Deloitte.

An appetite for change

Food and Beverage 2012

Eat, drink and be ready

Audit. Tax. Consulting. Corporate Finance.

Contents

Foreword

It has never been tougher to build a successful food and beverage business in the UK than it is today. Food and beverage companies face an array of increasingly complex issues and questions. The manner in which they choose to respond to these challenges will shape the future of the industry for many years to come.

Over the past twelve months the Food and Beverage team at Deloitte has carried out interviews with board level executives at more than seventy leading manufacturers, retailers and food service companies. We have spoken to relevant government bodies and undertaken a survey of more than 1000 consumers. This research has given us a unique insight into the current challenges facing the industry.

This report is just a snapshot of what we've discovered and has thrown up some interesting findings. We have focused on the six most prevalent issues that you have told us are affecting your businesses:

Strategy – What stance will you take on key issues?

- Health, nutrition and corporate accountability
- Tougher regulation
- Greenhouse gas emissions and the carbon footprint
- Food miles versus sustainable development

Execution – What will shape your future operating model?

- Manufacturing strategies: outsourcing and private label
- The role of private equity

Many people have contributed to this report, and I would like to thank those who have shared so many important insights with us. We hope you find this report useful and look forward to your feedback and the opportunity to discuss the future with you.

Lawrence Hutter
Global Managing Partner
Consumer Business

Challenging times ahead

Consumers are ever more demanding – expecting and getting more and more for less and less. Competition is getting tougher, downward pressure on process and margin continues, distribution and other input costs are rising. Most recently, growing preoccupation with climate change and the wider corporate responsibility agenda are colouring industry and consumer priorities. Such topics as the need to manage food miles or reduce carbon footprint would rarely have made it onto a boardroom agenda 2 or 3 years ago. Today the need to go green and be seen to be going green are vital elements of business strategy.

Society and its eating habits are also changing. A decade or so ago coffee shops of the Starbucks or Costa variety were still a novelty in UK high streets, sushi was available in Japanese restaurants not on mainstream supermarket shelves as a ready-made lunch-time snack and local produce was confined to a handful of embryonic farmer's markets and village stores. Today it is different. Health, nutrition, provenance, localness and authenticity are on the agenda. The "slow food" movement is gaining ground and, as our consumer survey reveals, families are once more making "eating together" a priority. We may all love the conveniences of ready-meals but a growing number of households are reverting to "cooking from scratch" to create a more healthy alternative. Keeping pace with these fast-moving consumer trends offers great opportunities but is not always easy: get it wrong and fingers can be badly burnt.

Understanding and responding to ever tougher and more complex regulation is a current priority. While today traceability, removal of hazardous substances, animal welfare and the vexed question of nutritional labelling and health warnings dominate the regulatory agenda, tomorrow it could additionally be carbon emissions and carbon labelling businesses are responding to. Government and consumer pressures to reduce emissions and introduce some sort of labelling that can enable consumers to make informed choices are increasing. While calculating the carbon footprint of products is not yet well developed as a science, the pressure to limit emissions and burn less fossil fuel will only increase. Whether this will involve adopting new forms of heat recycling, lowering supermarket lighting levels or an end to free plastic carrier bags, no one can be sure, but the one certainty is that we can expect the green agenda to increasingly impact operations as we approach 2012.

While the market is changing, so too are food and beverage companies. Private equity investment is, in particular, focusing attention on management efficiency. Any company delivering materially less value than it is capable of is likely to find itself a candidate for acquisition. The growing trend towards outsourced manufacturing is prompting many to rethink their core raison d'être: are they brand owners or food processors or both? In retailing the big continue to get bigger – concentrating more and more power in the hands of a few dominant players with the power to delist or demand additional allowances from their suppliers when times get tough.

As we look forward five years to 2012 what new challenges are the industry likely to face? Certainly these current issues will not go away: the oil price is unlikely to fall; pressures to be environmentally friendly will grow; health and nutrition will remain a priority; low cost economies offering cheaper production opportunities will not disappear; and consumers will not lose their taste for novelty, variety and great value. But there will be new challenges as well. The emphasis on health highlighted in our study could pave the way for a new generation of "nutraceuticals" and wellbeing products. Expect the emergence of new food retailing concepts that attract more affluent consumers away from the homogeneity of the majority of our hypermarkets and supermarkets. Growing use of alternative channels such as the Internet could lead to a growth in direct to consumer sales by food suppliers. Perhaps, too, we shall see greater regulation to control salt, sugar and fat content by governments obsessed with a need to address the long-term economic consequences of current public health issues.

It is clear that the next 5 years will present an increasingly complex set of issues and challenges for the food and beverage industry to resolve. The ability of individual businesses to identify relevant challenges and opportunities, develop appropriate responses and execute effectively will be critical to their short term and long term success. However, one thing is clear, by 2012 the debate about the responsibility of the industry to promote good nutrition and a healthy lifestyle will be over. Doing the right thing, and being seen to do the right thing, will be considered core to brand relevance, and ultimately business success across the industry.

"A decade or so ago coffee shops of the Starbucks or Costa variety were still a novelty in UK high streets."

Changing consumers

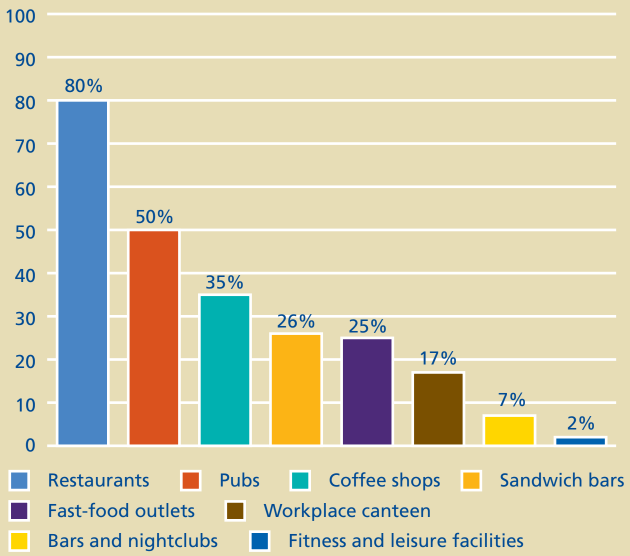
Today's consumers and shoppers are sophisticated and complex. They are constantly changing, becoming more diverse and sometimes demonstrate seemingly contradictory behaviours. The days when retailer and manufacturer marketers could neatly assign individuals to five or six fixed segments are long gone – 20 or 30 are far more typical now, while Tesco's permutations for its Clubcard mailings regularly run into six figures. In reality fixed consumer segmentations are becoming less and less relevant with occasion and outlet being just as important determinants of purchasing behaviours. Today's shoppers are "deal seekers", "cherry pickers" or "foodies" all at the same time. As our research highlights, they will be tempted by "three for two" and "buy one get one free" promotions while adding highly-priced premium products and luxury treats to their shopping baskets, often demonstrating substantial discrepancies between intentions and actual behaviour.

Although shopping behaviours may be less predictable, the demographics of the shoppers themselves are not. The population is ageing: by 2012, some 23% will be over 60 – an increase of 14.5% on 2004 figures. These older people will, however, be very different from the elderly of a couple of decades ago. They are the "baby-boomers"; the so-called "me generation" who have transformed society in the past 30 years. Many of tomorrow's pensioners will be well-educated, active, health-conscious, demanding and, for the most part, rather more affluent than the elderly of previous generations.

Consumer intention		Consumer reality
To buy healthy foods	→	Buying food on special offer Buying 'perceived healthy' foods rather than genuinely healthy options Buying what's available or succumbing to 'pester power'
To buy bargains on special offer	→	Buying premium products as an indulgence Overspending on promotions
Sticking to a shopping list	→	Buying more items than intended
Like to try new brands	→	Reluctance to try new brands among the growing number of aging consumers
To eat and drink healthily at home with the family	→	Increased alcohol consumption in the home
To eat more meals at home	→	66% of consumers buy a meal or snack outside the home at least once a week
To buy more locally-sourced produce	→	Consumer spend at supermarkets ever-increasing
To show concern on food miles	→	Expecting out of season produce to be available 365 days a year

Source: Deloitte research, survey of 77 senior executives at leading food and beverage businesses.

Which type of establishments do you normally eat out in?



Source: Deloitte consumer research.

We also know that the numbers of working parents will continue to increase time pressures and growing demand for both nutritious ready-meals and good quality casual dining restaurants. On average, consumers in our survey spent 27% of their weekly food budget on eating out with restaurants and pubs topping the list of preferred meal destinations.

Ethnic diversity is also set to continue to grow as more immigrants from Eastern and Central Europe, Africa and Asia become long-term residents. These different groups are spread unevenly across the country and, as the recent influx of workers from the EU accession countries well demonstrates, they can significantly impact local demand for specific foods. While many ethnic communities are well established, large numbers of newcomers can change demand patterns very quickly with major implications for targeted ranges and local merchandise assortment strategies. The 333% year on year growth in the consumption of Polish beer in the UK is an interesting example.

