Food Brands and Manufacturers Rethink Pricing and Product Strategy as Input Costs Rise

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Food for Thought

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As the economy continues to reopen—albeit in fits and starts—higher commodity prices and ongoing supply chain disruptions are forcing food and beverage brands, manufacturers, and retailers to develop new approaches to protect margins while maintaining market share.

Across the food and beverage industry, producers and retailers are navigating a very different challenge than they were 12 months ago. Rather than scrambling to keep shelves stocked with essential items, today the industry is thinking about strategically implementing price increases. Ongoing supply chain disruptions, higher input and freight costs, labor shortages, and the Federal Reserve's near-zero interest rate policies are fueling cost increases and forcing consumer packaged goods (CPG) companies and retailers to rethink their pricing strategies.

Major CPGs, including Coca-Cola and J.M. Smucker , have already announced price increases to offset higher costs, while others, like Kraft Heinz , have said that they are considering all their options. These decisions are much more complicated than determining how much of the cost increases to pass on to consumers. Manufacturers and retailers must also consider preserving strategic partnerships and maintaining loyalty and brand positioning in the minds of consumers.

In this issue of Food For Thought, we examine the inflationary pressures in the food and beverage industry and the extent to which rising costs are squeezing manufacturers' and retailers' margins—or being passed on to consumers. To better understand the occasionally conflicting dynamics between brands, manufacturers, and retailers, we also interview two sales and marketing executives (Tom DiPuccio of the Impact Group and Steve Gaither of C.A. Fortune) to learn how price challenges are being executed as goods flow to consumers.

Soaring Commodity Prices and Persistent Supply Chain Disruptions

Food-related commodity prices have surged in 2021. The World Bank expects agricultural prices to increase by 13% in 2021 before stabilizing in 2022. Several factors are driving up commodity prices, including increased demand from China, tighter inventories due to extreme weather events, and mounting speculation that the Biden administration could prioritize investment in biofuels. The cost of soybean oil, which is used in mayonnaise, salad dressings, and a host of other foods, has skyrocketed; soybean oil futures for September delivery are trading more than 120% higher than prices in March 2020.

Making matters worse, supply chains are having difficulty returning to their pre-pandemic levels of performance. Retailers and food manufacturers are dealing with rising freight and transportation costs, accelerated by higher gas prices and a global shortage of cargo containers. At a time when they are looking to ramp up production and keep stores open and shelves stocked, CPGs and retailers are struggling to fully staff their workforces in the wake of the enhanced unemployment benefits enacted during the pandemic and the multiple rounds of stimulus checks. This demand for labor is costing companies more to recruit and retain talent.

Over the past year, food producers worldwide have had to reduce shifts and temporarily close plants due to issues with their supply chains and input availabilities. In addition to affecting the supply and pricing of direct food inputs, supply chain disruptions have had a major impact on packaging and shipping materials as well. Texas's winter storm in February was a powerful example of just how vulnerable supply chains can be. Sanderson Farms reported losing 1.6 million chickens due to the storm, sending poultry prices higher. The storm also caused prices to spike for plastic resin, which is used to make food packaging, as processing plants were forced to shut down.

Steps Food Manufacturers and Retailers Are Taking to Protect Themselves

Food manufacturers and retailers have several levers they can pull when it comes to protecting their margins in this inflationary environment. We outline several strategies that companies are taking to maintain profitability with an eye toward preserving strategic relationships and market positioning.

Offering fewer promotional discounts: Many retailers and food manufacturers put discounting on pause during the pandemic—especially in the pandemic's early phases when the primary focus was to keep shelves stocked amid spiking demand. Some retailers also reduced discounting activity to help with social distancing measures and to limit foot traffic in stores. Many retailers and food manufacturers are continuing this trend and selling items at full price even though social distancing measures have since been relaxed in many metro areas.

Manufacturing and managing fewer SKUs: Manufacturers are increasingly focusing on core products. At the height of the pandemic last summer, CPGs were already taking steps to reduce their number of SKUs, a trend that is continuing today. J.M. Smucker, for example, plans to reduce its SKUs by 30%.

Cutting costs and automating key functions: Food manufacturers have invested in automation, artificial intelligence, and machine learning to strengthen forecasting, food safety, production, and product innovation. During the pandemic, restaurants pivoted to online ordering, investing in handheld tablets and point-of-sale systems to create a more seamless experience. Simultaneously, grocery stores made significant investments in digital technology to support curbside shopping and at-home delivery, conveniences that are now seen as the norm by consumers.

Changing package sizes: Food manufacturers have also reduced package sizes, a move dubbed as "shrinkflation," wherein they charge more per ounce to offset inflationary pressures. This is a common way for food manufacturers to protect their profit margins by offering less of an item while charging the same price.

Stockpiling inventory as a hedging strategy: Manufacturers are holding greater inventory of inputs to stave off potential inflation shortages and avoid paying more later. Similarly, supermarkets and other food retailers are keeping significantly more inventory on hand than they typically would to lock-in prices at current levels.

