Executive Insights

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The 'Wrap' on Pouches: Opportunities in Flexible Pouch Packaging

Two compelling phenomena are occurring simultaneously in flexible pouch packaging, a darling segment of the packaging market. And this confluence of factors is rapidly changing the pouch provider landscape (e.g., film producers and pouch converters), creating various pockets of opportunity for investors, converters, brand owners and upstream value chain participants alike to "play" in the flexible-pouch-packaging value chain.

First, as brand owners vie for consumers amid an increasingly competitive retail shelf, they are upping their product differentiation game by increasing the complexity of pouch packaging — employing features such as spouts, specialized barrier films and the ability to stand upright, to name a few. Second, pouch-making run lengths are shortening thanks to two drivers: an explosion in the number of stock keeping units (SKUs) and continued market gains by Tier 2 brands — which typically require shorter runs — over large, global Tier 1 brands. These combined dynamics of increasing complexity and decreasing run lengths are creating a recipe for abundant returns.

In this *Executive Insights*, we examine the two undercurrents running through the high-complexity pouch-making market right now and how they are expected to affect the future success of three key pouch-packaging players: vertically integrated pouch companies, specialists and the subspecialist "converter's converters." We also provide an analysis of those providers and discuss who is best-positioned and in what part of the pouch-making value chain it makes most sense for them to play.

All pouches are not created equal

Flexible pouch packaging is becoming more intricate as brand owners look to elevate their products' singularity within a sea of competition on store shelves and to accommodate consumers' needs. Pouch packaging runs the gamut of complexity, from the simple, flat pouch of a candy bar to a creatively shaped, childproof and resealable detergent container (see Figure 1).

As the cocktail of a product's packaging features becomes increasingly complex, integration by the brand owner becomes trickier and more involved. Therefore, while low-complexity packaging produced via flat pouch form-fill-seal (FFS) technology (e.g., candy bars) is more likely to be in-sourced by brand owners via their co-packer/co-filler network, more complex formats are often outsourced to third-party packaging companies, such as vertically integrated providers, specialists or subspecialists, depending on complexity type, run length and/or value chain activity.

The 'Wrap' on Pouches: Opportunities in Flexible Pouch Packaging was written by **Thilo Henkes,** Managing Director, and **Jeff Cloetingh,** Principal, in L.E.K. Consulting's Paper & Packaging practice.

