Rabobank

# Talking Points

## *The Big Surprises in 2017*

***RaboResearch***
Food & Agribusiness
far.rabobank.com

Nicholas Fereday
Executive Director
+1 (347) 215-4158

In this month's Talking Points, we're excited to share the main findings of our annual *We Didn't See That Coming* survey of food trends. We received responses from over 200 food industry players—ranging from start-up founders to CEOs of billion-dollar companies, and from authors and academics through to venture capitalists, bankers, and everyone in between (in food, all voices matter). As in previous years, we asked (in confidence): **"What surprised you the most in the last 12 months?"**—but we also asked a second question: **"What food innovation do you think presents the biggest commercial opportunity over the next five years?"** We received some great responses from this informal survey and are very appreciative of the time folk put in to reply. In this note, we will focus more on the first question, saving the second one to feed into our January 2018 edition (there is still time if you want to weigh in on this question).

## 1. The Amazon Effect: Whole Foods Is Just the Beginning

***"I hadn't anticipated that Amazon would partner with a bricks-and-mortar retailer."***

***"The most disruptive thing to hit food in a long time."***

***"An astonishing move that augurs for an incredibly unclear future for food retailing."***

***"The Amazon/Whole Foods deal and the realignment of the entire industry to that new reality."***

Surely it was no surprise that Amazon's summer purchase of Whole Foods Market was by far the biggest jaw-dropping moment of the year? Out of our audience, only one claimed: "Honestly, I was not surprised." After a few rocky years, some anticipated that Whole Foods would be acquired, especially "when activist investors started buying up Whole Foods shares," but many were expecting "a conventional grocery chain" to be the acquirer. Given that the implications of this deal—not only to the grocery industry, but to food distribution and other areas—are "significant and not easily understood," it is probably not a surprise that we received so many diverse opinions on what the deal means.

Interestingly, the extent of the reaction to the deal was a shocker to many: "The magnitude of the reaction to the Amazon/WFM deal surprised me the most"—and how six months on, everyone still seems to be preoccupied with it. Fear was cited by some respondents: The "size of investor fears about implications of Amazon's grocery expansion on packaged food companies" and "the way stock markets, analysts, and other industry participants responded really exposed a level of fear that was clearly right below the surface in an industry that has already absorbed a lot of channel change in the last 10 to 15 years." One respondent questioned the assumption that, post-acquisition, Amazon will be as dominant as people think: "Suddenly, they are the beginning of the end for all other retailers, from small co-ops to big conventional chains?"

Many put the Amazon deal into the wider context of the "accelerating pace of e-commerce in food" or the start of the "digitalization of food retail" that has "caused a cascade of other players to sit up and take notice." It appears, post-Amazon, that "the e-commerce channel can no longer be ignored" and "is now a serious topic at all FCMG companies." And apparently the 'Amazon effect' is a thing, as more than one referred to it. "I am surprised by the rate of the 'Amazon Effect', where the acquisition of Whole Foods appears to be the tip of that iceberg." One reader predicted Amazon would ultimately "disrupt food by owning and controlling the supply chain."

Although the bricks-and-mortar move by Amazon amazed everyone—especially "at a time when all the grocers are trying to build their e-commerce capabilities"—once the dust had settled, folk commented as to how "it made lots of sense as soon as you looked at it," including acquiring a "credible private-label food brand (365)" and noting the "cost is almost insignificant, at less than 2% of Amazon's market cap." The deal also added to a retail environment that was already under pressure, with "Walmart pushing back on suppliers on price to defend against Aldi and Lidl" and how some saw this as leading to a "race to the bottom on price, where the focus is: don't get beaten on price." For one, the deal was "simply the icing on the cake for a year in which competition for 'share of stomach' stepped up considerably."

Some saw the deal as the savior of Whole Foods, which was increasingly being viewed "as a struggling 400-ish store chain that appeared to be heading toward irrelevance." Others strongly disagreed with this assessment, noting "how much emotion and misreading there is of Whole Foods" and how "many people had left them for dead." One reader argued: "They are an incredibly strong brand that had just not developed the data-driven processes, systems, and discipline that are required in order to compete" with the big supermarkets. A few wondered how the merger would play out, highlighting the cultural differences between the two companies: "One should not underestimate the cultural challenges and systems challenges that come with integration," as they might lead to "unmet expectations on both sides."

As a result of this deal, the consensus appears to be that "food retailing's future is unclear," and the market is now anticipating a further "radical change in the grocery supply chain." But perhaps we should sum up with a moment of self-reflection and ask ourselves: "What does our collective surprise regarding this deal say about our world view and the food bubble we all live in?"

