KPMG

ConsumerCurrents

Issue 05

Issues that are driving consumer organizations worldwide

KPMG INTERNATIONAL

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Introduction

Welcome to the fifth issue of *ConsumerCurrents*, KPMG International's monitor of key issues for decision makers in retail and consumer businesses around the world. *ConsumerCurrents* offers new research and commentary on the trends that are driving and shaping consumer organizations today.

Issue 05 goes to press just as the global economy undergoes a sharp change of course. After five years of rapid consumption growth, new market expansion and an unprecedented rate of global wealth accumulation, the era of expansion has come to a sudden halt.

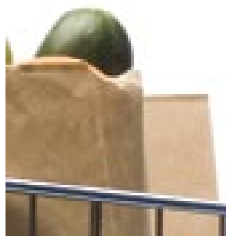
This downturn was forecast in the last issue of *ConsumerCurrents* – although in the event, it has proved more violent and more sudden than even the most pessimistic could have expected. Financial volatility and a virtual freeze of global credit markets have been followed by a widespread collapse in investor confidence.

The question now is how these changes will affect the real economy in the months and years to come, and how consumer companies can find growth and profitability in a recessionary world.

Credit has become hard to find: how will the consumer respond? Capital sources have contracted sharply: how will this affect new investment and acquisition activity in the consumer sector? Stock markets in the developed and the emerging economies have fallen fast: how far will consumer confidence follow the same downward track? And will expectations of continued growth in the consumer markets of the biggest emerging economies have to be revised downwards?

These are the themes of the latest issue of *ConsumerCurrents*, as we seek to gauge the impact of the financial crisis on the real economy.

Periods of downturn bring technical as well as strategic challenges. One such challenge will be accounting for altered performance under the new regime of international financial reporting standards (IFRS) that a large group of economies are due to adopt – either in whole or in part – between 2009 and 2012. These include companies in some of the world's most important growth economies, including China, India and Brazil, as well as established economies such as the U.S., Canada, Japan and South Korea. Yet KPMG believes that many companies headquartered in these economies may not be sufficiently prepared for the challenge – and that some consumer companies may be particularly vulnerable to the costs of unmanaged change. See page 02.



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"The question now is how these changes will affect the real economy in the months and years to come, and how consumer companies can find growth and profitability in a recessionary world."

Neil Austin
Consumer Markets
KPMG in the U.K.

Although consumer staple businesses are usually expected to ride out cyclical downturns, stock markets have sharply marked down the shares of large retailers since the beginning of 2008, as companies have issued profit warnings amid expectations of a protracted period of lower private consumption. On page 04 we interview Gordon Campbell, managing director of SPAR International, the world's biggest chain of general retailers; he explains why SPAR remains upbeat on the prospects for global retail growth.

It is already clear that the new financial reality is likely to have an impact that extends far beyond the short term. One indicator of the extent of the impact on companies' long-term plans for expansion and restructuring can be seen in the downturn in M&A, which KPMG tracks both in historical and forecast terms through analysis of completed deals, and through the 'KPMG M&A Predictor' which quantifies companies' future propensity to engage in mergers and acquisitions. Both measures show a sharp downturn in activity. But as our story on page 08 shows, one consequence of the cooling in overall M&A activity may well be a new emphasis on strategic purchases by consumer companies.

Sustainability is a rising concern for consumer businesses, as companies look for ways of fostering growth that both meets consumer concerns on corporate social responsibility, and that will survive tougher market conditions. Yet sustainability brings to the corporate table many issues that do not usually show up in the profit and loss account. Can consumer companies pursue sustainability and profit? See our story on page 12.

Luxury businesses have been one of the great consumer growth sectors of recent years. But history shows that once a consumer downturn takes firm hold, luxury brands are vulnerable. Some companies have prepared for that eventuality by assiduous brand building in recent years. Now that strategy is about to be tested. In a special profile of luxury watchmaker Patek Philippe on page 16, we ask whether brand power alone can weather the downturn.

As financial conditions get tougher, companies have to work harder to manage their cash and optimize their working capital. Research by KPMG shows that many consumer companies are trying to optimize their cash and working capital to keep financing costs down – yet many of those companies are failing to secure the long-term cost reductions that are within their grasp. In our story on page 18 we look at why: KPMG believes that the growing complexity of supply chains means that companies can no longer focus on internal measures alone to optimize cash management and reduce working capital. They also have to work with suppliers and customers to produce sustainable long-term gains.

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IFRS – Are you ready for the change?

Companies in a large group of economies are due to convert – either wholly or in part – from national financial reporting norms to international financial reporting standards (IFRS) between 2009 and 2012.

These include companies in some of the world's most important growth economies, including China, India and Brazil, as well as established economies such as Canada, Japan and South Korea, with the world's largest economy, the U.S., having recently announced its proposed roadmap for conversion to IFRS. Yet KPMG believes that many companies headquartered in the economies about to convert to IFRS (or incorporate some part of the IFRS approach in national rules) may not be sufficiently prepared for the challenge – and that some consumer companies may be particularly vulnerable to the costs of unmanaged change.

"It is easy for companies to fall into the trap of seeing IFRS as a technical exercise of relevance only in communication of performance to the outside world. But from a practical perspective, the implications are far more wide-reaching in terms of what it means for internal reporting, management incentive plans, banking covenants, tax returns and commercial contracts to highlight but a few areas which will need to be considered from the outset of the conversion process," comments David Matthews, KPMG in the U.K.'s Accounting Advisory Services.

