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Grocers, Costs, and Profits: Unraveling Canada's Food Price Inflation Post-COVID

Key Highlights

- **Post-COVID food price inflation** is largely driven by **rising input costs** in raw materials and industrial products, but **grocers' profit margins** have expanded significantly.
- **Input costs**, as measured by the **Raw Materials Price Index (RMPI)** and **Industrial Product Price Index (IPPI)**, are strong contributors to the rise in food prices, but there is generally **a lag** between these costs rising and food prices reflecting those increases.
- **Grocers' margins** have increased substantially since 2020, with some chains expanding margins by over 2 percentage points, **indicating potential profit-driven inflation**.
- The gap between **core inflation** (CPI-Trim and CPI-Median) and **food inflation** shows that food prices are rising much faster than general inflation.
- While rising input costs are undeniably pushing food prices higher, **grocers have also expanded their profit margins significantly post-pandemic**, making food price inflation a mix of **cost-driven** and **profit-driven** factors.

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Canada's grocery sector is under scrutiny as food prices continue to rise. But what's driving this inflation? Is it purely a matter of rising input costs, or are grocers expanding their margins, taking advantage of inflation? The data shows that **food price inflation is driven by both rising input costs and grocers' profit margins**, with a strong correlation between cost increases and the price increases seen at grocery stores.

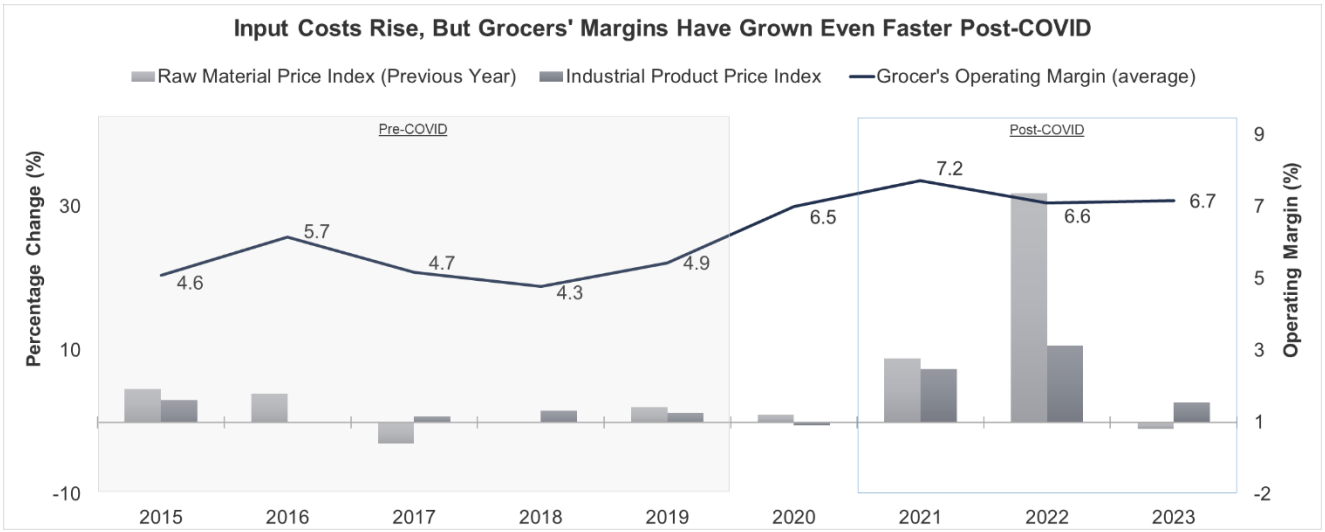
The Twin Engines of Inflation: Input Costs and Margins

Food price inflation generally stems from two main sources:

1. **Cost-Push Inflation**: This occurs when input costs—raw materials and production—rise, forcing companies to increase prices.
2. **Profit-Driven Inflation**: Firms may raise prices beyond what's necessary to cover rising costs, expanding profit margins in the process.

In Canada, recent food price inflation reflects both trends. **Input costs have risen sharply** since 2020, particularly in raw materials and industrial products used in food production. At the same time, **grocers have expanded their margins** significantly, suggesting that price hikes may also reflect profit-driven inflation (Chart 1).

Chart 1 - The Dual Drivers of Food Price Inflation



See Box 1 for additional notes.
Sample of Grocers includes: Loblaws, Metro, Empire, and North West Company.
Source: t6ix Economics calculations, Company financial disclosures, Morningstar Inc.