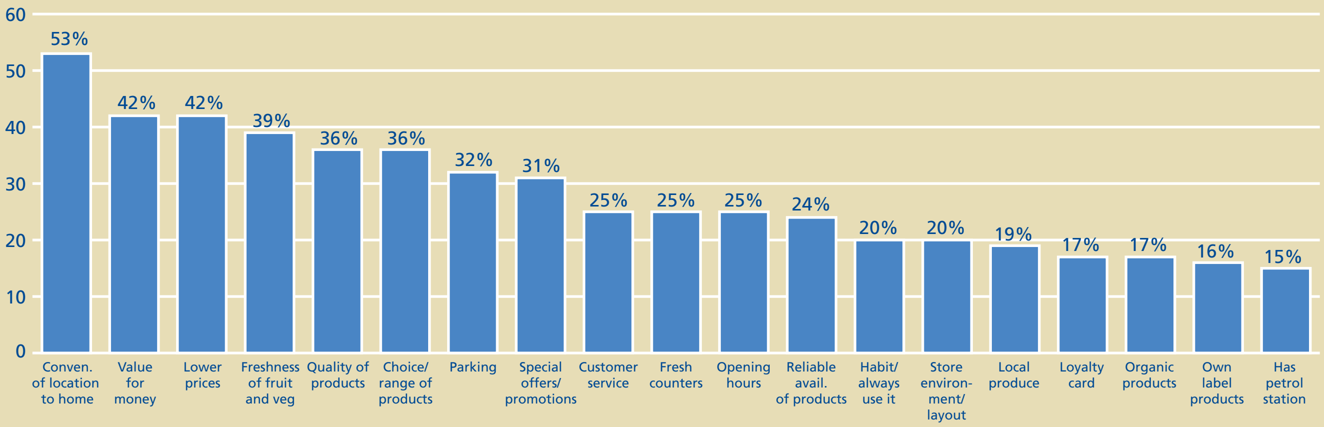
For the majority of today's shoppers, large format superstores with extensive product assortments are the norm. They expect to find whatever they want on the shelves and are increasingly intolerant of out-of-stocks. More than half of our shoppers (53%) put convenience to home as the most important factor when deciding where to shop. Lower prices (42%), value for money (42%), the availability of fresh fruit and vegetables and quality also ranked highly. Loyalty cards were cited by just 17%.

In contrast, when asked what both supermarkets and food producers can do to better meet customer requirements, our survey puts "more choice and variety" at the top of the list (15%).

In recent years, many UK consumer surveys looking at shopping patterns have tended to put price at the bottom of the list of influential factors which has been something of a contrast to consumer behaviours in other major European countries. This survey suggests that price is now becoming rather more important in the UK. This may well reflect the growing strains on consumer spending caused by the increase in fuel and housing costs with price-led competition between certain retailers also generally raising price-consciousness in the mind of the consumer.

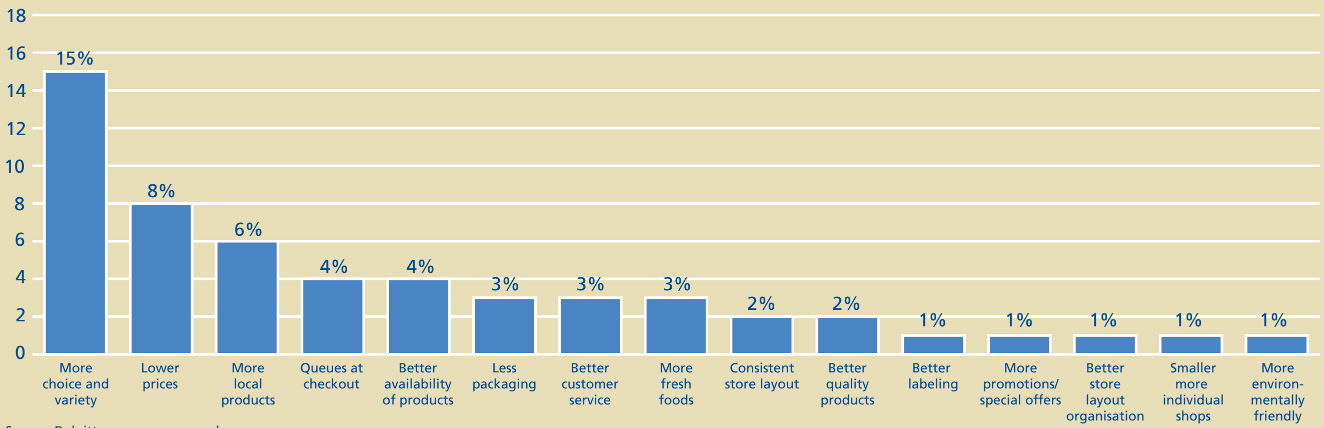
More than two-thirds of our shoppers actively looked for "buy one get one free" deals and similar special offers – although they were also reluctant to give up treats: 29% of the deal seekers also reported buying more premium products now than they had done so in the past. Asked what supermarkets and food producers could do to meet their food shopping requirements, just over 15% put more choice and variety at the top of the list , however lower prices cited by 8% of shoppers came second. The UK shopper is still less price-sensitive overall than his or her continental European counterparts.

Which are the most important factors in determining where you do your food shopping?



Source: Deloitte consumer research.

What can supermarkets and food producers do to better meet your requirements?



Source: Deloitte consumer research.

Health and wellbeing is as important as novelty, variety, treats and bargains in food and beverage selection. More than half of shoppers surveyed are likely to read the food label before buying while the "five portions a day" message has clearly been noted. Some 80% of women shoppers regard eating more fruit and vegetables as important for a healthy diet. The food and beverage industry is already very aware of these trends with 77% of those interviewed in the leading manufacturers, retailers and food service companies identifying "health and wellbeing" as today's key consumer trend.

This emphasis on nutrition and health is hardly surprising. Our children have one of the worst diets in the developed world including the highest levels of per-capita expenditure on confectionery and carbonated soft drinks. Government, healthcare professionals, consumer groups and the media now deliver a steady stream of healthy eating messages. There are tough new regulations especially focused on childhood diet, designed to limit promotion and access to unhealthy foods and thereby reduce obesity, prevent numerous ailments, improve social behaviour and encourage learning in schools.

Over the past few years, numerous studies have highlighted both a general lack of culinary skills and declining numbers of families eating regularly together. Our survey suggests that these tendencies may be changing. More than a quarter (27%) of those surveyed say that they are spending more time preparing meals than they did in the past, while 25% claimed to be spending less time. Inspiration for this cooking does not, despite the media hype, come from celebrity chefs and TV cookery programmes. "Upbringing and habit" was the most commonly cited inspiration for eating with recipe books in second place and family and friends in third. Perhaps of particular concern, the consumer research suggests that children in less privileged families with the worst diets are most likely to follow their parents dietary example. The good news is that almost two-thirds say they regularly eat meals together with family or household members. The emphasis on healthy living is a clear driver for these changes. As various respondents said:

"I am spending more time preparing meals from scratch because I want to make sure my kids have a healthy home cooked meal."

"I'm doing my best to teach my family good eating habits and making them aware of eating the right foods."

"We have children now, so we try to cook together, talk to one another, and really make it a family experience."

While making healthy meals from scratch at home may be a priority for many, time pressures are still apparent. 66% of those surveyed purchased and ate a snack meal outside the home at least once a week with 22% eating on the move five or more times a week. The trend was most apparent in younger age groups with around a quarter of the 18-24s and 25-34s admitting to "eating many of my meals on the move".

"We have children now, so we try to cook together, talk to one another, and really make it a family experience."

Obviously, many of these people will be eating snack meals at lunchtime during the working day with those eating out most often citing coffee shops (35%), sandwich bars (26%) and fast food outlets (25%) as the most likely destinations after restaurants (80%) and pubs (50%). Only 17% of those eating out regularly mentioned a workplace canteen as a possible eating destination, perhaps reflecting a downturn in corporate ability to provide subsidised staff benefits. Interestingly, the smoking ban which comes into force this summer looks like encouraging rather than deterring consumers from eating out: a third of those surveyed suggested they would be more likely to eat out after the ban with only 9% suggesting they would do so less often. We are already seeing the impact of the smoking ban reflected in higher quality food and beverage offerings across the hospitality industry.

However, while diners across the UK have stated that they prefer a healthy, smoke-free atmosphere, health does not appear to be a priority when it comes to much eating out – that is when we revert to our self-indulgent treat mood. Healthy food options were mentioned by only 11% of consumers we surveyed with a restaurant's reputation and variety topping the list . Price was in third place for those eating out frequently and significantly lower down the list for those eating out less than once a month.

Taken overall, the survey suggests rather more interest in quality, variety and good food than would perhaps have been suggested by the average shopping basket a few years ago. Media and Government messages about healthy eating are clearly having an impact. Price has not been seen as a significant issue affecting consumer buying decisions. However as costs of transport, housing and fuel continue to rise, price is clearly starting to become more significant. Maintaining low prices while delivering the good quality and variety consumers demand will clearly be a challenge in future.

An industry view of the challenges

While consumers may be becoming more focused on price and value, food and beverage companies still rank it low on their list of key consumer trends. However, on the importance of health and wellbeing, convenience and quality, they certainly agree with our surveyed consumers putting these three attributes at the top of the list. The industry is perhaps rather more pragmatic though, with several participating companies talking of products being "perceived" as being healthier and suggesting that consumers often lack sufficient nutritional knowledge to identify the genuinely good for you: "lower in fat" is not always a guarantee of goodness – witness the current discussion about the red-labelling of cheese.

