The Movitz Group

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State of the Natural Consumer Package Goods Industry

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With two-thirds of 2016 elapsed and planning for next year soon upon us, it's a good time to assess the forces shaping the business environment and consumer culture, and their impact on the natural consumer products industry. And boy are there impacts and changes afoot.

This is not the usual natural industry update because this is no longer the usual environment. A lot of attention is on an implied one-way shift of mainstream businesses and investors beginning to adopt the philosophies and values of the natural products industry. Seemingly the traditional food industry is looking to the natural products industry for inspiration. In turn, the natural products industry, consumers, workers, animals, environment and earth benefit. Yes, this is happening, but it is not the whole picture.

Macro forces in our culture are affecting all of us, including changes in, on, to and for the natural products industry. So important are these forces to all businesses that if the natural products industry doesn't adapt as well, even it will become followers at best, irrelevant, or at worst, part of history.

Market fundamentals are being impacted by seven macro forces:

- ✓ Consumers
- ✓ Technology
- ✓ Science
- ✓ Regulatory
- ✓ Economy
- ✓ Health Care
- ✓ Climate Change

These macro forces are converging to pull and push the natural products industry. It's being pulled into the mainstream, and being pushed to adopt more sophisticated business practices, technology and consumer marketing that used to be thought of as stuff for the mainstream business world. Guess what? The natural products industry is in the mainstream, mainstream is converging on it, and consumers demand more from all businesses.

Executives across industries the last year and longer have proclaimed, sometimes with exasperation, that the magnitude and speed at which marketplace changes are occurring are unprecedented. The newest influencer in the mix appears to be technology, so it seems reasonable to argue that technology is the parent of all forces impacting everything, and has given birth to a modern day 'industrial revolution'. However, technology by itself is useless without humans to create and interact in partnership with it (Artificial Intelligence aside). That interaction stems from the human mind.

It is the human mind - our thoughts and our consciousness, individual and collective - that could very well be argued as the parent of all forces.

No matter what side you are on in the age-old debate of whether marketers create or respond to consumer demand, in The Omnivore's Dilemma, Michael Pollan notes that ecology teaches us 'we can never do just one thing': What we eat can never be separated from how it was grown and how it reached our table (inclusive of processing, transportation, labor, etc.). So too when considering the macro forces impacting culture and business today.

So with changes imposed upon us, how do we respond? It's easy to feel uncomfortable, resist and retreat to the safety and comfort of what we know. Turns out there's a good reason for this: change forces us to lose a part of our identity[i]. No one likes the notion of losing a part of ourselves, but without change and challenge there is no growth. Our inborn nature is to grow, and if we are not growing then we are stagnating or shrinking, which eventually means we disappear. But change can be unsettling, even scary.

We might fear having to accept a product (or place or company) we devoted ourselves for years doesn't fit the realities of today any longer even though it was right for a time; we might fear the uncertainty of new plans; we might fear how consumers or business partners will respond to our new efforts; we might fear not being first or not being right. The good news is that we're all going through this together and we're all learning, but we can't know true potential, purpose, or optimization until we have the courage to let go of past notions and embrace the flow of what is.

As a matter of practicality, making incremental adjustments are fine if they are part of a grand vision that aligns to the wholesale transformation from how we used to think about things to where things are going. In today's environment, incremental adjustments as an end-game strategy will simply lead to redefining the mix of followers and leaders.

The key parts of four macro forces are summarized below. The first two related to the consumer and technology are expanded upon in this release. The macro forces of regulatory and science developments will be covered in a subsequent release. The three macro forces of economy, health care, and climate change will not be addressed in this series.

Key elements of the **Consumer Macro Force** dynamic:

1. Generation Millennial: coveted & influential
2. Generation Z: coming up next
3. Personalization: customized for "me", control on my terms
4. Personal values influencing shopping behavior
5. Seeking information about wellness from trusted social circles
6. Changing eating and shopping habits
7. Have an experience, not a shopping trip

Key elements of the **Technology Macro Force** dynamic:

1. Mobile & ubiquity of devices
2. Personalization
3. Direct to consumer marketing & fulfillment
4. Internet of Things
5. Ecommerce

Key elements of the **Regulatory Macro Force** dynamic:

