Food for thought

The changing landscape of the food and drink industry

Contents

Important: please note that all percentage figures used
in this report do not include those who responded
'Don't know' unless otherwise stated.

Institution of MECHANICAL ENGINEERS

IMechE Services Ltd

Introduction

The food and drink industry is the UK's largest manufacturing sector. Figures from the Food and Drink Federation indicate that it is a £95.4bn business.

It accounts for 18.3% of UK manufacturing output and employs 400,000 people directly, with a further 1.2 million people in jobs that are related to the sector. Food and drink exports from the UK in 2014 totalled £17.7bn.*

Optimism across the industry

There is a lot of good news for the industry. More than three-quarters (76%) of respondents to the surveys that underpin this report are optimistic about growth prospects for the coming year. A slightly higher number (77%) predict long-term growth in the next five years, while 63% expect to increase their profits this year. Confidence is also reflected in investment: 82% say that investment has been maintained or has risen in the past two years, and 71% expect it to rise or stay the same over the next two years.

This optimism and the willingness to invest go a very long way to counter an undercurrent of reservations about the structure of the UK food and drink supply chain. Changes that are under way within the food retail sector may alleviate some of the concerns expressed about the industry's ability to optimise effectiveness across all links of the supply chain through true partnership.

*Source: Office for National Statistics, January 2015. The ONS figures are taken from the ONS Statistical Bulletin, Q4 2014 called 'UK Trade in Goods by Classification of Product by Activity CPA (08)', published 17 March 2015.

Drivers for competitiveness

The report finds that there are many drivers for competitiveness in this industry. Engineering and technology are critical to the sector, both within the food and drink companies and more widely across the supply and distribution chains. Moreover, niche and premium products can offer routes for UK manufacturers to raise themselves above dependence on the big retailers.

The UK food and drink industry is worth
£95.4bn

To some extent, food and drink manufacturers are constrained in performance areas such as export potential and adoption of technology by factors that are not always within their own control. Export opportunities vary by product; the risk of important substitution also differs. Perishability and logistics are important factors for manufacturers operating in the sector, as are international market structures.

Working with the Institution of Mechanical Engineers (IMechE), the leading professional body whose members are active and influential within the food and drink industry, we have compiled this report in order to identify some of the changes, challenges and issues faced by food and drink manufacturers.

This report is based on detailed interviews with senior representatives from a range of manufacturing businesses and a survey of those working in the food and drink sector, which provided additional statistical analysis. The research addressed four interrelated topics: the structure of the UK food and drink industry, competitiveness and exports, technology and investment issues, and future prospects for growth.

Mike Rigby
Head of Manufacturing, Transport and Logistics

Section one: The supply chain structure

The UK food and drink industry is diverse and participants range from household name brands and giant multinational corporations, through to small family businesses and artisan suppliers. Supporting the producers are equipment and technology companies and project management firms.

This complex and varied supply chain also includes the upstream farmers, growers and breeders of the 'raw materials', and the downstream distribution groups and retailers, which are the principal routes to the end-consumers. Definitions within the industry are not always clear-cut: depending on the product there has been scope for vertical integration between suppliers of ingredients and product manufacturers and also between manufacturers, distributors and retailers.

73% of industry engineers see supermarket power as the biggest challenge they face over the next five years.

The route from farm to fork is therefore a partnership. It was felt by the manufacturers surveyed that this is not, however, consistently a partnership of equals and that the relationships can be complicated. The retail sector is viewed from within the food and drink industry as dominant, with its concerns setting the agenda for the whole industry.

The power of the supermarkets

The influence of the supermarkets dominates the responses in our research. We asked food and drink industry engineers what they viewed as the biggest challenges facing manufacturers over the next five years, and 'the power of the supermarkets' was selected by 73% of those who responded.

