

# Case Study

## Cola Wars: Coke Vs Pepsi

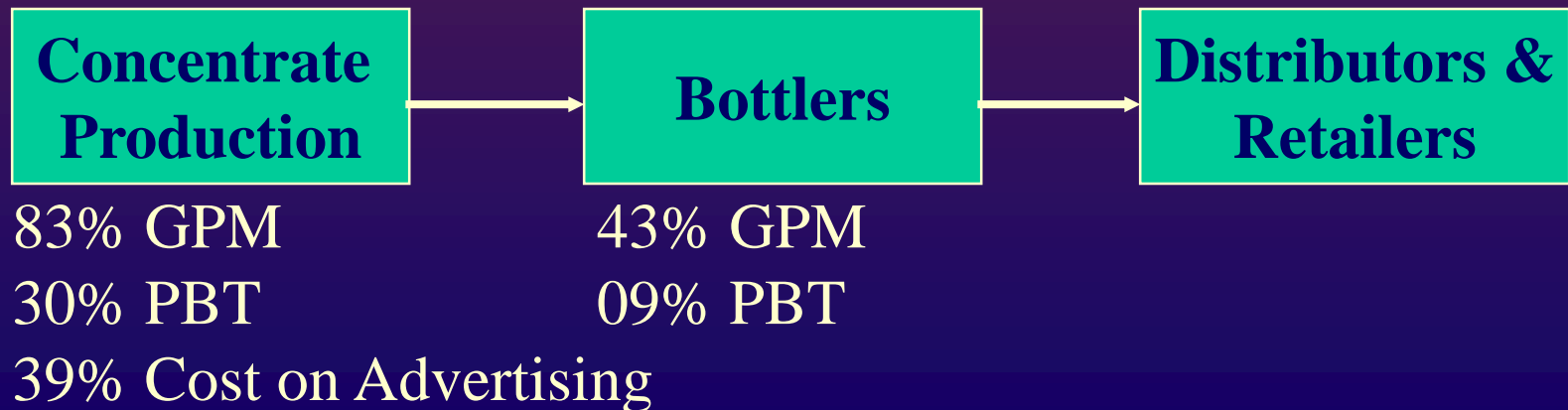
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# Introduction

- ❖ Which is the most profitable legal business in the history of the industrial world?
  - ❖ Cola
- OR
- ❖ Selling colored sugar water





# 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?

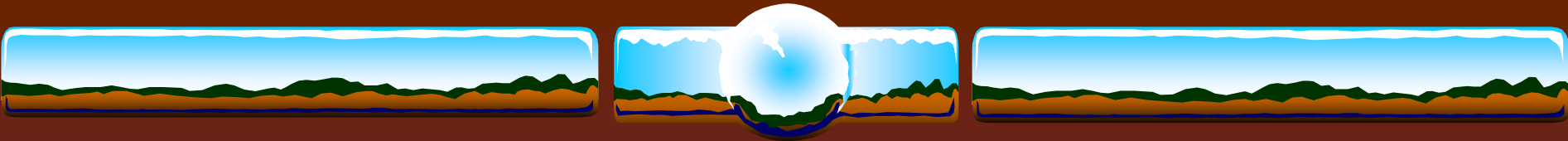
❖ Substitutes are not always conveniently available

❖ 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!



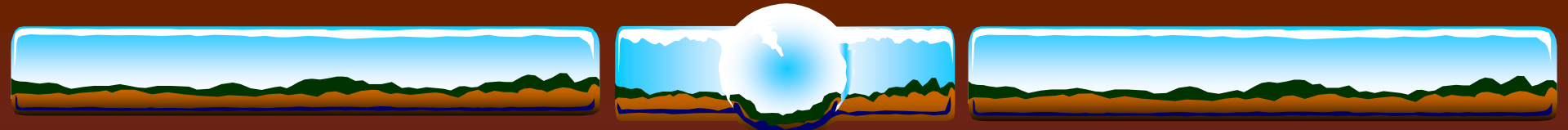
## ❖ Buyers

- ❖ 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

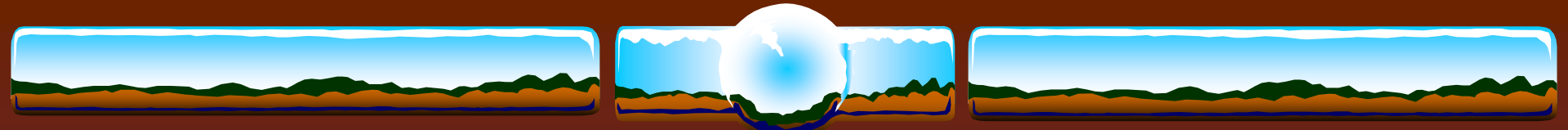


## ❖ Rivalry

- ❖ 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

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- ❖ 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 efficiencies

## ❖ 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

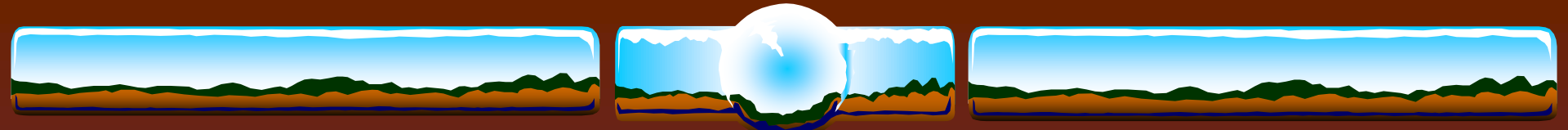
- ❖ Why should Coke and Pepsi buy their bottlers, since, bottling is a less profitable business?
  - ❖ Bottlers weakened due to Cola wars
  - ❖ Why did Coke attack independent Pepsi bottlers – not company owned bottlers, in responding to the Pepsi challenge?
  - ❖ Independent bottlers will not fight 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

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- ❖ 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