JOHNSTON CARMICHAEL

Annual Food & Drink Report

Review of 2022

Introduction

This is the second year we have delivered this survey and it has been encouraging to see both a doubling in the number of responses, as well as a wider geographical spread of responses from across the UK. This is important – whilst the UK is relatively small on a global scale, the diversity of the rural, urban and island locations of businesses across the country bring a range of different considerations.

The last 12 months has been an extraordinarily challenging year for all food & drink manufacturers who have endured raw material price surges, and difficult price negotiations with UK multiples.

Businesses have invested in automation to drive efficiencies in the manufacturing process, which improves margins and is undoubtedly part of the route to profitability, as well as assisting the ongoing challenge with labour resources. It was heartening to also read that a very significant majority of survey respondents are continuing to invest in new product development, viewing innovation as a route to success.

Increasing costs and consumer prices, (the latter the fastest for 15 years) has impacted on business performance and consumer spending. As business leaders look ahead, perhaps with less financial manoeuvrability than in years past, it is more important than ever to understand the funding options available and the implications for their business.

Brexit and global economics have resulted in more expensive raw material import costs and more complex EU export processes; however, Brexit has also created new opportunities for UK food & drink producers selling in the UK, as some EU businesses have struggled to sell their produce in the UK.

This report digs deeper into the key findings from the survey and is enhanced with commentary from our excellent team, who work closely with the food & drink sector throughout the UK. It also includes insight from our supporting partners; HSBC, Food & Drink Federation, Levercliff and Scotland Food & Drink. We all know the challenges that the sector is facing, but as well as shining a light on these, we also want to celebrate success. There was one comment in the responses that jumped out at me, and perhaps the best way to describe the strategy to adopt going into 2023 – "tighten our belts".

Adam Hardie
Partner and Head of Food & Drink,
Johnston Carmichael

Survey Participants

2/3
responses from Scotland

1/3
responses from rest of UK

42%
came from a widespread of food growers, processors, wholesalers, distributors and independent retailers

60%
of respondents were £0-£10m turnover size

40%
of respondents were £10m-£100m+ turnover

58%
were from food & drink manufacturers

58%
businesses had 0-49 employees

22%
businesses had 50-249 employees

20%
businesses had 250+ employees

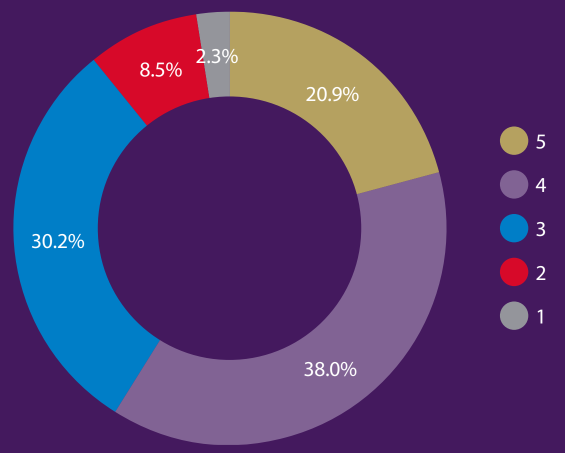
Your Business Health

Our View
Adam Hardie,
Partner and Head of Food & Drink
adam.hardie@jcca.co.uk

"After a year of unprecedented turbulence, it is heartening to read that the majority of our food & drink business leader survey respondents – 59% – were either optimistic or very optimistic about the future growth of their businesses. It also found that 30% were neither optimistic or very optimistic, and only 11% were not positive about the next 12 months. Despite challenges in the sector, it is worth remembering that food & drink is the largest element of UK manufacturing, and investment continues at a strong level in the industry."

Growth optimism

On a scale of 1-5, with 5 being the highest, how optimistic are you about the future growth of your business?



Large businesses are far more optimistic about future growth than small businesses.

Digging into the numbers: Less confidence exists within smaller businesses (0-49 employees), with only 46% scoring four or five, compared to 92% of businesses with over 250 staff, scoring either 4 or 5.

Challenges facing our industry

So, what of the challenges facing our industry in 2023? Inflation hit a 40-year historic high, and food & drink manufacturing has been disproportionally hit compared to other industries, with input costs driven up at a phenomenal level.

Lazy Day Foods, who took part in our survey, summarised the issues faced by so many manufacturers as they listed their top 3 challenges: labour shortages, supply chain challenges, and increasing costs – ingredients, packaging, labour and, of course, energy.

This has created an unprecedented year in 2022 for food & drink manufacturers, who are required to negotiate price increases with multiple supermarkets. It is perhaps even tougher for some small producers who supply independents.

Whilst many anticipated the negative impact of Brexit on imports and exports, another unintended consequence of leaving the EU has undoubtedly been the limited availability and retention of labour through 2022 – and it is difficult to see an early, or easy, solution.

