Lost in the Supermarket

In February 2019 something seismic occurred in the world of packaged food – Kraft Heinz took an eyewatering writedown of $15bn on its Kraft and Oscar Mayer franchises, two iconic American brands that have appeared on the tables of families for decades. And this was followed by a further $1.22bn in August of that year. The second writedown was the catalyst for me to begin a more detailed review of the branded consumer food space, talking to over 15 listed companies and attending the Consumer Analyst Group of New York (CAGNY) conference in Boca Raton in February this year. Although aware of the potential for permanent loss of value within certain types of consumer packaged goods, at Lindsell Train we do of course own a number of companies in this space - Mondelez, PepsiCo, and Unilever being the most significant holdings. So we wanted to deepen our knowledge of the challenges facing certain branded packaged products, and find out whether or not the “centre store” - the aisles of shelf-stable packaged foods found in the middle of supermarkets - is really a lost zone in terminal decline. I wanted to establish the dynamics at play in different global geographies, brands and categories – are today’s consumers really as health conscious as is argued? Are we all buying chia seed and coconut butter health bars from niche ecommerce suppliers, or is there still a place in people's hearts and fridges for the tub of ice cream and the ready meal? Is digital permanently disrupting big consumer goods as distribution channels change and a raft of challenger brands eat into market shares? And most importantly of all, why do we believe that Lindsell Train’s portfolios are invested in the right consumer brands to thrive and succeed in the future? I should make the disclaimer that the bulk of this work was carried out prior to Covid-19. But as I write this now in October, I am struck by how little the events of the last few months have changed many of the dynamics I observed.

Given the “all American” nature of the Kraft brands which suffered writedowns, geography seems like a good place to start. To many, Kraft Heinz’s writedowns are emblematic of the damaging shifts happening specifically within US-focused branded food companies - with 70% of its revenues from the United States and a portfolio consisting almost entirely of the packaged, highly processed foods you might think twice about giving your kids for lunch (boxed mac & cheese, Velveeta, hotdogs etc), Kraft Heinz seems terminally out of step with the modern, informed consumer. But I’d argue that US-centricity is only a problem if the brand in question fails to take advantage of the “developing market”-like qualities of the US. Put simply, the demographics of the US are changing: the Pew Research Bureau estimates that by 2050 the overall population will increase by 34%, and Caucasian Americans will become the minority[1]. The tastes of the nation are likely going to change irrevocably as a new generation of Americans arrives or is born, mostly unfamiliar with yesteryear’s staples like Kraft mac’n’cheese. Not for nothing did the CEO of ConAgra point out that the fastest growing snack portfolio in the US is owned not by Kraft Heinz or any of the other iconic American names, but by the Mexican multinational bakery Grupo Bimbo.

Certainly Grupo Bimbo is a smaller company than e.g. PepsiCo, but the fact that its snacks are growing – even from a small base – is telling in its intersection of demographics and category. The packaged consumer goods companies successfully building out emerging market businesses (whether in the US or elsewhere in the world) tend to focus on a number of categories, amongst which highly branded, impulse-driven, low unit priced and consumer loyalty commanding snacks are probably the most important. I am reassured anew about Unilever’s 60% and Mondelez’s almost 40% of revenues from emerging markets (including a 65% market share in chocolate in India with Cadbury, first launched there 70 years ago), where the newly minted middle classes increasingly seek to trade up to branded goods as their incomes allow. In September 2018, the World Data Lab predicted that a further 2.1bn people will join the existing 3.2bn in the global middle classes by 2030[2], bringing a flood of newly created wealth and spending power with them. The shifting demographics I cited earlier will likely see this play out in the USA as well, meaning that US-focused companies with a dominant share of their revenues coming from the right sort of categories – snacks, probably some indulgent foods – will fare better. Our portfolio company PepsiCo is a good example: 61% of its revenues originate from North America, but are almost exclusively from the sale of salty snacks and soft drinks. And other US-focused packaged food companies are taking steps to reposition their brand portfolios towards snacks - in 2017 Campbell Soup Co, with 92% of its revenues from the United States, bulked up its revenues from snacks from 32% to 47% with its purchase of Snyder-Lance, the second largest salty snack maker in the US after PepsiCo.

