Agri-food in the Netherlands: the bumpy road continues

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Executive summary

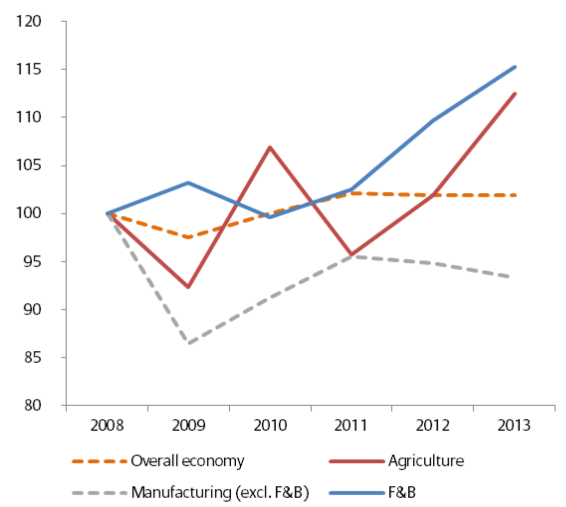
- The agri-food sector plays a key role in the Dutch economy, generating 7.5% of global agri-food exports.
- Although sanctions against Russia are causing turmoil in the industry, the overall forecast for sector exports this year remains positive (+4% in 2014).
- Despite strong exports, the Agri-food sector has come under pressure during the last 4 years: operating margins of food manufacturing companies have fallen by a third (down to 3.2% in 2013).
- Food manufacturers have seen their working capital needs increase by EUR100 mn, due to growing market power of food retailers, however obtaining additional finance has become more difficult pushing the industry to explore alternatives.
- To remain competitive, companies need, more than ever, to innovate, invest in R&D and deliver added value to customers.

Jewel in the crown

The Netherlands is the world's second largest exporter of agricultural products and home to one of the most profitable Food and Beverages (F&B) companies worldwide, such as Unilever, Heineken and Royal FrieslandCampina. Reputed for its productivity and renowned for its strong export orientation, the Agri-food sector is one of the driving forces behind the Dutch economy. Each year the sector accounts for approximately 5% of country's total value added and since 2011, it has constantly outperformed the manufacturing sector in terms of growth of value added (see chart 1).

A tight bond and cooperation between farmers, F&B companies, research centers and the government sets the Dutch Agri-Food industry apart. Companies tend to be concentrated around research centers, which attract the highest private R&D investment in EU, after Denmark. The Dutch government, in turn, identifies agri-food as one of the nine "top sectors" and set an objective to support it.

Chart 1: Value added in Dutch Agri-food and Manufacturing industry (basis 100=2008)



Source: Centraal Bureau voor de Statistiek (CBS)

In 2013, the sector's total export value reached a record level of EUR79bn (+5% compared to 2012). Accounting for a fifth of Netherlands' export value, Dutch Agri-food exports generated around 7.5% of global agri-food exports in 2013. Geographically, the industry's exports are concentrated inside the EU (around 70%), with Germany being the major client: Germany imported 26% of total Dutch agri-food exports in 2013. Both intra and extra-EU trade has shown strong growth in 2013, increasing by +11% and +8% respectively.

This year the industry is likely to feel the repercussions of the events happening on the international stage, notably Russia's food import ban. Although, total industry exports to the Russian Federation have not been very dynamic for the past couple of years, some segments have seen major growth. Dairy products, for example, have been increasing at a CAGR of +27% for the past three years with the biggest growth coming from the exports of cheese (see chart 2). The import ban is likely to increase an already high pressure on prices, causing concern throughout the whole agri-food value chain. Some sub-sectors, such as tomatoes, bell peppers and cucumbers, have been consistently showing signs of oversupply, while the dairy sector is expected to feel strain from the upcoming EU milk quota removal. The Dutch Federation of Agriculture and Horticulture (LTO Nederland) has already issued a statement calling food retailers to avoid lowering prices. Overall, the exports are expected to stay strong, EH forecasts that global Dutch agri-food exports will grow by +4% in 2014.

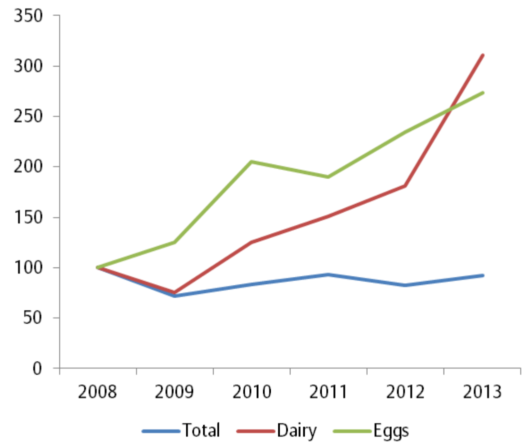
Falling margins

Despite healthy exports, the sector has been under pressure over its relatively small operating margins (3-5%) which make it sensitive to changes in commodity prices. Cost volatility in a slow-growth industry forces food manufacturers to find a balance between increasing prices and lowering costs. This is not an easy task, as the increase in prices has to be agreed upon with wholesalers and food retailers, who are often reluctant, while a further decrease in costs is complicated given the high level of productivity in the sector.

