Industry Report

August 26, 2014

Breakfast

Highlights

Breakfast isn't for breakfast companies anymore, or so the numbers suggest. Clarkston Consulting analyzed information from the latest quarterly earnings releases and quarterly filings of the fourteen dominant players engaged in the U.S. breakfast foods manufacturing category. The companies included in the analysis are ConAgra (CAG), General Mills (GIS), Kellogg Company (K), Kraft Foods (KRFT), PepsiCo (PEP), Nestle (NESN), WhiteWave Foods (WWAV), Group Danone (EPA:BN), Dean Foods (DF), Post Holdings (POST), Bob Evans Farms (BOBE), Hillshire Brands (HSH), Tyson Foods (TSN), and Hormel Foods (HRL).

The breakfast foods industry continues to face mounting pressure from acute input inflation costs, especially meat and milk; excess production capacity; changing consumer preferences across the spectrum of shopping habits, purchase behavior, and consumption patterns; as well as an ever more demanding retail customer base. In the wake of these challenges, there resides a number of opportunities that leaders in the breakfast foods industry are hotly pursuing including plant consolidation; margin enhancement through higher pricing; innovative protein-based breakfast foods with consumption appeal beyond the traditional morning hours; and M&A to harness synergies and new revenue growth.

Top 3 Consumer Trends

- Need for healthy, satiating, convenient breakfast
- Push for protein
- Growing comfort with online shopping

Top 3 Category Disconnects

- Emphasis on trade marketing spend with declining category performance
- Focus on retail despite the emerging online channel
- Attention on traditional breakfast with declining category strength

Impacts

- Despite general awareness of the benefits of a healthy, balanced breakfast, there are still many Americans skipping or skimping on breakfast, limiting the category's growth potential. An opportunity exists for a brand to take over breakfast through consumer engagement, as demonstrated in recent years by PEP's success with Frito-Lay engagement programs in snacks and with creative food service partnerships. Use open innovation to let the consumer create the breakfast experience for the brand, with the brand.
- Manufacturers need to be more nimble and open their innovation engine to fully understand and connect with their consumers. Those who are flexible to incorporating protein and other flavors or ingredients that are in high demand will be able to better compete for valuable retail shelf space and market share. HSH and TSN are in a great position with their dominance of the animal protein segment, and they are working to keep profit margins high in a volatile input cost environment by offering new products like breakfast sandwiches that include higher margin ingredients.
- To be a leader in the shift to ecommerce, manufacturers need to reevaluate their trade marketing spend to allocate their dollars to avenues that better align with how consumers are buying. Mobile and digital investments will pay off in both brand building and reaching consumers as they research, share information, and shop online. However, manufacturers who continue to pour money into physical retail promotional spend are experiencing diminishing returns from merchandised products as competitive retailers accept more promotions and dilute the effectiveness of any single promotion. Full omnichannel strategies will yield the highest return on investment.

Current Category Environment

Breakfast isn't just for breakfast anymore

Numerous studies reveal the benefits of breakfast and its importance to a healthy diet, yet many consumers still elect to skip breakfast, resulting in lost sales opportunities for manufacturers and retailers alike. Leading manufacturers recognize the enormity of the situation and are diligently working to maintain and gain consumer loyalty to breakfast foods by offering convenience products in smaller portions, enriched by protein and sold in innovative packages. These manufacturers (K, KFRT, HSH, and HRL) are in the midst of re-positioning their products for "anytime, anywhere" consumption and are proactively complementing their innovation strategies by leveraging a confluence of macro-consumer trends to their distinct advantage.

One of those macro trends is the soft performance of cereal. The cereal category was down 4.4% in Q1 and Q2 2014, and many manufacturers are looking to expand breakfast offerings outside of the traditional breakfast of sitting down with milk and cereal. Some, like GIS, are looking to increase their product range within cereal through gluten-free, high protein, and whole grain options, and others are branching out of the category entirely, like POST. They are breaking into the protein breakfast shake category, joining K, to capitalize on their taste profile and health knowledge from their Active Nutrition business, which sells protein bars, shakes and liquid supplements.

K is the first to strike a deal with BN to offer YoCrunch yogurts topped with K's Frosted Flakes and Froot Loops. This is an effort to avoid going up against the yogurt category, but instead work with the category to pair products for delicious and fun results that still meet consumers' health criteria.

Changing consumer habits are being fueled by multiple demographic cohorts such as millennials, Hispanics and baby boomers. Millennials and Hispanics are more likely to incorporate snacks throughout the day while baby boomers are known for extending food day parts, especially an all-day breakfast. With rising food costs, many consumers have taken typical protein-rich breakfast foods into other day parts, including lunch and dinner, as a way to save money while maintaining their healthier eating habits. Consequently, morning snacking has shown the greatest growth of any eating occasion over the past decade. HSH is hoping they can tap into Americans' changing eating habits and has just launched Jimmy Dean sandwiches and bowls to cater to the trend of snacking or eating several smaller meals throughout the day. Similarly, K's Special K Flatbread breakfast sandwiches have been a successful launch despite the "pitchfork" effect of the Special K brand and its increasingly irrelevant positioning.

Winners and Losers

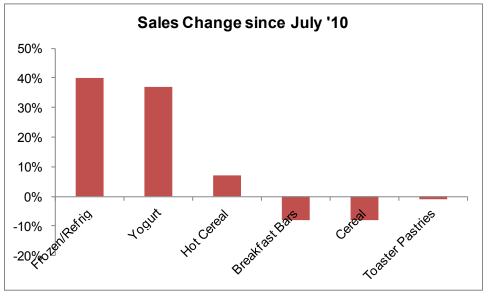


Figure 1. Consumption of ready-to-eat cereal – 40%+ of the breakfast category – continues to decline while more portable options high in protein gain favor with today's consumer.

Source: Wall Street Journal

Protein is King

Protein reigns supreme for consumers looking for healthy, satiating meals, especially to start the day.

Manufacturers have to feed this protein craving, while looking for ways to better control costs and manage margins in an inflationary and volatile input cost environment, exacerbated by situations such as the recent PED virus. For example, with foods like sandwiches and bowls, meat is just one of several ingredients — meaning profit margins are much higher. In an earnings call with analysts and investors last summer, HSH cited Jimmy Dean breakfast sandwiches as an example of how the company is managing cost pressures, noting that "only a fraction of the weight of the product is meat." Some Jimmy Dean sandwiches — including an egg white and spinach variety — don't have any meat at all.