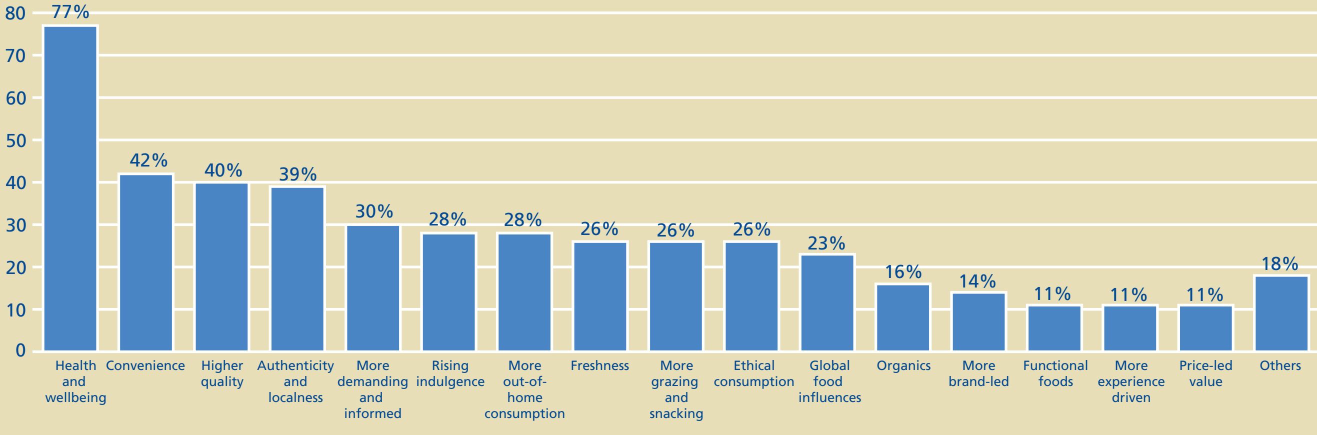
Both retailers (45%) and suppliers (46%) also rated "authenticity and localness" as important, well ahead of consumers. In contrast, a preference for local produce was mentioned by only 15% of consumers in our survey. The industry could be showing some prescience here. Over the past few weeks, as the green lobby has raised its profile and concerns over climate change have increased, emphasis on food miles has grown. Retailers, such as Marks & Spencer, have announced new labelling for products that have travelled by airfreight while food writers and celebrity chefs have joined campaigns to encourage local produce. If the industry is right, then we may well see greater consumer interest in local products in future. The industry is also more aware of EU traceability directives which are increasing the need for authentication. Again there are few signs of concern here among consumers.

Significantly, retailers rated consumer demand for "freshness", cited by 55% of those interviewed, well ahead of manufacturers and suppliers (mentioned by just 13%). "Freshness" may be another aspect of "healthy" – seen in declining sales of canned and frozen fruit and vegetables and increased demand for "fresh" product. It could also reflect the high levels of wastage and lost margin caused by products passing their sell-by dates. What is also clear is that consumer perception of what is healthy does not always reflect the true nutritional quality of different foods.

If manufacturers under-estimate the importance of freshness then they probably over-estimate demand for organic produce. This was cited as a key consumer trend by 25% of suppliers, 13% of food service operators but just 9% of retailers. In the consumer study a better selection of organic products in supermarkets was on the wish list of around 15% of consumers. While organic produce has its supporters many consumers take a rather more sceptical approach to the "organic" label: scrubbed and prepacked supermarket carrots labelled "organic" look and often taste much like the standard offerings and are very different from the rather dirtier and mis-shapen "organic" versions found in many farmer's markets and regarded as more "authentic". If "authenticity" becomes more transparent then this scepticism may diminish.

While all the food and beverage companies questioned put "health and wellbeing" at the top of their consumer trends list, there were significant differences in interest when the size of the company is taken into account. Some 94% of large companies (turnover >£1 billion) cited health and wellbeing as the most important trend compared with just 61% of smaller players (turnover <£200 million). Larger companies also rated higher quality, authenticity and localness more highly than either mid-size or small companies. In contrast the mid-sized players (turnover £200 million to £1 billion) rated "out-of-home consumption", "more grazing and snacking" and "global food influences" higher than either small or large companies. This may well reflect the primary market and consumer segments for these mid-sized companies or the higher level of"top-up" shopping found in mid-sized retail outlets as compared with the "big four".

Key consumer trends shaping the industry



Source: Deloitte research: Survey of 77 senior executives at leading food and beverages businesses

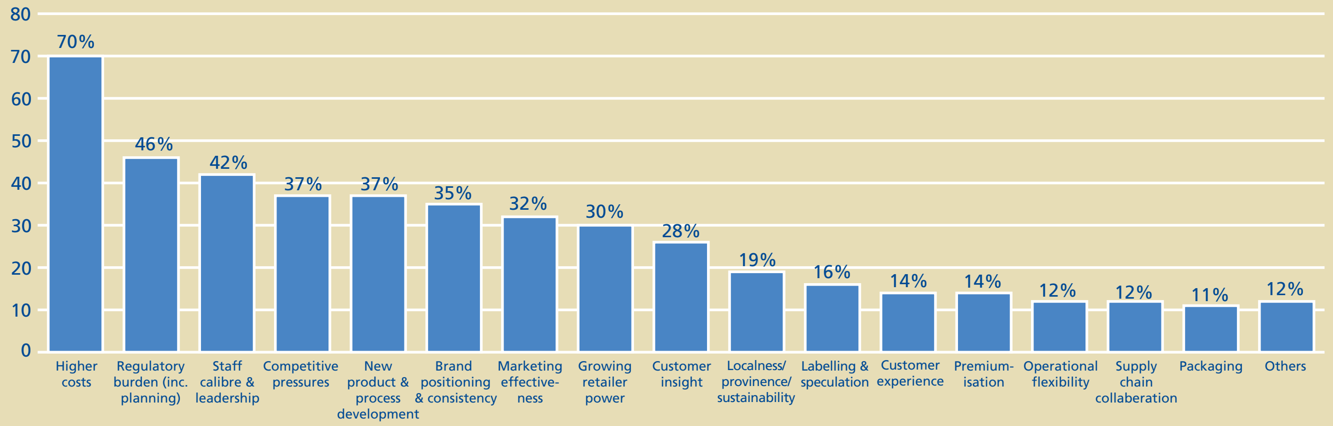
While the industry executives interviewed reflected a range of views of their consumers, they were more unanimous about the industry's key business issue. Higher costs were cited by 70% of those questioned (range 71% to 73% by company category). The regulatory burden was cited as a concern by 46% with staff calibre and leadership cited by 42%. Overall, these were second and third in the "issues" list but there was considerable difference in how company categories viewed these factors. A total of 91% of retailers cited the regulatory burden (including planning) compared with 33% of suppliers and 27% of foodservice operators, while staff calibre was a problem for 53% of foodservice operators, 64% of retailers but just 17% of suppliers.

Ranking of key consumer trends as perceived by retailers, manufacturers and foodservice operators

Ranking	Retailers	%	Manufacturers and suppliers	%	Foodservice operators	%
1	Health & wellbeing	73	Health & wellbeing	73	Health & wellbeing	73
2	Freshness	55	Provenance/authenticity/localness	46	More out-of-home consumption	47
3	Convenience	45	Conv/time driven	42	Higher quality	40
4	Authenticity & localness	45	Higher quality	38	More grazing and snacking	40
5	Higher quality	36	More demanding & informed	38	Conv/time driven	40
6	Off-trade growth	36	Ethical consumption	38	Global food influences	33
7	Others	36	Rising indulgence	29	Freshness	27
8	More demanding & informed	18	More grazing & snacking	25	Rising indulgence	27
9	Rising indulgence	18	Organics	25	More demanding & informed	20
10	More grazing & snacking	18	Functional foods	21	Ethical consumption	20
11	More out-of-home consumption	18	More out-of-home consumption	21	More experience driven	13
12	More brand-led	18	Global food influences	21	Provenance/authenticity/localness	13
13	Price-led value	18	Freshness	13	Organics	13
14	Functional foods	9	More brand-led	13	More brand-led	7
15	More experience driven	9	Price-led value	13	Others	7
16	Ethical consumption	9	Others	8	Functional foods	0
17	Organics	9	More experience driven	4	Off-trade growth	0
18	Global food influences	9	Off-trade growth	4	Food & drink combined	0
19	Food & drink combined	0	Food & drink combined	4	Price-led value	0

Source: Deloitte research. Survey of 77 senior executives at leading food and beverage businesses.

Key business issues shaping the industry landscape



Source: Deloitte research. Survey of 77 senior executives at leading food and beverage businesses.

"Both retailers and manufactures acknowledged that customer service is becoming an important differentiator and good service needs well trained and experienced employees."

Rising costs are clearly a major concern with several of those interviewed worried that cost inflation is exceeding the ability and scope for businesses to pass these increases on to customers – be they trade or consumer. This will inevitably affect performance and profitability and is obviously an issue for all businesses in the food and beverage value chain. While most cost concerns involved energy, fuel, raw materials, rents and utilities, the rising price of labour was also mentioned by many. Coupled with problems of recruiting and keeping good quality staff, talent management is certainly a big issue for the industry.

Both retailers and manufacturers acknowledged that customer service is becoming an important differentiator and good service needs well trained and experienced employees. Raising wages and offering good career development are accepted as important but may require culture and process change to achieve. As one operations director in the hospitality sector put it: "...current wage inflation is not sustainable. It is strengthening the focus on operating with fewer but higher calibre staff".

There was agreement over the importance of brand positioning and marketing effectiveness, both cited by on average a third of the interviewees. However, identification of other key business issues varied markedly between the categories. Retailers were particularly concerned about competitive pressures (listed by 82% of respondents) while manufacturers were preoccupied by new product and process development (63%). In contrast 27% of foodservice operators mentioned new product development which, perhaps surprisingly, and it was listed by only 9% of retailers. Manufacturers (58%) were especially concerned about growing retailer power – their second most highly ranked business issue.

While many regarded retail dominance as an inevitable consequence of consolidation, several of those interviewed were critical of the concentration in negotiating power and the difficulties in securing necessary input cost-related price rises that it causes. Some hoped for either a consumer backlash against the growing lack of retail diversity or greater efforts from the Competition Commission to curb supermarket expansion.

