First Bankers Trust Company

"Choosy Moms Choose… Kirkland Peanut Butter?"

Why America's Biggest Food Brands Are Faltering

Historically, America's largest processed food companies have been known as a reliable safe haven when economic uncertainty shows up at the doorstep. The idea is that during a recession, while the average American might spend less on discretionary items (e.g. clothing or tech gadgets), they will continue to stock their pantries with essential items (e.g. cereals, soups, or peanut butter) out of necessity. Moreover, Americans would stick with the established brands that they've grown up with such as Kellogg's, Campbell's, and JIF, seeing no good reason to explore other options. This provides a degree of certainty for investors, as the sales and earnings of these companies hold up relatively well during tough times – helping to support stock prices.

This may have proven true have in the past; however, times have changed. And while one might have seen these recurring pantry item businesses as the last to experience significant disruption, the recent announcement that Kraft Heinz (NYSE: KHC) would cut its dividend and write down the value of *century-old* brands (including Kraft and Oscar Meyer) by $15.4 billion has let the cat out of the bag. To put it simply, many of the conservative, safe-haven companies of the past are not safe havens today, as depicted in Figure 1.

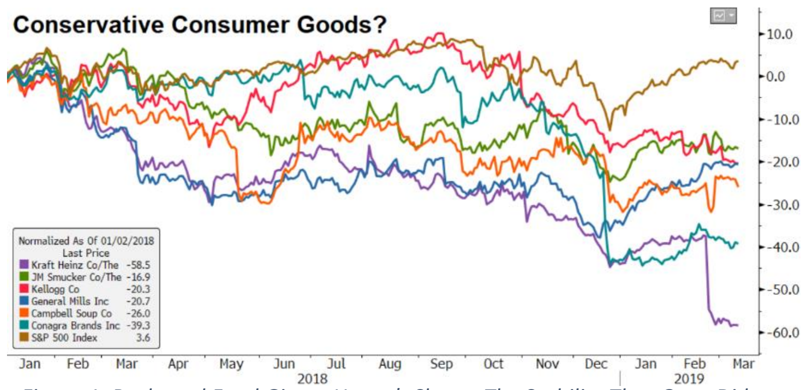


Figure 1: Packaged Food Giants Haven't Shown The Stability They Once Did – Made Visible by Kraft's 59% decline in value over the last 5 quarters (% Declines in Stock Prices from 01/2018 – 03/2019)

So, what's changed over the last few years? Quite a bit, actually.

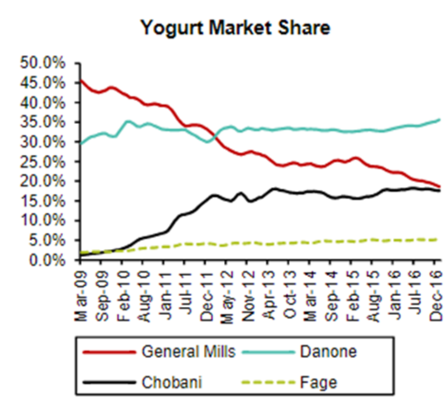
From Counting Calories to Counting Ingredients

Today's consumers are much more conscious of what is in their food, and retailers are adapting to these changing trends. Think about your neighborhood grocery store today versus how it looked five or ten years ago. You've probably noticed that the center of the store has shrunk. Produce, meats, and prepared foods account for much more of the floor space than they did previously – driven by the fact that today's consumer is focused much more on fresh, local, and natural foods and much less on processed foods.

Technology is Tearing Down Barriers to New Entrants

Before the internet, and way before social media ever existed, advertising was confined primarily to television, radio, and print media. Given the cost of running an ad campaign – sometimes pushing into the tens of millions of dollars – it was very difficult for upstart brands to enter the market, much less gain substantial brand awareness and market share.

