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FOOD INDUSTRY TRANSFORMATION

The Next Decade

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Technomic's Food Industry Transformation (FIT) report examines the accelerating changes in consumer demand and how food producers, suppliers, distributors and retailers must realign their businesses over the next decade to thrive within a new competitive landscape.

The Next Decade *At a Glance*

The food industry in 2025, according to Technomic projections:

$2.06 **trillion**

Total annual food idustry sales, comprising $1.06 trillion in retail food sales and $1 trillion in foodservice sales.

$715 **billion**

Total food industry growth over the next decade, split evenly between foodservice and retail food sales.

12%

Annual growth rate for fresh-format retailers' sales, reaching $60 billion annually in 2025.

13.5%

Annual growth rate for online and other retailers' (delivery, home meal kits, farmers markets and CSAs) food sales, to $60 billion annually in 2025.

20%

Annual growth rate for online distributors' sales, to $16 billion annually in 2025.

Consumers' Changing Values

Total food industry sales will increase by more than $700 billion to $2.06 trillion by 2025—big numbers, but at a compound annual growth rate of about 4%, paling in comparison to more significant shifts in consumer attitudes and behaviors. *Over the next decade, Americans will dramatically change how and where they spend their money.* The rate of sales growth for retailers, manufacturers, distributors and restaurants will not come close to the rate of innovation and change around them, which will create a take-share environment that forces all industry players to rethink their business models, product offerings and supply chains.

For the past few decades, the industry could count on consistent, check-driven sales and unit growth, based on meeting recognizable consumer needs with a model built upon predictable costs for food, labor and distribution. Demographic trends were favorable during this time as well, with population groups and lifestyles aligned with the industry's offerings. Also up to now, regulators have not imposed rules for food quality and safety much more stringent than the industry's voluntary standards. But growing consumer pressure will beget more government activism.

[FIT Shift]

Expect a replay of the popular outcry that purged trans fats from the U.S. food supply—likely directed next at a maligned additive like sodium, high-fructose corn syrup and/or phosphates—in the next 10 years.

Combined with plateaued spending from all but the most affluent consumers, an environment of accelerated change and increased regulation spells doom for outdated food products and behind-the-times retail outlets and restaurants trying to sell them.

Specialized retailers, manufacturers and distributors, many of which are upstarts today, stand to capture substantial revenue in a contest for market share. Legacy brands willing to think and act more nimbly can as well, as long as they align with values growing more prevalent among consumers.

What are those values? Regardless of consumers' age or economic situation, they will continue to develop more sophisticated tastes and noble ambitions for what their food supply should be. They will want food to be healthful and will define health in different ways, and they will want foodservice operators, food retailers and suppliers to have a clean bill of health from a corporate social responsibility perspective as well. If a retail or foodservice brand earns a reputation for putting profits above

[FIT Test]

How Healthy Is Your Supply Chain?

The supply chain of 2025 will reflect consumers' growing insistence on foods that contribute to the health of their families, the planet and society. Wellness and sustainability will lose their elitist associations and inform purchasing decisions in all segments of the food industry. How many of these descriptors apply to your supply chain?

Foodservice operators agreeing that _____ will have a great or moderate influence on purchase decisions in the future:

- **Health and wellness [89%]**
- **Buying local [84%]**
- **No chemicals [84%]**
- **Clean labels [82%]**
- **Sustainably produced [82%]**
- **No hormones/antibiotics [79%]**
- **Humane animal welfare [79%]**

Source: Technomic 2014 operator survey

people, communities, food, animals, or the planet, consumers will continue to find those companies hard to support with their spending and will shift their spending to companies more aligned with their values.

While healthfulness used to mean just calorie and fat counts, it now encompasses multiple descriptors from "natural" and "fresh" to "craft" and "artisanal." That idea will no longer be the purview of only upscale consumers. "Local" labeling will be crucial in grocery stores and other food retail venues. Consumers will demand that food sellers be radically transparent about the sources of their ingredients and will weigh the "true cost" they are asked to pay, such as the environmental effects of production. This dynamic will play out between trade customers and suppliers as well. The premium placed on transparency will extend to a brand's policies for everything from the wages it pays to promoting diversity in its executive ranks.

The Hourglass Economy

By 2025, the demographic and socioeconomic polarization taking shape in society today will become more pronounced, which portends a fundamental rethinking of dozens of industry practices.

U.S. consumers are becoming more stratified by both age and income in an hourglass shape. In demographic terms, the numbers swell for Baby Boomers and for Millennials and Generation Z, but there are several million fewer consumers in the middle classified as Generation X. Today, Baby Boomers still wield considerable economic and political clout due to their size as a group. But their Millennial children and grandchildren have become the largest generational cohort in American history. By 2030, Millennials will outnumber Baby Boomers by more than 20 million.

