




# Food Industry Outlook

OUTLOOK:  Positive fundamentals & outlook

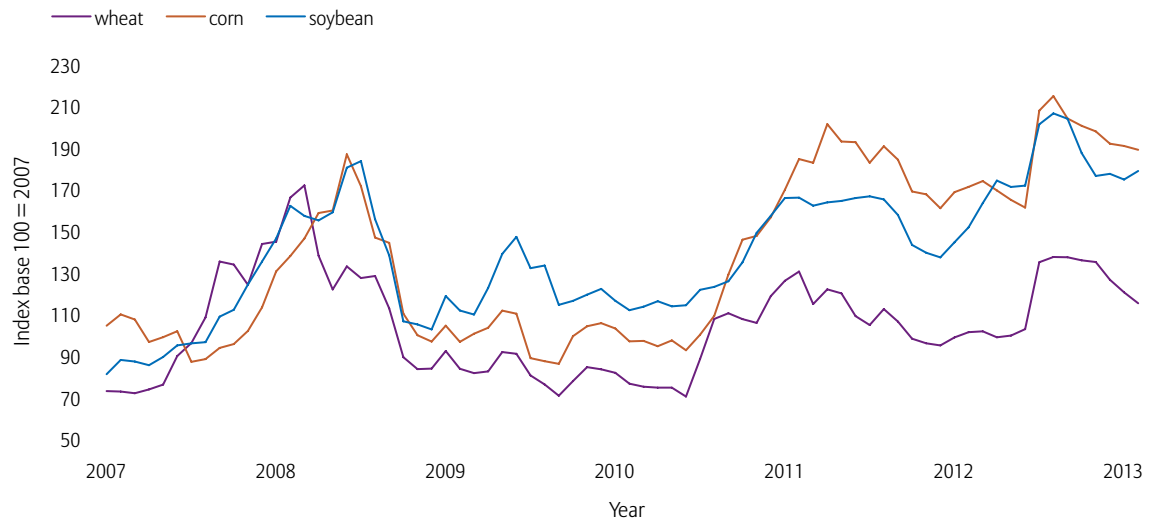
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# Key Points

- Food manufacturers and retailers are caught between high and volatile commodity prices and cash-strapped consumers.
- Traditional grocery chains continue to face competitive pressures from big box retailers as well as from a shift of consumer spending to purchases at restaurants, schools and work cafeterias.
- Debt reduction will be the focus for many large packaged food makers after several large brands changed hands over the past 12 to 24 months.

