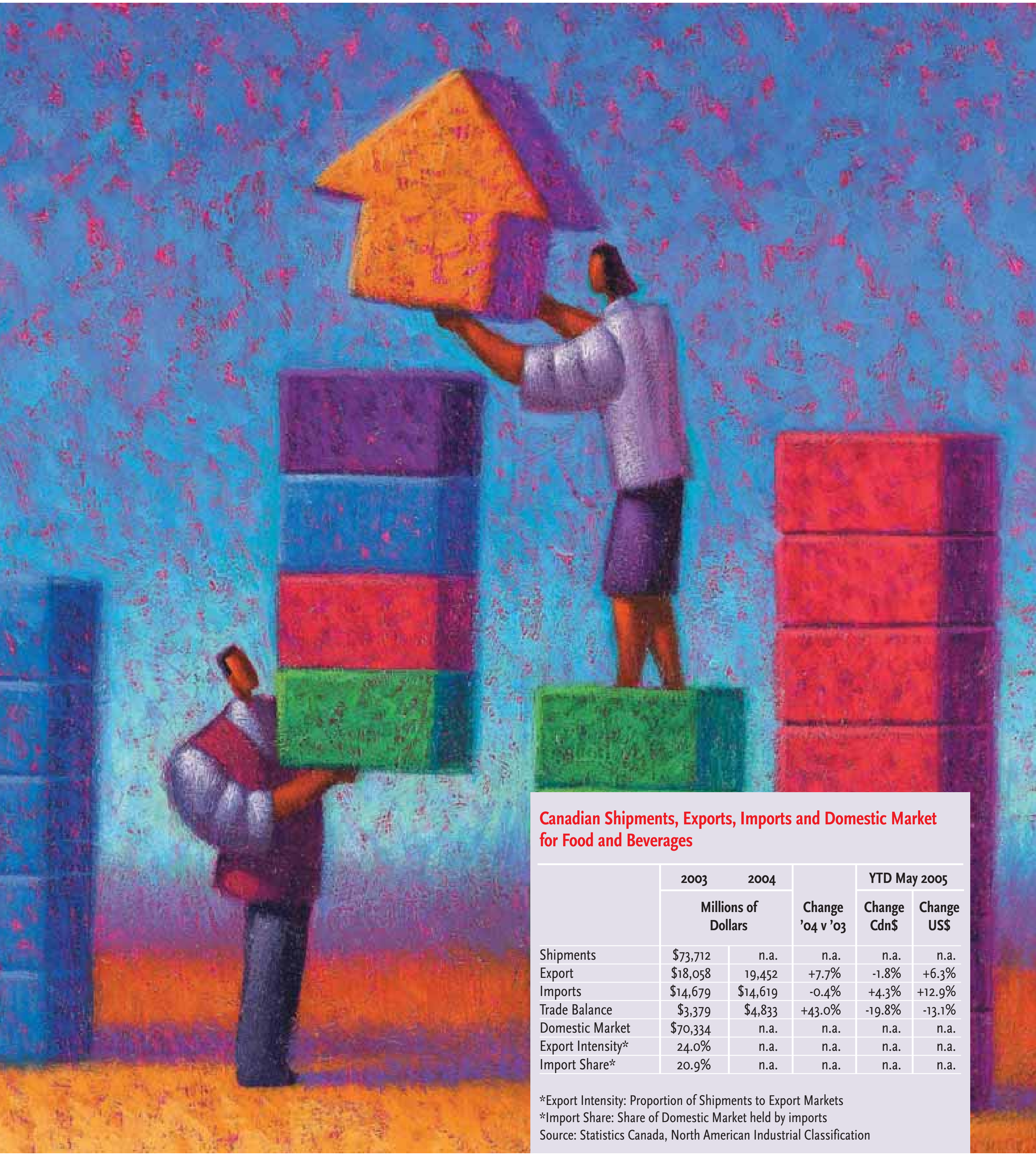

Canadian Shipments, Exports, Imports and Domestic Market for Food and Beverages

	2003	2004		YTD May 2005	
	Millions of Dollars		Change '04 v '03	Change Cdn$	Change US$
Shipments	$73,712	n.a.	n.a.	n.a.	n.a.
Export	$18,058	19,452	+7.7%	-1.8%	+6.3%
Imports	$14,679	$14,619	-0.4%	+4.3%	+12.9%
Trade Balance	$3,379	$4,833	+43.0%	-19.8%	-13.1%
Domestic Market	$70,334	n.a.	n.a.	n.a.	n.a.
Export Intensity*	24.0%	n.a.	n.a.	n.a.	n.a.
Import Share*	20.9%	n.a.	n.a.	n.a.	n.a.

