

# Insights into the Food, Beverage, and Consumer Products Industry

GMA/FPA Overview of Industry Financial Performance and Trends





The Grocery Manufacturers/Food Products Association (GMA/FPA) 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/FPA board of directors is comprised of fifty-two 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 website at [www.gmabrands.com](http://www.gmabrands.com)



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# Foreword

The Grocery Manufacturers Association (GMA)/Food Products Association (FPA) and PricewaterhouseCoopers are pleased to collaborate to bring you this year's overview of the consumer packaged goods (CPG) industry.

This, the eleventh issue of the Financial Performance Benchmarking report, continues to provide an in-depth look at operational and financial performance measures as well as an examination of several key issues relevant to manufacturers in the industry. This year, in the spirit of fostering additional collaboration across the industry, we also have included a discussion of financial performance highlights specific to the manufacturer's customer, the retailer,<sup>1</sup> and a review of some retailer-specific issues and trends. We believe that by better understanding both manufacturing and retailer performance and issues along the value chain, more value can be created for the consumer.

In Section 1, we look at a combination of pressing and emerging issues impacting the industry, using examples that provide insight into how companies are addressing these concerns. In Section 2, we look at the retailer component of the value chain and offer perspectives on the issues from the manufacturers and retailers themselves, based on conversations and interviews. Section 3 provides a set of key financial performance benchmarking results for the overall food, beverage, and household products industry, as well as various size- and product-based segmentations. A specific discussion on retailer performance is included as well, along with a discussion of effective tax rates for manufacturers.

Throughout this GMA/FPA report, we draw upon publicly reported company financial data, government statistics, and other published materials. The manufacturing benchmarks are based on data from 229 manufacturers, and the retail industry analysis is drawn from similar information. We have relied upon individual company and aggregate industry information as it has been publicly reported and we have cited all sources as appropriate. Example activities by specific companies referenced throughout this publication have been selected as illustrative of how GMA/FPA members and non-GMA/FPA companies have responded to the various trends discussed. Quotations from companies and individuals (listed either anonymously or by name) were gathered through a series of telephone interviews. For publication, we obtained explicit approval of the quotations and the context in which they are presented.

As you read through the report, we hope you will find it informative and insightful—helping you to increase your overall knowledge of the state of both the retail and manufacturing industries, including key financial performance trends and specific issues these companies are working hard to address. As always, GMA/FPA and PwC look forward to the opportunity to engage in discussion with you around these trends, issues, and benchmark analyses.

**Stephen A. Sibert**

Senior Vice President, Industry Affairs  
Grocery Manufacturers Association/Food Products Association



**Lisa Feigen Dugal**

North American Consumer and Retail Advisory Leader  
PricewaterhouseCoopers, LLP



**John G. Maxwell**

Global Consumer Packaged Goods Industry Leader  
PricewaterhouseCoopers, LLP



**Herbert E. Walter**

Business Analytics Leader  
PricewaterhouseCoopers, LLP



<sup>1</sup> For the purpose of this report, we define “CPG retailer” as companies that sell manufactured food, beverage, and household and personal care products to the end consumer. For a detailed discussion on retailer industry groupings included in the analysis in this report, please refer to Appendix A.

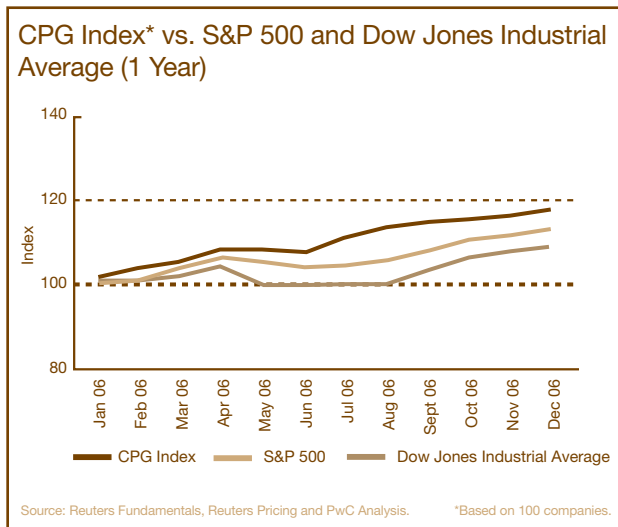


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# Executive Overview

Again this year, the CPG industry can celebrate some impressive results. In 2006, the median total shareholder return (TSR) achieved historically strong levels. The public equity markets saw the long-term value in CPG manufacturers, as industry shareholder return (as measured by a market-weighted index<sup>2</sup>) was greater than both the S&P 500 and the Dow Jones for the year. After uncharacteristically low one-year returns versus five-year returns in 2005, the adage “invest for the long haul” (in consumer products) looked especially true in 2006.



But operating in this industry continues to have its challenges. As overall spending on in-home consumption of food and beverage products has remained about the same (9.8% of discretionary spending in 2002 versus 9.9% in 2006),<sup>3</sup> manufacturers are looking for top- and bottom-line growth by expanding into foreign markets and focusing their portfolios on more profitable and growing segments. Further, there are more, and different, global sources of competition—especially for supply of raw materials such as corn and oil-related products. What can appear to be a relatively simple industry is increasingly complex and dynamic. Even the one constant in this industry—the consumer—has more diverse tastes, is more informed, and requires new kinds of experiences both in-store and online, through converged digital media technologies like cellphones, the Internet, and digital television.

As always, CPG manufacturers (and retailers) are responding to industry challenges with new and innovative ways of working and communicating. Through collaborating across the value chain, creating agile organizations, and developing an even better understanding of how to interact with the consumer, the industry continues to generate strong returns. Median net sales growth was more than 6.1% over 2006, earnings before interest and taxes (EBIT) growth was strong, and the industry continues to generate free cash flow at a rate of 6.3% of net sales.<sup>4</sup>

In the three sections of this report, we explore these results, issues, and responses in more detail.

2 For a definition of this index and how it was calculated, please refer to Appendix C.

3 U.S. Department of Commerce, Bureau of Economic Analysis. “Table 2.4.5U. Personal Consumption Expenditures by Type of Product” (April 30, 2007).

4 PwC Analysis, Reuters Fundamentals.

## Section 1: Organizations Confront New Challenges: Critical Issues and Trends

By leveraging robust data, focusing on the consumer, and building organizational agility, CPG manufacturers are finding common threads to address a new set of challenges. Traditional challenges such as supply chain effectiveness, manufacturing efficiency, and finding the balance between revenue growth and expense management are always top of mind for CPG manufacturers, yet these companies also are becoming more aware of new and unique challenges facing the industry. Globalization and rapid changes in technology used by consumers are creating an environment where targeted collaboration is more important than ever. CPG companies—manufacturers and retailers alike—are collaborating across the value chain, internally within organizations, and directly with consumers to drive improved operations, increase brand loyalty, and enhance financial performance. Companies can reap significant organizational benefits by answering three key questions:

1. How are we effectively managing increased volatility and rising levels of input costs?
2. How are we creating an organization agile enough to adapt to this constantly changing environment?
3. What are we doing to leverage the possibilities offered by new, converged digital media?

Those questions are addressed in the three parts of Section 1:

- **Risk Strategies in the Face of Commodity Price Pressures:**

Agile CPG companies are adopting a proactive, enterprise-wide approach to addressing the challenges and uncertainties of increased volatility and raw material prices. Global economic forces, changes in demand patterns, and new forms of legislation and regulation are creating new pressures for CPG manufacturers. Commodity price volatility is higher than ever and higher than financial volatility (as indicated by fluctuations in exchange rates or interest rates). Current USDA projections are that the price of many key raw materials will stabilize over time—but at higher levels than traditionally seen. To confront these challenges successfully, manufacturers are moving beyond traditional techniques of scale and hedged buying and have begun employing such strategies as product reformulation and substitution, portfolio realignment, and supply chain realignment.

- **Making Processes and People More Consumer-Centric:**

Agile companies align their people and processes, both globally and locally, in a way that allows them to collaborate and respond quickly and continuously to consumers' changing and diverse needs. Today's multiple performance-related pressures require organizations to drive agility. With commodity price volatility up, retailers looking to manufacturers for innovation to drive category growth, and consumers becoming more demanding, organizational silos and confusion are not acceptable options. Companies that enhance their traditional organizational structures by aligning people and process with consumer needs, selectively standardizing both non-consumer-centric and customer-centric activities, and leveraging internal collaboration are able to respond quickly and effectively in this environment.

- **Reacting to a Rapidly Changing Consumer and Media Environment:**

The way consumers are interacting with media is changing as the number of digital delivery platforms grows and their use increases. The “new” consumers created by these platforms tend to look for engaging, targeted, and timely interactions rather than broad-based information. By embracing these emerging trends, CPG manufacturers and retailers can position themselves to better understand their consumers and turn these new technologies to their advantage. Leading manufacturers are identifying internal technology champions, aligning advertising to consumer lifestyles, and identifying new mechanisms to leverage these platforms in order to better anticipate customer sentiment (both good and bad), build brand equity, and grow their business.

## Section 2: Creating Value for Consumers: Additional Perspective

Data and analysis in a vacuum are not particularly insightful. However, when you mix in additional perspective, you get an understanding of how players along the entire CPG value chain can work together. Highlighting retailer-specific implications of issues such as changing demographics, proliferation of outlets and digital technology, and retailers' current focus on private label will help inform the entire industry. Additionally, C-suite interviews with retail and manufacturing executives provide further insight into specific issues such as rising costs and private label. Hopefully, with this incremental understanding will come additional collaboration.

- **Additional Insights into the Retailer Landscape:**

After several years of focusing on cost management and cost reductions, retailers are driving top-line sales growth. Through a focus on consumer needs and providing differentiation across categories and store formats, retailers are looking to reverse recent declines in the median net sales growth rate. Some retailers are also focusing on private-label/own-brand products to help fill these needs. In this environment, manufacturers can work with retailers on several fronts: identifying ways to leverage consumer data from retailers, focusing on coexisting with private label, and building a relationship framework for long-term targeted collaboration.

- **Thoughts on Current Trends from the C-Suite:**

To gain additional perspective on the challenges facing the industry today, we went out and talked with several senior executives (COO, president, CFO, CEO) from both retail and manufacturing CPG companies. In our conversations, manufacturers and retailers readily acknowledged each other's particular strengths, and commented on the need to collaborate to achieve what should be a mutual goal of growth and profitability. These executives spoke with eloquence and passion about key issues relative to this industry: rising input costs, need for innovation and product development, private label, data sharing, and digital media.

### Section 3: Industry Returns Improve: Financial Performance Benchmarking

#### Manufacturers' Median Industry Operating Metrics (2006)\*

Metric	%
One-Year Total Shareholder Return (2006)	11.8
Net Sales Growth (2005-2006)	6.1
Gross Margin (2006)	36.9
Return on Sales (2006)	8.5
SG&A as % of Sales (2006)	24.1
One-Year Free Cash Flow to Sales (2006)	6.3

\*See page 40 for complete list of operating metrics for manufacturers with net sales > US\$50M.  
Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.

The final section of this report provides a set of financial performance metrics for a benchmark set of CPG companies. Using 229 public and private companies, we rank performance using a set of 11 corporate-level performance metrics and show those results for various size (very small, small, medium, large, and very large) and industry (food, beverage, and household products) segmentations.

As a whole, the industry's performance rebounded in 2006. Median total shareholder return for the aggregate industry returned to historical levels, with one-year TSR outpacing three-year and five-year returns. Large manufacturers continued to leverage their scale to outperform small and medium-size companies and obtain higher gross margins. Those margins also translated to the bottom line as median return on sales for large companies outpaced the other size segments. Size continues to matter, especially when it comes to the ability to generate free cash flow (FCF). Large companies generated significantly more free cash flow as a percentage of sales than either small or medium-size companies.

Contrary to last year, we are starting to see some signs of the pressure the industry is facing. All three size segments saw a decline in net sales growth rates. Smaller companies, while continuing to outpace other segments, still saw a drop in net sales growth rate rather than the significant increase seen last year. Additionally, we started to see some downward gross margin pressure in the food and beverage sectors. While still relatively soon to tell, this could be the early signs of the implications of rising input costs, a topic we cover on pages 6–13. Also in 2006, we saw an overall industry reduction in several return metrics—return on sales, return on assets, and return on market capital. However, as a whole, industry median free cash flow to sales has remained constant over the one-year, three-year, and five-year time frames, speaking to the consistently attractive nature of these businesses. Given the return of historical TSR, it appears the market rewards this cash-generation capability and is focused on the positive long-term aspects of the CPG industry.

# Section 1

## Organizations Confront New Challenges: Critical Issues and Trends

The adage “change is the only constant” is especially true in business today. Globalization, rapid advances in media and technology, changes in consumer spending habits, shifts in distribution channels, and other factors force today’s business landscape into a state of constant evolution. As such, it is increasingly apparent that an organization’s ability to manage risk while predicting, responding to, and even driving change is a key component of its long-term success.

Agility is a critical factor in these efforts. An agile company can react quickly to changes in the market and in consumer trends based on careful planning and implementation of strategic processes. Strategic planning is not complete, however, until CPG companies consider their relationship with retailers and understand how they may add and receive value through collaboration.

In this report, we examine three trends that are extremely relevant to the CPG manufacturing industry, and have great potential for long-term impact. We take a deeper dive into some of the challenges involved with each of these issues and, through examples, show how successful companies are managing these unique challenges, and prospering. Specifically, this section explores:

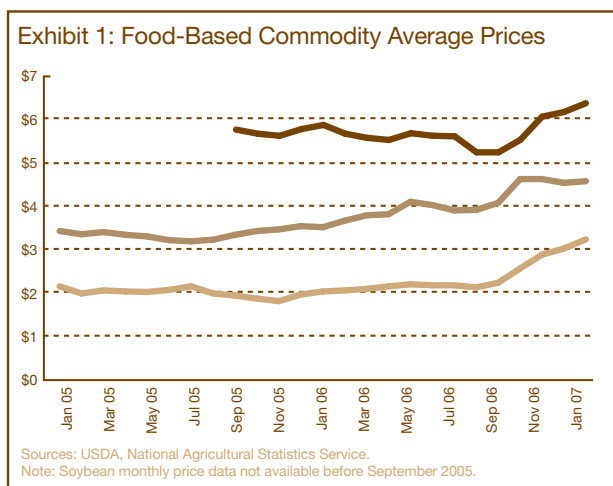
1. Risk Strategies in the Face of Commodity Price Pressures
2. Making Processes and People More Consumer-Centric
3. Reacting to a Rapidly Changing Consumer and Media Environment

### Risk Strategies in the Face of Commodity Price Pressures

*CPG companies often have to deal with external forces affecting commodity prices, such as the classic industry condition of severe changes in weather. Recent fluctuations in the price of corn, soybeans, and oil illustrate how other forces are adding complexity to commodity markets. An increased focus on alternative energy sources and rapid economic growth in emerging markets, creating new consumers in places such as China and India, have spurred demand—and, at times, boosted prices—for certain commodities. These forces, and others, have come together to drive volatility, illustrating that commodity prices have significant interrelationships. CPG companies historically have used a number of techniques to manage input cost prices and volatility, including leveraging procurement and managing commodity price risks through forward buying of raw materials. In responding to greater price and supply volatility as well as increased interdependence of risks, companies are adopting a holistic and integrated risk management approach to supplement traditional techniques and boost overall performance.*

## Commodity Prices Are Increasing

Commodity prices have been increasing over time. Corn prices have crept to their highest rates in almost a decade, with the daily price rising above \$4 a bushel at times in 2007 (for average monthly prices, see Exhibit 1).<sup>5</sup> Wheat and soybean prices are higher as well, and have increased significantly from the last quarter of calendar year 2006 to early 2007 (see Exhibit 1). While the impact of these higher prices may not yet be reflected fully in financial results for manufacturers, they have not gone unnoticed by companies in the supply chain. Cattle producers are feeling the pinch of the high cost of feed made from corn and soybeans, which has contributed to a \$30 per head increase in the price meatpackers pay for cattle.<sup>6</sup> Poultry producers too are being hit by price increases: For every 30-cent increase in the price of a bushel of corn, the cost of producing a pound of chicken rises by a penny, significantly eroding a 20-year industry average profit margin of \$0.025 per pound.<sup>7</sup> And soft drink producers and bottlers are likely to feel the effects of rising corn prices—particularly the rising price of high-fructose corn syrup (HFCS).<sup>8</sup> Recently, though, earnings releases for manufacturers (e.g., Procter & Gamble, SABMiller, Kimberly-Clark) have begun to comment on these commodity price increases.



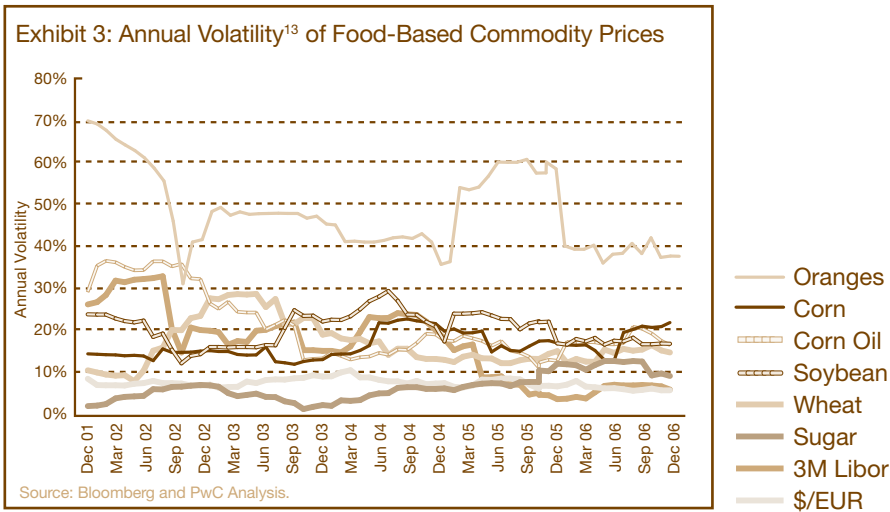
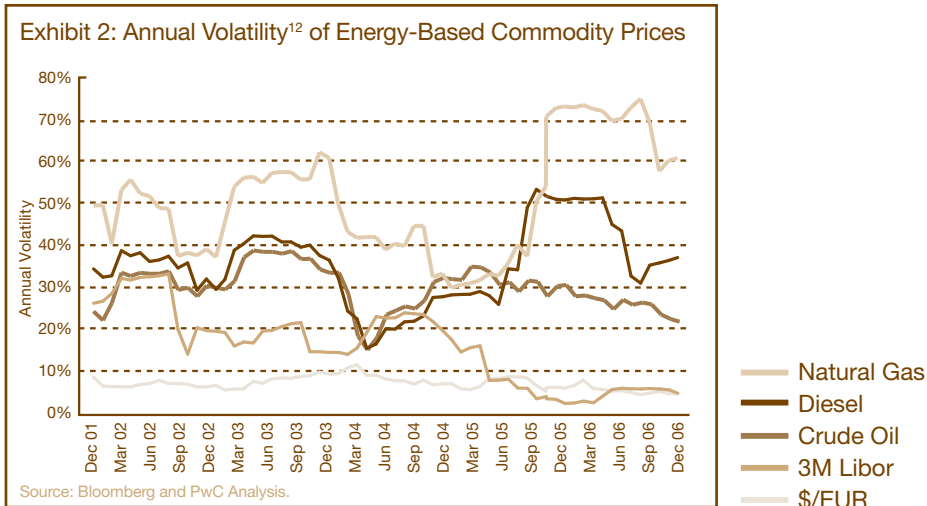
- Soybeans (\$/bushel)
- Wheat (\$/60-lb bushel)
- Corn (\$/bushel)

Even commodity prices that have dropped from their previous highs continue to worry CPG companies. For example, oil prices are a concern to manufacturers even though the price of oil has dropped somewhat from the all-time highs seen in 2005. While the price of crude oil hovered at \$78.40 per barrel in July 2006, it fell to below \$60 per barrel in October 2006,<sup>9</sup> and was at \$61.47 a barrel as of May 8, 2007.<sup>10</sup> Seventy percent of the respondents to PricewaterhouseCoopers' Consumer Products Barometer survey (a quarterly survey of senior executives in large, U.S.-based consumer products companies) are concerned about energy prices, and believe that they will be a potential barrier to company growth over the next 12 months. This is a significant increase over last quarter's report, in which 54% of respondents expressed concern.<sup>11</sup> CPG companies are continuing their work to understand and mitigate the increased impact of oil-related expenses on total delivered cost of products because oil- and energy-related price increases are felt in processes across the entire value chain—for example, in the cost of plastic for packaging and shrink-wrapping, the cost of transportation, and the cost of running conversion and manufacturing facilities.

- 5 Lauren Etter, Julie Jargon, and Conor Dougherty, "Ethanol Push Adds to Forces Lifting Food Costs," *The Wall Street Journal* (April 16, 2007).
- 6 *Ibid.*, Cattle-Fax data.
- 7 According to The National Chicken Council, as reported by Ann Davis, "Tyson Foods Refines a Recipe by Energy Firms," *The Wall Street Journal* (December 1, 2006).
- 8 Lauren Etter, Ilan Brat, and Steven Gray, "Politics & Economics: Corn's Rally Sends Ripples—Ethanol Boom Cheers Grain Farmers, Pinches Food Makers," *The Wall Street Journal* (January 18, 2007).
- 9 Standard & Poor's, Industry Surveys, Food & Nonalcoholic Beverages (December 7, 2006).
- 10 David Bird, "A Break for Gasoline Futures," *The Wall Street Journal* (May 8, 2007).
- 11 PricewaterhouseCoopers, Consumer Products Barometer, 1Q 2007 (June 2007).

### Price Volatility Is Increasing

In addition to rising prices, food- and energy-based commodities have also shown greater price volatility (i.e., tendency to change over time) recently than traditional financial currencies such as exchange rates and interest rates (see Exhibits 2 and 3). Volatility for some commodities, such as natural gas and diesel, has also increased year-to-year (see Exhibit 2).