At the same time, the process of conversion can be complex and resource-intensive, not just from the perspective of technical specialists but in the context of resource to implement potentially significant IT changes necessary to embed IFRS within affected systems. And all of this at a time when companies are likely to be looking to manage headcount and reduce cost.

"Some companies seem unaware of just how big a job this is and are in danger of starting the conversion process too late," says Johannes Siemes, Head of Consumer Markets, KPMG in Germany. "As far as the published IFRS financial information is concerned, companies only get one shot at this, so they must get it right."

And for those companies undergoing IFRS conversion today, the stakes are higher than before. Financial markets remain exceptionally volatile, and investors are unforgiving of companies that announce unexpected financial bad news. Says Daryll Jackson, Head of Consumer Markets, KPMG in South Africa: "imagine how the markets – in their current state – would react if a company were forced to restate their results because of failings in converting to IFRS. Yet I believe that there is a very real likelihood of this happening."

IFRS conversion is a challenge for all companies, but there is evidence that some consumer companies may find particular challenges in the transition. For example, large retailers with businesses that are widely distributed geographically have told KPMG firms that IFRS presents challenges that require meticulous preparation.

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"Time spent on this now could dramatically reduce both the overall costs of conversion and the likelihood of a restatement of results when the time comes."

David Matthews
Accounting Advisory Services
KPMG in the U.K.

In a study of the IFRS transition experiences of retailers in Europe, Australia and South Africa[1], companies cited the implementation of the component approach (for the depreciation of property, plant and equipment), revenue recognition, and accounting for leases as the biggest implementation challenges they were most likely to face. A wider range of issues was identified by some retailers: these included foreign exchange issues; impairment of assets; pensions; inventory; and accounting for goodwill. Several companies also identified lack of expertise as something that magnified the challenge.

For example, component accounting was identified as a leading challenge, and many companies agreed that the challenge lay in the sheer workload. A French retailer said: "there was a huge volume of items to analyze and split into components, as well as the related IT implications. This led to a lot of work."

The treatment of leases under IFRS was also identified as a leading challenge by more than half of companies. One of the most problematic areas was the treatment of stepped rental increases as having equal impact in all years of the life of the lease, irrespective of the inflation background or the actual timing of steps. Companies argued that this treatment of rental charges was potentially misleading to stock analysts.

An Australian retailer added that IFRS rules on accounting for cash generating units were particularly onerous, as units can no longer be grouped, but have to be treated individually. The retailer said: "we worked for 18 months wrestling with the cash generating units which is essentially on a store by store basis … Since we have 2,500 stores this was a phenomenal amount of work."

Whilst not all consumer goods companies will face the same issues as these retailers, other companies are likely to face similar challenges in other areas.

Clearly, companies that have already converted to IFRS have found that the extent of work involved was greater than expected. This, in part, is due to the fact that, for many companies, the transition represents a move to a much greater level of accounting detail.

"IFRS is a principles-based set of standards," says David Matthews. "But it is a fact that there are more details and specific requirements than under some national GAAP systems, such as UK GAAP, and this has led to a large challenge for some companies."

David Matthews believes that it is vital for companies entering IFRS conversion now to learn these lessons from companies that have already converted. IFRS is a one-off project, so companies undergoing conversion are unlikely to have staff with IFRS conversion skills already on board: they have to learn from other companies and from professional advisors.

"My advice is to take a long hard look at the experiences of those who have gone down this route already," says David Matthews. "Time spent on this now could dramatically reduce both the overall costs of conversion and the likelihood of a restatement of results when the time comes."

[1] IFRS and Retail, KPMG International, January 2007

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Explosive growth in emerging markets

Large-scale retailing has seldom seemed so challenging. Costs are rising, consumption growth is slowing, and as the scale of the downturn becomes clear, the market valuations of many of the world's largest retail groups are sliding fast.

Mark Larson, Global Head of Retail, KPMG in the U.S., sat down with **Gordon Campbell** of **SPAR International** to discuss.[2]

In the past, the consumer staple business has tended to ride out cyclical downturns: when incomes are tight, households still have to buy food and basic goods. Consumers in the U.S. and in Europe are under pressure from all directions: energy and food prices are high, employment uncertainty is growing, and consumer confidence is falling sharply.

The result has been profit warnings from many of the largest retailers in the developed economies. The share prices of international companies like the U.K.'s Marks & Spencer and France's Casino have fallen hard as companies warn of unexpectedly low profit prospects. And in the view of many stock analysts, the prospect is for more of the same so long as credit conditions remain tight. Yet according to Gordon Campbell, managing director of the Dutch-based food retail and wholesale network SPAR, the global outlook remains one of growth and opportunity.

SPAR is one of the world's biggest food retailers with around 13,500 stores in 33 countries worldwide. It is a cooperative retail and wholesale network with formats ranging from convenience stores to hypermarkets, in which many individual stores and store chains are owned by their operators or are franchisees. As such, SPAR is highly sensitive to trends on the high street – in Europe, in Africa and in Asia. As managing director, Gordon Campbell is responsible for the development and coordination of the worldwide organization, and *ConsumerCurrents* asked him for a global perspective on the current challenges facing food retailers.

"There is no doubt, our biggest concern today is consumer expenditure," says Mr Campbell. "We have just been through an era of cheap food, when food prices have not increased relative to other goods," he adds. "Now that has just ended very abruptly. This is altering consumer behavior in developed countries, and having even greater impact in poor countries – where food expenditure may account for 50-70 percent of disposable income."

