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OUR VIEW

The sudden and very sharp descent into recession over the last year, together with the rapid decline in retail food inflation has relegated discussion of the price and affordability of food to the background. This is understandable but the two events are not unrelated. One of the effects of the high rate of retail food inflation – as revealed in previous issues of VIEW – has been the sharp deterioration in the affordability of food after more than a generation of steady improvement. Now that the rate of increase in retail food prices is falling towards zero it is tempting to conclude that the affordability of food will soon revert to its longer-term improving trend. We are not so sanguine.

In our view, even on the basis of an optimistic future scenario, the recession has resulted in a permanent loss of food affordability for consumers. The impact of this for farming and food businesses will be an ongoing shift in their focus away from developing value added opportunities towards delivering greater value for money and a greater emphasis on production and supply chain efficiencies.

We define the affordability of food as the amount of their expenditure consumers' would have to devote to food in order to maintain a given volume and quality of food. In essence, the steady improvement in the affordability of food until 2006 reflected the fact that the rate of increase in retail food prices was less than the rate of increase in consumers' expenditure. This was sharply reversed in 2007 when the effect of retail food inflation took hold and just as the rate of increase in food prices is slowing, so the beneficial effects are being more than offset by the recession induced fall in consumers' expenditure. Whether or not the affordability of food resumes its longer-term improvement depends critically on the speed of economic recovery and the future performance of agricultural prices.



ROUTE OUT OF RECESSION

Figure 1: Real GDP recovery trajectories

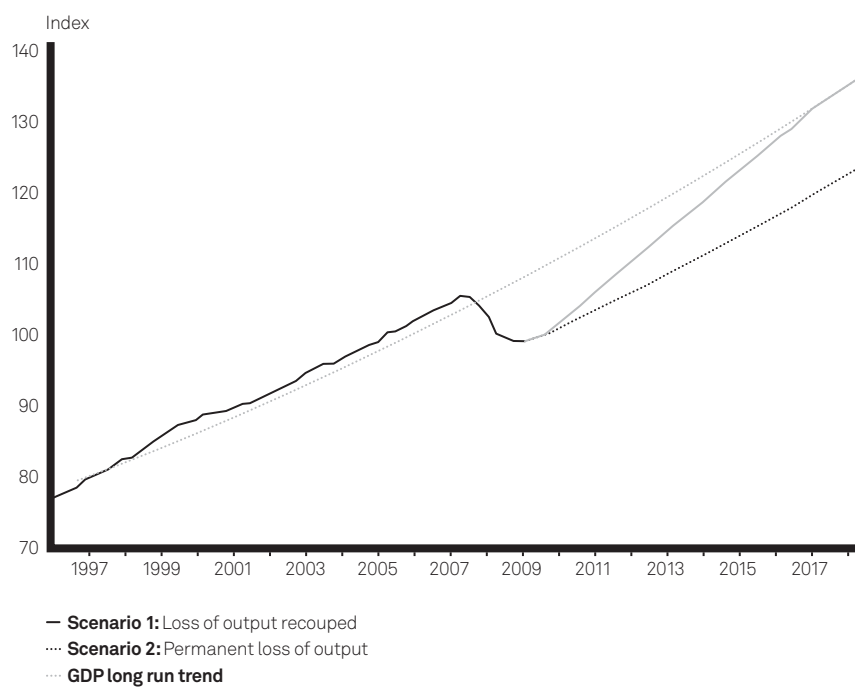
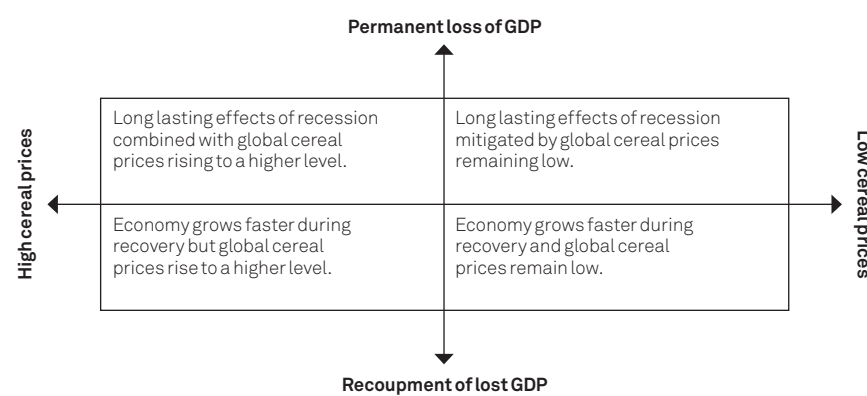


