The Ready-to-Eat Breakfast Cereal Industry in 1994 (A)

All is not well in the land of Tony the Tiger.[1]

In early 1994, the ready-to-eat (RTE) breakfast cereal industry had reached a critical turning point in its evolution. In an industry historically characterized by stability and above average profitability, slowing demand growth and a surge in private label sales threatened to undermine the dominant positions of the Big Three: Kellogg, General Mills, and Philip Morris. The 1993 year-end statistics showed that industry sales growth had slowed to under 2%, while private labels had topped 5% market share by sales and 9% by volume for the first time. Price increases by the Big Three had widened the gap between branded and private label products. The competitors had traditionally avoided destructive head-to-head competition, but this mutual restraint appeared to be crumbling. Each of the firms faced major decisions going forward about whether to break with the industry's lock-step moves and how to deal with the threat of private labels.

History of the RTE Breakfast Cereal Industry[2]

The ready-to-eat breakfast cereal industry got its start in 1894, when Dr. John Kellogg and his brother W.K. Kellogg invented wheat cereal flakes in an attempt to make whole grains appealing to the vegetarian clients of the Seventh-Day Adventist sanitarium Dr. Kellogg ran in Battle Creek, Michigan.[3] W.K. went on to invent the corn flake and to found the Kellogg Company, still the number one producer of ready-to-eat cereals in the world a hundred years later. Also in 1894, Henry D. Perky, founder of Perky's Shredded Wheat Company, promoted his cereal at the 1894 World's Fair in Boston with the claim that, "From the most abject physical wreck, I have succeeded, by the use of naturally organized

[1] James B. Treece, "The Nervous Faces Around Kellogg's Breakfast Table," *BusinessWeek*, July 18, 1994.

[2] A comprehensive account of the history of the U.S. RTE cereal industry can be found in Frederick M. Scherer, "The Breakfast Cereal Industry," in *The Structure of American Industry* (6th ed.), W. Adams, ed., (New York: Macmillan, 1982).

[3] Cara de Silva, "The cereal crunch; antitrust suits focuses on something consumers have known for years: cereal prices are sky high, "*Newsday*, February 24, 1993.

Professor Kenneth S. Corts prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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food, in reorganizing my body into perfectly healthy condition."[4] Perky sold his company to Nabisco in 1928, and his shredded wheat became their flagship brand. In 1898, a patient of Dr. Kellogg's, C.W. Post, introduced Post's Grape Nuts, which early advertisements claimed could tighten loose teeth and cure appendicitis. By 1994, Philip Morris had acquired both the Post and Nabisco lines of RTE cereals. The Quaker Oats Company diversified from its strong position in hot cereals into the RTE market with the introduction of puffed rice and puffed wheat cereals at the 1904 World's Fair in St. Louis. Thus, by just after the turn of the century, the predecessors of the Kellogg, Quaker, and Philip Morris cereal lines, which collectively accounted for 59% of 1993 RTE sales by volume, had already been established.

Sales of RTE cereals grew steadily throughout the 20th century, with a compound average annual volume growth rate of three percent between 1950 and 1993. Vitamin fortification, which first appeared during the second World War, presweetening, which gained wide popularity in the 1950s, and the surge of interest in granola and natural cereals in the 1970s and 80s fueled this growth. By 1993, the U.S. market consumed 2.82 billion pounds of cereal, grossing nearly $8 billion in sales for breakfast cereal manufacturers.

The RTE cereal industry had historically been one of the most concentrated of all U.S. industries, and firm market shares showed great persistence (see **Exhibit 1**). The largest cereal manufacturers were extremely profitable, routinely posting ROAs for their cereal divisions in the 15-30% range. However, the profitability of the industry attracted no significant entry, and the industry continued to become more concentrated. As a result, in 1972 the Federal Trade Commission filed a major antitrust suit against Kellogg, General Mills, and General Foods (then the maker of the Post line). The FTC argued that the leading RTE cereal manufacturers had jointly monopolized the RTE cereal market. The FTC case was based on the fact that the industry was concentrated and highly profitable, and not on specific actions that the firms might have undertaken to achieve this. Nonetheless, it became clear that the FTC believed that the firms had effectively raised industry profitability by restraining competition, and that the incumbent firms had taken specific steps to deter entry by new firms.

Some industry observers argued that the Big Three had restrained competition among themselves by achieving effective unwritten agreements to limit in-pack premiums—free toys or gifts included in the package—to one brand at a time for each company and to refrain from trade dealing—offering discounts to retailers for special treatment or special promotions. In addition, for many years after the appearance of the first vitamin-fortified cereals during World War II, the Big Three refrained from widespread fortification of their brands because it was believed not to be in the long run interests of the industry. Each of these practices—trade dealing, in-pack premiums, and vitamin-fortification—was viewed as a potentially powerful tool for increasing a firm's market share temporarily at the expense of its competitors. The Big Three feared that such tactics might be employed by one firm for its short-run advantage, but would be mimicked by the other firms, initiating a cycle of escalating costs that would wreck industry profitability. However, the Big Three successfully avoided these practices for many years.

Further, the FTC argued that economies of scale in production or advertising could not explain the lack of entry into this industry, and that the firms had taken specific actions to make entry into this industry unprofitable for new firms. The FTC argued that the Big Three had prevented entry into the RTE cereals industry by encouraging supermarkets and other retailers to adopt a shelf space plan that ensured that the Big Three's products received the most valued center-aisle positions. This plan (some variant of which was adhered to by many grocers and supermarkets) offered a simple resolution to the struggle for shelf space: space was allocated in proportion to historical sales volume. Newer, smaller companies could obtain good shelf space from grocers despite this plan, but doing so at the time of the FTC complaint typically required a discount to the grocer of ten percent off the normal wholesale price.

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[4] Frederick M. Scherer, "The Breakfast Cereal Industry," in *The Structure of American Industry* (6th ed.), W. Adams, ed. (New York: Macmillan, 1982)

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The proliferation of new brands was argued also to have contributed to the lack of entry. By introducing a multitude of new products, the FTC argued, incumbent firms may have filled all profitable niches in the cereal market, thereby preempting the introduction of cereals by potential competitors. Support for this argument was drawn from the natural cereals boom of the early 1970s. When demand for natural cereals surged unexpectedly, the Big Three were caught off guard and had not preemptively introduced brands in this segment. Entry by both small firms and large food manufacturers, including Pet and Pillsbury, ensued. The FTC argued that this demonstrated that product proliferation, and not economies of scale, was responsible for the lack of entry into the industry. However, within five years of the filing of the antitrust complaint, incumbent firms had introduced their own natural cereal brands, and all but one of the new entrants had withdrawn. The one remaining new entrant, Pet, had seen the market share for its Heartland brand fall to less than a quarter of one percent. The FTC suit plodded along for nearly ten years before the complaint was dropped in 1981, in the aftermath of the election of President Reagan.

