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**MGTOP 590: Case Study #1 -  
Nespresso**

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# **TABLE OF CONTENTS**

<b>Executive Summary.....</b>	<b>2</b>
<b>Case Study Synopsis.....</b>	<b>2</b>
<b>Questions 1, 2 &amp; 3.....</b>	<b>3</b>
<b>Questions 4, 5 &amp; 6.....</b>	<b>4</b>
<b>Questions 7, 8 &amp; 9.....</b>	<b>5</b>
<b>Questions 10, 11 &amp; 12.....</b>	<b>6</b>
<b>Question 13.....</b>	<b>7</b>
<b>Conclusions &amp; Recommendations.....</b>	<b>7</b>
<b>References.....</b>	<b>8</b>

## **Executive Summary**

Nespresso is a brand of individually-portioned, high-end coffee made by Nestle Coffee Specialties (NCS), a 100 percent owned subsidiary of Nestlé S.A., a food and drink company headquartered in Switzerland and founded in 1866. Nestle is currently the largest food company in the world measured by revenue. In the mid-1970s, when Nestle made the decision to pursue development of the Nespresso product, it dominated the global instant coffee market, a drink that comprised about 30 percent of total worldwide coffee consumption and which accounted for more than 70 percent of the company's revenues at that time (Kashani, p. 4). NCS was founded in 1986 after more than a decade of development of the Nespresso System (its commercial brand name). NCS developed the market strategy in the 1980s and early 1990s, and eventually broke-even as a business entity in 1995 (Kashani, p. 9).

## **Case Study Synopsis**

The goal of the Nespresso product was to combine the company's core competencies in coffee production and food R&D, and aim these competencies at the rapid growth of the premium coffee segment at that time. The company boasted a strong portfolio of intellectual property behind its espresso delivery system and brewing process. It licensed the rights to the proprietary Nespresso machine to leading espresso machine manufacturers and utilized these companies' retail distribution channels and customer service, and focused the Nespresso business model on the development and marketing of the individualized espresso pods.

Nestle decided early on to separate the Nespresso product team from the rest of the company, allowing it to develop independent mechanisms for finding its best possible marketing strategy and foster product innovation. This was done with the consistent support of top Nestle management, and the result was a product that was allowed to struggle in the early stages as it built up a valuable store of technical and consumer expertise, assets that proved valuable when competitors moved into this growing market later.

Among the key marketing breakthroughs was the decision to move away from an office and restaurant-centric focus, and pursue the high-end consumer. This "top-down" approach allowed the company to solidify the Nespresso brand with the very high-end of the coffee drinking market and exploit an advantage with its product quality image as it eventually broadened its distribution. Key to building its own proprietary market knowledge was the creation of its own direct-to-consumer service, known to consumers as the Nespresso Club. By eliminating distribution layers that could separate them from discerning high-end coffee drinkers, NCS became adept at translating market responses to their products into vital product and marketing adjustments.

The financial results of NCS were mixed. As of the late 1990s, it was viewed as having achieved a satisfactory performance but having fell well short of the 1 billion Swiss francs sales target of Nestle (Kashani, p. 16). However, it had succeeded in becoming Nestlé's fastest growing business unit, and had in the process added another core product that the company could exploit more broadly in the future: high-end premium drinks for the consumer household market.

**Question 1: Identify the macro- and micro-environmental factors that led Nestlé to pursue the productization of Nespresso. Which ones were most important, and why?**

The key macro-environment factor that drove the decision to commercialize Nespresso was the stagnation of the instant coffee segment, and the vast premium coffee market that Nestle as a company had not penetrated yet. There was very early support from Nestlé's food service division to use the Nespresso product as means to penetrate the restaurant market for premium coffee and espresso. This helped give Nespresso an early push, but almost immediately some key micro-environmental factors further honed the commercialization of Nespresso.

The key micro-level factor was the realization that the company could most aptly convert its technical advantage with the brewing process, and its quality image with consumers, if it focused on the household market. The distribution layers separating it from coffee drinkers in the restaurant and office industries impeded sales in most individual markets it sold in early on. It took these lessons in individual markets and used them to adjust its productization strategy.

**Question 2: What role did Nestlé's corporate culture play in the productization of Nespresso?**

Nestle had a firm belief in taking a long-term view on growth, and not allowing short-term financial pressure to derail a strong commitment to innovation. The company had a culture that viewed both innovation and "renovation" (incremental improvements in existing products) as key components to product strategy, and had repeatedly created new categories such as Nescafe, its leading instant coffee brand, and Nesquik, a chocolate powder brand. It is clear that Nespresso was viewed as a potential innovation on the level of these two core brands, and that its productization was therefore given the dual structure of top Nestle corporate support and marketing team independence

**Question 3: Who were the key players in the Nespresso productization, and which role did each one play?**

The key technology behind Nespresso, the three-stage coffee-brewing process ("prewetting", "aeration" and "extraction") originated outside the company, at the Brattelle research institute in Switzerland (Kashani, p. 4). Nestlé's management identified that it could license this technology and then use its own internal R&D to create the Nespresso System.

