Disruption: European Consumer Goods Makers Respond By Buying And Selling Brands

May 1, 2018

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As online and hard discount retailers continue to make headway with European consumers, product differentiation, pricing, and improved distribution are the keys to growth for consumer goods manufacturers.

Most large makers of fast-moving consumer goods (FMCG), including food, beverages, and personal and household care items are currently suffering from lackluster organic growth, albeit with differences among portfolios and countries. The biggest risk for the borrowers we rate in the sector is that their core consumers are abandoning weekly visits to large supermarkets in favor of periodic delivery of long-life (or shelf-stable) goods, supplemented with shopping for fresh and chilled products locally. To mitigate this risk, manufacturers must consider which products will best suit this shift in buying behavior, which retail platforms they will need to back, and how they will adjust their own distribution systems. This runs in tandem with the continuing and entrenched evolution of discount retail, which in Europe has moved into the mainstream and is now successfully branching out into higher-quality and fresh-produce offerings.

Key Takeaways

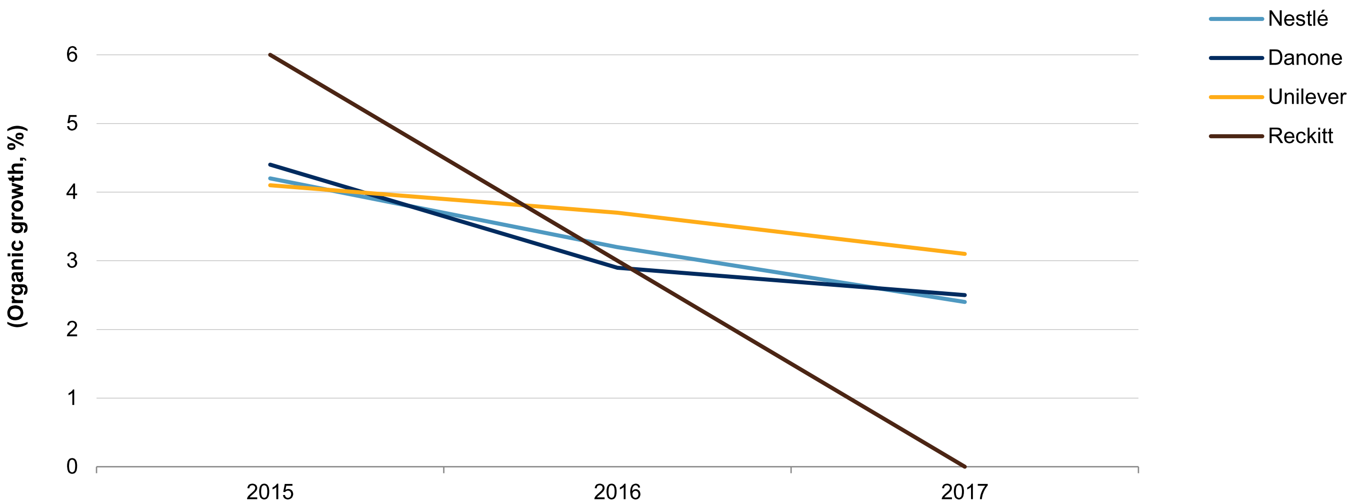
- In the short term, manufacturers may be able to survive by spinning off less profitable divisions and focusing on the higher growth products.
- Companies are also looking to realign their cost structures; multinational spin-offs, for example, are looking to procure raw materials more directly to their product range so they can benefit from cheaper spot pricing.
- We are expecting to see global brands take a more "add-on" approach rather than huge transformative acquisitions.

Seeking Short-Term Refuge In Product Reshuffling

Refining product portfolios has traditionally been manufacturers' first response to disruption, largely because this is within their control. Weak consumer confidence in the past five years in Europe has already pushed manufacturers to focus much more closely on "price cliffs"--that is, the level at which consumers might switch to a cheaper product or substitute. In many segments of the grocery market, such price points have put a stop to growth that couldn't be overcome by new product development (see chart 1). As a result, multinational groups such as Unilever (A+/Stable/A-1) and Nestle (AA-/Stable/A-1+) have spun off some of their slower-expanding divisions, in segments such as spreads, ice cream, and confectionery. The objective for manufacturers now is to ensure that they market global brands via global channels and local brands via local channels so they don't lose out to products that are perceived as better value locally, or to products of lower quality amid intense competition globally.

