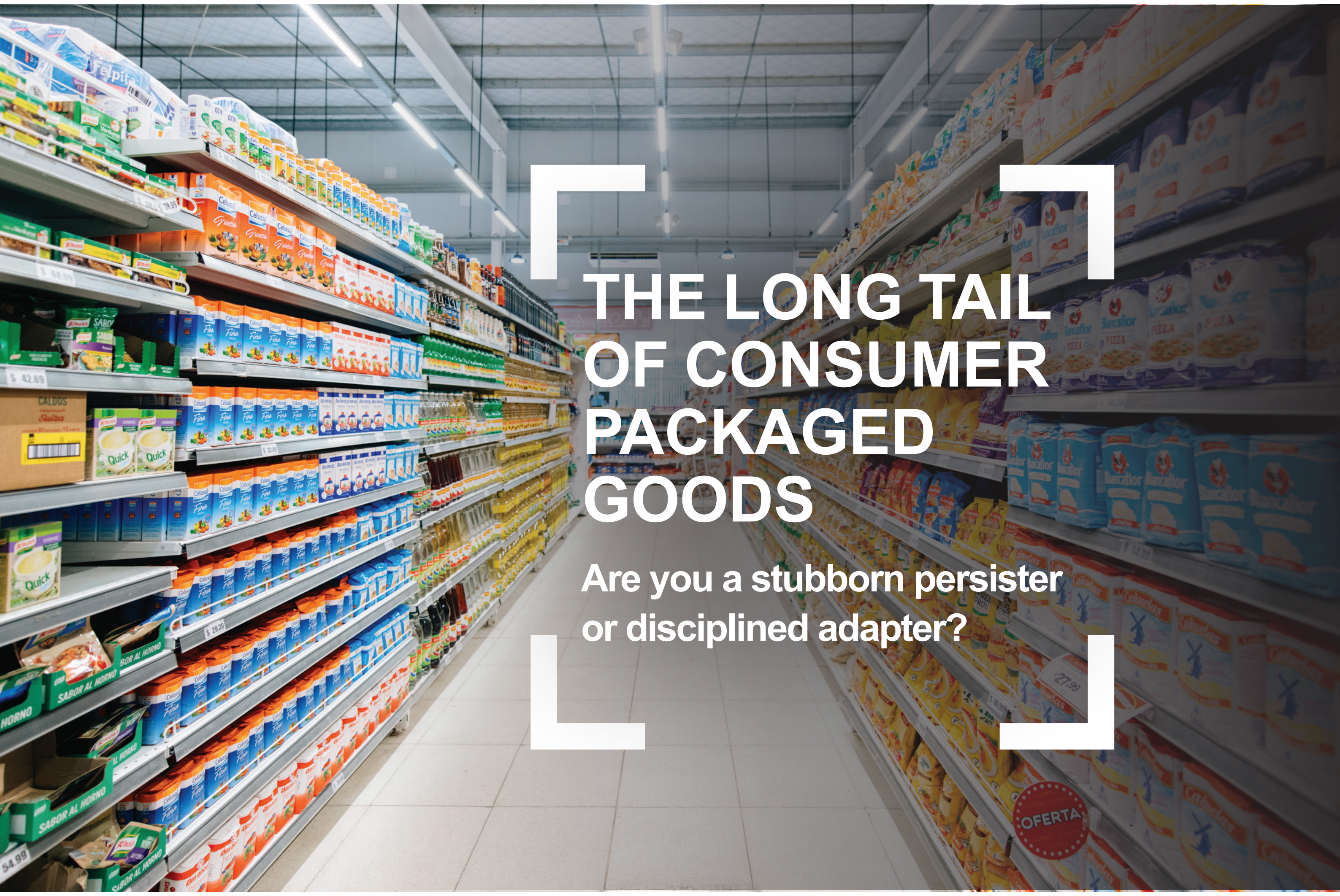
COMMENTARY



THE LONG TAIL OF CONSUMER PACKAGED GOODS

Are you a stubborn persister or disciplined adapter?

July 2020

Marakon

Management Consulting at Charles River Associates

Value-consuming products have long been a drag on the performance of consumer packaged goods (CPG), particularly in the food sector. So, the story goes: these offers add to the top line and cover fixed costs. To eliminate brands, would reduce the top line and leave a pool of stranded costs that compress margins, adding pressure to the already low expectations of investors.

But there's another version of this story, and management teams willing to change course can create a different outcome.