Industry Environment in the 1990s

Technology

There were five basic methods used in the production of RTE cereals. Of these, four—granulation, flaking, shredding, and puffing—had been in use since 1905. The extrusion process, in which dough was pressed through a die to form the desired shape before baking, found its first commercial application with the 1941 introduction of General Mills' Cheerios. The production of a flake cereal began with the automated combination of the raw ingredients to produce the dough, which was then flaked by drum rollers. The flakes continued on a conveyor through a continuous flake toaster and then tumbled through a rotating slurry enrober. Slurry contained ingredients like salt, sugar, honey, and the vitamin and mineral fortification. Finally, the finished flakes were dried and moved on to the packaging lines. Production of puffed or extruded cereals followed the same process, except that instead of being flaked by rollers, the dough was pneumatically "puffed" through automated conical guns or forced through shaped dies prior to baking. While the fundamentals of the process technology were relatively simple and well-understood by all firms, some processes—particularly the extrusion processes used in many children's cereals—were quite complex and required substantial engineering expertise and production experience to master. Some plants produced cereal that was shipped in bulk to packaging lines closer to the points of final distribution, rather than combine consumer packaging and cereal production under one roof. **Exhibit 2** shows the cost breakdown for a typical Big Three competitor in 1994.

A single cereal production line had a capacity of about 25 million pounds per year, or just under one percent of total annual domestic production. Because of economies resulting from feeding a single packaging line from multiple production lines, an RTE cereal plant was estimated to require a capacity of 75 million pounds per year to achieve minimum efficient scale. A plant of this capacity that combined production and packaging together in one plant employed about 125 employees and required a capital investment in excess of $100 million. Since the production process was relatively similar for all cereals and the main source of scale economies was in bagging, a single plant could produce many brands of cereal. For example, a new plant built by General Mills in 1992 produced Cheerios, Honey Nut Cheerios, Total, Wheaties, Cinnamon Toast Crunch, Raisin Nut Bran, Kix, Clusters, Total Raisin Bran and Oatmeal Raisin Crisp.

The RTE cereal industry as a whole spent about one percent of gross sales (or $80 million) on R&D in 1993, compared with the food industry average of 0.7 percent. The problems faced by cereal scientists had not changed much over the 100 year history of the cereal industry. Two basic problems persisted: it was difficult to keep cereal crispy in milk, and, in cereals like Raisin Bran, the flakes tended to become soggy in the box because they absorbed the moisture of the fruit. In the words of one cereal

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scientist, "It's not easy to combine things with varying water activity characteristics. If you're going to put berries in Cheerios or raisins in bran, you've got to monkey with the water activity."[5] A typical solution to this problem was to coat the fruit with a thin layer of fat to trap in the moisture, thus preventing the flakes from getting soggy in the box.

As with the process technology, the engineering expertise embodied in the product itself was generally neither complicated nor fast-changing; however, breakfast cereal R&D did generate proprietary new product developments. Post's Blueberry Morning (new in 1994) was an example. The method by which the blueberries were preserved in this "combination of multi-grain flakes, oat clusters, wild blueberries and sliced almonds" was not widely known in the industry. One industry consultant said of this introduction, "By coming out with something that's truly new, Post has more flexibility in building brand image and fixing price points." In 1993, General Mills introduced Ripple Crisps, which featured a new kind of flake, with ridges that prevented milk absorption and preserved crispiness. Of course, many new products embodied no technological advances, but merely offered different shapes, colors, flavors, or fruit and nut combinations than existing brands offered.

Distribution

Major RTE cereal manufacturers owned national distribution systems; cereal was manufactured at or shipped to regional distribution centers, where it was picked up by the major supermarket chains and taken to their own distribution centers and stores. Wholesalers and food brokers provided this final link in the distribution process for other outlets and smaller food stores in less well-developed markets.

In food stores, which had traditionally comprised the bulk of their business, the fight for shelf space had long been important, as evidenced by the emphasis on the shelf space plan in the FTC complaint. Between 1950 and the time of the FTC investigation the number of brands more than tripled from 26 to 80, and by 1994 the typical supermarket carried nearly 200 SKUs. As the number of RTE cereal brands expanded, prime shelf space became even more important. In the 1990s, securing shelf space (a 'slot') for a new brand required payment to grocers of a 'slotting allowance,' which could add as much as $1 million to the cost of nationally introducing a new brand. While large cereal firms were not exempt from this policy, they had more flexibility than new entrants in shuffling their allocation of space among brands, sometimes replacing a failed brand with a new introduction.

Major cereal manufacturers employed large sales staffs that worked closely with major supermarket chains and food stores to ensure the proper stocking, display and promotion of each firm's brands. In the 1990s, as part of a larger food industry effort known as the "efficient customer response initiative" (ECR), these firms increased their efforts to tailor distribution to the needs of each customer, making better use of scanner data to manage inventories, for example.

In 1993 non-supermarket sales of food accounted for 5% of food sales and were expected to grow to 10% by 1996 and to 20% by 2000.[6] A large portion of this increase came from expansion of the major national discount retailers into 'supercenters'—massive 125,000 square foot stores that combined a supermarket, a general discount retailer, and specialty retailers under one roof. In addition, more food was being sold through drug stores, convenience stores, and discount retailers like Wal-Mart. The division of shelf space in these outlets was significantly less entrenched than in supermarkets, allowing start-up value-oriented brands to obtain a market presence. In addition, these outlets did not require slotting allowances. **Exhibit 3** shows market shares by distribution channel for leading manufacturers of cereal. While the Big Three accounted for 75.6% of sales in food stores, they had only a 41.3% market share in mass merchandisers.

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[5] Elwood Caldwell, quoted in Bob Ferguson, "Cereal Science. (Special Report: Food Marketing Institute '94)," *Brandweek*, May 2, 1994.

