

## INNOVATION AND RENOVATION: THE NESPRESSO STORY

*Research Associate Joyce Miller prepared this case under the supervision of Professor Kamran Kashani as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation. Certain names, facts and financial data have been disguised.*

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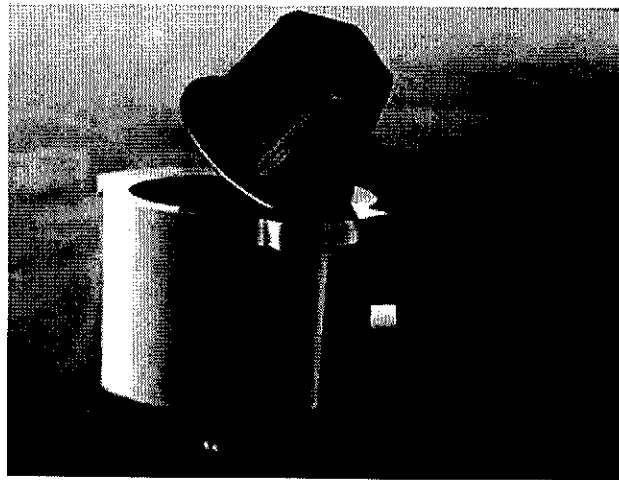
The business has two--and only these two--basic functions: marketing and innovation. Marketing and innovation produce results; all the rest are costs.

Peter Drucker

*Management: Tasks, Responsibilities, Practices*

To just keep pace in this industry, you need to change at least as fast as consumer expectations. That's *renovation*. To maintain a leadership position, you also need to leapfrog, to move faster and go beyond what consumers will tell you. That's *innovation*.

Peter Brabeck-Letmathe, CEO, Nestlé S.A.



Individualisation is a driving force in today's markets--in everything from the telephone to beer to tea to personal computers. The Nespresso System is an innovative concept that offers consumers individual portions of freshly-ground coffee in a range of tastes that result in an exceptional cup of espresso every time. We're convinced of the power of the idea and the technology behind it, and we're aiming to grow this business eightfold to SFr 1 billion in the next decade.

Willem Pronk, CEO, Nestlé Coffee Specialties

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## *Introduction*

Nespresso was the leading brand in portion coffee, a small but fast-growing category in the world coffee market. The product consisted of high quality coffee packed in aluminium capsules for exclusive use in specially designed machines. Developed at Nestlé, the Nespresso System, as the capsule-machine combination was called, offered the consumer a refined quality and individualised cup of espresso coffee with speed and convenience at the push of a button. In the stagnating global market for coffee, Nespresso had created a new growth segment.

This case is about the history of Nespresso's development and the challenges for its future. **Part I** describes Nestlé's strategies for growth through innovation and renovation, and traces the history of Nespresso from its uncertain beginnings to becoming one of the fastest growing businesses in the company. This section also describes the management's practices and views on promoting a climate for innovation. **Part II** explains the challenges facing management as the company aimed to grow the Nespresso business towards the SFr 1 billion level.<sup>1</sup>

## *PART I*

### *Nestlé and the History of Nespresso*

Established in 1867 in Vevey, Switzerland, by 1999, Nestlé was the world's leading food company, employed over 225,000 people, had sales of more than SFr 70 billion, and operated 495 factories in over 80 countries. Peter Brabeck, who took over the reins in June 1997 from long-time CEO Helmut Maucher, believed that continuous innovation and renovation would be the keys to meeting the company's ambitious 4% growth target in an industry where the norm was half that level. While changing demographics and lifestyles in industrialised countries, where Nestlé generated the bulk of its sales, meant opportunities for new business development, these markets were also increasingly characterised by discriminating consumers, powerful retailers, growth of private labels, and pressure on prices and margins.

In seeking new growth markets for its existing products, Nestlé had recently launched its strategic brand Nescafé, the pure soluble coffee that the company had invented in 1938, into the much wider area of ready-to-drink coffee beverages. Similarly, Nesquik, the company's global brand for chocolate powder, was extended into new liquid forms. In addition, a completely new product concept, a re-mineralised table water marketed under the brand Pure Life, was successfully tested in a number of markets in Asia and Latin America. For Brabeck, these were examples of new concepts that combined technological and market innovation. Brabeck commented:

The success of leading brands is proportional to their capacity for innovation and renovation. Innovation is taking something into the next category or inventing a whole new category. Renovation is keeping the product in the same category and improving it. These concepts are not only technical and production-related, but must be applied throughout our business: from organisational structures to finance, administration, marketing, communication, etc. To make a quantum jump into another direction, we need to look for new opportunities and we must be prepared when they arrive.

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<sup>1</sup> In 1999, US\$ 1.00 = SFr 1.50 (one Swiss franc = 100 centimes).

In Brabeck's views, certain management qualities were prerequisites to attaining the company's growth targets. These qualities were used as criteria by senior management in appointing individuals to important positions (*refer to Exhibit 1*). Although Brabeck was patient, he was not complacent about his objective of long-term growth through innovation and renovation. He remarked:

Nestlé has the lowest risk profile that a company can have. While we get pressure from the financial analysts to do things differently, the market is finally beginning to understand. We're not interested in compromising long-term shareholder value for short-term share price maximisation. We have a long-term vision for growth.

In generating growth through highly differentiated new products, Brabeck wondered what policies and practices might be needed at Nestlé to promote a climate for change and innovation. In the same context, he wondered what lessons the Swiss giant could glean from its long learning curve in bringing the Nespresso System to market.

### ***Nespresso System: Product Innovation Against the Odds***

The Nespresso System consisted of individually-portioned aluminium capsules containing 5 grams of roast and ground (R&G) coffee made for exclusive use in specially-designed coffee machines (*refer to Exhibit 2*). Hermetically sealed to preserve the freshness of the coffee for six months after production, the Nespresso capsules also had the advantage of being clean and easy-to-use compared to traditional, hand-measured espresso coffee. Each capsule corresponded to a single cup of coffee and worked only in Nespresso machines. Consumers could choose from eight available coffee varieties (*refer to Exhibit 3*).

The outward simplicity of the Nespresso technology masked its complexity. The coffee-making process involved three stages: pre-wetting (where water was sprayed on the coffee to expand it), aeration (where air was passed through the coffee to create small irrigation channels), and extraction (where water flowed through the coffee at optimal pressure and heat). The extensively researched Nespresso machine contained a chrome-plated capsule holder equipped with a built-in opening and filtering system, a microchip-monitored pump that delivered varying levels of pressure depending on the coffee blend, and a high precision thermoblock system to continuously heat water in the ideal range of 86° to 91° centigrade. This extraction process was seen to be highly innovative, incorporating years of research and learning that would be difficult for a competitor to replicate without patent infringement. The Nespresso concept currently outperformed all competitors in quality and convenience.

Nestlé held the patents for the Nespresso machines but licensed their production to manufacturers who distributed and sold them through selected household appliance retailers. The manufacturers also offered after-sales service. Nestlé did not make any money on the sale of the machines. It was only the sale of the capsules that determined the profitability of the business. Industry analysts estimated that profit margins on the capsules could be as high as 50%.

With its distinctive brand, luxury image, and focus on the small portion of the espresso coffee segment, Nespresso represented a major departure from most Nestlé lines of business reputed for large-scale production and mass marketing. Outsiders sometimes remarked that it was a company for "lifers"--managers who stayed with the company career-long.

## The R&D Push

The technology behind the Nespresso System actually originated in Geneva's Battelle research institute. Nestlé acquired the rights to commercialise the idea in 1974. At the time, Nestlé dominated the instant coffee market, which accounted for 30% of coffee consumption world-wide. Instant coffee generated over 80% of the company's coffee sales and commanded large promotional budgets and managerial attention. On the other hand, Nestlé had no significant presence in the much larger R&G segment, which represented the 70% of total world consumption. Furthermore, while the total coffee market was stagnant, even declining in some countries, management realised that a growth opportunity in the "gourmet" segment of the coffee market was rapidly developing in the US and elsewhere. In the same way that Grand Cru appellations distinguished top quality wine from everyday wine, "gourmet" referred to premium-end coffee (e.g., espresso) where special care and attention were devoted to the coffee variety, roasting process, and brewing phase.