Chart 1

Organic Revenue Growth For Selected FMCG Multinationals, 2015-2017



FMCG--Fast-moving consumer goods.

In a bid to restore growth, many newly independent businesses are re-engineering their cost structures to offer a broader range of price points. They also continue to invest in product improvement and innovation at the higher end. Management teams of businesses that have been spun off from the multinationals are trying to align procurement more directly to their product range, such that they can benefit from cheaper spot pricing and from buying raw materials to the exact (and simpler) specifications of their product portfolio. These businesses are also seeking to improve fixed-cost recovery by manufacturing private label products, a move that was often unacceptable under the strategies of large, brand-focused multinationals.

Those brands and businesses that remain in a multinational's stable will need to fit in with owners' strategic strengths--that is, expanding internationally--as well as enjoying scale and brand appeal to reach consumers through a variety of retail channels. A broad range of price points offered across a portfolio of separately presented brands in personal care should continue to serve their owners well. The same can be said of snacks with strong name-differentiation, pet food, and specialist nutrition products (for example, infant and medical). Multinationals in Europe, the Middle East, and Africa (EMEA) will continue directing product and marketing investments into building up and maintaining market shares in these categories. For example, Danone (BBB+/Stable/A-2) enjoys a market share in infant milk formula of more than 20% in seven out of its nine largest markets, according to data from Euromonitor. For Nestle, it's five out of nine.

Product differentiation works well, but is set to get tougher in tea and coffee. The dominance of Nestle's Nespresso in the fast-growing "coffee capsule" segment is challenged by Jacobs Douwe

Egberts, which has an eye toward taking the disposable, single-serving packets to the mass market through grocery retail. That said, innovation and higher incomes have fueled growth in brewed-coffee volumes, to 172 billion liters in 2016, from 130 billion in 2004. This market is forecast to expand to 187 billion in 2020, with 45% of consumption split nearly equally between North America and Western Europe, and the rest coming from emerging markets, according to Euromonitor. Tea consumption remains predominantly constrained by national preference and is more likely to supplement coffee in certain geographies than to rise internationally as a unified category in the same way that coffee, lager, and mineral waters have, for example.

Meanwhile, the biggest players in Europe's carbonated soft drinks market are Coke bottlers and rapidly consolidating private-label producers. In the latter category, the most notable player is Refresco Group (rated vehicle: Sunshine Mid B.V.; B+(prelim)/Stable/--), the world's largest independent bottler after its acquisition of Cott in 2017. The group enjoys strong relationships with food retailers (including Lidl, Aldi, and ASDA) and branded players (such as Monster, Welch's, and Ocean Spray) because of its ability to handle beverages including juices, waters, ready-to-drink teas, and energy drinks in a variety of packaging formats. With a strengthened position in North America, we expect the group to drive development in the category by partnering with customers to introduce new flavors and packaging to supermarket aisles. Consumers are increasingly looking for a healthy, value-for-money proposition, in our view. This may eat into the shares of Coca-Cola and Pepsi Co., whose products are often priced at a premium to store brands and other branded players.

For Europe-based Coke bottlers, Africa is the next growth frontier, with Coca-Cola Beverages Africa assets set soon to be put up for sale by The Coca-Cola Company (A+/Stable/A-1). Sales of traditional soft drinks such as Coke, Fanta, and Sprite are declining in mature markets such as Western Europe, hence Coke bottlers are looking to expand in emerging markets, where growth prospects are stronger. That said, low-sugar beverages such Coke Zero, and energy drinks such as Monster continue to become more popular in most markets. To offset the decline in traditional sparkling beverages, bottlers are selling smaller packs, which have higher revenues per unit.

