

North America US
Consumer Beverages

14 October 2004

Soft Drinks



Deutsche Bank



F.I.T.T. Research

Fundamental, Industry, Thematic, Thought-Leading

Deutsche Bank Equity Research's Research Product Committee has deemed this work F.I.T.T. for our clients seeking differentiated ideas. Here, our Beverages analyst asks, "Do you see what I see?" as he fathoms the industry's biggest challenge: CSD and water pricing power is weak, but pricing is needed to offset raw material cost pressure. The team's insights, supplemented by the input of DB's retail analysts, suggest the optimal strategic balance favors Pepsi over Coke.

Fundamental: profit goals are increasingly jeopardized

Industry: pricing needed – but really not wanted – as value tier grows

Thematic: Balanced innovation, pricing, merchandising needed

Thought Leading: surveys highlight retailer, consumer perspective

Raising PAS, PBG estimates \$0.01 each, cutting CCE target to \$20

Steering the ride at retail



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Deutsche Bank Securities Inc.

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Investors should consider this report as only a single factor in making their investment decision.

DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1



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Fundamental: profit goals are increasingly jeopardized

The threat: cost pressures at the bottling level are eating into gross margin. Prior research shows that inflation coming from higher oil prices can affect the beverage commodity basket – PET, aluminum, and farm goods – for some time.

Industry: pricing needed – but really not wanted – as value tier grows

Further pull on the price lever risks lower structural growth rates for CSD and water. Consumers are leaving the CSD category and retailers are choosing categories with higher gross profit. The value tier – long a staple of the take-home channel – is making quiet inroads in C-stores via water and in some cases B-brand CSD. The challenge to consumer economics, especially in the ethnic population, is worrisome.

Thematic: Balanced innovation, pricing, merchandising needed

We see a clear advantage to Pepsi over Coke at present: its combo of innovation, moderation, and leverage from Frito-Lay North America. CSD is a critical store traffic draw, and the black/orange Halloween tie-in of Mountain Dew Pitch Black and Live Wire is winning with stores and consumers during this surprisingly important retailer holiday. Conversely, Coke's ongoing 1.5-liter rollout is widely viewed as "less for more."

Thought Leading: surveys highlight retailer, consumer perspective

We conducted a comprehensive single-market survey and interviewed consumers, store managers, and national category managers. Our retail analyst team supplemented this fieldwork by reconciling observed market pricing and merchandising with retailer strategies.

Raising PAS, PBG estimates \$0.01 each, cutting CCE target to \$20

We see Pitch Black cold-drink leverage driving Pepsi out-performance in Q4 via increased presence and better price points on other packages. Coke's internal dissension is contributing to flawed pricing architecture. Beware the next shoe dropping in Q4 as Pepsi Halloween wins and the Spice rollout cuts further into Coke's traditional Christmas dominance.

F.I.T.T. Research

Key changes

CCE - price target	\$22 to \$20	↓	-9.1%
CCE - 2004E EPS	\$1.29 to \$1.25	↓	-3.1%
PAS - 2004E EPS	\$1.23 to \$1.24	↑	0.8%
PBG - 2004E EPS	\$1.74 to \$1.75	↑	0.6%

Companies featured

Coca-Cola Enterprises (CCE), US\$19.21		Hold	
	2003A	2004E	2005E
EPS (US\$)	1.30	1.25	1.60
P/E	14.8x	15.4x	12.0x
PepsiAmericas, Inc. (PAS), US\$19.35		Buy	
	2003A	2004E	2005E
EPS (US\$)	1.05	1.24	1.37
P/E	18.4x	15.6x	14.1x
Pepsi Bottling Group (PBG), US\$28.32		Hold	
	2003A	2004E	2005E
EPS (US\$)	1.56	1.75	1.92
P/E	18.2x	16.2x	14.8x
Coca-Cola (KO), US\$39.39		Hold	
	2003A	2004E	2005E
EPS (US\$)	1.95	2.00	2.15
P/E	20.2x	19.7x	18.3x
PepsiCo, Inc. (PEP), US\$48.05		Buy	
	2003A	2004E	2005E
EPS (US\$)	2.06	2.32	2.57
P/E	23.3x	20.7x	18.7x

Upcoming events

	Date
COT earnings release	20 Oct 2004
KO earnings release	21 Oct 2004
PAS earnings release	27 Oct 2004
CCE earnings release	28 Oct 2004

Related recent research

	Date
Just Coke Series	
Marc Greenberg	07 Jan 2004-21 May 2004
Emerging Value Tier Threatens C-Store Profits	
Marc Greenberg	08 Mar 2004

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Executive summary

Outlook: Coke and CCE are playing catch-up with Pepsi

Raised estimates for both PAS (Buy rated, \$23 target) and PBG...

Our research highlights a growing advantage for Pepsi vs. Coke on the domestic soft-drink landscape. The composite of survey findings, retailer comments, industry contacts and company contacts noted throughout this report increasingly suggest Pepsi is winning in the current quarter – and it may turn into a rout.

Consumers are clearly responding to strong merchandising around Halloween, while Coke sputters following an unimpressive C2 launch and a questionable rollout of its 1.5-liter smooth serve package. Coke and its largest bottler have some spade work to do in reconciling price elasticity – and importantly, what the retailer wants. In the short run, we expect system under-performance, but no radical shifts such as dramatic funding overtures by Coke to CCE.

We have changed some assumptions for the blue bottlers. Meanwhile, here's what we now see in the near term:

- **Cold drink expectations are too low:** Pitch Black Halloween enables better merchandising wins and positive mix shift from a primarily single-serve rollout. We have increased our cold drink growth assumption for PAS one percentage points, to flat, lapping 7% in Q403. We have also raised our cold drink volume growth one point higher at PBG to 3%, lapping 1% last year. In a best case, the blue system can lag on the price-ups, win on volume and still get mix.
- **Take-home volumes are also swinging up:** Wal-Mart's hot price on 2-liter Pepsi coupled with a solid Halloween win for Pepsi's overall portfolio appears increasingly likely to drive higher sales in the biggest slice of unmeasured channel. We have raised our PBG 4Q domestic volume assumption one percentage point, to 2% volume, while lifting revenue per case 50 basis points higher to 2.5%. We have taken our PAS 3Q US volume two points higher to -2%. (Last year carried an extra week, which contributed 4% incremental volume.). Revenue per case moves 50 basis points higher to 3%.

