Make Informed Decisions

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Prospects for CPG Manufacturing in 2016

Kevin Grier, November 2015

The Canadian consumer packaged foods industry has gone through a period of rationalization and concentration over the last several years. The industry downsized and lost thousands of jobs. The appreciated currency and soaring commodity costs as well as severe competition at the grocery levels were the primary challenges. As of 2015 and into 2016, however, a number of factors are lining up to indicate that for the first time in a long time, the prospects for Canadian consumer packaged goods (CPG) manufacturers are favorable. In other words the negatives have changed and arguments for a more positive environment are becoming clear.

Note that for these purposes the CPG sector is defined as those food manufacturers that produce packaged food, and does not include fresh or processed meats or dairy products. Essentially this is a discussion of the food products in the middle of the store in the grocery department.

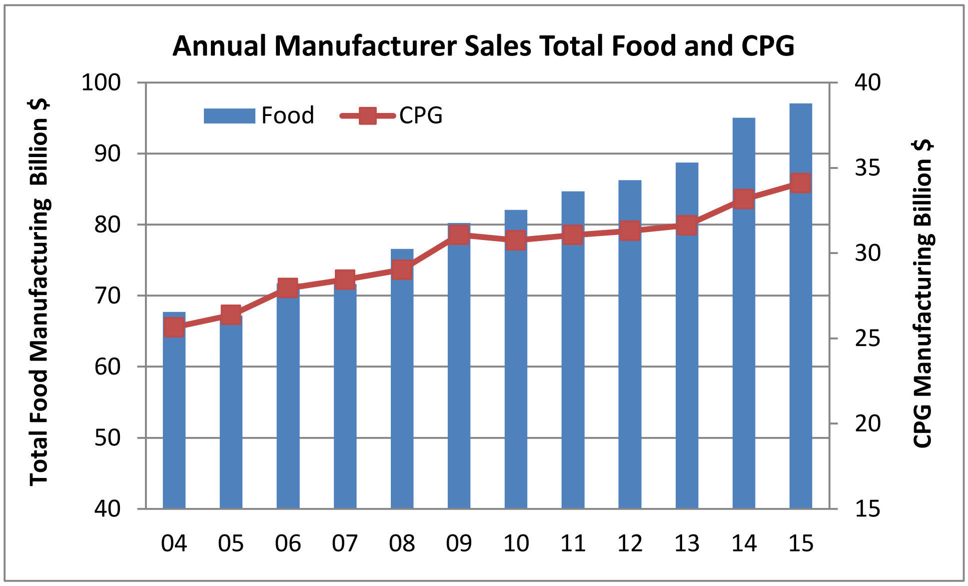
As a starting point note that this is an industry that has rationalized and downsized for several years due to a number of factors including the following:

1. The C$ appreciation exposed the high cost structure of the industry relative to the United States.
2. The C$ appreciation reduced the cost of importing product from the United States and reduced the returns of product exported to the United States, which eroded Canadian share of domestic and export markets.
3. A very competitive and pressured grocery retail environment made pricing gains extremely difficult to achieve.
4. Agricultural commodity prices were driven higher largely due to U.S. ethanol mandates beginning in 2007. That in turn increased the cost structure of the industry.
5. The post 2009 recession attitudes of consumers continued on a frugal, price conscious course.

