Grocery Trade Review

KevinGrier
Market Analysis and Consulting Inc.

Make Informed Decisions

December 2016

Canadian Food Industry Statistical Snapshot

Consumer Prices				
Change vs 2015	CPI All Items	CPI Food from Stores	CPI Restaurants	Packaged Foods*
November	1.2%	-2.0%	2.5%	-1.5%
Latest 12-month YOY	1.4%	1.6%	2.6%	0.8%

Manufacturing Industry Raw Costs and Goods Prices				
Change vs 2014	Raw Crop-Based Materials Costs	Raw Animal-Based Materials Costs	Finished and Intermediate Foods	Packaged Foods* Price
October	-1.8%	-12.0%	-1.1%	1.9%
Latest 12-mon YOY	-0.4%	-7.8%	0.7%	2.0%

Retail Sales Revenue				
Change vs Prior Yr	Supermarkets	Convenience	Drug	General Merchandise
October	-3.4%	-0.3%	2.9%	3.1%
Latest 12-mon YOY	0.1%	3.2%	6.8%	3.3%

Manufacturer Sales Revenue				
Change vs Prior Yr	Total Manufacuting	All Food	Soft Drinks	Packaged Foods*
October	-1.0%	4.7%	5.6%	7.9%
Latest 12-month YOY	0.3%	5.4%	5.8%	4.6%

* Packaged does not include meat, poultry, seafood, dairy, eggs or produce

HIGHLIGHTS

- Food store inflation will average 1% in 2016.
- November pricing declines in Canada were nearly universal across all items in the store.
- 2016 will end with deflation for the year on average in the United States.
- Supermarket sales in 2016 in Canada are likely to be unchanged compared to 2015.
- Commodity pricing and competition point to very modest food store inflation in 2017.
- Manufacturers and grocers will see margin pressure in 2017.
- Canada will have a processed food trade surplus with the United States in 2016.
- The depreciated currency will lead to a larger food trade surplus in 2017.
- Canadian consumer expenditures at food stores increased just 1% in 2016.
- Agriculture commodity prices increased modestly in December.
- Consumer confidence increased in December
- CIBC equity researchers assess Sobey's prospects.

Report Written by Kevin Grier

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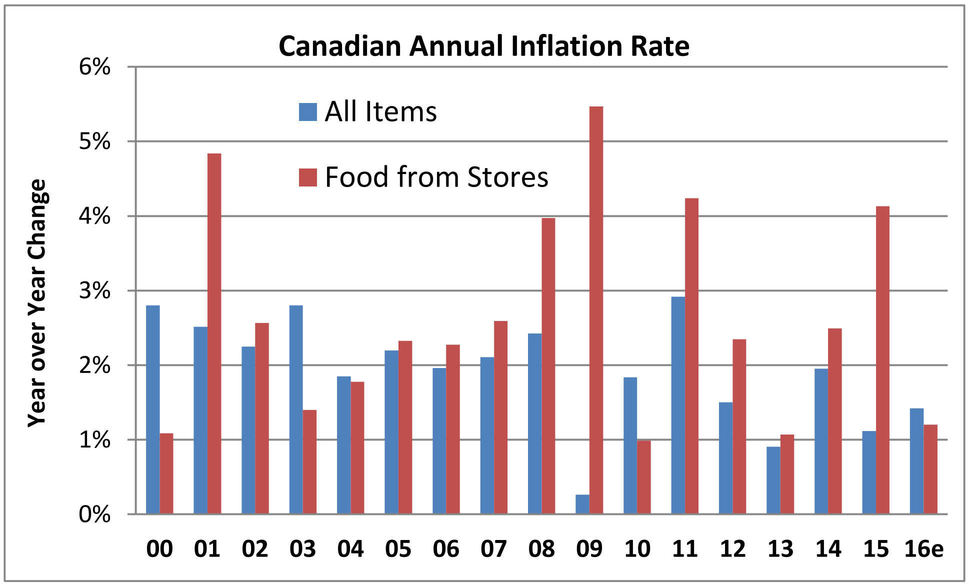
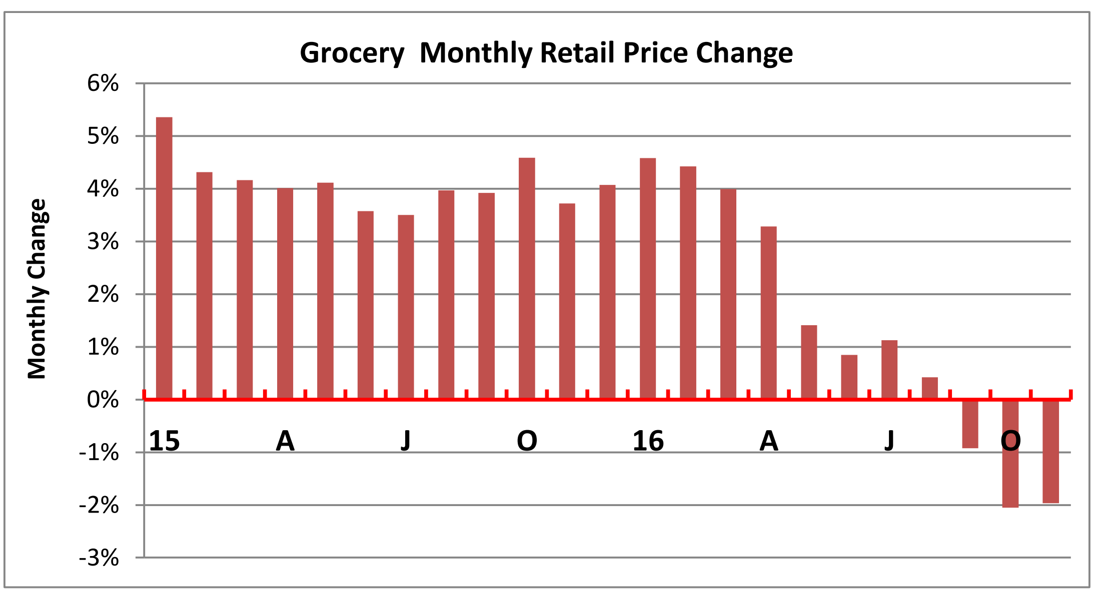
2016 & 2017 Food Inflation Assessment

2016: A Tale of Two Price Levels

While the final StatsCan data for December is not yet reported, based on the first 11 months of the year, the overall 2016 food inflation picture is very clear. Based on the Statistics Canada Consumer Price Index (CPI) the prices of Food Purchased From Stores will have increased at just over 1% in 2016. That is modestly lower than the price increase for All Items in the CPI. The 1+% increase this year also compares to the robust 4% increase in food purchased from stores prices in 2015. The 2011-2015 five year average rate of food store inflation was 3%. The food store inflation rate will likely be the second or third lowest rate of inflation since 2000 with 2010 standing as the lowest at 1%.

