How Pepsi lost its fizz trying to bypass its core product category

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Could we have done things differently? Sure... I wish we had stepped up our overall brand support... Indra Nooyi, Chairman and CEO, PepsiCo

Abstract

PepsiCo the poster boy of challenger brands has been taking the leader – Coca-Cola head on ever since existence. There were times and markets where Pepsi gained the coveted position of number one cola drink more than once and at other times it has always been a worthy ‘you miss, I hit’ opponent. All these years PepsiCo has also been selling snacks, alright, but it has never lost its control over its flagship Pepsi Cola. But it was in mid 2000s that a clear deviation from the ‘fun for you’ strategy started to surface, with the appointment of a new CEO Indra Nooyi PepsiCo focused on building a ‘good for you’ product portfolio and a similar corporate positioning. Citing reasons like the Americans becoming more health conscious and reducing consumption of CSDs (carbonated soft drinks) and the pesticide controversy in India, PepsiCo started to purse the ‘good for you’ direction across products and markets. At time when archrival Coca-Cola was selling gallons of carbonated drink, PepsiCo became a foods and beverages company which also sold cola; in effect adopting the ‘Bypass’ strategy, a strategy for challengers in which they bypass the stronghold of the enemy altogether and diversifying into other categories where the competitor is not present. This move is clearly evident from the company’s financials – according to the 2011 figures about 50% of the revenue came from global snacks and just 23% came from carbonated drinks, a similar trend was also observed in India. The net profits have a story to tell – PepsiCo with its relentless implementation of the said strategy managed to garner a net income of $6.462 billion in 2011 with a revenue figure of $66.504 billion, whereas Coca-Cola’s net income stood at $8.634 billion with a much less revenue of $46.54 billion. In India the gap is much more alarming with PepsiCo at a net loss of Rs 0.56 crore and Coca-Cola at a net profit of Rs 368 crore. The paper will analyse the effectiveness of this altruistic strategy and question the premise of this move from its comfortable core with just one major
competitor to the noncore of healthy snacks and fruit beverages – categories that are plagued with intense national and local competition, fluctuating raw material prices that are highly sensitive to economic and climatic conditions.

Introduction

1978 was when after decades of challenging the leader, Pepsi was number one, the then A.C. Neilson report showed that Pepsi had captured 30.8% share of the US cola market and Coke stood behind for the first time at 29.2% of the $3 billion cola market. “It was one of those moments for which you worked your entire career. We always believed since the early seventies, when Pepsi was viewed as the perennial also-ran, that we could do it. All of us started out with that objective, and we never took our eyes of it” said John Sculley PepsiCo’s president 1977-1983 (after which the flamboyant Steve Jobs convinced him to not sell sugared water for the rest of his life and play a part in changing the world). But throughout all these years, ever since an Atlanta pharmacist mixed the first Coke in his backyard in 1886 it became the leader and 12 years later Caleb D. Bradham, a North Carolina pharmacist made the first Pepsi-Cola, it became the challenger. During Sculley’s time they tried what it takes to beat the leader adopting the both frontal attack and flank attack working on all marketing aspects like: Packaging – Pepsi came up with a bigger 12 ounce bottle to fight Coke’s trademark 6.5 ounce, Distribution – Pepsi focused on supermarkets at a time when the organised retail was booming and the mom-pop stores were on decline, Branding – that was the time when the brand came up with one of the most recalled campaigns i.e. the ‘we are the Pepsi generation’ ads and when Pepsi bore this positioning that it’s a drink of the new generation and used Coke’s every strength as its weakness, Promotion – Pepsi initiated the Pepsi Challenge where people were asked to take a blind test between Pepsi and Coke and Pepsi came out as a clear winner, Price – Pepsi was charged less than Coke, Product – to appeal to the younger generation Pepsi was 9% more sweeter than Coke. These actions left Coca-Cola in dismay and they kept responding just to save the day and implemented some of the biggest marketing disasters like – in response to the Pepsi challenge Coca-Cola introduced the New Coke which was sweeter and changed their very strength of the secret formula, the ‘real thing’. This was faced by the infamous backlash by the American consumers and in less than 3 months after its introduction Coca-Cola was forced to bring back the old formula by the name of Classic Coke; They tried variations in the cola products to face the competition and ended with 8 cola brand, 6 of which were under the Coke brand –
Classic Coke, New Coke, Cherry Coke, Diet Coke, Caffeine-free New Coke, and Caffeine-free Diet Coke. This resulted in extreme confusion and irritation amongst the consumers.

