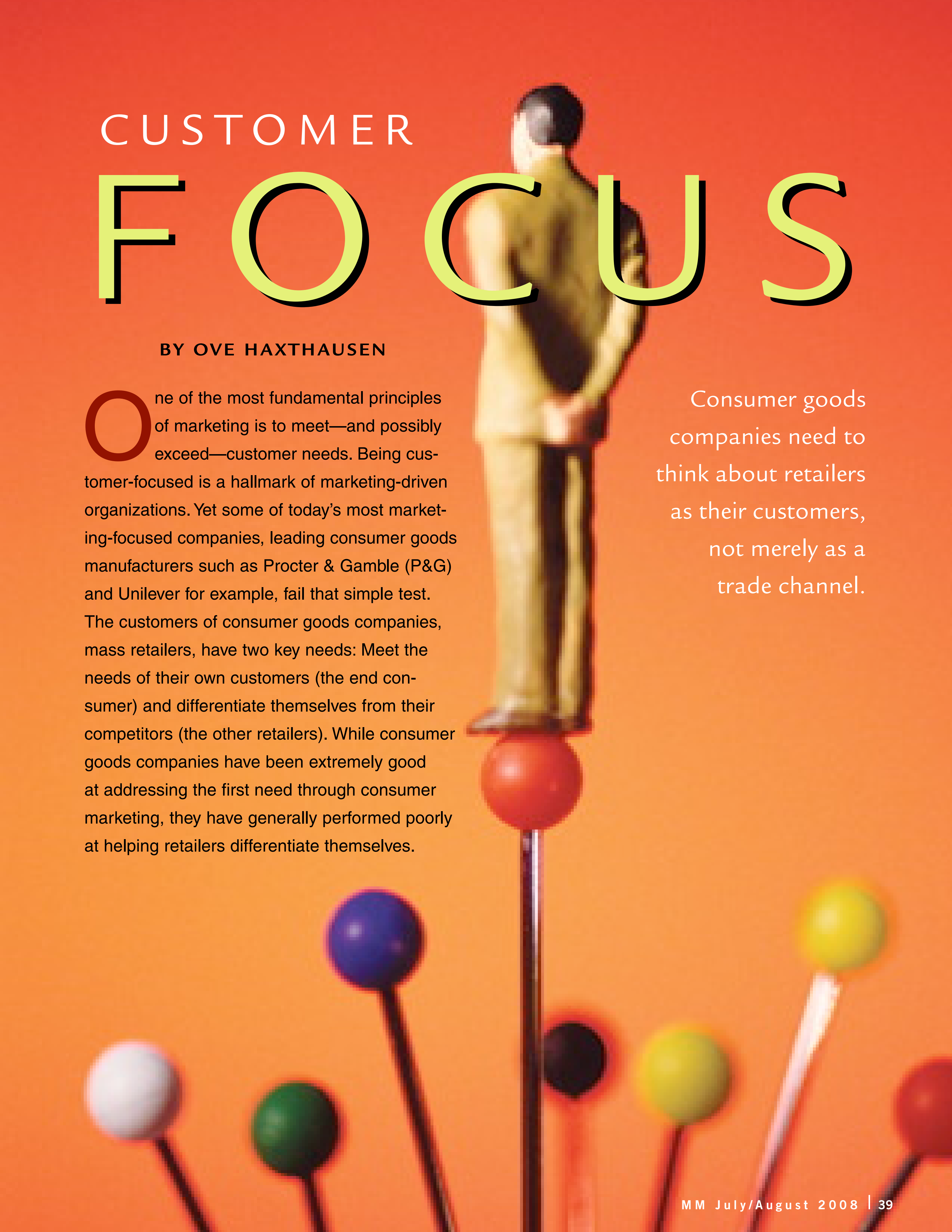


CUSTOMER

FOCUS

BY OVE HAXTHAUSEN

One of the most fundamental principles of marketing is to meet—and possibly exceed—customer needs. Being customer-focused is a hallmark of marketing-driven organizations. Yet some of today's most marketing-focused companies, leading consumer goods manufacturers such as Procter & Gamble (P&G) and Unilever for example, fail that simple test. The customers of consumer goods companies, mass retailers, have two key needs: Meet the needs of their own customers (the end consumer) and differentiate themselves from their competitors (the other retailers). While consumer goods companies have been extremely good at addressing the first need through consumer marketing, they have generally performed poorly at helping retailers differentiate themselves.

Consumer goods companies need to think about retailers as their customers, not merely as a trade channel.