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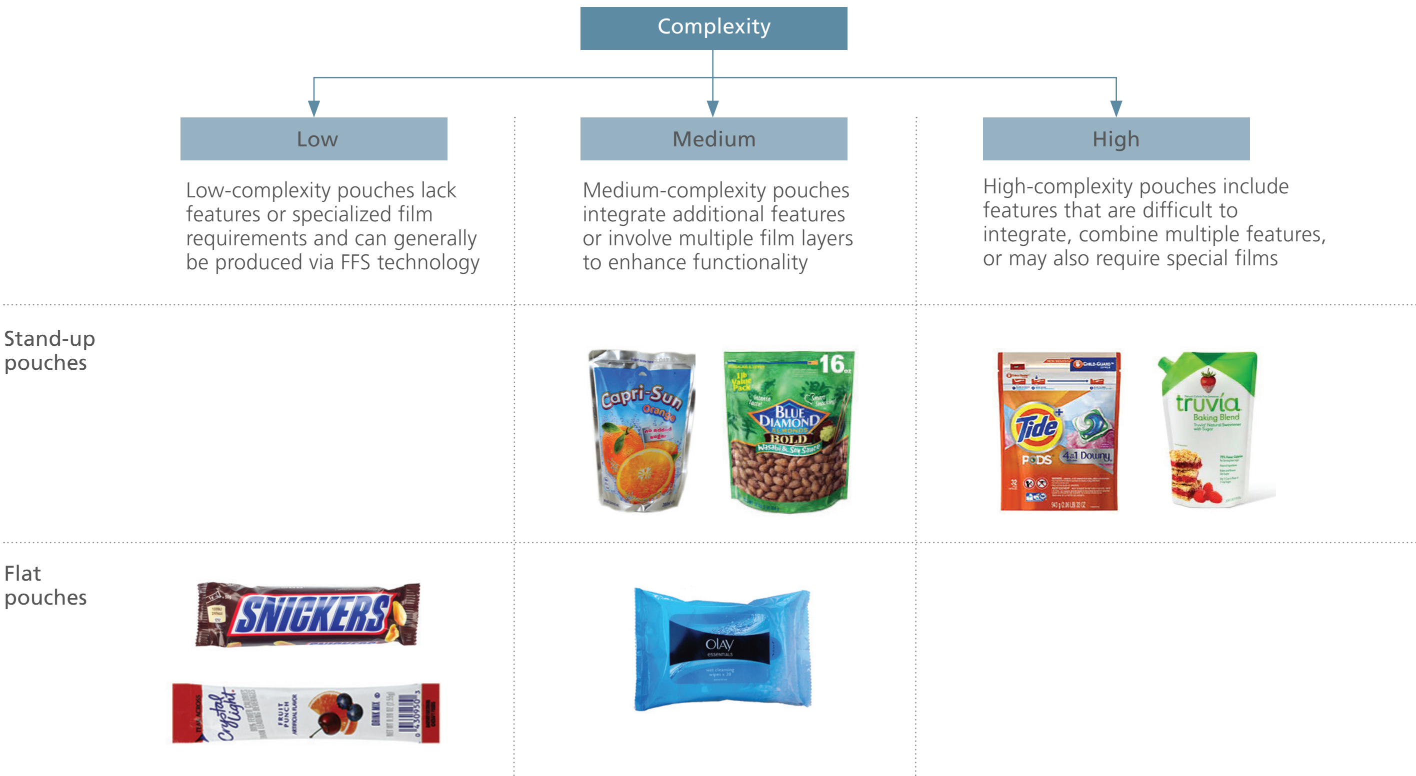
Figure 1
Relative pouch complexity



Source: L.E.K. analysis

For instance, creatively shaped pouches are often harder to fill and seal and require special equipment in which a brand owner cannot justify a capital investment. Or consider aseptic and retort pouches: These are typically used for keeping food fresh (i.e., sterile and safe) and, as a result, feature multilaminate film and require the additional technical competency of a specialist (see Figure 2).

Currently 40-45% of the pouches produced in the U.S. are medium-to-highly complex, and L.E.K. Consulting expects this rate to grow at three to four times the growth rate of the low-complexity segment. But that doesn't tell the entire story: Nearly 65-75% of U.S. pouch packaging's value as a whole is composed of medium-to-complex pouch packaging (see Figure 3). So while more-complex pouch packaging may not hold the lion's share of the market yet, it already retains a tremendous amount of value relative to low-complexity pouches.

Shorter runs may deliver greater returns

In addition to pouch complexity, brand owners continue to increase SKUs to create niche products and more choices for consumers; these are produced in smaller quantities, which are in turn produced in shorter run lengths. Larger brand owners may turn to smaller converters to handle the small-to-medium runs. This is also a sweet spot for pouch-forming specialists, who are nimble and highly efficient within the short-to-medium run length space.

Another trend to keep an eye on: Tier 2 brand owners are gaining share in the market at the expense of Tier 1 brand owners, and these Tier 2 customers are expected to continue gaining market share relative to Tier 1 companies. Short-to-medium run lengths represent the majority of the Tier 2/private-label packaging spend, and as a result, these customers primarily use specialists for pouch making.

If we unpack the numbers, short-to-medium run lengths are growing at two to four times the growth rate of the long-run-length segment (see Figure 4), driven by SKU proliferation, increasing pouch complexity and continued share gains of Tier 2 brands at the expense of Tier 1 brands (see Figure 5). In addition, 85-95% of the value of medium-to-high-complexity pouches is produced within the short-to-medium run segment versus 65-75% for the overall pouch market.

