Inflation and Canadian Grocer Margins

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There is an old food industry adage that inflation is good for grocers. In particular, the thought is that inflation is good for grocery margins. There are at least two points to back up the case. The first argument relates to the overall market situation and momentum, while the second argument pertains to simple arithmetic.

With regard to the overall market situation and momentum, the premise is that in an inflationary environment it is simply easier to pass along price increases to consumers. Consumers are more conditioned to price increases and the market is more conducive to price hikes. Retail price hikes are usually associated with better margins.

The Arithmetic of Price Increases

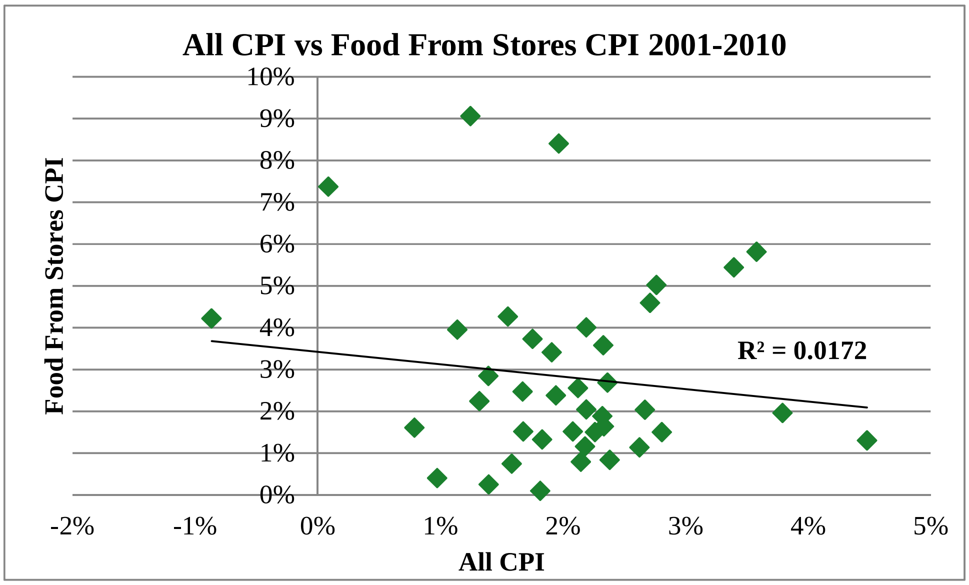
Of course, for retail price hikes to be good for grocer margins, they must outpace the grocers wholesale cost increases. That is where the arithmetic of price increases comes into play. Generally speaking, given that the retail price is going to be greater than the wholesale price, a percentage increase is going to have a greater nominal impact on the retail price compared to the wholesale price. The following table gives two examples.

Grocer Inflation Impacts on Margins							
	Start		Example 1			Example 2	
	Price/unit		Inflation	Price 1		Inflation	Price 2
Retail	$10.00		10%	$11.00		10%	$11.00
Wholesale	$6.00		10%	$6.60		14%	$6.84
Margin	$4.00			$4.40			$4.16

Consider at the start, with the retail price at $10 and the wholesale at $6, the margin is $4. If both retail and wholesale prices increase by 10%, the grocer’s margin increases by 0.40 cents. The retailer is 40 cents better off on each sale. Even if wholesale pricing inflation is much greater than retail inflation, such as in example 2, the retailer is better off by 0.16 cents. Of course there are limits to the arithmetic, but generally on paper, an inflationary environment is better off for retailers.

