Perspective

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Restructuring in Consumer Products

Pursuit of Coherence Drives M&A Agendas

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EXECUTIVE SUMMARY

The CPG industry is poised for the next wave of portfolio shuffling. Leading companies will increasingly build their product offerings around distinctive capabilities systems, which will lead to more asset swapping and M&A activity as brands migrate to those environments in which they will thrive.

It used to be enough to be big, but the traditional benefits of scale in manufacturing, marketing, and distribution are no longer sufficient to ensure success. Instead, scale around a select system of differentiated capabilities is the key to superior results on an ongoing basis. This realization is prompting many companies to rethink their portfolio and investment strategies.

This shift toward organizing around distinctive capabilities systems has been under way for at least a decade. According to our research, the companies that have emerged as the winners in recent years have focused their strategies, including their M&A agendas, on leveraging a system of three to six differentiating and mutually reinforcing capabilities. They have reorganized their businesses and constructed a product and service offering around that capabilities system.

Companies that want to excel as the industry reorganizes will need to double down on building capabilities that differentiate, focus on a few areas where they can truly win, and rigorously streamline their organization and portfolio to put the most energy and resources behind bigger, more thoughtful bets. A coherent capabilities system is the new and right type of scale in the consumer products sector.

CAPABILITIES ARE THE NEW SCALE

For much of the 20th century, growth in the consumer products sector was predicated on scale. Acquiring sheer size helped consumer packaged goods (CPG) companies compete. It furnished leverage in negotiations with retailers, clout in marketing and media buying, and economies in sourcing, production, and distribution. Through the early 1990s, scale conferred supply chain power and consumer access, and it erected formidable barriers to entry. It also drove an astonishing wave of consolidation.

In the 1980s and 1990s, consumer products giants converged and merged with startling frequency—Nabisco with Standard Brands and then R.J. Reynolds, Philip Morris with General Foods and then Kraft Foods, and, ultimately, Kraft with Nabisco.[1]

ConAgra absorbed 280 acquisitions from 1975 through 2000, at which point it was a collection of 90 independent operating companies spread across the entire food chain.[2] Also as the result of a string of acquisitions, Sara Lee had by the end of the 1990s a product portfolio that encompassed everything from Sara Lee bakery products to Ridsect insecticides to Hanes underwear and Coach leather goods.[3] Between 1965 and 1990, Unilever made 540 acquisitions, including seven that exceeded £100 million (US$156 million) in value in the last seven years of that period.

In a consumer market where retailers are fragmented and mass media channels are not, size matters. And as markets become ever more global, scale continues to be persuasive in opening doors in emerging markets.

But these "bigger is better" benefits have been steadily eroding for more than a decade as retailers have consolidated power while mass media channels splinter. Powerhouses such as Walmart, Costco, and Aldi have redefined the retail channel by allowing small manufacturers to achieve scale with a single account. Digital and cable fragmented media have transformed a captive audience into a horde of demanding individual consumers. Technology developments have reduced volumes for minimum efficient scale (MES). Partnerships and outsourcing provide the ability to realize scale benefits even without the corresponding volume. Patent terms expire, and competitors can readily copy technology or other intellectual property.

Today, it is possible for a small, focused CPG manufacturer to achieve virtual scale in sourcing, production, and even marketing and sales without amassing cumbersome assets.

This is a fundamental reset for an industry built on assets. For decades, CPG companies have made market participation decisions based on the assets that they *have*—at sufficient scale to exploit opportunities in the underserved markets they've identified—or that they can *acquire* or *build* to serve big areas of demand. To a remarkable extent, however, their strategic thinking has ignored what they *do* better than anyone else—what allows them to execute better than the competition and deliver superior returns on those assets. In other words, they have underplayed their capabilities.

By "capabilities," we mean specifically the interconnected people, knowledge, IT, tools, and processes that enable a company to execute better than the competition in a given industry or business.[4] But the magic of capabilities is how they align and integrate to form a mutually reinforcing capabilities system.

Through rigorous focus and constant refinement, a capabilities system can become a powerful competitive advantage. It is intricate, interdependent, complex, and cross-functional, and, as such, it is very hard to insinuate or replicate. In a world where products obsolesce and patents expire, a winning capabilities system enables a company to endure and prosper.

The challenge in identifying the system's three to six winning capabilities is to move beyond those repeatedly hailed in CPG market strategies and annual reports—consumer insight, innovation, trade promotion, supply chain management, sustainability—and drill deeper.

