

FOOD PRODUCERS

"PLEASE, SIR, I WANT SOME MORE" – UNDERSTANDING THE INVESTMENT FUNDAMENTALS OF FOOD PRODUCERS

By Alan Lok, CFA; Eunice Chu, ACCA; and Guruprasad Jambunathan, FRM

It is the essential thing that magnetically pulls us from our desks at midday, soothes family disagreements, or keeps us happy while watching a box-set at the weekend. We are talking about food. Behind all those sweet and savoury pleasures lies a peculiar and sometimes complex industry – food producers.

While most sectors are affected by a finite number of factors, food production faces a broader range of issues. At its heart is non-discretionary demand – namely, the need for us to eat. However, it is not quite so straightforward. As we radiate from the centre, the picture becomes more complicated, and it is this sinuosity that we want to help you understand.

It might be helpful to think of this framework in terms of packaging. The steady and reliable non-discretionary core (the food itself) is encased in several layers (factors) that deserve further examination.

A CHANGING PALATE

Such wrappings include the changing tastes of the developing world, where traditional staples are declining in popularity as households develop an appetite for, among other things, wheat-based products, meat, or dairy. Simultaneously, some in the developed world are renouncing their steaks and ice cream in favour of lower-fat poultry and fresh fruit. Tied to this is the expansion of the organic food movement, which registered sales in the United States of almost US\$50 billion in 2017. This growth was six times faster than that of the broader food market and is being led by millennials, who now make up 52% of organic consumers. If you want a glimpse of future trends, then it's worth paying attention to the eating habits of different generations across different countries.

BUMPER HARVEST?

The problem of food wastage is spreading from the United States and Europe to Asia; Singapore alone discards around 800,000 tonnes yearly. From an environmental perspective, it's worth contemplating the amount of energy required to produce all this discarded food: The industry is highly resource-intensive. In addition, we have a habit of burying unwanted food, which decomposes and releases methane into the atmosphere.

That said, we may simultaneously face a future in which demand outpaces supply from production hampered by a combination of change in climate, economics, and demographics. Global warming could affect water and energy supplies. In terms of economics, it may no longer be profitable to produce certain crops if the numbers don't add up. Also, the global population is expected to exceed 10 billion before the end of the 21st century, with the increase coming mainly from developing countries.

Interestingly, there are investment avenues to be explored with both over- and underproduction. The waste technology industry, although still relatively small, is growing in importance as startups seek ways to recycle unused food, for example as by-products for the agricultural sector. Meanwhile, many companies are finding innovative ways to increase output and tackle production shortfalls.

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INGREDIENTS IN THE MIX

Food production is undoubtedly a multidimensional stakeholder sector, with criss-crossing relationships a driving force behind innovation. Producers work with processors, who in turn liaise with distributors and, finally, retailers. Consumer power and views matter. The last thing this industry needs is a food scandal. Meanwhile, as these strands interlace, the regulators are keeping a watchful eye on developments. More recently, the role of non-governmental agencies has been added to the mix, as regulators monitor how companies operate in the developing world.

GRAB THE RHINO, SOUND THE HORN

In such a seemingly self-aware industry, there are still a few potential grey rhinos – the creeping megatrends that industry stakeholders may not fully understand. One such development is food delivery: the men and women on motorbikes who tear around our cities. Food Panda, Deliveroo, and GrabFood (which has already gobbled up Uber Eats) are becoming ubiquitous as we appear increasingly willing to tolerate tepid food to avoid venturing out. Fresh-food delivery is also on the rise, with supermarkets offering a minimum-spend for door-to-door service. Lastly, the arguments over genetically modified food could justify a report of their own.

CHEAP AS CHIPS?

How, then, do we analyse the business viability of a food producer?

Let's start by examining demand. This involves finding out how much of a company's product portfolio can be classified as fully non-discretionary or moderately discretionary and asking about the mix of volumes and revenues between these categories. How do these compare, and have any shifts in demand been identified or predicted? From here, we can go on to explore the impact of price changes on the company's offerings. Does unit demand alter when prices alter, and how does this affect different products in various markets?

Of course, the retail channels play a vital role in influencing the desire for a particular foodstuff. We have all seen large displays of dry foods in the middle of supermarket aisles. How much do these arrangements cost? In tandem, does the producer have a say about how its products are positioned and packaged by leading retail chains? Increasingly, it is also important to examine the producer's hold in the virtual world: Does it operate its own e-commerce channel or relies on third-party platforms to manage sales?

Look ahead as well. Investigate the issues or events that will drive structural demand growth. How saturated is per capita consumption of the company's products in its markets? Screen the anticipated incremental need for the goods it sells and discover which goods are expected to remain popular among customers. In addition, review the firm's business plan to see if the firm intends to enter new markets and understands the challenges it may face.

FOOD FADS

With a deeper understanding of the business, delve into the structure of the market(s) within which it operates. How much competition does the company face? What are the barriers to market entry? What is the company's overall share of the market? And how significant is the threat from private labels?

