JULY 2024

MORNINGSTAR Industry Landscape

Packaged Food

Firms that sell food products for at-home and away-from-home consumption.

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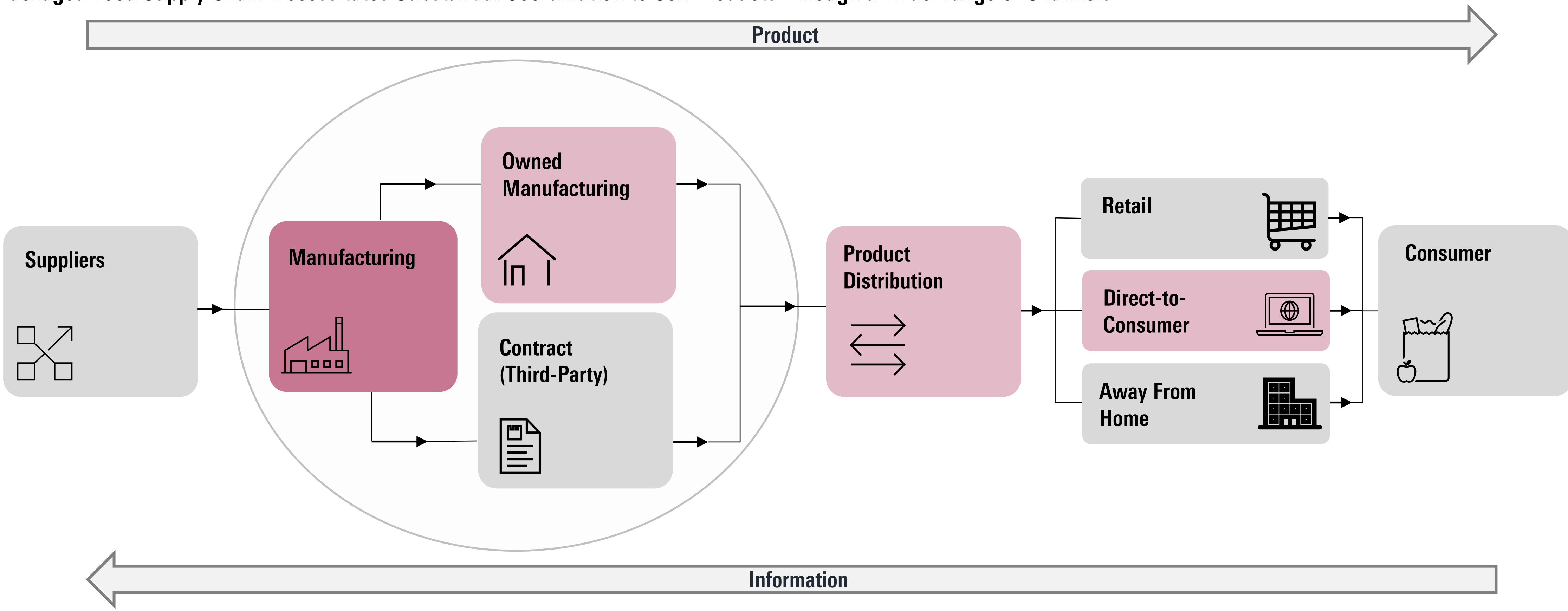
Executive Summary

Moats abound in this mature industry.

Industry Map

The packaged food industry manufactures and sells food for human and pet consumption through a wide array of retail channels including mass, grocery, drug, discount, and e-commerce. In addition, various packaged food offerings are sold into restaurants, travel and leisure destinations, healthcare facilities, and educational establishments. Finally, some packaged food firms distribute directly to consumers, affording more timely insights into the consumer response to new products.

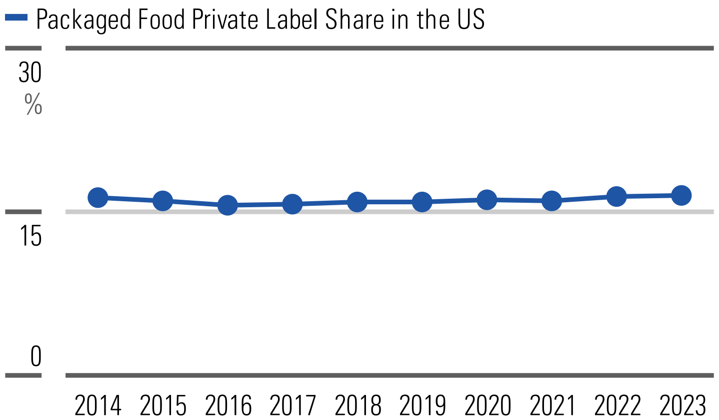
Packaged Food Supply Chain Necessitates Substantial Coordination to Sell Products Through a Wide Range of Channels



Source: Morningstar. Note: Gray=External Stakeholders, Dark Pink=Direct Firm Control, Light Pink=Partial Firm Control.

Key Industry Themes

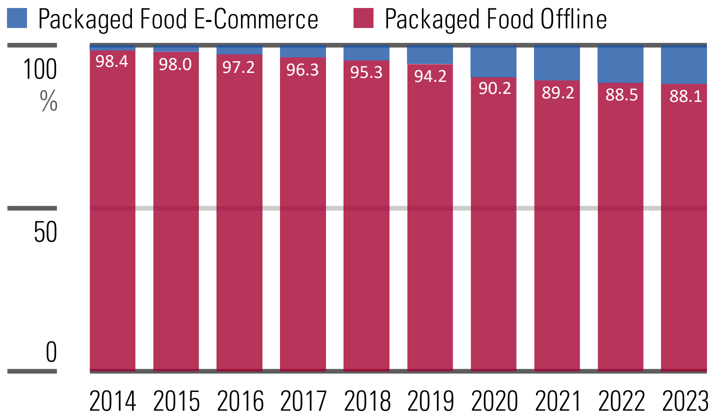
Private-Label Share Hasn't Oscillated Much Historically



Private-label market share has generally held steady over the past 10 years—at a midteens level on a value basis.

- It has won out in more commoditized categories like processed fruits and vegetables, dairy, and meat, amassing around one third or more of each category.
- We've also seen value options find favor in aisles where innovation has been lacking.
- From a macro perspective, consumers will likely continue adding private label to their baskets when the economic backdrop sours.

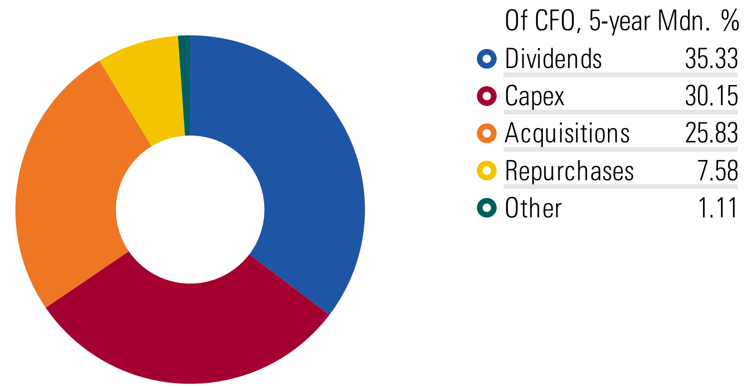
Store Dominance Holds Despite E-Commerce Adoption



Packaged food firms need to ensure their products are stocked where consumers are shopping.

- Prior to covid-19, e-commerce represented just a low-single-digit percentage of food purchases, even as the online channel proved disruptive to other categories.
- However, in 2020, nearly 10% of food sales occurred online and that share grew to 12% in 2023.
- As consumers prefer to seek out what's familiar or repurchase from prior orders, we think leading players command favorable product positioning in this emergent channel.

Dividends a Priority for Capital in Packaged Food



With gobs of cash, packaged food manufacturers have several options of where to direct it.

- Beyond brand spending, dividends tend to take top billing, accounting for 35% of cash flow from operations generated across our coverage.
- Spending on capital investments comes in a close second, as firms work to weave in automation enhancements to unlock efficiencies.
- A hunger for deals has also characterized the industry, as firms look to prudently expand their category and/or geographic reach.

Source: Euromonitor. Data as of June 27, 2024 (top left and top center). Morningstar, company filings. Data as of July 15, 2024 (top right).

Industry Value Drivers

Simplified Financial Statement: Kraft Heinz (Fiscal Year 2023)

Pro Forma Income Statement ($ millions)	2023	% of Sales
Revenue 1	26,640	
Cost of Goods Sold 2	17,714	66% of Sales
Gross Profit	**8,926**	
Selling, General, and Admin. Expenses	1,363	
Research & Development 3	147	1% of Sales
Marketing 3	1,071	4% of Sales
Depreciation & Amortization 4	961	
Operating Income	**5,384**	20% of Sales
Net Interest Income/(Expense)	(939)	
Pretax Income	**4,445**	
Income Tax Expense, Other 5	3,151	12% tax rate
Net Income	**2,855**	
Discounted Cash Flow	**2023**	
Operating Income	**5,384**	
Amortization and Other 4	(1,542)	
Earnings Before Interest	**3,842**	
Depreciation 4	710	
(Capital Expenditure)	(1,013)	
(Net Investment In Working Capital and Other)	(488)	
(Net Acquisitions)/Sales 6	0	
Net New Investment (NNI)	**(751)**	
Free Cash Flow to the Firm (FCFF)	**3,152**	

(1) **Revenue:** Packaged food firms sell items to retailers, away-from-home outlets, and consumers. Sales reflect price and volumes.

(2) **Cost of Goods Sold:** The mix of raw materials and products within portfolios will sway this line item. In addition, the extent of pricing power (or lack thereof) can also have an impact.

(3) **Research and Development, Marketing:** Brand investments are key to ensuring products are keeping pace with ever-changing consumer preferences. Media investments should align with consumers' shift from traditional to digital mediums.

(4) **Depreciation and Amortization:** Brands and fixed manufacturing assets are the primary drivers of depreciation and amortization.

(5) **Income Taxes:** Global tax rates will vary based on manufacturing and sales footprints around the world.

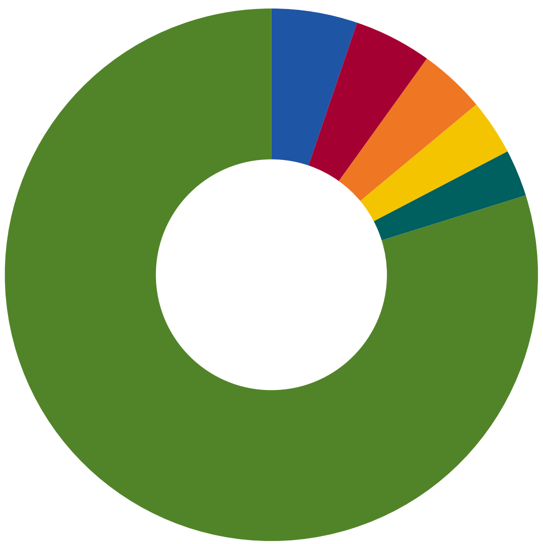
(6) **Net Acquisitions:** Firms in the packaged food industry pursue acquisitions to gain exposure to faster-growing categories and/or geographic markets while divesting brands and businesses that fail to generate sufficient returns.

Source: Morningstar, Kraft Heinz 10-K 2023. Data as of May 2024.

Packaged Food Market Share and Concentration

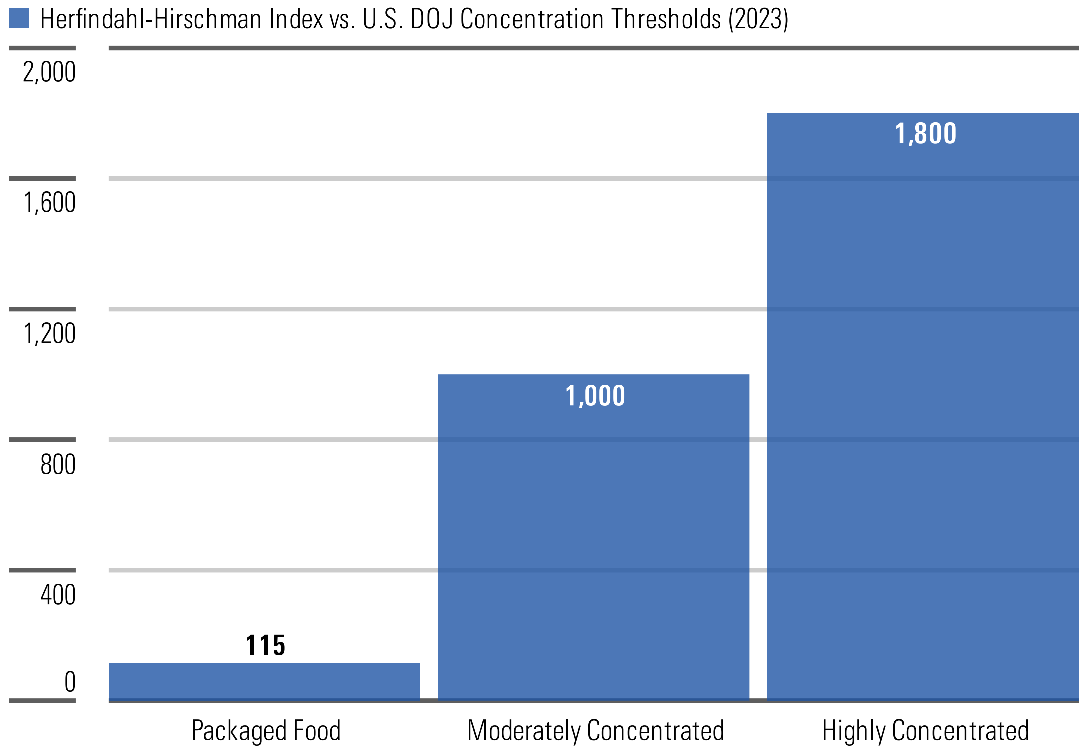
The top five companies by revenue in the US packaged food realm collectively accounted for a mere 20% of total sales in 2023. Pepsi's packaged food segments chalked up 5.2% share, slightly ahead of Nestle's 4.7% mark. Mars (4%), Kraft Heinz (3.4%), and General Mills (2.9%) round out the top cohort. Overall, while there are pockets of concentration, the industry is fragmented, with a Herfindahl-Hirschman Index score of just 115 that significantly lags the DOJ's concentrated threshold of 1,800.

Pepsi Nudges Out Nestle for the Top Spot in the US Packaged Food Arena



Market Share	%
Pepsi Co	5.21
Nestle	4.71
Mars	4.04
Kraft Heinz	3.37
General Mills	2.85
Others	79.82

An Overabundance of Packaged Food Firms Stirs Up Competitive Pressure



Source: Morningstar, company reports, US Department of Justice. Data as of May 2024 (bottom left and right).

Packaged Food Coverage List and Ratings

Within the packaged food landscape, Morningstar covers around 30 companies with a wide range of market capitalizations. The exhibit below highlights players domiciled in the North American, European, and Australian packaged food aisles.

Morningstar's North American, European, and Australian Packaged Food Coverage

Company (Ticker)	Market Cap (Billions,Local)	Moat Rating	Uncertainty Rating	Fair Value Estimate	Star Rating	P/FVE	FCFF Margin 3-year Average	EV/EBITDA	Yield	1-Year Return
Nestlé (SWX:NESN)	CHF 229	Wide	Low	CHF 105	★★★★	0.85	12.4%	16.2x	3.3%	(19%)
Mondelez International (NAS:MDLZ)	USD 90	Wide	Low	USD 75	★★★★	0.89	14.3%	14.4x	2.5%	(11%)
Kraft Heinz (NAS:KHC)	USD 41	Narrow	Medium	USD 57	★★★★★	0.59	22.2%	12.9x	4.7%	(7%)
Danone (PAR:BN)	EUR 38	Narrow	Medium	EUR 60	★★★	0.98	10.5%	13.8x	3.6%	6%
The Hershey (NYS:HSY)	USD 39	Wide	Low	USD 210	★★★★	0.92	11.9%	14.9x	2.6%	(17%)
General Mills (Food Products) (NYS:GIS)	USD 38	Narrow	Low	USD 74	★★★★	0.92	10.2%	12.6x	3.5%	(10%)
Lindt & Sprüngli (SWX:LISN)	CHF 25	Wide	Low	CHF 94000	★★	1.16	11.0%	23.8x	1.2%	2%
Tyson Foods (Food Products) (NYS:TSN)	USD 22	None	Medium	USD 80	★★★★	0.76	3.9%	25.9x	3.2%	10%
McCormick & Company (NYS:MKC)	USD 21	Wide	Medium	USD 67	★★	1.15	7.1%	20.1x	2.1%	(13%)
Kellanova (NYS:K)	USD 20	Narrow	Medium	USD 75	★★★★	0.77	9.8%	16.4x	4.0%	(8%)
Hormel Foods (NYS:HRL)	USD 18	Narrow	Medium	USD 31	★★★	1.03	-4.1%	15.7x	3.5%	(23%)
Conagra Brands (NYS:CAG)	USD 15	None	Medium	USD 33	★★★★	0.92	9.7%	16.0x	4.6%	(7%)
Campbell Soup (NYS:CPB)	USD 14	Wide	Medium	USD 61	★★★★	0.78	13.8%	13.3x	3.1%	3%
The J.M. Smucker Co (NYS:SJM)	USD 13	None	Medium	USD 133	★★★★	0.89	11.0%	12.5x	3.6%	(22%)
Saputo (TSE:SAP)	CAD 13	None	Medium	CAD 24.5	★★	1.29	0.1%	14.8x	2.4%	15%
Pilgrim's Pride (NAS:PPC)	USD 10	None	High	USD 32	★★	1.30	-1.1%	10.7x	0.0%	68%
Lamb Weston Holdings (NYS:LW)	USD 9	Narrow	High	USD 95	★★★★★	0.63	3.4%	9.0x	2.2%	(42%)
Freshpet (NAS:FRPT)	USD 6	None	High	USD 88	★★	1.35	-43.8%	85.1x	0.0%	60%
The a2 Milk Company (ASX:A2M)	AUD 5	Narrow	High	AUD 7.4	★★★	0.97	3.4%	21.0x	0.0%	41%
Treehouse Foods (NYS:THS)	USD 2	None	High	USD 37	★★★	1.06	-2.3%	15.2x	0.0%	(25%)
WK Kellogg (NYS:KLG)	USD 1	None	Medium	USD 27	★★★★★	0.64	3.2%	9.3x	2.8%	2%
Inghams (ASX:ING)	AUD 1	None	Medium	AUD 3.7	★★★	1.02	11.0%	6.8x	6.0%	30%
Bega Group (ASX:BGA)	AUD 1	None	Medium	AUD 4.2	★★★	1.06	-6.1%	-8.4x	1.6%	35%
Packaged Food Cap-Weighted Average						**0.89**	**10.9%**	**16.3x**	**3.1%**	**-9.7%**

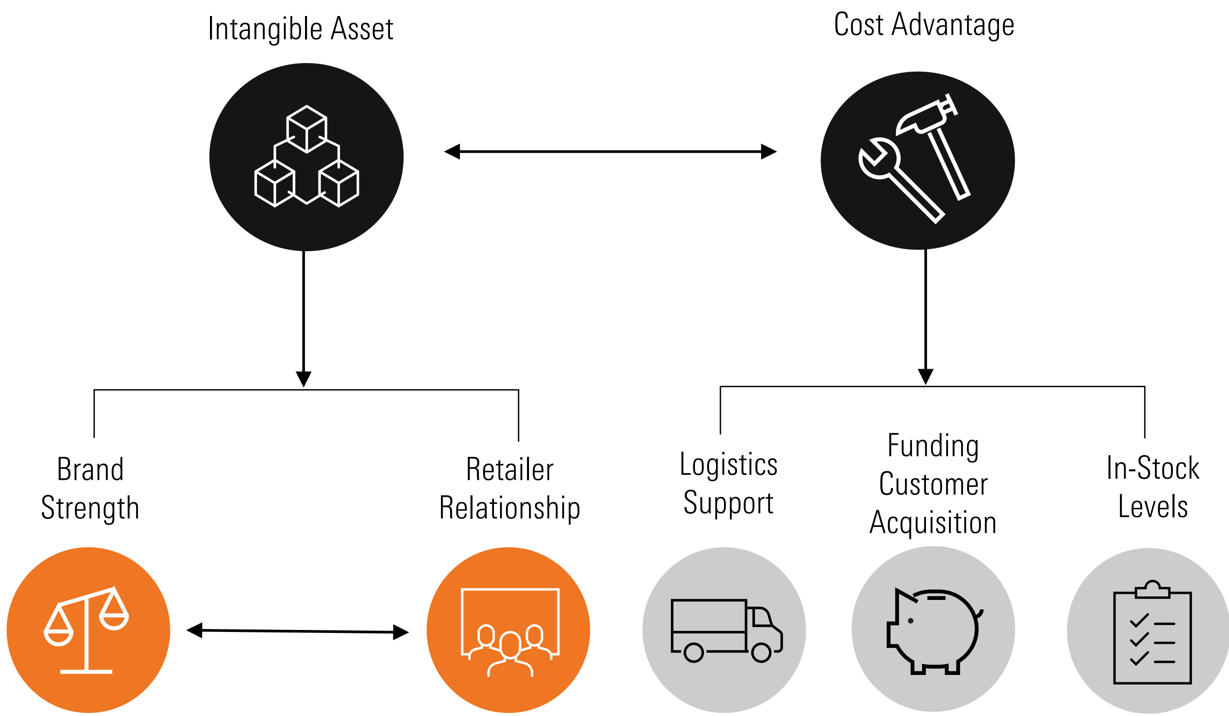
Source: Morningstar, PitchBook, Direct. Data as of July 30, 2024.

