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The Industry Gets a Wake-Up Call

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February 23, 2017

Late last week Kraft Heinz, with the backing of 3G Capital and Warren Buffett's Berkshire Hathaway, made a surprise offer to purchase Unilever. While the offer has since been withdrawn, it was shockingly bold, reflects painful realities of the food and consumer products industries, and will accelerate cost cutting and industry consolidation. Virtually no public company, regardless of size, will be immune from investor pressures to enhance margins.

The food industry is struggling to adapt to fundamental shifts in consumer behavior and attitudes. Both retail, especially center store, and foodservice are experiencing flat industry volumes. Shelf-stable and frozen food categories are losing share to fresh foods, the cachet of many major brands is eroding, new channels like consumer direct are gaining consumer loyalty, and "upstart" food companies are benefitting from these trends at the expense of established players.

While highly profitable, major food companies with dated, legacy assets, have added challenges in achieving profitable top-line growth that go well beyond deflation. These include:

- Foreign markets cannot be relied on for sustainable growth as they have significant political, regulatory, economic and currency risks and/or, in the case of Eurozone, limited growth prospects.
- The revenue impact of innovation is generally minor for multi-billion dollar companies and new products have generally not proven to be incremental to the base business.
- Brand renovation and supply chain modernization are costly and lengthy processes with limited or no guarantees of success.
- Most food companies are experiencing reduced pricing power.
- In an oversupplied industry, size, in and of itself, does not lead to real advantage vis a vis customers. "Power buyers" like Walmart, Costco, Kroger and Sysco will continue to have the upper hand with suppliers.
- Acquisition multiples are in "nosebleed" territory, leading to earnings dilution or, at best, minimal accretion.

The 3G Capital formula of drastic cost reduction has led to very significant margin enhancement for their acquired companies. Other companies have adopted their "playbook" but have not been nearly as successful in improving their bottom lines. Therefore, <u>we strongly believe the major industry participants will establish far more aggressive cost reduction targets and pursue large-scale acquisitions</u>. This will lead to:

- Greater focus on the biggest and most profitable brands, customers and markets and applying best practices by channel.
- Increased scrutiny and better analytics of trade and consumer spending and other investments, including innovation.
- A complete rethink of sales organization and deployment with a mindset to improve execution.
- Facility rationalization; for retail and restaurant companies, this means store closures.
- Headcount reduction in virtually all aspects of the business.
- Dividend increases and stock buybacks.
- A willingness to sacrifice volume for significant margin improvement

Over the next several years, the magnitude of structural industry change will be far greater and more consequential than the what's occurred to date. We urge all food companies to objectively review all options available to them to enhance their competitive position and to act with a high degree of urgency in accelerating improvement initiatives.