GREENWOOD REPORT

March 2011

CAGNY 2011

Last week, we attended the 2011 Consumer Analyst Group of New York (CAGNY) conference in Boca Raton, Florida. CAGNY is the first stop on our annual conference tour and, as expected, gave us a great briefing on the mindset of the consumer. We heard from 28 CEO's and CFO's of companies in the food, beverage, and consumer products sector about the opportunities and challenges facing their companies. Being located in the backyard of their largest customer, Walmart, we are always eager to hear the perspective of the "supplier community" directly from their top brass. Key takeaways are below.

Next week, we head to Washington for the annual National Association for Business Economics (NABE) Policy Conference, then on to London in late March for CAGNY's sister conference, the Consumer Analyst Group of Europe (CAGE). We'll round out the spring with a trip to Los Angeles in May for the Milken Global Conference where we'll hear from leaders in business, politics, education, health care, and entertainment. As always, you can expect us to come home with new ideas on the economy and their implication for investment management. Our clients will be the ultimate beneficiaries.

KEY TAKEAWAYS FROM CAGNY

Readers who recall our 2009 and 2010 commentaries (available on our website) are familiar with the *decade of change* experienced by many consumer products companies following the previous recession of 2001-2002. The re-organization, re-structuring, and re-vitalization touted by management paid off as the *Great Recession* set in. These "re" programs, designed to cut costs, improve efficiencies in the supply chain (via SAP), and position the companies for growth, contributed greatly to gross margin expansion and ultimately increased profits in the first decade of the 21st century. In fact, the S&P 500 Consumer Discretionary and Consumer Staples indices weathered the recession well and are *up* 8.7% and 15.1% respectively since the all-time high in the market (October 9, 2007). The S&P 500 as a whole is *down* 9.8% during the same time period.

As we move into 2011, many of the themes we've heard at past CAGNY conferences continue to be relevant. Kraft's CEO Irene Rosenfeld described their strategy as a "virtuous cycle": focus on core power brands, drive top line growth, and, through reduced costs and overhead, self-fund future growth. This strategic focus was not unique to Kraft and showed up in other presentations.

Focus on Core Power Brands

It came as a surprise that SKU reduction wasn't all bad for the industry as has been highly publicized through Walmart's reversal of Project Impact. By eliminating less-profitable SKU's, resources were redeployed back to the core, billion dollar brands. With lower media costs thanks to the recession, companies turned to advertising and promotion to drive unit volume growth in their bread-and-butter brands. The result of this sharper focus is expanding margins. Many companies are now only operating in categories where they hold the #1 or #2 position.

Drive Top-Line Growth

Developing markets continue to dominate discussion and are becoming a larger and larger component of gross revenues. The opportunity in China is staggering with an additional 250 million people joining the middle class by 2015. Brazil is expected to "feed the world" with their vast natural resources. Every company reported on their position in these markets but some are better positioned than others. All expect increased revenues from emerging markets in the next 10 years.

With the World Cup in 2014 and the 2016 Summer Olympics in Rio de Janeiro, Brazil is expected be the prime focus of advertising in the emerging markets this decade. Stay tuned for quite a show.

There is no shortage of cash. For months we have discussed the cash positions of global corporations as a bullish sign for continued economic expansion. Like many frustrated investors, these CEO's know that cash is a low-to-no earning asset. Uses of cash include dividends, share repurchases, capital expenditures, hiring, or as we heard at CAGNY, acquisitions. Jim Craigie, CEO of Church & Dwight (read Arm & Hammer) indicated that the mergers and acquisitions activity is as robust as ever. Many family businesses are looking to cash-in as they are still reeling from the recession. We favor this use of cash as a driver of top-line growth – especially as the recovery continues to take shape.

Reduce Costs and Overhead

We were encouraged to hear that SAP enterprise management software, a focus in the supply-chain, is being expanded to other parts of the business with additional costs savings expected to follow. Additionally, the recession has instilled a mindset of frugality where overhead costs are under a microscope and expected to shrink further. Companies are setting aggressive gross margin targets for the next five years in an attempt to unlock savings for reinvestment in marketing and innovation.

Future Growth

With a laser focus on the core, increased revenue growth, and continued cost savings, companies are positioned for the next decade of growth. We heard about significant investment in innovation particularly in packaging and package size, as well as product. Bill Johnson, CEO of Heinz, discussed a transformation in ketchup – the Dip & Squeeze. The ketchup hasn't changed, but the way it is served is driving growth in the category. Try it at Chick-fil-A and see why ketchup in the car is finally possible! Package size is also shrinking to accommodate single-serve portions in the emerging markets and pricing in the developed world (ie. a 10 oz bottle for the price of a 12 oz bottle two years ago).

Other Takeaways

- In 28 presentations, only one company mentioned the word "Compaction"; the practice of creating higher strength, lower volume products (ie. concentrated detergent). Compaction was one of the primary focuses of the last five years at CAGNY particularly in the area of sustainability.
- There was also very little mention of the dollar stores and the opportunity they present as a growing customer base. Big box retailers still dictate strategy.
- Every company mentioned rising input costs and the threat of commodity inflation. The overall concern, however, was tepid. Hedging practices coupled with higher gross margins will allow companies to absorb a portion of higher input costs. Additionally, nearly every company mentioned the ability to take price increases and believe they will be able to pass the excess costs onto the consumer without a large impact to demand. The 2008 market presented a similar dynamic: commodity prices rose sharply and pricing was taken; when commodities fell back to more normal levels, pricing held and profits rose.
- Demographics continue to shape the messaging of the consumer products companies with emphasis on boomers, millennials, women, teens, Hispanics, and the health and wellness trend. Those companies who can tailor their advertising and promotion to these segments will win.

While our comments are overall positive, they represent a very general view of the industry. There are challenges facing these companies and not all of them stand to benefit from every trend we outlined above. Our task in the coming weeks is to re-evaluate our exposure to the industry and ensure we own the best companies in the market. We look forward to reporting to you again after CAGE.

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