Blueshift RESEARCH **REPORT**

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Kellogg to Benefit Long Term from Warehouse Shift Despite Rocky Transition

Companies: ADRNY, CPB, GIS, JJSF, K, KR, MDLZ, PEP, PF, POST, SJM, TGT, THS, WMT **September 28, 2017**

Report Type: ☑ Initial Coverage ☐ Previously Covered ☑ Full Report ☐ Update Rating: 3.5/5

Research Question:

Will Kellogg's shift from direct-store delivery to a warehouse system for its U.S. snack division boost the company's fortunes?

Summary of Findings

- Kellogg Co. (K) eventually will emerge a winner in its move to a warehouse distribution system from a direct-store delivery model. Kellogg's sales are expected to fall 10% to 15% because of the switch, but the immediate cost savings and expected supply chain efficiencies should compensate for the lost sales, especially when judged six months after the transition is completed.
- Still, sources said the transition since July has been rocky as Kellogg tries to maintain store inventory while filling warehouses. Kellogg has lost share because stores are reducing or eliminating endcaps and displays once serviced by the company's reps. Shelf space remains unchanged, however. Sales declines likely will stabilize after the first year of the transition.
- Eight of 10 sources, including three of four competitors still using direct-store delivery, praised Kellogg's move. One competitor source said Kellogg's rivals are considering a similar change.
- Computer-assisted ordering, corporate-designed planograms, and a lessened importance of relationships have limited manufacturer sales reps' ability to affect sales in grocery stores. Sources in all three silos acknowledged the efficiency gains made in having deliveries come to stores from warehouses, minimizing out-of-stock products and providing more frequent and predictable deliveries.
- Kellogg's move will be more successful in large grocery stores with space and labor. The company likely will drop weak products and contract SKUs because warehouse space is expensive and scarce.
- Kellogg is offering concessions of about 5% to 8% to retailers, but one grocery source said this is not enough. Kellogg also has offered incentives to stores to keep sales from declining more than 5% during the first quarter of the transition.
- Kellogg is reportedly set to offer deeper promotions in time for the holidays. One grocery source said a nervous Mondelez International Inc. (MDLZ) is considering following suit, but two others said Mondelez stands to benefit most among competitors.
- The one-time bump Kellogg received from filling warehouses is unlikely to provide further benefit in the third and fourth quarters. In fact, two grocery sources said Kellogg could get hit by costs associated with "shrink," including damaged products and more products reaching their expiration dates amid slowing sales.

Silo Summaries

1) Category Buyers and Managers at Grocery Chains

All three sources raised near-term concerns for Kellogg with its shift from direct-store delivery to warehouse distribution, though two of these sources are optimistic about the company's long-term benefits. The move will lead to greater efficiencies in the supply chain as computer-assisted ordering, corporate-driven planning and in-store layout push aside perceived disadvantages from leaving the direct-store delivery model. **Third-party suppliers are challenged to free up enough warehouse space to house the influx of Kellogg products.** All three sources said Kellogg sales have decreased as stores eliminate its endcaps, which were serviced by direct distribution. Sales declines are around 10%, which one source said is not that dramatic given the transition's scope. Shelf space is unchanged. Kellogg will put the money it saves on reduced labor into better incentives for stores and more promotions for customers, especially leading up to the holidays. **One large independent grocer expects discounts of around 6% to start Oct. 1.**

2) Competitors

All four sources, each employing the direct-store delivery model, expect Kellogg to see declines in sales of as much as 15% and in market share, but three of these sources said Kellogg will come out ahead, at least on the bottom line, because of the cost savings in moving into warehouses. Two sources said they and other competitors are gaining share and that Kellogg will lose in-store displays even if shelf space remains the same. One source said private-label brands will also take advantage of this opportunity. **One source estimated warehouses may have room only for 50% of Kellogg's offerings.**

3) Industry Specialists

All three sources said Kellogg is making the right move in transitioning to the warehouse model. Kellogg will realize significant cost savings, but the bottom-line effect may not be determined for six months to a year. The shift will be particularly productive for Kellogg in large retailers which have more efficient systems in place to take on the added distribution responsibilities, but the **smaller retailers with less staff will have a more difficult time managing the increased burden.** Warehouse deliveries occur three to six days a week whereas direct delivery from food companies typically occur once or twice a week.

Kellogg Co.'s U.S. Snacks Segment

	Kellogg's Transition to Warehouse Model	Kellogg's Near-Term Sales	Kellogg's Long-Term Results
Category Buyers and Managers at Grocery Chains	↓	↓	→
Competitors	↓	↓	↑
Industry Specialists	→	→	↑

Background

In February, Kellogg announced plans to move its U.S. snacks, its largest segment, from a direct-store delivery method to a warehouse model used by its other U.S. businesses. The company wants to leverage efficiencies in an effort to cut costs and improve margins for its cookies and crackers division. It expects 15% in cost savings with the move. This also gets all of Kellogg's North American businesses on the same distribution model. The company said the move was made in part because of changes in how consumers shop, increasingly opting for retail outlets and online purchases. In the second quarter, Kellogg began closing its distribution centers; several thousand workers are expected to lose their jobs by year's end.

Kellogg saw second-quarter earnings and revenue exceed expectations. Earnings grew 6% though revenue fell 2.4% from a year ago. The company said the transformation from the direct-store delivery system is on track and near completion. Gross profit margin gained 30 basis points, and operating profit margin climbed 160 basis points in the second quarter. Quarterly sales in the U.S. snacks segment were the same as the prior year, outperforming Kellogg's other staple segment, U.S. morning foods, which saw sales drop 6.6% year to year. Kellogg reaffirmed its 2017 outlook.

The risk in moving to a warehouse model is Mondelez and Campbell Soup Co.'s (CPB) Pepperidge Farm could gain share as they maintain a direct-store delivery strategy, which includes salespeople going into stores to set up products and merchandise. A Mondelez executive reaffirmed his company's commitment to the direct-store delivery model. Campbell's also reiterated its belief in the benefit of the direct-store delivery method. The company's Global Biscuits and Snack division was a bright spot for its third quarter, up 2% in sales and 14% in EBIT.

Current Research

Blueshift Research assessed whether Kellogg's shift from direct-store delivery to a warehouse system for its U.S. snack division would boost the company's fortunes. We employed our pattern mining approach to establish four independent silos, comprising 10 primary sources and four secondary sources focused on Kellogg's transition to a warehouse model, its growing online sales, retailers pressuring food companies to keep prices low, and a Kellogg competitor cutting SKUs to improve operating margins. Interviews were conducted Sept. 11–25.

1) Category buyers and managers at grocery chains (3)
2) Competitors (4)
3) Industry specialists (3)
4) Secondary sources (4)

Next Steps

Blueshift Research's next report on Kellogg will track sales trends through the completion of its transition to the warehouse model. We will monitor how grocery stores (including small retailers) respond, whether supply chain efficiencies come to fruition, and how losing endcaps affects the brand. We also will learn more about Kellogg's price concessions, its competitive positioning, and pricing maneuvers on its products. Finally, we will determine if any of Kellogg's chief competitors are closer to adopting a warehouse model as well.

Silos

1) Category Buyers and Managers at Grocery Chains

All three sources raised near-term concerns for Kellogg with its shift from direct-store delivery to warehouse distribution, though two of these sources are optimistic about the company's long-term benefits. The move will lead to greater efficiencies in the supply chain as computer-assisted ordering, corporate-driven planning and in-store layout push aside perceived disadvantages from leaving the direct-store delivery model. Still, the transition is off to a rocky start; Kellogg is having a difficult time maintaining the freshest products in stores while also filling warehouses. Also, third-party suppliers are challenged to free up enough warehouse space to house the influx of Kellogg products. All three sources said Kellogg sales have decreased as stores eliminate its endcaps, which were serviced by direct distribution. Sales declines are around 10%, which one source said is not that dramatic given the transition's scope. Shelf space is unchanged. Kellogg is offering incentives of 1% to 2% on a sliding scale for retailers whose snack volumes do not fall below 5% for the first quarter of the transition. Kellogg will put the money it saves on reduced labor into better incentives for stores and more promotions for customers, especially leading up to the holidays. One large independent grocer expects discounts of around 6% to start Oct. 1. The source said Mondelez fears needing to lower its prices or to increase its promotional activity in order to compete. However, the two other sources said Mondelez will see increased sales and share in the short time Kellogg makes its adjustment. Also, the one-time warehouse fill that benefitted Kellogg in the second quarter may work against the company in upcoming quarters because the supply chain will be overstocked and too many products will reach their expiration dates.

