FDF analysis of drivers of food and drink inflation

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Food and drink is the UK's largest manufacturing sector

Food and drink manufacturing is the UK's largest manufacturing sector, with a footprint in every parliamentary constituency. Our industry has a turnover of more than £128bn, accounting for 20% of total UK manufacturing, contributing over £33bn a year to the UK economy, and directly employing over 450,000 people across every region and nation of the UK. We're an industry that powers entrepreneurs, with 97% of our industry made-up of small and medium-sized businesses.

The sector operates in a highly competitive market. It has faced significant cost pressures over the last three years due to a series of shocks. The industry has tried to absorb a proportion of these cost increases but is having to pass a share to retailers and consumers. There is a lag of seven to twelve months for these costs changes to materialise in retail prices due to the nature of contracts across the supply chain. Regardless of current inflationary pressures, the UK still has some of the lowest grocery prices in Europe.

Pricing in the UK food supply chain

Food manufacturing sits in the middle of the food supply chain. It buys ingredients produced by UK or foreign producers and processors (either directly from suppliers or through physical trades via commodity markets). Some manufacturers also utilise future markets to hedge against the risk of changing commodity prices. It then sells the finished product to wholesalers, retailers, hospitality outlets or sometimes directly to consumers in the UK or on international markets.

When it comes to buying supplies, our industry is a price taker for the majority of inputs used, because most key agricultural commodities are internationally traded and the government typically doesn't intervene in these markets. Because of this, prices are set globally, according to supply and demand. The seasonality of agricultural production and climatic impacts are critical driving factors that drive price changes for most raw materials.

There is typically a lag of seven to twelve months between changes in manufacturers' costs filtering through to prices on shop shelves. Retail prices tend to move slowly relative to underlying raw material costs. This time lag is due to the nature of fixed-term contracts used by producers when buying raw materials (forward buying), while some also make use of futures contracts traded on commodity exchanges (hedging) to help guard against the impacts of price volatility.

The tools used will vary between businesses depending on business plans and products. Food manufacturers can typically lock in the impact of rising commodity prices for up to 12 months – long enough to cover a season of bad weather, but short enough for underlying demand changes to feed through. For some commodities, delivery times can also be a key factor, especially where inputs take five months or more to be shipped across the globe, and this means that inventory held as buffer stocks will also delay the transmission of inflation.

Forward buying and contracts are an essential tool to help businesses manage the inherent volatility of agricultural supplies and prices. It provides certainty for operators by providing a clear signal of the demand that exists to enable agricultural producers to invest and deliver the ingredients that are needed, the price certainty typically helps shield operators from the potentially harmful effects of short-term price volatility. At the same time, this also protects consumers from price volatility, otherwise we would experience frequent price changes in shops, reflecting the seasonality of the ingredients used in the goods we buy.

On the selling side, manufacturers also negotiate contracts with supermarkets and in a market where buyer power sits firmly with UK retailers, this can restrict or delay the ability of producers to request cost price increases (CPIs).

The UK retail market is highly concentrated and the presence of discounters means that the big four supermarkets are under intense pressure to keep their prices competitive, so as not to lose market share. In turn, for our industry, that means that the negotiating process with supermarkets is an asymmetric relationship in which supermarkets have more market power and exert a lot of pressure to keep prices low. There is no shortage of media coverage in recent years of UK supermarkets delisting iconic products from many of the world's biggest food and drink manufacturers.

Larger manufacturers, which produce branded products, for which consumers have a stronger demand, typically have more negotiating power than smaller manufacturers and those producing own-label products. This allows larger manufacturers to sign longer-term contracts, of six to twelve months, with their customers. Smaller producers are less able to share cost increases and typically operate on short-term supply contracts of around four months. The implication for smaller producers is that they are working on razor-thin margins and find it difficult to invest in automation or product reformulation as they do not have the stability and long-term certainty needed to support such critical decisions.