Economic Moat

Intangibles, cost advantages buoy the edge of some packaged food firms.

Strong Brands and Solid Retail Relationships Feed Cost Advantages for Leading Packaged Food Manufacturers

Mutually Reinforcing Competitive Advantages Keep New Packaged Food Entrants From Making a Dent



Source: Morningstar.

Competitive advantages in the packaged food industry are mutually reinforcing in ways that result in supply chain entrenchment for manufacturers, particularly in the traditional retail channel. Beyond brands, this is one pillar of intangible assets in the space.

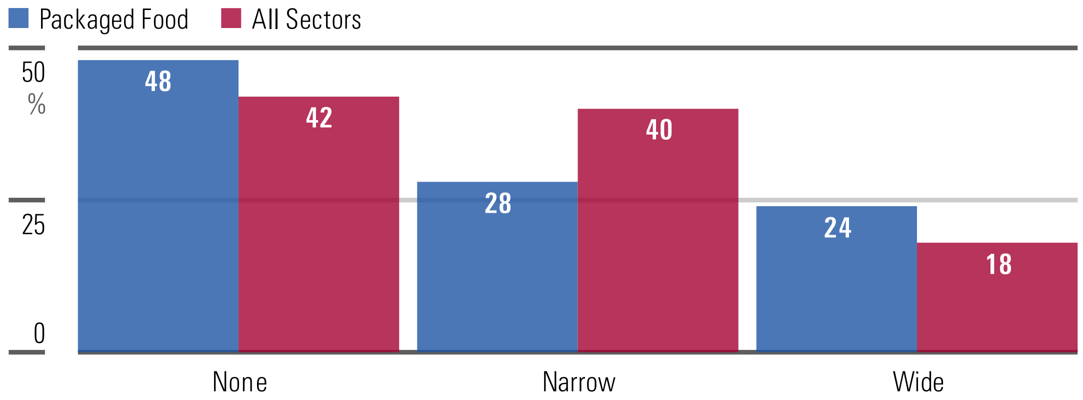
The scale and breadth of branded packaged food companies make them important suppliers to retailers. Further, these economies of scale can power cost advantages, affording incumbent manufacturers greater financial flexibility to compete on price and invest in marketing and new product development.

There are inherent risks to awarding shelf space to new entrants—supply interruptions, quality, consistency. Cost advantages give large manufacturers license to undercut new entrants as well as outspend them in marketing and brand building. As such, well-resourced vendors are difficult to dislodge from retailers' supply chains.

The Recipe for Packaged Food Moats Starts With Brand Intangible Assets

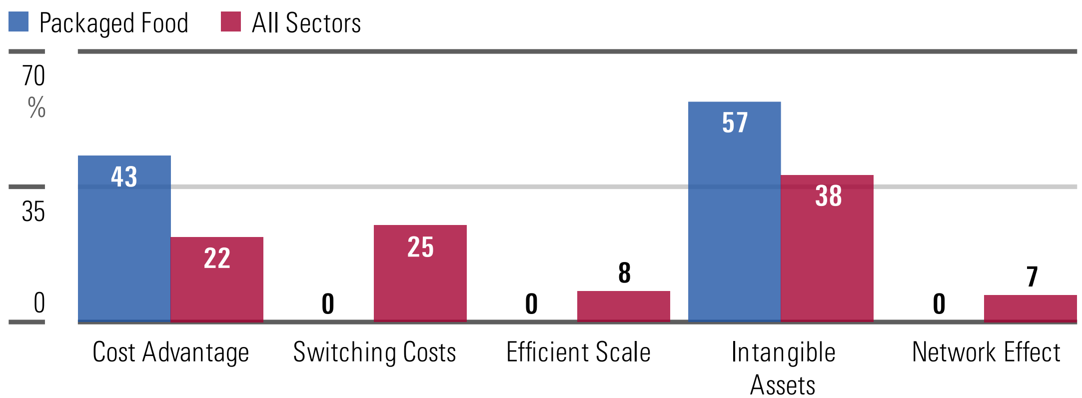
Morningstar's packaged food industry coverage includes several narrow- and wide-moat names. More specifically, 52% of our packaged food coverage has garnered a moat, a touch behind the 58% for our coverage across all sectors. Firms possessing a wide moat in the packaged food industry tend to house leading brands, exhibit an entrenched position with retailers, and boast expansive scale. Further, these operators maintain the resources to support their brands at the shelf and defend their share position against the encroachment of smaller foes. But a handful of companies with narrow moats tend to lack a cost advantage. There are no meaningful switching costs for end consumers.

The Majority of Our Packaged Food Coverage Boasts a Wide or Narrow Moat



Economic moats in packaged food stem from intangible assets (strong brands, valued partners to retailers) and/or cost advantages. In our view, firms with strong brands tend to enjoy dominant market shares in their respective categories and pricing power that permits manufacturers to pass inflation through to consumers without a material and lasting pullback in volumes. Cost advantages are typically underpinned by scale (buying power, manufacturing processes, economies of scope, route density, or advertising), proximity to customers, or access to low-cost raw materials. This allows businesses to either extract higher margins or secure greater volumes by offering lower prices. It is rare to enjoy a cost advantage without also having earned an intangible asset edge.

Intangibles Complemented by Cost Edge Underpin Economic Moats in the Industry



Assessing How Packaged Food Brands Stack Up Is Far From Elementary

The Morningstar Packaged Food Brand Strength Framework Considers Both Qualitative and Quantitative Factors to Gauge Whether Firms Merit an Economic Moat

Morningstar Packaged Food Brand Strength Criteria	Pricing Power	Conspicuousness of Consumption	Taste & Safety Significance	Private Label Penetration	Market Share/Industry Concentration
Metric at category level	Price elasticity	Importance of image, projected social status, or public nature of a product consumed	Importance of taste, safety, and/or efficacy of the product	Dollar share held by private label fare	Concentration of top 8 players and HHI
Metric at company level	Historical organic revenue (price and volume) growth versus competitors	Category exposure to products that emphasize image, projected social status, or public nature of products	Company's category exposure to products that emphasize the importance of taste, safety, and/or efficacy	Percentage of company revenue exposed to private label	Company market share

Source: Morningstar.

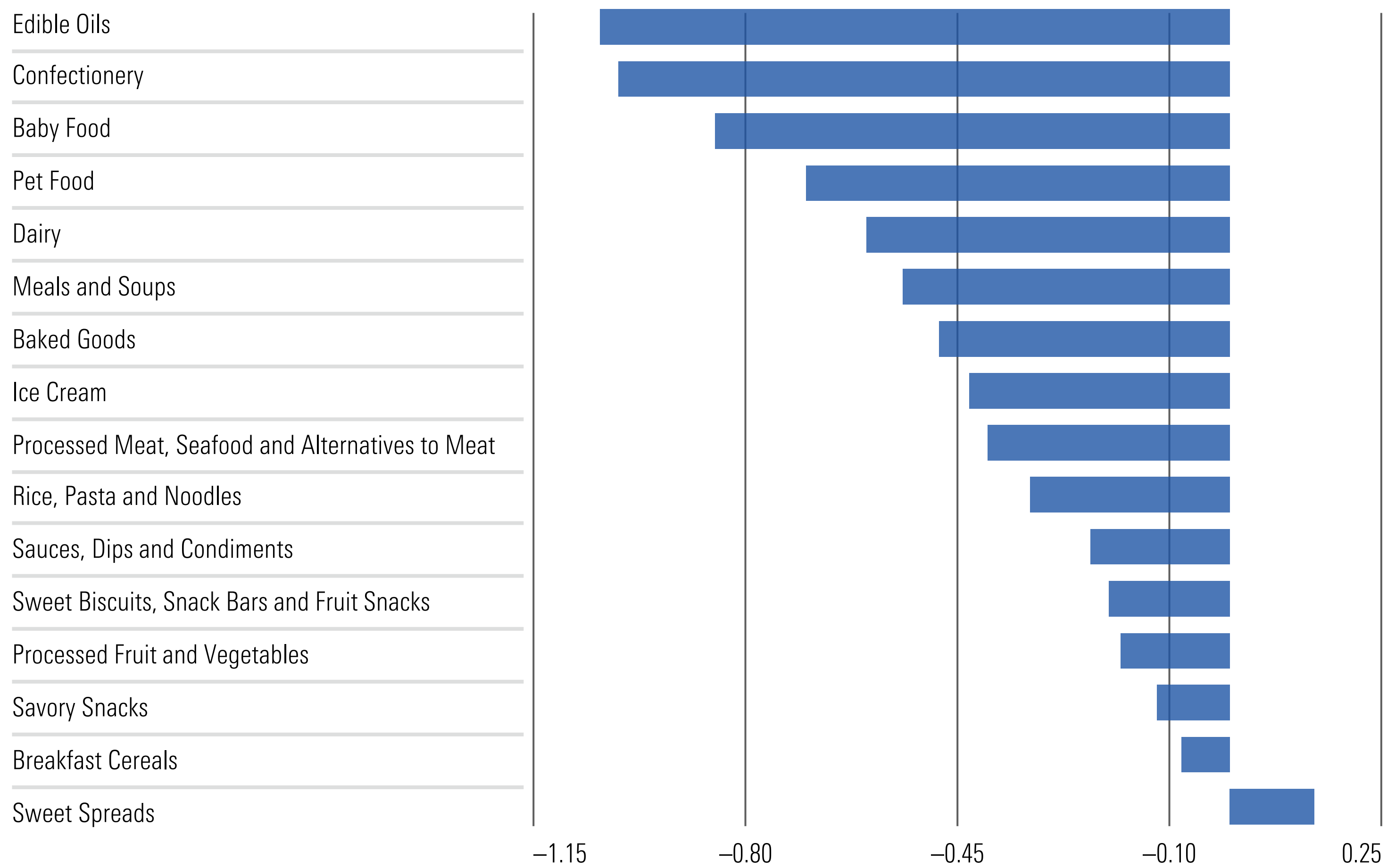
Pricing Power: Consumers’ Appetite for Higher Prices Shines a Light on Packaged Food Category Brand Power

Price elasticity measures the change in demand divided by the change in price. This provides a lens into consumer willingness to pay higher prices.

- For the majority of categories across the packaged food landscape, demand tends to be relatively inelastic (i.e. little change in demand is seen when prices tick up).
- But we surmise categories that are more discretionary, like confectionery, or where a host of substitutes exist and rate of purchase is low, such as edible oils, could be more susceptible to a retraction in volumes following a step up in prices.
- Conversely, categories that are consumed more regularly, like breakfast cereal, savory and sweet snacks, and fruits and vegetables tend to exhibit more inelastic demand. We attribute this to the frequency of purchase of these products and the degree to which they meet the needs of the broader family cohort.

Consumers Dial Back Spending on Indulgences When Prices Rise; Demand Unwavering for Daily Essentials

USA Product Price Elasticity (Five-year)

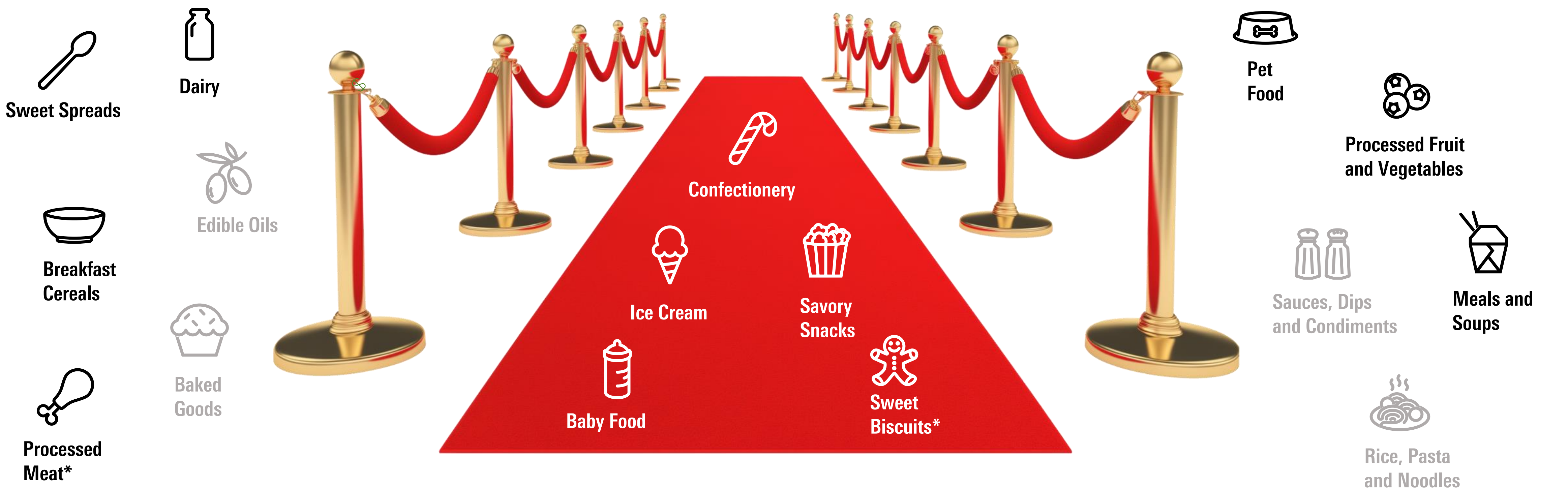


Source: Morningstar, Euromonitor. Data as of May 2024.

Conspicuous Consumption: Potential Public Consumption Props Up Strength Brands Wield in a Host of Categories

According to economic theory, when seeking a product for purchase, consumers should always rationally choose whichever provides the maximum benefit at the lowest price. But consumers are social creatures who often consider the image and perception use of that product will highlight to others. Although many packaged food products never see the light of day outside a buyer's home, we surmise brands within the indulgent snacks and baby food aisles are more likely to benefit from conspicuous consumption than pet food and dairy fare.

While Meats, Fruits, and Vegetables Fail to Amass Much in the Way of Conspicuous Consumption, Snacking Fare Falls in the Limelight
Conspicuous Consumption: White=High, Gray=Medium, Black=Low

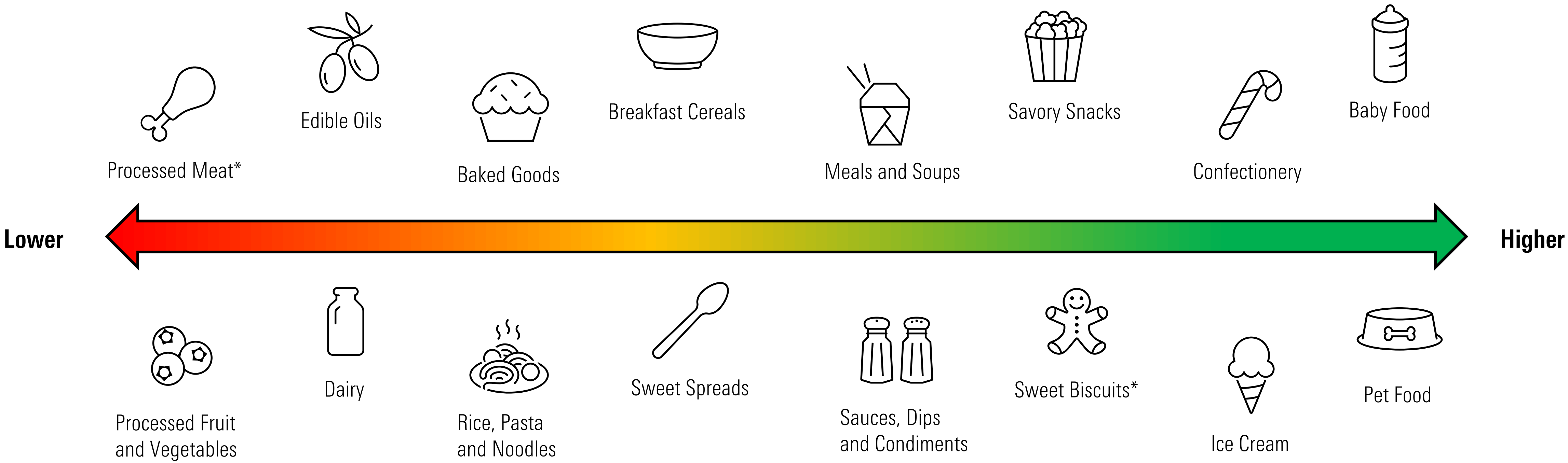


Source: Morningstar. Adobe Stock. Note: *Sweet biscuits includes sweet biscuits, snack bars, and fruit snacks; Processed Meat includes processed meat, seafood, and alternatives to meat.

