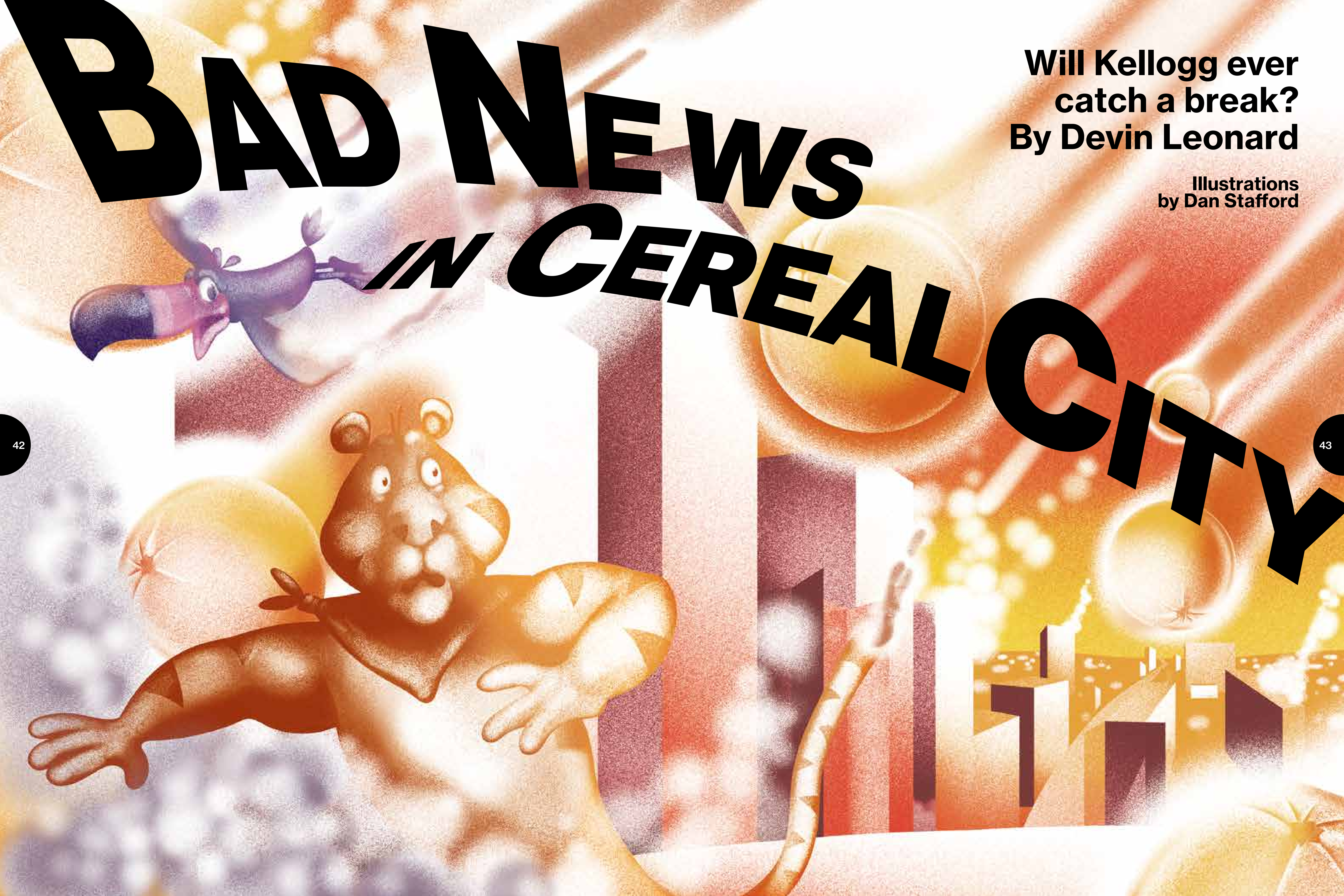
Bad News in Cereal City

Will Kellogg ever catch a break?
By Devin Leonard

Illustrations by Dan Stafford



John Bryant is a voracious cereal eater. Most mornings, he has a bowl of Kellogg's All-Bran Buds, a spinoff of the company's 99-year-old All-Bran, originally marketed as a "natural laxative." At night he's likely to snack on Honey Smacks, which is 56 percent sugar by weight. Sometimes he'll mix it with more nutritious Frosted Mini-Wheats. Bryant also feeds the stuff to his six children. "I can assure you that we go through an enormous amount of cereal," he says.

