COMMENTARY

FOOD FOR THOUGHT:

Beyond the Growth vs. Cost Debate

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Marakon

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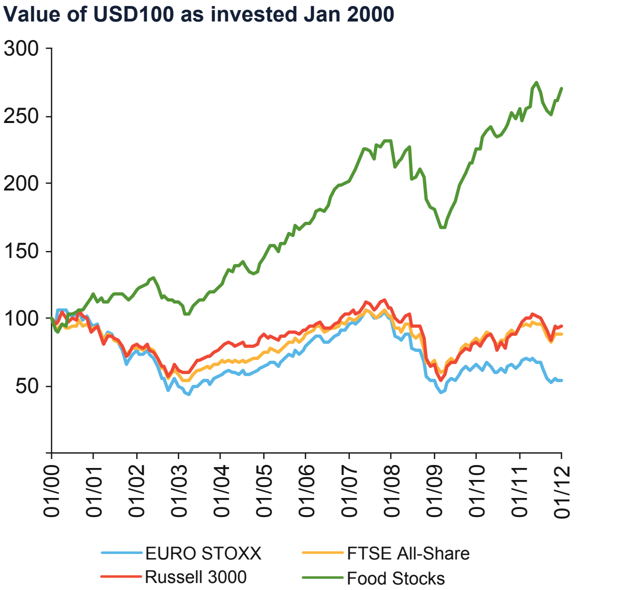
The global food manufacturing industry has historically benefited from a period of embedded market growth driving exceptional shareholder returns. As market growth has slowed, executives are under increasing pressure to change their focus. In this article, we discuss why trading a uni-dimensional focus on revenue growth for a uni-dimensional focus on cost reduction is not likely to drive sustained growth in shareholder value. We explore why moving away from "pendulum management" is particularly challenging for large food manufacturers, and suggest ways forward.

THE END OF AN ERA OF EMBEDDED GROWTH

The global food industry has historically delivered attractive shareholder returns. Looking at the world through the lens of that metric, investors in major food enterprises had a great run in the 2000-2012 time period.

Figure 1: Total Shareholder Returns versus Major Indices, Europe & N. America Food Stocks, '00-'12[1]



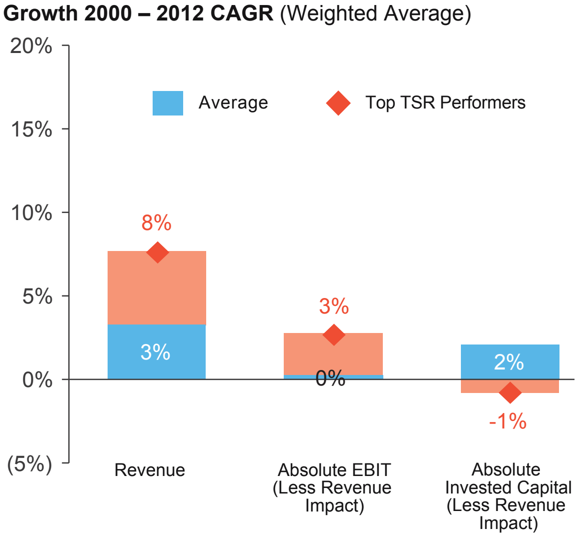
Source: Bloomberg and Marakon analysis

This track record was underpinned by a clear organisational model for winning, driven by the deployment of one or both of the following strategies:

- Riding the wave of economic growth and increasing affluence and disposable income in the US and Western Europe, with broader distribution and availability of offers
- Foraying into the higher-growth developing world and offering emerging middle classes access to aspirational developed-world brands

This model benefited from an unusual set of benign economic conditions. Specifically, predictable and material expansions in developed and developing market GDP and GDP per capita led to steady increases in disposable income for consumers. The net effect was consistent: revenue growth in a world of "rising tides" became shorthand for TSR performance. The numbers bear this out – average TSR performers in the Foods data set delivered primarily through revenue growth. Interestingly, top TSR performers in the same set delivered with a model of ~ 8% pa revenue growth and ~3% pa growth in EBIT (net of revenue growth) and a small improvement in capital efficiency.