[2] At CIES World Food Business Summit, June 18-20 2008, Munich, Germany

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"Our strategy in China is to concentrate on 'second tier' cities. Demographically they are very young, with a high proportion of residents in their 20s and 30s."

Gordon Campbell
Managing Director
SPAR International

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Explosive growth in emerging markets

The effect is going to drive retailers back to review the effectiveness of their underlying business models, believes SPAR. Gordon Campbell says that “wholesalers will have to continue to improve efficiency and reduce their costs. Retailers will have to focus on simplicity. Everybody will have to use more technology. And everybody will have to offer more services to the customer.”

SPAR believes that while the price of oil cannot be forecast, the situation is different when it comes to food – and that food retailers should expect prices to remain high in the medium term. “Irrespective of what happens to oil, we are still looking at the emergence of a new middle class on a worldwide scale. That means greater demand for food. It means more and more money chasing agricultural product. Eventually the global agricultural sector will adjust to this, and it will expand. But I don’t think we will see that adjustment begin to take effect before the end of 2009.”

In the meantime, conditions will remain tough, and SPAR concedes that good sales growth will remain a challenge in developed markets for the foreseeable future. Yet SPAR says the global outlook remains bullish, for the simple reason that emerging markets continue to grow. “It’s not difficult to see where the opportunities are for large-scale organized retail,” says Gordon Campbell. “The growth is in Russia, India and China. These are potentially huge markets.”

- **China offers the biggest opportunity of all.** “Our strategy in China is to concentrate on ‘second tier’ cities,” says Gordon Campbell. “They may be called ‘second tier’, but actually these cities are huge. Demographically they are very young, with a high proportion of residents in their 20s and 30s. And the second tier is also attractive because these are the cities where we have been able to identify the kind of existing regional retailers that can profitably become SPAR retailers.

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"For the next 10 years we just see opportunity. It doesn't matter how poor the immediate outlook is in the developed world, the emerging economy opportunities are going to compensate."

Gordon Campbell
Managing Director
SPAR International

- **The Indian opportunity will take time to mature.** Organized retail is less developed in India, compared to China, making expansion harder for a cooperative group like SPAR that recruits existing retailers (although SPAR is opening a chain of city hypermarkets in collaboration with India's Max Hypermarket, part of the Landmark Group). "In India there is still very little in the way of a supply chain – you have to create one," says Mr Campbell. "There are also still some tax barriers in India which disadvantage the retailing of any processed food – and that includes food in any kind of packaging. So for us, India remains a story of huge potential."

  Mr Campbell continues: "we see this market as a fabulous opportunity – if we can find the people to work with. We need retailers that are already there to come into our network. That stage has not yet been reached. I think we will have to wait around 10 years to see Indian retail evolve to that point."

- **Russia is the third big growth market.** "The Russian opportunity exists right now," says Gordon Campbell. "In Russia you have very many people who came out of state employment and who set up small retail businesses. But as that market has grown, those retailers see growing competition, and they see that they are losing exclusivity. They need larger-scale supply systems to maintain their competitiveness, and to modernize their businesses. And that is what we can offer."

  Getting emerging market growth right is not going to be easy, SPAR concedes. Above all, the challenge is one of building the right relationships. But nevertheless, the company believes that the opportunity remains one of extraordinary growth – an opportunity that far outweighs the threat of slowdown elsewhere.

"For the next 10 years we just see opportunity," says Gordon Campbell. "It doesn't matter how poor the immediate outlook is in the developed world, the emerging economy opportunities are going to compensate. What we are going to see in Europe is even more consolidation. What we are going to see in the emerging markets is growth."

Above
The retail landscape in China.

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M&A sees the credit crunch begin to bite

Merger and acquisition (M&A) deals in consumer businesses have slowed dramatically since the credit crunch really began to bite in October 2007.

"Until fears of a lasting recession evaporate, many potential deals are likely to stay in the pending tray."

David McCorquodale
Corporate Finance
KPMG in the U.K.

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According to data assembled by KPMG International, the global total of deals in the sector fell to $52.9 billion in the first quarter of 2008, compared to $116.6 billion in the same quarter of 2007 – a year-on-year fall of 50 percent.[3]

This represents all consumer deals worldwide for which the value is disclosed. They include financial purchases such as private equity acquisitions, corporate deals in publicly quoted companies, and private trade sales.

The pace of merger and acquisition activity is particularly important in the consumer sector, which is marked by a high rate of business creation, and thus is constantly generating fragmentation. A relatively high level of M&A activity is crucial to maintaining a balancing rate of consolidation to improve productivity and future profitability.

However, the latest release of KPMG's M&A Predictor, which tracks trends in companies' debt to profit and price earnings ratios – and thus forecasts the ability of companies to raise debt finance for M&A – suggests that international M&A will continue to fall through to the end of 2008.

