

The profit margin squeeze
Structural strategies for
consumer product companies



Contents

Executive summary	3
Introduction	6
Drivers of inflation and volatility	11
Price-sensitive consumers and bifurcation	13
Are these enduring trends or temporary changes?	18
Structural strategies instead of tactics	19
For the CEO: Four approaches to structural strategies and a stress test	20
Final words	22
Case study – Package size	23

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Executive summary

Consumer product companies face a challenging combination of rising and volatile input costs, and a price-sensitive consumer. Nearly every step from farm to retailer has been impacted by surging commodity costs. There are many drivers fueling this price increase, including rising food demand, constrained food supply, rising energy costs, and global economic uncertainty. Consumer spending patterns are also undergoing a shift, influenced by a higher degree of consumer frugality, increased availability of low cost options, widening consumer bifurcation between the top and bottom income quintiles, and retail bifurcation between discount and premium channels.

The questions consumer product executives should be asking, and are asking, include:

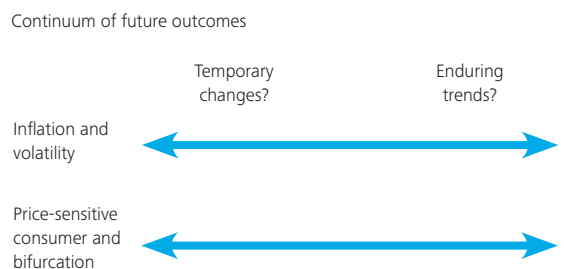
- What should consumer product companies expect in the future for commodity prices? Which changes seem to be enduring and which changes seem fleeting?
- To what extent will consumer price-sensitivity continue going forward?
- How does greater income bifurcation between the top and bottom quintile of U.S. consumers affect strategies to maintain profit margins?
- How should consumer product companies manage margin and risk in today's environment of rising commodity prices, high volatility, and frugal consumers?

Many of the drivers behind rising commodity prices and volatility appear to be enduring changes, while others appear temporary or episodic in nature. While there is a range of opinions from economists, many expect this high

commodity price environment to persist for some time. Likewise, many of the factors contributing to a price-sensitive consumer seem likely to remain in the near future. Complicating the notion of the increasingly price-conscious consumer in aggregate is the widening gap between the most and least affluent consumers in the United States — the bottom quintile remains encumbered by the recent recession and in a tenuous financial situation.

If higher prices and consumer frugality are seen as a temporary phenomena, pursuing a set of tactics to “grind out” quarterly earnings in the near term seems likely. However, if these are viewed as enduring changes, it means that a set of strategies, including structural changes, should be considered to tackle the increasingly bifurcated consumer segment.

Figure 1. Is the profit margin squeeze temporary or enduring?



These trends have left consumer product companies in a profit margin squeeze: Much higher costs in terms of commodities — crop, packaging, and energy — and consumers with a recessionary mindset.

Tactics vs. Structural strategies: There are a range of tactics and strategies that consumer product companies can deploy in response to the profit margin squeeze. These actions can extend across the entire enterprise — in Operations, Marketing, Finance, R&D, and Strategy (see Figure 2). To protect and grow margins, strategies may be developed and managed in these functional silos but with weak connections across the divisions. While the topic may be top of mind in the executive suite, each function seems to have resorted to a function-centric and uncoordinated approach. The Chief Operating Officer tends to focus on procurement, in addition to logistics and distribution. The Chief Marketing Officer and the brand team look at portion sizes, pricing, promotions, and product strategy. The Chief Financial Officer spearheads cost reduction efforts, and the Treasury group focuses on commodity and currency hedging strategies. The Chief Technology Officer pursues formulation, packaging, and other innovations. And, on occasion, the Chief Strategy Officer or business unit leader reexamines the existing business model in light of the current environment.



Figure 2. The typical uncoordinated function-centric approach creates risk of misalignment

Operations	Finance
<ul style="list-style-type: none"> • Supply • Logistics and distribution 	<ul style="list-style-type: none"> • Hedging • Cost reduction
Marketing	R&D
<ul style="list-style-type: none"> • Portion size • Pricing and promotion strategy • Product and market portfolio 	<ul style="list-style-type: none"> • Formulation • Packaging • Innovation
	Strategy
	<ul style="list-style-type: none"> • Business model

While many consumer product executives may be of the mindset that the inflationary and price-sensitive consumer changes are enduring, their company's actions seem to be consistent with tactics to address a temporary margin squeeze instead. While the tactics are important, by themselves, they typically do not prepare companies for a potential new reality of much higher input prices and consumers who are reluctant to pay more. The contrast between typical tactics compared to structural strategies is stark. However, if these current trends are viewed

as enduring changes, it means that a set of strategies, including structural changes, should be considered to tackle the increasingly bifurcated consumer segment.

Operations. Typical tactics include developing supply agreements to mitigate or share risk with suppliers, reducing dependence on volatile sources of supply, and tweaking logistics and distribution network design. However, possible structural strategies include investing in supply-side innovation including agricultural R&D, investing in local supply sources to mitigate risk, reconfiguring logistics and distribution network design, and rethinking inventory management across enterprises.

Marketing. Typical tactics include redesigning package and/or portion size to target price, using pricing strategies to maintain market share, changing the cadence of promotions, using portfolio diversification across markets

and geographies to dampen the volatility of earnings, and tweaking the tiered product portfolio to maintain a consumer base. However, potential structural strategies include revamping package size offerings across the portfolio, aligning promotion and pricing strategy to increase margin by consumer and channel segments, pursuing price discrimination via promotion strategies, shifting portfolios to more favorable markets and geographies, and rethinking the product portfolio at the extremes (e.g., low-end and premium).

Finance including treasury. Typical tactics include simple hedging strategies to dampen volatility and ensure a source of supply in the treasury group, and finance-led variable cost reduction initiatives. However, structural strategies to consider include developing hedging and risk management strategies for a range of economic scenarios, coordinating currency and commodity hedging strategies with procurement, and enduring finance-led structural cost reduction programs.

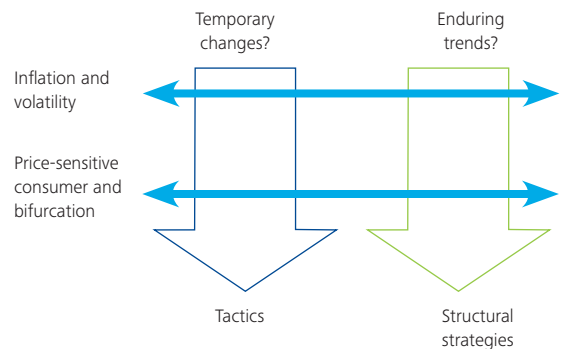
Technology including research and development. Typical tactics include developing alternative formulations with minor changes to reduce costs, using lower cost packaging materials and design, and reconsidering launch dates for incremental product modifications based on the economic environment. However, structural changes might include looking to emerging markets for lower-cost innovations that may appeal to U.S. consumers, investing in packaging innovation like material research, and developing truly new products with unique value propositions.

Strategy. The typical tactical approach usually results in slightly refined existing business models encumbered by the current mode of business; however, structural changes could include launching new business models, and pursuing forward or backward integration. While the appropriate mix of tactics and strategies to maintain or increase margins depends on product category and brand positioning, consumer product companies should consider increasing their mix of structural changes versus fleeting tactics. Shifting toward structural changes means pursuing these strategies that could touch nearly every part of an organization and consequently require a coordinated effort. With these structural changes in place,

a consumer product company can be better positioned for a range of future scenarios of higher or lower commodity prices, higher or lower volatility, and persistent or subsiding price sensitivity.

Figure 3. Tactics vs. structural changes

Continuum of future outcomes



Those consumer product companies that view these supply and consumer changes as enduring and embark on structural strategies may gain a tremendous competitive advantage, as structural strategies can improve a company's resilience to changes and provide flexibility in responding. An aggressive and pragmatic approach to structural changes across Operations, Marketing, Finance, R&D, and Strategy, would ideally be CEO-driven and extend well beyond incremental stop-gap tactics. The typical approaches are temporary mitigation tactics that help a bit, but often fall well short of a systematic approach across functions.

