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Is Category
Consolidation Inevitable?
*Shaping Category
Dynamics to Win in CPG*



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EXECUTIVE SUMMARY

For years, experts have been predicting that most consumer packaged goods categories would end up like carbonated beverages, razor blades, and diapers—product segments that are highly consolidated. In this view of the world, CPG categories would be dominated by a couple of big players that would take advantage of their scale to crowd out other rivals, with a handful of niche and private-label players battling over the scraps.

However, this theory—created around Procter & Gamble, the company that many people believe is positioned to win it all—has turned out to be only partially true. Even a casual scan reveals that a great many CPG categories—perhaps as many as half—are fragmenting instead of consolidating.

Consumers are the biggest single determinant of category dynamics; a highly engaged consumer base (as in areas like vodka and high-end chocolates) usually causes a category to fragment. Retailer behaviors and manufacturers' capabilities are other inputs in the consolidation calculation—and, indeed, manufacturers of certain CPG products and services may be able to reshape their categories in ways that will help them win.

For executives and brand managers, the key is understanding the dynamics of the category they're in, assessing whether they can change those dynamics, and figuring out the capabilities they need in order to do so.

HIGHLIGHTS

- Though widely predicted, consolidation hasn't happened in all CPG categories; many have fragmented instead.
- High levels of consumer engagement cause categories to fragment. Lower levels of engagement set the stage for consolidation.
- Having a framework for understanding market dynamics is half of what's needed. The other half is making an internal assessment of one's capabilities.
- Big CPG manufacturers should ask themselves whether they can create the conditions for consolidation. If they can't—if the category is fragmenting—capabilities unrelated to scale are more apt to determine the winner.
- Usually, niche companies have more of the capabilities needed to succeed at the high end of a fragmented market.

A BIFURCATED INDUSTRY

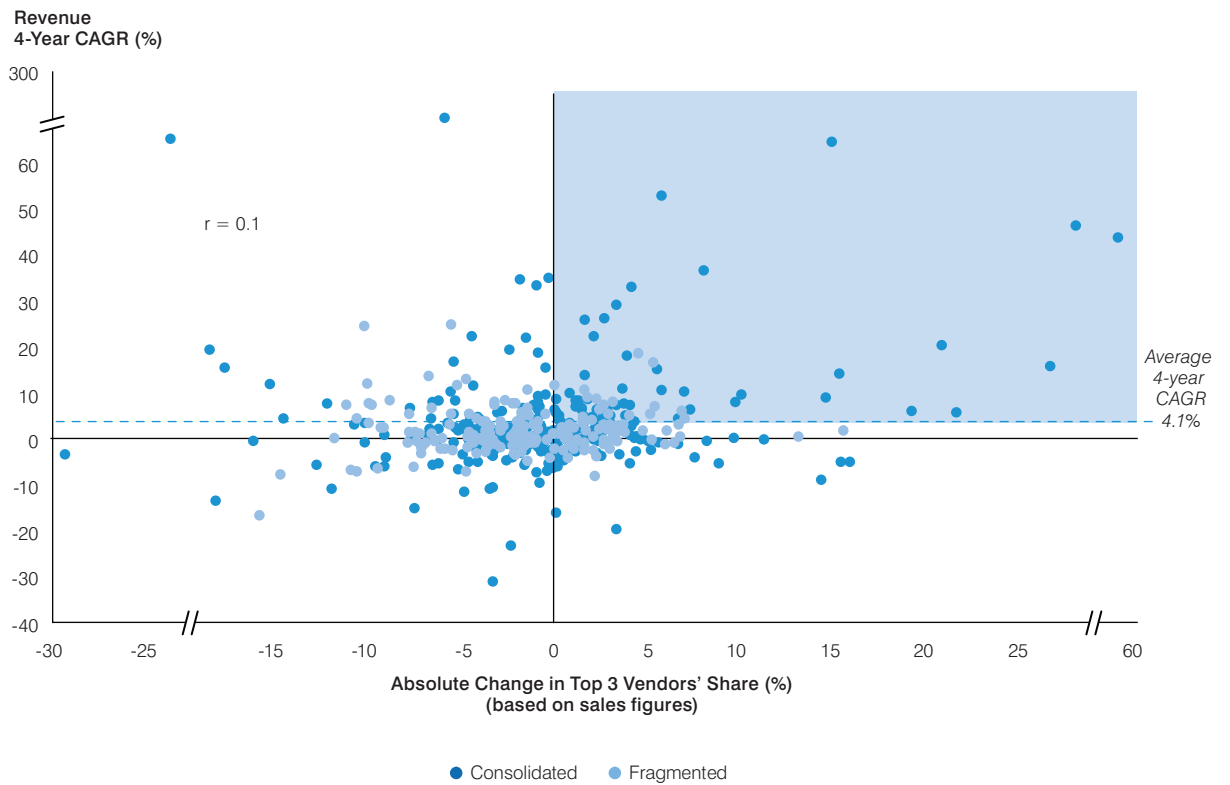
For years, CPG industry experts have been predicting the consolidation of most categories. The thinking was that categories like refrigerated milk, toilet paper, and cookies would narrow down to one or two national brands, a regional or local brand, and private-label brands. However, the reality has proven to be considerably more complicated. While brand consolidation has clearly happened in some categories, other CPG categories are fragmenting. The top two or three

