Poultry in Motion

10 Golden Rules for Winners in the EU Poultry Industry

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The EU poultry industry has been facing a turbulent market environment since 2006, with high and volatile feed costs, along with weak pricing power as a result of a weak macroeconomic environment. In addition, the industry—particularly in northwestern Europe—has been receiving ongoing criticism by NGOs over animal welfare and sustainability issues. Both national and European authorities but also the industry themselves have raising the bar on regulations, requiring a more sustainable and animal welfare-friendly product. This has further pressured the financial sustainability of the sector: costs are increasing at a time when market conditions do not permit these costs to be passed on to the consumer.

The emerging challenge for companies active in the western European poultry industry will be to adjust their strategy and business models. They need to acclimatise to a new market reality with a vocal and effective animal welfare lobby, a structurally weak economic environment, ongoing volatile input prices and a stronger and more savvy and price-driven customer base. This new reality requires a strategic repositioning of individual companies and significant investments.

10 Golden Rules for Winners in the EU poultry industry

We believe there are '10 Golden Rules for Winners' to thrive under the current fast-changing and challenging market conditions (*see Figure 1*).

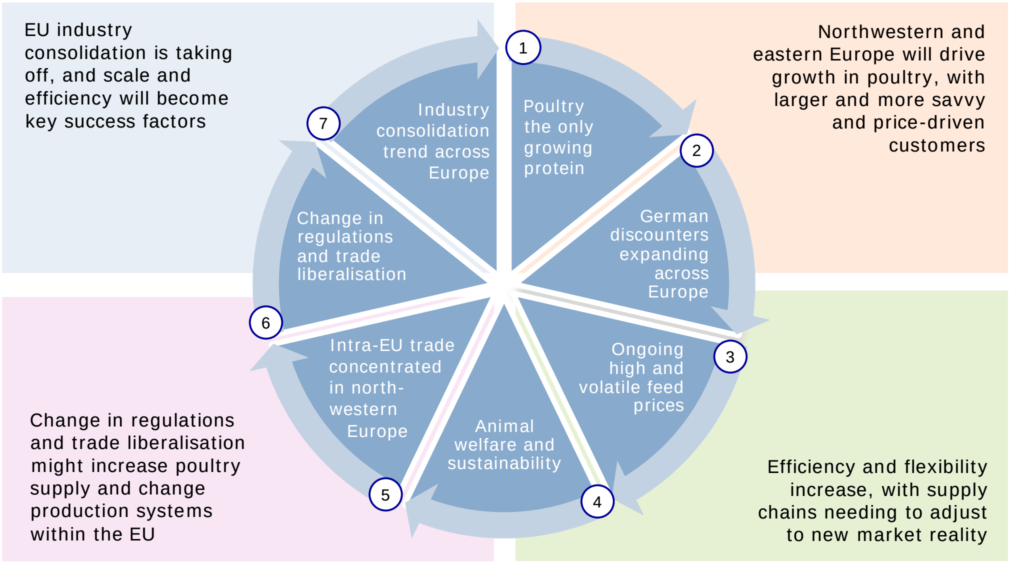
Figure 1: Ten golden rules for winners in the EU poultry industry

1. The customer is king. Invest in market intelligence and product development.
2. Be the category captain. Invest in #1 positions as the preferred supplier of winning supermarkets, QSRs and food companies.
3. Consolidate your market, think outside country lines with a fresh 1,000 km sales radius as base.
4. Scale up or find a niche. The middle segment will disappear and companies will need to choose.
5. Optimal efficiency of the whole value chain is more important than ever.
6. Improve your value chain model to fit the new market reality.
7. Participate in social debate and be prepared for NGO pressure.
8. Optimise the value of individual cuts and offal streams to increase revenues and profitability.
9. Exploit your industry and client knowledge, and follow your customers. Expand in new markets.
10. Reconsider your capital structure. Family ownership has been the dominant model, but does it fit with future challenges?

Source: Rabobank, 2015

While the market remains challenging in the near term, the longer-term outlook for the EU poultry industry is bullish, with a projected 10 percent expansion of the EU market expected over the period 2014 to 2025. But the road to 2025 will be a bumpy one, with ongoing high volatility in feed prices, stronger, even more savvy and price-driven clients, increasing social pressure on traditional production models, a growing 'buy local' trend, together with the recent introduction of country of origin labeling (COOL), and the prospect of further opening of international trade, introducing more competition from low-cost producers from outside the EU (*see Figure 2*). Recent outbreaks of highly pathogenic avian influenza (HPAI) throughout Europe have raised fears that the virus has become endemic in the industry. This further emphasises the importance of individual poultry companies to rethink their business models and to adjust to the new reality in which conditions will be volatile, price-driven and possibly affected by periodic outbreaks of avian flu. In our view, this will further magnify the differences between winners and losers in the industry, bringing opportunities as well as challenges for individual poultry companies.

Figure 2: Key trends in the EU poultry industry

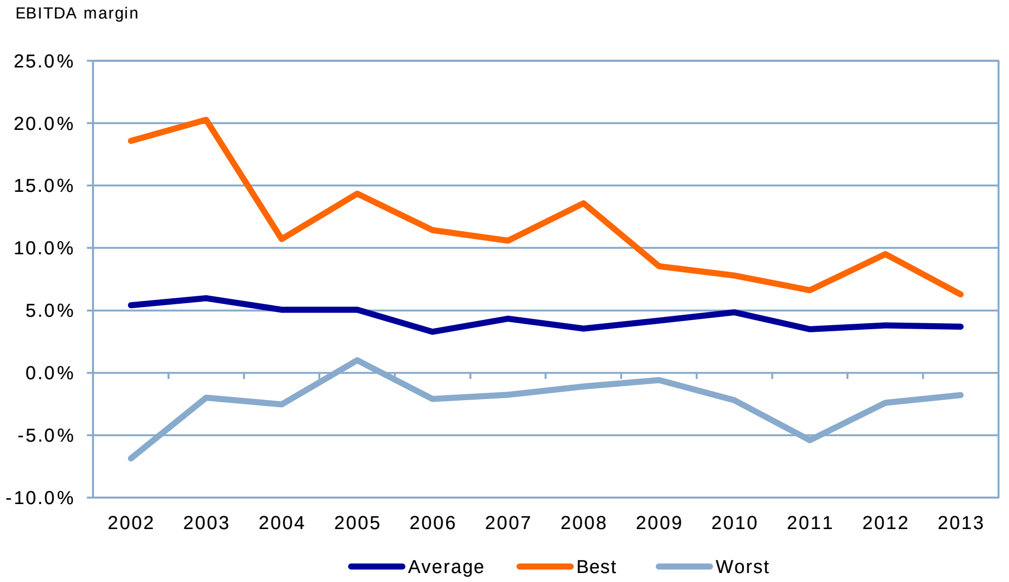


Source: Rabobank, 2015

This new market reality will push the industry to change. The years 2007 to 2014 have shown how much impact the market has on industry performance and structure. Companies who end up in this turbulent market environment without being optimally efficient or focused will come under high pressure. Firms like Tilly-Sabco and Groupe Doux (both from France) had to file for bankruptcy protection. This was a result of, in part, focusing too much on export markets in a production environment with relatively high costs. The same happened to Belgian company Lintor, a former market leader in retail supply in northwestern Europe. They also lacked state-of-the-art operational efficiency due to limited investments and an unclearly differentiated market strategy. Others like Flandrex, Astenhof, Stolle, Velisco and Cherry Valley Foods also suffered and were eventually acquired by stronger players. The stronger players are more focused on retail sales and have invested in optimal efficiency. Being optimally efficient has become a key success factor for any poultry company in the EU, as feed and broiler prices have become highly volatile and have, on average, risen significantly since 2006. Companies who are not efficient, but also not market-focused, will lose market share.