All this while Pepsi was playing its challenger role extremely well, driving the leader to the edge and making the leader uncomfortable. In India too PepsiCo survived a masterstroke from Coca-Cola – When Coca-Cola bought out Parle’s home-grown CSD brands and immediately staked claim to over 70% of the market as soon as it entered India in 1993. Even then PepsiCo kept troubling the leader with guerrilla tactics like the ‘nothing official about it’ campaign during the 1996 cricket world cup when Coca-cola was the official sponsor.

The transformation

2006 PepsiCo had a new CEO who had plans to transform the company; Indra Nooyi started working on the ‘good for you’ direction much before owning the CEOs chair. In her earlier role as PepsiCo’s Strategy and M&A chief, she was instrumental in acquisition of Tropicana in 1998 and Quaker Oats in 2001, she also helped the company spin-off its restaurant business (Pizza Hut, Kentucky Fried Chicken and Taco Bell, which now operate under Yum! Brands) and as CEO she brought in healthy foods like pita chips, hummus, and soy-based smoothies. This was paying off as the global nutrition groups of products were bringing $ 10 billion by 2010 and Nooyi wanted this group to grow three fold over the next decade. Slew of changes and acquisitions followed to manifest this ambition – an American coconut-water company, a Russian dairy and juices player and a British fortified water manufacturer were purchased. During that time PepsiCo got its first chief scientific officer and research was initiated on how to reduce sugar and salt in beverages and snacks. The company’s promotions too went through a ‘good for you’ change – in 2010, for the first time in 23 years, the company decided against advertising at the Super Bowl — the football match is the most-watched annual event on American television. Instead, Pepsi announced the $20-million Project Refresh that would give grants to deserving community programmes and local schools. The focus on healthy food kept getting prominent, but this didn’t go well with the share holders as Nooyi came under fire for her strategy to transform PepsiCo into a health and wellness company and there were rumours, earlier this year, that she will be asked to step down as CEO and that some investors have demanded that the beverage and foods division of PepsiCo be split into separate companies to maximise shareholder value.
‘Good for you’ India

In India after the 2006 pesticide controversy PepsiCo furthered the bypass strategy implementation – Tropicana and Firto Lay were already a part of the Indian portfolio. In 2006 they launched Lipton Ice Tea (in association with HUL), Nimbooz and expanded the pure juice segment through Tropicana. In the savoury snacks business, more variants of Lays and Kurkure were introduced and the company entered the regional snacks market with the Lehar brand. The following year, it brought in Quaker Oats. In 2009, the company introduced Aliva, a baked snack developed especially for India. The next year was the turn of Pepsi Max, a sugar-free variant of the cola as well as variants of sport drink Gatorade (Pepsi Max has since been discontinued). Even as the emphasis on foods increased, the focus on health and nutrition remained intact. In 2010, in keeping with its health focus, the company made a huge push into the value foods and non-carbonated drinks space in a 50:50 joint venture with Tata Global Beverages. The NourishCo business has recently rolled out products like Tata Plus Water, fortified bottled water being sold at Rs 16, in Tamil Nadu. There’s also Tata Gluco Plus, a glucose drink at Rs 6 aimed at lower-income consumers, and Iron Chusti, an enriched snack in Rs 2- sachets.

The result

The move towards health has not been all that healthy for the company’s books, a glance through the previous year’s financials and its comparison with Coca-Cola will tell us why the shareholders are at loggerheads with the management.