Grocery Pricing Relationships

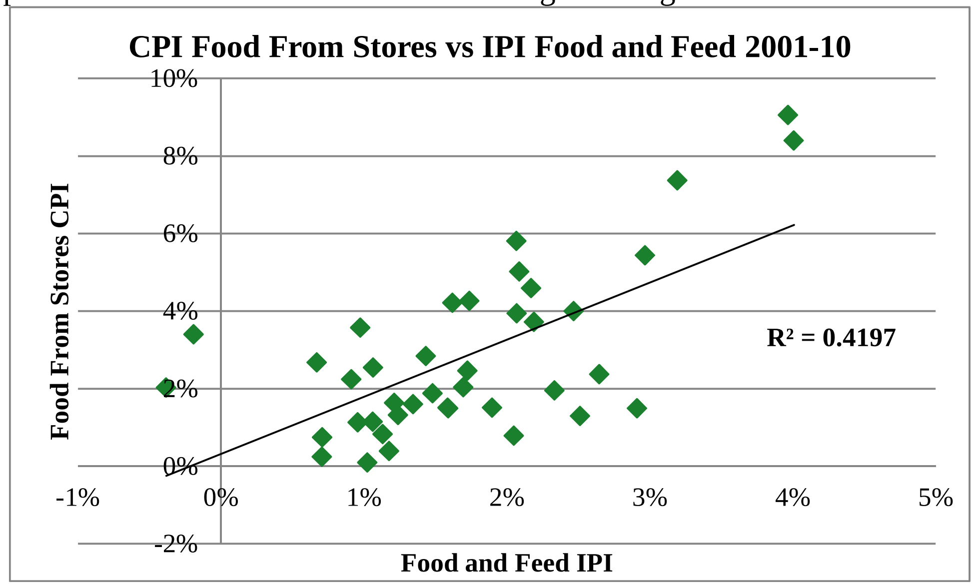
However, this industry exists in a competitive, dynamic market rather than on paper. First of all, there is not necessarily a relationship between the overall inflationary trends and the trends in prices for food from stores. Statistics Canada reports on the Consumer Price Index (CPI) for All Items, as well as the CPI for Food from Stores. The graph below shows the statistical relationship between changes in the Statistics Canada Consumer Price Index for All Items and the Consumer Price Index for Food from Stores on a quarterly basis. The data are the year over year percentage changes in the respective CPI's on a quarterly basis over the past decade.



The graph shows there is no statistical relationship between the changes in the total CPI and the changes in the CPI for Food from Stores. This is surprising in that it suggests that food is somewhat unaffected, at least on a quarterly basis, by the overall inflation rate. Nevertheless, food only represents 17% of the total CPI and food from stores represents 12% of the total. Furthermore, the food industry is comprised of a wide array of subsectors such as meat, produce, dairy, sugar, etc., that are all subject to their own supply and demand pressures. In other words, food is hard to generalize. The bottom line is that just because there is inflation or price stability in the overall economy, it does not translate into the same condition in the grocery store.

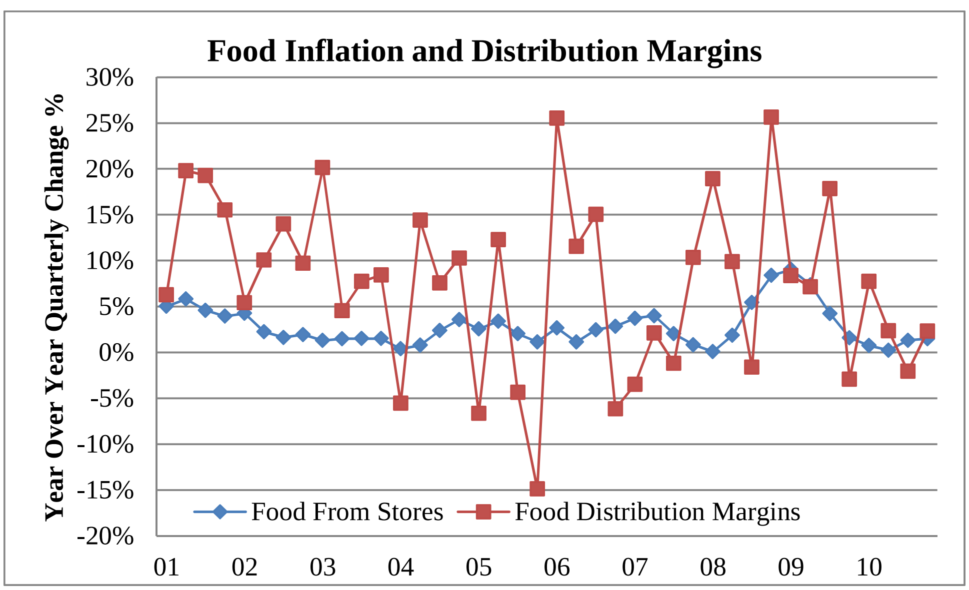
Alternatively, there is a recognizable relationship between the price changes for food purchased from stores and the changes in prices at the wholesale level. The StatsCan measurement of changes in prices at the wholesale level is called the Industry Price Index (IPI). The following graph shows the relationship between the food from stores CPI and the IPI for Finished Foods and Feeds for the past decade. The IPI for Finished Foods and Feeds is basically the wholesale commodity food price changes. It is a good measure of food inflation at the wholesale level between manufacturers and retailer grocers.

