

# Carnegie Consulting

*Strategic Solutions for Business*

Engines for Growth: Opportunities Outside of the  
Traditional RTE Cereal Market

Prepared for:  
The Kellogg  
Company





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## Executive Summary

Over the last century, the Kellogg Company has maintained a leading position in the ready-to-eat (RTE) cereal market, enjoying healthy profit margins and steady growth. However, changing consumer tastes and increased competition within the industry have presented the company with new challenges. The RTE cereal industry has traditionally been divided among the "Big Three" cereal companies. They were able to quasi-cooperate to constrain competition and increase profits. In recent years, this cooperation has eroded and private label, household, cereals have gained market share, increasing the competition within the industry. At the same time, the RTE cereal market has begun to decline because of increasing demand for mobile breakfast options. As consumers move to substitute goods, the RTE cereal market has contracted and competition for the remaining market has intensified. Faced with a declining RTE cereal industry, Kellogg must look outside of its core market to find new growth opportunities.

Carnegie Consulting recommends a framework for Kellogg to diversity into non-cereal markets. Kellogg must leverage its existing strengths in RTE cereal and other breakfast foods into non-cereal product growth. As the first step, Kellogg must develop a culture that rewards profitability over volume and evaluate future and current projects with the bottom-line in mind. This will lay the groundwork for steady earnings growth and establish the criteria for future product introductions. Next, Kellogg must build its brand name into a franchise that represents high quality and healthy products. This will re-establish the original power of its brand name, which has been gradually diluted over the years. In addition, building a powerful, healthy umbrella brand will enable the company to maximize its efforts in the high-margin health food market and the rapidly growing snack market. Lastly, we advise Kellogg to incorporate into its Keebler snack products the same successful marketing strategies used by Nabisco, the snack market industry leader. These recommendations taken together will enable the Kellogg Company to maintain steady earnings growth while reducing its dependence on the weakening RTE cereal industry.

## Company History

The Kellogg Company was founded by W.K. Kellogg in 1906, as The Battle Creek Toasted Corn Flake Company. W.K. Kellogg and Dr. John Kellogg ran the Seventh-Day Adventist sanitarium in Battle Creek, Michigan. In 1894, they invented flake cereal while searching for a way to make whole grains more appealing to their vegetarian clients. They accidentally left a pot of boiled wheat to stand and the wheat became tempered. When the wheat was rolled each grain emerged as a large thin flake. W.K. Kellogg went on to produce corn flakes and establish a market for ready-to-eat (RTE) cereal. Since its founding the Kellogg Company has been a leader in the industry, continuing to be the number one producer of RTE cereals in the world after nearly a century.

Battle Creek Toasted Corn Flake Company's original factory burned down in 1907 and, to replace it, the first building of the present-day Battle Creek Plant was built. *Kellogg's All-Bran Cereal* was introduced in 1915. In 1922 the company was renamed the Kellogg Company after its founder, who died in 1951, at age 91. *Rice Krispies* were introduced in 1928. One of Kellogg's most memorable, and lasting, advertising campaigns, *Tony the Tiger and Frosted Flakes*, was introduced in 1952. Kellogg branched into the toaster pastries market with the introduction of *Pop-Tarts* in 1964. To capitalize on a natural food craze, Kellogg established



its first line of whole-grain flaked cereal, *Nutri-Grain*, in 1981. In recent years Kellogg has made several large acquisitions to diversify its product offerings, buying Worthington Foods Co. (producer of *Morningstar Farms* products) in 2000 and Keebler Foods Company (the second largest U.S. producer of cookies and crackers) in 2001. Throughout the company's history it has expanded all over the world, from its 1914 factory in London, Ontario to its recent plant in Guangzhou, China (opened in 1995).<sup>i</sup>

Chart 1 shows Kellogg's increasing market value (since 1984). Over the years Kellogg's market value appreciated as its revenue base expanded, both in its core market of RTE cereal and in other business segments, such as snacks and cookies. The stock peaked in December of 1997, however, falling on concerns about the company's future earnings growth. In recent years, the market value of the company has again begun to gain ground, as management has refocused on earnings growth and diversified some of its revenue base out of the competitive RTE cereal market.

**Chart 1: Kellogg Market Value 12/17/1984 – 4/5/2002 (\$ Billions)**



Source: [finance.yahoo.com](http://finance.yahoo.com)

The Kellogg Company's brands include **Kellogg's®**, **Keebler®**, **Pop-Tarts®**, **Eggo®**, **Cheez-It®**, **Nutri-Grain®**, **Rice Krispies®**, **Special K®**, **Murray®**, **Austin®**, **Morningstar Farms®**, **Famous Amos®**, **Carr's®**, **Plantation®**, and **Kashi®**. Kellogg icons such as **Tony the Tiger™**, **Snap! Crackle! Pop!™**, and **Ernie Keebler™** are among the most recognized characters in advertising.<sup>ii</sup>



## Summary of Five-Forces Analysis of the RTE Cereal Industry in the U.S.

Force	Threat to Profits
Internal Rivalry	Medium to High
Entry	Low to Medium
Substitutes and Complements	High
Supplier Power	Low
Buyer Power	Medium

### Internal Rivalry

Kellogg is a leading producer in the cereal and convenience foods markets. The firm holds strong positions in numerous product lines within these industries. Kellogg possesses the #1 snack/granola bars, toaster pastries, frozen waffles and veggie foods businesses. The #2 RTE cereal, cookies and cracker positions are also held by Kellogg. Kellogg is currently the 12<sup>th</sup> largest food and beverage company. The firm's SIC code is 2043, cereal breakfast foods.<sup>iii</sup>

