

The Food, Beverage, and Consumer Products Industry

Achieving Superior Financial Performance in a Challenging Economy – 2008



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

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



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Foreword

Once again, the Grocery Manufacturers Association (GMA) and PricewaterhouseCoopers (PwC) are pleased to bring you our annual overview of the Consumer Packaged Goods (CPG) industry.

The industry's challenges in 2007 and 2008 have prompted us to issue our most wide-ranging and comprehensive report to date. Of course, we've kept those sections you've come to expect. Inside you'll find the Financial Performance Report, which provides an in-depth look at key operational and financial performance measures for the industry, as well as an examination of several critical issues. As we did last year, we've included a discussion of financial performance highlights specific to the manufacturer's customers — retailers and wholesalers — and a review of specific issues and trends that affect them. We also present some very interesting findings on sustainability practices and their apparent bottom-line implications.

Section 1 of this report, "Strategies and Tactics for 2008 — and Beyond," discusses how manufacturers and retailers can better align strategic initiatives. Other issues addressed in Section 1 include balancing risk and global growth opportunities, best practices in sustainability reporting, and how significant but often overlooked costs in the form of "indirect taxes" can be mitigated with just a little planning and foresight.

We've used several sources to compile the information for this report: interviews with GMA members (an offer to be interviewed for this report was issued to GMA members, and we gratefully acknowledge those companies that made executives available), publicly reported company financial data, government statistics, analyst reports, and other published material. The manufacturing analyses are based primarily on public information from 233 manufacturers and 86 retailers, and we have cited all sources. We obtained explicit approval for the quotes gleaned from our interviews, as well as the context in which they are presented.

There is certainly much happening in our industry, and as you read through the report, we hope you will find it informative and insightful. As always, the GMA and PwC look forward to discussing these strategies, issues, and analyses.

Stephen A. Sibert

Senior Vice President, Industry Affairs
Grocery Manufacturers Association



Brooke Weizmann

Senior Manager, Industry Affairs
Grocery Manufacturers Association



John G. Maxwell

Global Consumer Packaged Goods
Industry Leader
PricewaterhouseCoopers, LLP



Lisa Feigen Dugal

North American Consumer Packaged Goods
& Retail Advisory Leader
PricewaterhouseCoopers, LLP



Herbert E. Walter

Consumer Packaged Goods
& Retailer Advisory Partner
PricewaterhouseCoopers, LLP



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The Heart of the Matter

Achieving Superior Financial Performance in a Challenging Economy

Anyone searching for evidence of the interconnectedness of today's world need not understand satellite technology, global capital flows, or game theory. Instead, looking at the cost of a dozen eggs from the local grocery store should do the trick.

According to the Consumer Price Index, egg prices have jumped 30 percent from last year.¹ The spike in U.S. egg prices has resulted from several factors, not the least of which is a significant cost increase in feed corn for hens — an increase spurred partially by a surge in ethanol production.

Rising ethanol production has, in turn, been driven in part by spectacular price signals in the petroleum industry and increased concerns about U.S. dependence upon foreign oil. As of April 2008, gasoline prices had risen 22 percent compared to the previous year.² And oil prices? They'd soared to \$127 per barrel as of June 2, 2008, partly due to the explosion of demand in developing economies, among other macroeconomic considerations.

It is indeed an interconnected world. CPG companies, who operate within this web of mutual dependencies, experienced skyrocketing input costs throughout 2007 and early 2008. Overall, crop prices are up 31 percent from last year, and some prices have soared even higher: 62 percent for food grains, 55 percent for oil-bearing crops, and 56 percent for commercial vegetables.³ These raw material price increases can have an enormous impact on manufacturers. Large food companies such as Kraft Foods, Inc. and Sara Lee Corp., for instance, now attribute 45 percent to 55 percent of their products' prices to raw material costs.⁴

The bottom line: In a world more interconnected than ever, there's value to be created and competitive advantage to be carved out, even in challenging economic times — perhaps especially in challenging economic times.

While a shrinking world appears to have its drawbacks, we're using this year's study to illustrate how the interconnectedness driving accelerating input costs can be harnessed to create superior performance. First, we explore how companies are offsetting rising costs by looking overseas for both volume growth and low-cost sourcing and production. Then, we examine how global companies are changing their mix of product sourcing and rerouting their raw material flow to save on "indirect taxes," such as customs duties and VAT.

An interconnected world is a great reason for all of us to create a more sustainable world. In our third theme, we describe the progress being made in corporate sustainability reporting, and the ways in which forward-looking companies are deriving value both from sustainable practices and from reporting on those practices. Lastly, we investigate how manufacturers and retailers are developing long-range product and marketing strategies that target new and emerging consumer trends.

1 Andrew Martin and Kim Severson, "Sticker Shock in the Organic Aisles," *The New York Times* (April 18, 2008): www.nytimes.com/2008/04/18/business/18organic.html.

2 Energy Information Agency, "Weekly U.S. Retail Gasoline Prices, Regular Grade" (April 14, 2008): www.eia.doe.gov/oil_gas/petroleum/data_publications/wrgp/mogas_home_page.html.

3 Tom Graves, *Industry Survey: Food and Nonalcoholic Beverages*, Standard & Poor's (December 13, 2007).

4 Julie Jargon, "Food Companies Tweak the Recipe," *The Wall Street Journal* (March 7, 2008).

An In-Depth Discussion

The Story Behind the Numbers: Financial Performance and the Input Costs Wild Card

The acceleration in the rise of commodity prices in 2007–2008 has significantly impacted the overall input cost in the industry. Moreover, unlike the more modest increases in 2006, the cumulative effect of these input cost increases has begun to manifest itself in higher fuel and food prices for consumers.

That's not to say that the CPG industry didn't have some bright spots in 2007. In fact, industry shareholder return not only kept pace with both the S&P 500 and the Dow Jones Industrial Average for the year, but beat both of them. The median shareholder return for the overall CPG industry was 7 percent, matching the three-year median shareholder return. And all three major CPG sectors — household products, beverages, and food — saw upward sales trends in 2007.

In 2008, the CPG industry is performing even better relative to the S&P 500 and the Dow Jones Industrials. Exhibit 1 illustrates how the CPG Market Weighted Index outpaced the S&P 500 by more than 10 index points and the Dow Jones Industrial Average by more than 5 index points over the 15 months between January 2007 and March 2008. Exhibit 3 takes a longer view of the situation, showing how all three indices were tracking more or less together for the 39 months between January 2005 and March 2008. Given CPG companies' track record of adaptation and agility in times of economic distress, it's not entirely surprising that the CPG Market Index has thrived relative to other indices.

Exhibit 1: CPG Index vs. S&P 500 and Dow Jones Industrial Average (1 Year through March 2008)

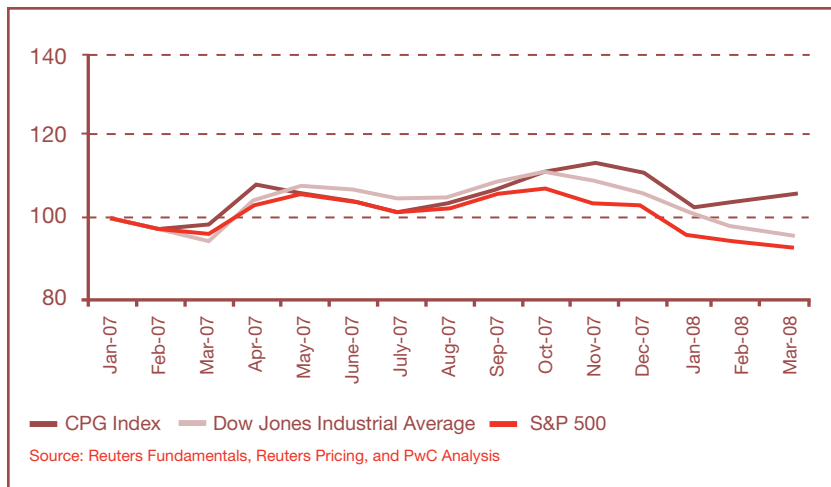
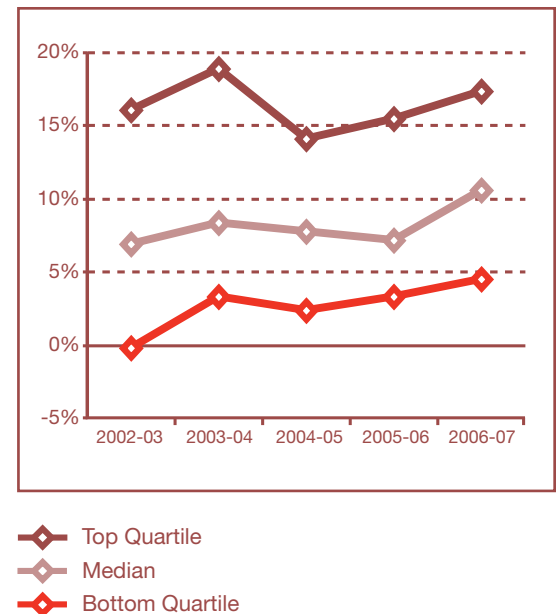


Exhibit 2: Net Sales Growth



Other financial metrics also showcased CPG companies' resilience. For example, all three CPG industry segments — food, beverage, and household products — outperformed the S&P 500 between 2005 and 2007. And while CPG margins were down overall in 2007, food companies experienced slightly higher margins than in 2006, despite spiraling input cost prices.

One statistic that could reveal the countercyclical nature of some aspects of CPG companies' business is that overall net sales among CPG manufacturers increased a healthy 10.6 percent in 2007, with all three primary sectors showing strong sales growth. With restaurant and gasoline prices soaring, consumers may have cooked at home more often in 2007, and thus had a greater need for CPG products. This same dynamic could, perhaps, result in similar sales growth volumes in 2008. In a related development, earnings before interest and taxes (EBIT) increased 15.1 percent among CPG manufacturers, again demonstrating strong overall cash flow for the industry.

The fact that CPG manufacturers seem to be weathering the current storm can be attributed to some of the cost-management and operational efficiency strategies described in Section 1 of this report. For example, cash conversion cycles in the industry have been dramatically reduced, indicating advances in logistics, consumer collection processes, and overall cost management.

Overshadowing everything in 2007 was the unexpected, dramatic rise in input costs. Plotted out in Exhibit 4, the "maturity curve" of input costs from 2005 to 2007 shows general stability in 2005, significant increases in 2006, and then highly accelerated input cost pressure in 2007. As Bob Schiffner, CFO of the Campbell Soup Company, put it in a recent interview with PricewaterhouseCoopers, "There was a strong feeling that, at some point, commodities prices were going to come down to historical levels. But that turned out not to be the case."⁵

Exhibit 3: CPG Index vs. S&P 500 and Dow Jones Industrial Average (3 Year through March 2008)

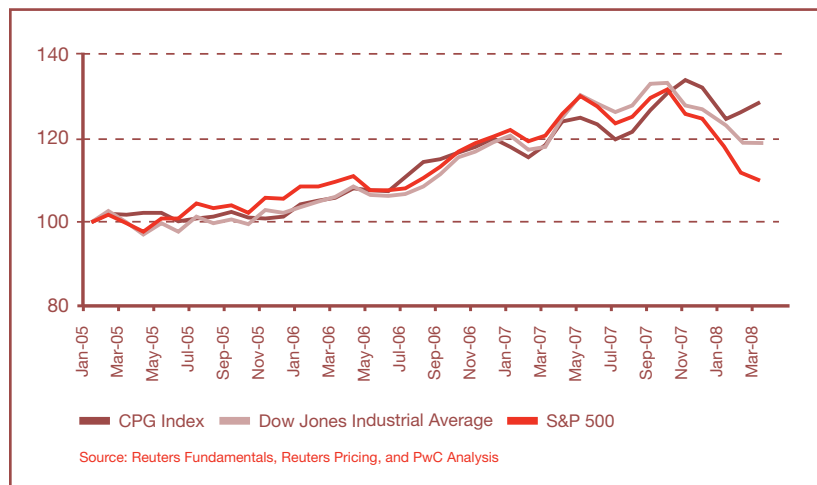
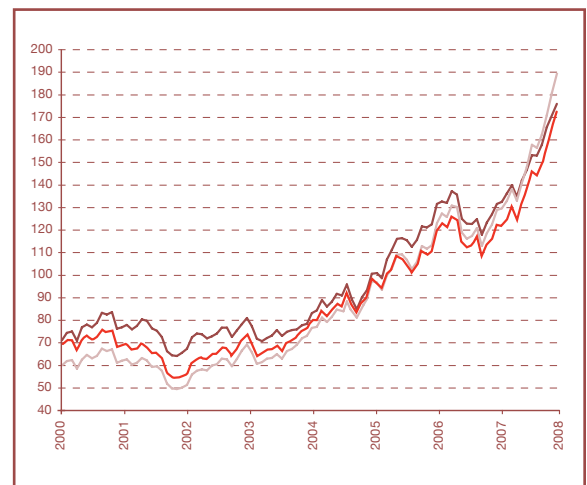


Exhibit 4: Indices of Primary Commodity Prices (2005 = 100)



Note: Combines indices of non-fuel primary commodity prices and petroleum prices. Prices deflated by U.S. CPI.

— In SDRs
— Real2
— In U.S. Dollars

5 PricewaterhouseCoopers interview (April 21, 2008).

Where are we now on this input cost maturity curve? Given the worldwide demand, it appears that commodities prices may remain elevated for the foreseeable future. Strong demand from the BRIC countries (Brazil, Russia, India, and China) and the boom in renewables (especially in biofuels such as ethanol) could continue to drive up prices worldwide. From a very long-term, macroeconomic point of view, high demand for commodities seems even more likely. The United Nations estimates another 2.5 billion people will crowd the planet by 2050, mostly in developing countries, raising the world population to 9.2 billion people.⁶

For years, the CPG sector has hedged against input volatility by using derivatives and option contracts. But hedging against big input cost increases, as effective as that practice can be, doesn't really address the long-term reality of increasing commodities prices from a corporate performance perspective. For this report, PricewaterhouseCoopers examined publicly available information and spoke to executives at several major CPG companies to see what they were doing to battle input cost increases and, more generally, achieve superior performance in a challenging economy. The four subsections in the following pages mirror the strategies and tactics discussed in Section 1 of this report.

Global Growth Opportunities: Balancing the Risks

Some CPG companies that have long focused on the U.S. domestic market are planning to penetrate the international market more aggressively. But savvy CPG companies are aware of the risks involved.

In the first quarter of 2008, for example, Hormel Foods Corp. saw double-digit increases in international sales of its SPAM family of products. While CEO Jeffrey M. Ettinger expects higher grain input and fuel costs for the balance of the year,⁷ he also says that product mix improvements and manufacturing efficiencies are helping the company offset these increased costs.⁸ In other words, Hormel is balancing an ambitious push overseas with cost management measures at home.

The Hershey Company, which in the past has focused mostly on growing its domestic sales, also plans to attack the international market more aggressively. The company has joint venture relationships in India and China, but is still searching for the right product mix to attract consumers in these countries. "You can't replicate overseas," says Hershey CFO Bert Alfonso. "Customers might want chocolate in a smaller size, or they might want it sweeter. You have to understand the local market."⁹ Like many CPG companies, Hershey isn't just seeking sales growth internationally; it's also investigating lower-cost production, and it recently built a manufacturing facility in Monterrey, Mexico.

Campbell Soup, the largest soup manufacturer in the world, spends years doing what CFO Bob Schiffner calls "ethnographic research" before it actually launches any of its soup products overseas. "We go in years ahead of our targeted date," Schiffner says. "We live with the people and understand how they make soup. We get a feel for some of the cultural and emotional factors involved in serving soup to their families." Campbell is now targeting Russia and China, which account for 50 percent of the world's soup consumption — though almost all of that soup is homemade.¹⁰

6 "World Population Boom Likely by 2050," The Associated Press (March 14, 2007).

7 Andrew Martin and Michael M. Grynbaum, "Costs Surge for Stocking the Pantry," *The New York Times* (March 15, 2008): www.nytimes.com/2008/03/15/business/15consumer.html?ex=1363320000&en=f35775738aa8e531&ei=5088&partner=rssnyt&emc=rss.

8 Hormel Foods Corporation press release, "Hormel Foods Reports First Quarter Results" (February 15, 2008): www.hormelfoods.com/newsroom/press/20080215.aspx.

9 PricewaterhouseCoopers interview (April 18, 2008).

10 PricewaterhouseCoopers interview (April 21, 2008).

Making Indirect Taxes Visible, Manageable, and Measurable

For CPG companies operating globally, the past few years have seen a sharp jump in what are generally referred to as corporate “indirect taxes,” or those taxes incurred during cross-border transactions: customs duties, value-added taxes (VAT), excise taxes, customs processing fees, port charges, etc.

CPG companies can mitigate these high indirect taxes, though, by improving efficiency in the way their raw materials and finished goods move through the global trading system. Leading companies are starting to address these hidden costs with a front-end assessment that considers the sourcing of raw materials and finished goods, capital equipment, the total taxes incurred in moving these assets from place to place, and any alternative scenarios that would result in immediate savings.

For example, Kimberly-Clark Corp. CFO Mark Buthman says that “there are many considerations that go into sourcing” when his company thinks about the impact of cross-border taxes.¹¹ Like several of the other executives we spoke to for this report, however, Buthman acknowledged that his company could look more closely at the indirect taxes issue.¹²

Best Practices in CPG Sustainability Reporting

One way to combat rapidly rising input costs is to simply use fewer inputs. That’s where sustainability practices come in, because using fewer raw materials is one of the main tenets of sustainability.

For example, General Mills, Inc. was one of the first companies in the country to recycle, and it’s been doing so since the 1930s, according to Vice President of Corporate Communications Tom Forsythe. Today, General Mills is even more committed to making its sustainability practices improve the bottom line. According to Forsythe, for instance, changing the case configurations of the company’s Progresso soup brand removed 2,000 tons of steel from Progresso’s annual steel input total. The company now spends less on steel and boasts lighter cans to boot, which consumers happen to like. According to Forsythe, “If you can make the jump from sustainability being a cost to a contributor to margin growth, that’s the key. If you are using less fuel but moving the same amount of goods, that’s a cost savings.”¹³

The Clorox Company has taken several steps to begin measuring its carbon footprint. But more important from a sustainability perspective, according to CFO Dan Heinrich, is that the company’s cleaning products are all naturally based. “The consumer trend toward sustainable cleaning products is one that we are very committed to,” he says. “At the end of the day, our reputation with the consumer is huge.”¹⁴

One company that keeps a laser-like focus on sustainability is PepsiCo, Inc. For example, in its India facilities, Pepsi has committed to achieving a “positive water balance” — replenishing more water than it uses — by 2009. In January 2008, it announced a partnership with H2O Africa, a foundation dedicated to fostering African clean water initiatives. “Water sits at the nexus of so many challenges,” says PepsiCo CEO Indra Nooyi. “Without clean water, none of the other fundamentals leading to a healthy and prosperous life are possible.”¹⁵

¹¹ PricewaterhouseCoopers interview (April 25, 2008).

¹² Ibid.

¹³ PricewaterhouseCoopers interview (April 23, 2008).

¹⁴ PricewaterhouseCoopers interview (April 21, 2008).

¹⁵ Angela Moore, “Indra Nooyi’s Pepsi Challenge; CEO Puts Her Own Brand on New Products and Global Goals,” MarketWatch (December 6, 2007): www.marketwatch.com/news/story/indra-nooyi-puts-her-brand/story.aspx?guid=%7B442A36A9-B79E-4A9D-BE2A-AAF7D8292BA3%7D.

