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Obesity - Reshaping the Global Food Industry

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Key Points

- Obesity is a major issue for our modern societies and has become a serious concern for the food industry
- 'Healthy' food is the key driver of sales growth in the F&B sector and offers significant pricing power and margin opportunity
- Foods misaligned with latest diet trends are declining but consumers seem unwilling to sacrifice treats and convenience
- Food companies' portfolio transformation implies an increase in R&D spending and suggests an acceleration of industry consolidation
- Potential new regulation could affect key growth levers but should create an even playing field
- Obesity creates risks and opportunities for the equity of food brands
- Litigation risks seem low but food manufacturers will have to step-up R&D efforts and explain more and promise less

Obesity: A global health issue and a serious concern for the food industry

The global obesity epidemic

- Globally 1 billion people are overweight and >300 million obese. c15% of kids are affected
- US - 2003: 34% are overweight, 31% obese vs. 1970: 32% overweight, 15% obese
- +200 million people across Western and Eastern Europe are affected by obesity

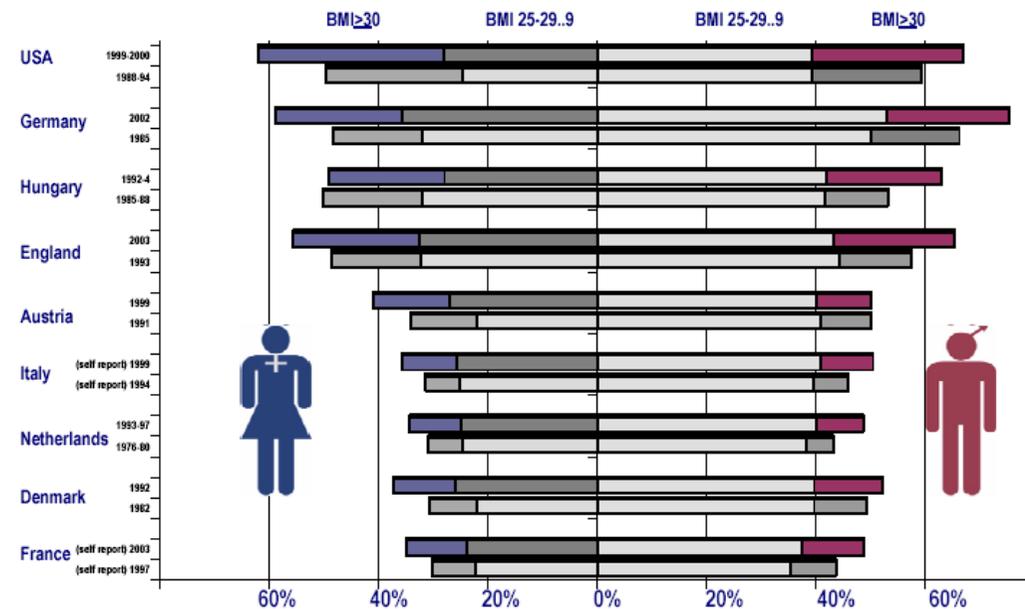
Huge human and financial cost

- Human cost: 300,000 deaths in the US a year. Associated with 78,000 cancers a year in Europe.
- Healthcare costs: \$117 billion in 2000 in the US. €70-130bn in Europe.
- Direct costs relate to type 2 diabetes, heart disease, high blood pressure brought on by obesity

Call for action

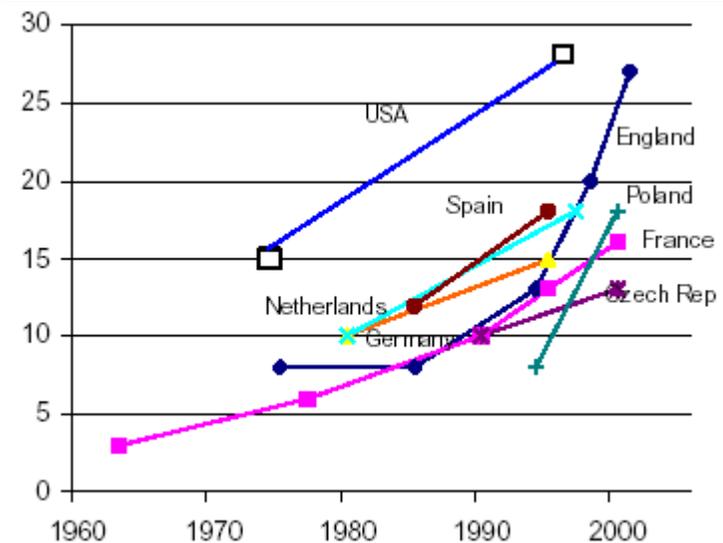
- Growing pressure from international health organization on governments to take action
- The food industry is an easy target

Fig. 1: Changes in prevalence of overweight and obesity in selected countries



Source: IOTF.

