



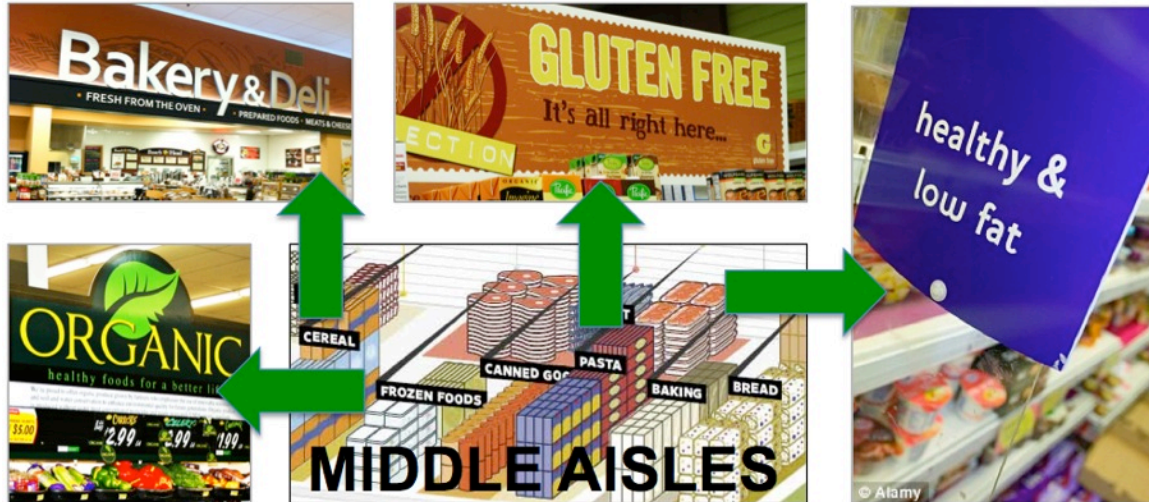
THE MIDDLE-AISLES EXODUS

US SHOPPERS FLEE TO HEALTHIER, MORE NATURAL FOODS

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- While the changes shouldn't be overstated—they are incremental, not revolutionary—and we should avoid viewing consumer shifts through a "big-city prism," the breadth of retailers lining up to observe these moves underlines that this is a very real trend.
- We expect these trends to continue to trickle down to mass-market consumers, and economic recovery is likely to strengthen them.
- As a consequence, we expect to see acquisitions among big brand owners who have long been dependent on middle-aisle categories as they seek to tap growth elsewhere, such as in gluten-free foods.
- And we expect retailers across the spectrum to continue to ramp up choice and offer innovations that serve this demand.

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From Campbell’s Soup and Kellogg’s Corn Flakes to Kraft Macaroni & Cheese and Mondelez Oreos, processed, ambient food brands have long been the cornerstone of US food retailing. These names are synonymous with American grocery, and they’re among the most successfully internationalized food brands.

But packaged, processed food products are now under threat as consumers migrate away from the middle aisles that showcase these foods toward fresher offerings that are typically found at the front and peripheries of grocery stores. A wealth of evidence suggests that US shoppers are switching to fresher, healthier, more natural and more niche offerings such as “free from” ranges of gluten-free or dairy-free products—all products that in this report we’ll categorize as whole foods.

What Are Retailers Seeing and What Are Consumers Doing?

We’ll turn later to what the biggest grocery retailers are reporting. First, though, let’s look at some top-line findings from two recent surveys of retailers and consumers.

