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Pepsi's Strategy in the Carbonated Soft Drinks Market

Term Project

MAN 385
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Introduction

The following paper analyzes how PepsiCo can increase profitability in the carbonated soft drink (CSD) industry. The industry is a tight oligopoly with Pepsi and its chief competitor, Coca Cola, comprising 70% of the total market.[1] Global beverage sales for PepsiCo in 2000 were $7.6 billion; however, sales growth has averaged only three to four percent in mature markets such as North America[2]. PepsiCo and Coke have expanded into other ready to drink beverages such as bottled water, tea, and juices in order to counter this low growth in the CSD industry; for the purpose of this paper, however, we will focus on how to affect profitability in the CSD industry.

In particular, the paper will examine how current actions by PepsiCo regarding differentiation, pricing, cooperation, and complements have affected their profitability in the CSD industry. Furthermore, the paper will give specific recommendations, with an emphasis on cooperation tactics and complements.

Industry Overview

The industry for carbonated soft drinks is characterized by the following five forces:

Threat of New Entrants – Currently, the biggest threat of entry faced by the majors is from private label manufacturers such as Cott Corporation. Private labels now hold an 8.1% share in the CSD market, the majority of which is held by Cott. The challenge to both Coke and Pepsi is to further build brand loyalty in their core cola products so that consumers will not be swayed by the cheaper, private label imitations products. More importantly, retailers, finding far more attractive margins with private labels, may choose to push these products instead of the majors. Given that access to distribution channels is currently one of the largest barriers to entry, Coke and Pepsi must maintain favorable relations with the large retailers so that this barrier remains strong.

[1] Stagnito Publishing Company, "Beyond Colas: The Soft drink category stretches from traditional colas into flavored soft drinks, energy drinks and alternatives". Beverage Industry, March 2002.
[2] Datamonitor Industry Market Research, 2001.

For both companies the end product is, despite extensive advertising campaigns that promote the contrary, almost identical. The product differentiation comes from established marketing campaigns that have created brand identification and loyalties. For a new entrant to compete effectively, they would have to be willing to expend the time and resources necessary to first convince the consumer to try the new product, and after trial, switch their loyalties. The threat of new entrants is partially increased by the low switching costs for consumers. Thus, the overall threat of new entrants is considered moderate with a special note made of the increasing presence of private labels.

Bargaining Power of Buyers – The level of bargaining power differs among groups of buyers. The bottlers, distributors and retailers have significantly greater bargaining power than the end consumer does. Large retailers such as Wal-Mart and national grocery chains are able to extract profits from the soda manufacturers through incentives such as volume-based rebates, promotions and displays.[3] These retailers are highly concentrated and can thus wield significant power, influencing a consumer's decision to purchase simply by altering the in-store displays. The bargaining power of retailers is lessened by the end-consumer brand loyalty. A retailer could risk losing groups of customers if they simply refuse to stock a certain brand.

The bargaining power of the end consumers is low. They are a fragmented group and no one individual's purchases account for a significant portion of the manufacturer's profits. Although the presence of substitutes does serve to increase buyer power for the consumers, the high degree of brand loyalty mitigates this power. The overall bargaining power of buyers is considered medium.

Bargaining Power of Suppliers – There are few suppliers for the carbonated soft drink industry. The end product is comprised of few ingredients, which are largely commodities. Also, it is safe to assume that Pepsi and Coke sales account for a large percentage of the

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[3] PepsiCo 2002 Annual Report.

suppliers' total revenues. Thus, the importance of the CSD industry to the suppliers serves to contain whatever bargaining power they may have. The overall bargaining power of the suppliers is considered to be low.

***Substitutes* –** There are many substitutes to carbonated beverages. However, each company has a significant presence in substitute markets so that a decrease in cola consumption can conceivably be made up in increased consumption of bottled water, juices, teas and energy drinks. The challenge lies in increasing brand loyalty within these substitute markets. Because the substitute products are, for the most part, contained with each manufacturer's product portfolio, the threat of substitutes is considered low.

Rivalry – There is intense rivalry between Pepsi and Coke. This rivalry leads to a downward pressure on prices and significant investments in advertising in an attempt to build and maintain brand loyalty. A 2000 article from the Competitive Media Reporting group reported that soft drink advertising expenditures in 1999 were $649.8 million.[4] In a maturing market such as the domestic carbonated sodas, the only way to gain market share is to steal from one's rivals. Thus, Pepsi and Coke fight heatedly over prices, suppliers, spokespeople, retail space and most importantly, the taste buds of consumers.

