Strategic Report

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19 April 2004

Background

In 1935 R. Stanton Avery founded Kum-Kleen Products, the world's first manufacturer of self-adhesive labels. After a fire destroyed the plant's equipment in 1938, Avery, who had by then renamed the company Avery Adhesives, improved the machinery used in making the labels. During World War II, the company grew rapidly in response to a dramatic expansion of new industrial uses for self-adhesive labels. Avery Adhesives incorporated in 1946. At that time Avery Adhesives sold 80% of its production, consisting of industrial labels, to manufacturers that labeled their own products. The company lost its patent rights for self-adhesive labels in 1952, transforming the firm and the entire industry. As a result, a new division was created -- the Avery Paper Company (later renamed Fasson) -- to produce and market self-adhesive base materials.

Avery Adhesives went public in 1961. Three years later it had four divisions: label products, base materials, Rotex (hand-operated embossing machines), and Metal-Cal (anodized and etched aluminum foil for nameplates). With annual sales at $300 million, Avery Products was recognized in 1974 by its inclusion on the Fortune list of the 500 largest U.S. industrial corporations. Renamed Avery International in 1976, the company closed some manufacturing facilities and cut 8% of its workforce in the late 1980s. Avery Dennison was created in 1990 by the strategic merger of Avery International and Dennison Manufacturing.

Since then, Avery Dennison has solidified its role as a leading manufacturer in the worldwide markets for pressure-sensitive adhesives and office supplies. Some pressure-sensitive adhesives and materials are converted into labels and other products through embossing, printing, stamping and die cutting, and some are sold in unconverted form as base materials, tapes and reflective sheeting. The Company also manufactures and sells a variety of consumer and converted products and other items not involving pressure-sensitive components, such as notebooks, three-ring binders, organizing systems, markers, fasteners, business forms, reflective highway safety products, tickets, tags and imprinting equipment. Avery Dennison has also significantly strengthened its international presence, moving aggressively into rapidly expanding consumer markets in developing economies in Asia Pacific, Latin America and Eastern Europe. With sales of $4.2 billion in 2002, Avery Dennison is ranked 384 on the Fortune 500 list of the largest U.S. corporations. With approximately 40 percent of sales generated outside the United States, the Company is focused on developing international growth opportunities, expanding its core markets, investing in new products and technologies and pursuing value-enhancing acquisitions.

Financial Analysis

Market Capitalization and Stock Price

Year	Shares Out.	Closing Price	Market Cap
1999	99.2M	72.88	7.2B
2000	98.3M	54.88	5.4B
2001	97.8M	56.20	5.5B
2002	98.5M	59.05	5.8B
2003	100.0M	54.71	5.5B
Current	109.0M	62.71	6.8B

On April 14, 2004, Avery Dennison was trading at $62.71. With 109.0M shares outstanding, this represents a market cap of $6.8 billion. Year to date, market cap has increased by roughly 24%. This is due mainly to the fact that shares of Avery Dennison spiked up after the Company reported better-than-expected fourth-quarter 2003 earnings. Over the past five years, Avery Dennison's market cap has remained relatively stable in spite of challenging market conditions. As can be seen, market capitalization has been highly correlated with the Company's stock price since 1999.

Income Statement Overview

(IN MILLIONS)	**2003**	**2002**	**2001**
Net sales	$4,762.6	$ 4,206.9	$ 3,803.3
Cost of products sold	3,304.6	2,853.2	2,563.1
Gross profit	1,458.0	1,353.7	1,240.2
Marketing, general and administrative expense	1,034.9	913.1	830.5
Interest expense	57.7	43.7	50.2
Other expense (income), net	30.5	32.1	(.3)
Income before taxes and accounting change	334.9	364.8	359.8
Taxes on income	92.1	107.6	116.4
Income before accounting change	242.8	257.2	243.4
Cumulative effect of accounting change, net of tax	-	-	(.2)
Net income	267.9	$ 257.2	$ 243.4

Avery Dennison's 2004 sales are expected to increase by about 4% to 6%, after 15% growth in 2003, driven largely by the acquisition of Jackstadt in 2002, new products and higher pressure-sensitive material sales, and favorable currency rates (strong euro). Rise in sales was also due primarily to a higher-than-anticipated rise in orders from several large office products customers. Net income from continued operations, however, fell 3% to $242.8 million. The decrease in net income is a reflection of higher administrative expenses. However, with an additional $25.1 million from discontinued operations, Avery Dennison's net income is $267.9.

