HOULIHAN LOKEY

STRATEGIC CONSULTING | Consumer

The Re-Emergence of Private Label

How should CPG manufacturers approach this new cycle of accelerated private label growth?

White Paper

The Re-Emergence of Private Label

How should CPG manufacturers approach this new cycle of accelerated private label growth?

Private label products represent a dilemma for many consumer product companies. They are a competitive threat, but they are also the products of major customers. Branded manufacturers can compete aggressively, but will that then compromise trade relationships? As retailers increase financial and managerial commitment to their private label offerings, consumer product companies will need to execute a complex balancing act in order to manage brands and retail relationships effectively.

For brand manufacturers this may be a difficult period to navigate, a time when the economy, consumer perception, and retail commitment will favor the growth of private label and store brands. However, it is also a time when the rules can be redefined: consumer buying behavior is still evolving into a 'new normal', and many share points are up for grabs.

"Retailers have been talking about taking out #3 or #4 brands for more than a decade. We're finally starting to see that happen."

Don Knauss
Chairman & CEO
Clorox Company

IS NOW THE TIME FOR 'REAL' PRIVATE LABEL GROWTH?

Private label products have existed throughout the history of retailing. In Europe, retailers such as Boots, Marks & Spenser, and Tesco have sold private label store brands for generations. During the recession in the early 1980s, generic 'no name' brands were introduced in the U.S. as low-cost alternatives to national brands. During the late '80s and the '90s, private label growth was phenomenal, with grocery unit shares reaching over 15%. Private label share was projected to surpass 30% by the turn of the century.

But then something changed. For the last 10 years, private label unit share in the U.S. has hovered around 21%, with little sign of significant growth against national brands. A lack of investment in private label product quality, packaging design and branding unquestionably contributed to this stagnation.

According to IRI, private label unit and dollar shares rose sharply in 2008 and are expected to continue to increase. The most dramatic growth was in the grocery channel, but noticeable increases were also observed in drug, club, and other retail channels.

Why are we once again seeing this dramatic growth? Could this private label growth spurt realize the 30% forecast of the 1990s? We see six fundamental drivers of renewed growth and sustained private label penetration:

The quality gap between national brands and private label products has been reduced or eliminated.

1. **The Recession.** U.S. consumers' increased emphasis on value and affordability, a result of an economic downturn of historical proportions, is one obvious explanation for the rise in private label sales. Consumers have shown willingness to experiment with and trade down to lower-priced alternatives. Even as the economy improves, the experimentation will likely go on and it will be difficult to convince consumers to return to their previously favored brands. However, the recession alone cannot fully explain this reinvigorated private level phenomenon.

2. **Retail Landscape Consolidation.** Private label penetration has proven to be highly correlated with the level of retail concentration in a given country. Higher levels of concentration not only give retailers greater bargaining power against brand manufacturers, but also create the critical mass required for making investments in the development of more sophisticated private label programs. As the consolidation of the retail landscape in grocery, mass market, and drug channels accelerates in the U.S., an associated increase in private label penetration is expected. Today, the top five U.S. retailers represent over 35% of all retail sales in the country.

3. **Improved Product Quality.** Private label quality has improved dramatically since the days of generic products. Several recent *Consumer Reports* studies have claimed that the quality gap between national brands and private label products has been reduced or eliminated. Accordingly, consumer perception has improved substantially, creating a highly positive attitude towards private label. In a recent survey by The Nielsen Company, 63% of consumers considered private label brands to be of equal quality to national brands, and 72% of the respondents felt that private label products were good alternatives to name brands.

4. **Enhanced Retailer Capabilities.** Over the past several years, many retailers have been improving the skills and capabilities required to develop and manage increasingly sophisticated private label programs. They have hired brand and category managers from consumer product companies, invested in marketing analytics, and ramped up their innovation and branding capabilities. As a result, retailers have developed a deeper understanding of consumer needs, segmentation and targeting, as well as more holistic portfolio strategies and brand positions for their own labels.