Post-Brexit, the UK Government is resolute on limiting immigration, whilst training new people is a slow process to fill gaps. Wages have increased to keep up with inflation and that is a necessary requirement to ensure attractiveness to a diminished labour pool. Some businesses are turning to innovative solutions to try and resolve these issues, such as hiring minibuses to drive employees to and from their place of work.

"Our top three challenges have been labour, supply chain, and increasing costs."

Emer Bustard, Founder, Lazy Day Foods

"Our top challenges are costs, uncertainty of consumer spending and the impact on sales. Plus the integration of the Wild Beer company team and business, into Curious Brewery."

Mark Crowther, Chairman, Curious Brewery

Drinks' producers and Deposit Return Scheme (DRS)

If you are a drinks business anywhere in the UK or overseas, with produce on the market in Scotland, then Deposit Return Scheme (DRS) is likely to be your number one issue at this moment in time.

Small brewers will be disproportionately hit but this legislation will impact every drinks producer who will have the labelling and the associated cash flow burden of a 20p deposit on every drinks container they place on the market, whether that is plastic, aluminium, or glass, and water, soft drinks, wine, beer or spirits. Scotland will launch the scheme in August 2023, whilst the rest of the UK has a target date of October 2025.

The timing of DRS implementation in Scotland is very challenging, drinks producers are still in recovery post the close down of hospitality through the COVID-19 pandemic period. This legislation will be extremely costly for business, whilst also dealing with spiralling energy bills.

Robust and bigger businesses will adapt to these changes, but smaller companies will be disproportionately hit and any transition assistance that can be offered would be a bonus.

Small drinks producers affect only 1% of all litter, and believe they are unfairly disadvantaged by these plans. Recycling is of course the right thing to do, but we need to make DRS work, given businesses and jobs are at risk. Johnston Carmichael recently wrote a technical paper to HM Treasury outlining our view that deposits under the DRS are outside the scope of VAT. This position appears to have been endorsed in part by HMT in a February'23 update. However, inconsistencies and complexities around DRS and VAT still remain which we will continue to seek clarity on.

"It's been a turbulent year for our brewery. Inflation has caused delays in customer and supplier payments, all our costs have increased, and that's before the implementation of DRS which will inevitably hit small businesses the hardest. However, despite these challenges we've diversified with a new taproom and product lines, and have made concerted efforts to keep our impact on the environment to a minimum, by transitioning to electric vehicles & a staff bike scheme, and only using local ingredients and suppliers."

Fiona MacEachern, Managing Director, Loch Lomond Brewery

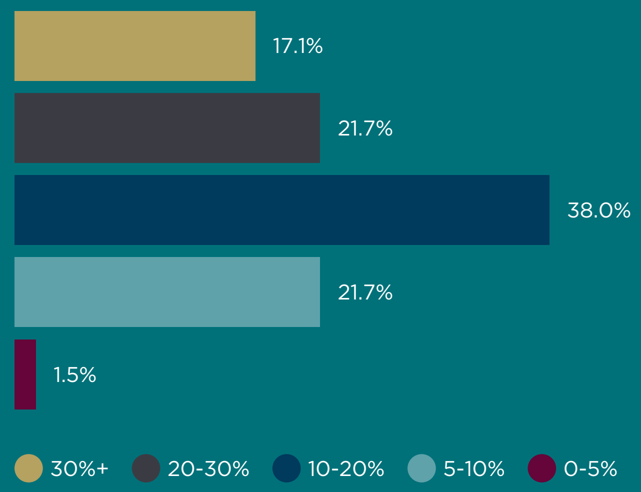
Performance and Profitability

Your comments

Strategies to mitigate cost increases were hugely varied across the different businesses, indicating there is no one size fits all approach. Some consistent comments included investigating supply chain options, reducing waste, investing in new and efficient equipment, and looking at all possible cost efficiencies. Other points include introducing price rises to customers, reducing their available ranges, negotiating with suppliers, as well as having an increasing focus on automation and whether restructuring is necessary within their business. Whilst these points demonstrate the extent of the challenges, they do show the incredible resilience of businesses and business owners.

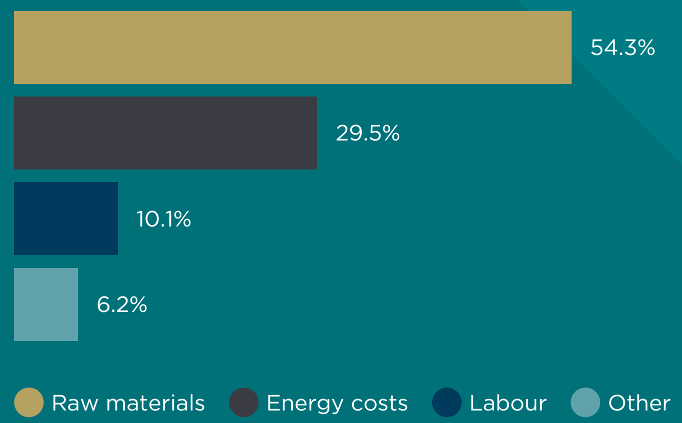
Cost base increase

How much did your overall cost base increase during 2022?