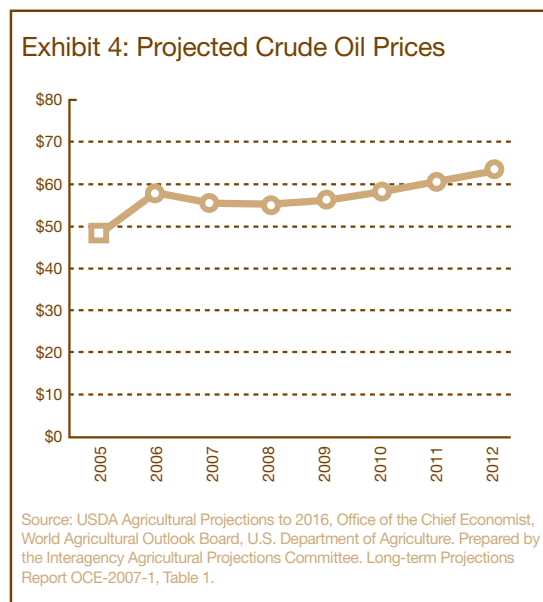
12 Volatility is a statistical measure of the tendency of a price to change over time. We measure volatility by calculating the annualized standard deviation of daily change in price. If the price of a commodity moves up and down rapidly over short time periods, it has higher volatility than commodities whose price does not change as significantly or as often.

13 Ibid.

The interconnected nature of risks makes managing commodity risk even more difficult. Risks rarely present themselves in isolation. They are interdependent. A number of events can come together, and their effects can be amplified as a result. For example, the increase in oil and gas prices after Hurricane Katrina was caused not only by hurricane damage to oil and gas terminals and refineries on the Gulf of Mexico, but also by factors such as the overall tightness of the oil and gas markets caused by Asian demand and the low value of the U.S. dollar. The hurricane itself joined with other factors (for example, the degradation of marshlands, which contributed to coastal flooding<sup>14</sup>) to produce a rise in sugar prices (due to the decimation of sugar crops) and a spike in the price of Polyethylene terephthalate (PET) resin due to the post-hurricane shutdown of several major U.S. refineries<sup>15</sup> which, in turn, affected the CPG manufacturers.

### Additional Forces Drive Prices

This year, two additional forces—a push to increase alternative fuel use (particularly due to legislative and regulatory initiatives) and rapid economic growth in developing countries—have come together to drive the price of food commodities higher. The coupling of volatile prices with demand from new sources (including alternative fuel, population growth, and economic growth in developing countries) will likely continue to put a strain on commodity supplies and prices.

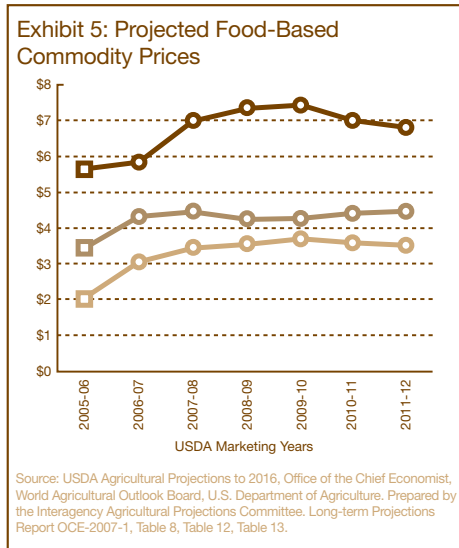


- Actual (U.S. Dollars per barrel)
- Projected (U.S. Dollars per barrel)

The expected continued rise in oil prices (see Exhibit 4) and the U.S. desire to reduce its dependence on foreign oil and lower climate-changing emissions of fossil fuels have sparked legislation around renewable fuels such as ethanol (which is corn based) and biodiesel (manufactured from vegetable oils, algae, or other biological material). The Energy Policy Act of 2005 specifies the new Renewable Fuel Standard (RFS), under which the U.S. oil industry is required to sell or dispense 4.7 billion gallons of renewable fuels to U.S. consumers in 2007, a figure that will climb to 7.5 billion gallons per year by 2012.<sup>16</sup> The U.S. ethanol industry receives an additional incentive in the form of a 51-cent-per-gallon tax credit, while also benefiting from a 54-cent-per-gallon tax on most imported ethanol.<sup>17</sup> As a result of these legislative and regulatory initiatives, ethanol production is expected to consume 3.2 billion bushels of the 2007 corn crop, up almost 50% from the 2.15 billion bushels used in ethanol production last year.<sup>18</sup> Until new technologies are developed that allow alternative feedstocks like cellulosic biomass (wood fibers and crop residue) to be used in ethanol production, or until regulatory ethanol incentives are lifted, it is expected that more and more corn will be diverted to feed the increased demand for renewable energy in the U.S.<sup>19</sup>

14 World Economic Forum, Marsh & McLennan Companies, Inc., Merrill Lynch, and Swiss Re, *Global Risks 2006* (2006), produced in association with the Risk Management and Decision Processes Center at the Wharton School of the University of Pennsylvania.  
 15 Standard & Poor's, Industry Surveys, Food & Nonalcoholic Beverages (December 7, 2006).  
 16 Energy Policy Act of 2005 (August 8, 2005).  
 17 Lauren Etter, "Meanwhile, Imports Are Rising" *The Wall Street Journal* (February 1, 2007).  
 18 Lauren Etter and Bill Tomson, "Big Corn Crop May Not Curb Prices," *The Wall Street Journal* (March 31, 2007).  
 19 Allen Baker and Steven Zahniser, "Ethanol Reshapes the Corn Market," *Amber Waves* (April 2006; updated May 2007).

Farmers have responded to increased demand for corn by increasing corn plantings. According to the USDA, U.S. farmers are intending to plant 90.5 million acres of corn in 2007—up 15% from 78 million acres in 2006. If planting projections are realized, the U.S. will soon see its highest corn acreage since 1944. As the availability of land is finite, this spike in U.S. corn plantings probably will be offset by an expected 8.4 million acre soybean planting decrease in 2007, adding up to an 11% decline in soybean plantings since 2006.<sup>20</sup> The fluctuation in supply likely will add to commodity price increases. Exhibit 5, built from USDA projections that take into account multiple variables (including potential legislation around ethanol), illustrates that U.S. corn, wheat, and soybean prices may continue to rise and remain high.



- Soybeans (\$/bushel)
- Wheat (\$/60-lb bushel)
- Corn (\$/bushel)
- Actual (U.S. Dollars per barrel)
- Projected (U.S. Dollars per barrel)

Putting additional strain on commodity prices, the world population is increasing and is projected to rise from 6.52 billion in 2006 to 6.84 billion in 2010.<sup>21</sup> Increased food consumption across the globe is contributing to food price inflation, and some economists are predicting that certain countries will not be able to produce enough food to meet local needs and prevent further increases in food prices in the future. Global food prices are being pushed even higher by rising food consumption in countries undergoing rapid economic growth, such as China and India. The 6% pace at which China's food prices are rising, for example, is more than triple that of a year ago,<sup>22</sup> driven in part by economic growth and a corresponding increase in consumption of beef, poultry, and pork—which in turn has created more demand for soybeans used in animal feed.<sup>23</sup> Tighter supply, amid surging global demand, portends continued increases in global soybean, corn, and food prices, which will be coupled with persistently volatile and rising input costs for CPG manufacturers in the near future.

Given that commodities or commodity-based inputs are major components of manufacturers' products, commodity price volatility and the interconnected nature of risks directly and indirectly affect a manufacturer's value chain. From strategic planning to management reporting, from procurement to manufacturing, from transportation to distribution, and on to sales and marketing, the impact of this volatility should be managed across the enterprise.

20 National Agricultural Statistics Service (NASS), U.S. Department of Agriculture, Prospective Plantings report (March 30, 2007).

21 U.S. Census Bureau, "U.S. Interim Projections by Age, Sex, Race, and Hispanic Origin" (March 2004).

22 Patrick Barta, "Crop Prices Soar, Pushing Up Cost of Food Globally," *The Wall Street Journal* (April 9, 2007).

23 Alexei Barrionuevo, "China's Appetites Lead to Changes in Its Trade Diet," *The New York Times* (April 6, 2007).

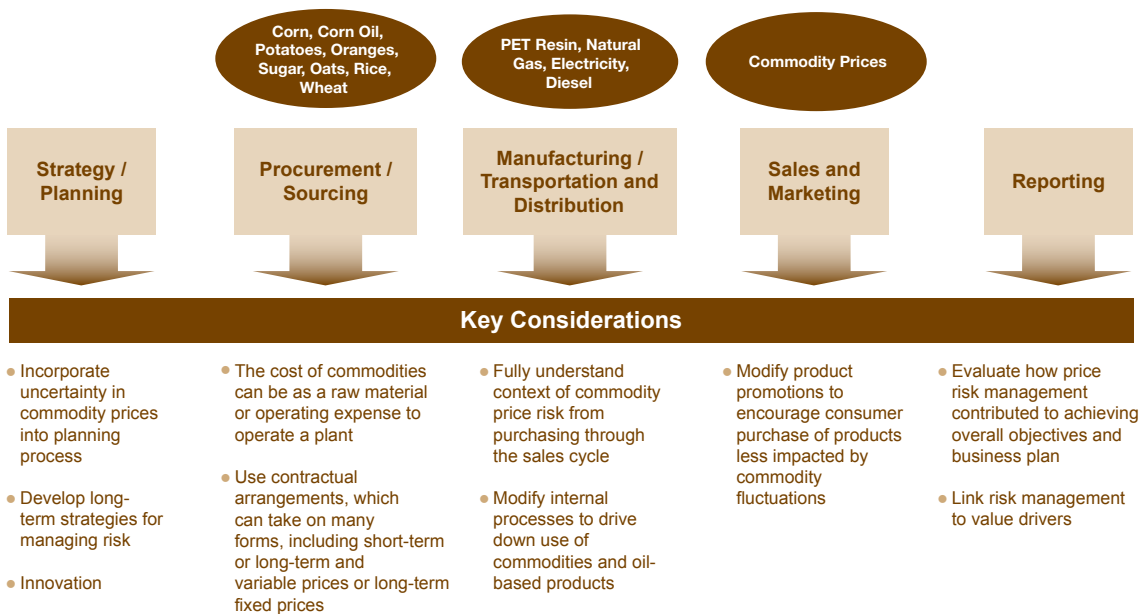
## Responding to This Environment Through Holistic Risk Management

As illustrated in the previous section, commodities are interconnected, and can have an impact across the value chain, affecting such areas as product innovation, product mix, and the supply chain. Leading companies are examining commodity-related risks across the value chain and developing strategies to manage these risks in a coordinated way (see Exhibit 6). More forward-looking companies are taking a robust and integrated risk management approach that allows them to realize value across the value chain, thereby becoming more able to manage and respond to this new risk environment.

Leading companies analyze data around both short- and long-term structural changes in the marketplace to assess the organization's overall exposure to risk. For example, Tyson Foods has been working to manage commodity risks through this kind of data analysis. To more effectively monitor grain, energy, and freight markets, Tyson uses software made by a risk management solutions provider that normally serves energy companies. Tyson's commodity trading and risk management group—which includes many members who have background working at energy companies—is applying practices from the energy industry to actively monitor the commodities markets and manage price volatility.<sup>24</sup>

This kind of data is leveraged most effectively when there is collaboration throughout the organization. A high level of transparency will ensure that employees are pushing in the same direction—understanding risks together across the entire company and implementing integrated risk management strategies. For example, sales and marketing professionals can appreciate how the cost of a beverage containing high-fructose corn syrup is affected by the rising prices of corn and energy. They can then relay important information to other departments about how much extra money the customer might be willing to spend for that beverage. Groups responsible for other functions, like innovation and procurement, can then collaborate on responding to this challenge. And finally, the reporting function can evaluate how price risk management contributed to achieving overall business objectives. Such an approach integrates strategic, operational, and financial strategies with overall company goals.

Exhibit 6: Management of Commodity-Related Risk Across the Value Chain



Source: PwC Analysis.

24 Ann Davis, "Tyson Foods Refines a Recipe by Energy Firms," *The Wall Street Journal* (December 1, 2006).

### **Managing Commodity-Related Risk Through Product Reformulation and Mix**

Since price swings in raw materials significantly affect product profitability, taking a holistic risk management approach to managing this volatility can lead companies to a solution beyond a traditional one like hedging. Product reformulation and substitution can be hard for CPG companies because of consumer sensitivities around taste and appearance, but can be a longer-term solution to input cost changes. When sugarcane prices increased and threatened the profit margins of soda makers, Coca-Cola and PepsiCo began using high-fructose corn syrup as a lower-cost alternative to sugar. Amid concerns of increases in corn prices, analysts are now speculating that some soft drink manufacturers may make the switch back to sugar.<sup>25</sup>

Additionally, companies can mitigate the impact of commodity input price changes and of increased volatility from more rapidly changing commodity prices by promoting consumption of specific stock keeping units (SKUs) or sizes that are less impacted by commodity price swings. Essentially, this alters the product mix, shifts consumer demand, and creates a new, more appropriate portfolio. Working across procurement, sales, and marketing, and understanding retailer needs along the value chain, can lead to a more agile organization that can quickly respond in a way that re-aligns the portfolio with minimal impact.

### **Managing the Impact of Volatility Across the Value Chain**

The value chain is also impacted by volatility, so taking a holistic, integrated view towards managing risk can help companies promote agility in the face of uncertainty. Better inventory management all along the supply chain, including maintaining greater transparency and improved product traceability, can help CPG companies increase productivity and decrease their exposure to a wide spectrum of risk, including the risks posed by exposure to volatile commodities. Companies can also take an expanded view of managing risks through inventory management by balancing the cost trade-offs between using inputs immediately and holding final product or holding inputs for production later. During periods of greater volatility, companies may opt to hold inputs either as canned or frozen instead of processing them immediately.

Consider the following. A bakery that supplied a global restaurant chain conducted a traceability initiative in partnership with a large U.S. flour mill and a cooperative of wheat farmers. Together, they analyzed the interdependencies and direct cost impact of the variability of inputs and final outputs in the bakery's operations. This analysis helped the bakery develop and implement more accurate raw material and supplier specifications. Each partner in the traceability initiative benefited from collaborating across the supply chain. The bakery was able to implement more stringent production controls and improve the overall productivity of baking processes by 5.7%. As a result of increased grain consistency, the mill enjoyed a 2% reduction in the level of foreign matter found in the raw material and improved manufacturing productivity. And by complying with these high quality standards, the cooperative was able to become "certified farmers" (preferred suppliers) to the global restaurant chain.<sup>26</sup> By engaging in a traceability initiative, a CPG manufacturer can decrease its exposure to certain inputs, and thereby decrease exposure to the risk of increasing commodity prices and volatility.

25 "Will Soda Makers Shuck Corn for Sugar?" *BusinessWeek* Online (April 2, 2007).

26 PricewaterhouseCoopers and John Deere FoodOrigins, *Responding to Challenges in the Food & Beverage Industry* (2004).

Another method of managing uncertainty around commodities is by improving data sharing and analysis between manufacturers and retailers, which can improve product ordering and new product innovation (as discussed in more detail on page 31). As retailers and their suppliers improve data sharing and analysis, retailers can place orders more accurately, and manufacturers can fill demand more precisely—a combination that can reduce the potential for overproduction or incorrect production and reduce unnecessary use of high-priced commodities. Additionally, improved data sharing and analysis can help manufacturers develop more ideas for potential new products. If manufacturers combine new product ideas with findings from their holistic risk management process, especially related to commodities, they can better address commodity volatility.

## No Silver Bullet to Managing Risk: Key Questions to Consider

There is no silver bullet for manufacturers to manage risks associated with commodity price volatility, but two methods certainly can help: first, an integrated approach to risk management involving an understanding of the interdependence of risks and their impact across the value chain; second, organizational agility and responsiveness that promotes innovation, product differentiation and substitution, and effective supply chain management. When taking a holistic approach to commodity price volatility risk management, CPG companies can ask:

- How does the company define and measure its exposure to commodities?  
Are all commodity exposures being captured?
- How is retail pricing data being monitored and analyzed? How accurate is the data?  
What sort of analytical tools are being used?
- How are risks being managed holistically rather than on an individual cost basis?
- How well are the objectives of the risk management strategy understood and shared throughout the organization?
- How are different business units collaborating and sharing knowledge about risks?
- How well-defined are risk tolerances over multiple time horizons (near- and long-term)?
- What is the organization actively doing to decrease risk through initiatives like increasing innovation, product reformulation, or substitution?

In order to track risks and collaborate across the value chain, an organization needs to operate in a way that promotes true responsiveness. In our next section, we explore how CPG companies may be able to best leverage different strategies to be flexible and adaptive to change.

## Making Processes and People More Consumer-Centric

*Today's multiple pressures require that CPG companies structure their organizations to drive agility, productivity, and efficiency on a global scale. But organizational structures alone don't always deliver the results companies and their shareholders have come to expect. Agility is a strategic business challenge, not just a structural or an IT issue. An agile organization strives to find the right balance between standardization and customization in order to coordinate its capabilities—from innovation and product development to distribution and sales—and efficiently deliver the outcomes consumers<sup>27</sup> most desire. Agile companies align their people and processes, both globally and locally, in a way that allows them to collaborate and respond quickly and continuously to consumers' changing and diverse needs.*

### **Align Local and Global Organizations to Become More Consumer-Centric**

All one needs to do is pick up a newspaper to read about reorganization. In 2006, major U.S. news publications and business publications printed 220 articles about reorganizations happening at 32 CPG companies.<sup>28</sup> These stories speak to the fact that CPG companies are striving to improve their organizations in the face of changing business conditions. Increased consumer diversity, an unpredictable global environment that is driving up commodity costs, retailer consolidation and diversification, and the need to reach new consumers in both emerging and mature economies all create an environment of uncertainty. In addition to fostering agility to respond to these changing conditions, the organizational structure of CPG companies must allow them to manage a number of brands, serve diverse consumers, make strategic merger and acquisition deals, and use multiple vendors—all across multiple geographies.

CPG and other companies began embracing the matrix organization structure in the late 1970s and early 1980s to manage their processes, increase productivity, and drive internal collaboration across geographies.<sup>29</sup> Structured in a way that allows employees from various business units to team together on a day-to-day basis as well as for specific projects, matrix organizations were expected to foster an environment in which employees collaborate across the organization, both at the national and local levels. For example, when Royal Philips Electronics began competing with Japanese companies that employed larger centralized plants, it changed its organizational structure—moving from a localized approach, in which it served customers through largely independently operating national organizations across the world, to a matrix structure aimed at aligning the company around products rather than geographies.<sup>30</sup>

While some matrix organizations have been successful, other companies have found that a matrix organizational structure can be complex and difficult to leverage effectively. In some cases employees find matrix organizational structures difficult to work within because having product (or geographic or project) as well as functional managers can cause role confusion and lead to conflicting priorities and expectations.<sup>31</sup> Factions and mini-fiefdoms can evolve within matrix organizational structures, where functions work for their own benefit rather than collaborating with other functions to increase productivity and company performance.

27 In this paper, we will use the word “consumer” to describe the end consumer of most CPG products. The concepts included in this report are directly applicable to what is sometimes called a “customer-centric” organization. For CPG manufacturers, the customer is the retailer or distributor and their needs and desires should be met too.

28 This number is based on a search in Factiva. The search parameters were: January 2006 through December 2006 in major news publications and major business publications.

29 Christopher A. Bartlett and Sumantra Ghoshal, “Matrix Management: Not a Structure, a Frame of Mind,” *Harvard Business Review* (July 1, 1990).

30 Pankaj Ghemawat, “Regional Strategies for Global Leadership,” *Harvard Business Review* (December 1, 2005).

31 Rita E. Numerof and Michael N. Abrams, “Matrix Management: Recipe for Chaos?” *Directors & Boards* (June 22, 2002).

By managing their global and local operations in a consumer-centric way, CPG companies can improve the effectiveness of organizational structures and bring employees together to best serve segmented consumer tastes across multiple geographies. This kind of consumer-centricity involves aligning internal processes around the consumer to enable a company to adapt and respond more quickly to changing consumers needs—an essential attribute for CPG companies. A consumer-centric company can identify processes that are ripe for standardization and will drive efficiencies, as well as processes that are best candidates for customization and will further the company’s goal of meeting consumer and customer needs.

### **Focused Standardization Can Drive Simplicity**

Because CPG manufacturers often function as brand-holding entities, with multiple products and brands that operate independently but are managed within one company, they can have redundant internal processes and people. Processes that stretch globally across the organization (such as IT and HR) and some that are practiced across the supply chain (such as procurement) can be standardized and shared across the organization to improve cost, compliance, and efficiency. Leading CPG companies standardize (or even outsource) only those functions and processes that can be harmonized without significantly decreasing the organization’s ability to be consumer-centric. For instance, at the Consumer Analyst Group of New York 2007 Conference, Coca-Cola Enterprises, which sells, markets, manufactures, and distributes non-alcoholic beverages, discussed an initiative to standardize its operations, practices, and procedures so it can meet the challenges wrought by a changing consumer environment and an expanding array of products, brands, and packaging. Through this initiative, it has simplified and standardized non-customer-related functions like HR, IT, and finance, along with some of its operations.<sup>32</sup>

While standardization is important for CPG companies, it must be done on a case-by-case basis in order to reduce the potential impact on the consumer or, in some cases, the manufacturer’s customers. The ability to quickly adapt and respond to consumers’ changing needs is essential in creating products that are tailored to consumers, meeting and exceeding their expectations. To serve different consumer tastes and buying patterns through multiple brands and products, CPG companies generally go to market in different ways depending on the product and geography. For example, in 2006 PepsiCo opened a research center in Shanghai to support analyzing and improving food and developing products tailored to the tastes of Chinese consumers.<sup>33</sup>

In some cases, too much customization has created complexity for some manufacturers, and they have begun standardizing consumer-related activities in ways that improve the consumer experience, rather than impacting it negatively. For example, Starbucks streamlined and standardized its in-store latte manufacturing process so that it could reach higher levels of manufacturing efficiencies. But it has customized the process in such a way that consumers remain satisfied that they are getting customized products. Heinz also has worked to simplify its operations, launching an initiative that aimed to decrease the complexity built up through mergers and acquisitions and the introduction of a vast product line designed to cater to local tastes. As part of the initiative, the company reduced its total number of products but remained consumer-centric by keeping products that had a loyal following and discontinuing products that were not attracting a loyal clientele.<sup>34</sup> Finding a balance between harmonizing processes and creating initiatives to enhance consumer-centricity can help a company be more flexible in adjusting to consumer needs.

