



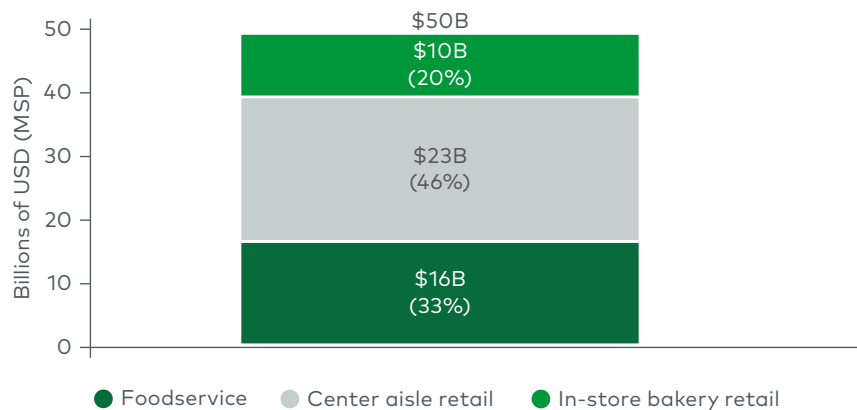
EXECUTIVE INSIGHTS

Bakery: An Attractive Opportunity for Modernization-Minded Investors

Baked goods evoke powerful memories of comfort and delight. They're a centerpiece of celebrations, an affordable indulgence or the wrapper for many a meal – from street meat to haute cuisine.

In North America, bakery is a roughly \$50 billion-a-year business across retail center aisle, retail in-store bakery (ISB) and foodservice channels (see Figure 1). According to Euromonitor, retail value sales of baked goods in the U.S. have risen about 3% per annum from 2008 to 2022,¹ showing steady historical growth despite the challenges of COVID-19. If that seems surprising, consider that the average American eats 44 pounds of bread – just one category of the bakery market – every year.²

Figure 1
US bakery market by channel (2022)



Note: MSP=manufacturer selling price
Source: L.E.K. research and analysis

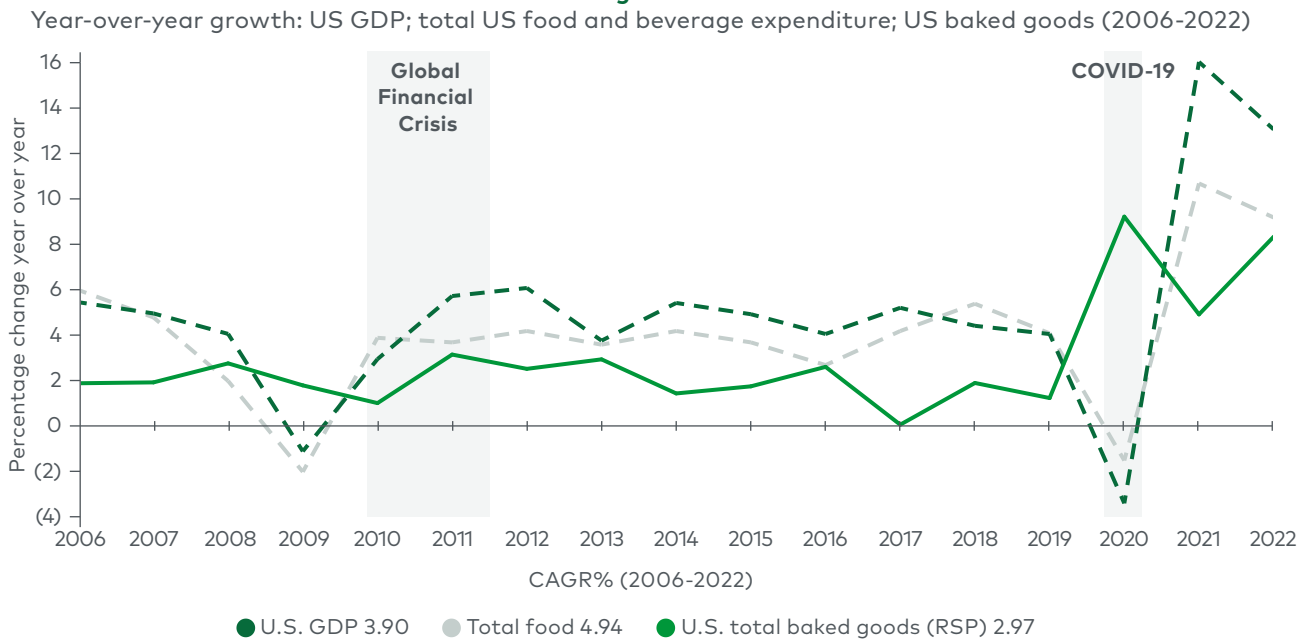
While there are some nationwide commercial bakeries, much of the market is made up of smaller, regional operators, many of which are undercapitalized.

