Cost cutting is not the only strategic choice for profit growth.
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The changes roiling the consumer packaged goods (CPG) industry are significant enough that companies will have to reexamine fundamental tenets that have in the past served them well. Consider CPG revenue opportunities. Historically, population growth and gains in consumer spending provided reliable fuel for CPG expansion. That has changed. The number of consumers in developed countries has either flatlined or fallen; birth rates in North America and Western Europe are below the replacement rate.

Moreover, the majority of consumers in mature markets have, until 2016, endured more than a decade of stagnant wages, and members of today's younger generation are at risk of ending up poorer than their parents. Those factors have combined to slow consumer spending. And in many emerging markets, such as Brazil, Russia, and China — where there is potentially a large market of new consumers counted on by CPG firms for future expansion — slowing GDP growth and currency weakness (sometimes mixed with high interest rates) have for now dampened consumer enthusiasm.

At the same time, consumer needs and habits are shifting, and CPG firms can no longer make the same assumptions about mass-market shopping activity. They could once rely on a large, relatively homogeneous group of middle-class consumers who would purchase staples and even a luxury or two at mid-priced stores, cognizant of cost but not overly concerned about it and seeking a modicum of quality for their money.

But in both the U.S. and the U.K., this uncomplicated consumer market has fragmented into two camps: survivalists and selectionists. Survivalists are cutting back and looking for value. Members of this group, which includes a vast and growing number of retirees and, in the U.S., millennials saddled with college debt, are stretching their budgets by limiting themselves to value retailers such as Aldi, Lidl, and Costco as well as online outlets offering lower prices and greater convenience. By contrast, selectionists can afford to be choosy and “select” for products they perceive as being of much higher quality.
CPG companies offering premium-price items have made inroads with this group through namesake stores that reflect the qualities of their products. The unorthodox Lush cosmetics outlets, offering a panoply of scents, massages, and customized shopping, are a good example. Similarly, stores managed by Godiva chocolates, Apple, and athletics gear provider Lululemon deliver their own versions of the personalized experience for a select crowd.

The result is that the discount and top-end companies are doing well and increasing their market share, while retailers in the middle — and the CPG companies that service them — are suffering. Many of these legacy mainstream retailers are saddled with excess physical store space that is bringing in less revenue than it once did and are desperately trying to adjust their operating models to remain competitive.

As retail channels have divided in response to these shifts in consumer behavior, CPG companies have increasingly had to support multiple retail formats. Long gone are the days when manufacturers were concerned mainly with winning grocery stores. In the U.S., the grocery channel share of all packaged-goods sales is forecast to drop from about 45 percent today to about 37 percent in 2025. Picking up the slack will be warehouse clubs such as Costco and Sam’s Club, dollar stores such as Dollar General, convenience stores, and online retailers, such as Amazon Fresh and Fresh Direct.

Although the U.S. and U.K. CPG environments are similar, the industry’s landscapes in Japan and China could not be more different; still, both Japan and China offer significant challenges to consumer goods companies. In Japan, domestic CPG companies have benefited from a highly fragmented, complex, and dense retail environment that has allowed them to control and flood distribution channels. Limited competition has meant these companies have not had to sharpen their skills in creating consumer value or in basic product marketing. But as Japan’s population ages, urbanization continues, retailers consolidate, and e-commerce becomes more popular, the old distribution mechanisms are creaking. CPG companies are struggling to field winning go-to-market strategies in the domestic market, which is forcing them to look outside the country for revenue growth — something that they are not equipped to do. This leaves the Japanese CPG market ripe for new entrants with the capabilities to break through the logjam of antiquated distribution structures and to market products to specific customers in multiple channels, including in-store and online.

In China, the CPG market is hyperdynamic and rapidly growing. The predicted boom in consumer products sales in lower-tier cities and western regions took shape very differently than predicted, in part
because residents in those less-wealthy areas have not been interested in buying Shanghai’s “last year novelties,” as they call them, and because e-commerce volume has exploded, up to about 15 percent of total consumption in China now, from about 3 percent in 2010. The e-commerce developments are especially troubling for traditional, brick-and-mortar-oriented CPG companies, which in general lack agility in direct-to-consumer sales and face thin margins on popular Web shopping services like T-mall.com, JD.com, and Dangdang. Certainly, CPG companies have more opportunities in the affluent Chinese cities, but they are also hampered there, as young consumers — the predominant growth market — are trading up and shunning the brands and products used by their parents. The biggest losers in this setting are large CPGs (including many multinationals) that are stuck with musty legacy brand portfolios. Consequently, CPGs are in the midst of reevaluating their strategic thinking for China, shifting toward product and brand innovation investments, opening up new distribution channels, and finding their bearings in the e-commerce free-for-all.

