Make Informed Decisions
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The Two Big Food Price Factors Point Lower

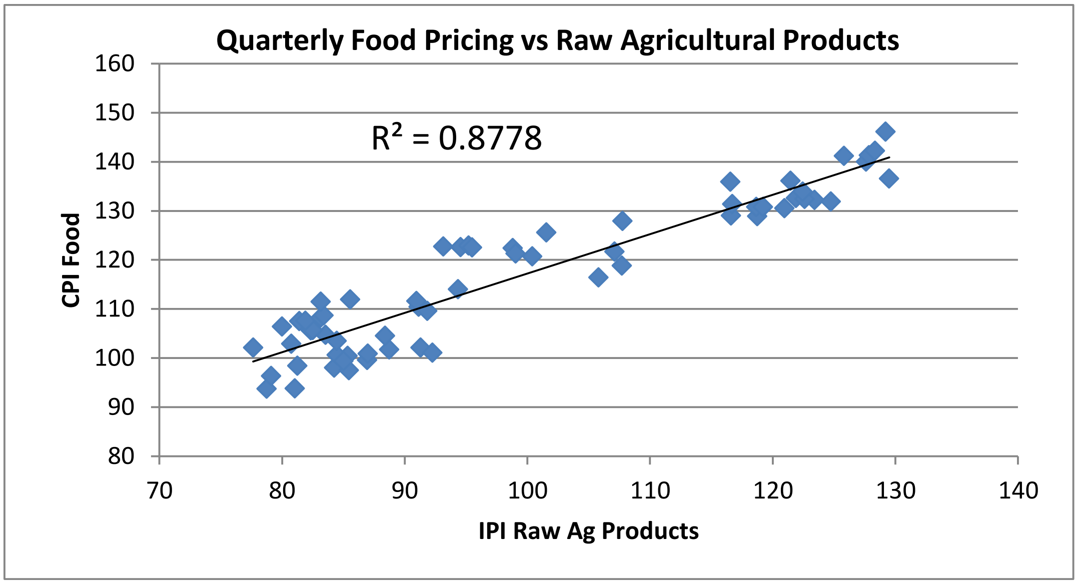
Introduction

There are few topics which generate more interest throughout the food chain from farm to consumer than the price of food. Everyone through the chain carefully watches food and commodity prices from farm to processor to grocer to consumer. This report argues that there are two main factors that drive food inflation in Canada: commodity prices and grocer competition. Both factors are not pointing to robust price increases in Canada. In fact both could be indicating very modest price increases for the rest of the year. The reasons are that commodity prices, while not at historic lows are relatively low and certainly under control. With regard to grocer competition, there are strong reasons to say that the competitive rivalry is heating up after cooling off in 2015. More intense competition usually means lower prices.