Cash Flow Overview

	2003	**2002**
Operating activities:		
Net income	267.9	257.2
Less: income from discontinued operations	25.1	7.4
Income from continuing operations	242.8	249.8
Adjustments to reconcile net income (loss) to		
Net cash provided by operating activities:		
Depreciation	143.9	125.1
Amortization	35.4	25.7
Deferred taxes	5.2	22.2

Asset impairment and net losses on asset sales	7.7	20.7
Changes in assets and liabilities	89.7	67.5
Net cash provided by operating activities from continuing operations	334.9	511.0

Avery Dennison's ability to produce cash from operations decreased significantly from 2002 to 2003. Depreciation and amortization has risen through the years, indicating an increase in investment.

	2003	**2002**
Investing activities:		
Purchase of property, plant and equipment	201.4	150.4
Proceeds from sale of assets	15.4	9.4
Proceeds from sale of business	58.8	-
Payments for acquisitions	6.9	397.4
Purchase of software	22.8	20.1
Other	8.7	16.8
Net cash used in investing activities of continuing operations	165.6	575.3

Cash flow from investing was particularly high in 2002, due to the Jackstadt acquisition. Apart from the acquisition, cash flow from investing increased from 2002 to 2003.

	2003	**2002**
Financing activities:		
Additional borrowings	417.9	697.0
Payments of debt	447.7	508.5
Dividends paid	160.2	148.5
Purchase of treasury stock	0.3	10.8
Proceeds from exercise of stock options, net	5.5	22.1
Other	18.1	17.4
Net cash used in financing activities of cont. operations	166.7	68.7

Balance Sheet Overview

(IN MILLIONS)

	2003	**2002**
Assets:		
Total current assets	1,440.9	1,215.5
Total assets	4,105.3	3,652.4
Liabilities and Shareholder's equity:		
Total current liabilities	1,496.0	1,296.1
Total shareholders' equity	1,318.7	1,056.4
Total liabilities and shareholders' equity	4,105.3	3,652.4

Avery Dennison's Key Figures/Ratios

Key Numbers	
Annual Sales ($mil.)	4,762.6
Employees	20,300
Market Cap ($bil.)	6.8
Profitability	
Gross Profit Margin	34.4%
Net Profit Margin	5.6%
Operating Margin	7.0%
Return on Equity	20.3%
Return on Assets	6.5%
Return on Invested Capital	12.1%
Valuation	
Price/Earnings Ratio	23.09
Price/Book Ratio	5.2
Operations	
Inventory Turnover	8.3
Asset Turnover	1.2
Financial	
Current Ratio	0.96
Quick Ratio	0.6
Per Share Data ($)	
Earnings Per Share	2.57
Sales	45.58
Book Value Per Share	12.51
Growth	
12-Month Revenue Growth	12.7%
60-Month Revenue Growth	6.6%

Results of Operations by Operating Segment

Pressure-Sensitive Adhesives and Materials

(IN MILLIONS)	2003	2002
Sales – US	$1,372.4	$1,329.6
Sales – International	1,804.4	1,374.0
Intrasegment sales	(167.9)	(135.6)
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Net sales	3,008.9	2,568.0
Income before interest and taxes	206.9	194.8

Consumer and Converted Products

(IN MILLIONS)	2003	2002
Sales – US	$1,252.3	$1,228.2
Sales – International	746.1	579.1
Intrasegment sales	(61.9)	(46.6)
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Net sales	1,936.5	1,760.7
Income before interest and taxes	225.6	235.1

