

CAGNY 2018: An Industry in Search of Growth

Key Message and Investment Thoughts

2017 was a difficult year for many consumer-packaged goods (“CPG”) companies due to decelerating sales growth trends. The industry has been dealing with several challenging dynamics including changes in sales channels, competitive pressure from smaller brands and private label, and rapidly changing consumer preferences. However, we believe the main reason for this soft top line environment in 2017 has been the industry’s ongoing focus on improving profitability over the past few years. This has led many CPG companies to underinvest in brands, which has paved the way for smaller challenger brands to gain share with innovative offerings.

In February we attended the 2018 CAGNY conference in the US. We listened to presentations from over 30 CPG companies during the four-day conference. Discussions around future industry consolidation, channel disruption from e-commerce and the continued shift of consumer preferences to healthier products were ubiquitous. However, the most meaningful insight was that industry leaders are again prioritizing top line growth, following recent years where margin improvements guided many corporate strategies. To us, this change in attitude indicates that the coming years are likely to be a period where margin improvements are not as easily achieved as in the past. In our view, much of the low hanging fruit, or easy to cut “corporate fat” in the CPG industry has been eliminated following a period of intense shareholder activism. Moreover, we believe that many companies looking to grow their top line sales, will be forced to increase their spending on innovation and A&P, or chose to acquire faster growing brands. While the success of such endeavors remains to be seen, we believe that the current market environment is an opportunity for long-term shareholders to cherry pick the best CPG businesses while market sentiment remains tepid.

We find there are two viable strategies to invest in the consumer staples sector in this environment. These are 1) investing in potential target companies in anticipation of further industry consolidation, or 2) investing in companies that have proven they can consistently grow their top line organically despite some of the headwinds that the industry is facing. As long-term investors, we believe the latter is the better approach. Our 2Xideas Library includes various businesses with a history of delivering strong organic sales growth such as: McCormick (US MKC), Colgate-Palmolive (US CL)

and Brown-Forman (US BF.B). We believe that these businesses will continue to grow organically, as well as benefit from strong competitive advantages. We had the opportunity to attend the presentations of McCormick and Colgate-Palmolive at the conference. On page 3 we summarize the key highlights.

During the conference we observed several reoccurring themes. Below we review a few of the most discussed topics amongst executives and investors.

E-commerce on the Horizon

A pressing question for many investors is how e-commerce will continue to change the landscape for food, beverage and household goods companies. While many consumer industries are going through profound transformations in the new digital world, the CPG sector has remained relatively insulated. To a degree this is quite logical given the perishable nature of many products, which makes them less suited for e-commerce, given the added logistic complexity and cost. Nonetheless, we came away from CAGNY with a sense that executives are quite acutely anticipating this to change over the coming years, in stark contrast to our conference impressions just a few years ago. While consumers in countries such as China and the UK are early movers and have embraced the e-commerce channel more quickly, many European countries, the US and developing countries are more nascent. In the US the issue has been amplified with Amazon’s recent acquisition of Whole Foods and Wal-Mart’s aggressive move into e-commerce. So how are CPG companies addressing the changing landscape? Executives highlighted that in order to be successful in this environment they must: 1) develop strong omni-channel capabilities, 2) engage in targeted online advertising, and 3) develop a supply chain capable of supporting an e-commerce channel. Many companies highlighted their efforts to develop channel agnostic business models, with the ability to serve the bricks and mortar and online channels, as well as combinations of both, such as click and collect. This has led companies to make adjustments to their supply chains, in order to create more end of line flexibility, as well as develop innovative packaging. Another key topic was the importance of online advertising, where executives highlighted the need for more local and targeted advertising. One of the key challenges from the shift into online advertising is the need for more content. Online advertising, especially video

advertising requires more content creation than many companies have been used to in traditional TV and print advertising.

Generally, we found most companies have well-formed strategies in anticipation of consumers shifting more purchases to online channels. However, one crucial question remains unanswered: “Will the e-commerce channel have a deflationary impact on the CPG industry?” The answer has been a resounding “yes” in many other consumer sectors such as apparel or consumer electronics. The CPG category could very well be facing deflationary pressures in the future as well. We, however, believe these will be product category and brand specific. In our view, strong brands that operate in a rational competitive environment, as well as perishable products will be the least affected by a deflationary impact from e-commerce.