Moving forward, millennials and a more ethnically diverse population are expected to further promote this trend as they can be more acclimated to less meat consumption and have altered their diets to include low cost/high protein options like peanut and other nut butters. HRL's fairly recent acquisition of Skippy Peanut butter may offer a foray into alternative protein sources.

Greek yogurt has been the rising star of the yogurt and protein categories, doubling per capita consumption in the last decade according to the NPD Group. Chobani drove this success into mainstream America, due to their commitment to great ingredients, their continued innovation in flavor and packaging, and their marketing of their products' high protein, all things timely with consumer trends. Chobani will have to work hard to maintain its leading position in the U.S., now facing an onslaught of various lawsuits and increased competition, including a national tour of direct comparison taste tests led by GIS' Yoplait brand.

Most manufacturers are now throwing their hat into the protein ring to compete, including the launch of BN's Danio high protein yogurt in France and DF's TruMoo Protein's growth from a regional to national launch. TSN is at the top of the heap in the animal protein space with their purchase of HSH, and GIS' strong innovation positions them as a leader in a space where manufacturers must move quickly to win.

Protein Content

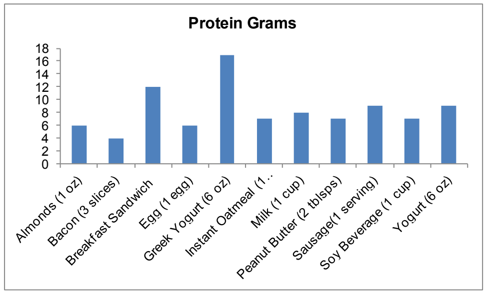


Figure 2. The protein content of Greek Yogurt has contributed to its popularity and growth as it contains more than twice the amount as many breakfast foods.

Source: Product Labels and websites

Selected Commodity Prices

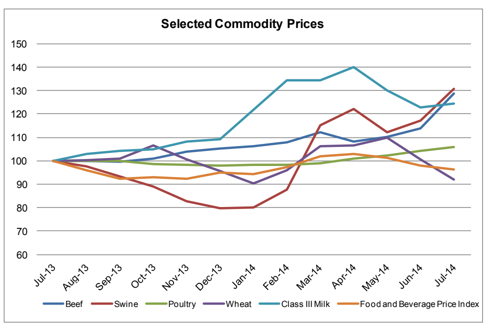


Figure 3. Manufacturers were faced with acute input inflation during the most recent quarter on proteins as the PED virus limited supply of pork.

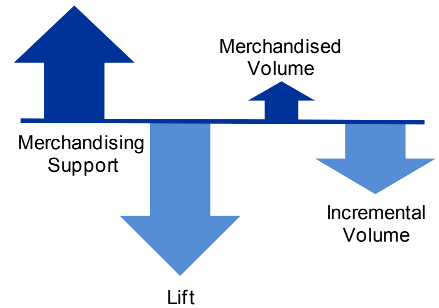
Source: IMF and USDA.

Consumer Revolution

In the same vein of thought as detailed in our previous publication Retail Revolution, a new consumer reality is changing the face of retail. In essence, consumers rule today's retail value chain – they are more connected, more educated, often more cash strapped, and more demanding than ever. GIS has made their number one priority for 2015 to accelerate top line growth through better consumer focus. The new consumer is creating a paradigm shift across traditional consumer, retailer, and manufacturer relationships. Consumers are less loyal to brands and to retail banners resulting in a perpetual state of competitive tension as trading partners fight to maintain share of market and profits. The exception to this diminishing loyalty is for retailers like Whole Foods who create a trusted reputation among their shoppers who know they are always buying healthy or well-sourced products.

Three trends are of particular interest here: trade spending; scale and relative competitive advantage; and channel ubiquity. According to KRFT and others, price sensitive shoppers continue to pressure retailers for lower prices, special offers and richer promotions. This, in turn, forces retailers to up the ante with manufacturers for increased depth and breadth of discounts and promotions to deter store switching. It is estimated that over $200 billion is spent annually on trade promotions, typically about 15% of gross sales, and this figure continues to rise in response to consumer and customer demands.[1] Manufacturers also rely on online coupons to drive purchase behavior but this tactic is becoming more unproductive as internet enabled shoppers "stack" multiple coupons and drive down margins. With many of the top retailers, manufacturers understand they must pay to devote increasing resources to trade promotion or risk competitive disadvantage and softer sales as retailers give preference to their compliant opposition. Never mind that promotion effectiveness can be veiled, and that trade spend dollars are a challenging for manufacturers to manage.

Exhibit 7 – Declining Trade Productivity



Manufacturers are experiencing decreased trade productivity in terms of lift and incremental volume due to saturation levels of merchandising activity at retail.

Source: Comments from the most recent round of Earnings Calls.

For example, GIS, K, and KRFT each commented on reduced promotion effectiveness as retailers increasingly practice dilutive merchandising tactics to the manufacturers' detriment. Manufacturers must then make difficult investment mix decisions to fund expanding trade budgets. Funds earmarked for other consumer and brand marketing initiatives often serve as the source of funds for reinvestment into trade promotion. This can boost short-term performance and satiate demanding retailers but comes at the expense of more strategic, longer-term initiatives and with the hidden implication of a deduction to gross sales.

Leading manufacturers understand that trade promotion will continue to be a "cost of doing business" for the foreseeable future but will ensure effective trade practices, more influence over in-store execution and invest in tools and analytics to eliminate waste and increase ROI. K is investing in a direct sales force of 125 “feet on the street” to drive improved in-store performance, and CAG is intensifying their focus on customers and joint business planning, maturing on the sales front to partner with customers, who are now regaining confidence in CAG. Their new president of retail sales is bringing field experience to fine tune analytics and institute deeper product knowledge on their front line.

