# Food industry: Still solid but price volatility will bear watching

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# Contents



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# INTRODUCTION

Food industries were able to cope with the crisis in 2009 thanks particularly to the decline in prices for agricultural commodities. But since June last year, the sector has been faced with a surge in prices that has increased the cost of foodstuffs worldwide, more sharply in emerging countries. Agricultural commodities have become an asset class like equities and interest rates with the phenomenon amplified by the risk aversion of investors and the amazing world liquidity surplus. But other factors have contributed to keeping prices high this year and will continue to do so in 2012 (growth of demand, expansion of arable land devoted to biofuel production, and so on). In this context, the margins and cash positions of weaker companies will be squeezed to varying degrees depending largely on their capacity to pass on price increases to customers. Meanwhile, the economic slowdowns in the United States and the euro zone with recessions expected in Greece, Portugal, and Ireland, the economic repercussions of the nuclear catastrophe in Japan, and the growth of inflation in emerging economies constitute a panoply of risks that could undermine the development of smaller companies, which unlike very large groups mainly have regional operations with only a limited presence, if any, in international markets.

The consolidation process will likely continue in the sector spurred by the return of private equity funds and intensified by the difficulties that smaller companies will encounter in financing their investment programmes especially with respect to health and environmental regulations with their access to credit remaining difficult at best.

The scope of the survey includes companies that process the products of agriculture (like wheat, barley, rice, cocoa, and sugar) or breeding for human consumption. It excludes wines and spirits regarding the world survey. Upstream to the food industries it will focus on trends in raw materials, and downstream, on wholesalers and retailers. The advanced economies covered by the analysis will include the United States and Western Europe with a special focus on France and Japan. Two emerging countries will be spotlighted: China and Brazil. Particular attention will be given to macroeconomic factors that might influence household and corporate consumption patterns. And microeconomic trends (like company size, bank credit, price negotiation, food safety for example) will also be examined to single out risks that could affect the margins of sector companies or, in the case of speciality retailing, the margins of their customers, and influence their payment behaviour in the 2011 second half and 2012.

A close look at the United States will be taken via a meeting with two managers from the Coface local subsidiary, Coface North America. And another viewpoint will be obtained on France via a discussion with an agrofood industry underwriter with Coface.

# Food industry: Still solid but price volatility will bear watching

## Raw materials: A new asset class in a context of demand growth and increasingly frequent weather crises

After their surge in 2007/2008, prices for farm raw materials began to soar again in June 2010, affecting foodstuff prices worldwide with particularly sharp increases in emerging countries. No other asset class registered jumps in prices as spectacular as those recorded by some farm raw materials with grain prices skyrocketing 36% year-on-year through August. Sugar prices also soared, up 50%. Prices for meat (beef, mutton, chicken) and dairy products rose over 15%. The price increase for rice was more modest with that commodity not traded on the futures market and only a small fraction of its production traded internationally.

Since March this year the pressure on grain prices seems to have eased substantially thanks to a 3.5% increase in the harvest production in 2011/212 compared to 2010/2011 (FAO projections). The level has nonetheless remained high with no significant replenishment of stocks materializing thus far.

The pattern for corn has been almost identical: With stocks running particularly low, Chicago market prices skyrocketed, up a stunning 77% year-on-year through August. Soybean stocks, meanwhile, have conformed to expectations, a performance expected to limit any rise in prices for that commodity. Cocoa prices have eased back to the levels prevailing before the Côte d'Ivoire crisis for two reasons: The large volumes of cocoa flowing back into the market, enabled by the resolution of the crisis and the shift of private equity funds away from net buy positions.

### Farm raw materials become another asset class

The current up cycle has seemed different from the last one, however, since it has been spurred by the extraordinary surplus liquidity sloshing around the world, fuelled in particular by the expansionary monetary policies adopted by various central banks, notably the US Federal Reserve. Farm raw materials will thus be considered henceforth as an asset class comparable to

shares and interest rates but with a significant difference: Positions taken by investors may cause sporadic shortages in farm raw materials with short-term rates tending to be more volatile in consequence. That is particularly the case for Europe where, unlike the United States, positions taken by financial traders on farm assets are not subject to limits.

### Demand has been growing amid the on-going expansion of agriculture devoted to biofuels

Although speculation has thus played a role in the rise of prices for farm raw materials, other factors have contributed as well: The continuing growth of a more urbanized middle class in many emerging countries has naturally tended to benefit retail products. The pattern of consumption gradually adopted by the new middle class consumers is increasingly centred on national and international brand-name packaged products and meat-based foods. The twofold increase in world meat production has thus been a crucial factor in determining the prices of grain for cattle feed. Meat prices have risen steadily since September 2010 with no surges.

That trend notwithstanding, according to research by Oxford Analytica food habits in the major world regions remained strongly influenced by the relative scale of local production in the various commodities. Food industries thus include in their products, in majority and in decreasing order of the volume produced, the following ingredients:

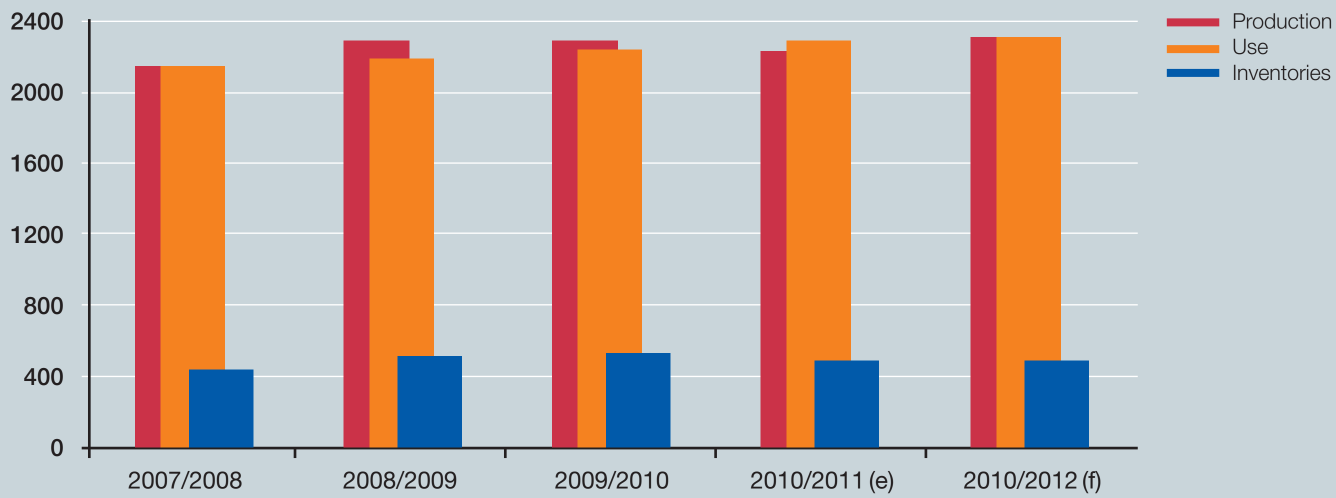
- meat, grain, potato, sugar, and vegetable oil in North America and Western Europe, and in majority in the United States and Western Europe,
- meat, grain, and potato in South America,
- rice, meat, and grain in East Asia,
- rice and grain in South Asia,
- corn and grain in South Africa,
- corn and vegetable in East Africa.

With the exception of rice whose price, as we have seen, has only been growing at a slow pace, all food families have recorded large increases these past months. Food-industry companies in advanced countries, where agricultural commodities not surprisingly show the largest spectre, will be the most exposed to the price volatility.

Concurrently, the expansion of arable land devoted to growing food for human consumption has been very weak. This trend is largely driven by the many reasons such as fallowing land in dvanced countries or the economic attractiveness (subsidies, yields, good profits) of land devoted to the cultivation of biofuel crops (particularly for diesel engines) in the United States and Europe. The trend towards devoting a growing proportion of arable land to this alternative type of farming has given little sign of letting up in  Brazil, responsible for 30% of world biofuel production according to Unctad (second largest after the United States, which represents 45%) or Africa, to the detriment of food producing agriculture.

**Cereal  production, use and inventories**

(in million metric tons)




Source FAO

### Weather conditions and stock levels, two additional factors that can influence prices

But the growth of demand is not the only possible cause of soaring prices. Completely unforeseeable weather catastrophes also made a significant contribution with the resulting loss of production prompting some producer countries to prohibit exports or set quotas. The recent natural catastrophes include drought in Russia, Ukraine, Kazakhstan, India, the United States (Kansas and Texas), Argentina, floods in Australia that have truncated grain harvests, torrential rains in April in northern United States, which damaged newly planted wheat, catastrophes in Japan that prompted authorities in various countries, like Food and Drug Administration in the United States, to take measures to control imports of products originating from north-east Japan. The drought gripping northern Europe since spring and the beginning of summer this year has raised fears of less-abundant harvests and the consequent difficulties, particularly in feeding cattle. The resulting pressure on prices has moreover been compounded by political events in northern Africa prompting some countries to increase their orders so as to build up stocks and be in a position to respond to the needs of their people in case of shortages. The events in Côte d'Ivoire have affected cocoa prices for several months now. Yet other factors could destabilise farm production including, for example, blight that could destroy entire crops, underutilisation of land in some countries, the sale by governments — particularly in sub-Saharan Africa — of land to emerging powers to the detriment of local food-producing agriculture. A lack of transparency on emergency stocks in terms both of their volume and geographic breakdown has moreover exacerbated the volatility. This non-exhaustive list of factors of risk shows how price volatility, as much as a price surge itself, constitutes a major source of risk for food-industry companies.