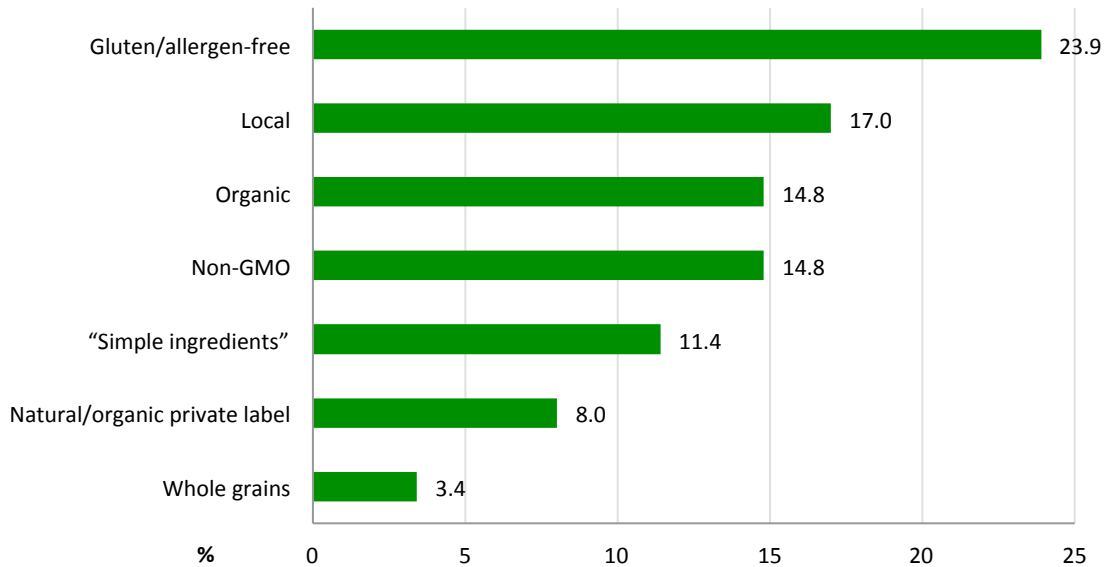
What Are Retailers Seeing?

New research on retailers and manufacturers confirms the ongoing consumer shift toward whole foods. Fully 79% of companies had seen an increase in sales of health and wellness–related categories over the last 12 months, according to the 2015 *Whole Health Survey* from *Supermarket News*. Just 4% said that sales in these categories had fallen in the past year.

The bad news for big food manufacturers is that this looks to be about shoppers turning away from products that are processed. It isn’t about “diet” products, such as low-fat versions of regular brands; nor is it about enriched products, such as breakfast cereals with added vitamins. It’s about shoppers looking for foods they perceive to be more natural, more wholesome or less processed. Results from the *Whole Health Survey* support this idea: retailers and wholesalers surveyed indicated that “gluten-free,” “local,” “organic” and “non-GMO” were the four wellness-related claims showing the strongest growth.



Figure 1. Strongest Wellness Trends Reported by Retailers/Wholesalers in 2014/2015



Base: 88 retailer/wholesaler respondents as of January 2015

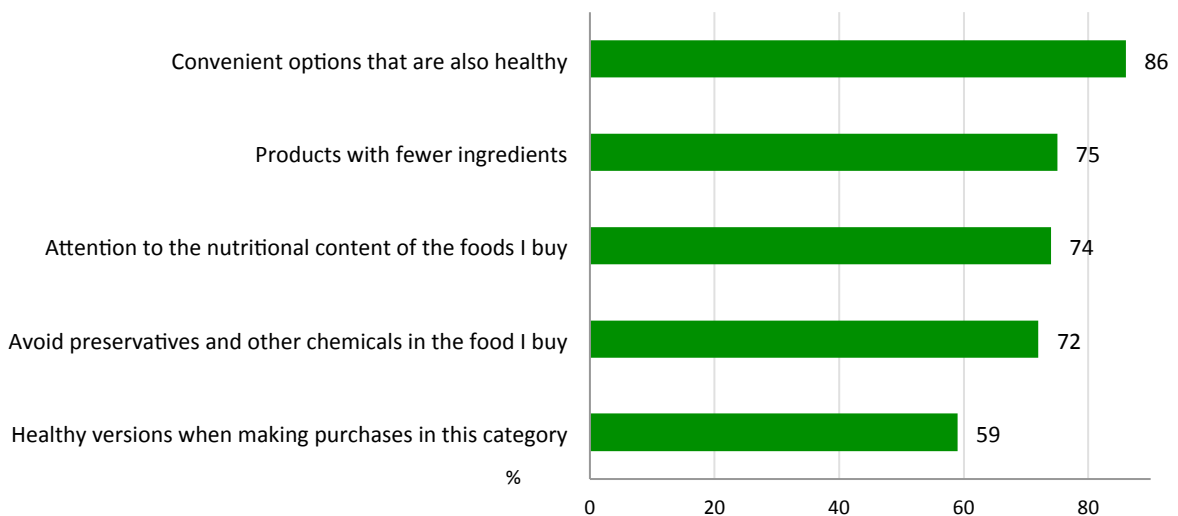
Source: Supermarket News Whole Health Survey

What Are Consumers Doing?