This makes the Bryant household somewhat of an anachronism at a time when Americans have moved on to granola bars, rediscovered the virtues of hot meals such as oatmeal and eggs, and fallen under the spell of Greek yogurt. But then Bryant would probably feel guilty if he joined them. He's chief executive officer of Kellogg, the world's largest cereal maker, whose brands also include Frosted Flakes, Rice Krispies, Corn Flakes, Froot Loops, and Apple Jacks. Kellogg needs all the cereal eaters it can muster.

On Feb. 12, Bryant, fortified by his customary helping of All-Bran, arrived at Kellogg headquarters in Battle Creek, Mich., to deliver bad news. He announced the company's U.S. morning-foods net sales fell 8 percent in the fourth quarter of 2014. It was the division's seventh quarterly decline in a row. "It's very frustrating," Bryant said in a postmortem telephone interview.

For almost a century, Kellogg defined the American breakfast: a moment when people would be jolted out of their drowsiness—often with a stupendous serving of sugar. Breakfast was personified by Kellogg's cartoon mascots like Frosted Flakes' vigorous Tony the Tiger; Froot Loops' pig Latin-spouting Toucan Sam; and Rice Krispies' Snap, Crackle, and Pop, a trio of elves who mischievously splashed around in a milky bowl.

Kellogg still spends more than $1 billion a year on advertising, but it no longer has the same hold on breakfast. The sales of 19 of Kellogg's top 25 cereals eroded last year, according to Consumer Edge Research, a Stamford (Conn.) firm that tracks the food industry. Sales of Frosted Flakes, the company's No. 1 brand, fell 4.5 percent. Frosted Mini-Wheats declined by 5 percent. Meanwhile, Special K Red Berries, one of the company's breakout successes in the past decade, fell by 14 percent. Kellogg executives don't expect cereal sales to return to growth this year, though they hope to slow the rate of decline and do better in 2016. But some Wall Street analysts say cereal sales may never fully recover. In Battle Creek, so-called Cereal City, that would be the equivalent of the apocalypse.

The 49-year-old Bryant, who resembles a cereal box character himself with his wide eyes, toothy smile, and elongated chin, blames Kellogg's financial woes on the changing tastes of fickle breakfast eaters. The company flourished in the Baby Boom era, when fathers went off to work and mothers stayed behind to tend to three or four children. For these women, cereal must have been heaven-sent. They could pour everybody a bowl of Corn Flakes, leave a milk carton out, and be done with breakfast, except for the dishes.

Now Americans have fewer children. Both parents often work and no longer have time to linger over a serving of Apple Jacks and the local newspaper. Many people grab something on the way to work and devour it in their cars or at their desks while checking e-mail. "For a while, breakfast cereal was convenience food," says Abigail Carroll, author of *Three Squares: The Invention of the American Meal*. "But convenience is relative. It's more convenient to grab a breakfast bar, yogurt, a piece of fruit, or a breakfast sandwich at some fast-food place than to eat a bowl of breakfast cereal."

People who still eat breakfast at home favor more labor-intensive breakfasts, according to a recent Nielsen survey. They spend more time at the stove, preparing oatmeal (sales were up 3.5 percent in the first half of 2014) and eggs (up 7 percent last year). They're putting their toasters to work, heating up frozen waffles, French toast, and pancakes (sales of these foods were up 4.5 percent in the last five years). This last inclination should be helping Kellogg: It owns Eggo frozen waffles. But Eggo sales weren't enough to offset its slumping U.S. cereal numbers. "There has just been a massive fragmentation of the breakfast occasion," says Julian Mellentin, director of food analysis at research firm New Nutrition Business.

