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Food Manufacturers' Surprise Profitability Set to Continue, High Prices Will Test Consumers

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Inside…

Key Points:

- Before the pandemic, conventional wisdom held that cost inflation squeezes food manufacturing margins, but that did not happen in 2021.
- A perfect storm of increasing input costs in mid 2021 led to a series of pricing adjustments, some of which are just now hitting grocery shelves. Additionally, consumer food spending has not returned to pre-pandemic patterns, upending industry expectations.
- With pricing actions taking full effect and consumers' grocery demand continuing to be strong, retail food manufacturers will continue to enjoy robust profit margins in 2022.
- The Consumer Price Index (CPI) for food at home will remain elevated through 2022, and may even edge higher in the first half of the year.

Introduction

For the first time in perhaps decades, food inflation is garnering headlines and sending government policymakers scrambling for quick solutions. The U.S. Bureau of Labor Statistics' Consumer Price Index (CPI) for food at home averaged 3.5% for all of 2021, but it really started climbing toward the end of the year. It averaged over 6% for Q4 and hit 6.5% in December, the highest monthly level since 2008.

As 2021 started out relatively calmly, most analysts believed consumer spending patterns were headed back to "normal" after almost a year of COVID lockdowns. But by mid-year, higher grocery prices began to gain momentum, driven by a "perfect storm" of factors. Unprecedented consumer demand (buoyed by government stimulus payments and newly forged eating patterns) was pitted against COVID-related supply chain delays, labor shortages, escalating commodity prices, and energy costs. The term "transitory inflation," so often heard last year, has now been relegated to the trash bin of bad economic predictions. Consumers are wary and preparing for the worst: They expect to pay 14% more for groceries in 2022, according to a recent poll by KPMG.[1] While we agree with their intuition, we are forecasting food at home CPI to average 5%-6% in 2022, though the potential for higher levels remains if food manufacturing costs continue to rise.