Taste and Safety: Weight Consumers Place Here Can Tip the Scales in Favor of Mightier Categories and Brands

The taste and safety of food products is vital in ascertaining brand strength. Whether it's refusing to purchase no-name meat sold at a gas station or resisting an unknown candy bar flavor, consumers have shown they are willing to pay for increased safety or superior taste. But perception also comes into play; if a manufacturer positions its brand as safer, better-tasting, or healthier, the pricing power can be just as powerful. This can also manifest negatively. While many product recalls fade from recollection over time, the impact can be more severe in categories in which safety reins supreme, such as in the baby food aisle.

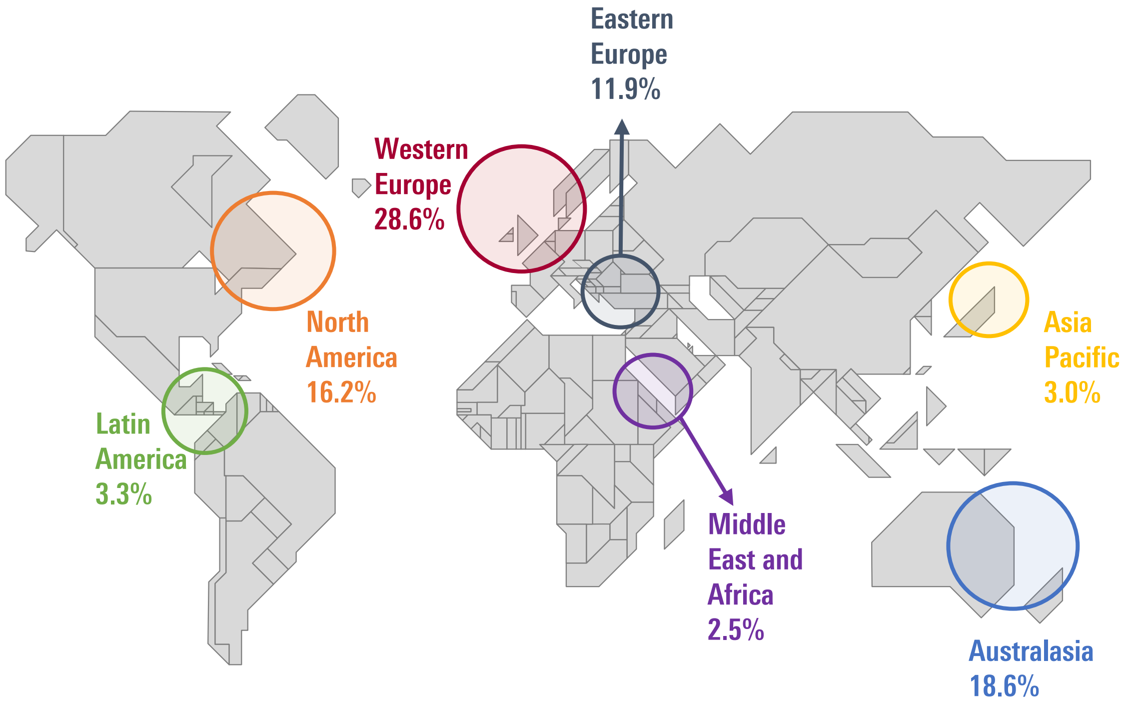
Taste and Safety Matters More in Categories That Cater to Kids and Pets, Whereas Significance Lags in Processed Meats and Cheeses



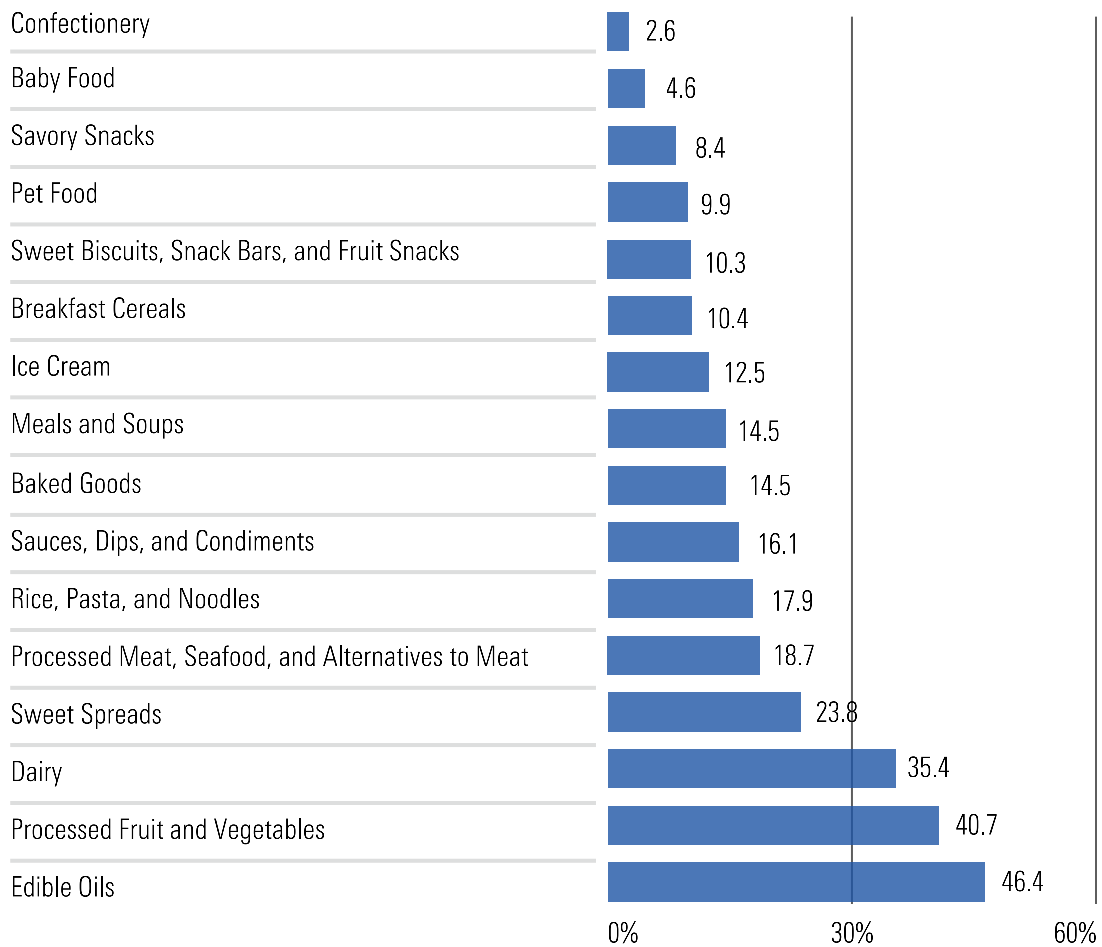
Source: Morningstar. Adobe Stock. Note: *Sweet biscuits include sweet biscuits, snack bars, and fruit snacks; *Processed Meat include processed meat, seafood, and alternatives to meat.

Private Label: Despite Wide Variations, an Onslaught of Valued-Priced Competition Can Dilute a Brand's Standing

Emerging Markets Haven't Developed a Taste for Private-Label Fare



US Private Label Rules the Perimeter, With Outsize Share in Meats and Produce

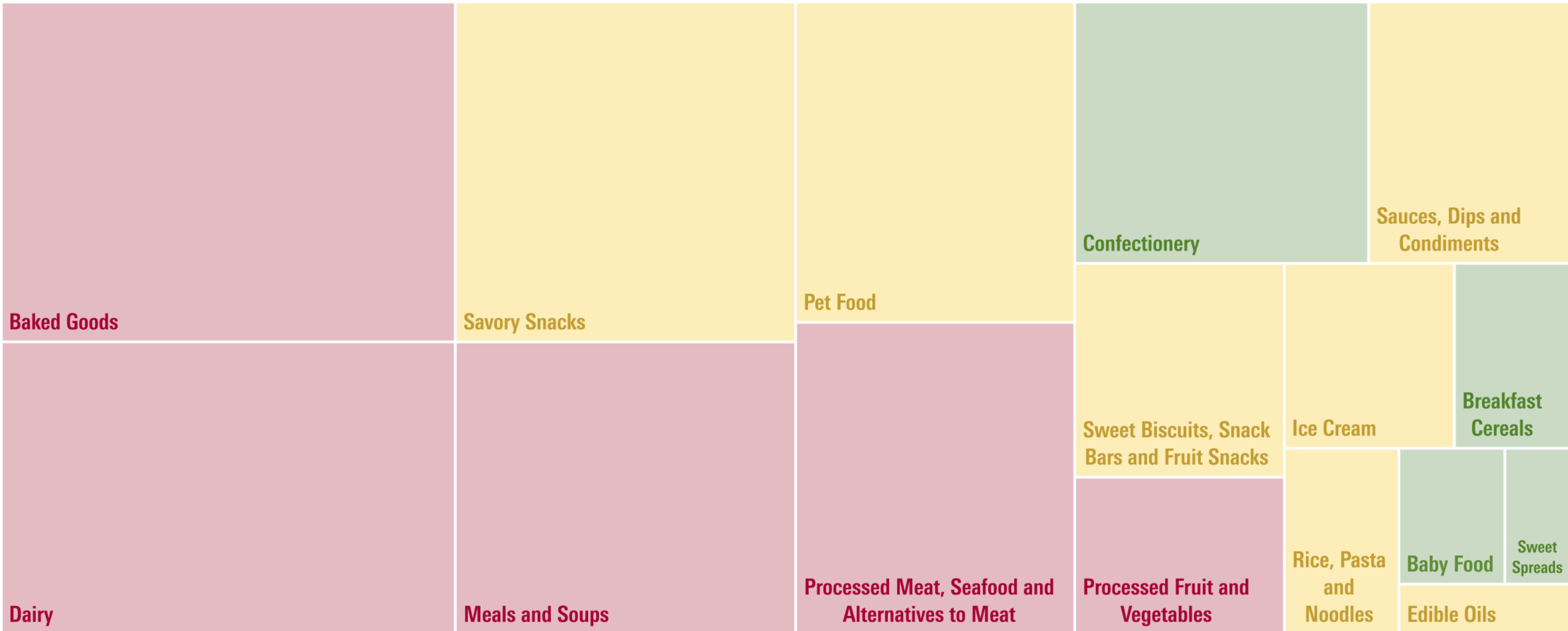


Source: Euromonitor, Morningstar. Data as of June 2024.

Industry Consolidation: Despite a Cornucopia of Operators, Pockets Seemingly Walled Off From New Entrants

While Commoditized Categories Drive Grocery Sales, Competition Tends To Be Steep, With a Vast Assortment of Players Vying for Share

Industry concentration: Higher=Green, Medium=Yellow, Lower=Red. Size of square denotes level of category sales.



Source: Morningstar.

Not All Categories Created Equal; Snacking Has the Ingredients for a Moat; Commodities Leave a Bland Taste

When Stacked Against the Five Pillars of Our Brand Strength Framework, the Savory Snacks Aisle Appears to Have Cooked Up a Competitive Edge

← Moatier

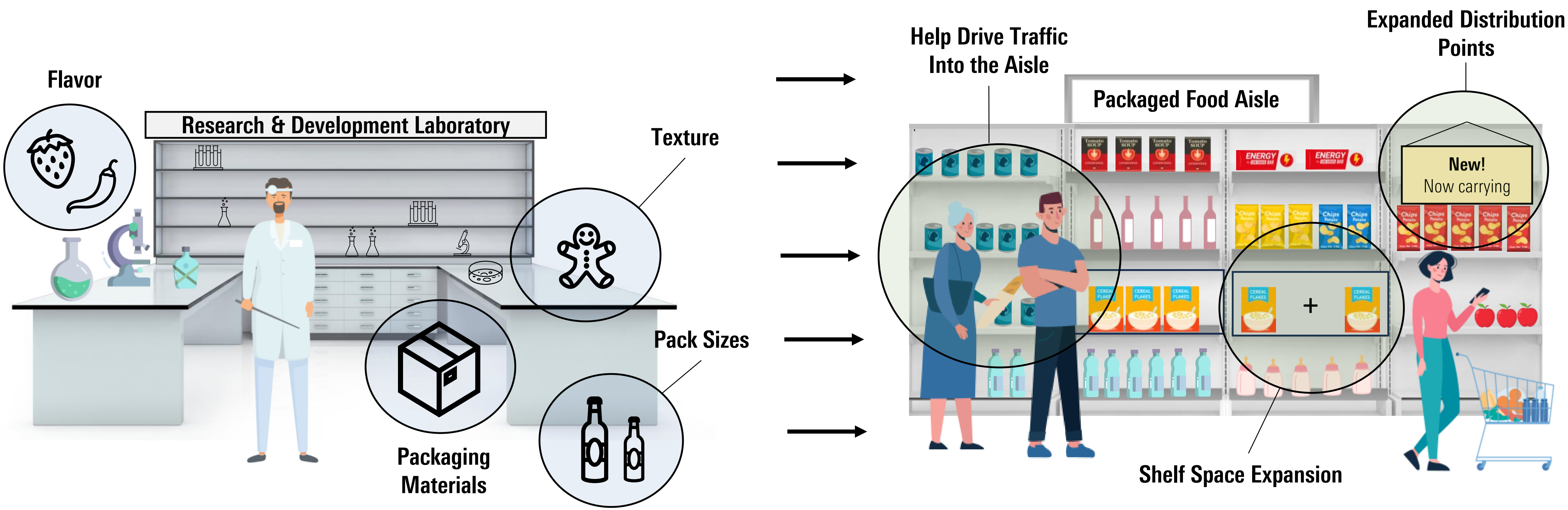
	Savory Snacks	Confectionery	Baby Food	Sweet Biscuits*	Ice Cream	Pet Food	Breakfast Cereals	Sweet Spreads	Sauces*	Baked Goods	Rice*	Meals and Soups	Edible Oils	Processed Meat*	Processed Fruit and Vegetables	Dairy
Volumes Hold Despite Price Hikes?	Yes	No	No	Yes	Mildly	No	Yes	Yes	Mildly	Mildly	Mildly	Mildly	No	Yes	Yes	No
Consumption Is Conspicuous?	Yes	Yes	Yes	Yes	Yes	No	No	No	Mildly	Mildly	Mildly	No	Mildly	No	No	No
Taste & Safety Considerations Significant?	Yes	Yes	Yes	Yes	Yes	Yes	Mildly	Mildly	Mildly	Mildly	Mildly	Mildly	No	No	No	No
Private-Label Penetration Low?	Yes	Yes	Yes	Mildly	Mildly	Yes	Mildly	No	No	Mildly	No	Mildly	No	No	No	No
Industry Is Consolidated?	Mildly	Yes	Yes	Mildly	Mildly	Mildly	Yes	Yes	Mildly	No	Mildly	No	Mildly	No	No	No

Source: Morningstar. Note: *Sweet biscuits include sweet biscuits, snack bars, and fruit snacks; Processed Meat include processed meat, seafood, and alternatives to meat; Sauces includes dips and condiments; Rice includes pasta and noodles.

A Suite of Captivating New Products a Key Component in Order to Fetch an Intangible Asset-Based Moat

For packaged food companies to capitalize on evolving consumer preferences, we surmise a solid innovation program is essential. Innovation can take many forms--enhanced flavor profiles, improved packaging, new pack sizes, and/or an enriched texture—and if done right, can serve to enlarge shelf space allocation and augment total distribution points for the manufacturer. While a firm's competitive position and financial prospects don't hinge on the success of any one launch, we think a pipeline of new products that align with the changing consumer ethos can also ensconce retail relationships by driving increased store traffic, supporting an intangible asset moat.

The Onus Remains on Packaged Food Firms to Keep Pace With Evolving Consumer Trends to Solidify Their Standing With Retailers and Consumers



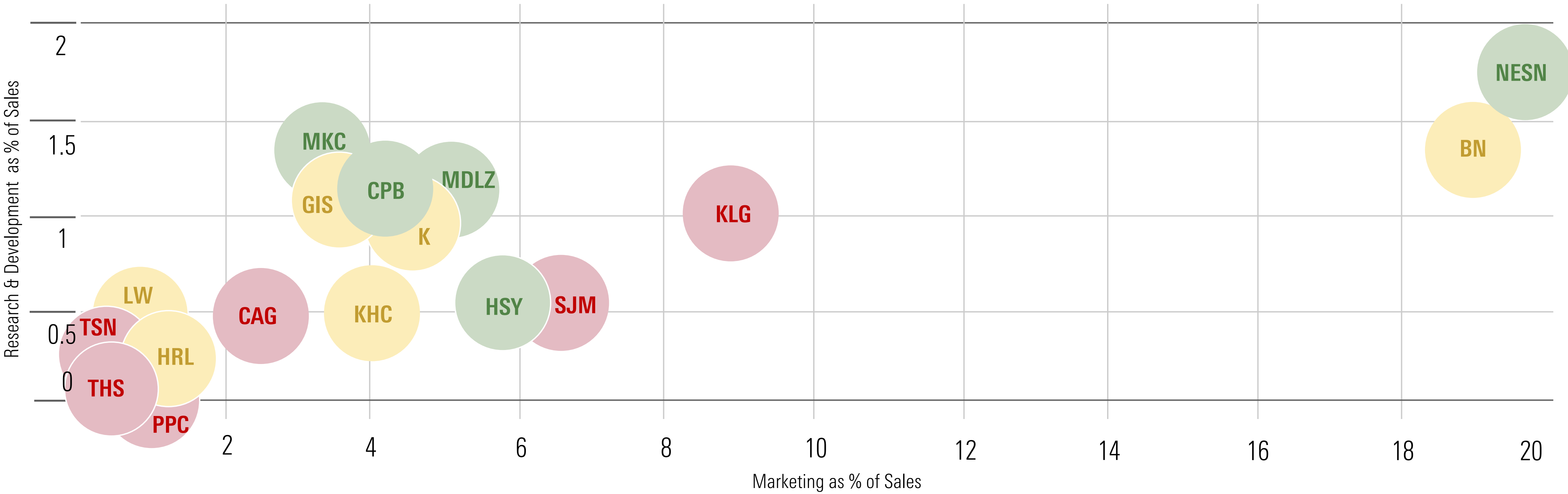
Source: Morningstar. Adobe Stock.

If Brands Are Starved for Investment, Packaged Food Moguls Unlikely to Carve Out a Competitive Edge

Beyond product development competencies, firms also need strong marketing programs to bolster their growth, increase brand awareness, and tout the benefits of their products. Even quality goods that fill unmet needs could be left on the shelf if consumers are unaware of them. However, stepped-up marketing spending alone is unlikely to drive a sales acceleration or boost a firm's competitive standing. Although no-moat WK Kellogg would like to think so, its improbable that extra marketing dollars will prompt consumers to buy another box of cereal.

