

# Case analysis of the soft drink industry



Caveats The only limitations on access to information were: 1. Financial information has not yet been made available for 1996. 2. The majority of the information targets the end consumer and not the sales volume from the major soft drink producers to local distributors. 3. There was no data available to determine over capacity.

### Socio-Economic

Relevant Governmental or Environmental Factors, etc.

The Federal Government regulates the soft drink industry, like any industry where the public ingests the products. The regulations vary from ensuring clean, safe products to regulating what those products can contain. For example, the government has only approved four sweeteners that can be used in the making of a soft drink (Crouch, Steve).

The soft drink industry currently has had very little impact on the environment. One environmental issue of concern is that the use of plastics adversely affects the environment due to the unusually long time it takes for it to degrade. To combat this, the major competitors have lead in the recycling effort which starting with aluminum and now plastics. The only other adverse environmental impact is the plastic straps that hold the cans together in 6-packs. These straps have been blamed for the deaths of fish and mammals in both fresh and salt water.

### Economic Indicators Relevant for this Industry

The general growth of the economy has had a slight positive influence on the growth of the industry. The general growth in volume for the industry, 4-5

percent, has been barely keeping up with inflation and growths on margins have been even less, only 2-3 percent (Crouch, Steve).

#### Threat of New Entrants

#### Economies of Scale

Size is a crucial factor in reducing operating expenses and being able to make strategic capital outlays. By consolidating the fragmented bottling side of the industry, operating expenses may be spread over a larger sales base, which reduces the per case cost of production. In addition, larger corporate coffers allow for capital investment in automated high speed bottling lines that increase efficiency (Industry Surveys, 1995). This trend is supported by the decline in the number of production workers employed by the industry at higher wages and fewer hours. This in conjunction with the increased value of shipments over the period shows the increase in efficiency and the economies gained by consolidation (See table 2).

Table 2

General Statistics: Year Companies Workers Hours Wages Value of Shipments

Year	Companies	Workers	Hours	Wages	Value of Shipments
1982	162	42.485	27.841	6807.519	8341.585
1983	18	2417	320.819	8439.881	78.511
1985	219	8514	1437.277	89.119	358.219
1986	133	535.573	59.772	0686.819	8711
1987	119	035.471	510.452	200619	8811
1988	113	535.271	810.782	3310.319	8910
1989	102	733.467	710.982	3002.119	9094
1990	132	65.711	482	3847.519	9131
1991	966.811	852	5191.119	9229.861	612.462
1992	260.419	932	7224.419	9427.456	913.392
1993	28188.519	9526.254	513.862	9152.519	9625
1996	2552.114	323	0116.5		

Source: Manufacturing USA, 4th Ed.  
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Further evidence of economies is supported by the increased return on assets from 1992-1995, as shown in table 3. Coke and Pepsi clearly show increased return on assets as the asset base increases. However, Cadbury/Schweppes does not show conclusive evidence from 95 to 96.

Table

3CADBURY/SCHWEPPE93949596ASSETS2963100326690035015004595000  
SALES3372400372480040296004776000NET  
INCOME195600236800261900300000Sales/Income5. 80%6. 36%6. 50%6.  
28%Income/Assets6. 60%7. 25%7. 48%6. 53%

COKEASSETS11051934120210001387300015041000SALES1307386013963  
0001618100018018000NET  
INCOME1664382217600025540002986000Sales/Income12. 73%15. 58%15.  
78%16. 57%Income/Assets15. 06%18. 10%18. 41%19. 85%

PEPSIASSETS20951200237058002479200025432000SALES2197000025021  
0002847240030421000NET  
INCOME374300158800017520001606000Sales/Income1. 70%6. 35%6.  
15%5. 28%Income/Assets1. 79%6. 70%7. 07%6. 31%

Source: Compact Disclosure

Capital RequirementsThe requirements within this industry are very high. Production and distribution systems are extensive and necessary to compete with the industry leaders. Table 4 shows the average capital expenditures by the three industry leaders.

Table 4  
Dec-95  
Dec-94  
Jan-94  
Jan-

93  
Receivables 1624333138576712266331077912  
Inventories 867666.

7803666. 7777366. 7716673. 7  
Plant &

Equip 5986333579536752466004642058  
Total

Assets 15022667140555001299790011655411  
Source: Compact Disclosure

The magnitude of these expenditures causes this to be a high barrier to entry.

