Special Report

BMO Capital Markets
We're here to help.™

A timely analysis of recent economic events

September 2017

Haute Cuisine

Another solid year for food processors—what next?

Aaron Goertzen, Senior Economist
aaron.goertzen@bmo.com • 416-359-8229

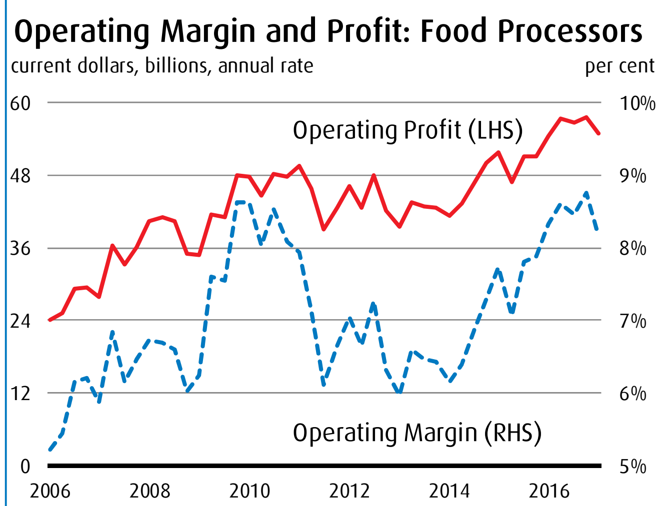
Earnings at U.S. food and beverage manufacturers continue to impress. Over the past year, depressed agricultural prices have continued to support profit margins, grocery deflation has stoked consumer demand, and an improving trade balance has given an extra lift to externally-oriented segments. And, while caution dictates that the recent run of results shouldn't be extrapolated too far into the future, there are few signs that the good times are about to come to an abrupt end.

Costs continue to steer margins and earnings

In the year leading up to the first quarter of 2017[1], earnings at U.S. food processors totaled an all-time high of $57 billion—up 11% from the prior year and more than one-third from the recent trough in 2013 (*Chart 1*). The upswing in earnings has resulted partly from sales growth, but by far the biggest driver has been the surge in margins that has played out as agricultural prices have plunged over the past few years. In the year to Q1, industry-wide operating margins averaged an impressive 8.5%—only recently matched during the late-2000s recession, when declining demand and sales offset much of the earnings lift.

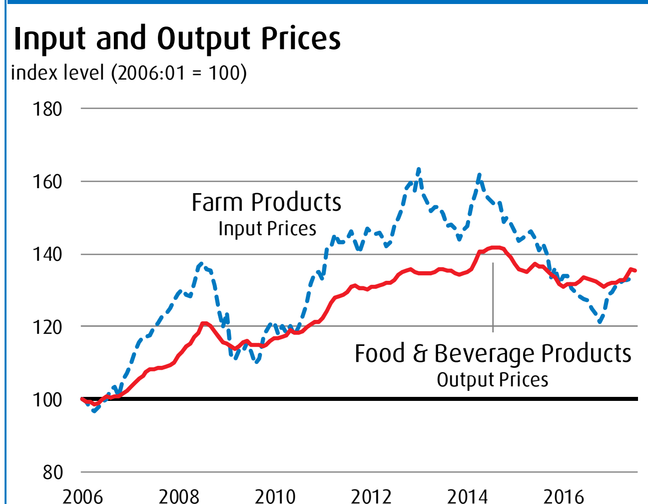
Today's low agricultural prices have resulted from an improbable series of North American and global bumper crops that began in 2013. Lower crop prices have provided direct cost relief for grain- and oilseed-oriented segments such as milling, and, by improving the economics of animal production, have also led to a major drop in livestock prices. Overall, the Department of Agriculture's all-encompassing farm price index declined 25% between mid-2014 and late 2016—an unprecedented occurrence in modern records, which run back to 1990 (*Chart 2*). Although competition within the food processing industry also saw selling prices drop over that

Chart 1
Earnings still hitting the spot



Note: Seasonally adjusted by BMO Economics. Source: Census Bureau.

Chart 2
Agriculture prices have bottomed



Note: Farm product prices seasonally adjusted by BMO Economics. Sources: Bureau of Labor Statistics, U.S. Department of Agriculture.

[1] Data on industry-wide earnings and margins are not particularly timely. The latest available observation is 2017:Q1.

