The food market in times of crisis

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Right now, we still do not know what direction the current crisis, the biggest since World War II, will take nor how deep it will be. Overall uncertainty is very high and any analysis of the branch can only be provisional.

The food industry is quite insensitive to crises. The impact is approximately 2% in developed countries, which absorb 70% of global consumption. Future growth will be based on introducing industrial food consumption with more than a billion consumers in developing countries and the growth of high value-added markets in developed countries.

Dramatic variations in raw material prices in 2007-2008 have been linked to massive speculation. However, it is true that agricultural prices tend to grow due to the lack of new croplands and improved productivity.

The macroeconomic context

When credit difficulties of a good deal of American and European financial institutions rapidly led to the so-called credit crunch in summer 2007, few could imagine that eighteen months later we would find ourselves in the biggest overall economic crisis since World War II, which we still ignore how long it will last and in how far it will affect the economic model we have been used to in the Western world over the last sixty years.

The crisis started in relation with the assessment of some assets of financial institutions and rapidly evolved towards a real financial crisis due to the need of replacing with new capital the enormous losses featured on the balance sheets of these institutions.

During many months, the crisis affected the real economy in only some branches directly related to the financial crisis, such as building and others. However, the continuous drainage of financial resources taken from the real economy to tackle the crisis as well as some dramatic, unjustifiable bankruptcies and frauds in the finance sector eventually led to a general crisis in which companies cut back investment and activity and consumers reduced any kind of consumption and yet more investment.

In late January 2009, the International Monetary Fund (IMF) estimated world growth for this year at 0.5%, even though the forecast still had been 2.2% in November 2008. These data are not only the worst since World War II but they have evolved at an unprecedented breathtaking pace, which makes it very difficult to have an overall view of what the long-term impact of the crisis will be once it is over. Opinions on its duration and depth are diverse and changing as this article is being written.

In January 2009, consumption went on declining for a forth consecutive month in the US, at -1.8%, which makes it difficult to believe in economic recovery in the next months. The IMF estimates the evolution of the eurozone GDP at -2% in 2009 and -2.8% in the UK.

This decrease is the more dramatic if we consider the efforts made by virtually all economic authorities around the globe to halt as quickly as possible the perverse crisis cycle that could lead us to an outright depression unless it is controlled. Interest rates are close to zero and all relevant countries in the world economy, both developed and developing, implement aid programmes of an unprecedented size. This overall uncertainty affects all economic sectors, including consumption, and more specifically the food industry.

Cycles in the food industry

As is generally known, the food industry is very stable as far as its cyclical evolution is concerned. Both in times of growth and recession, changes are relatively moderate, though definitely perceptible. As an example we may mention the dramatic difference between the 31% decline in new car sales in the US in January 2009 and the little 1.8% decrease in retail sales, basically food and hygiene and cleaning products. Although at a different rate, Spain also features a substantial difference between the decline in car sales (49%) and in retail (9%) that occurred in November 2008, which has been considered a «black» month.

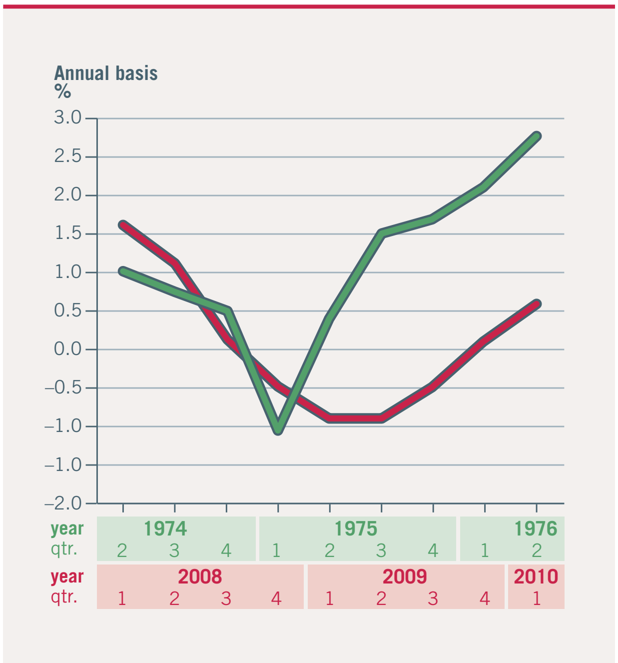
Since the end of World War II, the crisis with the biggest impact on consumption had been that of 1974-1975 following the first big energy crisis. Graph 1 compares the quarterly development of consumption during that crisis with data on the current one (partly actual, partly forecast) worked out by the Organisation for Economic Co-operation and Development (OECD) for the G-7 countries. For the whole of the OECD countries, the evolution in 2008-2009 was slightly less negative, at a decline roughly 0.5% lower.

