UrnerBarry CONSULTING

Prepared by Urner Barry Consulting

Angel Rubio • arubio@urnerbarry.com
Akash Pandey • apandey@urnerbarry.com
Humberto Godinez-Olivares • humberto.godinez@gmail.com

May 20, 2020

The Other Side of COVID-19

EXECUTIVE SUMMARY

Although each commodity's foodservice dependence varies widely, the ripple effects across supply chains continue to be felt, from inconsistent supply availability and price volatility, rising unemployment and changing consumer behavior. Naturally, food demand shifted from foodservice to retail. Even if we held production constant, or without any availability disruption, prices would remain volatile as these commodities would only have retail/grocery as the main distribution outlet. But the supply side of the equation has also become uncertain with pork, beef, and poultry plant closures, diminished schedules, further labor shortages, and plant re-openings.

The other side of COVID-19 looks to be brighter for eggs than other proteins. Eggs will continue to be supported by a strong retail demand due to its perception as a relatively low-priced animal protein, as well as its relative lower dependency on the foodservice sector. Though we could still see some bumps in the road if the economy re-opens and then closes again, production stability will be highly valued in comparison to other proteins.

Red meat has suffered significant supply disruptions due to labor issues. Labor shortages were already an issue prior to the current crisis and now the issue has been severely exacerbated, and the supply disruption has been unlike anything these industries have ever seen before. Wholesale prices for both beef and pork have skyrocketed due to the reduction in production. For these two industries, the future looks particularly blurry. We do not, however, see how prices at these levels can be sustained for a long time, though it's likely we'll see continued price volatility.

While the situation for the chicken industry is not ideal, demand for chicken tends to be less affected by prices during shocks as consumer perception is still that chicken is relatively lower-priced compared to other animal proteins available. We expect volatility to remain as a normal occurrence in the near to medium term, albeit at comparably lower prices than beef and pork. We believe that chicken is currently better positioned and is much more likely to recover at a faster pace than most animal proteins as the economy slowly re-opens.

For shrimp—the most consumed seafood item in the U.S.—the outlook is mixed to lower. Imports of shrimp, which comprise about 80% of the total U.S. supply, were already at a record high pre-COVID-19 and there was already a soft undertone in the wholesale market due to ample supplies. To offset the lost volume sold in the foodservice sector , sellers are likely to seek growing channels like meal kits and other direct-to-consumer avenues, it this trend could change the way consumers eat shrimp.

A large portion of salmon traded in the U.S. is fresh, either trucked from Canada or through daily air-shipments from Chile and Europe—and a large portion of the latter are shipped on passenger flights. With a significant reduction in passenger air-travel due to COVID-19, salmon suppliers looked towards increasing their cargo air shipments. March imports show volumes contracted compared to a year ago, while prices continued to adjust lower.

Assuming we have reached bottom, we believe the recovery for the foodservice industry will be slower than the growth this sector has enjoyed over the last five years. Food expenditures at home—mostly food purchased at grocery stores—will lead sales for several years. However, there are too many unknowns when predicting what the "other side" of COVID-19 looks like for the food industry.

From the protein commodity perspective, we do not believe that "other" exists. Our view is that the industry will be forced to rapidly adapt to a new "corona" economy. We predict at least a 40% contraction of sales in the foodservice sector and a maximum growth of 15% in the grocery sector in 2020. We therefore believe that the wholesale industry will struggle throughout 2020.

©a_namenko/Getty Images

INTRODUCTION

During the current COVID-19 crisis, there has been an accelerated focus on data analysis attempting to make sense of the current situation. It has also spurred data scientists to dare to predict where we are headed, or what does the "other side" of the current pandemic looks like—if there is one. Relative to our industry, it all comes down to a virtually paralyzed foodservice sector. Although each commodity's foodservice dependence varies widely, the ripple effects across supply chains continue to be felt, from inconsistent supply availability and price volatility, to rising unemployment and changing consumer behavior.

Naturally, food demand shifted from foodservice to retail, or from restaurants to grocery stores. Just like we mentioned in our ***Retail Report***, prices also became quite volatile as expected, making it very difficult to make any sensible prediction. Even if we held production constant, or without any availability disruption, prices would remain volatile as these commodities would only have retail/grocery as the main distribution outlet. But the supply side of the equation has also become uncertain with pork, beef, and poultry plant closures, diminished schedules, further labor shortages, and plant re-openings.

More importantly, the assessment ought to be approached by industry for many reasons, but mostly due to each commodity's **dependence on the foodservice sector**. For example, according to the United Egg Producers, upwards of 60% of shell eggs produced are destined for retail/grocery use while about only 7% goes to foodservice, and 30% to further processing. This is quite different to shrimp, where industry sources estimate that over 60% of sales take place in the foodservice sector. Therefore, the exposure to this shock varies widely by commodity.

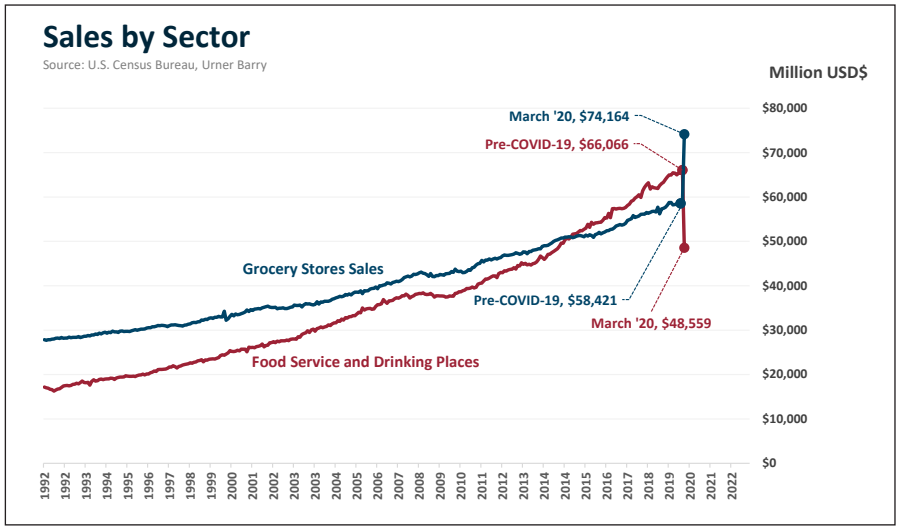


Chart 1. Advance Retail Sales, Seasonally Adjusted for Food Service and Drinking Places and Grocery Stores.

