

## Consumer products: Material difference

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[Bread riots](#) in Mozambique. [Price controls](#) mooted in China. In South Korea, a slashing of cabbage import tariffs to keep the fiery national dish of kimchi on family tables. And in the west, [warnings from consumer companies](#) that our evening supper, weekend pint and Friday night frock are all going to cost, give or take, 5-8 per cent more next year.

Food and clothing inflation is back with a vengeance. Wheat has risen in price by nearly two-thirds in the past six months and cotton by almost three-quarters.

“The age of ever decreasing clothing prices is over,” Lord Wolfson, chief executive of Next, the UK fashion retailer, said recently. “I don’t think we are necessarily going to see forever rising prices, but I think the era of ever falling prices is finished.”

In other words, a generation that has grown up with food and clothing deflation – courtesy, largely, of China’s arrival as a manufacturing powerhouse – must now get used to paying more for the shirts on their backs and the bread on their table. The options: less breakfast cereal in the carton and hair-raisingly static-inducing nylon shirts, or pummelled profit margins for the global food and clothing industry.

Investors, too, are as a result preparing for a new landscape of reduced profitability or greater consolidation. Western central bankers may meanwhile have to grapple with the dilemma facing their counterparts in Beijing: how can monetary policy be corralled to temper inflation?

The timing could not be worse for consumers, whose income is being eroded by [austerity measures](#) such as tax rises. As Richard Hyman, strategic retail adviser to Deloitte, the consultancy, puts it: the question is whether consumers will “literally and metaphorically wear price increases”.

The vigour of the latest surge in input costs has taken some by surprise. John Bason is chief financial officer at [Associated British Foods](#), which apart from its business in sugar and groceries also owns Primark, the European discount retailer famed for its £2 T-shirts and £5 trousers. That gives Mr Bason a 360-degree window on input inflation. “It’s much more of an issue than we thought in the summer,” he says.

Dealing with higher input prices, while seeking to protect – or even expand – profit margins without scaring off febrile consumers is the conundrum now facing the industry.

Diversified food producers, such as [Nestlé](#) of Switzerland and the UK’s [Unilever](#), spend about one-third of their sales on raw materials, including packaging. That means they face higher costs of around 5-6 per cent, estimates Michael Steib,

analyst at Morgan Stanley. This broadly chimes with guidance for cost inflation of 4-5 per cent from [General Mills](#) of the US.

The industry is divided on the severity of the threat. For some, volatile commodity costs are part and parcel of their industry: sometimes a tailwind, sometimes a headwind. Indeed, some say headline-grabbing rises in wheat prices make it easier to add 5 or 10 cents or pence to the price of bread – enough to cover increased costs and a few more pennies besides, which drop straight down to retailers' and manufacturers' profit lines for every loaf they sell.

Others say we are in for the long haul. "Current agrocommodity market inflation is a consequence of lower production yields and unprecedented increases in demand from Asia," says Pier Luigi Sigismondi, Unilever's chief supply chain officer. "Additionally, the world is losing arable land at a rate of about 40,000 square miles a year. That is land being used for biofuel production, while climate change is eroding away topsoil. Farmers will need to produce more food with less land."

Morgan Stanley's Mr Steib is in the same camp. "Longer term, agricultural commodities have only one way to go, and that's up," he says. "Simply because you've got a rising population, more health-conscious consumers and less arable land. The food industry needs to come to terms with that. Companies will have to continue to optimise their cost bases in order to deal with long-term structurally higher input prices."

There are several ways manufacturers can deal with this: those include hedging or forward buying, shaving costs, reformulating products, substituting lower-priced commodities and passing price rises on to their customers, in other words the retailers. But whatever they do, some of the effect will inevitably be felt by consumers.

Hedging alone is no panacea. "Whatever your hedging methods, you cannot buck market trends forever," says Mark Hughes, who as global procurement director for [Premier Foods](#) oversees a £1.1bn (\$1.7bn) annual spend on ingredients and packaging.

