

Megatrends impacting the European agrifood industry

A brief look at business issues

January 2015



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At PwC in Austria, Belgium, Germany and The Netherlands over 16,100 people work together from 52 offices. PwC helps organisations and individuals create the value they're looking for. We're a member of the PwC network of firms in 157 countries with more than 195,000 people. We're committed to delivering quality in assurance, tax and advisory services.

From megatrends to business issues

Agrifood in the spotlight

The Netherlands is the world's second-largest agrifood exporter with key trading partners Germany, Belgium, France, the UK and Russia. In 2013, Russia imported €527m of Dutch agricultural products, including dairy (€257m), meat (€89m), vegetables (€87m) and fruits (€52m) according to CBS. Germany is the world's third-largest agrifood exporter with the Netherlands, Italy, France, Great Britain and Austria as the most important trading partners. In 2013, Germany exported agricultural products and food for more than €64bn. In Belgium, total exported agricultural and food products in 2013 amounted to €27,1bn, with animal products (mainly dairy & meat) and vegetable products representing respectively €6,7bn and €5,8bn. Although these agrifood exports constitute less than 1% of total Dutch and less than 6 % of total Dutch exports, farmers, food companies and retailers actively participate in the public debate about the agrifood sector's resilience and future. Agrifood is making front page headlines. As the Ukraine crisis unfolds, the Russian boycott of EU agricultural products is frequently discussed at a European – as well as a national – level. So what are the determinants of the agrifood sector's future – geopolitics and beyond?

Megatrends induce change

To explore this question more fundamentally, PwC has identified five megatrends shaping our future. These megatrends heavily impact each link of the agrifood value chain. They can be used to explore the drivers of change as well as the long term outlook for the agrifood sector¹. For example, **demographic change** leads to an older workforce and fewer students opting for a career in farming and food engineering. At the same time, consumers spend less and spend differently – for example on healthier foods, or on smaller packages for singles. **Accelerating urbanisation** brings expanding cities and farming in closer proximity, shifting the sector's focus in stakeholder management from ministers to mayors. Cities also face logistical issues on how to bring food in – and waste out. **Technological advances** increases yields and reduces use of energy and water, while food processing has extended shelf life, reduced waste and widened the variety of products. Logistics enable year-round availability of fresh products. On social media consumers share recipes – as well as concerns about food safety. **Resource scarcity** contests the way we produce, source and consume. Whether it is phosphates for fertilisers, energy for greenhouses, or

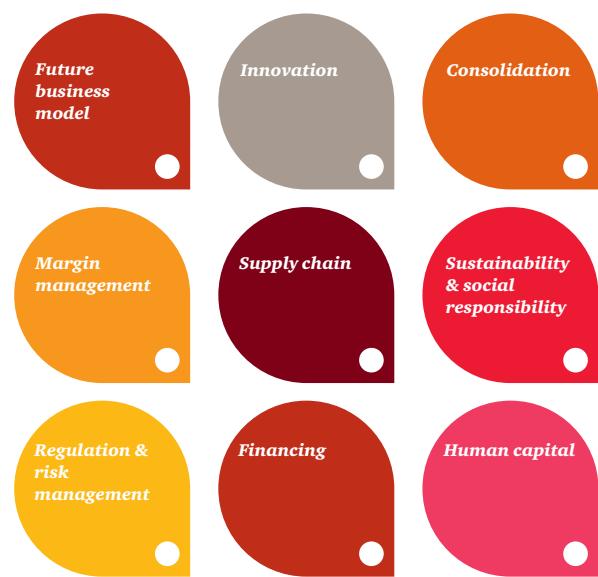
cocoa for food manufacturers, abundance is no longer obvious. Also, the way we ship, store, sell and dispose food needs rethinking. The **shift in economic power** increases living standards in high-growth markets, providing opportunities for agrifood companies to further expand their non-European footprint.

Business issues to resolve

The megatrends impact companies along the agrifood value chain: from seeds, fertilisers, animal feed and milk robots to farmers, trading houses, retailers – and ultimately consumers. All companies are impacted differently, depending on their exposure to each of the megatrends. To help companies formulate a response to their changing environment, PwC structures strategy development along nine business issues.

First and foremost, changes are faster. Companies need to assess whether their current business model is still valid, as megatrends affect industry and market dynamics. Many companies' **future business models** will need to be adapted – if not fundamentally changed. Companies can opt for investing in a differentiated position in the market through **innovation**.