Manufacturers have also taken notice of the growth of e-commerce as a viable shopping channel for perishables with Amazon and Wal-Mart leading the way. To boost on-line presence, Wal-Mart recently announced a major renovation to its e-commerce site to capitalize on the trend of growing sales which increased by 30 percent to over $10 billion (vs. Amazon’s $61B) in its latest fiscal year.[2] By comparison, Wal-Mart’s U.S. discount division had five straight quarters of sales declines at stores opened at least a year. Wal-Mart is not the only retailer suffering in response to changing consumer tastes and shopping behavior as on-line proliferates. Instead of aisle wandering and making impulse purchases, today’s more informed consumer uses mobile phones and computers to research prices, develop shopping lists, plan shopping trips and then make more disciplined purchases. According to Shopper-Track, shopper visits have fallen from a year earlier for every month for two years running. The shift to on-line is projected to continue unabated.

Leading manufacturers know that they must reach consumers through multi-channel “brick and mortar” and e-commerce platforms but must also carefully navigate so as to not alienate their retail partners. E-commerce is especially inviting for global firms with growth opportunities in emerging markets that are inadequately served by retail, where GIS notes the middle class is expected to reach 50% of the world’s population by 2030. With food as the first choice for spending of additional disposable income, penetrating emerging markets is top of mind for food manufacturers. E-commerce and digital are the most promising paths to consumers in these operating environments. NESN and PEP are well positioned with their seasoned global presence and GIS is making a successful push, with 1/3 of sales now coming from outside the U.S. and $2.5 billion in emerging markets.

Shopping Trips

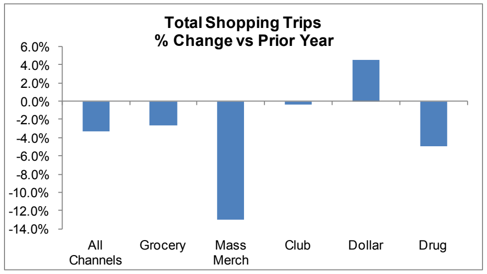


Figure 5. Excluding the “Dollar” format, consumers are shopping “brick and mortar” stores less frequently than a year ago

Source: Nielsen Household Panel (US) Total Food and Beverage

Online Growth

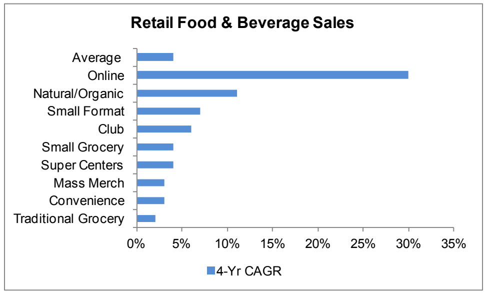


Figure 6. Consumers are increasingly migrating to online shopping for Food and Beverage as it has exploded at a growth rate nearly 7X vs. the average for all channels.

Source: GIS Investor Day, Kantar Retail and Nielsen Scanner data

M&A Activity

In a market landscape ridden with excess capacity, rising commodity costs, and margin pressure, coupled with a strong equity market and with plenty of cash and cheap debt financing available, it’s no surprise that M&A activity is increasing. Buyers in the food and beverage sector are hungry for acquisitions to spur growth and increase margins.

Consequently, last quarter was a very active deal market for food and beverage companies highlighted by HSH’s initial quest for Pinnacle Foods which eventually led to TSN’s acquisition of HSH. The steady rise of protein demand is expected to drive potential M&A activity. Global consumption of meat will increase 1.9% year over the next decade as demand for protein increases in nations such as China, Mexico, and Brazil. Foreign-based protein companies also joined in the acquisition fray. Brazil’s JBS S.A. that owned Pilgrim’s Pride attempted to purchase HSH but was outdone by TSN. China’s Shuanghui Inter-national Holdings purchased Smithfield Foods for $7.1B in order to help satisfy China’s huge and growing appetite for pork. The deal is the biggest purchase of a U.S. firm by a Chinese company.

Expect this trend to continue for strategic reasons as the industry needs more consolidation to harness inherent synergies between companies and to mitigate scale disparity with trading partners. For example, POST is a buyer for NSRYG’s Power Bar. At a $5B market cap (Appendix A), WWAV is a possible acquisition target, as their innovation in the dairy category, specifically their Silk almond milk, could be a good way for some of the larger players to diversify their product base. In addition, some companies, such as Danone (EPA:BN) will use M&A as a means to break into different regions, as shown through their 40% stake in Africa’s largest dairy company and their 10% stake in China's largest dairy company. WWAV has also entered into a joint venture with China's largest dairy company and is expected to begin sales there before year-end. This represents a huge win for WWAV, who is already seeing double-digit growth in most categories and regions.

An acquisition candidate is BOBE's foods division which has come under pressure from an activist stockholder who perhaps rightly sees untapped latent potential in BOBE's regional ~$400M food business that features breakfast convenience items. BOBE would make an interesting target for a breakfast foods manufacturer with a "protein product" gap in its brand portfolio, but with a national footprint supported by a strong trade function. A play by K for BOBE's food business would play into their strategy to acquire convenient, protein-rich breakfast items.

Proctor and Gamble's recent announcement that it would jettison 100 brands is a portent of what to expect from larger food and beverage companies as they look to divest underperforming or non-aligned business units and brands. Companies will increasingly scrutinize their operations to ensure continued strategic fit, growth potential, ability to effectively compete and resource intensity needed to win. Look for NESN to be an active participant in the brand transactions as it looks to shed underperformers and replace them with on trend growth options especially as it continues to face mounting pressure in coffee.

This strategic assessment is likely to lead to a bounty of "orphaned" brands which could bolster the brand portfolios, operational efficiencies and ultimately strengthen the competitive position of smaller players such as PF.

According to KRFT, retailers are coming to terms with changing shopper patterns and channel shifting. In the short term, adjusting to such momentous shifts favors the smaller, more nimble players because they are innovating faster and getting a more receptive audience from retailers. This short-term dynamic has the potential to translate into lasting disruption across the breakfast foods manufacturer competitive landscape.

Using the beverage industry as an analogue, Coke commissioned a study in 2007 determining that 20% of the sales and 50% of the growth in the beverage industry came from small, independently owned brands, a third of which did not even exist five years prior.[3]

This disruption for the industry could be heightened with the current manufacturer M&A shifts. Manufacturers like NSGRY, CAG, and GIS are all working to discontinue slow moving SKUs and spin off brands, which can get bought by these nimble, smaller companies, who will then in turn gain more volume and market share and become an even greater threat to the power dynamic of today's dominant manufacturers.

