Green Hasson Janks & Food and Beverage

2014 Industry Snapshot

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Introduction:

The dynamic U.S. food and beverage industry is driven by constantly shifting consumer trends, increased competition and constant innovation. To remain competitive, it is important for companies to continually evaluate their business models and offerings. Executives are cautiously optimistic about the future, reporting slower growth than anticipated over the last 12 months. Although topline growth was modest, companies continue to invest in product innovation and infrastructure refinement. With a new emphasis on expanding customer bases in existing markets, fewer companies are looking to expand into new territories. Deeply entrenched in their communities and with their customers, companies appreciate the impact and value of brand recognition.

Last year, executives expressed concerns about the challenges their companies would face in 2013. Although many of these challenges did materialize, most were not at the level initially anticipated. Competition and pricing continue to be top areas of concern for the coming year, and raw material costs persist as an ongoing worry. Yet, in spite of the challenges, the industry is optimistic predicting continued increases in sales, product offerings and workforces.

Green Hasson Janks recently conducted its annual Food and Beverage Industry Survey with west-coast business owners and executives. As in 2012 and 2013, this year's study demonstrates continued industry growth with the majority reporting modest increases in profit margins in 2013. More than half of the survey respondents report that last year's gross profit margins showed no change compared with the prior year or grew by less than five percent. Similar numbers of executives expect the trend to continue through 2014.

> *Competition and pricing continue to be top areas of concern for the coming year, and raw material costs persist as an ongoing worry.*

In addition, while more than half of executives report full-time equivalent employee increases in 2013, fewer than 20 percent expect double-digit workforce growth for 2014. With larger companies maintaining stable employee counts, executives are cautiously optimistic about the immediate future of the marketplace.

Sales and revenues continue to enjoy modest growth, but pinched gross profit margins are an ongoing concern for respondents. Industry executives are indicating slower growth with less marketplace growth between one and 10 percent.

> *Respondents state that increased market competition and pricing competition represent top-of-mind considerations for 2014.*

An overwhelming majority of participants reports expansion within existing customer bases as a primary revenue source. While a focus on new product innovation is down slightly from last year's study, nearly half of companies plan to invest in developing new products based on consumer input. In addition to new-product development, respondents say that pricing strategies will also drive future profits. Executives also plan to secure new customers in existing markets as additional sources of revenues.

Respondents state that increased market competition and pricing competition represent top-of-mind considerations for 2014. As demand over raw materials increases, concern over the costs rose through 2013 and is expected to top challenges for 2014. Executives also indicate that labor costs including employee retention as well as government regulations and food safety will continue to present challenges this year.

In response to tighter profit margins, companies are turning to digital marketing methods to launch new products and communicate with customers. With more than half relying on email campaigns, only slightly

fewer executives turn to social media for ongoing brand marketing and communication initiatives. While the overwhelming majority report the active use of a website, only half say that they use social media sites including Facebook, LinkedIn and Twitter among others. Additional reported uses for social media include gathering customer data, new talent recruitment and enhancing workforce productivity.

The majority of industry executives plan to continue 2013's investment in organic company growth, focusing on new-product development, pricing strategies and geographic expansion. An emphasis on business-model modifications in addition to improvements of operational and financial processes and technology also top the list of key management initiatives through 2015.

With industry growth of less than five percent predicted by industry experts for the coming year, food and beverage executives will need to employ strong initiatives to ensure stability and continued success in a turbulent and global economy. With processed food manufacturing being dominated by a powerful few, smaller brands will need to create a differentiated brand, products and experiences for consumers.

Globally, the entire industry is an extremely competitive market where profit margins are typically low. Increasing energy costs and changing consumer tastes have affected the processed food sector and escalating feed costs have impacted poultry and livestock companies. Similarly, technology and globalization have revolutionized the way businesses grow, process, package, transport, purchase and cook food.

Careful financial analysis, strategic planning and a commitment to innovation are keys to ensuring the industry's success. This report presents key factors that affected the industry in 2013 as well as a providing an outlook on the industry for 2014 and beyond.

