POD FOODS

STATE OF GROCERY 2022

— Navigating the new world

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Introduction

As the world attempts to regain its footing from the lockdowns over the previous 2 years, new challenges in 2022 and going into 2023 continue to shake the grocery industry.

In 2020 and 2021, we suggested that the post-pandemic industry would look different from the past. While COVID-19 proved to be an undeniable force for change, this year presented even more global events that continue to shape the trajectory of our industry.

Driving change throughout everything are new consumer expectations, which are forcing retailers and brands to continue to adapt their offerings. Beyond online shopping and fast delivery, consumers demand a personalized, curated assortment at the right price, place, and time. Emerging brands, now a staple in every forward-thinking retail store, continue to gain market share with 51% of global consumers buying a greater variety of brands today versus pre-COVID.[1] Private label products also continue to grow, and "big food" is investing in new products to compete.

Meanwhile, as optimism fades due to global conflict, a slowdown in the public markets, rising interest rates, and inflation, capital is at its most expensive in years. Venture resources for unprofitable "innovation" are drying up. Quick delivery solutions that raised billions in 2021 disappeared in 2022 largely due to their high-burn business models with no path to profitability.

Venture resources are also becoming increasingly limited for many CPG brands that have been responsible for innovation on the shelf. Expensive online ads combined with lack of transparency and visibility into wholesale sales velocity, trade spend, inventory, markups and distributor deductions negatively impact CPG margins and make it difficult for brands to self-sustain. As a result, these brands are made vulnerable to the uncertainty and volatility associated with macroeconomic market fluctuations, since they are reliant on external capital.

Retailers that identify sustainable, transparent, and profitable solutions to meet their customers' needs will win. Brands that can self-sustain will too.

This report is meant to shed light on the effects of the macroeconomic situation on the grocery industry as we head into 2023. We will cover innovation, top retail and CPG trends, and the state of the supply chain. Despite the struggles that the upcoming year will bring, the grocery industry is recession-proof and we are confident that the ideas presented in this report can help brands and retailers build towards a stronger future.

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[1] Nielsen IQ, "Brand Balancing Act Report", https://nielseniq.com/wp-content/uploads/sites/4/2022/09/The-2022-Brand-Balancing-Act-Report.pdf

Innovation in The Retail Landscape

The role of venture capital in grocery and CPG innovation

Although it is an essential, age-old industry, grocery and CPG have largely relied on venture capital to fuel "innovation" in the past 10-15 years. Such innovation includes solutions like Instacart and quick delivery retailers (GoPuff, Getir, Gorillas, etc.) as well as a number of CPG brands that have been able to raise money to fund growth and capture market share quickly. At times, these businesses make money – often they do not, and instead, grow at "all costs" in advance of a large exit. As the market continues to decline and uncertainty looms in geopolitics, the industry must adapt to build more economically viable solutions to meet consumer demands.

Consumer demand for Quick Delivery

$18.5 billion in venture capital went into "e-grocery" companies in 2021[2], a direct result of a changed consumer landscape due to COVID. These business models require massive scale and density for unit economics to make sense; labor and delivery costs significantly outweigh revenue from smaller delivery sizes typically associated with the quick-delivery value proposition.

Although many of these businesses imploded in 2022 as external resources dried up, this innovation combined with the pandemic changes have altered consumers' expectations of ecommerce and delivery. Retailers must navigate this new equilibrium and incorporate delivery solutions that meet these consumer needs without assuming a free-flow of capital.

