

Natural & Organic Outlook

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Nutrition Business Journal
Strategic Information for the Nutrition Industry

U.S. Shoppers Still Loading Up on Organics Despite Rising Sticker Shock

Increased prices at the supermarket driven by high fuel costs, surging demand and a supply crunch that is hitting meat and dairy farmers hardest

Amid unprecedented costs for commodities and fuel, organic food prices spiked as much as 25% on retail shelves between April 2007 and April 2008, reflecting a supply crunch that is hitting companies in nearly every food category and at every point in the distribution chain. “This is, without a doubt, the most dynamic and volatile period I’ve seen in my 25 years in the business,” said Gary Hirshberg, CEO of Londonderry, New Hampshire-based *Stonyfield Farm*, a leading organic yogurt producer. “There has been nothing even close to this in comparison, and I don’t see it ameliorating anytime soon.”

The weakening dollar has compounded the problem, making it harder for some companies to import goods. And many fear that the recently passed Farm Bill—with its large subsidies for growing corn for ethanol—will sway more conventional farmers to pursue biofuels rather than convert to organic. Some farmers have already begun to jump the organic ship, worsening the supply crunch as they switch to a conventional farming industry that is looking more lucrative than it has in years. The good news is that, contrary to what some in the industry have feared, consumers do not yet appear to be turning away from organic because of sticker shock. In fact, many small natural grocers are enjoying a boost in customer visits.

“The results have been mixed,” said Scott Van Winkle, managing director of Boston-based **Canaccord Adams**. “We certainly hear reports from traditional supermarkets that the growth isn’t as

strong as it has been due to high price. But we have actually seen accelerated growth in the independent retailer segment.” Why? “We see a nesting trend,” Adams explained. “Consumers are more interested in shopping at their local retailer or farmers market due to recent food scares and food safety issues.”

The Numbers

Although organic food prices have certainly grown in the past year, conventional food prices in most categories have shot up far more. According to the U.S. Bureau of Labor Statistics Consumer Price Index (which tracks all food, organic or not), food prices on the whole have shot up 6.9% so far in 2008, following a 4.9% increase in 2007. Conventional milk jumped 13.5% from April 2007 to April 2008. Bread was up 14.1% and eggs were up a whopping 27%.

Meanwhile, according to market research firm **SPINS**, prices for organic bread and baked goods were up 1.4% between April 2007 and April 2008 in natural food stores and 3.8% in conventional food stores. Organic egg prices were up 2.1% in natural food stores and 7.4% in conventional food stores. Organic milk was up 1.9% in natural food stores and down 2.1% in conventional food stores (presumably reflecting a temporary glut of organic milk that resulted from more farmers transitioning to organic last year, before more stringent federal requirements kicked in). Organic products that saw more significant boosts include baby food (up 6% in natural foods stores and 24.5% in conventional stores) and carbonated and functional beverages (6.9% in natural and 13.1% in mass).

While some of those percentages may seem small, when tacked on top of already premium prices, they mean a lot. And conventional stores, which tend to have more middlemen involved, have in most categories seen more significant price increases than natural food stores, according to SPINS data. Organic baby food, for example, on average cost \$1.41 per unit at conventional grocers at the

end of April, compared to \$1.24 in natural stores. Organic frozen entrees, pizza and convenience food ran, on average, \$3.87 in the conventional channel and \$3.71 in natural, SPINS data shows.

More moderate retail price hikes in some organic categories also reflect the decision of manufacturers to absorb some of their cost increases, rather than run the risk of scaring away consumers with higher prices.

“Margins are being squeezed pretty much at every level right now,” said Lara Christenson, director of natural products research for SPINS, which tracks 73 categories of organic food, and does not track private-label brands. Christenson pointed out that retail prices were creeping up in 2006 and 2007, but those boosts were mostly related to increased demand. Now that a host of supply-side issues have begun to kick in, she believes prices will continue to move upward. “I would say in the next year you are going to see a lot more announcements of price increases.”

A Confluence of Problems

A complex network of factors—which includes a growing middle class in China and India that wants to eat milk, meat and eggs—is fueling shortages of rice, corn, soybeans and other commodities around the world. Skyrocketing fuel prices and the recent unprecedented flooding of prime farmland in the Midwestern United States are making what was a serious problem that much more dire. “We have never seen a convergence of all these things at once before,” said Michael Funk, CEO of Dayville, Connecticut-based organic wholesale giant **United Natural Foods Inc.** (UNFI).