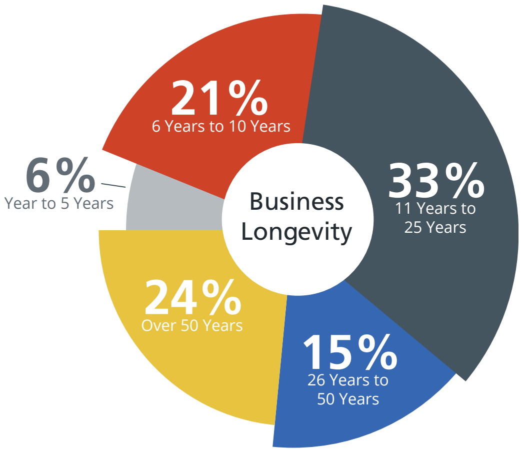
About the Respondents:

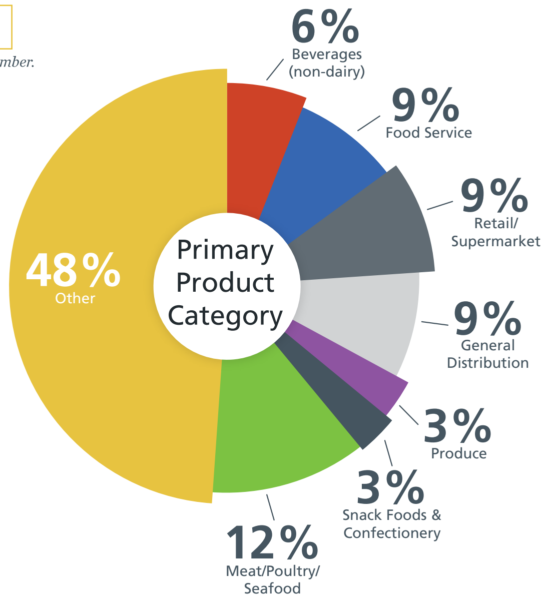
Green Hasson Janks' 2014 Food and Beverage Industry Survey respondents represent a diverse cross-section of the industry with the overwhelming majority of companies based in Southern California. All of the respondents were C-Suite executives or above with the majority representing CEOs and presidents.

Nearly one-third of companies are family-owned, and the overwhelming majority of companies (in excess of 70 percent) have been in business 10 years or longer. An impressive 39 percent have cited longevity of more than 25 years with 24 percent reporting corporate durability of a half-century or more.

Participant Profile

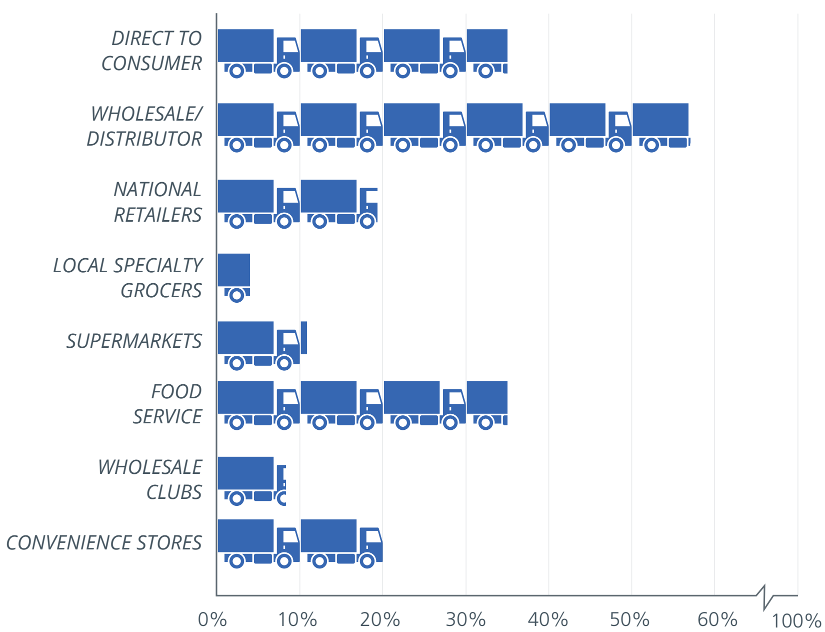
Values have been rounded to the nearest whole number.





Collectively, respondents report primary distribution (in excess of 50 percent) through wholesale or distributor channels. This is followed by food service (35 percent) and direct-to-consumer (35 percent) outlets. The majority of respondents represent the middle market with approximately 76 percent reporting 2013 gross sales of less than $100 million. With half of participants reporting a workforce of fewer than 25 full-time equivalent employees, more than 36 percent boast an employee count above 100.

Methods of Distribution



Background Information:

Experts report that the American household spent $6,599 on food in 2012, representing a slight increase (2.2 percent) over the previous year. This figure includes $3,921 for at-home meals and $2,678 dining out.[1] According to the Bureau of Labor Statistics, food accounts for 13 percent of the typical household's spending, behind housing and transportation expenses.[2] With Americans spending slightly

$6,599

average amount spent per household, per year on food.