Pricing

The US CSD market is mature. The industry sales growth is largely driven by population growth as well as the amount of advertising and product innovation taking place in the industry. Given the mature nature of the market, both Pepsi and Coca Cola have resorted to pricing discrimination strategies to maximize the value of consumer demand.

Direct Price Discrimination – the simplest form of extracting customer surplus is charging customers with different prices based on their location and purchasing power. This is evident in the international operations of both Pepsi and Coca Cola. Cola prices in Mexico, Brazil and Eastern Europe are lower than prices in the U.S., even though the cost of the concentrate is

[4] http://www.cmr.com/news/2000/041100_2.html.

practically the same. Domestically, direct price discrimination is based on distribution channel segmentation. Restaurant fountain drinks, single drinks at gas stations and take-home packs at supermarkets have all different prices on a per-unit basis even though their costs adjusted for packaging and distribution would not warrant such a discrepancy. Obviously, such segmentation helps situational-based pricing differences: the most price insensitive consumers seem to be restaurant customers who need a drink to go with their meal. Also, single-drink buyers at gas stations are more likely to be impulse buyers and therefore have less price sensitivity than weekend family shoppers at supermarkets who purchase 12-packs for home consumption.

Indirect Price Discrimination – Quantity discounts along with price coupons used in supermarkets are obvious indirect price discrimination tools Pepsi can use. However, the most effective indirect price discrimination tool Pepsi has is in fact its brand name. The Pepsi brand equity actually allows the company to maintain its pricing power. Its product image translates into perception for higher quality vis-à-vis private labels and other substitute drinks. Also, for both supermarkets and convenience stores the CSDs represent the number one and number three top-selling items[5]. Retailers use this product category to induce store traffic and create additional sales, which in turn reduces their power relative to Pepsi. Given the 80% margin on concentrate, it is easy to see why Wal-Mart and other discount retailers can undercut Pepsi's pricing with private labels, but still they will be ineffective in 'stealing' Pepsi customers as long as Pepsi's brand (and Coke's for that sake) maintains high customer loyalty.

Pepsi may enhance its price discrimination capability though creating bundle offers to restaurants and convenience stores. The Frito Lay brand, controlled by PepsiCo through Frito Lay North America, is the undisputed leader in the salty snack segment. If Pepsi bundles snacks with soft drinks as part of its pricing strategy aimed at fast food restaurants and c-stores it may be able to increase sales and obtain better shelf space from retailers. This may prove a very important tactic in trying to re-claim share in the fountain drink segment, a large

[5] Deutsche Bank Securities Inc., equity research, 10 February 2003.

part of which was lost after Pepsi's exit from the restaurant business in 1997. Currently, Coca Cola holds approximately 67%[6] share of the total fountain cola sales.

Complements

As competitors, Pepsi and Coke have incentives to cooperate on the provision of complements. The firms can provide the complements individually, but this often leads to too few complements being produced. [7]

There are three areas where complements should be considered for the firms in the CSD industry: products that are served/used with CSDs, how and where CSDs are sold, and inputs and distribution channels. Products that are used in conjunction with CSDs are such items as salty snacks, candy, vegetables, picnic and bar-b-q food, ice cream, ice, cups and coolers. Pepsi (through Frito Lay and Quaker) has made highly profitable and significant inroads to the salty snacks segment.

Another opportunity for the development of complements is venues and locations where CSDs are sold. Locations where the product is consumed on-site can be split into small venues (fast food chains, dine-in restaurants and specially stores like those of A&W Rootbeer®) and large venues (movie theaters, amusement parks, festivals, and sporting arenas). Pepsi ventured into ownership of fast food chains with its purchase of Taco Bell, Pizza Hut and Kentucky Fried Chicken. This proved to be a disaster and the company subsequently sold its interest, because Pepsi was viewed as a competitor by competing fast food chains, reducing their desire to carry Pepsi products. Pepsi has a large brand presence in the large venue category with such investments as the Pepsi Center (Denver, CO), home to the NHL's Colorado Avalanche and NBA's Denver Nuggets, the Pepsi Arena in Albany, NY, and Liberty Park Pepsi Amphitheater in Erie, PA.