The trend in EBITDA margins shows that the difference between the best- and the worst-performing companies in the EU poultry industry has grown smaller (*see Figure 3*). The best-in-class EU poultry companies now command approximately 7 percent to 10 percent EBITDA margins, while, a few years ago, this was above 10 percent. The worst-in-class poultry companies are still below zero.

Figure 3: EU poultry industry average EBITDA margins, 2002-2013



Legend: Best is highest achieved EBITDA margin level by an individual company in a certain year, low is lowest level

Source: Rabobank, based on public statistics, 2015

The big differences in performance can partially be explained by a company's market positioning, its efficiency and flexibility, its value chain model and the level to which it has anticipated societal changes regarding consumer concerns such as animal welfare, food safety and environment. Especially those companies who operate in close proximity to final customers like retailers, the food industry and quick service restaurants—and are able to combine this advantage with optimal efficiency and flexibility—usually do better than more commodity-focused players with less access to final customers.

Based on the differences in the performance of individual companies, EBITDA margins, net asset turnover and return on capital employed, along with analysing industry trends as described in the previous paragraphs, we can identify key differentiators between the best- and worst-performing companies in this industry, the winners and the losers. Based on this analysis, Rabobank has identified 10 Golden Rules for Winners in the poultry industry.

We believe that this set of golden rules could form a set of building blocks for successful, winning strategies in the EU poultry industry. Having said that, being the industry leader for all ten of the golden rules is not necessary, but companies should pay attention to each rule and formulate an effective response that suits their particular circumstances.

Rule 1: The customer is king. Invest in market intelligence and product innovation.

A strong consumer and customer focus should be the highest priority for poultry companies. They should invest adequate resources in market intelligence and research in order to have a clear understanding of the market in which they operate. All too often, the industry's operations are run in a 'business as usual' fashion, without properly understanding the fact that markets constantly change. This has been even more important in the past few years, during the economic crisis, when consumers and supermarkets have changed their market behaviour and they require a different market and product approach (*see Figure 4*).

Figure 4: Identified megatrends and opportunities for poultry innovation (as presented at the SIAL exhibition)

SIAL-identified megatrend	Poultry product innovation opportunity
Health, nutrition and well-being	Salmonella-free chicken
Local	Regional chicken products
Values: environment, sustainability, animal welfare	Animal welfare brands
Natural, minimally processed, clean ingredients	Natural chicken
Superfoods: ‘magical’ ingredients	Omega-3 chicken
Premium: affordable luxury, indulgence	Label Rouge
Convenience (buying, preparing, eating)	Ready meals, e-commerce
Exotic, but convenient	Thai chicken curry meals
Protein boost: protein power of animal products	Premium chicken

Source: Rabobank, based on THNS Global, Sial, 2015

According to the Global Innovation Index, in the past five years, the pricing of a product has become an increasingly important purchasing criteria for consumers. This has led to a shift in purchasing behaviour, as witnessed by the growth of German discounters throughout the continent and the introduction of a ‘value range’ of private label products in supermarkets (e.g. Tesco Everyday Value and AH Basic) (*see Figure 5*). The ongoing weak economic circumstances in Europe have been a main driver. This has resulted in a general trading-down trend: the average EU consumer has become more price-focused. On the other hand, some consumers take a very different approach and search for additional attributes in their purchases. They are increasingly prepared to pay a premium for these attributes. Indulgence, social conscience and other factors are driving consumers to demand ‘specialised’ items—and this has become a major driver of innovation in the food aisle, leading to increased purchases of exclusive, premium products for pleasure. Other trends like health, nutrition and well-being (e.g. in the guise of salmonella-free chicken); buying local (regional chicken products); ethics and values (welfare-friendly products); natural, minimally-processed (natural chicken); superfoods (omega-3 chicken); and exotic, but convenient (Thai chicken curry meals) link well with the indulgent consumer. Supermarkets have acted by offering visibly differentiated product categories: a mid-range category of products under an own-label brand, a premium segment (e.g. Tesco Finest or AH Excellent), a niche segment, often consisting of organic products, and a value segment, in which supermarkets compete with discounters.

Figure 5: Private label strategies of selected supermarkets and opportunities for chicken

Mid-range	Carrefour Tesco AH	Standard chicken and/or new concepts like ‘The hicken of Tomorrow’
Premium	Carrefour Superieur Tesco Finest AH Excellent	Value-added products like health, welfare, convenience
Niche	Carrefour Bio Tesco Organic AH Biologisch	Organic chicken, duck products, regional products
Value	Carrefour 1 Tesco Everyday Value AH Basic	Low-priced chicken, competition with discounters

Source: Rabobank, 2015

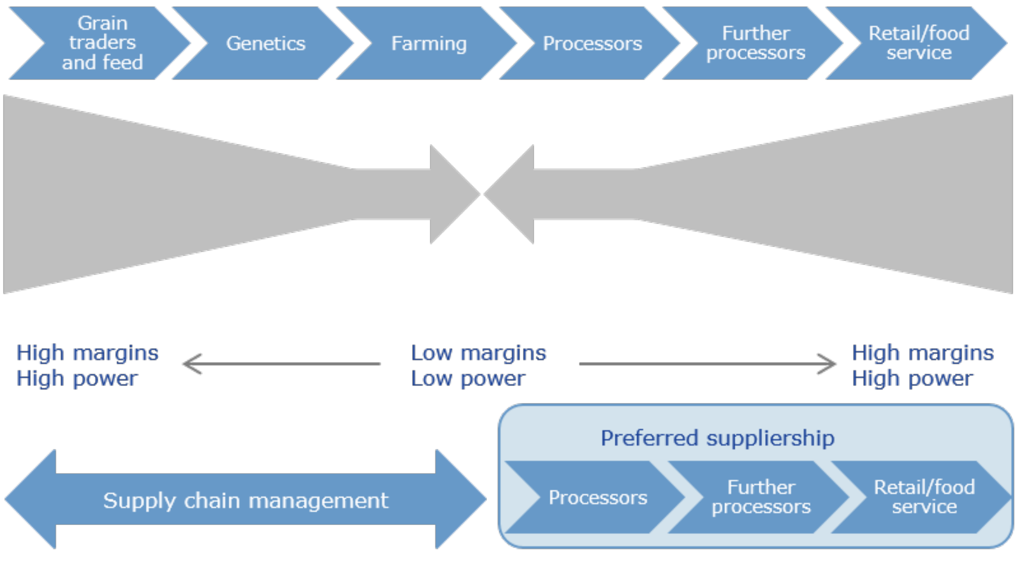
A combination of in-depth insight into consumer behaviour via market research, along with development, and strong retail relationships offers producers room to innovate. The retail private label brand categories can be considered a platform for innovation. Some categories, especially in the niche and premium segment, also offer opportunities for branding, but this will require significantly greater investments in innovation, market research, and market and product development.

Rule 2: Be the category captain. Invest in #1 positions as the preferred supplier of winning supermarkets, QSR or food companies.

The key rationale for this strategy is investing where the margins are. This is usually at retail level so those companies who distribute products directly to the consumer. By optimising the business model to become the key supplier to these players and to reduce exchangeability, a company would be able to move to higher profit margins. Almost all companies who are showing above-average margins in the EU poultry industry have built up excellence in this direction.

