

The evolving perspectives and strategies of dairy executives

The past several years have seen a significant shift in how dairy CEOs are viewing future opportunities.

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The mood of U.S. dairy executives has deteriorated, as flat growth, trade tensions, and changing consumer tastes have dampened prospects for the coming years. With regions beyond the United States experiencing growing demand, rising numbers of U.S. dairy companies have begun to pursue exports in the past several years. Other market factors, including the move by some consumers to nondairy alternatives, will also present challenges. New McKinsey research¹ sheds light on the mind-sets of U.S. dairy executives and their recent evolution as they attempt to jump-start growth.

Executives on dairy exports

In 2015, several developments in the global dairy industry suggested cause for optimism. The European Union removed its milk production quotas, and observers anticipated that a growing middle class in Asia would consume more dairy products. In our 2015 survey, 78 percent of CEOs believed that despite declining demand, the U.S. market had ample opportunity for growth. In the ensuing years, milk supply grew faster than demand, and prices and profitability have remained depressed ever since. As a result, in 2018 63 percent of survey respondents thought the downturn was not cyclical but structural, caused by a global surplus of milk and a fast-changing consumer environment (Exhibit 1).

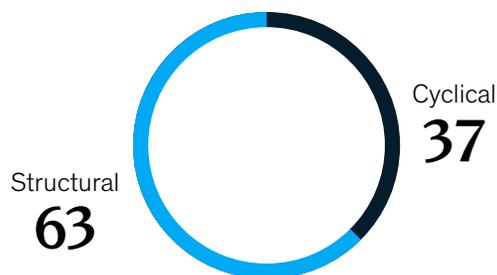
Exhibit 1

Concerns related to market factors

Do you view the recent declines in U.S. dairy market performance as

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

% of respondents



Source: 2018 McKinsey IDFA Survey

“To compete internationally we must shift our mind-set from being an exporter to a global partner.”

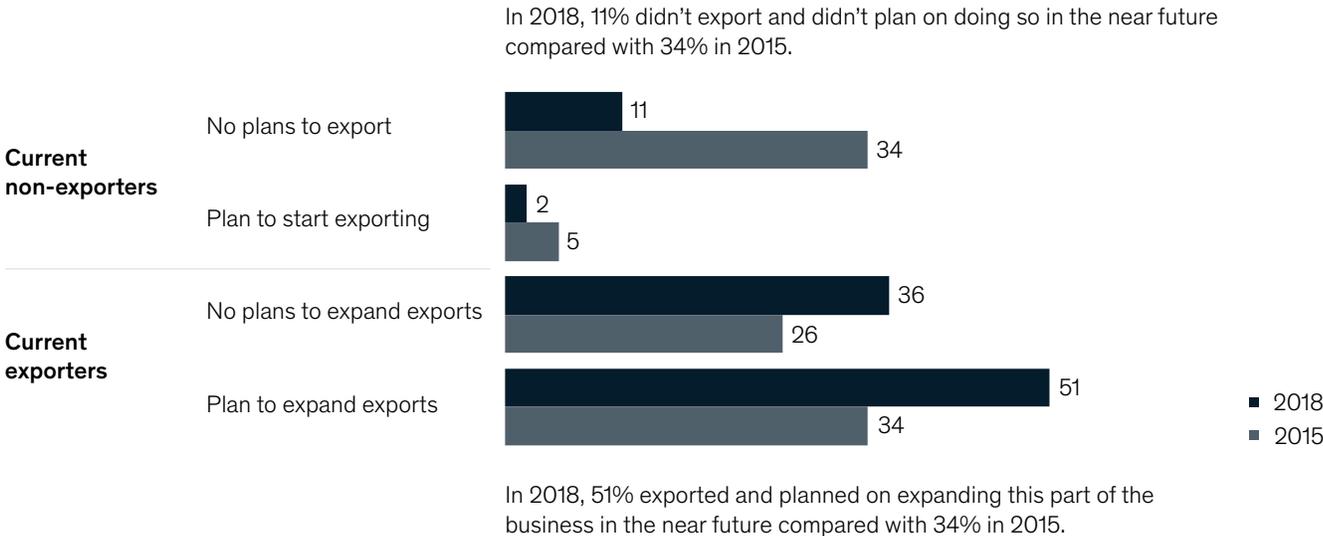
¹ McKinsey conducted a survey of 56 U.S. dairy CEOs in the fourth quarters of 2015 and 2018. These results were augmented with 30 in-depth interviews.