brands in a food category as of 2004, for instance, were just as likely to lose market share as to increase it over the next four years (*see Exhibit 1*). One sees a similar duality in the beauty segments, with some categories prone to consolidating and others to fragmenting.

Business unit managers can gain a tactical advantage by understanding the factors that drive consolidation versus fragmentation and how those factors are likely to play out in their own product segments. As part of the same exercise, they can calculate whether they could drive the transformation within those categories to their advantage, and figure out which capabilities they would need to do so.

Exhibit 1
Food Categories Are As Likely to Fragment As to Consolidate

REVENUE GROWTH VS. SHARE CHANGE FOR TOP 3 SUPPLIERS IN FOOD CATEGORIES



Note: Analysis excludes about 100 product segments less than US\$10 million.
Source: 2004-2008 IRI (excludes Walmart, HEB, and convenience, dollar, and club stores); Booz & Company analysis

CONSOLIDATING CATEGORIES

There are, of course, categories that have behaved exactly the way the experts predicted. Carbonated beverages (Coke and Pepsi have more than 70 percent of the market between them), breakfast cereals (Kellogg and General Mills), shaving products (Gillette and Schick), and pens (Sharpie and Bic) are all categories that have only a couple of major brands, a few local or niche brands, and private labels. These are among the categories where retailers—responding to consumers’ dislike of an overabundance of choices—are opting to simplify their inventory.

Many consolidating categories, in addition to supporting major brands,

appear to have room for private-label entries. This is partly driven by retailers; retailers naturally want to sell their own private-label products, since they make a higher margin on them. And consumers are willing to consider buying private-label brands, especially in product segments where there is little difference in quality or packaging vis-à-vis major brands, and particularly during economic downturns when value pricing is important.

Successful private-label brands can be found in areas as diverse as shampoo (Walgreens’ BioInfusion) and premium-value food (Target’s Archer Farms and Market Pantry). Indeed, in the U.S., it would be hard to find a retailer of any size, or in any category, that didn’t offer some private-label products of its own. Costco’s Kirkland products and Sears’ Kenmore line are two of the best-known examples.

Niche players, on the other hand, face a serious challenge in categories

that are consolidating and where retailers are cutting the number of SKUs they have on their shelves. These “center-of-store” strategies—in which retailers are increasingly stocking only the one or two top-selling brands in a category—are starting to have a big impact on who gets the money. When CVS Caremark recently decided to stop selling Energizer alkaline batteries and retained Duracell as its sole national brand, analysts estimated the revenue hit to Energizer at US\$25 million.

In consolidating categories, big manufacturers have a chance to increase their market share, often at the expense of smaller national brands or local or regional players. They can do this through the application of a differentiated capabilities system that allows them to establish better distribution or exploit other aspects of their scale (see “*Coca-Cola: The Right Capabilities for a Consolidated Category*”).

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Coca-Cola: The Right Capabilities for a Consolidated Category

At the supermarket, there are often specials on Coca-Cola right near the door. You can get a Coke when you stop at a gas station, at the pool in the summer, and quite possibly from a vending machine in the building where you work. The machinery of this \$31 billion beverage company and its bottling network is constructed to ensure that the flagship brand is always within arm's reach.