The influence of the supermarkets

34% are concerned about the volatility of input prices

73% of industry engineers see 'the power of the supermarkets' as the biggest challenge facing manufacturers over the next five years

SUPERMARKET
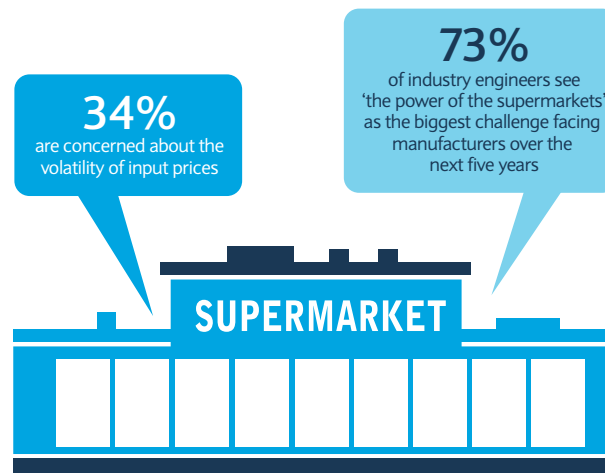
Other challenging factors include the threat from imports, consolidation within the sector, and to a lesser extent, access to labour.

The second highest factor, the volatility of input prices, was seen as a cause for concern by just 34%, and other factors that might be seen as challenging for the manufacturers, such as the threat from imports, consolidation within the sector, and access to labour, were considered of even less importance.

There is widespread recognition of the business acumen of the major supermarkets and in particular their emphasis on cost reduction. Comparisons with retailers in other countries indicate that UK consumers are getting a good deal in terms of range and availability of products and that manufacturers have more potential exposure for their own brands in the big stores than is the case in some other European markets.

Finding a niche strategy

One of the strategies employed by food and drink manufacturers is to attempt to remove themselves to a degree from the dependence on the supermarkets and cost-cutting by giving their products a unique selling point: operating within a niche or creating a premium brand.

Areas such as health foods and 'free-from' items have seen significant growth in recent years and now account for around 10% of the overall UK food market. The supermarket giants are keen to share in this trend, and this is an area where manufacturers can often take the initiative.

Partnerships in the supply chain

The relationships between the food and drink manufacturers and their own suppliers in the growing and breeding community appear to be positive. Long-term contracts and ownership of the growers and breeders by the manufacturers are commonplace features.

But there can be problems with these relationships too. The complexity of the supply chain produces a ripple effect, with consequences that are not always easy to forecast. Greater transparency and stronger partnerships from all parts of the industry could help here.

The purchasing habits of the UK consumer are undergoing significant change. Groceries are less frequently bought in large supermarkets and we're seeing an increase in demand for challenger brands from discount European retailers for a wider range of products at reasonable prices. Traditional farmers' markets, which offer consumers quality local produce, appeal to those who are conscious of investing in food sourced and produced by suppliers in their surrounding area.

High-end vs discount retailers

The results of this survey indicate mixed views on these developments. The rise of premium high-end retailers is welcomed by a margin of more than 12 to one. When asked whether the rise of discount retailers was good for UK food and drink manufacturers, 48% said no, 40% said yes, and 12% said they didn't know.

Discount retailers are reported to offer longer supply contracts, which encourages manufacturers to invest in areas such as automation, and they are willing to operate on slimmer margins for themselves than the big UK retailers.

They are after low prices, however, and their retail concept is largely based on own-label goods and very limited alternatives. If niche and premium products are the way forward for many manufacturers, then the discounters are a less interesting prospect.

Is the rise of discount retailers good for the UK food and drink manufacturers?

"We have a partnership with our growers and I don't think we're held to ransom by them or that we hold them to ransom."