Alternatively, they can strengthen their global presence through **consolidation** and aim for competitive pricing through **margin management**. Each of these directions has profound consequences for the company's **supply chain**, which is already increasingly challenged to meet a mounting set of requirements from **regulation, risk management, sustainability and social responsibility**. Last but not least, the company needs to strengthen its **financial capital** and **human capital** in order to be successful in the rapidly changing agrifood sector.



¹ Megatrends impacting the Dutch agrifood industry: towards a cleaner, healthier, safer, fairer, smarter and stronger sector, see www.pwc.nl/agrifood
Megatrends in der deutschen Agrar- und Ernährungsindustrie - Auf dem Weg zu einer wettbewerbsfähigeren und nachhaltigeren Branche, see www.pwc.de/agrifood

Addressing business issues in agrifood

Model your future business

With a rich agricultural history, The Netherlands and Germany have a well-established global position through their exports of agricultural raw materials and very high efficiency. The global top-25 importers of agricultural products are increasing their imports, as their populations purchase more food. This trend has two implications. Dutch and German exports of dairy, meat, fruit and vegetables continue to grow. Secondly, high growth economies are improving their domestic production, with the result that Dutch and German exports are shifting towards other (higher value-add) product categories. These product categories include fertiliser and animal feed, but also farming equipment and food processing equipment.

This shift has implications throughout the agrifood value chain. Seed companies increasingly serve foreign customers with products such as tomato seeds and potato seedlings. Similarly, companies producing farming equipment such as milk robots and high-tech greenhouses see their international sales growing. Further down the value chain, food majors across dairy, beer and fruit juices are moving closer to their customers in foreign markets, shifting from product exports to local production. Agrifood companies are carefully constructing their future business models by determining where to play and how to play. Depending on their position in the value chain they have different options.

We believe that companies need to decide whether they will aim for developing high-value products, serving high-growth markets, or both.

Developing high-value products requires investments in research and development (see *Drive innovation*). Serving high-growth markets requires building an international footprint and a robust supply chain (see business issues *Consolidate with care* and *Strengthen supply chain*). Companies that are unable to shift to neither high-value products, nor high-growth markets will need to achieve cost leadership to stay in business (see *Rally margin management*).

Drive innovation

The Netherlands is a global leader in agrifood research, with a prominent role for Wageningen University & Research centre (WUR). The Dutch government has identified both the agrifood sector as well as the

agricultural input materials as 'top sectors'. Government policy aims at stimulating innovation and knowledge development, alongside increasing competitiveness of the Dutch agrifood sector, despite declining government budgets. International agrifood companies value this rich innovative climate and established Research & Development (R&D) sites in The Netherlands. Many companies in animal feed, seeds and consumer goods have built their strategy around innovation to grow sales volumes and profitability.



It is our view that the corresponding R&D investments create challenges for agrifood companies. First, development of agrifood knowledge through R&D is costly, requiring highly specialised equipment and staff (see *Rethink your financing* and *Align human capital*). Second, commercialising innovations in agrifood is not straightforward: it requires an integrated approach for R&D, production and sales in order to bring innovations to market. Third, introducing innovative products by itself is not a goal. Only when these products account for a substantial share of total sales, they add value to the company's customers – and bottom-line. This requires a concerted marketing and sales effort with unambiguous incentives for the company's account managers.



In our opinion, agrifood companies that drive innovation need to partner and to focus. Partnering helps gain access to knowledge, capabilities and infrastructure while sharing the burden of R&D investments and bringing products to market. Examples include Seed Valley partners specialising in breeding, food majors collaborating in the Top Institute Food and Nutrition, as well as international joint ventures on a bilateral basis. Foreign partners can also improve access to markets that are more difficult to serve, such as the Chinese dairy market. Focussing is vital for clarifying what the company's competitive advantage is – and its contribution to the partnership. It also acts as a guide to invest limited financial resources most effectively. Lastly, focus helps decide what capabilities must remain in-house and which activities can be outsourced or divested, freeing up much needed capital for strategic investments.

Consolidate with care

Consumers in high-growth markets are catching up with the West in their consumption patterns. 60% of

the world's consumption growth will come from these regions. Agrifood companies have anticipated this shift, by building scale on a national – and increasingly international – level. Merger and acquisitions are common throughout the agrifood value chain. For example, Dutch animal feed companies recently made acquisitions in the UK, China and the Philippines. Dairy farm transactions are rising, while consumer goods firms acquired companies in meat processing, coffee, and beer. At the end of the value chain, supermarket chains disappear from the street view, as their stores are acquired and rebranded by the market leaders.

