2009 Financial Performance Report

Focusing on Today, Envisioning Tomorrow

Results for the Food, Beverage, and Consumer Products Industry

GMA
The Association of Food, Beverage and Consumer Products Companies

PRICEWATERHOUSECOOPERS

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

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

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Foreword

The Grocery Manufacturers Association (GMA) and PricewaterhouseCoopers (PwC) are delighted to bring you our 2009 financial performance report and overview of the consumer packaged goods (CPG) industry.

We've produced our most comprehensive document to date. This year, we focus on tactical ways that CPG companies are defying the recession—for instance, by containing IT costs—and offer strategic perspectives including a discussion of the implications of higher-priced credit. This report also contains an analysis of where the industry stands in relation to the current economic downturn, as well as interviews with GMA CFO Committee Chairman Don Mulligan (General Mills, Incorporated) and Vice Chairman Bert Alfonso (The Hershey Company).

For this year's report, we've moved our primary discussion of the year's data from the back of the book into an up-front Executive Summary. This summary then leads into our Top Performing Companies (TPC) analysis, which reveals those characteristics common among the best performing companies.

We've used several sources to compile the information for this report: interviews with senior leadership of GMA members (including members of the GMA CFO Committee), publicly reported company financial data, government statistics, analyst reports, and other published material. The manufacturing analyses are based primarily on public information from 157 manufacturers, sources cited within.

We would especially like to express our appreciation for the insights provided by the following CEOs and CFOs who participated in the interview process for this report:

Humberto (Bert) Alfonso, *The Hershey Company*

Robert Amen, *International Flavors & Fragrances*

Thom Gilday, *Celebration Foods*

Richard Goodman, *PepsiCo*

Donal Mulligan, *General Mills, Incorporated*

Craig Owens, *Campbell Soup Company*

Rick Puckett, *Lance, Inc.*

Bill Schumacher, *Sunny Delight Beverages Company*

Gordon Stetz, *McCormick & Company*

Duane Still, *The Coca-Cola Company*

Al Williams, *Bush Brothers & Company*

The current economic climate continues to test the CPG industry's resilience, and we've compiled this report as insight and information as to why this is so. GMA and PwC look forward to continuing the dialogue around these strategies, issues, and analyses.

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Table of Contents

Executive Summary: Strength in (the) Numbers 1

2008 Financial Performance Data Showcases CPG Companies' Resilience 1
The Overall Picture: Better than the Rest 2
The Food Sector Leads in Shareholder Return 4
Beverage Companies Look to Core Brands 5
Household Sector Sustained by Staples 6
Size Segments Deliver Profits, but Performance Declines 7
A Focus on Resilience: About the Following Sections and Articles 7

Section 1: Rewarding Resilience 9

The Best of the Best: Breaking Down the Performance of the CPG Sector's Top Performing Companies 10
More than Ever, Cash Is King: CPG Companies Not Immune to Liquidity Crunch 14
Battening Down the Hatches: Retailers Change Tack in the Midst of Economic Storm 19
"Core" Values: Conversations with Don Mulligan and Bert Alfonso 22

Section 2: Realigning Expectations 25

Connecting the Dots: The Potential Long-Term Effect of Tighter Credit Conditions on the CPG Industry 26
Survive and Thrive: CPG Companies Find New and Better Ways to Generate Needed Cash and Contain Costs 29
Getting Leaner through IT Cost Reduction: A Review of How Companies Are Achieving Rapid and Sustainable Transformation 32
Extra Credit: CPG Companies Uniquely Positioned to Claim State Tax Incentives and Savings 35
Protect and Preserve: How Secure Is Your Intellectual Property and Sensitive Data? 36

Section 3: Preparing for the Upturn 41

Still Standing: A Battle-Tested CPG Sector Looks to Better Economic Days Ahead 42
Divesting Non-Core Assets: When to Hold 'Em—and When to Fold 'Em 46
Making Sure the Price Is Right: For Both Bad Economic Times and Good, Transfer Pricing Processes Need to Be Improved 48
Sustainability and Long-Term Success: How Companies That Report Sustainability Data Measure Up against Those That Don't 50

Financial Performance Metrics 51

Appendices

Appendix A: Financial Performance Metrics Methodology 60
Appendix B: Manufacturer Company List 63
Appendix C: Definitions 64

Endnotes 66

Acknowledgements 68

Loud and Clear

Some of what we heard from industry executives during our research for this report:

"We are constantly looking to the next 100 years, and not the next quarter."

"With commodities, we are not interested in being speculators, but we also don't want to get killed by being on the wrong side of a position."

"Our theme is to not waste the current economic environment, but to take advantage of it, invest, lean forward, and come out of the other end stronger than we went in."

"We are providing our retailers with more extensive information."

"Global commodities are probably going to be higher priced in dollars because of the weakness of the dollar. The flip side is the weakening dollar will actually boost international earnings."

"I am encouraged by the number of institutions that are coming to us and saying, 'We are willing to provide credit.'"

"Sometimes the difficulty in the more mature brands is that you may not be connecting on quite the same emotional level as you had been before."

"One of our objectives is to be a great partner to do business with."

"We want our IT capability to have an intelligent dialogue with all parts of the business."

"This economy is not really hurting us. If anything, it is supporting our mission of continued growth."

"One way we leverage R&D is through external connectivity. Quite effectively, we can increase our level of innovation without having a similar size increase in our own research effort."

"There is a risk of not doing anything and of leaving products formulated in a way that over time is less and less relevant to people."

"Private label has come a long way. I would say over the past three to five years, consumers are definitely more accepting of private label products."

"We are still continuing to invest even though the environment has been difficult."

"There is risk from private label if you are not leading the category growth. They are largely taking share from the third or fourth brand."

Executive Summary: Strength in (the) Numbers

2008 Financial Performance Data Showcases CPG Companies' Resilience

GMA and PricewaterhouseCoopers titled our 2008 Financial Benchmarking Report *Achieving Superior Financial Performance in a Challenging Economy*. Now, as we release our 2009 report, it can be said that many consumer packaged goods (CPG) companies did, in fact, achieve superior performance in 2008, certainly on a relative basis. But few would have guessed that this success would come amidst 2008's string of sobering economic facts, which included:

- The biggest drop in consumer confidence since the Consumer Confidence Index (CCI) was created
- The disappearance of the investment bank as a business model
- Government bailouts of the financial services industry and bailouts and bankruptcies in the auto industry
- Double-digit declines in nationwide housing prices
- Skyrocketing unemployment

This was the environment in which the CPG industry operated in 2008, and to posit that it was no ordinary year would be a vast understatement. One need only look at the industry observations on the facing page to appreciate the breadth and variety of challenges the industry faced during the past 12 months.

Of all the financial performance data that will be discussed in the following pages, one simple fact about the American consumer stands out: After years of mass consumption, consumers moved by the end of 2008 to save over 4% of their disposable income,[1] the highest rate since January 2004 (see Exhibit 1). Clearly, things have changed for American consumers and for CPG companies.

Exhibit 1: Personal Savings as a Percentage of Disposable Income

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

The Overall Picture: Better than the Rest

CPG company median shareholder returns for 2008 were down slightly more than 25%, which actually constituted a significantly better performance than in the rest of the market.

In fact, as it did in 2007, aggregate CPG industry shareholder return beat both the S&P 500 and the Dow Jones Industrial Average for the year. Exhibit 2 illustrates how, during the 2008 calendar year, the CPG Market Weighted Index—comprised of 101 CPG companies that were actively traded on U.S. stock exchanges throughout 2008, and to which a market-weighted methodology was applied—outpaced the S&P 500 by more than 15 index points and the Dow by more than 10 index points. Carrying this comparison forward to May 1, 2009 (see Exhibit 3), the S&P 500 and the Dow had both achieved marked increases and reduced the gap with the CPG Market Weighted Index, but the CPG sector continues to outpace the broader market.

Exhibit 2: One-Year CPG Index (through December 2008)

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 3: One-Year CPG Index (through April 2009)

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

The CPG sector continues to outpace the broader market for the most recent 12-month period.

Exhibit 4 takes a longer view of the situation, showing how the CPG industry once again separated itself from both of these broader indices. What's behind these superior one- and three-year shareholder returns? Part of this better performance can likely be attributed to the CPG industry's core product mix of food products and household staples—items that still sell reasonably well in times of economic distress—but also to CPG companies' nurturing of core brands, conservative stance on leverage, and generally solid management.

Sales Are Still Strong—but What Kinds of Sales Are Being Made?

CPG manufacturers maintained a steady median sales growth in 2008, growing sales by 10%—a figure only slightly lower than in 2007, once again showing the stable nature of the industry. Even more impressive is that the top quartile of companies managed to grow sales by 18%, which was actually slightly higher than the previous year's sales growth for this quartile. While some of this sales growth is clearly attributable to the mid-year commodity-driven price spikes, it nonetheless served to offset volume declines and consumer purchasing patterns that showed a shift to lower-priced, value-oriented products.

Exhibit 4: Three-Year CPG Index (through December 2008)

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

"Value needs to be front and center right now."
—Craig Owens, CFO, Campbell Soup Company

Although sales grew, gross margins dipped slightly, underscoring what our team heard repeatedly from industry CFOs during interviews for this report: Product mixes changed as companies sold fewer higher-end products and encountered more competition from private label products. As Campbell CFO Craig Owens notes, "We might have a natural advantage because we are a great value at a very low cost, but value needs to be front and center right now."[2]

One very interesting trend we noticed in our separate analysis of Top Performing Companies (TPC) (see "The Best of the Best," page 10) is that, among most of these companies, SG&A (selling, general, and administrative) spending relative to sales actually increased slightly in 2008, indicating that top companies continued to invest in activities like marketing and R&D (research and development). But in Exhibit 5, it's clear that median SG&A as a percentage of sales stayed relatively flat in 2008 for the overall industry. If there is indeed a correlation between SG&A spending and better performance, perhaps companies will take note and next year's version of Exhibit 5 will show more of an uptick.

Exhibit 5: SG&A as a Percentage of Sales

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Our financial performance data shows that companies continued to invest in marketing and R&D, even in the midst of a deep recession.

As for profitability in our overall universe of 157 companies, median net operating profit after tax (NOPAT) margin and return on sales both fell by approximately two percentage points from 2007 to 2008. Regardless of where a company was in terms of 2007 profitability, the 2008 NOPAT decrease was largely consistent, meaning that even the most profitable companies felt some bottom-line pain.

Crunch Time

Lest anyone forget, 2008 was defined by an historic credit crunch, with the median short-term debt to long-term debt ratio increasing slightly from 2007 for the CPG companies in our study. Since short-term credit is generally more expensive, this represents a significant strain on the debt-raising capacity of the CPG sector.

As far as overall debt-to-equity ratio, it's worth noting that the CPG industry as a whole—regardless of top quartile, bottom, or median—was far less leveraged than many other industries, which at least partly accounts for its solid year-to-year performance, in good times and bad. A median debt-to-equity ratio of less than 1:1, as illustrated in Exhibit 6, speaks for itself in a business world recovering from an unparalleled period of easy credit.

Unsurprisingly, given the dire credit conditions and scarce liquidity in late 2008, the interest coverage ratio deteriorated markedly from 2007, and companies with large debt coverage loads suffered disproportionately during the credit crunch. While the top quartile of performers still recorded profitability about ten times higher than the interest payments on their debts, the bottom quartile approached zero in this regard, bringing up the real question of whether the companies in this quartile could continue to face a liquidity crisis in 2009.

The Food Sector Leads in Shareholder Return

With shareholder returns down by "just" 20%, the food sector had the best performance among the three major CPG sectors—beverage, food, and household products (see Exhibit 7). Sales also grew by a robust 10%, more evidence that consumers are increasingly cooking and eating at home, albeit with a preference for value-oriented products. Luckily, many CPG companies' portfolios include a broad swath of brands, and in 2008 investors rewarded these companies for their product diversification.

In terms of the pure financials, food companies experienced flat to slightly lower median returns on invested capital, market capital, and assets. While the sector fared better than the beverage business in each of these metrics, it lagged household products, which proved more resistant to the downturn than foodstuffs.

As seen in Exhibit 8, food companies also registered significantly lower levels of free cash flow to sales than the other two major CPG sectors in 2008, as they have for the past five years. Reasons for this include the sector's increasingly squeezed margins due to higher commodity prices over this period, the consumer shift to lower-margin value products, high SG&A spending to develop new products and maintain market position, and the increasing cost of debt.

Exhibit 6: Debt-to-Equity Ratio

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Top Quartile
Median
Bottom Quartile

Exhibit 7: Median Shareholder Return

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Beverage
Food
Household Products

Exhibit 8: Median Free Cash Flow to Sales

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Beverage
Food
Household Products

Beverage Companies Look to Core Brands

While gross margins and sales growth remained steady, the beverage sector still seemed to be swimming upstream, especially in the market that once fairly defined the sector: carbonated drinks. Indeed, while sales of carbonated soft drinks have been eroding steadily for years, the biggest players in the sector continue to respond aggressively to this trend.

For Coca-Cola, this has meant purchasing companies with new products and developing its own line of non-sparkling water drinks. It has also meant re-thinking aspects of its management structure. "We are first and foremost a brand company," says Duane Still, CFO, Coca-Cola North America. "We realized that we weren't really focusing enough on the brands themselves, so we created business units that align against our brands." For the first time in the company's history, for example, Coca-Cola has established a stand-alone sparkling beverages business unit with its own president whose sole focus, according to Still, "is driving new innovation for sparkling beverages—new packaging, new merchandising tools for large stores, small stores, and new ways of delivering the product."[3]

PepsiCo is also in the process of rejuvenating its iconic brand, especially as private label competitors try to gain market share. "You need to make sure that your brand stands for something and that it is differentiated in some meaningful ways from private label," says PepsiCo CFO Richard Goodman. "It's really about creating a sustainable, differentiated brand advantage and then continuing to innovate."[4] Earlier this year, PepsiCo made an offer to purchase two of its major distributors, a move that would allow the company to streamline its own supply chain and potentially oblige Coca-Cola to reassess its own franchise model of distribution, according to some industry analysts.[5]

Even as PepsiCo and Coca-Cola strive to parlay their core products into further growth, 2008 median shareholder returns for beverage companies were in the negative 30% range, the poorest result of the three major CPG manufacturing sectors. Too, the sector saw steep declines between 2007 and 2008 in return on invested capital, return on market capital, and return on assets.

And in the measure that really seems to distinguish top performing companies—profitability—the beverage industry as a whole showed significant declines. Median EBIT performance, for instance, contracted by a sharp 20%, a much larger fall than those experienced by the food and household products sectors (see Exhibit 9). At the same time, return on sales declined steeply, and median beverage NOPAT margins fell from the best of the three CPG sectors (9% in 2007) to a tie for the lowest NOPAT performance in 2008, at 4%.

One silver lining of the beverage sector's performance was that SG&A spend remained robust, as very large companies took a twofold approach: building upon or "re-igniting" their portfolio of core brands and developing new non-carbonated brands, or acquiring one of the many new and popular non-carbonated drinks. For instance, Coca-Cola acquired Glacéau, maker of vitaminwater, in 2007, and subsequently launched a lower-calorie, all-natural vitaminwater product, vitaminwater10.

"You need to make sure that your brand stands for something and that it is differentiated in some meaningful ways from private label."

—Richard Goodman, CFO, PepsiCo

Exhibit 9: Median EBIT Growth

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Household Sector Sustained by Staples

Those CPG organizations that make products to keep teeth gleaming, kitchens looking shiny, and people smelling good—household products companies—remained the most resilient of the three CPG sectors for 2008, maintaining superior results on invested capital and return on assets (see Exhibit 10).

