Q&A: The F&F Industry Through 2019

Industry analyst Pauline Tung on the rise of Asia-Pacific markets, the strength of the flavor segment, future M&A activity, and strategies for future success

Based on the general tenor of flavor and fragrance industry financials through the first half of the year, it appears that the industry will have a relatively strong 2010. Such impressions are comforting amidst the general murmur of double-dip recessions and weakness in the wider job and housing markets. So, too, is a new report from The Freedonia Group (*www.freedonia.com*), which forecasts 4.3% annual increases in the flavor and fragrance market (flavor and fragrance blends, essential oils, natural extracts, and aroma chemicals), which is expected to total $23.5 billion in 2014 and $29.1 billion by 2019. For comparison, Freedonia notes that the market in 2009 totaled $19 billion.

The report's authors anticipate accelerating growth in all geographic regions, excepting North America, which will slow from 4.1% growth/year (2004–2009) to 3.4% growth/year (2009–2014; **see T-1** on Page 32). The fastest rate of growth is expected in the Asia-Pacific region (5.3%), led by China and India, which are increasingly served by multinational producers. By 2014 this growth will push the region's market size to the number two spot, below North America, but above Western Europe. Countries/regions set to experience increasing growth rates include Canada and Mexico, Western Europe, Asia-Pacific Other (not including China and Japan), Central and South America, and Africa/Middle East.

At the same time, the report notes that the industry is "highly concentrated," with the top four companies accounting for 53% of total sales, and the next six largest organizations accounting for 19% of total sales. It is all but assured that this stable of top companies will further consolidate resources and market share.

Market Opportunities

What's fueling growth? Aside from gains in the developing world and predicted increases in personal income around the world, the Freedonia report notes that flavors—which accounted for 47% of 2009 aggregate demand—will lead, driven by food and beverage processing activity, including convenience foods, snacks, soft drinks, candy and confectioneries, meat and seafood products, sauces, and condiments. Foods and beverages containing functional ingredients such as vitamins and antioxidants will require both higher flavor loads and new flavor technologies to mask off tastes.

Meanwhile, fragranced cosmetics and toiletries will move into markets beyond North America and Western Europe, even as categories such as detergents will face the challenge of maturity. Overall, the report points out, "fragrances will continue to play an important role in product differentiation in the toiletry and cleaner segment, supporting demand for fragrance blends and aroma chemicals in related products." The booming skin care industry around the world will drive further growth opportunities, particularly for aging consumers seeking antiaging solutions.

On the other hand, a recent report from Euromonitor ("Reigniting Growth in the Fragrance Industry"; *www.euromonitor.com*) underscores issues facing the fine fragrance segment: "Two divergent trends have emerged in fragrances: diversification in response to trading down/lower demand to spur further interest; and drive for exclusive scents in response to oversaturation and demand for niche, tailored individual fragrances." The report goes on to note that mature market sales growth dipped to less than 4% in 2009 as consumers put off premium purchases. During the period, even the previously expanding Eastern European market suffered. Mass brands were relatively healthier, led by Latin American markets such as Venezuela, Brazil and Argentina, which actually increased fragrance spending in 2009. The overall loss of sales, paired with shrinking marketing budgets, according to Euromonitor, has led to a continued reliance on celebrity and flanker launches through 2010. Looking ahead, the Euromonitor report predicts that the Latin American and Eastern European markets will surpass those of Western Europe and North America by 2014.

Q&A: Pauline Tung

Recently, we asked Pauline Tung, industry analyst at The Freedonia Group, to discuss these and other forces that will reshape the flavor and fragrance industry and markets through 2019.

P&F: The Freedonia flavor and fragrance industry report predicts growth over the next few years. What effect, if any, will the economy have on growth? How would you compare its health relative to other industries?

Tung: The global flavor and fragrance industry is influenced by an array of variables, including the health of the world economy in general. In particular, growth in demand for flavors and fragrances is most closely related to the production of consumer nondurable goods, such as food and beverages, cosmetics and toiletries, and detergents and cleaners. Therefore, growth in these major end-user industries will support demand for flavors and fragrances as a matter of course.

