INNOVATION IN INFLATIONARY TIMES

A playbook for innovation leaders in the CPG industry

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EXECUTIVE SUMMARY

Innovating during inflationary times is tough but successful leaders have followed a disciplined approach empowered by strong research tools to navigate through the challenging times.

Successful marketers start by understanding the pricing landscape and decoding the driving forces that determine the magnitude of impact their category and segment will face. They map out cross-elasticity across existing offers in their space to find the best competitive position to innovate in.

To build an inflation-resilient innovation portfolio, marketers must bring DIFFERENTIATION to the space to reduce substitutability. Overlaying claims beyond the category's core cost-of-entry has proved effective overall, but the key is choosing the right claims that offer superior "permissibility to pay" and choosing brands with the right equity to carry those claims. Marketers must also constantly adapt their pipeline based on changing consumer behavior and attitudes, while balancing value and premium innovations to protect profitability.

When a price increase is inevitable, whether to increase price directly, or indirectly using discreet approaches like downsizing and cost reduction, the choice is a delicate one. To be successful marketers must balance short-term gain and long-term risks.

As concern over the Covid-19 pandemic recedes, central banks as well as global supply chains are starting to show signs of exhaustion. In the new inflation cycle that began in the second half of 2021, rising consumer prices once again dominated news headlines and dinner table discussions around the world. Three in four consumers globally are concerned that price increases in 2022 will outpace their income growth.[1] On the other side, leaders in the consumer goods sector have their innovation pipelines disrupted as they fire-fight emerging priorities such as rising cost of goods, stock shortages and rapidly shifting consumer sentiments.

It is a challenging time as innovation leaders face choices to completely redraw their pipeline, launch inflation-resilient innovations, or renovate to reduce pricing vulnerability. even when price increases are inevitable, whether to directly raise prices, downsize or use other indirect methods still present tough choices to make. At Ipsos, as one of the world leaders in innovation and pricing research, we are eager to share what we have learned from the past that have helped our clients navigate similar difficult periods.

> Successful leaders have followed a disciplined approach empowered by strong research tools to navigate through the challenging times. ”

PART ONE: DISCERN THE PRICING LANDSCAPE

UNDERSTANDING CATEGORY PRICE ELASTICITY*

Large category demand drops during an inflationary period is a dreaded scenario for brand managers planning innovations or renovations. However, not all categories react to inflation in universal ways; some are more resilient than the others.

For example, in 2001-2002, both Turkey and Argentina experienced dramatic consumer price increase triggered by currency fluctuations against a global backdrop of economic instability. **Turkish** consumer spending on **food and beverages** shrank 17% in 2001 vs. 2000 (at a constant exchange rate).[2] However, not all categories were affected equally. While packaged meat suffered a whopping -31% hit, packaged dairy products were relatively unscathed at -8%. Similarly, while **personal care** overall sustained a 11% decrease, paper products (-6%) were relatively unharmed compared to haircare (-16%). Meanwhile in **Argentina**, comparing 2002 to 2000, tea and butter showed a modest 2-5% decrease in consumption while mineral water and packaged snacks took a mind-boggling 40% loss.[3]

To understand where your category might land on the wide spectrum of category elasticity and how much that will impact the size of the prize for your innovation, it is important to identify the driving forces behind such disparities:

- Elasticity of the category demand itself: is the demand "must haves" like flour or salt, or **can it be completely done without underpricing pressure** like, for example, scented candles?[4]
- Substitutability of demand: if the demand itself is inelastic, **are there plentiful alternatives** that would provide consumers with means to price shop to meet the same demand, such as switching between fish and poultry for protein intake?
- Inflationary relativity: substitutable categories are bountiful, but **are they all experiencing the same price increase** to the same degree as your category?

Category elasticity is larger when the demand itself is elastic, when there are plenty of substitutions, or when the cost structure of substitutive categories makes them fare better than yours during inflation. Understanding the basic drivers behind category elasticity helps marketers make informed hypotheses on the potential impact of inflation on the spaces they are innovating in.