Our research suggests that we shouldn't be surprised. Many household products companies, such as Colgate-Palmolive, are powering through the recession because of a storyline written well in advance of the downturn. Colgate has been aggressively expanding its market share in developing markets, with a worldwide toothpaste share approaching 45%. The company has also been in the process of overhauling its IT infrastructure, with the goal of rolling out an SAP system across 85% of its global businesses by the end of 2009.[6]

One of the keys to success in this sector, then—and really, for all three CPG sectors—is a readiness to respond to the global consumer, which means recognizing the power of core brands, particularly in emerging markets. "I have been in homes in the interior of China where the family income is a dollar or two dollars per day," says Robert Amen, CEO of International Flavors & Fragrances (IFF). "One woman in China told me that she used the local brand, but that she really wanted to buy Tide. The emerging world is just that—they want to buy aspirational brands."[7] Indeed, companies like Colgate have developed an almost laser-like focus on consumer spending habits across all markets and regions, and this has helped them understand which new products to introduce and at what price.

As a sector, household products performed best when it came to profitability. Indeed, the sector had the highest median gross margins, the highest profit growth, the highest NOPAT, and the highest return on sales of the three sectors—even while continuing to have the highest levels of SG&A expenses. In fact, as we have noted elsewhere in this report, healthy SG&A spending seemed to correspond with superior performance in 2008. In other words, while all companies focused on managing costs—and, in many cases, cutting them—the winners spent to maintain their market positions and brand equity, and were rewarded for doing so.

"I have been in homes in the interior of China where the family income is a dollar or two dollars per day. One woman in China told me that she used the local brand, but that she really wanted to buy Tide. The emerging world is just that—they want to buy aspirational brands."

— Robert Amen,
CEO, International Flavors & Fragrances

Exhibit 10: Median Return on Average Assets

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Size Segments Deliver Profits, but Performance Declines

In addition to business segment, we also analyzed performance data by company size. (See "The Best of the Best," p. 10, for a discussion of the top performers in our large and very large company categories.) Large companies had the highest profit growth at approximately 7%, while small company profit growth took a steep dive, with median profits contracting by more than 10% compared to 2007 results.

And in a year when the CPG industry lost more than 25% of market capitalization, it didn't matter whether a company was big or small when it came to some broad performance measures. Each segment experienced lower margins, slower EBIT growth, falling interest coverage, and lower returns on invested capital (see Exhibit 11). In the midst of a recession, though, profitability is the key metric, and each size segment remained profitable based on its median return on sales and NOPAT results.

Exhibit 11: Median EBIT Growth

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Large Manufacturers
Medium Manufacturers
Small Manufacturers

A Focus on Resilience: About the Following Sections and Articles

Whether viewed from an overall perspective, by size, or from the vantage point of one of the three major CPG sectors, the industry performed remarkably well given 2008's singular circumstances. That's why the first of this report's three major sections is called "Rewarding Resilience." Its lead-off article shows how the top performing CPG companies defied the market downturn through specific actions, such as continuing to invest in their brands and monitoring balance sheet debt.

The second section of this report, "Realigning Expectations," lays out how the CPG business landscape might be quite different for some time, and how companies are responding.

The third major section, "Preparing for the Upturn," explores several ways in which CPG organizations can ready themselves to seize opportunities once the economy's growth engines are humming once again.

Section 1: Rewarding Resilience

It's long been accepted wisdom that CPG companies weather economic downturns better than companies in most other industries, largely because they sell staples that consumers need in both good times and bad. A recession deeper than any since World War II is the ultimate test of this thesis.

As detailed in the Executive Summary section and in the Financial Performance Metrics section, we analyzed the financial performance of the CPG industry from several perspectives, including by sector (food, beverage, and household products) and by size segmentation (large, medium, and small). Our analysis illustrates that, indeed, the industry is weathering this historic downturn better than many other sectors.

In our first article in this section, we dig a little deeper. In order to delve further into the industry's performance, we expanded our analysis to identify the Top Performing Companies (TPC) within each of our size segmentations, and then compared the performance of the top quartile companies within these groups with those in the bottom quartile. Our analysis reveals how TPC CPG companies—in each of our size segments—performed when faced with the economic challenges presented in 2008.

Success isn't just about numbers and data, which is why this report also includes qualitative, anecdotal information directly from industry executives who are managing through the day-to-day. In their Q&As later in this section, for example, Don Mulligan of General Mills, Incorporated and Bert Alfonso of The Hershey Company talk about the ways in which their companies have shown resilience in this economy. Both organizations embody what we heard repeatedly during more than ten in-depth interviews: CPG companies are taking a long-term view, focusing on emerging from this recession stronger than they went into it. We believe that many will do just that.

"You want to be like Muhammad Ali. You want to be powerful, but also able to turn on a dime. You want to be more agile than anybody else."

—Richard Goodman, CFO, PepsiCo

The Best of the Best

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

With the U.S. economy contracting and one of the longest recessions in U.S. history continuing, 2008 was a difficult and challenging year.

As a whole, the CPG sector fared far better than most. For example, collective 2008 shareholder return for CPG companies was down slightly more than 25%—a humbling result in any normal year, but compared to other sectors, where a dive of between 40% and 60% was commonplace, the CPG sector fared reasonably well. Shareholders of CPG companies should feel, in no small measure, buffered against the larger economy's widespread value destruction.

Indeed, some CPG companies remained more than just afloat in 2008, and were thriving. So, in our analysis this year, we set out to answer this question: What common threads link the CPG companies that are performing best during the worst recession in five decades?

A Word about Company Size

Company size is often perceived as an important indicator of an organization's success. However, while it's worth noting that most members of our large and very large top quartile of Top Performing Companies (TPC) were from the very large camp, it's also true that this camp contained several of the weakest performing companies in this group of 52. A more interesting phenomenon from our point of view is that, on average, household products companies achieved a higher score in our TPC rankings than non-household companies. This could be due to a more resilient product mix, demographic trends, a better performance in one or more of the five metrics discussed in "PwC's 'Power Ranking,'" or a combination of all the above. Given the narrower spread for the size of the medium and small companies, the size distinction within these segments is not a critical differentiator.

PwC's "Power Ranking"

We drilled down into the total sample of approximately 160 CPG companies for which we'd gathered publicly available data. Fifty-two met our criteria for large and very large companies, 35 for medium, and 28 for small companies.[8]

We wanted to avoid measuring companies primarily on shareholder return. As we've already seen, this standard corporate barometer—while of the utmost importance to investors—can be distorted through the lens of a deep recession. Instead, we assigned scores to each of these 52 companies based on their relative performance across three fundamental financial metrics: economic profit spread, which is based on return on invested capital (ROIC) and the weighted average cost of capital (WACC); return on assets; and the free cash flow to sales ratio. Guided by these results, we then ranked all 52 companies to create an index of the Top Performing Companies.

Armed with this breakdown, we could then easily compare groups of the ranked companies across all kinds of financial indicators, including growth, profitability, liquidity, and leverage. We were particularly interested in setting the top quartile (best performers) versus the bottom quartile (weakest performers) to isolate those business drivers that might further explain their ranking.

Our analysis reveals that, in this period of weak credit conditions and increased market volatility, the top quartile performers of our TPC index were propelled by excellence in five areas: profitability, liquidity, continued spending on strategic SG&A expenses, sustained gross margins, and managed debt capacity as represented by ability to cover interest payments.

In addition to our index of the large and very large Top Performing Companies described above, we also applied a similar scoring methodology to the medium and the small company segments.

Our findings indicate that most of the themes for large and very large companies prevail for medium players. The results for small companies, however, are decidedly more mixed due to their inherent volatility. In the ensuing pages, as we contrast the performance of the top and bottom quartiles for our large and very large Top Performing Companies, we'll also include findings from our study of the small and medium-sized companies, where appropriate.

Profitability—Not Sales—Is the Key

Most companies in our study group actually enjoyed positive sales growth in 2008, thanks to a fairly recession-resistant product portfolio. Yet, neither strong sales levels nor strong sales growth secured a company a place in the top quartile. Instead, profitability distinguished our top performers, specifically net operating profits after tax (NOPAT) margin. In Exhibit 12, the 2008 profitability performance of our top quartile companies—which increased to about 17% by the end of the year—dwarfed that of the bottom quartile. In our separate analysis of small and medium-sized companies, there was also a meaningful gap in profitability between the top and bottom quartiles, reinforcing the idea that the top performing quartiles in each of our size segments held the same advantages over the bottom quartiles.

Also telling in its relation to profitability is liquidity. Exhibit 13, "TPC Median Operating Cash Flow Ratio," shows the dramatic difference in cash flow between our top and bottom quartiles. Even as our top 13 performers increased their cash availability during a landmark credit crunch, the bottom quartile's ability to generate cash flow fell off a cliff. In other words, the cash flow of our top quartile during the recession has remained fairly consistent and even risen slightly, providing these companies with ample liquidity as well as the room to think and act strategically. According to Bill Schumacher, CFO of Sunny Delight, "Our cash flow and our earnings and our staying power allowed us to focus on making good choices with respect to how we wanted to go forward with the business in this environment."[9]

For this report, we spoke to several CPG executives separately from our TPC analysis in order to gain additional perspective on the issues facing all manner of CPG companies (quotes used from these executives bear no relation to the identity of our 52 ranked companies). The insights from these conversations have been used throughout the report.

Exhibit 12: TPC Median Net Operating Profit after Tax (NOPAT) Margin

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 13: TPC Median Operating Cash Flow Ratio*

**The Operating Cash Flow Ratio consists of cash flow from operations divided by current liabilities.*

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Don't Scrimp: SG&A Spending Crucial in Difficult Times

It's a given that major CPG companies maintain a continuous pipeline of innovative products along with core brands. What we found interesting in our analysis, though, is that our top quartile's investment priorities didn't change as a result of the worsening economy. In fact, for most of our Top Performing Companies, SG&A spending (relative to sales) actually increased—a possible indicator of their desire to invest and capture market share while others are not able to defend. This dynamic is highlighted in Exhibit 14, which illustrates how during the past five years SG&A-to-sales ratios for the top quartile of our TPC have been consistently higher than those for the bottom quartile.

Incidentally, our separate analysis of small and medium-sized companies shows that similar to larger companies, TPC medium-sized companies have been spending more on SG&A, but not at the level of large and very large companies. As for the TPC small-sized companies, the ratio of SG&A to sales does not appear to be a differentiating factor.

That's not to say, of course, that companies shouldn't be looking for ways to cut operating costs. Cost control has long been a dominant chord throughout the CPG industry, and that fiscal discipline is one of the reasons that the sector is better positioned today than others.

But members of the top quartile of our TPC have not lost sight of the powerful ways that strategic spending during an economic downturn can position a company to emerge stronger than ever before. Campbell Soup Company, which has aggressively invested in its IT infrastructure, is seeing strategic dividends. "To me the real power of investing in IT," says Craig Owens, Campbell's CFO, "is how IT investment has improved our visibility across the company. It's enabled us to look at how manufacturing facilities compare to one another, and to spot opportunities to dig in and improve quality or improve cost."[10]

Rick Puckett, CFO of Lance, Inc., notes that not only is his company focused on investing back into itself, but it also launched its first television advertising campaign recently. "We're focused on bringing forth new products that will continue to add opportunities and alternatives for consumers to snack in a nutritious way and a wholesome way," says Puckett.[11]

Strong Margins Born of Investment in Iconic Brands

Many of our top quartile companies own brands that have stood the test of time, maintaining their popularity across decades. As Exhibit 15 details, these organizations were able to sustain strong gross margins for 2008 due to solid pricing power stemming from these iconic brands and scale advantages with retailers. Indeed, a decline in certain inputs and commodity costs helped these enterprises to actually increase their gross margins slightly in 2008.

The Hershey Company, for instance, had a twofold response to the downturn that focused on its core brands, among them Hershey's, Hershey's Kisses, Reese's, and Twizzlers. The company increased its advertising spending significantly in 2008 and bolstered its retail sales force.[12]

ConAgra Foods, for its part, "drew a line in the sand," says CEO Gary Rodkin. "We were determined to transform the business through more aggressive and creative innovation, marketing, and selling on our three power brands: Healthy Choice, Marie Callender's, and Banquet. That put a very focused sense of urgency into the entire organization."[13]

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

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 15: TPC Median Gross Margin

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 16: TPC Median Interest Coverage Ratio

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 17: TPC Median Return on Invested Capital

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 18: TPC Median Shareholder Return

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Companies fortunate enough to maintain a stable of premium brands also have the leeway to anticipate shifting consumer trends. Gordon Stetz, CFO of McCormick & Company, says, "You have to make sure that you have adjusted your marketing programs to take advantage of the consumer shift, but at the same time you don't want to lose consumers on the other parts of your portfolio." Toward that end, McCormick is spending aggressively on print ads, coupons, website promotions, and other tactics to bolster its high-end spice brands.[14]

A recession, therefore, can be the triggering event for an aggressive move toward long-term growth via strategic spending in core brands and products. For Coca-Cola, this has meant both acquiring companies and developing its own line of non-sparkling water drinks.[15] Beverage rival PepsiCo made an aggressive move in April 2009 to acquire its two major bottle distributors for more than $6 billion, a takeover that, if completed, will give the company control of 80% of its North America distribution and allow it to squeeze out $200 million in savings, boosting annual earnings by 15 cents per share.[16]

Just like our large company TPC segment, medium-sized TPC were able to command higher gross margins, but not quite at the level of their larger brethren. Our small company top quartile maintained only a slight advantage over the bottom quartile.

As the Era of Big Leverage Ends, Some Are Already Ahead of the Curve

Unsurprisingly, the final key to the puzzle of what sets our top quartile of TPC apart concerns debt management. How much of a company's cash went toward interest payments instead of being available for investment opportunities was another key differentiator in our analysis. Exhibit 16, "TPC Median Interest Coverage Ratio," starkly contrasts the debt management abilities of our top quartile with those of our bottom quartile.

The 2008 profitability of the typical top quartile company was about 18 times higher than the interest payments on their debts, and this ratio has only increased during the recession—meaning that the strong get stronger when liquidity dries up. In contrast, the bottom quartile could only service about four times interest payments by the end of 2008.

Unfortunately, the bottom quartile is likely to suffer even more pain as the credit crunch drags out and any favorable lending terms they possess run out.

A Final, Overall Snapshot

One of the original yardsticks we used to rank our pool of top performing companies—economic profit spread—is derived largely from return on invested capital, and is an appropriate measurement to provide a final, arresting snapshot of the differences between the top and bottom quartiles. As shown in Exhibit 17, the top performers over the past three years earned an average of about 21% return on invested capital, compared to about 3% for the bottom quartile. Top quartile return was higher over the past year as well, again reinforcing the tendency of better-managed companies to increase their competitive advantage during volatile times. Also, Exhibit 18 shows top quartile companies being more consistent in delivering shareholder return than bottom quartile companies, whom they outperform over one-, three-, and five-year periods.

And—once again—when one factors company size into the equation, things don't change much. The top quartile of our small and medium-sized company segments holds an edge over the bottom quartile, suggesting that while smaller players might not have the muscle of large companies, the best of them can still create competitive advantage over their peers during an economic downturn.

More than Ever, Cash Is King

CPG Companies Not Immune to Liquidity Crunch

When it comes to corporate liquidity, the fairly stable nature of the CPG industry means that many grocery and beverage manufacturing companies still maintain reasonable earnings and consistent cash flow, suggesting that liquidity for this sector doesn't need fixing.

CPG Strength

Compared to the economy as a whole, CPG liquidity is holding up reasonably well. "This economy is not really hurting us," says Rick Puckett, CFO of Lance, Inc., which counts Cape Cod and Tom's among its snack brands. "We are firing on all cylinders, because we have value-oriented snack foods that people are still buying."[17] Adds General Mills CFO Don Mulligan, "We are seeing growth in our baking divisions that we haven't seen in years, as people are trading from restaurants into grocery stores."[18]

The rate of corporate defaults also illustrates the relative liquidity strength of CPG companies, and how well they have managed their debt positions relative to companies in other industries. Overall, the U.S. corporate default rate is projected to hit a record 13.9% in 2009.[19] As of March 27, 2009, 33 U.S. corporate bond issuers rated by Standard & Poor's had defaulted, and 51 had defaulted globally.[20] Moody's expects 300 global issuer defaults on bonds this year, and in 2008 the agency recorded 101 issuer defaults.[21] As Exhibit 19 shows, Moody's 2009 default forecasts for some segments of the CPG industry (what Moody's refers to as the "beverage, food, and tobacco" segment) show a far smaller percentage of expected defaults (6.7%) than for many other industries.