The 1974-1975 crisis was related to a crucial geopolitical event: the war in the Middle East and the immediate reaction of Arab countries, cutting the oil supply, which led to a dramatic price increase and created the first big energy crisis.

This crisis cannot be considered to introduce a model shift neither in long-term growth nor in big internal developments within the food industry.

Perhaps due to its relevance outside the economic system, the stage of decline in activity was very steep but relatively short. Later recovery was rapid and strong. Today we are facing an outright financial and economic crisis the profile of which seems to be deeper and longer in time. Within the current context, the OECD forecast for 2009-2010 needs to be taken with care. Nevertheless, all data confirm the low cyclical variation of the food industry, which could be set at a rough annual 2% for the most developed countries.

***Graph 1.* Quarterly comparison of consumption in G-7 countries**



Source: OECD

In 2008-2009, the quarterly evolution was less negative than in 1974-1975.

Consumption of industrialised food in developing countries grew by 5-6% in 2008 but still takes a low proportion of total consumption at approximately 30% and is less affected by the impact of economic cycles but rather by other items such as price evolution and product availability, which we will comment later on.

Generally speaking, it can be concluded that the current crisis is the biggest of all recorded so far and the one having the biggest and longest impact on our industry. However, it cannot be considered that this crisis will introduce a model shift neither in long-term growth nor in big internal developments within the food industry.

We have already seen that in times of deepest recession, the decline of consumption as to its total volume throughout the developed countries can reach a yearly 2% (1% less than the OECD forecast) as opposed to a pre-crisis FAO estimate of an average yearly 2.6% for the 2006-2015 period. There is no doubt that this forecast seems difficult to meet in such times as worldwide growth is virtually non-existent right now. However, the long-term upward trend in demand seems guaranteed.

The crisis affects above average some segments of the food industry. The most affected ones are of course those featuring a bigger elasticity based on the income level of consumers. Hence there is a significant decline in out-of-home consumption (-4.1% in the US in 2008), particularly in high-end retail, whereas fast food chains have increased their sales significantly all over. A similar development can be observed with cheaper products at home: private brands, smaller formats or the systematic search of products on special offer. A crystal clear example of such change is observed in the different evolution of sales in the US in January in overall retail (-1.8%) and in Wal-Mart, the world retail leader (+2.1%), thanks to giving priority to own brands and affordable products.

More than 950 million people have crossed the minimum acquisition power threshold to have access to industrialised food.

Within each company, the current crisis poses challenges but also creates opportunities. First, a new analysis of business plans should be made and priorities established and strictly respected according to the new situation. Efforts must not be spread and all targets that were feasible under normal growth conditions are to be met.

The implementation of plans and actions leading quickly to more efficiency need to be accelerated as competitors will follow the same path to reach a bigger share in a total market that is shrinking.

Companies competing in high segments within each product range need to offer a higher added value to consumers to retain their loyalty while keeping a premium price level. Quality, innovation and differentiation are therefore indispensable in a recession that forcibly fosters competition.

Long-term evolution of the food industry

So far I have tried to justify my opinion that the current crisis will not change the long-term development model in the food industry. It will certainly slow it down, create additional distress and introduce more demanding requirements to be successful, but it will not do away with the underlying trends guiding growth. Let us see what those trends are.