L.E.K. Consulting and Houlihan Lokey recently spoke with 11 leading executives in various bakery categories and channels. In this *Executive Insights*, we combine their insights with a closer look at the bakery market and its opportunities to modernize, invest in automation and amplify growth after one of the toughest periods in the industry’s history.

Resilience amid uncertainty

Bakery has proven to be one of the most resilient categories within food and beverage. During economic downturns and periods of disruption, bakery is a low-priced source of calories, especially where staples like bread are concerned. For example, the decline in baked goods was not as negative as that in total food during the Global Financial Crisis. The variety of savory and sweet baked goods on offer gives belt-tightening consumers a chance to treat themselves with a permissible indulgence. Because of this, the bakery category has been more insulated from market cycles than broader food and beverage (see Figure 2).

Figure 2



Total baked goods market was more affected than the U.S. GDP in 2021 due to closures and stay-at-home orders that impacted mostly the foodservice and ISB channels

Note: GDP=gross domestic product; CAGR=compound annual growth rate; RSP=retail selling price; ISB=in-store bakery
 Source: U.S. Bureau of Economic Analysis; U.S. Department of Agriculture Economic Research Service; Euromonitor; L.E.K. research and analysis

“Bakery is an economic food. It is a belly filler. People lean to that direction because it’s going to fill you up. People aren’t going to move away from this type of economical food choice, especially in this environment.”

— Bread bakery executive

“In the long term, bakery is well positioned. People are going to buy indulgences. Relative difference between buying a cake and buying a steak is massive. The steak is a bigger indulgence, and the relative affordability is real. Bakery is that affordable luxury.”

— Sweet goods bakery executive

What about growth periods? That’s when bakery pulls double duty as a platform for emerging food trends as well as a stable, reliable source of nutrition. Bakery’s versatility is demonstrated in its ability to serve consumers looking for “better for you” options (think high-fiber breads), indulgences (e.g., sweet pastries) and a balance between the two. The category’s steady presence on the American table has enabled it to adapt to rather than fold in the face of dietary trends.

Despite the resilience of the category, the past few years proved especially challenging for the industry. Amid supply chain disruption, rising input costs and labor issues, the bakery industry faced a period of turmoil not experienced in decades.

Recent challenges not forgotten, but pain is lessening

From the start of the pandemic, the bakery industry faced some of its biggest challenges. For starters, issues with bakery supply chains intensified. Failures in delivery from key supply partners led to constraints in serving customers, highlighting the importance of supplier diversification for bakeries.