$3,921 spent eating at home

$2,678 spent dining out

more overall than in previous years (3.5 percent),[2] the retail grocery store and supermarket industry is demonstrating continued growth with 2013 revenues reported at $650.1 billion, up from 2012's number of $634 billion.[1] Bargain-seeking Americans are buying food in discount outlets with $435 billion in food purchased at wholesale clubs and dollar stores.[1] Generic store brands are demonstrating growth and major supermarket chains are adapting merchandising strategies based on consumer needs. While the economy continues to present challenges and concerns for most Americans, the food and beverage industry may be one sector that continues to maintain or increase market share. Industry experts predict a modest yet encouraging growth rate of 4 percent by 2014, bringing total annual food-and-beverage industry revenue to as much as $1.85 trillion.[1]

Retail Supermarket & Grocery Spending Shows Continued Growth

Industry Trends:

1. ***Health and wellness is no longer a niche market.*** Every year it becomes more evident that healthy eating has transitioned from a niche market to the mainstream. According to a recent study, some of the fastest growing industry categories include energy bars and gels, shelf-stable functional beverages, frozen fruits and vegetables, and yogurt and kefir products.[3] "The biggest and most pressing issue facing the industry right now is the consumer shift into health and wellness," reports Alexia Howard, senior analyst for Sanford C. Bernstein. "There is a bit of a gold rush to develop the next niche brand," Howard says. While it was nearly impossible for niche brands to break out and achieve national coverage without being bought out by a parent company, "today independent companies are able to achieve success because they have online support," according to Howard. "We are also seeing a shift into proteins and away from carbs," Howard reports. David Janow, CEO and president of Axiom Foods, recognized the shift toward protein nearly a decade ago. While working in a rice-commodities business, Janow experienced an "a-ha" moment and

"The most pressing issue facing the industry right now is the consumer shift into health and wellness."
– Alexia Howard

conceptualized the use of plant-based proteins for human consumption. This resulted in the development of Oryzatein®, the industry's first and only patented brown-rice protein, processed without chemicals. With food sensitivities and allergies continuing to rise, the company enjoys an 80 percent share of the market. "The protein market is going through the roof," Janow says. The World Health Organization recently increased its protein-intake recommendations by 20 percent, he reports. "Because there won't be enough animal protein available by 2020, it's important to find different ways to procure it," Janow asserts. Clean labeling is increasingly important for consumers. "People want to be able to read the back of the package and see simple ingredients that they understand," Howard says. Various groups of consumers focus on different aspects of labeling, "and the issue is being compounded by online consumer activist groups that target specific brands," she says.

2. ***Increased competition in the food and beverage industry directly impacts sales and profitability.*** Industry consolidation has created fewer but more challenging competitors. Successful companies demonstrate a quality product mix and efficient operations. Cost and quality control can make the difference between a company that establishes a competitive advantage and those that merely keep pace. Responding to pressure from

Cost and quality control can make the difference between a company that establishes a competitive advantage and those that merely keep pace.

consumers, retailers are squeezing brands on pricing. Asked to provide wholesale pricing, faster delivery, increased efficiency and minimized risk, companies are under increased pressure to outperform competitors. However, some companies are not willing to compromise quality to decrease pricing. According to Michael Cigliano, co-owner and executive vice president of Santa Monica Seafood Company, consumer demands for high quality and food safety come at a price. "We might be a little more expensive, but we consider it an insurance policy that we provide our retailers with a great product that will ensure a quality customer experience and return for repeat purchases." Cigliano warns against brands focusing their sales presentations on price, which can create a climate of pricing considerations over quality products.

3. ***Bargain seeking consumers purchase more private-label products.*** According to the Private Label Manufacturer Association, one out of every four supermarket products sold in 2013 was a store brand.[4] A recent study shows that Millennials—the 100 million Americans born between 1980 and 2000—may be driving the private-label trend. Not loyal to particular brands, 40 percent of Millennials say that they buy store brands frequently.[5] Additionally, the study reports that 71 percent of Millennials cite value as the main reason for selecting a store brand over a national label.[5] As retailers develop and carry more private-label products, brands face increasingly tight profit margins and pricing pressures.

4. ***Innovation drives growth and long-term success.*** New-product development is a key driver in helping companies meet strategic goals by providing customers with the products they desire and establishing a competitive edge. But in the face of changing consumer demands and a volatile economy, innovation can be difficult for many brands. Santa Monica Seafood Company recognized increased opportunity for innovation in the retail sector of the industry. "Today's consumers are looking for healthy options, convenience and increased food-safety protocols," according to Cigliano. Santa Monica Seafood Company responded to this demand by introducing a line of pre-packed fresh seafood meals that can be quickly, easily and healthfully prepared at home. Howard agrees that consumers are looking for fresh, convenient and healthful options. "We are on the cusp of a shift into fresh prepared foods and an expansion of the refrigerated section of the store," she reports.

