What really drives profit? In consumer goods, market share alone is not the answer.

YOUR BRAND'S BEST STRATEGY

by Vijay Vishwanath
and Jonathan Mark

During the 1970s, Procter & Gamble moved aggressively to gain market share in the coffee business. Freed from a consent decree that had restrained its ability to grow geographically, Folgers, a P&G subsidiary, came east from its western stronghold and took on Maxwell House in a clash of the coffee titans. After the dust settled, Folgers indeed had moved to a new plateau of market share – from which it has not retreated. But its victory had a decidedly bitter taste. In committing to and achieving major gains in market share through its pricing actions, P&G effectively eliminated the industry profits of the entire "roast and ground" segment – a situation that persisted until the early 1990s.

What had gone wrong? Once Folgers had achieved its goal of gaining market share, why didn't significant profitability follow? Could Folgers have known in advance that its plan wasn't necessarily the best strategic move?

We believe that the answer is yes. Conventional wisdom holds that market share drives profitability. Certainly, in some industries, such as chemicals, paper, and steel, market share and profitability are inextricably linked. But when we studied the profitability of premium brands like Folgers – brands that sell for 25% to 30% more than private-label brands – in 40 categories of consumer goods, we found some surprising results. Chief among them, we discovered, was that market share alone does not drive profitability. In fact, market share explains only about half of the

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differences in profitability among brands; in some categories, there is hardly any correlation at all.

Instead, a brand's profitability is driven by *both* market share *and* the nature of the category, or product market, in which the brand competes. A brand's relative market share (RMS) has a different impact on profitability depending on whether the overall category is dominated by premium brands or by value brands to begin with. That is, if a category is composed largely of premium brands, then most of the brands in the category are – or should be – quite profitable. If, on the other hand, the category is composed mostly of value and private-label brands, then returns will be lower across the board. When we compared the actual profitability of the 40 premium brands we studied with their predicted profitability, using as variables RMS and the "premium" degree of a category, we found a strong correlation. (See the chart "What Explains a Brand's Profitability?")

The facial-skin-care category is filled largely with premium brands, and most players earn more than 15% pretax operating profit, or return on sales (ROS). What's more, even brands with market share one-fifth to one-tenth that of the category leader, Oil of Olay, have operating profits only slightly lower than Oil of Olay's. But processed meats, in which market leader Oscar Mayer and other premium competitors account for less than 40% of the category, are a different story. The brands with high relative market share earn about 10% ROS; those with low relative market share usually earn less than 5%. The category is what makes the difference.

Developing the most profitable strategy for a premium brand, therefore, means reexamining market share targets in light of the brand's category. In other words, managers must think about their brand strategy along two dimensions at the same time. First, is the category "premium" or "value"? (Is it dominated by premium brands or by value brands?) Second, is the brand's relative market share low or high?

If we visualize a matrix with those two dimensions, we can map the position of any premium brand within one of four quadrants. Each quadrant has different implications for a brand's profit potential. And each requires a different strategy. (See the matrix "Two Dimensions, Four Strategies.")

Procter & Gamble's strategy for Folgers was based on the implicit notion that greater RMS always means greater profits. But when the company went after share, it started a price war. Competitors responded, and a category that had once been premium became value. All players suffered. Given the quadrant that Folgers had originally occupied – a market share follower in a premium category – did P&G pursue the optimum strategy?