One trend to shake out from this demographic shift will be greater migration to cities over the next decade, as young consumers begin their careers in major metros and retired Boomers leave their "empty nests" to be near the action in urban neighborhoods. This will continue to minimize car culture, yet because of the "sharing economy," there won't necessarily be less traffic. City dwellers will enjoy the benefits of cars; they just won't own them. *Food businesses will pick up the slack with home delivery of groceries, single meals or large catering orders placed via digital channels.* Retailers will compete vigorously for real estate to pursue these consumers, and resulting rent inflation will necessitate smaller, efficient stores with lean labor models.

Applied to consumer spending, the "hourglass economy" means a relatively small number of affluent Americans hold the largest percentage of wealth and annual income in the economy and contribute a major share of the consumption that drives U.S. gross domestic product. On the other end of the income spectrum, a much larger group of low-income consumers produces its share of total spending in smaller chunks. That group often interacts with the food industry through discount retailers, limited-assortment grocery stores and quick-service restaurants. In between, shrinking numbers of consumers who consider themselves middle class feel stretched trying to afford escalating costs for higher education and home ownership, let alone luxury goods and services marketed to the affluent.

[FIT Shift]

In 2013, the median wealth of upper-income households in the country ($639,400) was 6.6 times that for middle-income U.S. households ($96,500), the widest gap in 30 years. Data point to clear trajectories of increasing wealth for upper-income families and stagnant wealth and incomes for middle- and lower-income households, challenging growth prospects for mass-market retailers.

Source: Pew Research Center

These shifts will also require the industry to reinvent long-standing logistics frameworks. Current distribution models are very efficient but were built by large players around bulk shipments, mega-

plants and large distribution centers. The aforementioned growth in demand for "fresh" and "local" also challenge the underlying assumptions of supply chain models built around goods with extended shelf lives.

Absent any major tax reform, the economy of 2015 will retain its hourglass shape over the next 10 years, perpetuating a two-tier system across the food industry. Sales and market share gains will flow toward high-end luxury products and experiences, as well as value-priced goods. Food companies will have to recognize that bifurcation and meet the demands of consumers wherever they are.

For example, Starbucks is building high-end Reserve Roastery shops in cities for well-heeled guests and experimenting with express units to get a limited lineup of drinks to value-conscious consumers. Others will diversify through acquisitions, as mass-market grocer Kroger did by buying upscale-market brand Harris Teeter to reach more affluent customers.

Since the end of the Great Recession, middle-class consumers have used any windfall, like today's relief from high gasoline prices, to boost savings or pay down debt rather than increase discretionary spending. This trend will persist through 2025. As a result of this stagnation in consumer spending, the sales and unit expansion of brands serving a lower-income customer, such as dollar stores and limited-assortment retailers—including Aldi and Lidl, a major European retailer set to debut soon in the United States—will outpace the growth rates of major retailers (including traditional supermarkets) and chain restaurants (especially casual-dining chains).

DRIVING THE NEXT DECADE

A Steady Supply of Challenges

Fears that the United States and the world can't grow enough food to feed a growing population repeatedly turn out to be overblown. Improved agricultural techniques and farming innovation have increased average crop yields worldwide by 10% per decade, according to the Stanford Center for Food Security and the Environment. Climate change has had a small deleterious effect on that progress, reducing crop yields by about 1% per decade, the same Stanford report found.

But the greater effect of climate change on the food supply is its contribution to extreme weather events that sporadically blight specific crops, disrupt the markets for those foods by keeping consumers cooped up and impede the distribution networks that make up the national supply chain.

Individual crops have been threatened time and again, from the California rice crop last year in the face of historic droughts to the Florida orange crop in 2015 due to deep freezes. Extreme weather also threatens the food industry when it interrupts the delivery of foods to market, as it did during 2014's polar vortex. The weather pattern depressed total foodservice sales between 3% and 4% in January and February 2014. Distributors in weather-affected areas lost between 5% and 15% of sales during the period.

Distribution and logistics bottlenecks already have the power to wreak volatility in the supply chain. *Over the next decade, transportation costs will rise between 50% and 100%, due mostly to the truck driver shortage and increasing intermodal rates. The nation's crumbling infrastructure is unlikely to meaningfully improve, negating much hope for new efficiencies or economies of scale in distribution.* Currently, the gap between open truck driver positions and qualified drivers to fill them is a 35,000-driver shortfall, according to the American Trucking Association. That gap is forecast to become a chasm, with nearly 250,000 fewer drivers than positions demanded by 2022.

The trucking industry's problems are both demographic and economic. First, the over-the-road lifestyle of long stints away from home appeals less to the Millennial workforce than it does to the rapidly aging and retiring generation of Americans who make up the majority of truck drivers. *That fundamental disadvantage will continue to put upward pressure on driver wages, at the same time that most carriers are expected to install electronic logging devices (ELDs) in their trucks to cut down on drivers' ability to exceed limits on hours of service to boost their pay-per-mile earnings.* Widespread adoption of ELDs will level the playing field among carriers, who no longer will be able to let drivers fudge their hours with manual logs. This will force distributors to compete for drivers based on competitive pay scales and services and value provided to customers.