Grocers' Margins: Significant Post-COVID Expansion

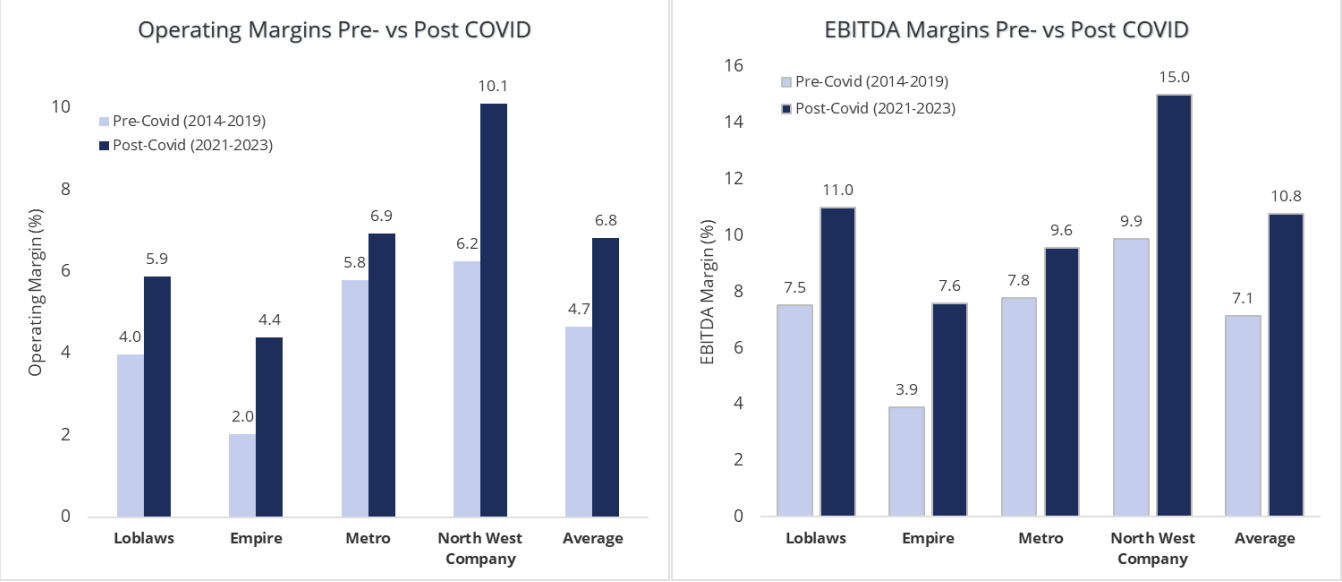
A comparison of **Operating and EBITDA margins** for major grocers—Loblaws, Metro, Empire, and North West Company—reveals that margins have widened since the pandemic. On average, **operating margins** across these four grocers have increased by **2.2 percentage points**, with **EBITDA margins** following a similar upward trajectory.

For example, **Empire Company**, after its challenging acquisition of Safeway Canada in 2013, has seen its margins rebound post-COVID. **Operating margins have grown from 2% to 4.4%**, reflecting both the recovery from past challenges and the ability to capitalize on the inflationary environment (Chart 2).

Similarly, **Metro's margins**, which were already robust, expanded from 5.8% pre-COVID to 6.9% post-COVID, indicating resilience and an ability to leverage its larger footprint following its acquisition of Jean Coutu.

On average, across all four grocers, **EBITDA margins** rose from **8.1% pre-COVID to 10.3% post-COVID**, highlighting an overall trend of expanding profitability in the grocery sector. This indicates that **grocers may be capitalizing on consumer inelasticity**—the fact that food is an essential good that consumers must continue to buy, even as prices rise—to increase their margins.

Chart 2 - Grocers' Margins Expand Significantly Post-COVID



See Box 1 for additional notes.
Source: t6ix Economics calculations, Company financial disclosures, Morningstar Inc.

Box 1

Empire and Metro: Accounting for Distorting Factors

To ensure the accuracy of long-term trends, certain data points have been excluded. **Empire's 2016 results** were distorted by the costly integration of Safeway Canada, which led to significant impairment charges. Including this data would skew the company's long-term margin trends, so it was excluded from the analysis. Similarly, **Metro's 2018 EBITDA margins** were impacted by the acquisition of Jean Coutu, which expanded the company's operations into drug retail, temporarily inflating its margins. Excluding this data ensures that the analysis remains focused on underlying trends in grocery operations.