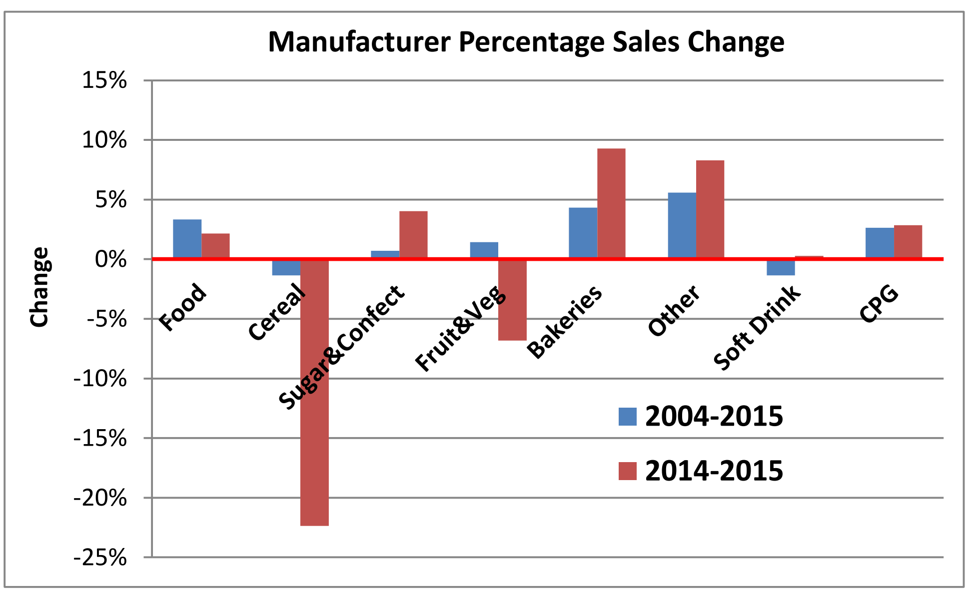
The main point is that these important factors that caused financial stress for CPG manufacturers have undergone a change in direction. The question then becomes whether the change will be translated into better returns for Canadian CPG manufacturers.

Sector Performance

During 2015, the Canadian food manufacturing industry, which includes dairy and meat as well as feed milling, animal feed and of course the CPG sector, has seen sales growth of about 2%. That compares to a 2015 growth rate for the CPG sector of about 3%. Over the ten years from 2004 through the 2015 estimate, the CPG and food manufacturing overall have both grown at annual rates of about 3%. As such, on the sales side, the 2015 is shaping up to be a better year for the CPG than for food overall. That is within the context of relatively steady, even growth over the past decade.

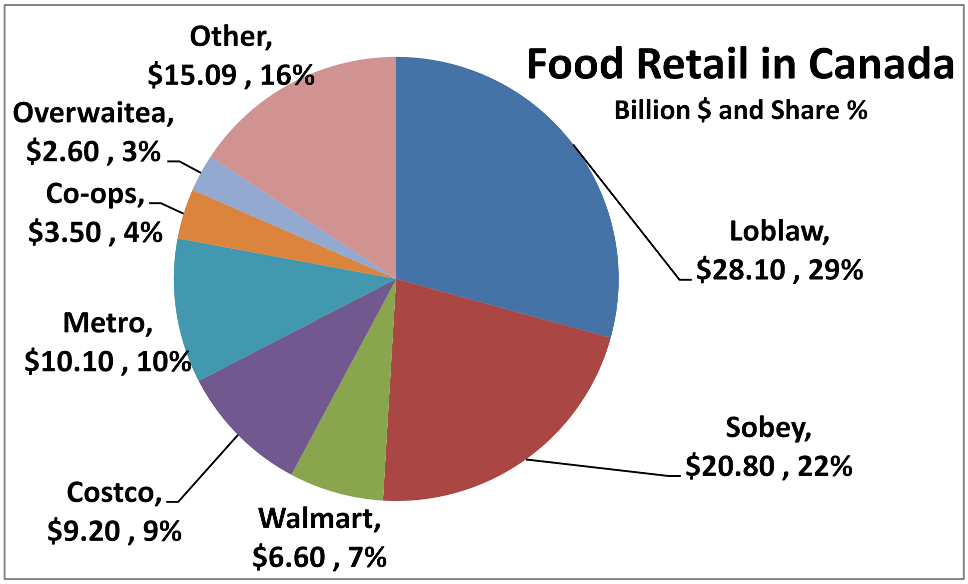


Of course the food industry and even the CPG sector is comprised of many different industries or sectors. Over the past ten years, the cereal manufacturing sector has seen serious declines in sales which is not surprising given the high profile plant closures. The fruit and vegetable processing sector has also seen declines, although not as severe as cereal. Meanwhile the soft drink sector has seen almost no growth at all over the last ten years. On the other side of the ledger, the bakeries and other manufacturing such as snacks, seasonings, coffee, prepared meals have grown up to 10% on average. The point of course is that it is a diverse industry and difficult to generalize.