## 2. They Paid How Much?!!

***"Desperate times, desperate measures."***

***"The multiples that strategics continue to pay for emerging brands."***

***"What surprised me the most is actually the inability of established food manufacturers to innovate."***

At times, it feels that if Big Food didn't exist, we would have to invent it. Our readers took turns in picking fault with the big players for their…

- **Failure to innovate to drive top-line sales.** We've heard it before, but the lack of innovation remains a common complaint, with "customers moving away from large brands, which is showing up in the top line of large food companies" because of "the inability of internal innovation to protect market share." Readers provided many examples of this trend. "Think Halo Top ice cream over the past two years vs. Ben & Jerry and Haagen Dazs" or "flavored water (Spindrift) vs. soda" or "small meat jerky brands vs. Jack Links." The reliance on "external innovations suggests that they are responding to a new kind of pressure that they aren't able to address from the inside." Consequently, we are left with "dying legacy brands" and a "flat-footed response to continued inroads made by entrepreneurial start-ups in food." Perhaps we should not have been shocked, therefore, by the "large number of high-profile CEO transitions in food announced over the course of the year." Others were more defensive of the approach, seeing this as the future: "Just as VCs are getting more hesitant to invest money into food, the big CPGs are making a number of bets. This is the future of rapid innovation, buying new ideas and talent from outside in."
- **Paying a premium.** Big players are focusing too much on M&A, and this led to our readers' number one observation: the rising cost of acquisitions in terms of valuations and multiples.
    - "M&A multiples continue at elevated levels."

- "The amount of money in the space and the multiples being paid."
- "More acquisitions of early-stage brands such as Sir Kensington's."
- "The prices being paid at very high multiples."

- **Questionable returns.** The higher price tag led to respondents begging the question: "Are these largely unproven emerging brands worth the money?" Paying high for a company "that brings the potential for growth" made sense to one reader, while another considered that the price premium "suggests that, in these bleak times, the cost of catch-up is very high." But for many it wasn't just the rising cost of these acquisitions. As one put it: "I really question the return on investment." Obviously, the "trending-higher valuations" are good news for the sellers, but for buyers the valuations "are not always supported by strong operating fundamentals," especially for assets with "challenging trends." More than one respondent asked whether "the commercialization opportunities have been fully vetted." Another responder put it more bluntly: "How grossly they are overpaying for their acquisitions of emerging companies—no way X is worth anywhere close to $Y." There was amazement that even "historically conservative companies" such as Nestlé and Unilever were getting into the "acquisition game" for "brands that are not driving growth in their categories." Others blamed the price inflation on the "amount of money in the space" and how investment houses had an "overabundance of low-cost dollars to invest."
- **Failure to connect.** Despite all the "growing food company acquisitions" and product renovations, there was still consistent criticism that many of the larger food companies "continue to struggle to connect with the American consumer and further contribute to this challenge by defending the status quo," with one respondent asking: "How many of the large companies are still in denial about consumer changes?" They have not been able to address the public perception of "Big Food = Bad."
- **No clear path forward.** Like a rabbit caught in the headlights, "the big food companies seem to be confused how to move forward." One attributed this to there being "too many small avenues of innovation, but no clear highway—where no obvious winner is emerging."
- **But it's not all dark.** Not everyone was down on the big players. Some recognized the "acceleration of the awareness of food corporates regarding the food tech revolution" and the "numerous initiatives we've seen in the last year"—from corporate VC funds to M&A to setting up or getting involved in food incubators and accelerators such as Rabobank's Terra. Some readers were even more gushing: "After being in the industry for nearly 15 years, I'm pleasantly surprised by the interest of large CPG corporations in start-ups." (Looks like someone is angling to get bought.)

## 3. No Elephant Deals

***"Kraft Heinz' failed USD 143bn bid for Unilever and their inability to get another deal done this year."***

***"I think the lack of blockbuster M&A in F&B in 2017 is surprising."***

***"I am surprised the big players did not push for more consolidating moves."***

In a related theme, "the paucity of really big transactions by the large food & beverage companies" was a revelation to our readership in an environment in which "everyone is struggling for growth." Readers felt their relatively strong balance sheets and access to cheap capital would lead to a "push for more consolidating moves." Given that there were not more acquisitions, people concluded that "cost seemed to be the focus of the agenda," or "the focus on cutting costs was a distraction" to bringing down that elephant deal. Danone's acquisition of WhiteWave at the start of 2017, for USD 13bn, was cited as the last big deal—although, of course, there were "a large number of minor acquisitions of small companies." Indeed, respondents commented on the new preference for smaller deals: "The rate at which the private equity space has gone further downstream in their capital allocation strategy and major CPGs' ongoing acquisition frenzy of increasingly earlier-stage brands." This included Nestlé's purchase of Blue Bottle, which stunned one reader, as it was "a big millennial bet."