Input Costs: Cost of Raw Material and Industrial Products as Key Drivers of Food Inflation

The **Raw Materials Price Index (RMPI)** and **Industrial Product Price Index (IPPI)** are key indicators of cost-push inflation. Both have risen significantly since 2020, but their impact on grocery prices is not immediate. There is a **lagged effect** between rising input costs and increases in grocery store prices, with food price inflation typically following RMPI by about a year (Chart 3).

In particular, **RMPI**, which tracks costs like **crop products** and **non-metallic minerals**, has shown a strong correlation with food price inflation, but the relationship isn't instantaneous. **CPI-Food** and **CPI-Food Purchased from Stores** lag behind RMPI by roughly one year, illustrating how it takes time for cost increases to filter through supply chains (Chart 3). This delay is due to several factors: grocers often rely on existing inventories, use long-term contracts, and may hold off on price hikes to maintain competitiveness.

Meanwhile, broader inflation measures like **CPI-Trim**, which excludes volatile components such as food and energy, reveal that **food prices are rising much faster than overall core inflation**, suggesting that food-specific factors are driving a disproportionate share of price increases (Chart 3).

Chart 3: Raw Material Cost vs. CPI-Indexes

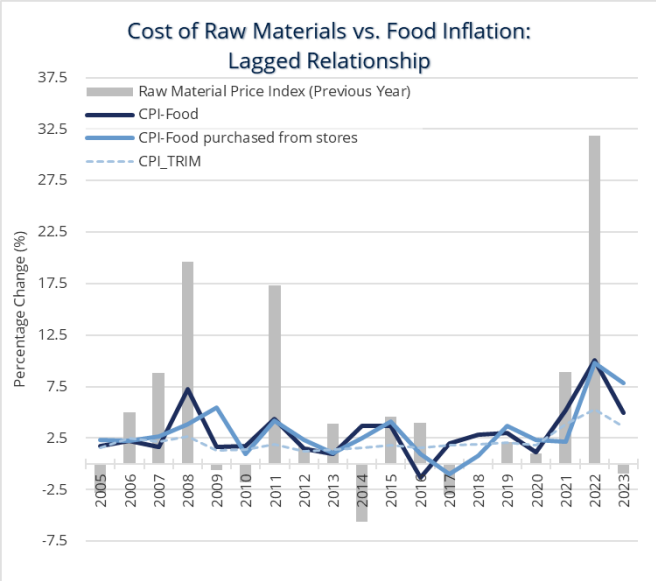
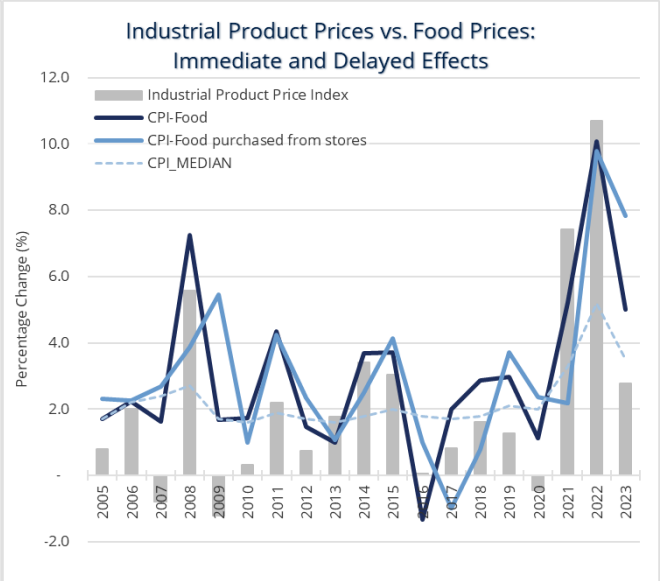


Chart 4: Industrial Product Prices vs. CPI-Indexes



See Box 2 for details on RMPI and IPPI.
Source: Statistics Canada, Bank of Canada, t6ix Economics.

Box 2

Modified RMPI and IPPI

Raw Materials Price Index (RMPI) was modified by averaging key components with the highest correlation to food inflation: "Crop Products" and "Non-metallic Minerals."

Industrial Product Price Index (IPPI) was similarly modified, including components like "Meat, Fish, Dairy Products," "Beverages (except juices)," "Textile and Leather Products," and others that show strong correlation with food prices.

Both indexes were adjusted to better reflect the specific cost pressures impacting food production and grocery prices.

Similarly, **Industrial Product Price Index (IPPI)**, which reflects the cost of processed goods like meat, fish, dairy, and packaging materials, also plays a significant role in food price inflation. The correlation between IPPI and food prices is immediate, particularly for restaurant and prepared food costs. However, the **CPI-Food Purchased from Stores** again lags by about a year, showing that retail food prices take longer to adjust to rising industrial costs (Chart 4).

