The food industry has emerged as one of the most dynamic sectors of the economy, transformed by rapidly evolving consumer preferences, shifting demographics, and disruptive technology. To gauge what is driving this change and where the industry is headed, we spoke with two professionals in the field: Roger Davidson, Owner & Chief Operating Officer of MaGi Foods, and Jim Hoeg, Portfolio Manager for the Consumer Sector at Citadel.
Roger, it seems like the food industry is undergoing a dramatic change. How would you describe where the industry has been and where it is headed?

Roger: In the 1980s, supermarkets dominated and consumers basically chose between similar competitors based on location. That began to change in the 1990s when discount stores like Wal-Mart and Target entered the market.

But the real watershed moment arrived in the early 2000s when alternative format stores began to take off and completely disrupt the industry. Club stores, dollar stores, drug stores, and specialty health and natural food stores all began offering grocery products in completely new ways. Internet retailers also entered the market, creating entirely new retail concepts and crossover formats. Today, the market is more complex than ever.

What is the current playbook for success?

Roger: In the 1990s, it was simpler. Location was key, and consumers had fewer choices. Today, success depends on a combination of three factors: price/value, convenience, and the “healthy/fresh” factor.

From 2005-2010, you could dominate just one of these three areas and succeed. But today retailers have to offer at least two of these factors, if not three. A good example is Costco. Sure, they compete on price, but now they are offering organic and natural products. They also offer convenience because they pre-select items for consumers. Instead of offering 40 printers like Best Buy, Costco enables consumers to choose between the two best available – one a basic price/value item, and the other a more premium model with added features.

Jim, what else has changed?

Jim: The Nutrition Labeling and Education Act of 1990 completely changed the game. This was the inception of today’s health and wellness trend, where sophisticated consumers began demanding healthier products. It’s no coincidence that the carbonated soft drink industry began its decline in late 1990s.

The Internet has only accelerated this trend, because consumers now have all the tools they need to make informed decisions. Data from Nielson shows that organic food options have grown approximately 10% over the past five years, compared to traditional packaged food, which has barely grown in the low single digits.

We’ve also seen an explosion of healthy natural store formats. Whole Foods now has approximately 400 stores – double the number in 2002. Whole Foods management has publicly identified about 1,200 locations nationally they could reach, with a near-term goal of 500 stores by 2017. The Fresh Market has 169 stores and management has publicly stated they expect to add 70 more in the next three years. Sprouts has 191 stores and management has publicly stated they expect to add 24 stores in the next 12 months.
What other format changes do you see taking place in retail, both today and looking toward the future?

Roger: The primary battle today is between Internet and “brick & mortar” stores. This competition is reshaping retail business strategy. Most major retailers are now embracing multiple channels to reach customers – offerings that include “brick & mortar” shopping, store pickup, and Internet delivery.

Some chains are as much restaurants and entertainment experiences as they are grocery stores. You can get a delicious seafood dinner at Whole Foods for $15 that would cost $50 at a nice restaurant. While the Internet can offer convenience and price, it can’t compete with the fresh, prepared meals specialty stores can offer. These stores are selling an experience. Most consumers still like to “touch, feel, smell and taste” – they want the sensory experience.

If you are a retailer dependent on packaged and frozen goods, you are more at risk. These items can be efficiently delivered through Internet home delivery and most consumers find little pleasure in shopping for them. Traditional CPG (consumer packaged goods) companies are feeling this pressure. Their once valued branded products – mostly processed foods and non-food items – are not trusted by a growing percentage of consumers. The retailers that are growing sales do not carry these brands.

Jim: The Internet can’t replicate the experience of prepared food, but a hybrid model is emerging. We see retailers starting to take advantage of new options that let customers buy online and then pick up prepared food in stores. Whole Foods is doing that. It’s the convenience of the Internet, with the experience of the store. This hybrid model is a differentiator.

Do Internet-only retailers like Amazon pose a threat to large, successful retail grocery stores?

Jim: The grocery industry historically has operated on small margins, so even relatively small losses can be significant.

Roger: A couple years ago, it looked like Amazon was going to own the home delivery market. When I looked at the retail landscape, I saw Amazon building these big distribution centers and transportation networks that could take anywhere from 3-5% of the major markets.

Looking ahead, I think home delivery will be a real problem for weaker retail operators. The well-positioned regional stores should get stronger as less innovative competitors begin to close or consolidate. These proactive chains will stay close to the consumer by delivering localized products and services at competitive prices. They will also move to a multi-channel model that includes some form of Internet home delivery or store pickup.
Are the retailers driving the change toward greater healthy/fresh food options, or is it supply driven?

**Roger:** Actually, it is the consumer who is driving the retailer who is driving suppliers. This is a dramatic shift. The big CPG companies previously developed new products, which retailers then placed on shelves for consumers. Today, with better information and technology at their disposal, the consumer now drives the product development process.

Retailers like Costco, Whole Foods, and Kroger that were early adopters of new technology are now taking advantage of this shift to a consumer-driven marketplace. New pricing, transportation, shelf management, and sales software enable progressive retailers to create more multi-dimensional business models.

