2010 Food, Beverage, and Consumer Products Financial Performance Report

Forging Ahead in the New Economy

GMA
The Association of Food, Beverage and Consumer Products Companies

PRICEWATERHOUSECOOPERS

The Grocery Manufacturers Association (GMA) represents the world's leading food, beverage, and consumer products companies. The association promotes sound public policy, champions initiatives that increase productivity and growth, and helps to protect the safety and security of the food supply through scientific excellence. The GMA Board of Directors is comprised of chief executive officers from the association's member companies. The $2.1 trillion food, beverage, and consumer packaged goods industry employs 14 million workers and contributes over $1 trillion in added value to the nation's economy.

For more information, visit the GMA Web site at www.gmaonline.org

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Foreword

The Grocery Manufacturers Association (GMA) and PricewaterhouseCoopers (PwC) are pleased to present our 2010 financial performance report and overview of the consumer packaged goods (CPG) industry.

Most economic indicators suggest that the worst of the recession may be over, but the economy remains weak, with high unemployment, tight consumer spending, and modest sales growth in many industries. CPG companies have felt the full impact of the recession and are being sustained primarily by consumers' desire for value in their food and beverage purchases and by the shift to more in-home meal preparation and less dining out.

Initially, most companies responded to the downturn by containing costs. Today, in addition to pushing for further efficiencies, they are also focusing on how to find new streams of revenue growth. Within the context of this highly uncertain environment, the topical articles in this year's report are divided into three sections: "Raising the Bar on Performance Management," "Spotlight on Regulation," and "Emerging Opportunities at Home and Abroad."

The report begins with the Executive Summary and our primary discussion of the year's financial data. This is followed by our Top-Performing Companies (TPC) analysis, which reveals those characteristics common among companies that showed the best performance in 2009.

We've used a number of sources to compile the information for this report: interviews with senior leadership of GMA members (including members of the GMA CFO Committee), publicly reported company financial data, government statistics, analyst reports, and other published material. The manufacturing analyses are based primarily on public information from 152 manufacturers.

We would especially like to express our appreciation to the following executives, who participated in the interview process and whose insights appear throughout this report:

Humberto (Bert) Alfonso, *The Hershey Company*

Doug Chavez, *Del Monte Foods*

Robert Dixon, *PepsiCo*

Kathleen Edmond, *Best Buy*

Kent McNeil, *Bumble Bee Foods*

Donal Mulligan, *General Mills, Incorporated*

Steve Neil, *Diamond Foods*

Bill Schumacher, *Sunny Delight Beverages Company*

Gordon Stetz, *McCormick & Company*

Duane Still, *The Coca-Cola Company*

Al Williams, *Bush Brothers & Company*

In addition, we want to highlight the extraordinary contributions of PwC team members Elizabeth Burkhart, Sriram Nagarajan, Jonathan Sackstein, and Patrick Yost, who guided the development and refinement of all aspects of this year's report.

We hope that you find the report insightful and useful. The GMA and PwC look forward to continuing our dialogue with you around these strategies, topics, and analyses.

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Executive Summary

Slim Growth at Home, New Opportunities Abroad

The U.S. and world economies are several quarters into recovery after the deepest recession since World War II. The good news for CPG companies is that every major national economy—each a potential CPG marketplace—is growing, some more vigorously than others. World trade is seeing sustained recovery, though it will take time for the global economy to claw its way fully back to prosperity.

Climbing Out of the Economic Foxhole into a New Landscape

After Weathering "The Great Recession," CPG Firms Must Look Beyond Mature North American Markets

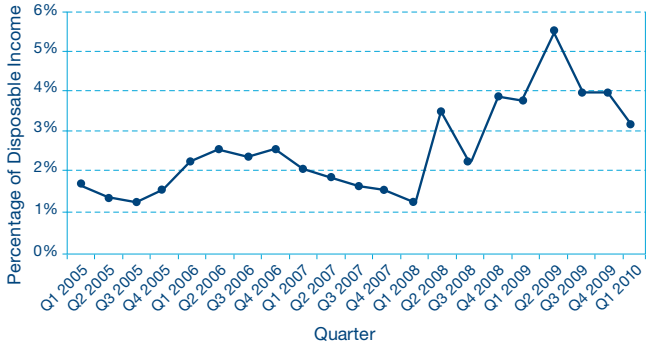
As GMA and PricewaterhouseCoopers release the 2010 Financial Performance Report, *Forging Ahead in the New Economy,* it is clear that the CPG sector, long known for its counter-cyclical resilience, registered consistent, across-the-board performance in 2009.

Equally apparent, though, are the fault lines that have begun to appear in the North American consumer products firmament: decreasing U.S. household purchasing power, increasingly mature markets for core CPG products like soft drinks and snack foods, and splintering media and advertising markets that make CPG brand-building all the more challenging.

Furthermore, the baby boomers—those big spenders who came to the U.S. economy's rescue time and again over the past two decades—are nearing retirement with depleted funds, reduced incomes, and fears of a double-dip recession. As Exhibit 1 shows, personal savings as a percentage of disposable income, while down from its peak of more than 5% in mid-2009, continues to run high by recent historical standards—a healthy development for imminent retirees and some U.S. households, perhaps, but hardly a harbinger of prosperity for CPG companies.

So where to find sales growth? Even as purchasing power in the U.S. stagnates, Asian consumers appear willing and able to open their wallets to an unprecedented degree. Incomes and domestic spending in emerging markets are on the rise, with data showing that consumers in these countries are buying more imported goods. Indeed, one striking irony of the recession is that it accelerated the rise of the middle classes in emerging markets. Savvy U.S. CPG companies have an historic, if perhaps limited window of opportunity to stake their claims in fast-growing emerging markets. We will talk more about those opportunities and possible limits later, but first, let's start closer to home and see how U.S. CPG companies fared against the broader stock indices.

Exhibit 1: Personal Savings as a Percentage of Disposable Income



Source: PricewaterhouseCoopers analysis based on data from the U.S. Bureau of Economic Analysis

CPG Companies Rebound from 2008, but Lose Ground to the Broader Indices

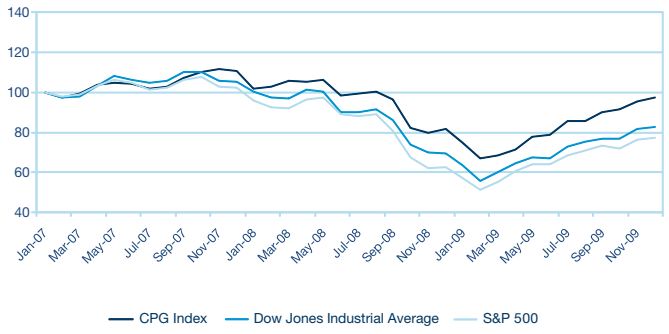
Last year, few CPG management teams would have passed if offered a 12-month shareholder return that would bring back pre-recession market capitalization levels—because they had good reason to expect (as our past reports have noted) that the CPG sector would continue to outperform the broader markets (see Exhibit 2). In 2009, though, that simply wasn't the case. Exhibit 3 illustrates how the CPG Market-Weighted Index—comprised of 103 companies that were actively traded on U.S. stock exchanges throughout 2009, and to which a market-weighted methodology was applied—lagged the S&P 500 by 5 index points, and the Dow by 1 index point.

As it turns out, the CPG industry, with its core mix of food and beverage products and household staples, fits the definition of a counter-cyclical industry to a tee: It doesn't perform as badly as others during recessions, but it balances the scales by lagging during expansions. In the dismal economy of 2008, CPG companies' median shareholder return of negative 25% actually stood out as strong relative to the rest of the market. Conversely, the sector's 2009 median shareholder return of 24.2% constitutes only a modest performance when contrasted with the S&P 500's 27% growth.

The CPG industry's 2009 results may reflect the fact that CPG companies have been adapting to market conditions and sacrificing some short-term growth in order to get their houses in order. Last year's report included a section on "Preparing for the Upturn," and the data we've collected suggests that many CPG companies spent 2009 doing just that: paying down debt, trimming workforces, paring brand and product portfolios, and generally increasing sales per employee.

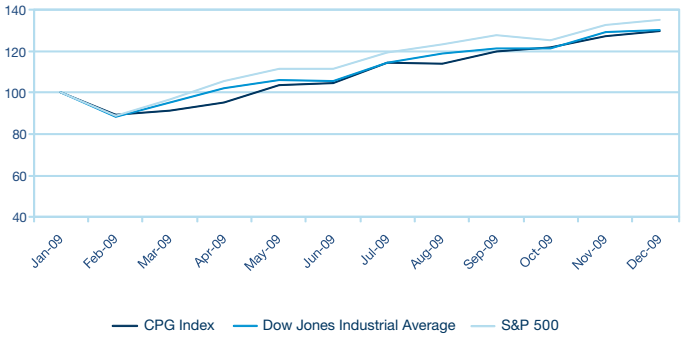
If organizations retooled in 2009 to manage long-term costs, as our interpretation of the financial benchmarking data and our interviews with GMA member executives indicate, many CPG companies are likely to emerge much stronger as we move through 2010. That's a good thing, because they'll need to be stronger to contend with a new North American environment characterized by more cautious, value-driven consumers and fluctuating commodities markets.

Exhibit 2: Three-Year CPG Index, Through December 2009



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Exhibit 3: One-Year CPG Index, Through December 2009



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

A Sector-Wide Sales Slump Doesn't Dent Earnings

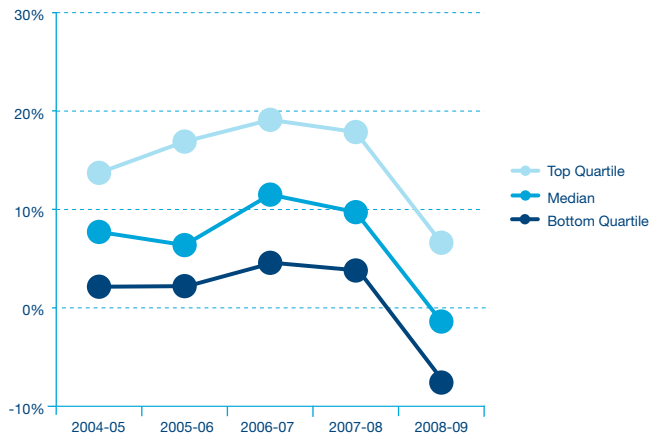
In 2009, CPG companies' median sales growth fell by about 10 percentage points, plummeting to essentially zero growth (see Exhibit 4). Interestingly, median earnings before interest and taxes (EBIT) growth was quite strong (see Exhibit 5), suggesting that, sector-wide, sustainable cost-reduction measures helped conserve cash and strengthen balance sheets. Clearly, consumers are continuing to trade down to lower price points for many staples—a trend that happened in part because sustaining volume was a priority for CPG companies in 2009, as evidenced by falling prices throughout the year.[1]

It's possible that the declining sales growth in 2009 represents a temporary nadir related mostly to the recession, and that ensuing quarters will see marked improvement. Yet we must also consider the structural obstacles to North American CPG sales growth: the graying baby boomer population, more health-conscious consumers, and a potentially long-term higher unemployment rate. If these and other factors usher in a prolonged period of lower net sales growth, then CPG companies must begin asking themselves how they're going to adjust to these new realities. The answer will likely be twofold: a push into emerging markets, and a renewed focus on innovation.

"You can't ignore the growth rates in the emerging markets."

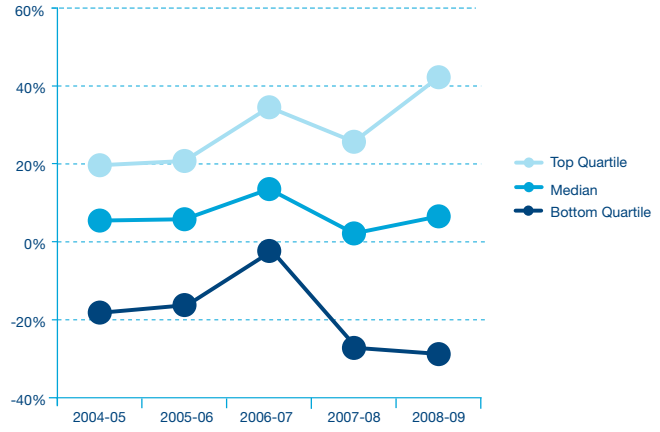
— Gordon Stetz, CFO, McCormick & Company

Exhibit 4: Net Sales Growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Exhibit 5: EBIT Growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

The Urgency of Emerging Markets

When one reads the global macroeconomic data and the anecdotal tea leaves, the verdict seems clear: CPG companies that want to generate above-average growth over the next five years need to expand their footprints in China, Russia, Brazil, India, and Southeast Asia. According to the *World Economic Outlook,* published by the International Monetary Fund (IMF) in April 2010, emerging market economies are expected to grow two to three times faster than developed economies over the next few years.[2] While foreign markets for CPG manufactured goods actually contracted during the recession, the growth opportunities inherent in the growing middle classes in these and other emerging regions should be plentiful as the global economy recovers. As CFO Gordon Stetz of McCormick notes, "You can't ignore the growth rates in the emerging markets. Asia Pacific represents about 7% of our sales outside the U.S., and we want to double that."

Establishing a foothold in emerging markets has taken on a sense of urgency. Capital flows faster than ever and new competitors can ramp up quickly. The middle classes are growing and forming attachments to new brands and products. To keep up with this accelerated change process, product growth cycles in emerging markets have accelerated, and success or failure of a product launch or brand introduction can now be determined in a matter of just 12 or 18 months.

CFO Don Mulligan says it took seven or eight years for his company, General Mills, to realize a profit from its Chinese operations. But that was a different time, when competition for market share in emerging economies wasn't as fierce.

Because it's important to strike quickly, McCormick's Gordon Stetz says that a company must assemble a local country team that's in tune with corporate headquarters and can communicate reliable information: "It's important to get information back that you can trust, monitor, and get clarity on so you can execute well. Emerging economies don't necessarily have all the infrastructure and robustness of reporting and information that we are used to, so you want resources committed to that from day one."

Innovation for an Era of Better-Informed Consumers

Under a scenario of long-term lower net sales growth, CPG companies will need to rethink the largely defensive actions they took in 2008 and 2009 to preserve shareholder value: divesting non-core brands, conserving cash, cutting costs. To grow revenues, companies either have to raise prices or drive volume—and that's where innovation comes in.

Innovation goes beyond technical advances. Many CPG companies are looking to innovate by reaching customers in more places—for example, by expanding their product presence in the workplace or targeting demographic groups like Generation Y through smart social media campaigns. Others are looking to tailor their products for local customer tastes in emerging markets.

Understanding customer priorities is central to innovation. Consumers in the United States are buying more carefully, buying different pack sizes, taking advantage of volume discounts, and trading down to brands with a different value proposition. Diamond Foods CFO Steve Neil explains that one key to innovation is a willingness to approach an old problem with a new perspective: "We have been successful at bringing product innovation to categories that historically have not been very innovative, and that has differentiated us," he says. For example, "We work with our retailers to help them position their private label. We want them to be able to offer the bulk big-value proposition, since we are not going to price at parity with them." Helping retailers help themselves is just one way that CPG companies can bring a different mindset to their business.

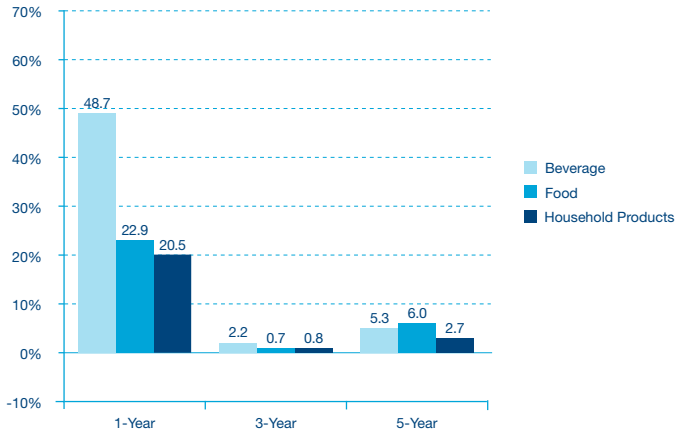
Sector by Sector: How CPG Fared in 2009

Beverage Companies Lead as Food and Household Products Adapt to a Lower-Growth Environment

With shareholder return up 49% in 2009 and median EBIT growth jumping a remarkable 33%, the beverage sector had the best quantitative performance among the three major CPG sectors: beverage, food, and household products (see Exhibit 6).

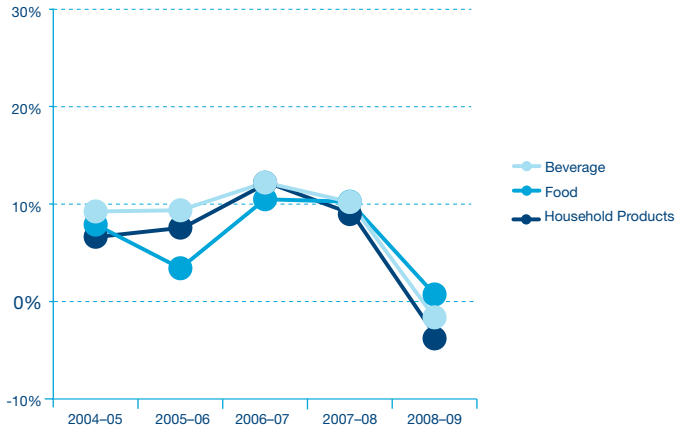
The sector's strong performance did not, however, reflect growing sales. Despite the first annual sales gain for carbonated beverages in five years—attributable to recession-wary consumers trading down from more expensive energy drinks and bottled teas[3]—the overall beverage sector showed a 1.6% net sales decline for 2009, its first negative growth in five years. As Exhibit 7 shows, median net sales growth sank in 2009 across all three CPG sectors.

Exhibit 6: Median Shareholder Return



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Exhibit 7: Median Net Sales Growth

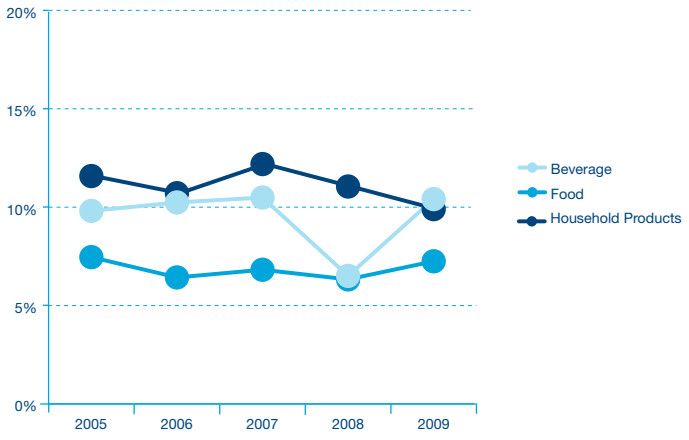


Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Instead of strong sales driving performance, the beverage sector as a whole seems to have benefited from some shareholder-value-building deals—namely, the Anheuser-Busch/InBev merger and moves by Coca-Cola and PepsiCo to purchase their North American bottling operations. These landmark deals are more important for what they tell us about the competitive terrain, however, than for any numerical measures of shareholder value. In the shrinking North American beverage market, the biggest global companies are pushing hard to claim competitive advantage by operating more cost-effectively and efficiently. As Coca-Cola North America CFO Duane Still says, "A huge opportunity for us is in better coordination across our network around the visibility and availability of inventory." In another example, PepsiCo is entering into a global procurement alliance with the newly formed AmBev. The apparent lesson is that in a time of mature growth, companies need to innovate to squeeze profit out of stagnant markets.

The success the beverage sector is having in tightening up operations is evident in other measures as well. Beverage companies were able to increase productivity as median return on sales and median sales per employee both increased significantly (see Exhibit 8), and they did so with a defensive mindset borne of the recent volatility in commodity markets. "The commodity markets and our ingredients are so volatile that we have occasionally had to turn to productivity savings to make our economics work," says Coca-Cola's Duane Still.

Exhibit 8: Median Return on Sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

A Food Sector Hungry for Sales Growth

Food sector sales growth fell to a mere 0.7% from 10.3% in 2008, but the drop still wasn't as steep as the sales decline for other sectors. By their nature, food companies are typically more resilient: While consumers certainly can "trade down" in food brands, food purchases overall are much less discretionary than purchases of beverages and household products. The stability of food companies is also reflected in sales growth figures dating back to 2007.

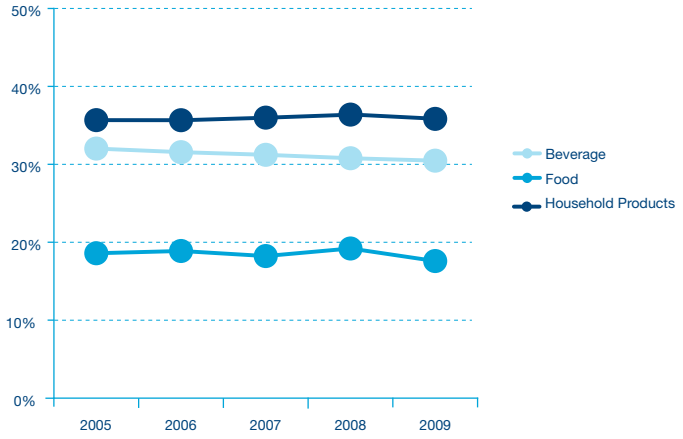
On the other hand, the search for growth is not as clear cut, as the emerging market play for foodstuffs is more complicated. "The challenge is that all food is local," General Mills CFO Don Mulligan says. "There is no global food customer. The product is individual to the local eating habit."

"All food is local. There is no global food customer."

— Don Mulligan, CFO, General Mills

Food companies responded in several ways to the year's drop in sales growth. Most significantly, the sector as a whole cut back on spending, as evidenced by its nearly 2% drop in median selling, general, and administrative expenses (SG&A) as a percentage of sales (see Exhibit 9). At the same time, the beverage and household products sectors kept SG&A spending relatively stable from 2008, and at levels already far beyond that of the food sector.

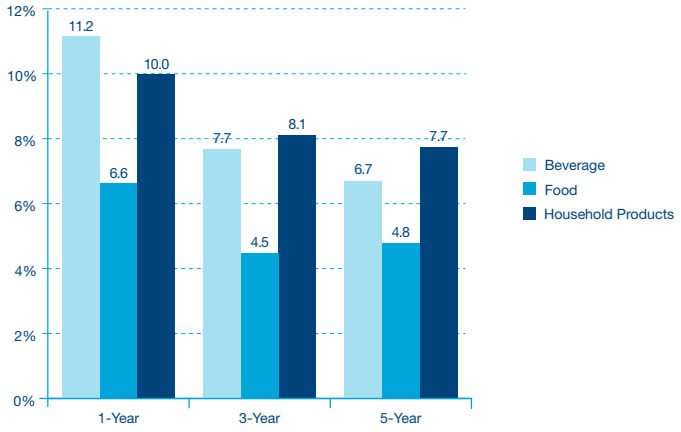
Exhibit 9: Median SG&A as a Percentage of Sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

While food companies' 22.9% median one-year shareholder return was less than half the return posted by beverage companies in 2009, the food sector's slow-and-steady nature shows its true mettle in the median five-year shareholder return metric, where its 6.0% return beat the performance of both beverage (5.3%) and household products (2.7%). As shown in Exhibit 10, food companies again registered significantly lower levels of cash flow relative to sales than the other two major CPG sectors in 2009, as they have for the past five years. The reasons include higher food commodity prices and the consumer shift to lower-margin products. Food companies experienced a one-year 7.6% median return on invested capital, which matched the sector's overall five-year performance.

Exhibit 10: Median Free Cash Flow to Sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

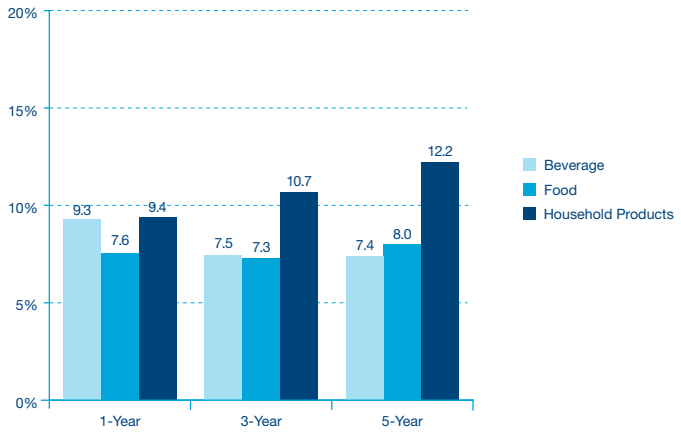
The Adaptive Household Sector Tightens Its Belt

Last year we reported that household products manufacturers were the year's most resilient CPG companies, but in 2009 they became instead the industry's most *adaptive*.

While household products companies saw negative median net sales growth for the first time in five years and had the lowest one-year median shareholder return at 20.5%, they mitigated this decline with the highest one-year median return on invested capital of any of the sectors (see Exhibit 11), the highest median sales per employee, and the highest median gross margins (at 49.5%). These metrics indicate that household products companies were able to take actions on the fly, such as shrinking headcount and shedding unprofitable inventory. Even the one-year median shareholder return statistic needs to be put in context. Although the sector shows the lowest one-year shareholder return, it suffered less when the bottom fell out of the market in 2008, meaning it did not have as much ground to make up in 2009 as the other sectors.

One area in which household products companies did not hold back was in SG&A spending, which is crucial for awareness and brand-building in this category. Some of this spending undoubtedly went into investments in building brands in emerging markets, from which the majority of growth for CPG companies is likely to come in the next decades. This spending did, however, contribute to the sector's poor median EBIT growth of negative 10.7%, which pales in comparison to food companies' 7.9% median EBIT growth and especially to beverage companies' 33.1% median EBIT growth.

Exhibit 11: Median Return on Invested Capital



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Company Size Segments: 2009 Trends

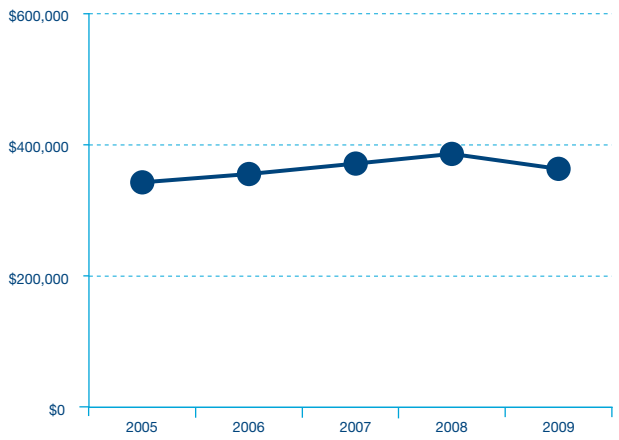
Large Manufacturers Still Investing Globally, Small Manufacturers Spending Big to Stay in the Game

In addition to analyzing performance data by industry sector, we also analyzed by company size (see page 15 for a discussion of the top performers in our large and very large company categories). One of the more surprising results shown by our 2009 data was a drop in sales per employee in the very large manufacturing segment (see Exhibit 12). One possible explanation was that these companies, with their large global footprints and healthy global brands, were still investing heavily in overseas operations, pushing down their sales per employee. At the same time, sales per employee for large and medium-sized manufacturers both went up significantly, meaning that these companies were able to get more productive as they likely grew leaner during the final stages of the recession.

The one-year median shareholder return for the very large manufacturers was stellar, at 24.2%. The picture looks even better when we examine the entire large manufacturers segment of our sample (all companies with net sales greater than $4 billion). Among this group, one-year median shareholder return for 2009 rebounded to 26.2% (see Exhibit 13).

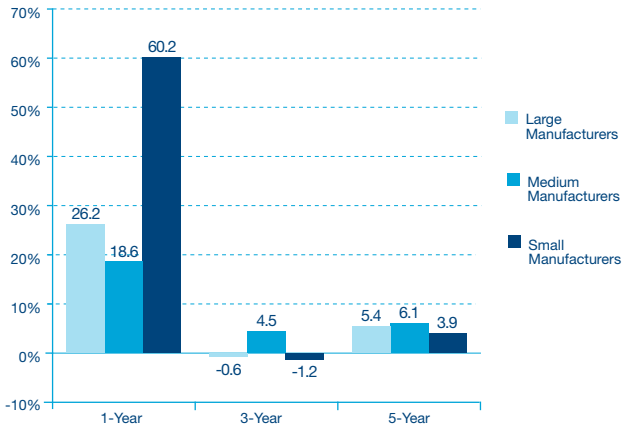
The eye-popping one-year median shareholder return for small manufacturers quickly gave way to the reality that they had the longest road to recovery from the effects of the recession. Despite their 60.2% one-year return, small manufacturers have still lost market cap over the past three years.

Exhibit 12: Median Sales per Employee for Very Large Companies



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

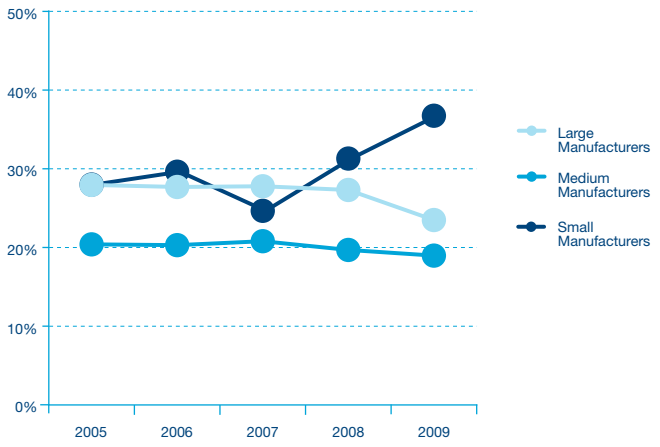
Exhibit 13: Median Shareholder Return



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

On the other hand, small manufacturers' 36.7% one-year median SG&A spend as a percent of sales comes in far higher than that of the other sectors (see Exhibit 14). Clearly, small players had to invest more talent and cash to keep their brands relevant. This makes perfect sense when considering the clout that bigger competitors bring to the table when dealing with retailers. If an organization has 10, 12, or 20 healthy brands, it's a far more cost-effective partner when filling aisle shelves.

Exhibit 14: Median SG&A as a Percentage of Sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

The comparably high SG&A spending could also signal that smaller companies, which also had a hard time managing cash in 2009 (their ratio of short-term to long-term debt increased markedly), were hunting for new market niches to replace those in which they'd lost their foothold during the recession. Costs also remained high for small manufacturers because, by definition, they have fewer places to cut during tough times.

One area in which the data shows smaller manufacturers with an advantage over their medium-sized brethren is in the cash conversion cycle. The big retailers have enough clout to delay payment to less powerful midsized manufacturers. By contrast, smaller manufacturers don't have as much exposure to the biggest and most powerful retailers and suppliers, and thus continue to enjoy a shorter cash conversion cycle.

