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Thought leadership from Credit Suisse Research and the world's foremost experts

# The power of brand investing

PHOTOS: KEYSTONE/CARO ANDREAS TEICH, COVER: ISTOCKPHOTO/ALEXANDER

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Brands have a crucial function in today's markets of abundance and overwhelming choice as they guide consumers towards expected quality, while allowing them to make a statement about themselves, arguably one of the most important features of brands in today's society. For this service, brands can charge their clients a sometimes very substantial premium.

A strong brand is often the most important asset for a company, and in this report we aim to provide an understanding of what drives brand value over the lifecycle of brands and what it means for investors. There are precious few true competitive advantages in modern industry: scale, proprietary technology, monopolies, and network externalities often come to mind. However, we believe brand is an equally powerful and even more sustainable advantage, but one that is often ignored by the financial markets because of their "fluffy" and intangible nature. Based on our research, we find companies with strong brands consistently generate outsized long-term growth, profitability and returns.

We believe the future for brands and brand stocks is very bright given their universal appeal and reach in virtually every corner of the Earth. Brand companies are particularly well positioned in a global environment that is poised to elevate hundreds of millions of new individuals into the modern consumer economy across Asia, India, Eastern Europe, and Latin America over the next decade. Whether it will be already well-recognized brands expanding their reach to new markets or new brands emerging to take advantage of product or geographic opportunities, we believe there will be many chances to invest in exciting brands in the coming years.


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# The search for brands

Companies that combine a strong brand with other competitive advantages can look forward to attractive returns and long-term growth. In our view, identifying great brand companies presents a significant opportunity for investors.

Brands play a key role in customers' purchasing decisions, whether as a shortcut or as an image enhancer. By implying a certain level of product or service quality and/or price expectations, brands serve as a way of simplifying routine purchase decisions. For industries such as consumer products, retailers, airlines, media, and even search engines and express delivery businesses, brands play a key role in helping consumers sort through the available options. Brands can also embody the image that the customer wants to project. These brands tend to fall into industry categories such as fashion, jewelry and watches, athletic footwear, automobiles, consumer electronics, hotels, cosmetics, retailers and even high-end coffee. Companies can leverage one or both of these customer benefits in building their brands. Because of the role that brands play in customers' purchase decisions, keeping a brand consistent, focused – but also current – is critical to building and reinforcing the customer's perceptions of the brand over multiple years.

**What does a brand do?**

For companies, brands create financial value as well as softer benefits. Clearly, sales growth, margin expansion and pricing power can all be achieved with brand leadership. Other benefits can include distributor/channel power, supplier power and even employee recruitment and retention advantages. Together, these benefits far outweigh the costs involved in establishing and maintaining a leading brand. There are precious few sustainable competitive advantages in the modern industrial world: scale, proprietary technology, monopolistic competition, network externalities often come to mind. While we certainly agree with this list, we believe branding is one of the most potent, leveragable and sustainable competitive advantages, though one that is often ignored by the investment community. Our research tells us that companies that combine a strong brand with other competitive advantages and competencies consistently generate out-sized long-term growth and returns. Over the last twelve years, companies which spent at least 2% of sales on marketing (brand index) have seen 67 percentage points of cumulative outperformance against the S&P 1500 (see Figure 1). And though this may be an overly simplistic analysis, it does at least tell us that companies focusing on brand-building (regardless of whether they are good at it or not) tend to outperform significantly.

**The Credit Suisse brand framework**

While we are all familiar with the great brand stories of the last generation, identifying great brands of the next generation is an extremely tricky task. Not only is it hard to identify which of today's up-and-coming brands will be the great brands of tomorrow, but it is also important to know at which stage of the brand lifecycle these businesses are, and when is the right time to invest in them. Our brand investment platform relies on two key frameworks: 1) identifying the industry and company-specific conditions and characteristics necessary for brand success; and 2) understanding the brand lifecycle and the relative investability of brands at various stages. In this report, we explore these issues with case studies of brands that are young and old, big and small, little known or famous.

Figure 1:

**Brand index versus S&P 1500**

Source: Credit Suisse

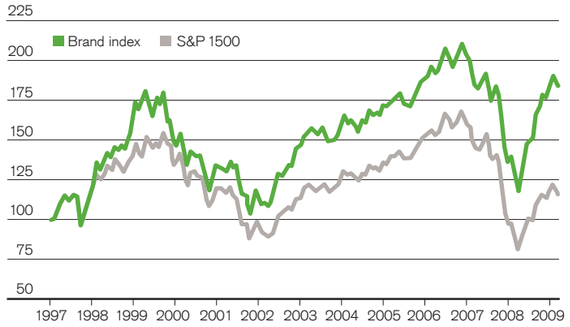


PHOTO: DREAMSTIME.COM/WELLESENTERPRISES

# Sources of brand value

Brand stocks appear to consistently outperform companies for whom building a brand around their core product or service is less of a priority. With potentially new brand-friendly sectors, we see further opportunities for companies to brand their products.

With the foundation of a great marketing strategy, solid quality and exceptional leadership, brands can select one or more of several ways to differentiate themselves. In our view, there are three broad sources of brand value: innovation, aspiration and scale. Some brands span two or even, in Apple's case, three of these categories.

**Innovation:** These brands innovate continuously, and more rapidly, than competitors, either in product development or in business processes. Intel introduced new chips every two years instead of the traditional four years. Southwest continues to find ways to reduce gate turnaround time, from boarding procedures to limiting food on flights in order to simplify clean-up and loading. L'Oreal invests more than twice as much in research and development as a percentage of sales than its competitor Revlon.

**Aspiration:** Probably the most obvious of the branding success stories, these brands use emotion, associations and personality to increase their strength with customers. LVMH brings to mind unsurpassed luxury, creativity and craftsmanship. Budweiser connotes qualities such as American, masculine, humorous, sports and casual. These brand intangibles can also be evident in a distinctive corporate culture and in attracting and retaining employees. Google's non-traditional workplace environment springs to mind as does Nike's headquarters with its state-of-the-art gym and buildings named after famous athletes.

**Scale:** These brands leverage their power over suppliers or distributors or through an installed base to maintain their brand positioning and competitive advantage. Toyota wrings inventory carrying cost-savings from its suppliers. Coca-Cola controls its

Figure 2

## Key drivers (innovation, aspiration and scale)

Source: Company data, Credit Suisse estimates


bottlers, who sell and distribute its product. Facebook grows organically by leveraging the connections of its members. Microsoft benefits from people sharing files and needing to have the same software programs to do so.

### Is the industry brand-friendly?

The starting point for building a world-class global brand is to compete in an industry that is brand-friendly. The three critical components of such an industry are 1) close proximity to the end-user (i.e. fewer steps or firms between the customer and the brand); 2) the perceived product differentiation among competitors; and 3) the importance of reputation in customer purchasing decisions.

