

Armed Forces Marketing Council

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Major Companies Represented by Member Firms of the
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to One or More Segments of the Military Resale System

Acclaim Entertainment	General Mills/Pillsbury	Oneida
Alberto Culver		Osram Sylvania
Alcoa		Panasonic
Allergan	Georgia Pacific	Pentax
American Italian Pasta	Gillette	
Anheuser-Busch	Glaxo SmithKline	
Arizona Beverage	Godiva Chocolatier	Pentel
Atari	Goodyear	Pennzoil Quaker State
Audiovox	Guess Watches	Pepperidge Farm
B&G Foods	Haagen-Dazs	Pepsi Cola
Banfi Vintners	Hamilton Beach/Proctor Silex	Perdue Poultry
Bausch & Lomb	Hanes	Pfizer
Bayer	Hartz Mountain	Philip Morris
Bic-Sheaffer	Hawaiian Isles Coffee	Pictsweet
Blue Bunny Ice Cream	Hawaiian Tropics	Pinnacle Foods
Bonne Bell	Heineken	Playtex
Brachs Confections	Heinz	Procter & Gamble
Bridgestone/Firestone	Hershey	Quaker Oats
Bristol-Myers/ Squibb	Hills Pet Nutrition	Reckitt Benckiser
Brown & Williamson	Hormel Foods	Reebok
Bush Beans	Hostess-Wonder	Reilly Foods
Campbell	IBP	Riviana Foods
Canon	JVC	Ross Labs
Carl Buddig, Inc.	Johnson & Johnson	S. C. Johnson & Son
Casio	Kikkoman	Samsonite
Challenge Butter	Kiwi Brands	Sara Lee
Chattem, Inc.	Konami of America	Sargento Cheese
Chef America	Konica Minolta	Schering-Plough
Chicken of the Sea Seafoods	Kraft-Nabisco	Sealy
Coca-Cola	Lancaster Group	Seiko/Pulsar
Colgate Palmolive	Land O' Lakes	Seneca Foods
Columbia Sportswear	Lea & Perrins	Shasta
ConAgra	L'eggs	Shop Vac
Contico	Lego	Shultze and Burch
Conwood Tobacco	Leiner Health	Sioux Honey
Dannon	L'Oreal	Slimfast
DeLonghi	Luxottica Group	Smucker s
Del Monte	Marcal Paper Mills	Snapple Beverage
Del Pharmaceuticals	Mars, Inc.	Snyder's Pretzels
Diageo	Maybelline	Solo Cup
Dial	Maytag	Sony
Dr. Pepper/Seven Up	McIlhenny	Stockmeyer
Dreyers Edy's Grand Ice Cream	Melitta, North America	The Wine Group
Dunlop Golf	Midway Home Entertainment	3DO
Durex Products	Miller Brewing	3M
EAS	Morton Salt	Timex
Eastman Kodak	Motts	Tony's Pizza Service
Euro-American Foods	Multifoods	Tootsie Roll
Eveready	Musco Foods	Unilever
Ferrero USA	Nabisco	United States Tobacco
Fleishmann's Yeast	Nestle	U.S. Nutrition
Florida Natural	Neutrogena	Vanity Fair Mills
Focus Golf	Newman's Own	Veryfine
Frito Lay	Nike Golf	VIP Frozen Vegetables
Future Brands	Norvartis	Vivendi

Voquestrap
Waterpik
Welch's
Wieder's Nutritional
Wilson Sports
Wrigley
Yankee Candle

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The Case for Military Commissaries

The military commissary system is a proven, cost effective government program. It provides taxpayers a substantial return on their investment, and contributes toward a properly compensated military force. Misguided proposals to privatize the commissary system fail to recognize or sufficiently credit the following:

1. Computation of total military compensation considers the savings realized from shopping in commissaries. It follows that any reduction in those savings amounts to a reduction in military pay.
2. Commissaries effectively reduce the Defense budget by over one billion dollars, because their non-monetary compensation value to military people is more than double the amount of taxpayer dollars appropriated for their operation.
3. Military members and their families consider commissaries to be the number one non-cash compensation program. To tamper with the commissary program would invite a severe adverse reaction and negatively impact morale, recruitment, retention, and readiness.
4. The Defense Commissary Agency (DeCA) has effected considerable reductions in operating costs and adopted the best commercial business practices, for which it has received three Hammer awards.
5. In operational productivity, commissaries surpass comparable commercial grocery stores in sales per operating hour, employee, store, and square footage.
6. In order to promote efficiency DeCA has already outsourced (contracted out) many in-store functions; such as, shelf stocking not provided by suppliers, custodial services, and delicatessens.
7. Privatization would cause the demise of many small and minority owned businesses; such as local and regional suppliers, distributors, manufacturers' sales representative firms, and firms granted set-asides.
8. A private sector contractor would use cheaper foreign flag carriers for overseas transportation. However, the Fly America Act of 1974 and the Cargo Preference Act of 1904 and 1954 require the use of American flag carriers for overseas transportation. The Defense Transportation System that the DoD maintains and exercises in peacetime is a

vital element of DoD's capability to project power worldwide, and is key to responsive force projection and a seamless transition between peacetime and wartime operations.

9. Privatization of commissaries without a sizable taxpayer subsidy would be an economic impossibility were a privatized system required to observe the same ground rules as the Defense Commissaries Agency; i.e.,
 - Sell all products at cost as required by law
 - Offer the same savings or compensation value
 - Stock the same product categories
 - Operate comparable physical facilities
 - Maintain service even in those small, remote and overseas locations where it is uneconomical to do so.
10. Commercial grocery stores carry a wider assortment of products to meet required gross profit margins and company profit expectations. This could not be done in commissaries without an adverse impact on the exchange services that must carry those products at a markup to cover operating expenses and inventory costs, while still generating dividends sufficient to meet MWR commitments.
11. A privatized system would no longer be exempt from the Robinson-Patman Act; i.e., manufacturers could no longer offer lower prices to a privatized commissary system than they do to other customers.
12. A privatized system would be required to collect state and local taxes, thus raising prices to the patrons.
13. Historically, government contract costs for large operations have frequently escalated to the point where they exceed the cost of performing the function in house. Privatization of the commissary system would be an irrevocable step with unforeseen long-term consequences.
14. Privatization would also result in loss of the following:
 - Surcharge revenue so essential to recapitalization. Currently, facilities built with this money, which is collected from the patrons, become the property of the federal government.
 - Vendor labor-saving support provided at no cost to the government; such as, shelf stocking and in-store merchandising which is not provided by vendors to the same degree in commercial grocery stores, except for Direct Store Delivery items -- dairy, soft drinks, and some snacks.

- Small and disadvantaged business set-asides currently required of the Defense Commissary Agency.
- Support for the NISH and the National Industry for the Blind (NIB) who currently supply goods and services to the commissary system.
- DoD infrastructure support. Commissary use of DoD communications, accounting, subsistence, postal, and utilities functions leverage rates charged to other DoD customers.

15. Past reviews have concluded that privatization will not work:

- In 1984, a joint GAO-CBO review could not validate the savings estimates for either closing or privatizing commissaries.
- In February 1985, a GAO critique of the Grace Commission study concluded that estimates of savings from privatization were questionable.
- A test of contracting out commissaries in the mid 1980's failed.
- Privatization recommended by the Defense Science Board in 1995 was deemed unworkable.
- In October 1997, a CBO study again proposed contracting out, but recognized that prices to the patron would rise.

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Consolidation of Military Exchanges

Success Criteria and Risk Factors

Success Criteria:

- First and foremost, the establishment of a compelling and proven business case for integrating the exchange services.
- Identifiable improvement in price savings, and merchandise selection, variety, and availability.
- Achievement of improved scores in both customer and employee satisfaction.
- Separate and distinct buyer groups to assure retention of the unique culture and shopping environment afforded by the current exchange services.
- Increased sales, earnings and dividends.
- No degradation in sales, earnings, or dividends during the transition.
- Realization of substantial savings in operating costs identifiable by both magnitude and source.
- Adoption of best business practices.
- Transition costs paid for out of appropriated funds.
- Assuring an equal voice by each of the military services in decision making and governance.
- Successful resolution of the potentially adverse financial impact of separating the Marine Exchange Service from the Marine Corps Community Services.