Mass-market consumer look to be driving these changes, with a large majority of American shoppers wanting healthier options.

According to Deloitte’s 2015 *American Pantry Study*, nearly nine in 10 surveyed wanting to balance convenience with health. The survey provides further evidence that large numbers of consumers are migrating to more natural options: it found that around three-quarters of respondents are looking for options with fewer ingredients and no preservatives or other chemicals.

Figure 2. Top Consumer Preferences When Shopping for Healthier Options



Base: 4,013 US consumers as of January 2015

Source: Deloitte 2015 American Pantry Study

This aversion to added ingredients is underpinned in part by increased sensitivity, or perceived sensitivity, towards product ingredients. Deloitte’s study found fully 35% of Americans described themselves as “ingredient sensitive” in 2015.

What’s Out, What’s In

Deloitte’s survey confirms that grocery shoppers are increasingly looking for products with as few added ingredients as possible. This explains why the most popular attributes associated with healthy products all focus on the *absence* of processed and unhealthy ingredients. Indeed, the survey indicated that descriptions such as “vitamin-enriched” and “contains functional ingredients” are much less popular than the high-ranking attributes shown below:

Six Highest-Ranking Attributes Consumers Associate With Healthy Products	
NO OR FEW PRESERVATIVES	NO HIGH-FRUCTOSE CORN SYRUP
LOW SODIUM	NO OR FEW ARTIFICIAL COLORS AND INGREDIENTS
NATURAL	UNPROCESSED/FARM-FRESH

*Base: 4,013 US consumers as of January 2015
Source: Deloitte 2015 American Pantry Study*

As a result of these trends, we expect to see the following types of products falling in and out of favor among US shoppers:

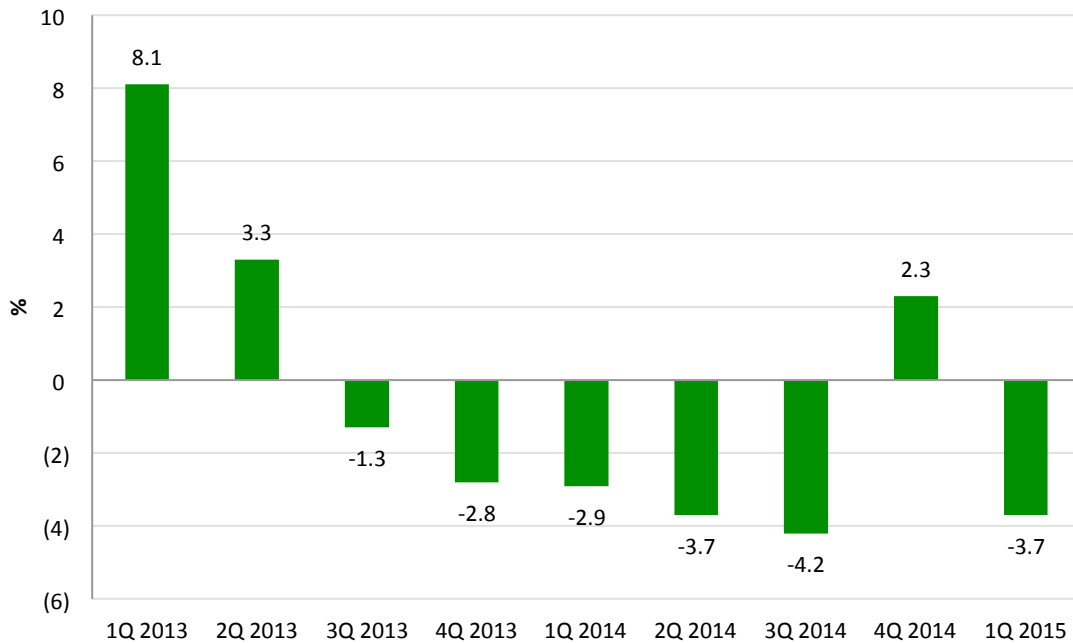
In	Out
100% fruit and nut bars	High-sugar cereal bars
Deli meats and cheeses	Dried mac and cheese
Gluten-free bakery	Sugary breakfast cereals
Paleo-themed products	“Diet”-branded products

Source: FBIC Global Retail & Technology

Overall, however, shoppers will continue to demand convenient products, so there will be scope for new product development utilizing more natural ingredients.