Recognizing 3G's system and model, respondents said "the 3G world has affected all big food companies," and their "seemingly amateurish" approach to Unilever via Kraft Heinz was a source of wonder to many. The company's failure was also surmised as the reason "bigger M&A did not happen" in 2017. One survey responder described the hostile bid as "the ultimate clash between the sustainable capitalism model vs. the short-term gains model of 3G." Some even questioned that Kraft Heinz's failed approach has halted 3G's M&A strategy in its tracks and led to a refocus on driving the top line: "We notice a bit more focus on innovation at Kraft Heinz—their [Seriously] Good mayonnaise is doing very well in the UK." But others thought 3G would soon resume its shopping spree—not by buying "any of the usual suspects. I think they'll go big, very big." For its part, Unilever, who has been "really shaken" by the attempted takeover, is now "fighting back" with an "increased focus on financial performance and may have to accelerate on-trend M&A." In a similar vein, others commented how Unilever was now "slashing costs, selling the spreads division, etc. to meet shareholder pressure," with one asking: "I'm curious what this will mean for their sustainability objectives."

The irony that the most disruptive event in food in 2017 came from the fourth-largest publicly traded company in the world was also a little surprising and possibly gives inspiration for Big Food to think about formulating its own disruptive strategies.

## 4. Not My Association

***"Campbell's and Nestlé pulling out of the Grocery Manufacturers Association."***

***"I was surprised by the growing split in the industry."***

***"This spells the beginning of the end for that trade group."***

Nestlé's announcement in October, on the back of Campbell's decision to pull out of the Grocery Manufacturers Association (GMA) in June 2017, was flagged by several readers who saw this as a very significant development: "This is a really huge deal." One wrote: "This is a large crack in the wall of agribusiness, and reflects tensions around GMO labelling and processed foods" and is "something to watch closely." Leaving the DC-based association, which has, on behalf of its 250 members, lobbied policymakers on issues such as mandatory GMO labelling, was interpreted as a "clear signal" by food companies that they "want to be more transparent and more independently decide their own policy destinies." It also represents a breakdown in the consensus on how to approach the changing consumer and food landscape.

Since we sent out the survey in mid-November, Mars has also announced that it would leave the GMA. And according to Politico, Dean Foods, Tyson Foods, and Unilever are also not renewing their membership (some of our readers have also heard rumors of other companies). Given this, and the herd-like nature of many food companies (for example, corporate venture capital funds was the me-too, must-have of 2016), we expect more to follow suit. As food companies try and stay relevant, and aligned to the needs and values of today's consumer, it appears that their associations are not moving at the same speed, leading to these fractures—increasingly, they are finding themselves on opposite sides of the debate. For example, reflecting the needs of their consumers, some companies are open to greater transparency (from labelling to supply chains), whereas the GMA has traditionally been a defender of the status quo, and opposed to any moves to label GMOs, trans-fats, and added sugars.

Unlike the Amazon/Whole Foods acquisition, the decision by large companies to distance themselves from the GMA was a little more predictable. We can connect the dots at least as far back as 2012, with California's Proposition 37 failed ballot measure on GMO labelling running through Michelle Obama's 'Let's Move' campaign to tackle childhood obesity (in 2013, she summoned leading players in the food industry to the White House for a dressing-down), through to General Mills' Cheerios going gluten-free in 2015, and Campbell Soup's voluntarily labelling of GMOs at the start of 2016. Factor in also "the advent of social media as a means for grassroots issue-based organizing" and the spate of M&A acquisitions of natural and organic brands by large players, as well as reformulations of their existing portfolios, and the decision by companies to leave seems more like a natural progression.[1] Beyond the GMA, other industry associations from A to U, the American Cheese Association through to the US Poultry and Egg Association (there are umpteen trade associations in the US alone) have been put on notice for the need to change or face a similar fate if they are not aligned with their members and ultimately the needs of the changing consumer.