*Export Intensity: Proportion of Shipments to Export Markets
*Import Share: Share of Domestic Market held by imports
Source: Statistics Canada, North American Industrial Classification

BRING IT ON

Manufacturers show they can build their businesses despite all kinds of pressures • BY DOUG BURN

The food and beverage industry has emerged from the wringer in surprisingly good shape. At home, the full effects of consolidation in the grocery industry were felt as the major chains resisted manufacturers' efforts to pass along rising energy costs. In the U.S. market and abroad our US$0.83 loonie forced exporters to cut margins or drop unprofitable products and accounts. While corporate earnings of our two dozen largest publicly listed manufacturers were badly squeezed, half reported higher earnings increases or declines no more than five per cent and the average overall was a one per cent increase.

"The appreciation of the Canadian dollar is working its way through the system with manufacturers exiting unprofitable export contracts," says Steve Smith, senior vice-president and director, corporate finance, KPMG LLP in Toronto. "This is reflected in sales and margin compression and we're getting close to the point where the loonie is being fully reflected in operating results with either slower growth or declines in earnings," he says. "This has been particularly hard on manufacturers co-packing value brands for U.S. food manufacturers or private label for U.S. retailers."

Toronto-based Associated Brands, a North American manufacturer of private label dry blend foods, attributes its decline in second quarter sales and operating earnings to reduced contract manufacturing in the U.S. (four of its five plants are in Canada) and increased competition from branded products in the Canadian market. Humpty Dumpty Snack Foods of Kitchener, Ont., reported a decline in sales and growing net loss to the planned elimination of its U.S. co-packing business and lower volumes in its private label and branded product segments.

Many manufacturers cite the growing resistance of retailers in the U.S. and Canada to price increases. Joanna Gibbons attributes this to "the effects of the retail consolidation of a few years ago." Gibbons, senior manager, corporate finance, Deloitte & Touche LLP – Canada in Toronto, explains, "It took a while for this to work its way through the system."

When Connor Bros passed on higher commodity prices in its retail prices for canned tuna in the U.S. market in the first quarter, retailers reduced their merchandising efforts and volume fell by a quarter. Similarly, High Liner's sales of its branded seafood products to U.S. supermarkets dropped 15 per cent due to increasing competition from both private label and branded products, meanwhile sales of its own private label seafood in the U.S. rose.

Adapting to the new reality

Manufacturers are adapting to the new reality of an expensive loonie and downward pressure on prices with a number of complementary strategies to reduce costs and increase efficiency.

Weston Foods and Connor Bros exited non-core businesses earlier this year with the former selling off the last of its Heritage Salmon assets and the latter selling its can-making operations at Blacks Harbour, N.B. Chris Lischewski, president and CEO of Clover Leaf Seafoods, explained in his announcement in May: "This transaction (selling the can and lid business to Impress Group, one of the world's largest can makers) allows us to focus on our core competency, which is marketing and supplying quality branded seafood and protein products. On our own, we do not move enough volume through the can-making plant to be as efficient as possible, nor do we buy enough aluminum on a global basis to obtain the most attractive pricing."

Saputo, Cargill, Premium Brands and Lassonde acquired complementary businesses in the last 12 months. Olymel merged with another poultry and pork processor and subsequently rationalized and consolidated its expanded capacity.

Building upon a partnership formed in 2002, Olymel LP s.e.c., the pork and chicken processing subsidiary of Co-op Fedérée, and Supraliment, the meat division of Groupe Brochu, agreed late last year to merge their meat processing operations to become Canada's largest pork and poultry processor. In May, Olymel announced plans to consolidate operations of its six Quebec meat processing plants into three. Olymel president and CEO, Rejean Nadeau, explained: "Olymel operates in an ever-changing market and is under different kinds of pressure, such as the appreciation of the Canadian dollar, the moratorium on pork production development, the consolidation activities of various players."

