**Teaching Note**

**Coca-Cola, Pepsi, and the Shifting Landscape of the Carbonated Soft Drink Industry**

**Teaching Objectives**

This case provides an understanding of the underlying economics of an industry and its relationship to average industry profits. The concentrate industry is, on average, more attractive than bottling. It also provides students with an opportunity to create an entry strategy for a new player in the concentrate industry.

After completing this case, students should have a much clearer understanding of the five forces that influence an industry’s attractiveness. They also should have an increased ability to analyze each of those five forces to assess and measure the overall attractiveness of a given industry. The case provides all of the needed information for students to use the supplier power and rivalry five forces tools from chapter 2.

**Study Questions**

1. Analyze the structure (Porter’s 5 Forces) of the soft drink industry. Why are Coke and Pepsi so profitable? What prevent other firms from entering this industry and accessing some of those high profits?
2. Compare the economics (costs and profits) of soft drinks (concentrate) versus bottlers. Why is the concentrate business more profitable than the bottling business? Why do you think Coke & Pepsi are in the bottling business?
3. Team Assignment: Create a 5 year proforma in Excel which projects the revenues, costs, and profits (both earnings before interest, taxes, and amortization (EBITDA) and earnings before taxes (EBT) for a company who enters the U.S. carbonated soft drink industry and who attempts to build a 10% market share position in the U.S. carbonated soft drink industry within a five year time period (please include fixed and variable costs in your analysis). To calculate interest expense, assume that you will need to raise 50% of the capital you require through bank financing at 10% interest. To calculate depreciation expense, assume that only a niche player (with less than 5% market share) can access the bottlers/distributors of Coke or Pepsi, which means you will need to build bottling plants (which you can depreciate using straight line depreciation over a 30 year life). Please provide your assumptions along with a one half page description of your market entry strategy.

**Teaching Plan**

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| I. Taste Test | 15 min |
| II. Board Exercise: Concentrate Environment | 30 min |
| III. Board Exercise: Comparison to Bottling Environment | 15 min |
| IV. Conclusion | 10 min |

*I. Taste Test*

While not required, this activity may help students understand more clearly that Coke & Pepsi are more differentiated by brand than they are by product.

In preparation for this activity, you will need a bottle of Coke, Pepsi, and generic cola. It is best to put each brand in a pitcher or other type of generic container as the two liter bottles are distinctive in appearance. Make sure you know which brand is in which container. This can be done with a number taped to the bottom of the container. Place each container on a table with a number in front of it. The students will use that number to identify which brand they think they are tasting.

Ask if any students drink a lot of cola and have a preference for a particular brand. At the end of the exercise you will specifically ask those students if they correctly identified each brand and if they chose the right one as their favorite.

Write Coke, Pepsi, and Generic on the board. Have either all or a subset of students taste a sample from each bottle and write down the number of the container beneath the brand they believe they are tasting. While some professors like to use a subset of students to speed up the exercise letting all students do the taste test really peaks their interest and engages them in the rest of the lesson. Also have the students select which cola they most like by placing an asterisk next to that selection on the board. After each student has completed the test taste, reveal to them which soda was which. Ask those who drink a lot of cola and were sure they could tell the difference if they got it right. While some may correctly identify all three, most of the students will likely not. It may also be interesting to note that some students that have a favorite cola (Pepsi or Coke) will mistakenly choose another cola as their favorite (e.g. Pepsi drinkers may mistakenly identify Coke or the generic brand as Pepsi). While with some classes the majority identify each cola correctly most of the time they do not and the generic cola is often chosen as the overall favorite.

*Question: What does it mean that you can’t tell the difference?*

The purpose of the Concentrate & Bottling Environment sections is to help students more concretely identify the sources of Coke & Pepsi’s profitability. These sections also give students an opportunity to identify what they would do to operate profitably in these environments (see Study Question #3).

*II. Concentrate Environment*

*Question: Coke & Pepsi make roughly 80% margins on a product that, according to the taste test, isn’t very differentiated at all. How can you explain how a company that sells a non-differentiated product makes higher margins than companies that make very differentiated products such as Intel or Apple?*

As students answer, help them see that the profitability does not solely come from brand equity. For example, it may be useful to refer students back to the taste test and ask a question such as: *If brand is the source of profitability, does that mean that Coke and Pepsi have convinced us that their product is better than the generic brand even though you can’t really taste a difference between them?*

During this discussion, it is likely that students will mention Coke & Pepsi’s spending on marketing and advertising ($234m & 136m respectively). As they do so, it may be useful to ask the following:

At this point, students should be describing characteristics of the competitive environment other than brand equity. A description of the concentrate industry environment is given below for reference.