There are certain industries in the nexus of these three criteria that are especially fertile for brand development. Not surprisingly, most of the global iconic brands reside in those industries, such as media/entertainment, consumer products, branded apparel, restaurants, resorts/casinos, and autos. However, there are competitors that can build a global iconic brand in a somewhat less brand-hospitable environment, such as Marlboro in tobacco products and Microsoft in software

Industries that show high-potential for brands include those where trust is a growing purchase criteria, either because of lack of product track-record, a proliferation of unknown competitors or risk to health or safety. Others include industries where intermediaries are disappearing and the end-user is becoming closer to the potential brands.

### New opportunities for brands

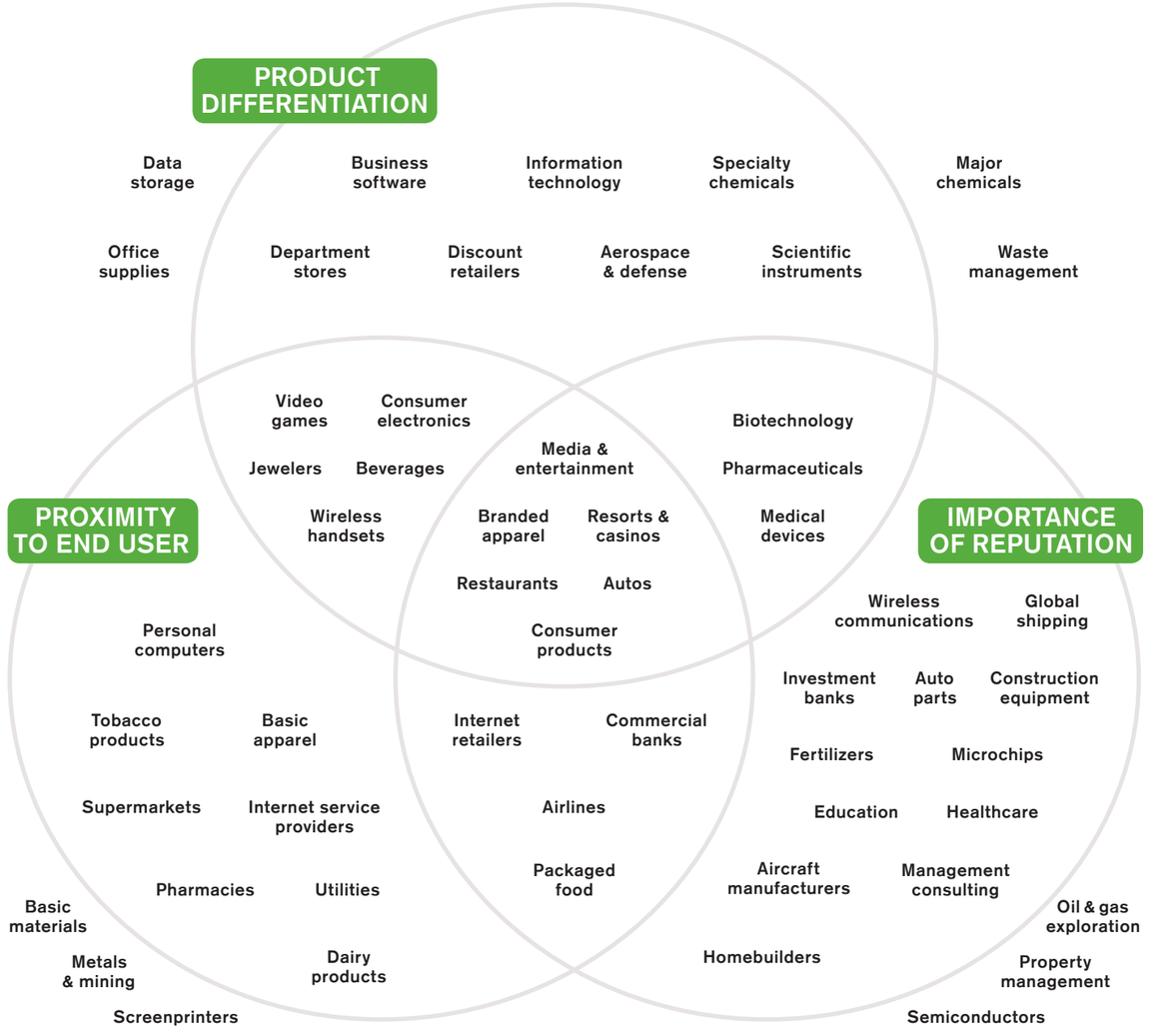
We see opportunities for companies branding their products in potentially new brand-friendly sectors, e.g. environmentally conscious branding or healthcare. The eco-friendly consumer



Figure 3:

## Brand-friendly industries

Source: Company data, Credit Suisse estimates




products industry is just emerging, and presents opportunities for new brands to emerge. Building a new category is an especially rich vein to pursue in building brands, as the consumer will link the category with your brand from the outset.

For example, Method Products, a private company started in 2001 to sell environmentally friendly soap and other cleaning products has grown sales from USD 11 million in 2003 to an estimated USD 71 million in 2006 and continues to grow and expand distribution. Originally launched in Target, but now sold in Stop & Shop, Costco and Office Depot, among others, this focused brand commands a price premium of 15%–100%-plus over equivalent, traditional cleaning products. It was ahead of the green wave with a strong management team. Their rival, in a subset of cleaning products, is Clorox with its "Green Works" brand, also priced at a 30%–40% price premium to regular Clorox products. Whether consumers will prefer a known brand like Clorox or a new, tightly focused eco-brand like Method remains to be seen. In any case, the white space of green innovation should be fertile for brand development.

Given the turbulence in the healthcare industry, with new legislation and a possible individual mandate to buy health insurance in the future, health insurers, pharmacy benefit managers (PBMs) and even hospitals may see branding opportunities. This type of industry, where trust is paramount, is ripe for branding in our view.


PHOTO: KEYSTONE/AP KATSUMI KASAHARA

# The brand lifecycle

A brand name is generally the result of a long-term process, whereby all brands tend to follow a similar arc of development, from their concept to the peak of success (or their failure). We call this course of events the "brand lifecycle."

Our brand lifecycle incorporates five distinct brand lifecycle stages, each of which is important to understand in order to make wise brand investment decisions: 1) emerge; 2) hit the wall; 3) transform and proliferate; 4) dominate; and 5) re-emerge. In each of these phases, there are key success factors and capabilities that brands must achieve to succeed, including consistency, continuous innovation, brand control, marketing, and strong management. Without these, a brand can fail at any point along the way.

**Emerge:** This is when a brand establishes itself as a relevant new presence in a marketplace, and is identified by consumers/customers for its unique product or service proposition. The emerging stage is relatively short (5–10 years) and is usually characterized by fast growth, an IPO, and strong shareholder returns, although a still relatively small market capitalization. The vast majority of brands fail during or just after emerging, and picking the winners here can be challenging.