EXECUTIVE briefing Today's mass retail landscape is very competitive. Fast growing chains compete fiercely on price, and use increasingly sophisticated private label strategies. Yet consumer goods companies have failed to meet their customers' need for differentiation. This failure has resulted in increasing profit and growth pressures on consumer goods manufacturers. To alleviate these pressures, manufacturers need to use new branding strategies to help mass retailers differentiate themselves.

The current consumer-focused marketing culture, predominant at leading consumer goods manufacturers, has historical roots. In the late 19th century—when companies such as Procter & Gamble, Cadbury's, Lever Brothers, and The Hershey Company were founded—they were leveraging newly invented mass production technologies to create large mass brands that could be marketed through a fragmented set of independent retailers to one consumer base, assumed to have the same needs. Using mass advertising, these new manufacturers were able to generate consumer demand and loyalty for their products, thus making them attractive to independent retailers by drawing consumers into their stores.

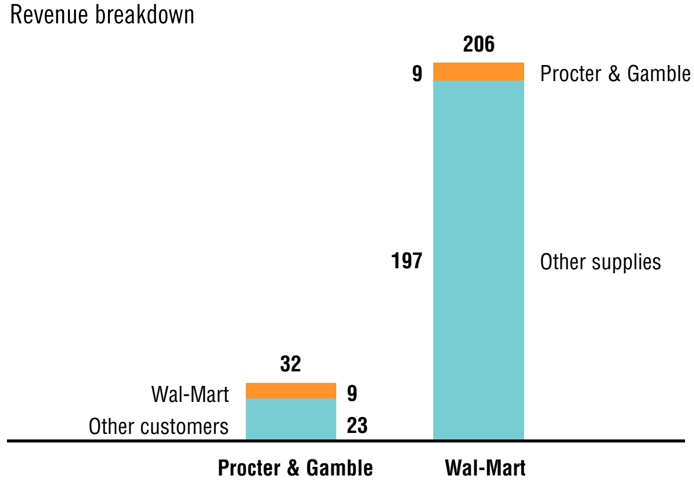
This consumer-focused marketing strategy has essentially remained in place within most large consumer goods companies until today—obviously with continuous updates, such as the increased focus on consumer segmentation. Leading companies such as Unilever and Kraft are focusing on managing a reduced number of large leading global brands that they market primarily to consumers. These large brands allow consumer goods manufacturers to be category leaders with retailers, and to generate economies of scale both in the supply chain and in marketing. The problem with this consumer-focused strategy is that the mass retail landscape has changed drastically, especially over the past 20 years.

Independent neighborhood shops and smaller local retail chains have nearly vanished—to be replaced by fast-expanding, national mass retail chains. The most striking example of retail chain growth is Wal-Mart, with revenues that have sustained an average annual growth rate of 18% since 1987—growing from $12 billion to $345 billion today. Retailers have grown so large that the bargaining power has shifted largely in their favor. As an example, we estimate (based on publicly available data) that Wal-Mart currently accounts for about $9 billion or 28% of P&G's U.S. revenues—whereas P&G's $9 billion only account for about 4% of Wal-Mart's cost of goods sold (see Exhibit 1). Put in simple terms: In the United States, Wal-Mart is seven times more important to P&G than P&G is to Wal-Mart.

In this context, it seems particularly crucial for consumer goods companies to serve their powerful customers well. However, consumer goods manufacturers' current prevailing strategy of delivering large, global, leading brands to retailers through consumer-focused marketing seems to fall short of one of mass retailers' critical needs: Offer products that enable them to differentiate themselves from other retailers. While consumer goods companies remain extremely good at driving consumer demand—an important benefit for mass retailers—they have typically paid little attention to the need to help mass retailers differentiate themselves from their competition. In the past, this made sense: Given the small size of retailers when the consumer marketing model was developed, there was no need to do that.

The failure of consumer goods companies to help today's large retailers differentiate their offering has had two consequences: strong growth of private labels and increasing competition among retailers on price—as illustrated by Wal-Mart's old tag line "Everyday low price," now being changed to a barely more subdued "Save money, live better." In the United States for instance, private labels currently account for about 19% of retail sales in the grocery channel, up from 14% in 1997, according to ACNielsen. In Europe, private labels are generally even stronger than in the United States, with the United Kingdom leading the pack. In the United Kingdom, private labels account for 43% of retail sales according to ACNielsen. In a 2005 global private label study, AC Nielsen also found evidence of correlation between retailer consolidation and share of private label: The more consolidated retailers are, the higher the share of private label tends to be.