<u>Key Silo Findings</u>

Kellogg's Transition to Warehouse Model

- 2 of 3 sources said the transition to the warehouse model has been a rocky one for Kellogg.
    - Kellogg is having difficulty maintaining the freshest products in stores while also filling the warehouses.
    - More growing pains will occur as positive results are not expected for the first 6 months.
    - 1 source's third-party supplier is challenged to find a couple hundred warehouse slots for Kellogg products.
- 1 said the transition will help Kellogg in the long run.
    - Corporate is more involved in the planning and layout so not having direct-store delivery is not as crucial to the product. Also, individual reps do not drive sales like they once did.
    - Warehouses are aided by computer-assisted ordering, creating more efficiencies for the retailers and reducing out of stock products.
    - He is not seeing much difference at the retail level.
- 1 said this move will not work for Kellogg and it will be costly long term with significant drop in sales volume.
    - Believes Kellogg may try to revise expiration dates to keep products on shelves longer.
    - Retailers may carry fewer SKUs or flavors of the same product, choosing only 3 different package combinations instead of 6, for instance.
- The one-time warehouse fill will cause a supply chain overstock, and many products will reach their expiration dates.
    - 1 said Kellogg will cede its warehouse fill advantage because of eventual lower sales.

Kellogg Sales

- All 3 said sales are falling and will continue to do so in the short run.
    - 1 said sales were falling before the switch as a dispute with Kellogg led to the removal of endcaps.
        - Has not noticed additional declines since the switch.
    - 1 eliminated its Keebler endcaps in July when Kellogg stopped servicing them because of the shift away from direct distribution, causing a 10% drop in volume.
    - 1 estimates sales could fall as much as 20%.

In-Store

- All 3 said shelf space remains unchanged, in part because of corporate planograms.
    - 1 said the warehouse model makes it easier for stores to manage and plan since all deliveries come from the same place at the same time.
    - 1 will review the category in January and will reset after seeing sales data, at which time shelf space for Kellogg could be affected.

    - 1 said if items are out of stock, store managers use their discretion to fill the empty space, including with competitor products. This threatens Kellogg since direct-store delivery was more of a just-in-time program.
        - Smaller, independent retailers and convenience stores have little to no stock room space, hampering Kellogg with its warehouse delivery system.

Pricing and Margins

- 1 said the warehouse model is more efficient for stores and the benefits outweigh the increase in labor costs.
- 1 believes Kellogg will drop prices 6% in October to match what it believes is the increased cost of labor for retailers, though the source said the increase will be more than the price concessions Kellogg is offering.
    - Kellogg is also offering incentives to retailers if they maintain certain sales levels, or keep declines at a minimum, through the initial phases of this transition.
- 2 said Kellogg will put the money it saves into better incentives for the store and more promotions for the customers, especially leading up to the holidays, packaging a 5-for-$2 snack deal instead of what was a 4-for-$2, for instance.
    - 1 said this is already taking place.

Competition

- 2 said Mondelez will benefit from Kellogg’s shift.
- 1 said Mondelez is nervous that Kellogg’s dropping prices will require a similar response, especially in the run up to the holidays.

1) Manager for a large chain in the Southeastern and mid-Atlantic states

Although the transition has been a bit rocky, Kellogg’s move away from the direct-store delivery (DSD) model should benefit both the manufacturer and large supermarket chains over the long term. Still, sales for the next few quarters likely will be hurt by the transition. Sales in his stores were falling before the switch as a dispute with Kellogg led to the removal of endcaps. Of note, vendor sales reps have increasingly lost their ability to influence merchandising decisions in individual supermarkets, especially those housed by very large chains. Computer-assisted ordering at the warehouse level should translate to much greater efficiencies in the supply chain, another plus for Kellogg. The fallout will be relatively small from the loss of direct-store delivery in snacks alone. The much bigger deal will be upcoming price negotiations; a key element of the deals will be how the various potential supply chain efficiencies from the warehouse strategy shake out. Still, a few months will pass before the supply chain effects become meaningful. The one-time warehouse fill is unlikely to help the third and fourth quarters. However, a big drop could come from the old supply chain, which may make many products unsellable because of the transition.

Kellogg’s Transition to Warehouse Model

- “The transition was a little bit rocky just because the amount of product that you need to supply into multiple warehouses. You’re trying to maintain your normal DSD avenue, so you don’t lose any sales right up until the day of the transition. But you’re also trying to fill the pipeline at the warehouse. There is where Kellogg stumbled.”
- “Also, when you do that, how do you maintain the freshest product, and make sure you don’t have unsellable product [because it passes its use-by date]? That, to me, would be a nightmare to manage, from within the supply chain and within that whole transition.”
- “There absolutely will be [more] growing pains, and that could be where people say this is a disaster. But I think when you get further down the line—four to six months out—then [Kellogg] should be able to put [these growing pains] behind them and then really start to get much better results long term.”
- “[Kellogg] may not have the lever of their sales force to go hit a number very quickly, to make Wall Street happy [in that sense], but it should really give them a much smoother long-term outlook.”
- “There’s so much change involved in that first six months that you almost have to discount that time, and look at six months and beyond to really get a better view of whether it’s headed in the right direction, and whether it’s going to continue to be profitable for both businesses.”

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Manager, large grocery chain
Southeast and mid-Atlantic

- “From the retail side of it, I have not noticed that much of a difference. I think we’re headed in the right direction.”
- “Within the last seven years there’s been a shift within how we—and I believe other major retailers as well—look at whether they’re going to allow their stores to have free rein over merchandizing, and individual relationships to give up floor space to vendors.
- “It used to be that [individual store managers had a lot of say in planograms and other merchandising decisions], and now the shift has really gone to corporate wanting to control [how individual stores make decisions about merchandising strategy] because there are much bigger negotiations going on around things like a volume incentive, for example, or floor space.”
- “[Corporate] is looking more wholly at the money we get from an individual vendor, and not just total sales dollars and total profit from them. If you’re only looking at the profit that a vendor [like Kellogg] is giving you through sales, you’re missing a lot. You could have a vendor that you’re much more profitable with because of all the other money that they spend on your business.”
- “As an individual store, you would never ‘get’ that aspect [of the bigger picture], and so that is where [corporate HQ has] really started to plan out all of our endcaps—even our display spaces. So now as a store manager, you don’t have free rein over all your extra space at the store. It’s really going to be called out and dictated by corporate.”
- “With that in mind, when I see the DSD companies come in who say they have sales reps who are going to push the business, I get that, but I really think that the salesmen’s ability to drive sales within their territories has been diminished over the last seven years.”
- “When I see companies say they’re going to go in-house and put [product] directly in the retailer’s warehouse, computer-assisted ordering is another aspect that comes up. A lot of companies out there are working on that and have it executed with their warehouse side.”
- “If we as a retailer can control [the ordering at the warehouse level], then we can really fix our problem spots.”
- “[The potential strength of the warehouse model is] if we bring this into the warehouse, we will have more control over what we do with the product, the velocity of the product, and we should really then minimize [what’s] out of stock at the store.”
- “There’s a significant shift [to where] the key account manager that calls on the account is now the one that’s going to have much more responsibility to be able to drive incremental sales above and beyond what was sold last year at the same time.”
- “And going into the warehouse kind of makes [the key account manager’s] job easier, because now your supply chain has just called Kellogg’s supply chain and told them what they need, which is much easier than trying to manager 300 to 500 sales reps that call on 1,000 stores—and they’re all over the place with execution. Now I can get consistent execution. And so I think this will help Kellogg in the long run.”
- “[The move away from direct-store delivery] can be a good move for Kellogg in the longer run because it allows much better control over the absolute planning. You kind of reverse-plan it: What is the key account manager going to sell at corporate? And he can then roll that back all the way to his supply chain back at Kellogg to say what raw materials they need in.”
- “[Conversely] if you had 500 to 700 sales reps out there, and maybe a third of them were able to secure massive displays—but your supply chain wasn’t expecting it—you might get those sales in those stores, but you’re going to negatively impact sales in other stores because your supply chain isn’t ready for it.”
- “So I would expect [real efficiencies in the supply chain to come from this warehouse strategy]. Now is that truly going to happen? Not sure. I would expect Kellogg to be at that level and to be able to really tighten up on their entire supply chain, their planning process, and really get a whole lot better results out of that.”
- “In the next couple months—after the six-month time frame—if [Kellogg’s] clients do not start to see the better results, then it’s time to ask the real tough questions as to … why are we still not seeing a better result in sales, or a better result from your supply chain, from efficiencies. Over the six-month time frame you should be able to get the kinks worked out and start to really see a much better impact on the business for Kellogg.”
- “[The one-time warehouse fill] would give them a good bump, but what did they have to do with the supply that they had in their own warehouses, to supply the DSD structure? What happened with that? There is a big negative potentially coming, and that is you got that big bump in Q2 as you’re filling the supply chain. But what happened to

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the old supply chain? And when you add those two numbers together, are you going to have higher unsellables because of this transition?"
- "So depending on how long the use-by date is on some of their products, and whether they put the right amount into the supply chain that they're filling up for direct warehouse … but what did they end up doing with that product that may have been left over in the DSD pipeline? Not a big positive, but there could be a big negative in a couple of quarters, potentially. I would think it could be … the third or fourth quarter of this year."
- "[The different supermarket banners] compare notes as they go through mergers—comparing cost of items and getting a sense of whether they've been getting a fair deal on cost of goods vs. other retailers out there."
- "There is a wide variety of [cost of goods between the various banners]. And we then try to level set with the vendors. By bringing in the warehouse, it doesn't affect this as much. But again, I think you might have a little more leverage as a company to drive those conversations."