### Proprietary Product Differences

Each firm has brands that are unique in packaging and image, however any of the product differences that may develop are easily duplicated. However, secret formulas do create a difference or good will that cannot be duplicated. The best example of this is the “ New Coke” fiasco of 1985. Coke reformulated its product due to test marketing results that showed New Coke beat Pepsi 47% to 43% and New Coke was preferred over old Coke by a 10% margin. However, Coke executives did not take into account the good will created by the old Coke name and formula.

The introduction of New Coke as a replacement of Coke was met by outrage and unrelenting protest by the public. Three months from the initial launch of New Coke, management apologized to the public and reissued the old Coke formula. Test marking shows that there is only a small difference in actual product taste (52% Pepsi, 48% Coke), but the good will created by a brand can have significant proprietary differences (Dess, 1993). This is a high barrier to entry.

**Absolute Cost Advantage** Brands do have secret formulas, which makes them unique and new entry into the industry difficult. New products must remain outside of patented zones but these differences can be slight. This leads to the conclusion that the absolute cost advantage is a low barrier within this industry.

**Learning Curve** The shift in the manufacturing of soft drinks is gravitating toward automation due to speed and cost. However, industry technology is low and the manufacturing process is not difficult, therefore the learning curve will be short and will have a low barrier to entry.

**Access to Inputs** All the inputs within the soft drink industry are commodity items. These include cane, beet, corn syrup, honey, concentrated fruit juice, plastic, glass, and aluminum. Access to these inputs is not a barrier to enter the industry.

**Proprietary Low Cost Production** The process of manufacturing soft drinks is not a proprietary process. The methods used in the process are relatively standard within the industry and the knowledge needed to begin production can easily be acquired. This is not a barrier to entry.

**Brand Identity** This is a very strong force within the industry. It takes a long time to develop a brand that has recognition and customer loyalty. "Brand loyalty is indeed the HOLY GRAIL to American consumer product companies." (Industry Surveys, 1995) A well recognized brand will foster customer loyalty and creates the opportunity for real market share growth, price flexibility, and above average profitability (Industry Surveys, 1995). Therefore this is a high barrier to entry.

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**Access to Distribution**Distribution is a critical success factor within the industry. Without the network, the product cannot get to the final consumer. The most successful soft drink producers are aggressively expanding their distribution channels and consolidating the independent bottling and distribution centers. From 1978 to the present, the number of Coca-Cola bottlers decreased from 370 to 120 (Industry Surveys, 1995). In addition, 31.9% of the soft drink business is in supermarkets, where acquiring shelf space is very difficult (Santa, 1996). This is a high barrier to entry.

**Expected Retaliation**Market share within the industry is critical; therefore any attempt to take market share from the leaders will result in significant retaliation. The soft drink industry is a moderately mature market with slow single digit growth (Industry Surveys, 1995). Projected growth rates are 4-5% in sales volume and 2-3% in margin (Crouch, Steve). Therefore, growth in market share is obtained by stealing share from rivals causing retaliation to be high in defense of current market position. This is a high barrier to entry.

**Conclusion**To be successful on a large scale, the high capital requirements for manufacturing, distribution, and marketing are high barriers to entry. Therefore the threat of new entrants is low making this an attractive industry.

**Suppliers**Supplier concentrationSupplier concentration is low due to the fact that the main ingredients are sugar (cane and beet), water, various chemicals, and aluminum cans, plastic and glass bottles. There are many places to get sugar and ingredients for soft drinks because they are commodity items. The containers (aluminum cans, bottles etc.) make up 36

percent of all the inputs that the industry uses. Other supplies like sugars, syrups and extracts account for 23 percent of the inputs (Manufacturing USA).

There are five major suppliers of glass bottles. Altrista Corp., Anchor Glass Container, Glassware of Chile, Owens Illinois, and Vistro Sa are the major makers of glass bottles (Compact Disclosure). This is a fair amount of suppliers considering that only five percent of soft drink sales are in glass bottles. There are even more suppliers of plastic bottles. This is good because 43% of all sales are from plastic bottles (Prince, 1996). All this makes the concentration for glass and plastic suppliers moderate.

The aluminum can industry is even older and more established than the plastic industry. Reynolds Metal Products, American National Can Company and Metal Container Corp. are the main suppliers of aluminum cans. 50.6% of total soft drink sales are packaged in aluminum cans (Prince, 1996). Since the aluminum industry is older and more established, these are likely to be the only manufacturers for a while. Even though the concentration of aluminum producers are low there are only three major players in the industry, Coke, Pepsi, and Cadbury. These three account for nearly 90% of domestic soft drink sales (Dawson, 1996). This makes the balance of power slightly favor the suppliers of aluminum cans, even though the number of producers and buyers are equal (3).

