2012 Financial Performance Report
Profitable Growth: Driving the Demand Chain

Results for the food, beverage, and consumer products industry

The Association of Food, Beverage and Consumer Products Companies

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Based in Washington, D.C., the Grocery Manufacturers Association is the voice of more than 300 leading food, beverage and consumer product companies that sustain and enhance the quality of life for hundreds of millions of people in the United States and around the globe.

Founded in 1908, GMA is an active, vocal advocate for its member companies and a trusted source of information about the industry and the products consumers rely on and enjoy every day. The association and its member companies are committed to meeting the needs of consumers through product innovation, responsible business practices and effective public policy solutions developed through a genuine partnership with policymakers and other stakeholders.

In keeping with its founding principles, GMA helps its members produce safe products through a strong and ongoing commitment to scientific research, testing and evaluation and to providing consumers with the products, tools and information they need to achieve a healthy diet and an active lifestyle.

The food, beverage and consumer packaged goods industry in the United States generates sales of $2.1 trillion annually, employs 14 million workers and contributes $1 trillion in added value to the economy every year.

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

PwC US helps organizations and individuals create the value they're looking for. We're a member of the PwC network of firms with 169,000 people in more than 158 countries. We're committed to delivering quality in assurance, tax and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com/us.

For more information about PwC's Retail and Consumer Products Industry Practice, visit www.pwc.com/us/retailandconsumer

Foreword

The Grocery Manufacturers Association (GMA) and PricewaterhouseCoopers (PwC) are pleased to present our *2012 Financial Performance Report* and overview of the consumer packaged goods (CPG) industry.

Perhaps more than those in any other sector, CPG companies constantly monitor the temperature of the consumer. Shoppers maintain some of their most intense product associations with many of the brands covered in this report. And yet, that series of activities that sparks and maintains consumer devotion to a product and a brand—in this report we call it the “demand chain,” a term that’s recently entered the business lexicon—too often plays second fiddle to the adults in the room: purchasing, operations, and, of course, the supply chain.

Given that US consumers have enjoyed another year of steady improvement in their purchasing power, we decided to produce the content of our 2012 report with an eye toward the demand chain. We think you’ll quickly see the difference, given articles with titles like “Catching up to consumers in the age of demand,” “Are your demand and supply chains in synch?” and “Is the time right to invest in a direct-to-consumer channel?” As in previous years, we begin the report with an executive summary that includes our top-performing companies analysis and an economic overview. The executive summary also includes a fuller description of the demand chain and how we view its rightful place in the corporate architecture.

We’ve used a number of sources to compile our 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 142 manufacturers. We would especially like to express our appreciation to the following executives, who participated in the interview process and whose insights appear throughout this report:

Bert Alfonso, *The Hershey Company*

Chris Davies, *Diageo*

John Gehring, *ConAgra Foods*

Don Mulligan, *General Mills, Inc.*

Steve Robb, *The Clorox Company*

Bill Schumacher, *Sunny Delight Beverages Company*

Duane Still, *The Coca-Cola Company*

Al Williams, *Bush Brothers*

In addition, we want to highlight the extraordinary contributions of PwC team members Tamara Beresky, Christine Hoyte, and Kristin Krogstie, who guided the development and refinement of all aspects of this year’s report.

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

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Table of contents


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Executive summary: Keeping pace in a demand-driven world

With consumers firmly in control, CPG companies need to rethink their value proposition

In 1982, management consultant Keith Oliver was helping a client to better align its typically excess inventory level with its sales goals. Oliver's insight was to consider all the processes that went into stocking the company's warehouses as one "chain of supply" rather than as a group of siloed activities executed by unrelated players.[1] History doesn't tell us what happened with Oliver's client, but the engagement helped birth the concept of the supply chain, and with it a new way of thinking about manufacturing.

Ever since, the supply chain concept has enjoyed enormous influence as companies around the world have met customer needs and delivered shareholder value by efficiently managing the logistics around sourcing, production, and distribution; outsourcing non-core activities; and moving manufacturing to low-cost territories. At the core of all these innovations is supply chain management.

But here's a question: What if there had been a different paradigm used instead of focusing on chain of supply?

What if, instead of approaching his client's issue from the angle of changing the way supply was managed, Oliver had decided to try and boost customer demand for his client's products? In other words, what if the demand chain rather than the supply chain had been reimagined? Well, the reality is that he probably wouldn't have gotten very far. Back in 1982, the tools to connect with consumers, measure their association with a given brand, or track their spending patterns were pretty meager—mostly advertising to communicate with consumers, and cash register data to understand what their tastes and spending patterns were.

Today, 30 years later, it's still critical to get supply chain management right. But in a flat world, incremental improvements extracted via a new shared service center or a relocated production facility are, generally, not going to distinguish a company. Fortunately, though, companies in the consumer packaged goods (CPG) sector now have at their fingertips all the tools they need to kick the tires on another driver of growth and profitability: the demand chain.

Meanwhile, at the other end of the value chain…

Loosely defined, the demand chain refers to the part of the value chain that creates profitable growth by driving numerous customer interactions with a company's brands and products. Put another way by Sunny Delight CFO Bill Schumacher, "The demand side consists of innovation, marketing, and sales, and I would say the key is how these three activities are integrated to identify and exploit opportunities."

No doubt, most CPG companies believe they are laser-focused on the consumer as never before, but the reality is that most organizations' strategic attention is still firmly fixed on the supply chain: trying to cut costs in manufacturing and betting that legacy products can, against all evidence, be rebranded in new territories without a lot of investment in new research and development. A focus on the demand chain, conversely, provides major new opportunities to realize brand promise and drive growth.

The obvious links in a demand chain at a typical CPG company might include front-end sales, marketing, customer service, and trade promotions. But a demand chain can also include brick-and-mortar retail partners, websites and online retailers, social media sites where consumer products are debated and discussed, and logistics partners who might manage the returns process or end-of-product-life recycling. In fact, a successful demand chain can be understood as a collaboration between manufacturers, retailers, and these other applicable partners to better identify and meet customer demand.

While supply chains have been engineered and re-engineered to the hilt, the demand chain is a work in progress. Companies are just starting to really notice that consumer expectations and attitudes are changing radically, and that keeping pace is critical to their survival. In fact, in PwC's *15th Annual Global CEO Survey* (January 2012), customer demand was the number-one reason given by both consumer companies (64% named this reason) and retailers (68%) for rethinking strategy.

But companies need better tools to monitor and understand demand. To understand why, in the consumer's mind, some services and products register as high-demand items and others lag as also-rans, companies must build more robust capabilities around digital commerce, ensuring the full integration of Internet and mobile strategies with other operations and developing ever-more-advanced consumer analytics technology. Today's multi-platform technology and information environment has given companies more ways than ever before to connect with consumers, but it's also made those consumers' attention spans more fleeting, and their whims ever-changing.

Clorox CFO Steve Robb reflects on this paradox: "Consumer information today is much more fragmented. It used to be you could put on a national TV spot and reach all of your consumers. But with the Internet, handheld devices, and other sources, consumers are getting information from many different places. This does not mean national TV advertising isn't important; of course it is. But it's not the only way to communicate with the consumer. The way we like to say it, you need to talk to the consumer where they are listening. And they are listening in different places."

With a better and better integrated demand chain, CPG companies will be able to more efficiently and effectively connect with consumers, no matter where in the digitally connected world they're hiding.

The demand chain in this year's report

In this year's report, we've made a point of weaving our demand chain theme throughout our three sections: enabling the demand chain, new paths for the shopping journey, and pursuing growth overseas.

In Section 1, the article "Catching up to consumers in the age of demand" shows how companies are deeply mining digital data to forge new marketing tactics, bundling product offerings in new ways, and exploring consumer behavior that's long been regarded as unknowable—such as why particular consumers frequently purchase a product one year, ignore it the next, and then start up again in year three. Another article, "Are your demand and supply chains in synch?" reminds us that a focus on the supply chain never goes out of style—it's just that consumer demand moves so fast, and consumers love new empowering technologies so much, that only those companies with fast, nimble, cost-effective supply chains can effectively meet that demand.

In Section 2, "New paths for the shopping journey," one of our articles explores "Is the time right to invest in a direct-to-consumer channel?" a question many CPG executives have been asking themselves these days. This is one of the most fundamental issues of our time, because it gets to the root of what CPG companies are, and how they relate to their retail partners.

Previous years' editions of this report have included an article on sustainability, and this year is no different. In keeping with our demand chain theme, though, this year's article, "Stirring up sustainability demand," looks at how companies today view sustainability efforts as basic "table stakes," and how the new Holy Grail is stoking consumer demand for a product based on its green credentials. But a caveat: Shoppers are wary of inauthenticity and are getting overwhelmed by the many sustainability stamps of approval they find all over stores and supermarkets.

Section 3 of this report tackles the topic of overseas expansion, and includes practical articles, "Capitalizing on emerging market growth opportunities" and "Before expanding abroad, dig deeper into the tax implications." But in a further nod to international growth, this year we've added a twist to our thinking around what constitutes a global company. Later in this executive summary, we've included a short article on how companies with at least 20% of their revenues coming from outside the United States perform in various metrics, versus companies whose international revenue is less than 20%. There are many reasons for a company to "go global," and surely revenue growth is one way to measure these efforts.

Economic recovery remains vulnerable on all fronts

From input prices to fiscal distress, too much volatility for comfort

The fragile environment of the first half of 2011—with high unemployment, a weak job market, and mixed economic signals—gave way to one of promise. By the second half of 2011, the US economy appeared to regain its footing and resume stable, if slow, growth. Positive developments in the labor market and reviving consumer confidence prevented the economy from slipping back into a downturn.

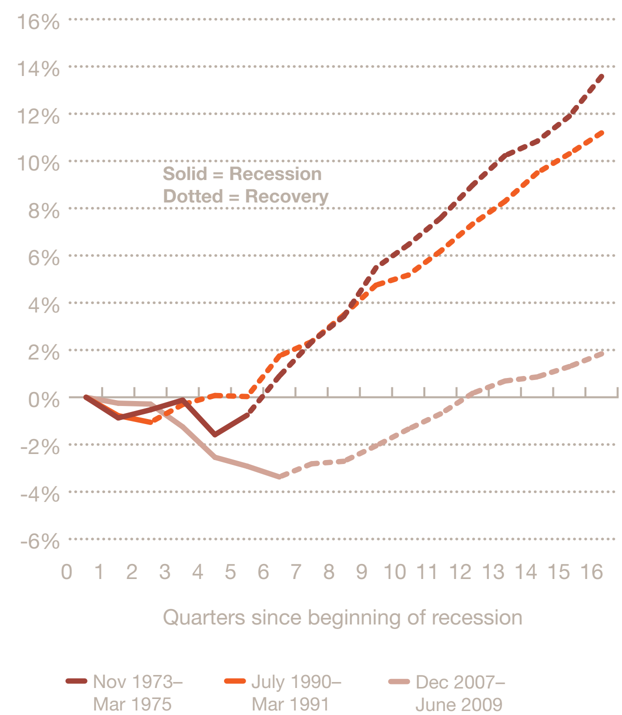
Amid the hopeful signs, risks remain for CPG companies. Volatile gas and commodity prices have raised operating costs while making consumers reluctant to boost their spending significantly. Export markets face their own risks, such as the fallout from the European debt crisis. Federal tax and spending policy changes are scheduled to take effect at the beginning of 2013 unless Congress modifies them before year-end, and could have major economic ramifications.

For CPG companies, then, it's been a one-step-forward, one-step-back recovery. "A significant portion of the population is seeing no income growth, and gasoline prices and healthcare costs are eating away at all disposable income," says Al Williams, CFO of Bush Brothers. "So while the overall economy may see some growth, the food industry might have to lag."

The recovery plods along

Compared to past recoveries, the current one that began in mid-2009 has been anemic. High US unemployment rates in 2009, 2010, and 2011 combined with low income growth to hold back consumer spending, and consumer hesitancy to return to the market served to dampen revenue growth. Real consumption (household spending adjusted for inflation) declined further during the recent recession than in prior recessions, remained low for a longer period, and increased only modestly during the recovery. Four years after the recession began, real consumption is only 2% above its pre-recession peak. By contrast, four years after the 1990–91 recession, real consumption had risen 11% from its pre-recession peak, and four years after the 1973–75 recession, real consumption had reached almost 14% higher than its pre-recession peak (see Exhibit 1).

Exhibit 1
Growth in real consumption during selected recessions and subsequent recoveries



Source: Bureau of Economic Analysis, National Income and Product Accounts Table 1.1.6, accessed March 2012; PwC calculations.

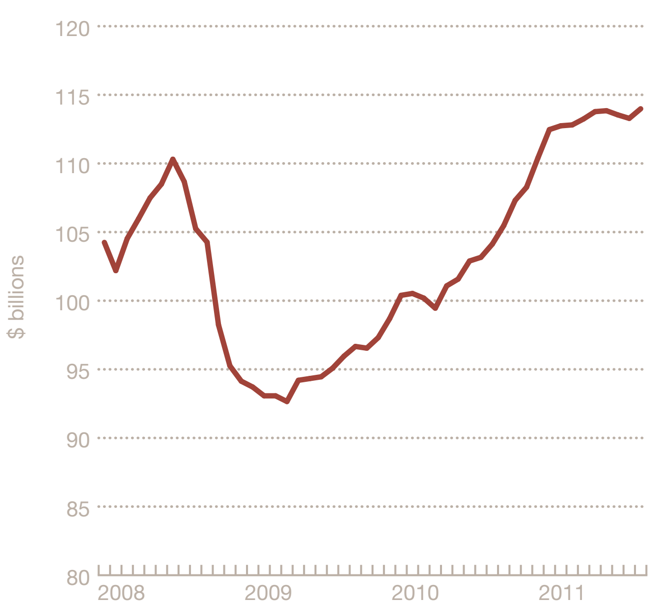
Real consumption fell by over 3% during the most recent recession. Total shipments by CPG companies declined further than overall consumption, but have recovered more vigorously. The value of CPG shipments hit their low in mid-2009, a level 16% below the high of mid-2008. Through mid-2011, shipments increased at an average annual rate of around 10%, in contrast to nominal consumption for all products, which grew an average of 4% annually after the recovery began.[2] However, during the second half of 2011, growth was essentially flat (see Exhibit 2, page 6). Two important developments help to explain the growth in the value of shipments in 2010 and 2011, as well as the subsequent slowdown in 2011: commodity price movements and consumer spending patterns.

Escalating commodity prices squeeze producers and consumers

Input price increases—a consequence of escalating commodity prices—had a major impact on CPG manufacturers last year. The spike in food commodity prices that began in mid-2010 continued through the end of 2011. By the end of December 2011, the average price of crude foodstuffs (livestock feed as well as inputs for food products) was more than 30% higher than it had been two years before, in January 2010 (see Exhibit 3). This increase drove producer food prices up 10% by the end of 2011. "If inflation every year was a predictable 4 or 5%, we could adjust," says Don Mulligan, CFO of General Mills. "It's when it's 10% one year and minus 1% the next that it gets tough for our industry—which is predicated on consistency, both for consumers and investors."

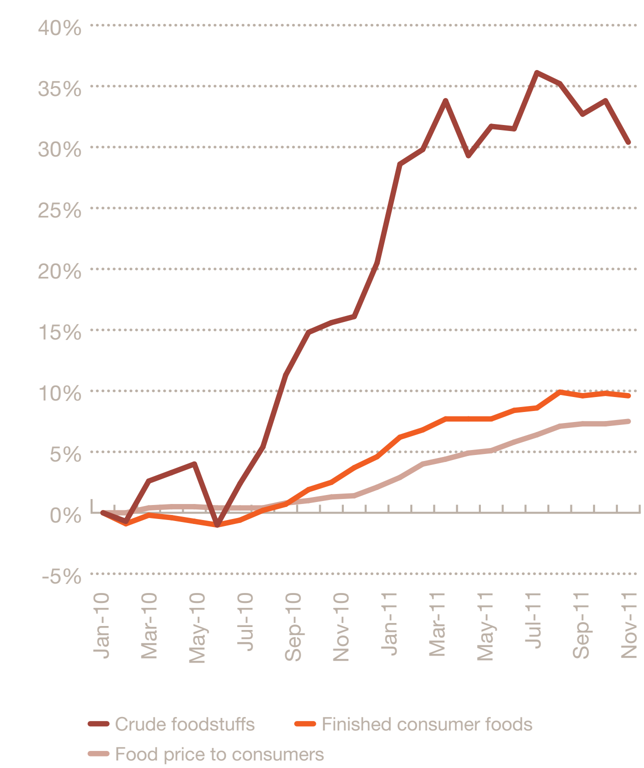
By the end of 2011, consumer prices were, in turn, 7.6% higher than they were in January 2010. Between January 2010 and December 2011, the prices charged by producers for finished consumer foods rose 10% while the value of shipments of CPG products rose 17%. The increase in sales during this period is largely attributable to this price increase.

Exhibit 2
Value of monthly CPG shipments, 2008–2011



Source: US Census Bureau, "Manufacturers Shipments, Inventories, and Orders," seasonally adjusted values, accessed February 2012.

Exhibit 3
Food prices, 2010–2011



Source: Bureau of Labor Statistics, values for Consumer Price Index (Food at Home) and Producer Price Index (Crude Foodstuffs and Feedstuffs, Finished Consumer Foods), accessed March 2012.

US Department of Agriculture research shows that approximately 24 cents of every food dollar (food consumed at home) goes to the farm, with the rest going to processing, marketing, transportation, and other links in the food production and distribution chain.[3] Given the 32.5% increase in commodity prices from January 2010 to December 2011, food prices to consumers should have increased by approximately 8%—and they did. At the same time, the significant rise in gas prices (a 20% average increase between January 2010 and December 2011[4]) has exacerbated the cost pressures on producers. This increase squeezed not only CPG companies but also consumers, affecting their purchasing decisions. During this same two-year period, average household income rose by only 5.7%.[5] Thus, households have had to adjust their spending to accommodate rising prices in the face of sluggish income growth. As Bert Alfonso, CFO of The Hershey Company, points out, "Consumers are watching how they shop and what they shop for, and those on the lower end of the income scale are living more paycheck to paycheck." If gas prices continue to escalate (as they did in early 2012), households could be forced to reduce their discretionary purchases, which could slow the recovery.

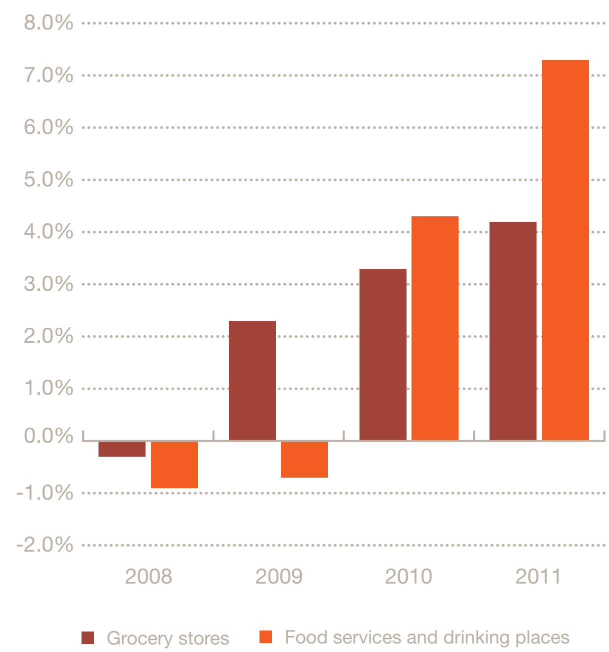
As consumers grow confident, restaurants gain

Just as CPG growth slackened in the second half of 2011, the job market and consumer confidence began to gain momentum.

Consumers behaved frugally during the recession, forgoing dining out. But data from 2011 suggest this trend is reversing. Annual spending at dining and drinking establishments grew more than 7% between December 2010 and December 2011; at the same time, grocery store sales increased by just over 4% (see Exhibit 4).

If rising consumer confidence leads households to shift more of their food dollars to restaurants, that may be a good sign for the economy overall, but it is a less welcomed one if it comes at the expense of those households' CPG spending. This trend follows the pattern seen after past recessions: In 1992, following the 1991 recession, household spending on food consumed at home fell by 0.3% while spending on food away from home increased 0.7%.[6]

Exhibit 4
Annual growth in retail spending
(December-to-December single-year growth rates)



Source: US Census Bureau, "Monthly Retail Trade and Food Services," March 2012.

Exports continue their steady rise

Although the US market, given its size, remains a key target of CPG companies, opportunities for profitable growth exist overseas as well. In 2011, food manufacturers accounted for the lion's share of total CPG exports: 73%, compared to makers of paper products (16%) and soaps and other cleaners (11%).[7]

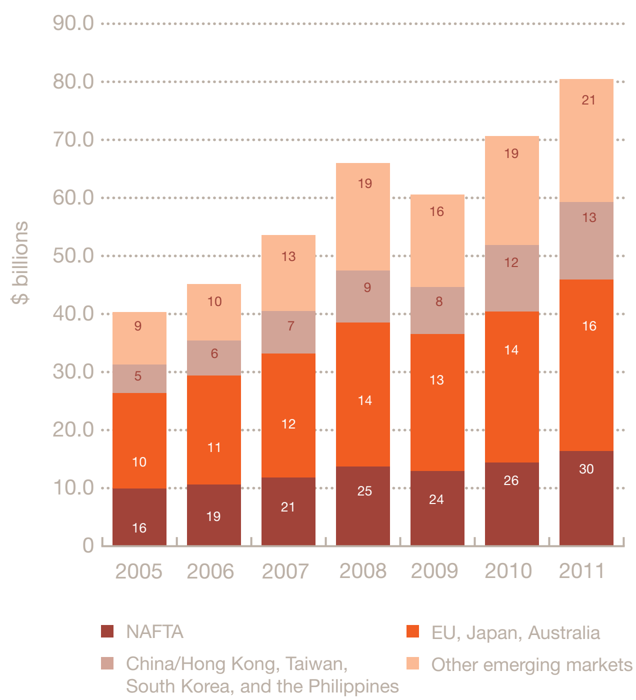
If an improving US economy revives sales for CPG products, the continuing globalization of the CPG market holds even greater potential for CPG companies. Between 2005 and 2011, total exports of CPG products essentially doubled, from $40.3 billion to $80.3 billion. The $40 billion increase was split evenly between traditional export markets (the European Union, Canada, Japan, and Mexico increased from $26 billion to $46 billion) and emerging economies (which increased from $14 billion to $34 billion) (see Exhibit 5).

To put the $40 billion exports increase in perspective, total US grocery store sales rose by $93.5 billion between 2005 and 2011.[8] The US dollar's strength relative to the Canadian dollar, the Mexican peso, and the euro in 2011 made US exports to those markets less competitive, although CPG product exports still increased. If the dollar strengthens further in 2012, CPG exports could suffer.

As EU countries tackle the sovereign debt crisis, the fallout in the real economies of those countries could erode demand, with US products likely to be impacted disproportionately. Currently, the European Commission projects negative growth for the euro zone economies in 2013,[9] so the near-term outlook is weak.

Emerging markets remain the most promising source of economic growth, as the expanding middle class in these countries consumes more and, in turn, boosts world demand. The Organisation for Economic Co-operation and Development (OECD) estimates that non-OECD countries will account for roughly 75% of global economic growth between 2012 and 2013.[10] For example, between 2012 and 2014, real growth in China is expected to range between 8.3% and 8.7%, while projections for India are between 6.7% and almost 8%.[11] Efforts to expand trade between the United States and these markets (for example, the free trade agreement signed by the United States and South Korea in 2011) will also help spur US exports. A strengthening of the Chinese yuan in 2011 relative to the US dollar made US exports cheaper for Chinese consumers. Indeed, US exports of CPG products to the largest emerging-nation purchasers (China/Hong Kong, Taiwan, South Korea, and the Philippines) almost tripled between 2005 and 2011, from $5 billion to $13 billion.

Exhibit 5
Exports of CPG products, by market



Source: International Trade Administration, *TradeStats Express* data for imports and exports, accessed March 2012.

While exports across all categories of products have increased, the largest portion is attributable to meat, dairy, and grain products. As income levels in emerging countries rise, consumers increase their consumption of protein-based products. General Mills' Don Mulligan says, "In the emerging world, as consumers' income increases, one of the first things they spend their new wealth on is eating better."

Uncertainty prevails: policy, political, and other risks

Many of the projections discussed here assume that current economic trends will continue in 2012. However, as history shows, significant unanticipated events can create shocks to the US and world economies. These include:

- **Policy change.** Significant changes that could occur in US federal tax and spending policies in 2013 may compound the economic uncertainties CPG companies face. For instance, as Congress considers how best to address the expiration of individual income tax rates, and whether to cut federal spending to reduce the deficit, economic growth and the housing and labor markets could be significantly impacted. At the same time, Congress and the Obama administration have been discussing the importance of tax policy in promoting US competitiveness. Considering both the constraints of the current budget environment and the level of disagreement over such basic questions as how to tax international income or appropriately distribute the individual income tax burden, any reforms to these policies are difficult to predict, particularly in an election year.
- **Political change.** Conflict in sensitive regions across the world can have broad impacts on the world economy. For example, tensions in the Middle East can lead to a further rise in oil prices, which could slow global and US economic growth. Economists have estimated that a sustained $10-per-barrel increase in the price of oil could lower employment by 120,000 people—almost 0.1% of total employment—after one year.[12] Additionally, political instability in other emerging markets could slow the development of these markets for CPG companies.
- **Financial market distress.** Europe has been on a slow path to resolving challenges associated with the sovereign debt crisis in certain euro zone countries, but public resistance to austerity measures has made finding a resolution more complicated. The current instability could give way to more financial market turmoil if slow or negative growth in Europe degrades government finances. Such turmoil would reverberate in the US economy, given the strong connections between the US and EU markets.
- **Natural disasters.** Beyond their direct local affects, natural disasters can have much broader impacts. The earthquake and tsunami that struck Japan in March 2011 had a devastating impact on the region, and rippled throughout the world. The supply chain disruptions triggered by the disaster were one of the main factors responsible for sluggish global economic growth in the first half of 2011.

Cautious optimism, yes, but adaptability is a must

The positive economic developments of the past year paint a more promising picture than we've seen since the United States began emerging from recession in 2009. But for CPG companies, market risks persist. Commodity price volatility is expected to continue, so CPG executives will need to factor this development into their sourcing and distribution strategies. Markets in the developed world do not represent an easy target for profitable growth, and emerging markets, for all their favorable indications, still hold the uncertainties of developing economies. Finally, new government policies could represent fundamental changes to the tax, regulatory, and operating environment in which CPG companies compete.

As CPG companies develop supply chain and demand chain plans that extend their geographic reach, addressing the risks associated with such low-likelihood, high-impact events is a challenge. "You can't build a plan that considers a tsunami or an earthquake or a flood," shares Duane Still, CFO of The Coca-Cola Company's Coca-Cola Refreshments operating unit. "The important thing is to build a plan with the ability to adjust as we see things happening in the marketplace—staying nimble, informed, and aware of what is going on for both contingency reasons and competitive reasons and adapting as we need to."

CPG economic impact

The CPG sector produces a variety of products, purchasing intermediate inputs from other parts of the economy and transforming them for final consumption. The industry's employees and its suppliers spend incomes earned in this production throughout the economy. The overall economic impact of the industry includes these separate components. In October 2011, the GMA released a report prepared by PwC on the CPG sector's overall contribution to the US economy.[13] The report found that in 2009, the industry was directly responsible for 1.7 million jobs, paid $94 billion in labor income, and contributed over $170 billion to US GDP (or "value added"). When the impacts of its supply chain and employee spending are included, the sector was responsible for 10.8 million jobs and contributed over $900 billion to US GDP (or "value added").

	Direct	Total
Employees (millions)	1.7	10.8
Labor income ($ billions)	$94.3	$518.5
Value added ($ billions)	$172.9	$93.6

Since 2009, employment in the CPG sector has remained relatively flat. While the US economy experienced accelerating job growth in 2011, employment in CPG companies remained at 1.7 million. Companies have been able to increase productivity without expanding their workforces.

A top-performing company analysis

Breaking down the performance of the CPG sector's top-performing companies (TPCs)

Despite signs of ongoing recovery in the overall economy, CPG companies continue to face challenges affecting both operating costs and demand. These include volatility in commodity prices, risks to export markets stemming from the European debt crisis, restrictive federal tax and spending policy changes that could take effect early in 2013, and persistent belt-tightening among key customer segments—to name just a few.

As John Gehring, CFO of ConAgra, notes, "I'd call the mood cautious optimism. For us, the challenge is that the economic downturn has disproportionately affected the people who are our core consumers—those making less than $50,000. High unemployment and high gas prices put an incredible toll on people in this group."