And Kellogg faces a more ominous trend at the table. As Americans become more health-conscious, they're shying away from the kind of processed food baked in Kellogg's four U.S. cereal factories. They tend to be averse to carbohydrates, which is a problem for a company selling cereal derived from corn, oats, and rice. "They basically have a carb-heavy portfolio," says Robert Dickerson, senior packaged-food analyst at Consumer Edge. If such discerning shoppers still eat cereal, they prefer the gluten-free kind, sales of which are up 22 percent, according to Nielsen. There's also growing suspicion of packaged-food companies that fill their products with genetically modified organisms (GMOs). For these breakfast eaters, Tony the Tiger and Toucan Sam may seem less like friendly childhood avatars and more like malevolent sugar traffickers.

Bryant says Kellogg is laboring to develop cereals that will overcome these cultural shifts and end its morning misery. Some of Kellogg's wounds, however, are self-inflicted. Its two largest competitors—General Mills, maker of Cheerios and Lucky Charms, and Post Holdings, whose brands include Grape-Nuts and Honey Bunches of Oats—are struggling with the same morning trends. Yet the decline in General Mills' 2014 cereal sales was half as bad as Kellogg's, and Post eked out a 2 percent increase.

Kellogg's dismal sales are indicative of the company's larger problems. Of the 21 analysts covering Kellogg tracked by Bloomberg, 19 have a sell or a hold rating on the company's stock. Only two recommend buying the cereal maker's shares. It's cut costs, only to amp up spending again. There have been three heads of U.S. breakfast foods in four years as the division's profits fell. Bryant's latest scheme to revive cereal sales—by adding more fruit and natural ingredients to some of its best-known brands—seems far-fetched at best. The meltdown in Battle Creek is puzzling because, until recently, the company was known as a well-managed organization. "Kellogg was perhaps the most respected consumer-product company out there," says David Palmer, a food industry analyst at RBC Capital Markets. "They went off the rails."

Bryant frequently pays homage to his company's founder, Will K. Kellogg, the man who practically invented the modern idea of breakfast. Throughout much of the 19th century, Americans woke up in the morning and ate leftovers. Predictably, this caused widespread indigestion. Wealthy people often went to sanitariums for exotic cures involving enemas and hydrotherapy. Kellogg worked at just such a health spa in Battle Creek run by his older brother, Dr. John Harvey Kellogg, an eccentric wellness guru memorialized in the 1994 movie *The Road to Wellville*. The Kelloggs were Seventh-Day Adventists and therefore strict vegetarians. They couldn't serve their patients eggs and bacon. So in 1894 they came up with something lighter: corn flakes. "They developed a flaking process," says Brian Wilson, a professor of comparative religion at Western Michigan University and author of *Dr. John Harvey Kellogg and the Religion of Biologic Living*. "That's the origin of the modern breakfast flake."

The Kellogg brothers were soon quarreling about what to do with the invention. W.K. Kellogg wanted to make money. In 1906 he founded Battle Creek Toasted Corn Flake Co., enlivening the taste of his cereal with sugar. His brother thought this was blasphemous. A legal battle ensued over who had the right to use the family name, and W.K. Kellogg prevailed. He introduced All-Bran in 1916. Rice Krispies followed in 1928. By then, Kellogg was a wealthy man known for his benevolence. He started a charitable foundation that supported children's health and education. During the Depression, he changed the factories' three eight-hour shifts to four six-hour ones to employ more people.

