Food & Agribusiness market update

Industry Consulting Team | Q1 2022

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Highlights

- While consumers are still feeling many downstream impacts from COVID, the industry was feeling these pressures prior to the pandemic; which quickly intensified bottlenecks that were already present
- Challenges that the pandemic has exacerbated include labor, commodity prices, transportation, and cold chain
- Though some price increases will be permanent, raising prices in perpetuity is not sustainable, which amplifies the importance of focusing on solutions where available
- As challenges in the industry will persist in a post-COVID society, companies will need to continue to identify creative solutions to keep profits and margins stable

The Emotional Premium of Food

Continuing challenges within the global supply chain are giving more frequent rise to misleading headlines, but one has been particularly thought-provoking for me over the last few months. The USDA's Food Supply Chain Guaranteed Loan Program, which was recently introduced with a predictable level of vagueness, has put a spotlight on an area of our distribution system that impacts consumers frequently and with direct, measurable consequences. The result has been rampant speculation about whether certain pricing activity constitutes price gouging, which reflects our fantastically misunderstood food production system.

We need to start with an acknowledgement that the challenges we are experiencing today are not solely the result of the pandemic, at least not as it relates to the food industry. This is a common misperception because food prices exhibited more relative stability in pre-COVID times, but numerous inequities have existed for many years. The reality is that the food supply chain has gotten more complex, adding layers during a period of time when unrivaled technological advances might dictate more simplicity. Perhaps there is some waste that can be trimmed, and certainly there are regulatory burdens that could be removed, but from a practical standpoint, these complexities exist because of the intricacies of consumer behavior. Over many decades, rising disposable incomes have given rise to unprecedented demand for variety, convenience, and differentiated eating experiences among consumers. When rising prices are misconstrued as price gouging, as is happening today, I worry that we don't really know where our food comes from.

The Consequences of Choice

According to the Food Marketing Institute, the average American grocery store carried over 31,000 stock keeping units (SKUs) in 2020; by comparison, this number was reported as low as 7,000 SKUs in the 1990s reflecting a remarkable increase in availability for the at-home meal sector. Over the same time period, as the away-from-home segment grew to account for nearly 50% of food consumption at its peak, menu experimentation increased in a never-ending quest for differentiation. Notable examples include the decades-long expansion of breakfast offerings among fast food operators or more recently, "chicken wars", which are resulting in record-high wing prices as we are subtly reminded of the anatomical limitations of a broiler chicken.

During this time of growing abundance, food prices have undoubtedly increased, but there have also been external forces that have been favorable for consumers, though not fully appreciated because of the lack of visibility. For example, the entrance of Wal-Mart into food retailing created significant price competition for traditional food retailers throughout the 2000s, which benefited shoppers. Similarly, the consolidation of various banners, most notably by Kroger and Supervalu, accelerated the movement of store-brand stratification, benefiting consumers by passing along the savings associated with purchasing power. Consumers didn't feel the entirety of the effects of rising prices because commodity producers and food manufacturers experienced varying degrees of margin pressure as the consolidated retail landscape demanded it.

Today, supply chain conditions are such that the balance of power has shifted towards the farm gate, and as food producers pass along higher costs of doing business, it is important to remember that pre-pandemic cost pressures already existed and are now being slowly, but aggressively, rectified. For most food manufacturers, the biggest cost pressures in the last two years have been related to labor, raw material prices (commodities), and indirect costs such as transportation and cold chain warehousing. This pandemic has exacerbated these challenges, but by no means are these new for our industry. Consider the following:

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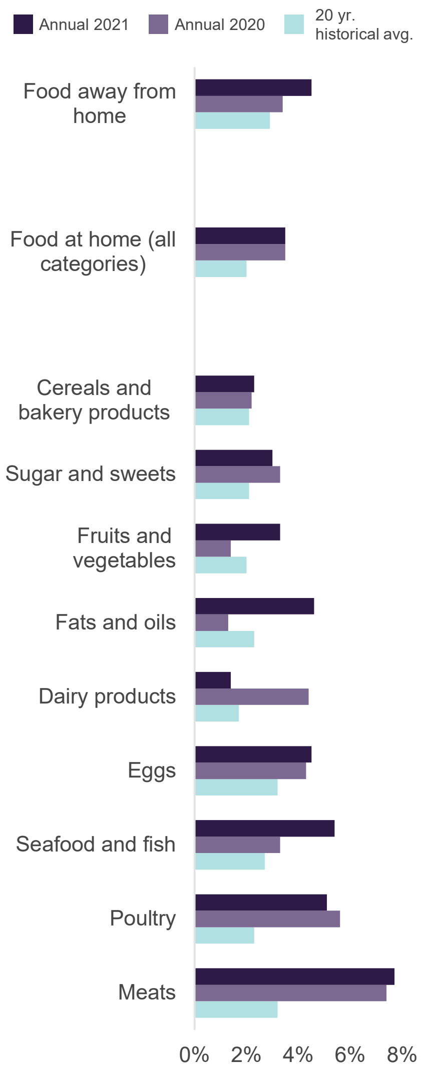
Changes in Consumer Price Indexes for food[1]



The Consequences of Choice (continued)

- ***Labor:*** Since at least the turn of the century, most major food manufacturers have reported routine annual turnover rates of 50-100%. Healthcare and drug costs, routinely provided to employees at little to no cost, were on a precipitous rise prior to 2020.
- ***Commodity Prices***: Most commodity markets have been earmarked by volatility over the last 20 years as food-for-fuel and other alternative use industries have created additional demand for feed grains and other commodities. Further, while today's commodity prices are elevated, we have not seen a black swan event in any of these markets during the pandemic.
- ***Transportation:*** There was a significant driver shortage prior to the pandemic, which was mostly spurred by regulatory mandates such as logging devices and mandated drug testing.
- ***Cold Chain: S***imilar to the retail grocery consolidation that occurred in the 2000s, there has been significant consolidation in public refrigerated warehousing. This has given rise to several price increases over the last decade as capacity became scarce in several markets. This was particularly noticeable in several eastern port markets, which have experienced tremendous volume growth from new and diversified trade routes.

The above observations are not to detract from the profound challenges that this pandemic has presented for the entire food industry. If anything, the industry should be commended for the resiliency with which it has absorbed all of these impacts over many years. I simply think that consumers would be more understanding of rising prices if these pre-existing conditions were more broadly known. And while I also believe that some of these price increases will be permanent, raising prices in perpetuity is not sustainable, which amplifies the importance of focusing on solutions where available. For the food supply chain, this will mean a further push towards automation along with a multi-year renovation of America's food retail landscape. But the consumer also has a role in this movement, which is to recognize that there is a growing emotional premium associated with food that will become more apparent as our abundance of choice eventually returns.

As the diversity of our food supply has skyrocketed over the past several decades, so have consumer expectations. Whereas consumers were previously the beneficiaries of weekly market share battles waged through creative pricing activity, limited production or service capacity removes the focus on market share gains in today's environment. Rather, companies are passing along cost increases to protect margins, and in several cases, limited raw material availability is helping manufacturers to rationalize SKUs or customers that are not adequately profitable.

These challenges, like seemingly all of the ones before it, are helping food companies get better, which over the long-term will undoubtedly benefit the consumer. But there were cracks in the foundation prior to COVID, and the investment required to create needed capacity and infrastructure within this industry will be reflected in the emotional premium you can expect to pay for food.

Conclusion

I think an interesting parallel is occurring between the changing mindset of food manufacturers, described above, and that of the average American worker. When corporations examine margins and returns, they are making decisions about the opportunity cost of capital; a laborer's decision to report to work centers around the allocation of a different type of resource but a similar examination of the opportunity cost of time. As reflected in worker absences, unemployment claims, and wage rates, the average worker's required rate of return has risen in the last few years. Through this lens, it may be easier for consumers to understand why the cost of food will continue to rise.

Sources: [1] U.S. Bureau of Labor Statistics *Consumer Price Indexes* (not seasonally adjusted) and forecasts by USDA Economic Research Service; Food Marketing Institute

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