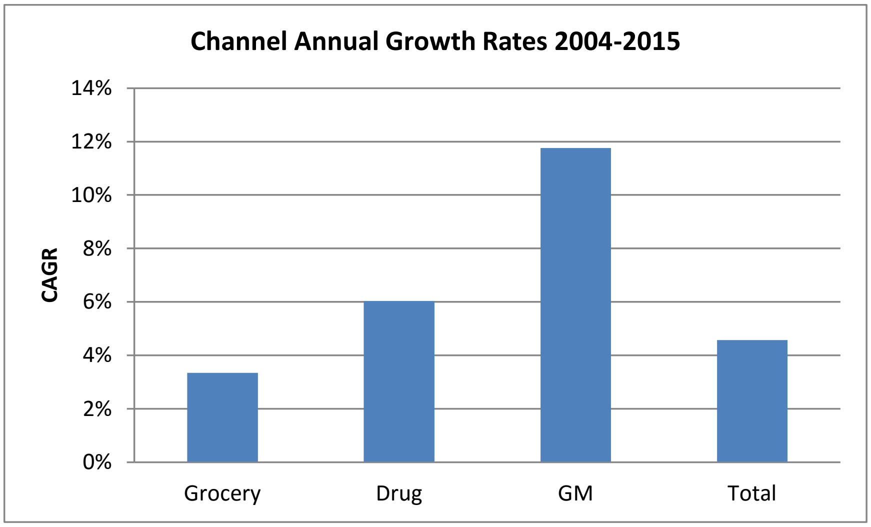
The Domestic Market

With regard to the market into which the CPG manufacturers sell, there are two ways to assess it. One way is that it is very concentrated and therefore very difficult. Fewer buyers imply less competition and more market leverage over supplies. Another way to assess it is that it is diverse and rapidly changing. Both are correct.



Source: CIBC Institutional Equity Research

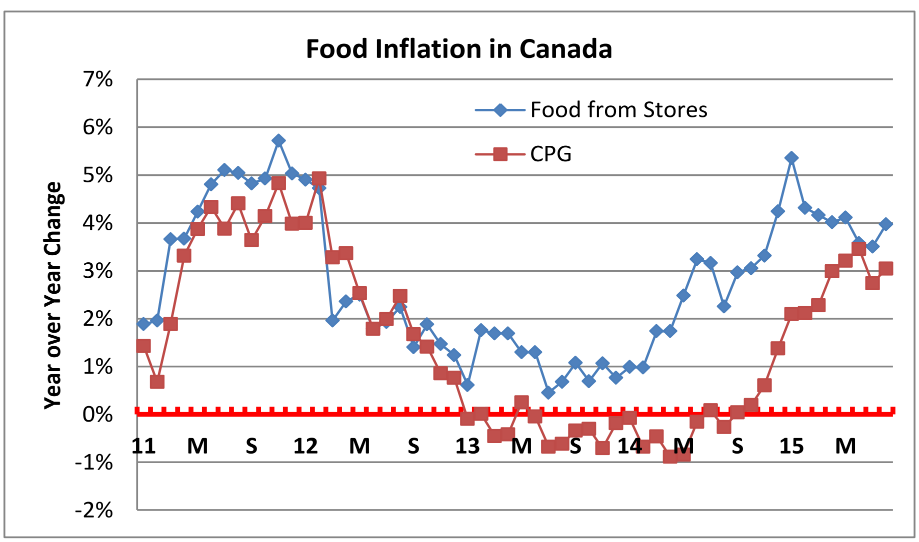
Clearly it is concentrated when two firms, Loblaw and Sobey have a 51% share of the food sales in the country. Conversely the traditional grocery channel is losing share each and every quarter to non-traditional food channels, particularly the general merchandisers, Walmart and Costco. Over the past ten years, while grocery store sales were meandering along at a 3% growth clip, the general merchandisers were growing nearly 12% each year in their food sales. So while the market into which manufacturers sell is concentrated, it is also dynamic in terms of the growth of competing players. In addition it can be expected that both Walmart and Costco will continue to grow and gain share. Ethnic grocers will also be an ongoing challenge to grocery. As such the market into which CPG manufacturers sell will become less and less concentrated.



