

Eating Up

As Shoppers Grow Finicky, Big Food Has Big Problems

Kraft Buys Back to Nature,
Seeks Upscale Offerings;
Atkins Diet Takes a Bite

At Giant Eagle: 375 Cheeses

By SARAH ELLISON

Tracey Daugherty grew up on Kraft Macaroni & Cheese, but she won't feed it to her 18-month-old son. That's a huge problem for Kraft Foods Inc.

With \$31 billion in sales last year, Kraft says it still helps fill pantries in 99% of U.S. households. But it and the other giants of the processed-food industry have hit a wall in growth, barely managing to stay ahead of gains in the population. Two big factors: price pressure from stores such as Wal-

33-year-old Pittsburgh mom, whose lawyer husband is trying to lose weight on the Atkins diet, says she started to worry about sodium and artificial foods when her son was born. These days she opts for fresh produce, chicken, fish and an occasional Amy's Organic frozen dinner when pressed for time.

"Kraft's products definitely have a childhood nostalgia, so it's hard to completely give up on them," she says. "But they're not on my shopping list."

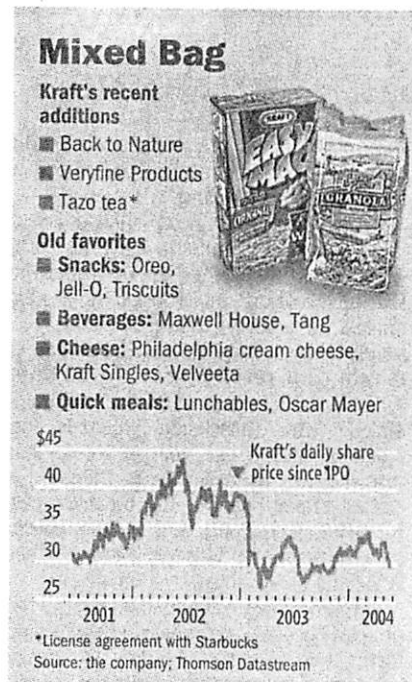
Ms. Daugherty and millions of other consumers are shopping at Whole Foods and other such markets, demanding healthier, tastier, more sophisticated foods—and they're willing to pay for it. Many are also growing wary of the very feature upon which Big Food built itself: mechanized food production and highly technical innovations to create "better than natural" processed food.

While natural foods and gourmet items still represent a small portion of overall food spending, they boast the best growth rates in the food industry. To capture a portion of that growth, the food behemoths are being forced to upend old business models, find new suppliers and rapidly improve the ingredients and quality of their products.

For Kraft, the nation's largest food company, keeping up with consumers' rapidly changing tastes has been especially tough. Four years ago, Kraft made a big bet on high-fat snacking when it purchased Nabisco, the nation's biggest maker of cookies and crackers. The timing was terrible: The deal was made just as consumers were becoming obsessed about obesity and other food-related health issues. Kraft's more recent efforts to buy its way into the organic world have had mixed results. Kraft's profit for the first quarter fell 34%, following a rise of just 2.4% last year. The company's shares were trading at \$29.95 in 4 p.m. New York Stock Exchange composite trading yesterday, down 47% from their peak in June 2002.

Kraft last year held discussions to buy or license the brand name of Organic Val-

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Mart, now the nation's largest food retailer, and continued competition from grocery-store brands.

That's why Kraft needs consumers such as Ms. Daugherty, who are setting the tastes for the next generation. The

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ley, a LaFarge, Wisc., organic-dairy cooperative where sales grew 25% last year to \$156 million. The meetings were friendly, but farmers that control Organic Valley were "aghast" when Kraft suggested using their organic milk in highly processed products such as Lunchables, said someone who was there.

"They were talking about making organic processed food, and that's not something that jibed with the farmers," said another person familiar with the discussions. No deal transpired, but Organic Valley is now supplying organic milk and dairy products to Kraft.

Both companies declined to comment on the details of the talks. But George Siemon, CEO of Organic Valley, said: "We've been approached by every major food company in the country, and we really believe in organics from the ground up, and we believe in our independence."

