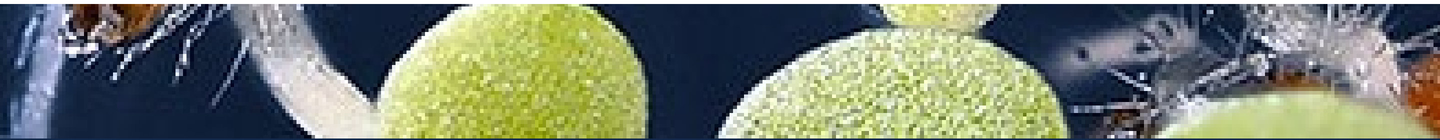
The Food Revolution

Research Paper

October 2024



F&B Producers to Reengage with Consumers through Product Innovation

Consumers' Limits Reached

After years of raising prices, food companies are now reaching the limits of what consumers are willing to pay. According to data from the U.S. Agriculture Department, U.S. consumers spent an average of 11.3% of their disposable income on food in 2023, a level not seen since 1991. In response, consumers have adjusted their shopping habits, seeking deals, purchasing items on sale, reducing basket sizes, and opting for store brands over branded goods. Despite these adjustments, many consumers have been left with a sour taste in their mouths: a survey conducted by the University of Illinois and Purdue University found that 70% believe restaurants, supermarkets, and food manufacturers are overcharging.

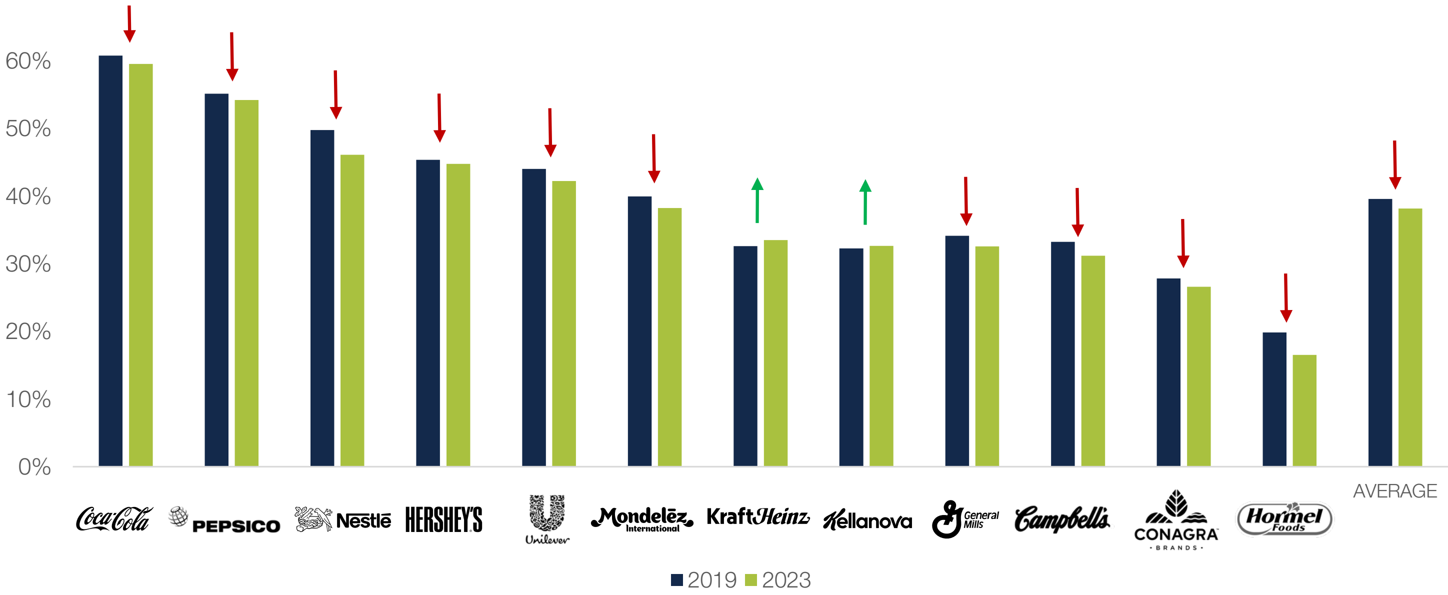
Figure 1: Consumers hit their breaking point