Increasing Value and Managing Costs through Joint Manufacturer and Retailer Efforts

Working more closely with their retail customers is another way CPG companies can offset input cost increases and achieve superior performance. Clorox, for example, is working with its retailers to “engineer out” unneeded input costs related to packaging. Clorox CFO Dan Heinrich says that companies sometimes get so enthusiastic about new products that they set in motion packaging and design initiatives that later must be undone because of retailer or consumer push-back. “I think a lot of companies make sub-optimal decisions on packaging to get that first-mover status,” Heinrich says. “When we do a project launch, we try hard not to embed costs that just have to be taken out later.”¹⁶

Campbell spent \$75 million revamping its trade promotion systems over the past six years, in response to consumer feedback and data from retailers. The company integrated its trade promotions with other marketing initiatives and eliminated its most unprofitable events. “You want to have events with meaning and drive enough volume to offset the cost of the event,” says CFO Bob Schiffner.¹⁷

“You want to have events with meaning and drive enough volume to offset the cost of the event.”

– Bob Schiffner
CFO, Campbell Soup

¹⁶ PricewaterhouseCoopers interview (April 21, 2008).

¹⁷ PricewaterhouseCoopers interview (April 21, 2008).

What This Means for Your Business

An Opportunity to Gain Competitive Advantage

When it comes to offsetting input costs, which are rising at historic levels, Hershey CFO Bert Alfonso puts it this way: “The biggest levers are the ones you control yourself.”¹⁸

Indeed, whatever the macroeconomic environment, there are cost management and value-building steps most companies can take. According to Alfonso, for example, Hershey is in the process of consolidating its manufacturing base. Clorox, through various initiatives, realized \$100 million in cost savings in 2007.¹⁹ The big question facing the CPG sector, then, is how to offset rising commodities prices while preserving prospects for long-term growth. Our research, both anecdotal and data-driven, suggests three levers, woven throughout this study: collaborating with retailers, tapping international markets, and becoming more sustainable as a company.

It’s worth highlighting here what some companies have achieved by investing in these areas. With its three-tier approach to going global (tier 3 being “new to the market” and tier 1 implying a full presence, including manufacturing), Clorox is enjoying double-digit sales growth internationally, compared to 1 to 2 percent growth domestically.²⁰ Manufacturers and retailers are working together in unprecedented ways, a good example being Kimberly-Clark’s Business Planner software tool, which builds predictive models for promotions, and which the company shares with its retail customers.

“The biggest levers are the ones you control yourself.”

– Bert Alfonso
CFO, Hershey

In terms of sustainability, early adopter DuPont saved more than \$3 billion in energy costs between 1994 and 2006 while reducing greenhouse gas emissions by 72 percent. The sale of eco-friendly products, appropriately enough, is also fueling the company’s goal-surpassing financial performance, accounting for \$5 billion in 2006 revenue.²¹

The modern CPG sector has shown remarkable adaptive abilities, responding to recessions in 1973, 1980–1982, 1991, and 2001–2002 with its trademark resourcefulness and resilience. No doubt, CPG companies will respond similarly to today’s challenging economic environment.

18 PricewaterhouseCoopers interview (April 18, 2008).

19 PricewaterhouseCoopers interview with Clorox CFO Dan Heinrich (April 21, 2008).

20 Ibid.

21 Nicholas Varchaver, “Chemical Reaction: Can DuPont Make a Fortune Improving the Environment?” *Fortune* (March 22, 2007).

Section 1

Strategies and Tactics for 2008 — and Beyond

Exhibit 5: View of International Sales

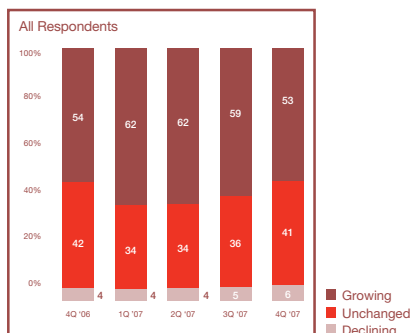
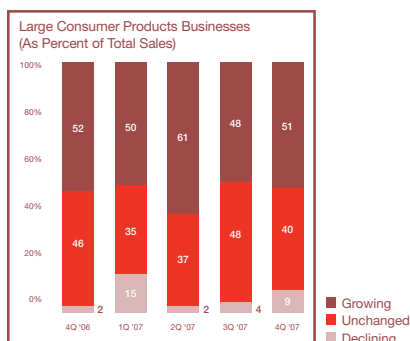
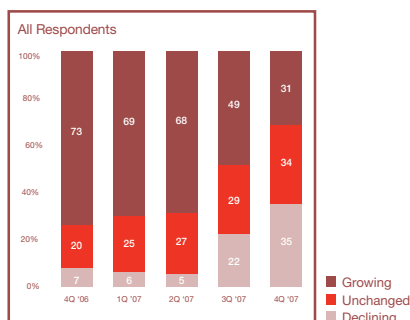
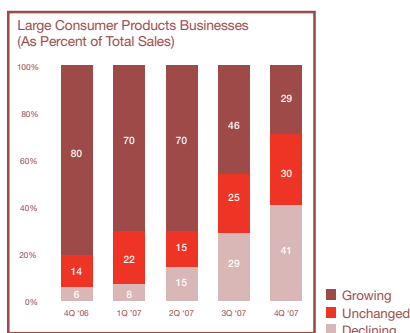


Exhibit 6: View of the U.S. Economy (to 4Q 2007)



Global Growth Opportunities: Balancing the Risks

For many multinational CPG companies, global expansion has become an imperative. In recent years, companies have looked to fast-growing markets in Brazil, Russia, India, and China — the so-called BRIC countries — and have seen the potential for increased sales as well as lower-cost manufacturing and service capabilities. These activities entail a certain amount of risk, but as global markets continue to mature, companies looking to the world stage can mitigate those risks by developing strategies that increase their agility and flexibility.

The case for global expansion is quite simple. As domestic markets are saturated, global expansion is one way to achieve sustainable, double-digit growth. Indeed, the recent economic downturn in the U.S. has increased the incentives for companies to expand their view of potential markets to the east and south — that is, to Asia, South America, Eastern Europe, Africa, and the Middle East. According to PricewaterhouseCoopers' 4Q 2007 *Consumer Products Barometer*, 36% of the surveyed companies reported decreasing sales.²² On top of that, operating in the U.S. may become even more daunting in the months ahead as retailer and manufacturer margins continue to be squeezed by the combination of slowing consumer spending and the continued rise of input costs. In that same *Barometer* survey, just 21% of companies stated their margins had increased since the previous survey.²³ In response to these and other pressures, some CPG companies are looking to developing countries to manage costs and support continued top- and bottom-line growth.

While the growth opportunities in the BRICs and beyond are undeniable, they seldom if ever come without risk. Not all forays into global sales and sourcing succeed, and even those that go forward often encounter unexpected challenges and consequences. Manufacturers seeking to develop frontier markets have found the business landscape fraught with more obstacles than they may have envisioned. Companies are encountering unexpected local competition, talent shortages, quality and safety issues, and macroeconomic challenges — all resulting in higher than expected costs. To succeed, companies can prepare strategies to mitigate the potential risks, maximize the opportunities, and deliver sustainable results. In the following pages, we introduce various opportunities and balance them with at least one major risk associated with each one.

²² PricewaterhouseCoopers, *Consumer Products Barometer: Business Outlook 4Q 2007* (February 2008).

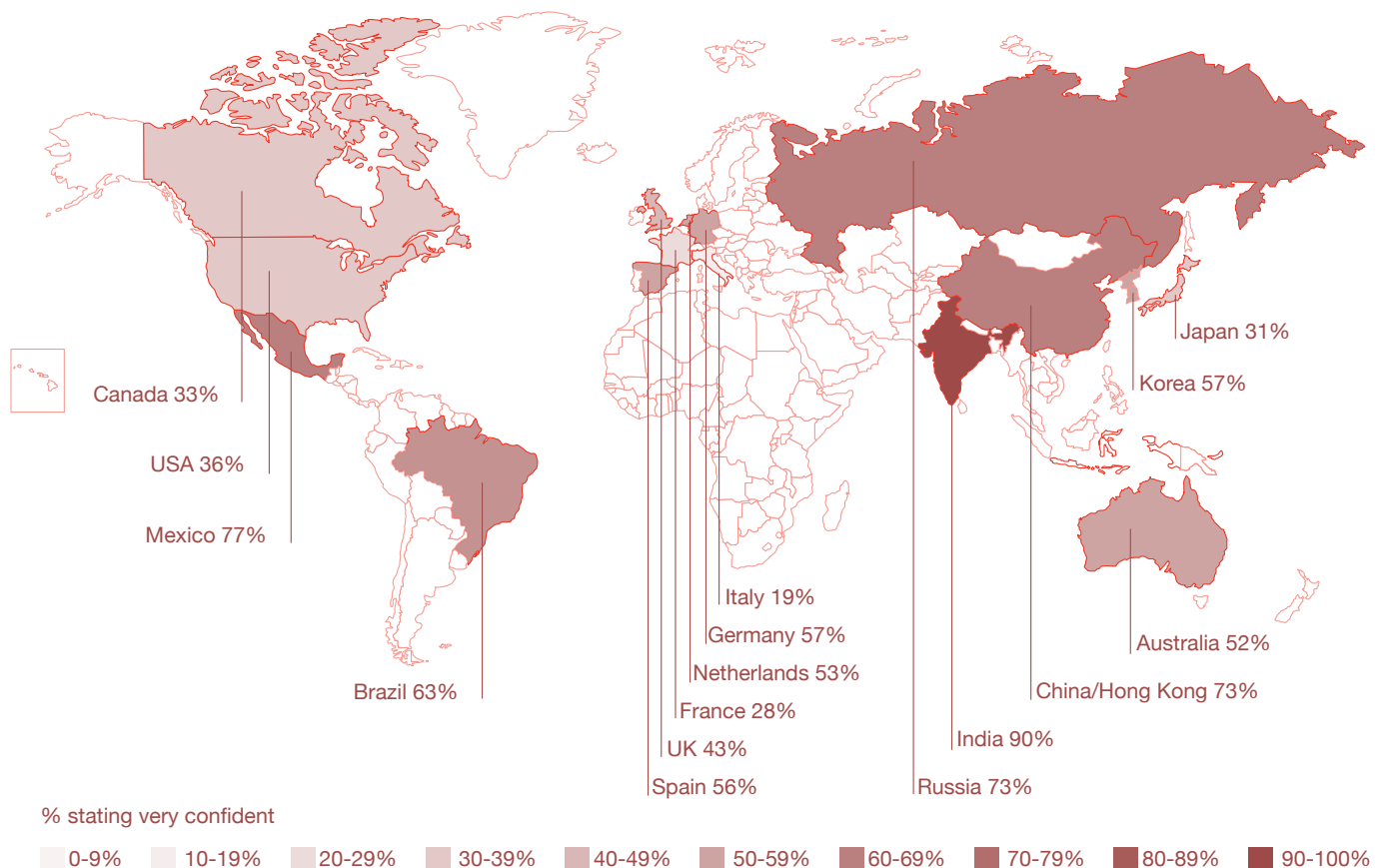
²³ Ibid.

Global Growth versus Underestimating the Local Market

Despite a 2007 dip in North American-focused investment in cross-border mergers and acquisitions,²⁴ the long-term trend has clearly moved toward more global investment. The impetus to enter new markets, extract synergies, more effectively utilize capital, and become more competitive is

still strong, and it is coming from new places. According to PricewaterhouseCoopers' *11th Annual Global CEO Survey*, CEOs in developing markets are much more bullish about the potential for growth than their U.S. CEO counterparts, only 36% of whom express confidence about growth in the year ahead. In contrast, 63% of Brazilian CEOs indicated confidence about the future, as did 73% of CEOs in China/Hong Kong and Russia and 90% of CEOs in India.²⁵

Exhibit 7: CEOs in Emerging Economies Report Remarkably Greater Business Confidence



Q: How would you assess your level of confidence in prospects for the revenue growth of your company over the next 12 months? (Base: All respondents 30-100)

Source: PricewaterhouseCoopers *11th Annual Global CEO Survey* (2008)

²⁴ PricewaterhouseCoopers, *11th Annual Global CEO Survey* (January 2008).

²⁵ Ibid.

As U.S. companies move into these new growth economies, there are many hidden economic costs: the level of infrastructure support required from the corporate office, the complexity of overseeing dispersed operations, and tax implications of transfer pricing and cross-border movements of raw materials and finished goods. In the section “Making Indirect Taxes Visible, Manageable, and Measurable” (page 19), we look at some of the indirect costs of these expansions. On top of these costs, there is also significant competition from other companies that are expanding abroad, not to mention some extremely competitive host-country companies that enjoy a home-court advantage: They are more familiar with local consumer demands, and enjoy more insight into the regulatory environment.

One way companies have been able to make market entry choices more judiciously is by taking the necessary time to understand local norms and idiosyncrasies. Savvy companies gauge a market’s ability to support another major supplier or a big player in a niche category. They often take a phased approach to entry, or even decide to delay an entry where it makes sense. Campbell, for example, has targeted the enormous but unrealized Russian and Chinese soup markets, and is laying the groundwork for its entry by studying the soup-eating habits of many local regions.²⁶ Clorox favors a tiered approach to market entry, preferring to learn by trading products through distributors before investing directly in demand-building and manufacturing.²⁷ In certain markets, General Mills waits for (and, where possible, cultivates) “favorable investment conditions” before diving in too deep, and has been rewarded for its more patient approach with favorable ownership requirements, better partners, and a “modern trade” distribution network.²⁸

The British retailer Tesco succeeded in cracking the retail market in South Korea, a country famously difficult for foreign multinationals. Tesco localized their operations by hiring a Korean chief executive and partnering with a local brand, Samsung Group, for name recognition. Today, Tesco is still going strong, with plans to double its store presence in South Korea by 2009.²⁹

Low-Cost Outsourcing versus Lack of Relevant Skills

In PricewaterhouseCoopers’ *11th Annual Global CEO Survey*, CEOs identified the lack of key skills in the foreign labor force as a top business threat.³⁰ Explosive growth in some countries has created labor requirements that have outpaced the local educational system’s ability to meet the heavy demand for well-trained, well-educated workers. Indeed, attracting, retaining, and developing key talent has become a major strategic challenge that has driven up labor costs significantly in so-called “low-cost countries.” Established players in the industry are discovering that their own recognized product brand doesn’t necessarily generate a corresponding “employment brand,” one that automatically attracts the best and brightest talent in the employee marketplace.

Then there are the human resources risks related to labor standards in offshore locations. In PricewaterhouseCoopers’ 2007 Global Outsourcing survey of 226 customers and 66 outsourcing service providers, 61% of customer respondents said that “labor and employment standards in offshore locations” would have the biggest impact on their future outsourcing decisions, by far the most popular answer.³¹ Yet another employee-related risk is simple ineffectiveness. Some U.S.-based CPG companies that have outsourced customer help desks, for instance, have received so many complaints from domestic customers that they are considering returning this customer service function back to the U.S.³²

26 PricewaterhouseCoopers interview with Campbell CFO Robert Schiffner (April 15, 2008).

27 PricewaterhouseCoopers interview with Clorox CFO Dan Heinrich (April 21, 2008).

28 PricewaterhouseCoopers interview with General Mills VP and Deputy General Counsel Eric Wedepohl (April 14, 2008).

29 “Deal Expands Tesco’s Presence in South Korea,” Reuters (May 14, 2008): www.iht.com/articles/2008/05/14/business/tesco.php.

30 PricewaterhouseCoopers, *11th Annual Global CEO Survey* (January 2008).

31 PricewaterhouseCoopers, *Outsourcing Comes of Age: The Rise of Collaborative Partnering* (2008).

32 “U.S. Companies Are Finding Savings They Used to Seek Overseas,” *Dallas Morning News* (October 28, 2007): www.dallasnews.com/sharedcontent/dws/bus/stories/DN-onshore_28bus.ART.State.Edition1.35b7e6c.html.

Together with a declining dollar, these risks have made real labor costs cheaper in the U.S. and are fueling a trend of “on-shoring,” or bringing jobs back from overseas to the U.S., often in rural areas. For example, Atlanta-based software company Xpanxion uprooted its Quality Center (testing center) from Pune, India, and moved it to Kearney, Nebraska, though it kept its main software development center in Pune.³³

The on-shoring trend doesn’t likely represent a slowdown in globalization. If anything, it suggests that globalization is maturing to the point that companies are less tied to location, and are more comfortable with shifting operations to the markets that make the most economic sense, whether that means Warsaw or Washington state.

Global Sourcing versus Quality and Safety Deficiencies

As companies try to manage costs through lower-cost sourcing, the resulting long-distance supply chain can lead to traceability and monitoring challenges when food safety and product quality deficiencies emerge. Moreover, sustainability considerations — especially the short-term costs involved in adopting sustainable practices overseas — can be daunting to companies that are unsure whether the advantages will outweigh the costs. In short, the lower-cost advantages of global sourcing are not simple to achieve and are only one part of the value equation.

While doing business offshore has long carried risks, the difference today is that the U.S. public, media, and policymakers have become far more attuned to this fact — partly due to several recent product recalls and safety concerns involving globally sourced goods and ingredients. This new level of scrutiny means that companies must monitor supply chains more closely than ever, even as they become more and more complex.

One way to mitigate these supply chain (and hence reputational) risks is to put in place a more formal and codified supply chain monitoring program. For example, a number of global food and drink manufacturers have recently joined forces with Europe-based Supplier Ethical Data Exchange (Sedex) to launch a collaborative initiative whose goals include increasing the efficiency and effectiveness of the labor auditing process. As raw materials and goods travel through the global trade system, Sedex tracks and compiles information on suppliers with regard to ethical performance, and works with suppliers to help them improve and meet international standards.³⁴ In another example, the global beverage company Diageo PLC, a member of Sedex, imparts best practices in labor standards to its suppliers and helps them with their sustainability efforts. Diageo also tries to source many of its raw materials very near where they are being processed — for instance, buying the majority of its supplies for East African Breweries within East Africa.³⁵

Another way to respond to potential brand image concerns is to take a long-term view of trends and act in a highly visible manner. One company that has responded in a positive way to brand-related concerns is PepsiCo. Recognizing an increasing consumer awareness of health and wellness, PepsiCo has implemented a gradual transformation of its core product portfolio (carbonated soft drinks and assorted snacks) through a combination of product acquisition and product reformulation.

This process actually began more than a decade ago, with the acquisition of such brands as Tropicana and Quaker. More recently, it has resulted in niche acquisitions, ingredient changes (such as reductions in sodium and trans fats), and the introduction of new products such as “Pepsi Raw,” which uses raw cane sugar instead of high-fructose corn syrup. The launch of Pepsi Raw shows that innovative companies can respond to changing consumer tastes and negative “buzz” in a positive way.

33 “U.S. Companies Are Finding Savings They Used to Seek Overseas,” *Dallas Morning News* (October 28, 2007): www.dallasnews.com/sharedcontent/dws/bus/stories/DN-onshore_28bus.ART.State.Edition1.35b7e6c.html.