UK-owned cereal foods group

YES
40%

NO
48%

DON'T KNOW
12%
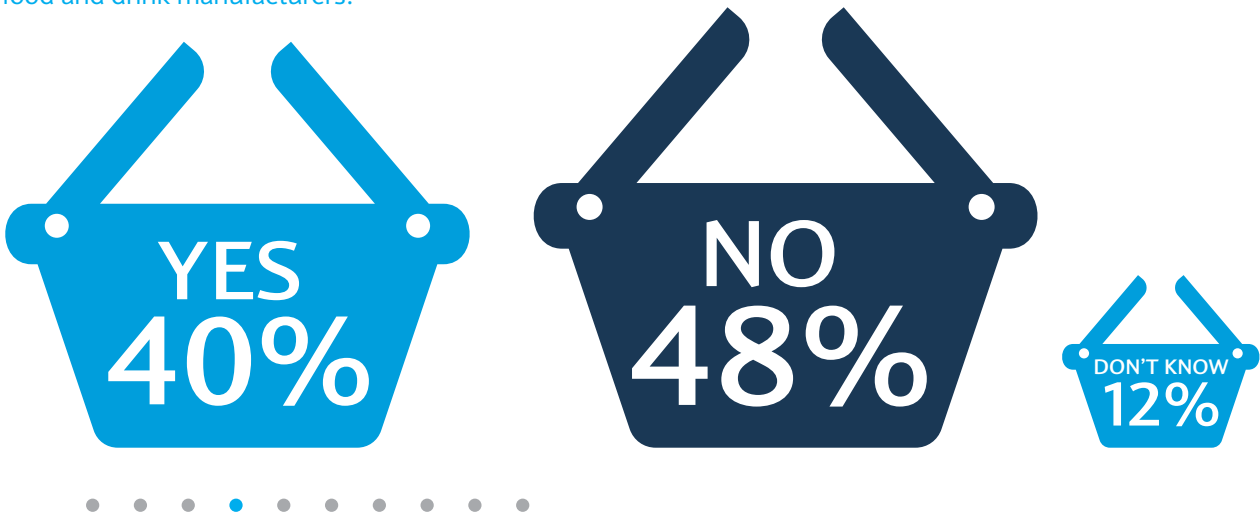
Section two: Competitiveness and the international dimension

Competitiveness is a difficult subject in the food and drink industry, since the overall market is very rigid. Despite this, it is possible to be flexible within market subsectors.

Standard measures of competitiveness in terms of business efficiency are only part of the equation in this industry. Other factors – the economy, individual and family spending power, seasonal variations, short-term fashions and novelty products, and long-term trends – such as the growth of fast-food and of low-calorie products – play a big role in business success for food and drink manufacturers.

Facing the competition

54% of respondents said that exports were an important part of their business plans, while exactly the same number said that food and drink imports from lower-cost countries were a threat to the viability of the UK-based industry. Some respondents thought the UK sector suffered from inertia, held back by an island mentality, while others felt that many British food and drink producers were world-class in their efficiency, their opportunism and their adoption of technology.

There are good reasons for some discrepancy in this area. The internationalisation of the food and drink industry seems to have picked up pace in recent years with the rise of major international food groups that have grown through acquisition; however, foreign ownership does not inevitably mean a threat to UK manufacturing. There are factors such as logistics, local and national markets, the perishability of many foodstuffs and sometimes the sheer bulk of product that influences decisions about sourcing.

"A lot of our products don't really travel well and have a fairly short shelf-life. You always have to look at where to make it in terms of different products, and heritage also matters."

UK-headquartered international drinks group

Do food and drink imports from lower-cost countries threaten the viability of the UK-based industry?