I would also underscore the fact that the shift to healthy and natural foods is not a fad; it’s a trend that can grow for a long time. Why? Because, healthcare costs are motivating consumers to be more proactive about managing their own health. Baby boomers and millennials alike are focused on healthy living.

**How do you distinguish between a fad and a trend?**

**Roger:** A fad is created by marketers and producers, regardless of whether it is low carb, low fat, low sodium, low sugar, etc. I believe trends stem from something more authentic. We see this in foods like almond, coconut, chia, flax seed, ancient grains, vegetables, yogurts and other products in their natural state. These types of products have been used for generations across the planet to improve health and wellbeing. There is a solid foundation there.

**Jim:** Healthy, fresh products aren’t just selling in isolated consumer segments. In almost every age group and income class, we are seeing increased awareness and adaptation to healthy foods. From my understanding, Wal-Mart is even increasing shelf space for these healthy products. Healthy food is not a noble belief – it’s smart business.

**How have CPG suppliers responded to the healthy/fresh movement?**

**Jim:** Once CPG suppliers realized this was a movement and not a fad, the first thing many of them did was to simply add organic material and labeling to their existing brands. They thought consumers would migrate. This failed miserably.

We are now seeing the second wave of the CPG response – the acquisition of smaller, independent organic brands. Recently Campbell’s acquired Bolthouse Farms for $1.55 billion, and General Mills acquired Annie’s for more than $800 million. These are significant acquisitions, and it is reasonable to believe that you will see more of them.

The other trend is that CPGs are going to re-formulate their existing products to get rid of chemicals and preservatives. Some day we may see Jell-O with only five ingredients! I don’t know how successful this will be at winning over consumers, but it will happen more and more.
Why did the CPG incumbents miss this shift?

**Jim**: I believe some people in the industry hoped it would be a fad, not a trend. The trend was scary because it meant they would have to make material and costly changes to their businesses. And even if they made those changes, success was not guaranteed.

If these companies had embraced the healthy eating trend earlier, it would have been a “bet the company” type strategy. For example, PepsiCo’s acquisition of Quaker Oats in 2002 was a big gamble and terribly controversial. The purchase came at a huge price tag. I give credit to PepsiCo for having the foresight to make that large a bet. Not everyone had that temerity.

But there has been a change in tone from the management of many CPG companies. Many now acknowledge this trend is not going away. I believe we will soon see every major CPG company embrace healthy/natural foods.

What strategy do you think they will follow?

**Jim**: I believe these companies will begin to allocate more marketing dollars to research and development and create more brands in line with the demands of today’s consumers – more natural, organic brands that are created from scratch. It’s hard for the existing brands that have been around for 60-70 years to re-invent themselves.

I also believe CPG companies need to implement a smarter acquisition strategy that focuses on earlier investment. That may mean buying a company today that can move the needle in 5, 10 or even 15 years. I don’t think buying some of today’s successful brands is necessarily the right strategy, because consumers and retailers can quickly fall out of love with a natural organic brand when a traditional CPG owns it.

As CPGs try to transition to healthier, fresher products, do they risk cannibalizing their own brands?

**Jim**: It’s a huge threat, but that cannibalization is going to take place no matter what. It’s better to have that share loss recaptured within the existing company than to let it go externally. Let’s take yogurt. Chobani created the Greek yogurt segment seemingly overnight. Traditional players had to become fast followers, and frankly, based on the publicly available market share data, they haven’t caught up yet.

**Roger**: CPGs face a dilemma right now because of their branding. Many have bought small specialty/healthy companies to align with this trend, but success has been mixed. For this model to work, I believe the big CPG companies have to let the smaller companies continue to operate autonomously.

Coca-Cola’s acquisition of Honest Tea is one success story. Coca-Cola let Seth Goldman, the previous owner, have control, and they gave him scale. Honest Tea evolved from a northeast regional player to a strong national brand by taking advantage of Coca-Cola’s distribution network. Honest Tea retained control of the brand, the message, the marketing and the ingredients.
What about private label? Is that a strategy for CPG companies?

Roger: Right now, organic private label is coming primarily from organic branded companies. Given that over 90% of U.S. corn, soybeans and sugar beets are non-organic, it is going to take another 3-5 years for the big CPG companies to seriously enter the organic product arena.

Jim: The big three factors driving the industry hold true here: price, convenience, and healthy/fresh. One advantage that CPG companies maintain versus natural and organic products is price, so they cannot just throw that away.

How far down in the market will the healthy/fresh movement go?

Jim: Price is the limiting factor. Lower-income consumers want these products, but they often can’t afford them. Scale is a big component that is bringing cost down, but it's also competition. It's economics 101. We've seen competition drive the cost down for these healthy products everywhere. So on the supply side it’s scale, but it’s also competition from a retail perspective.

Roger: Competition is bringing down the cost. The best example is Sprouts – a price-oriented, organic-natural food store. Their prices are significantly lower than most competitors. Look at their growth. From a base of 50 stores in the southwest in 2011, they are now a semi-national chain with 200+ locations reaching to Atlanta, GA. If you dropped another 300 Sprouts into the market today, they would absorb a significant portion of the traditional grocery store market, in large part because they cannibalize the weaker retail formats.

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