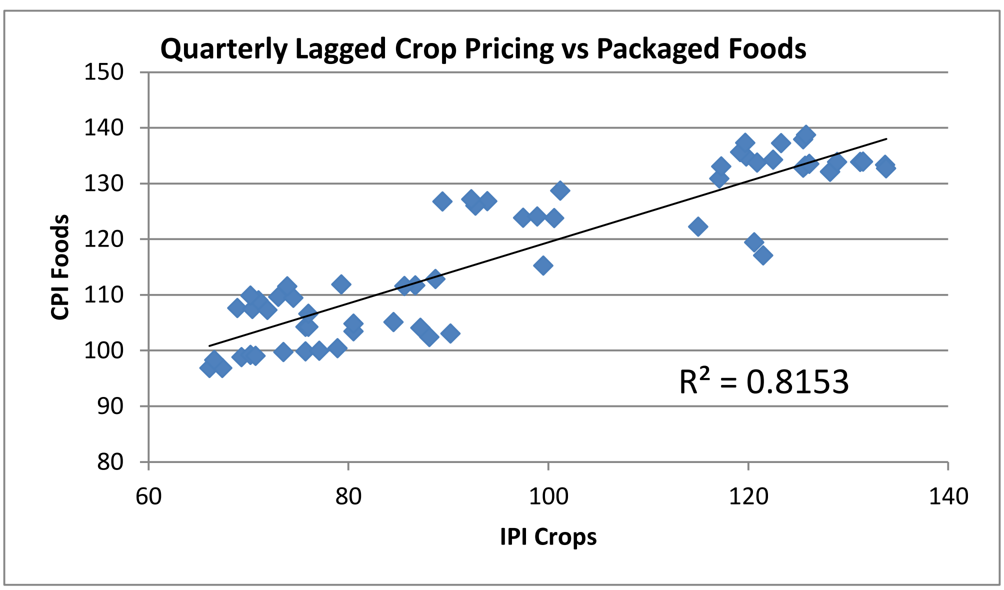
Commodities and Grocery Prices

There is a very strong relationship between food prices at retail and the costs of raw agricultural products. Raw material prices in turn are directly impacted by changes in the exchange rate. A depreciated currency generates upward pressure on commodity prices and vice versa for appreciation of the currency. One way to assess the agricultural commodity versus food price relationship is to match the StatsCan quarterly raw materials agricultural price indexes against quarterly Consumer Price Index (CPI) food prices. The CPI for food should be lagged by two quarters from the agriculture indexes to allow time for flow through the chain.

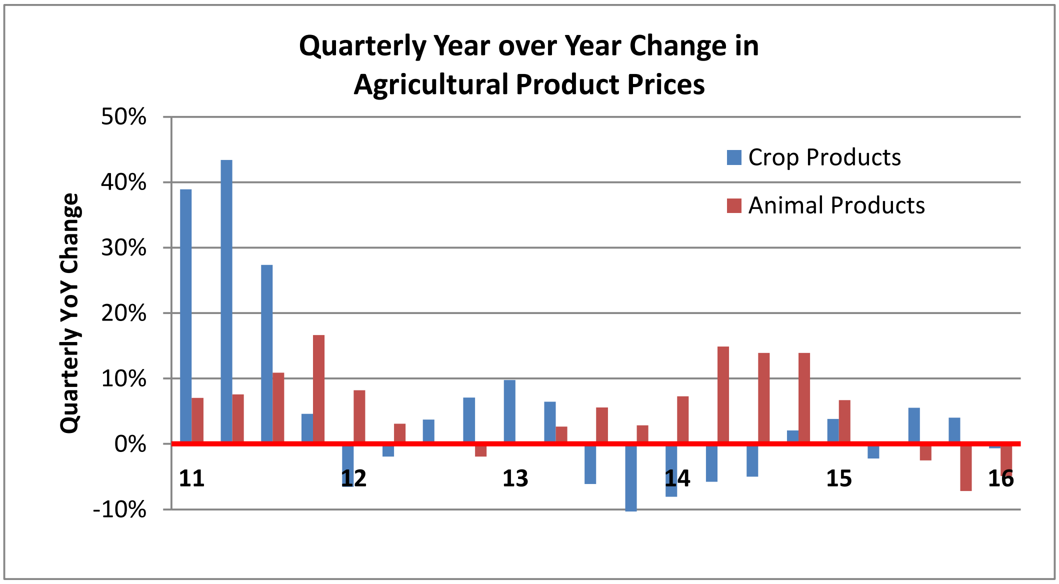
When that relationship is tested, it can be seen that from 2000 through 2016 there is an R-squared or coefficient of determination of 88% when quarterly average raw agricultural commodities (crop and animal combined) are regressed against quarterly food purchased from stores prices.



There is a certain common sense regarding the connection between raw agricultural pricing and fresh meat and vegetables. There is a direct link between the raw agriculture and fresh product sold at stores and the timing between harvest and sale is very close. There is less direct linkage however between crop prices and the packaged goods. The degree of manufacturing between raw and final product is much greater. Even acknowledging that less direct relationship, there is still a strong correlation between crop-based agricultural commodities and packaged food prices lagged by two quarters.



