MGT 682
February 18, 2003

Cola Wars Continue: Coke and Pepsi in the Twenty-First Century

I. Case issue: Implications of strategic rivalry on cola industry's structure and performance (See Exhibits 1 & 2 for analysis)
   A. Implications on structure of cola industry
      1. Bottlers have been consolidated by concentrate producers (CP), placing smaller CPs at the mercy of Pepsi and Coca-Cola's distribution systems (See Exhibit 3)
         a. Making it tougher for smaller CPs like Cott Corporation to compete and leaving them open to the threat of acquisition
         b. Exposing Coca-Cola and Pepsi to the risk of anti-trust legal or regulatory action with bottlers' exclusive territories and policies that forbid carrying competing cola products
      2. Bottlers' profitability is in danger with slim margins and declining growth (See Exhibit 4)
         a. CP should come to bottler's aide with financial assistance, concentrate price breaks or increased marketing to preserve industry structure
         b. Bottlers will have to upgrade their technology to handle expanded product lines (See Exhibit 2)
         c. Bottlers should consider diversifying into snack food distribution through alliances or CP acquisitions like Pepsi's Frito-Lay division
   B. Implications on performance of cola industry
      1. CSDs made up a substantial share of 2000 US Liquid Consumption (See Exhibit 4), but this doesn't make them immune to risk
         a. Declining stock prices show a corrected over-valuation of companies (See Exhibit 4)
         b. Declining growth rates for carbonated soft drinks and increasing non-carbonated beverage growth rates further threaten industry performance (See Exhibit 4)
      2. International markets are an important source of revenue (See Exhibit 3), and improvements in world economies are forecasted
      3. Growing health concerns for caffeine and sugar consumption threatens industry performance
         a. Alternative sweetener research and development
         b. Center for Science in the Public Interest (CSPI) continues to petition the FDA to study the effects of caffeine on people (See Exhibit 3)
         c. Risk of additional state taxes (See Exhibit 3)
         d. Develop and diversify into healthier beverages and snacks
      4. Demand for carbonated soft drinks is elastic so there's not a lot of room for price variation

II. Lessons learned/industry recommendations
   A. Industry should be proactive about growing health concerns in US Market
      1. Should continue to lobby FDA to prevent caffeine-warning labels
      2. Should promote exercise through sponsoring competitive sports tournaments
   B. Companies need to refocus energies on advertising to rejuvenate industry and to fuel product demand both domestically and abroad (See Exhibit 3)
   C. Cola industry leaders, Coca-Cola and Pepsi, should practice game theory to better understand their competitive market environment (See Exhibit 3)

Exhibit One – An Analysis of the Cola Industry Using Porter's Five Forces Model (p 80)

Potential Competitors:

- Companies that have a door to door distribution channel in place like snack companies could choose to diversify into soda industry
- Switching costs are low for consumers who risk very little by trying new brands or beverages
- Barriers to entry are relatively high, though, with large advertising budgets and competitive brand loyalty to big players like Coca-Cola and Pepsi
- The drinks with high growth and high hype are non-carbonated beverages such as juice drinks, sports drinks, tea-based drinks, dairy-based drinks, and especially bottled water

The Bargaining Power of Suppliers:

- Concentrate producers (CPs) negotiate directly with bottlers' major suppliers – particularly sweetener and packaging suppliers – to encourage reliable supply, faster delivery, and lower prices
- Coca-Cola and Pepsi are among the metal can industry's largest customers and maintain relationships with more than one supplier, giving these suppliers less bargaining power due to the availability of alternative suppliers
- Metal cans make up the majority of the bottlers' packaged product (60%), followed by plastic bottles (38%) and glass bottles (2%)

The Bargaining Power of Buyers:

- Bottlers own a manufacturing and sales operation in an exclusive geographic territory, with rights granted in perpetuity by the franchiser, subject to termination only in the event of default by the bottler
- 1980 Soft Drink Interbrand Competition Act preserved the right of CPs to grant exclusive territories to their bottlers, giving less bargaining power to Bottler's buyers because there is no alternative supplier
- Bottlers are locked into contracts that grant CPs the right to set prices and other terms of sale
- Bottlers are allowed to handle the non-cola brands of other Cps at their discretion
- Bottlers are also given freedom in choosing whether or not to carry new beverages introduced by the CPs but cannot carry directly competitive brands
- Competition for brand shelf space in retail channels gives some bargaining power back to buyers