The recent global economic slowdown will have a short-term impact on flavor and fragrance demand, but our forecasts cover a longer term (to 2014). Overall, compared to other industries, the health of the global flavor and fragrance industry is expected to be better than average.

P&F: Can you break out some general figures on market size?

Tung: In 2009, world demand for flavors and fragrances totaled $19 billion, with flavor blends accounting for 40% of the total; fragrance blends, for 34%; essential oils and natural extracts, for 14%; and aroma chemicals, for 12%.

P&F: What factors are boosting the overall market?

Tung: Overall advances will be stimulated by gains in food and beverage processing activity, which is the largest market segment. Growth in personal income levels and consumer spending will also boost demand for flavors and fragrances used in cosmetics and toiletries, a market segment historically concentrated in North America and Western Europe, but now seeing rapid advances in developing regions.

P&F: Conversely, what factors are going to hamper growth?

Tung: In developed countries, market maturity and below-average growth in key end-user industries such as food and beverages (e.g., carbonated soft drinks), combined with below-average population growth, will serve to limit demand for flavors and fragrances. Long-term declining trends in the tobacco industry will also hamper growth for flavors used in tobacco products.

P&F: What categories will fare the best?

Tung: Among the various product types, fragrance blends are expected to see the fastest gains. The most rapid increases are expected in the Asia-Pacific region, where growth in personal income levels and in the personal care industry is fueling demand for fragrance blends used in cosmetic and toiletry products. Good growth is also expected in other developing regions—i.e., Central and South America, Eastern Europe, and the Africa/Middle East region—which will benefit from foreign investment by large multinational producers of personal care and household cleaning products. The largest regional markets for fragrance blends will remain North America and Western Europe. In these developed regions, demand for fragrances is benefiting from interest in cosmeceutical and/or antiaging formulations as well as products with natural ingredients or those which provide aromatherapy benefits.

P&F: Which categories will fare less well?

Tung: Among the various product types, aroma chemicals are expected to see the slowest gains. Value growth will continue to be held down by a competitive pricing environment. This has resulted from several factors, including pressure from cost-conscious end users, the entry of large commodity chemical companies into this segment, and increasing exports of less expensive products from developing countries such as China and India. Pricing pressure has been particularly apparent in the industrial sector (detergents and cleaners), with less impact in fine fragrance applications. Still, gains in fine fragrances will continue to be restrained by a shift in consumer interest from prestige perfumes to less expensive body sprays and other alternatives incorporating less expensive fragrance materials or lower concentrations of high-value ingredients.

P&F: Can you elaborate on the factors boosting growth in Asia-Pacific?

Tung: Demand for flavors and fragrances in the Asia-Pacific region will be boosted by particularly strong gains in China and India. Due to their large populations, these two countries also have some of the lowest per capita consumption of flavors and fragrances, with considerable opportunities for growth.

Food and beverage processing in the Asia-Pacific region will continue to grow well above the world average rate, reflecting the rapid economic development forecast for several Asian countries, especially China and India. The region will also continue to account for the largest share by far of global food and beverage output, offering good opportunities for flavor producers.

Production of toiletries and cleaners in the Asia-Pacific region will also see above-average growth rates, boosting demand for fragrances. For instance, large multinational companies such as L'Oreal and Proctor & Gamble continue to expand their operations in the region. The largest toiletry and cleaner industries in the region will continue to be found in China, India and Japan, though Japan's output will not grow as fast as the rest of the Asia-Pacific regions, due to maturity and strong competition from countries with lower production costs.

P&F: The rise of Asia-Pacific reflects the growing importance of developing markets for CPG companies and, by extension, their suppliers; what effects will this have on the market? How will it change the types of flavor and fragrance solutions requested by customers?