Source: USDA, University of Illinois and Purdue University

Branded Products Losing Momentum

Food companies have cited pressure from rising input costs as the reason for increasing prices. Our analysis shows that FY23 gross margins remain below pre-pandemic levels, suggesting there was little, if any, excessive markup in response to inflation. Still, certain pricing strategies encountered challenges. Nestlé acknowledged this issue, with Steven Presley, President of North America, noting that price gaps with competitors in the frozen food category grew too large, weakening their competitiveness. Similarly, General Mills' Group President of North America Retail, Dana McNabb, admitted: "*We run 25 categories in North America Retail, and it's logical to assume we didn't get the pricing right in every category.*" Danone's CEO, Antoine de Saint-Affrique, echoed this view, stating: "*We made a couple of mistakes. We underestimated price elasticity, but have since corrected prices to a more competitive level.*"

Figure 2: FY23 gross profit margins remain below pre-pandemic levels



Source: Bloomberg, Picard Angst Research

Political Influence on Food Prices

The U.S. presidential candidates are actively debating food prices. Democratic nominee Kamala Harris advocates for a federal ban on "price gouging," attributing food price inflation to corporate greed. In contrast, Republican nominee Donald Trump names high energy costs as the root cause and promises to address it through increased drilling.

Focus on Volume Growth and Innovation

Given the consumer backlash, the need for competitive pricing, and the influence of political agendas, food prices are expected to decline. In this environment, focusing on volume growth has become crucial. Retailers have intensified their promotional activities, which should attract value-seeking consumers. More importantly, food producers are rethinking their strategies to re-engage consumers and revitalize interest in their products.

Kraft Heinz CEO Carlos Abrams Rivera emphasized this shift, stating, "We need to make sure that we have products that are worth paying for."

We are entering a new innovation cycle designed to drive volume growth. As Nestlé CFO Anna Manz noted, "We've been stepping up innovation because, during COVID, we were quite focused on recipe-led innovation due to the supply chain crisis and inflation, but that's not consumer-led innovation."

At the same conference, Unilever CEO Hein M. Schumacher highlighted the importance of innovation, stating, "Innovation is obviously the lifeblood of CPGs, much more so than we may have realized for some time."

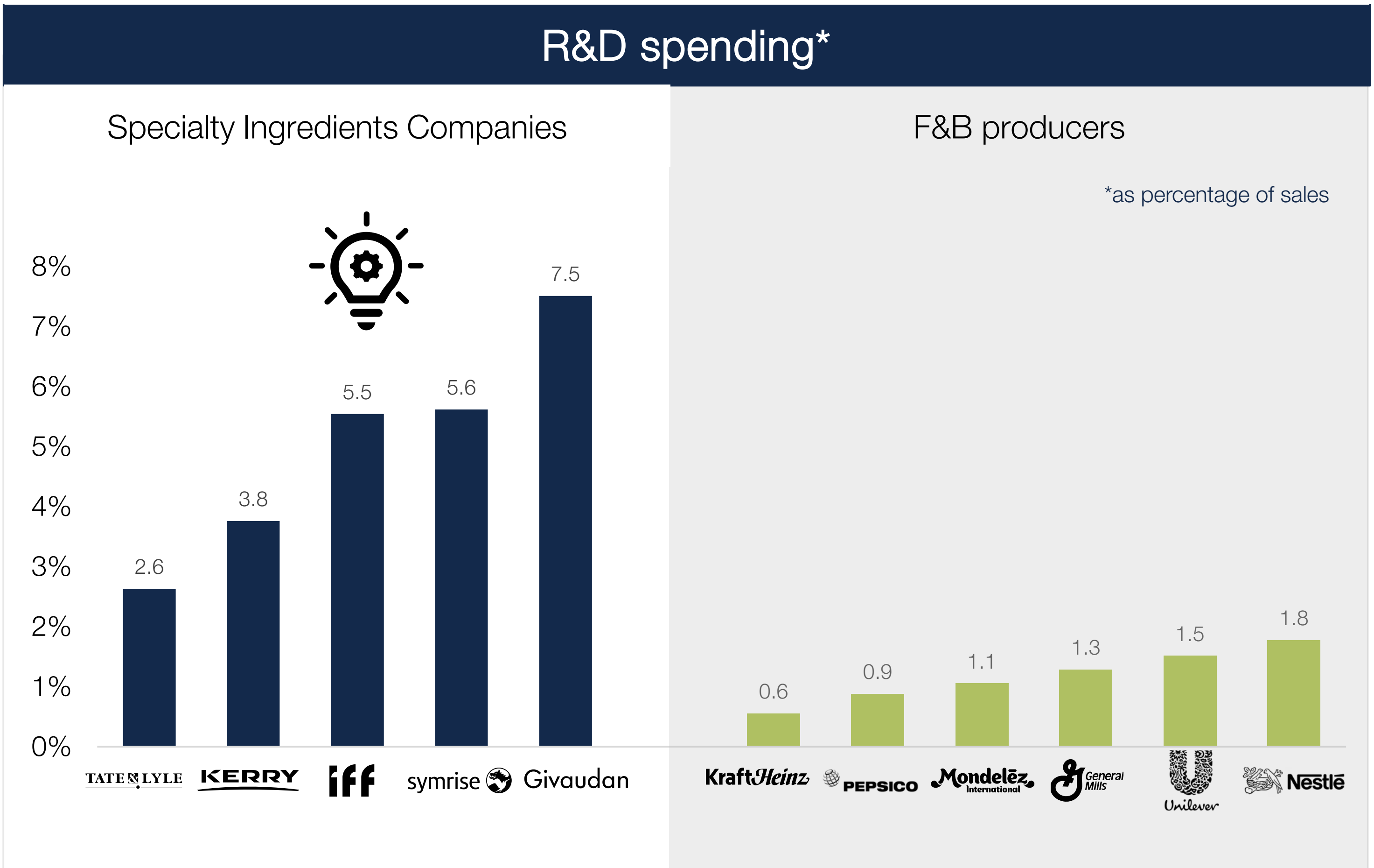
Changes in Leadership at Major Food Companies