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Advertising, Promotions, and Pricing

The 1993 media expenditures for the RTE breakfast cereal industry topped $800 million, accounting for over a quarter of all food industry advertising.[7] The RTE breakfast cereal industry had always been among the most advertising intensive of all industries, with an advertising/sales ratio as high as 18.5% in the 1960s. By 1993, this ratio had fallen to 10.2%, still high relative to most consumer products businesses. **Exhibit 4** shows 1993 media advertising expenditures for each company and selected brands. Advertising was especially intense around the time of a new product introduction. Recent introductions of Kellogg's *Cinnamon Mini Buns* and General Mills' *Triples* and *Basic 4* had averaged first-year advertising expenditures of $20 million.

The RTE cereal industry was historically typified by regular rounds of price increases, usually initiated by Kellogg and followed by the other manufacturers of branded cereals. These price increases were often justified to analysts as necessary to generate funds for promotions and advertising in a process known as "price up and spend back". In addition to being among the most advertising intensive of industries, the RTE cereal industry was the top issuer of coupons, and this reliance on coupons was increasing. In 1993, cereal manufacturers issued over 25 billion coupons (up 35% in two years).[8] The associated costs of printing, distribution, redemption, and reimbursement of the grocers' handling fee amounted to $610 million in addition to the $800 million in media advertising expenditures. Coupons were so prevalent that even though only about 2% of coupons issued were redeemed, over a quarter of all cereal purchases were made with coupons. By 1994, the average value of redeemed coupons had climbed to 87 cents.[9]

In addition to coupons, other forms of trade promotions were also becoming increasingly prevalent. These included per-case discounts to retailers and cash payments for special in-store promotions and cooperative advertising. Among the most prevalent and costly trade promotions were buy-one-get-one-free offers, known in the industry by the acronym BOGOs. By aggressive use of trade promotions, a single firm might achieve gains of 2-3% in market share by swaying the purchase decisions of the most price-sensitive consumers; however, neither coupons nor other forms of trade promotions were believed to stimulate total cereal demand very dramatically. Rather, these competitive tactics led primarily to stockpiling and brand-switching by the most fickle consumers.

The price-promotion spiral drove RTE cereal prices up 15.6% from 1990 to 1993, compared to a 5.9% increase in overall food prices. Cereal prices regularly outpaced other consumer prices, and in a 1994 market research survey breakfast cereal was voted the "no-contest worst value product winner." One consumer surveyed responded, "cereal prices are an obscenity—to take a genuinely basic food and make a luxury item out of it is an outrage, and not far from sinful."[10]

New Product Introductions

The major firms continually introduced new products, either through creation of a new brand or by the extension of an existing one. Development of a new brand required 2-4 years and R&D expenditure of $5-10 million. Brand extensions (like General Mills' introduction of Apple Cinnamon Cheerios in 1989) were generally considered more likely to succeed than new brands, were thought to

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[6] For further information, see "Wal*Mart Stores, Inc.," HBS case No. 794-024.

[7] Julie Liesse, "Cereal Giants Act to Control Spending," *Advertising Age*, September 28, 1994.

[8] Kathleen Deveny and Richard Gibson, "Awash in Coupons? Some Firms Try to Stem the Tide," *Wall Street Journal*, May 10, 1991, p. B1.

[9] Steven Pearlstein, "Making Shredded Wheat of Inflation. Cereal Price War is Facet of Forces Behind March's Modest Gains," *Washington Post*, April 14, 1994, p. a1.

[10] "Consumers in a box." Representatives Sam Gejdenson and Charles Schumer, March 7, 1995.

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offer economies of scale in advertising, and were technologically simpler to develop and produce because the basic process technology was already in use. Increasing rates of new product introductions had led to a more and more fragmented market for RTE cereals. In 1950, the six industry leaders offered only 26 brands of RTE cereal, and Kellogg's Corn Flakes alone accounted for 16% of the market. However, the number of product introductions increased until the market became so fragmented that a brand that captured a single market share point was considered a major hit. High rates of new product introduction led to high rates of product failure. **Exhibit 5** presents statistics on the success of the major firms' new product introductions.

The two most highly touted product introductions of 1994 were "co-branded" cereals, a segment that was forecast to grow dramatically throughout the 1990s. Co-branded cereals were produced and distributed by one of the Big Three, but relied on another company's brand name for the product's distinctiveness. Prominent 1994 introductions in this category were a line of multi-grain cereals from Kellogg, marketed as Healthy Choice from Kellogg's, and General Mills' Reese's Peanut Butter Puffs. In other food categories, Healthy Choice was an established brand manufactured by ConAgra, the U.S.'s second largest consumer foods company. Reese's was the brand name for Hershey Foods' peanut butter and chocolate candy. Industry observers suggested that the increasing speed to market and quality of private label products would drive an increase in the introductions of cobranded products: "Expect more co-branded deals, since the same labs that can knock off flakes or nuggets can do little to counter the added brand equity that, for example, the Healthy Choice brand gives Kellogg."[11]

Several companies had recently attempted to extend the reach of the RTE cereal category into snack foods. While Ralston's Chex cereal had long been popular as a snack food and several of the firms offered granola or other cereal snack bars, General Mills tried to blur the category distinction even further with its introduction of Fingos in 1993. This was packaged and marketed as a cereal, but as a cereal that could be eaten with the fingers, or as "the perfect commuter snack." General Mills even redesigned the box so that it could accommodate a snacker's hand more easily than the traditional narrow cereal box. Kellogg introduced of its own snack-oriented cereal, Rice Krispies Treats, in early 1994.

Competition

Kellogg

Kellogg was the clear leader in the U.S. RTE breakfast cereal industry with a 35.2% market share in 1993. RTE breakfast cereals accounted for over 80% of Kellogg's 1994 sales, making it the most focused of the major RTE cereal firms. Kellogg also had a strong position in toaster pastries (*Kellogg's Pop-Tarts*), frozen waffles (the Eggo brand), and granola bars. Total U.S. industry sales in these three categories exceeded $1.5 billion in 1994, and these categories continued to grow faster than the RTE cereal market. Kellogg had over 40 RTE cereal brands in national distribution in 1994, and was particularly strong in relatively simple flaked cereals, including *Corn Flakes*, *Frosted Flakes*, *Raisin Bran*, *Special K*, and *Complete Bran Flakes*. U.S. market shares by brand for Kellogg and its major competitors are presented in **Exhibit 6**. **Exhibits 7** and **8** contain selected financial results for these firms.

[11]Elwood Caldwell quoted in Bob Ferguson, "Cereal Science. (Special Report: Food Marketing Institute '94)," *Brandweek*, May 2, 1994.

