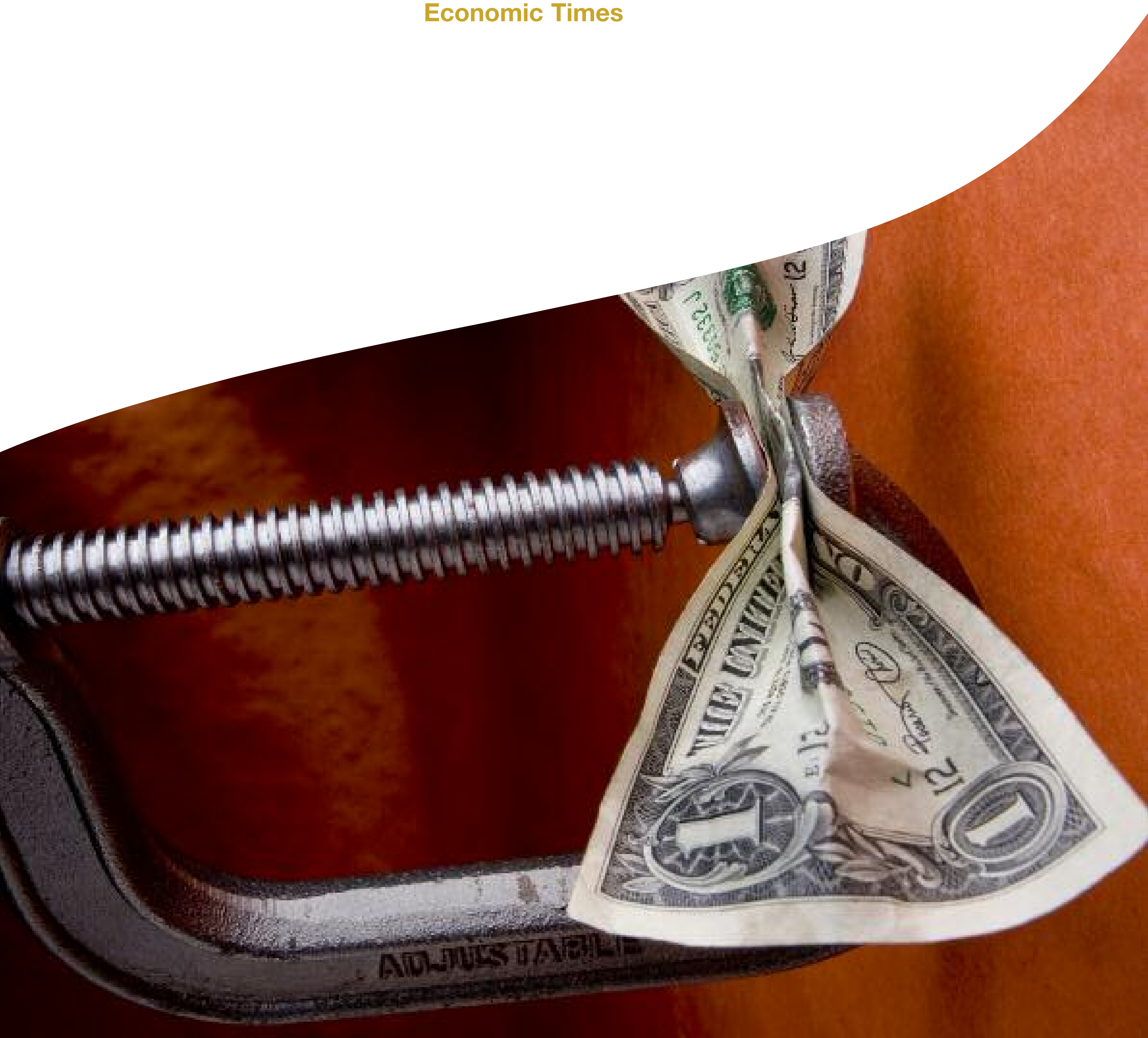
Resisting the Margin Squeeze

Four Strategies to Help Consumer Products Companies Thrive in Unprecedented Economic Times



In the current economic times consumer products (CP) companies will face unparalleled pressures that will squeeze their margins tighter than ever. The deteriorating economic picture will further compound the outlook as even some recent key growth areas lose aspects of their appeal.