Threat of Substitute Products:

- Threat from substitute products are probably second in importance to the cola industry only to the rivalry among established firms: coffee cafes, tap water, milkshakes, fruit juice, hot tea, hot chocolate, chocolate milk and so on

Rivalry Among Established Companies:

- Industry is largely consolidated with two major players and a few smaller competitors like Cadbury Schweppes, making the companies interdependent
- International demand for carbonated soft drinks is growing, but domestic demand is slowing down substantially
- Exit barriers are high for bottlers with expensive equipment, moderate for concentrate producers
- Advertising budgets are high, customers are influenced by brand perceptions

Source: Hill, Charles W. and Gareth R. Jones. *Strategic Management Theory.* Boston: Houghton Mifflin Company, 2001

"Cola Wars Continue: Coke and Pepsi in the Twenty-First Century." Harvard Business School, July 30, 2002

Exhibit Two – Macroenvironment Analysis (p 92)

<u>Technological Environment:</u>

- Innovations in computerized technology could affect the bottling process, which involves specialized, high-speed lines
- Hot-fill, reverse-osmosis, or other specialized equipment is necessary to bottle the non-carbonated beverages that have higher profit margins than the carbonated soft drinks (CSD)

<u>Social Environment:</u>

- Consumer trends shifting away from original product lines for health reasons– from diet soda, to lemon-line, to tea-based drinks, to other popular non-carbonated beverages
- An increasing trend in teen consumption of CSDs
- Metal and Plastic containers commonly used by bottlers are recyclable are viewed as environmentally friendly
- Cultural differences across international markets are challenging when it comes to daily operations and marketing cola industry products

<u>Demographic Environment:</u>

- Explosive population growth in foreign countries like China translates into explosive growth potential for those markets
- Aging baby boomer population in United States may lead to a decrease in cola product demand

<u>Political and Legal Environment:</u>

- Soft Drink Interbrand Competition Act of 1980 secured the right of Concentrate Producers (CPs) to grant exclusive territories to bottlers
- Anti-trust legal suit against Coca-Cola by Pepsi over fountain drink monopolization in the domestic market was dismissed in 2000
- Pressure from the scientific community for the FDA to research the affects of caffeine consumption and to enforce caffeine labels warning of the dangers of caffeine consumption
- Obstacles in international operations included political instability, regulations, price controls, advertising restrictions, foreign exchange controls and lack of infrastructure

"Cola Wars Continue: Coke and Pepsi in the Twenty-First Century." Harvard Business School, July 30, 2002

Hill, Charles W. and Gareth R. Jones. *<u>Strategic Management Theory</u>.* Boston: Houghton Mifflin Company, 2001

Exhibit Three – Supporting Quotes

I.A.1. "The bottler consolidation of the 1990s made smaller concentrate producers increasingly dependent on the Pepsi and Coke bottling network to distribute their products (10)"

"Cola Wars Continue: Coke and Pepsi in the Twenty-First Century." *Harvard Business School*, July 30, 2002

I.B.2. "It would be easy to conclude that the Atlanta-based soft drink giant is on the ropes in overseas markets, which provide 63% of sales and 75% profits. But the worst may be over."

Spiegel, Peter. "Foreign Fizz." *Forbes.com* August 23, 1999 <http://www.forbes.com/global/1999/0823/0216019a.html>

I.B.3.b. "Joining CSPI in support of the petition were 34 scientists and ten health and consumer groups. The supporters include prominent scientists from Johns Hopkins, Yale, Harvard, Duke, University of Michigan, University of California (Berkeley), and other universities, as well as the Association of State and Territorial Public Health Nutrition Directors, National Women's Health Network, Boston Women's Health Book Collective, and Society for Nutrition Education."

"Label Caffeine Content of Foods, Scientists Tell FDA" Center for Science in the Public Interest July 31, 1997. <http://www.cspinet.org/new/caffeine.htm>

I.B.3.c. "Perhaps 'Liquid Candy's' most controversial recommendation is that states tax soda pop to help fund major campaigns to improve diets, build bike paths and recreation centers, and support physical-education programs in schools. Arkansas takes in $40 million annually from its two-cent-per-can tax. Tennessee, Washington state and West Virginia also tax soda, while industry lobbying has won repeals in New York, North Caroline and several other states."

