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State of Industry Report

Q2 2023

Executive summary

- The FDF net confidence score gained 18 percentage points in Q2, reaching -12%, reflecting perceptions that market conditions have stabilised.
- Labour shortages continued to fall in Q2 to 4.8%, down from 5.9% in Q1, however vacancies persist across all skill levels.
- During the year to June (Q3 2022 – Q2 2023), output lost due to labour shortages is estimated to be £1.4bn, while the loss for Q2 2023 is assessed at £192m.
- Reported total cost increases facing manufacturers in the year to June were 17.8%, while selling price rises were less at 15.4%.
- It's expected that costs will continue to rise over the next year by 3.1%, and prices by 2.7%, on average.
- Innovation is a top priority for 54% of manufacturers, while 41% focus on adapting supply chains and restructuring operations.
- More than 78% of the UK's biggest suppliers believe government plans for UK-wide 'not for EU' product labelling will drive up costs and should be scrapped.
- Manufacturers are committed to growth, with 49% planning to increase their capital investment expenditure over the coming 12 months.

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Authors

Dr. Liliana Danila
Lead Economist
FDF

Uros Milosevic
Economic Analyst
FDF

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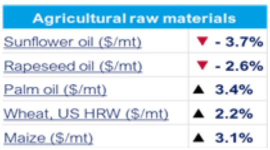

Agricultural raw materials	
Sunflower oil ($/mt)	▼ - 3.7%
Rapeseed oil ($/mt)	▼ - 2.6%
Palm oil ($/mt)	▲ 3.4%
Wheat, US HRW ($/mt)	▲ 2.2%
Maize ($/mt)	▲ 3.1%

Inflation commentary

Trade snapshots

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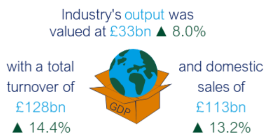


Growth pressures on the horizon

Food and non-alcoholic drink annual inflation slowed for the fourth consecutive month in July, reaching 14.9%, down from 17.4% in June, the sharpest drop in annual inflation yet. On the month, prices rose by 0.1%. Prices of sugar and olive oil were considerably higher than last year (Chart 1), while most other categories saw double-digit inflation.

ONS reported costs facing manufacturers were 3.0% higher in July than a year ago, but 0.5% lower compared to June (Chart 2). Changes in producer prices (costs) feed through to retail prices with a lag of between seven and twelve months – lag clearly shown in Chart 2. This delay is due to the nature of fixed-term contracts used by manufacturers when buying raw materials, while some also use futures contracts traded on commodity exchanges.

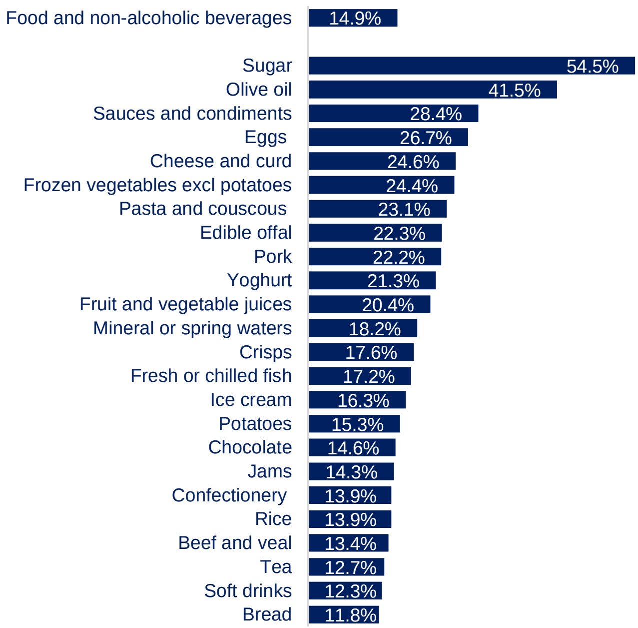
Food inflation will continue to slow. We think it will reach single-digit levels early next year. Manufacturers now see signs that cost inflation is subsiding after almost three years of increases in all elements of the production process, from ingredients and labour to logistics, transportation, packaging and energy.

Global agricultural commodity and energy prices have been falling, but remain significantly above pre-pandemic levels. Strong wage pressures persist, as labour shortages and the cost-of-living crisis continue.

