CONSUMER PULSE SURVEY

U.S. Consumers' Food Spending Habits Under Inflation

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LAZARD

CH Consulting Advisors

THE SURVEY

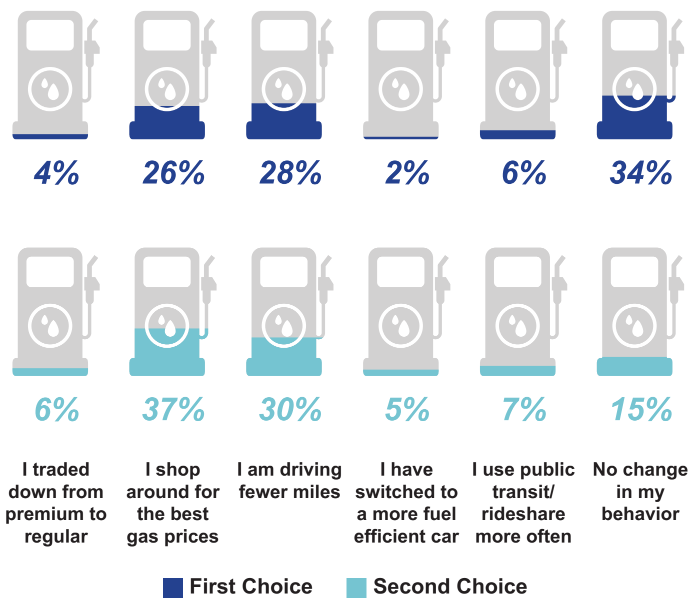
Numerator Insights reports grocery prices have increased 7.1% in October versus a year ago, with grocery and health & beauty care (HBC) leading the charge of inflation.[1] The last time we saw inflation this high was the 1970's era of WIN buttons ("Whip Inflation Now"), and around-the-block gas lines and odd-even rationing. From that era, food inflation led to the emergence of generic label products and meat substitutes. What will happen this time around? Some of the price increase is due to short-term supply chain disruptions and the COVID-19-driven shift from services to products, but even if partially temporary, clearly consumers are facing the first significant inflationary environment in generations.

How will consumers react to continued price increases? And what are implications for the food and foodservice industries? To explore the impact of inflation more deeply, Lazard Middle Market and CH Consulting Advisors fielded a consumer pulse of 1,000 U.S. consumers on how they plan to deal with inflation in the food and restaurant categories. The results suggest that manufacturers and operators need to prepare for consumers trading down and purchase volume declining, even in premium categories.

In all, we took a demographically proportionate sample of 1,000+ consumers and asked them more than 20 questions about their anticipated spending habits in light of increased food and delivery prices. Our survey respondents spanned a variety of age, income, geographic, ethnic, and other relevant demographic characteristics, which resulted in thousands of unique data points. To create a baseline of inflation behavior, we asked about a commodity category that has already established a reaction to high prices by consumers: gas. As shown in Exhibit 1, we gave a list of possible responses to increased gas prices and asked consumers to pick their top two responses. The most common response to gas prices is shopping around for better prices, probably because this is a relatively painless response to rising prices. The next most common response was reducing mileage driven, although nearly as many people reported no change in behavior.

[1] "Inflation in Mass, Food, Dollar Retail Channels Up 2X vs. Online." Numerator, Market Track, LLC and Affiliates, 17 Nov. 2021, https://www.numerator.com/ inflation-mass-food-dollar-retail-channels-2x-vs-online-numerator-reports.

Exhibit 1 - What have you done in response to recent increases in gas prices?



Grocery Products

Gas is likely one of the most difficult products for consumers to reduce consumption of while in an inflationary environment. How does the inflationary environment affect food purchases? We started exploring food with one of the most basic commodities: milk. We asked consumers how they would react to an incremental 15% increase in milk prices. As shown in Exhibit 2, almost half of consumers would not change their purchase levels even with a 15% price increase, and only 18% of consumers would decrease consumption by 15% or more. Unsurprisingly, milk is an inelastic good for which price increases result in a small decrease in consumption but a net increase in revenue.

Exhibit 2 - If milk at the store that you typically visit rose by 15%, what would be your likely response?

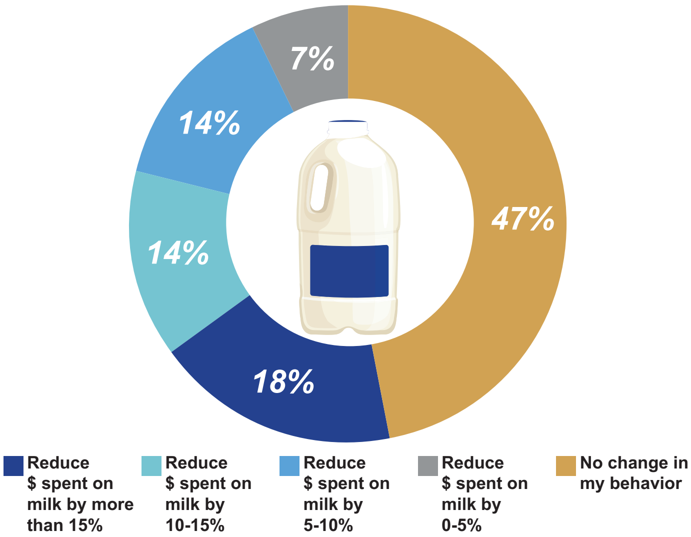
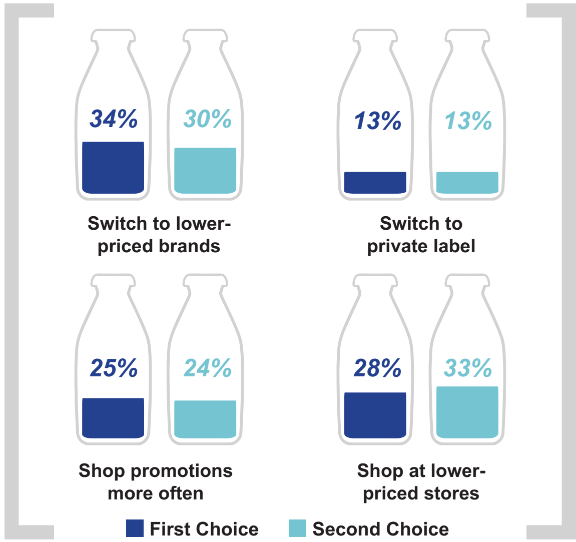