Figure 2: Four alternative futures



There is growing confidence that we are now over the worst and the outlook for the economy is now one of recovery. But great uncertainty remains as to the manner and length of the recovery. The IMF in its latest World Economic Outlook examines the recoveries from recessions caused by financial crises. It concludes that... the current recession is likely to be unusually long and severe and the recovery sluggish. If the extent and speed of recovery is uncertain so is the pattern of future agricultural prices. Following the substantial spike in global cereal prices in 2008 the world has benefited from two record harvests. As a result the stocks-to-use ratio has improved and UK cereal prices have fallen back though they remain some 25 per cent above their average level for the ten years to 2007. But many of the forces that contributed to the 2008 price spike remain in place. Most notably, global demand continues to rise in response to economic and population growth in developing countries while a host of factors ranging from water scarcity to energy prices and climatic change are threatening to constrain the longer-term supply response. In short, the easing of global grain prices looks more like a temporary respite and we are very much in accord with the OECD-FAO view that, over the next ten years, wheat prices will average out some 20 per cent above their 1997 – 2006 levels in real terms ie, after allowing for inflation.

The decline in the affordability of food since 2007 does not mean that consumers have reduced their expenditure on food. On the contrary, over the first half of this year total consumers' expenditure fell 2.2 per cent whereas expenditure on food rose 4.9 per cent. This reveals the fact that food is a necessity and food inflation started the year in double figures. Anecdotal evidence from leading multiples suggests that the 'flight to value' which characterised consumers' food expenditure over the past year might now be reversing. It is, however, too early to conclude that food expenditure will now display a rapid return to its pattern prior to 2006. The recession has yet to run its course, unemployment will continue to rise well into next year and all the signs are that current monetary and fiscal stimuli will be eased back over the coming months. In short, if the recession proves to be long and drawn out and the current levels of global grain prices prove to be temporary it will be many years, if ever, before the affordability of food returns to its 2006 level.

It is not possible to forecast how the economy and food expenditure will perform over the next decade and the accepted technique for analysing longer-term outcomes is scenario planning. We have used the technique to assess four alternative outcomes for the affordability of food. The affordability of food in the UK over the next decade will ultimately be determined by two key drivers: the extent and pace of economic recovery; and the level of agricultural prices. Recessions always involve a fall in a country's GDP but generally this persists for about a year and is then followed over a period of years by above average rates of growth so that eventually the economy recovers its full potential: this is shown as Scenario 1 in Figure 1. However, as observed by the IMF recessions caused by financial crises are much more severe and if the shortfall in demand persists it can do lasting damage to a country's ability to supply: the effect of this is shown as Scenario 2 in Figure 1 whereby the economy suffers a permanent loss of output.