In 1949, Kellogg hired Leo Burnett, the rumpled advertising genius who created the Jolly Green Giant and the Marlboro Man. Burnett persuaded Kellogg to promote his cereals on television, then a nascent medium. His agency was responsible for many of Kellogg's Disney-like cartoon characters. They became as famous as the ones in the Saturday morning shows sponsored by Kellogg, such as Yogi Bear and Huckleberry Hound. In fact, Yogi and Huckleberry sometimes cavorted in Kellogg commercials. Children, many of whom watched TV with a bowl of milk-soaked Kellogg's Sugar Pops or Frosted Flakes, were entranced. They ate cereal for breakfast, cereal for lunch, and cereal for a bedtime snack.

Kellogg died at the age of 91 in 1951. By the 1970s, Kellogg's share of the U.S. cereal market had reached 45 percent. The Federal Trade Commission said the company was too big and might need to be broken up. Nothing came of it. It was harder, though, for Kellogg to escape the consumer activists who criticized marketing junk food to youngsters. "Many of the kid-oriented cereals have a fair amount of sugar in them," says Michael Jacobson, executive director of the Center for Science in the Public Interest, a food industry watchdog. "Their Eggo waffles are mostly white flour. Pop-Tarts are white flour and sugar. For a company that started out as a health-food company, they've turned into something very different." (Kellogg says it has lowered the amount of sugar in its top-selling kids' cereal by as much as 30 percent in the past several years.) As sugary cereals started to lose their broad appeal by the early 1990s, Kellogg forfeited its dominant position in the U.S. to General Mills, whose Cheerios were marketed as a healthier alternative.

Kellogg's fortunes rose again with the ascension of Carlos Gutierrez, a handsome Cuban-born executive with dark hair and a snowy mustache who began his career selling Frosted Flakes out of a truck to hole-in-the-wall stores in Mexico City. Gutierrez took over as the company's CEO in 1999 and proved himself a gifted morning-food strategist. He believed that consumers would pay more for cereals they thought were better for them. He decided to push Special K, then a staid diet brand marketed to weight-conscious women. Kellogg spiced it up by introducing freeze-dried strawberries developed in the company's Battle Creek food laboratory. Special K Red Berries became a best-seller, inspiring a plethora of extensions such as Special K Chocolatey Delight cereal, Special K Cracker Chips, and a Special K low-calorie pink lemonade mix.

Kellogg also paid $33 million in 2000 for Kashi, a health-food cereal maker founded by an enterprising jazz trumpeter and his wife in La Jolla, Calif. At the time, Kashi was bringing in $25 million a year. Less than a decade later, its annual revenue had climbed to $600 million. Gutierrez made a point of keeping Kashi based in Southern California to give it some indie cred. But now that it was a division of Kellogg, the health-food purveyor no longer behaved like a mom and pop venture. It introduced Kashi Chocolate Almond Butter cookies, Kashi frozen pizzas, and other items that seemed closer and closer to processed food.

In 2004, Gutierrez departed to become President George W. Bush's Commerce secretary. After a two-year stint by James Jenness, a Kellogg director and former Leo Burnett executive, David Mackay, a balding, soft-spoken New Zealander and the company's chief operating officer, took the top job.

Kellogg's current problems began shortly thereafter. In 2008, Mackay embarked on a $1 billion, three-year cost-cutting initiative called K-Lean, which targeted wasteful spending

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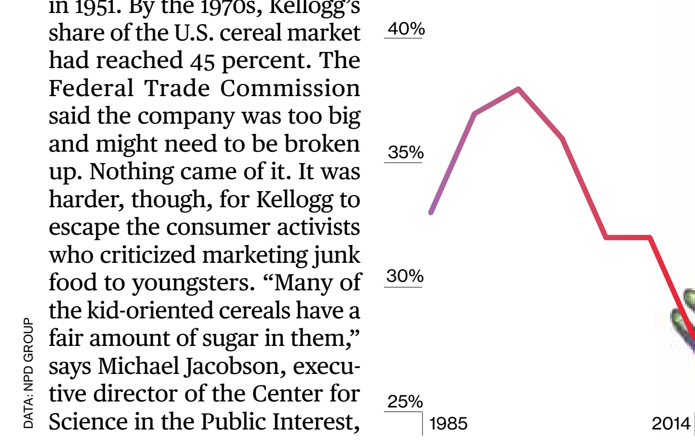
Share of American breakfasts that include cold cereal