Low fuel prices—for as long as they last—will help distributors' margins somewhat, but not enough to stall the reckoning each company faces with its labor model. Lower oil prices also cut down on the expansion of oil industry jobs siphoning the labor supply from trucking and distribution, but those price fluctuations will cycle up and down over the next decade.

The upshot for every food company over the next 10 years is that distribution costs will steadily climb as a result of wage inflation, higher trucking rates, shortfalls in rail capacity and degraded infrastructure, impacting food costs and pricing strategies for the long haul.

Regulation Nation

In 2010, before a divided federal government effectively halted law passage, Congress passed two pieces of sweeping progressive legislation that will bring about major changes to the food industry in the next decade and beyond: the Food Safety Modernization Act (FSMA) and the Affordable Care Act (ACA). Neither political party is likely to control the White House and both chambers of Congress again in the near future, and experts don't expect the Supreme Court to completely overturn these laws, so the industry should expect no chance of repeal and very little reform. *Retailers and manufacturers must learn to live with the FSMA and ACA and find a way to assimilate the resulting higher food and labor costs into their business models.*

From a practical standpoint, FSMA, and its requirements on manufacturers to trace the ingredient supply back to vendors meeting food-safety benchmarks, probably won't be more onerous than the industry's efforts to improve under the voluntary Global Food Safety Initiative. FSMA's intention to hold all players to the same standard should strengthen the supply chain overall. But there are costs involved with compliance; growers and producers likely will pass along these costs to distributors, retailers and, ultimately, consumers, leading to steady increases in commodity costs every year across the next decade.

[FIT Test]

Could the Food Industry Support a $15 Minimum Wage?

The federal minimum wage might or might not rise from $7.25 per hour. But dramatic action is already taking effect at the state and local levels. Of the 29 states (plus the District of Columbia) with higher minimum-wage rates than the federal minium, nine have wage floors tied to inflation, and another six states will follow over the next five years. Yet economic growth and reduced turnover might blunt much of the pressure on the labor line.

The Political Economy Research Institute estimated in a 2014 report that the restaurant industry could absorb a hike in the minimum wage to $15 per hour over four years, while maintaining a 5% profit margin and not laying off massive numbers of people.

The report assumes an increase in total wages for the Quick-Service Restaurant (QSR) industry from $52.3 billion to $83 billion and assumes companies would save $6.7 billion via lower turnover and bring in an additional $39.5 billion through economic growth. The projections allow for price increases of 3% per year and factor in a slight falloff in consumer demand.

Few meaningful changes to the ACA are possible legislatively thanks to political gridlock in Washington. The food industry likely won't get its hoped-for redefinition of 40 hours per week (not 30) as full-time work requiring ACA compliance, meaning companies will have to either provide health insurance to many of their workers or cut labor hours to avoid the coverage mandate. *Retailers, distributors and manufacturers will need to negotiate the best possible rates with health insurance partners, particularly with an eye toward 2017, when premiums could spike nationwide.* Stephen Parente of the University of Minnesota's Carlson School of Management warns that the ACA's stabilizing mechanisms of reinsurance and risk corridors are set to expire in 2017, along with extensions for noncompliant plans grandfathered in via a 2014 compromise between Congressional Republicans and the White House. Without a replacement or stopgap solution, premiums of ACA plans are projected to rise sharply, especially for low-cost "bronze"-level plans.

I just think people need to make a living wage with health benefits. It also puts more money back into the economy and creates a healthier country. It's really that simple.

Craig Jelinek
Costco CEO
in *Businessweek*

SEISMIC SHIFTS ALREADY TAKING SHAPE

The 'Food with Integrity' Effect

In foodservice and retail food sales, the future will look like a more widely adopted version of the present, in which so much of the shifting market share is going toward more upscale and progressive venues taking a higher-minded approach to the food supply. Expect more retailers to make announcements similar to McDonald's decision to purge chicken treated with human antibiotics from its supply chain. More manufacturers will branch out into organic, health-halo items, like Crisco's new certified-organic coconut oil.

Fast-casual pioneers like Chipotle Mexican Grill, new restaurants like Dig Inn and Bareburger, and Whole Foods in the fresh-format grocery space have been best suited to capitalize on consumers' growing interest in eating healthfully—or "cleaner" or "fresher" when that is what fits their definitions of health.

Chipotle has staked its brand positioning around the "Food with Integrity" message, but every limited-service brand will attempt to increase its credibility in that attribute in some way. Although bolstering their "better-for-you" bona fides can't hurt quick-service chains in the coming years, Technomic still forecasts that the fast-casual segment will have average annual sales growth about three times that of the QSR sector. Stock-market IPOs have reflected fast casual's momentum, including huge valuations for Shake Shack, Zoës Kitchen and Habit Restaurants. Emerging subsets of fast casual, such as "fast fine" brands like Fresh To Order or LYFE Kitchen, are coming into their own and may see similar kinds of growth.