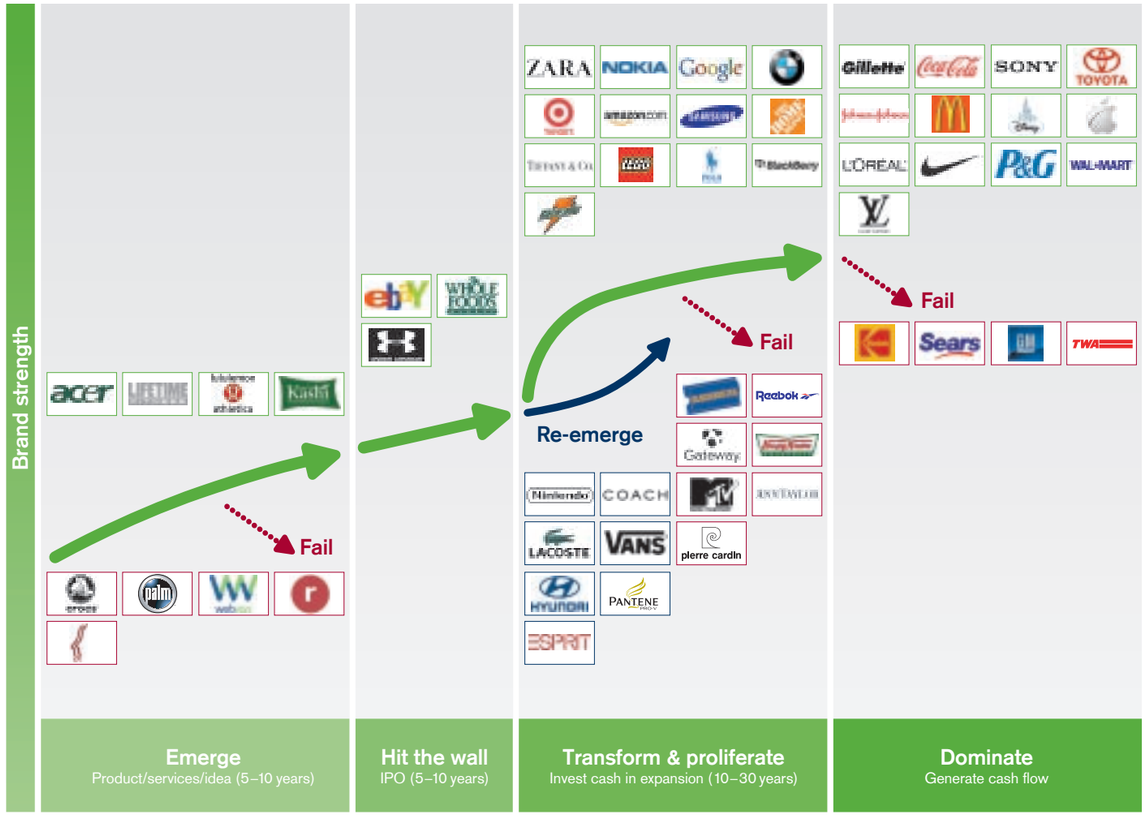
**Hit the wall:** This is when a company has difficulty making the critical step of transforming itself from a product company to a brand company (which is when a company can profitably leverage its brand across product categories and geographies). Most brand companies hit a wall before transforming themselves in a way that enables the brand to establish the next leg of sustainable, leveragable growth.

**Transform and proliferate:** This is when a company "makes the leap" from product company to brand company, which is a process that can last 10–30 years. Brands are validated in this stage by expanding distribution to new channels, countries, or product categories while simultaneously continuing product development and innovation. Characterized by consistently

Figure 4

## Lifecycle chart

Source: Company data, Credit Suisse estimates




strong top-line growth and usually some margin expansion (despite big re-investment into infrastructure build), this period is usually one of the best times to own brand stocks because this is when they generate the most absolute market value.

**Dominate:** Reaching this stage is the ultimate goal of any brand company. A brand is dominant when it has the number one or two market share, the brand essence or meaning is almost universally understood by consumers/customers, and the company starts to generate meaningful free cash flow because it has less need to invest heavily. It is also characterized by much slower growth and little margin opportunity. When brands achieve dominant status, it is usually time to sell the shares, as they can stagnate for years once becoming dominant (e.g. Wal-mart, and Sony).

**Re-emerge:** Sometimes a once-popular brand that faded from the landscape can reinvent itself and emerge as a strong growth brand once again, sometimes even stronger than before. This situation can often be an extremely high-return brand investment opportunity for investors (e.g. Coach and Apple).

### Reasons for brand failure

Failure or brand value destruction is a common occurrence that can happen at any point in the brand lifecycle. Crocs and Palm failed as they tried to emerge while Sears and Kodak fell from grace long after they had been universally recognized as dominant brands. Failure can occur for many reasons, including over-distribution (i.e. brand dilution), lack of innovation (resting on your laurels), under-investing/marketing, ineffective management, distracting non-strategic acquisitions, and so on.

The reasons that brands fail to reach dominant, iconic status are the opposite of the success factors that built them. For example, companies basing their brands on aspiration (emotion) might violate the essence or heritage of the brand or fail to invest enough in the brand. Innovators might fail to maintain their cutting edge. For any of them, ignoring a paradigm shift, or expanding in the wrong direction, either by losing control of distribution, over-licensing or growing too aggressively internationally and/or regionally can cause failure through a loss of focus and control of the brand.

During this period of transformation, brands provide zero returns on average for investors, with considerable variation and significant downside potential. Even great brands like Nike can average minus 44% returns during their "hit the wall" phase.




PHOTO: KEYSTONE/AP/JEFF CHRISTENSEN

**→ Ignoring a paradigm shift: MTV**

MTV is an example of a brand that failed to innovate with regard to its product and subsequently lost market share and brand power. Launched in 1981 with the unique format of music videos and video jockeys (VJs), which consumers and the music industry immediately latched onto, MTV successfully reached an attractive, young target market. However, by the mid-1990s, MTV had migrated away from its roots into reality shows, prank shows and animated cartoons, which made up the majority of its programming. At the same time, competitors in the form of traditional media players and online competitors replicated the product that MTV was creating, ultimately resulting in a drop in viewership.

**→ Violating the essence/heritage of the brand: Reebok**

After purchasing the US license from British athletic shoe manufacturer Reebok for USD 65,000, Paul Fireman introduced three high-end models and had some success. The breakthrough came in 1982 with the Freestyle model, the first athletic shoe aimed at women, which coincided with the aerobics trend in the USA. By introducing a new customer to the athletic shoe industry, Reebok found a white space in which to emerge. The Freestyle shoe was as much fashion as function, made from soft leather and coming in bright colors like red, orange and yellow, which was a departure in the white shoe industry. The brand experienced rapid growth and the company soon bought its own production factories in South Korea to lower production costs. Growing from USD 12 million in sales in 1983 to USD 2.16 billion in 1990, the brand was on a roll. But this explosive growth would be its undoing, as it had to chase new trends in the early 1990s. First, Reebok tried to position itself with little success as a performance (and men's) brand by expanding into basketball, football and soccer, which caused competitors like Nike to increase ad spend in these sectors. In 1990, it also went through a corporate reorganization, institutionalizing the straddling of the brand between fashion and performance. It then tried to gain endorsements with top athletes in the late 1990s, but failed. More recently, Reebok has tried to link music, hip hop culture with Jay-Z and other non-athlete based collections. Reebok also extended its brand into apparel, which helped sales, but failed to keep its heritage in women's footwear authentic. This lack of authenticity and customer focus has ultimately led to the decline of the brand.