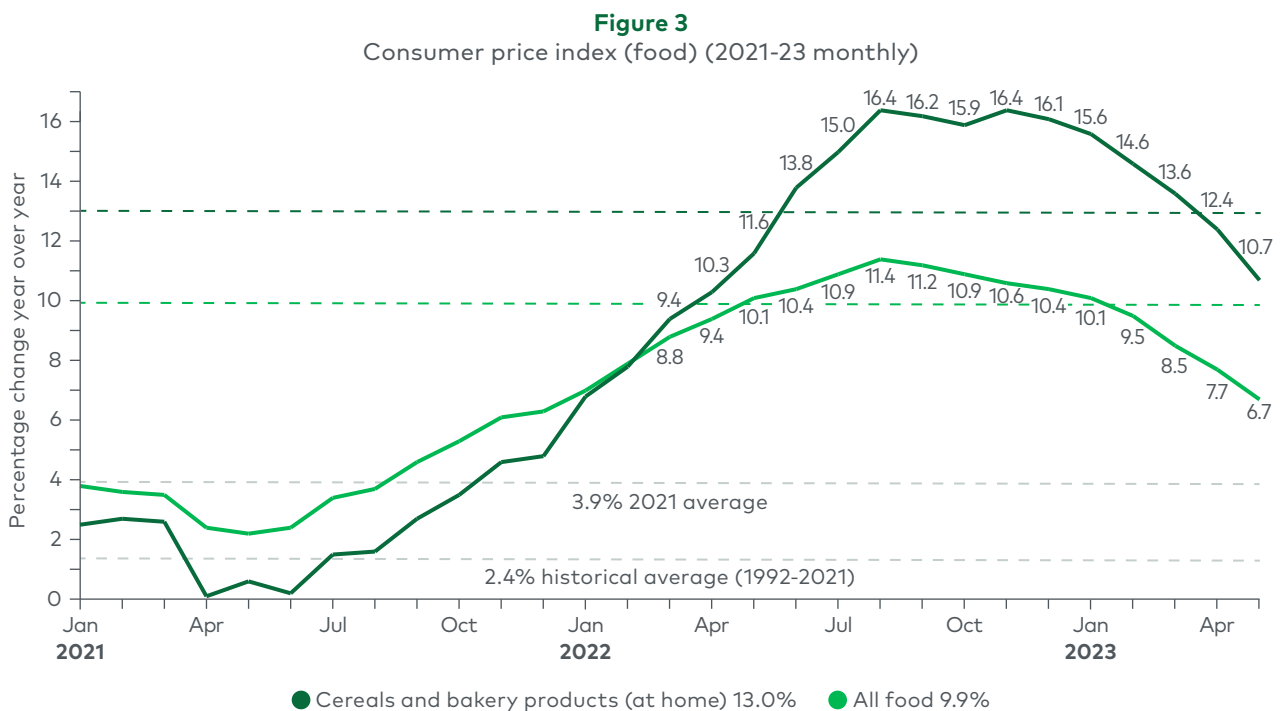
“Really making sure that our supply chain was diversified was critical. If someone failed us or couldn’t give us a good answer for why there was an issue, then we changed them out. It’s even more important to make sure that you really have the right partners You need to pick the right vendors that can keep up with demand and adhere to our high-quality standards.”

— Sweet goods bakery executive

“Bakery has been through a lot of challenges. I’ve spent lots of time in food, and these were the most interesting years that I’ve seen. The supply chain meltdown was catastrophic – from raw material to packaging, there were shortages across the board. You could have a few pounds of an input holding up millions of pounds of production.”

— Sweet goods bakery executive

At the same time, bakery was also impacted heavily by rising input costs. For example, with disruption to the wheat supply from Ukraine pushing up prices for manufacturers, wheat prices doubled between 2018 and 2022, from \$5 to \$10 a bushel. This forced manufacturers to have difficult conversations with customers about passing on those costs. We saw this phenomenon play out on shelves as bakery products experienced price growth above the average of all food and beverage (see Figure 3).



Source: U.S. Bureau of Labor Statistics; L.E.K. research and analysis

Labor challenges, while not unique to bakery, were also prominent. From 2018 to 2021, the total number of bakery production workers declined from about 85,000 to 75,000.³ A tight labor market during the pandemic left many commercial bakeries short-staffed. Baking requires skilled labor, and many industries were fighting for scarce high-quality talent from

2020 to 2022. Manufacturers then struggled to protect their margins while paying high salaries for the best personnel.

Aging infrastructure and workforce

While pandemic-era challenges are lessening, the bakery industry continues to experience headwinds of a different type, namely its aging infrastructure and workforce. The U.S. has an estimated 4,000-5,000 commercial bakeries.⁴ However, many assets have been in operation for several decades. Annual spend on repairs and maintenance increased from roughly \$290 million in 2018 to \$415 million in 2021, highlighting the scale of investment needed to keep facilities operational and moderately competitive.⁵

“The majority of this industry — small to mid-sized and some of the big guys with multiple plants — they have exhausted equipment, been in the system for 30-40 years. But it’s not efficient, not easy to work with. And the majority of them are not spending the money to do so. The investment within the industry is lacking.”