The U.S. Department of Agriculture estimates total food and beverage sales for 2000 to have been \$802.3 billion, an 8.4% increase from 1999.<sup>iv</sup> This figure includes \$442.4 billion in products for consumption at home and \$359.9 billion for products away from home. Major changes in the cereal and snack foods markets are driven mainly by changing demographics, i.e. the aging baby boomers and their slowing metabolisms, and a change of life style and dietary habits necessitating quick, easy meals.<sup>v</sup>

Kellogg relies on a widely diverse geographic base for its revenues. Nearly 70% of revenues are generated throughout the United States. Europe and Latin America provide 15% and 7% of revenues, respectively, and the balance is drawn from Asia, Australia and Canada. Kellogg significantly leads its cereal competitors in the international markets.

Some of Kellogg's top competitors include General Mills, Post (subsidiary of Kraft foods), Quaker Oats (subsidiary of PepsiCo), Danone and Interstate Bakeries. Many of these firms compete with Kellogg in only one or two product segments, such as Quaker Oats in the cereal and snack business and Danone in the cookies, crackers and snacks businesses.

The RTE cereal industry has historically been divided among three main competitors, all tracing their history to the turn of the 20<sup>th</sup> century. They are commonly referred to as the Big Three and are comprised of Kellogg, General Mills, and Post. Quaker has been a smaller competitor as well. Throughout the 20<sup>th</sup> century, the RTE cereal industry has grown steadily in size, both in volume and in sales. The compound average annual volume growth rate from 1950 to 1993 was 3%, representing reasonable, but not fast, growth over the years.<sup>vi</sup> This helped to minimize internal competition among the Big Three. Various trends in cereal consumption have fueled this growth of the past century: During the Second World War cereal producers introduced vitamin-fortified cereals; pre-sweetening gained extensive



popularity throughout the 1950s; and in the 1970s and 1980s granola and natural cereals grew in demand.<sup>vii</sup>

The branded RTE cereal industry has been very profitable for the largest manufacturers, with return on assets in the industry routinely in the 15%-30% range.<sup>viii</sup> Over the years this profitability did not attract significant entry into the market and the industry continued to concentrate. In 1972, Kellogg and its two major competitors at the time (General Mills and General Foods) were accused by the Federal Trade Commission of anticompetitive behavior.

Industry experts argued that the Big Three restrained competition among themselves through unwritten agreements to limit methods of competition that would inflate short-term profits at the cost of long term industry profitability. The practices cited were: in-pack premiums (e.g. free toys) were restricted by each company to one brand at a time; trade dealing (i.e. discounts to retailers for special treatment) was banned; and widespread vitamin fortification was limited.<sup>ix</sup> The antitrust suit dragged on for several years and was eventually dropped with the election of President Reagan in 1981. In the meantime, many early entrants into the natural cereal market that had emerged in the 1970s had been crushed by the natural cereal brands owned by the Big Three. The Big Three now face their biggest threat in the private label brands and the increasingly intense internal competition among themselves.

The market has become increasingly competitive over the past decade, with private label sales cutting into the Big Three's market share. Additionally, increasing pressure to engineer growth in a stagnant market has led to more competitive pricing and increasing costs. The traditional unwritten agreements between the Big Three have come under increasing pressure as the temptation to achieve short-term sales growth at the cost of long-term industry margins increases. RTE cereal manufacturers can no longer rely on market-wide growth and have turned to capturing market share to fuel the growth expectations of the equity market.



## Substitutes and Complements

### Substitutes

Substitutes pose substantial threats to profitability and growth in the RTE cereal market. In recent years RTE cereal industry has experienced a considerable weakening in demand, as consumers' preferences, especially in the breakfast market, have shifted towards greater convenience and speed. Over the past decade consumers have moved towards a more mobile lifestyle, which does not include the traditional sit down breakfast. Common mobile alternatives to cereal for breakfast include toaster pastries (e.g. *Pop-Tarts*), health bars (e.g. granola bars, *Breakfast Bars*, etc), health drinks (e.g. smoothies, breakfast drinks, premium juices, etc), pastries (e.g. donuts, scones, etc), and bagels. Even when consumers sit-down for breakfast, they may choose waffles, pancakes, hot cereal, or one of the common mobile alternatives mentioned above.

The substitutes, in both the mobile and sit-down categories, are generally priced competitively relative to cereal and are available from many of the retailers that sell cereal, resulting in minimal search costs for price comparisons. RTE cereal faces competition from these alternative breakfasts at two main decision points, purchasing and consumption. Customers often decide to purchase cereal, but do not consume it regularly because of the various other breakfast options. In order to generate sales, cereal manufacturers must convince consumers both to purchase their goods and to consume them.

The substitutes for the cereal industry currently provide significant pressure on the industry's profit potential. If the trend towards a busy and mobile lifestyle continues, the profit picture for the RTE cereal industry will continue to deteriorate.

### Complements

The RTE cereal industry benefits from lower prices in the milk market. The milk industry is cereal's biggest complement, with the two products intertwined in people's minds. Few consumers eat cereal without milk, making milk an essential part of most consumers' cereal breakfasts. When purchasing cereal, customers often factor in the cost of milk. Juice, especially Orange and Apple, and various breakfast fruits are also complements to cereal. Like milk, they are often a part of a complete cereal breakfast. Additionally, they provide extra incentive for consumers to eat a sit-down meal instead of a more mobile breakfast, which rarely includes cereal (as discussed above in the substitutes section).



