

Food and drink Autumn 2023



Sector Overview

UK businesses have been faced with a number of challenges following 3 years of systemic events that include Brexit, Covid and the war in the Ukraine. The overall market volatility is dissipating with energy and commodity prices bringing some stability.

Food inflation peaked at 19.2% in March 2023, and has steadily eased to 13.6% in the 12 months to August 2023 according to the Office of National Statistics ("ONS"). While headline economic data is positive news, it continues to remain elevated. Higher food inflation continues to be driven by the high input costs of ingredients, energy and labour which have not filtered through to consumer prices yet. The downward trajectory on food inflation continues to be monitored by the Bank of England and other policymakers. Innovation and productivity may be held back as a result.

Wage growth remains strong but there are signs of moderation within the goods and services sector, which should help restore price stability. According to the Food and Drink Federation, labour shortages have continued to fall in Q2 to 4.8% from 5.9% in Q1.

The UK's food and farming sector continue to lean on the government to broaden its seasonal worker scheme to lower the cost of labour since the UK left the EU and ending the freedom of movement.

Britain is the world's third largest net importer of food and drink according to the Food and Agriculture Organisation of the United Nations. EU based fresh food suppliers are likely to serve their local markets before overseas markets when supplies are low, as evidenced with the fruit and vegetable shortage earlier in February 2023 and therefore leaving the UK particularly exposed.

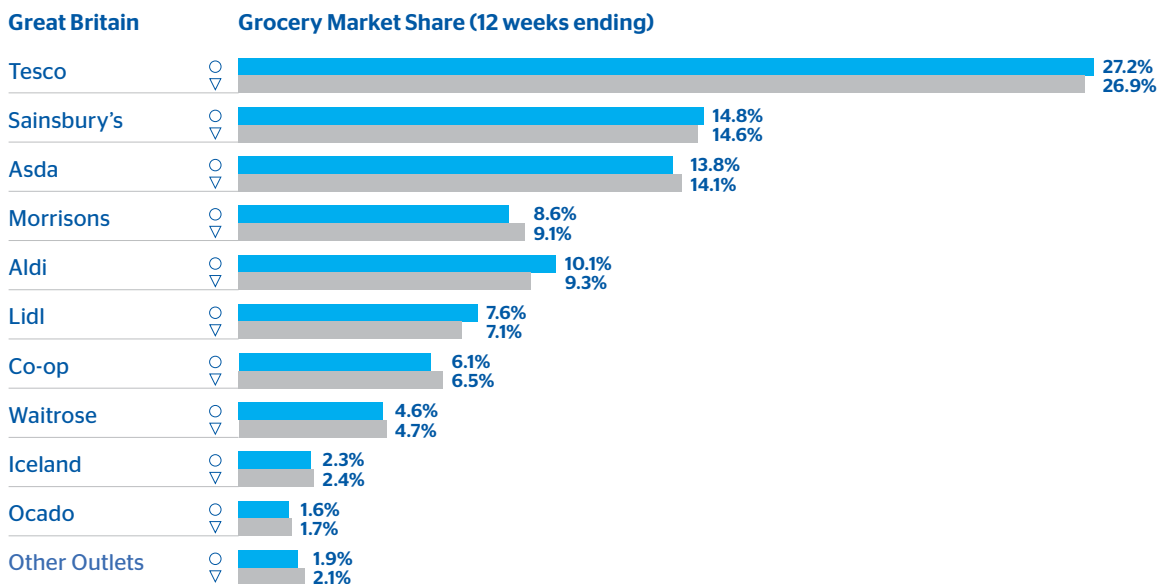
Food producers, including poultry, dairy and horticulture continue to face high agricultural input costs and owing to their increasingly competitive nature with supermarkets. Margins remain thin and are becoming unsustainable with farmers being forced to either absorb the additional cost or choose not to restock. Several supermarkets are offering financial incentives and initiatives to support and secure their supply chains.

Alcohol duty rates in the UK has been frozen since the 2020 Budget. In August 2023, the UK government phased in a new duty legislation levied according to the strength rather than the type of alcohol. The government has attempted to shield hospitality from some of the price increases by maintaining the duty for draught pints in the pubs rather levying the 4p increase retailers face.