Self-sustaining assortment innovation

In 2021, $20 Billion venture capital dollars went into food startups.[3] It's a startling figure, since with high variable costs, these businesses are not traditionally "venture scalable," and risk failure in pursuit of exponential growth. Regardless, consumer demand for emerging brands continues to grow, and external capital has continued to fund growth in response, pumping money through an archaic distribution and retail system that is not cost effective for emerging CPG. It is not uncommon for brands to have tens of millions in revenue or be iconic, household names and still not be breaking

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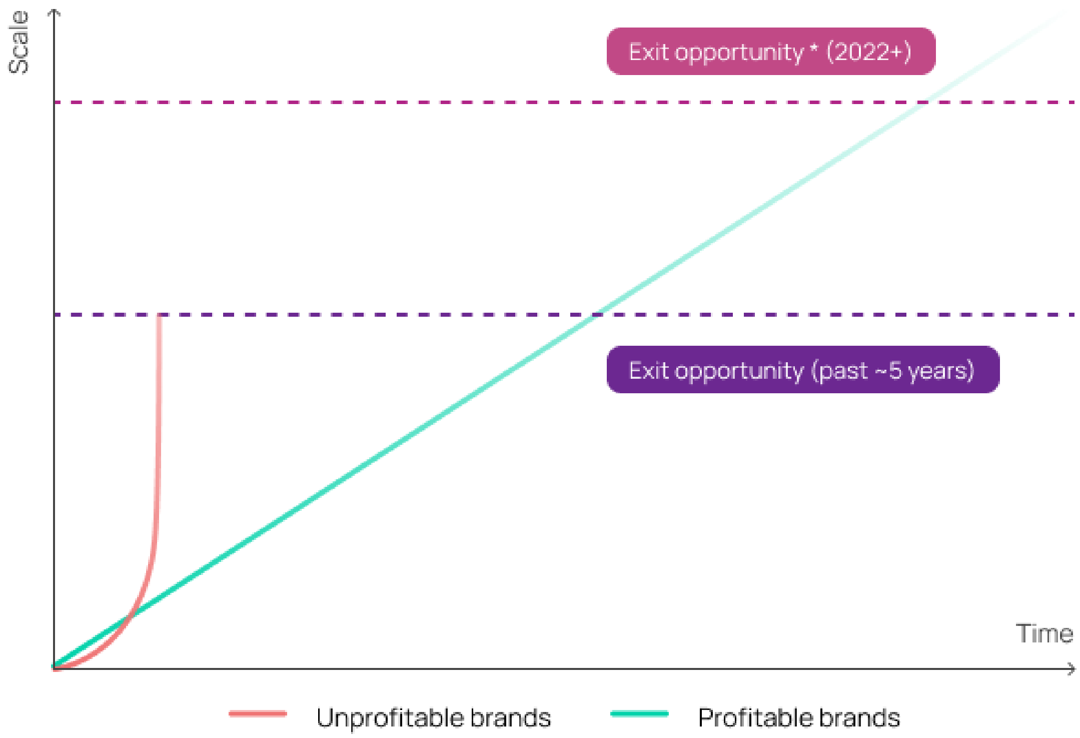
[2] Techcrunch, "The delivery market is coming down from its pandemic highs", https://techcrunch.com/2022/06/03/the-delivery-market-is-coming-down-from-its-pandemic-highs/

[3] CB Insights, "State of Retail Tech Q3 2022", https://www.cbinsights.com/reports/CB-Insights_Retail-Tech-Report-Q3-2022.pdf

even.[4] Deductions, chargebacks, lack of control and transparency, as well as hidden fees from distributors eat into a brand's margin, making them reliant on external capital for growth and survival.

Without as much external capital, brands need to adapt to be more self-sustaining and look to alternative sources of capital to invest in growth. Legacy distributors, which charge steep fees and demand massive volume are no longer the de facto path to success, and brands must take more control over their businesses through visibility and transparency throughout their supply chain and distribution networks.

