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Integrated Research

WELLS FARGO SECURITIES

Trade Promotion Insights Takeaways

Food
Beverages
Food & Drug Retail

- **We Hosted an Investor Call with Kurt Jetta, CEO of Tabs Analytics.** Dr. Jetta noted the macro pressures weighing on consumer packaged goods (CPG) consumption over the past five years, but also highlighted the bifurcation between larger firms (65% of CPG sales) where growth has decelerated, and smaller firms (i.e., less than $50MM in sales) where growth has accelerated. Dr. Jetta stressed that the underperformance of large companies tends to be self-inflicted, with poor trade promotion strategy and execution being the leading factors. Demonstrating a strong positive correlation and causation between trade promotion and sales, Dr. Jetta suggests that increasing trade promotion can significantly influence top line growth. As such, trade promo should be viewed from three angles: (1) as a driver of baseline and incremental sales; (2) as a barrier to entry against smaller firms; and (3) as a "cost of doing business" with retailers. **Net, an argument can be made for *increasing* promo expense, rather than *reducing* promotions, which is the strategy having taken root across CPG.**
- **U.S. CPG Sales Are $750B; Promo Is a $150B Bucket Essential to Sales.** Of the total trade allocation, 30% is spent on inventory load/forward buying and 70% is shifted directly to the consumer in the form of lower prices. TABS' analytics indicates that nearly all consumers exhibit at least one deal-seeking behavior and 35% use at least five deals. Deals are fundamental to how consumers shop and, as such, more deal activity yields higher sales. Further, consumers aren't trained to "buy on deal" as often as is commonly perceived. By contrast, trade promo provides a way to reconcile the various perceptions of a product's worth, held by manufacturers and consumers, to close a sale. Consequently, a reduction in trade promo can have negative implications for base and incremental sales.
- **Trade Promo Exhibits a "Riskless Arbitrage" That's a Barrier to Entry.** Manufacturer scale, goods with high baseline sales, high response, and high margins reduce the fixed cost hurdle rate required to cover the cost of a promotion. These characteristics place smaller manufacturers at a competitive disadvantage and, as such, larger firms can deploy trade promo as a barrier to entry, a particularly salient observation given the broad pressure from small companies and new entrants gain share across CPG. Net, larger firms are overlooking this differentiated competitive advantage and it raises questions as to the logic of reducing promotion when share is being ceded to new subscale entrants.
- **Traditional Promotion Methods Remain the Best Approach.** TABS' analysis suggests that "everyday low prices" and circulars are the most effective promo tactics, with 59% and 41% of consumers using such mediums. By contrast, newer approaches including loyalty cards (36% and three consecutive years of decline) and digital coupons (31%) are less effective. It suggests that tried and true, traditional approaches remain best.
- **CPG Focus Is on Millennials, But Households with Kids Are the Largest Buyers of Consumables.** Manufacturers have elevated the importance of Millennials and adjusted their marketing approach, but households with children are actually much larger buyers of consumables (38% vs. 24%). Further, the heightened focus on Millennials may have also caused some slippage in purchases by households with kids over the past two years (down from 47% in 2013).
- **Online Grocery Potential May Be Limited.** TABS has found that the online share of consumables is 1.2% and of the 33% of adults purchasing online, loyalty is limited at 12%. It compares to a worst-in-class bricks and mortar loyalty of 66% and only 4% of consumers purchase online regularly.

Please see page 20 for rating definitions, important disclosures and required analyst certifications
All estimates/forecasts are as of 04/21/16 unless otherwise stated.

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Together we'll go far

Kurt Jetta, Ph.D., is the CEO, Founder, and Lead Product Developer for TABS Analytics*. TABS Analytics is a technology-enabled retail and consumer analytics firm founded in 1998. Dr. Jetta is the inventor of analytics innovations including TABS AccuBase, TABS ProfitMaster, and TABS RetailWorks. These tools are widely used in the consumer and retail products industry. Prior to TABS, Dr. Jetta was the CEO of Binky-Griptight, a supplier of baby accessory products. Dr. Jetta is a member of the Board of Directors and Chairman of the Audit Committee for JM Global Holdings (NASDAQ: WYIGU) and the Director of the Research Unit of the Economics of Consumer Marketing at Fordham University's Center for International Policy.*

Executive Summary

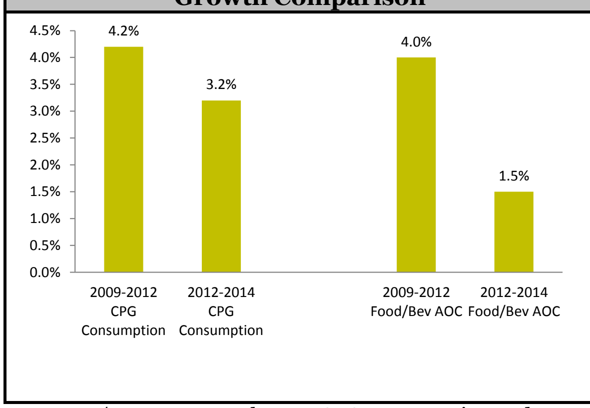
A contrarian view: reduced trade promotion is a leading cause of soft CPG sales. Manufacturers and retailers are guilty of suboptimal execution and an increase in promo spend may be required to recharge industry growth. Causation has been found to exist between trade promotion and retail sales, benefitting the baseline and driving incremental purchases. What's seemingly a straightforward approach in appealing to consumers' fundamental need for deals has been overcome by an increasing focus on full revenue sales by manufacturers. The reduction in trade promotion has been associated with a fall-off of incremental sales and softer baselines. Net, it may be in the manufacturer's best interest to promote <u>more</u>, rather than <u>less</u>, given the positive correlation with sales, the ability for trade promo to act as a barrier to entry, and to preserve share of shelf as a cost of doing business with retailers.