PHOTO: DREAMSTIME.COM/MOOPHOTO

# Factors driving brands

Brands emerge by either innovating or tackling inefficiency, or both. We have identified nine factors that contribute to a brand's successful passage through the "transform and proliferate" phase to the "dominate" phase of the brand lifecycle.

Innovation includes identifying a new or underserved market, launching a new technology or developing a differentiated product. In each instance, the brand is closely associated with this innovation – often a new category – and derives its brand identity from it. On the other hand, companies may identify inefficiency in either the production system or distribution process of an industry and leverage on that by forming a new business process. Again, the company develops a defining characteristic that becomes integral to the brand's identity early on. Returns during the "emerge" phase can be extremely high, averaging 46% for the brands we tracked. However, this is partly because of the survival bias (i.e. we do not include brands that failed after emerging). Nevertheless, if you can catch a rising star brand, it can clearly be lucrative. After emerging, the brand must make the leap by being validated in the marketplace and proliferating. This phase is key for investors, as this is when, post IPO, brands see the largest appreciation in stock prices, averaging 22% in the brands tracked. In addition, it is the most perilous time for brands as they maneuver to solidify their brand positioning.

Nine factors, some required, some optional, determine whether a brand moves successfully through the "transform and proliferate" phase. By this point in time, all brands must possess a viable marketing strategy, as well as provide reliable quality in their product or service and effective management and leadership. Other "optional" factors include corporate culture, product innovation, process innovation, sourcing or distribution control, network externalities or unique brand intangibles. While not all of these are required, most iconic brands use several of them as levers to build and maintain their brand position and strength.

PHOTO: DREAMSTIME.COM/AGNO AGNUS

## 1. Marketing strategy

This is the first criteria required for a brand to make the leap beyond the emerging phase of development. Market strategy can encompass everything from advertising and positioning to pricing and brand architecture. Whether it is an emotional brand personality like Marlboro or an end-user strategy like Intel that disintermediates the industry, marketing strategy plays a key role in every brand's validation and expansion.

**→ Intel**

While Intel was known for its rapid product innovation and proprietary manufacturing processes, its 1991 "Intel Inside" cooperative ad campaign, produced internally, catapulted the brand to a high-awareness among end-users (consumers) instead of just OEM manufacturers. This positioned the brand to take full advantage of the high-growth in the 1990s PC industry. By branding an "ingredient," Intel succeeded in pulling its product through manufacturers, something only a handful of ingredient brands have ever been able to do. As a percentage of sales, Intel spent more on selling, general and administrative expenses in 1992 than research and development (17.4% vs. 13.3%), and continued to do so into the late 1990s. This investment in brand-building paid off as it is one of only two brands to be highlighted (the other being Microsoft) on the exterior of most computers, besides the computer brand itself, thus indicating its branding power.

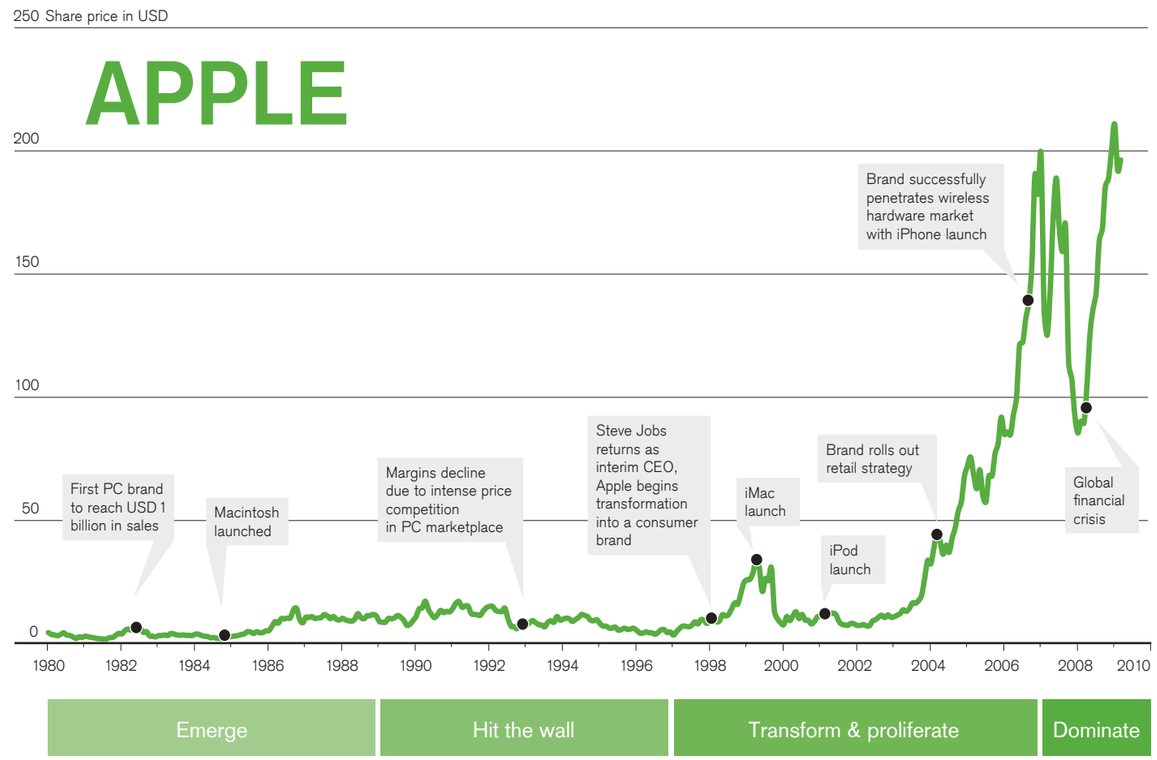
## 2. Reliable product/service quality

One key role that brands play in the purchasing decision is to let the customer know that what they are buying will meet their expectations of quality. No matter how good the marketing, if a product or service fails to meet or exceed quality expectations, the brand will fade into obscurity.

**→ Lego**

Privately held and family run Lego has kept the quality of its products intact since the 1958 patent on its brick design. The founder, a carpenter in Denmark, gave the company its mission of "only the best is good enough." Today, the company owns its production facilities, a strategy from which it briefly departed in 2007 due to profitability problems, outsourcing some of its electronics parts production. It quickly backpedaled on this decision, and now produces all of the 2,200 possible elements and 55 colors in the Lego range itself. The company's production tolerances are tight, with its injection molding machines accurate to two-thousandth of a millimeter (0.002 mm). It claims to have only 18 errors per million, a remarkable quality achievement. And any parent who has assembled a 300+ piece project with their child has surely been amazed that all of the required pieces are always included. Further, the company developed a proprietary ABS plastic material for its blocks, which gives them their clutch power, shine, color stability and resistance to nicking.