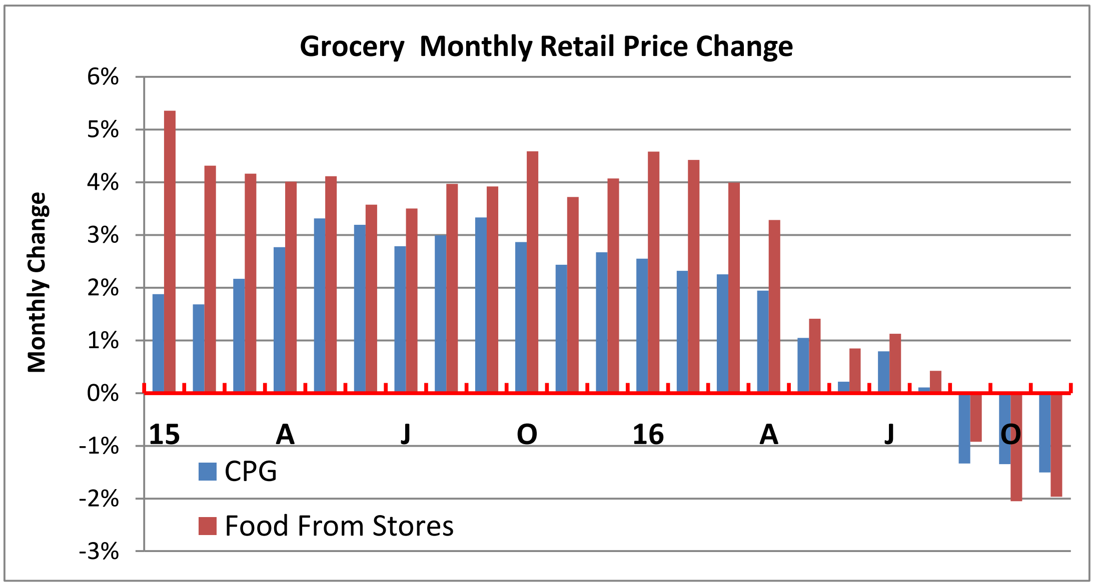


The food inflation picture during 2016 was particularly interesting as the year can easily be divided into two distinct pricing periods. The first four months of 2016 looked very much like 2015 in terms of inflation. By June however, price increases became much more tepid and by September, prices were actually in deflation mode. As seen on the graph below the price of food began to tip below year ago levels in September and continued through the latest data for November.

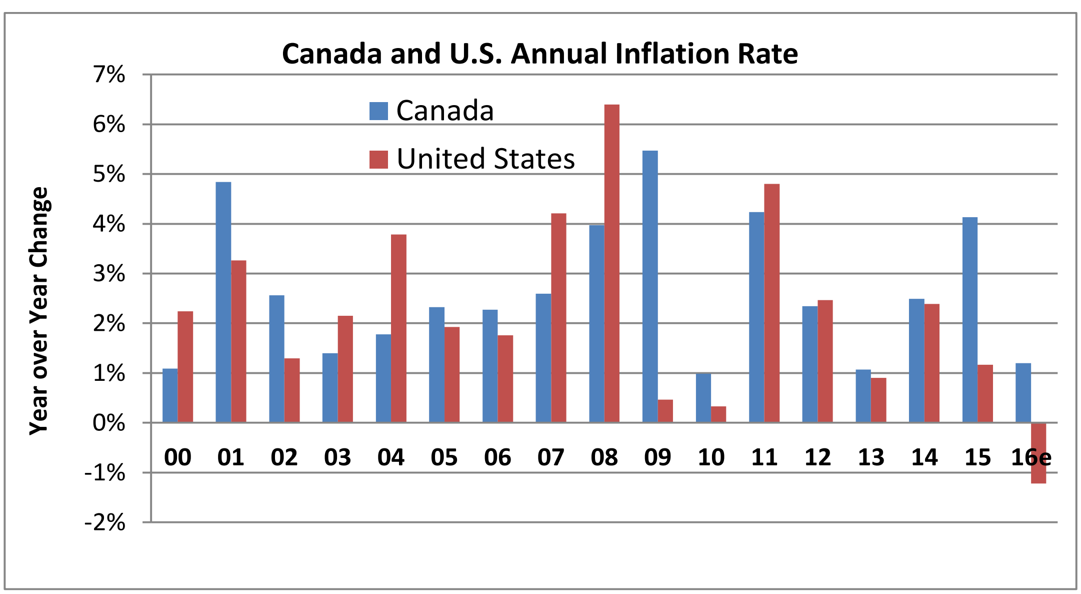


The specific food product pricing during the year is also very interesting. It is interesting because the pricing declines were nearly universal across the store. Given the decline in cattle and pricing, it was only a matter of time before meat prices began to decline. Meats make up about a fifth of the food CPI and so their direction plays a big role. With that said, however, almost all items from bakery, processed fruits and vegetables as well as dairy and eggs saw deflation in October and/or November.

In other words, the decline in price is not just related to declining meat commodity pricing. In fact my tabulation of consumer packaged goods (CPG) has declined right along with the overall food rate. As I have argued here before, the direction of consumer packaged goods can be a good indication of the level of grocery competition. That is, the only way to compete on ketchup, cookies or cereal is with price. The weakening of CPG suggests that grocer competition was robust in the second half of 2016.

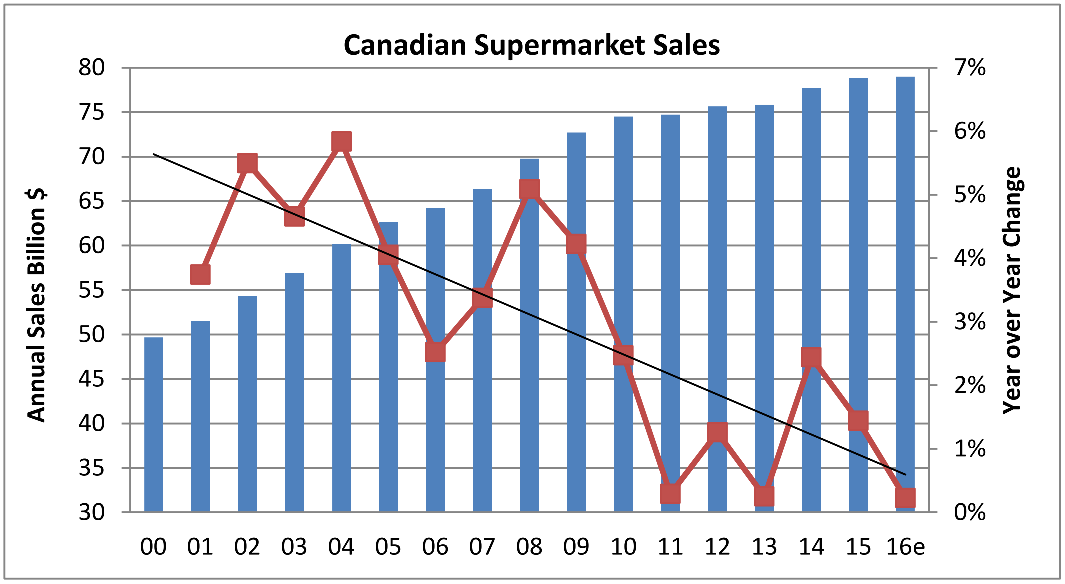


It is also of interest to look at the experience in the United States. In that regard, while Canadian prices increased by just a percentage point in 2016, U.S. pricing actually declined for the year. That comes on the heels of 2015 in which U.S. pricing only increased by about a percent versus the 4% in Canada. The divergence of experience in 2015 and 2016 demonstrates that Canada and U.S. pricing are not tightly linked. The U.S. deflation of 2016 does not portend the same in Canada. With that noted, the 2016 U.S. performance indicates there is no inflationary pressure coming to Canada from the United States.