YES
54%

NO
46%
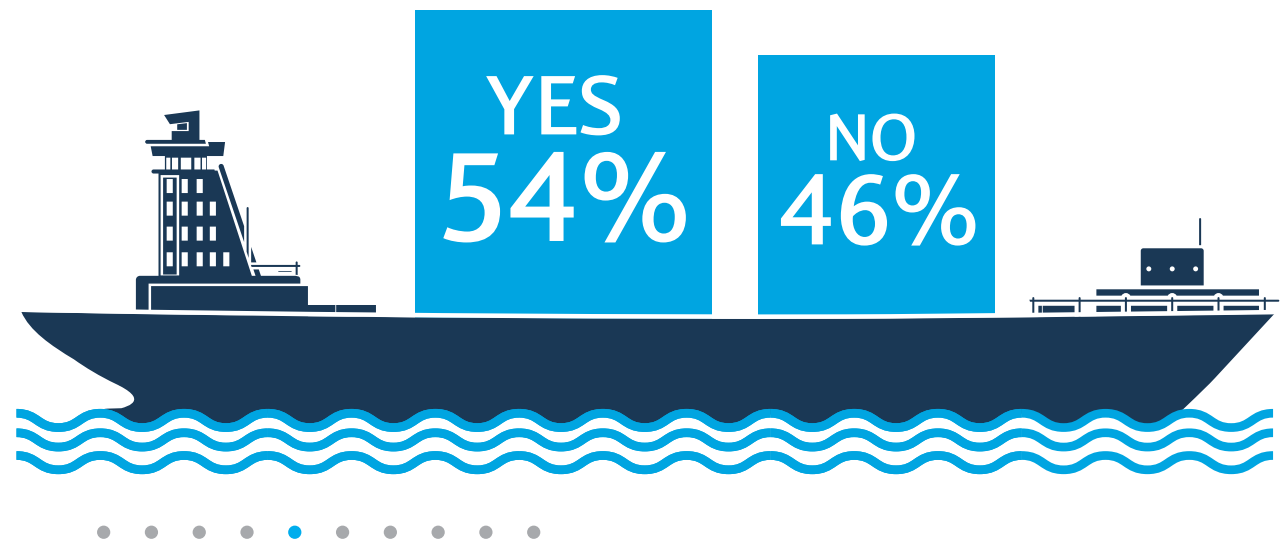
Tackling new markets

Few established companies expect to see major growth in the domestic market. Market steadiness is the expectation and volatility comes from new product introductions and re-launches which are often marketing or PR-led.

One interviewee pointed to a consistent 4% UK growth in one sector of his business. He noted that outside the industry this might be regarded as unacceptably sluggish, whereas within food it was unprecedented.

Breaking into the EU

Equally, the scope for increasing exports from the UK food and drink industry, though widely recognised, is cautious. One difference between domestic and foreign markets, emphasised in the survey, is the degree of dominance exercised by the big UK supermarkets. This is not matched in other countries, where the food-retailing sector is more diverse, with more players of different types.

"If you're used to dealing with UK retail customers then you should be able to do well outside the UK."

UK investment company with substantial holdings in food manufacture

However, attempts to break into other EU markets, have highlighted some advantages of the UK industry structure. French supermarket chains, reported one interviewee, devolve responsibility for the products on their shelves far more to individual store managers. There is no central point of contact and building a business relationship is more difficult and time-consuming.

"If you're used to dealing with the retail customers in the UK then you should be able to do well outside the UK where they are not as fierce," said one manufacturer. "If you can work in high-volume environments with low margins and demanding customers, the UK is not a bad place to be."

A fall in exports

Currency movements have also contributed in the past few years to an unexciting export performance by UK food and drink businesses. Overall manufacturing exports fell in 2014; the food and drink sector saw a fall in value of 7.6%*. The causes are largely beyond the control of the manufacturers. The cost of some imported raw materials has declined, but this is of limited use to many companies in the food and drink sector that source locally. At the same time the strength of the pound is pushing up the price of British products abroad.

Are exports an important part of the business plan for your UK food and drink business?
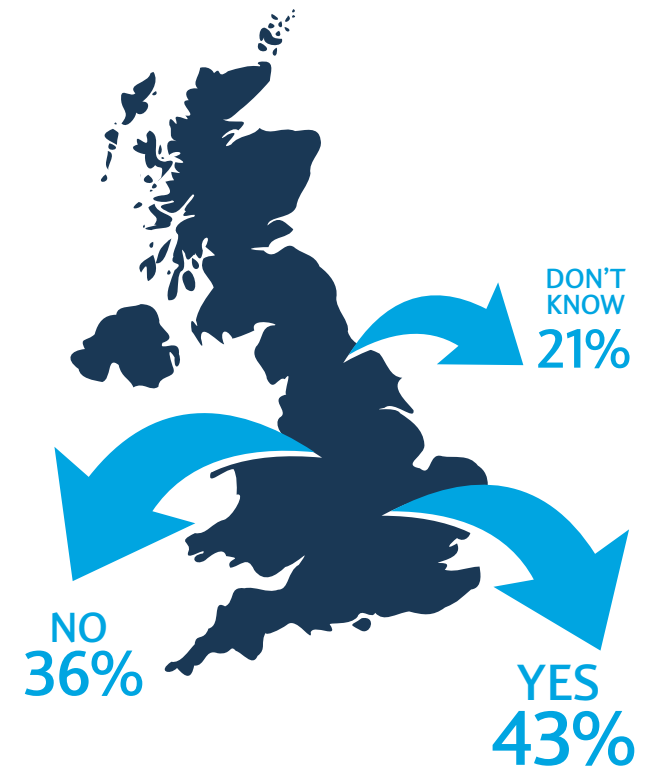
DON'T KNOW
21%

