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JPMorgan

Obesity

Re-Shaping the Food Industry

- **Growing awareness of the relationship between diet and health is having a major influence on consumption trends.** 'Healthy food' is a key growth engine for the sector as 18 of the 24 fastest growing food categories across the globe are related to consumer perception of health, according to an ACNielsen study. Conversely **a number of categories, perceived as less healthy by consumers** are **exhibiting slower growth or declining.**
- **Consumers seem willing to pay a premium for products perceived as healthy, offering a margin expansion opportunity to the industry.** However, our global analysis of profitability within sub sectors of the food industry shows that not all segments within the "healthy eating" business are attractive and that gross margin expansion may be somewhat offset by high product development and launch costs.
- **Forthcoming regulation in Europe is likely to put further pressure on high fat/high sugar products and will add complexity and cost for all.** In this report, we discuss in particular the role of the new proposed EU Regulation on "Nutrition and Health Claims made on Foods" and measures that are being taken/considered in the UK and France.
- **In the US, regulation threats seem remote but litigation risks exist.** Some lawyers have flagged their intention to take legal action against the food & beverages (F&B) industry. However unsuccessful they may be, we expect they will continue to grab headlines.
- **R&D could become key to building a sustainable competitive advantage within the sector**. While marketing budgets come under increasing scrutiny after a decade of uninterrupted inflation we believe that investment in research should continue to rise in the face of litigation risks, regulatory change and fast changing consumer demand.
- **We think that the large F&B companies have worked hard over the past 3-4 years to prepare themselves against potential regulatory and litigation risks.** We believe Danone, Nestlé, Campbell and Dean Foods are particularly well positioned to benefit from growing demand for healthy products.

Global Food & Beverages

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This report follows a request from a group of asset managers working with the United Nations for an analysis of the environmental, social and governance issues that may be material for company performance and, following on from that, a view on the potential impact on company valuations

The United Nations Environment Programme Finance Initiative (UNEP FI) works closely with 160 financial institutions worldwide, to develop and promote linkages between the environment, sustainability and financial performance.

UNEP FI Asset Management Working Group (AMWG) explores the association between environmental, social, and governance considerations and investment decision-making. Asset Managers that have participated in this project have combined mandates of US$1.7 trillion.

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Executive summary

Obesity is major public health concern and a serious issue for the food industry

Obesity (BMI >30) is a risk factor for many serious illnesses including heart disease, hypertension, stroke, type-2-diabetes, respiratory disease, arthritis and certain types of cancer. The rising prevalence of obesity across the world particularly among young people, has alarmed health experts, the media and the population at large, and is a major public health concern.

Apart from the human suffering it causes, **the economic consequences of the increasing incidence of obesity are of particular importance**. It is estimated that **in the European Union, obesity accounts for up to 7% of health care costs**, **and this amount will further increase given the rising obesity trends.**

With the vast majority of experts highlighting the multi-causal nature of obesity (food consumption, physical activity, environment, education, genetics) the role of the food industry is at the heart of the debate.

'Healthy food' is a key driver of industry growth but treats, convenience and affordability cannot be ignored

'Healthy food' undeniably is a key growth engine for the food industry…

Growing awareness of the relationship between diet and health and in particular of serious health risks posed by obesity is having a major impact on consumer purchasing behaviours and choices that will durably impact and reshape the food and beverages industry.

- **'Healthy food' undeniably is a key growth engine for the food industry as 18 of the 24 fastest growing food categories** (e.g. soy-based drinks, drinkable yogurts) across the globe are related to consumer perception of health and wellness, according to an ACNielsen study.

…while categories perceived as less healthy are exhibiting slower growth or declining

- **Conversely a number of categories which are perceived as less healthy by consumers** (e.g. carbonated soft drinks, sugar confectionery) are **exhibiting slower growth or declining**.
- Interestingly, our regional analysis shows that in countries like the UK where obesity and healthy eating has received enormous media attention in 2005, **the trends are even more marked with the boom of water, canned fish and drinking yogurts, while CSD, sugar confectionery, salty snacks and frozen meals/pizzas declined.**
- Nevertheless, global data shows that **consumers do not seem ready to sacrifice treats** - chocolate and snacks have continued to exhibit healthy growth rates – and the **need for convenience remains overwhelming**. This implies that we should see more initiatives from companies to offer healthy snacks and convenience food in the future.
- Although **this report focuses on branded food and soft drinks manufacturers** we highlight that the global market share of private labels reached 17% in 2004 and continues to rise. This means that retailers, as contractors of private labels, defining the specifications of final products, are playing an increasingly important role in shaping the diet of consumers and should be equally concerned by obesity. It is also a reminder that value for money is a key concern for consumers and that producers will have to find **the right balance in terms of pricing to avoid a marginalisation of their product offering and the creation of a niche for the happy few.**

'Healthy' food offers modest margin opportunity

Confronted with the obesity crisis and consumers' growing desire to follow a healthier diet, food and soft drink producers have two major options: I) enter the healthier and faster growing categories and/or II) improve the nutritional profile of products which are not in phase with consumer demand.

Profitability of most 'healthy' food and beverage categories is below industry average…

- Our **global analysis of profitability within sub sectors of the food industry** shows that with the exception of specialised nutrition (sports/clinical/infant) **the profitability of the vast majority of food and beverage categories usually regarded as healthy (e.g. water, dairy, soy, fruit/vegetables) is below industry average**. This certainly creates a dilemma for companies who enjoy above-industry average margins (e.g. confectionery, hot beverages, snack producers) and would like to enter the healthier/faster growing segments of the market. A typical example is that of carbonated soft drinks players who want to capture the growth of the water category but have long been deterred by the lower profitability of water vs. CSD.
- Moving down the value chain or seeing a reduction of its operating margin is hardly ever seen as an attractive option for industry players (except when growth prospects are too good to ignore). This is why, in response to changing consumer demand, **companies have been primarily working on the improvement of recipes and formulation** to offer healthier/'better for you' products.

…though we see some opportunities for improving gross margins

- We show that **the business of 'healthy eating' has given companies an opportunity to improve gross margins** in three different ways: I) by pricing at a significant premium products which are truly differentiated and make health claims, II) by lowering the cost of goods sold through reformulation that translates into a healthier proposition to consumers, III) by reducing package size while maintaining/lowering modestly the apparent retail price, therefore significantly increasing the price per volume unit. Having said that **we believe the impact on operating margins has been modest given the costs associated with new product launches** such as R&D, trade spend, A&P etc…

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Forthcoming regulation in Europe look set to exacerbate the trends and should result in higher costs for the industry

In our April 2003 report *Obesity:The Big Issue* we highlighted for the first time the risk of increased regulation for the food industry in light of rising pressure on governments to take measures to curtail the obesity 'epidemic'. Over the past three years obesity has definitely moved up the agenda of health policy makers in Europe and new legislation may affect companies in the way they produce, market and distribute products. Our key conclusions are as follows:

- **Less healthy food is coming under pressure.** Food, which will be ascribed a negative nutrient profile (e.g. probably soft drinks, ice cream, confectionery, snacks) as part of the implementation of the **new EU Regulation on "Nutrition and Health Claims made on Foods"** will not be allowed to make health claims and probably only very limited nutritional claims in the future. In the UK, the **Foods Standards Agency has developed a scoring system "**to help support the independent UK communications regulator Ofcom in its work to consider **possible restrictions to the advertising and promotion to children of foods that are high in fat, saturated fat, salt or sugar**". **In France, from 1st January 2006 advertising of food/drinks will have to include a health message or advertisers will pay a tax representing 1.5% of gross advertising cost**. In September 2005, **Ruth Kelly, the UK education secretary, announced that from September 2006 "junk food served every day in school"** will be banned. While **from 1st September 2005 vending machines are now banned from all schools in France.** In 2005, **the FSA started to test a front-of-pack multiple traffic light scheme** which should send a strong instantaneous signal to the consumer about the nature of the food based on the salt/fat/sugar content.

Large companies likely to have a competitive advantage vs. smaller operators, who may struggle with the new European regulations

- **Doing business in Europe will become more complex and more costly… giving the advantage to larger groups.** The new proposed EU Regulation on "Nutrition and Health Claims made on Foods" will make life more difficult for producers, in our view First, **health claims will be subject to prior approval by the European Food Safety Agency and will have to be supported by scientific studies**. **Companies will thus need to invest more heavily in R&D**. Secondly, the Commission has already given a long list of claims it may prohibit or accept in the future, implying that marketers/advertisers will have less room for manoeuvre and creativity while **food manufacturers will have to adapt formulation**. In general, we believe that **large companies will have a competitive advantage vs. smaller operators** who may struggle with the complexity of dealing with the European bureaucracy (EFSA registration etc…) and may not be able to afford more R&D investments. This further supports our view that consolidation/restructuring will continue and accelerate.

- **Winners/Losers?** Taken independently, **measures that are being taken or being considered** may sometimes seem rather symbolic but combined together they may start to have a material impact on category dynamics. Overall we believe that they **will lead to an exacerbation of the trends we have identified,** namely continuing growth for healthy food and an acceleration of the decline or deceleration of categories perceived as unhealthy (confectionery, CSD, snacks, sugar). We highlight that the **new proposed EU regulation on nutrition and health claims may lead to prohibition of health claims – a cornerstone of their growth strategy - on certain RTE cereals, fruit juice and medicated confectionery products in view of their high sugar content**. In addition, **the potential implementation of a subsidy on vegetables/fruit may help a number of producers operating in that field** (see Fat Tax vs. Healthy Food Subsidy section page 36).

US regulation and litigation risks analysis

With Federal regulation looking unlikely in the near term, litigation is a more likely route for 'consumer advocacy' groups

- Despite several attempts to introduce legislation at the Federal level to reverse rising obesity rates in the US as well as to regulate the sale, distribution, merchandising, and marketing of food and beverages, none of those initiatives have made it far in the federal legislative approval process.
- At the same time, federal agencies like the FTC and FDA have not taken a more leading role in the matter; in fact, the FTC has clearly indicated that it is more in favor of self-regulation, and will only go as far as developing guidelines jointly with the food & beverages (F&B) industry.
- Most of the change has taken place at the state (and local) level where bills to regulate the sale of F&B at schools have been approved by some state legislatures and then have been signed by the governors, as in the case of California (although in other cases, such bills, after passing the state legislative branch have been vetoed by the governors, as in the case of Connecticut).
- But even in those few states, change has really been confined at the school level.
- As we discuss in the Litigation section, so-called "consumer advocacy" groups have grown so disenchanted with the slow progress (as they see it) in terms of their attempts to introduce regulation, that they now believe they may be able to achieve change faster by taking legal actions (the litigation route) against the F&B industry.
- However, with limited liability laws in place or rolling out across most of the country, we think the risk of litigation to the industry remains very low. However, as new lawsuits (however unsuccessful they may be) are brought against companies, they will continue to grab headlines. If the fast food industry is any example, those headlines will probably not cast a very favorable light on the soft drink industry.

R&D as key competitive advantage – a small paradigm change

We expect research to take a bigger role within the industry…

- **The quiet rise of the labs… A subtle paradigm change**. We believe that growing consumer concerns about health and nutrition, the rise of obesity, regulatory change and litigation risks have created new challenges that the marketing function cannot take up on its own and have led industry executives to realize the importance of research. While marketing budgets come under increasing scrutiny after a decade of uninterrupted inflation we believe that investment in research should continue to rise as R&D establishes itself as a core competence in the process of building a competitive advantage. The subtle paradigm change we are describing here is one of increasing complementarities of research and marketing as opposed to one function being in the shadow of the other.
- **R&D organisation: in-house capabilities & network.** We believe that R&D spending reported in the P&L of food companies undoubtedly under-estimates the real cost of research because companies **do not rely on in-house capabilities only. University funding, exclusivity agreement with suppliers, venture capitalist funds creation, partnerships with biotech firms are other forms of investments in R&D**. We believe that **success in research may ultimately rely on the strength of networks** and partnerships that have been built.

- **The major challenges of R&D within the food industry, in our view,** include I) Improve the nutrition profile of products while maintaining organoleptic properties, II) Develop lower calorie but tasty snacks and confectionery, III) Develop nutritious and lower calorie convenience food, IV) Deliver products with a better nutritional profile at a reasonable price.

…with R&D giving food companies the opportunity to build significant competitive advantage…

- **We believe food companies can build a real competitive advantage through R&D**. We highlight two examples: I) The slow churn revolution in ice cream and II) The discovery of sterol plant cholesterol lowering properties that revived the margarine category. **Plant sterol-enriched products provide the ultimate example that there is an increasing convergence between the fields of advanced nutrition and pharma.**

…that then needs to be harnessed through strong marketing and brand promotion

- **Successful R&D requires strong marketing and great brands**. We believe the development of a competitive advantage through R&D can only be achieved by combining innovative research with marketing excellence. History shows that great innovation becomes great commercial success only when R&D is put at the disposal of good brands and properly supported in terms of marketing.

Risks and opportunities for brands

Obesity has become a political and social issue; consequently, we believe F&B companies are going to be under rising pressure from governments, health organizations, consumer associations and the media to behave as very good corporate citizens. Any form of marketing of foods to children, especially energy-dense and nutrient-poor products, should be considered very carefully because this may ultimately damage the brand. Brand association with educational programs about the benefits of good nutrition and physical activity should be managed carefully as it may backfire. However, we believe there is an opportunity for brands which genuinely embody ‘health’ and ‘wellness’ to build a long-term competitive advantage which should translate into sustainable sales growth and margin expansion. There are two major building blocks, in our view: I) Continuing product innovation and renovation, implying a true commitment to R&D, II) Honest marketing and information of consumers.

Investment recommendations

Danone, Nestlé, Campbell and Dean Foods seem well positioned to benefit from the growing demand for healthy products

Although obesity is a key theme for the industry it would be unreasonable for us to make stock calls purely based on that theme. Nevertheless, we believe some companies are better positioned and/or better prepared than others when it comes to analysing potential consequences of obesity for the sector.

We believe that Danone, Nestlé, Campbell and Dean Foods are particularly well positioned to benefit from the growing demand for healthy products.

Outside the consumer sector we highlight Sanofi as a potential beneficiary of the rising demand for treatments against obesity.

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Obesity: impact on the F&B sector

‘Healthy food’ is a key driver of industry growth but treats, convenience and affordability cannot be ignored

Over the past couple of years there has been an increasing amount of communication around the subject of obesity, health and diet at all levels of civil society across western nations and increasingly in emerging markets. To what extent has this influenced industry sales growth over the past couple of years?

- In this section we demonstrate that **'healthy food’ undeniably is a key growth engine for the food industry as 18 of the 24 fastest growing food categories** (e.g. soy-based drinks, drinkable yogurts) across the globe are related to consumer perception of health and wellness, according to an ACNielsen study.
- **Conversely a number of categories which are perceived as less healthy by consumers** (e.g. carbonated soft drinks, sugar confectionery) are **exhibiting slower growth or declining**.
- Interestingly, our regional analysis shows that in countries like the UK, where obesity and healthy eating has received enormous media attention in 2005, **the trends are even more marked with the boom of water, canned fish, drinking yogurts - while sales of CSD, sugar confectionery, salty snacks and frozen meals/pizzas have declined.**
- Nevertheless global data shows that **consumers do not seem ready to sacrifice treats** - chocolate and snacks have continued to exhibit healthy growth rates – and the **need for convenience remains overwhelming**. We believe therefore that we should see more initiatives from companies to offer healthy snacks and convenience food in the future.
- Although this report focuses on branded food and soft drinks manufacturers we highlight that the global market share of private label reached 17% in 2004 and continues to rise. This means that retailers, as contractors of private labels, defining the specifications of final products, are playing an increasingly important role in shaping the diet of consumers and should be equally concerned by obesity. It is also a reminder that value for money is a key concern for consumers and that producers will have to find **the right balance in terms of pricing to avoid a marginalization of their product offering and the creation of a niche for the happy few.**

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'Healthy' food is a key driver of sales growth

A recent ACNielsen study covering 59 countries and 89 food and beverages categories offers an interesting global picture of trends within the food industry. The data collected by ACNielsen represents dollar sales figures and therefore it may sometime be distorted by price evolution reflecting ups and downs in raw material costs. This study shows that in the 12-month period ended July 2004, **18 of the 24 fastest growing categories across the globe and 6 out of 7 categories growing at double-digit rate are related to consumer perception of health and wellness**. **Conversely food products perceived as less healthy by consumers tend to show signs of weakness.**

There seem to be three key drivers within this.

Healthy diet choices

In 2004, high protein-low carb diets (such as the Atkins our South Beach diets) have met with considerable consumer success, particularly in the US. This has led to a significant increase in protein-rich food such as egg, meat and fish consumption with sales up 6% across the world, and 11% in North America.

Conversely non-sweet carbohydrates (i.e. rice, pasta, potato, bread, RTE cereals) grew well below average globally (+2%) with the Eastern Europe/Middle East consumption boom not sufficient to offset the deceleration in North America (+1%).

Healthy Staples

Whether fresh, frozen, shelf-stable or prepared, fruit and vegetables, which have been identified by health organizations throughout the world as a healthy food group and one still under-represented in consumers' diet, grew above industry average in 2004 (+4%). Frozen fruit grew 9%, fresh vegetables 7%, shelf stable fruit and nuts (another illustration of the success of the Atkins diet) +6%. Interestingly fresh ready-to-eat salad grew 8% and with it healthy refrigerated salad dressings (+9%).

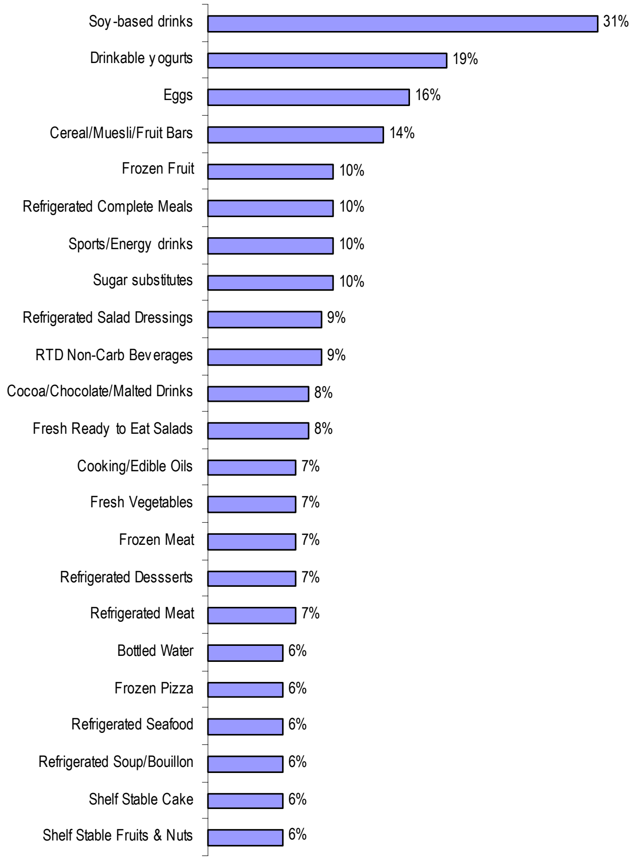
Healthy Alternatives

When offered the choice, consumers increasingly tend to go for the perceived healthy alternative. This has been the case for the past several years and 2004 data illustrates well this trend. In the large soft drinks universe, carbonated soft drinks (+3%, with regular flat to down and diet sharply up), dilutable concentrates (+2%) and coffee (0%) consumption is slowing but soy-based drinks (+31%) and drinkable yogurts (+19%) are booming while sports/energy drinks (+10%) and bottled water (+6%) continue to exhibit strong growth.

As far as cooking staples are concerned we note that raw sugar consumption is falling (-3%) but sugar substitutes (+10%), helped by recent "innovations" (notably Splenda/Sucralose), are booming. While butter consumption is broadly flat (+1%), margarine, helped by cholesterol lowering formula is doing well.

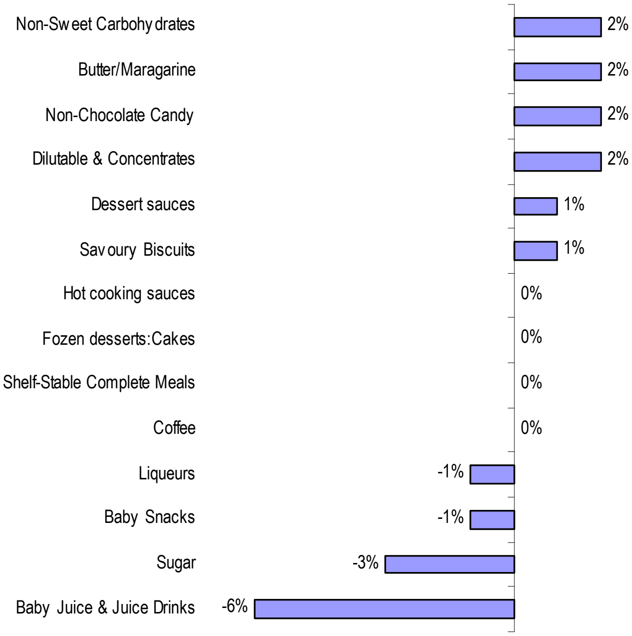
In the universe of snacks and confectionery we note that cereal/muesli/fruit bars are doing extremely well (+14%), helped by the perception of them being a healthy alternative to other snacks, maybe non-chocolate candies, which are growing at a rate below industry average (+2%).

Figure 1: Fastest Growing F&B Categories Across the World, 03-04



Source: ACNielsen. As of July 2004

Figure 2: Lowest growth categories globally, 03-04



Source: ACNielsen. As of July 2004

Regional Highlight – UK example shows consumption patterns exacerbated by massive media coverage

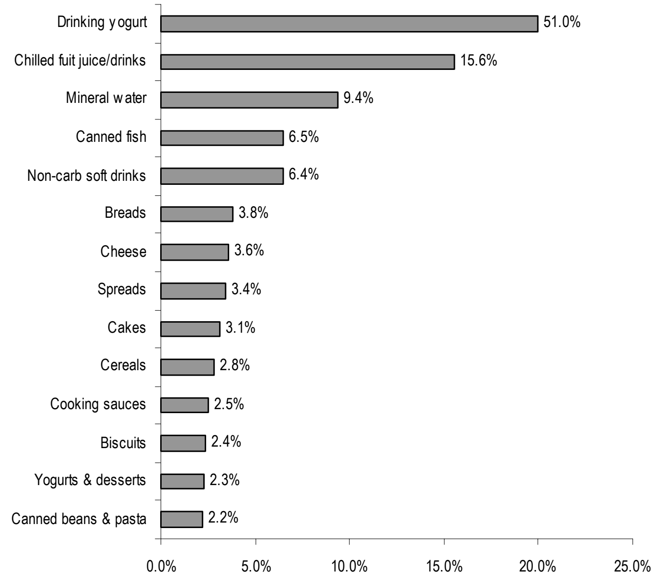
Although we observe differences from one region to another in terms of category growth our analysis of regional data (see Appendix IV page 98 for detailed European and North American data) shows that trends are very similar: categories perceived as healthy tend grow above average while categories perceived as less healthy have exhibited lower growth rate, with some exceptions. Having said that, recent detailed ACNielsen data published in the British trade magazine *The Grocer* provides an interesting example of an exacerbation of these trends following a deluge of media coverage of obesity as a public health issue and of UK government initiatives and plans to tackle obesity.

As *The Times* commented "it is the first time that consumer preoccupation with health and diet has had such a sharp impact on sales. Obesity rates may still be up but it is clear that consumers are taking on board healthy eating messages".

- **Figure 3 shows that categories perceived as healthy grew well above market average**. The biggest beneficiaries were drinking yogurts/prebiotics (+51%), chilled fruit juice (+15.6%), bottled water (+9.4%) and canned fish (+6.4%). Note that fat spread (+3.4%) was driven by significant price increases in margarine (+4.5%), attributable to the intro of healthy alternatives.

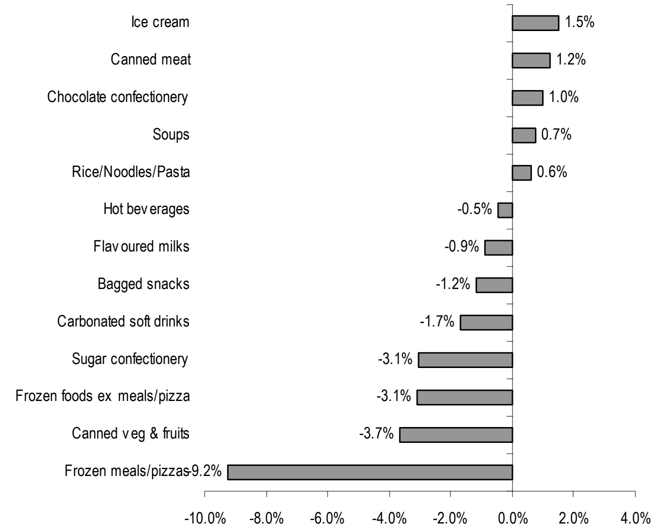
- **Figure 4 shows that categories that are usually perceived as less healthy have come under significant pressure**. Confectionery sales were very weak with chocolate up 1% and candies down 3.1%. Carbonated soft drinks sales fell 1.7% in spite of solid pricing while frozen pizzas/meals collapsed by 9.2% losing to chilled offerings. The odd one out considering the health trend is canned fruit and vegetables (-3.7%).

Figure 3: 2005 UK Food Sales Data: Healthy eating booms….



Source: ACNielsen in The Grocer. Data for the 52 week period ended 1 Oc 05.

Figure 4: … while categories perceived as less healthy struggle



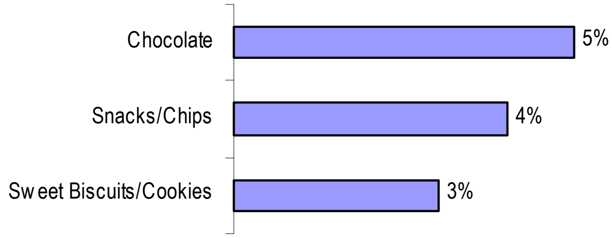
Source: ACNielsen in The Grocer. Data for the 52 week period ended 1 Oc 05.

Consumers seem unwilling to sacrifice treats and convenience

Somewhat paradoxically, given the growing consumer demand for "healthy" food and the rising awareness of health problems related to being overweight/obese, global ACNielsen data clearly shows that consumers are not ready to exclude chocolate confectionery and snacks from their diet. Global chocolate confectionery sales rose 5% in 2004, salty snacks +4% and biscuits +3% vs. 4% for the global market. This represents a solid performance, rewarding the marketing success of key players and the simple fact that consumers do not seem willing to sacrifice what they see as treats and what many in our stress-prone society refer to as 'comfort food'.

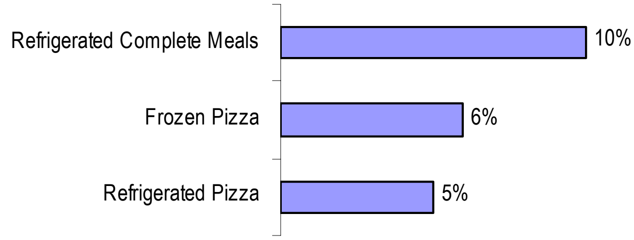
A question we cannot answer today, because we do not have sufficient qualitative and quantitative data, is whether the same individuals are responsible for the increasing demand for "healthy food" and confectionery/snacks or whether there is in fact an increasing polarization between classes of consumers: with, on one a hand, a group of consumers who are increasingly well informed about the principles of a balanced diet and opt for the "healthy" choice whenever they have the opportunity and, on the other hand, a group of consumers, who, for social/financial reasons do not have access to information and/or cannot follow the principles of a balanced diet. Such a question should not really matter for investors and analysts focused on macro/big-picture data but this is one companies will certainly need to address in the context of analyzing their broader impact on society.

Figure 5: Treats continue to exhibit above average growth



Source: ACNielsen. 12 months as of July 2004

Figure 6: Convenience Foods continue to grow strongly

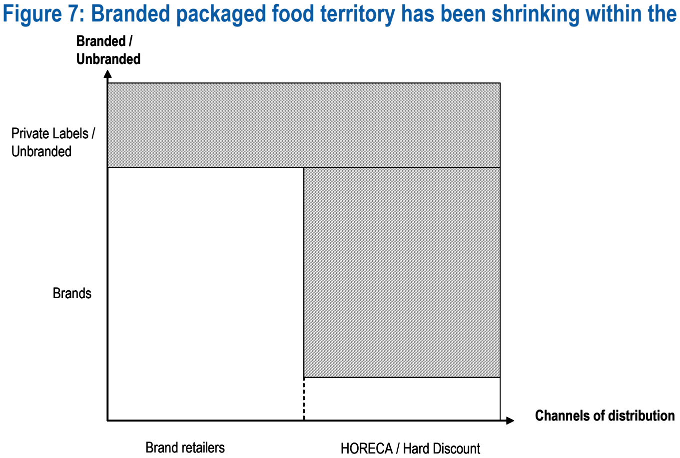


Source: ACNielsen. 12 months as of July 2004

Another key highlight from the ACNielsen global study is that **convenience food continued to enjoy very strong growth in 2004** with refrigerated complete meals sales up 10% for example. Within this category, **the 'healthy' options** (e.g. Lean Cuisine from Nestlé in the US) **are reporting growth rates above average**, illustrating once again consumers' desire to follow a healthier diet. Having said that we think the rise of convenience food is an overwhelming trend, owing to profound change within society such as the rising participation of women in the labour market, the dislocation of the traditional household (more singles, more single parents etc.) and the desire to allocate more time to leisure… all this leaving little time for proper cooking in the kitchen. We describe convenience food as an overwhelming trend because we believe that consumer desire for convenience is sometime so strong that dietary concerns may become a… secondary priority. Therefore, no surprise that frozen/refrigerated pizza and frozen snacks (e.g. Chef America, another division of Nestlé USA) are among the fastest growing categories within the global food industry.

At this stage, it is certainly important to keep in mind that **the large food manufacturers only play a relatively marginal role within the convenience food sector**. In Europe, out-of-home consumption accounts for 35% of total food expenditure while it reaches around 50% in the US – see Figure 7. Fast food restaurants, caterers and retailers (with refrigerated ready-meal and private label offering), which are not covered in this study, are much bigger players in this field.

Figure 7: Branded packaged food territory has been shrinking within the global food industry



Source: JPMorgan.

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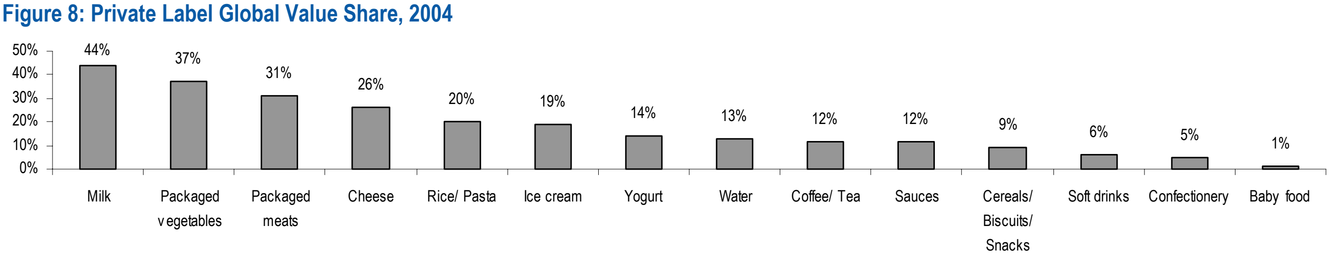
Value for money is a key concern for consumers

An important factor to keep in mind is that private labels continue to gain share at the expense of branded products and that hard discounters/dollar stores continue to outgrow traditional grocery stores/hypermarkets. One of the underlying drivers of that evolution is consumers' ever increasing sensitivity to pricing of food products. This is a major theme for the food sector and one which we discussed in details in our report *Hard Discount and Private Label* published November 2003. In the context of this report on obesity, the rise of private of label is relevant for three key reasons:

- First, while the marketing of healthy food to consumers offers pricing opportunity (see the next section on this) we believe that **food manufacturers have to find the right balance in terms of pricing to avoid a marginalization of their product offering and the creation of a niche for the happy few**. We believe that **affordability should remain a key driver of the underlying value of mass consumer brands**.
- **Branded food manufacturers have to find the marketing solution to explain that good or better quality food costs more.** Although most nutritionists argue that good food does not cost more than bad food the fact is that good quality packaged food usually costs more than poor quality one. As a food ingredients manufacturer explained to us while discussing the dilemma faced by prepared food manufacturers who are under pressure in the UK to reduce the salt content in their dishes "salt costs around $150 a ton vs. up to $2000 for other spices, which imply that to maintain palatability consumers will have to accept price increases". Similarly a recent French study showed that over the past 50 years the cost of fat has fallen by 50% while the cost of fruit increased by a third. In that context, we believe that **the marketing of food products will have to focus increasingly on explaining what's in the product and educating consumers about the quality of ingredients**. Given that retailers have been pushing private labels to consumers over the past years arguing that they offer the same quality as branded products at a 30% discount, branded food producers will have to be extremely convincing to make their point in the face of an increasingly skeptical consumer base. In that respect, Danone's recent advertising campaign ("Seul Danone sait faire du Danone" or "Only Danone can make Danones" - see www.seuldanone.com) which emphasises the uniqueness of Danone products is interesting.
- Last, it means that food retailers, as contractors of private label, defining the specifications of final products, are playing an increasingly important role in shaping the diet of consumers. **By positioning themselves, using their own brand, as providers of low cost foods to consumers they set the standard for minimum product quality** and to that extent have an important responsibility vis a vis consumers.

Figure 8: Private Label Global Value Share, 2004



Source: ACNielsen, JPMorgan.

‘Healthy’ food offers modest margin opportunity

- Confronted with the obesity crisis and consumers' growing desire to follow a healthier diet food and soft drink producers have two major options: I) enter the healthier and faster growing categories and/or II) improve the nutritional profile of products which are not in phase with consumer demand.
- We demonstrate in this section , based on our **unique global analysis of profitability within sub sectors of the food industry** that with the exception of specialised nutrition (sports/clinical/infant) **the profitability of the vast majority of food and beverage categories usually regarded as healthy (e.g. water, dairy, soy, fruit/vegetables) is below industry average**. This certainly creates a dilemma for companies who enjoy above-industry average margins (e.g. confectionery, hot beverages, snack producers) and would like to enter the healthier/faster growing segments of the market. A typical example is that of carbonated soft drinks players who want to capture the growth of the water category but have long been deterred by the lower profitability of water vs. CSD.
- Moving down the value chain or seeing a reduction of its operating margin is hardly ever seen as an attractive option for industry players (expect when growth prospects are too good to ignore). This is why in response to changing consumer demand **companies have been primarily working on the improvement of recipes and formulation**.
- Below we show that **the business of ‘healthy eating' has given companies an opportunity to improve gross margins** in three different ways: I) by pricing at a significant premium products which are truly differentiated and make health claims, II) by lowering the cost of goods sold through reformulation that translate into a healthier proposition to consumers, III) by reducing package size while maintaining/lowering modestly the apparent retail price, therefore significantly increasing the price per volume unit. Having said that **we believe the impact on operating margins has been modest given the costs associated with new product launches** such as R&D, trade spend, A&P etc…

Healthy food staples feature low margins but specialised nutrition is attractive

In order to better appreciate the economics of the 'healthy eating' business relative to the rest of the food industry we have done a global analysis of operating profitability within subsectors of the branded packed food industry – see Figure 9 for details. This benchmarking study is based on a detailed review of about 50 quoted companies operating globally, using full year 2004 data. Three broad groups clearly emerge from this analysis.