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But what about health and wellness - isn't this trend going to turn consumers away from sugary drinks and salty snacks? We often read that this is one of the main reasons for the decline in the 'centre store' – but I wonder if it is accurate to conclude that the centre store is indeed in terminal decline. It's true that we live in an information age and that the consumer knows more about nutrition than ever before; it's also true that consumers now more frequently cite an interest in health and wellness as influencing their shopping patterns. And it's likely that there has been a partial shift towards growth of fresh foods at the perimeter of the store – last year Deloitte reported that between 2015 and 2016, the "fresh perimeter" of the store grew just over two times in space allocation[3] – but the actual picture of what's happening is a little cloudier, with plenty of data suggesting that the centre store isn't dead yet. Similarly to the challenges of geography, the outlook for packaged food brands against the backdrop of growing health and wellness interest seems to come down to the category of product. Some types of shelf stable brands actually stand to benefit from a shift toward fresh: seasonings manufacturer McCormick and Old El Paso Tex-Mex meal kit owner General Mills both highlighted the benefits of selling condiments and meal ingredients which pair well with fresh meat and vegetables. McCormick's compound annual revenue growth rate of 5.3% over the last 10 years – versus, say, Kellogg's 0.7%[4] – certainly reflects this. And we think that with this in mind, it's important to look a little closer at the packaged food portfolio of our own holding Unilever. Much has been made of its active pivot away from food and into health and personal care (revenues from food have gone from 54% in 2008 to 38% today) but its largest food brand, Knorr, is arguably not badly positioned as a maker of sauces, stocks and other meal components which can be added to fresh produce to create a healthy and appetising meal. It's probably also worth reiterating that Unilever also achieved a 2.3x enterprise value to sales multiple for its spreads divestment back in 2018: a demonstration that even commoditised food products are still cash generative and valuable.

I also believe that although consumers are becoming more educated about health, it isn't wise to discount the human urge to indulge. As packaged dessert manufacturer ConAgra observed, survey participants frequently express a desire to eat healthily but their purchases tell a different story. Plus, as General Mills emphasised, it's dangerous to assume that the consumer is a monolith - a key challenge for packaged food companies is serving consumer desires for lots of different things, including snacking, which continues to accelerate as a trend as people's lives become busier. Some snacks are perennial favourites - both of Unilever's ice cream brands Magnum and Heartbrand have revenues of over a billion euros each, with no signs of slowing - but other categories also remain compelling as they become more snack-focused. Cereal, for example, is increasingly eaten as a snack, and both Kellogg's and General Mills told us that their 'sweet and indulgent' cereal brands are growing faster than their health-focused offerings. With this in mind, it is reassuring to us that the 4% of PepsiCo's revenues originating from US packaged food rather than salty snacks or beverages include the Quaker brand, originally known for porridge oats, but now offering a range of snack foods including granola and cereal bars.

At the start of this piece I put the question: is digital permanently disrupting big consumer goods as distribution channels change? The answer has to be a resounding yes. The oft-cited Jeff Bezos quote "Your margin is my opportunity" points to disruption not just being an organic process but an intention to actively disrupt existing business models. And my work showed that consumer branded food has never before been so challenged by a changed – and increased – competitive set, enabled by the advance of technology. Big brands have always competed with each other, but now they also have to contend with an influx of small challenger brands plus companies that are feeding people at speed without even needing to manufacture food or develop a brand, such as the Deliveroos and Uber Eats of the world. This has radically altered the concept of convenience itself. Historically, making up a box of Kraft brand mac'n'cheese or putting a frozen ready meal in the microwave represented the quickest, most convenient way to get a meal on the table. But now, powered by technology, orders can be sent to restaurants, completed and delivered to consumers in as little as half an hour. I'm by no means suggesting that ready meals are a worthless category – they remain the largest frozen subcategory in the US – but there is no doubt that the convenience focused consumer has more options than ever, many of which are much more appealing than a plastic tray of food. And this ties in nicely to the point about health and wellness – unlike the wide eyed consumer of the 1950s beholding the exoticism of a newly introduced TV dinner for the first time, fewer and fewer people will continue to regard these kinds of products as being either a treat or healthy. I sense that instead, the main point of differentiation for many such brands of convenience is consumer habit rather than real enthusiasm for the product, which may not be defendable in the long term.