...while trimming estimates on CCE – also lowering price target from \$22 to \$20

Thus we have raised estimates for both PepsiAmericas and Pepsi Bottling Group, while trimming our estimate on CCE:

- **PAS:** Our full-year 2004 EPS estimate has risen \$0.01 to \$1.24, versus \$1.20 consensus and guidance range of \$1.19 to \$1.21. We are adding a penny to 4Q04 (now \$0.25),
- **PBG:** Our 2004E EPS has also increased \$0.01 here, to \$1.75. vs. \$1.73 consensus and guidance range of \$1.68 to \$1.74. Again we are adding a penny to 4Q04 (now \$0.32).
- **CCE:** We have taken Q3 \$0.02 lower to \$0.37 and Q4 \$0.02 to \$0.17. Thus, our full-year forecast is now \$0.04 lower at \$1.25 – one penny below recently lowered management guidance. We have also cut our price target \$2 to \$20.

With regard to the blue bottlers, despite increased confidence in better than expected top line prospects, we are holding the earnings momentum down in light of persistent commodity related cost pressures. It may be a conservative stance, but looking into higher COGS next year and uncertain competitive response to share loss from Coke, building a rainy day fund seems more likely.

Increased confidence in above consensus 2004 estimate for PepsiCo - \$2.32

Our views on PEP and KO are unchanged for the time being

Too little credit is being awarded to Pepsi's domestic soft drink performance. We expect one more upside surprise. No change in our Q4 estimate of \$0.60.

Conversely, Pepsi's good fortune has an element of zero-sum to it this time around. Coke is not getting much incremental display in stores. Its innovation shortfalls have wounded credibility with retailers and Pepsi appears to be lagging the recent round of price increases in some markets. Consequently, we have lowered our domestic volume forecast 2% and 2% for Q3 and Q4. The loss in volume leverage may be offset by higher revenue per case, but the imbalance is disconcerting.

We recently lowered our Coke forecast in line with guidance for the quarter and the year, but our confidence is not high

As for Coke, we will save this long conversation for another day, but suffice it to say – we see some issues. That said, it is somewhat unlikely that new CEO Neville Isdell will take a radical step in the short run (i.e., provide a major step up in marketing support). We would argue that Coke has paid for such moves over the long run as it reinforces unwanted strategies such as the rate-based "growth plan" now being pursued at CCE.

Valuation: in bottlers, we remain most constructive on PAS

Pepsi Americas is rated Buy with a \$23 target price. This equates to TEV/EBITDA of 8.3 times, discounting 3.5% 10-year EBIT growth.

We would like to see more evidence that PBG's Mexican business is indeed on the mend

We think PBG is also likely to outperform in the quarter, but we would like to see more evidence that its Mexican business is indeed on the mend before becoming more constructive on the shares. We maintain our Hold rating and our price target remains at \$32, discounting 10-year operating income growth of 5.5%.

Many clients may take the view that CCE is "cheap enough" following its recent pre-announcement, but we do not expect the news flow to turn positive anytime soon. We are increasingly concerned that factors such as persistent late-quarter hurricanes in Florida may cause another shortfall vs. expectations. (Its fiscal year ends 9/30 vs. early September at Pepsi.) As for Q4, consumer and retailer response to the 1.5-liter smooth serve is weak, yet it continues to roll out nationally. CCE's retail prices have not been universally followed by Pepsi. Further, following a year of revising, the funding/concentrate agreement is being revised again.

At CCE, we see many reasons to expect underperformance and few signs of encouragement

In short, there are many reasons to expect underperformance and few signs of encouragement. The structural challenges with Coke may require management change, re-consolidation, revised funding agreement or all of the above. Our new \$20 price target equates to TEV/EBITDA of 8 times, discounting 10-year EBIT growth of 3%.

Risks: Coke could become more price-competitive

Coke may well provide enough support and new advertising to reinvigorate its domestic business via direct bottling subsidy. In such a scenario, Coke would become much more price-competitive and the loss in share volume could be reversed at Pepsi's expense.

We continue to see raw material costs on the rise, which is likely to pressure gross margins for some time. Retailer and consumer resistance to higher prices could further curtail volume growth for the industry.

Do you see what I see?

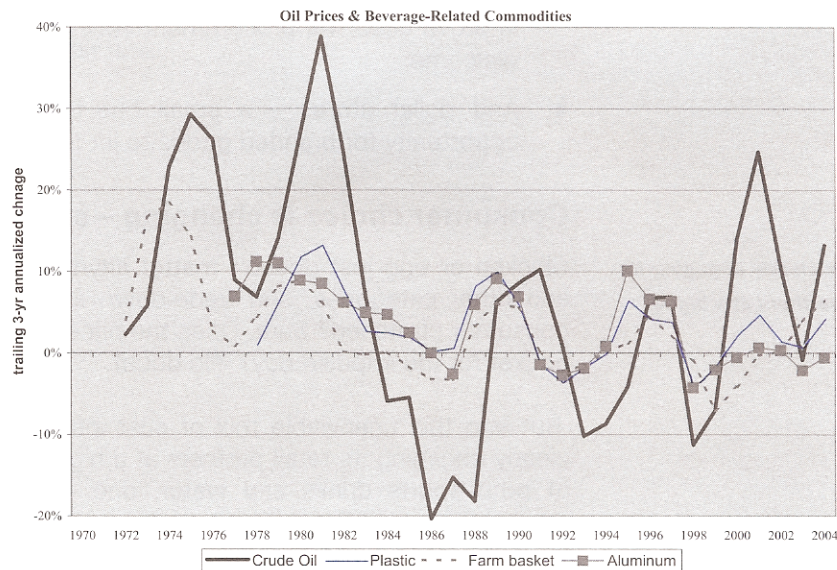
Cost pressures are mounting

It's a bit of a problem, actually. The domestic beverage industry has very real cost pressures at the moment. Our quarterly preview discussed how both coincident and lagging effects from higher oil prices are pushing most of the raw materials in the beverage basket higher. It has not happened overnight, and it may not go away tomorrow. In fact, history suggests it may be a fact of life for some time. So what to do?