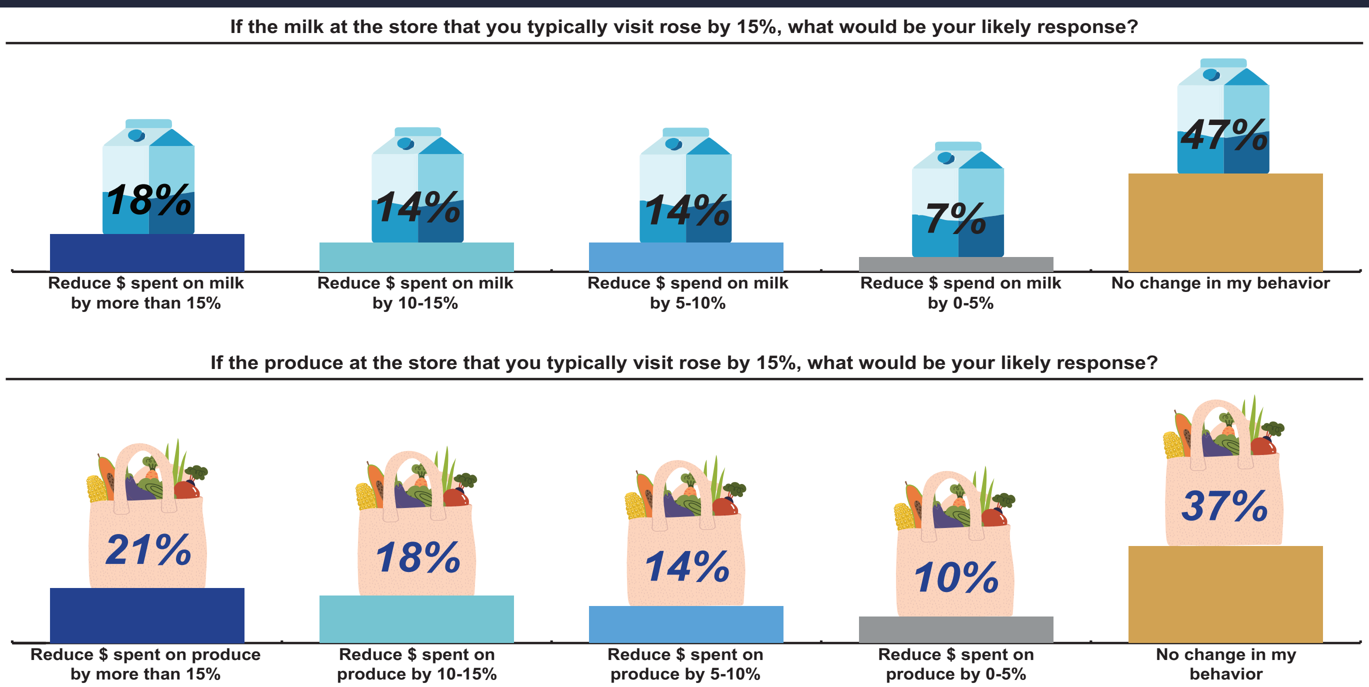
Exhibit 3 - If you cut back on milk spending, how will you do so?



If consumers do adjust their spending on milk, how will they do so? For consumers who indicated a change in consumption, we asked how they would change their spending. As shown in Exhibit 3, the most popular response was switching to lower-priced brands. This may reflect consumer perceptions that brands do not vary significantly in quality and may be a warning sign for premium milk brands. The second most popular response is shopping at lower-priced stores, so inflation may be a boon to discount and value grocery formats. Switching to private label may be less popular since the majority of milk sold in grocery stores is already private label.