Old Playbook

Other big food companies also are struggling to redefine themselves. At first, the industry stuck to its old playbook: adding new features to mainstay brands. These iconic names stayed ahead of generic rivals through brand extensions (Kraft Thick 'N Creamy Macaroni & Cheese, Oreo Double Stuff). Kraft spent a fortune on advertising and commanded a higher price than store brands. The Oreo cream was thicker. The Chips Ahoy! cookie had more chips. But the underlying product was the same.

In the last several years, Campbell Soup Co. has spent hundreds of millions of dollars refitting its factories to improve its soups. Unilever, dragged down by low-growth products like margarine, is revamping its Slim-Fast diet products and other products to fit the new low-carbohydrate craze. Nestlé SA, which has spent roughly \$20 billion acquiring brands from Ralston Purina pet food to Hot Pockets frozen sandwiches, is looking for growth in the intersection of food and pharmaceuticals—known in the business as "phood."

Back in 2000, Kraft looked as if it was putting itself on top of the food chain when it agreed to buy Nabisco. A year later, Philip Morris Cos. (now Altria Group Inc.) floated 16% of Kraft on the public market. The IPO, still one of the largest ever, carried big expectations. The company promised double-digit growth rates, and Kraft's portfolio of brands including Oscar Mayer, Jell-O gelatin and Ritz crackers was the envy of the food industry.

But last year, higher costs for retiree pensions and rising prices for commodities such as flour, milk and cocoa put a dent in Kraft's earnings. Growing worries about obesity and the mass appeal of the Atkins low-carbohydrate diet also took a toll.

After a series of earnings misses, Kraft late last year demoted its co-CEO, Betsy Holden, widely identified with Kraft's recent stumbles, and elevated her counter-

part, Roger Deromedi, to the sole CEO post. Mr. Deromedi, who had run the company's international businesses, quickly moved to cut 6,000 jobs, or 6% of Kraft's work force. He lowered the company's long-term targets for profit growth, saying Kraft needed to invest more money in freshening brands that had fallen out of favor.

"You can't keep selling the same thing forever," Mr. Deromedi said in an interview earlier this year. "Consumers are changing. Unless you change your offering enough to keep it fresh for today, then you are going to have a more significant problem going forward."

Since he took his position, he has bought up tiny companies like Veryfine Products Inc., maker of the fast-growing Fruit20 flavored water, and expanded Kraft's deal with Starbucks Corp. to distribute its Tazo tea in addition to Starbucks coffee in grocery stores.

The company is also working to in-

crease the healthiness of its offerings, such as removing artery-clogging trans fats from Triscuits and Oreos, and launching smaller, 100-calorie "snack-packs" of some products.

Eyeing the olives in the tapas cart, Ms. Beil said she sticks to the 'perimeter' of the store, avoiding prepackaged products in the center.

He is targeting "natural or organic seekers," the 15% to 20% of households that buy a natural or organic product three to four times a year.

Mr. Scott says Kraft has established strict "ingredient principles" for Back to Nature, which includes using no artificial preservatives, colors or flavors; no genetically-modified corn or soy ingredients; no hydrogenated or partially-hydrogenated oils, and to use natural sweeteners like cane juice and fruit sweeteners. The Back to Nature brand uses organic ingredients whenever it can, says Mr. Scott. "Sometimes we can't source an organic ingredient in the quantity we need, or we can't find an ingredient that meets our flavor profile," he says. Back to Nature cheese and its cheese sauces are all stamped with the USDA Organic seal, which means the products contain at least 95% organic material.

At a Pittsburgh Giant Eagle grocery store, shopper Rebekah Beil, 27, shows

just how much things have changed. The store's gourmet-cheese counter holds 375 varieties and the tapas cart holds 20 kinds of olives. The Kraft cheeses are aisles away in the dairy section next to the butcher.

