

A winning growth formula for dairy

Modest growth forecasts, shifting consumer tastes, and increased competition at home will force executives to look to a new model for growth domestically, and beyond their borders, for more attractive opportunities.

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Dairy is a ubiquitous part of food life, ever present in both food service and packaged goods—be that as an end product (such as milk and yogurt) or as a critical input for iconic products such as cheese pizza. Given its intrinsic presence, dairy is a microcosm of the food industry, with the preferences of dairy consumers largely being influenced by the same trends affecting the broader food industry.

Changing consumer behavior, competition, and trade action have resulted in slow growth for dairy companies. Research into a representative sample of global dairy companies revealed a 3 percent drop in cumulative return on invested capital (ROIC), from around 9.5 percent in 2008 to 6.5 percent in 2017. During the same period, revenue and margin growth have been 2 and 3 percent a year, respectively. The decline in ROIC suggests that revenue and margin growth are not keeping pace with the cost of capital to generate economic value. Nonetheless, the top five global dairy companies were able to increase their margins by 4.1 percent from 2013 to 2017. So, while the market is facing some headwinds, growth is possible but will rely on finding the right pockets of demand, domestically and internationally and having the right agility and operating model to tap into these pockets.

A look at the US market¹ tells a cautionary tale: from 2015 to 2018, top dairy products experienced sales declines, including cheese (-1.4 percent), milk (-4.9 percent), and yogurt (-2.3 percent). In contrast, according to Farm Bureau analysis of IRI household scanner data, sales of plant- and nut-based beverages in 2017 were up \$141 million, or 9 percent, from 2015 levels. On a value basis, the market share of nut- and plant-based beverages has increased from just below 10 percent in 2015 to more than 13 percent through July 2018. During this same time, the market share of traditional milk beverages has dropped from more than 90 percent in 2015 to around 87 percent in 2018.

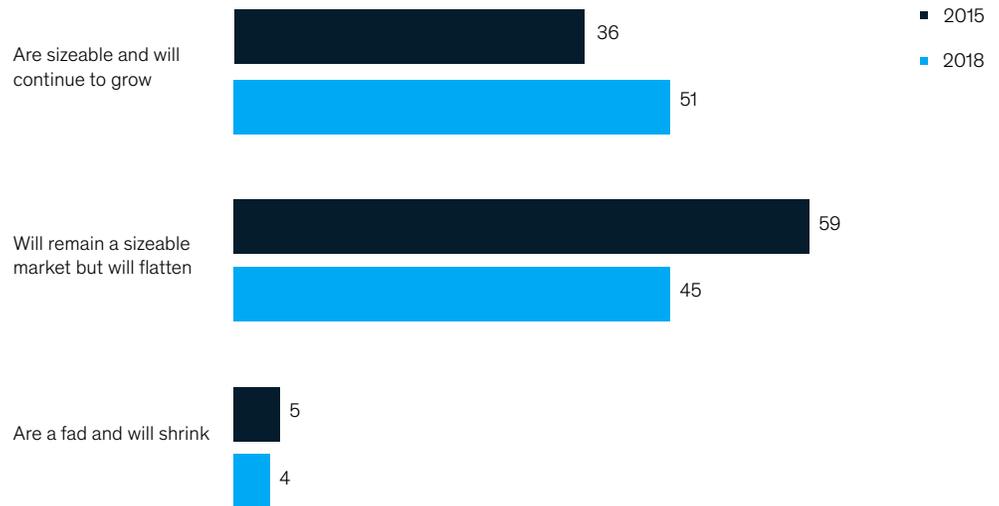
Interviews & surveys conducted in Q4-2015 and Q4-2018 with 56 dairy CEOs revealed that CEOs changed attitude towards the non-dairy alternatives market: 36% of CEOs believed that the non-dairy alternatives market would continue to grow in 2015 while 51% believe it in 2018 (Exhibit 1). “Among millennials we are seeing a shift to non-dairy, plant-based proteins,” one CEO reports. “We need to build relationships with these plant-based protein companies.”

¹Retail market, Nielsen data – excludes foodservice, exports and other ingredient / component usage

Exhibit 1

Plant-based competition on the rise: compared to 2015, more respondents feel that the non-dairy alternatives market will continue to grow

Which statement best describes your sentiment on the prospects for the non-dairy alternatives market (e.g. plant protein)?, % of respondents



Source: McKinsey IDFA Member Survey 2018.

Internationally, developed regions such as Europe and North America face a growing dairy surplus. For example, by 2027 the United States will be producing 12 million metric tonnes milk equivalent (26 billion pounds) more than the domestic market will consume. Developing markets, especially in Africa and Asia, offer a mirror image, with large supply shortages. China, for example, will have a forecast dairy deficit of 26 million metric tonnes milk equivalent (57 billion pounds) in 2027.

In collaboration with the International Dairy Foods Association (IDFA), McKinsey conducted research to understand the strategies and capabilities required to help US dairy grow domestically and internationally in the coming years (see sidebar, “About the research”).

Where is the domestic growth, and how can companies capture it?

In the traditional food industry, growth has been slowing for several years because of shifting demographics and the emergence of niche products. As US food and dairy executives seek to adapt to this new reality, six major trends—all applicable in varying degrees to both food and dairy—are shaping the consumer packaged goods (CPG) industry.

In our dairy CEO interviews & surveys, CEOs were invited to list up to three innovations considered to be the most relevant for the U.S. dairy industry. In 2015, the 3 most prominent were Greek Yogurt, Organic and Non-Dairy Alternatives. In 2018, all three changed to Fairlife, Protein, Packaging.

However, this field is evolving quickly and CEOs admit that their understanding of consumers can be improved. In fact, consumer insights capabilities ranked last (Exhibit 9) in a list of competitive advantages. As one CEO put it, “Dairy companies need a better understanding what the consumer values and then connecting that with what we do.”

1. The millennial effect

As of 2018, millennials now have more spending power than any other generation. Much has been written about the disruption caused by millennials due to their unique preferences and values as consumers. Empowered by digitization, millennials are on the whole more diverse, more sophisticated, and more demanding. They prefer to shop in channels beyond the mass market and gravitate to up and coming brands rather than established ones. Compared with baby

McKinsey research provides an in-depth look at the dairy industry's evolution around the world, the differences among markets, and evolving consumer tastes. To develop our insights, we surveyed a subset of International Dairy Foods Association (IDFA) members and conducted interviews & surveys with 56 CEOs of international dairy companies. These findings were augmented by discussions with industry experts and McKinsey research. In addition, we partnered with an omnichannel data provider to survey more than 1,000 US households on their dairy preferences. The survey was in the field from November to December 2018.

boomers, for example, millennials are 2.8 times more likely to believe newer brands are better or more innovative and 3.7 times more likely to avoid buying from "big food." In addition, millennials are more inclined to engage with "non-brand-generated" content such as consumer reviews and social media.