How This Report Is Structured

In the remainder of this summary, we discuss how the CPG industry is positioned as the economy begins pulling out of recession, and how the U.S. unemployment rate and consumers' buying patterns will affect the industry's growth prospects. We also examine the top-performing CPG companies of 2009, and analyze the common characteristics that allowed those companies to outperform their peers.

The year 2009 brought falling sales for many companies, but in many cases it also brought healthy earnings. It was a year of cost reduction, but for some also a year of preparing for the upturn. This last dynamic is why Section 1 of this year's report is titled "Raising the Bar on Performance Management." The articles in this section focus on implementing growth plans while still maintaining a focus on cost reduction.

Section 2 of this report, "Spotlight on Regulation," highlights the ever-changing regulatory environment that the industry faces, touching on such issues as healthcare reform, proposed lease accounting standards, and a potential value-added tax in the United States.

Section 3, "Emerging Opportunities at Home and Abroad," takes a look at the diverse growth opportunities that exist—and how they can be seized. From the emerging markets in India and China to the emerging social media technologies that will help companies capture future market share, the articles in this section tackle the big issues that executives will be working on in the years to come.

Sustained Economic Growth: Jobs Hold the Key

Inventories May Be Too Lean if Demand Surges

After the deepest recession since World War II, slow growth appears to be the likeliest scenario for the U.S. economy over the next few years—and that has a lot of appeal for many CPG companies.

Bush Brothers CFO Al Williams says that slow growth "plays well for us. We are not a highly leveraged company, so expanding quickly is something that we typically haven't done. A more stable environment gives us more time to understand consumers and what their needs are, which helps us put capital in the right places and invest in the right strategies."

For the CPG industry as a whole, performance over the next several years will depend largely on two factors: whether consumer spending increases as the economy starts to strengthen, and whether the industry is able to capitalize on new growth opportunities.

The recession began in December 2007, and through December 2009 total employment in the U.S. fell by over 6%.[4] The unemployment rate peaked at 10.1% in October 2009, then declined slightly to 9.7% in March 2010.[5] Economic output, as measured by real gross domestic product (GDP), fell by over 3% between the fourth quarter of 2007 and the third quarter of 2009.[6] That's almost twice the average 1.7% decrease in real GDP seen in other postwar-era recessions.[7]

While the economy has been showing signs of recovery, most projections expect only modest growth in 2010 and 2011. The unemployment rate is expected to remain above its recent 20-year average of 5.5% for the next several years, with projections from the Congressional Budget Office and the Obama administration both showing the unemployment rate averaging at least 8% through 2012.[8]

Given its role as a provider of consumer staples, the CPG sector has weathered the downturn slightly better than the overall economy, but it too has felt the impacts of the recession. Demand for sector output turned in the middle of 2008, and in 2009 the value of shipments declined in both domestic and foreign markets.

Many CPG executives are wondering whether the economy will go through another dip before experiencing a sustained recovery. Hershey CFO Bert Alfonso is in the camp that forecasts a gradual slow recovery. "I don't think we'll see another dip," he says. "If we do, it will start outside the U.S., could be a contagion in Europe, and some of that would hit our shores. But I don't envision a double-dip that is triggered by internal factors within the U.S., although I would not say the consumer is overly confident."

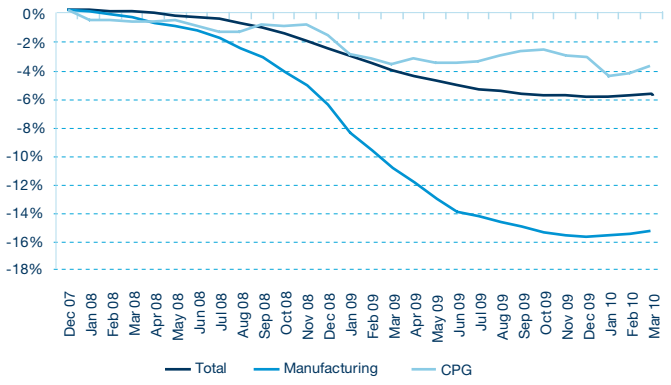
Consumers reacted to the recession by increasing their savings and lowering their discretionary spending. This trend has benefited food and beverage companies, Alfonso notes, because it stimulates in-home cooking and consumption rather than restaurant meals. "People are continuing to seek value, and I think it's a semi-permanent condition that will persist," he says. "There is a change in the psyche around what quality and value means."

Likewise at Sunny Delight, CFO Bill Schumacher says that as the mix of consumer spending changes, "our business is more structured around offering value to the consumer. We are in a fortunate position where our brand tends to do a little bit better because it is seen as more of a value play as opposed to a premium play."

Employment Slack, Despite Fewer Job Losses

Similar to the rest of the economy, the CPG industry experienced a significant decline in employment over the past two years. As of January 2010, total CPG employment had fallen by 4.7% since the beginning of the recession in December 2007. By comparison, total U.S. employment in all industries fell by 6.1%, and total manufacturing employment fell by 15.8% (see Exhibit 15).

Exhibit 15: Percent Change in Employment Since December 2007



Source: Based on Bureau of Labor Statistics data (accessed May 2010) and PricewaterhouseCoopers calculations

Job losses in the overall economy and the manufacturing sector have slowed over the past six months. By contrast, the CPG sector experienced two large drops, in late 2008 and late 2009, but has seen modest growth in recent months.

Employment will, of course, have an impact on consumer spending and the economic recovery. "The biggest drag is jobs," says Diamond Foods CFO Steve Neil. "Until you see a growth in jobs, you are not out of a recession. I don't think we'll have a double-dip recession, but I think the recovery is going to be L-shaped rather than U-shaped. I don't see people spending in greater amounts; instead, I see them reducing debt."

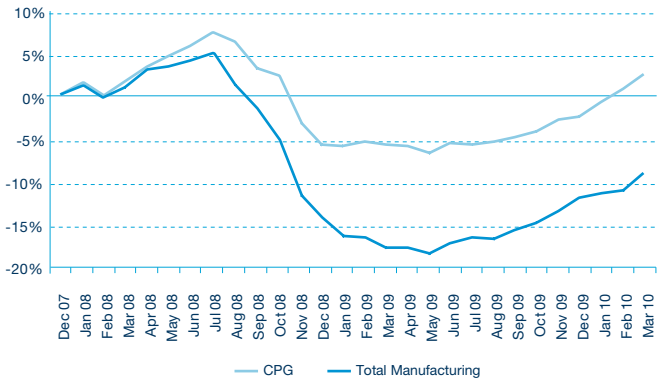
Assuming employment does not improve markedly over the next few years, CFO Don Mulligan says his company, General Mills, has to focus on offering the right value to the consumer. "Value isn't necessarily the lowest price point as much as making sure the offering is tailored to what the customer wants," he notes. Consumers moved strongly to private label during the worst of the recession, but are feeling somewhat more comfortable now, and on select purchases may find it worth the extra cost for a product with better flavor, more health benefits, or a faster preparation time.

Bill Schumacher views job growth as essential to the economic recovery. "Some of the spending patterns are starting to come back," he says, "but jobs have to come back in order for the recovery to be sustainable. If jobs don't come back, at least at some kind of modest level, I question whether the turnaround is sustainable as a robust recovery. Especially after the government stimulus works its way through and starts to come to an end, something needs to replace it."

Industry Shipments on an Upward Path

The value of products shipped by CPG manufacturers has followed a much different pattern than employment. Total manufacturing shipments and CPG shipments increased for the first eight months of the recession before falling steeply in the second half of 2008 (all shipments valued in current prices). By May 2009, the value of shipments in the CPG sector was 6.5% lower than the December 2007 level (compared to an 18.7% drop in manufacturing shipments in the overall economy). Shipments then began increasing slowly, and by February 2010 they had returned to their December 2007 level, as shown in Exhibit 16.

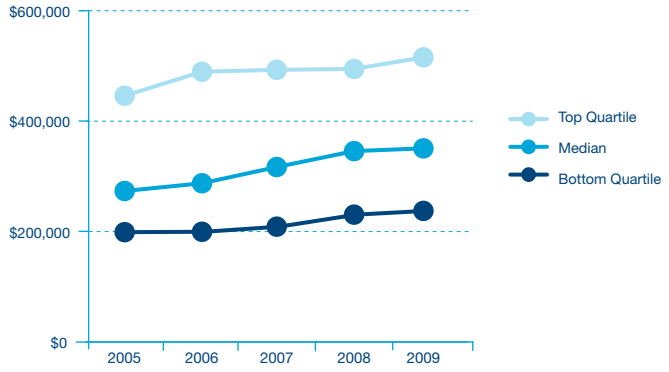
Exhibit 16: Percent Change in Value of Shipments Since December 2007



Source: Based on Census Bureau data (Manufacturers' Shipments, Inventories, and Orders Survey, accessed May 2010) and PricewaterhouseCoopers calculations

The increase in CPG shipments during a time of decreased employment is attributable to a rise in productivity over the past eight months. Further increases in shipments will likely require either additional productivity improvements or new hiring.

Exhibit 17: Overall Manufacturers—Sales Per Employee

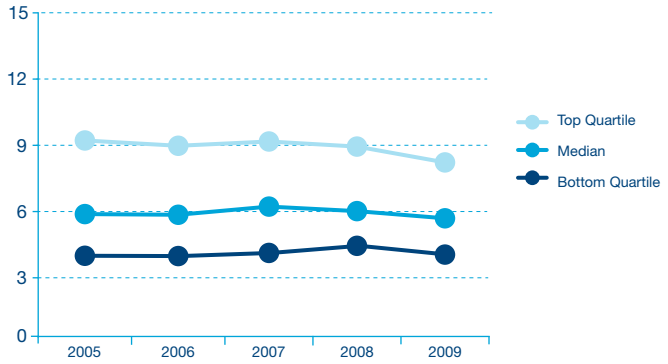


Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Inventories Cut to the Bone

Reducing inventories was one of the major ways companies cut costs in response to the global recession. However, many companies may now have gone past the tipping point. During recessions, companies typically cut back on production to avoid accumulating inventory. Later, as the recovery begins, companies allow inventories to decline as they wait to see if the economy is back on firm footing, then build up their stocks as appropriate. However, inventory levels in the CPG industry have moved differently through the recent recession (see Exhibit 18).

Exhibit 18: Overall Manufacturers—Inventory Turnover

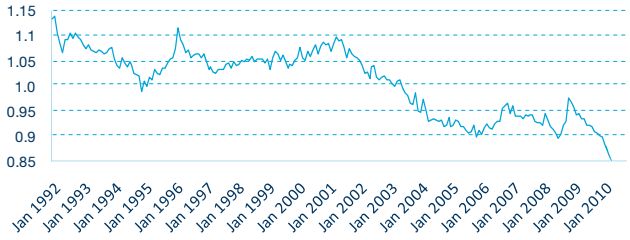


Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Over the past ten years, CPG manufacturers tried to control costs by decreasing the value of their inventories relative to their shipments. For example, for January 2001, industry inventories were valued at approximately $85 billion, while industry shipments equaled $79 billion, a ratio of 1.08—a typical ratio before 2001. That year, however, CPG companies began to lower the size of their inventories relative to sales. By January 2007, the inventories-to-shipments ratio had fallen below 1, to 0.96.

The ratio spiked in November 2008 at 0.98 and has been falling since, as shown in Exhibit 19. By March 2010, the value of inventories relative to shipments had fallen to 0.85, the lowest level seen in recent government data.

Exhibit 19: CPG Inventory-to-Shipments Ratio, January 1992 to March 2010

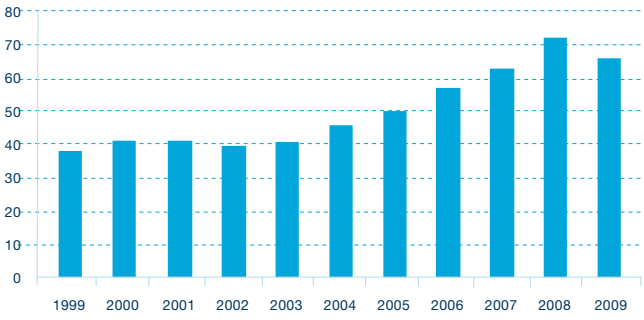


Source: Based on Census Bureau data (Manufacturers' Shipments, Inventories, and Orders Survey, accessed May 2010) and PricewaterhouseCoopers calculations

Exports Show Resilience

Foreign markets for CPG manufactured goods contracted during the recession. After exports increased by 15% in 2008 over 2007, the global slowdown cut demand and CPG exports fell by 8.6% in 2009, to $66 billion (see Exhibit 20).

Exhibit 20: CPG Industry Exports,1999–2009 (in $ Billions)



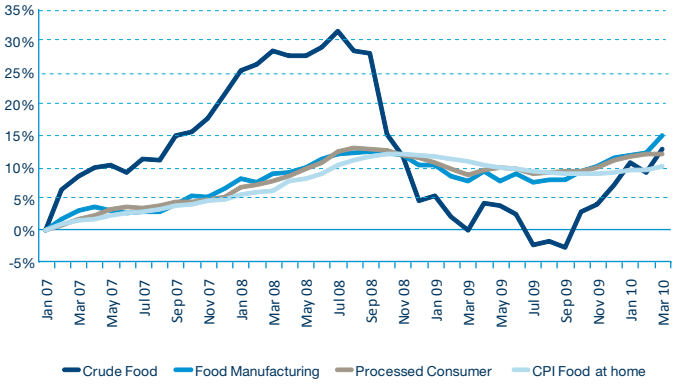
Source: Based on International Trade Administration data (accessed May 2010) and PricewaterhouseCoopers calculations

Commodity Prices Remain Volatile, While Retail Prices Hold Steady

Food commodity prices spiked from the initial stages of the recession through the middle of 2008, fell significantly through 2009, and more recently have begun to rise (see Exhibit 21).

Yet prices of CPG products, both in terms of prices leaving the factory and prices paid by consumers, have exhibited significantly less volatility. By the end of 2008, prices to consumers had risen approximately 12% relative to January 2007, well below the 30% spikes seen for raw foodstuffs. Current price levels for products at the different stages of production are between 10% and 12% higher than January 2007 levels.

Exhibit 21: Growth in Food Prices, January 2007 to March 2010



Source: Based on Bureau of Labor Statistics data (accessed May 2010) and PricewaterhouseCoopers calculations

CPG companies have addressed this price volatility through a variety of strategies, including hedging with futures contracts. Disruptions to financial markets in 2008 and 2009 made these activities more difficult because futures trading volumes were low and many participants left the market. However, companies continue to hedge commodities to even out their margins and avoid chronic price changes. McCormick CFO Gordon Stetz says, "In establishing prices in our industrial business, we're collaborating with our customers and taking forward-looking positions on commodities based on their direction. That way, our pricing mechanisms are not taking on commodity risk—which you can't afford in a volatile environment."

Al Williams at Bush Brothers also notes the challenges of dealing with commodity price swings: "At the end of the day, return on invested capital is still the fundamental metric that any company measures itself against. You can get very specific about the performance of individual products, but the economy has seen such substantial changes in commodity prices and input costs that you can get lost quickly in the noise. To over-depend on an annual ROI would be misleading, because it's hard to get a baseline over the past two or three years due to the way commodities have been bouncing around."

Forecasting economic turns is notoriously difficult. For Williams, too much emphasis on such forecasts can actually be a distraction. "My take is not to get too hung up on forecasts," he says, "but instead, just focus on taking care of business."

Coca-Cola North America CFO Duane Still expects continued volatility in commodities and says planning for it is key: "It's challenging and requires developing contingency plans and rethinking our pricing strategies and sourcing strategies, and even in some cases our formulation strategies."

CPG Companies Remain Resilient

Overall, the economy is still looking for consumer spending to take it out of its doldrums, a challenge that will continue as long as unemployment remains high. However, CPG companies look forward to a steady, slow-growing economy without the swings of the recent past, and the industry will likely continue to benefit from consumers seeking value in their food and beverage purchases. With better employment figures than the national average and increasing shipments, the sector continues to show resilience and stability.

The Best of the Best: A Top-Performing Company Analysis

Breaking Down the Performance of the CPG Sector's Top-Performing Companies

Recovery is real as the U.S. economy climbs out of a long, hard recession, but recovery is also slow, hampered by significant unemployment and underemployment. CFO Kent McNeil of Bumble Bee Foods believes another dip is unlikely, but predicts that it will take time before the CPG industry realizes a consistent turnaround in performance.[9]

General Mills CFO Don Mulligan agrees: "Our planning assumption is a slow rebound for the consumer. We don't see unemployment and underemployment getting markedly better in the next several years." The likelihood of prolonged slow growth underlines the continued importance of offering value to consumers. "Value is not necessarily the lowest price point," Mulligan says. "It's about making sure that your offering is tailored to what the consumer wants—which may be convenience, certainly taste in our industry, or health. Premium offerings may not play as well as they did four or five years ago, and they may not do so for an extended period of time."

Even the strongest CPG companies were hit hard by the recession, showing virtually no net sales growth in 2009. And yet, some CPG companies have managed to mitigate these economic challenges through strategies such as building and supporting strong brands. In our analysis this year, we set out to answer two questions: First, what common characteristics link the CPG companies that are performing best during the slow rebound? And second, looking back, have those distinguishing characteristics changed over time?

A Word About Company Size

Company size is often perceived as an important indicator of an organization's success. Indeed, of the 13 companies in our top-performing quartile, 10 (or 77%) are very large. However, several of the weakest-performing companies in our 2009 sample are also very large, and size did not prevent some companies from falling out of the top-performing quartile over the past year. From our point of view, market sector seems to be more important than company size in the current economic environment: In our 2009 ranking, 6 out of 13 companies (46%) in the top-performing quartile are household products companies, while 8 out of 12 companies (67%) in the bottom-performing quartile are food companies.

PwC's "Power Ranking"

In delving deeper into the total sample of approximately 150 CPG companies for which we gathered publicly available data, 51 met our criteria for large and very large companies.

We wanted to avoid measuring companies primarily on shareholder return, because this standard corporate barometer—while of the utmost importance to investors—tends to provide a distorted view of performance during hard economic times. Instead, we took a more balanced approach, assigning scores to each of these 51 large and very large companies based on their relative performance across three fundamental financial metrics: economic profit spread, which is based on return on invested capital (ROIC) and the weighted average cost of capital (WACC); return on assets; and the ratio of free cash flow to sales. Guided by these results, we then ranked all 51 companies to create an index of top-performing companies (TPC).

With this breakdown in hand, we were able to easily compare groups of the ranked companies across many different financial indicators, including growth, profitability, liquidity, and leverage. We were particularly interested in comparing the top quartile (best performers) with the bottom quartile (weakest performers) to isolate those business drivers that might further explain their ranking.

Our analysis reveals that, during the later part of this recessionary period, the top-quartile performers were distinguished from the bottom quartile in the same five areas we identified for 2008: gross margins, spending on strategic SG&A expenses, profitability, liquidity, and managed debt capacity as represented by the ability to cover interest payments. The story, in many respects, is 2008 redux: Some of the reasoning and outcomes may be different, but year over year, our top performers have been characterized by similar results.

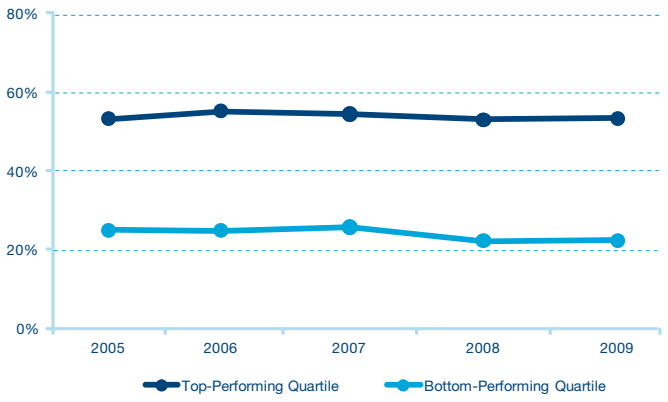
In addition to our index of the large and very large top performers, we applied a similar scoring methodology to the medium and small company segments, and found that the same themes apply. Therefore, as we contrast the performance of the top and bottom quartiles for our large and very large top performers, we will highlight outcomes for medium and small players only where there is a significant difference.

Strong Margins Measure the Intangible Value of the Brand

Gross margins, notes General Mills' Don Mulligan, tell you how valuable your brand is to the consumer. "This metric indicates how much more than the actual costs of the product itself the consumer is willing to spend," he says. "Therefore, gross margins measure the intangible value of a product and of a brand. By analyzing your gross margins, you can measure how much value your marketing is adding to the intangible value of the brand."

As Exhibit 22 shows, gross margin sets top performers apart, with a gap between top and bottom performers of close to 30%. This picture is extremely similar to last year's. Our top-quartile companies own well-established brands that have maintained popularity over time. Further, marketing support has been effective in communicating product value to consumers.

Exhibit 22: TPC Median Gross Margin



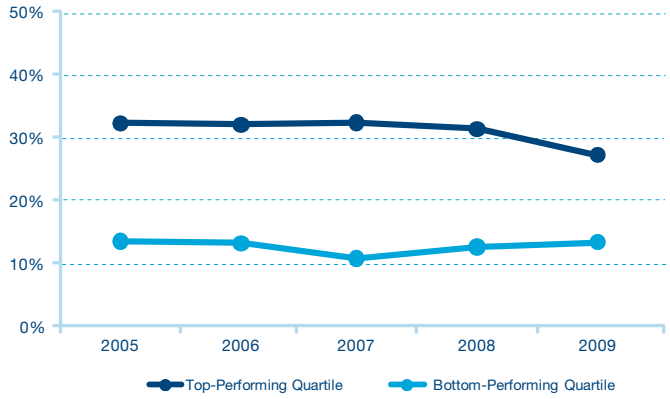
Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Belts Are Still Tight, but Strong Investment Is a Given Among the Top Performers

Major CPG companies fill their pipelines with innovative products as well as core brands. Just as in 2008, our analysis showed that our top quartile spends more on defending its market share than does the lowest quartile, as measured by SG&A spending relative to sales. Investment in brands and in long-term positioning remains a significant predictor of performance. For example, many of our top performers maintained or increased their sustainability initiatives, both to support the "social responsibility" component of their corporate brand and to control costs and reduce risk—e.g., decreased water use by a plant in China reduces exposure to that country's growing water shortage.

Let's turn to SG&A spending trends. In our 2008 report, we found that most of our top performers increased their SG&A spending, perhaps indicating a desire to invest and capture market that others could not defend. In 2009, we saw a significant drop in median SG&A spending for the top performers. Our analysis shows that the top quartile is managing SG&A spending more tightly, given the slow economic rebound (see Exhibit 23). Further, these companies have largely harvested the low-hanging fruit in cost management and are now looking hard and systematically at indirect procurement spending and other cost categories that lie off the beaten cost-management path.

Exhibit 23: TPC Median SG&A as a Percentage of Sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

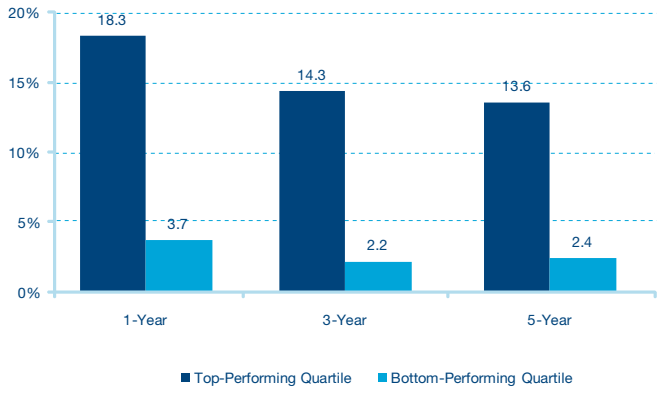
Top Performers Are Hoarding Cash and Dropping Debt

As the significant gap between quartiles in Exhibit 24 illustrates, the top CPG companies are both generating and hoarding more cash than weaker performers. Just as we found last year, there is a dramatic difference in cash flow between these quartiles. While the data suggest a drop in investment spending, having ample capital available does provide top-performing companies with liquidity as well as with the room to think and act strategically. Bottom performers are generating less cash, and because they have less access to credit, they do not have the luxury of hoarding what cash they have to defend their market share.

An analysis of the median interest coverage ratio supports these conclusions (see Exhibit 25). The increase for top performers indicates that they are not spending cash; instead, they are focused on reducing debt load. This makes sense: With more cash in hand, top performers have the luxury of taking on less short-term debt to meet their goals. The drop in debt-to-equity ratio that we would expect is shown in Exhibit 26.

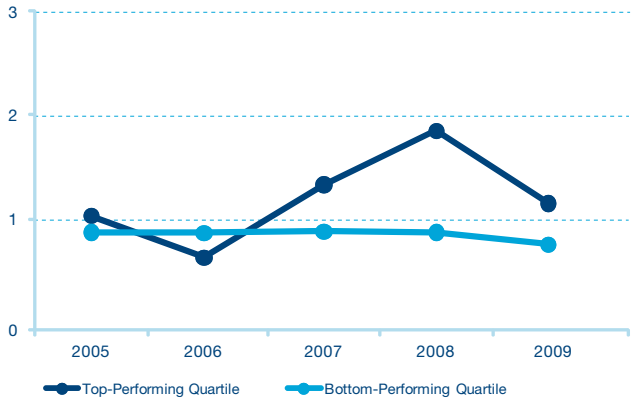
Exhibit 25 further strengthens this story. With more cash and less debt, top-performing companies find it far easier to manage the debt they retain. By contrast, the bottom quartile is struggling to cover interest payments, and their balance sheets are weakening.

Exhibit 24: TPC Median Free Cash Flow to Sales



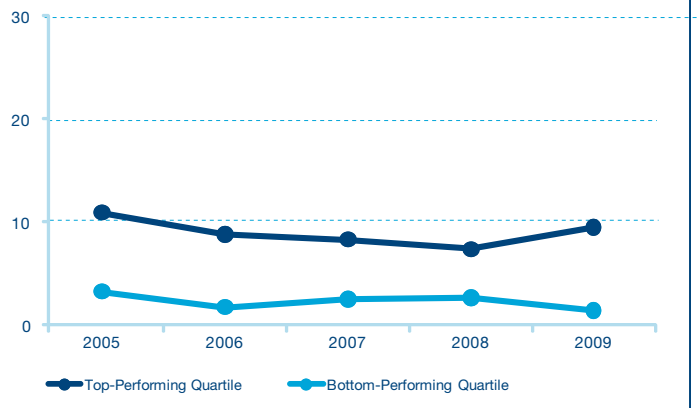
Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Exhibit 26: TPC Debt-to-Equity Ratio



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

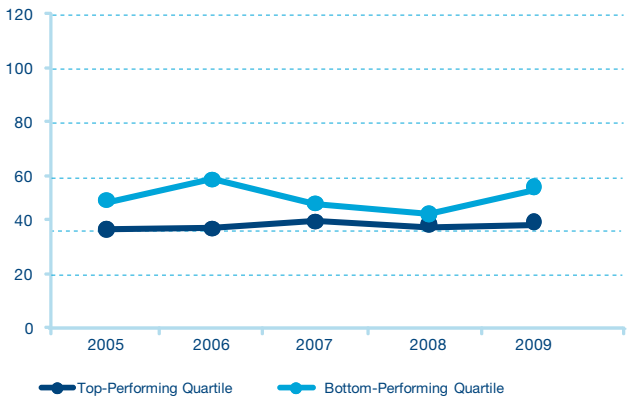
Exhibit 25: TPC Median Interest Coverage Ratio



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

An additional element in this analysis is the cash conversion cycle, which highlights the speed with which companies can turn assets into cash. A rising cash conversion cycle number, such as we see with the bottom quartile in Exhibit 27, indicates that a company is struggling to get cash in the door and is less efficient in converting assets into cash. A lower cash conversion number, which we see with the top performers in 2009, therefore speaks to a stronger liquidity and debt-management position.

Exhibit 27: TPC Median Cash Conversion Cycle

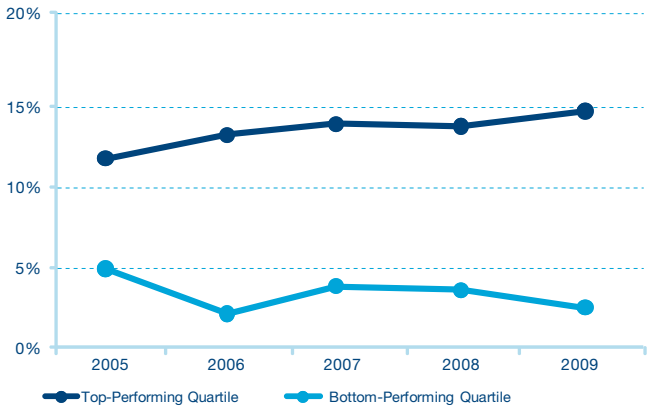


Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Profitability, Not Sales Growth, Points to the Capability to Drive Performance

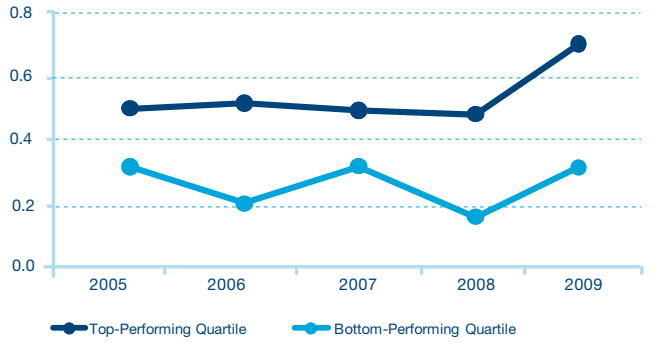
No quartile in our CPG group reported sales growth in 2009, in contrast to the positive growth that companies managed to eke out in 2008, deep in the recession. In both years, however, it was profitability, not sales, that distinguished the top and bottom quartiles. To tell that story, we examined companies' net operating profit after tax (NOPAT) margin and median operating cash flow (see Exhibits 28 and 29).

Exhibit 28: TPC Median Net Operating Profit after Tax (NOPAT) Margin



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Exhibit 29: TPC Median Operating Cash Flow Ratio*



*The operating cash flow ratio consists of cash flow from operations divided by current liabilities.

Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

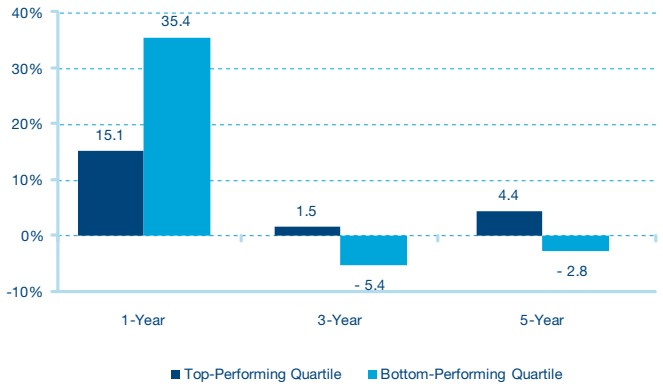
Among our top performers, the NOPAT margin has risen to 15%, while our bottom performers showed a margin below 3%. This represents a widening of the gap between top- and bottom-performing companies compared to 2008. Furthermore, the operating cash flow ratio increased for both top and bottom quartiles, though the rise is steeper for the top performers. These results point to our top performers' continuing ability to cover their debt effectively and defend their market share by providing value to customers.

Investors Looking for Long-Term, Stable Growth

Although we did not consider shareholder return in our ranking, it is worth looking at the dynamic displayed in Exhibit 30. At first glance, the one-year shareholder return may seem counterintuitive, with the bottom-performing quartile providing double the return as the top. As we said, however, shareholder return is not the best measure of how well a company is performing in volatile times. Our hypothesis, supported by our TPC rankings, is that top performers are stable, consistent in their earnings pattern, and focused on long-term growth. Bottom performers may provide an abysmal return one year and a better one the next. Since a short-term bump in returns is no indicator of what the next year will bring, these companies are, as a rule, less attractive to investors over the long run.

The three-year and five-year returns displayed in Exhibit 30 support this hypothesis. Over these longer time horizons, the top quartile of CPG companies has consistently outperformed the bottom quartile in shareholder return.

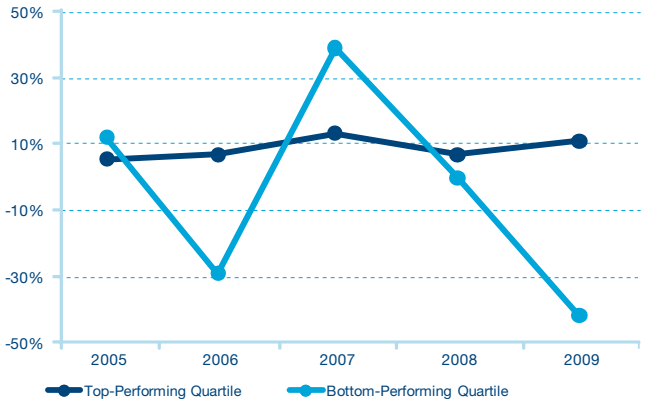
Exhibit 30: TPC Median Shareholder Return



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

EBIT growth also highlights the theme of top-quartile consistency versus bottom-quartile inconsistency. As shown in Exhibit 31, the top quartile exhibited significantly higher EBIT growth in 2009, similar to what we observed in 2008. Clearly, top-performing companies are better able to manage their bottom lines than are other large and very large companies. Further, the bottom quartile has experienced a much more variable EBIT growth over the past five years. This suggests that bottom performers were not able to manage their expenses sufficiently to offset plummeting sales.

Exhibit 31: TPC Median EBIT Growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Section 1

Raising the Bar on Performance Management

As CPG companies dust themselves off after the harshest recession in decades, management teams are implementing growth plans while keeping the pressure on costs. The new rule is “sustainable performance,” and this section covers components that are critical in achieving that goal: SKU assortment optimization, the lean and agile supply chain, and the new realities of trade promotion.

Assortment Optimization

When Retailers and Manufacturers Collaborate to Drive Category Growth

Out of favor while the economy was firing on all cylinders, assortment optimization is now once again the talk of the town. Assortment optimization falls under category management, also sometimes referred to as consumer or shopper development. Most retailers and CPG manufacturers perceive category management as a critical component of their strategy to address widespread slumps in sales, profits, and gross margins on investment.

Cautious consumers currently spend an average of 30 minutes per visit in grocery stores, hunting for value and focused on products that provide both convenience and quality. They scan each aisle of SKUs for a few seconds, largely ignoring the thousands of advertising signs blanketing the store. How can retailers capture the most value from those fleeting seconds?

Reducing the clutter is a popular tool for optimizing value from shelf space. For example, a struggling regional grocery chain optimized the assortment for its pourables (salad dressings) category, which had lagged behind market growth for years. In a mere three months, sales for that category rose from a double-digit decline to positive growth.[10]

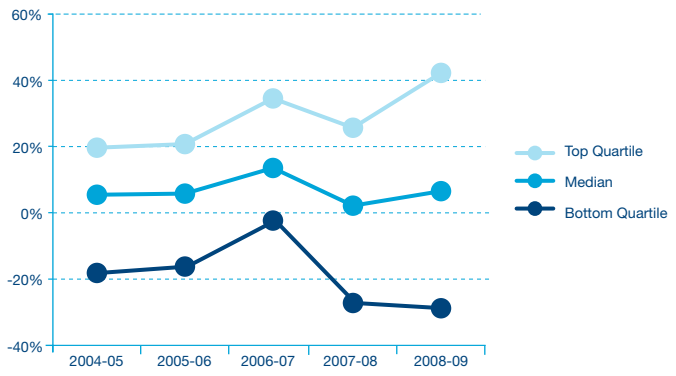
Quick wins are not unusual. A non-grocery retailer reduced its SKU count in writing instruments by 15% and saw category sales rise 7% and profit 3%.[11] A drug store chain streamlined its assortment after four years of declining sales in its general merchandise category and saw category sales rise by almost 15%.[12]

The cuts are often deep. Walmart, for example, has embarked on a rationalization program that will see 15% of SKUs removed from the shelves in the U.S.[13] For retailers, making room for private-label products is one impetus toward SKU optimization, yet both manufacturers and retailers recognize the benefits of reducing complexity.

"For years," says Coca-Cola North America's Duane Still, "we have been laboring under the assumption that consumers demand more choices. Across the industry, there has been a proliferation of SKUs that retailers have to carry and we have to manufacture and inventory and source ingredients for."

Partnering with manufacturers to drive category growth presents advantages to retailers of any size. For manufacturers, relationships with retailers are top of mind as they work to protect their margins, gather point-of-sale data, and push digital offers (e.g., e-coupons) to consumers in the store. The hypothesis is that as retailers and manufacturers work to optimize their SKUs, they are eliminating the non-profitable items which would lead to an increase in EBIT, as illustrated in Exhibt 32.

Exhibit 32: Overall Manufacturing EBIT Growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Manufacturers Should Use Their Category Knowledge to Inform SKU-Cutting Decisions

Retailers expect their manufacturer partners to provide a category perspective rather than a brand perspective—and that includes a deep knowledge of the consumer and engagement in driving category growth. "Even during the recession, we didn't cut back on advertising and promotion," explains McCormick's Gordon Stetz. "Retailers expect you to invest in tools, innovation, technology, merchandising—all those elements that drive growth. If you aren't, you will be pressured to up your game."

Driving growth and protecting margins may lead manufacturers to trim SKUs long before retailers do. "Over the last couple of years," says General Mills' Don Mulligan, "we've reduced close to 25% of our SKUs in the U.S. And our net result is actually better because the 80/20 rule absolutely applies to SKUs. Focus on the top 20% of your SKUs that are really turning and creating profit." Furthermore, remember that, due to the law of diminishing return of margin, the bottom 20% of SKUs drive less than 1% of sales.

Cutting SKUs provides room to innovate, but the criteria for selecting new products have changed. "We've been forced to think differently about price and attractiveness to consumers," says Mulligan. "Incremental products, like a new flavor of cake mix, may not achieve the margins we want. Consumers value the convenience and quality of a product like Betty Crocker Warm Delights [single-serving, microwaveable desserts]. These SKUs will help us achieve greater sales with higher margins."

Exhibit 33: What's Top of Mind For Consumers, January 2010

ISSUE	% Choosing Issue	2010 Ranking	2009 Ranking
The Economy and Consumer Demand (energy costs, demographic change, consumer trends)	50.4	1	1
Corporate Social Responsibility (sustainability, social standards, corporate governance)	38.1	2	3
The Competitive Landscape (consolidation, discount, new channels)	33.1	3	4
Food and Product Safety (standards, traceability, consumer confidence)	31.7	4	2
Retailer-Supplier Relations (trade costs, pricing, collaboration)	29.9	5	5
The Retail/Brand Offer (price points, assortment, format)	26.8	6	5
Consumer Health and Nutrition (product development, labeling, education)	22.3	7	7
Consumer Marketing (advertising, loyalty programs, promotions, customer service)	18.2	8	8
Technology and Supply Chain (logistics, out-of-stocks, in-store technology)	16.1	9	9
Internationalization (international expansion, global sourcing)	13.8	10	11
Human Resources (staff recruitment and retention, operational performance)	10.3	11	10
Regulations (store openings, pricing, labeling)	6.5	12	12

Source: Consumer Goods Forum press release, "Economic Concerns and Consumer Demand Remain Top Priorities for Consumer Goods Industry" (March 4, 2010)

A collaboration to drive category growth requires manufacturers to offer objective advice when it's the retailer's turn to drop SKUs. After all, says Mulligan, "Every manufacturer has slower-turning SKUs and you need to be ready to identify your own slow turners for elimination if you want your advice on which products to add to have credibility with the customer."

At times, that message will not be one that a retailer wants to hear. "The challenge," says Duane Still, "is when you have a dozen retailers, all wanting something different. Sometimes, we've held on to a brand longer than we should have because a retailer has asked us to do so—and that really doesn't work in a business that relies on scale to be successful. We have to be disciplined in applying our criteria for success."

Any advice from the manufacturer also needs to include realistic positioning against private labels. Steve Neil of Diamond Foods explains: "With nuts, we are not going to price at parity with private labels, which are targeted to consumers who are all about value."

"We are interested in another segment: professionals who cook in a meaningful way only occasionally," continues Neil. "That consumer says, 'I am going with a brand I know and trust. My mom bought Diamond. I know it's been around a long time and that's what I'm going for.' We manage the category so there are probably not as many private-label SKUs on the aisle, but they are certainly there."

The Art of Assortment Optimization Lies in Knowing How Far to Cut, and What to Add

A retailer begins an optimization effort by reviewing the category segment by segment. For each segment, such as the adult and baby segments of the laundry detergent category, products are ranked by sales. A bar is then set for the segment, and every SKU below the bar is a candidate for being dropped. The height at which the retailer sets the bar depends on its store strategy, as well as the strategy for the category. High-growth or destination categories receive special treatment, including more facing space.

Brand investment, focus on the consumer, and objectivity help manufacturers influence SKU cutting in the aisle, instead of just reacting to it.

Insights from customer data also influence where the bar is set, and help determine when a slow-moving SKU should be retained. Indeed, dropping unprofitable SKUs may actually decrease sales, both for the category and for the store overall. The art of assortment optimization lies in applying a variety of criteria to determine an SKU's fate (see the sidebar "Factors to Consider When Sorting Through SKUs").

A high market basket rating, for example, might be enough to keep an SKU above the retention bar. Ditto for high loyalty ratings or a tie-in to the target customer.

Trust between trading partners results in an optimal assortment. Manufacturers can provide consumer and shopper data while retailers provide data from loyalty cards, point-of-sale registers, and other sources. Together, they can analyze the combined data streams in light of the retailers' strategy and consumer trends. The manufacturer's data might help prove that an SKU has sufficient value to be kept, or it might highlight an SKU whose day has passed.

Start with the Core, then Add Localized and Geodemographic SKUs

Assortment optimization follows another variation of the 80/20 rule: 80% of the assortment should be core. If a store is part of a chain, these same products would appear in every one of the chain's stores.

Localized products fall into the remaining 20%. That 20% also includes products selected based on the geodemographics of the store's location, such as franchises in Florida offering options that appeal to retirees.

Factors to Consider When Sorting Through SKUs

Consider keeping an unprofitable or slow-moving SKU if:

- Selecting the SKU generates a larger basket (customers tend to buy accompaniments for the SKU).
- The SKU is important to the store's core customers.
- The SKU is important to enough customers during certain stages of their lives. Baby laundry detergent, for example, may be a slow-moving item because the majority of customers do not have small babies. However, keeping this segment of the detergent category represented on the shelves is important for grocery stores that serve families.
- The SKU differentiates the store from its competitors or is offered exclusively at that store.

Consider adding an SKU if:

- You need it to differentiate yourself in the marketplace or simply to compete with similar stores.
- Your target consumer segments want it.
- It will improve your sales, profits, turns, or competitive edge.

The Trick Is to Offer Customers What They Want, When They Want It—and to Remove the Distractions

With a slow rebound for consumer spending predicted over the next few years, people will continue to make choices based on highest perceived quality, best value, and greatest convenience. Shifts in demand are dooming slow-moving SKUs and catalyzing the development of new products that, because they fit these criteria, can support higher margins.

Consumers are doing more cooking and entertaining at home, for example, but not necessarily from scratch. Older consumers may not have the time, while younger segments such as Gen X and Gen Y may not have developed the cooking skills of their parents. For different reasons, both of these segments are looking for frozen food or partly prepared food that is perceived to have high value—meaning not only that it's priced right, but also that it's healthy, convenient, and as tasty as restaurant food.

In those few seconds they stand in a grocery aisle, consumers are actually making very careful choices. They are trading up or down for a good reason. Developing agility in SKU assortment will benefit both manufacturers and retailers in this new, slow-growth environment.

Lessons from the Food Industry on Assortment Optimization Wins

The best results in assortment optimization typically show up in perishable foods. Two main principles apply:

1. **High turnover is essential.** Cans of soup can sit for weeks until they sell. By contrast, a tomato that gets soft or spotted is not saleable.
2. **A slight undersupply relative to demand is preferable to an overstock.** This applies to all perishables. The supermarket shopper at 7 p.m. accepts the fact that fresh pies will be sold out, and will arrange to shop earlier next time if he or she wants a pie. Being out of stock in fresh pies makes better business sense than cooking 15 varieties that get stale as the hours pass.

Addressing Complexity in the Supply Chain

Reducing Complexity Will Position Companies for Post-Recovery Growth

During the recession, pervasive cost cuts—in head count, inventory, third-party spend, capital expenditures, and investments—affected every party in the supply chain. Changes in consumer buying habits ultimately triggered logistics providers to reduce their capacity and charge artificially low prices for the assets they retained. From end to end, global supply chains scaled back by several degrees, lowering their manufacturing capacity as well as their stocks of raw and intermediate materials.

Now demand is finally on the upswing, but transportation capacity is lagging and prices are rising again after large-scale rate cuts. Logistics providers are hesitant to add fixed costs prematurely, and smaller companies in the secondary market are having difficulty securing the financing they need to expand. Capacity is particularly scarce in the ocean transportation sector. Providers are now charging as much as $1,000 more per container than they were a year ago, which in some cases represents a nearly 50% increase. While these prices do not represent a historical high, supply chain executives should be prepared for rates to rise further while the industry recovers and reacts to the new demand.

Because of the depth of the recent recession (compared to that of 2002–2003), it will be harder to build supply chain capacity back to previous levels, and even companies with sophisticated supply chains and deeply embedded business intelligence capabilities will continue to face difficult challenges in transport. Ports are more congested. Fewer ocean routes are available than in the past 24 months, so it may take longer to move loads overseas. Expedited fixes for fulfilment errors are harder to implement because truck and/or airplane capacity may not be available. Pockets of lower capacity and lower availability will persist for some time, dampening momentum as more companies move to ramp up production.

Given these constraints on the supply chain, retailers and manufacturers alike must decide exactly which products have to be on the shelf and reassess how they put them there. They must ask themselves: How many products do we have? How many suppliers do we have? How many carriers? How many logistics providers? What is the time to the consumer? What capacity do we need to secure now?

Tasks such as rationalizing carrier lists may seem reasonably straightforward, but with cost pressures continuing for the foreseeable future, much more is going to be required. CPG manufacturers and retailers alike are searching for new areas of cost reduction. They are trying to build new processes and partnerships, both internally and externally, to provide the agility and demand-driven excellence necessary to succeed in an uncertain environment in which traditional demand signals have changed.

Our conversations with manufacturers and retailers have highlighted some of the key themes in how companies are adjusting their supply chains to succeed in the post-recovery landscape.

Shorten the Path to the Consumer to Save Time and Cut Costs

Factory location, relative to raw material sources and the consumer, continues to be an area worth reviewing for many CPG manufacturers. For example, Folgers Coffee is planning a $70 million factory expansion in New Orleans because that city "is where the coffee beans come in."[14]

Steve Neil of Diamond Foods says, "We had a roasting and packaging line in California for peanuts that come from Georgia. Our largest market is in the Northeast. So we added another line in Indiana. Now, instead of driving or training peanuts from Georgia to California and finished product back to New York, we go from Georgia to Indiana and from there east or west. We can't control where the product is grown, but we can control use of fuel."

Retailers also have opportunities to shorten paths to the consumer. Currently, Walmart buys less than 20% of its products direct from manufacturers. Over the next five years, as the company implements its new strategy with manufacturers, it expects to buy 80% of its products direct, cutting logistics costs by between $4 billion and $12 billion.[15]

Protect Your Raw Material Supplies

Manufacturers are exploring a range of options to protect raw material supplies, including vertical integration (e.g., Unilever's tea plantations), helping growers in emerging markets to meet local demand (e.g., PepsiCo's aid to Indian farmers), and working financial markets.

Build Supplier and Logistics Partnerships and Monitor Them Closely

Across many industries, the recession drove supplier rationalization efforts to obtain better prices, improve service levels, and reduce transactional costs associated with larger supply bases. The wins can be big—to the tune of $300 million for Kraft Foods Inc. Julia Brown, Kraft's Vice President of Procurement, explains the firm's approach: "We're essentially taking a white sheet of paper and saying, 'What is the right number of suppliers to support this particular category, who are they, what is the capability we need for now and in the future, and does the current supplier base have that?'"[16]

Decreased demand forced many suppliers to cut capacity and some to go out of business. Relying on fewer suppliers also raises risks. In order to maintain or further cut supplier spend levels, retailers and manufacturers are focusing on improved management and the creation of new partnerships.

For example, companies are reworking their supplier management programs to add more indicators of financial and operational health. The common practice of analyzing a supplier once before signing a contract and afterwards focusing exclusively on rates is no longer viable. Today, effective management requires multiple functions (operations, finance, procurement) to share account ownership, providing timely snapshots of supplier health, anticipating issues, and developing alternative supplier relationships as needed.

Businesses recognize the value of partnering with suppliers. "It's not really a price thing; it's really a total value in the relationship we're looking for," says James Foster, The Clorox Company's Chief Product Supply Officer.[17] Peter Heaver, Director of North Atlantic Sourcing and Supply Management for Kimberly-Clark Corporation, concurs: "We need suppliers to be profitable and healthy long-term, so we can be healthy long-term."[18]

Making collaboration work is not easy, however. Any partnership depends on the parties trusting each other with their data and knowing that competitors are not getting access to it.

One incentive for collaboration might be to develop best practices that can apply in other contexts. As Coca-Cola's Duane Still says, "We move so much product around between our bottlers, our food service business, and our Minute Maid business. We have enormous opportunity to be better coordinated with strategic partners in the freight and logistics space. Ultimately, better coordination across our network, including our franchise system partners, can serve as a model for how we can get better coordinated across other things that we do together as a system."

Determine the Right Inventory Levels

Both retailers and manufacturers have undertaken significant, across-the-board inventory reductions to improve working capital levels. Most of these inventory reductions were appropriate, given the sharp decline in demand, and more may be necessary.

The downside is that lean inventories leave companies little room for error, given the current constraints on transport capacity. "It's one thing to forecast how much you're going to make," says Philippe Lambotte, Kraft's Senior Vice President of Customer Logistics in North America, "but from a supply chain point of view, you have to forecast where you will sell [your product] from—meaning, will the inventory be in California or New England? When you don't have enough product, any move you make with the product had better be the right one."[19]

Duane Still echoes the sentiment: "In terms of process improvement, the biggest opportunity for us is in better coordination across our network, around visibility of availability of inventory and redeployment of inventory as needed."

Reduce Packaging and Number of Ingredients to Cut Costs and Please Consumers

In the past, CPG companies have gone to great lengths with packaging to ensure that the products are not damaged or spoiled during shipment. Now manufacturers are recognizing that reducing packaging generates value and reduces costs. Kraft has removed 150 million pounds from its packaging through the use of new tools such as its own Packaging Eco-Calculator.[20]

"Less is more" applies to food products as well: Frito-Lay Classic potato chips consist of just three ingredients: potatoes, all-natural oil, and a dash of salt. Häagen-Dazs's all-natural ice cream line, Five, is just milk, cream, sugar, eggs, and the flavor of choice. *Brandweek* notes that such simplicity makes it easy for consumers to feel good about their choices: "If marketers can distill things down to less clutter and more of a purity of message and purity of ingredients, that's what people are looking for now."[21] Dropping ingredients has other advantages as well: fewer raw materials to source, less complexity in manufacturing, and potentially fewer contaminants.

Packaging initiatives are an opportunity for retailers and manufacturers to work together. The Global Packaging Project of The Consumer Goods Forum was launched because retailers and manufacturers "need to find a common way of measuring environmental and sustainability improvements on packaging that can be used around the world."[22]

Accept that Business Intelligence Is Now Table Stakes

Companies minimize risk by using a base of master data and carefully selected key performance indicators to gain visibility into early warning signs (risk and resilience), optimize their internal processes (operational excellence), perfect demand planning (synchronize the supply chain), and optimize global demand and operations (global trade management).

Already, 40% of CPG companies have seen a decrease in "time to decision" and 50% have seen a decrease in "time to information."[23] Those percentages are likely to grow, as at least one third of CPG manufacturers are expected to increase their investment in business intelligence to support decision-making.[24]

Supply chain management is no longer a static planning function based on historical data. Today, tools are available that enable real-time trend analysis and data mining. Companies that have invested in these tools are seeing large benefits. For example, by implementing a demand-sensing software across its global operations, Procter & Gamble Company (P&G) reduced forecast error by 45%. This led P&G to integrate more demand signals into its planning process.[25] Almost 40% of CPG companies are collaborating with suppliers and customers to embed business intelligence capabilities throughout the value chain.[26]

Drive Continuous Improvement on a Global Scale, and Don't Try to Reinvent the Wheel

Many global manufacturers and retailers manage their supply chains on a regional basis, thereby losing the opportunity to optimize best practices on a global scale.

Gordon Stetz of McCormick says their CEO, Alan Wilson, appointed a vice president for global sourcing "to develop a common strategy across the globe around technologies and processes that will drive efficiency. Part of his role is to ensure that we are not making decisions locally that benefit local operations but do not necessarily benefit the entire global footprint."

There is a tension between the global and the local, Stetz recognizes, and the vice president "breaks ties and convinces people that McCormick is going to standardize on best practices. . . . The operating units have all been challenged to come up with initiatives to cut costs and provide funds for growth. The vice president chairs an informal cross-functional council of continuous improvement champions who share best practices drawn from these initiatives."

Break Down Functional Silos to Change the Spend Culture and Deliver Value to the Customer

Companies are rethinking longstanding functional processes to enhance profitability while delivering products more tightly tailored to consumers' needs. At General Mills, an approach called holistic margin management will save the company $1 billion over the next three years[27] by, in the words of CFO Don Mulligan, "bringing the consumer back into product development and the supply chain."[28]

A key principle, says Mulligan, "is to put the marketers at the center of decisions. For years, we and others in the industry succeeded very well with the supply chain folks working on productivity, the marketers working on advertising and new products, and the sales people working with customers. They could all work in parallel, and if they were successful in their silos, then the whole picture worked. But in today's environment—with higher inflation, consolidated trade, and a more difficult time reaching the consumer—those separate approaches don't work anymore."

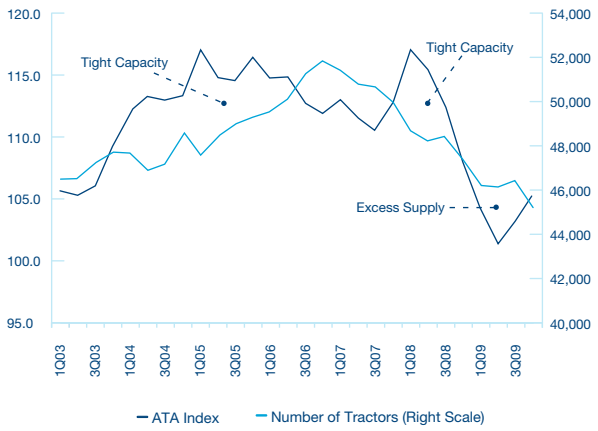
General Mills has linked earnings to investment: "We are committed to our R&D and product development," says Don Mulligan. "But we've really embedded in our organization the philosophy that we have to earn the dollars to do that, and the marketers themselves must earn the dollars to do that. We want marketers to think about this in a very tangible sense: If you earn $2, then you have the right to spend $1."

At the center is the consumer: "We want to offer products that have real value to the consumer," says Mulligan, "and if there are aspects to that product—such as how we make it, the ingredients, or the packaging—that are not adding value or aren't being paid for by the consumer, we take them out."

Planning for the Future

Retailers and manufacturers alike remain focused on cost-reduction efforts. At the same time, they are starting to think about supply chain agility as the economy improves. Constrained logistics capacity, which may persist for many years, underlines the importance of planning, supply chain visibility, and the adoption of best practices on a global scale.

Exhibit 34: American Trucking Association (ATA) Truck Tonnage Index vs. Tractor Count (at Publicly Traded Truckload Companies)



Source: Credit Suisse, "Trucking Sector Review" (March 25, 2010)

Indirect Spend: Tactics for Extracting Waste in a Post-Recession Environment

Retooling Spend to Support Growth Requires Rigorous Analysis, Company-Wide Coordination, and Awareness of Changing Conditions

In the current recession's early days, initial cost-cutting measures plucked off the most obvious targets. CFOs mandated spending freezes, cut capital budgets, and pressured their suppliers to reduce rates. Now companies are probing deeper to find what other costs they can take out. "We are challenging every dollar we spend," says McCormick's Gordon Stetz, "in order to create the funding to drive top-line growth."

Compared to direct procurement, which is often handled by a single management team, indirect spend is spread across multiple budgets and organizations, adding a complexity that's exacerbated by the number of stakeholders who expect input.[29] Both disciplined coordination and senior management commitment are therefore essential to selecting key vendors and gaining efficiencies of scale. The benefits can be significant: Hershey, for example, is targeting $80 million in the next few years by optimizing the supply chain.[30] Yet many companies believe they lack the resources or strategy to better manage their indirect spend.[31]

Guideposts for Tackling Indirect Spend Internally

For companies tackling indirect spend internally, using these guideposts should lead to better results:

- **Complete a rigorous spend analysis.** Indirect spend is often hidden among multiple departments and vendors, and many companies are surprised when they learn how many duplicative suppliers they have and how much they are really spending. A rigorous analysis will uncover numerous inefficiencies. A large company that has grown by acquisition, for example, may have five or six advertising agencies of record and be a minor client of each, rather than a key client of just one. Further, you can only cut what you can find, and indirect spend is far harder to locate than direct spend. Consider investing in the software capability to give you a clear view.
- **Develop true company-wide category strategies.** Category strategies for direct spend are widely seen as critical, but companies have not generally recognized the importance of such strategies for indirect spend—partly due to its decentralized nature. Focusing on category structures will help companies identify the spend owners and work toward a common set of spend and supply base goals.
- **Identify your company's sacred cows.** In earlier rounds of cost-cutting, many CFOs treaded lightly in functions they did not control directly, like marketing and IT. Now, even these functions are being tasked with putting together business cases and using metrics to measure spend-reduction effectiveness.
- **Challenge the supplier status quo.** The decentralized nature of indirect spend can create a supplier pool built less on market research and more on historical or personal relationships. The recession forced supplier rationalization that eliminated some underperforming suppliers; the challenge now is to continue supplier performance improvement efforts and challenge how well the supply base is performing.
- **Pay attention to non-strategic categories.** Much attention is paid, correctly, to those categories that are strategic to the business, but sourcing goals for non-strategic categories are generally limited to small rate reductions. This is a mistake, since focusing on under-represented categories can achieve significant savings.
- **Look hard at business and health insurance.** Involve employees in discussions about health insurance. They might prefer to share the cost burden rather than endure more layoffs as the company seeks to balance its insurance costs.
- **Source for the future, not off a past contract.** Renegotiating a three-year-old contract on slightly improved terms is not the definition of success. Any number of factors—for example, a change in your company's needs, or a shift in the supplier's cost position—could mean that the old rules no longer apply. Look not only at the rate but also at the capacity, the price, and the service to gain a better appreciation for the total cost.
- **Ensure an overall procurement technology strategy.** Procurement technology applications are often adopted as functional point solutions (e-sourcing, spend analysis, purchasing transactions, contract management), resulting in multiple disparate and underutilized systems. Review your capabilities to understand what information is already available that is not being used for cost-reduction decision-making.

- **Review support processes for activities that are no longer critical.** In every company, processes proliferate by accretion—for example, to support market segments that have declined in value or a product that has changed. Ask questions such as, "What is the process that supported the product we dropped, and how do we eliminate it?" or "Now that this customer segment is less important, can we remove five steps from the ten-step support process?"
- **Build in processes for sustainability.** Move beyond reactive cuts by developing effective business processes, implementing metrics for continuous improvement, and tracking cost drivers. These processes will help you progress from reactive cuts to a cost-conscious culture, and from there to a value-creating culture for the customer.
- **Avoid demoralizing slash-and-burn techniques.** Make it clear that cost cuts affect everyone, and look for hidden costs that have a large impact on indirect spend, rather than cutting small perks that employees really appreciate. Transparency engages employees in the effort and may inspire creative and innovative suggestions.

Outsourcing and Partnering to Achieve Volume Efficiencies

In addition to managing indirect spend more effectively through internal initiatives, many companies—including Kraft Foods, Pinnacle Foods Finance LLC, and United Biscuits—have begun to outsource functions outside of core competencies. Pinnacle CFO Craig Steeneck says, "Our goal is to reduce costs associated with indirect spend, while keeping our internal resources laser-focused on generating productivity across our supply chain."[32]

Other options on the table include group purchasing organizations (GPOs, such as the one that Anheuser-Busch and PepsiCo set up in late 2009)[33] and joint ventures. With GPOs, founding companies can allow other companies to pay a fee to join, and the GPO receives revenue from transaction fees. With joint ventures, members pay a fee to join the community and an annual fee to maintain their membership, and all benefits are passed to member companies to give them the lowest possible costs.

Tailoring Spend to Today's Needs, and Tomorrow's

Judicious choices in the next rounds of cutting indirect spend will prepare your company to take advantage of future opportunities. The rules have changed: Instead of basing decisions on your company's past history of indirect spend, focus on the spend you need to move agilely today.

