



cutting through complexity

CONSUMER MARKETS

The chocolate of tomorrow

What today's market can
tell us about the future

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Revenues from the chocolate industry continue to prove rewarding, with 2011 figures from IBISWorld predicting annualized growth of around 2% over the next five years, after dampened expectations during the dark days of 2007-09.

But behind the encouraging headlines, many companies are battling to stay on top of a rapidly shifting marketplace. Taste is diverging, as fast-growing economies and empowered consumers demand more from their products. For industry stalwarts, the requirement to offer local, highly tailored and increasingly diverse products represents a serious threat to market share.

Spotting the markets that are likely to grow quickly will make the difference between the winners and losers of tomorrow's chocolate landscape. According to official government figures, current hot spots include India (annual growth rate 15%), China (9%), Russia (6%) and Mexico (3.8%). They all exhibit a number of key factors that help them stand out from the pack, including a youthful population, rapid capital inflows and retail consolidation.

In this report, we'll take a tour of the factors shaping the chocolate market of tomorrow – from geography and demographics, to consumer needs and preferences, and other market drivers. And we'll attempt to offer a glimpse into the future by defining what might be the chocolate bar of 2030.



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Where next for chocolate?

The industry has weathered a global recession and is still seeking growth. But with some markets saturated, where does its future lie?

The global chocolate industry is many things, but as a bellwether for the wider economy its use is limited. Revenues have remained resilient despite a recessive global picture, falling disposable incomes, volatile commodity prices and increasing competition.

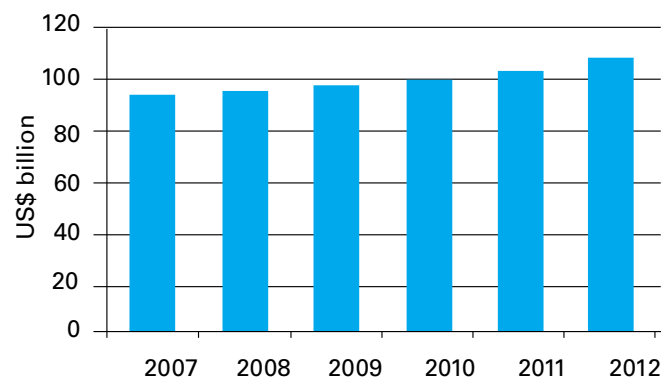
Chocolate is often described as recession-proof. Some economists call it the 'lipstick effect': when facing an economic crisis, consumers are more willing to buy less costly luxury goods, such as cosmetics and chocolate, even as they cut back on other luxuries. Revenues over the past few years would seem to back this hypothesis, although year-on-year growth remains relatively sluggish and the spectre of volatile input prices continues to cast a shadow over future projections.

Although the global market is still dominated by Western Europe and North America, emerging markets clearly represent the future. The BRIC countries (Brazil, Russia, India and China) accounted for 55% of global confectionery retail growth in 2011. Other emerging economies with youthful populations and an acquisitive middle class are likely to develop a taste for chocolate and, as their disposable incomes grow, they will represent important target markets.

With the traditional markets of Western Europe and North America seemingly saturated, manufacturers are being forced to pull even more innovative tricks out of the bag to attract consumers, from enigmatic flavor combinations to bolder health claims, portion control and personalized bars.

Like a large sharing tablet, the market is breaking up. Taste is diverging as the BRICs and empowered Western consumers demand more from their products. Where will the market take us next? ■