The pouch-packaging playing field

The compounded impact of increasing pouch complexity and shorter run lengths is creating an enticing opportunity for investors, converters, brand owners and upstream value chain participants alike. But who are the pouch-packaging players, and where are they best-positioned to operate on the pouch-making value chain as these market dynamics continue to reshape the pouch-packaging market? With these questions in mind, we see the following providers playing key roles in the pouch value chain for the foreseeable future.

1. Vertically integrated pouch converters. Vertically integrated pouch-packaging converters are widely diversified, participating across all or several of the five major steps of the value chain: film extrusion, printing, lamination, slitting and pouch conversion (see Figure 6). They are typically focused on medium- and longer-length runs, given the large number of individual small runs that would be required to meet their utilization rates.

In this current market, these providers have advantages that other types of pouch-packaging providers do not: They have access to large, global Tier 1 brand owners, and they perform very long runs for these customers. And they have the scale to serve those brand owners with a "farmer" approach — through nurturing client relationships and cultivating customer loyalty.

As Tier 1 brand owners continue to outsource to these vertically integrated converters, however, their challenge is to retain share of wallet in those relationships as SKU fragmentation prevails and Tier 1 brand owners look to outsource specialty or pre-made pouches; short-to-medium run lengths and/or medium-to-high-complexity pouches can be more challenging for these vertically integrated pouch converters to service relative to specialists and subspecialists. Vertically integrated converters must be aware of where the complex pouch-making market is going and be prepared to meet a rapidly transforming landscape head-on.

Figure 2
Pouch complexity index

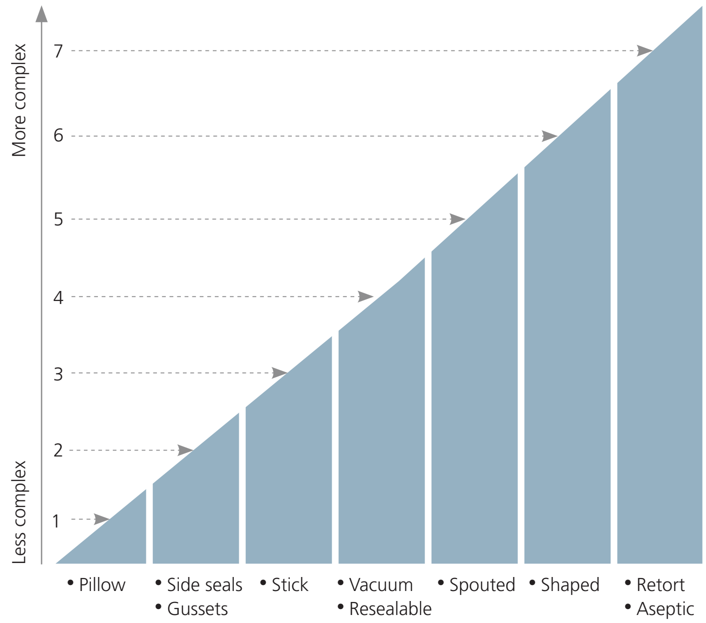
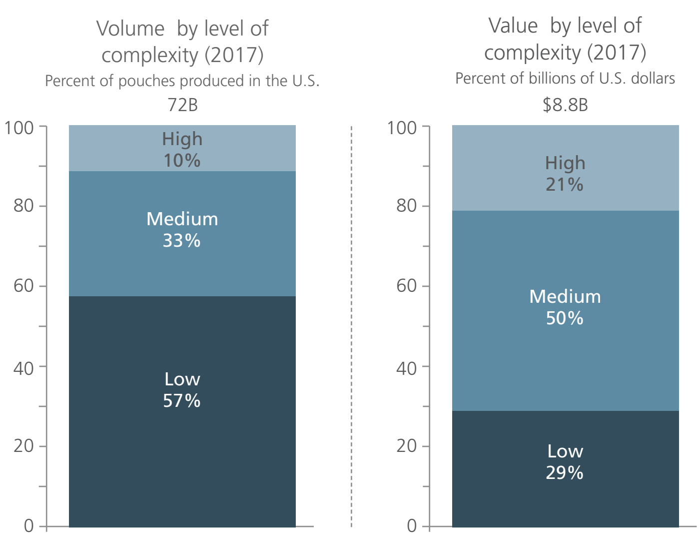
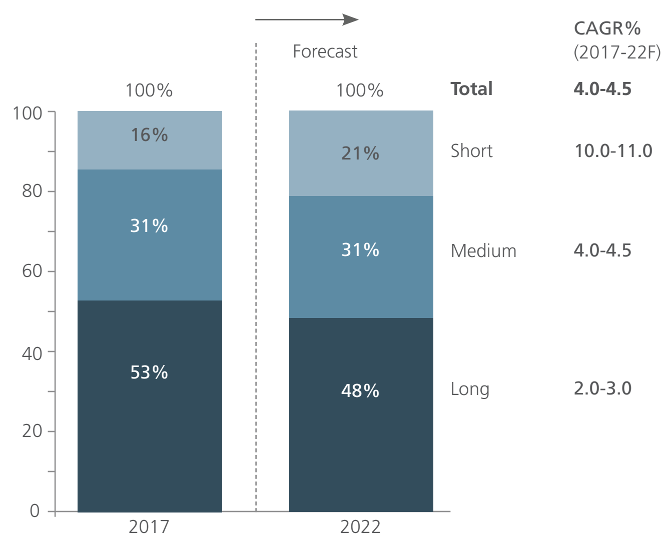