For the near term, there are two risks to inflation. The collapse of the Black Sea Grain Initiative will likely push up prices of vegetables oils, wheat and maize, with July global vegetable oil prices already 12% higher from June. While the heat wave in Southern Europe and wet weather in the UK could impact global crop production. At the same time, retail food sales, in volume terms, declined by about 4% in the year to May, as households saw their real incomes falling for 18 months.

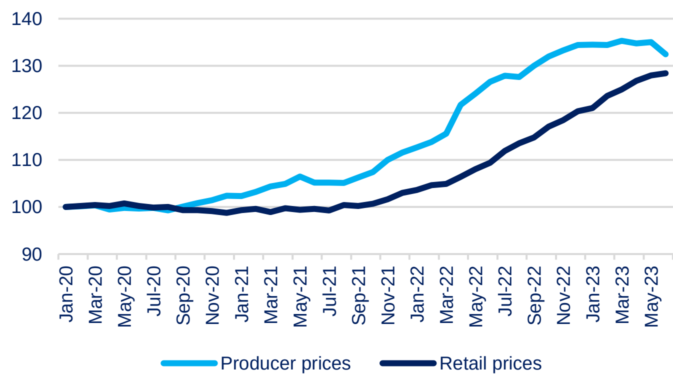
In Q2, the non-alcoholic drink saw robust growth, while the other subsectors stagnated or contracted (Chart 3). Quarter on quarter, some subsectors: dairy, grain mill and starches or ‘other food products’, have seen four consecutive quarters of contractions. This is troubling, as history shows that a series of negative shocks can result in poor economic performance. Global agricultural commodity prices more than doubled in 2008, real household incomes dropped sharply following the financial crisis, and a second agricultural commodity shock followed in 2012. As a result, the food and drink manufacturing shrank by 7.9% in 2010, by 5.1% in 2011 and by 2.4% in 2012. This suggests current conditions of intense cost pressures and lower spend are likely to result in a smaller food and drink sector.

Chart 1: Inflation by category, July 2023



Source: ONS

Chart 2: Food manufacturers’ (producers) price inflation and food and drink retail price inflation



Source: ONS, Index, Jan 2020 = 100

Chart 3: Growth by sector, Q2 2023

	Q2 2023 on Q1 2023	Q2 2023 on Q2 2022
Food manufacturing	**0.0%**	**-2.0%**
Meat	-1.3%	0.9%
Fish, fruit and vegetables	0.6%	-0.8%
Oils and fats	0.0%	0.0%
Dairy	-0.8%	-5.3%
Grain mill and starches	-0.8%	-5.3%
Bakery	-0.5%	0.0%
Other food products	2.3%	-3.6%
Non-alcoholic drink manufacturing	**4.3%**	**6.4%**

Source: ONS, GVA, chained volume measures. Dairy and grain mill and starches have seen similar rates of growth.

Businesses experience improved conditions

The Q2 FDF net confidence score increased by 18 percentage points, reaching -12% (Chart 4). This is the difference between businesses who perceived business conditions had improved in Q2 from Q1, and those believing conditions had deteriorated. Businesses that felt that conditions remained the same are therefore excluded from this calculation. 36% believed conditions remained unchanged. 26% of businesses said conditions had improved, up from 14% in Q1.

Perceptions of market conditions varied by business sizes. 46% of large businesses experienced a deterioration in business conditions compared to Q1, while SMEs fared better with 42% feeling circumstances had improved (Chart 5). Almost half (47%) of mid-size companies felt conditions remained the same.

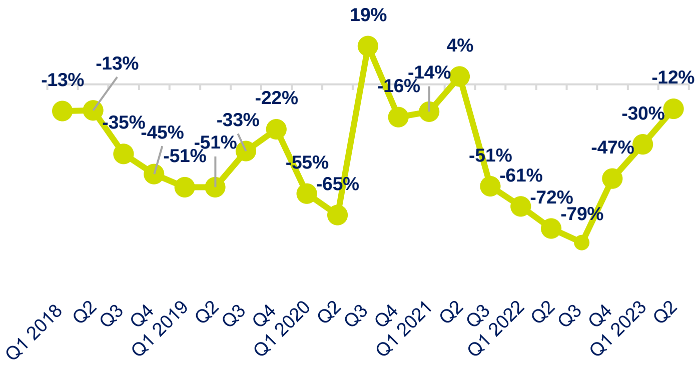
Looking ahead to Q3, over half (52%) expect business conditions will remain largely the same. However, outlook perceptions vary by business size. 91% of large companies expect conditions to remain the same, whereas nearly a third (32%) of mid-size businesses believe conditions will deteriorate (Chart 6). 42% of smaller businesses anticipate an improvement.

