

Food and beverage companies are facing rising production costs due to structural changes in agriculture brought by the biofuels boom and rising world population. Increasing implementation of enterprise-wide risk management is a result, writes *David Watkins*

Indigestion remedies

★ The global biofuels boom has created recent challenges for food and beverage manufacturers who, at a time of growing world population, find themselves in competition with energy producers for agricultural products. High commodity prices are further stretching the industry and forcing firms to recalibrate long-standing risk management strategies.

Biodiesel production in Malaysia and Indonesia has caused palm oil prices to spike, creating high food costs, whilst in the US, mandated production of corn-based ethanol is tightening supply and demand dynamics, raising corn prices and squeezing agricultural space for other crops.

For example, beer makers are threatened by higher barley prices as crops intended for biofuels take up more land. Higher corn prices, meanwhile, create higher input costs for everyone from cereal and tortilla manufacturers to soft drink and candy producers.

Indeed Kellogg, the US cereals and snacks company, highlighted what it called “structural changes” in the agricultural space as a result of the biofuels boom. “What is going on with ethanol and biodiesel is having a material impact on most of the raw materials that most food manufacturers use,” says David Mackay, Kellogg chief executive, during a recent investor call.

The company says that commodity and energy costs are having a huge impact on earnings, having increased by more than a third year on year. It estimates that wheat prices accounted for 25% to 40% of additional costs. Wheat prices

were at a 20-year high and had shot through \$7.80/bushel on the benchmark Chicago Board of Trade as *Commodity Risk* went to press. Bad weather in key grain-growing areas such as Canada and parts of Europe has limited supplies even as demand has grown, sparking fears of a supply shortfall.

Peter Brabeck, chairman of Nestlé, has warned that food prices are set for a period of “significant and long-lasting” inflation because of demand from China and India and the use of crops for biofuels. Packaging costs are also on the rise due to increases in aluminium and resin prices. Dairy costs are up too, driven by growing Chinese demand, and supply constrictions caused by severe drought in Australia and New Zealand, the world’s largest milk-exporting region.

Sugar turns sour

Meanwhile, US beverage producers are being hit by higher sugar prices. Brazil’s use of sugar cane to make ethanol, on which four million Brazilian cars run, has increased demand significantly.

Toronto-based soft drink maker Cott Corp, for example, posted lower operating profits in the second quarter of this year – \$6.2 million (Canadian) versus \$23 million last year – due to higher costs for key ingredients, including sugar.

“Continued weakness in the North American carbonated soft drink segment and higher commodity costs, which we were not able to offset with pricing until just after the end of the quarter, impacted our overall results,” said Brent Willis, Cott’s chief executive officer, during a call with investors.

Initially, high sugar prices led some firms to use high-fructose corn syrup as a cheaper

The Kellogg Company says higher commodity and energy costs are having an impact on its earnings



alternative to sugar. Current volatility in the corn market is forcing a rethink, however. “While product formulations tend to be well-guarded secrets, we have heard that many companies are now considering a switch back to sugar,” says Lisa Feigen Dugal, North American consumer and retail advisory leader at Pricewaterhouse Coopers (PwC), the international consultancy.

Holistic approaches

With more sustained price volatility across various commodities than ever, food and beverage companies are increasingly adopting enterprise-wide approaches with which to address the challenges.

“More companies are taking an increasingly holistic approach towards risk,” says Pablo Zuanic, food and beverage analyst with JP Morgan. “As well as focusing on the commodities and hiring specialist staff to work on risk management, they’re becoming more aggressive in terms of cost-cutting across the company,” he says. Zuanic adds that companies such as confectionery manufacturer Hershey and consumer goods maker Sara Lee are particularly proactive, with dedicated procurement teams.

A change in mentality is occurring across

the space. “We’re seeing a general change in strategy,” says PwC’s Dugal. “These companies have been aggressive in the past in terms of hedging and monitoring activity from a commodity basis, and this has guided some of them well. But with commodities now stabilising at much higher rates, companies are taking a much harder look at their portfolios and increasing innovation,” she says. One trend across the board is firms reducing packaging sizes, as these are heavily influenced by oil and lumber prices, she notes.

Tyson Foods, which supplies close to a quarter of all meat consumed in the United States, from McDonalds restaurants to packaged products in grocery stores, is particularly proactive. According to Jean Beach, a senior vice president with Tyson’s commodity trading and risk management desk, the company has been quick to appreciate the similarity between risk management in the energy and food spaces by participating in commodity markets to hedge against price swings in raw materials. Input costs include feed for chickens, cows and pigs and the energy needed to run livestock farms, processing plants and for fuelling delivery trucks.

This gives Tyson a commodity footprint across corn, soybean meal, soybean oil, wheat,

Protesters marched through Mexico City earlier this year to protest about price increases for basic food items like tortillas



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live cattle, lean hogs, pork bellies, natural gas, diesel fuel and propane alongside currency interest rates. According to Beach, Tyson has integrated energy merchant concepts into the food industry with a fully implemented trade risk capture system. Last year it expanded its risk management group, filling its middle office functions to oversee market and credit risk.