The aim of the Nespresso product development was to combine Nestlé's R&D strength with its deep knowledge of the coffee business to bring a high quality coffee product to the market. But a number of technical problems had to be overcome first. For example, the projected production costs were too high, the freshness of the enclosed coffee could not be maintained, and the quality of espresso<sup>2</sup> was inconsistent from cup to cup. Nevertheless, a few people in Nestlé's R&D organisation firmly believed in the project and pushed it forward. They improved both the coffee capsule and an espresso machine later produced by Turmix, a Swiss manufacturer. Other problems were resolved in time.

The project gained early support from Nestlé's food service division, which saw Nespresso as an entry into the restaurant market, thereby positioning Nestlé more strongly in this segment. But in 1982, following a market test with eight automatic machines in Swiss restaurants, that strategy was abandoned in favour of the office coffee sector. Sobal--a Swiss company that distributed appliances and was already present in office coffee--was approached to distribute the Nespresso System (the machine and the capsules) in offices and other institutions.

## Nespresso: A "Satellite" Outside of Nestlé's Main Coffee Business

To further develop, produce, and market the Nespresso System, a separate company was created in June 1986 as a 100%-owned Nestlé affiliate, located across the street from the company's headquarters. It was thought that the new unit, later called Nestlé Coffee Specialties (NCS), would be able to move faster in seizing the market opportunity in the newly-created, individual-portion coffee category. Exclusively responsible for promoting products under the Nespresso brand name, the company could develop its own commercial, distribution, and personnel policies separate from Nestlé. A special production line was opened to make the coffee capsules at the Nescafé plant in Orbe, Switzerland.

Camillo Pagano, at the time senior executive vice president in charge of several world-wide strategic product divisions and business units, commented:

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<sup>2</sup> A "good" cup of espresso was distinguished by its fine taste and its "crema," the visually distinctive creamy foam on the surface, which coffee connoisseurs considered an essential part of the espresso experience.

I saw this contraption in Orbe that somebody said was going to be fantastic. I discovered that the R&D team had developed this system without even really talking to the marketing side. There is no doubt that technical development can bring innovation. But internally, there was a lot of scepticism about the possibility to commercialise Nespresso. The business was physically moved out of Nestlé so that it could establish credibility and so that it didn't have to fight against all the company's rules.

People thought I was a 'nut' to spend so much time on this small thing and to support the idea. Nespresso is so different from what the company does in its day-to-day business. I felt that developing this business would take time and patience. You need champions at the top for a new idea. You need to give an idea support against criticism. Any innovation immediately hits resistance in an organisation. Small satellites like this can help people gain insight into how a business could be developed differently. These offshoots provide an opportunity to train and test people. If they make a mistake there, it's not so costly.

The Nespresso System was first launched in Italy, the world's largest espresso-drinking nation and in Switzerland, Nestlé's home market. Japan was also later included as it was one of the world's fastest growing coffee markets. Sales initially focused on the office-coffee sector. The Nespresso machines were designed internally by Nestlé and a Swiss design company and manufactured under license by Turmix for European markets. Sobal purchased the machines from Turmix and the coffee capsules from NCS and then sold the two together as the Nespresso System. Additionally, several companies that distributed vending machines in the office sector added Nespresso machines to their product line-up. It was thought that, compared with households, the office segment would be less sensitive to the relatively high unit price of the machine which, at the time, retailed close to SFr 800. A box of 10 coffee capsules sold to offices at SFr 4.

### **Worrying Signals from the Marketplace**

By the end of 1987 only half of the machines that had been manufactured were actually sold. The company was behind target on sales for both the machines and the capsules. And without the machines, further coffee capsules would not sell. There were also other worrying signs. Machine defects were absorbing a large part of the maintenance and service budgets, which Nestlé was covering in total. Slow sales in non-traditional espresso markets like Japan were also deepening the losses. Arguments were made to bring in someone from the outside with new ideas to save Nespresso from an early death. In 1988, Yannick Lang, a former Philip Morris executive, was recruited to the venture.

### ***Rethinking the Strategy of Nespresso***

Swiss-born and US-educated, 33-year old Lang came into the Nespresso team with a reputation for flair and creativity and a solid commercial and marketing track record, having catapulted the Marlboro Classics clothing line from SFr 20 to SFr 100 million within a few years. Pagano recounted:

The Nespresso business was at the point where we needed an entrepreneur to take it further. We needed to find somebody who wouldn't react like a Nestlé manager. People in our organisation are good, but at the time, everyone was asking, 'How could we sell this thing in supermarkets?' Nestlé doesn't bring people in from the outside as a common practice, but we needed someone who understood what it meant to sell a premium system--something between Louis Vuitton fashion accessories and Maggi bouillon. This needs a special mentality. What really convinced me was Lang's background, coming from Philip Morris where going into the clothing business was also a stab in the dark; it was not the usual thing to do.

Rupert Gasser, executive vice president in charge of Technical, Production, Environment, and R&D, to whom Lang subsequently reported, remarked:

Lang was purposely hired externally rather than internally. He was ambitious and strong-headed. He had a strong drive for recognition. He wanted to do something outstanding. Lang had personality; he was a force. And importantly, he did not carry all the trappings of the company history. He was outside of Nestlé's main coffee structure.

### **A Strategic Shift to the Household Market**

The idea of spearheading the development of Nespresso--a small operation in a separate company with a separate product--was very appealing for Lang. But the team of eight people he inherited were acting in a "skunkworks," and the business was losing money in the office segment with flat sales. Lang soon concluded that the prospects for the Nespresso System in the office sector were limited, but that there was potential, albeit unproven, in the household market. Lang thought that households headed by well-educated, affluent 35- to 45-year-old men and women, who enjoyed drinking restaurant-quality espresso at home, could constitute a profitable segment for the Nespresso System. Market trends evident in the late 1980s supported this idea. Cafés and bistros were opening up across Europe, and the success of gourmet and specialty coffee chains in the US (e.g., Starbucks, The Coffee Beanery, and Caribou) had led espresso to be perceived as a trendy, socially elite drink. The vast majority of espresso drinkers tended to be city dwellers with discerning tastes in food. The growth in popularity of Italian lifestyle, cuisine, and fashion had also fuelled interest in this method of extracting what was said to be the best aromas and positive components of coffee.<sup>3</sup>

Lang believed that to build long-term business with such discerning consumers, Nespresso had to be in the household market. Lang presented his revised strategy to Nestlé's general management in early 1989. Despite substantial internal scepticism about the prospects for the Nespresso System, he received the "green light" to launch the household strategy, but only in Switzerland. The rationale was that it was a high risk strategy that still needed to be proven, and that a single market could be shut down more easily than multiple markets. If Lang could deliver on his target to triple the sales volume within a year, the top management agreed, then the business could continue.

Very little market research on the household market existed at the time. What research had been done indicated low potential for the Nespresso concept. Some data showed that the perceived consumer value of the coffee capsule could not exceed the low figure of 25 centimes (as opposed to the target consumer price of 40 centimes). A market test with five upscale household appliance stores in Switzerland was similarly disappointing. The objective was to sell 100 Nespresso machines through intensive retail merchandising and demonstration. The actual sales, however, were less than half of the target. To avoid being shut down, Lang interpreted the market test results he presented to corporate management rather liberally, i.e., his presentation showed a more favourable picture than the evidence suggested.

Although most people in Nestlé considered the commercialisation of Nespresso to be impossible at the time, the Nespresso team was completely convinced of its potential, despite the grim market research findings. Pointing to the failure of the first market tests for fax machines and mobile phones, their attitude was that

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<sup>3</sup> Source: "Coffee International File, 1998 to 2002." Market Tracking International: 216-17.

consumer research tends to reflect past experience--which does not necessarily lead to innovation. The continuing conviction of Lang and his team was based on intuition and a strong personal belief in the Nespresso System.

