Case Study
Cola Wars: Coke Vs Pepsi

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Introduction

- Which is the most profitable legal business in the history of the industrial world?
- Cola

OR

- Selling colored sugar water

Concentrate Production → **Bottlers** → **Distributors & Retailers**

83% GPM
30% PBT
39% Cost on Advertising

43% GPM
09% PBT

Five Forces Analysis of the CPs

- Only $6-$9 million required to serve U.S. – why not more entry?
- **Barriers to entry**
- First-mover advantages
  - Brand equity: Cumulative spending on advertising. Established world wide brand identity over a long period of time; part of the American 'culture'
  - Limited shelf space, vending slots, and fountains: Displacing the filled slot is much more difficult
  - The franchise system: Bottling is very capital intensive ($3-$4 billion for U.S.). Bottlers have exclusive agreements with Coke or Pepsi.
- Scale economies in 'R&D' – new product, package introductions

- Are there any substitutes available? What do they cost? Why don't they have an effect on the price?
- **Substitution**
- Many substitutes – water, coffee, fruit juice, beer, etc.
- Most of them are much less costly or free
- How do the soft drink companies get away?
  - Substitutes are not always conveniently available
  - At times, soft drinks are an impulse buy
  - Life-style choices: of how you live (not just quenching thirst)
  - Addiction (half consumption by people who drink 8-9 cans per day!
  - Americans drink more soft drinks. In some countries including India, drinking Coke or Pepsi is a status symbol

- Do suppliers have any real power vis-à-vis the concentrate manufacturer? Who are they?
- Not manufacturers of cans or plastic bottles
- **Suppliers**
- What really goes into typical carbonated cola?
  - Not sugar (except Coke, which passes the cost)
  - Not water (added by the bottler)
  - IT'S A SECRET.
  - NO ONE KNOWS!
  - How much do you think the ingredients cost?
  - NOT MUCH!

- **Buyers**
- How much power do they have? Who are the buyers for CPs?
- Bottlers had very little power, even when independent
  - High switching costs
  - Franchise agreements locked in bottlers to exclusive deals
  - Concentrate is 35% COGS to the bottler, but CPs offer significant benefits: example – buying power for cans, sugar, etc.
  - Competitors are very concentrated and large relative to the bottling network
- Final customer
  - Though in billions, they are ‘fragmented’
  - Somewhat price sensitive but susceptible to advertising
  - No switching costs, but substitutes not always available

- **Rivalry**
- Who has won the cola wars? Who has lost? What have been the 'weapons of war?'
- Structural characteristics
  - Two players – with long histories of interaction, dominate over 70% of the market → the terms of competition are clear and well-defined; both firms have carefully avoided downward spirals
  - High degree of perceived differentiation
- Tools of war: How intense is the competition?
  - This has been a measured war from the beginning, where prices on concentrate have never been affected
  - Competition is largely focused on – shelf space, advertising (life style & brand name), selective discount on the downstream products

- Why doesn't the war escalate out of control? How do they keep the war within 'bounds?'
  - Opportunity for gaining advantage is very short term
  - Coke and Pepsi are capable of quickly imitating each other on almost every dimension
  - So, any escalation will simply be met by imitation
- Who has been winning the war?
  - 1950: Coke 47%, Pepsi 10%
  - 1970: Coke 33%, Pepsi 20%
  - 1993: Coke 41%, Pepsi 31%
  - Initially Coke due to extensive bottling franchise and brand name
  - Pepsi gains significant share (why?) – selective discounts in distribution outlets, targeted growing take-home market, motivated its bottlers, competed on package size and advertising, while, coke was focused on overseas market and diversification

- Who has been winning since the Pepsi Challenge was launched?
  - Both Coke and Pepsi have increased their share; and
  - They also expanded primary demand for colas
- Who has been losing?
  - Smaller brands (why?)
  - Historically, they could piggyback on Coke and Pepsi's bottler systems
  - Historically, little head to head competition
  - 1980s and 1990s:
  - Coke and Pepsi proliferate product (force head-to-head competition) – reduce bottler's incentive to use non-allied brands
  - Coke and Pepsi fill shelf-space, push small brands off the shelf

Short Summary on CPs

- Constrained competition
- High Barriers to Entry
- Locked-in buyers
- Secret ingredients (i.e., low cost, hard-to-imitate)
- Lots of substitutes, but advertising and widespread distribution limited the impact
- So,
- It is a great business

Five Forces Analysis of the Bottlers

- **Barriers to Entry**
- High
  - Exclusive franchises (most important)
  - High capital investment in bottling and canning lines
  - High investment in trucks, distribution centers
  - Shelf space limited
- If you could be a bottler for Coke or Pepsi, would you rather choose Calcutta or Chandigarh?
- Economies of distribution: 28% of total bottler costs is selling and delivery. The critical issue for bottlers to make money is large drop sizes. In Calcutta, a truck has to deal with traffic, parking, and has to deliver to thousands of small stores in small quantities.