**Price elasticity measures demand response to price change. If +1% of of price change results in -1% of volume change, it's said that the elasticity is -1. If volume change is -2%, then elasticity is -2. A larger numeric value means that demand is very vulnerable to price increase, and vice versa.*

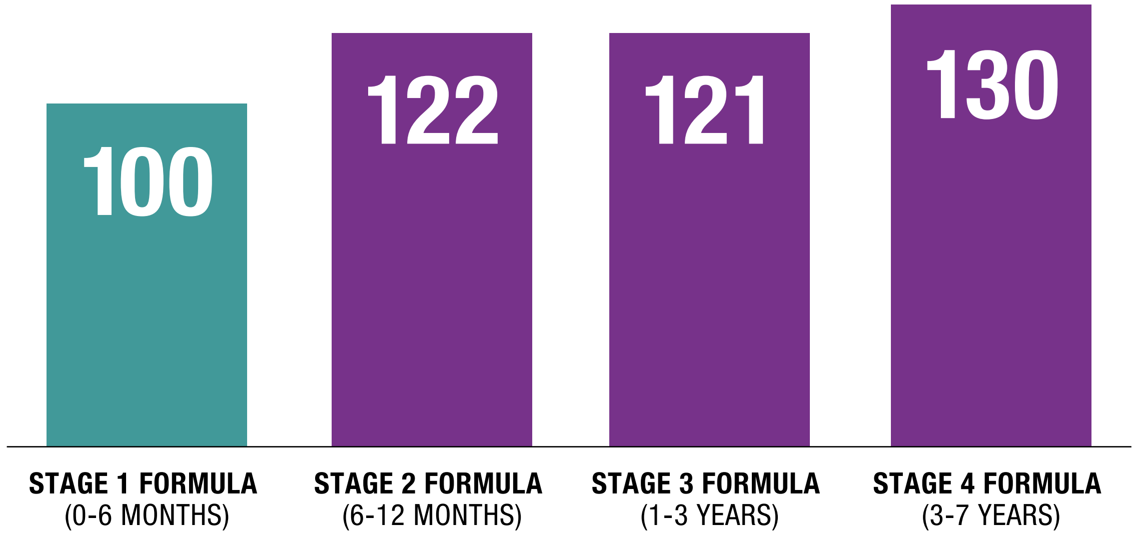
UNDERSTANDING SUBTLE DIFFERENCES IN ELASTICITY FOR SPECIFIC SEGMENTS IN A CATEGORY

For brand managers making decisions about innovations that play in specific category segments, understanding elasticity at a segment level is often more important than at a category level. Segment elasticity is controlled by the same driving forces, but the differences are often nuanced and subtle. Analysis based on historical data and desk research is not usually sufficient but primary research can be used to complement it.

In one such primary research example, while understanding that dairy products are relatively stable, the maker of a premium infant and child formula milk range commissioned Ipsos to understand how different formula segments might behave differently to price increase in a South East Asia country. Mothers of children from new-born to seven years old are observed to shop for formula and milk products. On the choice tasks, mothers are exposed to products that have varying prices as part of a carefully controlled experiment. The study revealed that stage one formula for new-borns has the lowest elasticity, meaning that the volume decreases the least when price rises. But as early as six months of age, mothers are already starting to accept substitutions to formula with a 20% larger price elasticity at that age group recorded vs. the new-born group. This disparity in elasticity expands to 30% for older children, indicating high vulnerability for formula products to price increase as children age. The detailed and nuanced findings at a segment level confirmed the client's strategy to focus on premium innovation in the new-born segment.

In summary, inflation does not automatically warrant complete remapping of your innovation pipeline; not all categories and segments suffer significant demand loss. It is essential to understand the elasticity of your space before taking drastic action.

Figure 1: Price elasticity index increases as babies age



UNDERSTANDING THE COMPETITIVE PRICING LANDSCAPE WITHIN A CATEGORY OR SEGMENT

Once marketers set decisions to innovate or renovate in a certain category or segment, the next step to understand your pricing landscape is to understand how brands within a given space interact with each other in competitive pricing scenarios. In other words**, how do brands in a category or segment change in relation to one another's price changes**. These interactive pricing relationships are referred to as **cross-elasticity.** For example, Brand A and B are said to have high cross-elasticity if a price increase in Brand A leads to a large volume switch to Brand B, and vice versa.