### **Positioning Nespresso at the Top**

Lang's new strategy involved positioning Nespresso away from the more utilitarian office coffee and targeting consumers at the top of the household market. Nespresso machines would be produced in Switzerland under exclusive agreement with a leading manufacturer of espresso machines. Nespresso machines were sold through selected household appliance retailers, department stores, electrical outlets, and kitchenware stores. Nespresso machines retailed in the range of SFr 350 to SFr 900. Retailers earned a 25% to 35% margin on the sale of the machines. Machine makers earned a 30% to 35% margin, typical for a product of this type. Again, Nestlé did not profit from the sale of the machines. To accompany his global ambitions, Lang subsequently developed "machine partnerships" with several international producers and distributors of household appliances like Matsushita, Krups, Philips, Alessi, Jura, and Magimix.

During this period, Lang and his team introduced modifications to the design of the coffee capsules that cut material costs while making them recyclable.

Gasser commented on the new strategy:

There were not many people in the company who believed in Nespresso, but Lang did. He was totally convinced of the opportunity. Nespresso was purposely run at arm's length and not built into Nestlé's main coffee structure. Our CEO challenged Lang a lot. He found the challenge motivating; he liked it.

Individually-portioned coffee was an idea mainly pushed forward by R&D. There was a lot of internal criticism at the time, but the project got support from Nestlé's CEO, who dared to do something different. When something is new, it will always meet with resistance. There will always be a lot of *ifs* and *buts*. Most people didn't think Nespresso would be a revolutionary idea. There was a concern that it would distract us from our core business in instant coffee. It was seen as competition to instant coffee.

### **Debut of the Nespresso Club**

The shift to the household market soon led to a re-evaluation of the strategy for distribution. The idea of channelling capsule sales through supermarkets was explored but rejected as Lang felt that this would simply transfer the profitability of the business away from Nespresso. An earlier attempt to sell the coffee capsules in US food outlets had actually failed because the consumer base had not been broad enough and retailers had been left with a considerable stock of stale coffee capsules. Experience showed that it could take up to three months for the Nespresso capsules to arrive on store shelves, cutting in half the time remaining until the best-before expiry date. With such a short shelf-life, quality could not be assured.

As there were still some nagging problems with the reliability of the Nespresso machines, and quick service turnaround was considered critical, Lang seized on the idea of using a direct marketing channel to stay close to the consumer. Turning a technical constraint into an elegant marketing solution, Lang conceived and launched the Nespresso Club, which, in addition to handling service calls, offered consumers:

- *Around-the-clock order-taking*: Consumers could telephone a national call centre 24 hours a day, 7 days a week. Orders for Nespresso capsules could be placed by toll-free telephone, fax, mail, and eventually over the Internet.
- *Prompt delivery of fresh coffee*: Within two business days.
- *Personalised advice*: Trained coffee specialists were on hand to advise consumers about the different flavours and provide technical assistance on the machine. Club members could also benefit from recipe suggestions, Nespresso accessories, special offers, and get information about new coffee blends.

Lang also put in place some stringent operating rules. For example, in the Nespresso Clubs, telephones had to be answered within three rings, and he insisted that staff and managers dress in a way that reflected well on the luxury image of the system they were selling.

The Club was an immediate success. Purchasers of the Nespresso machines, sold through household appliance stores, automatically became members of the Nespresso Club. The Club concept was the first direct marketing experiment within the larger Nestlé organisation. In 1990 there were 2,700 Club members in Switzerland, France, Japan, and the US. In that year, the stretch sales targets set a year earlier had been surpassed. Nespresso Clubs were later established in Germany and the Benelux (1992) and in Spain, Austria, and the UK (1996). The Nespresso System was also available through agents in the Middle East, south-east Asia, and Australia.

### **Spreading the Word**

As part of the strategy to further internationalise and position the Nespresso System as a premium product, the company sought the patronage of British Airways, Cathay Pacific, and Swissair, amongst others, which began serving Nespresso coffee on board their long-haul first class flights. Top restaurants, mostly in France and Belgium, were also solicited. In countries where Nespresso Clubs existed, heavy investments were made in training sales clerks in retail stores where Nespresso machines were sold. Experience showed that sales clerks needed to give a high level of attention to consumers in order to sell the Nespresso machines. The training and financial incentives were seen as keys to supporting and motivating retail clerks to demonstrate and sell the machines.

Despite the step-by-step international growth, no major advertising or public relations campaigns were undertaken. The Nespresso Club was the chief means of communication. The company relied mainly on word-of-mouth on the part of its extremely loyal consumer base to promote the Nespresso System. Alfred Yoakim, who had been part of the original Nespresso product development team, said:

Advertising is good for the image. It can reassure consumers and communicate an image of quality. But I'm not convinced it will make a consumer change to espresso and buy the Nespresso System. For this, we can only rely on word-of-mouth.

Rupert Gasser concurred:

We don't need mass media or television. We're targeting the *crème de la crème*. We need simpler means, unconventional ways of reaching new consumers.



## **Achieving Growth and Profits**

Under Lang's leadership, NCS achieved breakeven in 1995 and subsequently became one of the fastest growing business units in the Nestlé organisation. By 1997 Nespresso Club members numbered 220,000 (reflecting a 30% average yearly increase), the company's ristretto variety had won special recognition from the International Institute of Coffee Tasters, and the company had installed a second production line for the capsules and was manufacturing them around-the-clock.

Lang was known as a tough manager by the team of "young tigers" he had built, some of whom he had hired away from first-class consumer goods companies. Lang was also known as a strong-willed person who did not give up easily. People recalled that every win gave him a boost. He resisted all efforts to apply methods that might lead to risk-avoidance as he felt the Nespresso business had to go on taking risks. However, some who worked closely with Lang found his strong-headedness a barrier. In the words of one of his associates:

He was passionate about his own ideas but not those of his colleagues. He was impatient, wanting to make things happen in no time. He was a tough boss, a difficult person to work with and manage.

## ***Creating a Climate for Innovation***

Different opinions were expressed regarding what the experience of bringing the Nespresso System to market meant for the larger Nestlé organisation. Lang believed that he had created an environment where his team could take intelligent risks and where everyone could be an innovator. Lang felt that if he had stuck to an "army-like structure," Nespresso would have failed, as he believed that anything military-like would stamp out innovation. For him, having an infantry that marches when it's told to march and assumes that the chain of command knows best, would not lead to innovation. Lang was known to accept structure where it served his purpose and "helped people to do a good job." He rejected it in instances where "it stopped people from innovating."

Lang went to great lengths to keep the Nespresso concept alive, sometimes doing things at the edges of the Nestlé organisation. He also established privileged contacts with high level members of the top management. Former executive vice president Pagano, who before his retirement at the end of 1991 held private discussions with Lang, remarked:

Nespresso was developed as a totally innovative system. Lang crafted a strategic image that was consistently carried through. At one time, he was so convinced of the concept's potential that he even tried to buy Nespresso.

Pagano felt that an individual's personality was tremendously important with respect to innovation:

It's not necessarily the inventor of an idea who has the capability to take it forward. This needs courage, leadership, temperament, and charisma. An organisation also needs to build in the right to make mistakes. This message is not always going down through the 'bunker' of our middle ranks. It's stuck or not being properly explained. Nestlé needs people who can take an idea, believe in it, and bring it to fruition against the odds.

Rupert Gasser, who had overseen the entire Nespresso development and believed in giving broad responsibility to risk-takers, the “youngsters” as he called them, offered his insights into the innovation process at Nestlé:

Our problem is not a lack of good ideas. We have too many of them. The key is to be able to extract an idea, carry it forward in the organisation, and transform it onto the supermarket shelf. The real barrier to innovation is perceived risk. People ask themselves, 'Why should I engage in a process with an uncertain outcome?' People reject risk-taking because they feel it can endanger their current status, their jobs. At Nestlé, we need to create a risk-friendly environment where people don't feel unduly exposed. We must accept that people make errors. But failure due to trying something new shouldn't be a career risk. Sometimes you have to shelter the real innovators, the risk takers.