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General Mills

General Mills, a diversified consumer foods company, entered the RTE cereal business in 1928 through the acquisition of the manufacturer of Wheaties. By 1993, General Mills accounted for 24.3% of U.S. cereal sales by volume, second only to Kellogg. The cereal division, known as Big G, was General Mills' largest division, representing 30% of General Mills' 1994 revenues. The next two largest divisions were restaurant chains, the *Red Lobster* seafood chain and *Olive Garden* Italian restaurants, which accounted for 18.4% and 12.4% of General Mills' 1994 sales respectively. General Mills' other divisions were all packaged consumer foods businesses, where General Mills had a number of strong brands including *Betty Crocker* and *Bisquick* mixes, *Gold Medal* flour, *Yoplait* and *Colombo* yogurts, and *Gorton*'s frozen seafood. These brands were all number or one or number two in their respective categories. Big G had over 25 brands of RTE cereal in national distribution in 1994, and was particularly strong in puffed and extruded cereals. Over one fourth of its sales came from its family of *Cheerios* brands: *Cheerios*, *Honey Nut Cheerios*, *Apple Cinnamon Cheerios*, and *Multi-Grain Cheerios*. Other strong brands included the children's cereals *Kix*, *Lucky Charms* and *Trix*.

In October 1993, Stephen W. Sanger was named president of General Mills. Sanger was viewed as the heir apparent to Chief Executive Bruce Atwater, who was two and a half years from retirement. As Vice Chairman, Sanger had been responsible for Big G cereals, *Red Lobster* and *Olive Garden* restaurants, *Yoplait* yogurt, and the Consumer Foods Sales Division. A twenty-year company veteran, Sanger had also held the top job at Big G prior to taking on broader management responsibilities in 1991. Other management changes were also in the works. David Murphy, the current Big G president, was to be replaced by cereal veteran Charles Gaillard. Gaillard had already held the post from 1979-1988; during his tenure, Big G posted tremendous market share growth and made big gains on Kellogg. Gaillard then went on to Europe where he scored a hit with Cereal Partners Worldwide (CPW), the global cereal joint venture between General Mills and Nestle. The venture was outpacing its original sales projections and entering new markets ahead of schedule.[12] In addition to the Big G job, Gaillard was also to be responsible for the Consumer Foods Sales force and for the *Yoplait* division.

General Mills needed a change. Its stock price had dropped from a high of $74 in March 1993 to April 1994's $51.50. Although fiscal 1994 earnings were expected to grow by 12.9%, that was still a drop from the 14.6% compound annual growth rate that the company had achieved since 1989. The current slump was coming from the cereal division. Cereal tonnage was down in the second quarter of 1994 (from 1993), and the operating profits of the Consumer Foods division (which included Big G) fell by 2% in the third quarter. Not only did cereals' declining profitability hit overall earnings, it also limited the amount of cash that General Mills could get from Big G to help out with other enterprises such as its restaurants.[13] Executives acknowledged that the company's greatest periods of growth had occurred in periods of less diversification, when managers had increased responsibility and more focused incentives. Company representatives stated that "the changes in corporate structure that narrowed focus from participation in 13 industries in the mid-1970s to a concentration on only Consumer Foods and Restaurants in the late 1980s drove strong growth performance."[14]

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[12] Tony Kennedy, "Stephen W. Sanger named General Mills president," *Star Tribune*, October 26, 1993, p. 1D.

[13] Tony Kennedy, "Price cut latest weapon in cereal war; General Mills hopes new strategy will boost profits," *Star Tribune*, April 18, 1994, p. 1D.

[14] "General Mills moves to separate businesses," *Milling & Baking News*, December 20, 1994, p.1.

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Philip Morris

Philip Morris was a $60 billion consumer packaged goods company, which derived approximately half its revenue from food products and half from sales of beer (led by its *Miller* brand) and tobacco products (led by the *Marlboro* brand). Philip Morris' portfolio of what its 1993 annual report termed "the world's best brands" included a formidable array of food brands, representing nearly every aisle of the supermarket, in addition to its well-known tobacco brands. Major food brands included Kraft cheeses and condiments, Maxwell House coffee, *Oscar Mayer* meat products, *Entenmann's* baked goods, *Jell-O* desserts, and *Budget Gourmet* frozen dinners. In all, Philip Morris had 61 brands with 1993 sales over $100 million. Philip Morris entered the RTE cereal business in 1985 with the acquisition of General Foods (maker of the *Post* brand). The eclectic array of cereal brands "umbrella-branded" under the *Post* name included *Post Raisin Bran*, *Post Grape Nuts*, and *Post Fruity* and *Cocoa Pebbles.*

Philip Morris extended its presence in the RTE cereal industry in 1993 through the acquisition of Nabisco's cereal assets, which were integrated into existing Post cereal operations. Cereal brands acquired in the Nabisco acquisition featured primarily the *Shredded Wheat* family of cereals. The two cereal divisions combined represented 3.9% of Philip Morris' North American food revenues in 1993.

Quaker Oats

Quaker Oats was a $6 billion food company, with approximately a fourth of that revenue generated by its breakfast foods division. Quaker Oats was the dominant firm in hot cereals, capturing 65% of that $820 million market in 1993. Quaker also accounted for 79% of the rice cake market, 26% of the granola bar market, and 80% of the grits market. Other divisions of Quaker included *Gatorade*, which alone accounted for over $900 million in sales in fiscal 1994, *Golden Grain*, which sold grain-based dinner mixes, a convenience foods division that sold *Aunt Jemima's* pancake mixes and syrup and *Van Camp's* canned pork and beans, and the pet food division, whose brands included *Kibbles n' Bits.*

RTE cereal sales accounted for 39% of the breakfast division's sales, or about 10% of total corporate sales, in 1993. Quaker's RTE cereal brands included *Quaker Toasted Oatmeal*, *Life*, and *Cap'n Crunch*. From 1993 to 1994, Quaker's sales volumes of RTE cereals increased by 13%, raising Quaker's U.S. market share to 7.4%.