Understanding your brand's cross-elasticity with competitors is critical for setting the right positioning for the new product or renovation. **Pricing Proximity** and **Punch-Vulnerability** maps are two typical applications of cross-elasticity data in innovation positioning strategy:

- **Pricing competitive proximity map (see Figure 2) reveals clusters of brands with high cross-elasticity within**, understanding where those clusters are helping brand managers navigate innovation positioning away from the current offering and competitive areas to achieve higher price resilience and portfolio incrementality. In the example map here, new line extensions could aim to position away from the highly-priced competitive cluster which includes the parent brand and main competitor.

- **Punch and vulnerability map (see Figure 3) reveals competitors you are vulnerable to** when you raise your price while they don't, or brands you are able to hit hard when you offer pricing advantages. This understanding can be invaluable for choosing the right renovation projects, or for setting pricing strategy for line extensions with specific competitor in mind as targets. In the example in Figure 3, your brand could benefit from renovations that are positioned to steer you away from the brand cluster you are highly vulnerable to.

Figure 2: Pricing competitive proximity map

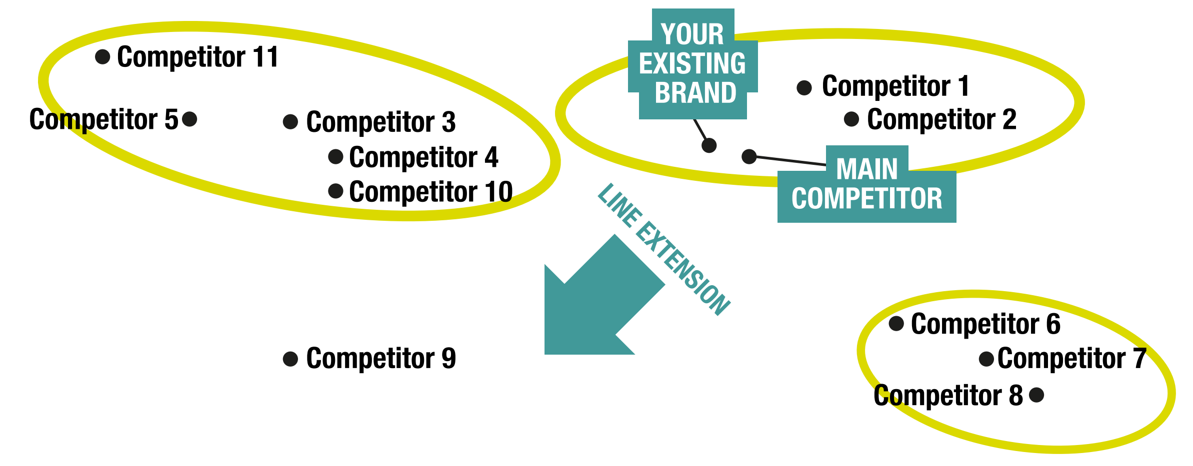
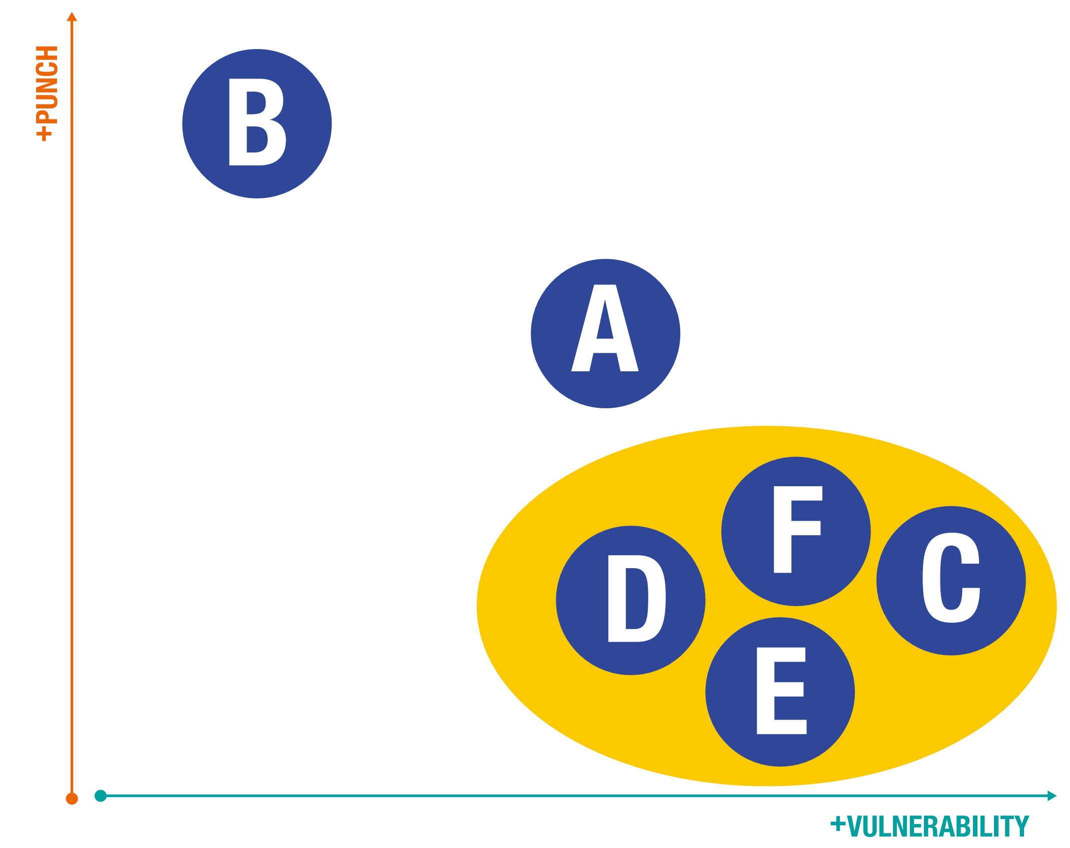


