Rabobank

What Next for UK Poultry?

Shaping the Industry for Future Competitiveness

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Contents

The UK poultry industry is currently at a crossroads. If the industry is to keep its competitive power in the consolidating EU market, it will need to improve efficiency. The current structure of the industry is not sufficiently effective, especially not when it comes to competing with powerful British supermarkets. The principal elements which will separate the winners from the losers over the next few decades include increased focus, wise investments in efficiency and more integration with the north-western European poultry industry. Adequate supply discipline is essential in realising these goals, and should form the basis of ensuring market balance, especially in today's highly volatile times.

Introduction

The UK poultry industry is currently at a crossroads. The industry is operating within one of the highest value-add markets in Europe, but high feed prices, limited volume growth and oversupply are eroding industry margins, especially those of second-tier companies that lack long-term customer relationships. Some focused players in the UK market have been able to gain sustainable margin levels thanks to strong, long-term preferred supplier relationships with retailers or quick service restaurants (QSR), but others are suffering due to a lack of focus.

Rabobank believes that the current competitive market situation in the UK is linked to some structural disadvantages which do not affect other EU players to the same extent. Above all, the UK poultry industry needs to improve its efficiency and supply discipline, as the industry's failure to benefit from the depreciation of the pound sterling is largely to blame on inadequacies of this kind. The industry's structure and focus also need to change as consolidation levels have not kept pace with consolidation trends in UK retail. This has prevented the poultry industry from being able to pass on more volatile, higher input costs.

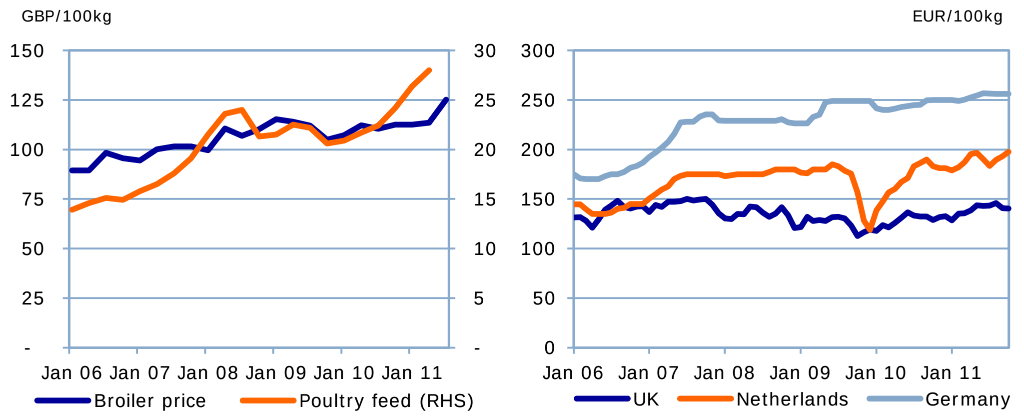
UK poultry players also need to improve their positioning in the regional north-western European market. Only one company, 2 Sisters Food Group (2SFG), has broadened their scope to include this region, and thus the only one to have been able to reap the benefits of more flexible and efficient sourcing. Others are still mainly concentrated on the UK market.

Companies need to be better focused in the market. Big differences exist between preferred suppliers to supermarkets and more interchangeable suppliers. Companies that can combine a strong retail focus with supply efficiency and market power are in a good position to become winners in the new market dynamics.

Market: UK poultry industry not benefiting from currency depreciation

The UK poultry industry is operating in a very turbulent market environment. On the one hand, the industry is being hit by higher feed costs (up 30 percent since Q4 2010) and oversupply. On the other hand, the industry is enjoying a potential cost advantage due to a 20 percent pound sterling depreciation compared to the euro during the same period, which offsets the historic higher cost of production in the UK.