The study showed only limited differences in attitude by company size. Larger businesses (>£1 billion turnover) were more aware of regulatory issues, supply chain collaboration, localness and sustainability issues, as well as moves towards higher priced premium products. Smaller players tended to rank brand positioning and marketing rather more highly. Among mid-size players (£200 million to £1 billion turnover) growing retailer power was a major concern. This group includes second-tier brand owners more at risk of their products being delisted as well as smaller grocery chains potentially squeezed by the majors.

In summary, the study highlighted the key challenges for the industry are dominated by concerns of price pressures, rising costs and reduced profitability which can limit the funds available to drive innovation and growth. Examples include pressures on wages and staffing levels making it even harder to attract top talent. The regulatory burden is unlikely to diminish nor will the increasing power of a handful of major supermarkets. Fortunately, most of the industry appears to be well in tune with consumer trends and priorities notably around health and nutrition, innovation and variety, convenience, guarantees of provenance, quality, and positive environmental and social contribution.

Ranking of key business issues as perceived by retailers, manufacturers and foodservice operators

Ranking	Retailers	%	Manufacturers and suppliers	%	Foodservice operators	%
1	Regulatory burden (including planning)	91	New product and process development	63	Staff calibre and leadership	53
2	Competitive pressure	82	Growing retailer power	58	Competitive pressure	33
3	Staff calibre and leadership	64	Marketing effectiveness	42	Regulatory burden (including planning)	27
4	Customer insight	36	Regulatory burden including planning	33	New product and process development	27
5	Sustainability	36	Customer insight	29	Marketing effectiveness	20
6	Marketing effectiveness	27	Competitive pressures	21	Customer insight	13
7	Labelling and specification	27	Labelling and specification	21	Sustainability	13
8	Operational flexibility	27	Staff calibre and leadership	17	Growing retailer power	7
9	New product and process development	9	Operational flexibility	8	Operational flexibility	7
10	Growing retailer power	9	Sustainability	7	Labelling and specification	0

Source: Deloitte research. Survey of 77 senior executives at leading food and beverage businesses.

The big debate

In consideration of today's issues and tomorrow's challenges, our research has highlighted six key issues companies are grappling with. While these do not represent an exhaustive list, they do seem to be those that are most "front of mind". How companies choose to respond will substantially impact what they will stand for, shape their business strategies and determine their operating models going forward to 2012.

Strategy – What stance will you take on key issues?

1. Health, nutrition and corporate accountability

As both our consumer and industry surveys demonstrate, nutrition and health have become a major concern for shoppers, retailers, food and beverage manufacturers and regulators. Government is increasingly using a combination of education and legislation to help change the nation's eating habits with children being a prime focus. Industry initiatives such as Tesco's Nutrition and Fitness programme and Sainsbury's Active Kids and Active Kids Get Cooking programmes are reinforcing these official messages.

Our food, including ready meals, has certainly become far healthier in recent years. Controls are tighter and there is a growing awareness of the implications of the use of artificial food colourings, pesticides, growth hormones and other additives. UK farming and animal husbandry is acknowledged as some of the best in the world. Yet, in their search for low-cost produce, major food and beverage companies may sometimes sacrifice quality and animal welfare for cheaper sources that deliver better perceived value.

Who should take responsibility for the healthy eating agenda? Is it the duty of Government, grocery retailers, food and beverage manufacturers, or individuals? Government clearly has a role to play in setting policy, framing legislation where it is appropriate, encouraging consumer education and establishing priorities for the relevant agencies – the Food Standards Agency (FSA) especially. With our leading retailers increasingly being the arbiter of choice for the UK consumer, the industry is also recognising the important role that it can and should play. Retailers are actively sponsoring consumer education programmes. Manufacturers are rewriting their mission statements and reformulating their products. Both communities increasingly accept the need to "do the right thing" on nutrition and health. Food retailers and manufacturers whose brands do not stand for good nutrition and health will become less and less relevant to consumers. The primary focus of all of this must be our children – those for whom it is not already too late to engrain healthy eating habits, though good nutrition is obviously important for the whole population.

Our research suggests that many consumers still enjoy their unhealthy treats while striving for a healthy diet. Others are more price constrained and must therefore opt on most occasions for whatever is cheapest – which in many cases is not a ready meal but food prepared at home with good quality basic ingredients. Education clearly has an important role to play and Government is right to focus its efforts here. However, it is important to recognize that health and obesity issues are not just about diet but about lifestyle more broadly. With a recent British Heart Foundation survey of 3,500 pupils from inner city schools highlighting "record levels of inactivity" amongst less privileged children it is clear that broadly based policies to improve nutrition and encourage healthy activity are essential.

In a litigious age the industry may also be held to account for any failures to deliver good nutritional products. We have already seen US consumers sue fast food chains for supposedly causing obesity and heart disease. It may seem bizarre to blame others for our lack of self-discipline or poor eating habits but if consumers start to view food and beverage companies as accountable for a variety of ills then the sort of litigation which has beset the tobacco and asbestos industries could become commonplace in other sectors.

Those marketing "unhealthy products" which are rich in fats and sugars or still, for example using the official definition of "meat" to include hide, hair or ground bones in their products, may need to re-think their strategies. Price will certainly continue to be important to consumers but using cheap filler ingredients is likely to become less acceptable to consumers in future. We expect to see significantly more reformulation of recipes by 2012 to ensure that products are, if not completely healthy, then as least "unhealthy" as they can be. Self regulation on such matters will be crucial.

That does not mean that less than healthy products will disappear. Producers of cakes, confectionery and biscuits report that consumers are "stubbornly loyal". Promoting these products as treats or as "taken in moderation, can form part of a healthy diet" will no doubt continue to be acceptable. Promoting such items in large "25% free" packs or "three for two" offers may become more questionable. While the industry is facing ever increasing regulation, such promotional and advertising offers are currently only limited to when they target children. This does not prevent unhealthy offers on supermarket, c-store or service station shelves and unless the industry is seen to behave responsibly, legislators may well turn their attention to such activities.

A natural corollary of this is the part industry can play in consumers' nutritional education. Certainly the major supermarkets are, as mentioned earlier, attempting some forms of food and wider lifestyle education, notably targeting healthy foods and promotional campaigns at children. However, our consumer survey suggests that only a small proportion of shoppers glean their menu inspiration from retail outlets: only 9% of those in socio-economic groups DE pay attention to in-store messaging and just 14% in those groups use store magazines or recipe cards. These figures increase slightly for higher socio-economic groups (peaking at 21% and 25% respectively for ABs), but the overall impression is that it will be harder for food retailers to succeed in educating those consumers who most need such help. This is likely to be one of the greatest challenges we face in improving the health of our children.

Good nutrition and health will remain high on the agenda of policy makers, regulators and consumers. If anything, it is likely to gain even greater prominence as we head towards 2012 and we expect the industry to respond. We believe one thing will change. The debate about the responsibility of the industry to promote good nutrition and healthy lifestyles will be over. Doing the right thing, and being seen to be doing the right thing, will be seen as core to brand relevance across the industry.

2. Tougher regulation

The regulatory burden has grown steadily over the last two decades and is a key concern highlighted in our industry survey. While Hazard Analysis and Critical Control Points (HACCP) remains the primary foundation of modern food safety legislation, this has been supplemented by a growing body of legislation such as:

- The Food Safety Act 1990
- Food Labelling Regulations 1996
- Beef Labelling regulation 1760/2000
- EU Regulation 178/2002 Articles 18 & 19
- EU Regulation 852/2004
- Food Allergen Labelling Act 2004
- General Product Safety Directive 2005 (update)
- Removal of Hazardous Substances (RoHS) Act 2006.

The RoHS Act means that manufacturers must completely remove named allergens, not just as ingredients but from their production plants entirely. For example creating a totally nut free production environment or else label everything produced in that facility with the relevant allergen warning. Such a rule can lead to labelling that the consumer finds slightly odd and sometimes bemusing where both fresh bakery and a butcher's fresh meat display are labelled "may contain nuts". Perhaps more worrying, consumers will cease to take notice of allergen labelling because it becomes so pervasive. However, it is only the latest in what will most likely be an increasingly complex regulatory environment that the industry will have to cope with during the next decade.

For food manufacturers, this presents several challenges. First, the very fact of keeping up to date with the legislative barrage. This can be a particular problem for smaller businesses. Secondly, all this is happening at a time of increased pressure on prices and margins and where consumer preferences are moving to potentially higher risk chilled and fresh products rather than the more predictable and long-lived dried, canned or frozen ranges. Re-engineering processes and systems to meet new regulatory requirements can be both time consuming and expensive. The good news is that those businesses that can afford to make these investments hand-in-hand with improving efficiency and reducing waste through better process design are likely to see positive returns on their investments.

Businesses can also expect the enforcement of these burgeoning regulations to be more rigorous in future. At present enforcement can therefore be a little variable and the FSA is not responsible for enforcement, this is the responsibility of the local authorities. In future it seems likely that the FSA may take on a wider role. What is clear is that all businesses directly involved in the food chain, large and small, will need to place increased importance and investment on ensuring they have a full understanding of the regulations, their implications and on attaining compliance.

Adding to these numerous rules are changing attitudes to traceability and authentication of provenance. Perhaps surprisingly, or so our consumer study suggests, there is as yet little demand from consumers for widespread traceability and authentication of source but, as the BSE crisis demonstrated, consumers can react very quickly to changing conditions in the food chain. With the threat of avian 'flu, or even the emergence of another newcomer of the SARS variety, we can expect consumers to become more interested in knowing the source of their food. Increasing interest in environmental and FairTrade issues will continue to raise authentication of provenance up the list of priorities in the mind of consumers and is likely to become a more important brand marketing issue for retailers and manufacturers alike.