More important, perhaps, is how the behavior of millennial consumers is influencing shoppers across generations. Increasingly, consumers are demanding experiences, not just products. This preference places the onus on CPG companies to establish relationships and bolster loyalty by maintaining an ongoing dialogue with customers.

These same patterns are evident in the dairy industry, which sees diverse consumers who exhibit a range of preferences and behaviors. Although nearly half of US consumers are still content with their current brand, a slim majority have explored other options in the past 12 months. Our survey found that 32 percent of US consumers are buying more private-label and store brands, while 20 percent (27 percent for the millennial age group) reported buying more premium and niche brands (Exhibit 2). US dairy consumers are also open to trying new brands and switching or expanding their purchase selection: 42 percent report trying a new brand in the past 12 months, and 48 percent of new-brand purchasers continue to buy both old and new brands.

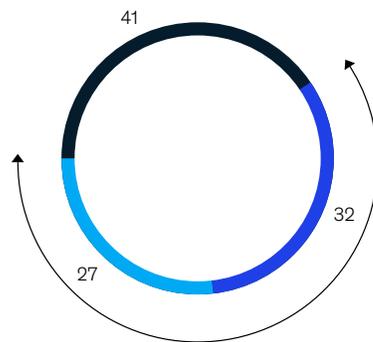
Exhibit 2:

Brand purchasing behavior, millennials (18-34 years old) and average across age groups

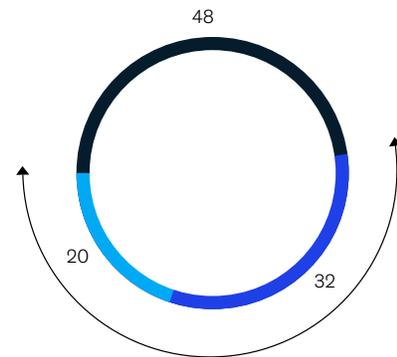
When buying dairy products recently...

- I haven't changed the type of brand I purchase
- I am buying more private label brands (store brands)
- I am buying more premium brands (niche brands, name brands, etc.)

Millennials (18-34 years)



Average across age groups



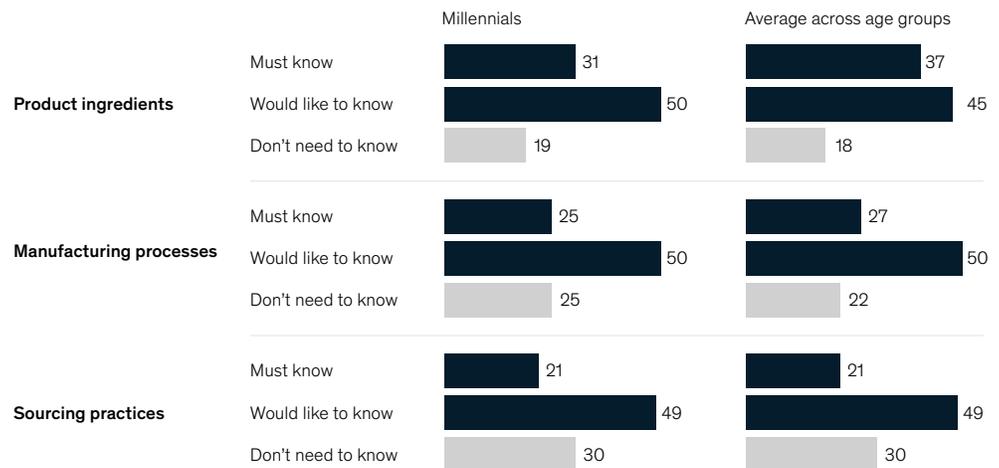
Source: McKinsey Dairy Consumer Survey, 2018 (n=1,139)

In addition, a majority of consumers have expressed an interest in knowing more about the manufacturing of dairy products, including ingredients, manufacturing processes, and sourcing practices (Exhibit 3). Our survey found that 82 percent of consumers “must know” or “would like to know” more about the product ingredients, and 70 percent express a similar desire for information on sourcing practices. No differences were observed for millennials. These results are consistent with other research conducted by the Center of Food Integrity, which shows that around two-thirds of US consumers are interested in knowing more about agriculture and food manufacturing practices. The desire of consumers to know more about products represents an underdeveloped opportunity for growth.

Exhibit 3:

A significant part of consumers “must know” or “would like to know” about a range of practices prior to purchasing products

Information requirements before dairy purchase %



Source: McKinsey Dairy Consumer Survey, 2018 (n=1,139)

2. Better for you

Consumers are redefining what “healthy” and “better for me” mean, increasingly demanding products that are natural, green, organic, and free from additives. Indeed, a focus on health and wellness is no longer a strategic differentiator but a must-have for many CPG categories. The most successful product launches around the world deliberately target consumer concerns for health. And customers have made reviewing product information a regular step before purchase: instead of automatically placing a familiar product into their shopping cart, they are now scrutinizing labels for unpronounceable ingredients, artificial flavors, and colors, GMOs, and high levels of sweeteners and sodium. This emphasis has translated to faster sales for fresh produce and health-oriented packaged goods. In the United States, organic foods are projected to grow at eight times the rate of some processed packaged food categories from 2016 to 2021.

Our survey showed 35 percent of dairy consumers report eating healthy foods, and 32 percent have read nutrition labels over the past 12 months. No significant differences in this behavior were observed across age cohorts. Moreover, health is not only an issue for young consumers and mothers. As a market segment in developed economies, the retired elderly is projected to grow from 164 million in 2015 to 222 million in 2030. This group will generate 51 percent of the urban consumption growth. Creating dairy products that address the nutritional needs of this group will be critical for growth in developed markets such as the EU and the United States.

The top three attributes associated with healthy eating are “all natural,” “low sugar,” and “organic.” Survey respondents who decreased their consumption cited three reasons: plant-based dairy products are healthier, a desire to try new products, and dietary requirements.

Consumers generally favor protein over fat for health, and plant-derived products over animal-derived ones (Exhibit 4).

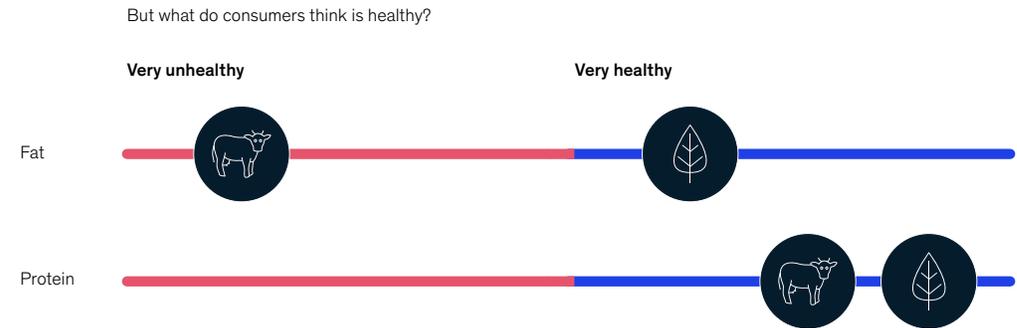
Exhibit 4:

Consumer perception: how healthy are the following types of food?