Margins are not evenly spread over the poultry value chain, nor are they stable. As a consequence of differences in market power, the highest profit margins can be found at the beginning and at the end of the value chain (supermarkets, QSRs) (*see Figure 6*). Supermarkets have the advantage of final access to the consumer. The dominant position of a few supermarket chains and food service companies offers also opportunities for poultry companies in terms of building up preferred suppliership relationships whereby a retail offers a branded outlet for products for poultry companies and poultry companies can take care about category management, product development and value chain management.

Figure 6: Market power and profit margins throughout the poultry value chain



Source: Rabobank, 2015

Companies who have invested in long-term retail relationships (like LDC, Plukon, 2 Sisters Food Group, Moy Park, Wesjohann, Rothkötter and AIA) benefit from this advantage. The key challenge with this strategy is to outperform your competitors by means of market intelligence, distribution, product innovation, service and pricing. This is a big challenge in a relatively commoditised business like the poultry industry, but it is possible to compete on this basis and be successful. However, this requires a long-term commitment to investments in retail supply, and dedicated value chain supply models and efficiency. The challenge is to be the category captain: to be the #1 supplier of a supermarket. Being #2 or #3 is tricky, as a company ends up being indistinguishable from other suppliers. Risk mitigation via a mixed customer portfolio of retail and QSR-preferred suppliers is important, especially for companies who fail to be the category captain to supermarkets.

A position of strong preferred suppliers as category captain with supermarkets also offers companies a platform for growth. Retailers prefer to work with companies who know their poultry category strategy and especially those who are able to supply the right quality for a competitive price. The recent horsemeat scandal has raised retailers' and food processors' awareness of value chain management, and this has led to an increased narrowing of companies' supply base.

Several retail companies have been shifting their purchasing strategies—from national to regional, and in some cases pan-European—but the horsemeat scandal has also increased the value of buying local, especially in the UK and Germany. In the future, international retailers will increasingly balance their sourcing between international sourcing—with scale (bargaining power) and efficiency advantages (reduction of the number of suppliers)—and local sourcing (appealing to the increasing appetite for local products). The local sourcing trend is linked to higher consumer confidence in local products in countries like the UK, Germany and France, while there are especially price and flexibility advantages to the international sourcing trend. The recent introduction of COOL will make it easier to see where poultry was produced, and this will favour the local sourcing trend. International companies are expected to deal with this trend by further internationalising their sourcing and production capacity in order to be able to also supply local products to their clients.

The preferred suppliers approach, in which retailers work with more strategic suppliers, is expected to increase in importance under these changed market concerns, with a growing importance of value chain management and a strong demand for local products.

The increasing trend towards internationalisation among European retailers especially in the case of discounters also offers opportunities for preferred suppliers of these retailers, as they also use this expansion as a growth platform for their own internationalisation (*see Figure 7*). Several European companies—like Plukon (Ahold), Rothkötter (Aldi), LDC (Leclerc, Carrefour) and 2SFG (Tesco)—have benefited from employing strategies like this when it comes to their international growth ambitions.

Figure 7: Top 10 EU retailers' presence in member states, 2007-2017f

	Sales growth		Northwestern Europe				Southern Europe			Eastern Europe				Nordic countries		
	07-12	12-17f	Germany	UK	France	Nether-lands	Spain	Italy	Portugal	Poland	Czech Republic	Hungary	Romania	Denmark	Sweden	Finland
Schwarz Group	6%	3%	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Metro Group	0%	2%	X		X	X	X	X	X		X	X	X	X		
Tesco	1%	4%		X						X		X				
Carrefour	-3%	1%			X		X	X	X	X			X			
Rewe	3%	2%	X		X			X		X	X	X	X			
Auchan	4%	4%			X		X		X	X		X	X			
Edeka	4%	1%	X											X		
Leclerc	4%	2%			X		X	X		X						
Intermarché	1%	2%			X				X	X						
Sainsbury's	2%	4%		X												

Source: Rabobank, based on Kantar and company sources, 2014

A successful strategy towards long-term retail relationships (preferably as a category captain) offers many advantages. With successful implementation, it could lead to better margin and growth potential, as it will differentiate a company from the commodity segment in the market.

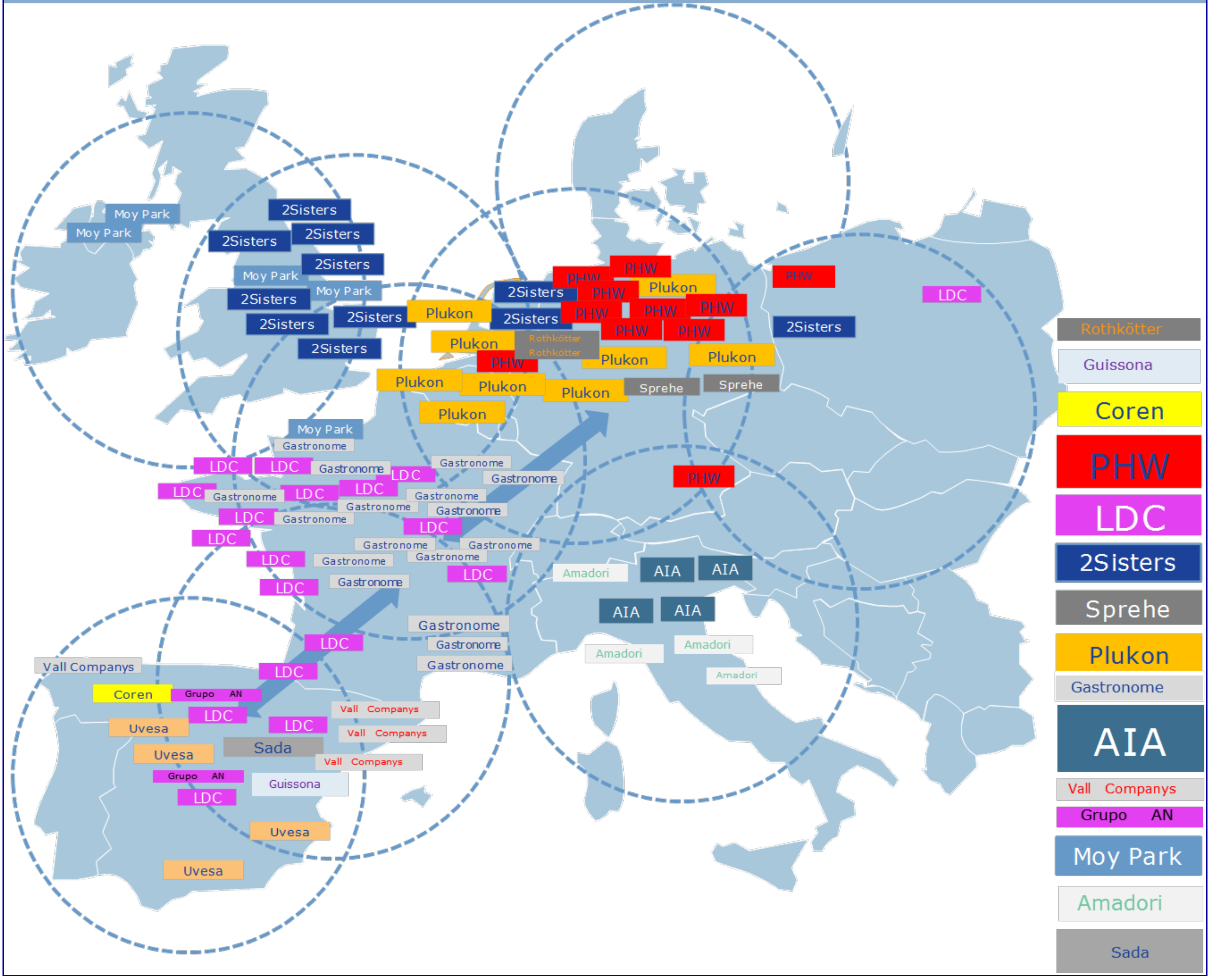
Rule 3: Consolidate your market. Think outside country lines with a 1,000-kilometre fresh poultry sales radius.