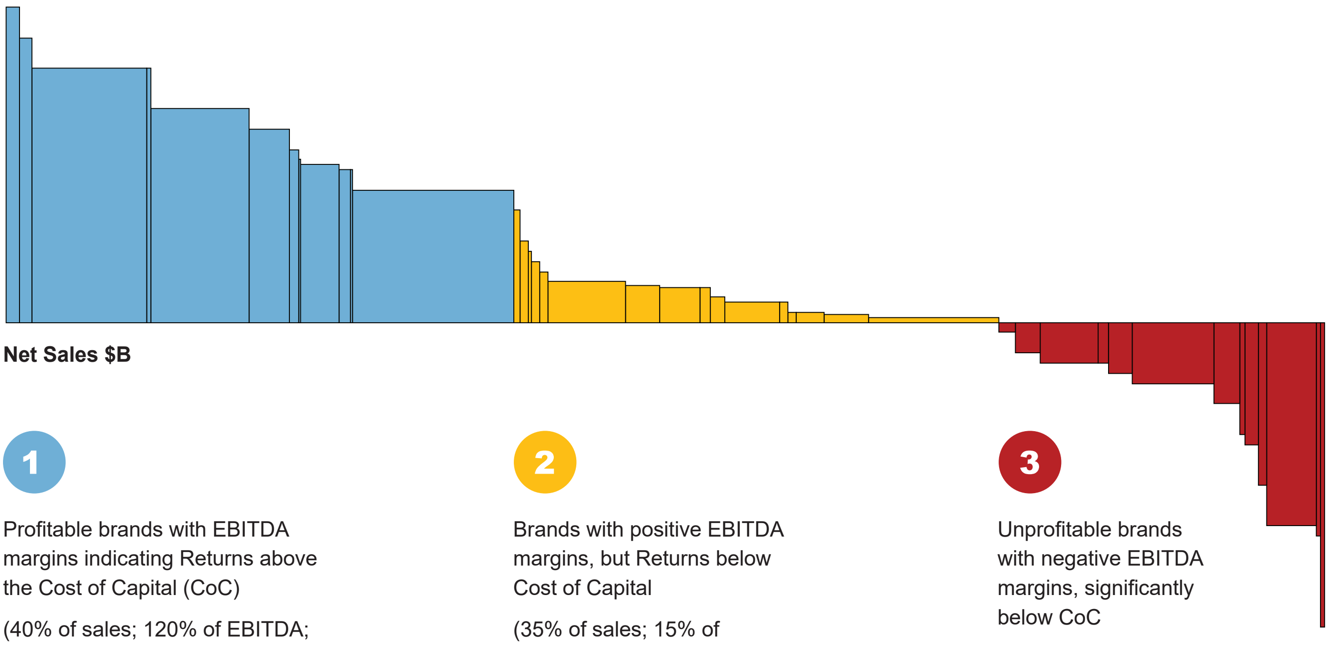
In our work with CPG companies and research on drivers of CPG performance, among companies that had historically underperformed (generating ~1% TSRs for the 4 years from 2011-14) half of them continued to languish, with TSRs of -2% over the subsequent 4 years from 2015-18. The other half were able to break out and deliver 24% TSRs from 2015-18. One key driver of this was the tendency of companies in the first group to stubbornly persist, pursuing top-line growth at all costs. In contrast, standout companies in the latter group adapted with discipline, including downsizing to a smaller and more profitable core with a better long-term outlook.

STUBBORN PERSISTERS AND DISCIPLINED ADAPTERS

Stubborn persisters and disciplined adapters share a common history; both chased unprofitable top-line growth, resulting in deteriorating margins, dwindling investment capacity, and declining returns for shareholders. Stubborn persisters doubled down, continuing to proliferate new offers that underperformed (even when on-trend), often due to limited differentiation and lack of focus on which product attributes consumers are willing to pay for. By continuing down this path unabated over the course of years, stubborn persisters destroyed significant value for investors and customers.

In contrast, disciplined adapters took steps to refocus their portfolios, often moving to smaller businesses well-positioned for profitable growth. These steps included divestitures of non-core assets and redeployment of investment dollars. The ensuing 2-3 turnaround years entailed difficult but steady change—tough medicine made even harder to swallow by investors who observed the short-term negative performance and were often unconvinced of the long-term trajectory. In the long term, however, the discipline yields profit growth and value creation for shareholders and other stakeholders.

Representative CPG Brand Waterfall



1 Profitable brands with EBITDA margins indicating Returns above the Cost of Capital (CoC)

(40% of sales; 120% of EBITDA; 30% of brands)

2 Brands with positive EBITDA margins, but Returns below Cost of Capital

(35% of sales; 15% of EBITDA; 40% of brands)

3 Unprofitable brands with negative EBITDA margins, significantly below CoC

(25% of sales; -35% of EBITDA; 30% of brands)

Note: Indicative of starting point for stubborn persisters and disciplined adapters; [1] 12% EBITDA Margin is required for break-even return vs. cost of capital, assuming D&A / Sales = 3%, Tax Rate = 27.5%, Invested Capital / Sales = 0.8, WACC = 8%

GROWING OUT OF POOR PERFORMANCE VS. TOUGH CHOICES

The chart above represents both performance types before taking action: 30% of the portfolio is EBITDA negative, and 40% is EBITDA positive, but fails to generate a margin sufficient to cover the cost of capital. Based on our research and experience, there is no growing out of this situation – it only gets worse for stubborn persisters. In contrast, disciplined adapters like natural and organic food company Hain Celestial, reap the benefits of tough choices: **focus first on profitability, then top-line growth**. Current management inherited a long tail that had generated -21% annualized TSRs from 2015-18; addressing the tail has been central to turning around Hain's performance – with annualized TSRs of 58% in the last 18 months. While Hain's starting point had unique characteristics, the long tail inherited by current management is common throughout CPG.

The COVID crisis makes the challenges of CPG companies even harder with price-sensitive consumers trading down, customer demands for higher trade, and consumer shifts to lower margin e-commerce. These are but a few from a long list of structural challenges to growth and profitability. The crisis presents an opportunity for CPG companies to restructure portfolios where they have been reticent to do so. Incremental demand from isolation, and customer focus on fewer SKUs, creates a window to take out the worst of the tail while minimizing top-line impact, given the short-term lift in food consumption at home. The scale of the "isolation benefit" won't last, so best to act now as the structural changes underway will require every arrow in the quiver.

Written by:
Mason Kissell
Vice President and
Practice Leader
mkissell@marakon.com
+1-212-520-7270

ABOUT MARAKON

Marakon is a strategy and organizational advisory firm with the experience and track record of helping CEOs and their leadership teams deliver sustainable profitable growth. We get hired when our client's ambitions are high, the path to get there is not clear (or taking too long) and lasting capabilities are as important as immediate impact.

We have a joint team delivery approach where client ownership and engagement is paramount. Partners are highly engaged in the work product and supported by strong analytical and industry relevant capability. We work as advisers and catalysts in close, trust-based relationships with top management teams.