Consumers say they want to eat healthier... but does it translate to action?

35%

of consumers want to eat healthier than they did a year ago



Source: McKinsey Dairy Consumer Survey, 2018 (n=1,139)

However, dairy companies may have an opportunity to strengthen health claims, since consumer perceptions are often contradictory and vary across categories (Exhibit 5). For example, consumers are both migrating away from and toward butter for health-related reasons, resulting in a net 4 percent gain in year-on-year sales.

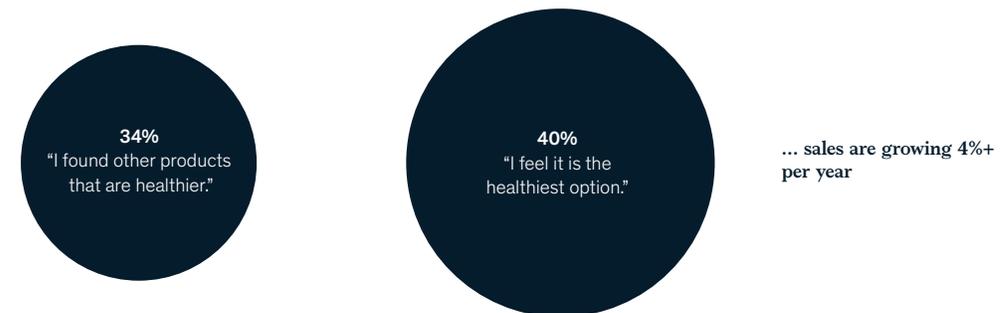
Exhibit 5:

Why consumers are buying more (or less) of a product category – e.g., butter

Butter– leading growth, despite mixed perceptions on “healthy”

#1 reason for buying LESS

#1 reason for buying MORE



Source: McKinsey Dairy Consumer Survey, 2018 (n=79 less often; n=103 more often), Nielsen for category growth

3. Infinite intimacy

The increased penetration of mobile devices and digital profiles is creating an unprecedented volume of data for savvy companies to collect from a wide variety of consumer and non-consumer sources (such as loyalty card data, weather info, trends, and preferences). At the same time, advanced tools and techniques are enabling companies to interpret vast amounts of data, allowing them to create highly personalized microsegments—even down to “segments of one.” Purchasing behavior is increasingly influenced by recommendation algorithms, and leading CPG companies are relying more on search engine optimization to promote products online. And in stores, retailers are using data to personalize the shopping experience, from mobile recommendations to targeted communications and product information.

Our survey revealed that although nearly 80 percent of consumers still purchase dairy products

in physical stores, the remaining 20 percent are making online purchases—and in the process providing dairy companies and retailers with a valuable window into evolving consumer behavior. Traditional and online shopping are becoming intertwined. For example, 30 percent of respondents have compared product prices between stores while shopping, and 22 percent looked up nutritional and ingredient information on dairy products. Since every interaction generates more data and allows companies to assemble a more detailed picture of consumer purchasing behavior, dairy executives have begun to make data-driven customer segmentation a top priority.

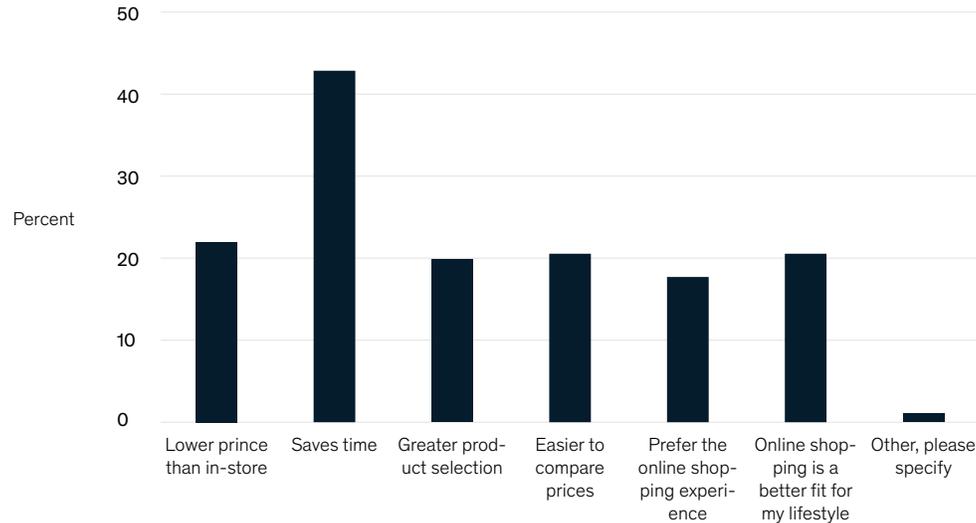
4. Retail revolution

The retail landscape is being reshaped by structural channel shifts. The emergence of value discounters and the growth of omnichannel retailers (especially Amazon) have led to channel fragmentation and bifurcation. Consumers have shifted to discounters or higher-end channels, putting pressure on players in the middle. Retailers are seeking to meet changing consumer needs and distinguish themselves from the competition by looking beyond stagnant large brands, instead selecting smaller, high-growth brands and model disrupters. A business model battle is under way in retail, with the e-marketplaces emerging as the uncontested leaders. In a review of the top 14 global players, e-commerce companies grew at a 25 percent CAGR from 2011 to 2016. By contrast, mass market retailers lost 0.1 percent during the same period. These divergent trajectories have made channel strategy top of mind for dairy executives.

To date, the impact of this trend has been less pronounced in dairy. Grocery e-commerce is set to grow at 34 percent from 2017 to 2025, but the share of US consumers who indicate they will buy dairy products online will remain flat. However, consumers are becoming more comfortable with using online channels to support purchasing decisions. Around 25 percent of survey respondents compare dairy prices online before shopping and have used a digital coupon to buy dairy products. Survey respondents who purchased goods through e-commerce channels cited time savings and lower prices online as the main reasons (Exhibit 6).

