THE VIEW

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AGRIFOOD:

NEW RISKS LOOMING AHEAD

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EULER HERMES

Allianz

EXECUTIVE SUMMARY

Marc Livinec, Sector advisor
+ 33 184 11 6198
Marc.livinec@eulerhermes.com

- **Major insolvencies are on the rise in the global agrifood industry.** At first glance, the global agrifood industry appears to be performing well, helped by the growing global population, especially in Asia. But since 2017, the sector has seen more than 30 major insolvencies on average per year, and the combined revenue of insolvent agrifood companies skyrocketed from USD6.4bn in 2018 to USD20bn in 2019.
- **Companies are facing five new challenges.** These include: a change in eating habits, especially in the West, with consumers seeking out healthier foods; the need to reduce the carbon footprint of food production; trade disputes that are forcing companies to diversify food supply channels; upside pressure on wages, which account for 11% of all operating costs in agrifood and the inability of food processors to pass higher input costs on to customers due to a lack of pricing power.
- **What do these new risks mean for agrifood companies?** We expect further deterioration in the operating margin rate of the whole agrifood industry, down to +9% in 2020 in comparison with +10.2% in 2018 (i.e. down 1.2 percentage points over the last two years on a global average). Overall, agrifood operating costs expressed as a percentage of revenues will increase by +1.4 percentage points to 21.8% in 2020, from 20.4% in 2015, growing faster than the rise in revenues. Even if the sector is still not close to a loss position, the impact of these new risks on agrifood companies' operating costs bodes ill for their future profitability.

>30

Major insolvencies
in the agrifood sector per year since 2017

MAJOR INSOLVENCIES ARE ON THE RISE IN THE GLOBAL AGRIFOOD INDUSTRY

At first glance, the global agrifood industry appears to be performing well, helped by the growing global population, especially in Asia. The sector, which encompasses agriculture, food and beverages manufacturers, was valued at USD4.7tn in 2019, up +1.7% per annum since 2010. And it ranks third after pharmaceuticals and IT in Euler Hermes' sector risk matrix, with 22 out of 69 countries recording low-risk ratings. So, agrifood could be considered as a healthy sector.

But several recent major bankruptcies raise concerns about the health of its main players. Since 2017, the sector has seen more than 30 major insolvencies[1] on average per year (see Figure 1). And the combined revenue of insolvent agrifood companies (see Figure 2) skyrocketed from EUR6.4bn in 2018 to EUR20bn in 2019.

While North America recorded only six major insolvencies in 2019, the severity in terms of turnover has been steadily increasing. In November 2019, Dean Foods the biggest U.S. milk processor (USD8bn in revenue in 2018), filed for bankruptcy with nearly USD1bn in debt. Impacted by a challenging operating environment, with steady declines in consumer milk consumption, and by tough competition, Dean Foods' insolvency was the latest sign of pressure in farming.

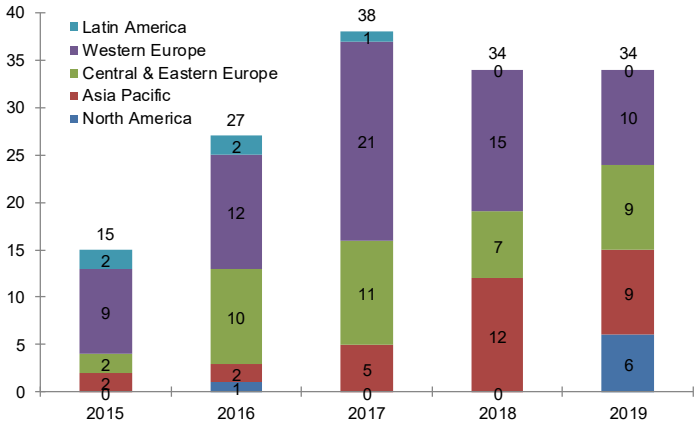
Western Europe is the major contributor to the number of major insolvencies, with 46 cases over the last three years, followed by Central Europe (27 cases) and Asia Pacific (26).