Indeed, if carbonated soft drinks are a consolidated market, the Coca-Cola Company (with 42 percent of the market in 2009, compared with number two PepsiCo's 30 percent, according to *Beverage Digest*) is a big part of the reason. Among its capabilities are a first-rate understanding of consumers and how to advertise to them. Loyalty to Coke seems to run in families, much as loyalty to a favorite sports team gets handed down from parents to children. The company's understanding of consumers also allows it to create new carbonated beverages in response to shifts in demand (e.g., the diet cola Tab in 1963, Diet Coke in 1982, and Coca-Cola Zero in 2006).

But Coca-Cola's capabilities in the area of brand building and carbonated beverage production only create the possibility of dominance. What ensures it is the distribution system, both on the direct-to-store side and on the franchise side. The company works with independent bottlers to strategically place cans, bottles, and cases of Coke on just about every street corner in more than 100 countries.

This nearly perfect distribution system has not proven as decisive in life-style and sports drinks, the non-carbonated area into which Coca-Cola has expanded in pursuit of new growth. This is a fragmented market that requires a kind of innovation capability the company did not have (which is why it has built this part of its product line largely through acquisitions). In addition, as the company has added new beverage offerings, the plants that manufacture its products have needed to make additional investments in thermal filling technologies, and the trucks that distribute its products have needed to deal with more complexity. Coca-Cola is continuing to evolve, and its shareholders will be watching how the company addresses the challenge of competing in markets that, for all practical purposes, require different capabilities.

FRAGMENTING CATEGORIES

Starbucks was a small but fast-growing company in the early 1990s when it came to the attention of Folgers, Procter & Gamble's ubiquitous coffee brand. The Folgers brand managers were sufficiently alarmed by the buzz around Starbucks that they decided to conduct independent taste tests. The tests were reassuring—most people preferred Folgers to the more bitter Starbucks—and the Folgers managers breathed a sigh of relief and essentially said, “This too shall pass.” Of course, history has shown their complacency to be misguided; between 1993 and 2008, Starbucks' revenue grew from less than \$200 million to \$8 billion, a 40-fold increase.

The rise of Starbucks, in a CPG category that had previously seemed stable, offers a couple of lessons, including how companies can

sometimes take over a category by changing the value proposition to something that they do uniquely well, or by changing the distribution paradigm (in Starbucks' case, it turned coffee into a category with a lot of cachet, with fresh drinks sold primarily in its own retail establishments). The Starbucks story also serves as a reminder that there are simply some categories in the CPG universe where capabilities related to scale don't determine the winner.

Fragmentation is often found in CPG product segments where consumers have a high level of engagement and are either aware of image or more sophisticated in their tastes. In food, the categories that are fragmented are wide-ranging and include hot drinks (the Starbucks example), balsamic vinegar (priced from \$3 or \$4 a bottle to more than \$100 a bottle at some specialty stores), ready-to-eat meals, and vodka, which is often available in a dozen or more brands at the average liquor store (see “*Ketel One: The Power of Aura in a Fragmented Market*”).

Fragmentation is also common in many CPG beauty segments. In

shampoos and conditioners, the most successful brand as of April 2009 was Procter & Gamble's Pantene. But it had only 16.4 percent of the market, a figure that had dropped three percentage points since April 2007, as Pantene lost share to newer products like Alberto Culver's TRESemmé and some budget-conscious consumers opted for private-label hair products. Hair styling is even more fragmented than shampoos, with the top three products barely accounting for a quarter of all revenues. Here, the smallest company's entry (again Alberto Culver's TRESemmé brand) pushed past the entries of two far bigger companies (L'Oréal's Garnier and Procter & Gamble's Pantene) in 2008 and 2009.

In fragmented categories, mass and price usually don't matter as much as perceived quality; it typically isn't the players with scale that are successful in grabbing the high end of these markets. In the New York area, for instance, 24-ounce jars of Rao's marinara sauce (the same sauce available in the famous Harlem restaurant of the same name) fly off the shelves of specialty supermarkets despite costing twice as much as other jarred sauces.

Ketel One: The Power of Aura in a Fragmented Market

Not many people, handed a cosmopolitan at a bar, would be able to discern whether the vodka in it was an everyday low-priced brand or a premium brand. Vodka is tasteless by design, making the different brands at least theoretically indistinguishable on the tongue. Yet plenty of bar-goers request an expensive brand anyway; it's a way of demonstrating their discernment, their appreciation of the good things in life.

