Structural Consumer Upheaval: How The Meat Sector Can Adapt


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Heather L. Jones / (804) 780-3280 / hljones@bbandtcm.com

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Seismic Shifts in Consumer Behavior

• Increased focus on health profile of food (perception can be reality)
• Greater demand for fresh, convenient meals; rejection of processed product
• Production process critical (labor, animal welfare, GMO, ABF, etc)
• Backstory important factor (local, producers’ story, etc)
• Rampant use of social media; everyone an expert
• Blurring of dayparts; less meals and increased snacking
• Greater distrust of big brands and companies
• Fragmentation of purchasing venues; consumers shopping as many as five different channels (supermkts, e-commerce, $ stores, club, mass, ltd assortment, C-stores, etc.)
What’s Changed?

**Changing Consumption Patterns**

- According to Nielsen, >40% consumers say natural, GMO, etc. important considerations in food purchases.
- Organic sales rose nearly 3X over past decade.
- Consumption of fresh prepared foods expanding at approximately 5X the rate of center-of-the-store processed foods.
- 3 squares in decline; being replaced by multiple snacking occasions. Proliferation of snacking options.
- Food no longer a one-stop shopping experience. Cost, selection, and convenience all driving consumers to patronize multiple channels.

**Fast-Casual Consumer Profile**

<table>
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<tr>
<th></th>
<th>2011</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prefer to eat foods grown locally</td>
<td>70.0%</td>
<td>87.0%</td>
</tr>
<tr>
<td>Believe responsibly grown ingredients taste better</td>
<td>76.0%</td>
<td>86.0%</td>
</tr>
<tr>
<td>Believe it is impt to buy organic for certain food items</td>
<td>61.0%</td>
<td>73.0%</td>
</tr>
<tr>
<td>Try to eat meat raised responsibly</td>
<td>53.0%</td>
<td>69.0%</td>
</tr>
</tbody>
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Source: Chipotle Q4’14 Earnings Conf Call
How These Changes Benefit Protein Producers

• More Robust Demand
  • Protein fits well with consumers perception of healthy diet. It is also well-suited for fresh, convenient on-the-go eating.
  • Consumption of ‘fresh’, including protein up >20% between 2003 and 2013.
  • According to Nielsen, sales of packaged foods with protein-related claims up >50% over last four years to $7.5B.

Source: NPD, BB&T Capital Markets
Challenges

• **Scrutiny of Production Processes – Arguably the Biggest Issue Facing Producers**
  
  • Animal welfare – increased humanization of animals; aggressive animal rights organizations; social media where everyone is an expert; livestock production not well understood by the general public; costs.
  
  • Traceability/Food Safety
  
  • ABF – a concern that is gaining traction; unlikely to go away; significantly higher costs, but potentially higher margins.
  
  • Organic – a core, very devoted consumer group, but size potential capped.
Opportunity

• **Strong Demand Growth**
  • Sales of specialty product, such as ABF and organic, is growing at a strong double-digit clip. Good visibility into continued robust growth trends.

• **Potentially Better Margins**
  • Most organic producers’ margins are no better than conventional producers and, oftentimes, lower. Some alternative production processes, however, offer enhanced margin potential.

• **More Stable Markets**
  • Given the niche and growth nature of the end markets, pricing should tend to be more stable than more conventional, commodity-like end markets.
How to Adapt

• **Convert**
  • Convert to alternative production process and market product. Demand outstripping supply, so many potential customers. Significant upside comes with substantial risk.

• **Align with end customer**
  • There is a growing trend of backwards integration (across many food sub-sectors). Less potential margin upside, but a lower-risk strategy. Pick the winners.

• **Don’t Change**
  • There is likely a relatively low ceiling to penetration of organic, due to prohibitive costs. Alternative processes focused upon ABF and animal welfare likely have more runway. Still, higher costs likely to limit the theoretical penetration of those, as well. The predominance of the market will remain, in our view, relatively conventional with possibly a few tweaks.
BB&T Capital Markets rating distribution by percentage (as of February 17, 2015):

<table>
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<th>All companies under coverage to which it has provided investment banking services in the previous 12 months:</th>
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<tbody>
<tr>
<td>Buy (1)</td>
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<tr>
<td>Hold (2)</td>
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<tr>
<td>Underweight/Sell (3)</td>
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<tr>
<td>Not Rated (NR)</td>
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<tr>
<td>All companies</td>
</tr>
<tr>
<td>Buy (1)</td>
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<tr>
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Buy (1): estimated total return potential greater than or equal to 10%, Hold (2): estimated total return potential greater than or equal to 0% and less than 10%, Underweight (3): estimated total return potential less than 0%


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