Eyeing the olives in the tapas cart, Ms. Beil said she sticks to the "perimeter" of the store, avoiding prepackaged products in the center. A real-estate broker, she cooks for her boyfriend most nights and shops on the weekends on the "strip," a collection of wholesale markets with Italian products, fresh fish and the like. She left the store with an assortment of deli meats, olives and cheese.

Organic and gourmet products, areas dominated by dozens of smaller players, are enjoying much faster growth than the giant food companies. The market for gourmet beverages and sweets has grown 48.4% to \$14.7 billion since 1998, according to a study by market-research firm Packaged Facts. Specialty condiments and cheese sales have grown 26.3% to \$5.5 billion in that period.

Some grocers have latched on to the trend. Last fall, grocery chain Albertson's, which long had relied on its low-end private-label entries, introduced a high-end line of frozen products called Essensia, which include tiramisu and ravioli striped with sun-dried tomato and flavored with basil pesto. "Our goal is to design food that can be served to the most discriminating dinner guests," says Terry Lee, vice-president of corporate brands for the grocery chains.

To understand the challenge Kraft faces, consider cheese, its single biggest product. In 1916, J.L. Kraft's patent for processed cheese helped catapult Kraft from a commodity business to a unique cheese company with a product that came off as-

sembly lines with more consistent quality than natural cheese and stayed on shelves longer without spoiling.

The company's next cheese breakthrough was Velveeta in the late 1920s. Then in the 1940s, Kraft scientists started working on a way to produce cheese in slices. Using a "chill roll" machine that caused hot cheese quickly to cool as it revolved over a cold drum, a sheet of cheese could be uniformly sliced into three-inch squares and stacked. Within one year of its national introduction in 1950, Kraft Deluxe processed slices became the most successful product introduction in the company's then nearly 50-year history. Cheez Whiz hit store shelves soon after.

The company has honed its skills, chopping and processing cheese into snackable forms, over several decades, as consumers demanded more convenience. Starting in the early 1990s, "shredding cheese drove the business for many many years," says Mr. Deromedi, who once headed the unit and still avows an "incredibly strong" passion for the cheese business. "We've had great success just slicing our chunks of cheese, or adding reclosable packaging."

While he says those kinds of changes "seem very mundane," they can boost sales with a relatively small investment. Kraft's bagged cheese cubes come in five varieties. Even Cheez Whiz is being marketed as a dip: It now comes in a wide-mouthed jar with a picture of a tortilla chip on the label. In March, Kraft introduced a new DiGiorno blend of shredded cheese with parmesan, romano and Asiago cheeses.

Lately, Kraft's cheese business has been pressured by an onslaught of high-end products. Last year, U.S. sales of natural Asiago cheese, primarily distributed by a handful of importers and private-label brands, jumped 43% to \$7.4 million, according to Information Resources Inc. Sales of Kraft aerosol cheese, which includes Cheez Whiz, fell 9.6%. Kraft's natural cheese sales grew 5.3%, while sales of its processed cheese fell 2%.

Paul Peterson, vice president of sales at Lactalis SA, a \$5.5 billion French dairy company that is the largest purveyor of Brie cheese in the U.S., estimates that U.S. sales have risen about 10% a year for the past three years, with last year's growth slightly higher.

These cheeses often require different skills than those of Big Food. Unlike the automated production lines at Kraft's plants, which churn out more than two billion pounds of cheese a year, the Lactalis U.S. plant in Wisconsin has its workers turn individual Brie circles by hand every day during the eight- to 10-day curing process. Some are ready earlier than others, and only trained workers watching the white layer of mold on each Brie circle can evaluate when it's ready.

As Kraft tries to move upscale with its Athenos and Back to Nature cheese lines, it is also still playing the repackaging game. It's latest effort: touting cheeses as low in carbohydrates on the packages. "The products have always been low in carbs," says Mr. Deromedi. "It's not like we've had to create a whole new something to get at that."

Seeking the 'Seekers'

Kevin Scott, a Kraft general manager in charge of Back to Nature, says he's not out to get the "loyalists," who eat only organic and who make up less than 2% of households in America. Instead, he says

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