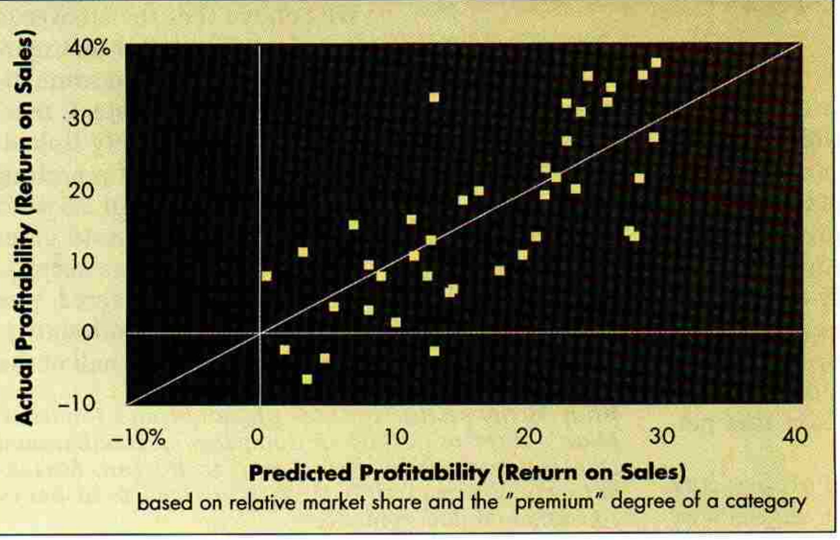
The Hitchhiker: Premium Category, Low RMS

Folgers was what we call a *hitchhiker*. And for hitchhikers – whose average ROS is generally between 15% and 20% – gaining share by lowering prices is dangerous. Hitchhikers shouldn't rock the boat; it is usually in their best interest to follow the leader's pricing moves.

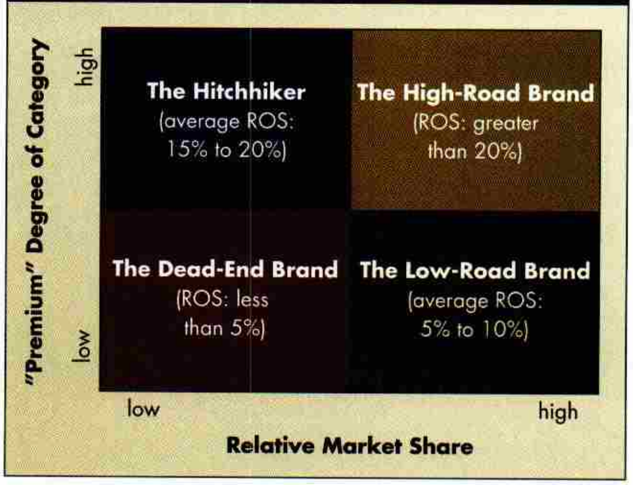
What brands in this quadrant *should* focus on is innovation coupled with niche marketing or variations on niche marketing. Successful hitchhiker brands either attract and keep a narrow base of loyal users, as Neutrogena does in the facial-bar-soap category, or lead the market in a subsegment of a larger category, as Post does in shredded-wheat and banana-nut cereals. The common theme is an innovative brand for which consumers are willing to pay a premium price.

Cereal, in fact, is a good example of a category in which the hitchhiker strategy can pay off. More than 60% of the category is made up of premium, or high-end, products, and consumers pay at least 30% more for those brands than they do for value brands, despite the recent price cuts. Kel-

What Explains a Brand's Profitability?



Two Dimensions, Four Strategies



logg is the clear market leader, but Post and General Mills each control certain subsegments and do very well following Kellogg in overall RMS.

For an interesting variation on hitchhiking, the automobile industry is worth a look. Over the past ten years, the category as a whole has become increasingly premium and profitable. Why? Automakers have figured out that it is far more rewarding to target specific customer groups with innovations – highly stylized vehicles – than to compete at the low end of the market with a high RMS. As a result, the average price of an automobile sold in the United States has risen much faster than the rate of inflation. Entire segments – such as sport utility vehicles and minivans – are continually being created and redefined; and the traditional four-door family sedan now accounts for only a small portion of the automobile category. Chrysler has been a primary driver – and the largest beneficiary – of this change. The company, which had long been a weak player in the market, now offers many niche vehicles and earns more than $1,000 in profit for each one it sells.

Brands that occupy the premium-category, low-RMS quadrant can maintain healthy profit levels for long periods. But the hitchhiker position is vulnerable – in particular to pricing moves by the market leader. If the market leader in a premium category lowers prices – as Marlboro did in the cigarette industry in 1993 – the hitchhiker's profits can erode overnight, especially if the price gap between premium and value brands was wide to begin with. It's true that many premium categories sustain large price gaps for years. But managers of hitchhiker brands must recognize and evaluate the risks.

