



SEPARATING THE WHEAT FROM THE CHAFF



First, wildfires damaged wheat crops in Russia, prompting the government to ban exports. Next, heavy rains reduced Canada's wheat crop outlook to its lowest level since 2002. Then, massive floods in Pakistan threatened to turn Asia's third-largest wheat producer from a wheat exporter to a net importer.

Growing concerns about wheat shortages worldwide are sending prices soaring. So far, these price spikes are not as dramatic as those experienced in 2008, which triggered bread riots in Pakistan and Egypt. And some analysts have started to openly question the validity of current fears about a return of food price inflation.

Regardless of whether wheat prices correct, it is clear that agricultural prices have entered a new age of volatility. Food companies, ranging from processors to manufacturers to restaurants, need to better prepare for a new market reality in which ingredient prices will increasingly impact their earnings.

For much of the second half of the 20th century, agricultural prices declined fairly steadily. In more recent years, many have tripled and remained at a high level over several seasons. In 2010, wheat prices jumped roughly 50 percent. Volatility more than tripled to 62 percent in the third quarter of 2010.

We believe such sudden shifts in agricultural prices are here to stay for several reasons. First, the global demand for food is increasing. As populations grow and become more affluent, people are consuming more protein and processed food.

VOLATILE AGRICULTURAL PRICES ARE REWRITING THE RULES FOR THE FOOD INDUSTRY

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Second, the frequency of agricultural shocks has been rising as the number of extreme weather events has tripled since 1980, according to reinsurer Munich Re. Devastating floods in Pakistan damaged an estimated \$1 billion of crops and left millions of people without food, shelter and water.

Finally, fluctuating agricultural prices are attracting financial trading participants who are contributing to unpredictable price movements. For example, British financier Anthony Ward helped send cocoa prices to their highest level since 1977 in July of 2010 by holding 241,000 tons of cocoa, according to the *Wall Street Journal*.

The potential impact of sharp swings in ingredient prices on the food industry is significant. If wheat prices remain at the level they reached in the second half of 2010, food companies will have to absorb an additional \$2 billion in costs on an annual basis or pass them on to

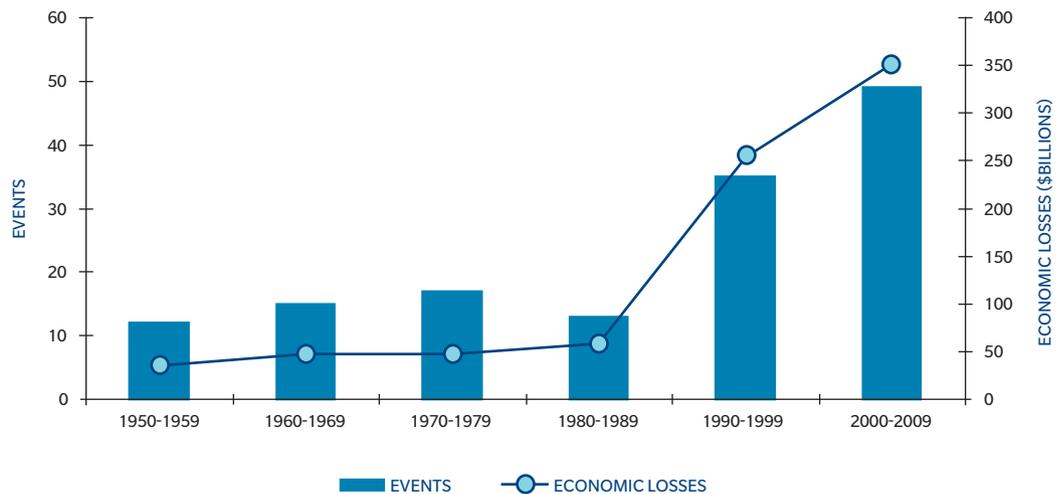
customers. Since the sluggish global recovery makes it difficult to pass on a large portion of this cost to consumers, higher wheat prices could put a significant strain on some food companies' working capital and margins. They may also drive more consumers to less expensive substitutes like private label products.

A reversal in wheat prices could create a whole new set of problems. Many companies have been benefiting from systematically buying a fraction of their future grain consumption for 12 to 24 months in the future. By buying far ahead in a slowly rising market, their actual costs have tended to be lower than the alternative of buying a full month's supply at today's higher prices. But that strategy will no longer work when the markets correct.

Food companies need to develop more sophisticated cost and margin

NATURAL CATASTROPHES ARE INCREASING

Updated value due to reanalysis of March 31, 1973, thunderstorm event in Georgia and South Carolina. The previous economic loss value for the 1970-1979 period was US\$ 52 billion.