The trend is confirmed by evidence that the fall in activity continued through the first three quarters of the year. The value of worldwide M&A in all sectors fell 25 percent year-on-year to $2.5 trillion during the three quarters, according to Reuters. Europe, Africa and the Middle East all saw declines of over 25 percent; the Asia Pacific region was the only region to register a year-on-year increase in activity, at a modest one percent. However, there is also evidence that the cycle of M&A is moving into a second phase, as corporate dealmaking in the U.S. held up well: $402 billion in the second quarter of 2008 against $404 billion in the second quarter of 2007.[4]

Many analysts had predicted such an evolution in consumer M&A. Prior to the credit crunch, finance was plentiful and cheap: 'financial bidders' for consumer companies often had the ability to outbid corporate or 'strategic buyers' – companies that were bidding for acquisitions to grow their businesses, rather than to turn a profit through restructuring and selling on. Now that the market capitalization of many consumer businesses has fallen and may fall further, and debt has become much more difficult to raise, financial bidders have less incentive to buy and may in any case be unable to finance large deals. Strategic buyers, on the other hand, have a longer-term approach and are less dependent on current share prices.

[3] Evalueserve

[4] Mid Year 2008 Dealmakers Survey, Thomson Reuters, June 2008
M&A Review, Thomson Reuters, October 2008

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M&A sees the credit crunch begin to bite

$52bn

In mid July, Belgian brewer InBev won its battle to acquire the U.S. brewer Anheuser-Busch in a deal worth $52 billion.[5]

$23bn

The buyout of Wrigley by Mars created the world's largest confectionery company ahead of Cadbury.[6]

It had also been predicted that consumer M&A would become more international during 2008, with cross-border buyers from Europe in particular attracted by the relatively low valuation of U.S. companies thanks to the low dollar. However, the cheapness of U.S. companies for Europeans is partially offset by lower cashflow returns from an acquired U.S. company. In addition, the dollar has risen markedly against the euro since mid 2008. "In any case," says David McCorquodale, KPMG in the U.K.'s Corporate Finance: "international M&A is not driven primarily by a low dollar: more important is the global expansion and consolidation of the major consumer companies."

The largest deal so far this year was a European takeover of a long-established U.S. consumer name. In mid July, Belgian brewer InBev, owner of brands such as Stella Artois and Bass, won its battle to acquire the U.S. brewer Anheuser-Busch, which owns the biggest selling U.S. beer Budweiser, in a deal worth $52 billion.[5]

However, U.S. buyers are also active. Other large deals have included the buyout of chewing gum maker Wrigley by Mars, creating the world's largest confectionery company ahead of Cadbury, the former number one. The $23 billion deal was financed largely from Mars' own cash resources, but private equity also played a role, with $4.4 billion of financing from investor Warren Buffett's Berkshire Hathaway. Mars/Wrigley now has a 14.4 percent global market share in confectionery, and many analysts see Cadbury (formerly Cadbury Schweppes) as a likely takeover target now that the company has demerged its drinks business.[6]

The drive to build market share was also behind the acquisition of Sweden's Vin & Sprit by French Pernod Ricard. Vin & Sprit, maker of Absolut vodka, was sold by the Swedish government in a public auction for $8.9 billion. Significantly, Pernod Ricard outbid not only other trade buyers such as Bacardi, but also a bid from a Swedish private equity group. The buyout has given Pernod Ricard a 14 percent market share in the U.S., by far the largest geographical segment in the increasingly concentrated world drinks market.[7]

[5] This deal was most recently completed and InBev's name changed to Anheuser-Busch InBev. See ab-inbev.com for further information

[6] Financial Times, April 28 2008

[7] The Economist, April 3 2008
Financial Times, April 1 2008

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"The pace of consumer M&A is likely to remain subdued for as long as financial conditions remain tight and confidence is weak."

David McCorquodale
Corporate Finance
KPMG in the U.K.

Some financial analysts saw the Pernod Ricard deal as relatively expensive – and Pernod's shares fell significantly following the buyout. Overall, the premiums paid in corporate buyouts during the first half of 2008 have risen to an average of 28 percent, compared to 25 percent in 2007, according to figures from Reuters. But that does not mean that deals are necessarily expensive: premiums are calculated as the price paid over the stock price in the week prior to the announcement of the buyout. As stock prices have fallen sharply since the beginning of the year, premiums that are moderately higher in percentage terms are still much lower in absolute terms.

One area of activity that has in the past been conspicuously absent from the data is cross-border M&A activity in Japan. The consumer sector in Japan is particularly fragmented, and many companies would like to invest in consolidation deals in that market, but have been discouraged by distance; by the challenges of language and culture; and by the existence of 'poison pill' takeover defenses (approximately 13 percent of listed Japanese companies have poison pills in place).

However, 2007 saw an increase in the number of takeovers of Japanese public companies (one example was the purchase of Sansei Foods by the U.K.'s Cadbury). KPMG believes that foreign investment into Japan will continue to increase both as a consequence of liberalization of takeover regulations, and because of a recent announcement that Japanese institutional investors will not vote for poison pill resolutions at this year's round of annual general meetings.

"Yet overall," says David McCorquodale, "the pace of consumer M&A is likely to remain subdued for as long as financial conditions remain tight and confidence is weak. The opportunistic financial acquirers are very susceptible to what has happened with respect to credit concerns and consumer confidence, as well as to fears of a lasting recession." McCorquodale continues: "and until those fears evaporate, many potential deals are likely to stay in the pending tray."

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Consumer businesses going green

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Sustainability concerns that were once seen as the province of heavy manufacturing and extractive industries are now becoming part of the strategic thinking in a much wider range of consumer businesses. But do sustainability and profitability go together?

"Sustainability is not just about protecting the environment," says Gareth Ackerman, chairman of South African retailer Pick 'n' Pay. "It has to do with issues such as food security; food safety; job creation and individual prosperity; healthy eating; fair trade and ethical sourcing of products; labor rights; customer loyalty; and poverty alleviation."[8]

That means that sustainability brings to the corporate table a large group of issues that do not usually show up in the profit and loss account. Responding to the challenge of making businesses sustainable may involve costs: can it also generate profits?

