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by Leslie Moeller, James Ryan, and Juan Carlos Webster

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A Breakaway Opportunity for "Inferior" Products

As the difficult economy causes consumers to trade down in their purchases, companies need to adjust their offerings to their customers' new behavior.

by Leslie Moeller, James Ryan, and Juan Carlos Webster

The current economic crisis is creating a "new normal" in consumer buying habits. Before the recent downturn, when consumers tried to save money, they traded down from branded products to private-label or so-called value brands. But they tended to keep buying some form of the product; they continued to pay for the convenience of, say, antibacterial throwaway wipes or gourmet frozen foods. In the current economy, they are not just trading down within a category, but switching to "inferior" products and services — paper towels instead of wipes, washcloths instead of paper towels. In the process, they are raising the value of the type of products and services economists call "inferior goods": those that attract consumers more when purchasing power declines.

This will require a major shift of focus for many consumer-oriented companies. During the past decade or so, marketers have grown accustomed to the trend known as "premiumization": Each year, consumers sought out higher-priced and more distinctive products. Sales went up for such premium goods as custom-blended cosmetics, microbrewed beer, antioxidant-laden breakfast cereals and soft drinks, and cars in every price range that featured amenities like video screens and extra cup holders.

Premiumization will never go away completely. But suddenly it has moved to the slow lane. The reason, of course, is the continuing economic downturn. In the U.S., unemployment rose from 4.6 percent to 5.7 percent between July 2007 and July 2008; average gas prices rose from US$2.90 per gallon to as high as $4.15 in one year; and real income and consumer spending have decreased dramatically. All of these factors, along with the meltdown of the mortgage and financial markets, have eroded consumer confidence to a 12-month low.

The net impact has not been gentle on premium products, even the relatively inexpensive or everyday kinds. Retail sales figures for the second quarter of 2008 showed declines of 0.7 percent for Target Corporation (versus a gain of 2.7 percent for Wal-Mart Stores Inc., which has much less of a premium focus in its category) and a significant "mid-single-digit" decline for the Starbucks Corporation. Although Target and Starbucks, the premium competitors in their particular categories, have had other difficulties, there is no denying that the market is not going their way.

The same is true for "casual dining" table-service restaurants like Applebee's and Red Lobster, which, for many of their patrons, represent a premium category. Until recently, casual dining constituted the fastest-growing restaurant segment, but now it is losing customers. Indeed, this is part of a significant shift

Leslie Moeller
(leslie.moeller@booz.com) is a partner with Booz & Company in Cleveland. He leads the firm's North American work in the consumer, media, and retail industries, and previously led the firm's global efforts in marketing and sales.

James Ryan
(james.ryan@booz.com) is a principal with Booz & Company in New York. He specializes in helping consumer companies achieve breakthrough growth via operational and organizational transformation.

Juan Carlos Webster
(juan.webster@booz.com) is a principal with Booz & Company in New York. He has extensive experience in strategy and change management for the consumer and industrial sectors.

throughout the food industry. The food component of the consumer price index has risen 7.4 percent over the past 18 months, outpacing both income (6.6 percent) and total household expenditures (6.4 percent). Faced with increasing food prices, people are forced to trade down. Previously, a consumer encountering difficult times would treat it as a temporary problem and switch food sources within a subcategory — from, say, Boston Market (where a meal might cost $12 to $13) to Chipotle (where it might cost $8 to $9). But that consumer would still patronize a "fast casual" restaurant. Now people are either switching categories to quick-service restaurants like McDonald's or decreasing the frequency of dining out altogether, switching to inferior goods such as packaged foods that they prepare at home — products that they didn't patronize in the same way before, when they perceived themselves as having more options because their purchasing power was greater.

A Trend Toward Trading Down

The idea of inferior goods might seem to confound common sense. Why would people increase their purchases of one item in difficult times? Wouldn't they cut back on everything? But there are recognized historical examples (even though there continue to be academic debates about which examples are most applicable). One classic story is that of the Irish potato. During the famine of the 1840s, almost one-quarter of the population of Ireland starved to death or were forced to emigrate. Yet even as potatoes grew scarce and their price rose, demand for them apparently increased even more than when prices were lower. Economists later hypothesized that potatoes became an inferior good; as everyone's incomes decreased, even the relatively wealthy consumed more potatoes. This further depleted the food supply for everyone.

In the present day, fortunately, a switch to inferior goods has less devastating effects. But it does have a significant impact on the food business, which is being felt not only in restaurants but across the food and consumer product categories. Kraft Foods Inc., for example, has recently refocused the marketing message of several of its brands to emphasize relative value, thus targeting consumers who are trading down from casual dining, quick-service restaurants, and food delivery. For Kraft's DiGiorno brand, the marketing message emphasizes that it costs half the price of a pizza delivered from a restaurant.