## Entry

Kellogg, General Mills, and Post (a division of Phillip Morris) dominate the \$7.6 billion market for RTE cereal.<sup>x</sup> In 1999, these three companies accounted for approximately 84% of all RTE cereal sales.<sup>xi</sup> Due perhaps to the high level of market concentration, profit margins have remained high. However, even with high margins, entry into the branded cereal market has been substantially curtailed. Private label brands of retail chains have made some inroads.

Brand loyalty has provided a significant barrier to entry for potential entrants. Customers in the RTE cereal market historically have been shown to have inelastic demand for established cereal brands. Children are a major consumer of RTE cereal and after watching advertisements for *Rice Crispies* or *Lucky Charms*, children are not willing to settle for generic or off-brand cereals. In addition, adults are willing to pay premiums for established brands due to brand loyalty developed throughout their own childhood.

Initial expenditures required to effectively promote and introduce a new product into the market are quite large. Recent product introductions from Kellogg and General Mills reportedly cost, on average in the first year, \$20 million in advertising alone.<sup>xii</sup> In addition, large manufacturers are able to realize economies of scale in advertising. Larger manufacturers are able to purchase ad space, whether on TV or in magazines, in larger volumes and, therefore, for discounted prices. The advertising for particular brands provides an external spillover over onto other similar, company products, providing some economies of scope in advertising. In the 1990's, companies began to introduce "co-branded" cereals, cereals manufactured by one of the market leaders but relying on the brand name of another product. Examples range from Sulley, the main character in *Disney/Pixar's Monster, Inc.*, appearing on the box for *Kellogg's Apple Jacks* to a *Kellogg's The Power Puff Girls*, a hit cartoon on the Cartoon Network, cereal. The market leaders have additional economies of scope in advertising due to the decreased costs associated with developing a product's individual brand by co-branding it with other existing products.

Beyond the advantages that existing cereal manufacturers have with regard to their existing brands and the economies of scale and scope in advertising, the largest barrier to entry to the market is the huge initial start-up fees associated with building a new plant and establishing product distribution channels. These initial costs are large and dissuade most would-be entrants from entering the market, regardless of the potential economic rents that could be gained from taking advantage of the existing cereals being priced above their marginal cost. The existence of large economies of scale in basically all facets of the cereal industry and the large set-up costs mean that the branded cereal market does not face many potential market entrants. Economies of scale exist for manufacturing, marketing, purchasing, and research and development.

An additional barrier to entry is the common practice among supermarkets and other RTE cereal distribution points to require higher margins from new cereal entrants to stock their brands in the coveted center isle positions. New cereal companies that do not pay the stores a premium receive less-valuable shelf space because space is allocated in proportion to





historical sales. In recent years there has been a strong move by private label manufacturers into the cereal business. Private label manufacturers are often owned by the supermarkets and supermarkets often receive a higher rate of return for them. This creates some incentive for supermarkets to place private label cereal in better self locations to boost sales. Private label manufacturers do not generally engage in promotion or perform extensive research and development. Lower costs facilitate their entry into the RTE cereal business. This advantage so far has not been sufficient to take substantial market share from Kellogg, General Mills, Post and Quaker because these national brands benefit from decades of expenditures on advertising and promotion, building strong brand loyalty.

The market share of private labels into the RTE cereal market has increased somewhat in recent years. By 1999, private-label cereals accounted for over 10% of total RTE cereal sales volume, an increase from less than 3% in 1980<sup>xiii</sup>. This growth in sales of private-label cereals appears to be continuing as chain supermarkets and other increased numbers of retailers introduce their own brands of cereal and other products and distribute them in their stores for a lower price than the branded equivalents. Although, as of yet, the Big Three have been able to maintain their profit margins, continued entry by private label manufacturers would erode their sales and profit margins.



## Buyer Power

The bargaining power of buyers, both retailers and consumers, has become an increasing threat to the RTE cereal market over the past several decades. Prior to the 1970's, the primary purchasers of cereal were small, independent retailers who stocked only what their customers demanded on a short-term basis to fill their stores. Due to the relatively small amount of cereal that each of these small stores demanded, these independent stores were unable to enact any sort of bargaining power on the major cereal manufacturers. Commonly these small retailers didn't even deal with manufacturers. They bought their inventories of cereal from local and regional wholesalers. However, as time passed, the size of retailers grew and so did their bargaining power.

Discount retailers have been consistently gaining market share in recent years. The market strategy of discounters has been to stock goods at competitive prices that are demanded by "value" consumers.<sup>xiv</sup> In order to do this, discount retailers such as Wal-Mart and Food-4-Less buy their cereal in large purchases, store the food in their own large warehouses, and then stock it themselves when necessary demand occurs in their outlets. Given the size of these large purchases, these stores often demand and receive volume discounts.

As a result of merger activity, chain grocery stores have achieved increased concentration ratios, not only in metropolitan market areas but nationally as well. This consolidation gives them the ability to successfully demand discounted prices for volume purchases from companies like Kellogg. In addition, several chain grocery stores currently produce their own branded cereals such as "Safeway Select Cheerios," and can leverage this position into advantageous pricing positions from the Big Three cereal producers.

Kellogg's largest customers, like Wal-Mart, have the power to demand that their suppliers perform work once done by the retailers themselves. For example, in addition to preparing in-store promotional materials, a long-standing practice, Kellogg and other companies are today asked to pre-sort merchandise on pads that can easily be dropped into place in the store.

