



Special Report

from BMO Capital Markets Economics



It's Not Just about Flavour and Aroma, It's Good Business Too

August 31, 2010

Kenrick Jordan
Senior Economist

www.bmocm.com/economics
1-800-613-0205

Don't let its staid appearance deceive you! Canadian food and beverage manufacturing has lots going for it! Whichever way you slice it, it's good business—much better than it gets credit for. It may not be as trendy as high-technology products, energy plays, or exotic financial instruments, but it sure is dependable. It is big, steady, has outshone all other manufacturers combined in terms of output growth, and makes a major contribution

to the economy. Not surprisingly, food and beverage processors have performed respectably on the financial front. However, they might have fared even better had they continued to meaningfully raise the capital intensity of their operations and, in particular, to upgrade their plant and equipment.

With an average output share of 13% over the last five years and 15.5% in 2009, the food and beverage sector is one of the largest in Canadian manufacturing. Sales are substantial, amounting to some C\$90 billion in 2009, of which food is by far the larger component, with 90% of the total. Using the past five years as a benchmark, the sector is about the same size in terms of shipments value as motor vehicle and parts manufacturing, nearly twice as large as primary metals, and roughly three times that of the paper and wood products industries. While important in every province, more than half of the sector—measured by the number of plants in 2008—is located in Ontario (34%) and Quebec (23%), with population an important driver of spatial distribution. The biggest segments are meat, baked goods, dairy, processed fruits and vegetables, and 'other food' (a motley category that covers snacks, seasonings & dressings, coffee & tea, fresh pizza and peeled cut vegetables).

CHART 1
MANUFACTURING
Canada (% of Real GDP)

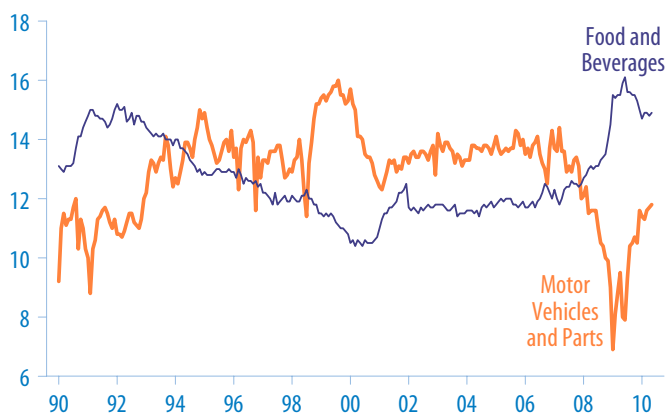


CHART 2
MANUFACTURING SALES
Canada – 2005-09

Ratio of Food & Beverage Products to Selected Manufacturing Industries

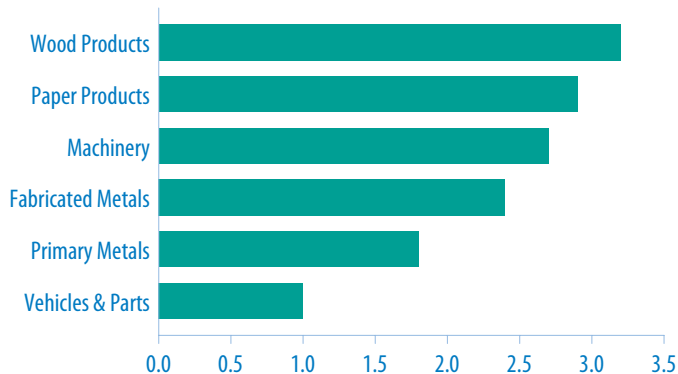


CHART 3
AVERAGE ANNUAL GROWTH
 Canada – 1982-09 (y/y % chng : avg.)

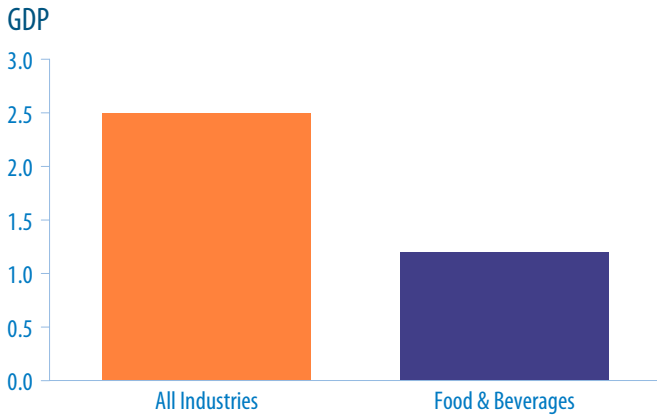


CHART 4
FOOD AND BEVERAGE INDUSTRY GROWTH
 Canada (y/y % chng : avg.)