Traceability and provenance information will need to be displayed using suitable labelling, an area which brings us back to the issue of nutritional education discussed earlier. Many consumers struggle to comprehend labels, be they based on the "traffic light" system preferred by the FSA or on the recommended daily allowances approach preferred by certain retailers and manufacturers. Recently anomalies such as fresh cheese being labelled as "junk food" because of its fat content per 100gm do not help to build consumer confidence.

That said, while the nutritional labelling debate has raged for at least two years, we have made progress. We rarely now debate if nutritional labelling is justified, just which type of labelling is most effective. Assuming we believe consistent labelling is important, it would be helpful if the industry could resolve the issue of labelling standards without the need for recourse to yet more legislation. Self-restraint and self-regulation are equally important: labels declaring "95% fat free" fool few.

If the industry is to avoid the risk of more heavy-handed legislation, then it needs to continue to be proactive in promoting good practice, ensuring scrupulous adherence to standards and delivering clear and consistent consumer messaging. Food manufacturers in particular have more to do in communicating with the consumer about the very high standards generally in place across the industry. Consumers generally only hear about what goes wrong. However, all this comes at a price. The question is how much investment in good practice will consumers be willing to pay for?

Regulation is unlikely to diminish, be that for example the planning regulations which so irk retailers or traceability and more stringent labelling demands which can be such a headache for producers. The response of the industry needs to include elements of both compliance and influence. From a compliance perspective the focus needs to be on understanding the legislation and building it into day to day operational practice. This may involve introducing new processes and systems which can also deliver wider benefits. New technologies and standards such as Radio Frequency Identification (RFID) and data synchronization between different participants in the end-to-end food chain also have the potential to make a major contribution.

From an influence perspective, self-regulation and agreement on labelling and other standards will be helpful in limiting further growth in the regulatory burden of the industry. Planning regulations are largely outside the scope of this study. However, retailer initiatives to contribute to the health, social and economic well being of local communities are unlikely to harm their cause when seeking planning permission for new stores and store extensions.

"Air freight has a high carbon footprint relative to the real benefits to the consumer and there is a growing view that such foods should be labelled."

3. Greenhouse gas emissions and the carbon footprint

While the debate currently continues over the preferred format for food content labelling, it has yet to begin where the carbon footprint of our food supply is concerned. The Carbon Trust is working on a scheme and supermarkets such as Marks & Spencer with its "Plan A" and Tesco are setting the pace. Since the start of 2007 Government and media focus on climate change has ramped up dramatically. The generally accepted view is that fossil fuel based carbon emissions are having a major impact on global warming and must be reduced. Fewer and fewer scientists would argue that the impact of greenhouse gases has been exaggerated. All would agree that it is important to reduce our use of diminishing fossil fuel reserves and cut pollution.

Considerable amounts of foods are air freighted into Europe: some to replenish dwindling local food stocks, such as in the case of Pacific caught fish, others to provide unseasonal vegetables. Air freight has a high carbon footprint relative to the real benefits to the consumer and there is a growing view that such foods should be clearly labelled. Will this encourage consumers to opt for low carbon footprint alternatives? As concern over global warming mounts, especially among younger age groups, then it may have an impact on demand. However, the issue seems less immediate to most compared with good nutrition and health. Until then, the prevailing view among many food and beverage businesses, seems to be rather more ostrich-like – "we can't be blamed for consumer preferences" is an oft-quoted get out clause.

Equally, air freighted cash crops deliver much needed revenue to many poor or developing communities. Remove Kenyan mangetout or Zambian beans from the equation and these societies would be considerably worse off. Clearly there may need to be a balance between carbon footprint and support for FairTrade-style projects to ensure consumer support for such imports in future.

Political demand to reduce carbon footprint will, however, inevitably increase and companies cannot hide behind consumer preference forever. The industry will need to make significant changes in order to forestall regulatory pressure. It will not be easy. The standards and methods for calculating the carbon footprint of a product have yet to be developed, let alone agreed. These future standards will however be helpful and the more proactive businesses will play an active role in shaping these standards.

The recent switch to chilled rather than canned foods, while linked to the rise in healthier eating, may have also substantially increased carbon footprint in distribution centres, since chilled or frozen storage is more expensive in energy terms than ambient shelving. The high light levels we have come to expect in our supermarkets could also be seen as another unnecessary use of energy resources.

In contrast, one can argue that home delivery reduces carbon footprint since one van can replace a dozen or more separate trips to the supermarket if deliveries are coordinated on a local geographic basis, something which, for example, Tesco, Sainsbury and Ocado are already doing in the UK.

The point-of-purchase packaging debate is also intensifying with a growing number of shoppers reportedly abandoning plastic trays and other packaging at the checkout while others will queue for hours to buy supposedly eco-friendly cotton carrier bags. Several countries, such as Ireland, have already introduced charges for plastic shopping bags. In the UK "bags for life" and bag recycling points within supermarkets are now commonplace. Much more could however be done. Tesco, for example, already sells its basic packs of breakfast cereal without an outer cardboard box while substituting recycled paper bags for plastic ones at self-service fresh produce counters could easily be achieved.

Packaging design is, however, strongly associated with brand image. Will manufacturers be able and willing to simplify and reduce packaging without changing consumer perceptions of the contents? Will a highly visible low carbon footprint logo compensate and help maintain brand esteem? The current debate around nutritional and organic versus food miles and carbon footprint is quite confused, with for example suggestions that a product cannot be labelled organic if it has been air freighted. We advise against such hybridization of labelling which will confuse the consumer even more. Nutritional labelling – yes. Carbon footprint labelling – yes. Let's not try to merge the two.

Will we also see a revival in re-use rather than recycling? In parts of Europe – notably Germany and the Nordic countries – a few cents are still paid for each glass bottle returned by the consumer. Glass bottles may take more energy to produce but they use less fossil fuel and create less pollution than the plastic PET bottles that dominate supermarket shelves in the UK. Could consumers in the UK be persuaded to do likewise? They certainly were happy to do so once. Reviving the returns business will require investment in suitable cleaning and processing facilities. Is this something that should receive Government support, or perhaps even legislation as in Germany, or will the industry move towards re-use without external pressures?

While many in the industry may prefer to wait for changing consumer attitudes or Government/EU pressures the whole area of reducing greenhouse gas emissions and carbon footprint is one where the industry as a whole could, perhaps should, be even more proactive. Clearly the industry must play its part in reducing emissions and waste. The climate is now right for industry leaders to make innovative moves such as potentially moving back to glass and abandoning outer cardboard boxes on cereal packets.

4. Food miles versus sustainable development

Food miles are essentially the distance a food item travels from producer to final consumers. The concept has been with us for years but has gained in publicity and consumer awareness as concerns over air freight and the high carbon footprint it causes has increased. Arguing that discouraging consumers from buying fresh produce that has travelled halfway around the world will help save the planet from global warming is, however, an over simplistic view of the issues involved in the debate around food miles.

Crops provide much needed cash for subsistence farmers as well as foreign exchange and employment in these developing nations. A counter argument suggests environmental damage may be incurred through these countries moving from low-concentrations of traditional food crops to intensive cultivation of Western luxury vegetables with a resulting need for increased use of pesticides and fertilisers. Even so, many believe it would be presumptive for us in the West to deny development opportunities to impoverished African nations simply to balance an imperfect carbon equation when there are so many greater adverse impacts.

Changing the production processes to enable alternative shipment methods could perhaps help to reduce carbon emissions and thus counter any public antipathy for high food mile products. The need for such change could be forced on the industry if governments start to use higher oil prices or aviation fuel taxation as a means of controlling carbon emissions.

Within Europe, over the past decades it has proved more cost effective for manufacturers to concentrate production in larger, more centralised facilities, shipping goods across national boundaries to service distributed markets. If Governments use taxes on carbon-based fuels to cut carbon emissions, will the resulting change in this balancing equation make smaller regional production facilities with higher processing but lower local distribution costs a preferable economic option? Given current disparities in labour costs across Europe this may seem improbable but as we move towards 2012 and beyond, this could well change.

The food miles debate is not, of course, confined to air freight or cross-border shipments. Reports abound of locally produced foods trucked to a distant regional distribution centre only to be shipped back again a few days later. Localness is perceived by the industry as an important consumer preference. If this is so, and demand for local food becomes mainstream and no longer largely confined to farmer's markets, then the industry may need to reassess distribution methods to eliminate unnecessary food miles. Direct deliveries to supermarkets have almost disappeared in the UK other than for very high volume product categories. On the other hand local produce counters abound in France and other parts of Europe.

Centralised merchandising and distribution systems can conflict with the growing interest in local provenance and can increase both pollution and congestion and may therefore not always be the most environmentally friendly approach. Perhaps smaller local shared distribution facilities could provide an alternative, providing cross-docking operations where local produce could be transferred to trucks from the regional distribution centre already heading for local stores? Such models would require significant industry collaboration between retailers but if "low food miles" becomes the new "organic", a must have criterion for a significant proportion of shoppers then such activities could be easily justified.

So far, food miles remain a minority consumer pre-occupation. However, as with carbon emissions, it would surely be better for the industry to be proactive in seeking solutions before it becomes a major issue. Providing the way forward rather than being seen as part of the problem. Bananas, after all, have always been shipped unripened by sea. Similar approaches and new technologies could be brought into play to help reduce the perceived extravagance of many food mile journeys.

Execution – What will shape your future operating model?

5. Manufacturing issues: outsourcing and private label

Manufacturers are undergoing fundamental change and not just in the food and beverage arena. Global outsourcing of production is now commonplace be it for consumer electronics in China or soap powder in Eastern Europe. Brand owners are increasingly turning to contract manufacturing to cut costs.