Figure 2: Operating Levers, Europe & N. America Listed Food Companies, '00-'12



Source: Capital IQ and Marakon analysis

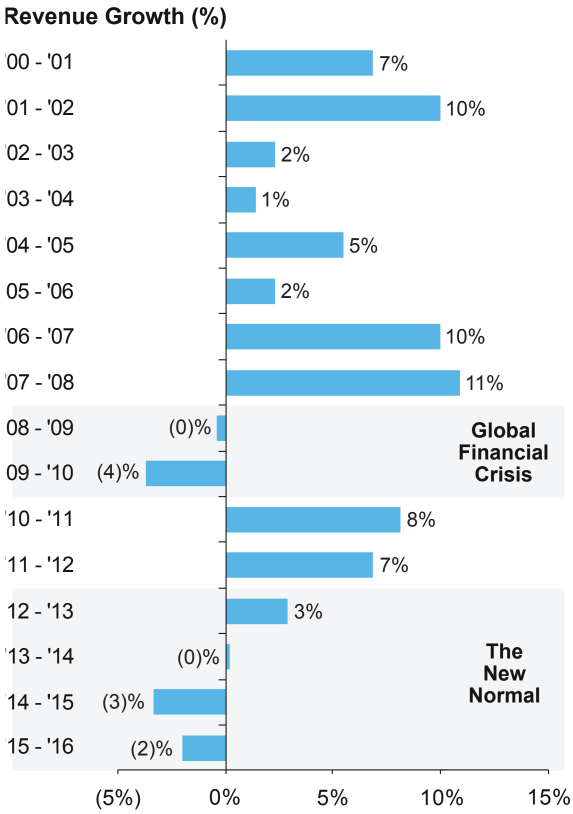
[1] Figures 1-4 based upon companies with market capitalisation >$1bn, a continuous listing since 01/01/2000 in either Europe or North America and a parent with a primary industry classified as "Food Products". N = 49. Top performers are those in the top quartile of TSR over the period. Growth calculated in local currency.

Since 2012, the market for food has been challenged on topline growth. Long-term domestic growth assumptions have been downgraded – for instance, in the UK the 3% pa GDP growth rate achieved before the financial crisis looked increasingly elusive even before the uncertainty of Brexit. In addition, increasing consumer price sensitivity, retail consolidation, and the entry of discounters, created a competitive environment that has fueled food deflation in many key western countries.

Emerging markets have experienced increasing saturation and stagnation too. Chocolate confectionary growth in China reversed into decline from 2015 despite double-digit growth just a few years previous.

This scenario is observed in the data: the period since 2012 has seen revenue growth reversals that have persisted even longer than the immediate fallout from the global financial crisis.

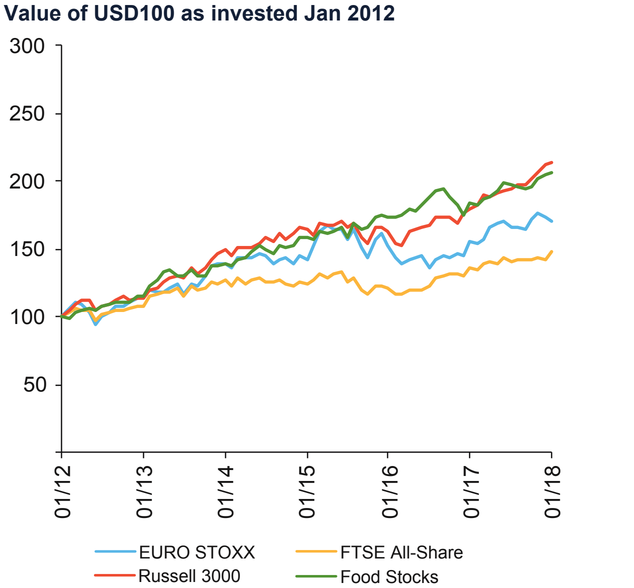
Figure 3: Annual Revenue Growth, Europe & N. America Listed Food Companies, ‘00-’16



Source: Capital IQ and Marakon analysis

The implications are significant. At a time when historically low borrowing costs should be incentivising the deployment of capital toward growth, that same growth is increasingly elusive and expensive for food manufacturers. Capital markets have reacted in-kind, and TSR growth, whilst still strong, no longer outperforms major indices.