According to Alain Caparros, CEO of the REWE Group – a cooperative retail and wholesale network with over 12,000 stores in Europe – sustainability need not be seen as an imposed cost: he argues that it will actually become a profit driver.

"Customers are now very sensitive to the way you behave," says Mr Caparros. "Today we are fighting for the trust of the end customer. Business in the future will not be based on competing on price, it will be all about competing on trust."[8]

An integrated sustainability strategy can also be seen as an effective way of limiting risks to the bottom line, says Dr August Oetker, CEO of European food manufacturer Dr Oetker. "Sustainability limits risk," he says. "It reduces your vulnerability to attack and at the same time it strengthens the brand, it strengthens sales, and it strengthens recruitment."[8]

According to the results of a poll of over 200 senior food industry executives carried out by KPMG International (KPMG/CIES Survey 2008: A survey into the growth and sustainability issues driving consumer organizations worldwide)[9], a large proportion of those companies now see sustainability as a core component in their strategies for future profitability. When asked what financial impact sustainability is having today on the bottom line, over two thirds report that sustainability is already driving profit.

"Food and beverage manufacturers and retailers are exposed to a high level of risk to reputation, especially when taking into account the ease with which consumers can switch brand."

Wim Bartels
Global Sustainability Services
KPMG in the Netherlands

[8] Quoted at CIES World Food Business Summit, June 18-20 2008, Munich, Germany

[9] In conjunction with CIES at the CIES World Food Business Summit, June 18-20 2008, Munich, Germany

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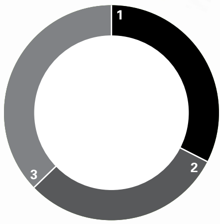
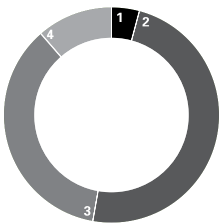
Consumer businesses going green

> "The most successful companies in the future will be the companies that care about the triple bottom line – about the economic bottom line, the environmental bottom line, and the social bottom line."
>
> **Gareth Ackerman**
> Chairman
> Pick 'n' Pay



What financial impact is sustainability having on your business today?

1. Net cost to the business 32.6 %
2. Some benefits which equal the costs 30.4 %
3. Direct positive impact on the bottom line 37.0 %



In an economic downturn, what would the impact be on your business' sustainability strategy?

1. Put on hold 4.4 %
2. Investment will be reduced but core areas maintained 48.4 %
3. No impact 35.9 %
4. Increased investment 11.3 %

Some companies argue that a sustainable approach to business can engender new ways of thinking about future profitability. Sustainable business emphasizes profits through innovation rather than through cost cutting, says Mark Price, managing director of Waitrose, a private partnership food retailer that operates 185 up-market supermarkets in the U.K. "The question is what is the best business model to embody sustainability," he says. "You can have what I call the fit model, where you reduce operational cost to reduce product cost to gain more customers. Or you can have the sustainable model, where you invest in product innovation to attract the increasing proportion of customers who are willing to pay more for innovation."[10]

Many consumer companies appear to agree that sustainability is a path to profit. While investments that do not have a direct and measurable impact on the bottom line tend to be cut or delayed during periods of a consumer downturn, the results of KPMG International's food industry poll suggest that sustainability investment will either be put on hold (4.4 percent) or reduced (48.4 percent) in an economic downturn. The remainder believed the impact would be neutral (35.9 percent) or positive (11.3 percent) for investment.

Brian Connell, KPMG in the U.K.'s Supply Chain Advisory, comments: "it would be unwise for businesses to significantly scale back on initiatives which lead to improvements in sustainability. The political and regulatory pressures are not going to go away. Those businesses that continue to invest in sustainability will see benefits over the long term."

The resilience of companies' sustainability investment plans reflects the increasingly central strategic role that sustainability is playing – and companies are clear that sustainability is now more likely to be driven by business need. When asked in KPMG's poll what the most important drivers of sustainability are, 56.2 percent of companies cited either supply chain pressure or stakeholder demand. Other answers, such as taxes, legal requirements and codes of conduct, rated much lower – as did carbon costs, cited by only 4.8 percent of respondents.

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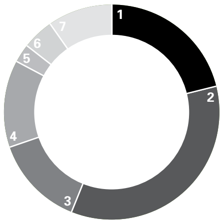
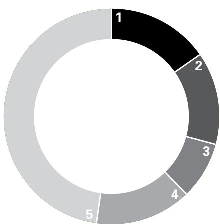


What is the most important driver of sustainability in your business?

1 Supply chain pressure 21.3%
2 Stakeholder demand 34.9%
3 Voluntary codes 13.7%
4 Ratings, benchmarking and sustainability indices 13.0%
5 Taxes and subsidies 2.7%
6 Carbon costs 4.8%
7 Legal requirements and prohibitions 9.6%



Which of the following best describes your business' approach to sustainability/ corporate responsibility?