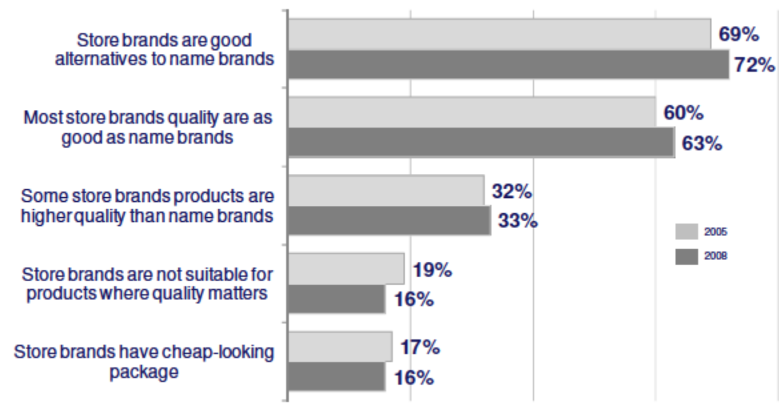
5. **Renewed Strategic Approach.** U.S. retailers are well positioned and willing to rethink their overall approach to private label, following the example of successful programs in Europe (e.g., Tesco) and Canada (e.g., Loblaw's). The traditional approach to developing low-cost, generic alternatives to national brands, targeting price-sensitive, brand-agnostic shoppers, is giving way to a much more strategic role for private label, as part of more

thoughtful shopper segmentation, category management and assortment planning strategies.

6. **The Wal-Mart Effect**. In early 2009, Wal-Mart announced that it was gearing up for an aggressive re-launch of its Great Value brand, a move that has the potential to create a step change in private label penetration in the U.S. With 5,000 products in its lineup, and representing 16% of Wal-Mart's unit sales, Great Value is already the largest food brand in the U.S. An aggressive push by the world's largest retailer will most certainly act as a catalyst for further investments in private label.

Many brand manufacturers are finding that their "brand" leverage has eroded and their product strategies must change.

U.S. Consumer's Perception of Private Label Brands Quality



Source The Nielsen Company

THE SOPHISTICATION OF PRIVATE LABEL

During recent years, we have witnessed a slow evolution of private label programs that will dramatically accelerate in the upcoming years.

The more traditional approach to private label has been to develop "store brands", which carry an explicit reference to the retailer's store banner. Tesco has mastered this approach in the U.K., and Trader Joe's (controlled by German retailer Aldi) has done extremely well in the U.S. In every case, the retailer has developed a brand identity that transcends category marketing and helps to brand the store itself.

But private label programs are beginning to produce own brands that transcend the store. Brand attributes such as "consistency", "trust", "reliability" and "innovation", for example, are enhancing the traditional "good value for the money" position. Retailers even see the opportunity to expand their private label brands beyond their own store networks. Loblaw's' President's Choice products from Canada are found on the shelves of Jewel grocery stores in Chicago due to a distribution agreement. Safeway has recently strengthened its effort to build partnerships that will grow distribution of its O Organics line of products in Asia and South America.

"We leverage our manufacturing and procurement capabilities to innovate and introduce new items that add value to our customers."

David Dillon
Chairman & CEO
The Kroger Company

Part of the magic behind these more sophisticated private label brands is an intense effort to understand consumers and shopping behavior. Retailers are grounding their private label strategies in deep shopper insight and powerful data mining, including loyalty card analysis. Dunnhumby, a U.K.-based research and marketing firm, has helped retailers such as Tesco and Kroger unlock insights hidden in their shoppers' behaviors. Through analysis of loyalty card and POS scan data, these retailers have refined their assortments, pricing, and consumer targeting efforts with significant success. Today, both Kroger and Tesco offer multi-tiered private label products, managed as part of a comprehensive portfolio.

Multi-layered approaches to brand positioning and assortment management have emerged as vehicles to attract different consumer segments to the store. After a period of copycat private label products, many retailers now understand how to use product branding and segmentation to develop unique store brands and categories for their shoppers. For example, Tesco has aligned its private label portfolio to suit each of the various customer segments and has used their own stores as a testing ground for creating unique and innovative products. Retailers are also offering a full spectrum of private label products, moving beyond the value segments into the territory of luxury and specialty sectors.