From the retailer's perspective, the shift to loyalty cards has been met with muted incremental sales on deal. By contrast, the traditional approaches such as "everyday low prices" (EDLP) and circulars remain most effective in driving conversion. Dr. Jetta advocates for a renewed emphasis on traditional promotions and often, a larger promo spend rate, as helpful to end the five-year sales malaise having affected the consumables industry.

CPG sales growth has slowed. Increasing trade promotion may be essential for a recovery. During 2012-14, CPG consumption growth decelerated by 100 basis points (bps) relative to the 2009-2012 compound annual growth rate (CAGR), and growth slowed by a sharper 250 bps for food and beverage. TABS has found that all consumables categories are highly elastic and sales grow exponentially with an increase in discounts. On average, sales tend to increase by 20% when on deal and it crystallizes the phenomenon that deals are an integral component of the CPG industry. The largest CPG firms make up the bulk of trade promotion spending and with promo spending being dialed back in recent years, the aforementioned softening of sales appears to be partially self-inflicted (macroeconomic issues explain the other variable).

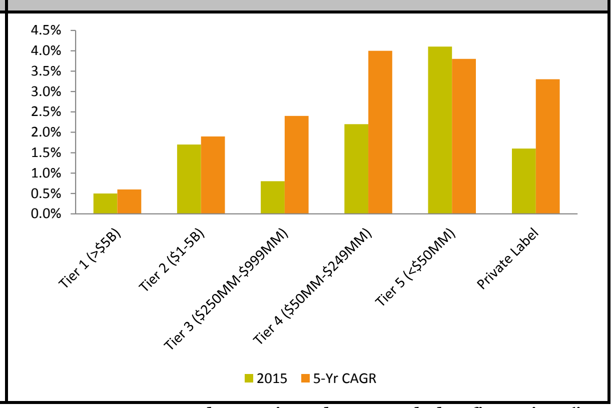
Exhibit 1. U.S. Consumer Packaged Goods Growth has Slowed; Smaller Firms Outperform

Measured Channel CPG and Food/Bev Growth Comparison



Note: Yr/yr percentage change; CPG consumption and food/beverage AOC channel sales
Source: TABS Analytics, Wells Fargo Securities, LLC

Sales Growth History by Firm Size



Note: percentage change in sales growth by firm size (in terms of sales); 2015 yr/yr and five-yr CAGR
Source: TABS Analytics, Wells Fargo Securities, LLC

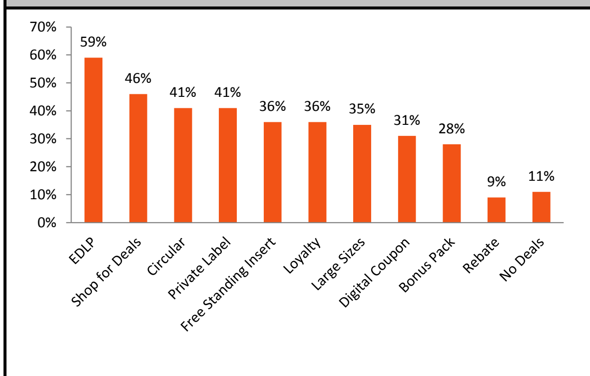
TABS' research has found that traditional trade promo methods remain the most effective and despite the shift in recent years to digital couponing and loyalty cards. This has triggered a "discouraged deal shopper" phenomenon wherein a noticeably higher percentage of consumers are not participating in any deal (11% in 2015 vs. 7% in 2013). EDLP resonates best with consumers (59% of survey respondents), and this is followed by shopping for deals (46%) and usage of the circular (41%). Even in the case of EDLP, however, promotion is required to meet the deal seeking that is a fundamental human behavior. This dynamic is demonstrated by the strong positive correlation (0.9) between the number of "active" deal tactics used by consumers and the share of total purchases by a given buying group. "Active" deals are those that require some degree of activity by the consumer to claim the deal (coupon clipping, etc.). Overall, 14% of consumers drive 31% of consumables purchases and the capture of such heavy users is essential for driving consumables growth.

Yet "new age" programs don't resonate as well. Loyalty card users are regarded as among the least loyal consumers to shop in a given store and Dr. Jetta has observed a "desert of despair," in which muted promotional lifts have emerged at retailers having shifted exclusively to loyalty card-only programs. In terms of digital couponing, the smaller degree of effectiveness can be viewed as a result of low e-commerce penetration (1.3% share). Only one-third of adults shop online for groceries and only 4% do so with regularity.