See Figure 1



Figure 3: Cereal price scenarios

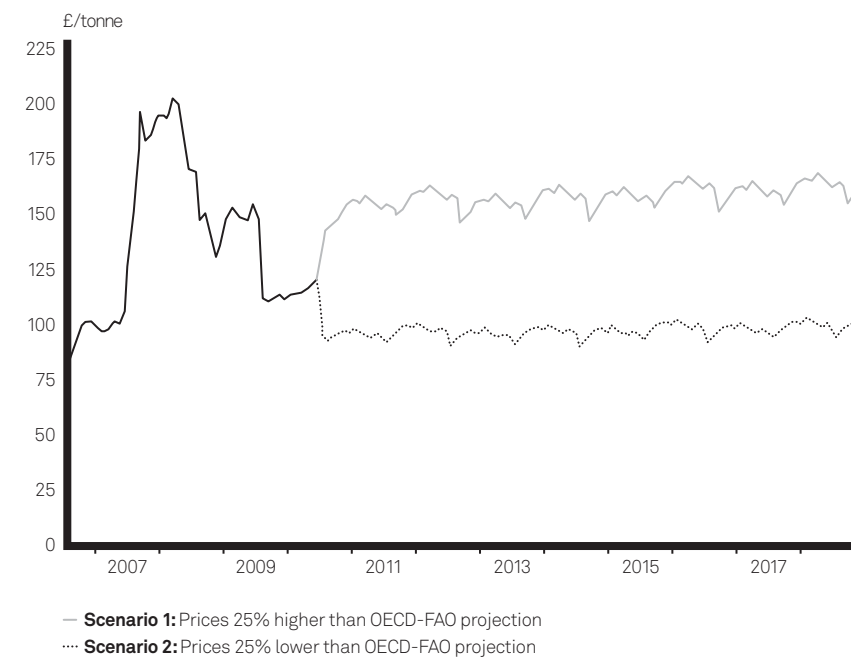
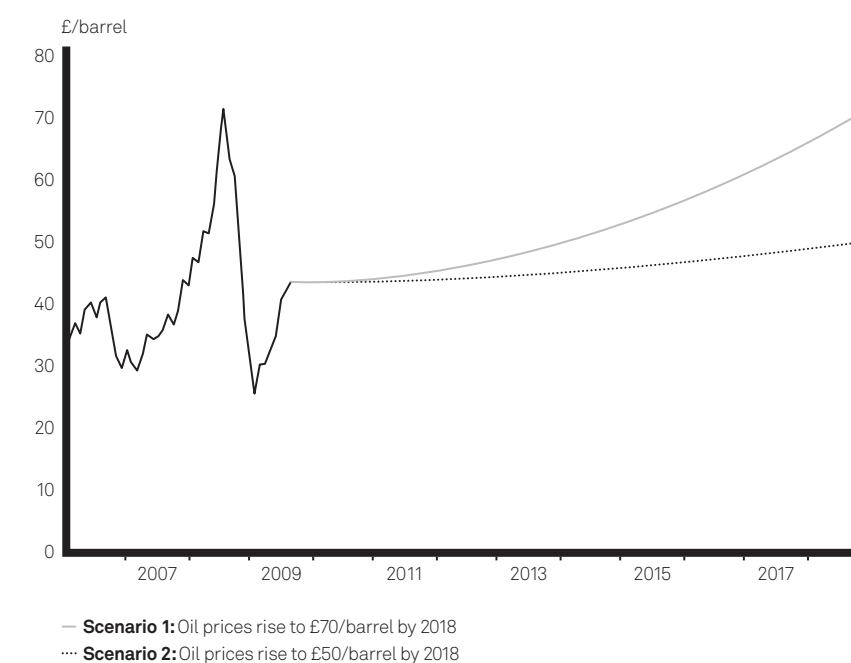


Figure 4: Oil price scenarios



The relevance of Figure 1 to our scenarios is that the growth of GDP is the major influence on consumers' expenditure, though the fear of unemployment and high interest rates are influential. We would expect total consumers' expenditure to rise faster under Scenario 1 than under Scenario 2 in Figure 1 but in both cases the growth of expenditure would be lower than the 4.7 per cent it averaged in the years immediately prior to 2007. Just what the effect of these two GDP scenarios would be for the affordability of food depends on retail food inflation. Over the longer term this is largely determined by the general rate of inflation and cereal prices. We have argued in previous editions of VIEW that the level of cereal prices is the major influence on the prices of meat and dairy products. Hence to complete our affordability scenarios we include two alternative outcomes for the level of cereal prices. This yields the four scenarios set out in Figure 2.

See Figure 2

As indicated above we have been broadly guided by the IMF in our GDP recovery scenarios and for cereal prices we have used as our benchmark projections published by the OECD-FAO. For our 'high' cereal price scenarios we have assumed that wheat prices will average out 25 per cent higher – in real terms – than the level projected by the OECD-FAO for the period 2010 – 2018. For our 'low' cereal price scenario we have assumed that real cereal prices will average out 25 per cent below the level projected by the OECD-FAO. Figure 3 shows the effect of these two cereal price projections.