— Bread bakery executive

Demographic shifts are taking a toll as well. The industry’s labor force is also aging, and many of the most experienced bakers are reaching the end of their careers. The pipeline of talent behind them appears light, with workers less committed to long-term careers in bakery.

“Bakers are not being born. We’re trying to create the environment where they want to come to work and [are] excited. Training is very important ... we want to transfer that legacy knowledge.”

— Bread bakery executive

“Bakery talent is walking out the door. Bakery is an art and science. Bakery can change by the day, can change by the raw material, can change by the operator. It’s a highly technical category, which is fun, but you need that art mixed in.”

— Sweet goods bakery executive

The lack of highly qualified bakers has required manufacturers to focus on perfecting the production of complex bakery goods. Introducing automation into facilities to ensure the reliability of future supply has become critical.

“Bakeries are a complex manufacturing environment. We’re not making cereal in a box. It’s a piece of art coming down the line. For some products, it’s going to cost \$10, and it has to be perfect for our consumers.”

— Sweet goods bakery executive

“It will help make jobs easier and more efficient, but it also allows us to be more consistent. That helps with our mixes, doughs and more. Automation is going to be key in our ability to continue delivering what we’re known for. We saw people retiring. We saw the knowledge go out the door, and we can’t let that happen.”

— Bread bakery executive

Opportunities going forward

During the pandemic, focus shifted from commercializing innovation to stabilizing supply chains, in part reflecting the priorities of customers. But new product launches have returned over the past year as retailers and foodservice operators brought new options to consumers. Now bakery suppliers are focused on innovation instead of navigating supply chain challenges.

“Over the past few years, there’s been little innovation. Everyone was trying to make what they could to deliver to their customers. Now that we’re past most of that, the innovation pipeline is coming in strong. There’s also lots of promoting to get the category back to a growth trajectory.”

— Sweet goods bakery executive

"In particular in foodservice, customers are looking at innovation again. There are a significant number of briefs coming our way. For the last few years, foodservice had to batten down the hatches and make sure they could get products. They had to pick the right partners. Now they're back to talking about the future."

— Sweet goods bakery executive

"Innovation provides an opportunity to build off historic strength, but with something different and unique. Innovation can take a lot of different forms. It could be something that's innovative, from flavor profile or format. It could be taking items that are hard to manufacture and making it easier, without sacrificing quality."

— Sweet goods bakery executive

The premiumization trend is clear in bakery as consumers prioritize affordable luxuries and indulgences. Consumers are willing to pay for something that is both delicious and unique.

"Premium is growing faster and pulling the category up. Even as consumers have less money to spend overall, they're not willing to give up their indulgence. They're willing to buy a smaller piece, but they still want really good chocolate cake."

— Sweet goods bakery executive

As part of premiumization, better-for-you (BFY) is top of mind within the bakery segment, as seen in many other categories as well (see Figure 4). However, in an indulgent category like bakery, there must be a balance between healthfulness and the indulgent experience. Consumers will prioritize having the better cake over the cake that is better for you.