34 Sedex: www.sedex.org.uk.

35 Global Compact Effort United Kingdom, Diageo case study: www.ungc-uk.net/pages/content/index.asp?PageID=61.

Rapidly Expanding Trade versus Market Saturation

As the U.S. market becomes saturated, it's reasonable to wonder when market saturation will arrive in some of the emerging markets as well. Income, GDP, and consumer spending have been growing in all four BRIC countries, especially in mega-cities teeming with urban-affluent consumers.³⁶ While economic growth rates in China and India are expected to level off sometime in the next decade, GDP in both countries is still expected to rival or surpass that of the U.S. by around 2050.³⁷

Forward-looking CPG companies are weighing the potentially sobering calculus of diminishing global resources when considering which markets could become saturated or, more likely, too expensive to try and penetrate. If consumption levels in developing countries worldwide were to reach those of developed countries, demand for energy resources and basic input commodities in many developing countries could exceed current sustainable production capacity.³⁸ One resource of particular concern is water. According to the International Water Management Institute, around 450 million people in 31 developing countries face serious shortages of water, a situation that will worsen by the end of 2025, when an estimated two thirds of the world's population will face severe and chronic water shortages.³⁹

Exhibit 8: Projected Relative Size of Major Economies (GDP at Market Exchange Rates)

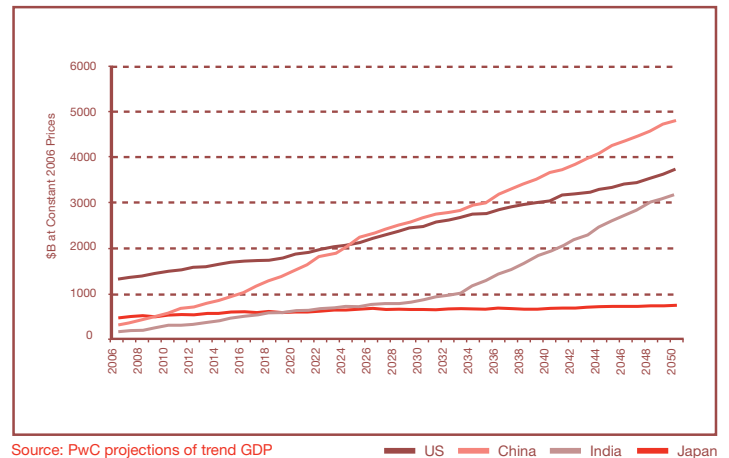
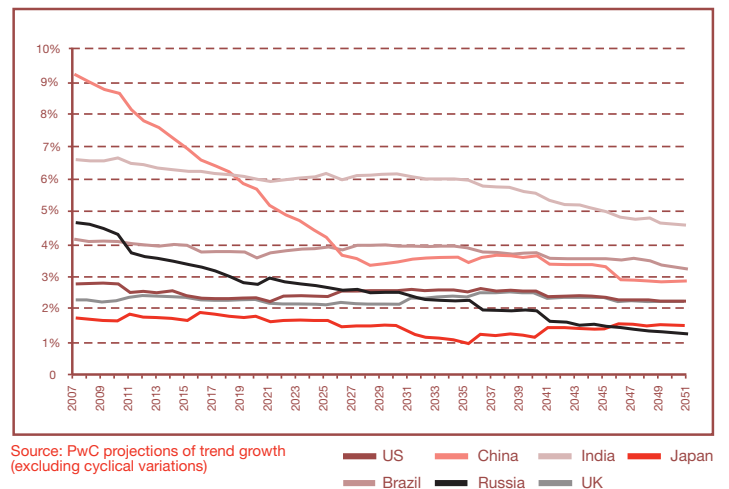


Exhibit 9: Projected Trend Growth Rates in Key Economies



36 A.T. Kearney, *Growth Opportunities for Global Retailers: The A.T. Kearney 2007 Global Retail Development Index* (2007); www.atkearney.com/shared_res/pdf/GRDI_2007.pdf.

37 PricewaterhouseCoopers, *The World in 2050: Implications of Global Growth for Carbon Emissions and Climate Change Policy* (September 2006).

38 Global Footprint Network: www.footprintnetwork.org.

39 UN-Water, *Coping with Water Scarcity* (August 2006): [ftp://ftp.fao.org/agl/aglw/docs/waterscarcity.pdf](http://ftp.fao.org/agl/aglw/docs/waterscarcity.pdf).

A few years ago, the public began questioning the amount of water that The Coca-Cola Company, the largest beverage company in the world, uses in water-scarce countries like India. Coca-Cola responded by implementing a number of successful initiatives that reduced its water use in India by 34% in six years.⁴⁰ Through rainwater harvesting, the company returns a substantial portion of the water it uses to aquifers. Partnering with India's Central Ground Water Authority, local governments, and communities, the company has also launched a multi-year partnership with the Water Environment Federation to conserve and protect freshwater resources. The goal: Replace every drop of water Coca-Cola uses in its beverages and production. By responding quickly and partnering with local organizations, Coca-Cola not only created an efficient, cost-effective, and sustainable water system, but also received widespread public recognition for its efforts.

Nestlé faced similar significant challenges in countries dealing with water scarcity. By 2008, however, the company was able to announce that in just four years it had reduced its water use in developing countries by more than 25% for every kilogram of product produced.⁴¹ Nestlé achieved these results through a combination of monitoring usage, investing in innovative technologies to reduce usage in processing/manufacturing, and finding ways to reduce agricultural usage.

Whether it's the beckoning consumer markets of the BRICs or low-cost production opportunities in countries like Mexico or Vietnam, doing business on a global scale has become an imperative for many consumer products companies. But the risks associated with such expansion, if not managed properly, can undo many of the gains to be made. By bringing flexibility and agility to how they adapt to changing conditions "on the ground," U.S. companies can drive non-domestic growth and bolster the bottom line.

Key Questions

- Have domestic economic challenges caused us to emphasize looking inward to save money or looking outward to seek growth?
- How can we leverage our domestic "employment brand" to be an employer of choice in growth markets overseas?
- How do we manage a complex supplier network to balance operational and cost advantages with quality and ethical risks?
- How do we communicate the value to shareholders of social and environmental imperatives that are necessary to earn and maintain our license to operate globally?
- Are we strategically prepared for sweeping changes in the next 10, 20, and 50 years, which include a shifting center of gravity in the global economy, short- and long-term resource constraints, and constructive participation in an evolving consumer conversation?

40 The Coca-Cola Company, "CokeFacts India: Q&A" (2005): www.cokefacts.com/facts/facts_in_qa.shtml.

41 Nestlé S.A., *The Nestlé Water Management Report* (March 2007): www.nestle.com/Resource.axd?Id=F7879D21-0C3F-4099-AF79-6BA10BF5A5B4.

Making Indirect Taxes Visible, Manageable, and Measurable

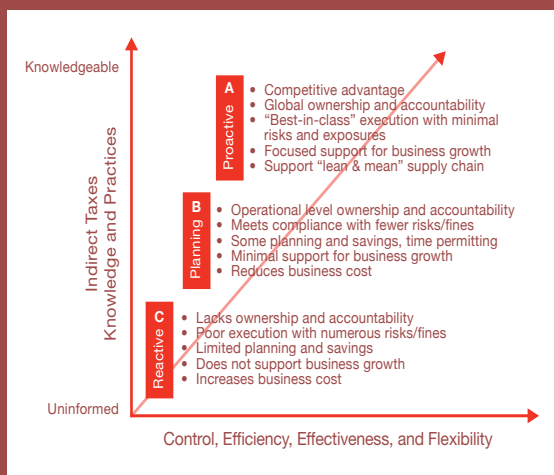
When sourcing or manufacturing abroad, companies tend to focus on those costs that are most transparent: expenditures related to plants and equipment, raw materials, and employees. But there are many hidden costs to moving goods through the global trade network, and one of these — indirect taxes — can be much better managed with just a little strategic foresight.

Consumer products companies operating on a global scale continuously procure and source raw and intermediate materials, purchase capital equipment, and transfer these assets around the globe to meet their production needs and customer demands. But companies rushing out to source and manufacture in the lower-cost countries, as well as to develop responsive and efficient supply chains to support global sourcing decisions, may allow tremendous savings to slip through the cracks in the form of indirect taxes, which are generally defined as customs duties, value-added taxes (VAT), excise taxes, customs processing fees, port charges, etc.

What many fail to appreciate fully is that quality, up-front planning around indirect taxes can make the difference between a money-losing or marginally profitable supply chain and a highly profitable one. This dynamic is particularly true in such emerging markets as Brazil, Russia, and China, where customs tariffs and other cross-border transactional taxes can drive overall landed costs up 30, 40, or 50 cents for each dollar imported.

Four Facts Executives Need to Know about Indirect Taxes

Exhibit 10: Indirect Taxes: Driving to a World Class



1. Customs duties on imported goods average about 15% globally, but range up to 300% of the value of goods depending on the commodity, destination, use, and/or special program eligibility/treatment.
2. With more and more countries implementing VAT and similar tax systems, VAT can be thought of as the "tax of the future."
3. Lack of controls and accuracy around indirect tax compliance and reporting requirements can cause significant delays in shipping (especially in less developed countries), creating negative impact on just-in-time manufacturing processes and, ultimately, customer satisfaction and profitability.
4. Penalty regimes that relate to indirect taxes tend to be among the most draconian, as the potential offenses

under the relevant statutes go beyond the "usual" fraud and tax-evasion charges. For example, smuggling has resurfaced as a serious global issue and has become the focus of tax authorities' attention, with the result that sentences for breaches of indirect tax legislation have increased dramatically over the past ten years. Financial penalties can range from 100% for fairly minor offenses to 800% or more. One company operating in an emerging market discovered that its local operation had been using two sets of invoices for its imports, with quite different values. One was presented to customs authorities at the border, and the other was used for the company's financial records. To account for flouting the country's laws, the company created a financial reserve equal to more than five times the market capitalization of the local operation.

Historically, many have looked at indirect tax management purely as a compliance issue, but in today's global business environment, savvy companies are looking to move from simply avoiding risks to actually creating value. Indirect tax management is a perfect example of this dynamic. Consumer products companies that plan strategically can bring these costs out into the daylight, measure them, manage them, and be all the more profitable for the effort. As Kellogg's John Bryant notes, "Any savings is better than nothing at all . . . and as such, there is something to be said for proactive planning around indirect taxes."⁴²

The Current Approach to Indirect Tax Management

In today's fast-paced product manufacturing and distribution supply chains, there is a tendency to pay scant further attention once a process is established and functioning reasonably well — the old “if it's not broke, don't fix it” approach. Indeed, unless merchandise is delayed by customs at the border or encounters some other disruption, many companies don't concern themselves with their product's journey through the global trading system.

In many organizations, for example, there is often no central point of management or accountability for indirect taxes. Some companies may think that this lack of focus is justified by the fact that their business is mostly domestic, but that's not always true. As an example, 15% of Hershey's business comes from overseas, and indirect taxes are not managed centrally. As Hershey CFO Bert Alfonso notes, “The company has not been that focused on indirect taxes. . . . [We] probably can improve our performance in this area.”⁴³

Like Hershey and many other global companies, the Kellogg Company manages customs duties and VAT where they arise, in the local country jurisdictions. Kellogg CFO John Bryant says that “the responsibility for managing indirect taxes has fallen to the local Kellogg operating companies in each country.”⁴⁴ In such situations, companies tend to rely heavily on third-party providers such as customs brokers and freight forwarders to manage transaction processing and general compliance with customs and duties obligations. Many CPG companies have simply relegated customs issues and activities to a clerical level within corporate departments such as logistics, traffic, or purchasing.

Because they are not managed centrally, indirect taxes are also famously hard to track. In fact, many of the transactional expenditures associated with global merchandise transfers are buried within the “costs of goods sold” (COGS) line in a company's financial statements. These types of hidden costs, when combined with the enormous detail that accompanies most cross-border transactions (purchase price/value, customs classification, terms of sale, origin certificates, etc.), can make even the best of managers throw up their hands, resigned to what seems like an unmanageable process. But there is a solution.

43 PricewaterhouseCoopers interview (April 18, 2008).

44 PricewaterhouseCoopers interview (April 10, 2008).

Why Address Indirect Taxes Now?

As companies are increasingly expanding into global markets, the costs of trade, duties, taxes, and general compliance with customs and international trade regulations are mounting. Under constant pressure to improve margins and profits, companies need to look for ways to control these costs instead of viewing them as fixed and unmanageable.

As part of this effort to manage profitability and costs, many global consumer goods manufacturers and suppliers are shifting their focus. Instead of simply thinking about the fastest route from sourcing to getting goods onto store shelves, they are managing the total cost of these cross-border movements of raw materials and finished products. That's where managing indirect taxes comes in. To better understand the potential impact that indirect taxes can have on the supply chain, consider that virtually every national government:

- Can largely create its own set of rules and regulations governing the requirements of international trade and commerce
- Maintains specific data requirements, documentation, and reporting processes and procedures
- Seeks the safe and secure movement of goods into its territory

- Collects transaction-based taxes

Add to that complexity the network of international trade agreements — local and regional, unilateral and multilateral — that contain very specific rules of origin and provisions, providing exceptions to the general trade rules and regulations imposed on a country's other trading partners. Companies also must factor in the global trading rules as determined by the World Trade Organization (WTO) and World Customs Organization (WCO), as well as the many different trade embargoes, non-tariff barriers, and retaliatory tariffs implemented by governments to protect against real or perceived unfair trade practices.

These different rules and regulations are shifting constantly in the service of changing government administrations, national special-interest political groups, and evolving perspectives on economic needs. As if that weren't enough for global business to contend with, they must also address heightened border security measures in certain countries that are attempting to block the movement of contraband or thwart terrorist activities.

A Golden Opportunity: Turning Indirect Taxes into a Strategic Initiative

Implicit in all of these questions is a golden opportunity: to view the treatment of indirect taxes as a strategic initiative and analyze their enterprise-wide impact at the global corporate level. Proactive management, real-time visibility, and the placement of management metrics and processes around indirect tax management all hold great potential for cost reduction and improvement.

But it's difficult to take advantage of these opportunities if companies approach international procurement and sourcing in a piecemeal manner. Effective pre-planning at the global, regional, and/or national level is critical. Without such planning, the gains achieved through low-cost sourcing and efficient supply chain strategies may be cancelled out by duties, taxes, and other transaction costs. As Kellogg CFO John Bryant notes, "Unfortunately, indirect taxes are not yet a strategic internal function, but the company realizes the potential benefits and issues out there."⁴⁵

Even best-in-class organizations struggle to meet this highly complex set of situational constraints, but the best practices that follow can help companies approach indirect taxes strategically.

Integrating Indirect Tax Considerations into Larger Strategic Discussions

One key best practice for better managing indirect tax costs is to make them an early discussion item when considering significant overseas initiatives. Before launching an enterprise-wide supply chain or IT initiative, for example, take the time to address indirect tax processes and strategies, and establish several different scenarios to better manage risk and reduce costs. Large-scale IT implementations may drastically affect a company's purchase cycle, sourcing decisions, supply chain management, financial reporting processes, internal reporting processes, and interfaces with legacy technologies. And this, in turn, will alter the indirect tax profile of a company's operations, potentially causing additional liabilities and risks, disruption of current processes and data flow, and increased transaction costs. This is just one example of the many areas of a company's operations that can affect indirect tax costs.

Forming a Centralized and Dedicated Indirect Tax Team

A second overarching key to success is to obtain management commitment for establishing a dedicated indirect tax team. Such a team will identify and address risk areas with a focus on transforming the indirect tax liabilities from the realm of "cost centers" to the realm of "value builders." By identifying where indirect taxes affect the company's revenue, growth, cost base, profitability, or risk profile, this team can develop and integrate an indirect tax policy into the company's technology systems to better track cross-border transactions. One major food and beverage manufacturer, for example, created a central team of customs and international trade specialists to help the company's global business units manage strategic customs, trade planning, and compliance issues. The payoff came when just one global customs classification initiative resulted in tens of millions of dollars in customs and indirect tax savings. With just this one effort, the team had contributed significant value to the company's bottom line and changed how the company sourced, manufactured, and distributed a signature product.

But teams that can have this kind of impact are hard to assemble. Indirect tax specialists with country-specific knowledge, technical abilities in the subject matter, and an ability to think strategically are extremely scarce and in ever-increasing demand, making it difficult to find and retain them. As a result, key decisions affecting indirect tax outcomes may be made by personnel with only cursory knowledge of customs or VAT rules and regulations.

Re-examining Procurement of Materials and Equipment

Another fundamental value-building strategy related to indirect taxes is re-examining the origin, classification, and valuation of materials and production equipment to better leverage international trade preferences and customs rules. When properly integrated into a company's procurement and manufacturing decision-making processes, changes here can reduce costs without sacrificing the quality of the finished product.

⁴⁵ PricewaterhouseCoopers interview (April 10, 2008).

One major consumer products company has found that gathering data and analyzing potential indirect taxes prior to signing capital equipment vendor contracts can produce significantly lower costs. Indeed, companies have reduced landed costs by up to 20% of the value of imported equipment by considering alternative vendor-sourcing scenarios.

Factoring in the Effects of Major Institutional Change on Indirect Taxes

Considering indirect tax consequences during a major upheaval or time of change at a company is another critical strategy. For example, when considering a merger or acquisition, the target company's potential customs liability should be unearthed and evaluated during the due diligence process. If the target has failed to effectively address its customs compliance obligations as part of its normal business operations (as is common in some industries), there may be unexposed multi-million-dollar liabilities in duty and/or customs penalties accruing and waiting for the unsuspecting acquirer. In the U.S., for example, customs fines may range from 20% to 100% of the value of the imported goods, if the goods are duty free (i.e., there is no revenue loss to the government). These liabilities can accrue for many years, depending on the customs statute of limitations in any given country.

Common Mistakes to Avoid

Those companies not quite ready to re-evaluate the way they move goods around the world can at least avoid some common pitfalls. Basic importing and exporting carry many different types of indirect tax liabilities, including those related to intellectual property.

For example, import duties may be assessed on the value of royalties or license fees that are paid by importers to foreign holders of intangible rights (e.g., trademark, design, distribution rights, etc.). For instance, if a royalty is paid by an importer in Country X to a foreign licensor in Country Y who also happens to be the seller/exporter of the goods, then the importer in Country X may also be liable for the value of the royalty included in the duty basis of the imported goods.

Offentimes, importers and exporters, as they go about structuring such royalty and import agreements, may be inadvertently increasing the duty basis of imported goods if the royalty is deemed a "condition of sale." If this is left unaddressed during the planning stages, companies run the risk of increasing their indirect tax liability, even on payments that may not be related directly to the imported good.

A variety of issues related to VAT also can trip up companies when it comes to indirect taxes, particularly those related to international marketing and promotion. Without the proper structuring of advertising and promotions contracts and offers, recovery of related VAT payments may be restricted and create a potentially significant cost. Moreover, output VAT liabilities can arise under certain types of promotion schemes. Many major retailers have experienced this when branching out into financial services such as issuing in-store credit cards and granting loans. Such moves into non-traditional activities could fundamentally change a company's VAT profile and its ability to recover input VAT.

While shaping public policy on indirect taxes is beyond the scope of individual companies, organizations are far from powerless. They can take action now, quantifying and then mitigating indirect taxes through their sourcing, logistics, and manufacturing choices. That way, regardless of the U.S. corporate tax rate, companies can reduce some costs of operating around the world.

Key Questions

- How much do we pay in customs duties?
- What percentage of our profits comes from international trade?
- What restrictions do we face in international trading?
- What strategies have we employed to control trade costs and customs duty taxes?
- Who "owns" indirect taxes inside our company?

CPG Companies and Effective Tax Rates

One reason indirect taxes are often overlooked is that they aren't captured in the corporate effective tax rate (ETR). 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. A company could have a very reasonable effective tax rate reported in its financials and still be spending significant resources on cross-border taxes and other costs.

The effective tax rates of CPG companies tend to vary significantly, as is clear from 2003–2007 figures (see Exhibit 11). Companies in the highest effective tax rate quartile between 2003 and 2007 had a median effective tax rate hovering near 40%, while those in the lowest effective tax rate quartile tended to be in the mid-20s. There are several potential reasons for this difference. For example, big multinational companies typically derive more of their profits from countries and territories with statutory tax rates that are lower than the U.S. domestic statutory tax rate.