The key driver for this strategy is to become the leader in the regional fresh poultry market, benefiting from efficiency and flexibility advantages in production from different, but closely linked production locations. Companies who follow this strategy do not think in terms of countries, but in regional fresh markets and supply chains in which fresh poultry can usually be optimally delivered over distances of up to 1,000 kilometres.

Historically, the EU poultry industry is a very local business, with specialised companies in each European country. This has led to a suboptimal structure in the EU poultry industry. The industry fails to reap the full the benefits from the advantages of industry regionalisation: benefits like economies of scale, risk mitigation, synergy in distribution and higher market power. Many markets are already relatively international. Northwestern, central and eastern Europe, as well as the Nordic countries, can no longer be considered as national markets, but as regional markets with lots of trade flows between individual countries. These trade flows are expected to further expand, as growth potential—especially in northwestern Europe—is limited.

Rabobank believes the EU poultry market will undergo a further shift in the next decade—from a national to a regional and finally to a pan-European market. The base of the shift from national to regional should be formed by trade relationships in fresh poultry, which is typically efficiently traded in an action radius of 600 kilometres to 1,000 kilometres from its production base. This scenario provides an overview of possible base sales markets for poultry players (*see Figure 8*).

Figure 8: Regionalisation of the EU poultry industry



Source: Rabobank, 2015

This strategy can only be successful if companies really exploit the potential of such an approach. This means creating economies of scale via capacity rationalisation from an international perspective; creating synergies in distribution by optimising supply chain management from an international perspective; and creating optimal flexibility by shifting between different processing bases to shield against volatility in supply and demand. A dedicated approach should also lead to more market power in the value chain.

HPAI outbreaks in Europe since Q4 2014 have resulted in supply chain challenges, especially for companies relying on a single production location. Companies with access to different production locations, both in a single country and in different countries—like Plukon, 2 Sisters Food Group and PHW Gruppe—have benefited from such position and from being able to keep supplying key clients from flexible locations.

The regionalisation strategy can be implemented using different approaches. The most common approach is through acquisitions of companies that fit well from a regionalisation perspective in terms of clients and/or supply base. This strategy has been followed by companies like LDC, 2 Sisters Food Group, Plukon, Scandi Standard and Agrofert. Another strategy is growth via greenfield investments. The emphasis at this stage of development is mainly on local growth, and examples of investors have been Moy Park, Cedrob and Rothkötter. Only one investor, Wesjohann, has combined a large-scale greenfield strategy with international expansion. In the past, they acquired a Polish company, which was then a base for greenfield expansion in Poland. Recently, they acquired a further two companies: Esbro in the Netherlands (a majority stake) and Ameta in Bulgaria.

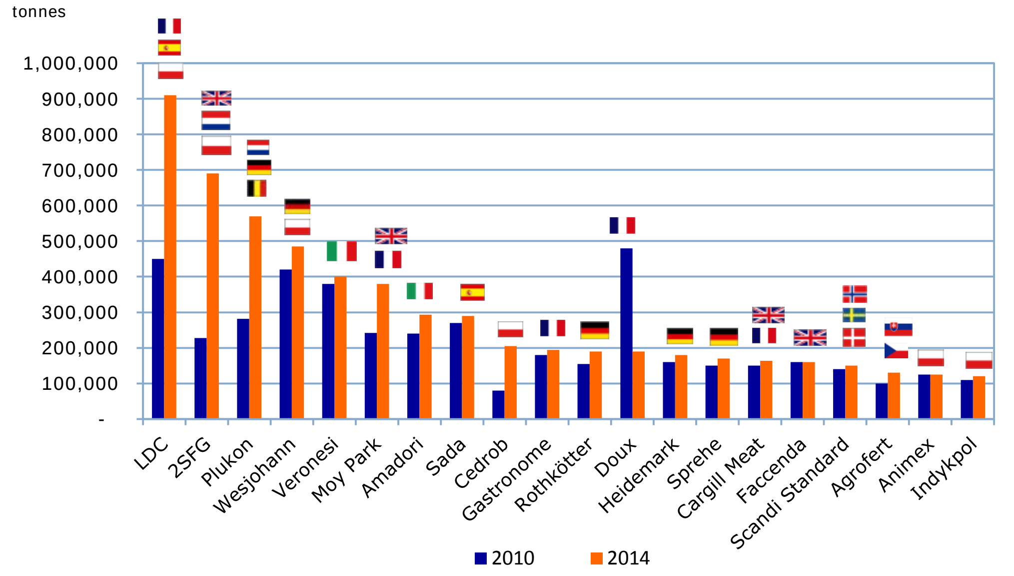
This regionalisation strategy is expected to be a key element of investments in the poultry industry, and it will make the whole industry much more international, more efficient and flexible—which all fit well with the new market reality in which the industry will operate.

Rule 4: Scale up or find niche. The middle segment will disappear and need to choose.

The rationale behind this rule is that companies in the middle segment will increasingly find themselves squeezed between consolidating industry leaders with economies-of-scale benefits and small, focused speciality players. They will increasingly be forced to choose between scale and niche when consolidation continues. Some companies who do not adequately reposition themselves in this changing industry environment will become easy targets for industry consolidators. Companies in the middle segment will lose competitive power when it comes to efficiency, flexibility and market power, compared to the industry leaders. In terms of innovation power, they will also lose to small, well-positioned players who are serving a speciality market.

The EU poultry industry landscape is changing fast (*see Figure 9*). The new market reality has pushed companies to refocus, and a strategy of creating scale could be successful if implemented properly. The main benefits from economies of scale are greater market power (less competition, or the only supplier to deliver nation- or region-wide), cost efficiency (rationalising capacity over different locations), supply flexibility (producing at different, efficient hubs), and risk mitigation (no dependence on a single plant). These benefits can only be exploited by the optimal implementation in a company's business model. If these benefits aren't fully exploited, it can lead to some unhappy endings, as witnessed in the past by companies like Bourgoin, Doux or Vion.

Figure 9: Top 20 EU poultry companies in volume terms, 2010 vs. 2014



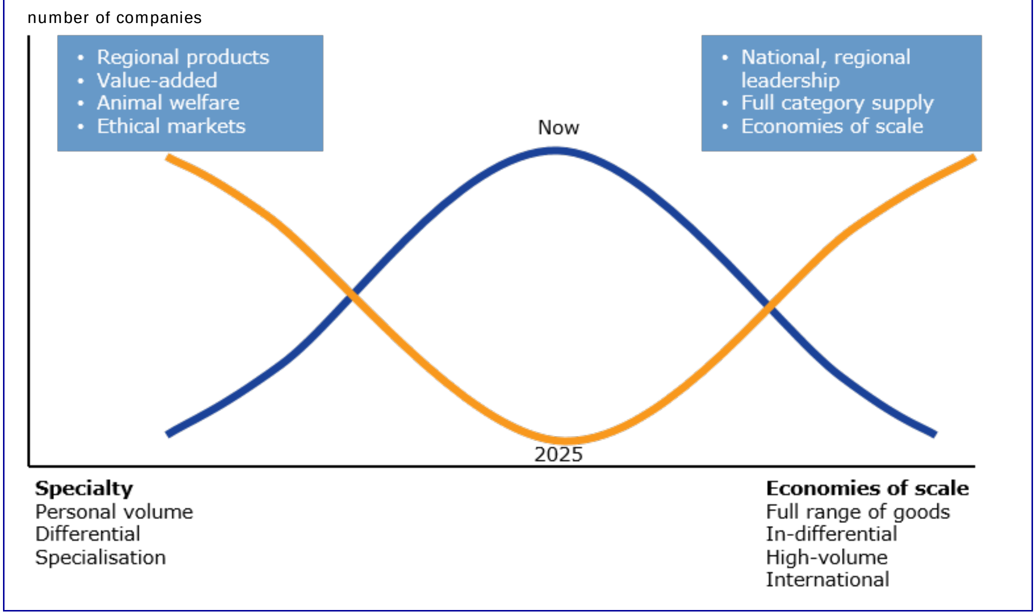
Source: Rabobank, based on public sources, 2015