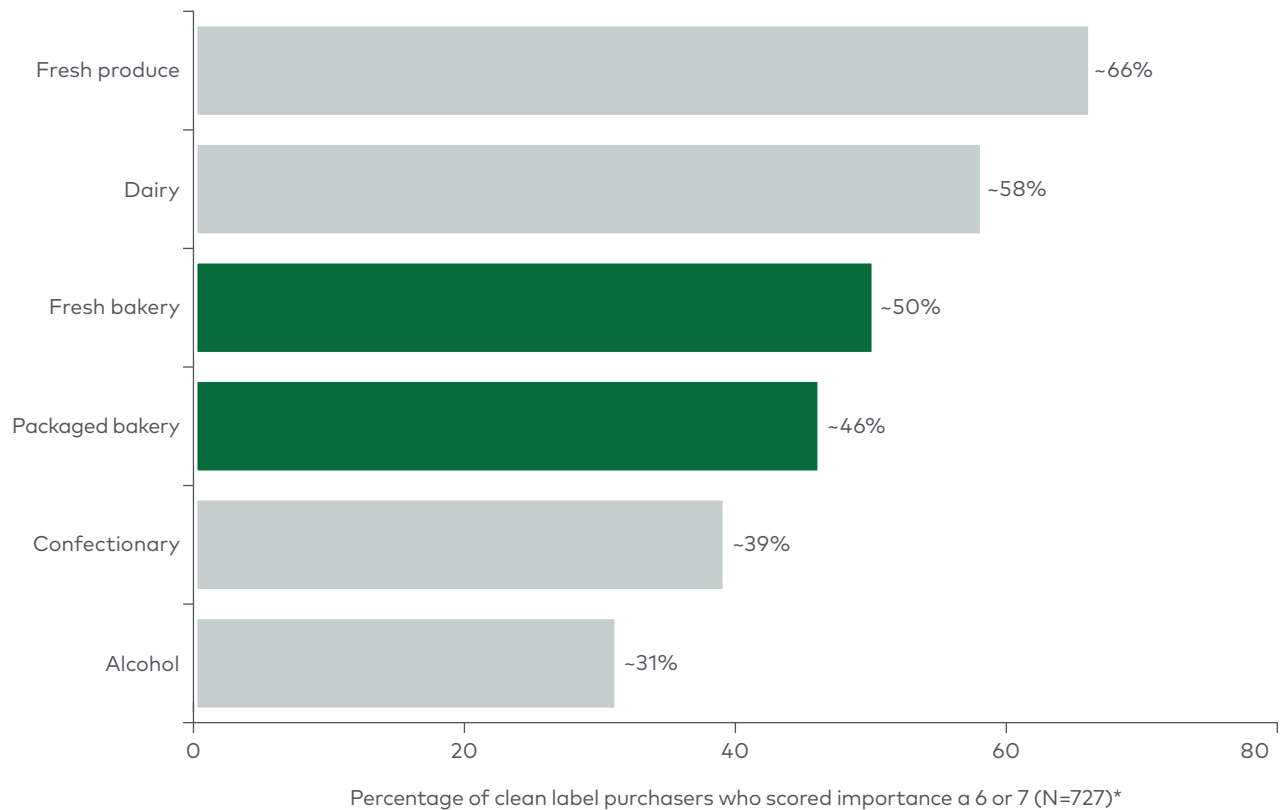
“What was growing pre-COVID was indulgent experiences, and that’s going to still be a driving force. What bakers are exploring is: How do I make bread better for you? Is it protein, probiotics, other things? They’re trying to blend together the perception of BFY and indulgent.”

– Bakery ingredients executive

“Bakery is still indulgent, but now consumers are looking at how long the ingredient list is. We won’t let taste or quality be sacrificed by it, but we won’t have preservatives in any of our products.”

– Diversified bakery executive

Figure 4
US perceived importance of ‘clean label’ across food categories



*Survey question: How important is a “clean label” for each of the following categories? (Please rate each food on a scale of 1 to 7 where “1” means “Not at all important” and “7” means “Extremely important”)
Source: L.E.K. survey

Meanwhile, the breadth of product shapes and sizes continues to evolve. Especially as consumers are now facing tightening wallets, smaller product formats are attractive. There may be price elasticity for a particular product, but not for the category itself. Consumers still want to eat baked goods, even if it's in a smaller quantity. We see this play out on shelves with "mini" versions of classic desserts, or sales of individual portions/slices in categories that were historically multi-serving (e.g., cakes, cheesecakes, pies). This also fits with the rise in snacking, including across bakery categories (see Figure 5). As a result, price pack architecture — the process of making decisions on which pack sizes to offer and how to price them — will continue to be top of mind for savvy manufacturers and retailers.

"With some bigger items like decorated cakes, you're seeing the consumers feeling the higher price point. What they've responded with is buying a smaller cake instead."