Porter's Five-Forces Analysis

Summary

Force	Threat to Profits
Internal Rivalry	Medium
Entry	Low - Medium
Substitutes and Complements	Low - Medium
Supplier Power	Low
Buyer Power	Medium - High

Internal Rivalry

Avery Dennison is a worldwide leader in two separate industries. The first broad category of products that Avery-Dennison distributes is the *Pressure-Sensitive Adhesives and Materials* segment. Many products of this segment are used to label commercial items for various purposes, including brand identity, product identification, and barcoding. They are also used to make signs for vehicles and highway safety, and to make adhesives for disposable diapers. Within the second broad category, the *Consumer and Converted Product* segment, Avery-Dennison produces Office Products, Retail Information Services, and Industrial and Automotive Products subcategories.

In this analysis, we will concentrate mainly on the former category, as the Company generates over 60% of its revenue from that market. Avery Dennison's Fasson-brand is the leader in the pressure-sensitive adhesives and materials industry, which deals mainly with such products as self-adhesive labels, stamps, surface technology, and graphics materials. In this industry, Avery Dennison's main competitors are Raflatac, Bemis, and Mactac. Competition and cost differences among these firms can be significant, as has recently been highlighted by Avery Dennison's accusations of Raflatac pricing their labelstock at or below cost, thus enabling them to sell at cut-rate prices.

Avery Dennison has also recently been the target of a Department of Justice probe that investigated an alleged attempt to fix prices between Avery and Finland's UPM-Kymmene, whose Raflatac subsidiary produces labelstock at a plant in North Carolina. The DOJ disclosed its probe of the industry in 2003 when it filed a complaint seeking an injunction to block the sale of Mactac (Bemis-owned) to UPM-Kymmene. A merger of Raflatac and Mactac, the second and third largest North American producers of pressure-sensitive adhesives, would have created a company with market share of 25%. Together with Avery, these companies would have accounted for more than 70% of North American sales. Although the court did not find strong evidence of collusion, brightening Avery Dennison outlook considerably, this incident is an indicator of the adhesives industry's history of "cooperative" pricing and cutthroat price competition.

However, Avery has clearly emerged as the leader in this rather unfractionalized market, with sales almost doubling those of their closest competitors. In the consumer and converted products industry (mostly office products and supplies), Avery has a niche market, with companies such as Afco and Sanford as the dominant suppliers.

Recently, in North and America and Western Europe, the self-adhesives and materials industry has become highly saturated. The industry's major players have been experiencing low single-digit core growth, and have responded by effectively concentrating on international operations. In 2003, international sales accounted for over 50% of Avery Dennison's business. In 2004, the figure is projected to be about 60%. In the next decade, one can expect to see the industry's major firms battling to establish strongholds specifically in Asia, Latin America, and Eastern Europe. Firms such as Avery have also been counteracting market saturation with the acquisitions of smaller adhesives companies. In 2002, Avery Dennison acquired Jackstadt and RVL, and has nearly completed integrating the operations of these acquisitions. The pressure-sensitive adhesives industry has also been characterized recently by weakening demand, which has further stimulated pricing wars between its major competitors.

Entry

Due to a high level of market concentration in the hands of only a few firms, entry by newcomers into the pressure-sensitive adhesives and materials industry has remained low. The market is saturated, as mentioned above, which would make it difficult for an entrant to establish market share. Furthermore, production in this industry entails significant economies of scale; Avery Dennison has recently begun realizing economies of scale from acquisitions made in 2002, and other firms in the industry have been following suit.

Unfortunately for entrants, intensive capital is required to enter the market; start-up costs are extremely high in the adhesives business. There are also significant economies of scope. This is hugely important in the industry, as firms such as Avery Dennison are extremely skilled at leveraging core competencies. That is, it makes more sense for Avery, an adhesives manufacturer, to diversify into the production of other adhesives-related items such as tape than it does for, say, an unrelated entrant that specializes only in the production of paper. For the company who makes only paper, much of the up-front investment in developing the research and know-how for working with chemical adhesives would have to be made just to get the expertise needed to make the adhesive-related items that Avery Dennison makes.