Reflecting the malaise in the middle aisles of America’s grocery stores is the performance of the Kellogg Company. In recent quarters, North American sales growth at Kellogg’s has been negative and trending downward.

Figure 3. Kellogg Company North America: Reported Net Sales Growth



Source: Kellogg Company

What Retailers Are Reporting

Quarter after quarter, the big grocery retailers are noting shifts in consumer preferences.

Target is among those ramping up its natural, local, organic and “clean” product offering. The company noted rapid growth of more natural options in its fourth-quarter 2014 conference call, saying, “While overall sales in the natural and organic industry are growing rapidly, sales of these categories at Target are growing even faster, outpacing the industry by 50% in 2014.”

In its first-quarter earnings call, Target noted that 98% of its shoppers purchase natural or organic products, and said, “We need to make sure we offer them the products and the selection they’re looking for. It doesn’t mean that conventional products don’t play a very important role going forward, but our guest has voted.” The company had earlier noted that it will bolster its assortment in yogurt, healthy snacks and perishables.

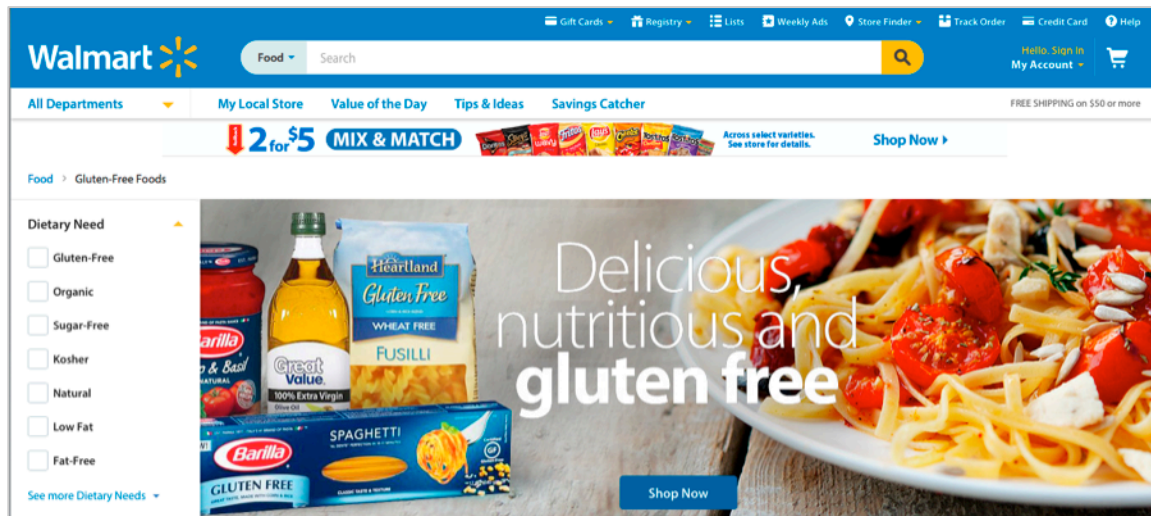
Kroger is already among the winners of this trend. Its **Simple Truth** whole foods and organics brand hit \$1.2 billion in sales in 2014, and the company claims that more than 20 million US households shopped the range during the year. Simple Truth is posting double-digit growth in value and unit-volume terms, the company said in its fourth-quarter 2014 conference call. Meanwhile, Kroger reported at the end of the first quarter of 2015 that its broader natural foods department is seeing “outstanding, double-digit identical sales growth.”



Kroger’s offering has been boosted by its 2014 integration of Vitacost, an online retailer of vitamins and healthy-living products that it acquired in 2013. Emphasizing that it already has a strong natural foods business, Kroger said that “Vitacost is helping us get better in that category.”

Walmart, too, is investing in fresh foods, with a particular focus on supply-chain improvements to bring fresher produce into its stores. In 2015, for instance, the company opened a new sorting center in LA, allowing for quicker distribution and providing space to ripen produce after purchase. In its first-quarter 2015 results, Walmart US CEO Greg Foran said, “Getting fresh right is critical to the customer experience.”

Walmart isn’t focusing on produce exclusively, though; it’s also putting delis and bakeries in all future Neighborhood Market stores. Neighborhood Markets are smaller, food-focused stores, and Foran told the media that they will feature these departments “because we absolutely believe that is important for the future.”