From a supply perspective there is also significant competition among and between manufacturers which ensures there are always alternative options for retailers to source similar products from other sources. Large, branded businesses compete with other large, branded businesses domestically, with challenger SMEs, with own-label products and with tens of thousands of producers overseas, facilitated by the ease of access into the UK market provided by UK Free Trade Agreements with global agrifood powers including the EU, Canada, Australia, New Zealand and others.

Almost three years of price rises

The turbulence experienced in recent years in agrifood supply chains is without precedent, with three structural shocks that took place in quick succession continuing to impact our sector: Brexit, the COVID pandemic and the war in Ukraine. While all other UK economic sectors experienced adverse impacts, food and drink manufacturing was disproportionately impacted compared to nearly all other industries:

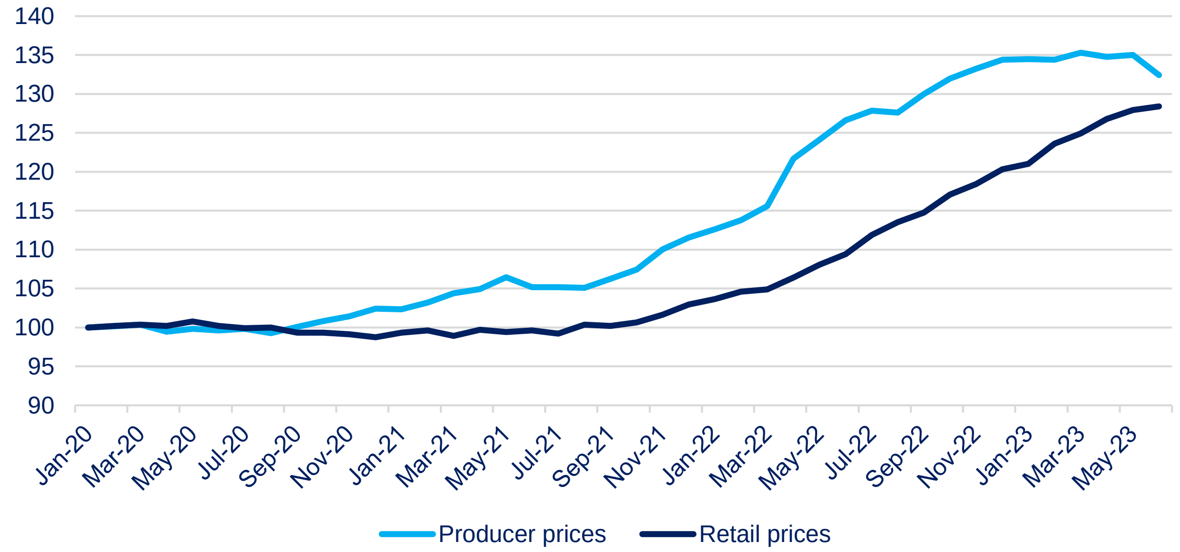
- Brexit increased the red tape involved in trading with the EU, effectively raising the costs for trading with the continental bloc. The UK-EU Trade and Cooperation Agreement (TCA) which shapes trade with our biggest and nearest trade partners, accounting for around 60% of our sector's total trade was not agreed until 24 December 2020. The terms of the deal were not made public until 26 December 2020 and this deal entered into force before guidance was available, on 1 January 2021. Businesses were literally given no warning or time to prepare and the trade data clearly shows the impacts, with UK-EU trade in food and drink dropping off substantially in Q1 2021 and taking nearly two years to recover. Brexit also contributed to a challenging labour market for agrifood and drink businesses.

- The pandemic shock meant that manufacturers had to adjust quickly to supplying supermarkets and shift away from the hospitality industry, and then to reverse this in the span of two years. To feed our nation, manufacturers focused on volumes and simplified product ranges, and in doing so more valuable product lines were dropped. Global shipping was significantly affected, goods and the paperwork to release them from ports couldn't be moved around the world and the cost of shipping soared. Moreover, the global change in consumption from services to goods wreaked havoc in global logistics and supply chains, against a backdrop of rising prices of agricultural commodities due to increased Chinese demand and adverse weather patterns. In the UK, the pandemic also added to existing disruption in the labour market, with severe labour shortages posing a serious challenge to businesses.