Figure 3: Punch-Vulnerability map for your brand



PART TWO: AN INNOVATION PIPELINE RESILIENT TO INFLATION

Armed with the knowledge of category and segment elasticity, and having understood desired positioning in a competitive pricing landscape, brand managers can now focus on making the most inflation-resilient product propositions for their innovation and renovations. **But what makes an inflation-resilient innovation pipeline?**

BRING DIFFERENTIATION, WHETHER INNOVATING OR RENOVATING

At Ipsos we evaluate thousands of innovation propositions each year and the relationship between concept performance and pricing resilience are often examined. One performance KPI that continuously stands out as showing high correlation with price resilience is **differentiation**. **Innovations that offer distinctive benefits reduce substitutability and consistently outperform competitors in withstanding price increases.**

Consider this example: a Brazilian client who owns a stake in the highly homogenized and commoditized instant coffee category searches for innovations that will bring the brand out of severe pricing competition while offering premiumization. After several rounds of development, Ipsos helped the client land on a highly unique proposition for an "Instant Espresso" concept that claims a café-like experience aimed at indulgence occasions. Consumers viewed the proposition as highly differentiated and hence much less substitutable. In the pricing pressure test that followed, this unique proposition was revealed to have only a fraction of the price elasticity vs. the category leader in share of choice.

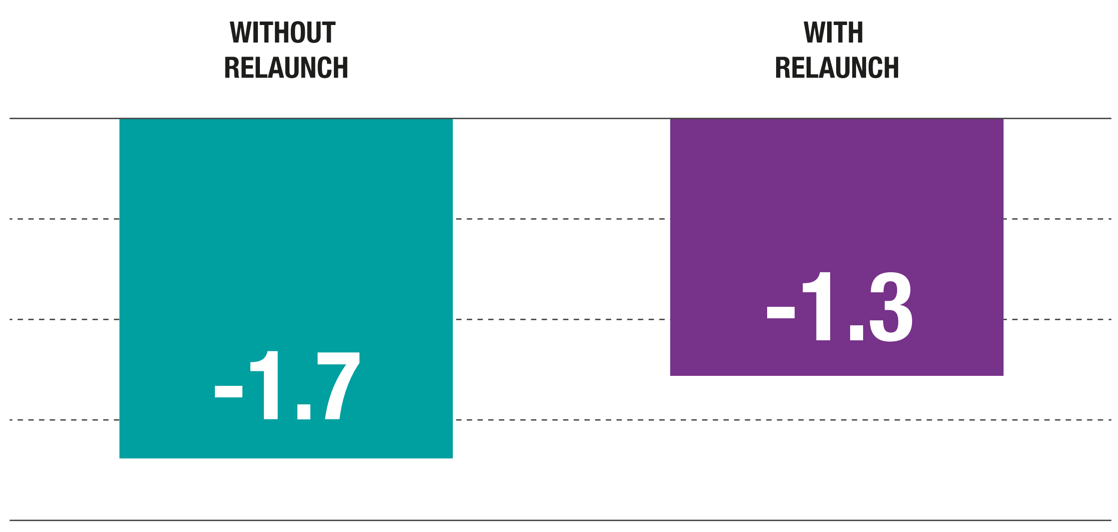
Figure 4: Price elasticity for innovations