World flavor and fragrance demand (million dollars)				T-1
Region	**2014**	**2019**	**Annual Growth 2004–2009**	**Annual Growth 2009–2014**
Global	**23,450**	**29,100**	**4.1%**	**4.3%**
North America	**6,610**	**7,830**	**4.1%**	**3.4%**
United States	5,500	6,400	4.0%	3.0%
Canada and Mexico	1,110	1,430	4.6%	5.5%
Western Europe	**6,410**	**7,740**	**3.0%**	**3.8%**
Asia-Pacific	**6,480**	**8,460**	**4.9%**	**5.3%**
China	1,330	1,900	12.0%	8.6%
Japan	1,990	2,210	1.6%	1.4%
Other (Asia-Pacific)	3,160	4,350	5.5%	6.8%
Other Regions	**3,950**	**5,070**	**5.0%**	**5.1%**
Central and South America	1,580	2,000	4.9%	5.1%
Eastern Europe	1,170	1,520	5.3%	4.7%
Africa/Middle East	1,200	1,550	5.0%	5.5%

Source: The Freedonia Group Inc.

Tung: Let's consider food and beverage processing, which will remain the largest application for flavors in the Asia-Pacific region. Growth in this sector will benefit from the popularity of soft drinks, snacks and other convenience foods, as well as a general trend toward the production and consumption of more highly processed foods. However, there is considerable variation among nations in terms of applications and flavor preferences. Countries such as Australia, Hong Kong, Singapore and Taiwan have relatively cosmopolitan markets. As a result, growth in these countries is being driven by a rising demand for convenient and healthy foods, boosting sales of high-value flavors, including natural products. In lesser developed countries, demand is strong for most processed foods, an outgrowth of increasing urbanization, rising per capita incomes and exposure to Western-style products.

P&F: Do these numbers tell you anything about the future of consolidation? Or about the rise of a regional flavor and fragrance leader outside of developed markets?

Tung: As large consumer product companies continue the trend toward globalization, the flavor and fragrance market has come to be increasingly dominated by high-volume purchasers desiring suppliers who can provide a range of flavors and fragrances on a global basis. While many acquisitions have already occurred, the presence of small and midsized flavor and fragrance companies specializing in niche markets affords plenty of opportunity for continued merger and acquisition activity at all levels. These smaller companies typically lack the financial resources and geographic presence necessary to bring their products to market on a global scale, and thereby represent prime targets for acquisition.

P&F: What role will Latin America play in the growth of the flavor and fragrance market?

Tung: In our report, Latin America encompasses Central and South America, and Mexico. In general, flavor and fragrance sales in Central and South America will continue to benefit from investment by large international consumer product companies and from growing per capita incomes for consumers, which are boosting demand for higher value foods and consumer goods. Through 2014, demand for flavors and fragrances in Central and South America is forecast to increase 5.1% per annum, above the world average. Advances will be led by countries such as Argentina, Brazil and Chile, while demand will also grow quickly in the smaller countries of Central America, aided by growth in food and beverage processing industries. However, in many of these smaller markets, most requirements for other consumer goods are largely met by imports and this will limit growth in applications such as cosmetics and toiletries.

Demand for flavors and fragrances in Mexico is forecast to increase 6.4% through 2014. This represents a notable acceleration from the pace of the 2004–2009 period (which was negatively affected by the global economic slowdown in 2008 and 2009). Healthy gains are expected in all major product segments, fueled by increases in output in important end-user industries (e.g., food and beverage processing), combined with rising levels of personal consumption expenditures.

P&F: What will it take for flavor and fragrance companies to survive and thrive moving forward?

Tung: In order to be successful in the global flavor and fragrance industry, a company will most likely employ competitive strategies that will allow it to capitalize on downstream trends in a timely fashion and encourage brand loyalty. Such strategies include product differentiation, market segmentation and the formation of strategic partnerships through cooperative agreements. Furthermore, flavor and fragrance materials typically represent only a small portion of the cost of a consumer product, whether it is a laundry detergent or a perfume. Price, therefore, is often a less significant determinant in selection of a supplier than are overall product quality, performance and customer service. As large consumer companies continue the trend toward consolidation and rationalization of product offerings, the flavor and fragrance market is increasingly dominated by high-volume purchasers desiring products tailored to the needs of their particular markets.

P&F: What does the forecast say about what the market might do post-2014?

Tung: Our ten-year forecast is similar to the five-year forecast. Global demand for flavors and fragrance is expected to grow 4.3% per annum through 2014, and 4.4% per annum between 2014 and 2019. p&f