Stagnant Supermarket Sales in 2016

The inflation rate of food purchased from stores of course has a direct impact on total sales for supermarkets. Based on sales data over the first ten months of 2016 as tabulated by Statistics Canada, it is likely that 2016 total Canadian supermarket sales will amount to just under $79 billion. That is up just marginally if at all compared to sales in 2015. Further to that point, 2016 will be the third year in the last six in which sales showed nearly no growth at all. In addition, as can be seen on the graph below, the year over year trend in sales over the past 16 years has been decidedly lower



2017 Prospects

Looking ahead to 2017, the question of the direction of food inflation is critical to the prospects for both manufacturers and grocers. As noted here many times before, the key drivers of food inflation in Canada are the direction of commodity prices and grocer competition.

There is a strong correlation between commodity prices and consumer grocery prices. Commodity prices in Canada are also closely tied to the direction of the Canada-US currency exchange rate. Further to that exchange rate question, as shown on page 10, the Bank of Montreal is forecasting a 2017 first half exchange rate of 0.7345. That compares to a first half in 2016 of 0.752. For the year 2017 the BMO sees an exchange rate of 0.73 compared to 0.754 in 2016. For further reference CIBC’s 2017 average is 0.735 while Scotiabank is closer to 0.725 and TD is at 0.7435. As such from an exchange rate perspective, there is inflationary pressure on commodities, if the BMO forecast is reasonably correct.

With that noted, as shown on the Bank of Canada commodities graph on page 8, the agricultural commodities are showing signs of life but remain at very low compared to recent years. The point is that anything can happen to commodity prices due to weather, currency or politics, but at the very least they start 2017 at very low levels. In other words, if commodities are going to cause inflation in 2017, it would have to be due to events that have not yet unfolded or are not yet at work. Further to that, cattle and hog inventories are on the rise. Based on pending slaughter levels, both beef and pork pricing should remain low or lower than 2016. As such the critical meat pricing part of the CPI is not likely to be a cause of inflation in 2017.

The intensity of grocer competition is also a key factor in pricing and inflation at grocery. In that regard, based on the performance of the CPG pricing, it appears that grocery competition is currently at very intense levels. To augment that statement, there are the well-publicized demands by the leading grocers for pricing concessions from manufacturers. That indicates that the grocers want consumers to think they are fighting on their behalf. It also indicates that they expect to see a tight pricing environment for the foreseeable future. In addition, with regard to competition, the margin and profit challenges at Sobey have led them to articulate pricing related competitive responses. Finally with regard to competition, Peter Sklar of BMO Capital Markets wrote in mid-December that based on their research, pricing at Walmart is continuing to deflate with significant declines in Montreal. Clearly Walmart is upping its game with regard to its food pricing positioning.

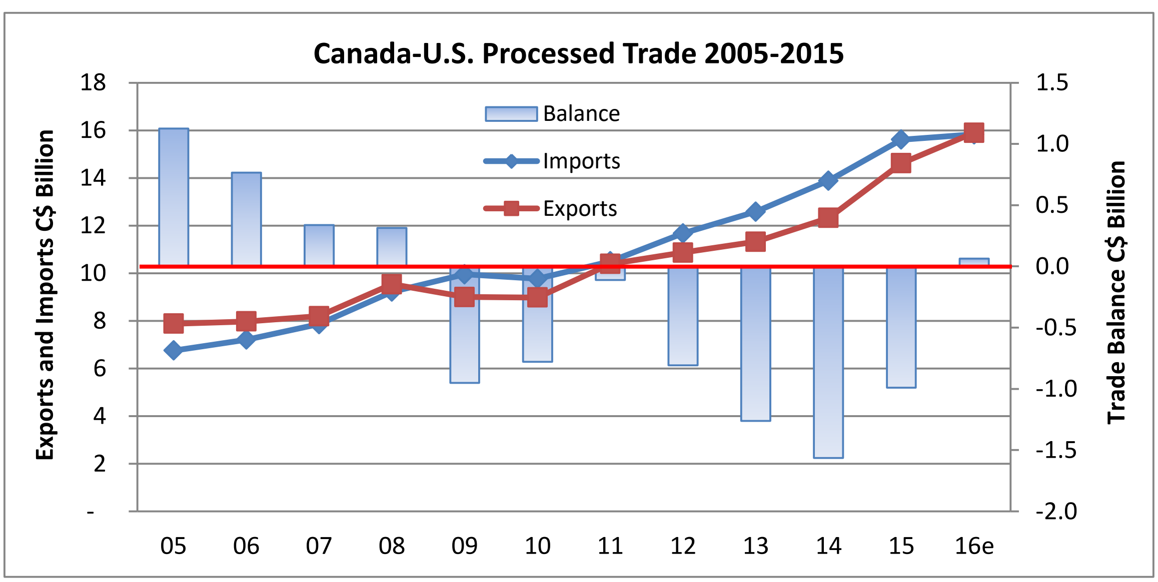
The main point is that with the exception of the exchange rate, the main drivers of inflation remain very tepid. The food pricing outlook for 2017 is for ongoing deflation into the first quarter with gradual increases in the second through fourth quarters. The average food store inflation for 2017 is not likely to exceed 2%.