Ralston

Ralston Purina was the world's largest producer of cat food and dry dog food (under the *Purina* brand), the largest supplier of fresh baked goods in the United States (*Wonder* and *Hostess*), the world's largest manufacturer of batteries (*Eveready* and *Energizer*), a major producer of soy protein, polymer products, and feeds for livestock and poultry, and an operator of several ski resorts (including Breckenridge) in Colorado. Ralston's 1993 RTE cereal sales were $571.1 million, accounting for about 23% of the Pet and Human Foods division's sales, and about 7% of total corporate sales. Ralston's mainstay in the branded cereal market was the *Chex* family of cereals, which had been further expanded with the introduction of *Graham Chex* in 1993. Ralston was the only branded cereal manufacturer to produce private label cereals, and held an estimated 50% of that market in 1993. In early 1994, Ralston Purina spun off its cereal, baby food, cookie, and cracker businesses by forming Ralcorp Holdings, an entirely independent publicly traded company. Ralston Purina shareholders received stock in the new company, and Ralston Purina retained no ownership stake whatsoever. Cereals accounted for 61 percent of this new company's sales.

In addition to its branded and private label cereals, Ralston had developed a large line of licensed cereals in the 1980s. These cereals were relatively short-lived brands tied to a movie or television show. Ralston was the leader in the production of these cereals, which constituted as much as one fourth of their sales volume in the late 1980s. While these brands were extremely popular in the late

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1980s and early 1990s, their popularity soon subsided. In fact, Ralston discontinued all licensed cereals in 1993. One industry source declared, "The most extraordinary non-event of 1993 cereal marketing was that not a single character-endorsed brand was introduced. In the year of Jurassic Park, Aladdin, Beavis and Butthead, and Barney, no cereal company tied its new product to a movie, TV or toy personality."[15]

The Private Label Threat

From 1991 to 1994, sales of private label cereal grew 50% to nearly $500 million, or 9.2% of all cereal sales by volume.[16] Private labels' share of the RTE cereal industry was projected to pass 15% by 2000. For grocery products as a whole, private label products accounted for 19% of unit sales and were anticipated to grow to 30% by 2000.[17] Despite the inroads made by private label cereals in the 1990s, not everyone was convinced that they presented a serious threat to the profitability of the branded manufacturers. A General Mills spokesperson said, "As the price of [RTE] cereals creeps up over time, I would think there would be opportunity for those companies in certain areas. But I don't think we would see them as a threat to any of our particular brands."[18]

Low price was the primary appeal of private label cereals. Private label cereals averaged $1.90 per pound at retail, 40% less than the Big Three average of about $3.20 per pound. Private labels did little advertising and made few attempts to differentiate their products in other ways. What little advertising they did undertake was devoted to raising awareness of their price advantage relative to branded cereals. Private label manufacturer Malt-O-Meal, for example, ran magazine ads showing a $2.03 bag of Malt-O-Meal's Sugar Puffs next to a $3.16 box of Sugar Crisp. The caption read: "You may not be able to tell the difference in your bowl, but we're sure you'll be able to tell the difference at the cash register."[19]

Private label cereals offered lower prices to the consumer, but were also perceived to offer better margins to the retailer, which contributed to a willingness of grocers to promote private labels enthusiastically. Private labels typically offered grocers 15% margins, compared to 12% margins for branded cereals. "Private label offers a good markup for us and savings for the consumer," said one grocer. "It doesn't take a genius to tell which products to put the signs next to."[20] However, one trade journal argued that "many retailers may not understand the fully burdened cost of private label. That is, how the costs of warehousing, merchandising, shrinkage and other issues affect private label profitability, compared with national brands." Industry analyst Bob McCann added, "I'm not entirely sure that what seems obvious is the right answer."[21]

The high prices and ubiquitous coupons of branded cereals were blamed by many for the market share gains of private labels. One industry observer said, "coupons have been a major eroding factor. Without them, shoppers feel like they are overpaying. Private label is an alternative if there is no coupon and no sales price."[22] The heavy use of coupons had more generally diminished brand loyalty

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[15] "Prepared Market Bowls Over with New Varieties," *Prepared Foods*, March 1994, p. 65.

[16] Zina Moukheiber, "Eye Off the Ball," *Forbes*, December 5, 1994, p. 76.

[17] Steve Weinstein, "The New Brand Loyalty," *Progressive Grocer*, July 1993, pp. 93-100.

[18] Dale Kurschner, "Cold Cereals are Hot Sellers in Strategy by Malt-O-Meal," *Minneapolis-St. Paul City Business*, July 23, 1990, p. 1.

[19] John Harris, "Your Tastebuds Won't Know, Your Pocketbook Will," *Forbes*, September 3, 1990, p. 88.

[20] Steve Weinstein, "The New Brand Loyalty," *Progressive Grocer*, July 1993, pp. 93-100.

[21] Michael Sansolo, "Battle of the Brands," *Progressive Grocer* (January 1994): 65-66.

[22] Mona Doyle in "Battle of the Brands," *Progressive Grocer* (January 1994): 65-66.

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by encouraging price-sensitive brand-switching. Brand loyalty was seen to have been further eroded by failed extensions of popular brands. One industry consultant argued that, "these brand extensions come out, and if they die, it tends to diminish the idea that these products are superior."[23]

Production and marketing of private label cereals changed dramatically in the early 1990s. For years private label suffered from poor quality and limited product variety. Black and white label generic brands found only short-lived success in the 1980s, and private label manufacturers discovered that even value-conscious consumers demanded a level of quality near that of a branded product. Increases in technological competence among private label manufacturers led to private label cereals that rivaled the branded products for quality. Still, the manufacturing costs per pound for a private label could be as much as 10-20% lower than for a Big Three firm because of their focus on simpler cereals with less labor intensive processes and fewer expensive fruits and nuts. Some private labels did away with the cereal box and sold cereals in clear plastic bags, reducing packaging costs by up to 25%.

Private labels relied on wholesalers and third-party distributors--which received approximately a 10% margin on the wholesale price paid by the retailer--for distribution of their products. These distributors did little more than deliver the product to stores and did not provide the on-site presence of the Big Three's large national salesforces.

The Big Three had systematically and publicly refused to produce private label cereals. In fact, some Kellogg packages boasted, "We don't make cereals for anyone else." While Ralston had at one point virtually monopolized the private label cereal market, by 1994 its market share of the private label cereals was estimated to have fallen to about 50%. After Ralston, the most established producer of private label cereals was Malt-O-Meal, which had been in the business since the 1970s. Other, more recent entrants into the private label RTE business included Grist Mill (the nation's leading supplier of private label granola bars and pie crusts) and McKee Baking (the nation's leading snack cake manufacturer with its *Little Debbie* brand).