This works well as a board exercise. Two approaches – one is to list the five forces on the board and fill in the various elements as students bring them up. Another approach, the one I typically use, is to ask for a five force, and then ask students to rate it low, medium, or high, and analyze why. As they do so write a summary of their analysis on the board. It is helpful to push the students to use the language from the chapter and identify the exact reasons that a force is high, medium, or low. For instance, one reason rivalry is low is because the concentrate manufacturing industry has few firms in it and they do not compete on price with their primary customers, the bottlers. Below is a simplified summary.

If you had the students use the rivalry tool as an experiential exercise when covering rivalry you may want to show the answers to five forces worksheet so students can compare it with their answers and see how a thorough analysis can inform the more informal analysis they are doing in class.

Threat of New Entrants

LOW- due to barriers such as limited shelf space\* and the high brand equities of incumbents

Competitive Rivalry

LOW - Coke & Pepsi have a large share of a shrinking market. Little price competition. Few firms in the industry.

Threat of Substitutes

HIGH – multiple substitutes – any other beverage. Get students to see how Coke and Pepsi have managed this threat by purchasing major substitute brands.

Buyer Power

LOW – The Bottlers are the buyers. They are locked into long term contracts with no ability to switch suppliers.

Supplier Power

LOW - All concentrate inputs are commodities.

\*Besides limited shelf space, limited fountain space and costs of vending distribution also create barriers to entry.

*Question: Why can’t another company successfully enter the concentrate industry by simply investing a large amount into marketing and advertising?*

If you had the students do study question #3 this would be the time to show the excel spreadsheet showing the 5 year proforma, focusing on the costs of advertising, creating a bottler network, and paying for shelf space.

*III. Bottling Environment*

*Question: Compare the attractiveness of the concentrate industry with the bottling industry? Why is the concentrate industry more attractive than the bottling industry?*

Push students to apply the 5 Forces model to compare the two industries. This works well as a board exercise. As with the concentrate manufacturers ask students for a five force, have them choose if the threat is low, medium, or high, and then analyze why.

If you had the students use the supplier power tool as an experiential exercise when covering supplier power you may want to show the answers to five forces worksheet so students can compare it with their answers and see how a thorough analysis can inform the more informal analysis they are doing in class.

A comparison between the two industries can be very instructive. At this point ask the students if the industries are attractive. On the surface both look attractive. However, you can point out that the concentrate manufacturers enjoy high profit margins while the bottlers do not. Ask the students why. While the bottling industry looks very attractive the lesson to be learned is that it can take only one of the five forces to be a major threat to industry profitability. In this case the extremely high supplier power that the concentrate manufacturers enjoy allows them to siphon off any extra profits from the bottling industry.

Threat of New Entrants

LOW- due to high capital costs to enter and exclusive contracts with Coke and Pepsi.

Competitive Rivalry

LOW – only two to three bottlers in any geographic area

Threat of Substitutes

LOW – Bottlers control most methods of bottling including glass and aluminum.

Buyer Power

MED – overall buyers are fragmented but in any geographic area supermarkets and warehouse stores are likely to represent a large percentage of sales.

Supplier Power

LOW for commodity inputs (such as glass) and Very HIGH for the soda inputs (such as Coke)

*Question: Why are Coke and Pepsi in the bottling business if it is so much less attractive than concentrate?*

Although the concentrate environment is attractive by itself, their presence in the bottling business is what protects the concentrate industry due to the increased barriers to entry. The purpose of this section is to help students understand why it would be difficult to directly enter the concentrate market and why Coke & Pepsi are experiencing such great profits.

*IV. Conclusion*

This case provides an understanding of the underlying economics of an industry and its relationship to average industry profits. The concentrate industry is, on average, more attractive than bottling.

Entry into the concentrate industry is limited by barriers to entry:

Brand Equity

Bottling/Franchise System

Limited Shelf Space

Relative to bottling, concentrate has:

Greater bargaining power over suppliers and buyers

A more attractive industry structure overall