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MARKET INSIGHT: UK FOOD & DRINK

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Contents

Xenia's Market Insight reports are designed to work alongside a credit insurance programme. The purpose of this report is to provide you with objective and practical information that will help to advance your understanding of the issues and how they might impact your business.

We welcome your thoughts and questions on the issues covered. Please email us on info@xeniabroking.com should you require any further advice or have questions about this report.

Introduction

The UK food industry comprises of companies that operate in manufacturing, producing, packaging, retailing and distribution of food products in various forms. It has evolved greatly over the past two decades thanks to technological advances, keeping pace with growing demand for convenience foods.

Demand for better quality foods and packaging to ensure safe, fresh, easy-to-use products, and in greater quantity means the food industry drives several other industries such as convenience stores, supermarkets, and restaurants.

There are many pressures bearing down on food related companies in the UK such as high inflation, pricing pressures, low consumer spend, fluctuations in raw material prices and demands for the reformulation of food to be healthier. Further pressure comes from the labour market and the challenge of finding skilled people to maintain the workforce as more employees retire in the next decade or have left the market following UK's exit from the European Union.

Nevertheless, the UK Food & Drink industry has a wealth of expertise, tradition, and tremendous opportunities to evolve and is known for its new product innovation by companies of all sizes. Companies in this sector can grow quickly, and the industry is a vibrant source of mergers and acquisitions. It is also the largest manufacturing sub sector in the UK.

Key observations

Food & Drink sector has undergone a significant change due to multiple challenges including shifts in consumer demand, changing compliance regulations and variations in raw material, all of which have devised a change in the way the world produces and consumes food. This together with the influx of food safety and waste challenges have resulted in a state of metamorphosis in this dynamic sector. Volatility driven primarily by global markets and macro events has had a severe impact on the supply chain and thus profitability indexes across the business landscape.

Despite the extremely challenging economic environment, some key observations and optics are moving in preferred direction as the UK aims to rebuild and enhance the offering from the iconic Food & Drinks sector.

Economic

- Whilst high inflation is now starting to track towards the 2% target, food inflation is still over 13% although it is easing from 14.9% in July and a record high of 19.2% in March
- The Food and Agriculture Organisation (FAO) Food Price Index (FFPI) averaged 121.4 points in August 2023, down 2.6 points (2.1 %) from July, reversing the rebound registered last month and pushing the index as much as 38.3 points (24.0 percent) below its peak reached in March 2022. But monthly Consumer Price Index (CPI) fell 0.3% in July 2023, whereas it rose by 0.6% in July 2022.
- Although we have seen an improvement in some areas, consumer confidence remains close to a record low, which suggests it's likely to take longer to restore confidence to previous levels.
- The Bank of England increased the base rate to 5.25% in August 2023, taking borrowing costs to their highest level since 2008.

Business Conditions

- CPI particularly food inflation and the continuing supermarket price challenges is making it difficult for manufacturers and suppliers to pass on price increases to customers, meaning that their margins remain under pressure.
- Larger players continue to push the supply chain on price and longer payment terms, leading to cash flow challenges to small food businesses mainly although this does span the whole horizon.
- One thing is for certain is that businesses will need to evaluate their supply chains, adjust their business models accordingly and consider introducing technology where applicable, a strategy that's been encouraged and recommended for some time.

Financing Conditions

- Financial obligations within the sector remain at typical and expected levels. Borrowing costs are up and capacity is restricted.
- Banking support and liquidity credit flows is tightening and thus hampering working capital needs.
- This sector is dependent and relies on this support therefore hopefully we can see less contraction.
- Firms are constantly exposed to price and currency volatility too therefore critical to monitor appropriate FX movements.

Export Endeavours

- The UK has 2.2% of the global Food & Drink export market but that share is considerably behind international rivals such as France (4.7%) and Germany (5.6%).
- Currently, more than half of the UK's exports head to EU nations, and the EEA remains the UK's most important export market, but many are now considering new markets following the European Union exit.
- For some businesses the EU exit represents a positive opportunity to import raw materials from non-EU markets at a lower cost and remove EU import restrictions and tariffs, but we are not seeing benefits from this in its entirety yet.
- For other businesses, the EU exit means a change to the status quo, which brings with it volatility and uncertainty. Europe and the USA remain key export markets with a shifting focus towards Asia and the Middle East.