Considering the changing landscape, U.S. dairy companies have changed their perspectives on expanding beyond U.S. borders. The importance of and participation in exports have continued to increase. In 2015, 34 percent of those surveyed had no exports and no plans to export. In 2018, that number dropped to only 11 percent. The share of companies that already export but have no plans to expand and those with continued plans to expand exports also rose from 34 percent in 2015 to 51 percent in 2018 (Exhibit 2). These increases likely reflect the growing importance of exports despite the current trade environment.

Exhibit 2

Which statement best describes your view on your company’s exports of dairy products from the U.S.?

% of respondents



Source: 2015 & 2018 McKinsey IDFA Surveys

“We are being forced to leave the U.S. and build elsewhere because of tariffs.”

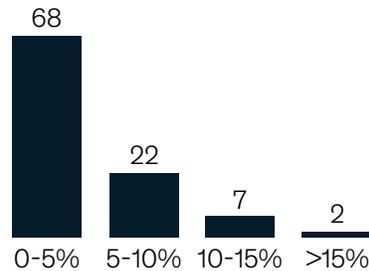
In the 2018 survey, opinions were split regarding how long current trade disputes would last: 53 percent of those surveyed believed that trade disputes were short-term in duration, whereas 47 percent believed they were here to stay. However, the impact of the trade disputes seemed to be universal, with 90 percent of the respondents reporting that they had already incurred a margin decrease between 0–10 percent and 95 percent expecting to incur a margin decrease of the same magnitude (Exhibit 3).

Exhibit 3

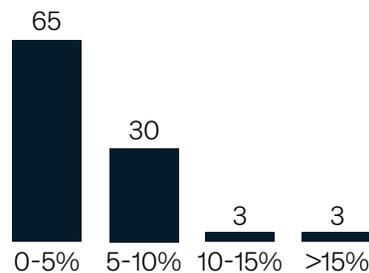
What percent margin decrease have you already incurred / expect to incur as a result of the new trade policies?

% of respondents

Already incurred



Expected to be incurred



Source: 2018 McKinsey IDFA Survey

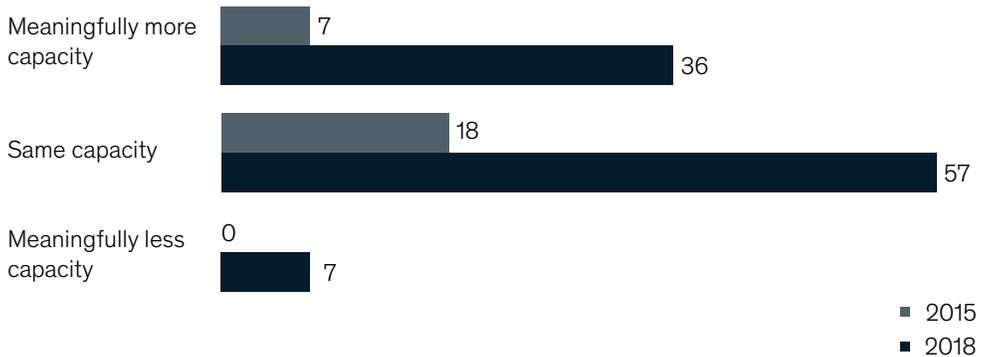
It is not clear whether the magnitude is low because trade disputes have a low impact or because the prices and margins were already on the decline before the disputes started. However, for those companies with significant export exposure (7–10 percent of the respondents), the impact of trade disputes has been significant in terms of discounts or lost opportunities, with margin decreases of 10–15 percent.