For example, if a core capability is innovation, is it geared to rapid-cycle flavor development (e.g., confectionery) or the highly regulated rigors of clinical trials (e.g., OTC healthcare)?

Take the U.S. household product manufacturer Church & Dwight. It has developed two distinct and winning innovation capabilities, one focused on pioneering developments in categories where the company is already the market leader (such as with its Trojan condoms/lubricants) and another oriented to maintaining fast-follower status in niches where it has a unique value proposition (with its Arm & Hammer and OxiClean laundry products, for example).

The failure of many large CPG companies to embrace capabilities as opposed to assets as the fundamental driver of value creation has cost them dearly, according to our research. Indeed, many have lapsed into incoherence through years of acquisitions, brand extensions, and adjacency plays that ultimately did not draw on the company's winning capabilities system. These companies lost focus, and their performance suffered.

The companies that have kept their leading edge are those that have consciously cultivated a set of three to six differentiating and mutually reinforcing capabilities and constructed a product and service offering around that capabilities system. These winning companies have focused their strategy and their portfolio on what they do exceptionally well. That means, oftentimes, divesting products and categories that don't fit their chosen approach to the market or their distinctive capabilities. It means funneling disproportionate resources to those functions and initiatives that are capabilities-consistent. The move toward a capabilities-driven strategy

Profiles in Coherence: A Tale of Two Giants

Procter & Gamble and Unilever are two industry giants that have recognized the importance of capabilities coherence.

P&G

Over the past 10 years, Procter & Gamble has led the industry by implementing a capabilities-driven strategy. It has steadily divested much of its food portfolio and moved heavily into beauty and personal care to better leverage its differentiating capabilities in global branding and technology-driven innovation.

During the late 1990s, P&G's margins suffered as marketing dollars and R&D resources were diffused over too broad a portfolio. A disproportionate share flowed to new product initiatives designed to surface the next blockbuster product, while long-standing franchise brands like Tide and Crest suffered. By mid-2000, when A.G. Lafley took over as CEO, the company was losing share in seven of its top nine categories in the U.S. and had lowered earnings expectations four times in two quarters.

After a massive restructuring program initiated by Lafley, P&G is now refocused on driving growth from its core—big brands, big customers, and big countries. And it is newly focused on those categories where its distinctive capabilities give it a right to win. P&G has acquired Clairol, Wella, and Gillette, strengthening its positions in beauty and personal care, both high-return businesses where the company's differentiating capabilities can generate strong results and, in the case of beauty, rapid global growth.

Take Olay as an example. Here was a tired product your mother and grandmother used, but by applying P&G's distinctive capabilities to a category where it had a right to win—beauty—the company was able to revitalize the product and turn it into a billion-dollar global brand, driving tremendous growth in the category.

Meanwhile, P&G divested snack, beverage, and other non-core food businesses (for example, Crisco and Sunny Delight). Many of its major food brands (such as Jif and Folgers) have ended up with J.M. Smucker, which, unlike P&G, has a well-honed capabilities system for managing staple food products and applying product and packaging innovation to them.

P&G's results speak for themselves. The company has more than doubled sales since 2000. By the time Lafley left the company in early 2010, its portfolio of billion-dollar brands had grown from 10 to 22, and the number of brands with sales between $500 million and $1 billion had increased fivefold. Moreover, the company's market capitalization has more than doubled, making P&G one of the five most valuable companies in the U.S. and among the 10 most valuable companies in the world.

In the recent recessionary environment, during which consumers have backed away from branded goods and migrated toward private labels, P&G has felt the pressure. But the company has not wavered from its strategy and the underlying belief that big brands and innovation are what matter over the long haul. Through concerted mass marketing programs, P&G has been able to communicate to consumers the value of important innovations to its core brands.

Unilever
A consumer products behemoth built by acquisitions, Unilever has confronted an even more challenging path to capabilities coherence. While it has arrived later to the party and results are indeterminate, it, too, has been making concerted efforts to focus its portfolio around top brands in core sectors (such as food) with a specific emphasis on growth in emerging markets.

Under its "Path to Growth" strategy, the company eliminated roughly 1,200 of its brands to focus on 400 regionally or globally powerful brands. It has exited nonstrategic businesses such as fragrances and industrial dry cleaning and made large acquisitions in its core food and home/personal care categories, including Ben & Jerry's, Best Foods, and Sara Lee's personal care business.