Demographics and economic growth in developing countries

The population in the developing world is still growing despite governmental action to avoid it, and this trend will hardly disappear in the next years. In fact, UN and World Bank data indicate that the population in developing countries grew by 710 million in the 1998-2008 period and further growth by roughly 750 million is expected by 2018.

An excessively important part of this population has no access to necessary financial resources to minimally afford consumption of industrialised food products. Nevertheless, the situation in many of these countries is changing for the better thanks to their economic development. In the last ten years, more than 950 million people have crossed the minimum acquisition power threshold, set at a rough annual $2500 per capita based on equivalent prices, to have access to industrialised food.

Obviously, the sort of food people with such an income level have access to is basic, with low unit prices and few added value (milk, bread, rice, soybean-based products, pasta, spices, biscuits, etc.).

Above $14,000 per capita, access to more elaborate products becomes possible, and roughly 230 million people have crossed this threshold all over the world in the last ten years. This is the main driver for growth in the global food industry. An important part of this new demand is satisfied through the spectacular growth of local companies, most of which were established only recently but have already reached a considerable sales volume. In countries such as China, India, Indonesia and Russia, local companies take large market shares.

It is obvious that the current crisis affects emerging economies with the reduction of imports from developed countries and a considerable decline in remittances from migrants. In the case of oil and gas producing countries, the price fall of these commodities has affected them decisively. These external causes, together with financial and stock exchange collapse in emerging countries, will doubtless pose a significant obstacle to their development.

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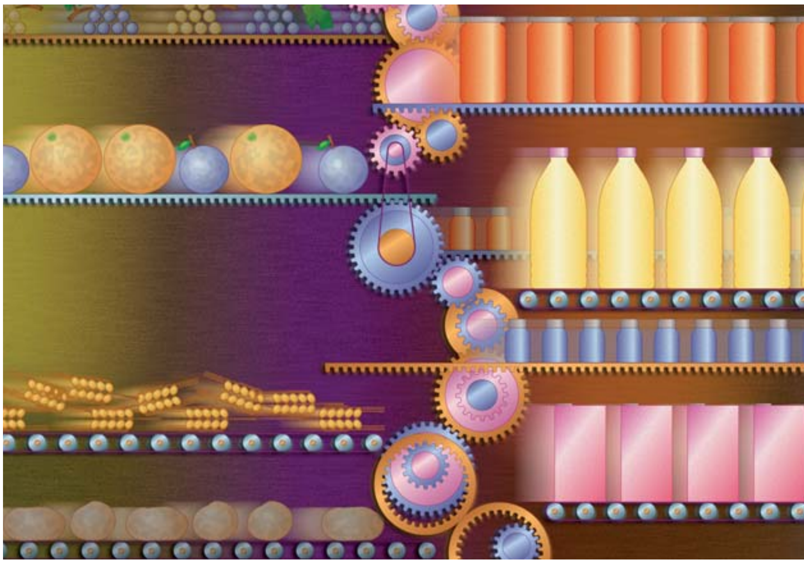
Nevertheless, the basic trends generated by dramatic growth in recent years still last, and although the crisis slows down their development, there is no reason to think that it will do away with their long-term impact.

Before the acute phase of the crisis, the World Bank expected the inclusion of 1.04 billion people into the industrialised basic food market in the 2008-2018 period and 370 million into the added-value product segment.

Even if the effect of the crisis reduces these figures, they are so big that they will remain the key driver in the food industry over the next decade. For Western companies operating in these countries, taking advantage of the evolution of demand is a true challenge for long-term, sustainable and profitable growth.

The traditional strategy of exporting and later producing locally the same products that are sold in developed countries only caters for a little part of needs in emerging countries and will never be enough to play a role in those markets nor to have related activities be more than marginal in the overall balance sheet. To really take advantage of these opportunities, products adapted to the consumers' eating needs and habits need to be developed, manufactured with local raw materials and adapting formats and unit prices to their low spending capacity. Local distribution channels are indispensable to reach out to consumers who have no transportation and are used to buy their supplies close to their home on a daily basis.