More Commoditized Packaged Food Operators Funnel Fewer Resources to R&D, While Also Capping Marketing Spending Far Below Center-Store Players

Moat Rating: Green=Wide, Yellow=Narrow, Red=None



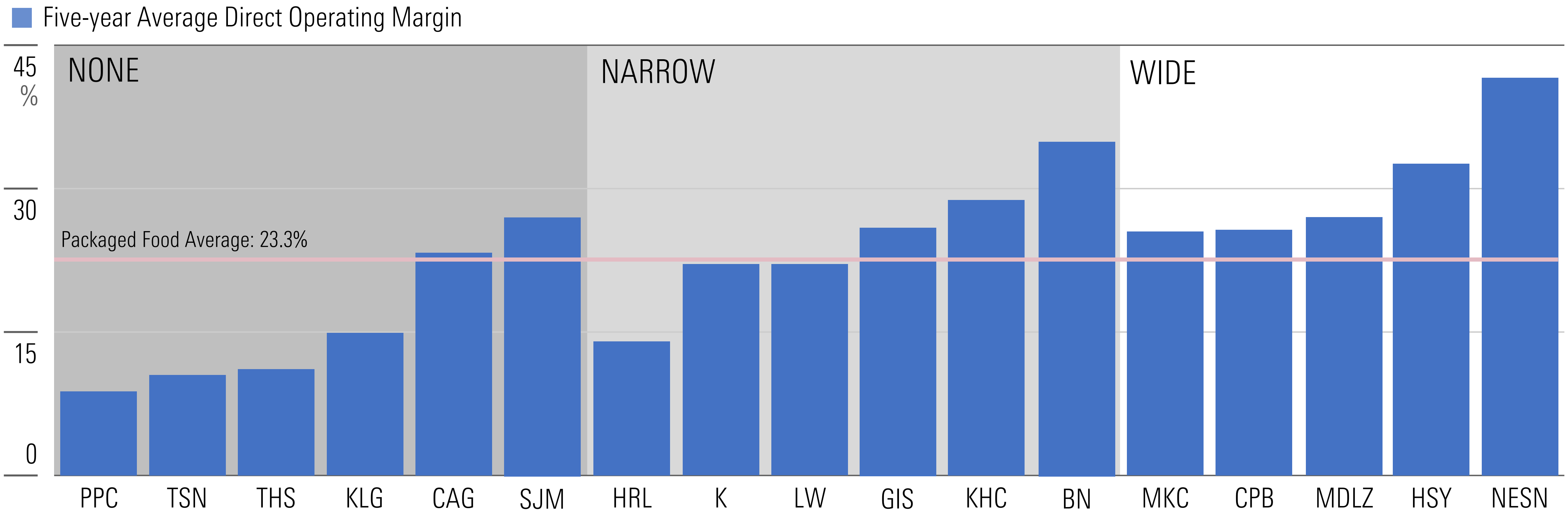
Source: Morningstar, company reports. Data as of June 2024.

Packaged Food Firms Work to Harvest a Cost Advantage to Lessen the Load to Acquire Consumers

Within packaged food, the wide variety of raw materials required to manufacture a diverse product mix makes economies of scale in manufacturing tough to unlock. More common are economies of scope, whereby efficiencies are generated in distribution rather than manufacturing. In assessing the cost positioning of packaged food firms, we find that Hershey and Nestle tout above-industry average direct operating margins, while meat processors Tyson and Pilgrim's Pride trail the pack.

Tyson, Pilgrim's Pride, and Treehouse Unable to Carve Out a Cost Edge, While the Profit Picture Appears Sweeter at Hershey and Nestle

Direct operating margin excludes discretionary operating costs, such as advertising and R&D, noncash costs including D&A, and nonrecurring expenses.

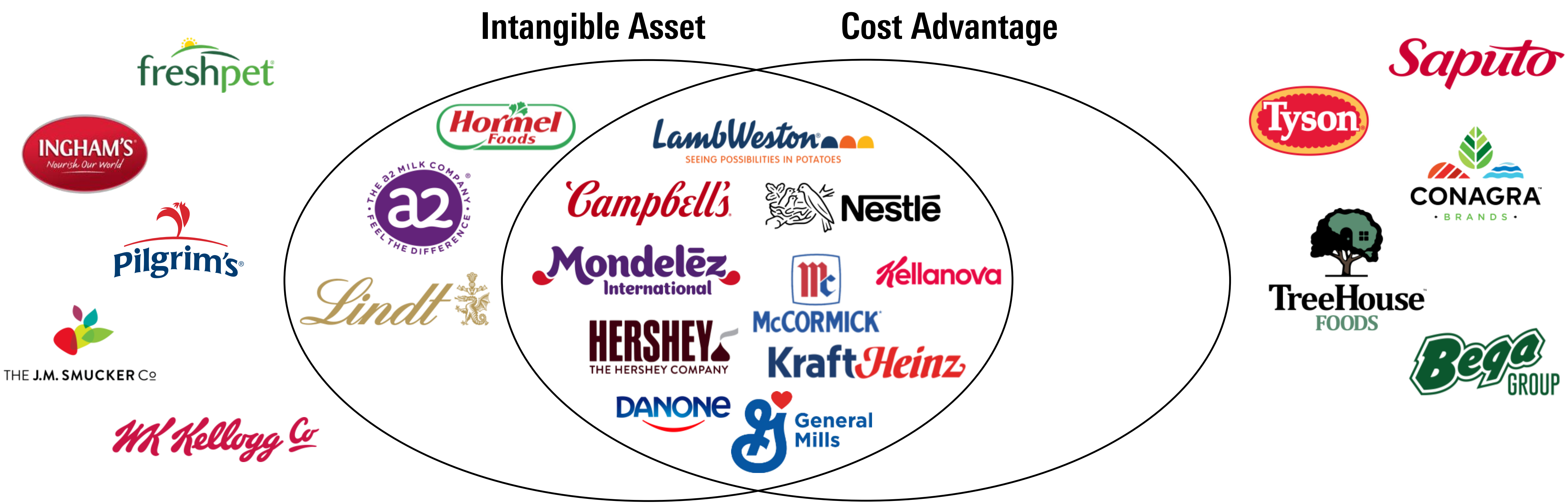


Source: Morningstar. Data as of June 2024.

Moats Proliferate Throughout Our Packaged Foods Coverage Universe

While moats have proved elusive for commoditized operators in the packaged food realm, branded firms have been more successful in carving out a competitive edge. Though a small cohort boast a moat based exclusively on intangible assets, the majority of the competitively advantaged packaged food players we cover have also unlocked a superior cost position.

Packaged Food Moats Are Anchored in Intangible Assets, Though This Stout Position Is Most Often Complemented by Cost Advantages



Source: Morningstar.

Industry Basics

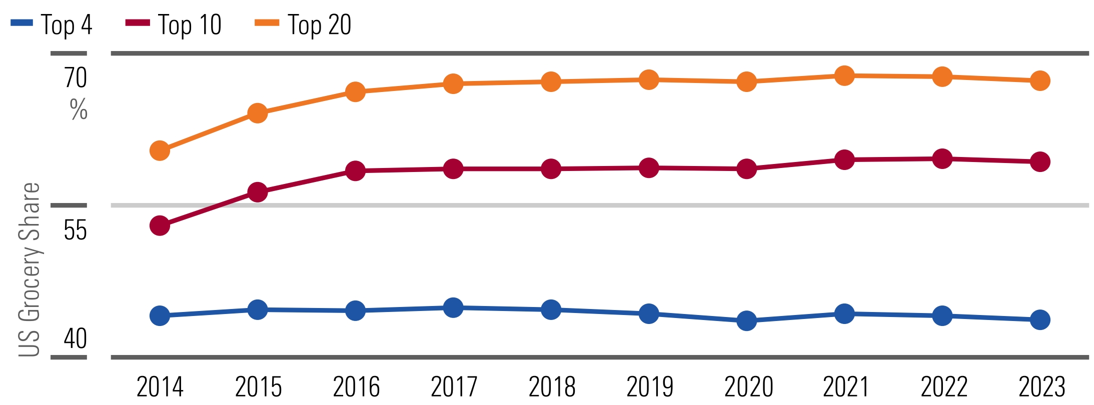
An evolving retail landscape won’t spoil packaged food’s hearty cash hoard.

The Degree of Retail Consolidation Sets the Stage for Who Has the Upper Hand—Retailers or Manufacturers

We believe there is an interdependent relationship between retailers and packaged food manufacturers to sell their wares profitably, particularly as consumers shop a number of channels.

- The top four grocers in the US continue to hold just more than 40% share of the market.
- However, the share of the top 10 players has jumped to 60% from around 50% in 2013.
- Further, the top 20 US defensive retailers now control nearly 70% of the market versus just 60% share 10 years ago.

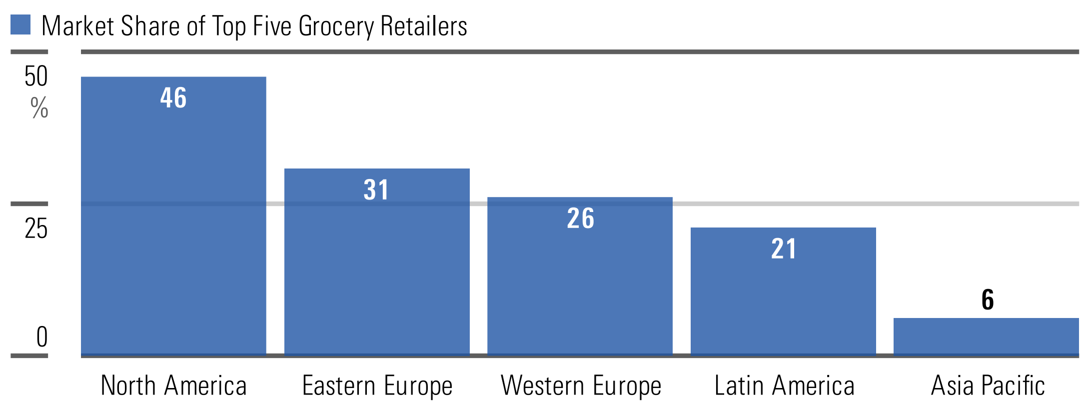
Although the US Grocery Industry Has Consolidated…



The consolidation of the US grocery landscape has failed to invoke a similar response overseas. And from our vantage point, the more fragmented the market, the more bargaining power packaged food manufacturers should wield over retailers in terms of pricing and shelf placement.

- While nearly 50% share is held by the top five grocers in North America, the top five players only control 25%-30% share in Europe.
- The Asia-Pacific market is even more fragmented, with the top five players having amassed less than 6% share.

…International Markets Boast Far More Defensive Retail Fragmentation



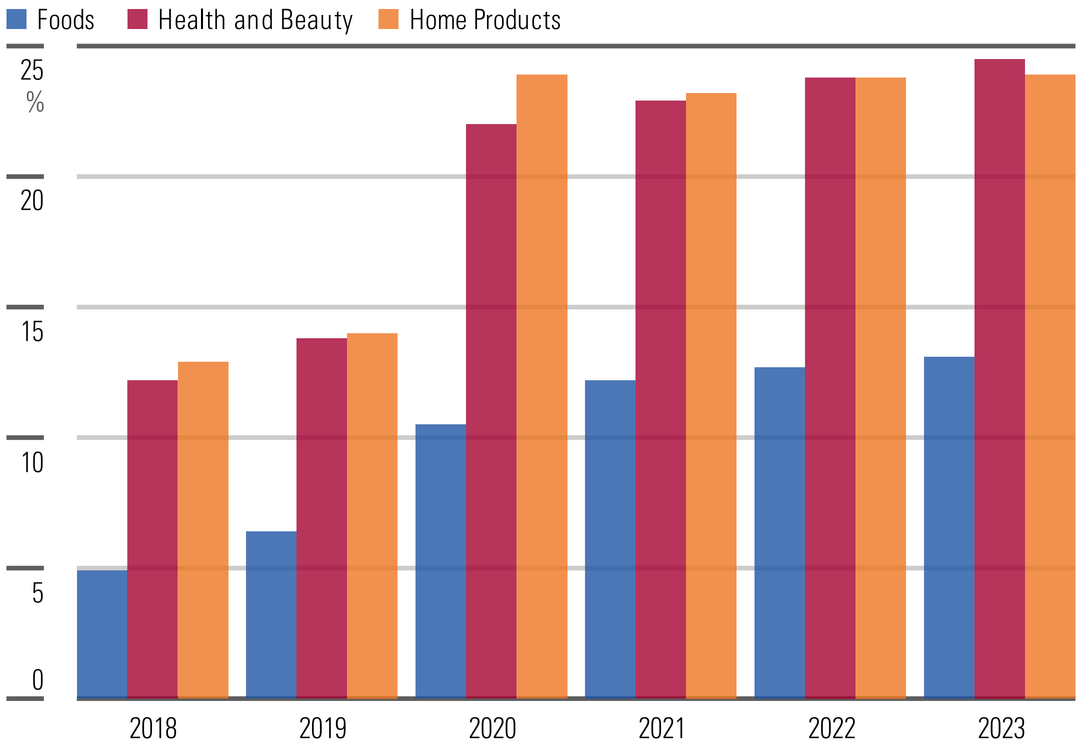
Source: Morningstar, Euromonitor. Data as of June 26, 2024 (top and bottom right).

Consumers Continue to Find Favor With the Convenience of the Online Channel

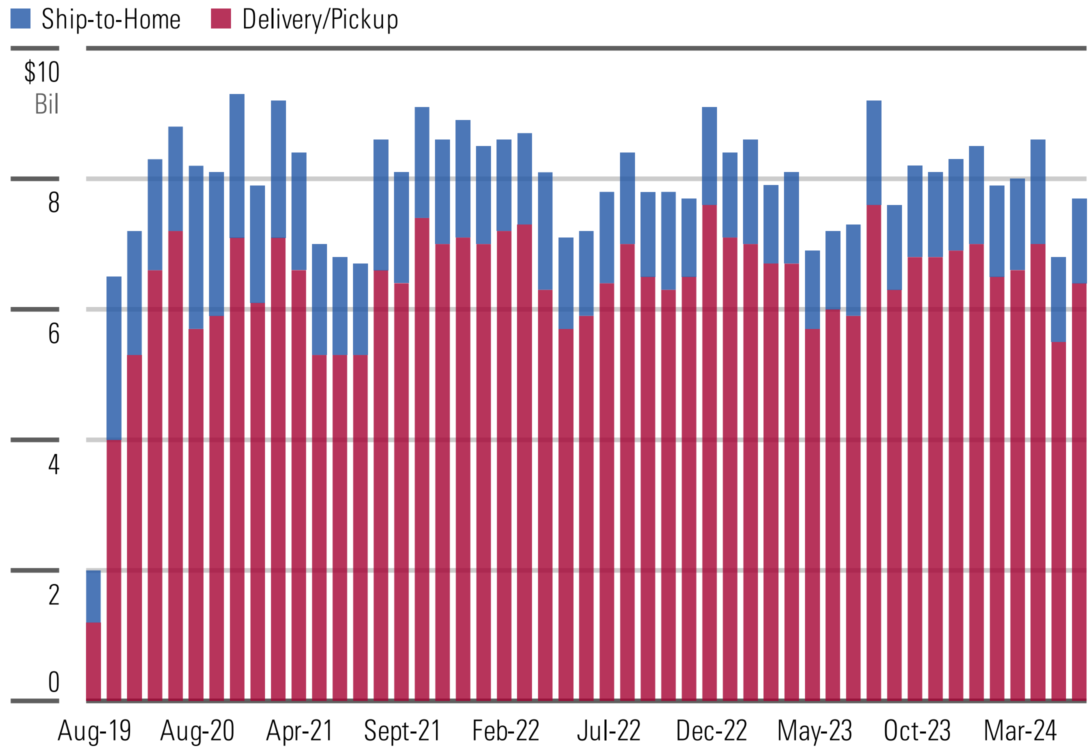
The quality concerns that had stalled adoption of online packaged food purchases were put to rest at the onset of covid-19. However, the low-double-digit levels of packaged food purchases made through the e-commerce channel still trails the nearly 25% home and personal care fare has amassed.

Despite facing increased financial strain, demand for delivery, pickup, and ship-to-home has generally held. In August 2019, online consumer product sales amounted to $2 billion, versus $6 billion-$9 billion monthly since the pandemic.

Although Online Food Retail Sales Lag HPC, E-Commerce Still Hitting the Mark…



…As Online Sales Tower Above Prepandemic Levels

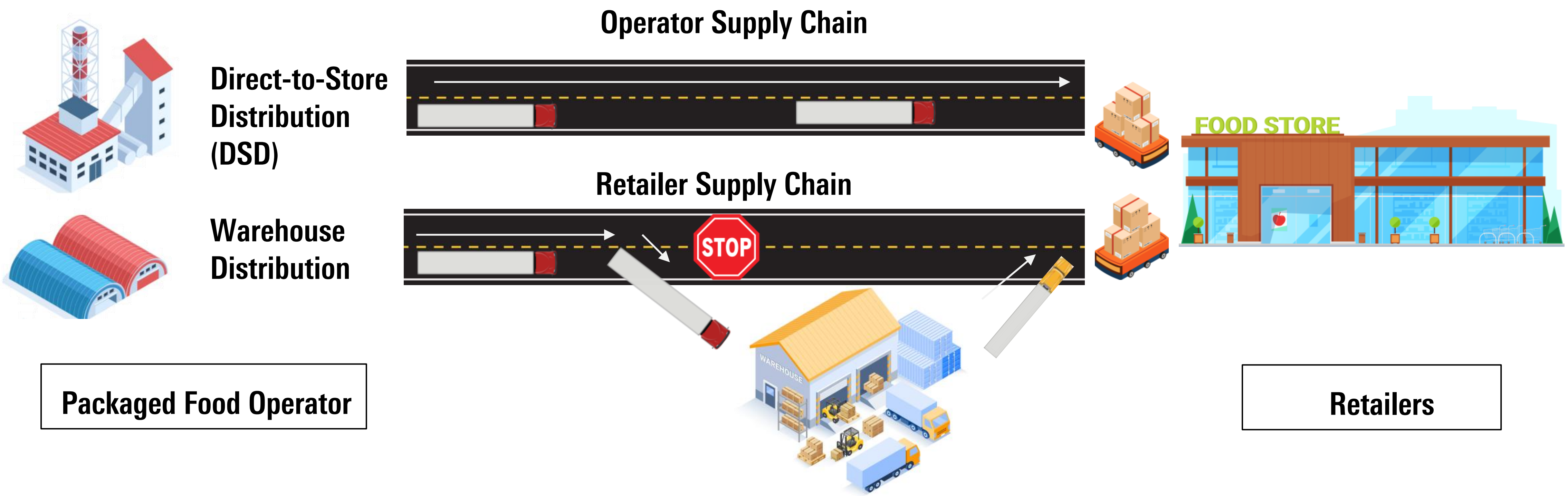


Source: Euromonitor. Data as of June 27, 2024 (bottom left). Brick Meets Click /Mercatus Grocery Shopping Survey. Data as of July 21, 2024 (bottom right).