"We are on the cusp of a shift into fresh prepared foods and an expansion of the refrigerated section of the store."
– Michael Cigliano

5. ***Social media offers cost-effective marketing opportunities.*** With the world in the center of a digital revolution, the importance of social media cannot be ignored. Research shows the influence that social media has on purchasing decisions varies by age group. While only 30 percent of baby boomers say that social media influences their purchasing decisions, half of millennials say that social media plays a role in what they buy.[6] Beyond a corporate website, companies need to establish two-way communication

"Social media is the cheapest, easiest and quickest focus group marketers have ever had."
– Kay Abadee, Axiom Foods

with customers and end-users. In addition to developing a strong and consistent brand presence, social media can be instrumental in influencing new-product development, collecting customer data and developing loyal consumer communities. "Social media is the cheapest, easiest and quickest focus group marketers have ever had," says Kay Abadee, director of marketing for Axiom Foods. "It provides brands with an opportunity to put a label design, flavor idea or other concepts out to consumers and receive instantaneous feedback," she says. Howard cites millennial moms with children under the age of seven as a key market for social media and online shopping. "These women are making decisions for about 30 percent of meals eaten at home," she says. "They are becoming a very influential group," Howard says, "and are presenting challenges for processed food products." In addition to more traditional channels such as Facebook and Twitter, Howard says that apps are increasingly influential in purchasing decisions. "The rise of food related apps is exploding right now," she says. Although it may be difficult to monetize the benefits of marketing via social media, a lack of social-media presence during this digital age may cost a brand dearly.

6. ***Big data is revolutionizing the industry.*** Data mining and business intelligence offer technologies that can predict trends, identify consumer shopping patterns, drive marketing initiatives and uncover previously unavailable customer-specific data. Used effectively, big data offers industry-specific insights that can help brands develop or enhance product lines, enhance pricing strategy, analyze the competition, identify new markets and improve efficiencies. In today's increasingly competitive marketplace, it is critical for companies to collect data, analyze it and transform it into actionable information.

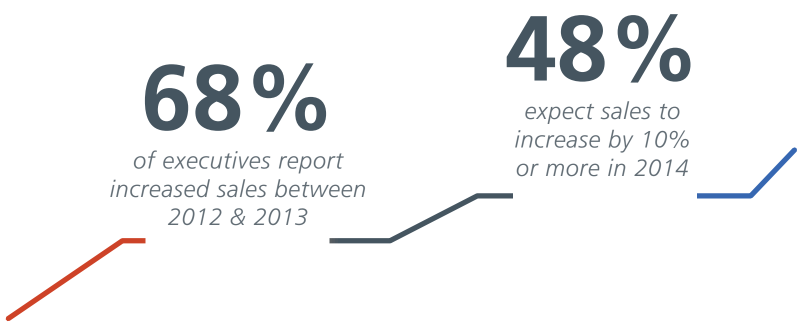
7. ***Rising raw material costs are a major factor for the food and beverage industry.*** A complex and intertwined set of factors contributes to rising agricultural raw materials costs. Increased energy costs drive up cultivation costs. Additionally, extreme climate conditions such as droughts and floods have adversely affected supplies. Increased demand for biofuels is also a factor. While prices have decreased since record highs in 2008, prices continue to climb. Recent reports show that July 2014 agricultural raw materials experienced an increase of 1.38 percent over 2013 numbers.[7] The continued drought, especially in California, may drive costs up even further. But companies shouldn't be afraid to look outside U.S. borders for ingredients. "Sourcing ingredients internationally offers some pricing flexibility for manufacturers," says David Janow. While respondents express concern over raw materials costs, experts predict that fears may be greater than the reality. "While commodity cost volatility will remain with us, the outlook is rather benign at present," Howard says.