A closer look at these acquisitions shows they serve one of three purposes: reduce cost through scale, gain complementing capabilities and access new markets. First, consolidation helps agrifood companies reduce their costs, by negotiating more favourable purchasing prices and conditions while capturing operational efficiencies (see business issues *Rally margin management* and *Strengthen supply chain*). Second, consolidation can be a means to acquire complementing capabilities. R&D capabilities in the areas of plant breeding, animal feed ingredients, high-tech greenhouses and food processing are highly relevant. Nonetheless, a partnership may require less capital to access these capabilities when compared to an acquisition (see *Drive innovation*). Lastly, consolidation can grant access to new geographies and market segments, such as food companies expanding in Asia and retailers growing their (online) businesses in Eastern Europe and the USA.

In our opinion, delivering on any of these three acquisition goals requires agrifood companies to carefully manage their acquisition process. When assessing an acquisition target, its legal and operational risks should be taken into account. Recent acquisitions illustrate the importance of site visits to evaluate Safety, Health and Environment standards and a legal due diligence to assess the potential impact of ongoing legal proceedings. The same holds for assessing economic, market, customer and supplier risks. Synergies forecasted based on past financial performance should take the target company's changing environment into account. Again, recent acquisitions underline the importance, with less-than-expected value creation resulting in goodwill impairments.

It is our view that the parent company must closely watch for changes in its own environment, as adverse conditions can add to the burden of debt-financed acquisitions (see *Rally margin management* and *Rethink your financing*). Lastly, acquisitions require a clear view on which staff to retain – and how (see *Align human capital*).



Rally margin management

While consolidation helps companies build scale, develop a global presence and acquire strategic capabilities, their customers tend to grow through consolidation as well. In various cases this tips the balance, with customers exercising considerable buying power and negotiating lower prices. At the same time, resource scarcity and climate change result in volatile prices of commodities, such as late frost destroying hazelnut crops in Turkey earlier this year. The shift in economic power drives global demand for commodities, outstripping supply for instance of cocoa beans from Ghana and Ivory Coast. This combination of higher input prices and lower sales prices puts pressure on margins, in particular for companies that produce goods that do not benefit from a strong brand.

We believe that companies need to continuously scrutinise their cost structure: outsourcing generic functions, investing in automation of production and steering their portfolio towards higher margin businesses. If unsuccessful, companies will need to divest part of their business to reduce debt and boost their solvency.



Strengthen supply chain

Margin management calls for supply chain efficiencies, especially for companies that are expanding their global footprint and face growing complexity. At the same time, the supply chain needs to be robust, with secure access to raw materials irrespective of disruptions such as natural disasters, supplier bankruptcy or breakdown of IT systems. Similarly, the quality and safety of products must be guaranteed throughout the company's entire supply chain. Whether it is melamine in baby milk or furazolidon in animal feed, the cost of errors is tremendous.



It is our view that agrifood companies need to invest in their supply chain: selecting suppliers for long-term partnerships and auditing them on a regular basis, rationalising the operational footprint from a logistics view as well as a tax perspective and boosting integral quality management. Although accidents cannot be fully prevented, companies need to thoroughly prepare for handling a potential product recall and the corresponding aftermath.

Address regulation & risk management

All five megatrends impact the environment of companies, resulting in more stringent and elaborate regulation and demanding diligent management of risks. A sample of annual reports shows that agrifood companies identify a wide variety of risks that can be categorised around: macro-economy, ongoing business

transformation, customers and markets, products and innovation, raw materials and suppliers, finance, regulatory compliance, IT and information, as well as staff and talent.

In our opinion, poor risk management is likely to come at a high cost.

Agrifood companies need to raise the bar: identifying risks beyond the financial domain, covering all critical aspects of doing business. Moreover, these risks should be prioritised, linked to the corporate strategy and mitigated. A standardised framework must be in place, founded on an enterprise risk management system, strong governance and clear control standards.