The results show that 82 percent of revenues from the surveyed companies come from the U.S. domestic market, with just 18 percent from exports. As other countries face surpluses and focus on foreign direct investment to complement dairy exports, the production capacity of U.S. dairy companies outside the United States is also growing. In 2018, 36 percent of the respondents had expanded their capacity outside the United States (over the course of five years), compared with only 7 percent in 2015. Fifty-seven percent of the respondents had the same capacity in 2018, compared with 18 percent in 2015, and 7 percent reported to have less capacity in 2018 compared to 2015 (Exhibit 4). This investment in foreign capacity is a hedge against the risk of losing out on the opportunity to capture more value and move away from commodity pricing and cycles. Winners in this space have transitioned from being commodity suppliers to functioning as strategic global partners.

Exhibit 4

In the last 5 years, how has your plant network changed...?

Outside the U.S.; % of respondents



Source: 2015 & 2018 McKinsey IDFA Surveys

In 2018, the results show U.S. dairy exports are mainly consolidated into two markets, Asia and Mexico, which represent 45 and 46 percent of the export revenues, respectively. As other countries gain access to compete in these markets, margins are expected to decline. Less than 10 percent of export revenues are associated with Africa and the Middle East, regions that will grow with their populations and economies and where several European and New Zealand companies already have a direct presence.

Risk and volatility management

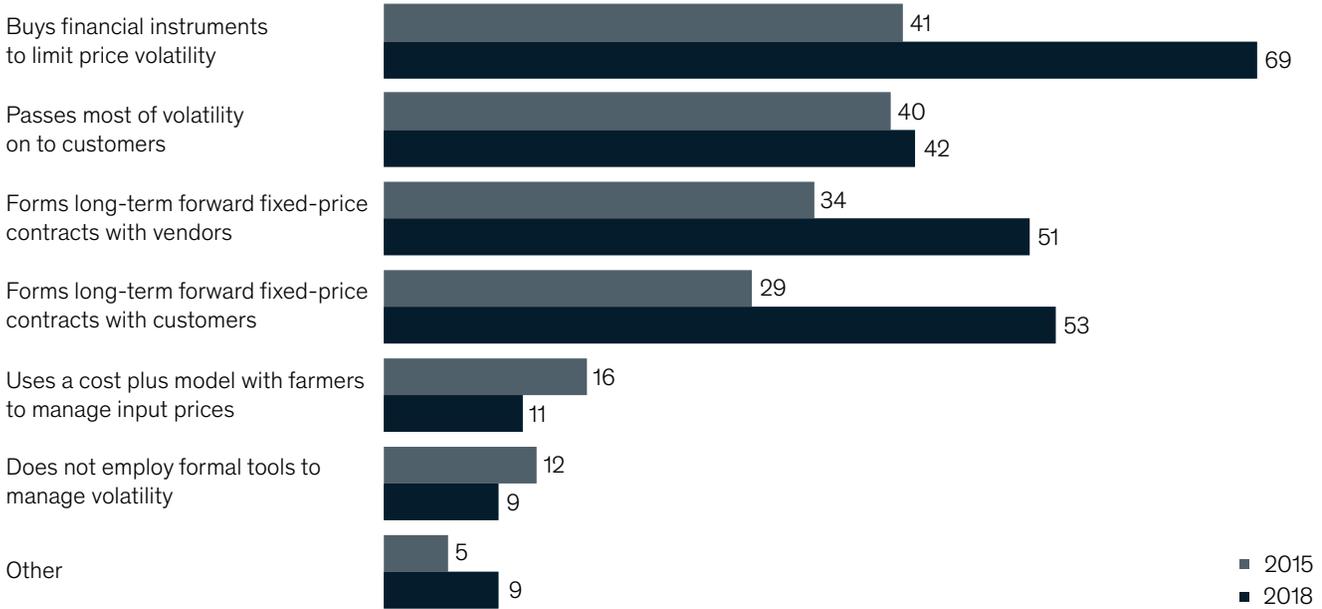
“We really need better tools for risk management.”

