Euler Hermes Economic Research

Euler Hermes Germany

Industry Report

Germany's agrifood: In search of new recipes to remain a master chef

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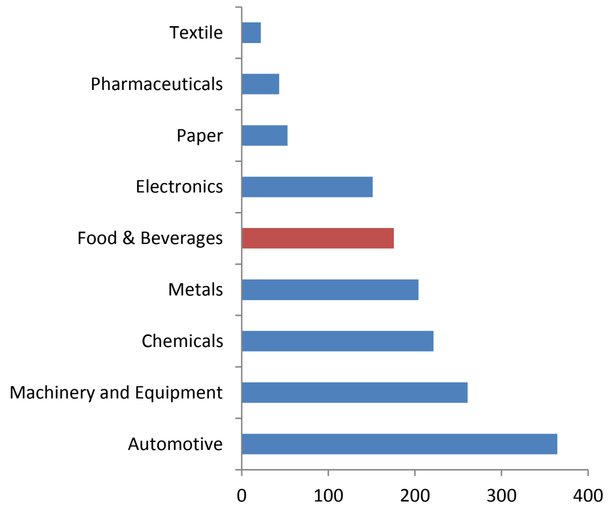
Executive summary

- Agrifood is the 5th biggest manufacturing sector in Germany, relying on a large domestic market and strong openness to foreign markets. Exports (1/3 of turnover) are expected to rise by EUR9.4bn by 2016.
- However strong growth momentum is gone. Total output is set to increase by only +2.7% in 2015 and +0.6% in 2016, compared with +4% between 2000 and 2008.
- Higher price pressure from discounters, lower consumer spending on food (EUR2bn lost in a decade) and exporters specializing in products facing sharp price decline (meat, dairy) put the model at risk.
- Investing in higher value-added products such as organic food for both the domestic and export markets will be key. Organic retail sales in Germany are forecasted to gain EUR4bn (+50%) by 2018.

A Top Sector

Agrifood ranks among the top five manufacturing industries in Germany accounting for 10% of the country's total manufacturing turnover and workforce. The resilience of the Agrifood sector has leaned on two pillars:
i) A large domestic market of 80M inhabitants ensuring a strong consumer basis in terms of volumes;
ii) Openness to foreign markets, which represent one third of total revenues.
At the international level, Germany is a major agrifood economy: eighth largest global producer with an output of EUR240bn in 2014 and the third largest exporter and importer with EUR70bn and EUR80bn, respectively.
Moreover, German companies enjoy a sound financial structure with little indebtedness (net debt ratio of 50%) and robust profits recording on average 4% of earnings before interest and tax (Ebitda) in 2014. This stability has been reinforced in the past years by important business concentrations.

Chart 1: Manufacturing turnover breakdown in Germany, 2013, EURbn



Sources: Destatis, Euler Hermes

This explains the very low level of insolvencies recorded in the sector – less than 1% of total insolvencies filed in Germany – since smaller players facing financing difficulties are acquired by stronger actors.