Net, Dr. Jetta views existing e-commerce grocery initiatives a low potential distraction. E-commerce features a low 12% loyalty and it's approximately one-fifth of even the lowest-rated bricks and mortar grocery retailer (66%). Net, the grocery industry may be better served by concentrating more focus, energy, and trade promo on traditional bricks and mortar, at least until the e-commerce demand pull from consumers increases.

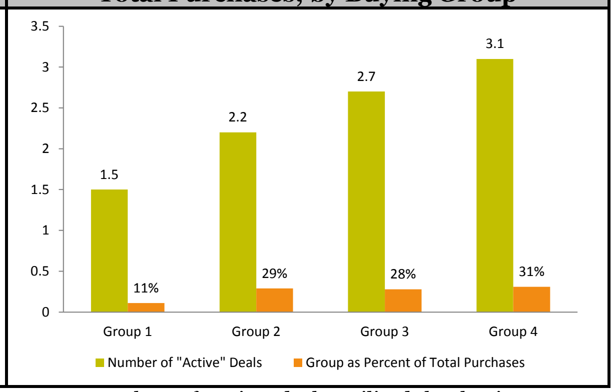
Exhibit 2. Traditional Promo Methods Remain Best; Heaviest Buyers Are Active on Deal

Percent of Consumer Use: Deal Type



Source: TABS Analytics, Wells Fargo Securities, LLC

Active Deal Tactics Utilized and Percentage of Total Purchases; by Buying Group



Note: Number of active deals utilized by buying group (requiring an action by the consumer to capture the deal) and percent of total purchases by buying group
Source: TABS Analytics, Wells Fargo Securities, LLC

Promo is a barrier to entry; CPG execution doesn't leverage this competitive advantage. Larger companies possess the resources to be much more efficient around trade spending and analytics. In addition, the trade promo hurdle rate is inversely related with average weekly revenue; and once that hurdle rate is cleared for lift on promo, it locks in a riskless profit for the manufacturer. As smaller companies lack the scale to appropriately compete, trade promo can be wielded as a barrier to entry, in addition to benefiting the baseline and incremental sales of the manufacturer deploying it.

What's disturbing to us is that this approach is contrary to that which is currently employed and, as such, the largest Tier One CPG manufacturers are reducing or ignoring an otherwise impactful barrier to entry. Current practice entails manufacturers seeking to lift sales by minimizing the degree of subsidies to base sales, but at lower discounts, there are also lower lifts. Absent the enforcement of the promo barrier to entry, CPG winners are dictated by those who can innovate the quickest and by those who are the most nimble. These are areas in which Tier 1 firms have been far out-executed by small- and midsize firms, in our view.

Further, trade promotion is viewed as a necessary cost of doing business. As retailers own the real estate and shelf space, they also maintain the leverage and particularly in an environment where consumers are actively seeking alternatives to branded leaders (niche manufacturers, natural/organic private label, etc.). Given the strong correlation/causation between trade promo and sales, a reduction in trade promo that results in lower baseline sales renders the product vulnerable to discontinuation or shelf space reduction to other competitors more willing to promote.

Transcript

John Baumgartner: Thank you everyone on the line for dialing in. I'm John Baumgartner, Senior Food Analyst on the equity side here at Wells Fargo. I'm joined by my colleagues Bonnie Herzog, covering Beverage, Tobacco and Convenience Stores, Zack Fadem, covering Food Retail and Food Distribution, and our fixed income counterparts, Bryan Hunt and Todd Duvick, covering high-yield and high-grade on the consumer side, respectively.

This afternoon we're pleased to present Kurt Jetta as our guest speaker on trade promotion. Kurt is the CEO and lead product developer for TABS Analytics, which he founded in 1998. His analytics are widely used in the consumer products and retail industries and prior to TABS, Dr. Jetta's experience includes time spent as CEO of Binky-Griptite, a supplier of baby accessory products. Dr. Jetta is also a member of the board of directors and chairman of the audit committee for publicly traded JM Global holdings and the Director of the research unit of the economics of consumer marketing at Fordham University Center for International Policy, where he also received his PhD in economics. I'll turn it over to Dr. Jetta.

Kurt Jetta: Thank you John and thank you to Wells Fargo for inviting me to present to everyone today. I wanted to just give you a little background information on how you can contact me after this. You can see from the deck that you received my phone number, my e-mail address, my Twitter handle is on those decks, and I also have a note about additional content.

During this presentation, you'll see and hear data and claims that may in your mind, or in your view, seem unsupported or there wasn't a lot of background on how we got there. Everything that you see here has some precedent of being substantiated in some of the webinar content at http://webinars.TABSAnalytics.com For example, when we talk about the strength of the cause-and-effect relationship of promotional activity and sales, that will have been one page of a 10-page thesis that was built up with several data sources.

The conference today is called "Trade Promotion," but I expanded that name to be "Trade Promotion and Other Misguided CPG Paradigms." The reason I've expanded that is because there is actually a broader thesis that we've been working under for the last several years, and trade promotion is the prominent one, but not the only misguided paradigm. The broader thesis is that the majority of the weakness, the historical weakness in the consumer packaged goods industry, is self-inflicted wounds. Primarily, they're self-inflicted by the largest companies in our sector.