Global chocolate retail market value

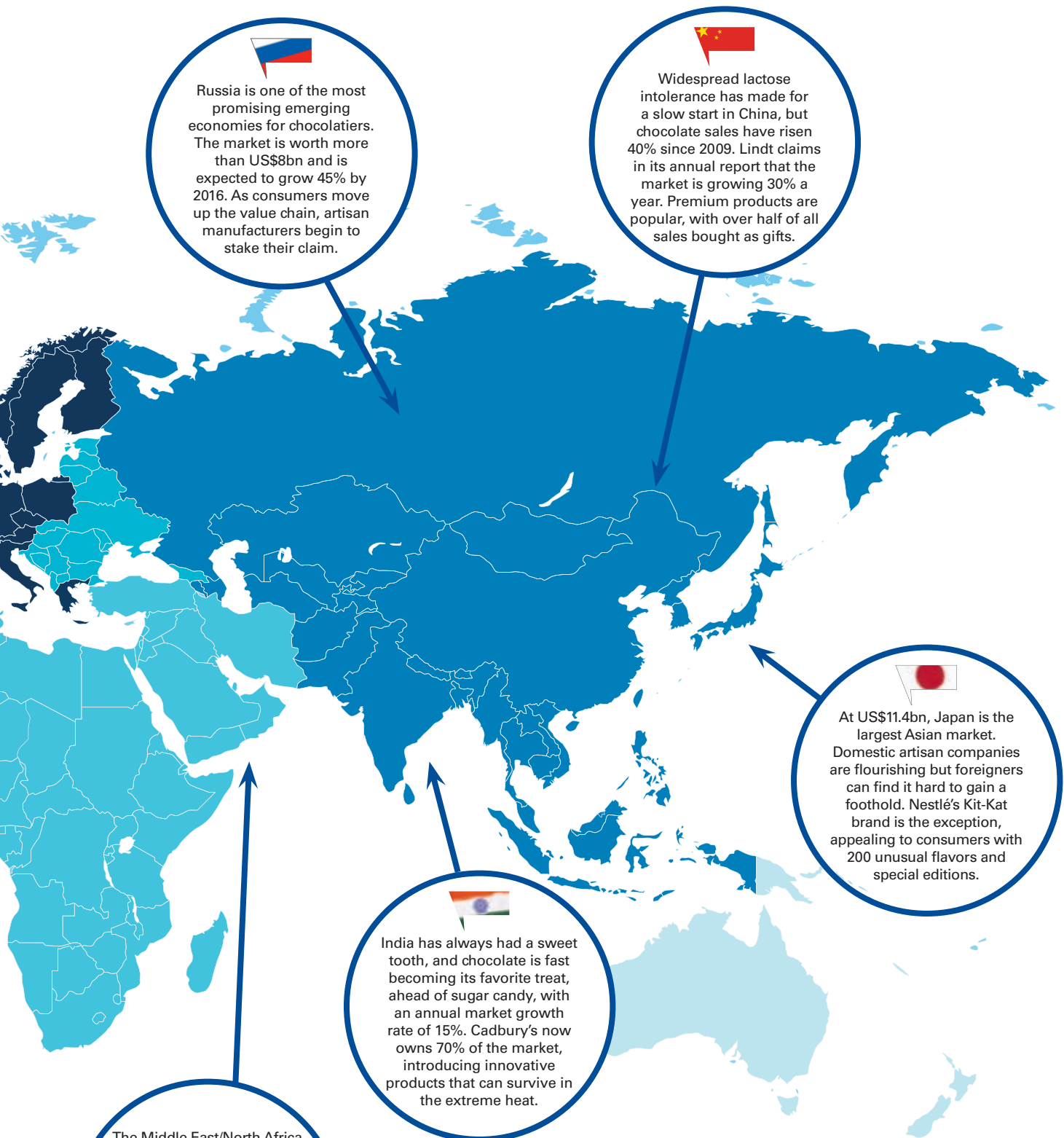


Source: Euromonitor



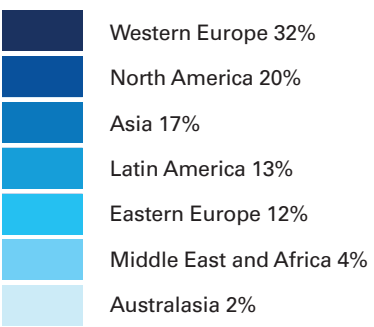
The world of chocolate

Geography is still key to understanding the specifics of consumer taste. What are customers across the world demanding?