[6] Gale Research Group, Business and Industry online research database, UT Austin Library.
[7] McAfee, *Competitive Solutions: The Strategist's Toolkit*, Princeton University Press, 2002.

Venues where the product is sold for off-site consumption include grocery stores, convenience stores and vending machines. In all of the channels where Pepsi and Coke compete, Pepsi is most effective in grocery stores, where it has 33% market share to Coke's 37%. However, in the fountain station channel, Pepsi has less than half the market share of Coke (67%).[8] Should Pepsi make a big push and investment with this complement (fountain stations), it could conceivably steal some highly profitable market share from Coke.

The final area for consideration of complements involves product manufacturing and distribution. Complements in this area include such inputs as carbonated water, sugar, caramel, plastic and aluminum (for bottles and cans) plants while distribution opportunities include bottling plants and trucking lines. With many of the inputs being commodities that are priced competitively, it is unlikely that the two firms could join together and actually reduce input costs.

Since there is not much room for continued reduction in manufacturing costs, the most successful strategy would be for the firms to develop complements that will increase worldwide demand and allow for price discrimination. Pepsi should continue to develop products through its Frito Lay and Quaker brands while pushing for greater market penetration for fountain stations both in existing and new markets.

Differentiation

Pepsi has attempted to differentiate its products from Coke's, but with little success. In an attempt to differentiate its products from Coke's, Pepsi shifted its focus to the growing American teenage market in the 1990s, while Coke continued to target baby boomers. Pepsi targeted the teen market by forming exclusive contracts with American schools and developing advertising campaigns such as "The Next Generation" and "Joy of Pepsi", featuring Britney Spears[9]. Both Coke and Pepsi have "moved to the middle" in recent years, however, as evidenced by the most recent Pepsi campaign, "For Those Who Think Young", to

[8] Gale Research Group, Business and Industry online research database, UT Austin Library.
[9] BusinessWeek, "Strategic Marketing: Coca Cola Company Versus Pepsico". March 1, 2002.

attract an older consumer, and by Coke's moves to modernize its packaging, in order to appeal more to younger consumers[10].

Pepsi focused on varietal differentiation since 1999 by introducing a string of niche products, although product innovation has been quickly copied by Coke. To increase volume in order to counter flat cola sales, Pepsi introduced Sierra Mist in 2002-2003 to take the place of 7-Up and go head-to-head with Sprite. Pepsi has also tried to boost volume by introducing products that appeal to specific target market segments that it currently is not reaching. Pepsi has introduced Code Red and Live Wire, extensions of Mountain Dew, Pepsi One, and Pepsi Blue. Finally, Pepsi is countering declining sales of carbonated drinks through the marketing and distribution of Starbucks ready to drink products, and the acquisition of SOBE and Gatorade. Coke has followed with the introductions of Vanilla Coke, Sprite Remix, and the acquisition of Planet Java, Odwalla, and Mad River Traders. Although these niche products might successfully keep out a third competitor through spatial preemption, most of these product introductions are not expected to generate over 1% of the total soda sales[11].

While non-carbonated beverages have remained the focus of much investor excitement, it is Pepsi and Coke's core products that are the driver of near-term growth.[12] However, the success of Pepsi's Mountain Dew Code Red launched in 2001 was the most successful soft drink innovation in 20 years and has spurred even more niche product introductions among both companies.

Unfortunately, analysts argue that line extensions often cost a lot while doing very little for actual sales. According to Tom Birko, president of Bevmark LLC, an industry consulting firm, "There's a littered landscape of [carbonated beverage] product extensions in the market."[13] Since product extensions generate considerable uncertainty with modest results and high cost, both firms could jointly de-escalate the introduction of new products in

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[10] Beverage World, "A Makeover Story: Coke, Pepsi Unveil New Looks". January 15, 2003.
[11] BusinessWeek Online, "Call It the Pepsi Blue Generation". February 2, 2003.
[12] Lehman Brothers. 2003 Equity research report.
[13] "Pepsi and Coke Roll Out Flavors to Boost Sales" The Wall Street Journal. Betsy McKay. May 7, 2002.

favor of focusing on core brands, with some emphasis on product innovation. Pepsi could signal this intent by announcing its strategy publicly, hopefully encouraging Coke to follow suit.