	INSTANT ESPRESSO INNOVATION	CATEGORY LEADER
Price increase 4%	-2.2%	-10.6%
Price increase 11%	-4.5%	-19.4%

Source: Brazil instant coffee portfolio pricing test

Using differentiation as a path to price resilience is not only common with **new product launches. Established brands** can also be revitalized with "new news" to differentiate themselves against competition and increase pricing resilience. In this example, a leading internal analgesics brand in the US decides to relaunch to reduce vulnerability to pending price increase. The relaunch is to be led by a new technology with which the brand could claim superior absorbency and faster action that further sets it apart from lower priced rivals. In the validation pricing test that followed, the relaunch proposition was proven to offer significantly higher resilience to price increase over the current state.

Figure 5: Price elasticity



Source: 2018 relaunch price elasticity test in US

BOOSTING PRICING RESILIENCE BY OVERLAYING CLAIMS THAT CREATE A MEANINGFUL DIFFERENCE

Among the propositions tested by Ipsos, we have found that innovations that make meaningful claims **beyond** category entry requirements create differentiation vs. competitors and make them more resilient to price increases. During inflationary times, as consumers diligently seek value for money, overlaying claims beyond basic efficacy claims often provides the justification consumers need to pay a little more than the absolute minimum to get the job done.

To illustrate this phenomenon, Ipsos recently introduced some hypothetical new shampoo propositions to some US consumers. Several new propositions were introduced that were only different in terms of the claims made.

Some made only category-average efficacy claims, while others included overlaying claims that went beyond the core, such as "sustainable packaging", "sulphate-free" and "no silicon", etc. Consumers were then asked to choose between these new ideas vs. leading brands in pair-wise forced choice exercises. With each choice exercise, the price for the new products would vary based on a carefully planned rotational design.

For each $1 increase in price, we found that propositions offering only basic claims suffered an average loss of 11% in win rate vs. competition, while for ones with overlaying beyond-the-core claims, the resilience to price increase improved significantly to only -6% loss with that increment of $1 in price.

Figure 6: Example choice screen from one of the innovation iterations by price and claims

PANTENE PRO-V DAILY MOISTURE

- Pro-V nutrients
- Antioxidants
- Deeply hydrates

$4.99

VS

A NEW SHAMPOO FROM AMERICA'S FAVORITE BRAND

- Deep moisturization
- Repair and replenish
- Sustainable packaging
- Sulphate-free
- No silicon

$5.99

Source: Ipsos

FINDING THE RIGHT CLAIMS FOR PERMISSIBILITY TO CHARGE MORE

Figure 6 shows a simplified illustration of the power of overlaying claims on price resilience. **It is however important to note that not all "beyond the core" claims are equally effective.** The term "Permissibility for Price Increase" indicates the power different claims carry in supporting price increases without losing volume. At Ipsos, each year we conduct many pricing permissibility tests for our clients in the quest for premiumization or price increases.

In one such example, a global beverage company looked for claims they could make on their renovation projects that could sustain the largest price increase without losing volume. Consumers were led to a behavioral exercise shopping for beverage products each making an array of carefully designed claims. The share of choice for the client brands were observed as the combination of claims changed. The study tested over 20 possible claims and revealed that two-thirds of these claims were not effective in sustaining price increases at all. Only a handful of claims were effective, among which the best performing claim carried a "functional wellness" message and packed an ability to support a 29% price increase while maintaining the share of choice at parity to current. The vast disparity of performances by different claims highlights the importance of understanding "permissibility" before major projects are decided.