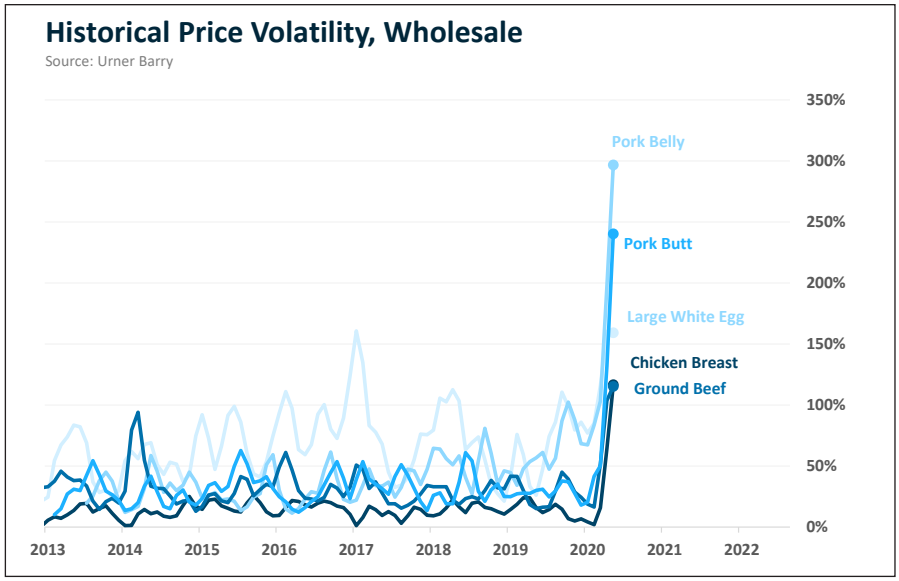


Chart 2. Historical Price Volatility using Urner Barry quotations. Weekly Price volatility, 4-week moving average.

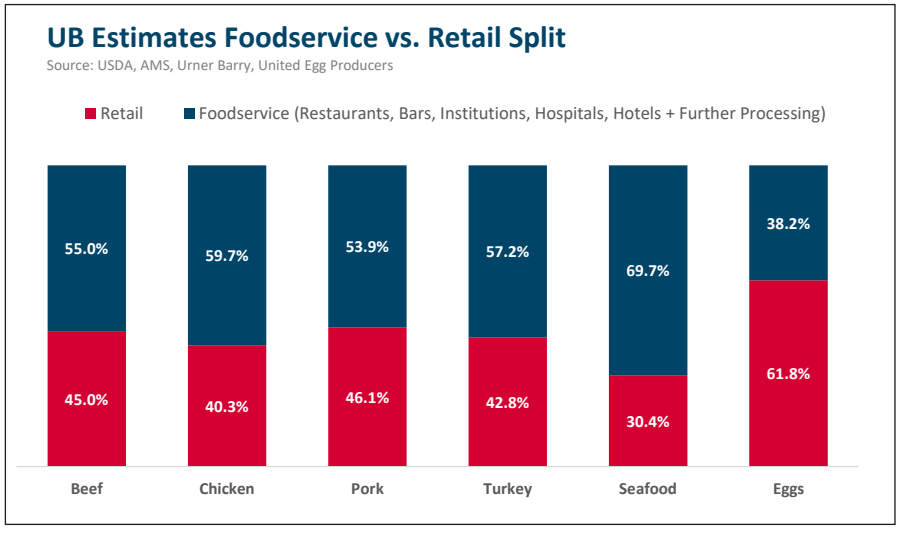


Chart 3. Urner Barry estimates of Foodservice and Retail/Grocery split. Beef, Pork, Chicken and Turkey is calculated using retail weight. Seafood is calculated using edible weight. Eggs were taken from United Egg Producers.

EGGS

Production of eggs is largely automated. From the laying houses to the retail carton, eggs might never be handled by a human. Though there are machine technicians and palette movers, among other workers, human density at egg processing facilities is nowhere near that of beef, pork, or poultry processing facilities. Therefore, egg production is considerably less exposed to supply variations due to absenteeism or COVID-19 infections, providing a considerably more stable production.

After the initial demand rush of late March/early April in which prices spiked at the fastest pace on record, these have adjusted to pre-COVID-19 levels. According to the USDA's figures, egg production during Q1 2020 remained largely unchanged compared to 2019, yet, at seasonally record high levels.

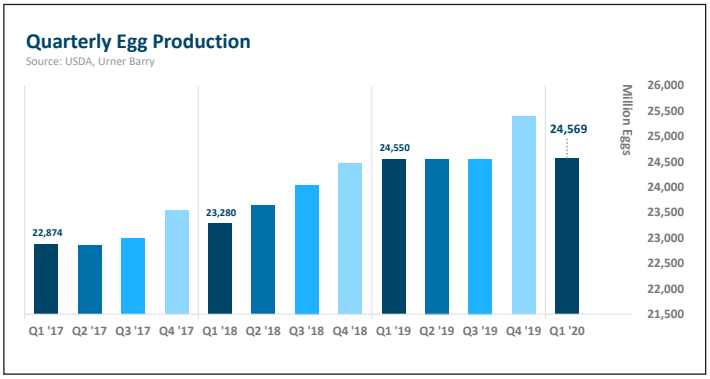


Chart 4. Quarterly Egg production. Despite a Y-o-Y drop in March, Q1 production was above last year.

