Prospects for Quebec's Food and Beverage Industry

Dairy Industry

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Questions ? Comments ?
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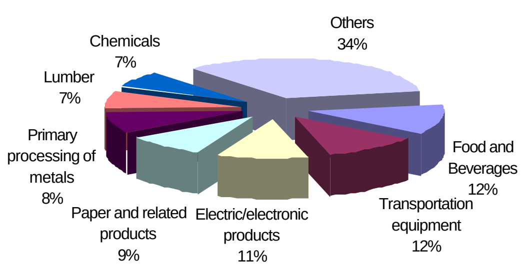
Canada

1.0 QUEBEC FOOD AND BEVERAGE INDUSTRY

Largest Manufacturing Industry in Quebec

Agri-food activities, from harvesting resources to delivering foods and beverages to consumers, constitute one of the cornerstones of the Quebec economy, accounting for close to 12% of all jobs, or over 400,000, and injecting close to $12.4 billion each year into the Quebec economy, or 8% of the Gross Domestic Product (GDP).

Shipments Value of Quebec Manufcaturing Industry[1], by sector, 1999



1 Own manufacturing
Source: Institut de la statistique du Québec

With shipments[1] of $13.8 billion in 1999, the food and beverage industry[2] was the province's largest manufacturing sector, representing 12% of all processing in Quebec. Food and beverage processing alone generates $5 billion each year in added value and 55,700 direct jobs in the economy. The Quebec industry accounts for 25% of food and beverage jobs in Canada and 25% of value added. [3]

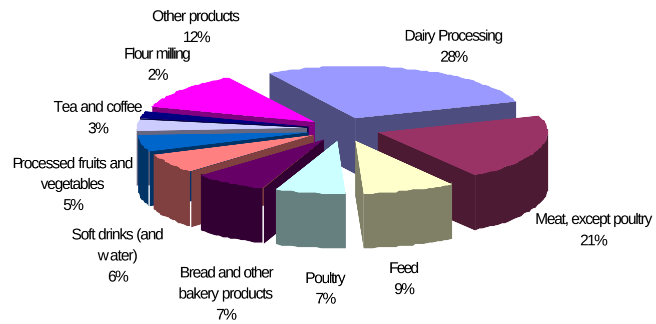
Quebec's geographic location, at the centre of a market of 100 million consumers living within 1,000 km, gives the industry here a tremendous advantage. The Quebec industry also benefits from an excellent multimodal transportation infrastructure that allows it to supply not just the large urban centres of the northeast but international markets, as well.

1.1 MANUFACTURING SHIPMENTS

A Booming, Diversified Industry

The Quebec food and beverage industry is highly diversified. The dairy industry is the largest sector, accounting for 28% of all food and beverage manufacturing shipments in Quebec for 1999. The red meat industry, chiefly pork, ranks second, with 21% of shipments, followed by animal feeds, with 9%.

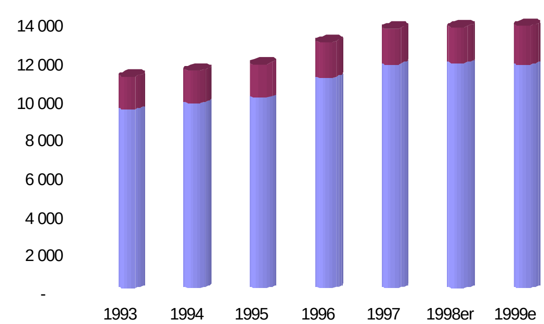
Shipments by Food and Beverage Industry Sector[1], 1999e



[1]Fish processing not included. Own manufacturing.
Total: $13,5 billion
Source: Statistisc Canada

The food and beverage industry has enjoyed strong growth over the last three years, largely due to the great strides made by the confectionery/chocolate and soft drink sectors. Between 1998 and 1999, total growth amounted to more than $570 million.

