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COMPANY OF THE YEAR
PEPSICO

BY JILL BRUSS

A WINNING HAND

A GANGBUSTER YEAR LEAVES PEPSICO HOLDING ALL THE RIGHT CARDS.

A famous gambler once said, "you've got to know when to hold 'em and know when to fold 'em." That certainly was the case in the beverage industry this past year as consolidation continued and announcements of acquisitions and mergers flooded the news. But one company in particular controlled the deal and sat comfortably at the table making moves and consistently drawing valuable cards to create a winning hand — *Beverage Industry's* 2001 Company of the Year, PepsiCo Inc.

During 2001, Purchase, N.Y.-based PepsiCo successfully executed the acquisition of South Beach Beverage Co., maker of the well-known and edgy SoBe products, which have added nutraceutical and alternative beverage playing cards to Pepsi's game. 2000 ended as PepsiCo acquired Chicago-based Quaker Oats Co., maker of No. 1 sports drink Gatorade.

Aggressively tackling the bottled water business in the United States and abroad put Pepsi's Aquafina brand at the top, and the carbonated soft drink business certainly didn't lack a trump card or two, as Pepsi rolled Mountain Dew Code Red, a new lemon-lime soda in Sierra Mist and lemon-flavored Pepsi Twist.

PepsiCo's juice giant Tropicana continued to dominate, and it joined forces with Pepsi-Cola North America to push Dole brand products to new heights in the juice category.

Overall this past year, PepsiCo has stirred the industry, created the news and drawn the right hand to create "a total beverage company."

The Quaker Coup

The last quarter of 2000 generated much ado about the future of the Quaker Oats Co. Having caught the attention of Atlanta's Coca-Cola Co. and Paris, France-based Groupe Danone, Quaker was ultimately granted to Pepsi in an almost $14-billion deal, just about one month after an original Pepsi offer was declined.

After the initial battle to win the sports drink giant and its No. 1 brand Gatorade, Pepsi faced yet more challenges as the FTC and other beverage manufacturers voiced concerns over unfair market control. Pepsi's existing All-Sport sports drink combined with Gatorade could have potentially created a monopoly in the category. Pepsi agreed to sell the All-Sport business to Atlanta-based Monarch, and it seemed like a royal flush as Pepsi now had control of Gatorade, which grabs about an 80 percent share of the sports drink category, compared to All-Sport's 4 percent.

But regulators imposed more strict conditions for the future of Gatorade and its role in the Pepsi culture. The FTC is allowing Pepsi bottlers to continue distributing All-Sport, and will not permit Gatorade to enter the Pepsi distribution system for about a decade. Pepsi is missing out on putting Gatorade in Pepsi vending machines, though the sports drink has developed a strong system of its own. Pepsi has indicated it will use the well-established Gatorade system to find new sales for its Tropicana brand juices.

Though 2001 marked an era when Pepsi was forced to re-shuffle in order to satisfy the concerns of the FTC, grabbing the Gator and closing the deal this past August was certainly an ace Pepsi needed to grow.

"PepsiCo has always been a growth company," says Steve Reinemund, chairman and chief executive officer at PepsiCo. "We believe adding Quaker makes us a growth company like no other. The new PepsiCo is a $25-billion corporation operating in the sweet spot of convenient foods and beverages. Our brand portfolio is broad and very strong. In fact, we have 15 different brands that each generate $1 billion or more in retail sales annually. Nine of those 15 brands are beverages, by the way."

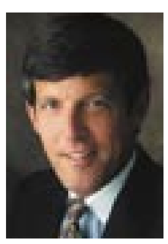
The acquisition of Quaker not only brings together powerhouse beverages Pepsi and Gatorade, but also adds Quaker's Cap'n Crunch, Quaker Oatmeal, Aunt Jemima and strong brands in snack foods, cereals and snack bars with the potential to complement Pepsi's existing Frito-Lay unit.

And Reinemund says the development of cross-functional teams from various divisions working toward sales and cost-saving efforts are on track, as the merger is expected to yield $400 million in synergies by 2005. "Virtually all of the synergy projects we'd identified early on are well underway… and they're hitting the milestones we'd set earlier," he says.