1 We do not have a sustainability strategy 15.5%
2 Compliance driven 13.8%
3 Risk management driven 8.6%
4 Focused on philanthropy and volunteering 14.4%
5 An important driver of innovation 47.7%

Some companies point out that they see reduction of costs not as an end in itself, but as part of a larger competitive strategy. Ray Anderson, CEO of one of the world's largest carpet tile manufacturers, InterfaceFLOR, says that his company is on track to reduce waste and carbon emissions to zero by 2020, and that such a total sustainability approach should not be seen as a cost, but as a competitive advantage. "If you eliminate waste, you can simultaneously eliminate cost," says Mr Anderson. "The target should be to reduce the environmental impact of your business to zero. From a business perspective you can achieve that target at the expense of competitors who are inefficient adaptors."[10]

"Energy-intensive industries, in particular, are likely to see increased savings to the bottom line by a continued focus on energy efficiency," says Brian Connell. "Even though prices have recently dropped, we have seen many businesses invest in 'green' initiatives which should lead to significant cash savings for the business in the short to medium term."

Companies also increasingly see sustainability as moving on from compliance and risk management, and becoming a driver of innovation. KPMG's food industry poll revealed that the largest group of respondents (almost half) characterized their approach to sustainability as innovation driven.

An analysis of published research into the future business impacts of climate change conducted by KPMG in the Netherlands' Global Sustainability Services[11] showed that while the physical and regulatory risks of future climate change are well understood by many businesses, the reputational and litigation risks to the bottom line are not fully discounted. Such business risks are emerging faster than research is anticipating, the report concluded.

According to Wim Bartels, Head of KPMG in the Netherlands' Global Sustainability Services: "Food and beverage manufacturers and retailers are exposed to a high level of risk to reputation, especially when taking into account the ease with which consumers can switch brand, and the material contribution the sector makes to a consumer's overall carbon emissions. However, once companies have developed a proactive climate change strategy and have started to communicate it, they are able to turn the brand-value risk into an opportunity by anticipating changes in consumer preferences."

The costs and benefits of sustainable business approaches remain an area of considerable debate, yet the conviction that sustainability can be positive for profitability is widespread. Says Gareth Ackerman of Pick 'n' Pay: "the most successful companies in the future will be the companies that care about the triple bottom line – about the economic bottom line, the environmental bottom line, and the social bottom line."[10]

Still other companies take the view that the cost of sustainability is not the leading issue. "It is not a question of whether we can afford sustainability," says Alain Caparros of the REWE Group; "the fact is we cannot afford not to afford it."[10]

[10] Quoted at CIES World Food Business Summit, June 18-20 2008, Munich, Germany

[11] Climate Changes Your Business, KPMG International, March 2008. Visit www.kpmg.nl/sustainability for further information

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Standing the test of time

The Geneva-based fine watchmaker Patek Philippe is recognized as the maker of some of the world's most prized timepieces. That is a luxury brand position that this privately-owned company has worked hard to create. But now, as consumer confidence dips throughout the developed world and stock markets everywhere register large falls, the value of the brand is likely to be tested as never before.

The company is certainly cautious about its own prospects in the current climate. "Last year, we had an outstanding year, like the rest of the industry," says Philippe Stern, CEO of Patek Philippe. "But, given the current economic environment, we remain extremely cautious for this year (2008) and the year to come, even though the market appears to be fairly stable for Patek Philippe at the moment."

The last few years have provided the luxury watch sector with an extraordinary boom. Global growth has been high – well above the long-term trend – and with low interest rates, real incomes have risen. Financial sector profits relative to gross domestic product (GDP) in the developed world have doubled since the late 1990s – and the financial sector is the source of much of the world's demand for premium mechanical watches.

And while the traditional markets for fine watches have boomed, new markets have opened up at a rate that has surprised even the most optimistic in the industry. Russia and China in particular have proved fertile ground for watchmakers. Russian spending on jewelry and watches grew by an annual 50 percent each year in the five years from 2000; Chinese spending on Swiss watches alone grew by 47 percent in 2007.

2008 may be different. Stock markets in the U.S. and Europe have fallen by over 20 percent. China has seen the valuation of its corporate economy cut by over 40 percent. Many analysts believe it is only a matter of time before these falls translate into lower spending on luxury goods: a survey of high income consumers by Ledbury Research suggested that premium mechanical watches could be particularly vulnerable in the current slowdown. The only exceptions, says Ledbury, may be brands that have built a strong niche following amongst wealthy connoisseurs.

That is exactly what Patek Philippe has tried to do. As a privately-held Swiss company – the watchmaker has been in the hands of the Stern family since 1932 – Patek Philippe does not disclose sales or profit figures. Nevertheless, the company remains no more than mid-sized: it employs 1,300 people in Geneva and makes around 40,000 units a year. And as a mid-sized company with high manufacturing costs which cannot easily be reduced by outsourcing or automation, Patek Philippe has had to build its brand cautiously and incrementally.

"Last year, we had an outstanding year, like the rest of the industry. But, given the current economic environment, we remain extremely cautious for this year (2008) and the year to come."

Philippe Stern
CEO
Patek Philippe

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1,300
People employed in Geneva.

40,000
Units produced a year.

One of the most visible ways it has done so is through advertising. Using low-key black and white photography and avoiding the use of celebrities, the company succeeded in turning itself from a respected but little-known maker into a brand with global recognition, all by the use of a single sentence: 'you never actually own a Patek Philippe... you merely look after it for the next generation.' The campaign deliberately set out to provoke – by suggesting that the watch brand cannot be bought – and so signal that while the product might be instantly recognizable, the brand was different.

