

Consumers: Soon to feed through

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By Greg Farrell in New York

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Kevin Gaffney had to face up to a double setback on Friday. The 53-year-old, made redundant by the airline that employed him at London's Heathrow airport, was obliged to sign on for jobseeker's allowance for the first time. And just when his income was at an unhappy ebb, what struck him at the supermarket where he stopped off for provisions was how much food prices were on the rise.

The outward evidence was the reverse. Garish red-and-yellow posters adorned the Lidl store in Haringey, an unassuming part of north London, announcing the German cut-price retailer's latest reductions. Baked beans, bacon and bread rolls were all down, by as much as 31 per cent.

But away from the special offers, having already made the switch from more upmarket chains such as Sainsbury and Waitrose, Mr Gaffney says he has "noticed even in here prices have gone up ... It's across the board, really, because the price of grain has gone up, which is used to feed the animals."

Further increases are in prospect. Confronted with a severe drought, Vladimir Putin, Russia's prime minister, this week sowed panic in world commodity markets when he **barred grain exports** for the rest of the year. At a time when the global consumer economy is still in the doldrums, a surge in the cost of wheat, milk, meat, cocoa and other staples of the world's daily diet is increasing the pressure on manufacturers and retailers to

pass the rises on to cash-strapped consumers across the US, Europe and parts of Asia.

According to the British Retail Consortium, in-store food costs rose 2.5 per cent in July from a year earlier, up from a 1.7 per cent rise the month before. In the US, the deflation the Department of Agriculture was projecting as recently as July 25 for cereals and bakery products such as wheat will need to be put under review. It is forecasting inflation of 2-3 per cent this year for meat as well as sugar and sweets. For milk, cheese and eggs, which fell in price last year, it predicts 1.5-2.5 per cent increases.

Big producers are **beginning to disclose mark-ups** in some cases rather steeper than those. J.M. Smucker is, for instance, imposing an across-the-board rise of 9 per cent for its coffee sold to US supermarkets under brands including Folgers, Dunkin' Donuts and Millstone. On Friday **Kraft Foods** followed with rises of more than 10 per cent in the US market on coffee brands including Maxwell House.

Will consumers countenance all these increases? "Household food budgets don't go up," says Paul Weitzel, managing director at Willard Bishop, a retail industry consulting firm in the US. Instead, "people change their shopping behaviour".

Confirmation of that is to be found at the north London Lidl. "I have to be more careful about what I buy," says Ola Jankowska, 35, a receptionist. On the other side of the capital and at the upper end of the food shopping market, the story at a Waitrose branch in the leafy commuter town of Tonbridge is much the same. "I have noticed prices sneaking up quietly across the board. When prices rise, I don't buy organic - I go down a bit," says Jane Boyle, a pensioner. "It's inevitable. Between the droughts and everything else you are bound to get price increases."

Julian Hardwick, consumer analyst at Royal Bank of Scotland in London, describes the trend: "In more difficult times, there's a tendency for consumers to trade down, and there's a hierarchy," he says. "People trade down from going to restaurants to eating a ready-made meal at home. And people trade down from a ready-made meal to food they prepare themselves, and they trade down from a branded label product to private label."

But most observers predict the coming price rises will be a boon to private label brands, just as they were in late 2007 and early 2008, during the last big run-up in commodity prices. "This is a blessing for private label brands," says Gary Stibel, who as head of New England Consulting Group advises food companies in the US and abroad. "Private label was beginning to lose share and brands were coming back. But the heightened price inflation will improve private label's ability to hold share gains of the last 18 months."

Irene Rosenfeld, chief executive of Kraft, disputes such notions. "I think the notion that one cannot take pricing [upward] in the current environment is not accurate," says the woman who recently led the takeover of Cadbury in the UK. "A big part of our investment in brands is to enable us to maintain customer loyalty."

Private label marketers will have challenges of their own, says Mr Hardwick at RBS. "In an environment where prices are going up, private label companies will have to raise prices by a bigger percentage, because raw materials are a bigger part of their gross margin," he argues. "For the same input costs, the increase will be a bigger percentage. Private label will still be cheaper, but the gap with branded products is going to narrow."

Overall, then, how much of the rise in input costs will feed its way through, and how soon? "Food companies have had success passing along commodity inflation in the past," says Judy Hong, a Goldman Sachs analyst. "It's going to be more challenging to pass through commodity inflation to the consumer this time around. You have to look at it much more on a category and company basis. There are categories where the competitive pressure is more intense," she adds, pointing to cereals and soup as two.

The pricing increases will eventually be passed along to shoppers, predicts Susan Anderson at Citigroup, but it will not happen quickly. "There will be a six-month lag instead of a one- to two-month lag," she says. If nothing else, that provides some reassurance for Christmas.

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Rising commodity prices in early 2008, led by oil, resulted in significant price boosts for a variety of food products, almost all of which were passed on to consumers two years ago.

But after the run-up peaked, the decline in input prices and the sharp economic downturn precipitated by the financial crisis led to stable and even deflationary pricing in the US and elsewhere. As a result, shoppers encountered something almost never seen in supermarkets and grocery stores: declining prices over an extended period of time.

But suppliers adjusted, leading to what we see now. Notably, flagging demand for beef in 2008, combined with high grain prices, led the large US cattle companies to reduce their herds over the past two years, which created an undersupply of beef and the consequent rise in price tags at supermarket meat counters.

Faced with that, shoppers will not immediately trade down to chicken, says John Rand at Kantar Retail, a consultancy. "This is more about mix management than pricing," he maintains. "Supermarkets will still sell meat, but it will be a different mix, maybe lesser cuts or a lesser quality of meat." Struggling consumers who were already buying the ground beef rather than cuts are more likely candidates to convert to chicken, while people already down to chicken might convert to grain-based products.

In 2008, during the last big run-up in food prices, the price of pasta in the US jumped by more than 20 per cent. Nonetheless, unit sales crept up slightly, leading to a 22 per cent gain in the dollar value of pasta sales across most US supermarkets. "At the very bottom of the consumption chain there's no place to hide," Mr Rand says. "You end up with pasta or rice. People have very few alternative bulk products that are going to be cheaper than that. It doesn't matter if the cost of spaghetti has gone to \$1.19 from 99 cents. But if you take my beef from \$6 to \$9, that's a different deal."

For supermarket chains the lowering of prices in the past 18 months was not necessarily good for business, despite the sustained foot traffic that it generates. "Deflation is generally no friend of the food industry," says Robert Goldin of Technomic, another food consultancy. Stores make money on margins, and the lower the cost of a product, the smaller the dollar value of the margin, he adds. "Inflation is good as long as it's not too much."

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Will the return of food price inflation make the jobless Mr Gaffney change his spending habits, then? "I don't think it will," he says back at the Haringey store. "I buy the minimum anyway just to get by. It would just mean less money to spend on other things."

What they buy and what they avoid helps some to avoid the squeeze. Jackie Kelly, also aged 53, is a childminder and a fellow Lidl shopper. "Nearly every day I come here for bits and pieces. I haven't noticed the prices going up," she says. Why? "I don't buy bread or biscuits. I buy a lot of fruit, salads and vegetables and I find it reasonable."

Other shoppers demonstrate a similar loyalty, though not always for the same reasons. At Tonbridge's upmarket Waitrose, Monica Long, 79, says that while luxuries such as their bottle of whisky had gone up in price, she and her husband "couldn't bear Sainsbury's - I think we'll stick with Waitrose and just buy less."

Additional reporting by Tom Wills and Bryony Sims

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