Figure 3
U.S. flexible pouch packaging by level of complexity



Source: L.E.K. interviews and analysis

Figure 4
Pouch conversion sales by run lengths (2017-22F)



Note: A short run is defined as one with fewer than 30,000 units per run, a medium run is between 30,000 and 150,000 units, and a long run is over 150,000 units
Source: L.E.K. interviews and analysis

2. Specialists. As their name implies, specialists focus their energy on a specific activity in the value chain (see Figure 6). They tend to be small-to-midsize flexible packaging companies, some of which may even specialize in pouch conversion (e.g., pre-made pouch-forming specialists). Operationally built for short and medium-size runs, they excel in efficiency — increasing speeds, reducing waste and facilitating quick changeovers, among other factors. This makes them an ideal partner for brand owners in the growing Tier 2 space, who demand short-to-medium-length runs.

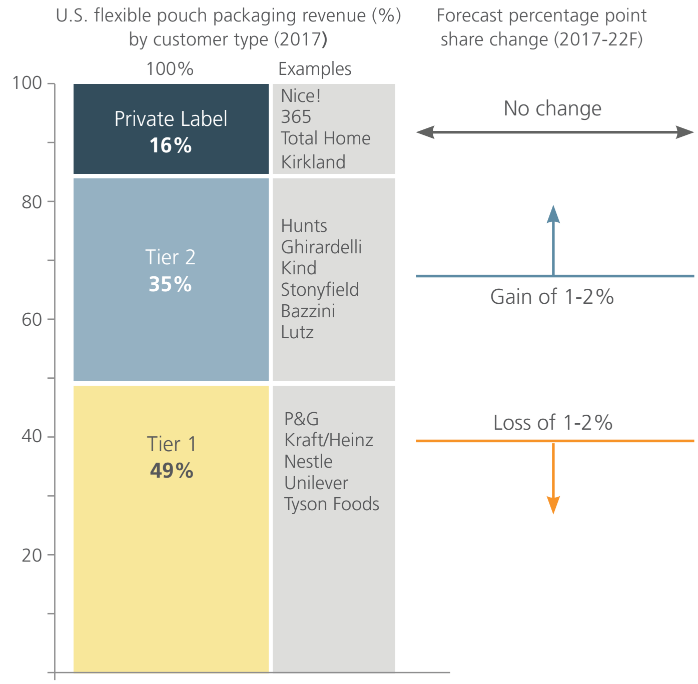
Several characteristics set specialists apart from other pouch-packaging providers. While nimble in their operations, they also take the same tack regarding sales, using a "hunter" methodology when acquiring new Tier 2/private-label brand owners. In addition, they are focused on specific end markets and are typically in geographical proximity to their customers.