Why it Matters

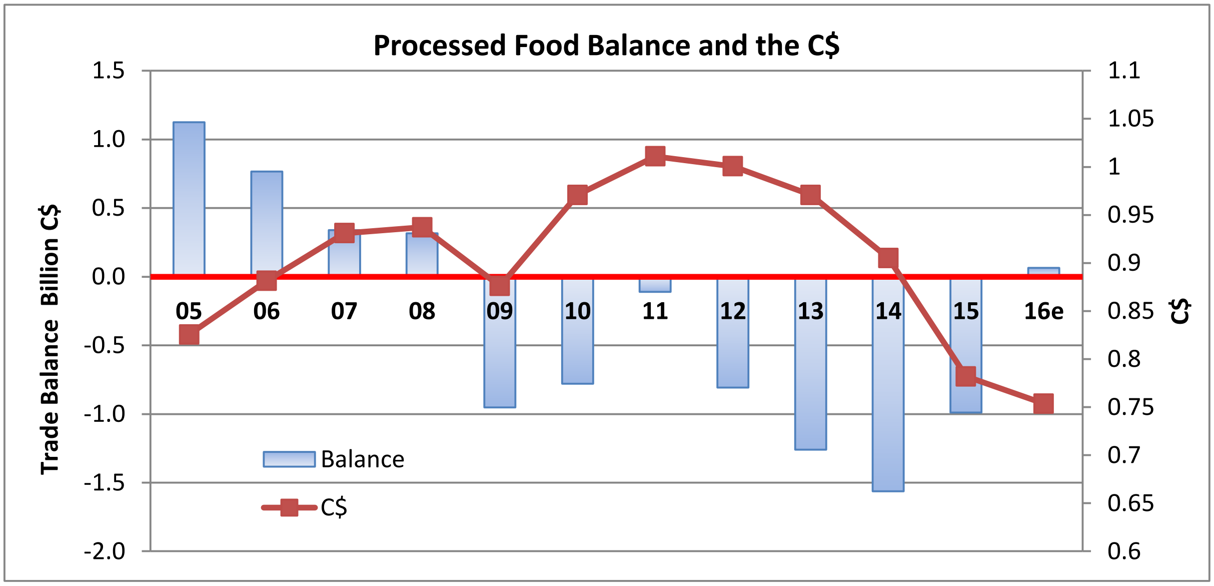
The grocery industry is likely to stay in intense competitive mode through at least the first half of 2017. A weaker dollar could cause some commodities such as fresh produce to increase in price in the first half. Beyond that however, it is likely that grocers and manufacturers will absorb the costing impact of the weaker dollar into tighter margins. A low inflation and even deflation environment is going to cause margin stress through the chain.

Processed Trade Surplus in 2016?

USDA Foreign Agricultural Service generates a trade data set called processed food (ag only). That data set contains processed foods and non-alcoholic beverages. It does not include prepared seafood or fresh meats, only processed meats. Based on the performance of processed food trade over the first ten months of 2016, it appears as if Canada will generate a modest trade surplus with the United States of C$60-65 million. This would be the first trade surplus on the processed food trade since 2008. In addition from 2009 through 2015, Canada has run a cumulative processed food trade deficit of nearly $6.5 billion.



The fact that Canada moved into a surplus with the United States in processed foods in 2016 coincides with the ongoing depreciation of the C$ versus the USD. It is easy to explain the trade-related competitive advantages of a depreciated C$. At the same time, however, there is not a strong correlation between the annual exchange rate and the annual processed food surplus or deficit. In fact in 2011 when the currency averaged near par, the annual trade deficit was very small. Conversely in 2014, when the currency was in its third straight year of depreciation, Canada's trade deficit was at its widest level since 2005. Part of the issue of course is marketing and competitive lags in currency adjustment. Nevertheless, in 2016, with the currency at its weakest level since 2003, the trade balance went from a deficit of one billion in 2015 to a small surplus.



> **Why it Matters**
>
> **The depreciating C$ causes inflationary pressure domestically. As noted in the first article above, based on the relatively aggressive retail environment, it is likely that the both manufacturers and grocers are going to be forced to absorb depreciated dollar cost increases into margins. This in turn is likely to make export markets more profitable relative to the domestic market. It can be expected that Canada's trade surplus will expand sharply in 2017.**

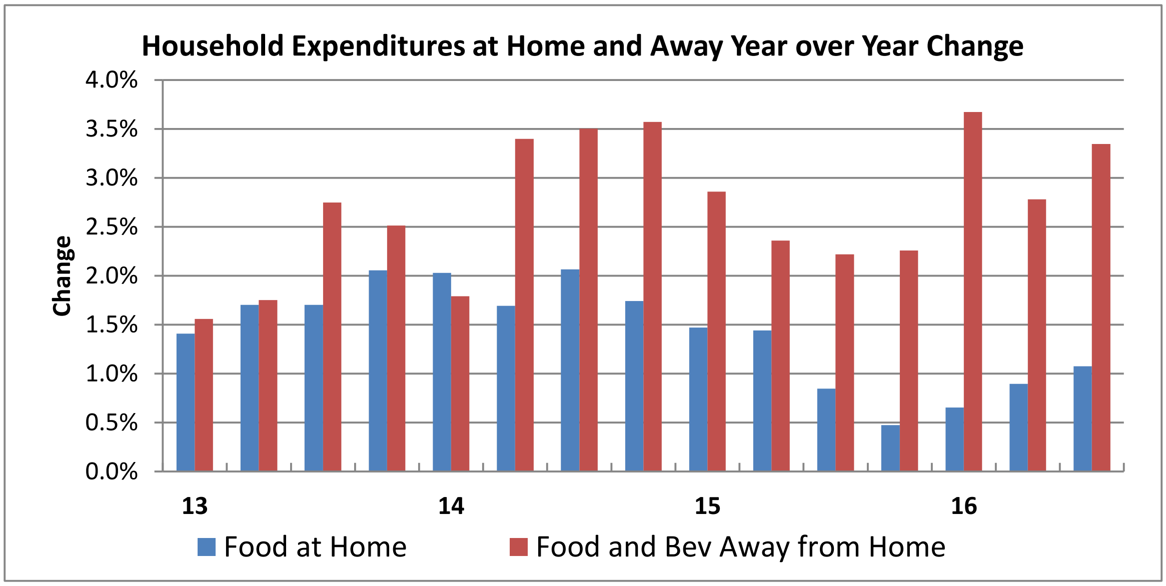
Monthly Statistical Highlight

Household Expenditures

Statistics Canada recently released the third quarter "Household Final Consumption Expenditure" data. The dataset breaks down the amount Canadians spend on an exhaustive array of typical household expenditures including food, fuel, rent, entertainment, clothes and so on.

In the third quarter, Canadian's spent $73.8 billion on food for home consumption (food from stores) on an annualized basis in 2007 dollars. That is up about 1.1% compared to the $73 billion spent in last year's third quarter. Canadians spent $56.5 billion on food and beverage services (food out of home) in the third quarter on an annualized basis. That was up by 3% compared to last year. By comparison, Canadian expenditures on clothing increased by 5% and shoe expenses increased by 7%.

The Canadian spending on food at home in the third quarter was the third quarter in a row in which spending increased, albeit modestly. The increase reversed a five quarter downtrend that began in mid-2014 and ran to the end of 2015. In the meantime, Canadian spending on food and beverages away from home has been consistently outpacing the food at home spending since at least 2014.



The summary point is that the growth in food at home spending is increasing but the rate of growth remains very tepid. In fact the third quarter growth rate, while the strongest in three quarters, ranks among the lowest since 2012. The main point is that while the most recent trend is working in favor of retailers, consumers continue to be very cautious about food at home spending. At the same time there is an obvious willingness to spend more lavishly on food and beverages away from home, which of course is direct competition to retail.