Syrups and extracts account for 16.7% of input costs to the soft drink industry (Manufacturing USA, Fourth Ed.). Even though these are a small percentage of inputs, all the major soft drink companies own companies that



produce flavoring extracts and syrups (Industry Surveys, 1995). This is probably due to the fact that they all have “ secret formulas” and this is how they protect the secret. Coke, Pepsi, and Dr. Pepper all have “ secret formulas”. This makes the concentration of suppliers for extracts very low but they are owned by the soft drink industry. This backward integration by the major players makes the power question moot.

Suppliers do have limited power over the soft drink industry. The concentration of suppliers remains relatively low, which would seem to give the supplier power. The sheer mass and volume that the industry buys negates that effect and balances, if not tips it back toward the soft drink industry.

#### Presence of Substitute Inputs

There is not a lot of variety in inputs. The biggest substitute input was when the industry switched from aluminum cans to plastic bottles. This made the glass industry almost shake out completely. The next big substitute input was for sugar. Since people were demanding more and more ways to lose weight and consume fewer calories, the diet soft drink exploded in sales. This demand made the soft drink industry find an alternative to sugar to sweeten their product. This substitute turned out to be Nutrasweet non-sugar sweetener. This was found to reduce the calories and retain the taste of their respective products. Other sweeteners, like molasses, do not work because they change the flavor of the product. Most of these substitute inputs had already taken place so they become less relevant to the industry as time marched on.

Substitute inputs usually do not become important until the customer or market changes dramatically. This happens when new studies come out from the government about how harmful something is. This was the case when scientists came out with the study that stated that saccharin was harmful to rats. The industry had to respond by reducing its use of saccharin and look for a substitute. At this time, the industry found Nutrasweet to be a reasonable substitute for saccharin, which was used more heavily in diet drinks.

All in all, there are a lot of substitutes for packaging but not for sweeteners because these sweeteners must have government approval (Crouch, Steve). This makes suppliers have power over the industry as seen in the almost overnight empire of Nutrasweet. This will most likely change drastically when Aspartain (NutraSweet) loses its patent in a few years.

#### Differentiation of Inputs

Sugar is commonly available while Nutrasweet is patented. There is no differentiation for sugar and only one choice in Nutrasweet. As far as the other chemicals and inputs, they are commodity items, and it does not matter who supplies them. This makes suppliers have little power over the soft drink industry.

#### Importance of Volume to Supplier

The soft drink industry buys a large portion of the Nutrasweet market but their percentage of purchases are falling as other products begin to use it. Sugar is bought but not in the volume that the grocery store or other

industries do. The aluminum can, plastic bottles and glass bottles (less now) are all pretty much dependent on the soft drink industry for their livelihood. This makes the supplier have pretty much no power over the industry.

#### Impact of Input on Cost or Differentiation

Since the inputs are basic elements there is no differentiation and therefore no impact on the final product for using different inputs. If the price of the input changed, it would dramatically change the price of the product as the aluminum cartel did in 1994. Since the major inputs are commodity items, the prices can change dramatically due to environmental forces. If the sugar industry suffers a loss due to weather or because of political unrest (like in Cuba), then the prices go up and the soft drink industry is usually left absorbing them. The soft drink industry can not, in all cases, simply pass along the price increase. Customers and distributors are more price sensitive than ever. This makes the supplier have a fair amount of bargaining power over the industry.

#### Threat of Backward or Forward Integration

With the current climate of “ sticking to the core of the company,” there is little threat of backward integration into the supplier’s industry. This is after the fact that they already have integrated into the extracts to protect their secrets. The integration into the extract-producing segment of the suppliers will be the extent of the backward integration. The suppliers do not have the capital required to forward integrate into the soft drink industry. This makes the industry attractive for investment.

### Access to Capital

The soft drink industry is very profitable and therefore looked upon favorably by financial institutions. This includes the stock market, direct investors (bondholders), and banks. Currently the operating margins for the industry have grown from 17.9% in 1992 to 19.5% in 1996. The projected operating margins are projected to grow to 20.5% from 1997 to 2001 (Value Line 1996). The profit margins and demand are increasing for the soft drink industry (Industry Surveys, 1995). What this means is that capital is available for expansion or upgrading, if additional capital is required. This is favorable to the industry.