Traditional supermarkets will continue to emulate the offerings and innovative merchandising on display at upscale retailers like Whole Foods, Sprouts and The Fresh Market. *Sales of traditional shelf-stable and frozen foods in the center store will be flat at best by 2025, but the market for perishables will explode.* As producers and distributors strive to meet the demand for sustainable, organic and local food, the nationwide

[FIT Shift]

Nationwide sales of organic food and products totaled $35.1 billion in 2013, according to the Organic Trade Association. Assuming a 14% compound annual growth rate, Technomic forecasts 2025 sales of about $170 billion for organic food and products in the U.S.

supply chain will evolve to include more small farms as well as more acreage devoted to these growing methods. Fresh-format grocery stores and specialty online retailers will win market share from this attitudinal shift among consumers, with a 10-year CAGR in sales of 12% and 13.5%, respectively, expected over the next decade.

Distributors could forge major category growth at the higher end over the next decade, especially if they invest in moving more local food not only to independent restaurant clients and upscale retailers, but also directly to affluent consumers in urban markets. Chicago-based specialty distributor Local Foods, for instance, will complete a 27,000-square-foot facility this spring that will house a farm-to-table distribution center with adjoining retail and dining spaces. The facility aims to be "the Eataly of local food."

[FIT Shift]

Sales of food marketed as "local" totaled $4.8 billion, according to the USDA. Assuming a 14% CAGR similar to that for organic food, Technomic forecasts 2025 sales of about $45 billion for "local food" sold in grocery stores and direct to consumers at farmers markets.

Establishment Food Companies Evolving in Response

In times of widening inequality for consumers, retailers that serve affluent customers, from fine-dining restaurants to high-end stores or luxury brands, will do just fine as long as indicators of wealth like stock and real estate valuations improve.

On the other end of the consumer income spectrum, millions of middle- and lower-income customers seek affordability from all sorts of restaurants and retailers, and they tend to leave any brand that strays too far from everyday value or tries to encourage trading up to higher-price items. Mid-tier offerings tend to get short shrift from companies as a result. Mass-market retailers cannot readily move away from a value-oriented positioning, but they can experiment in reaching out to more affluent consumers via partnerships or acquisition of other companies serving that clientele (see Fit Test at right).

[FIT Test]

Could You Buy Better Reach?

Several mass-market retailers have made growth-minded acquisitions to serve new customers and gain the systems and business intelligence they need to reach new markets:

- ***Campbell Soup*** buys organic-produce brands ***Bolthouse Farms*** and ***Plum Organics***
- ***Kroger*** acquires upscale grocer ***Harris Teeter*** and online vitamin retailer ***Vitacost***
- ***The Hershey Co.*** buys jerky brand ***Krave Premium Foods***
- ***Mondelez*** acquires ***Enjoy Life Foods***
- Wendy's franchisee ***Carlisle Corp.*** buys a controlling stake in ***LYFE Kitchen***
- ***Buffalo Wild Wings*** invests in ***PizzaRev***, looks for other fast-casual growth vehicles

When I found Bolthouse Farms, one of my board directors said, 'Carrots, Denise, really?' and I said, 'No! Packaged fresh!' It's an $18 billion category. … We can bring our capabilities and brands to fresh food.

Denise Morrison
Campbell Soup CEO
in *TIME*

Supermarket fresh prepared foods will lead the way in sales growth in the foodservice industry throughout the next decade by being one of the few segments able to appeal to both consumer groups. Supermarket fresh prepared foods are projected to grow 7.5% per year, as traditional supermarkets retool their stores and offerings with a greater emphasis on the fresh perimeter of the store. *The right mix of fresh prepared foods has the potential to appeal to affluent guests' demand for local, upscale and convenient offerings, while serving as an affordable alternative to restaurant meals for more price-sensitive customers.*

In addition to the double-digit increases expected for fresh-format and online grocers, better-than-average growth is also expected in segments dedicated to value-conscious shoppers. Club stores, dollar stores and limited-assortment stores are expected to log 10-year annual sales growth gains of 5.5%, 5% and 7%, respectively, all above the 3.7% growth rate projected for all retail food sales.

[FIT Shift]

The growth in craft beer's popularity is perhaps the most salient example in the food industry of a premium product taking market share from mass-market offerings, enticing affluent consumers at both restaurants and bars and in retail aisles. In 2014, craft beer and hard cider posted double-digit gains in volume while domestic light and regular beer shed volume. This trend will accelerate the next 10 years, as craft beer appeals widely to men, Hispanics, and Gen Xers and Millennials. According to The Brewers Association, the U.S. brewery count rose by 502 facilities to 3,040 in 2014, a 20% increase from a year earlier and nearly double the number of breweries in the U.S. in 2010.

Aldi, the leader in the limited-assortment grocery space, plans to grow from nearly 1,400 stores to 2,000 locations in the United States and enter key markets like Southern California. Yet it simultaneously plans to sell more organic produce, meat, wine and beer. Aldi plans to stay true to its no-frills, low-cost business model while selling more high-end private-label products—which will still be sold in Aldi's small-footprint stores by small staffs of versatile, cross-trained employees.

