

## Consumer goods: big brands battle with the ‘little guys’

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Large companies squeezed by innovative offerings from smaller rivals are now adopting their business models in search of higher growth

Scheherazade Daneshkhu in London FEBRUARY 28, 2018

Fairfax Hall was sipping a gin and tonic in Union Square, New York, with his childhood friend, Sam Galsworthy, when the idea struck. It was 2006 and the friends from the drinks industry had noticed how a handful of artisanal distilleries had sprung up in the US, following the boom in craft breweries.

“What fascinated us was seeing the reaction to these [little distilleries](#). People really do care where, and how, things are made,” says Mr Hall. There was a contrast with his employer at the time, [Diageo](#), the world’s biggest distiller and owner of global brands like Johnnie Walker scotch and Smirnoff vodka. “What these little guys were doing was almost in direct opposition to where the world of fast-moving consumer goods [FMCG] had been going — of globalisation and big companies getting even bigger.”

The two men decided to join the “little guys”. Three years later, they established Sipsmith as the first traditional copper gin distillery in London since 1820. At £30 a bottle, its Sipsmith’s London dry gin costs twice as much as Diageo’s Gordon’s and one-third more than its upmarket Tanqueray gin. Despite this, Sipsmith sales have soared, and just over a year ago it was [swallowed up by Japan’s Beam Suntory](#), the world’s third-largest distiller — though Mr Hall and Mr Galsworthy continue to manage the business.

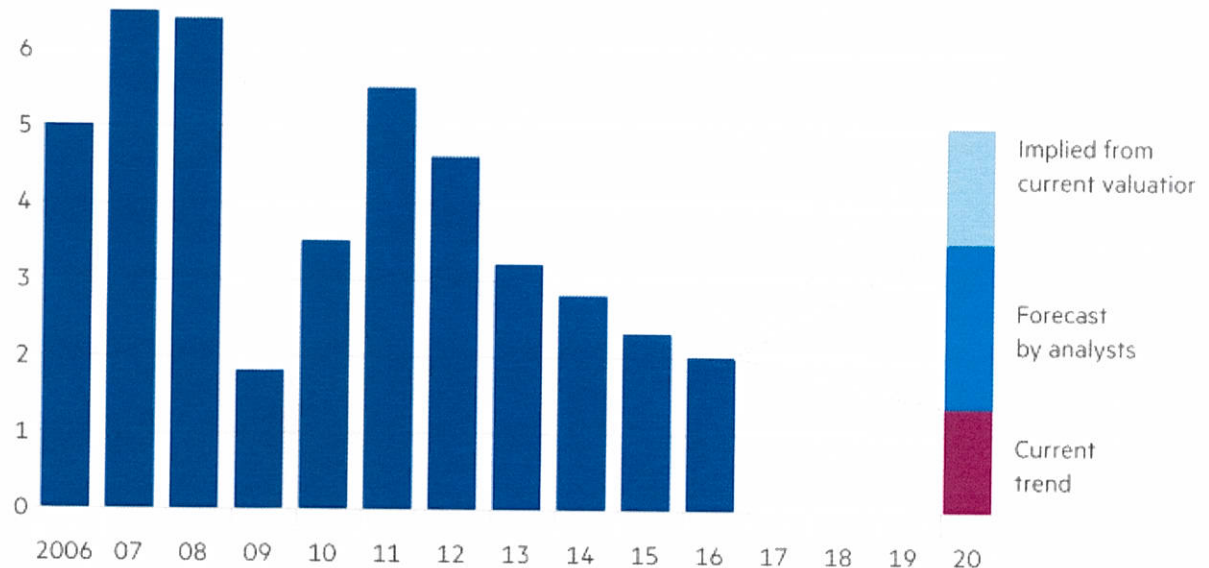
The acquisition is emblematic of one tactic employed by some large consumer groups trying to reverse five years of [weakening growth](#). In 2016, revenues of the large consumer goods companies — from [beer to soft drinks](#), [food](#) and [household products](#) — grew at their slowest rate since 2009, when the recession took hold. The 2017 results for many of those companies that have reported remain weak.