32 “Coca-Cola Enterprises Inc. at Consumer Analyst Group of New York 2007 Conference—Final,” Voxant FD (Fair Disclosure) Wire (February 21, 2007).

33 Dominique Patton, “PepsiCo Opens China R&D Centre,” BeverageDaily.com (March 30, 2006).

34 Mark Gottfredson and Keith Aspinall, “Innovation Versus Complexity: What Is Too Much of a Good Thing?” *Harvard Business Review* (November 1, 2005).

### **Align People to Become Consumer-Centric**

Along with making processes and functions more consumer-centric, both globally and locally, leading companies are striving to build corporate cultures that align their workforces around a consumer-centric strategy and encourage and reward consumer-centric behavior. For example, Seven-Eleven Japan has a culture that gives those who are closest to the consumer leeway to make educated decisions. In one such instance, a Tokyo Seven-Eleven employee noticed early one day that the weather had suddenly changed from cold to hot, and so decided to order cold lunch noodles instead of warm noodles from the Seven-Eleven distribution center. As a result, the store enjoyed its best lunch sales that year. This kind of culture, which promotes initiative and innovation, has resulted in offerings that reflect consumer needs, and has bolstered Seven-Eleven Japan's success.<sup>35</sup>

Aligning global and local workforces around a consumer-centric strategy is vital to enabling internal and external collaboration. In order to align a workforce with corporate strategies, employees must understand the reasoning behind those strategies, and there must be accountability for aligning employee behaviors with those strategies. According to a survey conducted by Saratoga/PricewaterhouseCoopers, HR, finance, and operations executives from 30 leading companies around the world start at the top when it comes to aligning their organization around a common strategy. The survey respondents said they focus most internal communications efforts on management so management shares a common understanding of and belief in the strategy, and follows through in their decision making.<sup>36</sup> When managers have a common understanding, they can educate their teams to gain an even broader alignment with the company's strategy.

### **Fostering Internal Collaboration**

Collaboration among employees can help local and global functions effectively understand and reach consumers. By encouraging collaboration between local and global employees, companies can foster innovation and drive success (see sidebar, page 17). These types of collaborative networks have benefited companies in other industries. 3M, a diversified technology company, encourages its researchers to engage in formal and informal networking and holds symposia to let R&D personnel share their projects and to encourage collaboration among employees.<sup>37</sup> BP also has reaped the benefits of collaboration by developing numerous initiatives to encourage collaboration between its business units and country operations. One such initiative has BP engineers spending about 5% of their time providing technical or problem-solving support to engineers and managers in other units, leading to cost savings, better decision making, and revenue growth. In the U.S., a BP business unit head who was hoping to improve service station inventory turnover sought out the expertise of her peers in the Netherlands and UK, and by implementing their leading practices managed to decrease working capital at U.S. service stations by 20%.<sup>38</sup>

35 Larry Selden and Ian C. MacMillan, "Manage Customer-Centric Innovation—Systematically," *Harvard Business Review* (April 1, 2006).

36 Saratoga/PricewaterhouseCoopers, Michigan Business School, and Dr. Richard W. Beatty, *Workforce Agility: The New Frontier for Competitive Advantage* (2005).

37 Michael Arndt, "3M's Seven Pillars of Innovation," *BusinessWeek* Online (May 10, 2006).

38 Morten T. Hansen and Nitin Nohria, "How to Build Collaborative Advantage," *MIT Sloan Management Review* (September 2005).

### Consumer-Centric Collaboration in Practice: Creating Crest's Naturals Toothpaste Line in China

Procter & Gamble's organizational structure lets it create consumer-centric products through innovation informed by the expertise of its local and global units. Its organization is structured into four main units: (a) Global Business Units (GBUs), which create the global strategy for products and brands, and expand product innovations and brands around the world; (b) Market Development Organizations (MDOs), which focus on local tasks, such as managing customer relationships, local marketing, and local consumer understanding; (c) Global Business Services (GBSs), which are business support services for the GBUs and MDOs; and (d) Corporate Functions (CF), which ensure the functional capability of the organization.<sup>44</sup> Members of Procter & Gamble's global and local operations work together to create targeted products, marketing campaigns, and distribution networks that aim to reach consumers around the world. For example, when the MDO team in China worked to expand P&G's distribution network to serve more cities, towns, and villages, it collaborated with the GBU teams on product development.<sup>45</sup> From this collaboration came the insight that Chinese consumers believe salt can clean and whiten teeth, which led to the development of Salt White toothpaste as one of the (Crest) Naturals toothpaste products. Procter & Gamble's MDO and GBU teams then used the company's scale to source ingredients and buy media at preferred costs, and built marketing programs that were based on Chinese consumer beliefs.<sup>46</sup> P&G then used the newly expanded distribution network its MDO team had developed to quickly get the Naturals line of products to Chinese consumers. As a result of this consumer-centered coordination and innovation, Crest more than doubled its value share in China.<sup>47</sup>

The flow of knowledge across an organization can either help or hinder innovation, and leading global CPG companies that are agile organizations understand the points at which consumer-centric collaborations and innovations are occurring. Today's technology enables the mapping of these collaboration and innovation networks in ways that were not possible until just a few years ago, further driving organizational agility. The use of organizational network analysis (ONA) techniques can help CPG companies see the critical nodes at which collaboration and innovation occur in their organizations, and whether the innovators in an organization are influential.<sup>39</sup> Employing ONA techniques can involve surveying employees about their collaborators within the organization, as well as fellow employees with whom they consult,<sup>40</sup> or it can involve using tools such as categorizing and analyzing email traffic and identifying Internet search words.<sup>41</sup> Many companies have begun embracing and benefiting from these ONA techniques. For example, after reorganizing along product lines, Capital One Financial Corporation began using organizational charts to bring people with similar jobs together into online communities, helping to share leading practices among people who would not normally work together. Well-connected employees were identified and encouraged to take on formal roles in the online communities.<sup>42</sup>

Forward-thinking companies can also look outside their four walls for strategic advice about how to align people in a consumer-centric organization. When Royal Philips Electronics decided to move away from its traditional focus on technology and instead focus on brand, consumer-centricity, and innovation, it enlisted the help of a Simplicity Advisory Board, a global group of external advisors that included a fashion designer, an architect, a radiologist, and a professor. Armed with the board's strategic advice, Philips changed its strategy and launched its 2004 "Sense and Simplicity" initiative, embracing a consumer-centric vision in order to offer health-care, lifestyle, and technology products designed around the consumer. To further bring the consumer-centric strategy to fruition, Philips gave consumers the chance to test its products and offer suggestions through product test centers across the globe.<sup>43</sup>

39 PricewaterhouseCoopers, "The Art and Science of Co-Creation: Enhancing Employee Networks," *view* (February 2007).

40 Jena McGregor, "The Office Chart That Really Counts," *BusinessWeek* Online (February 27, 2006).

41 PricewaterhouseCoopers, "The Art and Science of Co-Creation: Enhancing Employee Networks," *view* (February 2007).

42 Jena McGregor, "The Office Chart That Really Counts," *BusinessWeek* Online (February 27, 2006).

43 David Kiley with Ben Elgin, Michael Arndt, and Roger Crockett, "Best Global Brands: How the *BusinessWeek*/Interbrand Top 100 Companies Are Using Their Brands to Fuel Expansion" *BusinessWeek* Online (August 7, 2006).

44 Procter & Gamble, *Earning Your Trust: Annual Report* (2004), [www.fr.pg.com/download/rapport\\_annuel\\_2004.pdf](http://www.fr.pg.com/download/rapport_annuel_2004.pdf).

45 "Procter & Gamble Company at Morgan Stanley Global Consumer & Retail Conference—Final," Voxant FD (Fair Disclosure) Wire (November 10, 2005).

46 "Procter & Gamble Company at Prudential Equity Group Back-to-School Consumer Conference—Final," Voxant FD (Fair Disclosure) Wire (September 8, 2005).

47 "Procter & Gamble Company at Morgan Stanley Global Consumer & Retail Conference—Final," Voxant FD (Fair Disclosure) Wire (November 10, 2005).

## Maximizing Consumer-Centric Capabilities: Key Questions to Consider

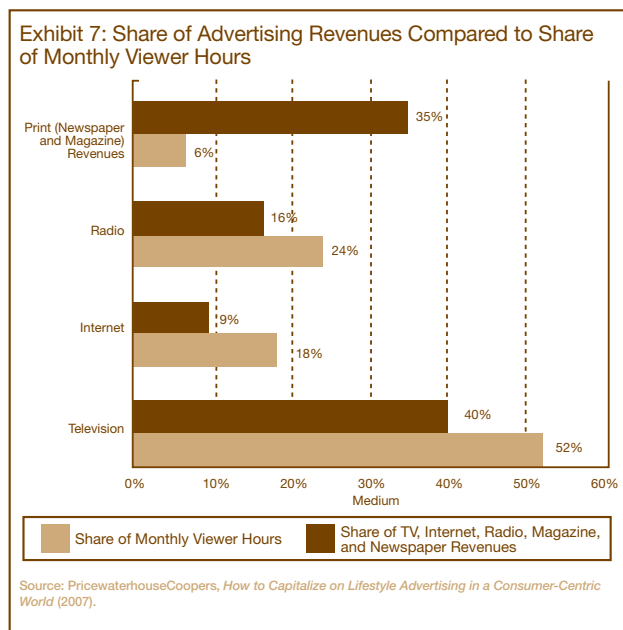
Creating an agile organization is about enhancing the right organizational structures and about a thought process and business philosophy that organizes people and processes around consumer-centric capabilities. The following questions can help CPG companies understand whether their organizations are moving toward this kind of agility and consumer-centricity:

- How are we identifying key capabilities in our organization that deliver outcomes desired by our consumers? How are we measuring them?
- What areas of the business should be localized in order to best serve diverse geographic consumers?
- Locally and globally, do we understand where collaboration and innovation are occurring in the organization?
- What technologies are we using to gain a thorough understanding of consumer tastes and preferences? How are these findings leveraged to drive our capabilities?
- Are employees being encouraged, empowered, and given incentives to create more innovative product offerings, marketing collateral, and other consumer-oriented initiatives?

As agile companies focus more on meeting consumer needs, they also need to be able to reach consumers effectively. The next section looks at one of the most interesting and potentially transformational trends of our time: the impact of digital media.

## Reacting to a Rapidly Changing Consumer and Media Environment

*Media has changed. Consumers are playing the part of journalists, critics, and artists. New technologies are empowering consumers to view advertisements in new mediums, and simultaneously to bypass advertisements at their discretion. As a result, leading CPG manufacturers are providing consumers with advertising that stretches across platforms and that is interactive, collaborative, informative, and entertaining. To best tailor advertisements to consumers, leading CPG companies are shifting advertising expenditures to more accurately reflect consumers' media consumption habits. Advertisers are creating advertisements informed by robust data about ever-changing consumer tastes and habits. Manufacturers are beginning to use the Internet and emerging distribution platforms to appeal to consumers' lifestyles, rather than marketing to mass audiences through traditional advertising platforms. And these leading companies are continuing to stay abreast of emerging technologies and platforms so they are ready to embrace changes in advertising distribution.*



### It Is an Increasingly Digital World

The way consumers engage with media has changed because of the existence of multiple platforms that are able to deliver digital, interactive content to them. According to a consumer focus group conducted by PricewaterhouseCoopers during a meeting of corporate executives, consumers expect advertisers and content producers to engage with them through these new emerging platforms, and expect advertisements to provide them with individual attention in interactive ways.<sup>48</sup> Consumers already are increasing their use of the Internet to learn more about CPG products, brands, and companies, as is demonstrated by the popularity of CPG-related websites. Food-related websites had about 38.2 million visitors in September 2006—up 15% from September 2005.<sup>49</sup> And, consumers are increasingly visiting corporate/brand CPG websites, with large CPG companies attracting millions of page views monthly.<sup>50</sup>

Despite these changes, advertising expenditures are not aligned with the share of time consumers spend with different mediums, as indicated in Exhibit 7.

48 PricewaterhouseCoopers, *How to Monetize Content: A Conversation Among Media, Content, Distribution, and Advertising Executives* (2007).

49 comScore Media Metrix data, as reported by Lisa Phillips, "CPG Online: Food and Beverages Party On," eMarketer (April 2007).

50 comScore Media Metrix data, as reported by Jack Neff, "Media Owners Take Heed: P&G's Staid Old Website Has You Licked," *Advertising Age* (December 4, 2006).

But things are starting to change. Companies across all industries, including CPG, slowly are shifting some of their advertising spending to more accurately take into account changing media consumption habits. CPG companies are expected to increase their online advertising expenditures to a projected \$600 million in 2007, up more than 20% from the \$470 million spent on online ads in 2006; by 2011, CPG online advertising spending is predicted to almost double, increasing to \$1.132 billion.<sup>51</sup> Not surprisingly, proposed 2007 ad spend for food and beverage companies has declined from 2006 advertising spend in all areas except for the Internet, where ad spend is expected to increase almost 27% (see Exhibit 8).<sup>52</sup>

Exhibit 8: U.S. Advertising Spending by Food and Beverage Companies in 2005 and 2006, by Medium

	2005 (\$M)	2006 (\$M)	% change
Television	5,538	5,389	-2.7
Magazine	2,170	2,218	2.2
Radio	573	533	-7.0
Outdoor	265	240	-9.5
Internet	145	183	26.9
Newspapers	134	101	-24.7
<b>Total</b>	<b>8,825</b>	<b>8,664</b>	<b>-1.8</b>

Source: TNS Media Intelligence (March 2007); eMarketer calculations (April 2007), as cited in Lisa Phillips, "CPG Online: Food and Beverages Party On," eMarketer (April 2007).

Consumers are embracing digital media, opening themselves up to a variety of new advertising techniques. The question, then, is how do CPG advertisers make the most of the digital opportunities being offered?

### Understanding Complex and Ever-Changing Consumer Behaviors and Segments

Predicting consumer behavior has become more difficult because of pronounced demographic shifts, changes in family structures, and shifting social norms, making it more important for CPG advertisers to have a real-time understanding of their consumers. Given these shifts, advertisers will need to appeal to varied demographic groups using a number of distribution platforms, from print to digital, if they want to capture and maintain consumer loyalty. According to a TNS Retail Forward study, in the future, companies may target their advertising and its distribution to consumers in three distinct demographic groups: the Baby Boomers, who are the most rapidly growing age segment; Generation Y consumers, expected to be more diverse in their shopping tastes; and the Millennials, expected to be the most technologically savvy.<sup>53</sup> All of these consumer groups increasingly will rely on the Internet for information and as a means of communication and will expect companies to appeal to them through digital platforms.

Though consumer behavior is more difficult to predict due to increased consumer segmentation, there is now a wealth of consumer-focused information for companies to leverage, enabled by online discussion boards, blogs, chat rooms, email, and product review websites. CPG companies can take advantage of their own online data sources—including emails sent by consumers, data entered by consumers when requesting product samples, and comments written on company blogs. But there is even more information that companies can access to learn about consumers.

51 Lisa Phillips, "CPG Online: Food and Beverages Party On," eMarketer (April 2007).

52 Note: Online advertising spend does not account for rich media or search advertising.

53 TNS Retail Forward and PricewaterhouseCoopers, *Retailing 2015* (2007).

New data-mining technologies are enabling corporations to learn more than has ever been possible about their consumers. CPG advertisers are beginning to take advantage of text-mining services offered by market research companies in order to understand what consumers are saying in blogs, other consumer-generated media, and news sources about products, brands, and emerging trends. Understanding the buzz (positive or negative) about a brand, product, or a specific organization can enable CPG companies to anticipate trends, develop new products, or adjust to potentially brand-damaging sentiment. Armed with this kind of data, leading companies have the opportunity to increase their agility and respond and adapt quickly to emerging trends.

Leading-edge CPG companies also strive to identify and maintain constant communication with key influencers, those consumers who actively engage in an online dialogue about a brand, product, or company, or who can capture the attention of a large audience and are able to influence that audience. Research conducted by VNU's Nielsen BuzzMetrics using its Homescan consumer panel illustrates the importance of capturing key brand influencers: 33% of people who create consumer-generated media in the form of videos or blogs also provide company or brand feedback via company/brand websites, and 13% participate in brand or company blogs.<sup>54</sup> Research can help CPG companies identify these key influencers, as can initiatives where CPG companies draw consumers to their websites, survey them, and begin and maintain a dialogue with the most willing and relevant consumers.

Forming alliances with these key influencers can result in even more robust relationships, potentially helping shape the consumer-generated content that is created about a company and encouraging consumers to participate in word-of-mouth advertising. Because key influencers, by definition, have large audiences, leveraging them will allow a company to reach more consumers. One way companies have identified and leveraged key influencers is through the use of Vocalpoint, a word-of-mouth marketing program developed to spread the word about companies' products. Members of Vocalpoint are mothers who have large social networks, many of whom were found through banner ads on such sites as iVillage.com. These members receive coupons, product information, and other offers in exchange for spreading the word about products. Vocalpoint members also provide feedback about products through surveys or by trying product samples.<sup>55</sup> In another example of using new media and key influencers to connect with consumers, this time in China, Pepsi and Motorola both aligned themselves with the "Back Dorm Boys," two Chinese college students who attracted a large online following for their videos that spoof the Backstreet Boys and other pop stars. Pepsi appealed to a large audience by placing these influencers in a commercial on Pepsi Max TV and by hosting webcam videos on its Chinese website, while Motorola commissioned the production and creation of viral videos featuring the two students.<sup>56</sup>

### **Aligning Advertisements with Consumer Lifestyles**

Leading CPG advertisers use data about consumers and their use of digital media to position brands within the individual consumer's lifestyle, rather than appealing to a mass audience.<sup>57</sup> These companies are mindful of the consumer when they create an advertising strategy for a brand, product, or corporation, tailoring advertisements to distinct consumers and appealing to those consumers' lifestyles through appropriate distribution platforms. For example, to reach its teen and young adult consumers in a new way, Mars worked with its ad agency to create a microsite called "Instant Def" for its Snickers brand. The Instant Def site hosted a five-webisode series featuring the Snickers brand and starring hip-hop group the Black Eyed Peas playing hip-hop superheroes.<sup>58</sup> The website, which also sold candy, drew an average of 12,000 unique visitors daily, providing an entertainment experience while getting consumers excited about the brand. In the 12-week period that ended August 13, 2006, during which the Instant Def website was live, Snickers consumption grew by 4.8% and convenience store sales rose by 11.6% compared with the same period in the prior year.<sup>59</sup> PepsiCo's Mountain Dew brand used a different strategy

54 As reported by Jack Neff, "Media Owners Take Heed: P&G's Staid Old Website Has You Licked," *Advertising Age* (December 4, 2006).

55 Robert Berner, "I Sold It Through the Grapevine," *BusinessWeek* (May 29, 2006).

56 Normandy Madden, "Marketers in China 'Grab the Sofa,'" *Advertising Age* (October 2, 2006).

57 PricewaterhouseCoopers, *How to Capitalize on Lifestyle Advertising in a Customer-Centric World* (2007).

58 Louise Story, "Programmed to Sell," *The New York Times* (November 10, 2006).

59 Marc Graser and T. L. Stanley, "What Flew (and What Failed) in Hollywood," *Advertising Age* (January 8, 2007).

to position its brand within the lifestyles of its consumers. In December 2005, Mountain Dew released a movie about snowboarding that played in theaters nationwide. “MD Films” appeared in the opening credits of the movie, and PepsiCo and Mountain Dew were mentioned in the closing credits—but the drink was not featured in the film.<sup>60</sup>

When creating advertisements, savvy CPG companies are mindful of their brand, product, and corporate image. For example, a brand that is playful and that stresses the consumer’s experience with that product can benefit from offering consumers personalized online content that allows them to connect and engage with the brand. But a product that has a stigma attached to it or a higher trial barrier—such as a powder to address foot odor—is not likely to benefit from an email campaign because consumers are not likely to respond to a forced personal connection with the product, even if they know they need it. For these types of products, online advertising can be positioned differently. According to Susan Ashley, executive director at Resource Interactive, a digital marketing agency, online media lets companies reach new consumers because it allows manufacturers to interact with consumers in deeper ways than were possible previously—offering new ways to overcome barriers to product trial and deliver relevant “calls to action.” In the case of a stigmatized product, a banner ad that offers consumers the choice to obtain more information about the product and receive a coupon, without their having to visit the product website, can let CPG companies more effectively reach their target audience and drive trial (see Exhibit 9).

Exhibit 9: Examples of Online Campaigns for Two Personal Care Products

	Product A (Stigma Attached)	Product B (No Stigma)
Campaign Type	Educational campaign	Interactive, entertaining campaign
Initial Contact with Consumer	Informative expandable banner advertisement; consumer can interact with educational content and can request a free sample or coupon within the banner; consumer has the option of clicking through to the web site	Expandable banner that invites consumer to interact with the brand by visiting a microsite; consumer is invited to play a game, view videos or create their own content; can request a free sample or sign up for the email program  Targeted email to existing consumer database to pull consumers to the web site or campaign microsite
Content of Website and Microsite	Educational website for consumers who click through the banner ad	Interactive microsite featuring videos, tips, and consumer-generated content such as videos and reviews
Call to Action	Educate consumer in order to overcome trial barriers; drive awareness and product trial through sampling or couponing	Drive awareness and product trial through brand participation, sampling, and couponing after interaction; drive amplification of the message by offering “send to a friend” functionality for coupons or other engaging content

Source: Based on interview with Susan Ashley, executive director, Resource Interactive, [www.resourceinteractive.com](http://www.resourceinteractive.com) (April 27, 2007).