This document explores the major strategic and operational pressures and sets out four strategies to protect and build margins.

Current Times Present Significant Challenges

Strategically for most consumer products (CP) businesses, the prospect of growth in developed markets is very low. Competition for precious shelf space is higher than ever in most categories and consumers are increasingly elusive, making it difficult for companies to land impactful product messages. The pressure on both marketing and new product development (NPD) budgets will make significant brand and consumer investments difficult, so focus and prioritisation will become key. What were once growth segments within relatively mature markets may also lose appeal as consumers replace their premium aspirations with more rational and basic needs as their disposable income is squeezed.

The large retailers will continue to grow as a channel in most developed markets, which in some cases will be margin dilutive. Even emerging markets, once a sure-fire way of achieving double-digit sales growth, may lose their allure if they become polluted by the economic instability of their developed cousins.

Operational Pressures Continue to Mount

During the past 10 years there has been a significant amount of globalisation and international expansion. The quest for new revenue streams in new markets or product areas has resulted in extended global operations achieved through both organic growth and acquisitions, often without realising the synergy potential. As growth slows, the higher SG&A, logistical and production costs become increasingly apparent.

Further operational pressure will be driven by elements of the "green" movement, socio-political expectations on CO_2 and climate change, plus operational and customer service improvement requests from the large retailers (for example, adopting new delivery models and packaging standards).

Reducing organisational costs will be made easier or harder depending on the CP company's stage in the ERP journey and what the underpinning technology will allow or support in terms of operational improvements.

All of these factors will cause margin pressure to reach new levels going forward. In this environment, key strategies that continue to drive the major margin growth levers of volume, price/mix, operating costs, cost of goods sold (COGS) and marketing expense are required. Capgemini Consulting proposes four strategies that combine shorter and medium-term initiatives to drive immediate margin benefits and ensure the CP company is able to cope with the likely volatile times ahead.

1. Challenge the existing operating model beyond the accepted paradigms.
2. Collaborate with the larger retailers to protect margins.
3. Continue to carefully seek high-growth, white-space emerging markets.
4. Prioritise and focus innovation on key consumer groups.

Pressure Points for CP Businesses

- Continued **brand erosion**, particularly in developed markets and categories with a high proportion of private label goods.
- **Brand proliferation** - an unprecedented number of line extensions and brand stretch initiatives, resulting in more on-shelf choice than ever for the consumer and a tail of unprofitable SKUs for CP organizations.
- Further **stagnation of developed markets** in softening economic conditions and a question as to how this may impact developing markets.
- **Slowing of consumer demand for typically premium "well-being" products** as consumers potentially reset their aspirations as disposal income is squeezed.
- The **growth of the large retailers** may be potentially margin dilutive as they press for larger promotions to generate footfall and make demands to reduce their own operational costs.
- The trade-off between **reaching profitable consumer groups** with a backdrop of the ever-fragmenting media landscape and **tightening marketing budgets**.
- **Consumer pressure for "greener" products** and socio-political pressure to collaborate and reduce CO_2 emissions.
- The **continued headwind commodity and input costs** coupled with the growing issue of **securing supply** as governments and organisations buy up suppliers and sources.
- The **burden of expensive operating models** caused by rapid expansions to growth markets and partially integrated acquisitions.
- **Complex and expensive ERP platforms**, which have only partially enabled the business change promised.

1 Challenge the Existing Operating Model Beyond the Accepted Paradigms

Margin pressures are not new to CP companies. Increasing competition, shifts in industry power and changing economics have driven organisations to undertake a series of cost optimisation programmes. Indeed, one could argue that driving such programmes has become a way of life and a core competence.