Centralisation of production across Europe by major food and beverage manufacturers has been commonplace for years (as all those multi-language packs of cat food or biscuits testify). Multi-nationals continue to consolidate with focused plants often producing a wide range of lines that vary only in the packaging and brand name. Historical tariff barriers and other regulatory barriers to importation protected Western Europe food manufacturing until recently. The accession of many Central European states has changed this with the single market now extending to Poland, Romania and Slovakia. Production of many food stuffs is therefore shifting steadily eastward and manufacturing is consolidating still further. If brand owners can now simply move production to lower cost economies and focus on R&D and marketing then do they need to have any involvement in production beyond quality control?

This trend has several implications for the food and beverage industry. First, it is important to remember that consumers like branded products, but they less and less differentiate between retailers' and traditional manufacturers' brands. Secondly, private label in the UK is far more important and sophisticated than in many other countries. Retail own-brand products are no longer regarded as cheap or inferior alternatives but are often premium products ranked more highly by consumers than manufacturer's names.

Private label items from "Tesco's Finest", "Sainsbury's Taste the Difference" or Waitrose are at the top of the retail price range. Retailers have managed to segment their own label ranges balancing the sale of premium products with basic or economy lines offering good value and everyday low pricing.

If food and beverage companies no longer own their own production facilities but are essentially brand owners managing a supply chain and focused on product development and sales and marketing, then how do they differ from retail merchandisers working with a contract manufacturer? Moreover, both groups are potentially vying for the same outsourced facilities which are themselves moving eastward and consolidating.

So might we reach a situation where retailers and global brand owners are both, essentially, performing the same tasks: developing products, packaging and marketing and liaising with remote contracted production units who actually make the goods? How widely available will capacity at these remote contract manufacturers facilities be? And if a major multi-national retailer wants exclusivity from a particular contract manufacturer then will traditional brand owners have problems sourcing production at the best price? Issues such as this are likely to play a key role in discouraging manufacturers from widespread outsourcing of production. In many cases where production capacity is moving east, we are seeing food manufacturers being careful to retain control. This may be a wise strategy.

Competitive issues will clearly have a part to play not just between private label and manufacturer's brand but also between the retailers themselves. Time was when the likes of Metro, Carrefour or Tesco did not compete directly as they operated in limited and distinct geographic markets. This is no longer true. These major players compete in numerous countries and if they can gain competitive edge by using a particular efficient or innovative contract supplier who is to say they will not?

For manufacturers a key challenge will be do they remain just that: producers of food and beverages rather than global marketing operations? And if they do take the outsourcing route then how will they compete with major retailers who are also global players and often with an equivalent or greater purchasing power?

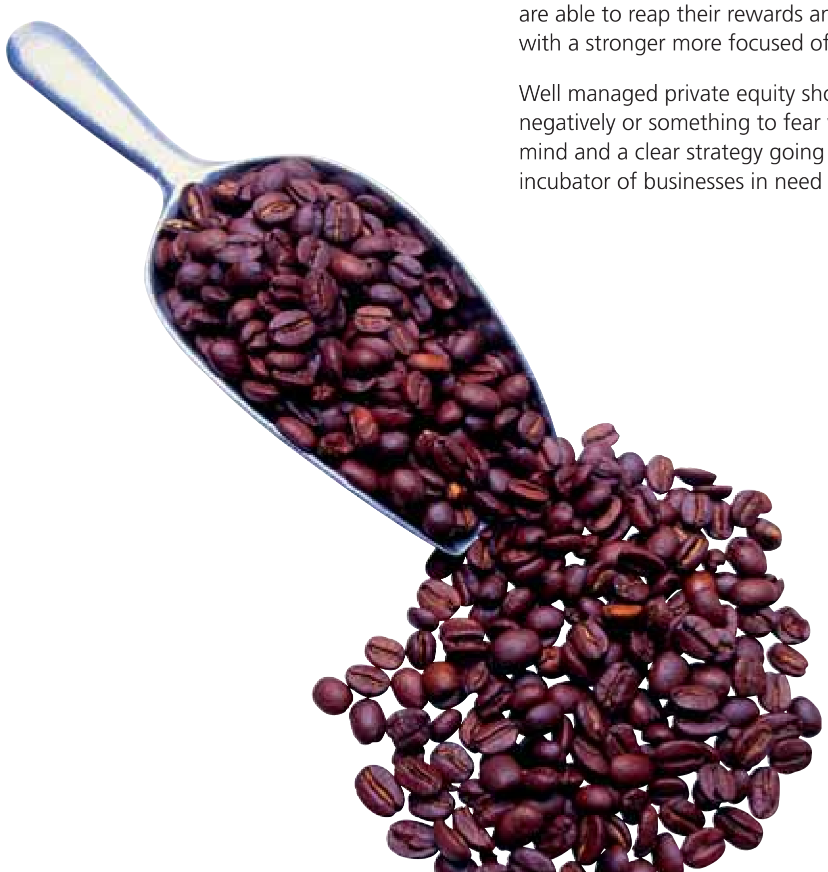
Perhaps most importantly, the food industry is far less globalised than many other categories of consumer products. National tastes and preferences play a key role in the interest in localness and authentication noted earlier. Most leading manufacturers will need to retain strong local in-market food production activities to give that preferred local flavour to their ranges. This may involve using a combination of smaller contract producers and their own specialist, local and premium facilities in order to satisfy consumers' more eclectic demands. Such exclusivity and local responsiveness could become an important differentiator for some market segments.

6. The role of private equity

Private equity has taken control of a significant share of the food and beverage industry over the past few years and continues to stalk some of the leading players. It is a move that has affected both retailers and suppliers most notably providing finance for Premier Food's acquisition of RHM earlier this year.

Private equity companies are often labelled as asset strippers, but they only invest where they can extract value and in the past public companies have not been averse to realising the value of their own assets as all those retail "sale and leasebacks" of a few years ago testify. One can also argue that private equity companies only succeed by delivering improved business performance and if management in target companies were doing that, then there would be nothing for private equity to improve upon.

Private equity companies are also accused of short-termism but many are prepared to play a longer game than some public quoted businesses driven by the need for quarterly announcements of year-on-year improvements in profits and sales. Managements in many public companies can certainly learn lessons from the private equity operators when it comes to deploying specific levers to deliver improved business performance, in particular through their unrelenting focus on identifying and building on core business strengths to drive profitable growth and value creation.



As discussed elsewhere in this report, food and beverage businesses need in many cases to reassess their strategies in the face of new opportunities but also multiple challenges. Should they be brand owners focused on capturing the imagination of the consumer, or producers focused on manufacturing products as cost-effectively as possible? Should a branded manufacturer own its own factories and distribution depots or should these be shed in order to focus on product development and brand marketing? Are there strategic acquisition targets that would held achieve strategic category dominance or transformational economies of scale? The same types of questions face retailers. Should they be more or less vertically integrated? What elements of logistics should be insourced or outsourced? What does the long term the growth of Internet shopping mean for some of the space offered by massive superstores – will it become redundant? Private equity finance can play an important role in such strategic reassessments, for example providing a useful catalyst to divest the business of activities which are no longer a good strategic fit and adding value.

In many cases, where private equity has bought into long-established food and beverage businesses we have seen an increased focus on brand, a culling of surplus SKUs and significant reduction in central overheads. These are all tactics that public company managements could also adopt to enhance performance but without the "zero-based" strategic thinking that private equity brings. Closer partnerships with private equity companies can provide a good way forward, for example, to fund strategic acquisitions. The private equity investors are able to reap their rewards and business is left in the longer term with a stronger more focused offering.

Well managed private equity should not always be regarded negatively or something to fear with good management. An open mind and a clear strategy going forward can provide a powerful incubator of businesses in need of new thinking.

In summary – a taste of things to come

The food and beverage sector in the UK is substantial, with consumer expenditure both in and away from home totalling around £153 billion[1] in 2005. While there is little overall top-line growth in the sector, this masks substantial changes in mix – both in what is consumed and where it is consumed. It is these changes that present both the challenges and opportunities for food and beverage businesses.

A successful future depends on how individual businesses, and the industry as a whole, respond and prepare to do business in what will be a somewhat different environment going forward.

The consumer in 2012

Today's consumers are sophisticated. They understand value versus price and are used to filtering the multitude of marketing messages aimed in their direction selectively. Tomorrow's consumers are going to be even harder to identify, convince, convert and retain, especially as media consumption habits fragment and new media became more important than old.

The impact of these changing consumer trends, behaviours and attitudes will continue to grow. This will further drive complexity and heighten the challenges facing the food and beverage business community.

Interestingly, the industry view of the future from our research is that the major future trends are, for the most part, all known quantities. The key challenge facing the industry would appear to be how best to deal with those future trends which afford the greatest opportunity for either success or failure. Anticipating the importance of these trends and the resulting impact on consumer demand and preferences will be key to future success. Whilst some of these trends will be generic in nature, there are many which will have very specific implications for individual sectors, channels and categories.

Whilst the industry may believe that the major future trends are all currently known this does beg the question as to what would be the impact of an unconsidered event or trend emerging. The chance of a significant geopolictical or economic discontinuity occurring sometime in the next 5 years is significant given current global conditions. The ability to respond to the unknown as well as the known issues is clearly going to be a differentiator for the would be winners.