The ethanol boom—which has convinced many farmers to forgo organic conversion in favor of growing corn for biofuel production—is another major engine driving up food prices. “We are locked into a war for acres with a very heavily subsidized conventional crop,” noted Lynn Clarkson, president of Cerro

2007-2008 U.S. Organic Pricing Trends by Product Category

Product	Nat.YA '07	YTD Apr '08	% Increase	FDM YA '07	FDM YTD '08	% Increase
Baby Food	\$1.17	\$1.24	6.0%	\$1.11	\$1.38	24.3%
Bread & Baked Goods	\$3.48	\$3.53	1.4%	\$3.40	\$3.53	3.8%
Functional & RTD Bevs	\$1.97	\$2.11	7.1%	\$1.50	\$1.70	13.3%
Candy & Indiv. Snacks	\$2.08	\$2.07	-0.5%	\$1.85	\$2.04	10.3%
Cheese & Cheese Alt.	\$3.78	\$3.85	1.9%	\$4.01	\$4.12	2.7%
Meat, Fish & Poultry	\$5.75	\$5.81	1.0%	\$6.37	\$6.21	-2.5%
Milk, Half & Half, Cream	\$3.35	\$3.41	1.8%	\$3.77	\$3.69	-2.1%
Oils	\$9.75	\$9.68	-0.7%	\$6.50	\$5.84	-10.2%
Packaged Fresh Produce	\$3.60	\$3.76	4.4%	\$3.03	\$3.12	3.0%
Sweeteners	\$5.98	\$6.13	2.5%	\$3.86	\$4.04	4.7%
Soup	\$2.51	\$2.56	2.0%	\$2.71	\$2.80	3.3%
Eggs	\$3.26	\$3.33	2.1%	\$3.27	\$3.51	7.3%
Yogurt & Kefir	\$1.55	\$1.59	2.6%	\$1.67	\$1.74	4.2%

Source: SPINSscan Conventional & Natural Supermarkets >\$2MM. SC Powered by Nielsen. ScanTrack. Nat= Natural/Specialty Retail. FDM= Food, Drug, Mass-Market Retail. YA= Year Ago prices gathered on 4/21/07. YTD= Year to Date, 52 weeks ending 4/19/08.

Gordo, Illinois-based **Clarkson Grain Co.**, which supplies organic feed to meat and dairy farmers and food-grade corn, beans, wheat and oats to manufacturers. Over the years, due to increased demand from consumers and a lagging supply of organic crops from farmers, Clarkson said he has had to raise his prices from \$10.50 for a bushel of feed soybeans to \$30.

Clarkson said he's seen conventional row crop farmers pull their land out of "transition"—a three-year period in which they must cleanse their land before they can switch to organic—and stick with conventional farming instead. He's also seen chicken and dairy farmers turn away from organic, "because they cannot afford the cost of the raw materials," Clarkson added.

According to the **U.S. Department of Agriculture** (USDA), the United States had 4.1 million acres of organic land in 2005 (the most recent data available), three times what it had eight years earlier. Data for 2006 and 2007 is not yet available, but Clarkson and others predict that growth in organic conversion has slowed substantially.

Ultimately, Clarkson said he predicts that large manufacturing companies will address the supply crunch themselves by buying up farm land so they can grow their own organic feed and seed. Such efforts could be supported by the Farm

Bill, which—along with biofuel subsidies—provides \$100 million in funding over a five-year period to research and promote organic farming.

Manufacturers Feeling the Sting

Squeezed between price hikes from suppliers and a price-sensitive public, manufacturers of organic products are probably feeling the most pain from rising organic food prices. "I have now had my eighth cost increase to pay for milk from my farmers," said *Stonyfield Farm's* Hirshberg. Despite facing so many price hikes on the supply side, Hirshberg said *Stonyfield Farm* (which is owned by **Group Danone**) has raised its prices for consumers only twice. "I cannot pass on all those increases to my customers."

In February, a small cup of *Stonyfield Farm* organic yogurt was running more than a dollar (compared to 69 cents for conventional) and a large container was approaching \$4—a price that Hirshberg says is "not sustainable." In March, the company was hit with yet another price hike from suppliers, which amounted to an unexpected expense of \$5 million. *Stonyfield* "ate" the increase, Hirshberg said, and further slashed its marketing budget and increased its efforts to manage its delivery system more effectively. "If you want to survive as a company, being the first to hit consumers with a cost increase is not exactly a good solution," Hirshberg said. "Brand and company

survival depends on finding other ways to save money." As a result, the company's margins are being pressured by increased supply costs, Hirshberg added.

Founded in 1983, *Stonyfield* has grown from a seven-cow farming school to a company with \$320 million in annual sales and an average annual growth rate of 24%. (Growth this year will be more like 18%, Hirshberg said.) Since the company's inception, consumer demand for organic food has exploded—Americans spent \$18.9 billion on organic food in 2007 alone, according to *Nutrition Business Journal* research—but organic still represents a mere 3.3% of the overall food market. Hirshberg's concern is that mounting retail prices could put a damper on future company and industry growth.

Stonyfield is far from the only company feeling the sting of rising supply costs. John Carroll, CEO of **The Hain Celestial Group**, calls the current organic supply crunch "unprecedented."

After years of dealing with annual cost increases of roughly 2%, Hain has seen its cost of doing business go up 8%-9% in the past year, Carroll said. These increases have hit nearly every food category. Carroll estimates that Hain has passed on about half of these cost increases to consumers via price hikes. The other half the company has absorbed.