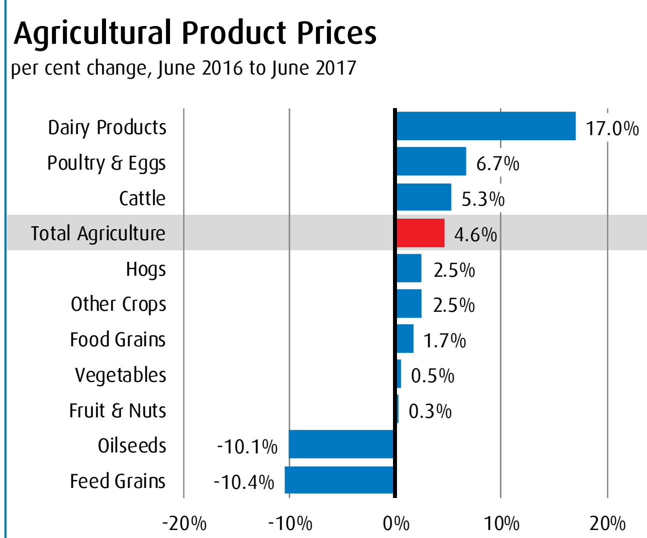
period, the decline was a far smaller 7% (thus the jump in margins). The fact that food processors have managed to maintain higher margins despite tough competition and the prevalence of large downstream buyers is an implicit acknowledgement that the good times will not last forever. A crop failure—even overseas—could quickly send the cost pendulum swinging in the other direction, and it's far easier to hold the line on prices today than it is to raise them when conditions become more challenging down the line.

While industry-wide cost pressure remains minimal, certain segments are now seeing an upturn in input prices. Raw milk, which is sold by farmers to dairy product manufacturers, dropped 44% in the two years to mid-2016 but has now risen 17% over the past year as farmers have rationalized production and capacity (*Chart 3*). Poultry, egg, and cattle prices, each of which also posted earlier declines in the 40-50% range, have also trekked higher of late. This represents a major shift from last summer, when most farm products were in freefall and even the most resilient were rising roughly in line with inflation. At this point, the only agricultural products that remain under heavy pressure are feed grains and oilseeds, both on expectations of yet another solid harvest this year.

Demand growth moderating as food inflation resumes

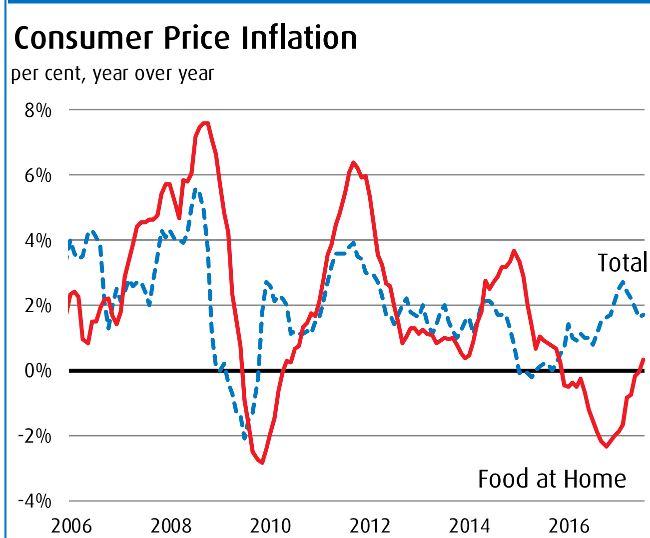
Importantly, the decline in costs that food processors did pass through into selling prices ultimately ended up being passed on to consumers as well, thanks to aggressive competition among retail grocers. Aggregate grocery prices declined 2.7% between late 2015 and early 2017—just shy of the drop seen during the global recession, which in turn was the largest decline in half a century (*Chart 4*). Households have responded to lower food prices by enthusiastically increasing their purchase volumes, which saw growth in real food spending reach 4.7% y/y toward the end of 2016—a 16-year high (*Chart 5 on next page*). Although demand growth has moderated over the past few quarters as grocery prices have stabilized, even the latest reading of 1.9% y/y remains more than respectable for an industry that typically sees sales volumes driven mainly by population growth.

Chart 3
Cost experience mixed by segment



Source: U.S. Department of Agriculture.

Chart 4
Grocery deflation done



Source: Bureau of Labor Statistics.