Before COVID-19, prices would fluctuate based on both foodservice and retail demand and, as such, inventories would fluctuate, too. For example, the fundamentals would suggest that a decrease in shell egg inventories would cause prices to rise, all else equal. While this is true for the most part, the number of cases broken for further processing has a noticeable higher negative correlation to shell egg prices than shell egg inventory itself.

While this could be reactionary from industry players to increase the number of cases broken due to an increase in demand for liquid eggs from the foodservice sector, or to process and store, the number of cases broken experienced the largest 4-week drop on record starting in March 2020. Similarly, shell egg inventory had the third steepest 4-week decline since 1996. From an inventory and cases broken perspective, the price spike seen in late March/early April was fundamentally justified. In addition, demand from retailers during this time is seasonally high due to pre-Easter purchasing and scheduled deliveries. Combined with the panic rush, this made sense. However, within four weeks prices came back down and as of May 15th, 2020, levels are now below pre-COVID-19.

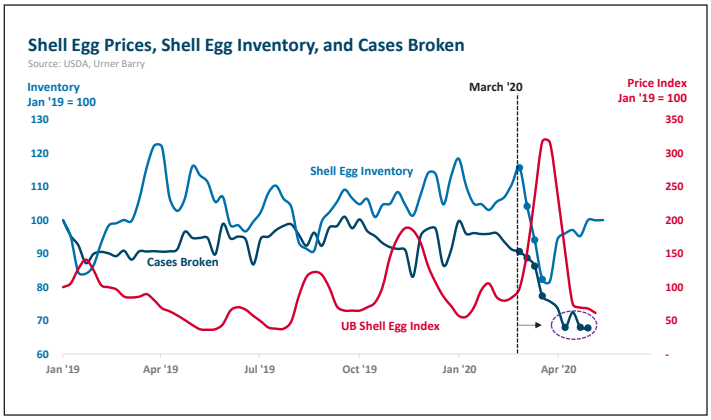


Chart 5. Egg Inventory, Cases Broken, and Price. Source: USDA, Urner Barry.

Historically, if the foodservice sector were to be open, we would have seen the number of cases broken increase as prices fell, but as of the third week of May, cases broken have remained comparatively low. This makes sense as a large portion of eggs processed end up in the foodservice sector; yet this sector remains largely paralyzed, and demand at the retail level remains strong. Therefore, given that production is not being affected by COVID-19, we believe prices will remain under pressure as the industry finds ways to allocate product used at the foodservice level.

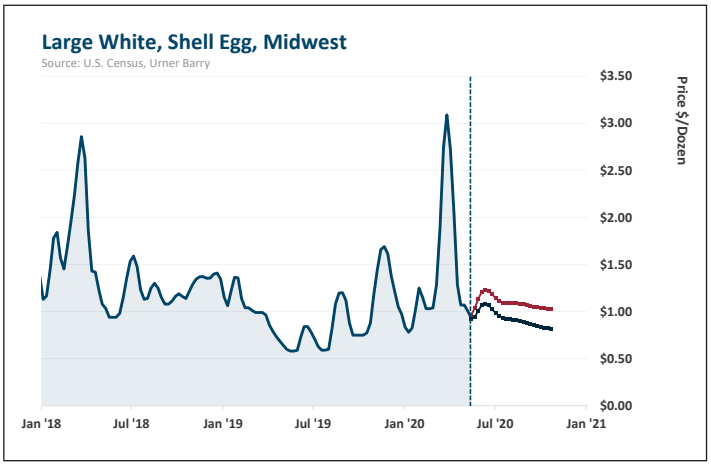


Chart 6. Large White, Shell Egg, Midwest. Source Urner Barry. Forecast, Urner Barry Consulting.

The other side of COVID-19 looks to be brighter for eggs than other proteins. Eggs will continue to be supported by a strong retail demand due to its perception as a relatively low-priced animal protein, as well as its relative lower dependency on the foodservice sector. Though we could still see some bumps in the road if the economy re-opens and then closes again, production stability will be highly valued in comparison to other proteins.

RED MEAT

Both beef and pork have suffered significant supply disruptions due to labor shortages as some workers test positive for COVID-19 while others fear contracting the virus. Labor shortages were already an issue prior to the current crisis and now the issue has been severely exacerbated, and the supply disruption has been unlike anything these industries have ever seen before. To illustrate this, we can see how cattle and hog slaughter has contracted significantly compared to a year ago.

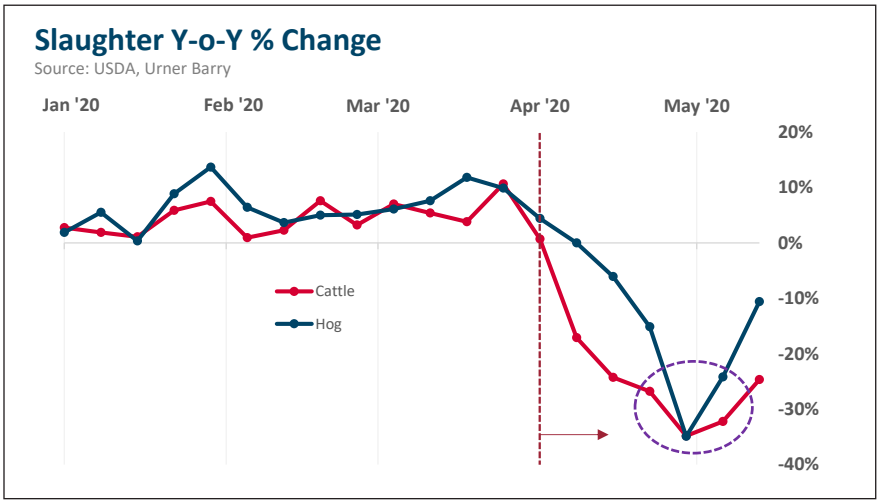
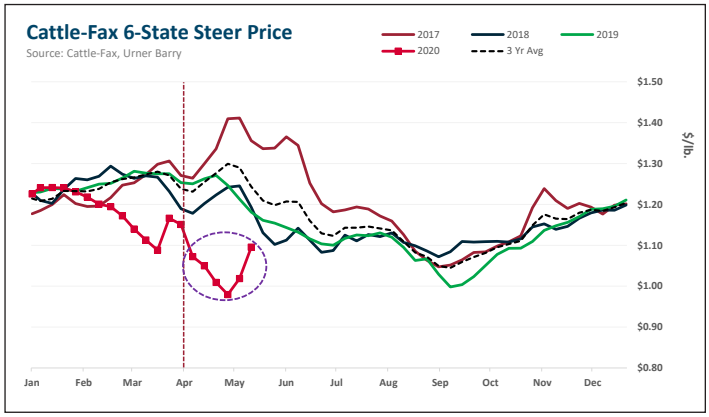
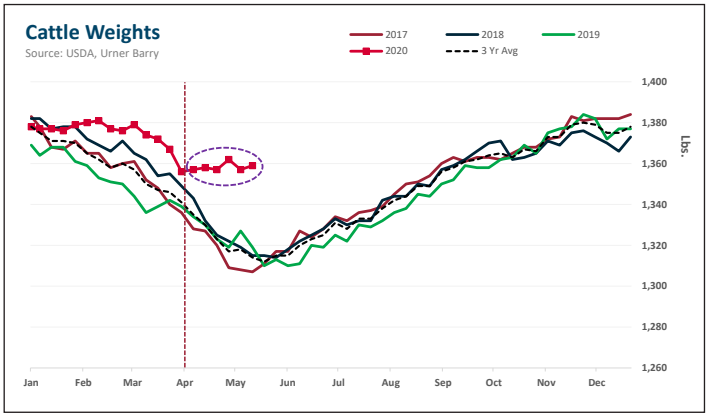