These trends might not be new but the industry is now facing fresh questions over whether it can restore the high growth rates these groups once enjoyed — and if it cannot what will be the reaction of investors? Bain and Company, the consultancy, says that on current valuations, the market expects these groups to return to organic growth rates of 5 per cent a year by 2020, but its own forecast is for 2 to 3 per cent over the next three years.

The gap between the two forecasts could add up to as much as \$70bn in lost value according to a Financial Times calculation.

### Bain forecasts FMCG organic revenue growth is unlikely to bounce back to historic highs

Annual (%)



Source: Bain and Company  
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“Companies will need to fundamentally revisit their way of working and transform themselves,” says Matthew Meacham, Bain’s global head of consumer products. “If they stay with the model of mass marketing, big sales forces, large investments in big manufacturing plants, they will struggle.”

It is not just the proliferation of vogueish upstarts like Sipsmith that poses a problem for consumer goods companies. People are [changing the way they shop](#) at a time when digital technology has made it easier for companies without large marketing budgets to reach consumers online removing the dependence on traditional distribution routes.

One way for consumer companies to combat such trends has been to innovate, create desirable new products, and charge more for them. But they have ceded ground in this area. “Large, fast-moving consumer goods companies are highly skilled at executing known business models,” says Richard Taylor, analyst at Morgan Stanley, “but their record on true radical innovation over the past 20 years is downright dire.”

### FMCG in numbers





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## 2%-3%

Bain and Company estimate for organic revenue growth for FMCG groups in 2020, against market expectations of 5%

## \$22bn

Sales transferred from large to smaller companies in North America between 2011 and 2016, says Boston Consulting Group

## 5%-6%

Nestlé's annual growth target which it recently abandoned. It recorded revenue growth of 2.4% in 2017

**Such groups have been** remarkably slow at spotting the changes in tastes. Younger consumers are breakfasting on Kind cereal bars or Chobani yoghurt, using Harry's or [Dollar Shave Club](#) razors, drinking Peet's coffee, laundering with plant-based Seventh Generation detergent, then relaxing in the evening with a [BrewDog](#) craft beer or Tito's vodka and Fevertree tonic.

According to Boston Consulting Group, \$22bn in industry sales transferred from large to smaller companies in North America between 2011 and 2016 and there has been a similar

trend in Europe. The share of the consumer goods market held by smaller companies, grew from 23 per cent to 26 per cent over the same period, say BCG and IRI research group.

As a result, and despite rising global demand, 34 of the world's 50 biggest consumer companies are suffering either from slower sales and profits growth, or both, according to Bain. Their revenues grew at an annual average of 7.7 per cent between 2006 and 2011 but that fell to just 0.7 per cent between 2012 and 2016. Average growth in annual operating profits was barely a quarter of what it had been in the earlier period, according to the consultancy.

Nestlé abandoned its 5-6 per cent annual revenue growth target after missing it for four years. Its 2017 revenues of SFr89.8bn (\$96bn) were only 2.4 per cent higher than in 2016 — the lowest rate of growth this century. Among the worst hit are leading US packaged food companies, such as Campbell of tinned soup fame; [General Mills](#), owner of Yoplait yoghurt and Cheerios cereal; Kellogg's and Kraft Heinz.

## The buyer: Unilever



The Anglo-Dutch group that makes everything from Axe deodorants to Hellmann's mayonnaise has been buying up small high-growth and innovative companies. Chief executive Paul Polman has spent €9bn on 19 [bolt-on acquisitions](#) since 2015 including Dollar Shave Club, the subscription-based razor company, Seventh Generation, an eco-friendly laundry group, and Carver Korea, the Seoul-based maker of skincare products.