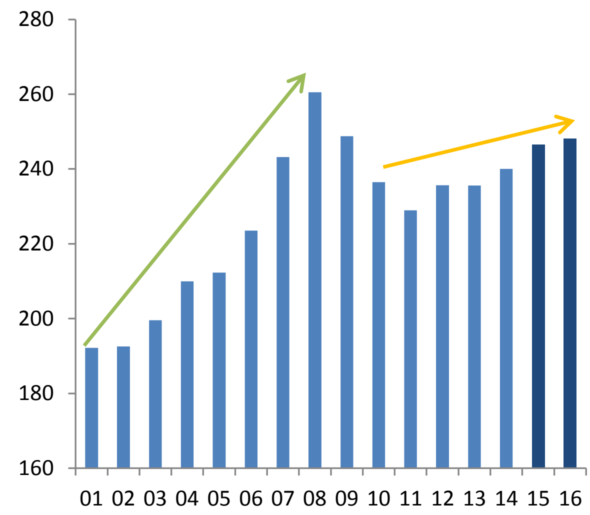
Major Challenges

The Agrifood sector, however, faces serious challenges, mostly stemming from the demand side, on both the final consumers and intermediaries level. These issues must be tackled to ensure bright development prospects. The output momentum has considerably slowed since 2009. After going through a three year long recession, it grew by a compound annual growth rate (CAGR) of only +0.9%, compared to healthy +4% between 2000 and 2008.
Despite a slight rebound in 2015 with output increasing by +2.7%, strong growth seems a thing of the past.
In 2016, we expect growth to reach no more than +0.6%. This slowdown is mainly linked to sluggish growth in the German domestic market combined with the recent slump in agrifood commodities' – with no upturn expected in the short run – contributing to lower output valuation (See charts 2 and 3).
On the other hand, exports continue to accelerate and now acount for 39% of turnover, up from 33% 7 years ago.
Germans are among the most price-sensitive and thrifty consumers in Europe with only 9% of household spending dedicated to food and beverage products (compared with 14% in France and Italy). Moreover these expenditures have continuously declined since 2005, down EUR2bn to EUR140bn.

Big Chains Cause Big Headaches

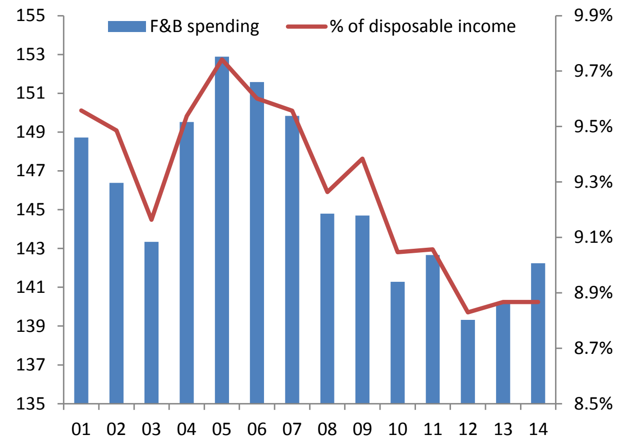
The ever-increasing domination of discounters in the German retail market is a key factor in the erosion of consumer spending. No-frills retail behemoths are extremely popular in Germany: four out of the five largest grocers in the country have expanded thanks to the development of their discount brands. Moreover the first two largest discounters worldwide are German companies.
This success hinges on two elements: firstly, rock bottom prices which smaller retailers struggle to compete with. Add to that a store format that fits the traditional German consumers' behavior and preferred shopping experience, with its legacy of neighbor or convenience store.
(See chart 5)

Chart 2: German agrifood gross output, EURbn



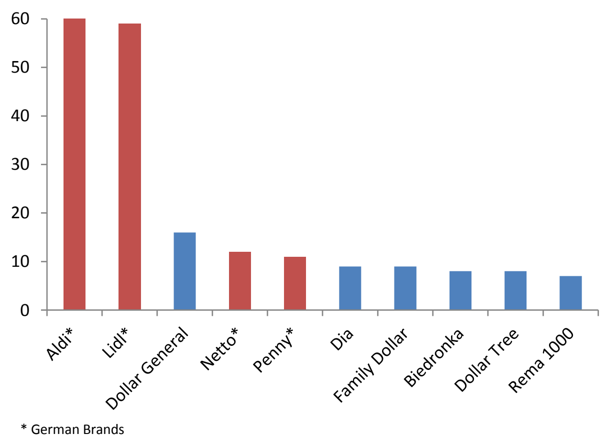
Sources: Oxford Economics, Euler Hermes

Chart 3: Household expenditures for Food and Beverages, EURbn



Sources: OECD, IHS, Euler Hermes

Chart 4: World largest discount brands worldwide, Revenues 2014 EURbn (*red stands for German brands*)



Sources: Planet Retail, Euler Hermes

Overcoming Massive Constraints

The drawback of consumer spending combined with a fierce price war imposes major constraints on the whole supply chain. This trend results in a constant erosion of producer prices (PP) over the past two years.