A few potential developments may explain these differences in expectations, including uncertainty and volatility in energy markets. While energy prices have been on a downward trajectory since December, gas prices have been volatile recently, with prices ranging from £53 to £99/thm over the course of June and July. Futures market prices exceed £130/thm for winter of 2024, more than double the pre-pandemic level. Food and drink manufacturing is energy-intensive, so energy costs remain a serious concern.

Uncertainty about future ingredient prices may also worry smaller producers more. The termination of the Black Sea Grain Initiative in July has seen prices of vegetable oils (sunflower, rapeseed, palm and soy) rising 12.1% from June. The extended heatwave in Southern Europe has also affected crops of tomatoes and cereals. Renewed cost pressures pose great challenges to food manufacturers. Brexit, the pandemic and the war in Ukraine have already eroded the sector's resilience.

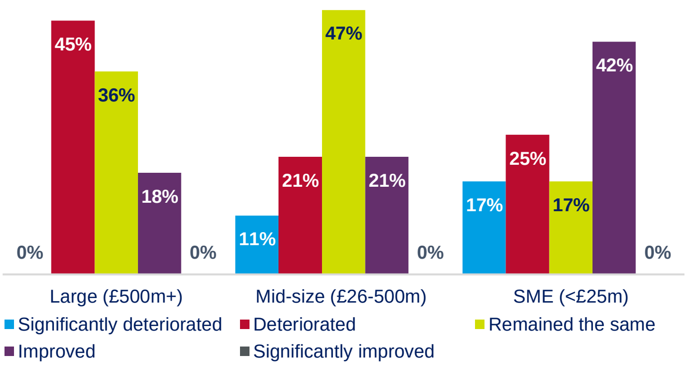
Finally, the rapid increase in interest rates over the last 18 months has made borrowing more expensive. Against a backdrop of substantial cost pressures, this has also proven more disadvantageous for SMEs, that typically operate on smaller margins.

Chart 4: FDF net confidence score



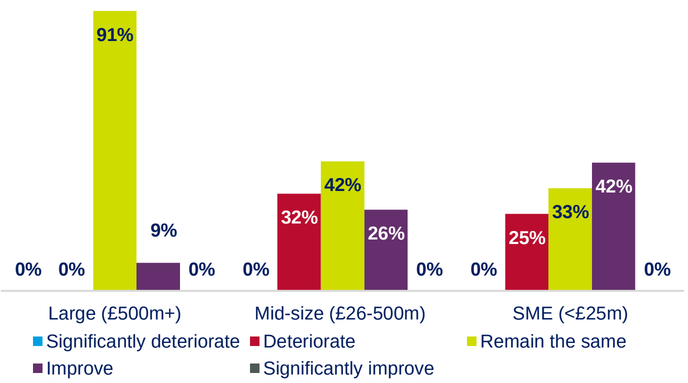
Source: FDF State of Industry Survey

Chart 5: Business conditions in Q2 2023 compared to Q1 2023 by business size



Source: FDF State of Industry Survey

Chart 6: Expectations about business conditions in Q3 2023 relative to Q2 2023 by business size



Source: FDF State of Industry Survey

The ongoing challenge of labour shortages

Industry's vacancy rate (the number of vacancies per 100 employees) eased in Q2 to 4.8% from 5.9% in Q1 (Chart 7). Labour shortages remain higher than those in wider manufacturing and the UK, of 2.9% and 3.3% respectively.

Over half of manufacturers (57%) reported vacancies of 0-5%. By size, two-thirds of large and small businesses had vacancies in the 0-5% range. Mid-sized businesses appear the most impacted by labour shortages, with half reporting vacancy rates of 6-10%.