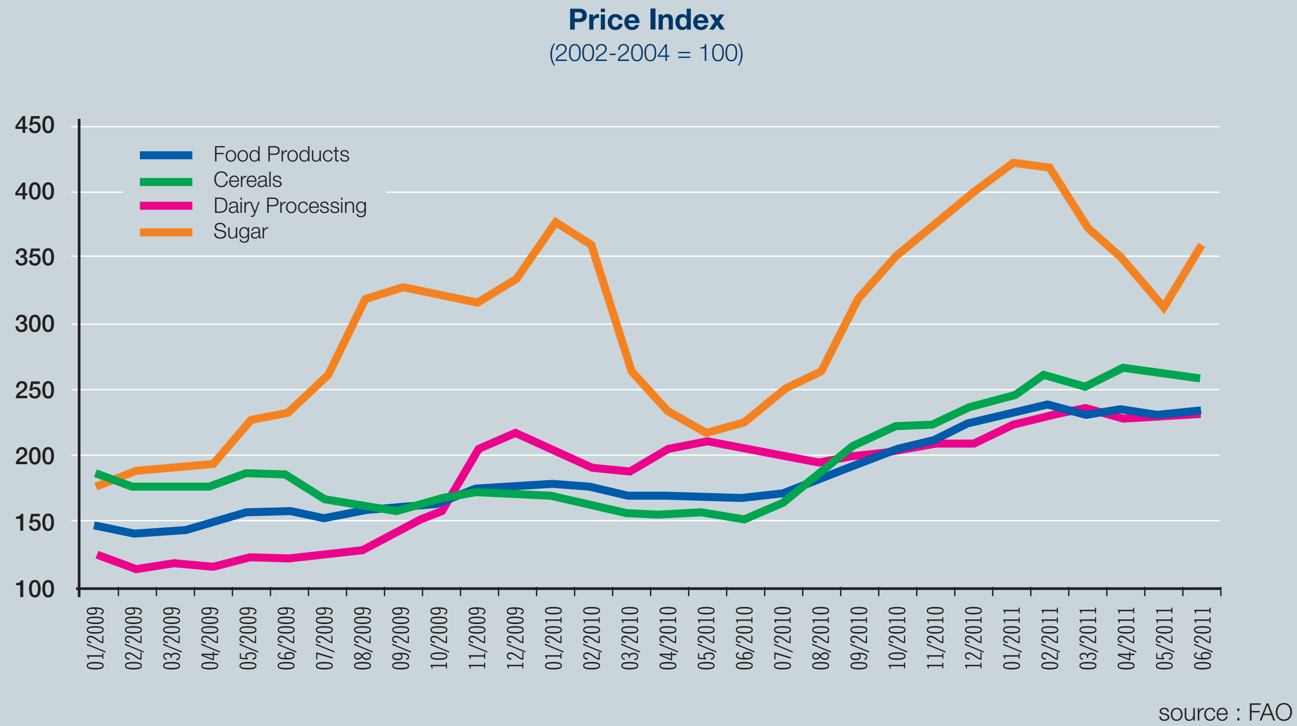
### Forecasting trends, a delicate exercise as in the case of grain, oil, and sugar

Attempting to forecast the possible rise or fall of farm raw-material prices is thus a very delicate task in view of the importance and unpredictability of current economic conditions. In an initial stage, the production outlook can be determined via surveys of farmers. In the case of grain, information on seeding plans and whether planting was done on schedule provides the basis for a first quantitative estimate. Data on stock levels enables judging the extent to which compensation could be made for a decline in production. Grain stocks are currently low *(see chart page 5)* and most new arable land is being devoted to the production of animal feed (soybeans for hogs and poultry for example) and even more so to producing biofuels.

Estimates put forward by various international organisations, particularly FAO and the World Bank, nonetheless reflect the likelihood that grain prices will continue to trend up. In the United States, the late start made this year in seeding wheat, the financial difficulties that have hobbled farmers and, in consequence, hindered the replanting of high-grade seedlings, in conjunction with low stock levels have already begun to put pressure on prices. And in Europe, the drought will likely affect production levels of the harvests and the prices of grain and meat. Bear in mind that the United States and Europe are dominant players in the grain industry. The trend in oils and oleaginous products seems to be stabilising but at high levels compared to those prevailing in spring 2010. Sugar prices, which had soared until January 2011, eased when a better-than-expected harvest in Thailand limited the severity of the shortage. And since May this year, they have resumed their upward trend with the markets appearing concerned anxiety over the prospect of a poor harvest in Brazil, which represents 50% of world exports. With harvests in the northern hemisphere only due to arrive on the market early 2012, keeping the world supplied will largely depend on Brazil's production. The longer term outlook meanwhile is bleak with the proportion of sugar cane used for biofuel continuing to grow. Fully 54% of the country's sugar cane production is currently siphoned off by the new energy in agreement with a government sensitive to the price Brazilians pay for petrol. The price of sugar will thus be unlikely to ease significantly any time soon.

### Durably high food prices despite the world economic slowdown

Food prices overall could at best level off: In August this year the FAO price index remained below 240 (base 100 = 2002-2004 average), which represents a 36% increase since August 2010. We believe moreover that the world will remain awash in liquidity particularly with the expansionary policy in the United States, pushing long term interest rates downwards, and thus making investment in high-yielded assets more attractive. **Prices for agricultural commodities are consequently expected to remain high through year end and in 2012, the world economic slowdown notwithstanding.**




# Who bears the brunt of the price rise in the food processing chain?

The impact of the price increases on the processing chain will depend on the agricultural commodity used. For example the flour industry, where products can contain a high proportion (up to 80%) of wheat, will thus be particularly affected. The same applies to coffee, for example. Processors and retailers can moreover find it difficult to react quickly to price fluctuations when their relationship is bound by supply agreements that can lock them in for months or even as much as a year. Negotiations thus tend to be tense undertakings especially with retailers exposed to very stiff competition between chains and squeezed by tight margins. Unlike industrial processors whose production cycle is relatively long from the entry of raw materials into stock to the bringing of end products to the marketplace. Retailers focus on short-term strategy and keep limited stocks. In broad terms, from spring this year, after their negotiations with the large retailers, the major industrial food processors in advanced economies were able to pass on the higher prices to downstream industries in the food processing chain. In the second quarter the cost of the increases was thus duly passed on to wholesalers and retailers, and depending on the pricing policy followed at the point of sale, ultimately passed on in consumer prices. Retailers that chose to make sharp increases in their prices, like Carrefour in France, suffered steep declines in sales volume. The repercussions in emerging countries were more severe, particularly in Brazil, China, and Indonesia.

The capacity of food processing companies to pass on all or part of the increased cost of their inputs depends on several factors including the leverage they enjoy in dealing with wholesalers and retailers, the brand recognition of their products, and the price sensitivity of end customers, and vice and versa *(see interview with Coface North America page 11)*. Some processors have been contending with pressure on their margins: Squeezed by cost increases they cannot always pass on, even partly, to the downstream industry and ultimately to the end customer. Several strategies for preserving margins are available to them:

- Pass cost increases downstream in the processing chain (a simple concept that can be difficult to implement as discussed above). But agrofood industries can compensate for reductions in sales volumes by announcing an innovation making it possible to keep list prices unchanged (such policy runs the risk, however, of driving vigilant consumers away),
- Agree to deliver several months-worth of stock to retailers at the old price in exchange for their acceptance of the new higher price for subsequent orders (retailers can thus gradually phase in the higher sticker prices to end customers).

Retailers, however, have little room for manoeuvre to effectively raise prices particularly with consumers in advanced economies facing not only the stagnation, even decline, of their disposable income but also the persistence of very high unemployment. Leverage factors will play a decisive role in dealings between industry actors, whether processors or retailers. Whoever comes out on top, however, this situation will doubtless lead to a reduction in the sales volumes and profits of actors in the branch and even the failure of the weakest among them. And inflationary surges could moreover develop in some countries The severity of the impact will depend on whether the processing companies operate in advanced countries where the proportion of food products in household shopping baskets is lower than in developing countries: Food products represent about 10% of household spending in advanced economies (9% in the United States and 13% in Japan, for example) compared to between 25% and 40% in developing economies and as much as 80% in the poorest countries.

The industrial companies that process the products distributed by retailers had to contend, however, with other additional costs notably linked to food traceability regulations and new packaging.

### For cost control purposes smaller companies lack the means available to large international groups

Rural financial markets make it possible to hedge price volatility through the use of call options that specify a transaction price. Such hedging devices are nonetheless best suited to larger companies in a position to recruit experts to manage this risk. An initiative taken just recently by the World Bank in association with a major US bank is expected to help limit risk in the future in the weakest countries. It involves making simplified financial tools available in emerging countries to enable local food companies to cover themselves against price volatility. In 2010, however, that facility was not available. In advanced economies, large industrial groups that resorted to such hedging contracts were thus able to delay price increases in the downstream processing chain. But subsequently renegotiated, the hedging contracts are now based on already high market prices for raw materials. As mentioned above, the renewal of the contracts between processing companies and retailers gave rise to very tense negotiations between the parties from February this year.

A high exchange rate against the US dollar, the main currency used in trading raw materials internationally constitutes a mitigating factor in the rise of prices for raw materials imported and incorporated in finished products. That has been the case for the Eurozone, Japan, Canada, Australia, the Scandinavian countries, and Switzerland in particular and for most emerging countries, ready to take action to limit the inflow of speculative capital while they combat the acceleration of inflation and the appreciation of their exchange rates (especially Turkey, South Africa, Brazil, and India). But the benefit becomes a handicap to companies that export highly processed products and consequently suffer from the strength of the local currency.

Any advantage deriving from a strong currency that reduces the cost of imported raw materials is sometimes limited by poor productivity in the production lines and the persistence of very high costs, particularly relating to promotional advertising. But reducing such costs could, however, affect sales volume with consumers often very sensitive to offers made via this type of advertising. While large groups certainly have some leeway to improve productivity, that is often not the case for distributor brands whose business model already calls for tight margins and low prices offset by high sales volumes. Distributor brands have leveraged the current crisis to improve their penetration rate, but vigilance will nonetheless be in order with companies that are subcontractors to distributors and accordingly have little leeway to impose price increases. It nonetheless appears inevitable that the price increase imposed on food processors and retailers thus far will be passed on to their customers in the 2011 second half and in 2012. The price increases will likely be relatively large in emerging countries that enjoy strong economic growth and more limited in advanced countries with sluggish economies.