Indeed, as is shown in Exhibit 12, the median effective tax rates of large — and generally more global — CPG companies during 2003–2007 reached no higher than 30% (in 2003). On the other hand, the highest median effective tax rate for small-sized companies with primarily domestic U.S. profits was 38% (also during 2003).

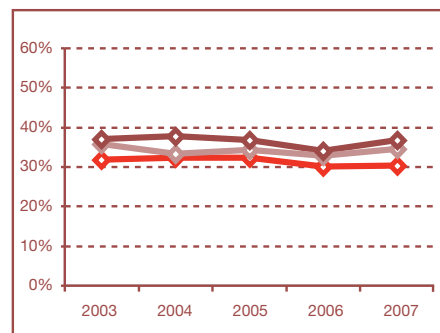
Exhibit 11: Median Effective Tax Rate



◆ Highest Effective Tax Rate Quartile
◆ Median
◆ Lowest Effective Tax Rate Quartile

Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Exhibit 12: Median Effective Tax Rate, Size Specific



◆ Large Manufacturers (net sales > \$4B)
◆ Medium Manufacturers (\$500M < net sales <= \$4B)
◆ Small Manufacturers (net sales <= \$500M)

Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis

Best Practices in CPG Sustainability Reporting

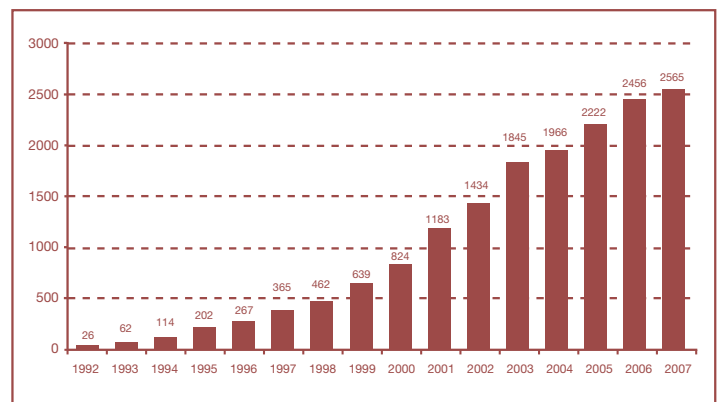
Sustainability reporting has evolved into a business imperative that alerts investors and other stakeholders to the regulatory and market pressures companies face. Sustainability reports can inspire greater confidence in a company's governance and overall performance, as they provide critical information about a company's strategies for reducing the use of water, energy, and packing materials, actions that can create cost savings and contribute to long-term growth prospects. Increasing scrutiny of sustainability reports is producing several best practices that can make these reports even more transparent and meaningful.

Consumer packaged goods companies are ideal candidates for issuing sustainability reports. First, many CPG companies have global, iconic brands held to the highest quality standards by retail customers and end-consumers. Second, many CPG companies source their commodities globally, meaning they need to closely monitor complex and constantly changing supply chains. Third, water and agricultural products are the lifeblood of CPG companies, and broad solutions to natural resource scarcity can only enhance future shareholder value. As the GMA itself stated in its *Environmental Sustainability Resource Guide*,⁴⁶ many GMA manufacturers now have trading partners that are committed to reducing their own carbon footprints, and expect their suppliers to comply with these standards as well.

More Companies Are Holding Themselves Accountable

Sustainability reporting isn't a new concept. The idea that companies should measure and quantify the impact of their operations on the world around them was first embraced in Europe in the early 1990s. Last year, more than 2,500 companies globally published some type of sustainability report (see Exhibit 13),⁴⁷ including almost 2,000 U.S.-based companies.

Exhibit 13: Global Report Output by Year

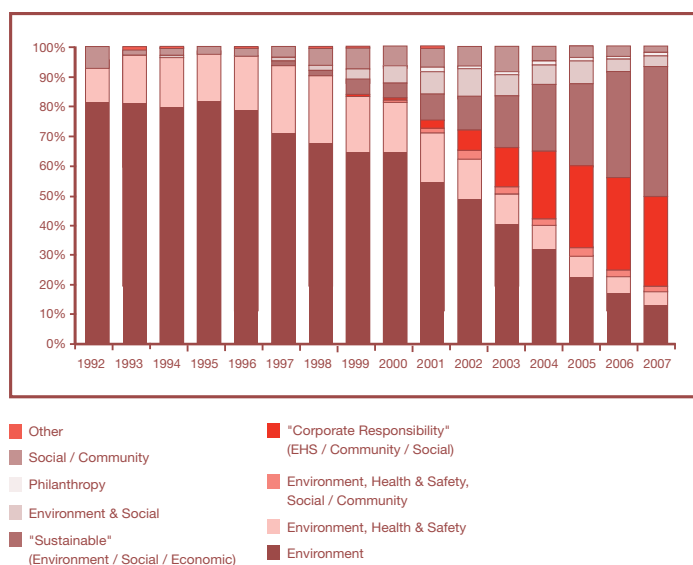


⁴⁶ Grocery Manufacturers Association, *Environmental Sustainability Resource Guide* (January 2008): www.gma-brands.com/publications/2008/ResourceGuideFinal.pdf.

⁴⁷ CorporateRegister.com, "Global Report Output by Year" (April 10, 2008): www.corporateregister.com/charts/byyear.htm. See also: Association of Chartered Certified Accountants, *Towards Transparency: Progress on Global Sustainability Reporting* (2004): www.corporateregister.com/pdf/TowardsTransparency.pdf.

Moreover, in 1997 sustainability reports accounted for around 1% of non-financial reporting. In 2007, this percentage increased to more than 70%, as can be seen in Exhibit 14.⁴⁸ The uptick in reporting signals a growing sense of urgency: Providing such reporting to investors has shifted from being a peripheral corporate concern to one that can directly affect the bottom line.

Exhibit 14: Global Report Output by Type



Recent significant developments in the U.S. regulatory environment have been key in driving the movement toward increased corporate sustainability awareness and reporting. In December 2007, both the Senate and House of Representatives moved forward with bills designed to address the risks of climate change and greenhouse gas emissions. These bills have the potential to shape future financial reporting and disclosure requirements, as the SEC and FASB continue their own projects in the area of greenhouse gas emissions. Many states also have begun to enact legislation limiting greenhouse gas emissions from industrial users.

Are We Ready for Outside Assurance?

Companies pondering an outside assurance evaluation may find it useful to apply an internal controls maturity test. Such tests determine whether controls for sustainability reporting are rigorous enough to manage related reporting risks. The following illustrates a framework that many companies use to evaluate their readiness and maturity.

Level 1: Unreliable

- Unpredictable environment where controls are not designed or in place

Level 2: Informal

- Controls are designed and in place, but are not adequately documented
- Controls are mostly dependent on people
- No formal training or communication of controls

Level 3: Standardized

- Controls are designed and in place
- Controls have been documented and communicated to employees
- Deviations from controls may not be detected

Level 4: Monitored

- Standardized controls are in place, with periodic testing for effective design and operation and results reported to management
- Automation and tools may be used in a limited way to support controls

Level 5: Optimized

- An integrated internal control framework is in place, with real-time monitoring by management for continuous improvement
- Automation and tools are used to support controls and allow the organization to make rapid changes to the controls, if needed

Unless a company believes its sustainability reporting controls are generally at or above Level 3, it will likely benefit from some form of pre-assurance controls review.

Sustainability reporting is part of a growing trend in which corporations are recognizing real risk in areas of business that have traditionally been peripheral to financial planning and analysis. Even now, regulation and legislation are creating profound price signals, especially for greenhouse gas emissions, that will change the way corporations do business. The upshot? Sustainability directly affects the bottom line.

⁴⁸ CorporateRegister.com, "Global Report Output by Type" (April 10, 2008): www.corporateregister.com/charts/bytype.htm.

Although sustainability reporting was originally a voluntary response to stakeholder demands for greater transparency, it has become more about addressing potential legal liabilities to shareholders, anticipating possible regulatory actions, and managing shareholder risk. These issues have come to the fore in the past decade as investor groups like the California Environmental Resources Evaluation System (CERES), environmental organizations, and other public-interest groups have begun highlighting the potential real-world consequences of “business as usual” — both to the markets and to the environment. Indeed, the markets already are incorporating sustainability reports into the business calculus, increasingly weighing the “non-financial” value that they contain. The GMA’s own program, the GMA Environmental Sustainability Initiative, is now developing consistent metrics that will help GMA members better measure environmental improvement in business operations. Indeed, at the organization’s Environmental Sustainability Summit in January 2008, a panel on sustainable packaging discussed ways that environmental stewardship can lead to continuous improvement.

Does the Market Reward Companies That Produce Sustainability Reports?

The growing popularity of indexes such as the Dow Jones Sustainability Indexes (DJSI) and the FTSE4Good Index, which track the financial performance of the leading sustainability-driven companies, suggests that sustainability performance is becoming an important key to investors’ decisions. Research by Sustainable Asset Management (SAM) and PricewaterhouseCoopers underscores this, suggesting that corporate sustainability performance could, in general, lead to more and better investment opportunities.⁴⁹ This would allow investors to perhaps achieve higher returns on invested capital (ROIC), maintain a potentially higher reinvestment rate (RIR), and, in some cases, generate a higher dividend yield. Companies that have maintained the due diligence required to stand behind their sustainability reports could well manage risks better than their peers. Lower risk premiums will lower required rates of return, reduce financing costs, and ultimately help to enhance shareholder value.

Aside from the market rewards for being perceived as “sustainable,” companies shouldn’t discount the possibility of immediate, actual cost savings related to employing “green” practices. According to General Mills’ Tom Forsythe, one very tangible way that General Mills can measure the impact of sustainability on the bottom line is through savings related to using less water, less packaging, and less fuel: “If we use less packing per unit of sale on a product, and therefore we have lower input costs, we can see that in the margins and that’s very measurable.”⁵⁰ General Mills also reconfigured the way it packaged certain items, which allowed the company to load more pallets of goods on trucks leaving distribution centers. “If you are delivering more goods with the same amount of fuel,” says Forsythe, “that’s sustainability in action, but it’s also better productivity.” The GMA’s Environmental Sustainability Initiative is looking at metrics that will help companies measure sustainability in three different areas: packaging reduction and recycling, water conservation, and reductions in greenhouse gas emissions.

In addition to potentially experiencing enhanced long-term shareholder value and short-term cost-savings, green companies are also becoming increasingly attractive to potential employees, particularly members of “Generation Y.” According to poll data from employment website MonsterTrak.com, fully 92% of respondents (mostly young professionals and students) said that all else being equal, they would be more likely to take a job at a company recognized for being environmentally friendly.⁵¹ Perhaps real estate developers should take note as well: In the Colliers International 2007 Canadian Office Tenant Survey, just over 90% of surveyed commercial tenants said that, given the choice, they would prefer to work in a green building.⁵²

49 PricewaterhouseCoopers, *The Sustainability Yearbook* (March 2008).

50 PricewaterhouseCoopers interview (April 23, 2008).

51 Kira Vermond, “Going Green Can Attract and Keep Employees,” *The Globe and Mail* (January 19, 2008): www.theglobeandmail.com/servlet/story/LAC.20080119.RWEEKENDWORKDOUT19/TPStory/Business.

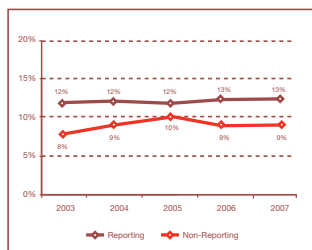
52 Ibid.

How Companies That Report Sustainability Data Measure Up Against Those That Don't

A recent analysis conducted by PricewaterhouseCoopers examined companies (designated as “reporting”) that have (a) established certain sustainability and social responsibility practices, (b) reported sustainability data along with financial results, and (c) achieved recognition for having done so through one or more of six well-known sustainability indices. The analysis attempted to measure how these reporting companies’ financial results performed in relation to companies that reported only standard financial data (designated “non-reporting”).

The analysis was based on 60 large companies, 27 that reported sustainability data and 33 that did not. For the purposes of this analysis, a company that reported sustainability data any time during the five-year comparison period was included in the sustainability reporting group. This study found that the sustainability reporting group generally experienced higher gross margins and return on sales, higher return on assets, and stronger cash flow and rising shareholder return.

Exhibit 15: Median Return on Assets



Higher Return on Assets

The companies that reported sustainability data consistently achieved higher return on assets than those that did not. (This metric, at times described as a capital intensity indicator, measures how efficiently a company manages its asset base.) Two factors might explain this result: investment decisions and operational improvements associated with adopting sustainable practices.

Higher Gross Margins and Return on Sales

When compared based on gross margins and return on sales, the companies that reported sustainability data outperformed those that didn't. There are two plausible explanations for those results. One is that companies committed to sustainable practices tend to operate more leanly, saving on energy costs and overall input costs. With energy prices rising and carbon pricing policies becoming more prevalent, companies employing sustainable practices should continue to enjoy the benefits of those initiatives.

The second possible reason for profitability is that consumers have begun placing a premium on goods produced in a sustainable manner. If this is the case, the willingness to pay extra for goods perceived as more environmentally friendly is likely to continue.

Incidentally, higher margins and return on sales help counter the argument that the expenses related to becoming a “sustainable company,” such as higher administrative costs, aren't worth the benefits.

Stronger Cash Flow and Rising Shareholder Return

In terms of generating cash flow, companies that reported sustainable data posted consistently higher free cash flow to sales ratios over 1-, 3-, and 5-year periods. Over the years, companies with sustainable practices have been implementing operational improvements and adopting best practices along their value chain. Those improvements have likely contributed to their ability to generate higher cash flows. The stock market clearly rewarded the sustainability reporting companies in 2007, as measured by their relatively higher shareholder return.

Exhibit 16: Median Free Cash Flow to Sales

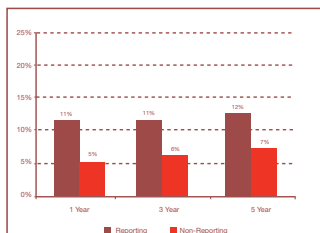


Exhibit 17: Median Shareholder Return

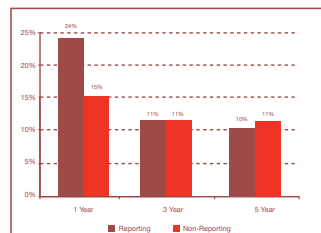


Exhibit 18: Median Gross Margin

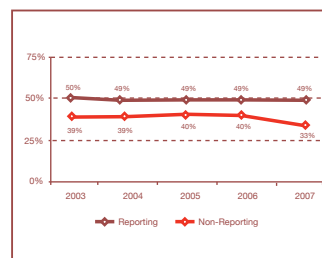
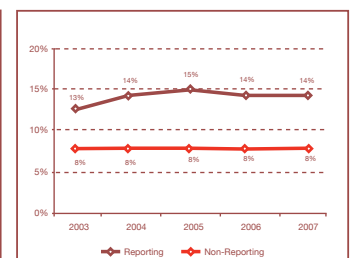


Exhibit 19: Median Return on Sales



Conclusion

The first-year findings of PwC's comparison offer some tantalizing connections between sustainability and performance. It's still premature, however, to conclude that these observations are indicative of a newfound market appreciation of green companies, or that sustainable companies may tend to be more innovative and flexible, and thus better able to adapt to changing markets and consumer demands.

Sustainability Reporting and Value Generation: A Case Study⁵³

PricewaterhouseCoopers conducted an experiment with Schroders Investment Management, a leading London-based investment firm, and Coloplast, a Danish company renowned for its corporate reporting, to determine how sustainability reporting affects the way analysts view a company's financial reporting. Coloplast regularly exceeds standard reporting practices — quantifying key sustainable activities, for instance, and linking them to expected financial performance.

For this experiment, PricewaterhouseCoopers used two different versions of Coloplast's annual reports. The first was Coloplast's actual report, containing all the information the company regularly includes about sustainability. The second set, styled after a more typical annual report, was stripped of Coloplast's quantified sustainability information. The Schroders investment team was split into two groups, one given Coloplast's actual report and the other given the altered version. The analysts were asked, among other things, to forecast revenue and earnings, as well as provide “buy” or “sell” recommendations for the stock, with supporting rationale. Each team worked separately — no conferring, no access to external data — for about two hours, after which they submitted their valuation analyses.

The analysts given Coloplast's real annual report, containing the company's sustainability information, forecast lower revenue and earnings than did the analysts using the second, altered version. When PwC looked at the two groups' recommendations on the stock, however, a different picture emerged. Among those analyzing the “sustainable” version of the report, 60% said they would buy shares in the company. By contrast, 80% of those with the altered version said they would sell the stock — *despite* having made higher forecasts for revenue and earnings. The reason for this surprising result? Confidence. The analysts with the original report had great depth and breadth of data by which to assess the quality and

sustainability of the company's performance. Those working with the altered report, by contrast, clearly struggled to analyze the stock's long-term potential.

A separate case study published by the GMA in its *Environmental Sustainability Resource Guide*, “Social Responsibility and the Transparent Organization,” reached a similar conclusion about the importance of “transparency” in today's world: “Information transparency is an essential aspect of the corporate social responsibility integration that drives growth on the value curve. Demands for transparency that once focused on financial disclosure have now enveloped all aspects of business.”⁵⁴

Strengthening Sustainable Reporting

Many investors still don't use sustainability reports to any great extent when completing their analysis and recommendations. Part of the problem may be the reports themselves, many of which fail to discuss the bottom-line effects of sustainability on a company. In addition, only a small percentage of sustainability reports are audited by independent third parties to ensure the information's accuracy, consistency, and reliability, though that number is growing (Starbucks, Carrefour, Puma, and LG Electronics, for instance, each obtain assurance opinions for their sustainability reports).⁵⁵

A company considering an assurance opinion should consider its cost, the level of effort required for its completion, and the potential reputational risks that might result if the company were to receive a less-than-flattering assessment. Moreover, an assurance engagement requires that the company provide third-party analysts sufficient evidence to support their evaluation process.

53 PricewaterhouseCoopers, *Trends in Corporate Reporting* (2006).

54 Grocery Manufacturers Association, *Environmental Sustainability Resource Guide* (January 2008).

55 Corporateregister.com.

There may be risks, of course, in seeking assurance prematurely. Companies should consider whether their data collection and reporting processes and controls are strong enough to withstand audit scrutiny. If they aren't reasonably comfortable, other options are available that will help them advance their sustainability reporting. An audit opinion is one such option. Individuals internal or external to the company — who are not involved in the sustainability data collection and reporting process — can assess the company's reporting capabilities. (See sidebar "Are We Ready for Outside Assurance?," page 25.)

There was reason enough for companies to provide investors with sustainability data when such reporting was considered solely an offshoot of corporate responsibility. Today, however, the market seems to be rewarding both the "halo" effect of sustainability reporting and, more important, the font of additional corporate information it provides. Moreover, some recent studies confirm that the increased transparency of companies reporting sustainability data bolsters stakeholder and investor confidence and burnishes corporate reputation. No doubt, more and more companies will quantify the social and environmental impacts of doing business.

Despite the somewhat limited universe of sustainability reporting, some other best practices⁵⁶ besides third-party audits are emerging:

- **Clear alignment to corporate strategy:**
CEOs should clearly explain why responsible and sustainable development of corporate resources is fundamental to their company's overall strategy. Such statements should highlight challenges, focusing on the impact of legislation, regulation, and other market activities on the company's performance.
- **Long-term targets and measurement of performance:**
Companies should establish a clear link between long-term strategic priorities and environmental, social, and governance related key performance indicators (ESG). These performance indicators should be based on both independent and internal surveys, as well as other available research, so as to address the needs of key stakeholders.