For the CEO, we have four approaches to structural strategies and an important stress test. First, consider revamping products and brands at the extremes. Second, think about re-fragmenting your supply chain, and moving upstream and downstream. Third, consider game planning hedging strategies for the future - all of them. Fourth, consider tasking the BRIC+ countries with developing products and technologies for the developed world. And a stress test: know your existing business models breaking point to prepare for scenarios where the margin squeeze tightens its grip on your business.

Introduction

Consumer product companies face a challenging combination of rising and volatile input costs, and a price-sensitive consumer. Nearly every step from farm to retailer has been impacted by surging commodity costs. From a historical perspective, this combination of trends was last seen during the 1970s in the United States. In the 1970's, the confluence of higher export demand, land retirement, weather-related crop losses, government food policy, U.S. dollar depreciation, and a spike in oil prices drove up agricultural crop prices. While the recent run-ups in crop prices are linked to similar supply demand imbalances and macroeconomic conditions, this decade is different. Additional factors in this recent run-up include growth in biofuels, declining R&D investment, global economic growth between 2006 and 2008, and the financial crisis.¹

From seed to consumer

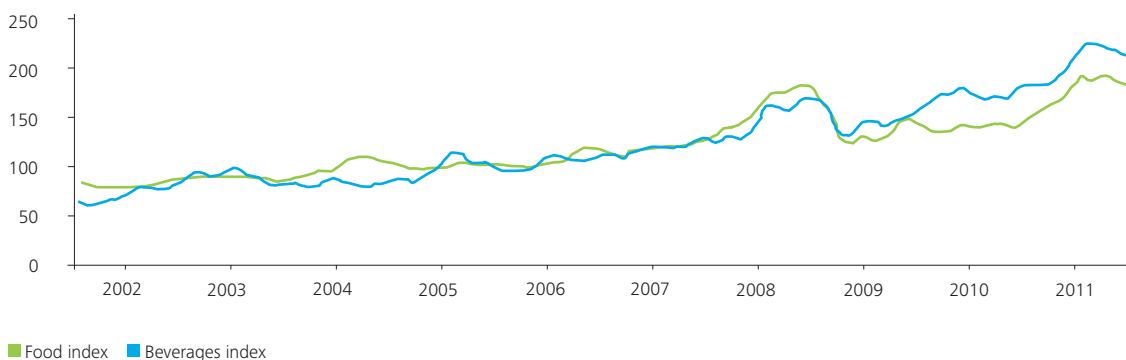
The typical shopper looking at a product on the shelf is unaware of the journey it has taken to arrive at a store. For a simple cotton shirt, the journey begins with a cotton seed, soil, and a mechanical planter. Add fertilizer, insecticide and irrigation. A few months later, a mechanical picker harvests the crop. The cotton is cleaned, ginned, and baled, and transported to a textile mill to be woven or knitted into fabric. After dyeing and finishing, the finished shirt is transported to a distribution center, to a store, and finally to a consumer. The path is similar for the contents in a box of cereal or a can of soup. It begins with a seed and ends with the consumer.

Rising crop commodity prices

Rising commodity prices combined with continued volatility have pervaded most aspects of the supply chain from source to consumer. Nearly every step has experienced price increases from fertilizer and fuel, to production energy costs, and packaging materials. As a result, crop commodities in categories like food (e.g., wheat, corn, rice, soybeans) and beverages (e.g., coffee, cocoa) and cotton have trended upwards over the past decade as shown in Figure 4. The IMF Food commodity index has more than doubled over the past decade, and the IMF Beverage commodity index has tripled.² These commodity indices represent the price paid by consumer product companies to farmers for crop commodities.

The farm value — the price paid to farmers — of each food dollar varies significantly by product category. On one hand, farm value was only a small portion (19 percent on average) in the U.S. during 2006 – less than half of what it was 60 years ago. On the other hand, a significant rise in absolute price paid to farmers compresses margin without a corresponding retail price increase. Furthermore, food categories like meats that have a much higher farm value than products like breakfast cereals are much more impacted by agricultural commodity prices.³

Figure 4. A decade of rising and food and beverage commodity prices



Source: IMF Food and Beverage Indexes, Monthly, 2005 = 100 in terms of U.S. dollars

¹ May Peters, Suchada Langley, and Paul Westcott, Agricultural Commodity Price Spikes in the 1970s and 1990s: Valuable Lessons for Today, Amber Waves, USDA, Economic Research Service, May 2009

² IMF Food and Beverage Indexes, 2005 = 100 in terms of U.S. dollars, IMF Beverage Index (63.20 in August 2001 to 209.96 in July 2011) and IMF Food Index (84.35 in August 2001 to 180.33 in July 2011)

³ Jason Henderson, What is Driving Food Price Inflation?, Federal Reserve Bank of Kansas City, 2008, Cited USDA data

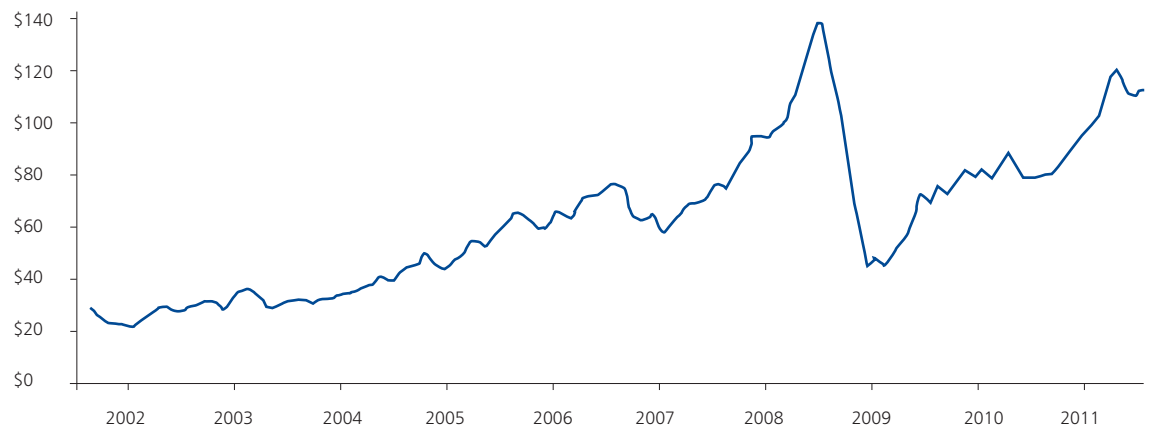
In addition to farm value, CPG companies face higher prices and high volatility in other steps during the manufacturing and distribution of consumer product goods. In 2006, packaging (e.g., tin cans, paper pulp, PET), transportation (e.g., inbound and outbound logistics), and energy costs (e.g., manufacturing) represented 15.5 percent of each food dollar spent.⁴ The costs of packaging, transportation, and energy face similar price and volatility characteristics as that of crude oil.

Higher crude oil prices

Monthly crude oil prices over the past decade can be broadly characterized in three phases as shown in Figure 5. In the first phase from December 2001 to July 2008, oil prices steadily rose over 700 percent (\$18.52 to \$132.55 per barrel). In the second phase from July 2008 to February 2009, monthly oil prices rapidly fell to less than one third of the July 2008 high (\$132.55 to \$41.76 per barrel). In the third phase from February 2009 to April 2011, oil prices rose back to \$116.32.