Sourcing ingredients internationally offers some pricing flexibility for manufacturers."
– David Janow

Key Findings:

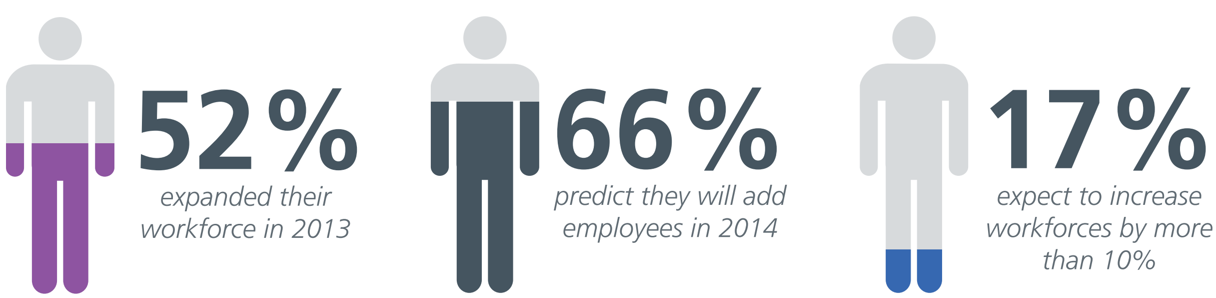
- ***Companies continue to enjoy modest growth.*** Demonstrating the ongoing health of the food and beverage industry, 68 percent of executives report increased sales between 2012 and 2013 with 20 percent indicating stable sales for the year. Nearly half (44 percent) of respondents indicated that sales were up by 10 percent in 2013 and even more (48 percent) anticipate continued double-digit growth for 2014. While sales and revenues continue to demonstrate modest growth, gross profit margins are tight. Two-thirds of executives saw gross profit margins remain stable or increase by less than 5 percent in 2013. Nearly the same number of respondents anticipates similar changes in gross-profit margins for 2014 while a promising 26 percent predict bottom-line growth in excess of 10 percent. Overall, companies are experiencing slower growth with modest marketplace growth between one and 10 percent.

Historical & Projected Growth



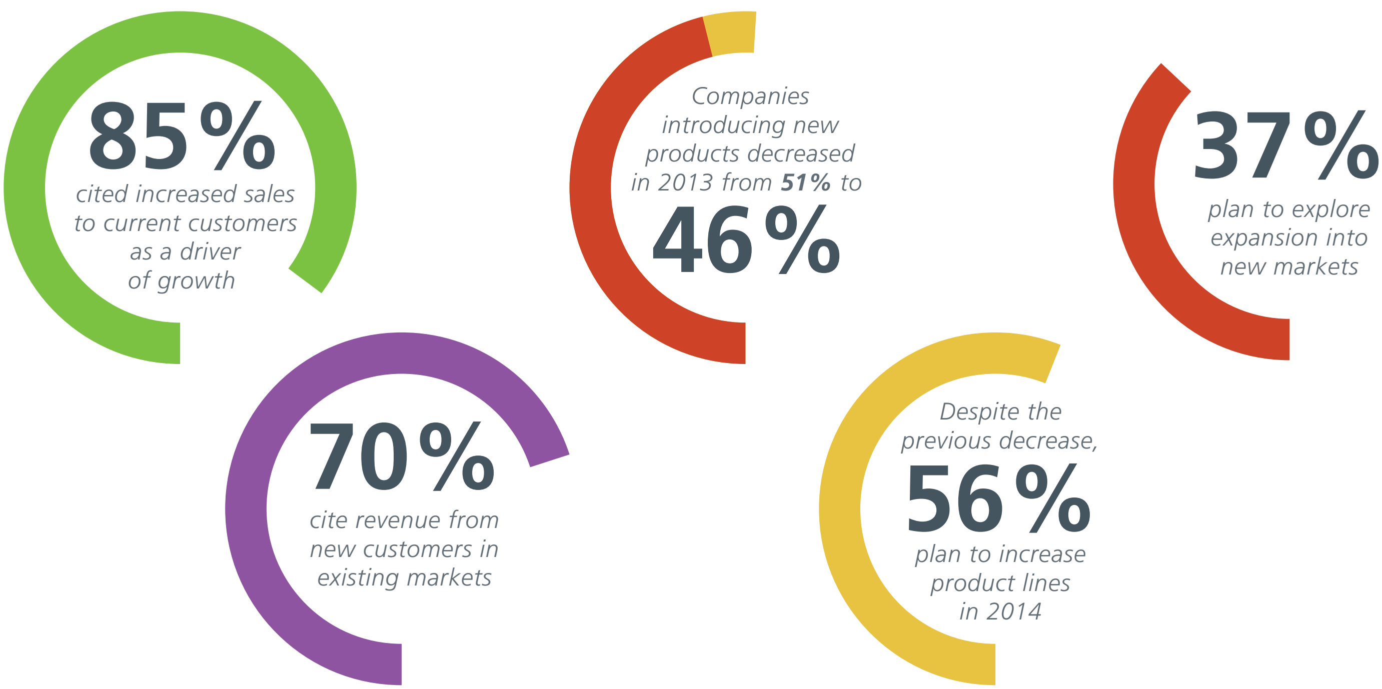
- ***Workforces expand in response to continued industry optimism.*** With more than one-third of executives reporting a stable number of full-time equivalent employees between 2012 and 2013, more than half (52 percent) expanded the size of their workforces. Overall, larger companies remained stable in terms of employee count and a fair number of those that grew by more than 10 percent did not experience as much double-digit revenue growth as those companies that maintained or decreased employee counts. Nearly two-thirds (66 percent) predict that they will add employees in 2014 with more than 17 percent of respondents expecting to increase workforces by more than 10 percent.