THE COMING SHAKEOUT

Navigating the Changing Landscape

Over the next 10 years, the lines will continue to blur between segments of the food industry in terms of service styles and design elements. *Food retailers may not know the final destination, but they're not standing still.* Generally, industry players will attempt to pitch their stores' aesthetics and their product offerings toward more upscale tastes—think fast casual for restaurant brands or fresh format for retailers—while remaining at price levels demanded by their core consumers. *Upgrades to appearances and conveniences will be aimed higher.*

However, the delineation between the two dominant tiers of consumers—affluent people seeking out ever-more upscale experiences, and the rest of the country increasingly prioritizing value above all—will become clearer. To target the value customer, *brands must innovate their product offerings for affordability. Even high-end retailers stand to benefit from giving all consumers more entry-level access to their stores.*

Witness Whole Foods' targeted discounts, expanded private labels, loyalty program and mass-media advertising debut.

In response, regular grocery stores will invest in more fresh prepared foods and on-site eating areas, self-serve stations, and highly trained expert staff like butchers and fish mongers. Labor costs will rise due to those upgrades, leading to new scheduling and labor allocation models that will pull resources from the center aisles of the store and from the ranks of cashiers and support staff up front.

We never wanted to be holy foods market. We want to be a one-stop grocery store.

John Mackey
Whole Foods co-CEO
in *Businessweek*

Expect meal subscription services, such as Blue Apron for fresh meal kits or Club W for wine, to grow in popularity, as such retailers can predictably forecast sales of repeat orders and schedule labor accordingly. Consumers will adopt subscriptions to make getting staple and everyday gourmet and specialty foods more convenient or to save a little money on treating themselves, as with wine clubs.

Traditional restaurant chains will remodel aggressively and incorporate more technology upgrades, often refranchising to accomplish those goals quickly. *Most initiatives will move chains toward a future in which they derive a much greater share of their sales from catering, home delivery and takeout, allowing them to downsize the footprints of their stores and the headcount for staff.* GrubHub has already proven that the demand for restaurant food home delivery was underserved. In the next decade, even fine-dining restaurants will get into off-premise sales via sharing-economy apps like Caviar (already available in 17 cities). Restaurants won't be the only game in town, either. Multiple startups are launching delivery-only models, including fine-food delivery services like Maple (a new venture devised by celebrity chef David Chang) and fresh food delivery services like Sprig (whose menus are devised by Nate Keller, previously executive chef at Google).

[FIT Test]

Where's Your Share?

The industry evolution toward fresher, higher-quality products will cause a fair amount of market share shift, including a realignment of the retail food channel.

Market share of traditional retailers (supermarkets, mass merchants, supercenters) will fall from 71% of retail-food sales to 62%. Nontraditional retail's gain from 29% of the market today to 38% in 10 years will be driven mostly by the online and fresh-format channels, each expected to increase their share of the market from slightly more than 2% of retail sales to close to 6% within the decade.

In distribution, online distributors' 20% annual growth will dominate, upping the segment's share from 1% of distribution sales today to 4% within 10 years.

Prevailing trends favor independents, small chains and fresh prepared foods at grocery stores in the share battle within foodservice. Small chains and independent restaurants will grow share by three percentage points; supermarket fresh prepared foods will rise by one percentage point.

Farmers, Food Manufacturers Cultivate Innovation

Food producers, distributors and wholesalers are continually working to adapt to consumers' changing behaviors, and over the next 10 years, innovations in farming and consumer technology will help them meet the demand for a more nutritionally balanced food supply. *Healthfulness and taste are driving that research simultaneously; innovation over the next decade will produce more whole foods with clean labels and shorter ingredient lists, light on processing and free of additives and genetically modified organisms.*

Vertical farming in urban greenhouses will enable more growers and distributors to keep food extremely local, with the added benefit of cutting down transportation and logistics costs for the end retailer. Setting up hundreds of greenhouse farms in cities would also limit the need for pesticides and herbicides and would cut down on crops' carbon footprints.

Smaller, urban producers and organic farms will also find ways to rotate and sequence what they grow to diversify output while maintaining high yields. Moving from monoculture farming to crop rotation allows growers to replenish nutrients in the soil that are lost from repeated harvests of one crop.

[FIT Test]

Can You Speak to Generation Z?

Generation Z will be the least likely to view advertising messages on a TV and will opt instead for using tablets and mobile phones. Food manufacturers should view this as an opportunity, not a challenge.

The trend opens up dozens of lower-cost, more finely targeted chances to put messages in front of consumers. Manufacturers should start adapting their marketing creative to include shorter videos like 5-second pre-roll ads and banners for mobile screens.

A shift toward a diversified food supply in the name of sustainability will favor smaller specialized distributors, who will grow their market share by leveraging local relationships with small farms to serve a resurgent system of independent restaurants, while power distributors and broadliners focus on chain clients and grow sales more slowly.