— Sweet goods bakery executive

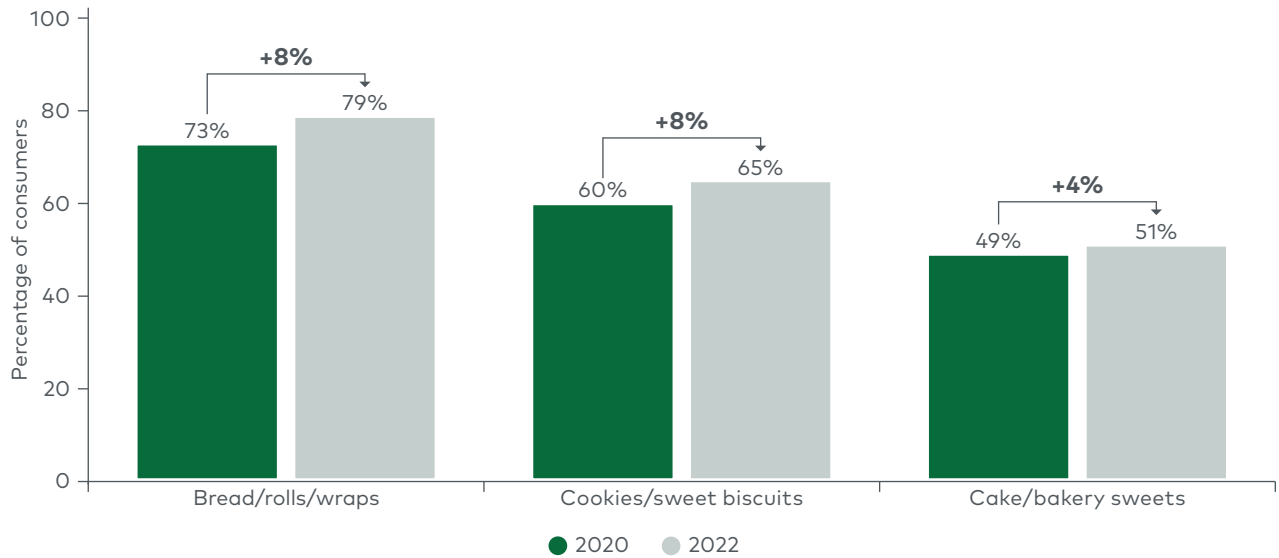
"When it's a smaller size like a snack size, it's not as big of a commitment for the consumer. Most meal occasions are snacking-related now too, so you have to have options for the consumers that are bite-sized indulgences. It's important for us to offer this for our consumers."

— Sweet goods bakery executive

"With where consumers are today, smaller sizes are growing better. The consumer has to make a decision to 'trade down' to the smaller size, but it's a good mix shift and we still see overall growth."

— Sweet goods bakery executive

Figure 5
Consumers who snack weekly (2020, 2022)



Source: Mondelez State of Snacking Report 2021-2022

While meeting the needs of consumers is a driver of growth within the industry, innovation to meet the needs of customers is also paramount. Customers – retailers and foodservice operators – continue to face unprecedented challenges as well. Innovating with the customer in mind is critical for bakery suppliers.

“We need to find ways to be really innovative to customers, to solve their true pain point. We want to come with a solution that isn't that hard, just solves the problem for our customer. It's important to listen to what they really need, understand what really solves their problem and efficiently design products to do just that.”

— Bread bakery executive

Most pressing to customers in recent years are product formats to alleviate issues caused by persistent skilled labor shortages. While a long-term trend, pandemic-era labor shortages have caused bakery customers to increasingly demand “thaw and sell” products, precut cakes and other innovations to minimize the need for skilled labor (e.g., qualified bakers who can bake, cut and/or decorate on-site).

“For us, innovation will come in manufacturing capabilities and solving the labor crisis at the store level. Stores that don’t have labor to get items from backroom to shelves — there’s a ton of loss there. They don’t have the people to pull it out and keep it stocked, so we need to have products that have shelf life that alleviates that challenge.”