Kellogg Sales
- "When Food Lion merged with Ahold [Delhaize N.V./ADRNY], they compared their internal costs at Delhaize to Ahold's internal cost on the items that they get from Kellogg. Part of the reason that Kellogg went down this road [to the warehouse model] was that they were not very consistent with their sales folks calling on corporate [retailers, including the different banners now owned by Delhaize]. You had more trade funds go to one retailer instead of the other, and when they merged they compared those costs."
- "They said to Kellogg that if [Kellogg] really wanted to work with them in a strong way, [Kellogg] needed to get these costs aligned. They also told Kellogg that if [Kellogg was] spending 10¢ in trade funds per item [in one supermarket chain] but only 2¢ in another, they expected [Kellogg] to bring both up to 10¢ across the board."
- "Kellogg didn't want to do that for good reasons. If they increase their trade costs by 8¢ per unit, they need to show the shareholders an increased sales lift, and they weren't necessarily going to get that. This is part of the background to what kicked off Kellogg's strategy of going into the warehouse. When they didn't want to pay [Delhaize] those trade funds, they started playing hardball with the entire Delhaize group."
- "Delhaize [retaliated] by telling Kellogg that if they weren't go to pay these trade funds [consistently across the board with the various supermarket banners], then Delhaize was going to stop displaying. Stores started taking endcaps off the floor, and [Kellogg's] sales dollars tanked."
- "[The Ahold/Delhaize deal was two years ago], but the negotiation process [on cost of goods with Kellogg] started about a year ago. Endcaps started coming off the floor around January 2017."
- "I don't know [the exact percentage that sales fell], but it would have to be significant. When you lose an endcap at 1,100 stores, there's a ton of product that you just lost off the floor and a ton of incremental sales that are off the floor."
- "So if [Kellogg] had a promotion coming up, [taking endcaps off the floor] really slowed those down, and stores didn't want to just run a promotion off the shelf because sometimes it's hard to cover the incremental sales lift, and then it would just cause out-of-stocks at store level. This had a significant impact on Kellogg though I don't know exactly how much."
- "This was probably a month or two before the switch from DSD, and I believe it was part of what drove that decision by Kellogg to say, 'If we're going to do [the warehouse strategy], now's the time.' Kellogg was already in a really bad position, and they had to do something."
- "Some of the sales declines [for Kellogg products] came from some product already in the warehouse [i.e., before the strategic move to warehouse for the snack division], but then there's a ripple effect that affects the snacks side of the business as well."
- "I don't think there was necessarily a bigger decline [in Kellogg sales after the switch away from direct-store delivery]. The impact was before [the move away from direct-store delivery], when Kellogg did not want to negotiate a new cost structure. That's when the decline happened."

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In-Store
- "Instead of a store manager worrying about another truck pulling up to the store, having to check their men through their own process of DSD receiving, now it comes in off my normal warehouse delivery truck, and I know now exactly when I'm going to get my product."

- "Our system of computer-assisted ordering … when you don't have a long time frame of that product, when you don't have a lot of history on that product … it's a little bit rocky. But then the longer that that product's there, then the better picture you're going to get on what are my expected sales going to be? Will I have enough product to get through to the next delivery? And also when I have promotional prices, what's my expected lift, so what do I need at the store to support that sale price?"
- "I really think that there's a time frame that—depending on which view you take—could be anywhere from two months to six months [from the start of the transition] to really get all the kinks out of the system, and then you're going to start to see much better results."

Pricing and Margins

- "To go into the warehouse, [Kellogg] absolutely would have had to do some type of price concession, but I don't have much of a view of that."
- "There's also going to be long-term efficiencies—supply chain, people, benefits, cars, fuel, mileage, even their fleet of trucks. So many pieces go into it, and I'm sure there's definitely costs that slip from one entity to another. But it should be more efficient down the road, at least the perspective of the retailer, because you're going to have better planning—and that better planning will be for both companies, will have a benefit for each one of them."
- "[These benefits in the supply chain, including better planning] should outweigh the added costs for us of labor. Just because they were DSD doesn't mean that we were not having to do things with that product. When the product is in my store and on my shelf, I still have a responsibility to make sure that the product is rotated properly … and make sure all the product is within code, so we don't have out-of-code product on the shelf. So there are things that we as a retailer have to do no matter what. You're already incurring some [labor] cost with that product on your shelf [by way of direct-store delivery], but now you're just incurring a little bit more labor to make sure you're getting it off the trucks, from your warehouse and on the shelves. But you're doing so much of that already that it's not a huge leap to say I'm going to bring in one more vendor to the warehouse."

> **For smaller companies, [this added burden of shifting away from direct-store delivery] may be greater.**
>
> *Manager, large grocery chain*
> *Southeast and mid-Atlantic*

- "For smaller companies, [this added burden of shifting away from direct-store delivery] may be greater. If you look at a convenience chain, they may plan for one extra employee to be there when a load comes in to put it up on the shelves, but they don't have it on a regular basis. And the amount that are in convenience stores, to me there's much more DSD there that you would have at a larger supermarket chain. So it would have a bigger effect on them."

Competition

- "Mondelez may get a benefit for a short period of time, because just at the corporate level, when you're coming in to negotiate within that category, you have a category manager that's sitting at the desk over snacks saying, 'Hey, I've got this one vendor that's not going to negotiate with us, so I'm not going to give them hot deals.'"
- "In a roundabout way, [that category manager] will be punishing [Kellogg], but with that, he or she will need to keep their category sales up. So they'll go to other vendors and negotiate maybe more incremental deals with them, or maybe [the Kellogg competitor] is in the flier more."
- "At the store level, I didn't see necessarily that [competitors] got more display space."
- "[Regaining the endcaps companywide will take] a matter of whether we get those supply chain efficiencies headed in the right direction, that things are smoothed out so that we have a good view of their products within our computer-assisted ordering. Because when you are DSD, you are not necessarily in the computer-assisted ordering system."
- "Once we make that transition, and we get some good history in there, and you also get some promotional history in there, then I think people [in our corporate head office] would be comfortable to say we can bring back endcaps [for Kellogg]. And we can start to negotiate incremental displays throughout the store, and we are very comfortable that we will forecast the best sales list."
- "If you take that stuff and you don't have good forecasting and good accuracy within your systems, you can just continue to create more and more problems on the supply chain side."
- "Delhaize looks at total investment that Kellogg makes. We used to only look at trade dollars. But now there's a much more robust program that they look at: what is your *total spend* with Delhaize? It includes trade funds; it includes if you have any type of shrink within our network. How do you compensate for that shrink? Does Delhaize own all of it? Does Kellogg pay for it totally? Or is there somewhere we meet in the middle? Are they spending any

dollars on marketing programs? Are they spending anything on community outreach programs? We roll that all into one and then compare vendors.”
- “Because a vendor could say, ‘I’m going to increase my promotional spending with you,’ but then they just cut it from somewhere else in the plan, and take it from one bucket to another. We are trying to catch all buckets to compare them to others within their category so we get a clear view of who is truly supporting an organization the best.”

2) Center-store merchandising executive at a 20-store grocery chain in the Midwest

Kellogg has lost endcaps and sales volume of about 10% as a result of the transition, which was initiated at this regional chain in July. Still, this source does not consider this a dramatic loss for the manufacturer. On the contrary, word from Kellogg of expected price concessions of around 5% after Oct. 1 should help retailers give the brand a massive push heading into the holidays. Mondelez sales reps are worried this will exert significant price pressure on the category. The decision to remove endcaps was purely about not having the extra labor to service them. Kellogg has offered concessions of 1% to 2% on a sliding scale for retailers whose snack volumes do not fall below 5% for the first quarter of the transition, which ends Oct. 1. This chain will run the numbers on Jan. 1, when it will have a better idea of how Kellogg’s snack products are selling and how shelf space will be changed.

Kellogg’s Transition to Warehouse Model
- “We’re a small regional chain. AWG [Associated Wholesale Grocers] is our third-party supplier. The wholesaler had to free up a couple hundred slots to put in the [Kellogg snack] items, and that was a bit of a challenge.”
- “The transition has been somewhat of a rocky road [since it started for us in the beginning of July]. But the bright side out of it that I think we’re going to see—and we’re maybe beginning to see a bit of it—is I truly believe that Keebler/Kellogg will take some of the money that was generated out of the elimination of their own distribution system and put it back into cost of goods, with deeper deals, that’s going to allow for some lower retails; and maybe improve on margins a bit at lower retails for them during special promotions. And particularly as we guide towards the holidays, we’ve already seen some of those presented to us.”

Kellogg Sales
- “We chose to eliminate an endcap in our stores that Keebler had [when the transition happened for us at the beginning of July]—basically because in the past [Kellogg] serviced it themselves; all the labor was theirs. So we did not reduce their shelf space, but we did eliminate an endcap only because it really became our obligation to sell it and order it, and at that point we chose to put some of our products up there instead of Keebler’s.”
- “So yes, they’ve lost some space in our stores as far as the endcap goes. For us, that might have been 10% of our volume. As a standard rule, often any of the ad items for the week would go on that endcap, so you have some extra space just vs. a shelf. So it’s bound to have cost them a little bit but not anything dramatic.”