The Give-And-Take Of Pricing Negotiations With Traditional Retailers

As European retailers ponder big strategic decisions about the size and shape of their real estate, they are unlikely to get extra pricing help from manufacturers. This is because years of jostling about how to pass through rising raw-materials costs to consumers have taught both sides where the limitations of their bargaining power lie. Manufacturers have been quicker than retailers to trim their products (in terms of stock keeping units [SKUs]) and to adjust package sizing if a retail price point doesn't work for them. Even the smaller manufacturers, which are narrow in their category focus, have trimmed their brand and SKU range. This allows them to maximize the efficiency of their marketing and supplement the product range by buying up innovative newcomers in the fastest-growing segments, such as organic, "free from," and convenience-focused items.

Years of jostling have taught retailers and manufacturers where the limitations of their bargaining power lie

Private-label manufacturers have improved their bargaining power through consolidation in order to rationalize their cost base and reduce exposure to individual contracts. Retailers' own drive for supply efficiency might be pushing them toward the larger and more consolidated private-label manufacturers, rather than away from them. This owes to the benefits of coordinated and reliable supply across national retail networks.

The quality and image of private-label products have also improved in the past decade, not least thanks to the larger players' competitive efforts. Examples of this trend are visible in many segments: hygiene products (Ontex), ice cream (Froneri), and soft drinks (Refresco). The European food and beverage industry still has excess manufacturing capacity, mostly in need of modernization, which will take a few years to unwind. This capacity is the main reason why private-label contract pricing is still volatile in many regional markets.

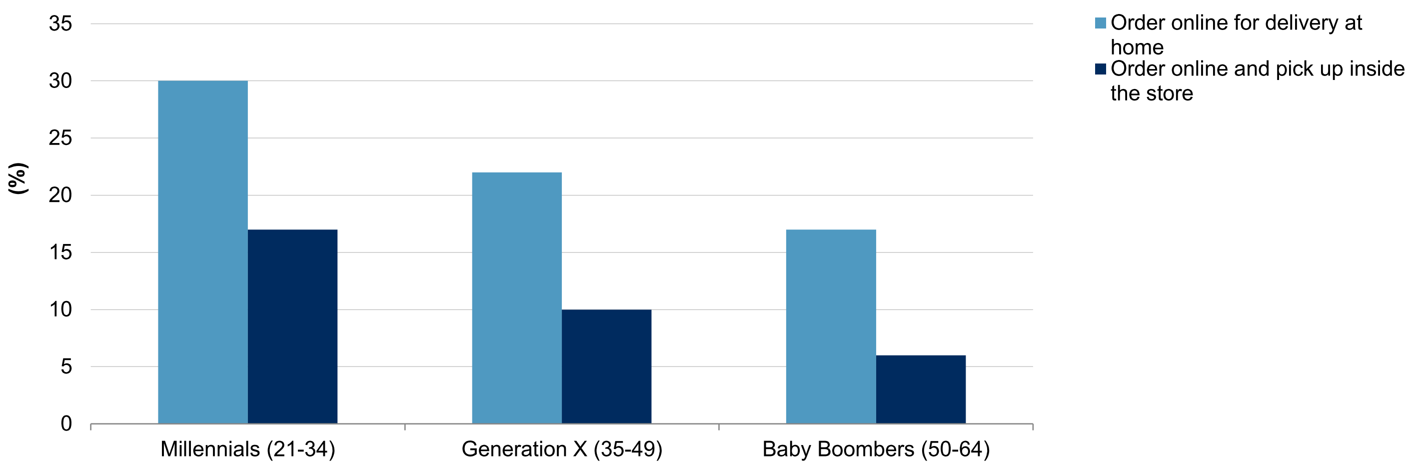
Meanwhile, leading European discount retailers, such as Lidl and Aldi, have moved firmly into the mainstream of grocery retail, offering growth opportunities to many manufacturers. Their strength lies in the initial focus on very streamlined product and SKU ranges, as well as highly cost-efficient real estate. Lidl and Aldi are also moving fast in step with key consumer trends, such as the focus on freshness and the careful selection of items that feel special despite the ordinary price points. They have added, for example, varied items such as selected wines and fresh bread, Iberica-style ham, and even celebrity-endorsed jeans. It's clear that the Lidl and Aldi business model wouldn't work for all products in all locations. Nevertheless, it is important that manufacturers are able to tap into the business opportunities offered by the discounters. Failing to do so might mean loss of volume and resulting weaker capacity utilization.