### Smaller companies are in a poor position to exercise control over the value chain and prices

Large companies have considerable resources to invest in diversification of their product range and development of the new structures needed to extend their presence in the fastest-growing markets. And their operations abroad enable them to procure raw material supplies at the best available price, especially, as evoked above, since they employ experts for that purpose. Companies so endowed will only be marginally affected by such major adjustment in the marketplace, with the slowdown in consumption in advanced countries offset by the continuing dynamism in some emerging regions. Their profits could nonetheless suffer from the consequences of the various commercial negotiations engaged with the major players in the food distribution segment. Retailers, meanwhile, will be affected by the limits they will face in attempting to pass on to their customers price increases granted to some powerful groups in the food industry, especially in the case of low cost retailers whose economic development model is based on narrow margins. Nonetheless, this situation could be partly offset by volume increases fostered by household cautiousness.

A completely opposite situation applies to smaller food companies for all the reasons just discussed but working in the opposite direction this time. This involves companies that operate locally and export little but are, however, often solidly established in their region. Companies in this segment will bear close watching particularly as regards:

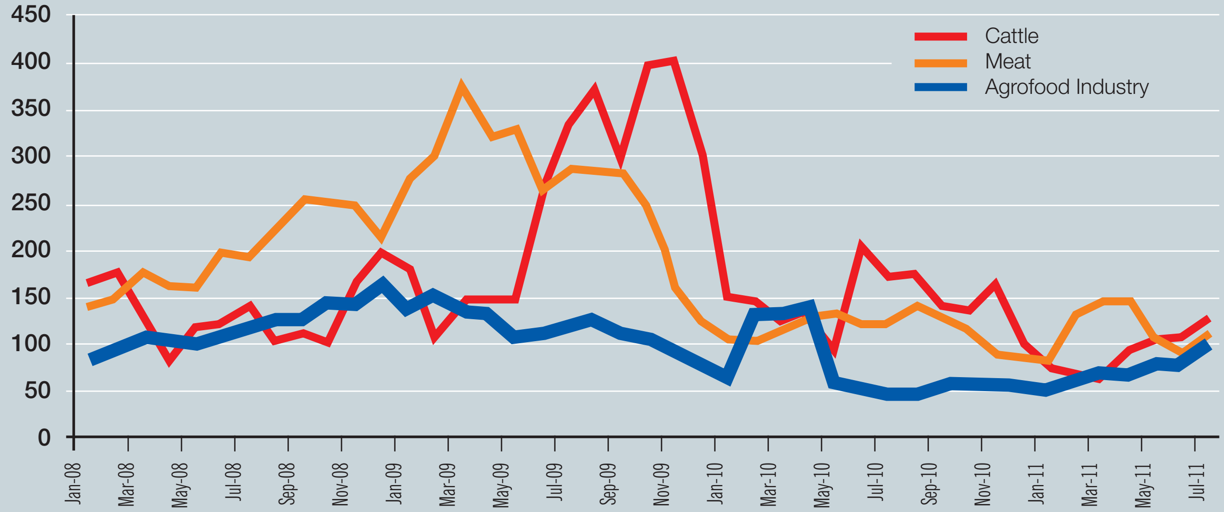
- heir geographic reach,
- their product positioning,
- the solidity of the farms on which they rest,
- the degree of their dependence on raw materials and their control over prices,
- their success, if any, with distributor brands that have been gaining market share,
- their distribution networks, (regional supermarket chains, neighbourhood retailers in urban areas with highly populated captive markets),
- their investment in promotional advertising,
- their debt and profit ratios and cash flow,
- the macroeconomic forces shaping the market, especially the trends in household disposable income, unemployment, the savings rate, and loan distribution.

With their mostly local geographic positioning, the relatively smaller food companies in many advanced countries are thus faced with either sluggish development prospects or, in the case of those on the periphery of the Eurozone, with recession. In emerging countries, where they also cohabit with large international groups, the relatively smaller food companies will benefit from the dynamism of consumption but will also have to cope with economic overheating phenomena that could weaken them.

**Coface agrofood industry payment incident index has been increasing since January 2011, in line with the rise in agricultural commodity prices.**

**Coface payment incident index evolution**

(100 basis : 2007 avg.)




source : Coface

## The increase in costs amid a persistent crisis has spurred consolidation and diversification in the sector

The crisis has prompted large groups to restructure. They also have a strong presence in emerging countries where very buoyant performance compensates for the sluggish growth in developed nations. Most have abundant financial assets that allow them to carry out successful consolidations. Indeed these have continued practically unabated, even during the crisis, which has opened up very advantageous consolidation prospects for the sector's leaders. Major industrialists have leapt at the opportunity to take over companies of various sizes operating in complementary sectors or niche markets, or doing business in emerging countries where the buyer is not yet operating. In 2011, with rising agricultural commodity costs squeezing the revenues of listed companies, further takeover opportunities have arisen. Other unlisted companies too small to absorb the increased costs they face, or to finance developments needed to comply with health and environmental standards, are easy prey for the larger players, particularly if the smaller companies are operating in niche markets. Consolidation in the food industry looks set to continue, spurred by the comeback staged by investment funds. These have been very active over the last two years: 3G Capital bought Burger King Holdings, while Ralcorp Holdings acquired American Italian Pasta Company. On the mergers side, Kraft took over Cadbury, which has a strong presence in 12 emerging countries, including India; General Mills took over Yoplait to strengthen its presence in this buoyant sector in emerging countries, where dairy product consumption is steadily increasing; PepsiCo purchased Russian giant Wimm Bill Dann; and JBS acquired Sara Lee's meat business.

Niche business is also likely to grow more rapidly thanks to wider operating margins. Last year's world leader Nestlé diversified into foods designed for consumers suffering from medical conditions such as diabetes, obesity or cardiovascular disorders. Restrictive food hygiene initiatives launched by the Food and Drug Administration are not unconnected to these strategic developments at Nestlé, nor indeed those at Danone, which was the first to initiate this kind of diversification. Food industry players are thus impinging on pharmaceutical territory, which means fierce competition is to be expected in these high-margin markets. Small, innovative companies that lack the necessary funds to adapt to clinical standards will now be targeted by both food and pharmaceutical giants, and this will up the stakes considerably.

In times of crisis or economic slowdown, as is now the case in advanced and even emerging countries, with increasingly fierce price competition in the context of rising input prices (e.g. raw materials, packing, and transport), boosting sales volumes becomes a key challenge. Since the beginning of the crisis, many major players in the sector have, in parallel with their branded products, developed low-cost lines to compete with distributor brands. Expected consumer resistance to higher priced products does not, however, seem to have materialized during the crisis. The profitability of this strategy, with prices rising not only for agricultural commodities but also for plastics, aluminium and transport, will be difficult to maintain without passing on rising costs further down the supply chain.

**Distributors who keep introducing special offers may well find their margins in a dangerous downward spiral.**

## United States: A balance of power in the sector in favour of wholesalers and retailers over SMEs

The United States economy is highly fragmented, but there are many multinational groups in the country. Of the ten largest world companies, seven are American, Cargill being the leader. The latter is a multi-product group, like Kraft which is fourth largest, behind beverages manufacturer PepsiCo. Then comes Archer Daniels Midland (cereals, edible fats and oils), while Coca-Cola (beverages) is in seventh place, followed by Mars (confectionery, ready-made meals) and Tyson Food Inc. (meat). Half of the thirty top world companies are American.

However even these large groups are facing drastic pressure from retailers, in particular "membership retailers" whose business model allows no leeway on margins. In the international context of increasingly high and volatile agricultural commodity costs, only part of the extra cost is being passed on to the consumer
*(see interview page 11).*

# Who absorbs rising costs in the USA: producers, distributors, or consumers?

A close look at the sector in the United States and current risks with **Patricia Patterson**, risk manager in the underwriting department of Coface North America, and **Tom Feuerstein**, analyst in the risk monitoring department

**Patricia Patterson,** risk underwriting manager with Coface North America

**Tom Feuerstein,** analyst in the risk monitoring department

**➔ Would say underwriting risks for the food sector in Coface North America is different from underwriting risk for any other sector?**

➔ **Patricia Patterson (PP):** No, it is not very different. Our clients are large corporations or medium sized companies with niche positions employing less than ten people processing packaged food products. They sell to very large retailers representing two-thirds of our portfolio to I would say mum and pop family businesses, employing two people at the most. The most difficult segment to underwrite risk on is certainly the family companies as there are no financial data available. Our information comes from visiting these companies, and even though it is tough job to get these data. I guess it is quite the same thing everywhere as there is no obligation for this type of companies to publish their accounts.

**➔ What does the sector represent in the US economy?**

➔ **Tom Feuerstein (TF):** The American food industry is actually highly segmented both in terms of the production chain and geographic region. The United States has roughly consumed over $1.100 billion of food in 2009, 8.2% of GDP. Food consumption has traditionally expanded at a rate similar to the population growth. And there is a correlation between income level and food consumption. And food remains one of the few industries in which the United States is a net exporter.

**➔ With this prolonged crisis, what headwinds are facing the food industries and food specialized retailers most?**

➔ **TF:** The deleveraging of American consumers, along with the rise in their saving rate -quite high now by American standards- is certainly one of the two main problems some actors have already adapted to. American shoppers are very keen on spending money on known labels, but now they seem to be very cautious in their spending, either at shops or for their leisure, hotels and restaurants. That is particularly true in areas where the unemployment or precarious jobs are the highest, such as Nevada, California, Florida or Mississippi, but at the same time California and Florida are very populated states, first and fourth ranks, and that is certainly a source of development for the industries. The second headwind is the rise in agro commodities, along with the high level in energy prices, which is a strain in the production process, for any company in any sector. More than the rise I would say the most difficult risk is to manage input price volatility, as sudden diseases or climate conditions exacerbate the industry environment with uptrend risks. The agricultural portion of the industry is facing constantly fluctuating fertilizer and pesticide costs. It relies on significant government subsidies and price control in order to remain viable and faces pressures with the restriction of the acreage of farmable land. And subsidies towards the production of ethanol-based fuel have impacted corn production and consumption, which has triple since 2005. Concomitantly, a weak harvest and a strong demand have caused the price of corn to swell, with consequences on the meat and dairy segments, as well as on food processors.