Source: Company data, Credit Suisse estimates

## 3. Leadership/management

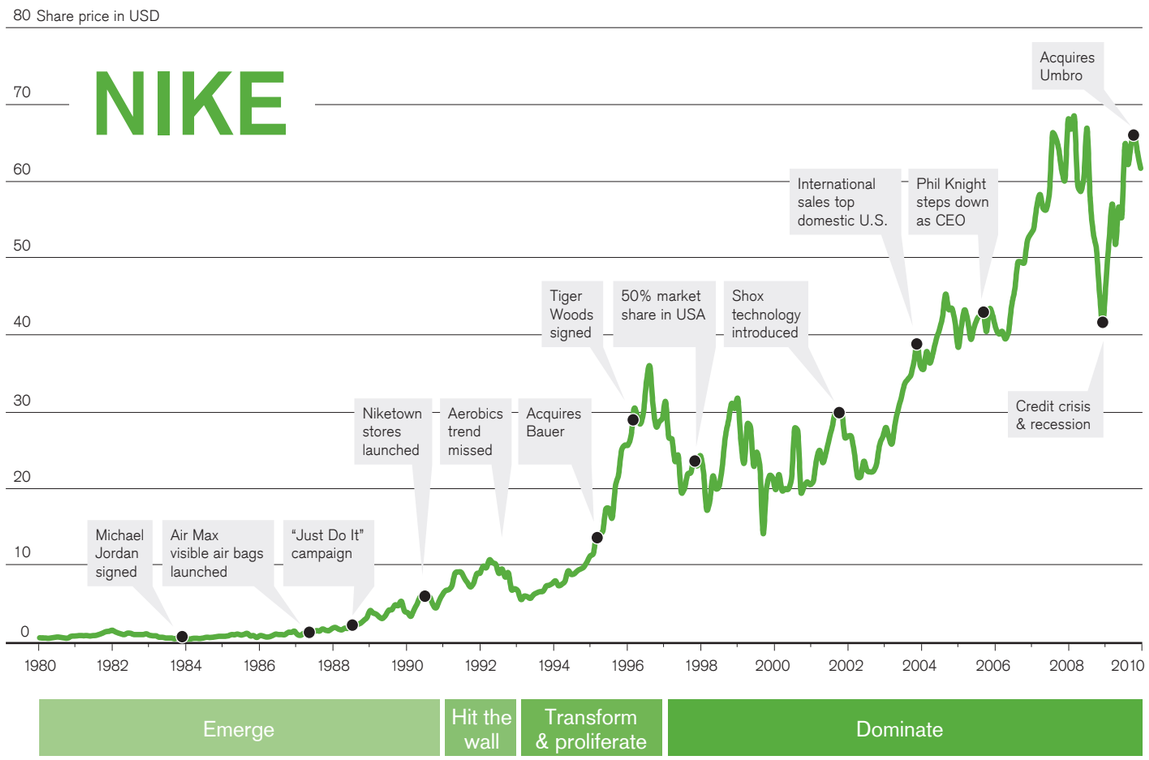
Leadership is an amorphous term that can mean different things to different people. In the branding context, it means setting a vision and guiding the brand through the potential derailing obstacles that arise as a company grows. What a brand says "no" to can be as important to its success, which comes from the top. Steve Jobs at Apple and Howard Schultz at Starbucks both founded the brands and were then brought back in during difficult times to revitalize and redirect the brand's trajectory. Leaders, with their vision and communication, bring the brand's organization along the chosen path, or fail to do so, as in the case of Kodak.

**→ Apple**

Steve Jobs was one of the three founders of Apple Computer in 1976 and was a leader in pushing for ground-breaking innovation and distinctive design. In 1979, while visiting Xerox PARC research facility, he saw the graphical user interface, which centered on a "mouse," and adopted this as Apple's platform for software development. Jobs led the team that developed the Macintosh in 1984, with its anti-establishment ad based on Orwell's "1984." Despite the Macintosh's success, Jobs was forced to resign from the company in 1985 after a power struggle with new CEO John Sculley. During the next decade, Apple continued to innovate with the Powerbook, which was ground-breaking for laptop computer design. Model proliferation followed with other less successful products, such as the Newton, cameras and TV appliances, none of which were break-out hits. With the rise of Microsoft in the 1990s and its market share gains through cheaper PCs, Apple looked expensive and not as cutting-edge, while the Macintosh platform was not powerful enough.

In 1997, Jobs returned, first as an advisor and then as CEO, and in 1998, Apple returned to profitability with the iMac. Jobs led the company with his vision of breakthrough technological innovation and his passion for aesthetic design. He became the face of the brand, presenting Keynote speeches as well as product introductions, as well as embodying its anti-establishment corporate culture, going barefoot around the office. With Jobs at the helm, Apple launched the iPod, iTunes store, and the iPhone. None of these products was the first mover in its segment, but all dominated and set the industry's direction once introduced.

| | Emerge | Hit the wall | Transform & proliferate | Dominate |
|---|---|---|---|---|
| Investment period | 1980–1987 | 1987–1997 | 1997–2007 | 2007–2009 |
| Avg. absolute return | 16% | (11)% | 16% | (20)% |
| Avg. relative return | 6% | (22)% | 45% | 12% |
| Δ Market cap | USD 3,824 | (USD 3,535) | USD 172,359 | (USD 50,491) |
| Sales CAGR | 56% | 10% | 13% | 22% |
| Δ EBIT margin | (6.2)% | (19.6)% | 24.10% | 1.00% |
| Ad spend. % sales | - | 2.00% | 1.90% | 1.50% |




Source: Company data, Credit Suisse estimates

## 4. Corporate culture

Brands based on aspiration can also powerfully impact the company's culture, helping to recruit and retain employees and to boost productivity and morale. The vast majority of great brands have entrepreneurial cultures, which help them to continue to innovate and remain nimble as they age. For this reason, many high-tech firms use this lever too, such as Google and Apple. However, there are exceptions, such as Toyota, Disney and Proctor & Gamble, which are successful but more conservative and bureaucratic in their cultures.

### → Nike

The distinctive culture at Nike headquarters revolves around great athletes and coaches. The names of the buildings include the Mia Hamm Building and the Joe Paterno Child Development Center (named after the Penn State football coach). Nike provides a state-of-the-art employee gym, which reinforces the brand's motto of "if you have a body, you are an athlete." The brand also cultivates an anti-establishment bent that reflects its marketing strategies and roots as a brand.

| | Emerge | Hit the wall | Transform & proliferate | Dominate |
|---|---|---|---|---|
| Investment period | 1980–1992 | 1992–1993 | 1993–1996 | 1996–2009 |
| Avg. absolute return | 25% | (44)% | 57% | 6% |
| Avg. relative return | 13% | (48)% | 48% | 3% |
| Δ Market cap | USD 5,850 | (USD 2,825) | USD 13,842 | USD 13,725 |
| Sales CAGR | 23% | 15% | 18% | 9% |
| Δ EBIT margin | 4.00% | (0.6)% | (1.0)% | (2.3)% |
| Ad spend. % sales | | 9.80% | 9.90% | 12.30% |

## 5. Product innovation

One way to be a perpetual innovator is to consistently improve your product. Brands such as Disney, L'Oreal, Medtronic and Goldman Sachs exemplify this strategy across a range of industries. They have all gone beyond the conventional boundaries of product design and functionality since their inception, and innovation has differentiated them from their competitors.