As each programme is delivered, however, less and less low-hanging fruit is available to drive margins. This has caused CP companies to look more fundamentally at their organisational structure, or operating model, to drive efficiencies and effectiveness.

Cross-country thinking. Leading CP companies are starting to adopt cross-country models across their business. Support functions are seen as essential, the supply chain is following, and some are targeting the front office. Category management is moving to global and regional levels. Marketing strategy, design and some execution activities are being managed outside the geography, leaving only a small amount of local tailoring in the geography.

This trend involves performing all aspects of brand management centrally – strategy formulation, planning, concept/opportunity creation, NPD pipeline, etc. Danone has begun to manage its biggest brands at a global level with many other companies such as Kraft and Cadbury organising above market around their categories.

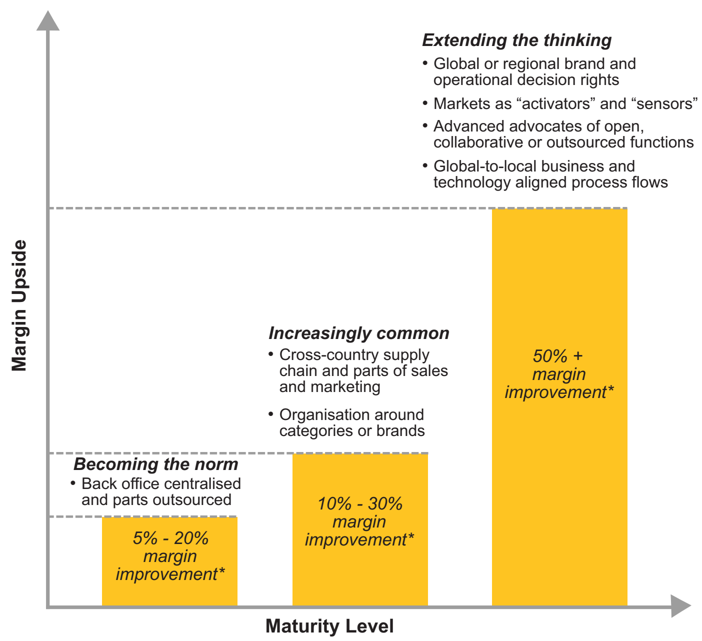
Even the sales function is receiving the same treatment, with global/regional process ownership being established to drive best practice, and global/regional key account management becoming increasingly common.

Our experience suggests that companies can achieve step changes in performance, with real examples of CP companies doubling profits through programmes that have been self-funding after the first year.

Outsourcing. Following the above-market logic it is becoming the norm that aspects of IT, finance and HR are being outsourced to third parties. The key deliberation is which aspects should be outsourced. Many companies have found that they went too far and are bringing some aspects back in house. An increasingly common alternative is the development of service-based models and development centres where third parties provide a combination of specialist skills and low-cost resources in partnership with own staff.

Some companies are extending this thinking outside the back office. Product design and brand innovation services are being provided by third parties. Will the trend stretch to the degree seen in the pharmaceutical or petrochemical industry where research, product development, manufacturing or extraction, marketing and sales can all be outsourced? Could the CP organisation of the future be primarily a design or brand house?

Challenging the Operating Model Beyond Accepted Paradigms



* Capgemini experience based on working with the leading CP organisations. Category and situation dependent.

Partner collaboration. Working with external organisations can improve effectiveness and generate greater industry insights. This is particularly true in the innovation area, as illustrated by Procter & Gamble's "connect and develop" approach, through which the company partners with many innovation houses to generate breakthrough concepts and ideas.

Overall, we see each operating model option placed on a maturity curve where some elements have become the norm, and all major CP companies should be focusing on them to survive. These increasingly common ideas are spreading across the global CP community and can create a competitive difference if effectively executed.

Becoming the norm. Many CP companies have looked at the support functions and adopted centralised shared-service or outsourcing models to leverage their scale and efficiencies by more efficiently serving multiple business units or geographies.

Increasingly common. Expanding the above market thinking into the supply chain, components of sales or marketing, organising around categories or even the larger brands.