The High Road: Premium Category, High RMS

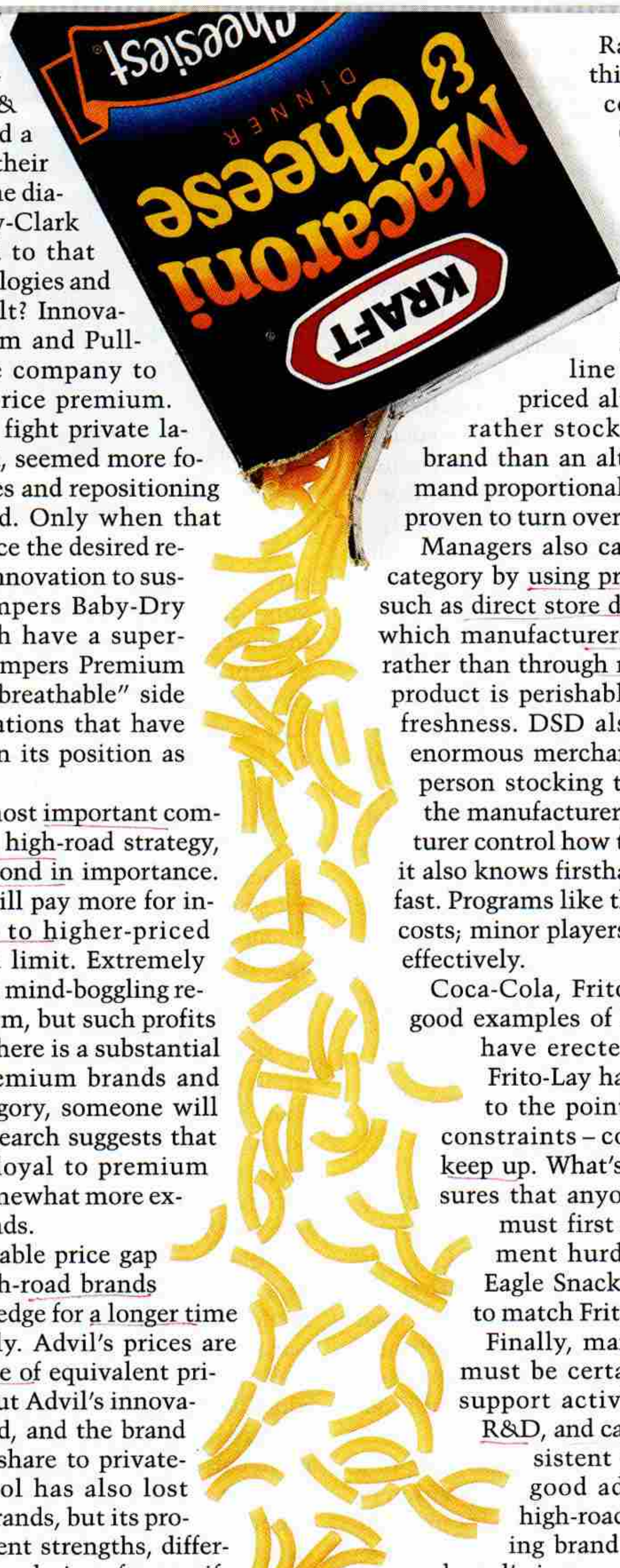
When a brand leads the market in a premium category, we call it a *high-road brand.* High-road brands generally earn more than 20% ROS. The keys to success in this quadrant are innovation, innovation, and innovation. Consumers of high-road brands tend to be loyal and willing to pay premium prices. In return, they continually demand improvements and changes – in form, size, and function – that deliver real value.