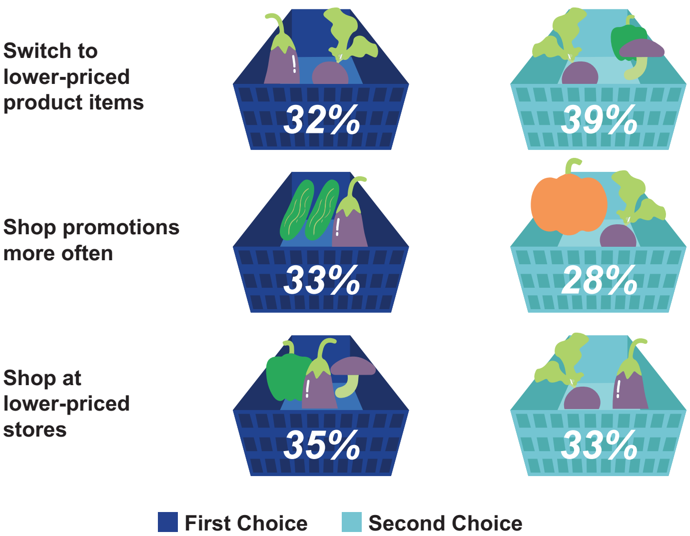
If most milk consumers are just going to swallow price increases, what do they think about produce inflation? We asked consumers how they would respond to a 15% price increase in produce and found fewer people would continue buying the same amount than with milk. Exhibit 4 compares the response to a 15% price increase for milk versus produce. Consumers are more likely to cut back consumption in response to price increases in produce than is the case with milk.

Exhibit 4



If consumers do decrease spending on produce, they plan to use a variety of ways to save money. The top choice for reducing spending was evenly split between buying less expensive produce, shopping promotions more and shifting to lower priced channels (Exhibit 5).

Exhibit 5 - If you cut back on produce spending, how will you do so?

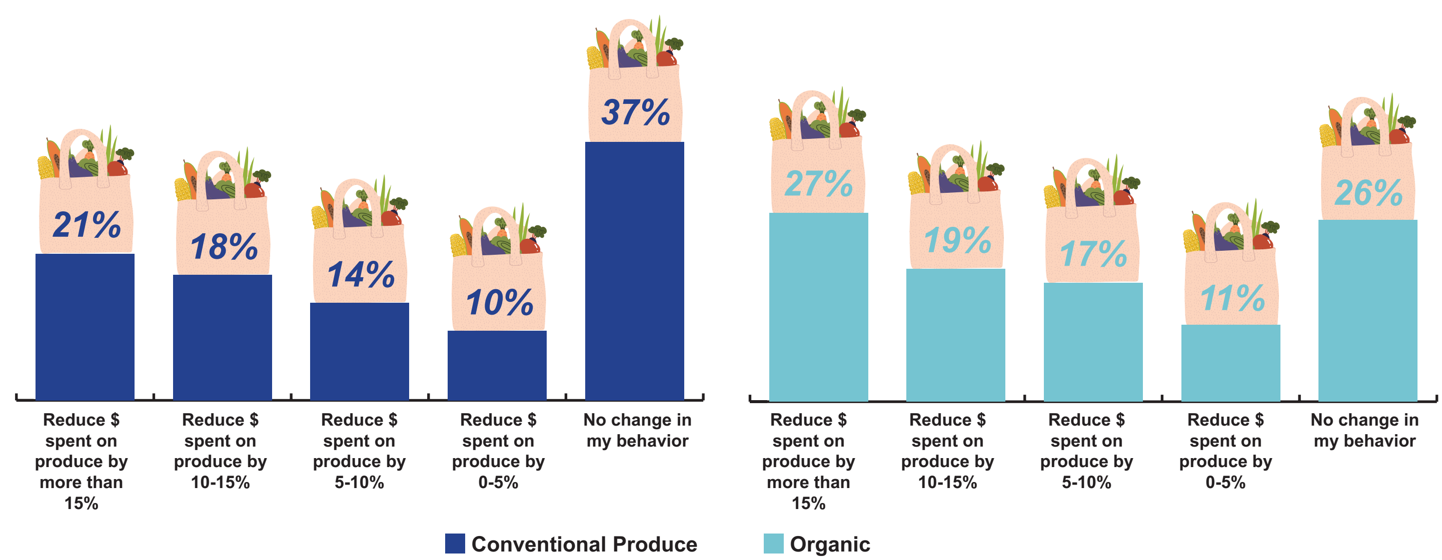


Are consumers committed to organic produce more willing to swallow price increases? To find out, we asked consumers who purchased organic produce at least monthly how they would respond to a 15% price increase. **Interestingly, consumers of organic produce are more likely to change their behavior in response to price increases than overall produce consumers** (Exhibit 6).

Exhibit 6 - Likely consumer response to 15% price increase of conventional vs. organic produce

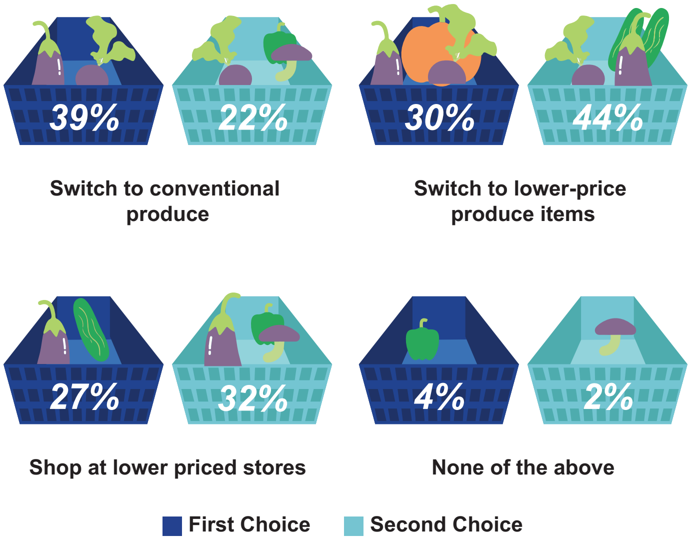
If the produce at the store that you typically visit rose by 15%, what would be your likely response?