I believe [Kellogg was] talking about doing a decline [in prices] beginning around Oct. 1 of 6%. [Kellogg] talked like that would be what they thought the cost of our operations were in labor [as a result of the transition]. But that’s a little bit low.

Center-store merchandising exec
20-store grocery chain, Midwest

In-Store
- “We still maintain promotions [for Kellogg].”
- “[Shelf space] may change as we review the category, and that will come up after Jan. 1 for us. We’ll take a look at it, depending upon what [the Kellogg snack category] does for sales. We try to set everything based on our own sales data, as well as using some of the syndicated Nielsen and IRI data for the market, to see if we’re staying competitive. But yes, shelf space could change. It’s probably too early to tell what effect the transition is going to have.”

Pricing and Margins
- “The way that our wholesaler works, I think [Kellogg is] making some deals with the wholesaler to try to keep [the costs to us of the transition] offset.”
- “I believe [Kellogg was] talking about doing a decline [in prices] beginning around Oct. 1 of 6%. [Kellogg] talked like that would be what they thought the cost of our operations were in labor [as a result of the transition]. But that’s a little bit low.”

- "Our prices didn't go up through our wholesaler; [the wholesaler is] maintaining what their prices were when it was still DSD. But my price [i.e., the cost to me of selling Keebler/Kellogg] went up when I'm now doing the labor instead of Keebler. So even though my base costs are the same, I've now got the labor that they used to take care of."
- "We have a fairly good direct relationship with Kellogg. I think originally they were offsetting the wholesalers or their distributors with some sort of [price concession] upwards of 6% during the transition for their cost of operation, and I don't know what [Kellogg] had to try to pay to get in."
- "So the talk now [with us, the retailer] is that there's a 6% decline in cost of goods coming, but I think that's just going to go straight back into absorbing upcharges from wholesalers and that kind of thing."
- "[Kellogg] did offer incentives [already] to their retail customers: if you maintain your volume, or didn't drop by more than 5%—it was kind of on a sliding scale—up until Oct. 1 for this first quarter of the transition. And I think that was just to try to keep retailers from taking space away from them."
- "They won't pay it until that first quarter [of the transition] is over, which ends Oct. 1. We transitioned right about July 1. We have to run our numbers and see where we're at, but I don't anticipate [a huge change in sales volume compared with before the transition]. The [promised] payout [from Kellogg] was 1% or 2%, depending on where you were [sales volume wise] vs. the same time a year ago."
- "Although I'm 20 stores, we still carry a little clout in the area here, so I'm probably going to get some offers that a one- or two-store mom-and-pop isn't going to get. Being a part of the same wholesaler, they're going to bring [this anticipated reduction in cost of goods] to a 20-store group that they know will perform, and they can measure the results."
- "So I wouldn't say [the price reduction] will be across the board by any means, but the larger independent chains [like us] will probably see the benefit of these additional [promotional] allowances, yes. Anybody who believes we all pay the same price needs to wake up. The Walmarts of the world, the reason they crush people is because they have an advantage [on wholesale prices and promotions by manufacturers like Kellogg]."

Competition

- "I do know, just through conversations, that Mondelez is concerned about what this is going to do to cost of goods around the holidays—whether Keebler's going to get a lot more aggressive. [Mondelez sales reps] are the ones that brought it up to me."
- "What [competitors] feared might happen appears to be coming to fruition. This is … based on rumblings in the trade, but if indeed Kellogg takes some of the savings that they've generated by eliminating thousands of jobs, closing distribution centers and so on, and put it back toward lower cost of goods for all grocery folks across the country, then Mondelez is going to have to react in some way. And they will still have their DSD system in place, so where's that money going to come from? [Mondelez thinks] it will put more pricing pressures on them."
- "It's amazing how DSD guys can move tags around. And Kellogg is not there to defend itself anymore in that particular aisle. So there may be some [short-term boost for Kellogg's competitors], but I think there's real concern [on the part of Mondelez] that a good deal on the holidays used to be a $2-for-4 on snack crackers, and Kellogg is now prepared to take some of that money and deal it down to $2-for-5 instead."
- "What's Mondelez going to do? They don't have the resources that Kellogg now has with their savings. Mondelez is going to have to increase their promotional spend. Maybe they'll get a little short-term gain [on shelf space], but I'm getting the distinct impression that Keebler will be dealing deeper to re-spend some of that money that they're saving. At least that's what they're trying to tell the independent trade anyway."

> **I do know, just through conversations, that Mondelez is concerned about what this is going to do to cost of goods around the holidays—whether Keebler's going to get a lot more aggressive. [Mondelez sales reps] are the ones that brought it up to me.**
>
> *Center-store merchandising exec*
> *20-store grocery chain, Midwest*

3) Category manager for a 150-plus store chain operating in the Northeast

Sales are going down for Kellogg and likely will keep falling, and the move to warehouse delivery will hurt Kellogg over the long term. Also, the benefit Kellogg booked in the first half of the year have to be given back in the second half when sales likely will fall short of expectations of the one-time fill that went into distribution centers.

Kellogg's Transition to Warehouse Model

- "This is not the first time [Kellogg] is doing this. They did it back in 2008, when I was at [another retailer] and oversaw that [snack] category. We were one of the first retailers, as a test, for Kellogg to go from DSD to [distribution centers]. And it was a debacle. It didn't work 10 years ago, and it's not going to work today. Six months after it started, they went back to DSD"
- "I've seen a very similar [scenario this time around]. Sales are dropping. You get hit right away, with the transition, but then that does level out a bit because you're flooding the stores with inventory."
- "[With the DSD model] you might have two weeks of inventory. But after the switch [to warehouse delivery] all of a sudden you have four to six weeks of inventory in the store and about three weeks of inventory at the distribution center. So now you've got five to six weeks of inventory on the brand, whereas before you only had two weeks."
- "Kellogg saves millions of dollars [in the short run] by doing this. That's great for them. But for us, a retailer, our costs go up."
- "This is going to hurt Kellogg over the long term. They're going to look at more and more brands that they can route through the [distribution center] so they can get rid of the DSD network. They're going to look at brands [for which] they can revise the code dates, so they can expand the code dates to have a longer [shelf] life."
- "If this is the route they're going to go [even more widely, beyond snacks], you're going to see a lot of animosity out there. I think there is already animosity out there already."
- "[As a retailer] you can't discontinue brands, but you can continue flavors and sizes. What I mean by that is instead of carrying six [types of a particular product available], I'm only going to carry three. That's what retailers do. It's hard to discontinue a brand, but it doesn't mean I have to support you in all your colors and your flavors. And it doesn't mean I have to support you in all your sizes."
- "And maybe I'll use another for an in-and-out promotional once or twice a year, but that's it. Kellogg will come back and warn that we're going to lose all our sales, but that's OK [with me]. I'll make it up with my other two suppliers who are DSD."
- "[Kellogg is] going to cede [that first-half benefit] throughout the [remainder of the year]. They may take one big shot that one time, but they're assuming that number. But what happens with all the other retail they want to convert to? There's no way they can take that hit in one quarter. … They'll take it in each quarter as it comes to fruition."
- "So I don't think there is a [long-term] benefit [coming from warehouse fill]. I think they're going to sell it as a benefit, and it is short term. But then when the sales go down … on the back end, how are they going to explain the fall in sales?"

I don't think there is a [long-term] benefit [coming from warehouse fill]. I think they're going to sell it as a benefit, and it is short term. But then when the sales go down … on the back end, how are they going to explain the fall in sales?.

Category manager
150+-store chain, Northeast

Kellogg Sales

- "Sales are dropping, and they are going to continue to drop. I don't have the percentages."
- "Long term, it's going to cost [Kellogg] more. Their sales go down because the store doesn't have in their budget in labor to take care of the displays. [Sales volume] is not going to happen, or it's going to happen but maybe at 20% of what it was yesterday."

In-Store

- "What you are going to find that's different [compared to when Kellogg did this in 2008] is that companies have more control over the footprint of the store, and they want to own every little piece of the space in the store. They don't want store managers to think anymore."
- "[However,] Walmart [Stores Inc./WMT] splits it between corporate programs, but then they give each store manager the freedom to work with their DSD guys to create additional programs at the store level to continue to drive the sales. So they become more customer-centric. Or tweak assortment based on demographics, because sometimes the numbers don't tell you everything."
- "Shelf space is dictated on a planogram, so I think the space stays neutral [in theory]. However, the reality is that if, as a category manager, you start seeing out-of-stocks, if you start seeing the manufacturer can't supply the goods, they lose all that space. It leaves it open to competitors like Mondelez and [PepsiCo Inc.'s/PEP] Frito-Lay."
- "DSD guys have a little bit more leeway based on the availability of product, the demographics, whatever it is. That's the difference between DSD and DC [distribution center]. DC product is 100% planogrammed. DSD is planoguides; you have more flexibility."