At the same time, Gasser believed that innovators needed to be occasionally challenged to make sure they had not ignored important details. He said:

Sometimes people who push for innovative ideas forget some basic things. But by being challenged in a dialectic process, they improve their solutions. It's a positive process.

Gasser recognised that innovation in a large corporation like Nestlé was a complex process:

Growth through acquiring brands and companies is relatively low risk. Building new business is different; it's more complex and carries higher risks. In our company, we must be able to get R&D, manufacturing, and the local Nestlé market companies to work in close proximity. This needs to be a constructive process; otherwise, innovation will not be successful.

He agreed that innovation and renovation were both necessary for Nestlé<sup>4</sup>:

To stay viable in the long-term, we need both innovation and renovation. Innovation is a quantum leap that is not necessarily only related to products. It can also be related to manufacturing process improvement or trade channels. Renovation, on the other hand, is more incremental; it allows you to sharpen your claws every day.

At Nestlé, identifying high potential individuals who would foster change and innovation was a senior management responsibility. Brabeck personally followed the careers of several individuals with the aim of picking the right people for tough assignments and helping them to grow in their jobs. He believed that Nestlé needed managers to keep the core businesses running, who would assure order and discipline and provide security and longevity. But he also saw the need to provide space for what he called “change drivers.” But this change was complex. Brabeck explained:

You can't impose change from the top. You can only create an environment that stimulates change. Many managers in large institutions have been trained to keep things running as they have been. They have learned to comply with an enormous number of detailed procedures and systems. They were taught by experience that they are better off following the expected and accepted tracks of routine rather than venturing out into the new and unexpected.

We need to create a climate where there is a certain freedom to fail, and where those people who are promoted have made decisions and carried them out, even if they were not always

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<sup>4</sup> Innovation and renovation referred to radical and incremental changes respectively.

100% successful. We don't want to advance the careers of those who have never made a mistake because they've never done anything except apply the rules. We have to identify, foster, and mentor people who have proven that they're willing to stick their neck out, who made a mistake, learned from the mistake, and are willing to continue taking risks.

On the other hand, Brabeck observed:

If you're only being innovative and creative, but not producing reliable products, you'll soon be out of business. For Nestlé, the quality and security of our products is fundamental.

For Alfred Yoakim, the head of the Nespresso development team from its early days, there were lessons on innovation from Nespresso's experience:

By staying in an ivory tower, you can improve an existing product, but you can't innovate. To innovate, you need the freedom to make your own decisions, to not follow the old rules. Marketing people can innovate because they are free of technical restrictions. Technical people can innovate because they are free of commercial considerations. What we have to do is put the two together. There's still room to innovate in the espresso market. The only limit to innovation is our imagination.

### *Nespresso Under New Leadership*

Lang's tenure at NCS was not without controversy. He was thought by some to be a maverick, an "out-of-the box" manager who forcefully pushed for his ideas, and who found being challenged by his superiors motivating. Gasser called him a real force behind the Nespresso phenomenon and a "rare bird." Lang was subsequently nominated to a select list of managers whom Nestlé considered as "corporate assets." Late in 1997 an opportunity came along for Lang to move to the US to work on Nestlé's large but under-performing ice-cream business. The appointment was considered by everyone, including Lang himself, a timely career move. However, less than six months later, Lang announced that he was leaving Nestlé, having been headhunted by another food company.

In the eyes of Nestlé's top management, NCS had now reached a critical stage in its evolution needing to shift gears for sustained future growth. In the words of Gasser:

The challenge for any small, innovative organisation is to make such a transformation. Nespresso needed structure, better operational efficiency, control of costs, quality, and inventory, in addition to modern personnel policies. As the company grew, these issues became increasingly important.

Willem Pronk, 44, a career-long Nestle manager, was appointed to spearhead the transformation at NCS. He was considered to be a very structured manager and a good marketer.

For Nestlé's CEO, Nespresso's development reflected solid technical know-how combined with the marketing spark of an individual embedded in a supporting organisation. Brabeck commented:

There was a long learning curve to transform the Nespresso innovation into an acceptable, perceivable end-product for the consumer. With Pronk, we've agreed to take the business from the SFr 150 million where it stands now to SFr 1 billion within the next 10 years. Then it becomes an interesting business for a company the size of Nestlé.

At the start, we realised that we had to separate this business so that it could develop its own life. At a certain point, a different management style was needed. Not everyone is good for all phases of a business. As a group, Nestlé has the resources to cover the whole spectrum. In a crisis moment, we may bring someone in from the outside, but normally we try to avoid this. We're not looking for saviours. We look for people who will become long-term collaborators at the service of the company.

## ***PART II***

### ***Towards the One-Billion Target***

#### **Pronk Takes the Helm**

In his own words, Willem Pronk was "born in Nestlé." Over the course of his 20-odd year career at Nestlé, Pronk had developed a reputation for being an innovator and a risk-taker. While managing Nescafé in the Netherlands, for example, he had introduced a new "*café a la carte*" concept to rejuvenate the brand's stagnating business in that market. Despite the scepticism of his superiors, he had allocated an entire marketing budget to promote the new concept: a selection of different Nescafé blends in a stylish wooden box. The concept worked with spectacular results, pushing sales up by more than 200%. This and other moves brought Pronk to the attention of headquarters. He quickly began to climb the Nestlé ranks. Reflecting on his early days in Nestlé Netherlands, Pronk said:

As Peter Brabeck says, 'If we had continued to do what we'd always done, we would have continued to have what we always had--an unsatisfactory performance.' I pushed for trying something new. If it didn't work, the worst case scenario was that I would be fired. But so what? People ask me if it's frustrating to work in a multinational like Nestlé. My answer is: No, I'm probably more frustrating to other managers than they are to me. In a big company like Nestlé, you have access to resources and all the sources of innovation. You can either accept the system or challenge it. There are no hard-and-fast rules. I'd rather ask for forgiveness than permission.

Soon after arriving at NCS, Pronk began working to enhance the consumer service side of the business. The Nespresso Club database was segmented according to consumption habits and the length of membership, and targeted communications were launched. Fifteen to twenty percent of Nespresso capsule orders currently came from small offices. "New" members (less than a year) were tracked closely as it was felt that their long-term consumption habits were formed by usage patterns established in the first few months. A Nespresso Club staff member personally followed up on "heavy" capsule users (more than 100 capsules per month) who did not place an order by the computer-anticipated date, to ensure that their machine was functioning, take orders, and answer questions. When machines needed service, the Club arranged for free home pick-up and return of the repaired appliance. The machine manufacturer did the repair. A Nespresso machine was loaned free to members during the period.

Pronk believed that the above renovations, among others, were needed to create customer intimacy, build long-term loyalty, and put Nespresso on the road to becoming a meaningful concept in the competitive world of coffee. (*Refer to the Appendix for background information on the world coffee market.*)

## Issues for Growth

With its 10 existing Nespresso Clubs in 1999, NCS was receiving 7,000 orders world-wide for coffee capsules each day, and had the capacity to produce 350 million capsules annually (*refer to Exhibit 4*). Close to 100,000 Nespresso machines had been sold in the past year alone, bringing the installed base up to about 350,000. New consumers were also coming on board (*refer to Exhibit 5*).

While the Nespresso concept had created and dominated an entirely new gourmet coffee category--the portion-coffee market--several issues still had to be resolved if NCS was to accelerate its growth. Pronk was very concerned that NCS had, to date, only achieved an average awareness rate of less than 5% in its international markets, and penetrated less than 1% of households. Some asserted that these ratios were significantly higher among upscale households, the current target segment for Nespresso. Nevertheless, the fact remained that very few coffee consumers actually knew about the Nespresso System.

Pronk saw the individualised portion concept on which the Nespresso System was based as a vital means for rejuvenating the mature coffee market. But little market research had been undertaken to date. Pronk remarked:

The quality of the future depends on the quality of the plans you put into action today, and the information on which they are based. That's why market research is key. For me, this isn't about getting reports; it's about being present during the interviewing and being totally immersed with the consumer. We need to know three things: Why do people buy our product? Why do they buy a competing brand? And why don't they buy any product in this category? Then we can look at the three ways to grow the business: sell more to current consumers, sell to consumers of the competition, and sell to non-category users.