NO
36%

YES
43%

*Source: Office for National Statistics, January 2015. The ONS figures are taken from the ONS Statistical Bulletin, Q4 2014 called 'UK Trade in Goods by Classification of Product by Activity CPA (08)', published 17 March 2015.

Product differentiation

In some cases, UK food manufacturing companies face a choice between maintaining their own brands and entering the own-label business, where they manufacture for the store to sell under its own name.

Brand vs own-label goods

For many food and drink companies, success has been achieved through niche products, differentiation and deliberately taking their products up-market. This puts an emphasis on brand development and marketing, which engineers recognise as key skills in the industry.

As in other manufacturing sectors, food and drink producers see the benefits of long-term planning, investment strategies and agility to meet changing market needs and new opportunities. Current changes within the structure of the UK food retail sector, mean manufacturers are more optimistic that they will be able to pursue these strategies. The development of niche and premium products offers them alternative routes to growth and profitability, and the example of health foods proves that change and partnership can be made to work.

The rise of own-label goods within the UK is forcing manufacturers to review their competitive strategies. This is not simply a choice for the suppliers between quality and quantity: many now produce their own branded goods alongside inevitably cheaper versions that sell under the supermarkets' name.

"Own-label goods are very competitive. We've got to get on the shelf and we've got to generate a good rate of sale and our branded product will be more expensive," said one global food manufacturer. "There is the reassurance of the brand and the reality of the quality they get from a company like ours that will set us apart. But we have to keep working on it through continuous improvement of the product and through customer contact."

Carving a niche

There is a consistent message from the food and drink manufacturers that niche products and premium products offer significant potential for growth in both domestic and export markets.

Customers will pay more for food if it offers consistently better quality, health benefits or other advantages.

Niche products are those where there is a specialist market, such as health foods, products with alternative ingredients for people with allergies and products made with proprietary recipes. Niche products enable manufacturers to position themselves so that they are seen to be assisting the major supermarkets with growth into new and developing markets, such as fitness foods.

One company, which has a stated policy of independence and does not produce own-label goods for the stores, finds space on supermarket shelves in the 'free-from' and health food sections, but admits that its plans for growth into more mainstream products will be "very challenging." In this particular manufacturer's case, growing exports of its current niche products may provide a more stable route to overall company growth.

Premium products

Many manufacturers' established food and drink brands are now facing competition from the retailers' own-label goods, some of which are often manufactured in the same factories. The manufacturers' brands are unlikely to win any battles based on price, so to maintain customer loyalty and grow their brands they need to emphasise difference and superiority over the retailers' goods. Customers will pay more for food if it offers consistently better quality, health benefits or other advantages.

'Premiumisation' is also about the manufacturer's brand as a whole. Successful food and drink companies in one part of the market can often transfer that success to new and different areas where their reputation acts as a guarantee of quality and performance. Better margins through premiumisation enable producers to be more adventurous, tackling export markets, for example.

Section three: Technology, innovation and investment issues

The food and drink industry faces particular pressures in terms of hygiene and uniformity of product that make it a prime candidate for increasing automation. This is a priority for more than half of the companies surveyed.

The diversity of the sector, its products and manufacturers' markets, however, mean within this overall picture of increasing automation there is wide variance.