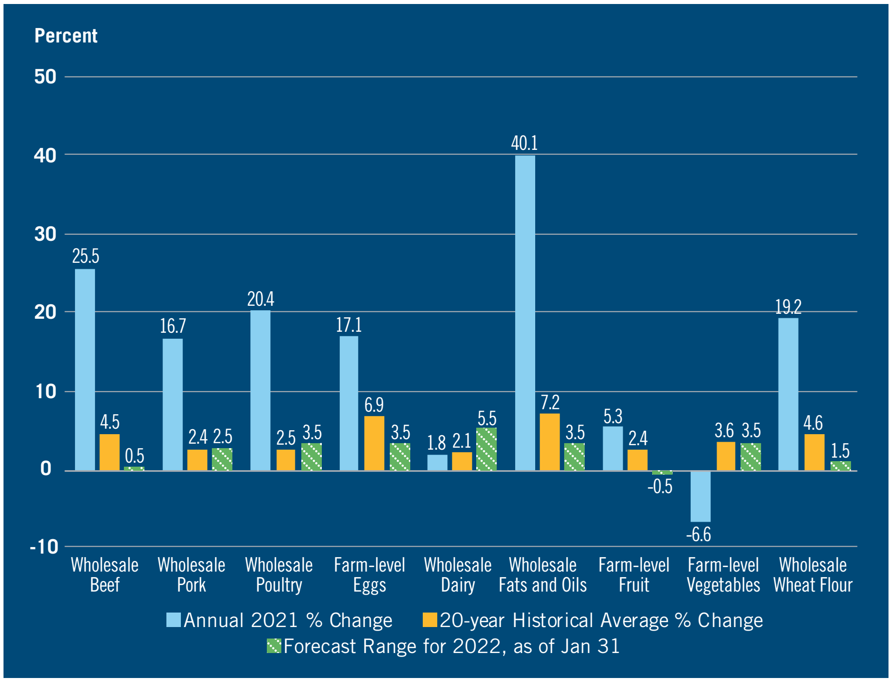
2021: The COVID Inflation Surprise

Prior to the pandemic, most food industry analysts shared the belief that for food manufacturers, escalating input costs (usually thought of as raw ingredients, energy, and labor) would initially lead to a squeeze in profitability. Conventional wisdom held that it takes considerable time for offsetting price increases to show up on grocery store shelf labels and that increased prices could initially lead to lower unit sales as companies vie for position in the market. However, as the thinking went, after some time when the inflationary cost period eases, the increased retail pricing tends to be "sticky," meaning the price increases last much longer than in the initial cost spike – and over the longer term, cost shocks could even prove to be net positive for food companies.

Instead, the unique circumstances of the COVID pandemic have led to a different situation.

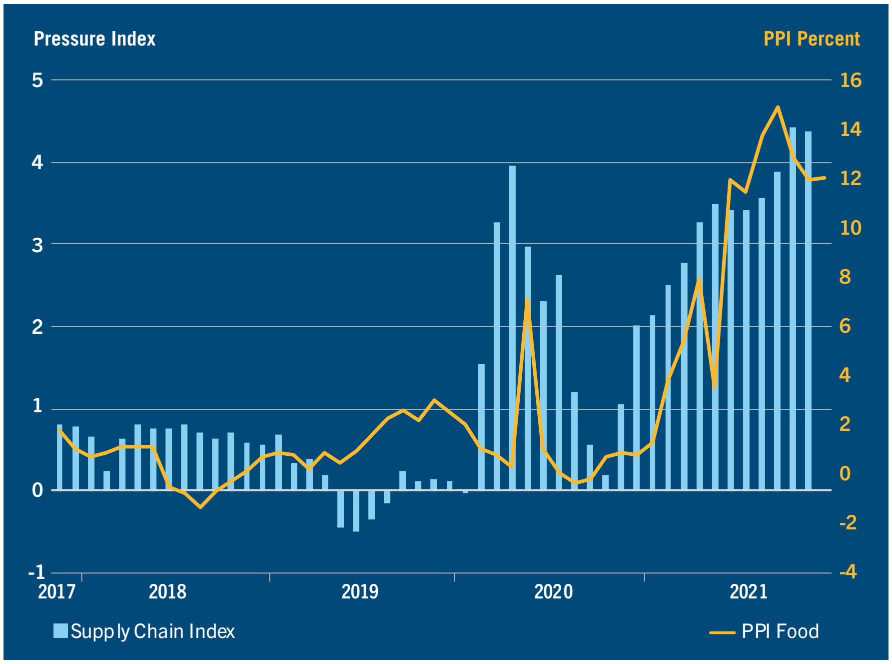
The hopeful outlook at the onset of 2021, when it appeared that the worst of the supply chain issues were behind us, quickly shifted by Q2. It became clear that global droughts would take a toll on grain harvests, vaccinations would not be a panacea for labor shortages, trucking companies were being overwhelmed by inventory restocking efforts, and energy supplies were not rebounding in line with the surging recovery in demand.

EXHIBIT 1: Changes in Producer Price Index



Source: U.S. Bureau of Labor Statistics' Producer Price Index and forecasts by USDA, Economic Research Service.

EXHIBIT 2: New York Fed Global Supply Chain Pressure Index Versus Food PPI (%)



Source: U.S. Bureau of Labor Statistics, Producer Price Index by Industry https://libertystreeteconomics.newyorkfed.org/2022/01/a-new-barometer-of-global-supply-chain-pressures/