More Bang for the Promotion Program Buck

Focus on Decision-Making to Align Promotion Program Spending with Core Strategy

Attention-grabbing displays, marked-down prices, rebates—after product quality, packaging, and sales performance, these types of promotions are the primary vehicles by which CPG manufacturers incentivize retailers to better position their products on store shelves, and make them move. The amount of money companies spend on promotion programs has more than doubled in the past two decades, to upwards of $100 billion a year,[34] making it the second-largest area of spending in the consumer products industry after cost of goods sold. The cost of promotion programs amounts to as much as 15% to 20% of manufacturers' total revenue.[35]

Promotions are just one element of the marketing budget. As one of the largest components of spend, it has the greatest ability to drive purchase behavior. The most effective marketing systems link the promotion programs to other elements of the marketing mix, including advertising, promotions, coupons, and pricing. The goal is to drive customers to make purchases, while providing retailers with added foot traffic and added sales.

Despite the investment, CPG companies estimate that fewer than half of their promotion programs yield positive returns. What's more, promotion program management (PPM) requires a large investment not only of cash but also of the human capital required to allocate, track, distribute, and manage promotion programs—a labor-intensive effort, to say the least. Given continued cost pressures, narrow profit margins, and increasing competition from retailers' own private-label brands, CPG manufacturers are more focused than ever on protecting share, managing distribution, and optimizing price. With all this in mind, today's CFOs must apply greater scrutiny than ever to promotion programs.

Flaws in the System

There are several potential reasons for the ineffectiveness of so many PPM programs:

- Companies often base their promotion program spending decisions on historical sales performance and specific account agendas rather than on broad, clearly defined financial objectives.
- Promotion strategies tend not to be data-driven; many fail to make use of the latest transaction-level analytics to continuously assess the return on investment by brand, market, and individual deal.
- Traditional top-down cost allocations inappropriately reflect the total landed cost of promotion programs, inhibiting companies' ability to evaluate effectiveness in terms of sales and margin goals.
- A lack of cross-functional communication (e.g., between sales and operations) causes decreased case fill rates and increased out-of-stocks, resulting in investment spend that is not fully leveraged.

Outdated software systems present another common problem of promotion program management. Many CPG companies rely on aging software tools, and some have customized systems that have embedded business rules and deal logic that predates today's configurable tools. Companies' continued use of these systems serves to ingrain a fragmented organizational approach to managing promotion programs. Breaking out of such a mold is difficult, but necessary.

Toward Promotion Decision Management

In 2009, we found many CPG companies aggressively managing their promotion spend to defend market share and manage price points as consumers traded down across numerous categories. The still challenging market of 2010 is driving CPG manufacturers to change their behaviors in many areas, including promotion program management. Some forward-thinking companies have started to more closely align their marketing, sales, and operational strategies with their brand objectives and overall corporate goals. They're also putting into place structures that facilitate cross-functional collaboration among a number of divisions, including accounting, manufacturing, logistics, marketing, and sales. This improves execution as well as consistency of program design. Companies are also modifying their planning processes to build in systematic review of promotion program strategies and corresponding spend adjustments on a regular basis (e.g., monthly or more frequently).

General Mills, for instance, uses a proprietary promotion planner system that tracks the vast number of promotions the company conducts and measures how much incremental volume is driven by promotion spending. Results from the system are shared throughout the organization, so what was successful for one geographical team can be considered by another.[36] Hershey also has a trade spend tracking system, and at the end of every quarter it examines the results of trade programs run during that period. CFO Bert Alfonso notes, "There is a lot of coordination between finance, marketing, and sales in terms of getting the right information analyzed that will allow finance to determine what the ROI is of a particular program and ultimately help us discern why Hershey and our trading partners should want one program over another."

However, many companies tell us that getting quality information on promotion programs performance is still a work-in-progress. Bumble Bee Foods CFO Kent McNeil encapsulates the views of many: "Gaining insight into the return on trade promotion is still a challenge. You need to link outside data along with your sales and trade promotion data. You want to gain real insight into benefits in a timely manner so that you can adjust your spending. But technically, it's difficult, and there is too much complexity in many of the trade promotion systems."

Innovative companies are integrating promotion programs with their enterprise resource planning and customer relationship management tools. Both tools can be designed to provide meaningful, granular feedback on program performance to enable companies to make changes in their functional areas in real time. For example, detailed, product-specific cost modeling and tracking provides greater visibility of total landed costs and cost to service. Similarly, point-of-sale and paneling data feeds can be aligned with management information systems to improve tactical decision-making. The point is, companies are starting to make improved investment decisions during the promotional cycle rather than after the fact.

In short, promotion program management is becoming program *decision* management.

The Challenge

The challenge for national brand leaders is to adapt to these leading-edge practices as quickly and effectively as possible. Doing so, however, involves more than simply buying a new software system or channeling greater streams of data. Companies should begin by aligning promotion program spending with corporate strategy (see Exhibit 35).

This requires:

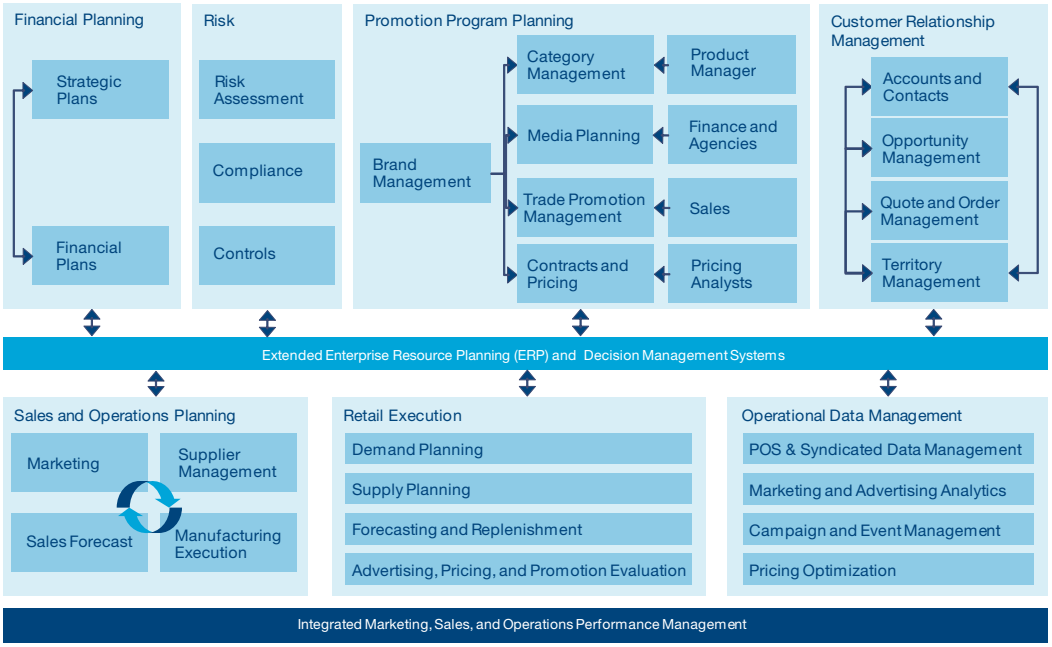
- Establishing a clear cascade of objectives
- Identifying potential misalignments for remediation
- Designing new processes for annual and quarterly planning and ongoing management

Companies must gain visibility into their own promotion spending by developing a common analytics framework and placing it at the core of their systems and processes. With promotion-related spending driving a large percentage of embedded costs, leading-edge companies are using these analytics to drive current activity and decision-making, not just as references for historical reporting.

Another central piece in the puzzle is for companies to develop "waterfalls" for their core performance program metrics. This enables them to identify the key drivers of costs and returns. At this point, companies must develop the data sources and computation models for generating these analytics on a daily basis.

These advances in promotion decision-making will help manufacturers enhance their level of engagement with retailers and maximize execution on both sides.

Exhibit 35: Trade and Media Decision Management Blueprint



Source: PricewaterhouseCoopers

Retailers, meanwhile, have their fingers on an increasingly large amount of consumer data thanks to the growth of private-label goods and loyalty clubs. The unit share of private-label products has increased in each of the past four years, to 22.8% of all consumer goods spending in the United States, with the most significant increase occurring between 2008 and 2009.[37] Now that retailers have made such a significant foray into product development and manufacturing, they have promotion program decisions to make similar to those faced by traditional CPG manufacturers. Loyalty and rewards programs, for their part, generate another source of data for retailers to analyze and ultimately try to leverage. The average U.S. household is enrolled in 14.1 such loyalty programs, and is active in 6.2.[38]

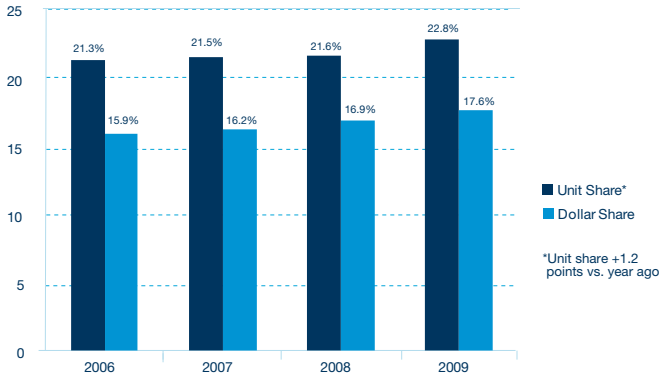
"Larger retailers want to run their own promotions," says General Mills' Don Mulligan. "Smaller retailers may have the same ideas, but they just can't do it themselves—they don't have the scale. Large retailers are doing more on their own, and selecting the branded and private-label items they want to sell. And increasingly, we need to figure out how to play within that." Diamond Foods' Steve Neil adds, "It's a one-on-one game between us and each retailer individually. That's the only way to control the return on promotional dollars. Every retailer does it a little bit differently, so the accountability goes back to the agreement with the retailer—what the terms were and what the benefit was."

Clarion Call

Both CPG manufacturers and retailers can take advantage of proven transformation methods, higher quality data, and more integrated systems capabilities to forge an effective approach to promotion decision management. The call to action is clear for most consumer products companies as they face heightened competition from private-label goods, demand for transparency of retail pricing, and the expanding possibilities for promotion via mobile devices and other new media channels. Some companies are now moving toward an overall advertising and promotion decision management framework, where there is a single budget for all options (e.g., online ads, trade promotion), designed to drive the highest return and best use of investment.

Retailers, too, face greater promotion program challenges than ever as they begin organizing transactional sales data they've acquired through private-label sales and loyalty programs. Seizing this opportunity to transform promotion decision management is becoming an industry leading practice.

Exhibit 36: Private-Label Share of CPG Spending, All Outlets



Source: IRI Consumer Network™; 52 weeks ending 7/19/2009 and same period prior years

Section 2

Spotlight on Regulation

Once-in-a-generation regulatory changes will have long-lasting effects on the CPG industry. Federal healthcare reform fundamentally alters the nature of employer-sponsored insurance, prompting companies to review their benefits strategies and compliance. How companies record leases for real estate and equipment on their financial statements is also getting a new treatment. And proposals to introduce a value-added tax in the U.S. are heating up.

Health Reform Has Arrived: What Should Businesses Do Now?

With the Healthcare Landscape Shifting, Companies Must Weigh a Range of Possibilities—for the Coming Year and for the Future

Now that President Obama has signed the Patient Protection and Affordable Care Act (PPACA) of 2010, health coverage is expected to surge in the United States over the next ten years. According to government estimates, 94% of non-elderly Americans will have health insurance coverage by 2019 if reforms succeed, up from 83% today.[39] New rules will fundamentally alter virtually all aspects of employer-sponsored insurance, from eligibility and plan design to underwriting rules, tax deductions, and funding. Companies will need to review their benefits strategies in light of the new law, and will have to weigh compliance with the new requirements against new alternatives—including possibly exiting the direct provision of employee health benefits.

Changes for the Next Plan Year

For group health plans, many provisions of the new law will become effective in the first plan year commencing after September 23, 2010. This year, companies should:

- **Plan to expand coverage to more workers and family members.** For plan years beginning after September 2010, employer-sponsored benefit plans must ensure that any annual limits they impose are "reasonable," must cover children up to age 26, and may not impose lifetime limits or contain pre-existing condition exclusions for children.
- **Review retiree drug costs.** When Congress expanded Medicare in 2003 to include drug coverage, it agreed to give a 28% tax-free subsidy to companies that pay for their retirees' drugs. Beginning in 2013, however, the new health reform law requires that employers' tax deductions for health benefit expenses be reduced by the amount of the subsidy received. Already, companies have had to account for changes in the tax treatment of Medicare Part D subsidies for their retiree drug plans. Looking beyond the immediate accounting impacts, companies should reassess whether the 28% subsidy is the best strategy for their retiree drug benefit plans, or if alternatives such as coverage through a customized Part D plan (i.e., an Employer Group Waiver Plan) or wrap-around coverage to a Part D plan would be preferable.

  The closing of the so-called "doughnut hole"—the difference between a Medicare beneficiary's initial prescription drug coverage limit and the threshold for catastrophic coverage—will enhance the value of the coverage provided under the Medicare Part D plan. Employers may want to review alternative prescription drug benefit programs that take advantage of this so they can potentially reduce their retiree medical liabilities.
- **Tap additional funding to pay for coverage for early retirees.** The CPG industry has a large number of employees in the manufacturing and distribution processes. Working in these areas can be physically taxing for older workers, and many companies have early-retirement options for these workers that include health insurance. Starting in June 2010, the government is creating a temporary reinsurance program for high-cost claims for early retirees. The funding is limited to $5 billion, and will be distributed on a first-come, first-served basis. Employers are allowed to use these funds to reduce retiree costs, but it is not yet clear to what extent employers may use the funds to reduce their own costs, or if they may do so at all. Further guidance from the government is expected in the near future.

On the Horizon for 2011–2013

Employers face even bigger changes from 2011 to 2013, affecting not only the level and type of coverage they offer but also the ways they deliver and account for those benefits. The major changes are as follows.

- **A potential drop in Medicare Advantage enrollment.** The new law cuts payments to Medicare Advantage plans, which cover about one fifth of Medicare beneficiaries and have been popular with retirees and their former employers. These plans may offer additional benefits such as vision and drug coverage, and have historically provided greater value than traditional Medicare coverage. Reducing payments to these plans could mean fewer additional benefits, higher cost-sharing for retirees, and higher premiums. Employers that offer Medicare Advantage plans to their retirees should be aware of the potential impacts of the changes in Medicare Advantage funding.
- **Reporting coverage value on W-2s.** To create greater transparency around healthcare costs, employers must begin reporting the value of an employee's health insurance on the annual Form W-2 in 2011. To calculate the coverage value, employers will likely need to follow rules similar to those for determining the cost of COBRA coverage.
- **Conscripting employees into plans.** Employers with more than 200 employees will be required to enroll workers automatically into company health plans on a date that has yet to be determined, but could be as early as 2011.

Major Changes Planned in 2014 and Beyond

The landscape for employer-sponsored insurance will change dramatically in 2014. Individuals will have guaranteed access to coverage through state-based health insurance exchanges, while employers may be faced with penalties if they fail to provide access to coverage, or provide inadequate or unaffordable coverage. One survey reports that, as a consequence of these changes, some 19% of large employers plan to step away from direct sponsorship of healthcare benefits over the next five years.[40] Starting in 2014, businesses will have to make decisions on the following issues:

- **State-based health insurance exchanges.** States will establish health insurance exchanges that provide one-stop shopping for standardized packages of benefits. Beginning in 2014, small employers and individuals may buy their insurance through these exchanges. In 2017, states may open their exchanges to large employers (defined as those with 100 or more employees). Because most employers customize their benefit plans to their particular workforces, each company should reevaluate its strategy for health coverage. Possible scenarios include continuing current plans, discontinuing company plans and instead subsidizing plans offered through the exchange, switching to a type of defined contribution approach, and offering plans that wrap around exchange-based plans, as regulations may permit.
- **New coverage requirements on employers and individuals.** Beginning in 2014, employers with more than 50 workers must provide access to coverage for all of their full-time workers or pay a $2,000-per-worker "free-rider" penalty, excluding the first 30 full-time employees. In addition, if a company offers access to coverage, but the coverage does not meet minimum adequacy requirements or the premium cost exceeds 9.5% of an employee's household income, the employer risks paying $3,000 for each employee who opts out of the employer plan, enrolls in a health plan offered through the exchange, and receives a premium tax credit. In addition to being subjected to the free-rider penalties, employers will have to ensure starting in 2014 that there are no waiting periods longer than 90 days in their health benefit plans.
- **Excise tax on "Cadillac" plans.** Starting in 2018, high-value health plans will be assessed a 40% excise tax. In general, these are plans with actuarial values over $27,500 for a family plan and $10,200 for a single plan. Amounts exceeding these thresholds will be subject to the tax. In response, some employers may shift compensation from benefits to salary. Additional regulatory guidance will be needed to determine if this provision applies to stand-alone retiree medical plans.

Cost Shifting and Plan Design Changes

In 2009, employers offering health insurance spent an average of $6,700 per employee—nearly double the amount spent in 2001.[41] Employers on average pay 80% of their workers' health benefits, and they also have large retiree health benefit liabilities.[42] As a result of those cost pressures, many employers are revisiting their health benefit strategies. Some have implemented plan changes and explored options including high-deductible health plans, wellness initiatives, and disease-management programs. A recent PwC survey found that 60% of U.S. employers are ready to push more of the costs to their employees in 2010 while expecting more employee responsibility for managing personal health.[43] Among the strategies employers are planning to implement, increasing cost-sharing and improving employee wellness top the list.[44]

Cost-shifting has many companies moving from an employee co-pay model to a co-insurance model, where the employee has a front-end deductible and then splits the remaining costs 30/70 or 20/80 with the insurer. In addition, about 20% of large employers now offer high-deductible health plans, up from 14% in 2008.[45] These plans combine high-deductible health insurance with employee-funded health savings accounts or health reimbursement accounts.

Employers surveyed by PwC said they would forgo customized health benefits in exchange for significant, direct cost savings.[46] Customization of healthcare plans adds to administrative cost, particularly among healthcare providers, and the majority of employers said they would be willing to accept less customization if insurers were to offer a reduction in administrative fees. Additionally, some large corporations are signaling that they want to go back to fewer vendors and more integrated solutions.

Recognizing that a healthy worker costs less than an ill one, more employers are expanding wellness and disease-management programs. A PwC survey found that while 71% of employers are offering wellness programs, few said these programs are very effective at lowering costs.[47] However, this could be because wellness programs don't work if employees don't participate, and fewer than 40% of eligible individuals actually enroll.[48] Participation generally increases following the provision of incentives such as cash, gift cards, or annual premium savings, even for an incentive as low as $75. As a result, more employers are considering offering incentives.

To prepare for the new health insurance market, employers should start addressing several key questions:

- Have we modeled financial scenarios around coverage requirements and/or penalties? What will the cost be to comply with the law and communicate and administer the changes over the next five to eight years?
- What are the long-term benefits of providing health coverage to our employees? Should we continue to do so or instead pay the penalties?
- Since the exchanges will provide guaranteed coverage for individuals, do we need to continue to subsidize coverage for spouses and dependents?
- Do we currently have the organizational capacity to administer new regulations around insurance coverage?
- Is wellness and prevention part of our culture?
- What strategies can we put in place to improve employee health and lower costs?
- How can we encourage employees to engage in our wellness campaign? What incentives should we offer?

The new law will have major cost and compliance implications for employers. But companies will have to consider the broader marketplace as well. Health benefits packages can be integral to a company's ability to attract and retain top talent, and employers should evaluate health plan decisions in the context of their overall benefits and talent strategies.

Exhibit 37: New Rules for Employer-Sponsored Benefit Plans
The Health Reform Laws Require Companies to . . .

	2010	2011	2012	2013	2014	2017–2018
Begin	• Providing coverage to children up to age 26 • Covering children regardless of pre-existing conditions • Considering participation in pre-65 retiree reinsurance program	• Reporting value of worker health benefits on W-2 • Considering offering new community living assistance services and supports (CLASS) benefit	• Providing uniform statement of benefits to employees • Providing 1099 for certain corporate service providers	• Notifying workers about the state insurance exchanges that will start in 2014	• If available, considering whether to join state health insurance exchanges (small employers) • Covering all full-time workers or pay the "free rider" penalty • Getting subsidies for providing coverage to their workers (small employers only) • Considering offering 30% wellness incentives to workers	• If available, considering whether to join state health insurance exchanges (large employers)
Stop	First plan year after Sept. 23, 2010 • Setting lifetime limits on benefits • Implementing annual benefit limits that do not meet HHS standards	• Allowing OTC drugs as qualified medical expenses		• Allowing FSA contributions of more than $2,500 • Deducting federal subsidies for retiree drug coverage	• Setting out-of-pocket limits that are greater than health savings account plan limits • Making workers wait more than 90 days to enroll • Setting annual plan limits • Excluding benefits for pre-existing conditions	• Offering high-cost benefit plans or face 40% excise tax

Source: PwC Analysis

A New Treatment for Leases

Retailers and CPG Manufacturers Are Likely to Face Major Accounting Changes

One of the most sweeping accounting changes in the history of the retail and consumer products industry could take effect in the next few years. At issue is how companies record leases on their financial statements. The proposed changes would vastly alter corporate financial statements, forcing companies to gather and evaluate a great deal of additional information on an ongoing basis. The new rules would have broader impacts as well, affecting essential financial metrics such as earnings before interest, taxes, depreciation, and amortization (EBITDA) and, in turn, debt covenants and executive compensation formulas. Companies would do well to begin preparing for these changes now.

The proposed changes are outlined in a discussion paper issued jointly by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).[49] The two standard-setting bodies suggest revamping practices that have been in place, both in the United States and internationally, for more than a quarter century.

Change in Expense Recognition

Currently, leases are treated as either operating leases or capital leases. Which category a lease falls under depends on what accountants call the four "bright line" tests. On any one of these tests—such as whether the present value of the payments on a lease is greater or less than 90% of the asset's fair market value at the beginning of the lease term—a company could score very close to the dividing line between what's classified as an operating lease versus a capital lease.

Lease accounting standards, however, do not make exceptions for such close calls; moreover, the distinction between an operating lease and a capital lease results in very different accounting treatment for very similar transactions. Capital leases are included on a company's balance sheet as an asset and corresponding liability. Operating leases—far more common in the retail industry than in other sectors—have no balance sheet impact and the lease payments are simply reflected in the income statement as part of operations.

The IASB and FASB are proposing that all leases be recorded on balance sheets, with no grandfathering of existing leases, with the exception of certain simple capital leases. This would require a company to recognize as an asset on its books its "right to use" the leased asset over the term of the lease and to report the committed cash payments as a corresponding liability (debt). The asset would be depreciated on a straight-line basis. The liability would be reduced through principal payments and interest expense, using an effective interest method, with more interest expense recorded in the earlier years. The net effect would front-load expense in the early years of a lease, compared to current lease rules.

Contingent Rentals

Another important issue for companies is how to treat contingent rentals, often the norm for retail outlets and defined as rental payments based on a percentage of store revenues (with or without an underlying base rent). The discussion paper calls for contingent rentals to be included in measuring the right-of-use asset. This will involve making an estimate at inception of contingent rentals over the lease term.

Changes in Determination of Lease Term

Based on the IASB's and FASB's most recent discussions related to renewal options, the number of renewal options to include in the determination of lease term will change compared to current accounting rules. Under the proposed rules, companies would measure the leased asset and the related liability based on the "longest possible lease term that is more likely than not to occur."[50] Adoption of this standard would result in longer lease terms, which will require companies to record larger assets and larger liabilities.

Practical Implications

The proposed model would affect financial metrics, information needs, and systems and controls. Companies may want to begin thinking about potential business implications now, well before a final standard is issued.

Implications for Metrics

For retailers and CPG manufacturers, some of whom enter into thousands of leases, a number of financial metrics would change. No longer would lease payments be treated as rental expenses (and therefore reductions against earnings), as they are now for operating leases. Instead, lease payments would be recorded as interest and depreciation expenses, and partially as debt reduction. Therefore, a company's EBITDA would increase. Net income, which factors in interest costs and depreciation, would decrease in the earlier years. A third measure—ratio of debt to equity—would also change, with the debt number on the balance sheet ballooning because of the newly classified liabilities.

These changes in metrics will affect a number of things, including:

- How companies discuss their results with investors and analysts
- Debt covenant calculations
- Internal measurements for budgets, incentive compensation plans, and other calculations

Implications for Information Needs, Systems, and Controls

The proposed rules do not contemplate grandfathering of leases, with the exception of certain simple capital leases. Therefore, all leases in place as of the standard's adoption date will need to comply with the right-of-use model. It is imperative, therefore, that companies develop systems to meet the needs of these new rules. Companies will have to account for and manage lease agreements differently. New contract management systems may be needed that can be integrated into existing accounting systems. IT and accounting solutions that meet future needs must be identified and implemented.

Timely assessment and management of the impact of the new rules on IT and lease accounting systems will help reduce business and reporting risks. Some enterprise resource planning systems are in the process of evaluating upgrades and solutions that will allow for integration of the accounting changes and potential related controls necessitated by the new lease rules; however, such discussions are only in the conceptual and planning phase, pending the issuance of additional accounting guidance.

Getting Prepared

An analysis by the Rotterdam School of Management, Erasmus University, and PricewaterhouseCoopers shows that, given its traditional reliance on leasing, the retail industry would be affected more than any other business sector by the proposed accounting changes.[51]

It is widely seen as inevitable that these lease accounting changes will take effect. Companies may need to invest in information systems that capture and catalog relevant information, and also reassess lease terms and payment estimates. Companies also need to determine whether they should change their operating models. For example, should they use more franchise arrangements, or reconsider lease-versus-buy decisions? Also, can companies accurately predict the impact the new rules would have on key performance indicators they provide to investors?

At the very least, companies should evaluate their systems and controls to ensure they have the appropriate infrastructure in place by the time the proposed rules take effect.

The Value-Added Tax Surfaces as a Debt-Reduction Measure

VAT Could Have a Heavy Impact on Retailers and Lower-Income Consumers

With the cost of entitlement programs growing considerably faster than tax revenues, the Obama administration has created a commission to make recommendations on how to reduce the federal debt to about 3% of GDP by 2015. The president has made clear that all revenue options are on the table for consideration, including a value-added tax (VAT), a type of consumption tax collected from companies at each stage of the supply chain. Adopting such a tax would put the United States more in sync with other major industrialized countries, but it remains to be seen whether a VAT is politically viable in the near future.

The United States is the only major industrialized country that does not impose a VAT. First introduced in France in 1954, the VAT is now the most common broad-based national consumption tax in the world, and is currently employed by approximately 150 countries, including every member state in the Organisation for Economic Co-operation and Development (OECD) except the United States. Every OECD and EU country that imposes a VAT also levies a corporate income tax.

Opposition to such a tax is broad and strong among retailers and CPG manufacturers. As Hershey CFO Bert Alfonso notes, "A VAT will impact the whole economy, not just CPG companies. It will push up prices and probably lower consumption. Though it may impact the fiscal imbalance, I also believe less spending is important as well. My guess is that there is a real possibility for a VAT."

"I'm certain it would have a detrimental impact on business for everyone, and force customers to cut back," says Coca-Cola North America's CFO, Duane Still. "It would impact growth, impact our expansion plans, and even impact our ability to maintain the resources and people we have today."

In 2005, one of the two tax reform options recommended by the Bush administration's Advisory Panel on Federal Tax Reform was the Growth and Investment Tax, which would replace taxes on business income with a subtraction-method VAT. Under the subtraction-method VAT, the tax base for each supplier is determined by subtracting purchases of goods and services from other businesses from the supplier's sales of goods and services. The Bush panel considered but did not reach unanimous agreement to recommend a credit-method VAT, which is the type used in most countries that levy a VAT. Under the credit method, VAT is collected on sales of goods and services, with a credit for VAT paid on purchases from other businesses (see Exhibit 38). For domestic transactions, given that there is a single rate and no exemptions, the two methods would raise the same amount of tax. Either way, taxes are added to the cost of a product as it proceeds along the supply chain.

Prominent figures on both the Democratic and Republican sides have made favorable comments about a VAT, including Speaker of the House Nancy Pelosi (D-CA), Senate Budget Committee Chairman Kent Conrad (D-ND), former Federal Reserve Chairman Paul Volcker, and former Federal Reserve Chairman Alan Greenspan. Rep. Paul Ryan (R-WI) has proposed legislation that would, among other things, replace the corporate income tax with an 8.5% subtraction-method VAT.

In 2007, standard VAT rates in OECD member countries ranged from 5% to 25%, with one or more reduced rates in 21 of 29 countries. Reduced or zero VAT rates are commonly applied to residential rent, electricity, heating oil, medicine and medical care, education, food and non-alcoholic beverages purchased for home consumption, and clothing.