Unfilled vacancies continue to affect a wide range of roles and skills, including:

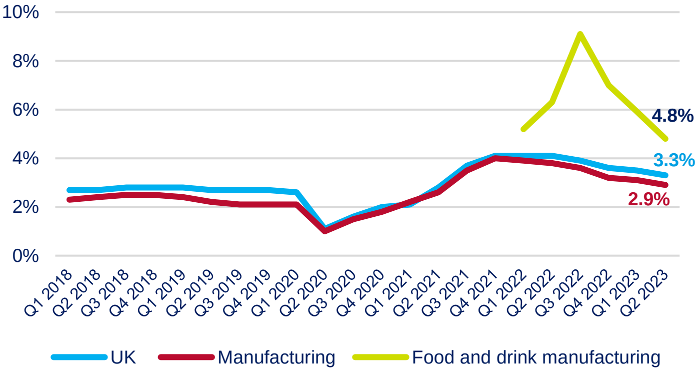
- **High-skilled workers:** project engineers, scientists, IT, sales & marketing.
- **Technical specialists:** lab technologists, catering personnel, plant engineering technicians.
- **Production operatives:** machine operatives, front line operations, warehouse operatives.

In the year to June (Q3 2022 – Q2 2023), output lost to the industry due to labour shortages is estimated to be £1.4bn[1], while for Q2 alone that loss is assessed at £192m. Labour shortages continue to impede growth, and will have repercussions on business investment and the ability to rebuild margins.

Businesses had, on average, a staff turnover of 8.6% over the last 12 months, with just over a third (34%) seeing turnover rates of 5-9% (Chart 8). Mid-size companies experienced a higher rate, with about 35% reporting a turnover exceeding 15%, compared to 50% of SMEs that reported 0-4%. Over the next year, staff turnover is expected to be 7.8%, indicating that businesses assume conditions will remain unchanged.

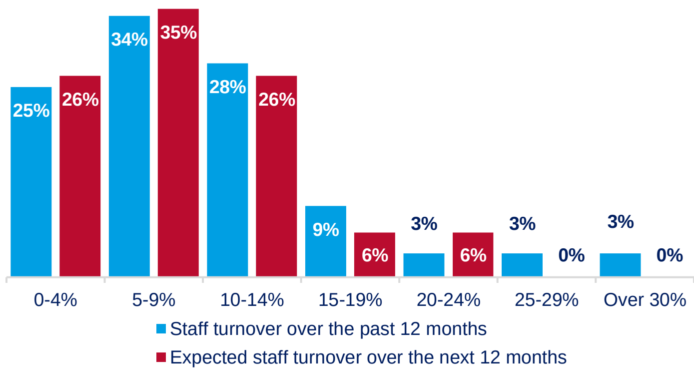
Apprenticeships can help deliver productivity gains by upskilling new and existing employees. Of those businesses that pay the Apprenticeship Levy, 45% used over half of their available funds, while 10% didn't spend anything (Chart 9). Greater flexibility within the Levy would help large employers use more of their funds to invest in skills. Of those that do not pay the Levy, which are smaller firms, only a third decided to invest in apprenticeships. Smaller businesses often require more support to identify appropriate Apprenticeship courses (standards), training providers and funding.

Chart 7: Vacancy rate in UK, manufacturing and food and drink manufacturing *(vacancies per 100 employees)*



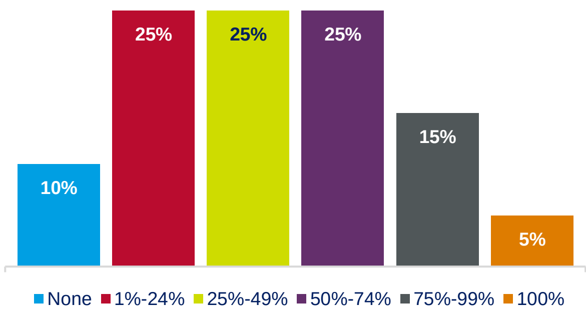
Source: FDF State of Industry Survey and ONS

Chart 8: Staff turnover over the past year and expected staff turnover over the next year



Source: FDF State of Industry Survey

Chart 9: Proportion of businesses spending the Apprenticeship Levy



Source: FDF State of Industry Survey

[1] This figure was estimated based on excess vacancy rates and per job productivity data. Excess vacancies were calculated as the FDF survey vacancy rate minus 2.5% (thought to be the long-term, 'natural' vacancy rate), and we assumed that food manufacturing and drink manufacturing had similar vacancies. Estimates of productivity per job come from ONS.