Risk Factors:

- Failure to realize the above critical success factors.
- Sidetracking of critical exchange initiatives due to diversion of human capital (i.e., best personnel resources) during the planning and implementation stages.
- Prime privatization target presented by a unified DOD exchange service.
- Potential for exchange earnings being used to offset the appropriated fund requirements for commissary operations. (Service members funding their own benefit.)
- Decrease in earnings, dividends, and capital improvements if projected savings are not realized.
- Lost sales with consequent reduction in earnings, dividends, and capital improvements.
- Magnitude of the up front impact upon the exchange services; e.g., early out pay-outs and IT system implementation.
- Increased bureaucracy and decreased flexibility.
- Stifling of creativity, and elimination of the current spirit of competition among the services, both of which foster innovation.

**From: John S. Strong
Lawrence J. Ring**

Date: January 15, 2004

Re: Review of Laseter Article

We have reviewed the article “Military Exchange Unification: The Strategic Case for Change”, by Professor Timothy Laseter of the Darden School of the University of Virginia.

We present our comments organized by each section of Laseter’s article. We show Laseter’s statements/findings in italics, followed by our response.

I. Introductory section (pp. 1-2)

1. Laseter claims that the exchange systems are in a weak position, and that stable revenues and contribution are not enough in today’s retail environment.

Given the 9 percent decline in the total eligible population of active, reserve, and retired military personnel cited on p.3, the fact that the exchange systems have been able to maintain stable and slightly growing revenues and contribution should be seen as a significant accomplishment. “Outside the gate” retailers have much better opportunities to grow revenue by adding new locations, which is not possible (or at best a limited option) for the military exchanges.

Exhibits 1a, 1b, and 1c reflect good performance – contribution/dividend, revenue growth and inventory turns are getting better. Also, the best performances shown in Exhibits 1a, 1b, and 1c are by the smaller of the services (NEXCOM and MCX), which should raise at least some question about Laseter’s asserted virtue of size.

2. Laseter claims that many studies have been done, all coming to the same conclusion showing the benefits of consolidation. He apparently agrees with the “mandate” of the current effort that there is “no need to argue over the numbers”. He claims a “strategic rationale” (p.2) that claims the potential opportunity is in the tens of millions or hundreds of millions of dollars.

We have reviewed many of these prior studies and offer a few comments. First, not all studies reached the same conclusions. For example, our review of the recent study by PricewaterhouseCoopers indicates that the benefits from consolidation were significantly overstated and that the costs were significantly underestimated. Moreover, many of the benefits in these studies could be achieved through actions by the exchange systems themselves or through lower cost cooperative efforts.

We think it matters whether benefits are in the tens or hundreds or millions – or if they are there at all. The exchange systems have worked hard to establish a policy of “data-driven decisions”, and this policy certainly should apply to an initiative as significant as consolidation.

II. Accommodating Structural Change (p. 2)

1. *Laseter claims that the change in locations and positioning of active duty personnel will put pressure on the economics of the exchanges.*

We are not sure about the claim that OCONUS exchange operations generate 53% of profits on 30% of sales (no reference is provided in the article). It is important to understand what activities are encompassed in the data as well (for example, does this data include slot machines, etc.?)

2. *Laseter claims that “the larger, more profitable sites must cover the losses from the smaller ones”.*

This is an assertion without evidence to support it. No evidence is presented that larger sites are more profitable or that smaller sites lose money.

3. *At the bottom of p. 2, Laseter notes that collaborative efforts help address fragmentation.*

We agree that there are many opportunities to work together. We would note that such working relationships are common in business short of full-scale mergers.

III. Responding to Customer Needs (p.3)

1. Laseter notes that from 1985 to 2000, there was a 9 percent decline in the customer base.

Again, the ability to hold revenues and contribution stable in a declining environment should be seen as good performance by the exchange systems.

