



SPECIALTY FOOD AN INDUSTRY STUDY

Things you will learn from this whitepaper:

1. What are the most common business challenges facing the specialty food industry?
2. How has competition affected the industry's landscape?
3. How does the advancement of technology affect the specialty food industry?
4. What sectors of the specialty food industry have the most growth potential?

This whitepaper will have special interest to:

1. Attorneys consulting with specialty food businesses considering mergers or acquisitions.
2. Judges presiding over business disputes & litigation cases.
3. Business mediators & arbitrators.
4. Those concerned with the valuation of specialty food distribution/manufacturing.

Notice & Disclaimer

In a forensic accounting setting, the purpose of an industry analysis is to allow a comparison of the subject company to its industry. This comparison is vital to assess the strengths and weaknesses of the subject company, as well as its industry and company specific risks.

The following study contains a brief, selected analysis of the specified industry. It is based upon a review of current economic statistics, articles in the financial press, reviews found in current business periodicals and information posted on numerous internet sites. It does not purport to be all-inclusive or to contain all of the information which a prospective investor or lender may require. Projections and opinions are based upon information provided by third parties. We make no representations or assurances that this information is complete or accurate. Neither Mark S. Gottlieb, CPA, PC nor any of its officers, employees, or representatives make any representation as to the accuracy of completeness of this report or its contents, nor shall any of the foregoing have any liability resulting from the use of the information contained herein or otherwise supplied.

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Industry Overview

The specialty foods industry is a dynamic, rapidly expanding sector of the retail food market. The category of specialty foods is broadly defined as any food or beverage product commanding a premium price due to its quality, availability or target consumer. In recent years, the industry definition has expanded to include coffee shops and home-based distributors.

Industry statistics are difficult to interpolate, as many products (e.g. meat, poultry, cheese, fish, dairy, bakery goods, vegetables, fruits) cannot be tracked with current scanner technology. Alcoholic beverages are also difficult to track, as laws regarding the place of sale of these beverages vary from state to state.

Despite these complications, sales of specialty foods at retail were estimated at \$22.8 billion through 2003 (excluding WalMart sales). This figure represents an estimated 20.4% increase from 2001. With the economy in full swing, and the demand for specialty foods seeming to grow exponentially stronger, the industry seems to be entering a golden period.

Competitive Landscape

Through the early part of the 21st century, the fastest growing segment of the specialty foods industry was chain coffee stores, which typically sell coffee beans, ground coffee, and cups of brewed coffee ready to drink. Baked goods, sandwiches and other food items are becoming standard offerings, as well.

Of the chains, Starbucks Corporation trumped all competition with \$4,075.5 million in sales for 2003. Starbucks has since continued its outlet expansion while simultaneously growing its product line. Despite the success of large retailers like Starbucks, though, this branch of the specialty foods industry remains competitive with both chains and independents. Nationwide, independents accounted for more than half of the industry's growth between 1996 and 2001, when the number of U.S. coffee houses doubled to 13,300 (including Starbucks). The majority of coffee houses established within the last decade have survived, according to industry sources.

Along with chain coffee stores, specialty foods retail stores claim a large portion of total industry sales. Whole Foods Market, Inc., the largest specialty foods retailer, reported \$3,148.6 million in sales for 2003. Trader Joe's Company, Inc., claimed \$2,500 million. General Nutrition, Inc. and Wild Oats Markets, Inc. placed third and fourth, respectively, with steady growth reported through 2005.

Home-based retailers such as Herbalife International, Inc., comprise a modest percentage of specialty foods sales, though Herbalife in particular has languished due to litigation brought forth by the Attorney General's office against pyramid scheme practices. Statistics for these types of businesses vary widely and are difficult to ascertain.

Products, Operations & Technology



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The U.S. specialty foods market has traditionally included: specialty baked goods and cereal-based products; specialty sauces, dressings, vinegars and oils; specialty beverages (herbal teas, juices, nutritionally fortified drinks); specialty meats; specialty dairy products; herbs and spices; organic, gourmet and ethnic foods.

The industry is complex with a diverse spectrum of retailers. Product suppliers are not as well consolidated as in the traditional retail foods industry, and managing a broad network of supply channels is necessary to the survival of most specialty food retailers. Some larger chains, such as Trader Joe's, have developed a substantial line of "in-house" products to create wider margins on items, and to streamline supply avenues.

Due to the steady escalation in demand for "organic" products, retailers must take care to order efficiently, as these items may not utilize traditional food preservatives, and typically have shorter shelf lives. That said, technologies to improve the shelf life of organic food have shown great promise as of late. Organic foods are a fast increasing component of the specialty foods industry, and even the largest chains may have local, regional, national and international suppliers.