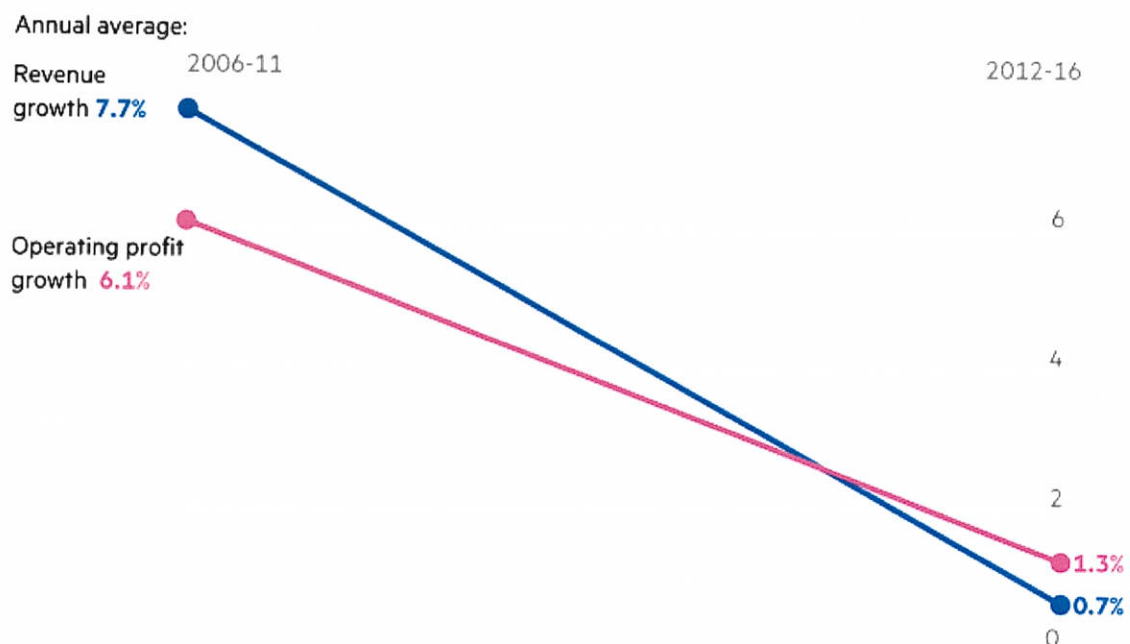


Cheaper, private-label products have added to the problems faced by the consumer groups and fuelled the growth of retail discounters such as [Costco](#), Aldi and Lidl, and spurred a cut-throat price war between supermarkets and online sites, including [Amazon](#).

Cyclical problems such as currency fluctuations, a slowdown in emerging markets and the difficulty of raising prices because of low inflation in the US and much of Europe, have all contributed to making “today’s environment one of the most volatile and uncertain that I’ve seen in my 35 years in the industry”, said Irene Rosenfeld, before stepping down in November as chief executive of [Mondelez](#).

The producer of Oreos biscuits and Cadbury chocolate bars eked out just 0.9 per cent growth in organic net sales last year, down from an already modest 1.5 per cent in 2016.

### Revenue and profit growth for leading FMCG companies has slowed



Source: Bain and Company  
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This relatively weak financial performance has made even the biggest companies vulnerable to [activist investors](#) agitating for changes to boost profitability, including Nelson Peltz of Trian investment group at P&G, and Dan Loeb’s Third Point at [Nestlé](#).

Many have felt compelled to cut costs by the approach 3G Capital took at Kraft Heinz. The “ruthless cost-cutting” led by the Brazilian investors has had a “revolutionary impact” on the food industry, said Peter Brabeck-Letmathe, former Nestlé chief executive and now its chairman emeritus. At Kraft Heinz, controlled by 3G and Warren Buffett’s [Berkshire](#)

[Hathaway](#) investment group, profits have shot up but sales have gone down, sparking a huge debate about how to strike the right balance between profits and higher revenues.

