Does size matter?

Rethinking the importance of scale in consumer goods companies
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### About the authors

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Since the 1980s, managements and boards in the consumer packaged goods (CPG) industry have been on a quest to get bigger — the conventional wisdom being that the best shareholder returns would accrue to companies with huge brands and the scale to compete in developing markets. But this assumption has turned out to be misleading, certainly over the last decade.

Instead, the best performers from the perspective of total shareholder returns have been small CPG companies with relatively narrow product portfolios supported by three to six differentiated capabilities.

These small companies exhibit “coherence,” a state in which their capabilities, product portfolios, and market strategy (what we call a “way to play”) all fit together. Coherence allows these companies to be efficient in their activities, disciplined about their portfolios, and unmatched at the capabilities that matter most to customers.

The importance of coherence does not mean there is no value at all to scale. In fact, scale is still critical for CPG companies trying to expand into developing markets. There the near-term advantage is to the swift, and the scale of a Procter & Gamble, for example, does represent an advantage. In general, scale matters more in markets that don’t have well-developed retail infrastructures than in markets that do.

No CPG company is perfectly coherent across all of its businesses. Indeed, there is so much incoherence in certain sectors that a company can often gain an advantage simply by being less incoherent than its rivals. At a management level, the practical question is where to pursue coherence full bore and where to tolerate some level of incoherence. The answer will depend on the company’s international profile and product portfolio, and on its sense of how the sectors it competes in will evolve over time.
The traditional kind of scale has lost some power in the CPG industry in recent years, as a handful of smaller companies have produced the best returns for shareholders.

These small companies have what may be called “scale at the shelf” — meaning they offer multiple brands at various price points and with different propositions. This is a type of scale that does remain important and is enabled by capabilities.

The shift toward capabilities has been accelerated by media fragmentation, the availability of outsourcing, and a consolidated retail environment. Retail consolidation has leveled the playing field and given small CPG manufacturers a way of getting broad distribution.

Most emerging markets, by contrast, don’t have consolidated retail infrastructures. That is why the Procter & Gambles of the world — those with scale — are rushing to those markets and finding a degree of success there that is eluding them back home.

CPG companies need to decide what they have to offer — what their differentiated capabilities are — in order to determine their market strategy, their degree of internationalization, and the products they are going to sell.
Giants will inherit the earth — that has been the prevailing wisdom in the CPG industry for years. After all, the example of success most often cited — Procter & Gamble — is a US$80 billion household goods company that uses its size to its advantage in four basic ways: First, by building a portfolio of large brands (Crest, Ivory, Pampers, etc.) with leading positions in their categories through innovation based on consumer insights. Second, by pursuing international growth, especially in emerging markets where population and income dynamics look favorable for the long term. Third, by realizing scale benefits at different points along the value chain, from sourcing and distribution to back-office operations. And fourth, by creating privileged relationships with retailers.

It is hard to argue with any of these tactics, in the case of P&G or any other big CPG company. Megabrands certainly have attractive economics. Emerging markets offer a lot of growth. Scale benefits free up funds for innovation and brand building. And large manufacturers consistently come out on top in the Cannondale rankings provided by retailers.

There is only one problem: Being big doesn’t by itself lead to higher shareholder returns for CPG companies — at least it hasn’t over the last decade. Indeed, an analysis by Strategy& found that, if anything, the correlation seems to work in the opposite direction, with small CPG companies being more apt to achieve above-average shareholder returns (see “Countering the Two Objections to the ‘Small Caps Do Better’ Argument,” page 7). Nor does a global footprint create an advantage in terms of stock performance. There was no correlation at all between those two things in the Strategy& analysis, which looked at roughly three dozen household goods and beauty players (see Exhibit 1, next page).
Exhibit 1
The limits of size and geographic reach in the CPG industry

**Total revenues vs. 10-year TSR**
(1999-2009)

**Revenues outside home market vs. 10-year TSR**
(1999-2009)

*Total shareholder return.*

Source: Thompson
Financial data; Strategy& analysis
Countering the two objections to the “small caps do better” argument

Any attempt to highlight the better stock-market performance of smaller companies compared to large ones, as in Exhibit 1, invariably runs into a few objections. Here are two of the most common — and the reasons they don’t invalidate the analysis.

