Grant Thornton

Fast Facts on Food Processing

Grant Thornton Food & Beverage Practice Part 2 of 3 – July 2010

Product and branding trends

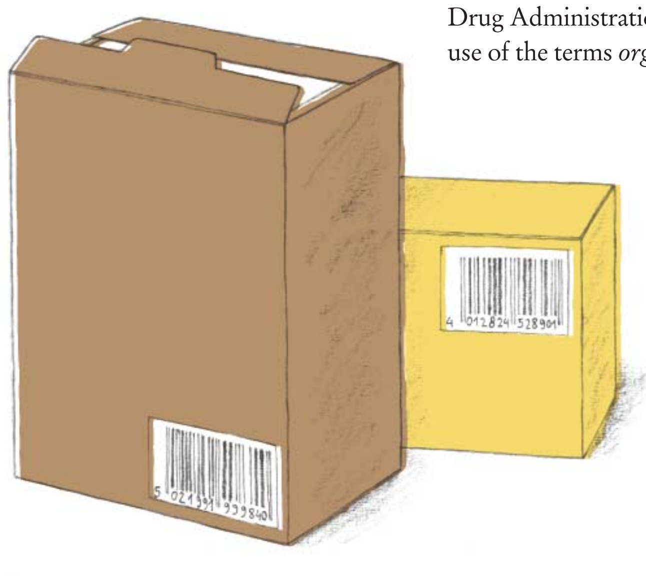
Food and beverage manufacturers continuously navigate a changing food landscape, always on the lookout for profitable niches in which they can grow and prosper. Many attempt to capitalize on current and growing trends such as organic or natural products. Others go after high-quality markets, promoting premium brands. And still others position themselves as value providers, offering good quality at low prices.

Yet even the most profitable niche or market can shift suddenly, as macroeconomic trends influence consumption, or disasters — natural and manmade — threaten critical food supplies. Product and branding strategies must be focused enough to differentiate among goods in the marketplace, but nimble enough to adapt to changing conditions.

Audit, tax and business advisory firm Grant Thornton LLP collaborates with *Food Processing* magazine on a series of industry surveys — *Fast Facts on Food Processing* — to offer perspectives on performance trends, challenges and opportunities within the food industry. This survey, *Product and Branding Trends*, examines where food and beverage manufacturers are distributing their goods, how they are attempting to differentiate their products and brands, and which emerging trends are affecting their businesses. Responses were received from 114 companies (see the participant profile at the end of this report) in April 2010.

Organic and natural labels

Products labeled as organic and/or natural continue to surge in popularity among consumers. However, many consumers are confused by the terminology. *Natural* means that a product has been made solely from botanical resources without additives or preservatives, while *organic* means that the product was grown in a chemical-free environment. The U.S. Department of Agriculture has an organic certification program in which producers follow a strict set of rules, but currently the Food and Drug Administration does not regulate the use of the terms *organic* or *natural*.



FOOD PROCESSING

Table 1: Products labeled as organic and natural*

% of products	Organic (% of respondents)	Natural (% of respondents)
0%	55%	21%
1–25%	36%	41%
26–50%	3%	7%
51–75%	3%	7%
76–99%	2%	8%
100%	2%	15%

* Responses do not total 100% due to rounding.

Table 2: Product distribution*

% of products	Nationwide (% of respondents)	Outside United States (% of respondents)
0%	14%	27%
1–25%	14%	41%
26–50%	7%	5%
51–75%	10%	6%
76–99%	15%	7%
100%	39%	14%

* Responses do not total 100% due to rounding.

"There is widespread confusion in the market over these terms. Their misuse in product marketing, labeling and advertising is a tremendous issue and a real problem for eco-conscious consumers. Consumers are uncertain: Which is better for the environment? Which tends to be more expensive? Is there any difference?" says Dexter Manning, national Food and Beverage practice leader.

The labels *organic* and *natural* may be synonymous to some consumers, but the industry's approach to applying these labels is well differentiated. More than half (55%) of food and beverage manufacturers have no products labeled as organic, and another 36% report that only 1% to 25% of their products are labeled as organic.

More than three-quarters (78%) of food and beverage manufacturers label at least some of their products as natural. Fifteen percent of companies label 100% of their products as natural (see Table 1).

Product distribution

The vast majority (85%) of food and beverage manufacturers distribute at least some of their products nationwide, while 64% of companies distribute more than half of their products nationwide. Nearly four in 10 (39%) companies distribute all of their products nationwide.

Similarly, nearly three-quarters (73%) of food and beverage manufacturers distribute some of their products outside the United States, and 27% distribute more than one-half of their products outside the United States (see Table 2).