➔ **PP:** For food processing industries, now all will depends on their ability to pass through the inputs rising prices on their clients, wholesalers, supermarkets, restaurants, convenient stores...in a context, as Tom has pointed out, of household being cautious when they shop for food or grocery and of high competition between the different distribution segments. This competition is actually more important between supermarkets and membership wholesalers, such as Costco, Sam's Club, a subsidiary of Wall Mart, or BJ's Wholesale Club. These extra low-cost retailers bet on high volume in sales at cheap prices: for example, goods are bulk-packaged, displayed for sale on the shipping pallets used for their transport. They are more dedicated to large families and businesses who have become members to be allowed to buy there. With a wide presence in the country, and abroad for the big ones, they have the power to compel food manufacturers to lower their prices, all the more with very narrow margins, around 1%, whereas supermarkets operating at regional levels have not this power to impose their conditions. At this stage, by mid-year, it seems that the rise in commodity prices have only partially been passed through to customers.

**➔ Do you think keeping a great part of the commodity price progression is sustainable for food distribution?**

➔ **TF:** As Pat said, food producers have been passing on increases in farm commodity prices to wholesalers since last October and wholesalers only began to pass them on two months later. Although doubtless affected by the delay in passing the increases downstream, food producers in general continue to enjoy wide margins. We nonetheless keep a watchful eye on the trend financial performance, The retail segment, however, will bear particularly close watching since it has proven unable to pass on to customers the higher prices charged by wholesalers with consumer prices thus rising only slightly. The crucial question at this juncture: how much longer will retailers put up with the resulting loss of income. In past months discounting operations on various products have become increasingly commonplace. With margins squeezed in consequence, such sales promotion strategy cannot be pursued indefinitely.

**➔ Could this situation be an opportunity for store labels to gain market shares?**

➔ **TF:** Private labels have gained consumers' favors with the crisis. In three years time, they have increased from 16 to 20 per cent in value, and to 24 per cent in volume. It is true American shoppers are extremely keen on international and national brands. So they were a little bit suspicious about the so-called house brands. But with rising food inflation, the price has become the determining factor. So Americans have chosen these products more largely, all the more with the improvement of the private labels quality. More Americans are now convinced store labels are as good as national brands, if not better, and they accept to pay more for them. With the last jolts of the crisis, these products are likely to still attract even more shoppers. Therefore there is an opportunity for larger sales turnover for the food industries that have specialized in the house label product processing. Growth is expected but it should not reach the market share seen in Europe, roughly 50% of the food sector spending. But e-commerce, industry promotion, technological developments and even market consolidation have opened opportunities to this segment of the industry. Retailers offering a good range of labels are likely escaping from a too high pressure on their margins as their store labels are sold at higher prices than the other products offered on the premises. Even the membership stores have their own brand, as Costco with its Kirkland label. It will be hard for the national brand industries to recover the market shares they have lost.

➔ **It seems that food industry is attracting investors. Is that a signal telling us the industry is in good shape?**

➔ **PP:** Certainly, we think the sector is globally in good shape. Some companies have attracted investment firms and banks, such as beautiful companies as Burger King Holdings acquired by 3G Capital, or American Italian Pasta by Ralcorp Holdings. Equity firms are strategic partners to industrial firms bringing them the cash they need to develop.
And private label processors should be wooed regarding the future development of this segment. The sector is actually likely to going on with further consolidation, as money is still cheap, credit available for large companies, which compose the sector business fabric in America. Some highly leveraged companies or SMEs operating in niche are looking desperately for cash. They have been unable to invest in R&D during the crisis to stick up to the changes in the consumers' purchasing habits. So they are ready made-preys to be taken over by bigger ones, such as Pilgrim's Pride, the largest poultry processor in the United States, picked up by the Brazilian meat processor JBS. Some will need more cash to stick to the new regulation.

➔ **Are you hinting to the new Safety law voted last December?**

➔ **PP:** Yes, this new legislation gives the Food and Drug Association more aggressive power in order to recall food products and to impose more encompassing food guidelines to curb obesity and to improve child nutrition. These new regulations will constrain food makers to invest more in R&D. Smaller ones might not have the funding for complying with them. This is a factor that will accelerate mergers and acquisitions in this year.

*« In past months discounting operations on various products have become increasingly commonplace. With margins squeezed in consequence, such sales promotion strategy cannot be pursued indefinitely »*

# Japan: Food processors faced with sagging confidence

There are some 40,000 companies in the food sector in Japan, representing 12% of total industrial production. Although Japan is self-sufficient in rice, it remains highly dependent (as much as 60%) on imports for its supply of meat, fish, fruit and vegetables. Japan is one of the world's largest importers of foodstuffs. Its chief suppliers include the USA, Canada, Australia, China, Korea and Thailand.
This is the context in which the March 2011 catastrophes occurred, with the destruction of fishing ports and radioactive contamination of soil. As a result, the nation's food industry is likely to suffer from a lasting loss of confidence in home-grown products by Japanese consumers. This particularly affects rice, meat, seafood, fruit, vegetables, and tea. A lack of transparency in the aftermath of the nuclear disaster at Fukushima, along with revelations of food contamination that have gradually filtered through, have prompted Japanese consumers to shun domestically-grown produce. Lack of public trust in official tests to measure levels of radioactivity in foods is unlikely to be reversed in the near future. Between mid-May and the early summer, almost 5,000 food products in 22 prefectures have been tested positive. Unless confidence in the food chain is quickly restored, consumers are likely to avoid nationally-sourced produce for a long time to come. These food safety concerns are likely to lead the Japanese to choose products from abroad, especially with the rise of the yen reduces the ultimate cost of imported goods. Although household consumption will likely decline in 2011 amid quasi-stagnant real wages, a slight rebound is expected in 2012. Nevertheless, food is likely to remain the chief household outgoing in Japan.
In this context, Japanese food processors, whether operating locally or for export, are likely to be particularly hard hit, although the strongest may be able to diversify their supply sources. Moreover the strong yen will continue to erode the competitiveness of Japanese exporters. In addition, companies operating in the east of the country, from the north of the archipelago to the Tokyo area, will have to cope with power shortages by finding other energy suppliers. The shutdown of some other reactors makes the electricity supply even more difficult.

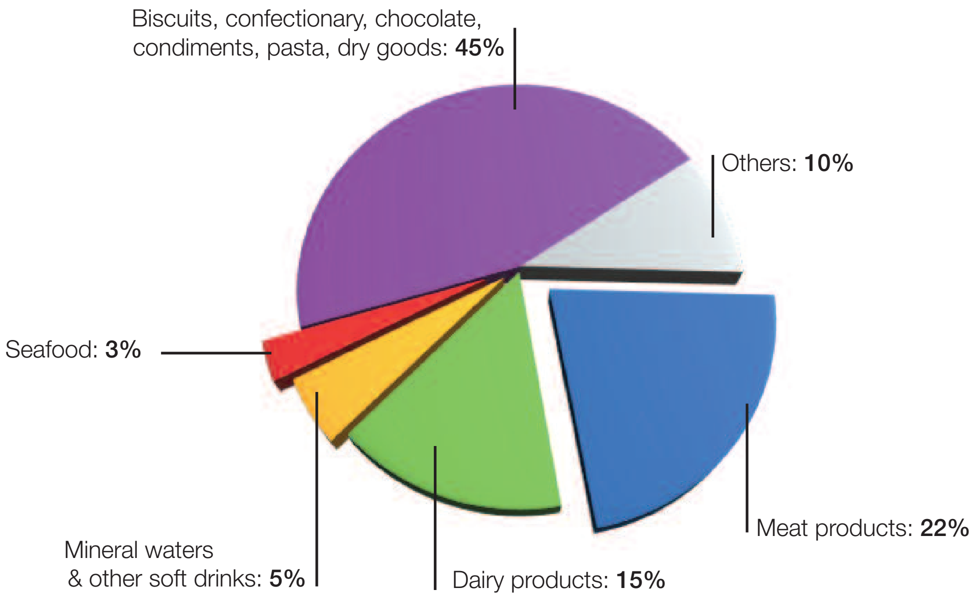
**Margins will thus likely remain under pressure in coming months. But the new Prime Minister Yoshihiko Noda's plan to ask for a vote, probably in October, on financial assistance focused on smaller companies jeopardized by the high level of the yen could bring exporters some breathing space.**

# Europe: A multitude of small and very weak food companies

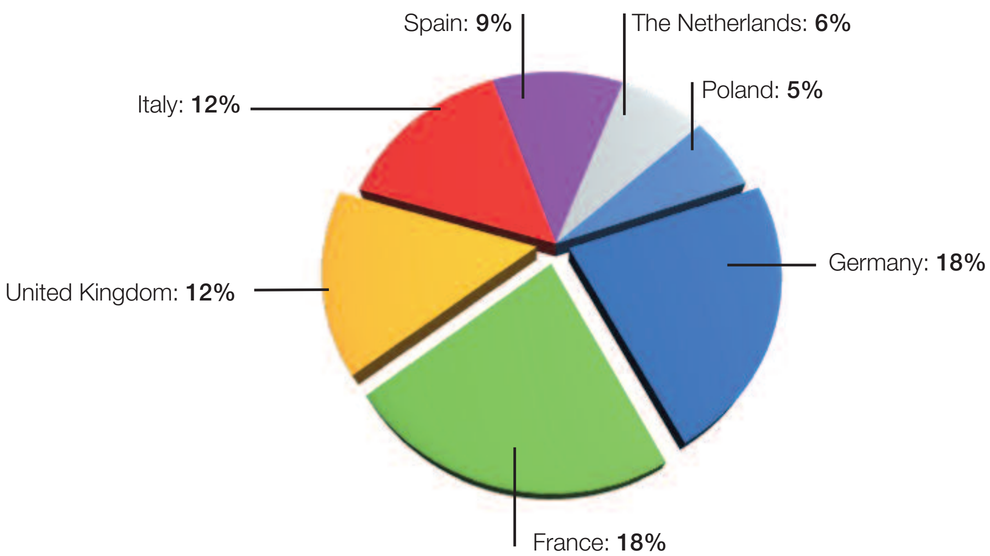
With some 310,000 companies operating in Europe, the sector appears highly fragmented. Of the ten top food companies in the world (excluding alcoholic beverages - wines, spirits, and beers – which are not within the scope of this study), only three are European groups. Nestlé is by far the largest in Europe, ranked second in the world after US giant Cargill; both are characterised by their highly diversified product range. The Dutch/British group Unilever, also a multi-product player, ranks sixth, with turnover one-third that of Nestlé, while Danone holds tenth place. The top ten include seven US companies. There are thus clearly few large companies in Europe. Meat products have the lion's share (22% of turnover and 14% of companies), followed by dairy products (15% and 4%). Mineral waters and soft drinks represent 5% of turnover, and seafood 3%, with 1.5% of companies operating in each of these sectors. Some 45% of turnover (73% of companies) is spread among biscuits, confectionery, chocolate, condiments, pasta, and dry goods.
Over 80% of turnover of sector companies is generated in seven countries: Germany and France around 18% each, the UK and Italy 12% each, followed by Spain (around 9%), the Netherlands (6%) and Poland (5%). The EU generates 75% of world food exports, a proportion 10 points higher than the overall manufacturing industry average. The biggest exporters are Germany, France and, thanks in part to its quality port infrastructure, the Netherlands.