- **Transparent reporting against ESG milestones:**
A base-case scenario should be used to determine a company's progress in meeting its ESG goals. In order to maintain true "apples-to-apples" comparisons, all ESG reports on performance must be made using the same assumptions that underpin the base-case scenario.
- **Quantification of returns from enhanced ESG reporting:**
Reports should include net savings from enhanced sustainability reporting, metrics analysis, and total tax contribution reporting, using the appropriate metrics.

Key Questions

- Have we incorporated sustainability initiatives into our short- and long-term strategic plan?
- Have we considered issuing a sustainability report?
- What business unit within our organization is responsible for monitoring and measuring our sustainability initiatives?
- How does our company define sustainability?
- Have we collaborated with our peer group in terms of sustainability initiatives and programs?
- What companies come to mind when we consider best practices in sustainability reporting?
- Has our company conducted an internal controls maturity test?

⁵⁶ PricewaterhouseCoopers, *Best Practice Environmental Social and Governance (ESG) Reporting* (2007).

Increasing Value and Managing Costs through Joint Manufacturer and Retailer Efforts

Through 2008 and beyond, manufacturers and retailers face a challenging environment caused by rapid hikes in commodity prices coupled with lower consumer demand. There are many innovative ways in which manufacturers can respond without the traditional and ultimately undesirable stop-gap of passing along higher commodities prices to retailers, and ultimately to consumers. Instead, manufacturers and retailers can use the economic slowdown as an opportunity to jump-start collaboration on a number of levels — from focusing on core products, to establishing and implementing efficiencies in packaging and design, to coordinating product promotions. Ultimately, success will continue to be driven by creating the right solutions to consumer needs for health, wellness, and convenience — at the right price.

In the past year, the U.S. consumer has faced significant challenges, including declining housing prices, a falling stock market, growing levels of unemployment, and higher prices for groceries (with food and beverages up nearly 5%⁵⁷) and gasoline (up 22% from last year⁵⁸). The net result? Consumer confidence in the state of the economy is at a 26-year low.⁵⁹

Manufacturers have been challenged by unexpectedly steep increases in commodity costs. While some manufacturers have actually profited by hedging to take advantage of rising commodity prices, several major food companies were unprepared for the severity of commodity price hikes, which could impact future earnings.

Traditionally, manufacturers and retailers have passed on a proportion of rising commodity costs to consumers, but such cost-recovery strategies may not work when consumer demand is slowing — and may even contribute to recessionary trends.

Against this challenging backdrop, CPG manufacturers and retailers are exploring innovative ways to collaborate to enhance product value and supply chain efficiencies. The end-goal is to maintain profitability without simply passing on higher costs to consumers.

Wal-Mart Stores, Inc. is among the best examples of resisting price hikes. In a recent article in *The Wall Street Journal*, food executives report that, while being fair about passing higher costs along to consumers, Wal-Mart is also “pressing [manufacturers] to do more price promotions and to look for ways to eliminate waste, such as making packages smaller and fully loading delivery trucks.” For its part, Wal-Mart allowed that, “When . . . grocery suppliers bring price increases to the table, we don’t just accept them. We will continue to work closely with our suppliers in every way possible to keep the prices down.”⁶⁰ To that end, the retailing giant is setting new

57 Andrew Martin, “Fuel Choices, Food Crises and Finger-Pointing,” *The New York Times* (April 15, 2008): www.nytimes.com/2008/04/15/business/worldbusiness/15food.html.

58 Energy Information Agency, “Weekly U.S. Retail Gasoline Prices, Regular Grade” (March 2008): www.eia.doe.gov/oil_gas/petroleum/data_publications/wrgp/mogas_home_page.html.

59 “Consumer Confidence Lowest Since 1982,” CNNMoney.com (April 25, 2008): http://money.cnn.com/2008/04/25/news/economy/consumer_confidence/?postversion=2008042511.

60 Julie Jargon, Ann Zimmerman, and David Kesmodel, “Grocers Tout ‘Sales’ Even as Prices Climb,” *The Wall Street Journal* (April 1, 2008).

standards of collaboration in sharing point-of-sale data with its many product suppliers (see page 32, “Working with Retailers’ Scan Data Provides Big Benefits”). Indeed, new levels of partnership between manufacturers and retailers may help meet the dual challenges of rising input costs and softening consumer demand by launching sustainable cost reductions across the supply chain and delivering enhanced consumer value and real solutions without raising consumer prices.

Collaborating to Build a Cost-Reduction Program That Lasts

The problem with most cost-reduction programs launched in a recessionary environment is that they tend to be highly reactive and unsustainable. A patchwork mentality prevails, with a tendency to focus simply on cutting discretionary expenses like travel or even advertising, instead of seizing the moment to redesign the underlying cost structure. To make the greatest impact, however, revamping the cost structure must focus on creating value for the consumer and must be executed *jointly* between CPG companies and their retail partners. Best practice manufacturers and retailers are focusing on three opportunities to collaborate to achieve these productivity enhancements: optimizing the product portfolio; rethinking product design, ingredients, and packaging; and enhancing the effectiveness of trade promotion spending.

Optimizing the Product Portfolio

Consumers make more than 70% of their purchase decisions in-store, according to a 2007 GMA study on shopper marketing.⁶¹ Yet, with limited retail shelf space, getting consumer attention and positioning products to greatest advantage on the shelf is more difficult than ever.

To capture consumer attention, manufacturers have tried introducing multiple new product lines and product line extensions, but these efforts can backfire. Indeed, based on new product sales tracked by Information Resources Inc. (IRI), less than 2% of new brands achieve revenues greater than \$50 million.⁶² One answer to this problem is product portfolio rationalization. Instead of spending time and money promoting a third or fourth brand in a category that retailers may not want anyway, manufacturers need to refocus on core brands that drive growth and profitability. Because retailers are ultimately the ones who set the shelves, their input needs to be included in any product line discussion. Manufacturers can collaborate with retailers, for instance, to develop the right product category plans based on consumer segments and point-of-sale data.

To optimize the value it gets out of its product portfolio, Procter & Gamble Company (P&G) divides its brands into four groupings, by performance: “leading brands” are those 41 brands with sales of \$0.5 billion or more, representing more than 80% of sales and 90% of profits; “future stars” are small brands built on proprietary technology or unique positioning, that have real potential to become billion-dollar businesses someday; “local jewels” are unlikely to become global leaders, but are well-known brands in particular geographies; and “underperformers” are brands that don’t have a unique value proposition and don’t deliver acceptable margins or cash flow. This categorization improves the productivity of P&G’s portfolio by flowing resources to brands most likely to generate superior consumer and shareholder value. “Future stars” are nurtured with the investment in resources they need to reach their full potential. “Local jewels” are preserved as long as they have a meaningful role to play. “Underperformers” are consolidated, divested, or discontinued.⁶³ Ultimately, both P&G and retailers benefit by having store shelves stocked with the right products that consumers actually want to buy.

61 GMA/Deloitte Consulting, *Shopper Marketing: Capturing a Shopper’s Mind, Heart and Wallet* (2007): www.gma-brands.com/publications/docs/2007/shoppermarketing.pdf.

62 Information Resources Inc., *New Product Pacesetters* (2007).

63 A. G. Lafley presentation, Consumer Analyst Group of New York (CAGNY) Conference, Boca Raton, Florida (February 21, 2008). Transcript: Thomson StreetEvents.

Rethinking Product Design Ingredients and Packaging Complexity

Today, the same product is often packaged in many different ways to accommodate different “retailer formats” — a package of six cookies for convenience stores, a standard package for grocery stores, and perhaps even a bulk package for wholesale clubs like Costco. With the expansion of these different retailer formats, packaging complexity has increased dramatically to serve their unique needs. Indeed, sometimes there’s no real business case for multiple package types, apart from satisfying retailer formats. If CPG companies work jointly with retailers to both understand and validate the consumer benefits and cost implications of packaging, significant savings can be realized.

Consumer research by General Mills, for instance, showed that most shoppers care more about the variety of pretzel flavors than the number of shapes, so the company reduced the number of pretzel shapes in its Chex and other snack mixes from 14 to 3. It also cut the number of pasta shapes it uses in Hamburger Helper in half, and food engineers and marketers even worked on the 10 remaining pasta shapes so they nestled together more closely, thus allowing for a smaller box. The result? General Mills now makes those same products with a 10% savings in the cost of raw materials.⁶⁴ In another example, ConAgra Foods, Inc. saved over \$20 million by reducing the number of can sizes from 100 to 20 on products ranging from Hunt’s tomato sauce to Van Kamp’s beans — part of a larger drive for \$225 million in cost savings for the company’s 2009 fiscal year.⁶⁵

Given rising ingredient prices, companies are also examining opportunities to narrow down ingredients or new formulations without compromising taste or value to consumers. Most of these efforts to date have focused on legacy products, but taking these insights and applying them to new product development offers a major opportunity.

Working with Retailers’ Scan Data Provides Big Benefits

For both retailers and CPG companies, knowledge of consumer purchasing patterns is power. Many large manufacturers are working closely with their retailers to glean value from the scan data created at the point of sale (POS). Scan data can provide real-time, detail-rich transactional data about which products are selling well and where, which products need improvement, and which should be discontinued.

Hershey chocolate bars, for example, sell in all manner of retail settings, and the company has three distinct ways of getting at the POS data generated by its retailers. First, Hershey receives unfiltered, direct POS data from some of the large retail drugstore chains, like Walgreens. Second, it receives specifically targeted data from the bigger retail chains like Target and Wal-Mart, which have their own proprietary systems to manage data collected from customers. Wal-Mart’s Retail Link, for example, captures sales, inventory, and delivery data for every stock-keeping unit (SKU) at every Wal-Mart facility. Hershey maintains a dedicated database for Retail Link data, which means it enjoys one convenient place for what Hershey CFO Bert Alfonso calls “very high quality” consumer data. “Retail Link provides us the ability to understand what has velocity, what doesn’t have velocity, and tests our assumptions around a particular price point or around the length of time we should be running a promotion,” says Alfonso.⁶⁶

A third way Hershey accesses data is through third-party research performed by companies like IRI and Nielsen, providers of consumer, shopper, and retail market information. According to Alfonso, “These companies do give you a broader reach and it comes in one data set to manage.”

In another example of sharing scan data, the Campbell Soup Company and its retailers use scan data to gain a better understanding of the effects of pricing and promotion on consumer demand. Campbell reviews scan data in slices related to specific promotional events and projects, enabling it to better understand what promotions are successful and why. Campbell CFO Bob Schiffner thinks the company — indeed, the industry as a whole — is just now realizing how valuable scan data will be: “This area has changed more than any other in the last 20 years,” he says. “We think that there is a lot of gold in mining scan data.”⁶⁷ PricewaterhouseCoopers will be exploring the enormous potential of scan data in a forthcoming white paper, which follows up on a 2008 white paper discussing more informal consumer data, *How Consumer Conversation Will Transform Business*.

64 Judith Crown, “Food: Always Room for Profits,” *Businessweek.com* (February 21, 2008): www.businessweek.com/bwdaily/dnflash/content/feb2008/db20080220_009749.htm.

65 ConAgra presentation, Consumer Analyst Group of New York (CAGNY) Conference, Boca Raton, Florida (February 21, 2008). Transcript: Thomson StreetEvents.

66 PricewaterhouseCoopers interview (April 18, 2008).

67 Gartner, “Making Sense of the Direct Point-of-Sale Options in the Consumer Goods Industry” (June 8, 2007): <http://mediaproducts.gartner.com/reprints/oracle/148112.html>.

Jointly Planning and Implementing Trade Promotions with Retailers

Trade promotions, which generally represent the largest component of marketing expenditures for CPG manufacturers, offer considerable room for collaboration and joint planning with retailers, who also want to attract loyal consumers into their stores and grow category profitability by driving sales of higher-margin brands.

Many manufacturers and retailers are already enjoying the results of such efforts, according to a survey published last year by DemandTec.⁶⁸ Indeed, 92% of retail grocers responding to the survey reported that collaboration was “very important” to future success. Other key benefits of collaboration cited by top manufacturers and retailers included “more effective and efficient planning” (cited by 83% of retailers and 68% of manufacturers, putting it at the top of the list), “revenue growth” (reported by 75% of retailers and 53% of manufacturers), and increased ROI.⁶⁹

Consider Hershey, which works with its retail partners to track how promotions of new products pan out under different scenarios. For example, the company discovers, through POS data provided by the retailer, whether it’s better to promote a new product on its own or in tandem with one of the company’s well-known core products, such as a Hershey Milk Chocolate Bar or a Reese’s Peanut Butter Cup.⁷⁰

When Clorox set out to improve trade promotional effectiveness in 2002, it conducted a study of several thousand promotional events across all product categories to measure the incremental ROI of each event. It used the study’s findings to issue guidelines for all future promotional events, and today Clorox performs ROI modeling and post-promotion event analysis, benefiting both itself and its retail partners.⁷¹

In another example, Kimberly-Clark CFO Mark Buthman says that his company continuously monitors its trade promotions to ensure that their resources go to support the brands and drive their business with strategic customers, and that it uses a pay-for-performance model.⁷²

Partnering to Provide Products for Health and Wellness

Health and wellness isn’t just about the “graying of America” and an older U.S. population wanting healthier meals. It’s a consumer desire that cuts across every age group and geography — people simply care more about the quality of what they’re eating. Indeed, as tracked by IRI, the top ten new food and beverage products launched in 2006–2007 were products that helped consumers meet their dietary, disease-fighting, and weight goals, without sacrificing taste. Examples included Campbell’s reduced-sodium soups, with 25% less sodium than traditional Campbell’s, and Birds Eye Steamfresh frozen vegetables, which meet consumers’ desire for steaming, perceived as a healthier cooking method. DanActive yogurt drinks and Dannon Activa Light yogurt are two other examples of successful new health-oriented product lines.

Retailers have made enormous efforts to attract higher-income customers with fresh and organic products. In Chicago, Safeway Inc.’s “lifestyle stores,” including most of those under the Dominick’s brand, have an entire line of private-label “O” organic products that enjoy their own separate section of each store. Whole Foods’ higher-than-average price structure is in large part based on its branding effort as a purveyor of healthy, organic foods. Trader Joe’s has created a competitively differentiated format based almost entirely on its own premium private label and internationally sourced products.

68 DemandTec, *Secrets of Success: Promotion Collaboration* (2008): www.demandtec.com/pdf/DemandTec_Collab0108.pdf.

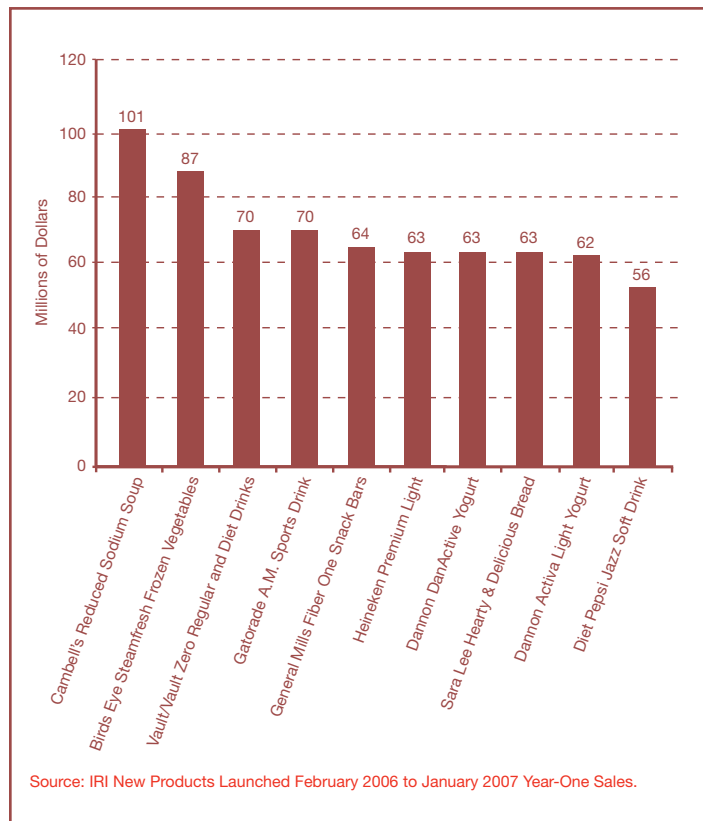
69 Ibid.

70 PricewaterhouseCoopers interview with Hershey CFO Bert Alfonso (April 18, 2008).

71 PricewaterhouseCoopers interview with Clorox CFO Dan Heinrich (April 21, 2008).

72 PricewaterhouseCoopers interview (April 25, 2008).

Exhibit 20: IRI Top Ten Food & Beverage New Products Launched, Year-One Sales (Food, Drug, Mass Retailers, Excluding Wal-Mart)



As more retailers use premium private labels as a means of competitive differentiation, manufacturers will be exposed to a higher risk of category share loss. To prevent this, manufacturers can partner with retailers to build health and wellness brands that draw the consumer to both the retailer's and the manufacturer's products. Some manufacturers are already doing just that: Kellogg's Kashi line of healthy cereal and breakfast bars, for instance, has grown at an astonishing 40% over the past five years, and Clorox recently acquired the health and wellness brand Burt's Bees, which enjoys considerable shelf space at Whole Foods.

For years, the dearth of robust collaboration between consumer product groups and retailers and manufacturers was easy for both sectors to overlook because of the strength of the American consumer. Today, however, slower growth and tougher economic conditions have exposed a gulf between retailers and manufacturers. The good news is, there's ample room for productive collaboration on many fronts.

Key Questions

- How sustainable are our cost-reduction programs and initiatives? Have we merely cut costs in the short term, or have we restructured our cost base to ensure there's no cost creep?
- How do we balance the time and effort spent on product portfolio optimization and SKU rationalization versus the time spent and cost of new product launches and brand extensions? How much retailer input do we use in optimizing the product portfolio?
- Do we create a business case for every packaging redesign performed to meet the needs of the different retail formats, or is this a knee-jerk response to requests from retailers and the sales force? What percentage of these redesigns would be considered a success?
- How much consumer insight do we use in designing trade promotions? Do we understand why, when, where, and how consumers purchase our brand and the implications trade promotions have on the premium they place on the brand?
- Do we truly understand trade promotional profitability at a retail store level and design promotions accordingly?
- Are we taking advantage of opportunities to work with retailers in growing brands to enhance the health and well-being of our consumers?

Section 2

Insights into the Retailer Landscape

Retailers Seek New Formula for Success

In several ways, 2007 was a watershed for retailers. A surge in commodities prices and other input costs prompted food and beverage companies to look for innovative ways to maintain margins without passing higher costs on to the consumer. Continued economic weakness in 2008 serves to remind retailers that what U.S. consumers want is value, and savvy companies are already adapting by rethinking their approach to international markets, actively responding to a growing market for healthy foods, introducing innovative product lines, and forging collaborative relationships with suppliers to better understand their customers.

Facing a myriad of significant challenges — rising costs, sluggish U.S. economic growth, a weak dollar, and declining consumer confidence — forward-looking American retailers are trying to devise a new formula for future success. What's particularly unique about the current slate of challenges is their context: Last year marked the end of a long period of U.S. retail market expansion, a period of growth fueled largely by consumers leveraging their homes and other assets to ramp up their purchasing power.