Survey respondents also indicated a sustained concern about volatility and ways to address it. In 2015, price volatility was the third-highest concern, right after consumption decline and food safety. The number of respondents reporting the use of financial instruments to mitigate price volatility has increased. Companies securing long-term fixed contracts with vendors and customers have increased as well (Exhibit 5). Demand volatility continues to be the top concern in 2018: 47 of 51 respondents reported being concerned and 32 of 51 very concerned about demand volatility. The evolution of consumer preferences seems to be connected to these concerns.

Exhibit 5

What tools does your company employ to manage pricing and supply volatility?

% of respondents



The top four perceived drivers of consumer demand have been stable from 2015 to 2018, but their order has shifted. Taste was the most important factor in 2015 and fell to number three in 2018, whereas price moved from number two in 2015 to number one in 2018. Health and wellness also rose from number three in 2015 to number two in 2018. Convenience remained number four in both 2015 and 2018 (Exhibit 6).

Exhibit 6

Which of the following do you believe are the top four most important factors in driving consumer purchasing behavior of dairy products today?

	2015	2018
1	Taste	Price
2	Price	Health and wellness
3	Health and wellness	Taste
4	Convenience	Convenience

Source: 2015 & 2018 McKinsey IDFA Surveys

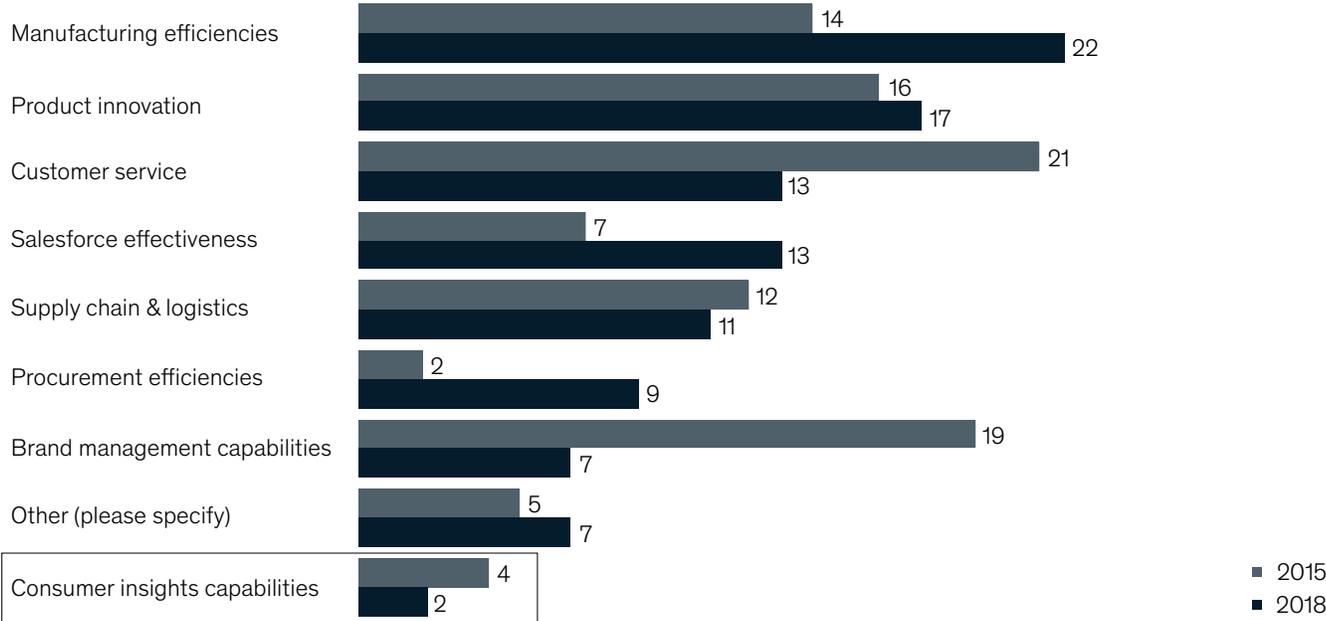
The survey results suggest CEOs are reassessing their companies' competitive advantages in a consumer landscape that is shifting toward small brands and a different set of preferences compared with older generations. In 2015, 21 percent of dairy CEOs had confidence in their