1. Non GMO Labeling
2. Nutrition Panel Facts Update
3. Menu Nutrition Labels in 2017
4. Revised NDI Guidance
5. FDA Definition of "Natural"
6. USDA Defining "Food Deserts"
7. Medical/Recreational Marijuana; CBD Oil
8. QAI Transitional Organic Certification

Key elements of the **Science Macro Force** dynamic:

1. Microbiome in the Intestinal Tract
2. Food as Medicine
3. Cultured "Meat"
4. Superfoods
5. CBD/Hemp/Medical Marijuana
6. HPP Food Processing

One final substantial influence in the natural consumer package goods industry that must be recognized is the influx of private and public investor capital and resources. Veteran natural food entrepreneurs, former CPG executives, angel investors, venture capital and private equity funds targeting 'better for you eating as a growth opportunity' are burgeoning, while funds established by traditional CPG total more than a half-billion dollars. Premium products are the new tech start up world for investors.

To traditional CPG companies these investments provide a platform to learn, grow, and mitigate the risk of unfamiliar products, supply chains, and go-to-market strategies. One study surveying company types across sectors found most startup/corporate interactions used to begin at the negotiation table, but corporations and startups increasingly recognize the benefits of earlier interactions. Corporations said that 67% now prefer working with startups at earlier stages, mainly "to explore new technologies and business models". An overwhelming 82% of corporations now view interactions with startups as "somewhat important" to "very important", and 23% indicated that these interactions were "mission critical". Innovation efforts, it seems, are no longer just nice-to-have programs within corporations.[ii]

The same study notes that startups are seeing corporations in a variety of roles—no longer are they cast solely as either "competitors" or "potential acquirers". As the startup culture matures, founders are realizing that corporations have a lot of wisdom, experience, and resources to be leveraged, and that perhaps working with, rather than against them, could be the smarter way to go. Also, in a post-Uber and Airbnb world, startups realize that the power is not only with large corporations, and that leads them to be more selective with whom they choose to work.[iii]

The bulk of company and entrepreneurial targets for all of these new investors and funds are emerging and thriving companies, built on a foundation of authenticity, transparency, mission and a deep connection to product attributes and positioning promise that resonate for the core as well as transitional consumer. The natural consumer package goods industry has from the beginning been defined by bleeding edge innovation and incubation. The influx of professional capital and business know-how underscores the growth trajectory of the sector. Although the buzz of investors in the industry creates excitement, all companies are subject to the same macro forces. This is not a time to be complacent.

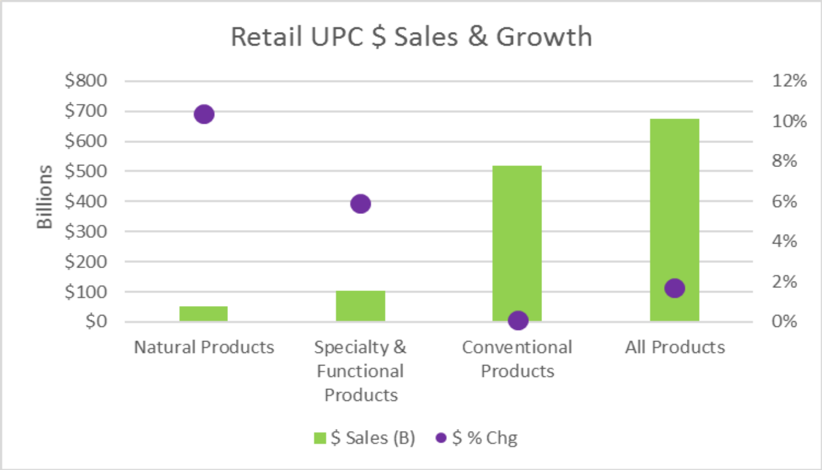
The Baby Boomer generation and Generation X still comprise almost 50% of the population, but it is the Millennial and Generation Z generations capturing all the attention because their distinct habits, behaviors & motivations. Millennials are defined as people aged 18-34 and number about 80 million (25% of the population). Too often an entire generation is amassed together as "the" reason something is happening, but like any other group, there are subsets with different likes, dislikes, inclinations, intentions and dynamics. A few distinct economic facts: 41% have kids, 50% higher than Baby Boomers; 27% are still paying off student loans; 75% only buy what they need, not what they want.[iv]