- **3-6% operating margin – The food staples group**. Unsurprisingly, operating margins tend to be low in the food staple group (fruit, vegetables, milk and meat) due to the commoditized nature of products. Most companies which operate in that segment have both branded and private label operations but the broadly undifferentiated nature of products leave little room for premium pricing. **Owing to structurally low margins, companies operating in these sub-sectors are at competitive disadvantage vs. companies operating in more sophisticated**

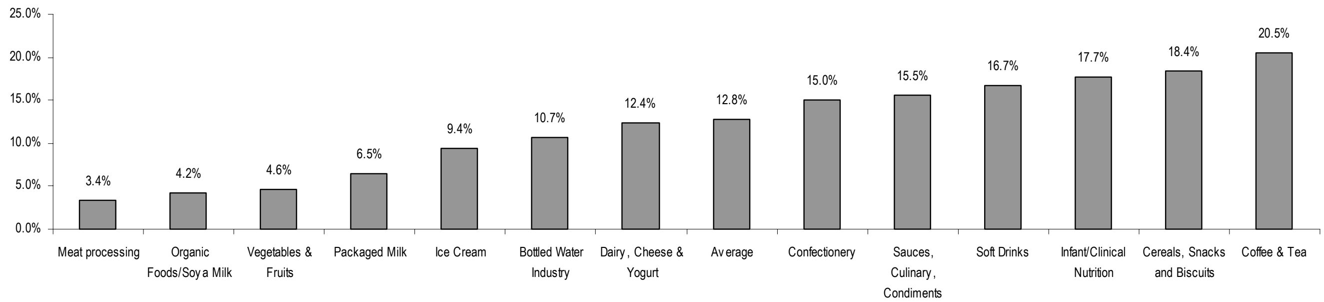
sectors of the food industry when it comes to investing in marketing and/or research. We note that margins of companies specialising in organic/natural food (including soya milk/beverages producers) tend to be low, not necessarily due to a lack of pricing power, but in our view because of a lack of critical mass, relatively high procurement costs and the fact that a number of producers have also opted for a model of vertical integration including retail concepts.

- **9-12% operating margin – Branded low/average value-added food.** Moving up the value chain, a number of companies have successfully created powerful brands for what remain relatively simple products like cheese (Kraft cheese//Philadelphia), water (Evian), ice cream (Dreyer's) or yogurt (Danone). Some of these brands enjoy very high operating margins but **average profitability within these categories is below food industry average**. The best players in these subsectors have over the years consistently invested behind their brands and product innovation/renovation in order to maintain and justify the price gap between low-cost players and private labels, which have been luring an increasingly large price sensitive consumer base.
- **Above 15% operating margin - Brands that embody pleasure & health/safety.** Our benchmarking analysis shows that margins are the highest, in coffee/tea, baby food/advanced nutrition, cereals/snacks/biscuit, soft drinks (including sports drink), confectionery and sauces/culinary products. **In these categories, the concepts of pleasure or/and security are of the essence and consumers are to happy to find and pay for brands that reassure and make them feel good**.

In the context of our analysis of the economics of the healthy eating business and the role that the food industry can/could play in helping consumers to live a healthier life there are a few important conclusions to draw from this benchmarking study.

- Within the branded packaged food industry **the only sector that truly stands out in terms of its health profile and high level of margin is specialised nutrition including baby food, clinical nutrition or sport nutrition.** In these categories brands play a key role in reassuring consumers about the quality of products and research represents an increasingly important success factor. As Nestlé explains "this business can be characterized as one in which the consumer's primary motivation for a purchase are the claims made by the product based on its nutritional content. As such, it lies somewhere between the food and beverage industry and the pharmaceutical industry". We believe this area should attract an increasing number of players within the food industry. However given barriers to entry are high we believe M&A will play a key role in expansion strategy. To a certain extent **the hot beverages segment could qualify too given it combines the highest margin within the industry with some health benefits** e.g. anti-oxidant properties of tea.
- Although the healthy staples food group (notably fruit/vegetables) should continue to exhibit good growth, benefiting among other things from the health promotion efforts from governments' and other NGOs, **there is limited incentive from a margin standpoint for large players who operate in the highly branded segments (where margins are in excess of 15%) to expand in packaged fruit/vegetables/basic dairy products**. Clearly, we believe **margins within the soft drinks, confectionery, biscuits/snacking industries are too high for operators within these categories to contemplate moving down the value chain. In our view, the only way up for them is to develop healthier alternative within their categories that can be priced in such a way that margins are preserved**.

Figure 9: Operating Margin within Sub-Sectors of the Branded Global Packaged Food Industry, 2004



Source: Company data, JPMorgan estimates.

Health positioning offers gross margin expansion opportunity but impact on operating margins may be more modest

The recent past shows that the business of ‘healthy eating' has given companies an opportunity to improve gross margins in three different ways:

i) by pricing at a significant premium products which are truly differentiated and make health claims

ii) by lowering the cost of goods sold through reformulation that translate into a healthier proposition to consumers

iii) by reducing package size while maintaining/lowering modestly the apparent retail price, therefore significantly increasing the price per volume unit.

Having said that we believe the impact on operating margins has been modest given the costs associated with new product launches **such as R&D, trade spend, A&P etc…**

Health claims support premium pricing which translates into margin growth
As we have been saying and writing for many years product innovation is the lifeblood of the consumer goods industry in the sense that it plays a key role in stimulating consumer demand and represents the only real lever (i.e. excluding inflation and input cost pressure) to pass on price increases to consumers. **Product innovation can take many forms** such as new flavors, new formulation, new packaging etc… but **over the past years the concept of health and wellness has overshadowed all others** in the field of new product development. The key reason for this is that food companies have been trying to meet general consumer aspiration to live a healthier life, manage their weight and adjust their diet.

The result is that **over the past three years close to two third of product innovation within the food industry has taken the form of ‘light’, ‘diet’, ‘better for you’, ‘enriched with’, or products making stronger claims** like ‘helps you reduce cholesterol’, ‘control blood pressure’ or ‘support your body’s natural defences’ etc…

A non-exhaustive review of retail prices at Tesco and Carrefour online grocery stores show that **products with a 'health' positioning have been priced at a premium ranging from 0% to almost 400% to the basic alternatives** - see Table 1 for detailed results. How to explain such a difference? We believe that the approach of food producers has been somewhat dichotomous.

- We believe that the **'light'/'better for you' versions have been priced at a zero premium to the regular where producers recognized that health concerns could jeopardize category growth**. Mayonnaise, salad dressing, carbonated soft drinks producers have reformulated products to offer reduced-calorie alternatives (zero in the case of soft drinks) at no cost to consumers. Having said that, the absence of price premium does not necessarily imply that producers haven't been able to improve margins. For example although diet CSDs are line priced, generally, less product is bought on deal, so the consumer actually pays a higher average price. This is because diet CSD consumers are more brand loyal. This helps bottler profitability. Also, because the artificial sweetener is in the concentrate, Coke and Pepsi actually charge a bit of a mark up to the bottlers, so, it actually is better economics, at least to some extent.

- **In other categories producers have been able to price their 'light'/'better for you' products at a premium ranging from about 15% to 380%**. The pricing of consumer goods product is as much of an art as a science but we believe that the premium can be explained in light of two key factors i) quality of the consumer proposition (strength and uniqueness of the health claim), ii) consumer acceptability of the price.

Given innovation has a cost (product research & development, marketing spend), some ingredients used in the formulation of more sophisticated healthy products are expensive (i.e. active bacteria, ferments, plant sterols) and new products require substantial marketing investments **we believe that price increases have allowed manufacturers to improve gross margins significantly and operating margins modestly**.

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Table 1: Price premium analysis of healthy products

Product name	Manufacturer	£/Kg	Premium to basic alternative
Flora Light Vegetable Low Fat Spread (1kg)	Unilever	1.73	
Flora Vegetable Spread (500g)	-	1.84	6%
Flora Pro-Activ Light Spread (500g)	-	7.46	331%
Flora Pro-Activ with Olive Oil (250g)	-	8.32	381%
Hellmanns Light Mayonnaise (400g)	Unilever	2.50	
Hellmanns Real Mayonnaise (400g)	-	2.50	-
Hellmanns Extra Light Mayonnaise (400g)	-	2.50	-
Hellmanns Caesar Salad Dressing (235ml)	Unilever	5.4	
Hellmanns Italian Salad Dressing (235ml)	-	5.4	-
Hellmanns Classic Light Salad Dressing (235ml)	-	5.4	-
Pringles Original (200g)	P&G	6.90	
Pringles Light Original (175g)	-	7.90	15%
Kelloggs Cornflakes (500g)	Kelloggs	2.78	
Kelloggs Special K (500g)	-	5.18	86%
Kelloggs Special K Red Berries (500g)	-	6.00	116%
Coca-Cola Regular (2l bottle)	Coca-Cola	0.7	
Coca-Cola Light (2l bottle)	-	0.7	-
Walls Vanilla Soft Scoop Ice Cream (2l)	Unilever	0.75	
Walls Vanilla Soft Scoop Light Ice Cream (2l)	-	0.86	15%
Tesco Longlife Healthy Living Half Fat milk (1l)	Unilever	0.5	
Pro Activ Milk (1l)	-	1.48	196%
		€/Kg	**Premium to basic alternative**
Danone Yoghurt Nature (4x125g)	Danone	1.80	
Danone Bio Nature (4x125g)	-	2.80	56%
Danone Taillefine cherry (4x125g)	-	3.06	70%
Danone Danacol (4x125g)	-	4.42	146%
Actimel (6x100ml)	-	4.98	177%
La Laitiere Vanilla Ice Cream	Nestlé	4.22	
Sveltesse Light Vanilla Ice Cream	-	5.08	20%
Poulain Milk Chocolate (2x100g)	Cadbury	11.6	
Poulain Ligne Gourmande Chocolate (100g)	-	16.8	45%
Prince Bisuits Regular (330g)	Danone	4.03	
Prince Bisuits Reduced Sugar (305g)	-	4.59	14%

Source: Tesco, Ooshop.

Reformulation can lead to healthier proposition AND lower COGS

Reformulations are usually seen as a source of additional costs for the food industry to the extent that they usually imply additional R&D costs, potential changes to the production process, potential addition of more expensive ingredients etc… But there are actually a number of examples where reformulations have produced the best of both worlds: a lower cost of goods sold and a lower calorie content. We discuss two examples below.

- **Hellmann's Mayonnaise - Real vs. Light.** Traditional mayonnaise, being primarily made of vegetable oil and egg yolk, is by definition everything but a light product – it contains about 722 calories per 100 gram. To meet consumer demand for lower calorie Unilever Bestfoods introduced years ago a light version in which around two third of oil is replaced by water and half of the egg yolk replaced by starch. The result is a product which contains 60% less calorie, tastes (basically) the same with a raw material cost which is probably 50% lower, and a cost of goods sold which is probably 10% lower on our estimates. The Light and Real Hellmann's mayonnaise being sold at the same price we estimate that Light is a higher margin product for Unilever.

Table 2: Hellmann's Mayonnaise - Real vs. Light

	Real	Light
Vegetable oil	77%	28%
Water	c13%	c60%
Egg	8%	4%
Modified starch	0%	c6%
Others	2%	2%
Calorie per 100g	722	299

Source: Company data, JPMorgan estimates.

- **Dreyer's Ice Cream - Regular vs. Low Churn.** Being made of milk, cream, sugar and flavours, ice cream is by definition an indulgent food product. In view of rising health concerns producers have been tying for many years to create a product reconciling health with taste. This came to fruition about 18 months ago when Dreyer's Grand Ice Cream, a subsidiary of Nestlé, introduced its slow churn process which allows to re-create the texture and mouthfeel of a regular ice cream with 25% of the fat content. Slow churned ice cream were launched at a retail price similar to the regular range but given that the cost of fat represents more than 50% of the raw material cost Slow Churned products should be regarded as a significantly mix enhancing product. In the short-term the margin impact may be less dramatic because of the investment in technology and the relatively high communication costs.

Reducing packaging size while maintaining retail price is the quickest route to margin expansion – 100 Calories is the magic number

After super-sizing, micro-sizing could be the new trend in the packaged food industry. In an effort to address consumer's desire to manage calorie intake a number of players in the confectionery and snacking industry have recently launched smaller packs, which are designed to offer consumers 100 calories.

Although a smaller packaging is not per se an innovation, the 100-calorie product represents a new consumer proposition to the extent that 100-calorie has become key selling argument, clearly communicated to consumers and incorporated in the name of the product, and not just nutrition data on the back of the pack.

In spring 2005 Cadbury launched in Canada Dairy Milk Thins, a 100-calorie chocolate bar, which sells at 70 cents for an 18-gram bar, compared with $1 for the regular 42-gram bar — about 50 per cent more expensive, unit for unit. In august P&G followed suit with the launch of the 108-gram carton of six Pringles 100 Calorie Packs costs about $3.99 each — or $3.69 per 100 grams. Pringles Light — the same one-third less fat chips as the 100-calorie product — comes in a 145-gram can and costs $1.99 — or $1.37 per 100 grams.

The attraction for the producers of this new consumer proposition is two fold. First, quite obviously, these products carry an extremely high margin given the massive price premium (62% in the case of Cadbury Thins and 191% in the Pringles example). Secondly, as Cadbury puts it "this new product has tapped into a consumer who probably wasn't buying chocolate before, or not buying very much," people who "would just avoid that whole chocolate aisle".

Going small, reversing the super-size trend, seems to be the new fashion as Coke has just introduced a 8-ounce can marketed as "100-calorie alternatives".

Table 3: Cadbury Dairy Milk – 42g vs. 18g – Regular vs. Thins -

	Dairy Milk Thins (18 g)	Dairy Milk (42 g)
Suggested price	69¢ (2.61¢/g)	99¢ (4.24¢/g)
Calories	100	220
Fat	5 g (18%	12 g (18%)
(saturated)	3 g (15%)	7 g (35%)
(trans)	0 g (0%)	0.1 g (0%)
Cholesterol	5 mg	10 mg
Sodium	15 mg (1%)	35 mg (1%)
Carbohydrate	11 g (4%)	26 g (9%)
(Fibre)	0 g (0%)	1 g (4%)
(Sugar)	9 g	22 g
(Sugar alcohols)	0	0
Protein	2 g	4 g

Source: Cadbury Schweppes.

Figure 10: 100 Calories - The Magic Number – A new profitable proposition

Source: Kraft (www.nabiscoworld.com/100caloriepacks)

Source: Cadbury Schweppes.

More regulation to come in Europe

In our April 2003 report *Obesity:The Big Issue* we highlighted for the first time the risk of increased regulation for the food industry in light of rising pressure on governments to take measures to curtail the obesity 'epidemic'. Over the past three years obesity has definitely moved up the agenda of health policy makers in Europe and we show in this section how new legislation may affect companies in the way they produce, market and distribute products. The key conclusions are:

- **Less healthy food is coming under pressure.** Food, which will be ascribed a negative nutrient profile (e.g. probably soft drinks, ice cream, confectionery, snacks) as part of the implementation of the **new EU Regulation on "Nutrition and Health Claims made on Foods"** will not be allowed to make health claims and probably only very limited nutritional claims in the future. In the UK, the **Foods Standards Agency has developed a scoring system "to help support** the independent UK communications regulator Ofcom in its work to consider **possible restrictions to the advertising and promotion to children of foods that are high in fat, saturated fat, salt or sugar**". **In France, from 1st January 2006 advertising of food/drinks will have to include a health message or advertisers will pay a tax representing 1.5% of gross advertising cost**. In September 2005, **Ruth Kelly, the UK education secretary, announced that from September 2006 "junk food served every day in school"** will be banned. While **from 1st September 2005 vending machines are now banned from all schools in France.** In 2005, **the FSA started to test a front-of-pack multiple traffic light scheme** which should send a strong instantaneous signal to the consumer about the nature of the food based on the salt/fat/sugar content.
- **Doing business in Europe will become more complex and more costly… giving the advantage to larger groups.** The new proposed EU Regulation on "Nutrition and Health Claims made on Foods" will make life more difficult for producers, in our view. First, **health claims will be subject to prior approval by the European Food Safety Agency and will have to be supported by scientific studies**. **Companies will thus need to invest more heavily in R&D**. Secondly the Commission has already given a long list of claims it may prohibit or accept in the future, implying that marketers/advertisers will have less room for manoeuvre and creativity while **food manufacturers will have to adapt formulation**. In general we believe that **large companies will have a competitive advantage vs. smaller operators** who may struggle with the complexity of dealing with the European bureaucracy (EFSA registration etc…) and may not be able to afford more R&D investments. This further supports our view that consolidation/restructuring will continue and accelerate.
- **Winners/Losers?** Taken independently, measures that are being taken or being considered may sometime seem rather symbolic but combined together they may start to have a material impact on category dynamics, in our view. Overall we believe that they will lead to an exacerbation of trends analysed in our first section with continuing growth of healthy and an acceleration of the decline/deceleration of categories perceived as unhealthy (confectionery, CSD, snacks, sugar). We highlight that the **new proposed EU regulation on nutrition and health claims may lead to prohibition of health claims – a cornerstone of their growth strategy- on RTE cereals, fruit juice and medicated confectionery, in view of their high sugar content**. In addition, the potential implementation of subsidy on vegetables/fruit may help a number of producers operating in that field (see Fat Tax vs. Healthy Food Subsidy section page 36).

Regulation on "nutrition and health claims made on foods"

Summary

This new Regulation will set a new legislative framework on the use of claims made on foods within the EU. There are three fundamental points in this regulation.

- **Food with a negative nutrient profile will not be allowed to make claims.** Within 18 months from the adoption of this regulation the Commission shall establish specific nutrient profiles by reference to the amount of fat, sugar and salt, which food or certain categories of foods must respect in order to bear nutrition or health claims. Foods with a negative nutrient profile will still be allowed to make nutrition claims (but not health claims) referring to the reduction in the amounts of fat, sugars and salt, if they can comply with a very precise and strict list of nutrition claims listed in an annex of the bill.

  What are the implications for the food industry? Nutrient profiles have yet to be established and there is therefore still a lot of uncertainty as to how the different product categories will be treated. Nevertheless it is clear from discussions with experts that **entire categories of products including sugary soft drinks, confectionery, salty snacks, ice cream are likely to be ascribed a negative profile that will prevent them from making any health claim and only limited nutritional claims in the future**. Health claims have played a limited role in the marketing of aforementioned product categories but it means that confectionery enriched with vitamins and marketed as such may have to be withdrawn from the market. **More critical, but it remains to be seen what the result from the consultation will be, is the potential that a "low fat" claim will not be allowed if a product contains high quantities of sugar or salt, e.g. low fat (but high sugar) biscuits, snacks, yogurts, cereals will have to stop making this type of claim**.

  The real challenge, in our view, could be for some categories, where marketing success has been built around health claims in spite of having a high level of sugar, fat or salt. **For instance a number of ready-to-eat cereals** which contain a high level of sugar **may be prohibited from making/maintaining health claims**, in our opinion. And what about **fruit juice** which contains more than 104g of sugar per litre (or 475 calories) or so-called **medicated confectionery**, which generally is almost pure sugar.

  To counter this we believe that food manufacturers will have to adapt formulation.

- **Health claims will be subject to approval by the European Food Safety Agency,** with the exception of claims, which are "based on generally accepted scientific data" (e.g. calcium helps reinforce bones and teeth). Health claims will have to be supported by scientific studies. The EFSA will have to give its opinion within 3 months. The scientific data and other information in the application dossier to EFSA may not be used for the benefit of a subsequent applicant for a period of seven years with some exceptions.

  What are the implications for the food industry? Health claims will be allowed in every singly European country, which is not the case at the moment everywhere. The cost of doing business will increase as companies will need to invest more heavily in R&D to justify claims. In that context, we believe large companies have a competitive advantage vs. smaller operators who may struggle with the complexity of dealing with the European bureaucracy (EFSA registration etc…) and may not afford a step-up in R&D investments. This implies that consolidation/restructuring will continue and accelerate. In our view, R&D has the potential to become a real competitive advantage in an industry where branding was traditionally everything.

- **Towards fewer claims - many claims should disappear.** In its Explanatory Memorandum the EU Commission has already given a long list of claims it may prohibit or accept in the future. For example psychological and behavioural claims such as "intellectual vitamins" for "good memory and concentration" will be prohibited. Claims referring to "general, non-specific benefits and to general wellbeing" such as "excellent for your body", "preserves youth" will be challenged. Claims that are true but may not be understood by the "average consumer" such as "folate may help normalize plasma homocystine levels" will be challenged too. Nutrition claims that are true but can be seen as misleading such as "90% fat-free" will also be prohibited. Instead, a list of nutrition claims that will be permitted such as "low fat", "energy reduced", "source of fibre" has been annexed to the bill with a clear definition (i.e. "source of fibre" means at least 3g of fibre per 100g or at least 1.5g of fibre per 100kcal).

What are the implications for the food industry? Marketers/Advertisers will have less room for manoeuvre and creativity. To make nutrition claims we believe that food manufacturers will have to adapt formulation.

This new regulation should come into force in 2006 but the definition of nutrition profile will also only happen in 2006 and we thus expect full implementation in 2007.

Background

This proposed European regulation wasn't initially specifically developed to curtail obesity in Europe but the strong support its garnered throughout Europe, the commitment of the EU commission to get it passed, the unanimous support of the European council is primarily related to its being seen as key to better inform consumers about their food at a time when tackling obesity is considered as a key priority for European health ministers and the EU Commissioner for Health and Consumer Protection.

This new Regulation will set a new legislative framework on the use of claims made on foods within the EU. The proposed Regulation covers nutrition and health claims used in the labelling, presentation and advertising of foods to be delivered as such to the final consumer. It shall also apply to foods intended for supply to restaurants, hospitals, schools, canteens and similar mass caterers.

Timeline

After several years of consultation the European Commission adopted in July 2003 the proposed Regulation on nutrition and health claims. In June 2005 the proposed Regulation was submitted to the European Parliament, which rejected two important articles concerning the establishment of nutrition profiles and the need to get prior approval from EFSA to make a health claim. However, late June, the European Council consisting of the Health Ministries of the Member States, unanimously approved the proposed Regulation in full. The proposed Regulation will be re-submitted to the Parliament shortly and is expected to be approved in full unless Members of the Parliament unanimously reject it - the probably of this happening is close to zero, in our view. This new regulation should gradually come into force in

2006 but the Commission will have up to 18 months to establish the nutrient profiles in consultation with the EFSA, the food industry and consumer groups. We thus expect full implementation in 2007.

"Nutrient Profile" concept is a major challenge for the food industry
The most important and controversial aspect of the proposed regulation is related to the introduction of the "Nutrient Profile" concept. Within 18 months from the adoption of this regulation the Commission shall establish specific nutrient profiles by reference to the amount of fat, sugar and salt, which food or certain categories of foods must respect in order to bear nutrition or health claims. These nutrient profiles will be established after consultation with the EFSA, the food industry and consumer groups. Foods with a negative nutrient profile will still be allowed to make nutrition claims (but not health claims) referring to the reduction in the amounts of fat, sugars and salt, if they can comply with a very precise and strict list of nutrition claims listed in annex of the proposed Regulation.

The proposed Regulation is going against the principle that there is "no bad food or good food" but the Commission justifies itself by arguing in the Explanatory Memorandum that "foods bearing claims are presented by the food operators as products whose consumption provides a benefit, and as "good" or "better" products than the others. In most cases, influenced by the promotional campaigns, consumers perceive them as such. This potential bias should be avoided […]".

The proposed regulation will prohibit beverages containing more than 1.2% alcohol volume to bear health claims and nutritional claims, others than those that refer to a reduction in the alcohol or energy content. Other categories may be added to the 'black list' in the future.

Nutrient profiles have yet to be established and there is therefore still a lot of uncertainty as to how the different product categories will be treated. Nevertheless it is clear from discussions with experts that **entire categories of products including sugary soft drinks, confectionery, salty snacks and ice cream are likely to be ascribed a negative profile that will prevent them from making any health claim and only very limited nutritional claim in the future**. Health claims have played a limited role in the marketing of afore mentioned product categories but it means that confectionery enriched with vitamins and marketed as such may have to be withdrawn from the market.

More critical, but it remains to be seen what the result from the consultation will be, is the potential that a "low fat" claim will not be allowed if a product contains high quantities of sugar or salt, e.g. low fat (but high sugar) biscuits, snacks, yogurts, cereals will have to stop making this type of claims on the package or in advertising.

The real challenge, in our view, could be for some categories, where marketing success has been built around health claims in spite of having a high level of sugar, fat or salt. For instance a number of ready-to-eat cereals, which contain too high a level of sugar may be prohibited from making/maintaining health claims. We believe that Fruit juice, which contains more than 104g of sugar per litre (or 475 calories) or so-called medicated confectionery, which is almost pure sugar, may also be at risk.

The alternative to not making claims is likely to be reformulation.

Health claims will be subject to approval by the European Food Safety Agency
With the exception of claims, which are "based on generally accepted scientific data" (e.g. calcium helps reinforce bones and teeth) health claims will be subject to approval by the European Food Safety Agency (EFSA) prior to their launch. To obtain the authorisation from the EFSA food companies will have to submit a dossier including scientific studies supporting health claims. The EFSA will have to give its opinion within 3 months.

The pre-approval requirement is one of the most controversial aspects of the proposed Regulation given it adds complexity to the product launch process - a simple notification was preferred by industry operators. Having said that we believe it should be manageable for the largest companies who we believe will be at a competitive advantage vs. smaller operators who may struggle with the complexity of dealing with the European bureaucracy (EFSA registration etc…) and may not afford a required step-up in R&D investments.

In fact, R&D has the potential to become a real competitive advantage in an industry where branding was traditionally everything. Article 18 and 19 of the proposed Regulation have some interesting provisions concerning data protection. First it says that health claims authorised on the basis of proprietary data are "restricted for use unless a subsequent applicant obtains authorisation for the claim without reference to the proprietary data of the original applicant". Secondly it says that the **scientific data and other information in the application dossier to EFSA, which are designated as proprietary, may not be used for the benefit of a subsequent applicant for a period of seven years**. The protection of research is a very important step forward for the industry as it should encourage the largest players to invest more vigorously to create the gap with competition. For example, had this provision been in place in the late 90s, when Raisio and Unilever demonstrated the benefit of plant sterol consumption on cholesterol level the two companies would have been able to cash in on their innovation without thinking about competition (including private labels) recycling their research and launching competing products making the same claims (without any R&D investment).

Another attraction of the proposed Regulation is that health claims will be allowed in every singly European country, once approved by the EFSA. This was not the case before, as rules concerning health claims differed materially from one country to another. For example, Austria and France were the only countries in Europe where pre-marketing clearance was required.

The broad conclusion is that the cost of doing business will increase as companies will need to invest more heavily in R&D to support health claims. We think this implies that consolidation and restructuring will probably continue and accelerate.

Towards fewer but higher quality claims?
Under a stricter framework (see above) the proposed Regulation will now allow food companies to make claims of reduction of disease risk. This was not possible under the previous legal framework and this should be seen as another incentive for the food industry to intensify its research effort. On the other hand the proposed Regulation will tighten the use of health and nutrition claims. Article 11 prohibits the use of:

- "claims which make reference to general, non-specific benefits of the nutrient or food for overall good health, well-being." Examples given the Explanatory Memorandum include "excellent for your body", "reinforces the body's resistance", "helps your body resist stress", "purifies your organism", "has a positive effect on your wellbeing", " has an harmonising effect on your metabolism", "helps keep your body feeling good", "preserves youth" etc…
- "claims which make reference to psychological and behavioural functions" e.g. "intellectual vitamins" for "good memory and concentration";
- "claims which make reference to slimming or weight control, or to the rate or amount of weight loss which may result from their use or to a reduction in the sense of hunger or an increase in the sense of satiety or to the reduction of the available energy from the diet";
- "claims which make reference to the advice of doctors or other health professionals, or their professional associations, or charities, or suggest that health could be affected by not consuming the food".

Claims that are true but may not be understood by the "average consumer" such as "folate may help normalize plasma homocystine levels" will be challenged too.

As explained in the Explanatory Memorandum "some claims may be misleading due to the way in which they are expressed, even if they are factually true. For example, claims stating that a product is "90% fat-free" may indeed be true, but they imply that a the product has a low fat content while it actually contains 10% fat which, for the majority of products, is not a low fat content." Such claims will be prohibited and instead, a list of nutrition claims that will be permitted such as "low fat", "energy reduced", "source of fibre" has been annexed to the proposed Regulation with a clear definition (i.e. "source of fibre" means at least 3g of fibre per 100g or at least 1.5g of fibre per 100kcal) etc.

Although we understand the need to avoid misleading claims and see the creation of definition of terms like light/low-fat positively **we feel marketers/advertisers' room for manoeuvre and creativity is being drastically reduced. As one of the EU specialist lawyers we consulted put it, after seeing the list of banned claims…"I'm wondering what's left?"… So do we.**

Advertising – No ban but restriction threats exist in the UK while France has imposed a special tax on food advertising

Banning or restricting advertising of certain food products to children was and remains to a certain extent one of the measures recommended by a number of consumer associations and international/national health organizations to tackle obesity. An **in-depth review of current legislation as well as proposals for policy at the national and international level within the EU leads to the conclusion that this threat remains relatively remote for the industry, maybe with the exception of the UK and small constraints in France. In general self-regulation seems to be the way forward.**

Over the past two years the UK and France have looked in great detail at potential regulation concerning advertising in the context of national health policy. **France has created a small tax on food & beverage advertising that will help finance health campaigns** (starting 1st January 2006). **In the UK, although the Ofcom (regulator for the communication industries) concluded a ban would be inefficient, the Government seems to be keen to introduce significant restrictions**.

The **problem with national regulations is that they could be deemed illegal within the EU framework that will be redefined by the forthcoming EU directive *Television without Frontiers***.

France – Advertising allowed in exchange of tax payment or health message banner appearing in commercials

From 1st January 2006, TV and radio advertising for drinks with added sugar, salt or synthetic sweeteners as well as processed food products will have to include a health message. However advertisers have the option not to do it and to pay instead a tax representing 1.5% of gross advertising cost. This tax will be paid to the National Institute for Health Prevention and Education (INPES). This tax will be used to finance advertising and education campaigns related to health and nutrition.

UK – Ofcom says a ban would be inefficient but the Government wants to introduce restriction

In July 2004 Ofcom (the Office of Communications), the independent regulator and competition authority for the UK communications industries, published the findings of "its research into the role of television advertising in the context of the wider public debate on childhood obesity. The study, which was undertaken in response to a request from the Secretary of State for Culture, Media and Sport, included interviews with more than 2,000 children, parents, teachers and nutritionists, together with an analysis of academic research and an analysis of characteristics of the food advertising market.

The findings suggest that television advertising had a modest effect on children's food consumption, although its significance was small compared to other factors such as exercise, trends in family eating, demographics and food labelling.

Ofcom concluded that there was no case for a ban, as such a move would be neither proportionate nor, in isolation, effective. However, **Ofcom's research did indicate potential areas of targeted change** - particularly in portrayal and scheduling." **Ofcom's study highlights there is indeed "support for**:

- **targeting the attractiveness of advertising to children (in general, not using celebrities or cartoon characters)**
- **targeted scheduling restrictions** (a ban during children's airtime or before 9 o'clock in the evening even though in qualitative research mothers acknowledged that regarding the former, children watch TV in adult airtime where they can still see HFSS (high fat/sugar/salt foods) advertising, and that, regarding the latter, such a ban was felt to compromise adult freedom to enjoy advertising."

In its White Paper 'Choosing Health' report that was published in autumn 2004 the British Government said it "considers there is a strong case for action to restrict further the advertising and promotion to children of those foods and drinks that are high in fat, salt and sugar. To have maximum effect, action needs to be comprehensive and taken in relation to all forms of food advertising and promotion, including:

- broadcast;
- nonbroadcast;
- sponsorship and brandsharing;
- point of sale advertising, including vending in schools; and
- labels, wrappers and packaging.

There is a range of ways in which the rules governing food and drink advertising and promotion could be enhanced and strengthened. These might cover:

- when, where and how frequently certain advertisements and promotions appear – for example, an option would be to consider different restrictions during children's television (pre 6pm), during peak times (6pm–9pm) and after the 9pm watershed;
- the use of cartoon characters, role models, celebrities and glamorisation of foods that children should only eat seldom or in moderation as part of a balanced diet; and
- the inclusion of clear nutritional information – perhaps based on a signposting system – and/or balancing messages in advertisements to counteract the influence of high fat, salt and sugar food advertisements.

Options will be dependent upon the nutrient profiling scheme being developed by the Department of Health and the Food Standards."

In addition, the White Paper recognizes that "marketing spend is not limited to television advertising and, indeed, may be increasing in other areas: this increase would probably be magnified when broadcast restrictions are increased unless a more comprehensive approach is adopted. Government is therefore also keen to see stronger controls on nonbroadcast and other types of marketing. **We will work with industry, advertisers, consumer groups and other stakeholders to encourage new measures to strengthen existing voluntary codes in nonbroadcast areas, including:**

- setting up a new food and drink advertising and promotion forum to review, supplement, strengthen and bring together existing provisions; and
- contributing funding to the development of new health initiatives, including positive health campaigns."

Beyond the fact the Government's objective "to halt the year on year rise in the prevalence of obesity among children under 11 by 2010", there is no precise timeframe for action. However the understanding**, based on discussions with industry contacts, is that the advertising/food industry has been given two years to implement a voluntary code on TV advertising so that there are no commercials for high fat/sugar/salt products before 9pm.**

In the meantime the FSA has developed a scoring system "to help support the independent UK communications regulator Ofcom in its work to consider possible restrictions to the advertising and promotion to children of foods that are high in fat, saturated fat, salt or sugar".

“The model utilises a ‘simple scoring’ system that rates the overall balance of nutrients in the food. This means the model identifies foods that are high in fat, salt or sugar, but recognises the importance of fruit and vegetables, cereal, meat, and dairy-based products in the diet.”

The UK Agency is currently proposing that the definition of 'high in saturated fat, salt or sugar' i.e. ‘less healthy' should apply to foods scoring four points or more and drinks scoring one point or more.