Given the nature of their business, agrifood companies have adapted to cope with erratic changes in climate (droughts, fires and floods) and with uncertainties over commodity food prices. Yet these abilities are no longer enough to contain operating costs for agrifood players. At the core of the rise in food makers' operating costs, our methodology has highlighted five key risks:

- New eating habits, especially in the West that force players into adapting their food offerings.
- People's greater attention to the rise in CO2 emissions and health and safety standards for food
- The growing capacity of mass retail to wield too strong a power on agrifood suppliers
- Higher trade policy interventions causing disruptions in the supply channels of agrifood manufacturers
- The ramping up of upward pressures on wages

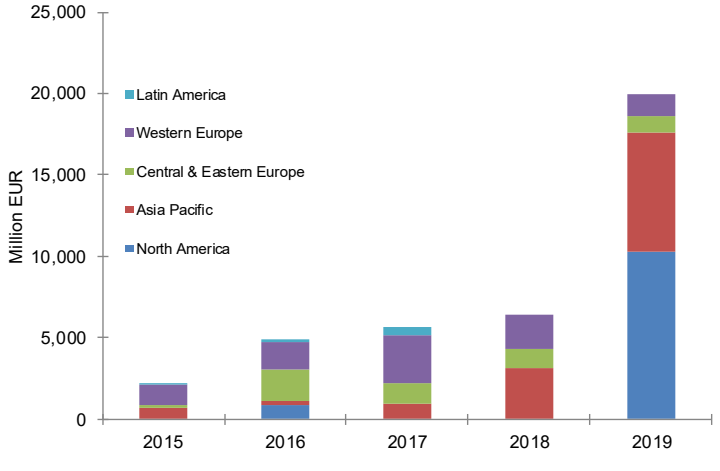
The three first risks can be considered as structural factors, of which the two first ones are of growing importance while the third one has been swelling. The last two risks we have pinpointed appear to be less structural than conjectural but they are nevertheless of great importance in food makers' new challenges.

Figure 1: Number of major insolvencies in agrifood



Sources: Euler Hermes, Allianz Research

Figure 2: Combined revenue of major insolvencies in agrifood



Sources: Euler Hermes, Allianz Research

[1] Euler Hermes defines major insolvencies as those affecting companies with total revenue over EUR50m

AGRIFOOD COMPANIES ARE FACING FIVE NEW CHALLENGES

In the context of the changing business landscape across the agrifood industry, five new risks are pushing up operating costs to a new level:

Challenge #1: The costs of adapting to changing eating habits

With consumers increasingly seeking out healthier foods that are less harmful to the environment, agrifood manufacturers have to adapt to a new paradigm of de-consumption. This requires investing heavily in their product mix to increase healthy, local-food offerings that otherwise would not boost organic growth. Besides, the rise of single-person and two-person households worldwide is further changing consumer eating habits, raising food makers' packaging costs. And evolving consumer tastes are shortening product-life cycles, even as speed-to-market remains crucial.

Adapting to these new tends has a cost, and it is being compounded by the fact that demographics in the West do not support food consumption in volume any longer. For example, the IRI institute identified that while the population of France grew by +0.6% over the past four years, food sales in volume had decreased by -2%. Figure 3 shows how volumes of food products sold in French food superstores have seen a downtrend since 2017.

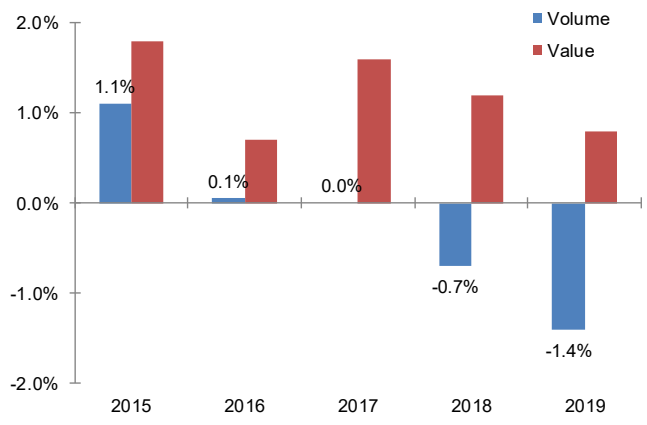
Challenge #2: Targeting a lower carbon footprint is coming at a price for food makers

Food production is responsible for one-quarter of the world's greenhouse gas emissions, so there is growing awareness that diet and food choices have a significant impact on consumers' carbon 'footprint'. The new cost for food makers is to zero in on the parts of the food production chain where CO2 emissions are the highest. Surprisingly, it is not transportation, which accounts for less than 10% of the total CO2 emissions from food (with the exception of products that are transported by air). The breakdown of emissions of CO2 equivalents in the US farming sector confirms that transport (i.e. fuel combustion) is a very small contributor compared to livestock: In 2010, crop cultivation, livestock and fuel combustion emitted respectively 300, 247 and 47 million tons of C02 equivalents in the U.S.; five years later, they were 299, 245 and 41 million tons of C02 equivalents. In 2020, they are expected to hit respectively 288, 284 and 30 million tons of C02 equivalents.