### Access to Labor

The industry is not highly technical except for chemical engineering. This means that the demands for skilled labor are not very high. Which means that the soft drink industry will not have trouble finding labor. There are no established labor unions. The average labor cost is no more than in any other industry. The average hourly wage is \$11.85 per hour, which just about the same as all manufacturing firms of \$11.49 (Manufacturing USA).

### Summary of Suppliers

When you sum up the different aspects of the suppliers you come to the quick conclusion that the power is definitely in the hands of the soft drink industry. This makes the industry very attractive for investment and for the companies already in the industry from the supply aspect. This means that it is attractive to new entrants as well.

## Buyers

### Buyer Concentration versus Industry Concentration

The buyers for the soft drink industry are members of a large network of bottlers and distributors that represent the major soft drink companies at the local level. Distributors purchase the finished, packaged product from the soft drink companies while bottlers purchase the major ingredients. With the consolidation that has occurred within the industry, there is little difference between the two.

Distributors are assigned to represent a specific geographic area, for example a town or a county. In turn, these distributors are responsible for distributing the product to the retailers who sell the products to the end consumer. In recent years, the national companies have been purchasing independent bottlers in an effort to consolidate the business and gain some distribution economies of scale (Thompson and Strickland, 1993).

### Buyer Volume

The contractual agreements, which are present in this industry, dictate that the major soft drink companies will sell their products to the distributors. Therefore, buyer volume is not a factor for this industry.

### Buyer Switching Cost

Independent bottlers have contractual agreements to represent that company within a certain area. Switching costs would include establishing

new relationships with other companies to represent and the legal costs associated with distributors being released from the contract.

### Buyer Information

Distributors are very informed about the product that they are distributing. Information flows freely between the soft drink Companies and the local distributors and down to the retailers. There are many co-operative promotions where distributors and soft drink companies collaborate on price and advertising campaigns (Crouch, Steve). For example, major soft drink firms will send a regular report out to its distributors describing upcoming promotional events where the cost will be shared between the two companies. For promotions that fall outside of this report, the distributors will have to coordinate that sponsorship with the soft drink company.

### Threat of Backward Integration

It is doubtful that local distributors will move into the actual production process of soft drinks. Distributors specialize in the transportation and promotion of the product that they rely on the carbonated beverage companies produce.

However, major retailers; for example Wal-Mart and Harris Teeter have begun distributing their own private label brands of soft drinks. Wal-Mart now offers Sam's Choice and Harris Teeter offers President's Choice at a significantly lower price. These private label competitors will not provide the variety of packaging alternatives, which make the national leaders so successful (PepsiCo 1995 Annual Report). For example, Pepsi offers 12-

ounce cans, 20 ounce bottles, 1 liter bottles, six packs, twelve packs, cases and “ The Cube” 24 can boxes.

### Pull Through

Pull through is not a factor from the independent bottler’s perspective.

These bottlers have a franchise agreement to represent a major carbonated beverage company on the local level. These distributors are legally bound to represent these companies and therefore cannot choose not to promote certain types of beverages.

### Brand Identity of Buyers

Brand identity of buyers is not relevant to the distributors because of the contractual relationship that exists where distributors represent the soft drink companies. The distributors have an exclusive contractual agreement to represent that soft drink brand.

### Price Sensitivity

Distributors are not highly price sensitive buyers. Independent bottlers are on a national contract so all distributors pay the same price for the same products.

### Price to Total Purchases

Soft drinks are the single product that the distributors are concerned with so price is very important to them. Soft drink companies rely on these distributors to represent them on the local level, so it is important to maintain a healthy relationship.

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## Impact on Quality and Performance

All three of the leading carbonated beverage producers, Coca-Cola, PepsiCo, and Cadbury Schweppes believe that their buyers (distributors) are an important step in taking their products to the end consumer. The service, which their distributors provide to the retailers, makes a difference to the retailers who sell the product to the end consumer. The actions of that distributor reflect on the soft drink company so if the distributor does not provide the level of service that retailer or restaurant desires, it may harm the company's image.

## Substitute Products

### Relative price/performance relationship of Substitutes

The carbonated beverage industry provides a non-alcoholic means of satisfying an individual's desire to quench their thirst. Traditionally, coffee and tea would be considered substitute products. In recent years, carbonated beverages have seen the emergence of many new substitute products that wish to reduce soft drink's market share. The soft drink market has been traditionally competitive, without the added friction from "ready to drink tea, shelf stable juice, sports drinks and still-water" competitors also. (Gleason, 1996) Leaders in these emerging segments include Quaker Oats, with their Snapple and Gatorade products, Perrier, and Arizona Iced Teas. "In other words, Pepsi isn't Coke's biggest competition, Tap water is." (Gleason, 1996). Generally speaking, soft drinks are less expensive to the consumer than these substitute products.