Based on the FSA scoring system advertising restriction to a very large number of categories including regular/sugary soft drinks, salty snacks, confectionery products, margarine, mayonnaise and certain type of ready-to-eat cereals etc…

Table 4: FSA's Nutrient Profiling Model – ‘Less Healthy Foods’ could face advertising restriction in the UK

Subset of foods	Healthier foods	Intermediate Foods	Less healthy foods
Bread, cereals & potatoes	Pasta, wheat biscuit cereal, wholemeal bread, white rice, oven chips	White bread (sliced), white rice (fried)	Chips, French fries, Flaked corn cereal, Honey & Nut Coated Flaked Corn Cereal, Sugar Coasted Puff Oat Cereal
Milk & Dairy Products	Fromage frais, yogurt (low fat), whole milk	Plain fromage frais, cottage cheese	Cheddar, crème fraiche (half fat), camembert
Fuits & Vegetales	Everything	-	-
Meat, fish & alternatives	Lentils, chicken breast grilled without skin, beef	Eggs, chicken, tuna, fish finger (cod, grilled)	Walnuts, chicken nuggets, ham, pork sausages (fried), bacon
Foods high in fat and/or sugar	Cola diet		Cola, Sponge cake, Digestive biscuits (plain), Potato crisps, Cookies, Margarine/Butter/Olive oil, Chocolate
Composite foods	Baked beans (canned in tomato), soya (non-dairy alternative), chilli con carne	Sardines, Strawberries (canned in syrup), Fruit crumble	Cottage's pie, Fruit pie, Peanuts (roasted & salted), Mayonnaise (incl reduced calorie)

Source: FSA

European Union – Limited action so far
At the European level there is no specific regulation in the making targeting advertising in the context of the debate on obesity. **At the moment the EU Platform on Diet, Physical Activity and Health is primarily seeking to encourage a strengthening of industry self-regulation; however, the Commission has made clear in several instances that if self-regulation fails to deliver results regulation would be considered.**

“As far as advertising and marketing is concerned, it has to be ensured that consumers are not misled, and that especially the credulity and lacking media literacy of vulnerable consumers and, in particular children, are not exploited. This regards in particular advertising for foods high in fat, salt and sugars, such as energy-dense snacks and sugar-sweetened soft drinks, and the marketing of such products in schools. Industry self regulation could be the means of choice in this field, as it has a number of advantages over regulation in terms of speed and flexibility. However, other options would need to be considered should self-regulation fail to deliver satisfactory results.” - EU Commission, Green Paper, 08.12.2005.

The EU directive concerning unfair commercial practices that came in to force in May 2005 provides some protection for children to the extent that it defines "a direct exhortation to children to buy advertised products or persuade their parents or other adults to buy advertised products for them" in an advertisement as an "aggressive commercial practice" that should be banned under National law. Nevertheless it seems to us that European voluntary codes of conduct of advertisers already recognize this and we consider this Directive to have no impact on the industry.

In our view, the most important Directive that could have an impact on the way food is being advertised is the Television without Frontiers Directive for which a draft legislative proposal was expected to be adopted by the Commission by the end of 2005.

What would be the financial impact of a ban of "junk food" advertising to children?
Such an important question certainly requires a more detailed analysis than we are able to attempt in this report but we think that the key points to consider, using the UK market as an example, could be summarized as follows.

Assuming a ban of advertising, taken in its different forms (TV, radio, press, posters, internet) to children of high fat/sugar/salt food, we believe:

- **Volume growth would decelerate or turn negative.** There is no question that advertising plays a key role in stimulating consumer demand for company products. In that context, were they to lose share of voice to other product categories and have no serious means to communicate product innovation to consumers, we believe that high fat/sugar/salt products would lose share to others and decline in importance in consumers' diet.
- **Barriers to entry for children products would be raised….** Confectionery, snacks and soft drinks products which are all about pleasure are characterized by high barriers to entry represented by brands (see our analysis in the previous section). Advertising undoubtedly plays a key role in building brand equity. As a result, we believe restricting/banning advertising would raise barriers to a level making the entry/creation of a new (children's) brands very difficult.
- **… Firms would regain (to a very limited extent only) pricing power....** As we've seen with tobacco, the creation of barriers to entry through the advertising ban has given companies great freedom on pricing. Over the past five years in markets where ad bans have been implemented cigarette prices have increased by 4-6% p.a. while volume declined by 2-4%. Having said that, given that children's products are most often adults' products too (with a few exceptions) it would be probably difficult for industry players to raise prices.
- **…..Companies would have the option to redeploy marketing budgets to stimulate adult consumption or increase operating margin.** Estimates of advertising budgets of high fat/sugar/salt products dedicated to children vary significantly depending on the definition of childrens' air time. According to ACNielsen the high sugar/fat/salt food companies and fast food chains spent £522m on TV advertising in 2003 including £32m during childrens' air time (or 6% of the total). However according to Campaign, food advertising before 9pm generates more than £220m in revenues for TV channels. According to Ofcom studies, more than 55% of advertising seen by children is during adult time. Obviously the impact on the industry would be somewhat different if the 9pm

watershed were to apply. In any event, we believe that a significant portion of the budget could be redeployed in adult time and some of it could feed margin expansion by up to 500bp, in our view.

- **But what if we're wrong.** A worse scenario for the industry would be that lower advertising support for their brands results in significant change in consumer behaviour. Unlike tobacco, where there is no substitution, food offers never-ending possibilities.

We conclude that banning/restricting advertising to children would probably have negative consequences on sales which could be mitigated by operating margin expansion implying that operating profit could be maintained (or even increased if we follow the example of tobacco).

Distribution – Vending machines in schools are at risk

Slowly but surely there seems to be a consensus building in Europe that vending machines in schools should not sell products which are high in sugar/fat/salt or be withdrawn. We estimate that around 1% of CSDs, confectionery, salty snacks are sold via schools in Europe. In a worse case scenario, the loss of this distribution channel should be manageable though negative for most operators. In reality a number of companies, notably soft drink players, should be able to mitigate the revenue loss by introducing more healthy products (e.g. bottled water).

Vending machines in schools are a key target - Already withdrawn in France
From 1st September 2005 vending machines are now banned from all schools in France. 8,000-10,000 vending machines were withdrawn from schools representing about €160m in revenues or about 8% of revenues in the channel according to the national vending machine association. Note the penetration rate in schools was relatively low at less than 40%. In France 86% of revenues of vending machines are derived from machines installed in companies.

In September 2005, Ruth Kelly, the UK education secretary, announced that from September 2006 “junk food served every day in school" will be banned. The regulation will cover both food and drinks served in canteens as well as vending machines. The regulation is expected to cover food and drinks that are high in fat, salt and sugar including carbonated and non-carbonated soft drinks (including drinks with artificial sweeteners), confectionery, salty snacks, hamburgers etc… under the proposals, children will be able to drink only water, skimmed and semi-skimmed milk, pure fruit juices, certain types of smoothies and yoghurt and milk drinks made with less than 10% added sugar. A broad consultation is under way and detailed measures should be announced in 2006.

In other European countries similar measures are being considered or about to be adopted. For example, authorities in Brussels have banned vending machines from the city's primary schools. In Germany, kiosks are no longer allowed to sell confectionery and drinks near school. In Scandinavian countries, proposals to replace energy-dense products by healthier products in vending machines are also being considered.

What would be the impact of ban of vending machines or of certain products sold in vending machines in school?

We estimate that around 1% of CSDs, confectionery, salty snacks are sold via schools in Europe. It is unfortunately very difficult to get information for each company under our coverage but we estimate that Cadbury Schweppes, Coke and PepsiCo are the most exposed to that channel. Even in a worse case scenario, assuming a 1% reduction in volumes in Europe for these companies, we believe the bottom line impact at the group level would be limited. Soft drink players who can offer zero-calorie products, notably water, should be able to manage the situation more favourably. We believe Danone should benefit the most from the space freed by high sugar/fat/salt products withdrawn from vending machines. Nestlé may lose on the confectionery side but could gain in water and dairy-based beverages (e.g. Nesquik).

Labelling – the UK is well ahead of the game

As we wrote in our first report on obesity in 2003, "product labels may not be the ideal way of educating consumers about nutrition but they remain the most practical, unavoidable means of conveying important information and messages. As a result, **product labelling is at the heart of the debate about obesity**." For the past couple of years there has been an intense debate in Europe at both the EU and national level. A few projects have evolved but the UK and… some players within the food industry seem to be well ahead of the EU in terms of thinking and implementing a more user-friendly label.

EU regulation: Stricter language will accompany the regulation on health/nutrition claims

As explained above, the proposed regulation on nutrition and health claims is accompanied by an annex which is listing the nutrition claims that will be permitted. "Low fat", "energy reduced", "source of fibre" and other commonly used terms will now have a clear definition. This was well overdue given that such definitions have been in place for many years and this is something we highlighted in our first report on the subject in 2003.

A stricter control of language/definition should not have any major influence on consumer behavior but if this reform is well communicated to EU consumers it may in fact create a more trusting environment for the light/diet products which have been heavily criticized – see recent ACNielsen survey on this Table 5 page 58. As explained before, we expect this to lead to some product reformulation, which would contribute to a continuing increase in the cost of doing business in the sector, but which, all in all, should be manageable for the largest operators, in our opinion.

Surprisingly, nutrition labels are not yet compulsory in Europe unless a nutrition or health claim is made and the EU commission seems to be at the preliminary stage of its discussion with various stake holders.

Food industry ahead of EU regulators?

Although nutrition labels aren't compulsory (except if a claim is made), a number of large companies already show detailed nutrition labels on their products on a systematic basis. This is a strong positive, in our view, as it shows the commitment of a number of industry players to better inform consumers.

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Going one step beyond, in our view, is Nestlé, which has redesigned its nutrition labels in a more user friendly and easier to read fashion while identifying the benefits of certain ingredients and nutrients and by giving some information about the physical activity it takes to offset the energy intake. In that example the nutrition label goes beyond consumer information and becomes a marketing tool too. In line with what we said earlier in the report, we believe this certainly is the way forward for the industry.

Figure 11: Nestlé Label – When nutrition information becomes part of the marketing tool box

Source: Nestlé

UK: Testing traffic light labelling
On November 16, 2005, the **UK Food Standards Agency launched a consultation with consumers and the food industry on a food labelling scheme providing "at-a-glance information on whether a food is high, medium, low in total fat, sugar and salt**". This scheme is described as a front of pack multiple traffic light (MTL) scheme. This follows on the Department of Health's 'Choosing Health' White Paper's objective to put in place " by early 2006, a clear, straightforward coding system, that is in common use and that busy people can understand at a glance which foods can make a positive contribution to a healthy diet, and which are recommended to be eaten only in moderation or sparingly."

The scheme is rather unique to the extent that i) it will appear on the front of the pack unlike traditional nutrition label that appears at the back, ii) it will list use a traffic light system which should send a strong instantaneous signal to the consumer about the nature of the food.

Although the official objective of this system is "to make the healthy choice, the easy choice" by better informing consumers we believe the Multiple Traffic Lights scheme is likely to deter consumers from buying too many products which are high in salt, sugar and/or fat. The consultation with consumers and the industry closes on 8 February 2006. The findings will then be analysed and a recommendation put to the Food Standards Agency's Board for agreement. The scheme will be launched following agreement by the Board.

Figure 12: Front of Pack Nutrition Information System is being tested in the UK

Source: www.food.gov.uk

Fat Tax vs. Healthy Food Subsidy

Within the EU, the fat tax has never received a lot of support; however, an opposite concept has recently emerged in the mind of a number of policy makers: a healthy food subsidy.

Drawing the conclusion from a massive study prepared by the French National Institute for Health and Medical Research (INSERM) that came out early October 2005 the French Senate stated that [“The access to fruit and vegetables should be made easier to lower income households. This objective could be met, assuming the consumer is rational, by subsidizing these products in order to make them competitive vs other food products and encourage consumption. This mechanism seems more efficient than a system based on the taxation of energy dense products ("fat tax"), which eventually penalizes the lower income households”.

The rationale for this is based on the fact that the cost of a calorie (energy) has fallen dramatically over the past couple of years on the back of fat products falling by more than 50% over the past 50 years (carbohydrates to a lesser extent) while vegetables increased by more than a third.

It is very early days as the concept is just emerging and it may take years before this materializes into policy (in France and maybe across Europe) but we believe that **subsidizing fruit and vegetables is a measure that should find a lot more support than a "fat tax" among various stakeholders.**

Such a measure would probably have a positive impact on the fruit and vegetable value chain and we would expect **Bonduelle**, the leading European vegetable packager, **to benefit** and to a lesser degree the more diversified food companies involved in soup and canning like **Unilever, Nestlé, Campbell or General Mills**. Assuming such a measure were to take a European dimension, companies like **Premier Foods**, the leading UK canned vegetable producer, or **La Doria**, one of the leading canned tomato producer, would also benefit.

US: regulation and litigation risks review

We have argued that rising concerns about obesity can affect food companies in four different ways: sales (dietary trends hurt sales of high carb products for a period of time, resulting for example in a fall in the sale of cookies), costs (forcing companies to change product formulations like changing oils to remove trans fats, and forcing them to expand their SKU offerings to offer a wider range of alternatives), litigation (suit against KFT re Trans-Fatty Acid on Oreos), and potential regulation (marketing to children, food labeling, sale of food within schools, "fat taxes"). In this section we focus on changes being proposed in the regulatory and legislative front. **Key Points:**

- Despite several attempts to introduce legislation at the Federal level to reverse rising obesity rates in the US as well as to regulate the sale, distribution, merchandising, and marketing of food and beverages, none of those initiatives have made it far in the federal legislative approval process.
- At the same time, federal agencies like the FTC and FDA have not taken a more leading role in the matter; in fact, the FTC has clearly indicated that it is more in favor of self-regulation, and will only go as far as developing guidelines jointly with the F&B industry.
- As we outline below, most of the change has taken place at the state (and local) level where bills to regulate the sale of F&B at schools have been approved by some state legislatures and then have been signed by the governors, as in the case of California (although in other cases, such bills, after passing the state legislative branch have been vetoed by the governors, as in the case of Connecticut).
- But even in those few states, change has really been confined at the school level.
- As we discuss in the Litigation section, so-called "consumer advocacy" groups have grown so disenchanted with the slow progress (as they see it) in terms of their attempts to introduce regulation, that they now believe they may be able to achieve change faster by taking legal action (the litigation route) against the F&B industry.

Legislation at Federal level a no-go so far

In the last year, Senator Ted Kennedy (D-Mass) and Senator Tom Harkin (D-IA) have proposed two different set of rules (discussed below) aimed at stopping the rise in obesity rates in the US. None have been approved.

Senator Kennedy reintroduced his Prevention of Childhood Obesity Act (S 799) in 2005, but although it has been referred to the Senate Health Committee, it has not moved forward. Among other things, the bill would:

- Create a Federal Leadership Commission to Prevent Childhood Obesity within the Center for Disease Control and Prevention to "assess and make recommendations for federal departmental policies, programs, and messages relating to the prevention of childhood obesity". The CDC director would serve as the chairperson of the commission.
- Require the Government Accountability Office to conduct a study on the effects of federal nutrition assistance programs and agricultural policies on childhood obesity.

- Require the Institute of Medicine to conduct a study and make recommendations on “guidelines for nutritional food and physical activity, advertising, and marketing to prevent childhood obesity."
- Appropriate $250 million in grants over five years for a variety of obesity prevention programs at the state level.

Senator Harkin has proposed legislation banning so-called junk food ads to kids. A senator from a farm belt state, Senator Tom Harkin (D-IA), has cited rising obesity rates among children (since 1950 the number of obese children has tripled) and the food industry's inability to self-regulate advertising of junk food to children as reasons for legislation. In 2005, Senator Harkin announced plans to introduce 2 federal legislative measures that would regulate so-called junk food advertising to children. The first measure would restore the FTC’s power to regulate marketing to children under age 18. The second measure would give the US Secretary of Agriculture the power to ban so-called junk food advertising in schools where parents are not present. Senator Harkin has challenged the food industry to limit the advertising of unhealthy foods to children. According to the Senator, the food industry has become increasingly aggressive in its marketing tactics—using cartoon and superhero tie-ins, “advergaming” (his term), cross promotions, toys, and books—with the goal of “encouraging children to consume unhealthy foods.”

- The first measure would restore the FTC’s power to regulate marketing to children under age 18, which had been revoked by Congress in response to the commission's efforts in 1978 to limit the advertising of sugar-rich, cavity-causing food products to children. Today, the commission has more authority to police marketing to adults.
- The second measure would grant the Secretary of Agriculture the power to ban all junk food advertising in schools where parents aren’t present.

These 2 proposed legislative measures aren’t Senator Harkins first foray into the fight against the obesity epidemic. In June 2004 he unveiled The Help America Act, which is major legislation pushing a comprehensive wellness initiative designed to fight the obesity epidemic and introduce healthy choices into individual’s lives (harkin.senate.gov). This legislation has not yet passed due to what Senator Harkin describes as the inability of Congress and the Executive branch to aggressively search for solutions to the obesity problem. The Help America Act would cover issues such as Healthier Kids and Schools, Healthier Communities and Workplaces, and Responsible Marketing and Consumer Awareness. Specifically, it would 1) prohibit the marketing and advertising of foods in schools, 2) require chain restaurants to disclose nutritional information on menus, and 3) it would give incentives to companies that start nutrition wellness programs for their employees, among other issues.

We doubt Senator Harkin's proposals will succeed. The current Congress and President generally tend to favor less regulation than more. In addition, due to a lack of authority in agencies like the USDA and FTC, previous failures of other similar proposed legislation, and 1st amendment issues, we believe regulating food advertising to children will be extremely difficult. The FTC has already tried to limit advertising of food products to children, but received a harsh reaction from Congress. In 1978, the FTC published a Notice of Proposed Rulemaking on possible regulation of advertising to children on television, in response to widespread concern about the health effects of advertising sugar-rich products to children on television. Back then the FTC offered 3 proposals: (1) Ban all TV ads to kids 6 and under, (2) Ban TV ads for the most cavity causing foods to kids 12 and under, and (3) Require TV ads for sugared products directed at older children to contain nutritional or health disclosures. However, the FTC rescinded the proposal in 1981 because it couldn't find a workable solution, due to a variety of points of disagreement:

- Protecting parents from the "pester factor" is not sufficient basis for FTC action. By "pester factor" we mean how certain advertisements encourage kids to compel their parents to buy food products.
- Crafting workable rules to restrict advertising is difficult due to a variety of factors: difficultly in limiting where/when ads could air, difficulty in defining which foods cause the problem, and difficulty in defining which ads are directed at kids.
- Evidence of the adverse effects of advertisements was ultimately inconclusive (in 1978).
- Deceptive marketing is unlawful and is not protected, but the 1st Amendment limits government regulations and FTC action on non-misleading speech in advertising.
- We believe that regulating food advertising to kids will be much more difficult than it was to ban tobacco, alcohol, and gambling marketing because all of these products, unlike food staples, are also illegal to sell to children.

Federal Agencies: not enough power?

Federal agencies may not have enough power to enact regulation. The agencies that could make a difference in the advocates' fight against the food industry include the Federal Trade Commission (FTC), the US Food and Drug Administration (FDA), and the United States Department of Agriculture (USDA). However, in our view, the ability of these agencies to reform the practices of the food industry is restricted because they must work within the limits of the authority they are granted by Congress.

The FTC is more focused on monitoring false claims from the industry (rather than regulating) and using prevention and education at the consumer level. In 2004 the FTC successfully sued Kentucky Fried Chicken over advertisements that made claims about fried chicken's nutritional value and its compatibility with low-carb diets. One month after receiving the FTC's subpoena, KFC discontinued the advertisements. The FTC can more effectively fight alleged deceptive marketing because it doesn't have to prove causality or injury in a court of law, while a plaintiff in a private tort action would have to prove both.

At the same time the FTC is developing guidelines for "voluntary" changes in the F&B industry's marketing practices. The FTC held a workshop over the summer that was attended by several major food and beverage companies to discuss marketing to children in the context of the obesity issue, and to decide whether advertising should be further regulated by the government. The FTC concluded it would not increase the level of government regulation on food and beverage companies, but suggested that manufacturer's step-up the level of self-regulation. Food and beverage companies have worked with a group called CARU (Children's Advertising Review Unit) to make suggestions on strengthening the existing set of self-regulatory guidelines on advertising to children. Currently, CARU is reportedly taking that input to formulate new guidelines. The FTC is expected to issue a report during the first half of 2006 on the findings and recommendations from the workshop. Net, we do not expect any significant changes in the regulatory environment.

The FDA's efforts to introduce labeling changes have had little success in recent years (except for the companies having to disclose the amount of trans fats per serving, starting 1/1/06). In June 2003 the FDA created an "obesity working group" that concluded there was need to improve nutrition information (nutritional facts) and set action goals along several factors (although we note little has come out from this, so far), such as labeling, education, restaurant industry information, enforcement, and trying to facilitate the development of new therapeutics. In terms of labeling, the FDA would prefer to have just one serving size per package, showing the number of calories in the front of the package (in large font), and indicate the calories as % of DV. The FDA has no regulatory authority over the restaurant industry, but is trying to work with the industry to provide more nutritional data to consumers. In terms of enforcement, the FDA is partnering with the FTC on challenging false claims by manufacturers.

The USDA is more focused on education

The Dietary Guidelines for Americans 2005, released on January 12, 2005, are revised once every 5 years and are the federal government's science-based advice to Americans on how to live a healthy life and avoid chronic diseases through nutrition and exercise. Experts have looked positively on the advice contained in the guidelines regarding fruit, vegetables, whole grain, sugar, trans fatty acids (TFA), sodium, and physical activity. Still, consumer advocacy groups believe the USDA and HHS could have gone further in giving specific regulation about sugar consumption and a quantitative limit on TFA intake.

Food marketing to children is just emerging as an issue

We believe that the marketing of food to children will gradually become a prominent issue, albeit the chances of Congress approving any legislation on the subject appear slim for now. But although legislation may seem unlikely for now, health advocacy groups are starting to issue their own marketing guidelines and, interestingly, some food companies are starting to follow. We consider these examples of self-regulation.

CPSI (Center for Science in the Public Interest) has announced its own guidelines for marketing to children. On January 5, 2005, the CSPI released new "Guidelines for Responsible Food Marketing to Children," which laid out criteria for how food and beverage companies should market products to children in a way that doesn't undermine their health.

- The CSPI's definition of marketing is very broad: television, radio, print, movie tie-ins, contests, games, sponsorships, licensing agreements and cross promotions, etc.
- The guidelines focus on marketing techniques (which most advocacy groups do as well), but more importantly, the guidelines also determine which foods should and shouldn't be marketed to children.
- In an ideal world the CSPI would like to see only fruit, vegetables, and whole grain products marketed to children, but the guidelines do allow a broader range of foods, "as long as the food in question provides some positive nutritional benefit and isn't too high in saturated and trans fat, salt, or added sugars" (CSPI).
- CSPI claims it is not against the idea of marketing, but wants to see it used in a way that promotes, rather than undermines, healthy eating.

Some food companies are starting to restrict marketing to children – Kraft being first. On January 12, 2005, Kraft announced that television, radio, and print media advertising to children aged 6-11 would be restricted to "better-for-you" categories as defined by Kraft (Kraft already had a policy in place that restricted media advertising of all products to children under 6). CSPI officers were encouraged by the fact that Kraft's new guidelines were similar to the CSPI's, but there were 2 small differences: (1) the CSPI's guidelines restrict the advertising of unhealthy foods to children in all forms of media, not just 3 as in KFT's case (television, radio, print) (2) the CSPI's guidelines age cutoff is 17, while KFT's is 11. Despite these small differences, CSPI has said it believes that KFT is taking more initiative than other food companies.

Other food companies may also follow. CSPI claims it has worked with a number of companies on their marketing policies, but that KFT is the only one to go public. CSPI believes a few others will make public announcements in the near future. While other consumer advocacy groups criticized Kraft for not going far enough with their new marketing guidelines (restrictions apply only to children under 11 and 3 forms of media), CSPI argues that a gradual phase-out—rather than an immediate, complete, restriction—is the best way to proceed in reforming marketing to children.

More Potential for Legislation at State and Local Level

Most changes so far are taking place only at the school level. In the last couple of years the most significant changes in terms of regulation and legislation have taken place at the state and local level, and have specifically targeted schools (K-12). Activists as well as legislators (and regulators) have initially focused on so-called "competing foods" at schools, while at the same time improving the schools' meals programs. Examples of "competing foods" (with the meals programs) include vending machines, a-la-carte food outside the meals program (snacks available during lunch in the school cafeteria), school stores, and fund raising food sales. In this regard in most states there have been attempts to pass "nutrition" bills targeting competing foods, but the final results have varied by state.

Results have varied by state. Generally, we consider the legislation passed in California, Tennessee and Louisiana to be more advanced and the most far reaching. Texas and New Jersey have also implemented significant changes, but this has been done through the state regulatory bodies (a process considered less political and faster). Two other dozen states have approached the matter differently, and are considering legislation that would ban vending machines in schools. There are some localities where the school districts themselves have introduced healthier, more nutritional food choices into schools. But the influence that food lobbyists have on state governments is also very strong, according to health-advocacy groups. In a few states, the food industry has helped kill or water down potential legislation.

California leads the way, for now. The state of California passed the so-called "Soda Ban" Bill in 2003, and later in September 2005 introduced more far reaching regulation. The 2003 bill banned the sale of CSDs in elementary and middle schools (K-8), although it did not ban consumption as students could still buy CSDs outside and bring them into the school, but the selling of CSDs was stopped. In 9/05 the California governor held an Obesity Summit and also approved three measures to control obesity:

- *Extension of the Soda Ban Bill to High Schools*. In September 15, 2005, as part of three major initiatives aimed to controlling obesity, the Governor of the state extended the "soda ban bill" to high schools. As part of this effort new standards were set regarding what beverages could be sold in schools based on caloric content and caffeine, among other factors. About 50% of the provisions of this bill will be implemented in 2007 and the rest by 2008.
- *Food Standards Bill*. The second initiative passed on 9/15/05 set nutritional standards for competing foods (rule SB19), and in the process took some foods out of vending machines (and schools) such as candy bars, cupcakes, cookies, and regular potato chips. These new rulings will be implemented in 2007. For now, in our opinion, question marks remain regarding enforcement and compliance. Manufacturers have tried to adapt by offering products that are "SB19 compliant", and more so-called nutritional bars (like Cliff) have taken the space of candy bars. Kraft as part of its "Sensible Solutions Program" has produced a list of products that it will and will not market in schools (we assume that the company's distributors will follow suit). It could be argued that, in this regard, while other companies have actively lobbied against new legislation controlling the sale of competing foods at schools, KFT has tried to work together with the legislators.
- *School Meals Regulation*. The Governor signed legislation that would increase the government spending on fruit and vegetables to increase their presence in the schools' meals programs. One example will include increasing the support of initiatives like the "Farm to School" program, which facilitates the availability of fresh produce from local farms to be distributed in schools meals programs (FtS is currently in place in 16 states, but the program is costly.

An example of what is being proposed in Maine (although there is no assurance this will be approved). Sean Faircloth, J.D.; Rep. D-Bangor, Maine State House of Representatives; has initiated a package of legislation addressing the obesity epidemic. According to Mr. Faircloth, the government promotes obesity by: 1) Subsidizing the oil and auto industries to the detriment of walking and biking paths, 2) Making it impractical for busy Americans to get nutritional info about the food they eat; 3) Giving large corporations free reign to advertise to kids; 4) Making tax-payer funded public schools advertising zones; 5) Directing billions in subsidies to the production of unhealthy commodities: 6) Failing to update and modernize the nutritional welfare policies from the 1940s and 1950s to the detriment of minorities. His proposal called "The Maine Manifesto: Four Freedoms of Health", calls for:

1. Freedom of Transportation Choice: Dedicate 1% of gas taxes in order to build and maintain walking and biking trails
2. Freedom of Caloric Information: Require chain restaurants to include nutritional info on their menus so citizens can make more knowledgeable choices
3. Freedom from Commercialization of Public Schools: Require schools to offer healthy choices in vending machines
4. Freedom of Child Health Information: BMI (Body Mass Index) info on children should be given to parents in confidence

Litigation risks

Advocacy groups like CSPI believe litigation may have greater chance of success in the short term than regulation. CSPI (Center for Science in the Public Interest)'s Executive Director, Dr. Michael Jacobson, argues the decks are stacked very seriously against the public health advocacy movement, and regulation is not the answer. He feels that litigation could force some action. He feels that regulatory agencies such as the FDA, USDA, and FTC don't have much influence to reduce obesity rates. These agencies have to work within the limits of the authority they are granted by Congress; if they overreach, Congress is likely to curtail what little authority they do have. For example, the FDA has no authority to compel chain restaurants to include nutritional labeling on their menus. Congress has the power to affect change in this fight against obesity, but he feels the Republican Congress and President are too anti-regulation to do anything substantial. Initiatives that he feels would not pass through Congress include funding dietary improvement and physical activity through a tax on unhealthy foods, and banning the marketing and selling of junk food in schools.

CSPI (together with PHAI) claims it is negotiating with the CSD industry. At least one of the groups that recently threatened to bring a class action suit against the soft drink industry for selling their products in schools is now negotiating a possible agreement with those companies that would keep both parties out of the courtroom. Late last year the Public Health Advocacy Institute (PHAI) and the Center for Science in the Public Interest (CSPI) announced plans to file a series of class action suits aimed at ending school districts' often lucrative exclusive marketing deals with soda companies and banishing the sugary drinks from school lunchrooms and hallways. Many expected the first suit to be filed before the end of 2005, but that didn't happen. CSPI Executive Director Michael Jacobson told OPR that the suit is on hold while both sides negotiate.

False claims suits may have better potential to succeed than personal injury claims. It is generally agreed that personal injury or product liability suits against the food industry have little chance of success, since the burden of proof is so high in these cases. Also, it is hard to establish a causal relationship between obesity and the products of food companies. Suppose a plaintiff claims he suffered a stroke because he was obese, and his obesity was caused by eating at McDonalds. McDonalds could argue that his weight gain was attributable not solely to its products, but to other factors such as his sedentary lifestyle, genes, eating at other fast food restaurants, etc. Lawsuits targeting deceptive advertising and misleading nutritional labeling will have higher chances for success. Also, we expect lawyers to aggressively challenge food companies for the ways they market to children, especially in school. The marketing of energy dense products to kids and the ubiquity of vending machines in schools are areas where food companies are particularly vulnerable.

Tort lawyers believe differences between the tobacco and food industry can be used to the advantage of the public health advocacy movement. Specifically, tobacco companies had bad reputations since the 1970s, long before any litigation was pursued against them. On the other hand, food companies in general have shinier reputations, and in our view, are probably more worried about maintaining them. Also, despite all the litigation against tobacco companies, their product still carries serious health risks, which aren't going to go away. Food companies, on the other hand, can change by making their products healthier.

Tort lawyers believe they are having more success against the food industry compared with those challenging the tobacco industry in the early days. It took more than 30 years after the Surgeon General's "Report on Smoking and Health" (1964) for a single dollar to be collected from tobacco companies. The litigious effort against food companies is moving at a faster rate than the one against tobacco. Also, public awareness of obesity as a national health epidemic is very high, while the first tobacco lawsuits were filed when the public didn't yet identify smoking as a pressing concern. To date, 5 lawsuits against the food industry have been settled out of court. In the eyes of a few of those tort lawyers, besides the penalty paid, some of those companies have changed their product formulations.

But no cases have made it to the "discovery phase". None of the lawsuits against the F&B industry have reached past the "motion to dismiss" stage and onto the discovery process of the trial. Legal experts like George Washington University Law School Professor John Banzhaf III, feel a real turning point could be achieved in their fight against food companies if a trial were to reach the discovery process. In such an event, the plaintiff's side could then gain free access to all of the company's internal documents, transcripts, notes, etc. Banzhaf believes this process would reveal tremendous amounts of valuable information about food companies that could be used in achieving a successful verdict in a class action lawsuit against them. Professor Banzhaf predicted that a tort lawsuit against the food industry would reach the discovery process within the next year, and that a successful class-action verdict would be achieved within 5 years.

Still, federal level legislation as well as state level legislation might make it difficult for the tort lawyers plans to succeed. There has been tort reform legislation passed at the state level that severely restricts lawsuits based on obesity-related claims. To this point, legislation has been passed in 12 states (Arizona, Colorado, Florida, Georgia, Idaho, Louisiana, Missouri, South Dakota, Utah, Washington) and is pending in 6 states (Michigan, Ohio, Pennsylvania, New York, Rhodes Island, New Jersey). The language in these bills severely limits obesity related litigation on the state level. For example, the liability protection for companies as stated in the Arizona bill "provides an affirmative defense against product liability actions related to obesity, and explicitly states that there is no duty to warn a person, regardless of age, about the dangers of excess food consumption." The bills in other states contain similar language. At the federal level, the 108th Congress approved the "Personal Responsibility in Food Consumption Act (HR 554)", also known as the "Cheeseburger Bill", which bars obesity-related lawsuits from being brought against F&B manufacturers and sellers. However, it will need to be reintroduced again now during the 109th Congress, as the companion bill did not make it out of committee in the Senate.

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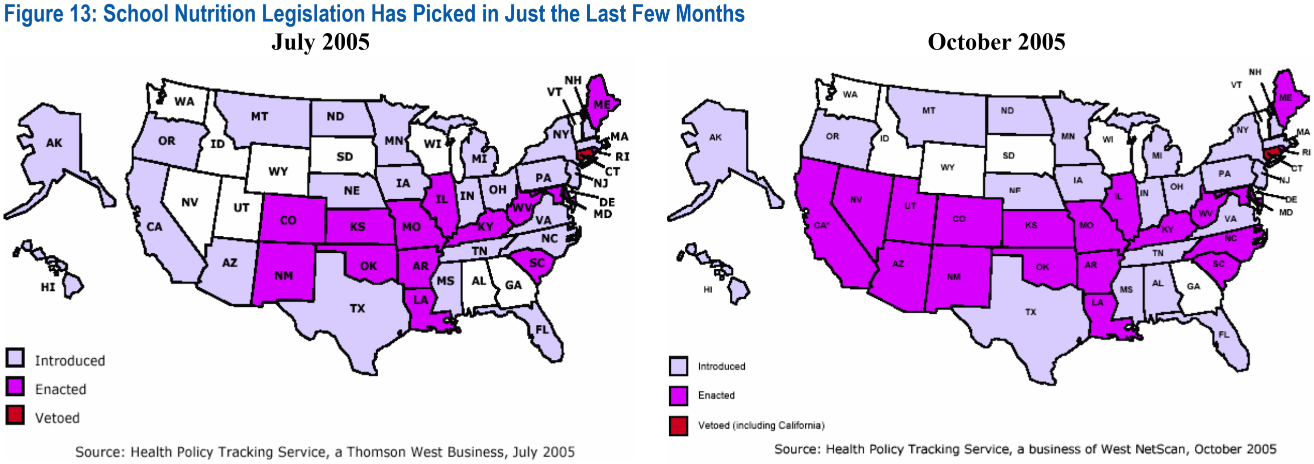
The debate over soft drinks in schools

Soda vending machines, which are currently located in roughly 90% of US public schools, have for some time been the target of public pressure and media scrutiny regarding the marketing of soft drinks to children and the potential link to obesity. Over the last 2-3 years especially we have seen a significant increase at the state and local level in the number of proposed and enacted guidelines concerning nutrition in schools. Nearly all of the proposed legislation has focused on some or all of the following: 1) setting stricter nutritional standards in schools, 2) restricting access to certain products during the school day (which almost always includes regular soft drinks), and 3) increasing the amount of physical activity during the day.

While most states have some form of nutritional guideline legislation in place or in the works, only a handful of states (including California, New Jersey, and Maine) have gone far enough to ban soft drinks in all schools. Several other states have put restrictions or partial bans on soft drinks in elementary and middle schools, but only a few have extended the bans to high schools.

At the end of September 2005, 42 states had introduced roughly 200 bills aimed at increasing the level of nutritional guidance in schools. As shown in the figure below, legislation was enacted in five additional states since July 2005 alone (when many state legislatures were out of session for the summer). To date, Connecticut has been the only state to veto a piece of school nutrition legislation, with the governor citing the need for local controls in schools and parental participation.

