



SAM M. WALTON COLLEGE of BUSINESS



Supply Chain Management Research Center



Phoenician Phoods, Breakfast Cereal Manufacturer and Distributor¹

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(All references to Phoenician Phoods are fictitious)

Introduction

October, 2008. Sara Haran fretted as she thought about the events of the past few weeks. So many plans that had been in the works for years were being considered all at once. How could she lead when so many disparate threads were loose?

Sara is the Executive Vice President of Business Units for Phoenician Phoods of America, Inc. Phoenician Phoods (PPA) are the fourth largest Ready-To-Eat (RTE) cereal manufacturer in the U.S.A. In the past 24 months, PPA's major competitors had all rolled out multiple initiatives to either increase prices or reduce their package sizes. PPA had seen their gross margins shrink, even as they were losing the battle for shelf space to their better funded competitors. Revenues were in decline. Kellogg's reduced the size of 1/3 of their line-up of cereals in early 2007. General Mills had revamped nearly its entire product package line in a "Right Size, Right Price" roll out in June of 2007. PPA was having great difficulty in keeping their 10% market share, due to inroads by their competitors in the all-important \$2 to \$4 price range. PPA had taken the strategy of increasing prices as costs increased, and even then their price per ounce was better than their chief competitors. But, as their retail prices exceeded \$4 per package, their market share plunged by 1.3% in 2007. The trend continued into 2008, decreasing another 1%.

The Ready-To-Eat Breakfast Cereal Industry

Kellogg's and General Mills are the leading competitors in the U.S. RTE cereal space, with about a 33.3% and a 28.6% market share, respectively, as of 28 January 2007 (Table 1). Post is at 14.3%. Quaker is at 6.3%. PPA had declined to 8.7% and private label cereals rounded out the rest.

Table 1. U.S. Ready-To-Eat Annual Sales Leaders (millions) and Market Share

52 Weeks Totals Ending on the Date Indicated:	U.S. RTE Cereal Sales (ex Wal-Mart) 28Jan07*	U.S. RTE Cereal Market Share*	U.S. Cereals, Dec 2004-Hot&RTE^	U.S. Cereals Market Share^
Kellogg's	\$2,100	33.3%	\$4,369	32.2%
General Mills	\$1,800	28.6%	\$4,234	31.2%
Post	\$899	14.3%	\$2,307	17.0%
Private Label & Generic	\$555	8.8%		
Phoenician Phoods	\$548	8.7%	\$1,357	10.0%
Quaker Oats	\$399	6.3%		

*"Cereal Breakfast Foods." *Encyclopedia of American Industries*. Online Edition. Gale, 2009. Reproduced in Business and Company Resource Center. Farmington Hills, Mich.:Gale Group. 2008. Data from Information Resources Inc. surveys of mass channels only, except Phoenician Phoods, which is fictional.

^Datamonitor Industry Market Research. "U.S. Breakfast Cereals". Dec 1, 2006. Datamonitor MarketDefinition. (includes hot cereal and RTE and all channels)

Public information about the cereal operations of the competitors is hidden in the financial reports of some major food manufacturers in the United States. Phoenician Phoods' competition is comprised of

much larger companies: Kellogg Company, General Mills, Kraft, and Pepsico all have annual revenues in excess of \$10 Billion. Kraft recently spun off Post Cereals to Ralcorp in a deal announced in November 2007, formalized in May 2008, and consummated 4 August 2008. Ralcorp had been a manufacturer of private label cereals, but purchased Post for \$1.7 Billion in stock, cash, and notes. An indication of the relative size and contribution of the cereal operations to the reporting business segment is in Table 2.

Table 2. U.S. Ready-To-Eat Cereal Portion of Parent Reporting Business Segment

Reporting Business Segment	2006 Annual Revenues of Reporting Unit* (millions)	U.S. RTE Mass Channel Cereal Sales ex Wal-Mart [^]	Approx. RTE Mass Channel Percent of Segment Sales
Kellogg's, North America	\$7,349	\$2,100	28.6%
General Mills, U.S. Retail	\$8,491	\$1,800	21.2%
Kraft, Snacks and Cereals (including Post)	\$5,810	\$899	15.5%
Private Label & Generic		\$555	
Phoenician Phoods	\$548	\$548	100.0%
Pepsico, Quaker Foods NA	\$1,769	\$399	22.6%

*General Mills' annual data is for period ending 27 May 2007. Data from annual reports, except Phoenician Phoods, which is fictitious. Data for Private Label is an industry estimate.

