

This article is an excerpt from the book, *Private Label Strategy: How to Meet the Store Brand Challenge*, which is published by Harvard Business School Press, February 2007.

Making Brands Come Alive

Manufacturer Strategies in the New Private Label World

As the big brands from Colgate, Procter & Gamble and Unilever have demonstrated, there are ways to overcome the private label onslaught. Manufacturer brands still have an edge in the consumers' mind, but only when they respond aggressively to the store-brand threat can these brands be truly successful.

BY NIRMALYA KUMAR AND
JAN-BENEDICT E.M. STEENKAMP

» In the last three decades, private label products have experienced unparalleled growth in various countries around the world. A striking example is Germany, Europe's largest economy and the third-largest economy in the world. Private label share increased over the last three decades from 12 percent to a whopping 34 percent! In the U.S. market, private labels have outperformed manufacturer brands in all but one of the last 10 years. They now account for 20 percent of U.S. sales in supermarkets and mass merchandisers, as well as a healthy share of sales in department stores, category killers, specialty stores and convenience stores.

As a result of the success in private label products, around the world and in various industries, global private label sales now approach \$1 trillion dollars, and counting. Manufacturers of branded products have been taken aback by the unexpected and continued increase in private label share since the 1970s. The question that keeps brand manufacturers awake at night is: How should we combat the large retailers and this new reality of private label? Is there anything manufacturer brands can do to stop the

onslaught of store brands? Our work has identified four different strategies that brand manufacturers might pursue in response to the private label onslaught.

GREATER PROFITS

Private label production by brand manufacturers is a ubiquitous phenomenon. In the U.S. alone, it has been estimated that over half of the brand manufacturers also engage in private label production. These manufacturers are typically secretive about it, lest it reduce the equity of their own brands. The arguments put forward are that it contributes to profitability and that it allows the brand manufacturer to manage the category. Surprisingly, more often than not, these benefits prove to be illusory.

Margins on private label sales are small and decreasing. In fact, the market of private label manufacturing comes as close to perfect competition as you can get. And as we know from basic economic theory, in perfectly competitive markets, price is driven down to the lowest point. Illustrative is the experience of a Spanish company in office supplies. Its chief executive comments: "It used to be a high-volume, moderate-margin business. Now it is a very low-margin business and when you take into account the transportation

and sales costs, it is difficult to justify. At the present level of margins, we would not enter this market."

Only under very specific conditions – which are not met by most companies – does private label production make economic sense.

Working with various European and U.S. companies, we also were never able to uncover "hard" evidence that making private label products enhances the relation with the retailer and leads to preferential merchandising support for the brand manufacturer's own brands. In fact, private label contracts can increase a brand manufacturer's dependence on a few large retailers, forcing the manufacturer to disclose strategic information on its cost structure and share its latest product technology. Private label production can lead to "organizational schizophrenia." The manufacturer brand mentality of long-term investment and (image-based) differentiation is inconsistent with the private label production mentality of short-term flexibility and lowest costs. In sum, we believe that private label production is not the way out for most brand manufacturers.

PARTNER EFFECTIVELY

Fast growing retailers such as Amazon, Best Buy, Costco, Lidl, Save-A-Lot and Walmart are often seen by

“Margins on private label sales are small and decreasing.”



manufacturer brands as destroying value because these retailers sell manufacturer-branded products at very low prices. This generates conflict for manufacturers vis-à-vis their traditional, and often, inefficient channels. But these retailers are growing precisely for this reason – they are extremely efficient in getting branded products from manufacturers to end consumers. The lower distribution costs means they are taking the branded products to the customer at a lower price, and thereby, expanding the market. Brand manufacturers have to follow and distribute their products where consumers want to shop or they will be stuck in dying channels. As Brenda Barnes, chief executive of Sara Lee put it: “Where the customer buys our type of product, we should be there.” Sara Lee now sells pies at Save-A-Lot.

All of this does not mean that efficient retailers do not face their own challenges. There are two areas where even these retailers can benefit from effective partnering with brand manufacturers: retailers need

to differentiate themselves from other retailers, and hard discounters need manufacturer brands in their assortment.