Largest cost increases

Where have you seen the largest % cost increases?



"With an extensive portfolio of over 300 convenience retailers, the impact of inflation has been continuous. Optimising our supply chain to drive efficiencies and lower costs has been critical. Given price fluctuations, one particular solution has been the increased use of technology via electronic shelf edge labels which allows us to quickly and easily update prices whenever necessary."

Jim Hepburn, Non Executive Chairman, CJ Lang & Son – Spar Scotland

Our View
Graham Marjoribanks,
Partner and Head of Audit
graham.marjoribanks@jcca.co.uk

Our survey discovered that cost base increases were evident across all sizes of businesses in the food & drink sector, which is worth noting, despite not being a huge surprise in the current climate. Most respondents reported 10-20% increases. This held true over all categories except for the 'under £1m turnover' category, which saw a relatively even proportion of businesses reporting increases in the 5-10%, and up to 30%, ranges.

These findings suggest that larger companies, while clearly not immune to cost pressures, are able to adopt more strategies to avoid larger increases. These strategies include use of forward contracts, and investing in automation and operational efficiencies, such as avoiding expensive agency labour by strengthening production forecasting to reduce seasonal spikes.

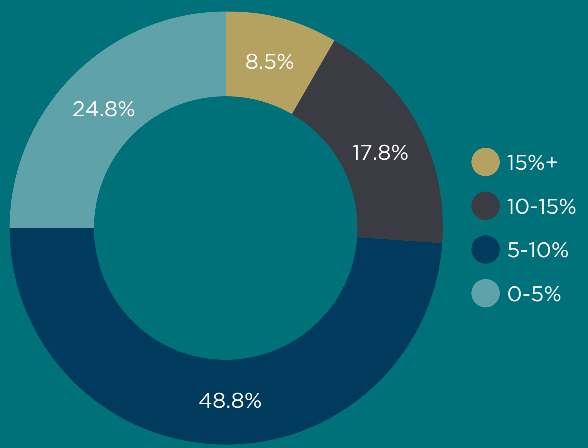
On average, the majority of price increases (54%) relate to raw materials which may be surprising given rising energy prices. However, half of all businesses fixed their energy costs for 2023. Interestingly, this significantly varied by size of business, with only 35% of businesses with a turnover of more than £100m fixing energy costs, compared to 60% of those with turnover under £1m.

Only 10% reported labour as the largest percentage cost increase, however this may change as we get further into 2023. In other sections of the survey, it is clear there are challenges in recruiting and retaining talent across the sector. With high inflation, businesses may have to consider higher wages in order to support staff and retain them within the business.

Cost increases were passed onto customers, with an average of 2.4 price increases during 2022. Almost half of all respondents increased prices by 5-10%, which resulted in lower profitability for these companies. A quarter of respondents increased prices by more than 10%, as well as a similar number in the 0%-5% category.

It remains to be seen whether these businesses are delaying further price increases until they have better visibility on longer-term cost base increases. Overall, less than a third of respondents reported a high degree of confidence in their ability to negotiate with customers to protect their margins in 2023. Interestingly, the most confident group were businesses in the £1m-£10m turnover range; 60% were either confident or very confident in their ability to negotiate and pass on cost increases in the year ahead.

Price increases
On average how much was the increase?



"All businesses are dealing with the same macro-economic challenges with inflation and labour shortages. We have firstly looked to optimise our own business, whether through stronger management of promotional activity or investment in capital expenditure to gain greater efficiencies, but where no other mitigation has been achievable it has therefore been necessary to pass on market-wide cost increases to customers. This gives us the comfort that we are only passing on the necessary cost increases and our customers are not paying for our internal inefficiencies."

Mark Steven, Managing Director, Highland Spring Group

Innovation and Automation

Our View
Stewart Pennington,
Business Advisory Partner
stewart.pennington@jcca.co.uk

Our survey results show a clear distinction in the ability to invest in growth driving activities based on the size and scale of the business.

The overall averages show that only 16% of companies had made no investment in new product development (NPD), whilst 34% of companies had no investment in automation.

Digging into the results further, we can see that the very largest companies were able to invest in innovation and automation last year and were able to devote time to exploring the associated tax benefits. Smaller entities in the food & drink sector appear to have been constrained by the economic conditions, with a third (32%) not investing anything in new product development, and roughly two thirds (60%) not investing anything in automation.