Extending the thinking.
Fundamentally changing the operating model by:

- Moving decision rights into regional or global hubs – establishing single, central accountability for brand and operational decisions.
- Setting up local markets as in-market "activators" and "sensors" to make valuable market observations and be the voice of the consumer.
- Managing smaller markets using a remote model to gain leverage and drive margins.
- Using collaborative models for certain NPD and marketing activities, leveraging expertise, lowering costs and reducing risks.
- Creating global-to-local business and technology aligned process flows.

In today's environment, seeking additional low-hanging fruit or challenging the businesses to find further efficiencies will not be enough. CP companies must look at their operating model in a more fundamental way, ever cognisant that the model that is right for them will be unique, and a factor of their market, portfolio structure, culture and competitive positioning. The only true best practice is to seriously challenge the status quo.

2 Collaborate With the Larger Retailers to Protect Margins

For most categories in developed markets, the large retailers are increasing their share of total CP sales when compared with other channels. This makes them a powerful and margin-sensitive customer. It is increasingly important that this delicate relationship, where branded CP organisations enjoy margins of 10% to 14% and retailers 4% to 6%, be managed collaboratively.

While collaboration isn't a new subject for the industry, the current economic climate demands greater, deeper collaboration, particularly to jointly reduce costs and improve the on-shelf rate of sale.

Category strategy and planning. CP business and retailer collaboration at the category strategy and planning level is an ideal opportunity to drive both volume and profitability to mutual benefit. CP organisations can influence assortment, space allocation and positioning, pricing and trade marketing to drive focussed offers toward target consumer groups.

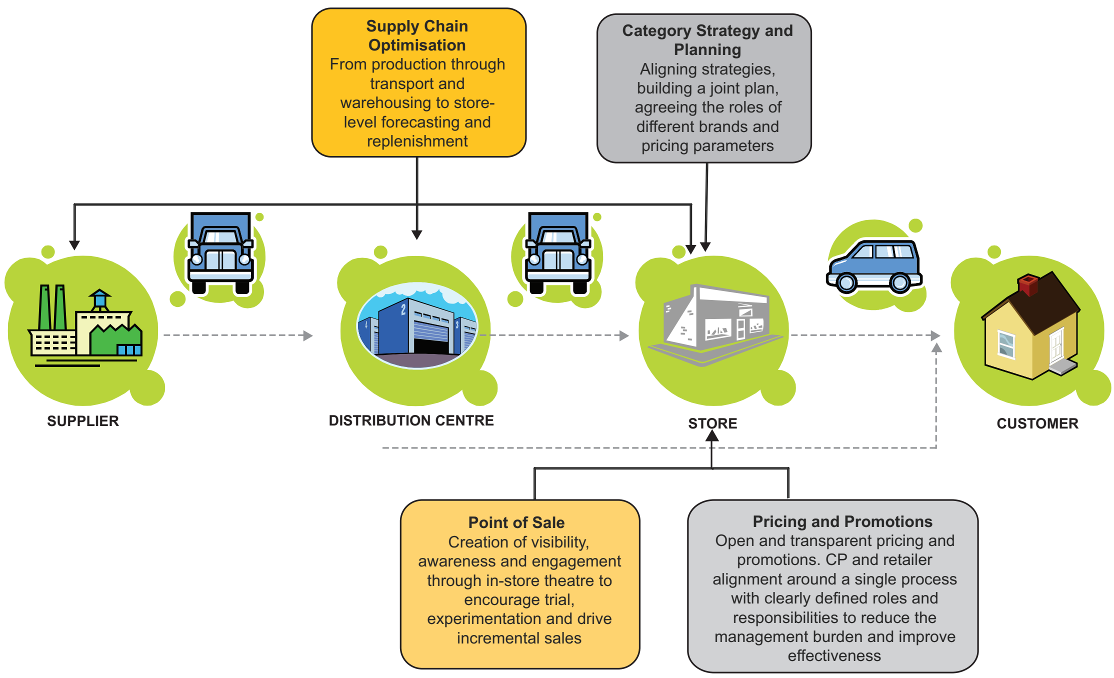
The large retailers carry a huge amount of sales volume. The key challenge is how to ensure and sustain healthy margins. Building a joint strategy that provides an open and mutual understanding of the role of different brands, target consumer groups, pricing parameters and promotion strategies is a key vehicle for a healthy, mutually beneficial relationship.