Instead, what consumers eat is far more important than where it traveled from, as shown in Figure 4. Producing a kilogram of beef emits 60 kilograms of greenhouse gases (CO2-equivalents) while milk or cane sugar emit just 3 kilograms per kg. Overall, animal-based foods tend to have a higher footprint than plant-based foods. When combined, land-use and farm-stage emissions account for more than 80% of the footprint for most foods.

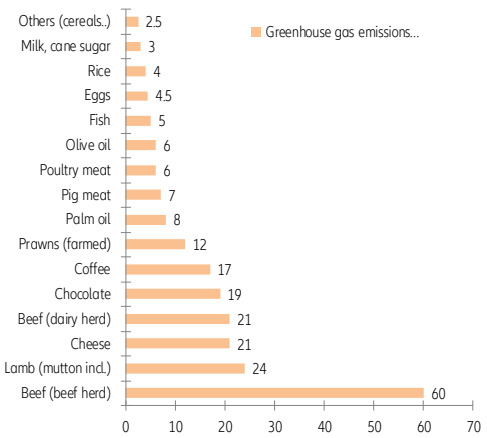
In this context, reducing carbon emissions requires changing farming practices, a time-consuming process, and securing a "green" supply of commodities, which is raising costs for food manufacturing companies.

Figure 3: Yearly evolution of agrifood sales in French food superstores



Sources: IRI, les Echos

Figure 4: Food C02 emissions (kg C02 -equivalents per kg product)



Sources: Oxford University, Poore & Nemecek study (2018)

Challenge #3: Rising trade policy interventions are forcing agrifood players to diversify food supply channels

Agrifood companies are coping with a higher number of trade policy interventions of all kind (from import-related to export incentives and export restrictions). Looking at the total of 6,000 new measures implemented since 2009 in the sector, however, only 40% have been dedicated to facilitate and liberalize trade, meaning in other words that a large majority (60%) are harmful. These 60% parts of trade policy interventions are complicating even further the lives of agrifood companies themselves, forcing them to diversify their supply channels and support increased operating costs.

Amid rising trade policy interventions across the agrifood sector, the soybean is an emblematic example of how strong changes in tariffs can raise the operating costs of food manufacturers. The U.S. is the world's largest soybean producer while China is the world's largest consumer, accounting for 60% of U.S. soybean exports before the beginning of their trade dispute. After U.S. President Donald Trump imposed an additional 10% tariff on $300 billion of Chinese goods, Chinese companies stopped purchasing U.S. agricultural products. At the beginning of 2018, U.S. soybean exports to China amounted to 30 million tons. After China imposed its retaliatory tariffs on April 2018, they plummeted by -85% down to 4.5 million tons before bouncing back to 16 million tons at the beginning of 2020. Between 2018 and 2020, U.S. soybean producers have seen their exports to China halve, much to the benefit of Brazilian ones.

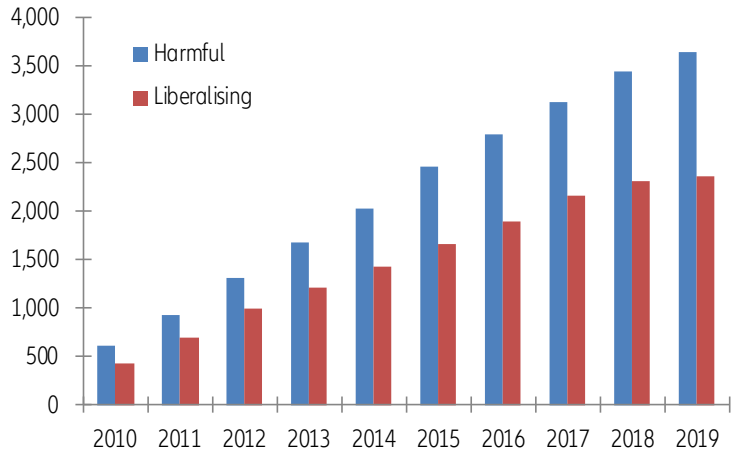
To manage the collapse of Chinese buying, American soybean farmers have searched for alternative markets. Moreover, they were left with a record high level of ending stocks, making their storage costs soar. Meanwhile, food makers have been forced to look for supply alternatives to Brazil. Tariffs have already taken a toll on upstream agrifood players. In the U.S., farmers have seen a surge in the number of bankruptcies since 2019. Yearly figures show that 595 farming businesses went bust at the end of October 2019 while there were only 354 at end January 2015. In other words, bankruptcies have gone up +19% year-on-year at end October.