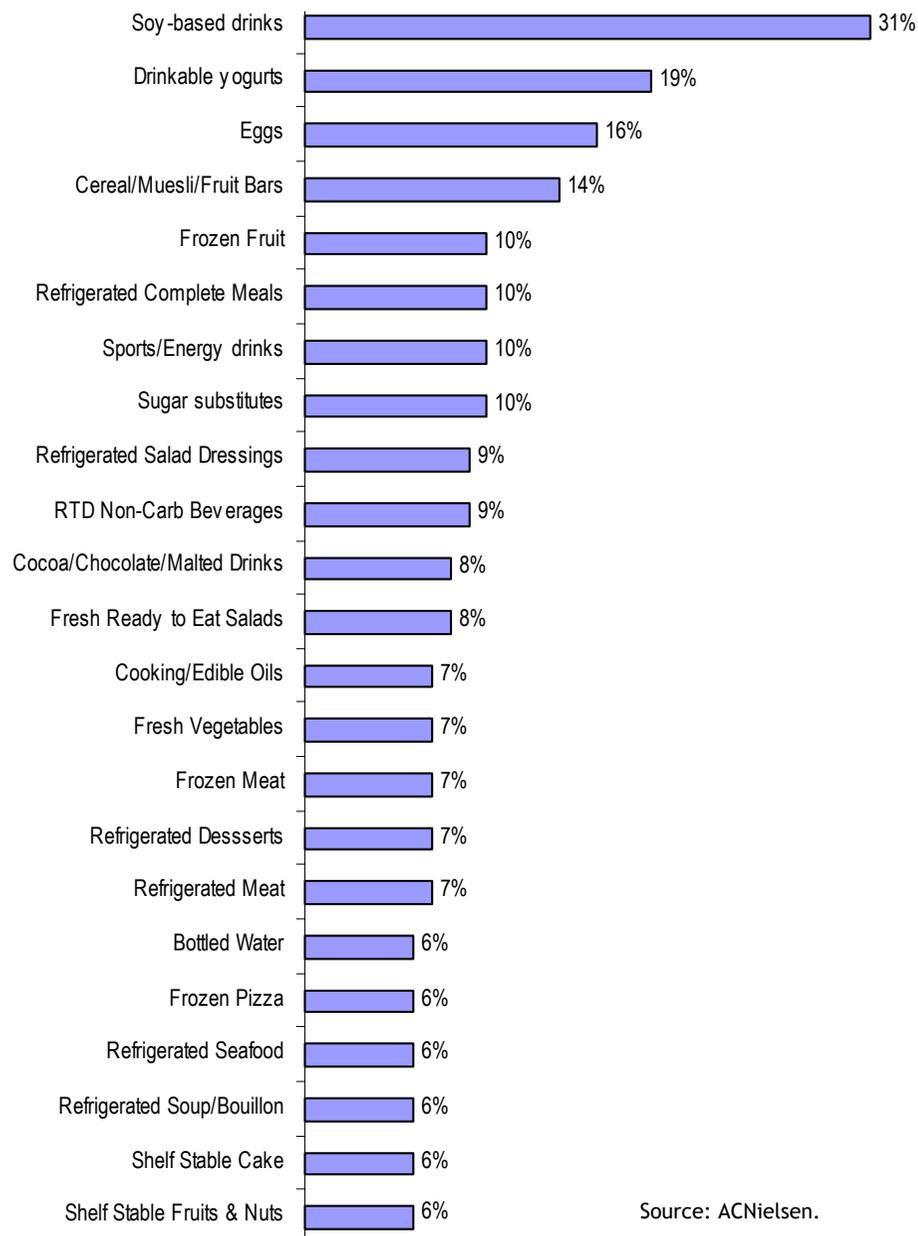
Fig. 2: Rising prevalence of Overweight among Children (5-11) - %



Source: IOTF.

“Healthy” Food is the key driver of Sales Growth within the F&B Sector

Fig.3: Fastest Growing F&B Categories Across the World, 03-04



Source: ACNielsen.

- Recent ACNielsen study shows that globally 18 of the 24 fastest growing categories and 6 out of 7 categories growing at double-digit rate are related to consumer perception of health and wellness.