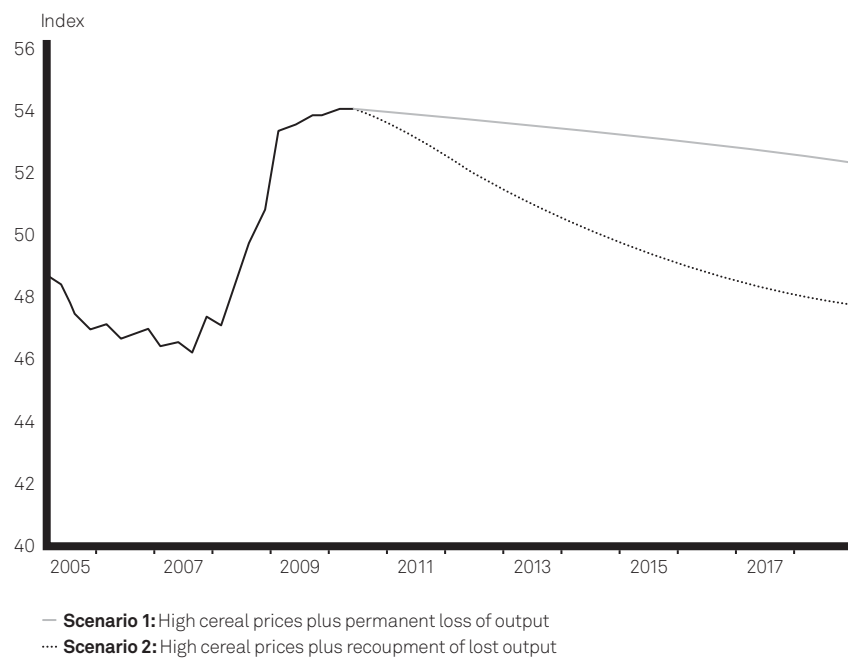
See Figure 3

In order to translate the cereal price scenarios into retail food prices we have used the EFP Retail Food Price model. This requires, in addition to cereal price projections, assumptions regarding crude oil prices as well as sterling's effective exchange rate and the general rate of inflation. We have taken note that high oil prices are correlated with high cereal prices; thus, for the high cereal price scenarios we have set oil prices on a rising trend culminating in a price of £70 a barrel by 2018; see Figure 4. For the lower cereal price scenarios we have assumed a price of £50 a barrel by 2018. We have left sterling's effective exchange rate unchanged from its current level over the period and we have assumed that the Bank of England continues to prevent the general rate of inflation rising above 2 per cent over the period.

See Figure 4

1987

Figure 5: High prices scenarios



The effect of these scenarios on the affordability of food is shown in Figures 5 and 6. In all cases as economic growth resumes so the affordability of food starts to improve. This is because over the coming year retail food inflation will remain subdued. Under our scenarios the price of cereals is not subject to inflation – save for the period in which cereal prices rise to their higher level – and consequently whether we are considering the high or low cereal price scenarios eventually the rate of food inflation converges towards the underlying rate of inflation in the economy.

Figure 5 shows the outcome for the two recovery trajectories when cereal prices are high. As cereal prices remain high but stable over the period rising consumer expenditure has the effect of improving affordability. Nevertheless, even with a full recoupment of lost output it is not until 2018 that affordability returns to its 2007 level.