Credit Risk Dynamics

- There has been a deteriorating trend in non-payments this year
- There is anticipation of further insolvencies during H2 2023 and the situation is expected to worsen in 2024.
- According to research from Atradius payments take between 45 and 60 days on average.

Insolvency analysis

One of the main reasons food businesses fail is because they are entering an already saturated market with high levels of competition. Just because a product is great, there is no guarantee that it will stand out on the shelf, especially against long-established brands and larger firms.

Insolvencies of UK food manufacturers increased by 108% in June 2023 and the key driver cited was the rapid rise in costs with approximately 287 businesses entering an insolvency process. This was an increase of 138 from the same period in 2022. This of course, was as a consequence of the war in Ukraine, the main producer and exporter of all grain and cereal in Europe. Furthermore, UK drink manufacturers saw their biggest rise in insolvencies on record with a surge of 123% to 87 from 39 in the previous year. There was also a 102% increase in insolvencies of other food companies from 99 to 200. In essence, 2023 has seen a significant rise in UK Food & Drink firms suffering from financial distress caused primarily by the food supply disruption and thus a demand for higher prices from suppliers, who are as a natural course of action, passing costs to their customers.

Administrations of Food & Drink manufacturers also saw a massive spike in H1 2023 increasing from 429 to 618. By and large more Food & Drink businesses have collapsed in the first six months this year than all of 2022 putting the sector behind Construction, Manufacturing and Retail in the league table of the most affected sectors.

Meatless Farm was one the year's most high-profile Food & Drink manufacturing failures with a fellow vegan producer Plant & Bean also compounded to obscurity in June. Other notable insolvencies in 2023 were Mara Seaweed, Mamamade, Farmison, Miso Tasty, Black Sheep Brewery, Waas Bakery, Loscoe Chilled Foods, British Honey Co, Big Prawn, Love Hemp and Cook & Lucas.

Struggling Retail sector together with the decline in high street footfall is of course also impacting the Food & Drink sector which includes restaurants, cafes and bars. Stores are disappearing from high streets at a rapid pace as consumers' changing behaviour is increasingly shifting from shopping in store to online. Many retailers find themselves in an uncomfortable position as margins are being squeezed between weakening demand and rising costs. This coupled with less money in the consumers' pockets, it is not surprising therefore to hear that even the larger traditional high street shops have struggled with some ceasing to trade. In August it was reported that a net record level of 964 stores either disappeared or were affected, according to new data from ONS.

In essence, when you factor in the above and higher borrowing costs, tightening of liquidity flows, and a lack of working capital, it's proving very challenging for businesses in Food & Drink sector to not only make ends meet but remain as a going concern.

Commodity analysis

Macroeconomic conditions continue to be challenging for all markets but especially Food & Drink. Supply chain issues, pandemic regulations, geopolitical conflict, and food commodity inflation continue to impact markets and create structural and volatile risks that carry across borders. Exchange rate volatility and its impact on the cost of food commodities and indirect items remains a prevalent issue for many producers and processors who rely on imported goods. As these costs remain, profit margins are thinning, and the prospect of passing this cost increase on to retailers is limited. Consequently, profit margins of food businesses deteriorated further in 2023 and this is expected to ensue in 2024.

Food Inflation

Although Food price inflation in recent months has eased reflecting both lower domestic prices for vegetables and lower global prices for meat, the cost of food in the UK remains relatively high and is having systematic impact across the business landscape. The inflation rate for food and drink in the UK was 12.1% in September 2023, down from 13.6% in August and a recent high of 19.2% in March 2023, the highest annual rate seen for over 45 years. The eventual impact of the pandemic and subsequent governmental policies and packages, supply chain bottlenecks and delays, our exit from the EU and FX volatility saw commodity prices jump to record levels, primarily as around 50% of the total food consumed in the UK is imported, so the cost control by both manufacturers and retailers is and has been made even more difficult.