- Three key drivers:

- Healthy diet choices. High protein-Low Carb diets have led egg/meat/fish consumption
- Healthy Staples. Fruits and vegetables categories in different forms (fresh, frozen, shelf-stable) have grown above average. Bottled water is the key beneficiary within soft drinks.
- Healthy Alternatives.
 - Soy-based/yogurts drinks, sports/energy drinks vs. other soft drinks
 - Sugar substitutes vs. sugar
 - Margarine vs. butter

Health positioning creates pricing power and margin opportunity

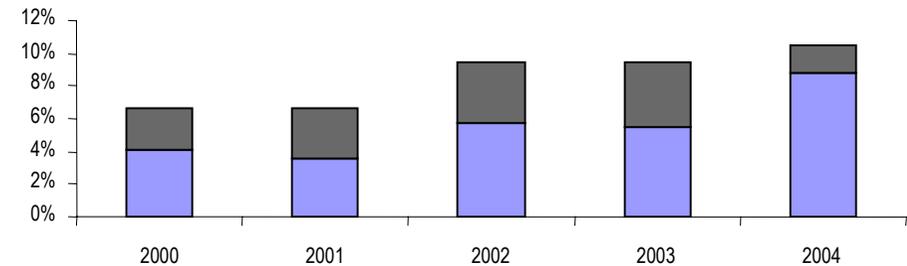
- An illustration of the relationship between health positioning, pricing power and operating margin is provided by Danone Fresh Dairy Products Division
- Health products enjoy a premium pricing...
- ... Allowing food companies to regain pricing power
- Pricing power translates into higher margin

Fig.4: Retail price of selected fresh dairy products

Product	Price per Litre/Kg
Nature (Kg)	1.72
Bio (Kg)	2.62
Danacol (Kg)	4.02
Actimel (l)	4.91

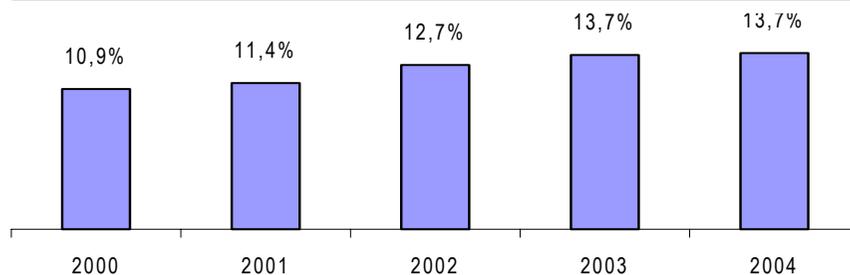
Source: Danone Company Reports

Fig.5: Danone Fresh Dairy Products Division LFL growth (00-04)