Figure 1: UK feed and poultry price trends and EU poultry prices, 2006-2011



Source: European Commission, Deffra, 2011

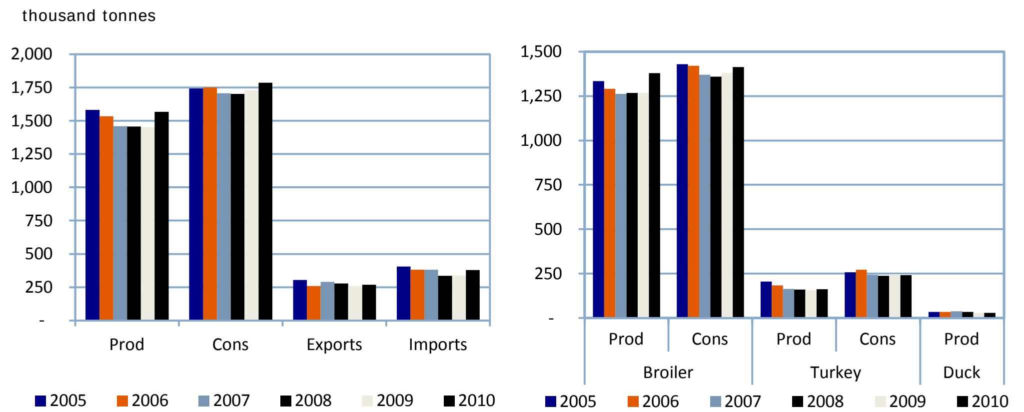
Furthermore, fresh poultry meat suppliers should be benefiting from the recently introduced new marketing standards prohibiting the use of frozen poultry in fresh processed food products, a practice which until recently was common in the industry. The fact that the industry has not significantly profited from an improved competitive position in the EU market compared to its main competitors (especially the Netherlands, Ireland, Brazil and Thailand), suggests that they may be dealing with additional structural problems (*see Figure 1*).

Although the UK poultry industry's market power has increased in recent years, the industry needs to take further steps to regain market power in the new market realities. Feed prices have gone up significantly since 2009 while poultry prices have increased only slightly. This situation has improved marginally in recent months, but not enough to fully compensate for higher feed costs.

Oversupply reduces margin potential in UK industry

The new market situation in Europe has created a new market balance for the UK poultry industry. The fact that the domestic market has shown only slight growth since 2007, combined with the shift in interest from retailers to 'buy British' programmes and the depreciation of the pound sterling have transmitted the wrong signals to the value chain. Local production has been stimulated by establishing new contracts with farmers, while the industry has overestimated both its own competiveness and the market changes in the UK.

Figure 2: Poultry supply balance sheet in general and by species, 2005-2010



Source: Eurostat, Deffra, MEG, 2011

The UK market is out of balance due to excessive local supply growth in 2010 (also forecast for 2011) and a recovery in imports, especially from the Netherlands and Ireland (*see Figure 2*). Companies from these countries have been targeting the attractive fresh-cuts market in the UK, while non-EU suppliers have been targeting the higher value-add segments of the market. Furthermore, an increasing share of further processed products is being produced outside the EU and then sold directly into the British retail channel and restaurant chains.

The UK poultry market is close to its maximum absorption level, since per capita consumption (22.8 kilogrammes per head for broilers, up from 17.4 kilogrammes per head in 2010) is no longer showing any real increase and total volume growth is only coming from population growth. This saturated and more competitive market situation will necessitate a change of focus on the part of suppliers. Local players will try to at least keep their market share, however, from an export perspective, the UK market is too important for foreign players to reduce export volumes. Growing internationalisation levels in the UK meat industry will also reduce the sensitivity to imports. Companies such as Moy Park, Sun Valley and Grampian are now foreign-owned, while 2SFG has large foreign operations in exporting countries (e.g. the Netherlands and Poland). The relatively inefficient supply structure and relatively high input costs in the UK is a common reason for companies to shift to international sourcing.

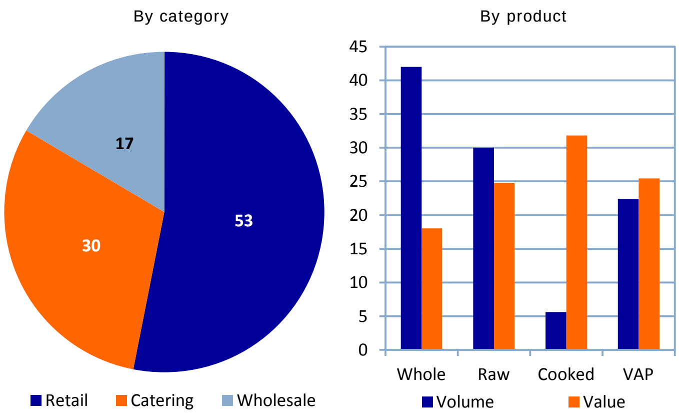
The supply/demand situation is the worst for the UK broiler sector. The turkey industry also went through a very turbulent time between 2006 and 2008, with disease outbreaks and negative media attention, but it now seems to be recovering, in part due to the improved EU market balance caused by production reductions throughout Europe.