Retailers, manufacturers, distributors, suppliers, elected officials and regulators will collaborate on new technologies to address challenges in the food supply. *Platforms designed to fight climate-driven crop shortages or meet consumer demand for local, sustainable food will attract scale-building investments.* For example:

- **Developed in central California by produce giant Driscoll's with a USDA grant, a wireless irrigation network buries moisture-measuring sensors in the soil to calculate where water is needed most, conserving resources.**
- **The Harvester by WISErg converts grocery stores' food scraps into organic fertilizer for farmers, who realize greater crop yields and sell their produce back to grocers, creating a sustainable, closed-loop system.**
- **Hampton Creek, a start-up purveyor of affordable and healthful foods with minimal impact on the environment, has attracted more than $90 million in venture capital and partnered with Compass Group to serve its eggless mayonnaise and egg- and dairy-free cookies.**

Look for progressive retailers to leverage predictive analytics and Big Data to improve assortment and cut down on shrinkage while educating guests about the sustainability of their offerings. Whole Foods, for example, invested in a systemwide point-of-sale platform to collect, unify and disseminate data about its products, from animal-welfare ratings and the presence of GMOs in fresh produce to the locations of farms where certain meats were sourced. Kroger's acquisitions also hint at its Big Data strategies. Its purchase of online retailer Vitacost gives it an entry into delivery, while the "click and collect" service at subsidiary Harris Teeter gives it an online-ordering platform. Kroger has a significant equity investment in Dunnhumby USA, a retail analytics firm that advises the chain on customer engagement and has helped Kroger develop direct-mail coupons with redemption rates of 70%.

Food Brands Embrace Lean yet Powerful Business Models

As the food industry's next 10 years play out as a story of market-share competition rather than broad growth across all categories, brands that want to expand their slice need to embrace big, experiential ideas in smaller, more efficient spaces. The economy of 2025 will combine today's bifurcated economy with the emerging "sharing economy" built on service-driven apps. Affluent consumers will come to expect high-quality service and experiences as table stakes for their spending. Middle-class consumers will seek out brands able to provide convenient services and high-quality offerings at affordable prices.

To meet demand for such experiences but also enable a leaner labor model and more affordable occupancy costs, new restaurants and grocery stores will operate in much smaller footprints. Already Walmart is showing growth of its Neighborhood Market format that fills in white space between its supercenter and club store locations, and that development will continue. Expansion of micromarkets in nontraditional foodservice settings also will likely hold its rapid pace through 2025, and Technomic projects next-generation vending could grow to $20 billion in annual sales.

Less square footage will go toward seating in restaurants and center-store shelves in retail units, and more space will be given to display kitchens and open food prep areas. A larger share of future wholesale clubs and grocery and convenience stores might incorporate features from Whole Foods' most recent prototype in suburban Atlanta. At this store, self-serve stations cover everything from pasta made on-site and bread cut in an automated slicer, to gelato, smoked fish and bulk candy. Dedicated spots in the store hold spaces for cooking demonstrations and consultations with health experts, while an in-store wine bar serves food ordered from a kiosk and delivered to a table.

Lean, efficient stores don't mean food brands will forgo significant, progressive investments. The more manufacturers and distributors face next-generation challenges in the food supply or skyrocketing energy and labor costs, the more resources they must devote to researching solutions. Investment in employees merits consideration, from higher wages to retention-minded programs like Starbucks' online-learning partnership with Arizona State University for baristas pursuing advanced degrees.

Apple, acknowledging climate change, partnered with First Solar to build an $850 million solar farm in California to power its operations in the state. In the food industry, leading suppliers like Chobani, Mars, Marriott, Mondelez and Coca-Cola have also made multimillion-dollar commitments to fund research incubators and accelerators, starting a movement that will grow out of necessity over the next decade.

[FIT Shift]

Competition Comes Online

New online channels for food shopping are building scale and taking share from brick-and-mortar retailers at a rapid pace, which will only accelerate over the next decade. As Instacart launched in Boston, Chicago, Washington, New York and Philadelphia, it was increasing customer counts by 15% to 20% per week. Google Express is in Washington, Boston and Chicago in partnership with Costco, Whole Foods and Target, while Amazon got its Amazon Fresh service off the ground in San Francisco and New York. And supercenters like Walmart were testing delivery services and pick-up fulfillment centers for online ordering.

But these express-grocery formats, as well as delivered meal kits like Plated and at-home private-chef services like KitchIt and Kitchensurfing, do face hurdles to growth. Namely, consumers still value the friendly staffs and in-store experience of shopping for food, and they are wary of marked-up prices and freshness of perishables from online channels.

According to Technomic's Retail Innovation Consumer Awareness and Attitudes Survey, usage is still low for many online food services, but familiarity is high, notably for online grocers (69%), personal shopper services (64%), call-ahead ordering (58%), subscription services (52%) and community-supported agriculture (46%).

Consumers ranked their likelihood of future use as follows: call-ahead (36%), community-supported agriculture (34%), online grocers (34%), personal shoppers (30%) and subscription services (26%).

FIT Models for the Changing Food Industry

By 2025, the transformed food industry will have seen major shifts in where consumers' food dollars go, and the resulting shape of foodservice and food retail will resemble the shape of the next decade's overall retail economy: lots of market share for premium products and services, lots for affordable items, and little for mid-tier foods and venues once marketed to the middle class.