Cooperation

Despite sharing a number of common interests, Pepsi and Coke appear to take little advantage of potential cooperative strategies. In fact, recent evidence suggests that both companies have actually engaged in mutually destructive behavior despite potential benefits from tacit collusion. In the following section, we have identified areas in which opportunities for cooperation exist and should be exploited for the benefit of both Pepsi and Coke.

***Development of Overseas Markets* –** Although Pepsi and Coke have avoided the temptation to run negative advertising in the U.S. where consumer penetration approaches 100%, both companies have engaged in ruthless advertising tactics abroad, where the opportunity for growth far exceed those domestically. Perhaps most confounding are Pepsi and Coke's recent spate of vicious attack advertisements in India.

A 1997 McKinsey study indicates that by 2005, the Indian soft drink market will grow to $2.5 billion.[14] More importantly, although per-capita consumption of soft drinks in India is only six bottles per year, one-third of India's one billion citizens are under 18, an important demographic whose consumption habits Pepsi and Coke would like to affect through compelling marketing.[15] However, both companies have engaged in a slew of television advertisements, which publicly ridicule the other's product and image. For example, when Coke hired Bollywood heartthrob Hrithik Roshan as its spokesperson in 2000, Pepsi fired off an advertisement featuring an unflattering Roshan look-alike spurned by a pretty girl in favor of Pepsi's celebrity spokesperson. Even Coke's director of external affairs, Rahul Dhawan, asserts that the Indian ad war between the cola giants is "dirty."[16] Last year, both companies

[14] "A Cola War Gets Personal". Time Asia. http://www.time.com/time/asia/magazine/2000/0612/india.html
[15] Ibid.
[16] "Destination Bollywood" The Week. http://www.the-week.com/99feb14/biz2.htm

were fined by the Indian Supreme Court for causing "environmental damage" by defacing Himalayan rocks with painted advertisements. Given the enormous size of the potential Indian soft drink market and the existing reluctance of Indian consumers to drink colas daily (Coke and Pepsi are simply too bland to go with typical Indian cuisine), it is baffling why these companies have engaged in behavior that damages both firms. Instead, Coke and Pepsi should cooperate to generate consumer goodwill toward the cola industry thereby increasing widespread acceptance of soft drinks by India's massive emerging youth market.

Distribution **–** Ethical issues aside, clearly both Pepsi and Coke share a common interest in generating revenues through distribution of their products through vending machines on primary and high school campuses across the country. Unfortunately, both companies have been ineffective in responding to outspoken critics such as the Center for Science in the Public Interest (CSPI). The CSPI is leading a campaign of public health experts to raise awareness of the adverse health consequences of increased soda consumption.

However, Pepsi and Coke would benefit through a concerted marketing effort to encourage distribution of soft drinks in schools. For example, no direct connection has been made between soda consumption and increased obesity.[17] Moreover, school officials across the country view soda vending machine contracts as a boon to ailing school district budgets. One official in the Washington D.C. school district calls its contract with Coca-Cola a "godsend," because it provides money for proms, bus tokens for needy students, and extra school books.[18] Finally, both companies distribute more than carbonated beverages through vending machines – they also distribute bottled water, juices, and sports drinks.

Pepsi and Coke would stand to benefit from shifting their focus from competitive actions to obtain exclusive school district contracts to creating a unified marketing approach that educates consumers about their community involvement and eliminates negative

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[17] "Fighting the Cola Wars in Schools." The Washington Post. http://www.washingtonpost.com/wp-srv/national/colawars032399.htm
[18] Ibid.

misperceptions. As a result, both companies would benefit from potential widespread acceptance of soft drink distribution in schools.

Pricing **–** Although price-fixing between Pepsi and Coke would likely lead to legal action, there are other ways in which both companies have missed opportunities for cooperation in pricing. For example, in a 1999 Brazilian magazine interview, Coke's chairman, Doug Ivester, mentioned the development of a vending machine which would automatically increase prices during hot weather. The story ran worldwide and generated a public outcry. Pepsi criticized Coke's intentions as exploitative and opportunistic.[19]

However, both companies missed an opportunity to build pricing flexibility into the distribution of carbonated beverages through vending machines – a common interest for both companies. Rather than join the chorus of contempt for Coke's actions, Pepsi should have attempted to explain the consumer benefits of lower soda prices in cool weather. As a result, both companies could have enjoyed the economic benefits of flexible pricing.