## Buyer Propensity to Substitute

Buyer propensity to substitute is low due to the contractual relationships between the soft drink companies and the distributors.

## Rivalry

### Degree of Concentration and Balance among Competitors

Three main competitors: Pepsico, Coca-Cola, and Dr. Pepper/Cadbury control the Soft Drink industry. Their combined total sales revenues account for 90 percent of the entire domestic market. This market dominance makes the industry a fiercely competitive and dynamic business environment to operate in. The single market leader is Coca-Cola with a 42 percent market share and over \$18 billion in sales worldwide. PepsiCo maintains a 31 percent market share with \$10.5 billion in sales worldwide. The smallest of the three leaders is Dr. Pepper/Cadbury, which holds roughly 16 percent of the market. Coke's consistent dominance of both Pepsi and Dr. Pepper/Cadbury has caused Coke to become a household name when referring to soft drinks.

As far as balance among competitors is concerned, PepsiCo is a much larger company than Coke and Dr. Pepper/Cadbury combined. The reason being that PepsiCo also owns companies in the snack and food industries (Frito-Lay, Pizza Hut, Taco Bell, and KFC). With a work force of 480,000 people, PepsiCo is the world's third largest employer behind General Motors and Walmart. This has not led to a more profitable soft drink business, nor has it

helped PepsiCo use its size to steal market share from Coke or Dr. Pepper/Cadbury.

### Diversity among Competitors

Though Coca-Cola dominates the industry in sales volume and market share, it does not dominate when it comes to innovative marketing and business strategy efforts. For instance, PepsiCo generates 71 percent of its revenues from the U. S., while Coca-Cola derives 71 percent of its from international markets. Similarly, PepsiCo only gets 41 percent of its total revenues from soft drinks. The remaining 59 percent come from its snack and food business. Coke on the other hand gets all of its revenues from its soft drinks. Clearly both of the industry leaders have different strategies as far as revenue generation is concerned.

However, as far as their product lines are concerned they are very similar and operate parallel to one another. Pepsi and Coca-Cola both have lemon-lime, citrus, root beer, and cola flavors. Dr. Pepper/Cadbury does not have as similar a product line to that of Pepsico and Coca-Cola. It manufactures Dr. Pepper (a unique spicy cola drink), ginger ale, tonic water, and carbonated water under its Schweppes and Canada Dry brands. Coke does have an answer to Dr. Pepper in its Mr. Pibb, but only holds a . 4 percent market share compared to Dr. Peppers 6 percent market share. The relatively low level of diversity makes the soft drink industry unattractive for investment.

### Industry Growth Rate

Although new product lines have come into the beverage industry over the past two to three years, the soft drink segment has held and grown its share steadily. The onslaught of the sport drink and bottled tea have proven to be a passing fad that has gained little if no long term market share from soft drinks. Growth figures for the soft drink industry have been very steady since 1993, and are projected to continue to be so into the last part of the twentieth century. As can be seen in Figure 1, volatility was somewhat prevalent in the 1980's but has since lessened and leveled off (Valueline, 1996).

Figure

Year	'87-'88	'88-'89	'89-'90	'90-'91	'91-'92	'92-'93	'93-'94	'94-'95	Growth
	5.7%	5.2%	2.3%	2.9%	4.4%	4.4%	4.4%	5.7%	5.2%

Over the past ten years soft drinks have gained 5 percent of total beverage sales, putting them over the 25 percent share level for all beverage sales. As for new and emerging markets, both Coke and Pepsi are attacking the international environment. Coca-Cola generates 80 percent of its revenues abroad, and Pepsi is attempting but failing to put more emphasis there as well. "Pepsi is losing customers to Coke in every major foreign territory. The company has always struggled overseas, but in the past few months it has lost key strongholds in Russia and Venezuela to Coke" (Sellers, 1996). Because of the consistent growth of both the domestic and foreign markets, the soft drink industry is attractive for investment.

Fixed Costs

The S&P Industry Survey has shown the soft drink industry profit margin to be on a steady incline over the past fifteen years. Levels in 1980 were near 14%, while as of year-end 1995 were over 20% and expected to flatten a bit. This flattening effect may be an indication that fixed costs are on the rise due to expansion