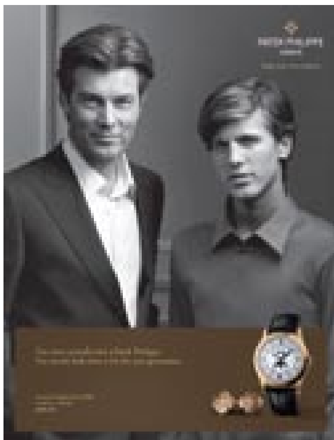
The advertising also played subtly on a key trend of the last 10 years, the great growth in personal wealth – and aspiration towards wealth. The unstated message was that Patek Philippe was a long-term investment, and the sort of purchase that is made by the knowledgeable rich.

The company also built the brand in other indirect ways. Patek Philippe was not the first luxury brand to create a brand museum – for example, Italian racing motorcycle maker Ducati created such a museum as part of a brand rebuilding project – but Patek Philippe's Geneva museum is perhaps the most ambitious. It includes watches from as early as the 16th century, 300 years before Patek Philippe began watchmaking, and is an important scholarly resource with its library of 7,000 books and documents.

The intended message of the museum is that Patek Philippe is not just a maker: it is a leading guardian of the European watchmaking tradition.

Patek Philippe has also shown itself to be expert at managing its retail distribution. The company maintains only three permanent single brand outlets, which it calls 'salons', in London, Geneva and Paris. Elsewhere, watches are sold through around 500 authorized retailers, where they have to jostle for space and attention with other premium brands. Patek Philippe has managed to maintain its profile by limited production and careful allocation of its collections and special editions – watches that retailers prize, not least because their customers know they will actually increase in value the moment they leave the shop.

That, at least, has been the story of the last 10 years. Now, as consumption comes under pressure in many parts of the global economy, luxury brands are likely to feel just as much stress. And brand managers everywhere will be watching closely to see if painstakingly-accumulated brand capital like that of Patek Philippe really is a defense against a downturn.



Left to right
Example of recent advertising campaign
Co-founder Antoine Norbert de Patek
Watchmaking in progress.

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Making your capital work harder

Financial conditions for consumer companies are tough. Direct borrowing costs have risen since the onset of the credit crunch late in 2007, and the availability of capital from alternative sources has been reduced.

Research by KPMG shows that many consumer companies are trying to optimize their management of working capital to keep financing costs down – yet many of those companies are failing to secure the long-term cost reductions that are within their grasp.

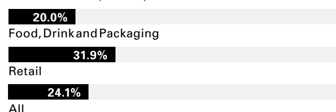
KPMG's 2008 CFO survey looks at the cash and working capital strategies of 556 large corporations in Europe and the U.S. The survey found that a very large proportion of these companies – 85 percent – consider that cash management is one of their top strategic priorities. However, only 24 percent of companies consider cash management to be the number one strategic priority.

"Many companies are opting for quick fixes of squeezing supplier payment terms and tightening credit lines to customers," comments Andrew Ashby, KPMG in the U.K.'s Cash and Working Capital. "However, this isn't sustainable and can be detrimental to the business if suppliers or customers fail as a result."

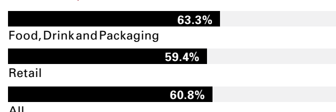
These cross-sectoral results were broadly in line with the results for consumer companies alone. One striking difference was the larger proportion of retail respondents who rate cash management as a number one strategic priority, with over 30 percent of retailers considering it their leading management issue.

Which of the following best describes where cash management ranks as a strategic priority for your business?

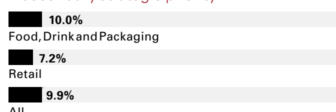
Number one priority



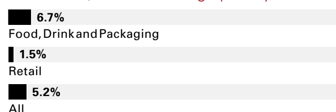
Among the top tier strategic priorities (ie, one of the 3-5 priorities for the whole business)



A secondary strategic priority



Of concern, but not a strategic priority



"Squeezing supplier payment terms or tightening customer credit lines isn't sustainable and can be detrimental to the business if suppliers or customers fail as a result."

Andrew Ashby
Cash and Working Capital
KPMG in the U.K.

556

KPMG's 2008 CFO survey looks at the cash and working capital strategies of 556 large corporations in Europe and the U.S.

85%

85 percent consider that cash management is one of their top strategic priorities.

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Making your capital work harder

While over 94 percent of all companies forecast their cashflow, and nearly 50 percent of all companies achieve an accuracy rate between plus or minus 10 percent, that falls sharply in the case of retailers. There is a common perception that forecasting cash is difficult in this sector, but KPMG member firms' experience is that it is possible to make significant improvements. Almost three quarters of retailers underestimate cashflow by 20 percent or more.

Andrew Ashby comments: "given current market uncertainty, companies should be rapidly increasing their forward visibility and control of cashflow. Focusing on getting the right people engaged from across the business and making them accountable for accurate cashflow forecasts is critical for success."

Retailers also place a lower priority on working capital management than the sample of all companies, with only a little over half of retailers allocating working capital a high priority – compared to 70 percent of their peers in the food, beverage and packaging sectors, and over 62 percent of all companies.

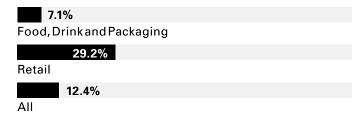
These results suggest that against the background of sharply-tightening financial conditions, consumer companies are relatively weak on cash and working capital management. But the results also suggest that companies can reduce their capital costs by incentivizing the achievement of cashflow targets.