Objection 1: The law of big numbers

“Companies like Procter & Gamble, Unilever, and Johnson & Johnson already have so much of the market, there’s no way they can grow as fast as a company that’s a fraction of their size.”

There is some truth to this — a smaller company, especially one with a hit product, always has a better chance of showing dramatic growth because of its small revenue base. Even so, if the advantages of size, international penetration, scale, and retailer satisfaction were really so great, one would expect bigger companies to do better than the vast majority of their smaller peers. Instead, they are on par with most smaller companies and far behind a few in the important area of total shareholder return.

Objection 2: The acquisition premium

“Small CPG companies with big shareholder returns have probably benefited from speculation that they would be acquired.”

There is some truth to this too — it would be hard to find a small CPG company that had never appeared on the radar of the M&A department at P&G, Unilever, or Kraft Foods. But the 10-year time horizon of the Strategy& analysis eliminates the impact of any acquisition premium, since the possibility of an exit event was probably as valid at the start of the 10-year period as it is now. That means any increase in share price, and certainly any outperformance of a larger company’s stock, must be attributable to economic value that the smaller company is creating and not an artificial lift from market speculators.
Scale’s diminishing benefits

What’s happening? It turns out that scale has declined as a differentiator in highly developed CPG markets.

To some extent, this is a phenomenon that happens in every mature industry. It is part of what Harvard Business School Professor Michael Porter had in mind in 1996 when he wrote in his article “What Is Strategy?” about the tendency for corporations to copy their rivals’ best practices, pushing everyone along “the productivity frontier.” As that happens, Porter wrote, companies’ operations become highly efficient and consumer prices come down. However, no manufacturer is more efficient than another; any relative advantage disappears.

In the CPG industry, three developments have accelerated the decline of scale’s importance:

**Development 1: Media fragmentation and the impact of new media**

A generation ago, network television was the most effective way for CPG companies to get their branding messages out to consumers. The advantage was to the players with scale, who could reach the most consumers and get the best deals with respect to airtime.

Now, there is no clearly superior route to creating an advertising or branding campaign; network TV may still deliver the largest number of consumers, but it isn’t necessarily the most efficient buy. Moreover, newer outlets, including “infomercials” and Internet sites such as Facebook, offer other options. Indeed, many CPG companies are de-emphasizing outside marketing partners in favor of brand-building experiences that they create on their own and deliver digitally through websites or mobile phones — an approach known as private-label media. In short, creativity and skill are supplanting sheer size as the determinant of marketing success.
**Development 2: Outsourcing**

It was once possible for a CPG company to maintain an advantage over its rivals by having better manufacturing facilities, specialized R&D, or superior customer service, among other things. It is now much harder to win through superiority in those areas. Many such functions can be offloaded to outside partners that can do the job as well as the largest rivals in a market, often at a cost below that incurred by those rivals.

A good example relates to decisions around pricing. Some large CPG companies staff a department of quantitative experts to run price elasticity models. Nowadays, a smaller CPG company that needs that information can outsource the function to a specialist firm.

**Development 3: Consolidation/evolution of the retail industry**

Back in the 1980s and early 1990s, when retail outlets were still highly fragmented, a manufacturer could gain an advantage by having a bigger sales or distribution force to knock on doors and get products on the shelves. As retail has consolidated, the advantage of having a national distribution network has declined. Now, by getting in at Walmart, a small CPG company can gain access to 30 percent of the market overnight. With another one or two big retail distribution wins, the company could be reaching 50 percent of its target market or more. What's more, most big retailers don't want to limit their relationships to large CPG players; to do so is to push the negotiating power, and thus the value, higher up in the supply chain, away from where the retailers themselves sit. Walmart doesn't say so, but this is undoubtedly part of the reason it so often highlights smaller suppliers in its annual awards.