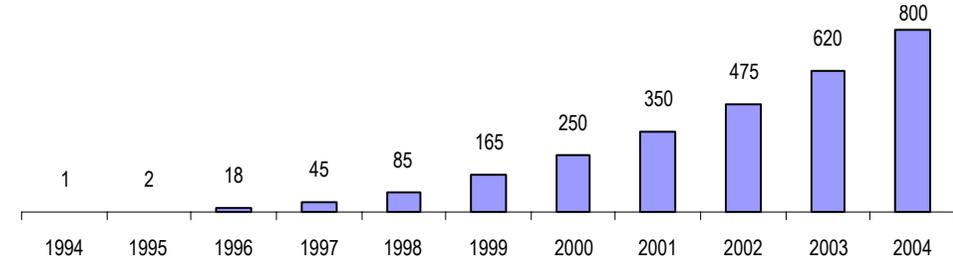
Source: Danone Company Reports

Fig.6: Danone Fresh Dairy Products Division EBIT Margin, 00-04



Source: Danone Company Reports

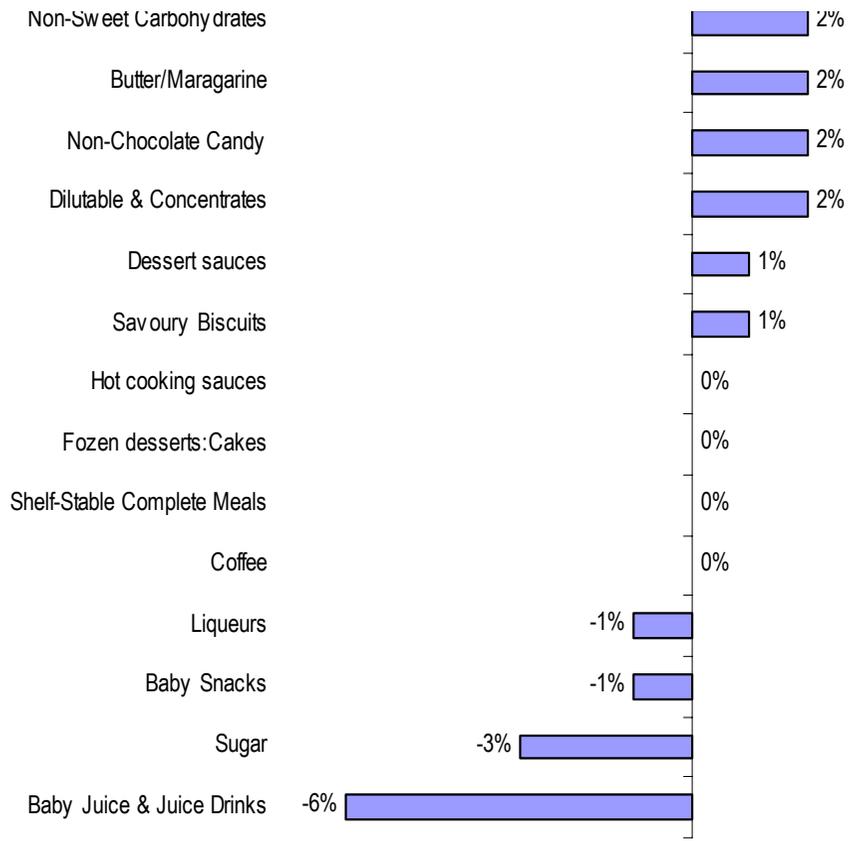
Fig.7: Danone's Actimel Success Story, Sales 94-04 (€m)



Source: Danone Company Reports

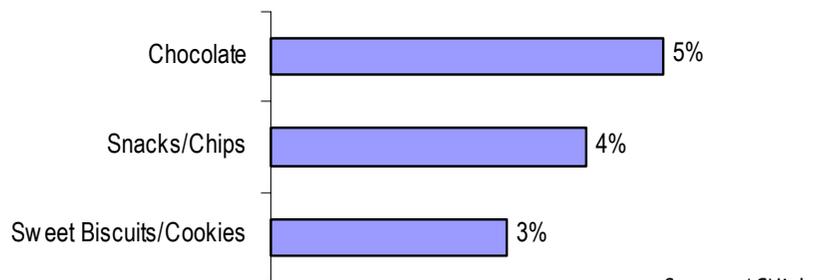
Food misaligned with diet trends is declining but consumers are not ready to sacrifice “Treats” and Convenience

Fig. 8: Lowest growth categories on a global basis



Source: ACNielsen.

Fig. 9:Treats continue to exhibit above average growth



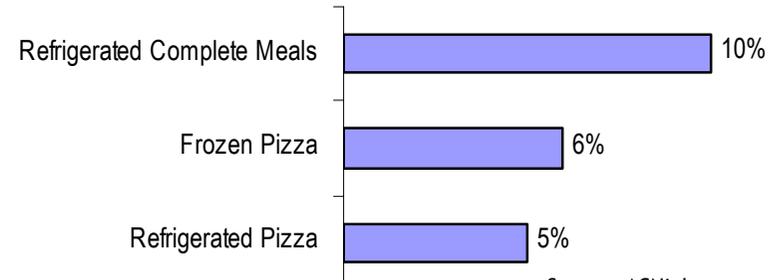
Source: ACNielsen.

- Product categories misaligned with latest diet trends or perceived as not so healthy... or sometimes just badly marketed are exhibiting below average growth rates...

BUT

- Consumers seem unwilling to sacrifice “treats”...
- The need for convenience food predominates

Fig.10: Convenience Foods continue to grow strongly

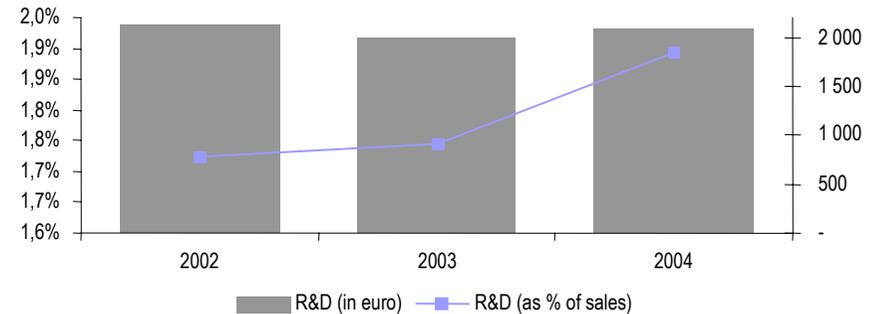


Source: ACNielsen.

