The Shareholder Value Triple Play

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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 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
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
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...
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 consequenc-
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. +