

SECTOR UPDATE AGRICULTURAL AND FOOD PRODUCTS:

Summer heat wave led to massive economic burdens

CURRENT TRENDS IN 2018

There are clear indications of massive economic damages in the agricultural and food products sector resulting from the summer heat wave. The German Farmers' Association [Deutscher Bauernverband] speaks of the *"worst harvest of the century"* ⁽¹⁾, the German federal government grants financial support to farmers, and the prices for agricultural products are changing dramatically. While winemakers are looking forward to an outstanding vintage, the majority of the farmers is struggling with low crop yields—losses are currently estimated at around € 2.8 billion. This is only partly offset by some increases in prices and the financial aid of the federal government. In terms of regions, the northern and eastern German states are particularly affected. The around 6,000 businesses in the food sector, the fourth largest industry in Germany, are forced to implement unusual measures.

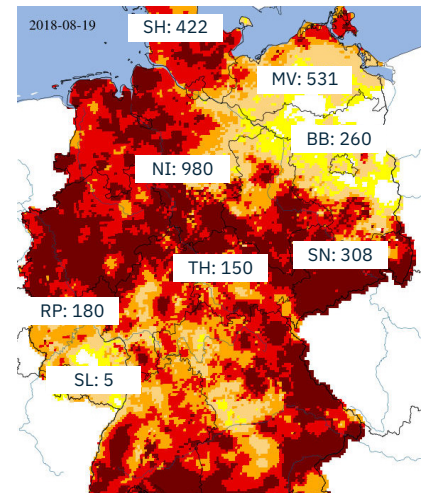
Many livestock businesses are already reducing their herds, for instance, as it will not be possible to feed the animals with home-grown fodder alone, and buying in fodder would make their business unprofitable. Because of the high supply in the short term, this will lead to falling meat prices, while prices will rise sharply again in the longer term.

Many other markets are facing similar challenges—with direct effects on the upstream and downstream stages of the value chain. The businesses which, due to their low market power, are unable to pass on the economic effects to customers and suppliers will feel the economic consequences most heavily. In Germany, these are mainly wholesalers, processors and producers' cooperatives who are obliged to fulfil supply contracts with food retailers. Most of these businesses do not have a secure supply of raw material and are forced to secure their input products through expensive external purchases or must fear contractual penalties and discontinuation of contracts with food retailers in the event of non-compliance with their delivery obligations.

WHAT HAPPENS NEXT?

When the crop report published on 22 August 2018 stated nation-wide crop failures, the German federal government and the governments of the federal states pledged support for farmers of up to € 340 million. This does not include wholesalers, processing companies and producers' cooperatives for the time being. These are forced to create higher risk provisions and also prepare for structural and financial challenges.

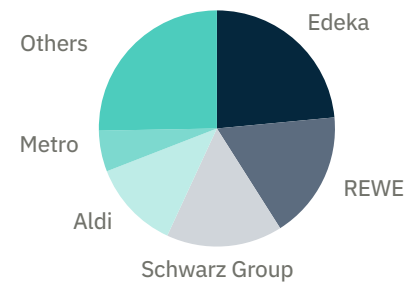
REPORTED DAMAGES BY FEDERAL STATE (€M)



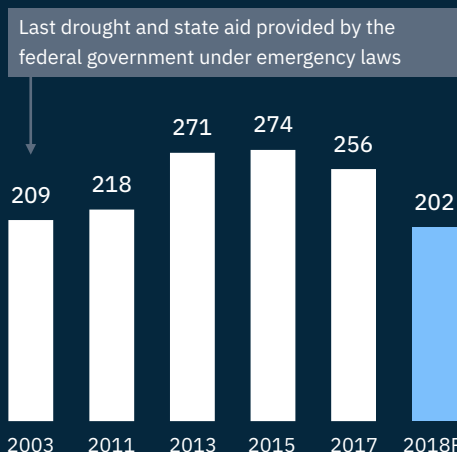
FOOD PRODUCERS IN GERMANY (2016)

- Number of businesses: 6.044
- Sector revenue: € 180 Mrd.
- Ø Avg. EBIT margin: 5,7%
- Ø Avg. net profit margin: 3,7%
- Ø Avg. equity ratio: 31,1%