How well sector companies cope with the expected decline in household demand will depend on their structure, particularly in Ireland, Greece, and Portugal, where another recession is expected this year. In Germany, there are twice as many small

## Breakdown in turnover by activity
(%)



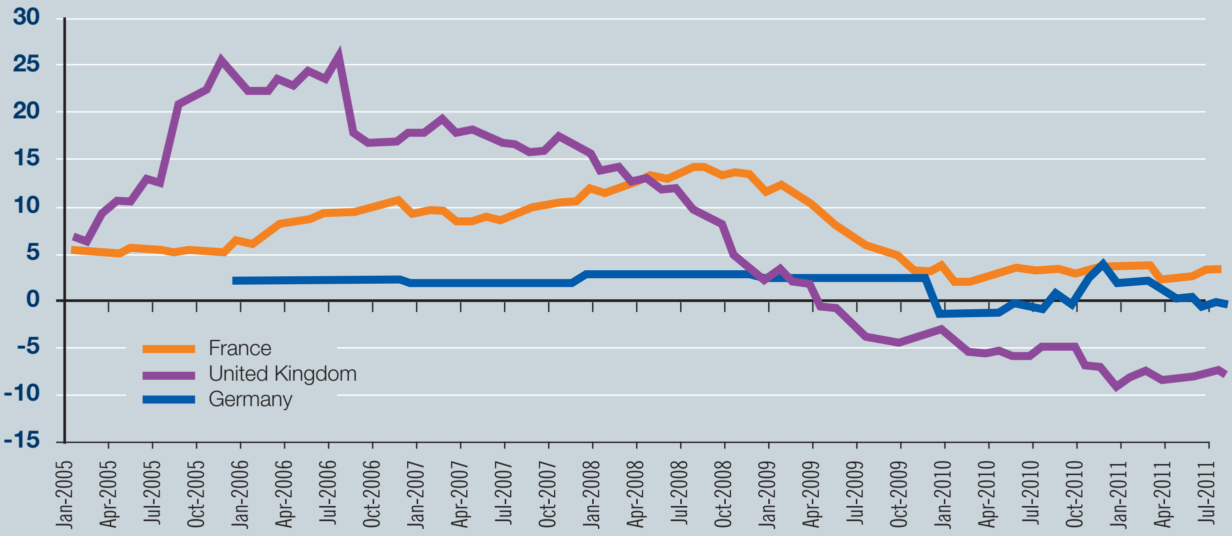

## Breakdown in turnover by country
(%)



companies in the sector as in France, and three times more than in Italy. As in other manufacturing sectors, they are larger than those operating in other European countries. They nonetheless have to cope with parameters specific to the German retail market: discount networks are highly developed, which leads to increased pressure on prices. Health regulations are also very strict in Germany. In 2011 and 2012, German companies are set to benefit from a stronger economic recovery in Eastern Europe than elsewhere in Europe, especially if the 2010 upturn in household consumption continues. However data available in 2011 augurs a likely slowdown in German consumer spending. Corporate credit remains tight in many European countries, and although it is picking up slightly in France and Germany, it is still below 2007 levels *(see graph)*. It is of note that in France, cooperatives control 40% of the food sector, via subsidiaries and shareholdings.
The high concentration of European distribution, coupled with strict product specifications prevents many small companies from getting their products onto supermarket shelves. This handicap is probably less strong in Italy, where companies find it easier to sell their products. Actually, they benefit from the existence of a profusion of small local stores and from national eating habits biased in favour of Italian products and labels of origin. In 2009, food purchases in Western Europe represented 8.5% of average household spending in the UK and 16% in Greece, while the figure was higher in Eastern Europe, reaching 23% in Lithuania (source: Eurostat). Growth in 2011 is expected to be around 1.6% in the euro zone with recessions in the three peripheral nations, and 1.1% in the UK. In this context, household consumption will decline sharply not only in Greece, Portugal and Ireland, but also in the UK. This will affect spending on food, despite its being, to a certain extent, incompressible.
**Food processing companies in these countries will face severe difficulties, and a rapid upsurge in bankruptcies is to be expected.**

**SEE FOCUS FRANCE**
- **A giant with feet of clay in the face of gloablisation** page 20
- **A discussion with Claude Eugénia, agrofood industry expert underwriter with Coface** page 25

**Credit bank to corporates**
(YoY change, %)

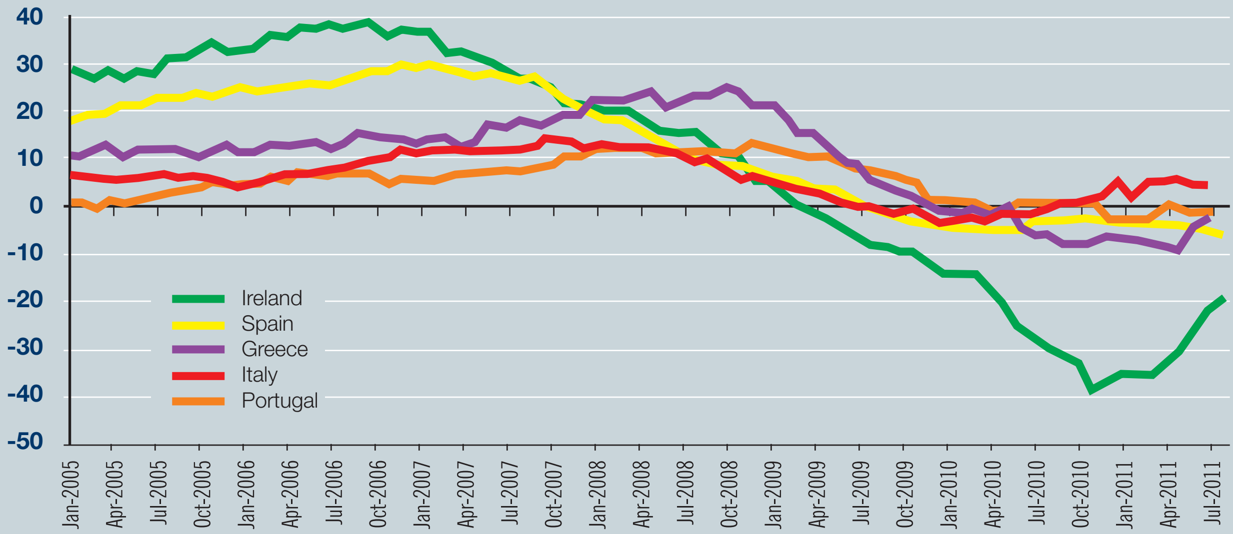


Growth in Eastern Europe is likely to be around 3.8%. Although household spending will be trending up in Poland and Lithuania (up 3.2% and 5% respectively), and even in Hungary (up 2.1%), it will be sluggish in the Czech Republic and Slovakia. With the exception of Poland, which avoided recession, the region has been severely affected by the crisis and consumption remains below 2007 levels.

*« Recessions are expected in Greece, Portugal and Ireland, along with a sharp decline in household consumption. This will affect spending on food »*

**Credit bank to corporates**

(YoY change, %)



# Emerging countries/Focus on China and Brazil: Food safety and inflation, risk factors for the food processing and distribution industry

## China: The food processing and specialised distribution industries confront two risks

**The first risk is structural: It involves food safety**

The sector, especially the dairy industry in 2008, was hit by food safety problems when tests revealed the presence of banned chemical additives. The legislation introduced in 2009 and recently reinforced and the raising of national standards expected by end 2011 bear witness to the government's commitment to clean up the sector. The authorities have tightened up checks and re-issued licenses. By April 2011 only 1,176 dairy industry firms had been granted authorisation to operate and over 3,000 firms in the sector were found to have been using unauthorised additives.

As a result, the sector has a major image problem among Chinese consumers. The consolidation now taking place is expected to result in the disappearance of the smallest firms, often family businesses, in favour of larger structures with the participation of foreign investors likely to quickly improve manufacturing-process reliability and product quality. So the stakes taken in Chinese food companies by private equity firms and multinational groups is a sign of strength.

The food-safety scandals, together with the emergence of a middle class with money to spend, have accelerated the changes in buying patterns in households whose rapidly rising incomes allow them to switch to food products with higher added value and better packaging.

**The second risk — an increase in inflation — is cyclical in nature**

Inflation has been particularly high in the food sector (above 10%). What is behind this is the elevated level of raw materials prices, the sharp rise in agricultural wages in particular (increasingly scarce labour supply in rural areas) and the implacable rise of rent for arable land, especially in proximity to towns, as well as the drop in production caused by the drought which affected the centre and east of the country. In one year, the price of pork has risen by 57%: Because the costs of animal feed are rising, pig farmers have cut their production at a time when the urban middle class are consuming meat more frequently on the back of rising incomes (over a third of income is spent on food). As a product particularly appreciated by the Chinese, pork is included in the food prices index which itself makes up about 33% of the total prices index. Inflation in 2011 is expected to be around 6% and around 4% in 2012. This trend could affect the confidence of Chinese consumers who could rein in their spending on food, which makes up about 30% of their total purchases. The impact could also be amplified by a more restrictive Central Bank monetary policy aimed at containing inflation.