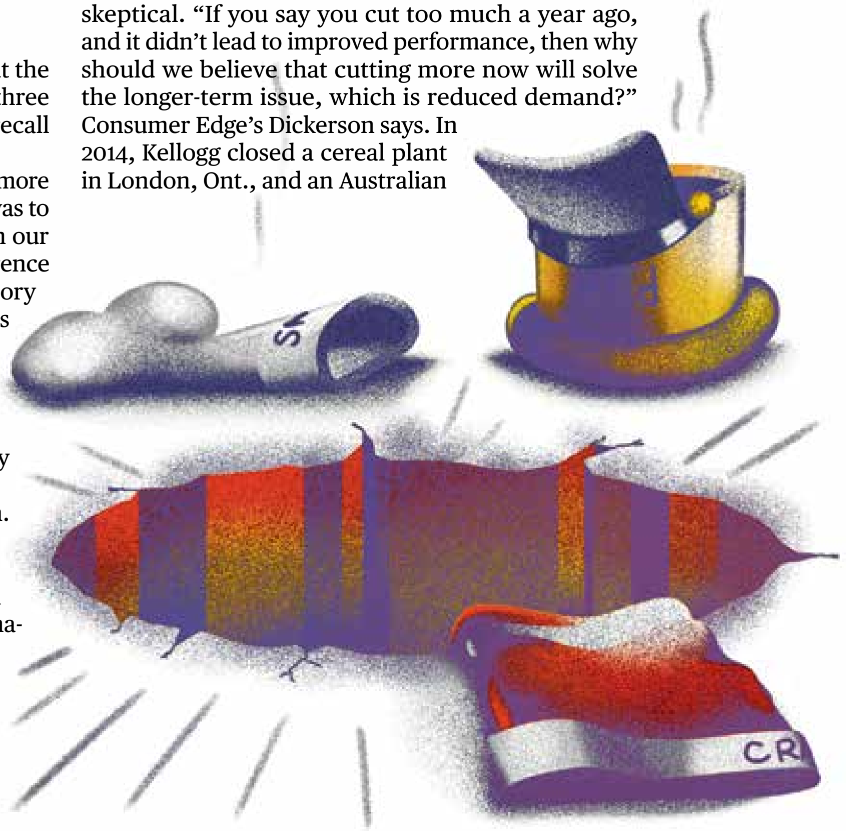
“For a while, breakfast cereal was convenience food. But convenience is relative”

in the company’s factories. It was soon clear that Mackay had gone overboard. A flood at an Eggo factory in Atlanta led to a debilitating frozen waffle shortage that battered the company’s financial results in 2009. The following year, Kellogg recalled 28 million boxes of Froot Loops, Honey Smacks, and others manufactured at its Omaha plant because of an odd stench and taste the company traced to the plastic lining in the boxes. Kellogg acknowledged that some customers started their day with these cereals only to be sidelined by nausea and diarrhea. “It was horrible,” says Trevor Bidelman, president of Local 3G of the Bakery, Confectionary, Tobacco Workers and Grain Millers International Union, which represents workers at the Battle Creek cereal factory. “They cut way too deep. Probably the biggest thing that hurt them was the thousands of years of experience that they ran out the door. Our plants could not run very effectively for two to three years after that.” (Kellogg says neither the flood nor the recall were related to K-Lean.)

By the end of 2010, Kellogg had replaced Mackay with the more gregarious Bryant, a 13-year Kellogg veteran. His first task was to clean up the K-Lean mess. “We did cut too many people in our facilities in the U.S. network,” Bryant admitted in a conference call in November 2011. He said Kellogg was hiring 300 factory workers and adding additional waffle capacity. Some analysts listening were astonished by the disarray in Battle Creek. “It seems like the more rocks that are turned over, there is more ugly stuff underneath,” Eric Katzman, a food industry analyst at Deutsche Bank, said at the time. “It’s amazing that a company like Kellogg, with its reputation, is actually going through this.”