Even more important, companies like Wal-Mart are now shifting the risk of forecasting their sales and inventory requirements on to their suppliers. Kellogg must provide just-in-time product to such chains. Companies like Kellogg today find that the ability to forecast sales, shipments and inventories to service their largest buyers is now one of the key requirements for success.

## Supplier Power

The bargaining power of Kellogg's suppliers, by contrast, is rather insignificant. The bulk of raw materials Kellogg requires to produce cereal are commodity items such as grains and wheat are available to Kellogg through a large number of both large and small distributors. Packaging companies have little power over Kellogg since there are numerous companies that Kellogg may solicit to fill their packaging needs at a minimal transfer cost if Kellogg's suppliers decide to increase prices.



# Strengths, Weaknesses, Opportunities and Threats

## Strengths

### *Brand Recognition*

The *Kellogg's* brand is one of the most powerful brand names in the world. The brand provides a significant competitive advantage for Kellogg in both its core cereal market and in new product categories, such as snack foods. In a *BusinessWeek* study, released during the summer of 2001, in a comparison of the value of the top 100 brands in the world, Kellogg ranked 39<sup>th</sup>. This is significantly ahead of Kraft, a major competitor in snack food, which ranked 65<sup>th</sup>. None of the other cereal brands even made the list. *Business Week's* analysis was done by InterBrand, a pioneering brand consultancy in New York. InterBrand's methodology was to estimate the present value of the cash flows stemming from the brand to extrapolate its market value. The *Kellogg's* brand was estimated to be worth \$7.01 billion in 2001 although this was a 5% decrease from its 2000 value of \$7.36 billion.<sup>xv</sup>

Kellogg has developed a branding and management strategy that targets growing high profit markets. Because of the firm's success in branding, Kellogg products are able to command higher prices and the firm typically operates at a slightly higher than average profit margin than its rivals in the RTE industry. The prospect of leveraging this brand name in new market segments should prove to be an important strength for the company's near term profitability.

### *In-depth Knowledge of Breakfast Industry*

As the oldest of the Big Three cereal manufacturers, Kellogg has significant knowledge about the RTE cereal industry, both on the consumer and the manufacturing sides. This knowledge base offers the Big Three, and especially Kellogg, a competitive advantage against newer entrants into the market. Kellogg's experiences in the RTE cereal industry and its early entry into many alternative breakfast markets, such as the introduction of Pop-Tarts toaster pastries in 1964, has created an extensive institutional knowledge about the breakfast market as a whole. This gives the company an additional advantage when it expands into other breakfast-type food markets, such as breakfast bars and many natural foods. These new markets are often served by niche players, who lack the breakfast-wide viewpoint of Kellogg.

### *Economies of Scale*

The Kellogg Company, with an approximate RTE cereal market share (by dollars) of 31% in North American and nearly 40% globally, has large scale advantages. Its size reduces the unit cost of production and distribution, especially in bagging production.<sup>xvi</sup> While the other Big Three firms have similar advantages of scale, smaller competitors, especially niche market manufacturers (e.g. health food companies), have difficulty overcoming their scale and scope disadvantages. Scale allows Kellogg to spread its hefty fixed costs, such as advertising and research and development (R&D), over a large volume of sales per item, and across a large number of products and product lines. This is especially true in advertising, where many of Kellogg's products are double-branded. The double-branded products (e.g. *Kellogg's Rice Crispies*) receive positive reputation spill over effects from other products' advertised under the *Kellogg's* common brand. The Kellogg/Keebler combination also gives



the company power to negotiate co-branding licensing agreements, which, for 2002, include agreements with NASCAR, the Cartoon Network, and Disney.

### *Diversified Product Offerings with Economies of Scope*

Kellogg's strong ability to scale into other markets is partially covered in the knowledge section, but additional company advantages augment these economies of scope. Many of the production facilities, advertising campaigns, and distribution methods are interchangeable between RTE cereal and other snack and breakfast-type markets. Kellogg has been able to generate significant synergies by developing a strong presence in the snack, cookie, and natural food markets. They have developed their presence through several large acquisitions and are now the number two player in the cookie and cracker market.

## **Weaknesses**

### *Historical Focus on Volume*

Kellogg historically has focused on volume measures to determine its performance in the RTE cereal market, downplaying product profitability. This has been an industry-wide standard and Kellogg has recently begun to re-evaluate it. Volume performance evaluations distort the company's sales force efforts. For instance, in the past, Kellogg's sales teams concentrated on selling large heavy cereal boxes in order to boost the company's volume figures. To illustrate the divergence of profit and volume measurements one can look at the sale of a 25.5 oz. box of *Kellogg's Raisin Bran* compared to that of a 12 oz. box of *Kellogg's Special K: red berries*. Using indexed prices, the average unit price of the Raisin Bran box would be 100 while the smaller *Special K* box would fetch 114. This yields a profit margin of 125 for the *Special K*, compared to a mere 100 for the larger *Raisin Bran* box.<sup>xvii</sup> Over the last year, management has shifted to prioritizing cash flow and net sales over volume, but the company's product portfolio continues to be burdened by low-return cereals.<sup>xviii</sup> Addressing the historical volume emphasis must be a key element of Kellogg's strategic plan going forward.

### *Limited Financial Flexibility*

Kellogg's acquisition of debt-ridden Keebler caused a dramatic increase in the company's balance sheet liabilities, resulting in credit downgrades and reduced financial flexibility. This has limited the firm's ability to focus on growth opportunities because it must use available cash flows for interest expenses and paying down its debt. This weakness is analyzed in more detail in the financial overview section of this report.