The 3G model looked unstoppable — until last year when it encountered a rare defeat. Kraft Heinz was forced to back down from an audacious [\\$143bn bid attempt for Unilever](#) after encountering huge resistance from the Anglo-Dutch group. Yet the fact that Kraft Heinz was confident enough to target a company with double the sales underscored the vulnerability of even the biggest names in the sector.

### The restructure: Reckitt Benckiser



The UK company behind Dettol disinfectant and Nurofen painkillers last year [split its business](#) into two units under the umbrella of the group, each with its own profit and loss account, to increase accountability. Rakesh Kapoor, chief executive, says the group's [\\$18bn](#) acquisition last year of Mead Johnson, the US infant formula group, precipitated the change: "Large companies are finding it difficult to outperform the markets. And the reason is large companies are facing smaller, nimbler, niched competition . . . a 'one size fits all' approach is an outdated approach."

The large groups have sought to combat the new threats in different ways. But virtually all have adopted some form of zero-based budgeting, the cost-cutting programme popularised by 3G's model of justifying costs across the board every year. This has helped drive up profitability.



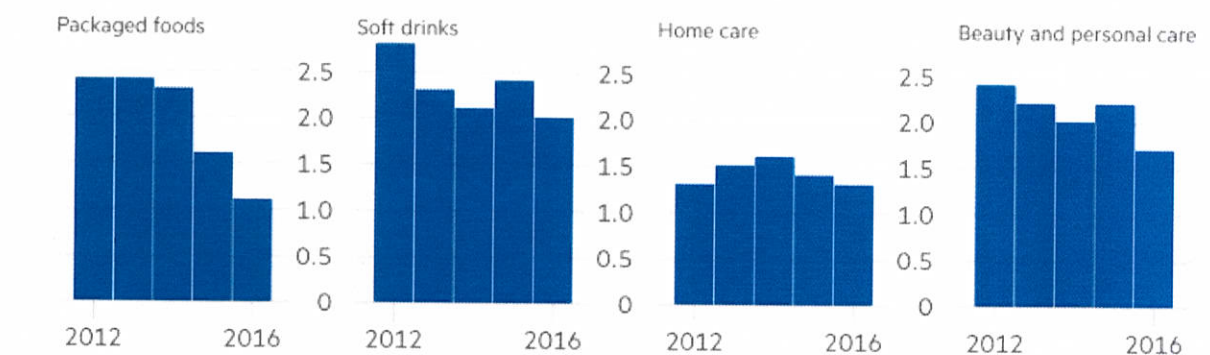
Many have adapted their products. Others have tried to buy growth; merger and acquisition activity has cranked up, with some groups acquiring the very start-ups that challenged their dominance. [Unilever has bought](#) 19 small companies over the past two years while [Danone](#) spent \$12.5bn on WhiteWave, the US natural and healthy foods company. They have also been divesting low-growth businesses — [Unilever sold](#) its Flora and Becel margarines business last year.

Then there is more far-reaching structural change. Procter & Gamble, the world's second-largest consumer group, owner of Tide detergent, Pampers nappies and Gillette razors, has slashed the number of brands it manufactures from 170 to 65 since 2004. Jon Moeller, P&G's finance director, told an industry conference last week that "P&G is a profoundly different company than just a few years ago". Yet Chas Manso, analyst at Société Générale, says: "Overall it is still losing global share and underperforming on organic sales growth."

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## The food sector has been hit especially hard

Global year-on-year growth in revenue (%)



Source: Morgan Stanley  
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**So can these large** organisations, structured for mass production, really cater for the greater customisation demanded by modern consumers? Can their problems be solved by adapting to new technology and a rebound in emerging markets?

John Zealley, senior managing director of consumer goods and services at Accenture, says the groups need to take more risks to balance "investment in innovations that will have more volatile returns" with restoring core products. But he argues that they must also take advantage of their scale to exploit areas like data analysis. "Much in the same way that 'fast fashion' reinvented the mass clothing market, so modern consumer product groups need to reinvent the mass consumer market," he adds.