All retailers, not just Walmart, are also placing less emphasis these days on product breadth and more on category-specific differentiation based on superior shopper and consumer insights. While this requires scale in a particular category and at the shelf level, it doesn't require scale in the usual sense of having the biggest fleet of delivery trucks, the most salespeople, or the largest trade merchandising budget.
New sources of advantage

Increasingly, what is replacing scale as the source of advantage in the CPG industry is a company’s ability to concentrate its resources and collective intelligence, particularly with respect to developing three to six differentiated capabilities that are uniquely suited to its product line and way to play. We call this a “capabilities system,” because when companies are operating the way they should, their capabilities reinforce and strengthen one another, the way each log in a well-built campfire makes the other logs burn brighter.

Equally important is a clear way to play. By this we mean a differentiated approach to capturing value in a particular market. For instance, a typical market strategy might be something like “We are a leader in the dairy products segment, where our goal is to grow at a rate that is 20 percent faster than the average of our rivals.” A clear way to play would be more along the lines of “We operate in the premium dairy segment, with a strong emphasis on health and wellness through product innovation.”

Most of the top-performing CPG companies in the Strategy& analysis — those with 10-year returns of 250 percent or more — have differentiated capabilities systems aimed at relatively narrow product portfolios and clear ways to play. They come closer to “coherence,” an ideal in which a company’s products and services fit its chosen way to play and are supported by a set of capabilities that apply across its entire portfolio.

Coherence is one of the goals of a capabilities-driven strategy, in which what a company does better than any of its rivals, day in and day out, is much more important to its long-term success than the positional assets it has. A coherent company — for that matter, a company that is simply more coherent than its competitors — gains several advantages. First, it focuses its investments on relatively few capabilities, increasing its mastery of those critical areas. Second, it doesn’t waste time and money on capabilities where “good enough” is sufficient and where it doesn’t need to outdo its rivals. This is an efficiency advantage.
Where scale retains its advantage: Emerging markets

A CPG manufacturer’s size may no longer guarantee success in mature markets, but it is arguably the most important success factor in developing countries.

This is because the retail infrastructure in developing countries is still fragmented — typically composed of independently owned stores and some regional chains. That gives the advantage to CPG players that can put the most feet on the ground and get maximum distribution, either directly or through partnerships.

Indeed, the CPG players that have historically done the most to build up their scale have generally done so out of necessity — it was the only way to grow in a fragmented retail market. That has been true even in the biggest markets. Twenty or 25 years ago, for instance, when companies like Walmart and Costco were still relatively small, a CPG manufacturer wanting to reach U.S. consumers might have had a list of 50,000 outlets it wanted to be in. Emerging markets are at that stage now, with the distribution power at the individual store level and big chains, for the most part, still a thing of the future.

Third, a coherent company has the lens of capabilities to use as a tool for making decisions about its product and service portfolio, including which products or services to acquire and which to divest. This can give it an advantage over CPG companies that make those decisions primarily through the lens of financial performance and may therefore be more apt to stay in a product segment that doesn’t fit and that might be siphoning off funds needed for segments that are part of its “core.”

The biggest CPG companies — those that see advantages in scale as it has traditionally been defined — almost always struggle to be coherent. Their wide-ranging portfolios, in most cases, require non-overlapping capabilities in order to thrive. One business unit requires one capabilities system; another requires a second.

As it happens, their scale still works for these large companies in emerging markets (see “Where Scale Retains Its Advantage: Emerging Markets”), and their success in those markets may be obscuring the challenges they face in more mature economies. The best-managed big CPG companies are already adjusting to a future in which they may have to settle for selling fewer categories of goods, and they are focusing on developing the right capabilities for the categories that will remain. A calculation along those lines undoubtedly figured into P&G’s decision to exit most of its food business in recent years. P&G may not have articulated it this way, but its exit from food was a step toward coherence.
On an industry level, one question is how long it will take for the majority of products and services in the CPG industry — probably through the mechanism of M&A — to find their way into the capabilities systems where they will be best able to thrive. Another question is whether the industry’s structure might change in such a way that big CPG companies will leverage their scale across multiple emerging markets, and smaller, more focused players will fine-tune single-theme portfolios as a way of achieving returns in developed markets.