- "Convenience stores can probably handle DC product coming through a distributor or wholesaler because they sell product a lot less. The problem is they have no stockrooms; it's the reason they like DSD items, because it's just-in-time. I can call on Monday if I'm running low on an item, and they can be here tomorrow. But when it's DC, this might take three days."
- "Both the [convenience stores and the large chains] that are hit [by the move to warehouse] because even though supermarkets have their [own] distribution centers and convenience stores have their distributor/wholesaler, the time frame is still the same. Your computer's either ordering it, or a human being [is]; you still have to go through a system and through the distribution center, and both will suffer from a longer time frame [to get any orders]."
- "Some convenience stores only get once-a-week deliveries; others get every other week. Supermarkets get three-times-a-week delivery, so they will probably get in stock a bit faster. So convenience stores may get hit the worst. But supermarkets are going to lose displays and other things. So they both lose—they just lose differently."

Pricing and Margins

- No comment.

Competition

- "Mondelez is the clear winner in this—all the way. Frito-Lay will benefit as well, but Mondelez goes head-to-head with Kellogg."

2) Competitors

All four sources, each employing the direct-store delivery model, expect Kellogg to see declines in sales of as much as 15% and in market share, but three of these sources said Kellogg will come out ahead, at least on the bottom line, because of the cost savings in moving into warehouses. One source said Kellogg made a good decision, and another said other competitors are looking to get into the warehouse model as well. Two sources said they and other competitors are gaining share and that Kellogg will lose in-store displays even if shelf space remains the same. One source said private-label brands will also take advantage of this opportunity. Meanwhile, Kellogg will cut underperforming SKUs because warehouse space is expensive and in short supply at large supermarkets and smaller retailers alike. One source estimated warehouses may have room only for 50% of Kellogg's offerings. Another said Kellogg's margins will not decrease much, while a third source said retailers will charge Kellogg an additional 1% to 8% for labor and logistics costs involved in shifting to the warehouse model.

Key Silo Findings

Competition

- 2 of 4 branded competitors said they are gaining share as Kellogg moves to the warehouse model.
  - 1 reported gaining shelf space.
  - 1 reported gaining in the form of in-store displays but said shelf space is constant.
  - 1 has heard Mondelez's Snack Works (formerly Nabisco) is also gaining share.
- 1 said private-label competitors will also benefit from this switch.
- 1 said direct-store delivery costs are so high that competitors are looking to transition to the warehouse model.

Kellogg

- 2 said Kellogg is losing share in the transition.
  - 1 said the move is short-sighted and that losing in-store relationships will hurt incremental growth.
  - 1 said losses will cycle out after the first year.
- 1 said Kellogg is making a good decision.
  - Will deal with short-term pain and loss of sales in the transition.
  - But will ultimately savings will outweigh benefits of direct distribution.
- 1 said Kellogg will come out ahead on the bottom line but not the top line.
- 1 said Kellogg will save millions, is already successfully in the warehouse with cereals, and other products that are category leaders will not suffer with the transition.
  - Warehouse slots are expensive so lesser products will have to be cut.
  - 1 estimated warehouses may only have room for 50% of Kellogg's offerings.

Kellogg Sales

- 3 said Kellogg will lose significant sales in moving away from direct distribution.

  - o 1 said sales will fall 10% to 15% in the first year, but then stabilize.
  - o 1 said sales will fall 15% and Kellogg will lose 2 to 4 points of market share.
    - But Kellogg will come out ahead in the end because of the cost savings.

Kellogg In-Store
- 1 said Kellogg will lose SKUs, shelf space and in-store displays.
- 1 said Kellogg will lose in-store displays, but shelf space will be unaffected.
- 1 said shelf space will not change in supermarkets, but it will be affected in independent stores with less shelf space that can only carry the best sellers.

Kellogg Pricing and Margins
- 1 said Kellogg's margins will not decrease much.
  - o Margins will grow as Kellogg gives lower costs, and retailers will not pass them all on to customers.
- 1 said retailers will charge Kellogg an additional 1% to 8% to pay for the increased labor in moving to the warehouse.

1) Southeastern regional manager for a major snack food brand

This source is already seeing gains in market share, shelf space and displays for his snack brands because of Kellogg sales reps' absence from stores. Kellogg's decision will result in cost savings initially but is a short-sighted move. Direct-store delivery is about building relationships with store workers and managers. Private labels also will gain share.

Competition
- "We've definitely gained market share from Kellogg already."
- "We are getting more shelf-space already and more displays around the store. I'm seeing that in a lot of the stores I go into."
- "Private label is also taking advantage of this shift, just like we are. Private label is definitely going to use the opportunity to take some of [Kellogg's] shelf space."

Kellogg
- "Moving away from DSD is very short-sighted on Kellogg's part. DSD is all about relationship building with store workers, connecting with managers and driving incremental growth through those relationships. It's part of service. Moving away from DSD, Kellogg is moving their people out of the brick-and-mortar stores. Everything is going through the warehouse."
- "Kellogg is going to lose a lot of space incrementally on the sales floor because they're not going to be able to merchandise all their products."

Kellogg Sales
- "Initially, they'll be able to save some money on salary cuts because of reductions. But in the long term, it's going to hurt their volume."
- "It might help the CEO of the company that he's going to cut costs and on his P&L statement he'll be saving money, but down the road, they're going to lose a lot of volume and a lot of productivity."

> **We've definitely gained market share from Kellogg already. … We are getting more shelf-space already and more displays around the store. I'm seeing that in a lot of the stores I go into.**
>
> *Southeastern regional manager*
> *Major snack food brand*

Kellogg In-Store
- "They're losing SKUs in stores, and they're losing displays around the stores. The stores don't want to merchandise all their products. They take it off the floor and put in different product."

Kellogg Pricing and Margins
- No comment.

2) Regional executive for a major snack food brand

Because of its move to a warehouse system, Kellogg will come out ahead on its bottom line but not on its top line. Kellogg sales will soften as much as 10% to 15% over the first year. This source's company, which plans to maintain its direct-store delivery model, is already seeing share gains in some categories; so is Mondelez. Kellogg is losing displays, but not shelf space, to manufacturers continuing direct-store delivery. Losses for Kellogg will vary by retailer and by category. Some large retailers like Kroger Co. (KR) have said they do not have all the warehouse slots that Kellogg needs and likely will reduce the number of products they carry. The effect, however, will be limited since Kellogg's top 20 products do a disproportionately high number of their business.

Competition

- "We've already seen some gains in market share in one of the categories, and so has Nabisco. We've both picked up Kellogg's losses."
- "We are getting more displays that we can substitute for theirs. But shelf space is not changing."
- "The reason these categories have generally been done through direct-store delivery is because they can be fragile and get mangled by the supermarket. They're not like cans of soup."

Kellogg

- "They're already losing some market share. The number is going to be different per retailer, whether the retailer aligned with it or not, and it will also be based on the category. Kellogg might take a bigger or smaller hit in cookies or crackers than on something else."
- "They'll cycle out of the losses after a year. They won't see as high display numbers or display lifts. That's where other people like us and Nabisco will see some benefits."
- "Kellogg will come out ahead on their bottom line, but I doubt if they'll come out ahead on their top line."

Kellogg Sales

- "There are retailers who fall on both sides of the equation. Some have capacity within their supply chain and they like this change, but there are others who don't. Some will be able to accommodate the warehouse slots and others won't."
- "Some retailers have taken a strong position because they don't have the capacity and they've said they can only handle maybe 50% of the offerings."
- "Kroger is one of the chains that's not aligned with it. Walmart is. Some small regionals are not either. Jewel [Osco Inc.], a big one, is aligned with it."
- "Kellogg's revenue will soften a bit. But as for most manufacturers, their top 20 [SKUs] probably [do] a disproportionate amount of their business. I'm guessing their sales could soften about 10% to 15% over the next year. After that it should stabilize."
- "What I read into this is that Kellogg was doing this because of pressure from Walmart. Walmart believes it has one of the best, if not the best, supply chains. It can distribute cheaper and faster than anybody else. Walmart does a lot of warehouse, but it also gets direct-store delivery."

Kellogg will come out ahead on their bottom line, but I doubt if they'll come out ahead on their top line.

Regional executive
Major snack food brand

Kellogg In-Store

- "Snacks have historically been a DSD category, and it'll be in the displays that they'll see the downside. Shelf space won't change."

Kellogg Pricing and Margins

- "Kellogg's margins will not decrease that much based on what they sell to the retailer [according to a retailer where we had some insights into the metrics]. The retailer will take more margin. Kellogg will be giving them a lower cost."
- "If Kellogg saves, for example, 10 points on logistics and they hand 8 of the 10 over to the retailer who now takes over the logistics, the retailer may or may not change the retail price point on the shelf. The retailer may make a little more margin to offset their labor and logistics that they're now doing."

3) Fulfillment planner for a major snack food brand

A source for a competitor that still is using the direct-store delivery model applauds Kellogg's decision to switch to the warehouse model, saying it will pay off in the long run. Still, Kellogg will see near-term sales losses as a result of the transition.

Competition

- No comment.

Kellogg

- "It's the right decision. I suspect there will be some short-term pain and perhaps loss of sales as they transition to the warehouse model."
- "Ultimately, however, the cost savings of the warehouse model will far outweigh the benefits of the DSD structure."

Kellogg Sales

- No comment.