### → L'Oreal

Now a house of over 500 brands worldwide, 23 of which are global, French beauty giant L'Oreal began one hundred years ago with a chemist's new hair color formula. It followed with additional innovations, such as the first sunscreen and the first mass market soap-free shampoo. Today, the company has over 2,000 researchers in five global research centers, ten times more people than competitor Revlon. L'Oreal outspends Revlon 2 to 1 on research and development as a percentage of sales and continues to increase this amount, compared to a three-year flat budget of Revlon. While L'Oreal's R&D spending is just one-tenth of its advertising spending, it does give them a competitive edge and is commensurate with the company's heritage of innovation. It has legally protected its innovation, with the company being the top nanotechnology patent holder in the USA.



PHOTO: KEYSTONE/CARO-FOTOAGENTUR ANDREAS BASTIAN

## 6. Process innovation

In addition to product innovation, the other way to be a perpetual innovator is to change the business processes of the industry. Brands such as Southwest, Zara and Toyota choose to compete as process innovators to eliminate costs, time or waste in their respective businesses.

### → Zara

Spanish retailer Zara streamlined the business process in the fashion industry to create "fast fashion" as the basis for its global brand. The starting premise of the brand's founder, Amancio Ortega, was to listen to the customer instead of trying to predict fashion. To do this, Zara had to be able to quickly design, manufacture and distribute products to its stores in record time. It did so by owning over half of its factories and locating these close to its markets (instead of low-wage faraway countries in Asia). It also invested early on in a computerized design system as well as an IT system that linked factories to stores directly. By making these process innovations, Zara reduced the elapsed time from design to store shelf to 2–4 weeks, compared to an industry average of six months. This had several brand-building, as well as financial benefits. On the brand-building side, customers perceive the scarcity of products, increasing their desirability and uniqueness, which then increases the frequency of customer visits to Zara. Because of its shorter cycle time, Zara is able to appear to be on target with its fashions, increasing its desirability. On the financial side, the "fast fashion" innovation leads to fewer, smaller fashion disasters, lowering the percentage of markdowns required.

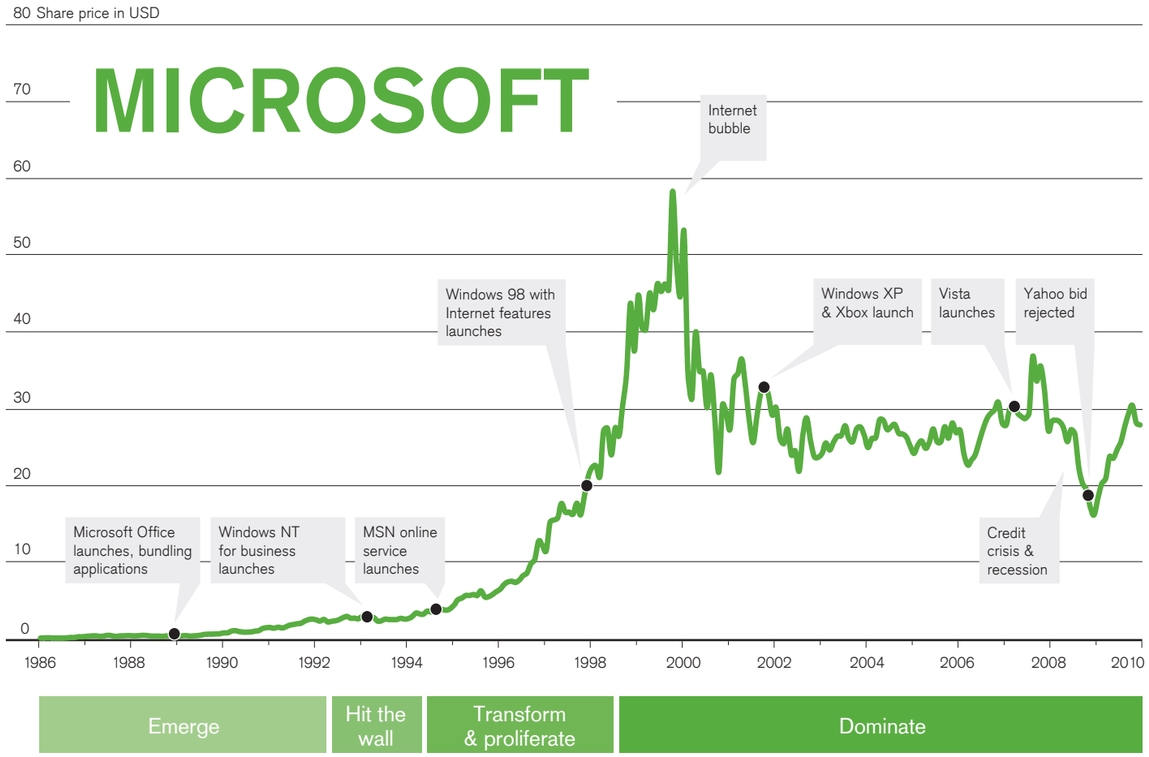
## 7. Sourcing/distribution control

Companies acting as "power players" (using scale to underpin their brands) can compete by closely managing their supply chains and/or distribution channels. Examples of this branding strategy include Coca-Cola with its bottlers, McDonald's with its franchisees and Costco and Medco with suppliers. In addition, some of these brands then proceed to compete on value, passing on some of the resulting cost-savings to their customers (e.g. Costco and McDonald's). Others use the control primarily for quality and reliability purposes, such as Coca-Cola.

### → Coca-Cola

Since its inception, Coca-Cola has pioneered distribution innovations, such as the first coin-operated open-top cooler, which was the precursor to the vending machine in 1929, and the first automated soda fountain dispenser in 1933. These sorts of innovations were key to Coca-Cola's emergence by ensuring uniform quality and increasing distribution points. But the real factor that helped it make the leap was its bottler system.

Coca-Cola built its expansion on its 300 bottling partners around the world, the so-called "Coca-Cola System," which enabled it to expand rapidly and stay in touch with local markets, especially as it grew overseas. Coca-Cola sells concentrate to the bottlers, who then add the carbonated water and sweeteners. They bottle/can the product, sell it, distribute it and merchandise it in the stores. Coca-Cola gives each bottler an exclusive territorial franchise. More recently, the company has invested directly in its bottlers with minority stakes aimed at consolidating them into "anchor bottlers."




Source: Company data, Credit Suisse estimates

## 8. Network externalities

Another type of power player is a brand that leverages its installed customer base or other assets to raise switching costs for its customers and to increase loyalty by creating network externalities. Microsoft and Bloomberg are prime examples of the installed base strategy.