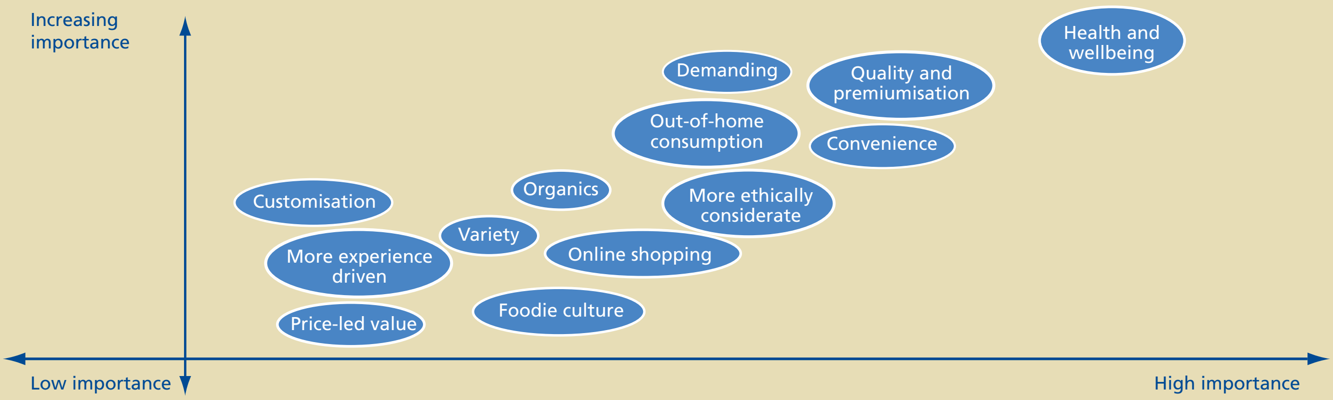
In addition to understanding the evolving complexity of consumer decisions and motivations, successful food and beverage businesses are going to have to contend with a shift in the demographic make up of the UK population. As noted earlier, over the next five years the UK population will continue to age with the percentage of people over 60 reaching 23% by 2012, representing a growth of 14.5% for that age group when compared with 2004[2]. With the post-war "baby boom" generation entering retirement, this segment of the population will include a significant portion of well educated, active, health conscious and affluent older citizens.

Business strategies that respond to the opportunities that these different groups represent will become more and more important to mainstream grocery retailers and food and beverage manufacturers.

An additional factor for the longer term is that the next few decades will see a massive shift in consumer wealth as the affluent baby boomers eventually die. They will pass on to the following generations far more wealth in the form of property and assets than any previous generation. Indeed, some commentators regard this transfer of assets as the greatest since the Black Death in the 14th century.

That transfer fuelled a spending boom among the inheriting survivors. While the predicted 21st century asset transfer may not be on quite the same scale, it is likely to lead to greater affluence at an earlier age in the next generation with a tendency to buy premium and luxury products as well as enhanced leisure experiences.

Comparative importance of key current and future consumer trends



Source: Deloitte research. Survey of 77 senior executives at leading food and beverage businesses.

1. Source: Food and Drink Federation

2. Source: Government Actuary's Department

Industry influences in 2012

Health and nutrition

As we have seen, industry is already well aware of the emerging nutrition, health and wellbeing agenda. As this increases in importance, stimulated by a virtuous circle of education, consumer preferences, regulatory action and commercial response, then it will become a Board-level priority for all major food and beverage businesses. Appropriate governance arrangements such as the appointment of a CNO (Chief Nutritional Officer) or similar corporate watchdog will become the norm, dedicated to ensuring appropriate standards. Nutrition and food safety will increasingly be seen as two sides of the same coin, both of great strategic importance to the business.

Moving towards 2012 we also expect that the industry will, for reasons of brand, reputation and a preference for self-regulation, choose to become even more actively involved in issues such as:

- Consumer education through the school curriculum and through other channels;
- Food labelling, both the ongoing debate around the pros and cons of alternative approaches to front-of-pack nutritional labelling plus the emerging discussion of possible carbon footprint labelling;
- Industry bodies taking a more proactive approach in representing the industry and publicly reassuring and educating the consumer.

Consumers may still demand unhealthy treats in 2012, but the industry may need to both modify formulations and couch its promotion of such products in the clear context of a balanced overall diet.

Environmental and social factors

As is increasingly obvious, going green is firmly on the agenda – for governments, businesses, lobby groups and consumers. Cutting greenhouse gas emissions, managing the carbon footprint and reducing food miles are all aspects of environmental concern that we expect will become increasingly important aspects of business and operational strategies across the industry in future.

Retailers and manufacturers alike will be expected to report progressive improvements in performance in these areas, as well as reduced waste, improved energy efficiency, increased recycling and more environmentally friendly approaches to national and local distribution, the wider global supply chain and manufacturing processes. We will see new consumer packaging approaches including an increase in re-usable transit containers and the end of the plastic carrier bag as we know it. All of these issues will also present significant opportunities to differentiate.

Attitudes to water use will also have changed significantly by 2012 with clean, fresh water increasingly seen as a precious resource that will become more and more expensive. Manufacturing strategies will be increasingly influenced by the availability of high quality, cost effective water sources.

We can expect a greater focus on animal welfare standards and the provenance of meat, dairy and other agricultural products. Tomorrow's affluent consumer will be willing to pay a premium for high quality, naturally produced foods. As a result, however, we can expect to see much tougher policing of provenance-related claims such as "organic". Difficulties such as avian flu, combined with concern about food miles, are likely to give a substantial boost to food produced close to home.

By 2012, we also expect that sensitivity to the social impact of business activities will have reached new levels. Major retailers and manufacturers will place an even higher priority on understanding how their stores and factories integrate into the local economy and community and must be able to demonstrate the positive nature of that impact. Both retailers and manufacturers face the need to strike the right balance between ensuring good employment practices wherever they do business around the world whilst reflecting local circumstances as appropriate. This also extends to sourcing strategies and the employment practices of suppliers. We can expect FairTrade and similar schemes to become much more widespread.

The future regulatory environment will demand much greater transparency of information about the environmental and social impact of both retailers' and manufacturers' activities. Comprehensive "triple bottom line" reporting will increasingly be the norm, covering the financial, environmental and social performance of the business.

Changing brand equity

What is clear is that consumers still love brands. However, the brand landscape is becoming more complex. Retailers are now as much in the brand marketing business as the traditional branded manufacturers. Consumer research consistently demonstrates that retailers' brands are more trusted than those of food manufacturers, which reinforces the need for the manufacturing segment of the industry to better present its case.

Private label products will continue to take a growing percentage of available shelf space, making major inroads into many of the areas which were once the sole preserve of the branded suppliers. The retailers have cornered some key high growth and high margin categories. Fresh chilled ready meals are an obvious example, almost to the exclusion of major branded suppliers. In addition, as discussed earlier, private label delivers some excellent lessons in brand extension and portfolio management. For many food manufacturers, the choice of whether (and how) to compete with or embrace private label is a key strategic choice which will shape the future development of their businesses.

As a result of the continued war for shelf space we predict that there will be as few as 1,500 brands in the average supermarket in the UK, with many familiar brands disappearing. The growing space allocated to non-food products will put further pressure on brand and product ranges.

It is not all doom and gloom though for branded suppliers. Retailers continue to look for innovative new products and categories to meet ever changing consumer demand. We will undoubtedly continue to see new emerging innovative brands and products such as Innocent or Walkers Sensations, which will claim significant share of mind and ultimately consumer spend. New products also typically command better prices and margins which should be good news for supplier and retailer alike.

In line with the growing multi-cultural society in the UK, we would expect to see more and more assortment and merchandising decisions being informed by the tastes and preferences of the local communities that each retail store supports. Loyalty card programmes will continue to offer valuable insight into which brands and products should be stocked by an individual store, reflecting the different preferences and needs of particular demographic and ethnic groups.

A tougher regulatory environment

The high levels of assurance dedicated to ensure the integrity of our food supply is very good news for consumers. For suppliers, new regulation in areas such as nutrition labelling, complete removal of hazardous substances, guarantees of traceability and production hygiene practices can also be a significant burden. This burden of regulation can be expected to grow further and enforcement will become more rigorous.

Smaller businesses may struggle to keep abreast of the changes, let alone fully comply. This will give added impetus to consolidation.

Continuing industry consolidation

Industry consolidation will continue unabated. This will be driven not only by the desire of companies to achieve category leadership and economies of scale, but also by the need to make the appropriate levels of investment in consumer and shopper insight-led innovation. We will see continuing bifurcation of acquisition strategies – some driven by regional and global category leadership strategies, others by national market and channel domination. We will also continue to see larger businesses which struggle to drive successful innovation-led growth seeking to acquire smaller businesses that bring innovative ideas, products and services. This will further encourage consolidation in the industry.

Scale and industry leadership will therefore become even more key enablers of business success in these areas. By 2012 we will see substantial further category consolidation, particularly of global brand-led businesses. We will also see other businesses more focused on building strong national brand portfolios acquiring complementary local businesses and taking over national food brands that are not viewed as strategic assets by global players. Contract and private label manufacturing businesses will also consolidate further to achieve effective economies of scale.

The rise of the hard discounters

The European hard discount movement started in Germany and has spread widely across Europe. Mainstream grocery retailers (assuming one can still make this distinction) generally struggle to find strategies that successfully compete with the value proposition offered by companies such as Aldi, Lidl and Netto. The store-in-a-store concept is not favourable with consumers. Establishing separate stores under a different fascia as part of a balanced portfolio seems to work a little better.

The hard discounters offer simple ranges and keen prices, with stores typically close to the town centre and offering easy parking. Their spread is causing another downward turn of the screw on prices and margins. The hard discounters also present new challenges to brand owners who will need to balance brand and merchandising values with the need for consistent volume. It is likely that leading branded manufacturers will do more business with the hard discounters as the norm going forward.

Technology and value chain integration

By 2012 we will finally be experiencing widespread adoption of much hyped but slow to take hold new technologies such as RFID and Global Data Synchronisation (GDS) for product information in the end-to-end supply chain. This will be encouraged by the combined pressures to improve availability on-shelf, take further cost out of the supply chain by reducing losses, improve labour efficiency and the need to provide ever higher levels of assurance of process integrity and traceability.