Malt-O-Meal

Malt-O-Meal, which had been producing hot cereal since 1919, began producing RTE breakfast cereal in the early 1970s. By 1989, its 14 varieties of cereal accounted for approximately 2% of the total RTE market. Its cereal was sold both through private label arrangements with major supermarket chains, including Kroger and Safeway, and under the Malt-O-Meal name.[24] Cereal marketed under the Malt-O-Meal name was sold in economical 15-ounce clear plastic bags. From 1989 to 1994, sales grew from $94 million to $210 million, about three quarters of which derived from RTE cereals. This growth led to numerous plant expansions, and by 1994 Malt-O-Meal had spent over $120 million to expand and equip a massive 860,000 square foot state-of-the-art production facility.[25]

A Turning Point

The first sign that the cycle of increasing prices and promotions by the Big Three might be ending came in August, 1993, when Kellogg announced its third price increase of the year, a 2.1% increase that would bring the year's total to 6.2%. General Mills announced that it had no immediate

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[23] "Private Label on the Rise as Consumers Cut Spending," *Milling and Baking News*, May 4, 1993, pp. 1-4.

[24] "Malt-O-Meal to Start Expansion Costing as Much as $80 Million in Same Month as it Celebrates its 75th Birthday," *St. Paul Pioneer Press*, March 28, 1994, p. B1.

[25] "Malt-O-Meal Will Expand in Northfield, " *St. Paul Pioneer Press*, February 19, 1994, p. B1.

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plans to increase prices, and Malt-O-Meal's CEO proclaimed, "The era of price hikes is over. This is the first time the industry didn't move in lock step. We think the price increases of the 1980s are history."[26]

In the coming months, Stephen Sanger and Charles Gaillard took their new posts as head of General Mills and the Big G cereal division, respectively. Sanger had been complaining for several months about the increasingly inefficient spiral of promotional spending plaguing the industry. With a new management team in place, Big G was ready to make a bold move.

In April 1994, General Mills announced it planned to cut $175 million out of its trade promotions and couponing budget, and simultaneously to reduce prices on its biggest brands (accounting for about 40 percent of sales) by an average of 11 percent. "The overall purpose is to improve the profit performance of Big G," Gaillard said.[27] Sanger explained this action:

> The practice of pricing up and discounting back has become more and more inefficient for manufacturers and retailers, and burdensome for consumers. . . . Clearly, the money we were spending to print, distribute and handle those additional coupons was not benefiting consumers. The 50 cents that the consumer saves by clipping a coupon can cost manufacturers as much as 75 cents. It just doesn't make sense.[28]

Sanger believed that he was speaking not only for General Mills but for all the cereal makers. He stated that, "This is a move that's good for General Mills and good for our industry. I would guess other manufacturers see the same wastefulness in coupon and other price promotions."[29] General Mills' announcement set off a feverish debate in the trade and financial situation. *Brandweek* dramatized the situation:

> Kellogg, in classic high noon drama fashion, will hew to the price up and spend back line. . . . Still, [Sanger's] move to restore sanity generated enough shock value to create a cereal drama, a sudden 180 that results in a showdown between Kellogg and General Mills. 'The two big gladiators are in the ring, with all the other little players ringside, and everybody else in the category jammed into the rest of the arena,' said a cereal industry observer. In three to six months, one or the other's going to have lost. It shouldn't take any longer than that for one or the other of them to cave, with the others going the way of the winner.[30]

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[26] Ibid.

[27] Tony Kennedy, "Price cut latest weapon in cereal war; General Mills hopes new strategy will boost profits," *Star Tribune*, April 18, 1994, p. 1D.

[28] "General Mills slashes budget for inefficient promotions," *Milling & Baking News*, April 12, 1994, p. 1.

[29] "General Mills sees price cut profits—interview," *Reuters Financial Service*, April 4, 1994.

[30] "Sanity's at stake in Steve Sanger's cereal showdown," *Brandweek*, April 24, 1994, p. 16.

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Exhibit 1 RTE Cereal Market Shares

Volume Market Share

	1950	1960	1970	1980	1990	1993
Kellogg	35.2	45.9	45.5	40.9	37.5	36.5
General Mills	22.3	19.5	19.7	19.9	24.4	24.3
Post	26.8	19.6	19.3	15.6	11.1	11.9
Quaker	5.5	3.6	7.8	8.6	7.8	7.4
Nabisco	6.6	6.0	4.8	4.9	4.4	3.1
Ralston	3.5	5.3	3.7	6.5	6.1	4.2
Private label					5.6	9.2

Sources: Thomas, Louis. Brand Capital and Industry Evolution. Harvard University dissertation, 1991.
J.C. Maxwell, Jr. "Cold Cereal Industry in 1991." Wheat First Butcher & Singer, Inc., March 25, 1993.
Adelman, L., et al. "Special Report - Cereal Industry." Dean Witter Reynolds, March 11, 1994.