With any major consolidation some re-organization is inevitable. Though Quaker will maintain its home in Chicago, PepsiCo has opened its doors to top Quaker management, as Quaker Chairman, President and Chief Executive Officer Robert Morrison has become a vice chairman at PepsiCo.

But the most effective re-organization isn't the one taking place in the corner offices of Chicago's Quaker Tower or in Purchase, N.Y. Pepsi and Quaker products can now potentially share sales, warehousing, distributing and other logistical services.

"In addition to combining Quaker's corporate organization with PepsiCo's, we've consolidated our efforts on several important fronts," Reinemund says. "First, we've combined the Quaker and Tropicana warehouse sales forces. This new organization is capable of calling directly on the headquarters of virtually all our major customers — including club stores, supermarkets and convenience store chains.



"The new PepsiCo is a $25-billion corporation operating in the sweet spot of convenient foods and beverages."

— STEVE REINEMUND, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PEPSICO

"We're also combining the hot-fill beverage manufacturing of Pepsi-Cola North America, Quaker and Tropicana. This new unit will yield valuable cost savings and operational benefits in manufacturing non-carbonated beverages, including Gatorade, Tropicana Season's Best, Tropicana Twister, Dole single-serve juices and juice drinks, and SoBe," Reinemund says. "We've created a worldwide procurement organization, as well. All of

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these units are up and running."

The view from the Quaker Tower is just as bright.

"When you combine two companies that have a passion for winning, incredibly strong brands and great drivers for future growth, you've already got similar cultures. It helps in the transition process," says Mark Dollins, vice president of public affairs for Quaker Foods & Beverages. "… We've made considerable progress in [integrating manufacturing, purchasing, logistics and sales] and have a clear picture of where our priorities are for 2002."

Playing with a full deck

Part of Pepsi's strategy since the early '90s has been to expand into the beverage industry and collect all critical suits to achieve a full deck of playing cards. This past year has certainly played an integral role in that task, tackling the sports drink category, as well as nutraceutical and alternative products under the SoBe brand. But it's not an entirely new strategy points out Gary Rodkin, president and chief executive officer of Pepsi-Cola North America.

"It's not exactly a new phenomenon for us. Craig Weatherup declared Pepsi a 'total beverage company' in 1991," Rodkin says. "And, yes, our portfolio is extremely broad, covering virtually every non-dairy, nonalcoholic beverage category. The scale is huge, so every decision is magnified. The products are ubiquitous, and every channel is important. So we need to think in many dimensions — by brand, package, geography, channel, customer and bottler."

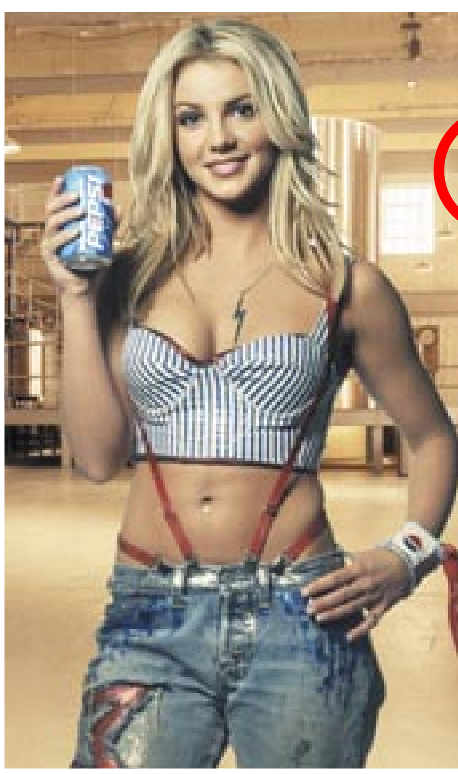
Throughout 2001 PCNA proved successful with this viewpoint, reporting double-digit growth in non-carbonated beverages, including bottled water, as well as growth in carbonated soft drink volume. Considering that carbonated soft drinks represent 85 percent of the business, the reported volume growth of about 1 percent makes a significant impact on retail value and scale, according to Rodkin. New products and flavor extensions, as well as strong retail promotions and marketing touting the names and faces of celebs such as Britney Spears and Bob Dole, have created what Rodkin says is "great traction in the marketplace."