Kraft Macaroni & Cheese is a good example of a brand that has successfully sustained its position in the high-road quadrant. Building on its original product, Kraft constantly engages existing customers and attracts new ones with its innovations. For example, over the past 15 years, the company has introduced spiral pasta, pasta in the shape of cartoon characters, and several different cheese flavors – all selling at premium prices in what has remained a premium category. Clorox is another good example. Not only has it innovated in its original category, household bleaches; it has also used innovation as a way to trade on strong customer equity and to muscle into ancillary categories, such as all-purpose cleaners and toilet bowl cleaners.

Gillette is a third good example. When Gillette's main competitor introduced low-cost disposable razors sold by the bag, the dynamics of the razor category began to shift. At first, Gillette's managers responded in kind by introducing their own packages of low-cost disposable razors. Realizing, however, that a dominant share in a value-oriented category would confine the company to an ROS of 5% to 10%, they also began to consider other paths to profitability. As a result, Gillette poured more than $200 million into R&D and introduced the Sensor shaving system. The Sensor sold at a 25% price premium over Atra, another Gillette brand, which until then had been the highest-priced system on the market.

Gillette successfully made consumers "trade up" to a new spending level – and a new set of performance expectations. What's more, 15% of Sensor sales came from people who had formerly bought competitors' disposable razors. Instead of paying roughly 40 cents per razor, they began to pay $3.30 for a shaving system that required 70-cent replacement cartridges. The Sensor and its succeeding generations of products – along with the innovations of other companies that followed suit – restored the razor category to premium status.

When managers of high-road brands are confronted with a price war or a threat from a private label, it is critical for them to think through the



consequences of their reactions. Kimberly-Clark and Procter & Gamble have long faced a private-label threat to their premium products in the diaper category. Kimberly-Clark has always responded to that threat with new technologies and applications. The result? Innovations such as Ultratrim and Pull-Ups, which allow the company to continue charging a price premium. P&G's early efforts to fight private labels, on the other hand, seemed more focused on reducing prices and repositioning its products downward. Only when that strategy failed to produce the desired results did P&G turn to innovation to sustain profitability. Pampers Baby-Dry Stretch diapers, which have a superabsorbent core, and Pampers Premium diapers, which boast "breathable" side panels, are two innovations that have helped P&G strengthen its position as a high-road brand.

If innovation is the most important component of a successful high-road strategy, judicious pricing is second in importance. Educated consumers will pay more for innovation, trading up to higher-priced products. But there's a limit. Extremely high prices can produce mind-boggling returns over the short term, but such profits are not sustainable. If there is a substantial price gap between premium brands and value brands in a category, someone will fill the breach. Our research suggests that consumers are more loyal to premium brands that are only somewhat more expensive than value brands.

If there is a considerable price gap within a category, high-road brands can maintain a pricing edge for a longer time by innovating profusely. Advil's prices are 100% higher than those of equivalent private-label analgesics; but Advil's innovations have been limited, and the brand has continued to lose share to private-label offerings. Tylenol has also lost share to private-label brands, but its prolific innovation – different strengths, different forms, different formulations for specific ailments – has proved a more effective strategy than Advil's.

Raising entry barriers is the third key ingredient of a successful high-road strategy. One way to do that is through product (or stock-keeping-unit) proliferation, as Tylenol has done. Not only does such proliferation signify the brand's growth, but it also acts as a line of defense against lower-priced alternatives. Retailers would rather stock a variation on a leading brand than an alternative that cannot command proportional shelf space and hasn't been proven to turn over at a rapid rate.

Managers also can block new entrants to a category by using proprietary delivery systems, such as direct store delivery – a program through which manufacturers deliver directly to stores rather than through retailers' warehouses. If the product is perishable, a DSD program ensures freshness. DSD also gives the manufacturer enormous merchandising power. Because the person stocking the shelves is employed by the manufacturer, not only can the manufacturer control how the product is displayed, but it also knows firsthand what is selling and how fast. Programs like these tend to have high fixed costs; minor players find it difficult to respond effectively.

Coca-Cola, Frito-Lay, and Nabisco are all good examples of high-road food brands that have erected those kinds of barriers. Frito-Lay has expanded its product line to the point where – given shelf-space constraints – competitors simply cannot keep up. What's more, its DSD system ensures that anyone who wants to compete must first confront a massive investment hurdle. Witness the demise of Eagle Snacks. Eagle simply was unable to match Frito-Lay's investments.

