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SPECIAL EDITION: DEALING WITH HIGHER COMMODITY COSTS

Hedging your bets: What will cost inflation look like in 2012?

By Elaine Watson, 23-Nov-2011

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Raise prices to offset cost inflation, and you can expect to take a volume hit. But if all your rivals are ratcheting up prices too, at least you're all in the same boat, right?

Not necessarily. As the third part of our special edition on handling higher commodity costs reveals, the price/volume equation only generates predictable results if your rivals jump into the boat with you at the same time.

Sara Lee: In some areas rivals have matched our price rises... In others, they haven't...

And one firm that is painfully aware of this is Sara Lee, which has taken *"pricing up quite aggressively"* on the back of higher input costs, only to discover that its competitors have not always followed suit.

"In some areas, we've gradually been followed," said chief executive Marcel Smits last month. "*In other areas, we haven't."*

The net result was that Sara Lee had taken a beating in some categories, and was now bringing some prices down again to claw back market share, he said.

"To the extent that we see competitors not reflecting the same commodity realities that we see, we'll defend our share with surgical precision. We will be taking precise pricing actions to improve volumes and firm up shares in key strategic categories."

But pricing was only one tool in the toolbox, he noted. In the long-term, the only solution to cost inflation has to be producing more genuinely exciting new products: "*We need to bring more innovation to the market."*

J M Smucker: 1% volume dip given recent price hikes isn't bad

Others feel they have weathered the storm rather better, notably J M Smucker's chief executive Richard Smucker, who told analysts last week: *"Being down 1% in volume for the quarter with the size of price increases that we've had to endure… is much better than models would show.*

"*We have a lot of models that say if you take your prices up as much as we've taken* *them… that would have a much more significant impact on volume than it has."*

Meanwhile, *"most commodity costs appear to have peaked in early fall and have retreated modestly in the past couple of months",* he claimed.

Unilever: 'We've come out of this better than we did in 2008'

Unilever's chief financial officer Raoul Jean-Marc Sidney Huet was equally pleased with himself in his latest quarterly earnings call, adding: *"In 2008… the last time prices increased significantly on the back of huge commodity cost inflation, we were not able to maintain volume growth.*

"In 2011, year-to-date, we have now seen positive price and volume growth."

Dean Foods: Rising costs have contributed to volume weakness…

As for dairy, *"higher retail prices have contributed to volume weakness in many of the categories we participate in",* Dean Foods' chief executive Gregg Engles told investors this month.

However, the commodity forecast was *"modestly more favorable over the intermediate term",* he claimed, with US milk production up this year while export demand had fallen off, which had dented the prices of many commodities.

Kraft: We're not out of the woods yet…

Most chief executives have been quick to stress that while some commodity prices have calmed down, they are still higher than they were this time last year.

Earlier this month Kraft chief financial officer David Breaton reminded analysts that while the prices of some "*headline commodities have come down",* the price of *"packaging, energy, transportation and more secondary ingredients"* had not.

"We would still see costs up again next year. [But] *nowhere near the impact we've had this year."*

Hershey: Many commodities are still trading at price levels greater than the two-year average

Hershey's chief executive John Bilbrey also noted that "*while the spot prices of most key commodities have declined from the 2011 peak, many are still trading at price levels greater than the two-year average".*

Chief financial officer, Humberto Alfonso, was equally cautious: "*Even in today's market, you've seen cocoa creep back up as the dollar weakens a bit against the euro."*

Heinz: 10% inflation likely to be 'high water mark' for the year

Craig Owens, chief financial officer at Campbell Soup, is predicting input costs to be in the "*8-10% range*" for the year, while Heinz executive vice president Art Winkleblack expects the 10% inflation on commodities in the last quarter is likely to be the "*high water mark for the year".*

He added: "*Full year market inflation is now expected to be about 7.5%."*

PepsiCo, Kellogg: Hedge, hedge, hedge…

Asked about his predictions last month, Dr Pepper Snapple Group chief financial officer Martin Ellen said: *"Okay, so this year, it's 9%."*

But he was not hedged up to the hilt*: "We are not, nor do we have our intent to be fully hedged nine or 12 months out."*

So how best to handle the volatility?

"Right now, our first quarter, I would call reasonably covered", he said*. "That's more than 50% for key commodities, a little less than Q2, and lesser amounts in Q3 and Q4. Much of that is for the important commodities. For us, that's aluminum and corn. PET rounds out the big three."*

Meanwhile, PepsiCo chief financial officer Hugh Johnston already had the *"full calendar year substantially locked in through our hedging programs"* by the middle of the year, while his counterpart at Kellogg Ronald Dissinger is also hedging his bets.

"*We expect commodity inflation to be slightly less than what we experienced in 2011,"* said Dissinger*. "Right now, we're hedged at about 50% on our commodities for next year. For comparison, I think we were a little over 40% at this time last year."*

Coca-Cola: We're buying now at higher prices even though prices have come off a bit

But there are always risks when you lock in prices, acknowledged Coca-Cola finance chief Gary Fayard when asked last month why input costs would likely be $800m for the year instead of $700m.

"We had some hedge positions and we're buying some more now at higher prices even though prices have come off a little bit. So the $100m, by the way, was not a big surprise to us."