Proven Trends

As presented in our *2014 Food Trends* paper in December 2013 and in our *Packaged Snacks* report in June 2014, a few key trends are vital to companies in the food industry, specifically the health conscious consumer, innovative packaging, and data sources to track promotional and marketing spend. This deep dive into the breakfast foods industry validates their continued impact on the industry.

Health Conscious Consumers

Similar to findings from the *Packaged Snacks* report, frequent snacks are replacing meal occasions for consumers. In fact, morning snacking has demonstrated the greatest growth of any eating occasion over the past decade.[4] Consumer adoption of healthier foods such as Greek yogurt is marginalizing the concept of a hard diet predicated on the concept of self-denial. Instead, consumers are increasingly more holistic in their choice of food products and actively consider source, ingredients, taste and nutritional value. The implication is that to compete and win, manufacturers must position breakfast foods as "not just for breakfast anymore" and provide demanding consumers with nutritious, protein rich food products. Protein, linked with satiety and weight management benefits, has become an increasingly appealing attribute to consumers, with 60% of men and 67% of women seeking the nutrient in packaged food products, according to Mintel. Conversely, weight-management based on calorie counting principles is no longer a meaningful product or communication platform. K must therefore renovate Special K's historical selling proposition or risk eventual brand impairment.

Innovative Packaging

In alignment with the findings reported in the Packaged Snacks report, breakfast foods manufacturers are also engaged in pursuit of ubiquitous distribution across fast growing and non-traditional retail channels such as club, dollar, convenience, drug and e-commerce. Manufacturers are evolving their packaging to smaller, single-serve sizes to meet the different merchandising opportunities afforded by these channels as well as the convenience needs of today's always-on-the-go consumer.

One of the major challenges for breakfast packaging is to make it portable, and while cereal manufacturers hoped that turning their products into bars would increase consumption opportunities, those products typically cannibalize cereal purchases.

Portability is driving growth in fast food breakfasts; even health-minded consumers are willing to get a fast food breakfast for the sake of convenience. Nearly 60% of the restaurant industry's traffic growth has come from breakfast over the past 5 years.[5] Success and high margins have brought many other players into the break-fast space, like Taco Bell's recently introduced breakfast line. Manufacturers like PEP who work closely with food service and fast food partners will find additional revenues streams.

K's To Go Breakfast Shakes, Diamond Foods' Emerald Nuts Breakfast On The Go nut and granola mixes, and PEP's Instant Quaker Oatmeal Cups represent snacking exemplars that will likely be extended into the breakfast foods category. As a parallel in support of both trends, within beverage, both Coke and PEP plan to offer more mini-can products as consumers replace diet versions with smaller-sized versions. WWAV has revamped the packaging of its Silk brand by displaying important health facts, such as non-GMO and being rich in protein.

The Breakfast Industry

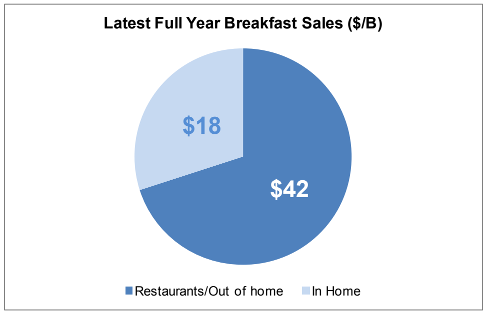


Figure 7. Dollar sales are dominated by restaurants as many fast food and fast casual chains smell opportunity making it a battleground for revenue growth.

Source: Nation's Restaurant News and Forbes

Data Sources & Analytics

Manufacturers report increasing pressure to offer more lucrative and frequent trade promotions to help retailers defend against consumer switching behavior – brand and store – as they shop for the best deals. The promotion frenzy in the category has resulted in recent promotional penetration nearing 2/3 of dollar sales – versus historical norms in the 15-20% range – and at a diminishing rate of return according to manufacturers. This unsustain-able cycle is creating undue dependency and adverse-ly conditioning consumers and retailers alike while potentially diverting investment re-sources from longer-term, more sustainable options. DF has measured the impact of timely promotions of its TruMoo brand using IRI data, noting 22% incremental volume due to promotions in February. Expect manufacturers to build out robust analytic capabilities moving forward.

Breakfast's Contribution

Where the information was available, the contribu-tion of breakfast foods to total company net sales of the analyzed players varied considerably with a high of nearly 100% for POST, a low of less than 10% for PEP and an overall mean of 40%. The least diversified players, such as POST, DF and BN, are concentrated in dairy and cereal and have the greatest exposure to breakfast market risk.

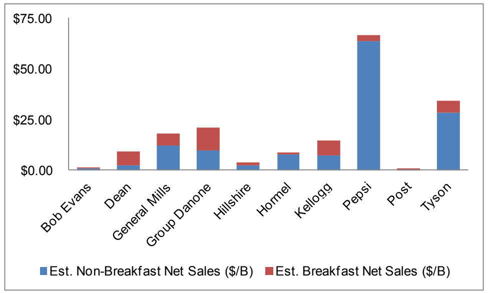


Figure 8. PEP, HRL, and TSN have the most diversified prod-uct bases within the group of analyzed players. These three players are best insulated against breakfast market vagaries but may not participate as fully in upswings with their current product mix.

Source: Annual Reports, CAGNY, Investor Day Presentations

Individual Recaps

PepsiCo (PEP)

PEP achieved their productivity savings goal for the quarter and is focused on their next generation produc-tivity program through 2019; the goals are to increase automation to replace labor with capital, expand shared services, optimize the global manufacturing footprint through restructuring, and restructure go-to-market systems to optimize their distribution network. Their consumer engagement programs continue to do well for snacks, bringing in millions of submissions and nearly a billion social media impressions. PEP acknowledges challenges across central store categories, including their 3 key categories for Quaker Foods North America, hot cereal, RTE cereal, and snacks. However, those three categories each gained value share in retail in the quarter and year to date. They are phasing in new innovation through an on-the-go cup for their hot cereal and mixing in crunchy granola to their warm oatmeal products. PEP is excelling in developing economies like China and Brazil and is well positioned to take advantage of the rapidly growing middle class in emerging markets. They are passing on the new taxes in Mexico to the consumer and seeing some stabilization as consumers adjust to the higher prices. Venezuela is a difficult geography with high inflation, political unrest, supply chain disruption, and uncertainty in the exchange rate.

