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Actionable Insight

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Value Trends and Traps in the Retail Food Sector

Our European Partner recently encountered this burger.

Quick

The Darth Vader Burger: Clever tie-in or Death Star?

No, those buns aren't burned, they're dyed black. The Belgian QSR "Quick" decided recently that a "Darth Vader Burger" would make a great tie-in to the release of the 3D version of *Star Wars Episode I: The Phantom Menace* in 3D.

Did Quick generate buzz with a black bun? Sure. And if you've ever dreamt of lounging in *Le Grand Place* in Brussels quaffing a beer and eating a Star Wars-themed burger, get to Belgium fast.

On the other hand, this type of black humor raises questions about what creates lasting value in the food sector, and how can you know what trends to pursue? Are promotions like the Darth Vader Burger viral marketing genius or long term value traps for QSRs and their suppliers?

To us that burger looks like the Death Star: yes, it's memorable, and it generates short-term buzz, but it puts Quick firmly on the wrong side of deeper food trends.

Deep Food Trends and Industry Implications

The larger social trends driving change in the food sector are by now well-documented. Consumers are demanding healthier (or perceived healthier) food options, and this demand is not a fad. If anything, this "health and wellness" trend will increase, driven by:

- Greater public awareness of the cost of the rising incidence of obesity, especially in children;
- Increasing life expectancies, which result in an aging, more self-aware and better educated average customer;
- Greater wealth over the long-term, resulting in a diminished total wallet-share for food, but a greater willingness to pay for premium food; and

- Increased information availability about healthy food from a wide variety of sources, ranging from greater health education in schools through to the internet and mobile computing.

If you doubt the persistence, depth and momentum of the "health and wellness" trend, consider how much a branded food giant like Kraft is putting into lowering the calorie and sodium count in their products, or Wal-Mart's recent addition of "Great for You" icon to its private label offering. These firms do their homework, and at their scale, when they adopt a trend they reinforce it.

That's the supply side. What about the demand side? For an interesting reference point, watch this 50-second video about "Fooducate," the winner of the U.S. Surgeon General's Web site to encourage software developers to create healthy apps (i.e. software for phones that helps people make better food choices). Then consider that, according to the *Economist*, "Nearly one-third of people living in America own a smartphone, and 70% of owners now use it to do searches while they are inside a shop, usually to compare prices." Further consider how quickly smartphone penetration is climbing. As consumers grow more familiar with these devices as shopping tools, it's almost a certainty that they will use them to compare far more than price. In our view, apps like Fooducate, TheGoodGuide and even a wine-chooser like Snooth Wine Pro or recipe finders like Blippar not only embody the fact that all products are becoming information products, but also that they will tend to drive healthier choices faster than many firms expect.

In short, on both the supply side and the demand side, "Health and Wellness" is here to stay, and that makes black buns more of a Phantom Menace than Jedi Knight marketing genius.

IAP's Investment Hypothesis: *Clean Up, Build Up, Roll Up*

In IAP's view, the Health and Wellness trend creates opportunities across many sectors of the food value chain.

Clearly, restaurant companies and retailers that have consumer credibility in the space, such as Roti, My Fit Foods, Freshii , Tender Greens and even Chipotle have a lead. But established players like Wendy's are also trying to catch up. In fact, Wendy's efforts highlights the second opportunity set that we see for foodservice suppliers that can supply "healthier" products to help large foodservice operators improve their health image. We know of one meat company, for example, that actively promoted its offerings to Wendy's franchisees by contrasting its breakfast product that contained six ingredients to the same product from "Brand M" that had over thirty ingredients. They got the business because they exemplified the trend towards perceived healthier offerings. Brand M is now heading in the same direction.

For all of the reasons noted above, IAP believes that branded good manufacturers that have the expertise to formulate, source and produce healthier products should be at the forefront of any acquisition target queues. Similarly, processors that can source and trace healthier ingredients are also prime acquisition targets. And by the way, as the *Washington Post* recently noted, the same trends towards greater information transparency in food retailing are also showing up in food wholesaling (see firms like HarvestMark and ATS).

We believe that "Health and Wellness" products can be segmented into two groups: "Active" and "Clean." On the Active side, you have products that purport to actively improve consumers' health because of something that is in the product. Think supplements, probiotics and nutraceuticals like Benecol.

On the Clean side, you have products that are passively better for you due to what *isn't* in them; i.e., the absence of additives or preservatives. The list of these fresh, organic, natural and clean label foods grows every day.

While IAP believes that both of these segments will grow quickly, we think the biggest opportunity for our clients is in the Clean segment. Development and testing of Active products is capital intensive, long and difficult. That's one of the reasons you see a lot of nutraceutical activity in Pet Food, but it's also why Nestlé just acquired Pfizer Nutrition for $11.85 billion. The need for deep pockets continues long after the development and testing of Active products, however, because consumers must then be educated to adopt this new food technology before it penetrates the market.

In contrast, growth from cleaner products will come through converting existing consumers to the "clean version" of what they eat already. The will eat more foods that are perceived as healthier – and frankly taste better – and can be introduced to the market relatively quickly and inexpensively. In other words, both the supply of these products and the demand for these products are less complex and capital intensive. Existing market participants can either build or buy their way into this trend. In fact, we believe it is essential that all of them at least pay lip service to this trend. The Twinkie died for a reason.

It wasn't so long ago that cleaner products were somewhat outside the norm – the purview of passionate amateurs and "Hippie" enthusiasts. That has led to an entire ecosystem of small, undercapitalized, local and regional firms making Clean products with great ingredients statements and strong food values that exactly suit an increasingly main-stream trend. And a lot of these baby-boomers are thinking of retiring; they're ready to be rolled up so they can go roll their own on a beach somewhere.

Meet the Existing Management Team

IAP's investment thesis in this environment is simple. It is difficult, but nonetheless imperative, to build the assets and capabilities required to be successful as a clean product manufacturer. Prospective targets will listen to overtures to be acquired because many have reached an age when they're ready to sell and they don't have what it takes to scale their passion up. These target companies have three advantages that are difficult to replicate for those that might be in a position to scale them:

1. Expertise in formulating and manufacturing clean products;
2. A strong culture and bias towards delivering healthier products; and
3. Relationships with suppliers and buyers of healthier products.

For both strategic and financial buyers looking for either potential platform companies or companies that have the potential to grow organically, assessing the scalability of the three clean advantages is, in our view, central to investment success. For strategic investors with established scale and reach, the key to a successful acquisition is assessing the ability to integrate such assets into their existing operation and grow them without diluting their value. A firm that is capable of doing so puts itself on the right side of a lot of trends with strong and deep roots on both the supply and demand side.

As consumer eating habits continue to evolve, the Clean segment will provide many interesting investment opportunities. And leave gimmicks such as black buns to the Belgians: no matter how much buzz you might get, if it bucks the health and wellness trend, it's a value trap.

Insight Advisory Partners advises companies in the food industry across all aspects of corporate and financial strategy including strategic growth initiatives, capital raising strategies, acquisitions and divestitures, retained search, due diligence, pre-and post-merger integration, turnarounds and financial restructurings.

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