- **Buyers**
- Who are the buyers?
- Fountains:
  - Large fountains have significant power (Exhibit 4)
  - Fountain is the only significant channel which carries only one brand: easy to play the dominant players against each other
  - Coke and Pepsi are strongly motivated to get the fountains to build brand awareness (give back money in the form of promos)
- Vending:
  - Highly profitable for the bottler – why?
  - Machines are in hard to reach places – allowing for high retail prices
  - BTE/Capital costs are high for vending machines
  - The bottler shares the prices with the owner of the real estate

- Food Stores/Supermarkets:
  - For the supermarket, it is a high turn product – since it draws in customer traffic (not necessarily price sensitive as in other product categories)
  - Coke and Pepsi try to minimize supermarket power by offering more efficiency i.e., product is delivered to the door, stocked for them
  - There is growing price sensitivity with warehouses and discounters offering lower prices due to superior operational efficiences
- Warehouse Clubs:
  - Huge drop sizes
  - Large volumes
  - Minimal selling and delivery expense

- **Suppliers**
- Do they have power?:
  - CP has significant power
  - Suppliers, like cans manufacturers, are intrinsically weak, and Coke and Pepsi negotiate the contracts on behalf of the bottlers
- **Substitutes for Bottlers:**
  - NONE (except direct delivery to the fountain by the CP)
  - Warehouse delivery reduces some of the functions of the bottlers
- **Rivalry:**
  - Other brands (share rivalry problems with Coke and Pepsi)
  - But, geographic exclusivity limits the competition among bottlers
  - Why do CPs keep a system of geographic exclusivity?
  - For CP producer, every sale is a profitable sale; for the bottler, the key is to find profitable sales. Also the CP wants exclusive franchises to force the bottlers to saturate their territory.

Short Summary on Bottlers

- High Barriers to Entry
- Limited substitution
- Suppliers – Coke and Pepsi appropriate most of the returns
- Buyers – vary with distribution channel
- Rivalry – only other brands, but can be fierce where Coke and Pepsi are fighting
- So,
- It is clearly less profitable – but not terrible

- **Vertical Integration**
- Why should Coke and Pepsi buy their bottlers, since, bottling is a less profitable business?
  - Bottlers weakened due to Cola wars
  - Why did Coke attack independent Pepsi bottlers – not company owned bottlers, in responding to the Pepsi challenge?
  - Independent bottlers will not fight as hard or give up as much profit as company-owned bottlers
  - If inefficiencies remain downstream in the bottling system, it becomes hard for Coke and Pepsi to keep the real prices down, increase raise the price of concentrate every year

- **Transition**
- What are the likely challenges to the stability of the industry structure in the 2000s? What are the potential drivers of structural change?
  - Globalization –a) much higher growth by increasing primary demand; b) big first-mover advantages; c) bottling operations are more flexible; and d) short- to medium-term they face traditional substitutes (water, coffee, and tea)
  - Demographics
  - New age beverages – Coke and Pepsi are attacking these categories themselves (*'total beverage company'*). Brand dilution? OR less profitable business in the future?
  - Private label
  - Growing power in the distribution channel

- What is happening in the Indian soft drink industry? How do the major developments affect smaller competitors?
  - Both players are being aggressive to gain the first mover advantage
  - Almost all big local soft drink manufacturers have been acquired
  - Other local drinks are not big and are of low quality
  - Substitute – Mineral water emerges as the biggest threat
  - Coke uses well-connected anchor bottlers that are very experienced in bottling operations around the world, and Pepsi takes a larger equity stake with local partners. In India, Coke is buying bottlers (?)
  - Coke and Pepsi are alleged to adopt some unfair practices
  - They are increasing their reach (especially in high per capita income zones) by using traditional/new channels such as mobile vendor(s)
  - In India, What would you advise Coke and Pepsi to do?

Summary

- How firms create and exercise market power
- Looking at the underlying economies of the firm and the industry
- Industry structure is not always exogenous, it can be endogenous
- Classic case of ‘smart’ competitors – when they go to war, they kill the bystanders, not themselves