In March, Saputo acquired Fromage Côte S.A. and Distributions Kingsey Inc., Quebec-based processors of cheddar and specialty cheeses with $110 million in sales, for $52.9 million. Saputo cited the complementarity of its current cheese making operations with those of Côte and Kingsey.

Cargill Limited acquired the beef processing assets of Guelph, Ont.-based Better Beef Limited in April. Better Beef produces a wide range of prepared and processed beef products including pre-cooked roasts. The deal follows on Cargill's September purchase of Caravelle Foods, a Canadian leader in meat patties for the quick service restaurant industry. The combination of Better Beef and Caravelle broadens Cargill's value-added product offerings and furthers the efficiencies of its vertical integration.

Lassonde Industries of Rougemont, Que., a leader in fruit juices and drinks, acquired Toronto-based Alfresh Beverages Canada last fall. Alfresh, makers of Fairlee, Alfreshand and other branded juices and drinks, had annual sales of $66 million. Jean Gattuso, president and CEO of A. Lassonde Inc., said the acquisition would strengthen Lassonde's presence in the sector and especially in the Ontario foodservices channel.

Product innovations offset price pressures

Manufacturers are driving down their costs by shedding unprofitable non-core businesses, products and accounts, scaling up in their specialties through acquisitions and consolidating margins with innovative new products that deliver profits to grocers.

High Liner credits a doubling in domestic sales of its new wild salmon and tilapia fillets to seafood departments for offsetting its loss of sales in the Signature line to imports. Likewise, its loss of some U.S. club store sales of cod was partially offset by the success of its new Multigrain Tilapia Fillets and two new barbecue products under the Grillerz brand.

Maple Leaf Foods credits new products, particularly the Maple Leaf Fully Cooked Roasts and recently introduced marinated Maple Leaf Fresh Grill lines, for raising operating earnings in its Meat Product Group 39 per cent – despite industry wide declines in fresh pork margins.

Export Outlook Improves

Canadian exports of food and beverages for the first five months of 2005 were virtually unchanged from the same period last year but there are near term and longer-term prospects for strong growth ahead.

By the second half of 2006, continuing strong growth in pork exports and a rapid expansion in beef processing capacity should raise our red meat exports to 1.8 million tonnes. To visualize that, imagine being parked at a level rail crossing as a train rolls by. In 2003, when our export markets for beef were blocked by the BSE crisis, all of our 1.25 million tonnes of beef and pork exports would have fit into 50,000 25-tonne refrigerated intermodal containers, or about 10 trains per week hauling 100 rail cars each. If forecasts of the beef and pork exporters are proven correct, in the latter half of 2006 we'll be exporting an additional five trains per week or, if it were allowed, the same number of trains hauling 144 cars.

We can also expect better cooperation from producers and governments as it becomes increasingly apparent that Canada's future in agri-food depends on adding value to our commodities. Myles Frosst was elated by the commitment of our federal and provincial agriculture ministers to the Canadian Agri-Food Marketing Council's (CAMC) new 2010 targets and enabling goals for exports. Frosst, executive director of CAMC, explained it this way to the ministers at the annual meeting held in Kananaskis, Alta., in July:

- Growth in the Canadian domestic market is insufficient relative to Canadian supply capabilities;
- The profitability of producers and processors is dependent upon exports;
- Commodity prices will continue to decline as other countries boost their agricultural production and exports; and
- Growth in value-added remains the *sine qua non* for long term profitability.

Among CAMC's enabling goals are: a commitment to encourage product differentiation from agri-food exports of other nations, such as Brazil and China, and building the Canada brand in export markets.

Frosst also noted that the increasing consolidation among producers, manufacturers and retailers "creates need and provides potential for increasing strategic alliances between producers and processors."

