# COMMENTARY

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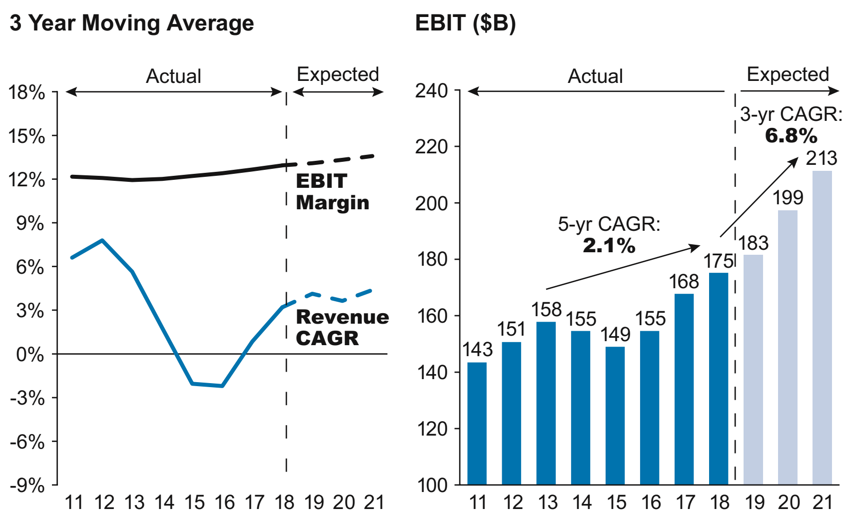
**Despite pressures on recent performance, market expectations for the consumer and packaged goods (CPG) industry are high. Growth has been trending up and margins are expected to continue to improve. Taken together the rate of profit growth in the next three years is forecast to be 3x what was delivered in the last five, see Figure 1. The challenge for CPG companies is how to meet and exceed the high expectations imbedded in their valuations, given the considerable headwinds.**

The story of CPG performance going forward need not be an unhappy one if company leaders steer a new course fast. Whereas favorable market characteristics explain much historical performance, to meet and beat investor expectations CPG companies need new strategies that deliver advantaged rates of profit growth relative to the sector.

**Figure 1: Global CPG Revenue Growth, EBIT Margin and EBIT**




Note: Peer set includes 200+ companies in packaged foods, personal, and household products with market capitalization greater than $1B

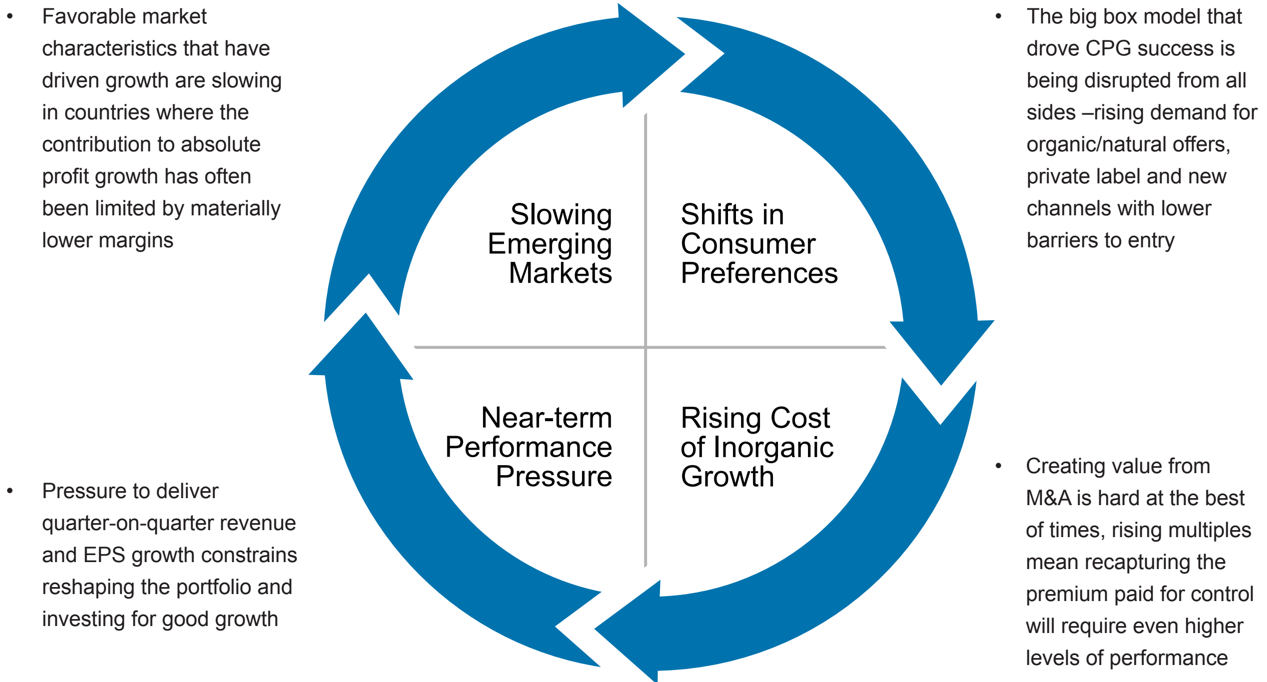
Source: S&P Global Capital IQ financials for 200+ global CPG companies with market capitalization over $1B