When comparing this to **CPI-Median**, which tracks the median price change across all goods, it's evident that **food price inflation has far outpaced the general inflation trend**. While core inflation remains more stable, food prices have surged significantly due to the combination of rising raw material and industrial costs (Chart 4). This contrast highlights the unique inflationary pressures within the food sector, even as

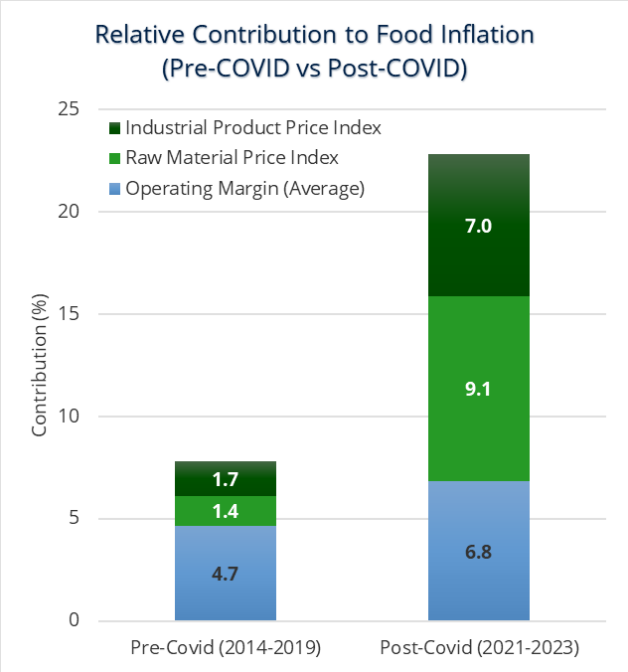
broader inflation metrics remain relatively controlled.

Margins vs. Costs: A Dual Driver of Inflation

When we look at the **relative contribution of rising input costs and profit margins** to food inflation, the picture becomes clearer. It's not just about passing on costs to consumers—**margins have also expanded**, indicating that grocers are increasing prices faster than their costs are rising.

Chart 5 breaks down the relative contribution of **RMPI**, **IPPI**, and grocers' **Pre- and Post-COVID margins** to food inflation. The data shows that post-pandemic, both input costs and margins have played significant roles in driving food prices higher. This suggests that food inflation is a mix of **cost-push** and **profit-driven** factors.

Chart 5 - Rising Input Costs and Growing Margins Drive Post-COVID Food Inflation



Source: t6ix Economics calculations, Statistics Canada, Company financial disclosures, Morningstar, Inc.

Pre-COVID vs. Post-COVID Margins: Evidence of Profit-Driven Inflation?

Grocers' margins have expanded notably post-COVID, even as input costs have surged. **North West Company**, in particular, saw its operating margin jump from 6.2% to over 10%—a 4 percentage point increase that far exceeds the rise in input costs (Chart 1). This signals that while grocers are undoubtedly facing rising costs, they are also using this environment to expand their profitability.

The comparison between pre-COVID and post-COVID margins suggests that **grocers are leveraging their pricing power**, taking advantage of the inelastic demand for food. This is particularly concerning for consumers, who have no

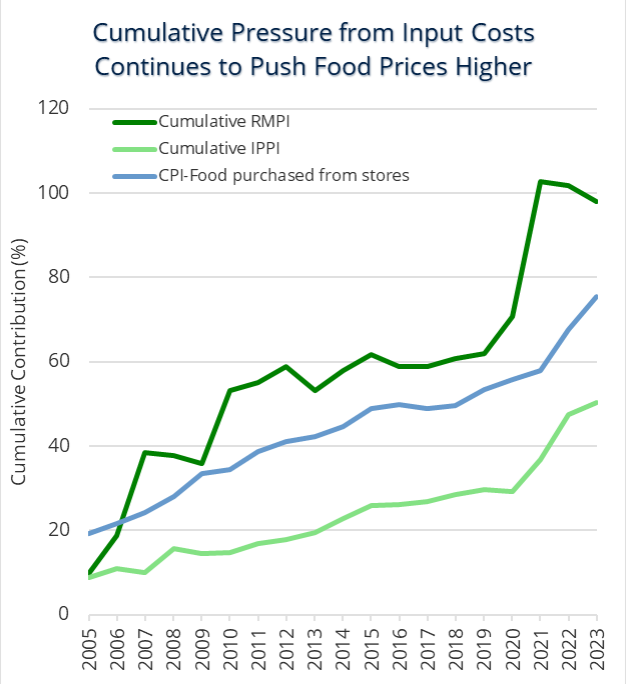
choice but to pay higher prices due to the essential nature of food.