- *Retailers’ need for differentiation.* Retailers want brand manufacturers to help them differentiate through exclusive brands and products. Historically, most brand manufacturers could not customize their offers for individual retailers without compromising their cost structures. Today the situation is a little different, with the large volume that mega-retailers are able to individually deliver. Brand manufacturers can cater to retailers’ need for differentiation through developing exclusive brands or exclusive SKUs on win-win basis.

Estee Lauder has recently created four brands (American Beauty, Flirt, Good Skin and Grassroots) that are, for now at least, available exclusively at the mid-priced U.S. department store chain Kohls. Kohls cannot compete against Walmart and Target on the mass-market brands, available from companies such as Procter &

Gamble and Unilever. And it makes no sense for Estee Lauder to move its prestige brands Lauder or Clinique from traditional department stores to Kohls. The exclusive brands may allow for a mutually successful partnership if Kohls is able to deliver the volume and Estee Lauder is able to keep its costs for these new brands under control.

Alternatively, manufacturers can offer dedicated SKUs consistent with the individual retailer’s strategy. Nestle, for example, designed a unique two-liter container of Vittel mineral water with a slim middle section to make it easier to hold. This bottle was made exclusively for Lidl in Europe. Each week, 54 trains loaded with the bottles leave a Vittel plant in France bound for Lidl’s European distribution centers. Peter Brabeck, Nestle’s chairman and chief executive, says it is “getting into a very good partnership.” In the United States, Macy’s is an example of a department store that is increasingly relying on exclusive merchandise to differentiate itself from competitors. Collaborating with brand manufac-

turers such as Tommy Hilfiger, it now sells \$2 billion of SKUs sold only in Macy's stores.

- *Hard discounters' need for manufacturer brands.* Increasingly, hard discounters – who have traditionally an overwhelming focus on private labels – are developing an interest in adding manufacturer brands. Discounters are looking for opportunities to differentiate themselves from one another through their assortment strategy, thereby moving beyond pure price-based competition. Having a balanced offering of both store and manufacturer brands may enhance the discounter's performance, as manufacturer brands are known to be major traffic builders. In addition, in many categories, there is a segment of consumers who prefer manufacturer brands.

The experience of Germany's powerful discounter Lidl is instructive. Manufacturer brands are currently a major engine of Lidl's growth. In contrast, the driver of the decline in overall sales of rival discounter Penny is its de-emphasizing brands, leading to a drop in sales that could not be made good by an increase in private label sales. Even mighty Aldi appears to be no longer immune to the lure of manufacturer brands. According to trade reports, Aldi is in talks with e.g., Ferrero about the sale of brands at its stores as Germany's leading discounter is planning to win over customers from its biggest rival Lidl.

BEATING PRIVATE LABEL

The single best approach to combating private labels is by offering innovative new products. Illustrative is what has been noted about man-

aging relationships with Walmart: "You need to bring Walmart new products – products consumers need. Because with those, Walmart doesn't have the benchmarks to drive you down in price. It doesn't have the historical data, you don't have competitors, it hasn't bid the products out to private-label makers. That's how you can have higher prices and higher margins." Our own research in scores of categories in more than 20 countries underlines the importance of innovation. We find that private label share is 56 percent higher in categories with low innovation activity compared with categories with high innovation activity. Once innovation activity in a market declines, brand manufacturers allow private labels to catch up.

We frequently hear the argument that nowadays products are so good, no further innovation is possible. We do not believe in this. In all markets,

“Retailers want brand manufacturers to help them differentiate through exclusive brands and products.”

there is significant room for innovation. An example is the cycle of innovation wars between Kimberly Clark and Procter & Gamble in disposable diapers. In a series of innovations, spanning several decades, diapers have been transformed from simple, badly fitting disposables to better-shaped fit, thin diapers with

gelling polymers to lock in wetness, elastic diapers, and most recently training pants, which give kids a temporary feeling of wetness to aid potty training. At several stages in these innovation cycles, managers at both companies wondered whether further innovation was still possible. But time and again, they were proved wrong. And it paid off: in the \$5 billion diaper market in the U.S., private labels are held at bay: Kimberly Clark and P&G jointly capture 85 percent of the market.