In this context, traditional distribution is under increasing competitive pressure by the use, in certain regions, at the initiative of local government, of low cost, highly subsidized sales outlets, especially for fruit and vegetables. The province of Guangdong has, accordingly, planned the opening of 300 stores on top of the 40 already in place. This new type of distribution now competes with the small family stores which still dominate the market and which have many weaknesses. In the past decade, the big multinational distribution companies (Hong Kong's China Resources Vanguard, France's Carrefour since gone, the American Wal-Mart, the Taiwanese Trust-Mart and the British Tesco) have penetrated the market alongside the three most important chains Lianhua, Hualian and Nonggongshang, all three publicly owned. Finally, the convenience stores are concentrated in the very large cities where households have greater purchasing power. Relations with the food industries follow the same model as in the industrialised countries. For foreign groups there is a growing risk of coming up against increasing competition with Chinese food industries and distribution chains, which will not shy away from "borrowing" the know-how of their western partners and touching the patriotic chords of consumers to win market share. Thus, Wahaha, manufacturer of mineral water, fizzy drinks and dairy products will be launching a chain of commercial centres allowing it to escape the iron grip on prices and the margins taken by mass distributors. There is the risk too of having to bend to government demands regarding prices so as to help fight inflation with the consequent risk of lower margins.

# Brazil: A twofold handicap with a high real and inadequate infrastructure

In Brazil, the development of the food industries benefits from the existence of a very affluent fringe of population and by the expansion of a middle class with growing incomes and ready access to credit Firms benefit from the great diversity of supplies available locally both tropical and temperate climates, impressive expanses of land and water reserves which have facilitated the rapid growth of agricultural production and cattle breeding. Innovation at the initiative of the public sector with the Embrapa research body (Empresa Brasileira de Pesquisa Agropecuaria) also contributes to development with its goal of increasing production while avoiding further deforestation and preserving ecological balance.
The sector is characterized, on one side, by large international multinationals and, on the other side, by a very fragmented local economic fabric but which nonetheless also includes some big players of Brazilian origin like Sadia and Perdigao, General Mills and Laticinios Condessa… capable henceforth of conducting tight negotiations with the major distributors. The international groups seeking to penetrate the market have had difficulty getting established with Brazilian consumers preferring long established brands or the more affordable local products of smaller companies.

The Brazilian heavyweights operate in various sectors including meat (Brazil Food, -ex Sadia and Perdigao- and JBS), sugar and ethanol (Copersucar, Cosan...), and orange juice (Cutrale, Citrosuce) segments, as well as in the dairy industry (Lacteos Brasil –ex Bom Gosto and LeitBorn-) and have benefitted from international financing.
Brazil has become a major exporter of agricultural commodities (coffee, maize, soya, sugar). Invoiced in dollars, the rise of the Brazilian currency is not a handicap for Brazilian sales of raw materials internationally. Against this, the industrial part of the sector (processed products, orange juice, poultry, beef) is being hit by rising import costs not offset by the real's appreciation. The Brazilian Central Bank increased its Selic rate during the first half of 2011 but lowered it for the first time in two years to 12% at the end of August, giving preference to spurring growth rather than combatting inflation. Despite this, capital flows are not expected to reverse significantly in coming months, keeping the Brazilian currency at high levels. Exports could moreover suffer from the slowdown in demand in the United States and Europe, the main customers for processed products, but benefit from the acceleration in intra-regional orders driven by growing urbanisation and rising incomes in the region. They could also benefit from orders from Japan, obliged to increase its purchases of supplies from abroad in response to the fears of Japanese households as to the safety of production on the archipelago.

Industrial profitability is also threatened by the state of infrastructure: the great distances between production sites and shipping ports, the lack of storage areas, and the poor performance of roads and railways.

Sales of food products are currently benefiting from a particularly strong surge in Brazil, which, like Chile, has rapidly emerged from the crisis and boasts a pace of urbanisation and a level of household incomes higher than in other regional countries of the zone. These trends also explain the existence of local supermarket chains, the largest being Group Pao de Acucar, and the presence of regional (the Chilean Cencosud) and international (Carrefour, Casino, Wal-Mart) groups.

# A giant with feet of clay in the face of globalisation

**A major player in both the French and global economy**
In 2010, the food processing industry posted a 3% growth in activity, to reach €143.6 billion, i.e. equivalent to 1.7% of France's GDP. Such a performance has kept it in the top spot among France's economic sectors, not to mention its position as the country's second leading industrial employer with some 512,000 employees spread over 61,500 companies.
This sector is mainly composed of small firms, with a high number of family-run businesses (accounting for 95% of very small firms). This distribution can be explained by the strong presence of bakers and pastry-makers, who are predominantly artisans and comprise over two-thirds of total food processing entities. Bakers and pastry-makers employ 31.8% of all sector personnel. The remaining sector employees are primarily divided across small and medium-sized firms and large companies specialised in other activities. The second leading food processing segment would be meats, which encompasses 12.8% of firms accounting for 23.3% of employment. The dairy industry segment comes in third in terms of number of jobs with 10.2% of personnel for 1.8% of total companies, immediately followed by beverages, which are led by wines and spirits segment at 6.7% of sector personnel and 4% of businesses.
France's food processing industry today encompasses approx. 9,000 exporters, in large part small and medium-sized.

Accounting for 7.1% of all French exports, this sector displays a surplus trade balance even though it has lost 3% of world-wide market share within the last 10 years, declining from 9% to 6.4%.
In 2010, the food processing surplus reached €8 billion, which represents a €2.7 billion rise relative to 2009.
France, which in 2009 stood as the world's third largest exporter of agricultural and food processing output (after the United States and the Netherlands), dropped to 4th place, now overtaken by Germany. Its primary market remains Europe.

**SNAPSHOT OF FRANCE'S FOOD PROCESSING SECTOR**

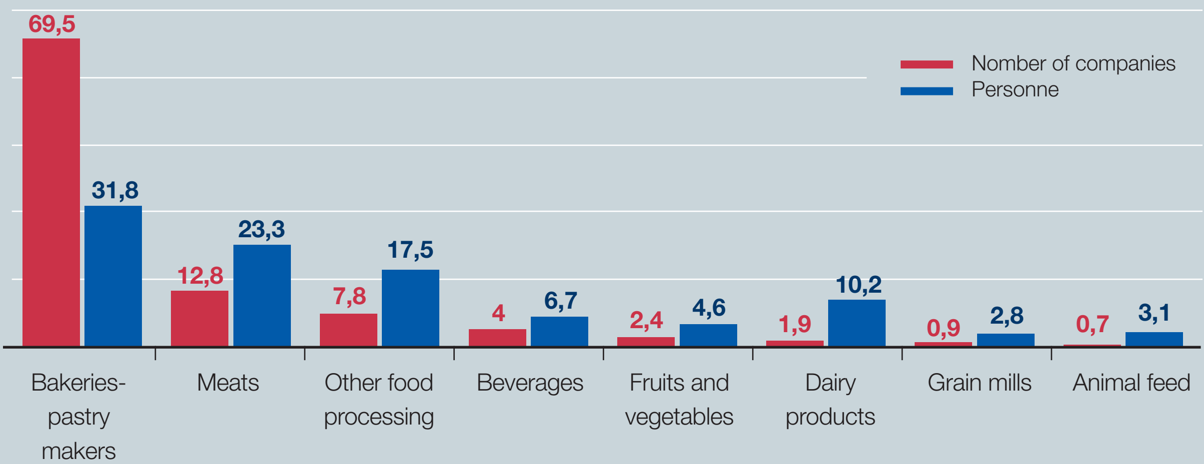
**61,487 businesses employing 511,840 staff, broken down as:**

- 1,391 firms, except meat & alcohol (84%) for 372,749 people (73%)
- 7,868 meat industry entities (13%) for 119,406 people (23%)
- 2,228 wine and spirits activities (4%) for 19,685 people (4%)

**An employment fabric consisting of:**

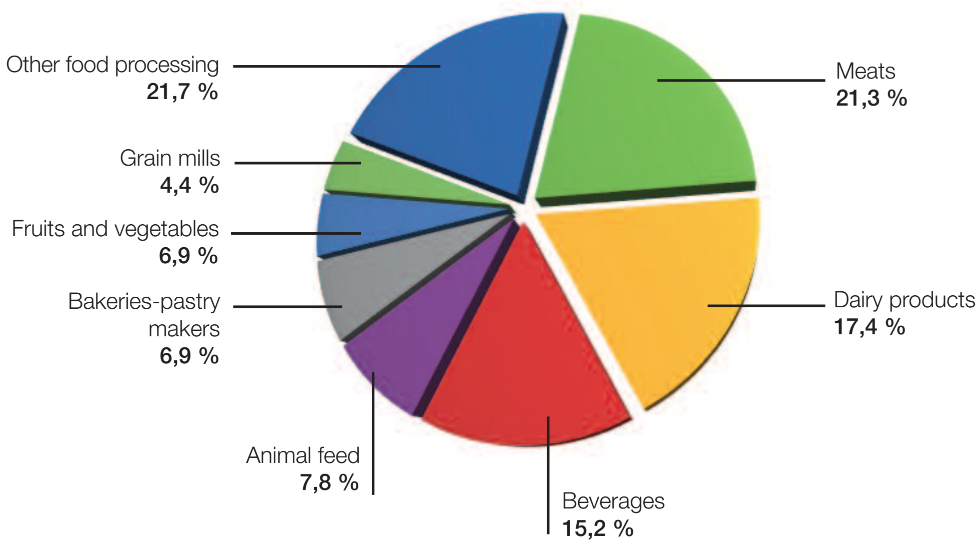
- 95% very small firms, accounting for 28.2% of all staff
- 4.5% small and medium-sized firms, accounting for 30.9% of all staff
- 0.5% large corporations, accounting for the other 40.9% of all staff

**Breakdown of companies and employees by activity** (%)




Source : Coface Services

**Breakdown in turnover by activity**




Source : INSEE

# Resisting well during the crisis…

**Activty levels hold stable**

Food processing is a mature market segment in both France and Europe. Over the past few years, the relative share of food expenditures in household consumption has stagnated, with volumes barely growing, leaving little room for new products.