— Sweet goods bakery executive

“Customers want products that reduce the need for labor or decrease wastage. We’ve created fully baked breads and rolls that you can pull straight from the freezer to the shelf. Our customers don’t have people to bake products in-house anymore, so these simplify the process.”

— Bread bakery executive

However, as with all things, it’s critical for innovation to be done smartly and in the context of the broader business, customer needs and market dynamics. Innovation for the sake of innovation will only cost time and money. Innovation should be there to truly meet a customer need.

“With innovation, it’s important to do it in the context of what problem you’re trying to solve. First you have to identify if it’s actually a problem you can solve. Then you have to think about whether it’s safe, whether it’s scalable for the customer, etc. It’s about problem-solving innovation.”

— Diversified bakery executive

“What’s key is listening to what customers really need [and to] solve the problems and efficiently design the products that do that.”

— Bread bakery executive

Why bakery is a great place to invest

Given these dynamics, bakery remains a great space to invest, with significant opportunity for return on investment. The most profitable bakeries are often the best funded, and incremental dollar profits can be driven by ensuring sufficient investment in maintenance and growth capital. Investment in automation technology can boost efficiency and throughput while simultaneously de-risking the business in terms of labor cost volatility.

Many commercial bakeries focus on niches within product types and channels. Manufacturers willing to explore expansion into adjacent customer sets and product offerings can benefit from cost synergies given the overlap in both required ingredients across bakery categories and the ability to drive utilization of common equipment and machines (e.g., frozen cold storage or ovens).

From an M&A perspective, the high level of fragmentation in the market today creates opportunity for investors to buy and build scale businesses that can gain competitive advantage. The space is primed for consolidation of smaller players with limited recent investment or appetite to grow.

"There's definitely consolidation opportunity in the industry. There continues to be opportunity for someone to create significant value with that strategy."

— Sweet goods bakery executive

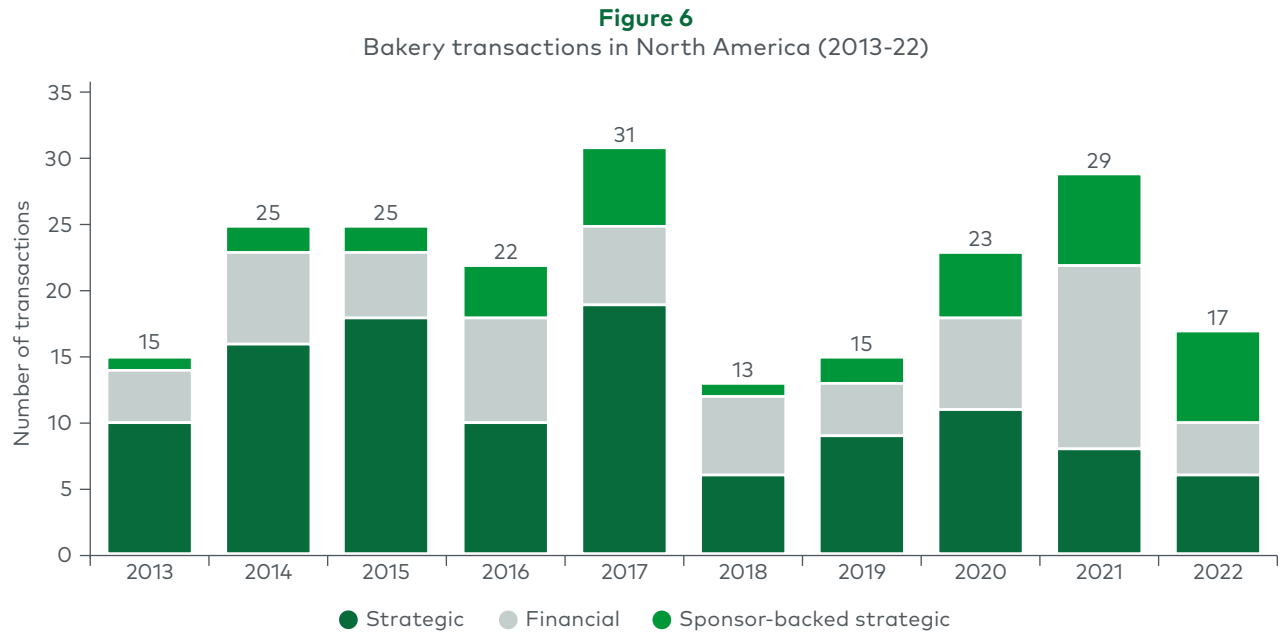
"There's still lots of opportunity to go after and help consolidate this industry, to make it a more rational industry."