“The team executes hedges across a spectrum of commodities including forwards, futures and options, while identifying underlying trends in commodities markets,” Beach noted in a recent presentation. Tyson holds a naturally short position in feed ingredients, its largest exposure, due to vertical integration in its poultry business.

Such methods are gaining traction across the consumer packaged goods space. “We’ve had a number of clients who look to energy companies for examples of how to employ enterprise risk strategies,” says Dugal. “This industry, which has been a little less regulated and a little better protected, is now reaching out to more regulated companies to understand how to manage this risk holistically.”

Consolidation is key

Operational consolidation is key to achieving this, according to Dale St Denis, vice president of commercial industrial business with SolArc, a software provider to commodity intensive business. Tyson is a client.

“Companies are consolidating their procurement practices and are trying to establish some standards in terms of how they manage these risks,” he says, noting that enterprise-wide risk management is increas-

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ingly becoming a feature.

“Instead of the previous model of having separate subsidiaries managing procurement and taking independent grain positions, companies are consolidating these into a central procurement organisation,” he says. “It’s a necessary step, enabling more standard practices in terms of how price risk can be managed, what types of derivatives instruments can be used, and what

limits are going to be placed around the amount of risk that is to be managed.”

St Denis says the recent focus on risk management in the industry started to build momentum in 2005, following the Energy Policy Act’s renewable fuel standard which called for increased use of corn-based ethanol, prompting more companies seeking risk management software solutions in order to manage basis, price and transportation risk via swap markets.

Efficiencies and correlations

While recent fluctuations in the price of corn, soybeans and oil illustrate how other forces are adding complexity to commodity markets, they nevertheless bring opportunities for profit.

“Packaged food companies face more complex risk management challenges,” says Zuanic. “If you’re selling soup, ketchup, cheese or cereals, a lot of those companies are being squeezed because the pass-through of price to the consumer is not so efficient, and you have a lot of different ingredients.”

How quickly companies can react to fluctuations in commodities depends on the product and how easy it is to pass on price rises to the consumer. The price of milk at the farm gate, for example, has doubled in cost in the past 12 months in the US. Milk prices have risen due to high corn prices making cattle feed more expensive, droughts in big milk producers Australia and New Zealand, and booming Chinese demand.

“You can’t really hedge milk – it’s not a liquid market, despite the presence of milk futures – and yet cost has doubled from \$11 to \$22 per hundredweight at the farm level,” says Zuanic.

Nevertheless, prices at supermarkets have gone up accordingly to pass through the costs. According to a recent statistics from consultancy AC Nielsen, prices per gallon of milk on August 11 were up by \$0.83 year on year. For producers to cope with growing expenses the retail price per gallon of milk would have to rise by around \$0.90, or around 45%, according to analysts. “This demonstrates that it is a very efficient market, as all the cost rise is passing through to the consumer,” says Zuanic.

In other markets costs can’t be passed on so easily, which often forces producers to manage



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their price risk more proactively with hedging.

Chicken and livestock companies tend to hedge their grains purchases anywhere from three months to nine months ahead, depending on the company. However, they also employ a key risk management strategy of adjusting supply when necessary. Tyson and Pilgrims Pride account for 50% of the US poultry industry. The domestic benchmark – boneless skinless chicken breast – has gone from \$1.10 to \$1.80 over the past 12 months, after companies reigned in physical supply by around 5%. “Volumes were cut 5% but prices have gone up 70%, and that is a good trade-off,” says Zuanic. “The price increase induced by supply cuts has more than offset higher costs.”

“Companies that were losing money in the spot market in the fall were making about \$0.25 per pound by the early spring, compared with five-year average profit spreads of about \$0.12,” noted an analyst who wished to remain anonymous. “From that group you’re talking about supply having adjusted very quickly to create these profits.”

He notes, however, that prices may not correlate so well with the commodity at other times. “If you’re a chicken producer selling to a well-known global restaurant chain, that chain would be looking to lock in a structured risk product around a fixed price. They will structure a very tight margin for the producer, who

will have to utilise hedging on the commodity if they are going to make it,” he says.

Continued commodity strength

Such hedging tactics will continue to be improved, given that the current commodity price environment shows no signs of weakening in the short term.

“We continue to hold a positive bias on the grains complex as a whole,” noted Barclays Capital in a recent research report. “Corn fundamentals remain positive, with demand buoyed by robust demand from China for feed and industrial use, coupled with strong US ethanol demand,” the investment bank says.

Fundamentals for agri-prices therefore appear skewed to the upside for the foreseeable future, and world population growth will continue to underpin that. Upward pressure on commodity prices will result in higher costs for agricultural firms as well as food and beverage producers. All these factors increase the need for these firms to create better risk management strategies.

“If you boil it down, companies need to look increasingly at their exposure, their risk appetite and whether they’re looking for a short-term strategy or longer-term strategy,” says Dugal. “Companies are saying they need to do a better job of managing risks.” [CR](#)

The global biofuels boom is squeezing agricultural space for other crops and raising the costs of food production and manufacture