Finally, managers of high-road brands must be certain that their spending on support activities – such as marketing, R&D, and capital improvements – is consistent with their strategy. That's good advice in any case, but for high-road brands it is critical. Building brand equity and reinforcing the brand's image must be primary concerns; hence spending on media advertising should be a dominant part of the marketing mix. And R&D, as we've said, should focus on innovation rather than on reducing costs.

Can high-road brands fall from grace? Certainly. If managers succumb to the temptation to "milk" the brand – scaling back innovations or raising prices without offering commensurate increases in value – consumers will balk. What's more, over time such actions will reduce the premium nature of the category as a whole. Managers then will confront the twofold task of turning around a flagging brand and trying to increase profits in an area that is no longer primed to encourage higher levels of profitability.

The Low Road: Value Category, High RMS

When a brand competes in a value category and has a high RMS, we call it a *low-road brand.* Most low-road brands do not realize significant profits as a result of their price premiums; they earn an average ROS of only 5% to 10%. That's because many low-road price premiums reflect bloated cost structures, not differentiated or more valuable products. In this quadrant, then, the primary goal should be cutting costs and plowing back the savings into lower prices. Managers should take a hard look at their cost structures and eliminate steps that do not add value. That way, they can free up resources to devote to building brand equity. The strategy is to encourage consumers who are buying value brands to purchase the premium brand by reducing the price gap between the two and by boosting the brand's equity – in effect, giving consumers "permission" to pay the higher price.

If a low-road strategy succeeds, the category as a whole may slowly begin to change, as has happened with beer.

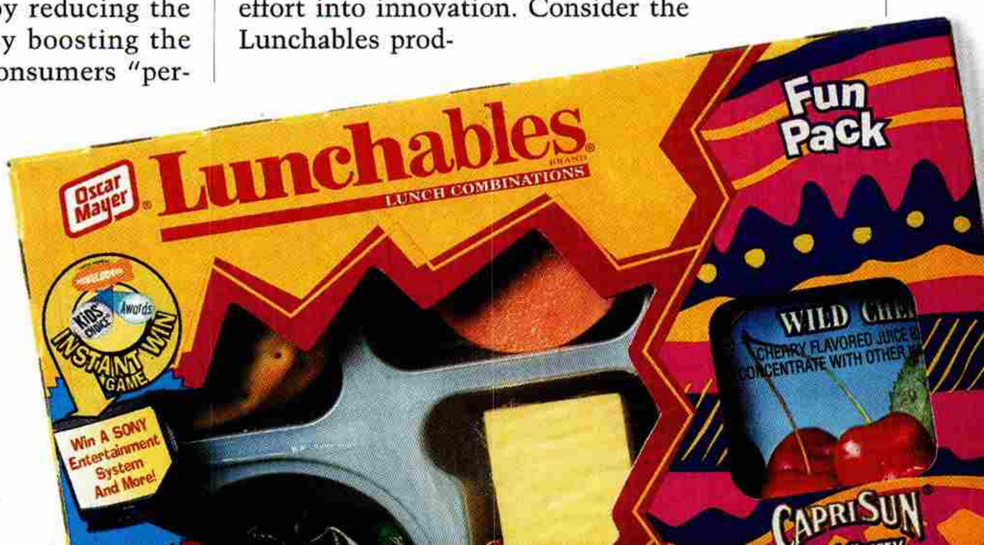
Managers can cut costs in many areas. One option is reducing stock-keeping units. Many low-road brands sport large numbers of SKUs because their managers believe that consumers value the variety. But in this quadrant, such proliferation does not ensure greater profits; often, it simply leads to more complex manufacturing and delivery systems, which in turn lead to higher overhead costs. High-road brands, with their strong customer equity and their position in a premium category, require the variety; low-road brands do not.