Commodity Prices Index: Wheat, Corn, Soybean



Source: CME



# Overview

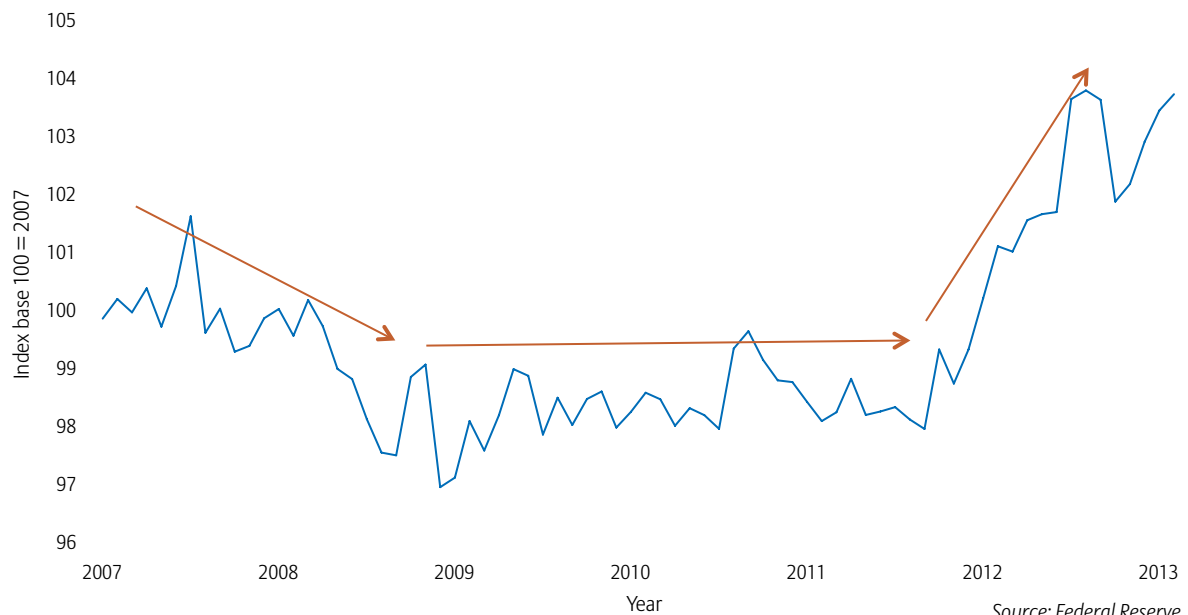
Over the past few years, the U.S. food sector has experienced volatile commodity prices which have led to fluctuating margins and profitability. In spite of these challenges, overall cash flows throughout the industry have remained strong, leading to healthy mergers and acquisitions (M&A) activity in various sections of the supply chain. The drought during the summer of 2012 led to fears of record high food prices, though the impact was mostly felt in beef and poultry. Other food products are expected to see rising prices in 2013.

During 2012, the food industry saw a 3.7% increase in manufacturing output while beverages saw a 3.8% increase in output, with strong contrasts between subsectors. While sugar and confectionary products manufacturing outperformed the sector with a 8.1% increase in output, meat slaughtering posted a limited increase (+0.5%) and grain/oilseed mills stagnated

(-0.1%). Food manufacturing output is expected to grow by 2% in 2013.

At the start of 2013, much of the Midwest was still experiencing severe drought conditions, though a heavy storm in April provided some much needed relief. Despite this, uncertainty surrounding commodity prices remains due to a larger than expected supply of corn and farmers planting on more acres than in the past. This volatility was felt in late March 2013 as corn prices saw their biggest drop since 2009. As major food makers are raising prices in an attempt to recover some of the margin erosion that they saw in the recent past, private label brands are offering consumers a viable option with minimal switching costs. In addition, consumers are continuing to shift spending from grocery stores to restaurants and other food-away-from-home establishments, reflecting a rebound in consumer confidence as well as a change in American lifestyle.

## Food Manufacturing Production Index



## Production by Subsector

Annual change in production	Food	Animal food	Grain and oilseed milling	Sugar and confectionery product	Fruit and vegetable preserving and specialty food	Dairy product	Animal slaughtering and processing	Bakeries and tortilla	Other food	Beverage
2007	0.5%	-0.8%	5.1%	-5.8%	2.9%	3.3%	-0.6%	-2.2%	2.2%	5.9%
2008	-1.3%	5.4%	3.9%	-8.7%	-3.0%	0.7%	0.6%	-5.0%	-1.8%	-4.8%
2009	-0.6%	2.8%	6.6%	-4.3%	-2.3%	-1.1%	-2.1%	-2.4%	-1.0%	3.6%
2010	0.4%	-1.0%	-2.1%	9.4%	-3.8%	2.3%	0.4%	0.5%	2.1%	-1.2%
2011	-0.1%	-2.9%	-7.8%	-1.1%	-0.4%	0.2%	3.0%	-0.3%	2.9%	4.7%
2012	3.7%	7.4%	-0.1%	8.1%	4.4%	2.5%	0.5%	3.9%	7.0%	3.8%