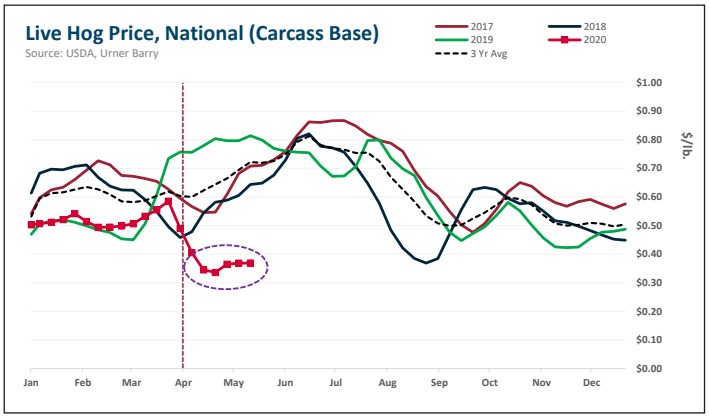
Chart 7. Weekly Y-o-Y Cattle and Hog Slaughter. Source USDA, Urner Barry.

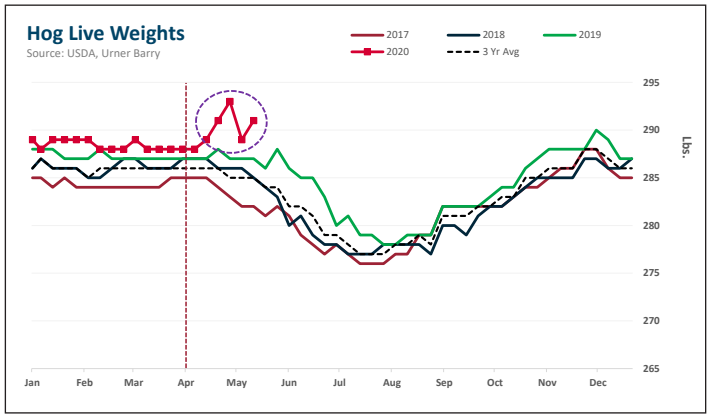
The problem with a reduced slaughter of this magnitude is the backlog it creates on the flow of livestock into the supply chain. This means that hogs and cattle that have reached market weight and are ready to be slaughtered will now have to wait longer. As a result, animal weights are increasing and livestock prices have been volatile, mostly on the downside. This situation is not expected to change in the near term and returning to full capacity is not likely attainable anytime soon.





Charts 8 and 9, Cattle Prices and Weights. Source: Cattle Fax, USDA, Urner Barry.





Charts 10 and 11, Hog Prices and Weights. Source: USDA, Urner Barry.

Red Meat continued next page

Red Meat continued from previous page

To make matters worse is the fact that wholesale prices for both beef and pork have skyrocketed due to the reduction in production. In other words, the supply reduction has overwhelmed the demand side of the equation despite the significant contraction of the demand from the foodservice segment.

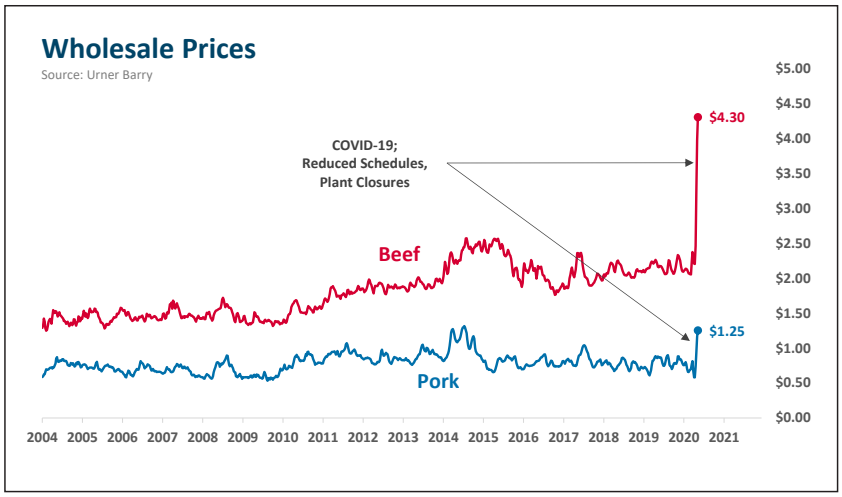


Chart 12. Beef and Hog Cutouts. Dramatic spike due to significant slaughter reductions.