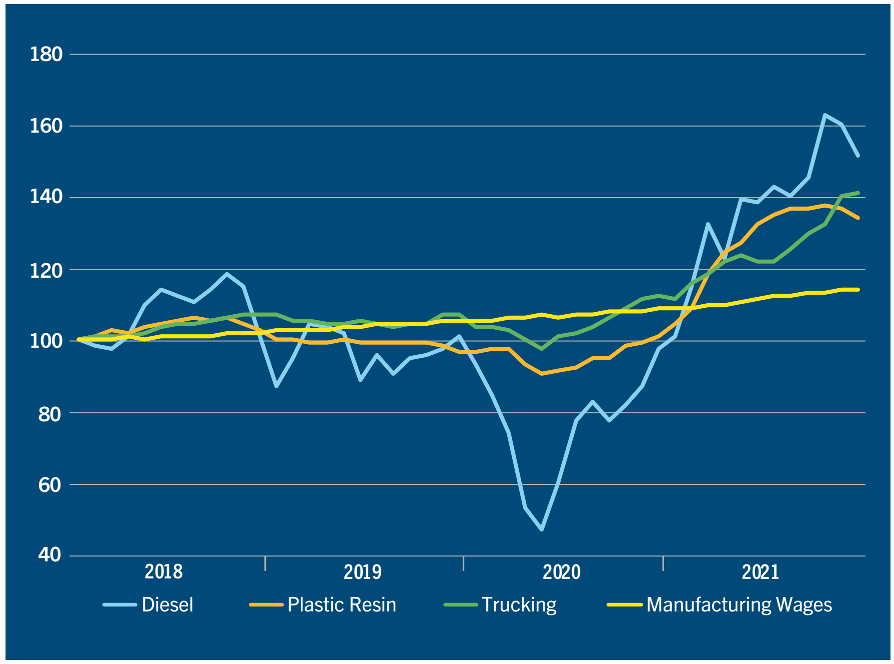
In addition, consumer demand for groceries remained unexpectedly and extremely strong, particularly as long-isolated consumers embraced the outdoor grilling season last summer. The combination of strong demand and high raw commodity input costs *(Exhibit 1)* sent most meat and poultry categories to record high prices.

While commodity prices were rising last summer, the supply chain situation was rapidly deteriorating. New York Fed's Global Supply Chain Pressure Index, which is an index of ocean, truck, and air freight rates, has risen over 400% from pre-pandemic levels amid a devastating shortage of trucks, trailers, drivers, and shipping containers *(Exhibit 2).* Of interest, note how closely supply chain issues are correlated with overall food manufacturing costs, which is likely an example of both causation and correlation. Cost inflation of some common manufacturing expense categories has jumped by double digits, with increases for diesel up 52%, trucking costs 41%, plastic resin 33%, and wages 14% *(Exhibit 3).*

An Industry Responds

So when the cost increases of virtually every input hit simultaneously by the end of Q2 2021, food industry observers expected to see a significant squeeze in food manufacturing margins through the rest of the year while the corresponding upward pricing adjustments slowly worked through the system. Additionally, most believed COVID would fade

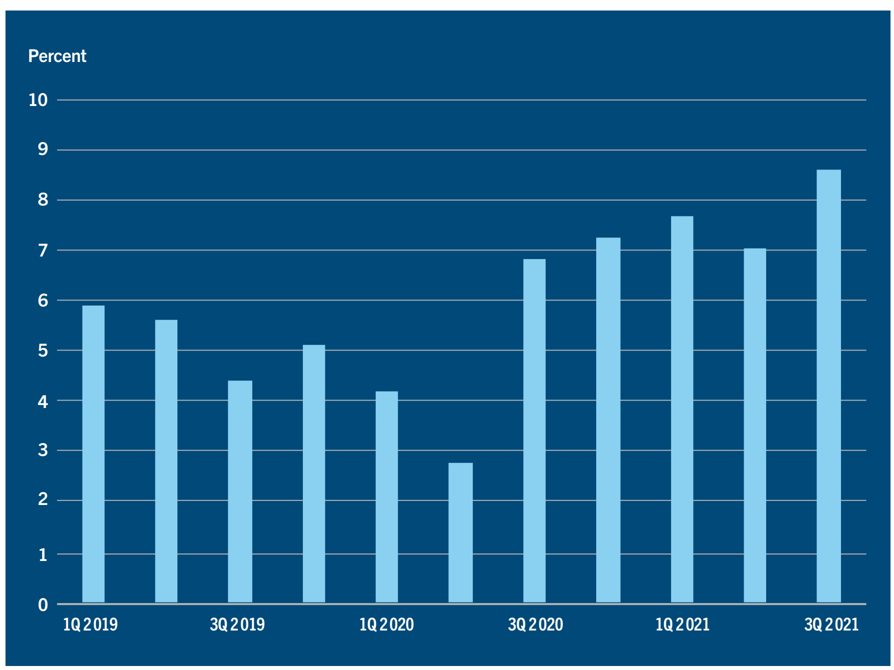
EXHIBIT 3: Input Cost Indexes (Jan 2018 = 100)