"We had a great year," Rodkin says. "Our ongoing goal has been to become the industry's fastest-growing total beverage company, and by all indications, we've hit that target in 2001. We're realizing the benefits of innovation, first-mover advantage and scale. Staying aligned with our bottlers has created a win-win situation. We're treating one another as partners and driving the business with passion and conviction."

In a system as large and complex as Pepsi's, a tight and sincere relationship with bottlers is critical. With the initial news of the South Beach Beverage Co. acquisition, murmurs from concerned bottlers and distributors wondering about hurdles from competitive restrictions, or even production complications, were certainly prevalent. Growing pains behind, though, Rodkin says the SoBe products have been integrated and will potentially reap the benefits of the powerful Pepsi direct-store-delivery system.

"We expected some growing pains, some bumps and bruises along the way, but we're still very excited about SoBe," Rodkin says. "Its conversion into the Pepsi bottling network actually has run ahead of schedule, with about 60 percent of the system converted so far. SoBe is a great brand platform with a lot of innovation potential."

The acquisition of the SoBe line truly stretched Pepsi's reach into a new niche, and one that has seen gangbuster growth over the past few years. There are skeptics who see the nutraceutical trend wavering a bit as consumers pull back on their once-adventurous spending habits, but SoBe's line of fortified teas and juice drinks have garnered a loyal following. The acquisition of South Beach, tagged at a reported $370 million, was another big win for Pepsi, and falls in line with what other major soft drink competitors are doing — Cadbury Schweppes grabbed Snapple, and Coca-Cola has nabbed Mad River Traders, a smaller alternative beverage manufacturer, as well as Planet Java and its chilled coffee products. SoBe takes Pepsi into the alternative category with a strong brand and a market of loyal consumers; and South Beach gets the benefit of being in the Pepsi family, once a huge shelf-space competitor.



PepsiCo's divisions constantly innovate and capture the market. SoBe offers new dairy-based beverages, Pepsi-Cola continues to flaunt pop star Britney Spears, and Dole pushes new packaging and flavors.

"Synergistically, both Coke and Pepsi had what we needed in terms of quality distribution and resources," SoBe co-founder and Chief Executive Officer John Bello told *Beverage Industry* when the deal with Pepsi was cinched in December 2000. "But [in addition to] the attitude and energy demonstrated by Pepsi, the personalities of the companies mesh a little better. Pepsi is more aggressive."

Pepsi's been on this aggressive track to grow outside of the carbonated soft drink market for some time, having established partnerships with companies such as Lipton and Starbucks, to increase its presence in the non-carbonated soft drink segments.

"We've been at this for a long time, starting with ready-to-drink tea," Rodkin says. "We're now celebrating the 10th anniversary of the Pepsi/Lipton Tea Partnership. We're also experiencing a hot-fill turnaround, with Lipton Iced Tea outpacing the category since its rocket bottle launch. We've got some exciting news in store for cold-filled Brisk iced tea, and we're extending the power of the Brisk trademark into lemonade — in both bottle-and-can and fountain.

"As to our other joint venture, Starbucks Frappuccino continues to define the ready-to-drink coffee market, with more news in the pipeline as we speak," he adds.

Other brands, such as cold-filled FruitWorks and the Dole line of fruit juices, are also getting Pepsi's attention in-house. The combination of partnerships, and Pepsi's own new product development has put the company in solid leadership positions in many categories. Rodkin says FruitWorks is among the nation's best-selling lines of single-serve fruit drinks, and Dole has seen much new flavor and packaging innovation during the past year.

"Dole is something near and dear to my heart," Rodkin says. "It's the right proposition at the right time — and proof-positive of the exceptional innovation capabilities across PepsiCo divisions, with PCNA and Tropicana pooling R&D efforts. It also speaks volumes about the power of an aligned system, with its awesome capacity, really executing and bringing a new brand to bear in the marketplace."