Lead in sustainability & social responsibility

As the megatrends significantly influence performance of agrifood companies, stakeholders increasingly demand adherence to their interests: governments through regulation and legislation, investors through scrutinising the company's risk management, governance and controls. Nonetheless, agrifood companies have a wider set of stakeholders across communities and societies, some of them less able to demand the safeguarding of their interests. For example smallholder farmers in countries such as Ghana, Kenya, Tanzania and Rwanda can benefit from training in responsible agricultural practices and environmental conservation.



We believe that agrifood companies should nurture mutually beneficial relations with their suppliers, resulting in sustainable production levels. Also closer to home, Dutch agricultural firms are reducing the use of water, energy, fertilisers and pesticides while lowering their production of waste and emissions. Further down the agrifood value chain, food majors and retailers alike focus on improving their sustainability to reduce cost and support their margins. Agrifood companies therefore need to lead in sustainability and social responsibility to reduce their cost of doing business.

Rethink your financing

Addressing the challenges posed by their changing environment requires agrifood companies to invest in scale, innovation, supply chain, organisational transformation, as well as risk management and sustainability. While this calls for careful balancing of projects and programmes on the one hand, it also creates funding issues. With a tighter supply of credit, companies more often need to explore other sources of funding. Alternative sources of debt and equity



could include private placements, issuing bonds, private equity or an initial public offering.

It is our view that agrifood companies need to reconsider their capital structure, while articulating a clear investment case to their current and prospective financiers. Those agrifood companies that are less capable of doing so are likely to face difficulties in refinancing their debt and execution of their strategic investment programmes.

Align human capital

Demographic shifts are transforming the current workforce, increasing the average age of employees – but also their level of education. At the same time, the shift in economic power brings new hiring needs as production has shifted to other countries. Agrifood companies have responded by rationalising their supply chain and production footprint, as well as investing in innovation to add more value to their products.



In our opinion, this calls for new policies in hiring and retaining employees. Innovation-driven companies are shifting towards a higher share of employees with university education, from MSc degrees to PhDs. As companies can no longer afford to sustain a large pool of fixed-contract employees, new forms of employment from flex pools to hiring self-employed staff are gaining ground. Companies therefore need to align their human capital with the changing dynamics in the agrifood sector.

Deciding on the future

From megatrends to business issues

Farmers, food companies, retailers and politicians are actively and vocally discussing the future of the agrifood sector. To help explore the sector's future, PwC has identified five megatrends and assessed their impact on each link of the agrifood value chain². Companies along the agrifood value chain are impacted by these megatrends: from seeds, fertilisers, animal feed and milk robots to farmers, trading houses, retailers – and ultimately consumers. Agrifood companies are impacted differently, depending on their exposure to each of the megatrends.

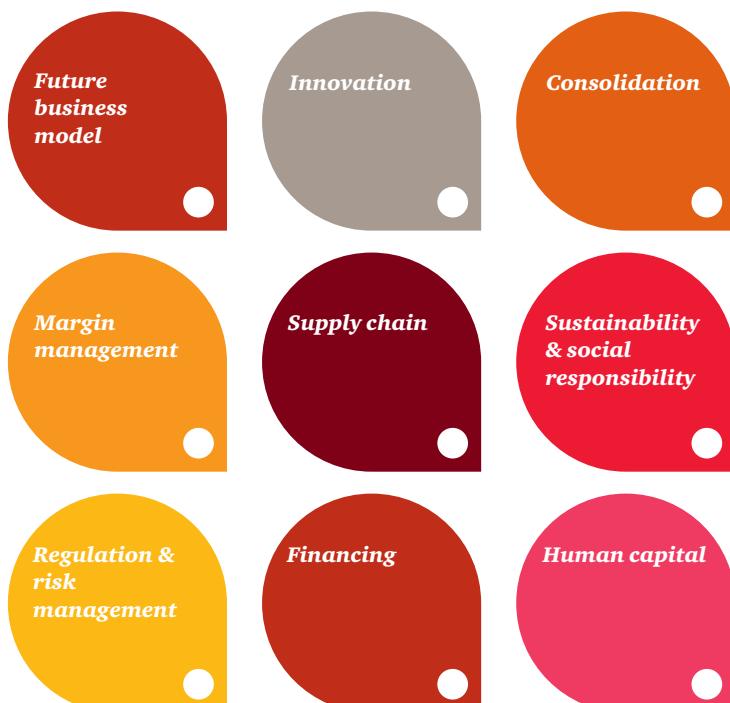
To help companies formulate a response to the changing environment in the agrifood sector, PwC has structured strategy development along nine business issues. First and foremost, companies need to assess whether their current business model is still valid. Often the company's **future business model** will need to be adapted – if not fundamentally changed. Companies can invest in their differentiated position in the market through innovation,

global presence through **consolidation** and competitive pricing through **margin management**. Each of these directions has consequences for the company's **supply chain**, which also needs to meet a mounting set of requirements from **regulation and risk management**, **sustainability and social responsibility**. As the **financial capital** and **human capital** are the foundation on which the company is built, they need to be carefully managed throughout the transformation programmes that many agrifood companies are currently executing.