[^]52 weeks ending 28 January 2007 (see reference from Table 1)

The recent performance of the business units containing the largest RTE cereal producers is in Table 3. The value of U.S. RTE cereal sales is growing faster than inflation, partly due to inflationary pressures and partly due to increased unit sales. Complicating the analysis is the trend, started by Kellogg's on one-third of its product lineup, to reduce package sizes while maintaining prices. The volume of air in packages when they are first sealed is strictly regulated by the federal government of the United States. So, in order to reduce the amount of cereal sold per package, the package size must be reduced. Post had actually increased prices throughout 2006 to 2008, but their sales suffered. Their competitors used their decline in sales to take market share. More recently, General Mills responded to the increase in raw material prices and the policies of their competitors to roll out their "Right Size, Right Price" strategy on June 25, 2007. "According to Landor Managing Director Allen Adamson, the idea of changing package sizes to give consumers the idea they're paying less is a common one and often works, because consumers tend to 'shop specific price points vs. price-per-ounce.' The important thing, he said, is to be 'careful to ensure it's a tweak rather than too far a push that will affect the value equation of the brand.'⁵" More recently, Kellogg's completed another round of package size reductions. According to the Wall Street Journal, "David Mackay, Kellogg's chief executive officer, said in an interview last week that his company has shrunk about 10% of its U.S. breakfast-cereal boxes by an average of 2.4 ounces."⁶ This time, affected products included Froot Loops, Cocoa Krispies, and Apple Jacks.

⁵ Thompson, Stephanie. "Big G yields on cereal-price cuts; Joins rivals in downsizing boxes to effectively lower consumers' checkout bill" in *Advertising Age*. March 19, 2007. Craine Communications.

⁶ Kilman, Scott. "Food Giants Race to Pass Rising Costs to shoppers" in *Wall Street Journal*. Aug 8, 2008. Dow Jones & Company, Inc.

Table 3. Competitive Segment Sales and Operating Profits for Parent Reporting Units to U.S. Cereal Manufacturers

<i>Fiscal Year</i>	Q1*	Q2	Q3	Q4	<i>Calendar Year</i>	Q1*	Q2	Q3	
Segment Net Sales	<i>2006 Total*</i>	<i>31-Mar-07</i>	<i>30-Jun-07</i>	<i>30-Sep-07</i>	<i>31-Dec-07</i>	<i>2007 Total</i>	<i>31-Mar-08</i>	<i>30-Jun-08</i>	<i>30-Sep-08</i>
General Mills, US Retail	\$ 8,491	\$ 2,108	\$ 2,031	\$ 2,032	\$ 2,521	\$ 8,692	\$ 2,301	\$ 2,219	\$ 2,290
Kellogg, North America	\$ 7,349	\$ 2,002	\$ 1,980	\$ 1,960	\$ 1,844	\$ 7,786	\$ 2,148	\$ 2,127	\$ 2,156
Kraft, Snacks and Cereals	\$ 5,810	\$ 1,396	\$ 1,464	\$ 1,475	\$ 1,519	\$ 5,854	\$ 1,430	\$ 1,539	\$ 1,274
Phoenician Phoods of America	\$ 610	\$ 151	\$ 146	\$ 132	\$ 119	\$ 548	\$ 140	\$ 138	\$ 140
Pepsico, Quaker Foods North America	\$ 1,769	\$ 463	\$ 390	\$ 411	\$ 596	\$ 1,860	\$ 495	\$ 406	\$ 391
U.S. Post (<i>Kraft 8-K from 19 Sept 08</i>)^	\$ 237	\$ 262	\$ 255	\$ 221	\$ 975	\$ 240	\$ 267		
	<i>*Gen Mills FY end 27May07</i>	<i>*for Gen Mills: 25Feb07, 27May07, 26Aug07,25Nov07 Pepsico: 24Mar07, 16Jun07, 8Sep07, 29Dec07</i>					<i>*Gen Mills: 24Feb08, 25May08, 24Aug08 Pepsico: 22Mar08, 14Jun08, 6Sep08</i>		
Segment Operating Profit	<i>2006 Total</i>	<i>31-Mar-07</i>	<i>30-Jun-07</i>	<i>30-Sep-07</i>	<i>31-Dec-07</i>	<i>2007 Total</i>	<i>31-Mar-08</i>	<i>30-Jun-08</i>	<i>30-Sep-08</i>
General Mills, US Retail	\$ 1,896	\$ 447	\$ 406	\$ 473	\$ 584	\$ 1,910	\$ 486	\$ 428	\$ 526
Kellogg, North America	\$ 1,341	\$ 361	\$ 365	\$ 333	\$ 286	\$ 1,345	\$ 403	\$ 380	\$ 380
Kraft, Snacks and Cereals	\$ 774	\$ 231	\$ 251	\$ 240	\$ 217	\$ 939	\$ 174	\$ 292	\$ 170
Phoenician Phoods of America	\$ 111	\$ 27	\$ 27	\$ 22	\$ 18	\$ 95	\$ 26	\$ 25	\$ 25
Pepsico, Quaker Foods North America	\$ 554	\$ 156	\$ 117	\$ 126	\$ 169	\$ 568	\$ 166	\$ 122	\$ 134
U.S. Post (<i>Kraft 8-K from 19 Sept 08</i>)^	\$ 76	\$ 96	\$ 83	\$ 77	\$ 332	\$ 78	\$ 94		