- The war in Ukraine severely disrupted global food supplies, as Ukraine and Russia were both significant global suppliers of wheat, other grains and vegetable oils. Overnight, many manufacturers were unable to access essential functional ingredients from these markets and it took time for UK Government to deliver additional flexibility for businesses to switch to alternative sources. The impacts on global commodity markets were significant and competition for alternative supplies increased rapidly. As Russia cut its gas supply to Europe, energy prices also skyrocketed, along with fertiliser prices (many fertilisers are a by-product of gas production) and other functional inputs produced as by-products including CO_2 which has a wide range of practical uses in food and drink, from its use in abattoirs to brewing and the packing of meats, salad leaves and carbonation of soft drinks.

Food and drink manufacturers have experienced almost three years of substantial upward pressures on all cost elements facing their businesses, from ingredients and packaging to labour, transportation and logistics. Producer prices (input costs) started rising in October 2020 (Chart 1) and by April 2023 they were 35% higher than in September 2020. It's noteworthy that costs fell in June by 1.9% compared to May, the fastest monthly decline since June 2021. Year on year, costs were still 4.8% higher.

Chart 1: Food and drink producer prices and retail prices
Index, Jan-20 = 100



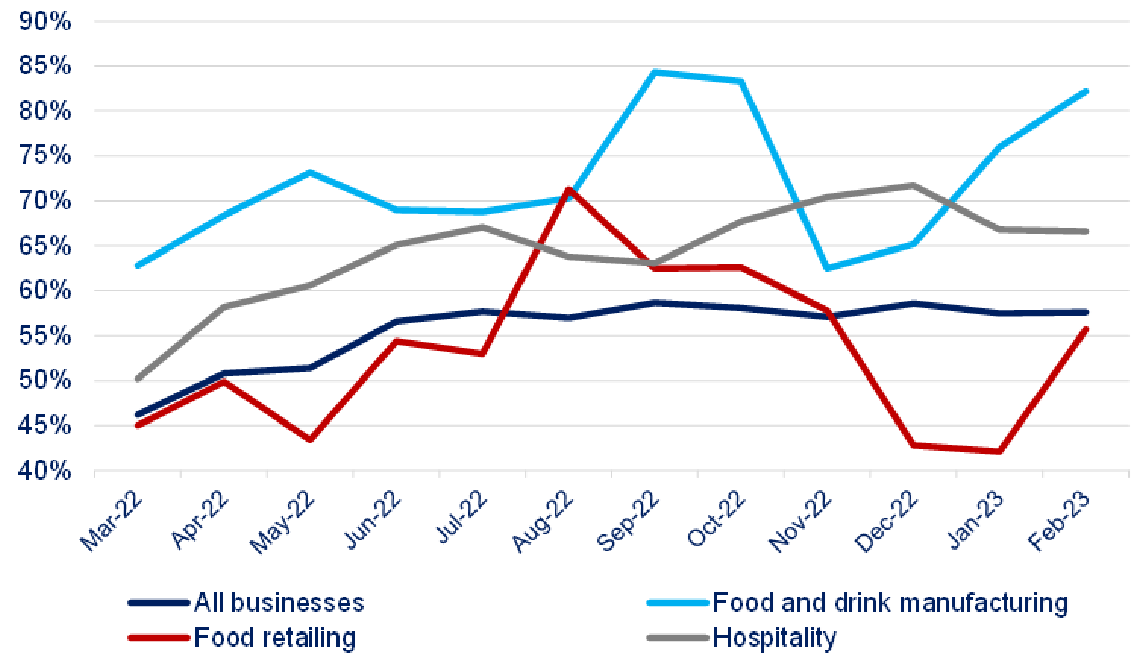
Source: ONS

A variety of ways to deal with cost rises

Faced with this barrage of cost rises, food and drink manufacturers dealt with pressures in a variety of ways. They reduced product ranges, became more energy efficient, switched suppliers, cut back marketing and training expenses, and paused or cancelled investment. They also absorbed a share of the costs (Chart 2). It is important to recognise that ONS data shows that more manufacturers have absorbed rising costs than food retailers or hospitality outlets. On average, over the past year to February, 72% of food and drink manufacturers absorbed a share of rising costs, compared with 56% of all UK businesses, 53% of retailers and 64% of restaurants and cafes. This is another indication of the disproportionate impact of recent challenges that has landed on our industry.

Findings from the Q1 2023 FDF State of Industry survey show that smaller firms absorbed a larger share of cost rises than larger companies. On average, reported total costs increased by 15.4%, while their selling prices increased by only 12.5%. By business size, changes in costs and prices respectively are the following: larger companies (turnover: £500m+): 15.7% and 13.0%, mid-size companies: 12.8% and 7.2%, while small companies (turnover: <£25m): 10.7% and 4.6%.

