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BY TOM HANSSON AND ABHIJEET SHEKDAR

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Many large, well-established companies in the food and beverage and broader consumer goods industries are struggling to deliver compelling shareholder returns. Their core businesses generate healthy gross margins, but top-line growth has been anemic, margins are under pressure, and cost structures remain stubbornly high.

In the past, shareholders might have given management time to make course corrections. But today, capital markets are less patient, and investors are acutely focused on enhancing shareholder returns. Specialized private equity firms have devised models for driving cost reduction and margin expansion far in excess of what leading companies have been able to do on their own — by about 800 to 1,000 basis points in two to three years. And shareholder activists are following suit.

Although it is uncertain whether the new investors have the ability to foster growth in the long term, they have delivered outsized near-term shareholder returns. Few management teams will be able to match the new benchmarks solely by cost cutting, and few are positioned to deliver enough growth to meet the challenge without also significantly improving their profit margins. In fact, the industry needs to change its trajectory, transitioning from slow, margin-dilutive growth to faster, margin-accretive growth. But simply executing current plans more effectively or refining traditional formulas won't do the job. The industry needs to develop aggressive plans that will produce discontinuous growth.

That sounds like a tall order. But on the basis of our recent analysis of 12 major U.S. packaged food and non-alcoholic beverage companies, we believe management can drive comparable shareholder returns by deploying an alternative formula that has three key components. The first is cost reduction. Companies must reduce costs sufficiently to offset the margin erosion inherent in their their businesses, create enough savings to allow for reinvestment in the business, and raise operating margins by 400 basis points. Second, companies must rationalize their portfolios so that they retain only businesses in which core capabilities create unique advantage. Third, and most significant, they must create new avenues for step-change profitable growth that build upon current capabilities. We believe this approach can increase shareholder value by 50 percent or more over three to four years.

Winners and Losers

Most major branded food companies have been fighting significant headwinds. Their marketing, sales, and R&D organizations are designed for growth and brand building, and they have mastered the complexities of channel fragmentation, product proliferation, and geographic diversification. But they maintain substantial

Tom Hansson
thomas.hansson@strategyand.us.pwc.com
focuses on M&A strategy in the retail and consumer sectors at Strategy&, PWC's strategy consulting business. He is managing director with PwC US in Los Angeles.

Abhijeet Shekdar
abhijeet.k.shekdar@us.pwc.com
is a deals professional based in New York who focuses on the shareholder value proposition of companies as part of PwC's strategic value consulting business.

cost structures, despite years of incremental cost reductions. And the market environment isn't particularly favorable. Grocery sales essentially grow with population in developed economies, and population growth has remained modest. Consumers have become more price-sensitive, and consumer preferences are shifting — away from the kinds of processed foods that the major food companies have focused on, toward more natural, healthier, and less-processed products. Many of the growth pockets have been captured by private-label companies (in the price-sensitive category) and by smaller alternative brands (in the healthier, less-processed category). These competitors are less reliant on scale and quantitative insights, and are more adept at interacting with trendsetting consumers — especially millennials (see "The Big Bite of Small Brands," by Elisabeth Hartley, Steffen Lauster, and J. Neely, *s+b,* Aug. 27, 2013).

The typical shareholder promise for the major food companies has been to deliver annual sales growth in the low-single to mid-single digits, operating profit growth in the mid-single digits, and high-single-digit earnings-per-share growth. To see how much economic return the companies have actually generated, we analyzed the performance of 12 major U.S. packaged food and nonalcoholic beverage companies from January 2010 to the middle of 2015. We focused on total shareholder return (TSR) minus the contribution of expanding multiples and changes in leverage. This measure, which we call operational TSR, reflects the management actions that lead to superior returns: organic growth, margin expansion, and M&A. Critically, it excludes the across-the-board multiple expansion we saw during the stock market recovery.

The companies' performance falls neatly into two categories *(see exhibit).* The lower-performing group consists of seven companies that had an average annual operational TSR below 6 percent, and average organic growth rates of about 2 percent per year — just ahead of the rate of inflation. But even this modest growth came at the expense of margins. These companies' average gross margin fell by 320 basis points over the five-and-a-half-year period, their average operating margin fell 130 basis points before one-time events, and their average annual operational TSR was 3.3 percent. By comparison, the S&P 500's operational TSR (excluding banks) for the same

Exhibit: **The Growth Challenge for Mature Food Companies**

An analysis of 12 major U.S. packaged food and non-alcoholic beverage companies between January 2010 and mid-2015 showed a sharp divergence between low-performing and high-performing companies.