Figure 13: School Nutrition Legislation Has Picked in Just the Last Few Months



Source: Health Policy Tracking Service. State Actions to Promote Nutrition, Increase Physical Activity, and Prevent Obesity; A Legislative Overview; July 11, 2005 (left), October 3, 2005 (right).

In addition to state legislation, a number of local and city governments have enacted restrictions of their own where they feel the pace or scope of state laws have not gone far enough. In 2003, New York City removed soda from vending machines in the nation's largest school system, serving about 1 million children. In 2004 the Philadelphia school district, which serves 214,000 students, decided to halt soda sales in vending machines. Over the last year, Chicago, Los Angeles, and Washington D.C. have also taken soft drinks out of public schools.

With legislative activity picking up, the soft drink industry announced in August 2005 that they had endorsed a number of new guidelines for the sale of soda in schools. The American Beverage Association (a trade organization that represents the big three soft drink makers) issued the following recommendations: 1) in elementary schools, the sale of soft drinks would be eliminated, 2) in middle schools, the sale of soft drinks would be limited to after school hours, 3) in high schools, soft drinks would be limited to 50% or less of the beverage selections in vending machines.

The announcement was one of the more meaningful responses we have seen by the soft drink industry in recent years, but some states have questioned the level of self-sacrifice by beverage companies and feel the new guidelines don't go far enough in limiting soft drink consumption by children. About a month after the ABA announcement, California passed legislation banning the sale of CSD's in high schools.

While the policy-making on school nutrition has been mainly at the state and local level, it is possible that the federal government will also step-in on the issue. The USDA, which is currently responsible for setting nutrition standards on school lunches, could potentially issue a more wide reaching policy that would include food and beverage served in vending machines (currently exempt from the guidelines). While this could theoretically ban soft drinks in schools across the country, Coke and Pepsi vending machines would in all likelihood remain (as they have in states where soft drinks were banned already) and continue to sell water, juices and in some cases sports drinks.

Figure 14: % of High School Product Mix - 2002

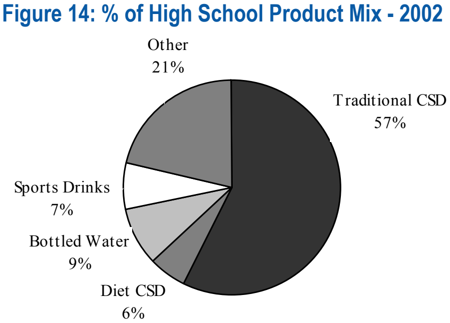
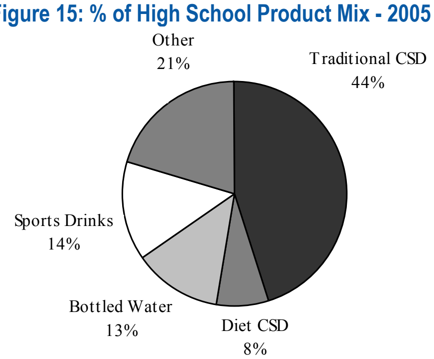


Figure 15: % of High School Product Mix - 2005



Source: American Beverage Association.

Bottom line, we expect Coke and Pepsi products (in one form or another) will remain in schools even if regular soft drinks are taken out. We point out that even a worst case scenario, where all Coke and Pepsi products are banned from schools, we think this would be immaterial to their businesses. We estimate sales to schools in North America represents substantially less than 1% of total sales for either Coke or Pepsi. Soft drinks are barely sold in elementary schools to begin with, and middle/high schools make up a very small percentage of total soft drink sales.

We think soft drink companies have demonstrated the ability to respond effectively to these changes which we expect will continue going forward. We think while new laws/restrictions and the threat of lawsuits has probably played a small role in the response by soft drink companies, we think consumers are effectively making their own choices on the matter, as evidenced by a recent ABA report. In early December, the ABA issued a report which further responded to claims that soda in schools has contributed to the recent spike in childhood obesity.

From 2002-2004, sales of non-diet soft drinks in schools declined 24% while sales of sports drinks increased 70%, water sales increased 23%, diet soft drinks up 22% and pure juices up by 15%. As a percentage of mix, regular soda is still the leader within schools, accounting for 44% of beverages, but this is down from 57% only three years ago. Over the same period, sports drinks jumped from nearly 7% to more than 14%, while water increased from 9% to nearly 13%.

Net, changing consumer preferences and demand are driving changes in the product offering at public schools, and across the country for that matter. While the soft drink industry may be concerned about litigation and regulation from the sale of soft drinks in schools, we don't think that is what's causing them to change. We think the greatest business risk from legislation and litigation is from the negative newsflow surrounding these stories, which we describe below.

Litigation risk remains low for the soft drink industry; headline risk could increase

Over the last few years, the food and restaurant industries have been the target in a number of highly publicized “obesity” cases brought by former customers. The customers typically claim that a company or restaurant chain should be held responsible for selling them a product that made them obese. Other than the negative newsflow associated with the lawsuits, restaurant companies have emerged relatively unscathed. Very few of the cases ever made it into a courtroom and those that have made it to trial have been unsuccessful. The soft drink industry has so far avoided becoming a direct target in obesity litigation, but we think that’s about to change with reports of a potential lawsuit by the Center for Science in the Public Interest (CSPI).

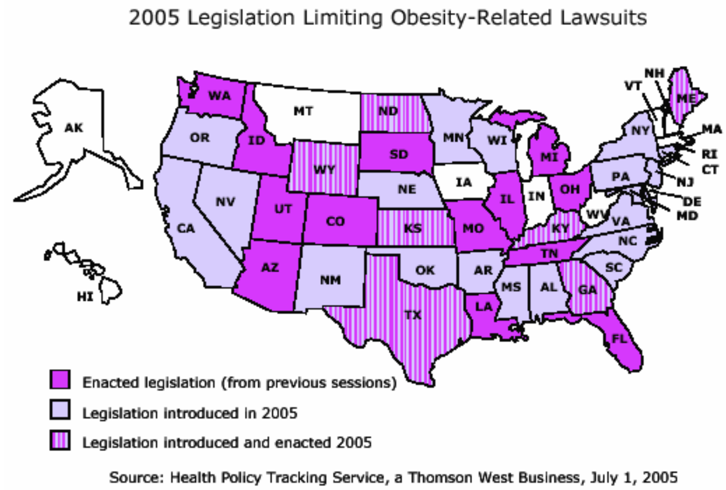
In early December, a group of trial lawyers in Massachusetts backed by the CSPI announced they were preparing to file suit against the soft drink industry (which would include Coke, Pepsi, and the local bottlers) regarding soft drinks in schools. The claim is that children in a school environment are not informed regarding the potential health risks of consuming soft drinks. They suggest this constitutes unfair and deceptive marketing practices on the part of the soft drink industry and that soft drinks should be banned from schools.

The soft drink case sounds very similar to previous lawsuits filed against the food and restaurant industries, and even if this case progresses to trial (most have not made it that far), we expect a similar outcome. That said the soft drink industry has not taken the matter lightly and responded in early December with a report from the ABA which argued that soda sales in schools are not a significant contributor to rising childhood obesity rates. Given the level of attention this story (and response by the soft drink industry) received when they were issued in early December, we think headline risk for the industry could increase if/when the suit is filed. The chances are that if this case makes it into a courtroom, the media will allocate plenty of space to it.

With the number of obesity lawsuits being filed against the food and restaurant industries spiking in recent years, lawmakers have stepped in to propose (and in several cases enact) laws which limit the civil liability of manufacturers for damages resulting from weight gain or related conditions (they are generally referred to as Commonsense Consumption laws).

Louisiana became the first state to enact legislation limiting obesity liability in 2003. During 2004, 26 states introduced obesity liability bills, and 12 governors signed them into law. In 2005, 40 obesity liability bills had been introduced in 26 states. As of July 2005, 20 states have enacted laws limiting obesity liability, including 7 states in 2005 alone. There are only 9 states that have not at least proposed some form of limited liability law.

Figure 16: Litigation Risk to Manufacturers is Limited Given Limited Liability Laws



Source: Health Policy Tracking Service. State Actions to Promote Nutrition, Increase Physical Activity, and Prevent Obesity; A Legislative Overview; July 11, 2005.

Net, with limited liability laws in place or rolling out across most of the country, we think the risk of litigation to the soft drink industry remains very low. However, as new lawsuits (however unsuccessful they may be) are brought against soft drink companies, they will continue to grab headlines, in our opinion. If the fast food industry is any example, those headlines will probably not cast a very favorable light on the soft drink industry.

R&D: a new competitive advantage in the food industry

- **The quiet rise of the labs… a subtle paradigm change**. We believe that growing consumer concerns about health and nutrition, the rise of obesity, regulatory change and litigation risks have created new challenges that the marketing function cannot take up on its own and have led industry executives to realize the importance of research. While marketing budgets come under increasing scrutiny after a decade of uninterrupted inflation we believe that investment in research should continue to rise as R&D establishes itself as a core competence in the process of building a competitive advantage. The subtle paradigm change we are describing here is one of increasing complementarities of research and marketing as opposed to one function being in the shadow of the other.
- **R&D organisation: in-house capabilities & network.** We believe that R&D spending reported in the P&L of food companies undoubtedly under-estimates the real cost of research because companies **do not only rely on in-house capabilities. University funding, exclusivity agreement with suppliers, venture capitalist funds creation, partnerships with biotech firms are other forms of investments in R&D**. We believe that **success in research may ultimately rely on the strength of networks** and partnerships that have been built.
- **The major challenges of R&D within the food industry** include I) the need to Improve the nutrition profile of products while maintaining organoleptic properties, II) Develop lower calorie but tasty snacks and confectionery, III) Develop nutritious and lower calorie convenience food, IV) Deliver products with a better nutritional profile at a reasonable price.
- **We believe food companies can build a real competitive advantage through R&D**. We highlight two examples: I) The slow churn revolution in ice cream and II) The discovery of sterol plant cholesterol lowering properties that revived the margarine category. **Plant sterol-enriched products provide the ultimate example that there is an increasing convergence between the fields of advanced nutrition and pharma.**
- **R&D needs strong marketing and great brands**. We believe the development of a competitive advantage through R&D can only be achieved by combining innovative research and marketing excellence. History shows that great innovation becomes great commercial success only when R&D is put at the disposal of good brands and properly supported in terms of marketing.

The quiet rise of the labs… a subtle paradigm change

Traditionally seen as a cost rather than an investment, Research and Development has never been considered as a top priority by top executives within the food industry. Actually we've shown in previous studies – Unilever, *Back to Square* One; Reckitt Benckiser, *Still Gleaming Brightly* – that continuing innovation within the consumer goods industry relies more on an organizational process led and coordinated by the marketing function than on the size of the R&D department. In that context marketing has always come first and will certainly continue to come first, in our view.

Having said that, we believe that growing consumer concerns about health and nutrition, the rise of obesity to epidemic proportions, regulatory change and litigation risks have created new challenges that the marketing function cannot take up on its own and have led industry executives to realize the importance of research.

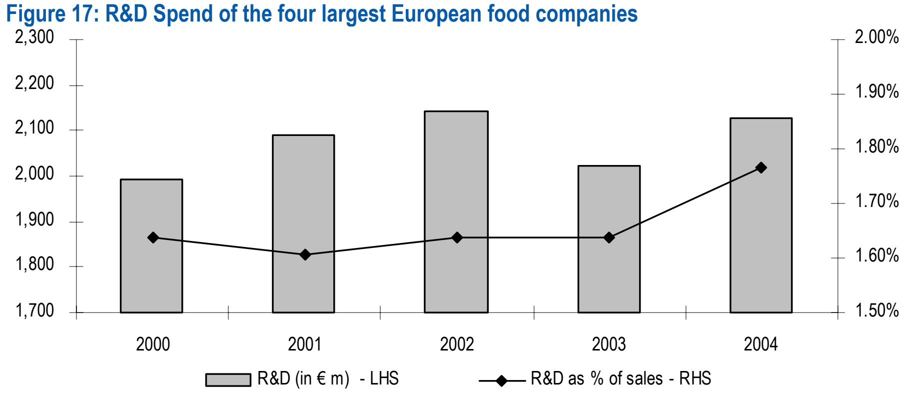
In line with what we predicted and had already noted in our first report on obesity in 2003, **investments in R&D, and notably fundamental research capabilities, have continued to increase, albeit at modest pace, in both absolute terms and as a percentage of sales in the food industry over the past couple of years**. In 2004 we estimate that the four largest European food companies spent about €2.1bn or about 1.8% of their sales on R&D, representing a 20bp increase in 5 years. To put this in context we estimate that in 2004 the same companies spent c€7.1bn or c5.9% of their sales on consumer marketing. **Importantly, we believe R&D spending reported in the P&L does not fairly reflect and undoubtedly under-estimates the cost of research for food companies which do not only rely on in-house capabilities. Investments in research in the sector take the form of University funding, exclusivity agreement with suppliers, venture capitalist funds creation, partnerships with biotech firms etc...**

It is also important to highlight that **research will be more valuable to the industry if it can be protected** and from that standpoint the **EU regulation on nutrition and health claims** which incorporates some data protection provision **represents a very positive development** (see section on European regulation for more information on this point).

Let's be clear, the food sector hasn't and will not become a R&D-driven industry. But **while marketing budgets come under increasing scrutiny after a decade of uninterrupted inflation we believe that investment in research should continue to rise as R&D establishes itself as a core competence in the process of building a competitive advantage**.

That does not mean the role of marketing will diminish because no matter how much marketing may need research now and in the future we believe that R&D would be worthless without good marketing. **The subtle paradigm change we are describing here is one of increasing complementarities of research and marketing as opposed to one function being in the shadow of the other**.

Figure 17: R&D Spend of the four largest European food companies



Source: JPMorgan, company data.

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The challenges of R&D

As mentioned above we believe that the marketing function, even associated with a solid development capability, cannot take up on its own anymore all the challenges created by an increasingly competitive environment and an increasingly demanding consumer who wants health, taste and convenience.

We believe that the major challenges of R&D within the food industry include:

- **Improve the nutrition profile of products while maintaining organoleptic properties**. This is for example the principle of Nestlé's 60/40+ initiative which has led to the reformulation of thousands of products over the past 18 months. Starting from the principle that the consumer is looking to food to provide nutritional and health benefits – not at the expense of taste but in addition to it – Nestlé has worked on the formulation to make sure that in rigorous market testing 6 out of 10 consumers prefer the Nestlé product to a competitor's equivalent, while offering a nutritional "plus".
- **Develop lower calorie but tasty snacks and confectionery.** Building on our analysis at the beginning of the report that consumers are not ready to sacrifice treats we believe that one of the axis of development of research will be to create snacks and confectionery products that taste good and offer lower calories. At the moment most products which have been introduced in that segment fail on taste.
- **Develop nutritious and lower calorie convenience food.** This probably has less to do with research than product development and price point management but we believe that ready-to-eat meals (frozen or chilled) branded or unbranded may eventually suffer from growing criticisms about their high fat/sugar and/or salt content if they don't adapt recipes.
- **Deliver products with a better nutritional profile at a reasonable price.** Healthy food must not become a niche market for consumers who can afford to pay for it. We believe that healthy food must establish itself as mass market and that research should play a key role in making the production processes more efficient to stick to a principle of affordability.

Building a competitive advantage through R&D – case studies

The food and beverages industry offers thousands of examples of successful product innovations which could not have taken place without research capability. However one has to recognize that innovation in this industry gets quickly copied and that most new products (even when research played a role) have more to do with smart marketing based on good consumer insight and product enhancement than fundamentally differentiated proprietary research. So, can food companies build a real competitive advantage through R&D?

We believe so and feel that research should become an increasingly importantly success factor in the future - and a particularly important one for large operators, which need to come up with bigger and not more product launch to maintain rates of growth, which imply to add up to €1bn in sales per annum.

We discuss below two examples. One relates to a technological/production process change brought about. The other one relates to the discovery of a food ingredient that provides a clear health benefit: sterol plant.

Ice cream: The slow churn revolution
In 2004, Dreyer's Grand Ice Cream, a subsidiary of Nestlé, introduced the "slow churned" technology, a new method of making ice cream that "delivers the taste and texture of full-fat ice cream in a light product" – 50% less fat, 30% less calories. This is not a marketing gimmick but real - based on consumer surveys and our test.

The taste and texture comes from kneading fat molecules at a colder temperature. The slow churn stretches and distributes the molecules widely so the ice cream tastes like it contains more butterfat. The process doesn't involve artificial sweeteners or fat substitutes. This major technical innovation had a cost though: according to Dreyer's CEO, $100 million were invested in this technology over the past 5 years.

With this new technology Dreyer's addressed a major consumer concern: reducing fat and calorie intake without compromising on taste.

The introduction of Dreyer's/Edy's low-churn ice cream (followed by the introduction of Haagen-Dazs which uses the same technology) was backed by the largest marketing campaign in Dreyer's history.

The results are impressive. Following three years of slow growth (and a stagnation of low-fat products) the US ice cream market exhibited extremely strong growth in 2004-05 (c15% p.a.). They key driver of that growth is Dreyer's which reported organic sales growth of c15% p.a. over the past 2 years and increased its market share to the extent of taking the market leadership ahead of Unilever.

Although this technology can be copied, it is proprietary to Nestlé, which benefits from the first mover advantage. In spite of its efforts to launch a competitive product Unilever has not been able to keep pace with Nestlé so far.

Margarine –Sterol plant cholesterol lowering properties revived the category
In 2000 Unilever introduced its first plant sterol-enriched range of pro.activ margarine after demonstrating in over 40 studies (led by Unilever and others including Raisio) in humans that plant sterols can actively reduce blood cholesterol levels, both in people with normal as well as people with raised cholesterol levels with cholesterol lowering properties.

Plant sterols, also known as phytosterols, naturally occur in small quantities in vegetable oils such as sunflower seed oil, rapeseed oil and soybean oil, but also in nuts, seeds and grains. Structurally they are very similar to cholesterol and because of this they partly block the absorption of cholesterol from the intestine. This results in a higher elimination of cholesterol via the faeces and a 10% lowering of 'bad' LDL-cholesterol within three weeks, if the recommended servings are consumed.

It cannot be said in that case that Unilever developed this product to respond to a particular demand from margarine users, but rather that margarine proved to be a great carrier for this ingredient and this innovation revived a dormant category dominated by Unilever globally. Importantly this innovation has allowed Unilever to limit the damage of increasing private label penetration at the lower end of the market.

Plant sterol-enriched products provide the ultimate example that there is an increasing convergence between the fields of advanced nutrition and pharma. The best illustration of this is that the Dutch health insurer VGZ allows its policyholders to claim up to €40 a year to refund purchases of Becel pro-active products made by Unilever. A similar agreement has just been struck in France.

R&D under its different forms

As mentioned earlier we believe that R&D spending reported in the P&L of food companies undoubtedly under-estimates the real cost of research because most companies rely on external research, which takes many forms, to fuel their innovation pipeline. Although investors may never know the true cost of research we believe there is absolutely nothing wrong with that.

In fact it would be illusory to believe that food companies can do everything in-house as if success was based on a return to a vertical integration model. We believe that success in research may ultimately rely on the strength of networks and partnerships that have been built. We believe that companies who are good at this may be able to build a competitive advantage through research.

We highlight below some interesting initiatives that could also prove to be interesting alternative investment opportunities.

Investment/Partnerships with biotech companies
It was announced on 15 December 2004 that Phytopharm (PYM LN) and Unilever have signed an agreement relating to Phytopharm's P 57, an extract from the South African plant Hoodia gordonii, under development for use with products that induce weight loss in the treatment of obesity. Under the terms of the agreement, Unilever acquired exclusive worldwide rights to the product. Phytopharm received from Unilever initial payments totalling approximately US$12.5 million of a potential US$40 million, as well as an undisclosed sales royalty on marketed products containing the extract. The two companies will collaborate on a five-stage safety and efficacy study program. Unilever will support applications for international patents for products. Phytopharm acquired rights to P 57 from the South African Council for Scientific and Industrial Research (CSIR). The product has demonstrated anti-obesity activity in a phase IIa trial.

Senomyx (SNMX US), a California-based biotechnology company, has entered into separate collaboration agreements with Coca-Cola, Campbell's, Kraft and Nestlé to develop novel flavors, flavor enhancers and taste modulators using proprietary taste receptor-based assays and screening technologies. Senomyx believes that its novel flavor ingredients will enable packaged food and beverage companies to improve the nutritional profile of their products and generate cost of goods savings, while maintaining or enhancing taste. They license flavor ingredients to collaborators on an exclusive basis, which should provide these companies with the ability to differentiate their products. The company's current flavor enhancer programs focus on the development of savory, sweet and salt flavor enhancers which will allow for the reduction of MSG, sugar and salt in food and beverage products. In addition, the company has a bitter modulation program to improve the taste of food, beverage and pharmaceutical products.

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Investment in venture capital funds
Over the past couple of years Unilever and Nestlé have invested substantial sums in venture capital funds with the objective of gaining better access to new science, technology and know-how opportunities in the field of life sciences (including food and nutrition in general, health-enhancing food, agricultural biotechnology nutrition), as well as commercial applications, such as consumer relation management, food processes and packaging technologies. However the approach of Unilever and Nestlé seems to be somewhat different to the extent that Unilever seems to have delegated the management of the bulk of its investment to third parties while Nestlé has set up independent but company-owned funds.

- **Nestlé - Major commitments**. In early 2002, Nestlé set up the "Life Ventures by Nestlé"/Inventages fund with capital of €150m. The list of Nestlé's investments is confidential but it was recently reported in the press that Nestlé's funds provided backing for the launch of a functional milk drink called Returnity in Austria and the Netherlands. The funds seem to have been fully invested as Nestlé announced in October 2005 that it was to set up the Nestlé Growth Funds with a committed capital of €500m to be invested over five to seven years. This new fund is intended to help Nestlé grow new promising businesses in the area of science and nutrition into a size that could allow them to be integrated into mainstream business units of the Group. The new step will contribute significantly to fostering and accelerating the Group's expansion into Health, Wellness and Nutrition, as the new fund will be investing in companies with products or processes in the final testing stage or about to come on the market. This fund will be co-led by Wolfgang Reichenberger who was formerly Nestlé's CFO.
- **Unilever.** Mid-2002 Unilever announced its decision to invest €170m in venture capital funds. €100m was committed to Langholm Capital, a newly created independent fund, which targets mid-market European consumer facing businesses, €30m was invested in Unilever Ventures (early stage business ideas) and €20m in Unilever Technology Ventures (technology-based business in the fields of genomics, advanced bioscience, advanced materials science and nanotechnology). Companies in which the Unilever funds have invested include Alleggra (powdered egg substitute made from soya), BrainJuicer, an automated market research business, BAC (purification products), Insense (woundcare),

Virtual strategic partnerships – when two leaders meet
Beyond direct investments that can be made by food companies into research we believe that there exists a third way to secure research that should not be underestimated: the association of food ingredient producers and consumer goods manufacturers.

Leading food ingredient manufacturers such as Danisco, Kerry, Christian Hansen, CP Kelco invest 4-5% of their sales on research and development and have been playing an increasingly important role over the past 10 years in coming up with solutions for their large clients who try to improve the appearance, the texture, the convenience, the palatability and the health profile of their products. More than ingredient suppliers, their value lies in their capacity to develop differentiated research capabilities, which are key to creating a captive client base.

Without creating capitalistic links, virtual strategic partnerships have developed between food ingredient manufacturers, which are leaders in certain fields, and packaged food manufactures, who are leaders in relevant categories. For example Christian Hansen, which is a leader in the field of dairy cultures, works very closely with Danone on the development of bacteria which can be used in yogurts and for which a health benefit can be identified. Recent enhancements of Activia's digestive properties are the result this collaboration

Marketing R&D

As described earlier we believe that marketing cannot function without R&D and vice-versa. Clearly we believe that a company who would excel in research but would not have the marketing muscle to support its innovation would not be able to make it in the consumer goods world. Therefore we think the development of a competitive advantage through R&D can only be achieved by combining great research and marketing excellence. There are many examples.

- In the probiotics war Danone’s Actimel has overshadowed Nestlé's LC1 because of marketing rather than product superiority.
- Unilever has taken a dominant position in cholesterol lowering margarine with its Pro-Activ concept vs. Raisio’s Benecol because Unilever had many established brands in that category it could leverage.
- Nestlé is now taking a leading position in US ice cream because its revolutionary low-churn technology is put at the disposal of two great brands (Dryers’ and Haagen Dazs).

Going one step beyond, and building on the “Intel inside” concept, Nestlé has been pushing the concept of Branded Active Ingredients (BAI). BAIs are physiologically active substances (molecules and bacteria) that have been selected by Nestlé for their health or wellness benefits and turned into a commercial brand. BAIs are added to products. For example *Calci-N* is a milk-derived calcium source used in a number of Nestlé products – see Figure 18. Clinical studies conducted by Nestlé in collaboration with the University of Geneva, have shown that *Calci-N* improves bone density and that the improvement is sustained for a long period of time.

According to Nestlé, products with a BAI represented over CHF 2.5 billion in sales in 2004.

Figure 18: Nestlé’s Branded Active Ingredients – Calci-N

Source: www.Nestlé.com

Risks and opportunities for brands

The rising prevalence of obesity across the world particularly among young people, has alarmed health experts, the media and the population at large, and is a major public health concern. With the vast majority experts highlighting the multi-causal nature of obesity (food consumption, physical activity, environment, education, genetics) the role of the food industry is at the heart of the debate.

Over the past three years most companies under our global coverage have made the headlines with their names and brands associated with obesity, sometimes in a positive way as their new product developments efforts or social actions get recognized, sometimes in a negative way as some of their products get depicted as a direct cause of obesity or their marketing practices criticized. Such an exposure represents a risk for their brands and their business in our view. However it also creates to a certain extent an opportunity for differentiation and positive brand building.

Corporate activity has come under intense scrutiny - media coverage creates a risk for brands

Over the past 3 to 4 years the food and beverages industry has come under increasing scrutiny of governments, politicians, health organizations, consumer associations and the media in search of a quick fix to the "obesity epidemics". Although experts recognize obesity is a complex and mutlifactorial issue the strong visibility of the food industry (due to the strength of its brands, communication and distribution) has led food companies to be permanently at the heart of the debate.

Advertising to children, marketing techniques such as the use of cartoon characters, vending in school, product qualities and formulation, sponsorship programs have all come under attack. Certain companies and brands have been openly criticized.

Unfortunately, even if most regulators want to encourage a multi-stakeholder approach to respond to obesity, we believe the food and beverages industry is likely to remain under pressure.

The largest companies are cognizant of that risk and have spent a great deal of time over the past years to protect themselves by I) creating advisory committees on health and nutrition including a number of external experts, II) reviewing marketing and vending policies to children, III) participating in community projects to inform consumers better about health and nutrition, IV) reviewing formulation, portion sizes, etc…

Having said that, we believe obesity remains an ultra sensitive issue and that communication campaigns against companies or brands may happen again. In general we believe that:

- any form of marketing/vending of foods to children, under all its forms, especially energy-dense and nutrient-poor products, should be re-considered very carefully because this may ultimately damage the brand.

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- brand association with educational programs about the benefits of good nutrition and physical activity should be managed carefully as it may backfire. A good example here is that of Cadbury Schweppes' "Get Active" campaign in the UK, which was heavily criticized in the general press - in brief, to win sports equipment for their schools kids had to buy a relatively large number of chocolate bars.

An opportunity for differentiation and brand building

Although we tend in general to regard obesity as a risk for the brands image we believe there is an opportunity for brands which genuinely embody 'health' and 'wellness' to build a long-term competitive advantage which should translate into sustainable sales growth and margin expansion.

There are two major building blocks, in our view:

- **Continuing product innovation and renovation, implying a true commitment to R&D**. This builds on what we discussed in the previous sections on growth dynamics and R&D within the sector. We believe that company will have to continue to work hard to I) improve formulation and the nutritional profile of their products incl. salt and/or fat and/or sugar reduction depending on the nature of the products while preserving organoleptic properties, II) develop products that offer nutritional or health benefits at a reasonable price.
- **Honest marketing and information of consumers.** A recent ACNielsen reveals that "on average, about a third of consumers in the four regions surveyed (Europe, Americas, Asia, South Africa) didn't believe food products really offered additional health benefits as they claimed – see Table 5. The distrust was the greatest in Asia Pacific, Europe and in South Africa towards fruit juices, while North and Latin American questioned oils/margarines that claim to lower cholesterol levels." This survey, which is very consistent with other surveys that have been carried out across the world, shows that companies still have a lot of work to do to convince consumers and gain their trust. In that respect, good quality and mandatory labeling (the EU has yet to make progress on this) is one thing, other information on the pack, on TV/site is another. From that perspective, the new proposed EU regulation on health and nutrition claims should be seen favorably. As far as nutritional information is concerned, it would be unfair to conclude without saying that the largest companies under our global coverage have made huge progress in that field over the past 3 years with most of them clearly labeling, even in countries where they don't have to, and posting information on their website and/or in brochures. Having said that, a number of surveys (including the one led by the FSA following the decision to use traffic light systems, which is corroborated by another ACNielsen survey – see Figure 19) show that a large number of consumers do not understand or understand only in parts the labels. Obviously, companies cannot be blamed for the lack of consumer education but in our opinion they should they take this into account when marketing their products and support without hesitation national health information campaigns.

Table 5: Reasons for not purchasing foods that promote specific health benefits

They are too expensive

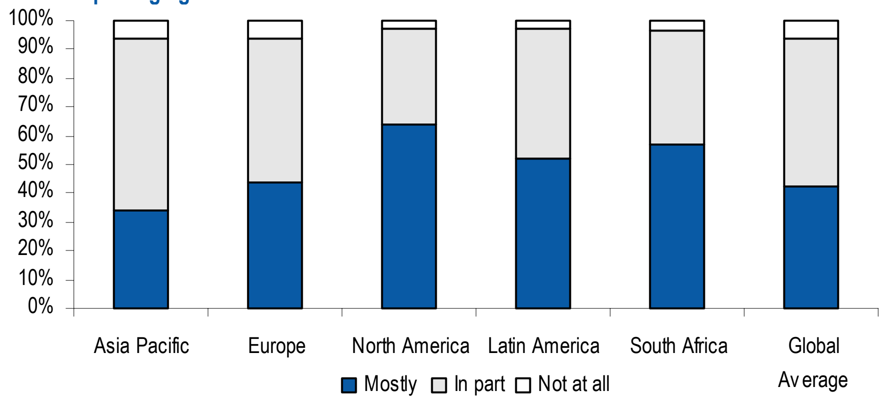
	Asia Pacific	Europe	North America	Latin America	South Africa	Global Average
Cholesterol reducing oils and margarines	16%	16%	16%	26%	11%	16%
Whole grain, high fibre products	18%	12%	14%	23%	13%	15%
Fruit juices with added supplements/vitamins	15%	14%	16%	24%	11%	15%
Iodine enhanced cooking salt	10%	7%	7%	12%	8%	8%

I don't believe they offer additional health benefits

	Asia Pacific	Europe	North America	Latin America	South Africa	Global Average
Cholesterol reducing oils and margarines	31%	42%	36%	27%	40%	38%
Whole grain, high fibre products	24%	29%	20%	13%	26%	26%
Fruit juices with added supplements/vitamins	42%	48%	32%	23%	45%	44%
Iodine enhanced cooking salt	32%	37%	32%	22%	30%	34%

Source: ACNielsen

Figure 19: How well do you understand the nutritional information panels / labels on food packaging?



Source: ACNielsen

JPMorgan

Benchmarking analysis, Company profiles and Investment recommendations

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Benchmarking analysis and company profiles

Benchmarking analysis & company profiles

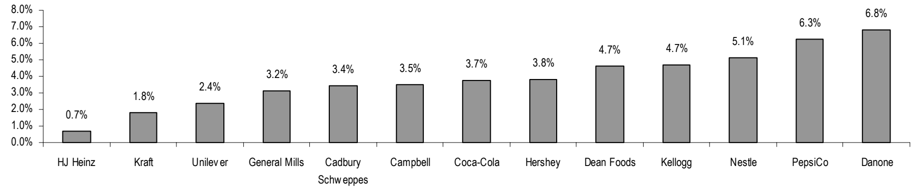
In order to better appreciate the operating performance of food companies and how it could have been influenced by consumer perception of their products (in terms of them being healthy/unhealthy) we have compiled a number of objective quantitative data and ranked companies.

- In order to assess the operating performance we have looked at like-for-like sales growth, defined as volume+price/mix, and EBITA margin from 2000 to 2005E.
- In order to assess their product exposure and appreciate the changes that may have taken place over time we have broken down the product portfolio between "Healthy", "Better for you" and "Less healthy". We recognize this is subject to criticism but several companies have adopted or validated this approach and this is also relatively consistent with the approach taken by a number of regulators across the world.
- We define as “Less healthy” products with a high fat/sugar/salt content. These include confectionery, cookies/biscuits, ice cream, sugary soft drinks, edible oil, mayonnaise etc. We define as “Better for you” products "Less healthy" offering a reduced calorie content e.g. light ice cream, light mayonnaise etc... We define as “Healthier” all others including diet soft drinks, fruit juices, most dairy products etc... They are not always perfect products from a nutritional stand point but they certainly are in a safer spot in the context of potentially tougher regulation.

Conclusion. As highlighted in the first two sections of this report consumption trends (healthy eating being the most influential) and the way companies adapt to these trends is having a major influence on performance. However product profile or category exposure is only one among many other factors explaining the operational performance of companies. Management quality, execution, regional exposure/expansion, cost savings initiatives are other key success factors.

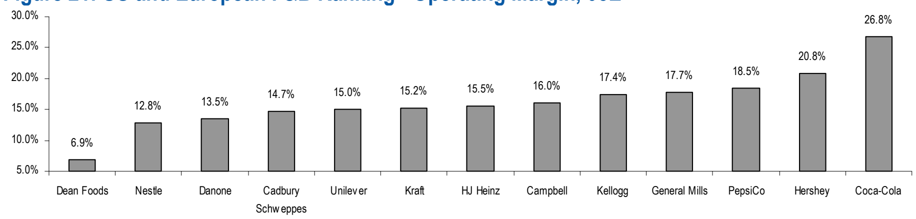
Operational Performance Benchmarking

Figure 20: US and European F&B Ranking - Like-for-like sales growth average 02-05E



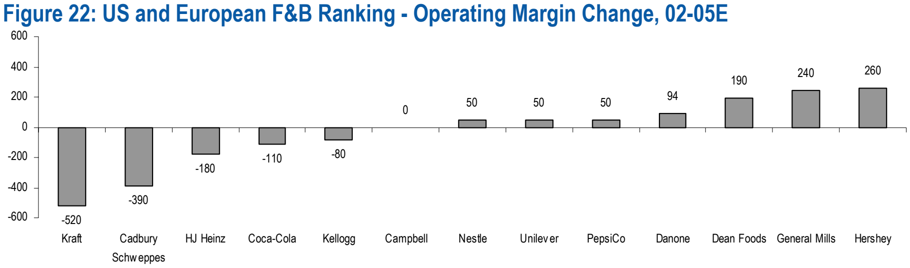
Source: Company data, JPMorgan estimates.

Figure 21: US and European F&B Ranking - Operating Margin, 05E



Source: JPMorgan estimates.