Direct-Store Delivery Could Fade Amid an Evolving Retail Landscape in Favor of Fueling Brand Spending

Direct-store delivery entails a manufacturer bringing product directly to a retail store, which lowers inventory days of fast-turning, and often fresh, offerings. This subsequently reduces incidences of lost sales due to spoilage. However, these benefits come at a cost—primarily a more complex and costly distribution platform. Conversely, warehouse distribution offers a simplified delivery network (with the need for fewer trucks), as product is shipped to the retailer's warehouse, at which point the retailer takes control of the inventory and ensures products make it to the shelf. This allows the manufacturer to funnel more resources to brand investment, versus costly fixed assets.

Warehouse Distribution Takes Complexity Out of Distribution Networks, but Direct-Store Distribution Affords Manufacturers Stepped-Up Quality Control

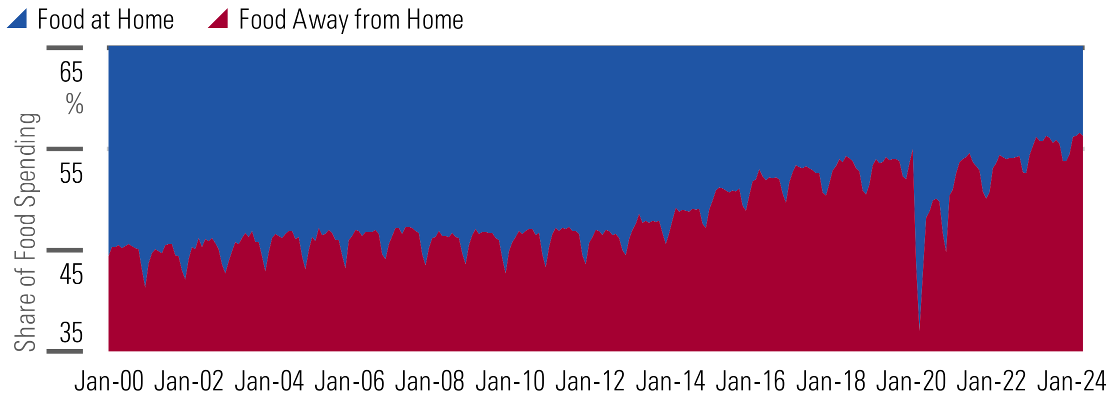


Source: Morningstar. Adobe Stock.

Over Time, Consumers Increasingly Flocking to Restaurants, Denting Grocers and Their Packaged Food Suppliers

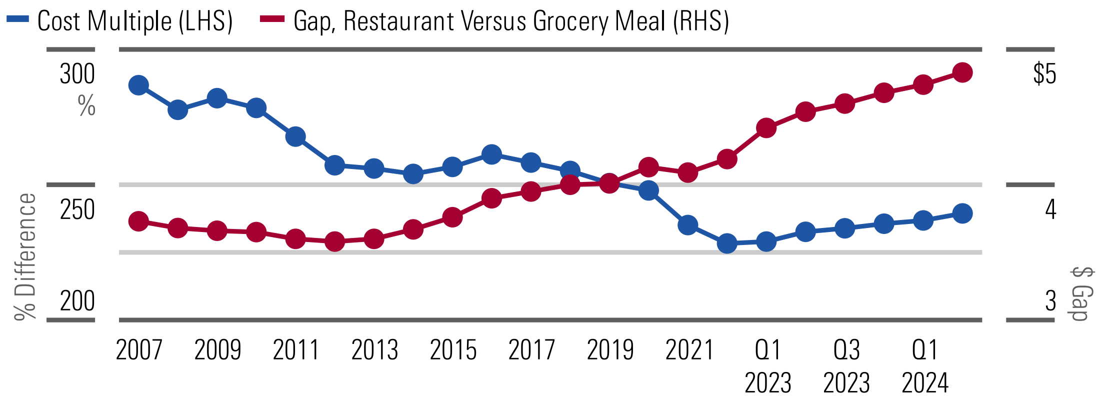
Packaged food manufacturers tend to derive the bulk of their sales through the at-home channel, where we estimate firms within our coverage universe garner more than three quarters of their sales. But on-the-go consumers are increasingly dining out, with away from home food consumption now approximating 57% of purchases versus roughly 45% two decades ago. Against this backdrop, it behooves packaged food manufacturers to alter their mix to serve this growing channel. Not only should this enable operators to drive sales, but also affords the opportunity to trial new products with an accelerated feedback loop before committing to distribution in the traditional retail channel.

Consumers' Long-Term Penchant for Convenience Spoiling Grocery Sales…



This shift has come despite the widening cost gap between a meal purchased from the grocery store versus one bought at restaurants. More specifically, the 5.0% inflation in the grocery channel during 2023 is much lower than we see at restaurants, which clocked in at 7.1%. Further, we surmise grocers' push into prepared foods and meal kits seems to be blunting restaurateurs' value proposition. With a quick-service meal averaging $4.80 more than a grocery store meal, by our estimates, we expect that a pressured consumer may prove temporarily amenable to a changeup.

…Even as the Absolute Price Gap With Grocery Meals Continues to Grow



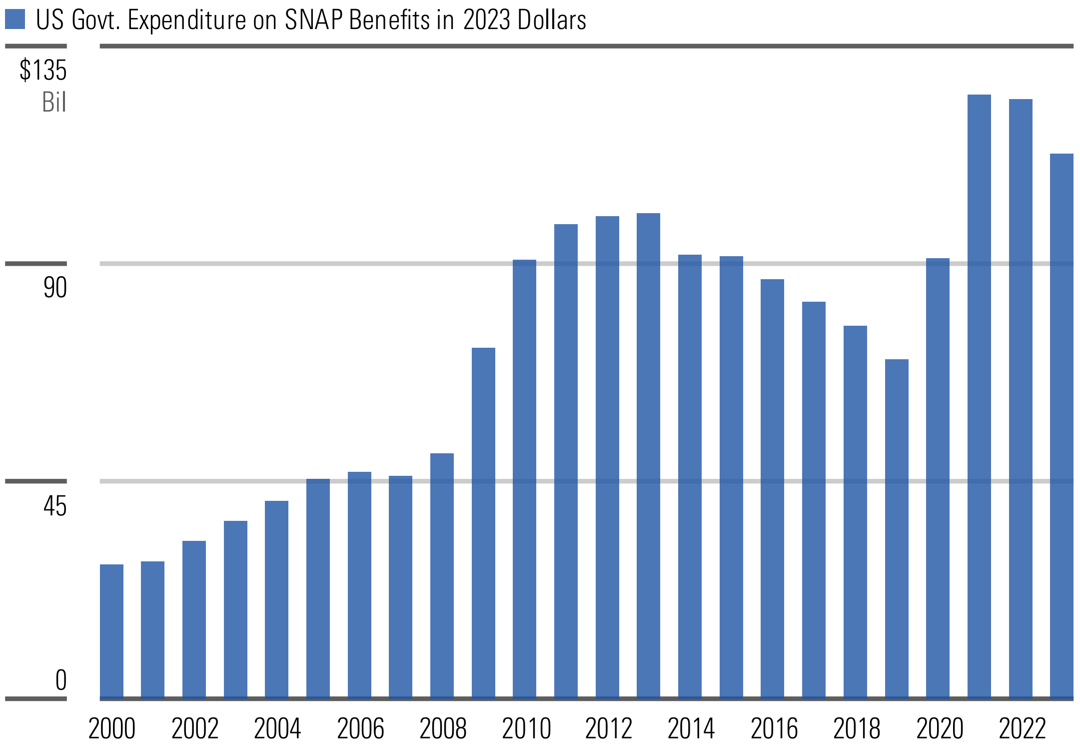
Source: USDA (top right). Euromonitor, BLS data, Morningstar calculations (bottom right). Data as of July 22, 2024.

US Consumers Spend Less on Food Than Others, but Dependence on Government Assistance Trends Higher

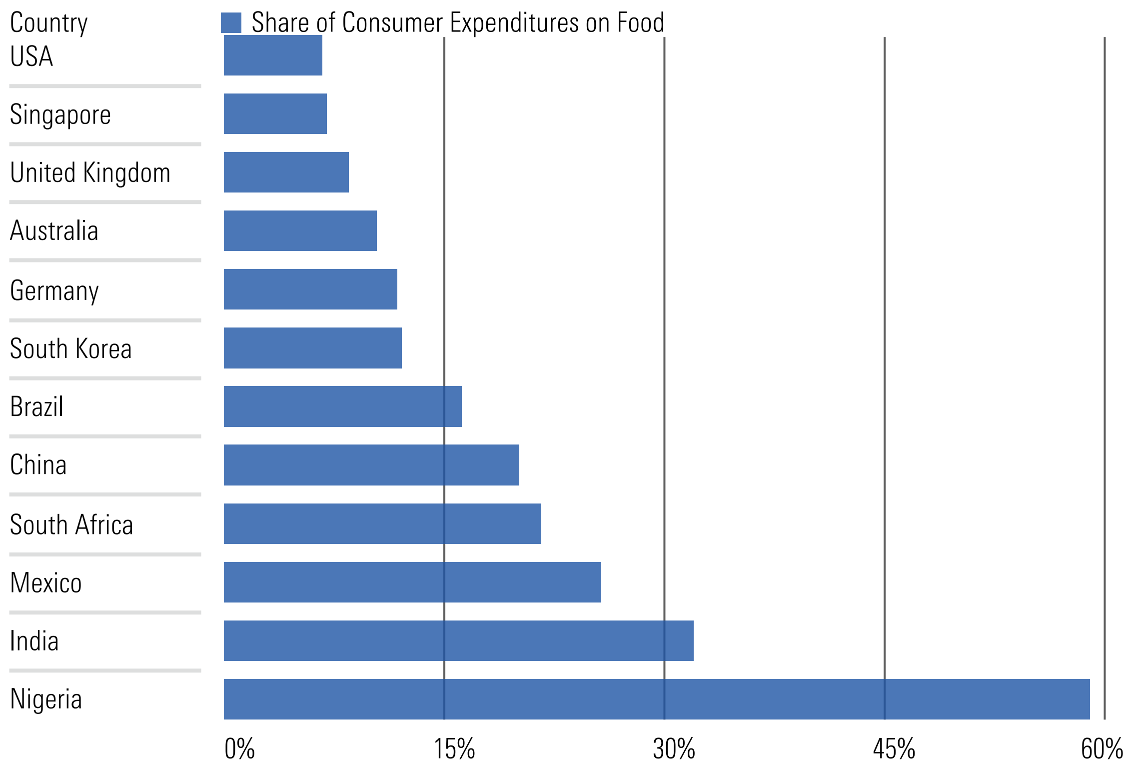
US consumers received over 4 times the level of government assistance for food purchases in 2023, versus 2000, approximating nearly $115 billion, due to increased benefits provided. This facilitates daily essential purchases but could foretell increased oversight if the government puts in place restrictions in how these funds are spent.

However, relative to other countries around the world, US consumers direct far less of their total household income toward food purchases, at just a mid- to high-single-digit percentage share, versus around 30% in Mexico and India and nearly 60% in Nigeria.

The Contribution of Government Aid to US Food Purchases Continues to Step Up



Emerging Markets Allocate Far More Income Toward Food Purchases



Source: USDA, Economic Research Service (bottom left and right). Data as of July 2024.

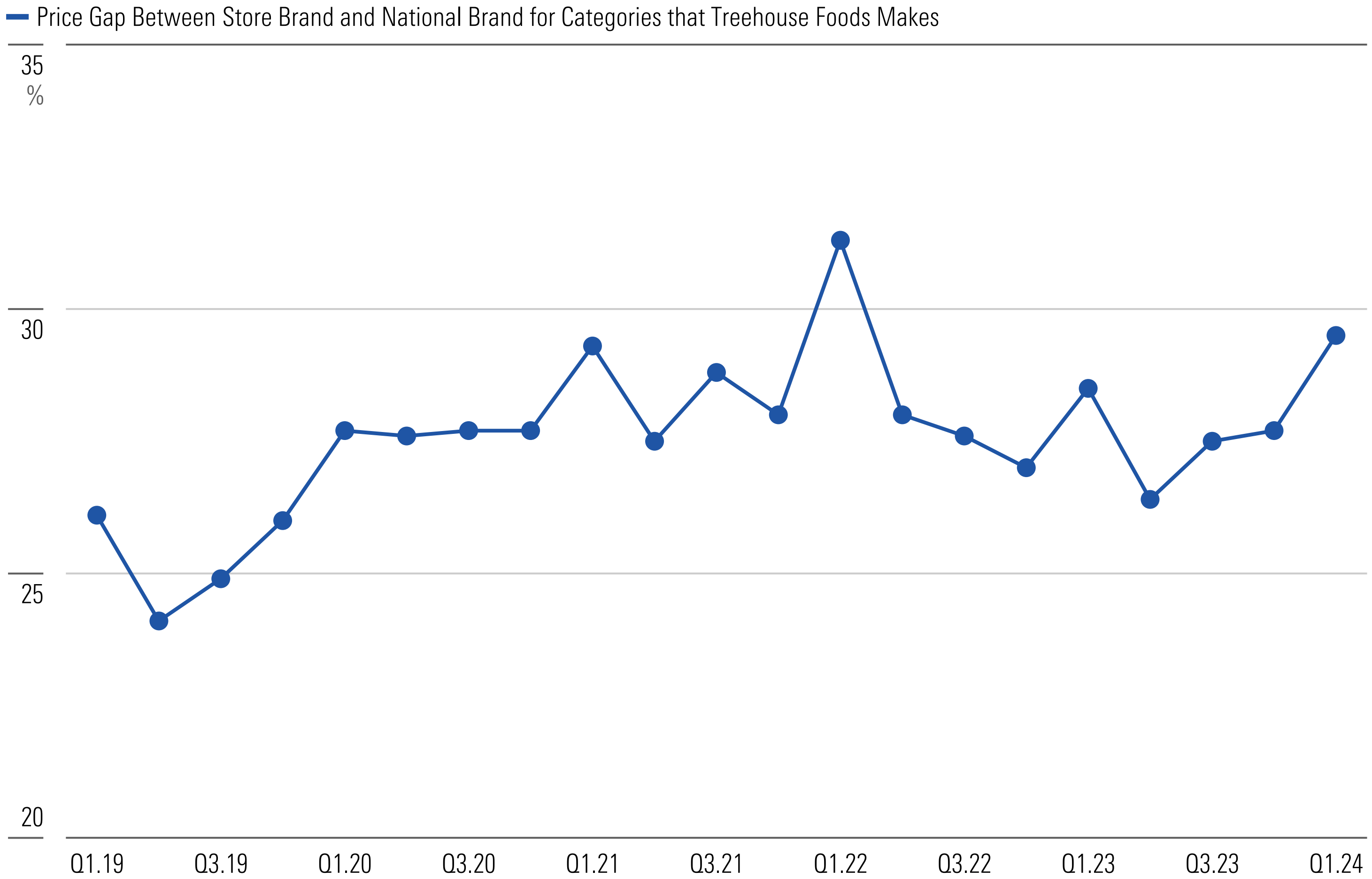
A Widening Price Gap Could Leave Consumers With a Bitter Taste for National Brands

Branded packaged food offerings tend to sell for a premium relative to private-label alternatives given the increased spending behind research, development, and marketing this value-added fare.

However, this price gap has widened of late, approaching 30% versus the 25% that had been the norm prepandemic for a select group of packaged food categories (as cited by no-moat Treehouse).

If consumers question the value they are getting for the higher price, this could prompt increased trade down and/or the emergence of lower-priced options, as we've seen in the past.

Brands a Bit More Expensive Relative to Value-Priced Offerings in a Cadre of Packaged Food Categories

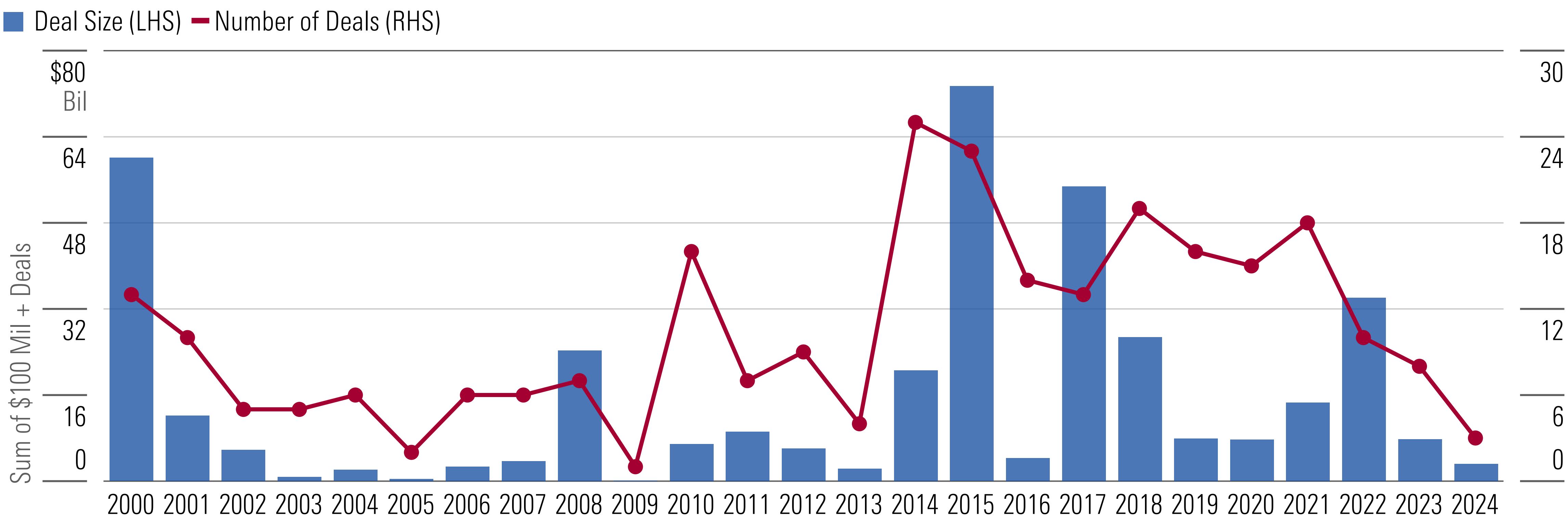


Source: Treehouse Foods. Data as of June 21, 2024.

Hungering for a Deal—Acquisitions Abound in the Packaged Food Sphere

We believe tie-ups can afford packaged food firms the opportunity to gain exposure to a new region by bringing in a local market expert that understands native consumers and the distribution network, lowering the inherent risk of expansion. Further, by acquiring niche start-ups, packaged food firms can test the waters of nascent categories and grease the wheels of their own innovation cycles, while opening previously locked retail doors for smaller operators.