2. Laseter notes that retirees are a growing share of the eligible customer base, but says they are less likely to shop at exchanges because of other retailers, especially Wal-Mart.

This is another assertion – no evidence is provided. Are there any studies that show that retirees are spending less at exchanges? Indeed, the fact that revenues are stable with a declining customer base might indicate that “share of wallet” is growing! Moreover, the statement that retirees are solely price-driven is also an assertion without support in the article.

3. Laseter claims that “younger people show far less brand loyalty than older consumers”.

What is the author’s source for this statement? There is lots of evidence indicating that younger consumers are very brand-conscious. Indeed, one of the competitive advantages of the exchange systems is the ability to offer brands that many of the discount stores cannot.

4. Laseter claims that the contribution to MWR programs may be of limited interest to any individual serviceman/woman, and that they only care about price.

Again, no evidence is cited showing that active duty personnel are purely price-driven.

In our experience with the exchange systems, we believe there are multiple customer segments, some price-oriented, some product- or brand-oriented, others service-oriented.

IV. Facing the Competition (pp. 3-5)

1. Laseter cites data on Wal-Mart to show that it is a competitive threat to the exchange system.

Wal-Mart is a competitive threat to almost everybody. The pressure on gross margins shown in Laseter's Exhibit 5 is widespread, affecting not just the military exchanges. The question that should be posed is whether consolidation would help the competitive position of the exchange systems.

2. Laseter's Exhibit 4 shows retailer revenues as evidence of the weak position of exchanges.

Exhibit 4 is in terms of total revenues, which reflect the fact that Wal-Mart and Target have opened hundreds of new stores, as well as undertaken many conversions of existing stores to supercenter formats. The fact that the exchanges have grown revenues compared with other broadline department stores (Sears, Dillard's, etc.) is evidence that the exchange systems in their current form are doing better than many of the other department stores.

Because the exchange systems cannot open new locations, a much better metric would have been to compare same-store sales for the companies in Exhibit 4.

3. Laseter claims that Wal-Mart is a particular problem for the exchanges because Wal-Mart has 17% of its revenues from outside the US, including the UK and Germany where military exchanges are located.

Wal-Mart bought ASDA in the UK and Wertkauf and Interspar in Germany as part of an overall expansion strategy. They inherited the existing store locations from these companies. To date they have not made money in Germany.

4. Laseter describes exchange product categories, and states that 39% of exchange sales are in "safe" categories (that is, with lower threat of competition.)

We would observe that having a base of such activities makes the exchanges better-positioned than many other retailers vis-à-vis discounters.

5. Laseter asks (p. 5) "Can the independent exchanges avoid further margin erosion and fend off competition from discounters that are 30 to 100 times larger?"

We agree that retail competition is tough – but the question that should be asked is whether consolidation can be the solution. Combining AAFES, NEXCOM, and MCX is saying \$7 billion plus \$2 billion plus \$1 billion = \$10 billion and that's what you need to compete. This is still very small compared to Wal-Mart, Target, etc. We are skeptical that "7+2+1" gives a significant incremental competitive boost to the military exchanges.

V. Leveraging Economies of Scale (p. 5)

1. Laseter claims that to win, the exchange systems must “leverage scale”.

We do not know what he means by “win”. As noted above, even with consolidation, the exchanges systems will never achieve the scale of Wal-Mart or Target. No data is cited with respect to the cost reductions in moving to “7+2+1”, or why achieving this threshold is what is needed. He also ignores whether many of the purported benefits can be achieved short of full consolidation. We would note that many retail systems and investments are coming down in cost, so that smaller retailers have opportunities to use technology in ways that were not possible before. (For example, the cost of scanning technologies has fallen dramatically.)

2. Laseter’s Exhibit 7 claims to show the effect of scale on profit margins.

We have a number of issues with this chart. First, we do not know if these approximately 70 data points are AAFES store locations or commands. This makes a difference – think about comparing one base that has a central retail location with another base that has many far-flung retail centers.