Valuations in terms of price-to-earnings ratios have proved resilient and suggest investors believe the companies can do this. "A substantial weight of investors don't seem terribly

concerned,” says James Edwardes Jones, analyst at RBC Capital Markets. “We think that’s a mistake.”

Mr Edwardes Jones has calculated that the return on investment among European consumer staples fell by 60 per cent in the past five years, compared with the previous seven, making it more expensive for the big companies to drive sales growth.

“This reflects an alarming rise in the cost to compete that has yet to be assimilated into share prices. These companies used to have the security of Swiss government bonds with some growth and yield thrown in; that’s no longer the case. Given the low growth and loss of market share, the sector is overvalued,” he argues.

## The start-up: Halo Top



“I don’t think [Halo-Top](#) would have been able to exist say 20, 25 years ago,” says Justin Woolverton, the Los Angeles-based founder of the sugar-free added-protein ice cream brand.

Launched in 2012, within five years the brand was outselling Unilever’s Ben & Jerry’s and Nestlé’s Haagen-Dazs in the US, in standard pint-sized tubs. Mr Woolverton says: “With digital, you can really make your limited dollars work. [Before digital] you would have had to take out a newspaper ad or do a radio or TV ad — if I had started with \$10m, we could have done something. Now if you have \$100, you can target people who are going to be much more receptive.”



Some investors agree. Raphaël Pitoun, chief investment officer at Seilern Investment Management, says: “The reaction of these companies is really telling: they are adding more debt, doing more M&A with high execution risks and increasing share buybacks. It is all reminiscent of the telecoms sector before the crash of 2001.”

Seilern has sold most of its holdings in consumer staples and is “focusing instead on a few well-positioned brands that look set to accelerate their growth prospects and margins through digital transformation”, says Mr Pitoun.

Some groups, noticeably [Estee Lauder](#) in cosmetics and [Heineken](#) in beverages, are bucking the trend and experiencing robust growth. Jamie Isenwater, founding partner of Ash Park Capital, a fund dedicated to consumer staples, says the industry is no more vulnerable to disruption than others.

“One of the many reasons why consumer staples have made such excellent long-term investments is that people will always need to eat, drink, clean and take care of their appearance. A lot of the talk about disruption as a major threat is overdone and much of the competitive activity that is being referred to is completely normal.”

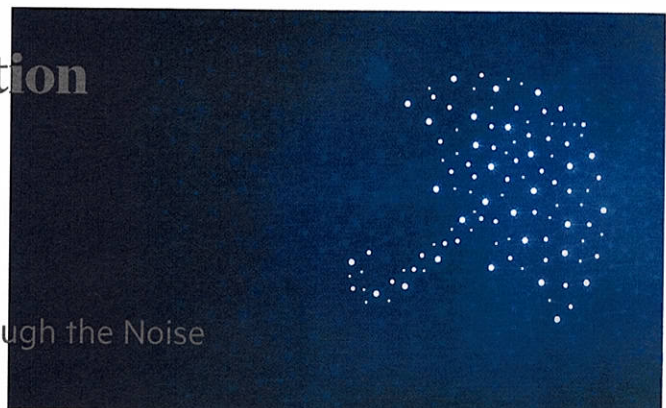
Nevertheless, Mr Isenwater believes that some companies do have problems — US food groups in particular. “Five years ago, you could have thrown darts into a board of consumer staples investments and your performance would have been very good. That’s no longer the case — you have to be more selective about where you invest. But companies in the top quartile will deliver exactly the same sort of returns as before,” he says.

For now, the big companies are paying close attention to their upstart rivals. Mr Hall says Sipsmith will be able to expand into other countries far more quickly than if it had stayed independent. “We will continue to run the business in the way we started. We’ve grown immensely but we’re tiny on the global scale.”

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