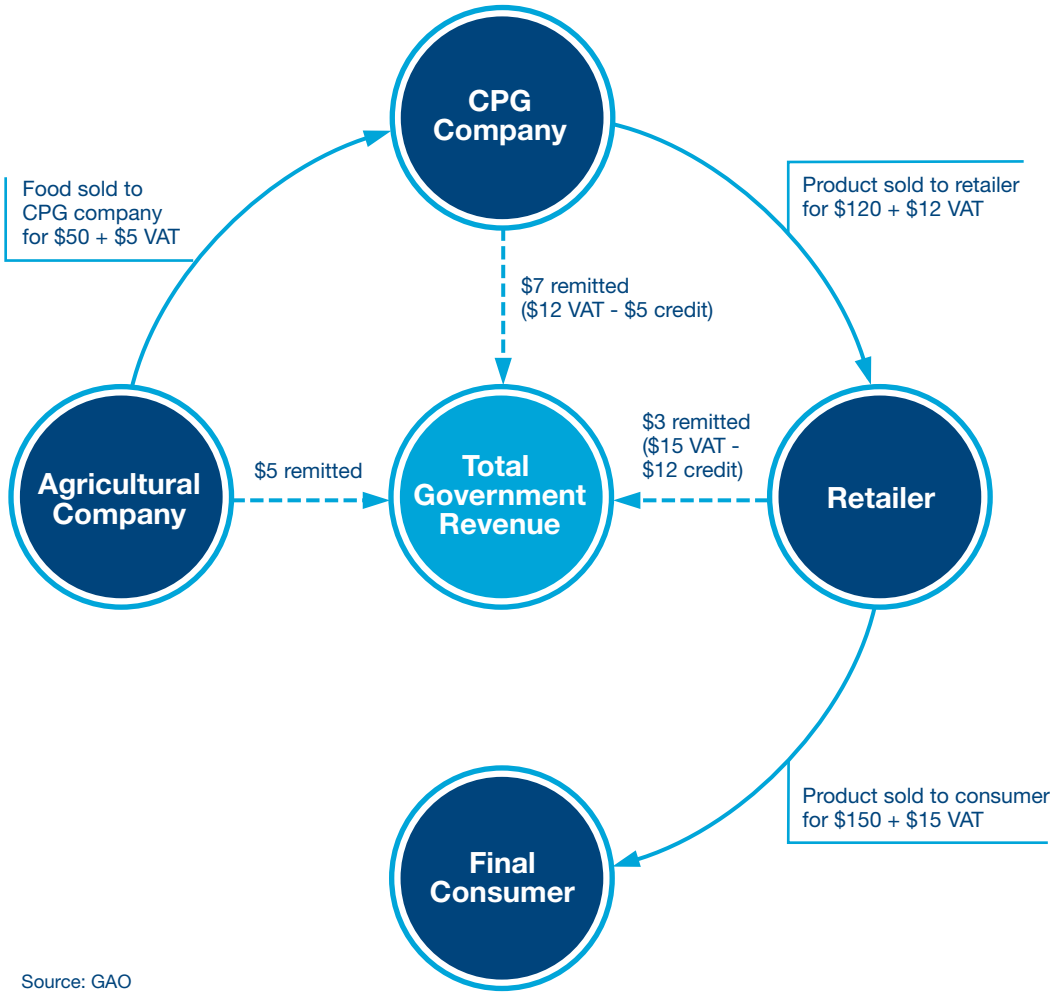
Economic and Policy Arguments

Proponents of a VAT argue that it could raise significant amounts of revenue to fund entitlement programs, reduce the deficit, and reduce corporate and individual tax rates or even replace the corporate income tax. On average, VATs in OECD countries raise about 0.4% of GDP per point of VAT—which in the U.S. would have amounted to $59 billion in 2009. A recent OECD study of 21 countries compared VATs to other types of taxes, and found that corporate taxes had the most negative effect on GDP per capita, while taxes on immovable property and on consumption (e.g., VATs) were the most growth-friendly.[52]

For U.S. CPG companies, a VAT would likely have the same impact on profits as would an increase in the retail sales tax. However, the net impact of a VAT would depend on how the revenues were used—e.g., to reduce the deficit or to reduce other taxes. In a December 2007 report,[53] the Treasury Department analyzed tax reform options, including one that would replace the corporate income tax with a VAT in the 5–6% range.

Opponents of a VAT argue that it unduly harms lower-income taxpayers, as well as American businesses. The Retail Industry Leaders Association (RILA) says that a VAT is a regressive tax that would increase retail prices, lower retail sales, and reduce retail employment.[54]

Exhibit 38: How a 10% Credit VAT Would Work



Source: GAO

Some of the hurdles to VAT imposition were on display last year when California's Commission on the 21st Century Economy[55] recommended a 4% net receipts tax similar to a subtraction-method VAT to replace the state-level sales tax and corporation franchise (income) tax. California retailers and grocers strongly opposed the tax, saying it would hurt labor-intensive, low-margin, high-volume businesses. To date, the proposal has not moved beyond the "informational hearing" stage at the California State Assembly, and the legislature's focus has shifted to other areas, such as reforming the corporation franchise tax.

It has been suggested that a VAT system would not be seriously considered in the U.S. until policymakers demonstrate that they have explored other avenues of raising revenue, including closing the "tax gap" and improving the performance of the income tax. Such arguments, along with resistance in the business community, lack of broad political support, and the growing influence of grassroots anti-tax, anti-big-government movements will make passage of a VAT difficult over the near term. Nevertheless, with the government facing exponentially increasing financial shortfalls, a VAT likely will be given serious consideration in years to come.

VAT Benefits and Drawbacks

Pro: In the 29 OECD countries with VATs, the tax accounts for an average of 19% of all government revenues, providing a sustainable funding source for programs and making possible top statutory corporate tax rates that are, on average, more than 13 percentage points lower than in the United States.

Con: Countries that have adopted a VAT have seen an increase in their consumer price index, significant costs of compliance and administration, increases in the VAT rates after the date of introduction, and the need to adopt measures to address concerns about regressivity.

Section 3

Emerging Opportunities at Home and Abroad

A brave new world holds tremendous potential for those firms that approach each opportunity with a creative yet disciplined approach. In communications, social networking websites afford a powerful means of tapping consumer enthusiasm. On the waste-reduction front, CFOs have stepped up their role in monitoring and reporting on environmental sustainability efforts. China and India, meanwhile, offer vast new customer segments for the right value proposition.

Social Media: Raucous, Risky, and Essential to Your Business

A Powerful Means of Tapping Enthusiasm, but Missteps Are Inevitable

Social media channels such as Twitter, YouTube, and Facebook are humming with commentary about companies, products, and services. How to respond to and tap into the "wisdom of crowds" is one of the most fluid and often-discussed issues in the retail and CPG industries today.

This is no longer the kids' domain, as every generation is participating in the creation and consumption of content over the web. People in their 20s to 40s tend to produce more content, such as blogs and videos, while those in their 40s to 60s spend a proportionally larger amount of their time consuming content produced by others.[56] Roughly 67% of global Internet users visit social networks, making them more popular than personal e-mail.[57] Worldwide, Facebook membership alone has climbed above 400 million.[58]

All of this activity is producing massive amounts of data. More than 1.5 trillion text messages were reported on carriers' networks during 2009.[59] Every minute, 24 hours of video is uploaded to YouTube.[60] Every month, 25 billion pieces of content are uploaded to Facebook.[61] And there's no letup in sight.

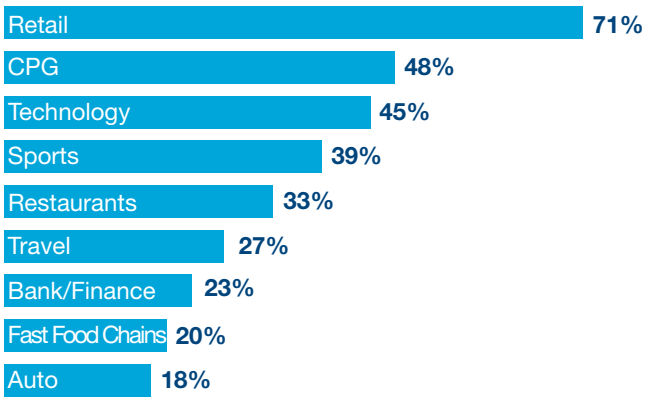
The volume of data generated by social media represents a massive opportunity for consumer businesses—as long as they can figure out how to discern useful patterns in the noise and mine this sea of sentiment and ideas. Indeed, never before have businesses had instant visibility into consumer opinions and needs. It used to take weeks, if not months, to gather consumer data through formal channels, meaning the information was outdated long before decisions were made. Today, companies can take their customers' virtual pulse in real time, one on one.

However, the risk associated with billions of mobilized and communicative consumers is as outsized as the opportunity. Intellectual property can leak around the globe in seconds, as can news of previously veiled corporate actions. Complaints—for instance, about a supplier allegedly using environmentally destructive practices or showing poor taste in an advertisement—can spawn thousands of commentaries within hours.

Clearly, CPG companies need a well-honed strategy for participating in social media, and that strategy must include a way to measure ROI. Best Buy, Hershey, Sunny Delight, and others are actively working on such strategies[62] while also engaging with their consumers in the here and now. They realize that sitting on the sidelines too long while developing plans could pose a far larger risk than the occasional messaging fumble.

After all, companies have to be "out there" to communicate their point of view. As Hershey CFO Bert Alfonso says, "Many consumers are now using digital media to get their information. You need a way to tell your story. And if you are going to tell your story in a world of blogs and streaming video, you better be able to communicate digitally."

Exhibit 39: Types of Brands Followed by U.S. Social Network Users Who Follow Companies/Brands on Social Networks, Q3 2009 (% of Respondents)



Note: n=158 ages 13+

Source: Dynamic Logic and Millward Brown, "AdReaction 2009: Brand + Consumers + Social Media," provided to eMarketer (January 26, 2010)

Furthermore, social media is evolving at breakneck speed. "It's going to be radically different five years from now than it is today, which is radically different from what it was five years ago," says Steve Neil of Diamond Foods. Companies that learn how to reach consumers efficiently and cost-effectively are, at the same time, building entry barriers to competitors.

The experiences of leading consumer firms to date suggest several themes that are useful to executives trying to find the right approach, and the right level of investment, for their own companies.

Accept that Privacy Is Dead, and Plan for It

Chief Ethics Officer Kathleen Edmond of Best Buy puts it bluntly: "You have to accept the fact that everything is going to be public." She describes a recent incident in which Best Buy issued an internal memo to employees about the investigation of a problem during a sales event. That memo was published on a UK gaming site within three hours. Because of incidents like this one, Edmond operates under the assumption that anything she writes will wind up on the Internet in a matter of minutes.[63]

The transparency, speed, and fluidity of social media make the walls of a company frighteningly sieve-like. There is no firewall thick enough to stanch the flow of information.

Edmond does not see the value—or the feasibility—of attempting to block access to social media at work. After all, employees can still use their phones to access Facebook and they can still text and e-mail.

Beyond information loss, companies are concerned about productivity. "I've heard social networking called 'social NOTworking,'" says Edmond. But it is a mistake to focus on a symptom rather than the cause of the problem. It's all about management. This is the same trend as employees using their personal phones and personal e-mail at work. As Edmond puts it, "It's a new version of an old problem."

Furthermore, every employee who tweets or posts on a blog could be perceived as a spokesperson for the company. What policies need to be in place, and who can speak on the company's behalf? As McCormick CFO Gordon Stetz says, "We are still trying to find the right balance, to figure out the right way to open this up in a controlled fashion."

Bring Social Media's Advantages In-House via Business Networks

Social media is not just an external phenomenon. Today, many companies are launching internal "water cooler" sites to give employees a voice they feel will be heard within the company. Best Buy's foray into social media began with an internal site called Blue Shirt Nation, on which employees were encouraged to talk honestly about any topic. Bringing underground conversations out into the open can have unintended benefits, too. For Best Buy, one such benefit was the quiet death of an independent site that did not facilitate transparent problem resolution.

On business networks, employees make connections and friend each other, just as they do externally. They share documents, stories, and expertise. Think of employees as nodes on a map: Every time one person talks to another on the business network, a line is drawn between them.

Some lines, such as to people known to be expert in a specific area, will grow as thick as tree trunks. Other areas of the map may show empty space. Information about where conversations are occurring is harvestable on a business network. And by investing in social network analysis (SNA), companies can gain a heightened understanding of their organization's informal dynamics.

According to IBM researcher Kate Ehrlich, "The main benefit of social network analysis is that it makes the lines of collaboration visible. And by making them visible, it makes them actionable." Work flow, team structure, and even organizational structure can then be optimized to promote the innovation that so often follows collaboration. There is, says Ehrlich, "an unacknowledged role of energy in innovation . . . in crossing the chasm from the unknown to the known,"[64] and acting on SNA insights can help companies bring the right people together to drive innovative ideas to fruition.

To Succeed in Social Media, Companies Must Engage Consumers with Respect and Provide Value

Social media follows the rules of any authentic conversation: You can't participate unless you are willing to listen, and the conversation will be painfully short unless you put down your agenda and offer information of value, without a heavy-handed marketing message attached.

Websites offer one avenue for distributing branded content, which is content created by a brand or company. Best Buy helps customers through Twelpforce.com, an interactive site where 1,700 employees answer customers' questions. Countless other avenues are currently being explored. P&G launched a record

label, Unilever made a soap opera, and Kraft Foods published an iPhone recipe application to inspire innovation among food lovers.[65]

PepsiCo's Refresh Project will distribute $20 million in 2010 to charities, causes, and businesses selected by voters on RefreshEverything.com. Further, to draw energy from the 2010 football/soccer World Cup, PepsiCo and Microsoft launched an online "entertainment experience" through the MSN portal, featuring interactive games and content from star players.[66]

"This is not about us pouring our messaging down," explains Bonin Bough, PepsiCo's global director of digital and social media. "It's about releasing control. The center of culture has evolved to the point where people own brands."[67] Value provided without strings attached builds relationships and encourages positive responses to brands.

Listening is an important first step for any company. "Social media is a conversation," says Doug Chavez, Senior Manager of Digital Marketing at Del Monte Foods. "You wouldn't step into a conversation at a dinner party and start talking without understanding the conversation. With social media, we listened for a while, and then when there was an opportunity for us to add value to that conversation, we have done that . . . and we have been rewarded for that."

Once You Are in, You Need to Be in for the Long Haul

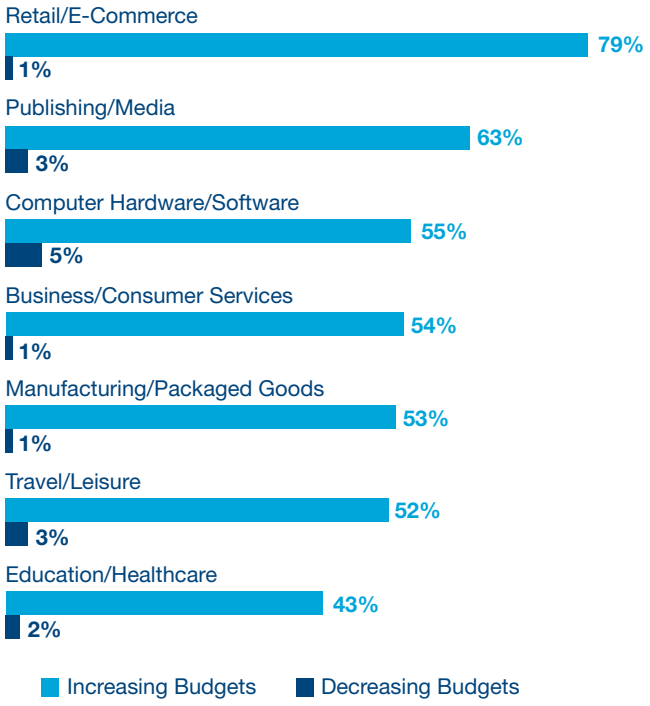
Consumers expect social media conversations to be two-way, which means that companies must be prepared to both converse and provide value on a long-term basis. Simply setting up a Facebook group or a Twitter feed and then standing back will not suffice.

Even short-term conversational dropouts can have an effect. If a company executive is engaged in an online discussion with customers and has to sign off mid-conversation, that can inadvertently come off as rude.

It is critical, then, for companies to select where and how they engage with customers and to resource those efforts appropriately. As Del Monte's Doug Chavez explains, "We focus on large platforms like Facebook and Twitter, coupled with niche social-media presences that attract highly engaged participants. For example, a site like FoodBuzz attracts very engaged cooking enthusiasts, [and] is a great place for brands like Contadina and College Inn to participate in the discussion."[68] Chavez also notes, "People ask me for a Twitter strategy or a Facebook strategy. These aren't strategies—they are levers."[69]

Additionally, infrastructure is required to support companies' social media efforts. "Social media now becomes the TV," says PepsiCo's Global CIO, Robert Dixon. "That's where consumers are receptive to engage the brand. So the brand develops its campaigns and marketing programs, and we need to make sure that we've got the capability underneath to supply those to the digital domain."

Exhibit 40: Social Media Marketing Budget Changes in 2010, According to U.S. Marketers, by Industry (% of Respondents)



Note: n=2,317

Source: MarketingSherpa, "2010 Social Media Marketing Benchmark Report" (December 11, 2009)

Cross-functional support is vital.[70] Chavez says, "Don't farm social media out to agencies, because it will be too obvious that the tweeting is coming from the brand and not an individual with a stake in the conversation. At Del Monte, we share the responsibility across marketing, consumer affairs, corporate communications, and public relations. By involving multiple stakeholders, we are breaking down silos. Now functions that have not typically worked easily together have a shared responsibility."

To organize these efforts, an increasing number of companies are hiring directors of digital media. One of the most recent is the McDonald's Corporation. As Heather Oldani, McDonald's Director of External Communications and Public Relations, says, "It's time to have [someone] dedicated 100% of the time, rather than someone who's got a day job on top of a day job."[71]

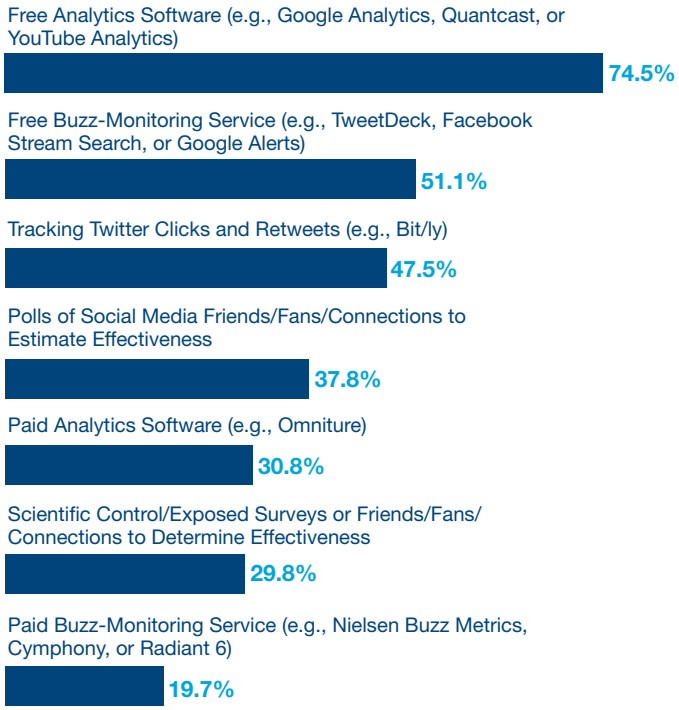
Figure out the ROI—Because Social Media Is Not Free

It takes time to create branded content, which is the value that consumers expect to receive through social media. It also takes time to post content, even if the social media platform itself is free to use. Companies must make choices about how to use their marketing dollar, as PepsiCo did in deciding to launch the Refresh Project rather than advertise during the Super Bowl, breaking a 23-year tradition.

As Bush Brothers CFO Al Williams points out, "You have to understand the consumer you are trying to target and how to reach that consumer in a way that drives a purchase. It's a zero-sum game. You only have so many resources to apply, so if you put those resources in social media, you have to choose to take them out of your mass-media advertising budget."

Del Monte's Doug Chavez suggests that companies focus on engaged customers, not raw fan counts: "We look at the richness of posted comments and at the number of people clicking from our Facebook page to a brand website, for example. I'd rather have fewer people going to our Milk-Bone 'It's Good to Give' page on Facebook and sharing with the community there—which shows their engagement in the story—versus a million people going to the same page and then leaving. By focusing on engagement, we have seen a lift in the brand."

Exhibit 41: Analytics/Measurement Tools Used by Social Media Marketers Worldwide, September 2009 (% of Respondents)



Note: n=1,513

Source: MarketingProfs, "The State of Social Media," provided to eMarketer (December 10, 2009)

Engage Consumers and Employees as Partners in Innovation

The real challenge—with the greatest ROI—is to draw on consumer and employee feedback to innovate.

Downturns are excellent times in which to grasp this opportunity. "We went back and looked at recessionary periods in the past, and a lot of great brands and innovation were launched during those periods," says Ian Friendly, General Mills' Executive Vice President and COO of U.S. Retail.[72] What better way to innovate than to draw on the free stream of ideas and sentiments from consumers?

There are many instances already of CPG companies inviting consumers into product development. Coca-Cola asked its Facebook fans to choose new vitaminwater flavors, for example, while PepsiCo's DEWmocracy campaign for Mountain Dew asks dedicated fans for their input on everything from flavor to advertising.

And Unilever, spurred by success at integrating consumer input into a trial of its Lynx Twist men's fragrance, has launched custom online communities to engage customers throughout product development. "There are two ways of doing it," said David Cousino, Unilever's Consumer Marketing Insights Global Category Director. "You could wait for something to go wrong and then use the community to fix it, but why not leverage the creative ability in the community that's already out there?"[73]

Social media have shifted the balance of power between consumers and companies. The question is not whether companies need to respond to customer complaints, but how quickly they can mobilize.

Where Criticism Can Go Viral (and Global) Overnight, Effective Crisis Management Is Key

When the commentary on social media is positive toward brands, the buzz is great. However, when the commentary turns negative, crisis management becomes urgent. In a matter of hours, a small incident can be magnified into a major problem.

As in any conversation, honesty and a willingness to hear and respond to criticism are expected in the social media setting. According to Del Monte's Chavez, social media gaffes—such as threatening to take down posts—show a lack of training and a lack of consistent involvement in the digital dialog. "We have a policy in place that provides freedom within a framework for our cross-functional stakeholders to respond quickly."

Furthermore, he says, most people just want to be heard. "We might hear a complaint like, 'I only got four cherries in my fruit cocktail mix.' We might send the person an online coupon and apologize. You would be surprised. Within minutes, that person will start retweeting our response and say, 'Look, Del Monte is listening.'"

What's Your Social Media Strategy?

Social media is indeed raucous, risky, and essential to your business. Communication channels continue to explode in number and usage, and corporate information that was once private is now decidedly public. Participation means CPG companies will have a voice in the conversation—and the opportunity to reach consumers in a fashion that fits with the way they work and live today.

The Intersection of Mobile Computing and Social Media

Mobile devices are changing how people access information, the kinds of information they need, and how they live. The future of computing is moving very rapidly into the mobile space, and social media is baked into the very nature of mobile computing. Indeed, much of the immediacy of response associated with social media comes from people commenting and updating via smartphones.

According to eMarketer, 242 million Americans will be mobile users by the end of 2010. The opportunity to reach those consumers is spurring 65% of marketers and publishers to develop plans to invest in mobile applications, according to a recent survey.[74]

Online coupons are one option being explored by Dole. "When engaging shoppers via their cell phones, relevancy is paramount," says CarrieAnn Arias, Dole's Senior Marketing Manager, Customer-Specific Marketing. "Shopper-driven mobile content produces incremental sales and profit."[75]

Other options include time-limited sampling offers, promotions, and advertising based on people's locations. Through a program with location-based network Foursquare, PepsiCo is notified when customers are near any location selling the company's brands. PepsiCo can push out offers to these loyal customers' cell phones instantaneously and, at the same time, use the data on customer movements to further deepen its understanding of these customers' preferences and habits.[76][67]

But just because a lot of brands have or are developing mobile applications, that doesn't mean all brands need them. "Some consumer products marketers might not need apps," cautions Tobi Elkin of eMarketer. "There's a lot of 'me too' in the marketplace." She urges CPG companies to follow basic social media rules in deciding whether to invest in creating mobile applications: Provide value to customers and stay true to the brand's overall marketing strategy.[77]

Regardless of whether they venture into mobile applications, however, CPG companies and their retailing partners need to prepare for consumers who are empowered with information from their mobile devices.

Exhibit 42: Key eMarketer Numbers—Mobile Social Networks

5.6 billion	Mobile subscribers* worldwide in 2013, up from 4.6 billion in 2009
1.4 billion	Mobile Internet users worldwide in 2013, up from 505 million in 2009
607.5 million	Mobile social network users worldwide in 2013, up from 141.4 million in 2009
43%	% of mobile Internet users worldwide in 2013, up from 28% in 2009
126.2 million	U.S. mobile Internet users in 2013, up from 68.6 million in 2009
56.2 million	U.S. mobile social network users in 2013, up from 21.9 million in 2009
44.5%	% of U.S. mobile Internet users in 2013, up from 31.9% in 2009

Note: As of December for each year; *refers to the number of active subscriptions; 2009 is an ITU estimate.

Source: Noah Elkin, "Mobile Social Networks: Marketing by Location Shows Potential," eMarketer (November 2009)

Sustainability Reporting Moves into the Mainstream

Comparing the Performance of Reporting and Non-Reporting Companies

Mandatory reporting of sustainability efforts is not yet a reality in the United States, but the possibility continues to be discussed in Washington, D.C., and is very real. Despite economic challenges, companies continue to have a strong interest in sustainability. Corporate disclosure on carbon emissions and climate change risk has increased significantly over the past two years, with 66% of S&P 500 companies submitting voluntary disclosures to the Carbon Disclosure Project in 2009, up from 56% in 2007.[78] Additionally, the U.S. Securities and Exchange Commission has issued guidance on how companies should report on climate change risk. It is inevitable that the number of companies reporting sustainability measures will continue to grow.

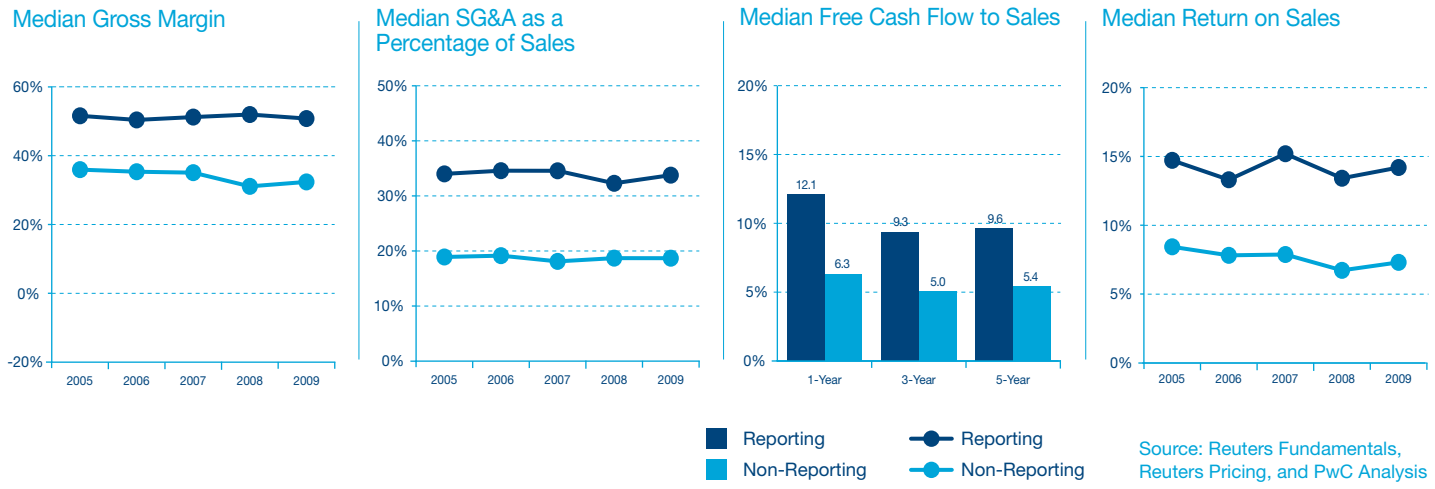
For the third year, PwC has prepared an analysis that compares the financial performance of CPG companies along sustainability reporting lines. "Reporting" companies include those that establish, report through one or more of six well-known sustainability indices, and achieve recognition for their sustainability activities. "Non-reporting" companies only report standard financial data. Our most recent analysis examined 30 reporting and 29 non-reporting very large companies. A company that reported sustainability data at any time during the five-year reference period was included in the reporting group.

This year's study found that, similar to previous years, there are notable differences between the performance of reporting and non-reporting groups, as shown in Exhibit 43:

- Reporting companies continue to trend notably higher than non-reporting companies in median gross margins. Over the past five years, reporting companies' gross margins have been, on average, 10 percentage points higher than those of non-reporting companies.
- Strong gross margins were supported by strong SG&A spending, with the reporting group consistently reporting approximately 12% higher SG&A spend as a percent of sales.
- Higher margins helped reporting companies to produce more cash than their non-reporting counterparts, as evidenced in their notably higher free cash flow to sales performance. This trend is also sustained over the three- and five-year time frames.
- At the reporting companies, strong gross margins continue to drive substantially higher return on sales.
- On average, reporting companies have generated higher shareholder return than non-reporting companies over the past three- and five-year periods.

While there's no question that reporting companies outperform their non-reporting counterparts, it's less clear how the process of reporting figures into the reporting companies' success—i.e., whether companies perform better *because* of their reporting efforts, or whether they're able to focus more of their attention to reporting activities because they're *already* performing well.

Exhibit 43: Performance of Reporting vs. Non-Reporting Companies



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

A No-Nonsense Approach to Environmental Sustainability

Seven Steps CFOs Can Consider Now

After a long journey from sideline to mainstream, the issues of climate change and environmental sustainability have finally landed in the CFO's domain. Investors, regulators, and other external stakeholders are placing increased demands on corporations to identify and address the risks to their businesses posed by climate change and the shift toward sustainable practices. As a result, CFOs are having to stretch beyond their traditional comfort zone and fill an entirely new role.

We focus here on environmental sustainability, including climate change. However, much of the discussion can also apply to other sustainability issues, such as social responsibility in the global supply base, local development expectations in emerging economies, and health and human concerns. We've chosen the environmental focus because recent government initiatives such as incentive programs, carbon taxes, and carbon cap-and-trade systems all fit squarely into the CFO's agenda.

The Effects of Consumer and Investor Awareness

Despite the recession and a faltering political agenda on climate change, sustainability remains a high priority for many major companies. Increasingly, companies across a range of industries are factoring issues such as greenhouse gas (GHG) emissions, energy efficiency, and natural resource conservation into their corporate strategy development and risk management activities.

Retail and CPG companies continue to demonstrate a clear commitment to sustainability, motivated in large part by heightened consumer awareness about the issue. Nearly two thirds of the CEOs polled in PricewaterhouseCoopers's *13th Annual Global CEO Survey*, released in January 2010, said they believe consumers place more emphasis on sustainability and climate change than they did in the past.[79] Of those CEOs, 90% said their companies planned to change their strategies as a result. In fact, some 82% of the industry's CEOs said the recession has spurred increased investments in their climate change strategy, or at a minimum has had no effect on their level of investment. These executives acknowledge that consumers' purchasing decisions may increasingly be influenced by their perception of corporate sustainability performance.

Investors, too, are demanding greater corporate attention to sustainability. During the 2010 proxy season, U.S. investors filed a record 95 shareholder resolutions involving issues related to climate change—a 40% increase over the prior year. A clamor for transparency underscores the growing pressure that public companies face to disclose climate-related risks and opportunities. Although many of these resolutions target companies in heavy-emitting industries such as oil, gas, and electric power, a number of them focus on the energy efficiency of retail buildings and manufacturing facilities.

Recognizing these and other investor calls to action, the SEC has turned a spotlight on the topic by issuing interpretive guidance on how corporations can disclose the climate risks material to them.[80] Given the growing need for companies to be more open about their sustainability track records, in particular as they relate to carbon emissions, CFOs of retail and consumer companies will have to devote more time and resources to sustainability and the disclosure of climate risks. The following seven key actions can help.

Identify and Assess Climate-Related Risks and Disclose Any That Are Material, Along with Strategies for Mitigation

The new SEC guidance takes a broad view of risk related to climate change. It describes both the obvious risks (direct consequences of existing or pending government measures on GHG emissions) and less obvious ones (increased consumer demand for carbon-friendly goods, the impacts of international accords, and the potential damage that severe weather events could wreak on corporate assets).