Large food and beverage manufacturers (those with annual revenues of more than $100 million) were more likely than smaller companies to report:

- A higher percentage of products being distributed nationwide — 58% of large manufacturers have all of their products distributed nationwide vs. 29% of companies with annual revenues of $100 million or less.
- Distribution outside the United States — 97% of large manufacturers distribute outside the United States vs. 60% of companies with annual revenues of $100 million or less. Interestingly, approximately 17% of smaller companies report that they distribute 100% of their products outside the United States. This is in contrast to just 8% of large firms that report distributing 100% of their products outside the United States.[1]

Reducing distribution costs through state and federal incentives and operational improvements

Most private fleets of food and beverage manufacturers have seen their costs rising, not only from increases in fuel prices, but also due to an increased focus on clean air and safety by the U.S. Department of Transportation's Federal Motor Carrier Safety Administration (FMCSA). The FMCSA's new program — Comprehensive Safety Analysis (CSA) 2010 — is intended to improve large truck and bus safety, and ultimately reduce commercial motor vehicle-related crashes, injuries and fatalities. CSA 2010 has a new enforcement and compliance process, as well as interventions for those carriers that do not meet safety standards.

A number of states, such as California, also have passed new emissions standards that require companies to purchase new equipment in order to continue to operate. Prior to Jan. 1, 2010, many companies took advantage of refundable federal income tax credits for the purchase of alternative fuels (natural gas, biodiesel, etc.), as well as for the new equipment and fueling stations to operate the equipment — for example, purchasing hybrid equipment.

While food and beverage distribution companies are not eligible for tax breaks available to truckers, because their fleets are not their core business, there are a number of opportunities to reduce not only their sales and excise taxes but, more importantly, their operating costs through operational improvements. Operational improvements — for example, upgrading tractor equipment and refrigeration units, altering routing, and addressing workforce issues — can lead to long-term cost reduction and improved profitability for many years to come.

[1] Seventy-three companies with revenues of $100 million or less, and 38 companies with revenues of more than $100 million.

Nationwide and global distribution makes sense for large companies, given the increasingly global demand for branded food products — e.g., Coors Light sent to Mexico or Starbucks coffee exported to Canada. On the other hand, smaller food and beverage producers are less inclined to engage in cross-border transactions due to the local nature of their supply chains.

"Unlike large organizations such as ADM or Cargill, smaller companies typically do not have the supply chains and networks to export significant amounts of food ingredients. For example, growing crops, grinding cornmeal, and producing corn oil in one location and then shipping those products overseas," says Jeff Olin, managing partner of the International Tax Services practice. "But there are notable exceptions in the food additive and spice markets, where producers of all sizes tend to work across borders because of the relatively light shipping weights of these ingredients and the global supply channels."

Another consideration for many companies is transfer pricing. "For companies that are distributing internationally for the first time, transfer pricing can be a big issue. It is also important to have the proper corporate structure and, at times, the right business partner in countries where companies are doing business," notes Manning.

Table 3: Private-label/store brands*

% of products	In 2009 (% of respondents)	In 2010 (% of respondents)
0%	29%	25%
1–25%	21%	24%
26–50%	20%	17%
51–75%	16%	14%
76–99%	8%	11%
100%	6%	8%

* Responses do not total 100% due to rounding.

Private-label/store brands

Over the last several years, the quality of private-label brands has improved considerably and now often rivals traditionally branded products. As a result, most major retail chains have adopted a private-label strategy. The recent recession has also spurred the growth of private-label products, since many consumers were apt to try private-label products as a cost-saving measure.

According to survey findings, nearly three-quarters (74%) of food and beverage manufacturers report the production of products that carry private-label/store branding in 2010, up slightly from 71% in 2009 (see Table 3).

"While most of the major retail chains have a private-label strategy, smaller retailers don't have the buying power or the retail space to offer private-label selections, so they typically go with the products that will produce the highest gross margin for them," explains Manning.

"There is little doubt that retailers will continue to pursue private-label products since they provide increased margins. In fact, many retailers are moving to multiple private-label product offerings, which are increasing the competition for remaining shelf space. For traditionally branded manufacturers, differentiation will be key," says Tony Perazzo, Audit partner.

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Table 4: Margins on private-label/store brands vs. company brands

	% of all survey respondents	% of respondents with both private-label and company brands
Significantly lower	10%	14%
Lower	26%	35%
No difference	16%	21%
Higher	16%	21%
Significantly higher	6%	9%
We do not have private-label brands	21%	
We do not have company brands	5%	

Table 5: Three-year change in SKUs*

	% of respondents
More than 20% increase	23%
11–20% increase	17%
6–10% increase	17%
1–5% increase	18%
0% change	11%
1–5% decrease	6%
6–10% decrease	7%
11–20% decrease	2%
More than 20% decrease	1%

* Responses do not total 100% due to rounding.

While private-label products offer better margins for retailers, the consensus among manufacturers, most of whom offer both private-label and branded products, is less clear. Three in 10 (30%) manufacturers report higher profit margins on private-label goods. At the same time, nearly half (49%) believe that private-label profit margins are lower than traditionally branded products. More than two in 10 (21%) report no difference in the margins between the two product categories (see Table 4).

Executives who took the time to explain their private-label strategies offered a wide range of viewpoints.

- "Since 2008, we've significantly reduced private-label sales. I think that stores are trying to streamline their offerings and have reduced how many offerings they carry in a certain category. I know that's happened at Trader Joe's."
- "(Private-label is) seen as a growing value-oriented category, and we don't incur the unsavory trade practices the distributors and retailers put upon vendors with name brands: i.e., rampant deductions, excessive marketing co-op charges and slotting."
- "There has been an increase in demand for our private-label products as we acquire additional customers."