Source: Federal Reserve

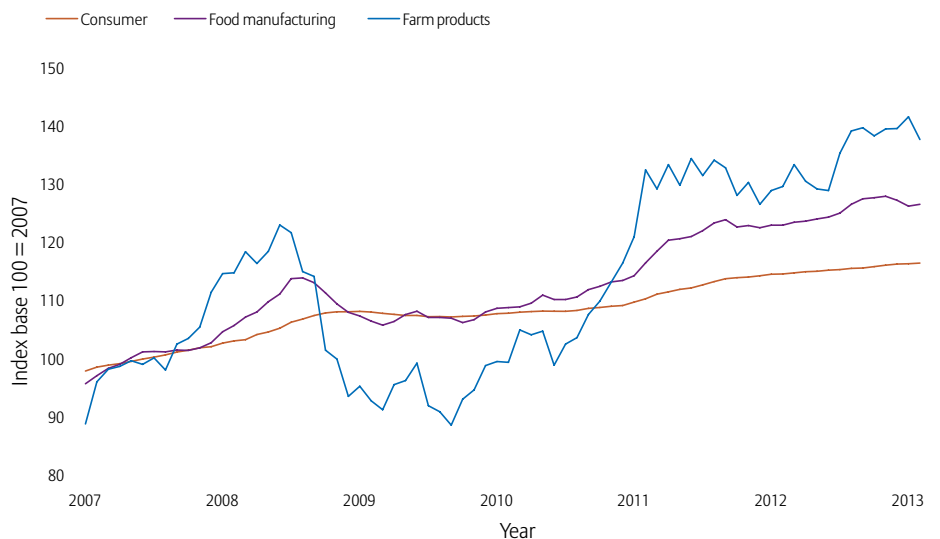
## Current Situation

The Consumer Price Index (CPI) for all food prices in 2012 increased 2.6%, which came in at the lower end of the U.S. Department of Agriculture's (USDA) 2012 forecast of 2.5 to 3.5%. The summer drought did not have as great an impact on overall food prices as was expected, largely due to smaller than anticipated increases in some items and even a decline in prices for others. Fruits and vegetables, which were expected to increase by 2 to 3%, saw prices drop by 0.6%, led by a 5.1% decrease in fresh vegetables prices. Cereals and bakery products also came in below projections with a 2.8% increase in prices. The drought's impact was expected to be felt the most in meats and dairy products, though both finished the year at the lower end of projections with increases of 3.6% and 2.1%, respectively. Beef and veal saw an increase of 6.4%, well above the initial projections, and poultry prices surged 5.5%, also above initial projections. These were offset by pork prices remaining essentially flat and a modest 2.4% increase in fish and seafood prices, which were below the initial projected increase of 4 to 5%.

According to the USDA, the drought has impacted prices for corn, soybeans, and other field crops which should, in turn, drive up retail food prices going forward. However, the impact of commodity price changes on retail prices typically takes several months to occur, and most of the impact of the drought will be realized in 2013. The CPI for all food is projected to increase 3 to 4% in 2013, driven by a 3 to 4% increase in meat, poultry and fish prices as well as a rebound in fruit and vegetable prices. An unusually cold January in California has impacted citrus, berries, and some vegetable crops, driving prices up for these items.

Rising food costs have negatively impacted margins throughout the industry. Most grocers are unable to fully pass on higher prices to consumers while large food companies such as Kraft and General Mills have to compete with low-price private label brands. In addition, as the economy is gradually recovering from the recession, consumers are shifting their food spending to restaurants.

### Food Price Changes



Source: Bureau of Labor Statistics



## Subsector Outlook: U.S. Packaged Foods

Many packaged food companies implemented price increases during 2012 in an effort to offset the inflationary pressure faced over the past twelve to twenty-four months. While a majority of companies were not able to fully offset higher commodity prices in 2012, they should be able to recoup some of the margin erosion in the coming year as the pricing actions will be in effect for the full year. The Hershey Company was successfully able to raise prices in 2011, which led to solid results in 2012 including an expanded gross margin, earnings growth, and greater cash flow generation. This has allowed them to lower debt levels as well as pursue acquisitions that will further fuel growth.