Exhibit 19: 2009 Corporate Default Rate Forecasts by Industry

Industry	U.S.	Industry	U.S.
Transportation: Consumer	31.8%	Services: Consumer	7.6%
Media: Broadcasting & Subscription	24.6%	Healthcare & Pharmaceuticals	7.0%
Automotive	22.6%	Finance, Insurance, Real Estate: Finance	6.8%
Media: Advertising, Printing & Publishing	22.3%	Chemicals, Plastics & Rubber	6.7%
Hotel, Gaming & Leisure	18.9%	**Beverage, Food & Tobacco**	**6.7%**
Consumer Goods: Durable	16.3%	Environmental Industries	6.2%
Consumer Goods: Non-Durable	14.7%	Energy: Oil & Gas	5.7%
Containers, Packaging & Glass	14.6%	Finance, Insurance, Real Estate: Real Estate	5.3%
Retail	14.6%	Telecommunications	5.2%
Services: Business	14.2%	Media: Diversified & Production	5.2%
Transportation: Cargo	13.6%	Energy: Electricity	4.9%
Metals & Mining	13.0%	Finance, Insurance, Real Estate: Insurance	1.5%
Construction & Building	12.5%	Utilities: Electric	0.9%
Forest Products & Paper	10.4%	Banking	0.4%
Capital Equipment	9.9%	Government-Related Corp. Issuers	0.4%
High-Tech Industries	9.4%	Utilities: Oil & Gas	0.4%
Wholesale	9.1%	Utilities: Water	0.1%

Sources: Moody's Corporate Default and Recovery Rates, 1920–2008

Cash Positions of CPG Companies Linked to Retail Performance

Still, CPG companies aren't necessarily in the clear. The liquidity crunch has become a major issue for suppliers, retailers, and restaurants, meaning that it could also affect CPG companies, whose fortunes can rise and fall along with these partners. "The key is managing your relationships with each of your customers, across all of your channels," says Richard Goodman, CFO of PepsiCo. "Given this economy, we are really trying to tailor our offerings to the channel strategy for each particular customer."[22]

Besides the short-term cash crunch that many companies related to the CPG sector are feeling, there's also ample evidence that corporate credit will be less readily accessible and potentially higher priced for some time. Banks have tightened both consumer and corporate lending and may continue to do so to meet possible new capitalization standards coming out of Washington, D.C. Credit rating agencies have permanently toughened standards for corporate and structured finance ratings, potentially making it more difficult for companies to raise capital. As illustrated in Exhibit 20, during the latter part of 2008, banks began holding on to much more cash, both to preserve against projected defaults and because of uncertainty over borrowers' eventual ability to pay back loans. Exhibit 21 illustrates the substantial change in corporate interest patterns during this crisis. While the relative price for higher rated debt has decreased, the price for average and lower quality paper has increased significantly. The much larger spread in more recent months between higher and lower quality paper is also notable as the cost of debt for the financially stronger companies has decreased, thus allowing them to improve their performance even more relative to companies viewed as less financially strong.

Exhibit 20: Bank Cash Holdings

Source: Federal Reserve

U.S. Commercial Banks: Cash Assets as a Percentage of Total Bank Assets

Exhibit 21: Corporate Bond Yields

Source: Factiva, Moody's Corporate Bond Index

Surging Private Labels

One trend that may put a serious dent in CPG companies' bottom lines during this recession is the accelerating consumer movement from national brands to private label brands. As the short-term value equation for consumers evolves, cash flow could tighten as manufacturers lose market share to effective private or store-brand products.

Those entities with a well-developed portfolio of brands can withstand this shift to private label better than others by continuing to focus on long-term consumer needs and maintaining the right price spread between their products and rival non-branded items. Robert Amen, Chairman and CEO of International Flavors & Fragrances (IFF), a renowned supplier to the CPG industry, spoke to us for this report. Amen looks at the private label challenge for CPG companies this way: "I think the headline is that you can't take your customers for granted. . . . Whether it's at the luxury end or the basic end, consumers don't want to stop buying, but they really want to buy and get value."[23]

Take Celebration Foods, for example, which saw the downturn starting to accelerate and planned for it. CFO Thom Gilday says that Celebration, which owns the Carvel brand of ice cream cakes among other product lines, started focusing specifically on a new value-oriented, non-Carvel product offering late in 2008. The new ice cream cake was developed with both sets of Celebration's customers in mind: supermarkets and the end-consumer. "We developed a new product with a lower price point to change the value proposition," Gilday says. "It's smaller in size and uses slightly different ingredients, so our retailers can continue to make the margins they are accustomed to making on a similar product."[24] Celebration's agility in quickly rolling out a product with a lower price point is a good example of retaining market share in a volatile market, when private label brands historically make further inroads.

No Time for Complacency

While segments of the CPG sector tend to be more recession-proof than many other kinds of businesses, a recession marked by one of the sharpest declines in consumer spending in history is no time to get complacent. In fact, well-worn patterns of consumer behavior during previous recessions suggest that traditionally resilient staples could still see some weakness. Consumer durables, such as homes, cars, and televisions, are typically the first to experience a demand falloff during a recession, followed by premium brands and then, finally, the value brands.

The second half of 2009, then, represents a golden opportunity for manufacturers and retailers to assume a more proactive approach to liquidity planning and insulate themselves against an even steeper downturn. Amidst a deep recession such as the current one, there are short-term, medium-term, and long-term strategies to help strengthen corporate liquidity.

The Short Term

Over the short term, techniques such as consolidating purchasing and tightening inventory management can be used to accelerate cash realization to improve liquidity. Certain business processes—managing input costs, reining in spending with suppliers—are especially relevant for CPG companies.

That's why prescient companies like Lance, Inc. have already acted to preserve short-term capital. By reorganizing its inventory management under one functional head and using technology more effectively, the company has removed approximately two days worth of inventory out of its distribution centers, which translates into significant cash savings. "Improving on the inventory side is really about focused effort and accountability," says Lance CFO Puckett.[25]

As Puckett suggests, inventory is a major cash driver for Lance and for many other CPG companies, and understanding where these liquidity levers reside in the organization is critical to maintaining adequate cash flow. In most organizations, cash can be generated from a variety of sources: revenues, working capital, capital assets, property holdings, various contracts and sales agreements, and many other sources. Once these are identified, companies can better forecast short-term cash flow. "Cash flow is the single biggest measure that any CFO looks at," says Al Williams, CFO of Bush Brothers & Company. "So we monitor cash going out very closely."[26]

The Medium Term

In the medium term, CPG companies are taking a broader view of improving liquidity, using methods that range from reducing capital expenditures to making advance purchases of commodities that look reasonably well-priced. For a CPG company with a global footprint, freeing up "trapped cash" in overseas company locations has ramifications for both operations and the tax team.

Duane Still, Coca-Cola's CFO for North America, notes that his company may manage costs by purchasing commodities like aluminum well in advance of production needs. "This is a completely different environment from a commodity point of view than last year," Still says. "Like everyone else, we have to ask ourselves if we should buy for the future at today's prices."[27]

Generally, a broad plan to boost medium-term liquidity might include:

- Tightly managing capital expenditures
- Renegotiating purchasing contracts
- Reviewing the supply base and real estate leases
- Improving cash, inventory, and raw materials forecasting

The Long Term

President Obama's chief of staff, Rahm Emanuel, said in fall 2008 that "you never want a serious crisis to go to waste."[28] Similarly, management teams should view this crisis as their own opportunity to examine long-term liquidity strength.

Over the long run, companies can reconsider their sources of long-term liquidity, concentrate cash availability and centralize cash planning, look beyond income tax savings to "indirect" tax savings in areas like value-added tax and customs duties, and ensure that they have access to a diversification of banking sources.

It's also helpful in this kind of economic environment to look at overall debt structure and capital structure for the long term. For example, does a company have the right mix of short- and long-term debt? Floating debt versus fixed debt? As illustrated in Exhibit 22, for example, the top quartile of our Top Performing Companies index (see "The Best of the Best," p. 10) has moved to a higher relative proportion of short-term debt versus long-term debt, signaling how much more dependent companies have become on short-term borrowing given cash flow demands, relative availability of debt, and the increasing cost of borrowing.

Exhibit 22: TPC Median Short-Term Debt to Long-Term Debt Ratio

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Having solid long-term liquidity (as opposed to simply having ample cash on hand to cover operations) allows companies to gain competitive advantage over cash-strapped competitors. In the case of Lance, Inc., that meant having the ability to recently acquire the Archway brand. "We're in the enviable position as it relates to the cost of debt, and because of that we have the opportunity to acquire something if we think it is consistent with our strategy," says Lance CFO Puckett.[29]

A Reflection of Business Health

While managing liquidity is important, a company's cash condition is really a mirror reflecting the enterprise's overall health. A lackluster business model coupled with a feeble economy can result in poor corporate liquidity. Conversely, if a business is well managed, has adequate cash cushions in place, and monitors its debt level, liquidity will usually take care of itself.

Found Money

One potential internal source of working capital for CPG companies is prior-year income tax payments. Some of these payments can be recouped by filing income tax refund claims based on net operating loss carrybacks. Carrying back losses to a particular year allows a company to offset taxable income generated in that prior year, resulting in a cash refund of taxes previously paid.

While most companies are aware of this practice, some might not know that certain types of net operating losses are allowed to be carried back ten years, rather than the typical two. The availability of a ten-year carryback period potentially allows more current-year losses to be carried back.

What constitutes a specified liability loss is not always entirely clear, and is subject to case-by-case facts and circumstances. Generally, they fall into one of two categories: product liability losses and deferred liability losses. A product liability loss includes liabilities for damages stemming from a product that causes physical injury or emotional harm to individuals, or damage to property.

Deferred liability losses cover a broader range of liabilities. They relate to liabilities resulting from workers' compensation payments and to the remediation of environmental contamination, among other items.

Product Liability Losses in the CPG Industry

One of the more common exposures for CPG companies is to product liability claims, and the number of these claims is on the rise.

The following two examples help illustrate the type of scenario in which a product liability claim might arise. In the first example, a beverage retailer sells a drink to a customer, which results in harm to that customer. The customer sues for damages and is awarded $1,000,000, which the retailer pays.

In the second example, a widget manufacturer sells a batch of widgets to a company. Subsequently, the widgets explode due to a defect and destroy the company's new office building. The purchasing company sues the widget maker for damages and is awarded $1,000,000, which the manufacturer pays.

Depending on the other facts and circumstances, the amounts paid in the examples above might be considered payments on account of product liability. It is also important to know that, in these examples, any liabilities associated with injuries while manufacturing, delivering, installing, or testing the product would generally not qualify as product liability claims in the context of specified liability losses, because such claims generally must relate to incidents that occur after the company has relinquished possession of the product.

Can Your Company Take Advantage of These Favorable Tax Provisions?

A simple checklist can help determine whether or not a company might be able to generate liquidity through a ten-year carryback and a refund of previous taxes paid due to a specified liability loss. Particularly in today's market, spending a little time researching this issue could result in a much-needed boost to working capital.

A Specified Liability Loss Checklist

- ☐ Does the company have a history of taxable income?
- ☐ Has the company experienced any recent tax losses?
- ☐ Are any of the recent tax losses related to product liability losses, environmental remediation expenditures, or workers' compensation claims?

Battening Down the Hatches

Retailers Change Tack in the Midst of Economic Storm

In last year's version of this report, we noted that "sluggish U.S. economic growth, a weak dollar, and declining consumer confidence" was prevailing upon savvy retailers to devise a "new formula" for success. One year later, while this new formula is still a work in progress, it's clear that retailers responded well in 2008 to conditions that few could have anticipated.

More a Tsunami than a Storm

Among the many "all-time lows" that have defined this recession came a report in February 2009 that the Consumer Confidence Index had hit its lowest mark since the Index began, in 1967.[30] It's hardly surprising that, as they have for CPG manufacturers, 2008 shareholder returns and sales growth for the retail industry have declined.

Yet, retailer median sales growth was still about 9% for 2008, nearly the same level achieved in 2007 (Exhibit 23). Why? Primarily because retailers responded to market conditions by providing consumers with the value-oriented products they want, and made appropriate price adjustments related to a mid-year spike in commodity prices.

To gain a bit more understanding of how the retail industry performed by segment, we broke out grocery retailers from the rest of the CPG retailing universe of companies. While it's clear that grocery retailers fared worse than their CPG retailing peers—who registered nearly 10% growth—grocery retailers still managed median sales growth of about 5% (Exhibit 24).

Several industry executives we spoke to for this report believe that value-oriented products will remain critical to retailers' and CPG companies' shared success. International Flavors & Fragrances (IFF) Chairman and CEO Robert Amen puts it this way: "Affordability is important. But it's not about cheapness—it's about affordability. There needs to be improved functionality and differentiation."[31]

Wal-Mart Remains the Game-Changer

While many supermarket chains are experiencing declining same-store sales, Wal-Mart is benefiting from the economic slowdown as shoppers flock to big-box stores that offer lower prices and one-stop shopping.

With more than 3,600 stores nationally,[32] Wal-Mart Stores, Inc.'s U.S. operations (excluding Sam's Club) reported a same-store sales increase of 2.8% for the period of November 2008 to January 2009[33]—a strong performance for a recessionary period, especially considering the number of shopper trips made per household was down 2.9% during that timeframe.[34] Moreover, approximately half of Wal-Mart Stores, Inc.'s U.S. sales (excluding Sam's Club) are in categories where it competes directly with food retailers,[35] a fact that makes conventional supermarkets' operating environment all the more challenging.

How exactly are supermarkets responding? The best are certainly not sitting still and watching their market share decline. Instead, they are undertaking several key initiatives to drive improved performance.

Exhibit 23: Median Net Sales Growth, Retailers vs. Manufacturers

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 24: Median Net Sales Growth, Grocery vs. Other Retailers

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

CPG Companies Can Help Retailers Achieve Differentiation

In a recent PwC study, more than 75% of retailers acknowledged that they have a long way to go in differentiating themselves.[36] Manufacturers can be a crucial partner in this endeavor. CPG companies are working with retailers on stock-keeping unit (SKU) rationalization, shelving priorities, and pricing strategy formulation. In one specific example, manufacturers can potentially leverage their market and shopper data to provide retail customers with insights to improve category business planning.

A factor in any conversation about CPG-retailer collaboration is, of course, private label programs. While the private label phenomenon has not been as explosive in North America as in Europe—where approximately 45%[37] of retail sales go to private brands—it's still a dynamic that manufacturers must consider as they work with retail partners.

For the average conventional supermarket chain, private label now accounts for approximately 19% of total sales, up from about 17% just a couple of years ago.[38] It is our expectation that this rate will climb over the next few years as new consumers are persuaded to try private label brands due to the low price points and improved quality. It is very likely that the trend toward private label products is a long-term one, as the category had slowly been gaining traction even before the recession.

Although the growing success of private label will affect national brands, both manufacturers and retailers should seize the opportunity to collaborate and ensure that store shelves contain excellent private label and national brand items in a time when shoppers are looking for value. Earlier this year, Costco began telling its suppliers that it will be eliminating national brands in favor of its private label, if pricing relief is not offered.[39] As PepsiCo's Goodman puts it, "Manufacturers and retailers have the shared interest of growing consumer volume."[40]

Revisiting Pricing Strategies

In a downturn, price often overtakes location as the key reason for choosing a place to shop as consumers search for value. If a retailer sets prices too low, it's leaving margin dollars on the table. If it sets prices too high, it runs the risk of driving consumers to seek more affordable options (see Exhibit 25).

This has been an even more complicated calculus since early 2008, when commodity prices entered a period of particular volatility. For example, some manufacturers locked in long-term supply contracts for commodities that have since declined in price. On the other hand, various commodities have remained quite high, as Bert Alfonso of Hershey pointed out when he spoke to us for this report. "It's true that commodity inflation has leveled off—particularly in energy—but you still have to look at individual commodities, many of which are still pretty elevated," Alfonso says.[41] The bottom line is that commodity price volatility can provide pricing headaches for both CPG companies and retailers.