## 5. Faster Food: The Rate of Change Is Accelerating

***"The ever-increasing pace of change."***

***"The pace of acquisitions of food-related companies is amazing."***

***"The acceleration of new foods, trends, and business models which continue to disrupt existing models and the inability on internal innovation to protect market share."***

The acceleration in the pace of change, "increasing from already high levels," is the perennial surprise for many survey responders, suggesting we have spent the last three years walking around in a daze. Judging by our readership, faster food is everywhere (see also *Category Shockers* in final section):

- **Changing retail.** Changes in retail are accelerating the pace of change. The acquisition of Whole Foods by Amazon is "symptomatic" of the "speed at which e-commerce is changing the world of food" and the competitive market structure and is something "that will have a 'seismic' impact on the F&B industry."
- **Changing consumer tastes.** This includes the acceleration in demand for "healthy and natural" products, as well as "the speed of adoption by the younger generation (quicker than I thought)" of vegetarian and flexitarian options, including alternative meats.
- **Greater competition.** The influx of new entrants "reaping share from medium and large companies" is leading to a "profound redefinition of the competitive market structure."
- **Speed of acquisition.** "The speed of M&A," where companies are barely standing on their own two feet before being snapped up, as well as the "amount of investment being made in a number of start-ups."
- **Rate of innovation.** The sheer volume of innovation across the supply chain, especially upstream, "from technology's vast innovation in farming practices to unique and different food-waste initiatives to blockchain technology."
- **The pace of change equation.** One reader, unfazed by all this change and bemused by "how many in the industry seemed to be surprised by the pace of change," broke it down for us: "It is part driven by technology, part by demographics, part by changing lifestyles… which is directly related to the first two."

Some referenced the pace of change more broadly in terms of "the increase in the velocity of life," but others more specifically in the consumer food world, where "the model of the past 60 years seems to be breaking down fast" and is being replaced with a new paradigm led by "smaller brands and shorter product life cycles." Others took an ecosystem approach to change, where unexpected guests were joining the "family table of food players," such as manufacturers of connected devices (Samsung, Whirlpool, etc.) or companies looking at food "through the lens of chemistry to improve Quality Food Safety or nutritional content," such as BASF and DSM. For this survey respondent, the question "how is the category doing?" has been surpassed by the more encompassing, "what is the territory we are looking at?"

## 6. In Other News…

Finally, to give a flavor of some of the other, often contradictory, surprising events of 2017, here is a list of quotes on a range of subjects:

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[1] During the meeting, she spoke about the need to "empower parents, not undermine them," citing research that found 85% of food adverts targeted to children are for foods high in sugar, salt, and fat, rather than for healthier products such as fruit, vegetables, and water.

- **Category Shockers**
  - “Halo Top's incredible growth. The success of Halo-Top ice cream, especially in taking market share off Unilever in US ice cream.”
  - “How Soylent seems unfazed by recalls, but was banned in Canada.”
  - “How many new brands continue to thrive within the (snack) bar category.”
  - “How quickly the emphasis around added sugar went away with the pushback of the date of implementation.”
  - “Bimbo’s Artesano white bread earned USD 103m in its first year of launch. White bread hasn’t been this exciting for two decades.”
- **Emotional Eating**
  - “It continues to surprise me that, for past six years straight, sweet & indulgent baked goods categories are rising in sales.”
  - “I continue to be surprised by the ‘conflict’ between consumers’ shift to health & wellness and the growth of indulgence product offerings.”
- **No to GMOs**
  - “Consumers moving against products containing GMO ingredients. Seems to be intensifying.”
  - “No company in the industry has been able to develop a winning GMO-based food solution for consumers that could begin to establish GMO as a trusted technology choice.”
- **Organic**
  - “I can’t believe I’m saying this, but I think organic is here to stay.”
  - “The overwhelming interest of conventional supermarkets in transparent, local, and organic products.”
- **Plant-Based Foods**
  - “Plant-based products are nothing new, but brands proudly describing themselves as plant-based and venturing into non-vegan markets is.”
  - “I’m continually surprised by plant-based foods that aren’t actually plants.”
  - “Eventually the meat industry was going to come around, just a little earlier than expected.”
  - “That the Impossible Burger has been so well received. It’s ‘science in my food,’ yet also speaks to consumer values of health and sustainability. So far, they have found early adopters to embrace the science.”
- **Rear-View Meal Kit Investments**
  - “The rise and fall of meal kits and other direct-to-consumer businesses. Just look at Blue Apron’s share price since IPO-ing.”
  - “I'm shocked people are still trying to start meal delivery companies, even though it seems clear the economics just don't work right now.”
  - “No one seems to have found a way to make direct-to-consumer profitable. CPGs have tried, but not succeeded.”
- **WTF**
  - “The lines around the block (literally) for a pop-up place selling—I’m not kidding—raw cookie dough.”

## Imprint


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Nicholas Fereday, Executive Director

nicholas.fereday@rabobank.com, +1 (347) 215-4158

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Banking for Food