Specialists are challenged, however, in their ability to provide a comprehensive suite of products to customers. This is critical to certain customers, particularly larger ones (e.g., the pet food end market).

3. "Converter's converter." A subset of specialists has created a market niche as a "converter's converter," particularly in the pouch conversion activity on the value chain. In other words, these specialists take on higher-complexity and/or shorter-run projects that vertically integrated pouch players would prefer to outsource for several different reasons:

- Mitigating risk with the brand owner in the event of quality issues
- Alleviating challenges associated with attaining the equipment utilization required for shorter-run, higher-complexity pouches
- Aligning capital expenditures to their most productive activities, given increasing scrutiny on capital return metrics from the investment community, e.g., ROIC (return on invested capital)

Figure 5
Brand owner share dynamics

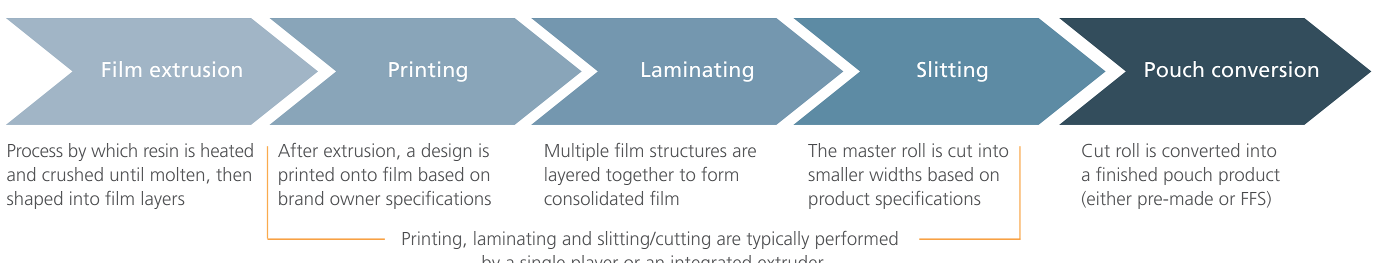


Note: The list of brands above is not exhaustive.
Source: L.E.K. interviews and analysis

Pouch conversion specialists are highly focused on converting pouches — so they are positioned to win and successfully execute on short-to-medium-length runs. And because of the proficiency of technicians operating the machinery, as with other specialists, their changeover times are drastically reduced and output is consistent. What's more, pouch conversion specialists are able to link multiple short-to-medium runs, driving higher utilization rates of their equipment.

Conversely, pouch conversion specialists lack broad geographic scale and product breadth versus vertically integrated players. And while there are a number of practical and financially prudent reasons for Tier 1 brand owners to utilize subspecialists, they must ensure that their value proposition is compelling.

Figure 6
Pouch value-chain activities



Source: L.E.K. interviews and analysis

Profitable ways to play in pouch packaging

Pouch-packaging complexity is expected to increase at a rate of three to four times that of the low-complexity segment between 2017 and 2022 as brand owners vie for more consumers through product differentiation, SKUs become more fragmented and Tier 2 brands continue to poach market share from large Tier 1 brands. And with this increasing complexity, run times will only get shorter — with the segment growing at a rate of two to four times that of the long-run-length segment. This exciting period of growth and transformation is creating an extraordinary opportunity for those who want to play in the complex pouch-making segment. Those players with the best grasp of who is best-positioned to play in what part of the value chain stand to profit the most.

About the Authors

Thilo Henkes is a Managing Director and Partner in L.E.K. Consulting's Boston office and leads the firm's Paper & Packaging practice. Thilo is also active in the firm's Building Products & Materials, Industrial Equipment and Private Equity practices. He joined L.E.K. in 2000 and has more than 17 years of consulting experience specializing in transaction support and developing post-acquisition, value-enhancing strategies for portfolio companies.

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About L.E.K. Consulting

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