Nestlé's food service division was another key player in the early productization of Nespresso. It allowed the product to be tested in the office and restaurant industries, an experience that while unsuccessful, eventually gave the NCP entity the confidence to pivot away from these markets and into the more latent, premium household market.

The crucial "pivot away" from the vision of the food service division was the move of a Nestle outsider: Yannick Lang, a young marketing expert who was brought in to run the newly formed NCS entity. Lang honed his premium consumer-branding skills at Phillip Morris, and had the

advantage of forming an independent marketing plan that eschewed Nestlé's traditional focus on mass-marketing campaigns and high-volume manufacturing. Whereas the early pursuit of the office and restaurant industry was an attempt at entering the large, existing commercial retail markets, Lang took a more innovative approach to productization. NCS began creating its own brand in a larger, but unproven market: home espresso drinking. Lang departed in the mid-1990s after successfully establishing NCS as an innovation company and the Nespresso Club as high-growth retail brand.

Willem Pronk, a seasoned Nestle product marketing executive, then guided the company into the next stage of more efficient cost control and operational efficiency. Pronk led the company's initiatives to broaden its consumer base and expand its sales in order to achieve the parent's company's 1 billion Swiss franc revenue target.

**Question 4: Based on what you know from the case study, what role did Nestlé's core competencies play in the productization of Nespresso?**

Nestle had underlying core competencies in coffee-making that played a major role in the productization of Nespresso. The technical know-how in manufacturing a coffee product, and the crucial role freshness plays, was one. The Nespresso pods were the key to the profitability of the business, and Nestlé's core competence of mass-manufacturing instant coffee that could stay fresh for long periods was likely a crucial asset.

Secondly, the technical competence of being able to assure quality remains consistent from cup-to-cup was another core asset of Nestle that applied directly to Nespresso.

**Question 5: What is meant by "innovation" and "renovation", respectively, in the Nestlé context?**

[Please refer to the answers to questions 2 and 3]

**Question 6: Which role did each of Nestlé's corporate functions play in the Nespresso productization?**

Nestlé's corporate functions had the following roles in Nespresso's productization:

***Manufacturing:*** When early technical issues effecting the Nespresso brewing process threatened the commercialization effort, Nestlé's manufacturing know-how played a role in overcoming this challenge. Also, the initial Nespresso machines were designed by Nestle in conjunction with third parties (Kashani, p. 4).

***R&D:*** Nestlé's R&D developed the foundation of the Nespresso technology that it had licensed from the Brattelle research lab and successfully developed it into a finished product comprised of a patented machine design and individual espresso pods.

**Human Resources:** While NCS operated independently of Nestlé’s corporate marketing teams, there was cross-over in personnel, such as when Willem Pronk, a product marketer at Nestlé, succeeded Yannick Lang as the top executive at NCS.

**Marketing:** The CEO of Nestle also played a key marketing role, consistently challenging the leadership of NCS to innovate and solve problems.

**Question 7: Identify the critical success factors in the productization of Nespresso.**

Crucial to the successful productization of Nespresso were the following factors:

**Leadership vision:** Nestlé’s management realized the company had a core competency in its instant coffee manufacturing that would provide the basis for a competitive advantage in the premium coffee market. The company structured its functional-level strategies, especially R&D, marketing and manufacturing - to give NCS the resources and capabilities to deliver superior quality and luxury branding into a growing niche market: espresso coffee.

**Customer responsiveness:** A key to building the luxury branding was ensuring quality, and this depended on the espresso machines being reliable and the espresso pods being used within their recommended use dates. By shifting to a direct-to-consumer model with its Nespresso Club retail service, the company “turned this technical constraint into an elegant marketing solution” (Kashani, p. 7). Going direct and controlling the consumer experience from end-to-end allowed the company to build a premium brand and perfect its service before going downmarket.

**The inherent profitability of the Nespresso capsules:** No doubt Nestlé’s existing core competencies in coffee-making allowed it to exploit its existing economies of scale, making the Nespresso individual pods a highly profitable product from the start. Combining its efficiency in coffee making with the premium pricing that comes with effective luxury branding was a critical success factor.

**Question 8: Why do you think Nespresso was first launched in Italy?**

The Nespresso product was first launched in Italy because of the popularity of espresso there, and also because at that early stage the Nestle food service division was driving the launch of Nespresso. The food service division was focused on the restaurant and office markets, and I believe that because of the prevalence of espresso as a drink in Italy’s restaurant industry, this influenced the decision to launch the product there.