Brand loyalty and a genuine affinity for the product will, however, most likely prove protective against the increasingly serious private label pressure, which (as at September 2019) now accounts for 17% of

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all packaged food production. Kraft reported that in 2018, 80% of its market share losses were in categories with “significant private label pressure”. And TreeHouse Foods, the US’s largest private label manufacturer, highlighted that large manufacturers’ share of total US grocery revenues fell from 49% to 47% between 2013 and 2018, while the share of “extra small” companies (i.e. those with revenues of <$100m) increased from 8% to 9%. These pressures aren’t new, but they do seem to be growing: not only are the likes of Amazon entering the fray with their own private label brands, but an array of smaller brands have entered the market (enabled by cheaper digital advertising and outsourced manufacturing) and consumers have become better attuned to ‘value’. Against this backdrop, it is easier for big brands with genuine resonance and consumer loyalty to stand out. And private label penetration is low in certain categories, such as confectionary – here global private label market share is just 5% in chocolate and candy – or gum, where US private label accounts for less than 5%[5]. This means that Mondelez’s #1 share of chocolate in the UK and its chunky 60% (also #1) share of Latin American candy and gum are even more appealing.

Much has been made of the ‘endless shelf’ of ecommerce and its ability to erode the competitive advantages of big brands. But something that emerged from nearly all my conversations with companies was that, in the words of McCormick, “the infinite ecommerce shelf is not infinite”. An ecommerce site may have multiple pages on which a plethora of brands and choices may be listed, but in reality, shoppers rarely make it past the first, second or (rarely) third page. This means that any brand large enough or willing to spend enough to appear on these initial pages is at a distinct advantage - just as it would be in a bricks and mortar store. And as ecommerce grows, it becomes more and more apparent that the dominant sites will be the online versions of leading supermarkets – indeed, in 2019 Walmart surpassed Amazon as the US’s leading online grocery retailer. For the strongest brands, I believe that ecommerce offers a real opportunity, one which is still at a nascent stage in many geographies: for example, in the US it’s estimated that just 6.3% of grocery shopping is done online[6] so the potential here is still significant.

And that mention of online shopping leads me on to the final part of my note - some observations from companies in the midst of the Covid-19 upheaval. Probably the most interesting theme was that the events of recent months are accentuating and speeding up all the existing trends, ecommerce in particular – but only if the company is in the happy position of having strong, resonant brands with enough consumer recognition and reasonable ecommerce infrastructure to begin with. We note with interest that PepsiCo has launched two new direct to consumer sites, Snacks.com and PantryShop.com, in response to increased ecommerce demand for its products, and that Unilever increased its ecommerce sales (across all categories) by 49% in the first six months of 2020. We are under no illusions that Unilever is about to become an internet company, but nevertheless it seems to us to be an important demonstration that Unilever’s products are compelling enough to successfully make the transition to new distribution channels – just as they have throughout the company’s history. On the other hand, despite being mainly distributed via ecommerce, it may not be the case that the crisis is helpful for the plethora of new entrants into various categories who may be struggling with outsourced production and a lack of scale. These small brands, often unprofitable and subscale, may also not have the balance sheet strength to weather the storm. Furthermore, brand equity continues to be important in an environment where trust, hygiene, quality and safety are uppermost in consumers’ minds.

The idea that people will turn to food for comfort, especially pleasurable snack food, seems to be more relevant than ever – our portfolio holding Mondelez, owner of Oreos, posted organic growth of 6.4% in the first quarter of 2020. CEO Dirk van der Put’s comment is worth reproducing here in full: “Originally, you would have said this was pantry loading, but this has now been going on for more than six weeks. And unless consumers are building a warehouse for Oreos at home, I think they are eating [them]”. There’s a big difference between fearful hoarding of basic groceries (or indeed lavatory paper!) and a positive turning to one’s favourite snack brands for a lift in difficult times. A recent conversation with Mondelez management revealed that market shares across the company have grown more during this crisis than at any other time in the company’s history.

In summary, while there are certainly more competitive pressures than ever before, we don’t believe that all food brands are terminally challenged. Within consumer goods there are more and less resilient categories, and within those categories there are better and worse brands. Some brands probably will continue to decline over time: those in the unhappy spot of being seen as unhealthy yet insufficiently "treat like" seem most at risk. If one generation (perhaps the hyper-connected, informed and digitally savvy millennials, now becoming parents) eschews these foods because of health concerns or taste, the next generation is unlikely to have any knowledge or affection for them. For investors, the challenge

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is to see beyond these outdated brands – and the terrifying writedowns they have been suffering – and to pick the very best brands from the very best categories, ideally also with sales from a broad range of geographies including emerging markets. And for brands of sufficient quality, ecommerce and digital present a big opportunity, not just a threat. Add to this the acceleration of all these trends during the Covid-19 crisis and my conclusion is that it's a very good time to be a top tier snack manufacturer – or an investor in one!

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Sources: Companies referenced; and as individually noted.

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