We also hope and expect to see real progress in integrating demand and supply planning processes across retailer and supplier facilitated by the GS1 sponsored alignment of data standards. This will have significant implications for the business processes and systems of both retailers and manufacturers. It may lead to the wider benefits of "favoured supplier" status for certain leading manufacturers with key retail customers, but such integration platforms will need to be seen as offering a level playing field and benefits for all.

The role of private equity

Private equity is already a major force in the industry and we expect this to continue into the future. It will play a substantial role in some of the changes described in this report.

Given specific business turnaround opportunities and the still fragmented nature of the industry, we expect to see private equity playing a role in future consolidation – both in building strong category positions and brand portfolios and in accessing the opportunities presented by economies of scale. If the potential returns are there – and they are – the availability of funds is not a problem. Private equity may cause businesses to radically challenge traditional operating models. For example, how can food businesses mirror the levels of innovation-led growth achieved by cosmetics and personal care products companies? How many branded consumer goods companies will own the majority of their manufacturing facilities in 2012? These questions are easy to ask. The challenge private equity investors face lies in finding the management talent that can develop and execute the strategies that will drive both revenue growth and eliminate unnecessary costs and create value for the investors.

Today's issues

Consumer
- Health and wellbeing
- Convenience
- Higher quality
- Authenticity and localness (value-for-time)
- More demanding and informed
- More out-of-home consumption
- Freshness
- More grazing and snacking

"The UK is one big melting pot of palates – and this is driving more adventurous eating habits"

Industry
- Increasing pressure on costs
- Lack of connection between brand and comsumer
- Growing regulatory burden
- Growing retailer power
- Sustaining consumer trust
- Attracting and retaining top talent

Future challenges

Consumer 2012
- Health and wellbeing
- Higher quality and premiumisation
- Stronger convenience
- More demanding e.g. organic variety customisation
- More out-of-home consumption
- Greater environmental awareness of products e.g. local origin of products, food miles
- More experience driven
- Price-led value
- Exploring new tastes

Industry 2012
- Health and nutrition
- Growing importance of environmental and social factors
- Changing brand equity
- Constant innovation
- Continuing industry consolidation
- The rise of the hard discounters
- An even tougher regulatory environment
- Service excellence
- Technology and value chain integration
- The role of private equity

Something to digest

There are challenging times ahead, certainly, as we move towards 2012. But there are also real opportunities for substantial growth within the food and beverage sector. Consumers, as we have seen, want more variety, greater choice, healthy products, occasion-relevant offerings and better quality and, of course, good prices. Businesses are faced with rising costs, increased regulatory controls, dynamic shifts in global economics and ever more demanding customers.

So, against the backdrop of this changing and challenging landscape, what can food and beverage businesses do to drive profitable growth and value creation? We strongly believe that there is real opportunity to create substantial value in the industry. Doing so requires businesses to do three things:

- Make the right strategic choices, decide where to play.
- Develop the right strategies, mobilise to win.
- Get the basics right.

Pillars of success

Make the right strategic choices, decide where to play

Be absolutely clear about **'where to focus'** based on real understanding of the available profit pools and realistically achievable capability to exploit these profit pools.

Develop the right strategies, mobilise to win

Be equally clear about **'how to win'** based on targeting the right consumers, through the right channels, with the right products and with value propositions that are relevant to both consumer and channel partner.

Get the basics right

Be relentless about **'what to do'** in pursuing operational excellence in planning, forecasting, marketing activation, channel partner investment and supply chain fulfilment, as well as in the ruthless pursuit of business simplification and back office.

The path to success

Make the right strategic choices, decide where to play

Making the right strategic choices now to prepare your business for 2012 is, we believe, essential. Every business has its unique strengths and core attributes and it is vital to identify and build on these – even if it requires some tough reassessment of strategy and, in some cases, significant cultural change.

For suppliers key issues will focus on brand marketing effectiveness, innovation and operational excellence. Is the company essentially focused on marketing and product development or does a significant part of its strength lie in cost-effective but high quality production servicing retail and other major brands? Many will conclude that they will need to do both.

How close is the business to its customers – be they trade or consumer? In the US, CPG companies are increasingly selling direct to consumers via the Internet, often using an alternative trading name to avoid upsetting major retail customers. While only 17% or so of consumers in our survey bought regularly via the Web, multi-channel retailing is expected to increase steadily over the next five years. For a niche business, is going direct a possible solution?

For mainstream players closer collaboration with channel partners will be key. Again, from the US, we are seeing growing interest in "flowcasting" with retailers sharing highly detailed store level data with suppliers in order to improve demand forecasting and enable production planning throughout the supply chain, not just one or two weeks ahead but up to 65 weeks out for longer term planning purposes. Many manufacturers will come to the conclusion that this sort of collaboration is essential for the efficiency, profitability and growth of their businesses The challenge for manufacturers will be to make the case that the investments required and associated returns are shared equitably with retail customers.

On which geographic markets should you focus? In the past major retailers like Wal-Mart, Metro, Carrefour and Tesco rarely competed head-on in the same geographies. Now they do. How can global suppliers achieve and maintain their market share in such a competitive environment? How much retail brand differentiation will be required and how will it be achieved? What are the pricing and margin implications of head-to-head competition between such retailers? What collateral damage may occur unless regulators step in?

A summary of the strategic issues food and beverage businesses should currently be debating and the choices to be made include:

- Are we clear about our future category and product portfolio focus?
- In which geographies should we operate? Should we continue to focus on growing market share in our home market or should we enter new, higher growth markets?
- Are we clear about our branded versus retailer private label strategies?
- Which channels to market will we exploit?
- Do we have a clear strategy to make the right acquisitions and divest non-core businesses?
- Are we sufficiently close to our key customers, what do we need to do to get closer?
- Are we sufficiently in touch with evolving consumer trends?
- Do we have an effective innovation engine room in our business? If not, what do we need to do to put this in place?
- What do we need to do to be in the middle of the current trend to healthier, more nutritious products rather than be left behind?
- What position will we take on environmental and social issues and the wider corporate responsibility agenda?
- What does "doing the right thing" mean for our business?

Develop the right strategies, mobilise to win

Having established the strategic vision, how can your business achieve its goals? As we have discussed in this report, achieving that vision might require material business change. The talent agenda will sit at the heart of this.

Engaging and enabling staff, offering a clear career path and providing satisfying working conditions and adequate reward will all be important. Many areas of the food and beverage industry have a poor employment image: long or unsocial hours, uncomfortable working conditions and low pay rarely make the sector a career of choice for the most able. This image clearly has to change if companies are to succeed in meeting future challenges from their internal resources. The winners are tackling and will continue to tackle these issues head-on.

Our study has highlighted that some sectors of the industry, notably foodservice and retailing, have particular problems finding staff of the right calibre, especially those with real leadership potential. This was the second most significant business issue for foodservice organisations, cited by 53% of the sample. Mobilising to win requires businesses across the industry to invest in management skills to equip them for the future.

Incentivising and retaining employees to reduce debilitating churn – currently over 100% in many areas of retailing – is an equally important priority for many.

Mobilising to win requires most businesses in the industry to address issues such as:

- Achieving a clearly defined operating model that supports the strategic aims of the business, potentially keeping separate and eventually divesting non-core assets.
- Equally importantly, ensuring readiness to integrate strategic acquisitions when they are made.
- Establishing a well-defined performance management framework linked to strategic goals and incentives.
- Investing in leadership and management skills.
- Building and promoting fulfilling careers.
- Strengthening commercial insight and decision making.
- Re-energising and focusing innovation.
- Driving the total value chain, not just the supply chain.
- Rationalising the business where appropriate.
- Retain and develop key talent within the business.

Private equity may have a role to play in such programmes of change, especially around acquisitions and divestments but also to provide the necessary working capital to complete the required restructuring programmes within a realistic timescale.

Get the basics right

Having a clearly defined strategy and well thought-through tactics are essential, but many companies must in parallel also address basic operational shortcomings as well. Stock management, wastage control, inadequate loss prevention, promotional compliance, poor planning and forecasting functions – the list of common inherent weaknesses goes on.

In buoyant times such shortcomings may be inconsequential but in difficult or highly competitive trading conditions they can make the difference between profit and failure. Some of these are also areas likely to be impacted by future regulation such as food traceability laws that demand much tighter control and awareness of inventory movements.

All are also areas where effective information technology solutions can be important enablers, but levels of investment in IT across the industry remain relatively low. IT costs currently run at no more than 1.5% of turnover in retailing and food manufacturing and are lower for many, in spite of the process and relatively information intensive nature of the industry. Recognising the important role that IT has to play is crucial in getting the basics right.

A summary of the operational issues most businesses need to address across the industry include the need to:

- Eliminate unnecessary complexity – in particular rationalising brand and SKU portfolios and focusing effort and investment on the winners.
- Improve discipline in managing commercial spend – price setting, pricing execution and trade promotions.
- Achieve operational excellence – streamline and simplify, use 6-sigma techniques to underpin a culture of continuous improvement in manufacturing and operations more broadly.
- Establish strong sales and operations planning discipline – balancing demand and supply in the medium term, sharing data and working in close collaboration with customers and suppliers.
- Standardise, strengthen and streamline operational and administrative processes – eliminating non-value adding activities and redirecting resources towards innovation and growth.
- Ensure one version of the truth – establish and integrate information systems to ensure integrity, consistent and immediacy of operational performance information.
- Embed quality – regulatory compliance should come as a by-product of a deeply held quality culture that is also reflected in integrity of process and systems design.

Continue the debate towards 2012

We are always keen to engage in discussion with the industry and would be very happy to hear your views.

To join the debate, or for further information about the future of the food and beverage industry please contact one of the team members below or visit **www.deloitte.co.uk/foodandbeverage.co.uk**

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