Some CPG companies are collaborating with consumers to offer even more interactive advertisements that position brands within consumers’ lifestyles. In late 2006, the Frito-Lay brand Doritos launched the Yahoo Video site “Crash the Super Bowl,” where consumers could upload their own user-generated Doritos commercials. Doritos picked five finalists, held a vote where users could choose their favorite, then aired the top two choices during the 2007 Super Bowl. The commercials proved popular with consumers, finishing among the top ten most-viewed moments of the game among TiVo DVR users.<sup>61</sup> To reach female high school athletes, P&G’s Tampax brand sponsored a cheerleading contest on Tackle.com, a social network for high-school athletes. High-school cheerleaders were given the chance to submit video clips of their best cheers, and Tackle.com users voted on their favorites, with the winner receiving \$10,000 worth of cheerleading apparel and equipment.<sup>62</sup> These types of collaborative, customized, interactive advertising campaigns—aimed at appealing to elements of an individual consumer’s lifestyle, such as a love of football or cheerleading—can help companies achieve a more unique and rewarding relationship with consumers.

60 Louise Story, “Programmed to Sell,” *The New York Times* (November 10, 2006).

61 Stuart Elliott, “Thanks to the Web, the Scorekeeping on the Super Bowl Has Just Begun,” *The New York Times* (February 6, 2007).

62 Brian Morrissey, “Tampax Enters Social Networking Fray,” *AdWeek.com* (March 12, 2007).

The combination of lifestyle advertising with technology that enhances interaction with the consumer is resulting in a new alignment of traditional advertising attributes. Advertising is often seen as sending a message to consumers, but companies can now think about having a two-way conversation with consumers instead (see Exhibit 10).

## Exhibit 10: Attributes for Traditional Advertising vs. Lifestyle Advertising

Attribute	Traditional Advertising	Lifestyle Advertising
Influence driver	Message	Conversation
Communication	One-way	Two-way
Relationship	Brand to mass audience	Brand to individual consumer
Directionality	Linear path to transaction	Multiple paths to transaction
Messaging	Static message	Dynamic message

Source: PricewaterhouseCoopers, *How to Capitalize on Lifestyle Advertising in a Consumer-Centric World* (2007).

### Align Advertising with Consumers Through New Distribution Platforms

The acceleration of current consumer technology trends such as online and mobile video has far-reaching implications for the future of advertising, for ways of doing business online, and for the creation and distribution of content.<sup>63</sup> Leading-edge CPG advertisers are educated about consumer technology trends and informed about new distribution platforms their products' target consumers are using, and how they are using them. They are agile, ready to embrace new trends and new ways of distributing advertising that are in line with their brand and target consumers.

Advergames—video games created as marketing tools, which typically place brand awareness as a central objective—are expected to be one of the distribution channels increasingly embraced by consumers and through which many companies will increasingly distribute content. A number of companies have already launched successful advergame campaigns to reach consumers. With Microsoft's Xbox division, Burger King developed games that leveraged the popularity of characters like Subservient Chicken and the King. Over two million copies of the Xbox games were sold in four weeks, making the advergames the best-selling Xbox games released during the 2006/2007 holiday season.<sup>64</sup> Due to the success of this means of advertising, U.S. advergame spending is expected to grow by a compound rate of 16% per year from 2006 to 2011.<sup>65</sup>

Internet Protocol Television (IPTV)—television that is delivered over the Internet—is another increasingly popular emerging platform through which CPG companies can choose to advertise, depending on whether their target consumers are using this medium. A study by Millward Brown illustrates the power of advertisements featured on Internet television, showing that consumers pay more attention to 30-second TV spots aired during online programming than they do to commercials aired on TV as part of a multi-commercial break. The study results showed that, compared to live TV, web spots increased viewer attention rates by 53%, awareness by 52%, consideration by 27%, and favorability by 25%.<sup>66</sup> Another study, published by Knowledge Networks, concluded that consumers who watch network TV shows online tend to have a higher opinion of the brands sponsoring the show.<sup>67</sup>

63 PricewaterhouseCoopers, *How to Monetize Content: A Conversation Among Media, Content, Distribution, and Advertising Executives* (2007).

64 David Jacobson, "Hits and Misses," *Business 2.0* (March 2007).

65 Lisa Phillips, "CPG Online: Food and Beverages Party On," *eMarketer* (April 2007).

66 *Ibid.*, Millward Brown data.

67 *Ibid.*, Knowledge Networks research.

Advertisements delivered to mobile phones offer yet another way of reaching consumers, especially those who might be more difficult to get in touch with through traditional means. Mobile banner ads have much higher click-through rates than Internet banner ads—between 2% and 3% for mobile banners, compared with just 0.2% for online.<sup>68</sup> In addition to reaching consumers more readily than online banner advertisements, mobile advertising opens up new opportunities for CPG companies to partner with retailers to offer shoppers coupons via mobile phones. Though consumers currently favor newspapers as their preferred source for coupons, this may change with the advent of new technologies that make it easier for CPG companies and retailers to send coupons to consumers, and easier and more convenient for consumers to receive and use those coupons. In summer 2007, a network of 17,000 local retailers and shops in the UK is participating in a “Shop Scan Save” campaign through which coupons are sent to shoppers via mobile phones, with barcodes that retailers can scan from the phone’s display. A number of CPG companies are participating in the initiative, including Unilever, P&G, Mars, and Nestlé. Companies are eager to participate in this initiative because they anticipate it will let them reach people who don’t usually clip coupons, such as younger men. Shoppers will even be able to request coupons by text messaging key words to the initiative, making on-demand coupon distribution easier.<sup>69</sup>

Leading-edge CPG companies are both agile and collaborative with consumers and key influencers, enabling them to keep up with the changing trends in technology, consumer preferences, and advertising that will allow them to reach consumers in new ways. To succeed, they can leverage their capabilities to drive performance that’s in line with their strategy, brand, and expectations.

## Operating in an Increasingly Digital Age: Key Questions to Consider

Understanding the consumer is more important for CPG manufacturers than ever. Consumer preferences and interests are constantly changing. To understand and capture consumer preferences in this increasingly digital age, manufacturers (or retailers) can ask themselves:

- How are we aligning brand, product, and corporate strategy with advertising strategy?
- How are we choosing the types of advertisements we offer consumers, and the vehicles we use to send those advertisements to them? Do we know what types of distribution platforms our consumers use currently and will likely use in the future?
- How are we thinking across multiple platforms in order to best reach consumers? How are we fully leveraging the interactivity of emerging platforms?
- How are we being proactive in facing the implications of user-generated content to our business?
- How are we monitoring emerging online trends? How are we monitoring new advertising technologies and their effectiveness?
- Are we able to react to emerging trends? Are we flexible enough to change advertising strategies based on consumer and trend data?
- How are we making these decisions in collaboration with our consumers?

In the next two sections of this report we discuss other issues and trends affecting CPG manufacturers and retailers, and address CPG and retail company performance.

68 Ibid., ABI Research data.

69 Maija Palmer, “Stores to Launch Discount Coupons via Mobile Phones,” *Financial Times* (April 13, 2007).

## Section 2

# Creating Value for Consumers: Additional Perspective

Over the past few years, retailers and manufacturers have become more entwined. Companies are finding that targeted collaboration is increasingly important for providing consumers with products and services that meet their changing needs, while simultaneously achieving efficiencies and ultimately increasing net sales and profitability. As the retailer and consumer landscape continues to evolve in the future, the industry will face many challenges, such as a shift in consumer shopping habits and the availability of ever-increasing amounts of consumer data (see sidebar below).<sup>70</sup>

This section examines recent changes among retailers, the effects of these changes on manufacturers, and potential areas ripe for targeted collaboration. The financial benchmarking section that rounds out this report also includes a comparison of financial performance of retailers and manufacturers. Together, these sections can help better educate the industry about opportunities for collaboration and performance improvements.

### Future Outlook for the Retailer and Consumer Landscape

- **Changing Demographics:** Baby Boomers, who emphasize youth and vitality, and members of Generation Y, who desire to live the lifestyle of their parents, will be target groups. Changing ethnic groups will lead to increased multiculturalism and the desire for products that reflect this diversity.
- **The New Consumer:** Consumers will be evolving. Their focus will be on their interests first, and they will want interactive input, the ability to obtain products and services very quickly, and products that are socially responsible and environmentally friendly.
- **Retail Outlets:** Consumer interest in conventional malls will continue to shift to neighborhood shopping centers that cater to very specific tastes. Shopping will continue to be more about eating, being entertained, and living the shopping experience. China and India will open up to the world's best retailers.
- **Strategic Outsourcing:** Companies will continue to outsource basic goods and will identify strategies to outsource non-core competencies. Management will focus on key business issues, collapsing time-to-market, new alliances, and understanding the inner workings of developing and emerging market cultures.
- **Targeted Collaboration:** Retailers will increase the beneficial value of collaboration with manufacturers in order to remove obstacles that occur naturally between the two groups. Retailers and suppliers will participate in more targeted collaboration on product launches, trade promotions, inventory management, and supply chain operations.
- **The Importance of Digital Technology:** Technology will help fill the enormous need to effectively manage business through business intelligence. Newer forms of technology delivery systems will provide real-time data, allowing for enhanced demand-based management. Business intelligence will make retailing more personal, with consumer data and relationships becoming more important to retailers.
- **Security and Privacy:** Increased information sharing across the entire supply chain will result in an intelligent value chain. Thus, protection of consumer data will become even more necessary because consumers will deny retailers the use of personal information if confidentiality is breached.

<sup>70</sup> For the purpose of this report, we define “CPG retailer,” referred to in this report as “retailer,” as companies that sell manufactured food, beverage, and household and personal care products. For a detailed discussion on retailers included in this report, please refer to Appendix A.

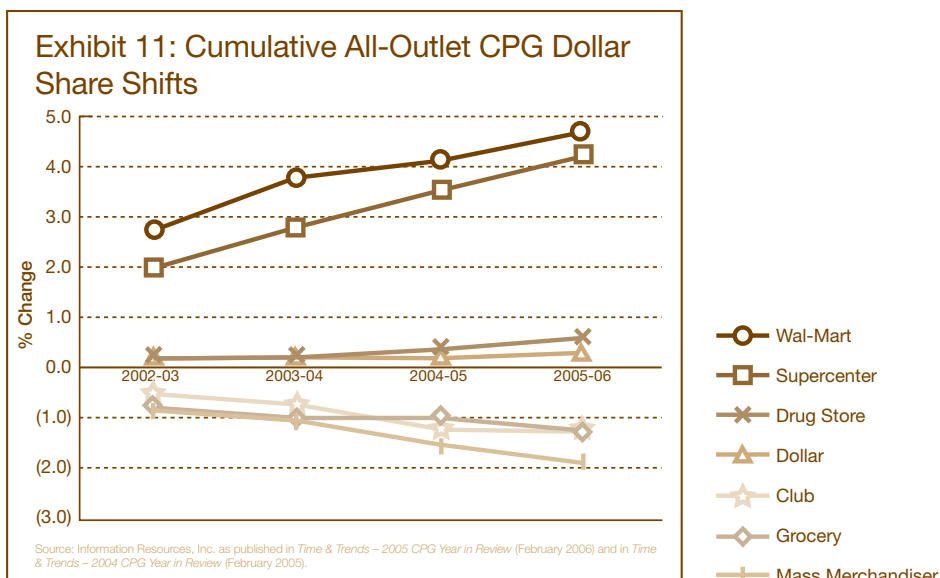
## Additional Insights into the Retailer Landscape

Consumer products are increasingly available through more channels, giving consumers more options. As retailers compete for consumers' discretionary income, they are becoming more consumer-centric and differentiating themselves to grow the top line. Retailers are focusing on product category growth, leveraging private labels, efficient and effective data sharing and analysis, and customized products and services from manufacturers to support their diverse formats and consumers. In support of retailers' focus, there are collaboration opportunities for retailers and manufacturers around planning of product mixes, new product launches, advertising and digital media, data sharing, and data analysis.

### The Retailer Landscape Is Changing

The retailer landscape continues to change dramatically year after year. Retailers have added or expanded food and beverage offerings, with some low-cost providers adding stand-alone grocery stores to their portfolio,<sup>71</sup> supercenters including entire grocery formats, many drugstores adding and/or expanding food and beverage sections, and even niche retailers like Home Depot and Staples selling gourmet candy.

Consumers are changing their buying behaviors in response to having a wider selection of outlets for food and beverages (see Exhibit 11). In 2001, the average consumer purchased 300 distinct UPCs in grocery stores, but today that number is down to 250, with consumers looking to alternative channels for the other 50.<sup>72</sup> Channel migration from grocery stores is expected to continue. Planet Retail predicts that of the top ten grocery retailers in 2010, only four will be supermarkets, with mass merchandisers and drugstores rounding out the list.<sup>73</sup> This migration has impacted dollar share for different distribution channels over the past five years. Consumer expectations increasingly are for choice—in products themselves and in where or how they buy them.



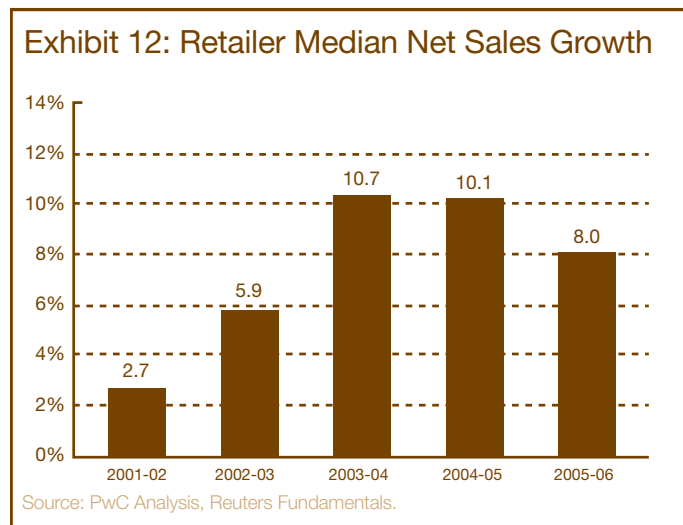
71 Jenny McTaggart, "Taking a Bite Out of Baggers," *Brandweek* (June 27, 2005).

72 Jessica Male, "Against the Tide," *Grocery Headquarters* (March 2007).

73 "Retailer Landscape Shifts, Too," *AllBusiness* (March 2007).

### As Retailers Aim for Growth, They Are Focusing More on the Consumer

Median net sales growth for retailers slowed between 2004–2005 and 2005–2006 (see Exhibit 12). More and more, retailers are competing with each other for consumer discretionary spending, reinforcing the strategy of focusing more on the consumer.



Consumer-centric retailers concentrate on meeting the consumer’s changing needs instead of purely pushing products. This level of consumer focus has led retailers to adopt a variety of tactics. For example, retailers are increasing their ethnic food selections to capture revenue from specific growing demographic groups, adding more organic products to fulfil consumer interest in health and the environment, offering more prepared meals to align with consumers’ busy lives, lowering specific SKU prices to attract cost-conscious shoppers, and creating unique consumer shopping experiences. Some retailers also are enhancing their store perimeter by adding service offerings such as banking and health care. Retailers often implement more than one tactic, either in a single store format or through a variety of store formats.

As one of the earliest examples of executing a consumer-centric strategy, Best Buy identified four types of consumers as its preferred consumers and has been redesigning some of its stores and improving certain services since 2003 to attract one or more of these target groups.<sup>74</sup> In FY 2006, Best Buy operated 300 of these newly consumer-centric stores, which equated to 40% of all its U.S. stores. In FY 2005, the consumer-centric model was in place at 67 Best Buy stores, and those stores saw an 8.2% sales increase compared to 1.9% at other U.S. stores.<sup>75</sup>

Recently, many traditional grocery chains and supermarkets have adopted a consumer-centric approach. H. E. Butt Grocery has focused on the Hispanic market and the Asian market in certain locations, as well as offering price cuts on some products.<sup>76</sup> To meet geographic and demographic needs, Kroger operates many formats, including combination stores, multi-department stores, extreme value stores, jewelry stores, and convenience stores.<sup>77</sup> Tesco, Britain’s largest retailer, is slated to open 100 stores in the U.S. by February 2008<sup>78</sup> with a focus on healthy, high-quality fresh and prepared foods, an emphasis on its private label, and a commitment to the environment—all criteria that are important to their targeted consumers.<sup>79</sup>

74 Matthew Boyle with Susan M. Kaufman and Joan L. Levinstein, “Best Buy’s Giant Gamble,” *Fortune* (April 3, 2006).

75 Best Buy, *Fiscal 2005 Annual Report* (2005).

76 Jenny McTaggart, “Taking a Bite Out of Baggers,” *Brandweek* (June 27, 2005).

77 Joseph Agnese, “Standard & Poor’s Industry Surveys: Supermarkets & Drugstores” (July 27, 2006).

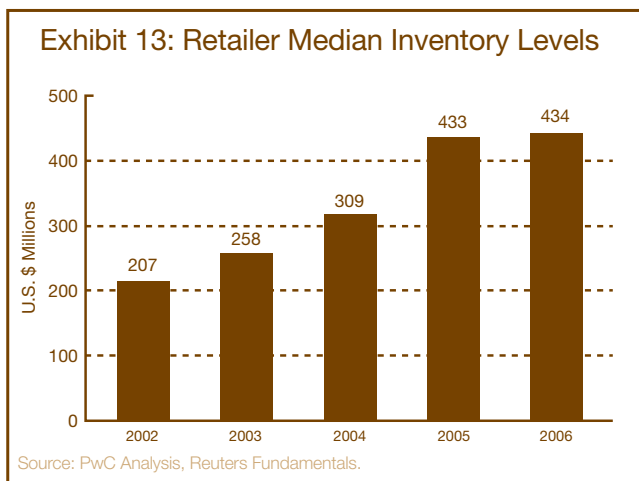
78 “Tesco Plans 100 Fresh & Easy Units by Feb. 2008,” *Progressive Grocer* (April 26, 2007).

79 Kevin Coupe, “Tesco Puts a Virtual Face on Its US Stores & More Money into Them,” *MorningNewsBeat.com* (April 18, 2007).

Safeway has adopted several consumer-centric tactics to attract consumers, redesigning its stores to what it calls a “lifestyle” format and improving customer service. The company is focusing on both the perimeter and the center store, emphasizing fresh produce (including organics) and offering full-service meat counters, bakeries, floral design centers, and sushi and olive bars. Safeway is collaborating with manufacturers to increase conventional grocery sales while expanding its private label.<sup>80</sup>

### With Store Differentiation Comes Customization

As retailers differentiate themselves, they look for a variety of customization opportunities, from different products to different store formats. Retailers focus more on getting the right product in the stores at the right time with the right advertising and promotional support to draw consumers into the store and to lead them to spend more of their discretionary income. Some retailers look for customization in the areas of product labelling,<sup>81</sup> which manufacturers handle in different ways and which can have a big impact on efficiencies. Manufacturers can manufacture the product and labelling together, which may get the product to the shelf quickly but could require shorter runs, resulting in more frequent changeovers. Or, manufacturers can manufacture product and then store it for labelling later, once specifications are determined, which requires manufacturers to hold more inventory and might lead to expiration date problems. This increase in complexity is leading to an increase in inventory (see Exhibit 13), and most retailers are working to improve levels of inventory investment. Last year, Wal-Mart announced an initiative to reduce inventory levels by \$6.5 billion.<sup>82</sup>



In a GMA/FPA study of CPG manufacturers published in 2006, 20% of respondents reported that customized products comprised more than 20% of sales. Respondents also reported that customization has grown in the past three years and they believe this trend will continue.<sup>83</sup> The extent to which this increase in customization has increased complexity is up for discussion. While the number of store formats has increased, a very large portion of the products sold throughout the different formats are the same. Manufacturers can continue to increase common efficiencies for these like products, which can give manufacturers more leeway and resources to address or invest in the complexity that stems from customized products.<sup>84</sup> One tactic for finding common efficiencies among similar products includes employing electronic data interchange (EDI), radio frequency identification (RFID), or related technologies to improve management of the supply chain. Retailers and manufacturers together can find the balance between customization and standardization to avoid increasing costs too much while meeting the demands of different consumers.<sup>85</sup>

80 John Karolefski, “Retailer of the Year,” *Grocery Headquarters* (May 1, 2006).

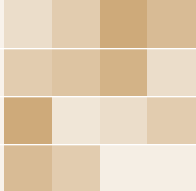
81 Grocery Manufacturers Association, *Creating Value Through Customization: Winning Through Shelf-Centered Collaboration* (2006).

82 Jack Neff and Kate MacArthur, “To the Last Drop: Wal-Mart Makes \$6.4B Squeeze; P&G, Others Take Hit as Retailer Strives for a ‘Zero-Inventory’ Stat,” *Advertising Age* (April 17, 2006).

83 Grocery Manufacturers Association, *Creating Value Through Customization: Winning Through Shelf-Centered Collaboration* (2006).