Upping the ante

In years prior to the new millennium, the game wasn't always so clearly defined for Pepsi, which trailed then news-maker Coca-Cola. Illustrated by the exceptional progress Pepsi has put on the table in the past few years, however, Pepsi continues to push forward, upping the ante with very significant acquisitions as well as distinc-

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tive new product development. Pepsi has put big money behind developing new products and line extensions with effective marketing to support and grow them. But doing so is a risky bet with high stakes, and it demands a strong partner in the bottling network.

"This has been a fantastic year, with a pipeline full of innovation and tremendous bottler execution," Rodkin says. "But it's clear that we need to find new ways to support and merchandise more SKUs and more complex product lines — to ensure we don't overload the system or cannibalize our own innovations. New products need room to breathe. Space and selling systems are critical to the success of product innovations, and I'm confident our bottling partners will help us figure out how to get the incremental growth we expect from innovation.

"That said, we've got to keep innovating to keep the business fresh and new," he adds. "We like to say innovation is our 'oxygen.' It's also our legacy. Our bottlers expect it, our customers expect it, and consumers expect it."

It's clear that Pepsi has put muscle behind recent new product innovations, as Mountain Dew Code Red and Pepsi Twist have filled shelves nationwide and are rapidly flying off them.

For Code Red, Pepsi banked on the gangbuster success of the Mountain Dew brand, and has since seen the payoff of that strategy. Code Red cannibalized the original Mountain Dew even less than anticipated and actually is pushing the bar for the already well-loved Mountain Dew brand.

"Code Red's results have been spectacular," says Dave Burwick, senior vice president of marketing for PCNA's carbonated soft drinks. "It projects close to a 100-million-case business, and as we speak, it gives us three of the top five 20-ounce soft drink SKUs in convenience and gas. This year, with solid, double-digit growth from Diet Dew and the rollout of Code Red, the Mountain Dew trademark is up more than 6 percent in total. The cannibalization we'd expected on regular Dew is much lower than anticipated. It seems to be coming instead from non-carbs and energy drinks outside our franchise."

Pepsi would be remiss to have not tapped the energy drink phenomenon, which has come from overseas to a burgeoning market in North America for the past few years. Launched just this past November, Pepsi's Amp Energy Drink also reaps the benefit of the established Mountain Dew brand. Packaged in the energy drink trademark slim can, Amp's sleek image houses a citrus flavor with the function of added ingredients, such as ginseng, taurine and guarana. Though its 10 million cases still classifies it as "tiny," Rodkin says, "energy drinks are the fastest growing segment in the convenience and gas, and grocery channels."

And though in the same category as SoBe sibling Adrenaline Rush — and packaged with a strong family resemblance — Rodkin is confident sibling rivalry won't be an issue.

"Adrenaline Rush is developing its own very loyal following," Rodkin says. "But consumers increasingly are looking for differentiation in this category, and Amp is a perfect extension of Dew's image and attitude. We see Amp and Adrenaline Rush as a powerful one-two punch that will maximize the energy drink opportunity for our bottlers and retail customers."

On a smaller scale, and not standing under the protective umbrella of a strong brand like Mountain Dew, Pepsi's new lemon-lime Sierra Mist is holding its own. Boasting a regular and diet version, as well as vibrant new packaging design, Sierra Mist is currently available in two-thirds of the U.S. system. "It has performed significantly beyond our expectations — on the order of 75 million cases in its first 12 months," Burwick says.

Another over-achiever is Pepsi's newest, Pepsi Twist. Also launched nationally this November, Pepsi Twist and Diet Pepsi Twist have outperformed expectations so far. The Pepsi product with a twist of lemon has experienced exceptional response, with the first 30 days of its national rollout recording nearly 10 million cases sold.

"… We're seeing nearly 60 percent of sales coming from regular Pepsi Twist — the point being that diet doesn't tell the whole story in lemon colas," Burwick says. "Ultimately, though, it's about taste, and we've got this one right."

To support the launch, Pepsi rolled a new ad playfully inviting variety-conscious consumers to try "a little twist on a great thing." Featuring Pepsi girl Hallie Eisenberg, and actors Halle Berry and Barry Bostwick, the piece whimsically moves through the transformation of characters as a can of Pepsi transforms to Pepsi Twist and then to Diet Pepsi Twist.