So, what lies on the other side of COVID-19 for beef and pork? We do not believe a prediction is reasonable at this point. Returning to full capacity is probably one of the main priorities for many packers and further processors, yet how soon that will happen remains to be seen. In addition, with restaurants opening in different states—at different capacities—it is hard to predict what foodservice demand will look like. For these two industries, the future looks particularly blurry. On one hand, livestock ready to be slaughtered is being pushed back because plants cannot slaughter and process them; on the other, demand is clearly outpacing supply despite a significant reduction in foodservice demand. We do not, however, see how prices at these levels can be sustained for a long time, leading us to return to the easy prediction we made eight weeks ago, which argues for continued price volatility.

CHICKEN

The case for chicken is similar to that of beef and pork. Reduced schedules and labor shortages are problems the chicken industry is also grappling with, but to a lesser extent. Though slaughter took a year-over-year dive at the same time pork and beef did, production recovered relatively quickly. The chicken industry enjoys much more flexibility in terms of supply adaptability compared to beef and pork primarily because of a significantly shorter production cycle; it only takes about 6-8 weeks to bring a hatched chick to market weight. To illustrate this, we can see how eggs set in incubators for future hatchery and chicks placed in the pullet house also moved lower. This means that available chickens to be slaughtered will be reduced in the future, reducing the pressure on the supply chain in a matter of weeks. This is vastly different from beef where any reduction in calf production will not be seen until at least 20 months from now.

While the situation for the chicken industry is not ideal, demand for chicken tends to be less affected by prices during shocks as consumer perception is still that chicken is relatively lower-priced compared to other animal proteins available. And while chicken prices at the wholesale level have also been volatile, overall prices remain below year-ago levels and far from record highs seen in the past for most items, despite the current shock. We expect volatility to remain as a normal occurrence in the near to medium term, albeit at comparably lower prices than beef and pork. This is another silver lining the chicken industry enjoys compared to other proteins. Therefore, we believe that chicken is currently better positioned and is much more likely to recover at a faster pace than most animal proteins as the economy slowly re-opens.

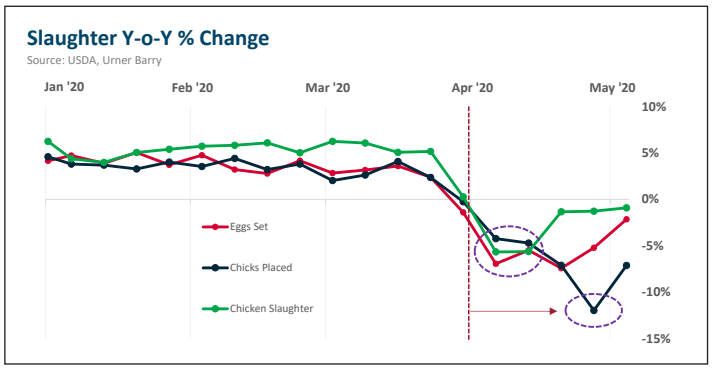


Chart 12. Chicken Hatch and Slaughter

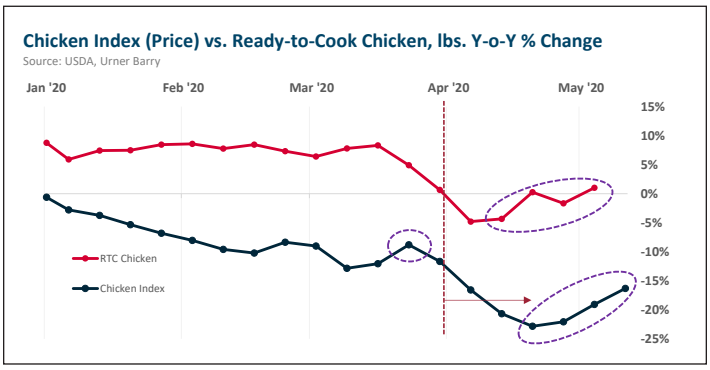


Chart 13. Chicken Index vs. Chicken Slaughter, Y-o-Y % Change.

SEAFOOD

We believe the seafood industry can seldom be analyzed as a monolith—but rather, each species must be analyzed individually. For instance, while estimates vary, some suggest that about 60-70% of the shrimp sold in the U.S. takes place in foodservice, while salmon could be evenly split between retail and foodservice.

SHRIMP

For shrimp—the most consumed seafood item in the U.S.—the outlook is mixed to lower. Imports of shrimp, which comprise about 80% of the total U.S. supply, were already at a record high pre-COVID-19 and there was already a soft undertone in the wholesale market due to ample supplies. Imports from India, Mexico, and Ecuador all were up from Q4 of 2019 through Q1 of 2020. Imports from Ecuador, the third largest shrimp supplier to the U.S., increased significantly from December through March (data from the most recent month available) compared to a year ago. These monthly increases were largely fueled by China closing its borders to imports, prior to Chinese New Year celebrations. Ecuador had to look for other markets, and shipments to the U.S. and Europe rose significantly as a result.