84 President of a major retailer, phone interview (April 27, 2007).

85 Darrell Rigby and Vijay Vishwanath, “Standardization, Meet Your Successor,” *Brandweek* (October 30, 2006).



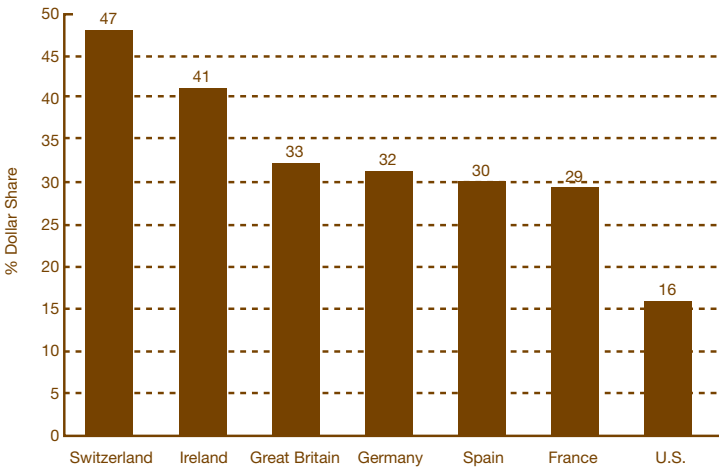
**Retailers Continue to Use Private Label Products for Differentiation and Category Growth**

Historically, private label product lines were used for varying purposes by both manufacturers and retailers. Clearly we have come a long way from when private label would conjure up only low-cost store brands or generic black-and-whites. In the U.S., dollar and unit share of CPG private label products did not change between 2005 and 2006, but their overall sales (accounting for a 16% dollar share) are enough to illustrate that they are not a fad. For hints at the future, the U.S. can look to Europe, where CPG private label products now account for between 29% and 47% of sales (see Exhibit 14).

In the U.S., other industries are also embracing private label products. Many department stores and mass merchandisers have created private label products for apparel, and some drugstores have developed successful health and beauty private label products. Still, private label products are more prominent in food categories by almost five unit shares and dollar shares than non-food products.<sup>86</sup> Even within food categories, these products are more popular in certain categories than in others.

Today’s private label products are of higher quality than in the past, and often have more attractive packaging. Retailers are promoting their private label products as manufacturers would promote their branded products, including giving private label products brand names and promoting specific attributes. Whole Foods represents its private “365” label as high-quality, flavorful foods made without artificial flavorings, colorings, sweeteners, preservatives, or hydrogenated fats.<sup>87</sup>

Exhibit 14: All-Outlet CPG Private Label Dollar Share in Europe and the U.S. (2006)



Sources: Europanel™ 52 weeks ending 6/30/2006 and IRI Consumer Networks, 52 weeks ending 9/3/2006, as published in Information Resources, Inc. *Times and Trends* (November 2006).

86 Information Resources, Inc., “Private Label Market Trends,” *Times and Trends* (November 2006).

87 Whole Foods, “Private Label Products,” [www.wholefoodsmarket.com/products/list\\_privatelabel.html](http://www.wholefoodsmarket.com/products/list_privatelabel.html) (April 24, 2007).

Some private label products are sold at a premium compared to branded products, while others are sold at a discount compared with branded products.<sup>88</sup> Pricing differences are found both at the category level (see Exhibit 15) and between a retailer's different private label brand names. Kroger, for example, offers consumers three private label products: The "For Maximum Value" products offer value and quality for cost-conscious shoppers; banner brands (such as Kroger, Ralphs, and King Soopers) offer excellent quality and value with a guarantee that consumers "try it, like it, or get the national brand free"; and the Private Selection label offers premium products of the finest quality.<sup>89</sup>

Exhibit 15: Private Label Products vs. Branded Products: Categories with Largest Price Differential\*

Private Label Price Premium	%	Private Label Price Discount	%
Toothpaste	125	Toothbrush/Dental Accessories	-57
Chocolate Candy	55	Razor Blades	-57
Frozen Meat	51	Paper Towels	-54
Frozen Dinners/Entrees	39	Air Fresheners	-51
Pies and Cakes	37	Facial Cosmetics	-50
Frozen Poultry	36	Toilet Tissue	-49
Eye Cosmetics	32	Carbonated Beverages	-46
Gum	18	Dry Packaged Dinners	-46
Frozen Seafood	17	Fresh Bread and Rolls	-45
Refrigerated Salad/Coleslaw	16	Soup	-45

\*Among top 100 categories.  
Source: IRI InfoScan Reviews, FDPx; 52 weeks ending 9/10/06 as published in Information Resources, Inc., *Times & Trends* (November 2006).

Regardless of varied pricing, consumers value private label products. In a poll by ACNielsen, almost six out of ten respondents said private labels were "just as good" as branded products.<sup>90</sup> Consumers are acting on this perspective, with different surveys reporting that all or nearly all consumers have purchased a private label product at some point.

Retailers see private label products as a key and increasingly important component of category growth. One grocery retailer that has made selective price cutting a major tenet of its differentiation strategy is interested in growing categories by including a range of products within each category at different price points, and thus attracting a variety of consumers.<sup>91</sup> A different retailer, Giant Eagle, offers the Valu Time line to provide lower opening price points in shelf-stable jelly and other staple categories.<sup>92</sup> Additionally, there is a perception that private label products can assist with category growth by effectively and efficiently meeting the full breadth of consumer needs.<sup>93</sup> In 2006, private label sales growth in the dried fruit category was 12.1%, helping to drive overall category growth of 9.1%. In the same year, sales of conditioner/cream rinse private label grew 36.5% compared to the total category growth of 10.5%. Laundry detergent private label sales growth was 7.7% compared to total category growth of 3.2%.<sup>94</sup>

88 Information Resources, Inc., "Private Label Market Trends," *Times and Trends* (November 2006).

89 Kroger, "Proxy, Notice of Annual Meeting of Shareholders, Proxy Statement, and 2005 Annual Report," [www.thekrogerco.com/finance/documents/proxystatement.pdf](http://www.thekrogerco.com/finance/documents/proxystatement.pdf) (no date).

90 Todd Hale, Marc Dietz, Kevin Sternecker, and John Krohn, "The Private Label Playbook: Less Stock, More Profit," *ACNielsen* (summer 2006).

91 CEO of a major retailer, phone interview (April 19, 2007).

92 Jenny McTaggart, "Taking a Bite Out of Baggers," *Brandweek* (June 27, 2005).

93 CEO of a major retailer, phone interview (April 19, 2007).

94 "No More Hand-Me-Downs," *Private Label Buyer* (February 2007).

Developing new products for category growth can be a challenge, and more than two thirds of them fail.<sup>95</sup> If CPG companies opt to develop new products in response to private labels, they need to look for ways to overcome challenges that hinder new product success. A major contributor to the high failure rate of new products is an inaccurate understanding of the consumer's needs. This can happen because traditional methods for collecting consumer feedback fall short because they are too biased, too expensive, too slow, too imprecise, and often misdirected,<sup>96</sup> and consumers are not engaged in a manner that allows them to convey their genuine thoughts to the researcher.<sup>97</sup> When retailers and manufactures collaborate on product launches, execution can be improved through the application of several key principles, including (a) having a shared understanding of the level of commitment each party will provide, (b) establishing criteria for success and key performance indicators to measure progress, and (c) focusing on post-launch activities.<sup>98</sup> As retailers and manufacturers increase their collaborations around new product introductions and private labels, both will benefit.

### **Data Sharing Can Help Retailers and Manufacturers Collaborate**

Retailers gather an enormous amount of data from consumers about their purchasing habits and demographics—particularly through point-of-sale technologies and consumer loyalty cards—and, in recent years, have improved their analysis of this data to assist with their strategies and operations. Tesco uses its Clubcard program to cater to several different types of consumers. It has used the card to identify products that appeal to cost-conscious shoppers and reduced the price of those products to compete with low-cost rivals. It also has offered coupons to consumers for products they buy, as tracked by the Clubcard, and for products they might like to buy. Clubcard data also helped Tesco identify consumer desire for an ethnic food line.<sup>99</sup>

Technology exists to capture and sort consumer data into detailed reports. However, technology alone is not sufficient to lead to effective data sharing and use. Retailers collect massive amounts of information, but do not always share it with manufacturers. When retailers do share data, there is often such a large amount of it that manufacturers cannot analyze it quickly and cost-effectively. Without data that has been analyzed effectively and in a timely manner, manufacturers do not have a complete picture to assist them with customization of products and services, product innovation, and category management strategies, including private labels.

Data sharing between retailers and manufacturers can also help manufacturers plan orders based on consumer sales data instead of less accurate demand planning. Making ordering more accurate can help manufacturers produce the right type and amount of product to meet consumer demand and develop effective replenishment strategies, thus reducing excess inventory, improving inventory turnover, and reducing the risk of stock-outs.

95 ACNielsen. "All About Your Consumers: New Product Development," [www2.acnielsen.com/products/crs\\_newproduct.shtml](http://www2.acnielsen.com/products/crs_newproduct.shtml) (April 23, 2007).

96 *The Essentials of Consumer-Driven Innovation*, Forrester Research, Inc. (May 2006).

97 "Reinventing Innovation at Consumer Goods Companies," *The McKinsey Quarterly* (November 2006).

98 PricewaterhouseCoopers and the National Association of Chain Drug Stores Advisory Board, *How Targeted Collaboration Between Retailers and Manufacturers Promotes the Success of New Product Launches* (2007).

99 Cecilie Rohwedder, "Stores of Knowledge: No. 1 Retailer in Britain Uses 'Clubcard' to Thwart Wal-Mart," *The Wall Street Journal* (June 6, 2006).

In a PricewaterhouseCoopers survey of senior executives of large consumer products companies, respondents identified collaboration activities with retailers that occurred during the past 12 months. The responses below indicate that some responding manufacturers (though not all) are already collaborating with retailers on certain initiatives discussed in this report (see Exhibit 16).

Exhibit 16: Collaboration Activities Between Manufacturers and Retailers

Collaborative Activity	Percentage of Manufacturers Engaged in Collaborative Activities with Retailers During the Past 12 Months
Inventory Management Program	62
Customized New Product Introduction	62
Synchronized Data Exchange Program	52
Co-branding Initiative	48
Purchase Data Sharing	36
None of the Above	4

Source: PricewaterhouseCoopers, Consumer Products Barometer Q1 2007 (June 2007).

### It All Comes Down to Targeted Collaboration

For a variety of reasons, collaboration between retailers and manufacturers is easier said than done. Retailers and manufacturers may believe that they are competitors, they may be hesitant to share information and analysis of that information, and they may not fully understand each other. Coming to a shared understanding around historically sensitive subjects can help manufacturers and retailers overcome barriers to collaboration. Retailers and manufacturers can each become more transparent in order to better understand how the other operates and can align goals to develop effective partnerships, including exclusive arrangements around certain products. Together, retailers and manufacturers can share and analyze data effectively to aid in jointly proposing new product mixes for various store formats, introducing new products to grow product categories, improving supply chain agility to better meet retailer customization needs, and reducing inventory levels. Retailer and manufacturer collaboration around consumer-centricity and differentiation can assist retailers in competing for consumers' discretionary dollars and in growing revenue while also benefiting manufacturers through increased revenue.

## Thoughts on Current Trends from the C-Suite

*The perspectives in this section are informed by conversations we had with C-suite executives from large CPG and retail companies. We found manufacturers and retailers readily acknowledging each other's particular strengths, recognizing the need to collaborate, and identifying ways to work together to achieve their mutual goals of growth and profitability. Whether regarding supply chain flexibility or data sharing, or even private versus branded labels, we detected openness to targeted collaboration in every area. We hope this attitude increasingly will define the way retail and CPG companies do business together.*

Here are some excerpts from our discussions.

### **On Rising Costs**

“We’re continually reviewing all of our raw-material positions. We keep asking ourselves: Do we have the right raw materials and the right quality of raw materials? And we have a continuous program of value engineering. But we balance the demands of value engineering in terms of more efficient cost and plant utilization against quality. It’s better to take a price increase than to reduce quality with a branded product.”  
— Senior CPG executive

“In the long term, price increases are inevitable. Companies should continue to innovate at the premium end of their category. That provides more room for margins to outrun cost for all players in the industry.”  
— Senior CPG executive

“At the end of the day, the consumer will make the choice about the point of resistance, the point at which the price exceeds the value he or she gets. Consumers are presented with a lot of choices, and their choice among those really becomes a matter of the value the consumer gets for the product compared to the price she paid for it.” — Senior retail executive

“Rising costs have challenged us to remain efficient. We’ve reduced our supply-chain costs. We’ve reduced our inventory. We’ve reduced our shrink. And ultimately, we’ve been able to simplify our staffing. We’ve taken a lot of complexity out of the management of sections of our stores. We’re moving from a service model to a self-service model.” — Senior retail executive

### **On Customization**

“I think companies have to start with making sure they have a platform that appeals to the masses, but is then mass-customized to the targeted demographic. And that may be as simple as flavor assortment in a specific geographic area. This means you’ve got the platform, which appeals to the masses, and then the SKUs simply are modified to meet the local market requirements.” — Senior CPG executive

“We have divided our business up into different zones and segments. So we apply our pricing and our product offering differently in different stores. But most of the buying is done centrally.”  
— Senior retail executive

“The real win comes when you understand the differences but you don’t forget the similarities.”  
— Senior retail executive

“While it is true that our store formats may be on two opposite ends of the spectrum, whether it’s the extreme upscale or the extreme value store, there’s still a very, very large middle market. You don’t have to tailor everything. Milk is going to sell in both locations; it just may mean that the ratio of sales is different. Manufacturers have to understand the middle, where there are a lot of consumers. As a retailer, we have to understand that as well and then work together with manufacturers to figure out how we branch out north and south of the middle.” — Senior retail executive

“We are partnering with not only the larger retailers in the United States, but also specialty retailers to develop programs that work effectively through their retail operations. For us, mass customization means working with each retailer’s business concept and what it represents. Companies need to be increasingly flexible both from marketing and selling perspectives to be able to adapt to the different retail formats to be successful.” — Senior CPG executive

### **On Innovation and Product Development**

“The greatest advantage that consumer packaged goods companies have and the greatest value they can provide, even as we expand our private label business, is innovation. We will never have their innovation capability. We will never have hundreds of people working in an R&D center.” — Senior retail executive

“There was a time in the not-too-distant past when product proliferation might have been the ticket to a manufacturer’s growth. But today we need more innovation, not proliferation. And I think manufacturers understand that.” — Senior retail executive

“With today’s busy lifestyles, consumers value convenience. People are looking for faster, more portable ways to prepare and consume food while all the time holding manufacturers to very high standards of quality. Even in the growing premium end of a category, we see convenience options being introduced. Convenience will continue to be a key driver of innovation in the future.” — Senior CPG executive

“Innovation has become a key strategy to drive the business. We all have an interest in bringing innovation forward for the growth and profitability prospects it provides. We’ve seen retailers really embrace innovation.” — Senior CPG executive

“The product range is the key to growth. The more innovation manufacturers can bring to the range that’s consumer spot-on, the more we’re both going to be able to grow.” — Senior retail executive

### **On Private Labels and Branded Products**

“While private label and brands are obviously competitive in the sense that they offer consumers more choice, it doesn’t necessarily mean that they can’t co-exist and grow jointly. I think the real challenge for both retailers and manufacturers is this: How do we gain a deeper understanding of consumer needs and really be serious about providing real solutions—and not just extensions of product lines that aren’t creating new markets?” — Senior retail executive

“The best way to grow a category is to have the right range of products and pricing to offer consumers. We believe that private label plays a real role, not by itself, but as a very important complement to growing the overall category. In our stores, we are evaluating the range and assortment of what we offer. We are moving toward a greater price range but a smaller assortment within each range.” — Senior retail executive

“Our view of private label is very simply that it is a reality of today’s marketplace and it will be a reality of the future retail environment. I think branded companies are looking at it in terms of: Is this something that will expand the strategic partnership between us and the retailer? Are private labels providing real economic growth in certain categories in certain areas? There are companies that exist solely to supply a private label and those companies are very tied to the strategies related to the private label business. And then there are the branded companies that often times offer private label retailers second-generation innovation, if they have the capacity to do it.” — Senior CPG executive

### **On Data Sharing**

“I don’t think the solution here is to debate whether information should be free and free-flowing. The debate should center around how we get to the information—in whatever form or fashion—that is helpful to both parties. Is the value of the information sufficient to actually improve our business together? If it is, then cost isn’t the issue. In my view, having deep insight into consumers is of tremendous value.”

— Senior retail executive

“If a manufacturer is going to take our data and use our insight to offer a product to all of our competitors, that wouldn’t be in our best interest. That’s the challenge with data sharing.” — Senior retail executive

“If you demonstrate results, protect confidentiality, and accomplish the objectives you set out, I think, that will continue to drive more sharing. We are working to build that level of trust and that level of information sharing with the majority of our retailer-consumers today.” — Senior CPG executive

### **On Digital Media and Online Distribution Channels**

“As manufacturers and retailers, we’ve got to make adaptive changes because the next generation and, in many ways, even our current generation is finding different means to get information. The in-store experience is going to have to be different. And then the external information and communication is going to have to be far different than it is today. It’s not going to be business as usual.” — Senior retail executive

“I think manufacturers will continue to increase the use of digital media in targeting and marketing their products. But I don’t expect a lot to happen overnight; it’ll be an evolution over a period of time.”

— Senior CPG executive

“Loyalty-card data is a magnificent thing and really is the foundation of our more targeted marketing activity. We can take our loyalty-card data, read what consumers’ particular likes and dislikes are, and contact them directly either through mail or email.” — Senior retail executive

“The challenge for the online grocery business has been the need to invest in brick and mortar. Some of them sort of overdid it. Projections of growth in online grocery were wildly optimistic. It is important and growing, but still a niche. It’s a high fixed-cost business and a tough model. So the industry has to figure out ways, particularly in more urban markets, to improve the model.” — Senior retail executive

“What, ultimately, is the winning model that will serve the online consumer and be economically viable? We all continue to wrestle with what’s the right model.” — Senior retail executive

## Section 3

# Industry Returns Improve: Financial Performance Benchmarking

This section of the report provides a set of clear reporting metrics for the CPG industry group, with financial performance measured by a set of key metrics relevant to the industry. To provide a balanced perspective on overall company performance, this report includes five types of metrics, which are provided for different company sizes (see Exhibit 17) and product types:

1. Operational performance (e.g., gross margin, free cash flow)
2. Cash management (e.g., cash conversion cycle)
3. Balance sheet management (e.g., inventory turnover)
4. Tax efficiency (effective tax rate)
5. Overall return (e.g., total shareholder return, return on market capital)

### Exhibit 17: Size Segmentations for Financial Reporting Benchmarking

Small manufacturers	\$50M < net sales <= \$500M
Medium manufacturers	\$500M < net sales <= \$4B
Large manufacturers	net sales > \$4B
Very small manufacturers	net sales <= \$50M
Very large manufacturers	net sales > \$10B

The companies analyzed here represent the core food, beverage, and household product manufacturers. Indicators are provided on a fiscal-year basis and are calculated using company-specific information obtained from Reuters Fundamentals and Reuters pricing dataset.<sup>100</sup>

#### Public Company Churn in the Industry

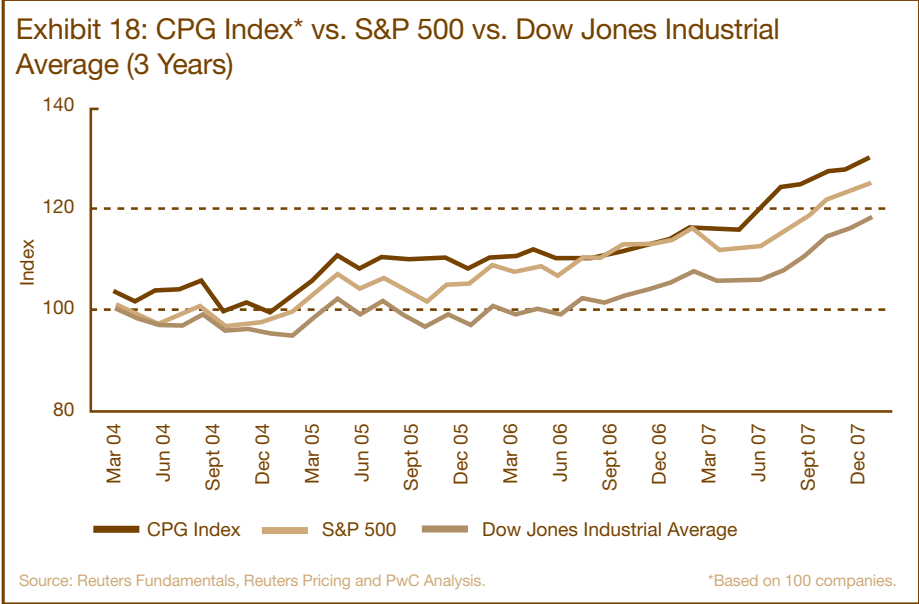
Company turnover has increased in the past few years after experiencing a decrease from 2000 to 2003, as is evident in our dataset. We note a decline in the inflow of companies into the PricewaterhouseCoopers benchmarking dataset, which may be ascribed to changes in venture capital and start-up activity over this period. We also find an outflow of companies from our dataset since 2000 that may be attributable to merger activity. The outflow of companies from our dataset in the past two years may reflect private equity activity. In all, the dataset is reflective of an active marketplace for the industry.

<sup>100</sup> A detailed summary of the methodology and sources can be found in Appendix A.

# Manufacturer Overview

## Manufacturers Outperform Broad Stock Indices

The industry is performing well. An aggregate market index comprising these companies, referred to as the CPG Market Weighted Index,<sup>101</sup> outperformed both the S&P 500 and Dow Jones Industrial Average in 2006 (see page 2) and in the three-year period 2004–2006 (see Exhibit 18). Each of the CPG industry segments (food, beverage, and household products) also outperformed the S&P 500, which is further evidence of investors’ positive outlook for the industry and its ability to generate future growth and positive earnings.



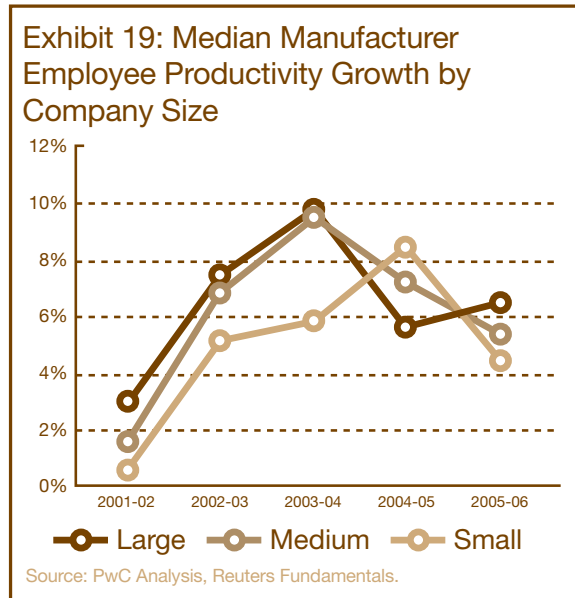
101 A detailed summary of the definitions of the Market Weighted Index and other metrics reported in this section can be found Appendix C.