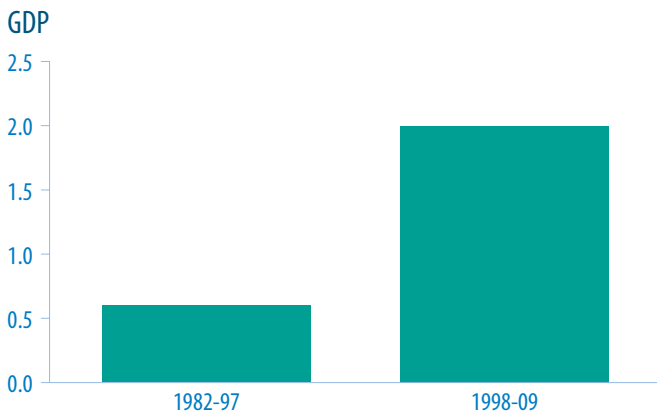
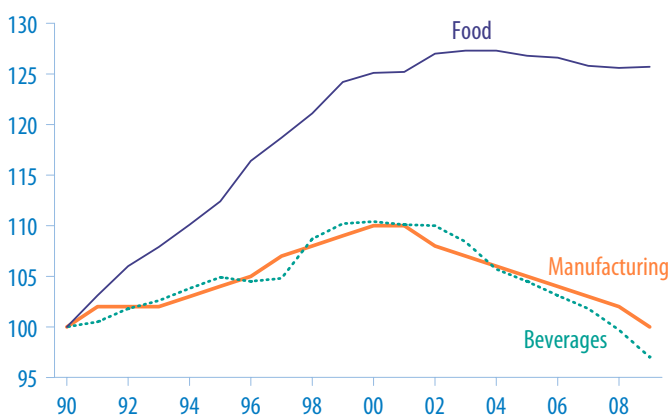


CHART 5
GROSS CAPITAL STOCK
 Canada (1990 = 100)



Not only is it large, the sector is distinguished by steady longer-term growth. Since the early 1980s, output has expanded at a rate just over 1% annually compared with 2.5% for the entire economy. However, the volatility of production has been low—far less than in manufacturing as a whole. Behind this stable growth profile are some important underlying tendencies, including the limited sensitivity of food and beverage demand to variations in income, the heavy influence of population growth, and the broad range of products covered by the sector. These traits allowed food and beverage processors to figuratively sail through the recent recession. Large size and the low risk implied by the stability of output growth make a desirable longer-term tandem for businesses.

Moreover, the stature of the sector within manufacturing has risen since extensive restructuring during the 1990s shifted it onto a notably faster growth track. Consolidation and an influx of investment, often from foreign entities, have facilitated significant productivity improvements. In particular, the sector's gross capital stock has increased at a relatively fast clip, boosted by investments during the 1990s. Productivity, measured by output per employee, has risen at an annual pace near 2% over the past ten years, which is a lot better than can be said for manufacturing as a whole. Productivity growth has been especially rapid for the baked goods, meat, and processed fruits and vegetables segments which, along with 'other food', have been growing in significance within the sector.

While restructuring and increased capital intensity have played a key role in promoting faster growth, the sector has also benefited from a number of constructive trends, which have supported innovation and value-added production and

CHART 6
FOOD TRADE BALANCE

Canada (C\$ blns)

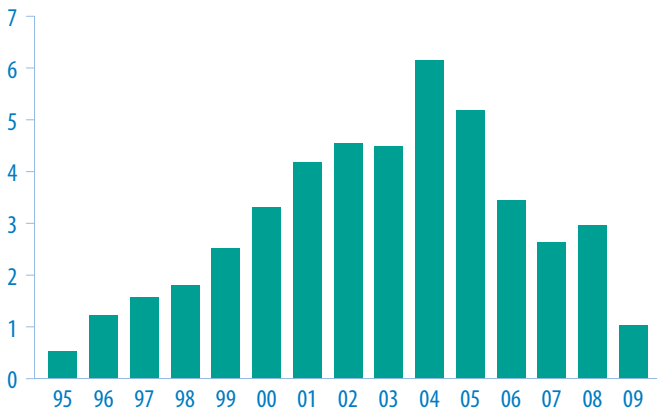


CHART 7
PRODUCT PRICES

Canada – 2000-09 (y/y % chng : avg.)