Conclusion

Given the extreme competitive nature of the CSD industry, the slow growing market size and the shrinking margins, a firm that is going to be successful and generate above-average returns must have a sound and coherent strategy. In order for Pepsi and Coke to protect their positions, they must be wary of private label infiltration. The biggest threat here is Wal-Mart's Sam's Choice CSD. Given the large amount of Pepsi and Coke that is currently sold at Wal-Mart, the consequences could be huge if the private label becomes accepted, and even preferred, by the consumer.

Pepsi should also focus on gaining a pricing advantage. One way this can be done by offering 'reverse' quantity discounts on new packaging (actually reducing the size of the offering and increasing the effective per-unit price). Another strategy would be to offer bundled products to convenience stores and restaurants.

[19] "Which Price is Right?" Fast Company. http://www.fastcompany.com/magazine/68/pricing.html

From a channel perspective, Coke is dominating Pepsi in fountain stations. This is a concern that Pepsi must address, and soon. Coke has achieved better distribution in venues with fountain stations, through exclusive contracts. For Pepsi, turning the tide in this channel is critical to long-term success.

Finally, Pepsi should assume the leadership position in de-escalating the "cola wars" that are occurring in developing markets. Both Coke and Pepsi would benefit from cooperation that helps to expand the market more rapidly and to more areas than currently exist.

Another opportunity for cooperation is for each company to reduce the number of niche products that serve only to drive up costs while adding little to the top line. By focusing on their core colas (including diet) and introducing a limited number of niche products to generate excitement and build on the core product line, both players should be able to continue to effectively compete against the private labels. Thus, by continuing to build loyalty in the core products and decreasing niche products, Pepsi can achieve greater profitability.

Pepsi has been successful in generating profits in this extremely rivalrous industry. What the company should do now is employ a strategy that not only addresses its own deficiencies in an effort to grow market share, but one that will increase the overall size of the pie. This strategy, in the end, will allow Pepsi to grow and sustain above-average returns.

Appendix

Figure 1. CSD Category Analysis

Company	2002	$ Share	4 Yr. CAGR	Oper. Margin	#1's RMS
Coca-Cola	2,672	43.7%	3.0%	30.3%	--
PepsiCo	1,866	31.6%	3.6%	29.8%	1.4
Dr. Pepper/Seven-Up	880	15.6%	2.7%	--	2.8
Cott	782	3.8%	7.2%	10.4%	11.5
National Beverage	404	2.2%	6.5%	--	19.9
Private Label/Others	546	3.1%	-4.6%	--	14.0
Total Sales ($ Millions)	$7,150	100.0%	3.1%	--	--

Source: Beverage Digest, Deutsche Bank Securities Inc.

Figure 2. Top-Selling Categories in Supermarkets and C-stores in 2001.

Supermarkets			Convenience Stores		
Dollars in billions	Sales	Dollar Share		Sales	Dollar Share
1 CSDs	$13.07	6.5%	1 Cigarettes	$43.36	38.7%
2 Milk	$10.55	5.3%	2 Beer	$11.13	9.9%
3 Bread	$7.87	3.9%	3 CSDs	$6.91	6.2%
4 Beer	$7.03	3.5%	4 Hot Dispensed Beverages	$4.65	5.0%
5 Salty Snacks	$6.68	3.3%	5 Candy	$3.79	3.4%
6 Cold Cereal	$6.49	3.2%	6 Milk	$3.30	3.0%
7 Cigarettes	$6.03	3.0%	7 Other Tobacco	$2.97	2.7%
8 Frozen Dinners	$5.78	2.9%	8 Salty Snacks	$2.54	2.3%
9 Cheese	$4.82	2.4%	9 Newspapers/Magazines	$2.24	2.0%
10 Ice Cream	$4.66	2.3%	10 Sweet Snacks	$2.03	1.8%
Total Sales	$201.08		Total Sales	$112.00	

Source: Beverage Digest, Deutsche Bank Securities Inc.

Figure 3. US CSD Market Segmentation, % by Volume in 2000.

Sector	% Share
Cola	71.0%
Lemon/ lime	14.2%
Mixers	6.4%
Orange	0.4%
Other	8.0%

Source: Datamonitor Industry Market Research, Annual 2001.