### Median Gross Margins Improve on Continued Net Sales Growth and Lower Cost of Goods Sold

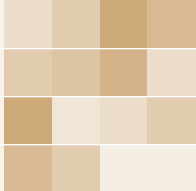
Part of the strong stock performance of CPG manufacturers in 2006 was due to continued overall net sales growth, though the rate of growth was slower than in previous years, with median net sales growing 6.1% between 2005 and 2006. The slight decrease in median net sales growth was driven by lower sales growth in both the beverage and food sectors. (Household products growth remained relatively steady over 2005–2006.) While top-line sales growth in the industry has slowed, cost of goods sold as a share of sales improved slightly in 2006 at 63.1% compared to 63.9% in 2005, supporting the corresponding increase in median gross margin over the same time period (from 36.1% in 2005 to 36.9% in 2006). This increase in gross margin, amid increasing commodity prices (see discussion on pages 6–13), could be attributed to an increased focus on higher-margin products as well as better hedging against rising input costs in the short term. As noted in Exhibit 1, the largest increase in raw material costs occurred in late 2006, providing impetus for even greater focus on product mix adjustments and sustained margin improvement moving forward.

On a sector basis, median gross margins increased slightly in 2006 compared to 2005 for medium companies and household and personal care product companies. Meanwhile, median gross margin fell in 2006 compared to 2005 for large companies and food and beverage companies, which bore the brunt of input price increases.

CPG manufacturers continued to focus on improving overall productivity to address margin pressure from rising input costs. Employee productivity has shown an upward trend over the past five years, although productivity gains have slowed since FY 2004 for medium companies and large companies and since FY 2005 for small companies (see Exhibit 19). Economies of scale continue to be apparent in the CPG industry, with smaller companies experiencing lower median employee productivity growth than medium and large companies in four of the previous five periods.



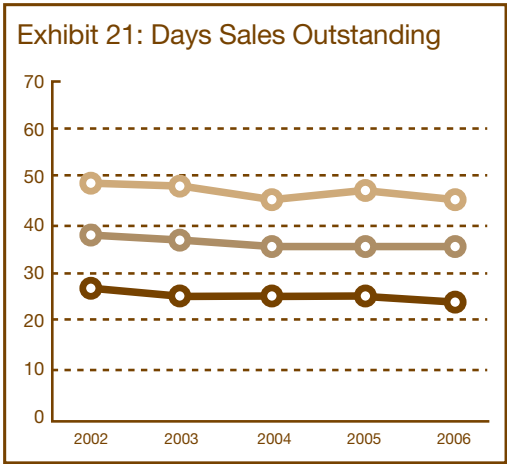
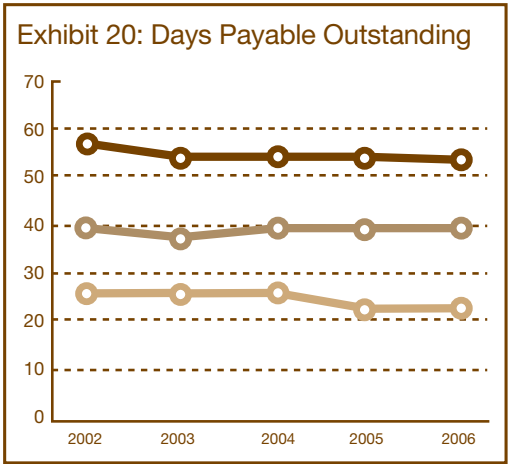
Overall, the efforts of manufacturers have resulted in a consistent level of return for the industry over time. Between 2005 and 2006, median industry earnings, measured in terms of EBIT growth, increased a healthy 10.9%. Small companies outperformed both medium and large companies in earnings growth, and household product company earnings inched ahead of those of food and beverage companies by several percentage points. The small companies' better performance in 2006 is a continuation of previous years' trends, as small companies continue to take advantage of trends in health, wellness, and beauty.



### Cash Management Improves Due to Continuous Enhancements in Supply Chain and Collection Improvements

Over time, manufacturers also have improved their cash position based on median cash conversion metrics. The cash conversion cycle was reduced by more than a week, from 65 days in 2002 to 58 days in 2006, freeing cash for investing in new products, acquiring new lines of business, paying down debt, and other uses. The long-term decrease in the cash cycle is driven primarily by improvements in both inventory turnover and days sales outstanding (see Exhibit 21), indicating continuous improvements in supply chain and consumer collection processes.

This past year saw a slight increase in the length of the median cash conversion cycle, but companies are still managing cash substantially better than several years ago. Gains in inventory turnover are also seen in specific CPG manufacturing segments, with the greatest gains in the beverage sector, reflecting a focus on improved supply chain efficiency.



● Top Quartile    ● Median    ● Bottom Quartile

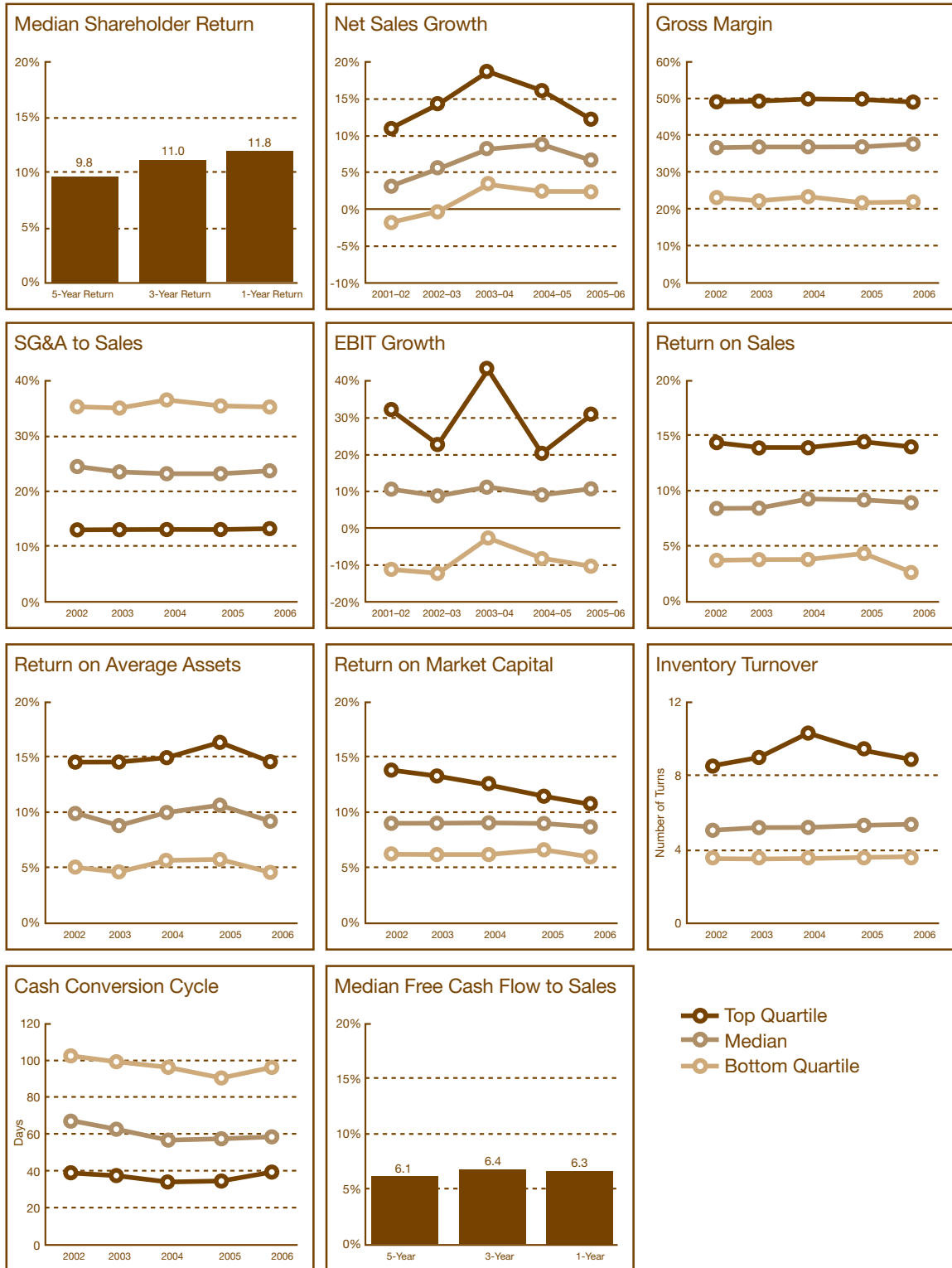
Source: PwC Analysis and Reuters Fundamentals.

### Shareholder Returns Recover from 2005 Low

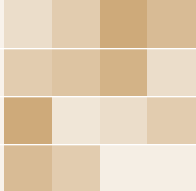
In the end, all of this activity helped CPG manufacturers to deliver a healthy one-year shareholder return of 11.8% in 2006, reversing the low return in 2005 and continuing the positive three-year and five-year upward trend. Total annualized five-year shareholder return is close to double digits (9.8%), indicative of investors' positive view for the industry's future growth. To this end, the median one-year free cash flow to sales was 6.3%, close to the five-year free cash flow to sales of 6.1% and the three-year free cash flow to sales of 6.4%.

As evidenced by the performance of the CPG Market Weighted Index, the industry continues to do well in spite of emerging input cost challenges, ever-changing consumer needs, and global expansion. The next several sections examine the performance of manufacturers, provide a comparison to retailers, and provide detailed metrics for both manufacturing size and industry segments.

## Overall CPG Industry (Manufacturers – All Companies > US\$50M)



Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.

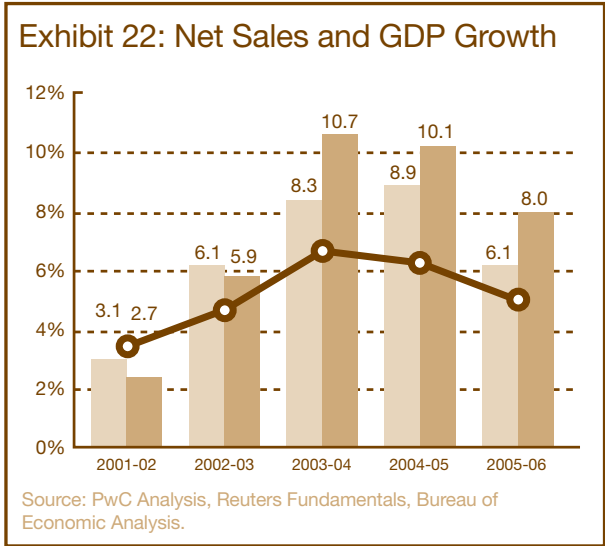


# Manufacturers Relative to Retailers

CPG retailers and manufacturers exhibited improved returns in 2006, with manufacturers posting a healthy 11.8% return and retailers posting an improved 16.2% return. Five-year returns for both manufacturers and retailers were approximately 9%, although retailers have experienced relatively more variable returns than manufacturers. For example, retailers' returns increased to 19.3% on a three-year basis and 16.2% on a one-year basis. Manufacturers have posted more steady returns, with all annualized returns ranging between 9.8% and 11.8% over the past one, three, and five years.

While retailers have exhibited higher shareholder returns in the short run, manufacturers have exhibited consistently higher rates of cash generation. Manufacturers' free cash flow as a percentage of net sales is nearly four percentage points higher than the cash flow results for retailers.

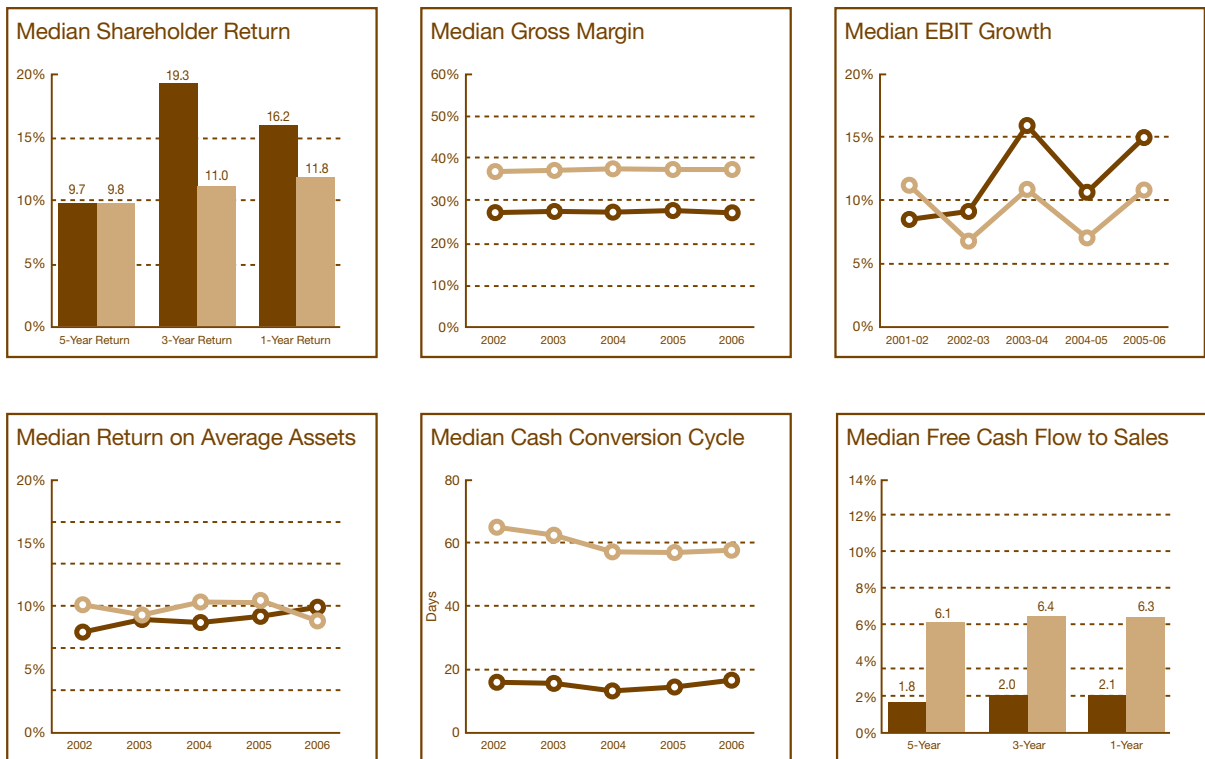
Net sales growth for both manufacturers and retailers slowed over the past few years, mirroring the drop in nominal GDP growth since 2004. Additionally, it appears that manufacturer sales growth lagged retailer sales growth by about one year in the 2000–2006 period (see Exhibit 22).



- Manufacturers' Median Net Sales Growth
- Retailers' Median Net Sales Growth
- Nominal GDP Growth

The following are additional highlights from the comparison between CPG manufacturers and CPG retailers:

- Both retailers and manufacturers have seen a great deal of variability in EBIT growth over the past several years; however, retailers enjoyed a higher EBIT growth than manufacturers over the 2005–2006 period.
- Manufacturers saw a slight decline in return on average assets, dropping to 8.8% in 2006 from 10.4% in 2005. In contrast, retailers saw an increase in this same metric, up from 9.5% in 2005 to 10.2% in 2006.
- Manufacturers’ median free cash flow to sales has consistently been higher than that of retailers.
- The long-term results for the cash conversion cycle differ significantly between retailers and manufacturers. Over the 2002–2006 time period, the median manufacturer cash conversion cycle dropped from 65 days to 58 days. During this same period, retailers’ median cash conversion cycle was significantly lower than that for manufacturers, and remained relatively steady at approximately 14 days. A large portion of this difference can be explained in the difference in days sales outstanding (35 for manufacturers versus 6 for retailers), as most retailers collect cash or credit card payments quickly. In addition, retailers do not have the financial burden of maintaining significant raw material inventories.



Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.

● CPG Retailers  
● CPG Manufacturers

## Manufacturers: Sector-Specific Analysis

### Food Manufacturers

Food manufacturers saw a year of modest sales growth coupled with higher profitability. Shareholder returns for the group were down slightly, with one-year shareholder return at 8.6% versus a three-year return of 11.0% and a five-year return of 9.6%. This could reflect the impact of higher raw material input costs, as discussed in pages 6–13.

Following are some highlights from our benchmarking calculations for food manufacturers:

- Food manufacturers' net sales growth dropped last year, from 7.9% in 2004–2005 to 4.8% in 2005–2006.
- Gross margin fell slightly, to 27.8% in 2006 from 28.3% a year earlier, indicative of rising input cost pressure.
- Efforts to control non-input costs were successful, with median SG&A spending decreasing to 16.7% of net sales from 17.1% in the previous year.
- While food manufacturers' EBIT grew as a percentage of sales, return on sales declined from 7.2% in 2005 to 6.2% in 2006.
- At 4.3%, the five-year free cash flow to sales for food companies was the lowest of the three sectors.

### Beverage Manufacturers

Beverage producers continued to post higher shareholder returns than producers of food or household products, despite a decrease in their net sales growth from 10.4% (2004–2005) to 6.1% (2005–2006). Median one-year shareholder return of 17.2% was an increase over both annualized three-year (11.5%) and annualized five-year (9.8%) figures.

Following are some highlights from our benchmarking calculations for beverage manufacturers:

- A slight increase in SG&A spending was coupled with a drop in gross margin from 43.4% in 2005 to 40.7% in 2006.
- Cost increases outpaced net sales growth and resulted in a drop in return on sales to 9.9% in 2006.
- Inventory turnover increased from 8.1 in 2005 to 9.5 in 2006, freeing up capital for other uses.
- The cash conversion cycle for this set of companies improved (shortened) in 2004–2006 relative to levels seen in 2002–2003, but it increased slightly in 2006 to 33 days.
- The five-year free cash flow to sales ratio is 9.1%, the highest of the three sectors.

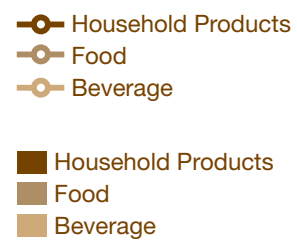
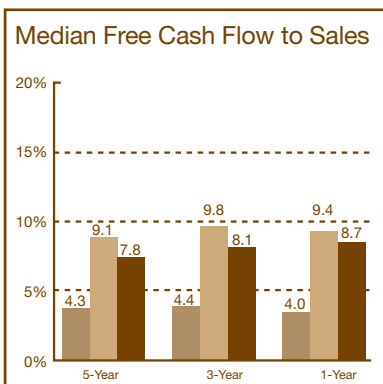
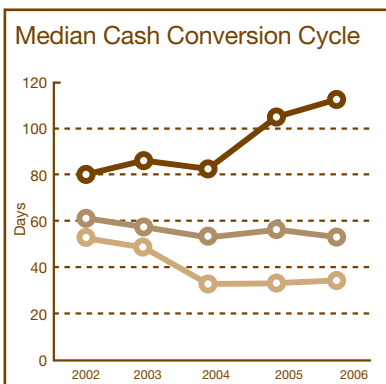
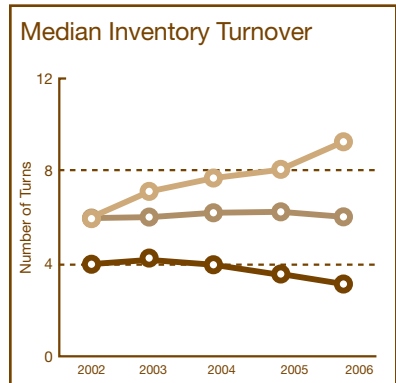
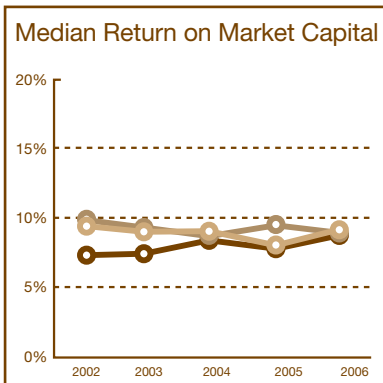
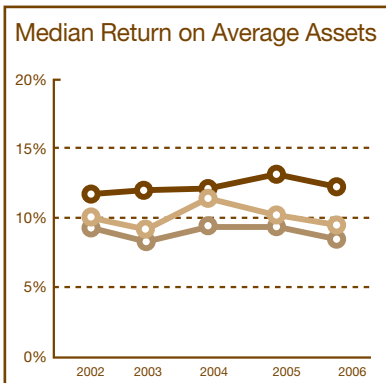
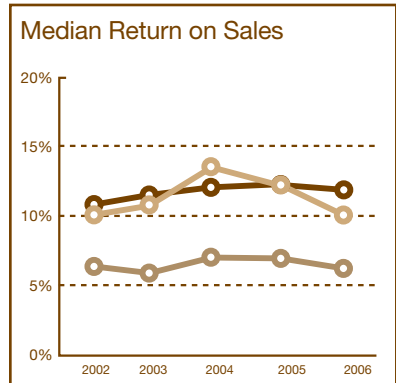
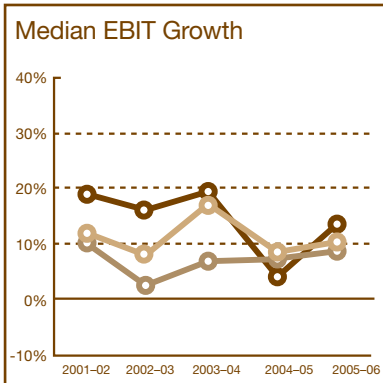
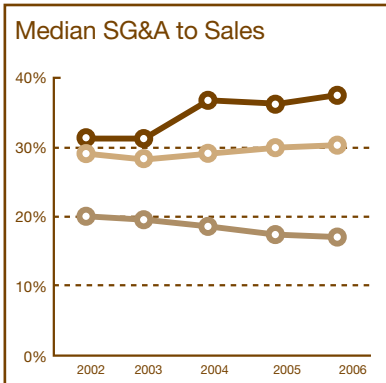
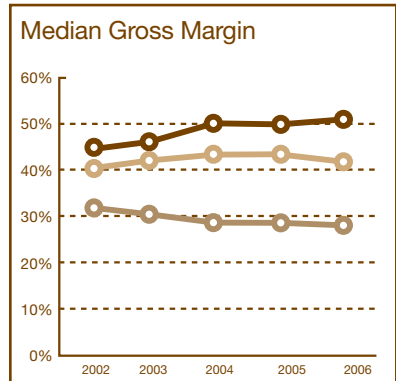
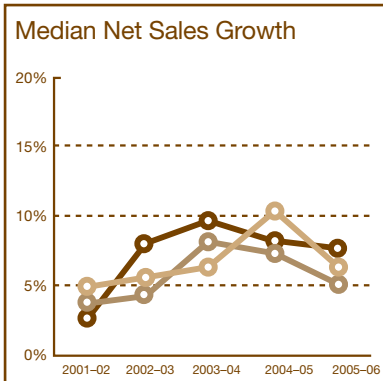
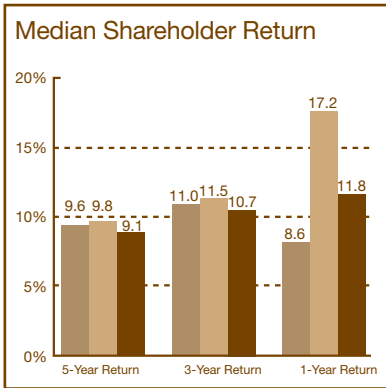
### Household Products Manufacturers

The median one-year shareholder return for household products companies was 11.8%, up slightly from the annualized three-year return of 10.7%. This occurred in a year when flat median net sales growth was offset by a rise in profitability (EBIT) growth.