Exhibit 6:

Reasons for shopping for dairy online



Source: McKinsey Dairy Consumer Survey, 2018 (total n=1,139, subset: n=160)

5. Explosion of small

Across the CPG industry, smaller brands are realizing more momentum than larger brands or private label due to the ability to capture an intimate brand story at moderate scale. The democratization of technology is a critical element of the heightened competition: advancements have made a range of tools affordable for even the smallest companies, leveling the playing

field and lowering the barriers of market entry. Many of these start-ups have embraced leaner operating models and a much shorter go-to-market cycle, all supported by technology, in the process gaining an advantage over larger incumbents. Consumers have responded favorably: despite making up a smaller portion of total sales, upstart brands account for an outsized share of growth in CPG segments such as food and beverage. For dairy companies, this trend stands out in contrast to the traditional industry focus on cost efficiencies and scale. Incorporating flexibility will be important as executives seek to expand to other consumer segments and jumpstart growth.

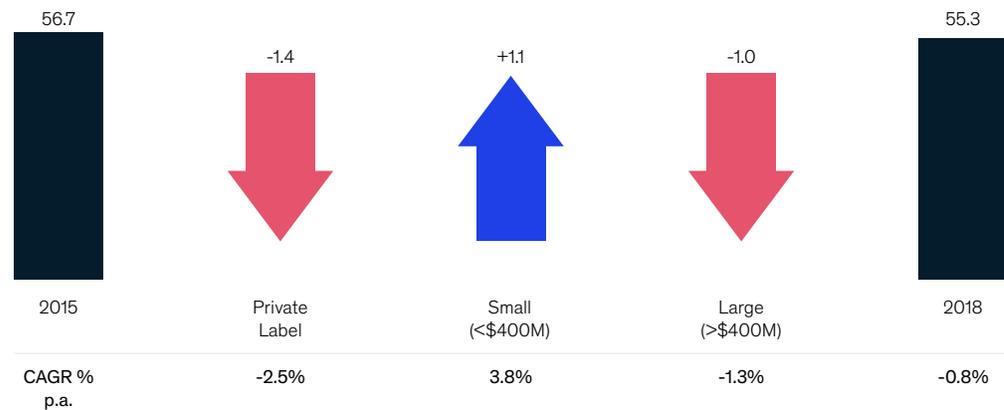
In dairy, small and medium-sized companies were responsible for all the gains in the US dairy market from 2015 to 2018, adding \$1.1 billion in revenues, a 3.8 percent compound annual growth rate (CAGR). Meanwhile, private-label and large categories saw their sales decline by \$1.4 billion and \$1 billion, respectively (Exhibit 7). Consumer interest in smaller dairy companies and start-ups was partly responsible for this segment's growth. Over the past 12 months, 41 percent of survey respondents reported trying a new dairy brand. Ten of the 16 brands were those of small and medium-sized companies, including companies known for innovative takes on traditional dairy products.

However, small company growth was not enough to offset total category decline: since these companies generally have a higher price point than other enterprises, this result was likely caused primarily by changes in market share rather than bringing new consumers to the category.

Exhibit 7:

\$ and % growth of different size dairy brands (small: <\$5M; medium: \$5M-\$380M; large: >\$380M)

Small brands are driving growth | Dairy retail sales \$, B



Source: Nielsen data extract (Nov 2018), dairy categories

However, consumers are willing to try new products. Forty-one percent of dairy consumers report having tried a new dairy brand in the past 12 months, and of this group more than 70 percent kept

this new offering in the mix (Exhibit 8). This pattern creates an opportunity for growth.

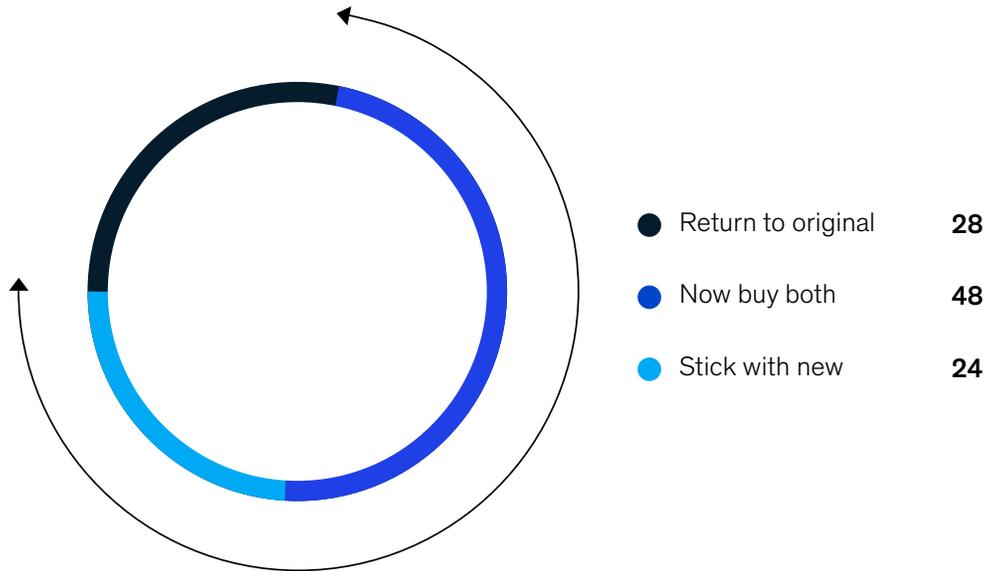
Exhibit 8:

Brand loyalty/brand switching behavior

Dairy consumers are trying new things

41%

of dairy consumers have tried a new dairy brand in last 12 months



Source: McKinsey Dairy Consumer Survey, 2018 (n=1,139)

6. Pressure for profit

The CPG industry has set higher expectations for spending transparency and the strategic redeployment of commercial resources. In trying to tailor value propositions to excite an increasing number of consumer microsegments, CPG companies face rising commercial costs from SKU growth, channel proliferation, and media fragmentation. In food and beverage, for instance, the number of channels that marketing campaigns must cover nearly tripled from 2012 to 2017. These trends largely hold true for the global dairy industry.

Many companies, seeking to increase transparency of spending and ROI, have adopted zero-based budgeting and the rigorous management of revenue growth and performance. Only some are investing to increase transparency and maximize ROI of every commercial dollar spent. Leading companies, however, achieve greater transparency by viewing spending holistically and marketing and sales as an integrated commercial function. They also deliberately and strategically redeploy resources to maximize profitable growth.

In the pursuit of profit, international dairy companies indicated that their top source of competitive advantage was a focus on manufacturing efficiencies, followed by product innovation and customer service (Exhibit 9). Notably, consumer insights capabilities were cited by just 2 percent of respondents, suggesting that investments in this area could support more targeted marketing and consumer engagement.