Some F&B players are undergoing major shake-ups to ensure they have the right leadership in place for the next phase of growth. The sudden departure of Nestlé CEO Mark Schneider can be seen as a strong signal. The incoming CEO, Laurent Freixe, has made driving sustainable topline growth through increased investments in innovation his top priority. Similarly, Starbucks' CEO was abruptly removed after a short 17-month tenure amid declining sales. The incoming CEO, Brian Niccol, who led Chipotle through a major turnaround, has already captured the market's attention, with Starbucks' stock soaring 18% upon his appointment. Successful menu innovations have been an important part of his playbook.

Specialty Ingredients Drive Food Industry Innovation

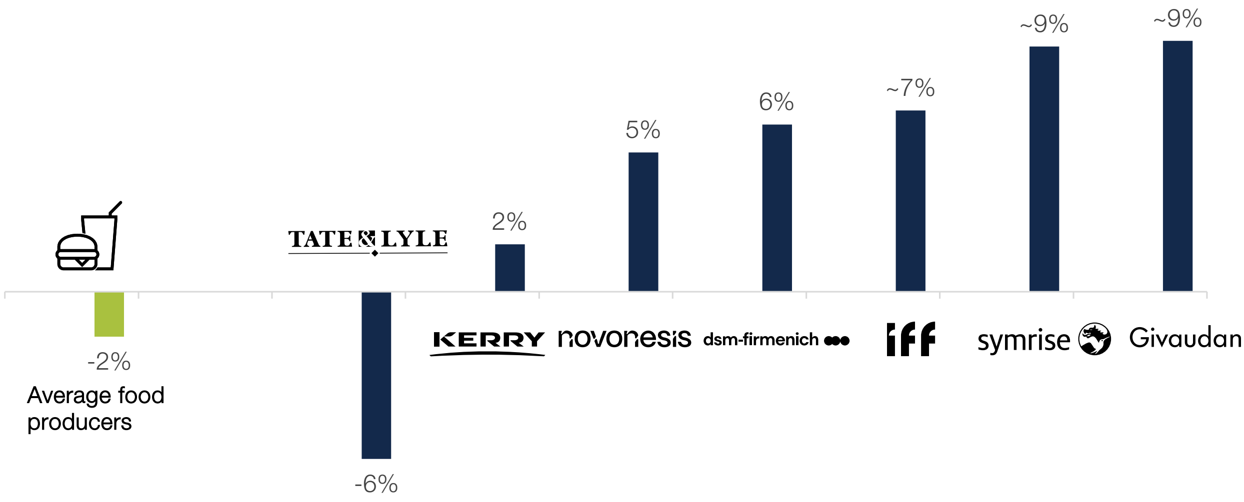
How does "The Food Revolution" fund capitalize on this trend? As highlighted in Figure 3, specialty ingredient companies invest significantly more in research and development (as a percentage of sales) than F&B producers. There has been a growing trend of outsourcing some or all innovative efforts to these players. As a result, we believe flavor and functional ingredient manufacturers are well-positioned to benefit from this innovation revival, and our thesis has already begun to materialize. While F&B volumes have shown only modest signs of recovery so far, specialty ingredient companies have reported strong topline growth. Overall, ingredients companies account for 26% of our portfolio and have achieved an average total return of 24% year-to-date.