Health & Wellness Remains Top of Mind

Danone’s CEO, Emmanuel Faber, pointed out that millennials today account for only one third of total food consumption, but for about half of total organic food consumption. To us, this illustrates why the food industry continues to focus on creating healthier product portfolios, as millennials increasingly become the main driver of consumer spending across the world. Increasing demand for healthy, natural and clean products has been a topic we have been hearing about for the past 5+ years and there was no sign of this trend slowing down in 2018. CPG companies across the board continue to ramp up their healthy offerings, either by launching new products, introducing clean ingredient labeling or through acquisitions, such as Hershey’s acquisition of Amplify Snack Brands in 2017. We believe the continued emphasis on health and wellness can be an attractive way to achieve higher growth and align with millennials’ consumption habits. However, we were a bit concerned that seemingly all companies are swimming in the same direction. In competitive categories with several incumbents, this could lead to accelerated spending on advertising and promotion, a risk to margins. We see risk especially in the snacking category, where consumers are opting for healthier options like granola bars over less healthy snacks such as candy or chocolate. Executives at PepsiCo.’s Frito Lay division, Hershey, Kellogg and General Mills all emphasized their strategic ambitions in the snacking category, which we believe creates some risk to the competitive dynamics.

Industry Consolidation

Portfolio optimization was a big theme among companies as many are reviewing underperforming brands and product categories. Executives seemed quite open to the possibility of divestitures, bolt-on acquisitions, and in some cases, transformative deals. Following what we learned at CAGNY, we believe the likelihood for transformative deals remains highest for companies that are not able to drive meaningful top line growth. These companies are likely to resort to acquisitions in striving to create shareholder value. While margin improvements have been the modus operandi over the past years, it is becoming increasingly difficult to expand margins without the support of top line growth, especially as most companies have already implemented some form of zero based budgeting. We sense that the investment community is fully expecting further deal-making in 2018 and beyond. However, we are skeptical of the long-term value creation of acquisition-led strategies, rather we prefer CPG companies that are able to grow organically on a standalone basis, and only selectively enhance their portfolio through acquisitions.

Corporate Cultures Under Review

An often discussed topic among companies was the need to create more agile and innovative corporate cultures. Many executives have identified that their corporate structures have become unable to adapt to rapidly changing consumer tastes and preferences. This has allowed many smaller challenger brands to win market share. These businesses have benefited from new sales and advertising platforms online, high-quality contract manufacturing and the ability for small start-ups to attract talented employees. This trend has been especially pronounced in the household goods and beverage categories, affecting companies like Proctor & Gamble, Johnson & Johnson Consumer and Coca-Cola. To paraphrase Johnson & Johnson’s Jorge Mesquita: “So what we’re seeing is a digital disruption, which is changing the face of our industry. And this is lowering the barriers for entry and paving the way for a new breed of start-up competition. And these small companies we see around the world are the ones that consistently win market share”. In order to combat these new entrants, many CPG executives highlighted the need to create more innovative and entrepreneurial corporate cultures. James Quincey, CEO of Coca Cola discussed the topic at length and advocated that his Company’s corporate culture must become much more agile, performance-driven and accountable. Mr. Quincey offered investors an example of how

the internal mindset is changing. Historically, Coca-Cola would use similar go-to market strategies for dominant brands such as Coca-Cola, as well as for new launches. However, this has now changed and the Company has implemented a much more agile approach focused on testing and adjusting their strategy based on market feedback.

2Xideas Library - Company Highlights

Among our library companies, we had the opportunity of attending the presentations of McCormick and Colgate-Palmolive at the conference.

McCormick

McCormick gave a very confident and compelling presentation at CAGNY. CEO Lawrence Kurzius and CFO Mike Smith emphasized that McCormick has consistently outperformed its peers on an organic sales growth basis. In management's opinion, the Company's strong top line growth has been a result of favorable category tailwinds and continued advertising and promotional investments behind its brands. A key differentiator, at a time when many CPG peers have pulled back on support in order to drive margins higher. McCormick's portfolio of spices and seasonings continues to benefit from tailwinds from consumers eating healthier and cooking more at home. McCormick remains committed to investing in its brands to drive top line growth. To this end, the Company will be introducing new packaging in 2018 that includes QR codes that can be read through mobile apps. This will enable consumers to receive product information as well as recipe ideas direct from the package. In addition, McCormick also shed some light on its aggressive e-commerce initiatives. The Company increased e-commerce sales by 67% in 2017, doubled their dedicated sales team headcount, tripled the amount of digital advertising content it created and launched a store front on Alibaba's Tmall in China.