Most CPG leaders we talk to believe they are taking the necessary actions. However, our experience suggests that the scope and pace of change is neither sufficient or fast enough. In this *Commentary*, we discuss four headwinds and introduce critical capabilities that, taken together, provide a basis for achieving winning performance. We will elaborate and illustrate each of these capabilities in a subsequent *Commentary*.

## Headwinds Challenging Profit Growth

CPG companies have a long-standing track record for delivering profit growth. Looking at the financial and strategic drivers of CPG value – past, current, and prospective – our assessment points to four headwinds challenging the historical model for success (Figure 2).

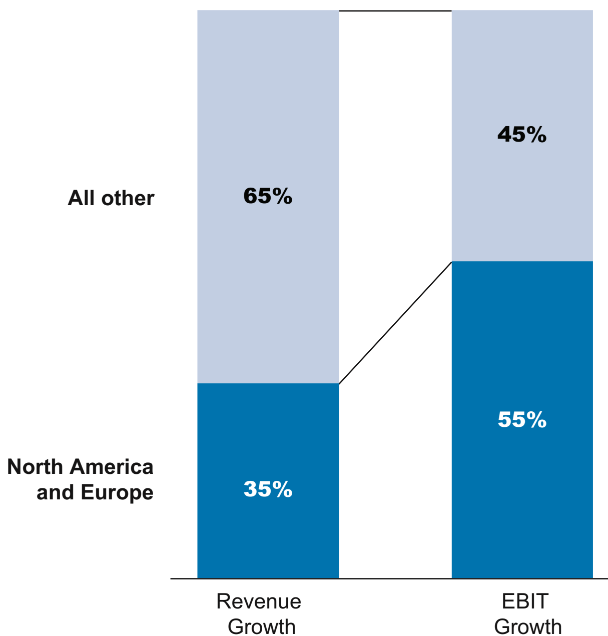
**Figure 2: The Headwinds Challenging the Historical CPG Model**




Source: S&P Global Capital IQ, Marakon analysis

## 1. Lower Profitability and Slowing Growth in Emerging Markets

**Figure 3: CPG Drivers of Revenue and EBIT Growth by Region 2008-2018**




Sources: S&P Global Capital IQ financials for 200+ global CPG companies with market capitalization over $1B

From 2009 to 2018, growth in North America and Europe was anemic; more than 65% of industry revenue growth came from outside these regions (Figure 3). Looking forward however, growth in China and the rest of world, while still relatively strong, is expected to slow. More concerning for CPG leaders and investors is that the rate of profit growth in these markets is much lower than top-line growth due to lower margins. While there are exceptions (e.g., international brands serving affluent Chinese customers in personal care, nutrition, and OTC), increased local competition and regulation is putting pressure on these too. With growth outside of North America and Europe expected to slow, the impact of lower margins on absolute profit growth will become even more acute.

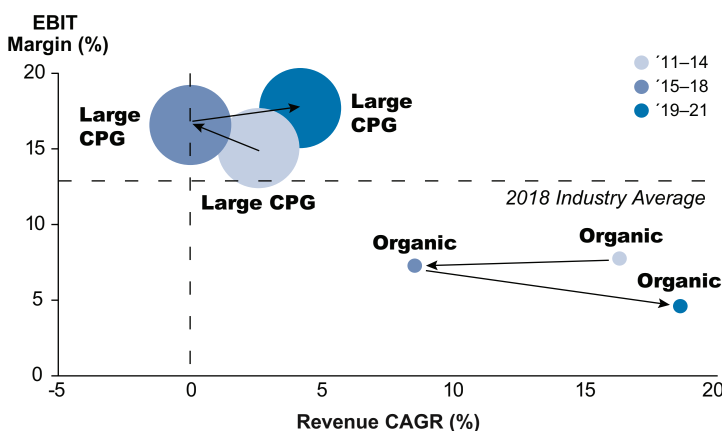
## 2. Shifts in Consumer Preferences and Purchase Behaviors

Innovation and marketing have long been core tenets of the “mass-brand model” and central to the success of CPG companies in creating lasting consumer relationships. Strong relationships with consumers will remain vital to the success of CPG companies going forward, however there are three shifts reshaping the tenets underpinning the relationship.