Source: Statistics Canada

In addition to selling into a concentrated, but increasingly dynamic sales market, the CPG manufacturers have been selling into a very intense competitive market. That is, over the period from 2010 through 2014, CIBC Institutional Equity Research has tabulated an unusual growth in grocery square footage. The growth in selling space far outstripped growth in real sales and growth in population. The increase in selling space was an indicator of intense competition among the grocers and the general merchandisers.

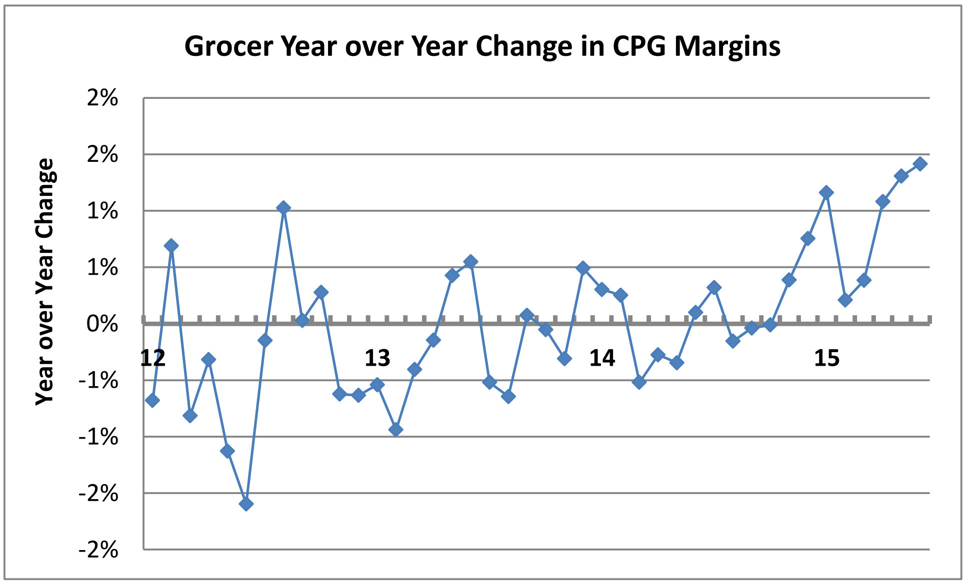
A symptom of this intense competition is the lack of food store inflation. In 2013 the average inflation rate for food from stores was just 1%. That compares to over 5% in 2009. Even more interesting or disconcerting from a CPG manufacturer perspective is that the prices changes of CPG items in store were often negative. That is, CPG items were in deflationary territory.



The prices of CPG are a bellwether of grocer competition. Grocers can compete in many ways but when it comes to the big grocery department of the store, there is only one way and that is through price.

Clearly the competition was severe in 2013 and 2014. It is also of note that the prices of CPG have staged a rebound in 2015. This is an indication of a truce or at least a cease fire in the intensity of the competition and the grocer level. It also coincides with a reduction in the growth in square footage tabulated by CIBC. It also corresponds with the announcements of store closures by Loblaw and Sobey.

The improvement in CPG pricing at the grocer level has led to an improvement in margins on CPG for grocers. When comparing the Statistics Canada CPG industrial price index, which represents the costs to grocers, with the retail prices of CPG, it indicates that grocer margins on CPG are improving.