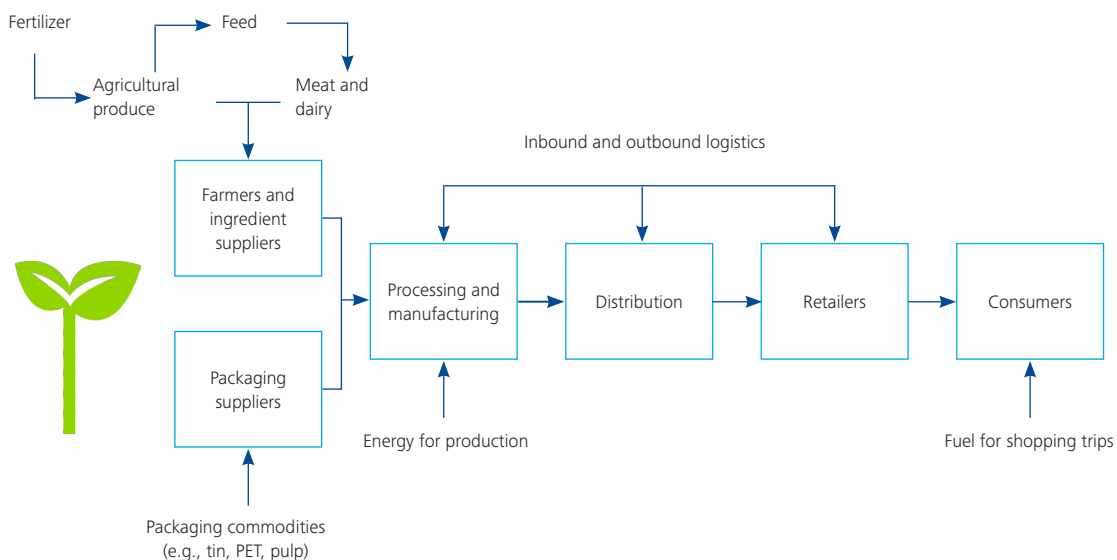
Figure 5. A decade of crude oil prices



⁴Jason Henderson, What is Driving Food Price Inflation?, Federal Reserve Bank of Kansas City, 2008, Cited USDA data . Packaging, transportation, and energy represented 8, 4, and 3.5 percent of 2006 U.S. retail food cost, respectively

Source: IMF, Average Spot Price of U.K. Brent, Dubai, and West Texas Intermediate in U.S. Dollars per Barrel, Monthly

Figure 6: The impact of crop commodity and oil prices pervades many of the steps from seed to consumer



Impacted value chain

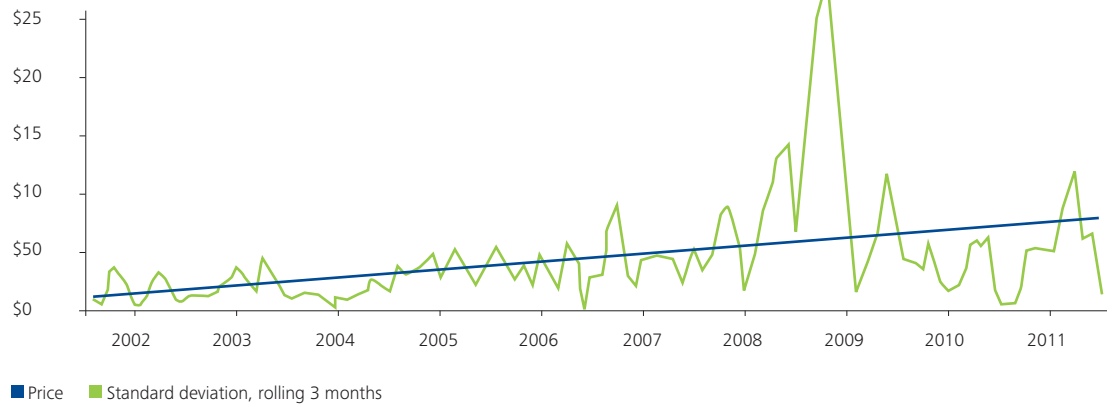
Crop commodity and crude oil prices impact consumer product companies, retailers, and consumers along the value chain as shown in Figure 6.

The overall impact of rising input prices varies based on product ingredients, formulation, processing, packaging, and transportation. For the food and beverage industry, higher agricultural commodity and oil prices cascade through many inputs like fertilizer, feed, and produce in addition to packaging, energy for production, and transportation costs. The apparel industry is similarly affected, as cotton and polyester are plant and oil-based products, respectively. Likewise products in the personal and household goods category are composed of a range of plant or petroleum-based products.

High volatility

In recent times, many commodities have experienced rising prices and high volatility concurrently. However, it is important to think about inflation and volatility as separate but interrelated phenomena. Volatility is simply a measure of variation — whether up or down — over time. Higher volatility implies greater uncertainty and risk to consumer product companies purchasing the commodities, and to the farmers, ingredient companies, and other sellers. Commodity price volatility can be measured in many ways. Simple measures of price volatility can include the standard deviation of prices over time (e.g., hourly, daily, monthly), while a broader index can examine market indices. Historical volatility characteristics vary across commodity categories like crude oil, food and beverage indices, and individual crop commodities (e.g., cotton). Crude oil prices have experienced rising volatility over the past decade, as shown in Figure 7. In this chart, volatility is measured as the three-month rolling standard deviation of monthly prices.

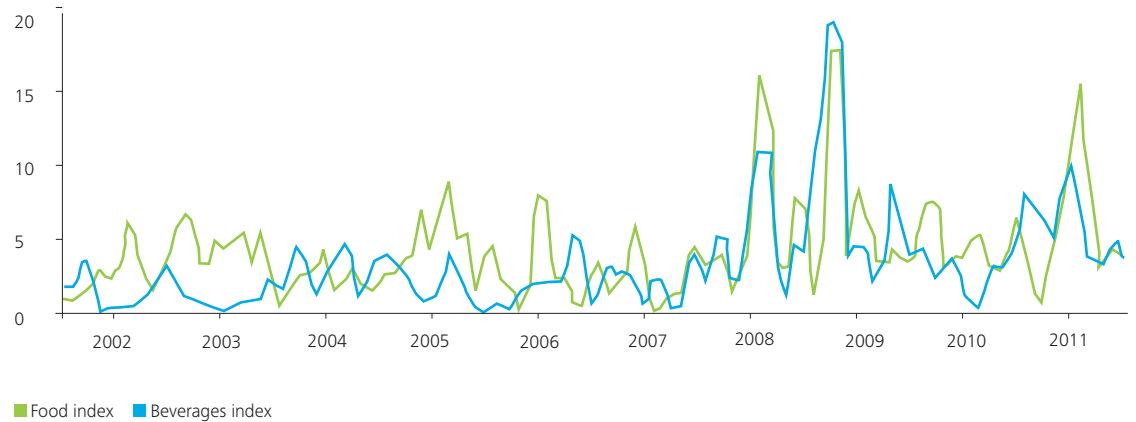
Figure 7. Increased crude oil volatility



Source: Average Spot Price of U.K. Brent, Dubai, and West Texas Intermediate in U.S. Dollars per Barrel, Monthly

The IMF food and beverage indices have considerable volatility as shown in Figure 8, while an upward pattern is not as clear as it is for crude prices. That being said, the volatility of broad indices is dampened to some extent due to variation across the many commodities included. For example, the food index is a combination of over 20 commodities including cereals, oils, meats, sugars, and produce. And to a lesser degree the beverage index, which is composed of coffee, cocoa, and tea commodities.

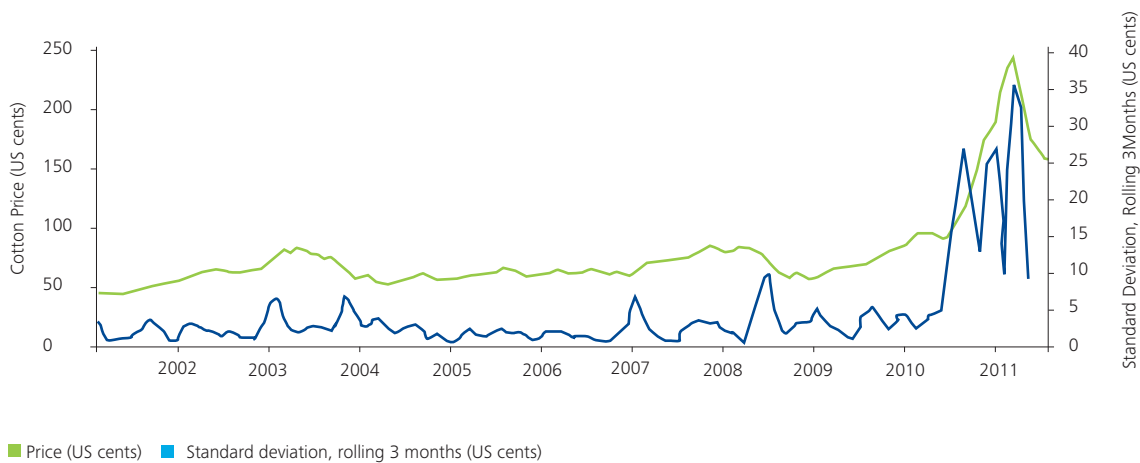
Figure 8. High food and beverage volatility



Source: IMF Food and Beverage Indexes, 3 month rolling standard deviation, Monthly, Index value in 2005 = 100 in terms of U.S. dollars

Individual commodities — like cotton — have seen significant changes in volatility in recent years, as shown in Figure 9. After eight relatively quiet years, a combination of rising global demand and sharp declines in supply due to extreme climate events in China and Pakistan, resulted in a price spike and corresponding volatility.⁵

Figure 9. Cotton prices and volatility



Source: IMF, Cotton Outlook 'A Index', Middling 1-3/32 inch staple, CIF Liverpool, US cents per pound

Across these three commodity categories — crude, food and beverage, and cotton — are examples of steadily rising volatility, relatively consistent volatility, and a rapid upward shift in volatility.