### Organic, Natural, and GMO-Free as a Right to Play

For many consumers, organic, natural, and GMO-free offerings in food, personal and household products have become a driver for purchase. The challenge for CPG companies is that organic, natural, and GMO-free offerings provide limited basis for differentiation. In the baby food space for example, many new parents see organic as a prerequisite for their purchase and the high level of switching across brands demonstrates the low value they place on brands.

**Figure 4: Growth and Margin of Large CPG vs. Organic & Natural Companies**




Sources: Marakon analysis of large CPG companies defined as those with market capitalization over $15B and publicly traded CPG companies that predominantly produce organic products. S&P Global Capital IQ

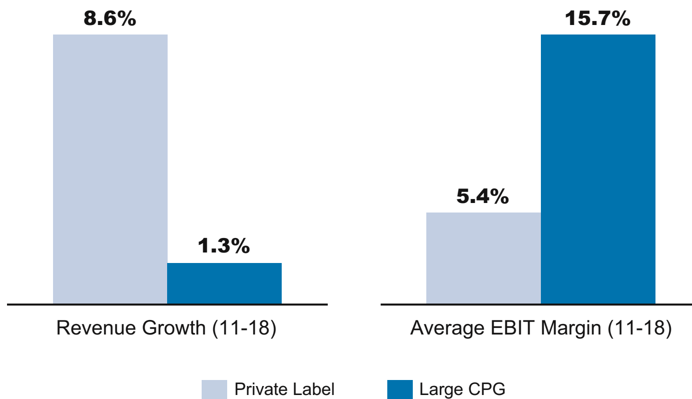
Complicating matters further, while consumers are willing to pay more for products with organic, natural, and GMO-free characteristics, the “upcharge” paid by these consumers is insufficient to cover the higher costs. As natural and related offerings continue to gain top-line share, the rate of industry profit growth will further slow due to an increasing mix of lower margin offerings (see Figure 3). Compounding the situation, the economics of the organic, natural, and GMO-free offerings are at a level where the investment needed to support marketing and innovation is hard to sustain; which is likely to add further downward pressure on growth and margin as offerings become less distinctive. These challenges are but a window on the pressure CPG companies face in realigning existing offers with changing consumer behaviors.

### Growth of Private Label

Like organic, natural, and GMO-free offerings, consumer attitudes towards private labels have shifted, particularly among millennials. Private-label products currently command a sizeable share of volume in US retail and many European markets (see IRI (2016), “Private Label: The Journey to Growth Along Roads Less Traveled” and The Nielsen Company (2018), “The Rise and Rise of Private Label.”). The benefits to customers are also clear, with store brands no longer just a cheaper “me-too” offering, but a

source of differentiation and an important and growing source of revenue and profit. Costco's Kirkland Signature private-label products generated $39bn of sales in 2018 and contributed a third of net sales growth. (Source: Costco 2018 Annual Report; Marakon analysis)

**Figure 5: Revenue Growth of Private Label vs. Large CPG Companies**




Sources: Marakon analysis of large CPG companies defined as those with market capitalization over $15B and publicly traded CPG companies that predominantly produce private label products, S&P Global Capital IQ

While the economics of private label show some positive signs – growth in revenue and absolute profit – they remain challenging (i.e., profitability and return on capital). By implication, price will remain a battle ground as private-label providers compete for share.

## Changing Channels of Purchase

Historically, CPG companies were built around a model of working with traditional retail channels to promote products and build consumer trust through brands. Under this model, the CPG company controlled the consumer relationship and the vast majority of system economics. That model has come unglued. Today consumers have a wide range of choices for what, where, and how they buy:

- Traditional retailers make greater use of store brands and leverage a wealth of information about consumers (e.g., psychographics, geolocation, etc.) that was previously inaccessible, to steer the consumer in-store experience and purchases at the expense of branded manufacturers.
- Specialty providers play to the purchasing power of the young and affluent who reject traditional brands and prefer pure e-commerce or an omni-channel experience over traditional retail.
- E-commerce players leverage convenience, price, and personalization to shift the value-add away from manufacturers by servicing direct to consumer (e.g., subscription services).