Table 1: Revenue and Net profit comparisons of PepsiCo and Coca-Cola for 2011

<table>
<thead>
<tr>
<th>Particulars</th>
<th>PepsiCo</th>
<th>Coca-Cola</th>
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<tr>
<td><strong>Global (2011, in $ billion)</strong></td>
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<tr>
<td>Revenues</td>
<td>66.5</td>
<td>46.54</td>
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<tr>
<td>Foods</td>
<td>32</td>
<td>na</td>
</tr>
<tr>
<td>Beverages</td>
<td>34</td>
<td>46.54</td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
<td>6.4</td>
<td>8.6</td>
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<tr>
<td><strong>India (2011, in Rs crore)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues</td>
<td>4,015</td>
<td>5,907</td>
</tr>
<tr>
<td>Foods</td>
<td>1,800</td>
<td>na</td>
</tr>
<tr>
<td>Beverages</td>
<td>2,185</td>
<td>5,907</td>
</tr>
<tr>
<td><strong>Net Profit</strong></td>
<td><strong>-0.56</strong></td>
<td><strong>368</strong></td>
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Source: PepsiCo and Coca-Cola annual reports 2011
At $66 billion, PepsiCo’s 2011 income was over 40% higher than Coca-Cola’s $46.5 billion, but just half of that came from beverages, in which carbonated sodas have less than half share. Pepsi’s soda sales last year was just under $15 billion. The move away from carbonated drinks is visible in India, too. While Coca Cola India had cumulative sales of Rs 5,908 crore and net profit of Rs 368 crore in FY11, the share of snacks in PepsiCo India’s revenue grew from 15% to nearly 45% between FY09 and FY11. In the same period, Pepsi’s beverages business grew at a compounded growth of 22%, but its segment profit went down from Rs 50 crore to Rs 4 crore. On the other hand, profit from its snacks business grew from Rs 56 crore to Rs 95 crore.

Table 2: CSD Ranking

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<tr>
<th>Ranking</th>
<th>Global</th>
<th>India</th>
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<tbody>
<tr>
<td>1</td>
<td>Coke</td>
<td>Thums Up</td>
</tr>
<tr>
<td>2</td>
<td>Diet Coke</td>
<td>Sprite</td>
</tr>
<tr>
<td>3</td>
<td>Pepsi</td>
<td>Pepsi</td>
</tr>
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</table>

Source: Global – Beverage Digest 2011 CSD ranking, India – 2011 Euromonitor report

According to trade publication Beverage Digest, for the past two years, Pepsi has been pushed down to the no. 3 slot in soda brands, behind Coke and Diet Coke. Between 2008 and 2010, PepsiCo constantly lost market share to Coke, which now has nearly 42% of the CSD market compared with PepsiCo’s 28.5%. In India the overall soda sales are around Rs 6,000 crore, where Coke brands account for 60% of the market and Pepsi for 37%. Coke’s brands Thums Up and Sprite are the leaders with 16.5% each, followed by Pepsi with 15% market share. Coca-Cola is also ahead in all the sub-categories with in beverages in which both are present – CSD (cola, orange, clear lime and cloudy lime), fruit-based drinks (Maaza is ahead of Pepsi’s Slice), lemonade (Nimboo Fresh vs Nimbooz), or bottled water (where Kinley beats Aquafina).

**Bypass Attack**

Bypass attack as a strategy for challenger brands as defined by Philip Kotler is – The most indirect assault strategy is bypassing the enemy altogether and attacking easier markets to broaden the firm’s revenue base.
The following are the circumstances under which a bypass attack would be effective –

- **When the challenger brand finds it difficult to enter the leader’s category** – This didn’t hold true with Pepsi at all as Pepsi was very much a part of the category.

- **The leader holds dominant position in its category** – The CSD market was always almost equally divided none holding a clear majority.

- **When the industry which the product belongs is falling** – One of the reasons as cited by Pepsi for the transformation was that the Americans were becoming more health conscious and were consuming less cola. Numerically this is true, as Beverage Digest figures show that the consumption of CSD declined in the US for the seventh year in a row. In 2011 the consumption fell by 1%, here Coca-Cola saw a 1% drop in volume but PepsiCo suffered a 3.9% fall. The diversification is smart strategy owning to the falling consumption but not at the cost of the core category which still has promise. Per capita consumption of CSD in India is just 12 litres a year while the global average is 92 litres, even Pakistan and China consume more at 80 litres and 60 litres respectively reflecting immense potential.