The Middle East/North Africa market is expected to reach US\$5.8bn by 2016, up 61% on today. Almost every part of Africa is growing: South Africa is the biggest market, but sugar confectionery is still 22% more popular there than chocolate, says Leatherhead Food Research.

Global market share by region, 2011



Source: Euromonitor

What consumers want

The psychology behind chocolate suggests consumers see it as a 'naughty but nice' impulse treat. But a closer look reveals three distinct types of buyer, each with different behaviors and demands



THE CONVENIENCE BUYER

Chocolate may be seen as an impulse purchase, but it's becoming increasingly everyday among consumers. Convenience is a major driver for chocolate lovers, who want to grab a bar from a local store or throw a multi-pack into the trolley during a weekly shop.

As convenience becomes more important to time-poor shoppers, sales of tablet bars are growing (up 37% in the UK last year) as consumers grab

and go. Premium chocolate-makers such as Godiva are rethinking their strategies to get a bite of this lucrative market, introducing smaller bar formats.

A desire for convenience is also increasing the popularity of sharing bags, particularly in Western markets, as consumers buy to share or finish eating later. Manufacturers have reacted with packaging innovations, such as the 'memory wrapper' from Mars that allows bars to be twisted, closed and saved. Mars says the innovation "empowers the consumer". It also drives brand loyalty.



THE VALUE BUYER

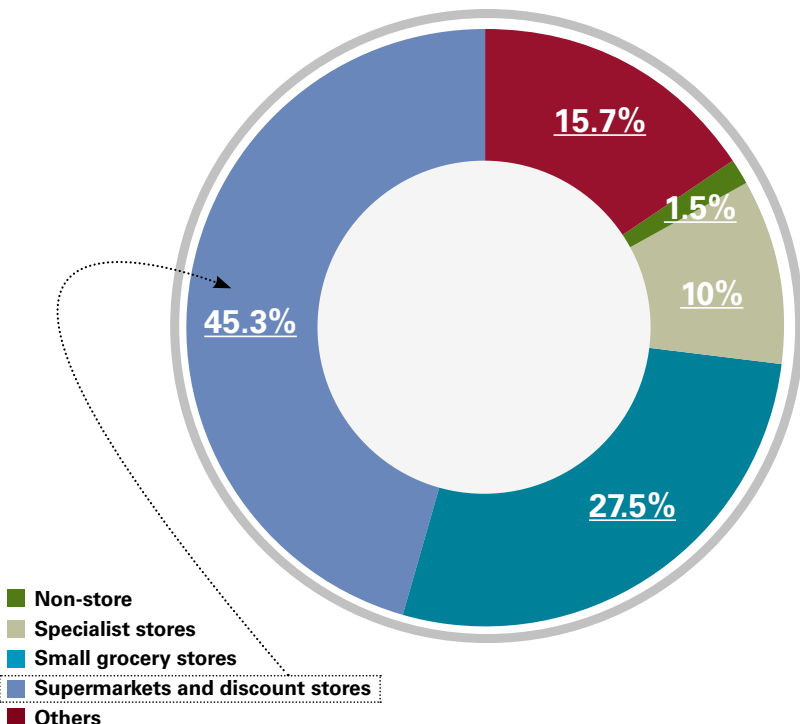
In many markets, value is a hot topic. In the US, 79% of consumers look for good value when choosing chocolate, although 70% also want a name brand, according to Mintel Oxygen – meaning even value shoppers are making demands of manufacturers.

Value is particularly important in economies where the middle class is still being defined – and may exist far below Western levels. According to research from financial services provider Rabobank, a 45g chocolate bar accounted for less than 1% of the weekly shopping budget in the US and UK in 2010, but in India the same bar made up 18% of the weekly food allowance: which means a snack comes at the expense of a full meal.

One-size-fits-all global pricing solutions are difficult when the income levels and aspirations of the fast-growing middle class differ so widely. Although disposable income is rising in emerging markets, we could assume that a large proportion of consumers will continue to look for the cheapest option.