Packaged Food Firms Scour the Fields to Bolster Growth Prospects and Gain Exposure to On-Trend Categories and Regions



Source: Morningstar, PitchBook. Data as of June 13, 2024.

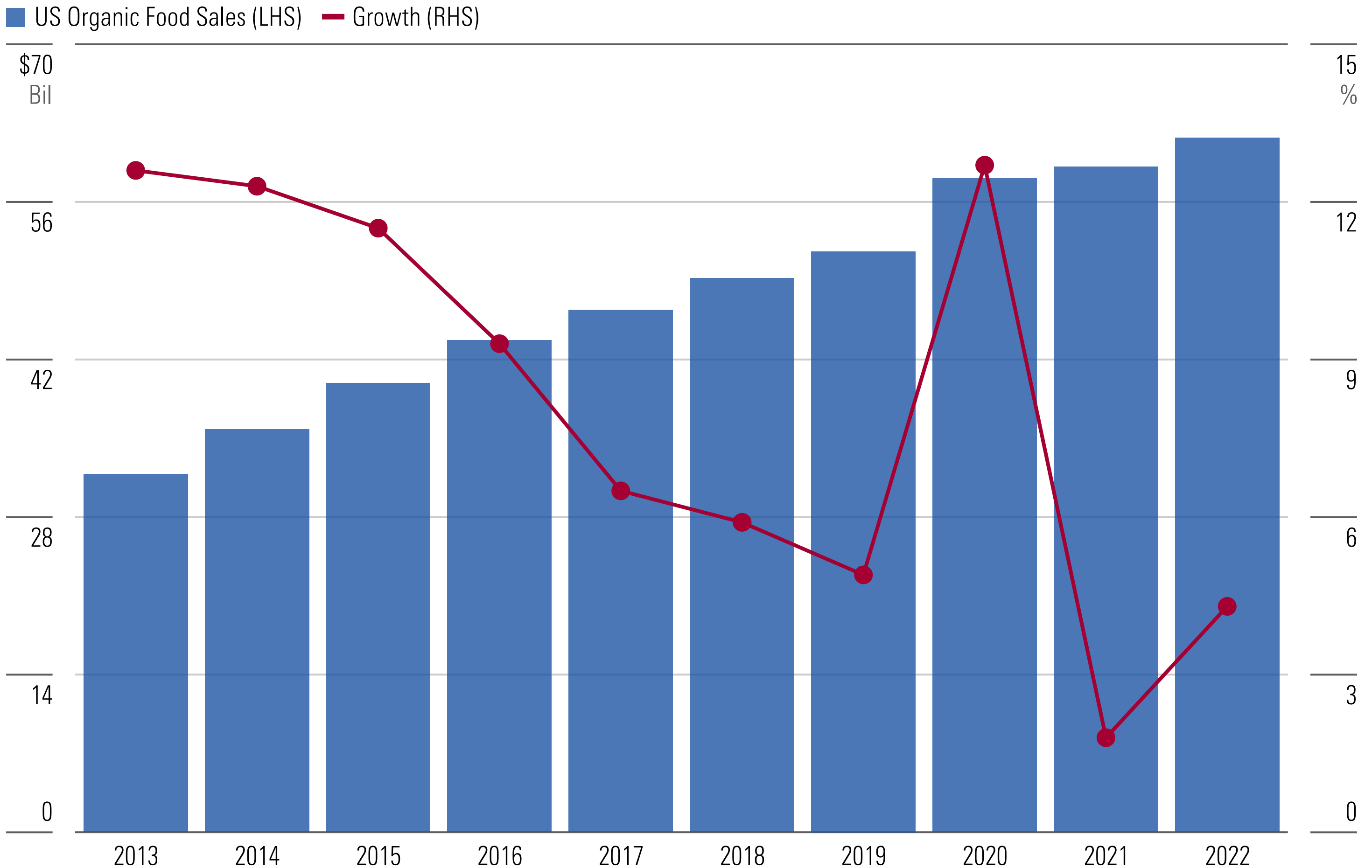
Organic Food Satisfies Consumers' Hankering for Health and Wellness Options

One area ripe for acquisitions the past few years has been in organics. Nearly every aisle within the grocery store now boasts organic food alternatives. Organics have carved out a low-double-digit slice of the US packaged food pie, up from just 7% in 2011.

This equates to nearly $60 billion in organic food sales in 2022, from around $30 billion 10 years ago. While growth in organic food sales is unlikely to resume the double-digit clip that has characterized the space in the past, we think this niche will continue to outpace the broader packaged food realm.

We think distribution gains and consumers' long-standing penchant for healthier fare could bode well for the organic offerings going forward.

US Organics Space Has Continued to Boast Impressive Growth Stats That Should Endure



Source: Organic Trade Association. Data as of May 10, 2023.

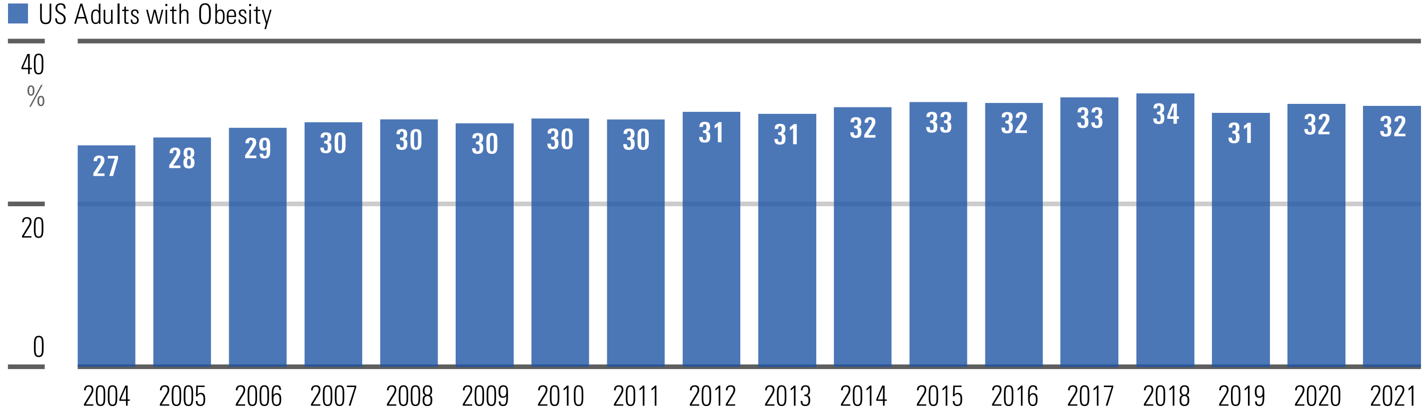
The Continued Deterioration in Consumer Health Around the Globe Stands to Plague the Packaged Food Industry

In the US, an increased percentage of adults classified as obese, at 32% of the adult population in 2021, up from 27% just nearly two decades ago. And these trends are also observed on a global basis. For instance, adult male obesity in Brazil shot up 1,500 basis points to 25% between 2000 and 2022. Even in China, where obesity inflicts just 9% of adult males, this is up 700 basis points since the turn of the century.

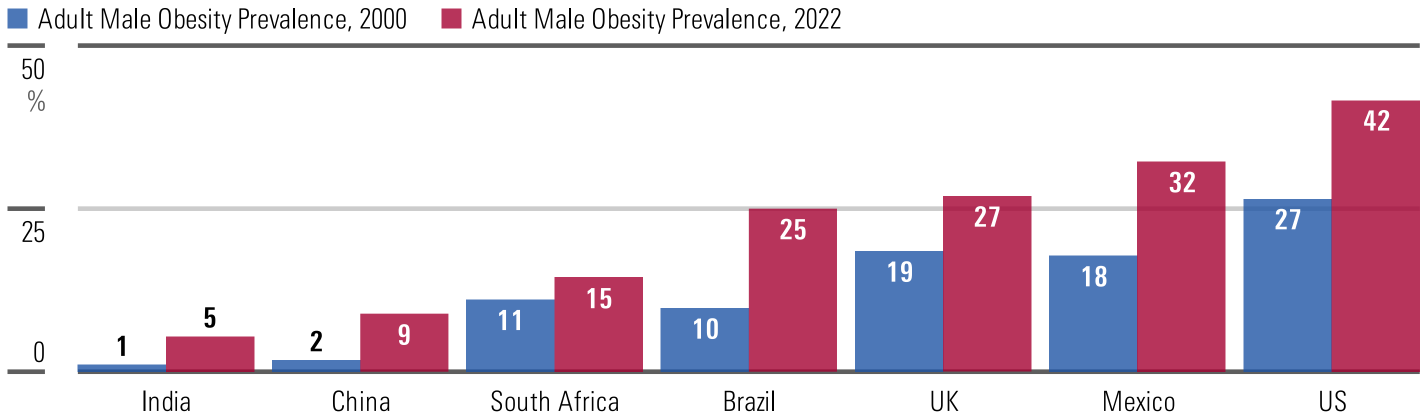
As such, packaged food firms have faced increased ire about the ingredients in their fare. While manufacturers have sought to improve the health profile of their products, marketing such changes to consumers can have the reverse affect, as a healthier product tends to conjure a less favorable perception regarding taste.

Packaged food firms are also challenged by evolving weight-loss trends, which have most recently included GLP-1 drugs. Against this dynamic backdrop, we expect leading packaged food manufacturers will continue to press ahead on innovation to ensure their fare continues to align with consumer preferences.

Despite the Penchant for Healthy Fare, Obesity Rates in the US Tracking Higher Over Time…



…And Similar Trends Can Be Seen Around the World, Though at Significantly Lower Levels

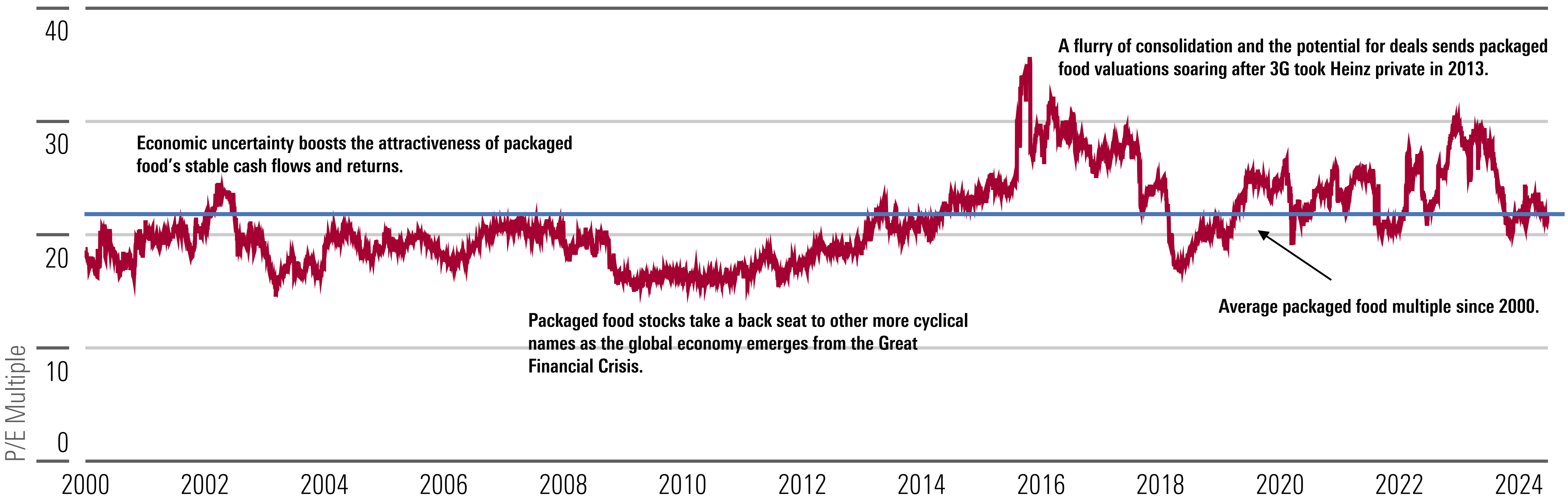


Source: CDC, Centers for Disease Control and Prevention (top right). NCD RisC, National Adult Body-Mass Index (bottom right). Data as of July 2024. Note: Obesity is defined as BMI ≥30 kg/m^2.

Macroeconomic Forces and the Degree of Frenzy Around Deal-Making Tend to Dictate Packaged Food Valuations

Morningstar's valuation methodology is anchored in our discounted cash flow models; however, traditional valuation metrics, such as price/earnings ratios can provide some historical perspective. Packaged food shares traded at a premium to the industry's long-term price/earnings average in the early 2000s following the tech bubble burst and 9/11. Conversely, shares fell out of favor in the late 2000s-early 2010s as the global economy bounced back after the Great Financial Crisis. But then P/E multiples jumped when 3G Capital took Heinz private in 2013, merged with Kraft in 2015, and hungered for further consolidation in the space.

Premium Valuations Manifest in Unfavorable Economic Climates and When the Market Suspects Acquisitions Are on the Horizon



Source: Morningstar Direct. Data as of June 28, 2024.

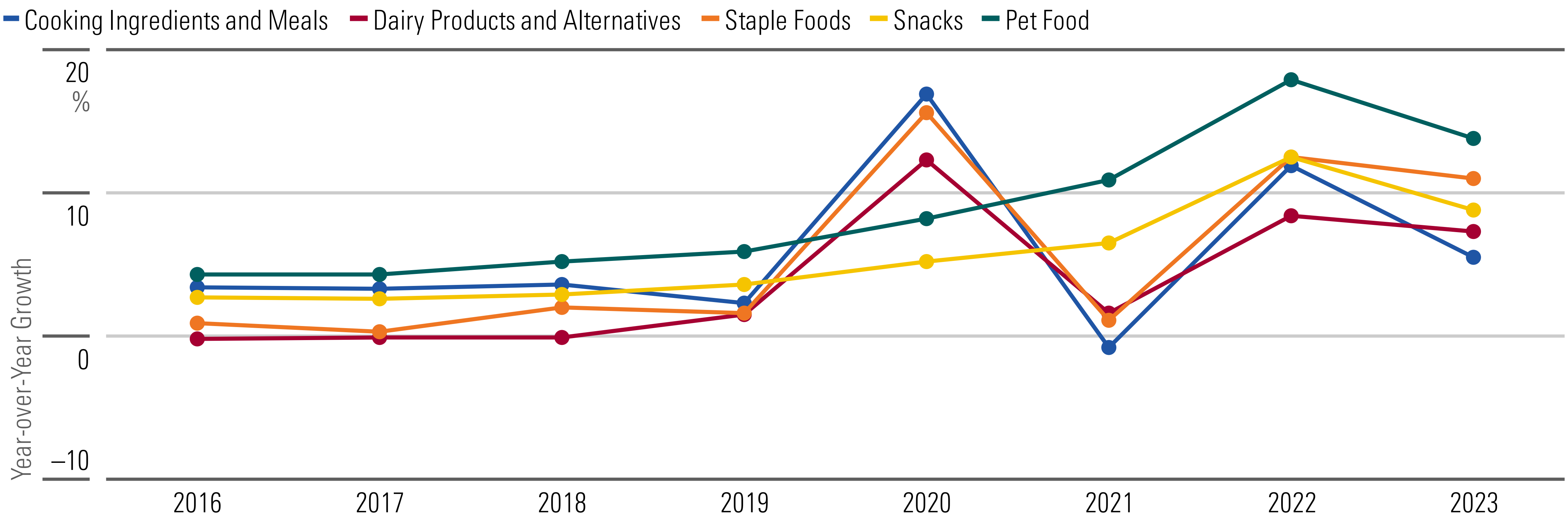
Outlook

Volumes and price juice sales; margins expand despite continued brand spending.

Excluding the Pandemic Surge, the Mature Packaged Food Industry Has Boasted Fairly Consistent Sales Growth

Given the more essential nature of the product mix, sales growth across the packaged food industry tends to be steady, albeit modest, throughout economic cycles. For example, pet care has benefited from the surge in adoptions (up midsingle digits) during the pandemic, which should persist over the life of the pet. Further, consumers' proclivity for convenient, on-the-go meal options has propped up snacking fare relative to the rest of the group, resulting in high-single to low-double-digit category sales growth more recently, a touch above the low- to mid-single-digit rate that the category has touted in the past.

Low- to Mid-Single-Digit Sales Growth Has Historically Emanated From Most Packaged Food Aisles



Source: Euromonitor. Data as of June 27, 2024.

Even as Packaged Food Has Historically Eked Out Muted Growth, Its Trajectory Isn’t Set in Stone

The sales and profit growth prospects for packaged food operators could be altered based on several macro and competitive factors.

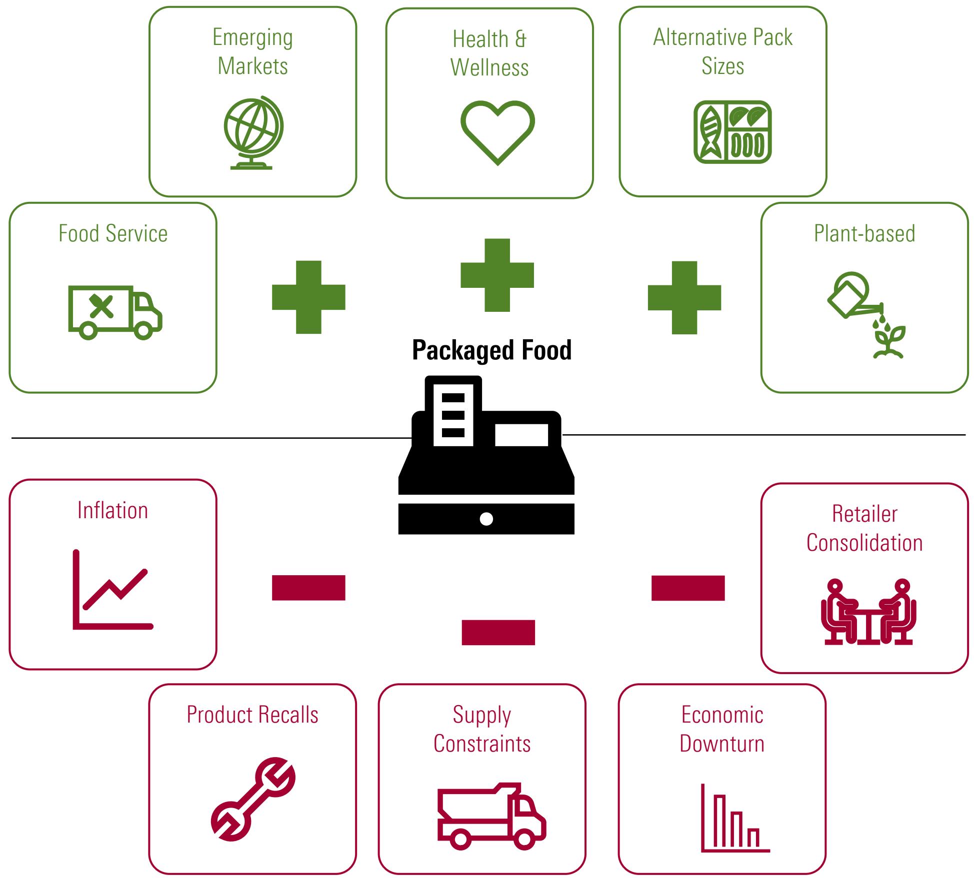
On the plus side:

- Alternative pack sizes: The inclusion of smaller and larger pack sizes can afford the opportunity to penetrate alternate channels, including discount and club.
- Emerging markets: A growing middle-income cohort could provide a large opportunity for operators that appeal to local consumers.
- Food service: This channel enables operators to expand their distribution, while testing new products with the benefit of more instantaneous feedback.
- Health and wellness: With a focus on health and wellness, consumers may increasingly opt for products lacking artificial ingredients.
- Plant-based: More environmentally friendly marketed products across a number of aisles in stores could continue to win out over conventional fare.