Looking to the future, Pronk was concerned about five issues: how to attract new consumers, whether to introduce a lower-cost system, how to serve a wider market, whether to diversify into non-coffee products, and how to pre-empt competitors.

### 1) Attracting New Consumers

Most people drank espresso "away-from-home" in restaurants, hotels, bars, and from vending machines in offices and public areas. Home consumption was limited, in part, because of the perceived high price of espresso-making machines. In Italy, espresso was inexpensive at 1,000 lire (SFr 0.75) a cup and widely available at the neighbourhood bar. Only 1 in 5 Italian households consumed espresso at home. In France, the world's second largest espresso-drinking nation, 66% of adults regularly drank espresso but only 12% drank espresso at home. In northern countries, like the UK and Germany, espresso-drinking was in its infancy, but growing. Most US households still used electric drip coffee makers.

Less than 1% of US consumers had an espresso coffee machine at home.<sup>5</sup> Pronk reflected:

The Nespresso System guarantees high quality and offers consumers individual choice, consistency, and convenience. These are the values of the future. One type of coffee for all is an old-fashioned concept. But despite the success of the Nespresso Club and our comprehensive knowledge of consumer preferences as a result of it, our awareness remains low in priority markets. Word-of-mouth is a slow process. We have to find other means of making the Nespresso concept known.

One idea that had been implemented a few years ago was to give free machines and coffee capsules to opinion leaders, like politicians, journalists, etc., in key markets. This was thought to be less expensive than a media campaign.

Until now, little advertising had been used to raise consumer awareness about Nespresso. Old timers like Alfred Yoakim were strongly against the idea. He said:

Advertising won't do us any good. It's just a waste of money.

Camillo Pagano was also cautious about the new growth strategies being discussed. He said:

I'm worried about the mass marketing mentality that is entering the picture. In this business, you can't talk about household penetration and market awareness.

To promote the Nespresso concept and sales of the machines, NCS continued to invest significant resources (upwards of SFr 200 per machine sold) in training retailers and doing merchandising and in-store promotions. Recent studies had shown that retail demonstration accounted for 40% of new converts to the Nespresso System. The remaining 60% of new customers came through word-of-mouth. In spring 1998, 2,100 Nespresso machines had actually been given away free to Belgian retailers as part of an incentive programme initiated by General Electric Belgium. Upon seeing that 55% of these new machine owners never called the Club to order coffee capsules and a year later, only 26% of the target group were active customers, Pronk noted:

The experience confirmed what we already knew: that people to whom the Nespresso System is targeted must have a desire to drink espresso coffee. If we promote the machines too much, we'll succeed in getting people to buy the machines, but not the complete concept.

## 2) Going Down Market?

By most measures, the Nespresso System was more expensive than alternative methods of making coffee. Compared with the cost of traditional filter coffee machines, the Nespresso machine was five times more expensive. Compared to regular espresso coffee, Nespresso coffee was three times more costly. Yoakim said:

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<sup>5</sup> Source: Wheeler, Michael. "Coffee to 2000: A Market Untamed." Economist Intelligence Unit, 1995.

Like all espresso machines, the Nespresso System is targeted to an affluent group of consumers, the top 10% of households. If they can afford the espresso machine, they can surely afford the coffee capsules. We're not selling a machine and then a capsule. We're selling a result: a cup of espresso. And I want the consumers to get the best result in their cups.

Pronk was adamantly against offering a lower-priced system and the idea of marketing the system under a different brand name. He believed there was still enormous growth potential in Nespresso's current strategy.

### **3) Distribution to Serve a Wider Market**

In markets like Switzerland, where a critical mass of consumers had been created, retailers had approached NCS about the possibility of selling the high-margin capsules. Going through traditional food retailers would be a departure from the past, a move Pronk was not entirely convinced of:

If we give away 25% margins to retailers, there won't be much left here to show for profits. Besides, the Club gives us a fantastic knowledge of consumers that would be lost if we went through retailers. On the other hand, if we continue to sell exclusively through the Nespresso Clubs, non-users won't see the product.

Another idea was to showcase the Nespresso concept through a chain of exclusive boutiques established in high street locations in major European cities. It was estimated that each boutique would involve a one-time investment of SFr 250,000.

### **4) Diversification into Non-Coffee Products**

New uses for the Nespresso System based on the "portion" concept had yet to be explored. For instance, individually-portioned soups or teas could broaden usage among current consumers and attract new consumers. The idea of non-coffee products was not very popular, however. Pronk and Gasser were both concerned that such a product extension would dilute the original concept.

### **5) Blocking Competitors**

NCS currently held a 90% share world-wide in the household segment of the portion coffee market, with Switzerland, France, and the Benelux being its most important markets. The remaining 10% share mainly belonged to Belgium's Malongo with its 1,2,3 *Spresso* system and Italy's Illycaffè, which had yearly sales of US\$ 130 million. Having pioneered the ESE Standard (*Easy Serving Espresso*), Illycaffè had begun supplying "L'Espresso" portions and its own espresso machine to hotels, restaurants, and bars. The company dominated this sector in Italy but was less established in the mass consumer market. Since 1994, Lavazza, a family-run Italian company with US\$ 700 million in annual turnover, had marketed four individual portions, containing 6.5 grams of ground espresso coffee, custom-made to fit its own espresso machines. Close to 80% of Lavazza's sales were in the office coffee channel.<sup>6</sup> These companies had entered the portion coffee market with lower-quality products and espresso-making machines retailing in the range of SFr 300 to SFr 350.

Although the technical complexity of the Nespresso System and related patents were major barriers, the NCS team was convinced that international food

<sup>6</sup> Source: "Espresso, Where the Leaders Stand." *Tea & Coffee Trade Journal*, November 1998, and "Coffee International File 1998 to 2002." *Market Tracking International*: 219-22.

companies with their large resources could challenge Nespresso's dominance by extending their long-established R&G brands into the portion coffee segment. In fact, NCS had learned that Sara Lee had recently registered a patent for a portion coffee concept with a different extraction process, which was as yet commercially unproven. In 1997 Kraft Jacobs Suchard had expanded its *Carte Noire* line in France to include "Espresso Dosettes Filtres." Additional developments were also underway that catered to the single-person households in NCS's target group for espresso drinkers.

Pronk expected a serious entry by one or more players into the high-quality, portion-coffee market where Nespresso was currently positioned. Nevertheless, he believed that NCS had several advantages: advanced technical knowledge, the Club, and a critical mass of consumers in some of its international markets. It was estimated that it would take a newcomer four years to establish a foothold in any national market, and a minimum of 15,000 to 20,000 installed machines to break even.

### ***Conclusion***

More than 13 years after Nespresso's debut, NCS had seemingly reached a satisfactory performance but still fell far short of Nestlé's high ambition of SFr 1 billion sales. At a time when Nestlé was seeking new growth opportunities, a couple of questions preoccupied those who were familiar with Nespresso:

- 1) What lessons could be learned about innovation or renovation from the Nespresso story?
- 2) What must NCS do now to reach its ambitious growth targets?