In 2010 there was a major spike in commodity prices (+25% y/y), which lead to a 22% fall in average operating margin in the industry. The food manufacturers responded by increasing prices. However, the increase in producer prices together with a sharp fall in commodity prices was not strong enough to reverse the trend and margins continued to fall in 2011.

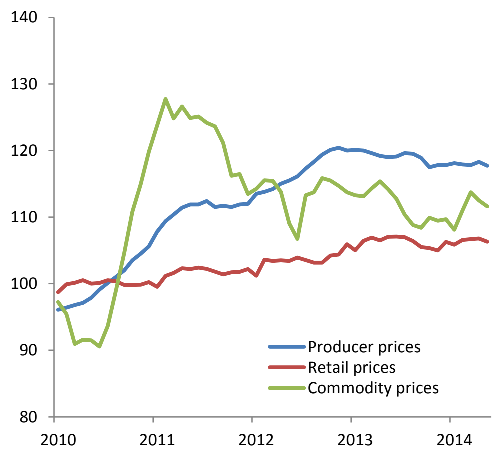
2012 marked a turning point as margins stopped falling, however the downward trend observed in producer prices since the beginning of 2013

Chart 2: Dutch agri-food exports to Russia (basis 100=2008)



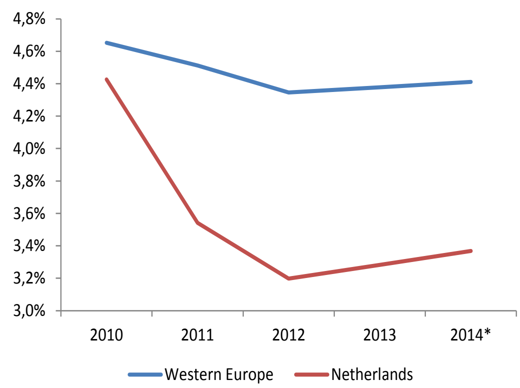
Source: OECD database

Chart 3: Agri-food value chain prices (price index, basis 100=2010)



Source: Eurostat

Chart 4: Average operating margin of food manufacturers (in %)



Sources: Bloomberg, Euler Hermes

suggests that the margins are unlikely to recover any time soon. Overall, the food manufacturing industry has seen its margins decreased by around a third in the last 4 years (see chart 4).

This pressure on the Agri-food sector is reflected in the bankruptcy statistics (see chart 5). Although latest available figures for 2014 show a declining trend since the beginning of the year, significant hikes were seen in 2009-2010 (+72% and +18%) and 2012-2013 (+24% and +6%). Notably, in 2013 Willy Selten (meat wholesaler), Van Luin Food Group (meat products) and Van Rijn Group (fruit and vegetables) filed for bankruptcy, additionally in 2014 with Kruidenier (wholesaler) and Van Hattem (meat) followed suit. Overall, the 2014 industry bankruptcy rates will remain higher than the 10-year average.

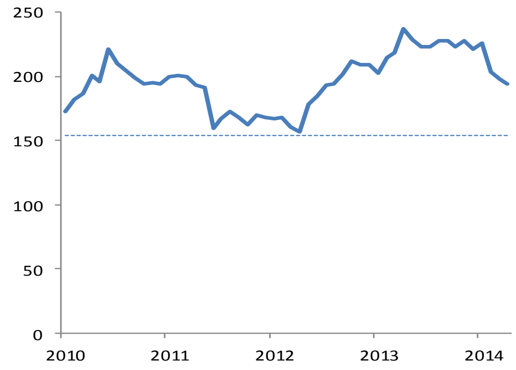
Passing the pain on to suppliers

Declining profitability has been caused to some extent by liquidity problems. The industry has felt the consequence of food retail chains increased market power over the past years. This phenomenon is not limited to the Netherlands, as in most EU countries today the market share of top 3 grocery retailers ranges from 30% to 50%. The Netherlands are clearly among the most impacted (51%) especially since the 2012 consolidation, where Jumbo Groep Holding B.V. took over C1000 stores, becoming the second largest supermarket chain in the country. The Herfindahl-Hirschman Index (HHI), which can serve as a proxy for market concentration, grew by 27% from 2010 to 2013, reflecting the increased concentration after the merger (see chart 6).