^Kraft sold Post to Ralcorp, a generic cereal maker, in a deal for \$1.7 Billion stock and cash, consumated on 4 August 08

As the General Mills initiative was announced, the Wall Street Journal interviewed the CEO: "Reducing the size of its cereal boxes is something General Mills' competitors have been doing for some time. 'As a result, shelf prices for our larger packages are often higher today than many competitors' products,' General Mills spokesman Tom Forsythe said. By being priced in line with rivals' smaller-size cereal boxes, the company hopes its products will look more attractive. The company also hopes its "Right Size, Right Price" initiative will boost margins -- something all food companies are trying to do as they get squeezed by lower-cost, private-label goods and more-expensive fresh and organic food."⁷

In reflecting on the General Mills strategic initiative of June 2007, *The Globe and Mail* noted, "The price per box will be lower, but the cost per ounce will be higher. 'Most consumers compare the price per box, not the price per ounce,' General Mills chief operating officer Ken Powell said. He acknowledged that the company has been losing ground to rivals who had already moved to smaller boxes. The maker of Wheaties and Cheerios cereals said it expects raw material costs to rise 5 per cent in 2008. This includes a \$260-million (U.S.) increase in the cost of corn, oats, natural oils and dairy."⁸

Competition at the Shelf

In contrast, Phoenician Phoods of America had raised prices several times in the past 2 years, causing many packages to exceed the \$4 price point. As a result, PPA's market share was falling and analysts were questioning how long the company could remain independent. According to Information Resources Inc. for the 52 weeks ending 9 September 2007, excluding Wal-Mart sales (See Table 4), "The top ten brands were: private labels with nearly \$588 million; General Mills Cheerios with \$297.4 million; Post Honey Bunches of Oats with \$287.6 million; General Mills Honey Nut Cheerios with \$262.6 million;

Table 4. Summary of 2007 Annualized Data from Information Resources, Inc.

Kellogg's	Million \$	General Mills	Million \$	Post	Million \$	PPA (fict.)	Million \$	Generic /House	Million \$
Frosted Flakes	239.4	Cheerios	297.4	Honey Bunches	287.6	Sugar Bombs	99.2	All Types	588
Frosted Mini Wheats	213.4	Honey Nut Cheerios	262.2			Corn Bombs	93.3		
Froot Loops	140.1	Cinn. Toast Crunch	144.9			Bombs Away	63.3		
Special K	137.1								
Rice Krispies	136.3								
Total	866.6		704.5		287.6		255.8		588
% of Co. Segment Sales	12%		8%		16%		42%		100%

⁷ Jargon, Julie. "General Mills Raises Price on Line of 'Big G' Cereals" in Wall Street Journal. June 6, 2007. Dow Jones & Company, Inc.

⁸ McKenna, Barrie with Tavia Grant. "The skinny on the food sector: smaller packages, same price" in *The Globe and Mail*. July 20, 2007. The Globe and Mail.