Hain is working hard to protect its margins by cutting operational costs in other areas, Carroll said. “We’ve done everything from re-engineer processes to set up a new warehousing system to be closer to our customers.” Hain generated net sales of \$264.6 million during the third quarter of this year, an 11.2% increase over the prior year’s third quarter sales. It also maintained a 30.7% margin (versus 30.5% last year) for its top brands, including *Arrowhead Mills* and *Garden of Eatin’*. But, unfortunately for consumers, Carroll said that Hain will likely bump up its prices again this year. As a result, “margin expansion will certainly become more problematic,” he added.

UNFI’s Funk agreed that manufacturers seem to be feeling the brunt of the current price situation. He noted that meat, egg and dairy companies have been the hardest hit. “Anyone who is having to buy feed to give to their animals—[those companies] are seeing the biggest cost increases,” said Funk, whose company supplies more than 60,000 products to 17,000 customers nationwide.

Unlike many manufacturers, UNFI is weathering the storm quite well—in part because wholesalers like UNFI have fixed (albeit smaller) margins and tend to pass cost increases, including fuel surcharges, on to retailers. For the third quarter of this year, UNFI grew its earnings 21% to \$887 million, compared to the same period last year. The company’s gross margin finished the quarter at 18.7%. Sales through independent natural food stores were up 11%, while sales through UNFI’s “supernatural channel” (which includes **Whole Foods Market** and the former Wild Oats stores) were up 8.1%. All of this is helping Funk to feel bullish about the state of the natural and organic industry. “When you have had the economy in the tank, and your sales have continued to strengthen, it’s easy to be optimistic,” he added.

Sticker Shock?

Of course, the million-dollar question remains: Have sticker-shocked consumers started to turn away from organics? The consensus: Not yet. Instead, consumers seem to be sacrificing an item or

two (perhaps skipping that organic iced tea in the cooler case at the check-out line), or turning to cheaper, store-brand options.

UNFI’s Funk said that, so far, consumers at independent retailers appear to be shelling out the extra cash for organics, rather than changing their buying habits. At conventional stores, he predicted that consumers could ultimately do more “trading down” to private-label organic brands that aren’t quite as pricey. But to date, he hasn’t seen evidence that much of that is happening either.

Mike Gilliland, CEO of **Sunflower Farmers Markets**—a fast-growing chain of natural and organic grocery stores in Colorado, Arizona, New Mexico, Nevada and Utah (and soon to be Texas)—said rising food prices seem to be driving more consumers into his stores, which are positioned as the lower-price alternative to “glitzy” stores such as Whole Foods. Although the chain has had to raise its product prices 3%-5%, customer counts and sales continue to grow. “The current economic climate has helped us,” Gilliland said. “A lot of our new customers are people who used to shop at Whole Foods but who are not feeling as flush as they once were.”

Like many retailers, Sunflower Farmers Market is aggressively growing its private-label line with the goal of adding 100 private-label SKUs every year for the next three years. Sunflower shoppers, Gilliland said, do seem to be increasingly choosing the store’s private label over pricier branded products. “In every category, our private-label offering is the leader,” he said.

Other independent retailers are experiencing similar growth. “Our customer counts are way up from last year,” said Kemper Isely, co-president of **Natural Grocers by Vitamin Cottage**, a family-owned chain in Colorado. Isely said the average customer ticket hasn’t quite kept up with inflation. But, overall, the down economy may have actually been good for business. “People have to buy food, and they tend to cut back on eating at restaurants” during lean economic times, he said.

Of course, everyone is wondering how rising organic prices are affecting high-end retailers. *NBJ* asked Whole Foods, which declined to comment. In May, the natural foods giant saw its stock plummet to a five-year low, amid its acquisition of **Wild Oats Market**, a sagging economy and increased competition from conventional supermarket chains that now offer organic. Whole Foods Global Grocery Coordinator Perry Abbenante told the *New York Times* in April that sales were strong and customer counts were up. However, he said: “\$6.99 for a gallon of milk is pushing it. We have to be very careful about not pricing organics out of the market.”

According to SPINS data, most organic food categories are still growing robustly, but just not as fast as in the past. For instance, despite a 3.8% increase in price at conventional food stores, sales of organic bread and baked goods grew 14.3% from April 2007 to April 2008 (from April 2006 to April 2007, they grew 16.9%). On the other hand, organic egg sales at conventional food stores were up nearly 24% from April 2007 to April 2008 (versus a sales spike of 16% the previous year).

Higher prices (not necessarily more units sold) have definitely contributed to some of those higher revenue figures, SPINS’s Christenson said, but experts across the board say they see consumer interest in organics remaining strong.

Eighty percent of organics sales are driven by a small, very committed consumer base, and these shoppers aren’t likely to overhaul their eating habits to save a few pennies, Christenson added. “Where you are really going to see more variation is in that other 20%,” she said. “Whether they will stop buying altogether, or will switch to private label, is really uncertain right now.”

Hirshberg, of *Stonyfield Farms*, said that in an era when more and more science is pointing to the health benefits of eating right, he’s optimistic. “Consumers are, as a rule, recognizing that what we are is what we eat,” he said. “They want to eat more healthfully and that will always, ultimately, lead to organics.” 