

Packaged Food Supply Chain: Higher Costs Force Radicalisation Of Strategy

Contributed by Euromonitor International
Tuesday, 20 November 2012

Data showing the expansion of UK manufacturing in March came in tandem with higher industrial costs.

This trend was consistent with the latest statistics from Eurostat on production costs in the EuroZone.

If this inflationary trend continues, food manufacturers – as well as others - will be forced to accelerate the polarisation of their offerings or risk facing oblivion.

Industrial output in the UK expands on the back of higher input prices

The Markit Purchasing Managers' Index, used by the UK industry as a benchmark for industrial production, rose from 51.6 in February to 52.1 in March, its highest level in 10 months. A PMI higher than 50 typically signals an expansion in manufacturing activity.

Interestingly, the sub-index for input prices jumped from 44.9 in January – a level that signals prices are actually falling - to 55.3 in February and 60.4 in March.

EU labour and production costs continue to rise

Production costs in the EuroZone are also rising, according to the latest data released by the EU statistics office (Eurostat).

Hourly labour costs in the EuroZone (EA-17) rose by 2.8% in the year up to the fourth quarter of 2011, compared with 1.7% for the same quarter in 2010. The two main components of labour costs are wages and salaries and non-wage costs. Non-wage costs mostly comprise employers' social contributions and employment taxes. Even more importantly, the EA-17 industry producer index – which excludes the construction industry - rose by two points between October 2011 and February 2012.

Labour costs in the EuroZone have been driven mostly by Germany. Germany saw nominal hourly labour costs rise by 3.6% in Q4 2011 on the back of strong economic growth. The German economy grew by 1.5% in Q4 2011, driven by strong exports and rising consumer confidence. The latest official data, released in March, shows that industrial output rose by 1.6% month-on-month in January when adjusted for seasonal variations. German exports rose by 9% in January 2012 compared to January 2011. In addition, wages were under upward pressure during March and April given rising discontent in the public sector.

Rising labour costs are not just being seen in Central European economies. In Spain, for instance, labour costs rose by 3% during Q4 2012, compared with a 0.7% rise during the same quarter of 2011. A fairly rigid labour market and higher wages paid for working longer hours in understaffed companies are some of the causes suggested by analysts for this rise.

Interestingly, research shows that the recent rise in input costs stems not only from higher labour costs but also from higher energy prices. Brent oil futures traded on the Chicago Mercantile Exchange, which are used by analysts as a benchmark to track global energy prices, increased by more than US\$15 per barrel during the first quarter of 2012.

Meanwhile, agricultural commodities have seen little movement in prices in the last three months but this could soon change. Sugar output for the coming season in Brazil remains uncertain. Cocoa production projections for 2012 are significantly lower than the previous year. Corn prices could soar again on the back of lower soybean output in South America.

Cost hikes unlikely to be passed on to packaged food retailers

European manufacturers' most common gripe about the recent rise in costs lies with their inability to pass them on to retailers. In the UK, for instance, manufacturers have increased their output prices over the last six months, but not enough to keep pace with the rise in input costs, according to PMI surveys.

This inability to pass on higher costs to the final consumer is even more relevant to the food industry. This is because of the relative significance of private label offerings and retail distribution through supermarkets and hypermarkets in most packaged food categories .

Frozen processed food is a key example of this trend. In 2011, supermarkets and hypermarkets accounted for more than 60% of total category retail value sales in Western Europe. In highly developed markets like the UK, this percentage is close to 90%. Crucially, the strong prevalence of private label in supermarkets and hypermarkets further increases the bargaining power of European retailers over food manufacturers.

In Spain, for instance, the current economic crisis has underlined the development of a low-cost culture that is permeating all layers of consumer behaviour. Private label has thrived in this environment. Its retail value share of packaged food sales stood at around 30% in 2010. In highly mature categories like milk, this percentage was close to 40%.

Choose between volume or value or face extinction

There is consensus among food analysts that input inflation strengthens the case for further price polarisation across packaged food offerings.

On one side of the equation, expanding output by volume allows food processors to benefit from economies of scale. Doing this, however, is easier said than done. Taking share from other food brands, expanding shelf space and, more importantly, increasing consumer demand is a costly – and not always successful – exercise. This is the reason why food manufacturers aiming for short-term volume expansion typically opt to increase the share of their output allocated to private label rather than their own brands.

Another option is to target the premium end of the food spectrum. Added-value products ranging from omega-3 enriched dairy products, fairtrade chocolate and exotic chilled pizza flavours have all been expanding steadily despite their comparatively higher retail prices. This is crucial because premium categories give manufacturers a larger margin and allow them to pass on higher costs to retailers.

Quality remains a key factor for consumers in accepting higher prices from retailers. More expensive organic milk in Western Europe, for instance, rose by 5% in retail volume in 2011. Milk as a whole, in contrast, managed to post only 0.3% retail volume growth. Higher production costs will therefore push some manufacturers towards option one (volume) and others towards option two (value). Those standing somewhere in between will face stagnation, if not oblivion.

Analyst Insight by Francisco Redruello, Senior Foods Analyst at Euromonitor International

Republished with permission from Euromonitor Market Research Blog, originally posted on 19 November 2012