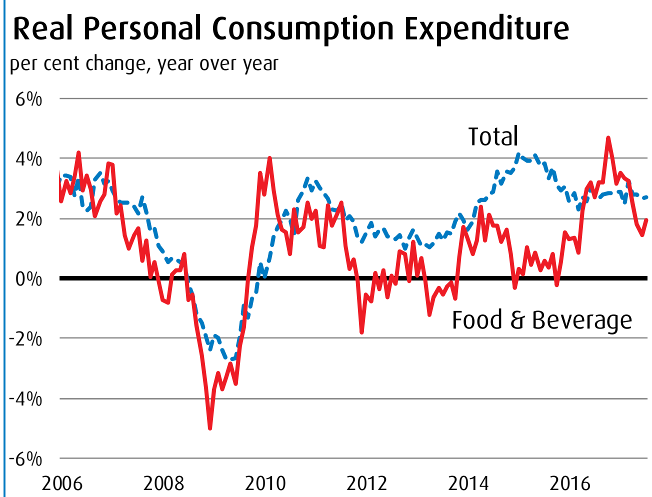
The decline in domestic food prices since late 2015 has also had a beneficial impact on net trade, which had previously been straining under the weight of the lofty greenback (*Chart 6*). Somewhat sturdier global growth this year hasn't hurt, either. Overall, food export volumes have jumped a solid 3.3% over the past year, while imports have stepped back 0.7%. While it's true that the industry as a whole is not particularly reliant on trade (exports account for only around 7% of sales), the upswing in international business represents an important positive for more externally-oriented segments like milling and meat processing.

What next?

Although aggregate farm prices remain very supportive, their continued rise over the spring and early summer suggests that processor margins have likely narrowed somewhat since the first quarter. Together with the moderation seen in demand growth, this will temper industry earnings, though results should remain strong by historical comparison.

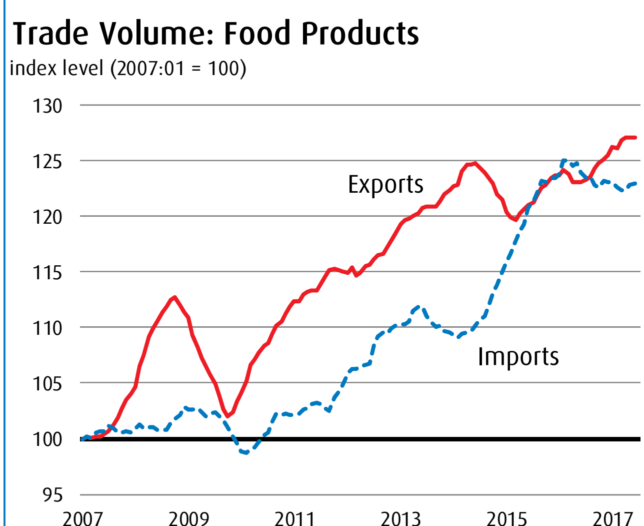
It is reasonable to expect that agricultural prices will continue to trend higher over the next few years, and that processor margins will continue to narrow accordingly. Many farm operators are in distress at current prices, so even if supply is not soon reduced by less-supportive growing conditions, it will ultimately be whittled down by producer exit. Fortunately, this increase in agricultural prices is expected to take place relatively gradually (at least, absent a catastrophic crop failure), as today's bulky crop stockpiles and large livestock herds will take time to work down. Although the continued uptrend in interest rates expected over the next few years will apply some additional cost pressure, the bottom-line impact should be manageable given the industry's relatively low capital intensity and declining reliance on debt financing. On the demand front, a solid labour market and sturdy household finances should see total real consumer spending grow by around 2.5% per year through 2018, but grocery spending will likely advance more gradually as food inflation resumes. Concerning trade, with the U.S. dollar likely past its cycle high, international competitiveness should improve steadily over the next few years, provided that domestic food prices remain relatively well contained. However, the ongoing renegotiation of NAFTA poses an important risk for the industry, given its trade surplus with Canada and Mexico (combined) and the network of supply chain linkages stretching across those borders.

Chart 5
Demand growth cooling



Note: Food purchased for off-premises consumption; does not include restaurant spending. Source: Bureau of Economic Analysis.

Chart 6
Trade now a tailwind



Note: 12-month moving average. Source: Census Bureau.