If organic produce at the store that you typically visit rose by 15%, what would be your likely response?



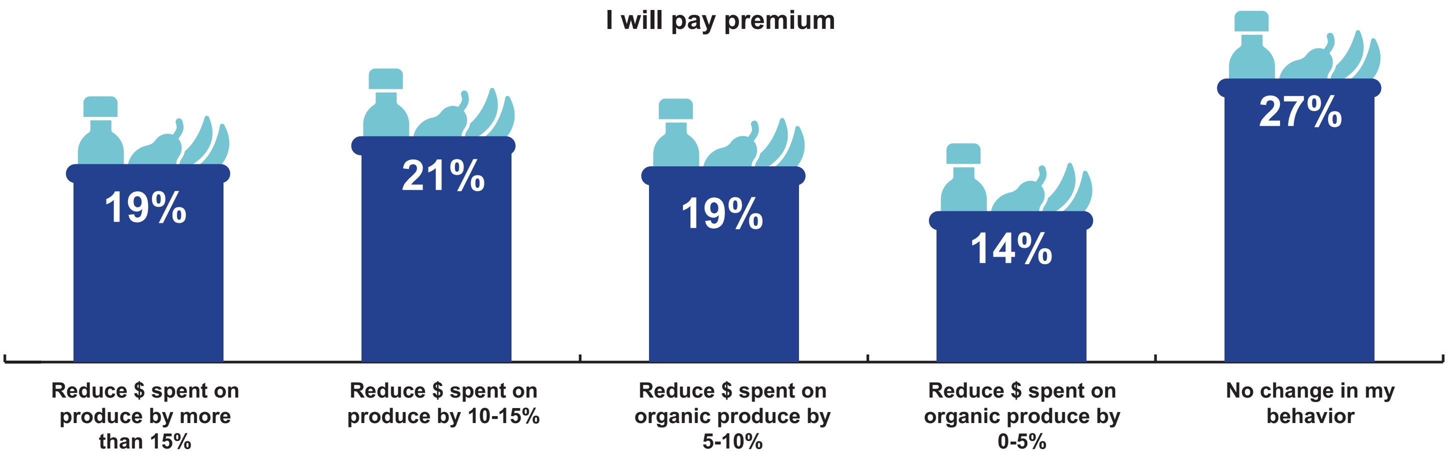
The more aggressive level of behavior change may reflect the obvious opportunity for organic consumers to trade-down to conventional produce. As shown in Exhibit 7, the most popular response to organic produce price increases is trading down to conventional produce. This may signal a broader vulnerability of premium products to suffer trading-down to more mainstream options during periods of inflation.

Exhibit 7 - If you cut back on organic produce spending, how will you do so?



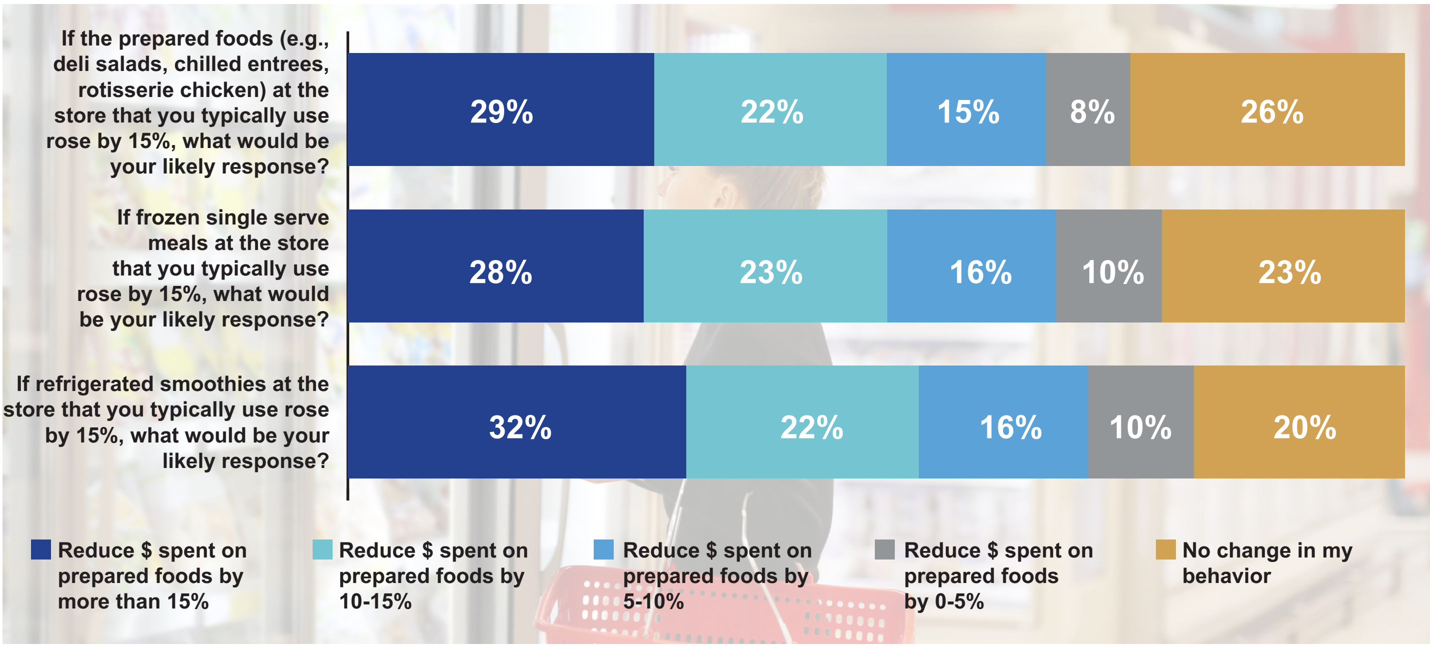
Is there a committed core of health enthusiasts who will buy organic at any price? Our research suggests no. We asked consumers to rate their agreement on a scale of 1-7 to the statement "I will pay a premium for health/natural foods" with 7 being strong agreement with the statement. We compared the consumers rating themselves 6 or 7 with consumers 5 and below on how they would respond to the 15% price increase. As shown in Exhibit 8, the health enthusiasts had a slightly higher likelihood of "No change in my behavior", but the two groups were quite similar. **This may suggest that budget trumps health when buying organics.**