Some brands have suffered at the hands of heavy discounting and promotional activity, which have undermined brand values – particularly damaging for premium products sold at mainstream prices. At the other end of the spectrum, some brands have been discontinued by large retailers because of the refusal to move on pricing and participate in certain promotions.

Leveraging both the CP company's and the retailer's data to gain useful category strategy insights is also essential. Valuable shopping and consumer behaviour information can be used to identify opportunities and inform the strategy. Too often valuable data is not used or it is too difficult to be usefully analysed. If a CP business is the category champion, this is a role that presents an opportunity to establish such win/win strategies.

Supply chain. Costs along the whole supply chain – from production through logistics to the store – can be driven out to benefit both parties. Supply chain efficiencies can also be achieved by standardising data formats using solutions such as global data synchronisation and data pools.

Four Key Areas for CP Company/Large Retailer Collaboration



In addition, retailers and consumer goods companies have the opportunity to reduce supply chain costs using new, innovative approaches focussed on sustainability, such as joint warehousing or collaborative transport.

An example of this is ECR France's joint infrastructure project, which is a collaboration of three independent manufacturers (Bénédicta, Nutrimaine and Lustucru), one third-party logistics service provider (FM Logistics), six regional haulers and one major retailer (Carrefour). This shared multiplayer approach is designed to enable more frequent deliveries and improved vehicle load levels. The project has resulted in benefits such as a 34% increase in average delivery frequency and a 115% increase in average load per delivery.[1]

Point of sale. The point of sale (POS) is an important driver of consumer purchase behaviour and, as such, working closely with the large retailers is important. Retail theatre and "retailtainment" are the coined phrases for high-impact and engaging point-of-purchase presentations. This is an increasingly important form of below-the-line (BTL) marketing, which can encourage incremental impulse purchases and experimentation by customers who don't currently use a particular product. Usually the displays leverage insights and research, possibly including input from multiple retailers, which target specific key purchase criteria or barriers to consumption.

Joint POS solutions may include specialised merchandising units and packaging formats, demonstrations and sampling. Our experience has shown that significant incremental sales increases can be achieved where customer-focussed collaboration on a product or category is adopted.

As the continued growth of the Internet as a proportion of total retail sales continues, retailers across the globe are considering the future role of the store. Early store innovations include the store as an experience centre, local collection point for Internet orders, a place to socialise and to conduct product research. The implications of this will be more profound for categories such as consumer electronics. This could be the driver for a step change in the importance of having strong POS capabilities.

Pricing and promotion effectiveness. Promotions are a fantastic way to encourage trial and experimentation of products and interaction with the brand. A few problems exist, though. Promotions are expensive, can be difficult to manage, result in supply or customer service issues if not planned properly, and can undermine a brand if not aligned to brand values.

Having process and data transparency is key to improving the management and reimbursement effectiveness. Problems usually arise because the process cuts across account management, marketing, sales and finance on the CP side and across commercial, buyers and finance at the retail end. Various individuals request and administer discounts and promotional support. The process is fragmented and siloed internally and disjointed between both parties. Having a transparent "net cost system" where both retailers and CP organisations align around a single, open process is the way to avoid stock-outs, payment errors, rework/waste and unknown levels of success (which, in the process described early in this paragraph, makes it almost impossible to understand true ROI).

1 "Future Supply Chain 2016: Serving Consumers in a Sustainable Way," Global Commerce Initiative and Capgemini, May 2008

3 Continue to Carefully Seek High-Growth, White-Space Emerging Markets

Developing economies are attractive compared with mature and stagnating developed markets. Emerging markets now account for more than 50% of global GDP and further growth is expected, with the number of middle-class consumers in emerging markets expected to rise from 430 million to 1.15 billion by 2015.[2] These middle-class consumers will increasingly care about their status, image, social positioning and are aspiring to be more international with regard to the products and brands they buy.