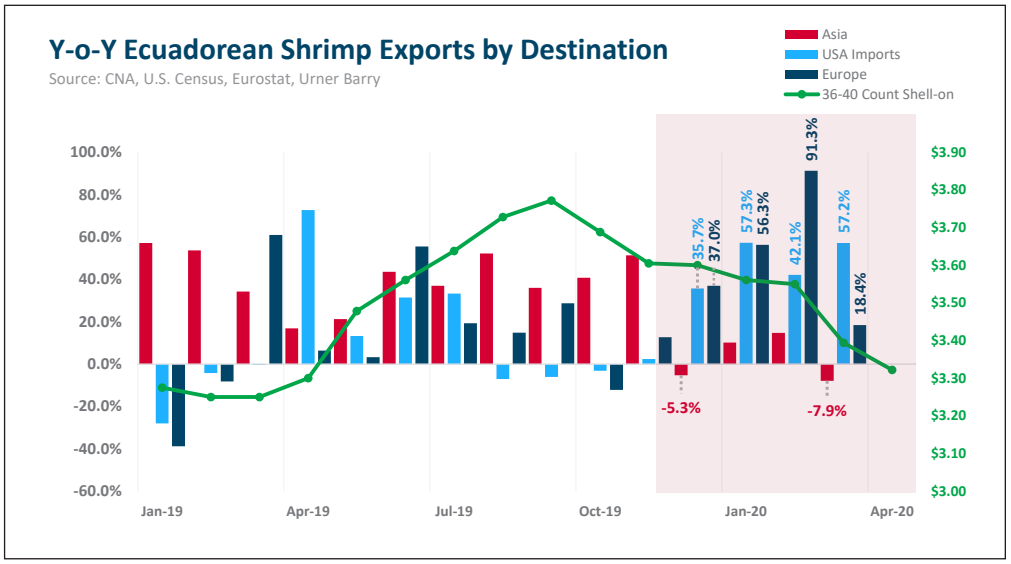


Chart 14. Ecuadorean Shrimp Exports. Shipments deviated from China to US and Europe as China closed its border.

But most shrimp sold in the U.S. market is frozen, providing sellers more time to find or develop other selling channels. Yet, although not ideal, most shrimp importers are not vertically integrated with packers and farmers overseas, which means importers could lower their purchases in the upcoming months to bring balance to the U.S. market. Unlike the chicken, beef, or pork industry, the shrimp industry is significantly less consolidated with many more sellers fighting for a diminished foodservice sector and an expanding retail sector.

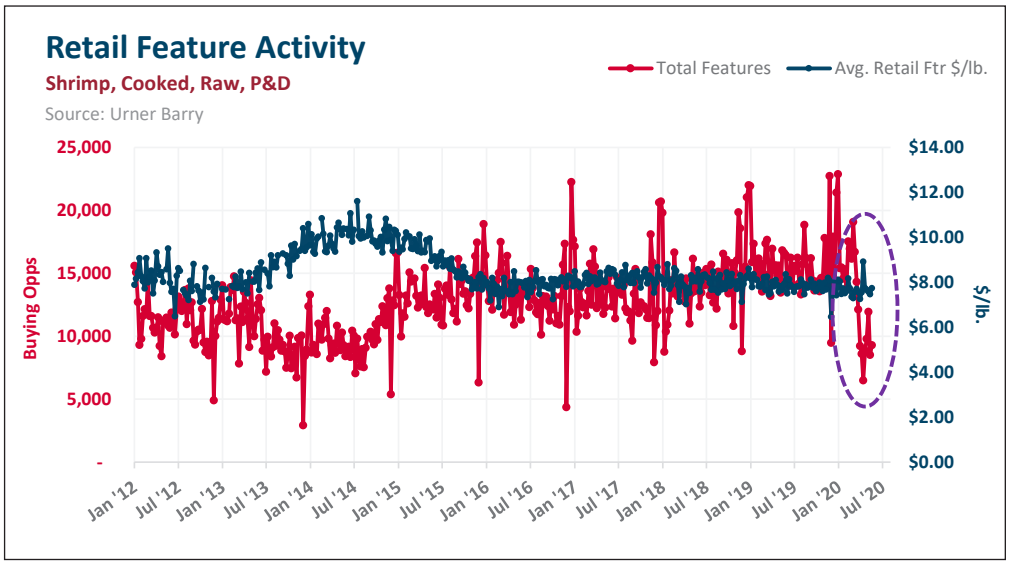


Chart 15. Shrimp retail feature activity. One-week jump on price, lower feature activity.

During the first weeks of the Great Lockdown, shrimmp retail promotions fell to the lowest level since November 2016. Average retail feature price also rose to the highest level since May 2015. At first glance, we can assume this was due to a strong retail demand during the buying rush we saw during the first few weeks in April.

Shrimp continued next page

Shrimp continued from previous page

Thereafter, promotions remained relatively low, but feature price came down to previous levels. Retailers will most likely continue to demand value-added products, such as peeled and cooked shrimp as opposed to other foodservice items like frozen blocks of shell-on shrimp. And, like any labor-intensive processing facility, capacity could be significantly reduced and could cause supply disruptions and therefore price volatility. For now, we have seen prices at the wholesale level adjust lower over the course of weeks, but we believe there are market splits; while the benchmark pricing has moved lower, there could be unreported discounts and premiums at the wholesale level depending on each seller's inventory position as well as financial situation.

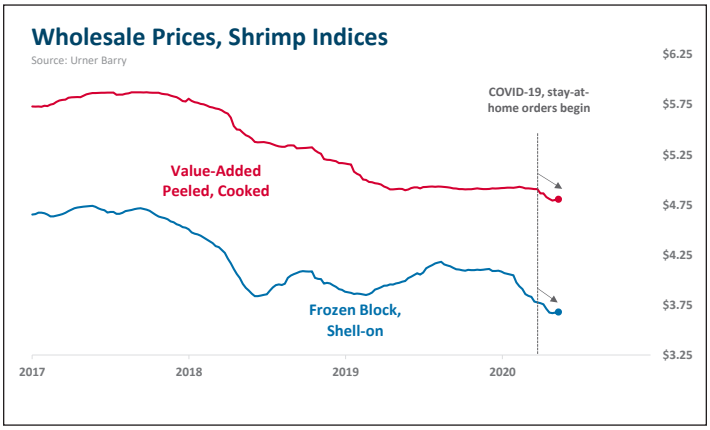


Chart 16. Urner Barry Shrimp Indices.

SALMON

While the split between foodservice and retail estimates vary, the nuances of the salmon trade are complex. A large portion of salmon traded in the U.S. is fresh, either trucked from Canada or through daily air-shipments from Chile and Europe—and a large portion of the latter are shipped on passenger flights. With a significant reduction in passenger air-travel, salmon suppliers looked towards increasing their cargo air shipments. March imports, the most recent data available, shows how volumes contracted compared to a year ago, while prices continued to adjust lower.