Price volatility measures indicate not only the magnitude of change of the underlying commodity, but also the pace of changes over time. The level of volatility is relative to historic norms, as there is some natural volatility for price discovery in markets, and also for events like unexpected storms impacting yield, regulatory changes, or steep changes in demand. Volatility is an important consideration for consumer product companies inasmuch as it impacts the decisions that suppliers, buyers, and consumers make.

For suppliers, including farmers, uncertain expectations of future prices impacts the amount and types of crops to cultivate. From a farmer's perspective, too much volatility can result in risk-averse behavior, like withholding the planting of certain crops or rotating produce. For buyers at consumer product companies, price volatility makes planning a challenge since it requires hedging strategies and risk mitigation. From a consumer's perspective, volatility brings more attention to the pricing of products and can change the price consumers expect for the next shopping trip.

So why are we in an environment of rising prices and high volatility across so many commodities?

⁵ Adam Cancryn and Carolyn Cui, Flashback to 1870 as Cotton Hits Peak, Wall Street Journal, OCTOBER 16, 2010, <http://online.wsj.com/article/SB10001424052748704300604575554210569885910.html>

Drivers of inflation and volatility



There are several drivers of inflation and volatility including rising global food demand, constrained global food supply, unpredictable energy prices, and economic uncertainty.

Figure 10. Is the profit margin squeeze temporary or enduring?

Continuum of future outcomes

Drivers of inflation and volatility

- Rising global food demand
- Constrained global food supply
- Rising energy costs
- Economic uncertainty

Temporary changes?

Enduring trends?



Rising global food demand. Rising global food demand can be attributed to a combination of dietary changes, rising incomes in developing countries, increasing populations, and the diversion of agricultural crops for bio-fuels. In the developing world, dietary changes from primarily grain-based to increasingly meat-based diets have resulted in greater demand for energy-intensive foods and

agricultural feedstock. Not only does the caloric intake increase as incomes rise but also the demand for high protein foods and high value goods like meat, milk, eggs, vegetable oil, and sugar.⁶ For example, from 1970 to 2005, the per capita consumption in developing economies increased 27 percent from 2,134 to 2,722 calories and, more importantly, calories from meat, eggs, and vegetable oils increased threefold.⁷

In a recent article looking at global food inflation titled “The global food fight”, two of our Deloitte colleagues summed up the impact of bio-fuels this way: “As a result [of increased support for bio-fuel consumption], more land was cultivated for crops used in the production of bio-fuels. Corn, a major feedstock for bio-fuel, became one of the hottest farming commodities in the United States during 2007. This was done at the expense of soybean cultivation, which declined significantly. In other parts of the world, food crops have been replaced by oilseed and sugarcane. The rise of bio-fuels not only reduced the production of food crops like wheat, it also increased the price of sugarcane, oilseed, and maize as competing demands between bio-fuel producers and consumers pushed prices up.”⁸

⁶ Ashok Gulati, Nicholas Minot, Chris Delgado, and Saswati Bora, Growth in high-value agriculture in Asia and the emergence of vertical links with farmers, December 2005, Paper presented at the workshop “Linking Small-Scale Producers to Markets: Old and New Challenges”

⁷ Consumption in developing countries increases 27 percent from (FAOSTAT) (2,134 to 2,722 calories)

⁸ Siddharth Ramalingam and Pralhad Burli, The global food fight, Deloitte Global Economic Outlook, 2nd quarter 2011, https://www.deloitte.com/view/en_GX/global/insights/deloitte-research/economic-research/global-economic-outlook/7b811aa045e4f210VgnVCM1000001a56f00aRCRD.htm

Constrained global food supply. Constrained global food supply can be linked to rising demand and agricultural yields not keeping up. While insufficient investment and innovation in farming methods is partly to blame, outside forces are also at work. Some agricultural economists observe an increased rate of extreme adverse weather events (e.g., droughts, hurricanes, flooding) that is constraining supply by decreasing yields or wiping out entire harvests. But in many developing countries, the mere availability of farm land is not keeping pace with the rapid population increase. The dietary shifts that have increased demand have also constrained supply for agricultural commodities that are now being used to feed livestock. Furthermore, inadequate investment in agricultural R&D (e.g., fertilizers, new crop variants, farming methods) has contributed to diminishing returns on land productivity. Also, in some developing countries, the mismanagement of stock is resulting in large quantities of wasted produce; there may be some opportunities here to ease supply shortfalls.

Energy prices. Crude oil prices ripple through the consumer product supply chain impacting an array of costs including fertilizer, harvesting, transportation, and manufacturing. Energy is a sizeable contributor to retail food costs as energy and transportation expenditures are estimated to represent 7.5 percent of retail food costs.⁹ It is no surprise that energy costs and volatility has historically been reflected in supply and demand imbalances that some attribute to greater global demand and inadequate investment in new production.

Economic uncertainty. Economic uncertainty sometimes ripples through the business ecosystem in the form of volatility. As monetary policy results in a weaker or stronger U.S. dollar, agricultural commodity values tend to rise or fall, respectively. Also, prolonged economic uncertainty in the United States and a shaky global recovery leaves companies in a difficult position when planning for the long term, while consumers remain cautious about their future spend. Just as economic uncertainty impacts the equity markets — as measured by the Chicago Board Options Exchange Market Volatility Index (VIX) — uncertainty impacts commodity prices. In a recent survey of finance executives in North America, not only was uncertainty cited as a major concern, but also CFO's are "increasingly concerned about inflation, rising input prices, and the possibility of longer-term economic malaise."¹⁰

⁹ Jason Henderson, What is Driving Food Price Inflation?, Federal Reserve Bank of Kansas City, 2008

¹⁰ Growth headwinds are taking their toll on CFO confidence, Deloitte CFO Signals, 2nd quarter 2011

Price-sensitive consumers and bifurcation

There are several contributors to the price-sensitive consumer and bifurcation in the United States, including consumer frugality, higher availability of low cost options, consumer income bifurcation, and retail bifurcation.

Figure 11. Price-sensitive consumer and bifurcation

Price-sensitive consumer and bifurcation

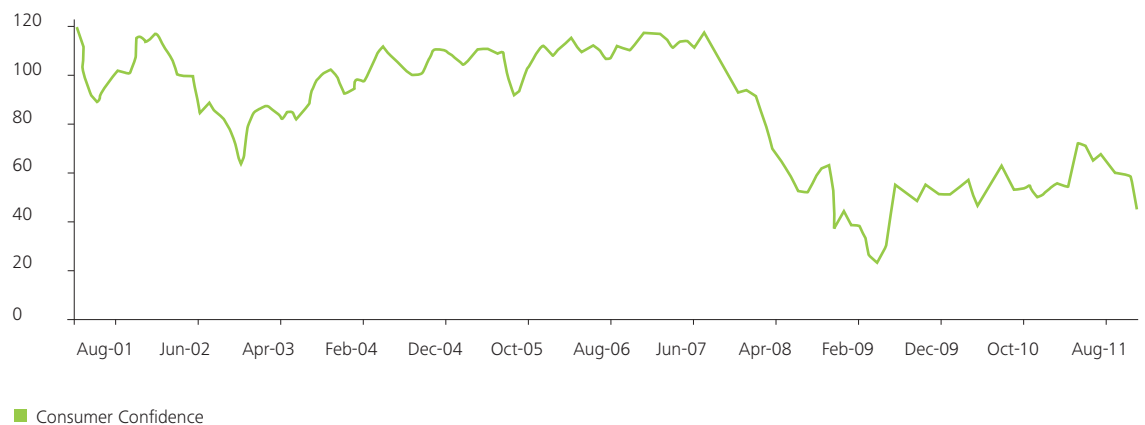
- U.S. consumer frugality
- Higher availability of low cost options
- U.S. consumer income bifurcation
- U.S. retail bifurcation



U.S. consumer frugality. In the shadow of the recent recession, many consumers have embraced frugality — some by necessity, some by choice. In a 2010 consumer survey, 61 percent of respondents described themselves as more price conscious and 42 percent identified themselves as being more frugal than they were prior to the recession.¹¹ As a result, many consumers are actively seeking discounts, comparing prices across channels, buying store brands, using coupons, and shopping with retailer loyalty cards. Consumer expectation of business and financial conditions as measured by the Conference Board Consumer Confidence Index (CCI) indicates a consumer with less propensity to spend and weaker confidence in the economy. This indicator of consumer confidence, while higher than levels seen during the depths of the recent recession, is still lower than pre-recession levels as shown in Figure 12.