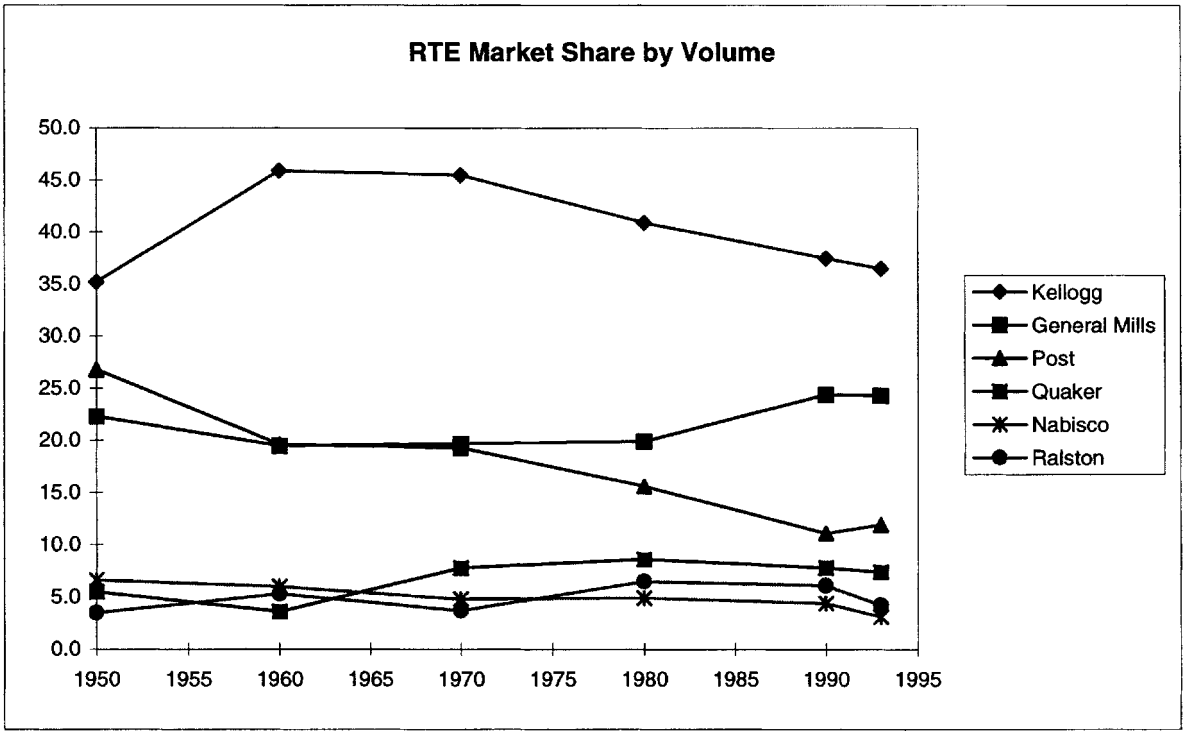

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Exhibit 2 Cost Breakdown per Pound for Typical Big Three Cereal Firm

Raw materials	$0.42
Packaging	.19
Labor and indirect manufacturing	.52
Distribution	.14
Advertising and sales	.75
Depreciation, overhead	.40
EBIT	.40
Wholesale price	$2.82
Retailer margin	.38
Retail price	$3.20

Source: Industry sources and casewriter estimates.

Exhibit 3 1993 Volume Market Share by Channel

	Food Stores	Drug Stores	Mass Merchandisers
Kellogg	36.3%	39.0%	18.7%
General Mills	24.3	34.9	16.6
Philip Morris:			
Post	11.9	6.9	5.6
Nabisco	3.1	1.8	0.4
Quaker Oats	7.4	2.1	14.3
Ralston Purina	4.2	8.9	2.5
Malt-O-Meal	1.7	0.3	3.3
McKee Baking	0.0	0.6	28.1
Other branded	2.0	0.0	0.0
Private label	9.2	5.2	11.9
Total Cold Cereal	100.0	100.0	100.0

Total industry sales: $7,954 million

Total industry volume: 2,820 million pounds

Sources: Adelman, L., et al., "Special Report—Cereal Industry," Dean Witter Reynolds, March 11, 1994.; Julie Liesse, "Cereal Giants Act to Control Promo Spending," *Advertising Age*, September 28, 1994; casewriter estimates.

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Exhibit 4 RTE Cereal Advertising

	Advertising ($ millions) 1993	Advertising/ Sales Ratio 1993	Revenue Per Pound 1993	Advertising Per Pound 1993
Kellogg	$315.6	11.11%	$2.76	$0.31
General Mills	239.7	10.32	3.39	0.35
Philip Morris	166.0	14.20	2.76	0.39
Quaker	73.5	13.20	2.67	0.35
Ralston	17.3	4.44	3.29	0.15

Top Ten Brands by Dollar Share, 1993

	Dollar Market Share	Volume Market Share	Advertising ($ millions)	Advertising/ Sales Ratio
Kellogg's Frosted Flakes	4.1%	4.8%	$31.7	9.7%
Cheerios	4.0	3.7	21.4	6.7
Honey Nut Cheerios	3.0	2.7	17.1	7.2
Kellogg's Frosted Mini-Wheats	3.0	3.2	29.7	12.4
Kellogg's Corn Flakes	2.8	5.0	25.0	11.2
Kellogg's Rice Krispies	2.8	2.9	21.4	9.6
Kellogg's Raisin Bran	2.7	3.4	24.4	11.4
Kix	2.3	1.8	7.2	3.9
Kellogg's Froot Loops	2.1	1.8	15.7	9.4
Post Grape Nuts	2.1	2.6	23.5	14.1
Total industry			$810.5	10.2%

Sources: "100 Leading Advertisers," *Advertising Age*, September 28, 1994; Adelman, L. et al., "Special Report—Cereal Industry," Dean Witter Reynolds, March 11, 1994; casewriter estimates.

Exhibit 5 Success of New Product Introductions by Company

	Major New Brands Introduced in 1980s	% New Brands Survived to 1993	% New Brands With 1% in 1993	% Sales from New Brands, 1993
Kellogg	30	30	0	13%
General Mills	19	58	11	33%
Post	9	22	11	13%
Quaker	5	20	0	8%
Nabisco	4	50	0	19%

Source: Based on analysis of data from: J.C. Maxwell, Jr., "Cold Cereal Industry in 1991," Wheat First Butcher & Singer, Inc., March 25, 1992; Adelman, L. et al., "Special Report—Cereal Industry," Dean Witter Reynolds, March 11, 1994.

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Exhibit 6 1993 Volume Market Share by Brand

Kellogg		**General Mills**		**Post**	
Corn Flakes	5.0	Cheerios	3.7	Grape Nuts	2.6
Frosted Flakes	4.8	Honey Nut Cheerios	2.7	Raisin Bran	1.7
Raisin Bran	3.4	Kix	1.8	Honey Bunches of Oats	1.0
Frosted Mini Wheat	3.2	Lucky Charms	1.5	Fruity Pebbles	1.0
Rice Krispies	2.9	Total	1.2	Banana Nut Crunch	0.9
Froot Loops	1.8	Cinnamon Toast Crunch	1.2	Cocoa Pebbles	0.6
Special K	1.3	Wheaties	1.2	Great Grains	0.6
Corn Pops	1.3	Golden Grahams	1.0	Super Golden Crisp	0.6
Complete Bran Flakes	1.0	Trix	0.9	Alpha Bits	0.5
Apple Jacks	1.0	Apple Cinnamon Cheerios	0.9	Fruit & Fibre	0.5
Rice Krispies Treats	0.9	Raisin Nut Bran	0.8	Bran Flakes	0.5
Crispix	0.9	Multi-Grain Cheerios	0.7	Toasties	0.4
Low Fat Granules	0.9	Total Raisin Bran	0.6	Brannola	0.2
Mueslix	0.8	Oatmeal Raisin Crisp	0.6	**Post Total:**	**11.9**
NutriGrain	0.7	Oatmeal Crisp	0.6		
Cracklin' Oat Bran	0.7	Basic 4	0.6	**Nabisco**	
Just Right	0.7	Clusters	0.6		
Cinnamon Mini-Buns	0.6	Cocoa Puffs	0.6	Spoon Size Shredded Wheat	1.2
Smacks	0.6	Wheaties Honey Gold	0.5	Big Biscuit Shredded Wheat	0.7
Frosted Bran	0.5	Ripple Crisp	0.4	Shredded Wheat with Bran	0.5
All Bran	0.5	Triples	0.4	Frosted Wheat Squares	0.3
Cocoa Krispies	0.4	Total Corn Flakes	0.3	100% Bran	0.3
Product 19	0.3	Fiber One	0.3	**Nabisco Total:**	**3.1**
Raisin Squares	0.3	Crispy Wheat & Raisin	0.3		
All Bran Extra Fiber	0.2	Count Chocula	0.1		
Kellogg Total:	**36.3**	**General Mills Total:**	**24.3**	**Philip Morris Total:**	**15.0**