## 3. The Cost of Inorganic Growth and Decline of "Scalable Box Offerings"

Inorganic growth has been a core tenet of CPG strategy. While findings from studies we and others have published consistently show that few acquisitions create value, M&A features in virtually all top performers' success. Our analysis shows that the top 12 large CPG companies by TSR in the past 10 years closed 34 acquisitions totaling $32B or 14% of their combined change in market capitalization. Over the same time period, the EV/EBITDA multiple for acquisitions in the industry has risen from 18 to 25. While many of these acquisitions were designed to play into higher growth segments (e.g., organic, natural), the level of profit growth has fallen short of that needed to recapture the premium paid let

alone generate a return on the capital invested. Our view is that M&A will only get harder as rising purchase premiums and shifts in consumer behaviors away from "scalable box offerings," which have been core to premium recapture, increase.

## 4. Near-Term Performance Pressures

Our assessment of CPG company performance and discussions with CPG leaders suggests to us that the sector is caught in a vicious performance cycle. While there are variants to the story, investor pressure for near-term performance is contributing to a number of leadership behaviors and actions that are creating a value-growth trap.

**Figure 6: Falling into the Value-Growth Trap**

| | |
|---|---|
| **Typical Investor Pressures...** | • Quarterly revenue growth<br>• Quarterly EPS growth<br>• Continuous margin expansion |
| **...Incentivize Common Behaviors and Mindsets...** | • Pursue all top-line opportunities subject to a nominal gross contribution<br>• Make EBIT margin (vs absolute profit growth potential) the basis for allocating investment<br>• Manage the highest margin businesses to margin not profit growth<br>• Redeploy resources from high margin businesses to those most challenged<br>• Across-the-board cost cutting<br>• Acquire businesses that add top-line and are earnings accretive |
| **...That Lead to Unintended Results** | • Large and rapidly growing tail of immaterial and uneconomic offerings<br>• Underinvestment in businesses that drive company value growth<br>• Buying top-line and earnings at uneconomic rates |

Source: Marakon analysis of 200+ CPG companies with market capitalization over $1B

Unfortunately, based on performance and actions taken, many CPG leaders don't yet see the scope of the value trap being created until it's too late. In our opinion, the resulting changes to leadership (whether board-induced or from the outside agitation) when companies have put themselves into a value trap is warranted, as is the pressure on margin improvement. But in many cases, we find the path to transform performance to be overly blunt and misguided; focused on taking out functional costs without a clear understanding of the cost/benefit relationship or similarly, streamlining offerings such as brands and SKUs without a clear linkage to category attractiveness, company and customer economics. While these actions can lead to improved profitability short term, they are less likely to lead to an advantaged portfolio and as a result undermine sustainable profitable growth.

The good news for companies caught in a value-growth trap and the leaders driving the change, is the uplift to intrinsic value is always material – typically 2x – and rarely priced into a company's stock.

## Turning Headwinds Into Tailwinds

CPG leaders face many strategic choices for how best to respond to changing market dynamics. The answer that is best will be different for each company. Our experience tells us the odds of getting to the best answer relies on six distinct but interrelated capabilities and behaviors.

1. **Identify value-drivers and erosion.** Ground the team on the sources and drivers of value (growth, profitability, risk) and erosion for the company, each line of business, geographies, brands, customers, and key intersections
2. **Make clear the level of performance required.** Reset the financial algorithm for managing the business including the required growth in absolute profit implied by performing at competitive levels, the combination of growth and return from each business needed to achieve it, and the linkages between financial targets and strategic measures of performance e.g., share of category value growth
3. **Get bigger/better or get out.** Define the future portfolio shape and role of each business including where to Get Bigger (invest to grow), which businesses to Get Better (fix before investing) or Incubate (bets on future materiality) and Get Out (harvest/exit)
4. **Maintain good growth.** Address the uneconomic investment across the portfolio i.e., within the parts that are performing well and those that are not, by releasing and redeploying resources in support of good growth
5. **Accelerate performance capture.** Align the organization by cascading value-growth goals for the company to each line of business, linking financial targets (combinations of growth/return and risk) to strategic and financial measures and clarify the roles and accountabilities for making it happen
6. **Strategic use of M&A.** Use M&A as a means to accelerate the reshaped portfolio strategy rather than treating M&A as a strategy in its own right (especially given the sector's history of using M&A to grow top line while destroying value)

Viewed through these six lenses, our experience with clients is the potential value uplift through systematically releasing and redeploying investment in support of profitable top-line is 2.5x the starting point. In our next *Commentary* we will share our scorecard on CPG company performance and illustrate how the capabilities presented above can be used to unlock value growth.

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## 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 help clients achieve their ambitions for sustainable profitable growth through:

- Stronger strategies and advantaged execution based on:

  A better understanding of what drives client economics and value

  Insight into changing industry dynamics and the context in which clients need to succeed

- A stronger management framework to generate better ideas and link decisions and actions to value
- A stronger organization with a more focused top management agenda and well-aligned resources
- A more confident and effective leadership team that's focused, decisive, and strategic

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.

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