Other cost-cutting measures – to round up the rest of the usual suspects – include rationalizing capacity (closing facilities), consolidating suppliers, and standardizing components. Managers also should scrutinize the designs of their products and packages. Over time, many manufacturers tend to develop an almost slavish regard for the "gold standard" and, as a result, build additional costs into their products or packages. They need to examine whether those extra costs are justified: do value-oriented consumers really appreciate the additional features?

Oscar Mayer occupied the low-road quadrant in the processed-meats business in the early 1990s and pursued a low-road strategy. The company attacked costs aggressively, eliminating more than half of its SKUs, closing plants, getting out of raw-material vertical integration, and consolidating suppliers. Then it used the savings to lower prices.

Oscar Mayer benefited greatly from its strategy: over a three-year period, profits improved significantly. But the entire category is benefiting as well: it is taking on more of a premium flavor. Now the challenge is increasingly about brand equity; profits for all competitors that can strengthen equity should rise.

Oscar Mayer is beginning to behave like a high-road brand, and because its category is shifting, that strategy should work well. The company is devoting more money to reinforcing its brand image. For the past two years, for instance, it has sponsored the Super Bowl halftime show – traditionally the bailiwick of high-road products. And it is putting more effort into innovation. Consider the Lunchables prod-



uct line – a premium convenience product designed for a specific meal. After a slow start, Lunchables has taken off and has been copied by competitors.

In most cases, premium brands competing in value categories do so against a host of regional value brands. Such was the case for Anheuser-Busch, which pursued a low-road strategy during the 1970s and 1980s. In the early 1970s, the beer market sported a number of small, regional value brands. Then, over a 15-year period, Anheuser-Busch reduced its costs and plowed the savings into advertising and lower prices, and consumers began to "trade up" to Budweiser. The once-regional beer market began to consolidate, eventually becoming a national business.

If a low-road strategy is successful, the category as a whole may slowly begin to change, as has happened with beer. New, high-end players have entered the market. Several market leaders – including Anheuser-Busch – are now concentrating on innovation. New consumers are being drawn to the category as they become aware of product variations. And increasingly, value-conscious consumers are willing to buy premium brands because they find the higher prices acceptable. Today the entire beer category is becoming more premium: a larger number of companies are competing on brand equity rather than on price.

It may be useful to reiterate the major differences between the high-road and low-road quadrants because, too often, managers of brands with high market share do not differentiate among brands in what are two fundamentally different situations. They pursue the same strategy in both cases and then wonder why their actions are not always rewarding. For low-road brands, cost reduction is critical, SKUs should be reduced, and R&D investments should be aimed at making the manufacturing process more efficient and reducing waste. In the high-road quadrant, cost reduction is not nearly as important, SKU proliferation is desirable, and R&D should focus on product innovation and manufacturing flexibility.

The Dead End: Value Category, Low RMS

Finding a winning strategy in the value-category, low-RMS quadrant is tough, even for those brands that command more than a minimal share of the market. That's why we call them *dead-end brands.* Premium products in this position simply don't make money: they generally earn an ROS of less than 5%. And, unfortunately, many managers of such brands are perennial optimists. "The brand isn't making money today, but it will in the future" is a common, but often misguided, refrain.

The fact is, dead-end brands will never make money. So the choices for managers are limited: either get out of the business or commit to a massive turnaround project, which will move the brand into another quadrant.

One way to "get out of the box" is to slash prices with an eye toward taking share from the market leader (the low-road brand). Such drastic price reduction is usually possible only if the brand is part of a portfolio of products that share internal costs. For example, a dead-end brand can gain ground if managers consolidate package suppliers across an entire portfolio. Another option is outsourcing in areas where the brand isn't large enough to command economies of scale. Or managers might consider bringing together a number of smaller brands in order to gain scale – a move that is commonly called a "string of pearls" strategy.

Heinz Nine Lives canned cat food is one of the best examples we know of a dead-end brand that turned its business around in that manner. Heinz is well known in general for its disciplined approach to cost reduction, but the managers of Nine Lives elevated cost cutting to an art form. After reducing prices several times in the 1980s to compete for share, and after unsuccessfully trying to break the price-war cycle by raising prices in 1991, the managers turned their attention inward. Deciding on a price per can that they believed would be acceptable to consumers, they set out to cut internal costs to meet that goal. They closed eight plants, integrated some of the business vertically (they now make their own cans), and began forming alliances with suppliers.