The unfortunate result of this multi-layered private label approach is that national brands are often caught in the middle in terms of price and assortment. Higher valued 'signature' private label brands are positioned above or at parity with national brands. Private label 'budget' brands are positioned to compete at opening price points and appeal to budget-conscious consumers. Often national 'name' brands are squeezed in the middle, with little room for differentiation and often unable to compete on price, and must rely on regular promotions and advertising to prompt sales.

Finally, the more established private label programs are even venturing into previously unimaginable product categories. Loblaw's, for example, has introduced a collection of 'fast fashion' clothes under its Joe Fresh brand. The effectiveness of these far-reaching initiatives is still unknown, but it demonstrates that no category is out of bounds for the incursion of private label.

RESPONDING TO PRIVATE LABEL GROWTH

Historically, consumer product manufacturers have been able to demonstrate superior value to both consumers and retailers based on their deep insights into consumer needs, proven product quality, cutting-edge innovation, and sophisticated brand marketing. On all of these dimensions, private label brands have shown significant progress and, in some cases, superiority. Many brand manufacturers are finding that their 'brand' leverage has been eroded and therefore their product strategies must change. CPG manufacturers who want to address the challenges posed by private label growth must first understand the playing field, including category-specific consumer and market dynamics, before devising appropriate responses.

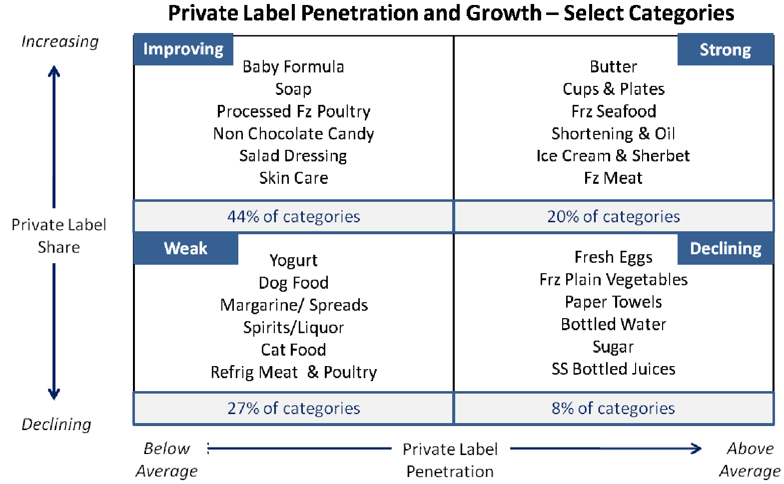
We have found that national brand manufacturers must focus on four key elements to develop more targeted responses to private label:

1. **Category characteristics**. Private label penetration is heavily skewed by product category. High private label share categories (e.g. milk, cheese, trash bags) have different competitive dynamics than the very low private label share categories (e.g., razor blades, laundry detergent, shampoo). This can be largely explained by what attributes are important to consumers and how consumers perceive certain categories. Commoditized categories tend to display higher private label penetration in comparison to categories where innovation is a major driver of consumer preference or where the risk of switching brands is perceived as high. Hence, intrinsic category characteristics will be a major influence on CPG manufacturers' responses to private label.

"Where the customer buys our type of product, we should be there."

Brenda Barnes
Chairman & CEO
Sara Lee Company

Private Label Penetration and Growth – Select Categories



Source: IRI, "Private Label 2008 – Shopping Patterns and Shifts in a Transforming Economy", 52 weeks ending 9/7/2008. 2008 vs. 2005

2. **Manufacturer position within the category**. Category concentration is another important consideration. Dominant brands typically slow private label penetration in a category, as consumer brand loyalty is slower to shift and as it takes longer for retailers to generate critical mass around a private label offering. But category concentration needs to be assessed in the context of how brands stack up in the hierarchy. If you are a strong number one or number two in a category with low private label penetration, your strategic options are much greater than if you are a tertiary brand. Third and fourth brands are highly vulnerable to displacement by private label tiered offerings.

Do you understand how your core consumer behaves with regards to private label?