Given the confluence of forces buffeting the CPG industry, perhaps it's not surprising that while sales grew somewhat during 2011, margins and cash flow decreased slightly and earnings were flat for many companies. Yet some businesses still managed to produce healthy margins, free cash flow, and other positive financial results. They continued building their brands in fast-growing emerging markets, and were able to balance long-term investment with smart cost management in ways that generated substantial dividends for shareholders. What separated these top performers from their more ordinary peers? As in previous years, we set out to discover possible answers to this intriguing question.

PwC's performance ranking

For this year's analysis, we examined CPG companies using a variety of financial metrics, then analyzed to find which common characteristics link the companies that ranked highest against those metrics during 2011, and whether and how those characteristics have changed over the past five years. We reviewed the total sample of 142 CPG companies for which we gathered publicly available data. We then sorted 53 large and very large companies into performance quartiles.

We avoided measuring companies primarily on shareholder return. This standard corporate barometer, while obviously important to investors, is relatively narrow. Instead, we took a more balanced approach by assigning scores to the 53 companies based on their relative performance across three fundamental metrics:

- Economic profit spread, which is based on return on invested capital (ROIC) and the weighted average cost of capital (WACC)
- Return on assets
- Free cash flow relative to sales

Informed by this breakdown, we compared groups of the ranked companies across many different financial indicators, including growth, profitability, liquidity, and leverage. We were particularly interested in looking at the top quartile (best performers) versus the bottom quartile (weakest performers) to isolate those business drivers that might further explain their ranking.

Of the 13 top-quartile companies, five are in the household products sector, four in beverage, and four in food. Our analysis reveals that this year, the top performers were distinguished from the bottom quartile in the same five areas we identified for the previous year's analysis:

- **Gross margins,** which remain significantly stronger among top performers than in the bottom quartile
- **Spending on strategic selling, general, and administrative (SG&A) expenses,** which has become relatively flat in the top quartile while decreasing in the bottom quartile
- **Operating profitability,** which remains consistent for our top-performing companies

- **Liquidity,** which continues to give top companies more options for making strategic moves, including acquisitions and increases in dividends
- **Managed debt capacity,** as represented by the best performers' greater ability to cover interest payments

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

Bottom performers pick up net sales growth but lag in margin

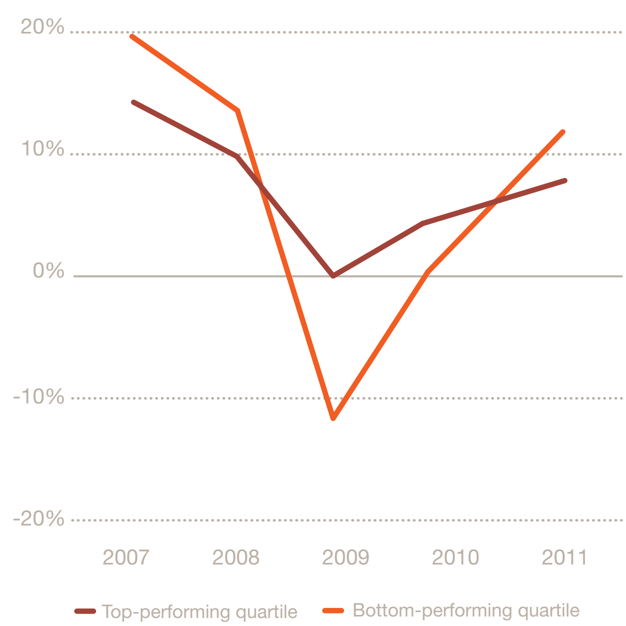
Both the top-performing and bottom-performing groups had seen their sales growth revive in 2010. During 2011, the two groups enjoyed continued revival of growth, but, for the first time since 2008, the bottom-performing group enjoyed higher net sales growth (11.4%) than the top-performing group (7.2%) (see Exhibit 6). This represented just a 2.5% improvement for the top group, significantly lower than the 10.6% improvement gained by the bottom group. The top-performing group weathered the recession without any years of declining net sales, likely because they had the money to continue to invest in marketing, promotions, and trade. The bottom performers, however, are beginning to pick up ground from a top-line perspective—though it's easier to pick up percentage growth when recovering from a net sales decline in 2009 and nearly flat sales in 2010.

One driver of net sales growth is increasing prices in reaction to rising input costs, and while top performers began to implement this in 2010, the bottom performers were slower to react and, in some cases, didn't get pricing in until 2011. Another driver for the bottom performers is buying growth with lower margins.

Despite the differences in net sales growth increases, the top performers in our analysis are still producing higher gross margins than the bottom performers. Indeed, in 2011, the gap between the two groups' median gross margin was nearly 40 percentage points, the largest we've seen since we began conducting this analysis. Our analysis showed that each of the companies in the top group had at least one brand in a number-one or number-two position during 2011.

Gross margin for the top increased by 1.8%; for the bottom group, it decreased by 1.6% (see Exhibit 7, page 13). Not only did top performers react to commodity price increases by more quickly passing those costs along to the consumer, but their improved margins are representative of the strength of their brands. Savvy commodity hedging and product mix strategies may also have contributed to the trend.

Exhibit 6
TPC median net sales growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

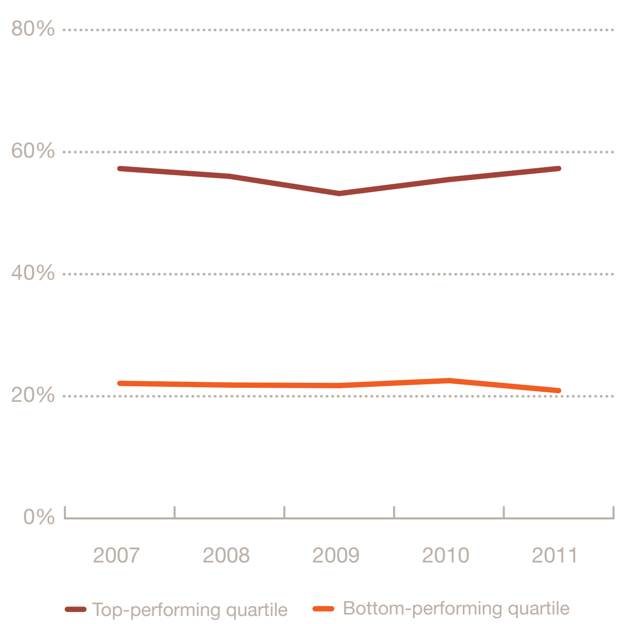
Flatter SG&A spending

Large CPG companies make substantial investments in innovative products as well as in marketing and advertising to support their core brands and drive future growth. Over the past five years, our top-performing companies have spent more on defending their market share than have the bottom-performing companies, as measured by SG&A spending relative to sales (see Exhibit 8). In 2011, SG&A spending in the top quartile remained essentially flat (decreasing slightly from 26.3% to 26.1%) while in the bottom quartile it decreased by 4.5%. Top-performing companies may have more cash available than their less successful counterparts to begin reinvesting in research and development (R&D), innovation, marketing, and other initiatives such as sustainability, all with the goal of driving future growth.

Investment in brands and in long-term positioning remains a significant predictor of performance and is critical to effective demand chain management. For example, many of our top performers have continued to invest heavily to promote corporate brands in emerging markets, with the goal of building trust and mindshare among hundreds of millions of consumers. Explains Hershey CFO Bert Alfonso, "I think that more investment and hiring are happening in emerging markets as compared to the US."

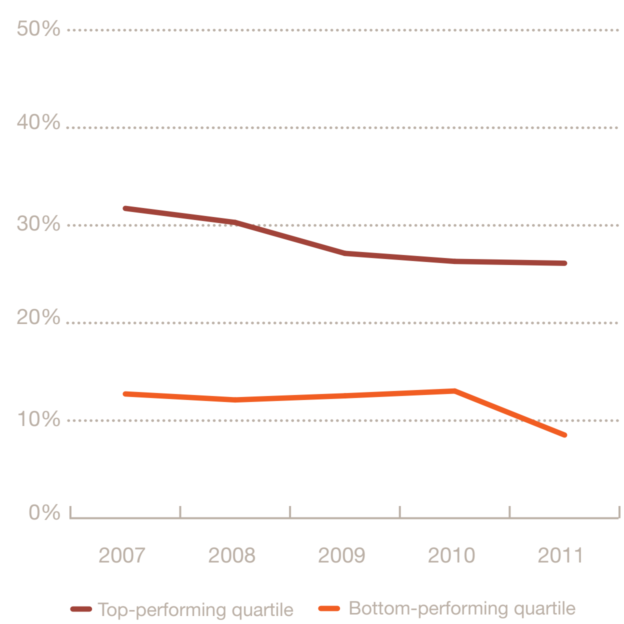
Some top performers also have expanded their sustainability initiatives with an eye toward controlling costs and risks while at the same time driving growth by building on consumers' interest in socially and environmentally responsible products. As ConAgra's John Gehring explains, "Sustainability is one of five elements in our Recipe for Growth strategy. In this most recent year, we met our goal of being included in the Dow Jones Sustainability Index.

Exhibit 7
TPC median gross margin



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 8
TPC median SG&A as a percentage of sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

We've also got a huge campaign going on regarding ending childhood hunger—'Childhood Hunger Ends Here'—and we're working with several large customers around joint promotions in this area."

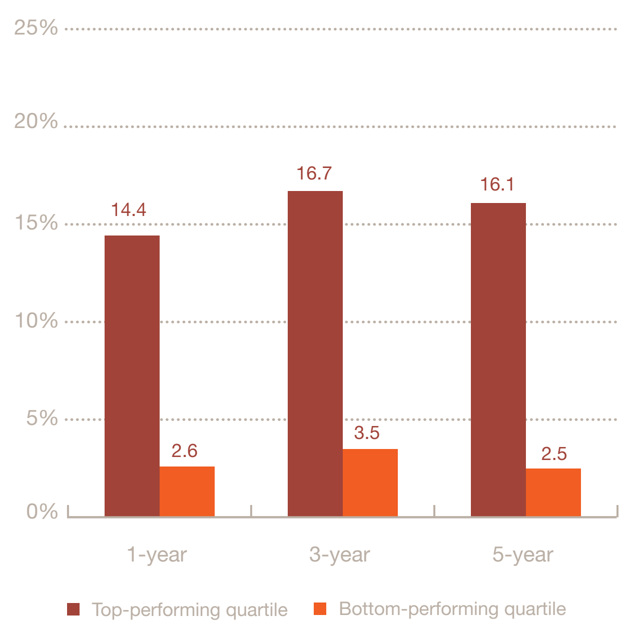
So some SG&A costs are "good" in the sense of investing for future growth, while other costs are "bad" overhead and should be continually tightened. As Coca-Cola Refreshments' CFO Duane Still explains, "It all goes into SG&A, but we've been trying to take more of the 'G&A' and move it into the 'S.' That lets us get out of what we call non-working spend and put it into working spend. We can put it into marketing, advertising, sales force capabilities, and other things that drive productive growth."

Maintaining strong cash flow and reducing debt costs

As the continued significant gap between quartiles shown in Exhibit 9 illustrates, the top-performing CPG companies are still generating and hoarding more cash than the bottom performers: 14.4% cash flow to sales for the top performers versus 2.6% for the bottom quartile. Clearly, top-performing companies continue to enjoy strong cash flow (possibly as a result of pricing actions), but their greater percentage of cash on hand may also be due to belt tightening and effective expense management. The hoarding of cash during the recession may have positioned the top performers to channel cash toward investments in R&D, marketing, and other key business activities, particularly in this past year, driving slightly lower free cash flow levels in the one-year period as compared to the three- and five-year periods yet contributing to the maintenance of the near 40-point disparity in margin.

This theory of increased strategic spending by top performers during the economic recovery period is evidenced also in the narrowing gap between top and bottom performers compared to the three- and five-year periods. Whereas the gap in free cash flow to sales is 11.8 percentage points for the one-year analysis, it rises to 13.2 and 13.6 for the three- and five-year analyses, respectively. Even with relatively flat SG&A spending, having capital available provides top-performing companies with liquidity as well as room to think and act strategically. For instance, top-performing companies are well positioned to make more acquisitions or increase their dividends. Bottom performers are generating less cash, and their limited access to credit means they don't have the luxury of hoarding what little cash they have to defend their market share.

Exhibit 9
TPC median free cash flow to sales



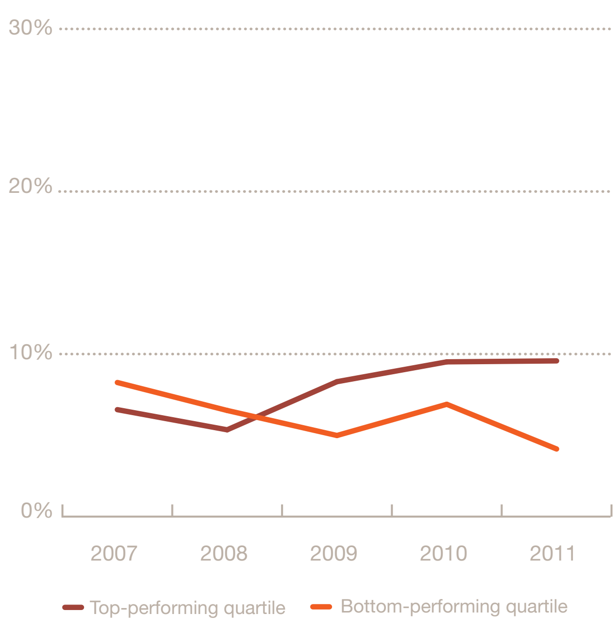
Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

A review of the median interest coverage ratio is consistent with this trend. Both top and bottom performers are focused on reducing the cost of debt (see Exhibit 10), but top-performing companies find it easier to manage the debt they retain. The bottom quartile has to cover higher interest payments, which weakens their balance sheets. However, the narrowing gap between top and bottom performers' debt-to-equity ratios over the past five years (see Exhibit 11) suggests that both are paying down debt.

For medium and small companies, the debt-to-equity ratio measured consistent for top and bottom performers in 2010; however, the bottom performers took on more debt in 2011, as borrowing became more readily available and interest rates hit record lows.

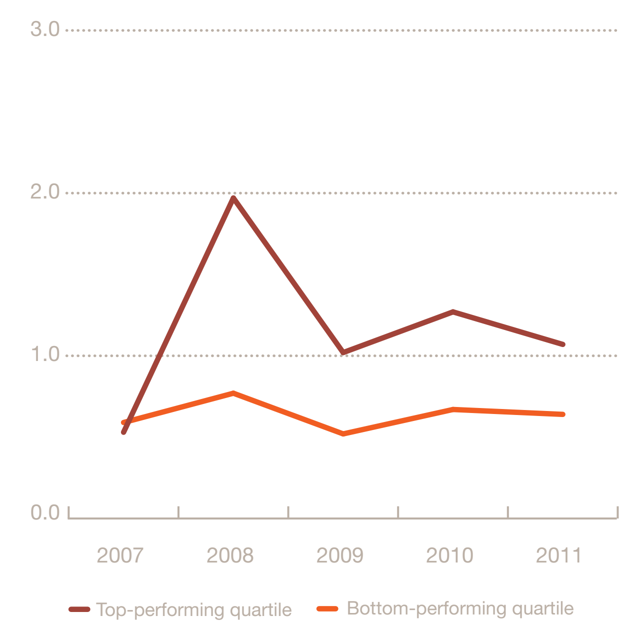
A related variable is the cash conversion cycle, which highlights the speed (in days) with which companies can turn assets into cash. The lower the number of days, the

Exhibit 10
TPC median interest coverage ratio



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 11
TPC debt-to-equity ratio



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

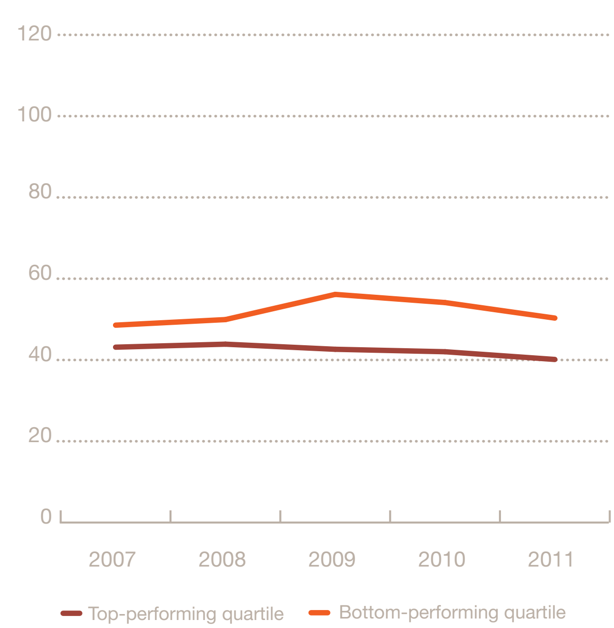
more efficiently a company gets cash in the door. We see in Exhibit 12 that top performers have a stronger ability to manage their day-to-day cash flow. However, both the top- and bottom-performing groups improved their ability slightly during 2011, with the bottom quartile improving at a somewhat larger rate.

A deeper look at profitability

A substantial gap in profitability, more so than sales, distinguishes the top and bottom quartiles in our analysis this year. Earnings before interest and taxes (EBIT) growth supports the notion that the top performers are more consistent than the bottom. As shown in Exhibit 13, the top companies saw EBIT growth drop from 7.6% in 2010 to 2.2% in 2011. For the poorer performers, the drop was much more extreme, from 32.3% to negative 22.0% in the same period—perhaps because, even though sales increased for the bottom quartile during this period, these companies' margins suffered. Coming off strong growth from 2010 to 2011 (owing to a very weak 2009), EBIT percentages decreased for all companies during this period.

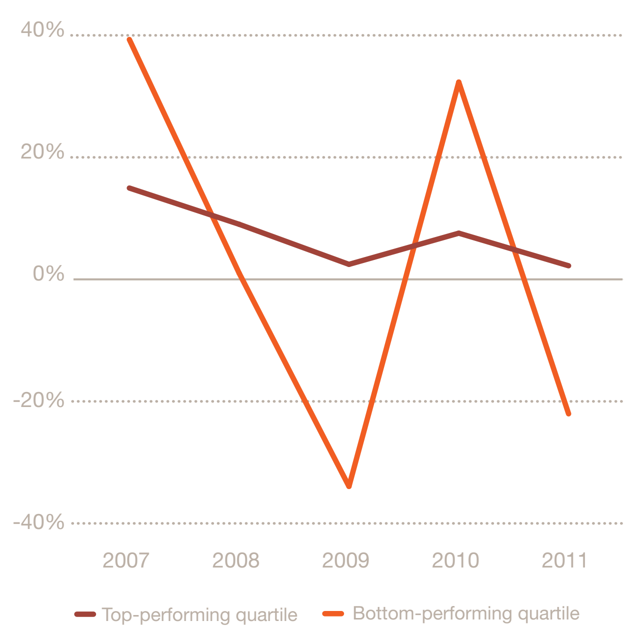
To probe a bit deeper, we examined net operating profits after tax (NOPAT) margin (see Exhibit 14, page 17). For our top performers, the NOPAT margin has hovered around 15% during the five-year period, while the bottom performers' margin has ranged between 2% and 4%, hitting the latter in 2010. A possible explanation for the

Exhibit 12
TPC median cash conversion cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 13
TPC median EBIT growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

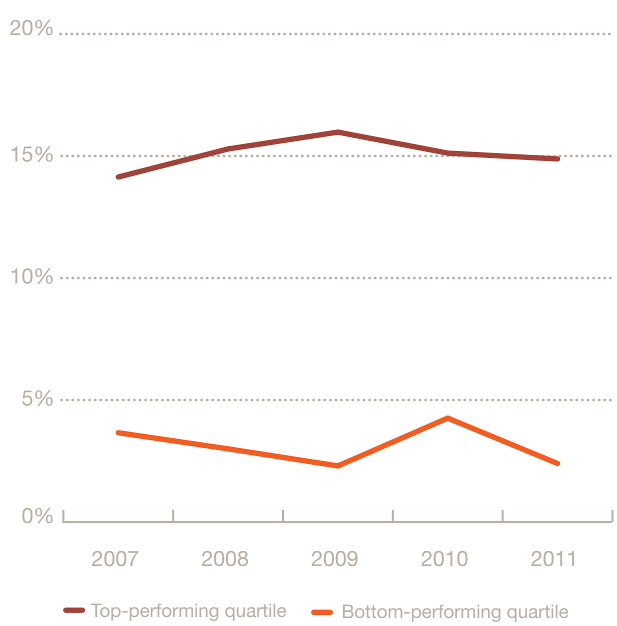
profitability gap between top and bottom performers may be that the best-performing companies can manage tax rates more effectively through international expansion. As ConAgra's John Gehring says, "With Japan lowering its tax rate, the US now has the highest corporate tax rate in the world. So almost any expansion into international markets will create additional financial leverage."

A final snapshot on shareholder return

Given the consistent performance gap between the top and bottom quartiles along all these metrics, it's not surprising that shareholder return shows a similar trend. Exhibit 15 illustrates how top performers provide higher and more stable returns over the long run, with a major gap appearing in the one-year period we analyzed. Top companies are better equipped to handle tough economic environments and thus became even more attractive to investors in 2011.

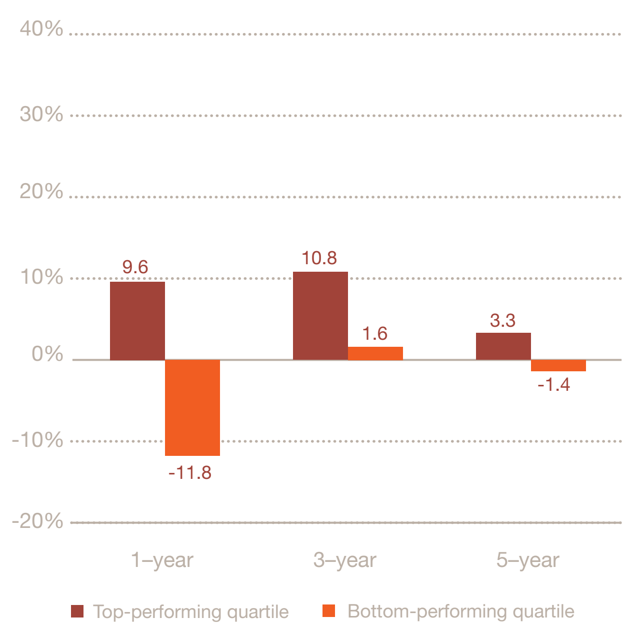
The Clorox Company has a strong track record of growing total shareholder return.[14] CFO Steve Robb says, "We are focused on the fundamentals—growing sales through innovation and strong brand-building. Increasing margins through multi-year cost-savings programs. Managing cash in a stockholder-friendly way. Over the last seven years, we have repurchased about 40% of our shares and doubled the dividend."

Exhibit 14
TPC median net operating profit after tax (NOPAT) margin



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 15
TPC median shareholder return



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Getting on the global map
The advantages of a global sales base

There are as many ways to be a global company as there are companies. In the interviews we conducted for this report, we heard all sorts of ideas about what success looks like on the global stage. For example, Sunny Delight's Bill Schumacher says that his company wants to "crack the code in China." Clorox CFO Steve Robb sees his company's plans partly as a demographic play in emerging markets that will allow the company to introduce progressively more profitable products: "As economies continue to develop, consumers will have additional purchasing power, which means not only that they'll be using more products, but also that they'll be able to trade up to more value-added products over time," Robb says. At Hershey, CFO Bert Alfonso says that being a global company is often a matter of taste, which requires research and testing to get right. "Take chocolate as an example," Alfonso says. "Depending on the market, it could be sweeter or less sweet, it can have more cocoa butter or a lower milk content. So you do have to formulate products for the local taste. That takes some R&D; it takes some consumer insight to formulate your brands so that they have the most acceptable local profile. You want to formulate the product, even with something as widely consumed as chocolate, to be local."

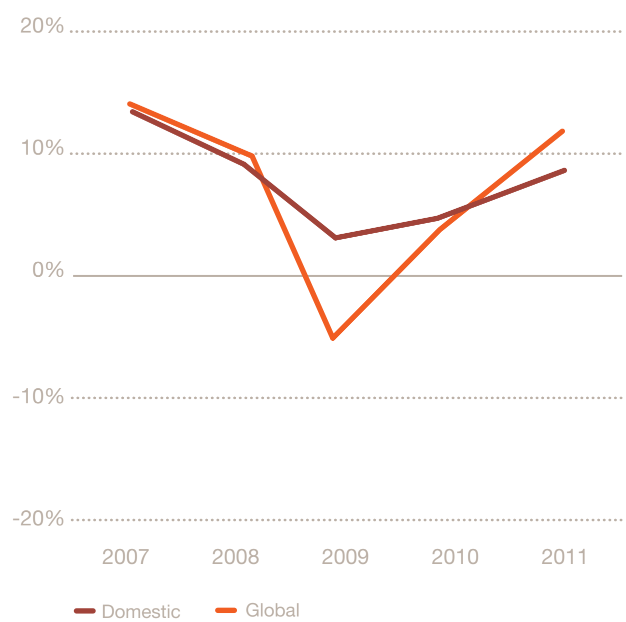
Since there are so many different ways to go about being a global player—many in the eye of the beholder—we've decided in this year's report to base our observations around one metric: percentage of non-US sales. We compared companies with "significant" non-US (global) sales and those without, using 20% as our indicator of "significant" global sales.

Overall, 68 out of our sample of 142 companies experienced significant global sales. The first and most obvious conclusion to draw is that, as expected, size matters, though not to the point of being a fait accompli. Out of the 35 very large companies in our benchmarking sample, 29 (or 83%) had significant global sales as defined by our 20% baseline. Conversely, just 4 of our 30 small companies in the sample qualified as having significant global sales—not surprising given that most maintain a distinctively domestic focus. So, generally, having more than $10 billion in net sales is a very good indicator of significant global sales. But, again, it's worth pointing out that small CPG companies that actively court non-US sales can achieve more than 20% sales outside the Unites States.

High risk, high reward

In terms of spotting some trends that distinguish the global sales group, it's striking how well these organizations have bounced back from the Great Recession, but also sobering to see how far they fell in the first place. Exhibit 16 shows that companies with at least 20% global sales nosedived during 2009 to well below negative growth, while domestic companies experienced a much shallower dive, falling to below 5% sales growth.

Exhibit 16
Median net sales growth



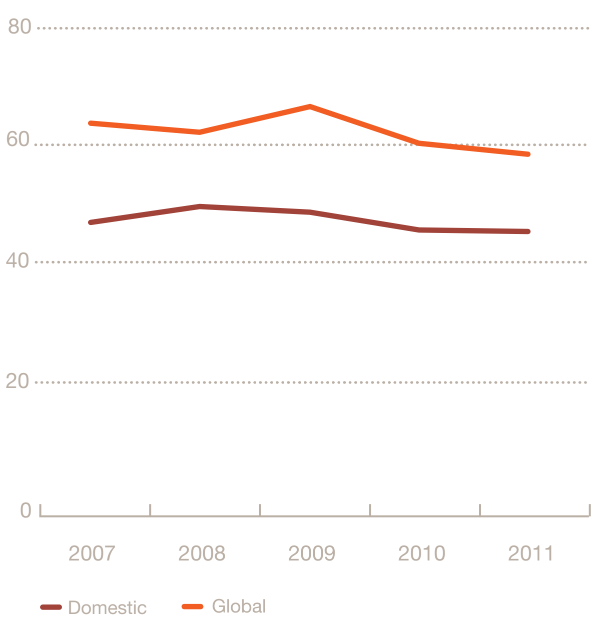
Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

But ever since 2009, global companies have ridden the wave of strong emerging market demand (most likely in Asia and Brazil), and net sales growth was back over 10% for 2011. The takeaway is that global companies benefited as emerging markets rebounded much faster, and may continue to be in a good position if the "new normal" persists and developed market consumption does not return to pre-crisis levels. One positive for domestic companies is that the consistency of the US consumption base, even during downturns, means that those companies might not experience the kind of volatile swings seen at companies with more global sales.

Another advantage the domestic companies tend to have is more efficiency in the actual business of selling goods and collecting payments. While the world has gotten smaller, it's still more difficult to collect receivables from abroad, make sure payments are accounted for, etc. As shown in Exhibit 17, it takes significantly longer for global companies to convert a sales transaction into a collected receivable.