Second, the regression line fit by Laseter is driven by the three locations with \$175-\$225 million in sales. We would note that the most profitable locations are NOT the largest. Excluding international locations, it appears in Exhibit 7 that the locations with the highest profitability (15% profit margins) have sales in the \$75-\$125 million range. We also would note that there is a large variation in profitability in any given sales range.

Third, we observe that only 6 of all the locations in Exhibit 7 are losing money. This would suggest that the need for large exchanges to support smaller ones (which Laseter claimed earlier in the article) is not true.

Fourth, Exhibit 7 indicates that overall profit margins are in the 5% to 10% range. While we recognize that tax status and other factors play a role, we would note that only 5 of the 35 largest retail companies in the United States in fiscal year 2002 achieved net profit margins (return on sales) of more than 5%. For reference, Wal-Mart’s return on sales was 3.3% and Target’s was 3.8%.

Fifth, even if Exhibit 7 did show that larger stores were more profitable, it says nothing about why a company with more stores is inherently more profitable than one with fewer stores. In other words, while it may be better to have more sales per store, it is not clear how consolidation would help that, or why it is better to have more stores in one organization rather than three.

3. Laseter claims many benefits from centralizing buying and distribution. He claims that Wal-Mart gains 1%-2% of cost advantage from the scale of its distribution network.

We would observe that a consolidated “7+2+1” exchange system is still very small relative to Wal-Mart, and that consolidation would likely have little effect on this cost advantage.

We agree that the exchanges might achieve cost savings and benefits from improvements and cooperation in supply chain activities, and would note that many of these are underway without full integration. Moreover, we would again point out that Laseter’s own Exhibit 1b shows that the best performance in inventory turns

are from the smaller of the exchange systems, not the largest, suggesting that bigger is not always better in practice.

VI. Achieving World Class

1. Laseter claims that the entire military provides successful examples of consolidation, citing DFAS and core military operations like the Joint Strike Fighter.

We do not think these examples are relevant to the question at hand, and indeed, are not sure that some of these examples have been successful. While we agree with his statement that military successes and logistics have been achieved by the Army, Air Force, Navy, and Marines working collaboratively, we would note that this collaboration stops short of full integration and consolidation of the different branches.

2. Laseter claims that consolidation has enabled the Defense Commissary System to save customers 30% today versus 23% in 1991.

This statement is based on a price comparison study, but it says nothing about whether the Commissary system is more profitable and more efficient than before. In addition, it is our understanding that such pricing is a deliberate strategy of the Commissary system – that is, the system is to provide benefits to our armed forces through lower prices. This is quite different than the objective of the exchange systems, including the role of dividends and contributions to MWR.

Moreover, if Laseter feels that lower prices are the goal, we would like to have seen comparable pricing studies for the exchange systems. For example, to what degree are exchange prices higher than outside, and how would integration affect this? Nothing is said on these points. It would also be useful to see how DECA prices compare to Wal-Mart Supercenter prices. We have seen many studies showing that Wal-Mart is underpricing the supermarket industry by 15 or more percent.

3. Laseter claims that consolidation would create more rewarding jobs in more narrow categories, that all groups would enjoy their jobs more.

These are assertions without backup. A decision as important as integration deserves better.

4. Laseter claims that consolidation will produce a “world class organization” with a “world class culture”.

We do not know what to make of this statement – he never defines what “world class” is, nor why being bigger as a single organization gets you there. Indeed, in almost any “best” companies list we can recall, there are numerous examples of companies with less size than any of the exchange systems.

VII. The Choice is Clear (p. 6)

1. Laseter claims that “huge synergies” would be released, leading to an “uncertain, challenging route to combined excellence”.

These are assertions without support and reflect unwarranted hyperbole. Certainly, any synergies associated with the “7+2+1” combination would hardly be “huge”.

2. *Laseter presents the choice to support consolidation as one to “make your country most proud”.*

Thinking about ways to improve the performance of the exchange systems is a difficult and complex task. Impugning the motives of those who have a different idea is wholly inappropriate.