Fuel prices have been climbing steadily over Q3, driven by price support in wider oil markets. There were also slight increases in monthly fertiliser prices between August and September. Any rises in natural gas prices in the next few months are likely to translate into higher nitrogen fertiliser and fuel prices. However, with the rate of inflation in prices starting to ease this is reflected in those key input costs which are significantly down compared to the peaks of 2022.

Food Commodities

- **Dairy -** Milk, cheese, and eggs, drove this decline the most, as the annual rate for milk, cheese and eggs plummeted to 15.3%, down from 18.7% in July.
- **Meat** – A drop in meat price had an impact the month before driving food inflation down from its soaring heights. Beef production was down slightly, compared to September of 2022. As always demand will intensify in the run up to Christmas. Beef exports have generally tracked below 2022 levels over the summer, and they were up slightly on the month, however down significantly compared to August 2022.
- **Poultry** – Poultry meat consumption in the UK has increased over the past year, despite falling production across the whole sector. As a result, a larger trade gap has opened with world, driven by a drop in exports, alongside a smaller rise in imports.
- **Crops** – Corn and soybeans climbed to their highest in a decade, creating exceptional returns to some crop producers. Wheat prices have since dropped to pre-war levels and palm oil has lost around 40% of its value.

Credit insurance market sentiment

Insurers remain committed to supporting this important sector, a fundamental part of the UK supply chain. Risk departments will continue to underwrite cover where possible but will remain strategic and prudent in their underwriting line.

The speed at which a suggested good performing business can deteriorate often requires extra scrutiny and evaluation of its top line, profit margins, its debt position, working capital management, risk control measures employed and its strategic roadmap. All of these are key areas that underwriters will pay close attention to along with the following critical guidelines:

- **Information is key** – Credit Risk departments remain in regular dialogue with a variety of businesses across the retail sector with a mission to furnish updated management accounts to fully understand both the trading performance in the current environment and the funding facilities that are being made available to support working capital
- **Refinancing** – When meeting with the key buyers in the retail sector, risk analysts and underwriters will seek to understand how they are mitigating inflation and the impact of increasing interest rates.
- **Case by case** – Each business is reviewed on its own financial merits for the purpose of its underwriting judgement.

There is certainly an air of caution radiating across the credit insurance market, however, support continues where possible to ensure strong risk management is in place whilst facilitating trade and growth.

Key risks & endorsed actions

The UK Food and Drink industry is an essential part of the global economy and encompasses a wide variety of businesses, including restaurants, cafes, bars, and food manufacturers. However, like all other sectors, they face their own challenges and key risks in this sector include:

Economic downturns: Recessions or economic slowdowns, as consumers tend to cut back on discretionary spending during such times. As a result, businesses in this sector may experience reduced sales and profits, leading to closures, downsizing, or other financial difficulties.

Changing consumer preferences: As consumer preferences evolve, businesses within the industry must adapt to stay relevant. Trends like health-conscious eating, sustainability, and demand for plant-based alternatives have forced companies to innovate and re-evaluate their offerings. Failure to adapt to these changes can lead to a decline in customer interest and performance.

Increased competition: The industry, by its very nature, is highly competitive, with businesses vying for market share and customer loyalty. The rise of e-commerce and food delivery services has intensified the competition, with more options available to consumers than ever before. In this environment, businesses must differentiate themselves and find ways to maintain profitability, which can be challenging.

Regulatory pressures: Governments around the world often impose strict regulations and standards on food and beverage businesses to ensure public health and safety. This comes with added costs and investment requirement amongst other inclusions. Compliance with these regulations can often be costly and time-consuming, which may place a strain on businesses, especially smaller establishments with limited resources. In some instances, smaller businesses have simply shut rather than invest in ways to stay up to regulatory standards.

Supply chain disruptions: Due to freshness, locations and more, the industry naturally relies on complex global supply chains for raw materials, ingredients and finished products. Disruptions to these supply chains, caused by factors like natural disasters, trade disputes, or pandemics, can lead to shortages, price increases, and production delays. Such disruptions can be challenging to manage and may result in lost sales and damaged reputations.