Figure 12. Conference Board Consumer Confidence Index (CCI)

Conference Board Consumer Confidence Index August 2001 - 2011



Source: Conference Board Consumer Confidence Index, United States

¹¹ 2010 American Pantry Study, Deloitte and Harrison Group, July 2010

Furthermore, in a July 2011 consumer survey, 50 percent of consumers believe the economy is still in recession and an additional 24 percent believe that the U.S. economy recently has been recovering from a recession, but it remains weak and may fall back into recession.¹²

In a May 2011 consumer survey, 88 percent of survey respondents believe that food prices have been increasing recently.¹³ Verbatim consumer comments reveal a shopper aware of and impacted by food price increases.

Rising prices and stagnant income ...

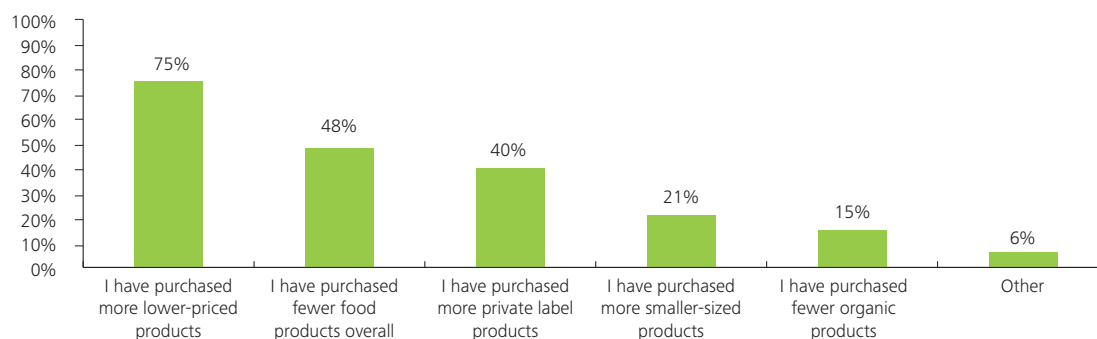
- **Consumers are struggling with rising prices:** "It is getting more and more difficult to stretch my food dollars"
- **Incomes are stagnant for many shoppers:** "Food prices are going up but not wages"

...resulting in changed shopping behavior:

- **Reduced consumption:** "I am buying less and shopping less, also eating out less at cheaper restaurants when I do eat out"
- **Buying in bulk:** "I have started checking the price per ounce and buying the largest packages, where the price per ounce is usually lower"

Figure 13. Consumer reactions to higher prices among those who perceive higher prices

Survey Question: As a result of food price increases, how have you changed your buying behavior?



Source: Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=1,087

While shoppers tend to be unaware of a consumer product's journey from seed to consumer, they are very aware of any price increase.

- **Buying less, and buying less expensive products:** "I have also started buying lower priced cuts of meat", "I no longer buy fresh fruit like I used to"
- **Using coupons:** "I have started couponing more as a result of the rise in prices"
- **Purchasing store brands:** "I have bought more store brands due to the rising price of food"

Of those who believe prices are higher a majority (62 percent) have changed their food buying behavior as a result.¹⁴ Consumers with changed purchase behavior due to higher product prices have pursued a range of tactics including purchasing more lower-priced products (75 percent), purchasing less food (48 percent), and adding more store brands (40 percent) to the shopping cart as shown in Figure 13.

¹² Deloitte 2011 Back-to-School Survey, July 2011, n=1,000, How do you think the U.S. economy is performing? 50% It still is in a recession, 24% It recently has been recovering from a recession, but it remains weak and may fall back into recession, 19% It recently has been recovering from a recession, and will probably continue to improve, 7% Don't know/no opinion

¹³ Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=2,000, Do you believe that food prices in food stores have recently been increasing or decreasing? 88% increasing, 7% staying the same, 3% decreasing, 3% don't know. Percentages do not equal to 100 due to rounding

¹⁴ Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=1,754

Furthermore, higher gas prices have also impacted consumer purchase behavior for many respondents. Verbatim consumer comments reveal a shopper aware and impacted by rising gas prices:

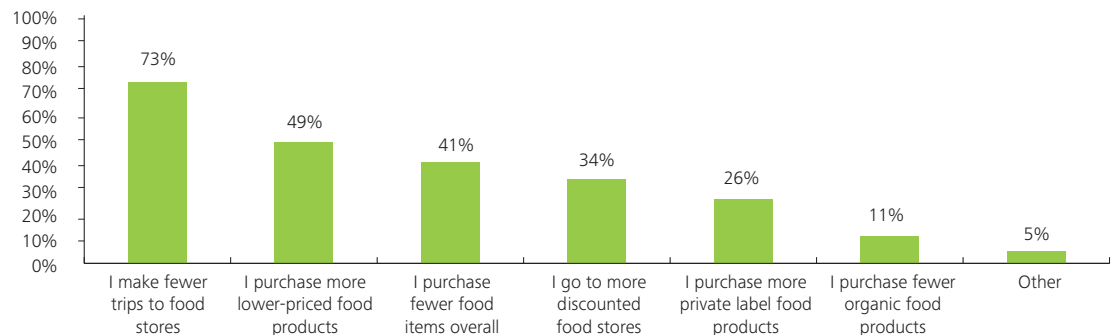
- **High fuel prices and gas prices:** “I tend to make my food last for the week and really minimize the extras when grocery shopping due to the increase in food prices and gas”
- **Limiting the number of shopping trips:** “I try to do all shopping in one day from several stores limiting trips to the store due to high gas prices”
- **Less cross-channel shopping and paying more:** “We used to go shopping at different stores for the better deals and sales but with gas being higher we can’t afford to go different places”, “ Sometimes buying the higher price food is cheaper than driving”, “I used to shop for food more frequently, but with [high] gas prices I actually spend more. I used to go to more stores to shop and cherry pick the best prices”, “Gas = money, so I only go to one or two stores and pay high prices”

- **Shopping locally to save gas:** “The nearest large supermarket is 30 miles from my home and the nearest [superstore] is 50 miles from my home, so I have been shopping at the little [local grocer] that is down the street from our home with the price of gas lately”
- **Buying in bulk:** “I buy more bulk items a few times per month to save on food and gas”

Fifty five percent of survey respondents have changed their buying behavior as a result of gas prices.¹⁵ Consumers have pursued a range of tactics to alleviate the effects of higher gas prices, including making fewer trips to stores (73 percent), purchasing more low-priced products (49 percent), purchasing fewer food items (41 percent), and going to more discounted food stores (34 percent) as shown in Figure 14. Consumers have an increasing array of low-priced options to choose from, both within stores and across channels. Examples include economy national brands, store brands, price-based promotions including coupons, and smaller-sized product package. Consumers are able to trade down across most product categories — often several tiers lower.

Figure 14. Consumer buying behavior changes due to higher gas prices

Survey question: As a result of higher gas prices, how have you changed your food buying behavior?