Kellogg Company (K)

K, the largest cereal seller in the U.S., continues to struggle as consumers seek alternatives to traditional sit-down breakfasts with carbohydrate-heavy foods in favor of higher-protein, more portable items like Greek yogurt and breakfast sandwiches available in the frozen aisle and from fast-food purveyors. K's problems are further exacerbated by an underlying consumer trend: target audiences no longer find Special K's "weight management through calorie counting" value proposition and communication platform particularly relevant. K's central thesis is that the cereal category and its brands will continue to offer long term growth potential from a dollar sales perspective and is stepping up efforts to improve performance. K is primarily focused on brand-building, sales execution and achieving operational efficiencies. Late last year, the company announced that it would cut up to 7% of its global workforce over four years. Kellogg recently said it would close a Keebler factory by the end of next year eliminating another 325 jobs. Perhaps K's biggest opportunity is to convince consumers that its brands and products are suitable "out of breakfast" consumption alternatives. Their solid brand positioning and significant investments in innovation, marketing, and supply chain initiatives require patience but should deliver results longer-term. Look for K to flex its marketing muscle by leveraging its scale in database (20 million names) as an enabler for effective 1:1 consumer communication.

Nestle (NESN)

NESN reported broad-based profitable growth in what was described as a tough and volatile trading environment. NESN remains focused on their Roadmap, the strategic and organizational transformation aligned against nutrition, health and wellness strategy. NESN described a slowing pace of growth in emerging markets coupled with deflationary pressure and weak consumer sentiment in developed markets. NESN continues to step up consumer-facing marketing spend and R&D to feed the innovation pipeline. Key NESN brands continue to struggle in the U.S. For example, health-conscious consumers are a drag on NESN's Lean Cuisine as consumers formerly attracted to self-denial diets now opt for healthier foods such as Greek Yogurt. NESN which gets about 20% of its $100 billion sales from coffee is struggling to grow Nespresso in the U.S. In response, NESN introduced a new system, Virtuoline, to replace the failed Dolce Gusto system, as well as entered into a multi-year agreement with Keurig to crack the U.S. single-serve market on multiple fronts. Nespresso has about 3 percent of the U.S. single-serve market compared with Keurig Green Mountain's 72 percent (Euromonitor). NESN is counting on building a solid base of business in the U.S. as its coffee business has slowed due to an influx of private-label rivals in its core European market and escalated competition from Mondelez. To stimulate organic growth, NSGRY is focused on penetrating fast growing distribution channels such as discounters and clubs with an eye on e-commerce. NESN believes that e-commerce is especially important in developing markets where retail infrastructure is underdeveloped as a consumer connection point. Look for NESN to place substantial bets on digital and e-commerce in fast growing developing markets and for innovative approaches to manage potential trade/channel conflict in developed markets. Looking forward, NSGRY affirmed 5% organic growth target this year. Consequently, look for NESN to stay busy realigning their portfolio by selling off underperforming business units (see Juicy Juice) and proactively pursue potential acquisition targets (primarily in organic foods and premium chocolates).

WhiteWave Foods (WWAV)

WWAV saw net sales increase 36 percent in the first quarter of 2013, reflecting the impact of the acquisition of Earthbound Farm, America's largest grower of organic produce. Absent of Earthbound Farm, WWAV still experienced double-digit top line growth, exemplifying the strength of their brands. The European segment of their business reported a 24% increase in sales (19% on a constant currency basis), while North America sales increased 39% (10% absent Earthbound). Due to the exceptional growth, expect an increase in capital expenditures in the near to mid-term future, as WWAV will need to support its production requirements. WWAV's Silk brand, which makes dairy alternatives such as soymilk, had its 12th consecutive quarter of double-digit growth, showing the importance that consumers have placed on healthy living. Silk almond milk has been one of the main drivers of this growth, and WWAV has responded by focusing on the almond milk over soy milk recently. WWAV has aimed at increasing brand and category awareness by launching redesigned packaging and new advertising campaigns. Expect this momentum to continue as innovative new brands offering plant-based products will be launched in Europe. The organic milk category grew 7% in Q1 and WWAV plans to expand the Horizon brand beyond just dairy. Innovation can also be seen in the flavored creamer category, where WWAV has launched new products offering sugar-free and fat-free alternatives. In Q2, WWAV will launch a new look for the International Delight brand, which includes coffee creamers and iced coffee, to help it stand out against competitors. WWAV's recently announced joint venture with Mengniu Dairy, the largest dairy company in China, showing their continued passion for defining the future of the food and beverage industry.

Groupe Danone (EPA: BN)

BN has reported pressure on their gross margin due to the inflation in milk prices. Their cost cutting efforts have helped balance this rise in milk prices, and they've been able to manage this challenge well. BN has carefully focused on innovation, launching Danio, a thick yogurt that is high in protein, in France, and coming up with new packaging for Evian for example. BN has also increased its stake in Mengniu Dairy, the largest dairy company in China, to 10%, as they continue breaking into early life nutrition in China, a key area of growth for the company. They've also taken a 40% stake in Brookside, the largest dairy company in East Africa, as a means to have a platform in Africa and showing their continued focus on being a global brand. In Europe, BN is focusing on cost cutting in order to invest in value-added products, thus improving their gross mar-gin. North America has been a struggle, as the market is only growing at low single digits, and actually declining in volume. After acquiring Happy Family, an organic baby-food maker, last year, BN has expanded the range of products for babies under their Stonyfield brand. Emerging markets have been an area that has slowed down but BN remains confident in the importance of this area in their growth. BN's targeted focus on different regions and continued innovation, specifically in yogurt, will allow for significant growth in the future.

Dean Foods (DF)

DF is experiencing substantial margin pressure as raw milk prices have reached all-time highs. They have seen a decline in fluid milk category volume and expect this to continue due to the continual rise of the price of raw milk. Despite these head-winds, DF is confident that they are moving in the right direction, focusing on cost reduction efforts, passing through input costs, and volume performance. DF continues to suffer from the partial loss of their private label business with a significant customer. Although there are challenges in the fluid milk category, DF has proven to be a leader in the category, seeing their fluid milk volumes increase 1.1% in Q1, compared to a category decline of 0.6%. DF also has a 35.9% share of the fluid milk category. The TruMoo brand continues to show positive signs, receiving positive consumer and retailer responses from seasonal promotions, showing the importance of better-for-you options in dairy. The regional launch of TruMoo Protein has been successful and DF plans to expand distribution nationally. Expect this product to take off, as consumers search for more protein-rich options in the mornings. DF continues to close plants in their efficiency efforts to offset lost business in 2013 and the record high raw milk prices and, moving into Q2, expect these challenges to continue.