Heinz Nine Lives already had strong brand equity and access to some inexpensive materials (tuna from the company's Star-Kist business). But it was the dramatic cost reduction that really turned the product around. The brand has been transformed from an also-ran to probably the most profitable product in the category. And Heinz didn't stop there. Once the Nine Lives cost-cutting process was complete, the company went on a pet-food-acquisition binge that more than doubled the size of its business.

Another way to leave the dead-end quadrant – albeit an even more difficult one – is to "trump" the category by introducing a superpremium product that completely resets consumers' expectations. Most often, it takes a new entrant to shake up a category to that extent. Witness how Häagen-Dazs introduced superpremium ice cream into what had been a low-cost, regional market. It is very hard even for established players to follow suit because of the ingrained images of their brands.

The coffee category is also worth another look in this context. Many established manufacturers have recently launched highly differentiated products such as coffee singles and premium roasts. They also are trying to brand coffee sources, such as Java and Colombian, for the first time. Interestingly, such retailers as Starbucks, the Coffee Connection, and Peet's provided the catalyst for change: in effect, they played the role of new entrant to the market, and the credit for resetting expectations lies with them. It remains to be seen whether the established manufacturers can successfully follow their lead.

The biggest mistake that managers make in the dead-end quadrant is hanging on to a brand for years without seriously asking the following questions: Can I become the low-road player through scale and cost reduction? Do I have a prayer of "trumping" this category? If the answers are no, the managers should sell or shut down the brand.

Managing a Portfolio of Premium Brands

In addition to setting strategic imperatives for individual brands, our matrix can help managers better understand the dynamics of a portfolio of products. By plotting their portfolio on the matrix, managers can see which brands are performing up to potential and adjust their expectations for individual brands – and their overall resource allocation – accordingly.

For example, R&D funds should be heavily skewed toward high-road and hitchhiker businesses and should focus on innovation. Often, managers who are overseeing a portfolio spend a disproportionate amount of R&D money on dead-end brands, believing that they can spark a turnaround. Usually, such spending is futile; the money is better spent in areas that promise a decent investment return.

Big-ticket media campaigns that are designed to build equity should be saved for high-road and hitchhiker brands as well. For low-road brands, spending on marketing should be limited largely to trade and consumer promotions – activities that lower a product's price. Of course, if managers are trying to change a category's dynamics and turn a low-road brand into a high-road brand, spending more to build equity can be justified. It's a judgment call, and it's all about timing. The important thing is to be aware of the implications of any action – and to resist the urge to spend money where it won't do any good. When considering a portfolio of brands, managers will be tempted to spend too much on marketing for dead-end brands. But throwing promotional money at the trade – offering discounts to supermarkets in exchange for product promotion, for example – simply won't work. It's far better to limit spending on dead-end products and move funding to brands in other quadrants.

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Capital spending for dead-end products should be limited as well. As we've said, for low-road and dead-end brands, the focus should be on cost reduction. It would be better to use capital resources to bolster innovation for high-road and hitchhiker brands. Spending money on reducing a product's time-to-market and on flexible manufacturing to churn out short-run SKUs is also worthwhile for high-road and hitchhiker brands. Again, managers must be aware of the possible consequences of any investment.

As we've stressed throughout, category dynamics can change. One of the brands in a portfolio may be a classic hitchhiker, and a competitor's move may cause the entire category to shift from premium to value almost overnight. Beer, once a value category, is now premium. The same goes for athletic footwear. Sneakers were once a value buy; now the category is solidly premium.

The matrix is not meant to be a onetime tool. Managers must reexamine individual brands and entire portfolios on a regular basis. Only by doing so can they successfully prepare for or initiate category shifts and, in the process, help their organizations maximize profitability by coalescing around innovation- and cost-driven businesses.

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