As a second step to "permissibility" understanding, **marketers need to ascertain the level of fit these promising claims have with their brands.** In a different pricing permissibility test conducted by Ipsos, an Italian food producer in the US discovered the claim "imported directly from Italy" had the highest permissibility overall. However, when they drilled down to individual brands, they found that only one of their current brands had the equity to carry this claim, when other brands in their portfolio made the same claim, believability was called into question by consumers.

A PLACE FOR PREMIUM INNOVATIONS IN INFLATIONARY TIMES

During inflationary times, anticipating decreasing consumer confidence and heightened sensitivity, marketers naturally flock to offer value tier products. This strategy is usually proven to work. In the aforementioned 2001 Argentina consumer price crisis, a global hair care giant quickly pivoted a recently launched brand originally positioned as a flanker, towards a new value proposition. The move proved to be extremely successful as the share of the brand shot up to 20-25% in the following years, averting volume to value and private label competitors.

However, as consumers trade down to low margin, low price products from higher margin alternatives, to protect **volume share**, the overall **profitability** of brand portfolios suffer.

Although it might not be intuitive to consider premium innovation during periods of low consumer confidence, **premium and super premium products are known to have on average lower price elasticity** than their mainstream peers.

In an Ipsos price elasticity study in US toothpaste, the high premium tier of products shows 40% less elasticity compared to the value tier. In extreme situations, super premium products such as some luxury beauty products, or top tier baby products, can even see demand increase with price (also called Veblen products*). The relatively low elasticity for premium tier products can be easily understood as the bulk of the category shifts lower, creating scarcity of substitutability for products at the top.

High margin, premium and super-premium products in inflationary times can offer much-needed balance to profit-draught brand portfolios, and should not be dismissed by innovation leaders.

**A Veblen good is a good for which demand increases as the price increases, which runs counter to the typical downward sloping curve shown by most products underpricing pressure.*

ADAPTING THE INNOVATION PIPELINE TO CHANGING CONSUMER ATTITUDES AND BEHAVIOR

Consumer behaviors and attitudes will undergo dramatic changes in inflationary cycles, these changes are witnessed in historical cycles and are also traceable in the current one. For example:

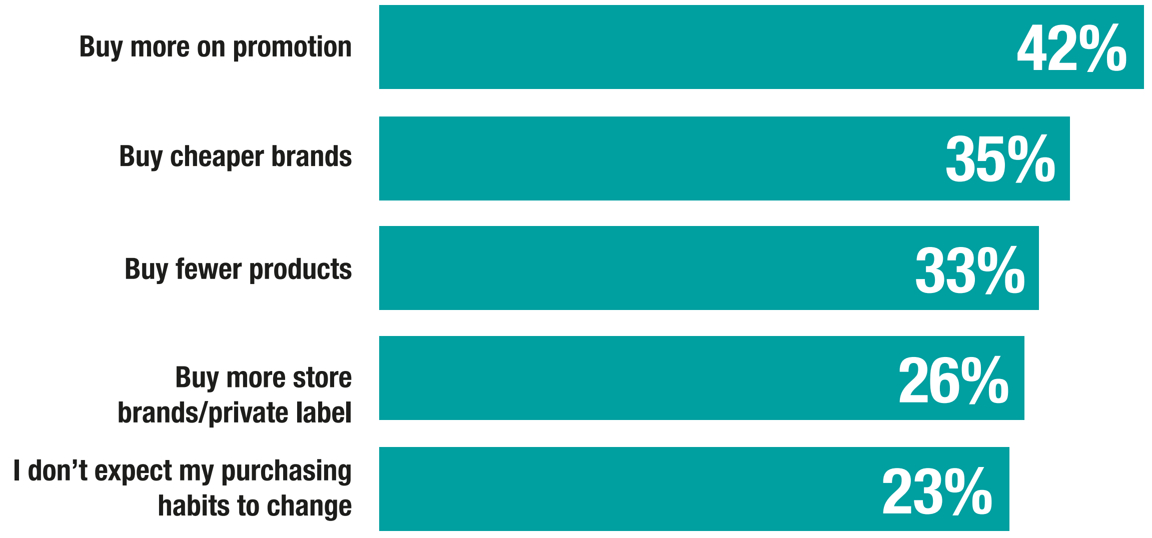
Shopping behavior change: early glimpses from the most recent US consumers tracking data[1] already indicated that shopping behaviors are starting to change around budgeting, purchase cycles, buying on deals, etc. (see figure 7)