The latter clearly indicates that automation is correlated to scale, but it is a concern if the SME cohort are restricted in their ability to innovate and develop products, and access the tax benefits that come with such activities.

It would appear that survival in the face of a barrage of headwinds, particularly in respect of supply chains, has been the priority for SMEs whilst larger businesses have been able to leverage their financial strength to consolidate and grow.

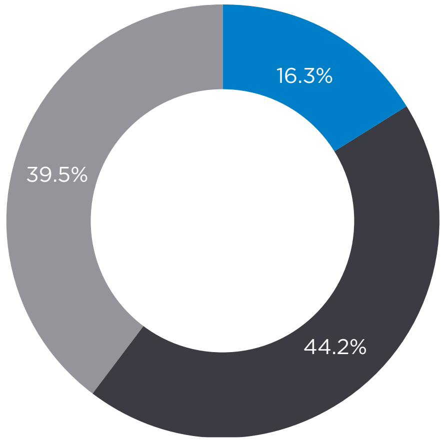
A clear message from respondents is that a more cohesive approach to encouraging, and not hindering, productivity growth at the macro-economic level would be welcome.

"Nairn's have invested significantly in automation in recent years which allows us to produce quicker and more efficiently, but also a better quality of product, which is just as important to us."

Martyn Gray, Managing Director, Nairn's

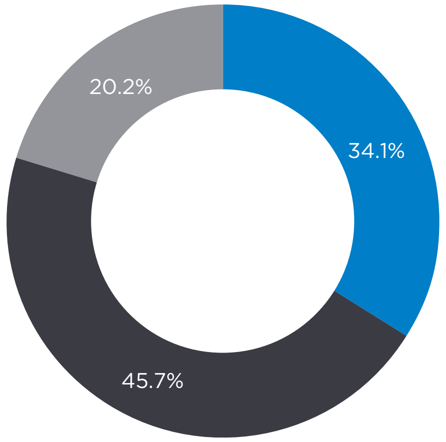
Innovation investment

How significantly have you invested in innovation or new product development in the last 12 months?



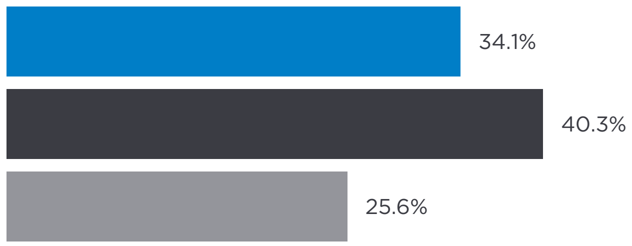
Automation investment

How significantly have you invested in automation with an objective to reduce your costs and/or improve productivity in the last 12 months?



Constraints on investment

Have your plans for investment in new product development and automation been constrained due to lack of resource?



"In the past 12 months we've gone from starting up to a business operating in multiple markets, turning over in excess of £100k per month. We've invested heavily in NPD to achieve this: a team of some of the world's best bartenders came together to create a production site (a bespoke manufacturing facility) and bring our novel proposition of premixed cocktails onto the market. As a start-up we've had limited resource so the priority was product & recipe development, however as we scale we will invest in automation. Our advisers (JC!) have guided us on benefiting from reliefs like R&D and Capital Allowances which has been vital in a resource constrained year one."

Ben Iravani, Co-founder, Whitebox Drinks

Whitebox Cocktails

Funding for Growth

Our View
Alan Hamilton,
Corporate Finance Partner
alan.hamilton@jcca.co.uk

The varied trading challenges across the sector, which the survey identifies, emphasise the importance for management teams in undertaking robust financial forecasting and scenario planning. Cost pressures and the potential impact on demand from the fall in real incomes have the potential to impact cash flows, as will growth opportunities where companies will typically have to invest in working capital and business operations.

Many businesses will continue to thrive in this vital sector but there will need to be consideration given on how best to handle the pressure from rising costs, whether companies believe demand for their product will hold up in 2023, and if there is potential for supply disruption to impact their business this year.

Some challenges are more pertinent for food & drink firms, given the sector is labour and energy intensive, and businesses may be reliant on discretionary customer spend.

Management teams should be planning ahead and considering fully the funding implications for their business and, where relevant, identifying potential funding options to support the business strategy. A well thought out business plan should address both the risks and opportunities the company will face in the months ahead.