Next, find out what the firm's customers think about its brands and products. Have their opinions been influenced by product recalls or controversies relating to health scares? Indeed, has the company ever faced regulatory action for violating any food safety practices?

Innovation is another aspect to assess. Consider new product launches and their frequency and study the steps that are taken to ensure that these do not cannibalise existing volumes. Lastly, think about the health of the consumer and inquire about sugar- and fat-related regulations. Do they exist in the company's markets? If not, are there plans to introduce them?

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IS IT BAKED TO PERFECTION?

We have examined competition, so now look at the company's books to see how it has performed against its peers. What are its margins and expense ratios? And do remember cash flows.

Have organic volume growth rates been achieved? Furthermore, check out the company's investment strategy and the extent to which input cost increases can be passed on to customers. It is good to know if the company's supply chain is vulnerable to external disruptions, such as geopolitical issues or natural disasters.

Given the energy-intensive nature of food production, we must pay particular attention to environmental, social, and governance issues. Screen any investment that the firm has made in recycling programmes or raising consumer awareness about food wastage. Does the firm put profit first or make an effort to treat its suppliers fairly? What's more, how much money is spent on minimising the release of pollutants?

Ultimately, any company that can manage the multiple stakeholder relationships, recognise changing customer tastes, and keep an eye on the future will thrive. We hope that the items on today's menu have whetted your appetite for a more in-depth study of the food production industry and help you to decide if the business model of a company is sustainable. If you want another helping, our complete framework is available on www.arx.cfa. Log in and feast.

About the Authors

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01 DEMAND DRIVERS

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A step-by-step guide to analyzing the food producers industry

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- Organic volume growth
- Hedging strategies
- New product launch track record

05 ESG FACTORS

- Health and nutrition product strategy
- Sustainable supply practices

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Food Products

1. What impact do price changes have on the company's products?

- How does unit demand alter when prices change, and how does this affect different products in various markets?
- How effectively can the company pass cost increases on without impacting demand for its products?
- How much does demand increase in response to price reductions? Are additional volumes sufficient to cover lower revenue per unit due to the price reduction?
- Does the company offer products across the price spectrum in the same category or sub-category?
- What is the company's stock keeping unit (SKU) strategy? How many different package sizes are typically offered in each product?
- How does the company ensure smaller SKUs do not cannibalize larger SKUs?
- Does the company actively try to persuade customers to down-trade or up-trade to avoid losing share of their total spending? If so, how successful have these efforts been in the past?

2. What proportion of the company's products could be described as discretionary?

- How much of the product portfolio can be classified as fully non-discretionary versus moderately discretionary?
- What is the mix of volumes and revenues between these categories? How do the margins compare?
- Are customers reducing product consumption in any category or sub-category where the company has a presence?
- If so, what are these sub-categories? What products are customers buying instead? Does the company offer products in the replacement sub-category?
- How are these demand shifts identified or predicted?

3. What is the role of the retail channel in influencing demand for the company's products?

- How extensive is the company's presence in the retail channel in its key markets?
- How much presence do the company's products have on the shelves of leading retail chains?
- How much increase in demand is observed from rises in shelf space presence?
- What is the impact of a reduction in shelf space presence?
- How much control/influence does the company have on the size and positioning of shelf space? Are some retailers more favorably inclined to the company than others? If so, what costs are associated with these favors?

4. What factors are expected to drive structural demand growth?

- How saturated are per-capita consumption and demand for the company's products in markets in which it operates?
- How much incremental demand does the company anticipate due to increases in consumer expenditure?
- What products are likely to continue to see per-capita demand growth?
- What new product types are expected to see strong demand?
- How does the company propose to drive structural growth? Does the company intend entering new markets or product segments? If so, what challenges are anticipated?

5. How are the culinary preferences of customers in key markets evolving?

- Are significant changes occurring in customer culinary preferences?
- If so, what are these changes? What is the impact on the market and to the company's product portfolio?
- How does the company intend to leverage these opportunities?

6. What is the impact of changes in customers' food attitudes?

- From a health perspective, what are consumers' perceptions towards packaged and processed food?
- How are these trends evolving? How important is the perception of convenience in softening the impact from any negative attitudes?
- What kind of foods do customers consider healthy? Has the company observed a significant increase in demand for fresh, natural and organic foods?
- How is the company's product portfolio being affected by these trends?
- How does the company intend to manage potential impacts? Are any measures being implemented to leverage these opportunities?

7. What is the impact of private label products?

- What is the market share of private labels in key product offerings? How is this trend evolving?
- How much brand power does the company have to help compete against private labels?
- How is this affecting relationships with retailers?
- How much impact is anticipated from the proliferation of private label products? How does the company plan on managing this?

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8. What is the impact of e-commerce growth?

- What is the share of e-commerce in the food and grocery segment in key markets?
- How does the company expect this to evolve in future? What challenges are being presented as a result of this evolution?
- In general, how much pressure are retailers facing as a result of e-commerce? How is this impacting the company specifically?
- Does the company have a presence in e-commerce channels? Also, does it sell directly or through third-party e-commerce platforms?
- What strategies are in place to leverage opportunities arising from the increased use of e-commerce?