A 35-year correlation with higher oil prices

Aluminum, PET (packaging accounts for the largest single component of cost of goods at the bottler, brewer level) and farm products appear to move in relation to higher oil prices over the last 35 years. According to bureau of labor statistics data (BLS), oil impacts were most significant in the 1974-1976, 1979-1982 and 1989-1991 periods.

Figure 1: Oil Impact on Beverage Commodities



Source: Deutsche Bank, BLS

Gross margin pressure drives up pricing, and ultimately investment spending

So soft drink and brewing companies try to move up wholesale prices to cover costs. And in many cases, the retailers recognize the pressures. But then something unintended happens. Retailer-funded or featured category promotions decline. As we have discussed at some length previously and repeatedly ("The Complex Carbohydrate Solution"), the greatest risk to both higher prices and increased product complexity is slower velocity or retail product turns.

It's a vicious cycle. Supplier raises prices. Retailer passes it through and takes higher pricing as well. Consumer interest in the so-called "fast turn" categories wanes as they are no longer perceived as good value relative either to last year or vs. private label. Retailer promotion into these categories slows. And both volume and value on the beverage company top lines fades.

Faced with declining category volume, the industry response is rarely along the lines of "we priced ahead of the opportunity." Instead it is typically the more proactive "We need to invest to drive volumes and growth". Then, as is so often the case, the "proof statement" to the Street comes in the form of higher advertising/media marketing. Of course, these investments – whether one-time or secular – impair operating profits.

From an analyst perspective, then, the question is ultimately not how much, but for how long? We are only just beginning to observe gross margin pressure from raw materials. If the need to pass through lasts longer than a year, what happens to the level of investment spending?

Retail price increases slowing volume, even causing declines

Price and price alone is not a winning strategy – retailers want to take costs out, not add them in

The major bottlers – CCE, PBG, PAS and Cott – have acknowledged the gross margin pressure and have pressed retailers to pass it along in the store. But price and price alone is not a winning strategy. As we highlight in concert with DB's retail team, most retailers today are looking to take costs out – not add them in.

- Wal-Mart wants to be the low cost provider and the price leader.
- Stop & Shop wants to deploy better technology along the supply chain to improve costs via procurement savings – DSD invoices in the store are not so welcome.
- And dollar stores – a small but fast-growing retail channel – present an opportunity for branded goods to lift their overall merchandise appearance.

Consumer choice is changing – so is Pepsi

Pepsi is clearly engaging its retail partners at a higher rate

Chicken or egg just doesn't matter anymore. CSD declines, migration into water and other categories, and trade-down into private label are happening. Is the consumer stretched? Sure. Does the price at the pump leave a few less coins in the pocket for the impulse buy? No doubt.

But into this unenviable mix of cost inflation and negative channel mix, Pepsi is clearly engaging its retail partners at a higher rate. Looking to leverage the success of both sports drinks and water, one retailer has recently changed its C-store schematic to add Propel inside both cooler doors. Its highly successful Halloween tie-in is winning merchandise floor space at a rapid rate and more importantly, driving key retailers like Wal-Mart to fund key CSD package promotions themselves.

And so, Darwinian friends – adapt or decline.

Coke system is either unresponsive or responding with the wrong approach

Coke and CCE may actually be exacerbating the current challenges

If it were only as simple as lacking product in the non-carb area, or simply plugging in more effectively to the Hispanic demographic – which Coke has historically ‘owned’ in the US market. Instead we fear that the Coke system – and in particular its lead domestic bottler CCE – are making decisions in the marketplace that exacerbate the current challenges.

- Most retailers we spoke with for this report felt the price elasticity for 20-ounce single-serve would not respond well to the next incremental dime of wholesale prices increases.
- Importantly, some noted that little in the way of product buzz or merchandising appeared to accompany this price up.
- Many have added private label water and other categories in the channel.
- The take home rollout of the smooth serve 1.5-liter has been roundly greeted as “less for more.”

In short, while it is clear that pricing is needed to offset margin pressure, the retailer, the consumer – and importantly, the main competition – are finding other ways than just rate.

Take a little look-see...

A telling picture of the beverage marketplace...

Market tour of Norwalk, CT

One market can not begin to tell the whole story, but as a composite, it can lend useful insights to a broader set of data, interviews, and national retailer commentary.

So we chose Norwalk, Connecticut to go fishing along the Sound for some idea of how the Coke and Pepsi bottling systems are serving all the market channels – not just the ones we can measure with scan data. So while the catch in mid-October remains surprisingly good for stripers and blues, we had some luck trolling the streets, C-stores, delis, dollar stores, warehouse clubs, Wal-Marts, Shoprites, etc.

...advantage – Pepsi

Our two-day survey of prices and consumers in Norwalk, CT yielded a telling picture of the beverage marketplace:

- Pepsi is best positioned to win at the top using moderate pricing and timely merchandising...
- ...while Coke has raised prices too high and dropped the ball on market execution.
- Traditionally a nondescript staple in grocery stores, private label is infiltrating local grocers, C-stores, drug chains, and even local on-premise outlets.

Figure 2: Norwalk CT. – not just a fisherman's world.