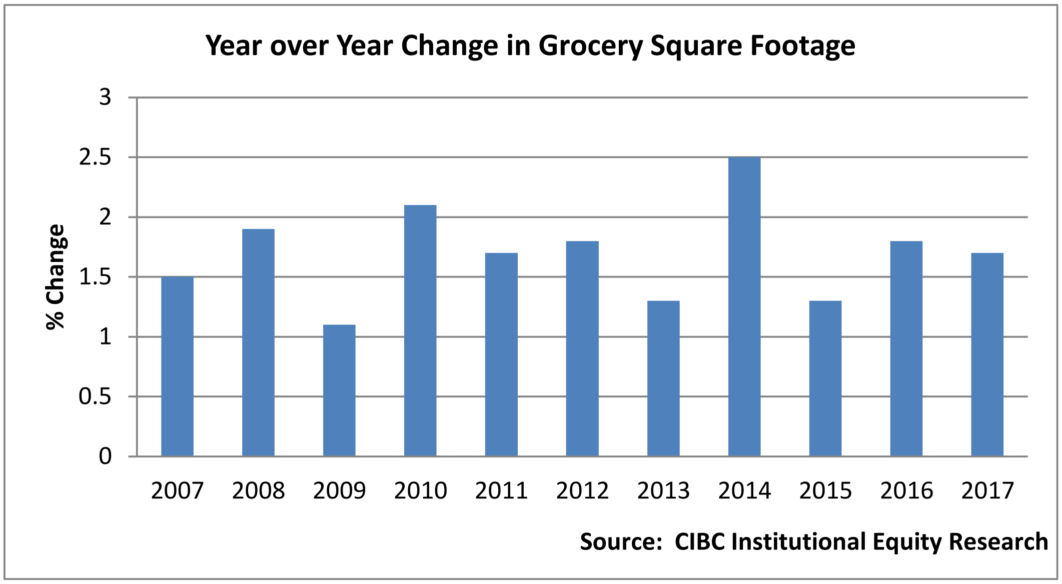
The main point of course is that the direction of raw materials prices provides a good indication of the direction of food prices. Further to that, as can be seen on the graph below, relative to recent history commodity prices remain very low. In fact over the last four quarters, crop based prices in Canada have increased by an average of 2% and decreased by 1% in Q1 2016. Animal product raw prices have declined 4% on average in the last four quarters and by 5% in Q1 2016.



The implication of course is that there should be downward pressure on meat prices in the second half of 2016. In addition there is greater potential for declining or at least steady packaged food prices in the second half of 2016. This all depends of course on growing conditions in North America and around the world as well as the performance of the Canadian dollar. With that acknowledged there is nothing about current commodity pricing that argues for higher food prices.

Competition and Price

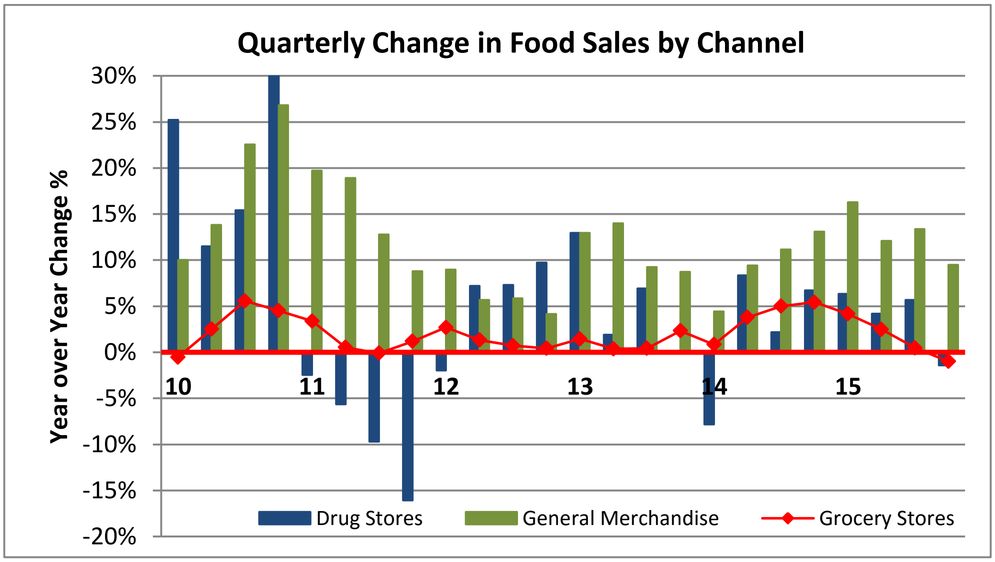
The other major driver in food inflation is retail competition. There should be a strong negative correlation between the intensity of competition and food store price inflation. The less intense the competition, the greater the ability to raise prices and the greater the inflation. Of course the question is how to determine whether there is competition. One measure that the analysts at CIBC Institutional Equity Research look to is the change in square footage. The greater the growth in retail floor space (store growth), particularly if it is growing faster than the population, the greater the competition. The graph below shows CIBC's square footage growth estimates from 2007 through the forecast for next year. The average growth for the ten years prior to 2017 was 1.7%. The growth rates for 2016 and 2017 are at 1.8% and 1.7% respectively. These 2016 and 2017 rates do not send clear messages either for or against a change in competitive rivalry.