customer service capabilities, followed by brand management. Only a minority considered customer insights to be a source of competitive advantage. In 2018, dairy CEOs had the most confidence in their operational capabilities, but very few listed brand management capabilities. Again, only a few cited consumer insights as a competitive advantage, which is surprising considering the influence of consumers on demand volatility. (Exhibit 7).

Exhibit 7

What do you believe is your company’s top source of competitive advantage?

% of respondents



Source: 2015 & 2018 McKinsey IDFA Surveys

Operational capabilities, while important, are just one element of a winning proposition; after all, *efficiently* making products that consumers *don't want* doesn't support growth. Successful companies have an efficient, agile, and global supply chain powered by consumer insights.

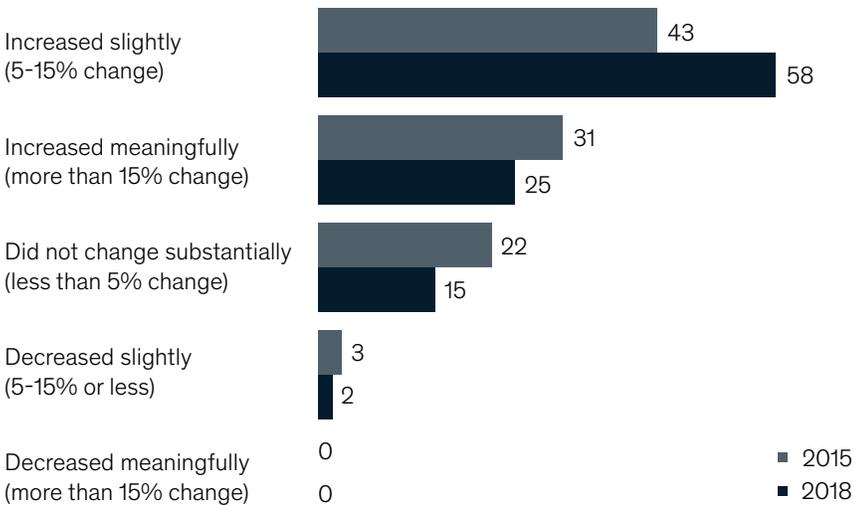
“There are opportunities in cheese, snacking segment, new protein drinks, new protein items/snacking items, cottage cheese with mix-ins, and spreadable cream cheese flavors.”

The results suggest companies are responding to the new landscape by increasing the speed of innovation. The number of companies changing more than 5 percent of their portfolio increased from 73 percent in 2015 to 83 percent in 2018. According to the survey, new products represent 6 percent of the total portfolio of products for companies with growing portfolios and 3 percent for products with decreasing portfolios (Exhibit 8).

Exhibit 8

As compared to five years ago, or when your company was first created if more recent, how does your company’s product portfolio compare in terms of the number of items offered to customers?

% of respondents



2018

What % of products does your company introduce as new annually?

6%

2015

What % of products does your company introduce as new annually?

3%

Source: 2015 & 2018 McKinsey IDFA Surveys

Milk alternatives and millennials

“The perception [is that] dairy has lost its wholesomeness.”