▲ In the last ten years, more than 950 million people have crossed the minimum acquisition power threshold to have access to industrialised food.

The development of the affordable product market for the bulk of the population coexists with that of the premium value-added product market for consumers with high purchasing power, the number of which is also growing rapidly in developing countries.

High value-added products in developed countries

The consumption volume of food products in developed countries has remained virtually stable for some years and will hardly grow significantly as basic needs are well covered. Also, total food expenditure is growing in the most advanced countries thanks to increasing expenditure on high value-added products among high-income consumers, i.e. above $25,000 per capita.

The reason for this growth lies in the fact that these consumers are increasingly replacing standard products with new ones launched to the market with unique features catering better for the needs of population segments able to pay higher prices.

Through a high degree of quality, variety, elaborate presentation and integrated distribution and preparation systems, it is possible to raise the interest of *gourmet* consumers ready to pay higher prices for more exclusive and customised products.

First, there are products with specific nutritional properties targeting well defined consumer profiles. This segment is experiencing a spectacular growth based on R&D investment by the industry, which allows it to offer products specifically suitable for different age groups, disease prevention, recovery after hospitalisation, additional nutrient intake for strong bodily activity, clinical nutrition, etc.

Within the different age groups, the increasing importance of people aged 65+ is noteworthy, as they will represent one fourth of European population within a few years, just to mention an example. Developing new products adapted to their needs, with appropriate commercial patterns and distribution channels, is a great opportunity for the industry.

The premium product segment is spreading throughout many product classes that were considered basic up to a few years ago, such as bread, oil and pasta, on top of other products featuring such a segment for years, such as wine, chocolate, ice-cream, coffee, etc.

Through a high degree of quality, variety, elaborate presentation and integrated distribution and preparation systems for these products, it is possible to raise the interest of a vast amount of *gourmet* consumers ready to pay considerably higher prices for more exclusive and customised products. The business model is different here as it is usually based on global brands with very selective distribution channels. Emotional communication is a very important added value in this product class, and time, perseverance and long-term consistency is needed to create the image such products require.

Food consumption out of home is rapidly growing among consumers with a high income level and amounts to up to two thirds of their total consumption. The current crisis will slow down this development, but the growth trend will pick up its pace in the long term. This segment had traditionally been regarded as an add-on to the business targeting household consumption, by simply offering larger formats and using specific distribution channels. Today, the industry is developing rapidly out of new technologies to prepare and preserve food as well as thanks to the power of large restaurant chains that are becoming increasingly global.

The industry needs to work together with these big customers to understand their needs and cater for them not only with products but also with services, if they want to take advantage of the growth opportunities provided by the branch.

Agricultural raw materials: price and production volume

Agricultural raw material prices remained generally stable for more than a decade (1997-2007), with obvious variations due to temporary imbalance between offer and demand. The volume of speculative positions in the futures markets was relatively low and handled by traditional branch operators.

From the second half of 2007, this scenario changed radically with the advent of new financial operators, hedge funds and other funds, which started taking strong speculative positions by pouring in resources from their divestment in stock, bonds, etc. This caused a dramatic price increase of virtually any agricultural product. The volume of options and other futures contracts grew five-fold within a few months and this was the main reason for agricultural prices doubling within one year, reaching their peak in July 2008.

The effect of such massive speculation has become apparent in the food inflation rate in all countries (e.g. 7.2% in Spain in July 2008) and were particularly devastating for consumers in low-income countries, for whom basic product prices are crucial for appropriate nutrition.