Generation Z is aged 17 and younger, numbering about 75 million (23% of the population). The Hartman Group notes they are the first generation to grow up completely digital. No question is unanswerable. Gen Z is twice as likely to be ethnically diverse/non-Caucasian which means they're more exposed to global food experiences. They are at an impressionable and inquisitive age in which they are busy forming perceptions of the companies, brands, products and marketing messages they encounter on a daily basis. Gen Z is well positioned to be the most diverse generation yet and is the first generation to truly grow up alongside the digital age'.[v]

A lot of research tells us that consumers want

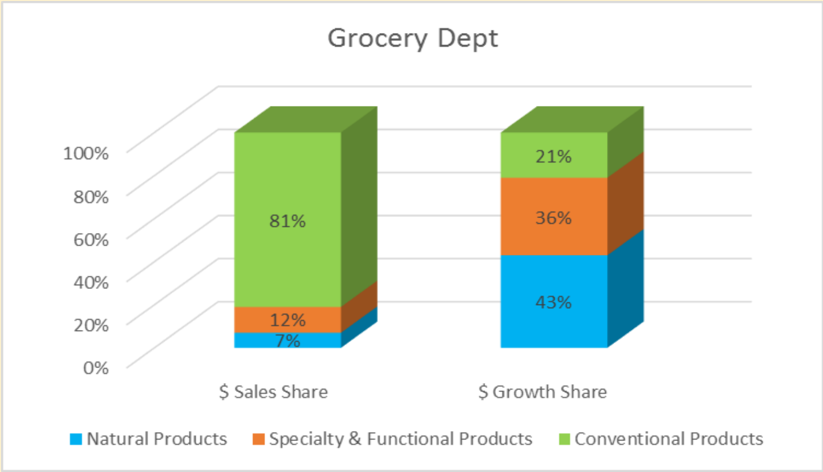
- Companies to be: transparent, authentic, trustworthy, accountable, purpose driven, mission based, mindful, sustainable, socially conscious, preventing waste, connected (to their consumers as well as the humanity of their farmers & suppliers)
- Products to be: fresh, less/minimally processed, all natural, organic, locally grown, simple and clean ingredients, nutrient dense, gluten/allergen free, plant-based, high fiber, a superfood, hormone free, cage free, animal friendly, wrapped in plant based and/or compostable packaging materials

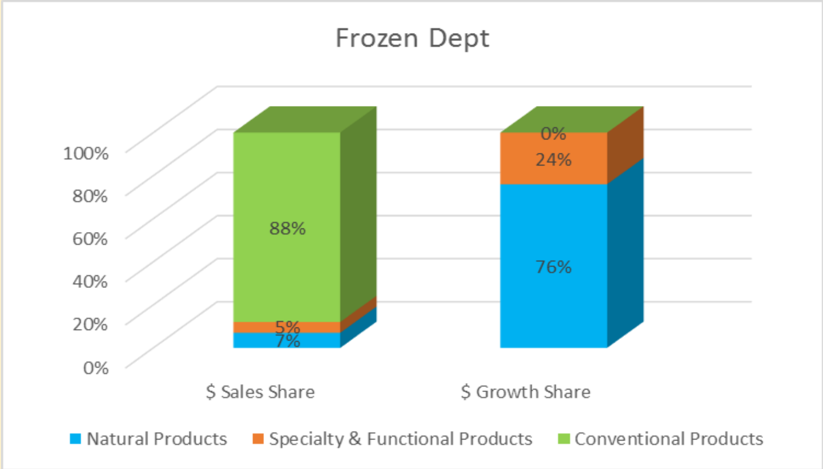
The following chart from SPINS demonstrates that companies and products that meet these criteria and positioned to these attributes are not only driving growth, but outpacing sales growth of conventional/legacy products across retail outlets by as much as 10x.[vi]



Source: SPINSscan Natural and Specialty Gourmet (proprietary), Conventional Multi Outlet and Convenience (powered by IRI), Total US, 52 weeks ending 8/7/2016. UPC coded items only.

Peeling this back one layer reveals growth in the conventional Multi Outlet channels is derived almost entirely from natural & specialty products. Below are two examples from SPINS for the dry grocery and frozen foods departments, showing the difference between share of sales and share of growth by product segment. In the grocery department, natural & specialty products comprise 19% of sales but 79% of growth. In the frozen department, all growth is from natural & specialty products while conventional products are actually in decline.[vii]





[v] Source: SPINSscan Conventional Multi Outlet (powered by IRI), Total US, 52 weeks ending 8/7/2016. UPC coded items only.

