

Food and drink update Autumn 2022



Sector overview

As we move clear of pandemic led business disruption, a new set of challenges face the UK food and drink sector. The Russia-Ukraine conflict continues to impact the price of world food commodities, UK food inflation is at its highest level since records began and consumer spending power is reducing in the wake of a challenging economic backdrop. With many businesses in this sector carrying sizeable covid related debt levels attention now turns to their ability to refinance on suitable debt structures whilst managing supply chain pressures, a decline in customer spend, and tighter overall margins.

Notable insolvency events

According to law firm Shakespeare Martineau, the level of insolvencies in the UK food and drink sector in the 6-months to June 2022 increased by 60% compared to 2021. 39 businesses including several breweries and restaurant chains failed during this period yet overall, this sector is the 6th most impacted in the UK and it only accounts for 6% of UK administrations. According to data shared by advisory firm Mazars, the hospitality sector (particularly breweries and restaurants), has been impacted by a 72% rise in insolvencies in the year to August 2022. QBE expect insolvency figures to rise across this industry in the midst of rising inflationary costs, labour shortages and supply chain disruptions.

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Economic data

The British Retail Consortium reported another record month for shop price inflation in September 2022 with food inflation accelerating to 10.6% during the month. Higher energy prices, inflation and rising interest rates has led to a shift in consumer shopping habits as customers look to trade down and save money. German retail discounters, Aldi and Lidl accounted for 16.4% of the UK grocery market share in the 12 weeks to 4th September 2022. Research by Kantar stated Aldi's sales rose 18.7% to become Britain's fourth largest supermarket group in the period. Of the other more established retail chains, only WM Morrisons and Waitrose saw sales decline in the period.

According to the ONS, more than a quarter of all UK businesses expect to raise their prices during October 2022, with more than half of businesses reporting energy costs as the main reason for the projected price increases. Supermarkets are attempting to hold firm on pricing as the likes of Tesco 'price-lock' and 'price match' products at the expense of profit. With inflationary pressures persisting and investors to appease, we still expect upward price movements to commence through the winter in this sector.

Brexit and the Northern Ireland protocol came into force in January 2021 to avoid the hardening of the Irish land border. Negotiations on treaty border reform for certain food products have stalled post-Brexit. Exports from the UK have decreased since the end of the transition period, however, Northern Ireland have benefitted with dairy, beef and lamb producers fulfilling supermarket demands in the Irish Republic.

While the EU remains the UK's biggest trading partner, The Food and Drink Federation stated that the UK's food and drink exports to other territories outside of the EU has grown significantly, particularly to the UAE, Canada, Australia, and India.

Russia and Ukraine, with the support of Turkey, signed an agreement in July 2022 to allow stockpiled grain to be exported through the Black Sea. As of 26th September 2022, approximately 2 million tons of grain product has been exported from the Port of Odessa. The Ukraine are a major supplier of sunflower oil, corn, barley, and wheat.

Strengths

- > **Agricultural Commodities:** Measured by the S&P GSCI Agricultural Index, Agri commodities have significantly outperformed the broader market over the past year with a total return of 19.2% compared with the S&P's 500 total return of -11% as of 1st September 2022.
- > **Fruit and Vegetables:** While the summer drought diminished some harvests many producers have benefitted from longer periods of sunshine, particularly soft fruits like blueberries and tomatoes, which brought down the supermarket prices for the consumer.
- > **Capital Investment:** Increased investment in automation/robotics across every link in the food supply chain (farm to fork) to try and reduce the impact of what is an increasingly challenging labour market has been noted across the sector.
- > **Sustainable food products:** The industry can often endure long and complex supply chains in the traceability of ingredients. A continued demand by consumers to purchase more sustainable food products is supporting the need for a higher standard of environmental and social responsibility through the food supply chain. Businesses are therefore expected to operate more sustainably for all their stakeholders with those that can provide the most transparency benefitting from increased sales.
- > **Energy cap:** The 6-month energy cap for business that was recently announced by the UK government will come into force from October 2022. Although energy prices will still increase, it provides short-term relief and clarity to businesses throughout the winter period.

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Challenges

- > **UK Sterling:** As the British pound remains weak against the US Dollar, commodities that are typically paid in US Dollars remain expensive for food and drink supply chains.
- > **Fertiliser:** With Gas being a key ingredient in the production of fertilizer, farmers are having to grapple with the increased cost of production. The National Farmers Union stated that a 3rd of UK farmers have changed their crop plans in the past 4 months with a switch away from growing fertilizer intensive crops like milling wheat.
- > **CO2:** As a by-product in the production of fertiliser, the gas is critical in the processing of meat, packaging and in carbonated drinks. The UK Government has previously offered short term funding to enable CO2 producers to continue operating but it remains unclear if they will do so again.
- > **Food manufacturers and food processors:** A subsector that is likely to feel the pinch with an inability to fully pass on input and distribution cost increases to their customers.
- > **Hospitality:** Expected to face ongoing staff shortages and rent increases as they campaign to extend the business rate holiday and reduce VAT.

Underwriting approach

- > **Information is key:** We remain in regular dialogue with a variety of businesses across the food and drink sector, with closer emphasis on food manufacturing and hospitality. We seek to obtain updated management accounts to fully understand the trading performance in the current environment and the funding facilities that are being made available to support working capital.
- > **A case-by-case underwriting stance:** Each business is reviewed on their own financial merits.

Contacts

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