In 2025, the food industry will likely reach $2.06 trillion in sales, an increase of $715 billion compared with 2014. While retail and foodservice will share the new growth equally, Technomic projects notable share gains by fresh-format and limited-assortment stores, online channels, independent restaurants and small chains, and supermarket fresh prepared foods. These shifts are a direct reflection of the changes in consumer demand discussed within this report. Within foodservice distribution, alternative channels, namely club stores/cash and carry and online, will be 16% of the market, compared with 12% in 2014.

Food companies will have to make upgrades in their food sourcing, IT infrastructure and people to keep up with changing behaviors and trends. *Investments in everything from wages and training to compliance with the FSMA and ACA all have their costs, but their absence will threaten profitability even more.* With that in mind, Technomic presents the following models to guide industry players' investments.

THE NEW Consumer Model

- **Consumers will be more ethnically diverse but also polarized in terms of age and income.** They will be interested in upscale food experiences or in maximized value.
- **Consumers will value healthful food** (fresh, GMO-free, local, organic, minimally processed, etc.) and corporate social responsibility.
- **Older and younger consumers** will drive more urbanization, favoring independents, digital channels for food and specialty distributors.
- **Consumers (and trade customers) will demand that companies be totally transparent** about business practices (not just ingredients)and corporate social responsibility.

THE NEW Labor Model

- **Staffing models will bow to popular pressure against low wages.** Brands will trade higher wages for lower turnover and relief from bad PR.
- **Progressive investments**, like Starbucks' tuition assistance or Whole Foods' on-site clinics, will be tools in the contest to attract the best talent.
- **New technology**, from labor scheduling software to digital ordering and fulfillment services, will help contain labor cost inflation as sales increase.

THE NEW Economic Model

- **Escalating occupancy costs in urban markets** will require restaurants and retailers to trim building footprints but maintain sales levels.
- Partnering with players in the digital space or building separate fulfillment centers for off-premise sales and delivery will **enable brands to harness Big Data and keep store-level economics efficient.**
- **Industry regulations won't let up,** adding layers of volatility to input costs. Brands should stay flexible through integration of in-store and consumer tech.

THE NEW Food Supply Model

- Consumer demand for fresh food and clean labels will shift food production to more organic and sustainable production and **require a supply chain that focuses on fresh and local.**
- National distributors will dominate the supply chain for retailers and restaurants, but **specialty distributors will carve out a sizeable niche.**
- **Consumers and regulators alike will push for radical transparency** from suppliers and food brands.

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THE CHANGING FOOD LANDSCAPE: INDUSTRY PROJECTIONS

SEGMENT	2014 Sales ($B)	2025 Sales ($B)	Annual Growth	RATIONALE
Traditional supermarkets	$363	$502	3.0%	*Greater emphasis on perishables, fresh prepared foods and delivery*
Supercenters/mass merchants	139	155	1.0	*Format is not shopper-friendly*
TOTAL TRADITIONAL RETAIL	**$501**	**$657**	**2.5%**	***Losing share to nontraditional channels***
Convenience stores	$61	$89	3.5%	*Increased focus on fresh prepared foods; new formats will emerge*
Club stores	58	105	5.5	*Continued emphasis on food, especially perishables; will develop smaller-footprint stores and expand online sales*
Dollar stores	8	14	5.0	*More emphasis on food to drive traffic*
Fresh format	17	60	12.0	*Ongoing innovation in all aspects; unit expansion will also drive growth*
Limited assortment	22	45	7.0	*Strong appeal to select shoppers, with significant unit expansion potential*
Small grocery	9	12	3.0	*Ethnic and specialty stores remain viable niche*
Drug stores	15	21	3.0	*Will continue to experiment with broader food offerings*
Online/other	15	60	13.5	*Rapid growth in home delivery and meal kits; farmers markets and CSAs to grow*
TOTAL NONTRADITIONAL RETAIL	**205**	**$407**	**6.4%**	***Aligns with changing consumer demographics and shopping habits***
TOTAL RETAIL	**$706**	**$1,063**	**3.7%**	***Innovative formats with good economic models will flourish***
Restaurants and bars	$431	$675	4.2%	*Will enjoy experiential advantage relative to most retail formats*
Top 500 chains	249	364	3.5	*Traditional segments like QSR are mature; fast casual is growth engine*
Independents/small chains	182	311	5.0	*Major growth in urban markets; ongoing innovation, adaptation ensure success*
Supermarket fresh prepared foods	23	51	7.5	*Will receive major investment and attention*
Other	186	272	3.5	*Most non-restaurant segments are stable*
TOTAL FOODSERVICE	**$640**	**$997**	**4.1%**	***Foodservice will grow faster than retail by a slim margin***
TOTAL FOOD	**$1,346**	**$2,061**	**3.9%**	***Foodservice and retail share new sales equally***
FOODSERVICE OPERATOR PURCHASES BY SEGMENT				
Top 500 restaurant chains	$80	$117	3.5%	*Slower growth than in prior years*
Other commercial chains	13	23	5.5	*Supermarkets, lodging are strong growth segments*
Group purchasing organizations (GPOs)	32	49	4.0	*Expanding into new segments, broadening services as they reach saturation*
All other segments	115	186	4.4	*Will be very receptive to new distribution models*
TOTAL FS OPERATOR PURCHASES	**$240**	**$375**	**4.1%**	***Market structure undergoes subtle shifts***
FOODSERVICE DISTRIBUTION				
Power distributors	$97	$136	3.2%	*Benefit by size and scale but have vulnerabilities*
Custom distributors	38	56	3.5	*Slower growth of chain market, especially QSRs*
Club stores/cash and carry	24	45	6.0	*Fewer unit openings, rising online competition cause slowdown compared with prior growth rates*
Online	2	16	20.0	*Will offer transparent pricing, convenient ordering; earliest adoption and penetration in shelf-stable foods and supplies*
All other	80	122	4.0	*Specialists and local-market distributors will benefit from market trends*
TOTAL FOODSERVICE DISTRIBUTION	**$240**	**$375**	**4.1%**	***Industry to grow by more than $10 billion annually***