Moreover, the company has made concerted efforts to strip out unnecessary complexity by focusing brands around one formulation, one packaging design, and one marketing strategy. This "One Unilever" plan has also resulted in a significant management restructuring, including the downsizing of 20,000 jobs.

Historically strong in the developing world, Unilever has targeted these higher-growth markets with even greater intensity. According to Unilever's 2009 annual report, nearly 50 percent of its revenues are derived from emerging markets and it sells its products in more than 170 countries.

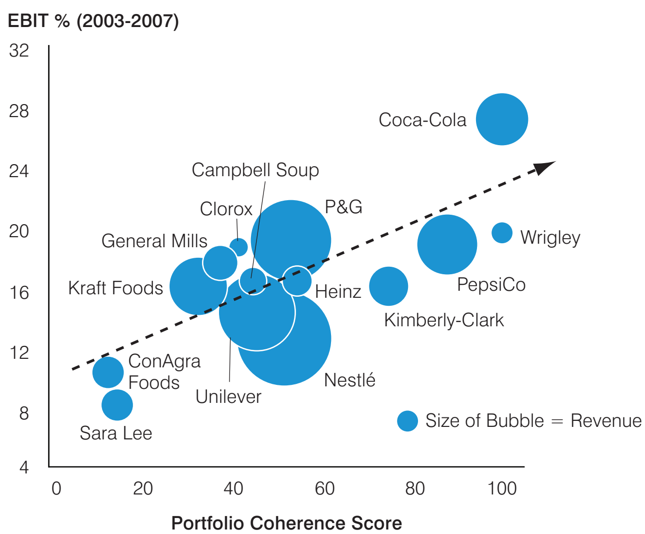
Unilever is proof that it is never too late to evolve. While still a work in progress, Unilever's focus on core brands, a streamlined organizational model, and categories where it has a right to win (as witnessed by its recent bid to acquire personal care player Alberto Culver) has resulted in performance improvements.

requires difficult and definitive choices and has far-reaching implications for all aspects of the CPG business model. In fact, consciously building a winning set of capabilities will increasingly reconfigure the entire industry, as assets and products migrate to where they will thrive (*see "Profiles in Coherence: A Tale of Two Giants"*).

Already, CPG companies are realizing the rewards of reestablishing focus on an aligned set of key capabilities. We call this the "coherence premium," and we've established its existence through a growing body of in-depth industry research that establishes a strong correlation between coherence, as we define it (*see "Coherence Explained"*), and superior performance over time (*see Exhibit 1*).

Exhibit 1
Companies That Leverage Capabilities Systems Create Superior Value

COHERENCE AND PROFITABILITY IN THE CONSUMER PACKAGED GOODS INDUSTRY



Our approach to scoring coherence is similar across industries and can be distilled into three essential steps.

Step 1: Define the segments each company serves.

Step 2: Identify the capabilities that drive value for the company in each segment.

Step 3: Determine the number of common capabilities across all the segments the company serves.

This score is mapped against EBIT margin to determine the coherence premium.

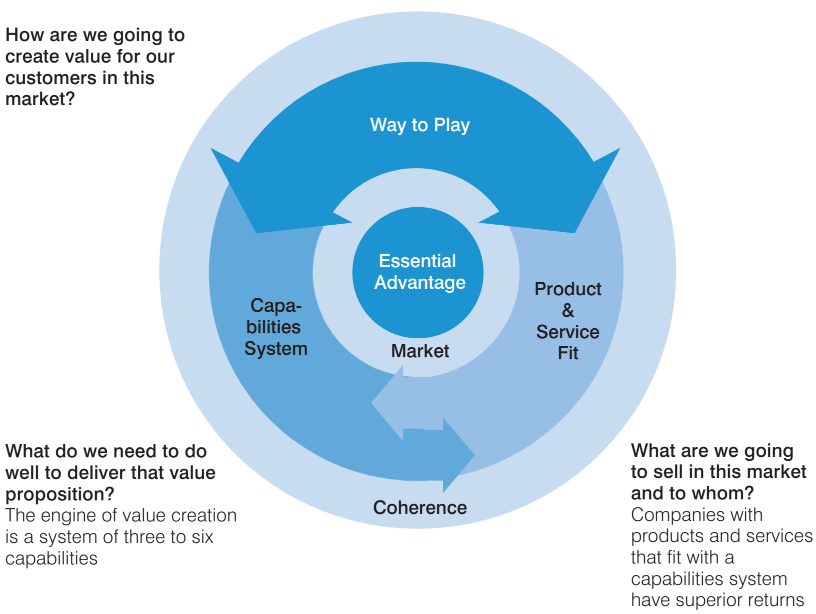
Source: Booz & Company; Capital IQ; Bloomberg

Coherence Explained

For a company to be described as "coherent," it must be resolutely focused and clear-minded in three critical ways: in the way the company creates value in the market (its chosen "way to play"), in the integrated system of capabilities it deploys, and in the products and services it provides to its customers.

