The lull before the storm

*With falling costs, companies need to rethink their strategic responses write Raju Bhinge and Bobby Pauly*

The Indian FMCG sector is witnessing a remarkable phase. Revenues have been declining steadily while profits are on their way up. Several large Indian and multi-national companies, including HLL, Tata Tea, Colgate and Gillette have reported negative volume and top-line growth. In a study conducted by TSMG, we found that the top ten FMCG companies have recorded a cumulative quarter on quarter sales decline of 7 to 5 percent over the last three quarters while simultaneously recording a profit growth of up to 14 percent during the same time period.

While numerous reasons, ranging from consumer down-trading, competition from regional brands, monsoon failure, high taxation and a distinct shift towards consumer durables have been attributed to the declining sales, none of them hold water on their own. Noted professor and management guru, C.K. Prahalad challenged each of these explanations. He has commented that substantial value engineering and other cost reductions in durables have led to a 25 – 40 percent drop in consumer prices and increased sales for the players. The same trend is yet to occur in non-durables. Companies have tended to hold consumer prices despite cost economies from sourcing, supply chain and logistics thereby pocketing fatter profits in the process.

**Crystal gazing: What does the future hold?**

So, what does the future hold? What factors are likely to shape the industry in the next few years? Going forward three factors could have significant impact.

1. **Indirect Taxation:** With a proposed CENVAT of 14%, the abolition of CST and the move towards a uniform state level VAT at 12.5% (within which all local taxes, eg. entry-tax, luxury tax, octroi etc. will be merged), the indirect tax burden on Indian products could fall from an average of 30% to about 20-22% of sale price (as estimated by the Kelkar Task Force).

2. **Import Tariff:** Import duties are likely to decline from the current average level of about 26% to an average of about 10% by 2006-07. This decline could lead to a potential drop of 4-6% on retail price depending on the extent of import parity priced inputs.

3. **Overheads:** Reduction in interest rates, procedural simplification and infrastructure improvement (roads, ports, and telecom) are likely to further reduce costs, improve efficiency and decrease cycle times.
Declining costs

All these changes are likely to result in a significant discontinuity; ‘a 20 – 25% compression in the costs of consumer non-durables’: 8-10% from indirect taxes (subject to complete implementation of Kelkar recommendations), 4-6% from reduction in import tariffs on inputs, 1-2% from softer interest rates, 2-3% from overall scale economies arising from larger volumes and another 4-6% through pro-rata drop in margins. This is a significant discontinuity that could alter the sagging fortunes of consumer non-durable companies.

Implications for Incumbents and New Entrants

Recent studies have indicated a high price elasticity of almost 300% for certain mass consumer products: i.e. a 10% drop in prices could lead to a 30% increase in consumption. Considering a near 20% decline in costs, there could be a substantial increase in consumption, should the incumbents decide to pass on the benefits to the consumer and realise long term returns. This could well be the panacea to the ailment of declining sales volumes. Alternatively, the incumbents could retain prices and continue to pocket short term profits as they have been doing in recent times. This has led to the mushrooming of several regional and local brands (a la Gold Winner Oil, Ghadi detergent) who are carving away share from the established players.

At the same time, there is also scope for new players to acquire market share through quality products at lower prices. Brands like Pataka Chai, Anchor tooth-paste have already started re-defining the price value equation and are gaining market share. New players, unlike the incumbents, are in a position to start from a clean slate, set up lean organizations and offer quality products at significantly lower prices. In doing so, they could achieve sizeable market shares and perhaps, expand the market itself.

Strategic Responses

How should consumer non-durable companies respond to this evolving situation? Should they pass on the benefits of lower costs to the consumer or can they hold prices and pocket higher profits? What will be the response from local/ regional players? Companies need to chart their strategic responses. The responses could vary from company to company in the same
sector, from category to category within the same firm and even from brand to brand within the same category. Companies need to decide based on a complex mix of factors.

Two of the most significant factors that companies need to evaluate are Retail Market Share and Competitive Intensity. While Retail Market-share embodies impact of brand equity, distribution strength, price value gaps etc, competitive intensity encompasses impact of number of players and pricing flexibility. Based on the above, consumer non-durable companies could be divided into four categories that can help guide their responses (Exhibit 2: The Strategy Matrix)

**Leaders:** The leaders are ahead of the pack. They are clearly supreme in their segment, and do not have to face the ire of stiff competition. They could hold prices of their leading brands and pocket higher margins with minimal risk of losing customers. Consider the case of Johnson’s Baby products; with clear market leadership and low competition, J&J could well hold prices and pocket substantial profits. This however, could lead to mushrooming of local/regional brands at lower price points offering superior price-value trade-offs. Leaders could counter this by launching flanking brands at competitive prices or initiate promotions to sweeten the deal for consumers until they have effectively nipped the local players.

**Defenders:** Defenders are in the thick of things. While they have high market-share, they are also in a segment with high competition. Brands like Colgate, Coke & Pepsi would fall into this segment. They need to protect market share at all costs. Like Coke and Pepsi have done in recent weeks, the defenders need to initiate drop in consumer prices and move ahead on the price-value equation. This will enable them to retain market share lest it be eaten into by the competition.

**Challengers:** The new entrants belong to this category. They could either aggressively attack the incumbents on price; or match prices and introduce temporary sweeteners like consumer and/or trade promotions to capture market share. The much publicized Dandi salt has done the latter by
providing high trade margins to capture retail shelf space. In either case the challengers need to ensure growth not only in market share but also profits.

**Warriors:** The warriors have a battle on hand. They are straddling aggressive competition on the one side and low retail acceptance/share on the other. It is their moment of reckoning. The warriors need to produce differentiated offerings and perhaps even lead a price war to capture retail market-share. Take the case of Anchor toothpaste, which has successfully countered competitors like Colgate and HLL and captured appreciable market share through a differentiated product (100% vegetarian toothpaste) at considerably lower consumer prices. Failing such a proposition, the warriors may well end up fighting a losing battle.

All this augers well for the Indian consumer who has never had it this good. She now has a plethora of choices at every conceivable price point. Simultaneously, a host of new needs and wants beckon: durables, housing, entertainment, healthcare, travel, education... The household budget now has to cater to many more competing demands. What this means is a unique situation, where the consumer exercises choices not just within categories, but across categories ushering in an era of consumer behaviour, where the traditional notions of value, price and consumer spending will get redefined.

**The lull before the storm**

*There is a storm brewing!* The stagnation we are witnessing today is the lull before the storm. The tempest that engulfed sectors like durables and telecom leading to intense competition and vibrant growth will soon impact non-durables as well. Consumer non-durable companies urgently need to revisit their strategic choices. Past track record and profit growth is no guarantee for future success. In the consumer non-durables market, there is a churn in the making. Regardless of how the future evolves for individual players, one thing is certain; the consumer is sure to win.

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