Figure 4: Total Shareholder Returns versus Major Indices, Europe & N. America Food Stocks, '12-'18



Source: Bloomberg and Marakon analysis

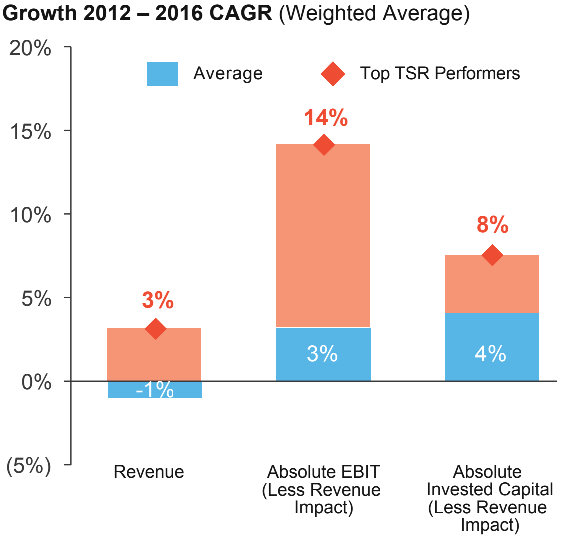
BEWARE OF THE PENDULUM RESPONSE

Disappointed with average returns, activist shareholders have demanded action. Dan Loeb has undertaken an activist campaign against Nestle’s perceived failure to adapt, calling for a margin target (now adopted); a portfolio review; and a more efficient capital structure. Though Unilever successfully avoided takeover by Kraft, they too were driven to adopt margin expansion activities to address shareholder discontent and eventually divested their margarines business altogether.

Our experience suggests that executives need to adopt a nuanced response: a single-minded focus on cost-cutting can be just as problematic as a single-minded focus on growth in today’s more complex world. Interpreting topline pressure as a call to retrench and await market recovery can turn organisations inwards and leave them vulnerable to competitors’ actions.

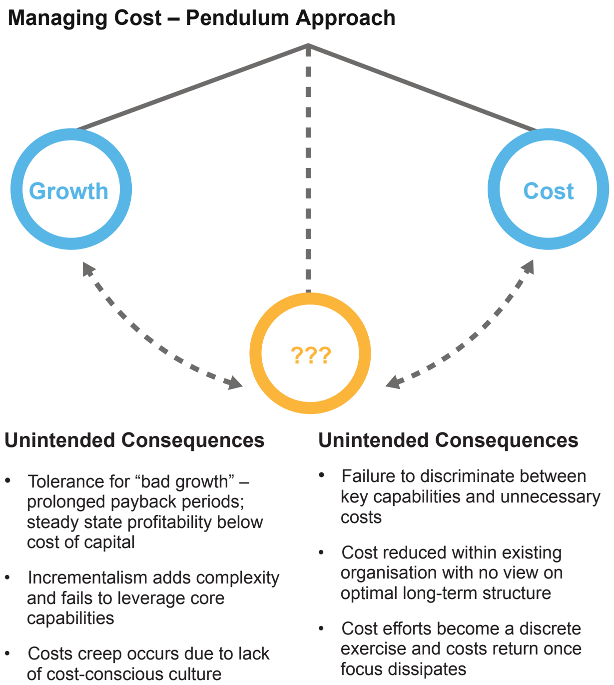
These observations can be seen in the data too. Top performers in the period since 2012 have accelerated both growth and returns, often profitably deploying significant capital to do so. Their less successful peers face diluted capital returns and relative revenue stagnation despite some EBIT margin expansion.