Figure 22: US and European F&B Ranking - Operating Margin Change, 02-05E



Source: JPMorgan estimates.

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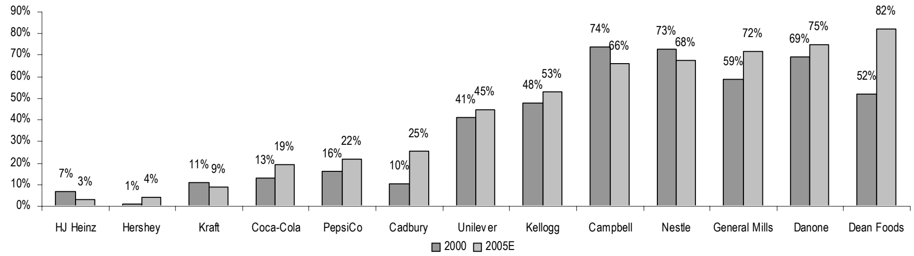
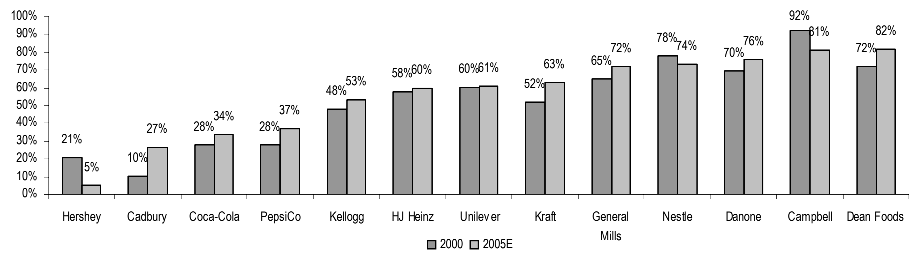
Comparative Portfolio Analysis

Figure 23: US and European F&B Ranking according to % of Healthier products – 2000 and 2005E



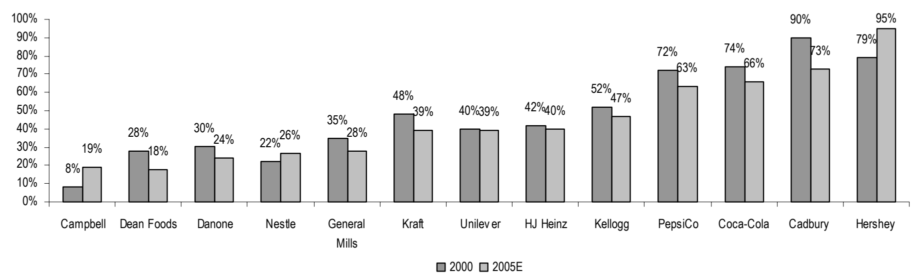
Source: JPMorgan estimates.

Figure 24: US and European F&B Ranking according to % of Healthier and Better for You products – 2000 and 2005E



Source: JPMorgan estimates.

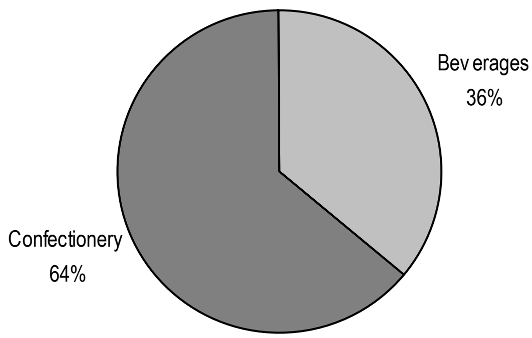
Figure 25: US and European F&B Ranking according to % of Less Healthy products – 2000 and 2005E



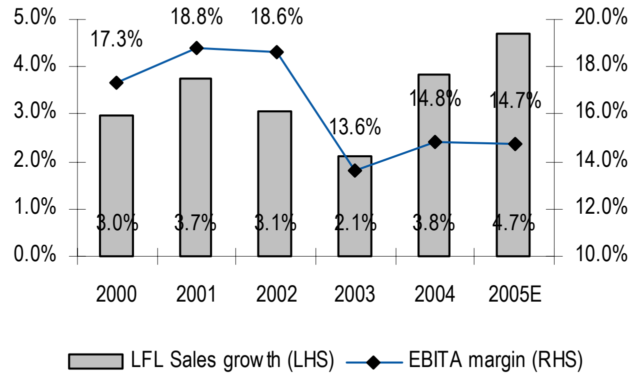
Source: JPMorgan estimates.

Cadbury Schweppes

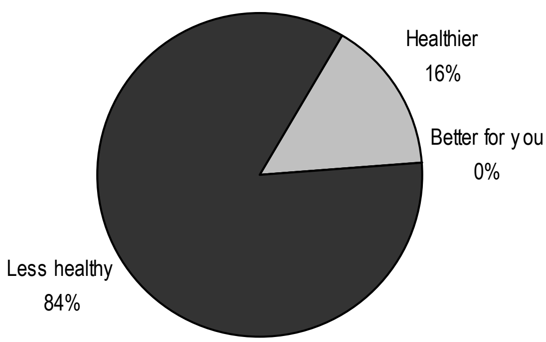
Breakdown of sales by categories, 2005E



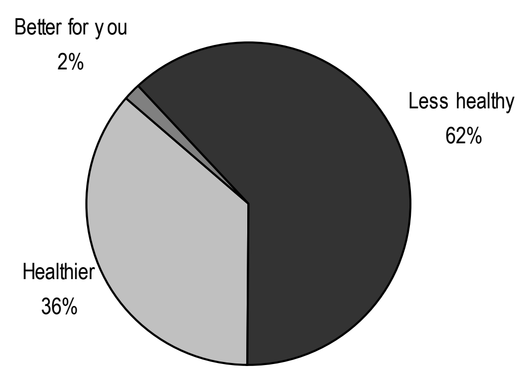
LFL Sales Growth and EBITA margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

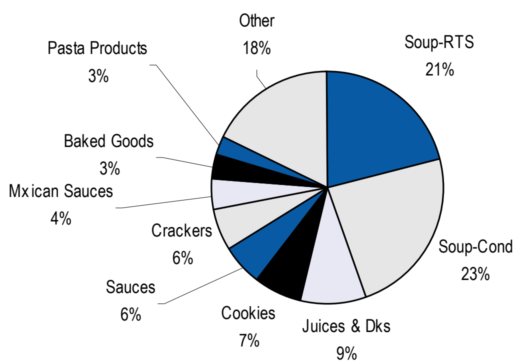
Although Cadbury Schweppes continues to be a focused player on soft drinks and confectionery, its product profile has changed significantly over the past five years primarily due to its expansion in chewing gum via acquisitions. Between 2000 and 2005, Cadbury acquired leading gum players in France, Nordic countries and North/South America and now controls c26% of the global chewing gum market. More than 80% of chewing gums are now sugar free. This combined with the strong growth in diet CSD and a decline in regulars has led to a sharp increase in the contribution of "Healthier" and "Better for you" products to group sales.

Response to obesity challenge in the context of the overall strategy

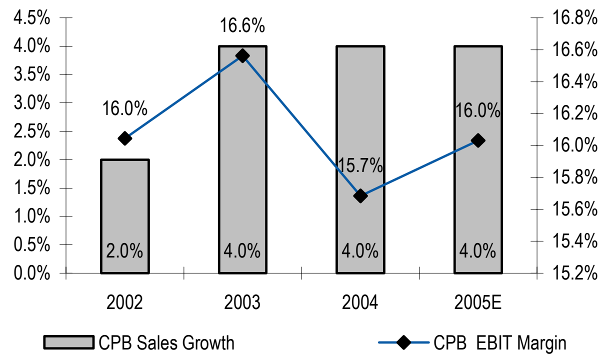
We think that portfolio changes at Cadbury are the result of management's stronger focus on top line growth rather than a reaction to the obesity challenge. Unlike Coke and Pepsi, Cadbury has decided to stay away from the water market, where management did not see any profitable growth opportunity. In the CSD sector, the group has been focusing a lot more on diet versions, which are still under-represented in its portfolio (c23%) vs. the market (c.30%). Specifically addressing the obesity challenge and the rising regulatory pressure/litigation risks Cadbury introduced smaller packaging for its regular products in 05. In the confectionery sector its most obvious response to obesity was the withdrawal of its super size chocolate confectionery bars in the UK and the introduction of the 100 calorie pack in Canada in 2005. It is worth mentioning that in 2004 the company launched a 12 point plan to respond to consumer health concerns including measures such as a new global marketing code (no advertising to children below 8), no vending in primary schools a review of single-serve portion sizes.

Campbell

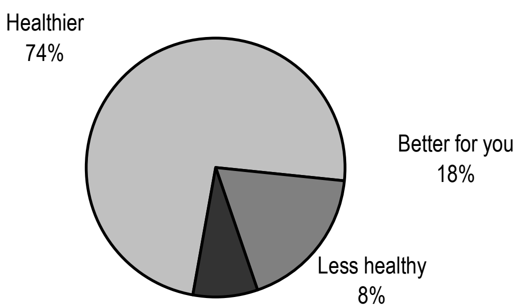
Breakdown of sales by categories, 2005E



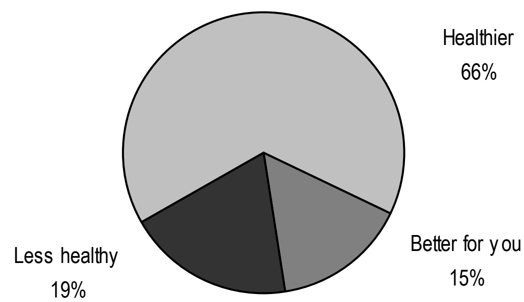
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

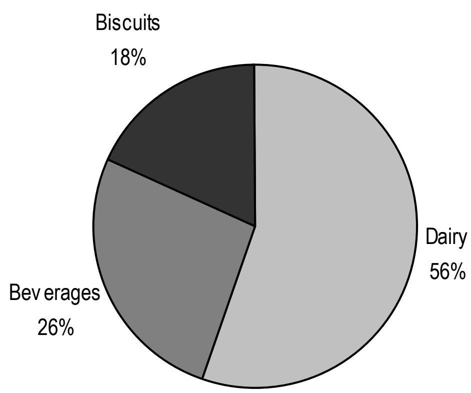
Although the portfolio is already generally well positioned to benefit from health and wellness trends, CPB has continued to expand its range of "good for you" alternatives. We believe CPB has done a pretty good job in providing “Better for you” product for consumers; however, we note that there is very little room for expansion due to the fact that their products are already considered healthy. Healthy Request (98% fat free, 480 mg or less sodium), fewer than 100 calories and certified by the American Heart Foundation) is a good example of innovation within their soup portfolio. Within beverages, V8 beverages are considered very healthy products. CPB is leveraging this image and continues to expand this brand with new products that include fruit and vegetables. We note that one of the problems with this brand is that it has high amounts of sodium, and although a low sodium V 8 is provided it does not do as well as the conventional V8. Furthermore, the company has launched new organic products (Organic broth, Organic V8 and Organic sauce), which further affirm their focus on health and wellness. CPB's Pepperidge Farm Brand has also seen good growth in their whole grain breads. Traditionally Pepperidge Farm has always been considered a healthy brand, and the company is using this as a platform to expand this brand to include more bakery products.

Response to obesity challenge in the context of the overall strategy

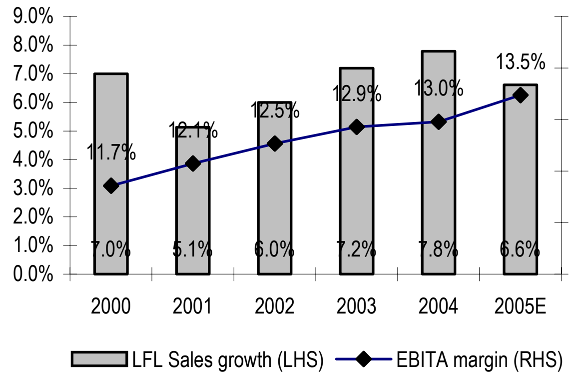
Management believes the product portfolio is well positioned to health and wellness trends, given its great reliance on soups, vegetable based juices (V8), and tomato based sauces (Prego, Pace). While CPB also competes in more indulgent categories like biscuits (PF cookies, Goldfish crackers, and Tim Tam cookies at Arnott's in Australia) and chocolate (Godiva), the growth is expected to come from soups. Top line and margin expansion is expected to come from soups as the company develops new platforms such as vegetable soups under the V8 name, aseptic soup, microwaveable formats, and refrigerated soups. Most of the company’s R&D dollars have gone towards improving the composition (or health profile) of CPB’s products and this trend has accelerated recently. Although the total dollar spend on R&D has remained stable, the proportion devoted towards reducing sodium and TFAs has increased over the years regarding ingredients, with programs that include: 1) *Sodium reduction program:* The company is currently engaged in various sodium reduction programs but has not given specific detail. Some product lines are offered with lower sodium content (Healthy Choice). This topic is of critical importance to the company due to its relevance regarding health claims. High sodium content does not allow the company to issue health claims; 2) *TFA reduction innovation:* Initiatives in this category have centered around their Crackers products, mainly in Gold Fish, which is now TFA free. Some of the other baked goods contain a little TFA. Within soups there is TFA in some of the products, but all Kids soups are TFA free.

Danone

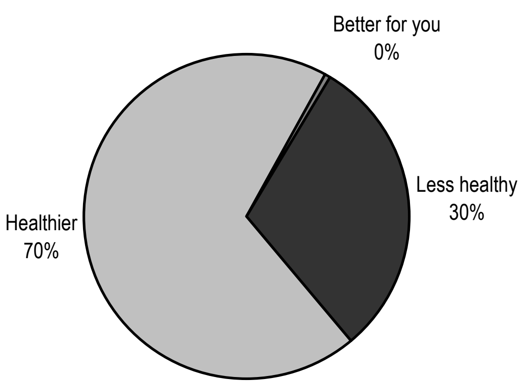
Breakdown of sales by categories, 2005E



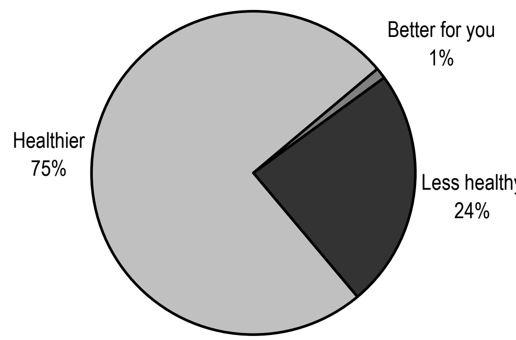
LFL Sales Growth and EBITA margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

When Frank Riboud took over from his father as CEO in 1996 he made the decision to refocus and reposition Danone as a “healthy food" company through branding, product innovation, R&D investments, acquisitions and divestitures. This led to the divestment of frozen food, beer, pasta and confectionery and a significant number of acquisitions in fresh dairy, water and biscuits. The broad portfolio transformation was more or less complete in 2000. We’ve continued to see adjustments to the portfolio over the past 3-4 years, with the divestment of a certain number of biscuits assets (in the UK and Latam in 2004) and its sauces business (2005) and some acquisitions in water and dairy, but strong organic growth in water and fresh dairy has played a key role in further improving the profile of the portfolio.

Biscuits explain to a large extent why 24% of the portfolio is characterized as “Less Healthy”. This may look a bit misleading or unfair given that close to half of sales are derived from Asia where Danone's biscuits are positioned (and recognised) as nutrition products often enriched with a number of nutrients to offset certain deficiencies while in Europe its products are increasingly marketed as substitutes to RTE cereals. We also note the efforts made by the group to develop lower-calorie biscuit ranges under its Taillefine/Vitalinea brands, primarily captured under “Better for you”.

Response to obesity challenge in the context of the overall strategy

Being positioned as a "healthy food" company, Danone has been a key beneficiary of growing consumer demand for healthier products. In many ways its strategic positioning has been vindicated as obesity became a major public health concern. Having said that, over the past 3 years Danone strengthened its R&D capability with a view to maintaining leadership in probiotics and support nutrition and health claims. This has notably taken the form of the creation of a large research centre (Institut Daniel Carasso).

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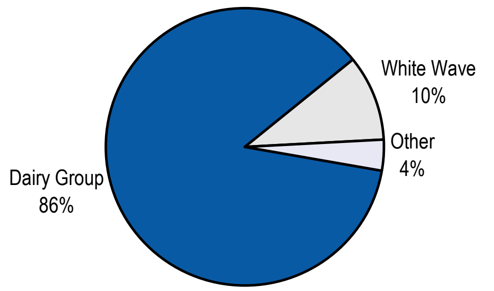
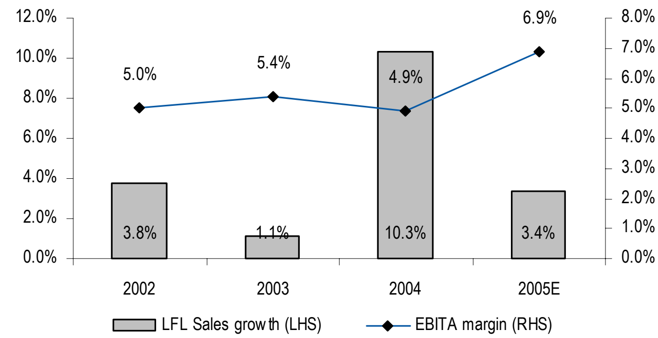
Dean Foods

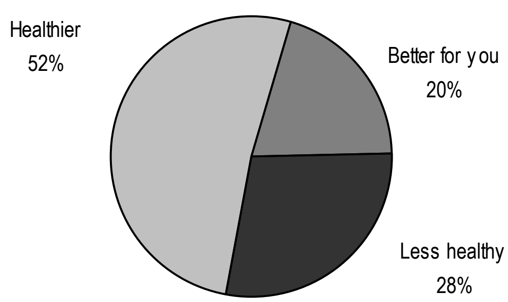
Breakdown of sales by categories, 2005E



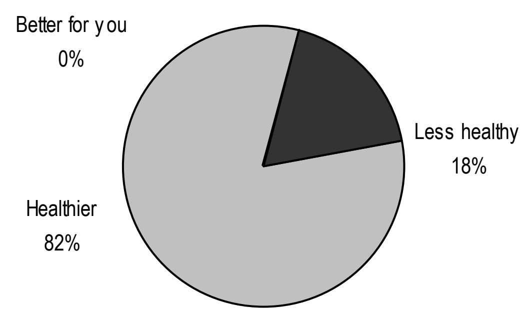
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

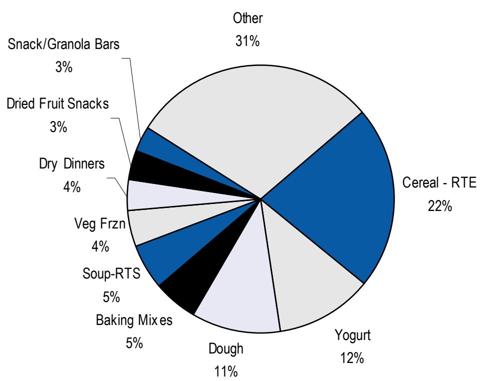
By FY07E Dean Foods should generate 75% of EBIT from its dairy business (primarily fresh milk) and the rest from the WhiteWave division, where products like Silk soy milk and Horizon organic milk account for about 60% of WW sales. DF span off its pickles and non dairy creamers business in 2005, and is now solely focused on dairy and the WW unit. We do not expect change in terms of product mix within the dairy unit (mainly fresh milk sales), while soy milk and organic milk will probably increase their contribution to total White Wave sales given they are growing at a faster rate than other products within WW (such as Land o' Lakes and International Delight).

Response to obesity challenge in the context of the overall strategy

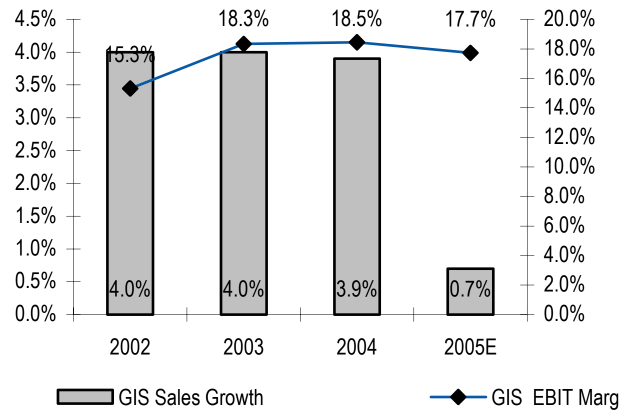
DF does not have a specific strategic approach to respond/adapt to the obesity epidemic as its product portfolio already positions the company rather well to increasing focus on health and wellness by consumers. Moreover, while cheese and ice cream are part of the current portfolio, the company's SKU rationalization program as well as ongoing double digit growth at Silk and Horizon should result in a greater portion of total company sales coming from "good for you" categories in the next two years.

General Mills

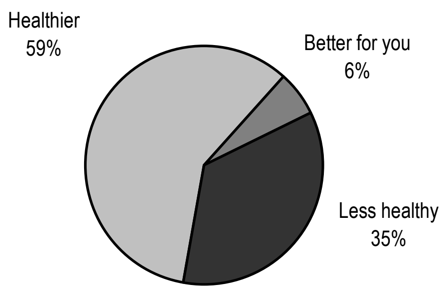
Breakdown of sales by categories, 2005E



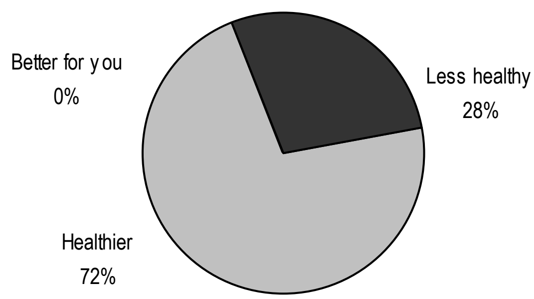
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

GIS aims to provide alternatives to consumers so that they can better meet their health and wellness needs. GIS offers a number of products that are low in calories, providing 250 products that have 130 or fewer calories per serving. As part of their health and wellness initiative GIS plans on leveraging the following four categories: Cereal, Yogurt (Yoplait), Veggies (Green Giant) and Organic Foods combined with Soy Beverages (combined they represent 41% of GIS's worldwide sales). They plan on using these categories as a platform to expand into and take advantage of the growing health and wellness trend. In Cereal they are pushing the Whole Grain line, Green Giant brand is expanding due to the demand for vegetables and Yoplait yogurt line has introduced some smoothies with "Better for you" alternatives. Mills has also worked on labeling programs. The Company places great focus on nutritional labeling. Through the "goodness corner" labeling program, key facts regarding the product's health profile are highlighted (i.e. Source of calcium, fiber, etc). Although this initiative is geared towards educating the consumer, there is a lobby that believes labels such as these can be misleading and at worst can misrepresent facts and confuse the consumer. We believe the company's recent push to market its products (in some cases brands) as "healthy" could expose it to potential criticism from regulators and lobbyists, and pose a long term risk for GIS.

Response to obesity challenge in the context of the overall strategy

The company believes that Health and Wellness will drive food industry growth in the future and that their portfolio is very well suited to capitalize on these trends. According to our estimates 72% of their portfolio can be categorized as healthier foods and the rest (or 28%) is considered "not so healthy". GIS look at the obesity issue from a product category perspective, and believe that they are mostly in categories that suit the health and wellness trend, which puts the at a strategic advantage. Their objective is to use health and wellness as an innovation platform to provide consumers with alternatives in terms of taste and variety, convenience, healthy or "Better for you" products. The company views the health and wellness trend as an opportunity for growth and is not too concerned about obesity related risks (due to their portfolio mix).

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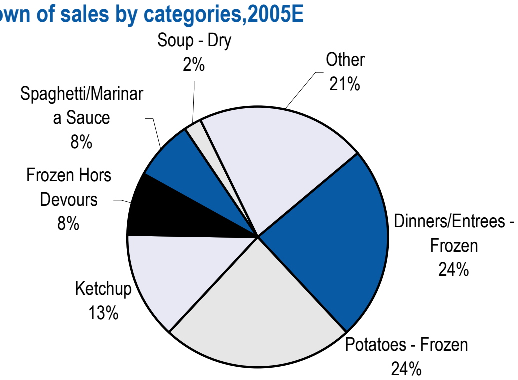
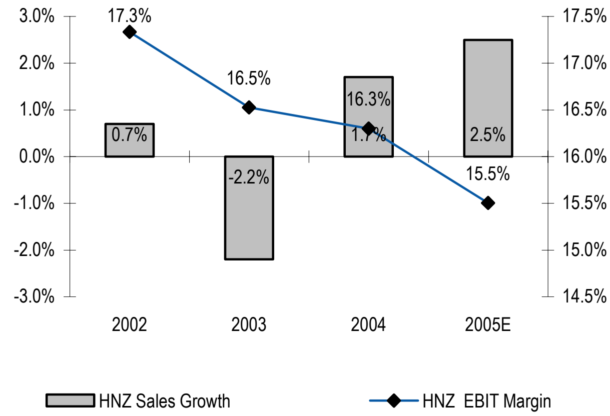
HJ Heinz

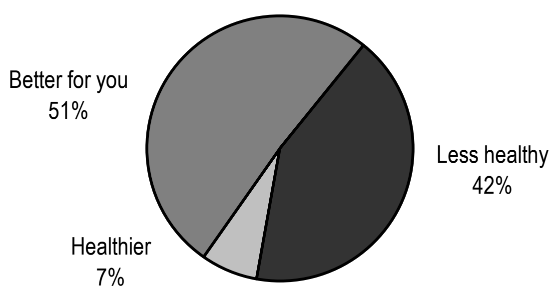
Breakdown of sales by categories,2005E



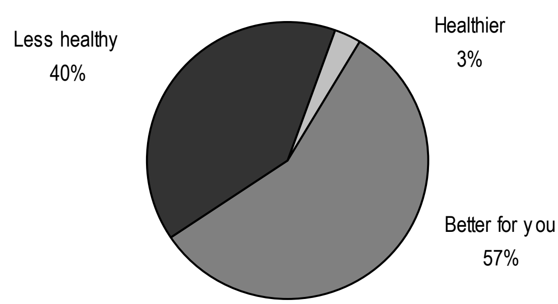
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

HNZ considers its portfolio to be pretty well balanced in terms of health profile, with Tomato Soup(HNZ is the largest processor of tomatoes in the world) and Bean products acting as alternatives to their core potato products. HNZ provides various alternatives to their typical fried potato products, including baked potatoes, and roast potatoes. These alternatives are their version of "Better for you" products with lower calories and fat content. In addition, reduced calorie products, such as Smart Ones are a good example of an expanding alternative product portfolio. Soups in the US tend to be considered as healthy food and an alternative to some of the other products in HNZ's portfolio. Beans are an excellent source of protein, having lower fat and high fiber content. Tomatoes have Lycopene, which is an antioxidant that can reduce the chance of prostate cancer.

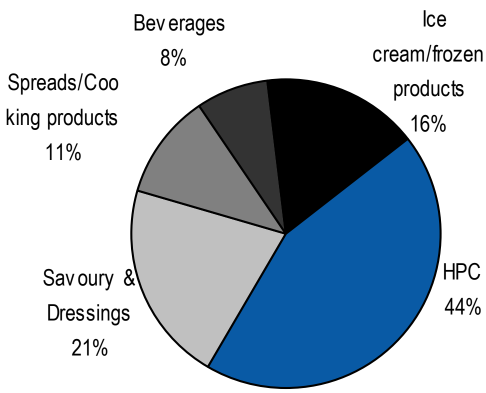
HNZ also believes its infant feeding business should benefit from health and wellness trends. This topic continues to attract attention from a nutritional value and taste perspective, especially in Europe. HNZ has become leader in this sector due to the creation of an "Environmental Oasis Program (through its Plasmon products) – purity of raw ingredients and production process". HNZ has shown consumers that their products were better than those that were made at home (homemade baby products are the main competition to HNZ in Europe). Again, this adds to HNZ's portfolio of healthier products, and provides consumers with greater choice. We note that tackling obesity in children is important in reducing overall obesity levels because most obese children tend to remain obese as adults.

Response to obesity challenge in the context of the overall strategy

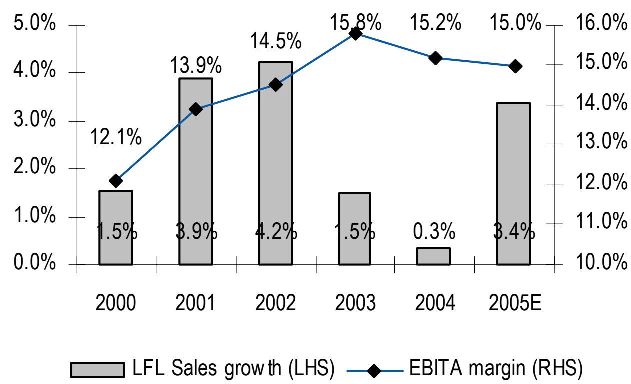
According to management, HNZ's portfolio has a good mix of "healthy" vs. "not so healthy" products (Beans vs French Fries, Soup and Tomato Sauce). However, due to the fact that a major portion of its sales come from potato related products (most of which are fried), the company is exposed to obesity related risks. The driving principle behind their product development, "quality and taste are necessary attributes of the final product" has limited the company's ability to transform itself into a manufacturer of healthy foods. However, we note that the company is making the most of its current portfolio mix (healthy vs. not so healthy) by leveraging products that have a better health profile.

Unilever

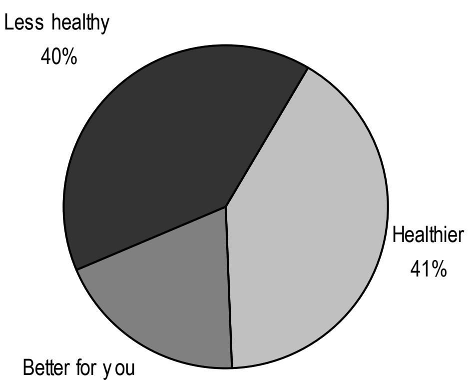
Breakdown of sales by categories, 2005E



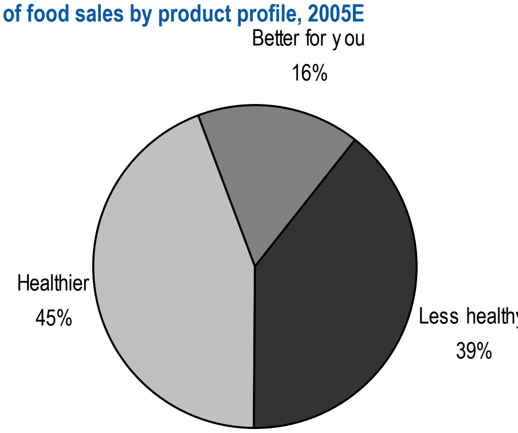
LFL Sales Growth and EBITA margin



Breakdown of food sales by product profile, 2000



Breakdown of food sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

Unilever is in the top ten of food companies globally but its food business only accounts for 56% of group sales - the remaining 44% being home and personal care. The profile of the food portfolio does not seem to have changed dramatically over the past 5 years with the contribution of Healthier and Better for you products up from 60% to 61%. However this masks major changes resulting from, on the one hand the acquisition of Knorr’s (via Bestfoods) relatively healthy meal solutions, Slim Fast and the divestment of cooking oils and some spreads, offset on the other hand by the acquisition of Hellmans’ mayonnaise and salad dressing (Bestfoods) and the acquisition of Ben & Jerry’s.

The proportion of less healthy products at 40% is the result to a large extent (c50%) of Unilever's large ice cream business and its mayonnaise and salad dressing business in spite of the group's efforts to introduce healthier versions (recognized in Better for you). The case for margarine/spreads is a difficult one as it is on the one hand healthier than butter, but by definition 100% fat –we have thus decided to allocate 50% to Healthier and 50% to Better for you.

Response to obesity challenge in the context of the overall strategy

In 2001 Unilever started to talk explicitly about obesity when it acquired Slim Fast. However the weight management category has gone out of favour and management was slow to recognize the low-carb trend and consequently the brand has lost more than half of its sales in 4 years. In response to the popularity of low-carb diets, which are a direct consequence of growing awareness that obesity poses serious health risk, Unilever launched its Carb Options line in 2004. In 2004 the group launched its Nutrition Enhancement programme which seeks to “achieve further reductions in trans fat, saturated fat, sodium and sugar levels, and understand better the inherent health benefits of some of their leading brands.” During 2004 Unilever assessed half its portfolio by sales value – some 10,000 product - and has put in place comprehensive enhancement action plans. According to Unilever, its “Vitality mission commits it to grow its business by addressing health and nutrition issues”.

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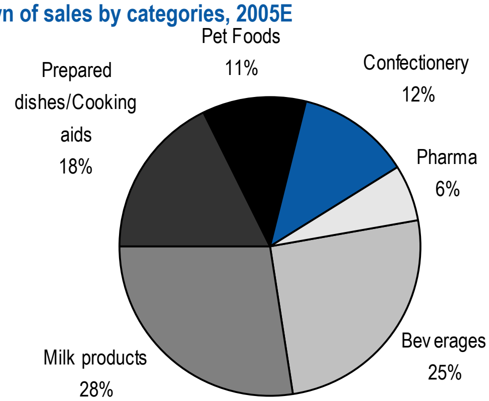
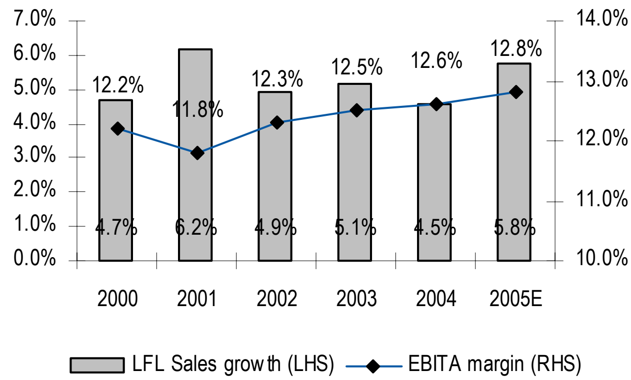
Nestlé

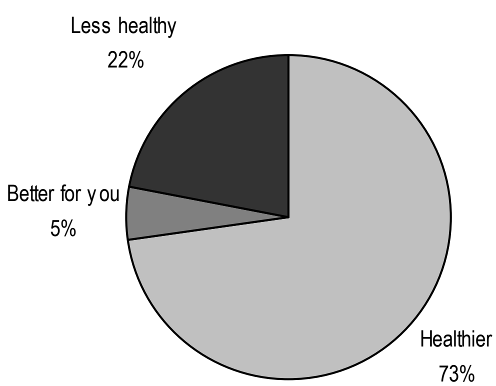
Breakdown of sales by categories, 2005E



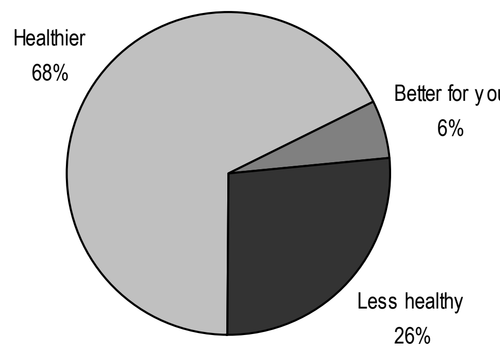
LFL Sales Growth and EBITA margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

Nestlé is largest food and beverages company globally. Food & beverages (ie ex-petfood and pharma) account for 83% of 2005E group sales. The proportion of Healthier and Better for you products declined modestly from 78% to 74% between 2000 and 2005 following the acquisition of Chef America (US frozen snacks) and several ice cream acquisitions (incl. Dryers', Schoeller etc...). These were to a certain extent offset by Nestlé's efforts to introduce lighter versions of its products (e.g. low churn ice cream). The products categorized as “Less healthy” primarily include ice cream, frozen snacks and confectionery. We expect Nestlé’s portfolio to continue to evolve favourably via acquisitions and new product development.