Labour shortages: Naturally labour-intensive, the sector requires a large workforce to operate effectively. However, businesses in this area often face labour shortages due to factors such as low wages, high turnover rates, and seasonal fluctuations. A lack of skilled workers can lead to operational difficulties, decreased productivity, and increased labour costs.

Some endorsed actions are:

- Ensure you continue to tighten credit control procedures and pay close attention on sudden changes in payment patterns
- React swiftly to late payment. It’s a most accurate predictor of business failure so don’t be tempted to extend agreed terms
- Become more familiar and aware of your suppliers and their operating base
- This ever-changing economic landscape and uncertainty can suddenly lead to problems in the supply chain
- Look to enhance and grow levels of business with new customers steadily and prudently
- Try to be agile and flexible. These are unprecedented times, and many businesses are feeling the pinch but there will be a bounce and it’s important to retain the flexibility to benefit from growth when it comes

Xenia analyst assertion

Generally, the Food & Drink sector remains under significant financial pressure. It also remains susceptible to weather and geopolitical events, together with health and hygiene issues. Continuing resistance from major retailers to accept price increases continues to conjure up issues and impact performance. These challenges are likely to continue into the next 12 to 18 months.

With all the challenges that remain prevalent companies will need to become more agile, embrace change, introduce or intensify use of technology, and be open minded to innovation in order to survive. It is clear that in the short term, where possible, suppliers should be considering strategic decisions to minimise their risk, through credit insurance as well as curbing any over-reliance on single customers. This year has seen a very sharp rise in companies in financial distress and reduced profitability, reflected in the surge seen in companies in administration and insolvencies during the first half of 2023. Although, inflation and costs are now starting to abate, businesses also need to be preparing for potential future risks. This often requires a leaner way of thinking including a revision of strategies and ways of working with their suppliers to ensure they can enhance and solidify their future resilience to further potential supply shocks.

UK Food & Drink sector is no stranger to challenges, as it must always navigate a complex and ever-changing landscape. 2023 has certainly been an eventful year full of surprises, layered with a large measure of uncertainty. Food and drink companies around the world face threats and opportunities from a range of factors including automation and product safety regulations. The outlook spanning the global food spectrum is disquieting with elevated concerns in respect of the disruption and impact from world events. An increasing global population and a shift towards convenience foods has continued to push the industry forward however.

In general the UK Food & Drink sector continues to perform reasonably well despite the challenges and trials. It does help that compared to other industries the food market is non-cyclical. Nevertheless, it remains vulnerable and susceptible to sudden downside risks with issues such as commodity price volatility, disease outbreak and unpredictable weather etc. Such matters could lead to an instant deterioration of business profitability, creditworthiness and in turn viability. Furthermore, an important challenge exists with higher input prices affecting meat producers and processors worldwide. At the same time, consumer habits are changing and the end-client increasingly demands full transparency of financial performance. Convenience is a key for many consumers and demand for processed, ready-to-eat, packaged foods is the reason demand has exceeded supply in certain food markets.

By and large, there’s no single or definitive answer on what the future holds for the industry. What is observable is that there are some significant and severe downside risks facing the nation with many businesses apprehensive of what will transpire for both business and the economy. The scale of transition is very hard to predict and calibrate, given the lack of meaningful precedent but undeniably any adverse change of such metrics will have consequences. Growth path over the next decade is unlikely to be as smooth as previously forecasted and therefore preparation and vigilance remain vital.

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ROBERTO IS A SEASONED CREDIT ANALYST WITH A STRONG ANALYTICAL BACKGROUND AND EXTENSIVE EXPERIENCE IN CREDIT INSURANCE AND FINANCE HAVING WORKED IN CREDIT INSURANCE FOR THE PAST 20 YEARS, PRIOR TO WHICH HE WAS AN ANALYST AT BARCLAYS BANK. ROBERTO PROVIDES GUIDANCE AND INSIGHT ON BUYER/GROUP FINANCIALS, TRADE SECTORS, INSOLVENCIES, THE CREDIT INSURANCE MARKET AND THE UK ECONOMY FOR THE XENIA TEAM AND CLIENTS.

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