Case example:

Halo Top

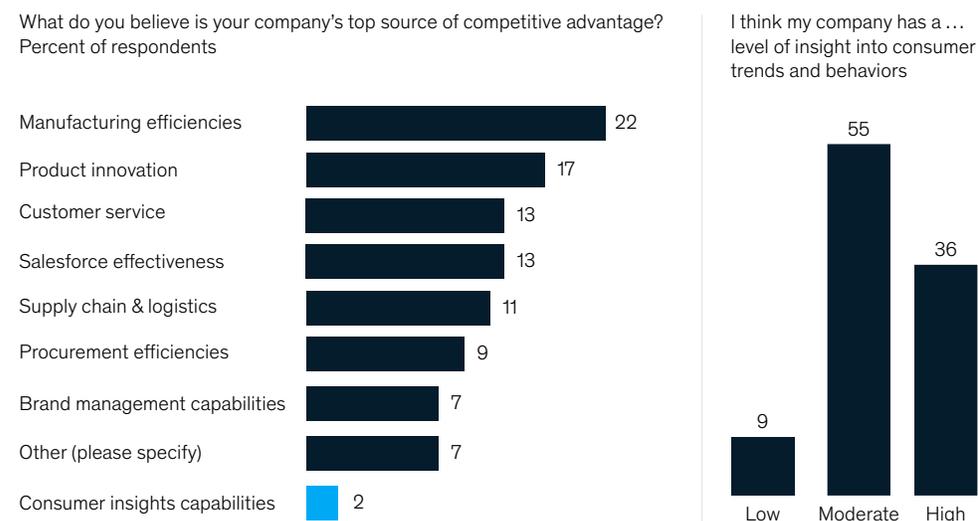
Los Angeles–based Halo Top Creamery, which was founded in 2011, has garnered a loyal customer base by developing ice cream products with a unique combination of low calories, high protein, and good taste. In 2015, the company simplified its packaging to ensure that the calorie count was displayed front and center below the ice cream’s name. The following year, Halo Top reported growth of 2,500 percent, increasing its sales channel with 34,000 stores in the United States in addition to stores in the Australia, Canada, Ireland, Mexico, and the United Kingdom.

The company used social media ads and recommendations from YouTube fitness experts to increase its online presence. Thanks to growing demand, in 2017 Halo Top became the most successful food and beverage brand in United States, with sales of \$324.2 million.

Exhibit 9:

Top sources of competitive advantage for dairy companies

Manufacturing efficiencies and brand management are the top sources of competitive advantage; consumer insight is at the bottom



Source: 2018 IDFA survey

7. Other trends shaping the domestic market

Dairy companies in developed markets are also facing industry developments and patterns that further complicate efforts to grow. Margin pressure at every stage of the value chain in their home countries means gains must be sought by expanding into new markets. Consolidation and vertical integration, led by large farmers, is putting pressure on the remaining small and medium-sized farms, which then must make difficult strategic decisions in an effort to remain competitive. For instance, shrinking margins have made it harder for milk processors to justify capital expenditures. The fewer, more productive farms that remain have caused supply to grow faster than demand, another key reason why the search for growth requires dairy companies to adopt a global perspective.

These developments, particularly industry consolidation, have reduced the impact of efficiency gains on operations. The disruption of international trade by tariffs and the strength of the US dollar are further influencing the competitive landscape in developed markets.

Crafting a domestic growth strategy

Given the heightened level of competition and surplus production in the United States, domestic dairy companies should concentrate their effort and resources in three areas:

Identify growth areas through analytics

Companies must get a better understanding of their target consumers—exactly what they value in their dairy products—to expand their market share. Finding these pockets of growth increasingly depends on greater visibility courtesy of data and analytics. These insights will inform strategic decisions across innovation, marketing, pricing, and assortment. A primary goal should be to combine product features such as ingredients, packaging, and cost in an effort to fulfill the need state of a particular consumer segment.

Make many quick, small investments versus a few big bets

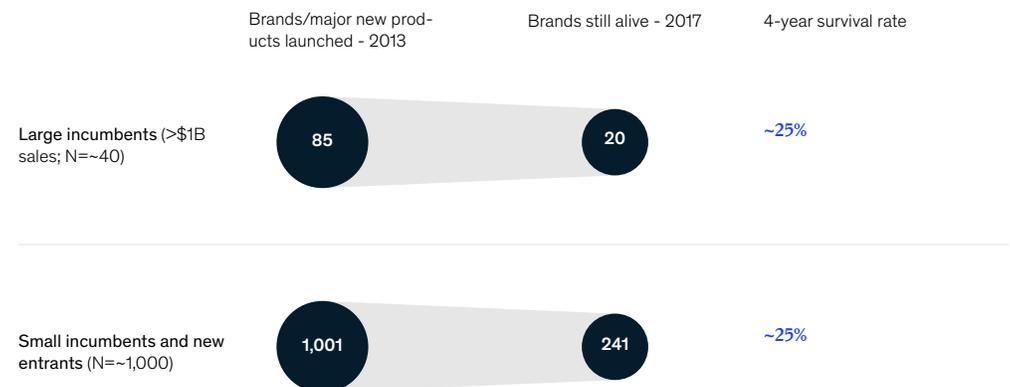
Getting new products successfully into market is vital. In all, 83 percent of IDFA survey respondents have increased their product portfolio in the past five years. Yet companies that have invested in a few big bets have not improved outcomes. A comparison of large and small

packaged-food companies that launched new products in 2013 shows that each segment had the same success rate four years later—25 percent (Exhibit 10). Evolving consumer tastes and the desire for products that address specific needs means that many products never find an audience. But by building the capabilities to develop and launch more products, companies can get a better sense of consumer tastes before investing to scale production and serve new markets.

Exhibit 10:

Brand survival rate by company size (based on brands available and fulfilled by Amazon in Aug 2017 and/or recognized by market reports as share leaders)

Big and small companies have similar success launching brands - Packaged food, US, 2013-17



Source: GNPD, Euromonitor, web search, McKinsey analysis

Invest in new supply chain capabilities

Just as dairy companies must adapt their operations to be more nimble and serve specific customer segments adroitly, so too must their supply chains become more responsive to changing demands. Three areas should be priorities.

Flexibility and agility. Companies should seek to develop modular and flexible manufacturing that can scale as required or be quickly converted to serve an adjacent product offering. Dairy companies can partner with other stakeholders across the supply chain to innovate and build capabilities. These partnerships can also increase cost transparency by giving stakeholders greater visibility into each step, which supports collaboration and increases trust.

Distribution. Innovations such as kitting and customized packaging have enabled the more effective distribution of goods in perimeter categories (especially with the growth of e-commerce). In addition, dairy companies can establish capillary networks to gain access to growing channels such as farmer’s markets. Last, advanced order and management capabilities can give dairy companies the tools to ensure the right inventory at the right place at the right time.