Despite the U.S. and China signing a Phase one deal aimed at abating trade frictions last month, it remains unclear how much economic relief it will offer, especially for agrifood players. We consider that the deal is very unlikely to produce gains sufficient to outweigh the losses already suffered. The longer the trade feud goes on, the higher the odds of U.S. exporters losing the Chinese market for good.

Challenge #4: Upside pressures on wages

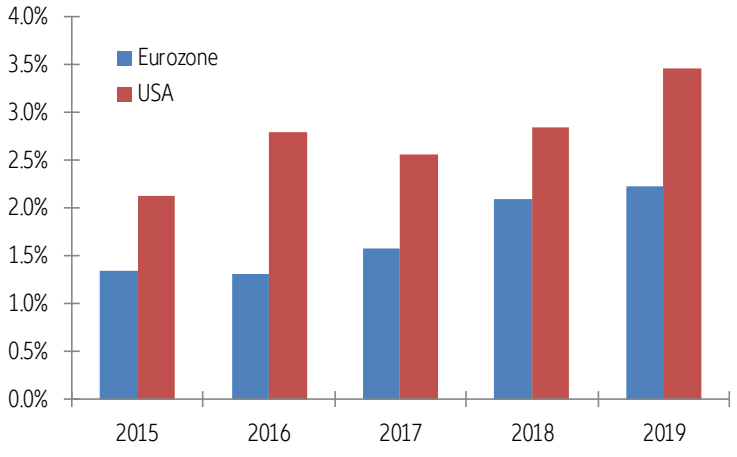
According to our panel of companies, the average weight of labor costs accounts for 11% of all operating costs in agrifood. This poses a challenge for manufacturers as the recovery in global labor markets has continued through 2019 (see Figure 6). The unemployment rate reached 6.7% at the global level and stands 0.2pp below its long-term average. In addition, job vacancy rates have continued to increase and doubled compared to 2009 in Europe, for example. They stand at above EU average levels in Belgium, the Netherlands, Sweden and the UK. This has driven up wage growth. In the Eurozone, for example, wage growth has peaked at 2.3% on an annual basis in 2019, above the long-term average of 2.1%. In the U.S., too, wage growth accelerated in 2019 and now stands above 3%.

Figure 5: Number of new trade policy interventions across the agrifood sector (cumulative figures)



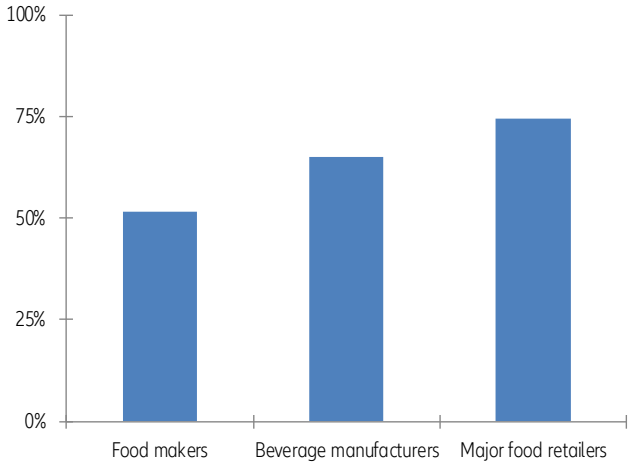
Sources: GTA, Euler Hermes, Allianz Research

Figure 6: Growth rates in wages for the U.S. and the Eurozone



Source: ECB

Figure 7: Share of large companies* in total revenue (agrifood vs.food retailing in Europe)



*Sources: Eurostat (latest data available in 2017) . *number of employees >250*

Challenge #5: The inability of food processors to pass higher input costs on to customers (i.e. mass retailers)

Last but not least, the paramount risk contributing to downward pressures on food processors' profits is the surge in raw material costs that they are unable to pass on to their vital outlets, namely mass retail. The surge is a result of the fallout from China's swine fever outbreak, which cut China's pork herd by more than a third from one year ago. As a result, pork prices have soared to record highs and the world's largest consumer of pork has had to massively import not only pork but also more beef and poultry. More broadly, the Asian outbreak has had a knock-on effect for commodity food prices worldwide. Forced to buy raw meat materials at a much higher price to churn processed food, food makers are bearing alone soaring supply costs due to their inability to pass them on major retailers.

