NEW DRINKS, OLD TRICKS

The OC&C **US Beverage Innovation Index** 2009

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The Thirst for Innovation

Judging by the hundreds of new products launched every year, the beverage companies are an inventive lot. Yet, many of these new products are mere line extensions and few are breakthrough innovations.

OC&C separates the true innovators from the copycats.

More than ever, product innovation in the beverage industry is an important tool when faced with shifting market dynamics.

- **Categories are maturing.** The majority of segments – including RTD beverages, functional drinks, tea, coffee, water and carbonated soft drinks – are expected to experience slower or even negative growth in the next five years
- **Fast changing consumer preferences continue to support strong growth in niche segments and specialized product formats**
- **Pricing pressure is affecting many categories as private label and value brands gain prominence.** Branded players are finding they need to add real value to their products in order to justify higher prices and keep retailer products at bay
- **Media outlets are becoming increasingly diversified.** With consumers distracted by the internet and able to skip TV commercials, branded products are no longer the only name of the game. Innovation and marketing are becoming increasingly complementary

WHAT HAPPENS AFTER A NEW PRODUCT IS LAUNCHED?

It is little wonder therefore that beverage companies recognize the importance of innovation and invest heavily. In fact, despite the downturn, they have not reduced their R&D investments, the right response for maintaining portfolio relevance when the recession ends.

However, the majors have generally failed to lead the innovation pack. Most are launching an increasing number of products but many are only line extensions and few are truly innovative. Through imitation or acquisition, the larger players have managed to fill the innovation pipeline and protect the core. Nonetheless, these protectionist strategies have often inhibited the development of more long-term value creating innovations.

Recognizing these problems, beverage companies are increasingly opening their innovation models to the outside world, through partnership and collaboration.

All the larger players are currently experimenting with platforms and processes for incubation, venture capital, and second stage growth development. Models will have to be customized to fit the players' position and culture but will likely be an important driver for competitive strengths.

While innovation is experiencing a surge in interest, it is poorly audited and measured. Many studies are concerned with measuring innovation volume and velocity: who is putting out new products and how fast. Very few studies monitor the early adoption and development years to track what happens after a new product is launched and whether innovation has helped the firm align its portfolio with the most recent consumer trends.

Thus OC&C has decided to rectify this and to measure innovation in a more robust way, by gauging the staying power of new product development and its alignment with trends.

Methodology

OC&C has developed a straightforward methodology to compare innovation performance in the U.S. beverage industry, benchmarking players along 5 key dimensions:

- Two "Positioning" dimensions
  - "Portfolio Dynamism" measures the extent to which the company is positioned on growing segments
  - "Alignment With Trends" measures the proportion of new products launched that offer benefits aligned with the major consumer trends observed over the last few years
- Three "Execution" dimensions
  - "Intensity" measures how many new beverage products the company has launched in the last 2 years
  - "Availability" indicates whether products introduced over the last 12 months are successful by looking at their availability on retailer shelves
  - "Sustainability" indicates whether products introduced two years ago have "stuck" on retailer shelves

Sources used to conduct this study include market research, company accounts, and 30 store checks in the Los Angeles, New York and San Francisco metropolitan areas.

Scores against each dimension were normalized on a scale of 1 to 5 and weighted equally to calculate the total score (see exhibit 1).

Exhibit 1:
Summary of Results

	Portfolio Dynamism	Alignment with Trends	Intensity	Availability	Sustainability	Overall
1	Red Bull	Red Bull	PepsiCo	Dr Pepper Snapple	Ocean Spray	**Red Bull**
2	Hansen	Hansen	Coca Cola	Kraft	Kraft	**Hansen**
3	Unilever	Water of America	Hansen	Ocean Spray	Red Bull	**PepsiCo**
4	Kraft	Unilever	Kraft	PepsiCo	Coca Cola	**Kraft**
5	PepsiCo	Sunny Delight	Nestlé	Red Bull	PepsiCo	**Coca Cola**
6	Nestlé	Nestlé	Sunny Delight	Coca Cola	Hansen	**Ocean Spray**
7	Coca Cola	Coca Cola	Dr Pepper Snapple	Unilever	Nestlé	**Unilever**
8	Water of America	Ocean Spray	National Beverage	Nestlé	Dr Pepper Snapple	**Nestlé**
9	Ocean Spray	Kraft	Ocean Spray	Hansen	Unilever	**Dr Pepper Snapple**
10	Sunny Delight	PepsiCo	Unilever	National Beverage	Sunny Delight	**Sunny Delight**
11	Dr Pepper Snapple	Dr Pepper Snapple	Red Bull	Sunny Delight	Water of America	**Water of America**
12	National Beverage	National Beverage	Water of America	Water of America	National Beverage	**National Beverage**

The Economic, Ecologic & Health Context

While the economic downturn has affected all categories of the US beverage market, decreases in growth rates are particularly noticeable in the premium segments. Consumers are trading down for familiar and cheaper soda brands, or out, in the case of bottled water, by adopting Brita or PUR products. Some beverage companies have responded to this trend by introducing smaller and cheaper bottles and refocusing on carbonates, mainly through innovative packaging.