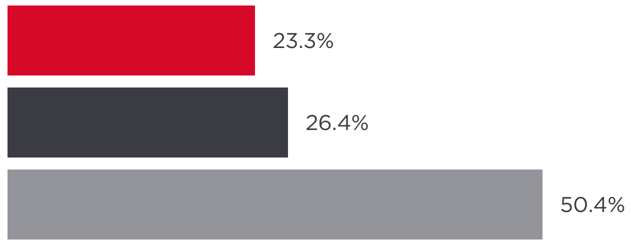
"Financial forecasting, cash management, and funding is crucial to helping us make the best, most informed decisions for the growth and development of the business. It helps us set goals/targets that are both realistic and achievable"

Willie Bremner, Head of Finance, Eden Mill

EDEN.MILL
ST ANDREWS

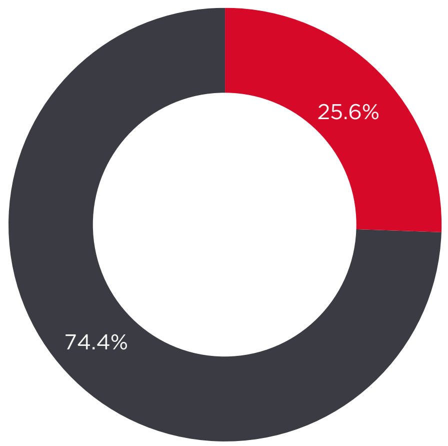
Financial forecasting

Do you have robust financial forecasting tools and processes that allow you to undertake scenario planning, assess opportunities and risk, make strategic decisions and identify funding requirements?



Funding requirements

Have you identified the level of funding which can be met from cash resources of your business, versus what is potentially required from external sources?



Smaller businesses have less robust systems in place for scenario planning and assessing funding. In terms of financial forecasting tools and processes, when we drill into the data more, 35% of £100m+ turnover businesses said they had tools and processes fully in place, this number rose to 44% in the £10m-£100m category, but it dropped to 21% for the £1m-10m and 13% for the £O-£1m.

Imports and Exports

Your comments

All aspects of the imports and exports section were dominated by very familiar issues; Brexit, war in Europe and a post-covid world, still dominating the discussion. There was a focus on all aspects associated with these issues; supply chain, raw materials, exporting processes, red-tape and inflation. But there was also mention of a changing of consumer habits off the back of these global issues. Some very specifically commented on the approach taken to Covid in China and how the delayed nature of it versus the rest of the world, has caused several challenges around doing business in the region.

Our View

Alex Nicholson,
Partner and Head of VAT & Indirect Tax
alex.nicholson@jcca.co.uk

The responses we received for this year's survey reaffirm the fact that 2022 has been another challenging year for imports and exports.

Few may have predicted that after the uncertainty around Brexit, and trading with the EU whilst no longer being part of it, that 2021 could indeed to some extent have been the calm before a storm.

Operators in the sector continue to grapple with the increasingly complex Customs Duty rules and bureaucracy, as well as frustrating ambiguity on when previously announced changes will eventually take place. In this regard, both the phasing out of the HMRC's Customs Handling of Import and Export Freight (CHIEF) customs declaration system and the introduction of additional licensing and controls for many animal and plant products were delayed – pushing the upheaval into 2023.

Geopolitical turbulence has played its part too. The war in Ukraine has led to raw material shortages, price increases and increased energy costs that almost all of our respondents cited as the biggest challenge to trade across 2022.

They were equally unanimous in their condemnation of HMRC's perceived lack of support to businesses involved in cross border trade from a VAT and Duty perspective. Just 5% awarded scores in the top two categories, whilst over 65% chose the lowest two, with comments reflecting views that HMRC should be doing more in this area. This situation will no doubt have been particularly frustrating to the nearly 60% of business who were targeting international markets, yet had fewer than 50 employees, where this assistance would have been vital. Many businesses feel equally little support has been provided in respect of the looming Deposit Return Scheme, with its many VAT complexities.

In response to these challenges, businesses called urgently for measures to be introduced to change the direction of recent travel and to make importing and exporting easier – from reduced paperwork, a revised "deal" and in some cases, re-joining the EU.

Whatever 2023 brings, it appears likely that Indirect Taxes will remain at the forefront of international traders' minds, with their management and mitigation almost mission critical.

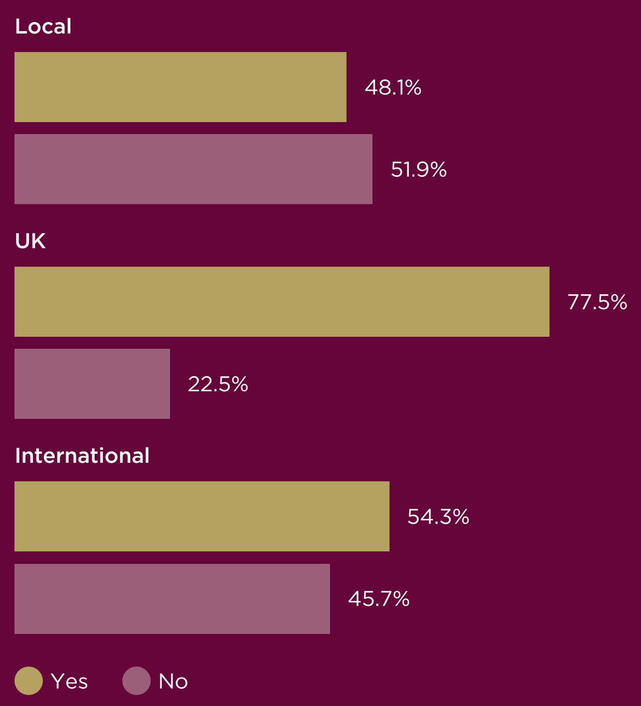
"International exports of our scotch whisky was impacted in 2022, more specifically the delayed impact of COVID in China slowed our performance in that region."