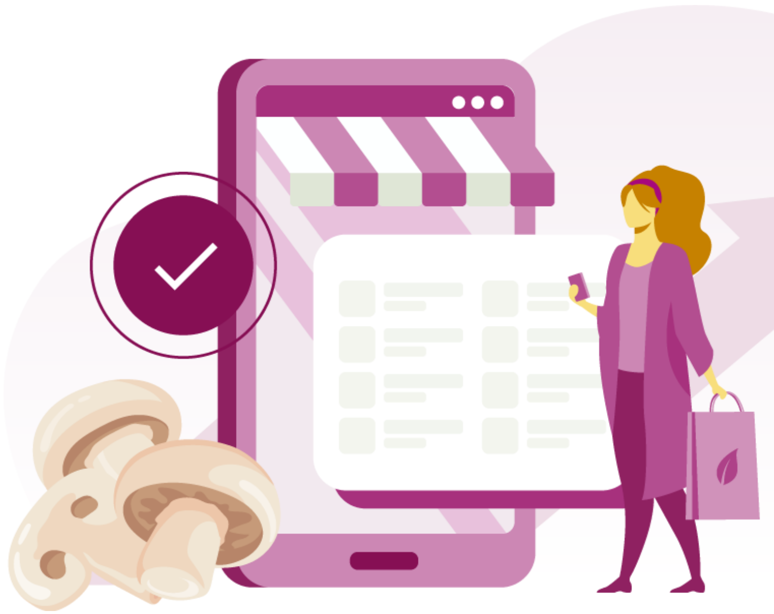


*** Exit opportunities moving forward will depend not only on scale, but on business health.**

In recent years, capital was widely available. Unprofitable brands could afford to scale quickly with little attention to their contribution margins or ebitda profitability. Many enjoyed large exits via M&A or SPAC. Moving forward, there will be new expectations. With more expensive capital, profitable brands will survive. Unprofitable brands risk growing too quickly and running out of money prior to finding a viable exit strategy or additional capital to fuel growth.

[4] New Nutrition, "Is Oatly en route to becoming one of the biggest failures in food industry history?", https://www.new-nutrition.com/nnbBlog/display/148

Innovation in products



The current economic climate yields different opportunities. To stay relevant, retailers must consider emerging-brand specific programs that allow for a competitive assortment and are more affordable than the slow and expensive legacy slotting programs they are used to.

Here are the CPG trends that Pod Foods' data highlights:

Rise in the mushroom market

Mushroom umami was a fascinating trend this year. Products in the sweets category jumped to almost 4-times the demand from last year while the popularity of beverages with mushrooms ballooned 3-times year over year.

The mushroom flavor was a popular choice across several different categories but as a product's main flavor, the mushroom market was not as in-demand. Only 10% of the mushroom-oriented demand was for products that tried to highlight mushroom as the main flavor.

Top 10 summer products included the usual suspects: sodas, hot dogs, ice cream (all were 10X growth over last summer). But 3 of these top 10 products were mushroom-oriented products (e.g. Mushroom powder and various mixes)

Interestingly, the winter top-10 most demanded products were all snacks, such as brownies, dips for chips, and popcorn.

Plant-based

The hype of plant-based meat has been waning over 2022. Beyond Meat and Impossible Foods, leading players in the category, have seen their sales fall for 22 consecutive months[5].

Overall, demand for plant-based products has had a significant deceleration, amounting to only one-third the growth rate from the previous two years. Across the board, we also see that the growth of plant-based products slowed by a greater amount compared to types of products in the same category.

This does not necessarily mean that consumers do not want plant based products. Though not yet indicative of the whole, in the Pod Foods marketplace, adjusted demand for meat-based counterparts remained relatively flat since last year. Indeed, the rise in plant-based products in recent years was partially a result of labeling hype. Some products and categories that could have always been considered plant-based suddenly started to identify as "officially" plant-based, which could have led to some of the increase in reported demand, which is now normalizing.

Like any category or product quality, plant-based products need to find the right price-point in today's economy, and they're likely to continue to win over consumers.

Sustainability

Environmental concerns gain an influence over one of grocery's fastest selling categories, beverage, with retailers seeing a surge in demand for eco-friendly products.

Within the Pod Foods marketplace, it is apparent that there is an increasing focus on recyclable packaging, with demand increasing 10x from last year across all major categories. Biodynamic products grew 15x year over year, and products with affiliation to regenerative agriculture grew 25x.

Consumers are increasingly apt to consider products holistically – not just the ingredients, but the source of packaging, the practices for production, and the supply chain. We anticipate this will be the case even with increased overall price sensitivity.