Workforce Growth



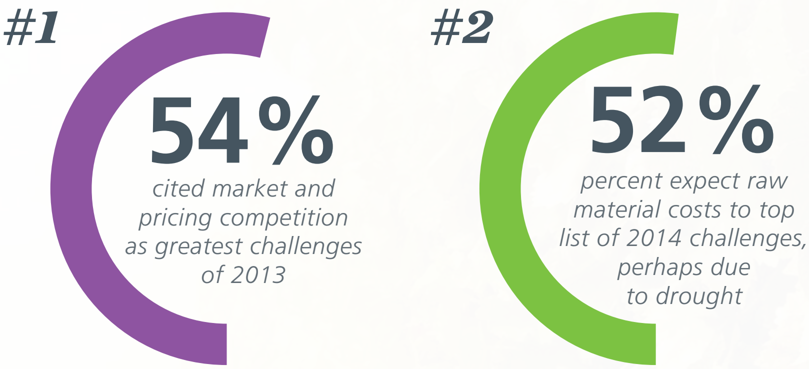
- ***Expansion with existing customers and obtaining new customers in existing markets top revenue sources.*** Nearly 85 percent of executives report 2013 revenue gains were a result of increased sales to current customers with that similar growth is expected to continue through 2014. With projected numbers (based on the 2013 study) consistent with actual numbers reported for 2013, nearly 70 percent of respondents cite revenue from new customers in existing markets as a primary growth source in 2013. This trend expected to continue through 2014 and represents double-digit growth from the 2013 study. More than 46 percent of companies introduced new product offerings in 2013, down from 51 percent in the 2013 study. Yet even more (56 percent) plan to expand product lines in 2014. More than one-third of executives (37 percent) will explore expansion in new markets for 2014, slightly up from 2013 reports. With companies clearly entrenched in the California market, as many as 52 percent of executives say that expansion into U.S. markets outside the state are not critical to their success. It appears that companies are increasingly interested in developing an existing brand rather that sacrificing brand recognition via private labeling, an area which participants predict no growth. Revenue sources via new-brand development and acquisition are also expected to remain stable through 2014.

Growth Planning Strategy



- ***Increased market competition and pricing competition cited as top challenges for 2013.*** While raw material costs topped the list of challenges for 2012, competition and pricing edged out anticipated concerns in 2013. More than half (54 percent) of executives report that increased market competition and pricing competition were their two greatest challenges for 2013. More than half (52 percent) of participants expect that raw materials costs, perhaps in response to the 2013 drought, will top the list of challenges for 2014, edging out concerns over competition, pricing and labor costs and retention.

Top Challenges



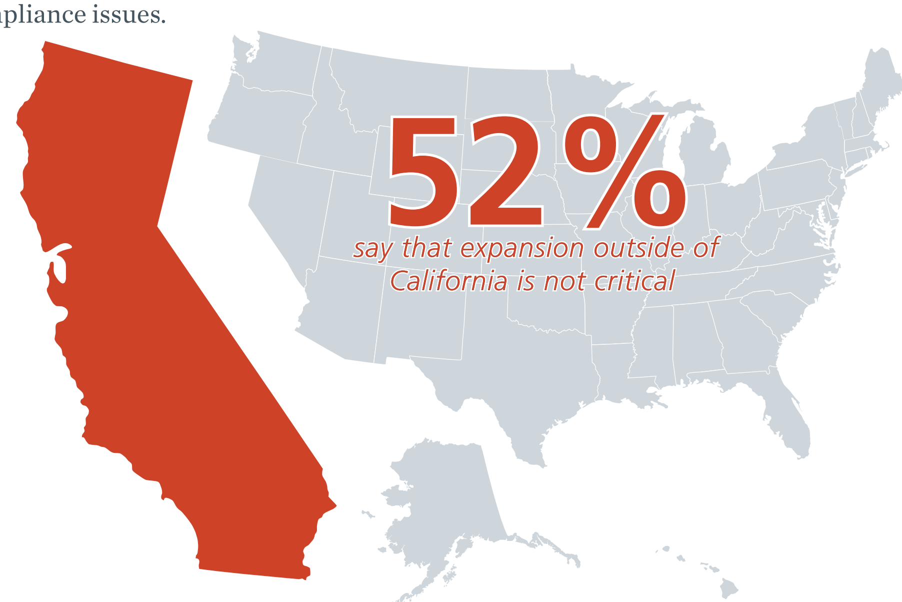
- ***Organic growth is a key initiative for the next 24 months.*** More than 42 percent of executives report that they will dedicate significant energy, time and resources into organic growth via new-product development, pricing strategies, and geographic expansion outside of California. More than 23 percent of companies plan make significant changes in their business models, likely in response to organic growth initiatives. Additional initiatives will include improvement in operational and financial processes, including related technology, as well as a focus on navigating changes in the industry's regulatory environment. While pricing competition is cited as a major consideration for 2013, no respondents plan to reduce product pricing as a means to grow the bottom line.