Much depends on geography, as Bernstein Research's Trevor Stirling points out. Prices for barley, used in beer, have been on "a massive rollercoaster" in Europe over the past five years, he says, ranging from €300 (\$402) a tonne to below €100 in the first half of this year.

But the impact varies widely. In western Europe, where most brewers are covered at least partially for 2011, the damage is muted. Even better is the US, where contracts of two to three years mean the average cost of malting barley was down by one-fifth in October year-on-year, the soaring spot price notwithstanding. In Russia, hedge books are shorter and problems in the local market forced brewers to import from western Europe, entailing additional transport costs.

Along with hedging, companies such as [SABMiller](#), Unilever and Premier Foods are sharpening up on procurement. SABMiller recently set up centralised systems that give it more clout in buying raw materials such as glass – previously, negotiations were carried out with the same glass supplier, Owens-Illinois, but at regional level. "Although they knew we are big, we never really used that muscle," says Graham Mackay, chief executive. "Now we are able to get better prices out of them."

## World food prices

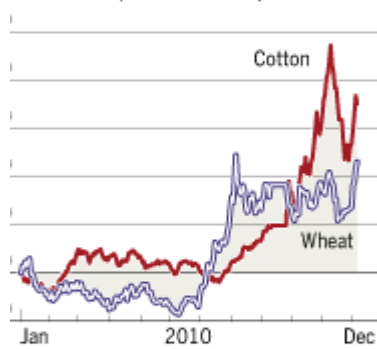
Food price index



Centralising procurement similarly allows for more standardisation and thus more bulk buying. Premier, whose products range from Hovis bread to Branston baked beans, says last year it was buying 28 types of black pepper across the group; it has ground that down to five. Local sourcing, for reasons including sustainability, plays a role too: cassava, for example, goes into some stock cubes and African beers.

## World commodity prices

Prices rebased (Jan 2010=100)



Further, companies are striving to make processes more flexible to enable ingredient substitution; some even turn this to a marketing advantage. Take Unilever: as the world's largest buyer of vegetable oils and fat, rising edible-oil prices affected the Anglo-Dutch giant during the last price spike in 2007-08. Discovering that lemon peel allowed it to slash the oil quotient in its mayonnaise, while maintaining the same taste, Unilever managed to reduce its oil bills as well as earn Brownie points for lowering its carbon footprint and doing its bit to reduce obesity. Fashion retailers are also going back to the design table, switching fabrics and restyling. Some are replacing cotton with nylon or viscose, a wood by-product typically used in knitted fabrics. One senior retailer says that whereas a man's shirt may have been made of 100 per cent cotton last year, this year it could be 80 per cent cotton and 20 per cent polyester.

## European consumer prices

Prices rebased (Jan 2000=100)



At the bottom end of the market, where most retailers are seeking to hold prices, the mix could become closer to 50-50. "My entry price point will be 50 per cent cotton, 50 per cent polyester," he says. "The further you go down the value chain, the more man-made fabrics you will find."

But the rush to find alternatives to cotton is pushing up the price of synthetic fibres, with polyester estimated to be up by a double-digit percentage.

Another senior retail executive expects retailers to modify products at opening price points – what the industry calls the cheapest end of a range. "If your opening price of £18 had to go up to £20 you would introduce polyester. With jeans you can always put one less wash in. There are always ways you can engineer your prices down." But making such money-saving tweaks can be a gamble. "The risk with doing that is the customer sees that, and you undermine the credibility of your entire brand."

At the other end of the spectrum, retailers can inject more fashion flair into garments, which means they can charge higher prices for them. On a man's shirt, says the first senior retailer, this could mean "reverse trimming" the cuffs, that is, putting a different fabric on the inside of the cuff to that on the outside, so that it becomes a feature. Alternatively, there may be a narrow band of fabric around the edge of the collar, through a taping or piping, to add more detail.