Kellogg In-Store

- No comment.

Kellogg Pricing and Margins

- No comment.

> **Ultimately, however, the cost savings of the warehouse model will far outweigh the benefits of the DSD structure.**
>
> *Fulfillment planner*
> *Major snack food brand*

4) Senior executive for a food company that has worked with both direct-store delivery and warehouse models

Kellogg's shift from direct-store delivery will allow it to save millions, even if it loses up to 15% in sales and 2 to 4 points in market share as a result of the move. Direct-store delivery has major advantages for stores, mainly because they can save on labor costs. However, it is very costly for manufacturers because of the price of personnel and the high cost of distribution. This is making others consider a move to the warehouse system. Kellogg already uses the warehouse system for other products like cereal and likely has analyzed the system. Some items from the product line will have to be dropped because Kellogg is unlikely to pay warehouses to carry pallets of all its products. Popular products like Cheez-It and the Keebler Fudge Shoppe line will not suffer because they are already well known and in-demand. Large grocery store chains will not allow competitors to remove or give less shelf space to these products, because they operate with planograms. Competitors that take advantage of the situation by claiming more shelf space would be fined. Independent stores that are smaller cannot carry all the products from a line and will reduce items that are less popular. Warehouse costs vary widely, and price and margin negotiations take this into account.

Competition

- "The cost of doing business in distribution is so high that everybody is looking to go warehouse, not just Kellogg. The cost of distribution has gotten so expensive that nobody wants to do it anymore."
- "A trailer over the George Washington Bridge in New York costs $90 for the toll alone. You have to send a helper with the driver. The stores make the truck wait for a half-hour or an hour, so two people are being paid to sit there for an hour. Plus, the insurance on these vehicles is ridiculously high."
- "The big advantages of DSD for stores is that the brand is doing the labor. They bring the product in and put it on the shelf. At most supermarkets, labor represents 8% to 9% of total sales. It's actually the only area where the store manager can control costs."
- "If 25% of a store's merchandise is DSD, the store could be reducing 25% of its labor costs."
- "That's especially true for major chains. Independents buy through wholesalers like Krasdale in New York. C&S also has an independents program besides the big chains. When independents buy from a wholesaler, they have to pay them in 10 to 15 days. With a DSD company, they can make deals and get longer credit."
- "An advantage for brands in having DSD is that they can immediately identify that the product was sold on that day and needs to be restocked tomorrow. There is great visibility also in establishing relationships in the stores."

Kellogg

- "Kellogg already has a lot of products in the warehouses, like their cereals. They're familiar with the warehouse system, and they know what they're doing. They did the analysis, and they're going to save millions of dollars."
- "Kellogg's Cheez-It and Keebler have the name already so the products will not have a problem selling out of the warehouse."
- "For brands that are not well known, having the wholesalers carry them does not help with their sales. People wouldn't buy them because they don't know them. You can't just go to the warehouse system because you want to avoid the cost. You have to build a name and a brand first."
- "Kellogg is likely deciding which items in their line they want the warehouses to carry because the slots are very expensive. They're not going to pay to keep their entire line of products in their warehouse slots. Some of the items might be cut. They'll focus on their top-selling items."

Kellogg Sales

- "Kellogg will lose some market share. I'm guessing they can lose up to 15% in sales and 2 to 4 points in market share, and they'll come out ahead. They'll be saving a fortune on employees, trucks, etc..."

Kellogg In-Store

- "The shelf space will absolutely not change in the chain grocery stores because everything is planogrammed. There are penalties for infringing on other people's spaces."
- "In the independent stores, however, it will definitely happen. They're half the size of the large chain stores, if not smaller, and they can't generally carry the full variety of brands because they just don't have the space. They'll only sell the best items anyway, like Cheez-it, or the Keebler Fudge Shoppe line."

Kellogg Pricing and Margins

- "The prices paid to the wholesalers vary by how they deliver the product to the stores, how the bill is paid, and many other factors. Depending on the individual deal, the upcharge can be anywhere from 1% to 8%."

3) Industry Specialists

All three sources said Kellogg is making the right move in transitioning to the warehouse model and away from the much more expensive direct-store delivery method. Kellogg will realize significant cost savings, but the bottom-line effect may not be determined for six months to a year. Kellogg's cost savings will be given back to retailers through price concessions and incentives, as much as 15% to 25%, according to one source. The shift will be particularly productive for Kellogg in large retailers like Walmart and Kroger, which have more efficient systems in place to take on the added distribution responsibilities, but the smaller retailers with less staff will have a more difficult time managing the increased burden. Sources do not expect shelf space to change, certainly not for competitors maintaining their direct delivery model, because stores now operate using planograms. Kellogg may, however, cede shelf space if fill rates lag. One source does not expect this to happen, though, as warehouse deliveries occur three to six days a week whereas direct delivery from food companies typically occur once or twice a week. Also, direct-store delivery does not guarantee a better maintained product on store shelves, especially as food companies stock their products in the middle of busy shopping days while retailers stock shelves at night. One source said Kellogg may look to hire a third-party agency to ensure proper stocking and appearance in stores.

Key Silo Findings

Kellogg's Transition to Warehouse Model

- 3 of 3 said the effect of Kellogg's transition to the warehouse model will not be felt right away; needs 6 to 12 months to play out.
- 3 said this is a good theoretical move for Kellogg because of millions in cost savings.
  - 1 said more companies will follow.
  - 1 said this is good for Kellogg in large efficient operations like Walmart and Kroger, but smaller, less efficient operations with less labor in their stores will have a tougher time with the transition.
  - 1 noted a lot of room for mistakes.
- 1 said retailers will increase their costs to pay for labor and added inventory so they need to obtain sufficient cost reductions from Kellogg.
  - Warehouse deliveries are 3 to 6 times a week, while direct-store delivery is 1 to 2 times a week.

Sales

- 1 said Kellogg has already moved cereals and other products to warehouse model and sales did not slip; expects snack foods to be fine as well.
- Keebler and Cheez-Its are so popular, they will not be affected by a change in how they are delivered to the store or where they are located on the shelf.

In-Store

- All 3 said shelf space is not likely to be materially affected by the change in delivery method.
- Shelf space will not change because all stores now have planograms.
  - 1 said Kellogg could lose shelf space if Kellogg's fill rates are low, not because of competitors' influence.
- 1 said direct-store delivery model is not necessarily better at stocking and servicing the products.
  - Retailers stock the shelves at night, while food companies stock in the middle of the busy day.

- Relationships in stores are not what they once were, so Kellogg is not losing much here.
- 1 said Kellogg may look to hire a third-party agency to help ensure proper stocking and appearance in stores.

Pricing and Margins

- All 3 said cost savings from changing models will be given back to retailers with price concessions and incentives.
  - 1 estimated it at 15% to 25%.
- 1 said grocery stores will also save money with this switch.
  - They'll receive fewer deliveries, which will be just-in-time and will not require as much storage in the stores.

Competition

- 1 said competitors also want out of direct-store delivery, but fear fighting the unions when cutting labor.
  - Also said only 30% of products are presently put in stores via the direct model anyway.

1) Food industry and supply chain consultant

Kellogg's shift to a warehouse system should boost its fortunes as long as it handles the changes to the supply chain correctly. Direct-store delivery is much more expensive than the warehouse system, and moving away from it will result in considerable savings for Kellogg. Kellogg already has many snack and cereal products going through the warehouse system. The company will not lose shelf space because stores have a planogram that has to be respected. Most retailers have been looking at moving away from direct-store delivery because of the high markup, but have not done so because of pressure from union delivery personnel. Long term, Kellogg's sales could be affected by more than moving its snacks to the warehouse system. Meanwhile, the company has been publicly attacked for its political leanings.

Kellogg's Transition to Warehouse Model

- "It's still early in the transformation to note any changes."
- "It takes time to sort it all out. You can't just flip the switch of going from having representation in the store to going in the warehouse. It may take as much as six months to a year to have it all sorted out and see an impact. We may not see any results short term, but long term it will be easier to tell if it was the right decision."
- "It will take time to go through the supply chain and get orders into the retailers' distribution centers. It won't happen overnight. But if they fill the pipeline correctly after they eliminate some of the DSD costs, they should see a reduction in expenses. That will add more profit to Kellogg if they haven't negotiated it out with the arrangements."
- "There will be a long-term benefit because they'll have reduced operational costs, as long as the supply chain works well."
- "It's a big undertaking, and there's a lot of room for mistakes and problems. The supply chain people have to know what they're doing and fix any mistakes quickly."
- "This will be a positive for Kellogg in the long term as long as they get the execution right, which is a big deal. It will also take time."