Figure 5: Operating Levers, Europe & N. America Listed Food Companies, '12-'16



Source: Capital IQ and Marakon analysis

Figure 6: The Potential Consequences of Pendulum Management



Source: Marakon analysis

Top performers across both time periods, we suggest, have rejected the underlying assumption of "pendulum management" —or the notion that it is only possible for the corporation to focus on either growth or cost at any one time across its entire portfolio. A more refined approach implies an enterprise that has the capability to carefully make growth, margin and capital intensity trade-offs at a segmented level within its category, geography and brand portfolio.

GOING BEYOND "PENDULUM MANAGEMENT" IS ORGANISATIONALLY DIFFICULT

However, the management journey described is often particularly difficult for the traditional multinational food business. We elaborate on common barriers below.

Legacy metrics are no longer appropriate

In a "revenue-driven" world, ubiquitous grocery sell-out data, more recently combined with store card consumer behavioural data, perpetuated a focus on market share at the highest ranks of the executive team. And whilst customer and market insight is necessary to build winning propositions, market-share centricity can blind leaders to more fundamental portfolio participation choices and hide economic trade-offs inherent in expanding share. This observation is backed up by the academic literature: data from J. Scott Armstrong's team at Wharton suggests competitor-oriented strategies generate significantly worse returns than those with a sharper focus on value generation.[2]

In the more recent "cost-driven" world, a similar syndrome can take hold of food businesses. Cost-centricity, as one might expect, can equally blind leaders to the potential of new / untapped opportunity, and can create a culture of undue conservatism, which is particularly problematic as food industry market trends change quickly and require rapid and scaled response.

[2] For an academic review, see Armstrong, J.S., & Green, K.C. (2007). Competitor-Oriented Objectives: The Myth of Market Share. *International Journal of Business*, Vol. 12, pp. 117-136.

The structural disconnect between demand and supply functions

Food multinationals frequently operate functionally-driven businesses. In such businesses, demand functions (sales, marketing) only understand and are measured on revenue, and supply functions (manufacturing, operations) only understand and are measured on cost and efficiency. The implication is that incremental opportunities to "grow faster at lower cost" or "take cost out without compromising on growth" are often very hard to identify and execute.

We recently worked with a food manufacturer seeking to reduce cost by removing complexity from its portfolio offer. Efforts had stalled due to concern from the sales teams that portfolio simplification ran counter to the customer agenda.

As we will elaborate below, one of our first and most basic recommendations was to reinstitute forums for dialogue between commercial and operational senior leadership. A step change in cross-functional dialogue across those two functions made the cost / operational complexity equation easier to get at without undue compromise on the growth / customer satisfaction agenda.

Legacy talent models put a premium on functional excellence

Many functional managers and even senior functional leaders in large food organisations are experts in their specific fields (e.g. marketing, sales, manufacturing). Functional managers are trained to think about their specific role (e.g. build brand equity, drive brand share, grow sales volumes in a specific account) and are often measured on their contribution to just one piece of the economic equation. Despite the fact that this dynamic is frequently understood, we continue to observe that progress made on this front is down to the quality and flexible mental model of individuals, rather than a clear organisational perspective on how to address it.

WAY FORWARD: BEYOND THE GROWTH VS. COST DEBATE

Conditions in the consumer food markets have fundamentally changed. The era of the "rising tide" is over. A new model is needed. Our experience suggests the way forward includes four components at a minimum:

1. **Think "portfolio".** Get business leaders to think of the total business not as one whole but as a portfolio of components with distinct economic / competitive characteristics – some requiring an emphasis on margin with a growth trade-off, others requiring an emphasis on growth with a margin trade-off. Use the portfolio to get more specific and clear on how the growth / cost agenda is brought to life in the business, and allocate resource accordingly.