Exhibit 1
Revenue breakdown



Notes: estimates based on P&G and Wal-Mart 10Ks for years ending in June and January 2007, respectively. Sources: SEC, MB Optimor analysis and estimates

Increasing competition among retailers on price and the growth of private labels illustrate retailers' efforts to gain an advantage over their competitors in an increasingly competitive market. And both competition on price and private label growth put pressure on consumer goods companies: Retailers use their bargaining power to pass on the lower prices to their suppliers, and their private labels challenge the market share of manufacturers' brands.

The evolution of private labels provides interesting insight into mass retailers' efforts to compete with each other. Traditionally, store brands have predominantly been lower-priced generic products. They have enabled retailers to capitalize on their retail brand's ability to attract shoppers, thereby capturing some of consumer goods manufacturers' market share and profits. Occasionally, this discount strategy has taken on a more aggressive character. Retailers have developed store label products imitating manufacturer branded products and packaging. These imitation products are found on the store shelves next to the manufacturer brands, but priced at a significant discount. Many drugstore chains still use this strategy in personal care categories.

Brand architecture can be a powerful way to address not only today's complex consumer segments, but also today's retail landscape.

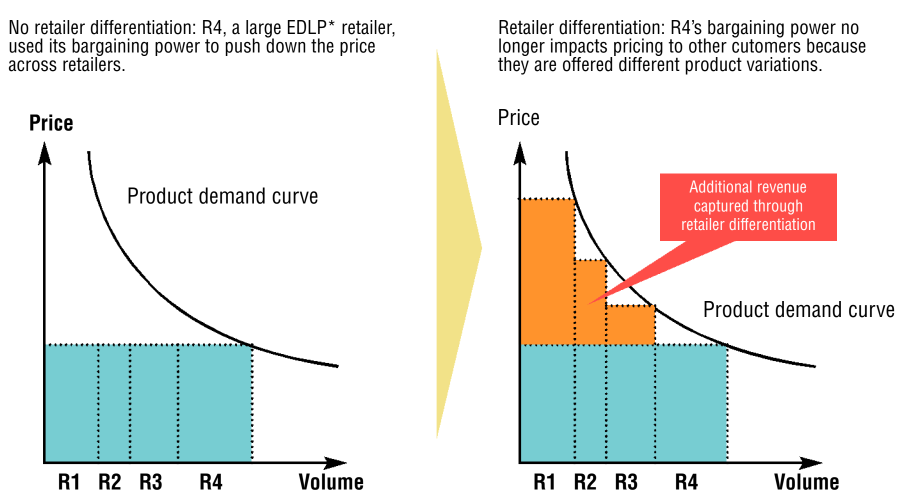
The newer trend is distinct, higher-end store labels—comparable in product range, quality, and price to manufacturers' brands. Unlike manufacturer brands, these private labels provide differentiation to the retailer because they can't be found anywhere else. Target's Archer Farms brand is one example of these brands. Archer Farms uses all the tricks of manufacturers' marketing play book: high quality, wide product range; more innovation to refresh the brand; and most importantly, consumer advertising through TV and other media channels. This new breed of private labels is a serious threat to consumer goods manufacturers because they challenge one of the last advantages manufacturer brands have left: Consumer loyalty built through consumer-focused marketing.

Faced with these increasing threats from their customers, how can consumer goods manufacturers use retailer differentiation to respond? By offering retailers something that is exclusive and therefore differentiated, consumer goods companies can prevent retailers from further developing their own private labels. Offering different products to different retailers can also provide manufacturers with more pricing flexibility. Exhibit 2 illustrates this pricing effect, looking at a simplified example of a manufacturer selling to four retailers: R1, R2, R3, and R4. On the left graph, the same product is offered to all four customers. The biggest of the four, R4 (which also happens to be an "every day low price" mass discounter), uses its bargaining power to "dictate" its price to the manufacturer. The three other retailers have to follow suit because they otherwise are not able to remain competitive with R4 on their retail pricing. The result is one low price across all customers, with the blue area showing the manufacturer's revenue. On the right graph, the manufacturer has decided to offer different product varieties to each of its four customers. While R4 still uses its bargaining power to negotiate a low price for itself, it no longer has the same influence over what the manufacturer can charge to its other customers—because the other retailers are getting different products. In the right example, the manufacturer helps its customers differentiate themselves while simultaneously achieving higher revenues through better pricing (as shown by the orange areas on the graph).