9. Competition levels and entry barriers in the industry.

- How concentrated is the market in general and, specifically, in categories and sub-categories in which the company operates?
- What is the company's market share in categories and sub-categories in which it operates?
- How much negotiating and pricing power does the company's scale allow?
- How easy or difficult is it for new players to enter the market? What factors affect the entry of new players?

10. Perceptions about the company's brands and products.

- How do consumers perceive the company's brands and products?
- Are there any controversies surrounding brands, considering factors such as labelling, use of preservatives, use of GMO ingredients, potential health risks from ingredients, etc.?
- Have there been any instances where the company has had to recall products?
- What has been the company's track record with respect to quality control at production facilities?
- Has the company ever been penalized, warned or faced regulatory action for violating any food safety norms?
- Is the company facing, or has it faced in the past, litigation regarding any aspect of its products?
- Has the company ever faced adverse media coverage for any reason? If so, please provide details and a summary of remedial measures undertaken.

11. Relationships with retailers.

- How fragmented or concentrated is the retail network in the company's key markets?
- How concentrated or diversified is the company's sales exposure to different retailers?
- Who are the top-three and top-five retailers in the company's market and what proportion of the company's sales emanates from these retailers?
- How much pricing pressure comes exposure to large retailers? How does the company expect this trend to evolve?
- In this context, what is the anticipated impact of the shift towards e-commerce? How much channel de-risking is expected?
- Do retailers charge slotting fees in key markets? If so, how much cost is incurred?

12. What is the company's product innovation strategy? What has been its track record in new product development/launches?

- How frequently does the company launch new products?
- How are new products or variants typically differentiated?
- What steps are taken to ensure that new product launches do not cannibalize existing product volumes?
- How much of the company's revenue is typically derived from new products?
- What is the company's strategy for managing the product life cycle?
- How much cost is typically incurred in the development and marketing of new products?

13. What is the extent of detail required on food labels?

- How detailed are food labelling requirements in key markets? Are these likely to get more stringent?
- Could customer perception of the company's products be affected by information about the goods that appears on labels?
- What requirements exist relating to labelling information about sugar and fat presence in food products?
- Are these requirements becoming more stringent? How is this trend likely to evolve and what is the impact envisaged?
- How much negative perception regarding sugar and fat currently exists in key markets? How is this evolving?
- How much total and added sugar is present in the company's products?
- How much total, saturated and unsaturated fat is present in the company's products?

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14. How are regulations relating to sugar and fat evolving?

- Do any sugar and/or fat taxes exist in key markets?
- If not, how likely is it that these will be introduced? What would be the likely impact on sales and customer perception of the company's products?
- How common is it for institutions to ban or restrict food products perceived to be high in sugar and/or fat from their canteens?

15. The regulatory environment and its impact on the company.

- Typically, how time consuming for the company are testing requirements?
- How much cost is incurred in the product testing and approval process?
- Does the company face any issues relating to water availability and effluent disposal?

16. How has the company performed operationally? How do key metrics compare to peers?

- What organic volume growth rates have been achieved?
- What level of price increase has been realized?
- What is the company's price investment strategy? To what extent can input cost increases be passed on to customers?
- How is the company placed on accounts receivable in terms of number of days?
- Is the company's supply chain vulnerable to any disruptions due to external factors, such as geopolitical issues and natural disasters?
- What has been the impact of commodity price changes on input costs? How sensitive are margins to changes in commodity prices?
- Does the company employ any hedging strategies to manage the impact of input cost volatility?

17. How has the company performed financially? How do key metrics compare to peers?

- What is the current SG&A expense ratio?
- On average, how much does the company spend on marketing and brand promotion?
- What are the company's current gross, operating and net margins?
- How much of the company's revenues are denominated in foreign currencies? How are foreign exchange risks mitigated?

18. Please provide details of the company's ESG principles, practices and track record?

- What is the company's strategy to address concerns relating to the health and nutritional aspects of its products? What programs are in place to address these concerns?
- What is the emission, energy, water consumption and pollutant release intensity of the company's products and manufacturing processes? What steps are taken to improve performance on these fronts?
- How much palm oil is used? Does the company practice source tracing of its palm oil supplies?
- Does the company use (or has it used in the past) palm oil sourced from suppliers accused of the destruction of rainforests and wildlife habitats?
- What measures are in place to ensure palm oil supplies are sourced in a sustainable manner?
- How much packaging material is used per unit of SKUs in different product types? Does the company intend to reduce packaging or increase the use of biodegradable or recycled material, without compromising on safety/quality?
- How much wastage occurs during the sourcing, processing, packaging and distribution of the company's products?
- What proportion of the company's products are discarded as unsold past their best use date? Are there any composting or recycling programs in place for discarded products?
- Does the company have any programs to increase customer awareness of food wastage, helping to promote responsible consumption?
- How does the company ensure fair treatment of crop, dairy and animal farmers, small suppliers and the rural communities from which products are sourced?