Population: 82,951
 73.95% white
 15.27% African American
 0.21% Native American
 3.25% Asian
 15.63% Hispanic
 7.33% Other
 (15.63% Hispanic, included in listed categories)
 Median age: 37 years
 Median household income: \$59,839
 (National: \$41,994)

Source: Deutsche Bank, US Census

Prices are pushing the elasticity envelope and slowing velocity

Don't be afraid of the dark!! – C-store channel findings

Our travels in the C-store channel ranged from major chains like Tiger Mart and Shell Food Mart to corner variety stores. The 20-oz single serve package dominates here, and prices are highest, as one would expect. However, our C-store contacts tell us prices are pushing the elasticity envelope and slowing velocity. Most stores carry both Coke and Pepsi products, each with one or more doors of cooler space depending on store size.

More little edges to Pepsi

However, the little things tell the biggest stories:

- For instance, more often than not, Pepsi doors featured promotional signs – “Don’t be afraid of the dark” signs for Mountain Dew Pitch Black, Live Wire, and Code Red, Pepsi Edge signs, along with “Get spotted and you could win” signs. One outlet featured a cooler up front containing Pepsi Edge and tear off coupons.
- Coke signs and promotional materials were sparse and appeared haphazardly placed. For instance, though C2’s marketing expenditure far exceeded Pepsi Edge, we saw more Pepsi Edge promotional material. Pepsi and Coke were often the same in this channel, and consistently the highest in the market.

The clearest picture here shows Pepsi gaining the edge with effective merchandising.

Figure 3: C-store 20-ounce – Norwalk Survey

	Mean	High	Low
Coke	\$ 1.33	\$ 1.50	\$ 1.25
Pepsi	\$ 1.36	\$ 1.59	\$ 1.25

Source: Deutsche Bank

Pepsi again shows outstanding tie-ins/promotions, plus lower pricing

On-premise: fast food, pizza, and delis – getting better for you?

The point of sale coolers at smaller format restaurants such as pizzas and delis are hotly contested by the majors – exclusivity by store can yield a steady profit stream. We reviewed establishments ranging from well-known fast food chains like McDonald’s and Wendy’s to local pizza shops and delis. Larger chains were fountain-exclusive, with the exception of the ubiquitous Dr. Pepper.

Pepsi scores the winning point here again with outstanding tie-ins and promotional materials. For instance, a joint Taco Bell/KFC features Pepsi cups tying into football season, and a healthy meal tie in with Diet Pepsi. Most on-premise channels featured coolers with Coke and/or Pepsi, with a largely equivalent representation between the two.

However, the CSD per ounce price average was 3% to 8% lower for Pepsi than Coke in on-premise.

Figure 4: On-premise Coke vs. Pepsi

	12-oz	20-oz
Coke	\$1.00	\$1.50
Pepsi	\$0.97	\$1.38

Source: Deutsche Bank

Take-home: less retailer promotion in soft drinks

We review Wal-Mart in greater detail separately, now focusing on traditional food, drug and mass – areas for which public volume and price data is readily accessible. Grocery channel retailers typically dedicated one full aisle to beverages, including CSDs, water, and sports drinks. Roughly 10-15% of prime grocery real estate – end cap positions – featured beverages, often showcasing specials on two-liter bottles or 12-pack cans.

Store manager comments tend to display some friction between these retailers and the DSD systems, as traditional hi-lo merchandising is not aided by higher prices. End caps are migrating to non-CSD beverage categories – beer and water. As we later discuss, we found Coke’s new 1.5 liter on display, but the value proposition to consumers is not strong at present. Pepsi features were typically more traditional packages and water (Aquafina), with overall grocery prices somewhat lower across the grocery channel.

Figure 5: Take-home : Average Large Bottle Prices: CSDs

Size	2L	1.5L
Coke	\$ 1.56	\$ 1.33
Pepsi	\$ 1.47	
DPSU	\$ 1.42	
Private Label	\$ 0.83	

Source: Deutsche Bank

Water: consumers know to wait for the lo in hi-lo

How long before water is yesterday's news for Coke and Pepsi? Bulk water multi-packs (such as a 24-pack half-liter and larger) dominate the water business in the channel. In fact, one store manager told us that 90% of water volume is based on what's on sale – \$5 or less for 24-packs.

To us, this suggests that the low-hanging fruit of double-digit volume growth for the category may have been arbitrated away by two things:

- A highly effective Nestle water distribution system...
- ...and a consumer who has been trained to wait for the lo in hi-lo retailer pricing strategies.

End caps draw a very clear grid of the beverage market

Drug stores: Pepsi's Halloween ties are crucial in this channel

Branded CSD and water assortment was comprehensive in the drug chains we visited. Again, however, Pepsi's "Don't be afraid of the dark" merchandising was afforded prime real estate in store. The highly visible display included signs plus two liter bottle and fridgepacks of Mountain Dew Pitch Black, Code Red, and Live Wire. Additional signs for Pepsi Edge were scattered throughout the store. We found one C2 display, but few other compelling Coke promotions.

Water promotions were neither red nor blue. Walgreen's walk-through paints an equally interesting picture. An aisle of private label CSD's and flavored water greeted us at the door. Two more end caps caught our eye in the front, one for water (private label, Dannon, Poland Spring) and another featuring Gatorade on sale. Next, the front CSD end-cap displayed Pepsi products combined with a Frito-Lay snack stand. Eye-friendly and on a valuable piece of store real estate, this display was easily the best in the store.

Coke took the opposite end cap halfway into the store, and shared its space with a few other brands such as 7-Up and Dr. Pepper. A Cooking Light tie-in with Diet Coke caters to the health-conscious consumer (not unlike Pepsi's meal tie-in at Taco Bell). Many older adult consumers drink fewer CSDs or are switching to water.

Of all five end caps dedicated to beverages, only two were CSDs – non-carb and private label representing the remaining three. We can't draw a much clearer grid of the beverage market than that.

From the consumer's mouth

On the outside looking in

To broaden our insights, we conducted brief interviews with consumers outside various distribution channels within Norwalk. We asked about CSD preference, willingness to switch brands, and primary beverage. Upon leaving the store, we proceeded to ask the consumer a series of questions as to their preferences within the CSD and water categories. Out of 50 respondents, most (70%) appeared to be in their 30s or 40s, while the female/male split was 60/40. Ethnicity roughly matched the area demographic - 74% white, 12% African American, 10% Hispanic and 4% Other.