Announcing price increases: Multinational CPGs including General Mills, Nestlé, Unilever, PepsiCo, and Coca-Cola have already announced their intentions to raise prices this year. Others will likely follow suit. Meanwhile, large grocery chains have said that they are well positioned to capitalize on price increases. Kroger CEO Rodney McMullen told analysts on the company's most recent earnings call that the grocery chain "operates best when inflation is about 3%–4%," adding that as long as inflation stays in that range, price increases can be passed on to the consumer.

Highlighting private label's value proposition: For retailers and private label manufacturers, the current backdrop of rising food costs is very favorable to private label market-share gains, enabling grocers and other food retailers to drive traffic to their in-house brands.

Views From the Frontlines: Q&A With Tom DiPuccio of Impact Group and Steve Gaither of C.A. Fortune.

For insiders' perspectives on how supply chain and inflationary issues are affecting negotiations between manufacturers and grocers, we spoke with Tom DiPuccio, vice president of sales and operations at Impact Group, a provider of sales and marketing services to CPG manufacturers, and Steve Gaither, chief marketing officer of C.A. Fortune, a privately held, vertically integrated national sales agency.

How much have food and beverage supply chains recovered as of summer 2021?

DiPuccio: *Supply chains have not recovered as quickly or robustly as one would expect following the crunch at the height of the pandemic. Smaller manufacturers, in particular, are struggling to add capacity and ramp up production. The challenge is especially acute for brands that outsource manufacturing; getting line time at manufacturing facilities has been a major challenge for some brands.*

Gaither: *Across the board, shipping and labor issues are major concerns for both manufacturers and retailers. The pantry stuffing from 2020 was initially a false flag of demand that put stress on existing supply. While demand has right-sized this year, there are now labor and ingredient shortages combined with shipping issues. In general, everything is slower and more expensive, and the outlook is not looking better in the foreseeable future.*

How aggressively are manufacturers trying to pass price increases on to retailers? How successful have these efforts been?

DiPuccio: *We have seen more pricing action over the last two months than ever before. The success of these requests for price increases depends largely on their reason. Currently, retailers are more likely to agree to a request based on commodity/ingredient input cost increases, and less likely to agree to increases that are due to ancillary costs that the retailer is also facing, such as fuel and other shipping costs, including the cost of pallets.*

How has the pandemic affected food and beverage brands' trade spending strategies?

Gaither: *We saw retailers and consumers pivot during the pandemic to online grocery delivery, such as Instacart and Shipt, as well as curbside pickup. This shift essentially created a new sales channel and a targeted area for manufacturers to focus their trade spend, rather than on traditional methods that were affected by COVID, including display and sampling. Food and beverage brands are now spending more money to promote themselves on grocery websites where brands can capitalize on search word queries, being ranked at the top or paired as a recommended product, and even to promote coupons.*

What should manufacturers keep in mind when thinking about pricing strategy?

DiPuccio: *Manufacturers should do their homework to fully understand a retailer's pricing strategy and ensure that their request aligns with the retailer's strategy. Retailers watch their competitors like a hawk, so if a manufacturer asks for a price increase from one retailer, other retail partners will find out. Manufacturers need to be laser-focused on providing the data that supports their price increase request. Retailers will be scrutinizing the data, and the review process could move slowly.*

How do you see the remainder of 2021 playing out in the CPG space?

Gaither: *Warehouse inventory is down, labor supply is down, and cost of goods sold is going up. Everybody wants to survive and make their margins. Manufacturers will have to raise their costs sooner or later; retailers will have to raise their prices sooner or later; and consumers will have to spend more sooner or later, in every channel.*

What Does This All Mean From a Dealmaking Perspective?

While inflationary pressures present challenges to CPGs and retailers, these headwinds have not slowed the robust pace of M&A activity in the food and beverage industry. Margin pressures are not affecting sellers' and buyers' decisions to transact due to one or both of the following M&A dynamics: 1) the company for sale has a clear (and demonstrated) ability to pass through needed price increases to consumers and supply chain partners; and 2) sellers are putting more weight into other timeline-influencing factors, including proposed capital-gains tax increases and a desire to transact at record-high valuations.

Similar to what we saw at the height of COVID-19, sellers and their advisors need to spend more time on the front end of processes preparing to answer buyers' questions about pricing strategy across channels. In conversations with potential buyers, it is vital to articulate the seller's ability to pass through price increases and use forward buys and hedges to offset commodity price risk. Typically, it is more challenging for companies to hedge input cost risks associated with labor and distribution than with food inputs, and buyers generally understand this dynamic.

Potential sellers also must highlight their ability to grow revenue and enhance profitability over time. It is particularly important for sellers to articulate their plans to increase automation or implement other measures to reduce unit costs. Sellers must position these efforts as growth/efficiency investments—rather than having them possibly misunderstood as capital expenditures that are required for steady-state operation.

If you have any questions about these trends and what they mean for your business, please don't hesitate to contact us.