Whatever a company’s profile — big or small, global or national — it needs to understand the rising importance of capabilities-driven strategy and of coherence. We offer profiles of two companies that have done a better job than most of applying a few differentiated capabilities to a tight product portfolio — and that have been rewarded, as a consequence, with superior shareholder returns.

**Alberto Culver**

With $1.43 billion in revenue, Alberto Culver Company is no giant. But it has done much better than other CPG companies — and the broader market — in generating shareholder returns in recent years (see Exhibit 2, next page).

Is it possible to operate on the value end of the beauty continuum and be aspirational at the same time? This is the balancing act that Alberto Culver has mastered and turned into a successful way to play. The way to play works because Alberto Culver has a tightly defined product mix — 80 percent of its revenues come from beauty products for hair and skin care—and a system of interconnected capabilities that give it an advantage in its categories (see “Focus vs. Hocus-Pocus at Alberto Culver,” page 16).

The company’s first critical capability is a deep understanding of consumer preferences regarding hair care, especially styling. Unlike the situation at broadly diversified CPG companies, the brand managers overseeing hair care products at Alberto Culver generally haven’t been rotated into their positions from some other business unit or product area; they’ve typically spent years or even decades marketing shampoos and conditioners. The same is true of the product development staff; they know nothing quite so well as they know hair care. Though this may limit the valuable insights that managers rotated in from other business units occasionally bring, it means deep expertise in the business at Alberto Culver’s core.

A second differentiating capability that Alberto Culver has relates to brand building — essential for supporting the “our Fords are like
Exhibit 2
Alberto Culver has out-performed the market over the last two years and commands a high valuation multiple

ACV valuation has remained resilient of the overall market downturn...

Indexed share prices: Jan 2, 2007 = 100, ends Dec 31, 2009

...Supporting a group-leading valuation multiple

Enterprise value / EBITDA (LTM)

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Note: Multiple as of 8/2/2010, FACE (Physician’s Formula), ACV (Alberto Culver), AVP (Avon Products), EL (Estée Lauder), CL (Colgate), CHD (Church & Dwight), CLX (Clorox), RDEN (Elizabeth Arden), REV (Revlon), NUS (Nu Skin), ENR (Energizer), ULVR (Uniliver), OR (L’Oréal), PG (Procter & Gamble).

Source: CapitalIQ; Yahoo Finance; Strategy& analysis
Mercedes’ approach that is at the core of the company’s positioning. (One example of Alberto Culver’s deftness at aspirational marketing: It was the first company to find a way to mass-merchandise products previously used in salons.) This capability applies not just to hair care but also to the company’s skin care line and thus meets one of the requirements of any key capability — the ability to be leveraged across multiple aspects of a company’s portfolio.

Its deep sector expertise helps Alberto Culver know what levers to pull — and how to use its small advertising budget — in order to give its value products a premium aura. In that sense, the two capabilities strengthen each other and are mutually reinforcing.

As with any CPG company with limited resources, Alberto Culver has to make decisions about capabilities that are not differentiating. Generally speaking, hair care isn’t a segment where there are huge differences in product quality, so though Alberto Culver’s products are usually on par with those of its rivals, and may be better in some cases, the company has a relatively small R&D budget and doesn’t over-invest in product development.