The 2014 year saw well above average square footage growth as the industry, particularly Walmart sought to make the atmosphere as difficult for Target as possible. By early 2015 as Target announced it was leaving Canada, there were store closures reported by both Loblaw and Sobey, in addition to the lost Target space.

Another gauge of competition though is changes in market share. If market shares are stable it suggests a level of equilibrium. If shares are changing it indicates a more dynamic and possibly more intensely competitive market. The broad-based market shares between grocery and the general merchandisers (GM) indicate a high level of competition. Statistics Canada has not yet released any 2016 data but for the year 2015 supermarket sales of food amounted to $69.5 billion compared to $18.25 billion for the general merchandisers. While grocery is nearly 4 times the size of GM when it comes to food sales, just four years earlier in 2011, the grocery channel's food sales were over 5 times greater than GM. In 2004, grocery sales of food were more than 9 times greater than the GM food sales.

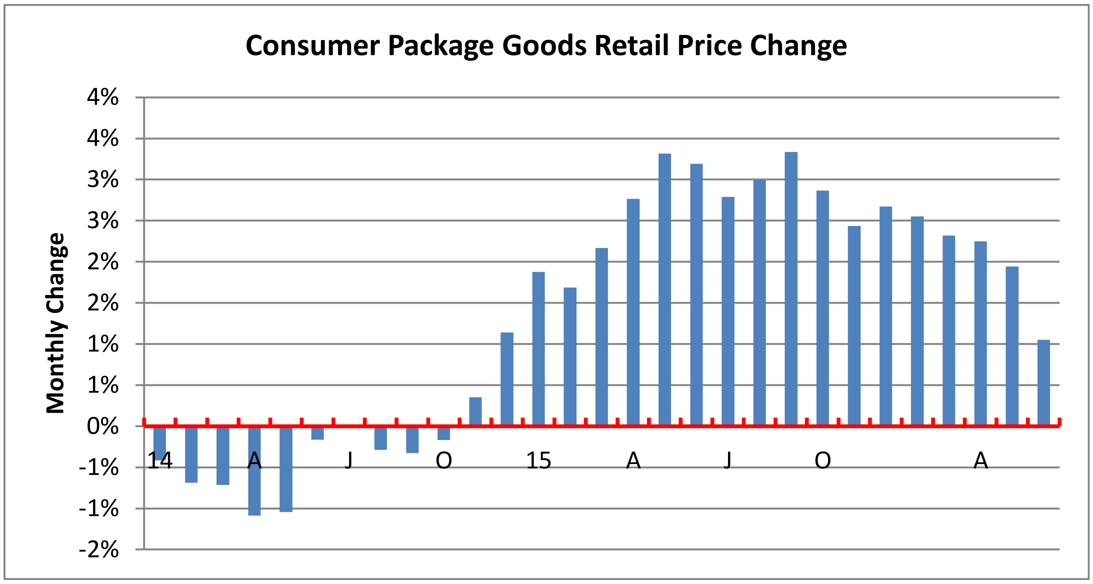
Furthermore, as the graph below shows, quarter after quarter the GM share (Walmart and Costco), continues to grow while grocery, in recent quarters stagnates. The big two retailers, Loblaw and Sobey, have seen shares trimmed over the last few years while Metro holds its own. The biggest gains are being made by Costco and to a lesser extent Walmart as it increases incrementally on food. The point is that changes in shares indicate a level of competitive intensity that is not abating.