As I said, trade promotion is the No 1 element of that misallocation of resources and based on failed and flawed paradigms. If you look at slide two, I'm not disputing the fact that there is some macroeconomic weakness in the industry. You can see that just in personal consumption, it's declined over the last several years, and our industry overall, the food and beverage has decelerated at a rate greater than overall personal consumption.

The universe that's tracked in Nielsen is down even more, so we're talking annual growth rates of 1.5%. The majority of that reason, in our analysis, suggests there's a major substitution effect at play. Where consumers, primarily driven by Millennials, but not exclusively, are shifting their purchasing preferences toward entertainment and electronics and away from not only consumer packaged goods, but even more prominently, apparel. I'm sure many of you have read about the pain being inflicted in that sector. It really has to do with this macroeconomic shift in consumer preferences, but that's still the minority of what we're seeing and the reasons why there's the decline.

The biggest piece of evidence supporting that is what we would look at on page 3. If we bucket the size of manufacturers in our industry from one to five, largest down to the smallest, and this is all based on Nielsen all-outlet retail sales, so Tier 1 we're defining as $5 billion plus, in what we'll call a general market channel. They're 36% of sales and look at their growth rates; and this is over the last six years, compounded annual growth of 0.6%, which is virtually anemic. And that is, in and of itself, the biggest drag on our industry because that's 0.6% in dollars. On a unit or volume basis, it's actually flat to down slightly.

You can see these three largest tiers account for almost two-thirds of sales and that's where the growth is the lowest. Now if the majority of the declines or the weakness was from macroeconomic factors, we would expect more or less an equitable distribution of the growth rates based on company size, but clearly based on this, we don't see that. The growth is really being driven by Tier 4, Tier 5, and then private label, as well. And really it's that Tier 4, even more than what you see written about private label, that's the biggest growth area of our industry.

Now, you'll hear me talk in shorthand when I refer to Tier 1. Really, that's the overarching description I'll provide to large multinational consumer packaged goods companies. We're talking Kellogg, General Mills, ConAgra, Procter & Gamble, J&J -- those types of companies. You can see the historical growth rate over the last six years is 2.2%. One other thing is, now, based on our estimates and with the help from Gartner, it's a $750 billion industry and roughly 20% of that is on trade, which is a huge number – that's $150 billion just spent on trade promotion. That is allowances or just the transfer of money from manufacturers to either distributors, or/and retailers.

What we are not referring to, on page 4, is the part of trade spend that is forward buying or inventory load. So we're talking about -- I need to make the end of the quarter, I'm going to give our grocery retailer an extra 10% if they buy X percent more than they bought last year. That's a pure inventory load and we can actually see that graphically here. If we look at this, it is a classic diverter situation where the retailer is buying way more than is being sold to the consumer. The light blue is weekly shipments.

There are four of those weeks that are higher than any week of retail sales and you continually see this kind of load situation in the light blue. If you look at the bottom graph, that's if you assume that none of this was diverted, it would be this massive increase in days of supplier inventory held by the retailer, which we know is not the case. That is a whole separate issue that is really more of a financial and managerial control issue and, based on our loose estimates, we're estimating about 30-40% of the trade dollars are going to that.

What we're referring to are the discounts that are going directly to the consumer, that the consumer now can buy products at a lower price than they normally purchase them. Why that is so important is if we go to page 5, where this data comes from is from an annual survey of the consumer consumables industry, which would be candy and salty snacks, and soft drinks and ice cream, and cereal. Fifteen different categories that are kind of the bread-and-butter, the bellwether of our industry, accounting for about 20% of sales. They're huge companies such as Mondelez, General Mills, Pepsi, and Coke and all the big Tier One manufacturers that people typically think of.

What this chart shows is how many, out of 10 deals that we asked consumers to think about, did they agree that they utilized regularly to get deals? Almost everybody has at least one deal-seeking behavior and 35% of the respondents use at least five deals. When we talk about deals, it's not something you can train consumers to get off to any great degree because it is just such a fundamental way that consumers shop. They have an arsenal of tactics that they're using from everyday low-price to circulars to bonus packs, etc.

An interesting phenomenon that we've identified is what we call the "discouraged deal shopper" phenomenon. There is a noticeably higher percentage of consumers not participating in any deals, so that number went from 7% to 11%; but that still means 89% of these consumers use at least one deal tactic. And there was a 20% decline in those using at least five deals, which we would consider to be heavy deal shoppers.

If we go to page 6, that shows what kind of deals we're talking about, and this list has been fixed for the last three years that we've done this study, always in August of the year. Across the board, everything in red is decreases in the number of consumers reporting they use these deal tactics. You can also see EDLP is the No. 1 deal tactic, which is the big explanation of why Walmart does so well. But there's also this big, other arsenal of these tactics consumers use.

One of the big things we point out quite a bit is loyalty cards; and that is really one of the fundamental issues that's facing the industry; this big shift that retailers and manufacturers are making, not only to loyalty cards, but to digital coupons. We see retailers, such as Kroger, which has been doing loyalty for quite some time, but a big increase in digital couponing, Walgreens, CVS, Meijer – that's four of them right there and enough of a critical mass that there's been this material change in the way promotions are executed because the old school tactics are still the most preferred. That's Sunday circulars, free-standing inserts, and buying private label.