John Laurie, Managing Director, Glenturret Ltd

The GLENTURRET

Target market

Do you currently target your product?



"The UK requires approximately 1.5 million people to fill jobs after the impact of Brexit. It is time for all MPs from all parties to work together for the good and future of the United Kingdom."

Peter Bruce, Chief Executive Officer, Entier

UK and overseas the biggest target markets

The percentage of businesses targeting UK and International markets was similar across all business sizes, with smaller businesses also targeting local markets more than the larger ones.

Transition to Net Zero

Expert opinion
HSBC

WRAP, the climate change non-governmental organisation, estimated recently that the whole UK food chain was accountable for an estimated 35% of the total carbon emissions from this country. To put that in perspective, the whole food chain constitutes around 10% of GDP.

This is all made more concerning when we consider that latest statistics tell us that as a nation we waste some 9.5 million tonnes of food per annum – two-thirds of which is estimated to be edible at the time of disposal. The challenge is obvious, and the opportunity is becoming clearer.

With the focus firmly on the UK food chain and the targets being set by Government to reach net zero, it was obviously going to be intriguing in terms of how the sector reacted to the post-pandemic demand and the Ukraine war-induced spike in inflation which has been with us for the past 18 months or so.

Some food businesses have naturally decided that focussing on the here and now – even business survival – is their priority, whilst a surprising number, as demonstrated in this survey, have used the current trading circumstances to deliver their sustainability plans and ambitions at a faster pace than may have seemed likely only a few months back.

They are finding that this action delivers two results: one for the planet, and one towards securing and retaining margins and their bottom line – with green energy for instance, aiding current cashflow from a trading point of view. Other common current investments include updating refrigeration facilities and reassessing end of line robotic packing and automatic storage to assist with labour sourcing and costs.

The survey also highlights the need for collaboration along the supply chain to ensure the benefits of sustainability and efficient resource management are apparent for all, helping to build further trust and confidence at a time when double digit inflationary cost pressures place strain at every level of production and processing. This matters to a sector so usually accustomed to single digit margins.

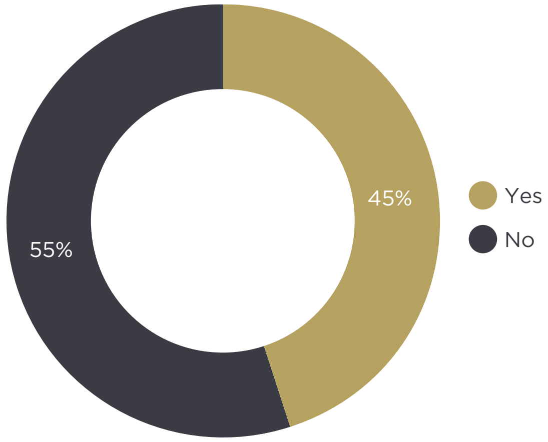
HSBC UK want to play our part in helping businesses achieve their sustainability goals alongside their wider ambitions for the businesses. We want to assist the food chain to build on its excellent heritage and very strong current international standing.

Allan Wilkinson
Head of Agrifoods, HSBC UK Bank plc

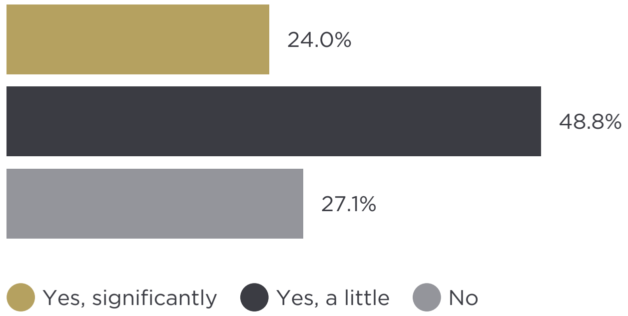
"Holyrood's hopes for Net Zero scope 1, is to look at utilising the distillery waste to fuel our lorries and using the boiler energy to heat the brand home. Scope 2 is difficult at the moment, we looked at solar panels on the warehouse roofs but insurance was very difficult. For scope 3, the team adhere to our 4 e's of spend: efficiency, effectiveness, economy and environmental, which serves them well in terms of their impact on the environment and their commercial impact to the business."