In one response, retailers are today seeing the wisdom of deeper discounts on fewer items. Conventional retailer wisdom holds that waves and waves of sales tags in a store create the impression that bargains are everywhere, but retailers have found that they are better off putting fewer items on sale and discounting them deeper.

Exhibit 25: Median Gross Margin

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 26: Median Inventory Turnover, Retailers vs. Manufacturers

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 27: Median Inventory Turnover, Grocery vs. Other Retailers

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 28: Median Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Optimizing Inventory Levels

With credit markets tightening, retailers are also trying to free up cash. Unlike manufacturers, which have multiple sources of cash to impact, retailers' primary lever for moving short-term cash is improving their inventory replenishment processes, both in stores and in distribution centers. One grocer we interviewed was able to eliminate its short-term debt by automating ordering processes.[42]

Better inventory management results in a stronger balance sheet, not to mention customers happy to find that the products they like are in stock. Exhibit 26 shows that, as one would expect, retailers maintain a higher inventory turnover than manufacturers, and thus a lower number of days inventory outstanding.

Refining this analysis for grocery retailers as compared to other CPG retailers, we see both increasing inventory turnover for 2008 (see Exhibit 27).

Retailers are clearly becoming more aware that inventory management is one of the keys to better cash management, and thus to a better and more profitable business. In fact, by increasing inventory efficiency, extending payables, and better managing receivables, retailers' cash conversion cycle went down significantly between 2007 and 2008 (Exhibit 28).

Cautious Optimism

Retailers have managed to grow amidst a deep recession by responding to consumers' demand for value, developing the agility to better adjust inventory, and managing their balance sheets. But when the economy bounces back, good "defense" won't be enough. Retailers and manufacturers need to work together to forge solutions for a new foundation for growth.

Don Mulligan

Bert Alfonso

"Core" Values

Conversations with Don Mulligan and Bert Alfonso

When it comes to resilience, two of the giants of American business have traditionally been General Mills, Incorporated and The Hershey Company. General Mills traces its history to 1866, and Hershey has been providing chocolate since 1894. While the U.S. and much of the world is currently mired in recession, both of these companies saw solid results across their brand portfolios in 2008 and into 2009.

As part of our research for this project, we recently spoke separately with Don Mulligan, Executive Vice President and CFO for General Mills and GMA CFO Committee Chair, and Bert Alfonso, CFO for Hershey and GMA CFO Committee Vice Chair.

Is the flagging economy causing consumers to trade down? If so, what are the impacts on your businesses and where do you see market opportunities?

Don: We're seeing growth in our baking divisions that we haven't seen in years, because not only are people trading down to the grocery store, they are also trading down within the grocery store. For example, instead of going to the in-store bakery and buying a ready-made cake, they are buying our Betty Crocker mix. In some cases, they are economizing even more by buying flour—our retail flour business is showing double-digit top-line growth.

Bert: You can see some trading down in the current market for premium chocolate. We have a small part of our portfolio that's dedicated to the premium space, our Scharffen Berger line. Perhaps unique to the confection industry, however, is that for chocolate, the private label segment is pretty small.

Along similar lines, have you experienced an increase in business, given that Americans are reportedly eating out much less often these days?

Don: As an industry, we are certainly benefiting from the decline in restaurant business. It's helping to accelerate some of our category growth rate and our fundamental growth rate. As for the cause of the trend, I think there are a couple of things coming together at once. Part of it is the uncertain economic times. But there are also some longer-term demographic shifts that we think are playing a factor. As people age, for example, they eat out less often; also, women's participation in the workforce has leveled off.

Bert: If American families are eating at home more, they are obviously shopping more in food stores or spending a greater part of their disposable income on groceries. That shift benefits our category and it benefits food manufacturers in general. We benefit greatly because grocery stores and other major outlets, of course, carry our brands and we have strong merchandising capability. We also benefit from the impulse nature of confection, whether it's at the front end of the store or in the candy aisle.

Have the troubled economic times spurred you to focus more on the core brands within your large portfolios of consumer products?

Don: Our strategic position is to be in categories where we can differentiate our product. We also want to make sure that we're a number one or a strong number two in those categories, because over time we think the pressure from private labels—or retailer brands, as we like to call them—is going to affect the third or fourth leading brands. I think all retailers are looking to simplify their sales, either in the number of brands or the number of SKUs. So if you are not one of the brands that are leading the growth, you are going to be at risk.

Bert: We did a pretty deep-dive strategic plan early in 2008, and one of the biggest changes to come out of it was to refocus on our core businesses. When we talk about our core, it's essentially the largest of our iconic brands: Hershey's, Reese's, Kisses, Twizzlers in the non-chocolate space, and Kit Kat. We've also got a lot of other brands that are well known, like Almond Joy and Mounds and Jolly Rancher, but certainly our large or core brands are the ones that have the most momentum right now. Coupled with that, we made a number of investments, including increasing our advertising at a pretty substantial clip—about 25% a year—and again, that is very focused on that core business.

What are CPG companies doing to innovate beyond the product side of the business?

Don: That's a really good question, because we talk about innovation as being one of the two key enablers of our growth strategy. The other one is margin expansion, and they're actually very closely related. If innovation occurs across a number of different areas, that will unlock growth opportunities. Because the number of challenges is so much greater today than, say, two or ten years ago, all grocery manufacturers have to do more in terms of consumer research—across hundreds of categories in the grocery store—to come up with products that the retailer is really going to value.

Bert: What we're doing in this space is less built into today's sales and more building into tomorrow's. We did a segmentation study of who our core users are and what brands and attributes they are looking for, and then linked it to various platforms. So instead of saying, "Let me design a particular health-and-wellness product," we look at health and wellness as an entire platform. Packaging is another platform. We've tried to take all that learning and all those insights and build them into the innovation process more than we did in the past.

How are you managing your retailer relationships in this climate?

Don: There is clearly more emphasis on the customer relationship now than there was ten years ago. It's a consequence of greater retailer consolidation. Each of our large customers matters more today. At the same time, there are emerging channels, like the discount stores and the dollar stores, that are starting to stock food. They have different needs that we need to be attuned to in order for them to distribute our products. For example, we really need to understand how they are trying to use food to drive their store traffic.

Bert: I think we're likely to see more relationships like the one we have with certain retailers. In consumers' minds, when they think of these retailers they think high quality. And that's what the partnership is about. It's really about leveraging our expertise and our distribution capability and combining it with the retailer's quality image. I think you will see many more of these types of partnerships in the future, as opposed to store brand types of partnerships.

Section 2: Realigning Expectations

Is the business world a fundamentally different place for CPG companies than it was just 18 months ago? This much is clear: Several basic realignments will require organizations to adapt.

The story for CPG companies doesn't end with the fact that the industry is somewhat buffered from this recession—far from it.

Like other businesses, CPG sector companies hold a weaker hand, for the most part, than they did two years ago: The cost of credit will likely remain high for some time, lower consumer confidence may translate into lower real consumer spending and a tough sell for some premium brands, and government deficits at both the state and federal level could mean a heavier tax burden.

And yet, even within these areas, CPG companies have proven more prescient than other organizations. For example, while many entities in other industries loaded up with cheap debt and now suffer the myriad of problems associated with being overleveraged, most food, beverage, and household products companies were managed prudently. Long before the phrase "liquidity crisis" entered the popular lexicon, the better-run CPG companies constantly improved their operations and emphasized strong cash flow, rather than just focusing on sales and volume performance.

The key for the sector today is to continue staying ahead of the curve in the face of changing expectations among consumers, regulators, and shareholders. As an example, one article in this section ("CPG Companies Uniquely Positioned to Claim State Tax Incentives and Savings," p. 35) explains how companies can benefit greatly by locating facilities in enterprise zones, taking advantage of state tax credits and incentives, and improving the processes around paying sales and use taxes. It's not a glamorous subject—but, after all, being flashy isn't what put the CPG sector in a better position than most other sectors.

"We are still continuing to invest even though the environment has been difficult."

— Bill Schumacher, CFO, Sunny Delight

Connecting the Dots

The Potential Long-Term Effect of Tighter Credit Conditions on the CPG Industry

Like many aspects of this recession economy, the manner in which CPG executives regard the credit markets largely depends on their company's competitive position. Entities with a healthy liquidity cushion are in the driver's seat, as their peers may be unable to "leverage up" and make product launches or acquisitions fueled by capital from sources other than operations. "You want to come out of this period better than when you went in," says PepsiCo CFO Richard Goodman. "But some companies may not have access to credit, and will be less able to complete mergers and acquisitions."[43]

It's fair to say that, in retrospect, the exceedingly benign credit markets of 2003–7 helped fuel a more adventuresome approach to business. High leverage, acquisitive growth rather than organic growth, and a reliance on risk dispersal rather than before-the-act risk management became standard practice. Exhibits 29 and 30 illustrate the sharp increase in mergers and acquisitions activity, both domestically and globally, in the years leading up to the current financial crisis and recession.

While CPG companies did not leverage up to the same extent as those in the financial and other sectors—the median debt-to-equity level was less than 1:1 for CPG companies, as shown in Exhibit 48 (p. 53)—they still benefited from this "easy money" era, in terms of getting favorable financing conditions and, most directly, enjoying growth fueled by strong consumer spending.

Falling Demand and Tighter Credit

The current economic and financial crisis means that consumer demand has fallen and credit is more difficult to obtain. The last vestiges of the freewheeling credit era will play out as 2009 progresses. Banks have already, on their own, tightened corporate and consumer lending.

The bottom-line impact of these developments is a long-term repricing of credit as banks and investors demand greater returns for a given level of risk. In turn, the cost of capital may increase commensurately for CPG companies, and could alter their approach to making acquisitions, raising capital, and proving their creditworthiness. "I think it will be much more difficult for companies to go out and do deals," says Sunny Delight CFO Bill Schumacher. "Certainly they are not going to do deals in the way that they were done a year ago. It's going to require more equity or more cash, because debt is going to cost a lot more."[44]

Exhibit 29: M&A Deal Value, USA Acquisitions

Source: Thomson Financial

Exhibit 30: M&A Deal Value, Worldwide Acquisitions

Source: Thomson Financial

And when credit is available, it's likely to be on more expensive terms than at any time in recent memory. If equity becomes the primary currency for business combinations, that could have the effect of incenting companies to manage their share price with a more short-term point of view.

Many CPG companies, for a variety of reasons, are in fine shape for the long haul. Businesses in a niche may still be relatively strong, or perhaps they avoided the excessive leverage that others took on. Some companies still enjoy debt covenants struck during times when credit was much easier to secure. Sunny Delight's Schumacher says that the beverage maker started retiring debt several years ago and now employs a very low 1:1 debt-to-EBITDA ratio. "This is something that we wanted to do as a company, and now we are in the position of being able to try and take advantage of opportunities," Schumacher says.[45]

Privately held companies are another group extolling their particular way of approaching business in this difficult credit environment. "We are constantly looking to the next 100 years, and not the next quarter," says Al Williams, CFO of privately held Bush Brothers. "We don't have the tough analyst calls or people asking about the stock price on a daily or weekly basis."[46]

Succeeding in a Less Debt-Fueled Business World

In a world of less readily available credit, companies will need to re-learn how to operate, putting a premium on organic growth, recognizing that they'll have less financial wherewithal for expansion, holding the line on discretionary spending, and concentrating on established, iconic brands.

Fringe brands—for example, those that rank third or fourth in their category despite adequate company investment—may be more easily culled from the brand portfolio. (See "Divesting Non-Core Assets," p. 46). Many of the CFOs we talked to for this report said that their companies were already slashing unneeded inventory, concentrating on fewer but more high-profile brands, and re-investing in their core businesses. Granted, no one was willing to discount the value of a well-timed strategic acquisition at the right price, but most weren't prepared to take on enormous leverage to make such a move.

"We are constantly looking to the next 100 years, and not the next quarter."

—Al Williams, CFO, Bush Brothers

Working with Credit Agencies

Credit rating agencies have been grading creditworthiness since John Moody first published *Moody's Analyses of Railroad Investments* in 1909. It took until the 2006 passage of the Credit Rating Agency Reform Act, though, to give the SEC any kind of regulatory oversight over Nationally Recognized Statistical Ratings Organizations (NRSRO) such as Moody's, Standard & Poor's, and Fitch Ratings.

Fast-forward three years, and the financial crisis has thrown the spotlight anew on the major credit rating agencies. Like most corporations today, many CPG companies use these agencies to rate the quality of their debt. But after the subprime mortgage and structured finance debacles that occurred during the financial crisis, the credit rating agencies are being criticized for their business model of charging issuers for ratings, and for consulting with companies on how to best arrange structured finance deals. As CPG companies work with their lenders and credit rating agencies to communicate their creditworthiness to investors, it may be worthwhile to understand some of the new ground rules under which credit rating agencies are operating.

New Rules

While it's clear that the SEC is most focused on ratings for structured finance products and not on corporate bond ratings, there are still new developments to which CPG companies should pay attention.

To decrease the likelihood of conflicts of interest relating to structured product ratings, the new SEC rules prohibit an NRSRO from issuing a credit rating if it has consulted on or made recommendations with respect to the security's issuance. While credit rating agencies can still communicate and meet with issuers to obtain crucial information about a bond or structured financial product, this rule is intended to ensure that NRSRO analysts don't cross the line and actually provide advice as to how to obtain a certain rating. New SEC rules also demand more transparency by requiring the credit rating agencies to make publicly available a random sample of 10% of their issuer-paid credit ratings and subsequent histories, at least for each class of ratings from which the NRSRO has issued 500 or more ratings.

A Re-emphasis on Perennial Assets

CPG executives have long understood that growth fueled by innovative products, steady sales, and managing costs is more sustainable than that generated by financial engineering, leverage, and balance sheet transactions. Over time, this view has been part of the reason these companies have been rewarded in the markets: Between 2005 and 2007, for example (the very height of the debt-fueled leverage era for many industries), all three major CPG industry segments—food, beverage, and household products—outperformed the S&P 500.[47] Living in the new era of scarce credit means that, more than ever, executives will be expected to nurture organic growth as a potentially large component of the overall growth platform. Companies will achieve that growth by creating new and innovative products, yes, but also by carefully preserving and promoting familiar, long-term brands that consumers already know well.

For example, carbonated beverage sales have been declining in the U.S. for more than a decade, but Coke is determined to increase revenues by getting the most out of its iconic soft drink brands. According to Duane Still, the company's North America CFO, Coke is approaching this challenge in several different ways, including launching new products and offering more packaging options. The idea is to simultaneously reinvigorate the core brand and get the most out of investment dollars. "We are investing in new products like Coca-Cola Zero to offer our consumers more choice, and we are coming up with different packaging bundles," says Still. "Innovations like more affordable entry points for a smaller size will help re-ignite the consumer's desire for a sparkling beverage."[48]

The Hershey Company also experienced a resurgence by refocusing on already iconic brands. In 2006, the company decided to reinvest in its core confectionary brands like Hershey's candy bars, Reese's, Kit Kat, and Twizzlers. After a transition year in 2007, the strategy paid off very well in 2008. "The strategy was a return to a much greater emphasis on our core confection business while ensuring that right level of innovation," says Hershey CFO Bert Alfonso.[49]

No Time to Hunker Down

Like all American businesses right now, CPG companies are facing twin headwinds: a deep recession and a deep freeze in the credit markets. The fundamental question for many companies, as Coke's Duane Still notes, is one of perspective. "On the one hand, you can view it as an environment where you have to hunker down and get defensive," Still says. "We are in the opposite camp—we say the current economic environment is an opportunity to speak to the consumer's desire to enjoy simple pleasures that are affordable."[50]

Survive and Thrive

CPG Companies Find New and Better Ways to Generate Needed Cash and Contain Costs

In the past, many CPG companies primarily focused their attention on new acquisitions, new product introductions, and geographical expansion. But with the current economic downturn, they are now concentrating on the cost side of the business. Though cost reduction opportunities always existed, they were often considered "nice-to-do" rather than "need-to-do" projects. Today, that's changed. Most companies realize they must systematically find ways to accelerate and sustain improvements in cash flow and cost structure to offset tighter credit and lower consumer spending.