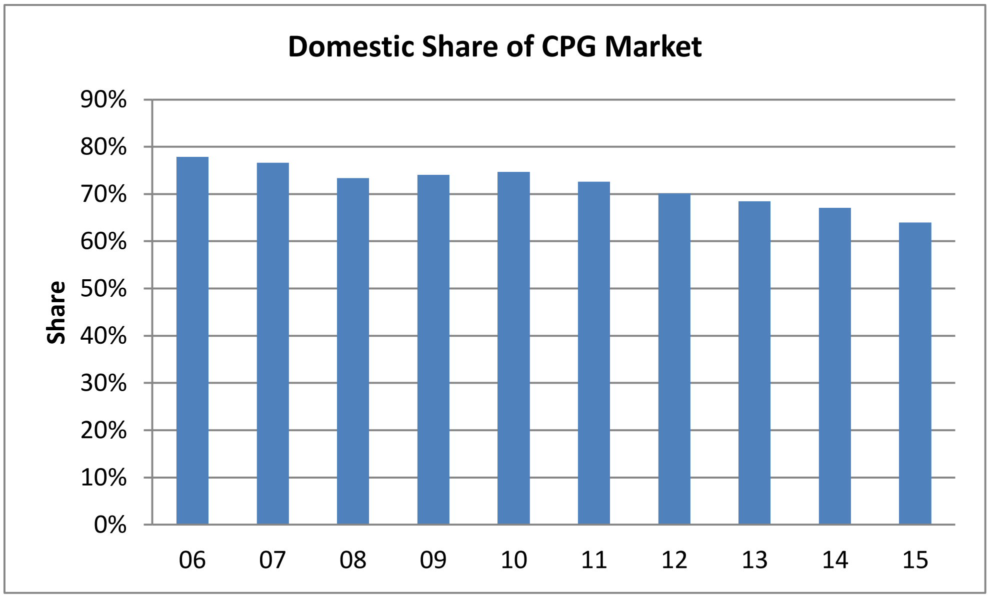


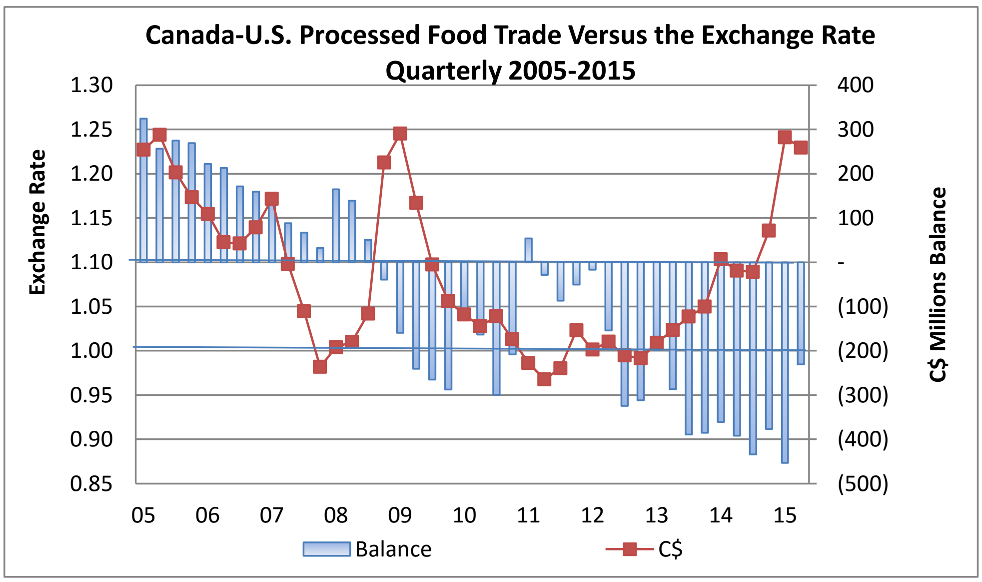
Clearly the domestic market conditions for consumer packaged goods manufacturers has improved. An environment of deflation and low margins has turned to inflation and improved margins. That plus the fact that the general merchandisers continue to gain share means that the market manufactures sell into has become more diverse.

<u>Import Competition</u>

Canadian consumer packaged goods participants are exporters. The domestic market is the biggest but each year, Canadian CPG manufacturers export about $12 billion worth of product to the United States. That is a critical share of the $30+ billion in total CPG sales. Exports to the United States have been growing at a rapid 6% rate on average from 2005 through the estimate for 2015. Alternatively however, imports of CPG from the United States have been growing at nearly 9% each year. As such, Canadian manufacturers are gradually losing their own market to U.S. manufactured goods.

Of course a large part of the reason why Canadian manufacturers have lost market share is the appreciation of the C$. As the C$ appreciated from 2005 through 2012, though interrupted by the financial crisis, the Canadian CPG trade balance eroded from surplus to deficit.