Likewise, a great deal of know-how for research and development is required for entry into the pressure-sensitive adhesives and materials industry. For instance, Avery Dennison has recently directed its energies in becoming a major player in the radio frequency identification (RFID) segment. RFID, which many analysts believe will revolutionize global inventory and supply chain management by facilitating more efficient inventory management systems, is swiftly becoming a vital technology of the future. Because Avery Dennison has core competencies in materials science, precision printing and high-speed roll-to-roll manufacturing, technologies that are crucial for the development of RFID, it has the potential to become the leader in this offshoot "materials" industry. An entrant into the market, without the previous R&D that the incumbent firms possess, would have an extremely difficult time establishing market share.

At least in the pressure-sensitive adhesives business, the importance of reputation or established brand loyalties in purchase decision seems not to be significant. Recently, buyers have been purchasing cheaper adhesives from smaller and less-known firms, in an effort to cut production costs.

Substitutes and Complements

The items within Avery Dennison's two industry subdivisions have very specific uses, and thus substitutes are rare. That is, printer papers and postage stamps, for example, cannot be replaced by other products. Nonetheless, many products have complementary relationships.

The Office Products Category includes primarily self-adhesive labels and labeling software along with standard office products such as binders, sheet protectors, and printing papers. Other office products and equipment will generally constitute some sort of complementary relationship. For instance, a new file cabinet will likely lead to a need for additional binders to fill the cabinets, paper and sheet protectors to fill binders, and labels and software to label the cabinet, binders, and the like. This is a fairly loose complementary relationship, as a file cabinet will often but does not necessarily require purchase of additional products, and such a relationship generally characterizes the complements of the office products subcategory. There are a few concrete, certain complements. For example, products such as computer printers and copy machines will certainly require printing paper to operate. However, these types of clear-cut complementary relationships are not abundant in the least.

The Retail Information Services subcategory includes many products used to label and identify retail products. Such items are woven and printed labels for clothing, price tickets, barcode printers, as well as service bureau printing applications for supply chain and security management. These products have few direct complementary relationships. Generally, though, more retail output of any kind will increase the demand for the labeling products that Avery offers. In this way, the items produced in the Retail Information Services can be seen as strongly correlated to macroeconomic conditions. In times of heightened economic activity, when many clothes are sold, for instance, the need for all of these products will increase.

Avery-Dennison's Industrial and Automotive Products subdivision creates products such as interior films for automobiles, long-life paint replacement films, postage stamps, and battery labels. As with most of Avery's products, these products are used in conjunction with certain products, and thus these specific products are complements. Increased sale of cars will increase automobile interior decorative film, increased production of envelopes will increase Avery's stamp output, and increased purchase of batteries will lead to higher battery label sales.

The products of Avery Dennison's Pressure-Sensitive Adhesives and Materials segment are used for a wide variety of purposes. Like other Avery products, the items produced in this segment have very specific uses, and thus have no direct substitutes. Their complements, however, are varied. Because much of this labeling is intended for general output, these products, like those of Retail Information Services, are correlated to general economic output. Specific items also serve as complements, such as cargo trucks and disposable diapers.

Supplier Power

The Company's self-adhesive materials are produced using emulsion/hot melt adhesive technology. The primary production processes require a steady stream of paper, plastic, and specialty polymers, which are subject to raw-material price fluctuations, but are generally available.

The bargaining power of Avery Denison's suppliers does not pose a significant threat to the Company. The materials used in production processes are supplied by a large number of firms. Furthermore, Avery Dennison ensures that no one company becomes what it sees as a "significant" supplier, and at any given time has several different suppliers for its machinery and raw materials. The Company avoids entering into partnerships with their suppliers. However, they are generally on good terms with their suppliers.