M&A activity was vibrant last year, as several major brands changed hands, including Kellogg's acquisition of Pringles, Campbell Soup's acquisition of Bolt House, and Con Agra's acquisition of Ralcorp, among others. The acquisitions have led to rising debt levels and debt reduction is a priority going forward. These companies hope to follow in Hershey's footsteps by realizing the full-year effect of price increases and using the improved cash flow to deleverage. In addition, Kellogg's and Campbell Soup have already committed to rein in share repurchases to free up additional cash for debt reduction, and Con Agra is likely to follow suit. According to Fitch, most of the acquiring companies maintain stable ratings and should see leverage return to pre-acquisition levels in about two years.

Packaged food companies are expected to see slow growth in developed markets, though cash flow generation should remain at healthy levels. In the U.S., several companies, have increased or are increasing marketing efforts to promote brand equity and fend off increasing competition from private label brands. Emerging markets continue to offer a greater growth opportunity as middle classes are expanding across several regions.

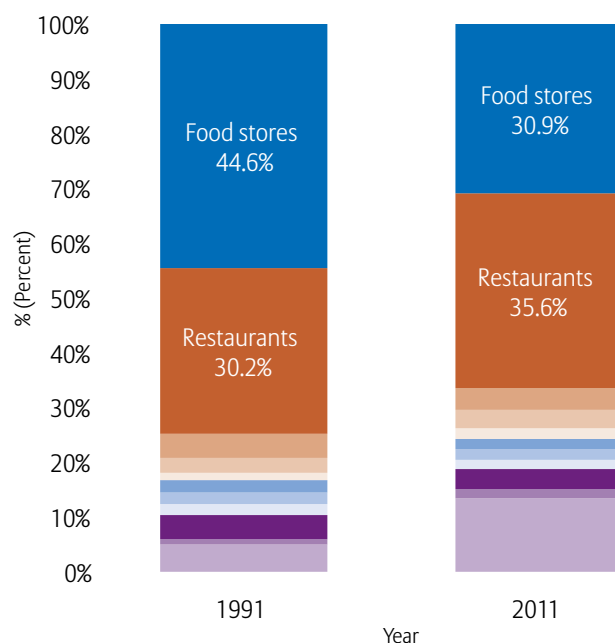
## Subsector Outlook: U.S. Food Retail

According to the USDA, total food retail sales, including food-at-home and food-away-from-home, grew by 8.8% in 2012 to \$1.35 trillion. Food retail sales have grown 18% since 2009, reflecting higher food prices and coinciding with the end of the recession. Approximately 53% of food retail sales were from the food-at-home category with the remaining 47% from the food-away-from-home segment. The USDA is forecasting a 4% increase in food-at-home prices and a 3.5% increase in food-away-from-home prices, largely due to

the impact of the recent drought conditions on commodity prices. Traditional grocery stores (i.e. Kroger, Safeway, SUPERVALU) have seen their share of the food retail pie shrink from approximately 45% to approximately 31% of total sales over the past twenty years, primarily due to an increase in competition from superstores like Walmart and Target and wholesale club stores like Costco. In addition, a greater percentage of the food retail dollar is being spent away from home at restaurants, hotels and schools.

Going forward, traditional grocery stores are facing a challenging environment in which they face volatile commodity costs as well as more frugal customers. IBISWorld industry research is projecting a paltry 0.4% annual growth rate through 2017, largely due to price competition from within as well as continued competition from supercenters and food-away-from-home establishments. Profit margins have seen deterioration over the past several years as big box retailers have lowered prices to woo customers. Traditional grocery stores have attempted to compete on price as well as with loyalty memberships, aggressive couponing and gas incentives. In addition, several have launched mobile apps that provide weekly promotional updates and create virtual shopping lists. They have also promoted their own private label brands in order to recoup some of the margins lost on national brands and have added a wider variety of prepared food offerings to combat a shift in retail spending towards restaurants.

### Retail Food Sales by Category



Source: USDA

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Positive fundamentals & outlook



Structural weaknesses



Signs of weaknesses



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