**Question 9: Why did Nestlé management keep an “arm’s length” relationship with Nespresso and bring in Yannick Lang, an outsider, to manage it? What does this say about Nestlé’s ability to innovate?**

Nestle management saw that the dominance of the company in mass-marketed instant coffee would make it difficult for NCS to innovate using new marketing strategies. For example, huge

advertising budgets and vast retail distribution chains were the norm for most product categories at Nestle, but Nespresso eventually succeeded because Lang brought the customer closer to the R&D team with its Nespresso Club service. Nestlé's ability to innovate is driven by close integration between R&D and marketing and a recognition of customer needs. The company had become so successful with instant coffee that its existing corporate functions were not suitable for Nespresso, and could potentially prevent it from making the necessary on-the-fly adjustments that are part of innovation.

**Question 10: Compare Nespresso's initial "stealth marketing" (word-of-mouth) strategy with its current use of George Clooney as "poster boy" for the product.**

The word-of-mouth strategy was partially driven by necessity: the company faced a lack of awareness by consumers that led to the espresso pods not being consumed within their freshness expiry dates. Training and incentivizing the high-end retail stores that carried Nespresso was key to the marketing strategy that solved this problem. The careful cultivation of a luxury brand image that communicated quality was the purpose of this stealth marketing strategy. It relied upon a key social trend in high-end consumer tastes: espresso increasingly represented an appealing socio-economic status.

The current use of George Clooney as the product pitchman is a natural evolution of the initial word-of-mouth strategy. Once the luxury brand has been established and the reputation of the product had spread more mainstream, the advertising needed to find ways to reinforce the association of Nespresso with social status. Clooney represents the urban, socially-elite image of the product brand very well given his sophisticated onscreen persona.

**Question 11: Do you think that Nespresso would have been as successful without Nestlé as a corporate parent? Justify your answer.**

I believe Nestle was uniquely positioned to make Nespresso successful. It had the aforementioned coffee-making competency as well as superior awareness of global trends in the associated gourmet coffee markets. The premium coffee market was largely borne in Europe, close to its headquarters, and the marketing cache of being a European company brought value to the brand that an American food company would not have had.

**Question 12: What are the main strategic challenges currently facing Nespresso?**

Nespresso in 2016 is still the leading brand in the individual espresso/coffee pod market, but its market share has been declining in the face of competition from Starbucks and many niche "pod" coffee makers. Its main strategic challenges at the moment are legal challenges from a competitor who claims the Nespresso machine infringes its patents, the expiration of the Nespresso machine's own patented design, and the growing social importance of functional health foods and drinks. The legal battle presents a significant risk: the potential damages are

large given that most Nespresso machines in Europe and the US use the disputed technology (Blackstone).

Nestle is focusing on innovating with the styling and features of the Nespresso machine, and continuing to expand its range of drink offerings within its pod menu (Blackstone).

### **Question 13: Do a “5 forces” analysis of Nespresso. Which opportunities do you see for potential competitors, and why?**

***Risk of Entry by Potential Competitors:*** What used to be a strength of the Nespresso system – only the Nespresso pods could be used on the patented Nespresso machine – has vanished since the company’s patents on the machine design expired in the early 2000s. Nestle was forced to allow its machines to accept pods made by other manufacturers, reducing one basis for charging high premiums for its espresso. This represents an opportunity for competitors to take market share based on cost. Nespresso still owns high brand loyalty as shown by its leading market share, and also maintains its absolute cost advantages given its overall size and coffee manufacturing know-how.

***Bargaining power of buyers:*** Nespresso originally grew its brand out of direct to consumer strategy – the Nespresso Club – but its machine now has grown into a more diversely distributed product (the pods are only available direct or through Nespresso stores). It is subject to the powerful position of some of its retail buyers, such as Target, Amazon, etc.

***Bargaining power of suppliers:*** Nespresso maintains a strong advantage here given that the ingredients and materials that go into its production have not changed significantly over the years.

***Threat of substitutes:*** This constitutes the greatest current threat to Nespresso. The expiration of its Nespresso machine patents, the diversification of the premium drink market and the rising social importance of functional health ingredients all represent competitive threats. Nestle is not known to have particular core competence in functional ingredients, and it is faced with stripping its beverages of artificial ingredients in order to keep up with its competitors (Chaudhuri).

***Power of complementors:*** The competition’s coffee pods that are used with the Nespresso machine can be viewed as complementary products now. The threat of these coffee manufacturers and their drinks taking more importance than the Nespresso machine is significant.

## **Conclusions & Recommendations**

Nespresso continues to boast the strongest consumer brand in home espresso and premium coffee drinking, with a market share of 11.1 percent (Chaudhuri). The fact that the third-leading brand in the individual coffee pod market is another Nestle brand, Nescafe Dolce Gusto, and that these pod products are still significantly more profitable than other core Nestle businesses units (Chaudhuri) leads me to believe that Nespresso should aim to augment its brand to stay ahead of the competition. I recommend the acquisition of a functional health drink company possessing strong R&D assets that would complement Nespresso. This would allow Nespresso to tap into the growth of the functional health food market and stay ahead of the competition.

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