As most of the actual materials and processes used by Avery Denison are not public knowledge we were forced to use most of the information given to us in an interview with an Avery Dennison executive. Suppliers are also confidential, but within the paper and polymer industries there are a plethora of suppliers. Here is a list of a few: Air Products and Chemicals Inc. BASF Corporation, The Dow Chemical Company, Dow Reichhold Specialty Latex LLC, Eastman Chemical Company, Johnson Polymer, National Starch and Chemical Company, the International Paper Company, Weverhaeuser, Louisiana Pacific, Myllykoski Paper, etc.

Buyer Power

Avery Dennison's business is dependent on a large number and a wide variety of buyers. However, sales of the Company's products are concentrated in about 8 major customers, principally discount office products superstores, mass marketers and distributors. These top 8 customers (i.e. Wal-Mart, etc.) have enormous price leverage over Avery Dennison. That is, there is a great deal of pricing pressure from huge retailers who demand price reductions, under threats of "we'll make our own", or private manufacturing.

Downward pricing pressures have continued because business conditions have weakened for self-adhesive labels used on packaging and mailers and other office products. Many analysts believe that customers of Avery Dennison, Bemis, and other makers of pressure-sensitive materials are "trading down" to lower-priced, lower-quality labels. For example, there has been a move by glass and plastic bottlers - a key customer segment - away from paper labels to "shrink sleeves" made of PVC. Overall, this is reflective of a fairly tough industrial environment.

Competitive Landscape (taken from Hoover's Online)

Key Numbers	Avery Dennison	Bemis	Industry	Market
Annual Sales ($mil.)	4,762.6	2,635.0	-----------------	-------
Employees	20,300	11,500	-----------------	-------
Market Cap ($mil.)	6,835.4	2,759.1	-----------------	-------
Profitability	Avery Dennison	Bemis	Industry	Market
Gross Profit Margin	34.38%	25.11%	28.32%	48.33%
Pre-Tax Profit Margin	7.03%	9.11%	2.25%	7.45%
Net Profit Margin	5.63%	5.58%	2.06%	4.48%
Return on Equity	20.3%	12.9%	4.6%	8.7%
Return on Assets	6.5%	6.4%	1.4%	1.4%
Return on Invested Capital	12.1%	8.5%	2.3%	4.1%
Valuation	Avery Dennison	Bemis	Industry	Market
Price/Sales Ratio	1.44	1.05	0.96	1.39
Price/Earnings Ratio	23.09	18.85	48.77	30.73
Price/Book Ratio	5.18	2.42	2.16	2.71
Price/Cash Flow Ratio	15.28	10.01	9.43	13.31
Operations	Avery Dennison	Bemis	Industry	Market
Days of Sales Outstanding	62.98	45.60	69.26	58.07
Inventory Turnover	8.3	6.4	6.3	7.7
Days Cost of Goods Sold in Inventory	43	56	57	47
Asset Turnover	1.2	1.2	0.7	0.3
Net Receivables Turnover Flow	6.1	8.0	5.2	6.4
Effective Tax Rate	27.5%	38.4%	5.9%	39.0%
Financial	Avery Dennison	Bemis	Industry	Market
Current Ratio	0.96	2.38	1.32	1.43
Quick Ratio	0.6	1.3	0.9	1.0
Leverage Ratio	3.11	2.01	3.24	6.08
Total Debt/Equity	0.90	0.52	1.17	1.50
Interest Coverage	6.80	20.00	1.70	2.40

Evaluation of Key Issues

The Problem

Based on the 15% growth in Avery Dennison's 2003 annual sales, with similar figures for the preceding years, it is not immediately obvious that the Company's most imminent issue lies in the matter of growth itself. Indeed, Avery Dennison's core unit volume growth (which excludes the impact of acquisitions, divestitures, changes in product mix and pricing, and foreign currency translation) has been steadily declining, with an increase in 2003 domestic sales of only 3%, compared to 8% in 2002. In fact, approximately 30 to 35 percent of sales for 2003 were a result of the acquisition of Jackstadt in May 2002, and over 45 percent of sales were due to the favorable impact of foreign currency translation. Avery Dennison's low core growth can be attributed mainly to a maturing domestic market for its products, high expenses, weak industrial and consumer demand in many of the Company's businesses, and a deficiency in growth initiatives. Although Avery Dennison continues to thrive and succeed in its industry in spite of these issues, it has become increasingly obvious that the problem of growth is one that will need to be effectively dealt with in the years to come.