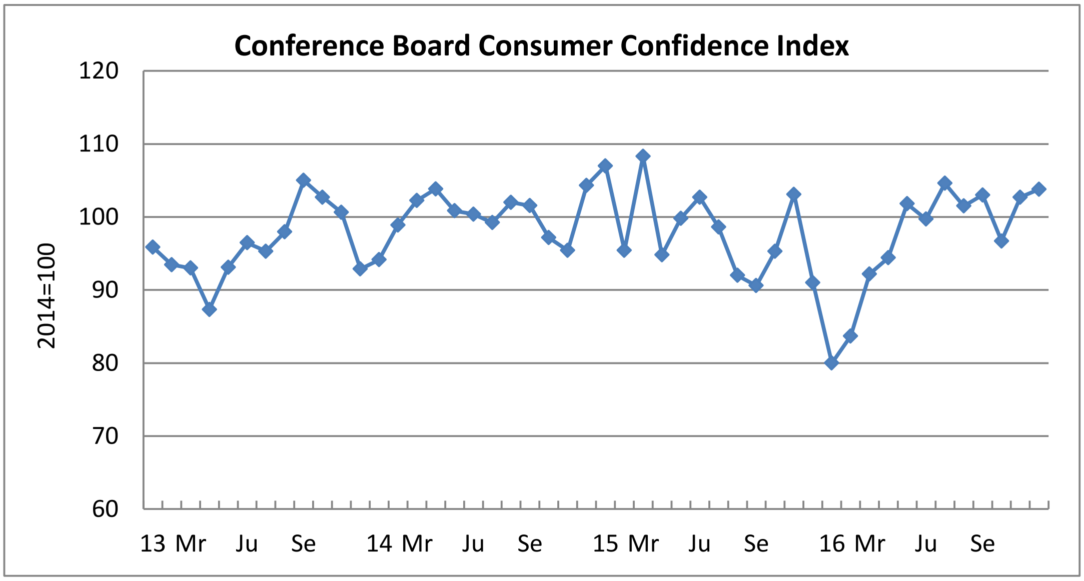
Why it Matters

As noted above, the prices of products purchased at stores has been declining. That means in the fourth quarter of 2016 and likely into the first half of 2017, consumers will be drawn to shop at retail due to lower prices. Lower prices will train consumers to expect lower prices. At the same time consumers will continue to enjoy spending on food away from home and on shoes. The spending patterns of Canadians points to continued grocery challenges in 2017.

Consumer Confidence

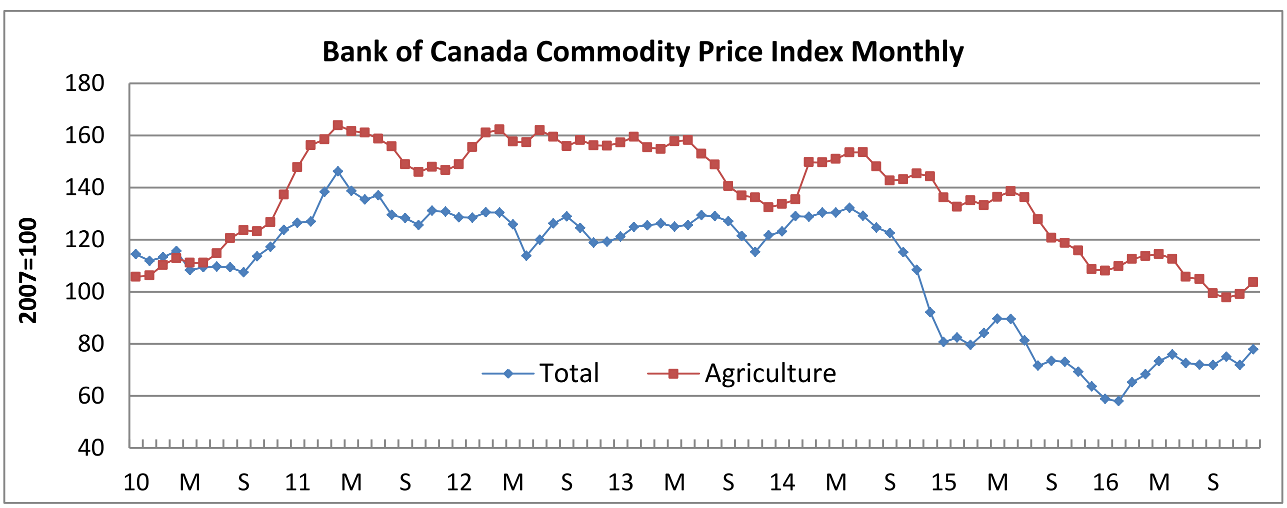
Consumer confidence can be defined as “the degree of optimism on the state of the economy that consumers are expressing through their activities of savings and spending.” The Conference Board of Canada has a monthly Index of Consumer Confidence which is constructed from responses to four attitudinal questions posed to a random sample of Canadian households. Measuring consumer confidence is important for the food industry as it provides an indication of consumer willingness to spend. While consumers will always need to purchase food, the volumes and types of expenditures will be impacted by their level of confidence.

The Conference Board of Canada’s Index of Consumer Confidence rose 1.1 points in December to 103.8 (2014 = 100). It was the second consecutive monthly increase. The Conference Board said that “bodes well for overall consumption spending entering the holiday season. Canadians appear to be holding out hope for the New Year despite the underwhelming pace of full-time job creation seen of late."