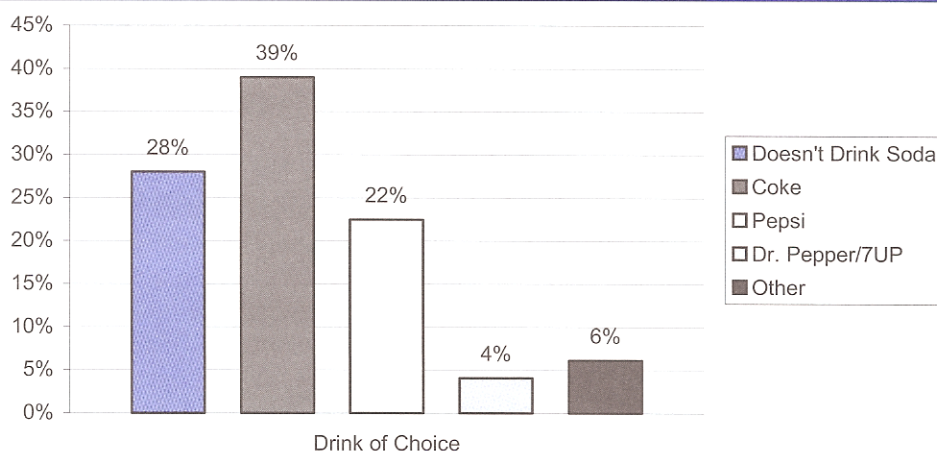
Key takeaways

"I don't drink soda"

Some 14 of 50 respondents (28%) informed us that they do not drink soda. Wow, ubiquity of CSDs in the purchase basket may be a thing of the past. This further supports the notion that brand-owners must address the needs of a changing consumer base as the take-home buyer is becoming more health-conscious. This is not new news. However, when we place it in the context of raising prices on CSDs to ease gross margin pressures on a declining consumer base, the data point becomes more relevant.

Increasing relevance in light of the CSD pricing/gross margin situation

Figure 6: Consumer preferences



Source: Deutsche Bank

Brand loyalty present, but vulnerable in CSDs

A majority of Coke and Pepsi drinkers (78% and 75% respectively) stated they would stick with their drink of choice, despite higher prices. Those that did not exhibit loyalty were more cost-conscious, stating that they like to look for sales and tend to buy whatever is cheap. As we later see, Wal-Mart's promotion of Pepsi 2-liter at \$0.88 vs. Coke 1.5-liter at \$0.97 is clearly targeting the 15% of total respondents surveyed who said they would buy what's on sale.

Poland Spring: a Clear winner – private label brands not far behind

46% of those surveyed chose Poland Springs as their preferred water brand, followed by 20% that would buy private label. We found that the consumer in this space is not as discriminating. Those that were surveyed would rattle off tap water, Aquafina and Dasani all in the same sentence.

Retailer spotlight

Wal-Mart: the frighteningly large "unmeasured" channel

"Other than *that*, Mrs. Lincoln, how was the show?"

The most troubling aspect regarding the inferences derived from measured scan data from providers like IRI and A.C. Nielsen is the exclusion of Wal-Mart, the nation's largest retailer. We estimate WMT represents close to 20% of total soft drink category sales, and it looks to expand square footage by 8% per year. It is almost certain, therefore, that the combination of its discount stores, supercenters, neighborhood stores, and Sam's Club will continue to gain market share.

To better understand which beverage companies manage this critical retailer relationship well, we asked Bill Dreher, DB's department store retail analyst, to provide a brief overview on Wal-Mart's key drivers. We later reconcile these insights with store observations, consumer survey results and comments from industry contacts.

Dreher's take on Wal-Mart

- **Basic strategy:** WMT's basic strategy is that of a low-cost producer and "Price Leader". WMT seeks to offer Every Day Low Prices (EDLP) while also maintaining cost proximity and product parity. The company plans to increase SF by 8% per year, primarily through new Supercenters and international expansion.
- **Business model fundamentals:** WMT is the cost leader and therefore must be at the forefront of technology in order to maintain its low-cost competitive advantage. The company constantly seeks ways to increase productivity in order to drive Every Day Low Cost (EDLC) and remain the EDLP leader.
- **Importance of suppliers:** Relationships with suppliers and buying efficiencies are important for WMT to maintain its low-cost producer strategy. The company typically has buying power over its suppliers due to the large volume of goods it purchases from its suppliers. This also allows WMT to utilize its suppliers to streamline efficiencies. WMT pushes the carrying cost of inventory back on its suppliers, increasing inventory turns and decreasing costs. In addition, WMT's suppliers have become increasingly important to the company's supply chain efficiencies with the introduction of radio frequency identification (RFID). If control over suppliers is lost, WMT's competitive advantage could be in danger.

Market impact

Wal-Mart's format and approach to category management can be very different from that of traditional food retailers. A clear example can be seen in both shelf-space allocation to private label and the branded/private label price gap found in our market survey.

Figure 7: Wal-Mart Private Label/Value Shelf Space Allocation

Beverage Aisle	50%
Free-standing displays	0%
Back-wall	10%
Cooler at Checkout	10%

Source: Deutsche Bank

The value segment includes local brands and in some cases DPSU brands at prices 15% or lower than Coke and Pepsi products.

Weak product or package innovation – a deterrent for Wal-Mart

Beverage facings: in-store, at checkout and back wall display. Most if not all private label products at Wal-Mart reside in the beverage category section of the a Wal-Mart store. Alternatively, branded products from Coke, Pepsi and others are merchandised around the store, in freestanding aisle displays and at checkout. The strength of these displays – particularly the innovations around merchandising or product/package – goes a long way in determining who wins the volume game. Alternatively, a relatively weak product or package innovation detracts from Wal-Mart’s willingness to use its own promotional dollars to fund attractive price points.