Painting the consumer profile and opportunity for marketers with a broad brush, about 20% of consumers have strong beliefs and motivations to know their food, how it's made, where it comes from, and the companies involved in the process. On the other end of the spectrum, about 20% of consumers are uninterested, unwilling or unable to engage in their food as other than something to eat when they're hungry. Brands large and small have attempted to reach the (seemingly less complex and more familiar) health mindedness of the 60% of consumers in the middle who are more apt to take incremental steps to wellness. Successfully engaging them requires the new lens through which we are all understanding today's consumer.

Before leaving the topic of consumer values influencing shopping habits and the resulting changes in what's selling, one note about private label - As retailers have elevated their game on private label by developing on-trend products instead of offering a lowest common denominator or commodity categories and basic fare, consumers are taking notice (Walmart's discontinuation of its Wild Oats Organic notwithstanding). It's not just about adding a dozen or so skus to the mix of a category – we're also seeing testing and expansion of entire retail locations based on premium private label: 365 by Whole Foods Market, Main & Vine by Kroger, Aldi Organics, and of course Trader Joe's. A premium private label product at a premium price is still usually less expensive than a national brand, allowing more consumers to partake in the healthy and premium franchise than could otherwise overcome the typically higher price hurdle of national brands. In fact, while more shoppers recognize a role for private label in their homes, the adoption of private label as a means to save money is slowing. However, one study shows shoppers have increasingly noted less difference in terms of quality or reliability between private-label and brand-name products. Shopper preference for brand names today is seemingly more linked to emotional connections and image than to the products themselves.[viii] National brands need to rethink the competitive threat from private label.

Consumers, and millennials in particular, want personalized product offerings and a direct relationship with the companies they support, or rather from their perspective, they want the companies to have a direct relationship with them. They want the company to "know" their preferences, motivations, and what has meaning to them, and offer products accordingly – similar to how their iPhone offers limitless unique services. They don't want to buy the same makeup their mothers bought or eat the same cereals their fathers ate. This is a form of self-expression and personalization.[ix]

Digital and mobile engagement in food consumption is expanding, and having a growing impact on decision making.[x] Consumers and shoppers are gravitating to companies who can discreetly leverage big data - social media, online behavior and click tracking, and similar technologies - that enable marketers to have a one to one relationship with them, engage in a dialogue, and personalize an experience or process for them. Digital, addressable, fragmented media shift the currency from tonnage [of traditional media advertising] to precision, mitigating the traditional scale buying advantages of large firms. Most smaller firms actively embrace the cost-effectiveness of digital, unshackled from the legacy analog traditions and processes.[xi] If consumers are gravitating to these digital formats, it means they're abandoning companies that don't.

On the personalized nutrition front, because an integrated and holistic solution has not yet emerged, a "biohacking" movement is emerging. Consumers use cutting-edge health technologies to gauge precisely what's going on inside their bodies and adjust their diets accordingly. For example, web-based Wellness FX allows customers to have their blood tested for things like anemia, thyroid dysfunction, or nutrient deficiencies, then use a computer algorithm and physician consultation to choose foods and supplements for them. Pathway

Genomics uses DNA testing to help guide consumers, via practitioners, to the ideal way of eating. UBiome enables people to send in a stool sample and find out precisely what bacteria types reside in their gut, what they are missing, and how to gain a better balance via food. And according to Mintel, 18 percent of people use some sort of wearable technology to track diet and fitness, and another 31 percent want to try one.[xii]

Mobile technology & the ubiquity of devices means instant access to any information possible - good, bad or ugly – wherever and whenever someone wants it. More shoppers are using digital tools and social media to help them plan, shop for and share food experience. Easy and instant access to the world of information empowers consumers to learn and shop on their terms. The consumer is now in control, and 70% of Millennials use their phone while shopping for a shopping list, contacting another HH member, searching for coupons, or looking up recipes.[xiii] According to Deloitte, digital interactions influenced 64% of retail store sales during the holidays. In addition, consumers are turning to their social circles, families, friends, and online reviews for health and product information, and often seek multiple opinions. According to The Integer Group and M/A/R/C Research, the number of shoppers asking the opinions of friends and family has tripled to 21% from 2009 to 2014. Marketers and advertising are not seen as trustworthy, transparent or authentic as the no-spin feedback they get from their peers or acquaintances, further emphasizing the need for brands to embrace these qualities while being consumer centric.