Source: U.S. Bureau of Labor Statistics, Producer Price Index by Industry

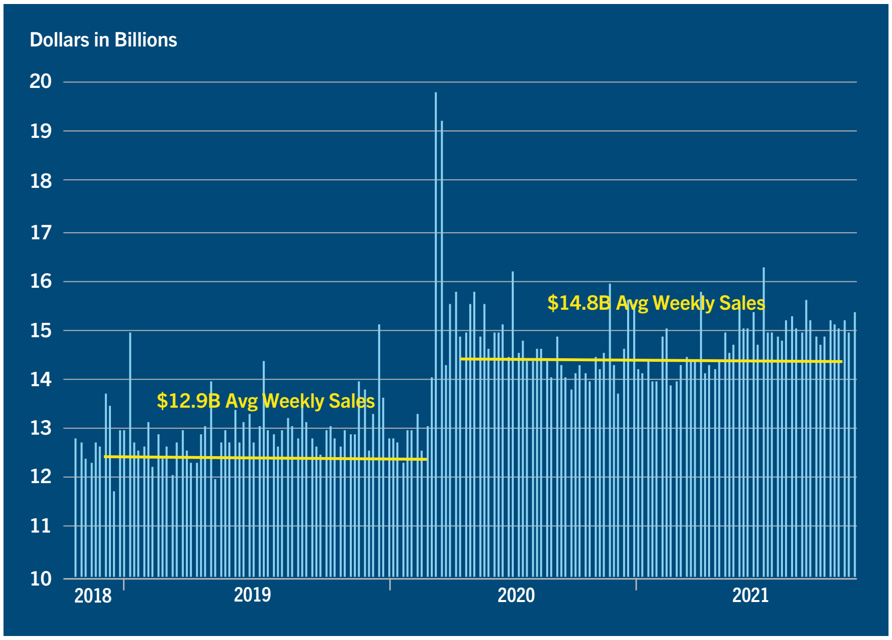
EXHIBIT 4: Food Processor/Manufacturer Operating Profit

Simple Average of Publicly Traded Companies



Source: CoBank Calculations, data sourced from CSIMarket.com

EXHIBIT 5: Weekly Retail Food Sales



Source: USDA ERS Weekly Retail Food Sales: https://www.ers.usda.gov/data-products/weekly-retail-food-sales/?cpid=email

by summer and consumers would be flocking back to restaurants, sending grocery sales back to pre-COVID levels. Thus, company stakeholders justifiably had some concern about profitability and cash flow in the second half of the year.

Alas, COVID did not fade away. Grocery demand remained robust, sales remained elevated, food companies were able to begin raising prices, and profit margins, on average, showed little sign of compression. The simple average of operating profit margins from 66 publicly traded food manufacturers/processors shows that profit margins remained strong and even widened in calendar Q3 of 2021 *(Exhibit 4).*

Recent earnings guidance from food manufacturers suggests strong profit margins will persist when Q4 results are unveiled in the coming weeks. In fact, strong unit sales – on top of product-line rationalization and early pricing actions – likely drove many food companies to record incomes in 2021. Admittedly, many of these companies also supply to the food service segment, but in 2021, food service spending was still below 2019 levels. Thus, we would posit that the strong food manufacturing profitability is being driven by the retail grocery segment.