Discount retailers remain the fastest growing grocers to August 2023. Its over a year since Aldi became the fourth largest supermarket in Britain, together with Lidl they have made some of the biggest market share gains over the past 12 months. According to Kantar, Aldi's sales grew by 17.7% and Lidl by 16.0% to September 2023, between them capturing a 17.7% market share.

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Kantar Grocery market share for the 12 weeks comparing 3rd September 2023 to the prior year's 4th September 2022



Sources: KANTAR

Notable Insolvency Events

Across the sector businesses have continued to be affected by labour, rising production costs, logistics and Brexit. According to PWC, there has been a significant uptick in insolvencies in the first 6 months of 2023. Hospitality & Leisure made up 17% of the H1 23 insolvencies as they continued to feel a squeeze on margins. Food and drink businesses make up 9% of the total UK administrations according to Kroll. The hangover from Covid and rising inflationary costs saw administrations rise 110% in the period.

At QBE we have seen a notable increase in repayment plans and insolvencies during the period. As part of our credit analysis, we focus on higher borrowing costs and the impact to working capital.

Some notable insolvencies for 2023 include:

Orchard House Foods Ltd (January 2023) -
Net assets of £20.9M

Parrs Foods Ltd (March 2023) -
Net assets of £234K

Loscoe Chilled Foods Ltd (April 2023) -
Net assets of £734K

Meat Factory Outlet Ltd (April 2023) -
Net assets of £277K

MyFresh Prepared Produce Ltd (May 2023) -
Net liabilities of £11M

Farmison Group Ltd (May 2023) - NA

The Black Sheep Brewery Plc (May 2023) -
Net assets of £4M

Meatless Farm Ltd (June 2023) -
Net-liabilities of £1M

Brew by Numbers Ltd (June 2023) -
Net assets of £120K

Jacksons The Bakers Ltd (September 2023) -
Net liabilities of £283K

Lloyd Fraser Holdings Company Ltd (September 2023) -
Net assets £11M

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Economic Data

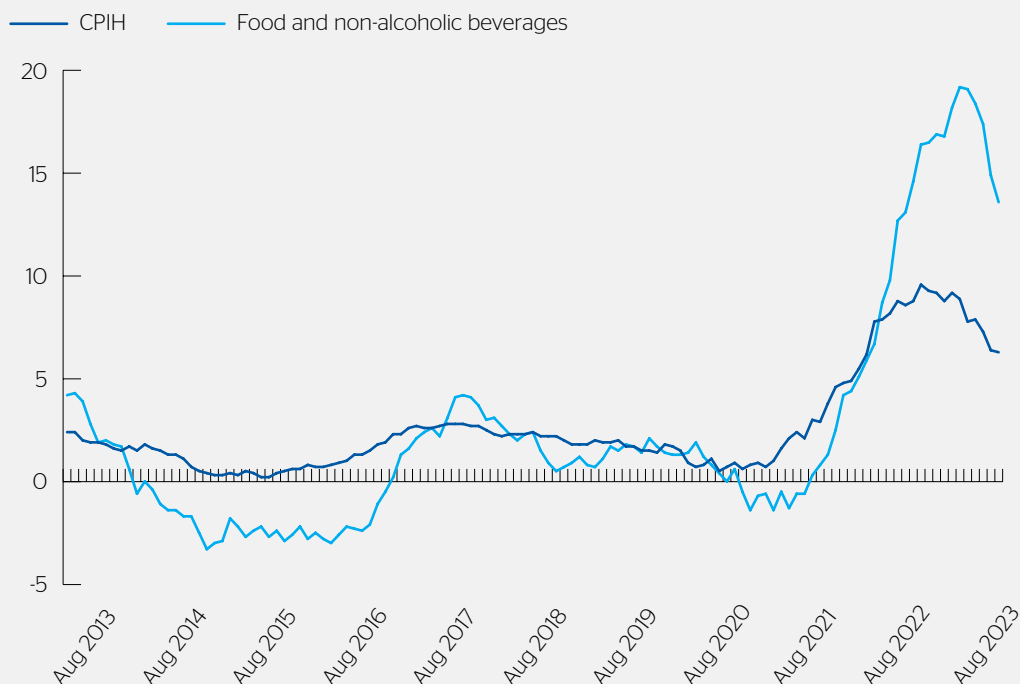
According to the Office of National Statistics, the Consumer Price Index, the annual rate of inflation reduced 10bps to 6.7% in the 12 months to August 2023. While this appears to be going in the right direction, having fallen for three consecutive months, it remains above the UK Governments <5% target. Food and non-alcoholic beverage prices have eased, owing to downward contributions from milk, cheese, eggs, vegetables and fish categories. We remain cautious on the outlook owing to the rise in crude oil and alcohol duties since August 2023.