While one can exhort brand manufacturers to innovate and launch new products, brilliant innovation is wasted if retailers constantly copy successful products. If necessary, the company should protect its products by legal means, too. Lawsuits can be effective in the fight against the retailers as Britain's United Biscuits, manufacturer of Penguin chocolate biscuits, proved by its successful lawsuit against the blatantly obvious Asda copy called Puffin. Procter & Gamble has successfully sued a number private label manufacturers, rather than retailers, over private label products that it considered to be too similar to some of P&G's best-known brands such as Charmin (bathroom paper), Crest (oral care), NyQuil (medicine) and Tampax (feminine protection). Diane Dietz, general manager P&G North America oral care, explains: "Conduct from private label manufacturers that can mislead consumers cannot be tolerated. P&G invests heavily in research, development and intellectual property and design, and must protect that investment."

Historically, manufacturers have been – understandably – reluctant to sue retailers on infringement of intellectual property. How do you

sue your own customers? And will this not result in being thrown off the shelves of the retailer in question? But this situation is untenable. Brand manufacturers need to develop a reputation for aggressively pursuing retail copycat violators. By developing a tough enforcement reputation, it becomes more likely that the retailer will copy other manufacturers, who do not have such an aggressive patent protection history. No wonder Kraft has recently doubled the number of its patent lawyers to ensure that its innovations are adequately protected.

RATIONALIZE THE PORTFOLIO

The rise of private labels has put a squeeze on manufacturer brands. But the impact has been asymmetric. It is the weaker manufacturer brands – those that do not occupy the No. 1 or No. 2 market positions – that have borne the brunt of the negative impact. Given the amount of innovation and advertising required to keep a brand alive and fit to fight against private labels, a manufacturer can only support a limited number of brands. Each company must have a clear vision with respect to the categories it desires to compete in and with what brands and SKUs. The answer is to fight selectively rather than on all fronts.

Procter & Gamble has done a remarkable job in rationalizing and turning around its brand and product portfolio. Under chief executive A.G. Lafley, P&G has shed Punica and Sunny Delight juice brands, Jif peanut butter and Crisco pastry shortening. He also has gotten rid of Biz, Milton, Sanso, Rei and Oxydol detergent brands. In turn, P&G has

Overall, manufacturer brands still have an edge in the consumers' mind, but the gap has been substantially reduced over the years.

acquired Clairol, a hair coloring firm, Wella, a German beauty company, and Gillette. The result has been a lower exposure to foods, where sustainable innovation against private labels is more difficult. Instead, the portfolio has a much sharper focus on health, beauty and personal care products that tend to have higher margins and lower private label competition. After the Gillette acquisition, health and beauty care now account for more than one-half of P&G's portfolio. In general, relative to food categories, consumers are more easily persuaded of the emotional benefits in health and beauty.

In 2000, P&G owned 10 brands with annual sales of more than \$1 billion. Five years later, it had 16 brands that together generated \$30 billion, 60 percent of P&G's total revenues. The acquisition of Gillette has added five more \$1 billion dollar brands. By shedding product categories and brands, P&G is able to reinvest the sales proceeds into fewer brands (Pantene, Lenor, Pampers, Crest, Ariel and Tide, for example) where the firm has the best chance

of winning. Rather than having the innovation effort spread over many small brands, R&D can now work on the most promising brands and products while marketing can concentrate on exploiting their maximum potential. The latter includes increased penetration of the large brands in developing countries, where the trade is less consolidated.

As this article demonstrates, it is not that brands are dead. As Colgate, Procter & Gamble and Unilever are discovering, they are alive and kicking. Overall, manufacturer brands still have an edge in the consumers' mind, but the gap has been substantially reduced over the years. As a result, the manufacturer brands on the retail shelves have become less important. Only when they respond aggressively to the threat from store brands will manufacturer brands be able to recapture their luster. <<

Nirmalya Kumar is Professor of Marketing, Director of Centre for Marketing, and Co-Director for Aditya V. Birla India Centre at London Business School. He was previously on the faculty of Harvard Business School, IMD-International Institute for Management Development (Switzerland), and Kellogg School of Management at Northwestern University. He can be reached by e-mail at nkumar@london.edu.

Jan-Benedict E.M. Steenkamp, PhD, MSc, BSc is the C. Knox Massey Distinguished Professor of Marketing and Marketing Area Chair at the Kenan-Flagler Business School, University of North Carolina. He also is executive director of AiMark, a non-profit foundation, bringing together the academic world and CPG companies. He can be reached by e-mail at jbs@unc.edu or by telephone at 919-962-9579.