Chart 2: Percent of businesses that stated they absorbed costs



Source: ONS, Business Insights and Conditions Surveys, March 2022 – February 2023

Recent challenges have led to a sustained erosion of resilience in UK food and drink manufacturing and we have been warning since Q4 2021 about the risk of a further market shock. Smaller companies have little negotiating power with supermarkets, leaving them particularly vulnerable to general market conditions and the willingness of retailers to engage constructively with CPI requests.

The most obvious evidence is the significant rise in insolvencies in our sector. In 2022, there were 244 insolvencies in food and drink manufacturing, up from 122 in 2019 – a rise of 100% (Table 1). That compares to a rise of 25% in Great Britain. Even more concerning, we may not have seen the worst of it yet. Over the first five months of 2023, insolvencies in our sector have already surpassed the total seen in 2019 by 10%, in stark contrast with the situation in Great Britain as a whole and also within the wider manufacturing sector.

Table 1: Number of insolvencies

	2019	2020	2021	2022	Jan-May 2023
Great Britain	18,204	13,276	14,810	23,189	10,707
Manufacturing (GB)	1,540	1,231	1,107	1,767	905
Food and drink manufacturing (GB)	122	124	82	244	134

Source: The Insolvency Service

There is a lag of seven to twelve months between cost changes and retail price changes

It's noteworthy that producers' costs started rising in October 2020, while retail food prices didn't begin increasing until August 2021, because of the time lag for increases in costs to filter through to shop shelves. Similarly, it will take a while for falling costs to feed through to retail prices as higher prices have been contracted in.

Chart 1 and Table 2 illustrate how changes in retail prices lag behind changes in producer costs. In 2021, producers' costs rose, on average, by 5.7%, while retail prices only increased by 0.3%. In 2022, costs continued to climb by 17.8%, but retail prices went up by 11.0%.

Table 2: Yearly changes in food and drink producer prices and retail prices

	All inputs into the production of food and drink	Imported ingredients	UK-sourced ingredients	Retail prices
2019	0.8%	3.2%	0.0%	1.4%
2020	0.8%	1.7%	1.1%	0.7%
2021	5.7%	0.6%	6.0%	0.3%
2022	17.8%	21.3%	16.2%	11.0%
Jan-Jun 2023	16.2%	28.6%	13.9%	18.2%