On the frozen side, imports grew significantly from December through March, partly due to processing and shipping disruptions of fresh product out of Chile as Chilean processors opted to freeze product to ship later. Such extra supply continued to place downward pressure on prices, and when the Great Lockdown began, prices began dropping further.

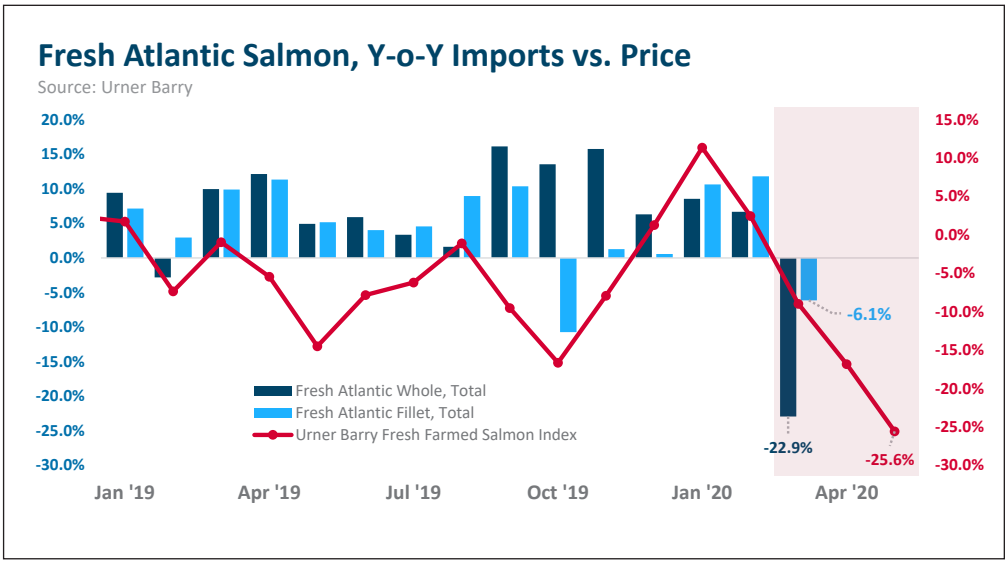


Chart 17. Fresh Salmon imports vs. UB Fresh Farmed Salmon Index

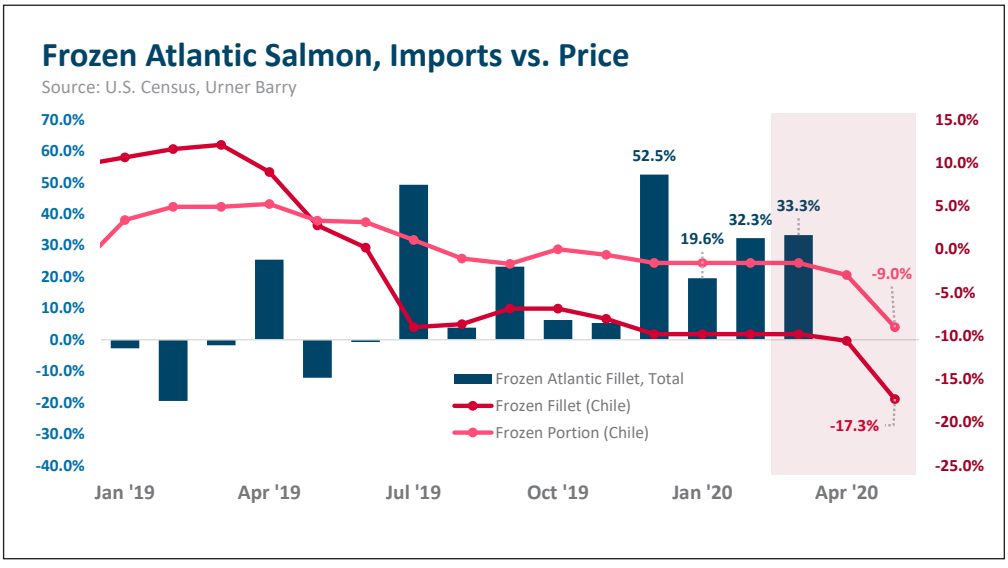
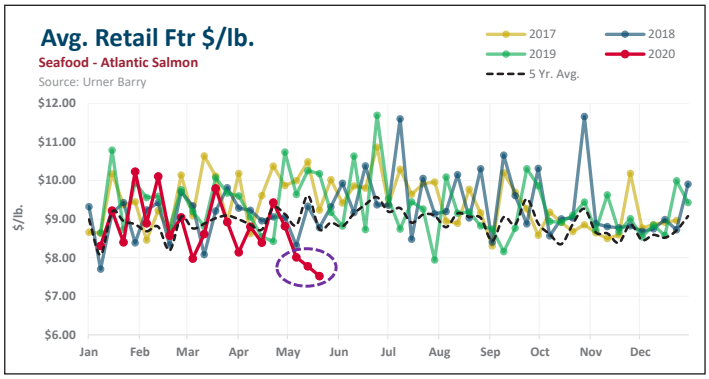


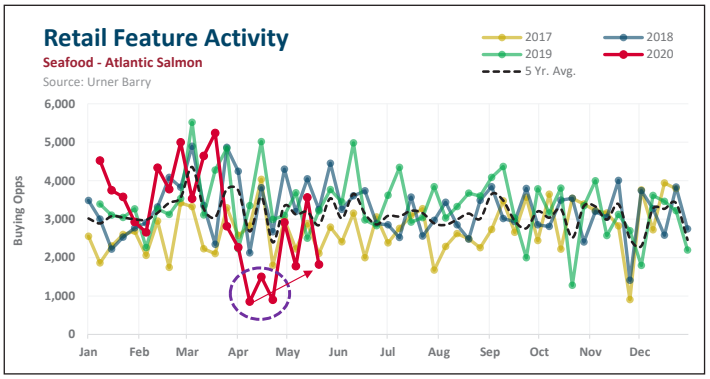
Chart 18. Atlantic salmon frozen fillet Imports vs. Urner Barry quotations.