Exhibit 8 - If organic produce at the store that you typically use rose by 15%, what would be your likely response?



What about less "commodity-like" categories? We asked consumers of prepared foods, single-serve frozen entrees, and refrigerated smoothies purchased in grocery stores how they would respond to a 15% price increase. In both categories, a larger proportion of consumers said they would change their behavior than in the commodity categories.

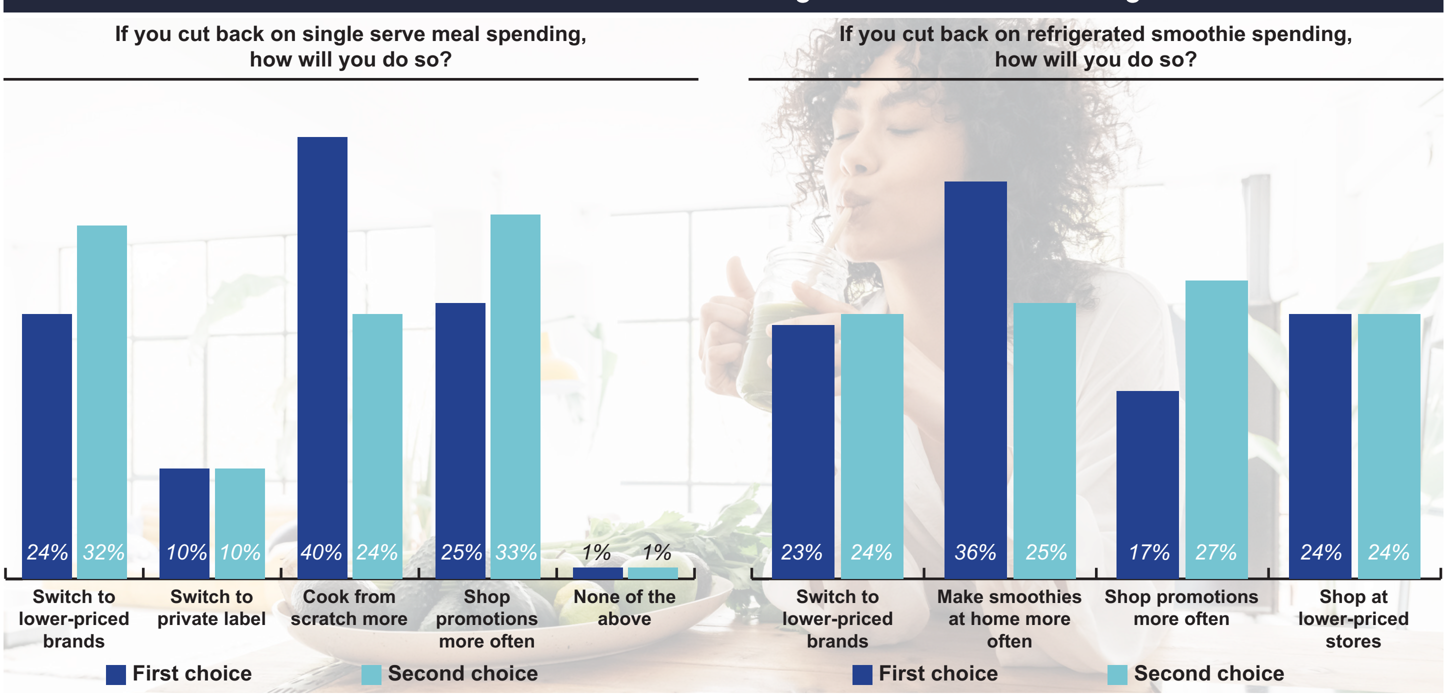
Exhibit 9 - Likely consumer response to 15% price increase of prepared foods, frozen single-serve meals, and refrigerated smoothies



Single-serve frozen dinners suffer slightly less of a consumption decrease under inflation than refrigerated smoothies, probably because they are seen as more of a necessity and less of a luxury.

As shown in Exhibit 10, convenience foods like single-serve frozen dinners and refrigerated smoothies face the risk of substitution from scratch cooking when prices rise. **Inflation could be a boon to manufacturers of basic foods at the expense of convenience foods.**

Exhibit 10 - How consumers will cut back on frozen single-serve meals and refrigerated smoothies



Food Away-From-Home

To many, the ultimate convenience food is restaurant meals. To get a sense of how inflation will affect food away-from-home, we asked consumers how they would respond to an incremental 15% increase in restaurant prices. Overall, consumers are much more likely to react to increases in restaurant prices with changes in behavior than they are to changes in grocery prices. As shown in Exhibit 11, only 17% of consumers would have no change in behavior to a 15% increase in restaurant prices. Furthermore, around a third of consumers would cut spending on restaurants by more than the 15% price increase.

