



2011 Consumer Packaged Goods Industry Perspective

There is cautious optimism about the outlook for companies that cater to consumers. Economic growth remains tepid and there is still plenty of uncertainty, but consumer sentiment, while still weak, appears to be slowly improving and retail sales are expected to show small signs of life.

The good news is that the consumer sector fared better than many others in 2010, although much of this improvement was due to productivity gains. The coming year promises to be challenging as consumer companies seek to generate real revenue growth to boost profits and maintain forward progress.

We believe companies can capture growth by pursuing opportunities generated by four key consumer trends. But in order to maximize enterprise value, CPG companies need to focus on those opportunities that are consistent with what they do well, on what distinguishes them in the marketplace, and on how their capabilities system should evolve to address them.

The four trends consumer companies and retailers can leverage to grow in 2011 and beyond are the following:

1. Frugality with a twist

During the Great Recession, many consumers were forced to focus on price. They drastically reduced their spending, as well as cut back on services that they once deemed essential. Even those people who could afford more began purchasing value brands and private-label goods, which suddenly seemed trendy. Today, the frugal spending habits that consumers adopted during the recession are showing signs of lingering longer than usual, due to the depth of the downturn and the slow recovery. For some consumers, these habits may become an enduring reality.

In our annual consumer survey, conducted in August, we found that consumers cut back on spending more in 2010 than in 2009. Even those who were optimistic about the economic outlook expressed little interest in increasing spending: Less than 10 percent of them planned to trade up in brands, and only 15 percent planned to spend more in discretionary categories – despite having deferred purchases for roughly two years. Consumers continue to defer purchases of discretionary items such as electronics and apparel, to trade down on essentials like household goods and groceries, and to generally seek more economical

alternatives to their current services, such as a Netflix subscription in lieu of cable TV.

A major challenge for consumer companies in the year ahead will be how to obtain top-of-mind positioning in a time when consumers increasingly see products and services as commodities. This will be more and more critical as manufacturers come under pricing pressure from the rising cost of raw materials.

That said, there are still opportunities for companies to grow, provided they can capitalize on the seemingly contradictory trend of frugal consumers who are nevertheless willing to open their wallets for products and services that satisfy their emotional needs in addition to their functional ones. In fact, consumers are willing to pay more for so-called high-touch experiences, as Apple's continued success in these difficult times proves.

Demand for products and services with emotional appeal is actually quite broad, extending far beyond iPads, iPhones, and other cool gadgets to luxury and personalized offerings. Consumers still want to reward or indulge themselves occasionally, by springing for a Hermès scarf, a Starbucks Frappuccino, or a weekend at the Ritz-Carlton. They are seeking greater personalization, as evidenced by the popularity of products and services that can be customized, such as Pandora's Internet radio service, which promises to "play only music you'll love."

2. An aging and health-conscious population

The trend with perhaps the most far-reaching implications is one that we've long anticipated but that is now reshaping the market for consumer goods. As the population ages, consumers are increasingly demanding foods, beverages, and other goods that promote health and well-being. They're buying more organic and natural foods. New categories are being created in weight management, performance nutrition, and disease support. Carbonated soft drinks, meanwhile, have been losing market share at an annual rate of 1.6 percent since 2004 to beverages that consumers perceive as healthier.

In a sign that this trend has reached critical mass, PepsiCo announced in October the creation of a Global Nutrition Group with the goal of tripling its business in "good-for-you" products by 2020. Nestlé is also creating a new nutrition subsidiary, along with a research group, aimed at developing products that prevent and treat conditions such as diabetes, obesity, cardiovascular disease, and Alzheimer's disease, positioning the company as a pioneer in a category it calls "personalized health science nutrition."

To play in new categories such as these, companies need to harness scientific research in the development of products for an aging population, practice

claims-based marketing, and both comply with regulations and influence government policy and professional communities.

3. Fragmented media, digital consumers

It is now abundantly clear that media is no longer monolithic and marketers can no longer rely solely on broadcasting brand messages via traditional television or print advertising. Further, consumers are becoming increasingly digital; they are going online to do research and look for deals, read reviews, and look for deals before making purchases. In the process, they are becoming less reliant on traditional marketing messages. In our 2010 annual consumer survey, we found that 23 percent of consumers identified themselves as “online window-shoppers,” up from 11 percent in 2009.

Now more than ever, companies need a marketing function that can reach consumers in the right way and at the right time no matter where they are on the path to purchase – at home, on the go, or in the store. The marketer’s mission is to simultaneously generate insights, engage and build lasting relationships with consumers, and drive sales.

