

Kraft loses ground in coffee war

Once America's most popular coffee, Maxwell House now trails P&G's **FOLGERS**. Regaining marketshare is critical.

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By **Julie Jargon**



Kraft's share of the U.S. ground coffee market slipped 1.8 percentage points over the last 12 months — a troubling trend for a company that derives 13% of its revenues from coffee.

Kraft Foods Inc. is losing a long battle with Procter & Gamble Co. in the ground coffee business.

Procter & Gamble's **FOLGERS** brand is stealing customers from Kraft's Maxwell House after surging in the past year to become the top ground coffee brand in the U.S. Observers credit clever new packaging for the 36% to 34% lead **FOLGERS** now holds over Maxwell House in the \$1.9-billion U.S. ground coffee market.

Maxwell House is dragging down Kraft's coffee business, which accounted for 13% of companywide revenue in 2004. Kraft's \$4.2 billion in worldwide coffee sales, which include its Jacobs and Gevalia brands sold in Europe, grew at the same 5.5% rate as the company's overall revenues last year, but are down from \$4.8 billion in 1999.

Coffee is a vexing problem for Kraft executives struggling to revive growth at the Northfield-based food maker, where companywide 2004 earnings, weighed down by restructuring charges, fell 23% to \$2.7 billion, or \$1.55 a share, on \$32 billion in sales. Sluggish sales in such a large business segment will make it hard for Kraft to hit its target of 6% to 9% annual earnings growth.

Kraft's coffee brands are rooted in the grocery store coffee market, a shrinking arena. U.S. sales of store-bought coffee have fallen 13% to \$2.7 billion since 1999, according to Information Resources Inc. (IRI), a Chicago firm that tracks sales in supermarkets, drugstores and mass merchandisers excluding Wal-Mart Stores Inc. Investing the resources needed to reverse declines in such a market looks dubious to some.

"I don't put a lot of faith in coffee as a growth driver," says Tim Ewing, senior vice-president and co-manager of the large-cap value portfolio at Mesirow Financial Inc., which holds 200,000 Kraft shares. "Now that they've committed themselves to the coffee business, I think they need to give it a shot, but two to five years from now, selling might be a choice they have to make."

Store sales of Kraft ground coffee dropped 2.8% to \$638 million nationwide last year, while Procter & Gamble's (P&G) ground coffee sales climbed 4.9% to \$675 million, according to IRI.

In an effort to capitalize on the coffeehouse culture, Kraft last summer expanded a licensing agreement with Seattle-based Starbucks Corp. to add more Starbucks whole-bean coffee to its grocery store lineup. Those sales helped offset Kraft's other losses, allowing it to maintain its 2-percentage-point marketshare lead over P&G in store-bought coffee, which includes not only ground but also instant and whole-bean coffee. But with P&G gaining, Kraft is seeking new sources of growth.

"In addition to our Starbucks business, we are now distributing Seattle's Best and Tazo teas," a Kraft spokes-woman says.

Kraft is also investing in new products such as single-serve filter pods and its \$189 Tassimo machines, which make fresh coffee and hot chocolate in single-serve portions.

Industry watchers doubt that Tassimo will be able to reverse the coffeehouse trend or make up for Kraft's losses in ground coffee.

"It's still too early to know, but my sense is that the machines will only capture a small portion of the market," says Judy Ganes-Chase, president of New York-based commodities research firm J. Ganes Consulting LLC.

And Kraft may have innovated itself into a corner with Tassimo. The coffee and hot cocoa disks can't be used in other machines.

"They might be facing the Gillette problem," in which they'll have to give away the machines to sell the disks, says George Rosenbaum, chairman of Chicago consumer research firm Leo J. Shapiro & Associates LLC.

Now that Kraft has matched P&G's 12% price increase in ground coffee — a result of higher raw material costs — Maxwell House may be a tough sell, too.

So, should Kraft follow the lead of Sara Lee Corp., which is selling its Hills Bros., Chock Full o' Nuts and MJB coffees, or drive growth by acquiring such brands?

"This is not a good time to be in ground coffee," Mr. Rosenbaum warns. "And it's hard to see better times ahead."