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Managing Rising Food Recall and Advisory Risks

(part 2 of 2)

By Crystal Carpenter
Senior Economist
Specialty Crops

Inside...

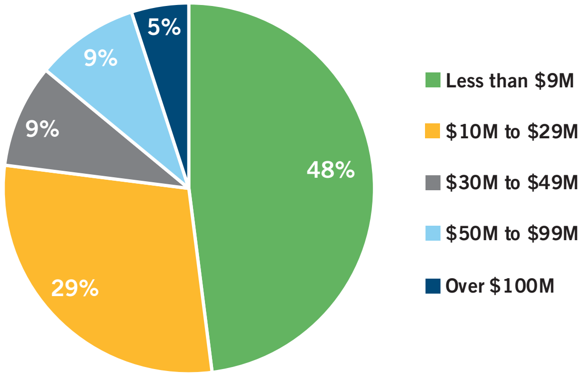
Key Points:

- The financial implications of a food recall or advisory can be enormous. Reputational damage on top of other costs can be catastrophic for suppliers, especially small companies found to be at the source of a contamination.
- The costs of a recall or advisory – and who bears the costs – can vary widely depending on: whether it is an advisory or a recall, specificity of the advisory, timing and duration, geographic distribution of the event and the company's operations, company size, product diversification, level of consumer awareness, and contract and insurance specifics.
- Unlike a recall, there is no insurance coverage currently available for an advisory. While policies are being developed to cover an advisory, the industry is skeptical of their true coverage and the potential costs.
- To actively manage the growing and significant food safety risks, food suppliers must: develop risk mitigation plans and make them a priority, invest in risk mitigation efforts, know their risk exposure, and have a recall/advisory plan in advance.

Introduction

In part one of this two-part series on food safety, the point was made that the financial risk and cost of food safety is increasing for food suppliers despite our food system being safer than ever. This report takes a deeper dive into the impacts of recalls and advisories, what factors influence these impacts, who bears the costs, and what companies are doing to mitigate these risks.

EXHIBIT 1: Price of a Recall



Source: Grocery Manufacturers Association, "Capturing Recall Costs," 2011

Impacts of Recalls and Advisories

Recall and advisory costs can include:

- Lost revenue.
- Transportation, storage, and physically discarding product.
- Operational disruption.
- Investigation expenses.
- Public relations.
- Litigation expenses.
- Government fines.
- Reputational damage.

In 2011, the Grocery Manufacturers Association conducted a survey to quantify the costs of a recall. It polled 37 members, including producers, processors, and manufacturers representing a variety of industries. Of those involved in a recall, 77 percent of respondents estimated the total financial impact to be up to $30 million (*Exhibit 1*). As a percent of revenue, these impacts vary greatly based on factors discussed in a subsequent section.

The total industry impacts are significantly larger for an advisory because demand for an entire category of food is affected rather than just a specific company or product. This impact, however, is spread throughout the supply chain.

Assuming the source of the contamination announced in the advisory is eventually identified, company costs and brand reputation are still at stake. For instance, an advisory typically creates more consumer awareness. This results in even greater reputation risk for a company or companies identified as the source of contamination. The following section will focus on the demand impacts from the 2018 romaine advisories in more detail.

> *Over 81 percent of survey respondents described the financial consequences of a recall as either "significant" or "catastrophic."*
>
> *Grocery Manufacturers Association survey*

Advisory Demand Impacts – Lettuce Case Study

Exhibit 2 and *Exhibit 3* illustrate the retail sales impacts from the 2018 romaine advisories, based on analysis of Nielsen grocery retail data. 2018 quarterly retail sales are compared against 2017 values and baseline 2018 projections.

The baseline 2018 projections represent reasonable expectations of what sales may have been without the advisories, based on historic growth trends, seasonal patterns, and actual first quarter (Q1) sales. It is acknowledged that this takes a slightly conservative view, as there may have been a minor impact from the late 2017 romaine advisory out of Canada suppressing Q1 sales.

EXHIBIT 2: Unit and Value Sales Impacts from 2018 Romaine Advisories

	Year over Year		2018 Baseline	
	Unit	Value	Unit	Value
Spring 2018 Advisory *(Q2 2018 vs. Q2 2017 & Q2 2018 Baseline)*				
Romaine	-14%	-24%	-13%	-13%
Leafy Greens Excluding Romaine	3%	2%	1%	1%
Other Lettuce	7%	3%	7%	10%
Spinach	5%	5%	5%	6%
Pre-Packaged Salads	1%	1%	-1%	-1%
Fall 2018 Advisory *(Q4 2018 vs. Q4 2017 & Q4 2018 Baseline)*				
Romaine	-26%	-27%	-23%	-20%
Leafy Greens Excluding Romaine	0%	1%	-3%	-1%
Other Lettuce	10%	22%	10%	23%
Spinach	0%	6%	-4%	8%
Pre-Packaged Salads	-3%	-2%	-6%	-5%

Source: Nielsen (data), CoBank (analysis & 2018 baselines)

Second quarter (Q2) 2018 – April romaine advisory

- Q2 romaine sales fell roughly 13 percent in volume and value terms relative to what may have been expected without the advisory.
- As romaine sales fell, other leafy greens were used as substitutes and their sales increased slightly (approximately 1 percent).
- Pre-packaged sales fell, but not to the same extent as romaine, as other lettuce was substituted in mixes containing romaine and sales of other non-romaine mixes increased.