The biggest companies are currently expanding fast in terms of volume. The three biggest companies in the EU, LDC, 2SFG and Plukon, have all doubled total production in only four years' time, mainly via acquisitions. All top 4 companies now produce more than the #1 EU producer four years ago (Doux, with 480,000 tonnes poultry production in 2010). They have all grown with the ambition to become market leader in their key markets, and all have a strong, retail-driven strategy and a focus on economies of scale in production. Doux, on the other hand, failed to find alternative markets for their traditional non-EU export markets, while their supply chains were not strong and efficient enough to compete in the European fresh chicken market. The remaining business of Doux has now been acquired by the Terrena who also owns Gastronome in France.

All other Top 20 EU poultry companies are currently expanding scale via production expansion and acquisitions, and all will—in most cases—benefit from economies of scale. Consolidation at national levels has increased significantly, and, together, the Top 3 companies in countries like France, Italy, the UK and Germany already have more than twothirds of total production capacity. Room for further national consolidation is, therefore, quite limited.

This change in industry structures and sizes will push mid-sized players—especially those who produce 50,000 tonnes to 100,000 tonnes—to choose: Am I going to follow the trend of scaling up, or am I going to choose a speciality strategy (*see Figure 10*)? Following the economies of scale trend will require resources and a clear leadership strategy. But focusing on the niche will also offer attractive opportunities, and a company could supply market segments which are usually undersupplied by big industry leaders. Some typical areas for investment as niche players are 'ethical markets' (including halal and kosher products), regional products, value-added products or welfare-friendly products. Companies who follow this strategy can also focus on supplying tailor-made products for food processors or food service companies. The way to differentiate themselves here from large players would be, for example, by providing chicken cuts of exceptionally high quality.

Figure 10: Consolidation and specialisation trends in the EU poultry industry



Source: Rabobank, 2015

In the years to come, the choice between scale and niche will be an important one that each individual company needs to discuss and decide upon. By 2025, this will have created a different international industry landscape—from a national, a regional and an EU perspective.

Rule 5: Optimal efficiency of the whole value chain is more important than ever.
The importance of having optimal efficiency is currently more important than it was prior to 2007, when we found ourselves confronted with a virtually new marketplace. Feed ingredient prices have increased two- to threefold and have become significantly more volatile. From a sales perspective, it has become significantly more difficult—especially if the competition can supply products cheaper or with similar prices, but with a higher level of service and/or quality—to pass on higher prices due to the trading-down market impact of the financial crisis. Many companies who have come into financial difficulties over the last year were not operating with efficient business models.

When it comes to efficiency, significant differences exist between poultry industries in the EU—on a country base, but also on a company base. We need only look at the average technical performance and cost price differences between poultry industries in different EU countries (*see Figure 11*). From an input perspective, France and Denmark have the lowest feed costs in Europe, followed by the Netherlands, Germany, Spain and Poland. But at the end of the value chain, average whole chicken costs are lowest in Poland, followed by Germany, Denmark and the Netherlands. The French poultry industry has 5 percent lower feed costs (making up 60 percent of live bird costs) than Poland, but the final total whole broiler costs are 10 percent higher. DOC prices are significantly higher in France than in countries with a specialised hatchery sector like the Netherlands, Denmark and Belgium, along with countries with more vertically integrated models like Poland and Germany. But big differences also exist at the farming level. The most efficient farmers are in the Netherlands, Germany and Denmark, where they are able to achieve a feed conversion ratio (FCR) of under 1.7 with birds weighing 2.2 kilogrammes to 2.3 kilogrammes. The least efficient farms are in southern and eastern Europe, with FCR levels above 1.75. At processing level, Poland (and other eastern European countries like Romania and Hungary) has, by far, the lowest processing costs due to relatively low labour costs. Germany, the UK and some southern European countries are also competitive due to lower labour costs. However, Germany is currently losing its position due to new social regulations regarding the minimum wage. Differences also exist in the broilers produced in different countries. Northwestern European poultry industries often work with broilers ranging from 2.2 kg to 2.3 kg, while, in France, the small bird of 1.9 kg is still the dominant bird. This is a good bird for whole-bird sales, but less suitable for the growing chicken cut and further processing market.

Figure 11: Cost price analysis from a value chain perspective, and drivers for improvement

Grains & Oilseeds → Feed → Breeding → Farming → Processing → Customer

	Compound feed price (EUR/100 kg)	DOC price (EUR/100 kg)	FCR	Live weight	Wages EUR/hr	Processing costs	Total cost whole chicken (EUR/100 kg)
Netherlands	37.8	30.7	1.67	2.2	21	33	173
Germany	38.8	31.2	1.68	2.2	15	28	171
UK	39.5	38.4	1.75	2.3	15	28	178
Denmark	37.7	33.7	1.65	2.1	34	39	183
France	36.8	31.2	1.75	1.9	20	32	178
Italy	41.2	35.5	1.85	2.5	13	27	182
Spain	38.8	31.7	1.95	2.7	14	27	175
Poland	36.7	31.7	1.76	2.3	5	21	156

Horizontal efficiency

- Efficient feed production
- Access to cheap grains

- Efficient hatching egg production

- Modernisation level farms
- Size farms
- Skills farmers
- Contract pricing model

- Modernisation level plant
- Line speed
- Labour use plant

Vertical efficiency

Value chain supply management
Pricing
Communication

Source: Rabobank, LEI, 2015

Companies can influence their cost position in the industry in several ways. The most obvious one is to invest in higher efficiency at all stages in the value chain. With the current high cost of feed (and indirectly chicken products), inefficiency disadvantages throughout the value chain will have a significantly greater negative impact than before. Improving efficiency, from 1.8 FCR to 1.65 FCR or even lower, will have a very positive impact on final whole broiler costs. In this case, it is important that farm size and plant capacity also follow the efficiency trend. French broiler farms typically contain 15,000 to 20,000 birds, whereas farms in the Netherlands, Germany and Denmark often have over 70,000 birds. Many slaughterhouse lines in southern Europe still operate at fewer than 10,000 birds per hour, while the northwestern European trend is closer to 13,500 birds per hour. Further automation of processing plants helps industries to reduce the cost of production, especially in northwestern Europe, where labour costs are high and availability of skilled labour poses a challenge.