At the same time, however, food costs rose in the U.S. and abroad, increasing by nearly 40% globally, according to the United Nations' Food and Agriculture Organization.⁷³ Such global food price trends — soaring global prices for rice futures, for instance, which led to decreased rice exports in India — have made some U.S. retailers nervous. In late April, two of the biggest U.S. warehouse wholesale clubs, Sam's Club and Costco, began limiting the amount of jasmine and basmati rice that its customers could purchase to four 20-pound bags per customer (regular rice was not restricted).⁷⁴ The move was indicative of a retail market that has grown more than a little jumpy about fluctuations in overseas production of basic commodities.⁷⁵ The reality was that grocery prices had, in fact, begun to sting the U.S. consumer, with overall prices jumping 5% — the biggest increase in 17 years⁷⁶ — and the price for some products, such as eggs, forecast to skyrocket above the global food average in 2008, to 48%.⁷⁷

Indeed, the unparalleled, explosive economic growth in developing economies has created a volatile dynamic, altering the traditional calculus governing the supply and demand of raw materials and commodities in ways that will likely shape the retail business environment for the foreseeable future. With crops like corn now used for both food and fuel, for example, food and beverage companies are facing competition, and thus higher prices, for raw products critical to their ability to meet customer demand. Taken together, these factors create a daunting economic environment for retailers, one that savvy companies will navigate by significantly shifting their current strategies.

73 Javier Blas and Jenny Wiggins, "Expensive Tastes: Rising Costs Force Food Up the Political Agenda," *The Financial Times* (March 17, 2008): http://us.ft.com/ftgateway/superpage.ft?news_id=fto031720081608184319.

74 Marcus Kabel, "Sam's Club, Costco Limit Rice Sales," *The Associated Press* (April 24, 2008).

75 Parija B. Kavilanz, "Don't Get Steamed over Stores' Rice Limits," *CNNMoney.com* (April 24, 2008): http://money.cnn.com/2008/04/24/news/companies/rice_issues/index.htm?postversion=2008042416.

76 Julie Jargon, Ann Zimmerman, and David Kesmodel, "Grocers Tout 'Sales' Even as Prices Climb," *The Wall Street Journal* (April 1, 2008): <http://online.wsj.com/article/SB120700801699678747.html>.

77 Ron Sterk, "Soaring Egg Prices Show Signs of Easing," *FoodBusinessNews.net* (April 1, 2008): www.foodbusinessnews.net/feature_stories.asp?ArticleID=92408.

Meeting the Consumer's Demand for Value

Last year in this space we wrote about companies becoming more consumer-centric. Retailers are continuing this focus and, as consumers face higher unemployment and a potential decline in the value of their homes, retailer strategies include a laser-like focus on consumers' increasing orientation toward value.

Price, of course, is a key component of value, but it is not the sole contributor. In fact, despite the rapid gains in food prices worldwide, average dollars targeted for food in American and European households actually decreased from 30% of total expenditures to less than 10% over the past three decades.⁷⁸ Beyond price, consumers also are associating value with products that contribute to a more active and healthy lifestyle, make less of an impact on the planet, and are available where and when consumers want them and in a style that's attractive and user-friendly.

Exhibit 21: Change in Consumer Price Index for Food (Year-to-Year Percent Change, Seasonally Adjusted)

	2004	2005	2006	2007*
Food at Home	3.8	1.9	1.8	3.9
Cereals and Bakery Products	1.4	1.4	1.9	4.1
Meat, Poultry, Fish, and Eggs	7.3	1.7	1.0	4.7
Dairy and Related Products	7.4	1.2	(0.6)	5.4
Non-Alcoholic Beverages	0.4	2.9	2.1	4.2
Sugar and Sweets	0.7	1.2	3.8	3.0
Fats and Oils	0.7	1.2	3.8	3.0
Other Prepared Foods	0.5	1.5	1.4	1.5
Food Away from Home	3.0	3.2	3.1	3.5

* Through September 2007. Source: U.S. Bureau of Labor Statistics

Yet the systemic nature of rising prices — with energy costs affecting producers, consumers, and retailers — makes the consumer's demand for different kinds of value more difficult to meet. In 2007, prices for everything from milk to fish to meat to cereal spiked (see Exhibit 21).

With pricing difficult to contain, it's even more important that retailers find other ways to provide value to consumers. Perhaps it's not surprising that many of these avenues to value — looking to new geographies for growth, introducing healthier foods and products, forming more productive partnerships with manufacturers, and sharing technology to leverage proprietary scan data — are discussed elsewhere in this report as paths to success for manufacturers. The first we'll talk about, though, is specific to retailers: continuing to be creative with store formats.

Creating Value through Evolving Store Formats

One way retailers are trying to provide value to more consumers is by attempting different format changes to lure consumers into stores and improve their shopping experience. Royal Ahold's Stop & Shop, for instance, has emerged as an innovator in adding value through product presentation and "funneling" the shopper toward certain choices. First, Stop & Shop de-cluttered shelves by reducing the number of products, providing the consumer with clearer product choices. Then, it separated products into three specific ranges of pricing: lower, middle, and premium. This more distinct pricing, as it turns out, appeals to a wider audience, helps Stop & Shop attract new customers, and gives all customers an easy-to-navigate purchasing framework. At the same time, reducing the number of products in its stores has enabled Stop & Shop to reduce its own costs.⁷⁹

⁷⁸ "Tightening Belts," *The Economist* (April 10, 2008): www.economist.com/business/displaystory.cfm?story_id=11021146.

⁷⁹ Royal Ahold, "Building Our Brands for Profitable Growth" (2006): www.ahold.com/page/4695.aspx#EJCA.

Some of the largest grocery retailers are adapting to these changes in consumer shopping behaviors by becoming multi-format operators. Tesco's Fresh & Easy Neighborhood Markets, launched in the U.S. in November 2007, are designed at roughly 10,000 square feet to provide customers with a faster, easier shopping experience. Similarly, Giant Eagle's Giant Eagle Express concept seeks to cater to consumers making numerous short shopping trips by combining convenience, drug, and grocery channels in a 14,000-square-foot format. For upscale urban consumers, Wal-Mart is testing Marketside, a small-format grocery store that's 90% smaller than the typical Wal-Mart superstore.⁸⁰

Another such example is Safeway, which has spent approximately \$2 billion reformatting its stores. The retailer once offered products under a single format, but now has introduced several different types of stores that cater to different demographics — for instance, a new format introduced in certain urban areas that caters primarily to the Latino market, one of the faster-growing demographics among U.S. shoppers.

Another Key to Value: Meeting Expectations of Healthier Consumption

The consumer-centric value proposition extends well beyond pricing and convenience. Consumers also derive more value from healthy consumption. This includes not only their own personal health and that of their families, but, increasingly, the health of our planet as well.

Basic shifts in U.S. demographics, including an overall aging of the population, have brought about a sea change in demand and choice, with more and more consumers interested in improving their health and longevity. Greater consumer awareness of food and dietary issues, along with rising consumer concern over the long-term social and economic costs of obesity and other food-related diseases, has forced retailers to rethink how they package and apportion food sold in grocery stores. Recent regulatory initiatives addressing citizens' health, such as New York City's ban on artificial trans fats in restaurant foods, point out further risks for the industry. According to a 2007 International Food Information Council survey, in fact, 75% of U.S. consumers feel that food and nutrition play the greatest role in maintaining or improving health.⁸¹ By no means is this simply an American phenomenon, as emphasis on more healthy consumption is occurring on a worldwide basis. Over half of Europeans in seven major markets have taken steps toward eating healthier on a more regular basis, with researchers finding similar behaviors in Asia.⁸² As for how retailers are responding, Wal-Mart's urban test-format store features a higher-than-average offering of organic products, while Tesco's new smaller-format concept clearly states its convenience and healthy consumption orientation in its name: Fresh & Easy. Meeting the trend for healthy consumption also depends, in

80 James Quinn, "Walmart to Mimic Tesco's Fresh and Easy," *The Daily Telegraph* (May 18, 2008): www.telegraph.co.uk/money/main.jhtml?view=DETAILS&grid=&xml=/money/2008/05/16/cnwalmart216.xml.

81 Carolyn O'Neil, "Good, Bad, Ugly Fat Facts," *The Atlanta Journal-Constitution* (July 3, 2007): www.ajc.com/blogs/content/shared-blogs/ajc/healthyeating/entries/2007/07/03/good_bad_ugly_fat_facts.html. See also: International Food Information Council, *2007 Food & Health Survey: Consumer Attitudes toward Food, Nutrition & Health* (May 22, 2007).

82 Datamonitor, *Moderation and Avoidance Trends in Food and Drinks: Implications for "Better-for-You" Offerings* (July 12, 2006): www.marketresearch.com/product/display.asp?productid=1526852&g=1.

large measure, on providing the right product mix. For this, retailers rely upon product development breakthroughs from manufacturers. One example of such successful innovation comes from ConAgra and its reenergized Healthy Choice brand, which is projected to generate \$100 million in sales in 2008 through improved frozen dinner taste and texture and creating consumer awareness about healthy recipes.⁸³

“Health and wellness is where the consumer is going,” says Kraft Foods CEO Irene Rosenfeld.⁸⁴ Kraft has tapped into the South Beach Diet’s renowned brand with its South Beach Living line of foods, and General Mills has introduced its Curves line of snack bars, created in partnership with the fitness and weight-loss franchise. But innovation doesn’t always mean manufacturers must go back to the drawing board to create a line of new, healthy products. According to Rosenfeld, “The forms within our health and wellness brands — the 100 Calorie Pack, Snack and Seal, the re-useable packages and other convenient forms that allow the consumer to control portions — are doing quite well, growing at 4% to 5%, five times the rate of our base business.”⁸⁵ Indeed, much like the trend toward smaller portions in restaurants, some grocery retailers are using this “less-is-more” or “portion control” philosophy to offer healthier, smaller-sized products — smaller candy bars and cans of soda, for instance, or 100-calorie offerings of snacks like cookies and chips.

Sustainability and the Retail Space

Environmental regulations are expected to reshape the retail environment, as they’ve already reshaped the manufacturing space. “Green” or sustainable practices will demand more management time and attention, but will also pay tremendous dividends in corporate performance and in building consumer trust and loyalty. Indeed, a Food Marketing Institute survey last year suggests that 92% of consumers think it is important for the U.S. food industry, both food manufacturers and retail supermarkets, to be more proactive about addressing environmental concerns.⁸⁶ Almost 90% of those surveyed last year said they were interested in “eco-friendly” products, with 30% saying they actively look for such products.⁸⁷ Perhaps most importantly, green and organic shoppers are 59% more loyal to their chain, in terms of their share of grocery expenditures — more than twice as loyal as the average consumer.⁸⁸

Going Global

The quest to deliver more value to customers will likely lead retailers to continue looking overseas both for market expansion and to achieve cost efficiencies. Current conditions in the U.S., epitomized by last year’s GDP growth rate of 2.2%, make the BRIC nations and other emerging economies appear even more tantalizing. While the notion of “going global” has been a mantra for the past 20 years, recent explosive growth in middle-class consumer markets in China and India, and their accompanying purchasing power, has made it an even more compelling strategic option.

But as we point out in this report’s “Global Growth Opportunities: Balancing the Risk” section (page 7), global expansion must be weighed against very real risks, including a potentially unwieldy supply chain, tariff and trade restrictions, compliance with the Foreign Corrupt Practices Act, reputational and ethical risks associated with subcontractors and joint-venture partners, and the expense associated with building a presence and acquiring local business knowledge.

83 ConAgra presentation, Consumer Analyst Group of New York (CAGNY) Conference, Boca Raton, Florida (February 21, 2008). Transcript: Thomson StreetEvents.

84 KFT/Kraft Foods presentation, Consumer Analyst Group of New York (CAGNY) Conference, Boca Raton, Florida (February 19, 2008). Transcript: Thomson StreetEvents.

85 Ibid.

86 Food Marketing Institute PowerPoint presentation, “The Sustainability Opportunity for Retail and Wholesale Executives” (2007–2008): www.fmi.org/docs/sustainability/Sust_Opp_101707.ppt.

87 Ibid.

88 Ibid.

Moreover, the rising consumer classes in BRIC nations have spawned well-capitalized and aggressive domestic competitors. For instance, India's largest retailer, Pantaloon Retail, operates 1,000 stores and is, literally, growing daily. In March 2008, same-store year-over-year sales growth registered 18%, 12%, and 25% for its clothing, food, and housewares outlets, respectively.⁸⁹ In China, the retail landscape is also highly competitive, with the top 100 chain stores operating 105,000 outlets and reporting sales of approximately \$1.3 trillion, an increase of 17% over the prior year, according to the China Chain Store and Franchise Association.⁹⁰ Clearly, neither the retailers in India nor those in China are going to back down in the face of foreign competition.

As we pointed out earlier in "Making Indirect Taxes Visible, Manageable, and Measurable" (page 19), retailers can also employ a rigorous front-end assessment and decision-making process regarding the cross border transfer of finished materials and some raw materials. Such a system means that the global procurement and transportation of a company's assets can be far better planned and executed, leading to lower indirect taxes and a safer and more efficient supply chain. Indeed, when it comes to selling products produced overseas, retailers must be exceedingly careful about product quality. During the past year alone, there have been product recalls linked to tainted ingredients in Chinese-made pet food, toothpaste, and toys. In June 2007, the U.S. Food and Drug Administration rejected approximately two dozen shipments of fish from China because of suspected contamination.⁹¹

There's an old saying that smooth seas do not make good sailors. Though it may be hard to endure the pain now, the imperative to deliver customer value during this "perfect storm" of soaring input costs, falling U.S. economic growth, and a wary U.S. consumer may ultimately deliver improvements for all stakeholders.

89 Pantaloon Retail (India) Limited, "Investor Update" (March 2008): www.pantaloon.com/mar08.pdf.

90 Rachel Liu, "Brief: Top 100 Chain Stores Hit Trillion Mark in 2007 Sales," *Emerging China* (April 15, 2008): www.emerging-china.com/articles/809604.html.

91 U.S. Food and Drug Administration, "FDA Detains Imports of Farm-Raised Chinese Seafood" (June 28, 2007): www.fda.gov/bbs/topics/NEWS/2007/NEW01660.html.

Section 3

Achieving Superior Returns: Financial Performance Metrics

In the past year, the “R word” — recession — has been on the minds of consumers, retailers, and manufacturers alike. Despite the trends that indeed suggest an economy approaching negative growth, the hard numbers that PricewaterhouseCoopers has analyzed reveal a robust CPG industry in 2007.

The general lesson of the data can be characterized this way: *Don't be distracted by short-term volatility*, because the long-term trends tell a much more compelling story. Take CPG manufacturers' one-year shareholder returns, for instance, which dropped significantly from 11.8% in 2006 to 7.3% in 2007. Time to sound the alarm? Maybe, but before we do, it pays to understand just how loud and hard to ring it. The three-year and five-year trends are decidedly upward. Total annualized five-year shareholder return, for instance, reached double digits (10%), indicating that investors have great confidence in the industry's future growth.

While it may be too early to start popping the champagne or pushing the panic button — rising input costs and lower consumer spending remain major challenges — these lean times have obliged industries large and small to rededicate themselves to improving operations. From optimizing product lines, to improving sustainable practices, to better managing cash conversion cycles, CPG companies are taking actions that bode well for the long term.

What follows is a set of key financial reporting metrics relevant to the CPG industry group. The companies analyzed 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 data.⁹² To provide a balanced perspective on overall company performance, this report includes four types of metrics, which are provided for different company sizes (see Exhibit 22) 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. Overall return (e.g., total shareholder return, return on market capital)

Exhibit 22: Size Segmentations for Financial Reporting Metrics

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

⁹² A detailed summary of the methodology and sources can be found in Appendix A.

Manufacturer Overview

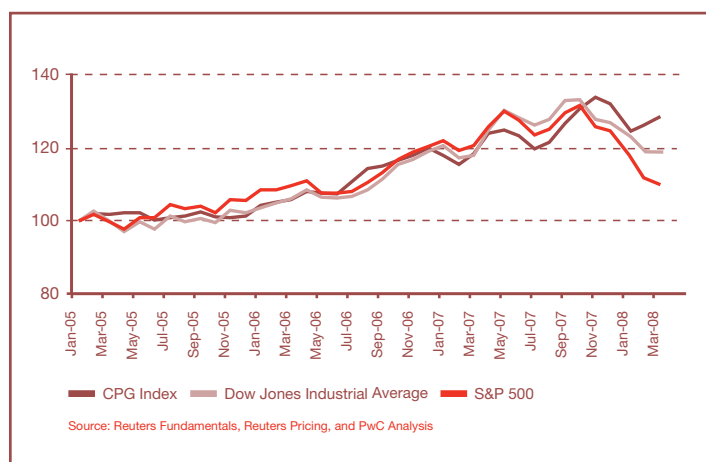
Economic Fundamentals Remain a Challenge, but Manufacturers Keep Outpacing the Broader Stock Indices

The industry's performance has remained relatively strong despite the threat of a market downturn, a softening in consumer spending, and higher commodity and input costs. Even with these challenges, an aggregate market index, referred to as the CPG Market Weighted Index, closely tracked the S&P 500 and Dow Jones Industrial Average for most of 2007 and was in line with them for the first two years of the three-year period 2005–2007 (see Exhibit 23). The fact that the CPG industry outperformed the S&P 500 is further evidence of investors' positive outlook for the industry and its ability to generate future growth and positive earnings.

Overall CPG Gross Margins Dip Due to Higher Cost of Goods Sold⁹³

During 2007, the CPG industry responded aggressively to increased input prices with commodity hedging practices and some necessary price increases. Still, gross margins for the industry as a whole dipped for the year. Gross margins for both the beverage and household and personal care sectors dropped slightly in 2007, while food companies actually posted slightly higher gross margins, even though they likely bore the brunt of input cost increases. One plausible explanation for food companies' higher margins is that a good many of the companies in our survey population sell large amounts of commodity food — much of which is priced at historic highs — and those sales somewhat offset the whole segment's gross margin results.

Exhibit 23: CPG Index vs. S&P 500 and Dow Jones Industrial Average (3 Years through March 2008)



93 Unless otherwise noted, comparisons in this section are based on median values.

Overall net sales increased among CPG manufacturers, with net sales growing 10.6% last year, an uptick driven by higher sales growth in all three sectors. As discussed in Section 1 of this report, rising costs and slowing consumer spending have provided manufacturers the impetus to implement new and creative strategies along the entire value chain, from focusing more closely on product mix to rethinking how they source raw materials.

Between 2006 and 2007, industry earnings (as measured by EBIT) increased a healthy 15.1%, though performance varied by sector and company size. Household product company earnings, for instance, jumped ahead of food and beverage companies by several percentage points during the past two years, and medium-size companies slightly outperformed both large and small companies in earnings growth. Smaller companies, though, continue to experience lower employee productivity growth than medium and large companies, which enjoy more favorable economies of scale.