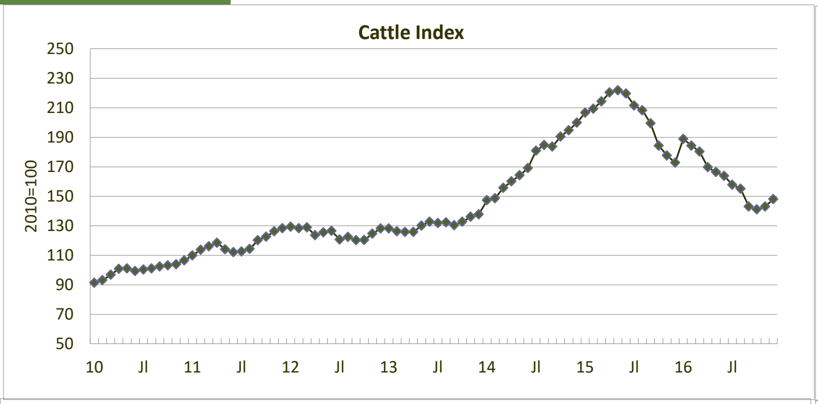


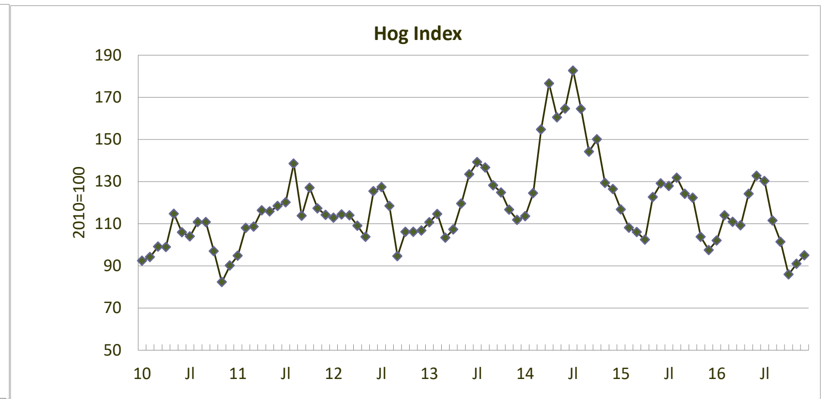
Commodity Watch

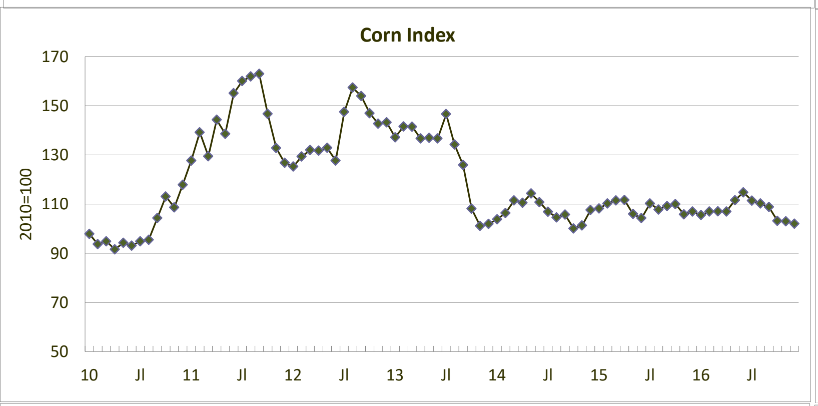
The Bank of Canada *Commodity Futures Index* for all commodities took a bounce higher in December after trading sideways for the past six months. The Total Index is off its trough of early 2016 but remains low by recent year standards. The Agriculture Index also increased in December, reversing a decline of about six months. Despite the increase in December commodities finish 2016 at very low levels relative to 2015

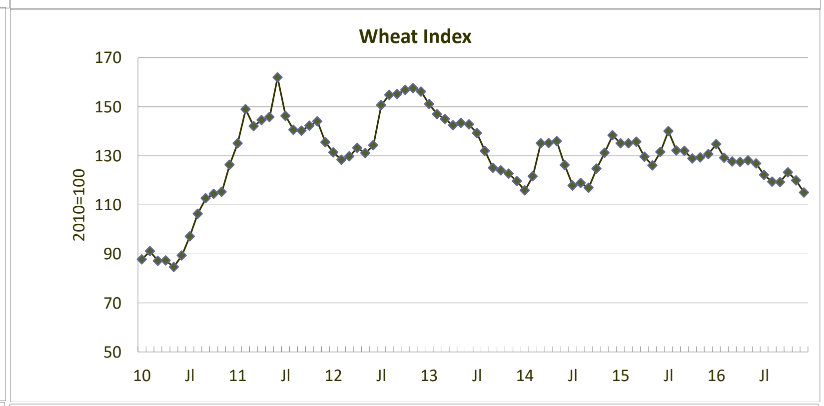


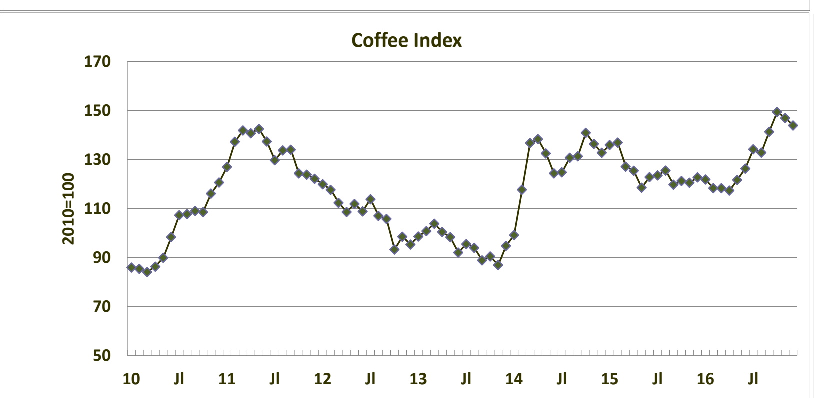
The following graphs show the monthly pricing performance for some of the key agricultural and raw food commodities in Canada from 2010 to present based on the StatsCan Raw Product Price Index.