Our interviews with CEOs revealed a sense of frustration over the speed of change in consumer preferences, including the emergence of natural, healthy, and socially oriented trends (Exhibit 9). Even so, executives recognize the necessity of listening to consumers and are trying to adjust strategy accordingly, with some expressing the desire to enter into a business partnership with their nondairy counterparts.

Exhibit 9

Concerns related to consumer factors

Trends	Quotes			
Natural	<ul style="list-style-type: none"> • Organic • Clean label • Traceable 	<p><i>“The perception [is that] dairy has lost its wholesomeness.”</i></p>	<p><i>“What else can we do that satisfies the desire to have more clean ingredients and more natural products but cuts back on sugar without artificial sweetener.”</i></p>	<p><i>“Consumers want something different – they want organic, something healthy, without a big company behind it.”</i></p>
Health & Wellness	<ul style="list-style-type: none"> • High-protein • Performance • Plant-based alternatives 	<p><i>“Young people are moving away from seeing dairy as a positive part of their nutritional diet.”</i></p>	<p><i>“I’m optimistic about the opportunities for cheese and whey protein – these products face less pressure from non-dairy alternatives.”</i></p>	<p><i>“Among millennials we are seeing a shift to non-dairy, plant-based proteins. We need to build relationships with these plant-based protein companies.”</i></p>
Socially-oriented	<ul style="list-style-type: none"> • Anti-dairy sentiment • Animal welfare • Sustainability • Transparency 	<p><i>“Dairy companies need a better understanding [of] what the consumer values and then connecting that with what we do.”</i></p>	<p><i>“Animal care was straightforward, but the wider sustainability issues are harder to know [regarding] exactly what consumers want (if consumers even know).”</i></p>	<p><i>“Being a leader in creating transparency and building trust, through investment in a robust supply chain, gives real competitive advantage.”</i></p>

Source: 2018 McKinsey IDFA interviews

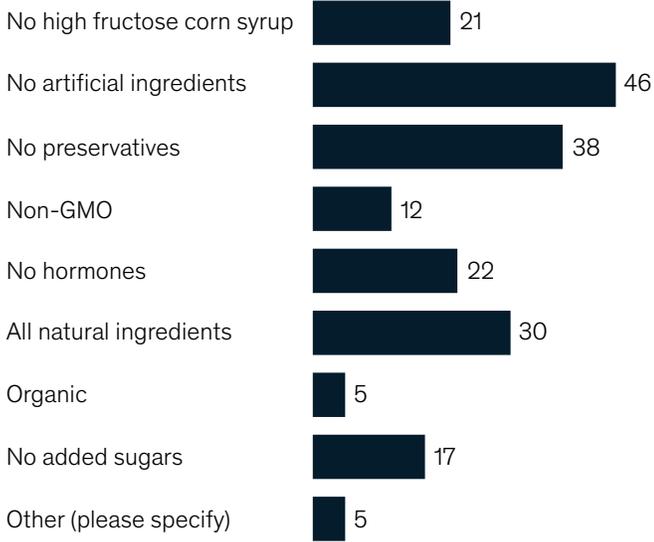
Executives exhibited moderate confidence in understanding such trends as clean labeling, which has a variety of meanings (Exhibit 10), and preferences for plant protein but not fat. As millennials become the largest demographic in the United States, companies need more insights into these consumers, who are more diverse, more sophisticated, and more demanding than other generations and prefer to shop in channels beyond the mass markets. Millennials also gravitate toward up-and-coming brands rather than established ones.

The views of dairy CEOs on the milk alternatives market has shifted significantly. In 2015, only 38 percent of the respondents believed that the nondairy alternatives market would continue to grow. In 2018, this number increased to 51 percent (Exhibit 11). Successful companies can respond by understanding the areas in which dairy has an advantage and exploit those markets, such as infant formula, geriatric, clinical, and others where nutrition is valued and price sensitivity is not a factor. Or they can invest in adding dairy alternatives to their portfolios; as one CEO noted, “We need to build relationships with these plant-based protein companies.”