Canada's food producers and manufacturers achieved CAMC's industry wide targets for 2005 three years ago, winning four per cent of world trade in agriculture and food, and a 60:40 split between value-added products and commodities, although due to the BSE crisis, SARS and droughts there was some slippage in 2003. The new targets, endorsed by the agriculture ministers, are five per cent of world trade and a 70:30 split between value-added products and commodities.

Manufacturers and investors optimistic

Food and beverage processors are, with a few notable exceptions, optimistic about the second half and beyond, and investors appear to agree. The average Price/Earnings ratio (ratio of a current share price to per-share earnings), Canada's publicly listed food and beverage manufacturers with over $100 million in annual sales, was 20:1 in mid-August, or the same as Loblaw Companies, their biggest customer. And despite the cost-price squeeze, the shares of 18 out of the 24 are trading within 20 per cent of their 52-week highs.

The optimism is partially explained by a growing sense that the worst of the energy price increases and dollar appreciation are behind us. Paul Ferley, assistant chief economist at BMO Financial Group in Toronto, explains: "The appreciation of the loonie was one factor dragging on economic growth and this was a restraining influence on consumer confidence. In 2006, the restraint imposed by the dollar will be fully dissipitated." BMO forecasts a levelling off in the exchange rate to just under US$0.83 by the end of 2006 and for crude oil prices to decline to just over US$40 on average throughout 2006 from current levels of just over US$50. Ferley also forecasts real (after inflation) growth in 2006 of 3.6 per cent as compared to a forecasted average or 2.9 per cent for this year.

Doug Burn is a Toronto-based freelance writer and editor.

Capital Investments On The Rise

The phones stopped ringing for some food and beverage equipment suppliers last November as the loonie soared to US$0.84 but the calls came flooding in by May as customers became resolved that (a) the loonie was plateauing and (b) they'd need to substitute capital for labour if they were to remain competitive in export markets and stave off increased import competition at home.

"We're having the best sales in the first half of [this year] than we've had in the past six," says Dan Plante, the Guelph, Ont.-based processed foods sales manager for North America for FMC FoodTech. He notes that the strongest growth is in meat patty production as processors replace older equipment and facilities to improve quality and efficiency.

Gary Taylor also notes a faster pace of sales for 2005, particularly for equipment that reduces labour costs. Taylor, who is vice-president operations of Reiser (Canada) Ltd. in Burlington, Ont., notes that rising sanitation standards and tougher inspections have spurred sales of equipment designed for quick and thorough cleaning. "Overall," he adds, "our customers are most interested in raising labour productivity."

Equipment originally designed for the foodservice industry is now being purchased to produce more convenient foods for retail, says Dennis Hicks, president of Mississauga, Ont.-based Pemberton and Associates. Citing the past success of bagged salads, Hicks notes that sales of equipment to pre-cook and dice ingredients for the HRI (Hotel, Restaurant and Institutional) sector is now being bought by manufacturers of fajita and other meal kits.

The biggest capital investments are now being made in beef processing as the producers and packers race to expand capacity due to reduced but continuing restrictions on cattle exports. Ted Haney, president of the Calgary-based Canadian Beef Export Federation, explains: "Prior to 2003, we slaughtered 3.5 million cattle in Canada and exported 900,000 live for a total of 4.4 million head. In the second half of 2006, we'll be slaughtering on an annualized basis 4.7 million to 4.8 million cattle in Canada for an increase of 500,000 tonnes of beef."

Maple Leaf Foods announced plans in July to replace the former Mitchell's pork plant in Saskatoon (acquired with the purchase of Schneider Foods) with a $110 million new fresh and value-added pork plant capable of processing 20,000 hogs per week on a single shift basis or 40,000 with two shifts. The current plant, at full capacity, can process 17,000 hogs. Construction begins in the second half of 2006.

Financial Results of Canada's 24 Largest Publicly Listed Food and Beverage Companies

	Fiscal 2003	Fiscal 2004	Change '04 v '03	Change Latest Qtr.*
	Millions of Dollars		Per Cent	
Revenues	$20,538	$23,510	+14.5%	+2.0%
Operating Income	$1,088	$1,329	+22.2%	+1.0%

* Latest quarter, typically, June 30, 2005 versus the same quarter of 2004
Source: Annual and Quarterly Reports