[5] The New York Times, "Beyond Meat Is Struggling, and the Plant-Based Meat Industry Worries", https://www.nytimes.com/2022/11/21/business/beyond-meat-industry.html?mc_cid=fc188f0224&mc_eid=c7ffe39812

State of CPG - Trends to Navigate and Strategies for Success

1. **Find the right strategy to coexist with private label**

   As data continues to inform retailers of consumer preferences for innovation and quality, private label brands have been strong contenders against branded CPG companies, with retailers like Whole Foods (365), Kroger (Simple Truth) and Publix (Greenwise) coming up with their own lines of better-for-you products. Private label is no longer limited to retailers with massive manufacturing capacity or purchasing power – smaller retail chains like Erewhon and Foxtrot are investing in these products as well, and leveraging smaller manufacturers.

   Especially in the face of inflationary pressures, private label brands have been steadily increasing in market share, making up 19.6% unit share of all groceries sold.[6] While not every category has seen the same exponential growth, turning to private label products to increase margins is one of the main strategies for retailers to claw back margins lost trying to keep products price competitive on the shelf.

   Emerging brands can navigate price sensitivity by marketing their unique story and value, and keeping their costs as low as possible. Another option is to invest in private label by acting as the manufacturer for retailers' private label products. While this may cannibalize their branded business, it can also serve as a profitable and consistent revenue stream.

2. **Drive sustainable and profitable growth**

   As venture dollars become more scarce for CPG, brands must prepare for long term uncertainty in the capital markets with slower and more sustainable growth. It is imperative to generate returns with every dollar and find "product market fit" in order to build a sustainable business that gets to net profitability as quickly as possible. With the public markets still in flux, adjustments to valuations, increased cost of capital, and reduced availability of funding in the private markets should be expected.

   Brands should consider alternative sources of funding such as short-term loans, PO financing, and other cash flow solutions. With rising interest rates, it is in a brand's best

[6] Forbes, "Why Private Label Brands Are Having Their Moment", https://www.forbes.com/sites/errolschweizer/2022/06/30/why-store-brands-are-having-their-moment/?sh=91271bf38bf6

interest to understand their margin structure for more predictable outcomes and to decrease reliance on non-revenue driven growth. Visibility and transparency into unit economics both wholesale and direct to consumer channels are essential.

3. Take a "Phygital" approach

While brands traditionally invest in physical retail to increase consumer awareness, the most successful brands today invest in building a fan following before finding themselves on store shelves. A targeted digital media strategy combined with high growth ecommerce sales packs a powerful punch to launch into wholesale distribution, driving the shelf velocity that retailers very much value. From there, investment in digital marketing should continue in a targeted fashion to increase turn rates in-store and attract the right shoppers into retail.

To execute a successful "phygital" strategy, synthesized, real time data is essential to provide the speed and transparency for marketing teams to act on. Identifying who the customers are, not only online, but also in store is a fundamental first step that lays the groundwork for successful marketing campaigns that reach customers where they are and in the way they want to be reached. To do this, brands must at least have access to which retailers they are selling products into (in addition to ecommerce analytics). The ability to combine such physical retail data with ecommerce trends in real-time allows for the most effective marketing strategy to drive more conversion and healthy unit economics both online and offline.

4. Develop the right retail strategy

Despite an increasingly competitive CPG landscape, opportunities continue to arise for emerging brands. Recent news about an Albertson's/Kroger merger in progress will create alliances in the grocery world forcing independent and regional retailers to band together for better pricing from suppliers and to compete even more on assortment. Local and emerging brands are in greater demand today than ever before as innovation continues to present itself as the number one factor in the competition for consumer wallet share.

The proliferation of emerging brands driven by the continued rise in demand leads to strong competition for retail shelf space. Winning the sale is only half the battle won. To keep their place on the shelf, brands must ensure that they keep up with inventory needs or risk losing their shelf space to another competitor. A consistent fill rate of 90% is expected to ensure that the brand remains on the Approved Product List (APL) of the distributor and retailer.