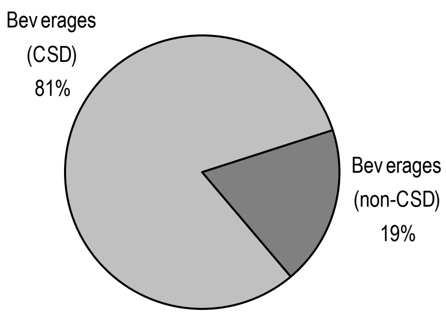
Response to obesity challenge in the context of the overall strategy

Nestlé’s strategy is to develop into the "leading food, nutrition, health and wellness company". This strategy is not a reaction to obesity itself but it is certainly a “response to the nutritional challenges of our day" in line with Nestlé's roots and fully consistent with the vision developed by Mr Brabeck since he was appointed CEO in 1997. The fact that obesity has become a major public health issue vindicated Nestlé's strategic positioning and brought greater impetus to the implementation of its strategy.

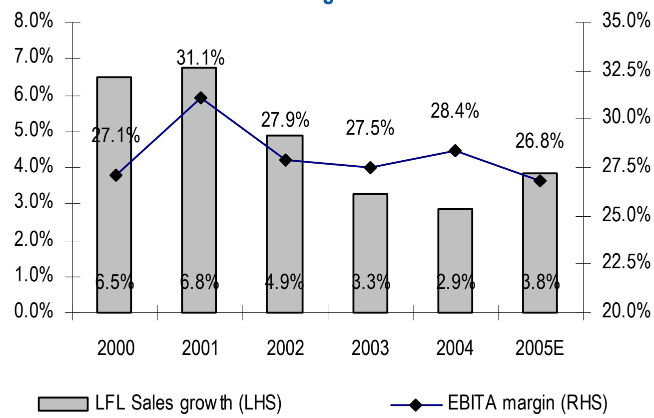
In 2004, Nestlé created Nestlé Nutrition, a global business unit, which brings together the infant/clinical/sports nutrition activities of the group. In addition a Corporate Wellness Unit was created with the mission of "driving the nutrition, health and wellness orientation across all its food and beverages businesses and to ensure that a separate team can focus all its energies on the broader nutrition and wellness opportunity". This Unit assumes responsibility for the implementation of the 60/40+ process that was launched in 2003 and seeks to ensure that Nestlé products are not only preferred by 6 out of 10 consumers but also have a better nutrition profile than competitors’. Nestlé also adapted its Corporate Communication Principles and issued a policy on nutrition labelling and health claims.

The Coca-Cola Company (KO)

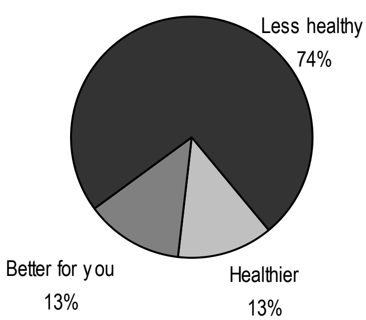
Breakdown of sales by categories, 2005E



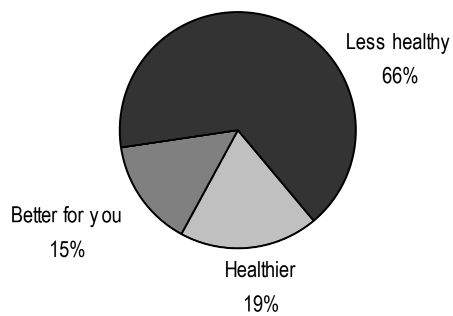
LFL Sales Growth and EBITA margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

More than ever, Coke appears focused on capturing the health and wellness trend by expanding and strengthening its brand portfolio with a greater focus on diet/light CSDs and non-carbonated categories as consumers move away from traditional full calorie soft drinks. Coke's 2006 new product pipeline looks solid with a greater focus on non-carbs, and the company has emphasized a balanced portfolio across multiple platforms as the key to driving sustainable growth. We estimate CSDs (soft drinks) now account for roughly 80% of Coke's business mix, compared with nearly 90% of mix only five years ago. Within the CSD business, we estimate diet/light brands account for less than 20% of mix but this business has been increasing over the last few years (especially in developed markets like North America and Europe). Net, while the Coke system hasn't moved as quickly into alternative beverage categories like bottled water and sports drinks as Pepsi, the company is making progress in terms of diversifying the product portfolio to capitalize on the health and wellness trend.

Response to obesity challenge in the context of the overall strategy

Similar to PepsiCo, we think the response by Coca-Cola has been mainly driven by changing consumer demand and preferences. Non-CSD categories and diet/light brands are outpacing full calorie CSDs, which we think is driving the change more than litigation risk. Last year, when Coke stepped up marketing support by $400 million, low calorie CSDs and health and wellness were identified as one of the main areas of focus for incremental investment. New product activity, especially in developed markets has been increasingly focused on non-carbonated beverage categories. In 2006, Coke plans to introduce a fortified juice called U Be and a sparkling juice called Haven. The company also launched sparkling and flavored versions of Dasani water, and a low calorie sports drink under the Powerade brand. In 2004, Coke created The Beverage Institute for Health & Wellness in Houston, TX, which supports scientific research on diet and healthy beverages as well as providing health and nutrition education.

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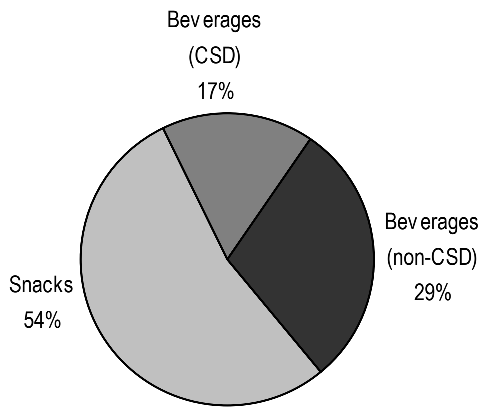
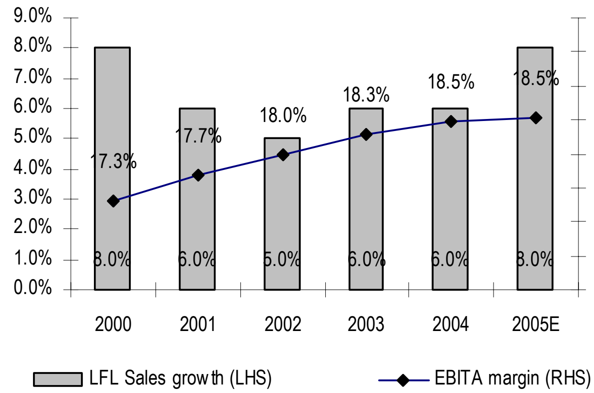
PepsiCo (PEP)

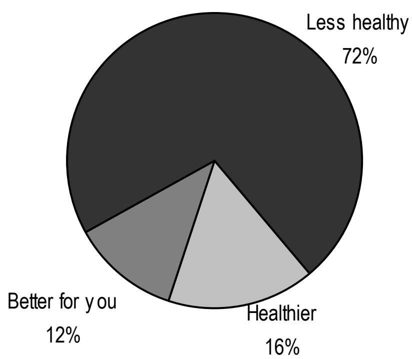
Breakdown of sales by categories, 2005E



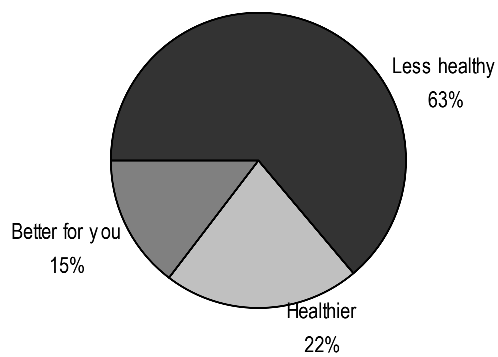
LFL Sales Growth and EBITA margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

Pepsi has taken a very proactive role in better positioning the business to capitalize on the growing health and wellness trend in recent years. As shown in the figures above, we estimate “better” and “healthier” products, in aggregate, now represent about 37% of PEP mix, up from 28% of mix in 2000. The company has focused on diversifying the portfolio through both large transformational acquisitions (such as the $14 billion Gatorade deal in 2001) and smaller "tuck-in" deals (such as the recently completed Stacy's Pita Chips). The Gatorade acquisition propelled PepsiCo into a leadership position in the sports drink category with more than two-thirds of the market. PEP also holds market leadership positions in bottled water (Aquafina), orange juice (Tropicana), and RTD tea (Lipton) and coffee (Starbucks Frappuchino and Double Shot). Solid growth in alternative beverage categories has more than offset softer CSD growth in recent years. Today, we estimate carbonated beverages (including low or no calorie products) represent less than 20% of Pepsi's sales.

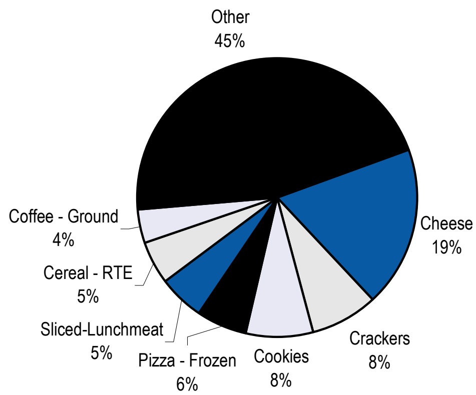
In addition, Pepsi has stepped up promotion and labelling of healthier (or better for you) products through its “Smart Spot” program which was introduced in the summer 2004. Products with the Smart Spot label now represent nearly 40% of mix and have grown at three times the balance of Pepsi’s portfolio year-to-date in 2005. In the most recent third quarter, sales of Smart Spot products at PBNA grew over 20% and comprised 70% of sales. The Smart Spot is affixed to products that are either fortified with certain ingredients, have limited fat, cholesterol or added sugar (or are reformulated to reduce fat, sugar and sodium), or provide specific health benefits. Pepsi’s relatively high level of “less healthy” products as a percentage of mix reflects the Frito Lay business, where Smart Spot products only represent 13% of mix, versus 70% of mix for the Pepsi Beverage North America business.

Response to obesity challenge in the context of the overall strategy

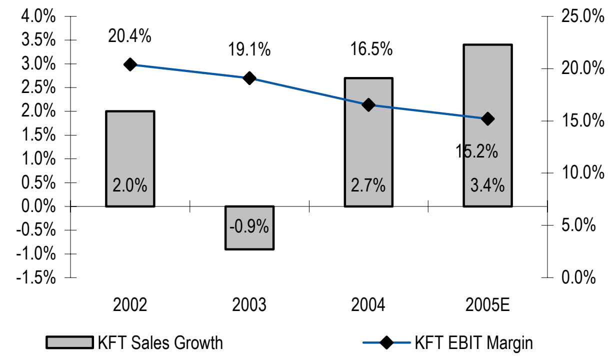
We think the changes at PepsiCo over the last few years could to some extent be put in the context of a response to the obesity challenge and the regulatory pressure/legal risk that comes with it. However, we think the much bigger issue driving the change has been a shift in consumer attitudes and preferences, which PEP has been quick to adapt to and capitalize on. We think solid growth in the FLNA business following the removal of trans fats (which PEP completed in 2003, well ahead of the 2006 FDA mandate) as well as solid double-digit growth in Smart Spot products since the inception of the program last year are both examples of consumer demand driving change in the industry.

Kraft Foods

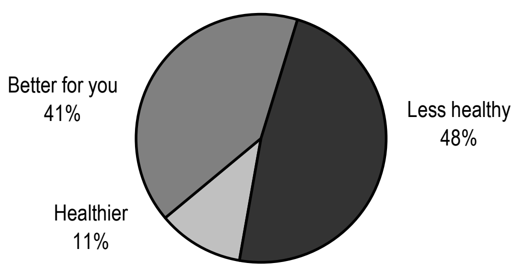
Breakdown of sales by categories, 2005E



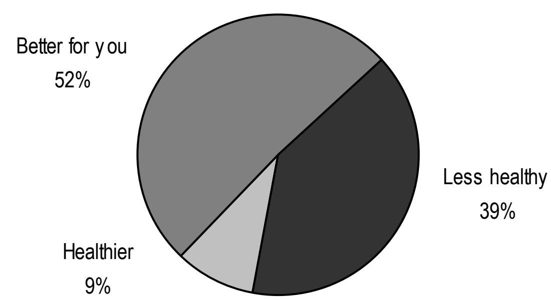
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

KFT is implementing a transformation of its portfolio through acquisitions and divestitures, and is aiming to be better positioned in developed markets to benefit from consumer trends regarding health and wellness as well as convenience (it believes the main issue in emerging markets is nutrition rather than obesity). In the last 2 years, the company has focused on packaging (smaller packs, offering 100 calorie packs), on ingredients (reducing TFA and sugar, as well as providing new alternatives in oatmeal cookies and whole grain cookies). It has also developed platforms that can be extended across various product categories such as SnackWells (followed by CarbWells), Back To Nature (extending a cereal natural brand into 17 other products), and more recently the South beach Diet platform. Moreover, each alternative product - such as sugar-free, fat-free, low-fat, reduced calorie and low-sodium products, and products enriched with important nutrients – adds to KFT's existing portfolio and is marketed differently. In the past, products like Lunchables had come under fire from consumer associations, based on their nutritional profile. However, KFT has made strides in this respect by not only introducing alternatives (Chicken Bursts) but also by changing the composition of the products within this category (reduced sugar content).

Response to obesity challenge in the context of the overall strategy

The Company views the movement of global consumer perception towards health and wellness as an ongoing trend that will strengthen over time, and believes that companies that don't make an effort to transform or reposition themselves into a "manufacturer of healthy foods" will be at risk. Hence, they view Obesity as an opportunity more than a challenge and to date have led the transformation process amongst the packaged food group that we cover. Although the company has taken the initiative in the transformation process, we note that approximately 40% of the company's portfolio can be categorized as "not so healthy", and hence is still exposed to Obesity related risk. KFT has begun repositioning itself through branding, product innovations, and advertising/communication and R&D initiatives.. Amongst the companies we cover, KFT has certainly been a leader in this transformation process. KFT has also worked together with federal agencies as well as state level authorities to develop self-regulation mechanisms for the food industry to help combat the obesity epidemic.

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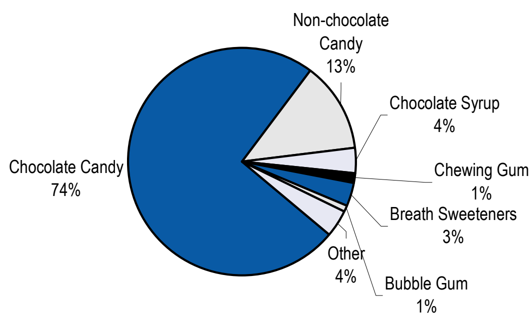
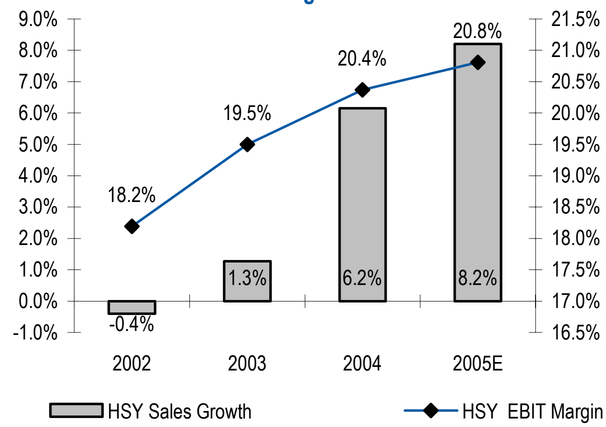
The Hershey Company

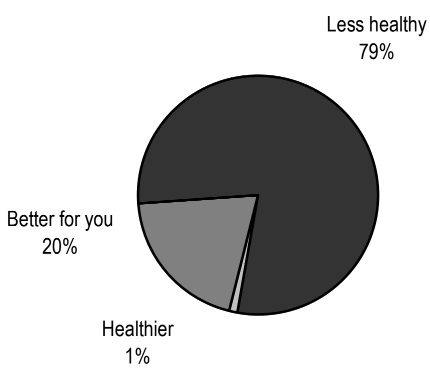
Breakdown of sales by categories, 2005E



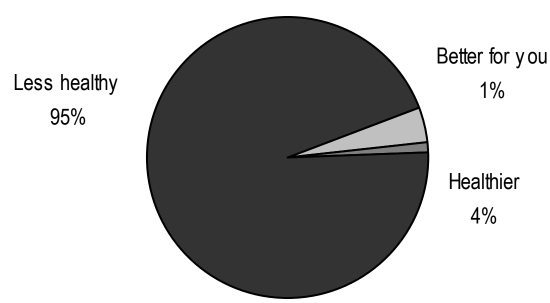
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

While chocolate remains the cornerstone of the HSY portfolio, the company is expanding into new categories. In addition to offering sugar-free chocolate (already sold for the past three years), HSY has launched its own line of cereal bars and nutritional bars (Smart Zone was introduced 2 yrs ago in conjunction with Dr. Barry Sears, founder of the Zone Diet), and recently launched a protein bar under the PayDay franchise. Furthermore, Hershey recently acquired companies in the macadamia nuts arena (nuts would be considered "better for you", as they are good sources of mono unsaturated fat and various proteins) and in the premium dark chocolate segment (dark chocolate has a higher cocoa content and as a result a greater dose of anti-oxidants). . The Mauna Loa acquisition and Scharffen Berger are good examples of this trend. Also, Hershey recently launched its own line of dark chocolate. All in all, the company's recent move into the broader snack market has diversified its product offerings and in some instances improved the company's "good for you profile".

Response to obesity challenge in the context of the overall strategy

HSY is in the indulgence business, and that will remain the focus. But by the same token, the company has recognized one of its key strengths is its distribution prowess to single-serve channels and has expanded its product portfolio to the overall snacks category, rather than just confectionery. Clearly, the broader snacks arena offers more opportunities in terms of introducing new products more geared to health and wellness, and we would expect HSY to further increase its exposure to better for you categories as its portfolio evolves (cereal bars, nutritional bars, protein bars, nuts).

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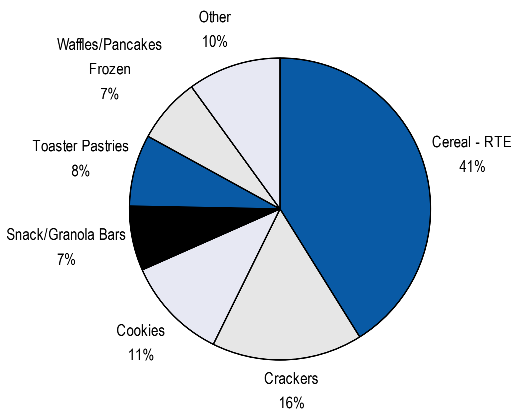
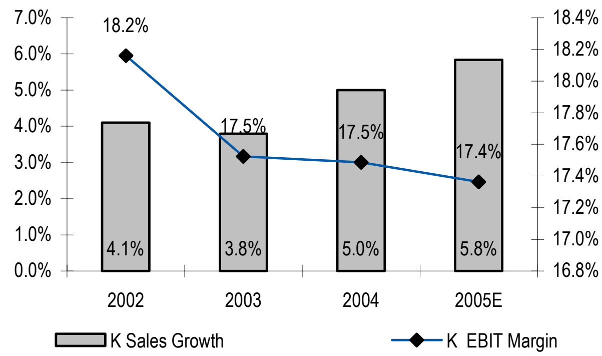
Kellogg

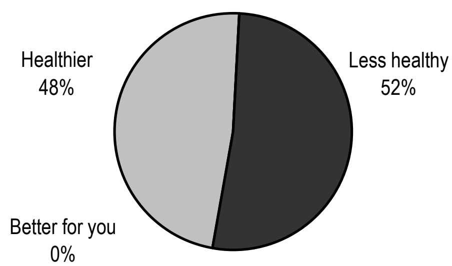
Breakdown of sales by categories, 2005E



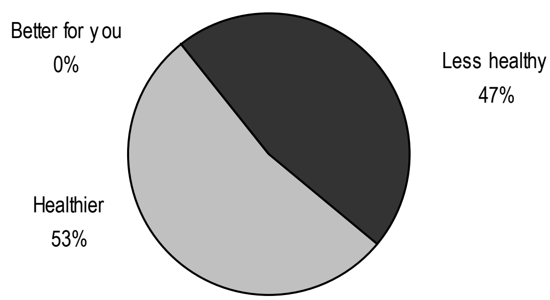
LFL Sales Growth and EBIT margin



Breakdown of sales by product profile, 2000



Breakdown of sales by product profile, 2005E



Source: Company data, JPMorgan estimates

Methodology and comments on portfolio evolution

RTE cereal and cereal bars account for the bulk the company's sales outside the US, but for only 50% of sales in the US, with the balance coming from indulgent categories like cookies and crackers, Pop Tarts and frozen waffles. The company is more focused on offering alternatives within each of its product lines, rather than just focusing on health and wellness. Regarding cereal, K has expanded its offerings of fiber, whole grain, and better for you cereal types, while at the same time offering lower sugar alternatives. K is also working on alternatives to remove trans fats from biscuits. The company has shown strong innovation in its adult cereal brands and is expecting good growth from its All Bran and Smart Start initiatives in 2006. K acquired the Kashi Brand in 2000 (producer of natural and organic cereal) to expand its portfolio and take advantage of Kashi's strong and loyal customer base; emphasized by its "seven whole grain foods" slogan, this brand aims to provide great tasting, all natural and innovative foods that enable people to achieve optimal health, wellness and weight management goals. K is also starting to leverage the purchase of Morningstar Farms (meat alternatives). Regarding TFA, we note that recently, the company announced a major initiative to reduce TFA in Foods; and invested in a newly developed low-linolenic soybean oil. This initiative should make it possible to reduce or eliminate TFA while also minimizing the saturated fat content of their products. As a major part of this investment, Kellogg will become one of the first food manufacturers to use low linolenic soybean oil through an agreement with Monsanto. However, there currently is a significant shortage of low-lin soybean oil.

Response to obesity challenge in the context of the overall strategy

Kellogg views it own portfolio as being comprised mainly of "healthy" products, and hence looks at obesity as more of an opportunity and less of a threat. The Kellogg brand is also viewed as "wholesome" by consumers, according to management. At the same time, K is more focused on offering alternatives for the various consumer profiles, rather than moving the overall portfolio into more "good for you" categories. We agree with the company's stance on Obesity in regards to their cereal, wholesome bars, and meat alternative products segments, but we think that the rest of the portfolio is not as well positioned as concerns about obesity rise, and as consumers buy more products in the Health & Wellness segment. About 47% of domestic sales come from products such as biscuits (cookies and crackers) and other products such as Pop Tarts and frozen waffles

Investment recommendations

In this report we demonstrate that obesity is major theme for the industry to the extent that I) growing awareness of the relationship between diet and health influences consumption trends in a major way; II) consumers seem willing to pay a premium for products perceived as healthy, offering the industry a modest margin expansion opportunity, although we caution that all segments within the "healthy eating" business are not attractive; III) forthcoming regulation in Europe looks set to put pressure on high fat/high sugar products and to add complexity and cost for all; IV) there are growing litigation risks in the US; V) a step-up in R&D investments is inevitable and certainly desirable to develop a long-term competitive advantage.

It would be unreasonable for us to make stock calls purely based on the obesity theme…

Having said that, the operational performance of companies within the sector is dependent upon many other factors including management quality, execution, regional exposure/expansion, cost savings initiatives etc… Therefore it would be unreasonable for us to make stock calls purely based on this theme. Nevertheless, we think some companies are better positioned and/or better prepared than others, from our analysis of the potential consequences of obesity for the sector.

…but we think some companies are better positioned and/or better prepared than others

We discuss below obesity and the conclusions of our report in the context of some of our stock recommendations. In addition, we highlight in this section what a few JPMorgan analysts consider to be interesting companies to watch around the theme of obesity outside the consumer sector.

Valuation discussion and risks to our ratings and price targets for stocks recommended in this section are summarised in Appendix VI.

European Food Sector

Cadbury Schweppes[1]

Cadbury Schweppes is leading producer of soft drinks and confectionery products. These products are indulgent products and the vast majority of them have by definition a high fat and/or sugar content. We estimate that the contribution of high fat/sugar /salt (HFSS) products to group sales decreased from c.84% in 2000 to 62% in 2005E – for detailed company profiles, benchmarking analysis and definitions, see the last section of the report page 59 – owing its expansion via acquisitions in chewing gum and strong growth in diet carbonated soft drinks.

Table 6: Top Cadbury brands in the UK

Brands	Sales growth
Cadbury Dairy Milk	-0.8%
Cadbury Flake	24.5%
Cadbury Roses	18.4%
Cadbury Buttons	1.6%
Cadbury Creme Egg	-13.6%
Cadburyland	3.1%
Total	2.9%

Source: ACNielsen (52 w/e 2 Oct 04 vs. 52 w/e 1 Oct 05), The Grocer.

Based on our detailed analysis of risks/opportunities created by obesity we draw the following conclusions. We think that Cadbury Schweppes should continue to benefit from solid growth within the chewing gum category – regarded by many consumers as a low-calorie snack – and we believe that the strong focus on new product development, the quality of its brands and marketing should lead to continuing market share gain and margin improvement. We think its chocolate business, which is primarily focused on the UK, Canada and Australia, may suffer a bit from rising health concerns and if chocolate is banned from UK schools, but in general we

[1] Under applicable law and/or J. P. Morgan Chase & Co policy the recommendation for this company has been removed

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Cadbury's diversified portfolio and recent innovation (e.g. 100 calorie bar) should allow the group to benefit from consumers' arbitrage

believe chocolate is seen as one of these treats people are not ready to sacrifice and we feel that Cadbury's diversified portfolio and recent innovation (e.g. 100 calorie bar) should allow the group to benefit from consumers' arbitrage – seeTable 6. We believe growth in its sugar confectionery business is likely to remain sluggish, in line with market trends. We think the Beverages business, which is focused on US/Canada/Mexico and Australia, should benefit from good growth in its under-developed diet carbonated soft drinks portfolio which should be offset to a large extent by a decline in regular CSD consumption.

In the US, its large non-CSD business (incl. Snapple, Hawaiian Punch, Mott's, Clamato) has been slow to introduce diet versions and this could represent an opportunity going forward. However, growth in the juice drinks, fruit juice and RTD tea categories has slowed significantly over the past 5 years and we believe that Cadbury has missed the growth opportunity offered by water and sports drinks. Last we highlight the risk of litigation in the US soft drinks industry as potential negative for the group.

Danone - Overweight

Ten years ago, Frank Riboud, CEO, made the decision to refocus and reposition Danone as a "healthy food" company focused on three core business: fresh dairy products (primarily yogurts), bottled water and biscuits. Over the past ten years, through strong marketing/branding, product innovation, R&D investments and acquisitions and divestitures Danone has grown to become a market leader (or co-leader) in its three businesses. The biscuits business, which accounts for less than c18% of 05e sales, seems to be the odd one out within a portfolio positioned to respond to consumer health and nutrition concerns. Having said that, close to half of biscuit sales are derived from Asia where Danone's biscuits are positioned (and recognised) as nutrition products often enriched with a number of nutrients to offset certain deficiencies, while in Europe its products are increasingly marketed as substitutes to RTE cereals.

Danone looks well positioned to continue to benefit from consumers' growing health and nutrition concerns

Based on our research, we believe that Danone is well positioned to continue to benefit from consumers' growing health and nutrition concerns. We expect sales to continue to grow at c.7% p.a., i.e. well above industry average, on the back of solid growth in fresh dairy products driven by pro-biotics such as Actimel, Bio and Activia, solid growth in beverages driven by Asia and flavoured/functional waters in Europe, moderate growth in biscuits. We think that Danone's new product development should support further margin progression in line with management guidance (c.30bp p.a.). On the downside, we believe that the new proposed EU regulation on "Nutrition and Health Claims made on Foods" will add some complexity to the product launch process (EFSA prior approval) in Europe and that Danone's marketers will have less room for manoeuvre and creativity in terms of claims phraseology. Having said that, we believe Danone is well prepared to deal with this and should ultimately benefit from the fact that R&D will be better protected.

Danone shares have outperformed the European food sector in five of the last six calendar years, making it the best performing stock with the sector since 2000. We have been positive on the stock all along and Danone remains one of our top picks in the food sector for 2006. Danone's strategic positioning on health and nutrition clearly underpins our investment thesis on the stock. Our recommendation on the stock is Overweight with a DCF-based January 2007 Price Target of €100.

Nestlé has been focussed on the nutrition, health and wellness market for many years now

Nestlé - Overweight

Nestlé is largest food and beverages company globally with 05e group sales of SF92.4bn. Food & beverages, excluding petfood and pharma, account for 83% of group sales. Nestlé is a #1 or strong #2 player in the vast majority of categories in which it competes including soluble coffee, bottled water, chocolate/malted drinks, shelf stable dairy, baby food, ice cream, culinary products, chocolate etc…. Nestlé's strategy is to develop into the "leading food, nutrition, health and wellness company". This strategy is not a reaction to obesity itself but it is certainly a "response to the nutritional challenges of our day" in phase with Nestlé's roots and fully consistent with the vision developed by Mr Brabeck since he was appointed CEO in 1997. In that context the strong presence of Nestlé in chocolate and ice cream, which represent slightly less than a quarter of group sales, could be questioned but we think these activities bring critical mass to the group in some markets, they carry the Nestlé brand and that Nestlé is comfortable with its presence in these activities. In total we estimate that "Healthier" products account for 68% of food & beverages sales and "Better for you" another 6%.

In conclusion, based on our research, we believe that Nestlé is well positioned to benefit from growing consumer demand for food products bringing clear nutritional and health benefits, both in terms of sales growth and margin. Its 60/40+ process - see page 51 and 71 for more information – should play a key role in this. Looking at its chocolate business what we said about Cadbury applies to chocolate: in essence, we don't see chocolate sales collapsing, although there could be short-term blips as regulatory measures take effect, but demand for lighter and better quality products should remain. However, we think sugar confectionery will continue to underperform and Nestlé does not have a chewing gum business to compensate. Considering its ice cream business, Nestlé, through Dreyer's, had a huge success after introducing its slow-churn technology, which allows it to cut the fat content by 75% without compromising taste. Such an initiative shows that keeping these businesses is not incompatible with the group stated strategy. Looking at other potential risk areas, we highlight the implementation of the new EU regulation on Health and Nutrition as making the new product launch process more complex. In addition, some RTE cereals products which have too high a sugar content may be challenged to reformulate or drop health claims under the new rules. However we feel Nestlé is well prepared – see our comments on labelling and R&D - and would highlight that we believe more regulation is good news for Nestlé.

We believe more regulation is good news for Nestlé.

Nestlé also is one of our top picks in the European food sector. Its "health, wellness and nutrition" strategy is key pillar of our investment thesis but its global reach, its market leadership, the quality of the organization and its valuation are equally important. Our recommendation on the stock is Overweight with a DCF-based January 2007 Price Target of SF460.

We estimate that high fat/sugar/salt products account for c40% of foods sales

Unilever - Underweight

Unilever is one of the global leaders in the food, household and personal care markets. Foods account for c56% of sales. We estimate that high fat/sugar/salt products account for c40% of foods sales primarily due to its large ice cream, mayonnaise, salad dressing and to a certain extent margarine businesses – in which Unilever has a global #1 position.

Based on our research, we feel that Unilever does not have the best portfolio to seize the opportunity created by consumer growing aspiration for healthier food products.

On one hand it has great assets such as I) the Knorr brand, its largest, which should benefit from its positioning as a provider of healthy and enjoyable meal solution; II) its cholesterol-lowering platform (pro-Activ) which has supported and should continue to support strong value creation within its margarine business, and which is creating opportunities in fresh dairy products too; III) a global leading position in tea, which has yet to fully exploit its health and wellness image. On the other hand, it has I) a large exposure to the ice cream market, which has been relatively slow, and Unilever has been slower than Nestlé to capture the low-fat opportunity; II) its mayonnaise/sauces business is very profitable but growth has been slow in spite of Unilever's continuing effort to introduce 'Light' versions; III) Margarine volume sales have been declining due to private label competition and declining penetration of the category. Now, we think that Unilever has responded well to the obesity challenge and there is a strong commitment internally to genuinely address health and nutrition issues (through reformulation for example – see page 70 for more information on this). In addition, Unilever has some strong R&D capabilities which could help bring more healthy products to the market.

However, Unilever has some strong R&D capabilities which could help bring more healthy products to the market

Unilever's organic sales growth has been disappointing over the past couple of years but there are several factors at play and product profile/category exposure is just one of them. Our recommendation on the stock is Underweight with a DCF-based October 2006 Price Target of €58/590p per NV/PLC share

Others

In our opinion, a beneficiary of the potential introduction of subsidies on vegetables/fruit, an idea which is gaining ground among health policy makers, could be Bonduelle (BON FP), which is one of the leading French and European leaders in that field (JPMorgan does not cover this stock). For more on this, see Fat Tax vs. Healthy Food Subsidy section page 36.

US Food Sector

US Food

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Campbell - Overweight

Campbell is the largest soup producer in the United States with a combined 70% market share (85% market share in condensed soup and 56% market share in ready-to-serve soup). The NA soup and food service division accounted for 39% of total sales in FY03, the global biscuits and confectionery business (Pepperidge Farm, Arnott's, and Go diva) contributed 27% of sales, and the NA sauces (Prego, Pace) and beverages (V8) division accounted for 19% of sales. In total about a third of company sales are generated outside the US (international soups and sauces sales account for 16% of total revenues).

Response to health & wellness trends: Management believes the product portfolio is well positioned to health and wellness trends, given its great reliance on soups, vegetable based juices (V8), and tomato based sauces (Prego, Pace). While CPB also competes in more indulgent categories like biscuits (PF cookies, Goldfish crackers, and Tim Tam cookies at Arnott's in Australia) and chocolate (Godiva), we expect growth to come from soups. Top line and margin expansion is expected to come from soups as the company develops new platforms such as vegetable soups under the V8 name, aseptic soup, microwaveable formats, and refrigerated soups. Most of the company's R&D dollars have gone towards improving the composition (or health profile) of CPB's products and this trend has accelerated recently. Although the total dollar spent on R&D has remained stable, the proportion devoted towards reducing sodium and TFA's has increased over the years regarding ingredients, the company is working on reducing sodium and cutting TFA: 1) *Sodium reduction program:* The company is currently engaged in various sodium reduction programs but did not comment any further on specifics of the projects. Some product lines are offered with lower sodium content (Healthy Choice). This topic is of critical importance to the company due to its relevance regarding health claims. High sodium contents do not allow the company to issue health claims; 2) *TFA reduction innovation:* Initiatives in this category have centered around their Crackers products, mainly in Gold Fish, which is all TFA free now. Some of the other baked goods have little bit of TFA. Within soups there is TFA in some of the products, and all Kids soups are TFA free.