Exhibit 11 - Likely consumer response to 15% price increase of food away-from-home vs. milk and conventional produce

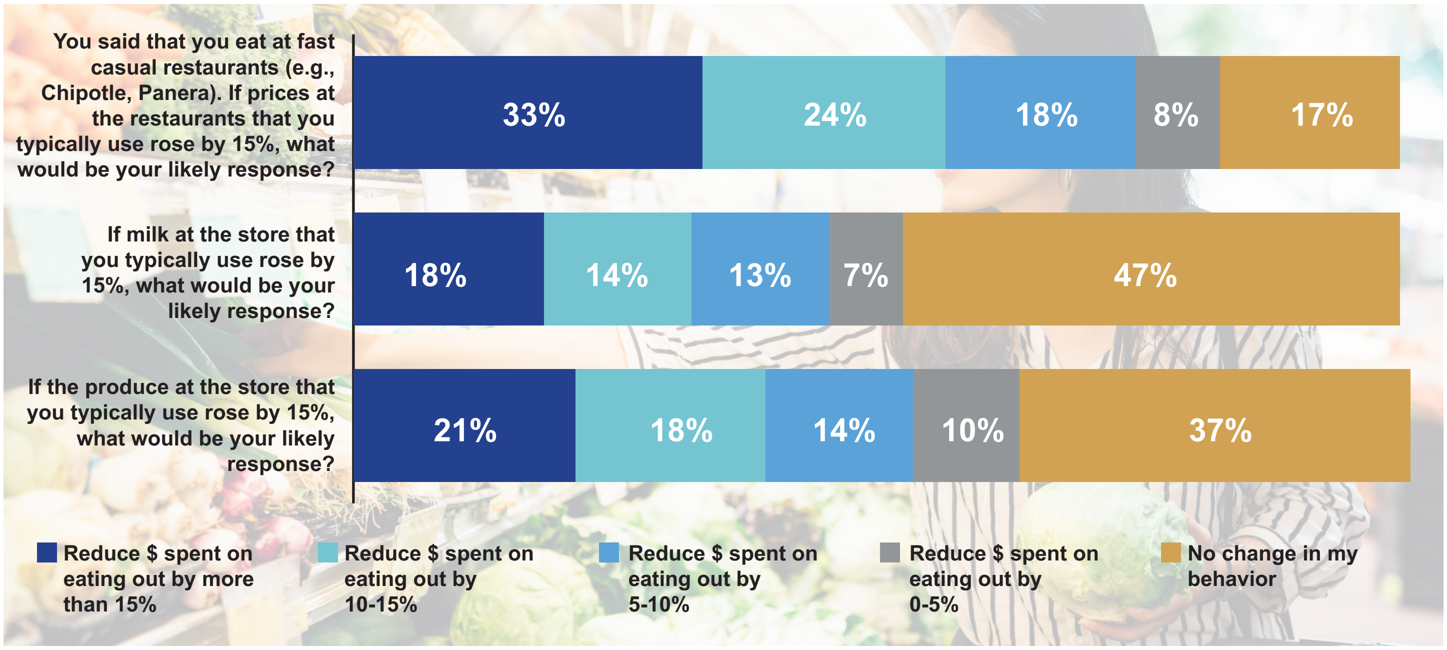
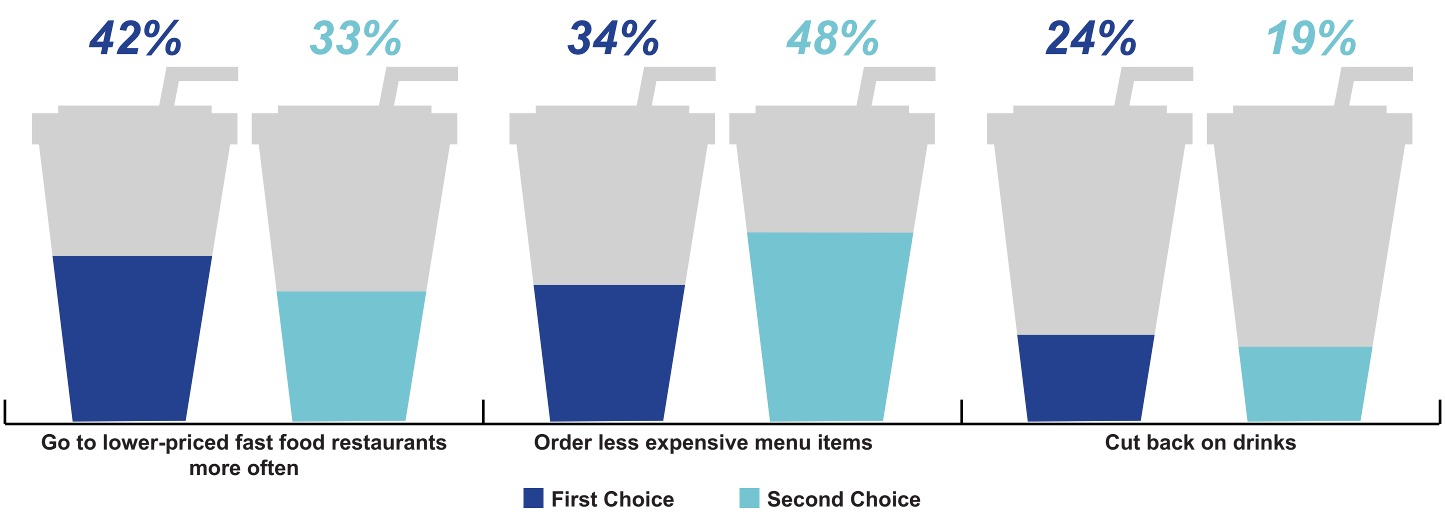