Success: why Pepsi is winning right now

As noted elsewhere in this report, Pepsi’s Mountain Pitch Black line extension has the not-so-quiet look of a winner. On the success and solid name recognition of the mother brand, Pepsi has successfully taken what would otherwise be known simply as orange and grape soda and co-branded a very effective Halloween promotion with its Live Wire (Orange) and Pitch Black. It has gained cooler space, displays and perhaps most importantly, correspondent benefits elsewhere in the store via retailer-funded Pepsi 2-liter packages.

Figure 8: Take-home CSD share by key package

	Volume share	Dollar share
2 liter	16.1%	21.3%
12-pack	48.9%	49.2%
1.5 liter	0.3%	0.3%

Source: Deutsche Bank IRI: Food, Drug, Mass Merch for 12 weeks ended September 5, 2004

As the data above indicates, 2 liter packages may not be the most profitable (dollar share significantly trails volume share), but our contacts indicate this type of package is often used by retailers to build price impressions. For example, Sam’s Choice 2-liter rolled back from \$0.57 to \$0.50 this year, while 12-pack pricing moved up from \$1.87 to \$2.00. If we apply the standard take-home mix of 2-liter vs. 12-pack above, (roughly a 75/25 split), we note that aggregate price realization on a per ounce basis is effectively 2.2%, or not much different than the 3-4% price realization public bottlers have noted.

As our consumer survey findings validate, offering more for less is likely to cause some switching – with the negative volume results at Coke still being felt

But more than the implied widening of prices, it is how such price impressions can also be used to promote value strategies for customers, in line with Bill Dreher’s comments. Back to 2-liter at \$0.88 for Mountain Dew vs. \$0.50 for Sam’s. Such a \$.38 premium over private label (75% premium) is also priced below with Coke’s new 1.5 liter at \$0.97. As our consumer survey findings validate, offering consumers more for less is likely to cause some switching – with the negative volume results at Coke still being felt.

Failure: how weak package innovation hurts Coke

Wal-Mart’s positioning of Pepsi 2-liters across the aisle from the free standing Coke 1.5-liter display at the same price is a clear value for consumers. Digging further, comments from a number of store managers in our market survey lend a more insight into why a broader national rollout of this package “as is” is likely to be further exploited.

Regional supermarket chains:

- "1.5-liter value is weak. Customers see it as a rip-off."
- "Coke pricing not likely to stick."

National drug store chains:

- "1.5 liter value to customer is weak"
- "2 liter Pepsi Edge selling well."
- "Difficult to position as consumer choice outside CSD is growing"

CCE's price-first strategy has limitations. One Coke insider commented on the decision to roll out the 1.5-liter package – also referred to as "smooth serve" – in the New York area. He felt the call was made in Atlanta by people who "do not understand New York." Given the Wal-Mart-funded competitive positioning of Pepsi 2-liter CSDs, we worry that those same people may not understand the rest of the country either.

Aubin's take on how traditional food retailers compete

Edouard Aubin, DB's food retail analyst, outlines the basics at Ahold's Super Stop & Shop (one of the take-home retailers in our survey):

- **Basic strategy:** Stop & Shop is a traditional hi/lo operator with an enviable position of strength in the New England region, a market that currently faces limited (but increasing) competition from major discounters such as Wal-Mart. The oligopoly of Stop & Shop, Hannaford and Shaw's creates industry-leading levels of profitability, illustrated by Stop & Shop's 8.6% operating profit margin in 2003, versus approximately 5% on average among the major US grocers (Safeway, Kroger and Albertson's).
- **Business keys:** Quality management, zoning restrictions and reasonable real estate strategies also translate into the highest sales density in the industry (sales per square foot of \$712 versus \$400 for the industry).
- **Importance of suppliers:** Ahold is ahead of the supply chain curve relative to Kroger, Safeway, and Albertson's. It benefits from the combined expertise of C&S (a leading wholesaler also headquartered in New England and the catalyst behind the ES3 project) and the expertise of Ahold in the Netherlands. Mounting discounter pressure will continue to drive initiatives to reduce costs and improve efficiencies – such as streamlining the supply chain through centralization of procurement. Shared supplier benefits come in order aggregation, data sharing, reduced number of procurement personnel at the retailer, improved procurement scale on a corporate level.

Impact on beverage companies

Our Pepsi system contacts keep alluding to the value of centralized procurement as a means to provide value to retailer – even among those with a bearish view of DSD systems. For example, were the PepsiCo portfolio of Frito-Lay North America, Tropicana, Quaker, Gatorade and the bottlers to create a single invoice system, the type of efficiency/inventory control referred to above could be significant. As we noted in our *Just Coke Series*, Coke's attempts in this regard via the Coca-Cola bottlers cooperative can provide one face to retailers. But while the initial savings from bringing together hot-fill and cold-fill manufacture showed promise, little profit leverage has materialized.

Our Pepsi system contacts keep alluding to the value of centralized procurement as a means to provide value to retailer – even among those with a bearish view of DSD systems

Baker on value retailing – dollar stores

One of the fastest growth areas for beverage sales has been through dollar stores. Michael Baker, DB's hardline retail analyst, outlines the basics – with the prospects for single-serve growth clearly encouraging:

- **Basic strategy:** The key to the dollar stores' success is to provide basic merchandise at a value price. This means not only providing products at \$1 (or close to it), but also providing the customer with a (perceived) value at that price point. The basic box format is simple – usually strip-mall based stores, containing low-cost fixtures, and low initial investments. Growth prospects for the sector remain compelling, with square footage growth rates on average rising 10% to 15% next year. Much of this growth is coming at the expense of “mom and pop” one-off stores located throughout the country.
- **Business keys:** Given the generally low-value, high-volume nature of the dollar store business, supply chain and technology are critical. Establishing multiple distribution centers and enhancing the supply chain helps to reduce stem miles to stores, allows for new geographical expansion opportunities, and drives expense leverage on sales gains. Point of sale (POS) store- or SKU-level visibility is also critical, as timely reordering of the correct merchandise for the correct store has proven challenging. POS technology allows for greater clarity of what is actually in the stores and what needs to be re-ordered.
- **Importance of suppliers:** While private-label branding and import penetration offer higher gross margin potential, dollar stores have also become a viable pipeline for nationally recognized products from major domestic consumer companies including Coca-Cola, Campbell's, General Mills, Hershey's, etc. The benefit to the dollar stores is that these products add credibility to their mix, offering customers instant recognition and a feeling that they are getting a value relative to what they would be paying elsewhere.