## **Opportunities**

### *High Growth Sectors*

While Kellogg's traditional RTE cereal business has experienced slowing growth because of the industry-wide trends discussed earlier, several of its smaller segments present substantial growth opportunities. This is particularly true for the health food and snack food segments. In 2001, Kellogg's *Kashi* brand of healthy natural foods achieved unusually large retail sales growth (68%). Additionally, last year its *Morningstar Farms* brand, which



specializes in veggie foods, experienced 5% retail sales growth.<sup>xix</sup> These are two of Kellogg's most promising brands and categories for fueling future growth

### *Direct Store Door (DSD) Delivery System*

Keebler's direct store door (DSD) delivery system provides Kellogg with a powerful distribution system to achieve market penetration for many of its snack, cracker, and cookie products. In a DSD system the product is brought into the store by Kellogg employees, rather than being dropped off at retailer's warehouses. The Kellogg's employees rotate the products, monitor and refresh inventories, and set up displays. The Keebler DSD system strengthens Kellogg's presence in both traditional supermarkets and non-traditional channels, such as convenience and gas stores, vending machines, foodservice, club stores, and mass merchandise stores. Kellogg has already begun to distribute *Nutri-Grain Bars* and *Rice Krispies Treats* through the system and during the 24-week period (8/12/01 to 1/27/02) retail sales increased (year-over-year) by 5% and 37%, respectively. Additionally, the DSD delivery system enhances Kellogg's control over how their products are displayed. This resulted in a year-over-year increase in display activity of 134%, during the period, for *Nutri-Grain Bars* and a 126% increase for *Rice Krispies Treats*.<sup>xx</sup> These gains are only the beginning of DSD's potential for fueling Kellogg's growth in the expanding snack market. DSD systems are more expensive than traditional retail channels, but for Kellogg/Keebler the increases in volume have more than made up for the increased cost.

### **Threats**

#### *Private Labels (Household Brands)*

Private label cereals, which offer lower priced versions of Big Three cereals to the consumer, have consistently gained market share in RTE cereal over the last decade. They have been able to take over prime shelf space from Kellogg and the rest of the Big Three because retailers believe they offer higher margins. This is not necessarily true when the costs of warehousing, merchandising, shrinkage and other issues are taken into account, but the perception has been strong enough to garner considerable support from retailer to promote sales of private label cereals at the cost of Big Three revenue.<sup>xxi</sup>

Private labels offer their cereal at around 40% less than the Big Three, creating price pressure for Kellogg and the other major cereal producers. Private labels are able to offer lower prices by avoiding high cost cereals, spending negligible amounts on advertising, and minimizing packaging costs (e.g. some private labels avoid boxes, reducing packaging costs by up to 25%<sup>xxii</sup>). Their continued penetration into Kellogg's core market presents a significant threat to the company's profitability and future growth. Kellogg, General Mills, Post and Quaker must make up for this difference in price by creating brand loyalty through advertising.

Many industry analysts blame the upswing in private label cereal to the high prices and aggressive coupon strategies of the Big Three at the beginning of 1990s.<sup>xxiii</sup> Consumers began to build in the coupon discounts when they priced cereal. This resulted in a widespread belief among cereal customers that non-discounted cereals were overpriced. As shoppers began to rely on coupons for determining cereal purchases (i.e. not buying cereal brands without a coupon), it diminished the brand loyalty and encouraged price sensitive brand-switching.<sup>xxiv</sup> Customers without coupons for their favorite cereal-types turned to private label alternatives. Private labels offered similar product quality to the Big Three and were able to retain many of these brand-switching customers.



### *Continuing Decline in its Core Business Market: Ready-To-Eat Cereal*

As detailed in the internal rivalry section, the RTE cereal market faces significant challenges. Market changes, in both demographics and lifestyle preferences, have slowed growth in the cereal market. This ended the historical growth in earnings that Kellogg had come to expect in its core business segments. It also brought about intensified price competition for market share among the Big Three. Increasing competition lowered operating margins in the sector, further pressuring the company to seek other segments for growth. Kellogg's purchase of Keebler addressed this threat. Kellogg's RTE cereal market's percentage of the company's worldwide revenue fell from 71% in 2000 to 55% in 2001.<sup>xxv</sup>