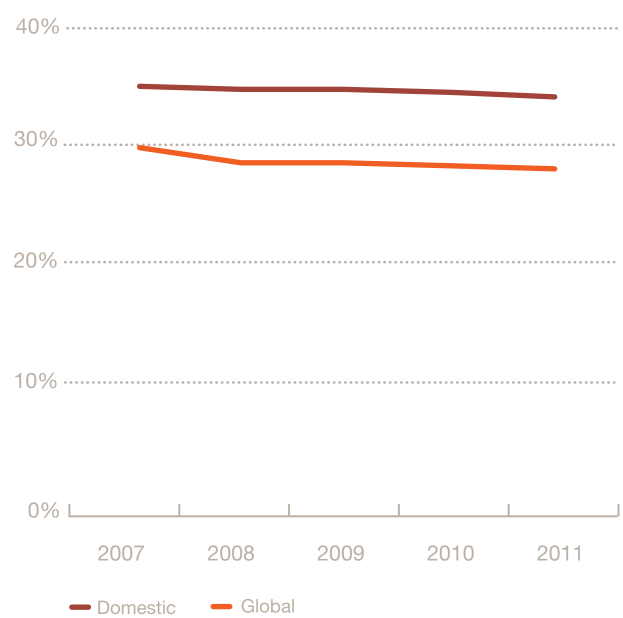
But that's a relative nuisance compared to some of the big advantages of booking a good portion of sales outside the United States. For example, the rock-solid global company effective tax rate of about 27% across five years (see Exhibit 18) would be much envied by our domestic cohort, whose collective effective tax rate hovered north of 35% during the same time period. While the Obama administration and Congress have proposed a number of initiatives to bring down the US corporate tax rate, little action has occurred to actually effect change.

Exhibit 17
Median cash conversion cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 18
Median effective tax rate

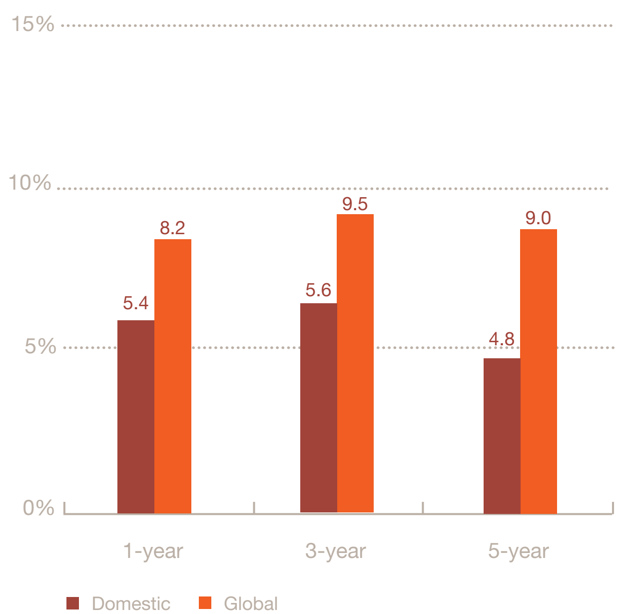


Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Global companies also have higher free cash flow to sales and return on invested capital (see Exhibits 19 and 20). It's a good bet that global companies (a segment that contains many organizations we categorize as "very large") enjoy better infrastructures and more efficient processes to prioritize investments, manage portfolios, and execute and track the success of investments.

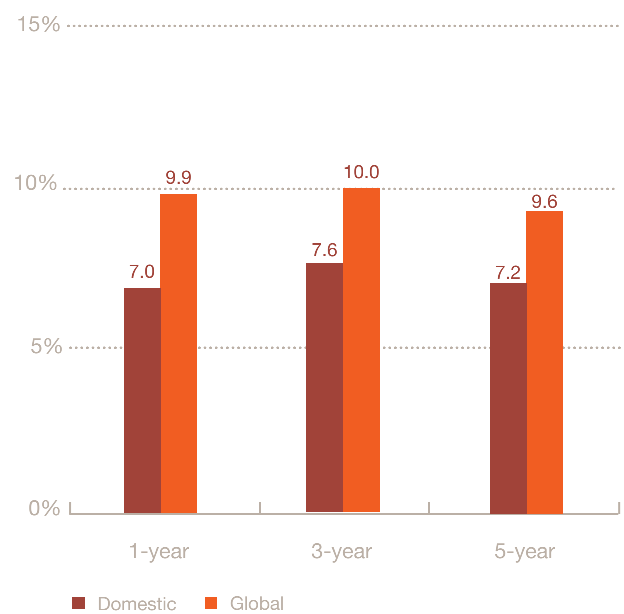
One area in which it appears domestic companies are outperforming global companies is productivity. As Exhibit 21 (page 21) illustrates, domestic companies have been increasingly more productive than global companies over the past three years. But that presumed advantage doesn't really bode well either for those companies or the larger United States employment picture. Given the generally slow sales growth in the United States, domestic company productivity is logically grounded in a slow hiring ramp-up, rather than in significant growth. In essence, the global companies are less productive because their global footprints mean they are hiring people in faster-growing parts of the world.

Exhibit 19
Median free cash flow to sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 20
Median return on invested capital

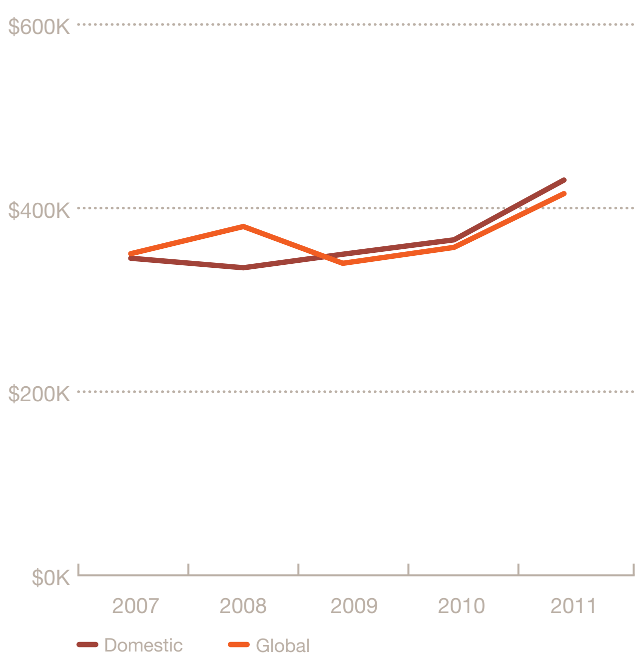


Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Some of our other data also support the idea that global companies are less productive because they are investing back into their organizations. For example, Exhibit 22 shows that global companies are continuing to spend on items like advertising. And that's a trend that exists well beyond the CPG universe: In 2011, global spending on advertising rose 3.4% overall, down from the 6.9% gain in 2010 but still healthy growth.[15] A larger portion of this spending is going to the digital space. Chris Davies, North American CFO of Diageo, explains: "The old model of a one-way broadcast message to consumers has long passed. Today's consumer spends more time online and on mobile than they do surfing TV channels, so we are redirecting advertising and promotion funds. In fact, digital now represents more than 20% of our total media spend in North America."

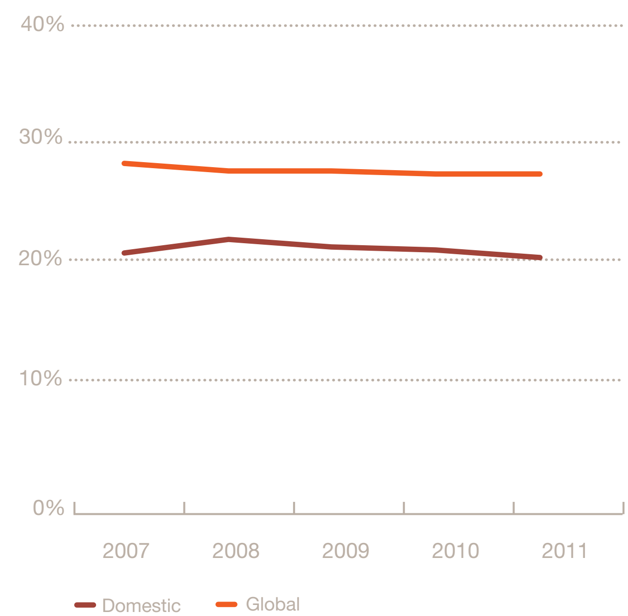
While there might be many ways for companies to be "global," building a healthy non-US sales base seems to be one investment that pays off.

Exhibit 21
Median sales per employee



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Exhibit 22
Median SG&A as a percentage of sales



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

Section 1
Enabling the demand chain

Consumer demand rules in today's CPG markets. Companies have made many improvements to the supply chain in recent years, but the demand chain is still terra incognita, with plenty of wilderness to explore. The ability to create demand—repeatedly and in any channel—will separate the winners from the losers in CPG markets, though the supply chain will still play a role since it must effectively and quickly satisfy the demand a company creates—a task that's complicated by the explosion of information technology (IT) and social media. Winning through the demand chain also involves innovation of the entrepreneurial, not incremental, variety. So get familiar with co-creation, open innovation, and other guides to help you navigate to the promised land.

Catching up to consumers in the age of demand

Anticipating what consumers will want, exactly when and how they want it

Welcome to the age of demand. For CPG companies today, the winners will distinguish themselves from the losers not just by *understanding* the nature of demand but by *creating* demand, and doing so repeatedly, in developed and developing markets, in any channel of the consumer's choosing.

The supply chain still matters, too, but strategy and execution on the demand side require more attention. Indeed, 65% of global CEOs and 75% of US CEOs recognize that consumer demand will be the biggest factor driving strategy in the coming year.[16] And virtually the same number expect to change their consumer connectivity technologies this year.[17]

Don Mulligan, CFO of General Mills, describes the attention shift in this way: "Companies can still drive competitive advantage through the supply chain, but the margin on that advantage is getting narrower. Going forward, the winners will be whoever has the best marketing ideas, the strongest sales organizations, and the right service delivery. That is the demand chain."

"You can't cost-cut your way to success today," adds Hershey CFO Bert Alfonso. "Sales or top-line growth has been harder to come by than cost management. And so there is a greater focus on consumer trends and exploring the consumer landscape now. Consumers may be value oriented but they still want quality—and brands represent quality."

A quarter of global consumers and nearly one third of US consumers claim companies usually fail to satisfy their expectations. Most consumers would be willing to spend more with companies that met their needs.[18] The gap in companies' ability to anticipate and create demand is huge, and therefore so is the opportunity.

Digital tools have raised the bar by empowering consumers to search for product information, to communicate easily with fellow consumers, and to know almost as much as a manufacturer does about a product market. Increasingly savvy consumers have come to expect distinctive, high-touch experiences and direct communication with brands in near real time.

Digital tools have also made it possible for manufacturers to tailor offerings to ever-finer consumer segments. Companies are now able to apply advanced analytics to massive volumes of market data to spot incipient shifts in consumer behavior, sense competitor moves, and predict coming trends.

Once all of these capabilities became possible, they became essential. CPG companies will meet higher consumer expectations, or their competitors will. They will be first to draw meaningful insights from shifts in consumer behavior, or they will watch their market share erode.

Predicting the next signal from consumers

Putting the demand chain at center stage means putting the consumer there as well. CPG companies need to use the digital tools now available to them to achieve a far deeper, more granular understanding of consumer behavior, then drive all marketing, sales, and service decisions from those insights.

This approach would give CPG companies other levers besides price to differentiate themselves. As an example, Sunny Delight's Bill Schumacher describes how the SunnyD brand achieves a respectable market share in a category dominated by two other big brands: "We want to identify who the real user is for our product and construct a product tailor-made for that user. We are midway through the work of flipping this existing brand upside down to meet a specific consumer need. That's better than staying where we are and continuing to slug it out with price."

Deeper insight helps companies select new marketing tactics, such as bundling offerings in new ways or communicating a different value proposition suited to the segment. Bush Brothers is exploring a variety of such tactics for baked bean products that consumers buy frequently one year and then inexplicably ignore the next. "Of course people go through phases," said CFO Al Williams. "We are trying to understand why products are relevant at one time and not

at others. And then find ways to become relevant with the same products, a different product, or other types of innovation. Keeping half of the consumers who drop us in a year would grow business substantially."

Even more vital for CPG companies to master are macrotrends that affect multiple categories, such as the recent industry-wide downturn in packaged food volumes. "There has been some change in consumer behavior around food that no one has fully figured out," says John Gehring of ConAgra. "What are people eating? Are they using food differently? Are they stretching food further? Are they using more leftovers?"

Investing in a more consumer-centric organization

Consumer-centricity is not a new idea, but moving the consumer to the crux of the demand chain requires a significant investment and a long runway. Hershey launched its deep dive on consumer understanding four years ago, for example. And according to Anthony van der Hoek, director of strategy and business solutions at the Coca-Cola Company, "It takes years, not weeks, to embed consumer conversations in an organization. Companies need to address this now or it will be a huge challenge to catch up."[19]

For the transformation to be successful, every function must evolve to integrate both internally facing (product-centric) and externally facing (consumer-centric) mindsets.

In marketing, for example, the shift to a consumer-centric organization entails creating new analytical abilities and points of view. Consumer needs must be considered along with product lines, and new sources of data (e.g., socioeconomic, web-based) must be incorporated so that marketers can generate deeper and more complex insights to create meaning for consumers.

Clearly, technology is an enabler in attaining a razor-sharp consumer focus. While maintaining product-specific metrics, companies must implement the technology to capture, analyze, and disseminate consumer-specific data, both structured and unstructured. (See the sidebar "Big data: Both a competitive imperative and an opportunity," page 28.)

To defend market share and to meet consumer expectations, companies' reaction times must now be measured in minutes, not days or weeks. Nongfu Spring, a Chinese bottled water company, is well on its way to delivering and then acting on "speed of thought" insight[20] from analysis of big data.

In the past, Nongfu devoted two days to collecting and producing point-of-sale (POS) retail data. Using new analytics tools, Nongfu now loads data in real time, allowing reports and queries to run up to 300 times faster. One business process that previously took 24 hours to complete now finishes in a mere 37 seconds.[21] By capturing the data more quickly and providing relevant analysis to planners, Nongfu has been able to improve customer shelf in-stock levels.

In addition, having multiple channels to the consumer drives additional complexities. Creating a true omnichannel experience for consumers is one manifestation of a company's success in marrying product- and consumer-centric mindsets. (See the sidebar "Evolution of terms," page 26.)

Customers expect to feel connected to a brand at all touchpoints. Consumer-centric organizations understand the interactions across the channels, and can provide the consumer with the right product in the right channel at the right price.

Evolution of terms

Over the past two decades, different terms have been used to describe brands' digital strategies.

- **E-tailing/e-retailing.** First used in the 1990s, this shortened form of "electronic retailing" refers to selling online. It does not necessarily extend to more recently emerged forms of electronic commerce such as social or mobile retail.
- **E-commerce/digital commerce.** A business transaction conducted electronically.
- **Multichannel.** This term has been used in the last decade when companies built separate, distinct channels to sell products to consumers. The catalog, online, and brick-and-mortar channels typically did not share data, and consumers would not necessarily know if a product they found online was available at a store. Simply having multiple channels was the goal.
- **Omnichannel.** Having multiple channels is no longer enough. "Omnichannel" implies that the brand presents a single, seamless face to the consumer across all channels, a "shopping any way, anywhere" experience that encompasses browsing and shopping on a mobile phone, electing to pick up and pay for items at a retail location, and adding items in the store, before checking out.
- **F-commerce.** Commerce transacted through Facebook storefronts.

Five guideposts for creating consumer demand

The ability to create consumer demand depends on the quality of consumer insights that inform a company's decisions. Executives can use these five guideposts in assessing how well they are positioned to meet consumer expectations.

1. **You are creating a consistent consumer experience of the brand across all channels and touchpoints**

   Dividing lines between channels and roles become hazier every day. Consumers are not focused on channels; rather, they expect a seamless experience of the brand wherever they interact with it. As General Mills' Don Mulligan says, "We're agnostic to the channel. We want to be where the consumers are going, and we want to shape those channels' growth opportunities."

   One of the critical challenges in omnichannel is obsolescence of the touchpoint before a brand puts content in the marketplace. As Coca-Cola's Duane Still says, "The challenge is knowing which technology has staying power, which technology will become the standard, and how we focus the spend so that we maximize the impact of our investment as opposed to just trying to do everything all at once."

2. **You are listening to consumers**

   Eighty-two percent of the world's online population uses social media,[22] yet PwC research has shown that only 37% of companies have invested in social media tools to understand consumers.[23] This disconnect underscores a missed opportunity to walk beside consumers on their shopping journeys and capture unique, timely, and relevant insights from their actions. Listening to your consumers in a social media setting can also provide advance signals of nascent trends, both positive and negative. Better to listen early than after the storm has hit.

Nearly half of the CPG manufacturers analyzed in our benchmarking study generate more than 20% of sales globally, and in many of these foreign markets, the digital experience is different. For some it is more mobile-phone-based, and for others it doesn't yet exist. Regardless of the source, companies need to make sure they are listening to consumers, and using a local ear. The key is to be gathering data and generating insights from the local market to drive product and channel solutions.

3. **You are focused on the right things and using the right data**

   The volume, format, and detail of consumer data present barriers to insight. Corporate Executive Board research finds that 85% of data captured by companies, such as freeform text, are unstructured and inherently more difficult to analyze.[24]

   While it might be easier to look at classic structured data, organizations must learn to discern between the signal and the noise in the unstructured data. What is new is that the consumer insight can come from many previously unexplored areas, and can come more quickly.

   Next-generation social intelligence tools, such as natural language analysis, allow companies to analyze context, mood, and intent within consumer conversations. Then companies can identify the attitudes, unspoken needs, and motivations behind purchase decisions. (For more on this topic, see Section 2 of this report, "New paths for the shopping journey.")

   In addition, CPG companies are turning to predictive analytics to make educated bets on future events rather than build strategy on the present or the past. One such tool can evaluate the impact of pricing actions before putting them into effect—a far faster approach than running tests in geographically dispersed markets and then analyzing the results. In addition to being effective, analytics software solutions are also becoming more affordable due to the increasing number of providers.[25]

4. **You are benefiting from new insights garnered from economics and psychology**

   Behavioral economics, which combines classical economics and behavioral psychology, can help companies understand how consumers actually make decisions. Southwest Airlines research found that bag fees evoked a strong emotional response from passengers. As a result, it declined to impose fees for first and second checked bags when all the other major US carriers did, and began framing its offers with the "Bags Fly Free" slogan. In 2010 and 2011, the campaign's first two full years, Southwest posted its biggest recent annual revenue increases: $1.75 billion and $3.55 billion, respectively.[26]

5. **You are conducting bottom-up experiments based on new insights**

   To react fast enough to consumer trends, brand teams cannot wait for top management to approve test-and-learn cycles. Instead, CPG companies can institute criteria to help teams structure waves of experiments, starting with the areas of greatest opportunity.

   These experiments may produce new channels (see "Is the time right to invest in a direct-to-consumer channel?" in Section 2) as well as new products, services, or approaches to communicating brand value (see "Play-to-win innovations: Disrupting the demand chain," later in this section). They may also help companies explore the differences in the demand chain for developed versus developing markets.

Managing the demand chain for growth

Domestic market growth in the Unites States remains slow, but there is a huge proliferation of available consumer information. This intersection of challenge and opportunity provides a window through which manufacturers and retailers can tap into consumer demand more effectively. By mining data and instilling a culture of listening to the consumer, cutting-edge companies will be able to begin to shift the focus to more effectively meet consumer needs and then proactively manage the demand chain for growth.

Big data: Both a competitive imperative and an opportunity

"Big data" is most commonly understood to encompass the technologies and tools necessary for the gathering, storing, and supporting of large volumes of structured and unstructured data captured by companies from multimedia, social media, and the Internet. PwC expands that definition to include business intelligence and information analytics.

Big data is how companies leverage the massive amounts of data and information that have recently become available to solve business problems. The definition covers the technologies, organization, and processes required to drive decisions from these huge volumes of data.

Exhibit 23
The big data ecosystem

Source: PwC.

Traditional approaches to implementing big data focus on technology-driven initiatives that drive commonality and efficiencies, but for the most part minimize "human interaction" with the solution. Such approaches can be expensive, counter-productive, and a major barrier to delivering data-driven insights and decision-making. A better philosophy is centered on how big data can work in conjunction with existing processes to aid and evolve your stakeholders' decision-making processes, rather than trying to replace them. The following example illustrates this approach of leveraging a mix of structured and unstructured data and, through collaboration, driving significant improvements in consumer-facing results.

A large manufacturer of food and beverage brands, headquartered in the United States, has successfully deployed a custom demand-driven replenishment system. The impetus for the initiative was the out-of-stock and growing backroom inventory at retailers, resulting in lost opportunity and higher inventory holding cost. The average out-of-stock was 13%, significantly higher than the industry average of 8%. Backroom inventory was also higher than the average.

The solution uses time series models to predict weekly demand at a store level for each stock-keeping unit (SKU). The analytic models are embedded in the company's mobile applications and processes. Now fully implemented, the solution yields around 70% reduction in out-of-stocks, 10% reduction in backroom inventory, and 15% reduction in headcount, which represents a $20 million annual earnings before interest, taxes, depreciation, and amortization (EBITDA) contribution.

Are your demand and supply chains in synch?
The new imperative: speed, flexibility, alignment, and integration

Consumers have always had influence, but today they have significantly more influence over what and where they buy. With the proliferation of digital channels, they have more purchasing options than ever before, as well as more information to inform their choices.

Meeting the evolving and increasing demands of consumers, and therefore driving profitable growth, requires more from CPG companies than in the past. Supply chain innovation is less of a differentiator, so companies are relying on their demand chains for substantial growth. Changing their business models is helping them to pursue market white spaces, to disrupt markets with innovative ideas, and to customize solutions for smaller and smaller slices of the market, essentially targeting their efforts to specific demographic subsectors.

To a large extent, these business model innovations are made possible by real-time conversations and collaboration extending outside the company walls. CPG companies now have the technological platforms, the tools, and the digital touchpoints to converse with consumers in real time and engage them in the creation and evolution of products and services. As a result, companies have access to the data they need to not only anticipate but also to influence and drive demand. (See "Catching up to consumers in the age of demand," earlier in this section.)

CPG supply chains have been finely tuned and automated to produce and distribute products at the lowest possible cost. Now companies need multiple supply chains, with low-cost production and distribution at one end, customization and pick-and-pack at the other, and hybrids in between—all delivering unique value propositions to customers at acceptable cost and service levels.

This new focus on the demand chain does not relegate the supply chain to the background. Instead, it shines a spotlight directly on the front end of the value chain. Will the brand fulfill its promises to consumers? Only those companies with fast, nimble, yet cost-effective supply chains will be able to answer in the affirmative.

Tradition has served us well

CPG companies have long focused process innovation and operational improvement efforts on their supply chains, striving for greater efficiency in procurement, manufacturing processes, and distribution channels. To support these improvements, companies have fine-tuned supporting activities such as IT and infrastructure management, customer service, inventory management, and supply chain partnership management.

In fact, until recently, leading companies spent almost twice as much as their peers on supply chain initiatives focused on bolstering long-term profitability.[27] Customer satisfaction was the primary goal of these companies' innovations to improve operational performance, under the assumption that better product availability would drive sales growth and build customer loyalty. Increasingly divergent retailer demands drove efforts to increase supply chain flexibility, while other initiatives were aimed at reducing costs and improving working-capital management.

These types of supply chain innovations protect manufacturers' current advantages, but they do little to enhance management of a company's demand chain or to strengthen integration between the demand and supply chains. In isolation, supply chain initiatives struggle to help companies maximize value creation—which is essential for profitable growth.

For these reasons, CPG companies can no longer consider their supply chains as a primary source of sustained competitive advantage and profitable growth. Companies that shift their focus to strengthening their demand chains—by understanding how demand is created, how consumers make purchase choices, and how to influence buying decisions—stand the best chance of pulling ahead of their rivals, and staying there. (See "Play-to-win innovations: Disrupting the demand chain," later in this section.)

"The better you read what the customer wants, the more efficient you can be at meeting those needs at the right price points and in the right packaging," explains Sunny Delight's Bill Schumacher. "The demand chains that will be successful in the future will have supply chains attached to them that can deliver on cost, as in the past, but also deliver on flexibility. The companies that figure out how to optimize both will win the game."

Building in flexibility to tailor and customize

Over the past decade, many CPG companies have developed more agile and responsive supply chains. These efforts have been undertaken in response to retailers' demands for less inventory, fewer stock-outs, and more efficient replenishment of inventory, as well as the companies' desire to protect valuable shelf space and ensure on-shelf availability.

In 1992, a GMA study identified 104 days of dry goods inventory in the CPG supply chain.[28] This was one of the factors that spurred Efficient Consumer Response (ECR), an industry-wide initiative to develop a consumer-driven supply system. ECR's basic tenets were timely, accurate, paperless information flow and smooth, continual product flow matched to consumption.

While ECR moved the industry forward, it did not live up to its potential. Information flow was one of the most daunting challenges—specifically the timely availability and sharing of information among trading partners. What is different today? Technology has advanced tremendously. Information is pervasive. Deeper analytical capabilities exist. Collaboration has improved. And the extended supply chain is much more integrated. Today, companies are much better positioned to capitalize on the basic tenets of ECR and achieve the promise of a flexible, responsive, and cost-effective value chain focused on the consumer.

What does this mean for a CPG company?

For the demand chain, it means continually monitoring consumers' needs and preferences, detecting trends, and identifying new opportunities. And for the supply chain, it means the ability to quickly respond to changes in consumer demand and execute cost-effectively. Supplier arrangements must be in place to quickly provide required ingredients and packaging. Flexible manufacturing processes and capabilities must allow the company to quickly adapt and produce product. And the company's distribution capabilities and customer relationships must accelerate new products to market faster than before.

As Coca-Cola's Duane Still explains, "For years, production technologies remained the same in the beverage industry. Now we are engineering a lot more flexibility into our supply chain so we can change packages, change products, change formulations, and produce packages or formulas that have not yet been developed."

"We have to be careful not to over-engineer, though, and drive up our costs to an unsustainable level," Still continues. "That's the challenge. Build the flexibility for the future, but build it at a cost that we can actually afford today and tomorrow."

Maximizing sales by better understanding consumer demand

Given the generally recognized 5% to 10% out-of-stock position at retail (depending on the category) and the still-high levels of inventory in the extended supply chain, understanding and forecasting consumer demand is challenging for many CPG companies. Gaining access to retailers' point-of-sale data has helped, but many companies have not yet mastered how to effectively mine this data, improve their forecast accuracy, share information, and effect appropriate responses throughout their supply chains.

To compound the problem, retailers are asking suppliers to take responsibility for their products' in-stock positions at the retail shelf in individual stores. This request has catalyzed companies to try to gauge demand at a much more granular level than was possible in the past, using the traditional measurement methods of shipments or retailer warehouse withdrawals.

New demand-sensing capabilities are the result. Many CPG companies are developing processes and capabilities to leverage new technologies for improving forecast accuracy (deeper analytics, better math) with the goal of improving in-stock availability at the retail shelf.

Equally important, they are building supporting IT capabilities to ensure synchronization across the extended supply chain, rapidly identifying the implications from the improved forecast and then identifying and sharing the required changes both internally and with suppliers and customers.

Improving the demand signal has multiple benefits. Early reads of demand changes can be shared throughout the supply chain for improved inventory management and deployment, production planning and scheduling, and distribution operations.

Feeding the news of shifting demand to suppliers will not only improve availability of materials and ingredients but also allow suppliers to become more cost- and service-efficient at meeting the needs of manufacturers. The demand signal can also be used to manage commodity volatility and inform the testing of new products, ideas, and services.

As ConAgra's John Gehring explains, "One area of opportunity for us is to get a more accurate demand signal, which will make us more efficient downstream with our supply chain. If you can't predict your demand signal very well, it's hard to maximize efficiencies with suppliers. And there are all kinds of places in the supply chain where you can drive efficiencies if you have a more accurate demand signal."

Chasing accelerated speed to shelf

The concept of "speed to shelf" is not yet ingrained in the CPG industry. The traditional CPG supply chain requires 60 to 90 days to put a new product on the shelf. The retailer has to agree to carry the product, UPC codes have to be assigned, the product has to be added to the retailer's information system, and on and on.

At that rate, CPG manufacturers will not be able to respond effectively to the insights they can gain, almost hour by hour, from direct-to-consumer and social media channels (see "Is the time right to invest in a direct-to-consumer channel?" in Section 2). Furthermore, they will be perpetually playing catch-up with omnichannel consumers, whose expectations of availability have been set high by online retailers.