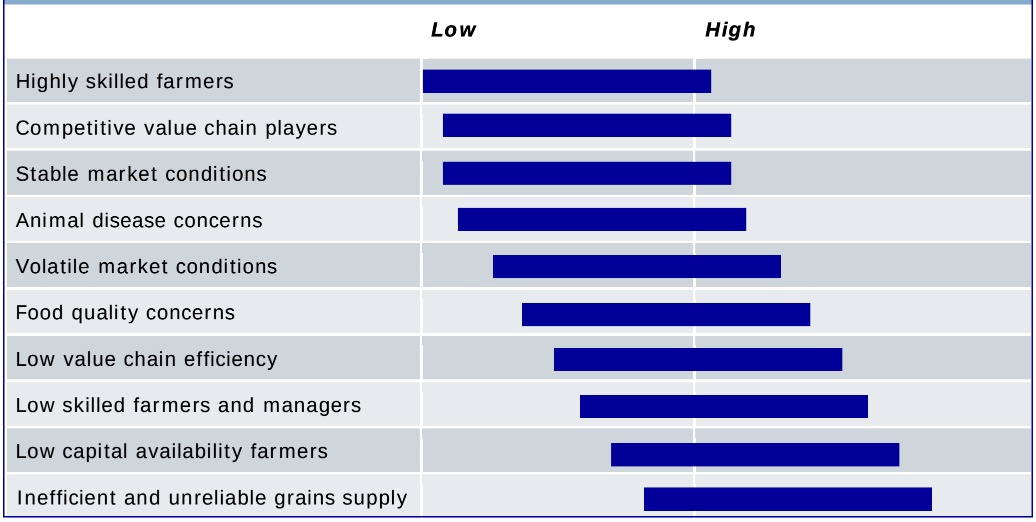
Optimal efficiency will also be influenced by the value chain model, which is used by the industry. The main efficiency benefits from vertically integrated models are better co-ordination between the different stages in the value chain, though they can lose horizontal efficiency. Pricing is key important and weak pricing models in vertically integrated models in the value chain could discourage value chain partners from modernising their facilities. This is what has happened in France, where fixed-margin contracts are often offered to farmers without clear exposure to feed costs.

Rule 6: Improve your value chain model in line with the new market reality.
We believe that value-chain models are not static, one-size-fits-all models. Instead, they should be fine-tuned, depending on industry and market characteristics, and expectations. Companies in the poultry industry have usually been running with similar models for years, without adequate consideration to whether the model still fits with the current environment. Could it potentially be optimised?

In the coming decade, feed prices and especially volatility are expected to remain high, and pressure on the industry from a social perspective, regarding production methods, will increase. The importance of consumer concerns like food safety, the environment and animal welfare will further increase, while the horsemeat scandal and a few other animal welfare scandals in western Europe have recently led to changes in markets and supply chains. Outbreaks of HPAI since Q4 2014 have added a new challenge. Optimal biosecurity throughout the value chain will become significantly more important, as will flexibility in terms of the ability to relocate supply in case of avian flu outbreaks.

Rabobank believes that the importance of having an optimal supply chain model will only increase. Each individual company should rethink their supply chain model relative to the market conditions in which they operate. Not all require a similar level of integration (*see Figure 12*). In general, the level of vertical integration is higher in situations where farmer skills, efficiency and availability of capital are low, amid serious quality concerns in the market. Volatility and pricing in feed ingredients can also be reasons to integrate further backwards in the value chain. This has become a standard model in Russia and Ukraine. Under these conditions, companies tend to invest throughout the value chain, with investments in farming and land the least preferred due to the high capital requirement.

Figure 12: Industry conditions as a base for value-chain model choice

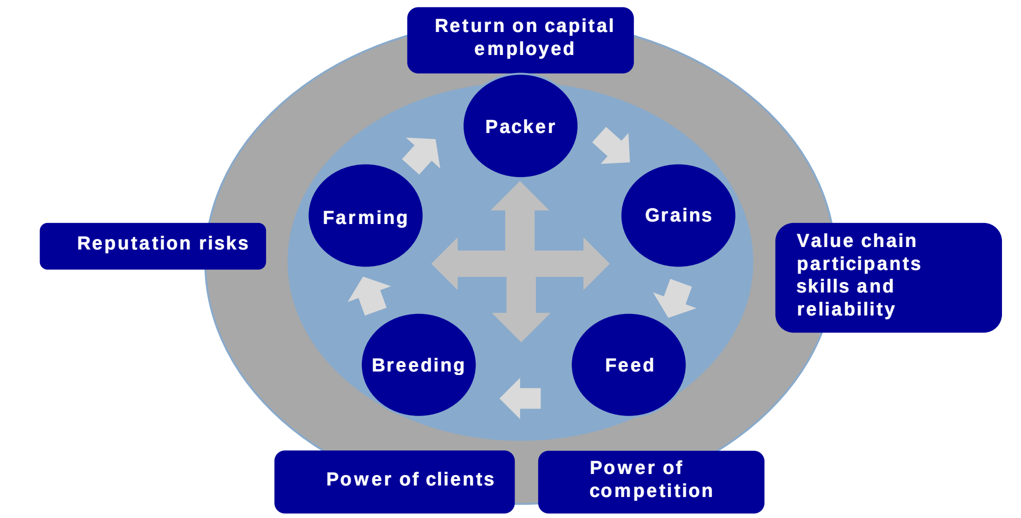


Source: Rabobank, 2015

At the other end of the spectrum—in countries with highly skilled farmers with good access to capital and competitive value chain players in feed and genetics—it is less relevant to invest backwards in the value chain, as long as pricing remains competitive enough, and quality and contract discipline remains high.

The final choice for the value chain model—horizontal specialisation model, semi-vertically integrated model, vertically integrated business model (feed to broilers), and multi-sector integrated model (grains to broilers)—will be decided by each poultry company individually. This is based on their objectives (e.g. return on capital employed); the power of clients and competition; the market requirements; the local value chain participants' efficiency and reliability; and potential reputation risks (*see Figure 13*). The general trend in the market, driven by consumer concerns, is towards a somewhat higher level of integration in the industry. This will better guarantee quality in the value chain; however, the level at which this is happens depends on the local industry environment and future developments should be decided on a case-by-case basis.

Figure 13: Key company strategic objectives for choosing a value-chain model



Source: Rabobank, 2015

Rule 7: Participate in the social debate, and be prepared for NGO pressure.

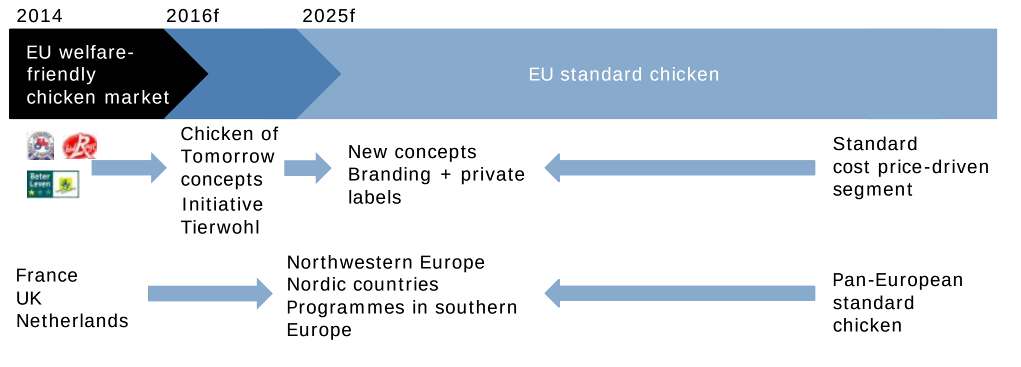
Social pressure on production methods in the industry is, and will be, increasing in the next decade. Key elements of consumer concerns are food safety, animal welfare, the environment and social responsibility. Several regulations regarding social concerns have been implemented in the EU, including bans on growth promoters, GMO restrictions, a ban on the use of meat-and-bone meal in feed, ammonia emission regulation, as well as the N directive. Most of these regulations have been environment- or food safety-related.

The recent horsemeat scandal has changed customers' policy on how to source meat products. Many retailers and processors have changed their policy and are now buying more local products from producers with full value-chain control.