Source: ONS

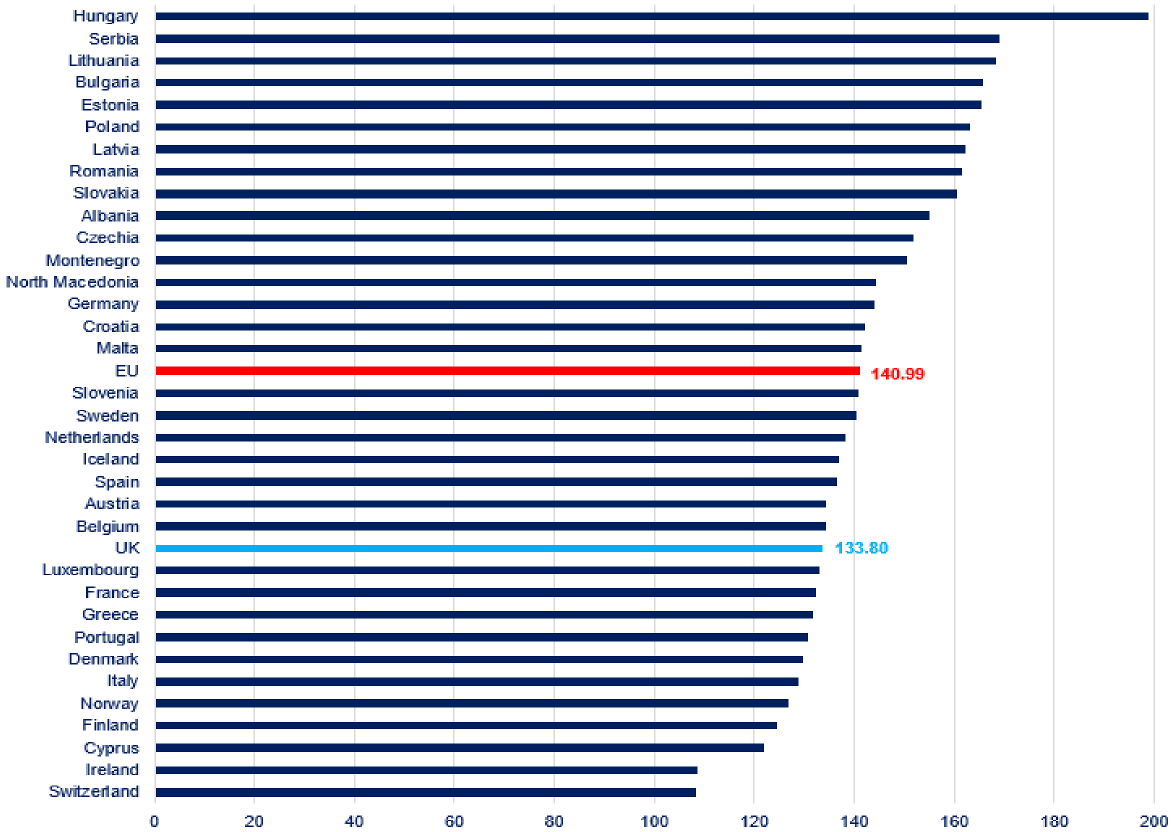
Rising costs of production can only be recovered with considerable delays due to fixed-term contracts and this means that manufacturers have faced further increases in costs that they still need to share with their customers. Nevertheless, the decline in real wages over the last year and a significant recent focus on allegations of profiteering indicates that manufacturers will find it increasingly difficult to pass on further necessary cost rises to supermarkets to help rebuild lost margins and support investment to drive future growth. Ultimately, retailers dictate the prices on shop shelves and not manufacturers.

UK food and drink prices are low in comparison to European prices, despite UK's high food inflation

The UK has a highly competitive grocery market, with pressure exerted by discounters ensuring that retailers vociferously defend value for money to consumers and ensuring their suppliers share their focus on value. So, despite the UK's current high rate of food price inflation, food and drink prices remain low compared to other European markets (Chart 3). In June, UK's food and drink prices were below food and drink prices in other 23 European countries. Compared to the EU average, prices in the UK were 5.1% cheaper.

Consumer loyalty is also not a given – companies can only raise prices within market tolerances or lose customers; another powerful driver for keeping costs down.