See Figure 5 and 6

Figure 6: Low prices scenarios

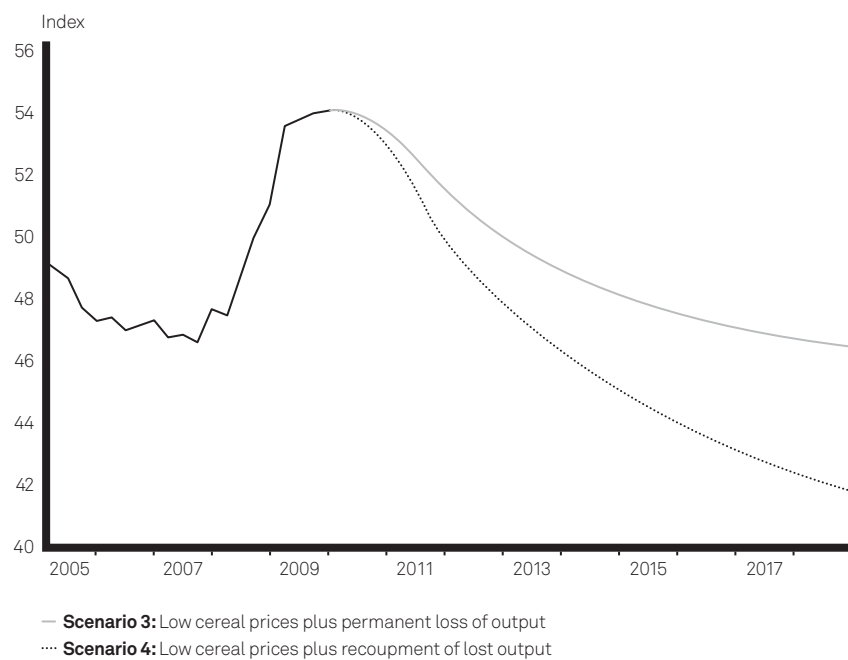


Figure 7: Affordability in perspective

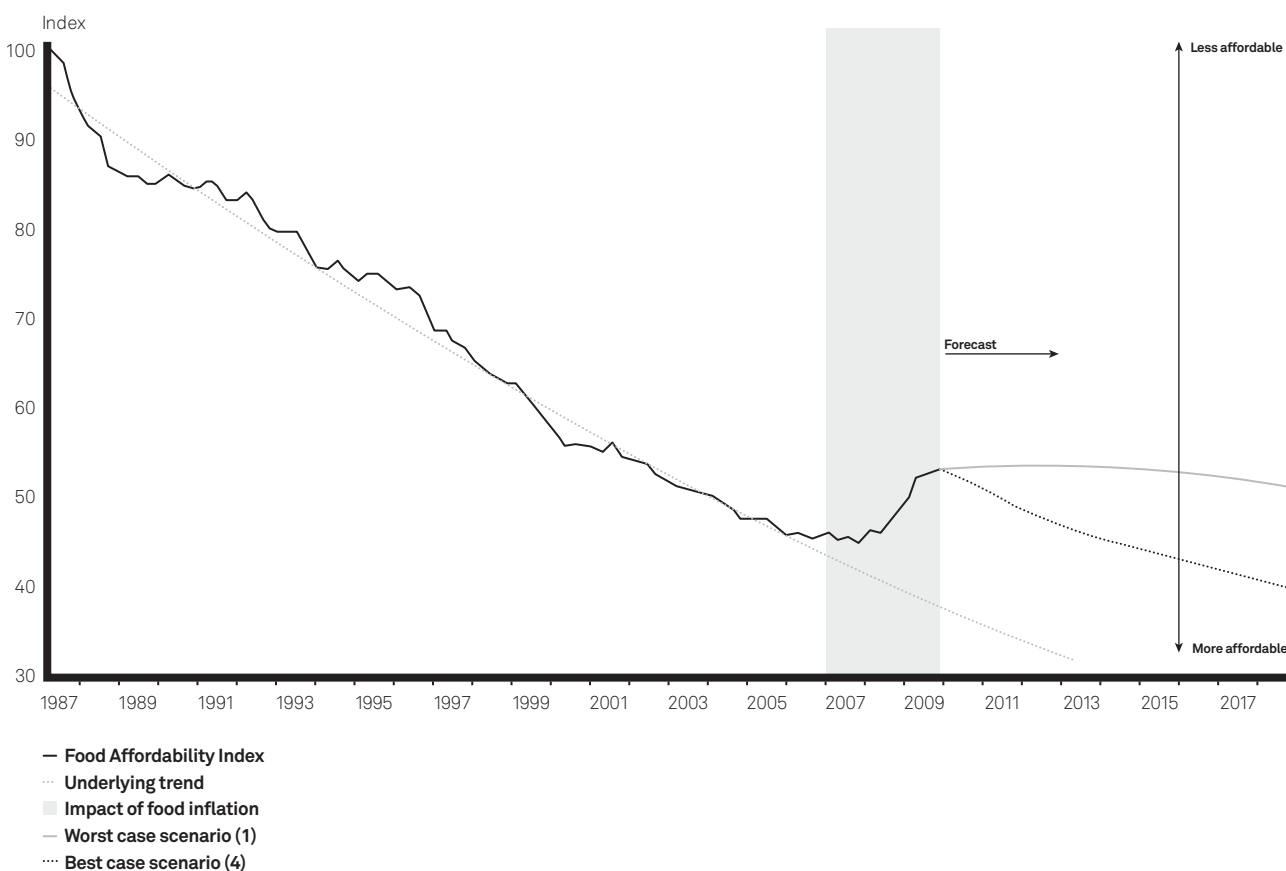


Figure 6 shows the outcome for the two recovery trajectories if cereal prices remain low. Under these price scenarios even with a permanent loss of output, affordability returns to its 2006 level by 2018 and demonstrates a significant improvement if the lost output is recouped. However, the projected improvements in affordability need to be placed in perspective. Figure 7 shows the outcome for scenarios 1 and 4 (from Figures 5 and 6) against the longer-term trend in affordability. After many years of significant improvement the rapid reversal in affordability in 2007 and 2008 can clearly be seen.

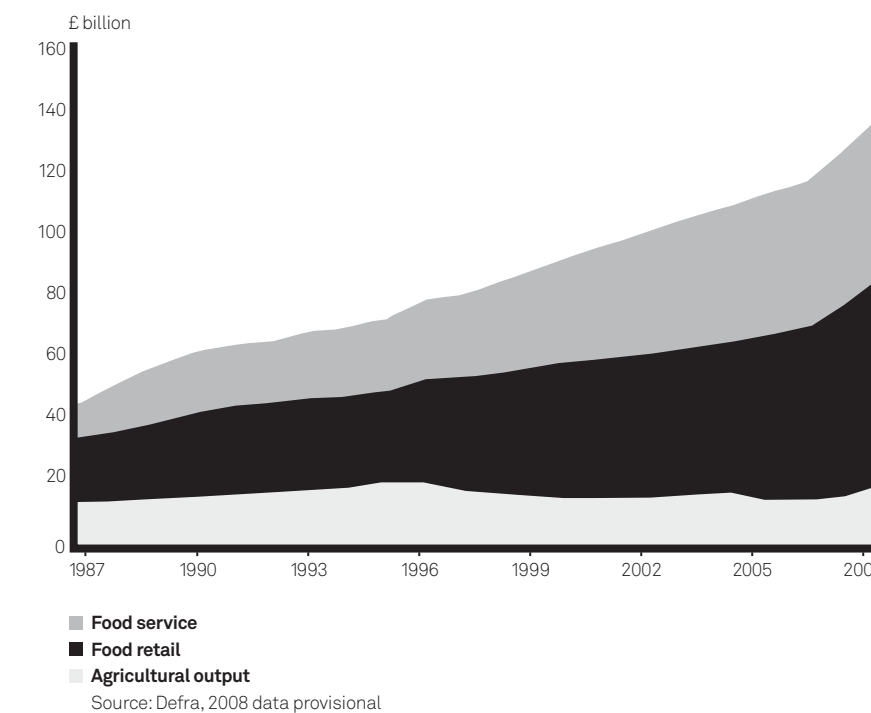
Even on the basis of our most optimistic scenario there is a permanent loss of affordability and under the more pessimistic scenario 1 it is possible that for the foreseeable future there would be only a very modest improvement in the affordability of food.

See Figure 7

THE STRATEGIC IMPLICATIONS FOR FARMING AND FOOD



Figure 8: The value of household food expenditure, food eaten out of the home & agricultural output



We now consider the strategic implications of the four scenarios outlined above for farming and food businesses. Our approach, based on Figure 8, is first to briefly examine the implications of improving affordability in the twenty years to 2006 before looking at how the situation changed between 2007 and 2009 and then the implications of the alternative futures implied by our scenarios over the next ten years.