The switch to tap water is also an indication of the rising importance of environmental concerns. The number of non-alcoholic drinks launched described with the words 'sustainable', 'environmentally-friendly' or 'eco-friendly' increased to 95 SKUs as of June 2009 compared to 70 SKUs for all of 2008. Larger beverage firms have reacted by introducing more eco-friendly plastic and glass bottles.

However, an ageing US population and concern over obesity have created a structural move to natural, functional and "better-for-you" beverages that is unlikely to be reversed by the economic downturn or the environmental trend.

For instance;

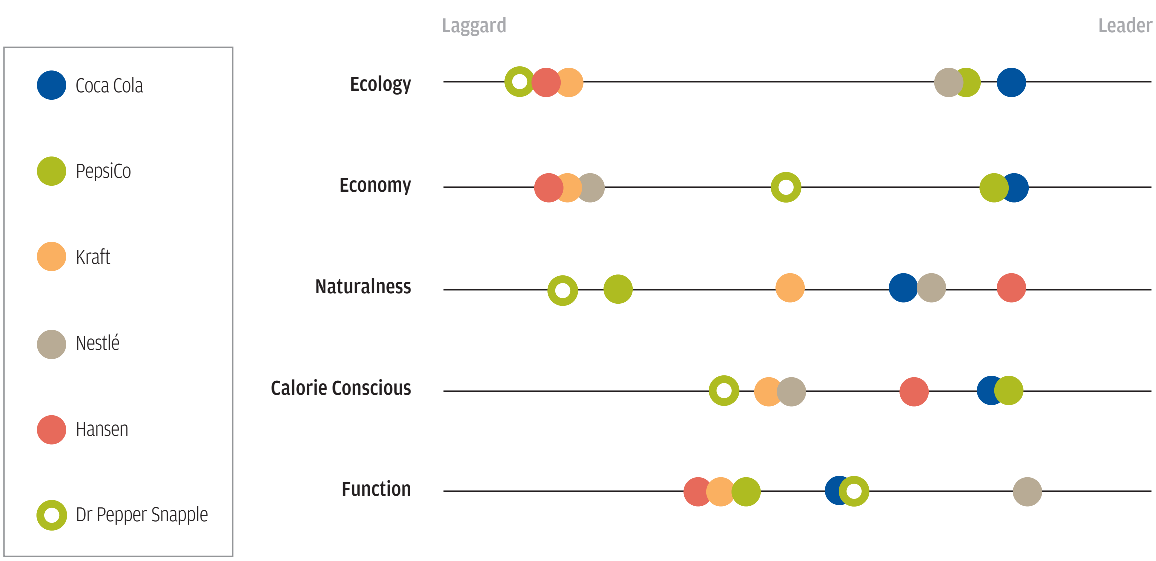
- Recent concerns over the health effect of artificial products (sweeteners, flavors, HFCS, etc.) is boosting sales of products branded as “all natural”. This has lead to the reformulation of drinks to include sugar or “sweetness from fruit” and the introduction of new organic products
- “Better-for-you” CSD, a $13bn industry, is expected to keep growing at a rate of 6% p.a. – as compared to -2% for the CSD market as a whole - as consumers continue to switch from carbonates to “healthier” alternatives (or at least those perceived as such). This year a lot of attention was put on the all-natural low-calorie stevia sweetener
- “New Age” drinks claiming functional benefits, also a $13bn industry, will continue growing at close to 9% p.a. Recent trends include the introduction of new super-fruits (acai, goji, yumberry, kombucha) and probiotic, a renewed interest in green tea, and the development of beauty and brain development functional beverages by leading brands (Aloe Vera, Marigold, DHA, etc)

Everybody Can Do Better

Competitive performance is very mixed in terms of innovation. The top 2 players in the energy category - Red Bull and Hansen Natural - appear best positioned to capture future growth, thanks to their strong positions in functional beverages. Through a series of acquisitions, PepsiCo has repositioned its portfolio to tap into new categories and emerging trends. The Coca-Cola Company is following the same path (by acquiring Glacéau Vitamin Water in 2007 and Honest Tea in 2008) but remains more dependent on the sluggish CSD segment. Dr Pepper Snapple's portfolio is still stuck in stagnant categories and Nestlé was penalized this year due to its over-exposure to the bottled water segment.