"Soft Drinks Undermining Americans' Health: Teens consuming Twice as Much 'Liquid Candy' as Milk." Center for Science in the Public Interest October 21, 1998. <http://www.cspinet.org/new/soda_10_21_98.htm>

II.B. "The company's core brand – the bubbly, brown, sugar water that provides the bulk of the profits to Coke and it bottlers – is in trouble. The growth of the drink abroad, where the company earns three-quarters of its income, has slowed; in the U.S., sales peaked in 1998 and have been flat since. Blame poor marketing."

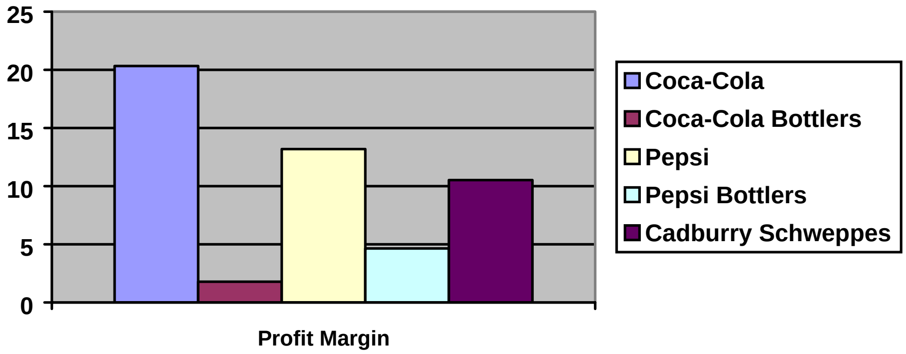
Sellers, Patricia. "Who's In Charge Here?" *Fortune.com* December 9, 2001. <http://www.fortune.com/fortune/print/0,15935,370035,00.html?>

II.C. "Since the process itself forces managers to think explicitly about the incentives and likely moves of other players, it can generate a breakthrough in strategic insight even when the game can't be modeled explicitly. Qualitative role-playing exercises and structured game theory may generate enough insight to lead to a change of direction on new-entry, capacity addition, pricing and other fundamental strategic decisions (95)."

Courtney, Hugh G. "Games Managers Should Play." *World Economic Affairs* Autumn 1997: 91-96.