Source: Munich RE

management capabilities to cope with agricultural price swings over the long term. Here are five ways your company can gain a competitive edge by limiting the impact of volatile agricultural prices on your results:

1) REEXAMINE YOUR RISK ANALYTICS

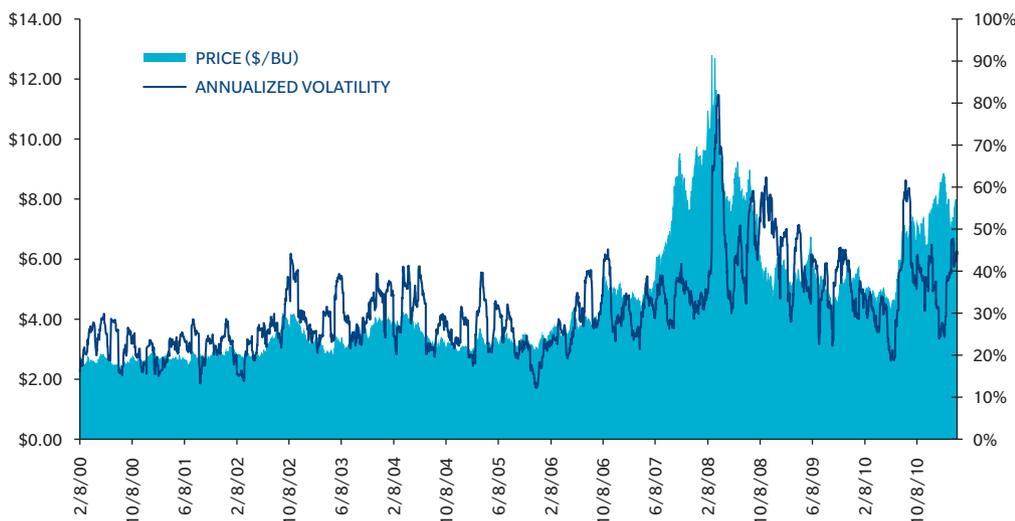
Wheat flour accounts for as much as 30 percent of the cost of producing baked products like bread and cereal. And yet, food companies devote substantially more resources to managing changes in consumer behavior than they do to price shifts in key ingredients.

Savvy food companies should take advantage of this disconnect by developing decision frameworks to help reduce the impact of one of the most significant causes of uncertainty in their results—volatile raw material prices. Looked at another way, agricultural price fluctuations have become a key lever to

stabilize profits. Food companies should consistently trace and review how highly variable ingredient costs reduce, or increase, profit margins. A well-defined decision framework includes both a recommendation based on evolving global market conditions and a playbook that defines the conditions under which a decision will be revisited.

2) THINK MORE LIKE A TRADER

Many food companies passively hold call options that protect them from price spikes until maturity because they mistakenly believe they are behaving like speculators if they unwind a hedging instrument earlier. In fact, restructuring a trade is often the most prudent step a company can take to achieve its commodity price risk management goal. Studies show that 70 percent of options turn out to be worthless once they expire. Food companies should regularly reevaluate whether earlier hedging transactions are still reducing the risk created



WHEAT PRICES ARE SOARING

Source: Bloomberg

\$2 billion

The additional amount of money food companies may have to absorb in extra costs

by agricultural price volatility in the current market. If not, they need to re-balance their portfolios.

3) EXPLORE ALTERNATIVE WAYS TO STABILIZE THE COST OF KEY INGREDIENTS

As agricultural price shifts increasingly create uncertainty in food manufacturers' earnings, companies need to consider adopting measures beyond financial hedging instruments to lessen their impact. For example, they should explore alternative ways of acquiring supplies at a stable cost, such as long-term purchase arrangements that use a combination of fixed and indexed prices. Some food manufacturers, like Nestlé, are even training farmers to grow coffee and supplying them with coffee trees. To be effective, companies must simultaneously establish regular communication across departments ranging from procurement to treasury so that senior managers can evaluate if the organization's entire range of commodity price risk management practices fits with its corporate objectives.

4) SCRUTINIZE YOUR ENTIRE SUPPLY CHAIN

Companies need to constantly reevaluate the earnings impact of formerly uncorrelated prices of crops moving in lockstep, or if an entirely different class of commodity—like oil or natural gas—suddenly decouples. As the wheat crisis illustrates, that calculation is becoming much more complicated. The price of oats has already become more correlated with wheat because they are both grown primarily in Russia and Canada. At the same time, wheat prices have decoupled from the prices of other crops that are usually correlated like corn and soybeans.

5) INCLUDE THE IMPOSSIBLE IN YOUR STRESS TESTING

It has become more crucial than ever for food companies to analyze if their products will remain price competitive even under new and unfamiliar conditions, especially given the rise of extreme weather events. Food manufacturers need to examine how immediate and longer-term commodity price shifts will impact their margins in a wide range of scenarios on both a hedged and unhedged basis. They should also consider the potential impact of events that are both historical and hypothetical across a broad range of commodity classes. Equally important, they need to scrutinize how macroeconomic events and fundamental changes in the food industry, such as the growing popularity of private label products, could alter their results.

As has occurred in the markets for energy, metals and minerals, the agricultural markets have permanently and fundamentally changed. Large agricultural price swings could potentially hurt unprepared food companies' earnings and force them to make difficult trade-offs. Instead, they should build up the risk management capabilities that will allow them to effectively manage sharp shifts in the prices of key agricultural commodities like wheat.

Michael Denton, Mark Robson and Alex Wittenberg are partners in the Global Risk & Trading Practice

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ABOUT OLIVER WYMAN

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