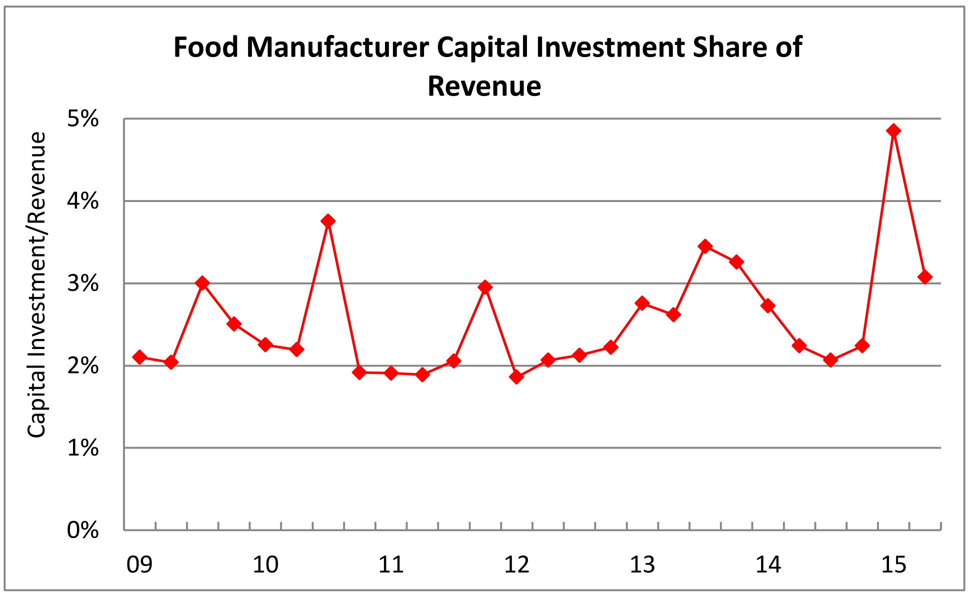


Source: USDA Foreign Agricultural Service and Statistics Canada

As noted above, the appreciation exposed Canada's competitive weakness. A C$100/unit cost of production equates to just as a US$80/unit cost at an exchange rate of USDCAD1.24. When the exchange rate goes to par, however, that C$100/unit cost is also a US$100/unit cost. There are no hiding higher costs at a par dollar. Furthermore, a strong currency at par or more reduces the costs of imports and reduces the ability to export profitably. Clearly the appreciation from the mid-2000's to 2012 resulted in reduced competitiveness, and lost market share domestically. From 2006 to 2014 a Canadian Agri-Food Policy Institute and the Ivey Business School research report found that 143 food plants were closed. The key reason was lack of competitiveness of which the C$ appreciation played a central role.

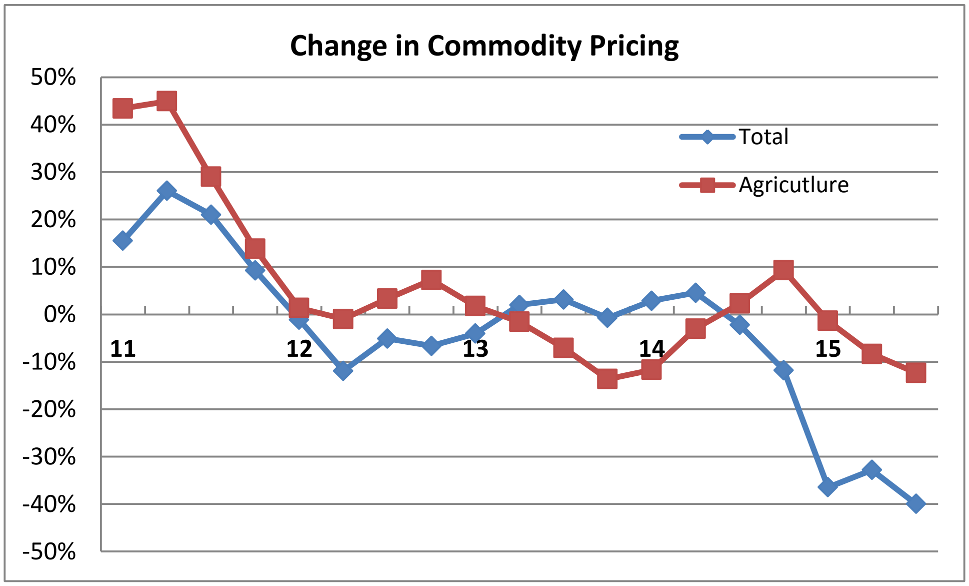
Of course the appreciation of the C$ appears to be in the past given the stark depreciation of the past two years and the last year in particular. The challenges of appreciation become reversed towards competitive advantages. Furthermore the depreciated currency has created an umbrella in which the overall costs of CPG in Canada can be increased due to the lack of a low cost U.S. alternative. The C$ depreciation changed the selling and buying environment significantly.