Changes in the Quebec Food and Beverage Industrie's Manufacturing Production



Total: $13,7 billion
Source: Institut de la statistique du Québec

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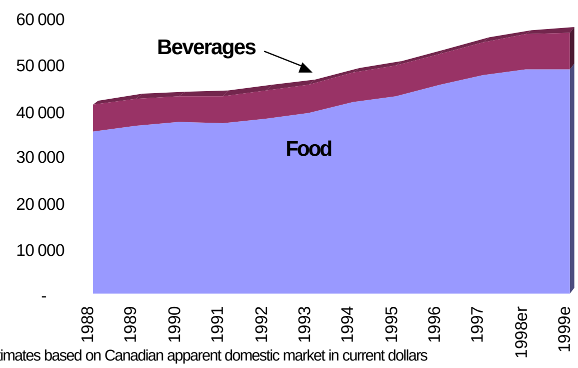
[1] If other receipts such as sales of goods purchased and resold as is are counted, the value of shipments and other food and beverage revenue in Quebec adds up to $15.1 billion.
[2] Or $13.5 billion, excluding fish processing ($300 million).
[3] Based on 1996 figures.

1.2 SUPPLY AND DEMAND[4]

The food and beverage industry has certainly benefited from the growth in the Canadian market[5]. Overall demand increased by 18% between 1994 and 1999, for a mean annual growth of 3.7%. Sectors in which growth in demand was particularly strong over the period are wines (11.2%), confectionery and chocolate (6.9%), flour milling (6.6%), vegetable oils (6%) and poultry products (6%). Between 1994 and 1999, the Canadian beverage market saw higher mean annual growth than the food market (4.9% as opposed to 3.5%).

Change in Canadian Food and Beverage Market ($M)

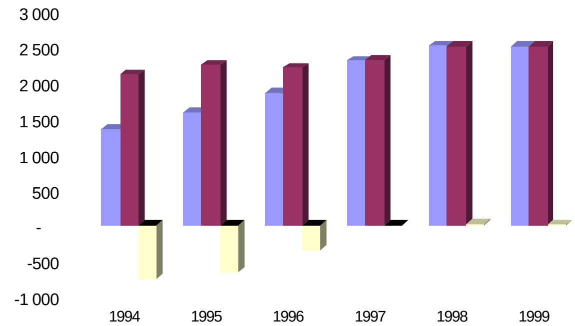


Estimates based on Canadian apparent domestic market in current dollars (shipments+imports-imports).
Source: Statistics Canada

The industry benefited most of all from a 86% growth in exports between 1994 and 1999. Despite the unfavourable economic conditions of 1997 and 1998, Quebec agri-food exports held steady at about $2.5 billion. The weaker growth in imports (18%) enabled Quebec to improve its agri-food balance of trade appreciably over this period, achieving a slight surplus in 1998 and 1999.

The United States is still the main trading partner of the Quebec food and beverage industry, accounting for 71% of sales, or $1.8 billion. Quebec purchases are more diversified, however, thus making its supplies less dependent on the value of the U.S. dollar. This contrasts with Canada as a whole, for which the United States accounts for almost two thirds of all agri-food trade (imports and exports). Quebec has therefore enjoyed a greater advantage from the weakening of the euro than has the rest of Canada.

Change in Qubec Agri-Food Trade,[1] 1994-99 ($M)

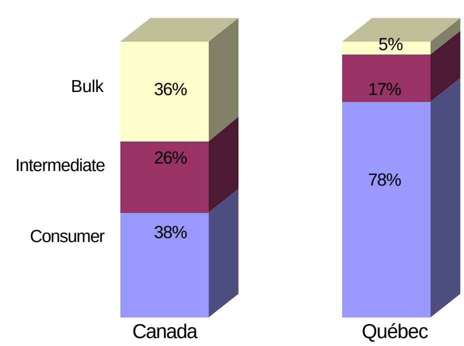


1 Not including fishery products
Source: Statistics Canada

Among Quebec's other trading partners, the European Union ranks second as a destination for our agri-food products, receiving 7.5% of trade, while Japan is the destination of 4.6% of our exports. It is worth noting that despite the North American Free Trade Agreement (NAFTA), Quebec exports only $11.5 million worth of agri-food products to Mexico, amounting to a mere 2% of Canadian exports to that country.

