Bringing Home the Bacon
Brighter Outlook for U.S. Food and Beverage Manufacturers, but Challenges Remain

The food and beverage (F&B) manufacturing industry is poised to realize a meaningful upturn in profitability thanks to strengthening consumer demand and last year’s dramatic drop in crop prices. But, while the outlook for the industry as a whole is looking more radiant, the rising tide will not lift all boats. Some producers will continue to wrestle with fierce competition, regulatory uncertainty, and stifling cost pressure, while an increasingly health-conscious consumer powers seismic shifts in the industry landscape.

The F&B industry produces an enormous diversity of products using a wide range of inputs (Table 1), but there is little question that high and volatile crop prices have been the industry’s biggest scourge over the past decade. After a reprieve during the Great Recession, grain and oilseed prices soared anew over the past few years thanks to growing global demand, surging ethanol production, and a multi-year drought in the Midwest. Since fierce competition and buyer concentration prevented producers from raising output prices sufficiently to compensate for higher costs, profit margins suffered. Millers, bakeries, and animal food producers, all of which make extensive use of grains and oilseeds in production, bore the brunt of the pressure. And, while soaring grain prices captured the bulk of the headlines, fruit, nut, and other specialty crop prices staged their own quiet advance, putting other F&B segments under pressure as well.

A household sector struggling with elevated debt and a weak job market added to the industry’s hardship over the past few years. After declining 5% during the recession, real consumer spending on food and beverages posted only a gradual rebound as households increased their saving and focused on purchases of real estate and durable goods, such as autos, which were deferred during the recession. Together, weak demand growth and soaring crop prices dragged operating profits down more than 10% between mid-2011 and mid-2012 (Chart 1).

Although earnings growth resumed in the second half of 2012, profits have yet to recover previous highs.

### Table 1
**The Pieces of the Pie**

<table>
<thead>
<tr>
<th>Industry Sales by Segment</th>
<th>per cent</th>
<th>$billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meat Products</td>
<td>24%</td>
<td>196</td>
</tr>
<tr>
<td>Dairy Products</td>
<td>13%</td>
<td>106</td>
</tr>
<tr>
<td>Beverages</td>
<td>12%</td>
<td>96</td>
</tr>
<tr>
<td>Grain and Oilseed Milling</td>
<td>12%</td>
<td>94</td>
</tr>
<tr>
<td>Other Foods</td>
<td>11%</td>
<td>90</td>
</tr>
<tr>
<td>Fruit &amp; Veggie Preserving</td>
<td>8%</td>
<td>64</td>
</tr>
<tr>
<td>Bakeries</td>
<td>8%</td>
<td>62</td>
</tr>
<tr>
<td>Animal Food</td>
<td>7%</td>
<td>54</td>
</tr>
<tr>
<td>Sugar &amp; Confectionery</td>
<td>4%</td>
<td>32</td>
</tr>
<tr>
<td>Seafood Products</td>
<td>1%</td>
<td>11</td>
</tr>
<tr>
<td><strong>Food and Beverage Total</strong></td>
<td>100%</td>
<td>805</td>
</tr>
</tbody>
</table>

### Chart 1
**Starving for Growth**

Operating Profits

- Food Manufacturing
- Total Manufacturing

[Graph showing operating profits over time]
Fortunately, the outlook for the industry has brightened. Crucially, **crop prices finally caved** last year, plunging 20% as better growing conditions in the United States and globally replenished dwindling inventories (*Chart 2*). Some individual crops, such as corn, registered even larger declines, though oilseed crops, such as soybeans, remain somewhat costly. Lower crop prices are giving a meaningful and much-needed boost to industry margins and profits. However, the improvement is not yet evident in the industry data; only a slight advance in earnings was reported for 2013Q3 due to still-high crop prices at the start of the quarter and widespread cost hedging, which temporarily locked many producers into higher input prices. Profit growth should accelerate sharply in coming quarters.

Outside the grain-intensive segments, **some producers are still grappling with elevated input costs**. Fruit and nut prices remain near record highs and the ongoing drought in California could maintain upward pressure in the near-term. Meat processors are also wrestling with soaring input prices, as dwindling herds pushed cattle and hog prices to record nominal highs over the past year. As a result, hog processor margins are now paper-thin, while beef packer margins are deep in the red. Unfortunately for meat processors, livestock prices are likely to hold near current highs over the next year or two as farmers retain animals for breeding in order to expand their herds. In the pork industry, Porcine Epidemic Diarrhea virus, which results in animal losses but poses no risk to food safety, will exacerbate near-term scarcity.