The lack of suppliers' pricing power vis-à-vis retail is much more linked to the very high level of concentration in the food retailing than to the rise in online outlets. This high level of concentration fosters fierce price competition between suppliers, which do not have any other choice for being referenced. More broadly, food manufacturers are caught between a rock and a hard place: Either they suffer from higher input costs that they cannot pass on to their selling prices. Or they are forced into matching price decreases when raw agricultural commodity prices are low. In both cases, food processors are totally powerless against mass retailers' requirements and they usually have to absorb the rise in their operating costs as a result.

Figure 7 illustrates the substantial difference in the degree of concentration between food manufacturers and food retailers companies and how difficult it is for the former to be able to pass on higher input costs on to the latter. Large companies in the food retailing sector account for 75% of total revenue while they only account for 50% of total revenue in the agrifood sector.

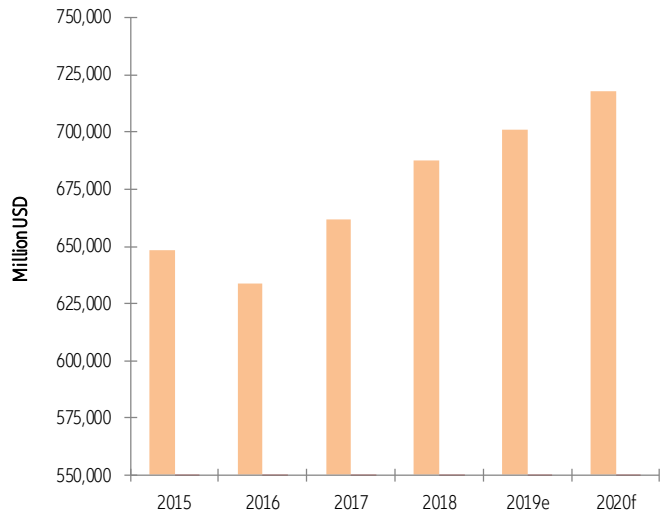
WHAT DO THESE NEW RISKS MEAN FOR AGRIFOOD COMPANIES?

In order to better understand how these five key cost factors are eating away at agrifood companies' profitability, we look into the breakdown of main operating costs for our panel of 53 companies. First, there is the cost of sales, which in our panel is forecast to rise by 1.7 percentage points to 69.2% in 2020, from 67.5% in 2017. In value terms, we expect it to hit USD718bn in 2020, up from USD634bn in 2016 (see Figure 8). The higher ratio of cost of sales to net sales indicates a poorer product mix due to the change in eating habits and also the inability of food processors to pass on higher input costs on to food retailers.

Then come all the other operating costs that can be summarized as follows: wage costs, marketing expenses, other operating costs and depreciation costs. Marketing expenses are all the more important now that agrifood manufacturers are compelled to aggressively expand their advertising spend to win back shoppers. It remains to be seen if the increased promotion of established staples will be enough to woo back shoppers who have defected to cheaper alternatives developed by retailers.

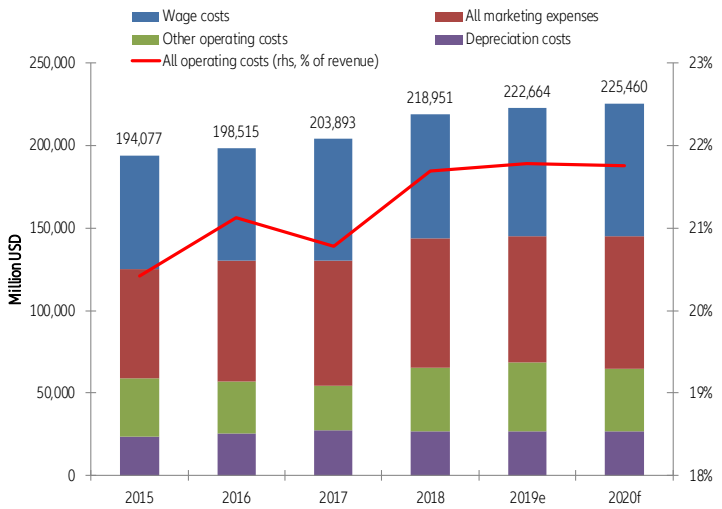
Figure 9 highlights the impact of the three other key new risk factors (costs of tariffs, reducing CO2 emissions, upside pressures in wages) on operating costs, especially since 2018, when the number of insolvencies in agrifood began to rise. We expect these three cost components to keep rising over 2020 and hit operating profits as a result.