Quebec also diverges from the Canadian average in terms of the type of exported products: 36% of agri-food products exported by Quebec are consumer products, in contrast with the Canadian mean of 5%.

Degree of processing of Exported Products, 1995-99 mean



Source: Statistics Canada

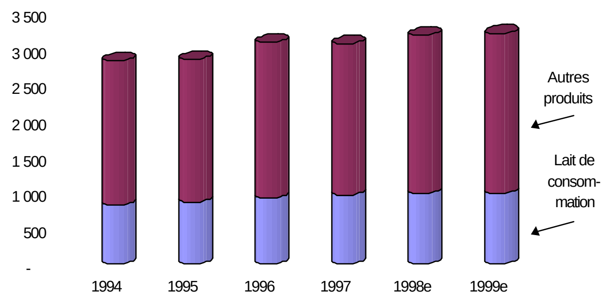
[4] Data on agri-food demand and trade exclude fish and seafood.
[5] Based on apparent domestic market (shipments + imports - exports).

2.0 DAIRY INDUSTRY

2.1 MANUFACTURING OUTPUT

With $3.2 billion in manufacturing shipments in 1999, 70% consisting of processed products, the dairy product sector is the largest agri-food processing sector in Quebec. In 1997, it accounted for 15% of all employment in the food and beverage industry, a total of 8,110 jobs, and 18% of added value, or $878 million.

Changes in Manufacturong Shipments of Quebec Dairy Processing Industry ($M)



Note: Shipments own manufacturing; does not include variations in stocks
Source: Statistics Canada

The value of dairy industry manufacturing shipments has fluctuated over the last 10 years between a high of $3.25 billion in 1990 and 1991 and a low of $2.8 billion in 1994. This fluctuation has affected the fluid milk and processing milk industries alike.

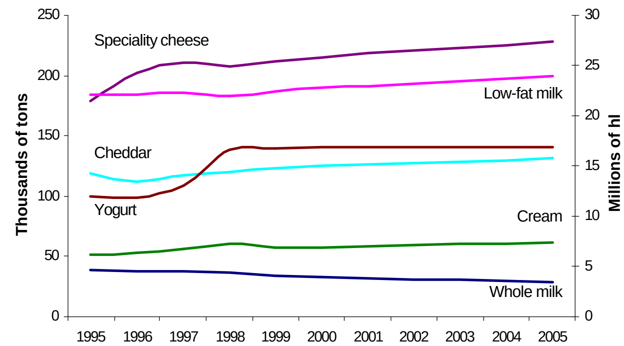
2.2 SUPPLY AND DEMAND

A Stagnating Domestic Market

Consumer trends in the industry indicate a mature market in which the growth of demand in certain categories (yogurt, speciality cheeses, low-fat milk) is offset by a drop in other categories (fluid milk, butter, ice cream). Consumers are switching from their traditional purchases to products that have high value added or that better meet their needs. Overall demand is not really rising except as a function of population growth. Consumers are looking for practical and low-fat products with good nutritional value.

Sales forecasts for the 1999–2005 period[6] indicate an annual decline of 2.4% for regular milk and mean growth of 1.1% for low-fat milk. There should be a 1.1% increase in Canadian demand for cheddar and 1.2% for speciality cheeses. Demand for ice cream should continue to decline at an annual rate of 2.1%. Interestingly, butter demand may rise by 1.3%, which would be a reversal of the historical trend. In this scenario, the price of milk paid by processors should rise less slowly over the period, because animal feed costs will decline and the rise in prices will be below the historical mean. In a supply-management context, the strategy of the primary sector should be based on flexible shipments to plants in response to signals from the market.