Why liquor has become an important platform for demonstrating one's sophistication is a question best answered by sociologists. How Ketel One capitalized on this tendency and became one of the best-selling premium vodka brands in the U.S. market is no mystery at all; it is very much a story about capabilities.

When Ketel One decided to expand to the U.S. in the 1990s, the Dutch family that owned the brand dispatched one of its sons to spend years in the States talking up the unique qualities of the vodka to bartenders. At first the son, and then an expanding cadre of sales personnel, brought samples, held seminars, and told the story of Ketel One's distillation process (using copper pot stills, in a factory in Schiedam, the Netherlands) to bartenders in New York, Los Angeles, Chicago, and Miami. In effect, the bartenders were the gatekeepers, the point-of-sale influencers, in the trendsetting "liquor capitals" of the United States. Over time, the strategy worked; the brand was "activated." Ketel One became an interesting story the bartenders could tell to customers, as well as a brand that was displayed prominently behind the bar. By 2006, Ketel One had become the number three super-premium vodka brand in the U.S.; it was so successful that liquor giant Diageo paid \$900 million for a 50 percent ownership stake.

In both consolidating and fragmenting markets, the key capability is always the one that leads customers to come back to buy your product on a recurring basis. In the case of Ketel One, that element was taste—not in the narrow chemical sense but in a more ethereal sense: taste as refinement, as evidence of superior judgment.

Consumers in certain CPG categories are willing to pay a lot for this quality (recently, \$43.99 for a magnum of Ketel One at one liquor store, compared with \$19.99 for a magnum of Gordon's). For manufacturers, the trick is being able to project, and hold onto, the aura. Ketel One was able to make this breakthrough with some incredibly smart one-on-one marketing—that was its essential capability. Everything else was secondary.

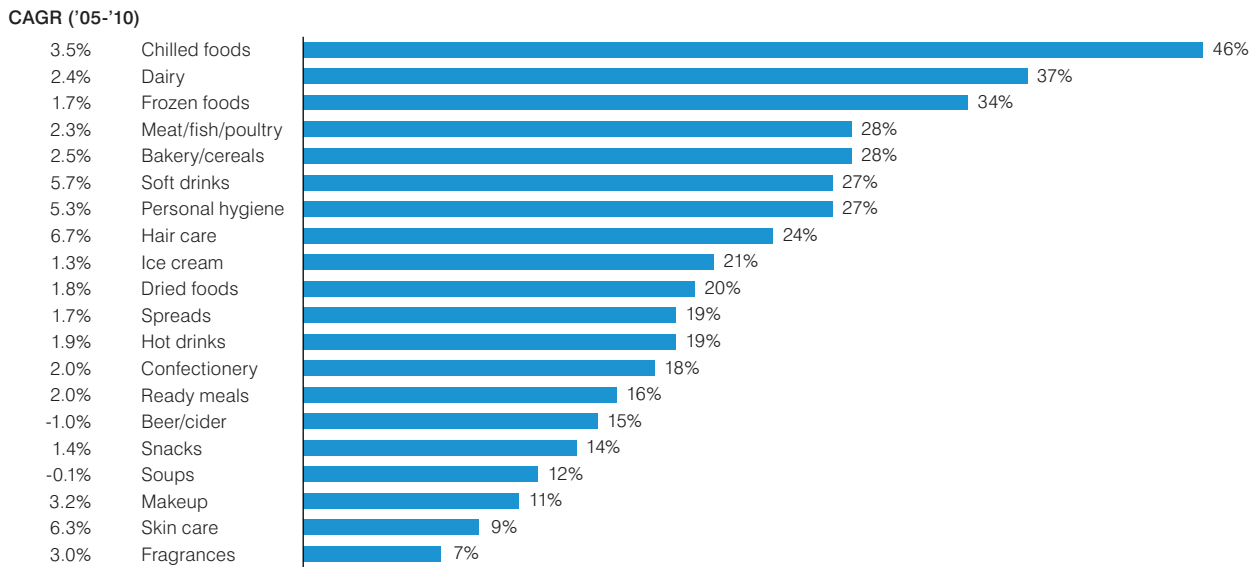
Moreover, not all fragmenting categories owe their fragmentation to consumer perceptions of product differences; some are fragmented because consumers don't believe the products are differentiated at all, so they care only about price. This is another area where private-label products often gain a foothold.