The Solutions

Foreign Markets

The problem with a maturing market is, in this situation, quite clear. If a market is not growing, as is the case for the self-adhesives and materials industry, it is extremely difficult for a company in the industry to achieve consistently high core unit volume growth. Fortunately, Avery Dennison has just begun to deal effectively with the maturing market issue through a number of avenues: heavy investment of capital and human resources in foreign markets, implementation of internal growth-oriented programs and initiatives, and intensive cost reduction measures. Although the Company's recent efforts have proven to be fruitful and have indeed set it on a new path towards growth, we will throughout this report make specific strategic recommendations that we believe will create new growth opportunities for Avery Dennison.

In response to the maturing domestic market, Avery Dennison recently began to invest heavily in foreign markets, namely, those of Eastern Europe, Latina America, and Asia. The Company has benefited tremendously from these high-growth markets; by the fourth quarter of 2003, sales at Avery Dennison's businesses in these emerging markets made up roughly 20% of the Company's total revenues. In 2003, international sales accounted for nearly 50% of Avery Dennison's business. By the year 2005, the Company predicts that this figure will reach upwards of 60%.

Furthermore, sales at Avery Dennison's businesses in these emerging markets have consistently been growing at double-digit rates, exceeding expectations of analysts and even the Company itself. International sales grew by approximately $430 million or 31%, due to higher sales in the roll materials segment (approximately $312 million), graphics and reflective segment (approximately $81 million) and specialty tapes segment (approximately $35 million). Particularly, Avery Dennison's business in China has served as a significant engine of growth since the Company opened its first pressure-sensitive adhesive materials manufacturing plant there 10 years ago. For example, in 2003, sales of pressure-sensitive materials in China grew by more than 35% over the previous year.

Clearly, it is in the Company's best interests to devote its time and resources particularly to these developing markets, as they appear to be a tremendous factor in sales growth. Therefore, it is our recommendation that Avery Dennison further develops its international growth opportunities by investing more heavily in its foreign markets, strengthening its presence in especially the Chinese market by meeting increasing demand for high-quality pressure-sensitive labeling and graphic materials, reflective films, office products and retail systems. The Company should also take advantage of the high-growth potential markets of other Asian countries, including Japan, South Korea, Hong Kong, Malaysia, Singapore, the Philippines, Indonesia, Thailand and India. Although Avery Dennison already has a presence in these countries, we recommend that the Company take advantage of high demand for its products in these countries by investing more heavily in them and outsourcing, establishing manufacturing capabilities in the countries for each of its key businesses. With over 3,500 employees in the Asia Pacific region, we feel that Avery Dennison is well-equipped to make this further investment.

Internal Growth-Acceleration Programs

Avery Dennison has also attempted to deal with the low core growth issue by recently implementing a major internal growth acceleration program: Horizons. Quickly becoming an integral part of Avery Dennison's culture, the Horizons process focuses on expediting global growth initiatives via three distinct platforms, fittingly referred to as Horizons 1, 2 and 3. Horizons 1 concentrates on short-term bursts of growth, granting small "teams" of employees a 100-day deadline to solve a specific problem in sales, marketing, or manufacturing in order to meet a customer's need. The Company has found that there is a sense of urgency and necessity associated with a short timeframe that enables one to focus more clearly on solving the problem at hand. There are currently 550 Horizon 1 teams consisting of 2,300 Avery Dennison employees in the midst of working on projects and trying to meet deadlines. The implementation of Horizons 1 has been successful, as revenue from sales generated by these projects reached approximately $50 million in 2003. The more long-term Horizons 2 and 3 projects focus on the exploration of new technologies and markets in a strict strategic framework. Horizons 2 projects are entrepreneurial ventures that target a defined market or group of customers; because they often involve the development of new skills, investments, and resources, Horizons 2 projects take about 18 months to two years to begin generating revenue. Horizons 3 programs are research projects, investments in emerging technologies and companies, also focusing on long-term growth opportunities.