A climate-related risk is deemed material if there is a substantial likelihood that a reasonable investor would consider such risk important in weighing how to vote or make an investment decision. For example, a beverage maker that wants to boost sales in Africa faces the risks of drought and water pollution. Investors will expect that management has considered those risks, laid out strategies for mitigating them, and communicated them clearly. It's the CFO's role first to gauge which of these risks would affect business continuity and then to convey these risks explicitly in investor communications. The CFO also needs to ensure there is a vigorous tracking process in place to effectively manage the risks.

Evaluate Capital Expenditures for Sustainability Criteria

Given finite resources, companies must take a careful approach to investments in sustainability—but companies often stumble when evaluating these capital expenditures. Capital budgeting analysis typically concentrates on direct financial returns that are relatively straightforward to measure. Sustainability initiatives, on the other hand, often generate strategic value (e.g., reputational benefit with a key regulator or policymaker) and risk management value (e.g., reduced likelihood of supply chain interruption). These factors should be incorporated into capital budgeting analysis, but seldom are.

Applying a capital expenditure filter, which requires management to consider sustainability criteria for a proposed capital project, provides companies with greater insight than they can get from a traditional financial model alone. PepsiCo's system for gauging the environmental risks of its capital expenditures factors in sustainability criteria (e.g., long-term impact on natural habitats and on renewable and non-renewable energy resources) for every spending request over $5 million. All such requests must include a review of related sustainability risks and opportunities.[81]

Companies sometimes hold sustainability initiatives to different return standards than they do other projects. It's not unusual for companies to employ a rule of thumb that any capital expenditure beyond core production expenses must yield a payback within two years. This reflects an appropriate desire to focus capital on large strategic assets, but it can lead companies to miss smaller investments that promise strong after-tax returns. A number of industrial companies have begun collecting energy-efficiency improvements into bundled projects for the purpose of capital expenditure analysis, positioning several of them as a single large, strategic expenditure rather than as multiple small expenditures.

Although there is no standard approach for screening capital spending for sustainability, the process is typically overseen by a special committee, often chaired by the CFO. In many cases, expenditures for known projects are preapproved at the start of the year as part of the planning and budgeting process. But new requests, as well as projects that exceed their preset amounts, require the committee's formal approval.

Review Sustainability Reporting Practices to Ensure Stakeholders Receive Relevant, Reliable Information

No matter how successful, sustainability initiatives won't burnish a company's reputation unless they're seen as credible in the eyes of stakeholders: investors, regulators, non-governmental organizations, board members, consumers, and employees.

To evaluate company performance, stakeholders will look at regulatory filings and voluntary company reporting to advisory bodies. They also will scan blogs and social networking media, most of which are outside the company's control. Questions to which stakeholders typically seek answers include: Are the company's internal operations running the way its external reports claim they are? Do its business relationships, particularly with supply chain partners, meet relevant sustainability standards? Does the company understand its risks, and has it fully disclosed them?

Published sustainability data should be both supportable and used to monitor actual progress, and companies should establish and communicate consistent, well-defined metrics and internal processes for moving toward their sustainability goals. CFOs play an integral role here, as many of the systems, processes, and controls for financial reporting and disclosure can be leveraged to assist non-financial reporting requirements. CFOs may also turn to third parties for verification of sustainability data. Statistics from CorporateRegister.com, based on 3,830 non-financial (sustainability or corporate social responsibility) reports issued during 2009, show that 23% included some form of third-party assurance.[82] Also, many cap-and-trade systems require third-party assurance of GHG emissions.

To Increase Transparency, Use Financial Reporting Standards as a Model for Carbon Accounting

Carbon accounting—the quantifying and reporting of a company's GHG (aka carbon) emissions—is becoming a higher priority for CFOs. Companies want not only to be able to manage their emissions better in the future, but also to have reliable data on hand to meet reporting and disclosure requirements. For example, reporting of GHG emissions data is mandatory for large emitters in the United States.

To ensure the quality and reliability of this data, more and more companies are working to improve their carbon accounting methods, using as guidance the rigorous discipline of corporate financial reporting and the expertise of financial executives. This practice is still in its infancy, however. Most corporate carbon accounting programs need to mature before executives can make informed decisions based on their data.

Although there is no single standard for sustainability reporting, there are some widely accepted frameworks in place. The Global Reporting Initiative (GRI) has issued a set of guidelines which are widely used, and to date close to 1,400 organizations that are using these guidelines have registered their reports with GRI. These guidelines offer advice on sustainability metrics and outline formats for presenting sustainability reports.[83] There are also several leading standards for assurance of sustainability reporting.

In the emerging practice of carbon accounting, CFOs and other financial executives have three major roles to play:

- They should understand from an operational standpoint how their organizations conduct their inventory of carbon emissions.
- They should guide the company's approach to creating reporting and governance structures, modeling their efforts on the conventions of financial reporting.
- They should grasp the potentially significant long-term financial impacts of their organizations' GHG emissions, including the risks associated with climate change and the potential opportunities to monetize carbon.

Companies that establish robust carbon accounting practices now will have a significant advantage in the future, when creating procedures for gathering and reporting further types of non-financial sustainability data.

Capitalize on Available Government Incentives

The U.S. government has set aside $83 billion in stimulus funding for sustainability initiatives, primarily to increase energy efficiency and reduce GHG emissions in the private sector. These incentives come in the form of tax credits, grants, and loans. Retail and CPG companies will want to monitor related developments at the federal level to ensure that they are taking full advantage of these opportunities.

The Energy-Efficient Commercial Building Deduction is one example of the federal sustainability incentives that apply to retail and CPG companies. The program, established under the Energy Policy Act of 2005, allows companies to deduct up to $1.80 per square foot for any interior commercial space in which they've installed significantly more efficient heating, cooling, or lighting systems.[84] Thousands of companies have taken advantage of this accelerated depreciation, which can shave years off the payback period for the efficiency measures.

Consider Launching High-Profile Sustainability Initiatives

Nothing sends a stronger message to stakeholders than undertaking a large-scale, highly visible sustainability initiative. A case in point: Walmart's goal to eliminate 20 million metric tons of GHG emissions by 2015 across the lifecycles of the products it sells.[85]

On the manufacturing side, P&G cites new research that finds strong consumer interest in goods that offer both environmental and economic benefits.[86] The company recently announced plans to reach more than 50 million U.S. households with information on how P&G products such as Tide Coldwater liquid laundry detergent can save water, energy, and waste.[87]

Beverage companies are making a major push to conserve water. Anheuser-Busch InBev (AB InBev) recently announced plans to reduce the amount of water it uses to brew beer. In 2007, every liter of beer the company produced required five liters of water. Faced with diminishing water supplies worldwide and with increasing pressure to reduce consumption, AB InBev plans to lower the ratio to 3.5 liters of water per liter of beer by 2012, a 30% decrease.[88] The company says it is already halfway to that goal. PepsiCo is making similar progress on its own water-conservation goals, thanks to a series of technological improvements in its manufacturing operations. In 2008, the soft drink and snack conglomerate reported cutting annual water usage by more than 7.5 billion liters from its 2006 baseline.[89]

While such initiatives can add luster to a corporate brand, management needs to be wary of charges of "green washing." External stakeholders, namely investors and analysts, will demand to see supporting data for any sustainability claims. In light of this, companies must establish robust data and transparency. CFOs, who are used to interacting with analysts and understand their expectations, are well suited to act as catalysts for both a data-driven culture and a system of transparency.

Factor Sustainability Criteria into Due Diligence for Mergers and Acquisitions

Due diligence of any merger or acquisition involves the evaluation of risks. An acquirer should be clear about the target company's sustainability initiatives, the underlying data and the processes through which that data is gathered, and any potential regulatory liabilities. If, for example, a target's GHG emissions have been low but are climbing compared to its peer group, it behooves the acquirer to understand if this is purely a function of expanding operations or a serious cause for concern.

The Ball Is in the CFO's Court

For most companies, a useful first step is to assure the reliability of its externally disclosed sustainability data—at a minimum, its carbon data. The standards for financial reporting serve as an important model for sustainability reporting, particularly as it relates to increasingly regulated GHG emissions. Finance executives, given their distinct skills, can play a key role in implementing and overseeing the new sustainability reporting systems.

There was a time when finance executives did not need to concern themselves with their organization's sustainability data. But today, increasing consumer, corporate, and government expectations regarding sustainability and sustainability-related risks—particularly those associated with climate change—require the expertise and focused leadership of the CFO.

Tapping the Complex Markets of China and India

Challenges in Winning Over Consumers and Managing Fragmented Supply Chains Are Vast—but So Is the Market Potential

Multinational CPG firms continue to spend big as they work to capture market share in China and India. These emerging markets are both characterized by fast-growing middle classes, massive and largely untapped rural markets, and enormous disparities in income and consumption, both between regions and between urban and rural citizens.

To win in Asia as mature Western markets slow, multinationals are pouring resources into on-the-ground consumer research and seeking to build trust in their brands by offering the right products at the right prices, pursuing local product-awareness and education initiatives, and working with local partners where advantageous. Meanwhile, Chinese and Indian companies are nipping at the multinationals' heels, particularly in food categories, as they learn how to seize the new opportunities in their countries and scale up efficiently.

Controlling distribution channels remains a major hurdle for tapping rural markets. Logistical infrastructure is far superior in China due to government investment, but in both countries the multi-tiered distribution model has few regional players and even fewer that operate on a national level. Environmental issues, particularly water scarcity, have become more acute as population growth and consumer demand collide.

China: A Perspective on Product Localization, Distribution Networks, and Sustainability

The 1.3 billion people in China represent the spending equivalent of the U.S. consumer market today—and yet consumer spending represents only 35% of China's GDP, compared to 70% of GDP in the U.S. Over the next five years, as Chinese households grow wealthier and spend more of their income, China's consumer market is expected to balloon to at least three times the size of the U.S. market.

How fast consumption will rise is the trillion-dollar question. And for the CPG manufacturers currently pouring investment resources into China, the follow-on question is how to establish a position that will seize this opportunity most profitably.

China is intent on transforming itself from a low-cost manufacturing center to a higher-value-add and consumer-driven society with the road, rail, bridge, and airport infrastructure to match. Other aspects of Beijing's five-year agenda and aggressive government policies—such as incentives to drive consumer demand, or support for green technology R&D—play a critical role in any CPG company's success in China.

Discerning consumer priorities and behaviors is a much more challenging task in China than in any other country. Meeting this challenge requires control over multitiered and labyrinthine distribution channels, which provide access to knowledge regarding which consumers are buying and which retailers are selling products.

Succeeding in China requires diplomacy, persistence, and flexibility, given the fragmented and complex business environment and the fluidity of consumer tastes. In this section we'll highlight three of the challenges inherent in the Chinese market—product localization, distribution, and sustainability—and discuss how some CPG companies have navigated their way to success.

Creating Demand Requires Trust, the Right Price, and Products Made for the Chinese Markets

There is no single "Chinese" market, but rather a quilt of many distinct regional and local markets. Sharp disparities in income and living standards prevail between rural and urban areas, and individual provinces are as different from one another as are countries in Europe.

Some of the drivers changing the habits of daily life—and therefore of CPG companies—include the rising earning power of the middle class, increasing availability of consumer credit, and greater access to goods. For example, the 20.1 million households now earning the equivalent of $10,000 a year (up from 4.4. million households in 2004) are spending more of their disposable income on appearance, hygiene, home cleanliness, and food safety.[90] GDP per person, however, remains extremely low. The average minimum wage is still about $1 per hour, after a recent 17% increase. Most Chinese save close to 25% of their disposable income,[91] and even middle-class consumers will argue enthusiastically over the equivalent of a few cents in price.

To win in such a frugal culture, CPG manufacturers must entice Chinese consumers to pay a premium for brand-name goods. Further, reaching beyond the urban centers to the 54% of the population that lives in China's countryside[92] will require CPG manufacturers to "straddle the pyramid" and offer a range of products at different price points.

So far, manufacturers have had little success in launching products in China that were not designed specifically for the Chinese market. P&G experienced this when it introduced a cheaper version of the same Pampers diaper it sells in the U.S. and Europe. That was not enough to shape people's tastes in a culture unused to disposable diapers.

Innovation for the Chinese market is necessary, and multinationals have turned both urban and rural China into a vast laboratory of consumer research to fuel that innovation.[93] At Unilever's Concept Centre in Shanghai, for example, consumers can browse the company's products in a shop, get their hair done in a salon, or sit in a living room to chat with friends—all while researchers look on from behind discreet one-way mirrors.[94] Part of P&G's research involves sending its marketers to live in rural communities for extended periods of time, watching how people live and handing out free products.[95]

Such intensive market research allowed P&G to develop a softer, more absorbent diaper product for the Chinese market. Even more important, the marketers crafted a message, backed by scientific data, that babies wearing P&G disposable diapers sleep better, and sleeping better leads to improved cognitive development—a persuasive message for parents who want to help their children succeed in a highly competitive educational system.[96] Fueled by this revamped marketing strategy, Pampers has become the top-selling disposable diaper brand in China.

Finding the right message and price point has helped propel General Mills' Wanchai Ferry dumpling brand, which blends convenience with reverence for a longstanding staple food. As CFO Don Mulligan explains, "We began with a dumpling, a product form that is indigenous to the local eating habits, and we expanded to a full range of dim sum offerings. This is a product that a Chinese grandmother would have spent all afternoon making by hand. Now middle-class housewives don't have the time for that—but they do have the money to go out and buy it."

"This product has a great heritage because we've involved a local Chinese entrepreneur," Mulligan continues. "It has great taste appeal, real authenticity, and it's at a price point that, while premium, is affordable for the emerging middle class. You have to start with a product that works in the local culture. And you apply your foundational capabilities in terms of product technology, route to market, and marketing to provide consistency across your offerings."

A similar strategy may help build Chinese demand for the type of healthier products CPG manufacturers such as PepsiCo have developed or acquired in response to changing tastes in Western cultures. To explain this strategy, PepsiCo Chairman and CEO Indra Nooyi draws an analogy to telecommunications: Developed countries evolved from electricity to cable to fiber to wireless, but emerging markets, which lack the infrastructure to dig trenches for utilities, have leapfrogged over the intermediate steps and adopted wireless.

Likewise, emerging markets do not have to follow the West's progression from carbonated soft drinks and salty snacks to healthier choices. In China, Nooyi says, PepsiCo is launching "'better-for-you' products [e.g., Diet Pepsi, Baked Lays] simultaneously along with 'good-for-you' products [Tropicana, Naked Juice]. As long as you're willing to build out a distribution network, you won't have to go through the logical progression and growth that we went through [in Western cultures]."[97]

CPG manufacturers are also investing in good corporate citizenship in China. Coca-Cola China, for example, has donated millions of yuan through China Youth Development Foundation (CYDF) to build 60 Project HOPE schools in areas devastated by the massive 2008 Sichuan earthquake.[98] Efforts such as these represent a long-term commitment to build trust and loyalty, not just with consumers but also with Chinese leaders.

Navigating the Distribution Network Is Necessary to Better Service Retailers and Consumers

Complexity in a distribution network makes it significantly harder to effectively and efficiently reach retail outlets and consumers—and complexity is unavoidable in China.

Only about 25% of goods in China are sold through national or regional chains, supermarkets, or hypermarkets, including multinationals such as Walmart and Carrefour. The remaining 75% of goods are distributed to local outlets, particularly mom-and-pop enterprises, outdoor markets, and retailers with a few employees.[99] Very few of the distributors used by CPG companies have a regional or national reach; instead, they work through their own tiers of distributors. To effectively reach outlets across the expanse of China, some manufacturers must employ hundreds of distributors, if not thousands.

The implications of distribution complexity for a CPG company include escalating costs, difficulty in obtaining consumer insights, and lack of transparency in meeting customer service levels, to name a few. Even managing the promotion process becomes that much more difficult, complicating the processing of rebates, free goods, and discounts, and the minimization of fraud.

For a CPG manufacturer to reach within and beyond the largest cities, it must put trusted feet on the ground to evaluate options. Without sufficient control of distribution channels, companies face an often insuperable barrier in gathering consumer or retail data. Some companies are trying to gain greater control by consolidat-

ing some wholesale tiers and terminating others without vastly increasing the cost structure. Others are anticipating the expected continued rapid changes in the consumer market and recognizing that networks that are efficient and practical today may not be so in a few years. As a result, they are purchasing local brands in order to gain access to an established distribution network.

As companies focus on improving their networks, most come to realize that traditional profitability is not their distributors' only objective, and that other forces, such as political and social dynamics, are in play. Further, the use of exclusive versus nonexclusive distributors creates interesting dynamics, such as in crafting the right incentives. Some distributors have limited capacity and want to carry only the most profitable products. Likewise, every distributor has relationships with retailers, the local government, and other distributors that it needs to manage. By taking the time to understand these dynamics, some CPG companies have been able to successfully manage the delicate but critical balancing act required to build their distribution network in China.

Meanwhile, China's small retailers also must be incented to carry or to increase stocks of a manufacturer's products. That too is a challenge, given that these products are often in categories for which consumers have habitually used homemade alternatives. Wariness of foreign products is also an issue.

Sustainability Should Be a Strategic Driver in China

Sustainability has become a critical topic in China. Beijing has pledged to make the country a global leader in green technologies across a wide range of sectors. The policies being put into place—such as the commitment to significantly reduce carbon dioxide emissions per unit of GDP by 2020[100]—will drive private investment as well as the pace of innovation. Government funds pouring into science and technology R&D make China the third-biggest spender in this area, behind the United States and Japan.[101]

At the same time, air, water, and soil pollution is rampant, stemming from the recent decades' manufacturing boom, the massive infrastructure build-out, and rising consumer consumption. Over 70% of China's rivers and lakes are polluted, as is the groundwater around half of its cities.[102] To make matters even more dire, China's overall water demand is expected to rise 32% over the next two decades, and certain regions of the country face the specter of water scarcity.[103]

There is an urgency, therefore, in implementing China's sustainability efforts, and companies that work to support these efforts will gain support for their own growth agendas. Whereas most sustainability initiatives start with a gathering of data in reports, China has begun with strategy. As a result, it is far more important in China, relative to other countries, for CPG manufacturers to incorporate sustainability into their overall strategy and commercial operations. Chinese consumers, on the other hand, are not yet demanding that companies be socially responsible, nor are they yet placing incremental value on sustainable and socially responsible products.

Initiatives by Coca-Cola and PepsiCo illustrate how multinationals are pursuing strategies that not only align with their own agendas but, maybe more importantly, with Beijing's agenda—which is smart business. For example, 39 of Coca-Cola's bottling plants in China have water recovery systems. A new green bottling plant in Chongqing, says Ken Newell, President of PepsiCo China Beverages, reduces 3,100 tons of carbon emission and conserves 100 million liters of water each year.[104]

Driving sustainability up the supply chain is important for some of the large retailers as well—and therefore also for the consumer product companies that sell to them. Walmart is now requiring its 10,000 suppliers in China to meet certain environmental standards, which include switching to more efficient light bulbs and using recycled rather than styrofoam packaging.

Alignment with China's interests makes it more likely that a CPG manufacturer will be able to seize opportunities and possibly help shape public policy. But the strategy is nothing if not complex. By itself, the process of building and maintaining relationships with public officials requires a significant commitment—some CEOs in China spend up to 65% of their time reaching out to government officials[105]—as well as exceptional diplomatic and negotiating skills.

A Long-Term Commitment

To succeed in China, one needs patience and persistence. As Don Mulligan says, "You have to have the fortitude to ride through the ups and downs. It took us seven or eight years to start making money in China. You have to be diligent in laying the groundwork to reach the end result. It's a formula that can be applied to other emerging markets as well."

India: The Prize Lies in the Countryside

It's obvious why India is so attractive to CPG manufacturers and retailers, with its 1.2 billion mostly young mouths to feed, its more than 600,000 square miles of arable land, a predicted average annual GDP growth of 7.8% through 2014,[106] and a retail market with an annual growth rate of 5.7%.[107]

Many multinationals, including P&G, McDonald's, Unilever, General Mills, KFC, Pizza Hut, Nestlé, Coca-Cola, and Kellogg, are competing aggressively for Indian market share, both with each other and with a growing cadre of local companies. But the recent global downturn, coupled with the challenges of entering a huge, highly diverse nation that lacks adequate modern infrastructure, has thrown up some roadblocks.

"We are not going to back off expectations of those markets," says PepsiCo's Indra Nooyi. "But the way we plan . . . is to variabilize more of the costs in a way that we don't have too high a fixed cost base and we can navigate through."[108]

PepsiCo's dedication to the Indian market is mirrored at many other CPG companies, whose executives[109] increasingly find themselves in India for board meetings. What they see there—watching consumers as they wash their clothes, apply skin lotions, eat in train stations, and quench their thirst—underlines both the localization requirements and the globalization opportunities associated with the Indian market. To be a player here, multinationals must "Indianize" their global product offerings; at the same time, the better they understand how to export "made in India" innovations elsewhere, the better they will be positioned in other emerging markets.

A major impediment to cost-efficient growth remains the supply chain—especially reaching the 12.2% of the world's population that lives in rural India.[110] In a country with low per-household disposable income, every rupee that can be wrung out of the supply chain and passed on in savings to consumers makes a difference, particularly for products aimed at the bottom of the pyramid.

Current CPG initiatives in India highlight how to navigate the difficult business terrain of this vast nation.

As Choices Proliferate, Value-Conscious Indian Consumers Become More Discriminating

Rising incomes, an increased awareness of available products, and a wider range of choices have made India's value-conscious consumers more discerning. Attracting these consumers requires multinationals to innovate in their products, positioning, and packaging, based on an understanding of the emotional benefits that this segment values.

For example, "There's a huge sort of resistance towards consumption, not in rural India only; it's in every part of this country," says Prasoon Joshi, Southeast Asia Creative Head at McCann-Erickson. "In India, people feel indulgence is bad. So if you want to sell indulgence, you have to sell it in the garb of convenience, in the garb of improvement of your life."[111]

Multinationals are building trust by localizing their brands and their messages. To develop a market for disposable diapers, for example, P&G focused on children sleeping through the night—a benefit that Indian mothers found more enticing than their own convenience. In addition, the New Pampers line in India includes features designed for comfort in hot, humid weather.[112]

Likewise, Nestlé is focusing on offering nutritionally superior food aimed at rural markets.[113] PepsiCo India markets Aliva, a baked cracker with Indian seasonings, and Kurkure ("crunchy"), a spicy, salty snack that is currently the leader in tonnage in its category.[114] Colgate is using popular Bollywood actor Shahrukh Khan as the face of a brand,[115] and P&G has developed a dedicated housewife character named Sangeeta Bhabhi to connect to consumers in rural villages.[116]

Fast-food chains face difficulties managing margin pressures without raising prices and thereby hurting volumes. McDonald's has adopted a strategy of affordability, supported by bulk buying, long-term vendor contracts, and manufacturing efficiencies. Having first launched home meal delivery in Mumbai in 2004, the company now plans to launch a web-based delivery service across approximately 75 "McDelivery" cities.[117]

The company plans to continue expansion in 2010. These plans are supported by a marketing campaign titled "Har Chhoti Khushi Ka Celebration" ("celebrating little joys in life"), which is intended to position McDonald's as a venue for enriching consumers' lives.[118]

Brand extensions and new packaging forms allow multinationals to address both the infrastructure challenges of rural India and the barrier of price. P&G, for example, is offering New Pampers at a lower price and also developing small sachet packaging,[119] while Coke has dropped the price of its large cans.[120]

Multinationals' successes in reaching value-conscious consumers are attracting competition from Indian companies, particularly in the food industry, where local companies do not have to "Indianize" their products. Pantaloon Retail, for example, is creating a large foods entity that, says CEO Kishore Biyani, "will capture the foods consumption story in India," offering home-grown favorites such as pav bhaji masala and lemon pickles. According to these Indian companies, corn flakes and packaged soups may work in cities, but not elsewhere.[121]

Local Sourcing Cuts Supply Costs and Opens Channels for the Delivery of Goods and Services

Local sourcing makes sense, particularly with food. India has both an abundance of arable land and diverse agroclimatic zones suitable for growing a vast range of crops. Today, India produces 41% of the world's mangoes, 30% of its cauliflower, 28% of its tea, and 23% of its bananas.

But India also presents a number of challenges to companies seeking to source locally, including:

- The logistics of transport, due to the country's poor infrastructure and inadequate roads
- Seasonality (seasonal production of crops versus year-round processing) and perishability
- Variability due to cyclic variations and changing weather conditions, which is a barrier to economies of scale
- Low adherence to quality standards—e.g., poor compliance with food standards of export countries, absence of basic standardization and certification infrastructure

Yet the pluses of local sourcing continue to outweigh the minuses, particularly because multinationals cannot own land in India.

PepsiCo's sourcing strategy involves working with 20,000 farmers in seven states, with plans to increase to 50,000 farmers in three years. The high number of farmers reflects the prevalence of tiny, fractured landholdings in India; in contrast, PepsiCo's Australian sourcing operation partners with only 20 farmers for the same tonnage of product. As part of PepsiCo's India strategy, farmers are taught better cultivation methods, such as direct seeding, which reduces water requirements by one third compared to traditional flood cultivation[122]—a significant and important improvement considering India's perennial water shortages.

The Indian government is supporting a variety of initiatives to improve local sourcing. For example, the Ministry of Food Processing Industries intends to set up food processing units that will create a projected 10 million jobs by 2015. India's private sector is also active in this area.

ITC Limited, an Indian conglomerate, has launched the e-Choupal initiative as a channel for carrying crops (e.g., wheat, soy, corn, spices) out of rural India and delivering know-how, services, and consumer goods to the farmers. Set up on a hub-and-spoke model, the initiative trains host farmers, called sanchalaks, to manage their local e-Choupal and maintain a computer in their home, linked to the Internet via phone line or VSAT connection. Farmers within a five kilometer radius can gather at the sanchalak's home to check on weather, order supplies from ITC or its partners at lower prices than otherwise available, and receive ITC offers for purchasing crops.

One reason for the growth of this channel is ITC's ability to build partnerships among village communities, specialist non-governmental organizations, and the national government to shorten the supply chain.[123] Even with this support, however, inadequate infrastructure remains a significant challenge in the countryside.

Foreign-based multinationals are also looking for solutions to poor infrastructure and inadequate roads in India. Ricardo Fort, Coca-Cola India Vice President of Marketing, says, "We are not going to be what we want to be if we don't take the rural consumer seriously. Presence, expanding distribution footprint, operational requirements like equipment, coolers, and electricity, how to keep the products affordable, are key. We have, for example, coolers which operate without electricity because shortage of electricity is a reality."[124] Over half a billion people in India are not hooked up to the electric grid.[125]

For years, India's inadequate infrastructure has been recognized as a barrier to growth. As Bidisha Ganguly of the Confederation of Indian Industry points out, "We don't build infrastructure ahead of demand. We typically build it once the bottlenecks are there and fairly apparent."[126] At a recent conference, Kamal Nath, a well-known politician, claimed that 16,000 out of India's 70,000 kilometers of roads "aren't worth driving on," resulting in almost half of India's crops rotting before reaching market.[127]

Exhibit 44: India's Prominence in Growing Food

Key Statistics (Production Numbers in Million Tons)	India	Global Rank	Share in Global Production
Arable Land (Million Hectares)	161	2	—
Irrigated Land (Million Hectares)	55	1	—
Wheat	65	2	12
Rice, Paddy	124	2	22
Coarse Grains	29	3	4
Milk	91	1	16
Fruits	47	2	10
Vegetables	82	3	10
Edible Oilseeds	25	3	7
Pulses	15	1	21
Sugarcane	245	2	21
Tea	0.85	1	28

Source: Ministry of Food Processing Industries, "Vision 2015: Strategy & Action Plan for Food Processing Industries in India" (April 2005)

It's not clear whether current efforts by national and regional governments, private equity firms, non-governmental organizations, and appeals to neighboring countries for partnerships will change this picture. As a further enticement, the national government is considering allowing 100% direct foreign investment to develop agriculture infrastructure.

"In India, historically, they overpromise and underdeliver," says Maggie Lee of the Invesco Asian Infrastructure Fund, though she notes that India could "theoretically be more interesting" than China if that picture were to change.[128]

Brand Conscious and Increasingly Mobile Younger Consumers Are Driving Shifts in Demand

Young Indian consumers are becoming increasingly sophisticated and brand conscious. In the upper middle class, these consumers are looking beyond the utility aspect of products and seeking intangibles such as the lifestyle statements associated with a brand. Brand affinity among the affluent young generation is driving a significant shift in demand from loose to branded products—a shift that is particularly noticeable now in the food and beverage sector.

In the cities, this segment may now be willing to go to a restaurant for lunch—but not yet for destination meals with high tabs. "It's all about going to a convenient place that offers cost-effective price points," says a spokesperson for T.G.I. Friday's, a chain which, along with Kentucky Fried Chicken and Pizza Hut, has begun offering cheaper products that could contend with Indians' love of street food.[129]

Branded food retail chains are also catching on to potential revenue streams presented by the mobility of young Indians. Over 20 million people ride India's trains every day, passing through 7,000 stations, and an increasing number of cars are on the highways. Over 43.3 million people boarded planes in India in 2009, primarily from Mumbai and Delhi. An increasing number of these travelers would be tempted by recognizable brands in a clean, off-street environment.[130]

Changes in government policy, when and if they occur, would create significant opportunities for companies able to move quickly to respond to shifts in demand. "The single biggest predicament for our industry is identifying and getting quality retail locations," says a McDonald's spokesperson. "The government is doing little to upgrade high streets, not every mall is a destination point. We feel that the government has to change policy, allow modern retail format to grow. A large chunk of prime retail location in the country is wasted on account of archaic rent laws."[131]

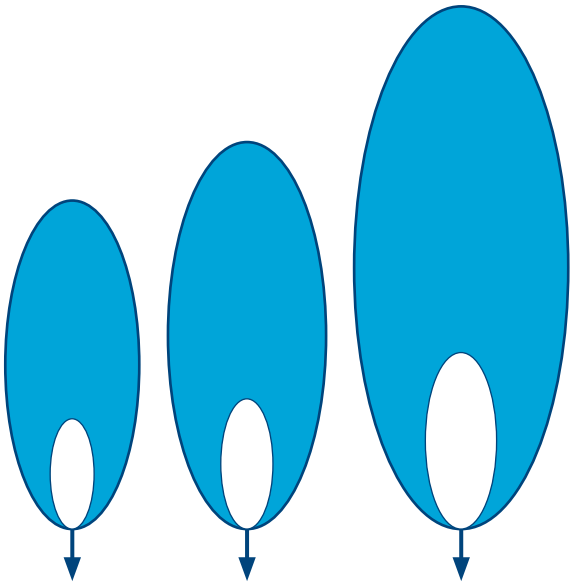
Retail Stores Are Still Modernizing

India's retail sector is in transition. Neighborhood retail grocers and chemists, along with pushcarts and open-air markets (also called wet markets), claim approximately a 95% share of sales, while modern trade accounts for roughly only 5%. Still, the modernized segment is growing aggressively at 30% annually,[132] with the help of both multinationals and smaller companies (e.g., Garden Foods, Cremica) that view helping retailers as an avenue for their own growth.[133]

The rural retail market is currently estimated at $112 billion, or 40% of the $280 billion sector in India.[134] To reach that market, many branded companies are approaching mom-and-pop stores, offering discounts that in the past they might have offered only to modern retailers. The numbers alone are an incentive: As an example, 40% of biscuits, a household staple, are sold through rural outlets.[135]

Reaching out to smaller rural retailers makes particular sense given the stiff competition major brands are getting from private labels in India's modern retail stores. For example, Star Bazaar, Tata Group's hypermarket on the outskirts of Mumbai, displays private-label noodles on reserved racks, touting them as 21% to 37% cheaper than the branded products one rack over. For modern retailers still striving for profitability, these private labels have obvious appeal, particularly in categories in which Indian consumers demonstrate more price consciousness than brand preference.[136]

Exhibit 45: Market Sizing, India



	2007–08	2009–10	2012–13
Total Retail	Rs 15.5 Trillion	Rs 19.7 Trillion	Rs 27.9 Trillion
Organized Retail	Rs 0.9 Trillion	Rs 1.1 Trillion	Rs 2.0 Trillion
ORP	5.5 Percent	5.6 Percent	7.3 Percent

Note: 2007–08 amounts are estimates; 2009–10 and 2012–13 amounts are projections; Rs = rupees; ORP = Organized Retail Penetration.