Unfortunately, many have come to this realization only through the crucible of this crisis—a "perfect storm" of declining consumer sales, troubled retail customers increasing credit collection risk from receivables, and lagging cost reduction efforts that have led to serious liquidity problems. This situation is further exacerbated for highly leveraged companies, some of which are struggling to make loan payments. The old adage "cash is king" has taken on a whole new sense of urgency.

Transforming a Breakdown into a Breakthrough

On one end of the spectrum are those companies that understand that breakthrough results often arise from breakdown situations, and that this environment is no time for elegant solutions and getting every little detail right. These organizations have mobilized their workforces to simplify operations, understanding that success today is grounded in speed, impact, and an embrace of the 80/20 rule—which in this context means focusing on the primary cost drivers (the 20%) that will bring the biggest savings opportunities (the 80%) quickest.

Some of these companies are taking the desire for breakthrough results one step further, using funds freed up from cost-related activities to strategically position themselves to emerge stronger after the economy recovers. For example, Procter & Gamble has expanded its presence in Asia during the financial crisis, even as other Western companies have fled.[51] ConAgra is increasing its advertising spend and re-launching its Healthy Choice product line to take advantage of consumers' increasing desire for healthier, easy-to-prepare foods.[52]

On the other end of the spectrum are those flat-footed entities that haven't turned off the spending spigot fast enough. Lacking good corrective action plans or execution capabilities, their misalignment is resulting in cash leakage and missed cost saving opportunities.

Nimble Companies Are Executing Long-Term Cost-Cutting Programs

In this challenging business environment, leading companies understand that knee-jerk reactions can do more harm than good. Ad-hoc spending cuts can damage a company's reputation and infrastructure and demoralize its employees. Rather than using slash-and-burn tactics, many companies now are focusing on making successful expense reductions by leveraging lean techniques (see sidebar, p. 30, for the reason some expense reduction efforts fail). Fully 60% of the Fortune 1000 has formally applied lean principles at some level,[53] most commonly to functions like R&D, finance, and transaction-related services such as order management. Avon, for example, is streamlining its transaction-based services as part of a restructuring program focused on global supply chain operations.[54] And since lean cost reduction addresses the elimination of waste, unneeded processes, and redundant steps, it focuses companies on long-term problems rather than the kind of short-term problems to which arbitrary, across-the-board cuts are generally applied.

Thom Gilday of Celebration Foods notes how short-term cost-pressure decisions can adversely affect long-term product quality. "Instead of skimping on quality, we continue to buy quality ingredients," Gilday says. "So if we end up spending a few more dollars in the cost of our product, we try to make up for it somewhere else, like pulling cost out of the distribution network."[55]

Suppliers to the CPG industry are also comparing long-term consequences to short-term savings. For example, International Flavors & Fragrances CEO Robert Amen told us that companies must factor in the long-term ramifications of cost-cutting decisions. "My organization could make cuts, and earnings would look great for three or four quarters, but then it would start to have an effect on us," Amen says.[56]

Today, CPG companies are finding some significant savings opportunities in high-impact areas such as advertising and marketing, procurement, packaging, and core process operations. For example, in product-related operations, Church & Dwight recently completed laundry product changes—compacting the products—and expects to see the benefits of this cost optimization program rolling forward.[57] In advertising and marketing, companies that have not consolidated vendors are looking at leveraging scale, and those companies that have are scaling back on spend that is viewed as marginally effective or poorly targeted. In procurement, some companies are working collaboratively with core suppliers to reduce the cost of input materials and discretionary spend. Kellogg's, for example, is reviewing its $1 billion procurement spend across the board to identify where savings can be found in areas such as administration, logistics, IT, and materials/repairs. The company wants to generate these savings through centralization of some purchasing.[58]

Why Do Most Cost Reduction Attempts Fail?

1. **Lack of a strong foundation.** Companies lacking financial discipline, stable cost management practices, and an in-depth understanding of their cost baseline will have difficulty identifying and tracking cost reduction opportunities.

2. **Dipping into the same well too often.** Once a certain action proves fruitful, enterprises tend to repeatedly focus on cutting the same SG&A back-office activities. Not only do these companies fail to address baseline operating costs and excessive third-party spending, but they may also inadvertently cut too deeply into crucial activities, like marketing and advertising. As Exhibit 31 shows, the top performing quartile of our Top Performing Companies index (see "The Best of the Best," p. 10) is actually maintaining relative SG&A spending during this recession.

3. **Failure to address cost management and control.** Companies regularly focus on reducing costs without addressing their spend culture—who can spend, how they spend, and how it's tracked.

4. **Inability to measure results.** Cost reduction activities often get lost within annual operating results. Without a strong monitoring process, it's difficult to know whether cost reduction plans are achieving desired results.

Exhibit 31: TPC Median SG&A as a Percentage of Sales

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

For cost reduction measures to stick, companies must clarify the cost drivers and use that knowledge to create a culture of cost consciousness. For example, it has been reported that at General Mills, all divisions have a three-year savings goal, and managers meet every week to discuss cuts. Ideas range from shrinking packaging and eliminating flavors to consolidating purchases of raw materials.[59] A culture like this cannot be built overnight, but the following ideas make for an effective foundation:

- **Set an environment for cost reduction.** Confirm the cost reduction targets and process, agree on the in-scope cost base, and complete a preliminary reduction analysis.
- **Agree on cost ownership.** Decide up front who is responsible for challenging which costs. Work from a pre-allocation cost basis that will prevent any costs from falling through the cracks.
- **Challenge the financial plan.** Clarify cost drivers, challenge operating cost assumptions, and reduce discretionary spend.
- **Look for contract leakage.** Perform a forensic review of suppliers that may uncover recoverable claims, pinpoint cost avoidance areas, and identify off-contract savings opportunities.
- **Gauge performance by measuring results.** Monitor business activities, capture related spend results, and produce robust reports for senior management.

Integrating Finance with Other Operational Processes

Managing expenses has long fallen under the domain of operations, but top performing CPG companies have also tied their financial processes (e.g., treasury, cash, and debt management) to their operational processes. These companies realize the tight link between managing uses of cash from sales (both for expenses and working capital) and healthy financial performance. This integration allows them to include cross-functional stakeholders in company-wide planning processes, meaning they don't get surprised as often as some other companies. It also allows them to better understand the effects of cash flow on the organization; they actually have the ability to answer questions such as, "What happens to my cash flow if sales are 15% lower than expected?" Our study of Top Performing Companies (see "The Best of the Best," p. 10) confirmed that in this period of economic decline, cash flow clearly distinguishes the top performers from the rest of the pack. As Exhibit 32 illustrates, the top performing quartile of our Top Performing Companies index dwarfed the bottom quartile in cash flow generation for each time period in which we measured.

Exhibit 32: TPC Median Free Cash Flow to Sales

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Exhibit 33: TPC Median Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Revisit Forecasting and Working Capital for Better Cash Management

Now that cash is a bit tighter for many CPG companies, deficiencies in cash forecasting and planning processes are easier to spot, as are weaknesses in working capital management.

To improve cash management, leading companies are improving their modeling techniques. The idea is to get a timely, accurate, and holistic snapshot of cash needs and availability. Critical elements that must be addressed for an improved forecast include:

- Cash forecast modeling, including developing the ability to forecast for longer durations, and to perform more intensive stress testing
- Model input accuracy (i.e., shift from historical to real-time inputs)
- Supporting processes such as data accuracy and timely adjustments

In addition to forecasting improvements, most companies are focusing improvements on working capital: receivables, payables, and inventory—the lifeblood of any enterprise. As such, leading CPG companies are improving the data and processes that drive billing timeliness and accuracy. Others are segmenting accounts receivable to accelerate cash collection, improving proactive dispute management and equitable adjustments, and ensuring the availability of lending facilities. For companies that have managed cash well in good times, the challenge in this economy is to hold on to solid cash conversion cycle performance. The top quartile of our Top Performing Companies index (as shown in Exhibit 33) had a consistent 2007 and 2008 performance in this regard.

Exhibit 34: Overall Manufacturers Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

As for accounts payable, companies are using a number of methods to standardize more favorable payment terms. Among them: segmenting vendors and eliminating multiple terms in each category, adopting a category approach to consolidate and leverage spend volumes, decreasing the number of suppliers, and maximizing the use of grace periods for necessities like power supply and telecommunications. In an example of more effectively purchasing from suppliers, AmBev is working collaboratively with suppliers to take full advantage of term discounts.[60]

Leading companies are refocusing efforts on managing inventory, from a "boil the ocean" approach to one that focuses improvements on the highest opportunity areas. For example, accelerating fast-moving products to move through the supply chain even more quickly is one technique to build on a competitive advantage. The corollary, of course, is reducing, eliminating, and/or liquidating slow-moving products.

Companies have long been under pressure to look for efficiencies and reduce costs, but never more so since the U.S. slid into recession at the end of 2007. The latest macroeconomic forecasts indicate a protracted period of weakness, which will challenge companies to dig even deeper.

Getting Leaner through IT Cost Reduction

A Review of How Companies Are Achieving Rapid and Sustainable Transformation

Information technology (IT) is one of the largest spending categories for large corporations. During belt-tightening times such as these, however, companies should guard against cutting the IT budget too deeply or slashing the wrong programs, which will only hamper IT resources that can be powerful tools of growth.

Indeed, the CFOs we spoke to recognize the ongoing value of IT, even as they search for ways to extract more value from it. "The key for us," says Campbell Soup Company CFO Craig Owens, "is for IT to constantly maintain an intelligent dialogue with all the different pieces of the business. This makes IT really part of the fabric of the business as opposed to being an isolated silo."[61]

In our CFO interviews, we discussed major areas of concern in IT and ways to address those concerns. We worked this information into the following three-phase approach, focused on strategically identifying the right IT costs to cut, creating efficiencies, and making savings sustainable.

Phase One: Where to Cut, and Where Not to Cut

Typically, IT cost reduction involves measures such as across-the-board layoffs, randomly halted projects, and arbitrary across-the-board percentage budget reductions. But these actions rarely result in achieving sustainable cost reductions of 25% or more. Instead, organizations should systematically calculate the total cost of IT resources, including staff, hardware, software programs, and data centers. The main objective of conducting an analysis of total spend is to discover the company's IT priorities and investments, and then be able to benchmark this information against other companies and industries. An analysis of total spend puts the company in an ideal position to spot IT efficiencies.

For example, a recent analysis of total spend conducted with a company helped quantify IT spending (which eventually totaled over $1 billion) and rate it according to its impact on both business objectives and risks. The analysis of total spend data was then compared against industry benchmarks to determine where

gaps existed. With the largest expenditure categories identified—IT staff salaries, telecom, asset management, external service providers, software and hardware maintenance—a quantitative analysis was generated indicating where spending in these categories could be reduced. Overall, the potential savings across the five expenditure areas was 7% to 12% of the total IT budget.

Interestingly, the analysis of total spend showed that this organization could save the most (estimated at 10%–25% of overall savings) in its dealings with external service providers. Because IT service acquisition and ongoing management of providers occurred independently across the organization, with no centralized vendor management, there was no visibility into the total amount being spent. Consequently, the organization could not fully leverage its buying power nor effectively measure the performance of its service providers.[62]

Celebration Foods CFO Thom Gilday notes the importance of cost savings for CPG companies in particular: "We are very focused on operating as efficiently as possible every day to make sure our retailers can get the margins they need for success while we continue to grow profitably as a company."[63]

Phase Two: Taking an Investor's Perspective when Implementing IT Cost Reductions

When going through Phase Two—implementation—it helps to adopt an investor's perspective and evaluate potential IT cost improvements *as if the company were being acquired.* This forces a strong look at structural IT transformation and incents both IT and the overall business to rethink what's being spent on IT, why it's being spent, and how it's being spent.

Once the entire array of potential IT cost reduction opportunities has been assessed, moving forward involves a series of critical actions, including:

- Delivering quick wins that bring credibility to the broader IT cost reduction program
- Clarifying accountability and ownership with regard to IT spending improvements, economies, and efficiencies
- Managing the entire cost reduction effort as an overall integrated program, rather than as a series of independent projects
- Implementing a benefits tracking and performance management mechanism based on key performance indicators (KPIs)

For example, at one company, the demand for IT services overwhelmed its IT capability. In addition, business units were very informal in their approach to establishing, integrating, and managing key IT goals. The result was a scattered and non-strategic set of IT "priorities" that cost the company too much money, rarely delivered on their promises, and hobbled the business units in achieving many of their objectives.

In response, the CIO launched an effort to understand the company's true IT cost and asset base. This included implementing an integrated, portfolio-based method of examining and setting IT priorities together with the business units, and initiating action plans designed to achieve greater levels of simplification, standardization, and rationalization across all IT operations. The approach yielded significant short-term benefits, drove fundamental changes into the IT organization, and laid the foundation for long-term, sustainable IT cost reduction.[64]

Phase Three: Engaging Management in Sustaining the Cost Reductions

This third and most crucial phase of the process—sustaining the cost savings—involves instilling a "culture of accountability" within IT and between IT and the business units.

One good example is a large industrial products manufacturer that instituted a very simple benefits realization process for new IT projects. The defining component of the plan was a new house rule that no IT-related effort would be initially funded for more than a three- to four-month period. Every large IT project was broken down into three- or four-month increments and cost out for those periods, and the potential benefits identified. The genius of this initiative was that it forced IT and the business units to accomplish modest benefits within a relatively small amount of time, and identified those projects that deserved longer-term investment. This approach was very successful for the company and drove the culture of accountability they were seeking.[65]

While IT costs will likely remain one of the largest spend categories for large corporations, this three-step approach allows executives to really see what they're spending and where they're spending it. As McCormick's Gordon Stetz says, "We are looking to optimize the investment we made in IT so we are more productive and able to generate savings that can be reinvested in high top-line growth."[66]

Don't Throw Out the Data with the Bathwater

Even as IT cost reduction has become an urgent matter, companies are still enamored of IT's ability to solicit input from consumers and track burgeoning trends.

Campbell Soup, for instance, has developed a consumer-facing web application that helps the company solicit ideas for new recipes and keep tabs on consumer trends and preferences.[67] Kellogg's IT cost-cutting has increased efficiencies in IT infrastructure and streamlined its truck and intermodal shipping, but it has also enhanced the company's strategic consumer-based marketing and point-of-sale displays.[68] Lance, Inc.'s new IT infrastructure has allowed the company to centralize its inventory management under one roof, and improved cash flow from inventory and receivables.[69]

General Mills employs over 1,000 food scientists and uses its IT infrastructure as a force multiplier to tap the knowledge of thousands of other food scientists around the world. Its growing consumer database works strategically with its marketing department to track consumer trends and discover new market segments to pursue.[70]

For a consistently "best-in-class" company, focusing on extracting more value from IT has allowed management to see itself better, and to analyze and compare the performance of individual business units with one another. "To me," says Campbell's Craig Owens, "the real power plays to efficiency and cost reduction, but also to effectiveness. It improves visibility across the company."[71]

Extra Credit

CPG Companies Uniquely Positioned to Claim State Tax Incentives and Savings

One way CPG companies are responding to the recession is by focusing on their state and local tax strategies. Two often overlooked savings areas are state and local credit and incentive programs, and sales and use taxes.

Credits and Incentives: On the Increase, but Often Overlooked

Although states are facing unprecedented budget pressures, they continue to offer new business credits and incentives, recognizing that economic growth will come as a result of business spending rather than taxes.[72] For example, New Jersey recently enacted legislation establishing the InvestNJ Business Grant Program. Examples of strategic approaches to credits and incentives include:

- **Retraining a labor force and retooling facilities.** When a company switches product lines, it can negotiate credits and incentives aligned with retraining its labor force and the capital costs of retooling.
- **Conducting business operations in enterprise zones.** Companies should be aware that opportunities often exist to expand an enterprise zone beyond its designated boundaries. States may also offer incentives for relocation to enterprise zones.
- **Going green.** Though state and local incentives for sustainability have not kept pace with public opinion in recent years, states are now beginning to offer them in increasing numbers. At the local level, companies may be able to negotiate a lower property tax in exchange for meeting certain green requirements for buildings.