> **It may take as much as six months to a year to have it all sorted out and see an impact. … This will be a positive for Kellogg in the long term as long as they get the execution right, which is a big deal. It will also take time.**
>
> *Food industry and supply chain consultant*

Sales

- "I don't think DSD is a good system. I would eliminate it. It's more expensive. With the warehouse system, if you look on the low end, the price of the truck, maybe about $60,000, and the salary of the truck driver, maybe about $40,000, go away and are replaced by a part-time young person who makes about $18,000."
- "There's a big markup involved in DSD."
- "Another issue is control. Manufacturers want to use DSD so they can control their product, make sure it's always where it's supposed to be, and they can handle any damage and returns if necessary. Giving it up and switching means they lose control. All they do now is deliver it to the retailer's distribution center and hope everything goes right. That's always a question mark."
- "Still, Kellogg's have products, cereals, that go through the distribution center, and everything does fine."
- "The potential is positive. The question mark is the execution."
- "The outcome, however, could be impacted because Kellogg has taken a turn toward the left politically, and they've been attacked for this. I think this will have a negative impact no matter what the results are from the move away from DSD. People might not buy the Kellogg product because of the Kellogg Foundation's support of liberal causes."

In-Store

- "Most stores have a planogram of where everything goes. Kellogg's shelf space in a store is not going to change whether it's DSD or goes through the warehouse. Anybody trying to steal shelf space would be in trouble."
- "When there was no planogram, it was an advantage for the DSD vendor's rep to steal as much space as possible. Today, the space in the aisle or the endcap is all mapped out."
- "If the new supply chain doesn't work though, if the fill rates are lower than when they used the DSD system, Kellogg could lose shelf space."
- "I don't think relationships are a big deal. There are no relationships anymore at the store level, with young people going in there to stock the shelves with their earphones on."

Pricing and Margins

- "I'm expecting Kellogg to drop prices by at least 15% and up to 25% because of their savings in the move away from DSD."
- "I'm sure the major players are requesting a price reduction, but it all has to be negotiated."
- "Supermarkets will save too. An average-sized supermarket gets up to 50 DSD deliveries per day. Somebody has to be at the back door to receive the delivery, there's paperwork, and if it's a retailer with 12,000 stores, they have to have 12,000 people to receive and handle 50 different invoices every day. A company with those same 12,000 stores may only have four distribution centers. Once it's in the system and it's in the distribution center, the need for all that personnel goes away."
- "Having DSD product in the back of a retail stores takes up space and costs money too. It's better for the retailer if it comes in and goes right to the shelf."

> **Most stores have a planogram of where everything goes. Kellogg's shelf space in a store is not going to change whether it's DSD or goes through the warehouse.**
>
> *Food industry and supply chain consultant*

Competition

- "Retailers have been looking at moving away from DSD for a long time, even ones like Pepsi. Most of them don't make the switch because they don't want to fight with the unions if the delivery is by union personnel."
- "Mondelez said they believe the system works and they're getting better coverage this way. However, the majority of products in a store come through a warehouse distribution system, and that works just fine too."
- "Only about 30% of the product in a store comes from DSD."

2) Henry Ho, cofounder at Field Agent, a retail-auditing solutions company

Kellogg should be able to make this transition work, but getting a meaningful read at the store level is not yet possible. A strategy this big and important always has a honeymoon period and is given a lot of management attention. This includes maintaining shelf space. After the first few months, however, a more realistic picture will emerge. The shift should benefit Kellogg at the large chains like Walmart and Kroger, where sufficient labor and sophisticated ordering mechanisms should feed into greater supply chain efficiencies and prevent a drastic effect on sales. At smaller chains, however, a lack of extra labor and head-office planning likely will hurt Kellogg.

Kellogg's Transition to Warehouse Model

- "It will be positive for Kellogg. They will have the most success in the efficient retail distribution channels like Walmart and the Krogers of the world, where they're big, they're centralized, they have big systems in place—and their efficiency will transfer over."
- "They'll struggle where they always struggle, which is in the less effective, less efficient distribution of some of the smaller guys, where there's very little labor in the store to do extras, and where it's not very efficient in the first place for getting product from warehouse to [distribution center]. So lower-volume stores will probably struggle more."
- "If you look at the overall picture, I think Kellogg will make it work. It's too early to measure [whether this transition can be considered a success]. You really need to look probably in the second quarter of the rollout. Everybody's still trying to figure out the execution."
- "There's always honeymoon periods during major retail execution. [In the case of Kellogg] I think it's management attention to make sure that the program gets executed well, so it's mostly around execution, because everybody's agreed to it."

- "Whether everybody likes it or not, everybody is going to be interested in making sure that it gets executed so the finger doesn't get pointed. So my guess is that there's a lot of attention to shelf space remaining the same [in the first quarter of execution], and that includes the competitors being on somewhat good behavior [while store managers oversee the transition]. The competition among DSD players can be rough."
- "Having said this, there are probably already signs that things are not working [in some places like lower-volume stores]. The battle is going to be at the store."
- "Kellogg doesn't yet know how the other DSD players will come in and start working against them."
- "What will happen over time [as the honeymoon period ends] is that things will settle down to their normal decay. This happens with any retail execution until it gets some management attention. And if there's some inherent weaknesses in what Kellogg are setting up, from an execution standpoint, you'll start seeing it."
- "When they bought the Pringles business from P&G way back, or Diamond Foods bought it from P&G, that was a snack item that went through the warehouse. So there are success models of it working in the snack and cookie category."
- "I've also seen an instance [of a soft drink category] that Walmart wanted to move from the DSD network and have us distribute through their warehouses. P&G agreed to do it, and it did not work. There were battles in the stores—the Coke vs. the Pepsi guy."

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>
> *Henry Ho, cofounder Field Agent*

Sales
- No comment.

In-Store
- "[Kellogg is] probably spending on retail labor to make sure this works. My guess is that Kellogg will be sending in third-party merchandisers/contractors into the Walmarts to make sure that [the retailer is] bringing the stock out of the back room and putting it on the shelf. Acosta [Inc.] and Advantage Sales & Marketing [LLC] are the big ones [and then there are a lot of regional players]."

Pricing and Margins
- "Whatever cost savings that Kellogg realizes by going to warehouse, they're going to give some—or almost all—of that savings to the retailer. They'll put it back into cost of goods, and incentives to the retailer."

Competition
- "There are people who are trying to make DSD more efficient—taking costs out of DSD without going through the warehouse. There is work in the industry to take costs out of a DSD-type process, but change some of the dynamics to drive costs out. And if it ever takes off, that could be a solution for many [manufacturers and retailers], and the retailer might buy into that as well as the brands. But it's still in development."

3) Marc Wulfraat, president of MWPVL International, a supply chain and logistics consulting firm

Some grocery retailers are themselves evaluating increasing self-distribution for slow-moving and specialty items in a system that has survived because it allowed manufacturers to maintain control of the retail shelf. In-stock levels are worse for direct-store delivery merchandise and can hurt retailers. Snack and beverage companies, however, are unlikely to transition because their products move too fast. Kellogg's decision to exit direct-store delivery indicates that it has calculated massive supply chain cost savings. The brands that Kellogg is shifting to direct-store delivery are popular, and store managers will make sure they are well stocked. The price negotiations between Kellogg and retailers likely resulted in a 50/50 split of the savings. At least two years will pass before the change's economic effect can be determined.

Kellogg's Transition to Warehouse Model
- "Now that Kellogg's/Keebler has moved away from DSD, retailers will increase their costs because now their own staff have to stock the retail shelves, the products now have to be received and shipped through their distribution centers, and they have more merchandise to ship to their stores. It also adds pressure to the amount of storage capacity and pick facings needed in their distribution centers."

- “The impact of this also hits the balance sheet. Inventory assets increase because the retailer has to carry more inventory. As a result, each retailer has to figure out what the cost impact is to their business so that they can budget for it and ensure that they obtain sufficient cost of goods reduction from Kellogg to compensate for their increased operating expenses.”
- “This move [by Kellogg] is indicative of the fact that companies are starting to realize that the DSD channel costs a fortune as compared to the centralized distribution model. In some cases, food manufacturers can no longer continue to support the DSD channel because it makes them less competitive from an overall economic perspective.”
- “At the end of the day, Kellogg decided they could save significantly on operating expenses by improving supply chain efficiency and that this change in strategy would not adversely impact sales revenue. It’s basically a reaction to the way the market is going now and how the market will continue to evolve over the next decade. More companies will go down this path, and I firmly believe this is just the tip of the iceberg.”
- “There’s a good possibility that down the road there’s going to be some type of change in distribution channel, either motivated by the manufacturers themselves or motivated by retailers seeking to cut costs out of the supply chain.”
- “The full-service DSD channel has survived as long as it has because manufacturers don’t want to lose control of the retail store shelf. Retailers, however, say that the in-stock level for DSD merchandise is worse than for merchandise brought through their own distribution center. Retailers usually deliver merchandise from the distribution center to the store about three to six times per week depending on the size of the store. Therefore, if the store runs out of stock they can always be replenished within two days, whereas DSD deliveries may only take place once or twice per week depending on the supplier.”
- “Some grocery retailers are now evaluating increasing self-distribution for slow or medium velocity/specialty DSD items where the option exists to do so. This adds more pressure to increasing warehousing, transportation and retail store labor requirements, but the overall cost may be lower than supplying merchandise through the DSD channel in some but not all cases.”
- “In the work that we have investigated in this area, transitioning DSD items to self-distribution can yield millions in annual savings for certain full-service DSD vendors where products can be self-distributed. Keep in mind that many beverage and snack vendors only support the DSD distribution channel, and self-distribution is not even an option.”
- “The companies that will likely maintain the DSD channel are the snack and beverage companies. These companies have extensive warehouse networks spread around the country to support the direct-store delivery channel. Their products move so fast and are expensive to transport such that these companies would often incur cost penalties if they distributed through centralized retailer and wholesaler distribution centers. I doubt that we will see Coke, Pepsi and Frito-Lay steering away from the DSD channel in any big way. They have massive logistics networks that involve thousands of trucks and human resources.”
- “The transition away from DSD to centralized distribution will mainly affect products like crackers, snacks, cookies, specialty foods, and slow-moving dry/frozen products.”
- “A retailer may have 15,000 to 20,000 SKUs on their store shelves that they distribute from their own centers. At the same time, there is a wide variety of SKUs that are supplied directly from DSD vendors or from wholesale distributors who ship directly to the stores. Retailers may decide to move some DSD merchandise through their warehouse. When this happens, they eliminate the cost of the manufacturers’ sales representative to travel to every store to stock their shelves. I believe that the historic notion that this is a ‘free’ service and, therefore, the store saves money is no longer the perception. Retailers want to be competitive, and that means looking at the total cost to serve and not just looking at one aspect of the supply chain.”