- **The challenger establishes itself in easier markets** – As the definition says that the challenger bypasses the flagship category and enters easier categories. This was not at all the case with PepsiCo as it entered a very difficult category that of snacks and fruit juices with many competitors and fluctuating input prices. In the CSD category PepsiCo fought with Coca-Cola but now its fights with ITC, Maggie, Dabur, Kelloggs, Balaji and many other local players.

**Factors that made PepsiCo lose its fizz**

There are some prominent factors on why the bypass backfired –

- **The bottling battle** – The two companies PepsiCo and Coca-Cola have different strategies when it comes to bottling which plays a major role in its costs. Coca-Cola in India is a nearly Rs 6,000 crore business, including the revenue of both the parent company, which focuses on marketing and selling the concentrate, as well as Hindustan Coca-Cola Beverages, through which it owns more than 70% of its bottling operations. PepsiCo, on the other hand, is a Rs 4,000 crore business that has franchised 55% of its bottling and distribution volume to the Gurgaon-based
Jaipuria family. Experts have maintained that in a growing market, it is better to control the sales and distribution operations.

- **The super market segment** – The segment that helped PepsiCo reach the top during the 1970s in America, the super markets and organised retail, is not being milked by Pepsi in India at a time when a large portion of sales comes from these. British cash-and-carry retailer Booker, which has three stores across Maharashtra, claims it sells 1.2 million cases of Coca-Cola beverages compared with just 250,000-300,000 cases of Pepsi beverages every month. When it comes to modern trade, Coke is far ahead with promotional schemes like 1.25 litre PET bottle of the cola free with the purchase of two more and the distribution to match.

- **The B2B segment** - Over the past few years, Pepsi has lost several key institutional accounts like Inox multiplex, even though it continues selling at all Yum! Brand restaurants, courtesy - a global lifetime contract. Consider JSM Corp, the master franchisee of Hard Rock Café (HRC) in India. The company was a key Pepsi account from 2006 till 2008, when it switched to Coke, not just for HRC but also other restaurant brands like Shiro and California Pizza Kitchen.

- **Half hearted branding efforts** – After the brand discontinued decade old relationships with celebrity endorsers – ace cricketer Sachin Tendulkar (who now promotes Coca-Cola’s social initiatives) and Shahrukh Khan, PepsiCo’s efforts with ‘Yougistan’ ‘Bleed Blue’ ‘Change the Game’ seems confusing and half-hearted.

- **The food business tougher to crack than soft drinks** – Raw materials constitute higher proportions of the cost in the snack business, meaning lower margins; most of the raw materials are perishable and are exposed to extreme fluctuations. Considering the perishability factor of raw materials and local tastes differing from region to regions the unorganised sector plays a major part in this industry. The growth rates in foods business are high, alright, but the growth is not as profitable.

**What next**

To be fair to PepsiCo it has done a good job with its food business in India and having an integrated food and beverage business has its advantages like including cost leverage across the value chain, commonality of consumers and the opportunity to cross-merchandise to promote the products. But ignoring the core business which it has built for about a century is a suicide. PepsiCo seems to have come to terms with this, as evident from a quote of Indra
Nooyi during a meeting with high profile investment analysts in February “This is an ‘and’ game, not an ‘or’ game. …We have to focus on both growing the core, which is the fun for you products and the better for you products, and step up our investment in ‘good for you’ products.” The company is now desperately trying to maintain the balance – they have announced a 15% increase ($500 million) in advertising and promotional spending, the company went back to the Super Bowl in 2011 and has gone a step further this year by becoming the halftime show’s title sponsor, Pepsi has also signed up with Michael Jackson’s estate for featuring the late pop star in an advertising campaign and on a series of special edition cans and the company has introduced Pepsi Next, a mid-calorie version that attempts to position itself between regular and Diet Pepsi.

Going forward the approach should be building the periphery but holding on to the core. A combination of frontal attack where PepsiCo should take the leader head-on as it did during the 90’s and Flank attack by keeping a constant eye on the flanks left by the leader or to create one as it has successfully done in the food segment.
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