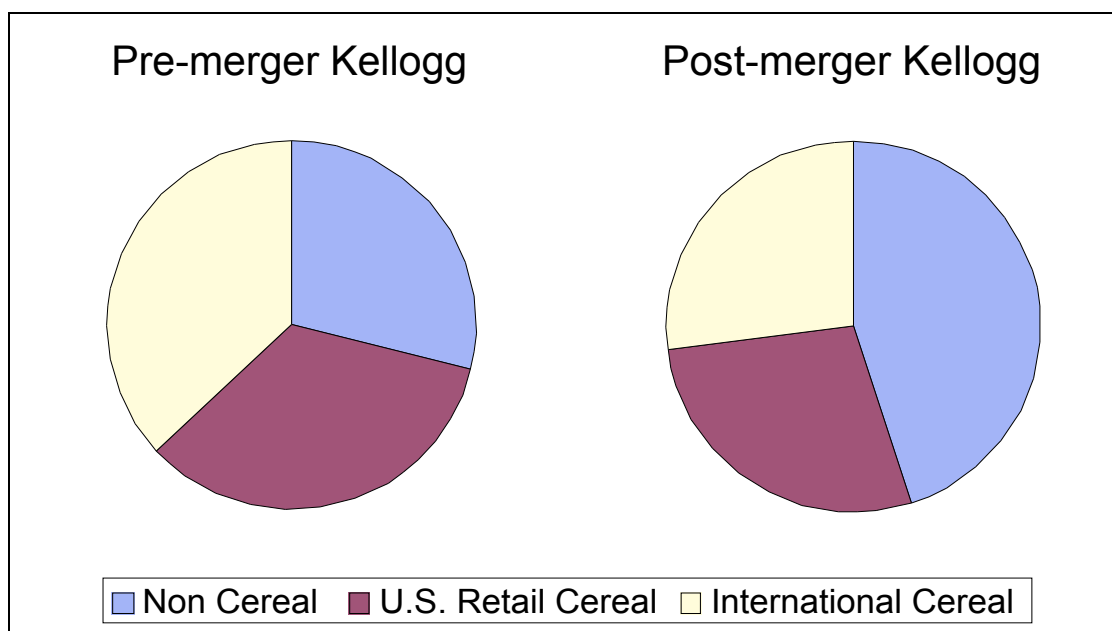
## Financial Outlook

Kellogg has achieved a relatively strong financial position, although its debt position signals a need for caution in the short-term. In 2001 net sales increased 27%, gross profit as a percentage of net sales grew 1.2%, and operating profit (excluding extraordinary restructuring charges) advanced by 12%.<sup>xxvi</sup> This unusually robust performance was primarily driven by the Keebler acquisition. A more troubling picture emerges when one compares current sales to pro forma 2000 numbers (Kellogg and Keebler combined 2000 sales). This more detailed analysis exposes that sales decreased slightly over the last fiscal year, from \$9 billion to \$8.9 billion.

Although 2001 net sales are slightly lower than in 2000, the company increased its profit margins due to the successful integration of Keebler and to cost cutting measures. Integration synergies are 100% higher than expected for 2001, totaling at \$40 million in cost savings. Kellogg anticipates 2002 synergies will increase 25% over previous estimates, to \$100 million in reduced expenses.<sup>xxvii</sup>

The Keebler acquisition significantly diversified Kellogg's revenues. Chart 2, below, illustrates this by comparing the pre and post merger segment revenues for the company. The acquisition created a new sales base for the company that was no longer reliant upon one product line to provide over 70% of firm sales.

**Chart 2: Kellogg Revenue Breakdown (by Segment)**



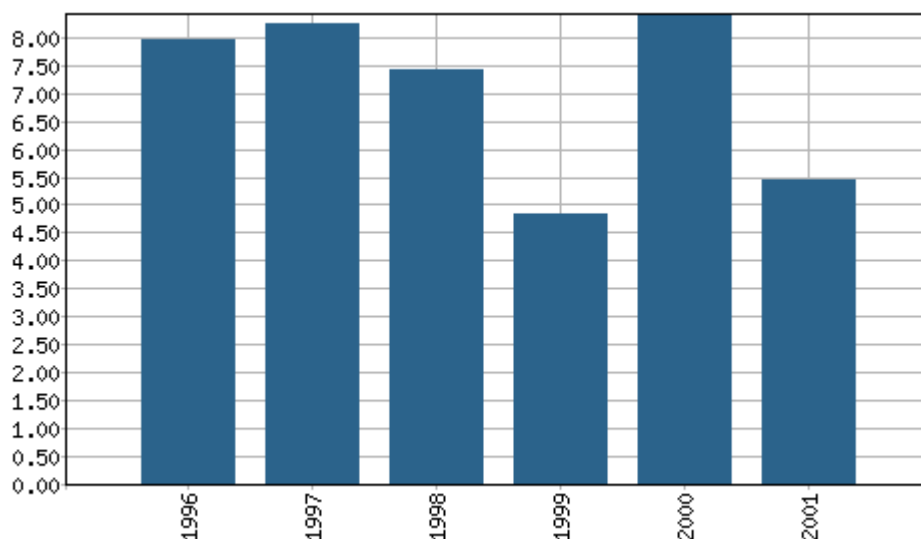
Source: Kellogg Company 2001 Annual Report

Gross profit margins increased to a commanding 53.4%, the highest rate since the U.S. cereal price reductions of 1996. Kellogg is able to boast high margins because of successful branding strategies with its core businesses. The firm's gross profit margins are among the highest in the entire food and beverage industry.<sup>xxviii</sup>



Successful branding strategies also contribute to higher expected net profit margins. In the food business, companies with homogenous products typically earn a profit in the 1% to 3% range. Kellogg historically earns a net profit around 7%. This number is lower in 2001 due to acquisition fees and higher interest expenses.

**Chart 3: Kellogg Annual Net Profit Margins (%)**



Source: [www.wsrn.com](http://www.wsrn.com)