We're in the early stages of how the 'internet of things' will start to affect how, when and where people shop. "The IoT" means devices communicate with each other to respond and react automatically, but more importantly anticipate and take proactive action. Some examples include self-driving cars, smart thermostats, and biometric monitors (i.e., Fitbit). IoT technologies are eliminating checkout lines, providing frictionless payment methods, helping customers find products, delivering personalized service, eliminating not finding the right product in the store by shipping it to them via in-store kiosk, and more. By digitizing business processes through connecting smart devices and sensors…retailers can reduce or eliminate points of friction that negatively impact customer experience, sales or operational efficiency.[xiv]

According to Juniper Research, retailers are expected to spend $2.5 billion in Internet-of-Things related investments over the next five years in the deployment of devices and sensors that collect and exchange information around consumer, inventory, and maintenance. Meanwhile, the number of IoT connected units is forecast to reach 38.5 billion by 2020. Data has become a new currency in retail and understanding how to apply it intelligently to drive desired outcomes such as delivering on the promise of personalization and creating mutually beneficial engagements between customer and the brand is the essence of future ready retail.[xv]

A handful of changes in eating habits are transforming the notion of meals:
What or how we eat:

- Snackification: Gone are the days of the idealized three balanced meals a day. Snacking is now so entwined in our food and beverage culture that it makes up fully half of all eating occasions. Snacking is no longer about a specific product category but rather about a set of behaviors — a way of eating and drinking — a kind of occasion. In other words, anything and everything can be a snack — and increasingly is.[xvi]
- Dieting is about lifestyle: People no longer say "I'm on a diet"; they now say, "I'm avoiding gluten and dairy; I eat paleo; I'm vegan"
- Fat Focus: Fat is now about source rather than quantity. Healthy fats are desired & sought after.
- Healthy Indulgence: Consumers want it both ways – not a fat free deflated version of a treat rather the full flavor treat but with simple and healthy ingredients

Where & how we acquire or prepare our food:

- No longer limited to preparing a meal at home, or going out to eat.
- Newer: home delivered meal kits, home delivered prepared foods, prepared foods picked up from the store, food truck
- Next: meal kits to pick up from the store
- Multi-channel shopping is now the norm, and immediate consumption is rising[xvii]

The days of the weekend grocery store stock up trips are fading fast. The grocery shopping errand grinds into a chore for the busy lifestyles of today simultaneously while technology enables the transformation of this 'chore'. Under a tight schedule, pushing a cart up and down aisles of white linoleum floors under bright fluorescent lights with a product's promoted value being only its price, then waiting in line to pay, is somehow losing its luster. More shopping trips involve immediate consumption rather than pantry loading, and consumers are increasingly shopping multiple locations and multiple formats during the same shopping trip to complete their list. According to a study by Coca Cola, shoppers are impulsive - 74% of shopping trips included no preparation and are more about 'grab and go'. Consumers are prioritizing 'experiential value'[xviii]– they want an experience, not a task, thus is occurring a convergence of food service and retail, the restaurant and the grocery store. Savvy retailers are adding beer & wine bars to foster a social scene, adding classes in the esoteric art of food like butchering, sausage making, or fermenting, and providing a platform for local farmers and activists to teach about authentic, back to the roots, and holistic living with the earth.

Fundamental changes are also taking place in value chains. Information conventionally flowed in one direction where retailers would display in their stores the appealing features of products produced by manufacturers and consumers would make purchases. It is expected that the future will see a further spread of value chains based on co-creation in which value is generated through collaboration between companies and consumers, and among consumers… As this trend unfolds, middlemen will be sidelined, and retailers, who traditionally played the role of connecting manufacturers and consumers, will thus face the risk of being eliminated unless they adapt to the new age and provide added value.[xix]

A brand's role in this is to be a shopper information partner to the retailer. Having said that, there's a lurking residual to the convergence of e-commerce, the consumer's desire for personalization, and the brand's ability to leverage data and analytics to create one-to-one marketing: selling direct to the consumer. For a brand in fact, selling direct to a consumer gives them direct access to highly valuable information on their shopper's profile and habits. Does it make sense for brands to own that consumer relationship, including order fulfillment and support? Technology is evolving to enable brands to do this, but there are strategy, operation, identity and retail/business partnership considerations too. It does boil down to the value equation in the path to a consumer. If the current players in the chain today don't add value in the chain of tomorrow, it's time to rethink how to remain relevant, and better yet, grow and win.