Sales and Use Tax: An Increasing Burden, a Missed Opportunity

With the economic decline and widening budget deficits, states are increasingly looking at sales and use taxes as a means of raising needed revenue. For example, California closed its huge deficits for mid-year fiscal 2009 and fiscal year 2010 in part by raising the sales tax by one percentage point, and numerous other states have increased their rates in recent years.

Forward-looking CPG companies are taking the time to identify and assess the strengths and weaknesses of their sales and use tax function. Strategies include:

- **Performing reverse sales and use tax audits.** This can provide an effective way of offsetting current audit liabilities, as well as recovering refunds for prior years.
- **Performing managed sales and use tax audits.** Under a managed tax audit, the state sets up specific audit procedures and guiding principles, allowing the taxpayer to perform the audit with state review.
- **Automating compliance and maintenance systems.** These systems allow for the automation of state and local sales and use tax compliance functions, including the all-important accrual of use tax on purchases.

No Time to Bury Your Head in the Sand

Now more than ever, companies need to minimize their sales and use tax exposure and maximize offsets and refunds. Shareholders are becoming aware of this issue, even to the point of class action lawsuits charging breach of fiduciary duty for overpayment of sales and use tax and failure to take advantage of statutory exemptions.[73] While this is an extreme example, it is a reminder that in today's rough economy, tax processes and state and local tax considerations should be priorities.

Protect and Preserve

How Secure Is Your Intellectual Property and Sensitive Data?

Companies are focused today on making access to information fast, easy, and ubiquitous. The security of that information, however, is often less of a priority, and this inattention carries risks. As CPG companies collect and share ever-increasing amounts of intellectual property, employee information, and customer information, the risk of that data getting lost or stolen grows as well.

The Challenge: Thwarting Increasingly Sophisticated Attacks

While data theft has made headlines for years, the threat is now getting more sophisticated—and more pervasive. A recent survey, for example, revealed that computer hackers stole more sensitive data in 2008 than in the previous four years combined.[74] While most of these breaches affected the consumer banking arms of big financial institutions (for example, PIN information relating to ATM accounts), there's little doubt that criminal groups will grow increasingly inventive about pilfering information from manufacturers and their retail partners (see "At Retailers, an Encryption Debate," p. 39), who are increasingly using web-based advertising and shopper data to get more in tune with their consumers.

According to PwC's 2008 Global State of Information Security Study, a worldwide survey of more than 7,000 IT and information security professionals conducted jointly with *CIO* and *CSO* magazines, 71% of respondents stated that their organizations do not maintain an accurate inventory of where high-value data is stored. Only about half of the respondents said that their company security policies address the protection, disclosure, and destruction of data. And while survey results suggest that the majority of companies worldwide encrypt data in transmission, far fewer appear to encrypt data at rest in databases, laptops, file shares, backup tapes, and removable media.

Companies feel a major reason for investing in IT security is business continuity (see Exhibit 35). Another reason for focusing on good data security for CPG companies is reflected in the comments of Duane Still, CFO of Coca-Cola North America. "In our business, there are two things that are paramount and worth protecting at all costs," Still says. "One is images of our brands. Second is the intellectual property that we have, which in our case is consumer information, customer information, and formulas. We have always taken great care around protecting our intellectual property."[75]

A PwC Survey: CPG Industry Needs to Do a Better Job of Data Protection

According to PwC's 2008 Global State of Information Security Study, financial services companies are the most aggressive in adopting security practices, perhaps because they are most frequently targeted. Conversely, consumer products and retail companies tend to be the most lax.

Exhibit 36 shows that when compared one-to-one with companies in the financial services industry, CPG companies are not as comprehensive in their approach to data security. In one telling statistic, fully 83% of financial services companies surveyed employed a chief security officer (CSO) or chief information security officer (CISO), compared to just 43% of CPG companies. And it's not just the financial services industry that CPG companies trail. Exhibit 37 compares how different industries approach data security. When it comes to developing an overall information security strategy, 59% of companies across all industries had done so by 2008, while just 52% of CPG companies had.

"The minute you build a better mousetrap, a better mouse shows up."

— Craig Owens, CFO, Campbell Soup Company

Exhibit 35: Companies Rank Business Continuity as the Top Reason for Investing in IT Security

Source: PricewaterhouseCoopers, 2008 Global State of Information Security Study

Exhibit 36: CPG and Retail Companies Compared to Financial Services Companies

Source: PricewaterhouseCoopers, 2008 Global State of Information Security Study

Exhibit 37: CPG and Retail Companies Lag All Industries

Select Security Benchmarks	Retail and Consumer			All Industries
	2008	2007	2006	2008
Has an overall information security strategy	52%	52%	34%	59%
Employs a CISO or CSO	43%	37%	24%	56%
Integrates security with privacy/compliance plans	34%	25%	17%	36%
Has cellular/PCS/wireless security standards	43%	25%	25%	40%
Uses tools to detect unauthorized devices	47%	34%	20%	51%

Sources: PricewaterhouseCoopers, 2008 Global State of Information Security Study

Compliance Doesn't Equal Safety

PwC's experience in conducting security assessments has shown that even those companies that follow compliance standards or have information-protection policies in place are still at risk of data and identity theft. For example, in one instance, PwC tested a company's data security systems. The PwC team was able to breach the company's defenses and obtain original copies of job applications, including applicants' Social Security numbers, birth dates, and more. The company had strong IT safeguards in place, but the team was able to make the breach via face-to-face interaction with employees.

Campbell Soup CFO Craig Owens notes that it's often helpful to get a fresh look at a company's data security framework, as standards are changing so quickly and hackers are improving their techniques. "We frequently engage outside experts on what we are doing, and how that compares to best-in-class," Owens says. "Typically, we get back a pretty good report card, but it is important that you never become complacent about it."[76]

The Impact of Not Being Prepared

Duane Still of Coca-Cola was quoted earlier about how a CPG company's trusted brand and proprietary information can comprise a large part of its unique assets. An organization that suffers a breach can face lost intellectual property, compromised strategic and marketing plans, brand damage, negative publicity, and loss of consumer trust. But the ramifications can also be more tangible and more debilitating over the short term: loss of revenue, legal fees, credit monitoring services for victims, reissuing of credit cards, government fines, and regulatory sanctions.

Furthermore, when data and identity theft involves consumer information—an issue highly relevant to CPG companies and their retail partners—the Federal Trade Commission can levy fines and mandate that the offending company conduct independent assessments of its information-protection program for up to 20 years.

The costs of a security breach were clear from PwC's 2008 global security study. Of the respondents who had experienced a security incident during the previous 12 months:

- Four out of ten reported a resulting financial loss
- Almost one-third classified their incident as intellectual property theft
- Over one-quarter said the incident resulted in damage to brand/reputation

Yet, for many companies, identifying these exposures has not been a priority. Only 44% of survey respondents said their company conducts a risk assessment periodically. Just 24% said they prioritize data and information assets according to risk level on a continuous basis, and 30% said that they do not classify data and information assets at all. Given the potential ramifications, CPG companies would do well to manage data privacy and security aggressively before an incident occurs.

At Retailers, an Encryption Debate

At retailers, data theft generally occurs at the point of sale. Today, a debate centers on whether card swipes should be encrypted so that information is more difficult for thieves to access. The cost of encrypting the machines is high, and retailers have to determine individually whether the benefit is worth the cost of encryption.

Additionally, retailers generally need to keep some form of customer information—typically a credit card number—in their records to prevent the inappropriate or fraudulent return of merchandise. Their dilemma is that they must devise ways of keeping enough information about customers to prevent these returns, while not retaining so much that it puts customers' information at risk. One way to address this is through new processes known as third-generation solutions, which send customer card swipe information to a trusted third party, which stores the customer data so the retailer does not have to retain it.

Privacy and the Company Website

Many CPG companies use their company websites to interact and collaborate with consumers, keep in touch with their needs, and showcase promotions or rewards programs. The websites often collect personal data from consumers, and the company then becomes responsible for the privacy and security of this data. Campbell, for example, uses its website to connect with consumers, and even lets them submit favorite soup recipes. The key, according to Campbell CFO Owens, is diligence. "Customers want to interact with you, the outside world wants to interact with you," Owens says. "We just have to be as diligent as we possibly can. We want to create an environment that lowers the risk as much as possible, but that doesn't shut the door off to the public."[77]

A Strategic Approach to Improving Security

Companies in the CPG industry are revamping their approach to data security, starting with some fundamentals:

- **Get the right people together.** Establish a chief information security officer (CISO), chief security officer (CSO), or chief privacy officer (CPO) position, then work to actively engage both business and IT decision-makers in addressing security.
- **Embed security awareness more deeply across the enterprise.** Once security policies have been clearly defined, make awareness of security and privacy issues a major and well-championed corporate objective, and follow up continuously.
- **Ensure that privacy protections extend to employee data and other sensitive information.** Many retail and consumer companies tend to focus privacy practices on protecting customer data, despite the fact that employee data can be a far richer target for thieves. Survey results show that when security breaches occurred, employee records were much more likely to be impacted than customer records (54% versus 38%).[78] Hershey CFO Bert Alfonso explains how Hershey actively reinforces this issue with employees, and how in 2008 it developed a company-wide initiative for safeguarding information: "We took an in-depth look at our confidential information practices, including how we secure and encrypt laptops, develop pass codes for Blackberrys, and ensure safety procedures for employees traveling with these devices," says Alfonso. "That's something you have to continuously do, because different attempts with new techniques are happening all the time."[79]

Stay Safe, Stay Protected

Data security is an ongoing concern that requires an overall corporate strategy. Beyond just having secure IT firewalls, it also includes educating each employee about the importance of data and about their own responsibility for keeping it safe, especially given the mobile nature of data today. The value of proprietary intellectual property, new product plans, marketing plans, and employee and customer information cannot be overstated. As McCormick CFO Gordon Stetz notes, "Business risks, like data security—in our case protecting formulas for our customers and our own brands—is one of those things we will invest behind if we feel there's exposure. Because, again, you have to think long-term."[80]

Section 3: Preparing for the Upturn

While facing the day-to-day realities of recession, CPG companies are also maintaining a strong sense of optimism about the future. The best prepared are those already turning that optimism into action.

Few predicted the financial crisis that preceded our current economic crisis, and rest assured that few will accurately project precisely when we will emerge from the downturn. But if history is any indicator, the CPG industry will continue to outperform other sectors in terms of employment and profitability.

Savvy companies are already honing their brand portfolios in anticipation of a return to growth, and are reassessing which assets will bring a solid return on investment. Hard decisions inevitably need to be made about whether low-performing brands have long-term potential or whether they should be carved out of the portfolio.

One indication that CPG companies are already planning for recovery is how suppliers and vendors are interacting with the sector. For example, Robert Amen of International Flavors & Fragrances told us that his company has undertaken numerous projects with CPG organizations looking toward launching new products in 2010 and 2011.[81] While another year of low or slow growth might seem like a grind, CPG companies can look at the situation another way: This is the perfect time to step back in order to look ahead, objectively and clearly.

"We want to be in categories where you can differentiate your product, but we also want to make sure that we're a number one or strong number two in those categories."

— Don Mulligan, CFO, General Mills, Incorporated

Still Standing

A Battle-Tested CPG Sector Looks to Better Economic Days Ahead

The current recession is undoubtedly taking its toll. Job losses have been significant and ongoing, and changes in commodity prices and consumer spending patterns have put pressure on wholesale and retail pricing strategies.

While the CPG industry has been affected by these trends, the sector overall has navigated the downturn well, generally showing an ability to keep employment levels relatively steady, smooth out price volatility, and maintain solid levels of imports and exports. The question facing CPG companies now is just how quickly consumers will regain their shaken confidence.

Near-Term Projections Foresee a Modest Recovery

The economic slowdown, which began in the financial markets, has spread to Main Street, and a turnaround will be neither fast nor dramatic. As of March 2009, the U.S. Bureau of Labor Statistics (BLS) was reporting that 5.1 million people had lost their jobs since the recession began in December 2007, with more than half of those job losses occurring in the five-month period between November 2008 and March 2009. According to the BLS, the total number of employed individuals has fallen by 3.7%, the largest decline since the 1957–58 recession. Gross domestic product (GDP) fell by 6.1% in the first quarter of 2009, after falling by 6.3% in the fourth quarter of 2008.

There is evidence that the economic downturn is reversing. Personal consumption spending, which had fallen in the fourth quarter of 2008 by the largest nominal percentage since tracking of personal consumption began in 1947, increased by 1.1% in the first quarter of 2009.[82]

Current projections assume an economic recovery that begins in the second half of 2009, but most of these growth projections are modest. The Blue Chip consensus forecast expects real GDP to grow a scant 0.4% to 0.5% in the third quarter of 2009 and 1.6% to 1.8% in the fourth quarter.[83] By comparison, the 30-year average growth rate in real GDP is 2.7%. Also, most of this 2009 growth will be driven by inventory restocking and manufacturer-side improvements, rather than by a consumer rebound.

But a slow recovery doesn't mean that individual CPG companies can't separate themselves from the pack. Those buoyed by balance sheet strength, dominant market share penetration, and effective supply chains can take advantage of this environment, whether by revitalizing a value brand or by scooping up a distressed business. "Even in a challenging macroeconomic environment," says Pepsi CFO Goodman, "you want to take advantage of any opportunities that present themselves and remain focused on the long term."[84]

International Flavors & Fragrances is seeing indications that the industry is already looking to the other side of this recession. "CPG companies have not gone into a bunker," says the company's Chairman and CEO, Robert Amen. "We have more long-term projects today than we did last year."[85]

The Slowdown's Impact on Employment

Even before the downturn, the overall U.S. manufacturing sector was facing a challenging environment. Unlike the rest of the economy, this sector did not see job growth in the early 2000s. Indeed, overall manufacturing employment fell a stark 16% between 2000 and 2004, then leveled off a bit through 2007 before heading into the steep declines of the current recession. As of March 2009, the manufacturing sector had shed 10.7% of its employment since December 2007.[86]

As overall manufacturing employment was falling, employment in the CPG industry remained relatively stable. At the beginning of the recession, CPG industry employment was essentially the same as it was back in January 2005, and while the rest of the economy pitched headlong into one of the deepest declines in 50 years, employment in the CPG industry fell by only 2.5%. Exhibits 38 and 39 illustrate the change in employment in the overall (non-farm) economy, the manufacturing sector, and the CPG industry since January 2005.[87]

One reason the CPG industry has experienced fewer job losses than other sectors is that many of the products produced by the industry are items that people need, even in a recession. There is also a stable element to the food and beverage components of the industry: As the economy slows, people stop dining out as much and eat more meals at home, which boosts the demand for packaged foods and beverages. However, companies must not become too complacent about this dynamic. CFO Gordon Stetz of McCormick told us that the sheer severity of the downturn has set another force in motion: pantry "de-loading." According to Stetz, "Food companies benefit when people start eating at home, but I believe they have been buying less during the downturn, and we have seen some pantry de-loading. Even staples that people thought would hold up are not doing as well as originally thought."[88]

Exhibit 38: Total Employment by Economic Sector, January 2005–February 2009 (Seasonally Adjusted)

Year	Total Non-Farm	Manufacturing	CPG Industries
Thousands of Employees			
Jan 2005	132,499	14,266	1,437
Dec 2007	138,152	13,777	1,435
Mar 2009	133,019	12,310	NA
Annual Growth Rate			
Jan 2005–Dec 2007	4.3%	-3.4%	-0.2%
Dec 2007–Mar 2009	-3.7%	-10.6%	NA

Exhibit 39: Cumulative Employment Growth

Source: PricewaterhouseCoopers analysis based on data from the Bureau of Labor Statistics (March 2009)

CPG Industry Performance in Previous Recessions

The severity of the current downturn already exceeds that of the 1990–91 and 2001 recessions and is rapidly approaching the levels of the worst post-WWII downturns. Although there is no telling how deep it will go before it reaches bottom and recovery can begin, its extremity suggests that the manufacturing industry—and the CPG segment—will be operating in a difficult environment for some time to come.

One way to gauge the cyclical sensitivity of an industry is to look at how much its output and payroll employment decreases from the peak to the bottom of a business cycle. The resulting peak-to-trough declines can then be compared between different industries and to the economy as a whole.