On the downside:

- Economic downturns: A weak economic backdrop could lead to lower levels of spending, even on daily essentials.
- Inflation: Consumers could trade down or out of categories to conserve resources.
- Product recalls: If quality is questioned, consumers could balk.
- Retailer consolidation: Further consolidation could shift the balance of power in favor of retailers that could take a harder line on pricing and shelf assortment.
- Supply constraints: Any situation that jeopardizes the ability to get product to shelf could prompt consumers to seek out alternatives.

A Host of Factors Could Lead to Above- or Below-Trend Growth in Packaged Food



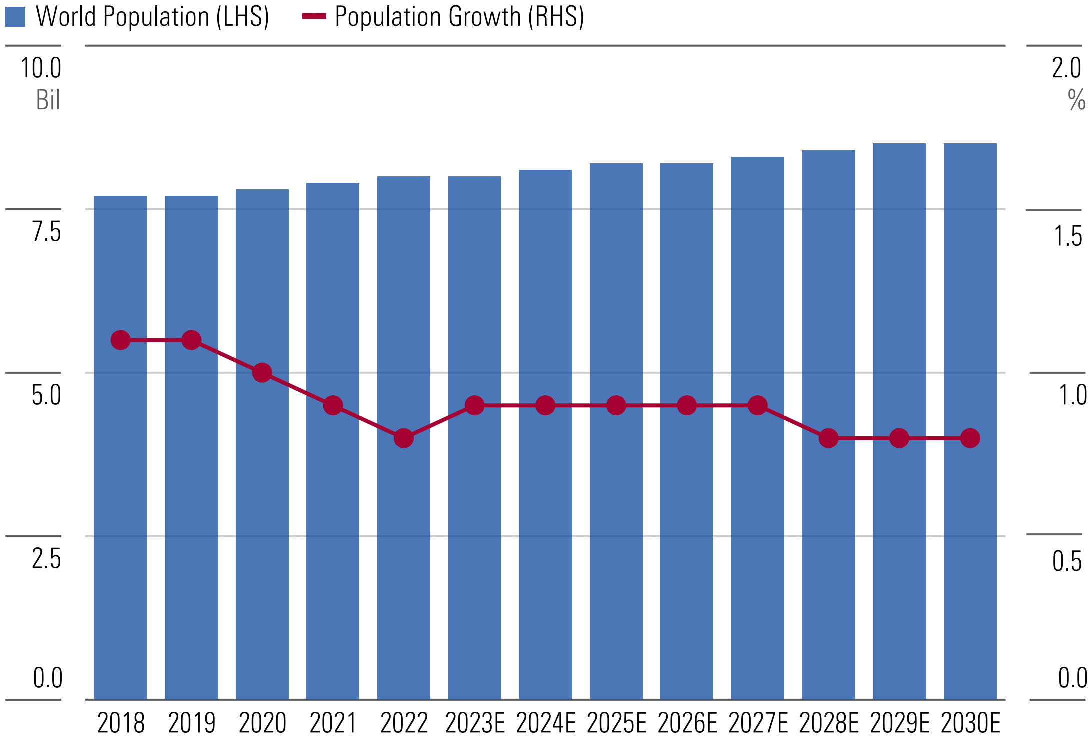
Source: Morningstar.

A Growing Base of Younger Consumers Provides a Foundation for Growth Across the Packaged Food Industry

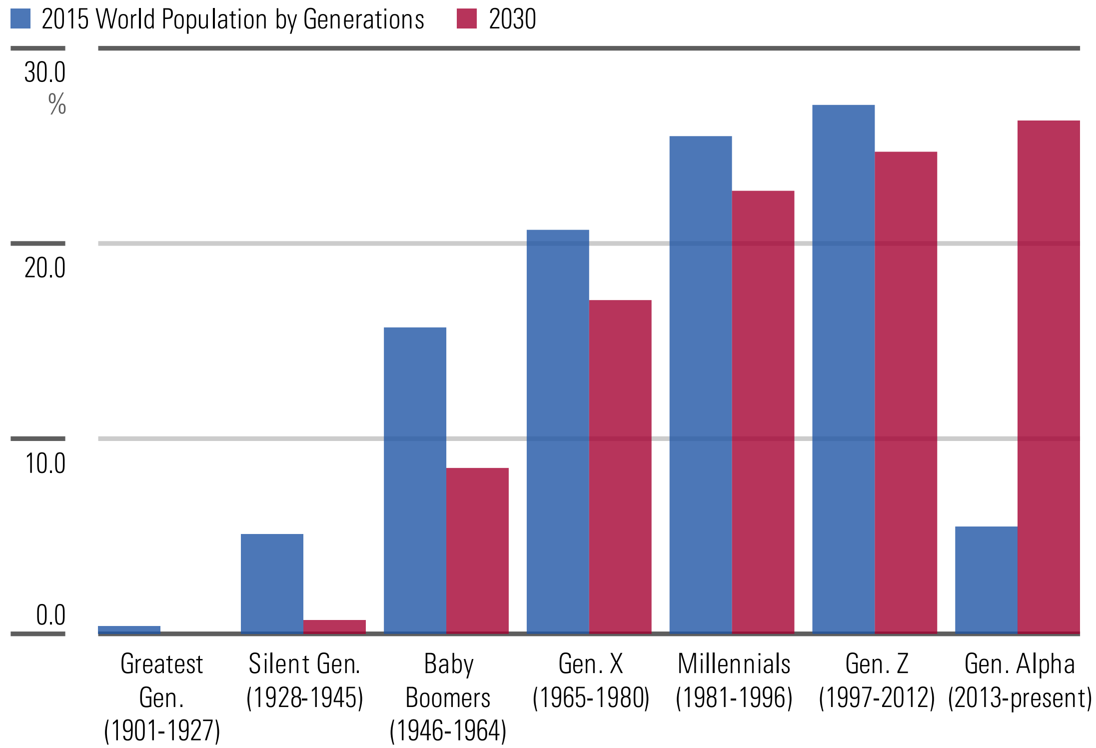
According to the World Bank, population growth around the world stands to increase at around 0.5% annually through 2030. We believe this should offer an expanding pool for packaged food firms to sell their wares over time.

While the baby boomer generation has long set demand trends within the food arena, individuals born since 1997 are slated to constitute more than half of the global population by 2030. This cohort will likely prompt packaged food manufacturers to alter their fare to align with evolving trends.

Modest Global Population Growth Can Buoy Sales of Essential Food Products



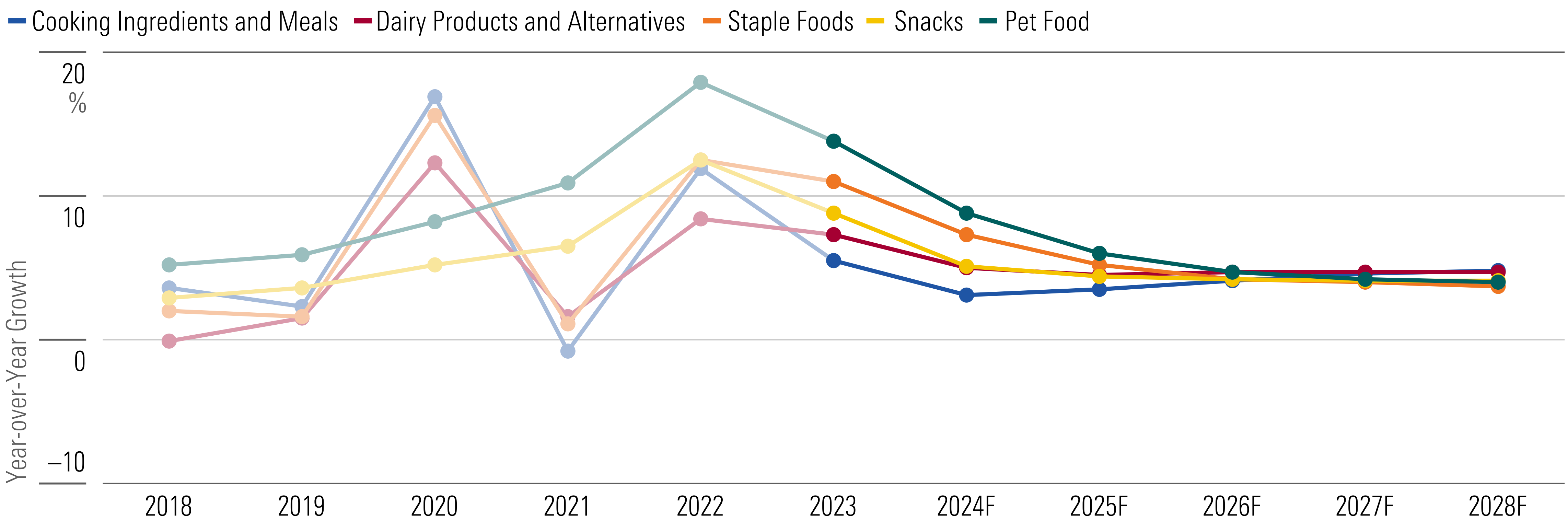
Packaged Food Operators Need to Keep Pace With an Evolving Demographic Base



Packaged Food Operators Poised to Serve Up Modest Top-Line Growth

We never expected the outsize growth during the pandemic (high single to low double digits) would persist. But we still think growth can be achieved in this mature space. In this context, we surmise snacking caters to consumers' desire for convenient, on-the-go fare, while cooking meals and ingredients should benefit from the skills consumers developed after spending so much time at home, with mid-single-digit category growth in the cards for each.

Despite the Heady Uptick the Last Few Years, We Expect Packaged Food Sales Growth Will Temper to the Low to Midsingle Digits Through Calendar-Year 2028

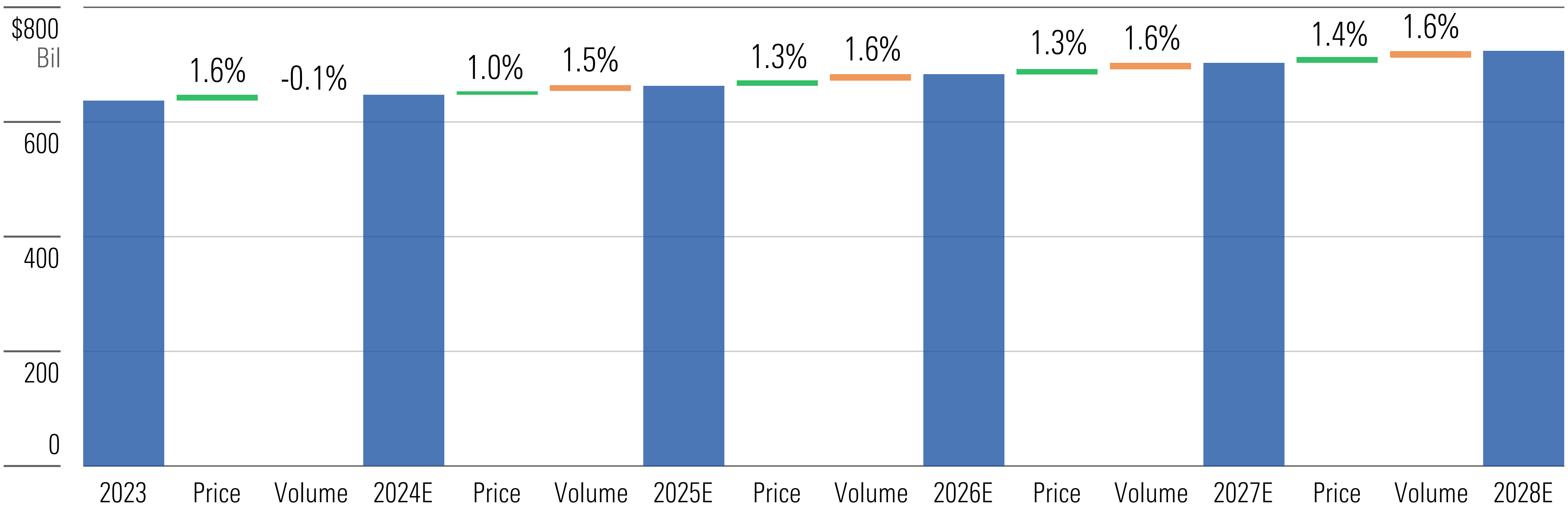


Source: Euromonitor, Morningstar. Data as of July 2024.

We Expect the Sales Lift in Packaged Food to Result From a Combination of Higher Prices and Increased Volumes

Packaged food manufacturers had been growing like gangbusters, following the higher prices put forth to offset intense inflationary headwinds. Even so, volumes have been holding up relatively well, which we attribute to more effective investments to take the pulse of evolving consumer trends combined with the savings that consumers amassed during the pandemic. And we think this information should yield more balanced contributions to top-line growth from prices and volumes over time, to the tune of around 1%-2% each.

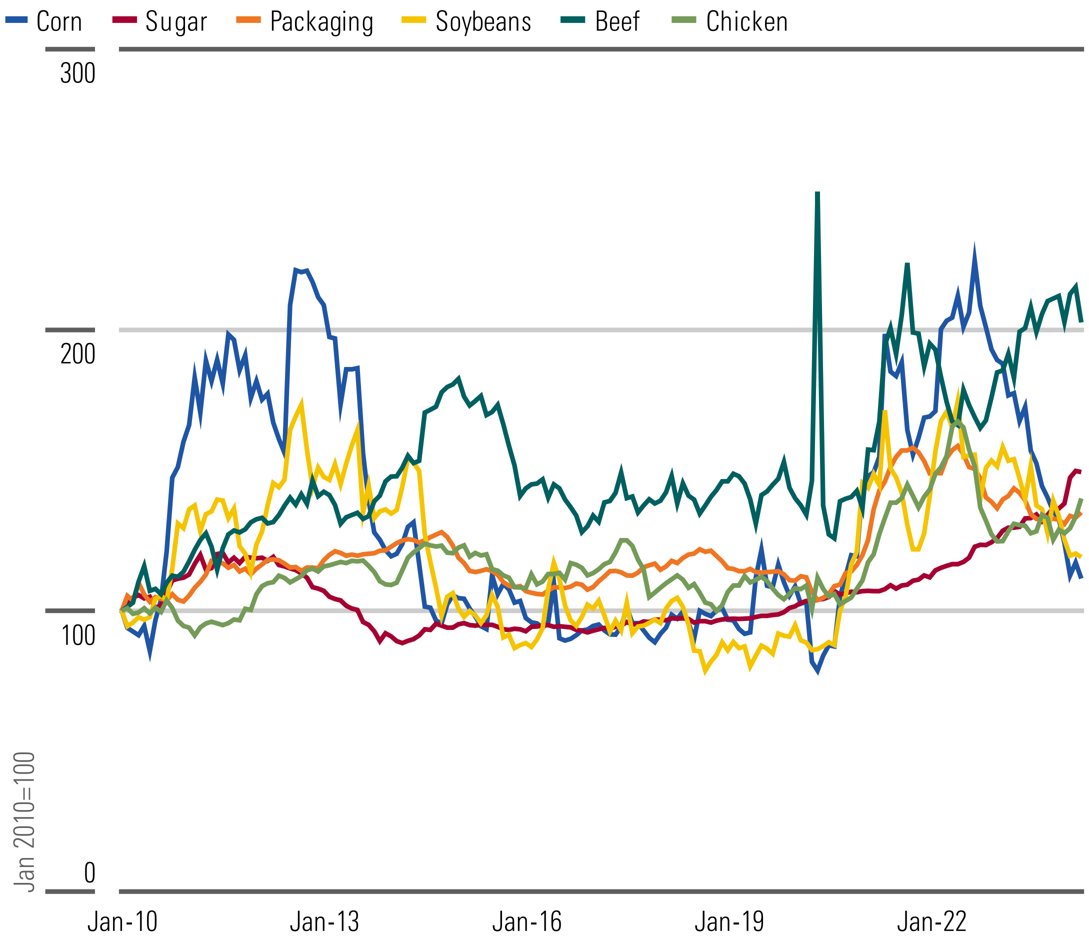
Longer Term, Across the Packaged Food Realm, Our Forecast Calls for Around a 1%-2% Benefit From Pricing and Volumes



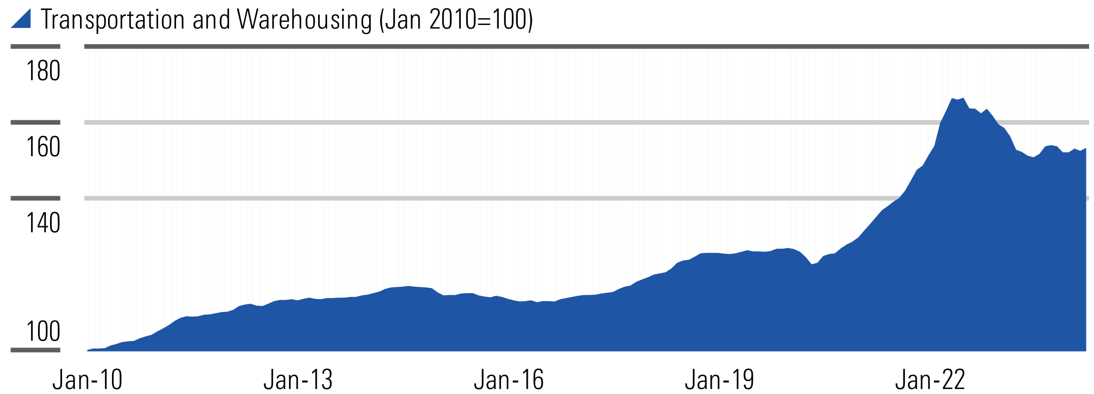
Source: Morningstar, Euromonitor. Data as of June 2024.