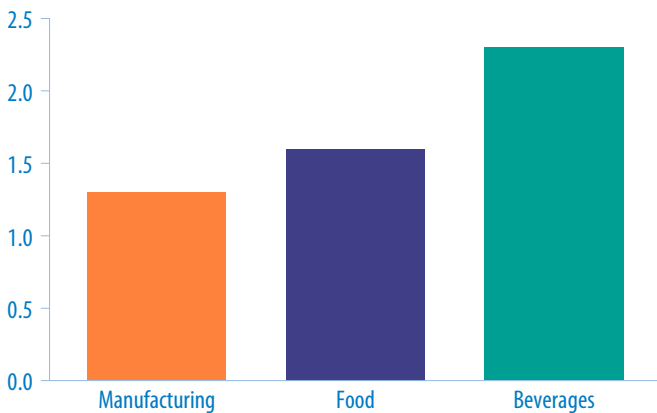
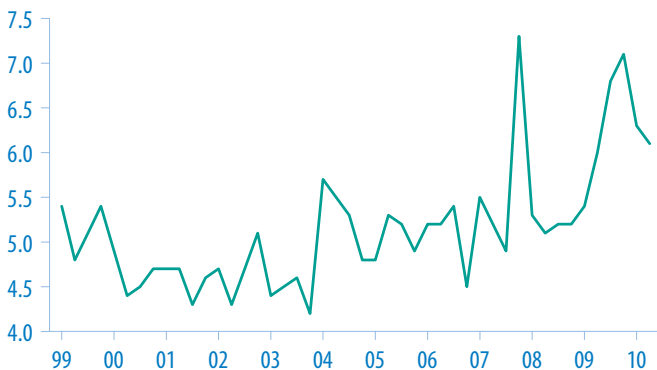


CHART 8
OPERATING MARGIN

Canada (percent)

Food Products Manufacturing



facilitated relatively brisk expansion. These include the increasing demand for convenience, greater ethnic diversity in developed-country markets, health and wellness concerns, environmental stewardship, and vibrant demand in emerging countries as a result of quickly-rising incomes and urbanization. These trends should be with us for a while, given increasingly time-strapped consumers, unfolding patterns of international mobility and culture, an ageing population (especially in advanced countries), the need to limit climate change, and a shifting balance of global economic power.

Productivity gains and a natural advantage in crop and livestock production have helped to keep Canada's food and beverage processors competitive, shielding them from import competition while facilitating their sales in export markets. Reflecting this edge, the food products industry has, without fail, made a positive contribution to the overall trade balance since 1995. The industry managed this despite being checked by the Canadian dollar's sustained strength over the past several years, some animal-disease motivated trade sanctions, and the recession-induced weakness in U.S. demand more recently. In particular, given a strong position in its domestic market, the impact of currency appreciation has been limited. Segments making big contributions to the trade surplus are grain and oilseed milling, meat, seafood products and baked goods.

Moreover, food and beverage processors have managed a fair degree of pricing power. Over the past ten years, the prices received for their products have risen faster than those for all other manufacturers combined. Producers of animal food, grains and oilseeds, sugar and confectionery, processed fruits and vegetables, dairy and baked goods have seen above-average price gains,

reflecting their ability to pass on to their customers at least some of the cost increases due to the commodity rally into 2008. Their influence over prices is noteworthy when we consider the hefty bargaining power of a consolidated Canadian retail food industry. The sector's pricing power has been aided by high and steady rates of capacity utilization on the food products side, which limit pressures to cut prices.

In view of decent steady output growth, cost reduction measures, and some degree of pricing power, it is not surprising that the sector's financial performance has been quite respectable, even through the recession. Over the past several years, profit margins have been rising, debt has been falling relative to equity, and liquidity has been improving. Still, the sector might have done even better had processors continued to boost capital intensity and, specifically, to upgrade plant and equipment, like they did during the 1990s. While capital intensity edged upward over the last ten years, this has been due to workforce reductions, as the capital stock has slipped. Sustaining solid financial performance in an increasingly competitive global marketplace will require a brisker pace of productivity-enhancing investments. Productivity gains, along with new-product development, support for stronger inspection and traceability systems, and proper consumer outreach efforts, will help food and beverage processors navigate the potential challenges of high raw material costs, undue strength in the domestic currency, further episodes of animal diseases and food-borne illnesses, and an evolving regulatory environment.

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N. A., and BMO Capital Markets Limited. TO U. S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U. S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U. S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd. TO U. K. RESIDENTS: The contents hereof are not directed at investors located in the U. K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.