On the demand front, producers are starting to benefit from a gradual, if choppy, **acceleration of real consumer spending on food and beverage products**. Indeed, growth in real consumer spending on F&B reached 1.8% year-over-year at the end of 2013 (*Chart 3*)—not exactly a sprint, but faster than longer-term norms and a meaningful improvement from the pace seen over the past few years. Stronger demand growth has been underpinned by sturdier household balance sheets, rising consumer confidence, and reduced economic fragility both in the United States and globally. Looking ahead, growth in real consumer spending on non-durable goods is forecast to upshift from 2.1% in 2012 to 3.1% in 2014, which should support further acceleration in food and beverage spending, particularly on more expensive, higher value-added products.
The industry is also benefitting from an **upswing in net exports** (Chart 4), which have doubled over the past 18 months despite a moderate appreciation of the trade-weighted dollar. However, the headline improvement belies a significant slowdown in export growth, which has been concealed as import stagnation has given producers a greater share of the domestic market.

Moreover, with exports amounting to just 8% of industry sales (and net exports equivalent to just 2% of sales), the upswing in trade represents a limited gain for the industry as a whole. Even in the milling segment—the most externally oriented in the industry—exports account for just 14% of sales, compared to 23% in the manufacturing sector as a whole.

With production on the upswing and virtually no new capacity added since the Great Recession, the F&B industry has made notable progress on **putting excess capacity back into operation**. Indeed, capacity utilization in the food industry rose to 84% at the end of 2013, the highest level since the late 1990s. Not only is this well above a cyclical low of 78%, it’s far stronger than capacity utilization for the economy as a whole, at 79%. The absorption of excess capacity should help curb aggressive competition and limit the influence of large buyers, which will support industry selling prices and help producers defend the increase in margins that they have realized over the past year.

On the financial front, ultra-low interest rates and ongoing revenue growth have continued to ease the industry’s debt-service ratio (i.e. the proportion of revenue required to service debt). In 2013Q3, the F&B debt-service ratio fell to just 1.4%, below the manufacturing sector as a whole at 1.6%, where capital intensity is higher. With debt well contained, **the eventual rise in interest rates should not burden the industry excessively**. The prevalence of fixed-rate financing also means that the interest rates actually paid by producers will increase only gradually as market rates rise, so producers shouldn’t find themselves suddenly stretched. However, operators in more capital-intensive segments may be somewhat more vulnerable than industry averages would suggest.
Back on the consumer front, the industry is grappling with a **pronounced shift in preferences**, as rising obesity and associated ailments over the past few decades are now leading consumers to make healthier dietary choices. Indeed, there has been a clear shift in consumer spending toward leaner options such as poultry and fresh fruit, and away from sweeteners, red meat, and processed fruits and vegetables (*Chart 5*). This poses a clear problem for some producers, such as confectioners and sugary drink manufacturers, but it remains unclear what rising health consciousness will mean for the industry as a whole. On one hand, it is driving growth in some segments and creating opportunities for product innovation; on the other, a consumer shift toward lower value-added ingredients, such as fresh fruits and vegetables, would weigh on processor-level profitability.

Meantime, on the supply side, the industry is **struggling to realize productivity growth**, which would be warmly welcome given the tremendous cost pressure endured over the past decade. Indeed, F&B labor productivity has flat-lined since 2005, and has dramatically underperformed total-economy productivity over the past 25 years (*Chart 6*). The lack of productivity growth has partly reflected the nature of production processes within the industry, some of which are not well suited to automation (such as in the meat-processing segment).

**Regulatory uncertainty** is posing another meaningful challenge for many producers. Perhaps most notably, the push for legislation requiring that genetically-modified foods be identified by special labelling has maintained momentum in a number of states, even though voters in in Washington and California recently rejected such laws. In the meat-processing segment, country-of-origin labelling requirements remain highly contentious and could yet provoke a damaging trade dispute. Current trade negotiations represent another question mark for the industry, as it remains unclear whether deals will be struck with the Trans Pacific Partnership and the European Union. An agreement on either front would stir the pot by opening new markets and raising competition at home.

**The Bottom Line:** Lower costs and faster demand growth portend better times ahead for the F&B manufacturing industry. But, conditions are unlikely to improve uniformly; weak productivity growth, shifting consumer tastes, and regulatory uncertainty will continue to loom large for some producers.
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