Uncertain energy prices

Total cost increased by 17.8% over the year to June 2023, whereas selling prices increased by 15.4%. Over a quarter (27%) of manufacturers listed cost rises of 20-25%, while the most common price rise (for 31% of companies) was between 5-10% (Chart 10). By business size, average changes in costs and prices, respectively, are the following: large companies: 18.7% and 16.7%, mid-size companies: 15.9% and 12.3%, while small companies: 13.5% and 8.9%.

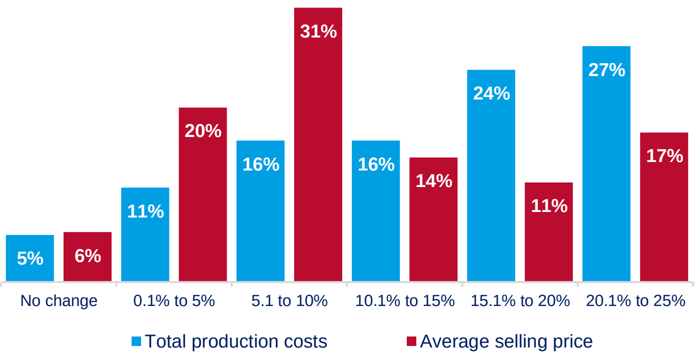
Price rises are below cost rises. This is due to both the lag with which cost changes filter into final prices, but also to the fact that manufacturers have absorbed some of the cost increases. It's noteworthy that smaller producers seem to have absorbed a larger share of the rising costs. As own-label products command little consumer loyalty, those producers have reduced bargaining power with the supermarkets.

On average, it's expected that production costs will rise by 3.1%, and prices by 2.7% over the coming year. By business size, average expected changes in production costs and prices, respectively, are: large companies: 4.9% and 4.0%, mid-size companies: -1.6% and -0.6%, while small companies: 3.2% and -0.5%. Most businesses (43%) expect prices to remain unchanged over the coming year (Chart 11).

Energy accounts for a larger share of total costs for many manufacturers than before the war in Ukraine. 25% of mid-size businesses and 17% of the smaller ones report energy was over 20% of total operating costs (Chart 12). On average, in Q2 2023, energy amounted to 8.4% of costs, up from 7.4% in Q2 2022, but below 9.7% seen in Q1 2023.

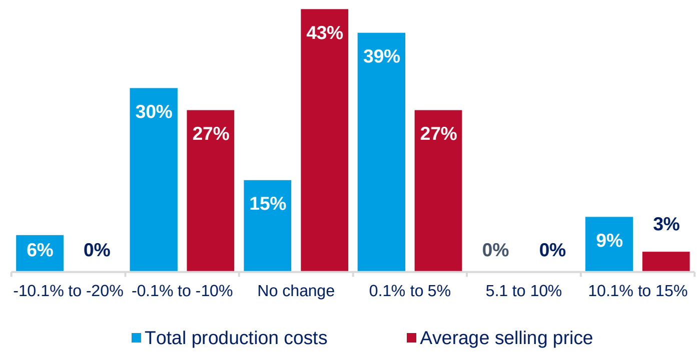
Only 33% of manufacturers that are on a fixed energy contract which is up for renewal this autumn think market conditions for energy have improved compared to autumn 2022. While 48% believe they have remained the same and 10% think they have worsened. This, alongside recent volatility in energy markets and futures market pricing, suggests the cost of energy will remain a significant concern for many in the coming months.

Chart 10: Changes in total production costs and average selling price over the year to June 2023



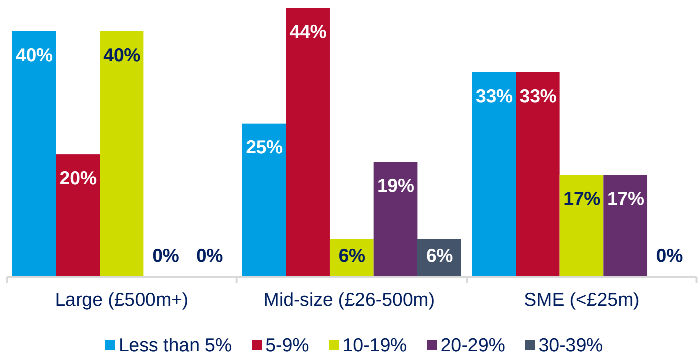
Source: FDF State of Industry Survey

Chart 11: Expected changes in total production costs and average selling price over the next 12 months



Source: FDF State of Industry Survey

Chart 12: Energy as a percentage of operating cost base by business size



Source: FDF State of Industry Survey

Manufacturers aim to adapt supply chains

Innovation remains the top focus for 54% of manufacturers (Chart 13). There is also a strong focus on adapting supply chains and restructuring operations for 41% of producers. The drive to boost energy efficiency fell out of the top three priorities for the first time since Q2 2022. This reflects that most manufacturers undertook significant changes to make their processes more energy- efficient and there's a limit to how much can be achieved in a short time span.

