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KITKAT IN JAPAN (B): The Roots of premiumization

Philip Sugai wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

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The memories of the relaxing New Year holidays seemed to quickly fade into memory as Ryoji Maki and Masafumi Ishibashi met ona cold winter morning in 2008 at the Nestlé Japan Co. Ltd. (Nestlé Japan) headquarters in Kobe to review for their team strategy session later that afternoon. The KITKAT team had experienced great success over the past few years by building a powerful and resonating brand and enhancing their production capabilities to enable them to adapt to changing demands from their channel partners. However, the harsh realities of a changing demographic landscape and increasingly powerful convenience store chains created a clear sense of urgency for creative solutions to continue their growth. Ishibashi and Maki felt that the ideas that had been generated in the closing months of 2007 held enormous potential to create growth through a previously overlooked retail channel. As they sat down to review the strategies, they wondered: Had they overlooked any important details that could affect their 2008 year?

THE RISE OF THE *CONBINI*

As far back as the spring of 2001, Japan’s convenience store chains had been increasingly predicted to influence the overall structure of retail sales in Japan. This predicted shift came with both great opportunities as well as significant risks. While sales of KITKAT through supermarkets allowed for advanced planning and relative stability, Japan’s convenience stores offered neither of these luxuries. Furthermore, their rapidly growing power suggested that the days of annual sales planning cycles were quickly coming to an end.

To understand the scale of the shift that was underway in Japan’s entire domestic retail sector, it was important to know that consumers generated more than ¥130 trillion[[1]](#footnote-1) in annual sales, with supermarkets accounting for ¥12 trillion, or 9 per cent of total retail sales, in 2001. However, these numbers were predicted to slightly contract or, at best, to remain flat over the coming decade. Convenience stores, on the other hand, accounted for ¥7 trillion in 2001 and were projected to grow to overtake department store sales within the next five years.[[2]](#footnote-2) In 2001, retail sales through convenience stores accounted for approximately ¥10 trillion in total annual sales.

In addition to these trends, the underlying structure governing how manufacturers like Nestlé Japan worked with these two retail channels was significantly different. Products in supermarkets in Japan changed according to a six-month cycle. Buyers for supermarkets slotted products into shelving space twice a year, once in the spring and once again in the fall. Following this standard cycle, shelf space was made available to Nestlé Japan for fun-size packs and single-package KITKATs.

In contrast, Japan’s convenience stores reviewed their shelf space decisions on a weekly basis, or 26 times as frequently as supermarkets. If a product did not sell up to expectations within any given week, it was quickly removed and replaced by a better-selling one the following week (see Exhibit 1). As Japan’s population increasingly moved into urban areas and away from the countryside, this trend was predicted to continue. This meant that the Nestlé Japan confectionery team had some serious work ahead, as it only had the two KITKAT products (four finger or smaller fun-size packs) to sell through this increasingly powerful convenience store channel (see Exhibit 2). Larger-sized fun-size packs were simply too big to sell in the limited shelf spaces convenience stores offered.

As Ishibashi explained:

We looked at the projections for the future power of Japan’s convenience stores and realized that in order to have any hope of expanding our presence there, we needed to expand the scope of our offerings. We knew that since the 1990s, there had been KITKAT flavor variations in other parts of the world, and felt that these held the key. The challenge that we faced, though, was the prohibitive costs of changing our manufacturing capabilities to accommodate these changes in flavor. But if we didn’t make these changes, we understood that we would miss out on all of the larger benefits that prominence within convenience stores would bring.

THE BIG INVESTMENT

The investment in the capabilities to mix different flavors into the milk chocolate of KITKAT—such as mint, in order to create a mint chocolate taste—or to mix additional ingredients into the cream between the wafers at the heart of the KITKAT bar required an investment of approximately US$1 million(¥104 million). Though not an enormous cost, an investment of this size required the approval of executives at the Nestlé S.A. (Nestlé) headquarters in Switzerland, and they had publicly stated that their sights were set elsewhere.