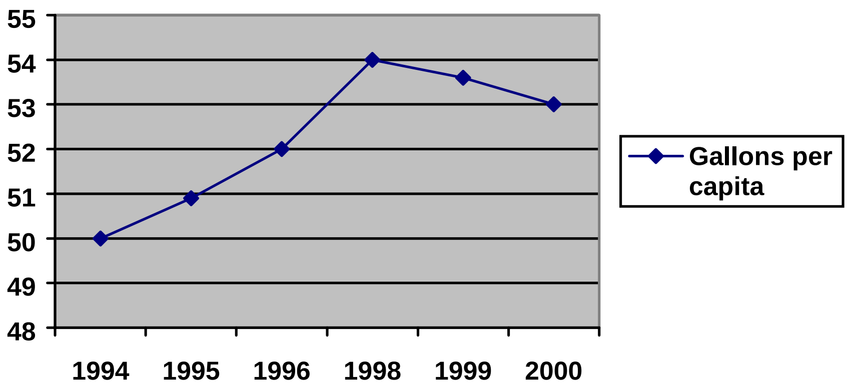
Exhibit Four – The Financial Analysis

I.A.2. *Profit Margins of Industry Concentrate Producers and Bottlers*

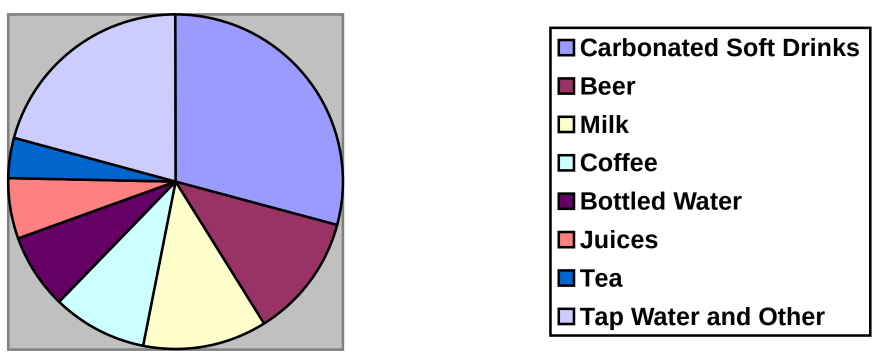


"Stocks: Company Information: Snapshot Report." Updated February 15, 2003
<http://www.marketguide.com>

I.A.2. *Declining Carbonated Soft Drink Consumption*



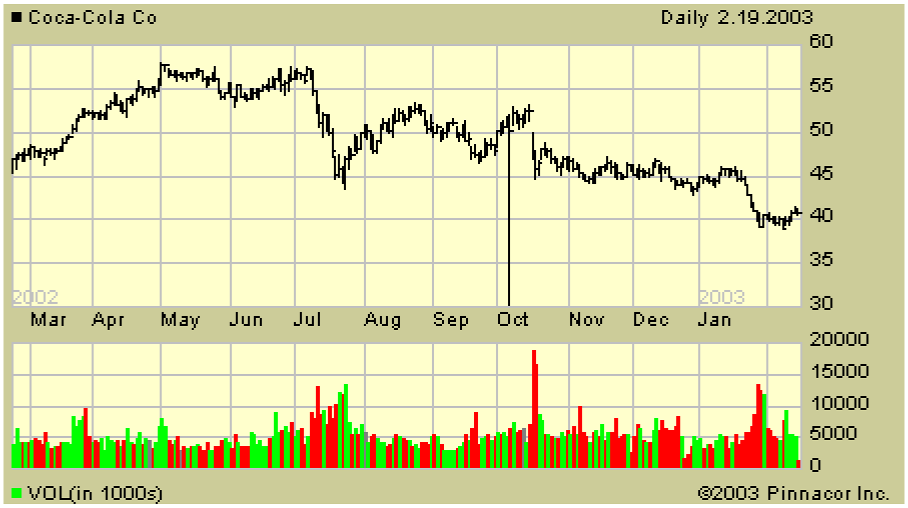
I.B.1. *U.S. Carbonated Soft Drink Market % of Volume in 2000*



"Cola Wars Continue: Coke and Pepsi in the Twenty-First Century." Harvard Business School, July 30, 2002

Exhibit Four – The Financial Analysis Continued

I.B.1.a. *Coca-Cola's Declining Stock Price*

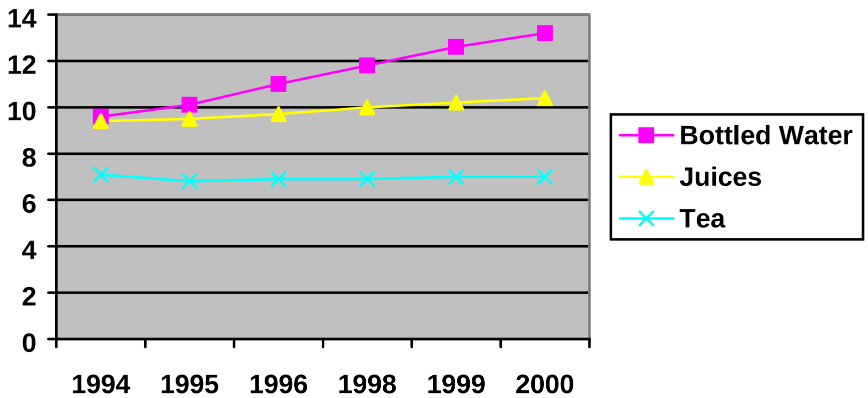


I.B.1.a *Pepsi's Declining Stock Price*

February 19, 2003 <http://www.marketguide.com>

Exhibit Four – The Financial Analysis Continued

I.B.1.b. *Growth of Non-carbonated Beverages*



“Cola Wars Continue: Coke and Pepsi in the Twenty-First Century.” Harvard Business School, July 30, 2002