Kellogg's Frosted Flakes with \$239.4 million; Kellogg's Frosted Mini-Wheats with \$213.4 million; General Mills Cinnamon Toast Crunch with \$144.9 million; Kellogg's Froot Loops with \$140.1 million; Kellogg's Special K with \$137.1 million; and Kellogg's Rice Krispies with \$136.3 million. Of these, Rice Krispies had the highest jump from the prior year with an increase in sales of 13.2 percent while Frosted Mini-Wheats had the biggest drop of 10.7 percent.⁹ On the same basis, PPA's top brands are Sugar Bombs with \$99.2 million in annual sales, followed closely by Corn Bombs with \$93.3 million in sales. PPA's third leading brand is Bombs Away (a multigrain sugared cereal) with \$63.3 million in annual sales. These leading examples show the value of a brand for a product category often thought to be a commodity. However, the rate of U.S. unit growth is slowing, even as price increases are sticking, just as with other consumer packaged goods (CPG). Grains and raw materials have experienced cost increases, too. Table 5 shows the changes in the U.S. market over five years. So, as volume growth is decelerating, revenue growth continues apace. Meanwhile, the jostling among the manufacturers for market share and profits continues.

A Case of Surprisingly Great Influence on Availability and Costs

Recent research indicates that cereal case size influences the profitability of SKUs (Stock Keeping Units—products with unique UPC codes) in the category, even when controlling for facings, price per ounce, and price per box¹⁰. Products that are “A” and “B” SKUs in rate of sales seem to benefit from larger case sizes, while “C” and “D” SKUs benefit from smaller case packs. This appears correlated to a reduction in out-of-stocks, due to the case size more closely matching the required rate of replenishment. Benefits include a reduction in labor requirements from reduced trips to the back room. These are the core supply chain management issues: choice of case pack size to match product sales velocity affects product availability and lowers costs due to inventory, transportation, packaging, and labor.

In addition, many retailers make cuts in product facings if the SKU has reduced case sales velocity, relative to others. So, a lower velocity SKU is more likely to keep its facing and to stay on the shelf, if the case sizes are smaller. PPA finds that its competitors are reducing package sizes to keep prices per box low and reducing packages per case pack for low sales velocity SKUs.

Table 5. Growth in revenues and volumes for the U.S. cereal market.

Year	U.S. Cereal Sales (millions)	Growth in Dollar Sales	U.S. Cereal by Weight (metric tons)	Growth in Weight
2002	\$11,000		1,598,100	
2003	\$12,700	14.7%	1,773,400	11.0%
2004	\$13,600	7.2%	1,840,300	3.8%
2005	\$14,700	8.4%	1,943,200	5.6%
2006	\$15,600	6.3%	1,973,400	1.6%

Data Source: Datamonitor Industry Market Research. “U.S. Breakfast Cereals”. Dec 1, 2006. Datamonitor MarketDefinition. (includes hot and RTE cereals and all channels)

⁹ "Cereal Breakfast Foods." *Encyclopedia of American Industries*. Online Edition. Gale, 2009. Reproduced in Business and Company Resource Center. Farmington Hills, Mich.:Gale Group. 2008.

¹⁰ Waller, M.A., Tangari, A.H., and Williams, B. D. 2008. *International Journal of Physical Distribution & Logistics Management*. Vol. 38, No. 6. Pp. 436-451. Emerald Group Publishing Limited.

Technical Difficulties

Not only was the market situation challenging, but the tech guys in PPA were telling Sara that 95% of their palletized loads do not conform to the Grocery Manufacturers Association (GMA) guidelines. GMA guidelines for 4-way pallet loads are that their dimensions should be 40" (101.6 cm) wide x 48" (121.9 cm) long x 50" (127 cm) high. If PPA could conform, they could fit 28 pallets on the floor of a roll-door 53-foot (16.15 m) trailer, internally 110" (2.79 m) high x 98" (2.49 m) wide and double stack the pallets. 30 conforming pallets can fit in the floor of a swing-door trailer. Overall, transportation and handling swell for GMA non-conformance adds 10% to transportation costs. Cereals are light freight, so trailers of cereal boxes always "cube out" due to volume. Any wasted space in a trailer is the same as shipping air. This is a problem from both economic and environmental standpoints. Transportation companies are charging more because the loads are inefficient, whether PPA ships truckload or LTL. But to retool loads requires a learning curve. In the mass market part of its business, which is 96% percent of PPA's volume, pallets usually consist of a single SKU delivered to the retailer's Regional Distribution Center. The retailer or PPA's contract warehouse then breaks the pallets and mixes cases for final delivery to retail stores.