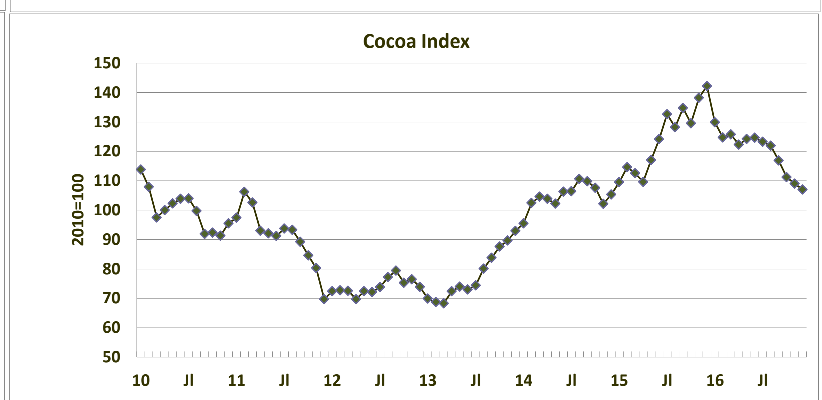


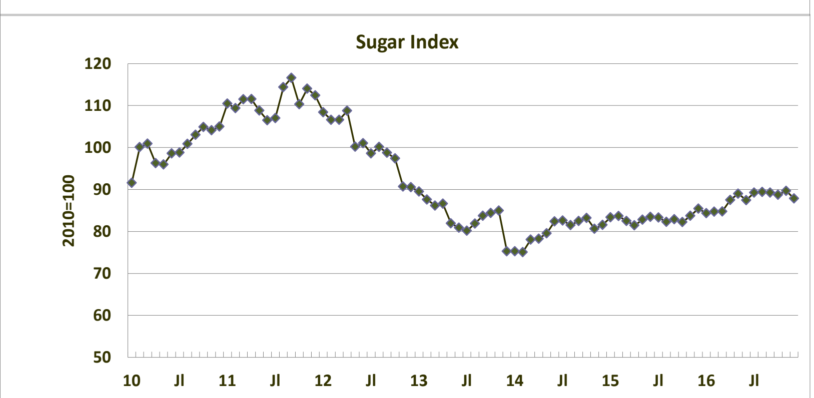


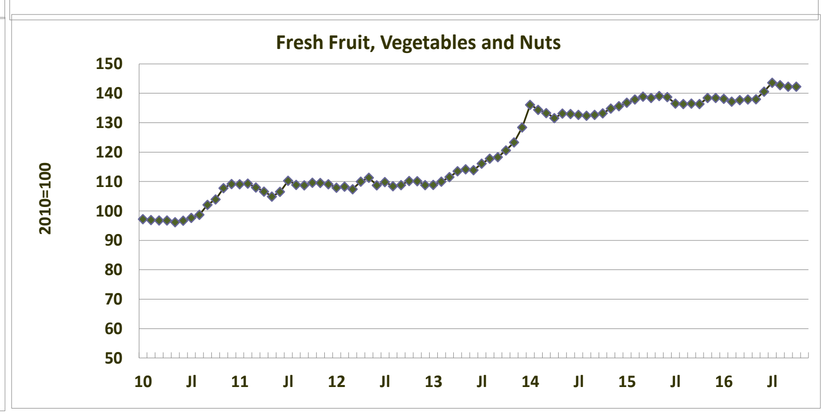






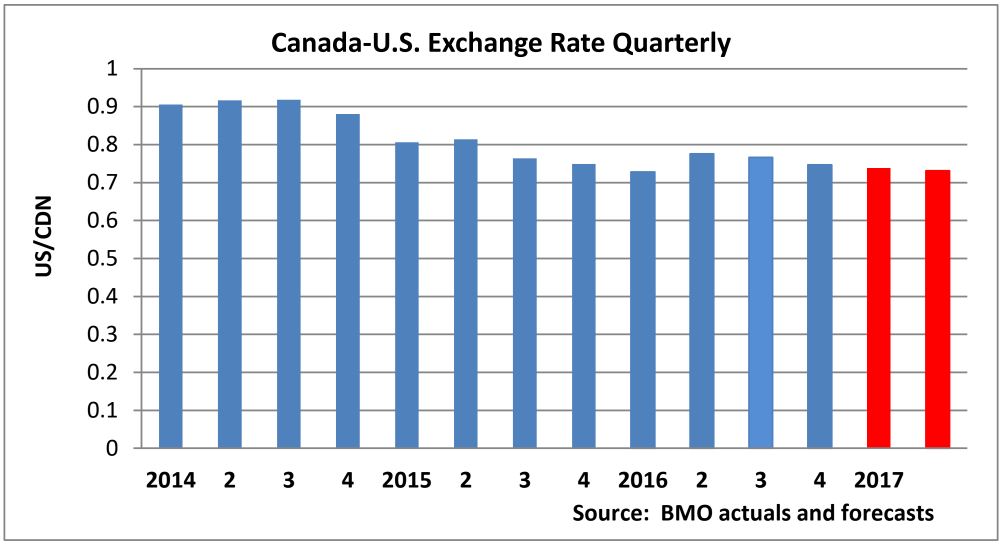






C$ Outlook

BMO Capital Market's Canadian Economic Outlook, December 23 is calling for a first quarter average of 0.738 (1.356) and a second quarter of 0.731 (1.368).