1987 – 2006: an age of prosperity

Between 1987 and 2006 the combination of steady economic growth and benign agricultural commodity prices increased the affordability of food which in turn created a host of value adding opportunities for food and farming companies. As food expenditure became less of a burden on household expenditure, consumers were able to indulge their preference for variety and quality and food and farming companies responded with vigour to the potential. For example, by developing products espousing health benefits (eg, pro and pre-biotic drinks); lifestyle aspirations (eg, premium products, organic food); ethical considerations (eg, environment, fair trade and animal welfare) and provenance. Thus the growth of food expenditure, up from £42bn in 1987 to £113bn in 2006 – see Figure 8 – reflected in large measure the emergence of niche markets boosting opportunities for margin growth in individual supply chains. Faced with such opportunities the dominant strategic focus for food companies was to create and capture value by extending and stretching their brands to new products.

2007 – 2009: change and uncertainty

As can be seen from Figure 8 the impact of food inflation was a marked increase in the growth of expenditure on food. Reflecting the rise in global commodity prices the value of UK agricultural output increased by 37 per cent over the last three years shown in Figure 8. Over the same period retail food expenditure and the value of food service sales increased by 29 and 14 per cent respectively. The period 2007 – 2009 also witnessed rapidly rising energy prices so what Figure 8 implies is that some of the increase in the prices of agricultural products were absorbed by food companies placing their margins under pressure.

The sudden deterioration in the affordability of food also brought to a rapid halt the growth of niche markets as consumers traded down to more basic food products. In responding to the changing demands both food companies and retailers had to revise their strategies introducing 'value' ranges and seeking new efficiencies to limit the pressures on margins. Since the early months of this year – as we demonstrate on page 13 – retail food price inflation has been falling rapidly largely due to falling agricultural prices and we now expect the rate of increase to be negative by the end of the year. However, as the fall in raw material prices has been very marked – along with lower energy prices – the current situation has created scope for food companies to rebuild their margins. It is worth emphasising that the fall in food prices is forecast to be marginal; consequently the level of food prices will remain more-or-less unchanged and the affordability of food will not improve. Put simply the food chain now faces the challenge of high food prices and a prolonged recovery from recession.

2020



A FOCUS ON THE SUPPLY CHAIN

The foregoing implies that the outcome under our four scenarios will be very different for the separate stages in the supply chain. A future in which agricultural products are plentiful and cheap will benefit food companies and their customers but it will lead to hardship and far reaching structural change at the farm level. If agricultural prices are entering an era of high prices then the benefits will be reversed with food companies and their customers seeking cost savings and security. Just how the separate stages of the food chain react to these two scenarios will depend on the extent and speed of recovery in consumers expenditure post the recession. Adaption and profits are more easily achieved in periods of buoyant consumers' expenditure whereas a slow recovery will intensify the competition for market share. Indeed, the combination of low agricultural prices and a sluggish recovery could spill over into price wars offsetting the scope to maintain and improve margins.

Whatever scenario turns out to best represent the future it is clear that all sectors of the chain have an interest in improving efficiency by raising productivity and eliminating waste. The evidence is now overwhelming that achieving world class levels of efficiency necessitates investment in collaborative and longer-term relationships between supply chain partners. Arguably the main source of pressure for closer relationships will vary according to the particular scenario and these are set out in Table 1. It is also the case that whatever the extent and speed of recovery there is always potential advantage to be gained from innovative value creating offers. But again the prime source of interest in such strategies would in our view vary according to which of our four scenarios turns out to best represent the future. We have attempted to capture these nuances in Table 1 to show how the response might vary at different stages in the chain under the alternative scenarios. We have also sought to summarise the general supply chain response.

2010–2020: A new normal?