Dairy-alternative products appear to be here to stay, so market insights and an openness to work with nondairy companies will be critical elements of strategy moving forward.

Exhibit 10

What does clean labeling mean to you?
(Please check all that apply); % of respondents



Source: 2018 McKinsey IDFA Survey

What impact does clean labeling have on your business?
% of respondents

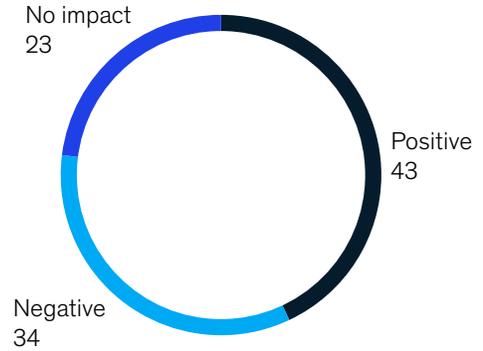
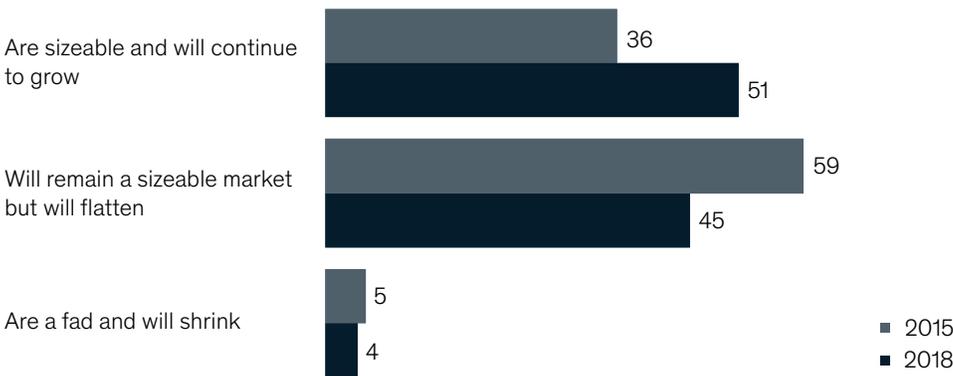


Exhibit 11

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

% of respondents



Source: 2015 & 2018 McKinsey IDFA Surveys

Conclusions

Between 2015 and 2018, themes top of CEO's minds have stayed consistent. As shared in our previous article² we believe North America dairy companies should use a combination of four strategies:

- Serve demand growth in areas with projected deficits through exports
- Invest directly or form partnerships to serve those deficit markets locally (based on a perspective on market attractiveness through economic cycles)
- Serve demand niches with a more agile and flexible supply chain
- Drive innovation based on deeper consumer insights powered by analytics

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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² McKinsey & Company. "A winning growth formula for dairy." <https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/a-winning-growth-formula-for-dairy>

Appendix

The surveys were conducted on 210 companies, all of them members of IDFA (International Dairy Food Association), of which 56 responded.

1) Business type:

In terms of company demographics within the industry, the demographic is stable, making results comparable.

Exhibit A

Shifts in Business Type from 2015 to 2018

	2015	2018
Private	35	31
Public	11	7
U.S. Division of International Organization	0	3
Cooperative	10	13
Other	0	2
TOTAL	56	56