Post Holdings (POST)

POST is focused on consumer needs to shift their growth prospects, particularly portability and convenience, protein rich and organic foods, and availability of breakfast away from home. They have grown share in nearly all brands, particularly through improvements in pricing, shelving, and merchandising for Honey Bunches of Oats, and larger bag sizes of Pebbles. Against a cereal category backdrop of a 4.4% decline, Post Foods saw a 1.2% de-cline in cereal over Q1 and Q2. To place bets outside the struggling cereal category and capitalize on consumer trends, Post Foods will begin sale of their first breakfast shake, Goodness To Go, with 15 g of protein in 3 flavors. They are borrowing from the taste profile knowledge of their Active Nutrition business. The Active Nutrition group is increasing distribution in food and drug mass channels, meeting the needs of consumers seeking healthier lifestyles, greater protein content, and convenient portable packaging. Their plant closure in Modesto, CA is on schedule to complete in August 2014. They have strength in organic, non GMO, and gluten-free cereals from Attune Foods. Their private label portfolio experienced double digit growth with their largest customers and will begin productivity projects and assessment of plant geographies. Troubles from severe winter weather resulted in missed shipments due to plant supply issues that are showing up in last quarter's financials. POST has had a heavy 12 months of acquisitions, boosting their presence in dynamic growth categories, and they expect to close a deal to buy PowerBar in Q1 2015.

Bob Evans (BOBE)

BOBE, the regional restaurant and food business, reported disappointing fiscal fourth quarter results and subsequently provided fiscal 2015 guidance well below consensus. Management reported that despite a difficult operating environment characterized by adverse weather conditions, historically high sow costs, reduced trade spend and a major supply disruption in its food business, BOBE continued key transformational investments during fiscal 2014. Management further asserted that completion of the Farm Fresh Refresh restaurant remodel program, along with BEF Foods' plant optimization (three additional plant closures) coupled with expanded product distribution initiatives, will position BOBE for long term profitable growth. That aside, management continues to be mired in distraction by an activist stockholder who is pushing for BOBE to divest its foods business (featuring refrigerated and frozen breakfast convenience items) and pork sausage, as well as sell its real estate. BOBE's reversal of fortune in the food business hinges on successfully achieving a number of concurrent initiatives. These include restoring its refrigerated side business back to growth after a recent supply disruption, reaping plant network optimization efforts, realizing sausage pricing benefits while also increasing SKU distribution depth and breadth across the retail landscape. BOBE also commented on the need for marketing programs to drive top-line growth but also indicated that it would shift funds from marketing to trade to improve its relative shelf pricing. Shifting investment from marketing to trade is understandable as a short-term tactic, especially in the current consumer pricing environment coupled with aggressive distribution expansion plans. But does BOBE have a sufficient innovation pipeline that will appeal to consumers' evolving palette for breakfast foods? Regardless, pricing execution and data analytics are, and will continue to be, essential ingredients for any successful CP company. The question is will BOBE continue to operate both a restaurant and food business or will mounting pressure force management to concede and divest the food business to a hungry suitor?

Hillshire (HSH)

What a quarter it was for HSH, first as a suitor for Pinnacle Foods then as a target of both Pilgrim's Pride and Tyson before finally being acquired by Tyson in a $7.75B deal expected to close next month. That aside, HSH enjoyed a successful run as a stand-alone company after being spun off from Sara Lee two years ago. HSH attributes its success to disciplined investment in brand building initiatives (i.e., solid positioning, world-class advertising, pricing execution) and innovation (i.e., line extensions, adjacent category introductions and contemporary packaging). These are augmented by superior capabilities in analytics and customer partnering as evidenced by increasing category captaincy with major retailers such as Wal-Mart, Kroger and Publix. HSH's focus on product innovation mirrors changing consumer preferences for healthier foods, adding "on-trend" flavors and innovative packaging, and for positioning breakfast foods for other day part consumption opportunities. HSH expects that up to 15% of sales will be derived from new products by the end of Fiscal '15. Case in point, Jimmy Dean, owned by HSH, is launching 16 microwavable products designed to be eaten later in the day, including a pulled pork sandwich and grilled steak bowl. HSH is hoping they can tap into Americans' changing eating habits as these products are designed to cater to the trend of snacking or eating several smaller meals throughout the day. These products have the added benefit of not being made entirely of meat, which currently suffers from acute input cost inflation, thereby helping to fatten profit margins. This is particularly important for companies that aren't vertically integrated on the supply side and susceptible to more risk. Going forward, the question is: how differently will HSH's new owner, TSN, manage the business and what effect will that have on future performance? The safe bet is that TSN won't slow down the spate of on-trend innovation and brand-building.

Tyson Foods (TSN)

While the majority of major food companies face strong headwinds in the coming periods due to market forces, TSN appears to have the wind at its back based on the combination of its protein based business model and HSH acquisition. TSN management stated that protein demand is up across the board. This favors TSN over its competitors in animal derived protein due to TSN's strength in chicken, its higher margin structure, and its increasing popularity due to relatively high and fast rising beef and pork prices. In fact, owing to tight supply rendered by the PED virus, pork pricing is up 23% at retail over the past 2 months. TSN uses trade promotion tactics jointly with retailers to massage supply/demand of pork in retailers' cases. TSN expects fiscal '15 to be a great year even before integrating HSH based on inherent strengths in its prepared food business, synergies from plant closures and strong cash flows to de-lever the balance sheet. The International Food Segment (6% of total OI) appears to the laggard in TSN's portfolio as China has been beset by scandals and food safety concerns while softer than expected performance in Mexico and Brazil forced TSN to announce impending plant closures. Expect the integration of HSH to further de-emphasize the International segment for the foreseeable future as it focuses on wresting out opportunities for growth and efficiency. In addition to the usual synergies from operational improvements, purchasing, and distribution, TSN expects the HSH combination to "turbo charge" growth in the prepared foods segment given that protein for breakfast is the fastest growing meal occasion in the prepared foods marketplace. Expect TSN to also benefit from gaining presence in the fast rising convenience and snacking segments of the food business as their brands become more omnipresent across high-growth trade channels such as c-store, dollar and club. In summary, the combination of TSN's operational strength in combination with HSH's consumer and trade marketing prowess should generate a series of organizational benefits including new product development and more efficient marketing, advertising, and promotion/brand spending.