Exhibit 24: Median Manufacturer Employee Productivity Growth (by Company Size)

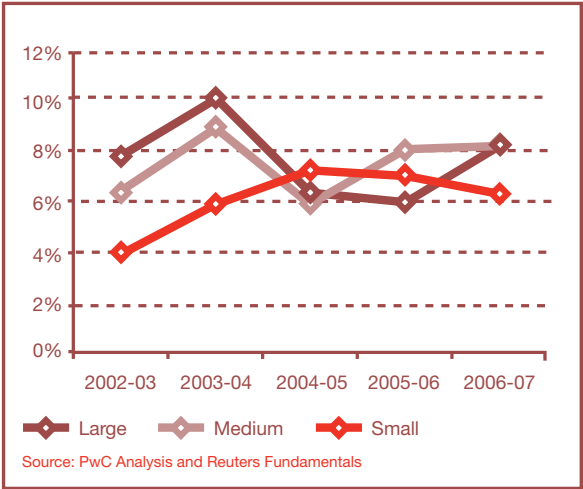
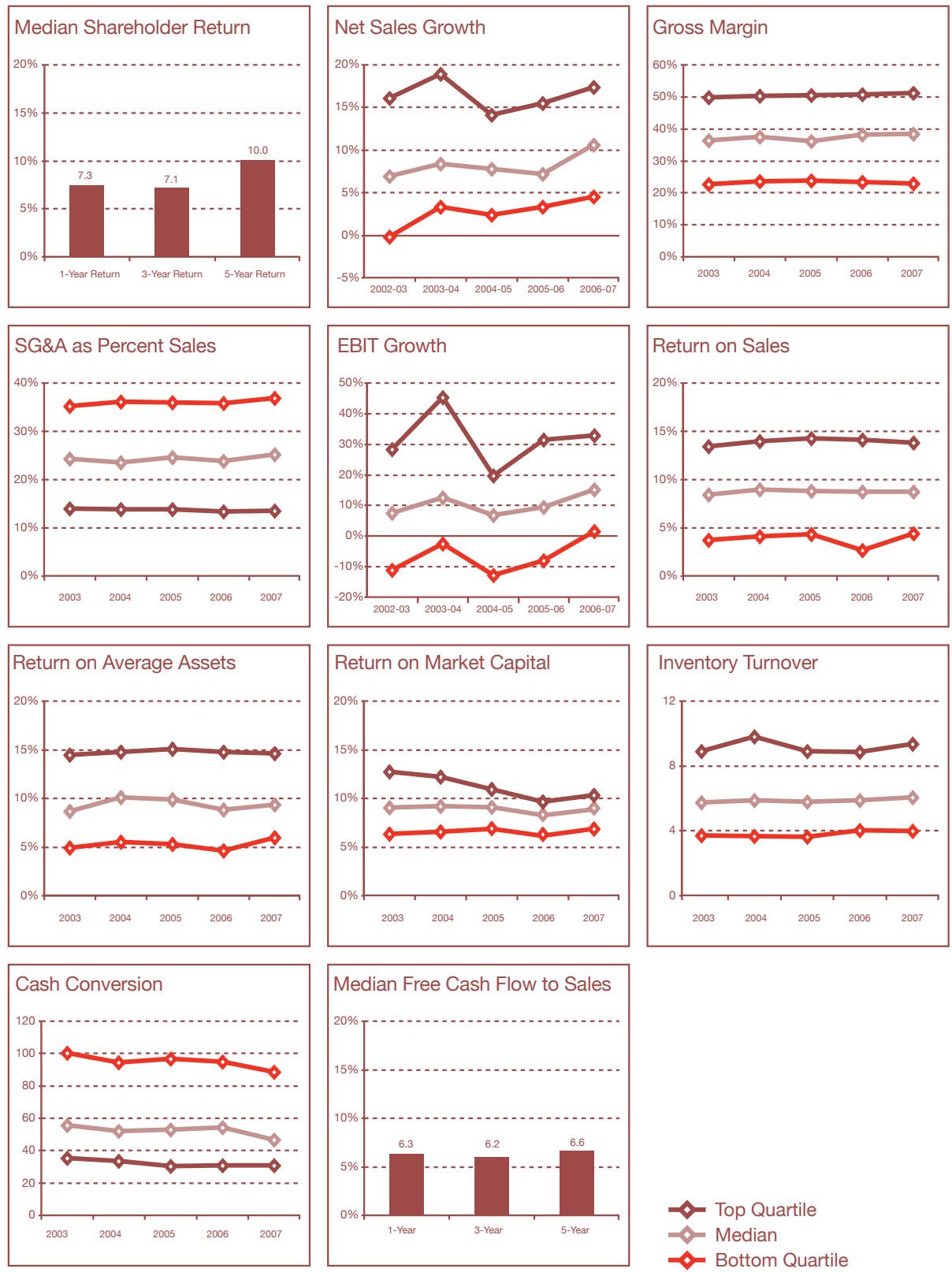


Exhibit 25:
Overall CPG
Industry,
Manufacturers
(Companies
> US\$50M)



Source: PwC Analysis, Reuters Fundamentals, and Reuters Pricing

Manufacturers Relative to Retailers

CPG retailers and manufacturers both experienced a drop in shareholder returns in 2007, with manufacturers posting a 7.3% return compared to 11.8% in 2006, and retailers posting a 12.2% return compared to 16.2% the prior year. Over the last five years, retailers' shareholder returns have consistently outperformed those of manufacturers, with five-year returns for retailers at 14.7% and manufacturers at 10.0%. Moreover, in the last two years manufacturers' EBIT growth — another important indicator that has trailed the retail sector for five years — has begun to rival the EBIT growth rate of the retailer sector, and may soon surpass it if the current trend continues. Manufacturers also have exhibited consistently higher rates of cash generation, and their free cash flow as a percentage of net sales is more than four percentage points higher than the cash flow results for retailers — 6.3% versus 1.8%.

Manufacturers' Cash Management Improves Due to Enhancements in Collection Processes and the Supply Chain

An example of the powerful effect of improved efficiencies over the long haul is a general decrease in the cash cycle, driven primarily by continuous improvements in supply chain and consumer collection processes. The cash management improvements came in three different areas: gains in inventory turnover, fewer days sales outstanding, and greater days payable outstanding.

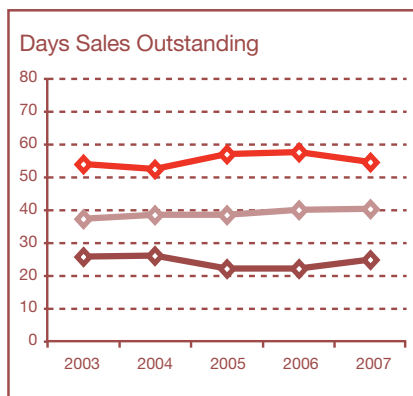
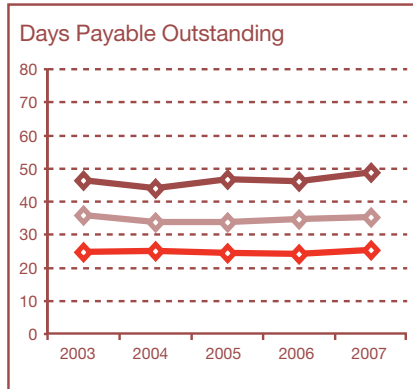
Gains in inventory turnover were seen in specific CPG manufacturing segments, with the greatest gains in the food sector. Days payable outstanding increased considerably between 2006 and 2007, particularly for the top quartile, meaning manufacturers were able to hold onto cash longer. Conversely, days sales outstanding decreased significantly for the top quartile between 2006 and 2007, reflecting more effective consumer collection processes.

In fact, one could posit that manufacturers are, in a way, becoming “more like retailers” in the way that they manage cash. Historically, long-term cash conversion cycles have differed significantly between retailers and manufacturers, largely because of the fundamentally different ways each sector does business. Retailers collect cash or credit card payments quickly, so the periods for days sales outstanding are vastly different for the two sectors: 6 days for retail, 35 days for manufacturers. Retailers, moreover, do not bear the financial burden of maintaining significant raw material inventories.

Now, however, manufacturers have improved their cash position relative to retail based on cash conversion metrics. The one-year free cash flow to sales ratio was 6.3%. This is close to the three-year free cash flow to sales ratio of 6.2% and the five-year ratio of 6.6%. The cash conversion cycle for manufacturers was reduced by more than a week, from 54 days in 2006 to 46 days in 2007, freeing cash for investing in new products, acquiring new lines of business, paying down debt, and other uses.

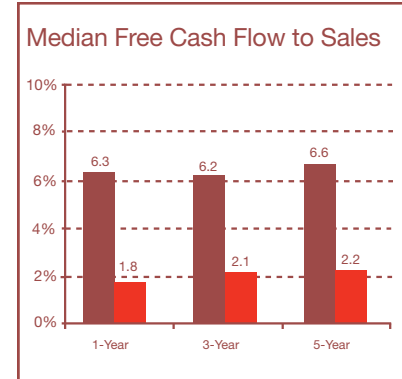
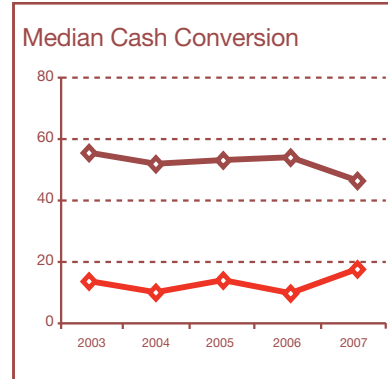
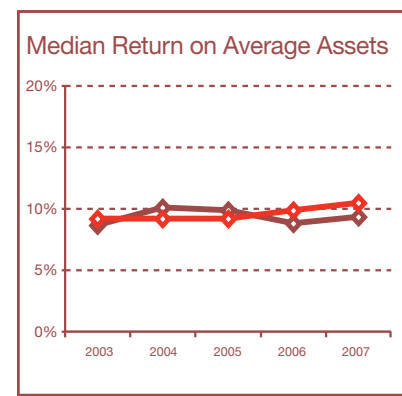
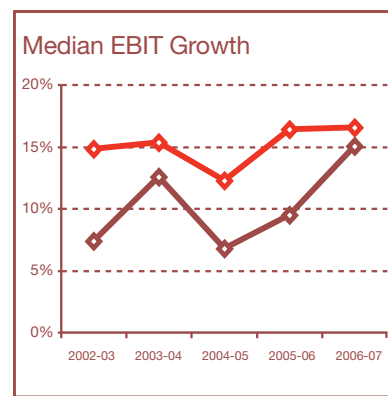
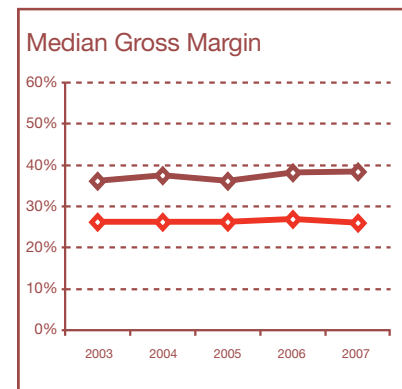
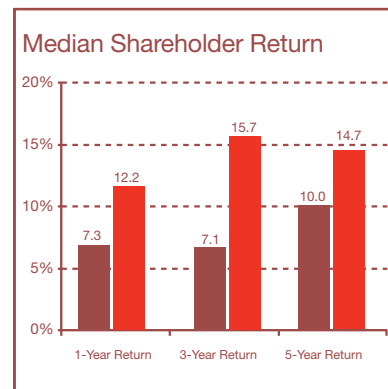
Now that we've compared the performance of manufacturers and retailers in 2007, it's time to dig deeper into the individual performance of the three sectors within manufacturing: food, beverage, and household products.

Exhibit 26: Manufacturers



Top Quartile
 Median
 Bottom Quartile

Exhibit 27: CPG Manufacturers Relative to Retailers



CPG Retailers
 CPG Manufacturers
 Retail
 Manufacturing

Source: PwC Analysis, Reuters Fundamentals, and Reuters Pricing

Manufacturers: Sector-Specific Analysis

Food Manufacturers

Food manufacturers continue to struggle with input costs. One-year shareholder returns for the sector were down 2.2% from 2006. Three-year and five-year shareholder returns also dropped compared to the previous year — to 5.6% from 11% for three-year returns and to 9.0% from 9.6% for five-year returns. But against these declines, the food industry still showed a year of healthy sales growth (from 5.1% to 8.2% in 2007) and slightly higher profitability (from 28.1% to 30.2% in 2007).

Other key highlights:

- Attempts to control non-input costs remain a challenge, with selling, general, and administrative (SG&A) spending increasing to 18.2% of net sales, from 17.6% in the previous year.
- While food manufacturers' growth in EBIT as a percentage of sales was robust, return on sales only increased mildly, from 5.4% in 2006 to 5.8% in 2007.
- At roughly 4% for each period, the one-year, three-year, and five-year free cash flow to sales ratio for food companies was the lowest of the three sectors.

Beverage Manufacturers

One-year shareholder returns for beverage manufacturers dropped almost by half, from 17.2% in 2006 to 8.9% in 2007. But again, the long-term situation looked much brighter, with the beverage industry posting three- and five-year shareholder returns of 14.4% and 12.0%, which were higher than the corresponding three- and five-year returns of 11.5% and 9.8% from the

previous year. These returns were also higher than the three- and five-year returns for the food and household product sectors. Net sales growth increased as well, from 8.4% in 2006 to 11.4% in 2007.

Other key highlights:

- A drop in gross margin from 46.1% in 2006 to 44.5% in 2007, partially due to higher cost of goods sold, was coupled with slightly lower SG&A spending in 2007.
- Cost increases outpaced net sales growth and resulted in a drop in return on sales, to 11.4% in 2007 from 13.4% in 2006.
- Inventory turnover dropped slightly, from 8.8% in 2006 to 8.6% in 2007, but remains at a fairly high level compared to the other two sectors.
- The cash conversion cycle for this set of companies improved (shortened) in 2007 relative to levels seen in 2003–2004, dropping from 43.8 days to 33.4 days; however, this is higher than the 26.7-day and 28.4-day levels seen in 2005 and 2006, respectively. The cash conversion cycle for beverages during the past five years was fairly low compared to those for the food and household products sectors.
- The one-year free cash flow to sales ratio was 11%, the highest of the three sectors. The three-year and five-year ratios of 10.7% and 10.3%, respectively, were also higher than those of the other two sectors.

Household Products Manufacturers

Household products manufacturers showed a strong 13.4% one-year shareholder return, as compared to an

annualized three-year return of 5.1%. This mirrors the trend of robust net sales growth in household products, which increased from 6.5% in 2005 and 7.8% in 2006 to 13.1% in 2007.

Other key highlights:

- The sector saw a sharp rise in profitability (EBIT) growth in 2007 compared to the past two years, increasing from -3.4% in 2005 to 11% in 2006 and 19.8% in 2007. This occurred despite a slight drop in gross margins, which decreased from 52.6% in 2006 to 51.4% in 2007.
- SG&A spending remained relatively steady, going from 36% in 2006 to 36.2% in 2007. The increase in EBIT while SG&A was relatively steady may signal that marketing-related SG&A spending was successfully targeted to more profitable consumer segments.
- The cash conversion cycle for this set of companies improved (shortened) in 2007 relative to levels seen in 2005 and 2006, dropping from 91 days to 86 days. The cash conversion cycle for household products during the past five years was fairly high compared to those for the food and beverage sectors.
- Free cash flow for this sector has been rising, with a five-year free cash flow to sales ratio of 8.4% and a one-year ratio of 9.4%.

Analyzing CPG manufacturer performance by sector is just one way of looking at the data. In the following pages, we again look at the performance of this same group of companies, but this time reported by company size.

Exhibit 28:
Sector-
Specific Data
(Companies
> US\$50M)



Source: PwC Analysis, Reuters Fundamentals, and Reuters Pricing

Manufacturers: Size-Specific Analysis

This discussion breaks down the performance of large, medium, and small manufacturers. To provide even more detailed information, we've further segmented these three categories to include two more groups: very large and very small manufacturers. Despite the dramatic headlines in the business press, large and extra-large posted solid total shareholder returns. One-year returns for large and medium companies were in line with three- and five-year returns, as these organizations are better able to handle higher commodity and input pressures, as well as growing retailer demands. Small companies continued to show the highest net sales growth, while large and medium companies had higher return on sales, return on average assets, and return on market capital.

Exhibit 29: Size Segmentations for Financial Reporting Metrics

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

Very Large Manufacturers (Net Sales > \$10 Billion)

These companies are the largest of the large, generally operating globally and able to reap the benefits of tremendous economies of scale. Results from these manufacturers are included in the previous manufacturer metrics overview and in the size- and sector-specific discussions. In fact, it's no coincidence that many of these companies were cited as examples in Section 1 of this report, as they have the resources, global breadth, and cash flow to do whatever it takes to improve performance.

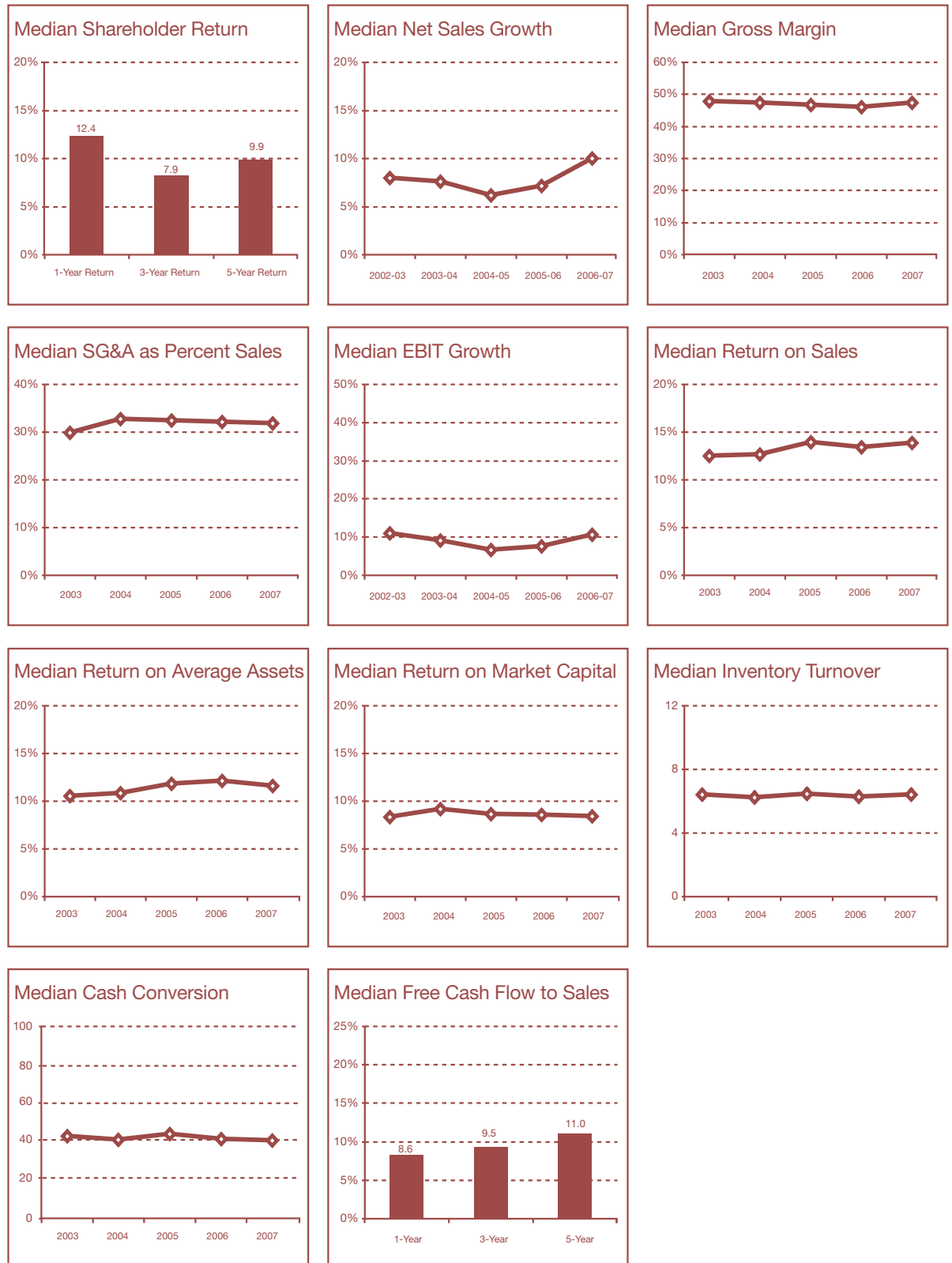
Shareholder return for these manufacturers was 12.4% on a one-year basis, up from the annualized three-year return of 7.9%. This one-year return was higher than the one-year shareholder return for the industry overall (7.3%) but lower than the 14.8% posted by large companies.