Changes in the Canadian Dairy Processing Market



Source: AAFC, Medium Term Policy Baseline, January 2000

Expertise and New Products

Meeting consumer needs better is one of the industry's constant concerns. Market segmentation and competition through product differentiation and quality are gradually replacing price-based competition. The Quebec industry has enviable expertise, coupled with modern techniques and processes. This expertise in product development and innovation is a definite asset for the future development of the industry. Through major research and development efforts, companies hope to come up with product lines that are value added and improve profit margins so that they can stay ahead of the competition, even in markets in which where there is little or no product differentiation. Some examples of successful innovations are the extended shelf life milks, Lactantia *Purfiltre* and Natrel *Ultra'Milk*, which have been on the market for five years now, Natrel's line of milk beverages called *Moostache*, launched in May 1998, as well as the fancy yogurt-type cheeses developed by Danone and Ultima Foods (including calcium-enriched *Caresse*, launched in 1998).

The range of specialty cheeses on the market is constantly expanding to include new categories,

[6] Source: AAFC. Medium Term Policy Baseline, January 2000.

and is gaining in both quality and popularity. Locally produced or imported, made from cow's milk, goat's milk or ewe's milk—consumers want more!

The dairy industry is also in a paradoxical situation, as consumers demand low fat content in everyday products but seem totally unconcerned about the fat content of products consumed only occasionally. Specialty cheeses benefit amply from this paradox, as does Häagen-Dazs ice cream. Liberty is even more daring, with its line of *Méditerranée* yogurt containing 8% fat. Similarly, Unilever is promoting its Breyers ice creams, which combine ice cream and chocolate bars. Quite a treat!

Exports: A Market in Flux

Canadian exports of dairy products have shot up in recent years. From a stable level of about $200 M in the first half of the 1990s, they rose to $367 M in 1999, a drop of 12% from the preceding year's total of $418 M. For the Canadian industry as a whole, exports amount to approximately 5% of manufacturing shipments. The chief exports are cheeses (36%), powdered milk (24%) and evaporated/condensed milk (10%). The main countries or regions importing them are the U.S., with 41%, by value, followed by the European Union with 14% and Central America and the West Indies with 13%. Quebec accounts for 60% of Canadian exports. Changes that must be made to the Canadian system of supplying plants for the export of dairy products affected Canadian exports in 1999 and 2000 (a 28% drop in the first six months of 2000).

Dairy producers and processors had set up the Optional Export Program (OEP) to promote the continuous supply of milk to processors for products intended for export. In the fall of 1999, in response to a complaint filed by the United States and New Zealand, the appeal body of the World Trade Organization (WTO), ruled that the Canadian dairy industry's export milk pricing system constitutes an export subsidy and does not comply with Canada's commitments under the WTO Agreement on Agriculture.

The direct impact of this ruling has been a major reduction in the amount of milk available to processors for export, as the authorized limits negotiated during the Uruguay Round were reached in February 2000 (milk year starting August 1). The Lactel Group, which derived close to one third of its sales from exports, found itself confronted with an insoluble business and financial problem and was forced to put itself up for sale. (Agropur management confirmed the acquisition of Lactel's assets on October 11).

In exports, the Canadian industry is developing a new approach that will be in line with Canada's commitments. Faced with a mature domestic market and operating in a supply management context where the only opportunities for growth lie in value-added products, processing enterprises must penetrate international markets, which offer the best opportunities for industry growth through the export of cheese and dairy ingredients, among other products. The absence of such a growth policy will limit companies to operating in the Canadian market, at a time when they face increased competition at home and abroad.