### **Exhibit 1**

#### **Qualities and Characteristics of a Nestlé Manager**

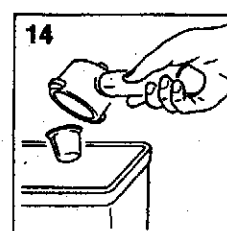
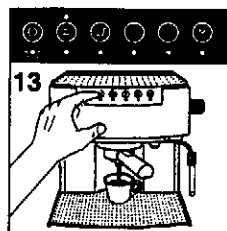
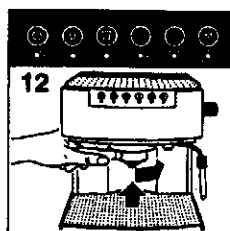
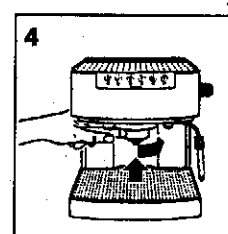
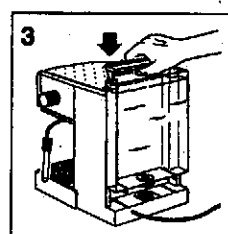
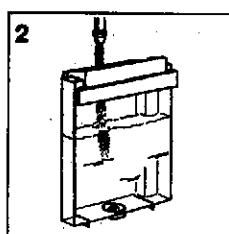
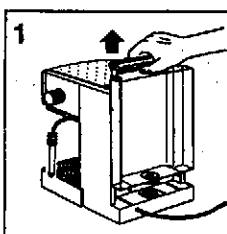
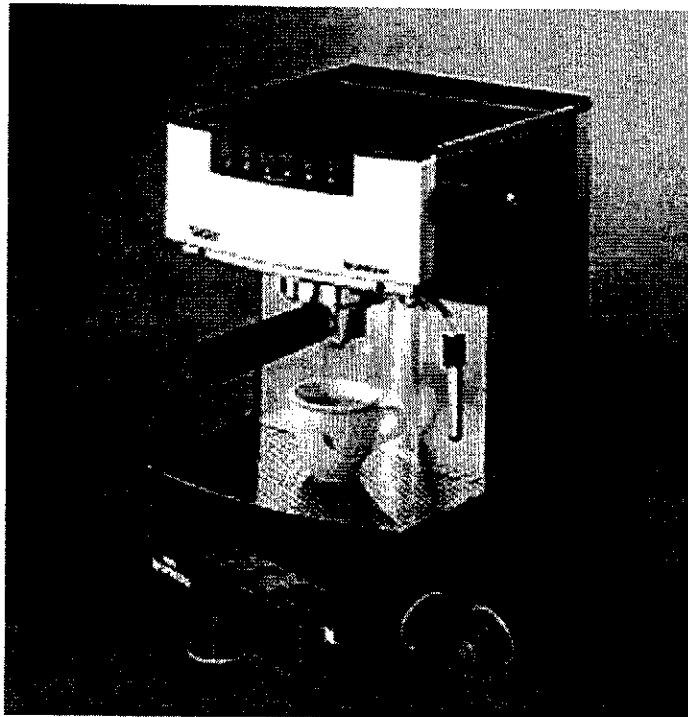
The higher the level of the position and the responsibility of a Nestlé manager, the more he/she should be selected on the basis of the following criteria (in addition to professional education, skills, and practical experience):

- Courage, solid nerves and composure; capacity to handle stress.
- Ability to learn, open-mindedness and perceptiveness.
- Ability to communicate, to motivate and to develop people.
- Ability to create a climate of innovation.
- Thinking in context.
- Credibility: in other words “practise what you preach.”
- Willingness to accept change and ability to manage change.
- International experience and understanding of other cultures.

In addition: broad interests, a good general education, responsible attitude and behaviour and sound health.

Source: The Basic Nestlé Management and Leadership Principles

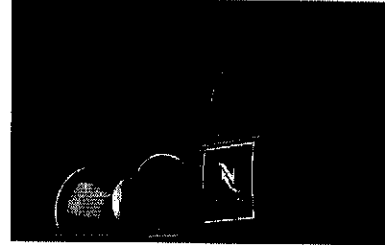
## Exhibit 2 The Nespresso System



Source: Company information

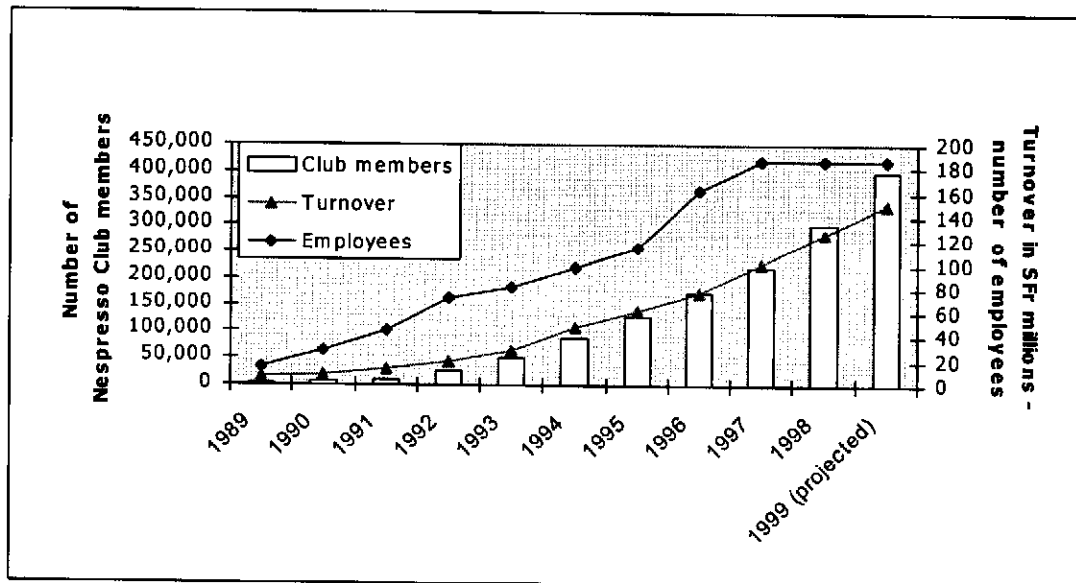
### Exhibit 3 Available Varieties of Nespresso Coffee Capsules

<b>Ristretto</b>	Composed of pure Arabica beans from Latin America for its finesse and a touch of Robusta for its intensity, it is savoured very short in a demitasse filled halfway.
<b>Arpeggio</b>	The Grand Crus of Central America give strength and fullness to its aroma while a touch of Brazilian Santos harmoniously balances its flavour.
<b>Roma</b>	A blend of Latin American Arabica for delicacy, this gives the strong, intense espresso of Italian "baristas" with a thick, rich cream. It is the ideal base for making a <i>cappuccino</i> .
<b>Capriccio</b>	A satisfyingly smooth espresso made from early Latin American Arabicas for a rich and straightforward taste, Brazilian Santos for full and consistent body, and a touch of Central African Robusta for intensity. Top with whipped cream for a true <i>Viennois</i> .
<b>Livanto</b>	Made from the best Arabicas of South and Central America, this espresso is rich, intense, and smooth. Savoured in a demitasse or cappuccino cup, with or without milk, it is the morning espresso par excellence.
<b>Cost</b>	A pure Arabica with all the fullness and flavour of the Grand Crus of Central America, the density of mountain grown coffees from Eastern Africa, and a touch of mildness from Brazilian Santos. With milk, this espresso can be savoured as a <i>con latte</i> .
<b>Volluto</b>	A delicate yet full-bodied pure Arabica espresso. The mellow richness of early Latin American beans gives this blend a distinct, elegant, subtle bouquet. Characterised by its mildness, it is ideal any time of the day.
<b>Decaffeinato</b>	Naturally decaffeinated, it has a delicate, balanced, and enticing flavour. Its freshness and intensity come from the great early Arabicas of Central America reinforced by a touch of Central African Robusta.