Value chain: retailers in the driver's seat and more powerful than ever

The weak supply situation in the UK market puts the poultry industry at a disadvantage with their main UK clients. While the UK poultry industry is suffering from oversupply, the market power of UK retailers is constantly increasing. This has put retailers very much in the driver's seat of the UK poultry value chain. Retail represents 53 percent of the total UK poultry market (*see Figure 3*). Within this segment, the top four supermarket chains, Tesco, Asda, Sainsbury's and Morissons, have a combined market share of 84 percent in total UK supermarket sales.

Figure 3: UK poultry distribution, 2010

percent



By outlet

	2006	2010
Tesco	29	31
Asda	15	17
Sainsbury's	15	16
Morissons	13	12
- Co-operative	—	7
- Somerfield	8	1
Waitrose	3	4
Other	17	12

Defra, Kantar, 2011

Compared to other European countries, the UK poultry industry is a relatively high-value market with a significant share of cooked and value-add products. Cooked and value-add combined represent around 27 percent of total market volume or 55 percent of total market value. Raw or whole chickens represent 70 percent of volume or 42 percent of value. Interestingly, the share of whole chickens is still very high.

The high-value profile of the UK poultry market is positive for the UK poultry industry because of the opportunities it presents for product development. However, it also represents some major disadvantages as many of these categories can be partly or entirely outsourced to international suppliers. This is one reason the UK is traditionally a focus area for both EU and non-EU exporters. Non-EU companies are major suppliers to the cooked and value-add product markets, while EU exporters are strong competitors for UK players in the fresh products market, both in retail packaging and ingredients. Importers benefit from the gradually increasing importance of both fresh raw chicken cuts and the higher value segment in total imports.

The other market segments—catering and wholesale—also use a high share of imported products. In order to reduce costs, some QSRs have begun to substitute frozen chicken for fresh chicken for their inputs.

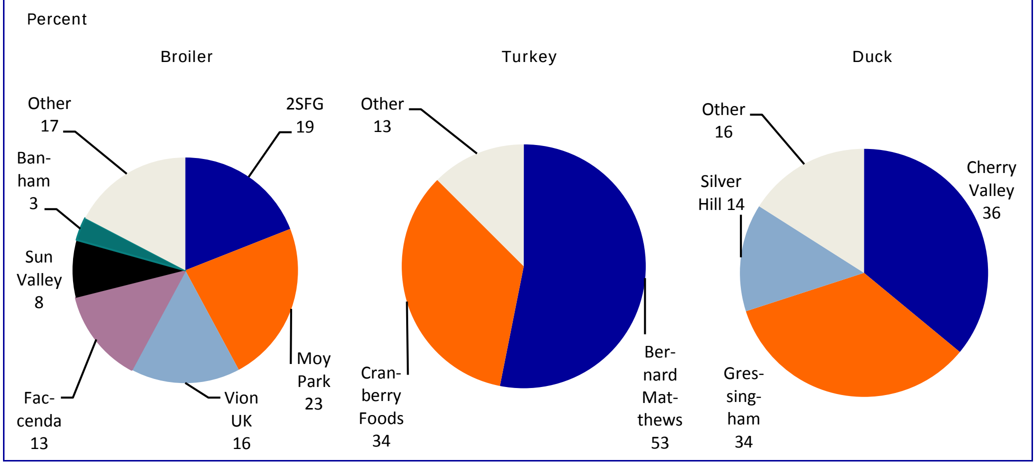
Shaping future industry leaders: Large, efficient and focused

The UK poultry industry has undergone a very significant change in the last decade with a fast change in ownership of the major players. Despite these changes in ownership, consolidation level has only slightly increased, but has not fully kept up with increased retail consolidation levels (*see Figure 4*). This has challenged the competitive position of key poultry suppliers.