Quaker Oats		**Ralston Purina**	
Cap'n Crunch	2.7	Rice Chex	0.8
Life	0.8	Corn Chex	0.6
Oat Life	0.8	Wheat Chex	0.6
100% Natural	0.8	Cookie Crisp	0.4
Oat Squares	0.6	Multi Bran Chex	0.4
Kretschmer	0.2	Honey Almond Delight	0.4
Christmas Crunch	0.1	Muesli	0.4
		Graham Chex	0.3
		Double Chex	0.2
Quaker Oats Total:	**7.4**	**Ralston Purina Total:**	**4.2**

Source: Adapted from Adelman, L. et al. "Special Report - Cereal Industry," Dean Witter Reynolds, March 11, 1994.

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Exhibit 7 Selected Financial Results

	1993 $ millions	1993 % sales	1992 $ millions	1992 % sales	1991 $ millions	1991 % sales
Kellogg						
Sales	$6,293.9		$6,227.4		$5,801.2	
COGS	2,989.0	47.5	2,987.7	48.0	2,828.7	48.8
SGA	2,237.5	35.6	2,140.1	34.4	1,930.0	33.3
Operating income	1,067.4	17.0	1,099.6	17.7	1,042.5	18.0
Interest	33.3		29.2		58.3	
Taxes	353.4		387.6		378.2	
Accounting changes	0.0		-251.6		0.0	
Net income	680.7	10.8	431.2	6.9	606.0	10.4
Total assets	4,237.1		4,015.0		3,925.8	
Long-term debt	521.6		314.9		15.2	
Shareholder's equity	1,713.4		1,945.2		2,159.8	
General Mills						
Sales	8,516.9		8,134.6		7,777.8	
COGS	4,458.2	52.3	4,297.6	52.8	4,123.2	53.0
SGA	2,755.5	32.4	2,578.2	31.7	2,516.3	32.4
Other	450.7		341.2		245.6	
Operating income	852.5	10.0	917.6	11.3	892.7	11.5
Interest	99.2		73.6		58.2	
Taxes	283.6		337.9		338.9	
Net income	469.7	5.5	506.1	6.2	495.6	6.4
Total assets	5,198.3		4,650.8		4,305.0	
Long-term debt	1,417.2		1,268.3		920.5	
Shareholder's equity	1,151.2		1,218.5		1,370.9	
Philip Morris						
Sales	60,901		59,131		56,458	
COGS	26,771	44.0	26,082	44.1	25,612	45.4
Excise taxes	10,280		9,036		8,394	
SGA	15,694	25.8	13,433	22.7	13,331	23.6
Other	569		521		499	
Operating income	7,587	12.5	10,059	17.0	8,622	15.3
Interest	1,391		1,451		1,651	
Taxes	2,628		3,669		3,044	
Accounting changes	-477		0		-921	
Net income	3,091	5.1	4,939	8.4	3,006	5.3
Total assets	51,205		50,014		47,384	
Long-term debt	15,221		14,583		14,213	
Shareholder's equity	11,627		12,563		12,512	
Quaker Oats						
Sales	5,955.0		5,730.6		5,576.4	
COGS	2,926.2	49.1	2,870.0	50.1	2,831.1	50.8
SGA	2,425.6	40.7	2,302.3	40.2	2,244.3	40.2
Other	134.8		35.6		12.1	
Operating income	468.4	7.9	522.7	9.1	488.9	8.8
Interest	89.7		55.1		67.4	
Taxes	147.2		180.8		173.9	
Accounting changes	0.0		-115.5		0.0	
Net income	231.5	3.9	171.3	3.0	247.6	4.4
Total assets	3,043.3		2,815.9		3,039.9	
Long-term debt	759.5		632.6		688.7	
Shareholder's equity	445.8		551.1		842.1	
Ralston Purina						
Sales	7,902.2		7,752.4		7,375.8	
COGS	4,322.0	54.7	4,223.1	54.5	3,974.3	53.9
SGA	2,755.3	34.9	2,716.2	35.0	2,513.8	34.1
Other	6.4		69.6		31.2	
Operating income	818.5	10.4	743.5	9.6	856.5	11.6
Interest	238.1		242.9		208.7	
Taxes	239.1		221.4		255.9	
Accounting changes	-218.7		34.0			
Net income	122.6	1.6	313.2	4.0	391.9	5.3
Total assets	5,071.9		5,150.5		4,632.1	
Long-term debt	2,054.5		2,111.3		2,071.3	
Shareholder's equity	469.8		655.2		783.8	

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Exhibit 8 Selected Financial Results by Segment

	1993 $ millions	1992 $ millions	1991 $ millions
Kellogg—United States			
Sales	$3,783.9	$3,564.9	$3,411.0
Operating Profit	452.2	458.4	388.3
Identifiable Assets	2,340.4	2,064.4	1,859.6
General Mills—Consumer Foods			
Sales	5,553.9	5,397.2	5,233.8
Operating Profit	653.1	772.6	744.3
Identifiable Assets	2,820.8	2,576.4	2,481.2
Philip Morris—Food			
Sales	30,372	29,048	28,178
Operating Profit	2,608	2,769	2,016
Identifiable Assets	33,253	32,672	31,622
Quaker Oats—U.S. and Canadian Grocery Products			
Sales	4,252.7	3,930.3	3,842.3
Operating Profit	430.9	447.0	435.0
Identifiable Assets	1,999.4	1,877.3	1,997.9
Ralston Purina—Pet and Human Foods			
Sales	2,534.8	2,550.6	2,517.4
Operating Profit	413.3	387.7	434.5
Identifiable Assets	873.9	877.2	838.8

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