Getting products into consumers' hands more quickly would help companies "ride the wave" of consumer interest, which can be considerably amplified through digital channels (see Section 2, "New paths for the shopping journey"). Eager consumers now have many touchpoints for providing feedback on products (e.g., new flavors or package sizes), and manufacturers can harness this creativity and loyalty to significantly extend product lifecycles.

CPG companies can gain these benefits by aiming for accelerated speed to shelf. To achieve that goal, they will need new processes and routes to market (e.g., new channels) as well as potentially more "feet on the street."

They also will need far closer coordination between the demand and supply chains. For example, once- or twice-daily reads of what is selling (point-of-sale data) could be fed into the allocation and replenishment system instantaneously. While it may not be cost-effective to ship what has sold today to each store tomorrow, vendor managed inventory (VMI) and other approaches are available to automatically release shipments to retailers/stores.

The trigger for shipment is often a specified threshold volume or the day of the week that allows products to be on the shelf by the weekend (peak selling days). To operationalize this response time, close collaboration between the CPG manufacturer and retailer is critical.

The quick response (QR) approach used in the fashion retail industry provides a glimpse into a similar level of collaboration. Fashion suppliers and retailers gather and analyze point-of-sale and consumer preference data in real time. These early reads of the data (typically daily, at times twice a day) reveal preference and purchase patterns for product features such as garment style, size, and color. Based on that information, suppliers and retailers adjust their procurement, allocation, and retail layout strategies. They also pass the data along to fashion design teams and brand managers as input into future product development efforts. Retail replenishment typically occurs between 2 days (if the product is in inventory) and 14 days (if more needs to be produced). The result? Savvy, end-to-end management of the fashion industry's entire consumer-centric value chain, with the goal of maximizing sell-through and profits and reducing markdowns.

Building systems similar to QR would require CPG companies to drive decisions based on the mining of immense volumes of data (e.g., from social media, point-of-sale, and loyalty cards). Further, the industry would need to evolve away from its traditional insularity to take advantage of outside capabilities (e.g., through open or reverse innovation; see "Play-to-win innovations: Disrupting the demand chain," later in this section).

Strengthening the integration between the demand and supply chains

Awash in consumer data, CPG companies and retailers must tie their demand and supply chains together more closely than has been the traditional norm. For this purpose, companies will have to resist the temptation to focus their improvement efforts on one function or another—such as by tweaking their sales strategy, reducing procurement costs, or reinventing their marketing approach. Instead, they will need to think holistically about their value chain. In particular, they will have to decide how their functional areas will collaborate not only with each other but also with external partners and, increasingly, with consumers.

This is why we are seeing a renewed emphasis on sales, inventory, and operations planning (SI&OP). Many CPG companies are re-examining their current SI&OP process to capture new sources of consumer insight and demand on the front end. They are collaborating more closely with their key retail partners as well as communicating consumers' changing needs more quickly to the supply chain on the back end.

In today's environment, an effective SI&OP process that brings demand and supply together is essential to effectively compete. CPG companies are also focused on identifying and integrating the most relevant information from their trading partners (point-of-sale data), from new internal (demand-sensing) capabilities, and from consumer insights (social media).

Many CPG companies have shifted IT resources from the traditional supply chain and back office accounting functions and dedicated them instead to garnering consumer insights and improving information flow and collaboration between the demand and supply chains. Others are examining their traditional organization constructs and interactions, with the goal of ensuring that all relevant functions have access to up-to-date information and are working together in harmony.

The solution is not necessarily reorganization of the company and of reporting relationships. Instead, what is needed is close and timely collaboration among historically separate functional silos. For example, many companies do not include the sales function in the SI&OP process. When the question is raised as to why sales isn't at the table, too often the response is, "Good question!"

Supply chain functions are typically well integrated and work closely together. In contrast, at many companies, integration is less well established among marketing (which drives the interaction with the consumer), sales (which drives the interaction with the customer), R&D (which develops new products), and consumer insights (which feeds information to everyone).

Functional leaders who are able and willing to foster collaboration and integration as well as to break down functional silos are a necessity to keep the supply chain in synch with a digitally enabled demand chain.

Aligned for growth

Successful CPG companies will ensure their strategies and operations are aligned with customers (retailers, the predominant avenue to the consumer) and also with consumers and their preferences/needs. Most importantly, successful companies will assertively incorporate timely consumer insights into their growth strategy.

The consumer is king. Consumer preferences and insights should be the center of any CPG growth strategy, influencing all functions and driving change. Operational excellence today is a given. Anticipating and delivering on emerging customer needs is the differentiator, and will drive the bottom line.

Play-to-win innovations: Disrupting the demand chain

How you innovate determines what you innovate

The demand chain has become a sandbox for commercially significant innovations. Look at how yogurt maker Chobani has exploded onto the US stage. Enough conventional yogurt consumers have switched to high-protein, tangy Greek yogurt to drive the market from $60 million five years ago to a projected $1.5 billion this year.[29]

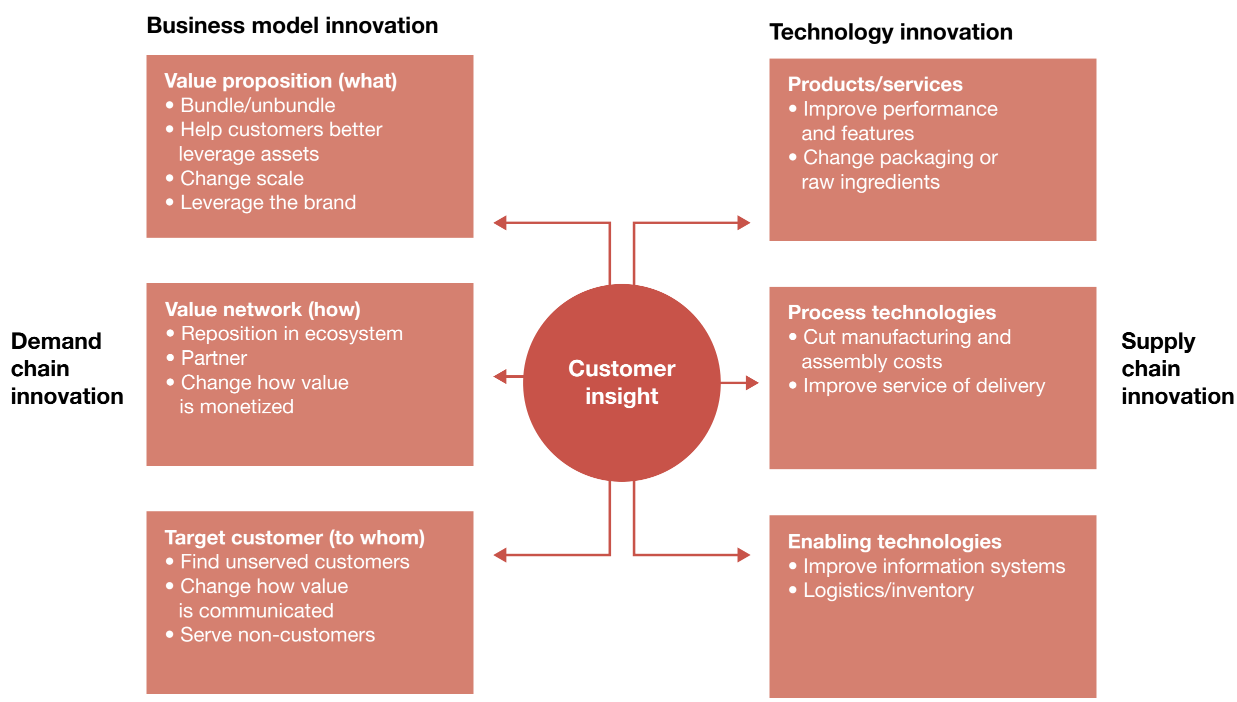
Or consider coconut water, a fledgling sports drink category that has doubled in revenues in the United States every year since 2005. With soda sales shrinking, players in this market are jockeying for control of nutritional drinks that could dominate in the country's $100 billion market for nonalcoholic beverages.[30]

Winning demand chain innovations are not created by luck. Companies need a strategy and an operating model geared to the right types of innovation.

The limits of incremental innovations

In many companies, innovation has been reduced to a series of small, incremental changes to existing products and services—a product feature is added, a more reliable supplier is found, or costs are lowered by 5%. Minor changes like these help maintain share and margins of existing offerings. This focus on technological and supply chain innovation (on the right side in Exhibit 24) has certainly spurred growth over the past few decades, and molded companies' business units into profitable engines of reliable, repeatable production. The problem is, growth from incremental technology improvements has plateaued. Companies can no longer attain substantial rates of growth or profit by tweaking the status quo. Indeed, many markets have entered a competitive churn in which companies almost instantaneously match each other's incremental innovations. The net result is little, if any, growth from incremental innovation.

Exhibit 24
Engines of corporate innovation



Source: Adapted from Tony Davila, Marc Epstein, and Robert Shelton, *Making Innovation Work*, Wharton School Publishing (2006). Many of the concepts in this chapter are drawn from that publication.

In search of changes that could create new streams of growth on a sustainable basis, many companies are innovating their demand chain, and particularly their business models.

Shake up the business model

Business model innovation is focused in three areas:

- What value is offered
- How that value is delivered and captured (monetized)
- The target customers to whom value is delivered, and how that value is communicated

By delivering more value in new ways, companies are starting to reap higher growth and to bedevil competitors scrambling to follow suit. Consider, for example, the 46 million Americans living at or near the poverty line.[31] By redesigning their business models, some companies are finding the bottom of the US economic pyramid to be a lucrative source of growth.

Ross Stores, the California-based operator of the Ross Dress for Less off-price department store chain, has had success taking over foreclosed stores in blighted areas for pennies on the dollar and then reopening them under its dd's Discounts brand. Even Walmart, long known for its focus on rural America, is moving into inner cities, expanding its grocery offerings, and offering basic medical care.[32]

The principal discipline of any demand chain innovation is consumer insight—a willingness to look at consumers in a new light. As Bert Alfonso of Hershey notes, "What you find is that insights into consumers—both for current portfolio and, in some cases even more importantly, for innovation—is just the new norm." The pivotal moment occurs when companies ask and answer these questions:

- Which segments do we underserve or not serve at all?
- What is critical in what we currently offer consumers, and how can we better deliver on the brand promise?
- How can we offer value in a different or better way?

Apple boldly addressed these questions, then created a massively attractive consumer experience, revitalizing its consumer retail operations and setting a new revenue-per-square-foot benchmark for retail. Shaking up the business model also inspired Amazon, a service company, to offer its first own-brand product: the Kindle e-book reader.

Likewise, McCormick changed its product line and marketing to focus on home cooks, which comprised 60% of sales, and offset weakness in restaurant demand.[33] And P&G broke from long-established demand chain concepts by extending its billion-dollar Mr. Clean and Tide brands into services such as car washing[34] and dry cleaning.[35]

Yet another shake-up strategy is to rethink how value is communicated. Gatorade's "Win From Within" campaign, for example, opens a dialog with teenagers about the role of nutrition in sports performance, with a goal of getting the attention of 23 million US teens.[36]

The challenge: Inject an experimental mindset

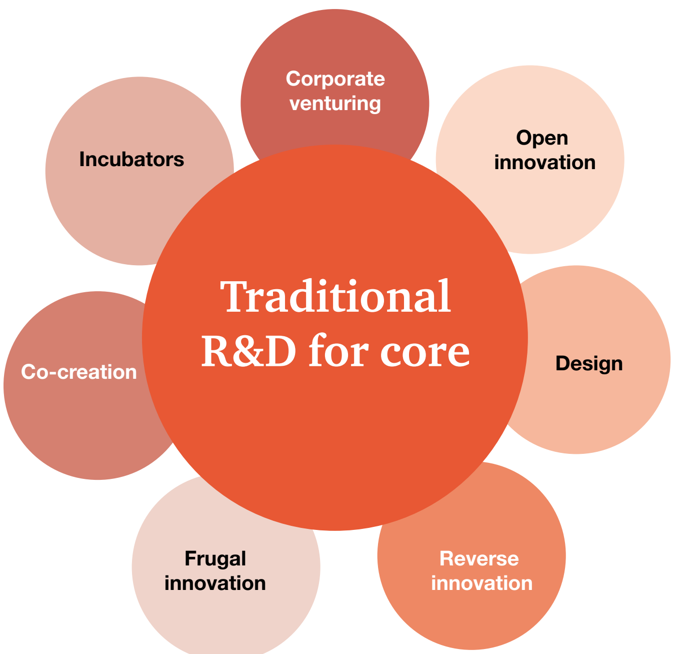
Demand chain innovation is relatively new, but there are a few basic rules for success. First and most important: *How* you innovate determines *what* you innovate. That is because innovation is a process-dependent approach to creating growth.

Currently, most companies rely on traditional R&D processes designed to protect share and hold margins in existing markets. These play-not-to-lose processes are brilliant for incremental supply chain improvements, but have been largely incapable of producing breakthrough innovations in the demand chain.

For that purpose, companies must add new operating models geared to discovering winning innovations and making them commercially successful.

Leaders in demand chain innovation are adding play-to-win entrepreneurial elements to their traditional R&D operating models (see Exhibit 25). All of the innovation approaches described below inject an entrepreneurial mindset and add a healthy dollop of breakthroughs to the portfolio.

Exhibit 25
Innovation approaches



Source: PwC.

- **Incubators.** Incubators operate like small, lean start-ups nestled inside the company. They are staffed by intrapreneurs—a special breed of innovators who have an entrepreneurial spirit and capabilities but can also leverage corporate strengths. Incubators use prototyping to test new business models and technologies, and learn which ones are winners. They experiment at a clock speed that is four to ten times faster than traditional R&D.
- **Open innovation.** Open innovation breaks from traditional approaches by including outsiders in the innovation process. For significantly lower costs than traditional R&D, open innovation puts a billion IQ points in play for any company that can figure out how to collaborate effectively and find the right people. "We look in many places where you wouldn't necessarily go for food ideas," says ConAgra's John Gehring. "It doesn't have to be invented here and, in fact, if we spend too much time focusing on things that are invented here, we're going to be fairly slow in terms of innovation." General Mills' Don Mulligan adds, "This willingness to look externally has permeated the organization. We are much more open to external partnerships, external advice, and external perspective than we would have been ten years ago. We are creating extended virtual organizations that let us tap into resources much more quickly, more fully, and less expensively than in the past." Those external partnerships can extend to joint ventures in noncompetitive spaces with competitors. Clorox CFO Steve Robb provides an example: "Our

partnership with Procter & Gamble has enabled us to leverage technology they've used in their diaper business and apply it in our trash bags to make them stronger and more elastic. It's good for the environment, because we use less resin, and it's good for consumers, because they get a better bag."

To support external outreach, companies are rushing to launch open portals, such as General Mills' G-WIN Digital. This portal solicits ideas for games and mobile apps for any of the GM brands. As General Mills Chief Marketing Officer Mark Addicks explains, "We have these iconic brands and we have consumers that are way ahead of virtually every company in terms of how they're thinking and using technology. We want to run as fast as we can behind them."[37]

- **Co-creation.** Co-creation goes a step further than open innovation. Customers are formally included on the innovation teams, putting them at the crux of the creative process. Directly involving the customer in the innovation process—rather than just getting their opinion or observing them—creates positive new insights and creative dynamics. The direct involvement stimulates new thinking and decidedly different outcomes than traditional R&D.
- **Design thinking.** Design thinking approaches innovation problems in a manner similar to that employed by cultural anthropologists or ethnographers. Insight is gained from careful observation of what users do when they engage a product or service. Like incubators, design thinking approaches use rapid prototyping to drive exploration and development.
- **Corporate venture capital.** Corporate venture capital captures companies in early stages of development to inject their intellectual property into the investing company. This is particularly effective for quickly building expertise in new areas in which the target companies have a head start.

Two other play-to-win approaches—reverse innovation and frugal innovation—are driven by a "less is more" philosophy advocating simple, rugged, and maintenance-friendly products. Instead of stripping down existing Western products to meet the needs of developing economies, reverse innovators start with a clean sheet in the target country.

- **Reverse innovation.** Reverse innovators start with "in country, for country" ideas focused on meeting local needs in less-developed countries (e.g., a heart monitor that does not require specialized training to use). When that hurdle is crossed, they move on to the "in country, for the world" phase, adapting and scaling products for global use.[38]
- **Frugal innovation.** Though not tied to a specific geography, frugal innovation is also energized by constraint. Google recognized the value of this approach years ago, making "creativity loves constraint" its eighth innovation principle.[39] As Marissa Mayer, Google's vice president of location and local services, once said, "Engineers thrive on constraints. They love to think their way out of that little box: 'We know you said it was impossible, but we're going to do this, this, and that to get us there.'"[40]

Build the capability to drive high-growth innovation

While the supply chain has a rich history of innovation to mine, there are no prescriptive, well-tested approaches to innovating business models. Companies are just now developing the capabilities to transform their demand chains to produce a reliable stream of improved value, as well as new ways to deliver that value.

Generating breakthroughs and substantive growth from the demand chain requires new capabilities in three areas: building culture, collaborating across boundaries, and enabling innovation (see Exhibit 26).

To build an innovation culture for the demand chain, CPG companies must define the goals of that innovation and the business implications of their choices. Then they need to instill the understanding that true creativity requires forgetfulness and fresh eyes—otherwise, companies will try to solve new problems using old solutions.

Like cultural anthropologists, companies need to look at how their brand manifests itself in the market, and then tear down assumptions that blinker their view of a brand's possibilities. At the same time, they must remove the barriers raised by "not the way we do things" protectionism.

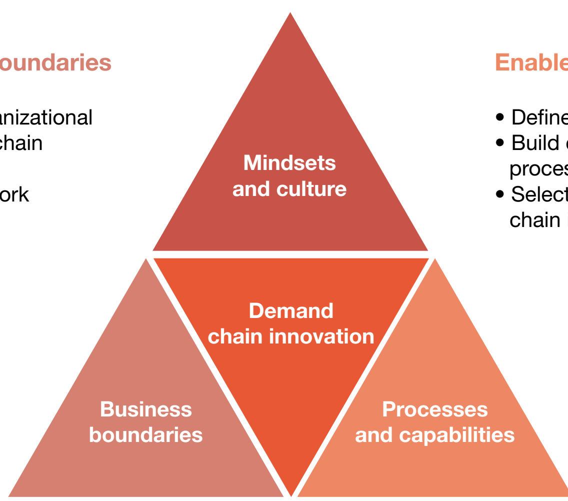
Exhibit 26
Three types of capabilities required for demand chain innovation

Build innovation culture

- Define demand chain's innovation goals and business implications
- Overcome "not the way we do things" mindset
- Create a culture of business model experimentation

Collaborate across business boundaries

- Manage innovation across the organizational elements responsible for demand chain
- Find and establish relevant partners in the demand chain network



Enable innovation

- Define missing assets needed for innovation
- Build capabilities required, and put necessary processes in place
- Select ways to measure and reward demand chain innovation

Source: PwC.

Bringing the right people to the table requires reaching across business boundaries that have traditionally been rigid and, at times, impermeable. Companies need strategies and processes for not only integrating siloed internal resources, but also for building collaborative networks of partners, thought leaders, brand ambassadors, and suppliers.

Finally, CPG companies must build or gain access to the capabilities required to get the job done. A good starting point would be asking, What are we missing to deliver a new value proposition? Do we have the creativity required to shake things up? Or the engineering and technical horsepower?

Demand chain innovation key performance indicators (KPIs) and incentives also fall under the capabilities umbrella. Without these, people will either resist change or will snap back to old habits if they think no one is looking. For example, building strong partnerships in the demand chain network makes sense, but getting people comfortable with collaboration outside of the company requires significant changes. In successful companies, KPIs make partnering a very clear priority and define how to become a partner of choice in the ecosystem. The incentives help people adopt new collaborative behaviors and overcome the fear of change.

Companies committed to demand chain innovation typically move through three stages of operational maturity:

- **Stage 1: Functional.** Companies add basic capabilities to generate ideas and gather consumer insights that catalyze new types of innovation. They break down silos, and they start to reach outside company walls for inspiration and executional support that will produce breakthroughs. In addition, companies begin to look across the entire demand chain to identify opportunities for innovation and growth. They put in place metrics and motivators that support new behaviors. And most importantly, they shift their mindset and operating stance to allow breakthrough innovations to occur in the demand chain.
- **Stage 2: Integrated.** This is an important transitional phase. Companies learn from their initial functional efforts and identify what else is needed to drive more and better demand chain innovations. They ramp up, adding more capabilities and spreading best practices that foster higher levels of performance. Demand chain innovation becomes integral to their way of thinking and acting—but there is still room for growth.
- **Stage 3: Orchestrating.** At this level, all the components are working together and companies begin to orchestrate more complex and effective breakthrough innovation. Companies have built their capabilities, defined their partners and established world-class collaboration, and mastered business model innovation. In addition, they've built the platforms and processes required to gather, glean, and act on consumer insights. By this point, they are capable of creating exceptional value and disrupting markets.

In search of the next big thing—for customers

In today's CPG world, the formula for growth requires insights and commercial introductions that are bold and valuable. Supply chain innovation has been the source of growth over the past decade, and companies can still achieve incremental growth by innovations such as reducing packaging waste and improving logistics.

But remaining focused on supply chain is not enough. Recent experience makes it clear: Embracing innovation in the demand chain provides the breakthroughs that drive significant growth. New approaches—such as incubation, co-creation, and reverse innovation—are opening up new possibilities to create value and deliver and monetize it in new ways.

Shaking up business models not only produces revenue and margin growth, but also excites customers and differentiates companies from their competitors. In the current global marketplace, disruptive innovation—the next big thing—will spring only from demand chain innovation.

Section 2 New paths for the shopping journey

There's a channel explosion going on, as consumers are researching and buying products through many avenues online. To capture consumers' hearts and minds as well as their feet and fingers, CPG companies will need to get smarter and more personalized in their digital engagement with and delivery to consumers. Building a digital direct-to-consumer channel, for instance, can enable real-time conversations with consumers. But some brands and some consumer segments are better suited than others to a direct channel, and companies will have to be ready to mine customer feedback and evolve products to fit the preferences of their target segments.

Consumers' hearts can also be won by helping them determine which offerings and brands are truly sustainable and therefore worth choosing. Forward-looking businesses are finding new ways to engage consumers on the subject of sustainability and to incorporate reputation management tightly into their brand management efforts—all while keeping their eye on the profitability of sustainable practices.

Getting smarter about digital engagement
Capturing the hearts, minds, feet, and fingers of consumers

The rapid adoption of social media, smartphones, and tablets means consumers are researching, comparing, and buying products across multiple, evolving, and even blurring channels. It's an evolution of the shopping journey that gives manufacturers the opportunity to converse with consumers, amplify their brand messages across digital touchpoints, and directly influence the buying process.

Orabrush embraced this opportunity to drive consumer awareness of its obscure $5 tongue scraper by creating zany online videos (including a parody of the iPad 2 introduction video and personalized appeals to Walmart buyers) that have attracted over 39 million views on the company's YouTube channel. This direct digital touch drove up brand awareness and created enough pull to persuade Walmart to distribute the device nationwide in its stores.[41]

Traditionally, only more established brands could afford the level of investment required to get distribution through third-party retailers such as Walmart. Today, though, emerging brands that are digitally savvy and know how to influence the consumer's journey are able to compete with larger, more established brands to win channel mindshare and secure scarce shelf space.

The playing field is rapidly shifting as brands large and small seek to participate in every single transaction with consumers across all channels. For example, Unilever has announced plans to make the mobile space its primary marketing channel, and is willing to cover some mobile data charges for customers interacting with its brands.[42]

To stay relevant to consumers, CPG companies must rethink their demand chains to drive awareness, conversion, and loyalty across all channels. They must be on the digital platforms that their customers prefer so they can influence the buying process directly, and they must also be ready to adapt as digital touchpoints evolve. In order to drive business results in the evolving landscape, companies must also develop metrics with which to measure the effectiveness of their digital efforts.

Be where your customers are

Consumers are driving and shaping the adoption of omnichannel shopping.[43] On this journey, the path to purchase has grown increasingly complex and nonlinear.[44] According to a recent PwC survey, 86% of shoppers use at least two channels as they research, shop, and interact with brands, while 25% use four or five.[45] Additionally, 40% said they value the option to bounce across channels (web, mobile, in-store).[46]

Being where your customers are requires companies to adopt an integrated view of the consumer across all channels rather than a siloed, channel-specific customer contact model that gives priority to business and product goals. By adopting a model that puts the consumer view at the center of sales, marketing, and service activities (i.e., the demand chain), manufacturers can address the needs of consumers in the channel of their choice, effectively increasing relevance and profitability.

To do that, CPG companies need to map their demand chains to the new paths of the consumer shopping journey, engaging those consumers where the brand messages and interactions are relevant and welcome (see Exhibit 27, page 42). They need to deliver a compelling and consistent brand experience at every touchpoint in every channel the consumers are using, especially given the evolving roles of the channels in the shopping journey. For example, while social media was once limited to generating brand awareness, it is now also recognized as a shopping destination.

To deliver that compelling brand experience, three-quarters of CPG companies expect to leverage social media for brand promotion over the next 12 months, and nearly a third (up from 17% last year) will engage in the social media conversation as an avenue for increasing consumer loyalty.[47]

Exhibit 27
Mapping the manufacturer's perspective to the consumer shopping journey

	Brand awareness and activation		Brand conversion		Brand ambassador support
	Research	Compare	Trial	Purchase	Service/ support
Physical store	x	x	x	x	x
Catalog/ phone	x	x	x	x	x
Corporate website	x	x			x
Etailers	x	x	x	x	x
Social media	x	x	x	x	x
Direct-to-consumer sales	x	x	x	x	x

Established and traditional channels

Emerging digital channels

PC, tablet, mobile

Source: PwC.

Generate brand awareness

Digitally savvy brands are capturing the minds of consumers by establishing touchpoints to engage in targeted two-way dialog and content sharing—a shift away from one-way, broad-brush push marketing, which often requires significant marketing investment.

Social networks are enabling this dialog between brand and consumer. Facebook fan counts for brands such as Starbucks or Coca-Cola, for example, are 10 to 100 times higher than unique visitor counts on the company's corporate websites.[48]

Brands are also employing cross-platform initiatives to align with consumers' ease in bouncing across channels. A mobile app for Unilever's Lynx Stream deodorant lets the young men who use this brand upload pictures of their nights out to their social networks.[49] And to drive follow-up and in-store purchases, brands like General Mills use Groupon to promote trial packs at a discount.[50]

"There are a multitude of channels now, some more attractive than others," says Sunny Delight's Bill Schumacher. "Part of our strategy going forward is to ask, how do we engage the consumer by recognizing the occasions, getting the right package to match that occasion at a price point that makes sense for the consumer, and how do we find the channels to deliver that? How do we match up the channels with that package and occasion?"

Win brand conversion

CPG manufacturers have long relied on retailers to win consumers' foot traffic and close sales. Now they need to capture consumers' fingers, too, if they are going to protect their market share.

In the United States, online CPG sales are expected to jump from $12 billion in 2012 to $25 billion in 2014.[51] To capture a slice of this fast-growing market, manufacturers are aggressively pursuing a variety of forms of direct-to-consumer e-commerce.

Heinz successfully generated marketing buzz and trial for its "limited edition" balsamic tomato ketchup, which was made available only through Facebook two months before appearing on supermarket shelves.[52] The promotion was not advertised, though an executive mentioned the promotion in a newspaper article. The social media buzz following the story added 35,000 new friends to the Heinz Facebook page in less than three weeks.[53] So far, however, companies have been having mixed success with full-fledged f-commerce (e-commerce on Facebook). As one analyst explained recently, "It was like trying to sell stuff to people while they're hanging out with their friends at the bar."[54]

The key for CPG companies is to use test-and-learn cycles based on a defined digital strategy (see "Is the time right to invest in a direct-to-consumer channel?" later in this section) rather than throwing random ideas against the wall to see what sticks.

Provide brand ambassador support

Given the multiplier effect of social media, it is even more important to establish customer intimacy and develop a loyal and vocal consumer base. After all, with a single digital posting, a consumer can influence thousands, if not millions, of people.

In fact, a recent comScore report on millennials, a segment with an estimated $170 billion in annual purchasing power, emphasizes the role of user-generated content in influencing the purchasing decisions of younger generations.[55] According to the study, 84% of millennials take content posted by strangers into account when purchasing, and 50% value this input more than input from friends and family.

This new ease of influence allows CPG companies to employ more grassroots-targeted campaigns. On the other hand, it also requires that they closely monitor social media channels for wildfires of negative commentary.

"It's like road rage in a car," explains Al Williams of Bush Brothers. "People get bold on a computer and post things more damaging than they would say on the phone, with less conversational context."