   This line of thinking has helped one of our UK food manufacturing clients ensure sufficient organisational focus in the right areas on growth even at a time of severe macro pressure on cost via ingredients, labour and exchange rate. Their performance speaks for itself – material year-on-year expansions in absolute profit with limited incremental investment into the business.

2. **Think "change the game".** In tandem with better and more segmented objective setting and resource allocation, a low growth / low cost of capital environment can be the right time for transformational M&A. For example, businesses invested in markets facing enduring overcapacity might explore the scope for industry transformation via material inorganic plays that seek to take capacity out. Our experience suggests that this kind of thinking only gets sufficient air time if the focus is not solely on the day-to-day management of cost and performance that is often the clearest symptom of the "pendulum" in action in today's food markets.

3. **Promote "general-manager types".** Get functional teams working together, and embrace variable, team-based objective compensation metrics (e.g. revenue growth AND return on capital) that represent controllable components of value creation. Reconsider organisational structures and talent models to foster integrated (GM-like) thinking; promote those who demonstrate it most, even if they are functional leaders.

Figure 7: Financial Measurement Metrics & Implications[3]

	Organic Revenue Growth	Revenue Growth and EBIT Margin	Absolute EBIT; Absolute EBITDA	Risk-Adjusted Absolute EBIT	ROIC and Revenue Growth	Intrinsic Value
Performance Commitment	*"Achieve 2% p.a. revenue growth in the UK"*	*"Achieve revenue growth of 1% p.a. and maintain EBIT above 20%"*	*"Grow EBIT 4% p.a."*	*"Grow risk-adjusted EBIT 4% p.a."*	*"Achieve revenue growth of 1% p.a. and maintain ROIC above 12%"*	*"Double intrinsic value in 5 years"*
Required Financial Sophistication	**Low** – Sales data	**Low-Medium** – Sales data – Transparent cost allocations	**Low-Medium** – Sales data – Transparent cost allocations	**Medium-High** – Sales data – Transparent cost allocations – Transparent risk allocation	**Medium-High** – Sales data – Transparent cost allocations – Transparent capital allocation	**High** – Sales data – Transparent cost allocations – Transparent capital allocation – Transparent risk allocation – Accurate forecasting
Alignment to Shareholder Value	**Weak** – Can incentivise unprofitable growth – Can incentivise increased capital intensity – Can incentivise risk-taking – Can be short-termist (e.g. over-reliance on the price lever)	**Weak-Medium** – Can limit growth-margin trade-offs – Can incentivise increased capital intensity – Can incentivise risk-taking – Can be short-termist	**Medium** – Can incentivise increased capital intensity – Can incentivise risk-taking – Can be short-termist	**Medium** – Can incentivise increased capital intensity – Can be short-termist	**Medium-Strong** – Can limit growth-returns trade-offs – Can be short-termist	**Strong** – Can be speculative in isolation and thereby requires interim KPIs/ performance metrics

4. **Evolve or change the metrics.** Consider implementing more nuanced metrics in preference to pure growth or margin targets. Do so in order to encourage the business to continuously make the best trade-offs in the pursuit of absolute profit growth. Tell the markets what you're doing and why you're doing it. The correlation between total shareholder return and value creation is stronger than other common metrics (e.g. EPS), so an increased focus on managing the value of the enterprise is typically welcomed. Some options are illustrated in Figure 7.

IN SUMMARY

Advantaged performers in food manufacturing before and after the financial crisis tend to be companies adept at optimising the trade-off between revenue growth, EBIT expansion and capital deployment. Top performers across both time periods, we suggest, have rejected the underlying assumption of "pendulum management". It is our hypothesis that the "mid-pack" has struggled primarily due to legacy organisational structures and ways of working that make the integrated management of value more complicated.

[3] Intrinsic value defined as the NPV of capital returns in excess of risk-adjusted cost of capital; Short termism can be diminished via longer term performance commitments/ incentives.

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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:

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  a. A better understanding of what drives client economics and value
  b. 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

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