NGOs are challenging the industry—especially in northwest Europe and in the Nordic countries—to raise its standards regarding animal welfare. Several scandals have received lots of media attention, together with NGO media campaigns focused on animal cruelty. This pressure from NGOs has resulted in a social debate, and, as one of the consequences, has added restrictions on the expansion of poultry farms in the Netherlands, Germany and the UK. The increased social pressure and the growing difficulty for the poultry industry in northwestern Europe to expand due to a very strict and difficult local permit application process have led to a situation in which the industry needs to fight for its licence to operate. This discussion will continue in the years ahead, and a proactive debate on the industry's social issues is more important than ever before. Individual companies can expect more social pressure and pressure from NGOs. Under these circumstances, having a solid corporate social responsibility policy is a necessity.

The social pressure is currently leading to a changed market approach for chicken in northwestern Europe (*see Figure 14*). Several quality programmes have been introduced in the last decade—from old innovative programmes like Label Rouge to red tractor and 'beter leven' star labelling programs in the Netherlands. All are methods guaranteeing the quality of products. Several individual companies have offered more animal welfare friendly products under both private label and own brands, but most initiatives have not been able to gain more than 5 percent of the total market. The newest initiatives are in Germany and the Netherlands, where supermarkets and the industry have agreed to phase out standard chicken from retail shelves and to sell, respectively, 'Initiative Tierwohl' chicken or the 'Chicken of Tomorrow'. These labels combine animal welfare advantages (like lower density) with sustainability elements (like sustainable soy and, in the case of the 'Chicken of Tomorrow', a slower-growing bird). Implementation of this sort of market standards has been challenging. The 'Chicken of Tomorrow' label was recently blocked by the Dutch antitrust commission, claiming that it added insufficient value to the extra price a consumer pays. Despite this setback, we believe that markets will be move further in this direction: via general programmes like 'Initiative Tierwohl', labelling like red tractor, freedom food, 'beter leven' and Label Rouge, or private labels and branding. Some leading supermarket chains in the Netherlands have started to compete, with their own minimum standard for chicken stocked in stores.

Figure 14: Projected expansion of the EU animal welfare market, 2014-2025f



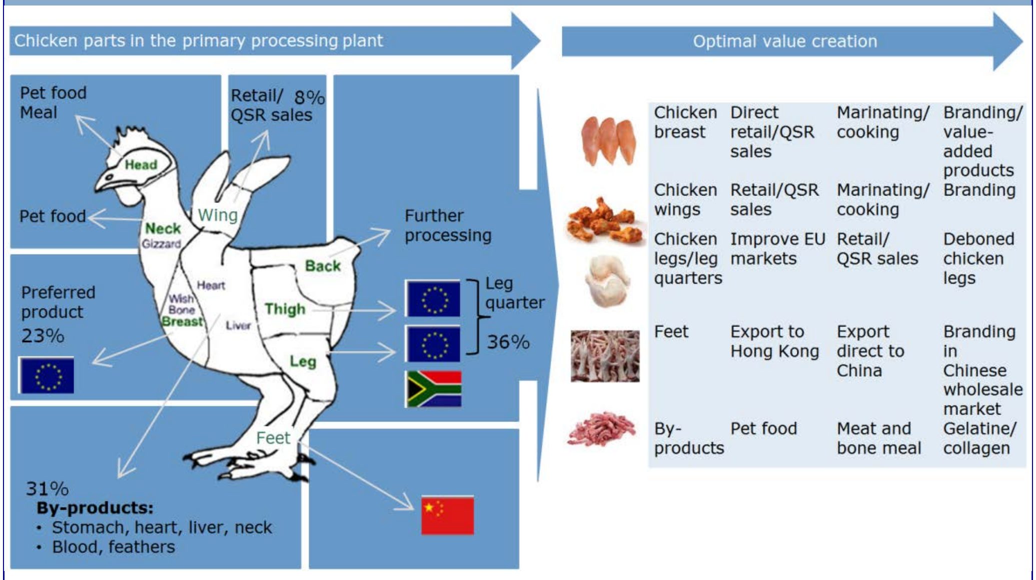
Source: Rabobank, 2015

We believe that all of these movements will gain further momentum in the next decade. Every poultry company should have a strong corporate social responsibility policy in place as a response to social pressure. Northern European and northwestern European markets will continue to increase their animal welfare standards, and the share of these products in the market will rise significantly. In some markets, there will be no alternative: The standard chicken will disappear. Meanwhile, in other markets, the share of welfare products will grow by producer and retail initiatives, via brands and private labels.

Rule 8: Optimise the value of individual cuts and offal streams to increase revenues and profitability.

One of the biggest challenges for the poultry industry is to optimise the value of all individual cuts and offal after cutting a chicken carcass. EU consumers have a very strong preference for breast meat and are able to pay a high premium for it. On the other hand, the preference for dark meat products like leg quarters, feet and even wings is relatively low. The big challenge for the poultry industry is to valuate all individual cuts as much as possible (*see Figure 15*). Companies that are strong in this valuation challenge can achieve higher margins.

Figure 15: The challenge of optimising the value of individual cuts



Source: Rabobank, 2015

We see two directions in which the industry can improve its valuation of individual cuts: via more international sales and/or via adding value to individual cuts. Adding value to individual cuts like legs, feet and wings is challenging. It will require strong market and product development skills, but it is definitely possible. Cooking, marinating and deboning (in the case of leg meat) are ways to add value, and—combined with a strong market development approach—can help to improve the value of these cuts. QSR restaurant chains like Yum have successfully expanded their product offering with many bone-in products—and such strategies can be copied in retail and food service segments.

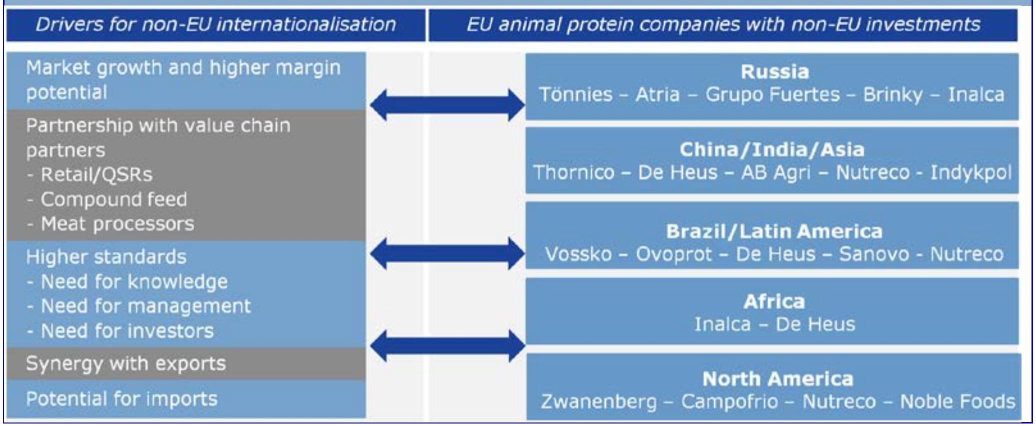
Another route to go could be to optimise the value of each bird through exports. Global differences in preference are a great basis for achieving higher value for individual cuts. Asian and African consumers prefer dark meat and bone-in products. They are prepared to pay a price premium for such products, above white chicken products. The challenge for companies is to sell these products worldwide. Access to markets via trade agreements—but also via the broad certification of plants—is of key importance and will help the industry to better valuate its products.

Rule 9: Exploit your industry and client knowledge, and follow your customers. Expand in new markets.