As Kellogg flailed, General Mills strengthened its position. That year, when many Americans were choosing yogurt over Cheerios, it paid $1.1 billion for a controlling stake in Yoplait, the world’s second-largest yogurt producer. As soon as he could, Bryant made what he considered a transformative purchase. In 2012 he orchestrated Kellogg’s $2.7 billion acquisition of Pringles, the 44-year-old canned potato chip brand, from Procter & Gamble. It’s hard to imagine a product more emblematic of the processed food that American consumers were shirking. But the deal boosted Kellogg’s net sales by more than $1 billion that year, to $14 billion, and enabled Bryant to claim that Kellogg was no longer so dependent on cereal.

Kellogg still counted on Frosted Flakes and its breakfast-food siblings for more than a third of its operating profits, which were dwindling. In November 2013, Bryant puzzled Wall Street by announcing a four-year cost-cutting plan with another memorable title: Project K. He vowed to eliminate 7 percent of Kellogg’s workforce and use a portion of the savings to create exciting new cereals, though he declined to provide further details at the time. Industry analysts were skeptical. “If you say you cut too much a year ago, and it didn’t lead to improved performance, then why should we believe that cutting more now will solve the longer-term issue, which is reduced demand?” Consumer Edge’s Dickerson says. In 2014, Kellogg closed a cereal plant in London, Ont., and an Australian snacks operation. Bryant has threatened to close one of its four American cereal plants this year if the bakers union won’t accept a contract enabling Kellogg to hire a new category of “transitional” workers who would be paid lower wages and be ineligible for a pension. “It is not our preferred approach,” Bryant says. “But if that’s where we end up, that’s a path we’ll have to go down.”



So far the union has declined his overtures. Bidelman, a fourth-generation Kellogg employee, doesn’t think the company’s founder would have treated his factory workers so callously. “The philosophy of the company seems to have changed quite a bit,” he says. Instead, Bidelman says, Kellogg should trim Bryant’s compensation, which was $7.9 million in 2013.

Morning-food sales continued to fall in 2014. Some Special K spinoffs posted double-digit declines, and the Kashi line was a particular embarrassment. Kashi Heart to Heart fell 27 percent. Kashi GoLean Crunch lost 30 percent. Analysts say that part of the problem is Kellogg’s indecisiveness with the division. In 2013 it moved Kashi from Southern California to Battle Creek, which Kellogg insisted would better position it for future growth. Then, last year, Bryant announced that Kellogg was moving Kashi back to La Jolla so the struggling unit would be closer to its roots. “Kashi is a brand that has lost its way,” says RBC’s Palmer. “Many of its varieties are not organic. Many have GMOs.”

While Bryant attacked costs, his competitors added new cereals in response to consumers’ shifting breakfast habits. In January 2014, General Mills announced GMO-free Cheerios. Post said it would release a similar version of Grape-Nuts. Kellogg says it can’t do the same with Frosted Flakes because almost all the corn made in the U.S. is genetically modified.

In November, Bryant made a belated attempt to get some new breakfast fare to market, unveiling a gluten-free Special K in an earnings call. He arguably went off message, however, by making a big deal out of a new peanut butter and jelly Pop-Tart. “If I ask you do you think peanut butter and jelly Pop-Tarts are where United States food culture is headed, the answer most likely is no,” Dickerson says.