Consumer companies are less likely than others to incentivize cashflow. While just over three quarters of all companies link cashflow targets to managers' rewards, for food, beverage and packaging companies that falls to 62 percent. Retailers score higher: 79 percent use incentives.

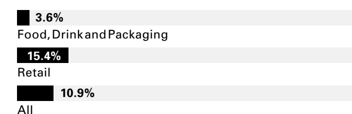
The results of the CFO survey also show a clear link between incentivization and effective control of capital costs. When companies were asked whether working capital had increased or decreased over the last three years, most retailers said working capital had decreased or stayed the same. Less than a fifth of retailers – who overall incentivize to a high degree – said that working capital had deteriorated. Companies in the food, beverage and packaging sector, who incentivize less, also had less success in reducing working capital. Only 40 percent of those companies had managed either to reduce working capital or maintain it at the same level; 60 percent had seen an increase. Among those companies that had run a working capital improvement program, again retailers were more successful in sustaining the improvement over time.

Over the past 12 months, please estimate the level of accuracy of your cashflow forecasting

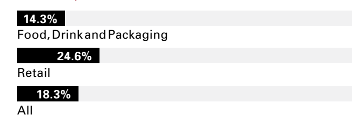
Under by more than 30%



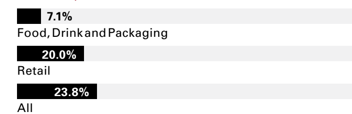
Under by 30%



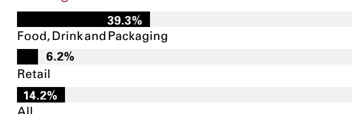
Under by 20%



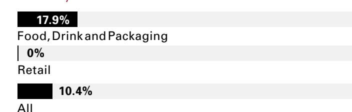
Under by 10%



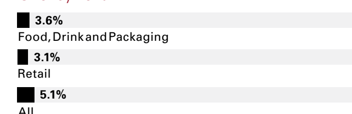
On target



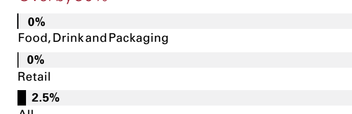
Over by 10%



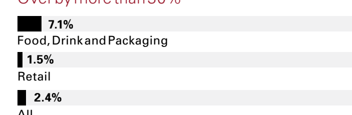
Over by 20%



Over by 30%



Over by more than 30%



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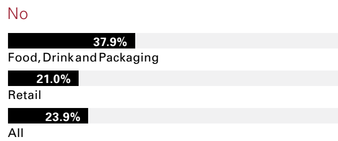
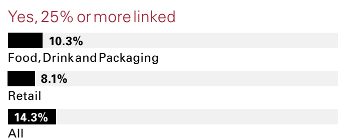
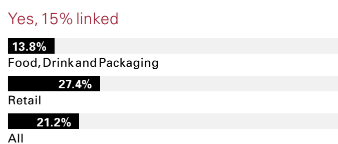
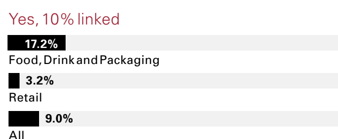
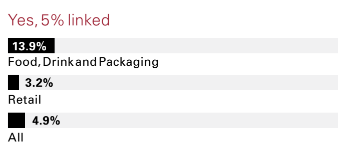
Are cashflow targets part of the management teams' incentives package at your organization, and if so, about what percentage of the package is linked to those targets?











KPMG can draw two conclusions from the results. First, that the linking of management rewards to capital cost targets works. Companies that do this have a better record of cashflow improvement and working capital reduction than those that don't. Second, that holding onto gains when it comes to managing capital costs is challenging.

One reason for the difficulty of sustaining improvements may be that the main pressures on working capital are particularly difficult to control. Overall, companies say that in the near future the main upward pressure on working capital will come from customers demanding extended payment terms; from rising commodity prices; and from costs associated with expanding into new global markets.

Adeeb Dhallai of KPMG's Advisory Services in the U.K. says that such complex supply chain pressures mean that companies are more likely to achieve sustainable working capital and cash management improvements through inter-company collaborations that address the entire supply chain. "My experience is that where companies work together with suppliers and customers, then it is far easier to manage and drive down working capital and improve cashflow through the whole chain," says Adeeb Dhallai. "Otherwise you simply end up moving the burden between the companies, and costs just shift backwards and forwards with no long-term gain for anyone."

Companies participating in the CFO survey are also clear about the internal success factors in controlling capital costs and improving cashflow. Over 62 percent of all companies say that consistent executive sponsorship is the most important factor, but that is closely followed by alignment of targets to individuals and departments, good communication of strategy, and an appropriate incentivization strategy.

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Key contacts

Neil Austin
Global Chairman
Consumer Markets, KPMG in the U.K.
One Canada Square, London E14 5AG, U.K.
T: +44 (0) 20 7311 8805
F: +44 (0) 20 7311 3311
E: neil.austin@kpmg.co.uk

Mark Twine
Global Executive
Consumer Markets, KPMG in the U.K.
One Canada Square, London E14 5AG, U.K.
T: +44 (0) 20 7694 3873
F: +44 (0) 20 7311 8936
E: mark.twine@kpmg.co.uk

Vanessa Geelen
Global Marketing Manager
Consumer Markets, KPMG in the U.K.
One Canada Square, London E14 5AG, U.K.
T: +44 (0) 20 7694 1954
F: +44 (0) 20 7311 8936
E: vanessa.geelen@kpmg.co.uk

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