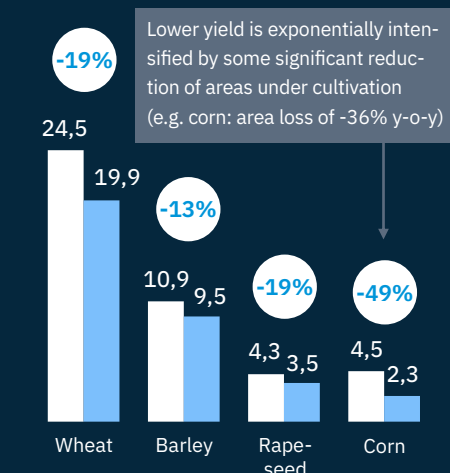
REVENUE SHARES ("BUYING POWER") OF FOOD RETAILERS IN GERMANY



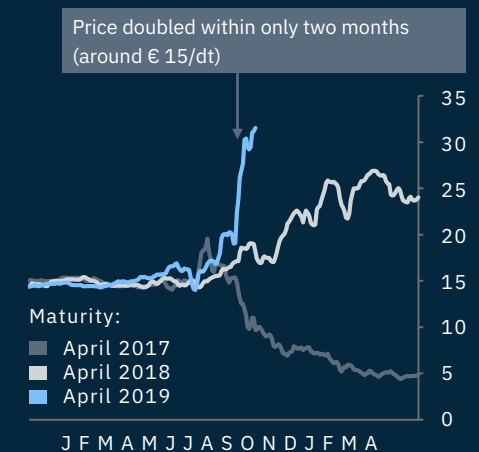
GRAIN YIELD TREND (DT/HA)



ERNT 2017 UND PROGNOSE 2018 (MIO. T)



PRICE TREND POTATO FUTURES (C/DT)



EFFECTS ON MARKET PARTICIPANTS



PRODUCERS (FARMERS AND FORESTERS)

- Due to lower volumes, income generated with agricultural products is expected to drop despite the rise in prices;
- While the federal government is providing financial support, this is not expected to fully compensate for the damages;
- Financial backers for working capital and leasing arrangements become more restrictive due to decline in financial prowess;
- Further acceleration of the death of small farms and structural change towards ever larger producers.



INTERMEDIARIES (PRODUCER COOPERATIVES, WHOLESALERS)

- Delivery obligations to processors and food retailers cannot be fulfilled or can only be fulfilled with losses because of expensive raw material purchases;
- Increased need for liquidity leads to strained financial situation as reserves are typically low in this sector; possible breaches of covenants in existing financing arrangements;
- Immediate countermeasures difficult to implement as cost structures lack transparency and processes are inefficient.



PROCESSORS

- Inability to fulfill delivery obligations or only with losses (contracts with food retailers are usually concluded for six months);
- Increased pressure to consolidate—financially strong market players use tense financial position for acquisitions;
- Possible breaches of covenants in existing financing arrangements—most processors do not have sufficient liquidity reserves due to market conditions.



FOOD RETAILERS AND CATERING INDUSTRY

- Slight increase in the risk profile because of contractual delivery obligations as typical for the industry;
- Short-term coverage of demand on the spot market leads to rising purchase prices, which are for the most part passed on to the end consumers;
- Lack of cost transparency and inefficient processes prevent adequate countermeasures, although these would be necessary because of the low-margin business model.

OUTLOOK

POLICY RESPONSE

- After the crop report was published on 22 August 2018, the German federal government proclaimed a state of emergency pursuant to Article 91 Basic Law (GG) because of damages of national extent.
- In total, the federal government and the federal states are to grant aid of up to € 340 million. The Minister of Agriculture has submitted a request to the Ministry of Finance.
- Farmers affected by the drought are to be granted support of up to 80% of the damage of a product—to compensate for at least 30% loss of income compared to the average of the last three years. Because of the large number of businesses applying, the federal government and the federal states are not expected to process the applications in the near term.
- State aid for other market participants (intermediaries, processors, food retailers and the catering industry) is currently not being discussed.

WHERE IS A PROMPT RESPONSE NECESSARY?

- There is an immediate need for action at all stages of the value chain upstream of food retailing. This is where most of the financial burdens occur and where there is typically a lack of crisis-tested commercial control instruments. Further more, these businesses also tend to have low liquidity reserves (avg. net profit margin 2016: 3.7%).
- The top priority is to ensure short to medium-term liquidity and manage this proactively. In the longer term, the business model and its risk profile must be reviewed.
- Given weak balance sheet structures and a lack of liquidity reserves, the operating business must be consistently adapted to the changed conditions.
- Additional investments might be needed to leverage cost reduction potential.

You are interested in industry trends for agricultural and food products? We look forward to hearing from you and would be happy to arrange an informal first discussion.

PETER LAMMERS

Phone: + 49 211 876360 -27
Mobile: + 49 151 64961979
lammers@andersch-ag.de

ANDERSCH AG

WIRTSCHAFTSPRÜFUNGSGESELLSCHAFT

Frankfurt a.M. | Hamburg | Düsseldorf
www.andersch-ag.de