R&D should increase and Industry Consolidation should accelerate

- We believe R&D spending will have to increase substantially to:
 - Improve nutrition profile of products while maintaining organoleptic properties. E.g. Nestlé
 - Develop lower calorie but tasty snacks and confectionery
 - Develop nutritious and lower calorie convenience food
 - Deliver products with a better nutritional profile at a reasonable price
 - This will take time and will imply more restructuring and rationalization in the sector
- Transformation from within may be too long for some of the big players and we thus expect M&A to accelerate
 - Successful makers of healthy food products sell for a significant premium

Fig. 11: Largest European Food Producers R&D Budget Growth and as a % Percentage Sales



Source: Company Reports and JPMorgan estimates

Fig. 12: M&A in the Health, Wellness and Specialized Nutrition Area

€ million

Target	Acquirer	Date	Price	Sales	Price/Sales
Slim Fast	Unilever	2000	2300	611	3,8
Power Bar	Nestle	2000	300	150	2,0
Stonyfield	Danone	2001	200	140	1,4
Quaker Oats	PepsiCo	2002	13400	5041	2,7

Source: Company Reports and JPMorgan estimates

Potential new regulation could affect key growth levers but should create an even playing field

- Potential new regulation concerning labelling will result in higher costs for the food industry
 - Direct cost incurred as a result of labelling changes limited to less than 0.5% of sales
 - ☞ Worse case scenario:
 - Brands could be weakened by making the nutrition labels bigger on packaging
 - Certain categories could be destroyed by identifying certain types of products as very significant calorie providers
- Potential new regulation concerning 'nutrition and health claims made on food' will result in higher costs for the food industry but it should create an even playing field
 - Manufacturers who have been unscrupulous in making claims on products with poor nutrient profile will be penalized however genuinely 'healthy' food suppliers should build a real competitive advantage
 - R&D costs will increase in order to support European Food Safety Authority (EFSA) approval
- Potential restriction on advertising to children should result in lower sales growth and diminished brand equity
 - ☞ Worse case scenario: A full ban of food advertising on certain products would result in:
 - Creation of barriers to entry and oligopolistic situations
 - Volume decline but increased pricing power and margin increase
- Potential new regulation/policies on distribution of certain products in schools/hospitals could result in lower sales and profit if manufacturers have no alternative products

Brand Equity - Risks and Opportunities

- Obesity has become a political and social issue; consequently F&B companies are going to be under rising pressure from governments, health organizations, consumer associations and the media to behave as very good corporate citizens
 - Any form of marketing of foods to children, especially energy-dense and nutrient-poor products, should be considered very carefully because this may ultimately damage the brand
 - Brand association with educational programs about the benefits of good nutrition and physical activity should be managed carefully as it may backfire

BUT

- There is an opportunity for brands which genuinely embody 'health' and 'wellness' to build a long-term competitive advantage which should translate into sustainable sales growth and margin expansion. There are two major building blocks, in our view:
 - Continuing product innovation and renovation, implying a true commitment to R&D
 - Honest marketing and information of consumers

Litigation risks seem low but food producers will have to step-up R&D efforts and explain more and promise less

- Litigation risks are much higher in the US than in Europe. However, in the US, legislation that would bar obesity-related lawsuits from being brought against food manufacturers and sellers recently cleared the House Judiciary Committee, paving the way for consideration by the full House.
- In the US, perception of deceptive marketing practices and misrepresentation can be severely punished. Food companies have already been punished for misrepresentation but no lawsuit has ever been brought in the form of class action using the obesity epidemic as a background
 - In 1983 the California Supreme Court gave the green light to a suit brought by an advocacy group against General Foods over the way certain breakfast cereals were being marketed to children. The case settled out of court.
 - In 2002 a class action lawsuit was instigated against McDonald's on the grounds it misrepresented the contents of its French fries. The case settled out of court.
- The actual benefits of products marketed as healthy or making functional claims may be challenged in court and companies will have to demonstrate that their claims are substantiated
- We believe companies may be forced to explain more and promise less: manufacturers will have to spend more on educating consumers and make good on their social responsibility

Conclusion - What's the winning strategy?

- The obesity 'epidemic' is a 'new' challenge for the food industry. The food manufacturers must embrace change and not to try to fight an overwhelming structural trend.
- Real product innovation and renovation supported by R&D should play an increasingly important role in differentiating companies from one another. Key challenges for research are:
 - To combine health with taste
 - To develop healthier snacks
 - To ensure convenience food remains a healthy alternative
 - To make sure healthy food is affordable
- Existing communication practices are likely to be challenged. New regulation should create an even playing field allowing producers of genuinely healthy food to create stronger brands.
- M&A opportunities should be explored for those with disadvantaged portfolios

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