Technology. Traceability systems and a stable backbone comprising data, analytics, and digital technologies can improve supply chain performance. Agriculture companies, for example, have applied blockchain to improve food safety by decreasing the time taken to track inputs. Similarly, IoT-enabled logistics can help companies manage their fleet and improve food safety control through environmental sensing. And digitization and analytics are used to enable predictive analytics in demand planning and analytics-based end-to-end network optimization. These advances can reduce spoilage in transit from manufacturer to retail shelf and also accelerate the identification of food contamination in the event of foodborne illness outbreaks.

Identifying and capturing international growth

Even US incumbents that have managed to maintain a solid market share in their home market

Case example— Walmart

Current tracking methods in supply chains are antiquated, making it difficult to track goods from origination to delivery. Walmart has been experimenting with blockchain in an effort to improve traceability, food safety, and access to supply chain information. Through blockchain, the company has a real-time view of product information on a single, safe platform. The impact has been gamechanging: Walmart has reduced its time to trace a package of mangoes on its journey from farm to store from days or weeks to two seconds.

To build on this initial success, the company is planning to require suppliers of leafy greens to use blockchain for a farm-to-store tracking system that will launch in September 2019, with a similar system for other fresh fruit and vegetable providers slated to go live soon after.

will be hard-pressed to capture significant additional value in the coming years. According to our analysis, from 2008 to 2017 companies with a global focus have increased their revenues significantly, while those active in local markets have seen their revenues fall. Global companies also have higher margins, with an EBITDA of 15 percent in 2017, compared with 10 percent for local companies.

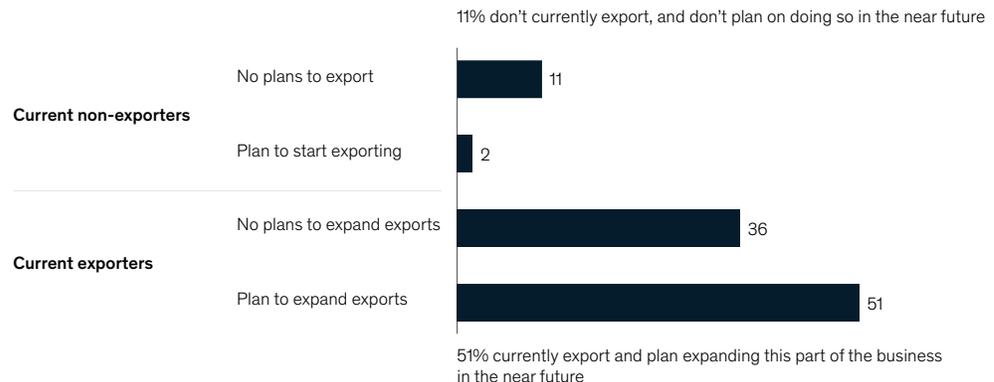
Our dairy CEO interviews & surveys revealed the direction of the industry switched from domestic to exporting between 2015 and 2018. One CEO warned, “To compete internationally we must shift our mindset from being an exporter to a global partner”. In 2015, 20 companies (36% of those surveyed) had no exports and no plans to export. In just three years, that number dropped to 6 (a drop of 70%). Among those that already exported in 2015, there was a steady increase both in the number of those with no plans to further expand (43%) and those with continued plans to expand (53%).

Despite the recognition that international markets offer the potential of higher growth, many US dairy companies are ambivalent about pursuing this opportunity. While 87 percent of respondents currently export, just over half indicated that they will invest in more exports in the near future (Exhibit 11). At the same time, 47 percent have no additional plans to increase their exports maybe because the current trade environment has made exporting a more difficult strategy.

Exhibit 11:

While 87% currently export, 47% of respondents don't intend to invest in more exports in the near future

Which statement best describes your view on your company's exports of dairy products from the U.S.?, % of respondents



Nearly half of international dairy companies don't plan to expand exports.

Source: 2018 IDFA Survey

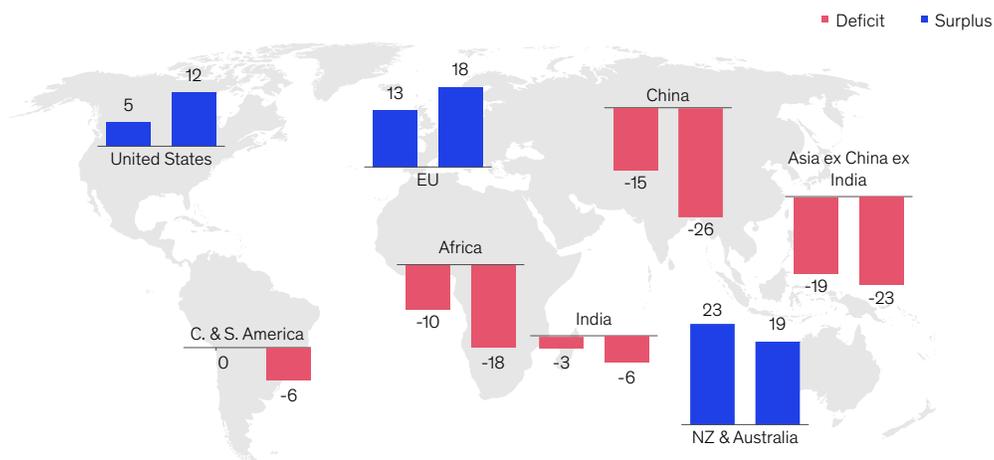
High-growth opportunities

An examination of the global map identifies a significant mismatch in production capacity and demand. The United States, for example, already has a significant surplus of dairy products, a total that will more than double by 2027 (Exhibit 12). In the longer term, US dairy exports are not fully aligned with future demand, suggesting an opportunity to look to new markets. The regions and countries with the largest dairy deficits—Africa and Asia—are currently not well served by the US dairy industry.

Exhibit 12:

There is a large, long-term global opportunity to capture

Dairy surplus/deficit Million tonnes milk equivalent in 2017 and 2027¹



2017-2027 current and forecast dairy deficit/surplus

Source: IFCN, USDA, McKinsey analysis

¹Based on 95 countries

Global competition to serve these markets will be fierce, however. The EU as well as Australia and New Zealand have a significant surplus and are better positioned to serve Africa and Asia—an advantage that goes beyond geographical proximity. The EU has negotiated 11 free-trade agreements with Africa and 8 with Asia (excluding China and India), while Australia and New Zealand have secured 11 agreements with Asia (excluding China and India). The United States lags far behind, with just four trade pacts across Africa and Asia combined.

Unexpected tariff movements over the past five years will continue to occur. This will test the ability of US dairy companies to manage risks. In 2014 Russia's embargo on several traditional western suppliers² was one of three factors leading a dairy market downturn. Currently, tariffs are affecting \$1 billion of exports to China and Mexico. Those events reinforce the need for planning and diversification to mitigate the impact of disruptions.