In 2009, despite the crisis, companies were able to maintain a positive average growth of 0.4% and sustain their profitability. Firms generating less than €2 million in turnover have led this trend, with an average growth rate of 0.8%, while larger operations have witnessed a drop in turnover (-0.1% for companies posting less than €50 million and -5.4% for the €50+ million category). Larger companies have been more adversely affected by the downturn in demand, as well as by their international exposure and falling consumer prices.

# … yet difficulties are mounting

**Bankruptcies on the rise, fewer new businesses**

In 2010, the entire sector was stung by a return to higher agricultural commodity prices, only to be exacerbated by price hikes in oil, packing, gas and electricity.

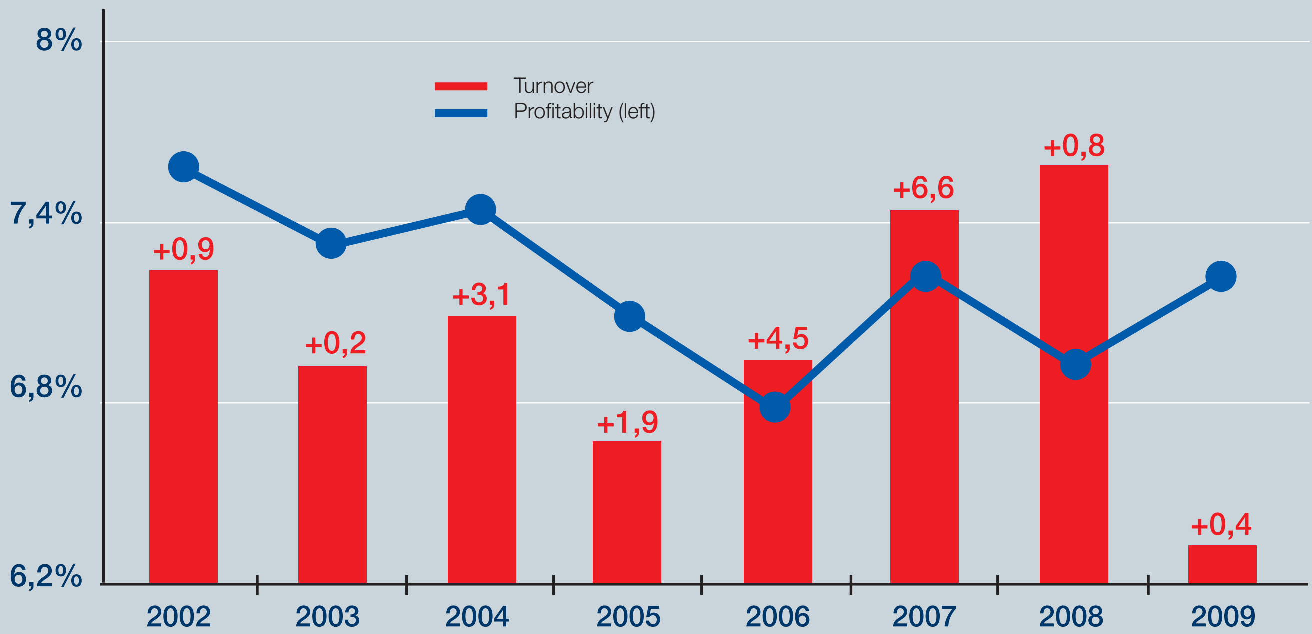
This difficulty was reflected by an increase in the number of bankruptcies, which for 2010 rose by 8.1%, with a total of 1,359 firms vs. a 3.4% decline in France's overall bankruptcy rate.

At the end of June 2011, this 12-month bankruptcies in food processing businesses was continuing to climb, at a rate of 5.7% with 1,420 vs. 1,344 at the end of June 2010. Along the same lines, the cost of bankruptcy (cumulative amount of outstanding supplier debt posted as a liability on balance sheets) was rising, reaching €57.4 million over the previous 12 months. This cost figure was 3.3% higher, due in particular to the disappearance of two meat processing plants.

The number of potential layoffs also increased by 3.1%.

In 2010, the number of new firms dipped: 5,143 businesses were created during the year, compared with 5,200 in 2009, off 1%. At the end of June 2011, the number of new firms in the sector had once again dropped, this time by 12% (4,675 over the previous 12 months vs. 5,308 at the same time in 2010).

**Growth and average profitability of food processing sector companies since 2002**




Source : Coface Services

# Adapting quickly to the new international context

**FOOD PROCESSING BANKRUPTCIES : +5.7%**
(12 months period ending in June 2011)

- 2.3% of all French bankruptcies stem from the food processing industry.
- The most adversely affected sectors in terms of number of firms are bakers/pastry-makers (82.4% of bankruptcies), meat processing (8.9%) and other food processing industries (5.1%).
- The sharpest differences between June 2010 and June 2011 were recorded for: Grain Mills (+33.3%), bakers/pastry-makers (+6.8%), and fruits and vegetables (+5.3%).

### Falling behind on the world stage

In a difficult market context subjected to increasingly rampant globalisation, French companies must meet some serious challenges in order to remain competitive, as competition has been intensifying and the number of international competitors exploding.

### Concentration and internationalisation

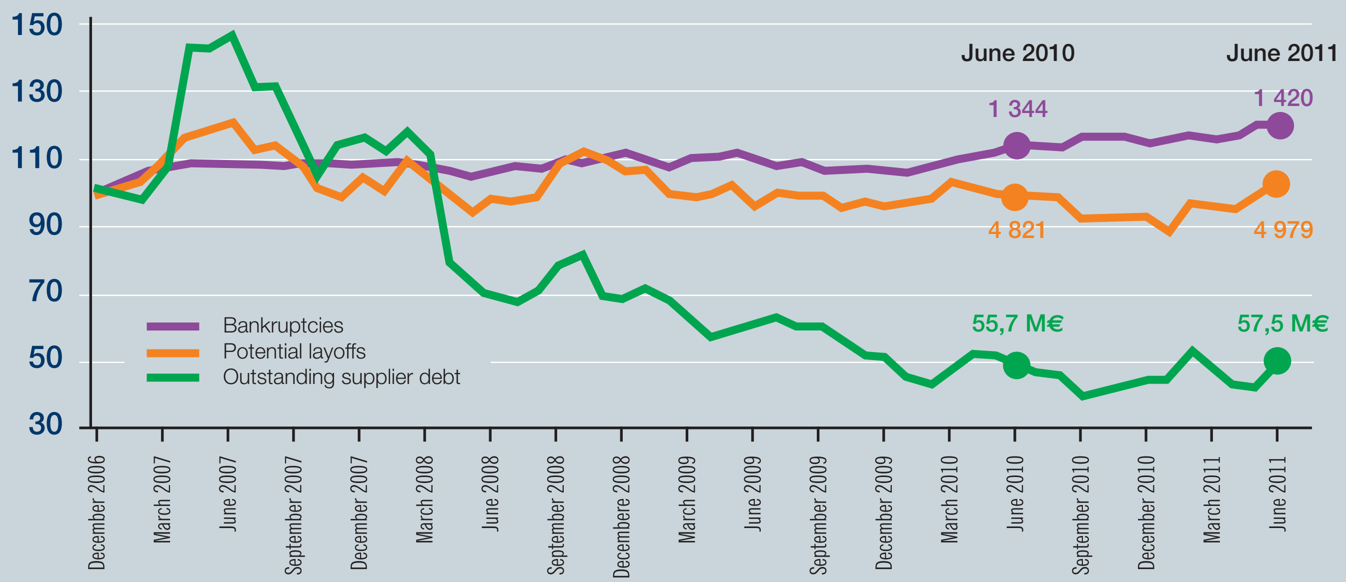
Faced with a mature European market and saturated supply, the French food processing industry's wiggle room is fairly limited. Sector concentration is now necessary through brand buyout (to accumulate market share), along with a globalisation strategy to take advantage of emerging markets. In France unfortunately, this sector is composed of many small and medium businesses and cooperatives remains highly fragmented. Few operators actually surpass the critical size needed for a more offensive market stance.

### Reorganisation activity still in its nascent stage

At present, this concentration thrust has affected the dairy segment, which already accommodates large internationalised groups. For many other segments in this sector, national and European mergers will be a logical first step. Yet assurances are needed that after two years of economic crisis, the financial positions of these players make them eligible to embrace such a strategy. The current situation regarding companies in this sector is somewhat compromised, especially for the segments of bakeries and meat processing, which have to cope with more volatile prices. Accounts impacted by low margins and resurgent commodity prices would partially explain this phenomenon. **We observe that the rate of food processing companies considered to be at high risk, as assessed by Coface Services' @rating score, has reached 9.2% *vs.* a composite 8% for all French companies.**

### Evolution in bankruptcies and associated costs

(Base 100: December 2006, sliding 12 months)




Source : Coface Services

### SECTOR LEADERS IN FRANCE

| | | | |
|---|---|---|---|
| 1 | DANONE | 17.010 M€ | 2010 * |
| 2 | LACTALIS | 14.700 M€ | 2010 * |
| 3 | PERNOD RICARD | 7.640 M€ | 2011 * |
| 4 | NESTLE FRANCE | 5.100 M€ | 2009 * |
| 5 | YOPLAIT | 4.500 M€ | 2010 * |
| 5 | SUCRE ET DENREES | 4.500 M€ | 2010 * |
| 6 | BONGRAIN SA | 3.570 M€ | 2010 * |
| 7 | TEREOS | 3.529 M€ | 2010 * |
| 8 | ETS JEAN SOUFFLET | 2.688 M€ | 2010 * |