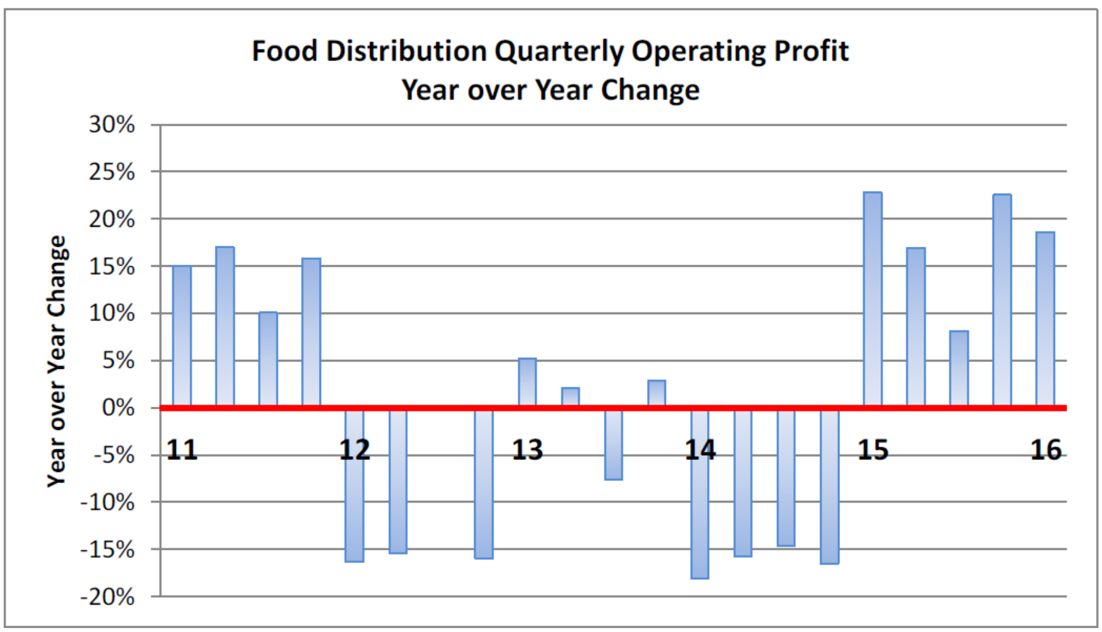
A key inflation marker is the price of consumer packaged food goods (CPG) because the grocery department in the centre of the store is the most price sensitive. The grocery CPG definition does not include the fresh products as well as meat, dairy and seafood. The main way to compete in the grocery department is on price. Therefore if competition is intensifying, the packaged goods should be showing less pricing inflation and vice versa.

In that regard the graph below has an interesting message. During 2014 when square footage growth was at its peak, the CPG pricing was in deflationary mode. Also in that year, the GM share was gaining significantly. In 2015 when stores were closing the CPG pricing jumped sharply. This was also a time in which the GM share was still gaining but at a reduced pace.