The packaging engineers tell Sara that if they reduced package sizes, the packages get stronger, so the box material and cases could be thinner. In order to conform to government requirements, the boxes when sealed must have no less than 80% of the package contents be product. In order to comply with the law, PPA had been adding extra cereal to each box, which is called "product swell" in the breakfast cereal industry. This product swell had been costing PPA 2% of the operating cost for their cereals.

A Plethora of Packages and Prices

PPA has 200 SKUs, divided into 25 box sizes and sold in 24 price tiers. The engineering department was always complaining about the time lost in changeovers from one size box to another. The packaging line involved in a changeover would be down for at least 8 hours (a full shift) if there was a need to change box sizes, but only 4 hours if the product changed but the box size was the same. Conversion of box sizes would mean paying a New Item Funding Distribution Allowance (NIFDA) fee to reserve a new UPC code, reenter all of the affected brands into the databases, and restock shelves of retailers carrying the new products. The standard NIFDA fee is 2% of estimated annual gross sales. There is a 10% discount for handling 10 or more SKUs at one time, a 20% discount for 25 or more at one time, and a 25% discount for 50 or more at one time. Rationalization to fewer uniform package sizes among the brand offerings and fewer price tiers that follow customer spending patterns would lead to cost savings.

Corn Bombs is the basic cereal that PPA produces. For Corn Bombs in 2008, a retail \$3 box of 18 ounces of cereal (dimensions 10.5 x 7.75 x 2.5 inches—26.67 x 19.69 x 6.35 cm) includes a \$0.75 cost of grain and raw materials, a \$0.35 cost of four-color printed packaging and liner, a \$0.35 cost of manufacturing (labor and depreciation), a \$0.05 inventory cost (on-site warehouse and logistics labor), \$0.30 is waste and damaged freight, \$0.15 for wastewater treatment and waste processing, and a \$0.45 transportation cost, leaving a \$0.40 operating profit and \$0.20 retailer profit for this basic brand. Basic brands use little

advertising. Premium brands like Sugar Bombs have added costs of \$0.35 to \$0.45 for sugar, \$0.35 for coloring and shaping, and \$0.35 for promotions (this cost is not variable by package size). Sugar costs depend on the commodity cost of sugar (price supports give a \$0.35 floor). New products with added fruit, like Cherry Bombs, have an added cost of \$0.30 per 18-ounce box for the fruit and new products bear a product development charge of \$0.45 for the first two years after launch in the PPA accounting system. Other additions to the cereal cost similar amounts. The vitamin fortification in Bombs Away costs \$0.35 per 18-ounce box. For the premium brands, there is a cost squeeze to stay under the \$4 tier, so this drives box sizes smaller. Clearly, package sizes can't go to zero. However, if case dimensions allow pallets to conform to GMA, transportation costs drop.

Last year, PPA had an overall cereal manufacturing utilization rate of 80% for a 365-day schedule. The packaging unit utilization rate achieved last year was 80%. If PPA could reduce product swell, more of the manufactured cereal could be used in filling packages to the weight counted on the label. If PPA could reduce the time in packaging changeovers, the existing equipment and facilities could produce more packages for sale. The inventory system at the PPA factory has excess capacity to cover even 100% utilization of current production and packaging units. Handling old and new inventory side-by-side would strain the system, so any packaging modification would need to be done in a strict sequence.

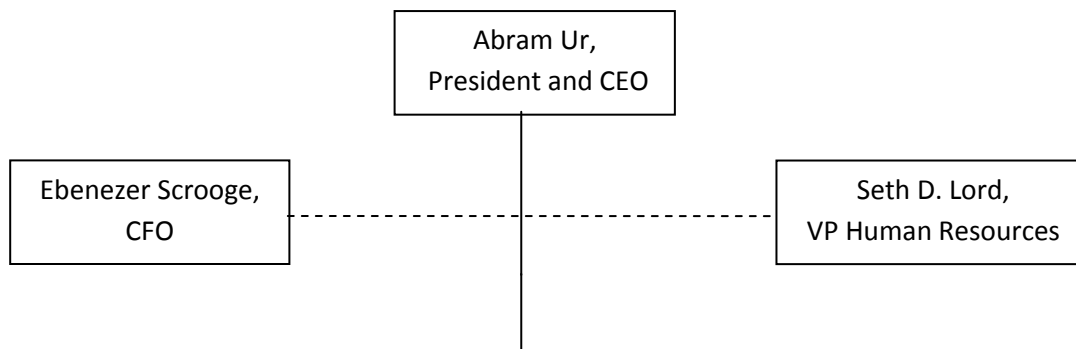
The Dilemma for Phoenician Phoods: High Risks, High Rewards