Smaller businesses (70%) are focused on growing sales internationally, while just under a third (30%) of larger businesses are focused on developing healthy new products. Nearly a half (47%) of mid-size companies are prioritising adapting/ simplifying their supply chains.

Manufacturers remain committed to growth, with almost half (49%) planning to increase their capital investment expenditure in the next 12 months and only 15% expecting a fall (Chart 14). By size, there are stark differences. 50% of large manufactures plan to increase investment while the other 50% will maintain it at current levels. While half of SMEs (50%) also plan to increase capital expenditure, the other half plans to cut investment. Smaller businesses are finding it more difficult to access finance and are harder hit by ongoing cost pressures.

More than a third (37%) of businesses report that their output has decreased over the year to June 2023, while 42% have increased production (Chart 15). Nearly two-thirds (64%) of manufacturers are optimistic and believe they'll grow their business over the next year. Only 11% think that they will see a reduction.

Any foregone investment will inhibit growth. With high borrowing costs and high labour vacancies, significant challenges will persist, but it is encouraging that producers recognise the need to invest to grow.

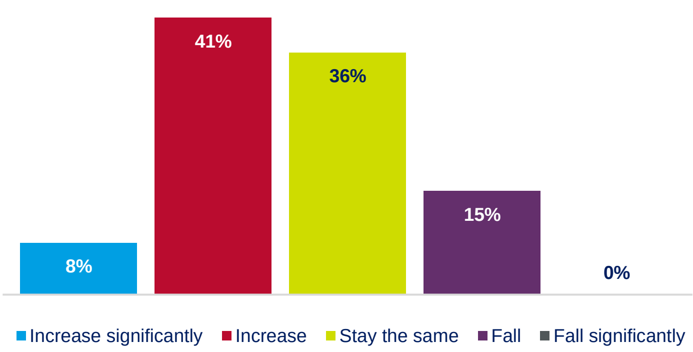
In terms of additional regulations that can further increase costs, 78% of the UK's biggest suppliers believe the government's plans to extend 'not for EU' product labelling on a UK-wide basis is not necessary to ensure the continued supply of food from the Great Britain to Northern Ireland, while a large share of the remainder aren't sure.

New arrangements to supply Northern Ireland enter into force in October. 37% of businesses remain undecided over which routes they will use, while others intend to use multiple options. 37% will use the green lane, 26% the red lane and 41% will move goods indirectly via the Republic of Ireland and/or GB retailer hubs.

Chart 13: Top three growth priorities

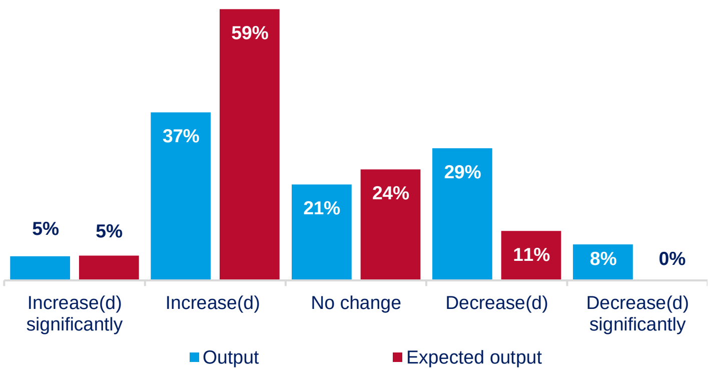
Source: FDF State of Industry Survey

Chart 14: Expectations of planned capital investment expenditure changes over the next 12 months?



Source: FDF State of Industry Survey

Chart 15: Output changes in the year to June 2023 and expected output changes in the next 12 months



Source: FDF State of Industry Survey

Who responded?

Manufacturers responding to our Q2 survey represented 14% of the industry by turnover. There was a good representation of the industry, with companies from all turnover bands, all employment sizes and from a wide range of industry sub-sectors.