Organic Growth Strategies

- ***Consumer input drives innovation.*** With a little more than one-third of companies boasting a dedicated research and development team, an overwhelming majority (72 percent) of companies innovate in response to consumer needs and requests. Additionally, 64 percent of respondents indicate that they identify industry trends and build upon best practices to further product innovation. While eight percent of companies indicate that they do not invest in any type of product innovation, half plan to create new products in the future. Key metrics for measuring the success of innovation initiatives included an increase in profit, topline growth and expansion of gross margins. Nearly one-quarter of survey respondents indicated that the timeframe for innovation—from product development to sales analysis—is determined within a six-month period. Cigliano says this isn't long enough. "Six month is the average time we spend just on research and development," he asserts. Unfortunately, many brands may not have the opportunity to prove worth when they are new to market, Abadee says. "Often the retailer pulls a product from the shelf if it isn't immediately successful," she says. "But brands should really give it a good year" before determining a product's success in the marketplace, she cautions. Many respondents agree with 56 percent saying that 6-18 months is an appropriate time frame to determine if a new product is a commercial success.

- ***Companies increasingly exploring sales and mergers.*** Nearly half (46 percent) of respondents report that they anticipate a sale or merger within the next five years, representing a 10-percent increase over last year's figures. Howard agrees that the industry is experiencing a growth in sales and merger activity. "Consolidation and M&A deal making is definitely coming up as a big theme," she reports. As the longevity of companies continues to increase and family-owned businesses develop exit strategies, this number may continue to grow in coming years. While a sale or merger may be top of mind for many executives, more than half (58 percent) do not expect to acquire another brand or company with in the next five years.

- ***Companies are deeply entrenched in the California marketplace.*** Approximately half of respondents indicate that expanding employees and capital into U.S. markets outside California is not critical to their success. Of those that do plan to expand nationally, more than one-quarter (28 percent) cite concerns over distribution and logistics as a primary barrier to expansion. Others report concerns over a lack of a qualified workforce in non-California markets as well as uncertainty surrounding economic conditions. While 40 percent say that tax policies have little or no impact on expansion plans, some companies cite it as a barrier to both expansion and growth through a merger or acquisition. For those companies who have expanded outside California, 24 percent report challenges with complex tax and regulatory compliance issues.



Green Hasson Janks Strategies for Success:

To establish brand differentiation and secure market share, food and beverages companies need to commit to six key business strategies. While these strategies may require additional resources in terms of time and finances, companies can expect success when they: 1) commit to planning for the future; 2) develop innovative products and services; 3) measure and monitor data; 4) carefully evaluate their finances; 5) obtain outside consulting when it is appropriate; 6) look to others within their industry to benchmark performance.

Strategic planning. It is essential to create short-term (six months) and long-term (three to five years) plans. Strategic planning involves vision, mission and even outside-the-box thinking. Strategic planning describes where you want your company to go and identifies specific corporate objectives and resources as they relate to the marketplace. Executives should understand that tactics related to a strategic plan need to be flexible in response to a changing marketplace. Still, the plan should address high-level initiatives that drive every division of the company. Review plans regularly to ensure compliance and performance and make any necessary adjustments.

Innovation. Successful companies not only respond to consumer demands, they anticipate future trends and develop ideas, products and services that allow the brand to meet an anticipated future demand quickly and effectively. Innovation helps companies stay ahead of the competition and establish brand differentiation. Innovation may take the form of improved quality, additional products, or enhanced manufacturing or logistical efficiencies. Cigliano encourages companies to ditch the “we’ve always done it this way” business model. While innovation does require an investment of financial and human capital, it is essential to developing brand distinction and increased market share. Brands may also need to invest more time before determining the success or failure of a new product. “If you’ve done the market research and really believe in the product you are creating, stick with it and educate the customer about why they need it,” Cigliano says.