Note that since the initial COVID wave in March of 2020, total weekly grocery sales have averaged 15% higher than pre-pandemic levels *(Exhibit 5).* Moreover, since the initial "hoarding" period eased in late summer 2020, sales have actually been trending upward. And, despite the higher prices, per USDA/IRI scanner data, September-November equivalent unit sales increased by 1.8% versus the year prior. With demand and sales this strong, food manufacturers have not needed to rely on discounts or promotions to boost sales, which provides another bump to the bottom line.

2022 Outlook and Implications

USDA is projecting a return to more "normal" farm commodity inflation rates of 2%-4%, which in the case of meat, poultry, and eggs would represent a major slowdown in cost escalation. But note USDA is not projecting a general decline in prices in any segment other than fruits. (USDA's forecasts are largely in line with CoBank's in-depth commodity analysis presented in the 2022 Year Ahead and January 2022 Quarterly publications). Looking at energy costs, the Energy Information Administration is projecting 2022 commercial natural gas prices to average 4.1% above a year ago and diesel prices to be unchanged. Given recent price movements, those projections will likely need to be revised upward.

On the supply chain side, there appears to be little optimism on the horizon with shoppers again facing empty grocery shelves – IRI recently reported 15% of food items are out of stock nationally.[2] The omicron variant is causing labor shortages across the food chain, from the plant to the warehouse, truck, and grocery store.

In the trucking market, van and refrigerator truck ("reefer") rates were up 25% and 30% respectively in December 2021 versus a year ago.[3] Container ship delays are as bad today as they have been in the past year as ports struggle with omicron-related labor shortages.[4] That could worsen if China is unable to keep a handle on omicron outbreaks as the nation celebrates the Lunar New Year and hosts the Olympics in quick succession.

The general consensus among economists is that wage rates will continue to rise in the coming months. In January, wages rose a whopping 5.7% year-over-year as unemployment steadied at 4.0% all while another 3.9 million workers quit their jobs and companies posted 10.9 million open positions in December.

At the grocery store, prices will likely continue their upward trend in Q1 as previously announced 5%-15% re-pricings kick in. General Mills, Hain Celestial, Conagra, and Campbell Soup announced price increases that would take effect at the beginning of 2022. Kraft Heinz just reported another round of price hikes across its portfolio, and we expect similar guidance when other food companies report earnings in the coming weeks.

While food manufacturing Producer Price Index (PPI) was still at 12% in December, it appears to have plateaued in recent months. We believe that consumer food spending habits, firmly entrenched after two years of the pandemic, will persist for a good while even if COVID fades into the background by mid-year. The combination of tailwinds from the pricing actions now taking full effect with the continuing strong consumer demand means retail food manufacturers will continue to enjoy strong profits in 2022.

We also expect CPI for food at home to persist in the 5%-6% range throughout 2022, which would be the highest annual level in at least 30 years. If this scenario holds true, it will surely be one of the big stories of the 2022 election cycle.

References

[1] KPMG Consumer pulse survey | Grocery forecast 2022 (kpmg.us) Downloaded Jan 18, 2022. https://advisory.kpmg.us/articles/2022/consumer-pulse-survey-grocery-forecast-2022.html

[2] IRI CPG Demand Index - U.S. (iriworldwide.com) https://indices.iriworldwide.com/covid19/index.html?i=0

[3] DAT Freight and Analytics: Trucking Industry Trends - DAT Downloaded Jan 18, 2022. https://www.dat.com/industry-trends/trendlines

[4] Containers take up to twice as long to reach their destination (freshplaza.com). Fresh Plaza, Jan. 19, 2022. https://www.freshplaza.com/article/9391704/containers-take-up-to-twice-as-long-to-reach-their-destination/

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