Huw Wright, Head of Finance, Holyrood Distillery

Sustainability strategy
Do you have an existing sustainability strategy?



Impact of inflation
Have your sustainability plans been negatively impacted by the rising cost of inflation?



Sustainability is high on the agenda

The businesses with an existing sustainability strategy varies significantly depending on size. In general, the larger the business, the greater the importance placed on a sustainability strategy:

£0-1m turnover
25% said yes to having a strategy

£1-10m turnover
42% said yes

£10m-100m turnover
50% said yes

£100m+ turnover
88% said yes

Investment in Brand

Expert opinion
Levercliff

Investing in brands even in the current economic climate is a key focus for food and drink companies irrespective of size, with 78% of respondents citing it as important. What is interesting to note is that the focus around investment is more about improving profit margins and securing price increases, (30% combined) than it is promoting the brand itself (10%). Looking at the results through a binary lens it seems as if most of the energy in 'brand investment' is directed at optimising all things relating to physical availability at the expense of any meaningful investment in mental availability. This is undoubtedly a reflection of the times we are in and the inflationary pressures facing the sector.

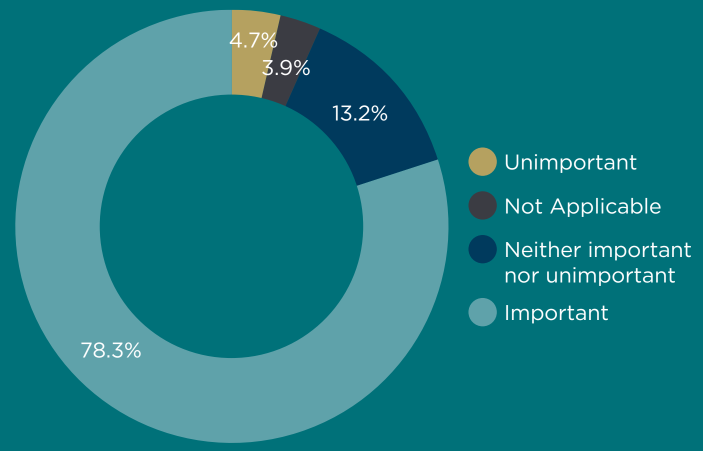
It was also perhaps unsurprising to see the number of companies looking to Governments to either (a) step in and support businesses or (b) complete their bonfire of regulations and delay the introduction of new ones, such as DRS for the drinks sector.

What was somewhat surprising from the results was not the fact that companies are looking to improve their profit margins but the fact that so few of them were looking at the levers they could control e.g. pack optimization (4%) and ingredients (6%) alongside negotiating better trade terms. We know from our own work that 50% of consumers would accept a smaller pack size in order to keep prices down.

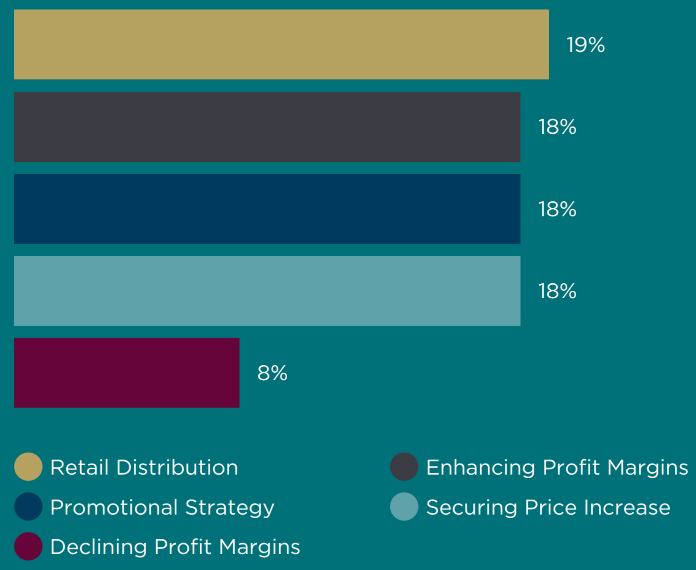
Clodagh Sherrard
Director at Levercliff

Brand is king
The vast majority of businesses agree that a strong brand is key to their business success, with most businesses looking to invest the same level of marketing or more in their brand in 2023. The most crucial areas of focus for brand development are enhancing profit margins, reviewing promotional strategy, retail distribution and securing a price increase.