Automation: a crucial strategy

For some companies – and this appears especially true of drink manufacturers where standard beverages are produced in defined sizes and huge numbers – automation and control systems are a crucial part of a broader plant management strategy. Managers and engineers talk in terms that manufacturing engineers in other industries would recognise.

"If you can't measure things you can't control them, and flexibility is an important part of the business."

International drinks manufacturer

"Automation and control systems give us competitive advantage," said one international drinks manufacturer. "If you can't measure things you can't control them, and flexibility is an important part of the business. It's not just meeting the demand from retailers; it's about seasonal changes and fast introduction of new products. It's all about lean manufacturing, improvement, benchmarking and organisational design."

Challenges in the food sector

Food, however, is different from other manufactured goods. Opportunities for automation within the production process can be limited by product variables – butchery, for instance, is often difficult to automate since animals come in different shapes and sizes. Some operations that are essential in many food processing and preparation factories, such as tasting samples from the production line of a ready meal to ensure it meets quality and customer expectations, are impossible to automate.

Overall, however, increasing automation could be a positive move for food and drink manufacturers to make sure they remain competitive in a challenging marketplace.

Is your company increasing its investment in process automation for food and drink production?

NO 26%

YES 52%

DON'T KNOW 22%

Automating the process

Automation is seen as particularly beneficial in areas such as packaging, and several of the interviewees said they saw scope for more investment to integrate the producer operations with those of the supermarkets and other retailers.

There is widely felt to be scope for greater use of automation within UK firms, as this global food manufacturer explained:

"It's a case of putting automation into the right areas, such as where there is heavy manual work and where you want to remove variability. Obviously the more you can automate weighing and dosing the better. But you can't substitute for people everywhere."

Working with the supermarkets

"The supermarkets have a big influence here," said one multinational dairy products manufacturer. "Until recently, most people had only one-year contracts, so they can switch very easily. They ask themselves whether they should invest [in automation] or hire temporary workers, for instance, to pack the food. That's changing, but the need historically has been handled with flexibility of labour."

The trend towards premium brands, artisan and 'hand-made' products mean that automation is being introduced cautiously by many UK food producers.

Mass-produced vs 'hand-made'

The trend towards premium brands, artisan and 'hand-made' products mean that automation is being introduced cautiously by many UK food producers. One interviewee with products for the health-conscious market had found limited opportunities for automating operations, and was using it in cutting the finished products and ingredient inspection for contaminants. Full automation would negate the 'hand-made' selling point.

For mass-produced items, however, automation is essential as a delivery mechanism for the 'product innovation' and agility that are often driven by marketing rather than any intrinsic change to the products themselves. Other mass-producers see benefits in traceability right the way through from the reception of ingredients to the despatch of finished goods to retail.