This is coupled with increasing stability in more countries. A recent Economist Intelligence Unit (EIU) study, which measured the change in organisation risk between 2002 and 2008 across 10 categories, found an across-the-board reduction in risk in all emerging-market regions with the exception of Asia Pacific, which maintained the same risk rating.

Yet many CP organisations are under-exposed to emerging markets. In fact, the average revenues that large CP companies generate in emerging markets is around 30% of total sales.[3] Whether under or significantly exposed to emerging markets, the future strategy with emerging markets will need to consider how reduction in consumer spending will affect these markets where GDP is more closely linked with disposable income.

Careful assessment of white-space markets is required and the list of markets for consideration may well have to go beyond more obvious candidates. A comprehensive framework for assessing the potential of markets is required to ensure that the size of the prize is weighed against the ability to win and the amount of risk involved.

In addition to whether to enter, companies must take into account the factors that will make it profitable to operate in these markets, including the level of ambition and aggression of entry, a suitable portfolio and an operating model to get product successfully into the market.

In evaluating, entering and serving the market, it is important to ensure that the assessment approach is structured and rational enough to avoid cognitive biases that can over-inflate the size of the prize.

2 "Promise or peril? The lure of the emerging markets," Economist Intelligence Unit, 2008
3 "Food Producers & HPC [home and personal care]," ABN AMRO, 2008

In addition, companies must consider the market potential, not just the current size when evaluating a market – the markets will be nascent by definition and have low consumption per capita. Look at adjacent categories and other affinity markets to build a set of category development scenarios. Consider also the current and future ability to win in the new market. This will change positively and negatively over time depending on a number of factors, some of which can and should be considered in advance.

Companies should not under-estimate the local competition. While they may not have big marketing and NPD budgets they often have very granular local consumer knowledge, privileged distribution, lower cost bases, and are able to act quickly and take bigger risks.

CP businesses must also make careful portfolio decisions balancing global standards with local taste, packaging, channel and format preferences. In addition, they must take care not to make the portfolio too premium too early. It's important that the products get consumer pick-up and make an impact. However, it takes time to build consumer appreciation for product innovations and a willingness to pay a premium for them.

Organisations must ensure that their strategy and product portfolio does not result in a very niche level of participation. Products lifted directly from developed markets will be expensive and only reachable for upper-income consumers. Products should be accessible by the large proportion of people in the mass market.

A new market should not be automatically overburdened with an operating model from a developed economy. Often a new market isn't significant enough to accommodate such a model, resulting in margin loss, inflexibility and poor market response times.

Finally, CP companies should use innovative distribution models to give maximum reach to the intended purchasers. The use of agents, informal credit and direct sellers are examples of how some organisations have accessed large consumer bases.

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Key Factors in Entering and Serving Emerging Markets

When determining their emerging-market strategy consumer products companies must consider two aspects: "assessing the market," which consists of pre-entry activities to determine which markets to enter; and "serving the market," which involves post-entry activities related to managing and growing the market.

4 Prioritise and Focus Innovation on Key Consumer Groups

Shareholders increasingly put pressure on consumer products businesses to innovate in order to stimulate growth in stagnant, mature markets. While consumer products companies typically generate only about 10% of their revenues from products launched in the past year, innovation pays off in a number of ways. One report found that innovation leaders in the consumer products industry have posted share price growth rates at least double those of the industry average.[4]

However, in today's economic climate it's tempting, perhaps even mandatory, to scale back on innovation to cut costs. Innovation is more important in a tough economy to encourage consumers to part with their reduced disposable income. Some anecdotal evidence even suggests that CP organisations that invest heavily during a recession are more likely to prosper afterwards.