Customer service has always been a critical factor in building (or eroding) brand loyalty. Today, a digitally enabled demand chain provides many more touchpoints for forging loyalty and building community. By placing product on the periphery and focusing on consumer choices and lifestyles, for example, General Mills successfully targeted Hispanic mothers through the website QueRicaVida.com.[56]

Open innovation (see "Play-to-win innovations: Disrupting the demand chain," in Section 1) is another powerful option for CPG companies to connect with consumers and create brand ambassadors. Bringing consumers "inside the circle" and allowing their ideas to drive new development fully engages their hearts and minds in the success of those initiatives.

Digitally enable your demand chain

Being where the consumers are in digital channels is fast becoming table stakes for CPG companies. Few question the inevitability of this digital transformation, but the challenge lies in preparing the organization and putting the processes, tools, training, and governance in place quickly enough. Manufacturers should consider the following guiding principles as they seek to maintain relevance in this omnichannel environment.


DAIRY MILK
ARNOTT'S
Assorted Creams
ARNOTT'S
Assorted Creams
4.82

Be clear about your objective and engage deliberately

While digitally enabling the demand chain transforms the way that brands interact with consumers, the basic business goals remain unchanged. Therefore, to fully realize the business benefits of a digitally enabled demand chain, a company must establish a digital strategy that is linked to its business strategy and goals. The company needs to understand the impact on its business model, figure out how to interact in a compelling fashion with consumers, and consistently meet those consumers' expectations.

Organize around the consumer

The ease with which consumers jump between channels provides a challenge for manufacturers committed to providing a consistent brand experience across these channels. Providing consumers with the right experience, at the right time, through the right channel requires companies to build a single, unfractured view of the consumer across touchpoints. To do that, brands need to develop the appropriate organizational models to support all the channels.

Companies must also build governance structures that allow the consumer to be placed at the center of the demand chain (see "Catching up to consumers in the age of demand," in Section 1). To this end, companies are recruiting heads of digital strategy/social media to define strategy, direction, and messaging while embedding a holistic view of consumer needs across the organization.

Exceed consumer expectations and deepen relationships

Omnichannel consumers are growing increasingly savvy and empowered. As their comfort grows, their expectations rise, leading to demands for faster service, wider selection, and 24-hour response time for complaints posted online.[57] In other words, they expect distinctive, high-touch customer service that keeps pace with their wants and needs.

Traditionally, customer service was relegated to the channel, the owner of the consumer relationship. Today, though, brands are in a position to have direct ownership and must understand their obligation to the consumer. To do this, they must be responsive on any channel that the consumer chooses. Manufacturers must scour relevant sites and blogs to monitor what consumers (and competitors) are saying about the brand, and be in a position to respond quickly and accurately.

Consider the risks and plan accordingly

While a digitally enabled demand chain can elevate a brand, it can just as easily contribute to its downfall. For example, a campaign may go viral (the desired outcome) but the organization may not be prepared for the increased demand, potentially resulting in backlash, consumer fallout, and damage to the brand's reputation. Before launching an initiative, it is important to understand the impact on the organization and put in place the supporting people, processes, and systems.

In addition, the issue of who owns the consumer becomes increasingly relevant as touchpoints cross product lines, marketing, sales, and service. To ensure consistency in brand delivery, companies need to consider training and education programs to coach employees in communicating messages that are consistent with the business and brand objectives.

Digitally transform and gain social intelligence

CPG companies are constantly seeking to develop a deeper understanding of consumers. For example, they are often trying to understand what attitudes and unspoken needs are conveyed by consumer choice. Why do they buy at this time? Why are they buying via this channel versus another? What is their motivation?

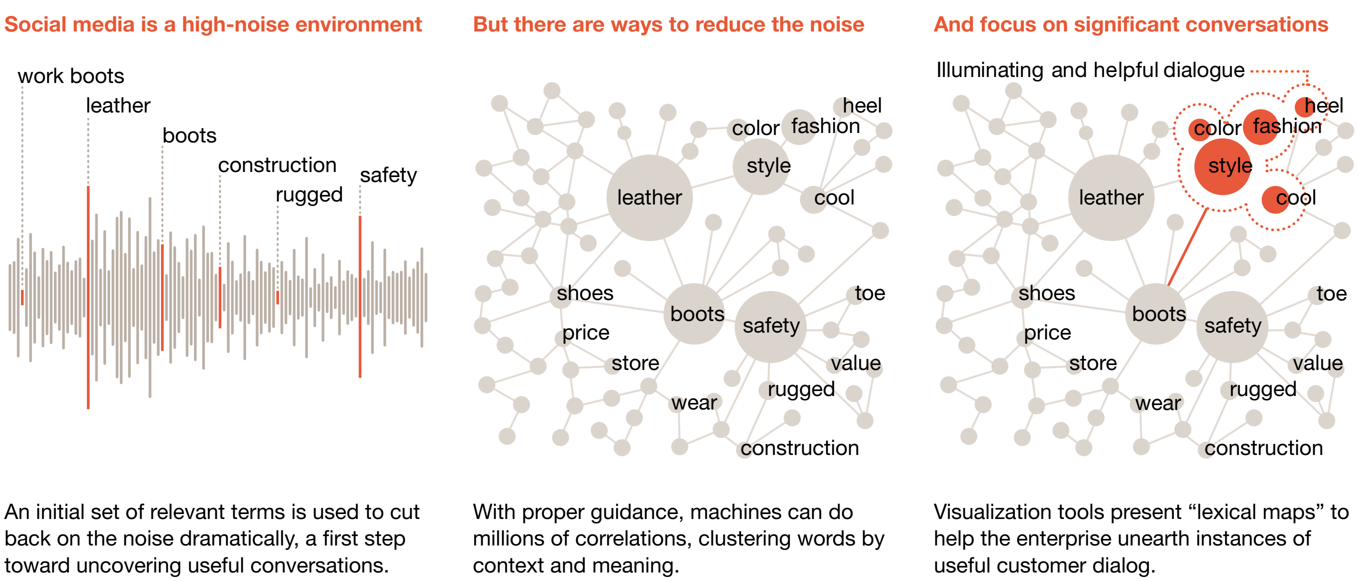
To answer these and other questions, companies have run focus groups, conducted consumer research, and pored through third-party data. Now, all of a sudden, the information they have long sought is available instantly through digital touchpoints along the shopping journey. Companies may have this information in their possession, but they still have to figure out how to mine all the data from multiple platforms and extract the relevant insights.

CPG companies that learn how to separate the signal from the noise on digital platforms will change the game so fast that their competitors will struggle to keep up. They will develop the social intelligence to answer the questions they have long asked, and therefore will be able to accurately predict consumer behavior.

To "read" the signal in social media, companies need to put processes, tools, and analytics in place to sift through all the unstructured and semi-structured data created in digital channels—the so-called "big data" (see the sidebar "Big data: Both a competitive imperative and an opportunity," page 28).

By using social media insights to augment the data to which they already have access internally, companies are likely to discover unexpected opportunities. For example, a North American apparel maker that wanted to reposition a brand of boots and shoes used third-party social media analytics to tease out the signal from thousands of blog entries about the product and focus on key blogging influencers. Uncovering insights it had not gleaned from its conventional research data on its footwear brand, the company discovered it had been missing an entire market segment. While its shoes had been designed for industrial markets, bloggers bought the shoes for their fashion appeal and for rugged recreational use, including riding all-terrain vehicles off-road (Exhibit 28).[58]

Exhibit 28
Improve the signal-to-noise ratio in social media monitoring



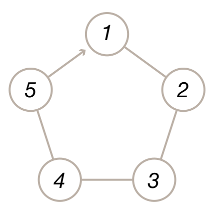
Source: Nexalogy Environics and PwC, 2012.

Adding social intelligence to traditional business intelligence processes produces better, more robust results. By expanding on the consumer insight process and running focus groups near the end of the cycle (after the social media analysis), the North American apparel maker was able to validate its newly gleaned market segment insights and successfully reposition itself (see Exhibit 29).

Exhibit 29
Adding social media techniques to business intelligence (BI) processes

One apparel maker started with its conventional BI analysis cycle

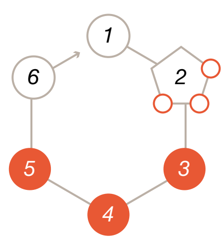
Conventional BI techniques used by an apparel company client ignored social media and required lots of data cleansing. The results often lacked insight.



1. Develop questions
2. Collect data
3. Clean data
4. Analyze data
5. Present results

Then it added social media and targeted focus groups to the mix

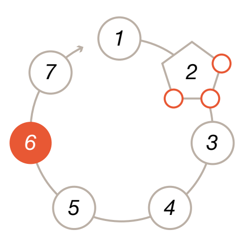
The company's revised approach added several new elements (including social media) and expanded others, but kept the focus group phase near the beginning of the cycle. From social media conversations, the company was able to mine new insights about market segments that it hadn't thought to target before.



1. Develop questions
2. Refine conventional BI
   - Collect data
   - Clean data
   - Analyze data
3. Conduct focus groups (retailers and end users)
4. Select conversations
5. Analyze social media
6. Present results

Then it tuned the process for maximum impact

The company's current approach places focus groups near the end, where they can inform new questions more directly. This approach also stresses how the results get presented to executive leadership.



1. Develop questions
2. Refine conventional BI
   - Collect data
   - Clean data
   - Analyze data
3. Select conversations
4. Analyze social media
5. Present results
6. Tailor results to audience
7. Conduct focus groups (retailers and end users)

● New step added

Source: PwC.

Measure effectiveness and drive business performance

As CPG companies begin digitally transforming their demand chains, they should consider evolving their approaches to measuring effectiveness across the multiple touchpoints. While digital channels may be among the most directly measurable mediums available, companies are still in the early stages of figuring out what to measure, and how.

Chris Davies of Diageo explains: "We have research that shows that 'friends' of brands are more likely to purchase, and we have research that shows that household panels exposed to our Facebook advertising spend more on our brands. We are examining ways to isolate the digital impact of multifaceted campaigns and considering digital-only campaigns to test our measurement tools."

Part of the challenge for other digital investments lies in the constantly evolving set of metrics that are relevant in the digital landscape. Leading indicators of consumer engagement—fans, friends, followers, likes, digs, check-ins, mayorships, retweets, reposts, forwards, shout-outs, comments, replies, etc.—may change as popular social media destinations alter their approaches and new entrants emerge. Front-line engagement measures need to be flexible and able to dynamically recognize the changing importance and influence of social behaviors.

Traditional demand chain metrics such as brand awareness, purchase intent, and loyalty will remain relevant through this process. However, understanding the effectiveness of the digital demand chain will also be important as brands seek to apply their limited resources across the channels.

Common metrics in the digital space (for instance, number of visitors or pageviews) may be helpful guides. These dashboards of digital performance, however, are irrelevant if the metrics they track do not tie to the broader brand goals (irrespective of medium) and to the underlying business economics.

"The ability to get more granular with digital, down to the individual consumer, is the real upside," says Don Mulligan of General Mills. "The exact metrics are still being fully developed, but they have to be founded on the return on investment. That's still going to be the key measure—it's just a matter of how you measure it as each new avenue to the consumer comes along."

To the extent that brands can assess their performance, they will be better positioned to make robust brand/business decisions and apply their resources more prudently. A digital index (see the sidebar "Building a digital index," page 49) enables companies to compare themselves in terms of key online performance indicators.

Consumers' brand of choice

To become a brand of choice today, companies must be digitally savvy, understanding how, when, and where consumers are interacting with their products. They must have a single view of the consumer, and know how to capitalize on insights across touchpoints. Further, they must recognize the risks that digital missteps present to the brand, and adopt the digital metrics and the just-in-time learning mindset required to evolve their strategies in synch with changing consumer demands.

Building a digital index

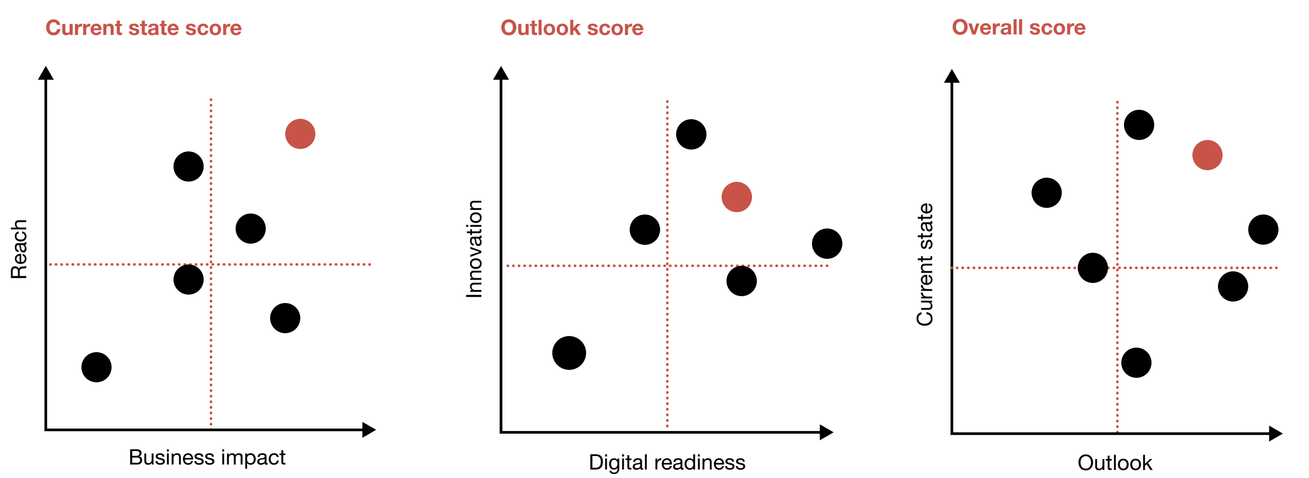
A digital index provides companies with a clear, objective measure of the effectiveness of their digital efforts and how they compare to key competitors. By better understanding the effectiveness of their efforts, companies can make changes to their digital initiatives, exiting those that are not yielding business results and reallocating resources as appropriate.

A digital index scores companies on key online performance indicators such as:

- **Reach.** The breadth, depth, and influence of the company's digital engagement
- **Business impact.** Attributable, quantifiable improvements to enterprise economics and reputation
- **Innovation.** Measure of the company's influence on breaking new ground for digital enterprises
- **Digital readiness.** The flexibility and scalability of the company's digital technology platform

A core set of KPIs for each category can be identified by combining available data and scoring algorithms (e.g., social media influence, digital IQ, digital readiness) with external leading practices and industry-specific data and measures. Each KPI can be measured and weighted for the company and then benchmarked against leading brands across major industries.

Exhibit 30
Achieving an overall digital score



Reach and business impact scores will combine to measure ***current state* digital index score** + Innovation and digital readiness will combine to measure ***outlook* digital index score** = Current state and outlook will then combine for an ***overall* digital index score**

Source: PwC.

Is the time right to invest in a direct-to-consumer channel?

Determining the right brand positioning, operating model, technology enablers, and talent

Digital commerce is enabling your global brand teams to market and sell directly to consumers, including direct fulfillment. Direct-to-consumer (DTC) sales sets up an ongoing dialog that is richer, deeper, and more valuable than any channel traditionally available to CPG companies. Purchase behaviors provide very strong signals of consumer needs and preferences, and CPG companies and suppliers have long sought these insights unfiltered by retailer channels.

Even interactions at digital touchpoints such as Facebook are not as valuable for understanding consumers as direct purchase behavior data.

"It's hard to know how many cases of baked beans a Facebook friend is worth," explains Al Williams of Bush Brothers. "We have been successful in getting people to 'like' us, but we don't have any way to tell whether the people who like us are new customers or whether they are buying more product than they did before."

Other factors beyond the lure of direct purchase data are also prompting CPG companies to test or at least consider DTC channels. Retailers continue to use private labels to drive traffic, basket, and gross margin, for example, leading national brands to worry that they have only a single lever (price or promotions or advertising) to play today.

Then, of course, there are the consumers with their rising expectations: to interact with the brand online, to purchase products 24-7, and to see their input reflected in product offerings. A number of CPG companies are already mining new and very specific consumer experience niches. Candy manufacturer Mars, for instance, gives online consumers the ability to order customized M&Ms in specific colors and with messages printed on the candy, and have them delivered to their door.[59]

Digital commerce platforms lower the entry barrier for conversing with and selling directly to consumers. While CPG companies are testing business models for getting their brands into the pantries, refrigerators, and homes of consumers, so are local brands that no longer need a brick-and-mortar presence. The playing field is a little more even, and these local brands can now jockey for position with larger companies that are far better financed.

All this activity will disrupt the market, and that disruption will create new consumer experiences (such as product subscriptions or automated consumer replenishment) and potentially allow for entry into new markets with lower costs. The use of DTC over traditional retail brick-and-mortar will present risks to larger players that have less nimble, responsive supply chains.

Global CPG brands—from massive multinationals to regional players—acknowledge they lag other industries (such as consumer electronics) in exploring the DTC channel. Everyone is trying hard to figure out a truly winning strategy. The game is open and some early adopters are already out in the market learning how to win in the digital commerce playing field.

How to position brands in the DTC channel?

Before starting to extend a DTC channel, companies must rationalize which of their brands are the best positioned for the channel. In addition, they must figure out how to leverage their current channels while keeping true to their brands as they expand into new and continually evolving digital channels.

"The direct-to-consumer model makes sense from a replenishment standpoint for products that consumers use on a regular basis, like Brita water filters," says Clorox's Steve Robb. "Small, lighter-weight products with an appropriate margin structure, like Burt's Bees, also make sense. It's harder to see how the model works for heavier products like charcoal or bleach."

Coca-Cola's Duane Stills concurs: "Our business model is all about working closely with our valued customers to reach their consumers. Our current distribution system provides us with a great deal of flexibility to meet our customers' needs, but we may also test the selling of certain niche products via new channels."

Whether a product is easily customized is also a key factor in prioritizing brands for launch into a new DTC channel. Companies will need to learn quickly how to mine customer feedback and evolve products to fit the preferences of their target segments. Product lifecycles will shorten significantly, and there will be a drive toward low-cost customizations. These will make test-and-learn cycles easier to justify.

Where to sell direct?

Companies select DTC channels based on their target segments. Hindustan Unilever, for example, has successfully used 45,000 entrepreneurs in India to reach approximately 135,000 villages across 15 Indian states.[60]

Amazon is one of the early movers in the DTC channel. Many CPG companies turned to Amazon initially as a way of selling online. Today, this online retailer remains an important channel for many companies, as shown by the number of Amazon links on brand websites. However, an Amazon presence does not give companies a complete picture of the customer, so many of these companies are building their own DTC channels based on their targeted segments. Relationships with Amazon are evolving and will inevitably change further as CPG companies and entrepreneurs stand up their own channels. The threat of the digital commerce providers is real, and it's likely only a matter of time before these companies move into private label competitive brands.

Alice.com is an example of an entrepreneurial organization interested in selling CPG products online. This online marketplace features over 6,000 products from approximately 600 CPG companies. The site provides consumers with direct-from-manufacturer prices, doorstep delivery, automatic coupons, reordering tools, and a mobile shopping app.

The founders of Alice, however, are not simply providing a channel for CPG products. Their business model includes back-end advertising and selling the insights from the gathered data to manufacturers. It is not yet clear whether this model will be profitable, especially given the mechanics and the required investments involved.

Another approach to selling direct to consumers is to couple valued content for a particular customer segment with an e-commerce function. Such highly specialized segmentation is a hallmark of first movers into a DTC channel. General Mills is testing this approach with its Gluten Freely site, built in the cloud (see the sidebar "Quick and sticky: General Mills' Gluten Freely e-commerce site," page 52).

Quick and sticky: General Mills' Gluten Freely e-commerce site

General Mills' Gluten Freely site, launched in mid-2011, culminates the company's four-year pursuit of a huge, previously untapped market. Celiac disease, a digestive condition triggered by eating foods containing gluten, was virtually unrecognized prior to 2003. Now, the National Institutes of Health estimates that 1 in 100 people worldwide have the disease.[61]

It took a thousand batches to create a gluten-free version of Chex cereal.[62] Since then, not only General Mills but also other companies rushing to meet the needs of this segment have delivered a steady flow of gluten-free baking products, cereals, energy bars, and organics. According to a recent Nielsen report, the volume of these products sold rose 37% over the past year.[63]

Don Mulligan of General Mills says, "We wanted to expand our reach from a gluten-free standpoint. What we found was that you really need to bring more than just the products. We're bringing the community and the education."

To make the science a focal point on the site, General Mills partnered with the University of Maryland Center for Celiac Research, the University of Chicago Celiac Disease Center, and the General Mills Bell Institute of Health and Nutrition.

"There's so much more that you need to make a site sticky beyond the products themselves," Mulligan adds. "And that's particularly important as gluten-free products have become more readily available in traditional groceries. The site is very much in test mode, but we like what we are seeing so far."

By building in the cloud, General Mills was able to bring the site to market twice as fast and at half the cost of a traditional IT development effort. Further, with this model, the team can add infrastructure as customer demand grows rather than taking the costly traditional route of building out servers and systems at the start of the project.[64]

Which strategy to employ?

CPG companies interested in a DTC channel are searching hard for the right go-to-market strategy and operating model to employ. Should the organization be separate from the core, for example? How should the DTC function leverage or interact with other parts of the business? Who owns the profit-and-loss (P&L) statement? How do we deliver on the last mile to the home?

CPG companies have well-honed expertise in broadening and extending brands. DTC, however, is a transformational business model and, as a result, represents greenfield exploration. Different types of innovation will be required, so even companies adept at product innovation will be stepping into new areas of the consumer experience and the last mile delivery to the home.

These new business models are being defined in a disruptive environment in which technology platforms, tools, and consumer experience are rapidly evolving. There are no mature examples showing how DTC affects a company's supply chain, product development, or base business.

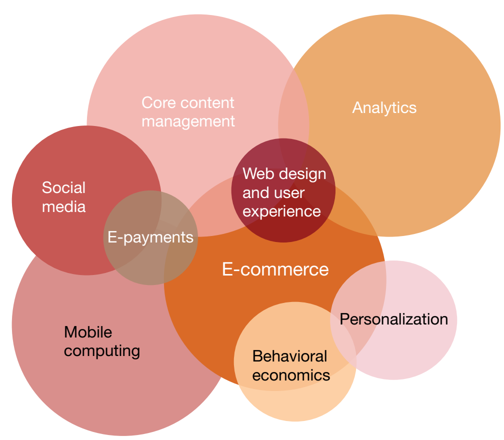
Startup costs and appropriate return on investment (ROI) will require significant attention, given that building an online channel is so different from extending a mass-market brand. There is huge potential for companies that find the right path, but in the meantime, DTC teams will need to set executive expectations appropriately. ROI will be lower initially, for example, and required investments higher than for a brand extension.

A monetization model based on consumer insights from analytics is critical to DTC channel success. Consequently, companies are conducting ongoing tests of monetization models in markets globally, and the results are closely guarded.

Wary of the sizable risk, companies have so far controlled their investments in DTC. Many are taking small steps with a few SKUs, for example, or focusing on building foundational components like data analytics platforms to produce insights based on consumer purchase behavior.

As they would for any new business, companies must go beyond monetary goals and develop strategic goals as well, based on benchmarks. Building an integrated digital transformation strategy requires an understanding of the key components involved (see Exhibit 31).

Exhibit 31
Areas of focus for CPG companies moving into DTC



The size of the bubble represents the significance of discussions with members of the PwC client base over the last 12 months.

Source: PwC.

Companies moving into DTC must define key strategic goals for such areas as:

- DTC value proposition
- Target consumer segments and experience model
- Target market(s)
- Marketing relationships, existing and new
- Modes of delivery

In addition, capabilities and criteria for operating must also be defined, including:

- Speed to market
- Data analysis technologies and insight platforms capable of digesting and monetizing information
- New product testing and deployment models
- Speed with which the organization will need to learn and be able to respond to markets, promotions, and consumer demands
- Feedback loops and innovation requirements

Build capabilities to sell direct to the consumer

Consumers' expectations for an omnichannel brand experience require many capabilities that are currently in varying stages of development within organizations. Top-tier talent will rapidly command a premium as CPG manufacturers, retailers, local brands, online marketplaces, and third-party providers vie for the same small pools of people.

Companies will need to think through whether they will build, acquire, or partner for the capabilities they need. In all likelihood, companies will pursue a combination of these approaches, based on the market and geography.

Analytics is a well-recognized gap for many companies. Even if the work is outsourced, the criticality of analytics means that internal organizations must be capable of directing the work and interpreting the results.

Other talent gaps are in less obvious areas, such as consumer interactive behavior with online navigation. A large toy manufacturer struggled for months, for example, to find someone who understood the behavioral dynamics of navigation well enough to architect an effective site for DTC.

CPG companies going direct have a choice: They can reconfigure their supply chains to be nimble enough to handle e-commerce orders, or they can outsource fulfillment (see "Are your demand and supply chains in synch?" in Section 1). As Clorox's Steve Robb says, "CPG supply chains are organized around building full cases, pallets, and trucks of product for major retailers. With direct-to-consumer, you need to look at different fulfillment models that make more sense for the consumer."

Commit to test-and-learn cycles

Because the DTC marketplace is so new, CPG companies need to commit to test-and-learn cycles. They need the processes and the culture to support iterative testing and, given the volatility in the market, they cannot approach the new channel like an SAP implementation. Speed of learning will separate the winners from the also-rans in the DTC channel.

To identify, prioritize, and quantify opportunities for testing, CPG companies can follow these guidelines:

- Develop a baseline opportunity and cost model over the geographies defined as part of the strategy to define the target market.
- Leverage internal (e.g., point-of-sale, inventory) and external (e.g., third-party) data to develop a baseline, and confirm the size of potential opportunities.

- Develop metrics and measurements for tests.
- From a business case perspective, value qualitative and quantitative results equally, at least initially. Insights from both will be valuable.
- Create appropriate tests and structured timelines for results.
- Be deliberate in setting up the appropriate feedback loops and repositories for analysis of customer behavior. Leverage internal and external data to confirm testing outcomes.

Digital touchpoints provide immediate feedback to these pilot efforts, allowing manufacturers to learn literally hour by hour, as one executive marveled. An important component of these test-and-learn cycles, therefore, is to set up processes for quick implementation of changes (e.g., to a promotion or price) based on this feedback.

Never give up who you are

In an omnichannel world, brand and all of a brand's potential customizations and extensions will remain crucial to success.

It is essential for companies to address how a new DTC channel—and the direct, real-time conversations with consumers that the channel enables—will quickly change their brands in ways they could not have imagined a few years ago.

Stirring up sustainability demand
Two essential ingredients: consumer engagement and reputation management

After years of focus on sustainability-related initiatives, CPG companies and retailers have made progressive gains in cost-cutting, transparency, and improvements around energy use, packaging, ethical sourcing, and other aspects of their environmental and social footprint. But now the big opportunities lie in thinking creatively about the demand chain.

This is no small feat. For one thing, it can be confusing for consumers to sort through a dizzying array of claims about sustainability associated with the products they buy.

Moreover, sustainability has different meanings for different consumers, ranging from fair labor and trade practices and low carbon emissions to the buy-local movement, more humane raising of animals for food, and the importance of addressing childhood hunger.

How can companies best help consumers determine which offerings and brands are truly sustainable and therefore worth choosing—all while running a sustainable business that's also profitable? Companies that solve this challenge stand the best chance of moving sustainability from a nice-to-have novelty groundswell to a genuine competitive advantage.

The encouraging news is that companies are demonstrating more innovation and experimentation and, more importantly, are learning from both successes and setbacks. Armed with insights gained through hard experience, some enterprises are taking sustainability to a new level—integrating it into more aspects of their business and approaching it more systematically than ever before. Forward-looking businesses are finding new ways to engage consumers on the subject of sustainability and to incorporate reputation management tightly into their brand management efforts. We maintain that such approaches now constitute table stakes for any business seeking to tap into sustainability demand.

Don't just educate consumers—engage them

Companies have long sought to educate consumers about sustainability by pushing information at them. But augmenting education with engagement—fostering multidirectional dialogue about sustainability with consumers—could yield even more valuable results for companies. According to Coca-Cola's Duane Still, "When we actually talk to people and they understand what we're doing, generally, opinions improve. I think it's a combination of communicating with a wide range of stakeholders and encouraging them to communicate with us as well."