Leaders in technology

Some respondents take a very optimistic view of the UK industry's status as early adopters of key technologies. UK engineering skills in areas of process automation are highly regarded and UK expertise in food industry projects is sought after internationally. Know-how about food processing and manufacture is a significant export business and one that has potential for growth.
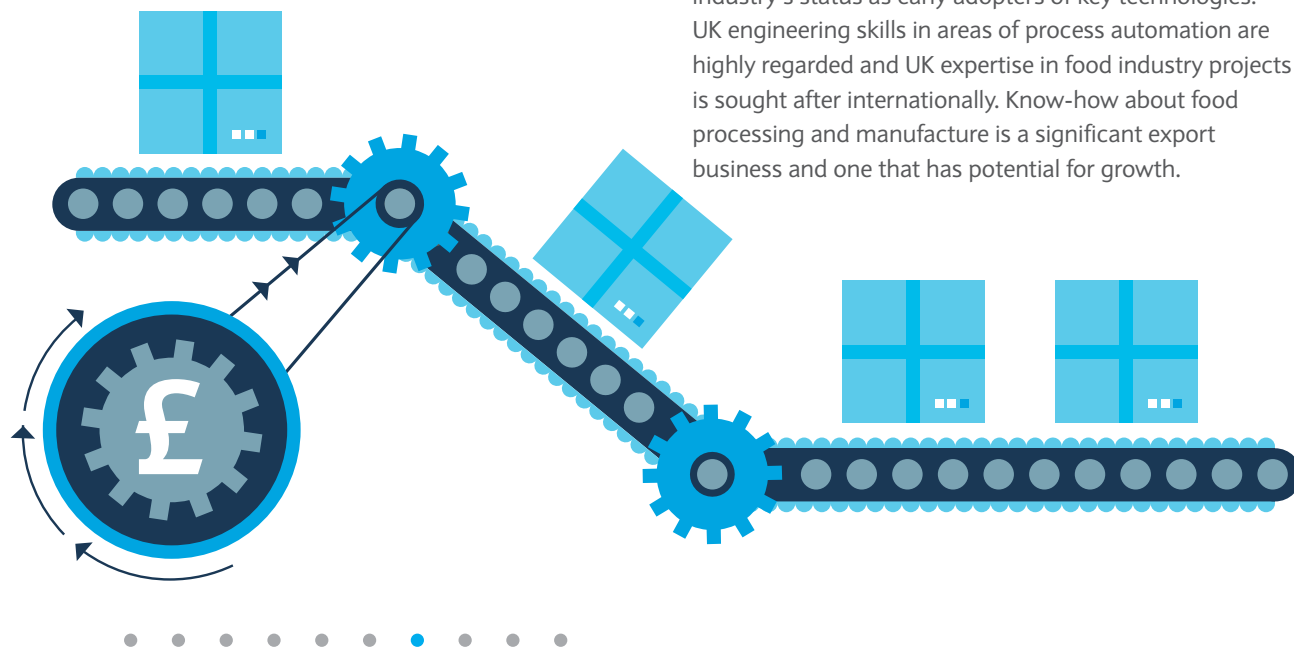
Reducing labour costs

In many engineering industries, automation is seen as the key to removing labour content and as a component of competitiveness by evening out the high cost of labour.

There is an appreciation within the food and drink industry of this argument, and 91% of respondents saw UK wage costs as a significant factor driving the industry towards greater automation.

However, for perishable goods or for products where distribution is a high proportion of overall product cost, outsourcing to a distant but lower cost base economy is not realistic. The stimulus to automate in these cases is a broader need to increase or safeguard margins, rather than because there is a cheaper alternative in a different location.

Heritage matters

There are other factors too. One of the world's largest drinks manufacturers told us that although the group was known for global brands found in many countries, with a lot of its products "heritage matters." It is important where food and drink products come from, and many are tied to specific places. Scope for outsourcing is therefore often limited. Although automation is cited in some sectors as funda-mental to business agility, for others the opposite is the case.

"Labour is 90% of the cost, but humans are the most flexible machinery you can get and robots really can't match them until you get to super high speeds," said one cereal foods manufacturer. "New products are often going to be manual because it's one way of being agile and getting going quickly. Your profit margin may not be so good, but it gets you there quickly."

Investments in automation and technology improvements within the food and drink industry are seen as essential to competitiveness, and the current investment climate in the UK is widely seen as supportive – more so now than it was before the economic downturn.

Leaning towards long-termism

If the climate is favourable towards investment, however, then some still see other hurdles. In a business that is perennially operating on small margins and faces continuous pressure, several interviewees said there can be a tendency for business owners and managers to be focused on day-to-day concerns rather than on the opportunities that they might derive from their products.

Our survey provides evidence in many areas that this kind of short-termism, driven by short contracts and perennial cost-cutting, is on the wane. Investment in automation demands the confidence that comes with a long-term vision and with a degree of business certainty. All parts of the supply chain have a role to play in engendering this attitude.

Automation and technology do not represent a universal panacea for the food and drink industry; rather they are tools that, applied judiciously, can make significant impact in terms of competitiveness, quality control and regulatory compliance. They can help business agility, new product introduction, and variations in production levels. The degree to which automation can or should be applied is always likely to vary, but it should be in every manufacturer's toolbox.