One area of growth in retail is global emerging markets. According to the McKinsey Global Institute, emerging economies have accounted for almost two-thirds of the world GDP growth and more than half of new consumption over the past 15 years. Urban growth is another driver: one billion people in rapidly growing cities will become consumers by 2025. These trends make it clear that the future of dairy is global and that the next generation of consumers will be in cities that have yet to achieve prominence.

The burgeoning global middle class, especially in developing markets, represents a high-value target for US dairy companies (Exhibit 13). Leading trends for these consumer segments are convenience, snacking, and food innovation. Dairy companies can easily use their capabilities and size to reach out to these consumers and grow beyond their core markets. Rising income levels are a promising indicator, but they don't tell the whole story. Asia has the most potential as measured by the number of consumers and GDP per capita, for example, but dairy faces a slow adoption curve. By comparison, Latin America, where dairy is considered a basic staple, has higher consumption at lower GDP per capita.

Also, many emerging markets have a lower degree of consolidation than those in which the US and EU retailers command less power. These opportunities can be transformed into advantages with the right mix of scale and innovation.

Crafting an international growth strategy

US dairy companies with a presence in international markets will need to pursue a two-pronged

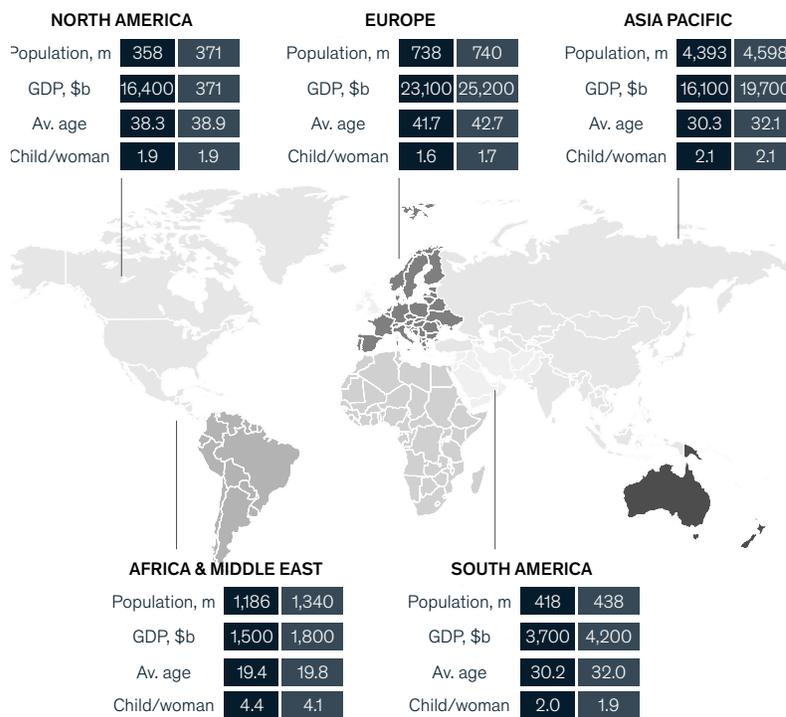
strategy to expand their global footprint. The current uncertainty in global trade will force companies to play defense to maintain their position in existing markets. 63% of CEO's think that the recent declines in the US industry are structural and not cyclical (Exhibit 14). As a first step, they should systematically and proactively identify risk by developing insights on supply, demand, policy and political factors, and trends. With this more detailed view of the markets and relevant exogenous factors, executives can build a robust tool kit of financial and demand-hedging tools to manage risk as it occurs. Proactive risk management can enable companies to increase the resilience of their supply chain by collaborating closely with customers and suppliers. Such efforts can help dairy companies develop contingency plans in the event of unforeseen challenges.

Exhibit 13:

Macro consumer trends will shape global food consumption patterns in different ways across regions

Trends and global food consumption patterns across regions

Indicator '15 '20



Middle class explosion

Mostly in Asia – and can afford to spend significantly more than their parents (China's average wages at ~45% of US vs. 5% today)

Millennials taking over

Millennials will be the largest age cohort in spending in 5 years: internet natives desiring instant gratification and personalized products

Urbanization

Globally, 60% of people will live in urban areas in 2030, compared to 53% in 2013

Aging population

Global median age will increase by 4 years by 2030, driving growth in health & wellness products spending

Shrinking household size

Average household size continues to fall, especially in developed markets (US average household fell from 3.67 to 2.55, 1948 to 2012)

Source: "Dairy Market Maps and Trends Update". McKinsey & Co. Dec. 2016

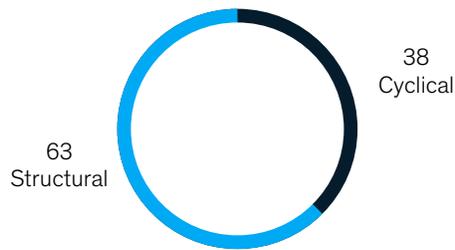
² USDA Gain report RS1584 15-Oct-2015 on dairy and products annual – Russian Federation

Exhibit 14:

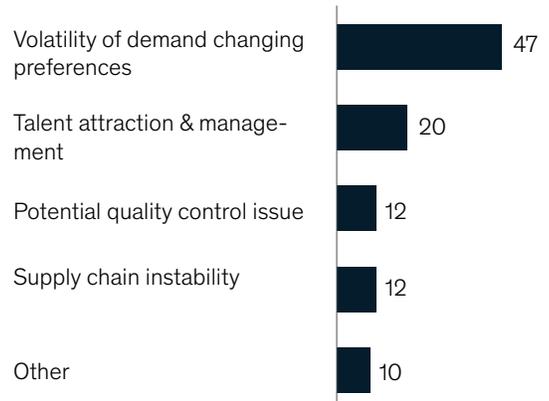
A majority view current dairy industry declines as structural in nature

Do you view the recent declines in US dairy market performance as

- **Structural** (unlikely to change) or
- **Cyclical** (likely to resolve in the near/medium term)? % of respondents



What do you view as the most significant risk to your business?, % of respondents



A majority view current dairy industry declines as structural in nature.

Source: 2018 IDFA Survey

At the same time, US dairy companies should take actions to play offense and capture growth in selected global markets. By choosing countries where the United States has trade agreements in place and by making strategic investments, companies can enter markets with long-term dairy deficits. Focusing primarily on export growth in general will not be enough, however, since the US free-trade agreement network trails that of other countries. US companies can use advanced analytics to pinpoint territories that are a good fit and speed product development and testing. Robust manufacturing and a resilient and geographically diversified supply chain are also critical factors in successful international expansion, so dairy companies should devise long-term strategies for capital, talent, and products.