Shopper attitudinal change: in the 2001-2002 crisis in Argentina, Ipsos traced a clear change in consumer attitudes regarding risk tolerance, financial optimism, and novelty seeking before vs. after the cycle (see Figure 8).[3]

Channel preference change: inflationary cycles also bring large changes to channel preferences. Using the 2002 Turkish crisis as an example, share of trips dropped almost 30% for chain grocery stores while discounters enjoyed a 50%+ increase.[2] Fast forward to 2021, the same shift towards discounter is happening once again in the new inflation cycle, this time not only on share of trips but also on $ share of discounters.[6]

Figure 7: Spending will be impacted by inflation over the next few months. Some people will buy fewer things, but will trade down to cheaper options

Q. How, if at all, will inflation or current price increases impact your purchasing habits over the next few months



ALMOST 80% SAID THEY WOULD DO AT LEAST ONE OF THESE THINGS BECAUSE OF HIGHER PRICES

Source: Ipsos Coronavirus Consumer Tracker, fielded January 4-5 2022, among 1,160 U.S. adults

It is therefore crucial for innovation leaders to actively anticipate attitudinal and behavioral changes and prepare the portfolio accordingly. Here are some quick win examples:

- **Economy sized packaging innovations** could answer channel preference shift towards discounters.
- When launching new products, providing **lower entry price points and trial packs** could be necessary tactics to connect with risk-averse consumers.
- **Individually packaged products** could work in developing markets to reduce shock at price tags.

It is important to caution however that although there are commonalities on how consumers change in inflationary times, there are no common tactics that work for all. How your pipeline and tactics will adapt should always start from diligent research in **your** market.

Figure 8: Argentina consumer tracking in 2002 (% agree to statement)

	BEFORE 2002	DURING 2002 CONSUMER PRICE HIKE
I think shopping is a good way to relax	45%	42%
If I need anything, I would buy it on credit	27%	22%
I like buying new products and trying them out	47%	37%
I prefer products that offer the latest technologies	48%	42%

Source: Ipsos Argentina 2003 consumer tracking research

PART THREE: RAISE PRICE, DOWNSIZE, OR OTHER MEANS TO REDUCE COST?

When price increases are inevitable, marketers still face the choice to directly increase, or alter value propositions through other tactics such as changing size or modifying products to lower costs. In this chapter we examine the pros and cons of these alternative approaches to direct price increase.

DOWNSIZING VS. PRICE INCREASE

Renovating existing products through downsizing is commonly used by marketers as a discreet alternative to direct price increases. At Ipsos we have helped numerous clients evaluate downsizing vs. price increase options. Due to the silent nature of downsizing (changes are not communicated to consumers), evaluation of downsizing effectiveness generally uses observational techniques where consumers are observed to interact with downsized products while shopping in realistic virtual shelves. In many of these evaluations, downsizing, or a combination of downsizing and price change indeed offer effective ways to prevent short-term user alienation compared to direct price increases.

In one such observational experiment done for a US Salty Snack manufacturer, consumers were exposed to shelf settings that contained various downsize and direct price increase scenarios and are asked to shop as they normally would. For the test product, we observed a -1.2 price elasticity when we directly raise price. But for the same product, when the price increase is concealed with a downsize, the elasticity drops to only -0.3. In other words, consumers are a lot more sensitive to direct price increase than to hidden price increase through downsize, this is at least the case at trial purchase which can be well predicted through a simulated shelf test.

