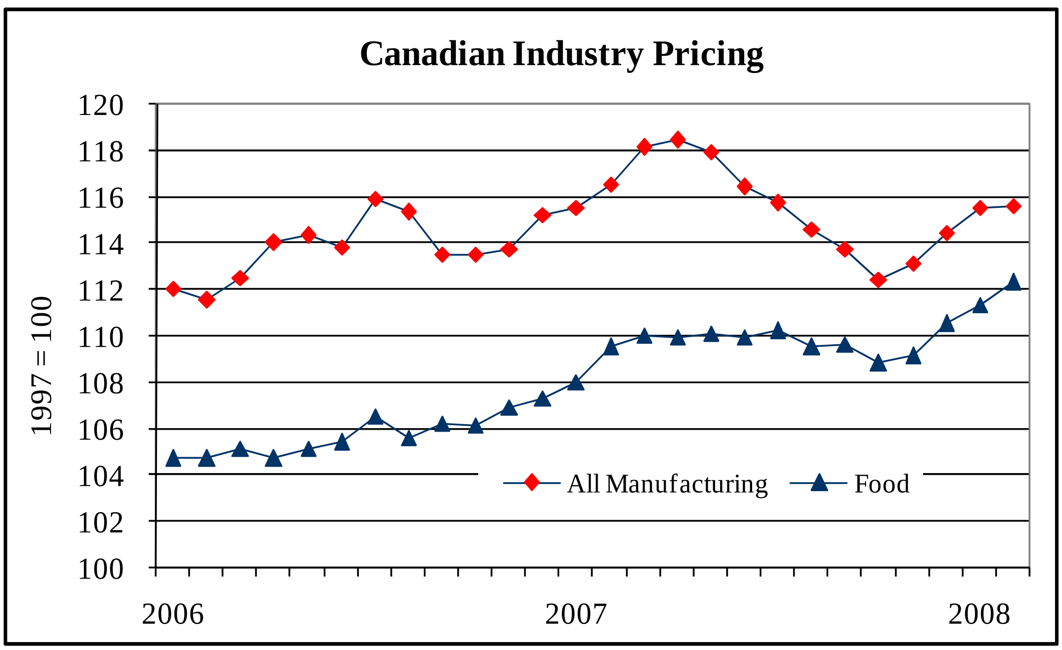

Figure 3 **Source: Statistics Canada**

Comparisons to the United States are generally useful in making relative performance measurements. Figure 4 shows the performance of the Canadian Consumer Price Index for food purchased from grocery stores and the US Bureau of Labor Statistics Consumer Price Index for food consumed at home. Both indexes generally attempt to measure representative consumer baskets of food. Both indexes, in turn, are re-indexed by me so that January 2007 is equal to 100. Over the course of the past 14 months through February, US food prices have increased by 6%. Canadian food prices have increased less than 2%.

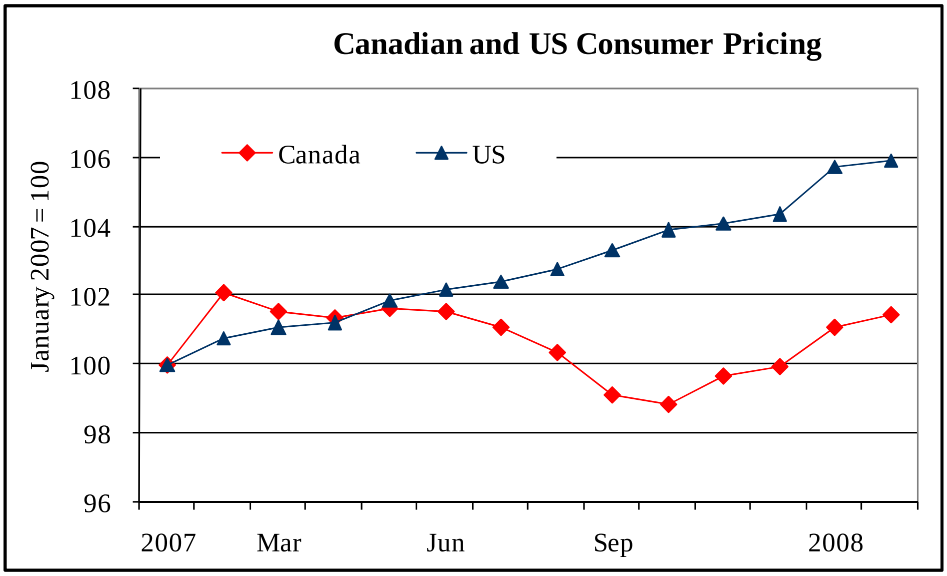

Figure 4 **Source: US Bureau of Labor Statistics and Statistics Canada**

Given the firm upward movement of the Industry Price Index, which is a good gauge of consumer pricing near term, and given the performance of US consumer pricing, it is reasonable to expect that Canadian consumer pricing will be on the rise. For its part, Scotia Capital has stated that "as global commodity prices surge, we anticipate that the Canadian grocers will be impacted by the food cost increases. To date, the rise in the Canadian dollar has sheltered much of the cost inflation in the past year, as evidenced by the deflation in produce prices. However, as we approach the anniversary of US dollar parity in the fall, this benefit will begin to erode."

The wild card in this, however, remains the exceptional competitive environment in the Canadian grocery sector. As Loblaw continues to try and regain its dominance and as Sobey and Metro/A&P seek to maintain or garner market share inroads, pricing is going to be the key competitive tactic. Further to that point, Scotia Capital asserted that "with Loblaw committed to aggressively lowering prices in conventional stores, we do not expect all cost increases will translate into retail price inflation. As such, we do not believe Metro (or any grocer) will be able to fully pass on higher costs to consumers and we believe food inflation will be negative for the grocers." (*Scotia Capital Daily Edge Equity Research report, April 16, Ryan Balgopal)*

Furthermore, as the entire grocery sector fights to maintain share against non-grocery food retailers, price again will be the weapon of choice. Finally and closely related to the latter point, the Wal-Mart effect will dominate Canadian grocery for at least another year. The Wal-Mart Supercentres are having a pricing impact in Canada far beyond what their very modest store numbers would indicate.

A version of this report originally appeared in the George Morris Centre publication, Grocery Trade Review. If you are interested in a free two month subscription to Grocery Trade Review, e-mail Kevin Grier at kevin@georgemorris.org