Adding to the complexity, the perception of what is a commodity, and therefore should be purchased on the basis of price, differs between regions and across geographies. In Germany, for instance, more than 60 percent of consumers resist buying branded toilet paper: They do not believe it is any better than the

(cheaper) private-label variety. In general, Europeans are very receptive to private-label products in the areas of chilled and frozen foods, dairy, and bakery—many of which they believe to be the same quality as the branded alternatives (*see Exhibit 2*).

Exhibit 2
Private-Label Infiltration in Europe: Comparing 20 Categories

EUROPEAN PRIVATE-LABEL SHARES AND GROWTH RATES



Notes: Based on spending, 2010e.
Source: ACNielsen; Datamonitor; Booz & Company analysis

INPUTS TO THE EQUATION

To be sure, understanding which CPG categories are prone to consolidation as opposed to fragmentation is partly a matter of studying the data. However, that is inherently a backward-looking exercise. A framework that takes consumer engagement into account—and that also looks at the motivations of retailers and manufacturers, the two other sources of power in CPG markets—can be more predictive than data alone and can explain the amount of consolidation in just about any category.

Consumer Impact

We have already discussed the role that a high level of consumer engagement can have in driving fragmentation in some CPG categories. Think of the chocolate lover who refuses to eat a “lowbrow” brand like Hershey’s or the bagel connoisseur who wouldn’t be caught dead reaching into the freezer at the supermarket to grab a bag of Lender’s bagels.

Consumers can also tip a category in the other direction, toward

consolidation, when they feel less strongly that products differ meaningfully in quality, and when they aren’t concerned with what a non-differentiated brand says about their own image or sophistication. These categories are where retailers can be aggressive about moving toward shelf simplification, even if that means ceasing to stock some national brands, and where retailers are most apt to promote their own private-label brands. Indeed, if the retail outlet is already known for value pricing, or if economic conditions are especially difficult, the definition of what is a low-engagement category can prove malleable. For instance, in the last few years, 7-Eleven has enjoyed a fair amount of success selling its own private-label snacks, including potato chips and cookies, two categories about which consumers tend to be pickier when times are good.

Retailer Impact

In the ways stated above, retailers can push a category toward simplification.

In consolidating categories, retailers can be aggressive about moving toward shelf simplification, even if that means ceasing to stock some national brands.

In the majority of cases, they can feel confident that they won't be upsetting customers as they do so. At least when it comes to basic items, consumers dislike shelves that have an overwhelming number of products—what retailing experts call “clutter”—and that make it hard for consumers to find what they're looking for. In these categories—frequently the categories where value pricing is key—retailers have been vigorously rationalizing SKUs. Walgreens, for instance, is cutting the number of items it carries by 10 to 20 percent and making reductions of more than 50 percent in some non-core categories, such as superglue. Manufacturers that don't make the cut, whether at Walgreens or at other retailers, will face increased financial pressure and may wind up having to discontinue or sell their “delisted” brands.

That said, retailers' simplification decisions aren't always easy. A retailer needs to be sure that the products it is dropping do not have such high shopper loyalty that the

consumer is driven to another retailer's store. In addition, while a retailer may want to simplify the number of products on its shelf, it does not want to inadvertently reduce the number of manufacturers in the category, since that would leave one less manufacturer to create demand for shelf space and pay rent. This may explain why the CVS drug chain continued to carry Energizer's lithium line after it dropped the company's alkaline batteries earlier this year.

Manufacturer Impact

Though they are affected by consumers' and retailers' behaviors, CPG manufacturers are not powerless to influence category dynamics. Scale does retain an advantage in many CPG categories; by using their scale along with other differentiated capabilities, big manufacturers that already have a strong position can often push a category toward consolidation.

For instance, some food and cosmetics manufacturers (especially in the

baby food and cigarette categories) have differentiated capabilities in the area of regulatory management. Other companies have unique capabilities in brand management or in distribution.

Sometimes a big company is able to add new capabilities to existing ones and determine the shape of a changing market. This is what Apple, a master at human interface design, did with iTunes, which could not have succeeded had Apple not added two significant new capabilities: digital delivery and knowledge of how to work with major music labels. While other companies came at the opportunity more narrowly, assuming that they could build on a single capability or take advantage of a positional asset they had (the music labels' assumption), Apple created an experience that would work for consumers. The result is an original and vastly profitable franchise that has left virtually all of its competitors in the dust.