Research shows that when customers engage with companies on social media sites, their dollar spend is an average of 30% more than other customers, and they experience a deeper emotional connection to these companies.[65] And consumers who feel deeply engaged by a company or product category are often willing to spend more money in the category they care most about. For example, sales of Fair Trade Certified products (which include apparel, food, body care products, packaged goods, condiments, and spirits) rose by 75% overall in 2011, and consumers appear willing to pay 5% to 10% more for the Fair Trade label.[66]

Social media is such a powerful platform for engagement because it enables companies to take part in a two-way or multilateral dialogue with consumers, in real time. This differs from pushing marketing messages out to consumers over carefully scheduled intervals. Some companies have already engaged consumers by soliciting their insights on a broad range of business issues. Unilever has defined a sustainable business strategy that calls for doubling the size of its business without increasing its environmental footprint.[67] In pursuit of this goal, the company has invited consumers to help shape the future direction of its brands, marketing, and products through a customer panel called "At Home with Unilever." The goal is to gain more insights from consumers and "drive the future of the business in line with customer demand" by seeking comments on sustainability issues and concerns as brands move into new markets. Unilever also runs a Facebook program called Unilever VIP, which asks Facebook users about their preferences and opinions; solicits responses to new offerings, marketing campaigns, and sustainable product initiatives; and asks specific questions such as how consumers recycle Unilever packaging.[68] Programs like these help Unilever assess and manage the environmental impacts of its current products by better understanding how people use them, while simultaneously creating an interactive space where people can inspire each other to adopt new sustainable products.[69]

Through social media, a company can let consumers know that it, too, is learning about sustainability and wants to do the right thing. Businesses can ask consumers questions such as, "How can we make it easier for you to 'buy green'?" and "What are your thoughts and concerns about sustainability?" These sorts of questions can spark dialogue that generates valuable insights for consumers and companies alike. For example, companies and consumers can exchange thoughts about the trade-offs involved in living and doing business sustainably, as well as which consumption behaviors are truly the most sustainable.

Don't just manage your brand—burnish your reputation

In addition to augmenting consumer education with consumer engagement, companies can benefit by integrating reputation management even more tightly into their brand management efforts. In an interconnected world, information about products, brands, and companies is now a mere search and click away, and the ease with which anyone can see what consumers say about a business or brand, unprompted, in the marketplace, has huge implications for corporate reputations.

Today, a company's or brand's reputation may be affected more by what consumers are telling each other about it than by what the company itself is telling consumers through its marketing messages. Bert Alfonso of Hershey comments on how consumer awareness about sustainability issues can color a company's reputation: "Undeniably it's important to today's consumer, and some geographies more than others, and so not only is it the right thing to do, but frankly, competitively, if you're not active in those sustainable efforts, the consumer will notice, and it does have an impact."

For these reasons, companies may want to put more emphasis on reputation management as part of their brand management efforts when it comes to sustainability. Building trust with consumers involves demonstrating that a company doesn't just think differently, it also acts differently.

One way companies can do this is to make their business practices even more transparent to customers, investors, employees, and suppliers. For instance, a company can invite outside experts with high status and high credibility (such as third-party authorities and non-governmental organizations) to observe their operations. Such authorities can confirm that a company's sustainability-related practices reflect its policies.

As General Mills' Don Mulligan explains, "It's about ensuring you are known in the circles of credible external organizations—whether they're environmental organizations or publications that rank companies in terms of sustainability efforts or corporate social responsibility. If the opinion makers have a favorable view of you, then by word of mouth, you will strengthen your corporate reputation." Some businesses may also get third-party assurance on their sustainability reporting (see the sidebar "Spotlight on sustainability reporting," page 59).

Some companies are also giving consumers a window into their operations. For example, PepsiCo's Frito-Lay division announced in 2011 that about half of its portfolio would be made with all-natural ingredients by the end of that year. The division gave consumers an inside look at its operations by broadcasting activities taking place in its Flavor Kitchen, located at headquarters in Plano, Texas. Action in the Flavor Kitchen was streamed live for a week on screens reaching 22 stories above New York's Times Square and on the Frito-Lay Facebook page. Consumers could see for themselves how Frito-Lay creates recipes using all-natural ingredients.[70]

Retailers can play a key role in winning consumers' trust. For example, they can take responsibility for selecting products that not only deliver good prices, quality, and functionality to consumers, but that are also sustainable or that come from manufacturers or producers using sustainable practices. This puts an increased emphasis on the manufacturers as total entities, rather than emphasizing certain of their brands.

Coca-Cola's Duane Still explains: "There are elements of sustainability related to specific brands when that is the right thing for those brands, but our efforts generally are more at a company level. Our brands are generally identified as being a product of The Coca-Cola Company so our messaging is around the Company." Adds Don Mulligan of General Mills, "Corporate reputation is more important now than it ever has been. Consumers are increasingly saying, 'Who is the company behind the brand? Do I think they are trying to do the right thing?' Sustainability has become more important from that standpoint."

When a retailer uses choice control—screening out non-sustainable offerings or those coming from manufacturers with questionable practices—consumers might feel an enhanced level of comfort shopping there, trusting that the retailer has done the research for them.

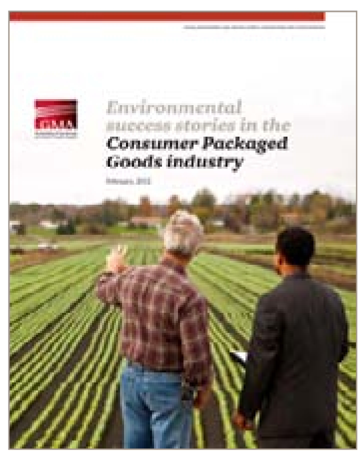
For instance, Walmart established a sustainability index to provide buyers with the information they need to evaluate products' sustainability.[71]

Moving sustainability to a new level

The practices described above could help companies move sustainability from mere compliance to efficiency, then onward to true market leadership. By advancing these ways of thinking about and conducting business, companies can further channel the energy generated by the sustainability groundswell toward integration of sustainability into every aspect of their business. The result may be a welcomed increase in consumer demand.

Environmental success stories

Earlier this year, the GMA released a new report spotlighting progress and achievements by food, beverage, and consumer products companies seeking to reduce their environmental footprints and promote sustainable business practices. Titled *Environmental Success Stories in the Consumer Packaged Goods Industry*, the report features industry environmental success stories in the categories of air, water, and waste management.



Spotlight on sustainability reporting

Disclosure on sustainability metrics, particularly around greenhouse gas emissions and, more recently, water, is commonplace within the CPG industry. The information flow—whether through Bloomberg terminals, supplier sustainability scorecards, or annual reports—is becoming more focused on demonstrating actual performance and return on investment. In 2011, 339 (68%) of the S&P 500 companies submitted voluntary disclosures, including information on carbon reduction performance, to the Carbon Disclosure Project on behalf of 551 investors with assets of $71 trillion.[72]

For the fifth year in a row, PwC has analyzed sustainability reporting among CPG companies. Reporting companies in our study include those that establish sustainability strategies, report on them, and achieve recognition for these activities through well-known third-party sustainability indices. Non-reporting companies report only standard financial data. A company that reported sustainability data at any time during the five-year reference period was included in the reporting group.

Our most recent analysis examined 59 large CPG companies ($4 billion or more in annual revenues). Of these 59 companies, 56 have some form of sustainability reporting, whether through website content, standalone reports, or content integrated into annual reports. Clearly, sustainability reporting has advanced in this sector. These results are similar to the prior year, when 89% of the companies we analyzed qualified as sustainability reporters.

The natural evolution in sustainability maturity from "tell" to "show" is mirrored in the shift from environmental and social disclosure to performance reporting, resulting in a more intensive critique of available data.

One of the resulting factors and more interesting trends that we saw among these CPG companies was that 45% now get a third-party view on some or all of the sustainability metrics they're reporting—a result markedly higher than the 18% we found in the prior year.

The Dow Jones Sustainability Index (DJSI), a set of indices to measure the financial performance of companies that are considered sustainability leaders, follows this trend. The DJSI awards high scores to those companies that can provide assurance over environmental and social aspects of their sustainability strategy. Another sustainability reporting organization, the Global Reporting Initiative (GRI), allows reporting companies to enhance their self-assessed reporting grade with a plus (+) to indicate that the data was assured by a third party.

Less visible to stakeholders is the real internal value companies can gain from going through the assurance process with a third party. As with other business processes, another expert review can highlight inefficiencies in a system or provide suggestions for process improvements, including documentation retention, data calculations, emission factors, governance procedures, and controls. This is critical when it comes to sustainability data, because businesses may have little experience collecting such data. Moreover, new software solutions have recently been implemented and have not yet been globally adopted by companies or tested through long-term use.

Section 3
Pursuing growth overseas

Emerging markets are evolving rapidly as their middle class expands and domestic brands and retailers come on strong, with technical savvy and a deep knowledge of local consumer behavior. Knowing where, how, and when to invest is the first question for multinational CPG firms, whose investment decisions should also be informed by careful risk/reward analysis. You can't simply transplant your US business to a foreign market, and you'll need to invest in the right talent to pull off overseas expansion. Different operating models, moreover, come with different commercial and tax considerations that can dramatically alter the economics of the business. Best-in-class companies, therefore, build tax considerations into their strategic decision-making process.

Capitalizing on emerging market growth opportunities

How to approach two areas of particular challenge: brand and talent

For the past decade and a half, the rate of growth in emerging markets has been twice that of developed countries, a trend that is unlikely to slow anytime soon. Today, urban populations in emerging markets provide 60% of the world's GDP growth.[73] And these markets are rapidly expanding: A population the size of Miami (6 million), for example, is expected to push into Delhi over the next 15 years.[74]

The growth opportunities become even richer when emerging market segments are targeted regardless of their geography. "The world's largest and most profitable emerging market is right here in the United States," says Diageo's Chris Davies, referring to the changing multicultural makeup of the country. "With that mindset, we can bring our global marketing to bear here—e.g. borrowing Johnnie Walker Chinese New Year activation from AsiaPac and running in targeted demographic clusters in key US cities."

Winning significant rewards in emerging markets, however—whether at home or abroad—is an ever-more-complex proposition, even for companies that are well established globally. New rivals are crowding in as commerce between emerging markets (south-south) continues to increase dramatically.[75] A case in point is Dubai's DragonMart, chock-full of Chinese companies offering cut-price products to the rising middle class. Similar marts are rising up across the Middle East and Africa.[76]

In addition, the rise of digitally enabled consumers in both developed and emerging markets is helping to catalyze a fundamental shift in the consumer base, in consumer preferences, and in consumer behaviors. As with all economic shifts, the winners will be those companies that can quickly understand the most profitable areas of demand and focus their attention accordingly.

Brand and talent continue to challenge CPG companies and retailers as they develop their globalization strategies. Brand is the essence of the offering and the power of the potential, and talent is the catalyst that allows companies to execute in the short timeframes now required to compete. Focusing on these elements early on will help companies figure out how to place their bets, and where.

Select the brands, then appeal to local tastes

A company's brand strategy sets the stage for everything that follows. "Know thy customer" is an obvious dictum, yet many companies have been stymied in their efforts to translate the essence of a product to different cultural consumers without suffering a breakdown in brand identity.

Strong global brands such as Apple have in-demand products that easily translate across continents, but retailers and CPG manufacturers with broader mixes of product formulations and packaging must make more adjustments to meet local demands, including the local palate.

Before putting in that work, companies need to select the brands to globalize. "We are going to pick our spots," explains ConAgra's John Gehring. "For different reasons, snacks and potatoes are categories where we expect to win. In these and other select categories we have a compelling and relatively lower-risk proposition."

"We do have brands that spike with specific cultures," adds Diageo's Chris Davies, "but they are the icing on the cake. The bigger prize is in activating our global brands in ways that are relevant in these cultures—execution that is true to the global brand essence, but tailored to resonate locally."

For Kraft, the Oreo cookie is the $2 billion power brand that could potentially span cultures. That had not yet happened five years ago, when Kraft considered pulling the brand out of China because it was "spectacularly underperforming."[77] After the cookie had been in the Chinese market for ten years, Kraft began testing new formulas to adjust the sweetness and size of the cookie to suit local tastes. Eventually, new flavors such as green tea, raspberry, and blueberry drove a 60% growth in annual sales and made Oreo the top-selling cookie in China.[78]

The same type of consumer insights are leading to bidding wars for other potential multicultural power brands. Nestlé, for example, recently paid 20 times Pfizer Nutrition's estimated earnings in a bidding war for the drug company's infant nutrition brands. Now Nestlé has the goods to target Chinese mothers who pamper their single children with expensive foreign brands, particularly after the 2008 melamine scare.[79] In 2011, the Chinese baby food market reached $6 billion, and that number is likely to double by 2016.[80] Further, newly middle class mothers in other emerging countries could well make the same choices for the same reasons as Chinese mothers.

Indeed, insights from one market are an excellent avenue for understanding and targeting consumers in a similar market. Cultural, religious, and life experience similarities are often far more important than geographical location. As a result, in-market incumbents have an obvious edge both in emerging markets and when building south-south market presence.

How to speak the brand language

The brand message is a springboard for product innovation and customer engagement. As such, CPG companies and retailers need to draw on in-country experiences with similar products and market testing to select the necessary local adjustments. A toothpaste manufacturer, for example, might choose to market "shining white teeth" in America, where appearance takes precedence over the other functions of toothpaste (tartar control and gum health). The opposite decision might be made in other markets where oral health is a stronger draw.

Speaking the brand language isn't only about extending and stretching the brand but also keeping a true core "language" for the brand. Companies must hold close to what a brand stands for in its purest sense—in any new market, across time, and across multiple permutations. Or, they must find their way back to the fundamental value of the brand, as Pepsi has tried to do with the newly launched "Live for Now" campaign.

Brad Jakeman, PepsiCo's president of Global Enjoyment Brands and chief creative officer, explains the problem: "As a brand, we have moved from one advertising campaign to another to another. We need to get a lot more disciplined. Because we haven't had an enduring piece of brand language, we just attached different things to the logo all the time."[81]

To get back to the roots of what Pepsi is about, a team of PepsiCo executives visited a plethora of different markets such as Argentina, Australia, Russia, and the United Arab Emirates. PepsiCo executives had not undertaken a similarly ambitious effort to gather consumer insights since the 1990s.[82]

Brand translators wanted

Of course, it takes talent to work toward and form insights about localizing the brand. According to PwC's *15th Annual Global CEO Survey,* the lack of talent in the right place is the single biggest problem CEOs face in trying to expand their companies globally.[83]

This war for talent can be both internal and external to the organization. One top executive recently recounted how his direct reports nodded in agreement when he raised the need for top talent to execute the company's global expansion plans. But when he circulated a list of preferred executives to oversee the global efforts, a chorus of voices protested that all the people on his list were mission critical to their current initiatives.

Externally, retailers and CPG companies are looking for unique skill sets: innovative thinking, an understanding of the culture and nuances, entrepreneurial spirit, a facility for measuring performance and progress, and strong systems, process, and operational capabilities. And their needs span technical, business, marketing, finance, supply chain, product, and manufacturing.

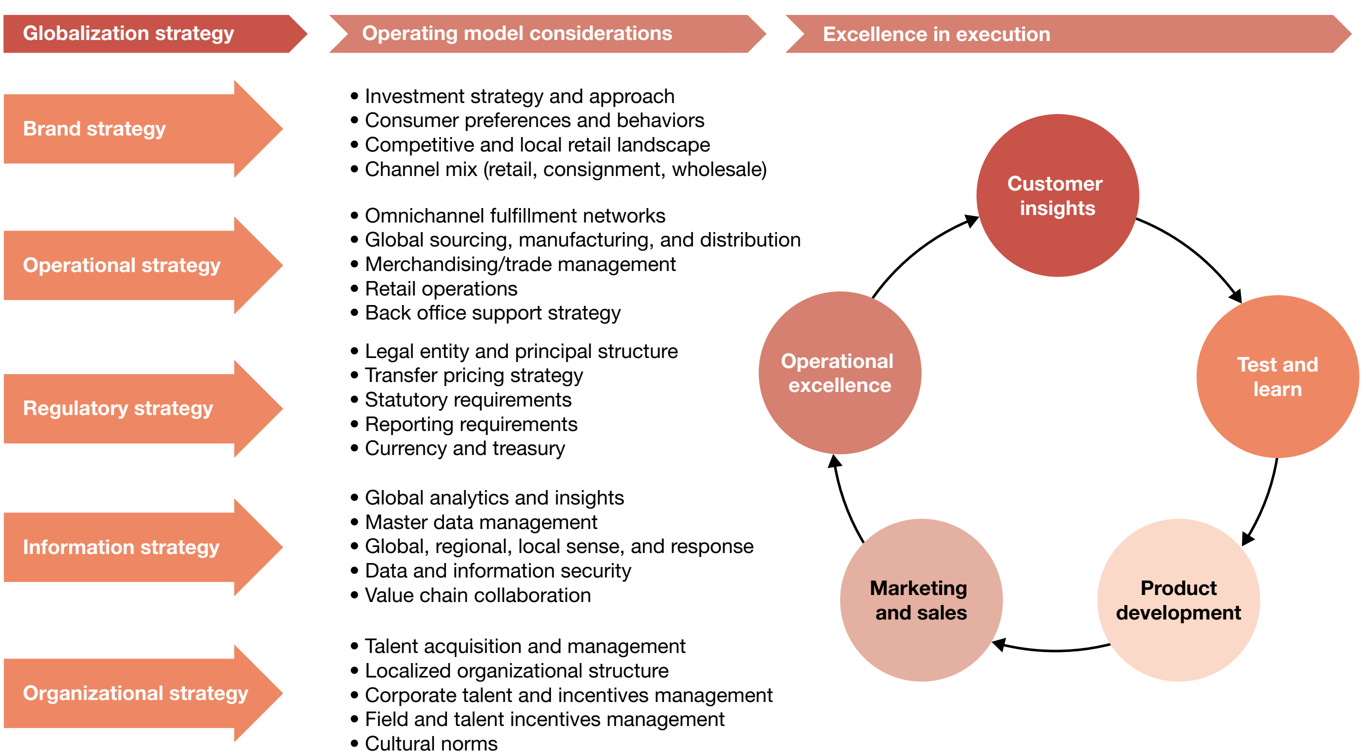
Talent retention is as much of a concern as talent acquisition in markets such as China. Hershey's Bert Alfonso explains: "It is very hard to retain strong talent that has a solid base of working with global companies. There is a strong demand from both local companies and multinationals. Companies use expatriates, but you can't depend solely on that strategy."

As research and advisory firm Gartner recently suggested, "More strategically, as companies continue to globalize, finding and retaining the right talent are viewed as two of the primary challenges."[84]

Put it all together in a globalization strategy

Even though talent and brand are at the top of the priority list for expanding in emerging markets, they must be addressed within the context of a global go-to-market strategy. The basic tenets of that strategy have been in place for a while, according to Coca-Cola's Duane Still: "We used to talk about the three A's. First of all, your product has to be acceptable. Second, it has to be available and we have to find outlets, we have to find partners. We have to have a business model that allows our partners and customers to make money. Third, it has to be affordable. We have to tailor our package sizes and our product offerings around the world to meet the needs and finances of the population that we're trying to reach."

Exhibit 32
Elements of a globalization strategy for CPG companies and retailers



Source: PwC.

Though the tenets may have stood the test of time, execution based on those tenets has definitely changed. A methodical, phased, US-centric approach to market entry—market by market, from developed marketplaces to emerging markets—no longer works.

Because of increased competition and specialization, and the new realities of sophisticated, digitally connected international markets, consumers are ahead of and driving the demand curve. A consumer-driven model that delivers more personalized and customizable products results in a globalization strategy that is complex in all of its elements (see Exhibit 32, page 64).

Speed and innovation count as never before, in everything from developing branding strategy and product mix to integrating the supply and demand chains. Two important areas of innovation that, while not unique to international expansion, are especially challenging to it, are anticipating the new changes in demand (simultaneously at the global and the individual-consumer level) and the rise of the omnichannel shopper.

Companies must redesign their approaches to communication, innovation, and supply chains to address these new challenges or risk being sidelined by consumers who switch to competitors better able to address their demands.

In this new reality, CPG companies and retailers don't have a long window of opportunity to test and learn. Tight controls over product innovation and customer feedback loops will be necessary market disciplines to build successful global markets. Further, companies must be willing to make mistakes while limiting sunk costs and ensuring lessons learned are communicated through the organization. And they must be willing to draw on both conventional and nonconventional sources of innovation.

As Diageo's Chris Davies explains, "Demographic changes in the United States mean we have to be every bit as focused on 'emerging' opportunities here as we would in classic emerging markets. We use a number of different models to drive innovation, both in-house and through various partnership models. Some of those initiatives will inevitably fail to meet our objectives, but where we take gambles, we do it small, to get into the space without taking undue risks. The key is to have a risk-balanced innovation portfolio."

Emerging market brand success

There are and will be many necessary lessons learned in approaching, building, and leveraging brand opportunities in new emerging markets. To be successful, companies need to be ready for the investment in people and the ongoing translation and redefinition of their brand. Winners will recognize emerging market expansion as a long-term commitment and a continual education process, both locally and globally.

According to Harry Broadman, PwC's chief economist and head of the PwC Emerging Markets practice, "The industrial landscape of the world market has changed unalterably. But this is just the beginning. There will be multiple growth nodes from here on out and not just between the advanced countries and the emerging markets—but within emerging markets. The effect on companies from the developed world will continue to be profound. Adopting an investment strategy informed by accurate information and trusted partners with deep local insights and experience is the best way to navigate the risk-opportunity tightrope."[85]

The biggest risk is not acting at all.

What do I need to ask about my brand?

Take stock of what you know—and don't know—at the beginning of your brand development/redevelopment process. Going through the questions on these key challenges will help you advance your organization in making key decisions. But keep in mind that this question process is not linear; the feedback loop creates a need for constant refinement. Each answer should inform the other questions; ignoring them may create a risk that undermines the entire effort. Here is a short starter list.

- **Brand delivery and customer service.** What are the local requirements and norms that may be different? How do I adjust my service levels and brand to address cultural differences and norms?
- **Insource/outsource partnership models.** What are the most effective market entry models? Who are the right partners in the market to help me execute my vision? What is their local reputation? Are they able to scale with me? Do they have an online presence?
- **Merchandising, product positioning, and pricing.** How will products be modified and manufactured to suit local market tastes? How should they be packaged? What are the appropriate market price points and positioning?
- **Securing people talent.** Are the right people available in the markets where we would like to operate? How can I effectively ramp up and down efforts based on market demand?
- **Organizational structure.** Do we have a centralized or decentralized structure? What reporting structures would be most appropriate for supporting market growth?
- **Supply chain.** How flexible and scalable is it? How quickly can it respond?
- **Technology support.** What corporate systems and software can be leveraged locally? What are the business requirements now—and over the long term as demand grows? Can available technologies scale to requirements and integrate? What new technologies need to be deployed? Do they need to be locally customized?

Before expanding abroad, dig deeper into the tax implications

Involve your tax function from the start to inform creation of a tax-efficient business model

CPG and retail companies planning international expansion face many decisions about how best to build brand and grow revenues. Different operating models, from e-commerce to direct sales, come with different commercial and tax considerations that can dramatically alter the economics of the business. When companies decide to expand in a local market by shifting demand chain activities, careful consideration of the tax consequences should be undertaken.

The decision about whether and how to enter a foreign market should hinge first on the investor's criteria for evaluating business opportunities (What is a market opportunity? Is it strategic? And what other competing investment opportunities exist?), but tax considerations should also play an important role. ConAgra's John Gehring describes the role of taxes for his company: "It might impact how much risk we're willing to take, and it might impact some of the return metrics in terms of how good we feel about going into a market."

Companies should align business development teams with tax executives to understand the tax aspects of expansion on several fronts:

- **Operating models.** Ensure operational and tax strategies are aligned. With rare exceptions, tax structuring without full business sponsorship will eventually fall apart.
- **Compliance.** Tax and regulatory compliance burdens should not be underestimated. Accounting, tax, treasury, and information systems are all areas that must be carefully considered and maintained.
- **Identifying new markets.** Many US-based companies have traditionally maintained limited demand chain footprints overseas through e-commerce, external franchising/licensing, and basic/limited-risk store modalities (including "pop-up" stores). As the demand chain expands, executives should evaluate structuring and tax-planning opportunities that did not exist within these three models.
- **Law change uncertainty.** Even the best structures must be constantly re-evaluated. Changes often arise in tax laws or the broader business climate. Recent tax proposals in India, for instance, are sending mixed signals to multinationals about investment prospects in that country, and should be weighed carefully.

Getting tax departments involved early in the strategic planning process can lead to more informed decisions about international expansion.

Tax considerations for three operating models

Many US-based companies planning to expand internationally struggle with choosing the right model for a given market or region. Although the laws vary widely across markets, there are several key considerations for the three basic operating models: e-commerce, franchise/licensing arrangement, or direct physical presence.

Export/e-commerce

This "toe in the water" approach allows companies to explore overseas opportunities with little or no investment in additional infrastructure. Growth opportunities through a strictly e-commerce operational model will be limited by long distances, which compound the logistics and costs of order fulfillment. Moreover, because e-commerce opportunities are often managed entirely from the United States, limited opportunities exist to implement tax planning. Absent meaningful international involvement, including in-house supply-chain activities located outside the United States, most e-commerce profits will flow back to the United States and be taxed at one of the highest income tax rates in the world.

Franchise/licensing

Franchising is often perceived as a way to have a physical presence in a foreign market without being subject to the same level of regulation, market risk, or financial investment requirements, since these risks are borne by the franchise partner/licensee. The business advantages of franchising/licensing over export/e-commerce businesses carry risks in finding the right partner, as well as increased tax complexity:

- **Withholding tax liability.** Royalties from an overseas franchise are generally subject to local withholding tax. A company franchising or licensing a product offshore must be mindful of how those payments are structured and the jurisdiction it chooses to ensure a reasonable withholding rate. The structure must make commercial sense, however, rather than being designed purely for the purpose of achieving lower withholding tax rates through "treaty shopping," which tax inspectors will evaluate during an audit.
- **Risk of "permanent establishment" designation.** Franchise or licensing arrangements invariably require guidance, training, and some degree of supervision from the parent company. Once a US company deploys personnel to the licensee to provide such assistance, it risks a "permanent establishment" designation, which creates a local taxable presence. While the risks can typically be managed with proper planning, in some countries, the creation of a taxable presence has a low bar. In Kuwait, for instance, the receipt of royalties from Kuwaiti sources, without any other commercial connection, may be sufficient to subject the recipient to net income taxation and the need to register and file tax returns with local authorities.
- **IP ownership.** Royalties are generally required for intellectual property held by companies in the United States, subjecting the IP owner to taxation at one of the highest rates in the world. Even for companies that own the legal or economic rights of licensed intangibles outside of the United States, US tax rules make it difficult to avoid tax from the offshore franchising/licensing operations. The so-called "subpart F" rules target income from highly portable property, including royalties from intangibles. While US taxation of income earned by foreign subsidiaries of US companies is deferred until the subsidiary remits the profits back to the United States, royalty income generally constitutes one type of subpart F income and is taxed immediately in the United States. Exceptions exist for foreign subsidiaries that earn royalties from unrelated parties if such foreign subsidiaries are "active developers" or "active marketers" of the licensed intangibles. But meeting these subjective exceptions can be difficult in practice.

Direct physical presence

Once the business decides to locate a direct physical presence in a new market, a tax liability, or filing requirement, typically arises in that local market. Additionally, some form of taxable compensation is due from that local market to the United States for the intellectual property owned by the US parent, and for services performed. From a tax perspective, this is often akin to the franchise/licensing model, except that the licensor/licensee relationship is internal. When intellectual property is located outside the United States, US tax deferral planning for royalty income received by a foreign subsidiary can be somewhat simpler. The deferral provisions involving related party royalty income tend to be more objective and offer greater certainty than the tests applicable to an unrelated party.

For those companies with developed in-house supply chain models that sell into local markets, the intercompany inventory flows must be evaluated under a different set of tax rules. Unless a subsidiary is buying directly from unrelated parties or selling any property purchased from a related party wholly within the subsidiary's country of incorporation, it is difficult to achieve US tax deferral on such income. For example, the income earned by a Dutch regional distributor that buys inventory from its related sourcing company but sells to customers throughout Europe will effectively be taxed at the US rate of 35%, not the lower Dutch statutory rate. Integrating the supply and demand chains is critical to an effective tax strategy when a company commits to entering a new market.

The tax implications of an efficient business model

As US-based companies expand their presence abroad, they inevitably migrate demand-chain activities into the local region, introducing new tax considerations and potential opportunities.