Lower Performers	Financial Metric	**Higher Performers**
2% per year	**Organic Growth**	7.7% per year
–320 bps	**Gross Margin**	+40 bps
–130 bps	**OI Margin**	+110 bps
3.3% per year	**Operational TSR**	13.6% per year
Changing the trajectory from margin-diluting, slow growth to margin-accretive, high growth	◀ **Challenge** ▶	Finding potential for continued above-trend growth, especially without changing strategies

Source: Strategy&, PWC

period was 10.2 percent per year.

The margin erosion can be ascribed to traditional margin pressures, to merger and acquisition activity that diluted margins, and, critically, to a structural portfolio problem. Many of these companies earn their highest returns in areas that either are not growing or are shrinking (often highly processed or "health-challenged" categories). At the same time, they are generating growth in lower-margin businesses — either in less-differentiated product areas (where the margin potential is lower) or in foreign markets where the companies lack scale and their brands have less relevance (and where the impact of currency fluctuations is greatest). Some of these companies face the additional challenge of being, in effect, conglomerates of different businesses with different performance characteristics and capabilities requirements. As the economic value of pure scale has been diminishing, and as the "best" marketing and selling capabilities become less differentiating, pressures increase to simplify portfolios. Some companies have proactively addressed this challenge by creating pure plays, and some others are moving in this direction by gradually divesting units that can no longer support the cost structure of the parent.

The second category in our study, the high performers, consists of five companies that had operational TSRs well above 6 percent per year and that achieved an average annual organic growth rate of 7.7 percent. Companies in this group were able to eke out an average gross margin expansion of 40 basis points over the five-and-a-half-year period, expanded EBIT margins by an average of 110 basis points, and generated an average annual operational TSR of 13.6 percent — well above the 10.2 percent of the S&P.

These more successful companies have succeeded, on average, in boosting growth along with modest margin improvement. However, although this model makes sense in a high-margin environment where returns are already ample, it would not necessarily make sense in the less-branded, lower-margin segments of the food industry.

The Cost-Focused Challenge

For those that don't generate profitable growth, another option is available. Eliminate the costs and resources devoted to that search for growth. Simplify the organization, eliminate complexity, focus brand investments, cut loss-making lines, and streamline the supply chain. Run the business by the numbers, and reinforce the new direction with clear individual objectives. This model will work particularly well in highly branded businesses that have high cost structures, and in which brand equities generate ample margins even if the top line shrinks. Evidence so far suggests that such an aggressive strategy can increase EBITDA margins by approximately 800 to 1,000 basis points. This approach has set a new benchmark for shareholder value creation.

But how can the management teams of the lower-performing major food companies — and companies in other industries with similar profiles — meet this new benchmark? Most management teams lack the skill or experience to raise margins by 800 to 1,000 basis points on the back of cost cutting. Nor is it realistic to expect they can match the shareholder return propositions of the high-performing food and beverage companies by driving 7 to 8 percent sustainable organic growth without margin erosion.

A Combined Approach

The alternative for most companies will be to pursue a three-pronged approach of margin improvement, portfolio rationalization, and revenue growth that will deliver shareholder returns of the same magnitude as those delivered by the cost-focused formula. Many combinations will achieve the same value, but a good starting point might be to split the difference, and aim to combine an increase of 400 to 450 basis points in margins

Illustration by Martin Leon Barreto

through cost cutting with sustainable, profitable top-line growth of 4 to 6 percent per year (or M&A to add the equivalent value). Although this is a big challenge, it is achievable. Here's how to do it.

Cut costs. Most companies will need to raise margins by 400 to 450 basis points over two to three years through cost reductions and rationalization. This appears consistent with the targets that at least some companies in the food industry are setting themselves, and with the "bigger and faster" cost reduction that's been gaining traction in response to the activist challenge (see "Be Your Own Activist Investor," by Deniz Caglar, Vinay Couto, and Gary L. Neilson, *s+b,* Oct. 19, 2015). But rather than mandating across-the-board cost reduction, this shareholder value formula calls for an approach that both cuts costs and preserves and enhances the distinctive capabilities that are critical to growth (see "Is Your Company Fit for Growth?" by Deniz Caglar, Jaya Pandrangi, and John Plansky, *s+b,* May 29, 2012).

Rationalize the portfolio. Managers need to be very selective in deciding which horses to bet on among their businesses. For each business unit they decide to keep, they should be able to answer "yes" to three questions:

• Can we create more value from the business unit than it is worth to someone else?

• Can the business unit benefit from our capabilities enough to support our new, slimmed-down cost structure?

• Does the business unit fit with our new shareholder return proposition to investors?