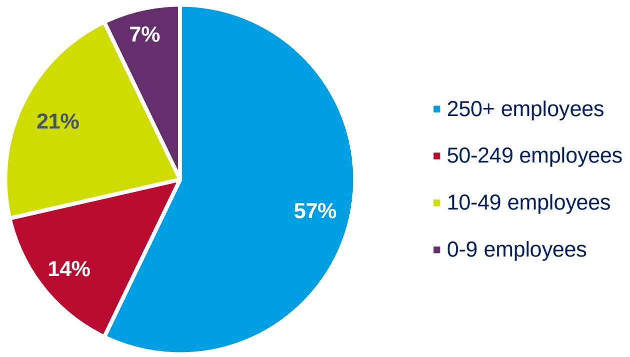
37% of the businesses surveyed are large employers with more than 250 employees, while 7% are micro-businesses with fewer than 10 employees (Chart 16).

By turnover, a quarter (21%) are small businesses with a turnover of £5m or less, while 12% are businesses with a turnover in excess of £1bn (Chart 17).

Businesses also represented a wide variety of sectors (Chart 18). Over a third (36%) operate in the bakery goods sector. The second best-represented sectors were soft drinks and ingredients, with 18% each.

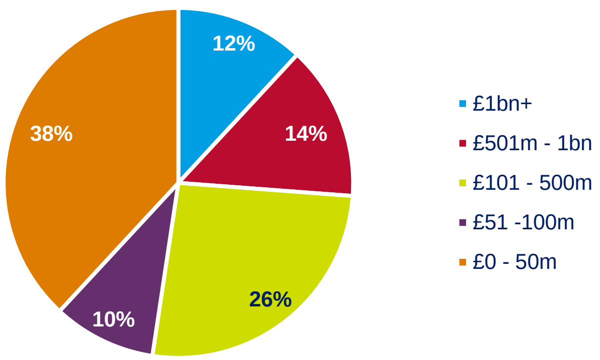
Nearly three quarters (71%) operate in England, while 24% manufacture in Scotland and 11% have production facilities located in Wales.

Chart 16: Respondents by employment size



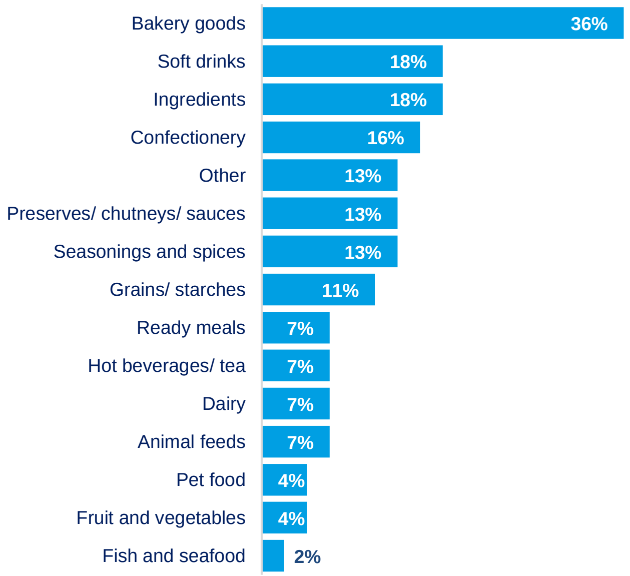
Source: FDF State of Industry Survey

Chart 17: Respondents by turnover



Source: FDF State of Industry Survey

Chart 18: Respondents by sub-sector



Source: FDF State of Industry Survey

About the FDF

The FDF is a powerful voice for the UK's vibrant, resilient and diverse food and drink manufacturing industry. For over 100 years, we have successfully contributed to policy making and legislative development, championing our members' views – large and small – on the critical issues of the day.

We bring together business, government and stakeholders to ensure our manufacturers have the right conditions to grow, invest and employ, while continuing to produce high quality, nutritious and affordable food and drink. With more than 1,000 members – from the most recognisable global brands to the most innovative start-ups – we represent the largest manufacturing sector in the country.

Food and Drink Federation
10 Bloomsbury Way
London
WC1A 2SL

Tel: 020 7836 2460
Email: generalenquiries@fdf.org.uk
Web: fdf.org.uk
Twitter: @Foodanddrinkfed

fdf food & drink federation
passionate about food & drink