While figures demonstrate that the Horizons programs have indeed created tremendous benefits and opportunities for Avery Dennison, we urge the Company to divert a number of its resources from the short-run oriented Horizons 1 program to the more long-run reaching Horizons 2 and 3 programs. In a maturing market, we believe that a company has more to gain in expending its resources in search of new technologies and markets rather than emphasizing short-term growth opportunities. With over 2,300 employees currently working on Horizons 1 programs, we feel that Avery Dennison clearly has the capability to concentrate more intensely on developing essential longer-term growth prospects.

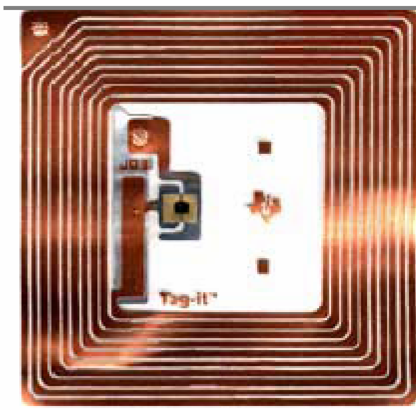
Expense-Reduction Efforts

In a maturing market, the firm that achieves the lowest cost wins. Avery Dennison's marketing, general and administrative expenses increased 14 percent to $1.03 billion in 2003 compared to $905.2 million in 2002. Likewise, insurance and employee benefit costs (including pension expense) increased by approximately $15 million in 2003 compared to 2002. Net income for 2003 actually fell 3% to $242.8M, due primarily to these high expenses. Generally, we see potential for improvement in Avery Dennison's high-cost situation. The Company is just beginning to receive significant cost synergies from the 2002 acquisitions of Jackstadt, RVL Packaging, and L&E Packaging. The integration of the Jackstadt acquisition has involved facility closures and headcount reductions, as well as other cost saving measures. In general, 2003 entailed a good deal of cost restructuring for Avery Dennison; close to 1000 employees were laid-off, a number of plants were shutdown, its fleet admin was moved online, etc. As a result of the aggressive cost-cutting, the Company expects higher earnings in 2004 than the previous years. We recommend that Avery Dennison continues to engage in cost-reducing measures by shutting down plants and outsourcing to Asia, in order to more effectively counter the problem of the maturing market.

Entering a new market: RFID

Put simply, the best option for a firm experiencing low core growth in a maturing market may be to enter into a new market in which opportunities for growth are limitless. The market for radio frequency identification technology, or RFID, may indeed be Avery Dennison's single largest long-term growth opportunity. This technology, which many analysts predict will revolutionize global supply-chain management, features embedded computer chips that allow for automated inventory-tracking on containers and even individual products. Experts claim that RFID has the potential to reduce $500 billion of inventories by facilitating more efficient inventory management systems. Procter & Gamble Co. believes that RFID will enable it to cut all inventories by half. RFID technology has the capability to change even the way in which information is collected and managed through a number of avenues: logistics, security, health care, access control, product safety, ownership verification, and other applications. Deemed too expensive and unfeasible in the past, RFID is now becoming a commercial reality.