Note: Inflation assumed to be 2-3% per year.

Source: Technomic Inc., government reports

GET MOVING:
FIVE EXERCISES TO GET YOUR BRAND FIT FOR 2025

1

Reimagine, Reinvent, Reallocate, Repeat ➤ Consumers already have begun to shift what and how they buy in response to evolving demographics, changing priorities, and new realities in the economy and in the food supply, and they increasingly are moving away from traditional brands and venues. They are gravitating toward more contemporary, socially responsible products and suppliers. They won't wait for food companies to catch up via incremental tinkering of their business models (e.g. line extensions, unit expansion, promotions). To stay in the game, companies must fundamentally reimagine how they go to market and reinvent themselves (with a sense of urgency) to fit those changes. *Significant resources, both people and capital, will need to be reallocated to growth channels and categories, which over the next decade will include a more healthful food supply built on fresher offerings and digital platforms for buying and distributing those items.* New offerings must be acceptable to health-conscious consumers and accessible to anyone via online, mobile or digital means. The revamping process will be continuous: Just as food companies today can't rely on what they've always done, they won't be allowed to stand pat with the next round of platforms and products, either.

2

Act Small to Grow Big ➤ If they are to accelerate their pace of change and their speed to market, *FIT food companies in 2025 must act and think like a small company—or acquire small brands nimble enough to meet shifting demands quickly.* Retailers, suppliers and manufacturers must test new products and platforms and be ready to either scale those solutions quickly or fail fast and move on. Corporate strategies must increase a brand's relevance to and coverage of emerging nontraditional channels, as well as growth segments like supermarket fresh prepared foods, GPOs and independent restaurants. The "less is more" ethos will play out in productivity initiatives and efficient store designs that fight skyrocketing food, labor and other operating costs.

3

Embrace Digital and Big Data ➤ Companies must build their research and predictive-analytics teams for consumer and trade customer insights, because the challenges of the next decade—including consumers' demand for greater transparency and food integrity, falling profit margins, and disruptions to the supply chain—can be mitigated with data-driven solutions. Commerce and communication will continue to migrate online and to mobile devices. *Food brands need to develop their capabilities in these channels or partner with digital startups and experts to turn today's transactional data into tomorrow's winning strategies.*

4

Anticipate and Pre-empt the Demand for a Health-Focused Food Supply ➤ Consumers' definitions of health will continue to evolve, and descriptors like "fresh," "local" and "sustainable" will lose their elitist associations and be demanded by all consumers, not just the affluent or activists. *Companies must move their food offerings to higher levels of health and food safety before their key accounts begin to request them.* The day has come when noncommercial segments like schools and healthcare are demanding fresher, natural and local food, for instance. Revamping the supply chain to meet this demand will span everything from manufacturing and sourcing processes to packaging to where plants are located and how their deliveries are scheduled.

5

Boost Your CSR Quotient ➤ Radical transparency will be the price of entry for consumers, not just on food companies' ingredient labels, but also on their brand identity as good corporate citizens. Big companies ignore economic and environmental issues at their peril, especially if activists or upstart competitors are ready to besmirch their reputations. *Brands must audit their policies on the three P's (people, products, planet) with a sense of urgency—but still be mindful of the fourth P: profitability.* They should address everything from antibiotics and humane animal treatment in the supply chain to carbon footprint to employee compensation—and be ready to show leadership in at least one of these areas.

About Technomic

Only Technomic delivers a 360° view of the food industry. We drive growth and profitability for our clients by providing the most reliable, consumer-grounded, channel-relevant data, with forward-looking, strategic insights. Our services range from major research studies and management consulting solutions to online databases and fact-finding assignments. Our clients include food manufacturers and distributors, restaurants and retailers, other foodservice organizations, and various institutions aligned with the food industry. For more information, please contact Bob Goldin, Executive Vice President, at bgoldin@technomic.com.

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