Shopping for deals; this is consumers saying "hey, I actively changed my store to get the best deals." The whole notion of a loyal shopper is somewhat misguided. I don't have the page here, but what we show is that loyalty card users are actually among the least loyal consumers that shop in any given store. As I mentioned at the beginning, we build the case that it is a cause-and-effect, it's not correlation; and this is based on survey data that will then corroborate with syndicated scan data -- more deal activity yields higher sales. We see these dynamics for every sector that we've looked at. (Slide 9) shows Tier 1 through Tier 4 on a buyer basis, the lightest to the heaviest buyers, and it shows what percent of the purchases they account for.

For a Tier 4 buyer, that's 14% of the buyers doing 31% of the purchases; and if we look at the average number of active deal tactics that they use, you can see from the green line a very strong relationship. The "active" is that the consumer actually has to do something to get the deal. They have to clip a coupon or read the circular. The "passive" is I show up at the shelf and I get the deal. I buy a private label, it's at an everyday low price, or it's a bonus pack, etc. You can see that the explanatory power of passive tactics wears out going from Tier 3 to Tier 4; but those active tactics still hold a lot of explanatory power on why heavy consumers are heavy consumers. Much of it is driven by deal offers and activities in that whole deal-seeking behavior.

On Slide 8, this is what that looks like in reality. This is three years' worth of weekly sales data at a major food retailer on ice cream. Notice this pattern where they're doing two weeks on, two weeks off of bonus -- of buy one, get one free in their circular, usually complemented with displays. The big notion, and here's a big flawed paradigm of trade, is that, "oh well, I just offer these deals and I'm training consumers to buy on deal, or I take them out of the market, or I just pantry-load them."

What we can see is that when I'm off of deal, those sales are going pretty close to baseline. This is about as predictable of cadences as you can imagine. So you would expect the consumers will time the deals and only buy on deals, but clearly that's not happening; 80% of the sales of this brand are incremental. And what we'll show in a couple of pages is if they went away, those sales would go away entirely. We don't train them to then buy on full revenue. What's happening is these products aren't worth full price, but this is the price that's worth it for consumers to buy more and use more.

There's also the flawed paradigm perceived mainly by manufacturers, and retailers to a lesser extent, that the consumer is just switching from one brand to another and it doesn't grow the category. On slide nine, let's flip to something that is the definition of non-expandable consumption, adult incontinence. These are three brands, one being private label, where 80% of the weeks at a major drug chain, over 52 weeks, were promoting at significant-enough levels that you see this big incremental spike in sales. You also see the baseline of sales go up over that time. Not only are we not diluting the baseline, the baseline is actually being enhanced over that time, so again, another flawed paradigm.

What happens if I take them all away and take away those deals? We have the cliché, on slide 10, of taking your consumer "off the needle"; you're just addicted to promotions. Again, we're only talking about the discounts going to the consumer. Here's a major juice brand, at a major food retailer, that decided early in the year to get totally off of promotions. Notice how the baseline declined 19% over that time. So what happened is some of the marginal items didn't have that incremental volume to stay afloat, so they were discontinued. They also lost some prominent shelf position just because there were other manufacturers that are more willing to promote.

This is JCPenney on a micro scale. This is one brand and in one retailer, but we saw retailer JCPenney totally go off promotion. This is basically what happened. Their incremental sales went down immediately and their baseline sales deteriorated fairly significantly over a two-year period. We also recently saw that at Jos. A Bank and Men's Warehouse. We see empirical support for a lot of these theses we're putting forward.

On slide 11, there's no ambiguity in the data. We see what happens to sales when we switch over, cold turkey, to these loyalty card-only programs. We call it the "desert of despair." We get these big nice incremental lifts you see at the beginning and then there's no question, no ambiguity, on when they went over to loyalty cards. So the lifts become much more muted and the offers were somewhat similar.

There's a webinar where I provide some notion as to why loyalty cards aren't working. Look at the sales results, year one versus year two. Total revenue for the manufacturer was down 8%; baseline actually came up a little bit (+3%), but it's all based on their incremental sales down 49%. We see that time and time again. I could give you tens of thousands of instances.

On slide 12, here's an example where the retailer had the old school display and reduced pricing; we call it temporary price reduction. They went to the loyalty card offers through digital couponing, the double whammy of "desert of despair" and a total air ball on digital couponing. They realized that they were underwater and went back to the display and reduced pricing. So we sandwich good promotional practices with bad promotional practices.

Based on our estimates, also during this desert of despair, their spend rate actually went up quite a bit. A lot of that is because the manufacturers in these types of offers are now covering the entire subsidy. Before, under the old traditional way, there was a shared pooling of the discounts. That is not so much the case anymore.

If we know that there's this fairly predictable increase in sales from certain types of promotional performance and through my doctoral thesis, which was called, *A Theory of Retailer Price Promotion Using Economic Foundations,* we identified what's called an arbitrage opportunity condition, i.e., riskless profits. I won't take you through all of the details, but basically what this does is provide a mathematical formula of a hurdle rate that a brand needs to achieve, as far as sales lift on promotion, to guarantee lift with riskless profits. If they generate more sales than the hurdle rate, it's riskless because no money comes out of pocket until the consumer pays for the product and then all the value chain, the supply chain gets paid after that.