The PP index, which refers to the price received by producers for a given output, of German food manufacturing has particularly drawn back since July 2014 and fallen below the European average. As a result, turnover has declined faster than input costs entailing a steep fall of profitability.

In 2014, the revenue of the ten largest listed agrifood groups in Germany was down -1% while earnings before interest and tax (EBIT) - although still substantial - decreased by -10%.

Given the predominance of discount retail in Germany upgrading the output toward higher value added products and increasing internationalization appear as complementary, winning strategies to overcome this challenging environment.

(See chart 6)

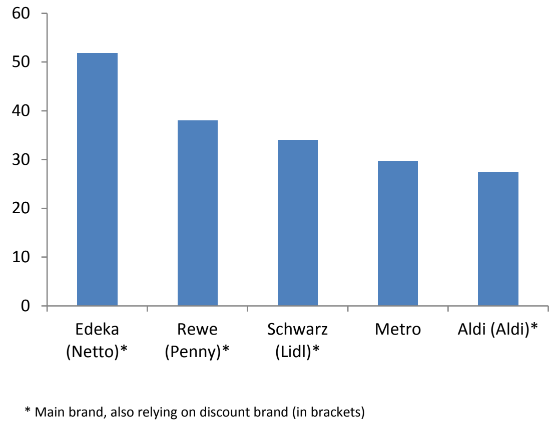
Enter the Organic Juggernauts?

German agrifood is at a turning point. Consumers' awareness of and appetite for healthy diets is rapidly growing and reshapes the consumption landscape. Natural food stores have considerably developed to now generate a third of retail revenues in Germany. This new 'bio' and 'organic' trend is a serious competition to the discount stores market which is getting saturated.

The organic segment is one serious opportunity for the German agrifood industry since the European Union offers tremendous development possibilities with retail sales of EUR22bn in 2013, the second largest market of its kind after the U.S. (EUR24bn). This aligns with Germany's IN FORM national action plan which aims to boost the organic sub-sector's growth.

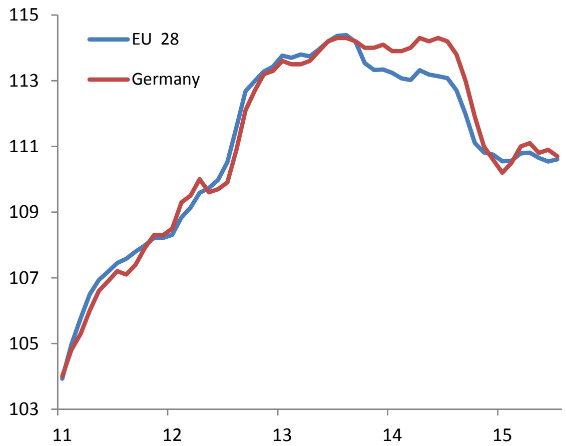
Germany enjoys the largest market share (31%) in terms of organic retail sales; but it also benefits from serious assets to develop this segment as a producer. Hinging on the rising appeal for this healthy food and increasing interest of agrifood industry, EH forecasts German organic sales to gain EUR4bn by 2018, reaching EUR11.7bn. Besides, organic food consists of a variety of products, both crops and animal sectors, hence accessible to a wide range of food processing activities. Several countries in the EU are promising as well regarding high average annual growth rate of organic retail sales over the past decade – Denmark +12%, France +10% or Italy +6%. These countries could prove to be dynamic export markets for German top products, i.e. dairy and meat, that turn out to be among the most preferred organic products in Europe.