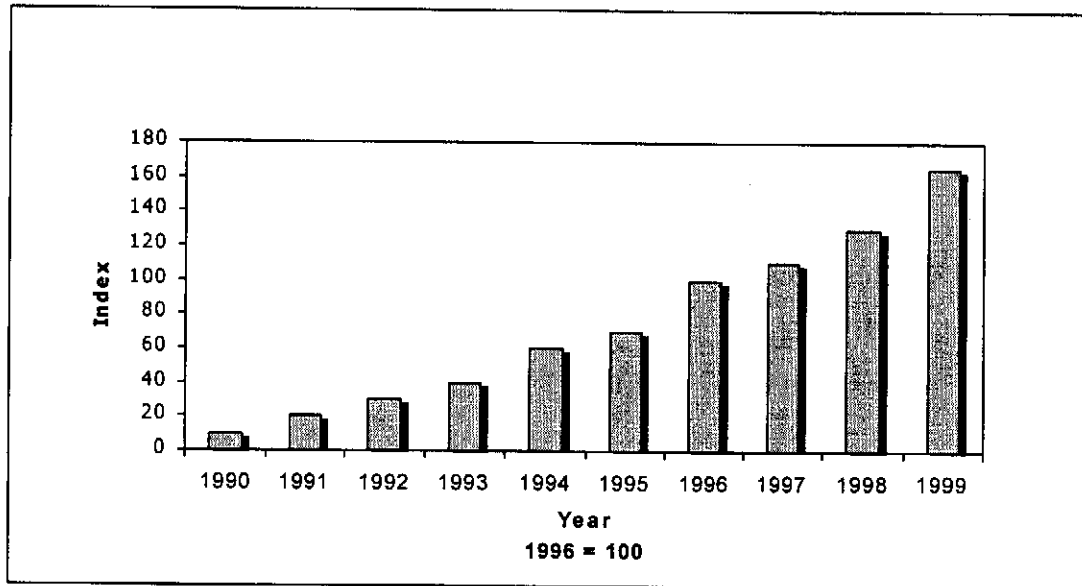
Source: Promotional material provided to Nespresso Club members

### Exhibit 4 Growth of Nestlé Coffee Specialties Turnover, Employees, and Nespresso Club Members 1989-1999



Source: "Nespresso Prodiges." *Bilan*, April 1998, and company information

**Exhibit 5**  
**Development of NCS Capsule Sales**  
**1990-1999**



Source: Company information

## APPENDIX

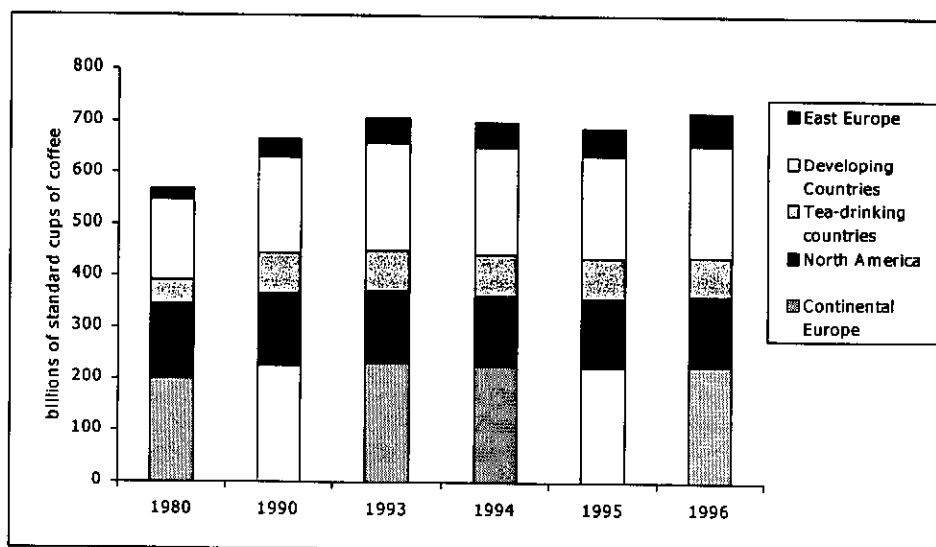
### The World Coffee Market: Mature and Highly Competitive

Globally, the coffee market was in a mature stage. Growth had been achieved only through increased retail prices and growing consumer demand for high quality, gourmet coffee (*refer to Table 1*). European countries led the world in per capita coffee consumption, with Scandinavian nations heading the list (*refer to Table 2*). The coffee market was split between R&G coffee and instant coffee, and secondarily between the "away-from-home" and "in-home" sectors (*refer to Tables 3 and 4*). World-wide, R&G accounted for almost 70% of coffee sales or about US\$198 billion at average consumer retail price, whereas instant coffee accounted for 30% of sales or US\$85 billion (*refer to Table 5*).

The coffee industry was dominated by food multinationals renowned for their strong brands, aggressive pricing, and high marketing expenditures. Nestlé was actually the world's largest coffee company with a 23% share of the total market (*refer to Table 6*). The company dominated the instant coffee segment with a 56% share from its flagship brand, Nescafé, and its numerous product varieties, but the company was ranked fourth in the R&G segment with a 7% share. Philip Morris (Kraft Jacobs Suchard, Maxwell House), whose food business generated over US\$27 billion, was the second largest coffee company with a 14% share of the total market. The company was the leader in the R&G segment with a 13% share and second in instant coffee. Sara Lee (Douwe Egberts), with an annual turnover of US\$20 billion, was the third largest coffee company with a 7% share of the total market. It was the second largest player in the R&G segment. Procter & Gamble (Folgers Coffee), with an annual turnover of US\$37 billion, was the fourth largest coffee company with a 6% share of the total coffee market.

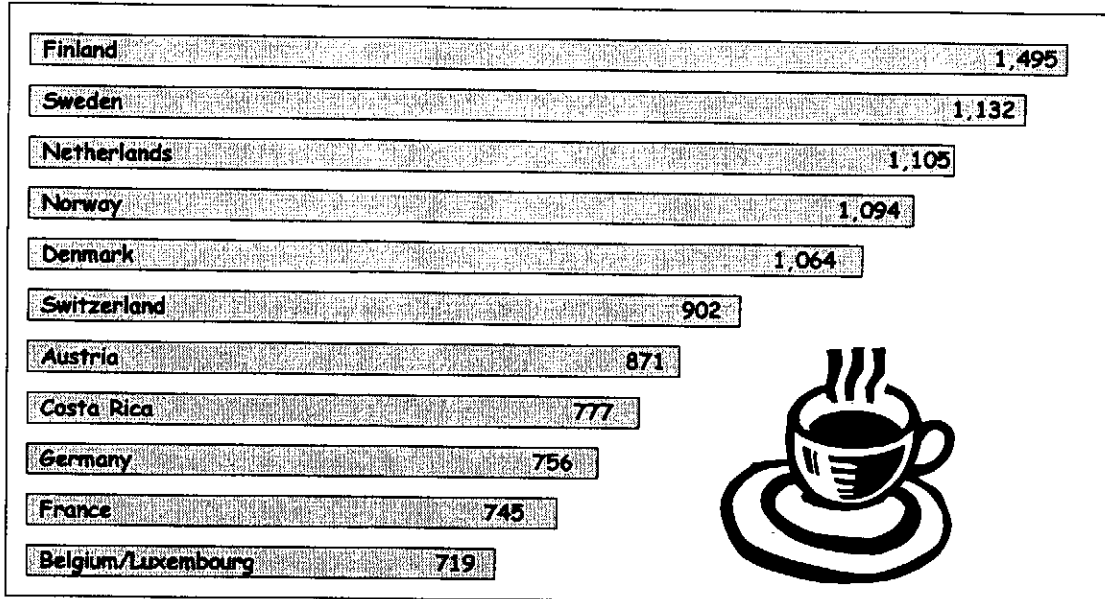
In recent years, profit margins for coffee producers had been narrowing as a result of growing competition in the R&G segment. This trend had encouraged companies to enter the smaller, but higher-margin, high growth gourmet coffee segment. In 1999, this segment was estimated to be worth US\$10 billion world-wide and was growing at a rate of 20%.