By their nature, very large manufacturers generate significant amounts of cash, which can be used for investments in new markets and products or for dividend payments. Indeed, over 85% of very large companies in our dataset paid dividends in fiscal 2007 — a jump of 15% from last year and substantially higher than manufacturers overall in the same time period. The one-year free cash flow to sales ratio for this category of manufacturer was 8.6%, 2.3 percentage points higher than the overall manufacturing percentage. One-year free cash flow to sales for very large manufacturers in 2007 was slightly lower than the three-year and five-year figures.

Other highlights:

- Very large companies continued to see strong increases in net sales growth, from 7.1% in 2006 to 10% in 2007.
- Profitability (as measured by EBIT) also increased, up from 7.6% in 2006 to 10.6% in 2007.
- SG&A as a percent of sales remained steady in 2007 compared to the prior year.

Exhibit 30:
Very Large
Manufacturers
(All Sectors)



Source: PwC Analysis, Reuters Fundamentals, and Reuters Pricing

Large Manufacturers (Net Sales > \$4 Billion)

Taking advantage of economies of scale, large companies (including the very large companies described in the previous section) continued to outperform smaller companies on several operating metrics. Large companies earned higher gross margins of 41% compared to 35.7% for small companies and 32.7% for medium-size companies. Large companies, moreover, were able to invest more money than the smaller companies in SG&A, which typically includes marketing expenses, sales expenses, the cost of media, and advertising. Large companies also were able to convert sales to cash more quickly than small or medium companies, enjoying a cash conversion cycle of 42 days in 2007, compared to 47 and 68 for small and medium companies, respectively.

Again, despite negative sentiment on the health of the U.S. economy, most of the financial data for large manufacturing companies offered good news.

Other highlights:

- Profitability, as measured by EBIT, was remarkably higher, at 15.1% in 2007 versus 4.7% in 2006.
- Net sales growth for the group of large companies was 10.1% in 2007, a healthy increase from 6.4% in 2006, primarily driven by price increases made to offset higher input costs.
- Inventory turnover for large companies increased slightly to 6.5 turns annually from 6.3 in 2006.
- Large companies consistently generated significant amounts of free cash flow, with a five-year free cash flow to sales ratio of 9.2% — significantly higher than those of either medium or small companies.

Medium Manufacturers (\$500 Million < Net Sales < = \$4 Billion)

Several key performance metrics for medium-size CPG manufacturers improved in 2007. Shareholder return topped the other size segments across the three-year and five-year windows but remained lower than that of large manufacturers in one-year returns. Net sales growth rose from 4.8% in 2006 to 9.9% in 2007, while gross margins increased slightly to 32.7% and the EBIT growth rate jumped from 12% to 16.7%. However, SG&A increased somewhat, while return on sales experienced a slight drop.

Other highlights:

- Medium-size companies had lower inventory turnover over the past five years than large companies, and about the same level of inventory turnover as small companies. As medium-size companies continue to better obtain and apply scan data, employ warehouse management software, and use other information technology tools, they should be able to realize the same kind of just-in-time inventory benefits that large companies have been enjoying.
- Medium-size companies were successful at shortening their cash conversion cycle in 2007, reaching 68 days — a healthy improvement from 74 days in 2006. This should free up cash to support marketing, R&D, and other revenue-generating strategies.
- Free cash flow as a percentage of sales has been rising over the past five years, with one-year free cash flow at 6.6% and five-year free cash flow at 5.3%.

Small Manufacturers (\$50 Million < Net Sales < = \$500 Million)

Even while the markets look stormiest for small manufacturers — which posted negligible one-year, three-year, and five-year shareholder returns — the sales growth rate at smaller organizations continues as the highest in the industry. While net sales growth increased from 11.7% in 2006 to 13.1% in 2007, EBIT growth dropped from 22.7% to 12.5% in the same period. Strong net sales growth combined with lower EBIT growth suggests that small companies are being hit hard by input cost increases, despite price increases. A slight decrease in gross margin to 35.7% in 2007 was coupled with a sharp increase in SG&A expenses, from 23.2% in 2006 to 27.7% in 2007. This resulted in a slight decrease on return on sales to 4.5%. At the same time, however, return on average assets rose from 5.9% to 7.5%.

Other highlights:

- Free cash flow as a percentage of sales for small companies remained the same, around 1% on one-year, three-year, and five-year bases.
- In 2007, small companies were very successful at shortening their cash conversion cycle, reaching a five-year low of 45 days from the 2006 level of 84 days.

Exhibit 31:
Size-Specific
Data
(All Sectors)



Source: PwC Analysis, Reuters Fundamentals, and Reuters Pricing

Very Small Manufacturers (Net Sales < = \$50 Million)

The characteristics of these companies are different enough that they warrant a separate reporting of their metrics. Results from these manufacturers are not included in the previous industry size- or sector-specific discussions.

Shareholder return for these companies was negligible on a one-year basis — a sharp drop from the annualized three-year return of 11.4%. One-year free cash flow to sales was -8.5%, much worse than the three-year and five-year cash flow numbers of -3.8% and -3.3%. Net sales growth has been quite volatile for very small companies. From a five-year low of -2% in 2004, it rose to a high of 14.5% in 2006, then dropped to 11.3% in 2007.

Other highlights:

- Very small companies are less likely to be able to negotiate volume discounts as effectively as larger companies, which may explain why they have been outperformed by all other sector sizes except for small companies. In 2007, however, gross margins for very small companies rose slightly, to 33.6% from 30.4% in 2006.
- Very small manufacturers have been able to compensate for their inability to leverage their costs of goods sold by focusing on carefully managing SG&A costs, which showed a remarkable decrease from 61.9% in 2006 to 42.7% in 2007.
- The cash conversion cycle lengthened, from 36 days in 2006 to 49 days in 2007 — another sign of the lack of clout wielded by very small manufacturers.
- Return on market capital continued a positive two-year trend, slightly outperforming 2006 by .8%, to 7% in 2007.

Exhibit 32:
Very Small
Manufacturers
(All Sectors)



Source: PwC Analysis, Reuters Fundamentals, and Reuters Pricing

Appendix A

Financial Performance Metrics 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 36). 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 2002 through 2007, by fiscal year, for publicly traded companies.

The report uses restated data that accounts for mergers, acquisitions, divestitures, and accounting changes. All data used to construct indicators in Section 3 is “as reported” by the companies for U.S.-based companies. For non-U.S. companies, currency exchange rates were applied to financial data fields denominated in non-U.S. currencies. Conversions were computed based on the annual averaged exchange rate for each fiscal year operating period.

Lastly, the study team collected financial data for 13 private-sector manufacturers through a survey administered by the GMA.

Exhibit 33: Distribution of Manufacturer NAICS Codes by Sector

Sector	NAICS	NAICS 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	111411	Mushroom Production*
Food	311211	Flour Milling*
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	311423	Dried and Dehydrated Food Manufacturing*
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

Sector	NAICS	NAICS Description
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	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	311119	Other Animal Food Manufacturing*
Household	322110	Pulp Mills*
Household	322121	Paper (except Newsprint) Mills*
Household	322291	Sanitary Paper Product Manufacturing
Household	325412	Pharmaceutical Preparation Manufacturing*
Household	325611	Soap and Other Detergent Manufacturing
Household	325612	Polish and Other Sanitation Goods Manufacturing
Household	325620	Toilet Preparation Manufacturing
Household	327213	Glass Container Manufacturing*
Household	331312	Primary Aluminum Production*
Household	335912	Primary Battery Manufacturing
Household	325311	Nitrogenous Fertilizer Manufacturing*
Household	325320	Pesticide and Other Agricultural Chemical Manufacturing*

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

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

Fifty-two NAICS codes were identified that represent the core GMA manufacturing activities. These included NAICS codes across the food (32 NAICS codes), beverage (6 NAICS codes), and household and personal care (14 NAICS codes) sectors.

The Reuters extract includes a primary industry code for each company.⁹⁴ These 52 NAICS codes were used to generate a set of companies for inclusion in this analysis. This produced a list of 247 companies, 17 of which did not have financial data for any of the years under consideration (2002–2007) and 8 of which had financial information for 2002 only.

These 25 companies were removed, reducing the list to 222 companies. In addition, 2 companies were identified whose primary industry did not fall into the GMA set (one is a defense company and the other a financial holding company). Both companies were removed from the list, leaving 220 public companies.

Data from 13 privately traded companies (from surveys that were sent out by the GMA) was added to the public company data, bringing the grand total of manufacturers to 233 companies.

Exhibit 33 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. Eleven NAICS codes that represent the core GMA retail activities were identified. These 11 CPG-related NAICS codes were used to generate a set of 102 retail companies for inclusion in the analysis. Four of these retailers did not have any financial information for the years under consideration (2002–2007) and 4 only had financial information for 2002; removing these left 94 companies. Examining the size of the companies using the definition on the next page of this appendix, we removed the 8 “very small” companies (i.e., those having a net sales value of \$50 million or less) from the total set, leaving 86 companies with net sales value greater than \$50 million.

Exhibit 34 gives the distribution of retailer NAICS codes and NAICS code descriptions by sector used in Section 3 of the report.

Exhibit 34: Distribution of Retailer NAICS Codes by Sector

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

⁹⁴ Reuters determines the dominant business segment of a company and then assigns, as the primary NAICS code, the NAICS code describing that segment.

Data Preparation and Metric Construction

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

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

Eight companies 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.

Eleven companies 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.

The quartiles were then calculated based on the financial metrics. Definitions for each metric can be found in Appendix C.

Data Reporting

Reported results utilize median in order to reduce the effect of performance outliers on the overall metrics. 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.

Firms with more than US\$10 billion in net sales in their last reported fiscal year were included in the industry benchmark, among the results for the “large” firms. They have also been highlighted in a separate “very large” grouping.

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

Exhibit 35: Size Segmentations for Financial Reporting Metrics

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

Counts for the number of manufacturers included in each size- and industry-based segment are included in Exhibit 36.

Exhibit 36: Manufacturing Companies by Industry Size and Segment

	Very Small	Small	Medium	Large (Very Large) ⁹⁵	TOTAL
Food	22	37	31	24 (13)	114
Beverage	20	9	9	18 (12)	56
Household Products	23	9	12	18 (11)	62
No Industry Designation ⁹⁶	—	1	—	—	1
TOTAL	65	56	52	60 (36)	233

⁹⁵ The set of “very large” companies is a subset of the overall manufacturer data set and is included in the “large” company sub-segment.

⁹⁶ One private company did not provide its industry designation.

Appendix B

Manufacturer Company List

Agfeed Industries, Inc.	Coca-Cola Bottling Co. Consolidated	Golden Enterprises, Inc.	Medifast, Inc.
Agria Corporation (ADR)	Coca-Cola Enterprises, Inc.	Golden State Vintners	Molson Coors Brewing Company
Alberto-Culver Company	Coca-Cola Femsa, S.A.B. DE C.V. (ADR)	Gordon Biersch Brewery Restaurant Group, Inc.	Monsanto Company
Alcoa, Inc.	Coca-Cola Hbc S.A. (ADR)	Greatbatch, Inc.	Monterey Gourmet Foods, Inc.
Allied Domecq PLC (ADR)	Coffee Holding Co., Inc.	Green Mountain Coffee Roasters, Inc.	National Beverage Corp.
American Dairy, Inc.	Colgate-Palmolive Company	Groupe Danone SA (ADR)	National Stem Cell Holding, Inc.
American Enterprise Development Corp.	Conagra Foods, Inc.	H.E.R.C. Products, Inc.	Nestlé SA
American Italian Pasta Company	Constellation Brands, Inc.	H.J. Heinz Company	New Dragon Asia Corp.
American Water Star, Inc.	Cosan Limited	Hanover Foods Corporation	Northern Technologies Int. Corp.
Anheuser-Busch Companies, Inc.	Cott Corporation (USA)	Hansen Natural Corporation	Novartis AG (ADR)
Anonymous	Cruzan International, Inc.	Heineken N.V. (ADR)	Oak Ridge Micro-Energy, Inc.
Archer Daniels Midland Company	Cuisine Solutions, Inc.	Hormel Foods Corporation	Ocean Bio-Chem, Inc.
Armanino Foods of Distinction, Inc.	Darling International, Inc.	Human Pheromone Sciences, Inc.	Ocean Spray Cranberries, Inc.
Ascon Corporation	Davi Skin, Inc.	Hydron Technologies, Inc.	Oregon Fruit Products Company
Atlantic Wine Agencies, Inc.	Dean Foods Company	ImageTix, Inc.	Otis Spunkmeyer Holdings, Inc.
Atlas Resources International, Inc.	Del Laboratories, Inc.	Imperial Sugar Company	Overhill Farms, Inc.
Avani International Group, Inc.	Del Monte Foods Company	Inter Parfums, Inc.	Owens-Illinois, Inc.
Avon Products, Inc.	Diageo PLC (ADR)	Interstate Bakeries Corp.	Pacific Sands, Inc.
B&G Foods, Inc.	Diamond Foods, Inc.	Inventure Group, Inc.	Paradise, Inc.
Barilla	Doane Pet Care Company	J&J Snack Foods Corp.	Parlux Fragrances, Inc.
BASF SE (ADR)	Dole Food Company, Inc.	Jamba, Inc.	Peet's Coffee & Tea, Inc.
Basic American, Inc.	Dr. Pepper Snapple Group, Inc.	John B. Sanfilippo & Son, Inc.	PepsiAmericas, Inc.
Baywood International, Inc.	Dreyer's Grand Ice Cream Holdings, Inc.	Johnson & Johnson	PepsiCo, Inc.
Big Rock Brewery Income Trust (USA)	DSG International Limited	Jones Soda Co. (USA)	Perdigao SA (ADR)
Birds Eye Foods, Inc.	Ecolab, Inc.	Kagome Co., Ltd.	Physicians Formula Holdings, Inc.
Bridgford Foods Corporation	Eldorado Artesian Springs, Inc.	Kellogg Company	Pilgrim's Pride Corporation
Brooklyn Cheesecake & Desserts Co., Inc.	Electro Energy, Inc.	Kerry Group PLC	Pinnacle Foods Finance LLC
Brown-Forman Corporation	Elizabeth Arden, Inc.	Kimberly-Clark Corporation	Playtex Products, Inc.
Bunge Limited	Embotelladora Andina S.A. (ADR)	Kirin Holdings Company Ltd. (ADR)	Premium Standard Farms, Inc.
Cadbury Schweppes PLC (ADR)	Energizer Holdings, Inc.	Knouse Foods	Provena Foods, Inc.
Cagle's, Inc.	Exide Technologies	Kraft Foods, Inc.	Pyramid Breweries, Inc.
Campbell Soup Company	Faribault Foods	Kyzen Corporation	QuantRx Biomedical Corporation
Castle Brands, Inc.	Farmer Brothers Co.	Lancaster Colony Corp.	Quilmes Industrial (Quinsa) S.A. (ADR)
CCA Industries, Inc.	Flowers Foods, Inc.	Lance, Inc.	Ralcorp Holdings, Inc.
Celsius Holdings, Inc.	Fomento Economico Mexicano SAB (ADR)	Land O'Lakes, Inc.	Reckitt Benckiser Group PLC
Centennial Specialty Foods Corp.	Foster's Group Limited	Leading Brands, Inc.	Reddy Ice Holdings, Inc.
Chalone Wine Group, Ltd.	Furmano Foods	Lee Pharmaceuticals	Redhook Ale Brewery, Inc.
China Fruits Corp.	Galaxy Nutritional Foods, Inc.	Lifeway Foods, Inc.	Revlon, Inc.
China Precision Steel, Inc.	General Mills, Inc.	L'Oreal	Rica Foods, Inc.
China Water and Drinks, Inc.	Georgia-Pacific Corporation	Lucille Farms, Inc.	Richelieu Foods, Inc.
China Yingxia International, Inc.	Global Beverage Solutions, Inc.	M & F Worldwide Corp.	Rocky Mountain Chocolate Factory, Inc.
Chiquita Brands International, Inc.	Global Seafood Technologies, Inc.	Mariani Packing Company, Inc.	Royal Wessanen NV (ADR)
Church & Dwight Co., Inc.	Gold Kist, Inc.	Maui Land & Pineapple Co.	SabMiller PLC
Clearly Canadian Beverage (USA)		McCormick & Company, Inc.	Sanderson Farms, Inc.

Sara Lee Corp.	Sweetheart Holdings, Inc.	The J.M. Smucker Company	Unilever PLC (ADR)
Scott's Liquid Gold, Inc.	Sylvan, Inc.	The Pepsi Bottling Group, Inc.	Universal Food and Beverage Co.
Sea Wright Holdings, Inc.	Synutra International, Inc.	The Procter & Gamble Company	Veridien Corporation
Seaboard Corporation	Tasker Products Corp.	The Robert Mondavi Corp.	Vermont Pure Holdings, Ltd.
Seneca Foods Corporation	Tasty Baking Company	The Stephan Co.	Vina Concha Y Toro S.A. (ADR)
Sherwood Brands, Inc.	Tate & Lyle PLC (ADR)	The Topps Company, Inc.	Vita Food Products, Inc.
Shiseido Co., Ltd. (ADR)	Tendercare International, Inc.	The Unimark Group, Inc.	Welch Foods, Inc.
Smart Balance, Inc.	The Boston Beer Company, Inc.	TNR Technical, Inc.	Wholesome & Hearty Foods Co.
Smithfield Foods, Inc.	The Clorox Company	Tofutti Brands, Inc.	Who's Your Daddy, Inc.
Sovereign Exploration Associates Int., Inc.	The Coca-Cola Company	Tootsie Roll Industries, Inc.	Wimm-Bill-Dann Foods OJSC (ADR)
Spectrum Organic Products	The Dial Corporation	Tree Top, Inc.	Wm. Wrigley Jr. Company
Sterling Sugars, Inc.	The Estee Lauder Companies, Inc.	Treehouse Foods, Inc.	Wyeth
Sunopta, Inc. (USA)	The Fremont Company	Tyson Foods, Inc.	YoCream International, Inc.
Sweet Success Enterprises, Inc.	The Hain Celestial Group, Inc.	Ultralife Batteries, Inc.	Zep, Inc.
	The Hershey Company	Unilever N.V. (ADR)	

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 98 CPG companies that were actively traded on U.S. stock exchanges from January 1, 2005, through December 31, 2007. 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 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

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

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.

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Core Team Members

Michael Anderson
Ramakrishnan Balasubramanian
Michael Berger
Michael Brewster
Michelle Caulk
Vincent Diaz
Jillian Dorans
Jeff Dufty
Matt Hannafin
Peter Hurley
Gwendolyn Lane
Mark Ludwig
Irene Magielsen
Christopher Michaelson
David Moss

Christy Parrish
Joseph Przybyla
Alexandre Rossin
Philip Russell
Elena Shtern
Pamela Singh
Donald Soares
Michal Svec
Sanjay Subramanian
Andrew Taylor
Kerry Tice
Robert Vettoretti
Rebecca Weaver
Patrick Yost
David Zwickel

GMA 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 Association
(202) 659-5900

Brooke Weizmann

Senior Manager, Industry Affairs
Grocery Manufacturers Association
(202) 295-3955
bweizmann@gmaonline.org

John G. Maxwell

Global Consumer Packaged Goods
Industry Leader
PricewaterhouseCoopers, LLP
(973) 236-4780
john.g.maxwell@us.pwc.com

Lisa Feigen Dugal

North American Consumer Packaged
Goods & Retail Advisory Leader
PricewaterhouseCoopers, LLP
(646) 471-6916
lisa.feigen.dugal@us.pwc.com

Herbert E. Walter

Consumer Packaged Goods & Retail
Advisory Partner
PricewaterhouseCoopers, LLP
(202) 414-1350
herb.walter@us.pwc.com

For additional copies of this report, please go
to www.gmaonline.org or email your request to
alarkin@gmaonline.org

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