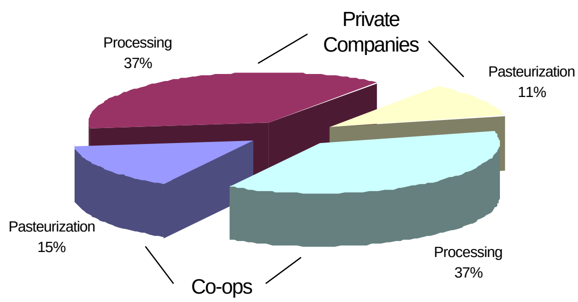
2.3 STRUCTURE/INVESTMENTS

The dairy industry has been through a period of major restructuring in recent years. This now seems to be over, for the most part, as the number of establishments rose from 71 to 74 between 1994 and 1997. Yet these figures disguise the true situation by category, as the number of establishments active in the fluid milk sector declined from 25 to 21 over the same period and the number of processing establishments went up from 46 to 53. This shows the major consolidation going on in the fluid milk market in Quebec, as in the rest of Canada. In the case of processing companies, the new establishments are the result of investments in the manufacturing of fine cheeses.

The industry is dominated by big businesses, whether co-operatives like Agropur and the Lactel Group or private companies like the Saputo Group, Danone and Parmalat. Intense competition both on the Canadian market and abroad is forcing companies to adopt various approaches to increase their competitiveness.

In 1993, for instance, Agropur entered into a strategic alliance with Dairyworld to create Ultima Foods, which is responsible for all operations related to the production of yogurt and fresh desserts for both co-ops. Natrel, a division of Agropur, decided to expand its fluid milk operations by purchasing establishments in Ontario (1997) and British Columbia (1998). Agropur also acquired an Alberta cheese plant in 1998. The most recent transaction (October 2000) involves the acquisition of some of the assets of the Lactel Group, bringing Agropur's total sales to approximately $1.8 billion.

Milk Allocation to Plant
1999



Does not include shipments under OEP
Source: Fédération des producteurs de lait du Québec

The most striking example of a successful expansion strategy is undoubtedly that of Saputo Inc. (formerly the Saputo Group). After going public, the company undertook a huge program of acquisitions across North America.[7] Its preferred targets were firms concentrating on speciality cheeses, mainly mozzarella. Saputo has since become one of the biggest milk processors in North America and the fifth-largest cheesemaker in the U.S. This example highlights the factors required to ensure successful growth in the current competitive environment: easy access to capital, rationalization or grouping of operations, adoption of modern technologies and development of value-added products.

In a mature domestic market, the greatest challenge faced by the Quebec dairy processor is to increase revenue and earn satisfactory profit margins. Growth through merger and acquisition is one of the best ways to establish big companies that operate internationally and are able to compete successfully on a variety of markets. In the dairy industry, whether in Quebec or elsewhere in Canada, growth through acquisition has traditionally been the means chosen to increase market share and profit from the associated supplies. This method of growth is becoming increasingly difficult, given the limited number of companies that can be acquired. The latest deal (February 2000), the purchase of the Cayer-JCB Group by Saputo Inc., is a good example. Saputo's expertise in acquisitions means that new companies are assimilated smoothly. Nonproductive costs are soon eliminated and efforts are focussed on making the most of productive assets and seeking operational efficiency at low cost. Agropur is now federally chartered and its objective for the near future is to become a pan-Canadian co-operative. Despite the quality of their products and infrastructures, many Quebec companies have poor financial performance that limits their capacity to invest, whether it be to increase market share or to conduct research and development.

The changes that the industry is undergoing have given rise to a significant number of investment projects. Natrel invested $17.4 million in its St. Laurent plant in order to launch its new milk beverage *Moostache* in the summer of 1998. In May 2000, Agropur announced the second phase of a project to modernize and expand its Oka cheese production facility at a total cost of $5 million, while in June 1999 Ultima Foods announced an investment of $25 million over three years to expand its Granby plant and increase the plant's output capacity by 50%. The Lactel Group began producing cheese at its brand-new facility in Chambord, which is estimated to have cost over $30 million. Finally, in 1999, Fromagerie Bergeron, which specializes in Gouda, finished making a $1 million investment to increase the production capacity of its St. Antoine de Tilly plant by 50%.