Consider the case of a US-based retailer adapting its brand and product to the culture of the new host market. The local team may develop a customized store concept or create branding and advertising distinct from the platform already developed by and for the United States, for which a royalty is likely paid or due to the US parent. The new, localized intangible asset will drive the retailer's future success in the jurisdiction and future taxable income for the local government. A similar situation could occur with a CPG distributor that develops a new product, strategy, or process for the local marketplace.

When we consider other common types of intangible assets—trademarks, trade names, patents, designs, patterns, franchises, licenses, contracts, and so on—the link between demand-chain activities and the impact of those intangibles on profitability has to be analyzed. Intangible assets are often associated with the company's brand, the reputation and strength of the brand drives demand, and demand drives profits. Accordingly, demand chains must be carefully structured from a tax perspective.

- **Choice of jurisdiction.** When first expanding offshore, picking a jurisdiction close to customers and talent is vital. Once critical mass occurs offshore, businesses may want a global or regional hub to manage demand-chain activities. A centralized model in a tax-efficient jurisdiction can have a significant impact on a company's return on investment. Cross-border activities conducted by a global or regional hub require significant business substance and must be carefully monitored to avoid creating additional tax issues.
- **Favorable treatment in target markets.** Once the tax burden in the global or regional hub is addressed, the supply and demand chains throughout the local markets must be designed in a tax-efficient manner. Among the questions a prudent tax advisor might ask is whether the royalty payments to the IP holder are subject to withholding taxes or whether such payments are fully deductible from the payor's local tax base. Further, one should evaluate the different results that could be achieved by structuring payments as a royalty, as a service fee, or as a mark-up on products sold.
- **Integrated profit redeployment.** Reinvestment of cash generated from the performance of a strategically designed business model is an important factor to consider. A globally expanding company should develop a plan early on for redeploying such profits without incurring substantial tax leakage from withholding taxes or direct income taxes incurred from distributions directly to the United States. Any plan will be closely tied to the company's need to use such funds as part of its global expansion.
- **An expedient exit.** Because business realities and laws change, an expansion plan should include understanding the tax aspects of an exit strategy. The strategy should include capital gains taxes, liquidation costs, and the use of tax attributes (such as tax losses carried over from prior years) to offset the cost of exiting.
- **Transfer pricing.** How a company allocates profits internally between US, global, or regional headquarters and an overseas operation is under constant scrutiny by local tax authorities. Arbitrary profit allocations allow room for tax authorities to attack a company's transfer pricing policy or argue that, because profits have moved across borders, assets must also have moved—and thus subject such asset transfers to exit taxation. Companies must use caution when initially establishing intercompany agreements to understand the current and long-term consequences of such arrangements.

- **Documentation.** It is important to maintain current, comprehensive documentation of all activities within the value chain. Documenting relevant business substance is necessary for defending the intercompany transfer pricing approach used in allocating profits between tax jurisdictions.

Best-in-class companies build tax considerations into their strategic decision-making process so that they can forecast the benefits that will flow from them. Long-term, this can lead to a lower effective tax rate, reduced tax risk, enhanced cash flow, and greater shareholder value. Within such companies, tax is viewed as a strategic partner and is a key part of all strategic decisions.

Dealing with change

After the considerations above have been addressed, operating and tax structures must be constantly reviewed and adapted. For example, the transfer of key decision-makers from one market to another as a result of centralization of regional pricing decisions or the integration of an acquired company could require a rethink of the factors above in light of the company's future operating model.

Countries are constantly adapting their laws and audit approaches. For emerging markets such as India, this change is a consequence of market maturation; in more developed countries, it may be the result of governments' intensifying need for revenues in an era of increasing national debt. Many jurisdictions are also vigorously reviewing transactions to ensure they have business substance.

As business executives weigh their options for international expansion, they should consider their tax experts as true partners in developing a tax-efficient business model. Whether restructuring businesses, prioritizing overseas investments, or making channel decisions, the tax function should be involved from the outset. Duane Still says that at Coca-Cola, tax is "a key factor in our considerations—so important that we literally teach everybody in finance to consider it and think about it." He goes on to state that taxes are considered "sometimes even in the conceptual stage of a project before it gets to a significant decision point. It's just that important to us."

Financial performance metrics

- Retailer performance data
- Manufacturer performance data
- Size-specific data
- Sector-specific data

Retailers and manufacturers

This section contains charts illustrating the 2011 performance of CPG retailers as a whole, relative to the population of manufacturers in our performance database.

From a macroeconomic standpoint, by definition, the recovery that began in 2010 continued throughout 2011, yet shareholder returns declined for both retailers and manufacturers. Our analysis over the past several years has shown that retailer shareholder return has trended along with the state of the economy, with big declines in 2009 during the peak of the recession and then big improvements in 2010 as the industry emerged into recovery mode.

The telling story this year is that retailers have only a slight edge on manufacturers: 10.3% versus 8.7% shareholder return, a narrow margin of 1.6% as compared to the prior year's difference of 8.8%. This may be an indication that investors are not as bullish toward the CPG industry as they were at the start of the recovery. Let's explore if this sentiment is supported by retailers' actual financial performance.

Net sales increased for both retailers and manufacturers, which is at least in part a result of manufacturers and retailers passing along increased input costs to the consumer through price increases. But how much were they able to recover? A look at margins indicates that both groups experienced an approximate erosion of 1%, with retailers declining from 26.5% to 25.5% and manufacturers declining from 36.8% to 35.7%. With the difficulty both retailers and manufacturers experienced in fully recovering increasing input costs, companies are attempting to introduce more product capabilities, such as stronger cleaning capabilities for household products. But the rub is that product performance has to support the new price point.

Notwithstanding strong sales growth and only narrow margin deterioration, EBIT growth declined at a sharper rate for manufacturers, from 14.4% to only 1.7% growth, while retailers maintained steady EBIT growth at 10.8% in 2011 compared with 10.9% in the prior year. Both, however, are likely below what was hoped for at this point a year ago. With a decline in margin, this minimal earnings growth for manufacturers is likely still the result of cost-cutting initiatives but, as discussed throughout this report, the real growth potential lies within the demand chain.

Retailers have consistently had quicker cash conversion cycles compared to manufacturers, principally due to their ability to collect from consumers at the point of sale, yet benefit from 30- to 60-day payment terms with manufacturers. This trend continued during 2011, though both groups saw improvements in conversion periods: Manufacturers improved 55.5 to 53.3 days, and, impressively, retailers improved from 12.0 to 10.2 days, representing the second year in a row that retailers cut more than one full day out of this cycle.

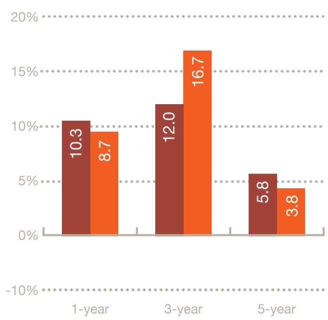
So, while performance improved for both retailers and manufacturers, as measured by earnings growth, investors remain tepid and are not yet rewarding these companies through shareholder returns. It will be interesting to watch how these consumer sentiments develop during 2012.

Retailers have only a slight edge on manufacturers in shareholder return: 10.3% versus 8.7%, a narrow margin of 1.6% as compared to the prior year's difference of 8.8%.

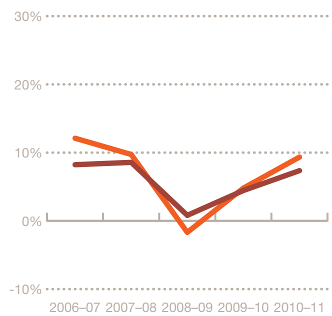
Companies are attempting to introduce more product capabilities, such as stronger cleaning capabilities for household products.

Exhibit 33
Retailers: Comparison to manufacturers data

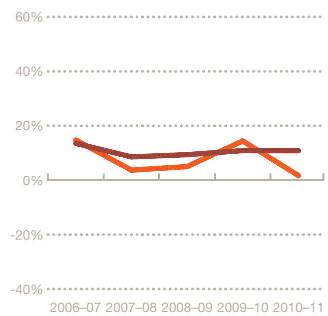
Median shareholder return



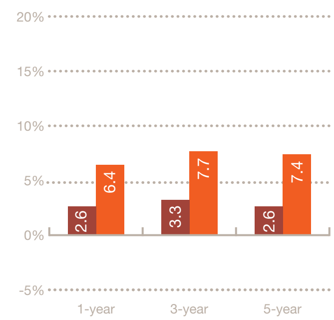
Median net sales growth



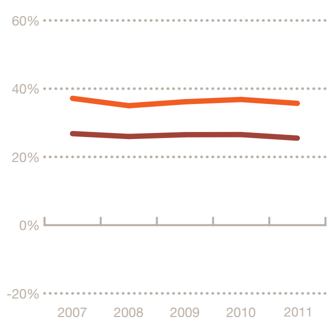
Median EBIT growth



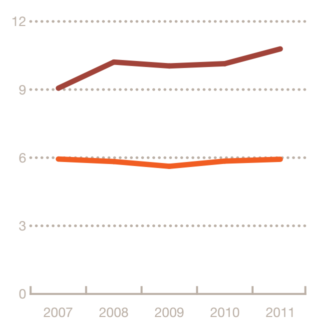
Median free cash flow to sales



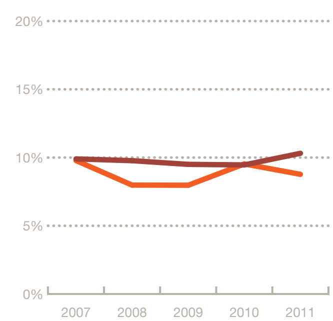
Median gross margin



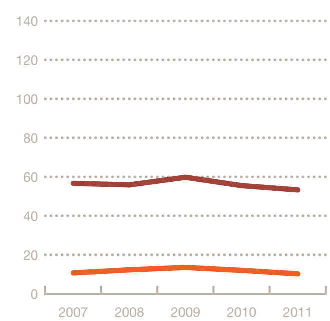
Median inventory turnover



Median return on average assets



Median cash conversion cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

■ Retailers
■ Manufacturers

— Retailers
— Manufacturers

Overall CPG industry: manufacturers

While the recovery began in 2010, the pace of financial improvement was slower than many expected in 2011. Outside of the consistent net sales growth among the manufacturers in each quartile, there has been a decrease for manufacturers as it relates to shareholder return, EBIT growth, and return on sales. There are a number of drivers of these declines, but what's more important is what manufacturers are doing now to get back those strong results that gave hope to a recovering economy.

Median one-year total shareholder return decreased from 15% in 2010 to 8.7% in 2011. The slow economic recovery has left its mark on the manufacturing industry. Nevertheless, net sales growth continues to be on the rise and manufacturers have lost very little on gross margins across all quartiles, providing comfort that consumers are still spending, albeit cautiously.

EBIT growth declined, particularly within the bottom quartile. This group was on the verge of breaking the positive mark in 2010, but has now tumbled to negative 26.5%, likely driven by increased input costs and weaker brands that could not fully recover through increased pricing. This is also evidenced in return on sales, which declined from 9.7% to 9.2% from 2010 to 2011.

On a more positive note, the return on invested capital stayed relatively consistent at 9.4%, compared to 9.6% in 2010. Investments companies are making in areas such as emerging market expansion are now resulting in steady returns, and have the potential to lead to even greater returns as large-scale investments come to fruition.

Productivity measures suggest that companies are keeping a steady workforce level, even with increasing sales figures—so increased investments (including hiring) in the emerging markets suggest that employee levels in the United States are declining. While good for current P&Ls, this trend does not bode well for the overall US economy. Companies are starting to look to capital spending but are also using marketing spending to improve their financial performance.

A look at SG&A as a percentage of sales sheds some light. The steady median percentage (23.3% to 23.6%) indicates some modest spending on marketing initiatives, likely in areas such as social media, digitalization, and mobilization to meet consumer purchasing behaviors, particularly within the millennial generation. With the economy undergoing constant shifts, manufacturers have been able to maintain their consumer base and focus on it particularly during these times.

Looking at liquidity trends, median debt levels are keeping steady (as seen through the consistent debt-to-equity ratios and short- and long-term debt ratio) and the slight decline in the interest coverage ratio is principally driven by the corresponding decline in EBIT growth offset by lower costs of debt experienced this past year. Free cash flows have continued their decline from 2009 and 2010, but have still stayed relatively strong.

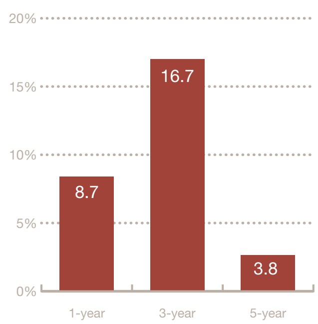
Consumers are still spending, albeit cautiously.

Companies are starting to look to capital spending but are also using marketing spending to improve their financial performance.

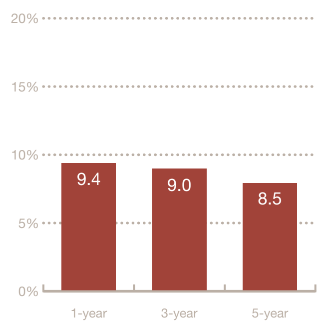
Exhibit 34
Overall CPG industry, manufacturers (companies > US$50M)

Return metrics

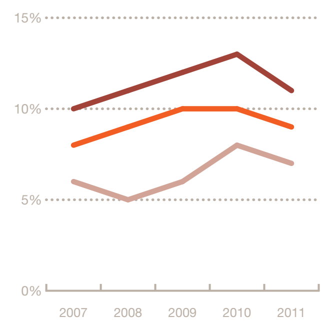
Median shareholder return



Median return on invested capital

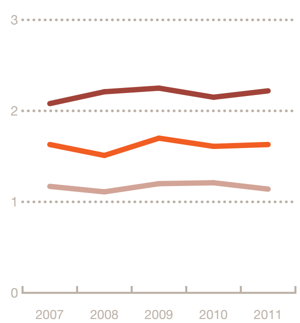


Return on market capital

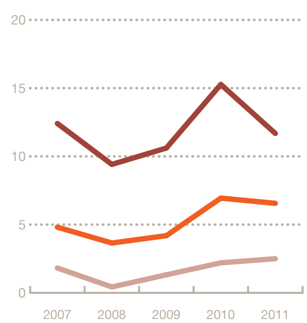


Liquidity metrics

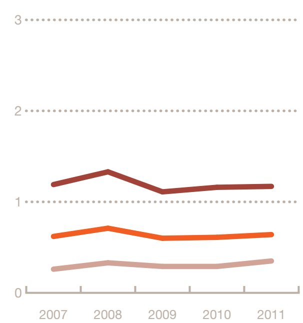
Current ratio



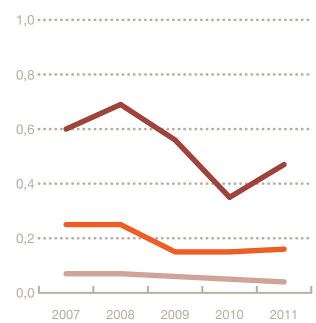
Interest coverage ratio



Debt-to-equity ratio

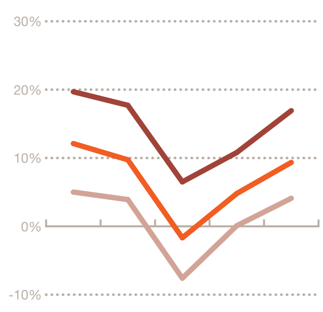


Short-term debt to long-term debt ratio

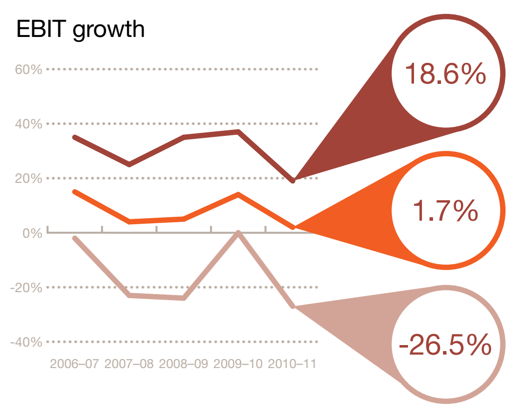


Growth metrics

Net sales growth



EBIT growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

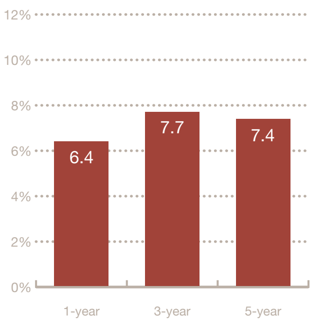
■ Median

Top quartile
Median
Bottom quartile

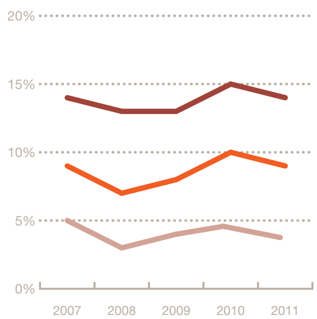
Exhibit 34 *(continued)*
Overall CPG industry, manufacturers (companies > US$50M)

Income statement metrics

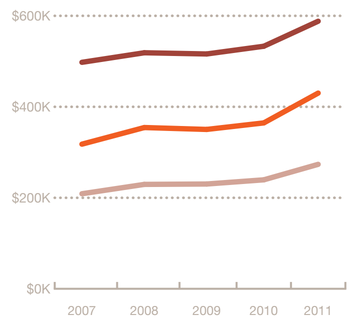
Median free cash flow to sales



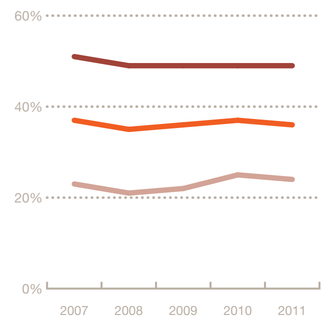
Return on sales



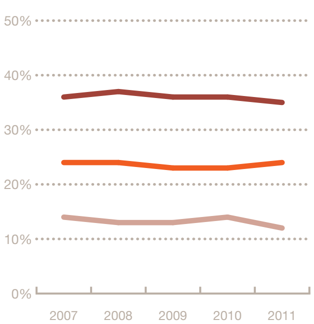
Sales per employee



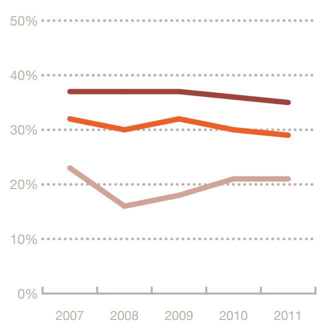
Gross margin



SG&A as a percentage of sales

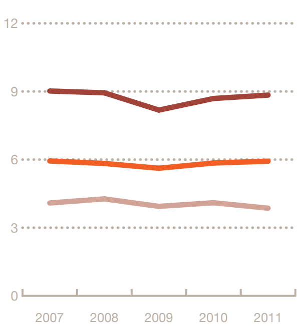


Effective tax rate

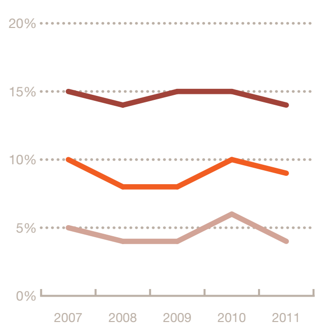


Balance sheet metrics

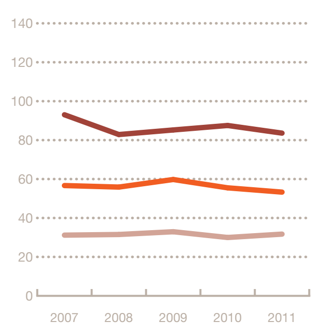
Inventory turnover



Return on average assets



Cash conversion cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

■ Median

— Top quartile
— Median
— Bottom quartile

Size-specific data: large, medium, and small manufacturers

This section includes charts analyzing the performance of large, medium, and small manufacturers.

As we have highlighted in the previous sections, shareholder return has been a defining data point for 2011, and that's no less true in the size-specific comparison. All three size categories saw declines in shareholder return, but the most significant drop was in the small manufacturers category, which declined steeply from 26.6% in 2010 (the highest that year among the size categories) to negative 31.9% in 2011—a 58.5% swing. Small manufacturers were also the only size category to have negative shareholder return. Tepid consumer confidence typically hurts small companies the most. Small companies, as measured by revenue dollars, generally have more modest capitalization levels, making them more vulnerable to volatility. But another point of view is that investors are naturally putting their dollars with larger companies that are demonstrating stronger overall financial performance, leading to an ability to grow into the future—what many call an example of the virtuous cycle.

The trend of improved net sales growth continued with each of the size categories, though small companies took a bigger hit to margins (with a decline of 3.2%) compared to medium companies (which saw an improvement of 0.5%) and large companies (whose margins were flat). Small companies experienced an even steeper decline in EBIT growth, at negative 29.2%, where medium and large companies experienced modest EBIT growth. Small companies generally do not boast brands that are strong enough to command price increases, even in times of increasing input costs. Additionally, they do not have as much flexibility to move between channels to fit the latest consumer trends, whether shoppers are bargain-hunting at the dollar stores or looking for flexibility through digital channel purchases.

On the bright side, small companies seem to have much more borrowing flexibility than they did during the credit crunch. Their overall debt levels increased, as seen in the debt-to-equity ratios, but these borrowings are at shorter terms with lower rates, as demonstrated by an improved interest coverage ratio and a higher short-term to long-term debt ratio. What remains to be seen is whether smaller companies use these borrowings for investment purposes, as their larger counterparts are doing, or whether they need them just to survive.

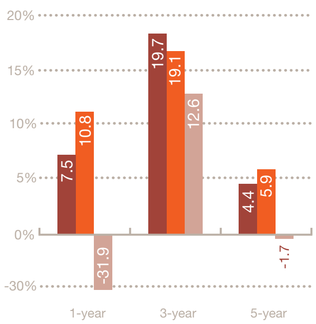
All three size categories saw declines in shareholder return, but the most significant drop was in the small manufacturers category.

The trend of improved net sales growth continued with each of the size categories, though small companies took a bigger hit to margins compared to medium and large companies.

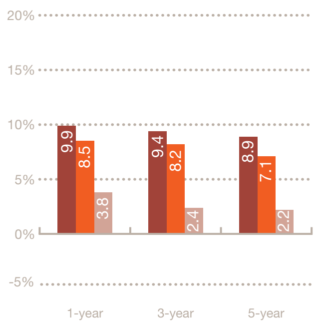
Exhibit 35
Size-specific data, all sectors

Return metrics

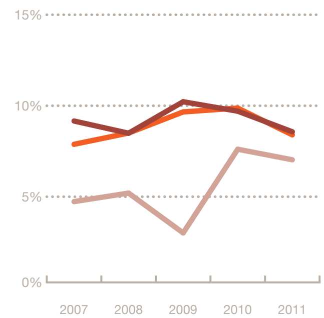
Median shareholder return



Median return on invested capital

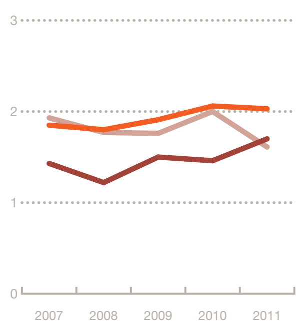


Median return on market capital

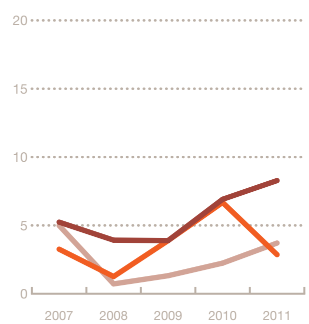


Liquidity metrics

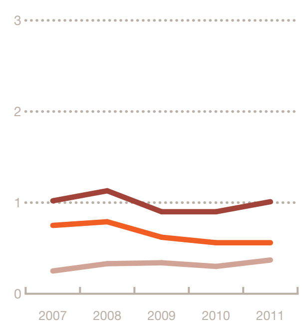
Median current ratio



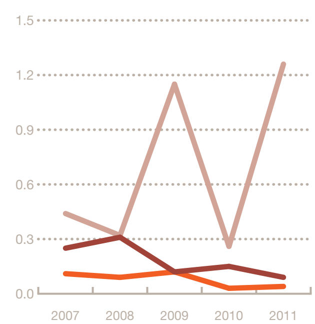
Median interest coverage ratio



Median debt-to-equity ratio

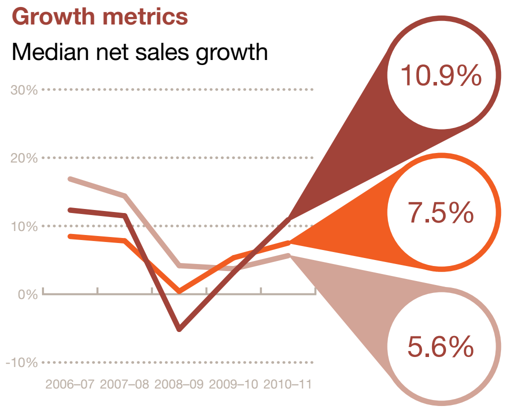


Median short-term debt to long-term debt ratio

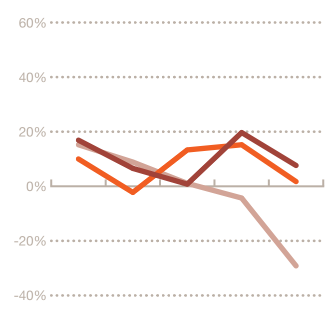


Growth metrics

Median net sales growth



Median EBIT growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

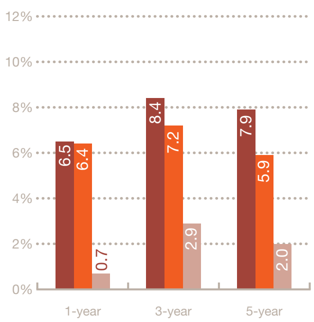
- Large manufacturers
- Medium manufacturers
- Small manufacturers

- Large manufacturers
- Medium manufacturers
- Small manufacturers

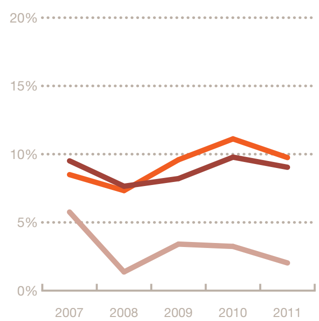
Exhibit 35 *(continued)*
Size-specific data, all sectors

Income statement metrics

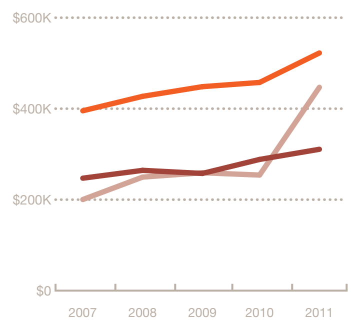
Median free cash flow to sales



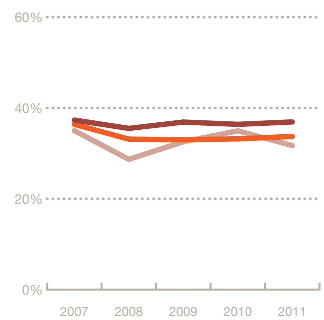
Median return on sales



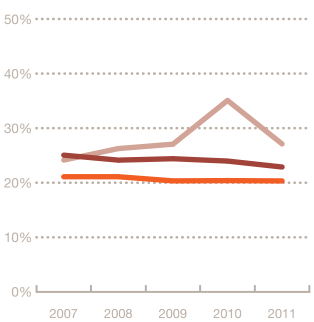
Median sales per employee



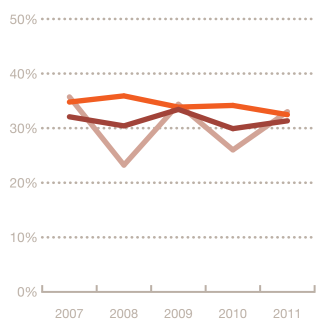
Median gross margin



Median SG&A as a percentage of sales

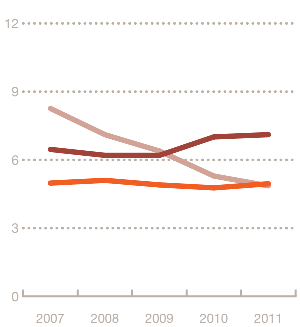


Median effective tax rate

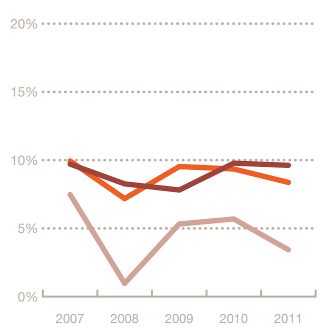


Balance sheet metrics

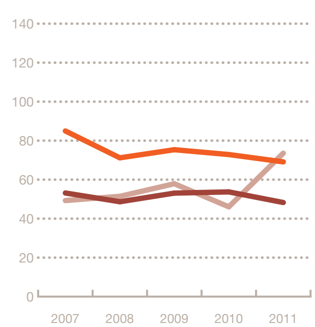
Median inventory turnover



Median return on average assets



Median cash conversion cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

- Large manufacturers
- Medium manufacturers
- Small manufacturers

- Large manufacturers
- Medium manufacturers
- Small manufacturers

Size-specific data: very large manufacturers

This section includes charts analyzing the performance of the largest of the large manufacturers, those with reported net sales of greater than $10 billion in the latest reported fiscal year. For these companies, much of the storyline continues from the previous size discussion. In this discussion, however, we will focus on a different return metric—return on invested capital (ROIC), rather than shareholder return—to highlight the fact that size had a significant impact on financial performance during 2011.