"It's really about answering consumers' calls for flavor variety among colas," Burwick says. "In another great example, Wild Cherry Pepsi has been among the market's fastest-growing carbonated soft drinks over the past five years, posting strong double-digit gains. The core essence of Wild Cherry Pepsi is that it's about 'more' — taking the great taste of Pepsi and adding a little more flavoring."

Pepsi Twist is just in its early stage, though with two summers of test marketing behind it and a whirlwind first few months on the market, the future seems sweet for the citrus-laced cola. And it certainly has company in the Pepsi family as new products and line extensions are frequent.

"There's no monopoly on good ideas, but we're obsessive about innovation, working in lock-step with our bottlers and customers. That's key to ongoing growth. We have a model that works. And as long as we provide news and excitement across the categories in which we compete, there should be incremental growth for everyone involved," Rodkin says.

Pepsi makes a statement in many new and existing categories with Amp Energy Drink, Mountain Dew Code Red and lemon-lime Sierra Mist.

The cola card

Certainly Pepsi's innovation has made big inroads for the cola giant, but no good player would leave its ace-in-the-hole too far behind. Despite declining growth rates of carbonated soft drinks overall, and in particular the cola category, Pepsi stands tall behind its flagship product and its carbonated relatives.

"We are obsessed with our responsibility to deliver the goods that drive the business," Rodkin says. "But we've also got to strike the right balance to keep our core, base business vibrant.

"There is no question in my mind that CSDs are here to stay," he continues. "I'd say our CSD innovations within the past year proves there is plenty of growth left in the category, which really dwarfs all others combined. Certainly, there is far more vitality to be realized in CSDs. Year on year, with flavors and diets pulling most of the weight, even 1 percent total CSD growth is big, compelling play."

Thanks to the immense size of the carbonated soft drink category, Rodkin emphasizes that even half a share-point increase is substantial, representing more than $300 million in growth. He says customers and consumers "respond enthusiastically when you give them a reason to revisit the CSD category," referring to the recent successes of Code Red, Sierra Mist and Pepsi Twist.

Burwick, too, emphasizes the tremendous influence that carbonated soft drinks have on the overall odds, and cola in particular. In the United States, the cola category is six billion cases, he says, a category six times larger than any other carbonated soft drink category, and more than ten times larger than any non-carb category in which Pepsi competes.

"There is a tendency to lose sight of the massive appeal that colas maintain today," Burwick says. "In fact, colas remain the preferred beverage choice across all age groups and dayparts, again, dwarfing all other categories."

With strong promotions touting Pepsi pop star Britney Spears and the power of the PepsiStuff.com program with Yahoo!, Burwick says Pepsi is "certainly not folding the cola tent."

"The key to future growth is to go out and engage the next generation of cola consumers with product, package and marketing innovation. We're all about choice. It's part of our marketing heritage — 'Pepsi, the Choice of a New Generation' — and it's reflected in our understanding that consumers want and need choices today. We're not giving up on that premise, so we're giving them a choice of regular, diet, caffeine-free, and more recently, flavored cola."

"We've got to keep innovating to keep the business fresh and new. We like to say innovation is our 'oxygen.' It's also our legacy."

— GARY RODKIN, PRESIDENT AND CEO, PEPSI-COLA NORTH AMERICA

Pure and simple

For Pepsi's bottled water Aquafina, it's the "Purity Guaranteed" tagline that keeps it in line with the Pepsi culture, committed to developing leading brands in its competitive categories. 2001 recorded Aquafina's membership in the billion-dollar club, joining 15 other powerhouse brands from PepsiCo's entire organization, nine of which are beverages.

"I'd say we've demonstrated that a traditional soft drink player can make it in the bottled water category," says Robin Kaminsky, director of non-carbonated brands at PCNA. "In our case, it's been about marrying a great marketing platform with a powerful distribution system. It's a great example of the power of the DSD system in general and the Pepsi system, in particular."