In February, Bryant acknowledged that Kellogg’s U.S. snacks division was also ailing. Last year its sales declined 2 percent. This put even more pressure on him to resuscitate the cereal division, so Bryant has been pushing what he describes as a long-term rescue plan. He wants to rebrand Special K from a diet brand to a cereal for the health-conscious with new variants such as Special K Protein Cinnamon Brown Sugar Crunch. The company is also promoting Raisin Bran with Cranberries. Bob Goldin, executive vice president of Technomic, a food industry consultant, doubts that these new cereals will have a big impact on the company’s sales. “The category is pretty mature,” Goldin says. “It’s not so easy anymore to introduce a new line or do a new TV ad and life is good again.”

Bryant is also determined to restore Kashi’s credibility with health-food shoppers. Kellogg already has 15 GMO-free cereals in supermarkets. It hopes to add more this year. At the same time, Kellogg’s less publicized political maneuvers aren’t helping it with anti-GMO consumers. In California, Washington, and Oregon, Kellogg is spending $1.4 million to defeat ballot initiatives that would force companies to identify GMO ingredients on their labels. Alexis Baden-Mayer, political director of the Organic Consumers Association, says Kellogg is alienating customers: “It seems counterintuitive.” Kellogg says state-by-state labeling would confuse shoppers and increase costs.

Focusing on Special K and Kashi comes with the risk of neglecting older brands–the ones keeping Kellogg afloat. Even though Frosted Flakes is hardly a next-generation breakfast product, the company sold $439 million worth last year, making it the second-most popular cereal in the U.S. after General Mills’ Honey Nut Cheerios. What’s more, Kellogg increased Froot Loops sales by 3 percent, to $266 million, by marketing the technicolor rings to adults as a late-night snack. “These are not dead brands,” says Mary Zalla, global vice president of Landor Associates, a branding adviser. “There’s amazing equity in Kellogg’s name. Then they’ve got this other whole layer of value: the characters. Sometimes they have longevity. Sometimes they don’t. But think of Ronald McDonald.”

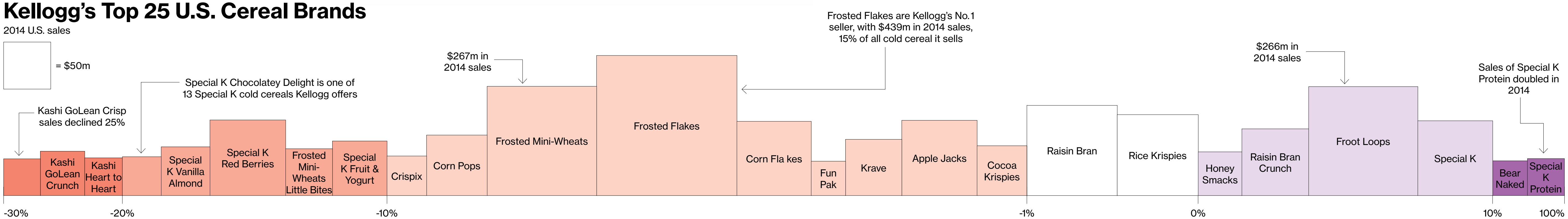
Bryant isn’t worried. “The company has been around for 109 years,” he says. “We have the time. We have a plan to turn it around.” He better show results in a hurry. The consensus on Wall Street is that Kellogg is a takeover candidate. “He’s at a critical point in his career,” says Palmer of Bryant.

Perhaps it’s time for the CEO to imagine what W.K. Kellogg would do. It’s doubtful the company’s founder would let things get so out of control at his factories. It’s hard to think of him taking away employee benefits. He wasn’t a trend follower: Kellogg created breakfast flakes and foresaw the power of TV advertising. There must be some way for his successors to sell breakfast food to working parents and their children who are now watching YouTube instead of Saturday morning cartoons. Bryant could always triple his All-Bran Buds consumption and entice his children to eat more cereal, too. It may not save Kellogg. But at least he’ll be able to say he went down fighting. B

—With Matthew Boyle

Kellogg’s Top 25 U.S. Cereal Brands

2014 U.S. sales



Change in U.S. sales, 2013 to 2014

DATA: CONSUMER EDGE RESEARCH