This move [by Kellogg] is indicative of the fact that companies are starting to realize that the DSD channel costs a fortune as compared to the centralized distribution model. In some cases, food manufacturers can no longer continue to support the DSD channel because it makes them less competitive from an overall economic perspective.

Marc Wulfraat, president
MWPVL

Sales

- “It’s much too early to say if there have been any market share shifts as a result of this move by Kellogg. They’re still in the process of implementing this transition. It will take at least 24 months or more to understand the impact on Kellogg’s economic performance.”
- “If it wouldn’t generate massive supply chain cost savings, they wouldn’t have dismantled the DSD channel. They are losing control of the retail store shelf, and this is difficult to let go of.”

- "In stock position and service, levels are not necessarily better with DSD. Many retailers will admit to this. Unless it is a highly perishable high-velocity product such as fluid milk, DSD in stock performance is only as good as the replenishment frequency that the food manufacturer provides."

In-Store

- "DSD sales representatives ensure that shelf space is provided for their products. They also try to make their products look good on the shelves. They are good at ensuring good presentation."
- "Overall though, the competitive advantage of having a manufacturer representative in the store aisle is not necessarily significant compared to the retailer's staff doing the work. The DSD sales rep may end up restocking the shelf at a time of day when the store is busy making it hard for shoppers to access products; whereas retailers tend to stock their shelves with merchandise from their distribution center at a quiet time of the day."
- "Keebler and Cheez-Its are popular brands that people are going to buy regardless of how they get delivered to the store shelves."
- "The option for the retailers is to either bring the items to their own warehouse or to source them from a wholesaler who will supply them in the form of store-ready pallets."
- "If they decide they don't want to bring the items through their warehouse, they might decide to outsource the item to a company like UNFI [United Natural Foods Inc./UNFI]. Retailers often order through UNFI the items that are slow-moving specialized products or items that they cannot stock in their own distribution centers because they do not move enough volume. UNFI aggregates volume from many retailers and supplies these specialty products nationwide."
- "A wholesale distributor can prepare pallets of specialized products by store and then deliver these pallets to the retailer's distribution center, such that the retailer cross docks the pallet and transports them to their stores."

> **Keebler and Cheez-Its are popular brands that people are going to buy regardless of how they get delivered to the store shelves.**
>
> *Marc Wulfraat, president MWPVL*

Pricing and Margins

- "The old Kellogg cost of goods structure has to be adjusted now that they no longer perform the full-service DSD function. For example, if the cost of goods included a 7% factor to pay for the DSD supply chain then this should be adjusted downward to compensate the retailer for their increased cost to service the stores with Kellogg's merchandise. The math behind this is unique to each business, but at the end of the day the transition to centralized distribution will have to include a cost of goods concession so that retailers can pay for their additional labor."
- "Kellogg is not going to put all this into their customers' pockets. They're doing this to cut their own supply chain costs, to make themselves more competitive. This is where negotiations come into play, and when all is said and done the split might be 50/50."

Competition

- No comment.

Secondary Sources

These four secondary sources focused on Kellogg's transition to warehouses, its growing online sales, retailers pressuring food companies to keep prices low, and a Kellogg competitor cutting SKUs to improve operating margins.

Sept. 5 Supply Chain Dive article

Retailers are pressuring CPG brands to keep prices low in order to bring customers back into their stores.

- "Already beset by waning customer demand, many CPG companies are now under pressure from retailers to lower their prices further, according to The Wall Street Journal. Campbell Soup, for one, told The Journal it will lose significant revenue this winter because it failed to reach an agreement with a major retailer—identified by the Journal as Walmart—on promotional pricing and shelf space."

- "Under intense competitive pressure themselves, retailers large and small are lowering prices to draw customers to their stores. And although back-and-forth negotiations between grocers and manufacturers over pricing is nothing new, sources agree retailers have gained the upper hand."
- "Walmart, which accounts for as much as one-fifth of sales for General Mills, Kellogg and Kraft Heinz, has been particularly aggressive with price cuts lately. The company has said it wants to be 15% cheaper than the competition 80% of the time."
- "And it's not just Walmart that's pressuring beleaguered suppliers to lower their prices. Conventional chains like Kroger have becoming increasingly price promotional of late, as have smaller chains and specialty stores like Sprouts Farmers Market."

Aug. 9 Food Business News article

Snyder's-Lance (LNCE) is considering dropping nearly 750 SKUs to improve operating profit over the next three years.

- "Executives of Snyder's-Lance, Inc. expect a six-area performance transformation plan, which includes dropping hundreds of stock-keeping units (s.k.u.s), will improve operating profit by about $175 million over the next three-plus years. The company expects to complete the plan by 2019 and to achieve its full benefits in 2020, said Brian J. Driscoll, president and chief executive officer, in an Aug. 8 earnings call."
- "Removing low-profit, low-velocity s.k.u.s from retail shelves will allow Snyder's-Lance to redeploy trade dollars into high-velocity, high-margin s.k.u.s, Mr. Driscoll said. The s.k.u. reduction also will allow Snyder's-Lance to expand space and presence for its core items at retail."

Sept .7 Supermarket News article

Kellogg's move away from direct-store delivery puts it in position to capitalize on improved online sales.

- "[Deanie Elsner, Kellogg's U.S. snacks president] argued however that the time had come to make the move, noting that Kellogg's products didn't have the shelf velocity or the fragility to require special handling, and that the more sophisticated warehousing, pricing and shelving capabilities retailers use today made DSD more of a challenge than a help to them. But the most important reason, she said, was that DSD for all its costs did little to address that fact that consumers were increasingly buying items online."
- "John Bryant, Kellogg's CEO, in the same presentation noted that the company's U.S. e-commerce sales grew by 70% in its most recent quarter and that experience in overseas markets suggests the company can command a greater share of its categories in click-and-collect than in stores."
- "The move out of DSD included rounds of negotiations with retailers, a reduction in the number of SKUs and higher prices for items that remain, Elsner said. While acknowledging 'there's no playbook for what we've just done,' she said she expected to see faster growing and more profitable sales by the middle of next year."

Sept. 8 Just Food article

Kellogg updated its move to warehouse model, saying it was making good progress despite challenges.

- "Kellogg has sought to reassure the market its decision to move the distribution of its US snacks from a direct store delivery (DSD) network to a warehouse model is beginning to pay off."
- "Speaking at this week's Barclays Global Consumer Staples Conference, Deanie Elsner, the president of Kellogg's snacks business, said: 'This has been a complex project, difficult to manage. What you can expect though is a slightly smaller, more focused business that is stronger and more profitable.'"
- "But Elsner admitted it has not been an easy process."
- "Elsner said a crunch time for the transition was the month of August."
- "'I call this as kind of our ugly period. If there's a period where things look really bad, it's the month of August because we exit our DSD at the beginning of the month,' she said."
- "'We exit our merchandise at the beginning of the month. We shift to a new warehouse model. And we have not yet completed the shift all the way through to our customer on shelf and training them how to now manage the shelves that we are no longer shelving.'"
- "But she said a lot of the hard work has been done."
- "'The good news is of the stage gates in this project, we are through the majority of the difficult stage gates,' she said."

Kellogg Co.'s U.S. Snacks Segment

- "'We've negotiated with our customers one by one. We've agreed to terms on how we're going to readjust the price when they do the cost to serve in-store. We've also agreed on assortments. We've also agreed on the SKU rationalisation, and we began to do the SKU rationalisation within our organisation.'"
- "'You will see our displays down tremendously. You will see our average price up. You will see our weeks of merchandising down because we couldn't risk disrupting this shift and drive merchandising in-store,' she said."
- "'So, we chose to pull back as did our customers. That's what's showing up in the numbers today. We also pulled products off our shelf while we reset the prices. And so, that's what's going on to the numbers today. That's going to get us to less of a tail to deal with as of front half of 2018.'"

Additional research by Emily Carr and Eva Cahen.