2) Business sectors represented

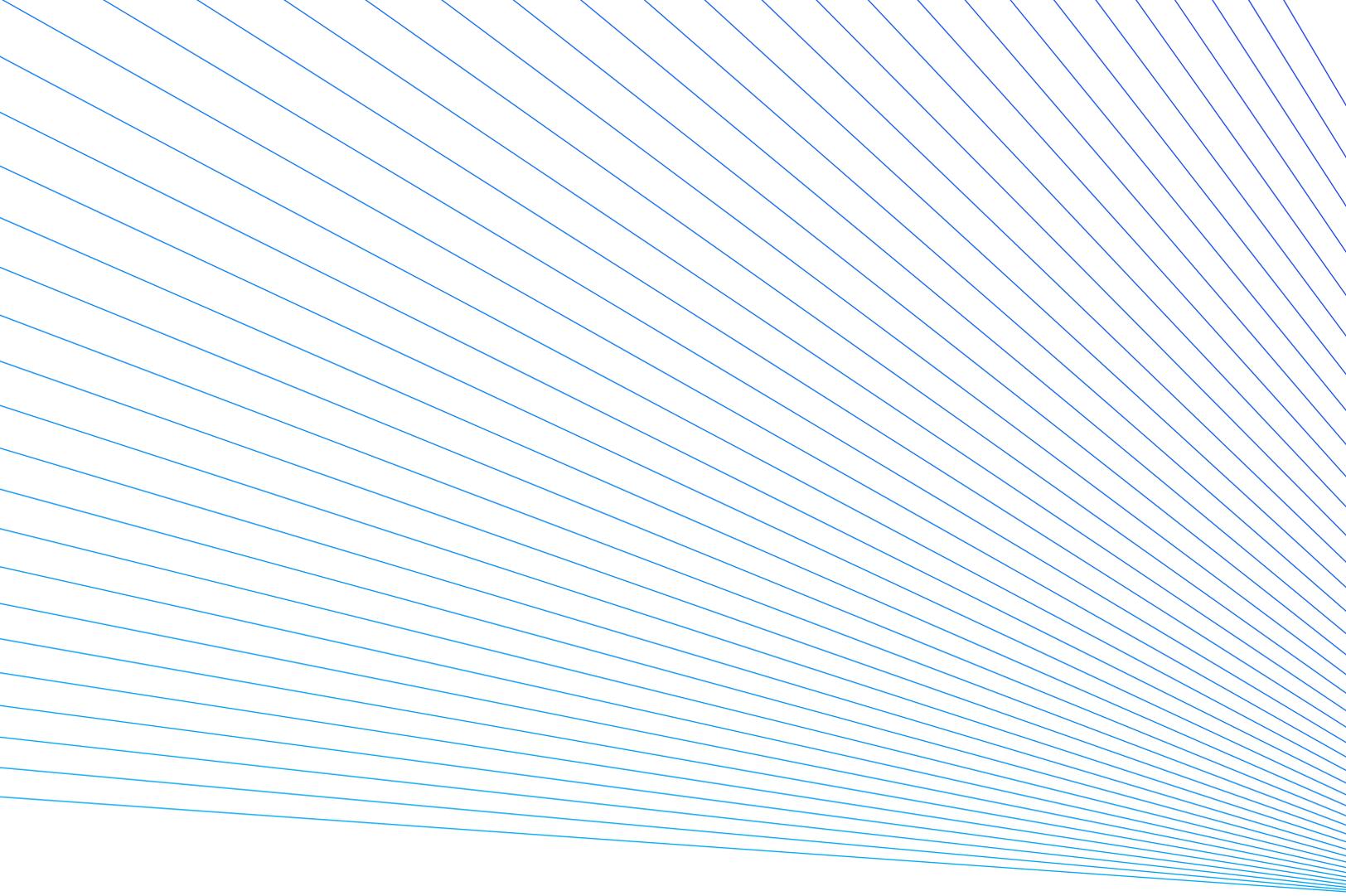
Exhibit B

Shift in Sectors from 2015 to 2018

	2015	2018
Retail	49	52
Packaged goods	n/a	39
Food service	46	56
Other B&B	32	48
Food ingredients	27	54
Other	4	2

3) Top innovations:

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: Fairlife, Protein, and Packaging. (See Exhibit C.) As one CEO put it, "Dairy companies need a better understanding [of] what the consumer values and then connecting that with what we do."



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