"Last-Mile" Risks May Challenge Manufacturers' Distribution Strategies

The prospect of consumers in developed markets abandoning their regularly scheduled visits to a large supermarket will need a strategic response from consumer products manufacturers. At the moment, a significant shift in grocery shopping behavior toward online shopping for shelf-stable products supplemented by shopping locally for fresh and chilled foods, looks to be a long-term prospect. This could turn very quickly, however, in the same way that rapid broadband and mobile penetration changed the consumption of print media a decade ago. The shift this time is likely to be driven less by technology (which already exists) and more by logistics, that is, the "last mile" capability of retailers. As the old adage goes, the consumer will ultimately drink what is behind the bar. Product features and pricing advantages might not be strong enough for the consumer to commit more time and effort to getting hold of the product. The age gap in the use of e-commerce is already well-established globally (see charts 2 and 3).

Chart 2

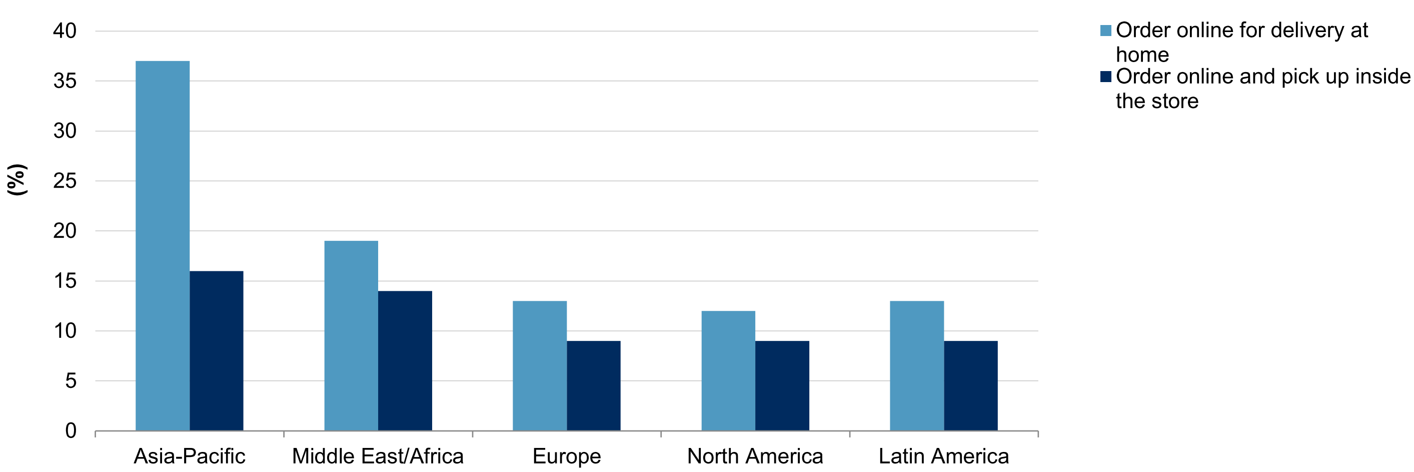
Share Of Age Group Using E-Commerce Options For Grocery Spending (%)



Source: Nielsen Report 2015 - The Future of Grocery.

Chart 3

Shared Proportion Of Total Population Using E-Commerce Options For Grocery Spending By Region (%)