General Mills – Neutral
General Mills is the second largest packaged food company in the US, with 2003 revenues of $10.5 billion. The company derives 71% of revenues from retail sales in the US, which includes cereal, baking and dinner mixes, soups, refrigerated dough, granola bars, and yogurt. Mills also operates a foodservice arm, which contributed 17% to 2003 revenues. The international business so far only contributes 12% of revenues (Canada alone accounts for 30% of the international business). UK-listed drinks group, Diageo, owns 21% of General Mills, and the rest is chiefly free float.

Response to health & wellness trends: The company believes that Health and Wellness will drive food industry growth in the future and that their portfolio is very well suited to capitalize on these trends. According to our estimates 72% of their portfolio can be categorized as healthier foods and the rest (or 28%) is considered "not so healthy". GIS looks at the obesity issue from a product category perspective, and believe that they are mostly in categories that suit the health and wellness trend, which puts them at a strategic advantage. As part of this health and wellness initiative they plan on leveraging the following four categories; Cereal, Yogurt (Yoplait), Veggies (Green Giant) and Organic Foods combined with Soy Beverages. Their objective is to use health and wellness as an innovation platform to provide consumers with alternatives in terms of taste and variety, convenience, healthy or "better than" products. The bottomline is that the company views the health and wellness trend as an opportunity for growth and is not too concerned about obesity related risks (due to their portfolio mix). However, we will be watching closely the company's recent push to market its products (in some cases brands) as "healthy". Health claims are a hot topic amongst regulators and could pose a long term risk for GIS.

Hershey - Overweight
Hershey Foods generated $4.2 billion in revenues in 2003, operating primarily in the candy and gum categories in the U.S. (chocolate is 77% of revenues). Hershey owns or distributes strong brand name products including Reese's, Kisses, and Kit Kat. Hershey derives 90% of sales from the U.S., 5% from Canada and Mexico, and the remainder from overseas operations. The Milton Hershey Trust owns 78% of Hershey's voting shares and 33% of its economic interest.
Response to health & wellness trends: HSY is in the indulgence business, and we expect that to remain the focus. But by the same token, the company has recognized one of its key strengths is its distribution prowess to single-serve channels and has expanded its product portfolio to the overall snacks category, rather than just confectionery. Clearly, the broader snacks arena offers more opportunities in terms of introducing new products more geared to health and wellness, and we would expect HSY to further increase its exposure to 'better for you' categories as its portfolio evolves (cereal bars, nutritional bars, protein bars, nuts).

HJ Heinz - Underweight

Heinz generates 60% of revenues from its International division, 25% from Consumer Products in North America, and 15% from U.S. Foodservice. Heinz has focused its global business on 15 core flagship brands that account for 60% of sales and 70% of EBIT. In the United States, Heinz derives 35% of revenues from prepared frozen foods, 27% from frozen potato, and 17% from ketchup. However, the international product portfolio remains significantly more diversified. In total the UK and Continental Europe account for more than 60% of Heinz's international sales. Heinz's vision is to be the "world's premier food company." The company is no longer controlled by descendants of H.J. Heinz.

Response to health & wellness trends: According to management, HNZ's portfolio has a good mix of "healthy" vs. "not so healthy" products (French Fries Vs Beans, Tomato Sauce and Soup). However, due to the fact that a major portion of its sales come from potato related products (most of which are fired), the company is exposed to obesity related risks. The driving principle behind their product development, "quality and taste are necessary attributes of the final product" has limited the company's ability to transform itself into a manufacturer of healthy foods. However, we note that the company is making the most of its current portfolio mix (healthy vs. not so healthy) by leveraging products that have a better health profile.

Kellogg –Overweight

Kellogg generated revenue of $9.6 billion in 2004 (33% from outside the US). Its most visible product categories include cereal, cookies, crackers, and wholesome snacks. Kellogg faces competition from General Mills in cereal (and from Kraft and Quaker Oats, to a lesser extent) and Kraft is Kellogg's primary competitor in cookies and crackers. In 2001, Kellogg paid $4.6 billion for Keebler and diversified its portfolio into the faster growing snacks category. In addition, the acquisition provided the company with a mature Direct Store Delivery (DSD) infrastructure.

Response to health & wellness trends: Kellogg views it own portfolio as being comprised mainly of "healthy" products, and hence looks at Obesity as more of an opportunity and less of a threat. The Kellogg brand is also viewed as "wholesome" by consumers, according to management. At the same time, Kellogg is more focused on offering alternatives for the various consumer profiles, rather than moving the overall portfolio into more "good for you" categories. We agree with the company's stance on Obesity in regards to their cereal, wholesome bars, and meat alternative products segments, but we think that the rest of the portfolio is not as well positioned as concerns about obesity rise, and as consumers buy more products in the Health & Wellness segment. About 47% of domestic sales come from products such as biscuits (cookies and crackers) and other products such as Pop Tarts and frozen waffles (combined approximately 47% of sales).

Kraft Foods – Neutral

With total revenues of $30 billion in 2002, Kraft is the second largest food company in the world (after Nestlé). Kraft North America accounts for 72% of total revenues, and Western Europe accounts for more than half of the company's non-US business. Kraft sells a wide portfolio of products including cheese, cold cuts, crackers, cookies, coffee, cereal, desserts, and powder drinks, and ranks #1 or #2 in several product categories. Altria (MO) has an 84% economic interest in Kraft and controls 98% of the votes. Kraft had its IPO on June 12, 2001 at a price of $31 per share

Response to health & wellness trends: The Company views the movement of global consumer perception towards health and wellness as an ongoing trend that will strengthen over time, and believes that companies that don't make an effort to transform or reposition themselves into "manufacturer of healthy foods" will be at risk. Hence, they view Obesity as an opportunity more than a challenge and up to date have led the transformation process amongst the packaged food group that we cover. Although the company has taken the initiative in the transformation process, we note that approximately 40% of the company's portfolio can be categorized as "not so healthy", and hence it is still exposed to Obesity related risk (maybe more so than other packaged food companies). KFT has begun repositioning itself through branding, product innovations, and advertising/communication and R&D initiatives. Amongst the companies we cover, KFT has certainly been a leader in this transformation process. KFT has also worked together with federal agencies as well as state level authorities to develop self-regulation mechanisms for the food industry to combat the obesity epidemic.

Dean Foods - Overweight

Dean Foods is the largest processor and distributor of fluid milk and manufactured dairy products in the US, generating sales of $10.8 billion in FY04 (ending December). The company's line of branded and unbranded dairy products are sold through all relevant distribution channels and include fluid milk, ice cream, cultured products, soymilk, and organic milk, among others. In 2005 the company span-off its Specialty Foods division, a manufacturer of private label pickles and non-dairy powdered creamers. Dean Foods currently has 3 divisions: (1) The Dairy Group, which made up 80% of FY04 consolidated sales, (2) White Wave (11% of sales), and (3) Specialty Foods (6% of sales). Dean also has dairy operations in Spain and Portugal (3% of sales), which are reported as a part of the Corporate/Other division.

Response to health & wellness trends: DF does not have a specific strategic approach to respond/adapt to the obesity epidemic as its product portfolio already positions the company rather well to increasing focus on health and wellness by consumers. Moreover, while cheese and ice cream are part of the current portfolio, the company's SKU rationalization program as well as the ongoing double digit growth we expect at Silk and Horizon should result in a greater portion of total company sales coming from "good for you" categories in the next two years. By FY07, we estimate Dean Foods should generate 75% of EBIT from its dairy business (primarily fresh milk) and the rest from the WhiteWave division, where products like Silk soy milk and Horizon organic milk account for about 60% of WW sales. DF span off its pickles and non dairy creamers business in 2005, and is now solely focused on dairy and the WW unit. We do not expect change in terms of product mix within the dairy unit (mainly fresh milk sales), while soy milk and organic milk will probably increase their contribution to total White Wave sales given they are growing at a faster rate than other products within WW (such as Land o' Lakes and International Delight).

US Beverages Sector

US Beverages

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The Coca-Cola Company - Overweight

The Coca-Cola Company is the largest beverage company in the world with four of world's top five soft drinks brands and exposure to a number of other beverage categories. While Coke is still behind the curve relative to Pepsi in terms of health and wellness positioning, the company has become increasingly focused on expanding and strengthening its brand portfolio over the last couple of years, especially in diet/light CSD's and non-carbonated categories. We estimate CSD's now account for roughly 80% of Coke sales, compared with nearly 90% of mix only five years ago. Within the CSD business, we estimate diet/light brands account for less than 20% of mix but this business has been increasing over the last few years (especially in developed markets like North America and Europe).

We think Coke's 2006 new product pipeline looks solid with a number of new non-carb brands and line extensions. Last year, Coke stepped up marketing support by $400 million, much of which went towards new product development in non-carb and diet/light categories. In 2006, Coke plans to introduce a fortified juice called U Be and a sparkling juice called Haven. The company has also launched sparkling and flavored versions of Dasani water, and a low calorie sports drink under the Powerade brand. Net, while the Coke system hasn't moved as quickly into alternative beverage categories like bottled water and sports drinks as Pepsi, we think the company is beginning to make progress in terms of diversifying the product portfolio to capitalize on the health and wellness trend.

We like Coke heading into 2006 given solid volume momentum, limited downside risk to margins, and attractive valuation, which was punished in 2005 despite strong fundamental results. While currency risk is a concern, we think this is more than reflected in Coke's valuation. In addition, we think Coke volumes could come in above expectations in 2006, given: 1) underperforming markets such as Germany, India, and France should improve sequentially. 2) We think results in Japan and Latin America (two highly profitable markets for Coke) will remain strong this year given solid macro trends, which should offset lingering weakness in certain European markets. 3) We would expect Coke's $400 million in incremental marketing spending, most of which occurred in the back half of 2005 (especially in Q405) to have an impact on 2006 volumes.

PepsiCo – Overweight
PepsiCo is one of the world's largest food and beverage companies with 2005 sales expected to exceed $32 billion, on our estimates. The company's principal businesses include Frito-Lay, Pepsi-Cola, Gatorade, Tropicana and Quaker. We estimate that slightly more than half of PEP's sales come from food products with the balance coming from the beverage businesses.

More than any other name in the US beverage sector, Pepsi has focused on developing a portfolio with greater health and wellness positioning over the last few years. The company has diversified its portfolio through both large transformational acquisitions (such as the $14 billion Gatorade deal in 2001) and smaller "tuck-in" deals (such as the recently completed Stacy's Pita Chips). PepsiCo now has market leadership positions in sports drinks (Gatorade), bottled water (Aquafina), orange juice (Tropicana), and RTD tea (Lipton) and coffee (Starbucks Frappuchino and Double Shot). The company's solid positioning in non-CSD categories has offset softer CSD growth in recent years. We estimate carbonated beverages (including low or no calorie products) represent less than 20% of Pepsi's sales. We estimate "better" and "healthier" products, in aggregate, now represent about 37% of PEP mix, up from 28% of mix in 2000.

PepsiCo remains our top pick in the large-cap Beverages group. The company has a significant amount of earnings flexibility which we think has driven greater earnings consistency and visibility in earnings growth. Given very solid results year-to-date – in 2005, we think PEP has strong momentum heading into 2006, driven by: 1) its leadership position in fast-growing non-carbonated beverage categories, 2) continued strength at FLNA and PI, and 3) limited commodity cost exposure. We also think Pepsi International is well positioned to capitalize on both the growing Latin American market and favorable currency trends, and expect the division should continue to provide a strong source of profit growth over the next several years. PepsiCo is one of the few companies in our beverage universe with greater Latin American exposure than European exposure. Looking at Pepsi's quarterly earnings performance versus consensus expectations on a three-and six-month forward basis, it has demonstrated better consistency than the majority of its peers. Pepsi has not missed beginning of quarter consensus once since Q1 1999. We think this consistency of performance supports a higher relative valuation versus its large cap consumer peer group.

Thinking outside the (consumer analyst) box

While this report focuses exclusively on the European and US Food and Beverages sector we have asked a few analysts at JPMorgan to consider the implication of obesity for sectors they cover and the relevance of this issue in the context of their investment thesis. We have also added to the lists one or two companies that are not covered by JPMorgan, but whose activities are influenced by obesity.

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Pharmaceuticals & Obesity

Several drugs have been approved for weight loss but so far with relatively limited commercial success. The most popular pharmacological approach to obesity came in the 1990s with the combination of two existing diet drugs (fenfluramine and phentermine) into a cocktail known as "fen-phen". Each of these drugs were approved for short term use only and had not been studied in combination. Unfortunately this combination, when used chronically, was found to cause heart valve disease and sometimes death. This episode underlined the importance of side-effects in an area that is essentially treatable with lifestyle change and has left a highly cautious attitude amongst physicians and regulators. Nevertheless, this has not stopped the pharmaceutical industry from trying to develop new anti-obesity drugs.

The two main options available today to treat obesity are Meridia (Abbott) and Xenical (Roche / GlaxoSmithKline). In our view, these drugs have modest commercial value for three reasons:

1. Side effects: Meridia can raise blood pressure and has been associated with depression. Xenical requires strict adherence to a low fat diet otherwise patients will suffer uncomfortable gastrointestinal side-effects.
2. Cost & reimbursement: Xenical costs around $80 for a one-month supply and is not covered by medical insurance plans unless a patient is severely obese. We believe coverage rates are between 15-30% in the US.
3. Modest efficacy: Currently approved weight loss drugs help patients to lose some weight over a 12-month period, typically an additional 6-10lbs over diet alone. This sort of weight loss is recognized as providing a meaningful health benefit but it is not a radical change in weight or appearance. It's our perception that patients expecting these drugs to offer an easy way to substantial weight loss are frequently disappointed with the outcome and as a result are likely to stop taking the pills.

Sanofi-Aventis is developing a new type of weight loss drug that could be approved in the US in early 2006 according to management. This drug, Acomplia, works on a new drug target known as the cannabinoid receptor. Acomplia doesn't offer a major step forward in weight loss - as with existing weight loss drugs Acomplia can help patient lose an additional 10lbs of weight over diet alone across a 12-month period. However Sanofi-Aventis has shown that Acomplia has additional benefits beyond simple weight loss alone, for instance the drug favourably improves patients cardiovascular risk profile by raising "good" cholesterol and lowering triglyceride levels. In addition the drug has substantial benefits in type II diabetics and improves blood glucose control. These extra effects are the key to Acomplia's commercial potential (we expect the drug to be a multi-billion dollar revenue generator) because the positive effects on cardiovascular risk factors make it look more like a typical medicine and less like a lifestyle obesity drug. We believe this is the key to improving physician acceptance and unlocking reimbursement.

For now, the prescription obesity market remains a market for morbidly obese patients with substantial risk factors and certainly does not offer an easy way to rapid weight loss. From a consumer perspective we note that GlaxoSmithKline and Roche are attempting to move Xenical from prescription status to over-the-counter status (under the brand name Alli) as an adjunct to weight management programmes.

JPMorgan analyst Alistair Campbell rates Sanofi-Aventis Overweight with a multiples-based 12 month price target of €81.

TF1 & ITV - Underweight

Sebastien Mourot

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In this report, we have highlighted why we believe food companies will, in future, need to invest more heavily in R&D. As R&D becomes key for food manufacturers to build their competitive advantage, the marketing function will, in our view, become complementary rather than their primary focus. As a consequence, we expect marketing budgets to come increasingly under scrutiny after a decade of uninterrupted inflation. Above and beyond this structural trend, regulators in France and the UK have also been proactive in trying to setup more stringent rules restricting how certain food products are advertised, in particular to children.

Food companies have been spending, over the past decade, significant amounts of money to advertise on TV, and are now one of the main clients of TV broadcasters. In France, we believe the 10% decrease in adspend by food companies in 2005 led to a 330bps decrease in advertising revenue growth for TV broadcasters. Given the secular trends we highlighted above and new restrictions in place in France since 1 January 2006 and forthcoming in the UK, we would suggest investors take an underweight stance on European TV broadcasters and, in particular, French broadcaster TF1 (Underweight) and UK broadcaster ITV (downgraded to Neutral from OW on 13 Jan).

Weight Watchers - Neutral

Dara Mohsenian

(1-212) 622-6542

We believe Weight Watchers is well-poised to benefit from high and increasing global obesity rates given its position as the leader in education-based weight loss, strong brand name, a unique network of classroom leaders who are all former members, and a proven track record of sustainable weight loss. The company offers a weight loss education program with weekly meetings focusing on education and group support. Each week, over 1.5 million people attend approximately 46,000 Weight Watchers meetings in 30 countries, which are run by approximately 15,300 classroom leaders. Company-owned operations accounted for approximately 78% of total worldwide attendance in 2004, with the balance operated as franchises. 62% of 2005E revenues are expected to stem from weekly meeting fees, with the balance in product sales (26%), franchise commissions (2%), weightwatchers.com (5%), and other royalties (6%).

Despite solid long-term expansion potential, we rate Weight Watchers a Neutral given peer group high valuation at 20.8 times 2006E PE and 13.3 times 2006E EV/EBITDA. We also are concerned that alternative weight loss programs (NutriSystem, Curves, self-help diets, etc.) and diet drugs (Acomplia, in the Sanofi pipeline, which has more limited side effects than previous weight loss drugs) could limit Weight Watchers' share gains in the weight loss market. Despite the rapid dissipation of low-carbohydrate diets in NA over the last 18 months, Weight Watchers North-American company owned (NACO) organic attendance results have remained weak, with two year run-rates down -5.7% in both Q2 and Q3. We think this is partially attributable to competing diet programs.

Biotech Firms working in partnership with the industry
Phytopharm and Synomex are two pharma/bio-tech companies that seem to be well positioned to benefit from the growth in R&D budgets within the food industry. They have signed agreements with a number of food companies to develop ingredients and technologies in the fields of sweeteners and weight-loss reduction among others. For a detailed description of the partnerships see our section *Investment/Partnerships with biotech companies* page 53.

These companies are not covered by JPMorgan.

Appendices

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Appendix I: Extracts from the EU Commission Green Paper - 08-Dec-05

Taken and adapted from the EU Green Paper "Promoting healthy diets and physical activity: a European dimension for the prevention of overweight, obesity and chronic diseases" - 8 December 2005.

Obesity (BMI >30) is a risk factor for many serious illnesses including heart disease, hypertension, stroke, type-2-diabetes, respiratory disease, arthritis and certain types of cancer. The rising prevalence of obesity across Europe, particularly among young people, has alarmed health experts, the media and the population at large, and is a major public health concern.

EU data on obesity

Evidence from population surveys suggests that **obesity levels in the EU have risen by between 10% and 40% over the past decade**, and current data suggest that **the range of obesity prevalence in EU countries is from 10% to 27% in men and up to 38% in women**. **In some EU countries more than half the adult population is overweight** (BMI >25), and **in parts of Europe the combination of reported overweight and obesity in men exceeds the 67% prevalence found in the US's most recent survey**. Despite efforts by individuals, the loss of health to the population as a whole due to unhealthy diets and inactivity is very high: **a small increase in Body Mass Index (BMI), e. g. from 28 to 29, increases the risk of morbidity by around 10%**.

The number of EU children affected by overweight and obesity is estimated to be rising by more than 400,000 a year, adding to the 14 million-plus of the EU population who are already overweight (including at least 3 million obese children). **Across the entire EU25, overweight affects almost 1 in 4 children**. Spain, Portugal and Italy report overweight and obesity levels exceeding 30% among children aged 7-11. The rates of the increase in childhood overweight and obesity vary, with England and Poland showing the steepest increases.

The determinants of obesity

Weight gain in an individual is the result of an excess of energy consumed as food over energy expenditure. The **factors underlying the onset of obesity** are widely known:

- **high intake of energy dense micronutrient poor foods or sedentary lifestyles** are the most convincing factors determining obesity risk;
- **high intake of sugars, sweetened soft drinks and fruit juices, heavy marketing of energy dense foods or adverse socioeconomic conditions are also probable determining factors**.
- **High intake of non-starch polysaccharides and regular physical activity are convincing factors lowering obesity risk**;
- breastfeeding and home or school environments supporting healthy food choices for children are also probable lowering factors.

It should, however, be borne in mind that for some people it is going to be harder to maintain a healthy weight than for others because they are genetically disposed to storing fat, or because they have genetic dysfunctions which make it difficult for them to control the feeling of hunger. In fact, even if some scientists estimate that 40-70% of the variation in fat mass between individuals is determined by genetic factors, environmental factors remain important and determine the expression of these genes in individuals. Addressing the "obesogenic environment" therefore has a strong potential to curb obesity.

Obesity: A leading cause of diabetes, CVD and cancer

The relationship between diet, physical activity and health has been scientifically established, in particular regarding the role of lifestyles as determinants of chronic noncommunicable diseases and conditions such as obesity, heart disease, type 2 diabetes, hypertension, cancer and osteoporosis.

According to the *World Health Report 2002*, six of the seven most important risk factors for premature death (blood pressure, cholesterol, Body Mass Index, inadequate fruit and vegetable intake, physical inactivity, excessive alcohol consumption) relate to diet and physical activity (the odd one out being tobacco). Unhealthy diets and lack of physical activity are therefore the leading causes of avoidable illness and premature death in Europe.

In particular, dietary risk factors include shifts in the diet structure towards diets with a higher energy density (calories per gramme) and with a greater role for fat and added sugars in foods; increased saturated fat intake (mostly from animal sources) and excess intake of hydrogenated fats; reduced intakes of complex carbohydrates and dietary fibre; reduced fruit and vegetable intakes; and increasing portion sizes of food items. Other important lifestyle-related risk factors, apart from smoking and excessive alcohol consumption, include reduced levels of physical activity. Of particular concern is the increasingly unhealthy diet and physical inactivity of adolescents and children.

As relatively few risk factors cause the majority of the chronic disease burden, the related morbidity and mortality is to a great extent preventable. It is estimated that up to 80% of cases of coronary heart disease, 90% of type 2 diabetes cases, and one-third of cancers can theoretically be avoided if the whole population followed current guidelines on diet, alcohol, physical activity and smoking. Addressing lifestyle factors such as nutrition and physical activity therefore has an enormous potential for the prevention of severe morbidity and mortality.

- Type-2-diabetes, which accounts for over 90% of diabetes cases worldwide, is related to obesity, a sedentary lifestyle and diets high in fat and saturated fatty acids. Both prevention and treatment of type-2 diabetes need to focus on lifestyle changes (weight loss, physical activity, diets low in fat and saturated fatty acids). Particularly alarming is the increase in the prevalence of diabetes.

- Cardiovascular diseases (CVD) are together with cancer the most important causes of death and disease in Europe. Stopping smoking, increasing physical activity levels and adopting healthier diets are the most important factors in the primary prevention of CVD. The key recommendations for CVD prevention are maintenance of normal body weight, moderate physical activity of 30 minutes or more every day and avoidance of excess consumption of saturated fatty acids and salt.
- Dietary factors are estimated to account for approximately 30% of all cancers in industrialised countries, making diet second only to tobacco as a theoretically preventable cause of cancer. Consumption of adequate amounts of fruit and vegetables, and physical activity, appear to be protective against certain cancers. Body weight and physical inactivity together are estimated to account for approximately one-fifth to one-third of several of the most common cancers.

The economic consequences of obesity

Apart from the human suffering it causes, **the economic consequences of the increasing incidence of obesity are of particular importance**. It is estimated that **in the European Union, obesity accounts for up to 7% of health care costs**, **and this amount should further increase given the rising obesity trends.** Although detailed data are not available for all EU countries, studies underline the high economic cost of obesity: A report prepared by the United Kingdom's National Audit Office in 2001 estimated that obesity in England alone accounted for 18 million days of sickness absence and 30,000 premature deaths, corresponding to an annual direct health care cost of at least GBP 500 million. The wider costs to the economy, which include lower productivity and lost output, were estimated at a further GBP 2 billion per year. The 2004 report from the United Kingdom's Chief Medical Officer on the impact of physical activity and its relationship to health estimated the cost of physical inactivity at GBP 8.2 billion annually (including both the health care cost and the wider cost to the economy, such as days lost from work). In Ireland, the direct cost of treating obesity was estimated at some €70 million in 2002. **In the US, the CDC estimated obesity-attributable health care costs at $75 billion**. At an individual level, studies estimate that the average obese adult in the United States incurs annual medical expenditures that are 37% higher than an average person of normal weight. These direct costs do not take into account reduced productivity due to disability and premature mortality.

An analysis made by the Swedish Institute of Public Health concludes that in the EU, 4.5% of disability-adjusted life years (DALYs) are lost due to poor nutrition, with an additional 3.7% and 1.4% due to obesity and physical inactivity – a total of 9.6%, compared with 9% due to smoking.

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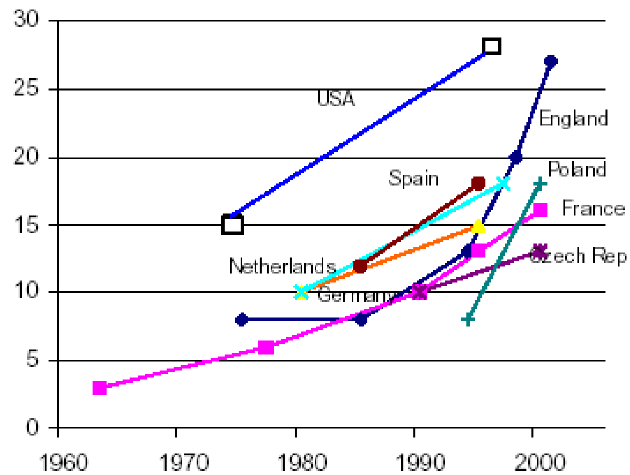
Appendix II: Obesity data

Figure 26: Rising prevalence of overweight children (5-11)

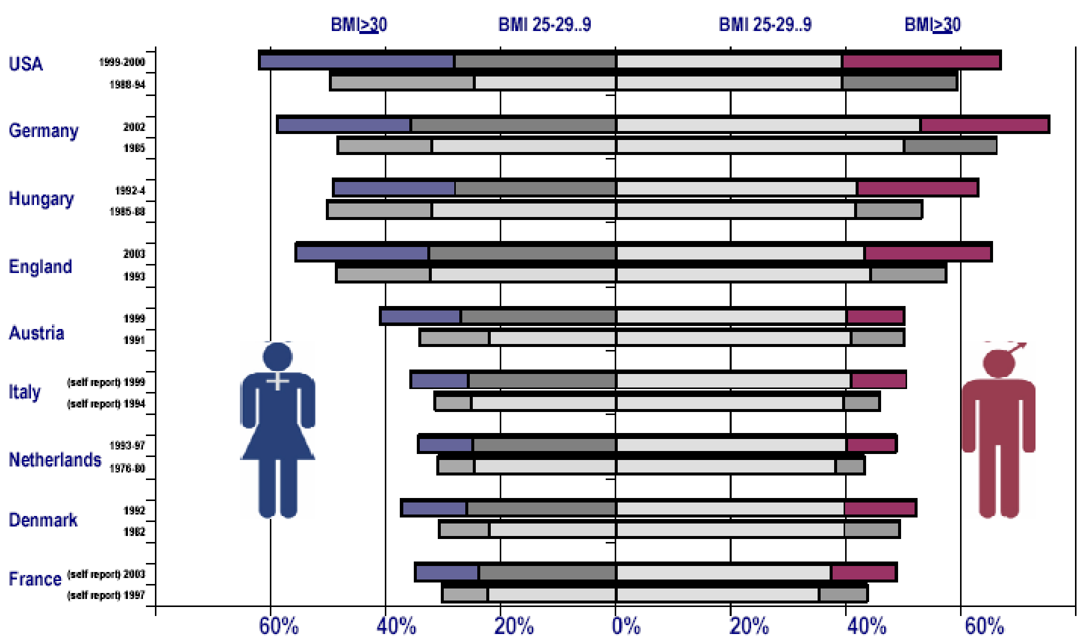
%



Source: EASO

Figure 27: Changes in adult overweight and obesity in selected countries

BMI



Source: EASO

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Table 7: Overweight and obesity among adults in the European Union

%

		Males			Females		
Country	**Year of Data Collection**	**% BMI 25-29.9**	**% BMI >30**	**Combined BMI>25**	**% BMI 25-29.9**	**% BMI >30**	**Combined BMI>25**
Austria	1999	40	10	50	27	14	41
Belgium	1994-7	49	14	63	28	13	41
Cyprus	1999-2000	46	26.6	72.6	34.3	23.7	58
Czech Republic	1997/8	48.5	24.7	73.2	31.4	26.2	57.6
Denmark	1992	39.7	12.5	52.2	26	11.3	37.3
England	2003	43.2	22.2	65.4	32.6	23	55.6
Estonia (Self Report)	1994-8	35.5	9.9	45.4	26.9	15.3	42.2
Finland	1997	48	19.8	67.8	33	19.4	52.4
France (Self Report)	2003	37.4	11.4	48.8	23.7	11.3	35
Germany	2002	52.9	22.5	75.4	35.6	23.3	58.9
Greece	1994-8	51.1	27.5	78.6	36.6	38.1	74.7
Hungary	1992-4	41.9	21	62.9	27.9	21.2	49.1
Ireland	1997-99	46.3	20.1	66.4	32.5	15.9	48.4
Italy (Self Report)	1999	41	9.5	50.5	25.7	9.9	35.6
Latvia	1997	41	9.5	50.5	33	17.4	50.4
Lithuania	1997	41.9	11.4	53.3	32.7	18.3	51
Luxembourg	45.6	15.3	60.9	30.7	13.9	44.6	
Malta	1984	46	22	68	32	35	67
Netherlands	1998-2002	43.5	10.4	53.9	28.5	10.1	38.6
Poland (Self Report)	Published 1996	n/a	10.3	n/a	n/a	12.4	n/a
Portugal (Urban)	2003	n/a	13.9	n/a	n/a	26.1	n/a
Slovakia*	1992-9	49.7	19.3	69	32.1	18.9	51
Slovenia (Self Report)	2001	50	16.5	66.5	30.9	13.8	44.7
Spain	1990-4	47.4	11.5	58.9	31.6	15.3	46.9
Sweden (adjusted)	1996-7	41.2	10	51.2	29.8	11.9	41.7

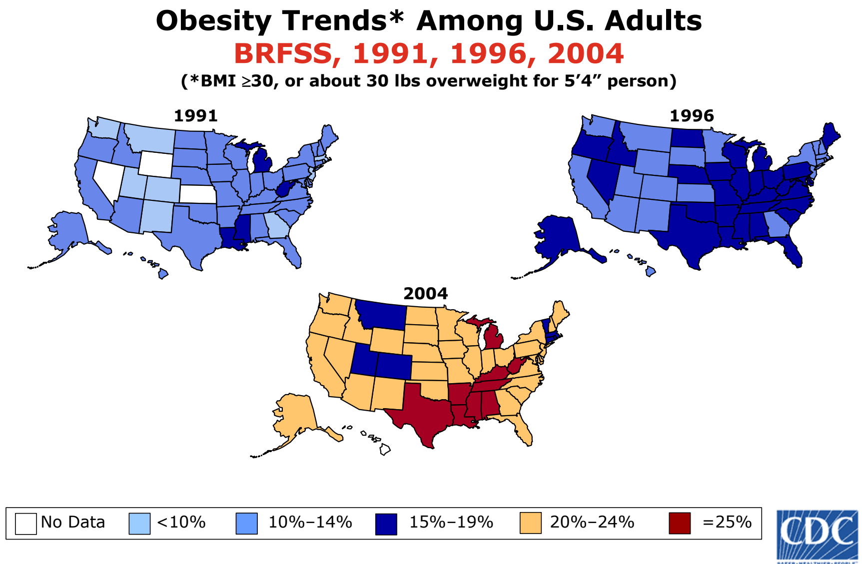
Source: IOTF Database

Age range and year of data in surveys may differ. With the limited data available, prevalences are not age standardised. Self reported surveys may underestimate true prevalence.

* - Slovakia: IOTF estimate based on measured data.

Obesity Trends Among U.S. Adults between 1985 and 2004 – Source: CDC

Figure 28: Obesity Trends* Among U.S. Adults



Source: Behavioral Risk Factor Surveillance System, CDC.

- The data shown in these maps were collected through CDC's Behavioral Risk Factor Surveillance System (BRFSS). Each year, state health departments use standard procedures to collect data through a series of monthly telephone interviews with U.S. adults.
- Prevalence estimates generated for the maps may vary slightly from those generated for the states by BRFSS (http://aps.nccd.cdc.gov/brfss) as slightly different analytic methods are used.

During the past 20 years there has been a dramatic increase in obesity in the United States. In 1985 only a few states were participating in CDC's BRFSS and providing obesity data. In 1991, four states had obesity prevalence rates of 15-19 percent and no states had rates at or above 20 percent.

In 2004, 7 states had obesity prevalence rates of 15–19 percent; 33 states had rates of 20–24 percent; and 9 states had rates more than 25 percent (no data for one state)."

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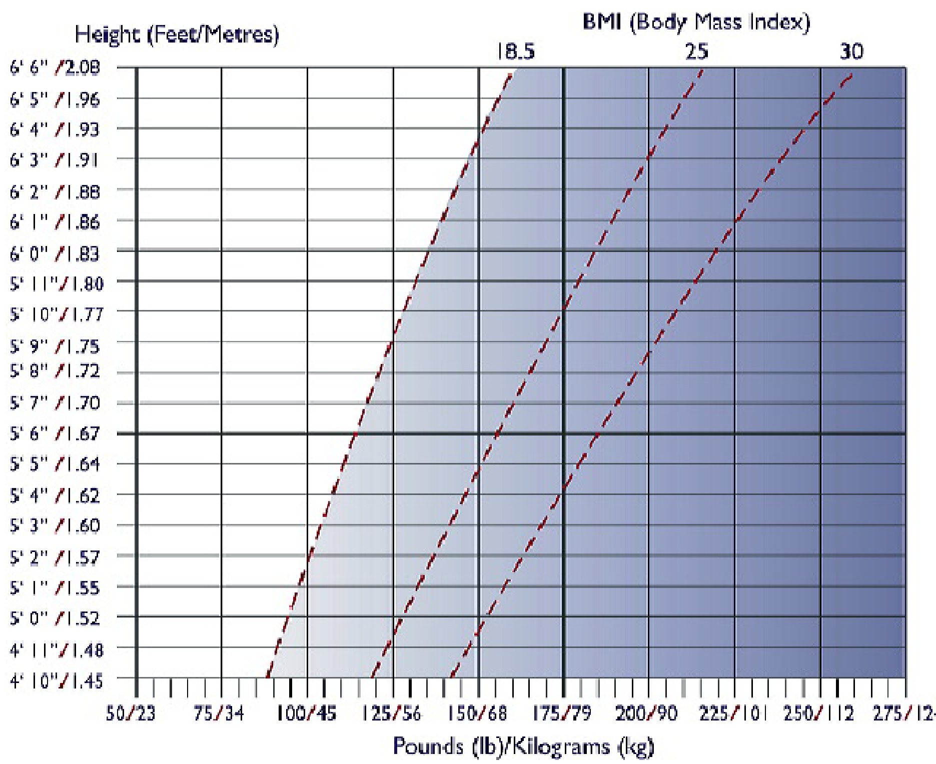
Appendix III: BMI calculation

Taken and adopted from International Obesity Task Force's EU Platform Briefing Paper.