"Labour is 90% of the cost, but humans are the most flexible machinery you can get.**"**
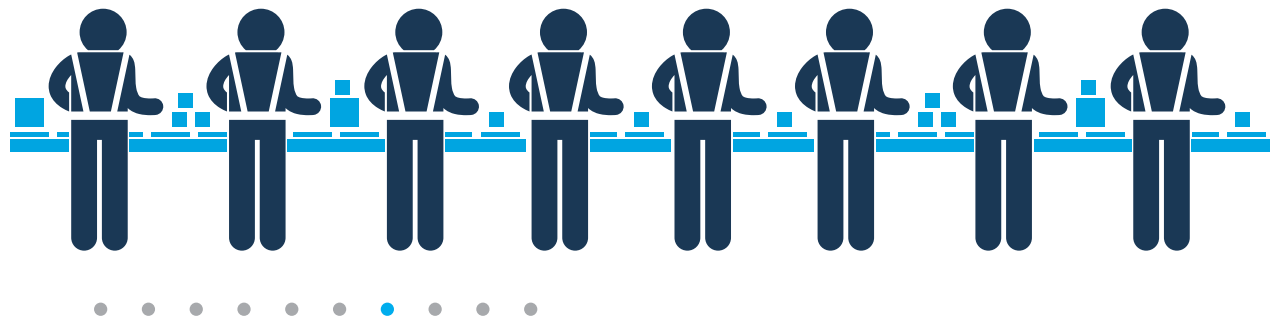
Section four: Future prospects for growth

Despite ongoing challenges, the food and drink industry is optimistic for its future. Optimism and confidence are likely to be reflected in increased investment, both in manufacturing technology and market development, which may for some companies include exporting.

Looking to the future

Asked whether they felt optimistic about growth prospects for the industry as a whole in the next 12 months, the reply was largely favourable (76%). Perhaps most encouraging of all, asked if they were optimistic about prospects for the next five years, 77% said yes. This is a sign of long-term confidence in an industry where short-termism has been common.

This optimism is backed by a perception that investment in the sector has increased and will continue to do so. 82% of respondents indicated that investment in the business had risen or been maintained in the past two years; 79% expect it to rise or be maintained in the next two years.

Space for newcomers

The market for new ideas in food and drink products themselves is seen as relatively open to newcomers and the industry as a whole thrives on novelty, much of it marketing-led. Niche companies, start-ups and family firms can work very well alongside national and multinational companies in this industry, though there can be difficulties in up-scaling production or expanding out of a niche.

Government involvement and red tape

Interviewees were asked whether there was a role for the government and the European Union in improving the competitiveness and the performance of the food and drink industry. Past government-backed schemes, that delivered advice to companies on areas such as automation, were flagged up as helpful, particularly where companies faced the need to make a step-change in production volumes following a big order.

Food and drink companies complain about the burdens of red tape and also point to the necessary legislation in areas such as health and safety, energy usage schemes, food hygiene and environmental impact. Relations with the Food Standards Agency are seen as largely productive. Another point raised was European Union membership, with many interviewees commenting that they want the speculation over the UK's membership to be sorted quickly.

Future prospects for growth

76%
are optimistic about the industry's growth prospects for the next 12 months*

77%
are optimistic about prospects for the next five years

82%
indicate that investment in the business has risen or been maintained in the past two years

79%
expect investment to rise or be maintained in the next two years

*Despite ongoing challenges, the food and drink industry has an optimistic future. Market confidence is likely to create increased investment in manufacturing, technology, development and exporting.

Key takeaways

- Significant changes in the UK food and drink retail sector will impact on the products that manufacturers supply and the visibility of their own brands, bringing both opportunities and causing concern for manufacturers

- Niche products and premium brands offer all food and drink manufacturers opportunities to exploit new markets – a route to greater business agility

- Engineering and technology, in the form of automation and supply chain logistics, have significant potential to change the business equations for food and drink manufacturers

- The impact of technology will be significantly reduced if the industry continues to be dominated by short-term considerations

- The sector is tough and resilient; these are qualities that give the food and drink industry confidence to invest for the future

- The food and drink supply chain model could benefit from further collaboration and partnership, enabling the UK industry to increase competitiveness and opportunities to export.

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