Exhibit 40 shows the peak-to-trough decline in output for the past six business cycles. On average, the CPG industry has performed broadly in line with the total economy, although sudden, severe recessions such as that in 1973–75 and the current one seem to have a more significant negative impact on the CPG industry.

A dearth of payroll employment data constrains that comparison (Exhibit 41) to include only the past two recessions. The patterns are, broadly speaking, the same as for industrial production, although the recession of 2001 comes across as somewhat deeper in terms of job losses than in terms of output loss, reflecting the rapid pace of productivity growth that characterized the manufacturing industry during that downturn.

Exhibit 40: Performance during Recession: Peak-to-Trough Change in GDP and Industrial Production

Source: PwC analysis based on data from the Bureau of Economic Analysis, Federal Reserve, Macroeconomic Advisers

Exhibit 41: Performance during Recession: Peak-to-Trough Change in Payroll Employment

Source: PwC analysis based on data from the Bureau of Labor Statistics

Price Fluctuations Hit Manufacturers Too

Over the past two years, swings in commodity prices have imposed heavy burdens on the CPG industry. As we discussed in a prior Financial Performance Report co-published by the GMA and PwC, CPG companies have used various strategies to respond to price volatility, such as commodity hedging and better management of input costs.[89] These responses have helped to protect margins and insulate consumers from price shocks.

Bush Brothers CFO Al Williams says that commodity volatility has become the wildcard in his company's efforts to plan for growth. "You can set prices and make projections and budgets," says Williams, "but everything has changed so much in the past year from a commodities point of view, it just kind of becomes an exercise."[90]

Exhibit 43 presents the evolution of food prices between January 2006 and January 2009 at different stages of the supply chain. Prices of crude foodstuffs increased more than 40% between mid-2006 and July 2008, but this did not translate into equivalent price increases at the intermediate or final processed food stage, or in the price paid by consumers. Between January 2006 and July 2008, intermediate food inputs rose by over 25%, processed consumer foods costs rose by approximately 15%, and consumer food prices only increased approximately 12%.

If manufacturers had simply passed along all of these price increases to consumers, the food prices that consumers saw at the store would have risen by well over 13%. Including the impact of energy price increases, which also were spiking during this period, would have pushed this figure even higher. But manufacturers, knowing that the slowing economy was also

putting pressure on consumers, wisely absorbed some of these costs. Since July 2008, commodity prices have fallen and the price pressure on manufacturers has eased. Already, consumers are beginning to see some of the benefits of these lower prices, as food prices fell by approximately 1% between November 2008 and March 2009.

Future Growth: The CPG Industry in the Global Market

The importance of the international market to the domestic CPG industry increased in recent years, in terms of exports. As shown in Exhibit 42, the value of CPG exports more than tripled between 1990 and 2008. The increases have accelerated since 2004, with export growth averaging 17% per year.

The recession, which has spread across the globe, will slow some of the recent export growth, and could even reverse it. But long-term, according to IFF's Robert Amen, the CPG industry is in an enviable position. "There are five billion people in the emerging world," Amen says. "The job of the CPG industry is meeting the needs of a society based not on 'selling more,' but based on what makes sense for that point in their development."[91] As emerging market consumers increasingly show a demand for aspirational brands that are affordable, multinational CPG companies have good reason to be optimistic about the future. Exhibit 42 demonstrates steady long-term growth of CPG exports.[92]

Exhibit 42: Exports of Food and Beverage Manufactured Goods, 1999–2008 ($ Billions)

Source: U.S. Census Bureau, Foreign Trade Statistics, *FT900: U.S. International Trade in Goods and Services,* accessed through the International Trade Administration's TradeStats Express (tse.export.gov)

Exhibit 43: Changes in Prices along the Food Supply Chain, Relative to January 2006

Source: PwC analysis based on data from the Bureau of Labor Statistics, Consumer Prices Indexes (from http://www.bls.gov/cpi) and Producer Price Indexes (http:www.bls.gov/ppi)

Divesting Non-Core Assets

When to Hold 'Em—and When to Fold 'Em

While some organizations view this downturn as an opportunity to gain market share, others are focused on preserving their position and weathering the recession as best they can. And in these times of limited capital resources and deteriorating markets, making poor investment choices—such as investing in assets unlikely to yield an adequate return—could jeopardize a company's stability.

For that reason, CPG companies are taking a critical look at their brand, product, and SKU portfolios to understand the value that each asset provides, and deciding which strategy for that asset—more investment, licensing, joint ventures, divestiture, or liquidation—makes the most sense for the overall business.

Survival of the Fittest

With household wealth at risk and available credit still scarce, consumers are spending less, prompting food retailers to become increasingly aggressive about managing the consumer value proposition through product formulation, size, and price point of the goods on their shelves. This pressure to provide "value" increases pressure on CPG companies, which are left with the choice of finding a way to operate in a leaner fashion or watching their traditional margins erode. Factor in pressure from private label competitors and CPG companies can be left in a difficult position, struggling to move existing inventory and wondering what will fuel their future sales growth.

Exhibit 44 shows consumer credit to be a leading indicator of food-at-home prices, and both have recently peaked. Exhibit 45 reveals that while liquidity has decreased for CPG companies, it has strongly decreased for the top ten grocers, as debt has become higher relative to cash on hand and access to credit has tightened.

The Importance of Objective Portfolio Assessment

The squeeze from consumers and retailers, together with a recession that many expect will continue into 2010, has many CPG companies taking a long, hard look at their portfolio of businesses and brands. One challenge in doing so is that historical methods of evaluation are not very relevant in the current climate. Until recently, the question for many CPG companies was, "What can we do to keep growing?" Today, the question for some is instead, "What can we keep?" Of course, there is still a third question for the strongest and/or most visionary companies: "What assets can we pick up cheaply in this environment?" Sunny Delight CFO Bill Schumacher gives a prime example: "If we can find things that we can tuck in or fit well with what we perceive our strengths are," he says, "we are interested in growing bigger and acquiring in this environment."[93]

Exhibit 44: U.S. Total Consumer Credit Outstanding and Food-at-Home Price Index, 1Q 2005 to 1Q 2009

Source: Bureau of Labor Statistics, Food-at-Home Price Index; Federal Reserve, Total Consumer Credit Outstanding

Exhibit 45: Liquidity Ratio Index* Performance for Top 10 Grocers and CPG Companies, Jan 2006 to Jan 2009

**Liquidity Ratio Index consists of the current, quick, and cash ratios for each of the top 10 U.S. grocers or CPG companies*

Source: PwC analysis

To identify which of these three questions is most appropriate for their particular organization, CPG companies must rethink how they evaluate their asset portfolio—including brands, products, SKU range, patents, and even where they do business. In recent history, sources of capital have stayed relatively plentiful, even in downturns. Now, many entities without existing sources of capital and liquidity will be hard-pressed to fund the growth agendas of even their "best" assets. As such, quarterly or monthly planning is no longer a process of figuring out how much to invest in each business or asset within a portfolio, but instead begins with figuring out which businesses or assets are worth investing in at all.

A Good Growth "Story"

As a basic starting point, CPG companies have looked to objectively understand the growth prospects and viability of each of their assets (both short and long term), the corresponding investment required to drive this growth, and the overall likelihood of reaching potential sales targets. There are two primary pieces of information that management teams are looking to evaluate: whether the asset has a resounding growth "story" and, if so, whether that story can be realized within their organization. Once these are determined, companies can prioritize assets and identify strategic options.

A number of leading CPG companies have developed competencies in assessing their asset portfolios in this manner. For example, Procter & Gamble performs ongoing evaluations of its brands, ensuring that they are performing well and fit strategically within the larger brand portfolio. This process led in March 2009 to the company selling one of its hair care product lines, Johnson Products Company,[94] as well as its Infusium 23 brand.[95]

In this recession, some of the traditional resources used by manufacturers when trying to project the future performance of assets—such as input from customers and suppliers—may no longer be enough. Often, supply chain companies are struggling with the same market dislocations as manufacturers, and may not have any additional insight regarding what's to come. In response, many companies are taking a more holistic approach, such as a business review, to consider the impacts of such factors as evolving customer tastes, future demand based on demographics, and the potential ramifications of ongoing industry changes.

Approaching a Business Review

A business review allows a CPG company to understand each asset's relative value and performance in the overall portfolio. There are two primary issues CPG companies have traditionally considered as part of the multi-step process of conducting a business review:

1. How is the asset performing, relative to key company-defined metrics (e.g., hurdle rates, sales growth targets, etc.)?
2. How well does it fit within the portfolio, taking into account such factors as its brand messaging, price point, geographic positioning, and operating model?

Generally, companies leverage a three-step process in conducting a business review. These steps are shown and described below.

Step 1: Portfolio Analysis

Each asset of a company is affected by the larger market situation as retailers potentially face bankruptcy, competitors change strategies, and consumers shift their spending habits. For example, an increasingly important issue that CPG companies can assess through a portfolio analysis is the growing threat from private label products.

Not surprisingly given consumers' emphasis on value today, private label products have grown even more popular in the past year, with 2008 sales of food and consumer product labels rising by 10%, to $82.9 billion, according to the Private Label Manufacturers Association.[96] In comparison, sales of branded products grew by 2.8% during the same period.[97] As many food retailers increasingly turn to private label and store brands to both please consumers and boost margins, CPG companies—especially those with brands that rank outside the top two or three in their category—should consider how big an impact private label will likely have on their sales growth.

Step 2: Scenario Value Analysis

Once a CPG company understands how its asset portfolio is performing relative to the larger market, it can begin to weigh its options.

The most fundamental question considered when deciding to invest (capital, funds) in an asset is if there is significant value that is not currently being realized and a worthwhile opportunity for profitable growth. It is crucial that, particularly in distressed times, CPG companies allocate capital (promotional, marketing, advertising, or capital for expansion/retooling) only where the potential return on investment is greatest.

Hershey, for example, has been open about its desire to grow internationally, and has now entered into joint ventures in India and China. "The international space is probably where we expect the fastest top-line growth in the marketplace," says Hershey CFO Bert Alfonso.[98] Other CFOs we spoke with shared the same opinion about the growth potential of the international market.

Joint ventures are just one of the ways companies can leverage an asset. Other strategic options generally considered in the CPG space are licensing, divestiture (either through sale or spin-off), harvesting, or liquidation. The most complicated of these choices, of course, is a full divestiture.

Step 3: Divestiture Strategy

If a company decides to divest an asset, it can develop a strategy that covers potential price, timing, process of sale, and how it can best market the asset to potential buyers. Successful marketing approaches require understanding the likely motives of potential buyers. For example, are buyers looking for an asset as a means to enter a new product or geographic market? This was the case in 2008 for Del Monte, when Korean fishery business Dongwon sought a means to enter the U.S. fish products market. Del Monte was able to position its StarKist seafood business as the credible North American foothold that Dongwon sought, obtaining over $350 million in the process.[99]

Another scenario would involve a buyer looking to quickly gain additional market share or acquire specific industry expertise and equipment. When Kraft divested its cereals business to Ralcorp in 2007, it understood that Ralcorp was looking not only to gain share in the cereals business, but also to acquire reputable brands to augment its already growing private label business. As such, Kraft could position the Post stable of brands as delivering on both fronts, netting the company over $2 billion in value for a business it felt no longer fit its long-term growth strategy.[100]

Tending to the High-Performing Businesses and Shedding the Laggards

In today's rough-and-tumble economic climate, CPG companies have stepped up the process of revisiting their asset portfolios to determine which assets will truly drive future growth. That's not to say, of course, that some steady, low-margin businesses don't have a place at the table. The trick is to identify those assets that are not in an organization's future plans, and then do something with them to generate value. That frees up CPG companies to focus on their high performers and put themselves in a strong position for when the eventual recovery occurs.

Making Sure the Price Is Right

For Both Bad Economic Times and Good, Transfer Pricing Processes Need to Be Improved

The ravaged bottom lines of many companies are creating a decrease in corporate income tax collections. As a result, the federal, state, and international tax base is shrinking and probably will continue to do so for some time. In fact, the Congressional Budget Office, in its analysis of President Obama's 2010 budget, projected a 43% decrease in corporate income tax revenue, from $304 billion in 2008 to $174 billion in 2009.[101]

That means both domestic and international taxing authorities are likely to increase their efforts to collect taxes, and that the number of audits—including those focusing on transfer pricing—is likely to increase. Further, this issue won't go away as the economy improves. With many CPG companies anticipating growth abroad in the coming years, transfer pricing will become even more of an issue.

The Multinational Nature of CPG Companies Makes Them Particularly Vulnerable to Greater Scrutiny

Transfer pricing refers to the pricing of transactions between related companies. These intercompany movements of funds and goods often have a substantial impact on income, and are therefore scrutinized closely by tax authorities. Companies must adhere to the "arm's length" standard—meaning that prices in their intercompany transactions must be similar to those charged between independent companies.

Many CPG companies are multinationals, and one of the first items the IRS looks at when auditing multinationals is their transfer pricing transactions. Even companies with strictly U.S. operations may receive a higher state tax bill if they do not have solid, documented transfer pricing processes.

Responding to the Current Environment

In today's economy, companies are expending considerable effort to reduce costs and increase operational and tax efficiencies in a sustainable manner.

Take, for example, a hypothetical U.S. company that sells products in the EU (as well as elsewhere) and is thinking about establishing a principal company in Europe to manage its EU business and to hold the intangibles. In 2008, the company's stock price and profitability declined substantially due to the economic

downturn. This lower stock price may offer the company an opportunity to lower the tax cost of establishing an EU principal company by transferring intangible rights to the principal company at a time when the company's market value is diminished.

Such a move will naturally affect the company's intercompany transactions, and taxing authorities are increasingly scrutinizing the transfer pricing consequences of these kinds of restructurings. Coordination of the tax and transfer pricing aspects of such business moves will be needed to identify the appropriate assets, operations, and personnel to be transferred, as well as to ensure that all facets of the business bear the appropriate costs relative to their operations and revenues.

Considering Comparables

To analyze their transfer pricing performance, companies compare themselves against companies with similar functions, risks, and resources. The profitability of these comparable companies is the primary benchmark, and the time period for which they analyze the profits of the comparables is generally the previous three years. However, due to the highly atypical profitability figures caused by the current economic downturn, some organizations are expanding that period beyond three years to a length that captures a full business cycle.

Finding good comparables is always a challenge, and it is even more difficult today since severe economic conditions can create a serious mismatch between a company and others it may consider as comparables. For example, an upscale retailer that considers comparing itself to a discount retailer may find that the discounter severely outperforms it during periods of recession. Or if the comparable is in another industry, that industry may enter or leave the recession earlier than the company's industry.

The Advantage of Advance Pricing Agreements

Many consumer products companies, including food and beverage manufacturers, have completed advance pricing agreements (APAs) in recent years. An APA is a multi-year contract between a company and at least one taxing authority regarding the transfer pricing method applied to that company's transactions. Through the APA, the tax authorities agree not to seek a transfer pricing adjustment for specified transactions, as long as the company adheres to the terms of the APA. With an APA, any transfer pricing disputes are resolved in a cooperative manner, rather than through the traditional examination process. Companies expecting increases in their transfer pricing scrutiny may want to consider pursuing APAs, especially since the current rough economic environment has spurred the IRS to show greater latitude in developing APA agreements.

Increased State Activity around Transfer Pricing

As states have become concerned about rising budget deficits and declines in tax revenues, some have increased their number of transfer pricing audits. Many have modeled their transfer pricing statutes or regulations after the arm's length standard. But states, unlike the federal government, are not necessarily limited to applying just one transfer pricing method. For example, a state generally applying the arm's length standard may also require the add-back of various expenses related to intangible property, the disallowance of management service fees that involve intangible assets or non-routine services, and selective combined reporting.

To successfully protect their transfer pricing method if challenged by state tax authorities, multi-state companies must be able to provide supporting documentation for their intercompany transactions. Some states, such as New York, are expected to increase requests for transfer pricing documentation prepared contemporaneously with associated transactions or reorganizations.

With corporate structures growing more complex, some states and jurisdictions, such as New Jersey and the District of Columbia, are hiring outside experts to prepare domestic transfer pricing reports to help them determine the tax liability of multi-state companies.[102] This makes it even more vital to have high-quality, compliant, transparent transfer pricing processes and documentation.