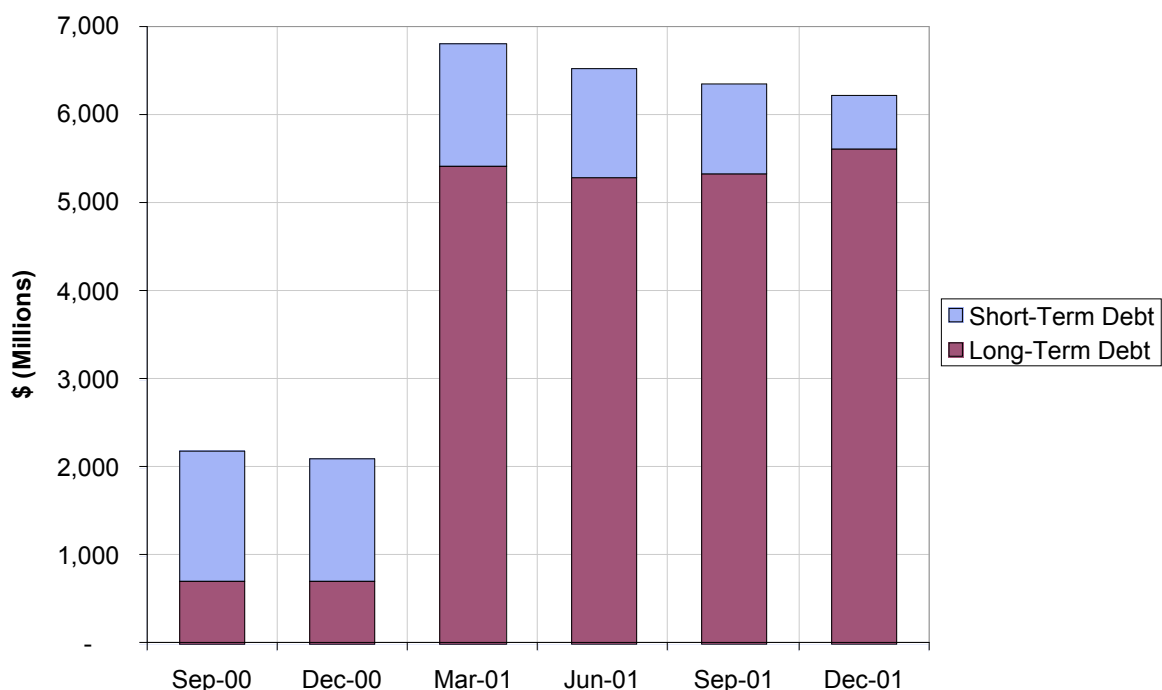
Cash flows from operations have increased incrementally over the past four years as well. Strong growth in operations cash flows signals financial health in Kellogg's core businesses. In fy2001, Kellogg reaped the highest operating profits in the firm's history, \$856 million, due to an emphasis on cash flows and product value in the new managerial plan.





This emphasis on cash flow reflects Kellogg's need to improve its debt situation after the acquisition of Keebler, which brought high levels of debt onto the company's balance sheet. This dramatic increase can be seen in the chart below. Kellogg has a quick ratio of 0.45 and a current ratio of 0.86, both signaling a weak balance sheet (sector averages are 0.59 and 1.13 respectively). Its Total Debt to Equity ratio of 7.13 also indicates that the company is over-leveraged, using debt for too much of their financing (sector average is 1.27).<sup>xxx</sup> Kellogg has a high dividend payout rate, with dividend expenses consistently in the \$400 million range. This limits its ability to pay down debt. However, the Kellogg management team has set debt reduction as a priority, in order to restore the company financial flexibility. To this end it has appropriately directed the additional cash flows stemming from acquisition synergies.<sup>xxx</sup> Over the last several quarters management has successfully reduced its total debt, focusing first on reducing their short-term debt load.

**Chart 4: Kellogg Quarterly Total Debt Breakdown (\$ Millions)**



Source: Kellogg's 10Q and 10K filings (from September 2000 to December 2001)

Kellogg currently holds a P/E ratio in the high twenties. The ratio is relatively high for an "old-economy" firm and represents strong earnings and high expectations for future performance.<sup>xxxi</sup> Kellogg's management continues to set high financial goals. Management plans for single-digit sales growth, mid-single digit profit growth, high single-digit EPS growth, and strong cash generation. Analysts are optimistic that with this strategy, Kellogg will continue to meet and exceed profit expectations.



## Strategic Analysis: Engines for Growth

After performing a Porter's five-force analysis of the RTE cereal market in the U.S. and then examining the Kellogg Company's current market position, Carnegie Consulting is optimistic about Kellogg's long term prospects. Some pessimism comes from various threats to the RTE cereal industry's profitability. Kellogg however, is poised to leverage its numerous strengths into new areas of growth. Several key overarching factors will allow Kellogg to prosper and grow

### *Products Must be Evaluated by How They Effect the Bottom Line*

Management must break the tradition in the cereal industry of measuring success by volume of shipments. Kellogg is shifting to a business model of "Value to Volume," where net sales are the guiding measurement. Enshrining this idea, that operating profit is the key measurement of performance, into the corporate culture at Kellogg will be essential to the continued success of the company.

This new success criterion has already created additional value at the firm. Sales representatives are focusing their efforts on products with a higher rate of return rather than those with a higher weight.<sup>xxxii</sup> These gains must be reinforced through continuing managerial training and employee reward incentives. Volume-based evaluation can be sustained if a culture of evaluating a project's rate of return takes hold throughout the company.

### *Refocus Powerful Brand Name*

Kellogg still evokes an image of healthy food products with many customers, despite its history of offering many unhealthy breakfast and snack foods (e.g. *Kellogg's Rice Crispies* and *Kellogg's Frosted Flakes*). This positive image will give the company a competitive advantage in the rapidly growing health and natural foods categories. By refocusing the Kellogg's brand name on a healthier lifestyle the company will be able to respond to the demographic shift to an older population. Baby Boomers like products that are advertised as healthy, organic, and natural. Building these characteristics and perceptions into Kellogg products will enable the company to boost profit margins by charging premiums for their products,. Strengthening the brand name in this way will also enhance the company's plans to introduce more health food product lines.