Tackling the 3 key business issues first

Three business issues stand out: the business model for the future, innovation and consolidation. Agrifood companies need to decide whether they will aim for developing high-value products, serving high-growth markets, or both (see **Model your future business**). Developing high-value products helps maintain or even improve product margins, but requires investments in research and development (see **Drive innovation**). Serving high-growth markets enables volume growth and scale benefits, but also requires diligently building an international footprint (see **Consolidate with care**).

The other business issues are then linked to these decisions. Agrifood companies that are unable to shift to neither high-value products, nor high-growth markets will need to achieve cost leadership to stay in business (see **Rally margin management**). Those companies that are moving towards high-value products and high-growth markets will need to create a matching and robust operational footprint (see **Strengthen supply chain**). In addition to meeting the company's requirements, the supply chain also needs to meet external requirements from governments and societies (see **Address regulation & risk management** and **Lead in sustainability & social responsibility**). The last set of constraints that completes the companies' balancing act are those in terms of financing and staffing the companies' future business (see **Rethink your financing** and **Align human capital**).



² Megatrends impacting the Dutch agrifood industry: towards a cleaner, healthier, safer, fairer, smarter and stronger sector, see www.pwc.nl/agrifood

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PwC experience

PwC is strongly committed to the agrifood sector in Europe as well as on a worldwide basis. In Europe, we have a dedicated team of people firmly rooted in the sector and the members of our practice have a solid track record in agrifood. We're a network of firms in 157 countries with close to 195,000 people who are committed to delivering quality in assurance, tax and advisory services – on all levels, from strategy to execution.

PwC created a global Agribusiness Research and Knowledge Centre, in order to keep our staff and clients around the world updated on the main issues and trends. This Agribusiness Research and Knowledge Centre also provides market intelligence services about and towards the industry and supports local practices. Some examples of our experience within the agrifood industry:

Food safety

PwC has helped various governments formulate comprehensive food security strategies. These have looked at the key risks and exposures those countries faced with regards to food security; changing food supply/demand dynamics locally and globally; issues by key food commodity type; assessing current plans to address current issues; formulation of new initiatives to solve key food security risks, both in the short and long term; overall cross-government coordination and implementation plans. Furthermore, we advise food producers and retailers on choosing and implementing technology for traceability along the supply chain, like barcodes, RFID and mobile applications.

Sustainability and climate change

Recent projects in the sustainability and climate change area include: evaluating the business case and socioeconomic benefits for local sourcing of agricultural raw materials, development of a methodology and carbon calculator for understanding emissions from small holder agriculture, and assessments of market and financial opportunities for climate-smart agriculture. PwC also prepares and audits annual sustainability reports, develops ecological profit and loss statements (eP&L) and detects "hot spots" along the supply chain, for example regarding CO2 or water savings.

Internationalisation and realigning your business & tax model

An increasing number of market players is streamlining and realigning their international organisation. PwC helps agrifood groups with these processes and thought alignment of strategy, operational opportunities and tax position. PwC – in close and joint effort with its clients – creates and designs a tax-efficient business model. PwC has unique and broad experience in transforming and integrating future business and tax models and to drive the required transformational change. Hereby risks are mitigated and a platform is provided for future growth of the respective company.

Supply Chain as facilitator for Profitable Growth

The Agrifood focus on profitable growth creates a dual role for supply chain management. Its new role is to support and facilitate the growth, to make sure that the new products and services get to the market quickly and that the distribution channel is well equipped to serve the new markets flawlessly. PwC has helped numerous agrifood organizations in this transition, where agility and responsiveness are added to the list of performance criteria. This comes on top of the traditional supply chain role of reducing cost and improving efficiency. At PwC, we understand that the objective of cost reductions and efficiency improvements is not anymore downsizing but freeing up the resources that are needed for growth.

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