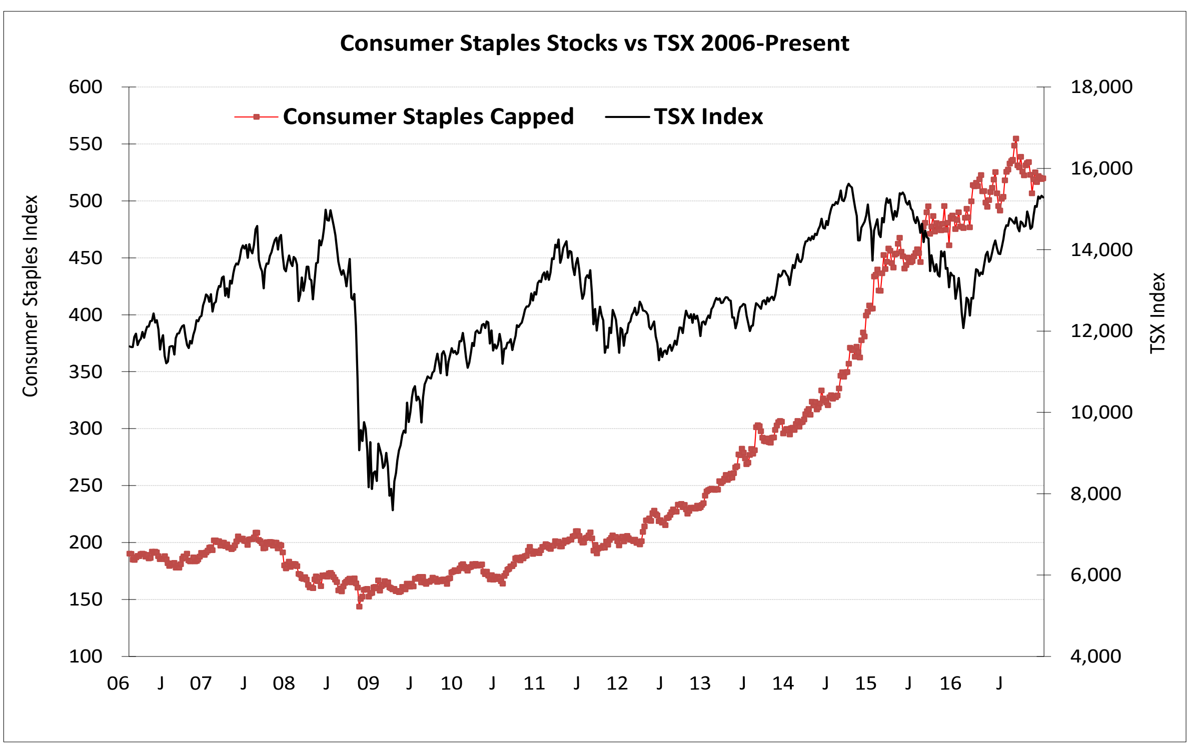


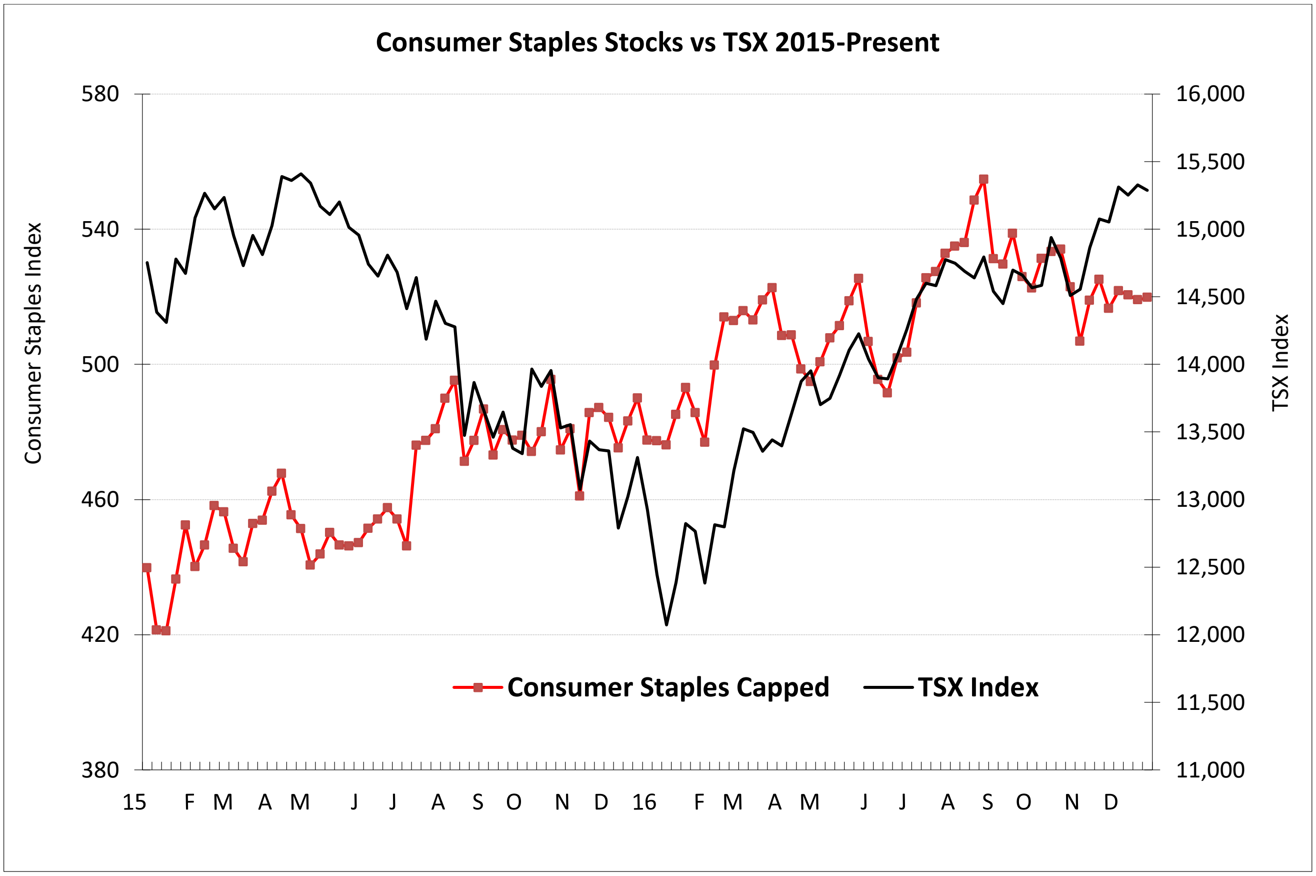
Consumer Staples Retail and Manufacturing Stock Performance

This section provides a review of the consumer staples and discretionary stocks in Canada. The *Consumer Staples Index* classification of companies listed on the TSX is a cross section of ten manufacturers and retailers: Alimentation Couche-Tard, Cott, Empire, George Weston, Jean Coutu Group, Loblaw, Maple Leaf Foods, Metro, Saputo, and The North West Company. The *Consumer Discretionary Index* stocks include diverse companies like Dollarama, Hudson's Bay, Restaurant Brands International, Canadian Tire, Linimar and Magna International.

The following table shows the changes in the values of the TSX as a whole as well as consumer staples, and consumer discretionary. The following two graphs show the longer and shorter term performance of the consumer staples versus the TSX as a whole.

	December 2016 vs 2015	52 week vs Previous 52
TSX	17%	-2%
Consumer Staples	8%	11%
Consumer Discretionary	8%	-5%





Stock Performance Focus: Empire Company Limited.

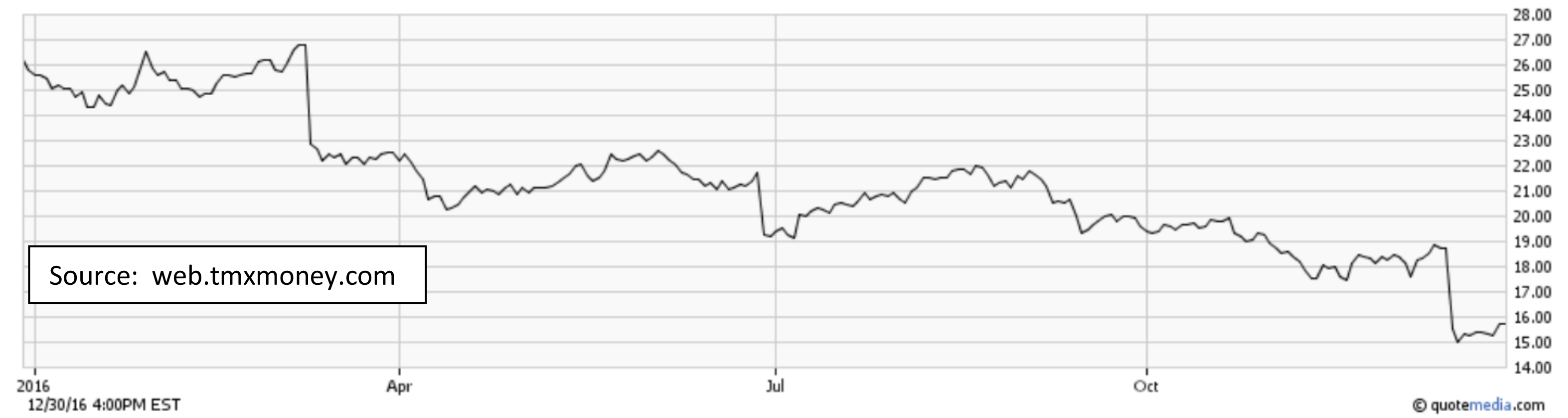
CIBC Institutional Equity Research, December 15 noted that Empire's Q2 results acutely summarize the immense challenges facing the business. The researchers noted that amidst the rollout of its Simplified Buy & Sell (SBS) program to the West, margin investment increased while tonnage remains materially negative. Furthermore, operating expense rose on implementation costs. Add it all up and Grocery segment EBITDA of $158MM was…down 47% y/y.

In the view of the CIBC analysts, SBS is a necessary step to maintain competitive relevance, but it is not a solution in a market where consumers continue to move toward the discount channel. Conventional flyers are as aggressive as they have been in years and simply flagging lower centre store prices is not enough to get shoppers to stray from their mission of fresh and cheap.

The analysts say that the lack of a discount offer in any region outside Ontario is now such a glaring gap in the company that it cannot be ignored, and they would not be surprised to hear about the launch of FreshCo in Western Canada in the coming months. Of course, this will come with capital, marketing and price investments. Recall that FreshCo, which had a relatively simple Ontario rollout because it replaced an existing discount asset, was a drain on earnings and cash flow for a few years before developing into the strong business it is today.

CIBC says that it is difficult to pinpoint the timing of a turnaround amidst such uncertainty, but they believe one is likely over time, under-pinned by quality locations. EMP.A could again approach $25-$30, but this could take 3+ years.

Charting for Empire Company Limited Non-Voting Class A Shares



FINAL BRIEFING

"That's it? You just want the time? I can also tell you my heart rate and blood pressure."