Our analysis over the previous five-year period has shown that the larger the company, the stronger the ROIC performance, indicating that larger companies are more effective at managing their capital investments. So where has this investment spend been going recently? Our research has shown that the emerging markets strategy makes the agenda of nearly every very large company, but is absent at many small companies. This may be an area of opportunity for small companies to put better practices in place to manage investment spend more effectively, particularly as the debt markets have opened up and cash for investment may be more readily available.

From an income statement perspective, net sales growth was strong for very large companies, at 10.5%. At the same time, the very large companies maintained their margins, supporting the theory that larger companies generally have stronger brands and are better able to pass pricing along to the consumer. Additionally, EBIT growth improved over the prior year, a feat that no other size category achieved in 2011.

Productivity improved, as measured by sales per employee; however, taken with the sales growth noted above, this was likely driven by a flat or declining workforce. Based on the unemployment measures experienced by this industry, if workforces are flat overall, that likely points to an employment decline in the United States and an increase in the global economies.

All in all, strong financial results for very large companies signal that they have continued to thrive despite a slow recovery. They are doing this by launching initiatives such as international expansion and being where the consumers are, particularly in the digital channels.

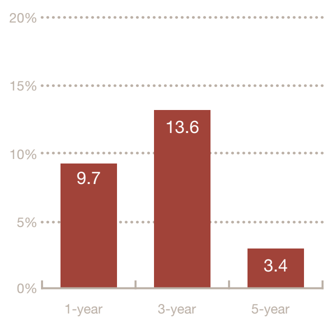
Net sales growth was strong for very large companies, at 10.5%.

Very large companies are thriving by launching initiatives such as international expansion and being where the consumers are, particularly in the digital channels.

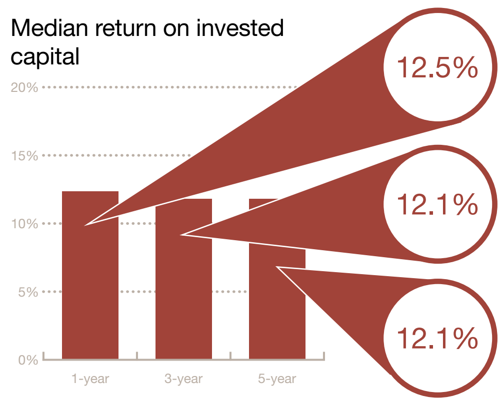
Exhibit 36
Very large manufacturers, all sectors

Return metrics

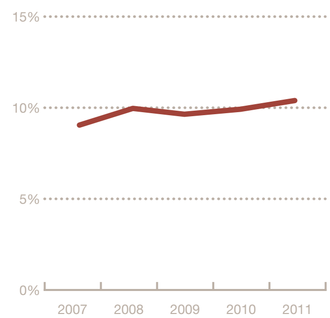
Median shareholder return



Median return on invested capital

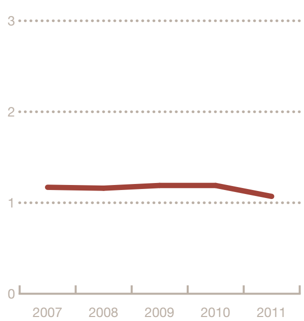


Median return on market capital



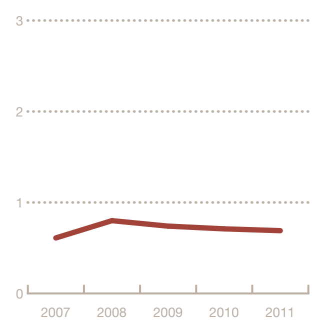
Liquidity metrics

Median current ratio

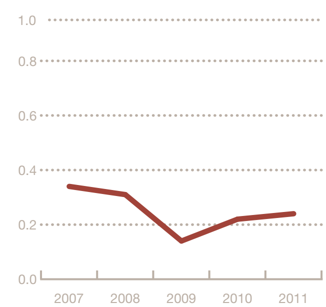


Median interest coverage ratio

Median debt-to-equity ratio

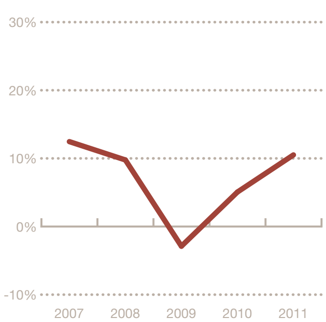


Median short-term debt to long-term debt ratio

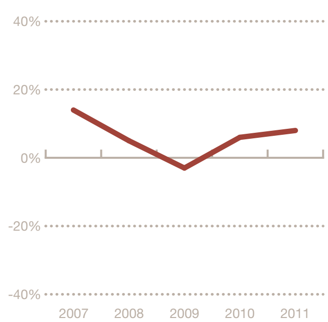


Growth metrics

Median net sales growth



Median EBIT growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

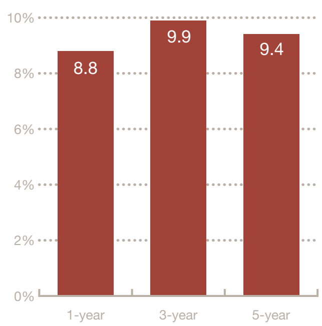
■ Very large manufacturers

— Very large manufacturers

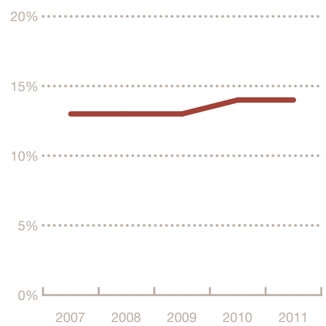
Exhibit 36 *(continued)*
Very large manufacturers, all sectors

Income statement metrics

Median free cash flow to sales

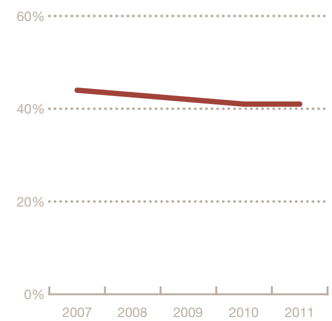


Median return on sales

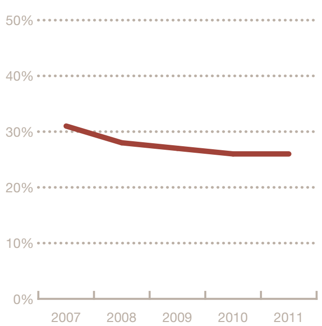


Median sales per employee

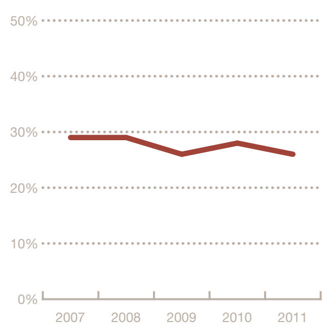
Median gross margin



Median SG&A as a percentage of sales

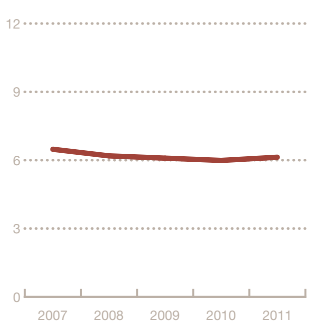


Median effective tax rate

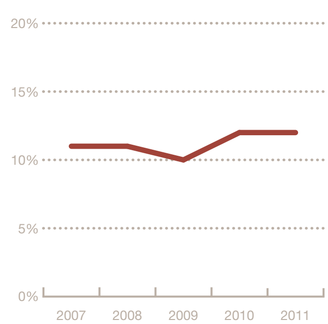


Balance sheet metrics

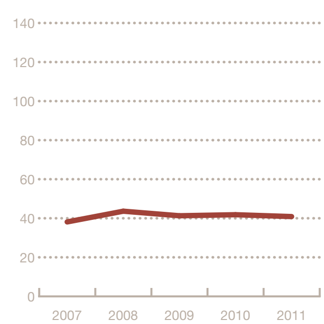
Median inventory turnover



Median return on average assets



Median cash conversion cycle



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

■ Very large manufacturers

— Very large manufacturers

Sector comparison

This segmentation of our industry data breaks the companies into three groups: companies that produce primarily household products, companies that produce primarily food, and companies that produce primarily beverages. The comparisons in the graphs are all written based on median values.

In 2011, the three-year median, as it relates to shareholder return and return on invested capital, now seems to be the timetable needed to reap the most return from your investment. This is a turn from 2010, which reflected one-year returns significantly improved over the three- to five-year median. However, each of the sectors continued to show strong net sales growth. Food, beverage, and household product companies experienced net sales growth of 9.5%, 10.5%, and 7.5%, respectively.

The beverage sector continued with its strong performance from 2010, with improving financial metrics such as return on sales and gross margins, and at the same time improving productivity as measured by sales per employee. Furthermore, median cash conversion decreased from 49.9 days in 2010 to 45.1 days in 2011, inventory turns stayed flat, and return on average assets increased from 9.7% to 10.8% in 2011. This reflects healthy assets that can quickly be converted into cash and support a profitable business.

Unlike the beverage sector, the tide had changed for the household sector in some instances. In 2010, the household products sector experienced strong EBIT growth; however, in 2011, EBIT actually declined by 5.6%—the steepest drop of all the sectors and the only one to experience a decline in this measure. The household products sector also saw increased borrowing costs, as reflected by the considerable drop in the median interest coverage ratio, which had been on a steady incline. Also notable is the increase in household product companies' effective tax rate, which moved from 28.9% in 2010 to 30.8% and made household products the only sector to experience an increased rate. There are some challenges being faced by this sector as an economy on the rebound is still being cautious. The household products sector had the lowest net sales growth of all the sectors and experienced a decrease in its return on sales for the year, from 11.1% to 9.8% in 2011. Some good mentions would be the sector's ability to hold cash conversion cycle and inventory turnover ratio relatively flat. Gross margin also rose slight over 2010, from 46.5% to 47.3%.

For the food sector, the needle has not moved far from where the results landed in 2010. Return on sales and EBIT growth stayed relatively flat, and only slight movements were noted in gross margin and the balance sheet metrics of inventory turnover, return on average assets, and cash conversion cycle. Despite food price increases through 2011, the food sector is keeping a steady pace, maintaining its improved results from 2010.

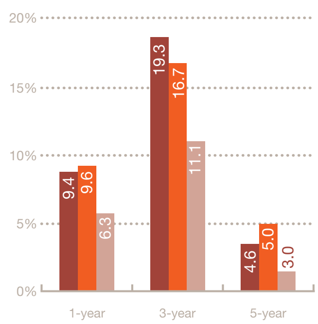
Food, beverage, and household product companies experienced net sales growth of 9.5%, 10.5%, and 7.5%, respectively.

Despite food price increases through 2011, the food sector is keeping a steady pace, maintaining its improved results from 2010.

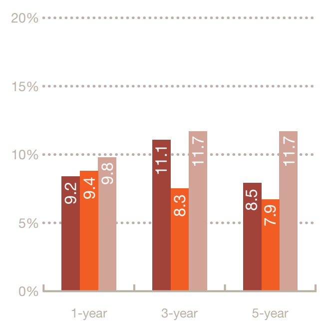
Exhibit 37
Sector-specific data, all sectors

Return metrics

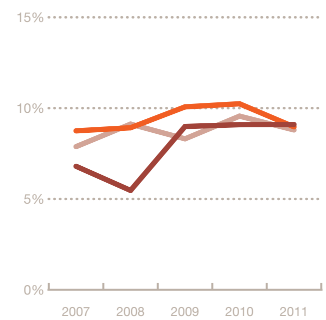
Median shareholder return



Median return on invested capital

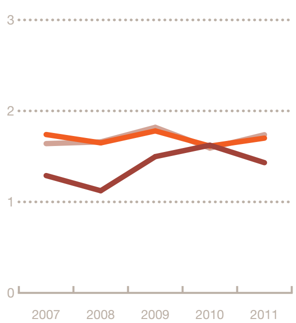


Median return on market capital

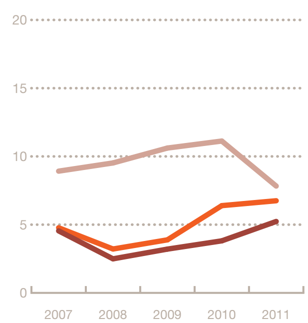


Liquidity metrics

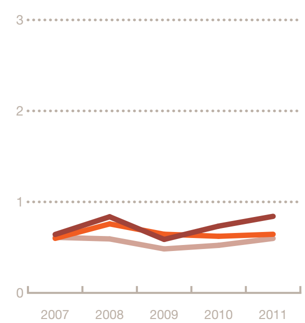
Median current ratio



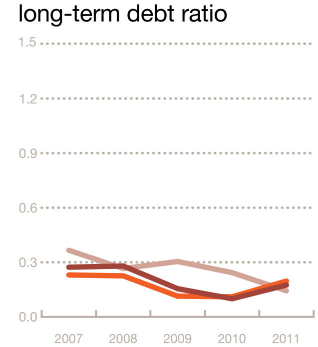
Median interest coverage ratio



Median debt-to-equity ratio

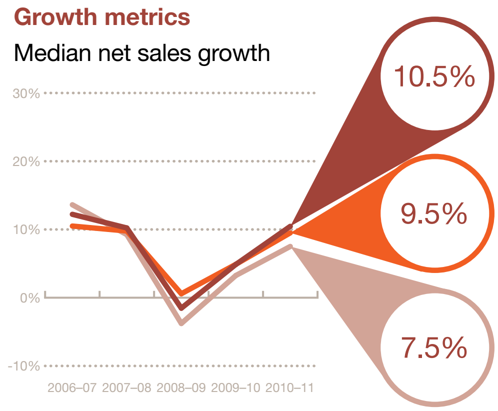


Median short-term debt to long-term debt ratio

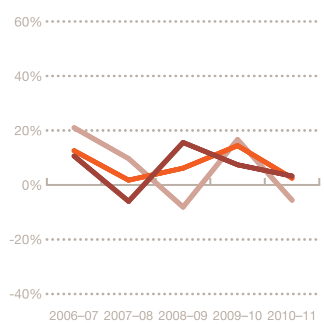


Growth metrics

Median net sales growth



Median EBIT growth



Source: Reuters Fundamentals, Reuters Pricing, and PwC Analysis.

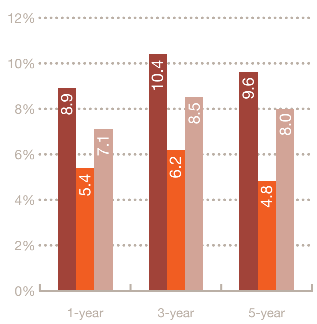
■ Beverage
■ Food
■ Household products

— Beverage
— Food
— Household products

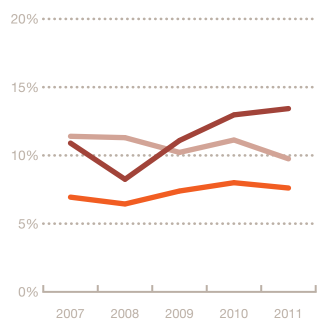
Exhibit 37 *(continued)*
Sector-specific data, all sectors

Income statement metrics

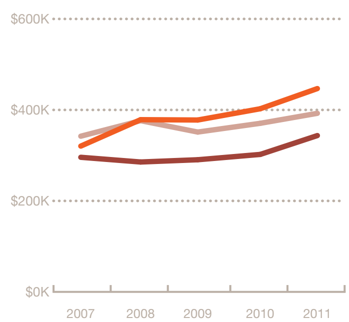
Median free cash flow to sales



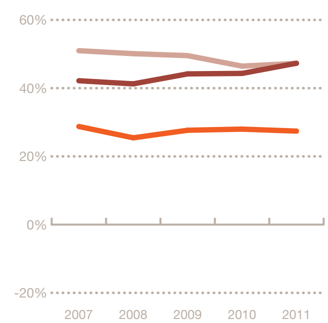
Median return on sales



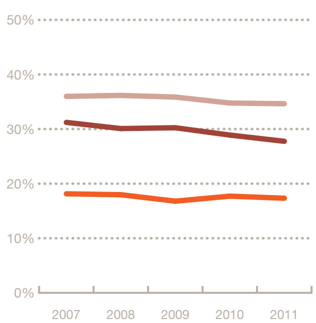
Median sales per employee



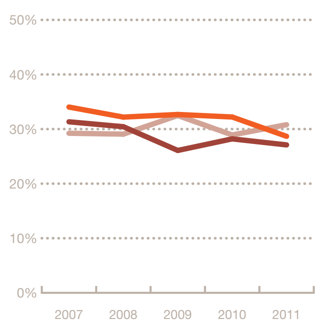
Median gross margin



Median SG&A as a percentage of sales

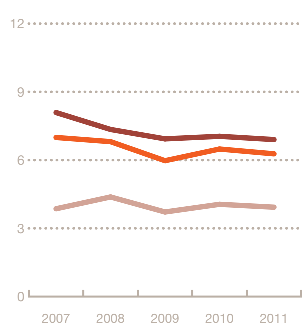


Median effective tax rate

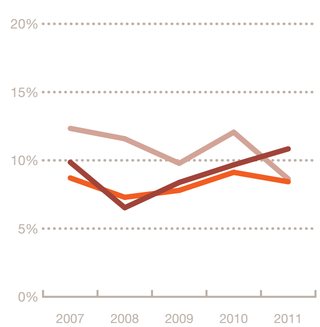


Balance sheet metrics

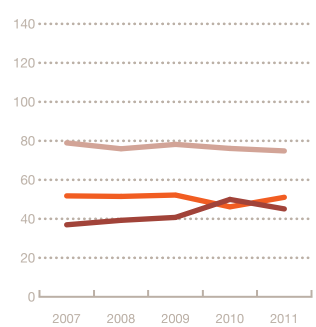
Median inventory turnover



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 industry metrics, some of which are discussed throughout the report, based on an analysis of financial data for a set of CPG manufacturers and retailers (see Appendix B and Appendix C). 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 2006 through 2011, 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 38
Primary manufacturer NAICS codes by sector

Sector	NAICS code	NAICS description
Beverage	312111	Soft drink manufacturing
Beverage	312112	Bottled water manufacturing
Beverage	312120	Breweries
Beverage	312130	Wineries
Beverage	312140	Distilleries
Food	311211	Flour milling
Food	311225	Fats and oils refining and blending
Food	311230	Breakfast cereal manufacturing
Food	311312	Cane sugar refining
Food	311320	Chocolate and confectionery manufacturing from cacao beans
Food	311330	Confectionery manufacturing from purchased chocolate
Food	311340	Non-chocolate confectionery manufacturing
Food	311411	Frozen fruit, juice, and vegetable manufacturing
Food	311421	Fruit and vegetable canning
Food	311511	Fluid milk manufacturing
Food	311514	Dry, condensed, and evaporated dairy product manufacturing
Food	311520	Ice cream and frozen dessert manufacturing
Food	311611	Animal (except poultry) slaughtering
Food	311612	Meat processed from carcasses
Food	311615	Poultry processing
Food	311812	Commercial bakeries
Food	311823	Dry pasta manufacturing
Food	311911	Roasted nuts and peanut butter manufacturing
Food	311919	Other snack food manufacturing
Food	311920	Coffee and tea manufacturing
Food	311942	Spice and extract manufacturing
Food	311999	All other miscellaneous food manufacturing
Household products	311111	Dog and cat food manufacturing
Household products	311119	Other animal food manufacturing
Household products	322291	Sanitary paper product manufacturing
Household products	325412	Pharmaceutical preparation manufacturing
Household products	325611	Soap and other detergent manufacturing
Household products	325612	Polish and other sanitation good manufacturing
Household products	325620	Toilet preparation manufacturing
Household products	335912	Primary battery manufacturing

Source: PwC.

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 United States 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 38 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.

Exhibit 39 lists the retailer NAICS codes and NAICS code descriptions used in the Financial Performance Metrics section of this report.

Exhibit 39
Primary retailer NAICS codes

NAICS code	NAICS description
424410	General line grocery wholesalers
445110	Supermarkets and other grocery (except convenience) stores
445120	Convenience stores
445299	All other specialty food stores
452110	Department stores (excluding leased departments)
454110	Electronic shopping and mail-order houses
446110	Pharmacies and drug stores
446120	Cosmetics, beauty supplies, and perfume stores
446191	Food (health) supplement stores
447110	Gasoline stations with convenience stores
452910	Warehouse clubs and superstores
452990	All other general merchandise stores
453910	Pet and pet supplies stores

Source: PwC.

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-US 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 D.

Data reporting

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

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

Other size-based segmentations were defined using the benchmarks noted in Exhibit 40.

Exhibit 40
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

Source: PwC.

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 41.

Exhibit 41
Manufacturing companies by industry size and segment

	Small	Medium	Large (very large)	Total
Beverage	8	12	16 (11)	36
Food	19	25	30 (16)	74
Household products	5	10	17 (10)	32
Total	32	47	63 (37)	142

Source: PwC.

Appendix B: Manufacturer company list

AgFeed Industries, Inc.
Agria Corporation (ADR)
Ajinomoto Co., Inc.
Alberto-Culver Company
American Italian Pasta Company
Anheuser-Busch Companies, Inc.
Anheuser-Busch InBev NV
Archer Daniels Midland Company
Associated British Foods plc
Avon Products, Inc.
B&G Foods, Inc.
Bare Escentuals, Inc.
BASF SE (ADR)
Beam, 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
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.
Corn Products International, Inc.
Cott Corporation (USA)
Craft Brew Alliance, Inc.
Crystal Rock Holdings, Inc.
Cuisine Solutions, Inc.
Dakota Growers Pasta Co., Inc.
Darling International Inc.
Dean Foods Company
Del Monte Foods Company
Del Monte Pacific Limited
Diageo plc (ADR)
Diamond Foods, Inc.
Diedrich Coffee, Inc.
Dole Food Company, Inc.
Dr Pepper Snapple Group Inc.
DSG International (Thailand) PCL
Ecolab Inc.
Elizabeth Arden, Inc.
Energizer Holdings, Inc.
Exide Technologies
Farmer Brothers Co.
Feihe International, Inc.
Flowers Foods, Inc.
Fomento Económico Mexicano S.A.B. de C.V. (ADR)
Foster's Group Limited
General Mills, Incorporated
Golden Enterprises, Inc.
Greatbatch Inc.
Green Mountain Coffee Roasters Inc.
Groupe Danone SA (ADR)
Gruma, S.A.B. de C.V. (ADR)
H.J. Heinz Company
Heineken N.V. (ADR)
Hormel Foods Corporation
Imperial Sugar Company
Inter Parfums, Inc.
Interstate Bakeries Corp.
Inventure Foods, 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.
Land O'Lakes, Inc.
Lifeway Foods, Inc.
L'Oreal
Marine Harvest ASA
McCormick & Company, Inc.
Mead Johnson Nutrition Co.
Medifast, Inc.
Merisant Company
MGP Ingredients, Inc.
Molson Coors Brewing Company
Monster Beverage Corporation
Monterey Gourmet Foods, Inc.
National Beverage Corp.
Nestlé SA
Novartis AG (ADR)
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
Ralcorp Holdings, Inc.
Reckitt Benckiser Group plc
Reddy Ice Holdings, Inc.
Revlon, Inc.
SABMiller plc
Sanderson Farms, Inc.
Sara Lee Corporation
Seaboard Corporation
Seneca Foods Corporation
Shiseido Co. Ltd. (ADR)
Smart Balance, Inc.
Smithfield Foods, Inc.
Solo Cup Company
SunOpta, Inc. (USA)
Synder's-Lance, Inc.
Synutra International, Inc.
Tasty Baking Company
Tate & Lyle PLC (ADR)
The Boston Beer Company, Inc.
The Clorox Company
The Coca-Cola Company
The Estée Lauder Companies Inc.
The Hain Celestial Group, Inc.
The Hershey Company
The J.M. Smucker Company
The Pepsi Bottling Group, Inc.
The Procter & Gamble Company
Tootsie Roll Industries, Inc.
TreeHouse Foods Inc.
Tyson Foods, Inc.
Ultralife Corporation
Unilever PLC (ADR)
Vina Concha y Toro S.A. (ADR)
Wm. Wrigley Jr. Company
Wyeth
Zep Inc.

Appendix C: Retailer company list

99¢ Only Stores
Alimentation Couche-Tard Inc.
Alimentation Couche-Tard Inc. (USA)
Amazon.com, Inc.
Arden Group, Inc.
Big Lots, Inc.
BJ's Wholesale Club, Inc.
Cargills (Ceylon) PLC
Casey's General Stores, Inc.
Cost Plus, Inc.
Costco Wholesale Corporation
CVS Caremark Corporation
Dairy Farm International Holdings Limited
Delhaize Group (ADR)
Distribucion y Servicio D&S S.A. (ADR)
Dollar General Corp.
Dollar Tree, Inc.
drugstore.com, inc.
Duane Reade Holdings, Inc.
Duckwall-ALCO Stores, Inc
Empire Company Limited
Family Dollar Stores, Inc.
Fred's, Inc.
Harry & David Holdings, Inc.
Ingles Markets, Incorporated
J Sainsbury plc (ADR)
Koninklijke Ahold N.V. (ADR)
Loblaw Companies Limited
Longs Drug Stores Corp.
Magnit OAO
Medco Health Solutions Inc.
Metro, Inc.
Nash-Finch Company
Omnicare, Inc.
Perfumania Holdings, Inc.
PetSmart, Inc.
PharMerica Corporation
PriceSmart, Inc.
Publix Super Markets Inc.
Rite Aid Corporation
Ruddick Corporation
Safeway Inc.
Sally Beauty Holdings, Inc.
Sears Holdings Corporation
Shoppers Drug Mart Corporation
Spartan Stores, Inc.
Stater Bros. Holdings Inc.
SUPERVALU INC.
Susser Holdings Corporation
Target Corporation
Tesco PLC (ADR)
The Great Atlantic & Pacific Tea Company
The Jean Coutu Group (PJC) Inc.
The Kroger Co.
The Pantry, Inc.
The Penn Traffic Company
TravelCenters of America LLC
Ulta Salon, Cosmetics & Fragrance, Inc.
Village Super Market, Inc.
Vitacost.com, Inc.
Vitamin Shoppe, Inc.
Walgreen Company
Wal-Mart de Mexico, S.A.B. de C.V. (ADR)
Wal-Mart Stores, Inc.
Weis Markets, Inc.
Whole Foods Market, Inc.
Winn-Dixie Stores, Inc.

Appendix D: 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 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.

Domestic companies
Companies with less than 20% of their revenues coming from outside the United States.

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.

Global companies
Companies with greater than or equal to 20% of their revenues coming from outside the United States.

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

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

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

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

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

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

Market capital
Sum of total debt and total market value of equity.

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

Net sales
Net revenue as reported by a company.

Operating cash flow ratio
Cash flow from operations divided by current liabilities.

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

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

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

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

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

Selling, general, and administrative (SG&A) expense as a percentage of sales
Ratio of selling, general, and administrative expense to net sales, for the same fiscal year.

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

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

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

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

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

Endnotes

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

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- Chris Davies, CFO, Diageo's North American Operating Unit (May 2, 2012)
- John Gehring, CFO, ConAgra Foods (April 5, 2012)
- Don Mulligan, CFO, General Mills, Inc. (March 28, 2012)
- Steve Robb, CFO, The Clorox Company (April 25, 2012)
- Bill Schumacher, CFO, Sunny Delight Beverages Company (April 4, 2012)
- Duane Still, CFO, The Coca-Cola Company's CCR Operating Unit (April 10, 2012)
- Al Williams, CFO, Bush Brothers (March 29, 2012)

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