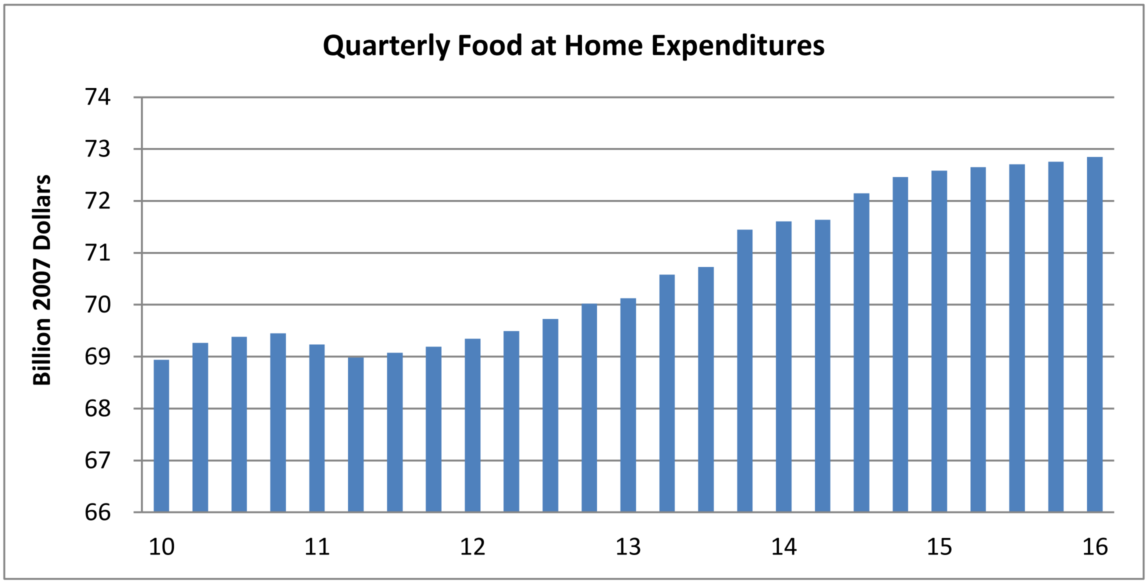
It is likely and rational that the CPG pricing is both an indicator of the degree of competition and an outcome of it. That is, it can be argued that the CPG price inflation is both a cause and effect of competition at the grocery level. The fact that the rate of increase in CPG's is decreasing, and decreasing rapidly in May is a symptom of rising competition. It is also an indicator that the competition is heating up.



Of course it should not be surprising that in an inflationary environment grocer margins tend to perform better than in periods in which pricing is under pressure. That was exactly the case in 2014 and 2015 when pricing and margins performed in tandem.



Other factors that portend to increased competition is the fact that consumer spending on food is very lethargic. Consumer spending on food at home has flat-lined. Expenditures of food for home consumption hit an annualized rate of just under $73 billion in the quarter which was barely more than Q1 2015. In fact for the past six quarters the food expenditures have barely nudged up on a quarter to quarter basis. In contrast during much of 2014 the rate of increase ran around 2%. Depressed economic conditions in the west are going to keep that factor from changing for the better. That means that there needs to be greater competition to drive sales.



Another factor the will increase the competitive intensity this year and into next is the actual financial results of the three main grocers. The poor financials announced by Sobey recently is likely to lead to a more intense competitive response from that firm. Interestingly the very good results announced by Metro in April will also stimulate increased competition. Metro announced same store sales growth in their Q2 of 5%. That sent waves through the industry, especially through the competition. That caused competitors to wake up and either worry about their own sales or seek to match Metro. How did Metro do it and how can I copy, means more competition. Interestingly though Metro's strong sales were often the result of differentiation and better store peripheries, not through price. Nevertheless the response from competitors is likely going to be with price, not better marketing.

Summary

This report argues that there are two main factors that drive food inflation in Canada: commodity prices and competition. Both factors are not pointing to robust price increases in Canada. In fact both could be indicating very modest price increases for the rest of the year.

There is a connection or statistical correlation between raw agriculture commodity pricing and total food inflation at retail. It is the case in general and of course with specific commodities such as meat and even crops and packaged food. The direction of raw commodities pricing gives a good indication of the direction of food prices six months later as the changes flow through the chain. In that regard, given the sluggish performance of commodities in recent quarters, there is little or no reason to argue for robust inflation, at least using that variable.