In addition to varying the flavors, Ishibashi and his team knew quite well that Japanese consumers would expect a strawberry-flavored KITKAT to be pink, a banana-flavored KITKAT to be yellow, and a green tea-flavored KITKAT to be green. This meant that, in order for Nestlé Japan to be truly successful, it would need the ability to produce KITKAT using white chocolate as the outer layer so that when other ingredients were added, the actual color of the KITKAT would match. Without such synergy between appearance and taste, the possibilities for widespread growth within Japan’s highly demanding consumer market would be limited. Yet the cost for building such capabilities was nearly 10 times the investment in making flavor modifications, requiring more than ¥1 billion to develop such manufacturing prowess. As Ishibashi explained:

When we looked at all of the numbers and calculated the overall sales potential from these expanded capabilities, the investment seemed reasonable—especially when we balanced this against the total advertising expenditures that we spent annually to promote KITKAT. With a manufacturing capability like this, we would be able to leverage this asset for years to come. But as the financial impact of such an investment was far different from an advertising budget, a clear business case was needed, but unfortunately we couldn’t predict the response from Japanese consumers.

THE QUESTION OF WHITE CHOCOLATE

When Ishibashi called a team meeting in 2001 to review the current situation, he wrote three key points on the meeting-room white board to get the conversation started:

* Success in Japan’s convenience stores required variety and frequent change.
* Japan’s confectionery consumers required alignment between flavor and appearance.
* Nestlé headquarters in Switzerland needed a clear business case for an investment the size and scale that a new white chocolate manufacturing line required.

As the team discussed the impact of these three facts on its operations, two key questions emerged: Would Japanese consumers buy different KITKAT variants? Would Japanese consumers buy White Chocolate KITKAT, (thus allowing this to be a standard offering on its own)?

To answer the first question, Nestlé Japan successfully convinced Nestlé headquarters in Switzerland to make the approximately US$1 million investment based on the team’s well-prepared business plan and also successful flavor variation launches in other global markets. Said Ishibashi:

In the spring of 2000, we introduced Strawberry KITKAT into Hokkaido (Japan’s northernmost island) to prove that the initial investment decision was correct by confirming that Japanese consumers would buy different flavor variations of KITKAT. The results actually went well beyond our expectations. We sold five to six times more of these Strawberry KITKAT versus our traditional KITKAT sales in that same region, and all Strawberry KITKAT in Hokkaido sold out within one month.

Based on these results, the answer to Nestlé Japan’s first question was a resounding “yes!”

Building on these results, the Nestlé Japan team created a national rollout of a Strawberry flavored KITKAT, and in 2001, it introduced an Orange flavored KITKAT, to similar levels of success. Proof of the acceptance of *flavor* variation and of Nestlé Japan’s ability to become profitable with these capabilities became clear. If KITKAT Japan wished to match these new flavors with new colors, however, they would need to know that Japanese consumers would be willing to purchase KITKAT made with white chocolate. However, ideas for how to test whether Japanese consumers would be equally willing to buy White Chocolate KITKAT proved to be a much more challenging question to answer, as it was estimated to cost more than $10 million to integrate white chocolate manufacturing capabilities into the KITKAT manufacturing plant—that is, until one of Ishibashi’s marketing team members took a trip to Australia during the summer of 2001 and hit upon a plan to help justify this investment.

FROM DOWN UNDER TO THE LAND OF THE RISING SUN

On a trip to Australia in 2001, Ryosuke Itoh, a marketing manager in Ishibashi’s team, found plenty of White Chocolate KITKAT available for sale. Itoh also found that the capacity of the Australian manufacturing line exceeded the demand for White Chocolate KITKAT within the Australian market. When he learned this, he immediately called Ishibashi with a plan. Why not fill the extra production capacity in Australia for White Chocolate KITKAT, find a way to package it for the Japanese market, and then ship it in refrigerated containers to Japan? Itoh explained, “If we could prove that we have a viable and sustainable market for White Chocolate KITKAT on its own, without any color or flavor variations, we would be able to justify the investment in creating white chocolate manufacturing capabilities in Japan.”

A one-time agreement with Nestlé Australia Ltd. was created in 2002 to produce White Chocolate KITKAT for a Japan test launch. Finished goods were manufactured in Australia and co-packed in Japan to comply with the local packaging regulations. This second test of whether or not Japanese consumers would accept White Chocolate KITKAT as a standalone product again returned favorable results. Based on such positive consumer responses, and after many meetings, presentations, and discussions, the KITKAT Japan team was given the approval to invest in white chocolate production capabilities. The challenge now was how to recoup the costs of this investment and build a long-term, profitable business based upon these new manufacturing capabilities.