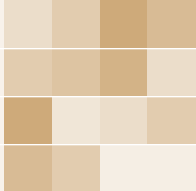
The following trends were evident in 2006 for household products manufacturers:

- Median EBIT growth jumped from 4.2% in 2004–2005 to 12.8% in 2005–2006. This was driven in part by higher gross margins, which increased from 50.6% in 2005 to 51.5% in 2006.
- SG&A spending increased by almost one percentage point from 2005, rising to 37.2%. The associated increase in EBIT may signal that SG&A spending was targeted successfully to profitable consumer segments.
- The cash conversion cycle for household products companies increased (worsened) in 2005 and 2006 relative to levels seen in 2002–2004, slowing to 111 days in 2006.
- Free cash flow for this sector has been rising, with a five-year free cash flow to sales ratio of 7.8% and a one-year ratio of 8.7%.

## Sector-Specific Data



Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.



# Manufacturers: Size-Specific Analysis

*In this section, we look separately at the performance of small, medium, and large companies. All three posted solid performance in 2006 in terms of total shareholder return. One-year returns for all size sectors were more in line with three- and five-year returns as the shock-related effects of Hurricane Katrina and oil-related issues wore off. Small companies continued to show the highest median net sales growth and EBIT growth rates, while large companies had higher median gross margins and greater investment in SG&A.*

## Exhibit 23: Size Segmentations for Financial Reporting Benchmarking

Small manufacturers	\$50M < net sales <= \$500M
Medium manufacturers	\$500M < net sales <= \$4B
Large manufacturers	net sales > \$4B
Very small manufacturers	net sales <= \$50M
Very large manufacturers	net sales > \$10B

### Large Manufacturers (Net Sales > \$4 Billion)

The importance of economies of scale continues to be evident in the CPG industry, as large companies outperform smaller companies on several operating metrics. Large companies continued to have higher median gross margins (41.7% versus 32.9% for small and 32.2% for medium companies) and invested more money than the smaller companies in SG&A (which typically includes marketing expenses, sales expenses, the cost of media, and advertising). Additionally, large companies are able to convert sales to cash more quickly than small or medium companies, with a median cash conversion cycle of 49 days in 2006 (compared to 76 and 75 for small and medium companies, respectively).

Following are some observations about the financial performance of large manufacturing companies:

- Net sales growth for the group of large companies was 6.0% in 2005–2006, a one-percentage-point drop from 7.0% in 2004–2005, partially driven by differences in the U.S. dollar exchange rate and a general softening of same-store sales growth.
- Profitability was 6.7% in 2005–2006 as measured by EBIT growth, down slightly from the previous period.
- Inventory turnover for large companies remained flat at 6.2 turns annually.
- Large companies consistently generated significant amounts of free cash flow (FCF), with a five-year FCF to sales ratio of 8.6%—significantly higher than either medium or small companies.

### **Medium Manufacturers (\$500 Million < Net Sales ≤ \$4 Billion)**

While shareholder return for medium-size CPG manufacturers was higher than in other size segments across one-year, three-year, and five-year windows, several key performance metrics continued to demonstrate softness. Median net sales growth fell for the second year to 4.8%, while median return on sales fell slightly, to 8.3%. On a positive note, gross margins increased slightly, reaching 32.2% in 2006, and the EBIT growth rate jumped from 3.3% in 2004–2005 to 10.0% in 2005–2006.

- Medium-size companies were the only companies to increase median inventory turnover in 2006, from 5.5 turns in 2005 to 5.8 turns in 2006.
- Medium companies failed to shorten their cash conversion cycle in 2006, reaching 75 days—the highest point in the last three years, due to the sharp decrease in the number of days payable outstanding.
- Free cash flow as a percentage of sales has been rising over the past five years, with one-year FCF at 5.9% and five-year FCF at 5.3%.

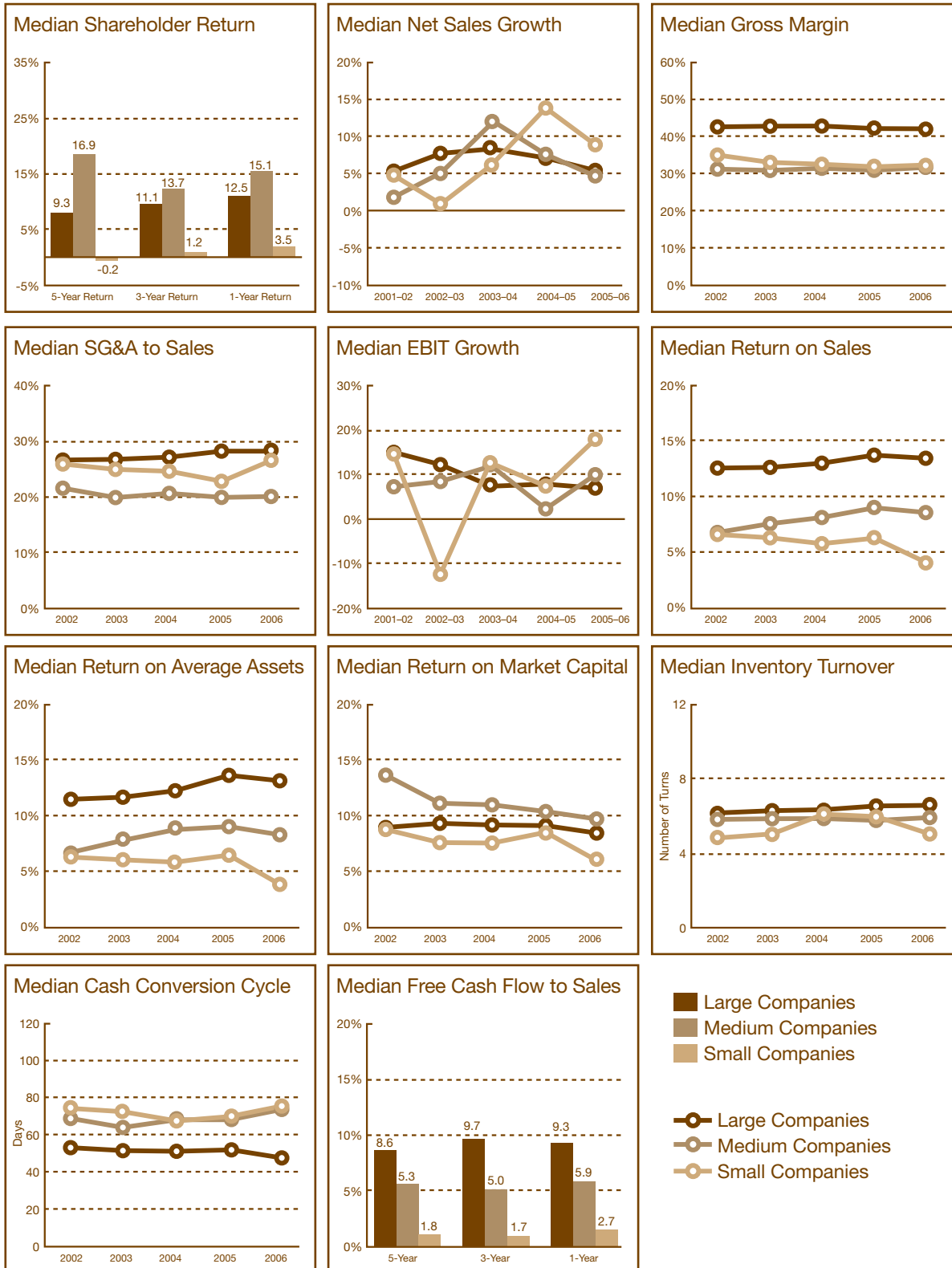
### **Small Manufacturers (\$50 Million < Net Sales ≤ \$500 Million)**

Small companies continue to lead the industry when it comes to sales growth and EBIT growth rates. While median net sales growth dropped from 13.3% in 2004–2005 to 8.9% in 2005–2006, median EBIT growth increased to 18.9%. A decrease in gross margin to 32.9% and a sharp increase in SG&A expenses, to 25.2%, resulted in a drop in operating return metrics between 2005 and 2006: Return on sales fell from 6.7% to 3.9%, and return on average assets fell from 8.8% to 5.9%. Strong median EBIT growth and median net sales growth could indicate that investments companies made in increasing revenues are working. Markets reflected a better long-term outlook for small companies than in previous years as one-year shareholder return rose to 3.5% over a three-year TSR of 1.2%.

The following observations are evident given our calculated metrics for these companies:

- Free cash flow as a percentage of sales increased for small companies as one-year FCF was 2.7% versus consistent three-year and five-year FCF rates of 1.7% and 1.8%, respectively.
- In 2006, small companies failed to shorten their cash conversion cycle, reaching a four-year high of 76 days, primarily due to a sharp increase in the number of days inventory outstanding.

## Size-Specific Data



Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.

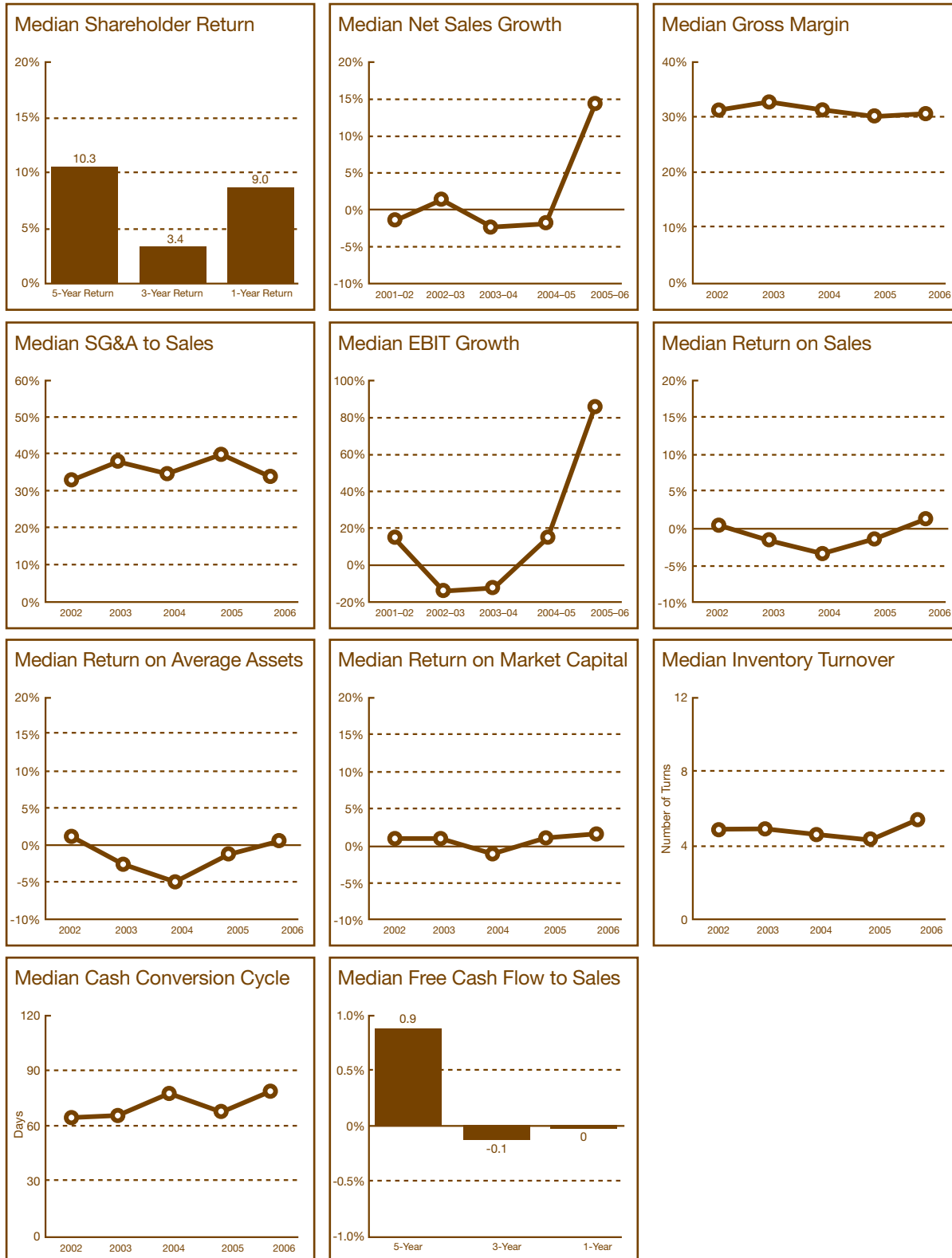
## Very Small Manufacturers: Size-Specific Analysis

Very small manufacturers are defined as having had less than or equal to \$50 million in net sales in their last reported fiscal year. The characteristics of these companies are different enough that they warrant a separate reporting of their benchmark metrics. Results from these manufacturers are not included in the previous industry-, size-, or sector-specific discussions.

In spite of challenging results in some areas, shareholder return for these companies was a strong 9.0% on a one-year basis, up drastically from the annualized three-year return of 3.4%. One-year free cash flow to sales was zero—close to the three-year cash flow number of -0.1%, but slightly down from the five-year free cash flow to sales ratio of 0.9%. Very small companies saw a reversal of a decreasing inventory turnover trend that was evident over the 2003–2005 time period. Inventory turns increased from 4.6 in 2005 to 5.7 in 2006. The following trends are evident for very small CPG companies.

- EBIT growth was an impressive 83.4% in 2005–2006—although that figure is somewhat driven by the small number of companies for which data is available.
- Gross margins remained relatively flat between 2002 and 2006, and came in slightly lower (at 30.4%) than all other size segments. This may signal the inability of very small companies to leverage their cost of goods sold, as they cannot negotiate volume discounts as effectively as larger companies.
- In order to partially offset this lack of leverage, this set of manufacturers focused on managing SG&A costs, with SG&A spending as a percent of sales down from 39.4% in 2005 to 34.0% in 2006.
- In another potential sign of the lack of clout wielded by very small manufacturers, their median cash conversion cycle lengthened, from 66 days in 2005 to 79 days in 2006.
- Return on market capital continued a positive two-year trend, with median returns reaching 1.5% in 2006.

## Very Small Manufacturers



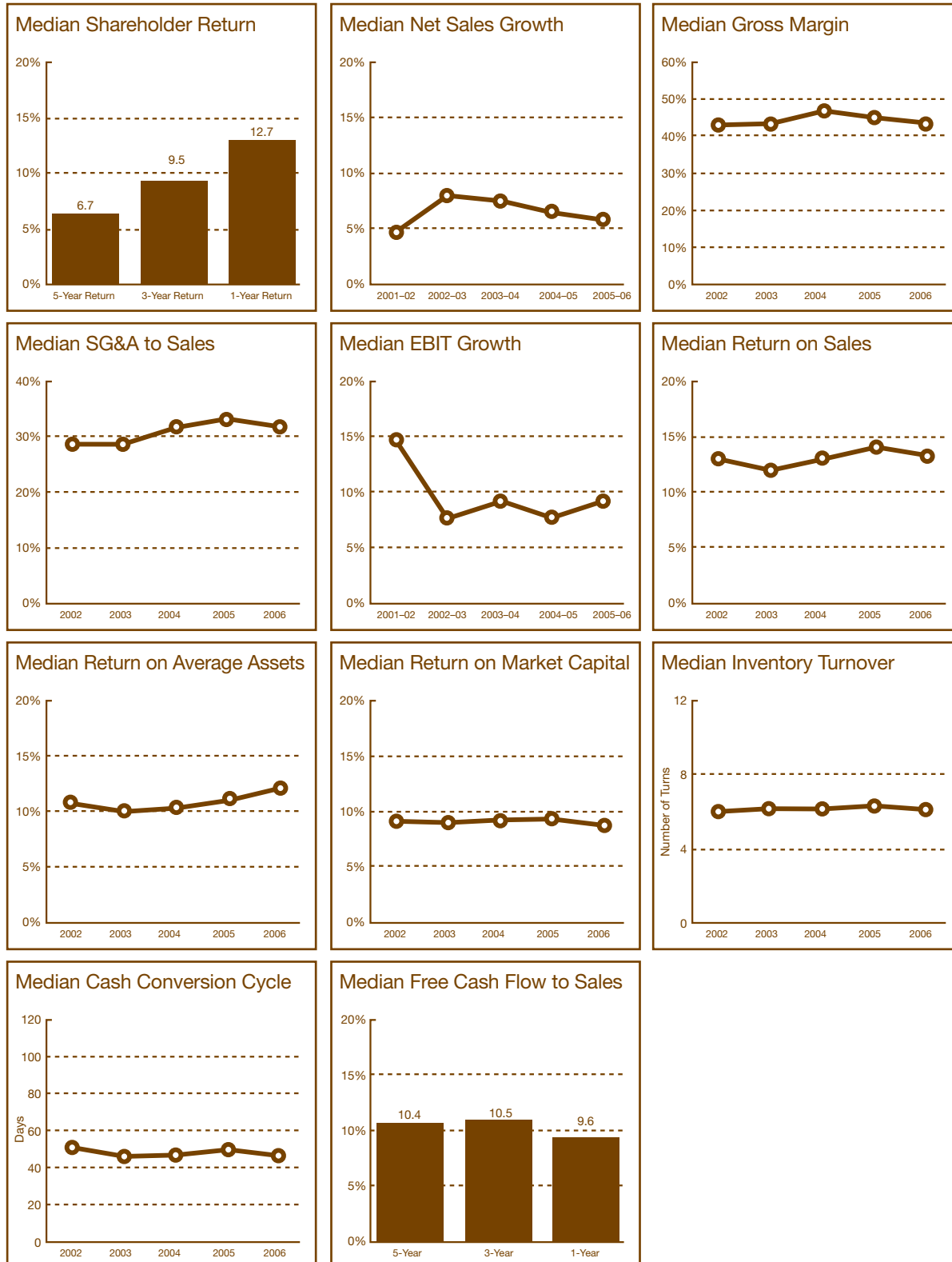
Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.

## Very Large Manufacturers: Size-Specific Analysis

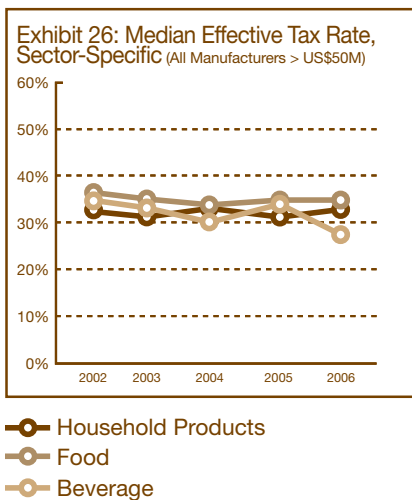
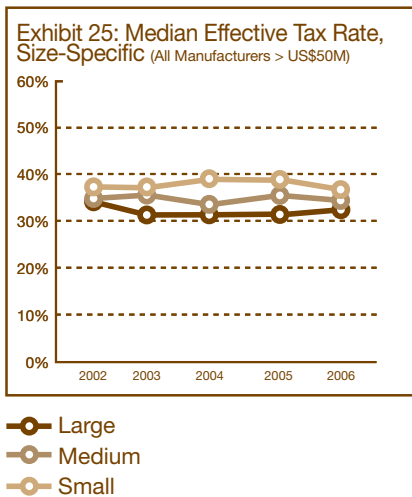
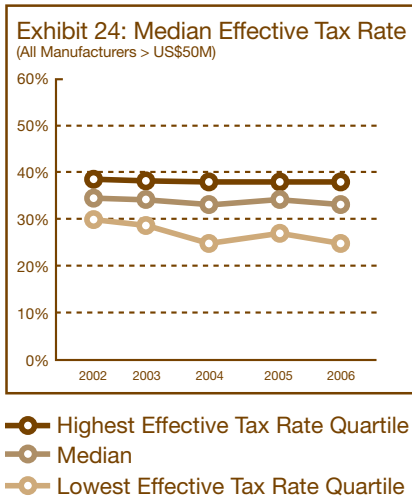
Very large companies are defined as having had over \$10 billion in net sales in their last reported fiscal year. These companies are the largest of the large and they generally operate on a global basis, leveraging economies of scale and reaping the benefits of that scale. Results from these manufacturers are included in the previous manufacturer overview and in the size- and sector-specific discussions. Median shareholder return for these manufacturers was 12.7% on a one-year basis, up from the annualized three-year return of 9.5% and higher than the median one-year shareholder return for the industry overall (11.8%) and for large companies (12.5%). These manufacturers also generate significant amounts of cash to be used for investments in new markets and products and for use as dividends. Over 75% of very large companies in our dataset paid dividends in FY 2006, a substantially higher percentage than manufacturers overall in the same time period. The one-year median free cash flow to sales ratio for these very large manufacturers was 9.6%, 3.3 percentage points higher than the overall manufacturing median and also higher than all three size sub-segments. For very large manufacturers, one-year free cash flow to sales is slightly lower than both the three-year and five-year figures.