However, the rise of internet platforms such as Google, Facebook, and Amazon have democratized advertising and given challenger brands a chance to build awareness through targeted ads and word of mouth. In 2018, over half of U.S. advertising dollars – a $200 billion-plus market – were spent online. The effect can be seen in the substantial share gains



Source: Nielsen Enhanced Scantrack AOC+C

Figure 2: U.S. Yogurt Historical Market Share (03/2009 – 12/2016)

of upstart brands such as Chobani in yogurt (see Figure 2), Kind in snack bars, and Skinny Pop in – you guessed it – popcorn.

Biggest Customers Increasingly Becoming Competitors

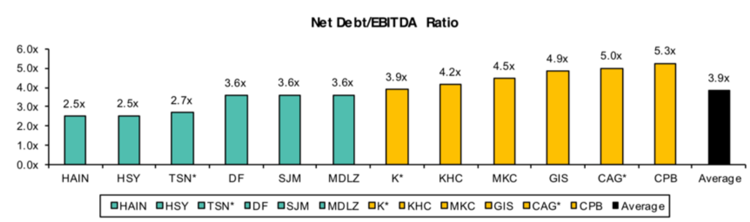
Perhaps the biggest change over the past few years has been the relationship between top retailers and their key suppliers. In the past, retailers and consumer packaged goods ("CPG") companies have had very strong relationships – with retailers providing ample shelf space to top brands and quick moving products, and happily passing along any price increases to the end customer. Unfortunately for many processed food companies, this is no longer the case. With their products not turning as quickly on shelves – combined with the entrance of new retail competitors such as Amazon and the expansion of hard discounters such as Aldi and Lidl – incumbent retail grocers have been forced to rethink their strategies.

To combat these issues, grocers have focused on decreasing prices of these goods and developing stronger "private label" store-brands (think Kroger's "Simple Truth" or Whole Foods' "365" brands) – both of which negatively affect the sales (and profits) of branded food companies. Given the increasing popularity among private-label brands, retailers are feeling more confident in their ability to push back on price increases from their branded suppliers.

Evidence of this trend is abundant: for example, while Walmart's comparable sales growth in the U.S. has increased by over 3% on average during the last year, organic sales from many of the retailer's largest suppliers have actually decreased over the same time period. Other examples include the continued growth of Costco's Kirkland Signature brand, which generated over $39 billion in sales in 2018 and now represents nearly a quarter of the company's overall revenue. Amazon has brought Whole Foods' private label "365" brand to their online marketplace and Kroger is making significant investments in its own "Simple Truth" brand. In fact, Simple Truth product sales crossed the $2 billion mark in 2018 and are growing at more than three times the rate of the overall market.

So, what's a troubled food company to do? Unfortunately, there isn't an easy answer. So far, the overwhelming response has been to reallocate capital away from their declining core businesses by acquiring growing assets – sometimes unrelated, and at hefty premiums – while taking on sizable amounts of debt to do so. Debt relative to the annual cash flow that a company generates is known as leverage – and as Figure 3 shows, leverage is increasing at an alarming rate.

EXHIBIT 15: **Campbell, Conagra, and General Mills are the most levered in the 5x range following recent acquisitions of Snyder's-Lance, Pinnacle Foods, and Blue Buffalo, respectively.**



Source: Company filings, Bernstein analysis and estimates
Note: 2018 YTD / Pro form is as of the latest reported quarter (2Q or 3Q:CY18).
* Note: Pro forma leverage ratios are calculated for TSN and CAG to reflect recent acquisitions of Keystone Foods and Pinnacle Foods, respectively. Pro form leverage ratio is calculated for K to exclude cash proceeds from securitized accounts receivable outstanding.

Figure 3: For reference, the average leverage ratio of American food companies was 2.1x in 2013.

Leverage is not necessarily bad in isolation. However, an industry-wide shift of companies taking on significantly more debt while their core businesses deteriorate could be equated to pouring gasoline onto the fire. And while it's possible that the surprise announcement by Kraft Heinz might have been a one-off, we can't help but to wonder if it is instead the first of several branded food companies to inch closer to their expiration dates. We hope to continue to speak with you on this topic in our discussions as we journey through 2019 and reinforce our focus on finding high-quality companies that have not only been incredibly successful in the past, but also have a great chance of continuing to generate shareholder value well into the future.