Companies that are coherent with respect to their capabilities typically have a culture and an organizational structure that allow them to focus on the few activities they regard as critically important. This is true of Alberto Culver, where members of the management team all work in close proximity at the company’s headquarters in Melrose Park, Illinois. The result is an entrepreneurial culture that is exceptionally good at mobilizing behind agreed-on priorities, that responds effectively to competitive threats, and that can capitalize on opportunities. Indeed, in Alberto Culver’s case, this entrepreneurialism has become a capability in and of itself, adding a sort of velocity to the company’s other capabilities. Entrepreneurialism is part of what allowed Alberto Culver to get the Nexxus hair care line into broad distribution after it bought the company in 2005.

Finally, Alberto Culver’s coherence is reflected in the disciplined way it thinks about its product portfolio. Companies in the beauty industry have many opportunities to expand into adjacent product segments. To its credit, Alberto Culver always asks whether potential opportunities are consistent with its capabilities system. One new area the company was considering required a capability in celebrity marketing; a second required the ability to anticipate fashion trends. Creating superior capabilities in those areas would have been too costly for Alberto Culver, given the expected returns. So it dismissed these opportunities, as every focused company must occasionally do.
Church & Dwight

Church & Dwight Co. has generated total returns far exceeding those of bigger CPG companies — including some it has bought assets from — by developing a deep expertise at brand extension and by concentrating on narrow product segments.

The company's biggest asset is undoubtedly Arm & Hammer, which in 2010 will become its first $1 billion brand ever. This achievement is possible only because of the capability that Church & Dwight has developed in the areas of brand cross-pollination and extension. Arm & Hammer and its distinctive logo long ago ceased to be associated simply with baking soda, or sodium bicarbonate. In recent years, the Arm & Hammer brand has also helped Church & Dwight, now a $2.5 billion company, increase its market share in areas like liquid detergent, cat litter, and oral care.

With an M&A strategy that always considers whether the target business is in a narrowly defined subsegment of household or personal care, Church & Dwight has bought the SpinBrush toothbrush line from Procter & Gamble and toothpaste brands including Pepsodent and Aim from Unilever. As it builds its portfolio (adding an Arm & Hammer-branded product if it makes sense), Church & Dwight typically ends up with multiple brands at various price points, offering different propositions. This — scale at the shelf — is a kind of scale that does matter for CPG companies in developed markets, since it makes the buyer at a retail chain more apt to listen to the manufacturer and provide promotions and advantageous positioning.

Church & Dwight’s other big brand is Trojan, and though this brand cannot easily be extended to other segments, the company has extended the line from condoms to other intimacy-enhancing products including vibrating rings.

As at Alberto Culver, Church & Dwight’s narrow product focus allows it to get a lot for its marketing dollar. To advertise the Arm & Hammer brand is to advertise the company’s shower scrubs, clothing stain removers, and battery-powered toothbrushes. In this sense and others (including some of its R&D efforts), the company is pretty far along the coherence curve, with its daily activities benefiting not just one of its businesses but often several that are clustered together.

Its narrow product portfolio enables Church & Dwight to wring manufacturing and cost efficiencies out of many parts of its operations. Indeed, the company takes a relentless approach to improving its P&L, using a type of financial discipline more common at private equity firms. This has made its stock a top performer in the CPG universe during the last 10 years and is a capability in and of itself.
Some people look at Alberto Culver and say it must be a competitive disadvantage to be a fraction of the size of our behemoth competitors. But we look at our size and know that it is actually an advantage. We are passing $1.5 billion in sales, recently completed the acquisition of the second largest skin care brand in the United Kingdom (Simple Health and Beauty Group Ltd.), and have a valuation multiple in the top range of our peer group.

How do we do it? Our size allows us to do five things really well.

1. We are focused and operate in two categories and in a select number of geographies. As a result, we are able to efficiently transfer our knowledge across our brands and countries. People here have a deep understanding of what it takes to win. We don’t run down a lot of blind alleys.

2. We know that in order to be successful we need to do things differently than our competitors. We are able to try new things, be innovative, and apply our insights in new ways. An example is our success in taking the Nexxus hair care brand from salon channels into mass channels.