National category manager comments

Confirming our findings

We drew from several of the country's largest convenience store and petroleum retailers

To amplify our C-store findings, we spoke with a number of retail category managers to gage the current pricing environment and other emerging industry trends. As we have in the past, we drew from several of the country's largest convenience store and petroleum retailers.

Higher single-serve price points will hurt volume

Coke's recent wholesale price increases have equated to a dime increase in retail price points in most geographies. In several West Coast markets (as well as our survey), 20-ounce bottle prices are \$1.39 or higher – a price point causing many retailers to express concern.

First, several said taking prices higher in a mature category implies that all of the higher sales will come from price inflation, not volume. (Haven't we seen enough downside risk from too much pricing already?) Part of the case or "sell-in" argument proffered by branded players is that the consumer will pay as evidence by continued strong growth in energy drinks at even higher retail price points. Again, many responded that the comparison was invalid given the growth characteristics of that market segment.

CSD category volume flat – water levels rising

The already wide gap between Dasani/Aquafina and the Nestle portfolio did not leave any room on the pricing envelope at present

Retailers expect shelf space and floor space allocated to the water category to continue rising as new category schematics unfold for the coming year. Also, many expect local brands and retailer private label to account for a large portion of that incremental growth. Many disputed the notion that a better push in DSD accrues some benefit to Coke and Pepsi systems. Instead, they noted that the already wide gap between Dasani/Aquafina and the Nestle portfolio did not leave any room on the pricing envelope at present.

Figure 9: C-store: Single Serve Water

	.5 liter	20ounce	24 ounce
Coke		\$ 1.33	
Pepsi		\$ 1.25	
Nestle	\$ 1.08		\$ 1.33
PrivateLabel			\$ 0.99

Source: Deutsche Bank

Complexity risk: retailers less receptive to package innovation

Work done at several national chains suggests that distribution penetration has suffered and out-of-stocks have risen as a result of product and package proliferation, (see our 3/8/04 note, "Emerging Value Tier Threatens C-Store Profits"). This may explain the lukewarm response retailers are giving Coke and Pepsi on the introduction of 14-ounce single serve (at lower price points).

Pitch Black – good timing and execution

Most of the kinks have been worked out by the blue system as it executes on the third iteration of Pepsi’s Mountain Dew line extension, (Code Red, Live Wire, Pitch Black). Front of store barrel placement and good point-of sale promotions were commonly noted. The finite aspect of such in and out promotions has been well received. Pepsi bottlers have gained competitive advantage here.

C2 – distribution has been uneven

In what may be an outgrowth of the complexity problem, a few retailers noted problems with product availability on Coke’s C2. To us, this suggests that underlying demand may be greater than volume trends indicate, which is the worst kind of opportunity cost for a bottler.

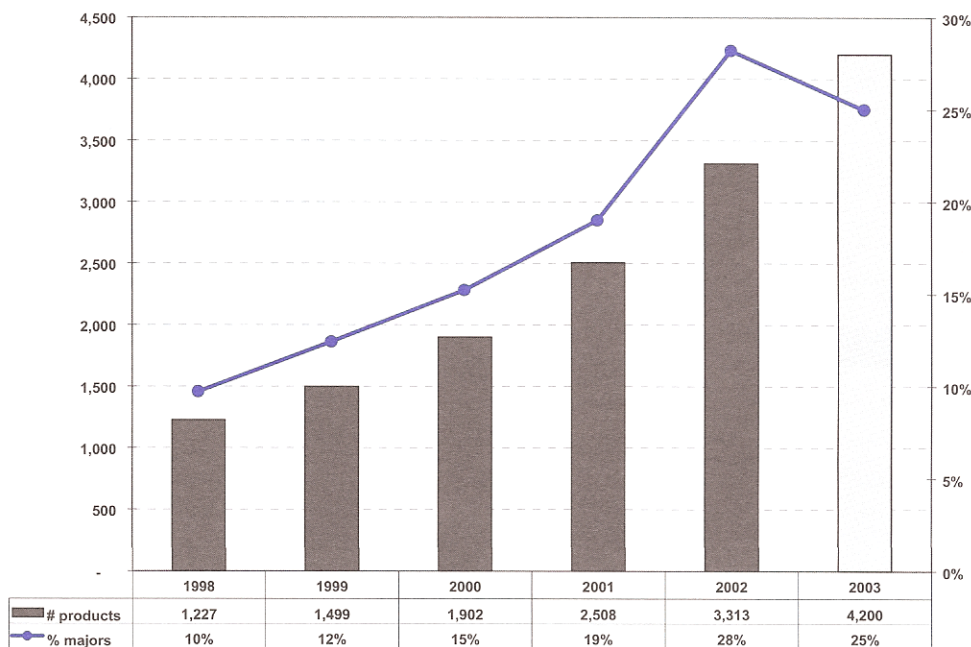
2004/2005 single serve looks challenging

In short, we expect resistance to higher pricing architecture by way of a growing creep in the value tier. DPSU brands already price below Coke and Pepsi brands inside the cooler door, and on the water side, many retailers have grown comfortable with using warehouse-distributed water brands – opening the door for private label.

Product innovation: a different (Internet) look

The retailer comments above hark back to an earlier theme from last fall’s “Complex Carbohydrate Solution,” where we outlined the risk and rewards of a rapid innovation cycle. Our basic view has been that there is nothing wrong with innovation – as long it’s good.