Exhibit 12 shows how consumers say they would reduce their restaurant spending. Unlike with convenience foods, where the major reaction is increased scratched cooking, **restaurant consumers tend to trade down to less expensive formats** (Exhibit 12). In restaurants, the convenience of not having to cook trumps a loss in quality. This bodes well for quick service restaurant (QSR) and other lower-priced restaurant formats and suggests that offering value priced options may be critical for restaurants to retain their traffic.

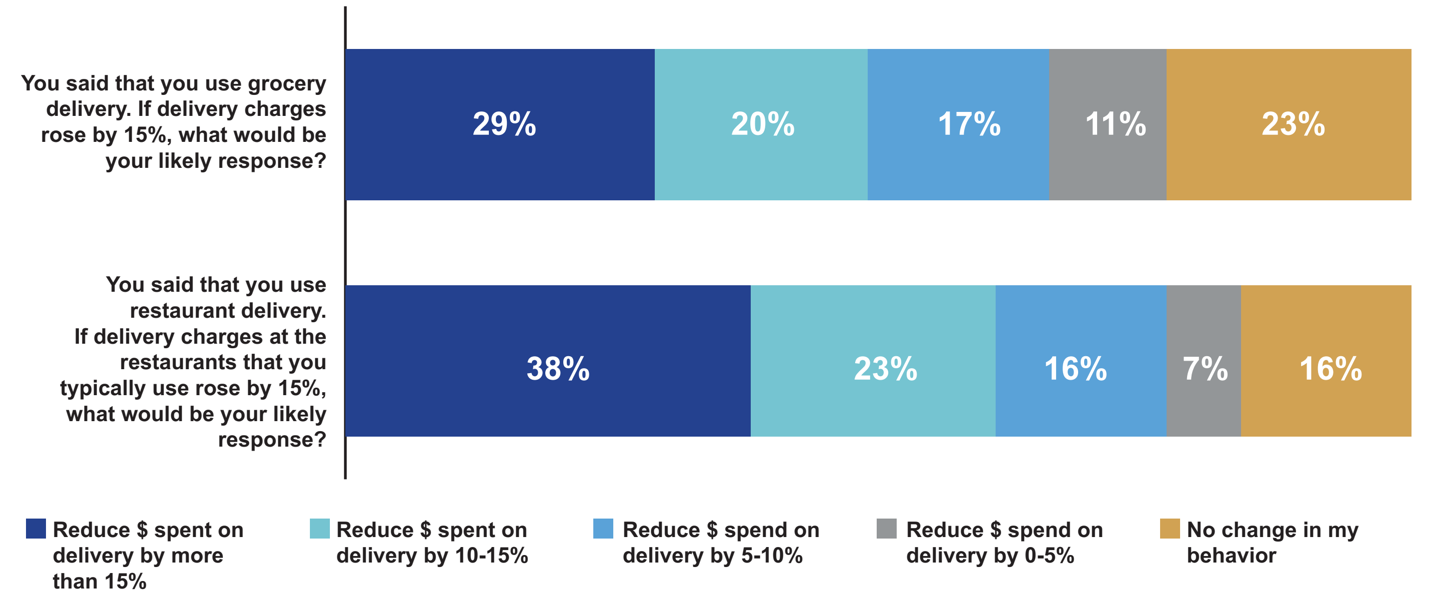
Exhibit 12 - If you cut back on fast casual restaurant spending, how will you do so?