At the same time, the share of foreign ownership in the industry has increased, thereby broadening poultry companies' international scope. International sourcing has become a major focus for some of the leading global players, turning UK supply into just one of several options instead of the only option.

UK poultry suppliers have come under increasing pressure as retailers and QSRs have exploited their market power. In the current economic climate, price is a more important marketing tool and retailers often choose to work with one strong key supplier (if present) and a number of other smaller suppliers to keep prices competitive and drive innovation. Poultry suppliers without a preferred supplier relationship often find themselves in the difficult situation of having to fight for retail tenders with price competition from other suppliers, or decide to only supply ingredients to supplier companies which do have retail access. This market structure increases competition, which is especially high in times of oversupply and rising feed costs, as has been the case over the last few years.

Figure 4: Key UK industry players, 2010

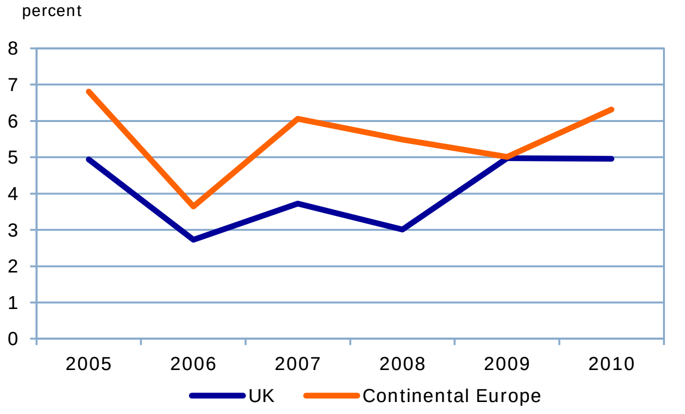


Source: Rabobank, publically available information, 2010

Achieving efficiency in operations and better cost price leadership is vital in such situations. Companies which do not maximise efficiency will be not able to pass on cost price changes. The UK poultry industry is not well known for having an efficient value chain, which is one reason why exporters are still able to maintain market competitiveness despite the pound sterling depreciation.

The key elements in the future competitive landscape of the UK poultry industry are the levels of retail and QSR access, as well as efficiency and economies of scale. Access to retail through preferred supplier relationships has repeatedly proved to be the most solid base for higher industry margins. Cost price leadership and sufficient scale are the key factors upon which companies can improve their competitive power and increase their margins. Adequate scale is linked to having the market power to achieve sufficient margins for the company, and scale is also linked to having enough international presence to benefit fully from international cost and quality differences.

Figure 5: Average UK and continental European poultry company EBIDTA margins, 2005-2010



Source: Rabobank, publically available information,2011

On average, UK poultry companies underperform compared to continental European players (*see Figure 4*). Having said this, within the difficult UK market, having a clear market focus also pays off. Companies that combine long-term preferred supplier relationships with leading retailers, and QSRs with market intelligence and value-chain efficiency still have good opportunities to achieve attractive margins. The big trouble threatens those players that underestimate the importance of strong client relationships and real supply-chain efficiency. These players are often pushed into a second or third supplier position, or into supplying more bulk markets such as wholesale and ingredient supply.

What's next for the UK poultry industry?

Rabobank believes that the UK poultry industry needs to take the following steps:

- Further consolidation: the level of market consolidation should at least be similar to retail consolidation levels.

- Focus on efficiency: the industry needs to further optimise efficiency. Rabobank believes that the UK industry is less efficient than similar industries in exporting countries such as the Netherlands and Germany.

- Further internationalisation: only 2SFG is benefiting from a north-western European network for sourcing fresh meat. We expect others to follow this trend in the coming years in order to achieve maximum efficiency and flexibility.

- Supply discipline: recent oversupply in the UK market has again shown that supply discipline should be one of the industry's top priorities. Local market growth is limited and any imbalance between supply and demand will affect industry margins, especially those of the less strongly positioned players.

This report has been published in line with Rabobank's long-term commitment to international food and agribusiness. It is one of a series of publications undertaken by the global department of Food & Agribusiness Research and Advisory.