HOW THE GROCERY INDUSTRY IS USING FUTURES MARKETS

By Suzanne Cosgrove Sep 24, 2013

Changes in the availability of food brought on commodity market volatility in 2008 and 2009, and its implications are continuing to filter down to the grocery business.

The big run-up in 2008 and the subsequent crash in 2009, “caught a lot of people off guard,” says Steven Windh, vice president, supply chain, at Windsor Foods, a frozen foods manufacturing company headquartered in Houston, Texas.

“A commodity focus before that was not a priority,” but 2009 changed that standpoint, Windh says. “We moved near those same levels in 2011 and 2012,” and those companies that had a good

commodity management function in place were able to manage that risk better than those that did not."

Commodities shifted from the "absolute dead markets of the 90s" to a "massive increase in volatility that continues to this day," says Curt Goulding, senior vice president of global sales at FCStone.

That burst of volatility, and the interest in risk management that followed, was a force behind INTL FCStone's Grocery Outlook Conference in Chicago last year. A second Grocery Outlook is slated for Las Vegas on Sept. 26, 2013.

"We felt we needed to get the message out that, 'You don't have to be a price taker,'" Goulding says. "There are things you can do to manage these prices, to flatten them out a little bit and help you compete ... or just to maintain your margins, instead of having your margins completely squashed."

Most major food companies, like Kraft or Hormel, already use futures, but Goulding says FC Stone began to look at the food companies' customers as well. Ultimately, it's getting down to the regional distribution points, he says.

FC Stone generally helps clients with $5 million or more in aggregate risk. That usually means regional grocery chains with 150 or more stores, or distribution warehouses, Goulding says.

“Many of the regional chains are doing their own house brands,” and have to deal with things like green coffee prices, roasting and distribution, Goulding notes. “Even dealing with distribution, there is a lot to do to cap costs.”

Hedging and Staying Competitive

Linda Whiteside, is a category manager at Kansas City, Kansas-based Associated Wholesale Grocers (AWG), with responsibility for AWG’s private-label dairy and frozen food products, including cheese, ice cream and frozen bread. Those brands include Best Choice, Always Save, Superior Selections, Clearly Organic and IGA.

AWG is a member-owned coop serving more than 2,900 stores in 24 states with total sales representing $8 billion. While AWG is a distributor, not a producer, Whiteside said it still is her job to maintain pricing integrity.

“Our concern is controlling our costs,” Whiteside says. AWG’s members are independently owned stores, and are both small and large, in small towns and larger cities.

“Our goal is to keep them very competitive in their markets,” she adds.

To control costs, AWG works with vendors to ensure price points,

Whiteside says. For example, she works with cheese vendors to hedge their needs over a certain period of time, generally via CME Group Class III milk futures or cheese futures contracts.

"Where we can, we will work with vendors to establish a hedge that they might choose," she says, "but every vendor is different, and we work with multiple vendors to insure consistent supply."

Demand for Produce

A shift in demand for certain food products also is part of the food chain equation.

Ronnie De La Cruz, principal at Monterey, Calif.-based De La Cruz Consulting says demand for fresh produce has increased dramatically in recent years, not just in terms of variety in the United States, but also in terms of overall consumption globally in regions where there is a rising middle class.

That has spurred changes in the purchasing dynamic for the fresh produce industry, he says. Many purchasing organizations and other companies involved in the produce business have moved toward constant or fixed prices via contracts, De La Cruz says, and are seeking to remove volatility. Grower and producers have responded by developing new planting, cultivation and harvesting processes that lend

themselves to producing crops for the contract purchase market.

Companies will contract with suppliers for 70 percent to 90 percent of their total anticipated volume, based on the types of crops and geographic regions of supply, De La Cruz says. Once guaranteed, the supplier must deliver at the set price and volume, even if the crop runs short. In the event of a shortfall, the supplier has to buy product on the open market to make up the difference, regardless of the price.

International demand and investment in commodities as an asset class also have become bigger factors in the mix, De La Cruz says.

Even the produce industry is asking if China or other countries are going to be an exporter of certain products to Japan or Europe, possibly taking market share from U.S. producers, he adds.

A Rise in Volatility

At Windsor Foods, Windh says his company, which has 10 plants across seven states, has been "fairly active in commodity management."

A privately held North America-based company, Windsor had net revenues for the 12 months ended June 30, 2012 of approximately $800 million. The company has market leadership in Italian,

Mexican, and Asian prepared foods, as well as pizza toppings.

With such a broad scope of products, Windsor "is very commodity intensive," says Windh. The company uses pork, beef, poultry and grains – such as corn for its tortillas and tacos. Soy also is used as a protein source and oil.

Whiteside has been with Associated Wholesale Grocers for 17 years. "I've seen more volatility, especially in commodity prices over the last five to seven years," she says, "which makes it all the more reason we have to study them more closely."

She attributes that rise in volatility to shifting market conditions: changes in weather patterns, fuel prices and the U.S. economy in general. "Customers are more price conscious, and stocking up is not always something they can afford to do" when fuel costs also are competing for their dollars, she adds.

Windh predicts "we're coming into a period of a little more stability" for commodities, but adds that energy risk has been challenging.

"We're looking at some controls from an energy standpoint," Windh says. "That's actually a point of a little more focus for us."

He says he's bullish on natural gas, which the company uses as a basic

heat source and for food preparation at its plants.

On the transportation side, Windh says he is actively hedging his fuel needs with NYMEX heating oil futures, and with over-the-counter contracts in which the settlement is tied to the Department of Energy's reported price for U.S. No. 2 diesel fuel.

The company ships frozen foods to Canada and Mexico as well as to the United States. Vegetable products also are shipped from the Pacific Northwest down to Windsor's various production plants.

Normally, that shipping is done by trucks, but some intermodal transportation systems also are used, Windh says.

"The first thing we probably look at [with clients] is their energy consumption," Goulding says. We look at it from the point of view of running the stores and distribution warehouses, "because energy has had the greatest volatility over the last couple years," he says.

Traditionally, when grocery clients talk about risk management, they think of insurance risk like floods, tornadoes, health insurance risk prevention, he notes. "This is different. It's a different mindset" for futures markets.

Depending on the client, "We pick out two to three items to start with,"

such as eggs, flour, energy costs, "that are volatile and are hedgeable, then we bring in the futures/derivatives that make the most sense" for their risk management program.

Goulding says this client group maintains a "medium- to long-term focus," but needs to be aware of what is going on. We don't really worry about any one day's move."

It's not unusual in the grocery business to use forward contracts with vendors, he says. But producers don't necessarily hold all the contracts and vendors have to hedge their risks as well.

Going forward, "guys who are successful" have to manage risk, Windh says. "There is a greater reliance in the supply chain now, particularly in purchasing, on guys being in the mode of managing the overall market risk, as opposed to just getting a good deal.

"There is a lot more money at risk if you don't manage the markets. ... You just can't bid this stuff out," Windh says, referring to the practice of soliciting food suppliers for bids. "The successful buyer in today's market is significantly more astute."

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