Figure 3: R&D spending as percentage of sales



Source: Bloomberg, Picard Angst Research

Figure 4: Ingredients' 1H24 volume growth exceeds food producers'



Note: Tate & Lyle's data includes one quarter (year-end March 2024). In 2023, the company prioritized margins over volume and adjusted its business mix.

Sources: Company fillings, Picard Angst Research

Health and Wellness Innovations Are Taking Center Stage

Product innovation revolves around consumers' increasing focus on health, wellness, and premium offerings. Key trends in the F&B innovation landscape include salt and sugar reduction, the use of natural ingredients, and enhanced nutrition profiles with added health benefits, such as supporting the microbiome and gut health. Ingredient suppliers are contributing to this trend with their specialized expertise.

Kerry, for example, is particularly proud of its salt reduction platform, while **Tate & Lyle** offers one of the fastest-growing low-calorie sweetener platforms based on stevia. **Novonesis** supplies a probiotic known to target the gut-brain axis, promoting mental wellness and opening the door to stress-reducing food and beverage products. **Symrise** has made natural ingredients a key focus area, and **Givaudan** has developed an attractive hydration and refreshment platform, crafting healthy beverages with functional benefits. **DSM-Firmenich** is transforming early life nutrition with the introduction of Human Milk Oligosaccharides (HMO), bringing baby formula closer to breast milk. Finally, **IFF**, with the broadest product portfolio, is tapping into each of these areas, aside from HMO.

Increased Volumes Boost Packaging Demand

Following this line of thought, once the innovation cycle takes hold and consumers are lured back to reengage with the packaged food category, the next beneficiaries will likely be packaging companies. We have started to increase our exposure to this subtheme. In June, we initiated a position in **Huhtamaki**, a Finnish provider of sustainable packaging solutions. Its product range includes both food retail and food service applications, from molded fiber egg cartons to on-the-go paper cups. More importantly, the company has strong innovation capabilities, as demonstrated by its development of the recently launched fiber-based coffee capsule for Nespresso. Similarly, in July, we initiated a position in **Graphic Packaging**, a U.S. paperboard packaging provider. The company offers food-service cups and cartons, paperboard bowls and trays, as well as advanced packaging design and premiumization capabilities.

Structural Shift from Plastic Packaging to Aluminum Cans, Glass, and Cardboard Packaging

Finally, we hold core positions in **Crown Holdings**, the U.S. beverage can manufacturer, and **SIG Group**, the Swiss aseptic carton provider. According to the Can Manufacturers Institute, more than 70% of new beverage launches are packaged in aluminum cans, as consumers are increasingly moving away from plastics. This bodes well for **Crown**, given the ongoing innovation cycle. **SIG Group** has faced challenges this year, but it provides valuable packaging technology that extends shelf life and eliminates the need for refrigeration. We anticipate that a return to volume growth from its key customers will serve as a catalyst for the stock. Our portfolio currently has a 16% exposure to the Sustainable Packaging Solutions sub-theme, and we are exploring ways to further increase our investment.

To conclude, we are entering a new consumer-led innovation cycle expected to boost volume growth for F&B companies. After years of sluggish growth, this shift represents a significant catalyst for change. Specialty ingredient companies are poised to be key beneficiaries, serving as outsourced R&D departments for food producers. Additionally, increased volumes will drive higher demand for packaging solutions.

**Together, ingredients and packaging constitute approximately 40% of "The Food Revolution" portfolio.
As a result, the fund is well-positioned to capitalize on these trends.**

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