Hormel Foods (HRL)

HRL continues its transformation from "commodity products" to "value-added" branded products complemented by consumer-centric innovation and resilient marketing investment. HRL achieved a record second quarter both in terms of dollar sales and earnings per share while improving operating profit margins on a total company basis and in four of their five segments (Specialty Foods was the exception). The Refrigerated Foods segment (50% of Net Sales, 34% of Total Segment Operating Profit) saw segment profit increase by 38 percent as higher pork operating margins offset elevated raw material costs in the value-added businesses. Hormel continues to respond to changing consumer dynamics by rolling out innovative new products such as Rev Wraps, Jennie-O Turkey or by making additional strategic acquisitions. Rev Wraps are meat based single-serve burritos available in a variety of on-trend flavors in response to protein-based snacking trends whereas Jennie-O Turkey appeals to health-conscious consumers by offering a variety of better-for-you products for all eating occasions. HRL recently announced the acquisition of Cytosport, the makers of Muscle Milk, in a $450M deal. The acquisition is aligned with HRL's focus on protein, mostly on beef products, while also acting to diversify its portfolio away from meat. The acquisition should allow HRL to expand into protein-rich foods which possess a growing appeal among young consumers who increasingly resist meals high in carbohydrates. With carbohydrates no longer fashionable along with obesity issues in the U.S., many consumers are choosing to add more protein to their diets. These busy consumers are opting more frequently for protein rich meals they can drink quickly as part of breakfast or after lunch. HRL credits its innovation strategy – understand the consumer, understand product usage, develop new products/marketing and merchandising as the cornerstone for their success. As such, we should expect continued emphasis on innovation, strategic acquisition and analytics as drivers of future HRL growth.

General Mills (GIS)

The number one priority for GIS for the near term is to accelerate top line growth through a tighter focus on consumers. They have split their consumer focus into four main groups: the rising middle class in emerging markets, which is expected to reach 50% of the world's population by 2030, and is experiencing urbanization and greater female participation in the work-force; millennials, who share food ideas and are inquisitive label readers; adults 55 and older, who grew up with GIS and will hit 30% of the population by 2020; and multicultural Americans, led by the growing Hispanic population. Hispanic households show higher cereal buy rates than other demographics. GIS is changing the way they brand their cereal to remain competitive in a stagnant category. They are pushing the protein content of their cereals with milk, providing new flavors of their winning brands, and simpler whole grain and gluten-free options. They are highlighting weight management programs with oat-meal and selling portable oatmeal cups for the 20% of breakfasts not eaten in the home. They are facing off with Chobani in their yogurt category, taking Greek yogurt taste-offs across the country with the sup-port of increased advertising for 100 calorie yogurt and their newer indulgent flavors. GIS is eager to continue growth in emerging markets with one third of sales now outside of the United States. Product quality is considered job number one while they enhance their capabilities, and they are enhancing food safety practices and have doubled their QA staff. Their holistic margin management program is being adopted throughout the organization to generate hundreds of millions in savings in 2015. GIS's operating principles are to invest in cereal and return yogurt to growth, while accelerating better-for-you snacking. They are accelerating into the club channel with innovation and in store merchandising, getting into stores daily to succeed since the channel typically has product rotations. They are also eager to get involved in the online channel, and will bring their physical shelf knowledge to help retailers develop their virtual shelf. Although their merchandising effectiveness isn't down as much as in their categories, GIS is experiencing less incremental volume gains from merchandising efforts due to saturation. Retailers are offering a greater frequency of merchandising events as they compete with one another. They see promise in school breakfasts after the USDA rule for healthier meals in schools.

Kraft Foods (KRFT)

KFRT management reiterated the strong headwinds facing today's Food and Beverage Industry Players and the drag on manufacturers' ability to drive profitable growth. Chief among the challenges are changes in consumer preferences, evolving shopping behavior characterized by fewer trips combined with more disciplined purchase behavior due to a tough spending environment all of which are hurting retail sales. KRFT's performance was further impacted by what management deemed as a rare confluence of events across the value chain. With input costs reaching record highs, KRFT was compelled to increase prices and then shift spend from brand building activities to price promotion at retail as competitors did not raise their prices in response to KRFT or rising input inflation. Retailers also continued to be more demanding of manufacturers for promotional offers to drive shopper retention and market share. Since nearly 2/3 of dollar sales arise from promotional offers, it is imperative for manufacturers to become more proficient in this key area. According to KRFT management, promotion efficiency is below historical norms due to changing retailer merchandising schemes and sub-optimal execution. Interestingly, KRFT believes smaller food players are advantaged with retailers because they are more agile and can innovate faster. Look for the wave of M&A activity to grow as larger players remove competitive threats by gobbling up smaller players and smaller players acquire spun-off brands from the majors as they streamline portfolios.

ConAgra (CAG)

CAG is still working through some hard-ships with the Ralcorp integration. They underestimated the efforts that would be required to consolidate Ralcorp and integrate with them; they are especially experiencing issues with customer service and manufacturing. Despite soft performance of their private brands in recent quarters, they reiterated confidence in their investment in private label and that the challenges they are facing are not a reflection of broader private brand industry challenges or a result of their combination of branded and private label. Once they can spend less time and money on course correction, they are looking forward to gradually improving their mix and seeing margin expansion. They made some pricing concessions this quarter as an investment to stabilize customer relationships. CAG's network optimization plan will restructure their DC geographies and close 3 plants. The Ardent Mills joint venture will provide CAG more stability without the sales volatility of a commodity oriented business. CAG is experiencing less merchandising effectiveness due to limited space in stores and concurrent merchandising in retail areas where they have formerly held solo spots. Several investors asked questions about the strength of their portfolio mix, but man-gement is not at this time concerned with changing their portfolio, but instead with better execution.