New arrangements to supply Northern Ireland under the Windsor Framework agreement will be phased in from October 2023. The framework will allow supermarkets to operate UK wide rather than moving towards an Island of Ireland model. The labelling of UK goods will be phased in with the words 'Not for EU' on meat and fresh milk.

This may inadvertently lead to further price increases owing to packaging costs.

Russia's withdrawal from the earlier Black Sea grain deal with the Ukraine in July 23 created a short rise in global grain prices. Grain exports from the Ukraine are being transported from alternative ports and have been exported by road and rail which are time consuming and carry a higher cost. The price of wheat has fallen more than a fifth since the end of July 2023 owing to an exceptionally strong crop in Russia. While the Russian surplus will offset falling yields in other major wheat producing countries, the market remains susceptible to sudden moves against unpredictable geopolitics and poor harvests. In September 23, the European Commission lifted the ban on the import of grains from the Ukraine. There is potential for cheaper Ukrainian grain to enter the European market, thereby under cutting local farmers.

CPIH, and food and non-alcoholic beverages annual inflation rates, UK, August 2013 to August 2023



Sources: ONS

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Strengths

- > **Sustainable food products:** The industry can often endure long and complex supply chains in the traceability of ingredients. Businesses need robust supply chains that are founded on sustainability, collaboration and transparency as consumers demand more sustainable food products.
- > **Capital Investment:** Increased investment in automation/robotics across every link in the food supply chain (farm to fork) to try and reduce the impact to an increasingly challenging labour market has been noted across the sector. Artificial intelligence will play a significant role through personalisation like Chatbots.
- > **Mergers and Acquisitions:** International forecasts predict that mergers and acquisition activity should pick up from 2024.
- > **Pet Foods:** In Britain, half of households own a pet. According to Mintel, the cat and dog food market has seen volumes fall in 2022 and into 2023 as pet owners look to economise on their pet food spend. There has been a market share gains on dry food which have elevated broths and gravy sales. We have also seen an uptick in online purchases and subscription services of pet food and related products.

Challenges

- > **Refinancing** - With tighter credit conditions and some businesses still retaining sizeable Covid related debt levels, refinancing on suitable debt structures may become a challenge.
- > **Plant based alternatives** - The segment has attracted an influx of investment in recent years. Producers are reporting softer demand in the plant-based meat category. Rising inflation and weakened consumer spending have impacted sales as consumers believe swapping meat for plant-based alternatives can be more expensive.

- > **Food manufacturers and processors** - A typically low margin industry continues to face elevated costs throughout their supply chains from energy prices to labour costs. On average total costs increased 15.4% while selling prices rose by 12.5% in Q1 23. It is, however, common to experience a lag due to fixed term contracts and commodity price lock ins.
- > **Casual Dining** - Casual dining outlets across the UK fell 4.2% in the 12 months to March 23 according to data from CGA, Nielsen IQ and AlixPartners. We have seen some positive trends as consumers remain willing to eat and drink when spending allows. Consumers appear to be trading up to a less frequent luxury meal or trading down to a take-away and dining at home. The overall sector continues to be impacted by wage growth, higher business rates and increased food costs. Optimising locations, service and operating hours do provide opportunities.

Underwriting Approach

- > **Information is key:** We remain in regular dialogue with a variety of businesses across the food and drink sector. We seek to obtain updated management accounts across the portfolio to fully understand the trading performance in the current environment.
- > **A case-by-case underwriting stance:** Each business is reviewed on their own financial merits, which allows us to retain a stable and consistent approach to risk underwriting.
- > **Focus upon funding arrangements:** The overall reliance on working capital facilities in this sector means there is particular focus on funding facilities that are being made available to support working capital, meet their financial covenants and the ability to refinance.

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