This is totally contrary to the way manufacturers now are operating. Their idea to lift sales is that you're minimizing how much of the base sales you're subsidizing, but when you go to lower discounts you have lower lifts and therefore, more subsidy to products you would've sold anyway at full revenue. That's the basic concept.

On slide 14, I also talked about other misguided paradigms, and all of these are close cousins because there are people wishing or trying to be a futurist, or knowing what's best for the consumer versus actually looking at the data. Based on our survey methodology, which we've corroborated with other data sources to ensure accuracy, e-commerce share of consumables is flat and it has been for the last three years. Again, we're using consumables as a proxy for grocery.

You can see that we have (e-commerce) share that we're estimating, of total occasions, of about 1.3%. That's important because you can see how much of the effort and how much of the discussion in our industry is against online grocery, when really it -- at this point – it's just a distraction. The bigger issue, obviously, is that whole trade promotion bucket. Even if we want to look at where there are channel opportunities or risks, discount grocers like Aldi present a bigger risk to most manufacturers because most of that volume is private label.

On slide 15, in fact, there's just this general fallacy of e-commerce potential because first of all, most people don't buy online for grocery. In fact, two-thirds do not; 34% purchase online, but the most important statistic is only 4% buy regularly and that's abysmal. That's what we call a 12% "stated loyalty." For some context, 95% of consumers buy in grocery and 34% online, so there's just a much bigger gap of penetration.

The average number of trips (for consumers) to grocery stores is about 40 per year and 26 to their favorite store, to their No. 1 choice. In this survey, we're only defining "regularly" as six times per year, so it's a very low hurdle rate where we define loyalty. The worst in class retailer we found, for brick-and-mortar groceries, is 66%. Online grocery, as a complete channel, is 12%. So you see just this massive gap; and until that is addressed and understanding why, there's just not a whole lot of potential in this channel.

Another misguided paradigm is this fixation we find in the industry on Millennials, just talking about, writing about it, and marketing to them. The biggest target market in our industry is households with kids; and this has been where we've seen some of the biggest declines. On slide 16, what we're looking at here is what percent of the buyers of each of these demographic groups are what we consider "heavy buyers" of consumables. Look at the decline in household with kids, but are the major cereal and carbonated beverage and other manufacturers talking about that? No, they tend to be talking about Millennials -- again, misallocation of resources, misguided paradigms, and shooting ourselves in the foot.

On slide 17, let's find some other misguided paradigms. First of all, the obsession with organics -- based on our research, 13% of shoppers consider themselves regular purchases of organic drinks and snacks or consumables. Now we know that is much higher for produce; but again; produce is not the majority of products.

Even among the vaunted Millennials, the 18-34 year old group, that rate is 22%. Organic is not a thing in the mass market. Certainly there are niches for it, certainly it has been popular with Whole Foods; but again, Whole Foods is a small part of the country. Of the market, Whole Foods has a disproportionate skew. Their share, that we've measured among incomes of $150,000-plus, is 9%. Their share among all other households is 3%. So they're kind of getting that upscale consumer.

Also, we see diet and low-calorie drinks and snacks. This is not so much misguided as it's just an interesting dynamic. Basically, that whole better for you premise is kind of the consumers aging out. Notice how the highest preference for that kind of buying, diet and low-cal, is 55-plus years old. If you recall from the prior sheets, that is among the lowest target market. So, for the youngest consumers, now there's definitely no question there's a shift toward organic and natural, and all those other things. The question, though, is, is it a big enough opportunity to allocate the amount of resources and time and effort that manufacturers and retailers are allocating into it?

If we look at any data into any category we have access to, which is just about all of them, organic is always at the bottom of the list as far as best-selling items. Now granted, the benefit of organics, for a mass-market retailer to carry, is they have a very high degree of incrementality, meaning the more organic you have that's kind of on a percentage basis, those sales tend to increase linearly. As far as people show-rooming, or researching their purchases online, it's a very small percentage at 6%. Only 11% of shoppers even consider themselves heavy online shoppers; 15% of ages 18-34 and way below at the 65-plus year old group.

But even online, to heavy online penetration overall, and this is for everything, just is not mainstream yet. It's certainly growing, I'm not disputing that, but we're again talking about a misguided paradigm and a misallocation of resources. So with that, I would like to turn it back to John and open it up to any questions or comments anybody has.

John Baumgartner: Thanks. Maybe just to kick it off here for the Q&A, listening to your commentary, clearly some contrarian viewpoints there. In terms of your experience or research, why or what do you think drives your differentiated views relative to some of the more conventional marketing approaches we're seeing in the industry today being adopted?

Kurt Jetta: So, you're saying why – what's with the contrarian-ness?

John Baumgartner: Yes. What drives it? What drives your confidence in the analysis?

Kurt Jetta: Well -- and it's not meant to pick on it, but it's just the most recent and actually the most vocal and probably the most discussion, but it has happened with a lot of other manufacturers. ConAgra just had their conference call, talked about trade and how they're reinvesting in trade. And this is consistent with every manufacturer, retailer, everybody that I've heard from, they talk about trade. They never support it with data, ever. They never show that all these paradigms – you're taking consumers out of the market, you're training the buy on deal.