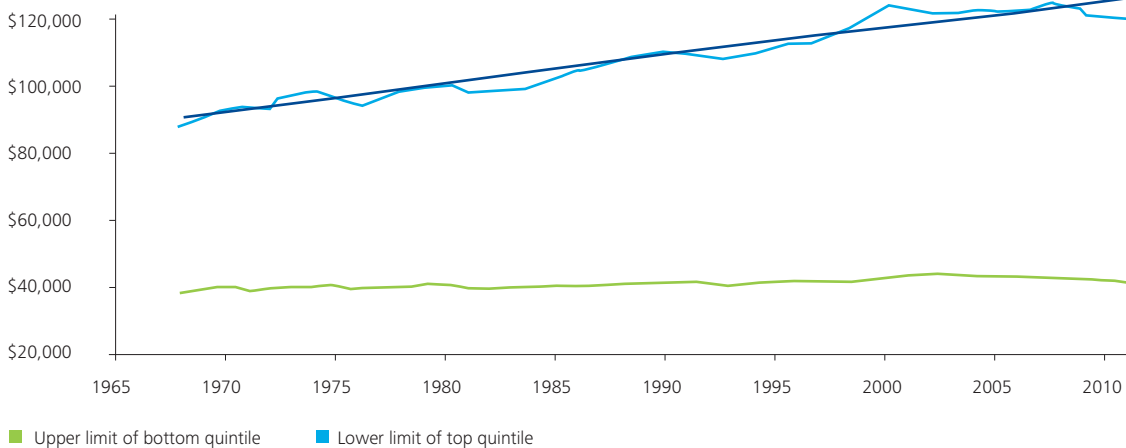


Source: Deloitte 2011 Consumer Food and Product Insights survey, May 2011, n=907

¹⁵ Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=2,000

Consumer income bifurcation. Over the past few decades, income growth for the segment of most affluent consumers — the top quintile — has outpaced the income growth of the bottom quintile consumers in the United States as shown in Figure 15.

Figure 15. United States Household Income (2010 Dollars), Top Quintile vs. Bottom Quintile



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements, Households as of March of the following year. Income in current and 2010 CPI-U-RS adjusted dollars

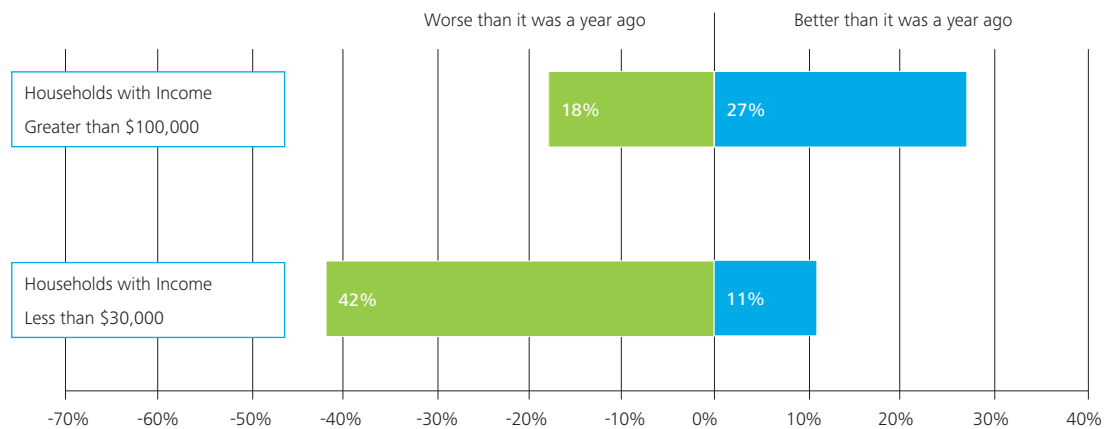
In a recent article, “Mind the Gap: What business needs to know about income inequality”, our colleague, Ira Kalish, Director of Global Economics, Deloitte Research, Deloitte Services LP, examined the implications of the “widening gap between the affluent and everyone else in the U.S.”¹⁶ He describes a bifurcation between higher-income households where before-tax household incomes surged 68 percent from 1979 to 2003 and lower-income households where incomes increased only 3.5 percent in the same time period. As for future expectations, he asserts that income distribution will likely endure and most consumers will be unable to take on significantly more debt — partially due to declining home asset values. Therefore, “given the expectation of two different types of consumers (affluent consumers with rising income versus low- and middle-income consumers with stagnant incomes) companies should target them separately.” For consumer product companies, this means distinct products and strategies for targeting the low-end and premium segments and a middle market that is less attractive.

In a consumer survey conducted in May 2011 while respondents were uniformly bearish about the state of the economy irrespective of the income group they belong in, there were significant differences in the direction of change regarding their household financial conditions. When asked about their household’s financial situation today, respondents making less than \$30,000 per year were more likely to be in a worse financial situation than a year ago compared to those making over a \$100,000 per year (42 percent vs. 18 percent), as shown in Figure 16. Similarly, the lower-income group was less likely to be in a better financial situation than the most affluent group (11 percent vs. 27 percent).

¹⁶ Ira Kalish, Mind the Gap: What business needs to know about income inequality, Deloitte Review, 2011

Figure 16. Financial situations of lower-income consumers are more likely to have deteriorated compared to more affluent consumers

Survey Question: Thinking about your household's assets (home, cash, car, etc.) and your liabilities (credit card bills, mortgage, etc.) would you say your household's financial situation today is:



Source: Deloitte Back to School Survey 2011, n=1,000

The declining or stagnant household financial conditions of the lower-income group could explain why low-income respondents were more likely to have modified their food buying behavior due to higher food prices compared to higher-income respondents (68 percent vs. 48 percent).¹⁷ The preferred consumer tactics used in response to rising prices varies somewhat by income. Low-income respondents were more likely to have purchased more lower-priced foods (77 percent vs. 65 percent) and purchased fewer food products overall (53 percent vs. 35 percent) compared to the higher income group. Interestingly, lower income and more affluent consumers were similar in their likelihood to have increased their purchases of private label products (36 percent vs. 40 percent) due to higher prices.

Retail bifurcation. Moving lock step with consumer income bifurcation, there has been rapid growth of discount retail channels like dollar stores and discount grocery chains. The products in many of these discount channels differ from traditional retailers, with smaller package sizes and more store-brands or less-prominent brands. Several retailers caught in the “middle” seem to be deciding to refocus on either lower-income consumers or shifting up market to target more affluent consumers.¹⁸ As a result of retail growth at the low-end, consumers have more economy product and channel options when they shop.

¹⁷ Ibid.

¹⁸ Deloitte 2011 Leaving home: Global Powers of Retailing 2011

Are these enduring trends or temporary changes?

The impact of rising supply costs and price-sensitive consumers is putting pressure on the bottom line of consumer product companies. How long these trends will continue is an ongoing topic of debate. However, when looking closely at the drivers of inflation, volatility, and consumer sentiment, many economists believe that the high and volatile commodity prices, frugal deal-seeking consumers, and bifurcation will persist. While a global slowdown could ease the demand pressure on commodity prices, many economists do not see a return to prices of a decade ago.¹⁹

When it comes to rising crop prices and volatility there is reason to believe that some (but not all) of the drivers like rising global food demand, constrained global food supply, rising energy prices, and economic uncertainty seem likely to continue. Similarly, the price-sensitive consumer — particularly in lower-income households — and bifurcation seems likely to persist with consumer frugality and the availability of low-cost options.

That being said, those consumer product companies that view these supply and consumer changes as enduring and embark on structural strategies may gain a tremendous competitive advantage, as structural strategies can improve a company's resilience to changes and provide flexibility in responding.

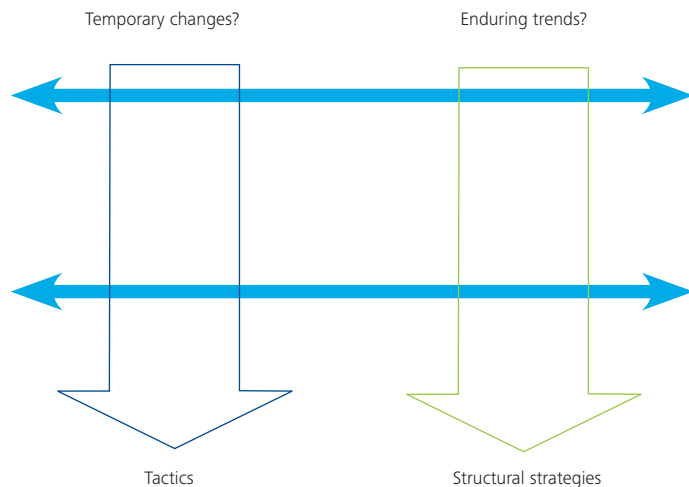


Consumer product companies that view these supply and consumer changes as enduring and embark on structural strategies may gain a tremendous competitive advantage.