Sales & Marketing

The National Association for the Specialty Food Trade (NASFT) estimates that the U.S. market is comprised of over 50 million "heavy buyers" of specialty foods. Many of these are concentrated in large metropolitan areas, where retail stores are prevalent. Print and media advertising are increasingly utilized, with direct mail campaigns frequently targeted at established customers. Research by independent firms is utilized, and certain demographics may be prioritized for mailings.

In addition to retail outlets, many specialty foods retailers have established online venues. Some companies, such as Wild Oats, feature websites with real-time inventory and automatic updates to accounting ledgers. Websites are promoted heavily in-store, and employees are encouraged to register customers to online accounts.

Finance & Regulations

Retailers in the specialty food industry are subject to the same regulations as general food retailers. Most specialty food retailers will not handle a product lacking UPC (Universal Pricing Code) identification, but this designation protocol is generally the responsibility of suppliers. Organic and fair-trade appellations are often sought by suppliers as well; these aid in marketing products to retailers, and ultimately, to consumers.

Regional & International Issues

Specialty foods seem to be popular targets in trade disputes between countries. In June of 2000, the U.S. imposed heavy duties (100% or greater) on a wide array of specialty products from the European Union in response to the E.U.'s refusal to alter its banana trade policy, and its import ban on beef raised with growth hormones. Furthermore, strong lobbies from local producers often result in legislation against international imports of specialty foods.



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Because regionally derived products comprise such a bulky component of the specialty foods industry, gross margins are often affected by regional trends. Store location is important, and retailers that choose to emphasize local or regional products may see less stability in supply than large chain stores, which manufacture and brand their own specialty items.

Business Challenges & Critical Issues

Established Branding – As the specialty foods industry becomes increasingly mainstream, brands with established recognition and consumer loyalty will be most poised for success. Chain coffee stores, in particular, have come to evince this fact. Grocery outlets have followed suit with the increased branding of products.

Distribution Channels – Like traditional grocers, specialty foods retailers will need to develop reliable, streamlined distribution channels in order to offer product consistency and stabilize margins.

Critical Mass – With increased hegemony by retailers like Whole Foods and Wild Oats, and the entry into the specialty foods market by megastores like WalMart, many companies may find themselves marginalized in the long run. Smaller and mid-sized retailers will need to develop “critical mass” in order to compete in national markets. Otherwise, niche markets will be slowly eroded and suppliers apt to deal with larger contracts.

Regional “Proof of Concept” – Specialty foods producers need to establish solid regional markets in order to demonstrate product quality and viability. Without proof of concept, producers will have difficulty taking products to a national level.

Demographics – While the specialty foods industry has established strong niche markets among ethnic, elderly and health-conscious populations, the industry must continue to expand its primary market, as well as tap into new demographics. Currently, adults age 45-65 are the largest consumers of specialty foods, as this group has the most disposable income of any U.S. demographic. Young, affluent females spend more per capita than any other group on specialty foods. Young males seem least apt to purchase specialty foods, particularly organic and gourmet products.

Other Business Challenges

Placement in supermarkets – Though some supermarket chains realize that specialty foods can distinguish their stores from mass merchants, many have found it difficult to give up lucrative slotting fees from large food manufacturers. This has led some analysts to believe that specialty foods will have difficulty attaining widespread distribution until the big food manufacturers step in.

Food Brokers – Food brokers often find specialty food lines less attractive because they are made by smaller concerns unable to pay commissions. Brokers are also likely to push a proven product rather than promote a new one. Therefore, specialty food products will need to step up promotions and demonstrate salability in order to make themselves more attractive to brokers.

Industry Outlook



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With consistent annual growth, the specialty foods industry looks poised to continue its expansion, and make further forays into mainstream markets. The trend toward mergers and acquisitions has provided the industry with capital and greater distribution. Blockbuster transactions such as Coca-Cola's purchase of the upmarket juice maker Odwalla have been industry standard for over a decade, and consumer demand for specialty products seems to increase commensurately with market visibility.

One of specialty foods' more remarkable attributes is its imperviousness to substandard economic conditions. Despite higher prices, the industry performed well during the economic recession of the late 1980s and early 1990s. According to Progressive Grocer, specialty foods retailers weathered the recession because their clientele were not bargain shoppers in the first place, and because, in general, people ate out less and entertained more at home. In all, the specialty foods industry has enormous potential, and should continue to expand well into the 21st century.



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