Commercial relations between food retailers and their suppliers (farmers, food and beverage companies and wholesalers) have always been a subject of debate. In 2009 a study, conducted by Authority for Consumers & Markets (Netherlands competition authority) and LEI, found no evidence of unfair practices between market participants. However, since then consolidation in food retail has continued, reviving talks of market power abuse. In 2012, a large retailer attempted to introduce a unilateral discount of 2%, which was soon replicated by other retailers leading agricultural producers to fear that wholesalers would lower purchasing prices to offset the discount given to retailers.

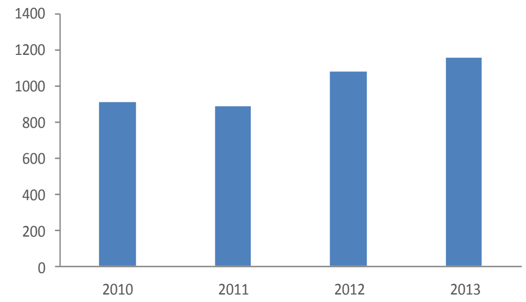
Indeed, the data from Bloomberg for the past four years suggests that there has been pressure on F&B companies to offer better payments terms. For instance, from 2010 to 2013 Days Sales Outstanding (DSO) of food manufacturing companies have risen by 2 days, meaning that the whole F&B industry had to finance additional EUR 100 million per year. The data also suggests

Chart 5: Number of bankruptcies in Agri-food



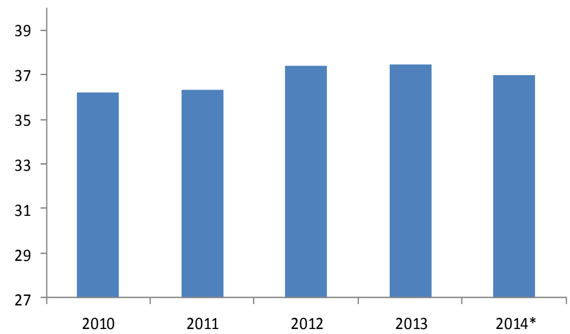
Sources: Centraal Bureau voor de Statistiek (CBS), Euler Hermes

Chart 6: Market concentration in Dutch food retail (Herfindahl–Hirschman Index or HHI*)



Sources: Official statistics, Annual reports, Euler Hermes

Chart 7: Payment terms of Dutch food manufacturers



(*) forecast
Sources: Bloomberg, Euler Hermes

that over the same period these companies tried to pass the financial burden on their suppliers (wholesalers and farmers). These dynamics demonstrate that the changes in market power of food retailers have repercussions on the whole agri-food value chain (see chart 7).

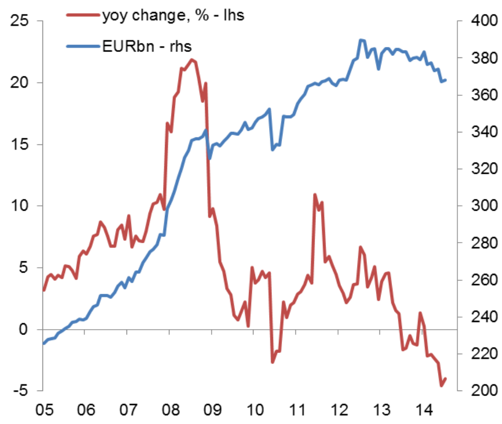
Need for new ways of financing

Agri-food businesses traditionally use bank credit to finance working capital needs and capital expenditures. Over the last 10 years bank borrowing in the sector has more than doubled, amounting to approximately EUR765 thousands per enterprise. Today, an average Agri-food enterprise borrows 90% of its long-term debt from banks.

The global financial crisis has brought on tighter regulation, requiring banks to adjust to higher capital requirements. The banks have thus imposed tougher lending terms for consumers and businesses (see chart 8). As a result, lending to euro-zone enterprises has fallen for two consecutive years and the Netherlands are not an exception. In this context, agri-food businesses are looking into alternative ways of financing, notably crowdfunding, credit union financing and reverse factoring. A recent example of the latter is Superunie, a leading Dutch food wholesaler, which offers reverse factoring as a means to speed up payment to its suppliers, while certain agri-food players utilize crowdfunding. The amount of money financed through this method is expected to increase 8-fold in 2-years' time to reach EUR255 mn.

Alternative financing methods cannot fully replace traditional bank financing, and therefore are only part of equation. To get through these challenging times agri-food enterprises need, more than ever, to innovate, invest in R&D and deliver added value to customers.

Chart 8: Credit to private sector in the Netherlands



Sources: Bloomberg, Euler Hermes

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