Packaged Food Firms Need to Pursue Multiple Avenues to Offset Inflation in Raw Materials, Logistics, and Labor

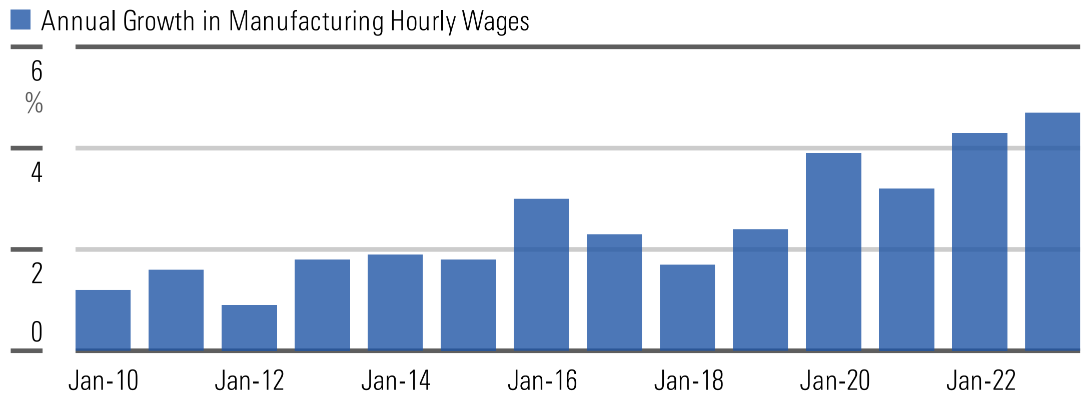
Despite Yearly Volatility, Commodities Have Been Trending Higher Over Time



Transportation Proving an Outsize Expenditure Since the Pandemic Took Hold



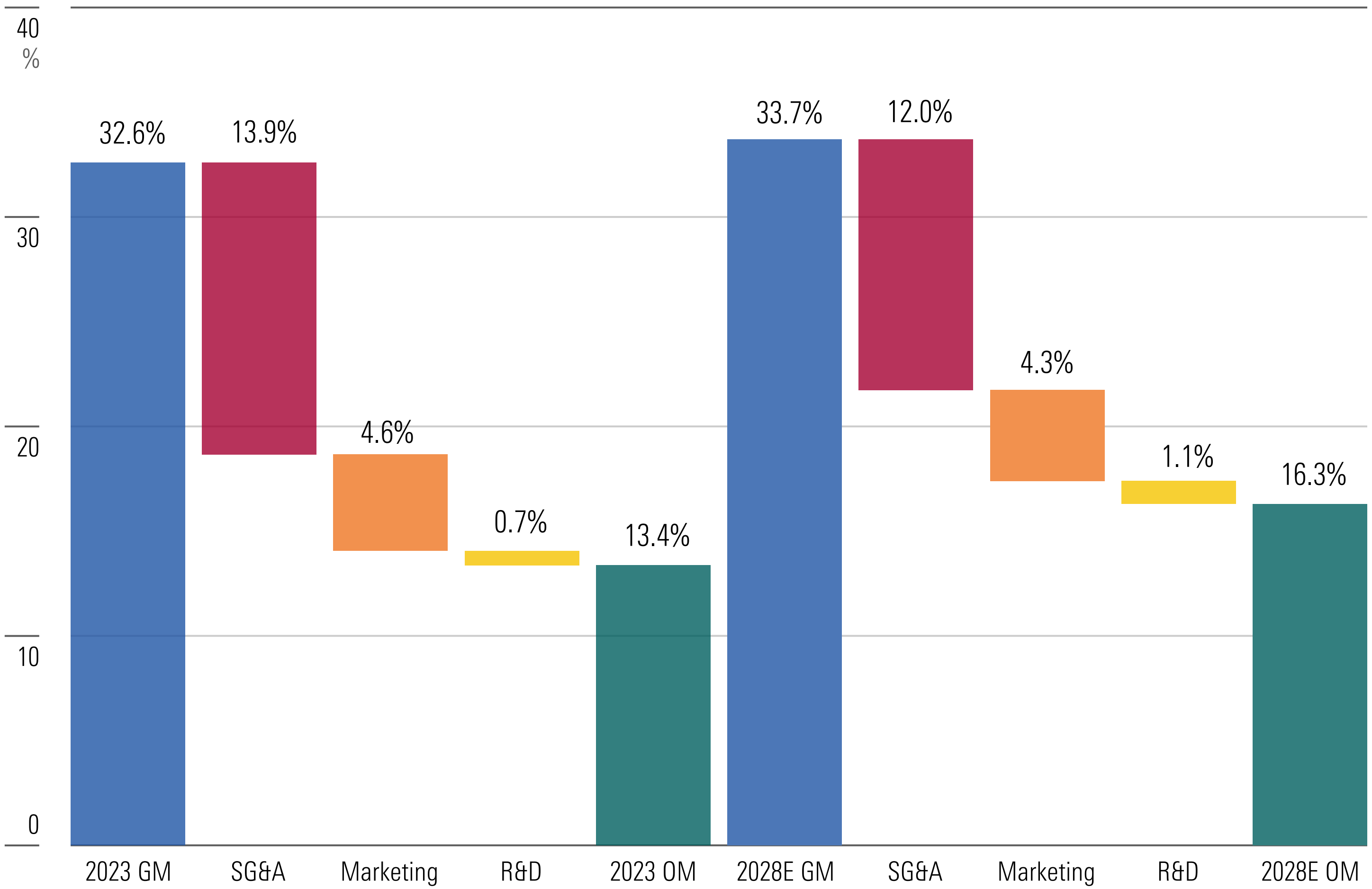
Wage Cost Pressures Stand to Eat Into Packaged Food Firms' Future Profits



Source: FRED. Data as of July 2024.

After Digesting Inflation's Wrath, We Think Packaged Food Margins Should Sweeten Over Time

The Combination of Tempered Inflation and Efficiency Gains Should Unlock Margin Improvement



While gross margins across the packaged food industry were hampered by stepped up labor, logistics, and raw material costs, we believe firms are making strides in blunting the hit.

- Gross margin sank to less than 31% in 2022, down 300 basis points relative to the industry's prior five-year average but improved to more than 32% by 2023.
- We forecast another 110 basis points of gross margin expansion by 2028, reflecting the benefit from higher prices and the unrelenting pursuit of cost savings.
- We don't foresee the industry retracting on brand spending to inflate profits, with our forecast calling for more than 4% of sales to be allocated to marketing and north of 1% to research and development five years from now, generally in line with the levels expended in 2023.
- As a result, we think the industry's operating margin can edge up to the midteens by 2028 from the low teens in 2023.

ESG Snapshot

Product governance and resource use hazards are unlikely to derail food behemoths.

While ESG Risks Not Pervasive, Resource Use and Product Quality Could Prove To Be Pitfalls for Packaged Food

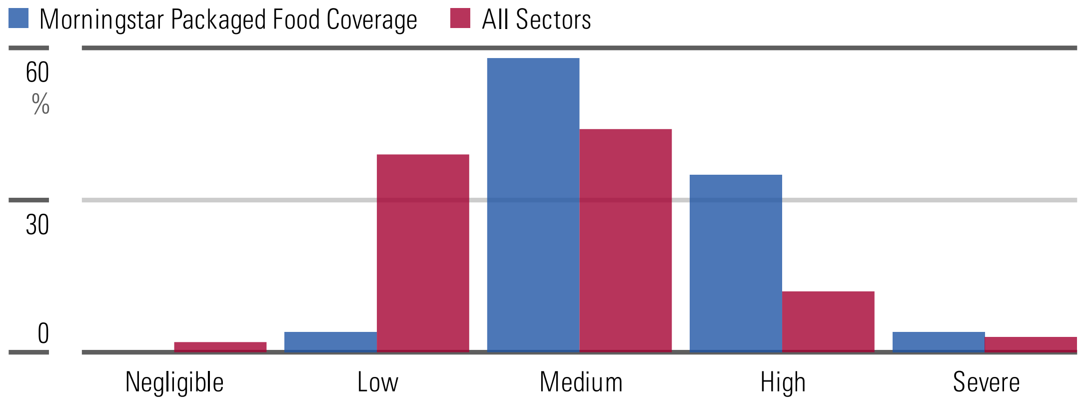
The majority (nearly 60%) of Morningstar's packaged food coverage has garnered a medium ESG Risk Rating by Sustainalytics, versus about 40% across all sectors. The most significant factors to consider when assessing ESG risk among packaged food firms relate to product governance, resource use, and the environmental and social impact of products and services.

Product Governance: The safety of packaged food is critical in this space, as is ensuring marketing messages effectively communicate the attributes of a particular product. A dearth of material incidents (including product recalls) limits the potential impact to valuations.

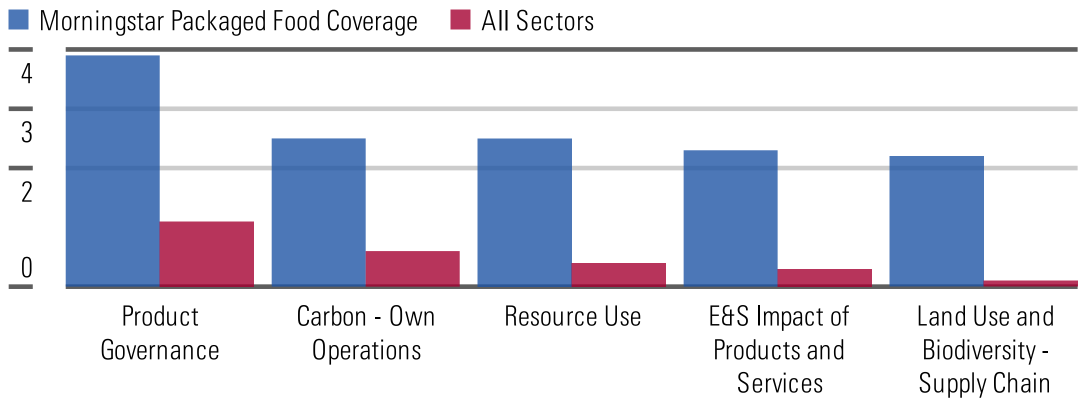
Resource Use: Access to water for the production of various offerings as well as to operate manufacturing facilities around the world is essential in the packaged food industry. Despite the potential for rising costs to secure this scarce resource, we don't posit a lack of access will come to fruition in the near to medium term.

Environmental and Social Impact of Products and Services: This environmental, social, and governance risk can manifest in increased regulation and/or taxes levied to curb the adverse health impacts of center-store packaged food fare. But thus far, such actions have failed to sway volumes.

The Majority of Morningstar's Coverage Possesses a Medium ESG Risk Rating



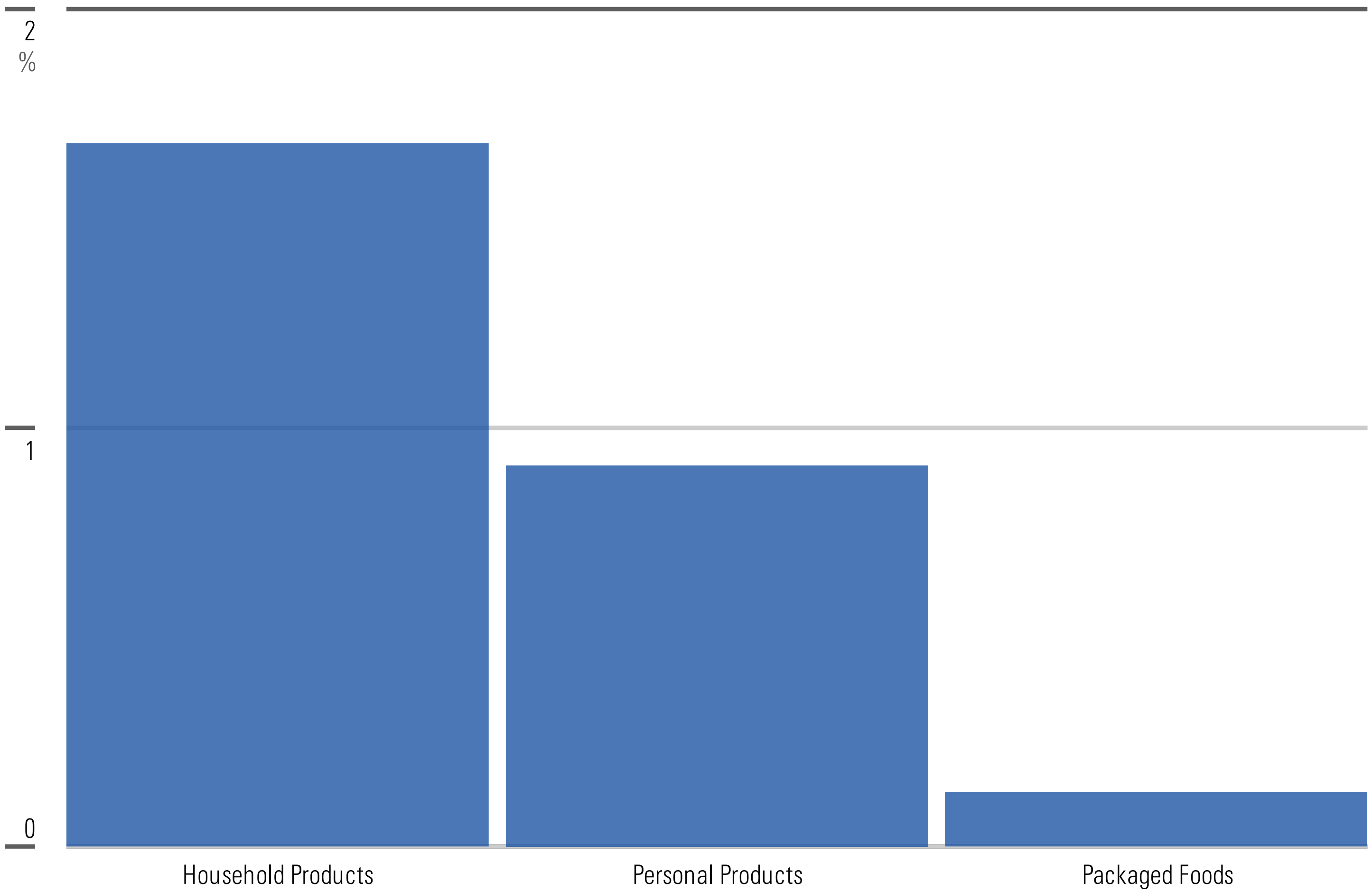
Product Governance and Resource Use Score as Top Material ESG Issues



Source: Morningstar, Sustainalytics. Data as of June 2024.
Editor's Note: Adelina Ciumau, Director ESG Sector Research, Anna Yuryeva, ESG Research Manager, and Alexandru Mironiuc, Hannah Rojas, and Sydney Krisanda, Analysts, ESG Research contributed to this section.

Despite the Hype, Product Recalls and Indictments Around Marketing Haven't Felled Packaged Food Firms

At Less Than 1% of Market Capitalization, Packaged Food Firms Have Faced Bland Financial Penalties
Fines and Settlements Last Five Years as % of Market Capitalization.



Product recalls can dent trust and halt sales (at least for a limited period). Further, lawsuits on the back of misleading marketing practices are likely to garner media coverage and can cause reputational damage.

Product governance failures often translate into fines and legal settlements. But over the last five years, fines and settlements amounted to significantly less than 1% of a packaged food firms' market capitalization on average.

We attribute their ability to withstand such penalties to the fact that companies in this sector tend to be large, stable, and profitable with healthy balance sheets. In addition, most packaged food firms operate with diversified portfolios, implying limited reliance on any one product or brand.

Source: Sustainalytics, Morningstar. Data as of July 1, 2024.

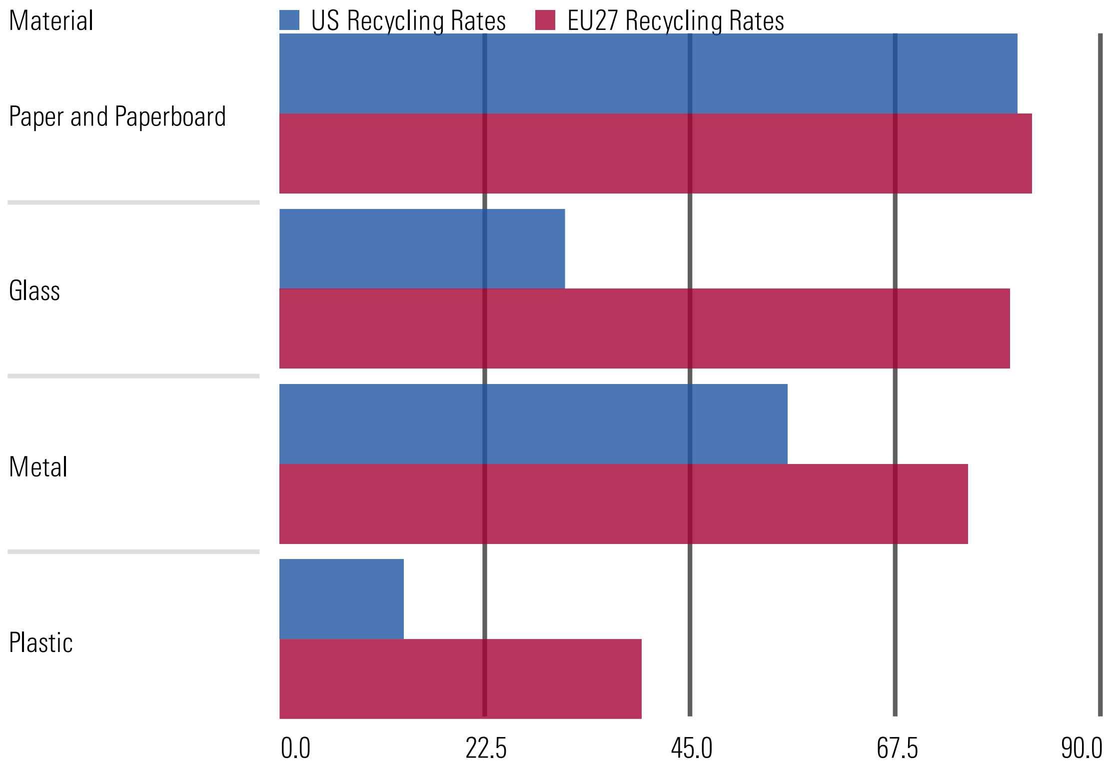
Packaging Is a Sizable Consumer of Plastic, but Recycling Rates Inferior to Glass and Paper

Around 44% of all plastic produced annually is used for packaging. Moreover, because it's single use, it has a disproportionately high contribution to plastic waste, a challenge compounded by its less than 20% recycling rate in the US (placing it far behind the 80% and 33% rates boasted by paper/paperboard and glass, respectively). Even against this, the superior strength-to-weight ratio plastic touts combined with its food preservation benefits make wide adoption of other materials far from ideal. Rather, we surmise minimizing plastic usage and increasing plastic recycling are the most viable route to reducing its environmental impact.

Packaging Is the Single Largest Use for Plastic

Category	%
Packaging	44.00
Building and Construction	18.00
Automotive	8.00
Electrical & Electronics	7.00
Household, Leisure & Sports	7.00
Ag., Farming & Gardening	4.00
Other	12.00

Plastic Recycling Significantly Lags Other Packaging Materials



Source: Plastics Europe. Data as of October 2022 (left). EPA. Data as of 2018 (right). Eurostat. Data as of October 2023 (right).

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