Faced with these challenges in areas around the globe, many old-school CPG companies have taken comfort in the ramifications of the 2015 purchase of Kraft Foods for US$40 billion by Brazilian private equity firm 3G Capital and Berkshire Hathaway. The new owners almost immediately announced they would cut $1.5 billion in annual costs before 2018, increasing profit margins and boosting the stock price while slashing the number of employees, management levels, and brands.

The results have already begun to show. Before 3G took over, Kraft — like H.J. Heinz prior to its acquisition by 3G in 2013 — had operating margins typically in the 15 to 18 percent range. Thanks to 3G’s cost-cutting campaign, which so far has mostly involved shuttering plants and laying off workers, at the end of the third quarter of 2016, the combined Kraft Heinz boasted a margin of around 22 percent — the best in its peer group. That was enough for other CPG companies to begin to mimic 3G’s tactics, improving margins across the industry.

That’s good news, but profit margin improvements based solely on ferocious cost cutting can be short-lived and ultimately leave companies unprepared to take advantage of marketplace opportunities, which are the real keys to growth. Clearly, in this environment, CPG companies must focus obsessively on their cost base and drive continual efficiency. However, it is equally important for them to be sophisticated in how they manage and improve the top line: by deepening their understanding of consumer appetites and shopping habits, uncovering pockets of profitability in small brands, and realigning their brand portfolios for growth. What follows is a road map for a CPG executive to follow for a sustainable outcome.
Exhibit 1

CPG companies have struggled to raise operating margins primarily by cutting costs

2016 year-end operating margin, trailing 12 months

Source: Company reports
3G’s budgeting may have piqued interest throughout the industry, but copycat cost cutting is not necessarily an effective growth strategy. Instead of making cuts across all brands to reduce costs, analyze your portfolio to see whether it is coherent. In other words, ask whether the products you offer align logically with the market categories and niches your company is focusing on. By identifying the rationale behind your portfolio, you can avoid reacting opportunistically to changing markets with hastily developed brand extensions, new products, or acquisitions.

And, just as important, portfolio coherence can help a company both decide which products to acquire or divest and leverage its reputation and expertise in specific categories to achieve growth in new markets. In fact, this approach offers a growth model for large brands that want to reposition themselves without abandoning their roots; realize extra profit margins with the right mix of product and pricing; innovate products and packaging that fill in gaps; and use the power of an umbrella brand to expand into adjacent categories and markets.

CPG players that have followed this formula include Innocent Drinks, a U.K. brand bought by Coca-Cola, which used its popularity as a smoothie maker to reach into the health and wellness aisles with sparkling juices and coconut water blends. In like fashion, Procter & Gamble’s Old Spice modernized its long-lived positioning — it’s now “Smell like a man, man” — to support its expansion from aftershave into deodorants, body washes, shampoo, and styling aids. From its base of familiar bouillon cubes, Knorr now offers side dishes, recipe mixes, and kitchen advice, with videos on its website and an active presence on YouTube. Church & Dwight’s Arm & Hammer brand is now a $1 billion mega-brand in a dozen categories, including the original baking soda, toothpaste, kitty litter, and laundry detergent.

As you reexamine your portfolio, ask yourself these questions:

- Which products or brands are making money, and which might make money if unnecessary costs were pared down?
• Which products presently match market preferences, and which don’t? Identify brands that have deep connections with consumers that can be tapped into differently, perhaps with new niche products.

• Which brands have the potential to be leveraged in adjacent markets? (It is important to take a broader view and not focus only on the immediate possibilities. The current adjacent markets may not be profitable now, but they can provide a step into more lucrative markets yet to be tapped.)
Small players — those with annual sales of less than $1 billion — are outperforming the competition in 18 of the top 25 categories, including the largest and most consolidated, such as dairy, bakery, snacks, and ready meals. Consumers choose these brands because they offer authenticity (The Body Shop), a connection to local growers (Cabot Creamery), the promise of healthy ingredients (Bob’s Red Mill and Annie’s Homegrown), or a quirky story (Ben & Jerry’s).

From 2009 to 2012 in packaged foods and from 2008 to 2011 in beverages, small players grew revenue about three times as fast as the overall category. Specifically, in packaged foods, small players gained 1.7 percent of market share, while large players saw their market share decline 0.7 percent.

This small-brand renaissance is occurring in all major markets around the world, as is evident, for instance, from the impact of small Korean cosmetics brands in China, in the rest of mainland Asia, in Japan, and on the U.S. West Coast. Most of these companies do not invest in R&D or manufacture their own products, but rather buy them from third-party providers and sell them through “brand shops” or digital outlets. The strengths of these companies lie in branding, merchandising, and building a compelling narrative — in other words, storytelling — around their products.