Chart 3: Food prices in selected countries, June 2023
Index, 2015 = 100



Source: Eurostat and ONS

Growth in some subsectors has slowed recently (Table 3). In Q1, compared to a year ago, food manufacturing output was 1.2% lower than a year ago, with the following subsectors shrinking: fish, fruit and vegetables; dairy; grain mill and starch products; and other food products.

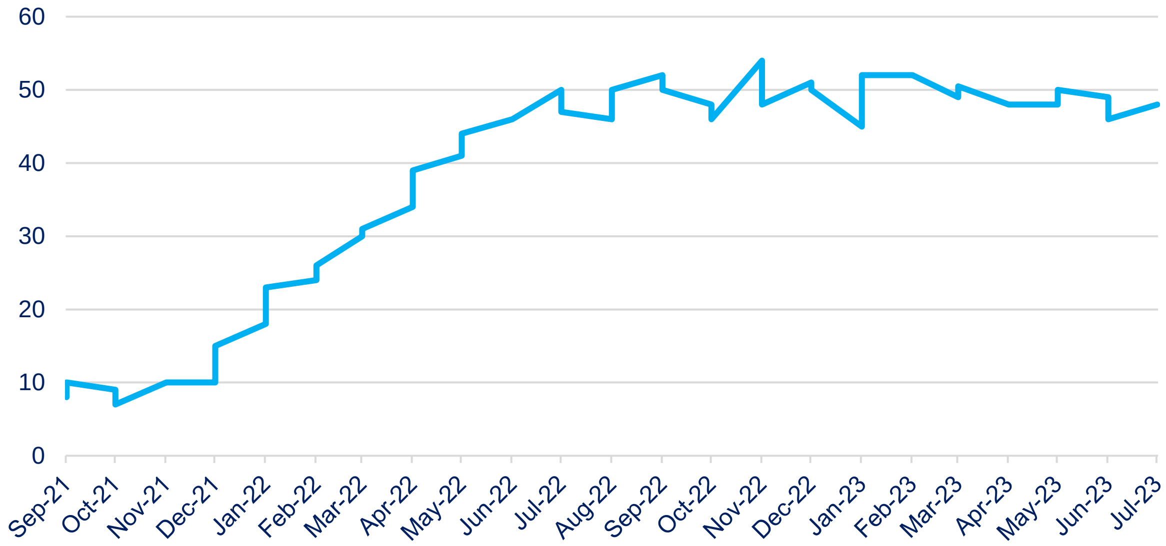
Table 3: Food and drink manufacturing growth by sector, Q1 2023
Gross value added (GVA), chained volume measures

	Compared to Q4 2022	Compared to Q1 2022
Food and drink	**0.2%**	**-1.2%**
UK	**0.1%**	**0.5%**
Meat	1.1%	2.9%
Fish, fruit and vegetables	1.4%	-1.5%
Oils and fats	-13.3%	0.0%
Dairy	-1.4%	-2.3%
Grain mill and starches	-1.0%	-3.8%
Bakery	1.9%	2.7%
Other food products	-1.9%	-7.2%
Non-alcoholic drinks	3.4%	0.4%

Source: ONS

As the cost-of-living crisis hit British households hard, this is not surprising. Worryingly, many people are dealing with the rise in prices by buying less food, with about half of the UK's population reporting lower food purchases over the last year, compared to fewer than 10% in October 2021 (Chart 4).

Chart 4: Percent of adults stating they are buying less food



Source: ONS, Opinions and lifestyle surveys

The short-term outlook for the industry

The biggest short-term challenge for the industry is the ability to secure cost price increases (CPIs).

Cost pressures are subsiding, albeit slowly. International shipping disruption has now largely dissipated, as reflected in the price for international cargo which now have returned to their 2019 levels.