### *Focus on Health Foods*

Using vitamin fortification, an innovation dating from the time of the Second World War, Kellogg should develop foods that can be advertised for their strong health benefits. Products that are advertised as fighting various illnesses, with applicable certifications (e.g. American Heart Association), could provide high margins and good revenue growth. Carnegie Consulting recommends that the company build the Kellogg franchise around a focus on healthy breakfast and snack foods, helping to distinguish its product. This strategy would be particularly effective in combating the private label threat because private label products lack Kellogg's brand name credibility, a quality that high-end health foods require. Healthier on-the-go breakfast items, such as the Nutri-Grain Bars and Kellogg's Breakfast



Bars, are beginning to be developed and marketed. They should provide significant earnings growth moving forward.

### *Emulate Nabisco's snack model*

The snack market is one of the most important markets to Kellogg as it looks for profit opportunities. As consumers shift to a more on-the-go lifestyle, especially in their dietary habits, snacks will take on additional importance in the food industry and continue to grow at elevated levels. In order to capitalize on this market, Kellogg's Keebler brands need a major marketing overhaul. The Kellogg/Keebler products need upgrading in order to attack Kraft's Nabisco brand, which is the world's leading snack business with \$3.5 billion in sales.<sup>xxxiii</sup> Kellogg's Keebler packaging is undistinguished and the company needs to focus on more impressive promotion of its products to both consumers and retailers. Kraft's Nabisco division has excelled at advertising, differentiating their snack from the competition through creative packaging. For the short-term, the most cost effective method of improving Kellogg's business segment is to emulate Nabisco's business model and marketing strategies in the market. This, combined with leveraging the increasingly valuable Kellogg's brand, will enable Kellogg to achieve significant growth in this important industry.

## **Conclusion**

The Kellogg Company stands at a pivotal point in its company's history. After nearly a century of market leadership in the RTE cereal industry, Kellogg finds itself turning to non-cereal markets for the company's future. Diversification will provide some risks of failure, , but it will also offer Kellogg its best opportunities for extensive growth. The RTE cereal market is mature and its growth is slowing. Carnegie Consulting recommends that Kellogg ingrain profitability-based evaluation into its corporate culture, refocus the Kellogg's brand to represent high quality and healthy products, concentrate growth efforts in the high-margin healthy food market, and emulate Nabisco's successful business strategy for the snack industry. With these strategies the company will thrive for many years into the future.



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- <sup>i</sup> <http://www.kelloggscareers.com/aboutpgs/timeart/history.html>
- <sup>ii</sup> Kellogg Company Webpage ([www.kelloggs.com](http://www.kelloggs.com)), Investors: Corporate Profile
- <sup>iii</sup> Standard and Poor's industry report: Food and Nonalcoholic Beverages Dec. 6, 2001.
- <sup>iv</sup> Ibid.
- <sup>v</sup> Ibid.
- <sup>vi</sup> Corts, Kenneth. "The Ready to Eat Breakfast Cereal Industry in 1994." p 2
- <sup>vii</sup> Ibid.
- <sup>viii</sup> Ibid.
- <sup>ix</sup> Ibid.
- <sup>x</sup> Kellogg Company 2001 Annual Report
- <sup>xi</sup> Price, Gregory K. "Cereal Sales Soggy Despite Price Cuts and Reduced Couponing."
- <sup>xii</sup> Corts, Kenneth. "The Ready to Eat Breakfast Cereal Industry in 1994."
- <sup>xiii</sup> Price, Gregory K. "Cereal Sales Soggy Despite Price Cuts and Reduced Couponing."
- <sup>xiv</sup> Folta, Tim. "Analysis of the Ready-to-Eat Cereal Industry in 1994."
- <sup>xv</sup> <http://www.businessweek.com/pdfs/2001/0132-toprank.pdf>
- <sup>xvi</sup> <http://www.buec.udel.edu/kory/BUAD441/Lecture%202-Strategy%20&%20Industry.htm>
- <sup>xvii</sup> Banc of America Securities: Consumer 2002 Conference, Kellogg Presentation, April 8, 2002
- <sup>xviii</sup> Ibid.
- <sup>xix</sup> Ibid.
- <sup>xx</sup> Kellogg Company 2001 Annual Report 2001, p 11
- <sup>xxi</sup> Corts, Kenneth. "The Ready to Eat Breakfast Cereal Industry in 1994." p 9
- <sup>xxii</sup> Corts, Kenneth. "The Ready to Eat Breakfast Cereal Industry in 1994." p 10
- <sup>xxiii</sup> Ibid.
- <sup>xxiv</sup> Ibid.
- <sup>xxv</sup> Kellogg Company 2001 Annual Report, p 5
- <sup>xxvi</sup> Kellogg Company 2001 10K filing, income statement.
- <sup>xxvii</sup> Banc of America Securities: Consumer 2002 Conference, Kellogg Presentation, April 8, 2002
- <sup>xxviii</sup> Standard and Poor's industry report: Food and Nonalcoholic Beverages, Dec. 6, 2001
- <sup>xxix</sup> Multex Investor,  
<http://yahoo.marketguide.com/MGI/mg.asp?target=%2Fstocks%2Fcompanyinformation%2Fratio&Ticker=K>
- <sup>xxx</sup> Kellogg Company 2001 Annual Report 2001, p 5
- <sup>xxxi</sup> Standard and Poor's industry report: Food and Nonalcoholic Beverages Dec. 6, 2001
- <sup>xxxii</sup> Banc of America Securities: Consumer 2002 Conference, Kellogg Presentation, April 8, 2002
- <sup>xxxiii</sup> Kraft Company Webpage ([www.kraft.com](http://www.kraft.com)), Investors: Brand Portfolio