As the No. 1 branded player in the category, when Aquafina grows, it continues to dramatically affect the numbers, at least doubling the category growth rate each year, according to Kaminsky. Nationally, Aquafina is the best selling single-serve bottled water in large- and small-format channels, recording an increase of 66 percent in measured channels this year. Aggressive expansion is also underway as Aquafina moves into take-home with six-packs of 12-ounce bottles, half-liter and 24-ounce PET.

"With Aquafina, our bottlers have done a tremendous job of putting bottled water where it simply wasn't available a few years earlier," Kaminsky says. "And we've complemented that physical placement by carving a sizable niche for Aquafina in the mind of the consumer."

One of the key attributes to Aquafina's marketing success is that Pepsi is "careful not to take ourselves too seriously," Kaminsky notes. One of Aquafina's campaigns played on the voice-over of *Friends'* star Lisa Kudrow, who plays a wacky and playful character on the popular show. Even with Coca-Cola's successful Dasani entry and the many other bottled water products out there, Pepsi is confident that the distribution system and brand equity of Aquafina will keep its success pure and simple.

"Aquafina has been a great growth engine for PCNA, and we don't envision any slowdowns in the foreseeable future," Kaminsky says.

"We have a very vibrant single-serve business in the cold channel, with different dynamics and economics," she adds. "The key to making this work with our bottlers and customers is to take a holistic view of this very dynamic growth category. It's all about system strength and execution with the right packaging and brand positioning."

Worldwide wins

The competition in the beverage industry abroad is intense, and the past few years have been riddled with challenges due to a suffering global economy. After quite a few years of leaping hurdles in the international market, Pepsi has begun to make significant inroads, focusing on specific markets that offer ample room for potential growth.

And in conjunction with the closing of the Quaker Oats merger in August 2001, Pepsi-Cola International grew to encompass all international beverage businesses under the title PepsiCo Beverages International. PBI comprises a total beverage portfolio that includes Tropicana juices, Gatorade, SoBe products and Aquafina.

"While Pepsi-Cola North America has been unaffected in terms of any physical re-organization, the formation of PepsiCo Beverages International combines all of our international beverage businesses," Reinemund says. "This new unit gives much-needed scale to our beverage businesses outside North America and sharpens our focus on both carbonated and non-carbonated beverages."

Under the leadership of President and Chief Executive Officer Peter Thompson, PBI has overcome many international challenges and maintained a focus on the core markets and products worldwide.

"The key to our strategy has been ruthless focus — focus on our core CSD brands, Pepsi, 7 UP and Mirinda; focus on franchising as our primary go-to-market model; focus on building operating capability around all of the core processes of making, selling, delivering and franchise management; focus on our key customers; and finally focus on a few key geographies where we can really build scale," Thompson says.

With diligence in key markets, Thompson says successful international business has to weather economic fluctuations and be able to seize opportunities that will build market share. And, he emphasizes, there needs to be a "strong, well-capitalized bottling network with localized cost base… This allows us to continue to offer affordable products and to maintain marketing support during economic downturns. Over the past five years we have stuck consistently to our focused strategy, and have continued to invest for the future in key emerging markets like China, India and Russia," he says.

Tapping approximately 30 markets where Pepsi has a "reasonable position today," Thompson says many of regions have the potential to eventually become as big as the U.S. market.

India, for example, already has a strong management team in place and efficient local franchise bottling partners. "While profitability has been limited by punitive local taxes, we believe that India is a key beverage market of the future," Thompson says. "We will be looking to continue double-digit volume growth to sustain our strong Pepsi share leadership, and continue to export Indian talent to other key markets."

Currently, Mexico is PBI's largest market and the second-largest carbonated soft drink market behind the United States. The lead Pepsi bottler there is Pepsi-Gemex, and it has been on the consolidation path for some time now, as it acquires smaller bottlers to make one, cohesive organization. Two key acquisitions over the past few years were Agral in 1997 and Emvasa in 2000. Thompson says the Mexican plan is to continue acquiring other franchises.

As for the overall market in 2002, Thompson says it "will be a watershed year for PepsiCo's international beverage business… Our goal will continue to be to go deep rather than wide, building strong-scale profitable businesses in key markets." *BI*