Value-conscious shoppers favor a new generation of outlets. Discount stores are flourishing, which is forcing supermarkets to think more like discounters to attract fickle customers, including increasing their private label ranges. Small grocery stores may lack the economies of scale to compete on price, while 'specialist' formats are being crowded out. In emerging markets, 'one-stop' retail locations are becoming popular due to low prices and greater choice.

Where they're buying



Global chocolate retailers market share 2011. Source: Euromonitor



THE LUXURY BUYER

The luxury chocolate market continues to embrace the mainstream – and not just in developed economies. “The psychology is that even expensive chocolate is an affordable luxury,” says Marcia Mogelonsky, Global Food Analyst at researcher Mintel.

Chocolate is becoming increasingly premiumized, and brands such as Godiva and Lindt have become almost mass market as consumers develop a taste for everyday glamour. Godiva, which has increased its sales from US\$400m to almost US\$700m in 10 years and is now owned by Turkey’s Yildiz Holdings, plans to become a staple for the health-conscious, sweet-toothed consumer. “Our revenues have increased in all our markets, especially in China and Japan, which are the

most important markets right now,” Godiva CEO Jim Goldman has said. “[Marketing our product] is a balancing act. And it’s different in every country. We do retain our prestige... but we have to be relevant.”

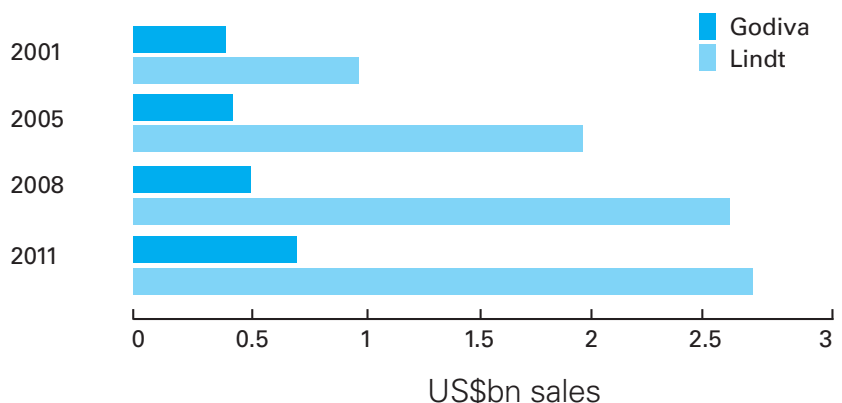
In Russia, the chocolate market is expected to grow 45% over the next five years, to reach US\$11.6bn, says Euromonitor. Belgian artisan chocolatier Jean-Philippe Darcis has his eye on the country, predicting: “The market will evolve and people will have more buying power.” Lindt is enjoying double-digit sales growth in the Middle East. In China, rich dark chocolate is thriving, with Ferrero Rocher and artisan chocolate maker Senz launching exclusive premium dark brands in the last two years. Unsurprisingly, larger manufacturers are keen to get a bite of this burgeoning sector but, without the personal story required to sell

such products, they can struggle. The solution: purchase artisan brands and market them as separate entities – large producers’ economies of scale mean this phenomenon makes life hard for surviving artisan brands. Mars has Ethel M, Nestlé bought Maison Cailler and Hershey owns Dagoba and Scharffen Berger. “It may sound counterintuitive, but what’s happening in the [global financial] crisis is a quest by consumers for value, for more affordable products, but also for products that overtake their expectations,” says Laurent Freixe, head of Nestlé’s European business.

