

Global Equity Observer

# The Power of Premium Pricing over Private Label

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Brands grow by getting into the hands and minds of the consumer—and staying there. This mental and physical availability builds a conscious and unconscious relationship with the purchaser. Consciously, brands signal a wide variety of attributes including price, quality, efficacy and reputation. Unconsciously, they help reflect and validate a purchaser's ideals, their beliefs, their principles and their standards; effectively, they inhabit their values system, which ultimately influences their decision-making. Combined, these tangible and intangible features characterise the brand. They are the “cues” that brand owners use to sustain and develop their brands over time.

Big brands have the distinct advantage of having more cues to help keep and stimulate consumer attention than either small brands or “private label/own label”. Private label pretty much has just one cue: price. Small brands are typically limited to just a few cues. For them, it's not often price (as the absence of economies of scale works against low price offers), but more often focusing on ultra-niche, local markets, often highly novel, and with limited supply and distribution. Largely, they are frictional noise in the face of the large, firmly established global brands.

Big brands simply have greater physical reach than smaller ones, or private label. They are dominant on the shelves.

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They are available in far more places. Crucially, in the digital channel they enjoy enhanced visibility—who goes to page two on a website or on an automated online shopping list? Digital isn't an infinite shelf. It's all about data and scale. Who has the data and scale? The big brands. Who knows the most about the consumer? The big brands.

But being big isn't everything. You need to be relevant too. Tastes change and categories develop. Brands require continued investment, they need nourishment and innovation, and they demand an intense level of marketing. After all, if the average supermarket has 40,000 items for you to choose from, but you're only looking for 50 for your basket and spending only about 13 seconds making your choice, then being front of mind (mental) and in front of your eyes (physical) matters. Having the cues to make this happen is the territory of the well-invested brand.

Who are brands appealing to anyway? Using an industry 20/50 rule of thumb, 20% of customers account for roughly 50% of sales for a typical brand. These customers have a higher frequency of purchase than the remaining 80% of customers who account for the other 50% of sales. Therefore, increasing the frequency of purchase for this larger cohort is a key element in the advertising and promotion strategy.

Why does all of this matter? In the current climate of rising prices and a global squeeze on the cost of living, a question we hear frequently from our clients is whether big brands—with their premium pricing versus cheaper alternatives—face the risk of consumers “trading down”, where such alternatives exist.

What matters here is the perception of price. The consumer equation is price + quality = value to me. What's important is the price gap difference. What is the spread between the branded product and the alternative? What premium is the consumer paying? Ironically, in a world of rapidly rising prices, this gap typically narrows rather than widens, increasing the relative value proposition for the branded product. This is because, in order to maintain its margin, the lower margin alternative must raise its price more than the branded operator. For example, Business A with a 25% gross margin needs to raise prices by 15% to offset a 20% increase in input costs. Meanwhile, high quality branded Business B, with a 50% gross margin, only needs to increase prices by 10% for the same rate of input cost inflation.

Another disadvantage facing lower quality, lower margin competition is the inability to invest and innovate (if at all)

at a meaningful rate. These companies simply can't afford to compete at the same scale and intensity as the disciplined, large-scale branded players, leaving them as price takers and innovation followers. For example, one of the world's leading beauty companies—based in France—maintains a very high gross margin of approximately 70%. Its operating margin is roughly 20%. This means operating costs are about 50% of sales, giving the company the freedom and flexibility to spend 30% of revenues on marketing alone. The average company in the MSCI World Index has a gross margin of about 30%. If the average company spent 30% of sales on marketing, it would probably go out of business. Not only can the beauty company spend the money required to ensure it meets the mental and physical requirements of the consumer—right place, right premium, right product, right positioning—the architecture of its profit and loss statement acts as a wide moat and a very strong barrier to entry.

Of course, in times of economic hardship, there will be decisions where price is paramount and the branded product may not be chosen. But the risk tends to be far more geared to the mid-tier pricing segment, where weaker brands or more expensive private labels exist, than it is for a trade down from premium straight to the “cheapest”.

Further, from a portfolio perspective, the right category exposure matters. Beauty, beer, spirits, soft drinks and niche homecare segments are more strongly correlated to advertising and promotion and research and development spend, and are much less vulnerable than food or laundry for example—categories with weaker pricing power, coupled with challenging competition from private label and increasingly sophisticated discounters.

Elsewhere, we like the long-term opportunity the emerging market consumer offers in countries where brands are particularly strong owing to the absence of a large-scale and consolidated retailer network, and where a strong brand heritage already exists and the demographics are compelling—i.e., young, growing and engaging with brands.

The results we've seen so far this year from our branded consumer staples holdings have been encouraging. Moreover, in a very challenging year for the broader market, the relatively defensive characteristics of the consumer staples companies we own have come to the fore, just as they did in previous tough times, from the 2001 recession to the 2008 financial crisis, and more recently at the nadir of the COVID-19 pandemic in 2020.

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**Operating Margin** is calculated by dividing the company's operating income (earnings before interest and taxes) by its revenue. It is a measure of a company's profitability.

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