The goal is balance: A coherent company strikes a balance in which the product and service portfolio naturally thrives within a capabilities system consciously chosen and implemented to support a deliberate way to play (*see Exhibit A*). Companies that achieve this balance, in our experience, earn the "right to win" in their competitive space over the long term.

Exhibit A
The Power of Coherence



Source: Booz & Company analysis

SUCCESSFUL M&A INCLUDES A CAPABILITIES COMPONENT

In the last 10 years, leading CPG companies have recognized the incoherence penalty and begun organizing their business, their approach to market, and their product and service portfolio around distinctive capabilities systems. Their performance reflects the wisdom of such a strategy.

We identified and evaluated the top 50 M&A deals by transaction value in the consumer staples industry since 2002 to assess performance one and two years after the deal announcement. We classified the rationale of each transaction as either capability building (leveraging one or both companies' distinctive capabilities), diversification (moving away from the core business into an unrelated area), or scale consolidation (expanding in the same market to capitalize on economies of scale and synergies). Companies enjoying returns in excess of the S&P 500 index one year out were deemed "winners" and those lagging behind the S&P were determined to be "losers."

Notably, there were no diversification plays in the industry's 50 largest transactions since 2002. Consumer products companies have recognized in recent years the cost of incoherence and are increasingly focusing on building portfolios that leverage a few distinctive strengths, rather than adding disparate categories simply to gain size or establish or expand a geographic presence.

Among the deals we evaluated, 32 were classified as scale consolidation and 18 as capability building. Interestingly, the ratio was reversed when it came to sorting winners from losers. Sixty-seven percent of capability-building transactions were deemed winners, while only 44 percent of scale consolidation deals beat the S&P 500 one year out (*see Exhibit 2*).

Furthermore, the performance gap widens over time. Capability-building plays, on average, returned to shareholders a 15.4 percent increase in the value of their investment after one year, versus 4.8 percent for scale consolidation transactions. Two years out, capability-building returns were nearly 25 percent on average, versus negligible returns of 0.1 percent on scale consolidation moves (*see Exhibit 3*).

The increasing complexity and customization required to access consumer markets around the world require greater skill, not scale. Scale still matters, to be sure, but it is scale around capabilities rather than assets that will differentiate the winners in consumer packaged goods moving forward.

Many companies have already recognized this basic truth and are reorganizing and reallocating resources accordingly. They have explicitly articulated their winning capabilities system and defined their core businesses, brands, and markets accordingly. They have preferentially allocated people and funds to these core businesses, brands, and markets. They have tuned all of their business processes—from R&D to sales and marketing—to support this focus. They have developed a talent development strategy centered on recruiting, training, and retaining those employees skilled in winning capabilities. And they have targeted these capabilities in building an M&A agenda.

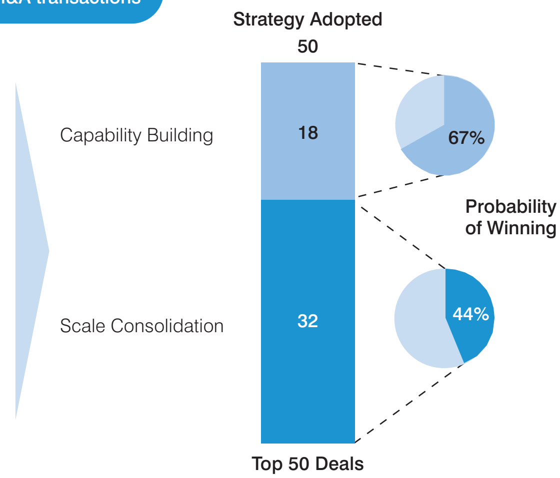
The increasing complexity and customization required to access consumer markets around the world require greater skill, not scale.