* consolidated data

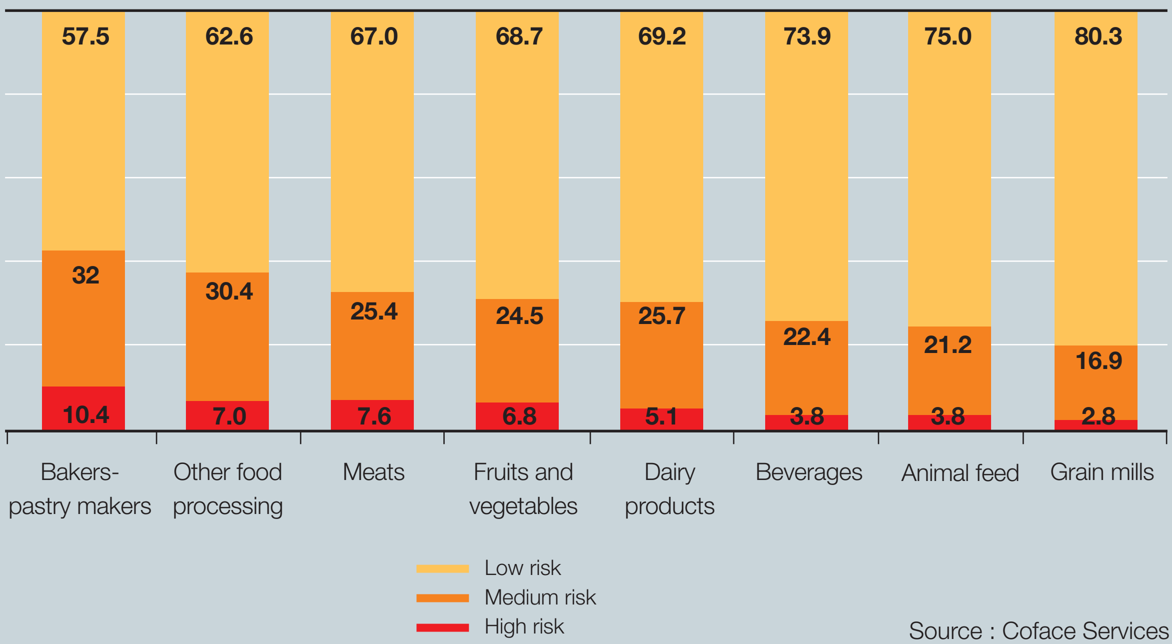
### LATEST NEWS

- The American General Mills, which also owns Häagen-Dazs ice creams, has finalised the buyout for more than half (51% to be exact) of the French player Yoplait.
- Sodiaal, whose portfolio includes Candia and the other 49% of Yoplait, has taken over activities of the Entremont dairy group.
- France, the world's 3rd leading wine exporter, was once again named in 2010 the world's top producer.

### CLOSELY FOLLOWED…

- Agricultural commodity prices,
- Company bankruptcies,
- Innovation, exportation and sustainable development will provide an effective means for countering the fall in turnover,
- Constitution of a strategic committee in order to restore competitiveness at the international level.

**Company breakdown by risk category** (%)




Source : Coface Services

## A discussion with **Claude Eugénia**, agrofood industry expert underwriter with Coface

**Claude Eugénia,** agrofood industry expert underwriter

➔ **Who are insured with us, who are the buyers whom we take credit risk decision on?**

➔ **Claude Eugénia (CE):** The firms we insure are of all sizes — international agro food groups, manufacturers of more modest size, cooperatives and their processing subsidiaries, operating in all the sub-sectors: dairy, cereals, meat, fruit and vegetables. And in wines and spirits, which are outside the scope of this study. We insure multinational groups but also small farms and trading companies. Their buyers, agro food companies from the smallest independent operators to large French groups, wholesalers, particularly in fruit and vegetables, independent bakers, charcuteries and so on, mass retailers and speciality retailers. The latter, essentially smaller companies buy from a very large number of suppliers whereas mass retailers carry products from limited number of suppliers through their central purchasing offices. Risk underwriting, therefore, involves both large credit exposures and companies with complex structures likes LBOs, as well as processing firms and small and medium sized distribution companies for very variable amounts.

➔ **You refer to agricultural cooperatives: What do they represent in France?**

➔ **CE:** The 2,900 cooperatives and their collection and processing subsidiaries are responsible for about 40% of French agrofood industry turnover. This sector is still highly fragmented but there is a clear move towards concentration: 75% of turnover is now generated by one tenth of the cooperatives. Tis trend has arisen as a response to direct competition with the agrofood multinationals, on the European market in particular. Apart from the fact that the cooperative is a company of persons and not of capital, its major distinctive feature is its attachment to the land of its farmer members. Cooperatives cannot therefore become international in the usual sense of the term. However, for several years, big cooperative groups such as Invivo, Terrena, Sodiaal, Cooperl, Tereos, have been diversifying and creating subsidiaries abroad by calling for investors.

**➔ How do you include the rise in raw materials prices in your risk underwriting?**

➔ **CE:** Dairy, meat, cereals, fruit and vegetable and beverage businesses are all very sensitive to raw material prices. Whether or not the rise in these costs will affect their margins depends on their size and their importance in the sector. Apart from the financial situation of the customers of the businesses we insure, we look closely at price trends and at the way in which relations are organised between all the players in the sector. Not only the rise of prices but also their volatility makes it difficult to stabilise prices throughout the distribution chain from producer to end consumer. In general, it is the intermediaries that enjoy the widest margins. With regard to the dairy industry, measures have been taken to stabilise milk prices, fixing the price of milk at around 330 euros for 1000 litres last year and setting quotas. However, since April the measures recommended by the Law on the Modernisation of the Economy have been implemented, resulting, in particular, in the ending of quotas and the introduction of contract agreements between farmers and buyers. The debate remains open, but regulation seems to be a vital element for the survival of the French sector. France is today the second largest European milk producer behind Germany, which has favoured the development of fine cooperatives such as Lactalis, now world leader in dairy products, thanks to the buyout of the Italian Parmalat or Sodiaal and famous international firms like Danone of course and Fromageries Bel, in the cheese sector. The cereals sector is more specific because the major outlet is cattle feed and it indirectly affects the meat sector.

**➔ Is meat specific in terms of risk taking?**

➔ **CE:** The changes in the nutritional behaviour of the French particularly with regard to meat-based foods are included in our analysis: pork consumption having declined for two years, we are particularly mindful of the situation of meat curing businesses. We are keeping a close eye on regulation and on administrative directives likely to have repercussions on the financial situation of businesses or their strategic development. We also observe a decline in beef consumption. Poultry consumption, which contracted in early 2000 on account of the bird 'flu scare, seems to have stabilised. We observe that unit costs in the poultry sector increased by 50% last year while selling prices have remained more or less unchanged at the distributors. The latter have not assumed their share of the price rise, which has therefore been very largely borne by the producers alone. This, let it be said in passing, makes problematic the implementation of the investments required by the European Commission with regard to egg production, for example, in a context of tighter credit to businesses and shortage of cash. Exports of poultry, of which France is the biggest exporter in Europe, moreover face increasing competition from Mexican and Brazilian producers, another factor contributing to weakness in this segment.

**➔ Which subsector is most affected by payment problems?**

➔ **CE:** The fruit and vegetable segment is certainly the weakest. Disputes are numerous; bankruptcies can affect the big players. It is a very fragmented sector, which, like the dairy sector, now works on a contract basis and whose products are rapidly affected when weather conditions deteriorate. We are therefore very vigilant. Moreover, the aggressive actions of French farmers in August are symptomatic of the sector's unrest. Another example: in June, the final price of lettuce remained unchanged at the distributors at around 1.50 euros, while the producers, who received 9 cents per lettuce, destroyed the overproduction caused by an early spell of sunshine, on a massive scale. Well, there are very few intermediaries between the producer and the consumer! And this in a context of recurrent competition from Spanish and Italian producers.

**➔ How far could the rather weak recovery in France affect the number of claims in the sector?**

➔ **CE:** Food accounts for more than 10% of French household expenditure. This is not much but enough to prompt them, given the context of a weak economic recovery, to be more price conscious. The crisis has definitely had an impact on their buying behaviour. This explains the increased penetration of distributor brands. These are, moreover, increasingly manufactured by industrial groups in the sector attracted by the growth associated with this type of product, whereas a few years ago they were almost entirely produced by smaller companies. As already mentioned, the increase in farm prices and the way in which it has or has not been passed on downstream, as well as the scale of the contraction of the different operators' margins is THE most complex problem to analyse. The large industrial groups find themselves in a strong position vis a vis the big supermarkets, like Lactalis which withdrew its brands from major distributor which refused to apply its price rises. Of course, it is more difficult for small structures to resist supplier pressure. For example, bakers and restaurateurs carry little weight with the millers. The fact that the price of the lowest price baguette is regulated could make one think that higher wheat prices cannot have an impact on bakers. Well, the latter are affected by the rises and they set off the impact on the other products of which the prices are unregulated. We can observe the same phenomenon in the mass distribution sector which also offers regulated products.

➔ **In brief, what are the most important risks today for this sector?**

➔ **CE:** The increase in raw materials prices is certainly the major risk for this industry and I think the costs will remain at a high level. But globally it is a sector situated on the margins of the economic cycles. Thus the number of claims was not very high in 2009. Nevertheless, there exist risks of a more structural nature. Take cattle rearing, where the numbers leaving the profession pose a unique risk to the whole sector. Businesses are for the most part greatly indebted, which has led to a collapse in the numbers aspiring to enter the livestock profession. The key issue, therefore, is to maintain this first rung of the industry: A number of food processing businesses which obtain their supplies locally would be considerably weakened by a reduction in the supply of their raw material, cattle. Particularly since European subsidies go to processors more often than they do to breeders. In the area of agriculture, diversification into the production of plants for more profitable biofuels is admittedly an element which enables farmers to strengthen themselves financially, but this also poses a risk for businesses in the food industry which obtain their supplies on the local markets. Let us not forget that the structure of this industry is made up mostly of small and medium-sized businesses closely integrated into their regional markets. We can legitimately ask whether agriculture should feed the planet or fill the tanks of cars with diesel?

*« Bankruptcies can affect the big players in the fruit and vegetable sector, and disputes are numerous »*

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