As a final note with regard to the exchange rate, the reality is that a strong currency encourages investment in plant and equipment. That is especially the case because the equipment is often manufactured outside Canada. Those companies that used the period of the appreciation to invest are now well positioned to compete in this period of a depreciated currency. Based on StatsCan data, it appears that Canadian food manufacturers were busy investing during the appreciation period.



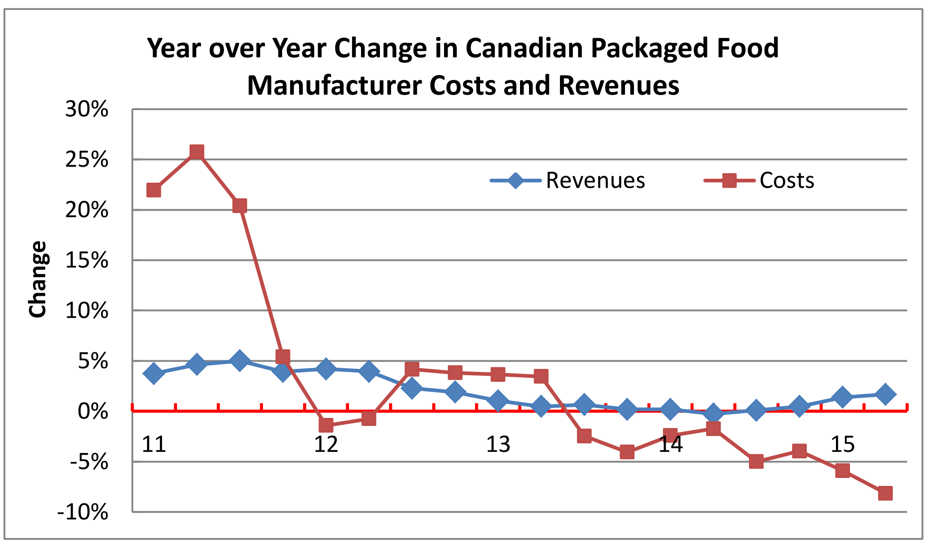
Commodity Costs

As noted above, agricultural commodity prices were driven higher largely due to U.S. and Canadian government ethanol mandates beginning in 2007. There is a strong correlation between corn costs and other agricultural commodities from tomatoes to hogs. Given that the ethanol mandates drove corn prices higher, it follows that ethanol drove other agricultural commodity costs higher. In the last three years, however, additional corn acreage and increased yields have moderated corn prices which in turn has moderated other agricultural commodities. Other non-agricultural commodities have also trended lower, all of which helps lower food manufacturer cost profiles.



Source: Bank of Canada Commodity Price Index

The net result for Canadian consumer packaged goods manufacturers of lower input costs and a more inflationary market environment is an improvements in margins.



Why it Matters

This paper began with five reasons why the CPG manufacturers had been challenged in the market prior to this year. With the depreciation of the exchange rate, a more inflationary grocery market and lower commodity prices, the environment has changed sharply. The one thing that has not changed is that consumers remain frugal and lacking confidence (see confidence index below).

The point is that both domestic and export markets have changed more in favor of CPG manufacturers. That is particularly true for those manufacturers that used the period of the appreciated dollar to invest in plant and equipment. The overall market and cost structure has improved. The question is whether or how Canadian CPG manufacturers can take advantage in 2016.

A version of this report first appeared in the October edition of the Kevin Grier report, "Grocery Trade Review. If you would like a free two month trial to Grocery Trade Review contact Kevin Grier.

Kevin Grier Market Analysis and Consulting 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.

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