While all major players have launched many products aligned with recent trends (see exhibit 2), The Coca-Cola Company was one of the most active on the environmental front, by introducing a series of eco-friendly packages. Red Bull and Hansen Natural had the highest proportion of recently introduced products aligned with trends, but Nestlé was clearly the most active on the health and wellness side, with products being introduced in all major sub-segments of the functional space (e.g. brain development, bone reinforcement, beauty and skin care). Nestlé's extensive network of partners in universities, start-ups, and venture capital firms appears to be paying off.

Exhibit 2:
Summary View of Major Players' Alignment with Trends



Test More, Launch Less

New product development was once again very intense this year. Beverage makers are, on the whole, trying to bring tangible "news" to the market. However, only one-third of new products were entirely new variants or reformulations, rather than just a new flavor or packaging change (see exhibit 3).

PepsiCo took on the rebranding and reformulation of many of its brands and therefore topped the "Intensity" list while Dr Pepper Snapple was more focused on its reorganization and introduced very few products. Kraft has reformulated many of its core concentrate brands to align with the wellness/healthy trend.

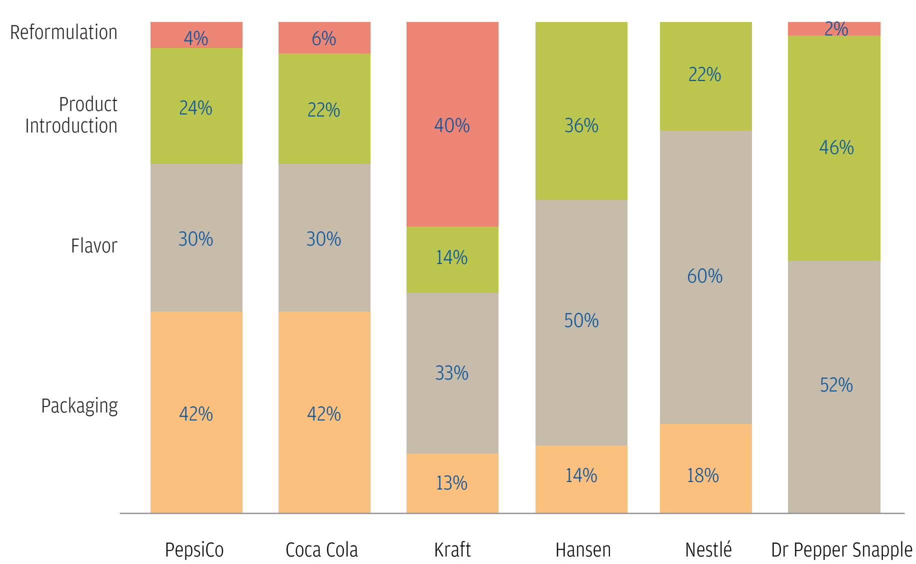
Overall, availability of products introduced over the last two years was fairly limited. While most new products were located at least once during our store checks, the percentage of stores where they were available varied widely and was often low.

Not surprisingly, companies with lower development intensity (Dr Pepper Snapple, Ocean Spray, Red Bull) have fared better than the others. They seem to have focused their resources, successfully, on few new product introductions. Kraft's performance is partly explained by a stronger reformulation activity – as these new products do not have to compete for shelf space but simply replace phased-out products.

With so many products introduced every year and such low average availability, one has to wonder how meaningful new product development is. Manufacturers may need to plan their innovation strategy better and re-think the impact their new products will have on consumers' buying behavior over the long-term. For example, the use of "limited edition" packages aims solely at short-term spikes in sales and does not typically drive long-term category leadership or sustained payback.