Fourth quarter (Q4) 2018 – November romaine advisory

- Q4 romaine sales fell roughly 23 percent in unit sales volume and 20 percent in value terms relative to what may have been expected without either advisory.
- Data available to date does not fully answer the question: "How long does it take consumer demand to return after an advisory?" However, the data does show that retail romaine sales had not fully recovered from the April advisory when the November advisory hit (third quarter sales remained 3-5 percent below the 2018 baseline).
- As romaine sales fell, other lettuce was substituted and sales increased 10 percent by unit sales and 23 percent by value relative to seasonal trend expectations.
- Pre-packaged salad sales decreased more than in Q2. Yet, this decline was not as steep as it was for romaine due to some degree of substitution within the mixes.

Adding up the losses

The 2018 romaine advisories resulted in lost revenue at the retail level totaling an estimated $52 million. However, this is just a fraction of the total costs. It does not include any of the other costs (discarding the product, business interruption, investigation, transportation, etc.) or any costs from other parts of the supply chain. For example, many growers and shippers lost revenue, were forced to discard product, and had to disk under un-harvested crop. However, the cost impacts by individual growers and shippers varied greatly depending on a multitude of factors covered in the next section.

EXHIBIT 3: Leafy Green Sales Trends

Source: Nielsen (data), CoBank (analysis & 2018 baselines)

Factors Impacting Cost and Cost Distribution

The costs associated with a recall or advisory – and who bears the costs – can vary widely depending on many factors. The following lists some of these key factors and, where applicable, provides examples from the 2018 romaine advisories.

- **Type of announcement** – Was it a recall or an advisory?
- **Specificity** – If an advisory, how quickly did the advisory give product or geographic specifics? Had the fall 2018 romaine advisory been limited to California-grown produce at the start, the industry-wide impact would have been significantly less.
- **Timing** – Was it during peak demand or during harvest season? If the romaine advisory had occurred in the middle of the California harvest season versus the end, the impacts would have been much greater for growers and shippers.
- **Duration** – How long did it take to remedy the situation? And in the case of an advisory, how long did it take to identify the source of the contamination?
- **Geographic distribution** – How large is the impacted geographic footprint? Where are the company's operations in relation to the food safety event? In the case of the fall 2018 romaine advisory, growers with Arizona operations were able to take advantage of the increased romaine price once the advisory lifted and the supply chain had to be completely refilled with Arizona supply.
- **Product diversification** – Does the company have a diverse product portfolio? For growers and shippers of other leafy greens, there was some degree of substitution that helped to partially offset costs during the 2018 romaine advisory.
- **Consumer awareness** – There are many voluntary recalls that safely remove product from the market without the consumer ever becoming aware. Others are widely publicized. The greater the consumer awareness, the greater the potential demand impact and brand risk.

- **Size of the company** – Many larger companies can better absorb the impacts of a recall or advisory. They often have food safety personnel on staff to help mitigate risk and respond to a food safety event. Also, there are a number of risk mitigation and recall costs that benefit from economies of scale. In the event of an advisory, larger companies are in a better position to push back on large buyers as they try to push some of the costs down the supply chain. In case of litigation, larger companies are in a better position to fight; however, they are also larger targets for consumer groups.
- **Contract specifics and insurance** – Specific contract and insurance language can have huge impacts on how the cost burdens (including lost revenue) are distributed.

In addition to total costs being greater for an advisory than a recall, most food companies have some form of recall insurance. There is currently no insurance available to cover an advisory. Some insurance companies are developing policies to cover advisories, but one must pay close attention to the details of the wording to know exactly what the policy will and won't cover. There is also industry concern regarding what the costs of true advisory coverage may be, given that any payout would be largely industry-wide. There is skepticism of what an advisory policy will really cover until it is tested.

Mitigating Risks

Below are examples of what companies are – and should be – doing to help manage the growing risk and costs of food safety.

Develop food safety plans and make them a high priority. Critical to mitigating risk upfront is having a food safety plan that:

- Meets or exceeds regulatory, certification, and buyer requirements.
- Identifies key areas of risk and actionable steps to take when an issue is identified.
- Provides proper training of the plan to all employees.

It is also important that company employees at all levels recognize the importance of the plan and properly prioritize it among varying company goals and objectives.

Invest in mitigation efforts. Proper financial evaluation should be given to investments in technology, infrastructure and equipment, dedicated food safety personnel, insurance, and other risk-mitigating services and products. This is not to say that every company needs all the latest food safety technologies and services, but investments that help to mitigate food safety risks should be carefully considered – both against the risk as well as for any potential competitive marketing advantage it may provide.

Know your risk exposure. There are many different insurance policies covering recalls and now some being developed for advisories. However, not all are created equal. It is important to carefully evaluate the wording and know what is and is not covered. Likewise, sales contracts can have important language that impact how the costs are distributed in the event of a recall or advisory. It is important to know what those details mean before a food safety event occurs.

Have a recall/advisory plan. Time is critical when responding to a recall or advisory situation. Having a plan and/or identifying outside resources in advance can help to minimize the impact. It is important to respond as quickly as possible and to communicate early with your insurance provider and any other service provider that has been identified in advance.

Conclusions

The financial implications of a food recall or advisory can be enormous, and if a company is found to be the source of the contamination, reputational damage on top of the other costs can be game-ending for some. This is particularly true for a small, non-diversified company found as the contamination source following a widely publicized advisory situation. Larger companies, and companies with diverse product portfolios and geographic footprints, are generally in a better position to withstand the impacts.

With the risk of a food safety incident increasing and with the potential impact being so high (and rising), it is becoming increasingly critical for all food suppliers to actively manage this growing and significant risk. Develop risk mitigation plans and make them a priority, invest in risk mitigation efforts, know the risk exposure, and have a recall/advisory plan in advance.

CoBank's Knowledge Exchange Division welcomes readers' comments and suggestions. Please send them to KEDRESEARCH@cobank.com.