When companies combine defensive risk management and proactive investment, they can unlock a positive cycle of global growth. However, expansion in the current landscape will also require dairy executives to adopt a different mind-set. An emphasis on agility in core operating systems and innovation can enable products to be developed and introduced to market more rapidly. This capability should be matched with a venture capital approach to investments, in which a series of smaller investments are used to identify promising ideas, introduce a minimum viable product to market, and then scale up based on consumer response.

McKinsey has developed a set of core beliefs to succeed in international expansions across different sectors:

- I. Profitability in international markets is strongly affected by end-to-end industry structure (including channels) and barriers to entry. Early due diligence and input from market experts can help companies understand the risks and limitations in a given market.
- II. Having a defined route-to-market strategy (including infrastructure) is critical to winning and influences where companies choose to play.
- III. Economies of scale are crucial in building the relationships, brand, and other capabilities needed for a profitable and sustainable international business. Markets that are still in the early stages of consolidation are good targets for companies that have learned to scale up quickly.
- IV. Companies should adopt a market-specific approach that takes into account how consumer needs and perceptions differ in each market. Each market is different, so neglecting to understand and adapt to the preferences of local consumers is a recipe for failure.

- V. International growth gives rise to new uncertainties (for example, regulations, currencies, and import restrictions), so companies must develop new capabilities to manage these risks. The difference between failure and success in international expansions is a company's ability to learn from its mistakes.
- VI. A company's geographic strategy should be integrated into its overall corporate strategy and culture. Further, resources should be carefully allocated (for example, the decision to infuse talent into other geographies). International strategies must be aligned with a company's business models and capabilities, since it is challenging to build core capabilities that don't exist or aren't supported by the parent company.

Last, developing a successful international strategy requires an evaluation of the following factors:

- Category attractiveness—what category matches the company's value proposition.
- Market opportunity—A market's potential versus risk to determine ease of reaching scale and growth.
- Fit with capabilities and market dynamics—are consumer preferences and market structure compatible with company's competences and abilities.
- Opportunity and risk assessment—the opportunity size, timelines, risks, and resources required to enter a market.
- Market entry options—Structure (such as partnership, joint venture, and M&A) as well as the resources required to execute.

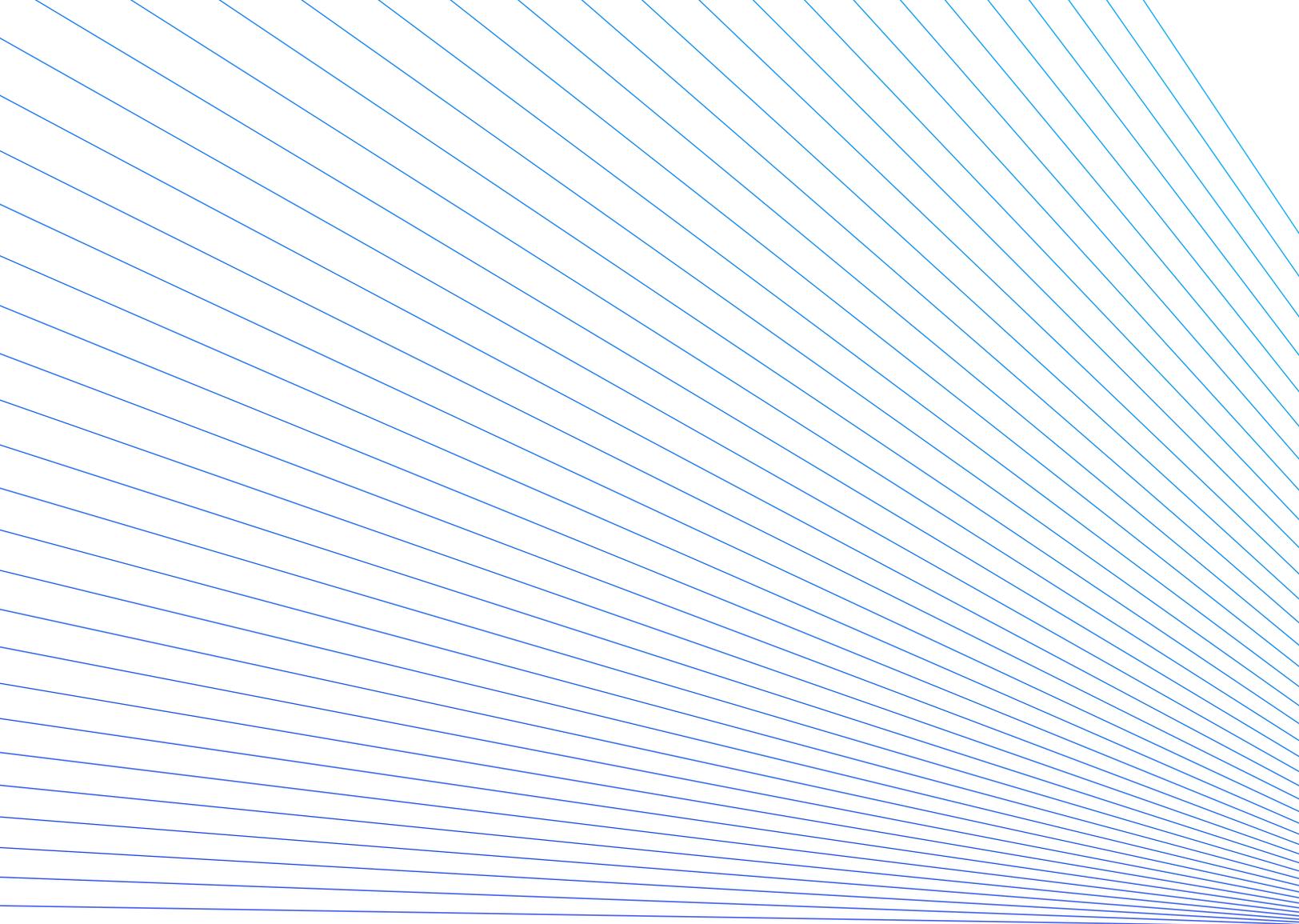
Moving forward

Given the shifting landscape and long-term trends, each dairy company must determine the right strategy based on its current capabilities and footprint. At a high level, our analysis suggests that a combination of four strategies offer a path to growth.

- Domestic growth driven by innovation and supported by a deep consumer preference analytics capability.
- Serve new demand niches by revamping your supply chain and make it more agile and flexible.
- Serve demand growth in areas with projected deficits. Depending on the specific geographies, the free trade agreement network might be the first step to identify export markets.
- When exporting is not a possibility or if the goal is to maximize long-term value capture or market exposure, investing directly in deficit markets to serve those markets locally is the route to go.

A rapidly changing consumer and global environment requires a bold new outlook, and a growth model that can deliver on this challenge.

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