State of Supply Chain

While many consider the pandemic to be behind us, the impacts are still lingering and continue to impact the global supply chain. However, there is cautious optimism that we're achieving some stability as we adjust ourselves to the new world.

Warehouse capacity

It is largely expected that warehouse and fulfillment capacity will remain constrained throughout the near terms. Rising inventory levels are driving the demand for storage capacity. However as companies begin to aggressively manage the reduction of inventory, vacancy rates amongst warehouses should increase. Based on a report from real estate services firm Cushman & Wakefield, vacancy rates in the third quarter in 2022 were 3.2%, up from 3% in the previous quarter.[7] This represented the first increase in the last 2 years; however, it is still well below the 5% average in 2020. Refrigerated and frozen storage capacity remains highly constrained and expected to remain that way in the near term.

Labor

According to the U.S. Bureau of Labor Statistics, there are 425K vacant warehousing and transportation positions.[8] With high turnover rates, increased competition for qualified labor, and expected demand increases for labor, this is one area that appears to be a challenge for the foreseeable future. With continued focus and innovation around warehouse automation, this may provide relief; however not until these new methods become cost effective and scalable.

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[7] Supply Chain Quarterly, "Warehouse rents to climb through end of 2023, Cushman and Wakefield says", https://www.supplychainquarterly.com/articles/5900-warehouse-rents-to-climb-through-end-of-2023-cushman-and-wakefield-says

[8] MH&L News, "Hidden Costs of Warehouse Labor", https://www.mhlnews.com/technology-automation/article/21253288/making-the-business-case-for-supply-chain-automation

Inventory Levels

Perhaps the eventual outcome of high inventory levels was predictable, but it was unpredictable to determine just when this would occur. The pandemic demand spikes eventually subsided, but the lag in adjusting procurement patterns has created record high inventory levels. Retailers like Walmart and Target have canceled billions of dollars of purchase orders to help alleviate excess inventory levels[9] – this holiday shopping season may set all time records and consumers can capitalize on great deals.

Shipping and Transportation

Transportation has experienced shortages for quite some time now and the pandemic only made it worse, but there's hope. In September 2021, the cost to ship a container across the Pacific Ocean was over $20K; now it's under $3K.[10] With companies mitigating rising inventory levels, naturally the demand is falling. Additionally, ports have been able to catch up from the significant backlogs that existed earlier in the year. Domestically, high demand and rising fuel costs have kept the cost of freight high.

Inflation

Perhaps the most commonly used word of 2022; Inflation has been a part of the headlines throughout the year. Many factors can drive inflation, from increased demand, currency valuations, rising costs, the pain is felt when consumers realize it in witnessing higher prices. The supply chain challenges discussed have impacted inflation; however once again, there is a sense of cautious optimism that high inflation is now retreating. Regardless of when it returns to normalcy, inflation has challenged key decision makers to make strategic decisions around inventory levels, amount of SKUs to produce, and rising prices to protect profitability to name a few.[11] The key question is when inflation reverts back to norms, how quickly will these decisions be reversed.

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[9] Retail Wire, "Walmart and other retailers are canceling billions of dollars in orders", https://retailwire.com/discussion/walmart-and-other-retailers-are-canceling-billions-of-dollars-in-orders/

[10] The Washington Post, "Ocean freight rates are down, so why aren't prices on shelves dropping?", https://www.washingtonpost.com/business/2022/10/17/holiday-shopping-ocean-freight-rate/

[11] Forbes, "Top Supply Chain Trends Heading Into 2023", https://www.forbes.com/sites/stevebanker/2022/11/02/top-supply-chain-trends-heading-into-2023/?sh=158e915055e2

Raising Venture Capital in this Environment

While capital is more expensive and scarce, it is not all gone. We interviewed a number of prominent CPG investors and advisors including XRC Labs, Barrel Ventures, TIG Brands, Boulder Food Group, and Powerplant Ventures. If you are a brand looking for capital, here are the big takeaways:

1. **The industry is recession proof, but it's not inflation proof – it's still possible to raise money, but you need to make sure you know who your customers are and be more targeted**

   Reduced spending power means people will be turning towards private label and away from brand names, at least to a certain extent. That doesn't mean there is no spending power for emerging brands, but it is increasingly important for brands to know who their customers are. Fewer individuals will have capacity to try new products and dip in and out of a given customer base.