FROM WHITE CHOCOLATE TO EVERY IMAGINABLE Flavor

With the barriers now removed from Nestlé Japan’s abilities to create new color and flavor combinations, it first launched a *pink* *colored* Strawberry flavor variant nationally in 2003. This was followed by a yellow colored lemon cheesecake variant and a green colored Matcha (green tea) variant in 2004, to great fanfare and sales success.

As predicted, overall retail sales through convenience stores continued to grow in Japan, and alongside this growth came the increasing demand from these convenience store chains for new and exciting products. This new reality continued to push manufacturers who supplied these convenience stores to create ever-changing flavors, tastes, and packaging variations. Nestlé Japan was now perfectly positioned to fully support these trends, and from its five national taste variations in 2004, it expanded to nine in 2005, 16 in 2006, 26 in 2007, and 33 in 2008.

Because these taste and color variations were constantly changing, they became limited editions that, once sold out, would not be produced again. In fact, when a variant was launched a second time, the recipe and packaging were typically modified to maintain a fresh image. While some tastes were introduced only once, the Matcha KITKAT became such a big hit, not only with Japanese consumers, but also with growing numbers of international tourists, that it became the most popular flavor variant of all time.

This growth of variety also had positive spillover benefits for the supermarket retail channel, which in terms of total sales remained Japan’s top retail channel. Nestlé Japan carefully monitored sales of each flavor variant and brought the most popular variants into supermarkets in the form of fun-size packs.

LOCAL *MEIBUTSU* FLAVORS

While Japan was a relatively small country compared to the United States or China, there were noticeable differences in climates and customs between towns and cities across the archipelago. Different areas had their *meibutsu* or “famous foods and tastes,” which were sources of local pride. For example, all residents of the Niigata Prefecture were proud of their famous rice, *Koshihikari,* but even within Niigata, there were different qualities and grades of rice. This same rice varietal grown in the Uonuma region of Niigata, Japan’s most famous (and expensive) rice-growing area, was called Uonuma *Koshihikari*. Within the Uonuma region, the south or *minami* region of Uonuma was even more famous for its rice, so Minami Uonuma *Koshihikari* commanded the highest price for rice throughout Japan and was an ongoing source of pride for those who lived and worked in the region.[[3]](#footnote-3)

This pride in locally produced delicacies was consistent across Japan, and many of these delicacies were rarely transported across town or city borders. Partnering this with the cultural practice of gift giving created an entire industry of goods targeted to both business and leisure travelers based on these local tastes. In fact, when traveling to a different region of Japan, it was a common custom to purchase a gift from that area, which would be appreciated by the recipient even more if it was considered to be that area’s *meibutsu* delicacy.

The KITKAT Japan team built a deep understanding of local specialties across Japan, and gathered insights from travelers to solidify its plans for creating a new KITKAT souvenir product. Compared with the standard retail products, souvenir products were generally priced higher across nearly every retail category, and confectionery was no exception. Along these lines, KITKAT area souvenir editions were packed in special boxes and positioned within the premium price range at approximately four times the price of an original milk chocolate KITKAT.

THE ROOTS OF PREMIUMIZATION

As travelers to Japan quickly realized, chocolate was big business, with Japan serving as the largest chocolate-consuming country in all of Asia. According to the All Nippon Kashi Association, in 2007 alone, Japanese consumers purchased more than 218,000 tonnes of chocolate. Japan’s *Nikkei Weekly* newspaper reported that in 2007 Japanese retailers imported more than ¥18.8 billion[[4]](#footnote-4) in chocolate from overseas and that sales from luxury brands, such as luxury brands from Switzerland, Belgium, and France, remained strong. Sales of these imported chocolates generated on a retail basis “about ¥40 billion, accounting for roughly 10 per cent of total consumption.”[[5]](#footnote-5)

The investments that Nestlé Japan had just made in its new manufacturing capabilities had the entire confectionery team thinking of ways to compete within this higher-end category and directly with imported chocolates from overseas such as Lindt, Godiva, and other premium brands. Through its successful *juken* campaign, the KITKAT brand had become infused with positive emotional meaning, and Ishibashi and his team wondered if they could build upon this positive branding and add a premium line to their portfolio. The first person they went to speak with was one of Japan’s most prestigious *pâtisserie* chefs, Yasumasa Takagi.