Better Practices Boost the Bottom Line

With state, federal, and international taxing authorities increasing their enforcement of tax codes, greater scrutiny is going to be paid to companies with transfer pricing issues. Lax standards and processes may cost a company precious resources, not just now, but over the long term. However, with a robust and well-documented transfer pricing process, companies can reduce the risk of double taxation that may result from these new enforcement efforts.

Sustainability and Long-Term Success

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

In last year's report we offered some interesting connections between sustainability practices and corporate performance. Despite today's economic challenges, companies continue to have a strong interest in sustainability and see it as a differentiator and opportunity in the marketplace. As Campbell CFO Craig Owens notes, "Sustainability is relevant to the consumer, it's relevant to employees, and it's more and more an issue in recruitment. Constituents really want to understand what you are doing about it."[103]

Another reason sustainability is still top-of-mind is that the U.S. Congress has introduced more than 200 propositions related to climate change and carbon cap-and-trade plans since 2007. Now, with the Obama administration viewing cap-and-trade as a key component of its energy policy, the possibility of a regulated reporting system eventually being established in the U.S. is very real.

Sustainability and Performance, the Sequel

Last year we introduced a PricewaterhouseCoopers analysis comparing the performance of companies that establish, report through one or more of six well-known sustainability indices, and achieve recognition for their sustainable activities ("reporting" companies) against companies that only report standard financial data ("non-reporting" companies). Our most recent analysis consisted of 64 large companies, 28 reporting and 36 non-reporting. For the purposes of this analysis, a company that reported sustainability at any time during the five-year comparison period was included in the sustainability reporting group.[104]

We found that, similar to our analysis last year, there are notable differences between the performance of the reporting and non-reporting groups as outlined below and depicted in Exhibit 46:

- Reporting companies had higher median gross margins than non-reporting companies. Over the last five years, the reporting companies' gross margins have been, on average, 10% higher than non-reporting companies. In 2008, this gap widened to 15%.
- Strong gross margins were supported by strong SG&A spending, with the reporting group consistently reporting roughly 12% higher SG&A spend as a percent of sales.
- Strong gross margins drove substantially higher return on sales for the reporting group.
- Higher margins helped reporting companies produce more cash than their non-reporting counterparts, as evidenced by their notably higher free cash flow to sales performance. This trend is also sustained over the three- and five-year time frames.

While strong performance of reporting companies correlates with their sustainability efforts, the question we cannot answer yet is which came first: Are better-performing companies able to focus more of their attention to establishing, reporting, and achieving recognition for their sustainability efforts because they are already performing well, or do companies perform better because of their push to establish, report, and achieve recognition for their sustainability efforts? It will take more analysis over a long period of time to definitively answer this question. In the meantime, the facts show that sustainable companies outperform non-sustainable companies on a number of key financial measures.

Exhibit 46: Sustainability Performance

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Financial Performance Metrics

Retailer Performance Data

This section contains charts illustrating the 2008 performance of CPG retailers as a whole. Since the fourth quarter of 2008, the main storyline concerning retailers in the financial and business press has been the precipitous drop in U.S. consumer confidence, which presumably drives retail sales.

And, sure enough, 2008 shareholder returns and sales growth for CPG retailers declined year-over-year. But the retail sector's ever-increasing agility has allowed it to avoid a worst-case scenario.

For example, median sales growth for CPG retailers was about 9% for 2008, just short of that achieved in 2007. As for grocery retailers specifically, they registered median sales growth of about 5%, lower than the overall CPG retailing sector but a positive result nonetheless (see Exhibit 24, p. 19). By working with manufacturers to quickly get value-oriented products on shelves, as well as making judicious price adjustments related to a mid-year spike in commodity prices, retailers were able to produce decent returns in one of the most difficult environments in decades.

Exhibit 47: Retailers: Comparison to Manufacturers Data

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Overall Manufacturing Data

This section includes charts analyzing the overall performance of CPG manufacturers. As mentioned in the Executive Summary, the industry's median shareholder return declined slightly more than 25%, meaning that CPG companies still outperformed the S&P 500 and the Dow Jones Industrial Average in 2008.

CPG manufacturers' top-line growth was quite healthy, with median sales growth of 10%—much of this likely stemming from consumer moves to eating more frequently at home, the trend to value-oriented products, and mid-year commodity price spikes. Median gross margins dipped slightly, as consumer spending patterns shifted to value-oriented products at lower price points. At first blush, the industry's mean return on market capital looks very healthy, particularly in the midst of recession. But the slight increase can be attributed to the fact that contracting market cap values pushed the return rate higher.

From a balance sheet point of view, the stark contrast between the CPG sector and other industries was clearer than ever. The sector, which had a median debt-to-equity ratio of less than 1:1 in 2008, was far less leveraged than many other industries. But the weakest CPG companies, the bottom 25th percentile, didn't have an easy time managing their debt, as their ratio of short-term debt to long-term debt increased. Also, the interest coverage ratio for this group sank to near zero in 2008, meaning that these companies were barely covering interest payments and had little room for further deterioration of their financial position.

Exhibit 48: Overall CPG Industry, Manufacturers (Companies > US$50M)

Income Statement Metrics

Median Free Cash Flow to Sales

Return on Sales

Sales per Employee

Gross Margin

SG&A as a Percentage of Sales

Effective Tax Rate

Liquidity Metrics

Current Ratio

Interest Coverage Ratio

Debt-to-Equity Ratio

Short-Term Debt to Long-Term Debt Ratio

Balance Sheet Metrics

Inventory Turnover

Return on Average Assets

Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Top Quartile
Median
Bottom Quartile

Manufacturers: Large, Medium, and Small Company Data

This section includes charts analyzing the performance of large, medium, and small manufacturers. It's conventional wisdom that large companies have the scale, bench strength, and financial resources to better stay on course during tough times. But we found that medium-sized companies, in particular, are also weathering the economic storm fairly well.

In fact, the medium-sized CPG companies we analyzed have demonstrated superior shareholder return over one- and three-year periods than either large manufacturers or small manufacturers. Large companies did tally the highest profit growth in 2008 at approximately 7%, while small companies' profit growth took a steep dive as median profits actually contracted by more than 10% compared to 2007 results. Small companies also fared the worst with a one-year median return of approximately negative 50%, due in large part to a combination of slightly lower gross margins and slightly higher SG&A costs.

Looking to some broad performance measures, each of the size segmentations reflected deteriorating performance with generally lower margins, EBIT growth, interest coverage, return on assets, and return on invested capital. While these factors pushed profitability down, the good news for each segment was that they remained profitable based on their median return on sales and net operating profit after tax (NOPAT) results.

Exhibit 49: Size-Specific Data (All Sectors)

Income Statement Metrics

Median Free Cash Flow to Sales

Median Return on Sales

Median Sales per Employee

Median Gross Margin

Median SG&A as a Percentage of Sales

Median Effective Tax Rate

Liquidity Metrics

Median Current Ratio

Median Interest Coverage Ratio

Median Debt-to-Equity Ratio

Median Short-Term Debt to Long-Term Debt Ratio

Balance Sheet Metrics

Median Inventory Turnover

Median Return on Average Assets

Median Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Large Manufacturers
Medium Manufacturers
Small Manufacturers

Large Manufacturers
Medium Manufacturers
Small Manufacturers

Manufacturers: Very Large Company Data

This section contains charts showing the 2008 performance of the very large GMA manufacturers, a group that consists of manufacturers with sales over $10 billion for the most recently reported year. While it might be a stretch to say that as the very large CPG companies go, so goes the industry, the performance of these companies does serve as a bellwether of sorts.

Overall, these manufacturers experienced solid sales growth of approximately 10% in 2008, just slightly lower than 2007. (These very large sales statistics do, in fact, parallel those of the overall universe of CPG companies we analyzed.) EBIT growth declined significantly, while the NOPAT margin was down approximately 2%. SG&A spending as a percentage of sales remained solid even in a weak economy, hovering around 30%. This trend has persisted in both weak and strong economies, showing that the very biggest players in the industry see a link between investing in their brands and strong sales growth, and continue to spend accordingly.

The 2008 median interest coverage ratio for very large GMA manufacturers dipped slightly compared to 2007, but profitably remained a steady six to eight times interest. These companies improved their cash conversion cycle by four days between 2006 and 2008, allowing them to free up more cash from their balance sheets during a time when profits are narrow and access to credit is tight. Return on invested capital and return on average assets were down by very small amounts compared to 2007, but demonstrated strong consistency when looked at over the past five years.

Exhibit 50: Very Large Manufacturers (All Sectors)

Return Metrics

Median Shareholder Return

Median Return on Invested Capital

Median Return on Market Capital

Growth Metrics

Median Net Sales Growth

Median EBIT Growth

Income Statement Metrics

Median Free Cash Flow to Sales

Median Return on Sales

Median Sales per Employee

Median Gross Margin

Median SG&A as a Percentage of Sales

Median Effective Tax Rate

Liquidity Metrics

Median Current Ratio

Median Interest Coverage Ratio

Median Debt-to-Equity Ratio

Median Short-Term Debt to Long-Term Debt Ratio

Balance Sheet Metrics

Median Inventory Turnover

Median Return on Average Assets

Median Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Manufacturers: Food, Beverage, and Household Sector Data

This section includes charts analyzing the performance of the CPG industry's three major sectors: food, beverage, and household products. Each sector exhibited strengths that contributed to the industry performing as well as could be expected in the midst of a deep recession.

Among the three CPG sectors, food manufacturers registered the best overall performance from a shareholder return perspective. The sector's financial returns remained strong considering the impact of the recession, with median returns on invested capital, market capital, and assets either flat or down just slightly. Sales grew by 10%, driven by consumers shopping for value and doing more eating at home, and also by some price increases to partially offset higher commodity prices. Overall, food companies remained profitable with only minimal declines, as shown by flat EBIT growth, slightly lower return on sales, and a slightly lower NOPAT margin.

Shareholder returns for beverage companies fell by more than 30%, the weakest performance of the three sectors. Also telling was that return on invested capital, return on market capital, and return on assets all fell significantly in 2008, and median EBIT performance contracted by 20% after last year's growth of 10%. Median NOPAT fell from being the highest of the three sectors at approximately 9% to tying for the lowest at 4%.

For the household companies, the story continued to be one of weathering the economic storm quite well. While shareholder returns fell by just under 30%, the sector recorded the highest profit growth, median NOPAT margin, and return on sales, though these figures declined from 2007.

Exhibit 51: Sector-Specific Data (All Sectors)

Income Statement Metrics

Median Free Cash Flow to Sales

Median Return on Sales

Median Sales per Employee

Median Gross Margin

Median SG&A as a Percentage of Sales

Median Effective Tax Rate

Liquidity Metrics

Median Current Ratio

Median Interest Coverage Ratio

Median Debt-to-Equity Ratio

Median Short-Term Debt to Long-Term Debt Ratio

Balance Sheet Metrics

Median Inventory Turnover

Median Return on Average Assets

Median Cash Conversion Cycle

Source: Reuters Fundamentals, Reuters Pricing, and PwC analysis

Beverage
Food
Household Products

Beverage
Food
Household Products

Appendix A: Financial Performance Metrics Methodology

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

Data Sources

Reuters Fundamentals data was the primary source of data for the analysis presented in the Financial Performance Metrics section of this report. This Reuters dataset includes annual financial data from 2003 through 2008, by fiscal year, for publicly traded companies. The report uses restated data that accounts for mergers, acquisitions, divestitures, and accounting changes. All data used to construct financial metrics is "as reported" by the companies. Additionally, the study team collected financial data for private-sector manufacturers through a survey administered by the GMA.

Exhibit 52: Primary Manufacturer NAICS Codes by Sector

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

Company Choice

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

Manufacturers

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

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

Retailers

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

Exhibit 53 lists the retailer NAICS codes and NAICS code descriptions by sector used in the Financial Performance Metrics section of this report.

Exhibit 53: 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 Superstores
452990	All Other General Merchandise Stores
453910	Pet and Pet Supplies Stores

Data Preparation and Metric Construction

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

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

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

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

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

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

Data Reporting

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

Firms with more than US$10 billion in net sales in their most recent 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 benchmarks noted in Exhibit 54.

Exhibit 54: Size Segmentations for Financial Reporting Metrics

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

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

Counts for the number of manufacturers included in each size- and industry-based segment are included in Exhibit 55.

Exhibit 55: Manufacturing Companies by Industry Size and Segment

	Small	Medium	Large (Very Large)	TOTAL
Beverage	7	8	17 (12)	32
Food	31	28	27 (17)	86
Household Products	8	11	20 (13)	39
TOTAL	46	47	64 (42)	157

Appendix B: Manufacturer Company List

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

Appendix C: Definitions

Beverage manufacturers

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

Book capital

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

Cash conversion cycle

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

Cost of goods sold

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

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

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

CPG Market Weighted Index

This index is comprised of 101 CPG companies that were actively traded on U.S. stock exchanges from January 1, 2006, through December 31, 2008. A market-weighted methodology was applied in computing the index. The value of the CPG Index at the end of each month represents the aggregate total of market capitalization of each of the companies present in the CPG Index. For a given company, the market capitalization was computed as the product of closing monthly price and the average of the reported and previous fiscal year's total common shares outstanding. The one-year index through April 2009 included the same group of companies, as available.

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

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

Current ratio

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

Days sales outstanding

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

Debt-to-equity ratio

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

EBIT

Earnings from continuing operations, before interest and taxes.

EBITDA

Earnings before interest, taxes, depreciation, and amortization.

Economic profit

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

Effective tax rate

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

Food manufacturers

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

Free cash flow as a percentage of sales

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

Gross margin

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

Household products manufacturers

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

Interest coverage ratio

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

Inventory turnover

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

Large companies

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

Market capital

Sum of total debt and total market value of equity.

Medium companies

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

Net sales

Net revenue as reported by a company.

Return on average assets

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

Return on invested capital

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

Return on market capital

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

Return on sales

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

Sales per employee

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

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

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

Shareholder return

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

Short-term to long-term debt ratio

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

Small companies

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

Total debt

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

Very large companies

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

Endnotes

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[2] PricewaterhouseCoopers interview with Craig Owens (April 7, 2009).

[3] PricewaterhouseCoopers interview with Duane Still (March 31, 2009).

[4] PricewaterhouseCoopers interview with Richard Goodman (April 6, 2009).

[5] "DealWatch: PepsiCo's Bid for Bottlers Could Spur Rival Deals," *Money.com* (April 22, 2009).

[6] Colgate-Palmolive at Consumer Analyst Group of New York (CAGNY) Conference (February 20, 2009).

[7] PricewaterhouseCoopers interview with Robert Amen (April 22, 2009).

[8] In our criteria, large companies were those with sales of more than $4 billion for the most recent reporting period, while very large were those with sales of more than $10 billion. Additionally, medium companies were those with greater than $500 million and less than or equal to $4 billion net sales in their last reported fiscal year, while small companies were those with greater than $50 million and less than or equal to $500 million in net sales in their last reported fiscal year.

[9] PricewaterhouseCoopers interview with Bill Schumacher (April 6, 2009).

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[11] PricewaterhouseCoopers interview with Rick Puckett (March 31, 2009).

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[23] PricewaterhouseCoopers interview with Robert Amen (April 22, 2009).

[24] PricewaterhouseCoopers interview with Thom Gilday (March 12, 2009).

[25] PricewaterhouseCoopers interview with Rick Puckett (March 31, 2009).

[26] PricewaterhouseCoopers interview with Al Williams (March 23, 2009).

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[28] Gerald F. Seib, "In Crisis, Opportunity for Obama," *The Wall Street Journal* (November 21, 2008).

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[32] Wal-Mart Stores, Inc., SEC Form 10-K for the fiscal year ended January 31, 2009 (May 12, 2009); http://walmartstores.com/Investors/SECDisplay.aspx?ipage=6245246&repo=tenk.

[33] Wal-Mart Stores, Inc. press release, "Wal-Mart Reports Financial Results for Fiscal Year and Fourth Quarter" (May 12, 2009); www.walmartstores.com/news.

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