   Because of lack of transparency in traditional distribution, many brands still only have a vague idea of who their customers are, especially in retail. It's important to get a clearer picture so that any online ad spend or in-store trade spend is targeted and provides clear returns. Investors want to invest in something that's already working, and less in costly customer discovery.

2. **Margins matter more than they ever did – so understand how much money you're actually earning with every transaction**

   "The Natural Products industry has attracted a lot of capital over the last decade," said Ben Fenton from Boulder Food Group, "most of which favored growth over fundamentals and profitability, at valuations that were very inflated." Nate Cooper from Barrel Ventures shared the sentiment: "Founders should try to build their business as close to profitability as possible, because the old days of doing 50-100m in sales and not being profitable is over – money is not free."

   It's not just about gross margins, it's about understanding trade spend. Elliot Begoun from TIG brands mentioned that too often, brands have disregarded contribution margin in an effort to achieve scale as quickly as possible. It's a fallacy to believe that costs will magically go down in accordance with that scale – on the contrary, scale often exacerbates things. Brands should have control of their margins as they grow, which requires transparency from partners.

   Target margins depend on category but it is widely accepted that 40-50% gross margins are generally considered healthy, and contribution margins should be positive.

3. **M&A activity will slow down – so build a business that can self-sustain**

   Beyond gross margin, companies should target *net* profitability to avoid reliance on external sources of capital in advance of an exit. "We will still see M&A activity," mentioned Fenton, "but I anticipate it slowing down materially. Large CPG's cost of capital has gotten more expensive, which has implications for their ability to do deals and to stretch valuation-wise. There will always be exceptions, but the bar for acquisition, from a size and profitability standpoint, will likely go up."

4. **Even though margin expectations are higher than they ever were, VC's largely want to see the same growth – (so, again, build a business that can self-sustain)**

   Despite increased scrutiny on margin health, no investor said they adjusted their expectations for how quickly companies should be growing.

   "We believe that exceptional brands will still enjoy exceptional growth, even as capital gets tighter," said George Birman from Powerplant Ventures. "As the air gets thinner so to speak, there will be some natural divergence between those businesses that can continue to scale the mountain and those that are increasingly out of breath..."

   It makes sense. The irony is that with healthy margins and high growth, any company's need for outside investment (especially dilutive capital) decreases drastically. We think it is a good thing – good for our industry, good for small business owners, and good for consumers. We also think it is possible – with the right fundamental infrastructure in place to sustain the industry.

About Pod Foods

Pod Foods is a logistics and technology enabled B2B marketplace, connecting brands directly with retailers and built for the new era of grocery. We work with growing brands of all sizes as well as grocery retailers, including both traditional retailers and online delivery solutions.

Find out how we can help you grow:

Unparalleled Assortment of Products - Our unique business model allows us to support the most in-demand, latest-and-greatest brands and products that incumbent distributors cannot carry. We can also support established brands with full-service distribution, or forage for products that fit each store's specific needs.

Consolidated Order Fulfillment - Our proprietary, software-first, end-to-end logistics enablement helps retailers get products faster, in one delivery. Brands can grow their businesses and access the infrastructure needed to scale affordably.

Transparency and Data - Full and free transparency into order and inventory management. Our matching capabilities and supply chain are data-driven, and customers can access real- time sales insights through the platform and mobile app.

Support and Resources to Grow - We have aligned incentives with our brands and retailers, and we are customer-service oriented. No hidden fees, no opaque practices. Grow with a dedicated account manager and the support of our team.

Visit https://podfoods.co/ or contact hi@podfoods.co for more information.