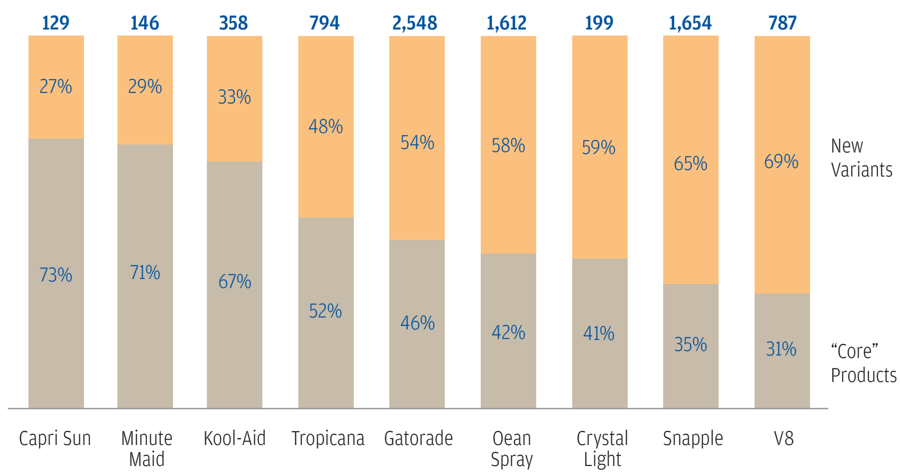
LIMITED EDITION PACKAGING IS ONLY A SHORT-TERM SOLUTION

Exhibit 3:
Innovation Intensity by Innovation Type
% of Products Introduced[1]



1. Products introduced in multiple sizes are counted once

Exhibit 4:
Shelf Space by Variant for Juices & Concentrates
Linear Shelf Space, Inches



Looking at the shelf space distribution of specific brands also highlights some interesting contrasts (see exhibit 4). The brands on the left still mostly rely on the core "regular" version product, while those on the right have successfully diversified into new variants. Brands like Crystal Light have been particularly adept at using a continuous stream of new products to maintain dominant visibility in their aisles.

Based on OC&C's field research, about 75% of new products launched were found in at least one store, with Hansen and Nestlé the only notable underperformers at 50% and 55% respectively. The biggest differences were found in the convenience channel, where PepsiCo and Red Bull distinguished themselves from their peers in their ability to place a greater proportion of their new products on shelves. Kraft and Ocean Spray did well in the supermarket and grocery channel on both availability and sustainability of new products.

Given the strong correlation between performance and innovation, we can expect to see an ever-increasing stream of new products and purported benefits coming from the beverage sector. However, beverage companies will need to do more than just load the marketplace.

Each company faces its own challenges, either to better position its portfolio or to better execute new launches. Methodical innovation strategies that get ahead of consumer trends and master the distribution game will separate the winners from the losers. As players continue to innovate, they will also need to closely manage the added complexity to the business, specifically the inevitable proliferation of SKUs that comes with innovation and the marketing dollars needed to support new product launches.

Focus on innovation and measured rationalization will continue to drive results.

Stay Focused

1. Red Bull

Red Bull has had limited but targeted and efficient product development activities over the last 2 years. The firm has entered the energy shot segment with a sugar-free version that became readily available at many convenience stores. Red Bull Simply Cola is available at many stores and in all channels.

2. Hansen Natural

This was a particularly intense year for Hansen on the innovation front. Monster Energy achieved over $1bn in gross sales for the first time in 2008, partly due to the introduction of Monster Hitman, Sniper and LoBo Energy Shooters. Java Monster was primarily responsible for the sales increase in RTD Coffee and the “coffee+energy” concept was quickly copied by most competitors. Its other brands, Hansen’s and Blue Sky, hold unique appeal in the functional and better-for-you categories (high fructose corn syrup was replaced by cane sugar in all Hansen’s Natural Sodas). Hansen Natural’s issue rests on the weak availability of its products, especially at supermarkets, and it is too early to assess the impact of the recent distribution agreements with Anheuser-Busch and The Coca Cola Company.

3. PepsiCo

With Tropicana and Gatorade, PepsiCo has demonstrated true category leadership adding new flavors, packaging, and launching healthier variants. Over the last two years, the firm has gone through an innovation frenzy, trying to reproduce such models with Amp, SoBe, and Izze, while rebranding its top brands. However, the high volume of product development has impacted the availability of its innovation on the shelves.

The presence of Red Bull and Hansen Natural at the top of our "Overall" list demonstrates that product development intensity may not be the best indicator of innovation quality.

4. Kraft Food

Long considered a dormant giant, Kraft Food has recently revitalized its concentrates business by aligning it with the health and wellness trends. The firm has added antioxidant green tea mix, probiotic and skin essential formulae to its Crystal Light line, electrolytes to Tang Sport, and many gluten-free products. Kraft has also advertised heavily the natural benefits of its existing products (e.g. low calorie, high vitamin) and has joined force with Brita and Nalgene to promote the FilterForGood.com concept.

5. The Coca-Cola Company

The Coca-Cola Company is now demonstrating its ability to react to changing consumer preferences. Coke Zero was one of the biggest and most successful product launches in FMCG history. VitaminWater, Honest Tea, and Jianchi were strategic additions to align the portfolio toward more dynamic segments. Nonetheless, the firm's launch activity is still skewed toward the declining CSD category.

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