Similarly, the new normal is bad news for restaurants and bars that sell liquor, but good news for off-premise liquor retailers. Although consumers are not doing as much drinking in public, they are still buying premium brands in liquor and grocery stores. With cocktails at home being turned into an inferior good, these retailers can increase sales by stocking an assortment of premium liquors, beers, and wines, continuing the alcoholic beverage industry's past success in trading consumers up to more expensive brands.

The Scotts Miracle-Gro Company has found another way to succeed in this environment. In mid-2008, Scotts reported an interesting sales dichotomy: It was showing continued growth and increased market share in its premium segments (such as Miracle-Gro Moisture Control and Organic Choice potting soils and Nature Scapes mulches) and its lowest-priced lawn fertilizers (those without insect or weed control, selling for half the price of the premium line). Meanwhile, sales of Scotts' mid-tier fertilizers and potting soils had recently declined.

These results demonstrate two important phenomena facing the branded lawn and garden category. First, there are new consumers for premium garden supplies. They are trading down from other categories, either by taking fewer vacations (and spending more time at home instead) or by giving up contracted lawn services and doing the work themselves. They are willing to take some of the money they have saved and spend it on a premium garden and lawn. It's significant that the revenue gain from the high-end products more than compensated for the revenue loss from Scott's midrange products.

Second, core lawn-product consumers are still loyal to brands such as Scotts Miracle-Gro. They are migrating to more affordable Scotts products, but not to private-label (such as supermarket brand) goods. Even if they have less purchasing power, they still seem to have an interest in status and quality, which can be satisfied only through brand-name products. Thus, the era of the new normal is not necessarily a boon to manufacturers of private-label products and value brands. Consumers may exit such manufacturers' category altogether, and new entrants may want the benefits of a brand after trading down from a much more premium category.

Taking Advantage of the New Normal

In short, if you can attract consumers to your category from another, the era of inferior products may bring you superior opportunities. How, then, can companies maximize value in this kind of environment? Consumer-oriented companies should consider the following options when facing the current economic slowdown:

1. Don't blindly lower prices to regain volume. Simply reducing prices could well be financially disastrous; it already has been for several casual-dining restaurant chains. Across-the-board price-cutting may lower the price of a $12 meal to $9 or $10, and thus affect the perceived value of, say, Boston Market versus Chipotle, but it will not have any effect on a consumer who is opting for a $5 meal by eating at home. For restaurants, it may make sense to add some value options. But sustained success will require attracting and retaining the smaller group of consumers who still dine in the casual segment, and fixing restaurants' cost structures accordingly. Many of these chains will have to battle for survival, and success will require winning on this segment's terms.

2. Find the inferior products that will attract consumers as their purchasing power decreases. Introduce a new brand or sub-brand in the categories to which consumers are moving in this downturn. Of course, companies will run the risk of potential cannibalization, but that's still better than losing customers altogether. Retailers with their own distinctive product brands, such as Starbucks, will do more business in more non-premium channels; they may sell proportionately more packaged coffee in groceries or value retailers. Similarly, if you are a spirits manufacturer, increase the distribution and merchandising of your premium brands for consumption at home. If you are a convenience store, turn your own retail brand into an inferior good by making sure you are consistently well-stocked in the staples, like bread and milk, that people need most — so it does not pay for consumers to drive to another store like Wal-Mart when they run short.

3. Cement consumers to your brand. Once you have attracted consumers to your inferior product, bind them to your brand. Give them an experience that merits repurchase. Think about the products you can trade them up to when the economy starts to recover — for example, the health-conscious, convenient, or premium products that will make them stick to your brand as their incomes increase. The previous wave of premiumization left behind many food manufacturers. When the economy bounces back, they may have a chance to replay the game.

4. Make the new normal feel better. Downturns represent breakaway growth opportunities for those clever enough to influence consumers' attitudes; you can help consumers feel good about migrating to inferior goods by enabling them to justify their decisions in terms other than affordability. Toyota Motor Company's Prius is a great example: Consumers don't feel bad about trading in their BMW or Escalade, because they are doing their part for the environment; it's not simply that they can't afford anything more expensive. The objective is to leverage the downturn to get ahead of new trends in consumer behavior.

How long will the new normal last? It depends on the industry. In some, this will probably be a permanent phenomenon. For example, U.S. car buyers may no longer equate luxury with vehicle size; they may well continue to drive smaller, more fuel-efficient vehicles with less environmental impact. In other sectors, such as casual dining, consumers are likely to change their behavior again once economic growth and individual income growth return.

In many categories, for at least the next few years, companies will need to be prepared to effectively compete under both the old and the new normal. Brand owners and companies that offer products or services to customers across a broad range of price points, and that can manage the cycle, will fare better than those with more focused products and offerings that can't adapt up- or downstream as consumer choices change. +

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