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IMPLICATIONS FOR CAPABILITIES DEVELOPMENT

What does all this mean for business unit executives and brand managers? Clearly, an accurate assessment of the dynamics of a category is integral to formulating a strategy. It is also critical to helping brand teams figure out where their capabilities need to be exceptional—and where they can simply be good enough.

Here is the sequence of questions managers should ask in markets that are on the verge, or in the midst, of some sort of change:

- What is the dynamic of this category? Will it consolidate around a few brands, or will it fragment, with new brands coming in?
- What is our position in the category? Are we market share leaders or laggards?
- What is our way to play—that is, our differentiated approach to creating value in this category? For example, are we leaders in innovation or in cost?

- What is our capabilities system—the three to six differentiated capabilities that have supported our way to play thus far? Is our capabilities system one that will allow us to change the dynamic of our category or to become more successful in it if the category is coming our way?

The capability implications of operating in a consolidated category are very clear. If you already have significant market share, you should take advantage of your size and see where along the value chain you can create a scale advantage and run with it (*see Exhibit 3*). This might mean investing in R&D to improve

Exhibit 3
The Capabilities Required to Win in Consolidating and Fragmenting Categories

Capabilities for Consolidating Categories	Capabilities for Fragmenting Categories
Cost/scale advantage - Distribution - Manufacturing - R&D Power at the shelf Mass advertising Deeper insights in category economics and dynamics	Highly differentiated brand proposition Innovation and R&D Customer engagement Iconic/distinctive positioning in the category Manufacturing scale (not a differentiating capability) through outsourcing or partnerships

Source: Booz & Company analysis

product quality, introducing a set of packaging innovations, building or modernizing plants, buying up international distributors, making white-label versions of your product for retailers, or investing in a direct store delivery capability. As a big player, there are certain things you probably cannot do well. For example, big players are not generally good at innovation, so their way of capturing a new source of growth in their category is often through acquisition. Coca-Cola used this strategy in 2007 when it bought the manufacturer of Vitaminwater to expand in energy drinks and non-carbonated beverages. Coca-Cola leveraged its unique distribution and marketing prowess to add value to a third party's innovation.

By contrast, a smaller company looking to win in a consolidated category might need to change the dynamics

of the category. An example of this much trickier feat is Starbucks in the 1990s using its capabilities as an experience provider and brand creator to redefine how people drank coffee. Starbucks turned the category into a coffeehouse experience—there were actually a dozen or more ways to drink coffee if you were a true connoisseur. Coffee did consolidate, but Starbucks shifted consumer engagement in its own direction—and took over the category as a result. In the process, Starbucks not only changed category dynamics by increasing consumer engagement but also redefined scale—it has become less important to lead in market share on the grocery shelf and more important to lead in retail outlets.

With the right capabilities system, a company may also be able to force a fragmented category to consolidate and make itself the

biggest beneficiary of that trend. This is what Frito-Lay did in the late 1980s, when it systematically set out to increase its market share. Frito-Lay's activities during that time are a formidable example of coherence—a state in which a company's capabilities, product portfolio, and way to play all fit together and give it an advantage over its competitors. Having streamlined its product portfolio, Frito-Lay used its world-class distribution system (the company has ways of getting its snacks everywhere—supermarkets, gas stations, vending machines, corner bodegas) to apply pressure to the competition. By 1996, two of Frito-Lay's biggest competitors, Borden and the Eagle Snacks division of Anheuser-Busch, had exited the market for salty snacks, and Frito-Lay's share of the category in the U.S. had jumped to 55 percent from 38 percent.

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CONCLUSION

If CPG categories were static—if market share never changed, new opportunities never arose, and categories never underwent transformation—there would be little point in devising new strategies for them. In fact, though, most CPG categories are in a constant state of evolution. This being the case, it is essential for companies to anticipate the changes that are coming and position themselves to take advantage of them (or at least not get hurt).

Consumer preferences and behaviors have always been the biggest determinant of where categories are headed; they still are. For manufacturers, the real challenge is developing a set of differentiated capabilities that lets them give consumers what they want—and what will keep them coming back. These capabilities are very different in consolidating categories and fragmenting categories. The manufacturers that understand this—and that are constantly refining the capabilities that matter to consumers—will be able to take advantage of category dynamics and stay ahead.

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