And what happens when technology, retail and operational know-how converge? Amazon.com. Then what happens when drones are perfected to crack the code on delivery speed? In 2015, 7% of shoppers bought groceries online in the past 30 days. In 2016 it was 10%[xx]. This may not sound like much but it's almost a 50% increase.   How disruptive is e-commerce to traditional brick & mortar retailing? An 11 on a scale of 1-10. Do retailers need to pursue a seamless, Omni-channel strategy? Yes, as an interim 5-10-year play. Is there still a place for brick and mortar? For sure, but in 10 years it won't look like it does today. Where does this ultimately lead? If the same can of x, box of y, or jar of z is available from dozens or hundreds of outlets for just pennies difference in pricing, it doesn't make sense to use space in store as an expensive exhibit. Create an e-commerce solution for center-store, non-perishable everyday & ubiquitous items and ship them to customers from a warehouse. Downsize the brick and mortar location and make it all about adding value to your shoppers' time and meeting their lifestyle needs: differentiated items, unique displays, high quality produce, fresh prepared meals or meal kits, in store restaurants, on site butchering to order, micro farms and gardens either in-store or adjacent to, and services and sessions to help them and their families and friends relax, grow, and thrive. Bits and pieces of this are emerging now. It's only a matter of time when it becomes commonplace…

There's plenty of consumer research and publicly available information quantifying the degree to which all of the above is occurring. Numbers can vary depending on the source, methodology, timing and scope of studies, but are directionally similar. What is striking is the disproportionate influence and sense of urgency the new or emerging trends have on strategic adaptation by legacy businesses. Groups or responses factoring in the 30%, 20%, and even 10% range are deemed significant enough to move the needle and mobilize strategy and planning. That means the emerging collective consciousness, while still a relatively 'smaller' part of the overall picture, is having a profound influence on how it expresses itself through the marketplace. Why? Because these expressions are simply the right things to do.

Perhaps, but looking at these numbers in the reverse means that 70%, 80%, and 90% of groups or responses are not yet (or won't be) aligned to these trends. We must recognize the existing market of highly processed industrial food represents the vast majority of existing assets and revenue for brands, suppliers and retailers.

Is highly processed industrial food going away entirely? At some point yes but it's likely on a ten-year horizon before we see it in the rear view mirror as it exists today.

We are thus in a period of transition:

- The consumer market is defined by new terms of desires, behaviors, connections and principles.
- Companies are reacting and responding to varying degrees, updating their supply chains, business models and financial structure to account for the new normal.
- Technology is quickening the pace and increasing magnitude of opportunity (or of falling behind).

In this transition process, legacy conventional products by necessity will become less processed, use cleaner ingredients, and be healthier. Traditional retail will employ bolt-on ecommerce and digital marketing solutions on the path to redefining their business model entirely. Farmers and suppliers will need to grow and process in ways in which the market is moving to build supply to meet the new normal demands. Some investors will exit the food arena while the transition occurs and uncertainty looms, returning in time when financial fundamentals have normalized or stabilized in newly redefined models. Other investors will bet on the leaders, innovators and disruptors of today, buying in to the vision of tomorrow.

Finally, as mentioned early on, core healthy consumers seem to have an outsized influence on how the future of food will be defined. The 60% of consumers in the middle are likely to be moved up the ladder to some degree of integrating core shopper beliefs into their lifestyles, to be more mindful, holistic and committed. But the uninterested and disengaged 20% will benefit greatly as well. For them, if the food system exists simply to feed them, their ability to live well based on their state of health can only be as good as the inputs into their lives. The food they and we consume is a fundamental building block to health. The longer tail of a better food system is thus not just in profits, but in better lives as well. Ideally this would not be the long tail but instead a primary motivation of the market makers. The changes consumers are demanding of these companies certainly feels like it's moving in this direction.

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