We're talking dozens and dozens and dozens of conversations, not just one or two. Hopefully you've seen and this is just obviously a very, very small snippet of the data that we've looked at. I've looked at well over 100,000 promotional observations across virtually every category in the store and I haven't found anything that deviates from the fundamental premise that trade promotion is incremental and the formulas are just math. I'm not – it's not magical, the data is available to pretty much everybody, as far as looking at the weekly sales. It's just for whatever reason, people tend to go back to their paradigms and their conventional wisdoms that aren't supported by any data.

Bryan Hunt: If I look at your slide three, you talk about the Tier 4 and Tier 5 companies growing very, very quickly relative to the much larger companies. It's kind of contrary to your theoretical conclusion on page 13, that the very large manufacturer should be taking share because they have the resources to be much more efficient on trade spending and analytics. What do you think is causing this and do you think it also communicates that there is much lower barriers of entry today than there were several years ago?

Kurt Jetta: There are a lot of components, so it's not kind of contrary, it's completely contrary. If anything, (larger companies) should be putting the foot on the pedal and going after this because it is what could be a major barrier to entry, because just by definition, again, it's just math, this expectation of weekly revenue, the average weekly revenue that has to be large to send the hurdle rate low. The lower this is, the higher the hurdle rate is off the lift you need to pay out and so smaller guys can't do that.

As far as the barrier, what it suggests is the Tier 1 manufacturers are reducing or ignoring that potential barrier to entry. Then we get into an issue of who can innovate quicker, who is more nimble? That then defaults to the small and midsize manufacturers that can move things and act quickly, and respond to the consumer much more quickly. They're the ones that have that advantage, that comparative advantage.

Todd Duvick: I appreciate your presentation and your thoughts. One question I have for you is with respect to the standard industry practices and the way companies are spending money for, not only trade promotion, but advertising and marketing in general. One of my takeaways is there might be a lot of waste in the industry. From our standpoint, what do you recommend we look for in terms of the companies that we cover, in terms of smart use of their trade promotion dollars or advertising dollars?

Kurt Jetta: I would say that the tell is when manufacturers talk about, "well we're looking actively at how we spend our money." There have been a lot of complaints that they're getting less impact for the dollar. That's not just a ConAgra thing. I've heard it with Kraft when they were still a stand-alone, Campbell, etc.

The tell is when they say they're kind of looking actively, but there is never a bias toward, maybe we need to actually spend more to make some money versus just cutting out waste and inefficiency. Either is a viable strategy. There are times, for low response categories out there, cough colds would be the classic example. What was interesting about the consumer OTC information I showed was that many of those categories in there are very low response; digestion, which is antacids, cough cold, certain segments of nutritional supplements. So that's the one thing.

Also, when they put the stake in the ground on numbers that they think they can save and the number as a percent of what they're spending is anemically low. I would say that was again back to a ConAgra example. They put in $100 million, which sounds impressive on first blush, but based on not only our estimates, they're probably spending about $2 billion in trade. That number, of what can be saved and reinvested, and reallocated and redeployed, is about $1 billion. I mean, there's about 50% of that.

We haven't seen any Tier 1 manufacturer, on our estimates, actually make money. We've seen a couple breakeven; but the vast majority of them are getting for every dollar that they spend they're generating roughly $0.7 in incremental revenue. So, I mean it also gives you a good model if you use that 0.7. If somebody says, well we think we can cut $200 million out of trade, then multiply that times 0.7 and that's what you want to take off the top line. So there are very kind of consistent formulas that can be deployed to forecast performance with some of these manufacturers.

Todd Duvick: Over the last probably 10 or even 20 years, we've seen considerable consolidation in the grocery channel. Kroger has gotten a lot bigger. Walmart obviously is the No. 1 player. Amazon's getting in. But we've seen pretty consistent consolidation. Do you think that there has been a shift or do you envision a shift in the future, in terms of power shifting increasingly to the retailers, or where are we on that continuum?

Kurt Jetta: The power is very much in retailers and that's why I mean it has been fairly heavy-handed on getting manufacturers to spend with the loyalty programs. The benefit is to the retailers, even though it's not increasing retail sales, and we can see that empirically with very flat same-store sales. Who are the biggest utilizers of the drug channel? We're seeing a pretty significant shift among non-food companies -- a shift of trade dollars to drug. We're not seeing any impact at the top line, but there's a pretty significant impact at the bottom line.

That is – I referred to it earlier as kind of how the deal subsidies and how is each party allocating the discounts offered to consumers? There used to be a much more equitable split on that. Now much, if not all, of the subsidy is going to the manufacturer. On digital coupon, I think it's by definition 100% the manufacturer's picking up.

If you kind of think about an old, let's say $3.99 ad which was 25% off, that 25% discount you would have expected manufacturers would have covered two-thirds roughly and retailers one-third, or maybe half and half. But that's shifted much more to manufacturers. When that happens, retailers are happy.

Todd Duvick: Given that situation, how do the CPG companies gain some of the power back? Is really the only arrow they have in their arsenal new product innovation?