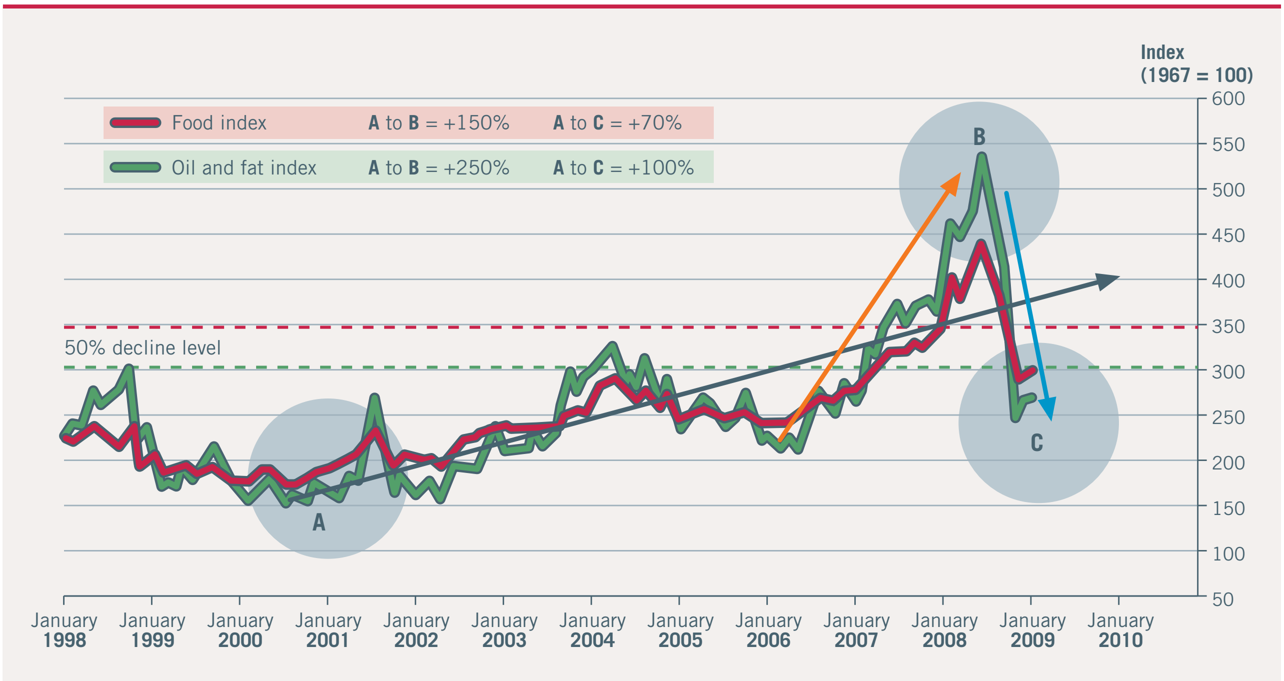
With a new phase in global recession having started in late 2008, financial difficulties of speculators became compelling, so they needed to look for rapid liquidity, which led them to sell massively their futures positions, causing a general price collapse that drove them back to the 2007 level within a few weeks.

Beyond the dramatic change stated in the last months regarding raw material prices, there is an objective long-term trend towards price increase based first and foremost on steady growth in demand in developing countries with demographic growth, increasing income level and expanding urban population.

Furthermore, the lack of investment and credit to extend croplands and improve production hampers the expansion of the offer. According to the FAO, agricultural productivity has had an average yearly increase of just 1.1% since 1990, while in the previous twenty years it had been 2%.

As a consequence of these trends, current agricultural product stock levels are at the lower edge of their level over the last sixty years, which allows to forecast that prices will rise

***Graph 2.* Food and oil and fat indices**



Source: Commodity Research Bureau.

Food and oil and fat indices have been affected by massive speculation.

again, though without speculative movements involved. The first months of 2009 already pointed towards some recovery, and this trend is expected to become stronger in 2010.

The policies of several governments, encouraging the use of croplands for biofuel production by means of subsidies, only increases the problem of lack of food availability for the future.

According to the FAO, there are still 900 million people with severe malnutrition all over the world, and this trend is growing, together with price increases and the diversion of a part of production towards biofuels.

Political priorities will need to be set with a global view of energy and food problems at supranational level in the long term. Withdrawal from a part of agricultural production and excessive use of water to produce biofuels are only a tiny contribution to solve the energy problem while causing massive harm to the most helpless.

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