**Table 1**  
**Total World-Wide Coffee Consumption**  
**in billions of cups: 1980-1996**  
(all coffee, all channels)



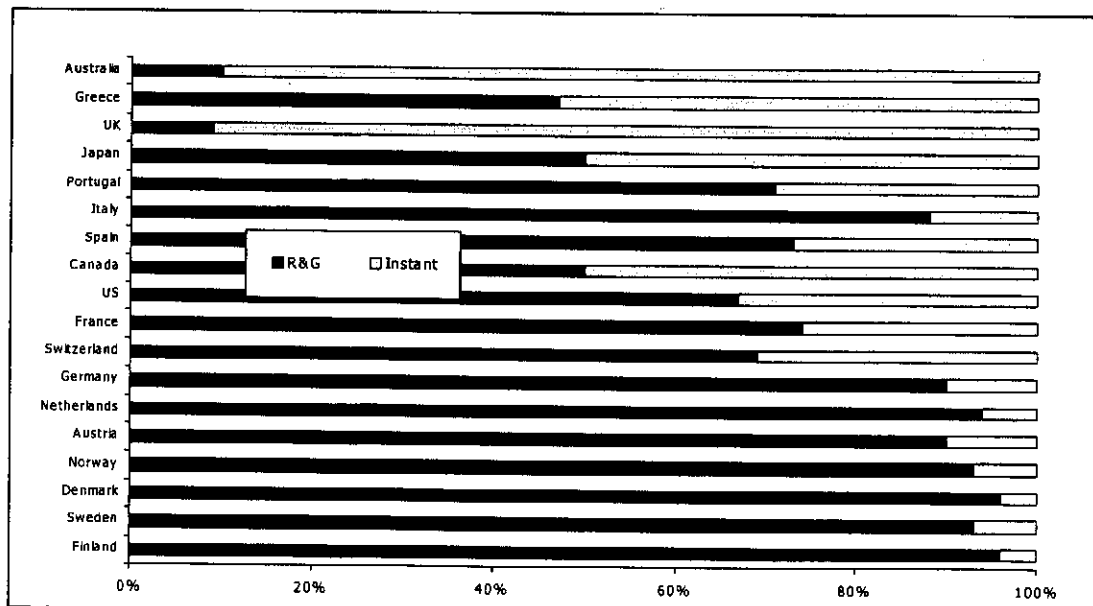
Source: Company information

**Table 2**  
**The Leading World Markets for Coffee Consumption**  
**per capita consumption in total cups, 1996**



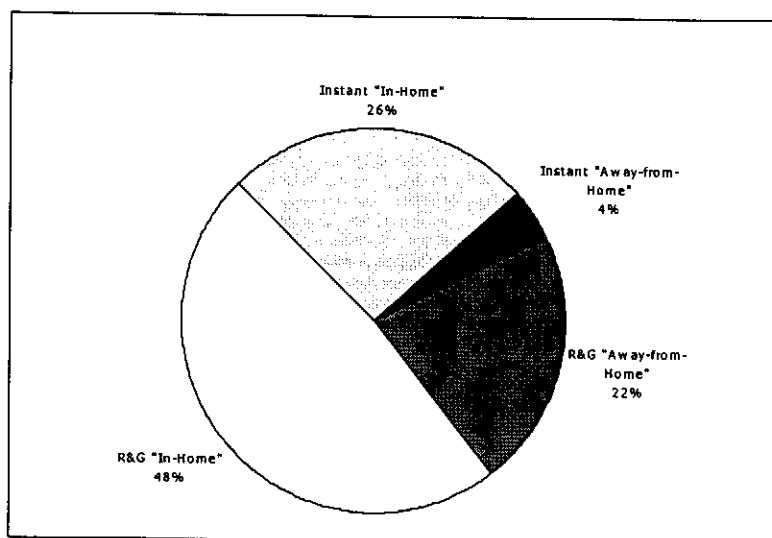
Source: Company information

**Table 3**  
**Market Breakdown by Country**  
**R&G vs Instant Coffee**  
**1995**



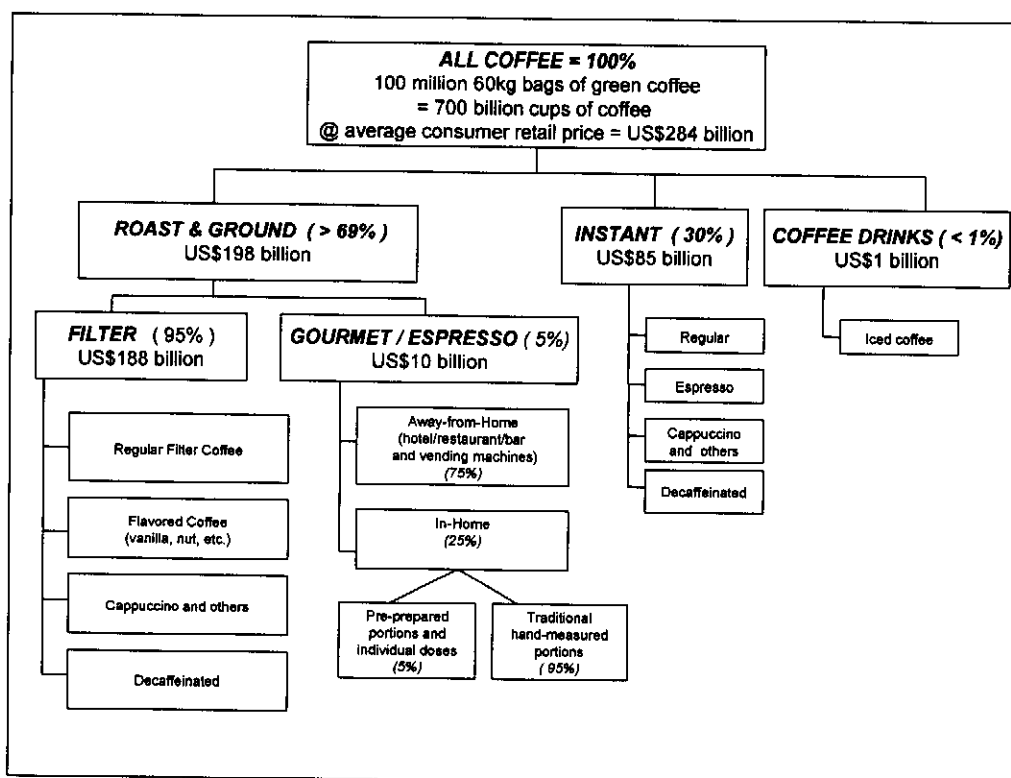
Source: International Coffee Organisation

**Table 4**  
**"Away-from-Home" vs "In-Home"**  
**R&G and Instant Coffee**  
 (world-wide consumption in billions of cups: 1996)



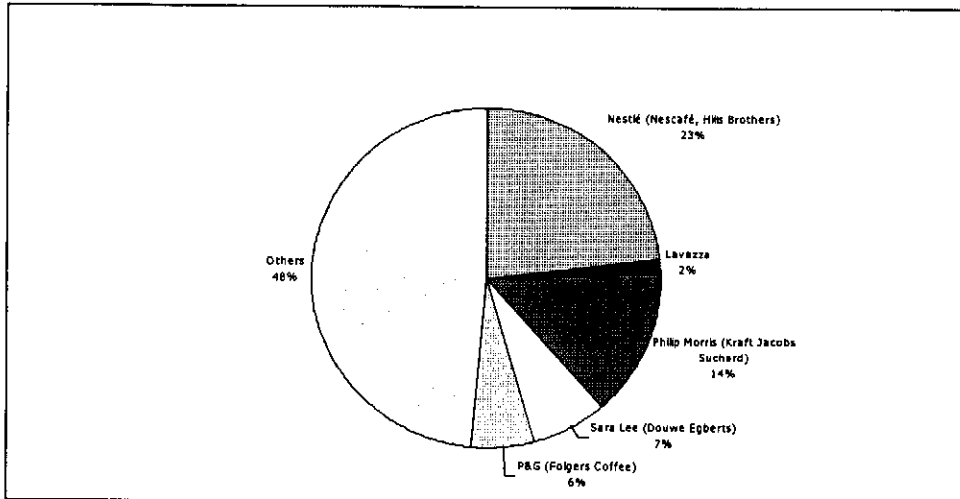
Source: Company information

**Table 5**  
**Partial Structure of the Global Coffee Market, 1999**



Source: International Coffee Organisation and company information

**Table 6**  
**World's Leading Coffee Roasters**  
**Market Share by Volume, 1995**



Source: International Coffee Organisation, Encyclopaedia of Global Industries, (Food, Drink, and Tobacco Products), and company information