Salmon continued next page

Salmon continued from previous page

Like other mainstream proteins, retail feature activity fell considerably after mid-March and subsequently through April. While some of these decreases could be attributed to seasonal factors, such as typical post-Lent declines, the data clearly shows feature activity began its downward trend two weeks earlier, suggesting a strong demand as the lockdown began and therefore a reduced need to promote. What is very interesting to see is that features began trending higher towards the end of April into May, and retail feature prices have declined to their lowest levels since at least February 2016! What this suggests is that retailers are passing the savings of lower wholesale prices to the consumer.





Charts 19 and 20, Atlantic Salmon Average Retail Feature Price and Feature Activity.

CONCLUSION

Retail sales from March painted a grim picture for the foodservice industry as expected. Sales at grocery stores on the other hand, skyrocketed—also as expected and as mentioned at the beginning of this report. We must remember that many restaurants, bars, and other venues remained open at least through the first week of March. So, when retail sales' figures were released on Friday May 15th, it came as no surprise to see that sales at restaurants in April 2020 (Food and Drinking Places) were even lower. Similarly, sales at grocery stores should have eased somewhat after the demand rush experienced from mid-March to early April and as such, April retail sales for grocery stores came out lower than the previous month.

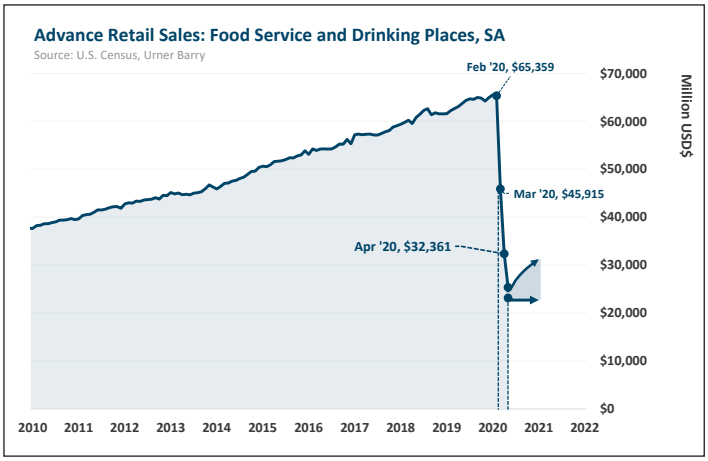


Chart 21. Advance Retail Sales, Food Service and Drinking Places. Forecast, Urner Barry Consulting.

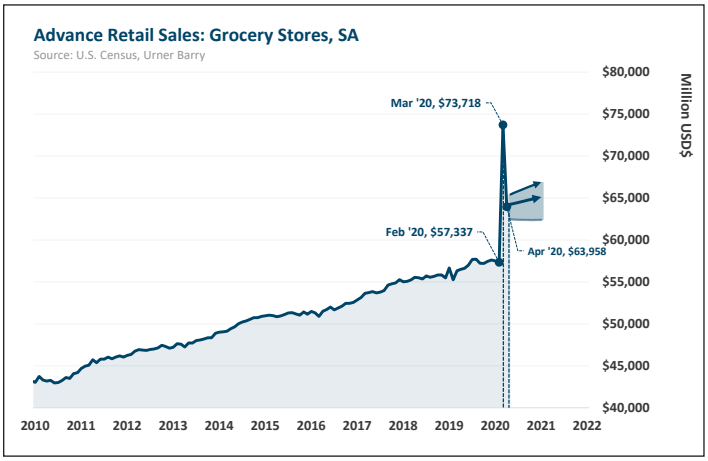


Chart 22. Advance Retail Sales: Grocery Stores, SA. Forecast, Urner Barry Consulting.

Conclusion continued next page

Conclusion continued from previous page

Assuming we have reached bottom, we believe the recovery for the foodservice industry will be slower than the growth this sector has enjoyed over the last five years. We still expect further declines for the foodservice sector going into May as more restaurants close, but then rebounding as we move into the summer. Food expenditures at home—mostly food purchased at grocery stores—will lead sales for several years. However, there are too many unknowns when predicting what the "other side" of COVID-19 looks like for the food industry. What sort of "stickiness" would there be to consumers eating at home? To what extent will online ordering for groceries remain? Will consumers stick to ordering online or will the lockdown fatigue push people to go out? Will the labor shortage at slaughterhouses and processing facilities be solved in the near-term? How far will stimulus checks go in supporting some sort of spending? Could the current situation lead to food inflation?

We must remember that about 10 percent of the labor force is employed in the entertainment, accommodation, and foodservices sector. Even if unemployment in this sector recovers swiftly, it is hard to imagine that we will go back to pre-Great Lockdown levels. And as we know, when unemployment rises, discretionary income usually contracts and eating habits change.

From the protein commodity perspective, we do not believe that "other" exists. Until there is a vaccine for COVID-19, any prediction is as valid as it is invalid. Our view is that the industry will be forced to rapidly adapt to a new "corona" economy in which some sort of distancing restrictions are likely to perdure for some time, from the meat packing plant or fish cutting room to occupancy restrictions at restaurants. Additionally, significant changes in consumer behavior such as an increasing demand for delivery, meal kits, prepared foods, and ready-to-cook meals, or more variations of convenience and delivery options are likely to remain. While we are already seeing some of these changes taking place, it is nearly impossible to know which of these changes will remain due to regulations, or in the event of long-term changed consumer habits.

We predict at least a 40% contraction of sales in the foodservice sector and a maximum growth of 15% in the grocery sector in 2020. We therefore believe that the wholesale food industry will struggle throughout 2020.

We are not sure if there will be light at the end of the tunnel just yet. We are at least testing reopening the economy—and restaurants—in certain states, and at limited capacity. This should lend some support to our industry. But seriously, let us hope there is not a second wave of COVID-19 infections in the fall.