Shifting from a short-term to long-term focus reveals different pressures and while things will tend to get back to normal it will be a 'new normal'. The challenge for food and farming will be to create value in the long and slow route out of recession that lies ahead. Whilst the worst may be over for the general economy it will not be back to business as usual for farming and food. In the last two years the industry has lost over five years worth of improvement in the affordability of food and this has constrained the scope for value creating opportunities that the industry has enjoyed over the twenty years to 2006. Indeed, the scope will remain severely constrained if recovery is very slow. This new era starts with retail food prices some 22 per cent higher than their level at the start of 2006 and enormous uncertainty as to the extent and speed of economic recovery. For consumers the choice is stark: they must either part with a greater proportion of their income to sustain their food consumption preferences or – out of necessity – they must reduce their food expenditure.

Under our most optimistic scenario (number 4 – see figure 6 on page 6) where the economy is able to recoup lost output and agricultural commodity prices are benign, affordability returns to trend and we might characterise this scenario as a return to 'business as usual'. Under our most pessimistic scenario (number 1 – see figure 5 on page 6) where agricultural commodity prices are high and the economy suffers a permanent loss of output food affordability appear unlikely to reach 2006 levels in the foreseeable future. Scenarios, as observed above, are not forecasts but rather opportunities to explore the strategic implications of alternative futures. It is possible as indicated by scenario 4 that as far as consumers and food companies are concerned the patterns of the last twenty five years will soon re-emerge but it would be unwise and dangerous for any food company to attach a very high probability to this outcome. At the very least prudent food companies should consider how they might refine and adapt their strategies if the harsher of our scenarios turns out to better represent the longer term future.

If the future is one in which factors combine to slow the growth of total consumers' expenditure significantly below the rate of the last ten years and the global balance between the supply and demand for agricultural products is such that their prices settle at levels considerably higher than has been the case prior to 2007 then both consumers and food companies will need to fundamentally adjust to what will be a new era of austerity. In such a future, food companies will face much intensified competition for market share and margin pressure emanating from the high price of agricultural products. The winners in this environment are likely to be those businesses that achieve super levels of efficiency and have the capability to seek and exploit innovative sources of value creation.

There is a second dynamic to our scenarios involving higher prices for agricultural products; namely, world markets would become an attractive option for UK farmers. Higher raw material prices imply scarcity and greater volatility. The extent to which farmers gain under such scenarios depends on the price level of their inputs eg, fertilizers and energy, but there can be no doubt it would lead to far reaching change in the relationships between farmers and their downstream customers. After a generation of strategies based on a plentiful supply of raw materials food companies would need to give a much higher priority to securing their raw materials. To our minds in such a future the benefits of supply chains working in partnership towards a common goal could not be exaggerated.

Table 1: Outcomes of alternative futures

Scenario	Farmers	Processor/manufacturer	Retailer/food service	Supply chain focus
1. High cereal prices and permanent loss of GDP.	Incentive to increase production but growing opportunities in export markets.	Acute margin pressure from supply and demand side; focus on securing raw materials and unit cost reductions.	Margin pressure leading to innovation and intense rivalry to protect and secure market segments.	<ul style="list-style-type: none"> Improve productivity and efficiency. Security from upstream relationships. Intense competition to protect market share.
2. High cereal prices and recoupment of lost GDP.	Incentive to increase production for both export and domestic markets.	Potential to ease margin pressure with value adding opportunities but need to secure raw materials.	Higher consumers' expenditure but also innovation to counter high prices and raise margins.	<ul style="list-style-type: none"> Improve productivity and efficiency. Security from upstream relationships. Product and process innovation.
3. Low cereal prices and permanent loss of GDP.	Acute income pressures, rapid structural change and search for customer relationships.	Balancing value added opportunities with demands for value while securing advantage with upstream relationships	Competition to protect and secure market share plus greater focus on value segments.	<ul style="list-style-type: none"> Improve competition to secure market share. Avoid temptation to initiate a price war. Competition to secure market share.
4. Low cereal prices and recoupment of lost GDP.	Income pressures, focus on greater efficiencies and search for partner relationships with key customers.	Emphasis on developing value added products and securing advantage through upstream relationships.	Competition to increase market share and innovation to capture discretionary consumers' spending.	<ul style="list-style-type: none"> Product and process innovation. Avoid temptation to initiate a price war. Local advantage from upstream relationships.