As Chef Takagi recalled in a CNN interview, “After I gained training at various famous shops in France and Belgium, I thought that it was my mission to fill the gap between Western countries and Japan.” Initially approached about a collaboration with KITKAT, he rejected it, saying, “I believed I couldn’t create chocolate freely [and] without ties.”[[6]](#footnote-6) But after a number of discussions, Chef Takagi agreed to work together with Nestlé Japan to create the types of flavor combinations that he felt were most appropriate and supported his own personal dreams. Combining Nestlé’s passion to delight consumers through premiumized KITKAT with the skills and passion of Japan’s top *pâtisserie* chef led to some of the most creative and innovative products in Japan’s entire retail industry.

In 2005, in collaboration with Chef Takagi, the first premium-priced KITKAT was introduced to the Japanese market, and it was also the world’s first Passion Fruit KITKAT, sold at ¥150 per package. This was followed by other premium variants, including black chocolate (noir), wine, and many other premium variants co-branded with Chef Takagi over subsequent years.

In addition to this, with advances in freeze-drying techniques and the mixing capabilities that Nestlé Japan had built into its production facilities, Nestlé Japan executives found that they could also mix different ingredients into the outer chocolate, bringing the ability to modify the texture of the outer chocolate layers. For example, in 2005, Nestlé Japan launched another Strawberry KITKAT, but this time it included freeze-dried pieces of strawberry mixed in with the outer chocolate.

As the collaboration with Chef Takagi deepened and Nestlé Japan’s production capabilities became increasingly efficient, it seemed like KITKAT had found a clear recipe for success.

THE *JUKEN* CAMPAIGN REVISITED

As the sales of KITKAT flavor variants expanded and the collaboration with Chef Tagaki brought greater possibilities for the Nestlé Japan team to infuse a more premium image into the KITKAT brand, Ishibashi and Maki brought their focus back to the *juken* campaigns for test-takers. Since they began this new branding effort in 2002, overall January to February sales of KITKAT had increased 150 per cent from their 2002 levels by 2007.

As Maki, who had transitioned into the Nestlé Japan confectionery business full time as a brand manager in 2005, and Ishibashi reviewed all of the facts related to the evolution of the KITKAT brand in Japan, they could not get the images of the handwritten messages on the boxes of KITKAT out of their minds (see Exhibit 3). While they had changed the overall branding and the imagery on the KITKAT box, could it really be that the box itself had become a platform for sending heartfelt messages to those facing a challenge? And if this cultural shift was truly underway, was there a way that Nestlé Japan could help support this process more effectively?

As they finalized their thoughts for their afternoon meeting, they knew that their entire team was excited to answer these questions and had the capabilities to do so. What was still unclear, though, was exactly what answers the team would arrive at by the time this important meeting ended.

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**EXHIBIT 1: IN-STORE CONVENIENCE STORE SALES, 7-11 TOP 10 PRODUCTS SOLD**

Source: “Japanese Convenience Stores—Numbers Say a Lot,” *Nipponia*, no. 19 (December 15, 2001), accessed October 10, 2017, http://web-japan.org/nipponia/nipponia19/en/feature/feature12.html.

**EXHIBIT 2: SMALLER FUN-SIZE PACK SOLD THROUGH CONVENIENCE STORES**



Source: Company documents.

**EXHIBIT 3: *JUKEN* KITKAT WITH HANDWRITTEN GOOD-LUCK MESSAGE**



Source: Company documents.

1. ¥ = JPY = Japanese yen; All currency amounts are in JP¥ unless otherwise specificed; JP¥1 = US$0.10 on March 31, 2008. [↑](#footnote-ref-1)
2. FamilyMart, *FamilyMart Annual Report 2010*, accessed March 27, 2017, www.fu-hd.com/english/ir/library/annual

   /document/fm/fm2010.pdf. [↑](#footnote-ref-2)
3. “Koshihikari, Rice of The Highest Quality in Japan”, Minamiuonuma City Resort Tourist Association, 2017, accessed July 7, 2017, www.m-uonuma.jp/en/access.html. [↑](#footnote-ref-3)
4. JP¥1 = US$0.01 on March 31, 2007. [↑](#footnote-ref-4)
5. *“*Strong Euro Holds Down Japan Chocolate Imports By 0.2% in ‘07,” *Nikkei Report*, February 1, 2008. [↑](#footnote-ref-5)
6. “Japan’s KitKat Craze: It’s Gone Gourmet with over 300 Flavors,” CNN, March 11, 2017, accessed April 7, 2017, http://edition.cnn.com/2016/08/30/foodanddrink/japan-kitkats-chocolate. [↑](#footnote-ref-6)