Before you can roll out new product, you must develop a plan for the old SKUs. Everything would need to be coordinated to avoid empty shelves. If the retailer sees empty shelves where your product should be, they might choose to cut your products. Empty shelves mean lost sales to a retailer. Existing inventory would need to be sold out, shelves reset, and new product restocked. It would have to be seamless. The risks are huge. Is it worth it? So many things need to be done at once. Thirty-year professionals in operations and logistics at PPA had never made this many simultaneous changes in a single product line, let alone all of them at once. The company would not survive a faulty rollout of this magnitude. With the NIFDA fee, retooling, renegotiation of transportation contracts, and temporary labor, this kind of change would be very expensive. Would the cost savings give a reasonable ROI?

Sara Haran of Phoenician Phoods finds herself in a difficult situation. Her competitors are better funded and increasing market share, while PPA has a declining market share. Up until 2007, sector growth helped PPA. However, now there was margin pressure, market share pressure, decelerating sector growth, and financial turmoil. The cereal sector has been considered recession-proof, because "people always need to eat". Cereal volume trends run opposite stock market trends, because RTE cereals are relatively cheap nutrition. But if your competitors are eating your lunch, you are bound to go hungry.

PPA uses a matrix style of organization (Table 6). One of Sara's Brand Managers, Roland "Rolly" Rao, insists that the graphics on the boxes of his brand are outdated, representing yet another needed change. Sara knows that Rolly is fighting for what is best for his brand, but how could she influence her counterpart, Laban Tyre, the EVP of Operations?

Table 6. Phoenician Phoods of America Organizational Chart



EVP of Business Units, Sara Haran	SVP of Sales and Marketing, Rebecca Sunnybrook	COO/EVP of Operations, Laban Tyre	SVP of Engineering and R&D, Isaac Stern	VP of Transportation & Logistics, Esau Stevens	CQO/VP of Quality and Regulatory Compliance, Ishmael Kant
Manager of Sugar Bombs, Rolly Rao	Mass Channel Sales, Kate Wiggin	Cereal Operations, Marcus Welby	Plant Engineering, Harvey Mudd	Procurement, Balthazar King	Legal Services, Oliver W. Holmes
Manager of Corn Bombs, Gordon Lightfoot	Club Sales, Johann Wyss	Packaging Unit, Hideki Origami	Product R&D, Marie Curie	Outbound Transportation, Melchior Prince	Environmental Compliance, Rachel Carson
Manager of Bombs Away, Jim Hightower	Pricing and Marketing, P.T. Barnham	Plant Personnel, Redd Skelton	Equipment Design, Charles Alton Ellis	Inbound Bulk Transportation, Caspar Wise	Quality Assurance, Ralph Nader
Manager of New Brands, Alvin Toffler	New Brand Sales, George Orwell	Production Analysis, Jonas Salk	Warehouse Design, Augustus Roebing	Inventory Control, Elizabeth Windsor	Waste & Cost Control, Jacob Marley
Manager of Old Brands, Adam Ant	Old Brand Sales, Eve Horizon	Production Scheduling, Father Time		Commodity Analysis, Charles Dow	Regulatory Liaison, Bartleby Scrivener

Conclusion

Sara talked last month to the CEO, Abram Ur, about all of the problems. Many of the problems were not under Sara's authority, but the matrix organizational structure helped her to point out that her brands are affected by the inefficiencies. She has a reputation as a confrontive, powerful person. She and Abram get along well, so Abram responded to her concerns, telling her that she should create a comprehensive plan to present to him. He was open to anything, "just show me cost savings to offset any costs." Any one-time costs not offset in the current fiscal quarter would need to be approved by the Board of Directors and Abram was not keen on approaching them on that issue with a recession imminent.

Your team is a consultant to Sara and her executive team. Develop the plan she needs to present to Abram Ur, tomorrow. Use the limitations and factors described above to address, at a minimum: manufacturing utilization limitations, transportation and inventory costs, packaging costs and utilization, case pack sizes and pallet dimensions, competitive pricing, short-term vs. long-term perspectives, and company responsiveness and culture. Assume that your solution will help Phoenician Phoods of America to survive independently and to retake lost market share, not to prepare to be sold.