Exhibit 2
Capability-Building M&A Transactions Prove Most Successful in CPG

Capability-building M&A transactions have a 67% chance of winning vs. 44% for scale consolidation M&A transactions

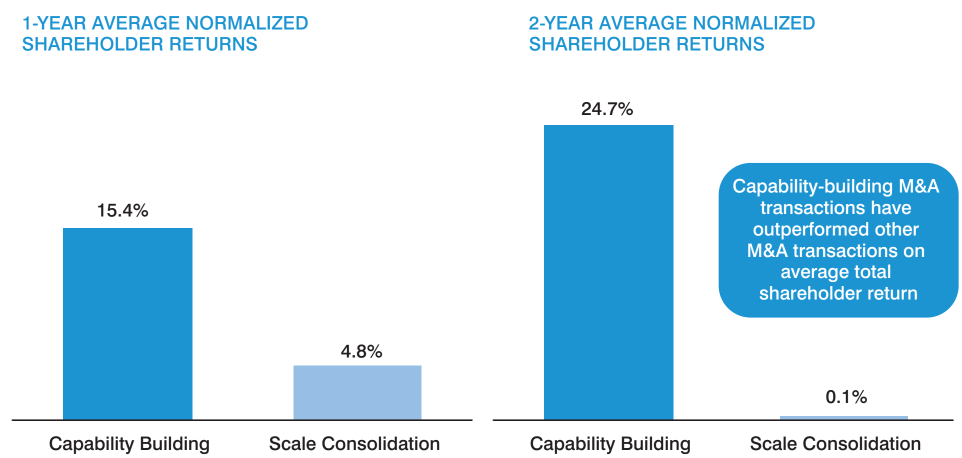
Strategy Definition

STRATEGY	DEFINITION
Capability Building	- The acquiring company either leverages an existing capability to benefit the acquired company or derives benefit from a capability in the acquired company - The acquisition enables both companies to leverage the unique capabilities of each to achieve sustainable growth
Diversification	- The acquiring company moves away from its core business through acquisition of an unrelated business
Scale Consolidation	- The acquired company produces the same product or service - The acquisition produces economies of scale and achieves synergies by removing duplicative activities



Note: Analysis is based on the top 50 acquisitions of U.S. headquartered targets by transaction value announced after 2002 in the consumer staples industry. One-year shareholder return for each company was normalized using the S&P 500 index; companies registering returns in excess of the S&P 500 index for the same period were considered winners.
Source: Capital IQ; Booz & Company analysis

Exhibit 3
Capability-Building M&A Transactions Deliver Superior Returns



	Capability Building	Scale Consolidation	Capability Building	Scale Consolidation
Number of Deals	18	32	18	32
Transaction Value	$119B	$160B	$119B	$160B

Note: Analysis is based on the top 50 acquisitions of U.S. headquartered targets by transaction value announced after 2002 in the consumer staples industry. Both 1-year and 2-year shareholder
returns for each company were normalized using the S&P 500 index.

HOW CAPABILITIES ARE DRIVING THE CPG M&A AGENDA

The CPG industry has gone through multiple waves of M&A driven by quests for efficiency through size, geographic expansion, and, most recently, alignment of portfolios against advantage-sustaining capabilities. While elements of each wave are ever present in industry M&A agendas, the game changing plays of late, as we've demonstrated, have focused on moving CPG portfolios toward greater coherence.

Mars's 2008 takeover of Wrigley furnishes a window on the future, acquisitions that build on a common set of winning capabilities that fit within an overall brand portfolio. One of the most consistently profitable consumer goods companies over the last several decades, the Wm. Wrigley Jr. Company is a case study in capabilities coherence. Founded in 1891, this Chicago-based confectioner stuck to its gums, quite literally, for more than a century, branching out into mints and candies only with its acquisition of Life Savers and Altoids in 2004.

This 120-year-old business has consistently owned its category with a honed capabilities system based on rapid-cycle flavor and packaging innovation and front-of-store execution. It was Wrigley that came up with the blister pack of gum—an innovation that tripled the price per pack. And Wrigley quickly outflanked first mover Listerine PocketPaks in the breath strip market when it exercised its winning capabilities to fill checkout shelves with five flavors before Listerine could launch two.

Wrigley's rigorous capabilities focus paid off handsomely in April 2008 when chocolate giant Mars swept in with a rich $23 billion all-cash offer for the company.[5] Mars's decision to leave Wrigley intact as a stand-alone business based in Chicago suggests that this acquisition was not

A case study in capabilities coherence, Wrigley stuck to its gums, quite literally, for more than a century.

motivated by scale as much as by an interest in marrying its own strengths in sales, marketing, and distribution with those of Wrigley.