Global food commodity prices have been falling since their March 2022 peak, although they're still 23% above levels seen in February 2020, with sugar prices 66% higher. The collapse of the Black Sea Grain Initiative threatens to push up prices of vegetables oils, wheat and maize. The current heat wave in Southern Europe and the El Niño could have damaging impacts for key crops around the world.

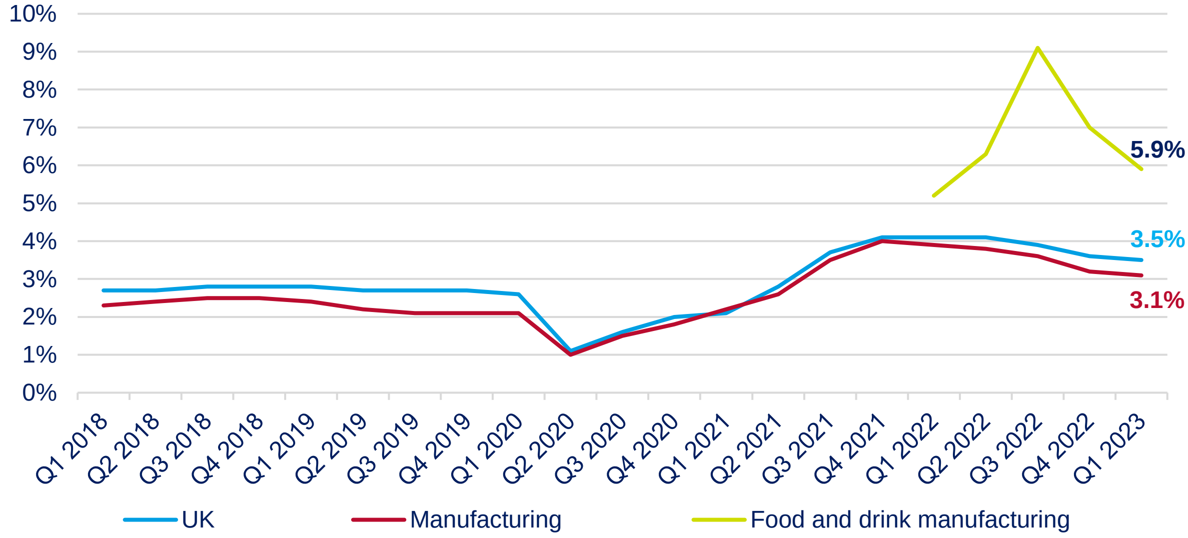
Energy markets remain highly volatile, with gas prices varying between £99 and £59/thm over July, and futures markets pricing it over £130 for January and February, more than double the pre-pandemic levels. As many food and drink manufacturing processes are energy intensive, this remains a source of concern for the industry.

Labour vacancies in the industry remain uncomfortably high. In Q1 there were 5.9 unfilled positions for every 100 jobs in Q1 2023, down from 7.0 in Q4 2022 and 9.1 in Q3 2022. It's worth mentioning that labour shortages were significantly more acute than across the economy or the whole manufacturing sector (Chart 5). Indeed, in Q1, vacancies in the industry were almost double than vacancies in the whole manufacturing sector and significantly above the UK average.

Labour shortages in the industry have been reported across a wide range of roles and skills. Specifically, the industry is in short supply of:

- **High-skilled workers:** R&D specialists, engineers, procurement specialists, scientists, commercial, finance, and marketing roles.
- **Technical specialists:** bakers, specification technologists, food technologists, NPD technologists.
- **Production operatives:** production and machine operatives, delivery drivers, packing operators, night shift workers.

Chart 5: Vacancy rate in UK, manufacturing and food and drink manufacturing *(number of vacancies per 100 employees)*



Source: FDF State of Industry Survey and ONS

Longer-term outlook

For the medium and longer-term, subdued investment and climate change are the main risks to growth. A slow economic recovery in which consumer spend fails to recover, and poorly designed government regulatory, such as the introduction of UK-wide ‘not for EU’ product labelling, will further inhibit investment and growth.