Figure 17. Is the profit margin squeeze temporary or enduring?

Continuum of future outcomes

- Drivers of inflation and volatility**
 - Rising global food demand
 - Constrained global food supply
 - Rising energy costs
 - Economic uncertainty
- Price-sensitive consumer and bifurcation**
 - U.S. consumer frugality
 - Higher availability of low cost options
 - U.S. consumer income bifurcation
 - U.S. retail bifurcation



¹⁹ Ronald Trostle, Global Agricultural Supply and Demand: Factors Contributing to the Recent Increase in Food Commodity Prices, Economic Research Service, USDA, July 2008.

Structural strategies instead of tactics

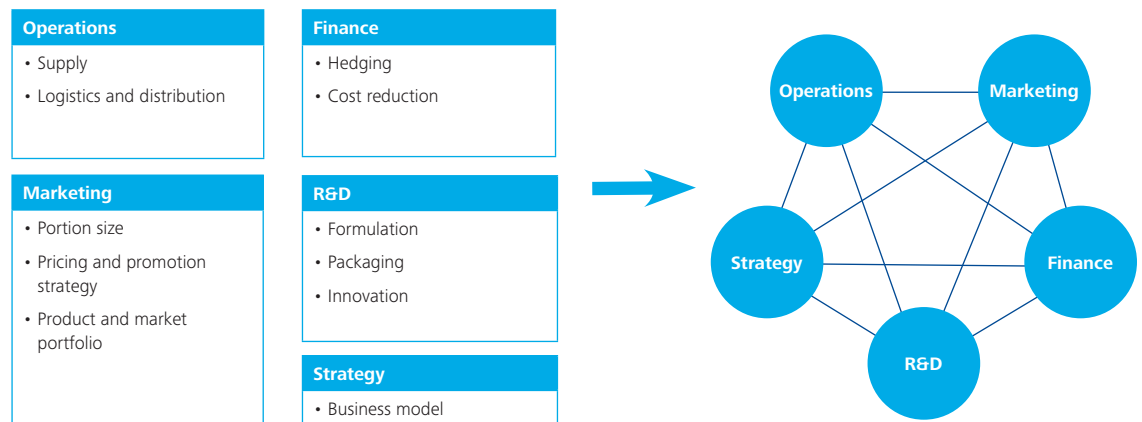
There are a range of tactics and strategies that consumer product companies can deploy in response to the profit margin squeeze. These tactics and strategies extend across the entire enterprise, often led in functional silos with some connection across the divisions. Typically, tactics are developed and managed within Operations, Marketing, Finance, R&D, and Strategy across a broad spectrum to protect or grow margin

Classic example of misalignment:

- **Supply:** Signs long-term contracts of volatile commodity X to lock in a price and ensure supply
- **R&D:** Scientists concurrently reformulate products to dramatically lower need for commodity X
- **Treasury:** Unaware of long-term contracts. Deploys hedging strategy that assumes ongoing need for commodity X

A classic example of misalignment involves the procurement, R&D, and treasury groups, which can be uncoordinated in managing risk related to an inflationary and volatile commodity prices. First, the procurement group signs a long-term contract for commodity X to lock in a price and ensure supply to help brand managers manage uncertainty. Second, scientists in R&D concurrently reformulate products to dramatically lower the need for commodity X. Third, the treasury group, unaware of the recently signed long-term contract, initiates a hedging strategy that assumes ongoing need for commodity X. While each of these actions on their own are well-intended, this uncoordinated approach can exacerbate the margin squeeze.

Figure 18. An uncoordinated function-centric approach may result in misalignment



For the CEO: Four approaches to structural strategies and a stress test

While many consumer product executives may be of the mindset that the inflationary and price-sensitive consumer changes are enduring, their company's actions seem to be consistent with tactics to address a temporary margin squeeze instead of an enduring change. The contrast between typical tactics compared to structural strategies is stark. While the tactics are important, they may not prepare companies for a potential new reality of much higher input prices, consumers who are reluctant to pay more, and bifurcation. If the commodity and consumer changes are enduring, it would be more effective for consumer product companies to pursue strategies that are more structural than the business-as-usual stop-gap tactics.

Structural strategy 1. Consider revamping products and brands at the extremes. In addition to higher input prices, consumer and retailer bifurcation fundamentally changes the optimal product line-up at the low-end, premium position, and everything in between. Due to differing needs and varying levels of price sensitivity, consumer product companies should consider revamping the product portfolio at the extremes (i.e., low-end and premium offerings). At low-end, it may mean that fighter brands which advanced during the recession could be redesigned and repositioned as permanent brands. Additionally, there may be a need to rethink the middle segment of the market in terms of size, viability, and differentiation in the remaining product line-up. This could mean unique pricing and promotion strategies, not just targeted products. This might also mean rethinking package size for the consumer and case pack size for the retailer — and determining the appropriate route to market. The urgency of and the path to escape the profit margin squeeze differs based on two primary dimensions: product category and brand characteristics. For the first dimension, product categories that target low-income consumers, usually contain a higher farm value, rely on few ingredients, and include a high share of store brands or products that can easily be traded-down or deferred, are more susceptible to the margin squeeze. Similarly for the second dimension, brands that are strong, typically command a pricing premium,

provide a strong value proposition, and have clearly differentiated premium positioning are less susceptible to the margin squeeze. Therefore, the strategy for strong brands in product categories marginally impacted by margin pressures may be to embark on moving up market to maintain margin. In stark contrast, the strategy for weaker brands in product categories that are much more impacted by rising input prices and a frugal consumer may be to reposition the product lower or selectively cede margin. Assign to the Chief Marketing Officer.

Structural strategy 2. Consider re-fragmenting the supply chain, and moving upstream and downstream. Consumer and retailer bifurcation combined with higher input prices has exposed shortcomings in concurrently trying to serve large mass merchandisers and discount channels. The inefficiencies are the result of growing differences in terms of desired products, promotional support, case sizes, package sizes, and price-points between retail channels. The art of leveraging supply chains to serve the large traditional national retailers and discount channels is transforming. For example, if a consumer product company was able to create a clean sheet design for the optimal route-from-source and route-to-market for large mass merchandisers and wholesale clubs compared to discount stores and independent stores, they would have two very different supply chains. In one case, they may invest in local supply sources across regions as a natural hedge, have direct store delivery, and co-packing capabilities in-house. In another case, they may rely on global supply markets, traditional warehousing, and outsource co-packing. Of course, there is a need to weigh the advantages and disadvantages of a bifurcated supply chain in terms of performance, efficiency, and costs. Similarly, the decisions to acquire or invest in the supply base or acquire co-packing or distribution capabilities have a set of pros and cons to consider. Assign to the Chief Operating Officer.

Structural strategy 3. Consider game planning hedging strategies for the future ... all of them. Consider creating a comprehensive commodity and currency hedging strategy for a range of economic scenarios. Some consumer product companies may be uncoordinated between treasury, procurement, and R&D along many basic aspects of commodity management, much less currency management. Similarly, natural commodity hedging (e.g., acquiring farmland) and currency hedging (e.g., revenue from or procurement in local markets) may be underappreciated as important components of hedging strategies. Game planning across an organization — not only finance and treasury, but also procurement, logistics and distribution, marketing, and operations — for a range of scenarios, could reveal blind spots and a need for greater coordination. One consumer product finance executive we spoke to said this: “the ad-hoc and relatively uncoordinated commodity and currency strategies of the past have left us underprepared for the higher uncertainty we face.” In the recent article, “The Great Debate: Inflation, Deflation, and the Implications for Financial Management”, our Deloitte colleagues debate the direction of the economy and propose recommendations in times of uncertainty.²⁰ Our colleagues emphasized the importance of agility, and recommended a number of strategies, that include “monitor[ing] changes in inflationary expectations” and increasing “diversification along a range of dimensions: funding sources and maturities, currency exposure, and manufacturing and selling destinations.” In an environment where consumer product companies are expected to have a solid grasp of commodity prices and volatility, any sign of unmanaged commodity volatility can have severe repercussions. Assign to the Chief Financial Officer.