Management provided more detail around the RB Foods acquisition and how it plans to achieve sales synergies. Most importantly, in the second and third quarter this year, McCormick will launch new products for the Frank's RedHot brand. McCormick will introduce a line of seasonings and recipe mixes, as well as new hot sauce flavors, an example of how McCormick can leverage its core competencies in spices to create new sales opportunities for RB Foods. Furthermore, Frank's will be rolled out in the food service channel internationally, with a first priority on the UK and China. We also learned Frank's customer base in US food service is 30%

larger than McCormick's, which gives it the opportunity to sell the McCormick portfolio to a new customer base. For French's mustard, the Company will be rolling out a large summer promotion featuring the Company's entire line of grilling products such as marinades, spices and French's mustard in a large out of aisle promotion. In addition, French's will be introducing two new lines in the second quarter: Dijon and Honey Mustard. Lastly, McCormick will be introducing the Frank's and French's brands under its „McCormick for Chef's“ platform. Overall, we came away with the impression that management was eager and confident in the incremental sales opportunities from the RB Foods acquisition. We believe these initiatives could accelerate organic growth above the historic mid-single digit range, with expectations for high single-digit growth for the Frank's product range and low single-digit for the French's brand

In addition, McCormick confirmed both its 2018 and long-term financial targets. The Company continues to expect top line growth of 4-6%, operating profit growth of 7-9% and EPS growth of 9-11%. Interestingly, management gave some insight into the long-term potential for Industrial operating margins in the breakout session. CEO Kurzius elaborated that he believed that operating margins over time could be closer to its peers by way of a favorable mix effect and further cost improvements. McCormick's operating margins in the Industrial segment are around 12% compared to peers like Givaudan or IFF in the mid- to high-teens.

We came away with increased confidence that McCormick is a best in class CPG company with the ability to drive solid organic growth going forward. The Company benefits from a set of strong competitive advantages and in our view, will be able to thrive even in a difficult macro-economic environment.

Colgate-Palmolive

Chairman and CEO Ian Cook presented at CAGNY. He started off by acknowledging the difficult trading conditions the Company had experienced during 2017, resulting in weak top line growth (+1%, compared to c+5% p.a. over the previous 15 years). However, he gave an optimistic view on 2018 trends to date. The Company expects to achieve positive pricing in 2018, supported by expectations for higher inflation. During his presentation Mr. Cook discussed the Company's medium-term priorities. He focused primarily on organic growth, margin potential and returning cash to shareholders. However, we want to focus on the Company's

strategy to drive top line growth, as this seems to be the biggest industry challenge at the moment. This is a key initiative in emerging markets where educating consumers on oral care is a crucial factor to increase toothpaste usage. In terms of innovation, Colgate has introduced a variety of herbal infused toothpastes in India, as well as focused on refined lines of whitening products in North America and Europe. In packaging, the Company has created new solutions for the e-commerce channel. An example is in China, where Colgate allows customers to create customized messages on packaging when buying online, a great way to create customer engagement.

We remain confident in Colgate's long-term opportunity to drive organic sales growth. To paraphrase Mr. Cook „about 68% of the population brushes their teeth less than once per day“. To us this represents Colgate's single largest opportunity to generate additional sales growth over the coming decade. Much of this population lives in less developed countries, where toothpaste consumption will increase as standards of living improve. Colgate reiterated its plan to achieve 3-5% organic growth p.a. The Company's strategy is to focus on its strengths, such as engaging and connecting with consumers, as well as innovating. Colgate currently spend 25% of its working media¹ budget in digital, with the bulk going into search optimization and targeted advertising. Furthermore, Colgate has created an online engagement platform where customers can ask professionals about oral care related issues.

In conclusion, we still believe Colgate's long-term business opportunity is compelling and the Company's status as a world class marketer remains untouched. While we will closely monitor the CPG environment during these disruptive times, we believe that Colgate is well equipped to weather the „new digitalized“ world. As a side note, investor interest for Colgate was very high at CAGNY with the breakout session being one of the most well attended at the conference.

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¹ Working media is defined as spending which is directly related to driving impressions, and excludes back-end costs such as content production or analytics.