3. **Level of sophistication of the retailer private label program.** Some retailers have developed their private label offerings into stand-alone offerings (e.g., Wegmans, Kroger, Loblaw's), while others rely on control label brands offered by wholesalers and buying groups. The more sophisticated the retailer's private label program, the more important it is for branded product manufacturers to develop a clear brand positioning strategy for their products in relation to the store brands.

4. **Strength of the retailer relationship.** Finally, not all retailers are created equal. Manufacturers must segment their retail customers the same way they segment their consumers. Sales volume, growth, profitability, strength and length of relationship will all influence the relative position of brands in the store, shelf space allocation, price strategy, and promotional intensity. In many cases, manufacturers will not be able to fight private label brands promoted by a key retail partner and will have to determine a way to co-exist and differentiate their products alongside the store offerings. Ultimately, the consumer determines the assortment strategy. Too many private label products and too few national brands may frustrate shoppers looking for their favorite brand.

BRAND MANUFACTURERS MUST CHOOSE THEIR STRATEGIES WISELY

Branded consumer product companies who choose to ignore or combat private label will inevitably find themselves at odds with their own customers. These companies need to consider several key initiatives as part of their product and category positioning strategies:

Include private label in your competitive maps
Private label can no longer be considered a generic denomination or a mere price point. In many categories, it must be considered a proper brand. As CPG manufacturers evaluate private label brands, they must look beyond basic performance monitoring and enhance their understanding of brand positioning, consumer appeal, pricing, assortment, and promotional strategies.

Understand the impact on your core consumer segment
The general demographics of private label shoppers have been well documented, but how specifically does your core consumer segment behave in regard to private label products? Undertaking consumer research in collaboration with retail partners is a path many companies are beginning to pursue more systematically.

Enhance category understanding and management

Private label plays different roles and creates different dynamics across categories. In some cases, private label plays a benign role by enabling an "entry point" that elicits experimentation among non-users and promotes the entire category, while in others private label severely cannibalizes branded sales. It is critical to understand broader category dynamics, and to determine whether private label is indeed a threat or if it is rather an opportunity.

> *"We will stop being the sales agent for the manufacturer and become the purchasing agent of the consumer."*
>
> Dave Nichols
> Former President Loblaw's
> and creator of President's Choice

Understand retailer motivation, strategy and direction

Retailers also need to find points of differentiation from their own competition, through a combination of pricing, assortment, service and store environment. Private label is one of the tools retailers use to entice shoppers. Understanding the true motivation behind retailers' private label programs will allow manufacturers to find the most appropriate approach to address private label growth in relevant product categories: combat, co-exist, collaborate or promote.

Increase pace of product innovation
Brand manufacturers have historically been able to compete effectively by creating innovative products and package designs. Branded companies should explore other areas of innovation beyond product and packaging in order to strengthen brand relevance and maintain category vibrancy.

Improve in-store marketing and merchandising execution
Some of the most traditional tools in the trade marketing playbook are still important and should be leveraged. Shopper marketing and in-store promotional campaigns should be adjusted to target specific consumer segments in the context of private label adoption. Companies should look for opportunities to work with their trading partners to understand the broader impact of these activities on the category and ensure that brand objectives are aligned with retailers' goals for the category.

WHAT'S NEXT?

There is no realistic scenario where future private label penetration will be lower than it is today; market forces continue to indicate an upward trajectory. Private label is expected to increase its market share and become more pervasive in most grocery categories. Corporate strategists and marketers must incorporate private label as a major consideration into their business planning activities.

Brand manufacturers can no longer ignore or take an entirely adversarial stance against private label offerings. They must carefully consider specific dynamics within relevant product categories, changing consumer behavior, and retailers' strategy and position in order to devise appropriate responses to private label. They may even discover that private label may not constitute a threat in all cases. In some categories and for some CPG manufacturers, there will be interesting opportunities to explore together with retail partners.

HOULIHAN LOKEY

For more information, please contact us at 312.456.4700 or visit us at: www.HL.com.

CORPORATE FINANCE

FINANCIAL ADVISORY SERVICES

FINANCIAL RESTRUCTURING

STRATEGIC CONSULTING

HL.com