Women's garments can be lined with a higher quality fabric or stitched in a contrasting colour. Dresses or tops can be embellished with beading or sequins. There can be more gathers, folds or tucks, or more lace and trimmings. All this detail means shoppers may be willing to pay more. "If I spend £1, I can put £3 on the selling price, but the customer is seeing a lot more," says the retailer.

There are always retailers – such as Primark, at the bottom end of the clothing scale – who will have to take higher costs on the chin. These days, that is increasingly true in food, too. Take turkey, as much a birthright for Americans on Thanksgiving as it is for the British at Christmas. Although prices for the festive bird are up 25 per cent so far this year, most retailers are selling them below cost, says Meredith Adler at Barclays Capital.

But ultimately, at least some of the extra buck is passed to the consumer. Some, have already done so, such as Kraft with coffee. Three months ago the US food giant responded to higher coffee bean prices with an 11 per cent increase in the cost to retailers of its Maxwell House brand; some stores passed the rise on to consumers.

Brewers, along with a slew of food and clothing companies, are following suit; the price of clothes is expected to rise by a figure approaching double digits early next year. All are nervously watching to see whether consumers balk, seeking to ensure that their margins are preserved even at the cost of falling top-line revenues.

Early evidence suggests [manufacturers are succeeding](#) in passing on higher prices, at least for now. “We’ve come out of the shoot, and quickly responded with pricing. We’re entering that into a generally weak consumer environment, but so far we’re quite pleased with the reaction from our customers, direct customers, retail partners – and the consumer response has been OK as well,” Tim McLevish, Kraft chief financial officer, told investors last month.

But for most the jury is still out. “The consumer,” says Mr Bason: “That’s the \$64m question. Consumers are quite resilient today, but maybe if it’s a constant diet of bad news we will start to see a real change in consumer behaviour. That’s the tightrope that food manufacturers and retailers are walking.”

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## AGRICULTURAL COMMODITIES

As reserves fall, it will take more than a bumper crop to bring prices down

Agricultural commodity prices have surged in the past month to peaks last seen at the height of the 2007-08 [food crisis](#), writes Javier Blas . The rise comes on the back of a string of drought-induced crop failures in Russia, Ukraine and Kazakhstan – all leading cereal exporters. The shortage has been aggravated by the imposition of export restrictions that triggered panic buying.

Other nations, from the US to Indonesia, are reaping smaller than expected harvests of corn, wheat and palm oil. With demand booming as developing nations such as China or India emerge from the global economic crisis, the shortfall is denting reserves.

The price spikes mean that this year the total amount that countries pay for imported food will exceed \$1,000bn for only the second time, according to the UN. The 2010 bill is up nearly 15 per cent from last year and within a whisker of an all-time high of \$1,031bn set during the food crisis in 2008.

“We are in a dangerous zone,” says Jacques Diouf of the UN’s Food and Agriculture Organisation. “Unless countries manage the situation carefully, we could end up in another crisis.”

But he adds that the world is not there yet, noting that, in contrast with 2007-08, riots in emerging countries have so far been small.

The FAO’s benchmark food price index, tracking the wholesale [cost of wheat](#), corn, rice, oilseeds, dairy products, sugar and meats, last month stood at more than 20 per cent higher than a year ago. The index has been higher only during a brief period in mid-2008 at the peak of the food crisis. The Rome-based organisation has painted a worrying outlook for 2011, warning that unless farmers “expand substantially” their planted acreage and weather is favourable, the world should “be prepared” for even higher prices. Traders believe that even a bumper [crop](#) will not cut prices significantly as inventories are low.

Wheat prices this week hit their highest since mid-2008, trading in Paris above €235 a tonne, up from €130 in January. Corn is near a two-year high, trading in Chicago between \$5.50 and \$6.0 a bushel, an increase of 50 per cent since the start of the year. Oilseeds such as soyabean, palm oil or rapeseed are also at a two-year high. Sugar recently hit its highest price since 1980. Rice, the staple food of 3bn people in Asia, is the only agricultural commodity yet to spike significantly, thanks to a large crop in the south-east of the continent.