- These companies continued to see slight decreases in net sales growth, to 5.6% in 2005–2006.
- Profitability (as measured by EBIT growth) increased slightly, up from 7.5% in 2004–2005 to 9.0% in 2005–2006, despite a slight drop in net sales growth.
- Return on average assets also continued a year-over-year positive trend, measuring 12.5% in 2006.

## Very Large Manufacturers



Source: PwC Analysis, Reuters Fundamentals, Reuters Pricing.



Source: PwC Analysis, Reuters Fundamentals.

## How Do Your Taxes Stack Up?

The challenges of running a tax function in today's environment are enormous. From navigating the increasingly complex regulatory environment to applying the inextricably linked web of intricate tax and financial accounting rules, it is more important than ever that an organization understand where it fits among its peers. Effective tax rate (ETR) benchmarking allows companies to measure their tax profile against similarly situated companies. The ETR is the total tax provision as a percentage of income before tax taken directly from the income statement. It is the most fundamental and frequently used metric to analyze the impact of tax on financial results. While for some companies this may highlight opportunities to reduce the effective tax rate and increase shareholder value, for other companies it may highlight areas that could subject the company to enhanced scrutiny.

The median 2006 ETR is approximately equal to the statutory rate, and this median rate has decreased slightly from 2005 (see Exhibit 24). The ETR in 2006 benefits from favorable adjustments for the extraterritorial income exclusion/manufacturing deduction (Section 199), but in 2005 the ETR was impacted negatively by unfavorable adjustments from costs of cash repatriation under the American Jobs Creation Act ("Homeland Dividends").

The American Jobs Creation Act (AJCA) created a temporary incentive for U.S.-based multinationals to repatriate accumulated income earned abroad by providing an 85% dividends-received deduction for certain qualifying dividends from controlled foreign corporations. The deduction results in an approximate 5.25% federal tax rate on the repatriated earnings. Although this reduced the possible U.S. tax cost by 85%, this 15% cost was incremental. Most companies previously had asserted the APB 23 indefinite reversal exception and had not recorded deferred taxes for these earnings, resulting in one-time significant (albeit reduced) charges in 2004 and 2005.

Multinational companies have a greater ability to lower their tax rate using international and cross-border planning. Profits may be earned in territories that have statutory tax rates lower than the domestic statutory tax rate. As opportunities arise to undertake cross-border tax planning, a benefit can be taken from differences in tax regimes, and specific operations can be located in tax-efficient locations. By contrast, domestic companies have not availed themselves of that opportunity to the same degree, and their ETRs are correspondingly higher.

Transfer pricing implications and increasing merger and acquisition activity in the retail and consumer products industry have meant that transfer pricing issues are high on the agenda for retail and consumer product companies.

# Appendix A

## Financial Performance Benchmark Methodology

In Section 3 we present several key metrics relevant to the CPG industry, based on an analysis of financial data for a set of CPG companies (see Exhibit A). 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 Section 3 of this report. This Reuters dataset includes annual financial data from 2001 through 2006, by fiscal year, for publicly traded companies. The report uses restated data that accounts for mergers, acquisitions, divestitures, and accounting changes. Reuters makes no further adjustments to the actual values that the company reports, so all data used to construct indicators in Section 3 is “as reported” by the companies.

Two variables used in the financial benchmarking analysis—share price and foreign exchange rate—are taken from alternate sources. Share price data is taken from Reuters Pricing.<sup>102</sup> Exchange rates from Factiva were applied to financial data fields denominated in non-U.S. currencies.

Lastly, the study team collected financial data for nine private-sector manufacturers through a survey administered by the GMA/FPA.

Exhibit A: Distribution of Manufacturer NAICS Codes by Sector

Sector	NAICS Code	NAICS Code description
Beverage	312111	Soft Drink Manufacturing
Beverage	312112	Bottled Water Manufacturing
Beverage	312113	Ice Manufacturing
Beverage	312120	Breweries
Beverage	312130	Wineries
Beverage	312140	Distilleries
Food	311225	Fats and Oils Refining and Blending
Food	311230	Breakfast Cereal Manufacturing
Food	311311	Sugarcane Mills
Food	311312	Cane Sugar Refining
Food	311320	Chocolate and Confectionery Manufacturing from Cacao Beans
Food	311330	Confectionery Manufacturing from Purchased Chocolate
Food	311340	Nonchocolate Confectionery Manufacturing
Food	311411	Frozen Fruit, Juice, and Vegetable Manufacturing
Food	311412	Frozen Specialty Food Manufacturing
Food	311421	Fruit and Vegetable Canning
Food	311422	Specialty Canning
Food	311511	Fluid Milk Manufacturing
Food	311512	Creamery Butter Manufacturing
Food	311513	Cheese Manufacturing
Food	311514	Dry, Condensed, and Evaporated Dairy Product Manufacturing
Food	311520	Ice Cream and Frozen Dessert Manufacturing
Food	311611	Animal (except Poultry) Slaughtering*
Food	311612	Meat Processed from Carcasses*
Food	311615	Poultry Processing*
Food	311711	Seafood Canning*
Food	311712	Fresh and Frozen Seafood Processing*
Food	311812	Commercial Bakeries
Food	311823	Dry Pasta Manufacturing
Food	311911	Roasted Nuts and Peanut Butter Manufacturing
Food	311919	Other Snack Food Manufacturing
Food	311920	Coffee and Tea Manufacturing
Food	311930	Flavoring Syrup and Concentrate Manufacturing
Food	311941	Mayonnaise, Dressing, and Other Prepared Sauce Manufacturing
Food	311942	Spice and Extract Manufacturing
Food	311991	Perishable Prepared Food Manufacturing
Food	311999	All Other Miscellaneous Food Manufacturing
Household	311111	Dog and Cat Food Manufacturing
Household	322291	Sanitary Paper Product Manufacturing
Household	325611	Soap and Other Detergent Manufacturing
Household	325612	Polish and Other Sanitation Goods Manufacturing
Household	325620	Toilet Preparation Manufacturing
Household	335912	Primary Battery Manufacturing

Note: \* symbolizes NAICS codes new to this year's report.

102 Presentation in last year's report used Thomson and Yahoo! Finance data as sources for stock prices.

## Company Choice

The companies analyzed in Section 3 were identified as companies that operate in the CPG manufacturing or retail industries. This designation is based on a company's primary industry, identified using the North American Industry Classification System (NAICS).

## Manufacturers

A total of 43 NAICS codes were identified that represent the core GMA/FPA manufacturing activities. These included NAICS codes across the food (31 NAICS codes), beverage (6 NAICS codes), and household and personal care (6 NAICS codes) sectors.<sup>103</sup>

The Reuters extract includes a primary industry code for each company.<sup>104</sup> The 43 CPG-related NAICS codes were used to generate a set of companies for inclusion in the analysis. Four foreign firms not in the Reuters dataset, one additional food products company not in the NAICS code list, nine private firms, and 11 GMA/FPA members not covered by other industry groups were then added to the set of companies, for a total of 229 companies.<sup>105</sup>

Exhibit A gives the distribution of manufacturer NAICS codes and NAICS code descriptions by sector used in Section 3 of the report.

## Retailers

The Reuters extract includes a primary industry code for each company. A total of ten NAICS codes that represent the core GMA/FPA retail activities were identified. These ten CPG-related NAICS codes were used to generate a set of retail companies for inclusion in the analysis. Nineteen additional retail companies were then added to the set for a total of 70 companies.<sup>106</sup>

Exhibit B gives the distribution of retailer NAICS codes and NAICS code descriptions by sector used in Section 3 of the report.

### Exhibit B: Distribution of Retailer NAICS Codes by Sector

NAICS Code	NAICS Code description
445110	Supermarkets and Other Grocery (except Convenience) Stores
445120	Convenience Stores
445310	Beer, Wine, and Liquor Stores
446120	Cosmetics, Beauty Supplies, and Perfume Stores
447110	Gasoline Stations with Convenience Stores
453910	Pet and Pet Supplies Stores
454210	Vending Machine Operators
445291	Baked Goods Stores
445292	Confectionery and Nut Stores
445299	All Other Specialty Food Stores

## Factiva

Factiva was used to conduct secondary research and locate several of the publicly available sources used throughout this report.

103 This list of NAICS codes was developed in conjunction with the GMA/FPA.

104 Reuters determines the dominant business segment of a company and then assigns, as the primary NAICS code, the NAICS code describing that segment.

105 It should also be noted that nine companies were removed from the analysis because they trade on foreign exchanges, are inactive, or are wholly owned subsidiaries, and 54 companies were excluded because of missing sales data for the 2001–2006 time period.

106 It should also be noted that 17 companies were excluded because of missing sales data for the 2001–2006 time period.

## Data Preparation and Metric Construction

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

For manufacturers and retailers, a total of 24 and 13 companies (respectively) report financials in currencies other than U.S. dollars. Exchange rates from Factiva were applied to convert the financial data for these companies into U.S. dollars.

Eight manufacturers and two retailers were found to have changed their reported fiscal year starting and ending dates for at least one of the reporting periods. This resulted in duplicate data across fiscal years. The duplicate fiscal year observation was removed by annualizing the reported financials where necessary.

A total of ten manufacturers were found to have lengths for their reporting period that were markedly different from the standard length of a calendar year (i.e., 12 months or 52 weeks). Data elements associated with these observations 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.

Statistical software was then used to calculate each of the financial benchmarking metrics. Definitions for each metric can be found in Appendix C.

### Data Reporting

Reported results utilize median in order to minimize the effect of performance outliers on the overall benchmarking. When sample size is large enough, we also report quartile figures.

In the overall industry performance benchmarks, companies with less than US\$50 million in net sales in their last reported fiscal year were excluded as their performance would have appreciably altered the median values. These “very small” firms are reported as a separate industry group.

We have provided another set of benchmark figures for “very large” firms (those with over US\$10 billion in net sales in their last reported fiscal year) but have also included this group in the industry benchmark, among the “large” firms.

Other size-based segmentations were defined using the following benchmarks (including any firms in the dataset with last reported net sales > US\$50M):

- Small firms: \$50M < net sales <= \$500M
- Medium firms: \$500 < net sales <= \$4B
- Large firms: net sales > \$4B

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

### Exhibit C: Manufacturing Companies by Industry Size and Segment

	Very Small	Small	Medium	Large (Very Large <sup>107</sup> )	Total
Food	26	38	27	23 (13)	114
Beverage	18	13	12	14 (10)	57
Household Products	21	8	12	16 (9)	57
No Industry Designation <sup>108</sup>		1			1
<b>Total</b>	<b>65</b>	<b>60</b>	<b>51</b>	<b>53</b>	<b>229</b>

<sup>107</sup> The set of “very large” companies is a subset of the overall manufacturer data set and is also included in the large sub-segment.

<sup>108</sup> One private company did not provide its industry designation.

# Appendix B

## Manufacturer Company List

AER Energy Resources, Inc.	Eldorado Artesian Springs, Inc.	Mariani Packing Company, Inc.	Sovereign Exploration Associates International, Inc.
Alberto-Culver Company	Electro Energy Inc.	Maui Land & Pineapple Company, Inc.	Spectrum Organic Products
Alcoa Inc.	Elizabeth Arden, Inc.	McCormick & Company, Inc.	Stearns & Lehman, Inc.
Allied Domecq PLC (ADR)	Embotelladora Andina S.A. (ADR)	Medifast, Inc.	Sterling Sugars, Inc.
American Dairy, Inc.	Energizer Holdings, Inc.	Molson Coors Brewing Company	SUN Interbrew Limited
American Italian Pasta Company	Exide Technologies	Monsanto Company	SunOpta Inc. (USA)
American Water Star, Inc.	Faribault Foods	Montana Mills Bread Co., Inc.	Suprema Specialties, Inc.
Anheuser-Busch Companies, Inc.	Farmer Brothers Co.	Monterey Gourmet Foods, Inc.	Sweetheart Holdings Inc.
Anonymous	Flowers Foods, Inc.	National Beverage Corp.	Sylvan Inc.
Aqua Clara Bottling	Fomento Econo Mexicano, SAB de C.V (ADR)	National Stem Cell Holding, Inc.	Tasker Products Corp.
Archer Daniels Midland Company	Foster's Group Limited	NCH Corporation	Tasty Baking Company
Archibald Candy Corp.	Frederick Brewing Co.	Nestlé SA	Tate & Lyle PLC (ADR)
Armano Foods of Distinction, Inc.	Galaxy Nutritional Foods, Inc.	New Dragon Asia Corp.	TenderCare International, Inc.
Asconi Corporation	Gales Industries Inc.	Northern Technologies International Corp	The Boston Beer Company, Inc.
Atlantic Wine Agencies Inc.	General Mills, Inc.	Novartis AG (ADR)	The Classica Group, Inc.
Atlas Resources International, Inc.	Genesee Corporation	Oak Ridge Micro-Energy Inc	The Clorox Company
Avani International Group Inc.	Georgia-Pacific Corporation	Ocean Bio-Chem, Inc.	The Coca-Cola Company
Avon Products, Inc.	Global Beverage Solutions, Inc.	Ocean Spray Cranberries, Inc.	The Dial Corporation
B&G Foods, Inc.	Global Seafood Technologies, Inc.	Odwalla, Inc.	The Earthgrains Company
Barilla	Gold Kist Inc.	Otis Spunkmeyer Holdings, Inc.	The Estée Lauder Companies Inc.
BASF AG (ADR)	Golden Enterprises, Inc.	Overhill Farms, Inc.	The Fremont Company
Battery Technologies Inc.	Golden State Vintners	Owens-Illinois, Inc.	The Hain Celestial Group, Inc.
Baywood International, Inc.	Gordon Biersch Brewery Restaurant Group, Inc.	Packaged Ice, Inc.	The Hershey Company
Big Rock Brewery Income Trust (USA)	Greatbatch Inc.	Panamerican Beverages, Inc.	The J. M. Smucker Company
Birds Eye Foods, Inc.	Green Mountain Coffee Roasters, Inc.	Paradise, Inc.	The Pepsi Bottling Group, Inc.
Bridgford Foods Corporation	Groupe Danone (ADR)	Parlux Fragrances, Inc.	The Procter & Gamble Company
Brooklyn Cheesecake & Desserts Co., Inc.	H.E.R.C. Products Incorporated	Peet's Coffee & Tea, Inc.	The Robert Mondavi Corp.
Brown-Forman Corporation	H. J. Heinz Company	PepsiAmericas, Inc.	The Smithfield Companies
Cadbury Schweppes plc (ADR)	Hanover Foods Corporation	PepsiCo, Inc.	The Stephan Co.
Cagle's, Inc.	Hansen Natural Corp.	Perdigao S.A. (ADR)	The Topps Company, Inc.
Campbell Soup Company	Heineken N.V. (ADR)	Physicians Formula Holdings, Inc.	The UniMark Group, Inc.
Castle Brands, Inc.	Hibernia Foods plc (ADR)	Pierre Foods, Inc.	TNR Technical, Inc.
CCA Industries, Inc.	Hormel Foods Corporation	Pilgrim's Pride Corporation	Tofutti Brands Inc.
Centennial Specialty Foods Corporation	Human Pheromone Sciences, Inc.	Pinnacle Foods Group Inc.	Tootsie Roll Industries, Inc.
Chalone Wine Group, Ltd.	Hydron Technologies, Inc.	Playtex Products, Inc.	Tree Top, Inc.
China Precision Steel, Inc.	Imagenetix, Inc.	Premium Standard Farms, Inc.	TreeHouse Foods, Inc.
Chiquita Brands International, Inc.	Imperial Sugar Company	Provena Foods Inc.	Tyson Foods, Inc.
Church & Dwight Co., Inc.	Inter Parfums, Inc.	Pyramid Breweries Inc.	Ultralife Batteries, Inc.
Clearly Canadian Beverage (USA)	Intercorp Excellence Inc.	Q.P. Corporation (ADR)	Unilever N.V. (ADR)
Coca-Cola Bottling Co. Consolidated	Interstate Bakeries Corporation	Quantrix Biomedical Corporation	Universal Food and Beverage Co
Coca-Cola Enterprises Inc.	Inventure Group, Inc.	Quilmes Industrial (QUINSA) S.A. (ADR)	Vermont Pure Holdings Ltd
Coffee Holding Co., Inc.	J&J Snack Foods Corp.	Ralcorp Holdings, Inc.	Vina Concha y Toro S.A. (ADR)
Colgate-Palmolive Company	John B. Sanfilippo & Son, Inc.	Reddy Ice Holdings, Inc	Vita Food Products, Inc.
ConAgra Foods, Inc.	Johnson & Johnson	Redhook Ale Brewery, Incorporated	Welch Foods Inc.
Constellation Brands, Inc.	Jones Soda Co. ( USA )	Revlon, Inc.	Wholesome & Hearty Foods Company
Cott Corporation (USA)	Ka Wang Holding, Inc.	Rica Foods, Inc.	Wimm-Bill-Dann Foods OJSC (ADR)
Cruzan International, Inc.	Kellogg Company	Rocky Mountain Chocolate Factory, Inc.	Wm. Wrigley Jr. Company
Cuisine Solutions, Inc.	Kimberly-Clark Corporation	Royal Alliance Entertainment Inc.	Wyeth
Darling International Inc.	Kirin Brewery Company, Ltd. (ADR)	Royal Wessanen nv (ADR)	YoCream International, Inc
Dean Foods Co.	Knouse Foods	SABMiller plc	Zapata Corporation
Dean Foods Company	Kraft Foods Inc.	Sanderson Farms, Inc.	
Del Laboratories, Inc.	Kyzen Corporation	Sara Lee Corp.	
Del Monte Foods Company	Lancaster Colony Corp.	Scott's Liquid Gold Inc.	
Diageo plc (ADR)	Lance, Inc.	Seaboard Corporation	
Diamond Foods, Inc.	Land O'Lakes, Inc.	Seneca Foods Corporation	
Doane Pet Care Company	Leading Brand Inc.	Sherwood Brands, Inc.	
Dreyer's Grand Ice Cream Holdings Inc.	Lee Pharmaceuticals	Shiseido Co. Ltd. (ADR)	
DSG International Limited	Lifeway Foods, Inc.	Smithfield Foods, Inc.	
Ecolab Inc.	L'Oreal	Southcorp Holdings Ltd. (ADR)	
	Lucille Farms, Inc.		
	M & F Worldwide Corp.		

# Appendix C

## Definitions

### **Beverage manufacturers**

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

### **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 100 CPG companies that were actively traded on U.S. stock exchanges from January 1, 2004, through December 31, 2006. 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 previous fiscal year's and reported fiscal year's total common shares outstanding, as reported in the balance sheet.

### **CPG retailers (referred to in this report as “retailers”)**

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

### **Days inventory outstanding**

The average of the previous fiscal year's and reported fiscal year's inventory divided by the reported fiscal year's average daily cost of goods sold.

### **Days payable outstanding**

The average of the previous fiscal year's and reported fiscal year's accounts payable divided by the reported fiscal year's average daily cost of goods sold.

### **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.

### **EBIT**

Earnings from continuing operations, before interest and taxes.

### **Effective tax rate\***

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

### **Employee productivity**

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

### **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 (FCF)\***

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 and personal care manufacturers (HHP)**

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

**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.

**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 market capital**

Earnings before interest, taxes, depreciation, and amortization 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.

**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.

**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.

**Very large companies**

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

**Very small companies**

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

Note: \*symbolizes metrics new to this year's report.

# Acknowledgments

We would like to thank several people for the contributions they made, and for providing their input. The core team members have been instrumental in the success and completion of the GMA/FPA publication through collaboration of efforts. We would also like to acknowledge the contributions made by our researchers, administrative personnel, and industry experts, and thank them for their ongoing level of commitment. Over 50 people were involved in creating this report.

A project of this magnitude required passion and dedication from all involved.

## **Core Team Members**

Troy Beeler  
Megan DeYoung  
Julia Y. Fungard  
Matt Hannafin  
Cathryn Marsh  
Parisa Morrell  
Christy Parrish  
Marie I. Prokopets  
Christopher Scandlen  
Elena Shtern  
Deepali Srivastava  
Kerry Tice  
Patrick H. Yost



GMA/FPA and PwC professionals are available to discuss the data, analysis, and commentary in this report, as well as help you address the opportunities discussed within.

For further information, please contact:

**Stephen A. Sibert**

Senior Vice President of Industry Affairs  
Grocery Manufacturers/Food Products Association  
(202) 337-9400

**John G. Maxwell**

Global Consumer Packaged Goods Industry Leader  
PricewaterhouseCoopers, LLP  
(973) 236-4780

**Lisa Feigen Dugal**

North American Retail and Consumer Packaged Goods Advisory Leader  
PricewaterhouseCoopers, LLP  
(646) 471-6916

**Herbert E. Walter**

Business Analytics Leader  
PricewaterhouseCoopers, LLP  
(202) 414-1350

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# Insights into the Food, Beverage, and Consumer Products Industry

## GMA/FPA Overview of Industry Financial Performance and Trends