Figure 10: Product flow and majors share



Source: Mintel, DBSI

But with so much of it – an increasing proportion coming from the majors – system complexity negatives have clearly outweighed incremental revenue positives. We see this in the case of C2, in the rollout of Coke’s 1.5-liter smooth serve bottle, and in a growing anxiety about the true value of DSD among retailers.

Is part of that reaction avoidable? What about better innovation? What about bringing products front and center that create a buzz, and how would one measure such a thing?

Bevnet

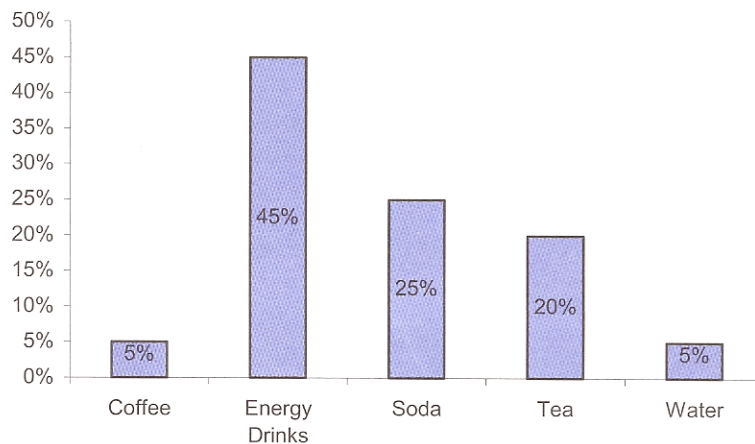
BevNet.com is an internationally recognized resource for the beverage industry. This website compiles beverage rankings within each of the major product classes. Various constituents along the beverage supply chain use this online publication and are given the ability to vote and rank their favorite beverages. According to Bevnet president Jon Craven, 70% of Bevnet's readers are within the US, with the remaining 30% in Europe.

Rather than look at rankings for how it tastes or how it looks, we measure something a little less subjective: how many people actually took the time to vote. We outline the top 20 vote-getters below.

Waning CSD market

Energy drinks were the favored product line, comprising 45% of the Top 20 beverages, with the remaining 50% consisting of mainly tea and soda. Clearly, a growing product line of energy drinks has trumped the need for caffeine within the traditional CSD market. These numbers illustrate that the need for product differentiation is key in a marketplace where the consumer has more places to go for an energy kick.

Figure 11: Top 20 ranked beverage by product type

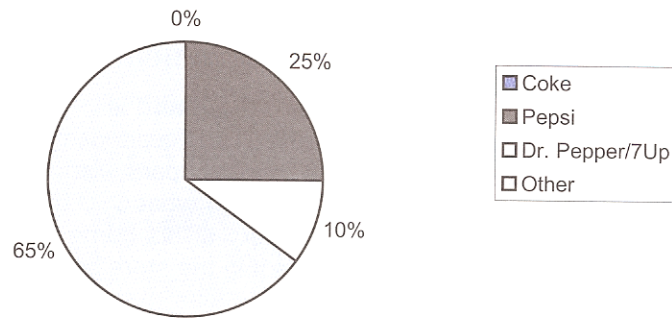


Source: Deutsche Bank, Beverage Network

Pepsi has some buzz, Coke doesn't.

Of the Top 20, just seven came from the industry's largest players – five from Pepsi, two from Cadbury Schweppes.

Figure 12: % Share of top 20 beverages by company



Source: Deutsche Bank, Beverage Network

None of Coke's brands made the Top 20 – and we find this meaningful

None of Coke's brands made the Top 20, with just 17 on-line votes for C2. Pepsi's Edge mid-calorie also had low buzz, with 7 votes. Does it mean anything or is this just frivolous, fizzy fluff? Well, let's frame it this way: Coke's pre-selling season push behind C2 included a product tie-in to American Idol, a multi-million dollar ad campaign, and a record number of free product trails. Pretty hard not to regard an anecdote like this one as a disappointment – just 17 people cared enough to have a point of view.

Figure 13: Pepsi and Cadbury Schweppes Beverages Catching a Buzz

Pepsi	# of Votes
1. SoBe Beverages	88
2. SoBe Adrenaline Rush Energy Drink	78
3. AMP Energy Drink	70
4. Mountain Dew LiveWire	70
5. Starbucks Frappucino	48
Cadbury Schweppes	
1. Dr. Pepper Red Fusion	49
2. Snapple Elements	48

Source: Deutsche Bank, Beverage Network

Figure 14: Middle Calories CSDs-Not So Much Buzz

Middle Calories CSDs-Not So Much Buzz	# of Votes
Coca-Cola C2	17
Pepsi Edge	7

Source: Deutsche Bank

Other trade commentary

Store owner comments: "Mom and Pop"

Home is where the brand is

An encounter with an Ecuadorian storeowner shed light on the growing presence of private label market, particularly within lower-income areas that are ethnically diverse. When asked what CSD he preferred, he told us of a brand called Tropicale, which is a product of his home country of Ecuador. Not only does he prefer this brand, but sells it in the store he owns not far from the convenience store where he was shopping. He also mentioned that he would purchase Snapple water in bulk from Costco to sell in his stores as opposed to purchasing it directly from the vendor.

Coke route salesman comments:

See Coke raise prices

- A friendly Coke driver told us his job was challenged recently when Coke raised wholesale prices without effectively communicating this move to retailers ahead of time via pre-selling. In recent weeks, some regular customers had been refusing truck deliveries as they occur.
- Retailers were also said to be left in the dark when it came to the delivery of new Coke products/packaging. They cited the new Sprite 0 packaging as a recent example – retailers are asking, "What is that"?
- Timing, in his mind, was also questionable – following a noticeably "slower summer than last year". When asked if Pepsi would also raise its prices, the driver was highly skeptical.
- Coke's recently launched C2 was said to be doing "okay."