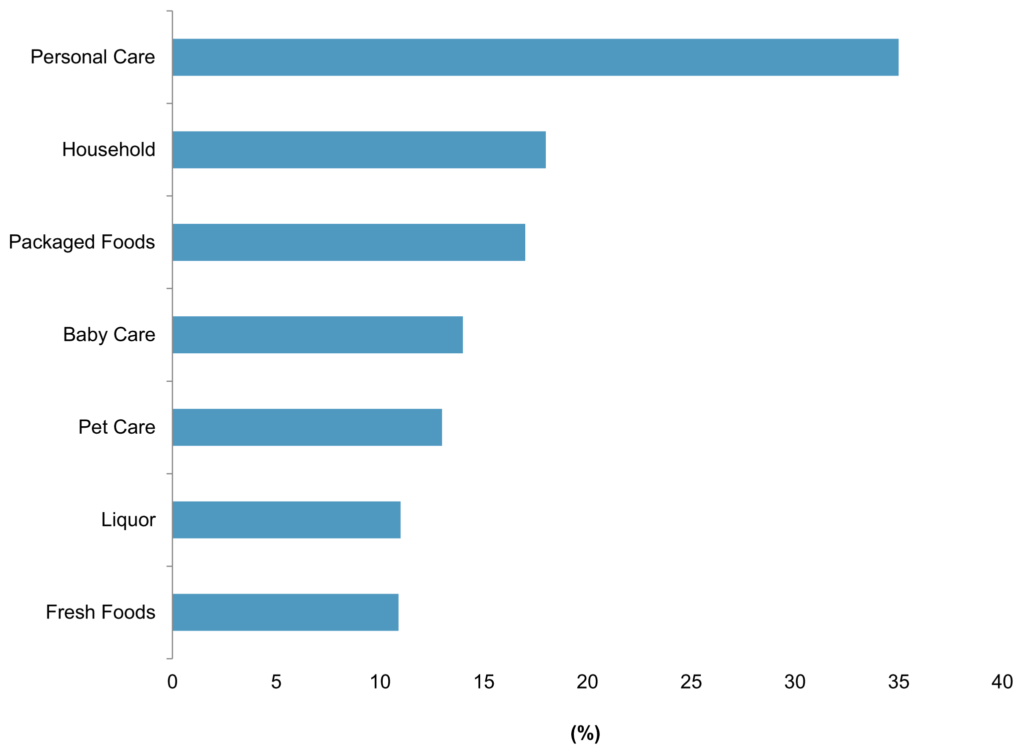


Source: Nielsen Report 2015 - The Future of Grocery.

From manufacturers' standpoint, the greatest adjustment might be the need for different marketing and distribution models. In the online channel, there are no point-of-sale displays or advertising, and orders are shipped from a few large warehouses. The first point will have implications for product launches and brand building, the second for inventory forecasting and distribution contracts. Large multinationals are already accustomed to this environment in their personal care, pet food, and specialist nutrition businesses. The difficulty, however, will lie in scaling up and running the online and traditional retailer relationships in parallel. Positively, the product categories that are most brand-differentiated and of utmost importance to the growth prospects of FMCG majors already have well-developed online presences, according to a 2016 global study by Nielsen, which measured the percentage of consumers who regularly shop online (see chart 4).

Chart 4

Share Of Consumers Who Buy Online By Product Category (%)



Source: Nielsen Connected Commerce Study - 2016.

Asset Spin-offs And In-Fill Acquisitions To Rise

Over the short term, we anticipate that EMEA consumer goods manufacturers will continue doing what they know best--buying and selling brands. Sizable M&A transactions along the lines of the failed $20 billion spin-off of consumer health care products by Pfizer Inc. (AA/Stable/A-1+) look increasingly unlikely. Large multinationals are no longer inclined to pay a large multiple for a mixed portfolio of assets, some of which will be immediately slated for disposals. With private equity funds unwilling to step up to leveraged buyouts in excess of $10 billion in this sector, most transactions are likely to be put together well below that figure. The hunt for digital assets and innovative products will continue, pushing up acquisition multiples for the more promising ideas. The decision by luxury brands owner Richemont (A+/Stable/--) to acquire online luxury retailer

Yoox Net-A-Porter (YNAP) is one of the most visible moves of brand owners into controlling an online market place to "talent spot" new trends and product launches. This strategy has already been successfully executed by LVMH (A+/Stable/A-1) via the development of its Sephora online channel in cosmetics and personal care. This proves that for global consumer brands, the add-on approach is now more likely to be value-adding than transformational acquisitions.

Related Research

- U.S. Consumer Products Companies Struggle To Adapt To A Rapidly Changing Marketplace, May 1, 2018
- Food Retail Disruption: U.S. Grocers Must Stay Fresh To Meet Customer Demand, May 1, 2018
- Food Retail Disruption: How Can "Modern" Grocers And Consumer Goods Makers In The U.S. And EMEA Remain Seasoned? May 1, 2018
- Disruption: The Sands Are Shifting Under Europe's Traditional Bricks-And-Mortar Grocers, May 1, 2018