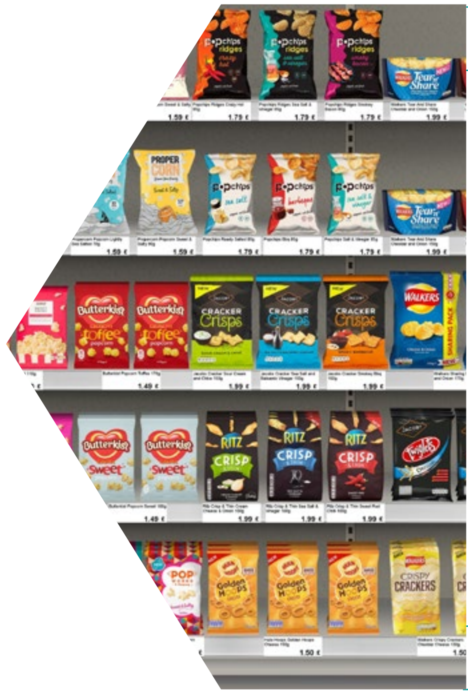


Figure 9: From observation - price elasticity

DIRECT PRICE INCREASE	INDIRECT PRICE INCREASE THROUGH DOWNSIZE
-1.2	-0.3
VOLUME LOSS ALMOST LINEAR	PRICE INCREASE WELL CONCEALED

Downsizing also offers marketers an opportunity to add new news to further conceal price increase in a brand renovation; this is a flexibility not possible with direct price increases. When done right, the excitement created by a brand relaunch can even completely offset any negative impact from downsizing.

In one such successful case researched in the US mouthwash category, a 6% downsized bottle for a leading mouthwash brand was presented in a sleek and modern new design together with new pack functionality claims. Consumers were positively impressed by the renovated brand and the new bottle design and paid little notice to the reduced size. In this case, the relaunch was able to completely avoid share of choice erosion for the brand, even achieving a small growth.

In both examples, downsizing provided effective alternatives to price increase at trial purchase, which can be measured at the shelf. But there are a lot of watch-outs as repeat purchases continue. Besides the reaction of consumers to a downsized product at shelf, we assess how consumers perceive and notice the downsizing through product tests in a central location or in-home, depending on the category. This research reveals some hidden long-term risks:

- Honesty, transparency and brand authenticity are increasingly valued by consumers. Downsizing, when eventually noticed, has the risk of breaching trust, causing longer term damage to the brand.
- For frequently purchased categories, downsized products expose consumers to accelerated re-purchase cycles that come with increased risk of brand switching.
- Downsizing could incur new costs due to redesign of packaging, reconfiguration of manufacturing equipment for the new sizes, etc. Such an indirect cost can sometimes offset the savings on cost of goods.

Figure 10: Share of choice observed from choice exercise


Current design


New design with new claims

	CURRENT	RELAUNCH
Size	18 oz	16.9 oz
Total Variant Sum	9.0%	9.2%
Variant A ($3.98)	6.5%	6.6%
Variant B ($3.98)	1.9%	2.0%
Variant C ($3.98)	0.6%	0.6%

OTHER MEANS OF COST REDUCTION

Apart from downsizing, product modifications in ingredients or packaging materials are some other popular approaches by marketers to avoid direct increases when faced with inflation. At Ipsos we have conducted a lot of cost rationalization research as part of our product testing practice. To move such a project forward, we need to understand whether the potential gain from a cost reduction initiative outweighs the potential loss. More specifically marketers are encouraged to:

- Assess the impact of product change on consumer acceptance, confirming either no decline in acceptance or a notable increase.
- Regardless of change, ensure no notable franchise erosion/alienation.
- Fine tune product/communication based on risk assessment powered by consumer data.
- Evaluate whether the cost to redevelop product and re-aligning supply and manufacturing would offset savings made.
- Aim high, target improving the product, beyond just statistical parity vs. today.
- Pay attention to competitive reaction and especially targeted hostile communication

In summary, there are alternatives to direct price increases, but these approaches should be evaluated with caution through consumer research to balance short term and long-term gains.

PARTING THOUGHTS

Winston Churchill once said: "those who fail to learn from history are doomed to repeat it…." The world might not be smart enough to avoid another cycle of inflation altogether, but we can at least learn from how successful innovation leaders have navigated inflationary times in the past. At Ipsos we believe knowledge is the best weapon against uncertainty. Two years ago, when the pandemic first hit, we helped our clients navigate the rough waters through historical comparisons of crisis cycles of the past.[5] Today, as new challenges surface, we invite you to join us in the new quest to emerge victorious.

> The world might not be smart enough to avoid another cycle of inflation altogether, but we can at least learn from how successful innovation leaders have navigated inflationary times in the past. ”

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