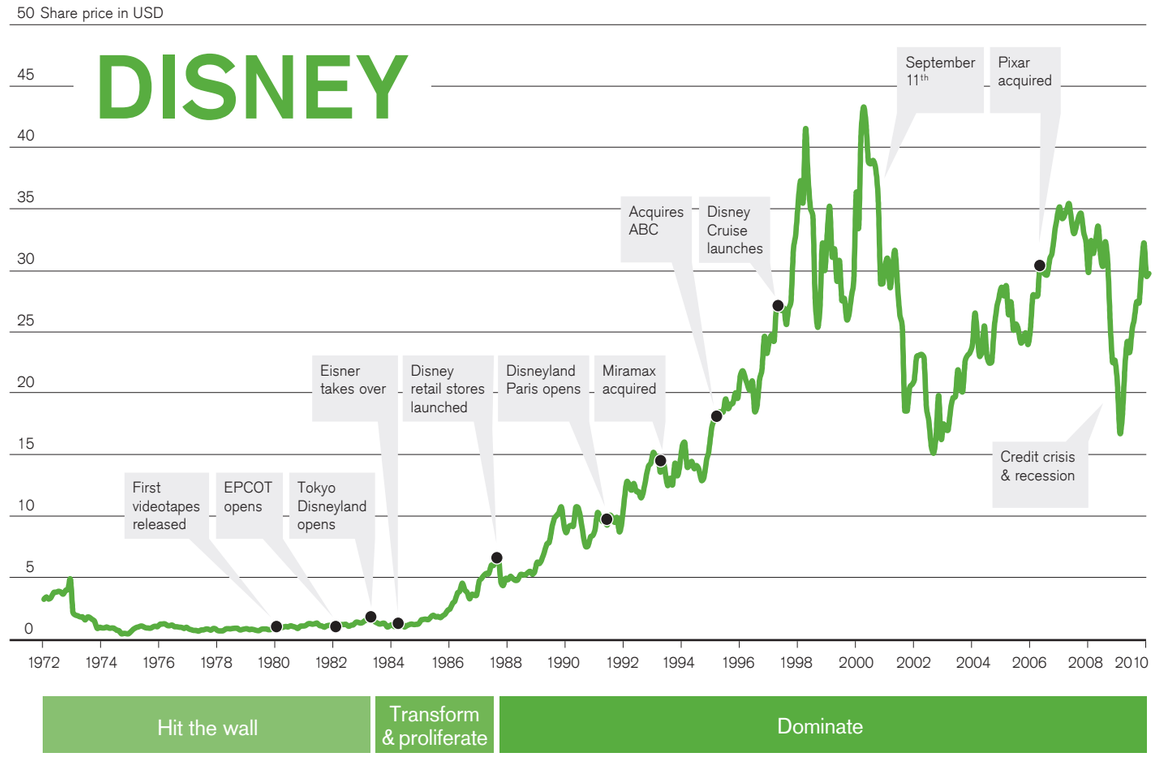
| | Emerge | Hit the wall | Transform & proliferate | Dominate |
|---|---|---|---|---|
| Investment period | 1986–1992 | 1992–1994 | 1994–1998 | 1998–2009 |
| Avg. absolute return | 63% | 20% | 53% | (2)% |
| Avg. relative return | 48% | 17% | 36% | (1)% |
| Δ Market cap | USD 23,212 | USD 11,694 | USD 312,592 | (USD 96,948) |
| Sales CAGR | 55% | 30% | 33% | 14% |
| Δ EBIT margin | 7.00% | 1.00% | 9.20% | (10.4)% |
| Ad spend. % sales | - | 2.30% | 2.30% | 2.40% |

### → Microsoft

Microsoft's emergence and success in transforming and proliferating rested largely on its ability to quickly create an installed base that would then increase the switching costs for existing customers and increase the incentives for new customers to buy Microsoft's operating system and productivity software. After landing the IBM PC operating system contract in 1981, Microsoft quickly realized the potential of the PC clones and aggressively marketed its MS-DOS program to these manufacturers. It then began selling its Windows version directly to consumers in 1985.

The other strategy which was more controversial was the bundling of its productivity software into Microsoft Office. By selling these programs together as a package, Microsoft increased its share in the application software segment of the market. Later, with Windows 98 and Internet Explorer, there were legal challenges to Microsoft's allegedly anti-competitive bundling practices. Together, the establishment of an installed base and bundling were key to Microsoft dominating the desktop computer market.






Source: Company data, Credit Suisse estimates

## 9. Unique brand intangibles

While every great brand must have some marketing capabilities, some brands use aspiration to create powerful and unique brand intangibles, such as Disney, LVMH, MINI Cooper, Budweiser and even GEICO. These brands reflect their customers' values and inspire their customers' dreams. By giving the brand a distinct personality that resonates with the customer and an authenticity that is not easily replicated, some brands use unique brand intangibles to differentiate themselves.

| | Emerge | Hit the wall | Transform & proliferate | Dominate |
|---|---|---|---|---|
| Investment period | 1962–1970 | 1970–1984 | 1984–1987 | 1987–2009 |
| Avg. absolute return | 30% | 6% | 14% | 8% |
| Avg. relative return | 24% | 2% | 39% | 1% |
| Δ Market cap | USD 554 | USD 1,340 | USD 5,862 | USD 43,368 |
| Sales CAGR | | | 20% | 13% |
| Δ EBIT margin | | | 11.00% | (5.0)% |
| Ad spend. % sales | | | | 7.70% |

### → Disney

The Disney "magic," known the world over, relates to the brand's storytelling and creativity, as well as its ability to awe young children. It also links connotations of wholesome family entertainment to children's fantasy worlds, which differentiates it from competitors. Disney is also relatively timeless, which pays dividends when Disney monetizes its library of movies. In order to preserve this brand image, Disney consistently invests about 7%–8% of sales in direct advertising spending, most recently USD 2.9 billion or 7.7% of sales in 2008. The company also limits the ability of customers to buy its movies, creating scarcity and exclusivity for their older titles, like the princess movies, releasing only one per year on DVD. And the Disney retail chain gives these brand attributes a home in the physical world.


PHOTO: KEYSTONE/AP STEVEN SENNE


PHOTO: KEYSTONE/CARO CARO/JANDKE

## Dominating the market

If brands succeed in "breaking through the wall," it is often a 5–10 year process of revisiting core brand strategies and adjusting business models, and often increasing marketing spending to finally overcome this phase.

When exactly a brand enters the "dominate" phase of development, the goal of any brand, is not always a bright line. But certain factors must be present to qualify as a dominant, iconic brand. The brand must be tested in the broader international market through a successful globalization strategy, like Coca-Cola's and McDonald's. It must, in the customer's mind, own the category it competes in, such as MP3 players in the case of Apple or family entertainment for Disney. It must have a loyal customer base, like Nike and Johnson & Johnson. It must have critical scale and market share in the segments it competes in, such as value retailing for Wal-mart and consumer products for Proctor & Gamble.

### → Wal-mart

Founded in Arkansas by Sam Walton in 1962, Wal-mart established its brand position and business model early, pricing below competitors and owning its distribution center and satellite network as of 1970. It did not charge slotting fees to suppliers, but rather focused on replenishing popular items more quickly. Through store expansion to neighboring states in the Southeast, creating the supercenter format in 1988, and continuing to improve its efficient distribution processes, Wal-mart transformed and proliferated by the mid-1990s.