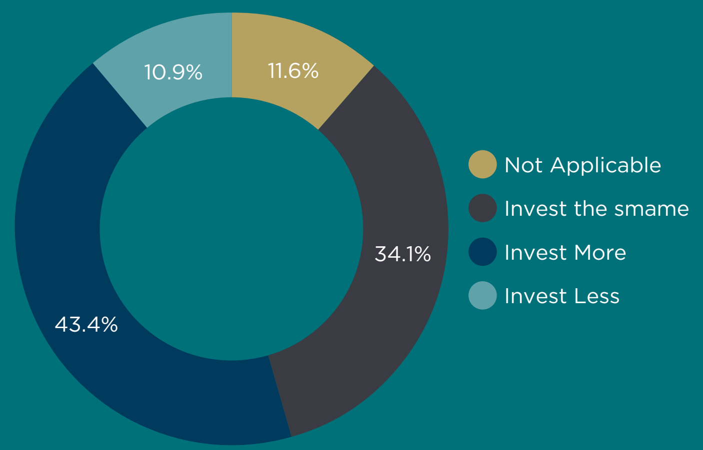
Brand importance
In the current economic climate, how important is investment in your brand?



Top brand focus
Which of the following is your most important area of focus in the short term for brand development? Top 5 listed below



Brand investment changes
In the current economic climate, how do you expect your investment in brand building to change in 2023 versus 2022?



"Brands are caught between a rock and hard place in the current economic environment. With the pricing challenges faced by manufacturers, it is increasingly difficult to fund both above the line investment for the longer-term health of the brand, and short term tactical below the line promotions to drive volumes and maintain/drive year on year sales. Consumers will say they want prices kept as low as possible, which would suggest a policy of EDLP (Everyday low price), however, it is clear from category data that they are increasingly less brand loyal, and shop more promiscuously attracted by offers."

Mark Gowdy. Commercial Director, White's Oats

Spotlight on Scotland

It was great to see so many businesses in Scotland responding to this year's survey to help us get a sense of how businesses are feeling about their current trading environment and prospects for the future. It is less positive to see just how challenging the situation is right now for food and drink businesses in Scotland, large and small.

"As a Scottish owned family ingredient manufacturer, the price of raw materials and energy has impacted our business over the past 12 months, both with consumer buying behaviours and of course suppliers. In this challenging environment it is vital that membership bodies- both at a local, national, and with a voice in Government – prioritise initiatives and legislation that will alleviate the availability of capital and labour, and support advances in innovation."

Alastair Macphie, Chairman, Macphie UK

Expert opinion
Scotland Food & Drink

It's clear that the cost base has risen for all. In around 42% of cases, costs are up by more than 20%. Compare that to the average price increase where 74% of respondents have raised prices by less than 10%, and it is easy to see the squeeze, which is cause for concern.

Fewer than half of respondents have fixed energy prices for the next 12 months, so will be facing an increase in the coming year.

Across Scotland, businesses are experiencing challenges of employee recruitment and retention, cost inflation and supply chain plus the dampening of consumer demand. Additional challenges north of the border include the pressure of forthcoming regulation Deposit Return Scheme and the proposed Alcohol Advertising Restrictions for drinks businesses.

There were some positives in the survey. 56% of respondents said they were optimistic about the future growth potential of their business and 78% have invested in innovation or NPD in the past 12 months. 73% of businesses are seeking more trade with the rest of the UK and 54% are targeting international markets.

We know that things are difficult right now, but businesses in this industry are resilient, innovative and solutions focussed. I believe that by working together we can overcome the current challenges and achieve a bright future.

John Davidson
Deputy Chief Executive,
Scotland Food & Drink

Conclusion

Hopefully the results and insights provided in the report have been relevant to you, and perhaps have brought some comfort to you and your business knowing that your challenges are felt across the sector.

Despite the obvious challenges, it is encouraging to see so many businesses re-working their strategies and showing incredible resilience. The UK food & drink industry is huge, indeed, it is the largest part of UK manufacturing. It is successful and has great potential for export and future growth. It does, however, need continued support, greater flexibility, and more positive intervention from Government areas outlined in the report.

This is our second food & drink report, following our nationwide survey, and once again it has proven to be a hugely insightful experience for us as a firm. The relationships we build with our clients is key to the way we work and the more we can get under the skin of the sector and to truly understand the reality of the challenges, the more we can develop and shape our services. Thank you to our friends at Scotland Food & Drink, Food & Drink Federation, Levercliff and HSBC for their support and their insights into the survey. And thank you to all the individuals that took time to complete the survey and engage so positively.

Let's not forget that 58% of businesses said they were optimistic about the future. Does 2023 become the year that the tide starts to turn in favour of the food & drink sector?

Adam Hardie,
Head of Food & Drink,
Johnston Carmichael

Where sharp minds meet

Aberdeen
01224 212222

Dundee
01382 411790

Edinburgh
0131 220 2203

Elgin
01343 547492

Forfar
01307 465565

Fraserburgh
01346 518165

Glasgow
0141 222 5800

Huntly
01466 794148

Inverness
01463 796200

Inverurie
01467 621475

London
0203 7144 350

Perth
01738 634001

Stirling
01786 459900

JOHNSTON CARMICHAEL