Data analytics. Experts agree that the use of big data—large pools of data that can be brought together and analyzed to identify patterns and make better decisions—will be a key to the growth and success of any business. Data analytics allows companies to increase productivity, reduce waste, enhance product and service quality, predict trends and gain a competitive edge. Once limited to technical companies and IT departments, today’s data offers unique and specific insights into consumer buying patterns, preferences, and even lifestyles. A strategic evaluation of relevant data can uncover a goldmine of information about customers, suppliers, employees, finances, and the marketplace.

Accurate financial records. As a number of companies look toward mergers and acquisitions, it is critical to have accurate and complete financial records in place to establish appropriate business pricing and value. Accurate financial records are also important for investors and creditors when evaluating the financial health of an organization. Additionally, incomplete or inaccurate financial statements can lead to decisions that may detrimentally affect the bottom line.

Use consultants where appropriate. To run a business effectively and profitably, executives need to know a great deal about the marketplace, consumers, and competition, among other issues. Outside consultants who are not emotionally or financially tied to an organization offer specialized experience and objective third-party advice that can help organizations reach strategic goals. Carefully selected consultants can provide an injection of knowledge and experience in areas such as marketing, technology, logistics, finance and taxes.

Benchmark against others. In today's increasingly competitive marketplace, it is more important than ever that companies measure themselves against their peers and industry standards to identify areas of needed improvement. This means of improving operational efficiency is essential to helping the organization meet its strategic goals. Research shows that companies whose best practice performance measures rank in the top quarter of their industry are 10 times more profitable than companies than rank in the bottom quarter.[8]

Summary and Conclusion:

Industry executives believe that the primary challenges for 2014 include the unpredictability of raw-material costs, increased competition including pricing, and concerns over labor costs and employee retention. Uncertainty about the economy continues to plague consumer confidence across all industry sectors. Although they predict modest growth, food and beverage executives are cautious about increasing their workforce. Technology and Big Data will continue to transform the industry, offering new and deepened insights into consumer purchasing trends. Companies that make innovation a priority will remain relevant within the industry and establish new revenue streams within existing or new marketplaces. To remain competitive, it is important to plan strategically and carefully analyze finances to ensure a healthy bottom line. The most successful companies will be increasingly proactive with product development and strategic financial planning. Executives should also develop a collaborative team of professional services professionals to help organizations address challenge and achieve financial goals.

Green Hasson Janks, LLP, would like to extend its sincere thanks to those who participated in the 2014 Food and Beverage Industry Survey.

About the Author:

Donald J. Snyder is a partner at Green Hasson Janks and heads the firm's food and beverage practice. Don has more than 25 years experience in public accounting and chairs the firm's Accounting and Auditing Department, as well as the Quality Control Department. He provides audit, accounting and consulting service to clients in numerous industries, including manufacturing, wholesale/distribution, restaurant, food and beverage, nonprofit and technology. He is a well-known business consultant in the food distribution, food processing and manufacturing industries. A popular industry speaker, Don also writes for the firm's quarterly Food Digest newsletter, hosts a number of food and beverage networking groups and organizes and leads food executive roundtables.

Don is involved in assisting clients with designing and assessing their internal accounting controls and has been a frequent lecturer in this area. He has also written several articles on the subject of fraud prevention and detection in the work place. In September 2011, Don was nominated for a San Fernando Valley Business Journal award as one of the "Valley's Most Trusted Advisors."

Don holds a Bachelor of Science degree in Administration with emphasis in Accounting from the University of Colorado. He is a member of the California Society of Certified Public Accountants and the American Institute of CPAs.

About Green Hasson Janks:

Founded in 1953, Green Hasson Janks is one of the oldest independent accounting firms on the west side of Los Angeles. Ranked as a top-20 largest accounting firm on the Los Angeles Business Journal's Book of Lists, the firm has 13 partners and more than 120 staff members that serve over 3,000 clients.

The firm is a member of the American Institute of Certified Public Accountants (AICPA), the AICPA Governmental Audit Quality Center (GAQC), the California Society of CPAs and the California Association of Nonprofits (CAN) and the Public Company Accounting Oversight Board (PCAOB).

Green Hasson Janks is also an independent member of HLB International, a worldwide organization of professional accounting firms and business advisors represented in over 100 countries. This affiliation provides access to the subject-matter experts of other member firms in most major cities around the world. Green Hasson Janks is the exclusive member firm of HLB in Los Angeles County.

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