Cumulative Impact: Building Inflation Pressure Over Time

The cumulative impact of rising input costs is clear. As **RMPI** and **IPPI** climb year after year, their effects on food prices compound. **CPI-Food Purchased from Stores** follows this cumulative pressure, with prices rising steadily as input costs accumulate (Chart 6).

By 2023, the cumulative effect of RMPI and IPPI has built up significantly, driving food prices higher even as grocers expand their margins. This **compounding inflation** paints a stark picture for consumers, who face both rising costs from grocers and increased prices due to higher input costs.

Chart 6 - Cumulative Inflation Breakdown: Raw Materials (RMPI), Industrial Products (IPPI) and CPI-Food Purchased from Stores



Source: t6ix Economics calculations, Statistics Canada, and Morningstar, Inc.

The Future of Food Prices in Canada

Canada's food price inflation is being driven by a combination of rising input costs and expanding grocers' margins. **Cost pressures from raw materials and industrial products are real and significant**, with RMPI and IPPI showing clear links to food price inflation, albeit with a delay in the grocery sector. However, **grocers have also expanded their margins**, suggesting that prices are rising faster than costs alone would justify—a sign of profit-driven inflation.

This dual narrative—cost-push inflation combined with margin expansion—suggests that food prices will remain high

in the near term. As long as input costs stay elevated and grocers maintain their pricing power, consumers will continue to face higher prices at the checkout.

Policy Implications: What Can Be Done?

Policymakers should focus on ensuring competition within the grocery sector. With a limited number of large players controlling the majority of the market, the potential for price manipulation is high. Regulators should consider measures that increase transparency around pricing practices and encourage competition. **Greater transparency on pricing**—particularly during periods of stabilizing input costs—would also help ensure that grocers aren't using inflation as a cover for excessive price hikes.

For consumers, it's crucial to recognize the difference between **legitimate cost-push inflation** and **profit-driven inflation**. While input costs are a significant factor, grocers' margin expansions indicate that prices are rising faster than necessary in some cases.

Key Takeaways:

- **Grocers' margins have expanded post-COVID**, suggesting that prices are rising faster than costs justify.
- **Input costs**, as measured by **RMPI** and **IPPI**, are major drivers of food price inflation.
- **Competition and transparency** in the grocery sector will be crucial to preventing excessive price hikes.

APPENDIX 1: Why Our Focus on Canadian Grocers is Representative

In this analysis, we focused on key Canadian grocers—**Loblaws, Metro, Empire, and North West Company**—because they offer a clear and comprehensive view of the dynamics in Canada's grocery market. While multinational chains like Walmart and Costco play a role in Canadian retail, their inclusion in an analysis of food price inflation and margins could distort the findings for several reasons:

1. **Local Market Focus**: Canadian grocers are more directly influenced by local economic factors, including Canadian supply chains, regulations, and consumer behaviors. Multinational chains, on the other hand, often source globally and operate with different cost structures that aren't as tightly linked to the Canadian economy.
2. **Different Business Models**: Walmart and Costco operate under fundamentally different business models. Costco, for example, operates a membership-based, bulk-purchase model that doesn't reflect typical grocery shopping patterns for most Canadians. These chains also leverage extensive global supply networks and economies of scale that could mask the specific cost pressures faced by Canadian grocers.
3. **Cross-Border Revenue and Pricing Strategies**: Both Walmart and Costco derive a significant portion of their revenue from operations outside of Canada. Their global footprint allows them to smooth out regional price increases through international operations. This global pricing flexibility doesn't reflect the more regionally constrained operations of Canadian grocers, who are more susceptible to local supply chain disruptions and cost fluctuations.
4. **Price Leadership and Loss-Leader Strategies**: Multinational chains often engage in aggressive pricing strategies, such as using food items as **loss leaders** to attract customers to their stores for other non-food purchases. This pricing strategy skews their profit margins and complicates a direct comparison with traditional Canadian grocery chains, which rely more heavily on food sales for profitability.

By focusing on the major Canadian players—**Loblaws, Metro, Empire, and North West Company**—our analysis remains rooted in the realities of the Canadian grocery market. These companies are directly exposed to Canadian supply chains, pricing pressures, and consumer behaviors, making them representative of the trends shaping food inflation in Canada.

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