However, large manufacturers with designs on artisan businesses must be careful. “Consumers like artisan companies because they are high quality and unique,” warns Mary Nanfelt, Food Analyst at IBISWorld. “That uniqueness and independence must remain.” ■

“What’s happening in the financial crisis is a quest by consumers for products that are more affordable but that also overtake their expectations”

■ Luxury sales on the up



Driving growth

From sustainability to eventing, four factors that are increasingly important in understanding the global chocolate market – and the opportunities they could create both now and in the future

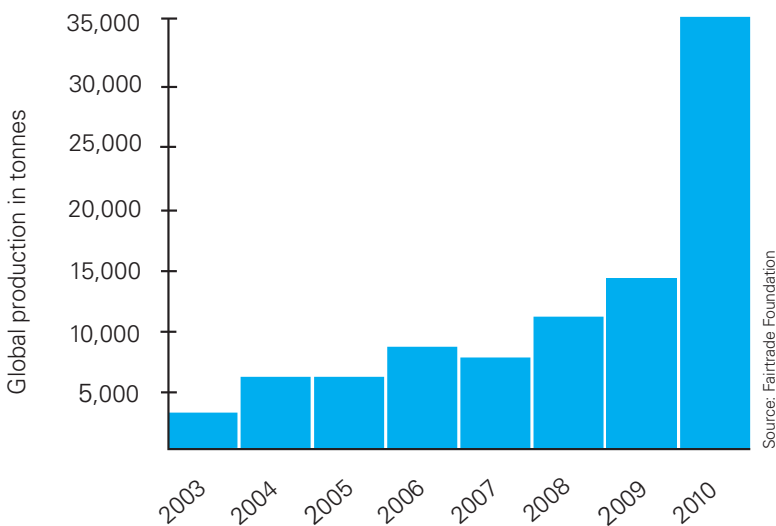
SUSTAINABILITY

Food origin is an increasingly important driver for consumer purchasing decisions in more developed markets, particularly at high-end retailers. Mary Nanfelt, Analyst at IBISWorld, says: “Americans in particular are becoming more socially conscious in their choices, buying chocolate from sustainable and organic sources.” Globally, use of Fairtrade cocoa has risen dramatically over the last few years, and smart phone users can even download ethical shopping apps.

All the major manufacturers have embraced Fairtrade to some degree. Kraft’s Cadbury brand has tripled the amount of Fairtrade cocoa it uses, and Cadbury’s Dairy Milk, the UK’s best-selling bar, is certified Fairtrade. Hershey announced this year that it would begin to source the cocoa for its Bliss brand through Fairtrade farms, while Mars and Nestlé already have best-selling Fairtrade lines.

Fairtrade takes off

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INNOVATION

As consumers become ever more demanding, innovation is crucial to market share. And personalization is likely to be the next consumer-driven revolution in the industry.

Nestlé is leading the pack in this area. Maison Cailler allows customers in Switzerland, the world’s largest per capita chocolate market, to create personalized taster packs based on their preferences. Its Spanish brand Diselo con Chocolate recently launched an e-commerce platform where customers can create their own assortments. Gum and candy businesses such as Wrigley’s have already introduced personalized packaging (particularly aimed at gifters) and chocolate could soon follow suit.

The next logical step is for consumers to design chocolate bars that cater to their unique palate – but which manufacturer will take on the production challenge involved?

HEALTH

Although many consumers view chocolate as an occasional treat and don’t obsess over its effect on health, fat is becoming a major issue for manufacturers. So-called ‘fat taxes’ are threatened in a number of major economies, including the US and the UK, while European countries such as Denmark and Hungary have already introduced surplus taxes on unhealthy food. In Japan, the government has gone one step further and is taxing companies and local authorities with a high proportion of overweight employees or residents.

An increased emphasis on healthy lifestyles is an imperative for governments facing rising healthcare costs, particularly in developed economies that are battling childhood obesity. This has impacted child-focused product launches, which fell 62% last year in the US and Brazil, both countries that are struggling to keep their weight down (more than 35% of Brazilian children under six are overweight or obese). Globally, 21% of parents reported switching products to give their children healthier snacks, potentially reducing brand recognition among the next generation.

To combat this, the industry should debate the potential health benefits and enable chocolate to be among the next generation of functional foods, pushing the antioxidant effects of dark chocolate or investigating the energy-boosting properties of bars with oats, nuts or ‘super fruits’. Latvian brand Laci is using ‘super berry’ sea buckthorn in its products. Smaller bars (Mars has capped its bars at 250 calories in the UK and Australia, and will follow suit in the US in 2013) can encourage awareness of portion sizes.