Delivery

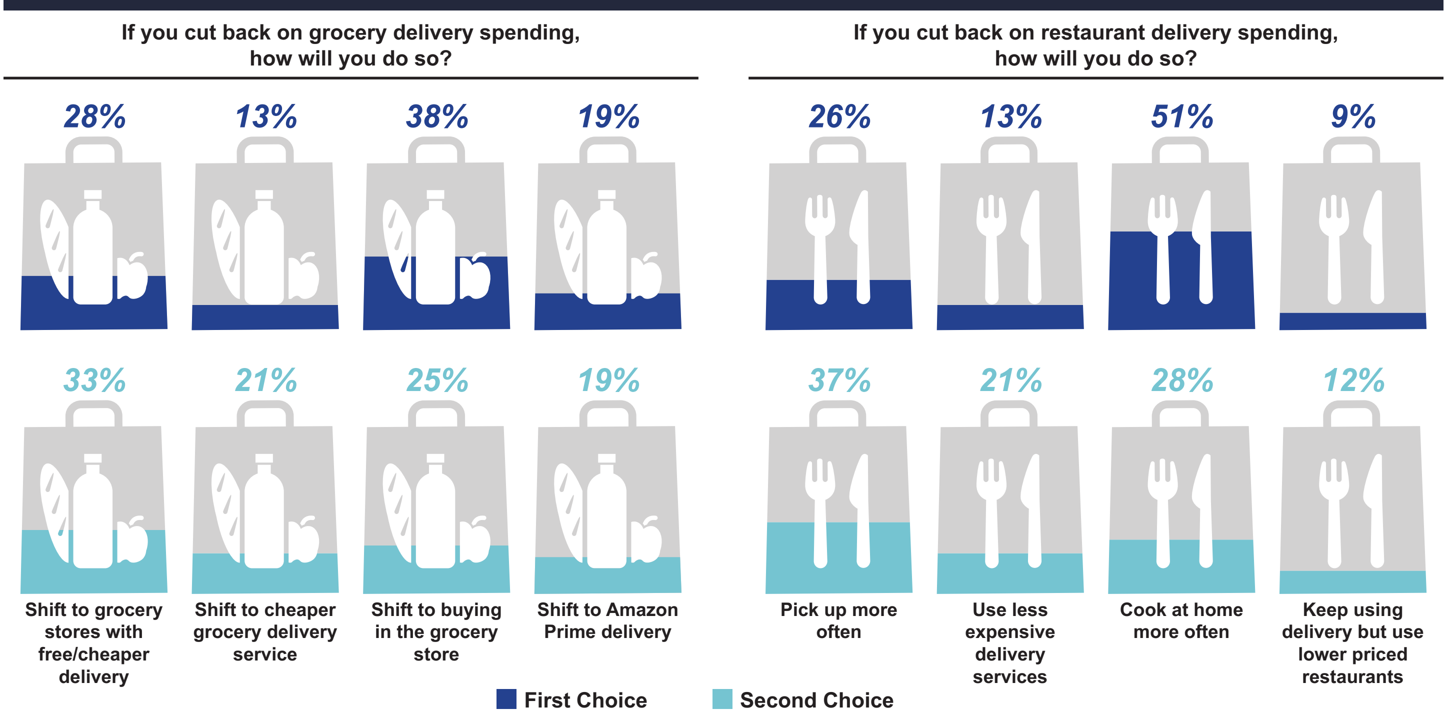
Our research also suggests that the boom in delivery for both groceries and restaurant food may be slowed by an inflationary environment. Asking about pricing for grocery or restaurant delivery is tricky, since delivery costs are often baked into food costs. Nonetheless, we asked consumers how they would respond to a 15% increase in delivery costs. As shown in Exhibit 13, consumers believe that they will cut back on delivery spending if the cost increases.

Exhibit 13 - Likely consumer response to 15% price increase of delivery for groceries and restaurants



Of those who would cut back on restaurant delivery, the most common response is to cook at home more often (Exhibit 14). Not surprisingly, the most common response to higher grocery delivery costs is to shift to shopping for yourself.

Exhibit 14



Implications

How should food manufacturers and foodservice operators manage this inflationary environment? In commodity foods (i.e., milk and produce), less than half of consumers will do nothing. Consumers will shop promotions and lower priced channels more aggressively. Brands might be well served by raising prices slightly more right now and putting some of this price increase into increased promotion. If organic vegetables are representative of premium healthy products, then those brands will not be immune to consumer cutbacks in consumption, even from health committed consumers. Managing the price gap with commodity goods will be critical.

Meanwhile, restaurant operators must prepare for another consumption haymaker from inflation on top of the COVID-19 punch. Retaining your customer base with value-oriented menu items will be critical to avoid trade-down to QSR brands. Brands with lower income demographics may also need to create alternatives to full-priced delivery services to retain their share of stomach.

If inflation proves to be a short-term supply chain phenomenon, then riding out inflation with one-time price increases is a viable solution. If inflation remains sticky, then fundamental changes in pricing, promotion, and menu strategy may be needed.

New deals coming to market during this time may face new P&L and valuation challenges. *How do you value a business of which revenue is driven by price increases as opposed to units sold and, on top of that, how do you value such a business when those price increases are necessary to cover increased cost of production?* Many of us have never witnessed this phenomenon. Sellers should ensure that proformas incorporate thoughtful pricing and promotion assumptions to navigate this inflation surge, which has driven unit growth rates and short-term pricing in many areas

Ongoing COVID-19 waves could continue to disrupt the broad consumer landscape for the foreseeable future. Inflation may continue to put pressure on big parts of the economy, and the longer it lasts, the bigger the impact for branded companies, private label manufacturers, foodservice operators, and investors.

ABOUT LAZARD

LAZARD

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DAVID IVERSON
Managing Director
Group Head of Consumer, Food & Retail
david.iverson@lazard.com

OWEN BALDRICA
Vice President
owen.baldrica@lazard.com

TONI KUZIELA
Business Development Manager
toni.kuziela@lazard.com

Other Senior CFR Members

JIM D'AQUILA
Managing Director
Head of Consumer & Retail
jim.daquila@lazard.com

RYAN HAYS
Managing Director
ryan.hays@lazard.com

ADAM WIEDEN
Managing Director
adam.wieden@lazard.com

ADEEL AHMAD
Director
adeel.ahmad@lazard.com

CHRIS BACKSCHEIDER
Director
chris.backscheider@lazard.com

HARSH SINGH
Director
harsh.singh@lazard.com

ABOUT CH CONSULTING ADVISORS

CH Consulting Advisors

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BRUCE COHEN
Co-founder & Managing Director
bruce@chconsultingadvisors.com

PETER HSIA
Co-founder & Managing Director
peter@chconsultingadvisors.com

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