— Sweet goods bakery executive

"Consolidation will continue because of the need for automation in the space. You need deep pockets to make it happen. The more sophisticated players will continue to automate and improve their cost position."

— Sweet goods bakery executive

This continues a historical trend of successful M&A within the bakery industry among strategic and financial buyers (see Figure 6). The market has also driven significant value, with EV/EBITDA multiples growing from around 8-9 prior to 2015 to 10-11 since 2015.⁶



Source: S&P Capital IQ and Houlihan Lokey market intelligence

Getting your piece of the pie

Investors willing to deploy capital can eliminate some of the inefficiencies seen in the market today. Along the way, an investor can build world-class bakery operations fit for serving the largest retailers and foodservice operators in the U.S.

To get started, consider the following steps:

- **Put the right team together**, with experience in high-standard bakery operations and the ability to think quickly and creatively about tackling problems in pricing, supply chain and other critical areas of the business.
- **Support the team for the long term**, focusing on culture and training as differentiators in an industry that has struggled to retain the best talent.
- **Invest in technology and automation, but do so smartly**, increasing efficiency and production in the business and reducing exposure to volatile labor markets.

“When we think about growth, we have a mindset of where are we today, where do we want to go and what bets will we have to place on capital needed to get there. You have to be very conscious of tying capital to your strategic plan.”

— Sweet goods bakery executive

- **Invest in innovation and R&D**, assembling teams to work closely with consumer insights and commercial groups to ensure the latest market trends are influencing the product pipeline. At the same time, these teams should set the agenda with exciting new products, formats and ingredient profiles to shake up traditional categories.
- **Take a customer-first approach**, recognizing the challenges retailers and operators face in the current environment. Design food products and packaging that limit the labor requirements on the customer's end. Above all, focus on the basics of good customer service: quick and reliable supply of high-quality goods.
- **Build distribution partnerships that can scale**, ensuring access to the market's fastest-growing customers and segments. It's critical that the distribution strategy align with both the product manufacturing strategy and the commercial strategy.

When it comes to investment opportunities, bakery isn't always on everyone's radar. But it's a business with staying power, adapting to changing consumer preferences and holding steady through financial downturns. The inefficiencies that many operations have today open the door to outsized returns via automation, consolidation and strategic realignment.

For more information, please contact strategy@lek.com.

Endnotes

¹Euromonitor, "Baked Goods in the US, Nov. 2022." <https://www.portal.euromonitor.com/?noRjXNIh64Moj0hyLwozOHPO51cxibgzVttvOlPpEINIP2WZIT2hijA%3d%3>

²Statista (March 1, 2023). Per capita consumption of the bread and cereal products in the United States from 2017 to 2027 (in kilograms) [Graph]. Retrieved July 25, 2023, from <https://www.statista.com/forecasts/1374278/size-of-the-bread-and-cereal-product-market-in-the-united-states>

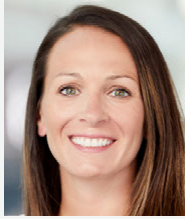
³U.S. Census Bureau, "Annual Survey of Manufactures: Summary Statistics for Industry Groups and Industries in the U.S.: 2018–2021." <https://data.census.gov/table?q=311812:+Commercial+bakeries>

⁴NAICS Association, "NAICS Code Description." <https://www.naics.com/naics-code-description/?code=3118>

⁵U.S. Census Bureau, "Annual Survey of Manufactures: Summary Statistics for Industry Groups and Industries in the U.S.: 2018 – 2021." <https://data.census.gov/table?q=311812:+Commercial+bakeries>

⁶S&P Capital IQ and Houlihan Lokey market intelligence

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