The EU poultry industry's level of internationalisation is relatively low. The industry is currently moving from the stage of being a national industry to becoming a regional industry. Very few EU poultry companies have been interested in investing outside of the EU. Having said this, we see a change in attitude toward non-EU investments in recent years. Several animal protein companies have recently started to invest outside of the EU (*see Figure 16*). The main rationales for non-EU investments are:

1) Access to market growth and higher margin potential. Markets in eastern Europe, Asia and Africa are growing significantly faster than the EU market; average margins are also usually higher than in the EU.
2) Partnerships with value chain partners. Several meat companies are following customers in food service or retail, but also in animal nutrition in international markets. Many European retailers (like Metro Group, Tesco, Carrefour, Aldi, Auchan and Ahold) have a wide presence in international markets and offer a platform for growth. Also, feed companies like De Heus, Nutreco and Invivo have large non-EU operations and can probably be used as platforms for growth via JVs.
3) Potential synergies in export (Asia, Africa) and imports (Thailand, Brazil).
4) The shift to higher standards in emerging markets as a result of several food-safety scandals. The EU poultry industry can provide know-how, management and skills to seize this opportunity.

Figure 16: Drivers for non-EU internationalisation and EU investors by country



Source: Rabobank, 2015

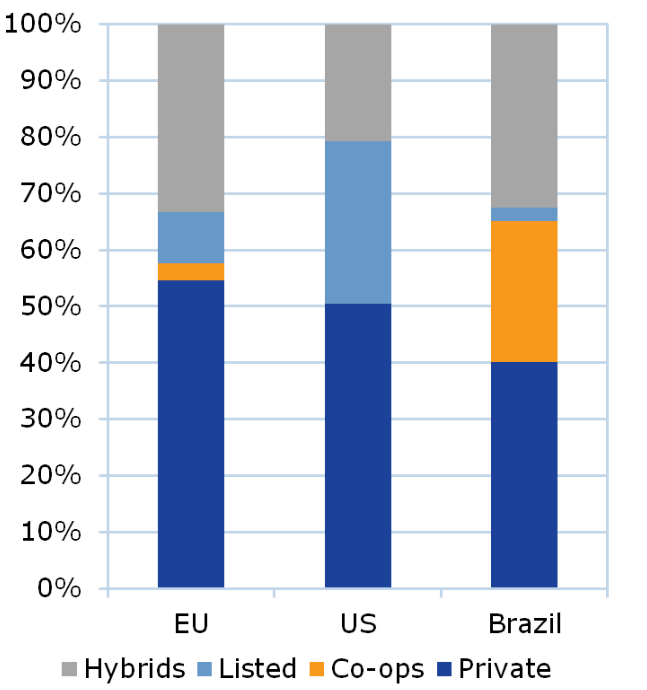
In recent years, EU investors have paid the most attention to Russia, with investments by Tönnies, Atria, El Fuertes, Brinky and Inalca. But interest in other emerging markets—especially Asia—is growing.

Rule 10: Reconsider your capital structure. Family ownership has been the dominant model, but does it fit with future challenges?

The EU poultry industry is traditionally a private business, with many companies set up in the 1960s, when growth in the EU chicken industry took off. The changed market reality requires significant investments, especially if companies want to follow the consolidation and international trend in Europe. The leading players in this field have all changed ownership models in recent years. They are now a mix of private equity, quotation at exchange rates and private ownership (*see Figure 17*). This helps these companies to quickly anticipate market opportunities and to adjust to the new market reality. Individual companies should rethink their ownership models. This choice is very much linked to the position of a company with regard to the 10 Golden Rules—and especially its future ambition in the scale or niche question, along with the internationalisation trend.

Figure 17: EU, US and Brazil ownership models, and a case study of 'new' formats

Ownership models in EU, US and Brazil based on market shares



Plukon: Private equity majority owned

Turnover	EUR 1.4 billion
Ownership	Agrifirm, De Heus, EW Group, Gilde and Management
Focus	Market leadership in Northwestern Europe with #1 positions in Netherlands, Belgium and #3 in Germany, exports to French retail
Acquisitions	2010: Maïski 2011: K&K Fruits & Vegetables 2012: Stolle 2013: Interchicken 2013: Lintor Olen Plant
Changes since MBO	2009: Gilde acquired majority stake in Plukon Sales growth of 100% since 2009 Gilde entrance 2015: New shareholders consortium: Agrifirm, De Heus, EW Group, Management and Gilde

Scandi Standard's IPO as new opportunity?

Turnover	EUR 362 million
Ownership	Free float 66%, CapVest 16%, Lantmännen 15%, Management 3%
Focus	Market leadership in Nordic region, no. 1 in Denmark and Sweden, no. 2 in Norway
Acquisitions	2013: Cardinal Foods
Changes since MBO	2013: Capvest acquired majority stake of 52% 2014: IPO in June - Initial pricing: 8.2 EV/EBITDA - Current pricing: 9.5 EV/EBITDA

Source: Rabobank, based on public sources, 2015

Conclusion

The turbulent outlook for the EU poultry industry will further challenge the position of individual poultry companies. We believe that, under these circumstances, the differences between winners and losers will only grow. A rethinking of individual companies' strategies is more essential now than it has ever been before.

Markets are changing fast, and consumer behaviour has hybridised. Under the current volatile market circumstances, price is definitely a key driver for market change. And high-value segments are also growing fast. Animal welfare concerns are driving new product concepts in the industry: a development which is only going to grow further.

Industry structures are changing fast, and the movement from national to regional and pan-European, along with the power of clients, is further increasing due to expansion and consolidation. Individual companies need to respond and reposition themselves in this changing industry landscape, regarding scale or niche as the main focus. Questions about capital structure will become increasingly relevant in the next years, as consolidation will continue, and many companies will face challenges regarding capital requirement when following the consolidation trend.

Society in general, consumers and customers are expecting more action from the industry when dealing with social challenges like animal welfare, the environment, animal diseases and food safety. These changes require investments in proactive corporate social responsibility, especially in the northern European and northwestern European industry, where companies are under high pressure: the industry needs to protect its licence to operate. Markets will also continue to evolve, and animal welfare-driven concepts will play a significant role in the total market in the next years. This trend will start in northwestern Europe, but will move into other parts of the continent.

Expected ongoing pressure as a result of animal disease will also force the industry to change. It is expected that avian flu will be endemic and might occur from time to time. The industry needs to reply by further raising biosecurity standards, and by rethinking its business models and geographic locations. Avian flu outbreaks since Q4 2014 have demonstrated the value of producing at more national and international locations in order to become flexible in times of outbreaks. Locations near bird migration routes in water-rich areas might also be reconsidered, as risk is believed to be higher here.

From an input perspective, we predict ongoing high and volatile input costs will remain, and the differences in horizontal and vertical efficiency will become even more important. This will mean investments in state-of-the art technology and know-how need to be optimally efficient, but it will also mean rethinking supply chain models regarding efficiency, flexibility and reliability.

This fast-changing industry environment will lead to bigger differences between companies. Individual companies need to rethink their future position in the value chain. The industry is moving from a national to a regional industry now… and towards a pan-European industry in the next years. Can we, and do we want to, follow the internationalisation trends? What are our natural market segments, which we competitively supply? And do our value chain and capital models meet the future market position which we want to supply in 2020 to 2025?

Rabobank believes that the 10 Golden Rules for Winners model could help individual companies to position themselves in this changing industry landscape. They could help individual companies to paint a road which they want to develop in the next five to ten years.

This report has been published in line with Rabobank's long-term commitment to international food and agribusiness. It is one of a series of publications undertaken by the global department of Food & Agribusiness Research and Advisory.