Structural strategy 4. Consider tasking BRIC+ countries with developing products and technologies for the developed world. Greater income bifurcation, rising costs, and price sensitivity have led some consumer product companies to look to developing economies for products that appeal to low-end consumers in developed countries. Companies have been thoroughly scanning their emerging markets product and technology portfolio for

lower-cost or more convenient innovations that appeal to consumers in the United States, Western Europe, or Japan. These products — by design and necessity — often have favorable cost structures and improvement trajectories to better meet consumer needs. Who better to task with developing the next generation of products for low-income consumers? Assign to the Chief Technology Officer or Senior Vice President of Research & Development.

Stress test: Know your existing business models breaking point via stress tests. Each of the four structural strategies discussed above has direct implications to the business model. While the profit margin squeeze is testing the viability of current business models in many companies, brands and products, any further exacerbation of commodity price and consumer frugality trends may actually break existing models. Consumer product companies should consider stress testing their business model to understand the breaking point, and to identify opportunities to revamp the business model. For example, the following questions might inform your stress tests:

- What would your company do if commodity costs doubled and half of your consumers demanded a 20 percent reduction in price?
- What business model(s) and corresponding cost structure would you need to profitably serve this consumer base?
- How would this change your relationship with consumers, suppliers and retailers?

How do you respond quickly to meet the challenge and find advantage in this environment?²¹

In addition to the scenario of the margin squeeze intensifying — where price sensitivity and commodity inflation increase hand-in-hand — it would be effective to look at how to profit if there is a mutual easing of commodity prices and consumer frugality. And finally, it would also be valuable to prepare for mismatches in supply and consumer trends to profit from transient opportunities to pass on increased costs if consumers become less price-sensitive or drop prices quickly for price-sensitive consumers if commodity prices fall. Assign to the Vice President of Strategy.

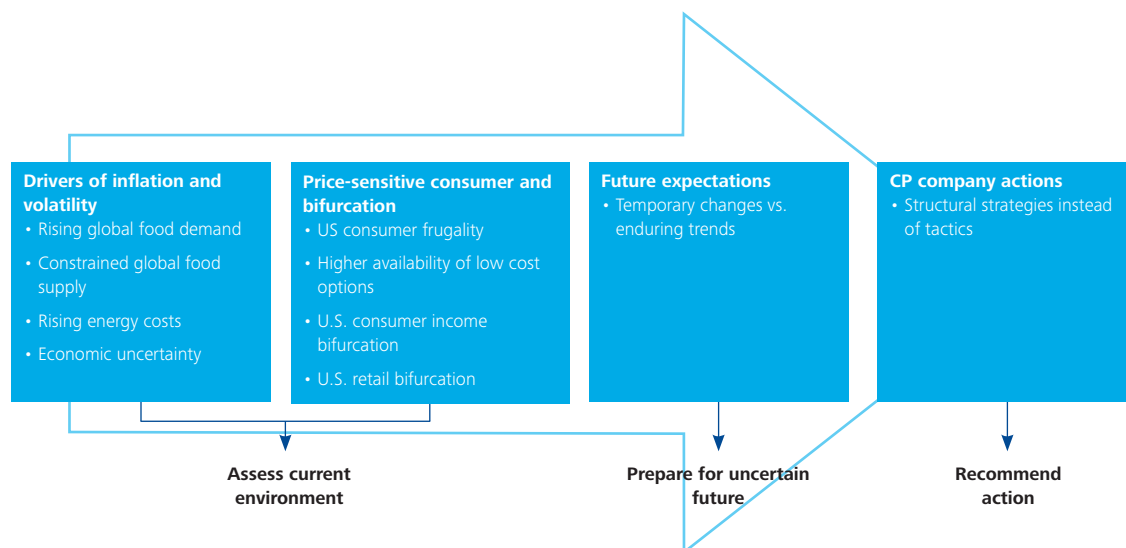
²⁰ Carl Steidtmann, Dan Latimore, and Elisabeth Denison, *The Great Debate: Inflation, Deflation, and the Implications for Financial Management*, Deloitte Review, 2011

²¹ Ibid.

Final words

The bottom-line of consumer product companies continues to be squeezed by rising supply costs and a price-sensitive consumer. Those consumer product companies that view these supply and consumer changes as enduring and embark on structural strategies may gain a tremendous competitive advantage, as structural strategies can improve a company's resilience to changes and provide flexibility in responding.

Figure 19. Developing structural strategies for an uncertain future



For the CEO, we have four approaches to structural strategies and an important stress test. First, consider revamping products and brands at the extremes. Second, consider re-fragmenting your supply chain; move upstream and downstream. Third, consider game planning hedging strategies for the future — all of them. Fourth, consider tasking the BRIC+ countries with developing products and technologies for the developed world. And a stress test: know your existing business models breaking point to prepare for scenarios where the margin squeeze tightens its grip on your business.

An aggressive and pragmatic approach to structural changes across Operations, Marketing, Finance, R&D, and Strategy, would ideally be CEO-driven and extend well beyond incremental stop-gap tactics. The typical approaches are temporary mitigation tactics that help a bit, but often fall well short of a systematic approach across functions. Furthermore, factors to keep in mind when developing structural strategies to address the margin squeeze include: the increasing consumer bifurcation in the United States: the rising income divide between the top quintile of consumers who are thriving even in this environment, and the bottom quintile who are struggling to keep up. As a result of the increasing gap, consumer product companies should consider pursuing unique marketing, product, operational, and business strategies at the low- and premium-end of the consumer market.

Case study – Package size

In response to the profit margin squeeze, food product manufacturers are using a range of tactics to maintain margins, including reduced package sizes.

Deloitte recently surveyed 2,000 U.S. consumers to assess the impact of shrinking package sizes on purchase behavior and measure consumer awareness of these changes. Most surveyed consumers (74 percent) believe that the sizes (in ounces) of some packaged foods have decreased.²² Furthermore, nearly half of the respondents (46 percent) who notice the decreasing sizes of some packaged foods feel that this trend is changing their buying behavior.²³ Consumers who believe that package sizes have decreased and have modified their shopping behavior are resorting to the following shopping tactics:²⁴

- 64 percent look for lower priced brands, including store brands
- 53 percent switch to brands that retain the package sizes of their original product choices
- 33 percent buy products in bulk.

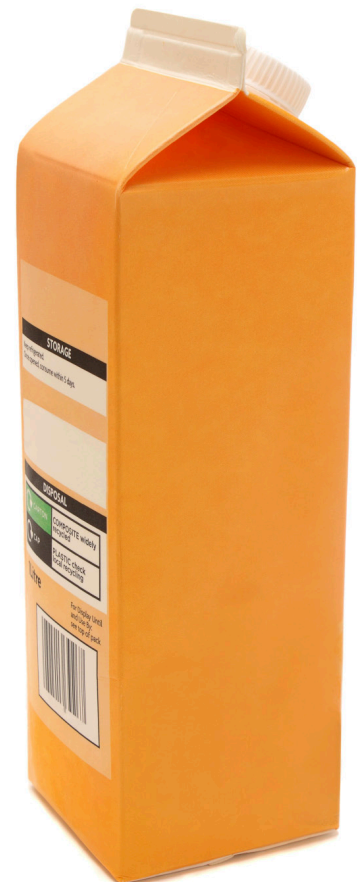
In addition to changing their shopping behavior, many consumers are unhappy about smaller packages that are not accompanied by a reduced price. Surveyed consumers spoke in no uncertain terms:

“I hate the smaller sizes that disguise price increases”

“I think that companies that put less food into packages and charge the same prices should have to tell the consumer that they are doing it”

On the one hand, consumer product companies trying to maintain margins in an environment where input prices are increasing should note that smaller package sizes could drive consumers to store brands, other national brands, or to bulk purchases. Furthermore, stealth reductions in package sizes may alienate previously loyal consumers. On the other hand, in an interview with a food brand manager discussing a recent package size that reduced the number of ounces over 15 percent while maintaining the same price stated that “consumers complain about packaging changes, but they still buy for now.”

How long can consumer product companies expect this to last?



²² Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=2,000

²³ Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=1,480

²⁴ Deloitte 2011 Consumer Food and Product Insights Survey, May 2011, n=676

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