Stabilize the old core. Portfolio rationalization is not always a simple prospect. Given the economic realities of highly branded mature categories, management teams may not always be able to get adequate returns by divesting (or spinning off) some of these businesses. As a result, some will remain in the portfolio. Food companies are responding in a variety of ways to this challenge. Some run these businesses purely for profit, raising margins and accepting sales declines. Some are investing "just enough" to stabilize them. And some are doubling down, betting that material innovation and marketing initiatives will reverse the decline. The right answer will not be the same for all, but the consequences for getting it wrong can be significant. Underinvestment may erode a massive profit pool, and overreliance on a turnaround may simply leave the company without growth — with excessive time, resources, and focus spent on the old core at the expense of new growth avenues.

Expand existing profit pools. Many companies underestimate the growth potential in their existing core, either because they are distracted by what they see as more attractive opportunities in other markets or because they fail to see opportunities to use their own distinctive capabilities to gain share in their competitors' profit pools. Companies should identify and surgically invest in the company's most attractive profit pools to maximize profitable growth from existing businesses — those where distinctive capabilities provide superior returns and allow the company to gain share or tap into growth pockets. These investments may take many different forms, including focusing product innovations on specific channels, boosting promotional spending for specific customers, or devoting more R&D resources to specific product categories (see "Secrets of the Activist Manager," by Larry Jones and Joseph Duerr, *s+b,* Dec. 16, 2015).

Pursue step-out growth. Most companies don't have enough attractive investment opportunities in their portfolios to create sustainable, profitable growth at an annual rate of 4 to 6 percent. Thus, creating new profit pools — which can be done through a combination of organic means and M&A — is an imperative. The key is to focus on a few material initiatives that leverage and strengthen what the company does best, and to extend those by category or geography.

These step-out plays can take a variety of forms, including:

"Big bang" innovation. In most instances, innovation will be a component of any winning strategy. But in some cases a big, successful initiative may be the key — hitting home runs rather than singles. An obvious example in the food and beverage category has been single-serve coffee systems. The companies that developed them successfully redefined their businesses around these products (at least for a period of time).

New approach to foreign markets. Many large food companies have struggled abroad. They earn lower returns where their brands are less well-known. As a result, attempts to grow in all geographies result in margin erosion. An alternative is to focus resources in a couple of countries at a time to move from a follower position to a leadership position, raising margins while driving growth. This strategy may involve acquiring local competitors or focusing innovation in the country, and will likely include upgrading in-country capabilities. Returns follow the ability to add value.

Nuanced approach to on-trend businesses. Many large companies have struggled to reach consumers who seek healthier, less-processed products. As a result, many established firms have purchased smaller entrepreneurial businesses. The challenge is to derive enough value from these acquisitions to move the needle, especially given their small size and the high prices usually paid for them. Buying and holding upstarts separately doesn't create enough value, and absorbing them in a "billion-dollar brand" organization stifles them by imposing the parent's institutional methodology on the acquired companies' more flexible take on innovation and brand building. Part of the trick is to find a happy medium that enables acquired companies to grow by providing sales access and distribution resources to boost the targets' sales, while allowing them to remain entrepreneurial. But critically, the parent also must apply the insights that make the target company successful to its traditional core business in order to change the parent company's growth trajectory and experience a step change in value.

Roll up your sector. The more focused a company becomes on a narrow range of products, the more it is able to develop advantaged capabilities in that category — through insights, innovation, category management, commercial processes, and operational expertise. Global or regional consolidation will be the attractive play where these capabilities are sufficiently differentiating (see "Grow from Your Strengths," by Gerald Adolph and Kim David Greenwood, *s+b,* Aug. 18, 2015).

Adjacent M&A. Mergers and acquisitions are a proven inorganic growth strategy, but one fraught with risk. Most acquisitions fail — particularly those that are made outside the existing core. "Near-in" adjacencies are the most promising. Companies that can identify where their distinctive capabilities will provide advantages outside their existing business, or identify how they can jointly build advantage with an adjacent target, will have the best chance to add value.

Thinking Big

Executives in food and beverage companies are facing a truly challenging situation. Capital markets have become much more demanding, and outside investors have shown how much value can be created. Most companies will need to pursue a triple play of cost reduction, portfolio rationalization, and growth of a magnitude not often seen before.

But before picking and choosing tactics, executives have to change their mind-set. The industry may be focusing on cost reduction, but many players will still fall short of the targets necessary to establish a competitive shareholder value proposition, and only some companies have taken significant steps to simplify their portfolios. And there is certainly nothing incremental about the growth challenge most companies face.

As a result, companies need to adopt a far-reaching top-down approach that maps out the potential growth avenues over a five-year time frame. They must identify a portfolio of big ideas to make the kinds of step changes that will likely double or triple the value of their most advantaged units — while ensuring that the resulting corporation will be strategically coherent and competitively advantaged.

Executing this strategic triple play won't be easy. But the rewards will be significant for companies that succeed. They will be positioned to achieve consistent, profitable growth and future value creation. And they might even fall off the activists' radar. ✚

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