Chart 5: Top retailers in Germany, prevalence of discounters, Revenues 2014 EURbn



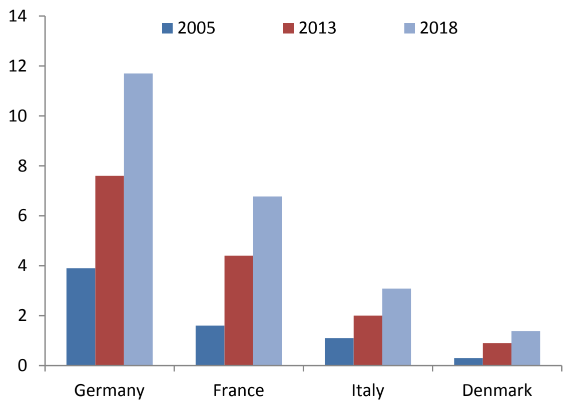
Sources: Trade Dimensions, Euler Hermes

Chart 6: Producer Price Index, food manufacturing in Germany and EU28, 2010=100



Sources: Eurostat, Euler Hermes

Chart 7: Organic Retail Sales, EURbn



Sources: AMI, FIB &IFOAM 2015, Euler Hermes forecasts

Universal Appetite, Meaty Risks and Fruity Opportunities

Beyond organic food, EH forecasts foreign demand of German agrifood products to gain EUR9.4bn by 2016; particularly voracious are the Netherlands (EUR1.7bn) France (EUR1.4bn), and the UK (EUR1.0bn). Such gains still rely on Germany's traditional products, i.e. Dairy and Meat which account for respectively 14% and 11% of total exports.

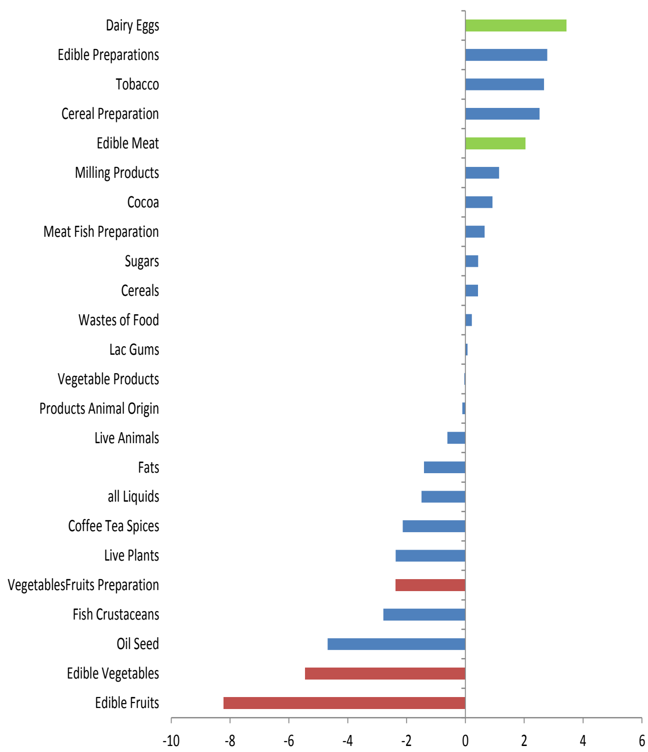
On the other hand, specialization puts the German model at risk: Dairy and Meat are the products facing the sharpest price decrease (-10% and -4% respectively since their last peak) exacerbating the trade balance deficit to EUR10bn in 2014. (See chart 8)

Diversification toward products that are enjoying a sharp rise in prices, particularly fruits and vegetables (F&V) will be key to restore German agrifood's export vitality.

The consumer price index increased by +6.6% for fruits and +9.3% for vegetables, y/y as of August 2015. These products had a combined net trade deficit of EUR13bn in 2014. Such imported inflation addresses the import dependency issue and raises the need –and opportunity - to produce locally.

A new focus on organic F&V can tackle both issues: beating imported inflation and seizing new market opportunities, both domestically and abroad.

Chart 8: German agrifood trade balance, EURbn



Sources: ITC, Euler Hermes

The Next Growth Spurt

Whatever the option, domestic market diversification or higher internationalization, investment is the inescapable way forward. It should be considered as long as the industry can afford it. The combination of low interest rates and sound financial standing is an almost ideal environment for investing.

However, capital expenditure by food processors grew by only +2% per year between 2010 and 2015. No upturn is foreseen in the short run with only +1% of investment expenditures to be realized in 2016-2017. Although a tough issue to tackle investment it is the only way to address the challenges producers face.

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