Existing companies have the capacity to meet the needs of the Canadian domestic market effectively and so there is little room for new foreign investors. Only an organization that can offer new technical know-how or that is seeking to develop new market niches could establish itself successfully and be profitable for the Canadian industry.

2.4 CHALLENGES/OPPORTUNITIES

In its dealings with the primary sector, the industry will have to focus on its competitiveness internationally, particularly with respect to the cost and availability of raw materials. Moreover, continued investment by producers in the purchase of ever more expensive quotas raises questions about the long-term impact of financing and the transferability of the enterprises. And finally, the industry will have to implement a new formula that is in line with Canada's commitments and that will enable it to develop a long-term vision and strategy in order to take full advantage of export markets.

A number of other major constraints will help shape the future of the industry. The maturity of demand on the domestic market will force companies to develop new products more actively. It is interesting to note

[7] Stella Foods (U.S.) in 1997, Avonmore Cheese and Waterford Food Products (U.S.), as well as Riverside Cheese and Butter Inc. and Bari Cheese Ltd. (Canada) in 1998, Cayer-JCB Group (Canada) in 2000.

that growth has been the strongest in sectors where the most effort has gone into developing new products, such as yogurts, milk beverages and frozen desserts. Changes in consumer habits will also give rise to new constraints. More frequent dining out and changes in the types of products consumed will also require companies to renew the range of products they offer, especially to provide better service to the hotels, restaurants and institutions (HRI) market. The increasing share taken by private labels and the growing power of food distributors will force Quebec companies to make more of an effort to understand and meet the specific needs of retailers with respect to the products requested, their costs and the logistics of supply.

The development of dairy products that respond to health concerns also represents a major challenge, especially considering consumer expectations and the complexity and/or vagueness of the regulatory framework. For the dairy industry, the use of whey is one of the most promising channels to explore. The fact that Quebec is home to a number of research centres, including the Institut de recherche sur les aliments fonctionnels et les nutraceutiques [Functional Foods and Nutraceuticals Research Institute, or IRAFN], with which the Centre de recherches en sciences et technologie du lait [Dairy Science and Technology Research Centre, or STELA] is associated, helps foster innovation in this area. In addition, since its establishment in 1995, Novalait Inc. has demonstrated an ability to focus scientific and technological research for the dairy industry according to the benefits that will accrue to the industry. These efforts could favour the development and sale of dairy ingredients intended expressly for the production of functional foods. Some observers are even claiming that this area of interest could be a major factor in the development of new products over the next five years.

Relentless competition from soft drink, beverage and juice makers will continue to influence the buying habits of younger target groups of consumers to the detriment of dairy products. New competing products that are attractive to the industry in more than one respect are soy-based products, especially soy beverages. They have many characteristics in common with dairy products and are often found in refrigerated counters next to milk and other dairy beverages. Several dairy processors have already incorporated them into their range of products, including Parmalat and Dairyworld in Canada, and the U.S. industry leaders Dean Foods and Suiza Foods. Of the new market niches worth exploring, organic products and soy-based products deserve special attention. Dairy products are the largest, fastest-growing sector of the organic food industry. In the United States, this category had estimated sales of $300 million in 1998, up 50% over 1997. Estimates point to a potential market of $2 billion in 2005.[8]

The commercial and technological expertise of the Quebec dairy sector is worth developing and fully exploiting. The main challenge for the industry is to open up to the outside, which assumes that it will have access to Canadian supplies for producing exports or that it will manage to establish a presence outside Canada by entering into strategic alliances, purchasing companies or setting up operations abroad.

[8] Source: www.foodonline.com, News & Analysis, April 11, 2000