During its "dominate" phase, Wal-mart went international, often under a different brand name and with varying models for expansion – from acquisitions (UK), to joint ventures (Japan) to franchises (India). Clearly, as the employer of 2.1 million people around the world and with nearly 8,000 locations, Wal-mart has dominant scale. It uses this scale to continue to extract concessions from its suppliers, primarily on how suppliers interact with Wal-mart's distribution centers. In the early 2000s, it required its top 100 suppliers to begin using RFID chips in their deliveries to better track inventory and aid replenishment, an innovation that met with such success that it now has 600 suppliers using the technology. In the late 1990s, Wal-mart entered into the grocery business, leveraging its dominant position to increase customer savings as well as the frequency of their visits. As a result, over 100 million people visit Wal-marts every week in the USA alone.

### → McDonald's

In the past two decades, the brand has expanded internationally to huge new markets like China, India and Eastern Europe. It makes efforts to source from local suppliers and is patient in setting up an efficient and high-quality supply chain in new countries. In India, for example, the company took seven years to establish a network of farmers who could supply ingredients to its franchisees that were new crops in the region, e.g. iceberg lettuce. Today, over half of the brand's outlets are international, with an astounding 30,000 restaurants and 5,000 franchisees worldwide.

The brand is not flawless, however, and struggled from 1997 to 2002. The reasons for this period of brand problems were a loss of focus on its core brand as well as cost-cutting, which affected the delivery of the company's brand promise. During this time, McDonald's corporate organization searched for growth and tried to expand to other "partner" brands through acquisitions, joint ventures and partnerships. These small US and international chains were seen as opportunities to leverage McDonald's process know-how and brand-building expertise to expand nationally and even internationally. While these partner brands were being grown, the core McDonald's brand was being mismanaged. Franchisees were not pleased with the corporate focus on so many new brands.

By 2002, McDonald's realized that it needed to refocus on the core brand and began divesting its partner brands. The company reinvested in its core brand with the most comprehensive redesign of McDonald's global packaging ever. It also refurbished many restaurants. It re-ignited the innovation engine, most prominently with the McCafe concept, an Australian idea for higher-end coffee. McCafe is now in over 7,000, or 50% of US locations, and is set to roll out to 85% of locations. This concept is a close extension of the core brand (fast, quality and value compared to Starbucks). It is also a frequent, often daily purchase, and brings in adults to compliment McDonald's traditional target of families with kids. The company has seen same store sales rise, despite – or perhaps because of – the weak economy, especially internationally in the past year.

PHOTO: DREAMSTIME.COM/MOOPHOTO


# Outlook for brand investing

We believe brand stocks will outperform the market in the near term. Historically, brand stocks have outperformed by 1,800 basis points in the six quarters following an economic slowdown. In fact, brand stocks have already started to outperform the S&P 500 (+700 basis points) since March 2009.

Owing to their universal nature, appeal and reach in virtually every corner of the Earth, we think brand companies are extremely well positioned in a global environment that is poised to elevate hundreds of millions of new individuals into the modern consumer economy across Asia, India, Eastern Europe, and Latin America over the next decade.

### Emerging market brands

In our view, the outlook for brand stocks is especially strong in emerging markets, as we believe that consumption of brands is approaching an inflection point. Many consumer staples companies already enjoy robust penetration in these markets (companies like McDonald's, Procter & Gamble, and Coca-Cola), and we believe more discretionary branded categories such as apparel, consumer electronics, hotel/leisure, and internet shopping, are poised to follow their lead. A similar chronology occurred in Japan in the 1960s, 1970s and 1980s. For example, when GDP per capita breached the USD 3,000 mark (roughly where China is today), spending on branded fashion goods exploded, quadrupling over the following ten years.

Japan started its dynamic economic development in the 1960s. In the 1950s, companies in the USA and Europe had used Japan as a source of low-cost manufacturing to feed their own distribution chains. A decade later, Japanese companies turned the tables, building up their own brands and distribution systems. They developed innovative products and production processes at such a pace that, by the mid-1970s, they were dominating American and European companies in sectors from automotives to consumer electronics, with brands from recognized export champions such as Toyota and Sony and mirror companies such as Nomura becoming world leaders from a zero base. While Japan accounted for 1.5% of world exports in 1953, its export share had jumped to 7.5% by 1978.

### Reshuffling the cards

Looking ahead, we believe that while many emerging market domestic brands are developing rapidly, it will only gradually become apparent as to which of these have the potential to follow in the footsteps of successful companies like Sony, Toyota or Nomura. A number of firms have the potential to emerge as new global brand leaders. With the financial crisis, the cards have been reshuffled and the likely winners of the race to successfully build up a new brand will be the companies that match the new reality.

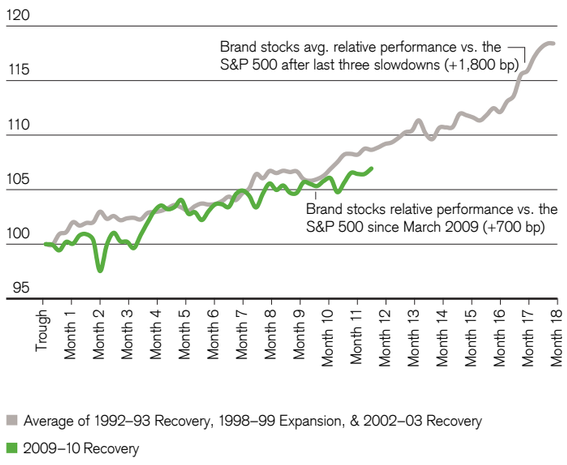
Perhaps counter-intuitively, many consumer staples companies have found that low-income consumers in the emerging markets are more brand loyal than their counterparts in the developed economies. We believe this loyalty is partly attributable to a lower level of shopper sophistication, but even more relevant is the unwillingness of those consumers to take risks

PHOTO: KEYSTONE/AFP TOSHIFUMI KITAMURA

**Figure 6:**

**Relative performance of brand stocks in a recovery**

Source: Credit Suisse, Datastream




on unproven products, due to tight budgets that do not allow purchase mistakes. We also believe consumers in emerging markets are more brand and image conscious than investors think, as many individuals in these regions desire to advertise their success to the world through more conspicuous consumption of branded goods. Thus, as the world becomes increasingly multipolar, this is also likely to be reflected in the brands that we rely on in our daily shopping and business decisions.

## Developed market brands

While the outlook for discretionary spending in many developed markets is clouded by high consumer leverage and constrained access to credit, we believe brand stocks are still well positioned to increase market share and drive organic growth for two key reasons: 1) when considering the age-old debate of "content versus distribution," we believe that the proliferation of the internet and a vast array of alternative distribution mechanisms has served to accelerate the shift in power toward content generators (i.e. brands); and 2) we also believe there is still room even in mature highly developed markets for new innovative existing and new brands to take advantage of opportunities arising across product categories, distribution channels and pricing.



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