The competitive advantage for food and beverage manufacturers may lie in supplying a mix of products, including both brand-name and private-label products, as noted by one executive: "We continue to produce store-brand products for retailers who also distribute our branded products. This is a strategy based on partnership with the retailer to supply a tiered, complete-category solution that encompasses premium, branded and private-label products."

"The key for most retailers is determining which products will contribute to sales volume and throughput. Given the limited amount of retail space, it usually is not practical to have a tiered category for every product," notes Manning.

Products and competition

Product proliferation is a concern among food and beverage manufacturers, as a bloated product lineup can inflate operational costs at every step in the supply chain, resulting in increased ingredient sourcing, production changeovers, multiple packaging configurations, and oversaturated in-store displays and placements. Indeed, determining which products to carry on their shelves is a major challenge for retailers. For new food and beverage companies, the rampant product proliferation and stiff competition for shelf space form a high barrier to market entry.

Yet food and beverage companies continue to grow their product lineups. Three-quarters (75%) of food and beverage manufacturers report that the number of SKUs their company produces has increased over the past three years — and 23% of *Fast Facts* participants report that SKUs increased by more than 20%. Only 16% of food and beverage manufacturers report a decrease in SKUs, while 11% report no change to their number of SKUs (see Table 5).

Table 6: Competing brands

Number of brands competing for shelf space	% of respondents
5 or more brands	46%
4 brands	13%
3 brands	19%
2 brands	9%
1 brand	13%

Large food and beverage manufacturers (those with more than $100 million in revenues) were more likely to increase SKUs: 51% of large companies have increased SKUs by more than 10% over the past three years vs. just 34% of food and beverage manufacturers with $100 million or less in revenues.

With large retailers taking a hard look at available shelf space (and reports of reductions in the number of brands carried), many food and beverage manufacturers are fighting for placement against multiple brands. Nearly half (46%) of participants compete against five or more brands for shelf space, and another 13% compete against four brands. Few manufacturers (13%) find only one competitor on retailers' shelves (see Table 6).

The "greatest competitive differentiator" for *Fast Facts* respondents — the characteristic that compels a customer to buy one product over another — varies. Approximately 20% of companies cite quality as their competitive differentiator (e.g., "Quality, quality, quality" and "great quality keeps customers"), while another 19% combine quality and value (e.g., "Same quality, lower price" and "Similar quality, better pricing").

More than one-quarter (27%) of food and beverage manufacturers view healthy, organic or fresh/natural products and ingredients as their competitive differentiator. Thirteen percent point to the strength of their brands and loyal customer bases. Pricing alone is cited by a mere 3% of companies. Companies' use of sustainable business practices is also becoming important to a growing number of consumers.

Approximately two-thirds of companies promote the safety of their products and ingredients. Many executives specifically identify their safety efforts — "Safety is a claim that is detailed right on our product specifications across the board" and "the consumer is demanding safety more and more." Others simply note that their products are known for safety: "The safety of our products and ingredients is a hallmark of our company's quality."

Regardless of whether food and beverage manufacturers promote their products' safety, it is extremely important to monitor and track suppliers in order to avoid food safety issues and potential product recalls. "Companies should periodically visit their suppliers and understand the controls and food safety standards that their vendors are employing — it's not enough to just take their word for it. Although this will result in incremental costs, it is much cheaper than the alternative — product recalls — which can be devastating," cautions Perazzo.

Some *Fast Facts* respondents believe that safety will continue to be the most influential product trend over the next 12 months. This will be affected by the direction of pending federal legislation calling for more ingredient tracking, which will require companies to upgrade existing technology and internal controls related to food safety.

Among companies that don't actively promote safety, reasons ranged from not supplying products that have a safe image (e.g., alcohol) to a belief that there could be a negative backlash. Said one executive: "We do not focus on safety for two reasons: First, we do not possess a clear advantage or differentiating feature. Second, a positioning associated with safety takes consumers to a negative place with food (fear-driven) rather than focusing on more rewarding emotional connections."

Given the stiff competition and product proliferation in the marketplace, companies with an appetite for success must be able to successfully differentiate their products from the many others on the shelves. At the same time, they must be able to keep costs down, yet still keep up with ever-changing regulations and food safety protocols, customer preferences and brand strategies. Those companies that do so effectively may be able to have their cake and eat it, too. •

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Profile of participants

A diverse group of food and beverage manufacturers is represented in the results of *Fast Facts on Food Processing: Product and Branding Trends*. Two-thirds (66%) of survey participants report annual revenues of less than $100 million; 12% report revenues of $100 million to $500 million; and 22% report revenues of more than $500 million. Approximately 50% of participating companies produce processed foods, followed by meat, poultry and seafood (23%); miscellaneous/other (23%); and bakery products (20%).*

* Participants were able to select more than one category.

For more information

In the coming months, Grant Thornton and *Food Processing* magazine will continue to offer perspectives on emerging industry events and issues, exploring trends and how they may affect your business. For more information about how Grant Thornton can help your organization or to offer comments about this survey, please contact:

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