To take advantage of some of the benefits that smaller brands generate, large CPGs can either build or buy their way to faster growth. Consider artisan chips — high-end potato chips cooked in small batches — a category dominated by two small players: Cape Cod and Kettle Chips. Frito-Lay entered this category with Lay’s Kettle Cooked, positioning the product as a lower-priced alternative to Cape Cod and Kettle products and as a healthier way to enjoy Lay’s potato chips. Lay’s “category captain” position in traditional flat potato chips gave Frito-Lay the power to influence product placement in grocery stores and supermarkets. And with that advantage, in 2015 sales of Lay’s Kettle Cooked chips hit $368 million, outstripping Cape Cod potato chips’ sales of $225 million, and Kettle brand’s $181 million.

Pay attention to small brands that can deliver big profits
Exhibit 2
The success of small brands is making larger consumer products companies rethink their market strategies.

<table>
<thead>
<tr>
<th>Category</th>
<th>Three-year compound annual growth rate</th>
<th>Share of growth</th>
<th>Market share change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private-label products</td>
<td>6.2%</td>
<td>42%</td>
<td>0.5pp</td>
</tr>
<tr>
<td>Small manufacturers</td>
<td>2.8%</td>
<td>30%</td>
<td>2pp</td>
</tr>
<tr>
<td>Medium manufacturers</td>
<td>1.6%</td>
<td>15%</td>
<td>-1pp -1pp</td>
</tr>
<tr>
<td>Large manufacturers</td>
<td>-3.7%</td>
<td>-15%</td>
<td></td>
</tr>
</tbody>
</table>

Note: Numbers have been rounded up to the nearest percentage point.

Source: Euromonitor; Strategy& analysis
Coca-Cola, by contrast, tends to move into smaller-brand markets through acquisition — recently, of Glaceau enhanced water, Fuze vitamin-enriched beverage, and other specialty drinks, including Odwalla, Honest Tea, Innocent, and Zico. Coca-Cola targets brands that are market leaders in their limited niche, then seeks new customers by positioning the products as premium brands priced higher than the competition. To keep each new brand distinct and attractive to its customer base, Coca-Cola does not affiliate the acquired brand directly with the Coca-Cola brand.

To succeed with a small-brand strategy, consider the following questions:

- Does your product have a source of special authenticity — perhaps its origin, its organic provenance, or its affiliation with a celebrity chef?
- Does your organization have the capability to produce targeted marketing content and insights?
- Are you able to promote sales and distribution in nontraditional outlets?
A “one-size-fits-all” approach will no longer work in the global market. Brands that want to do well in emerging economies in Asia, Latin America, and the Middle East, where demographic trends offer more potential for growth than developed markets, must tailor their products to local demands.

Take, for example, the challenges of local distribution, especially in countries with large rural areas, such as India and Vietnam. Colgate sells its oral care and household products to more than half of the world’s population (65 percent global penetration in 2013, according to Kantar Worldpanel’s Brand Footprint ranking) because it has built awareness and sales in emerging nations with small pack sizes, which encourage trial and are more affordable. Heinz tackles distribution challenges by acquiring and expanding existing local brands.

Global CPGs also succeed by customizing products and flavors for local markets. Colgate’s Indian toothpaste strategy includes three products: Active Salt Neem, Clove, and Cibaca Vedshakti, an herbal ayurvedic line that is going head-to-head with local heavy hitter Patanjali Dant Kanti.

Similarly, because consumers in all regions are increasingly interested in health issues and local governments are reacting by crafting stricter food and drink regulations, global CPGs are altering the fundamental formulas of some of their iconic products. Nestlé recently announced plans to reduce sugar in its chocolate bars by 40 percent, starting in 2018.

Navigating “glocal” strategies is becoming thornier as the insular sentiments expressed by nationalist and populist political movements spill over into consumer markets. Some CPG companies will want to affirm their domestic brand credentials — for instance, with a “made in USA” label. Others (or even the same companies) will promote themselves around the world as global citizens — think Coca-Cola — to avoid backlash in markets that may be disturbed by the policies emanating from the CPG company’s home country.
To sharpen your strategy as your company moves into local markets around the world, consider the following questions:

• What trends can your company leverage in the local market, and what insights from other regions can you use in this new market?

• Can your company use global scale to gain an advantage in the local market?

• Can you partner with a player in the new market so you can respond rapidly to either consumer or regulatory shifts or give the brand a local feel?

Left out of this discussion — only because their impact is still uncertain — are new technologies such as artificial intelligence and virtual reality. In the coming years, as much as CPG companies will need to navigate changes in consumer attitudes and preferences, they will also have to manage the marketing obstacles posed by software like Amazon’s Echo and Apple’s Siri, which will increasingly mediate the shopping relationship between consumers and consumer packaged goods companies. CPG strategists will have to take seriously questions like: How does my firm reach customers when machines place the orders for them?
Roll up your sleeves

Clearly, plenty of hard work awaits consumer goods companies as they reevaluate their strategic biases and redesign their operating models for a far different business environment. But as a starting point, CPG companies have two imperatives: Take the profit margin challenges seriously because they are not going away, and recognize that you cannot buy your way out of trouble through cost cutting alone. Companies able to do this will likely learn that they can outperform in the CPG market.
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