With regard to competition, during 2015, grocery retailers enjoyed a favorable pricing and inflationary environment. During this time, grocery margins were robust. Arguably at least part of the reason was a lessening of competitive rivalry. This less intense competition occurred despite ongoing loss of market share to Walmart and Costco. During 2016 Canadian grocery retailers have seen very mixed results in terms of quarterly financial reports. A share of the blame for the less favorable returns is that the consumer and competitive climate is working towards a lower inflationary environment. It can be expected that the competitive climate will continue to intensify as grocers react to both the financial returns and the consumer climate this year.

Kevin Grier
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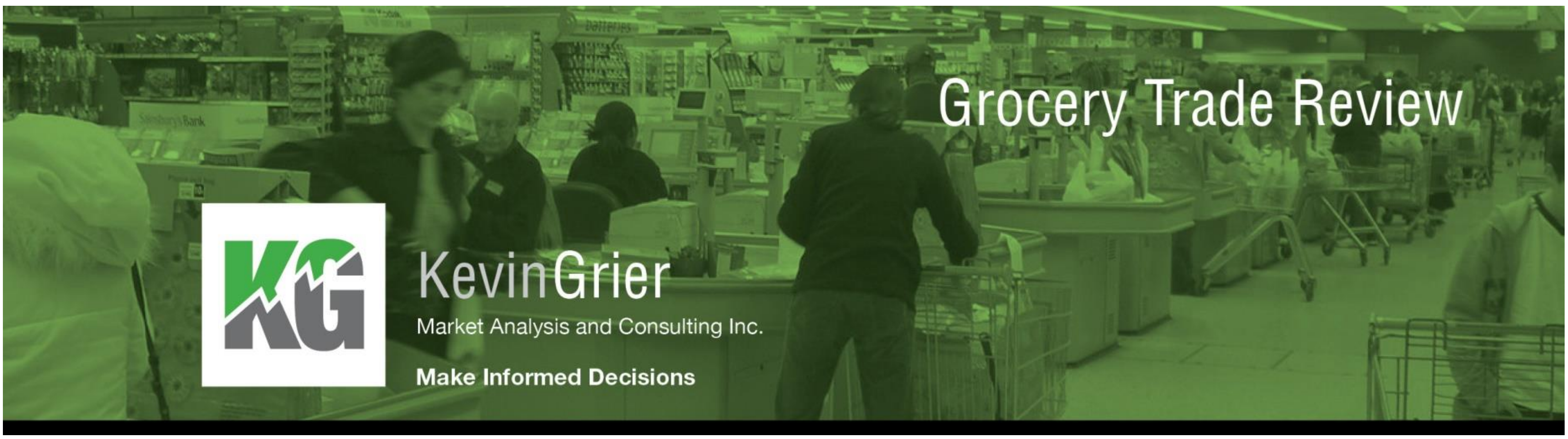
A version of this report first appeared in the May and June editions of *Grocery Trade Review*. *For a free trial subscription of Grocery Trade Review, contact* [*Kevin@kevingrier.com*](mailto:Kevin@kevingrier.com)



Kevin Grier is a respected and connected agriculture and food market analyst with a solid understanding of industry issues from farm to retail. His research and analysis helps companies, producer groups, financial service organizations and governments make informed decisions that impact their bottom line. The main industry focus is livestock, poultry, meat and grocery markets.

With more than 25 years of experience, Kevin Grier brings clients a solid economic research and market analysis skill-set combined with thorough knowledge of the Canadian and U.S. agriculture and food industry. Two key competitive advantages include an extensive network of high level contacts throughout the industry and an exhaustive data and information base.

Kevin Grier provides consulting services which deliver economic and market analysis research projects. Kevin also authors five must-read industry publications: Canadian Cattle Buyer, Canadian Boxed Beef Report, Canadian Pork Market Review and Canadian Chicken Market Review. The publications and research projects provide industry insights, issue assessment, market analysis and outlook. The reports and projects are focused solely on helping subscribers and clients make more informed and more profitable decisions regarding procurement, marketing, investment and operations.