Personalization is likely to be the next revolution in chocolate... the logical step is for consumers to design bars that cater to their unique palate

EVENTING

In many countries, chocolate is an essential component of religious events, special occasions and festivals. The seasonal chocolate market is worth US\$4.9bn in the US, an increase of 6.4% since 2010, says Mintel.

Easter is the biggest chocolate event globally and, although the shelves can appear full of competing products, the market is in fact far from saturated. Easter products launched worldwide rose 45% during 2011. Canada has proved particularly fruitful for manufacturers, with seasonal activity increasing 89% in 2011. In gift-hungry Western Europe, growth in seasonal product launches is particularly notable in the UK and France, where seasonal activity increased 53% and 41% respectively.

In more mature markets like the US and Australia, there is evidence to suggest consumers are choosing to buy a smaller number of high-margin, luxury items rather than focusing on value products. In Australia, where Easter

chocolate spending is expected to grow 3% in 2012 to over US\$178m, specialty retailers stocking luxury Easter eggs from the likes of Lindt have been reporting robust growth.

China has seen a seasonal boom. The expanding middle class is spending more on premium chocolate, which makes the perfect gift. More than half the chocolate bought in China is purchased as a gift, with Christmas and the Lunar New Year peak buying times. According to Shaun Rein, author of *The End of Cheap China: Economic and Cultural Trends that will Disrupt the World*, costly confectionery fills a gap in traditional present-buying. "Chocolate hits a good market position. There just aren't that many other prestige gift items in the \$50-\$200 range." ■



Q&A

Bert Alfonso
CFO, Hershey

Q How has Hershey maintained growth in a time of financial uncertainty?

A: We have focused on productivity gains, which have been reinvested in the products consumers are looking for, and increased marketing activity. Gross margins have increased over the last few years as a result of several actions, including raising prices in the US market to offset rising commodity costs. We believe we're in the middle of a secular bull market for commodities, driven by the growth of emerging economies.

What steps have you been taking to mitigate rising raw material costs?

Aside from pricing, we use hedging programs in everything but dairy. Certain costs are predictable but when it comes to commodities, we follow the fundamental as well as technical market indicators for materials such as cocoa and sugar. Longer-term, there's an opportunity to improve cocoa yield in regions such as West Africa. The methods being used at the moment aren't that sophisticated, which is why we are involved in farming training to enhance cocoa-growing productivity. Overall, cocoa farming is still profitable at current market prices – and some markets are actually increasing production.

How much of your future revenue would you like to see coming from overseas?

We have targeted US\$1bn revenue from our overseas operations by 2015 – we've actually been pacing ahead of that. Mexico, Brazil, India and China are the most important markets for us, and we now manufacture in all of them. We have been manufacturing in China for several years, rather than just exporting there, because US chocolate simply isn't formulated for the local taste profile.

How do you see the luxury market developing in future?

I believe that smaller artisan companies will find it harder to stay in the market in the long term. Luxury is growing again as a segment and competition is intensifying. It could eventually account for 20% of the market over time.

What type of chocolate will we be eating in 2030?

A lot of the products currently available in the US market still have longevity. There will be more personalized products as the market seeks to deliver on unique taste profiles. Also, consumers are looking for more permissive, better-for-you alternatives. The digital aspect of personalization is still at an early stage and we will see further investment from manufacturers. The mass market won't go away, but it will evolve.

Looking to the future

What kind of chocolate will we be eating in 2030? The rapid change of the past few years gives us some vital clues to the industry's direction

Innovative packaging

To stand out on the shelves and reduce costs, packaging could undergo a revolution. Manufacturers will devise new ways to ensure chocolate doesn't melt in the extreme heat of many emerging markets, as well as introducing new bar sizes.