So practically speaking, how does retailer differentiation work? A retailer-differentiated strategy can be as simple as providing different pack sizes to different retailers. And it can be as complex as launching exclusive products, sub- or

Exhibit 2

Pricing impact of retailer differentiation simplified



*Every day low price
Sources: MB Optimor analysis

co-brands, or even new exclusive brands with key retail customers. Specific flavors or other new product innovations could be exclusive to key retailers, co-branded exclusive lines could be created on the model of what has long been common practice for higher-end men's apparel in department stores with the "made exclusively for …" label. In some cases, the creation of new brands might even be appropriate for offering a new price point and fresh differentiation to a key retailer. The point is that brand architecture can be a powerful way to address not only today's complex consumer segments, but also today's retail landscape.

Of course, a retailer differentiation strategy will introduce new complexity into consumer goods companies' marketing and supply chain functions. For one thing, trade marketing will have to become a less tactical function, and include more strategic considerations (such as brand architecture). This could mean that the trade and consumer marketing functions will have to operate in a much more integrated fashion to develop brand strategies that work—both from the consumer perspective and the retailer perspective. Also, new customer exclusive offerings will increase supply chain complexity, and potentially marketing costs. The good news is that today's manufacturing and supply chain technologies have significantly lowered the cost of customization. In addition, pricing remains a more powerful profit driver than costs. Assuming a consumer goods company has a 20% profit margin, a 5% increase in revenues due to better pricing from differentiated products will increase profits by 25%, whereas a 5% increase in operating costs due to the additional complexity associated with retailer differentiation will only lower profits by 20%. This would leave the company with a net profit improvement of 5%.

There is strong evidence that retailer differentiation strategies work. One of our clients, from a leading consumer goods company, recently told us that he was able to alleviate the pressures of a price war among his key customers in a South American market by offering different pack sizes to each of these retailers. Providing different pack sizes to different retailers seems to be a well-established practice in many consumer goods categories. Different pack sizes are often a request from major retailers, to allow them to differentiate and avoid price pressures. If differentiating just by pack size can impact pricing, one can imagine what a more sophisticated retailer differentiation strategy could do.

One company that has long been known for its sophisticated brand architecture strategy is Polo Ralph Lauren. The company's brand architecture is organized around multiple dimensions that include product categories (apparel, home products, fragrance, and accessories), consumers (kids, younger adults, and male and female adults), and price points—with implications to retail channels. In women's apparel for instance, Blue Label is sold only through Ralph Lauren stores in the United States, whereas the low-priced Lauren is sold only through department stores and online at polo.com. The Women's Ralph Lauren Collection and the Women's Black Label are sold primarily at Ralph Lauren stores, but also at "select department stores" and "fine specialty stores," according to the company's documents. Most recently, Polo Ralph Lauren has been pushing retailer differentiation one step further with the creation of its Global Brand Concepts group. The group is helping retailers create exclusive brands—in other words, more sophisticated private labels. In the spring of this year, Polo Ralph Lauren launched the new American Living brand exclusively at JCPenny. American Living is a lifestyle brand with a full range of men's, women's, and children's apparel and accessories as well as home products.

Another example of manufacturers helping retailers differentiate themselves is Hasbro. The company is licensing its Playskool brand exclusively to CVS for use in baby care products. CVS and Hasbro worked together to develop an exclusive Playskool line of baby care products to be sold in CVS stores—including diapers, wipes, bottles, bottlebrushes, and other feeding accessories. The line was launched with great success in the fall of 2006, and was recognized by License magazine as the best direct-to-retail license of the year. These examples illustrate some of the many ways in which brand architecture and brand licensing can be used by manufacturers to achieve different price points and more differentiation with retail customers—thereby limiting the pricing power of any one customer, while becoming more relevant to them. Retailers themselves tell us that they need to use branding for differentiation. Target's 2006 annual report states: "Delivering merchandise assortment that is distinctive, exclusive and unexpected in its design and value is a key focus in our effort to connect with our guests and differentiate Target from our competitors. We continue to introduce specialty brands, expand our premium owned and licensed brands, and offer a carefully edited assortment of trusted national brands." Perhaps if the assortment of "trusted national brands" had an exclusive element to it, it would be less edited.

So does this mean that consumer goods manufacturers have to let go of their consumer focused marketing, and their strategy of offering leading, global brands across mass retail channels? Of course not. Consumer marketing remains a powerful way of generating demand, and leading global brands build strong loyalty with consumers. However, we believe consumer goods manufacturers could benefit from providing their increasingly powerful mass retail customers with new means of differentiation. Retailer differentiation can help manufacturers resolve two of their most pressing issues: price pressures from big retailers, and the growth of private labels. It also benefits their customers. Such a win-win proposition seems hard to ignore. ■

About the Author

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