To address these challenges, marketers are spending more on nontraditional programs and what we call “private-label media,” such as temporary “pop-up” stores, e-newsletters, and company-sponsored websites. These venues have nothing in common with infomercials. Instead they connect consumers to brands and other fans of the brands; General Mills’s BettyCrocker.com, for instance, has more than 8 million unique visitors per month. These and many other nontraditional strategies are aimed at reaching consumers when they are in “shopping mode” (rather than interrupting them when they are doing other things), and are focused on helping companies gain targeted insights into what motivates shoppers.

Building on these insights, companies are increasingly using the point of sale as a channel to strengthen their brands and stimulate sales. Nestlé, for instance, sells its Nespresso coffee capsules and high-end espresso machines through a fast-growing chain of boutiques. By doing so, it creates a more intimate consumer experience and insulates itself from the pricing pressure it would surely face if it sold the capsules in supermarkets. By year’s end, the company expects to be operating 220 outlets, including some in Bloomingdale’s stores in the United States.

Mobile marketing and mobile commerce also are emerging as ways for retailers and brands to engage shoppers on the go – driving action and gaining insight in the process. Many consumers already receive coupons and other offers on their smartphones. And Facebook has a new feature called Deals that promises to deliver promotions from more than 20 companies, including Gap and

McDonald's, to potential customers when they are near their locations. E-tailers, meanwhile, are increasingly tracking consumers' shopping behavior online so they can target ads to people based on the products and websites they have viewed.

4. Big emerging markets

The final trend that many consumer companies should be addressing is the rapid growth in the big emerging markets of China, India, and Russia. In China, for example, GDP growth in 2011 is expected to *slow* to 8.7 percent, compared to 2.9 percent in the U.S., according to the World Bank. Key companies in China's food and beverage industries routinely ring up double-digit sales and profit growth. In India, GDP growth in 2011 is estimated at 8.7 percent, and income levels are rising rapidly, with significant growth in middle- and upper-income households.

Consumer companies already know that these markets hold rich potential, but capturing this value depends on their ability to navigate some complex challenges. For one thing, competition is fierce, both from established multinational corporations and from local companies that already have a strong, focused set of capabilities. Furthermore, these markets are not homogeneous – consumers are in different stages of development both across countries and in individual countries, such as China, where major differences exist between urban and rural markets as well as regional markets. Given the scale needed to win in these markets, big investments are usually required, virtually guaranteeing low profitability in the early phases of expansion.

Winning in emerging markets is also dependent on being able to attract and retain the highest-caliber talent – a major challenge in and of itself in some geographies. Expansion initiatives require executive teams that can marry a multinational perspective with local knowledge, as well as the training and development of competent, highly engaged front-line managers.

Coherence is the key

Effectively addressing these trends presents complex challenges for consumer companies. Generating the value that consumers are demanding requires more differentiation in the marketplace, better consumer insights, and new channels for reaching shoppers. Playing in the new health and wellness categories requires companies to develop “scientifically advantaged” products and practice claims-based marketing. Building a leading position in emerging markets requires a business model that will probably look very different from the one most companies use in developed markets, where the basis of competition is share and increased efficiency.

In the midst of all this complexity, our recent research demonstrates that sustainable, superior returns accrue to “coherent” companies that focus on what they do best. When measuring shareholder return over the past 10 years, we discovered that consumer companies whose business models, capabilities systems, and product portfolios are well integrated and focused – such as Church & Dwight, Alberto Culver, Nu Skin Enterprises, Tupperware, and Kellogg – outperformed larger, more diversified competitors.

Surprisingly, it’s not necessarily the big, global companies that are creating more value in the long run, but rather those companies that know and develop what they are best at (in terms of business model and capabilities) and grow by adding brands, products, and services that match. These companies don’t try to be great at everything. They know that no company has the capacity to achieve that. Rather, they focus their resources on building a differentiating position in relatively few capabilities, enabling them to make the significant investments required to develop the critical combination of people, knowledge, processes, IT, and tools that will allow them to outperform their rivals.

These coherent companies have built a system of three to six differentiating and mutually reinforcing capabilities. The specific capabilities in the system, which might support retail execution or the design of highly engaging new products and services or help wring maximum efficiency from the supply chain, will be unique to each company. But in each case, the company’s capabilities system supports the success of its product line and intended market strategy, and the creation of differentiated value.

To capture the coherence premium, we encourage you to think about the trends described in this letter and how you can turn them to your advantage with a capabilities-driven strategy. Toward this end, we suggest the following:

1. That the opportunities you explore be consistent with what you do well and what distinguishes your company in the marketplace.
2. That you identify the three to six capabilities that differentiate your company and determine whether your “right to win” is under threat due to changes in the marketplace.
3. That you understand how your capabilities system should evolve to address changes in consumer behavior and other trends that are reshaping the consumer market.

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We hope this letter has been useful to you. In the past, our year-end missives have prompted executives to call or write us with their own thoughts and comments. We hope this one sparks a dialogue with you about the challenges that consumer companies face in the coming year and how we can help you make your company more prosperous in 2011.

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