The approach to dealing with this paradox should have three tenets:

Focus and prioritise. Consumer values change significantly during a recession so it makes sense that some products and brands may need to be repositioned with a combination of further NPD and/or marketing. With pressure on budgets, choices have to be made based on priority consumers, channels and customers.

A consumer and customer segmentation framework is a good mechanism for making decisions around where to invest. Arbitrary, across-the-board cuts can kill mid-term value creation unless consumer vulnerability and profitability is understood by segment. If this is understood it is likely that, even though the overall marketing budget will be reduced, some segments and channels will receive more investment. Other low-profit, high-vulnerability segments may receive no short-term investment at all. The essence of this strategy is to understand where investments are going to have the most significant shorter-term returns while still building a platform for mid- and long-term value creation.

Innovation vs. renovation. In cash-strapped times, successful innovation is about selecting the right balance between innovations that are truly "new to the world" and less costly product renovations and refreshes. Clearly a renovation is not likely to have the same sales impact as a successful "big bet" innovation, but the returns can be attractive, especially when weighed against the alternatives.

Certainly for non-priority consumer areas, a major innovation in recessionary times would probably be inappropriate. Could a packaging refresh be used to protect market share instead? For example, Ocean Spray used a packaging renovation to stand out on the shelf. Once the product engaged the consumer, the packaging reinforced some key brand messages around antioxidants and "protecting you [the consumer] from the inside." Such renovations can be a less costly way of affecting consumer purchase decisions made in fractions of seconds at the point of sale.

Use lower-cost collaborative methods of innovation. One infamous category director was once quoted as saying, "Why do I employ all these brand managers to understand who our

4 "Innovation Leaders 2007/8," innovationleaders.org

customers are and determine what they want – why don't I just hire a consumer and they can tell me!" Engaging consumers into NPD and marketing processes has its advantages. The earlier the customer is engaged in product development, the earlier a company can incorporate their insights, increasing the chances that ideas will succeed.

Greater use of the web has enabled businesses to gain insights in different ways. For example, Adidas, considered the fourth best global innovator,[5] uses virtual world Second Life to test new shoes with consumers before they are produced. Dell, Dyson and P&G have all established a direct dialogue with consumers early in the process to reduce research costs and the risk of failure.

Open collaboration, as it is commonly referred to, is a way of leveraging otherwise expensive or unavailable expertise by collaborating with external organisations. This can take the form of formal joint ventures, informal partnerships or forums, including consumer groups, academic institutions, industry bodies and other corporations. Consider, for example, the partnership between L'Oréal and Nestlé to jointly develop a new market segment known as "cosmeceuticals" or "active cosmetics" (nutritional supplements for cosmetic purposes).

Marketing can also engage consumers to help understand consumer requirements, and design and build marketing campaigns. This is often referred to as "citizen marketing." Some CP organisations invite consumers to submit ads on their websites where they ultimately interact and engage with the brand. Such campaigns are then submitted into online forums where public chatter determines the winner. The submitted ads are often more authentic and stand out against in-house campaigns. Consider PepsiCo's Dewmocracy programme where consumers were instrumental in selecting new Mountain Dew flavours, names, packaging, launch activities and so forth.

Conclusion: Thriving in Unprecedented Economic Times

There's no question that the coming year will be filled with the sound of profit warnings. One of the most margin-sensitive levers in this stagnant or even contracting market is cost reduction. When done well it can release substantial savings in the mid-term and produce significant results quickly.

To get step-change benefits, difficult decisions are needed. P&L accountability will almost certainly have to change along with the executive governance model. Making large-scale operating model changes without destroying future ability to create value is challenging and care must be taken.

The leading consumer products organisations will successfully and radically redefine their operating models and pursue other growth strategies to improve their competitive positioning. For those brave enough to take these steps, class-leading margins may await.

Innovation is more important in a tough economy to encourage consumers to part with their reduced disposable income.

5 Ibid

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About Capgemini's Global Consumer Products and Retail Insight Group

The consumer products and retail insight group carries out research and produces thought leadership on current global issues affecting the industry.

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