Mars has since transferred its non-chocolate brands, Starburst and Skittles, to Wrigley's portfolio to leverage Wrigley's differentiating capabilities and stimulate the growth of these brands. Mars knows chocolate. Wrigley knows gums and candy. Together, the combined company knows how to launch and market confectionery products—both locally and now globally. Mars CEO Paul Michaels summed it up best when he said the deal was "not about being bigger—it's about being the best."[6]

More recently, Kraft's acquisition of Cadbury reveals a similar move toward capabilities coherence. Through this transaction, not only has Kraft broadened its portfolio in a growth category and strengthened its geographic footprint in Europe and Latin America, but it has also gained greater access to convenience stores and other profitable immediate consumption channels where Cadbury is very strong. Kraft and Cadbury have highly complementary portfolios, market positions, and capabilities. Confectionery is a high-margin category with good growth trends, particularly in emerging markets. The sales forces can cross-sell each other's products in underpenetrated markets. The transaction is coherent; it makes capabilities sense.

Of course, given the sheer size and diversity of many CPG portfolios, the move toward capabilities coherence is often witnessed in what a company divests rather than what it acquires.

ConAgra Foods has made concerted efforts to reverse the incoherent effects of its acquisition binge by shedding non-core businesses, including a number of its meat businesses, to focus on manufacturing and marketing higher-margin, branded products to retail and food-service customers.

Sara Lee has undertaken three major restructurings in the last decade and has divested its manufacturing facilities and select non-core brands including its Coach, Hanes/Playtex, and Champion apparel lines, and its global body care and household businesses. Since 2005, the company has sold or spun off businesses representing approximately 40 percent of its annual revenues in an attempt to focus on a food and beverage portfolio that leverages its strongest capabilities. As this Perspective goes to press, the company may be in its final stages of breaking into two separate and coherent businesses.

While the global economic meltdown temporarily put the brakes on CPG M&A, it is now clear that this sort of capabilities-driven asset swapping will continue. Consider Unilever's recent bid for Alberto Culver and Bimbo's bid for Sara Lee's bakery business. In fact, we can expect sector M&A to increase over the next five years as consumer markets settle into a "new normal." As the levee breaks, the macro themes driving industry M&A will be growth categories and access to emerging markets, especially the BRIC countries (Brazil, Russia, India, and China), but the underlying glue will be capabilities.

CAPABILITIES POINT THE WAY AHEAD

As consumer products companies look to expand, a single-minded focus on scale is not enough. Growth cannot come at the cost of coherence, as too many CPG companies have learned. Instead, companies must identify their differentiating capabilities and build product and service portfolios around them.

The global economic crisis of the past few years has catalyzed important long-term trends that, in turn, exacerbate the need to get the CPG model right. The consumer packaged goods sector is on the brink of the largest space reallocation and assortment simplification it has likely ever seen. The nature of competition will change, favoring strong brands that find the capabilities systems that drive their particular advantage, meaning much clearer and cleaner portfolios, and a more articulate definition of value through M&A.

The winners on this re-leveled playing field will not necessarily be the absolute biggest, but they will be well capitalized and will have high levels of portfolio coherence based on differentiating capabilities that can be extended across multiple markets. CPG companies have realized that it is easier and better from a financial perspective to realign a product portfolio around a few winning capabilities than to try to create the capabilities set needed to compete successfully in peripheral categories.

As CPG companies evaluate potential acquisition and merger candidates, they need to apply a lot more emphasis up front to assessing the capability benefits of a deal. Beyond the cost synergies or geographic expansion opportunities, does this acquisition leverage common or complementary capabilities systems to make the combined portfolio more coherent?

That investigation does not close with the transaction. Many times in our experience, companies have discovered a deal's hidden gems only after the due diligence is concluded and the merger completed. Realizing the full value of these hidden gems requires an open, thoughtful, and adaptive integration process.

When managed well, capabilities not only drive value for a portfolio of businesses but also define the composition of that portfolio. Consumer packaged goods companies are increasingly recognizing that capabilities-based strategies are a powerful tool for navigating a rapidly evolving marketplace and creating essential advantage.

Endnotes

[1] Steffen M. Lauster and J. Neely, "The Core's Competence," *strategy+business,* Spring 2005 (www.strategy-business.com/article/05105), supplemented by en.wikipedia.org/wiki/Nabisco.

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