Body Mass Index
This was developed in the early 19th century by the celebrated Belgian mathematician Adolphe Quetelet who used the formula BMI = kg / m^2 to aid his pioneering research on population statistics. The Quetelet Index now referred to more commonly as the Body Mass Index divides weight in kilograms by the square of height in metres.

WHO classification [1]

The World Health Organization adopted a classification to help define BMI status for adults:

- BMI < 18.5 - underweight
- BMI 18.5-24.9 – normal range
- BMI 25-29.9 – pre-obese
- BMI >30 – obesity

The pre-obese category is often referred to as overweight although this term technically refers to all those with a BMI of 25 or above, including the obese.

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Obesity is subdivided into three further categories:

- BMI 30-34.9 - Class I
- BMI 35-39.9 - Class II
- BMI >40 - Class III

In addition a WHO expert group has recommended that for Asian populations a lower "action point" of BMI >23 should apply in assessing weight and health status, given evidence of their vulnerability to heightened risk for related chronic diseases at lower BMI levels. [2]

[1] WHO - *Obesity: preventing and managing the global epidemic* - **WHO Technical Report Series 894 Geneva 2000**

[2] *Appropriate body-mass index for Asian populations and its implications for policy and intervention strategies –*

WHO expert consultation **THE LANCET • Vol 363 • Jan 10, 2004**

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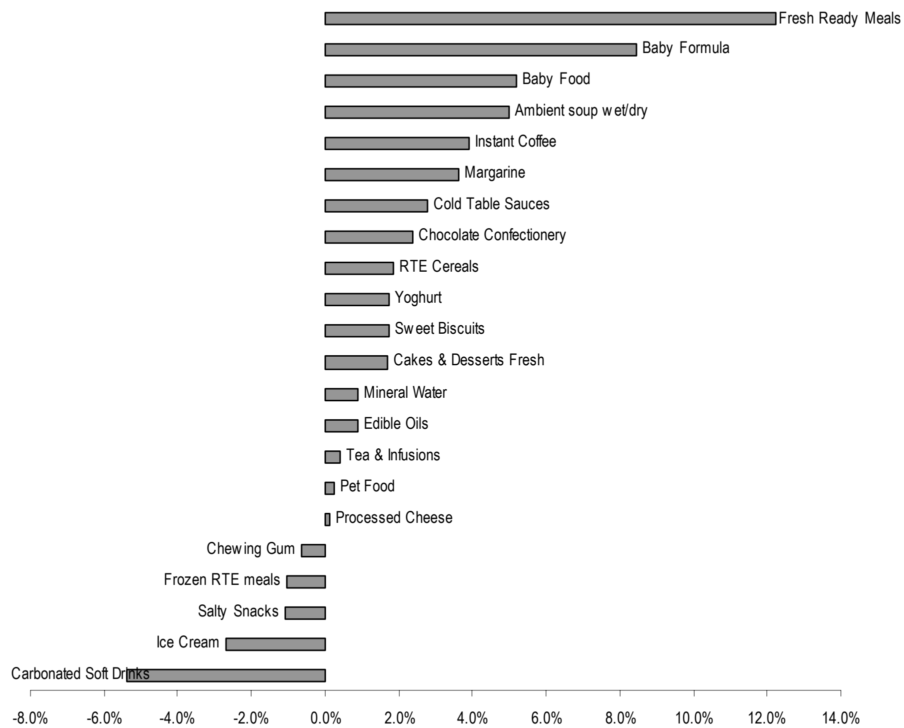
Appendix IV: Volume/value trends in the US and Europe

Figure 29: Volume growth of largest food categories in Europe, 04/05



Source: ACNielsen.

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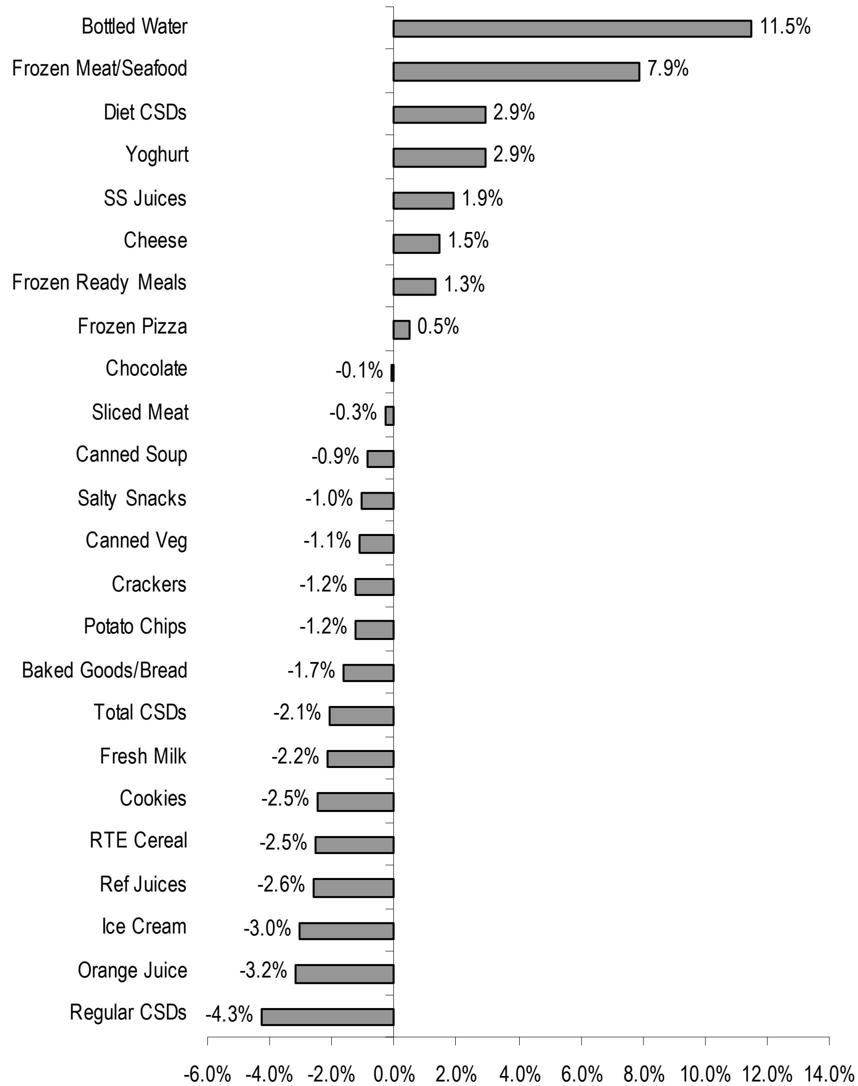
Figure 30: Volume growth of largest food categories in the US, CAGR 02-05



Source: ACNielsen.

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Appendix V: Front of pack nutrition information in the UK

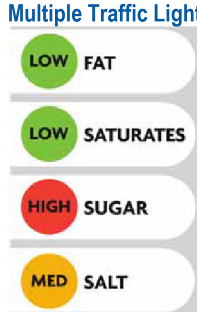
On November 16, 2005, the **UK Food Standards Agency has launched a consultation with consumers and the food industry on a food labelling scheme providing "at-a-glance information on whether a food is high, medium, low in total fat, sugar and salt**". This scheme is described as a front of pack multiple traffic light (MTL) scheme. This follows on the Department of Health's White Paper's objective to put in place " by early 2006, a clear, straightforward coding system, that is in common use and that busy people can understand at a glance which foods can make a positive contribution to a healthy diet, and which are recommended to be eaten only in moderation or sparingly."

Three systems were initially tested with consumers in the first part of 2005 and according to FSA research consumers preferred the Multiple Traffic Lights system to the Simple Traffic Lights, which was found to be too basic, and the GDA Concept, which was found to be too difficult to understand by a third of surveyed people (see illustration below).

The scheme is rather unique to the extent that i) it will appear on the front of the pack unlike traditional nutrition label that appears at the back, ii) it will list use a traffic light system which should send a strong instantaneous signal to the consumer about the nature of the food.

Simple Traffic Lights

Multiple Traffic Lights



GDA Concept with colour coding

	Per serving	GDA
FAT	7.7g	70g
SATURATES	2.0g	20g
SUGAR	42.4g	40g
SALT	2.0g	6g

HIGH MEDIUM LOW

Source: FSA

Appendix VI: Summary valuations and risks for companies recommended in this report

The most recent JPMorgan research report on securities mentioned herein is available at https://www.morganmarkets.com, or you can contact your JPMorgan representative

European Food Sector

Danone

We have an Overweight recommendation on Danone, with a January 2007, multiple and DCF-based price target price of €100 (from €95 previously), implying some 14% upside potential (based on an €87.0 share price at cob 18 January). Valuation remains attractive. With a PE for 06E of c18x, we believe Danone is now fairly rated both against the sector (c15% premium) and on an absolute basis. In the next 12 months we expect the stock to move more or less in line with EPS growth, or c. 15% based on our 2006 estimates, and thus we see the stock reaching €100 by January 2007. Our multiple-based price target for Danone is further supported by what we consider to be a relatively conservative DCF model pointing to €109 a share. To be clear, this represents a standalone valuation of Danone and this is consistent with what we wrote in our major September 2004 report in which we identified Danone as being significantly undervalued. Having said that, as we've consistently written through 2005, we believe that in a takeover situation, Danone could fetch up to €120-140.

Risks to our rating and price target: Downside risks to our Overweight rating and €100 price target include: a combination of significant slowdown in China, further deterioration of trading conditions in France and a further rise in oil prices.

Nestlé

We have an Overweight recommendation on Nestlé, with a January 2007, DCF-based price target price of SF460 (from SF425 previously), implying 19% upside. Nestlé's Food & Beverage business remains significantly undervalued, in our view. We estimate that 57% of the growth in Nestlé's market capitalisation (and share price) can be explained by the extraordinary performance of Alcon shares (+90% in Swiss Franc in 05) and to a lesser extent L'Oréal (+13%). This means that Nestlé's underlying food and beverages business hasn't rerated meaningfully in 05: based on our revised numbers (incl. c2.8% EPS upgrade for 06E and 07E), Nestlé's F&B business trades at a PE06E of 12.4x. At our new target of €460, Nestlé's F&B business would trade at a PE06E of 16.1x.

Risks to our rating and price target: Downside risks to our Overweight rating on Nestlé and price target include negative FX movements, a further deterioration in raw material cost pressure, and performance disappointments in Europe which could impact top line targets and delay realization of cost savings at the bottom line.

Unilever

We have an Underweight recommendation on Unilever, and a price target to October 2007 of €58/590p per NV/PLC share, offering little upside from the share price of €57.1/580p at cob 18 January. Valuation remains unattractive, in our view. On our estimates Unilever is currently trading at a PE06E of 16.0x i.e. more or less in line with Nestlé but on a c.10.4x EV/EBITDA 06E, which represents a premium to the sector. We see no room for multiple expansion given the disappointing operating performance and the risks related to the turnaround exercise. This is confirmed by our DCF analysis which points to a fair value of c€58/590p, our price target for NV/PLC shares.

Risks to our rating and price target: Upside risks to our rating, estimates and price target include a material improvement in the trading conditions in Europe and the US and a much faster than expected acceleration in LFL sales growth. Additionally, Unilever is exposed to many currency movements, which could affect sales and earnings.

US Beverages

PepsiCo - Overweight

We remain Overweight on PepsiCo, which is our top pick in the large-cap Beverages group. The company has a significant amount of earnings flexibility which we think has driven greater earnings consistency and visibility in earnings growth. Given very solid results year-to-date, we think PEP has strong momentum heading into 2006, driven by: 1) its leadership position in fast-growing non-carbonated beverage categories, 2) continued strength at FLNA and PI, and 3) limited commodity cost exposure. We also think Pepsi International is well positioned to capitalize on both the growing Latin American market and favorable currency trends, and expect the division should continue to provide a strong source of profit growth over the next several years. PepsiCo is one of the few companies in our beverage universe with greater Latin American exposure than European exposure. Looking at Pepsi's quarterly earnings performance versus consensus expectations on a three-and six-month forward basis, it has demonstrated better consistency than the majority of its peers. Pepsi has not missed beginning of quarter consensus once since Q1 1999. We think this consistency of performance supports a higher relative valuation versus its large cap consumer peer group.

Risks to our rating: We think the primary risk to our thesis on PepsiCo is a sustained slowdown in the Frito business. Another risk factor is share loss in the U.S. soft drink business given the much more aggressive competitive stance coming from the Coca-Cola system at this point.

The Coca-Cola Company

We rate Coke Overweight and like the stock heading in 2006 given solid volume momentum, limited downside risk to margins, and attractive valuation, which was punished in 2005 despite strong fundamental results. While currency risk is of concern to us, we think this is more than reflected in Coke's valuation. In addition, we think Coke volumes could come in above expectations in 2006, given: 1) underperforming markets such as Germany, India, and France should improve sequentially. 2) We think results in Japan and Latin America (two highly profitable markets for KO) will remain strong next year given solid macro trends, which should offset lingering weakness in certain European markets. 3) We would expect Coke's

$400 million in incremental marketing spending, most of which occurred in the back half of 2005 (especially in Q405) to have an impact on 2006 volumes.

Risks to our rating: We think currency represents the greatest potential risk for Coke, but think this is generally reflected in the current valuation and think downside is limited. We also think if the company fails to make strides against its revised objectives, we think the stock could underperform over the medium to long term.

US Food Sector

Kraft Foods – Neutral

Unattractive valuation, still see downside risk (would not buy on weakness as upside is pretty limited, in our view). On a 1-year forward basis our estimates are more than 20 cents below consensus, and based on the COB price of 20 January, the stock seems more than fairly valued on our estimates at a 1-year forward PE multiple of c16.5 times that puts in line with our large cap packaged food group average of c16.5 times. Given the operating risk, potential for even a lower base than currently anticipated for 2006, and downward profit margin trends, we would argue the stock should trade at about a discount to the group (KFT trades at a 5% discount on consensus estimates, but we do not believe these are realistic). As such, we see downside risk on KFT.

Risks to our rating: *We believe Kraft could outperform its peers if* a combination of some of the following events take place: 1) the company is able to post high single digit EPS growth, ahead of guidance and consensus; 2) the new marketing investment program leads to sustainable market share gains and higher price premiums; 3) the company's cost savings and productivity initiatives lead to margin expansion despite the higher marketing costs planned, 4) management announces major and accretive acquisitions that better position Kraft relative to "health and wellness" trends, and divests businesses in more volatile, lower-margin, commodity-like categories; and, 5) innovation brings back excitement to categories like cookies and crackers and results in higher value-added products in the more commodity-like categories. *Kraft could underperform if* 1) the company's marketing investment program does not improve market share trends, 2) new products prove cannibalistic and not accretive to margins, 3) the company is forced to increase marketing spend considerably in 2005, 4) commodity costs, especially in dairy, do not ease as expected, or lower costs are entirely offset as competitors (including private label) cut prices; 5) management is forced to cut guidance again, and, 6) dollar strength erodes overseas earnings.

Dean Foods – Overweight

We rate Dean Foods Overweight and estimate the valuation is attractive both in absolute PE terms and sum of the parts analysis. We expect DF to continue to outperform the peer group due to above average earnings growth potential (mid teens) and because the PE valuation does not yet fully reflect the WhiteWave division (Silk/Horizon) growth potential. We expect EPS growth in the mid teens in the next two years due to improving margins in the fresh milk business (as diary costs come down) and as the company reaps efficiencies from the acquisitions it has made in the sector over time (DF already has 30% share in fresh milk); we also expect DF to continue to roll up the fresh milk processing sector. The market implied valuation of WW is c15.5x 2007E but we believe that unit should trade closer to 30x given its top line growth trends in the high teens (gradual consumer switch to organic milk, soybean milk becoming more mainstream). Besides multiple expansion the potential for absolute above-consensus earnings upside in the next two years (both in Dairy and WhiteWave) should drive the share price up, in our view. Over the next two years we think the potential for a higher PE multiple and mid teens EPS growth should result in above average returns for DF shareholders, which should lead DF to outperform the food group.

Risks to our rating
We would highlight the following risks to our Overweight rating: 1) ability of Dean Foods to pass higher fluid milk costs to pricing given increased competition at processor and retailer level; 2) risk of deceleration in growth of Silk and Horizon if consumers do not respond to the new marketing program and as distribution gains become less extensive; 3) limited supplies or organic raw materials (for soybean milk as well as for fluid milk) could limit growth of White Wave in the short term (particularly of Silk and Horizon); and 4) disappointing valuation of the specialty unit once it is spun off later this year (in calendar 3Q05), or meaningful medium-term dilution to earnings could create downside to DF shareholders (spin-off will be debt-free).

HJ Heinz – Underweight

We rate HNZ Underweight. We are warming up to the company's fundamentals (improving trends), but remain Underweight due to valuation concerns, particularly when adjusting EPS (normalizing) for the asset sale dilution (25-29c), for the extra week in FY06 (5c), and for a more normal tax rate of 34-35% (10-16c). Making the above adjustments HNZ proforma 2006E EPS would be $1.90, which would imply the stock trades at c18.8 times based on COB price of 20 January. If we were to include guidance for 21 cents in one off items, the multiple would be 21 times. We observe none of these estimates assume option expense, which the company will start booking in FY07. While fundamentals may be improving, we do not believe these would justify the implied premium to the food group. The large cap packaged food group ex confectionery trades at 16.1 times 2006E on our estimates and at 15.3 on consensus. The 3yr average HNZ PE is 14.9 times.

Risks to our rating. The stock could perform better than we expect (in terms of our relative call vis-a-vis the packaged food group) if Heinz were to notably (1) benefit from recent product launches both in terms of top line and profit margin trends across all divisions, (2) generate meaningful cost saving from a more focused portfolio in the United States and overseas, (3) report sustainable improvements in the top- and bottom-line in Europe in organic FX neutral terms, (4) reap benefits from greater appreciation by consumers of the health benefits of tomato (and of tomato-based products), (5) engage in M&A activity that is meaningfully accretive to earnings at least by the second year, and or (6) become an industry consolidator.

Hershey – Overweight

Investment thesis: Rationale for our positive stance? We rate HSY Overweight because the company has the potential to provide absolute returns in the mid teens (EPS and dividends) in the next two years, faces low competition risk in chocolate, and is now more inclined to pursue value enhancing acquisitions in the domestic market (and overseas if the distribution synergies with the US market are immediate). Even without PE multiple expansion, we believe HSY should outperform peers just on EPS growth and dividends.

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Risks to our rating and price target. We would note the following risks: (1) an obesity backlash against chocolate and or heightened concerns about saturated fat, or reduced consumer purchasing power hurting confectionery sales (2) more aggressive price competition from Mars, (3) Hershey's new chocolate product platforms resulting in cannibalization, (4) marketing costs significantly creeping up as a result of new product launches in new segments, (5) an unsuccessful launch of new nutritional bars or delays due to the Abbott action, (6) a sustained spike in cocoa prices and or other raw materials (sugar, milk, almonds), (7) current CEO Rick Lenny leaving the company, (8) an acquisition that destroys value, and (9) Confectionery companies like WWY, Mars, Nestlé, and CSG starting to execute better at immediate consumption channels and taking shelf space or check-out counter space from HSY.

Kellogg Overweight

Investment thesis: On a fully comparable apples to apples basis, Kellogg trades at a c2% discount to the large cap food group based on our 2006 estimates, based on COB price of 20 January. Because First Call estimates reflect stock option expense for some companies and not for others, and treat so-called one off restructuring charges as one off for some companies but as recurring for others, we believe that comparisons of valuation multiples based on FC estimates for food stocks have little validity. To normalize and make earnings comparables, we are including on our "for valuation purposes EPS' both stock options expense as well as restructuring charges. As we see it, Kellogg actually trades at a 2% discount to the large cap packaged food group, compared to an 8% premium when not using normalized EPS. We believe the adjusted PE multiple of c18 times 2006E which implies a c2% discount to the group is still attractive given a PEG ratio of 1.8-2.0 times (on 9-10% EPS growth).

Risks to our rating and price target. The following could lead Kellogg to underperform its peers: (1) with Pillsbury integration glitches apparently behind it, General Mills is ramping up innovation and marketing investments in cereal, and it may pose a stronger threat to Kellogg (both companies have 32-33% market share); (2) pricing in cereal may become less favorable as GIS starts to cut promotional price points, and private label and Malt-O-Meal cut prices; (3) Kellogg faces new competitors in the wholesome snacks category; (4) the company's Keebler business faces tough price competition from Nabisco and Pepperidge Farm both in crackers and cookies, with the added concern that the company's cookie business has lost market share recently; (5) a failure to meet earnings guidance could dent Kellogg's valuation premium, particularly given the widespread belief (that we share) that recent cost savings programs have built a safety net that should allow Kellogg to at least meet GAAP EPS guidance in coming quarters.

Campbell – Overweight

Investment thesis: We rate CPB Overweight and have a June 2006 target price of $38 and the company is on the JPMorgan US Analysts Focus List. Our target price is based on our projection for 8-9% EPS growth, 2.5% dividend yield, and the potential for the current PE discount (on our numbers) to the large cap packaged food group (ex HSY/WWY) to become a slight premium. On a fully comparable, apples to apples basis, we estimate CPB trades at a 5% discount (the steepest in the group) to the large cap packaged food group. It also offers one of the most attractive PEG ratios in the food group, on our estimates. Better soup category dynamics, improved

EBIT margin visibility, consistent high single digit EPS growth, and enhanced sentiment on management, should all lead to a higher PE multiple, and a premium to the group. We expect the stock to trade at a 5-10% premium on a PE basis once the company begins to show clear indications of sustainable improving profitability trends both at the consolidated level and in the core soup business. With clear improving top-line and margin trends, CPB should trade above its historical averages, as the company's successful product innovation programs and "going to market strategies" warrant a premium to the stock's historical valuation, in our view.

Risks to our rating and price target. Campbell shares could underperform the group and the stock may not reach our $38 June 2006 target price if (1) EBIT margin expansion does not materialize by 4Q05 either because input cost trends worsen or the company does not realize the 4.8% soup price increase as planned (due to competitive pressures and or to a negative response from consumers/customers); (2) our thesis of sustainable growth in the condensed soup business is wrong, and recent growth proves to be only a one-off event; (3) rising obesity concerns hurt cookie/crackers sales at PF; (4) intensified competition outside soup hurts profit margins and sales (the PF division already faces the onslaught from Kraft in cookies and crackers, and Arnott's faces rising pressure from Frito Lay in Australia), or (5) the implementation of SAP causes serious sales disruptions and does not result in efficiency gains.

General Mills – Neutral

We have a Neutral rating, although we now have a more positive EPS outlook. In apples to apples terms (including options and charges for all companies) we see GIS as attractively valued relative to the group (c.16.5 on 1-year forward EPS, or about 6% below the large cap group average), which given its portfolio of leading brands (and good presence in "good for you" categories) and top line momentum could imply upside to the PE multiple. However, given our concerns about price premium sustainability, the potential impact on profit margins from lower yoy prices and higher A&P expense, and GIS's lack of a consistent track record in recent years (including coming in significantly above or below guidance), lead us to believe the current valuation is fair. Net, we do not see GIS as a food company that can consistently grow EPS in the high single digits.

Risks to our rating and price target. The following are risks to the upside: (1) significant management shake-up that boosts investors' sentiment on a turnaround at GIS as well and appeases our concerns about governance; 2) the product innovation pipeline helps to ignite category growth and leads to sustainable market share recovery in key segments like cereal, yogurt, baking mixes, and dough, without price cuts; (3) GIS starts to realize consistent price/mix gains in its retail division, without a meaningful impact on volumes; (4) foodservice produces faster than expected top and bottom-line growth; and (5) the IRS approves the claim of an $800 million capital loss (we note that GIS had pre-tax gains of $499 million in FY05 but only $284 million after tax gains, implying a tax rate of more than 40% on the gross gains). The following are risks to the downside: (1) Mills fails to meet EPS growth guidance owing to an overall more challenging competitive environment, given increasing new product actions from Kellogg in its US RTE cereal and in the granola bar business, share loss in refrigerated dough to Nestlé and private label, improved sales execution from Danone in yogurt, and more aggressive pricing and marketing from Campbell in the RTS soup business; (2) price realization in US retail is below guidance, (3) the company has to ramp up marketing spending significantly above the amount budgeted in the current guidance; and, (4) growing private label penetration in some of the company's key categories further limits pricing power.

Sanofi-Aventis – Overweight

Sanofi-Aventis trades at 15x 2006 earnings (on prices at COB 19 Jan), a 17% discount to the European sector. Our €81 12 month price target assumes 7% multiple expansion to move the rating to around a 10% discount to the group. Some discount is warranted, in our view, given the risks to key drugs; however, we assume the company gets an approval for its obesity drug, Acomplia, in 2006 and this new drug launch goes some way to offsetting other risks in the sales line. We expect Sanofi-Aventis to offer 12% compound earnings growth from 2005-2010, at the top end of the peer group excluding Roche.

Risks to our rating and price target: Our price target and Overweight rating assume a first half 2006 launch for Acomplia. Although we expect this drug to gain approval, there is always some risk with regulatory decisions. If Acomplia were to fail at the FDA the stock is highly likely to underperform. We assume no generic competition to Lovenox until mid-2008. It is possible that generic competition could come later (a positive) or earlier (a negative) however our mid-2008 estimate seems a fair balance of risk on this event.

Non-consumer stocks

ITV – Neutral

We rate ITV Neutral with a 12-month price target of 115p. ITV trades on a narrow discount to its European TV peers, currently trading on a 3% discount to its peers on 2007E PE but offers an 07E dividend yield of 3.7% vs. 3.9% for the sector. We note however that we could also adjust ITV's trading multiples to take into account the forecast decrease in its licence fee, given that by 2012, ITV will pay virtually no licence fee. If we adjust ITV's trading multiples by deducting licence costs from earnings forecasts and add back the 2005-12E NPV of licence costs to the share price, it trades on a 9% discount to its European TV peers on 2007E PE on our estimates. Given substantial decreases in licence and Public Service Broadcasting ("PSB") costs that we forecast in the forthcoming years, we believe DCF is the best tool to value ITV and use DCF (9.3% WACC, 2% terminal growth) to set our 12-month price target of 115p. Our price target of 115p was a 5% discount to ITV's closing price on 19 January 2006, and we believe the stock is fairly valued.

Risks to rating and price target: Risks include, on the upside, an acceleration in UK TV ad revenue growth, a removal of the Contract Rights Renewal ("CRR") remedy and a faster/greater than anticipated reduction in PSB costs. On the downside, risks include a slowdown in UK TV adspend growth, a slower/lower than anticipated reduction in PSB costs and CRR remaining as it is beyond 2008.

TF1 – Underweight

We rate TF1 Underweight with a 6-month price target of €21.0. The stock trades on a significant premium to its European TV peers at 20.4x 06E PE (vs. 16.8x for the sector) and offers an 06E equity-FCF yield of 4.3% vs. 5.5% for the sector. Following the recent successful launch of digital terrestrial TV in France, we expect to see declines in TF1's audience share and pricing power over time. Even after factoring in the positive impact of retail advertising deregulation in France from

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2007, we believe the stock is overvalued. We use a combination of DCF (8.9% WACC, 2% terminal growth) and SOTP to value TF1 and derive our 6-month price target. Our €21.0 price target was a 19% discount to TF1's 19 January 2006 closing price.

Risks to rating and price target: Upside risks to our rating include a greater than expected recovery in advertising revenues in 2006. Downside risks to our rating include execution risk associated with the reinvestment of TF1's large free cash flow, and a faster/greater than anticipated erosion in its audience share and pricing power following the recent launch of digital terrestrial TV in France.

Weight Watchers – Neutral

We rate Weight Watchers a Neutral. We see a number of positives: (1) WTW has a very solid business model with 2005E operating margin of 29.8% and ROIC of 24.3%, and a variable cost structure, (2) WTW has plenty of room for US expansion potential given its penetration of its target market of 25-64 year old overweight women, is only 8%. However, we think valuation of c.21x times 2006E EPS based on COB price of 20 January reflects the solid business model, and worry long-term about competing programs, including diet drugs with more limited side effects.

Risks to our rating: Upside risks to our Neutral rating include: (1) greater than expected organic NACO attendance growth, (2) upside from licensing activity or corporate solutions, and (3) a quick UK rebound. Downside risks to our Neutral rating include: (1) competitive pressure from alternative weight loss programs, and weight-loss drugs, including Sanofi's pipeline Acomplia drug, (2) lower than expected results from WTW's key growth initiatives, including licensing, .com, and corporate solutions, or (3) continued weakness in the UK.

Table 8: Stock recommendations / prices

Company	Rating	Price
European Food Sector		
Cadbury	**	555p
Danone	Overweight	€ 85.85
Nestlé	Overweight	SF 379.75
Unilever	Underweight	€56.35 / 570p
US Beverages		
PepsiCo	Overweight	$57.28
The Coca-Cola Company	Overweight	$40.09
US Food Sector		
Kraft Foods	Neutral	$4.00
HJ Heinz	Underweight	$33.60
Hershey	Overweight	$54.42
Kellogg	Overweight	$43.33
Campbell	Overweight	$30.40
Dean Foods	Overweight	$37.57
General Mills	Neutral	$49.23
Other Stocks		
Sanofi-Aventis	Overweight	€ 74.86
ITV	Neutral	108p
TF1	Underweight	€ 24.42
Weight Watchers	Neutral	$46.03

Source: Datastream. *** Under applicable law and/or J. P. Morgan Chase & Co policy the recommendation for this company has been removed.

Prices as at COB 20/01/2006

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Coverage Universe: **Arnaud Langlois:** Cadbury Schweppes (CBRY.L), Danone (DANO.PA), Nestlé (NESN.VX), Numico (NUMCc.AS), Premier Foods (PFD.L), Reckitt Benckiser (RB.L), Unilever NV (UNc.AS), Unilever plc (ULVR.L)

JPMorgan Equity Research Ratings Distribution, as of January 3, 2006

	Overweight (buy)	**Neutral** (hold)	**Underweight** (sell)
JPM Global Equity Research Coverage	41%	42%	17%
IB clients*	46%	45%	38%
JPMSI Equity Research Coverage	35%	49%	17%
IB clients*	63%	55%	43%

*Percentage of investment banking clients in each rating category.
For purposes only of NASD/NYSE ratings distribution rules, our Overweight rating falls into a buy rating category, our Neutral rating falls into a hold rating category, and our Underweight rating falls into a sell rating category.

Valuation and Risks: Company notes and reports include a discussion of valuation methods used, including methods used to determine a price target (if any), and a discussion of risks to the price target.

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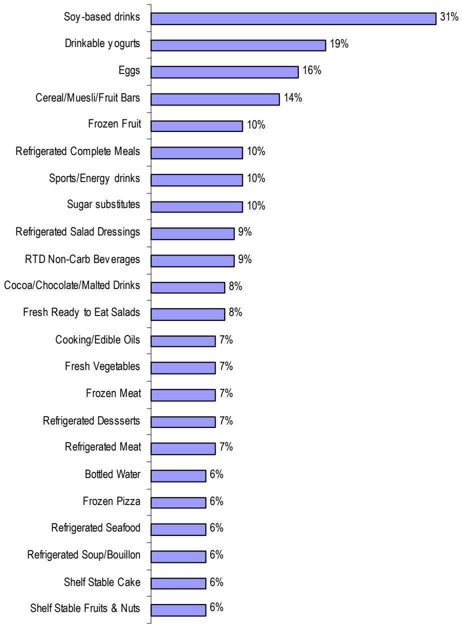
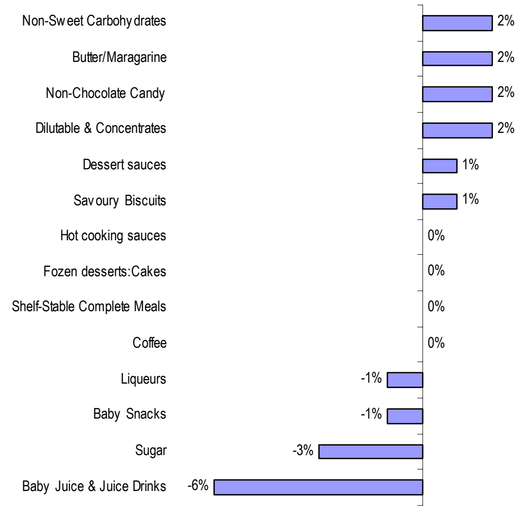
Figure 31: Fastest growing F&B categories across the world, 03-04



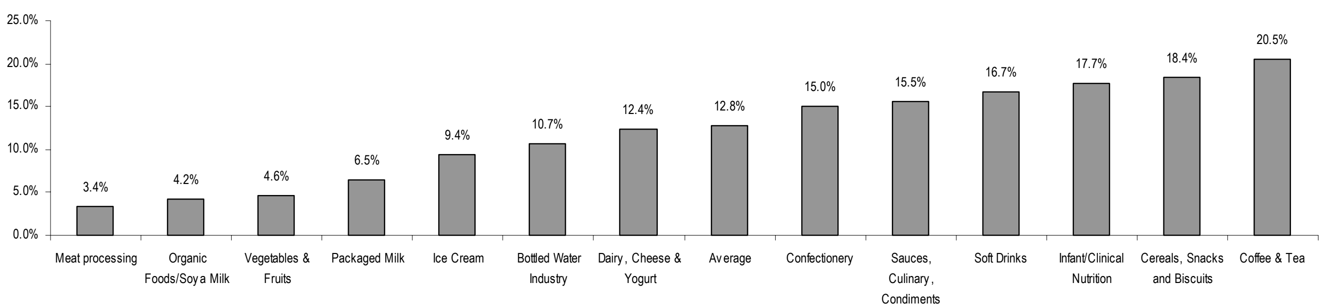
Source: ACNielsen. As of July 2004

Figure 32: Lowest growth categories globally, 03-04



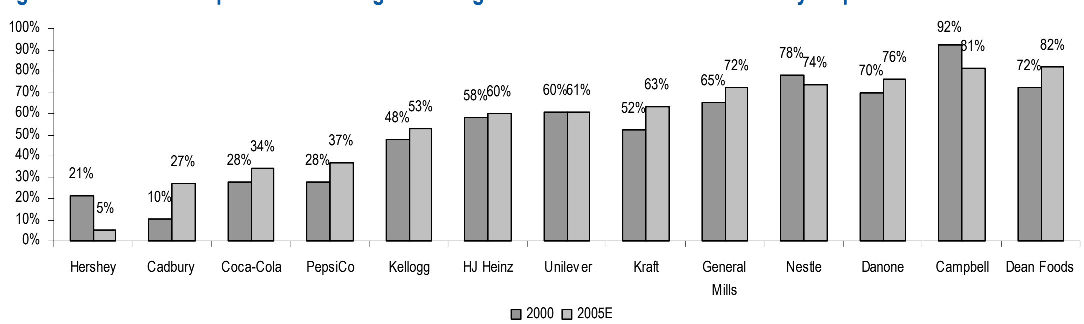
Source: ACNielsen. As of July 2004

Figure 33: Operating Margin within sub-sectors of the branded global packaged food industry, 2004



Source: Company data, JPMorgan estimates.

Figure 36: US and European F&B ranking according to % of 'healthier' and 'better for you' products – 2000 and 2005E



Source: JPMorgan estimates.