Whole Foods Market is the most obvious retailer to gain from surging demand for fresher, more natural options. At the end of the first quarter of 2015, Co-CEO Walter Robb noted that “[t]he demand for fresh, healthy foods continues to surge, and we are best positioned to benefit as the leading retailer of natural and organic foods.”

Subsequently, Whole Foods Market announced that in 2016, it will launch a new, lower-price, more-limited-line chain aimed at younger shoppers: 365 by Whole Foods Market. As Whole Foods sees more mass-market grocers (such as Kroger) encroach further on its territory, we think a lower-cost fascia with more mainstream appeal looks like a wise move.

Finally, a note on two retailers that aren’t currently in the market:

British grocer **Tesco** launched in the US in 2007 with **Fresh & Easy**, a chain of smaller-format stores focused on private-label fresh and chilled foods. After struggling with losses for a number of years, Tesco finally sold the chain of around 150 stores to investment firm Yucaipa Companies in September 2013 (the sale was completed two months later). After the acquisition, Yucaipa Companies pushed more heavily into lower-cost organic lines and emphasized freshness and natural ingredients.

Fresh & Easy continues to operate, and the store format and product focus it pioneered now look like a good fit with consumer demand for smaller stores and more natural food. Unfortunately, this shift came too late for Tesco.

Looking ahead, **Lidl**, the German hard discounter, is planning to launch in the US, possibly as soon as 2016, according to media reports. Elsewhere in the world, Lidl has shown that it’s willing to tailor its offering to regional markets, including by offering premium own-brand ranges and boosting its fresh foods offering. Moreover, in its home market of Germany, the retailer already has well-established organic ranges.

So, we expect Lidl to push hard on fresh and natural foods when it launches in the US. And we think its smaller-store format, coupled with a strong fresh and natural offering, could win it a great deal of loyalty among shoppers.

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What Can We Expect Next?

There are opportunities for brand owners and retailers to ride this wave—but, particularly in the case of brands, we think it needs to be done convincingly.

From Brand Owners: Improving Legacy Brands and Buying New Ones

We’ve already seen some brands respond to consumer demands by reformulating products to make them more natural. In 2015, Kraft, for instance, began removing artificial colors from its Macaroni & Cheese product, while Hershey’s announced the removal of artificial colors and GMOs from its candies.

Although some consumers may welcome these moves, we’re skeptical that these kinds of reformulations are compelling enough to help the brands gain share among consumers demanding whole foods. Similarly, we think brand extensions and new product launches into fresh and natural categories by big, processed-food makers could fail to convince shoppers of their authenticity.

We think acquisitions offer the best opportunities for the food giants to serve demand for whole foods. Some are already hunting suitable brands: General Mills, for example, bought Annie’s, a natural and organic processed-foods company, in 2014. The *Supermarket News Whole Health Survey* supports our perception; it said that 71% of those surveyed expect mergers and acquisitions in the natural/organics space to increase over the next year. And gluten-free items and organics look to be ripe for brand acquisitions and consolidation, as retailers’ private labels have often been the drivers of innovation and product extensions.



From Retailers, in-Store Innovations and Greater Choice

From retailers, we expect an ongoing extension of product ranges in fresh produce, organics, “free from” and fresh categories such as dairy and bakery. All the evidence suggests we’ll see this across the spectrum, from hard discounters (such as Aldi) to mass merchandisers (Walmart) to midmarket chains (Kroger) to premium names (Whole Foods).

We also think there’s opportunity for innovation from retailers:

- Over in the UK, Lidl and Tesco have moved to offer “healthy checkouts,” stripping out candies and chocolates in favor of dried fruit, nuts, cereal bars, water and fruit juices. We think US retailers could run with this idea, further serving demand for whole foods at the front of stores.
- Rebranding and repackaging can serve to bundle existing products as part of a whole foods range and can drive consumer awareness. Kroger’s successful Simple Truth range, for example, includes some conventional products, such as nonorganic granolas, alongside its natural and organic products.
- We expect to see whole foods become more prominent in convenience stores. Fresh and more natural options are likely to blossom among the coffee and donuts traditionally featured in small, local stores. And as they push into small-store formats, big chains such as Walmart are likely to lead the way.

Key Takeaways: FBIC's View

- There’s a wealth of evidence that US shoppers are migrating from ambient, packaged, processed foods to fresher, more natural and organic foods and niche ranges such as “free from”.
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