Source: CRISIL Research

Straddling the Local and the Global

For multinational companies, India fits into a larger context. Shantanu Khosla, Managing Director of P&G India, says, "Today, consumers in Mumbai have more in common with consumers in Shanghai, Tokyo, and New York than with consumers in rural India. Consumers in rural India are very similar to consumers in rural China and Mexico. This scale allows P&G to invest in innovation for these consumer clusters. It helps us bring expertise from one part of the globe to another where similar problems exist. For example, many African countries similar to India battle the problem of cultural stigma around the subject of feminine hygiene."[137]

Unilever is considering a different spin on rolling out innovation across geographies: "Someone in New York comes up with a new recipe and standardizes the basic dough, adds different masalas for different markets, and rolls it out globally with a lot less palaver than if each region had to come up with its own product," said Vindi Banga, a senior executive at Hindustan Unliver before his 2010 retirement. "Essentially all meals have protein, vegetables, and starch. The difference is in the last mile on taste. . . . The advantage is that we can roll out in 40 countries at a snap—for instance, we're relaunching Sunsilk shampoo and it will be in 55 countries in one go."[138]

CPG manufacturers recognize the importance of local management teams that can straddle both worlds—the foreign-based multinational, with its standards and codes of conduct, and the local market. Getting feet on the ground helps ensure that reliable information is being used to set strategy and monitor execution.

In an emerging market like India, a healthy dose of realism is also necessary. As CFO Gordon Stetz of McCormick says, "These are emerging economies without the infrastructure and robustness of reporting that we expect. You have to bring their processes into alignment as quickly as possible and be sure you have resources committed to doing that from day one."

A Three-Pronged Strategy for Increasing Footprint in Rural India

To reach rural India, CPG manufacturers and retailers must address availability, affordability, and acceptability. Multinationals should also take full advantage of the opportunities India offers to test new approaches, owing to its cost benefits (e.g., low labor rates) and huge demand. The southern Indian states of Tamil Nadu and Kerala, for example, have proven good pilot locations for fast-moving consumer goods such as Frito-Lay's Stax.[139]

1. Availability of the Product to the Consumer

- Strengthen the distribution network. Use a hub-and-spoke system, since India's poor transport infrastructure doesn't allow for efficient centralized distribution. Appoint large distributors for contracts and smaller ones for daily cash-basis transactions.
- Include all means of transport, including both trucks and rickshaws, to suit Indian roads.
- Identify high-potential villages and ensure full loads.

2. Affordability of Product Pricing

- Set lower prices to suit rural affordability.
- Change size and quantity of products to suit the rural palate and make brands affordable.

3. Acceptability and Ability to Convince Consumers to Buy the Product

- Market through mass media using recognized Indian personalities, as well as outdoor advertising.
- Study and understand different regional markets and cater to their specific tastes.
- Participate in weekly fairs through temporary retail outlets to increase presence and penetration.

Financial Performance Metrics

Retailer Performance Data

This section contains charts illustrating the 2009 performance of CPG retailers as a whole, relative to the population of manufacturers in our performance database.

Over the past year, the primary macroeconomic trend affecting the marketplace has been the lingering softness of the U.S. economy. As consumers faced a seemingly interminable recession and continued their individual struggles toward recovery, buying patterns they'd developed over the previous decade began to change. Consumers became more mindful of their spending and more selective in their purchasing decisions.

Retailers continued to feel the brunt of the market activities as their one-, three-, and five-year shareholder returns lagged manufacturers' returns. While the markets had a robust rebound, and some retailers posted stronger financial performance, investors continued to remain skeptical about the near-term prospects of the group. While median net sales growth fell from 8.4% in 2008 to 0.9% in 2009, the median was still a positive number, whereas manufacturers' posted negative net sales for 2009. Similarly, retailers' median EBIT growth was on par with manufacturers (6.5%), and retailers were able to improve median free cash flow as a percentage of sales from 2.0% in 2008 to 2.7% in 2009. While their performance for the year was not spectacular, retailers did show significant resilience in managing their operations aggressively to survive the economic downturn.

Exhibit 46: Retailers: Comparison to Manufacturers Data

Overall CPG Industry: Manufacturers

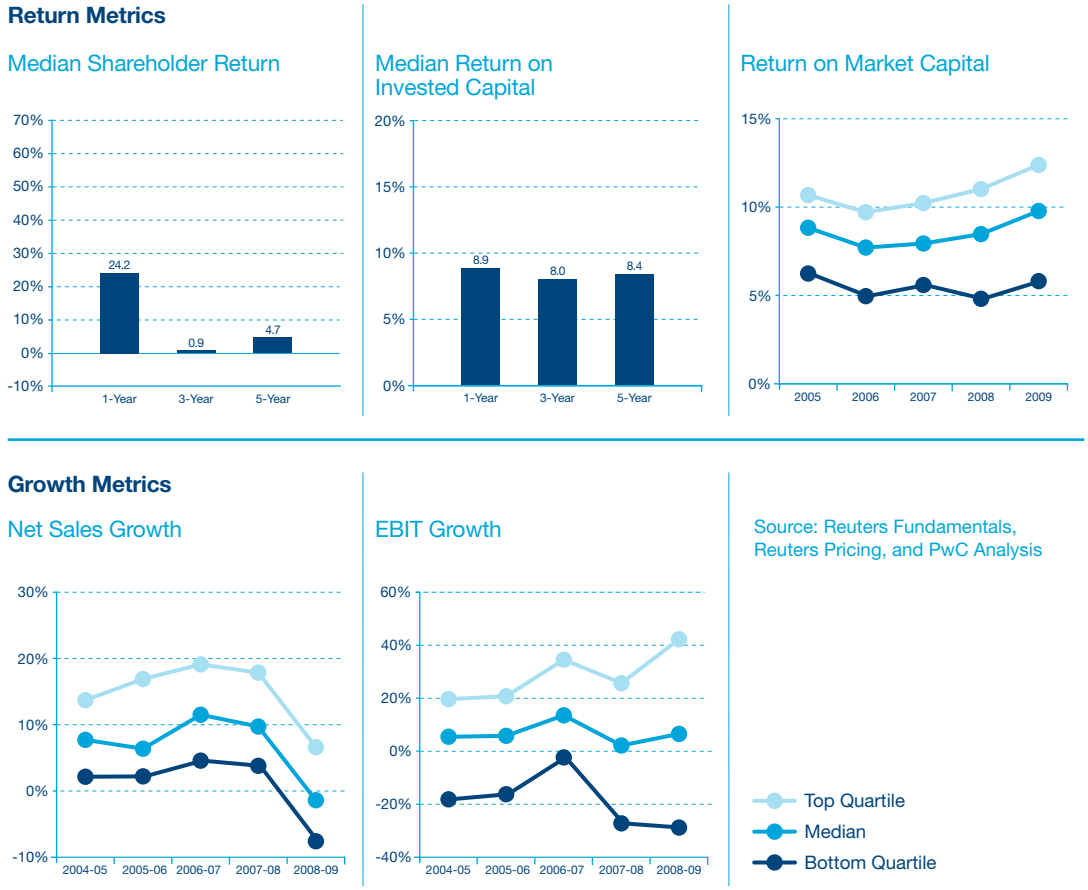
This section includes charts analyzing the overall performance of CPG manufacturers. As mentioned in the Executive Summary, the industry's median shareholder return of 24.2% for 2009 constitutes only a decent performance when contrasted with the S&P 500's 27% growth. This is in sharp contrast to the results of previous years, when the CPG industry consistently outperformed both the S&P 500 and the Dow Jones Industrial Average, and is indicative of the industry's counter-cyclical nature. Due to the fact that their core product mix is made up of food, beverage, and household staples—items that sell reasonably well even in times of economic distress—CPG manufacturers were able to post a decent performance compared to other industries at the worst point in the recession. Today, as the recovery continues, the scales are returning to balance.

CPG manufacturers' median top-line growth plunged into negative territory for the first time in recent history. It is worth mentioning, however, that the top quartile still had decent sales growth of around 8%. The median performance for the industry suggests that the combination of shifting consumption patterns, continued high unemployment, and lowered consumer confidence may produce a prolonged period of lower growth.

The median debt-to-equity ratio dropped significantly, as it also did for the top quartile of companies, suggesting that, during the recession, these companies focused on paying down debt and becoming less leveraged. Median short-term to long-term debt ratios decreased substantially, with the top quartile leading the way with a significant decrease from 0.6 to 0.4—which gave a big boost to their balance sheets. The bottom-quartile companies showed a slight decrease in their debt-to-equity ratio and an increase in their interest coverage ratio, indicating a slight improvement in their financial position.

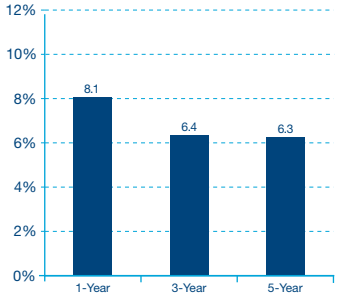
Median cash conversion cycle increased slightly. This held true for top-quartile companies as well, which was surprising since for three consecutive years our report has shown top-quartile companies shortening their conversion cycles and converting assets into cash that much more efficiently. We performed some additional analysis and noted that this year's results were mainly attributable to a 10% decrease in the median days payable outstanding (roughly five days, which was a bit surprising given today's economic environment), coupled with a slight increase of 4% in the median days sales outstanding (roughly one day). This means these companies were paying their vendors more quickly but not receiving cash from their customers in as timely a manner.

Exhibit 47: Overall CPG Industry, Manufacturers (Companies > US$50M)

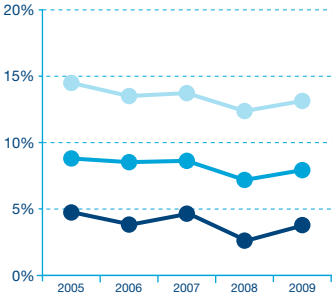


Income Statement Metrics

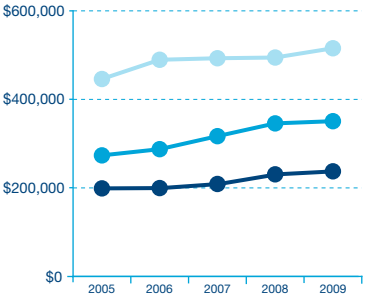
Median Free Cash Flow to Sales



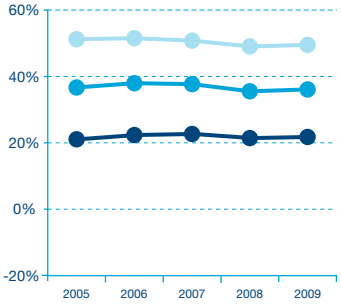
Return on Sales



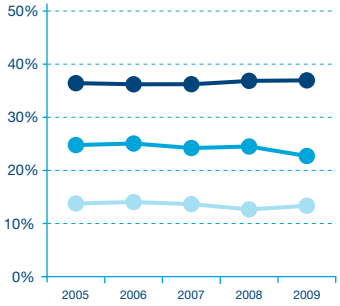
Sales per Employee



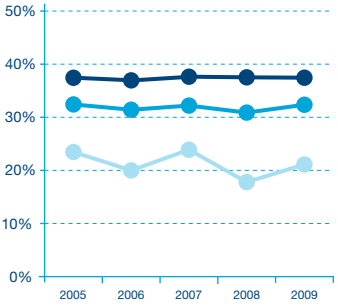
Gross Margin



SG&A as a Percentage of Sales

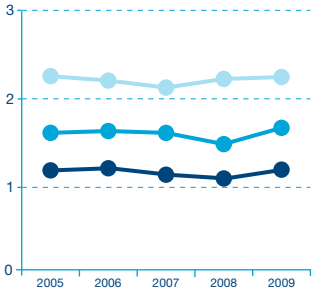


Effective Tax Rate

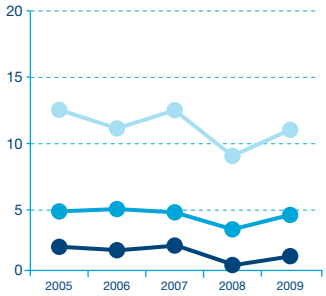


Liquidity Metrics

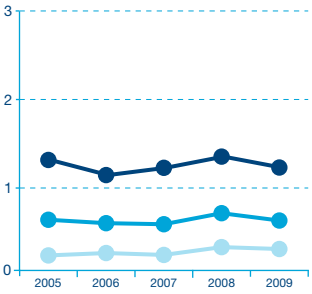
Current Ratio



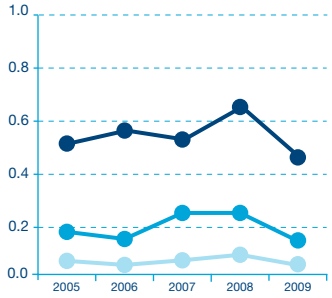
Interest Coverage Ratio



Debt-to-Equity Ratio

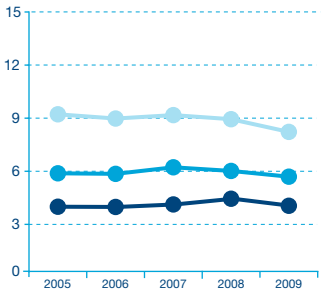


Short-Term Debt to Long-Term Debt Ratio

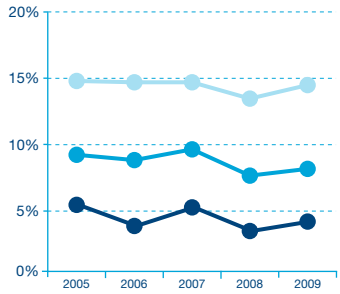


Balance Sheet Metrics

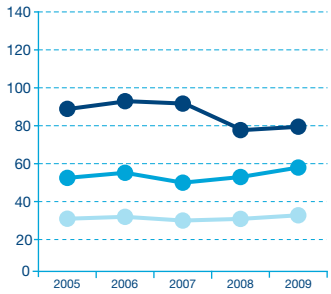
Inventory Turnover



Return on Average Assets



Cash Conversion Cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Top Quartile
Median
Bottom Quartile

Size-Specific Data: Large, Medium, and Small Manufacturers

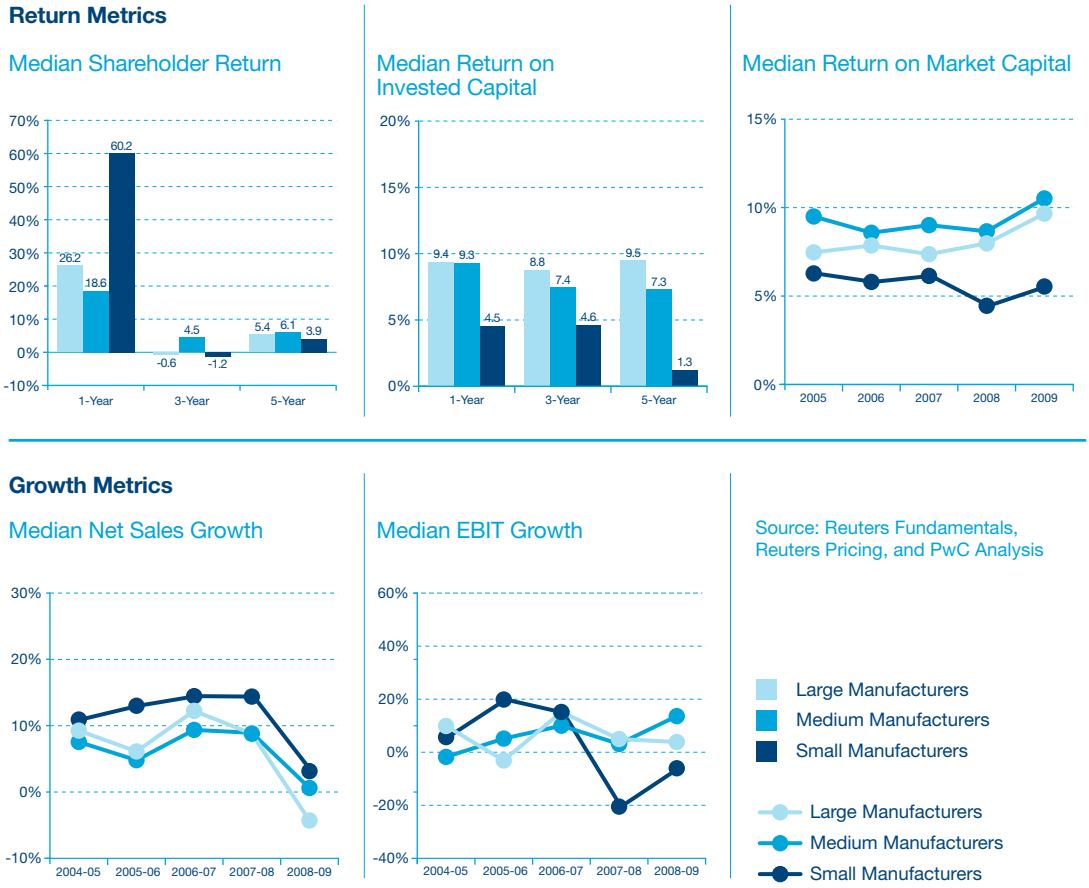
This section includes charts analyzing the performance of large, medium, and small manufacturers. Our analysis found that median cash flow over one-, three-, and five-year returns was generally up from the prior year in all three size sectors, indicating strengthening balance sheets.

The small manufacturers demonstrated superior shareholder return over the one-year period, going from a return of negative 48% in 2008 to a positive return of 60.2% in 2009. Although impressive, a look at three- and five-year returns indicates that this huge one-year return still did not propel these smaller companies to their pre-recession levels.

Net sales growth declined dramatically across the board, with both medium and small companies showing double-digit declines and large companies actually registering a negative sales return for the first time in recent history. On the other hand, median return on sales was up across the board, as was median EBIT growth except among large manufacturers, where EBIT dropped slightly, indicating a shift in consumer spending patterns to more value-conscious options.

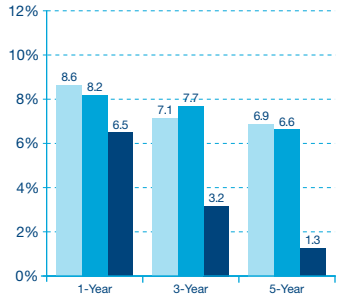
Looking to some broad performance measures, each of the size segments reflected improved performance from the prior year, with gross margins registering generally flat (though small companies showed a slight increase), median return on assets showing a general increase, and median return on invested capital rising across the board.

Exhibit 48: Size-Specific Data, All Sectors

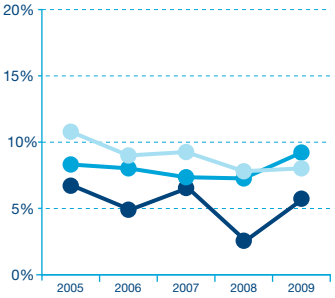


Income Statement Metrics

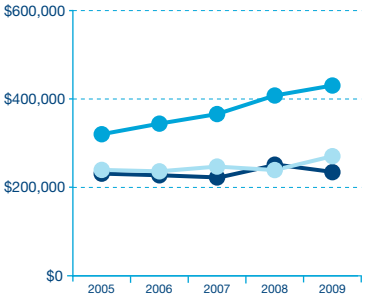
Median Free Cash Flow to Sales



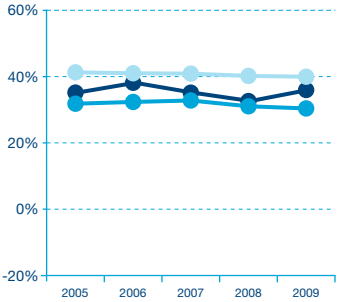
Median Return on Sales



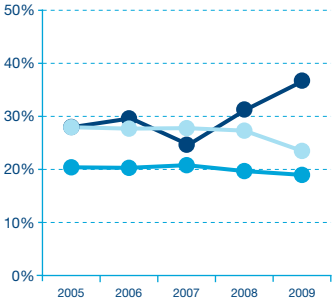
Median Sales per Employee



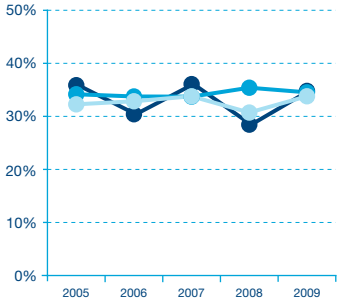
Median Gross Margin



Median SG&A as a Percentage of Sales

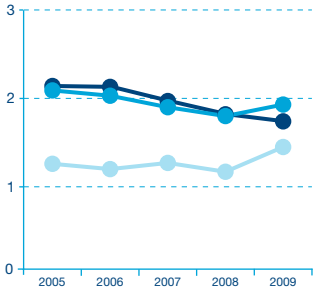


Median Effective Tax Rate

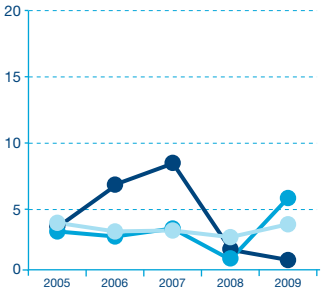


Liquidity Metrics

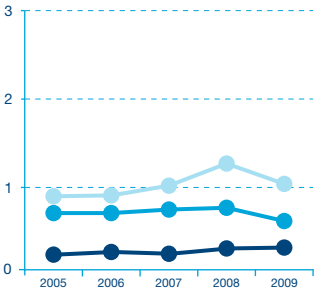
Median Current Ratio



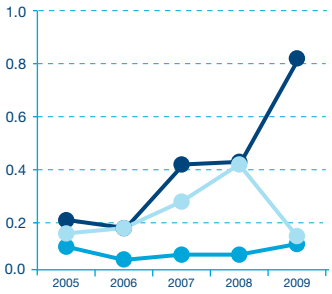
Median Interest Coverage Ratio



Median Debt-to-Equity Ratio

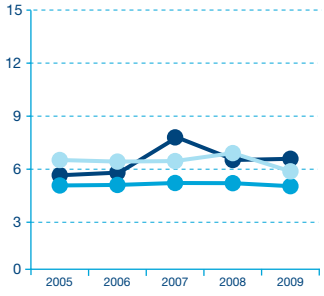


Median Short-Term Debt to Long-Term Debt Ratio

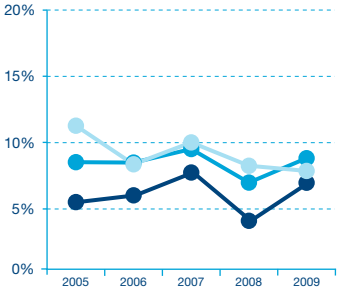


Balance Sheet Metrics

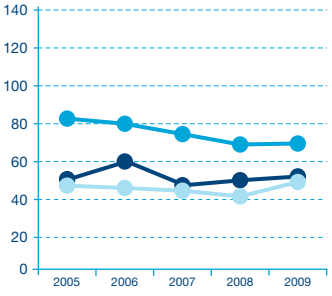
Median Inventory Turnover



Median Return on Average Assets



Median Cash Conversion Cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Large Manufacturers
Medium Manufacturers
Small Manufacturers

Large Manufacturers
Medium Manufacturers
Small Manufacturers

Size-Specific Data: Very Large Manufacturers

This section includes charts providing information on the performance of the largest of the large manufacturers, those with reported nets sales of greater than $10 billion in the last reported fiscal year. For these companies, 2009 was a challenging year, with results starting to show some stress from the ongoing recession.

Consistent with other analyses on both size and sector bases, shareholder return for this group of multinational companies made a dramatic recovery from 2008, moving from negative 29.0% in 2008 to positive 24.2% in 2009. This was most likely driven by market-related moves, however, and core financial performance metrics for the segment showed a more mixed performance. On the positive side, a slight improvement in median gross margin, to 41.1%, showed very large companies' continued ability to leverage their scale. Additionally, the median effective tax rate improved by more than 300 basis points, falling to 26.6%. Potentially, these very large multinationals are beginning to reap the benefits of structural improvement efforts they began several years ago. Finally, return on sales improved, but partially due to the reduction in net sales numbers.

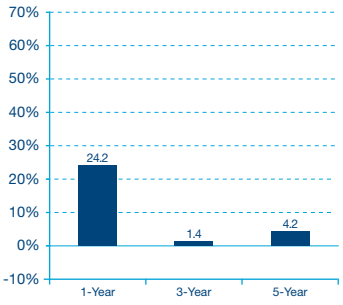
On the downside, there were several metrics in which very large manufacturers' median performance was weaker than in 2008. Net sales growth was negative for the segment, falling from positive 10.3% in 2008 to negative 2.2% in 2009. This downturn was much more significant than that experienced by small and medium-sized manufacturers, neither of which fell to negative growth levels, and was most likely a result of the combined effects of consumers trading down and of manufacturers feeling continued price pressure to compete in order to maintain their margins. Median inventory turnover also fell among very large manufacturers, from 6.3 in 2008 to 5.8 in 2009. This 14% drop was the first in this metric in the last three years, and could be an indication that retailers' efforts to pare down selection and deload are having an effect. It also highlights the need for companies to focus on the urgency of assortment optimization. Largely as a result of the inventory changes, the median cash conversion cycle rose for the first time in five years, moving from 38.5 to 42.0, a 9.1% increase. Finally, median sales per employee fell as productivity management efforts failed to keep pace with net sales decreases.

Although it was a mixed year, very large companies continue to provide strong returns for their shareholders. Five-year and three-year shareholders continue to be in a strong position despite the current economic times.