Attracting youth

Marketing to the youthful populations of emerging markets (especially India and Latin America) will be vital. Use of popular culture, including bands and TV shows, in marketing campaigns may increase, as will viral marketing and social media interaction, as young people broaden their channels. While children prefer sweeter chocolate, concerned parents will look for chocolate with added health value.

The outsourcing solution

The most successful chocolate companies could be purely marketing and R&D operations after outsourcing their production to industrial suppliers. The public won't even have heard of the world's largest chocolate producers, who will work behind the scenes to supply well-known brands.

Health benefits

Chocolate could ride the trend for nutraceuticals. Nestlé has already announced plans to invest US\$510m in "pioneering a new industry between food and pharma". Medicinal herbs could be used as an ingredient, or even aspirin. Additional better-for-you ingredients such as super-fruits, nuts and oats may become more common. Additive-free chocolate will become the norm in developed economies. Dark chocolate could increase in popularity as consumers become more aware of its health benefits.

Luxury vs commodity

A growing middle class will continue to propel the luxury market, and will increasingly drive it into mainstream retailers. But this will pose a challenge: although middle class consumers in emerging markets may develop expensive tastes, their disposable income will still be relatively limited. Manufacturers may need to choose between margins and volume, positioning themselves carefully as either a luxury or commodity player.



2030

The personal touch

Bespoke bars may be commonplace. One artisan chocolate maker says he envisages smaller shops offering people the chance to create their own bar. As consumer palates grow more sophisticated, unusual flavors will become the norm, with chocolate-lovers choosing their own combinations. Consumers may also be able to design their own packaging.

New distribution channels

Chocolate will be available from a wider variety of outlets, from coffee shops to health food stores, to cater for convenience buyers. Supermarkets and discount stores will continue to dominate sales, particularly among value customers. Premium chocolate could become available in mainstream stores as luxury buyers proliferate. Brands might seek to move up the value chain by creating their own flagship stores, something Hershey and Mars (through its M&M's brand) have already done successfully.

Middle class rule

Manufacturers are likely to offer more chocolate from ethical sources to meet aspirational buyers' needs. Middle class consumers will also be keen on premium chocolate for gifting purposes, and seasonal launches, which increased 6% during 2011, will continue to grow.



o bar

Fresh flavors

In developed markets, flavors may become increasingly unusual as palates grow more sophisticated and brands seek a marketing boost. Combinations of sweet and savoury (such as bacon and chocolate) will increase, and salt, olive oil, herbs and flowers will all be used as flavorings.

A new recipe

Milk chocolate will have a lower cocoa content due to rising prices, and manufacturers will be forced to use cocoa more sparingly. Demand for cocoa could spiral out of control: one Latin American manufacturer predicts that China and India increasing average per capita consumption by just 1kg could make most manufacturers' current models unsustainable. In that scenario, artificial cocoa could become a viable alternative.

Think small

Rising obesity levels and government regulation will lead to manufacturers limiting portion sizes. Sharing bags of smaller bars will become more popular as people seek to limit the amount eaten in one sitting. Average per capita consumption (currently 8kg in Europe) may drop, although overall consumption is likely to rise as the global middle class mushrooms.

Price vs size

In emerging markets, chocolate takes a hefty bite from the household budget. As input price volatility continues, manufacturers may have to keep value in mind or risk losing consumers. Price per gram is rising fast in developed markets, but research shows consumers feel cheated if bars get smaller but price is static. Mainstream manufacturers could be forced to choose between containing cost, at the expense of size, and moving further up the value chain.

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KPMG is organized by industry sectors across our member firms. The Consumer Markets practice, which encompasses the Food, Drink and Consumer Goods and Retail sectors, comprises an international network of professionals with deep industry experience.

This industry-focused network enables KPMG member firm professionals to provide consistent services and thought leadership to our clients globally, while maintaining a strong knowledge of local issues and markets.

It's clear the chocolate market is shifting rapidly, and presents a range of challenges and opportunities. To discuss any of the issues raised in this report, please get in touch.

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