Kurt Jetta: Well, they can get the power back on trade, but they're going to have to abolish some of the paradigms and because there are often -- again, we're talking lots of money being spent – where manufacturers can benefit by spending more. The leverage is, "Look, I'm going to show you a path where we can actually make money with these dollars and I'm going to spend more with you. What I need, in return, is for you to work me on how this deal gets subsidized." That doesn't strike me as a big ask, but I mean there are a lot of institutional barriers to that. Even though you think everybody's rational businessmen, why wouldn't they want to do it, if you have a buyer that's compensated on margin percentage? By definition, everybody has to take a lower margin percentage on sales that are by definition marginal and incremental.

There is that institutional barrier that senior retailers are going to kind of have to get off of if they want to start taking advantage of some of these opportunities. That to me would seem the leverage point. It is so far from a reality because of the well-entrenched paradigms, but we see it empirically in a lot of the client-specific research we do.

Retailer X, not as an overall company strategy, but they were losing money last year, they spent more money this year, and they still lost money. They didn't lose as much and consequently, the marginal profit of the extra spending was actually profitable. That's because they restructured deals.

Operator: Our first question will come from the line of Chris Moffett with Loomis; please go ahead.

Chris Moffett: Thanks for doing the call. I'm curious on your thoughts on why the digital couponing doesn't work a bit better? Is it just that people are trying these applications out and then don't really stick with it? Is there something fundamentally wrong with the idea?

Kurt Jetta: First of all, there's a certain level of online engagement a consumer has to have anyway. So if I'm not a heavy online shopper, I'm much less likely to use digital couponing. Second, there is just the whole shopping and couponing experience, so you don't get the visibility to lots of deals quickly like you do in just your traditional Sunday circular. I can just page through and see all the deals.

Here, I have to page through. I have to describe what department I'm looking for. Some are better than others; but when I talk about these digital coupons not working, I can't emphasize enough how poor they are at generating really any incremental revenue. You see a little bit on page 12; that's about as much as we've ever seen.

The volume of that they're going out is just massive. I don't quite understand why. Even more what I don't understand, retailers and manufacturers should clearly be able to see this, yet they're not really trying to figure it out, which puzzles me to no end.

Chris Moffett: O.K. Thank you.

Bryan Hunt: When you look at price lock activity, it seems like it has picked up momentum with certain retailers where they lock in prices on 800 items, or pick a number, and then they expand that. I was wondering, based on the evidence you've seen, one, are you seeing good elasticity and profitable growth for the CPG companies that participate in this, as well as is there an increased loyalty impact for the retailer when they commit to long-term low prices on a specific product group? Thanks.

Kurt Jetta: We're still looking for the evidence of just one – I'm only asking one, because there have been dozens that have done it – just one retailer where moving to (EDLP) worked. What we typically see is very low elasticity, less than -1.0, which a -1.0 would mean your revenue stayed the same. Profits would go down because more units.

Here we don't even see that. Also, what happens is, not only do the prices get lowered, the manufacturers get strong-armed to lower their prices and the retailers more often than not do not pass through the entire discount. So they actually will tend to make a little margin. From that standpoint, I don't have all that visibility to every single one of those pricing actions obviously, but retailers may not be as negatively impacted as it would imply based on top line results.

Again, empirically, we look at what happened with Wal-Mart trying to double down on all the (EDLP) that they've been doing recently. We can't identify any positive impact that it's had on sales and they're no different than we know. Ahold tried it and Food Lion tried it, and J. C. Penney obviously, Weis Markets -- just keep the laundry list going and we just never find any evidence that that's a good move.

John Baumgartner: One more follow-up for me, just coming back to manufacturers getting the power back and the idea of that – can you maybe expand a bit more on that topic? I think on one hand, you said there's money out there for manufacturers to recover, but on the other hand, it sounds as though there's a need to spend a bit more, at least at the outset, so …

Kurt Jetta: There's a pool of $150 billion out there. Tier 1, 2, and 3 – just even proportional at $100 billion, and we're estimating they're probably more like $110-120 billion of that. That is a big pool of money to try and leverage. It's not even so much getting the power back, it's equivalizing the power and it's not such a bad thing that retailers make money, too, as well as manufacturers. There's also, I think, this fear that – well, and again – it's based all on the paradigm – misguided paradigm that trade is bad.

If they spend more, they're going to "start a price war" and again, I show you that just one example. Again, I could show you thousands of all three bands promoting at high levels consistently and everybody benefits. There was an instance in nutritional supplements where they went the opposite way; they got off and it's just a massively negative impact on the category, on the retailers.

I would think that there would be even almost a little bit more retailer encouragement or trying to find that path so manufacturers can make money because then they would be willing to spend more and retailers would make out more in that scenario.

Operator: Ladies and gentlemen, this concludes today's conference. Thank you all for joining and you may now disconnect.

END

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Life Science Tools, Services, & Diagnostics	
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Managed Care/Ancillary Benefits	
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Medical Technology	
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Specialty Pharmaceuticals	
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Katie Brennan	212-214-8060
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INDUSTRIAL

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Containers & Packaging

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Diversified Industrials

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Shipping, Equipment Leasing, & Marine MLPs

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MEDIA & TELECOMMUNICATIONS

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Telecommunication Services - Wireless/Wireline

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REAL ESTATE, GAMING & LODGING

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Lodging/Multifamily/Retail

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Communication Technology

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Information & Business Services

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IT & BPO Services

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IT Hardware – Wireless Equipment

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Semiconductors

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STRATEGY

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Retail Research Marketing

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