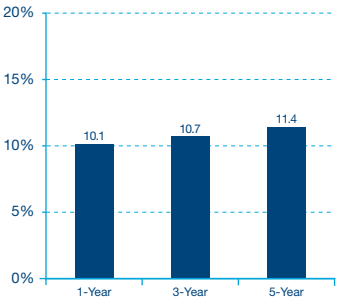
Exhibit 49: Very Large Manufacturers, All Sectors

Return Metrics

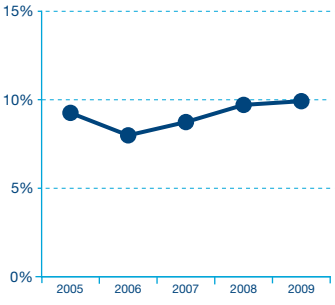
Median Shareholder Return



Median Return on Invested Capital

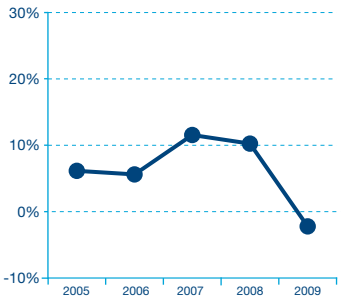


Median Return on Market Capital

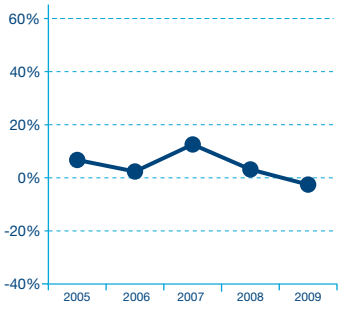


Growth Metrics

Median Net Sales Growth



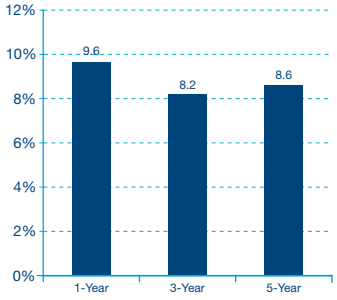
Median EBIT Growth



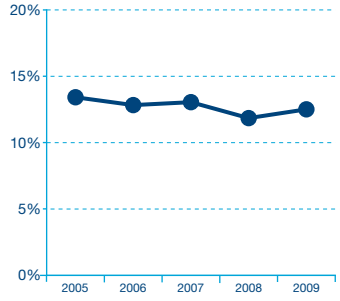
Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Income Statement Metrics

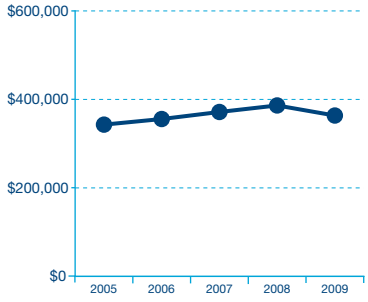
Median Free Cash Flow to Sales



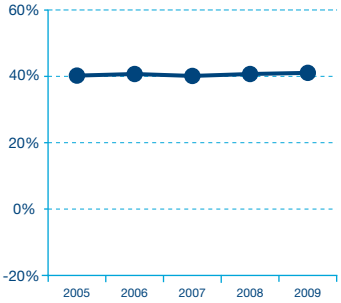
Median Return on Sales



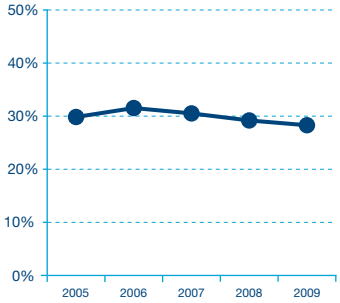
Median Sales per Employee



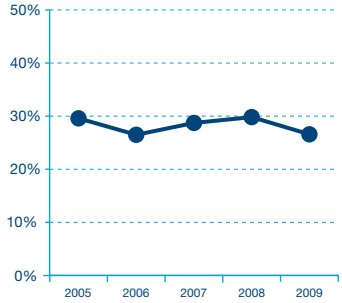
Median Gross Margin



Median SG&A as a Percentage of Sales

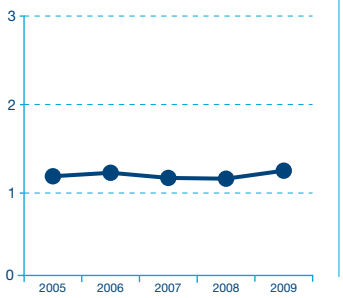


Median Effective Tax Rate

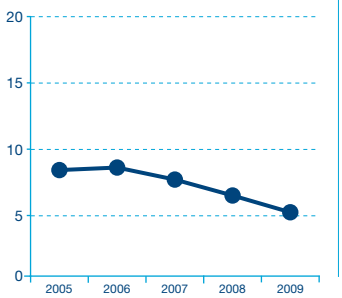


Liquidity Metrics

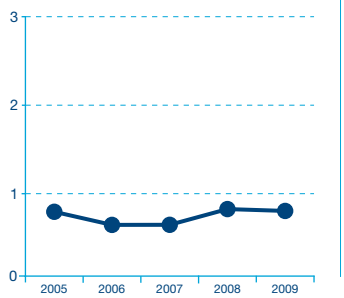
Median Current Ratio



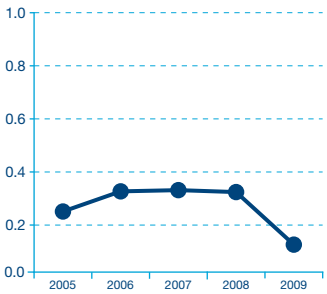
Median Interest Coverage Ratio



Median Debt-to-Equity Ratio

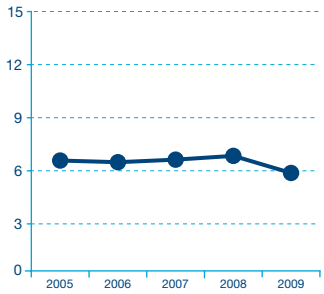


Median Short-Term Debt to Long-Term Debt Ratio

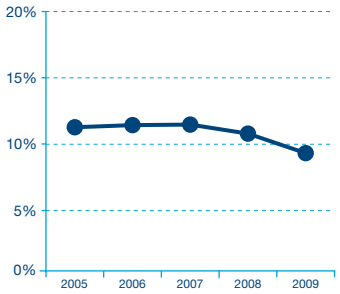


Balance Sheet Metrics

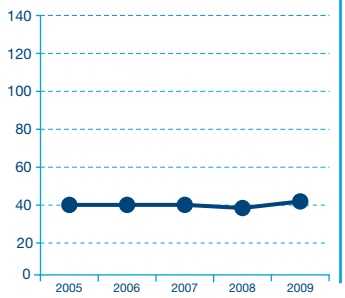
Median Inventory Turnover



Median Return on Average Assets



Median Cash Conversion Cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Sector-Specific Data: Food, Beverage, and Household Products

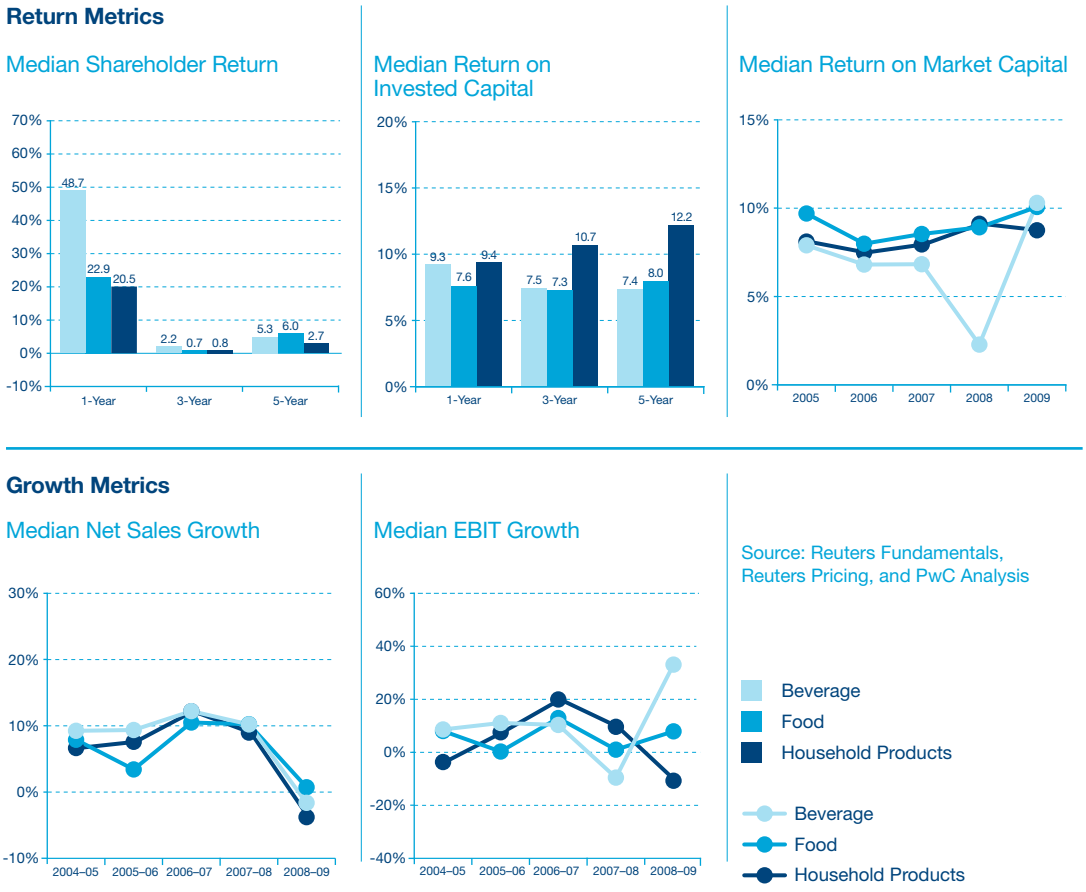
This section includes charts analyzing the performance of the CPG industry's three major sectors: food, beverage, and household products. While each sector exhibited strengths, the beverage sector showed marked improvement from 2008, despite the overall economic conditions. For each of the sectors, one-year median shareholder return essentially reversed itself from the prior year's results, with beverage companies registering a 49% return, the best overall performance among the three sectors. The food and household products sectors also saw their fortunes turn, but more in line with overall market expectations.

Median net sales growth continued to fall across the board, with both the beverage and household products sectors dropping into negative territory and food manufacturers posting a meager 0.7% growth. The change in consumer buying behaviors had an effect as consumers continued to trade down to lower price points for many staples. Median EBIT growth varied widely by sector, with beverage companies showing a sharp increase while household products companies saw a sharp decline, continuing a downward trend.

On a one-year basis, median free cash flow to sales ratios were up across all sectors, with beverage manufacturers once again putting in the strongest performance with 11% free cash flow generated. Interestingly, household products companies had a high one-year free cash flow generation of 10%, up from 7.9% in the previous year. This suggests excess cash that could be reinvested to gain efficiencies and drive EBIT growth.

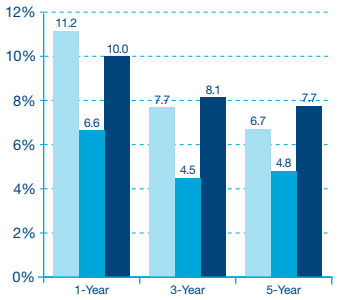
Across-the-board increases in productivity show the effects of CPG companies' emphasis on expense reduction over the last 12 to 18 months. In spite of negative or zero net sales growth, the beverage and food sectors showed an increase in median sales per employee. In the household products sector, which experienced a 3.8% decline in net sales growth, productivity was flat. Both the beverage and food sectors also showed slight increases in median gross margin, likely the result of cost-cutting measures and corresponding to the productivity increases discussed. Both the beverage and household products sectors saw their SG&A expenses drop slightly as a percentage of sales. This mix of higher gross margins and reduction in SG&A helped to mitigate the decline in sales growth.

Exhibit 50: Sector-Specific Data, All Sectors

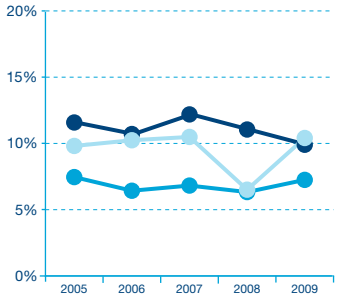


Income Statement Metrics

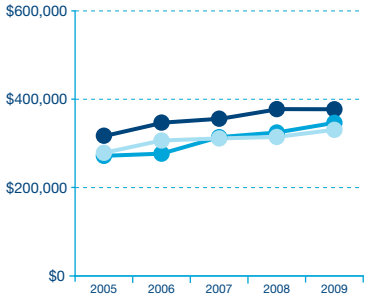
Median Free Cash Flow to Sales



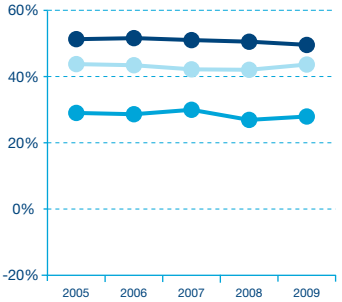
Median Return on Sales



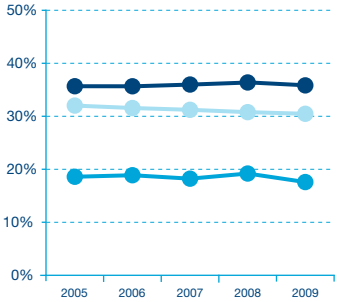
Median Sales per Employee



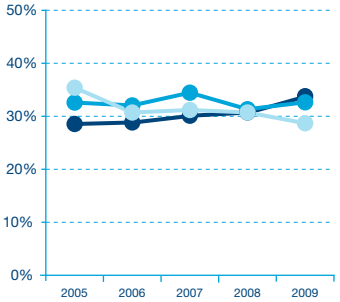
Median Gross Margin



Median SG&A as a Percentage of Sales

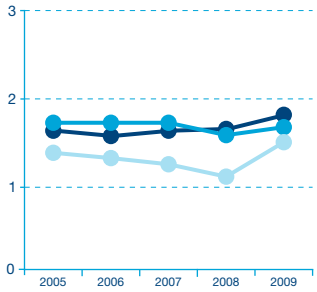


Median Effective Tax Rate

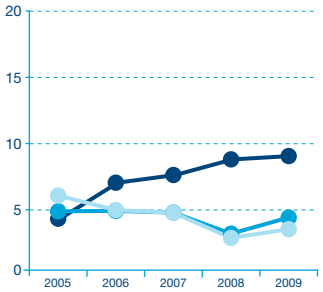


Liquidity Metrics

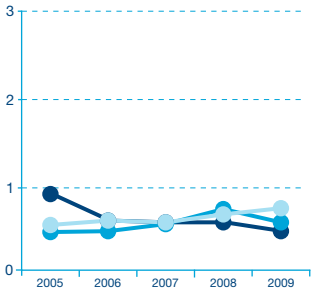
Median Current Ratio



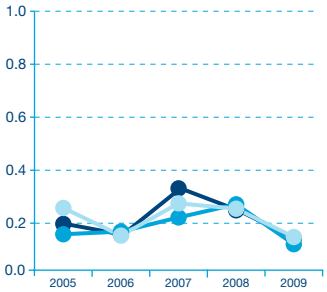
Median Interest Coverage Ratio



Median Debt-to-Equity Ratio

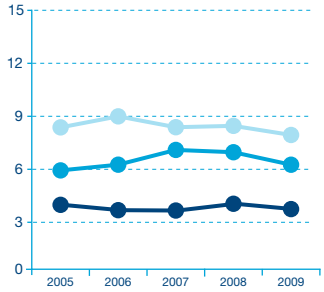


Median Short-Term Debt to Long-Term Debt Ratio

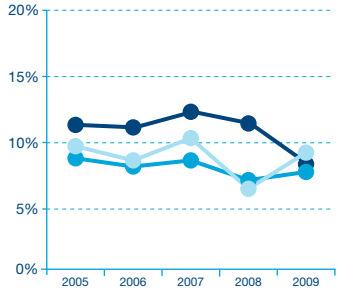


Balance Sheet Metrics

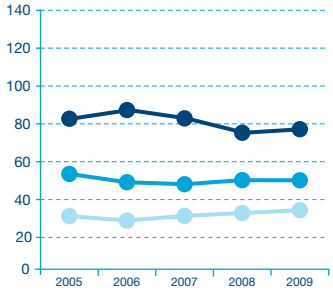
Median Inventory Turnover



Median Return on Average Assets



Median Cash Conversion Cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Beverage
Food
Household Products

Beverage
Food
Household Products

Appendix A: Financial Performance Metrics Methodology

In the Financial Performance Metrics section we present key CPG industry metrics, some of which are discussed throughout the report, based on an analysis of financial data for a set of CPG companies (see Appendix B). In this Appendix, we describe the data sources used and the data preparation steps taken to produce these metrics.

Data Sources

Reuters Fundamentals data was the primary source of data for the analysis presented in the Financial Performance Metrics section of this report. This Reuters dataset includes annual financial data from 2004 through 2009, by fiscal year, for publicly traded companies. The report uses restated data that accounts for mergers, acquisitions, divestitures, and accounting changes. All data used to construct financial metrics is "as reported" by the companies. Additionally, the study team collected financial data for private-sector manufacturers through a survey administered by the GMA.

Exhibit 51: Primary Manufacturer NAICS Codes by Sector

Sector	NAICS Code	NAICS Description
Beverage	312111	Soft Drink Manufacturing
Beverage	312120	Breweries
Beverage	312130	Wineries
Beverage	312112	Bottled Water Manufacturing
Food	311421	Fruit and Vegetable Canning
Food	311211	Flour Milling
Food	311812	Commercial Bakeries
Food	311615	Poultry Processing
Food	311920	Coffee and Tea Manufacturing
Food	311612	Meat Processed from Carcasses
Food	311911	Roasted Nuts and Peanut Butter Manufacturing
Food	311919	Other Snack Food Manufacturing
Food	311230	Breakfast Cereal Manufacturing
Food	311330	Confectionery Manufacturing from Purchased Chocolate
Food	311411	Frozen Fruit, Juice, and Vegetable Manufacturing
Food	311611	Animal (except Poultry) Slaughtering
Food	311823	Pasta Manufacturing
Food	311999	All Other Miscellaneous Food Manufacturing
Food	311340	Non-Chocolate Confectionery Manufacturing
Food	311520	Ice Cream and Frozen Dessert Manufacturing
Food	311225	Fats and Oils Refining and Blending
Food	311312	Cane Sugar Refining
Food	311511	Fluid Milk Manufacturing
Food	311514	Dry, Condensed, and Evaporated Dairy Product Manufacturing
Food	311942	Spice and Extract Manufacturing
Household Products	325611	Soap and Other Detergent Manufacturing
Household Products	325620	Toilet Preparation Manufacturing
Household Products	335912	Dry and Wet Primary Battery Manufacturing
Household Products	311119	Other Animal Food Manufacturing
Household Products	322291	Sanitary Paper Product Manufacturing
Household Products	325412	Pharmaceutical Preparation Manufacturing
Household Products	311111	Dog and Cat Food Manufacturing
Household Products	325612	Polish and Other Sanitation Good Manufacturing

Company Choice

The companies analyzed in the Financial Performance Metrics section were identified as companies that operate in the CPG manufacturing or retail industries. This designation is generally based on a company's primary industry, identified using the North American Industry Classification System (NAICS) as designated by each company and reported in Reuters.

Manufacturers

A core group of NAICS codes was used to categorize companies according to CPG industries, including food, beverage, and household products manufacturing activities. After reviewing this list, we excluded a handful of companies, either because they predominantly do business outside the U.S. or because their primary activities did not align with the CPG sector. Additional food, beverage, and household products companies were included in the analysis based on the nature of their products, given diverse manufacturing activities.

Exhibit 51 lists the manufacturer NAICS codes and NAICS code descriptions by sector used in the Financial Performance Metrics section of this report.

Retailers

A group of core NAICS codes that represent GMA retail activities were identified, and used to generate a list of retail companies for inclusion in the analysis. To gain more understanding of how the retail industry performed by segment, we broke out grocery retailers from the rest of the CPG retailing universe of companies based primarily on the NAICS code designation for the retailer.

Exhibit 52 lists the retailer NAICS codes and NAICS code descriptions by sector used in the Financial Performance Metrics section of this report.

Exhibit 52: Primary Retailer NAICS Codes

NAICS	NAICS Description
445110	Supermarkets and Other Grocery (except Convenience) Stores
422410	General Line Grocery Wholesalers
445120	Convenience Stores
445299	All Other Specialty Food Stores
446110	Pharmacies and Drug Stores
446120	Cosmetics, Beauty Supplies, and Perfume Stores
446191	Food (Health) Supplement Stores
446199	All Other Health and Personal Care Stores
447110	Gasoline Stations with Convenience Stores
452910	Warehouse Clubs and Superstores
452990	All Other General Merchandise Stores
453910	Pet and Pet Supplies Stores

Data Preparation and Metric Construction

The following data preparation steps were necessary before calculating financial metrics.

Currency exchange rates were applied to financial data fields denominated in non-U.S. currencies. Conversions were computed based on the annual averaged exchange rate for each fiscal year operating period.

Companies that changed their reported fiscal year starting and ending dates for at least one of the reporting periods resulted in duplicate data across fiscal years. The duplicate fiscal year observation was removed by annualizing the reported financials where necessary.

Data elements associated with companies that have reporting periods markedly different from the standard length of a calendar year (i.e., 12 months or 52 weeks) were either annualized or dropped.

Data used to calculate metrics presented in this report was compared with 10-K filings for selected firms to check for inconsistencies.

The quartiles were determined based on the companies with reported data for each financial metric. Definitions for each metric can be found in Appendix C.

Data Reporting

Reported results utilize median figures in order to reduce the effect of performance outliers on the overall metrics. When the count of companies with reported data is large enough, we also report quartile figures at the 25th and 75th percentile observations.

In the industry benchmark, firms with more than US$10 billion in net sales in their most recent reported fiscal year are highlighted in a separate "very large" grouping, but are also included in the "large manufacturers" results.

Other size-based segmentations were defined using the benchmarks noted in Exhibit 53.

Exhibit 53: Size Segmentations for Financial Reporting Metrics

Very Large Manufacturers	net sales > $10B
Large Manufacturers	net sales > $4B
Medium Manufacturers	$500M < net sales < = $4B
Small Manufacturers	$50M < net sales < = $500M

Companies with net sales of less than $50 million for the most recent reported fiscal year were excluded.

Counts for the number of manufacturers included in each size- and industry-based segment are included in Exhibit 54.

Exhibit 54: Manufacturing Companies by Industry Size and Segment

	Small	Medium	Large (Very Large)	TOTAL
Beverage	9	10	16 (11)	35
Food	26	27	26 (17)	79
Household Products	8	13	17 (11)	38
TOTAL	43	50	59 (39)	152

Appendix B: Manufacturer Company List

AgFeed Industries, Inc.
Agria Corporation (ADR)
Ajinomoto Co., Inc.
Alberto-Culver Company
Alcoa Inc.
American Dairy, Inc.
American Italian Pasta Company
Anheuser-Busch Companies, Inc.
Anheuser-Busch InBev NV
Archer Daniels Midland Company
Ascendia Brands, Inc.
Associated British Foods plc
Avon Products, Inc.
B&G Foods, Inc.
Bare Escentuals, Inc.
BASF SE (ADR)
Basic American Foods, Inc.
Birds Eye Foods, Inc.
Bridgford Foods Corporation
Brown-Forman Corporation
Bunge Limited
Bush Brothers & Company
Cadbury plc (ADR)
Cagle's, Inc.
Campbell Soup Company
CCA Industries, Inc.
Chiquita Brands International, Inc.
CHS Inc.
Church & Dwight Co., Inc.
Coca-Cola Bottling Co. Consolidated
Coca-Cola Enterprises Inc.
Coca-Cola FEMSA, S.A.B. de C.V. (ADR)
Coca-Cola HBC S.A. (ADR)
Coffee Holding Co., Inc.
Colgate-Palmolive Company
ConAgra Foods, Inc.
Constellation Brands, Inc.
Cott Corporation (USA)
Craft Brewers Alliance, Inc.
Cruzan International, Inc.
Cuisine Solutions, Inc.
Dakota Growers Pasta Co., Inc.
Darling International Inc.
Dean Foods Company
Del Monte Foods Company
Del Monte Pacific Limited
Diageo plc (ADR)
Diamond Foods, Inc.
Diedrich Coffee, Inc.
Doane Pet Care Company
Dole Food Company, Inc.
Dr Pepper Snapple Group Inc.
DSG International Limited
Ecolab Inc.
Elizabeth Arden, Inc.
Energizer Holdings, Inc.
Exide Technologies
Farmer Brothers Co.
Flowers Foods, Inc.
Fomento Económico Mexicano S.A.B. de C.V. (ADR)
Foster's Group Limited
General Mills, Incorporated
Gold Kist Inc.
Golden Enterprises, Inc.
Greatbatch Inc.
Green Mountain Coffee Roasters Inc.
Groupe Danone SA (ADR)
Gruma, S.A.B. de C.V. (ADR)
Grupo Industrial Maseca S.A. de C.V. (ADR)
H. J. Heinz Company
Hansen Natural Corporation
Heineken N.V. (ADR)
Hormel Foods Corporation
Imperial Sugar Company
Inter Parfums, Inc.
Interstate Bakeries Corp.
Inventure Group, Inc.
J&J Snack Foods Corp.
Jamba, Inc.
Jarden Corporation
John B. Sanfilippo & Son, Inc.
Johnson & Johnson
Kellogg Company
Kerry Group plc
Kimberly-Clark Corporation
Kirin Holdings Company, Limited (ADR)
Kraft Foods Inc.
Lancaster Colony Corp.
Lance, Inc.
Land O'Lakes, Inc.
Lifeway Foods, Inc.
L'Oreal
Marine Harvest ASA
Maui Land & Pineapple Company, Inc.
McCormick & Company, Incorporated
Medifast, Inc.
Merisant Company
MGP Ingredients, Inc.
Molson Coors Brewing Company
Monterey Gourmet Foods, Inc.
National Beverage Corp.
Nestlé SA
Novartis AG (ADR)
Otis Spunkmeyer Holdings, Inc.
Overhill Farms, Inc.
Owens-Illinois, Inc.
Parlux Fragrances, Inc.
Peet's Coffee & Tea, Inc.
PepsiAmericas, Inc.
PepsiCo, Inc.
Physicians Formula Holdings, Inc.
Pilgrim's Pride Corporation
Pinnacle Foods Finance LLC
Playtex Products Inc.
Premium Standard Farms, Inc.
Provena Foods Inc.
Ralcorp Holdings, Inc.
Reckitt Benckiser Group plc
Reddy Ice Holdings, Inc.
Revlon, Inc.
SABMiller plc
Sanderson Farms, Inc.
Sara Lee Corp.
Seaboard Corporation
Seneca Foods Corporation
Shiseido Co. Ltd. (ADR)
Smart Balance, Inc.
Smithfield Foods, Inc.
Solo Cup Company
Synutra International, Inc.
Tasty Baking Company
Tate & Lyle PLC (ADR)
The Boston Beer Company, Inc.
The Clorox Company
The Coca-Cola Company
The Estée Lauder Companies Inc.
The Hain Celestial Group, Inc.
The Hershey Company
The J.M. Smucker Company
The Pepsi Bottling Group, Inc.
The Procter & Gamble Company
The Topps Company, Inc.
Tootsie Roll Industries, Inc.
TreeHouse Foods Inc.
Tyson Foods, Inc.
Ultralife Corporation
Unilever PLC (ADR)
Vermont Pure Holdings, Ltd.
Vina Concha y Toro S.A. (ADR)
Wm. Wrigley Jr. Company
Wyeth
Zep Inc.

Appendix C: Definitions

Beverage manufacturers

Manufacturers of beverage products, including breweries, distilleries, and wine producers.

Book capital

The sum of total debt and the book value of equity.

Cash conversion cycle

Sum of days sales outstanding and days inventory outstanding minus days payable outstanding for the same fiscal year.

Cost of goods sold

The total cost of the inputs to producing products, including excise tax payments.

CPG manufacturers (referred to in this report as "manufacturers")

Companies that manufacture food, beverage, and household and personal care products.

CPG Market-Weighted Index

This index is comprised of 103 CPG companies that were actively traded on U.S. stock exchanges from January 1, 2007, through December 31, 2009. A market-weighted methodology was applied in computing the index. The value of the CPG Index at the end of each month represents the aggregate total of market capitalization of each of the companies present in the CPG Index. For a given company, the market capitalization was computed as the product of closing monthly price and the average of the reported and previous fiscal year's total common shares outstanding. The one-year index through April 2010 included the same group of companies, as available.

CPG retailers (referred to in this report as "retailers")

Companies that sell manufactured food, beverage, and household and personal care products.

Current ratio

Current assets for a reported fiscal year divided by the current liabilities for that same year.

Days sales outstanding

The average of the previous fiscal year's and reported fiscal year's accounts receivable divided by the reported fiscal year's average daily net sales.

Debt-to-equity ratio

Total debt for a reported fiscal year divided by the total book equity for that same year.

EBIT

Earnings from continuing operations, before interest and taxes.

EBITDA

Earnings before interest, taxes, depreciation, and amortization.

Economic profit

Economic profit spread is calculated by taking return on invested capital (ROIC) and subtracting the weighted average cost of capital (WACC).

Effective tax rate

Income tax divided by earnings before tax for the same fiscal year.

Food manufacturers

Manufacturers of food products, including dry coffee and tea producers; frozen fruit, juice, and vegetable producers; and dry, condensed, and evaporated dairy product manufacturers.

Free cash flow as a percentage of sales

One-year, three-year, or five-year cumulative cash from operating activities, less capital expenditures plus cash interest paid as a percent of cumulative net sales, for the same time period.

Gross margin

Ratio of net sales minus cost of goods sold to net sales, for the same fiscal year.

Household products manufacturers

Manufacturers of household and personal care products, including primary battery producers and dog and cat food producers.

Interest coverage ratio

EBIT for a reported fiscal year divided by interest expense on debt for that same year.

Inventory turnover

Cost of goods sold for a reported fiscal year divided by the average of the previous fiscal year's and reported fiscal year's total inventory.

IRR

Internal rate of return, used in capital budgeting to measure the profitability of investments.

Large companies

Companies with greater than $4 billion in net sales in their last reported fiscal year.

Market capital

Sum of total debt and total market value of equity.

Medium companies

Companies with greater than $500 million and less than or equal to $4 billion in net sales in their last reported fiscal year.

Net sales

Net revenue as reported by a company.

Return on average assets

EBIT for a reported fiscal year divided by the average of the previous fiscal year's and reported fiscal year's total assets.

Return on invested capital

Net operating profit after taxes for a reported fiscal year divided by the average of the previous fiscal year's and reported fiscal year's book capital.

Return on market capital

EBITDA for a reported fiscal year, divided by the average of the previous fiscal year's and reported fiscal year's market capital.

Return on sales

EBIT for a reported fiscal year divided by net sales for that same year.

Sales per employee

Net sales for a given year divided by the average of the previous year's and reported fiscal year's total number of employees.

Selling, general, and administrative (SG&A) expense as a percentage of sales

Ratio of selling, general, and administrative expense to net sales, for the same fiscal year.

Shareholder return

Annualized percentage return from stock prices and reinvested dividends for a fiscal year-end.

Short-term to long-term debt ratio

Short-term debt for a reported fiscal year divided by long-term debt for that same year.

Small companies

Companies with greater than $50 million and less than or equal to $500 million in net sales in their last reported fiscal year.

Total debt

Total debt outstanding including notes payable/short-term debt, current portion of long-term debt/capital leases, and total long-term debt.

Very large companies

Companies with greater than $10 billion in net sales in their last reported fiscal year.

Endnotes

Unless noted otherwise, quotes from the following business leaders were sourced from interviews conducted by PricewaterhouseCoopers on the following dates:

- Bert Alfonso, CFO, The Hershey Company (March 30, 2010)
- Doug Chavez, Senior Manager of Digital Marketing, Del Monte Foods (May 6, 2010)
- Robert Dixon, Global CIO, PepsiCo (April 7, 2010)
- Kathy Edmond, Chief Ethics Officer, Best Buy, (2010 PricewaterhouseCoopers roundtable discussion, "The Rise of Social Networking - Risks & Opportunities") (March 4, 2010)
- Kent McNeil, CFO, Bumble Bee Foods (April 9, 2010)
- Don Mulligan, CFO, General Mills, Incorporated (April 1, 2010)
- Steve Neil, CFO, Diamond Foods (March 25, 2010)
- Bill Schumacher, CFO, Sunny Delight Beverages Company (March 7, 2010)
- Gordon Stetz, CFO, McCormick & Company (April 28, 2010)
- Duane Still, CFO, Coca-Cola North America (April 30, 2010)
- Al Williams, CFO, Bush Brothers & Company (March 25, 2010)

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7 U.S. Bureau of Economic Analysis, National Income and Product Accounts (accessed May 2010); National Bureau of Economic Research, Business Cycle Dating Committee; and PricewaterhouseCoopers calculations.

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22 Sonia Raja, Global Packaging Project Co-Chair and Head of Packaging, Tesco, as quoted in Consumer Goods Forum press release, "Retailers and Manufacturers Join Forces to Drive Global Change in Packaging" (January 27, 2010).

23 Aberdeen Group, "BI for the CPG Industry—Supply Chain Visibility Drives Performance" (September 2009).

24 George Lawrie, "Industry Essential: Consumer Packaged Goods Industry," Forrester (December 28, 2009).

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32 "Pinnacle Foods Signs Procurement Outsourcing Agreement With ICG Commerce to Drive Cost Reductions," GlobalNewsWire (Februrary 9, 2010).

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Acknowledgements

We would like to thank a number of people for their contributions and for providing their input. Through their collaborative efforts, the core team members have been instrumental in the success and completion of the 2010 Financial Performance Report. We would also like to acknowledge the contributions made by our subject-matter specialists, knowledge managers and researchers, and administrative personnel, and thank them for their ongoing level of commitment. More than 50 people were involved in creating this report. A project of this magnitude required passion and dedication from all involved.

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