Conclusion

Based on the combination of our predicted trends from the beginning of the year and the trends we see being influential moving forward, the acquisition of HSH catapults TSN to the leadership position in the protein segment. This combination enables substantial operational synergies and should facilitate top-line growth based on their consumer-centric, protein-based product innovation focus. PEP's focus on innovation and emerging markets and K's strength in brand building, consumer marketing and sales will bode well for these two manufacturers. GIS is likely another winner in this space as the manufacturer has demonstrated a keen understanding of the changing consumers' needs and wants and backed it up with spate of on-trend new product launches. WWAV's focus on organic and healthy living is riding a consumer trend expected to grow as millenial's gain purchasing power. Finally, we expect to see continued shift of marketing and trade spending to support omnichannel marketing as consumers shift category purchases from retail to online. As with the snacks industry, we are expecting heavy merger and acquisition activity in the mid-term as manufacturers shed and acquire brands and business units to ensure continued strategic fit while also satisfying their desire for channel ubiquity and market access. Productivity projects will continue to sweep the industry as manufacturers work to cut costs in the face of volatile input costs, as well as prepare for or react to M&A activity. We will see many more plant consolidations in the next 36 months, especially after M&A events, to ensure that supply chains and distribution capabilities are optimized geographically.

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Appendix A

NAME	TICKER	MKT CAP	F_P/E	P / S	1-YEAR CHANGE IN P/S	TEV / EBITDA	GROSS MARGIN	1-YEAR CHANGE IN GROSS MARGIN
Nestlé S.A.	NESN	$220,593	19x	2.6x	16.1%	14.3x	48%	-0.3%
Pepsico, Inc.	PEP	$138,233	19x	2.1x	8.5%	11.0x	54%	1.8%
Kraft Foods Group, Inc.	KRFT	$33,654	17x	1.8x	4.8%	10.7x	32%	-22.1%
General Mills, Inc.	GIS	$32,187	17x	1.9x	-2.9%	13.4x	35%	-1.4%
Danone	BN	$31,787	18x	1.5x	-8.1%	13.1x	47%	-4.8%
Kellogg Company	K	$23,041	16x	1.6x	-0.9%	11.5x	39%	-1.8%
Tyson Foods, Inc.	TSN	$14,144	12x	0.3x	7.6%	7.2x	7%	-9.3%
ConAgra Foods, Inc.	CAG	$13,350	14x	0.7x	-21.6%	8.0x	20%	-3.0%
Hormel Foods Corporation	HRL	$12,392	20x	1.4x	1.9%	12.2x	17%	2.9%
The Hillshire Brands Company	HSH	$7,744	34x	1.8x	83.7%	22.5x	28%	-1.2%
The WhiteWave Foods Company	WWAV	$5,707	31x	1.7x	42.6%	18.6x	34%	-6.5%
Post Holdings, Inc.	POST	$1,669	41x	0.6x	-47.2%	16.0x	27%	-37.7%
Dean Foods Company	DF	$1,483	40x	0.2x	-3.7%	15.6x	17%	-21.4%
Bob Evans Farms, Inc.	BOBE	$1,117	25x	0.9x	11.5%	13.9x	36%	-3.6%
Median		$13,747	19x	1.5x	3.4%	13.2x	33%	-3.3%

Table 1. Financial metrics based on most recent earnings. WWAV's superior financial metrics display investors' confidencearound their category innovation, as evidenced by the success in their plant-based products, especially almond milk. Many companies have faced substantial pressure on their gross margins over the last year, largely driven by the rise in dairy costs to historical highs (see Figure 3). HSH's boost in P/S is due to being acquired by TSN. CAG's recent struggles are reflected by their lower than average metrics and drop in P/S ratio. POST's high forward earnings multiple signals investor confidence surrounding the integration of their many acquisitions.

Overall the companies are in-line with the S&P 500's forward multiple of 18x.

Source: S&P Capital IQ, 8/ 14 / 14

Appendix B

NAME	TICKER	MKT CAP	NORMALIZED EPS, CURRENT QUARTER	2013 NORMALIZED EPS	2014 NORMALIZED EPS
Nestlé S.A.	NESN	$220,593	$0.62	$2.71	$3.59
Pepsico, Inc.	PEP	$138,233	$1.15	$3.82	$4.76
Kraft Foods Group, Inc.	KRFT	$33,654	$0.80	$3.97	$3.25
General Mills, Inc.	GIS	$32,187	$0.55	$2.61	$3.02
Danone	BN	$31,787	$0.51	$2.10	$2.88
Kellogg Company	K	$23,041	$0.86	$5.33	$4.04
Tyson Foods, Inc.	TSN	$14,144	$0.70	$2.74	$3.11
ConAgra Foods, Inc.	CAG	$13,350	$0.66	$2.13	$2.24
Hormel Foods Corporation	HRL	$12,392	$0.50	$2.05	$2.30
The Hillshire Brands Company	HSH	$7,744	$0.25	$1.43	$1.86
The WhiteWave Foods Company	WWAV	$5,707	$0.20	$0.73	$1.08
Post Holdings, Inc.	POST	$1,669	-$0.34	-$0.48	$0.66
Dean Foods Company	DF	$1,483	-$0.12	$0.00	$0.37
Bob Evans Farms, Inc.	BOBE	$1,117	$0.13	$1.28	$1.97

Table 2. EPS from most recent earnings release. Most companies are projected to have earnings growth in 2014 despite recent headwinds in dairy prices as well as a shift in consumer preferences. POST will begin seeing a positive impact from their many acquistions later in 2014, as evidenced by the uptick in earnings projections. Analysts project K to struggle as the year goes on, as the cereal category continues to fall out of favor with health conscious consumers. BN will see postive earnings growth as they retrieve value out of breaking into new markets. WWAV continues to push forward with its innovative product, with no slowdown in sight. DF should begin seeing a turnaround as milk prices come back down historical highs (Figure 3) and as they realize cost-savings from their various productivity projects.

Source: S&P Capital IQ, 8 / 14 / 14 (Victor – please update)

Important Disclosures

Clarkston Consulting analyzed information from the latest public presentations and SEC filings of eleven dominant players in the U.S. snack manufacturing category including: chips, crackers, cookies, nuts, and other sweet or savory packaged snack foods. The companies included in the analysis are Campbell Soup Company, ConAgra, Diamond Foods, Flowers Foods, General Mills, The Hain Celestial Group, Kellogg Company, Kraft Foods, Mondelez International, PepsiCo (Frito-Lay North America), and Snyder's-Lance.

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