3. We don’t waste money on activities and capabilities that don’t matter. R&D is a good example. Innovation is important in hair care, but it is possible to spend a lot on little nuances that, quite frankly, are invisible to the customer. We avoid that hocus-pocus, if you will, and put our investments into what is truly differentiated in the consumer’s mind.

4. We can be nimble, flexible, and quick. We do not have layers of people, and that lack of bureaucracy makes it possible for us to identify opportunities or issues and take action. It is easier to get people together around the globe and to put a decision into action.

5. Our size allows us to get to know our employees and see what they do. Everyone plays an important role in building our success. Our people are proud to be working at a company where they know they can make a difference.

— James Marino, president and chief executive officer of Alberto Culver Company
Coherence as a choice

Should coherence as we’ve defined it — a product portfolio that all draws on the same three to six differentiated capabilities and is integrated with a clear go-to-market strategy — always be the goal? Probably the best answer to this question is that CPG companies should have a clear understanding of how the three elements of coherence function together, and of the benefits that coherence can create. After all, even companies that can create coherence in only one business unit or product segment are better off doing that than being incoherent everywhere.

A kind of coherence is practiced at many smaller CPG companies (including the two we’ve profiled) that have been successful at increasing the revenue and profits they derive in tightly defined product segments. In developed markets especially, these small companies can focus their efforts on creating products that their customers value — and on building up the capabilities that allow them to do so. There is no need, and often no opportunity, in developed markets for companies to use their footprint or financial power to achieve distribution success; the retail infrastructure in these markets shifts the power to retailers and end consumers, making winning more a function of having the best strategy and capabilities. In markets that are highly developed from a retail perspective, relative coherence usually determines the winner.

By contrast, a company trying to get a toehold in a developing market may well choose to temporarily sacrifice coherence. The landgrab that characterizes most emerging-market opportunities sometimes forces CPG executives to make moves that, by a strict definition, are not coherent. For instance, the acquisition of an indigenous CPG manufacturer or retailer in a new geography may add some ill-fitting products or services along with essential capabilities in the area of distribution. This can force the company to undertake what is essentially a two-part deal: first, the acquisition of the target company; second, the divestment of unneeded brands, assets, or personnel. During the period when the unwanted pieces remain attached — consuming resources, distracting management, and quite possibly creating morale problems — the CPG company pays an incoherence
penalty. Still, this can be the right move if it gives the manufacturer a strong foothold in a fast-growing new market.

Of course, there are other factors that a company should consider when it decides how much incoherence it is willing to accept. Consumer preferences are one factor; the CPG sector it’s operating in is another. For instance, food companies often can’t get an advantage on the basis of size alone, no matter how big they are; the preferences are too regional. Beauty companies have an easier time operating globally.

And then there is the question of time frames. Potentially, today’s fastest-growing markets are tomorrow’s developed ones; an approach that makes sense today may make less sense in a few years. To take the most obvious example, will China still be a developing market in five years, or will it have the characteristics of a developed market by then? And might a smaller CPG company get the scale it needs in China by climbing on the back of Walmart?

The bottom line is that no company can afford to be incoherent in every market all of the time. The only question is when, and on what, the company chooses to focus.
Conclusion

For the last 30 years or so, most CPG companies have assumed that their chances of winning, in every region and every product segment, were enhanced by scale. More salespeople, a bigger distribution footprint, a bigger advertising budget — these were the ingredients of success.

However, scale as it has traditionally been defined has ceased to be a differentiating asset, at least in developed markets where the retail environment is now highly consolidated. Conventional scale is only a differentiator in emerging markets where the lack of dominant retailers favors companies that can drive distribution through sheer mass.

By contrast, the kind of scale that matters in developed markets is scale at the shelf — an area in which smaller CPG companies, especially in niche product areas, are starting to prove superior to bigger ones. Their seeming size disadvantage has forced these companies toward choices that have made them more focused and pushed them closer to the ideal of coherence.
Strategy& is a global team of practical strategists committed to helping you seize essential advantage.

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