As can be seen from the graph, as food wholesale prices increase, so too does food from store prices. With that seen, it is also clear that on a quarter by quarter basis, the relationship is not statistically strong. The orders of magnitude will differ and at times the overall direction differs. The relationship becomes stronger when the retail prices are lagged by a quarter. That allows the wholesale prices another three months to work through to the grocer's shelf.



The Margin Question

The question is whether there is a relationship between increasing food prices and grocer margins. In addition to inflation price reporting, Statistics Canada also compiles data on food industry revenues and profits. The next graph shows the year over year changes in margins as well as the year over year changes in the CPI for food from stores. The graph shows that the year over year changes in margins is very volatile compared to food price changes. That margin volatility is a function of the varying response of retail prices to wholesale costs as well as factors such as operating costs and sales volumes. There is a small correlation between food prices and food margins, but there are a large number of other factors at play.



Will High Prices Cure High Prices?

The final point is that while in a general sense it is true that grocers do arithmetically benefit from higher food prices, there are many other factors that need to go right in order to say that inflation definitely benefits grocers. Further to that, the Canadian grocery sector is now going through a period in which consumers are being extra cautious with their money. Surveys are showing that US consumers and likely Canadians to a lesser extent, are still being cautious with their expenditures. High unemployment, soaring gas prices and general uncertainty are keeping us all a little more tight-fisted.

As an example of that, in the recently completed quarter, Metro reported retail food *deflation* of just under 1%. Metro attributed the deflation to competitive pressures (square footage additions by Walmart Supercentres and aggressive pricing by FreshCo in Ontario) and the impact of generic drug reform by governments in the provinces of Ontario and Quebec. This contrasted with StatsCan's monthly measure of retail food prices, which indicated monthly inflation (as opposed to deflation) ranging from 1.9% to 3.7%, and averaged 2.5% in calendar Q1/11. Peter Sklar, BMO Nesbitt Burns Inc noted in a recent report that the StatsCan data often varies considerably from the grocers' actual retail inflation/deflation experience. He noted that StatsCan measures a fixed basket "whereas in reality, consumers substitute for categories that are inflating rapidly, and seek categories that are deflating rapidly." The consumer trades down and as such, actual changes in prices of goods purchased could actually decline, as shown by Metro's experience in the last quarter.

Also, alternative aggressive channels such as Walmart, Canadian Tire, Shoppers Drug and dollar stores are taking market share. In this case, passing along cost increases is increasingly difficult or not possible. Canadian grocers could find that now an inflationary environment could actually harm margins. That would be because they cannot pass along manufacturer increases.

Finally, this report began with an old food industry adage that inflation is good for grocers. As such, it is fitting to end with another old market adage "that nothing cures high prices like high prices." The converse is also an old reliable truism: Nothing cures low prices like low prices. At the risk of being patronizing, the idea is that higher prices make people back away from buying, and hence prices start to slide. The opposite is true when prices are low. The low prices draw buyer interest which drives pricing higher. The basic message is that the consumer is going to decide whether inflation is good for grocer margins or not.

A version of this report first appeared in the May edition of the George Morris Centre publication, Grocery Trade Review. If you would like a free, two month trial to Grocery Trade Review, please contact Kevin Grier at kevin@georgemorris.org