Figure 8: Cost of sales of the global food and beverages industry



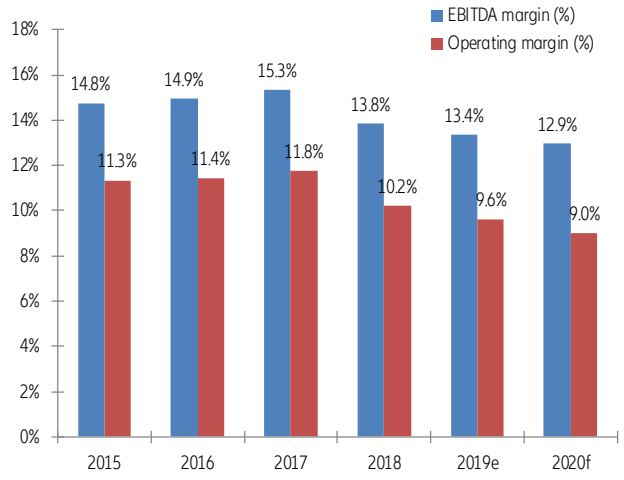
Sources: Bloomberg, Euler Hermes estimations

Figure 9: Breakdown of operating costs (cost of sales excl.) for global food and beverages



Sources: Bloomberg, Euler Hermes estimations

Figure 10: Change in the profit rates of the agrifood industry as a whole



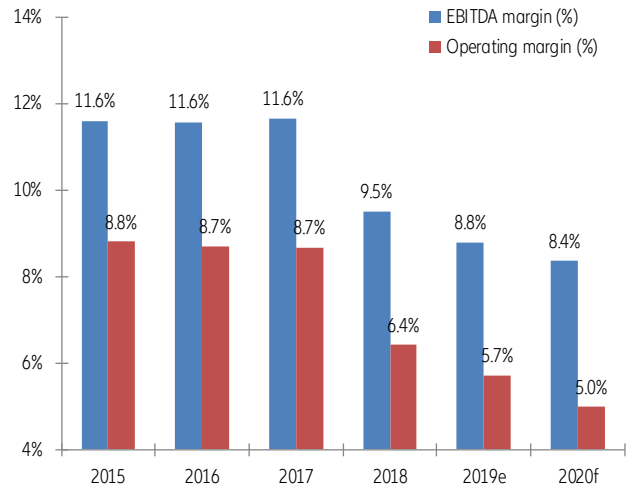
Sources: Bloomberg, Euler Hermes estimations

Taken together, this is likely to result in a fall in both EBITDA and operating margins over 2020, as shown in Figure 10 below. We expect the operating margin of the agrifood industry on average to drop by a further 0.6 percentage points in the current year, after already dropping from 10.2% in 2018 to 9.6% in 2019. Overall, agrifood operating costs expressed as a % of revenues will increase by +1.4 percentage points to 21.8% in 2020, from 20.4% in 2015, growing faster than the rise in revenues.

Even if the sector is still not close to a loss position, the impact of these new risks on agrifood companies' operating costs bodes ill for their future profitability.

The looming trend for the whole agrifood sector is regrettably being concealed by what we consider as the resilience of beverages. Even if we expect the average operating margin rate of beverage groups in our panel to go down from 21.9% in 2018 to 21.2% in 2020, the fact remains that this level is still going to be four times higher than that of food groups alone. Food makers alone are indeed expected to go through a very challenging 2020, considering the tumble in the average operating margin rate from 8.7% in 2017 to a meager 5% expected in 2020 (see Figure 11).

Figure 11: Change in the profit rates of food makers alone



Sources: Eurostat (latest data available in 2017)

Director of Publications: Ludovic Subran, Chief Economist
Euler Hermes Allianz Economic Research
1, place des Saisons | 92048 Paris-La-Défense Cedex | France
Phone +33 1 84 11 35 64 |
A company of Allianz

http://www.eulerhermes.com/economic-research
research@eulerhermes.com
euler-hermes
eulerhermes

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