Exhibit 1: Diagram of an RFID chip



(taken from CSFB report)

As more retailers learn about the advantages of this technology and realize that it is not just "hype", use of RFID labels and tags will become widespread around the globe; it has been predicted that by the year 2015, electronic labels containing RFID microprocessor chips will be as common as printed barcodes on labels today. Driven largely by Wal-Mart, some shippers have already begun to use RFID tags to track containers and move goods more quickly to stores that need them. Wal-Mart wants its top 100 suppliers to start using RFID tags on cases and pallets shipped to it by January 2005. This equates to about 1 billion tags in 2005. The U.S. Department of Defense has also required that all suppliers to the U.S. military use this technology on containers and pallets, which could equate to roughly 3-5 billion tags. The problem, however, is that the tag's microprocessor chip, which transmits price and location data to retailers, costs about 35 to 40 cents. Therefore, it may be several years before the chips' prices fall by enough so that the RFID tags can be used on every individual item, and not just on containers. Credit Suisse First Boston estimates that the tags' price will fall to $0.05 by 2007. Thus, in time, it is almost inevitable that RFID will replace today's printed labels and tags, many of which are produced by Avery Dennison.

With Avery Dennison's core competencies in materials science, precision printing and high-speed roll-to-roll manufacturing (capabilities that are essential in developing RFID solutions), the Company has a tremendous opportunity to be at the forefront of the RFID revolution. Avery Dennison's expertise in producing pressure-sensitive adhesives and manufacturing specialized labels in quantities of billions makes it an ideal supplier of every component of the RFID tag, short of the actual microchip itself. For example, Avery Dennison's technological expertise in applying coatings onto substrate surfaces to produce adhesive material is ideal for developing the media in which RFID microprocessor chips can be embedded and attached to a variety of products. Put simply, Avery Dennison possesses the manufacturing know-how and technology that would give it a huge advantage in this new market.

Analysts at Credit Suisse First Boston estimate that the RFID opportunity could mean a minimum of $1.75-6.25 per share to Avery Dennison's stock. Furthermore, this figure does not assume that the majority of retail products will be labeled on a unit basis, which would boost the numbers much higher. Also, assuming growing demand for RFID (27 billion tags to retailers, 5.8 billion tags to pharmaceutical companies, 1.2 billion tags to airports by 2012), the total market for RFID tags could in time grow to $2.7 billion. Assuming that Avery Dennison continues to manufacture every major component of the tag except the microchip itself, the Company could grab up to 65-75% of the total tag profits, or about $112 million of incremental operating profit by 2007. Furthermore, CSFB predicts that Avery Dennison could start out with 25% market share and eventually maintain a level of about 20% share in the RFID tag industry. The potential benefits to Avery Dennison are, in this case, of epic proportions.

Avery Dennison is currently working with leading technology and merchandising companies, such as Microsoft and Metro AG, to produce RFID tags and labels for potential customers. Some companies that have already committed to using RFID tags or are showing significant interest are: Carrefour, Target, Tesco, Best Buy, Blockbuster, Costco, CVS, Home Depot, Lowe's, and Albertson's (for an estimated total of 12 billion tags). We recommend that the Company takes advantage of this lucrative opportunity and fully submerges itself into the budding RFID market. With a huge boost in RFID investment, Avery Dennison can position itself into playing a significant role in the up-and-coming RFID revolution. The Company should also begin serious dialogue with Philips and Texas Instruments, companies that will most likely specialize in the actual RFID microprocessor chip production. By devising new methods for producing RFID tags and labels in huge volumes at affordable costs, Avery Dennison will be able to take a giant step away from a sagging, maturing market and towards unhindered growth in a brand new industry.

Conclusion

Avery Dennison, overall, appears to be in good shape. As the figures demonstrate, sales and revenues are high, stock prices as well as market cap are up, and profits continue to grow. However, the issue of low core unit volume growth, which may not be of great burden to the Company in the present, must in time be effectively dealt with. Although Avery Dennison has begun to take steps toward countering this issue, we are recommending, in short, that more be done. By investing more heavily in foreign markets, restructuring internal growth acceleration programs, cutting costs, and entering into the promising new RFID market, we feel that Avery Dennison can in time achieve solid and healthy long-term growth.

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