





Nestlé's perfect start-up

Nespresso is one of the fastest growing businesses in its parent group and has established itself as a luxury brand in a niche market

BY Emilie Filou

Perfect espresso is to coffee what fine Bordeaux is to wine: the gold standard. The refinement and artful chemistry required to produce both are equally unforgiving. A single coffee bean has over 1,200 aromas, most of them highly volatile. The espresso process – 90°C water and 11-19 bar pressure, depending on the machine – releases these compounds. Overheat the water or miss out on a couple of bars, and you end up with a nondescript concoction. Espresso machines have come high on the list of domestic appliance disasters, but it hasn't been for want of trying – manufacturers have been at it for years (see box). But all these efforts may have finally paid off: meet Nespresso, Nestlé's latest invention, and all the rage in some parts of Europe.

ERIC MEOLA / GETTY IMAGES

Nespresso is the result of many years of research by Nestlé in the quest for the perfect home espresso. After a relatively quiet start, the brand has grown in leaps and bounds over the past 10 years; the Nespresso Club now boasts 2.2 million members (buyers automatically become members of the Nespresso Club when they acquire a machine) from just 180,000 in 1996. Nespresso estimates revenues for 2006 will be in the region of \$fr1 billion (\$818 million) – and forecasts double that by 2010 –

and there has been a compound growth rate of 30% over the past five years.

Impressive? Certainly, although today's success reflects many years of hard work: Nestlé invested in its wholly-owned subsidiary for 10 years before it started making any money. Nespresso also chose to position itself as a luxury brand ('the Louis Vuitton of coffee'), which meant that the company was banking on a relatively small segment (espresso) of an even smaller market (pre-packaged, portioned coffee) to make an impact. The gamble paid off for two reasons.

First, espresso is one of the fastest growing segments of an otherwise unreliable market, and portioned coffee is fast becoming the biggest trend in coffee drinking since Starbucks. Gerhard Berssenbrügge, CEO of Nespresso, reckons that portioned coffee will make up about 25% of the market in five years' time compared with 4% today. If you're reading this with a cup of filter coffee in your hand, its days are numbered.

Second, Nespresso succeeded because its concept was new and extremely clever. To produce the best espresso at home, a machine has to be capable of mastering the physics. It also has to be simple to use, reliable and easy to maintain. Add a touch of design and you have the perfect yuppie gadget to build a

PRICE OF MACHINES AND PODS

Machines

Nespresso	€149-€649
Senseo	€59.90-€71.90
Tassimo	€115-€129

Pods

Nespresso capsule	€0.31
Tassimo pod	€0.25
ESE pod	€0.25
Senseo pod	€0.14
Generic pod	€0.13



Nespresso capsule



Senseo pod



Tassimo pod

luxury brand. As for the actual coffee element, Nestlé had been researching the idea of capsules since 1970. Coffee starts to deteriorate the minute it has been picked, and particularly once it has been ground. By storing it in an individual hermetically-sealed aluminium capsule, the quality of the coffee is prolonged for several months.

To crown its 'exclusive' appeal, its pre-packaged capsules can be bought only by mail-order or online (the machines are available from retailers). Nespresso also prides itself on its customer service: of 1,400 staff, 1,000 work in its 'relationship' centre dealing with customer orders, trouble-shooting temperamental machines or talking customers through the cappuccino or apple ginger coffee recipe. Currently, the range comprises 12 espresso blends, from the full-bodied Ristretto, darling of the connoisseurs, to the decaffeinated, and including three Lungo blends for a larger cup.

But becoming the Louis Vuitton of coffee isn't necessarily the obvious strategy for a company that produces Nescafé. Nestlé therefore chose to make Nespresso a stand-alone company. "I think it was a very wise decision," Berssenbrügge says. "It takes a lot of dedication to get a small company working. At the time Nespresso started, it may not have survived had it been integrated into the whole business. Also, our synergies with Nescafé were limited: we're a mail-order business, Nescafé is a retail product. It's mass market and we have gone for a niche."

However, Nespresso is not the exception at Nestlé. Alcon, its US-based pharmaceutical company, runs independently, and Nestlé Waters, which owns several water brands including Perrier, San Pellegrino and Vittel, also stands as a separate entity. Jon Cox, analyst at Kepler Equities in Zurich, says that Nestlé has favoured a multiple-unit business approach rather than a monolithic group. "It has gone for something a little bit more nimble, where you can spot opportunities easily and seize them."

Cox says that the food sector as a whole has been under pressure to innovate to improve its sales growth: with a stable sales market in the developed world, the onus has been on new products to generate growth. Nespresso, with its 30% growth rate, has done just that, and as a stand-alone company it has made quite a statement of it.

In fact, Nestlé decided for the first time this year to introduce individual reporting for companies such as Nespresso. Nestlé Nutrition, Nestlé Waters and "other food and beverages", as well as joint ventures Cereal Partners Worldwide and Beverage Partners Worldwide, all received separate lines in Nestlé's first-quarter report for 2006, allowing their handsome growth figures to stand out.

However, Nestlé made Nespresso a 100% subsidiary to preserve its investment. Phil Anderson, professor of entrepreneurship at INSEAD, explains that this type of 'intrepreneurship' happens when none of the business units of an organisation is able to create the new product. "In Nespresso's case, the parent company is a complementary asset that's vital.

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Gerhard Berssenbrügge, CEO of Nespresso

NESPRESSO FACTS AND FIGURES

- HQ Paudex (Lausanne), Switzerland
- 1,400 employees
- Present in 35 countries and has 42 boutiques worldwide
- With 36% growth in 2005, one of the fastest growing businesses of the Nestlé group
- Compound growth rate for past five years of more than 30%
- Global sales in 2005 of Sfr819 million (\$670 million)
- 1.7 billion coffee capsules sold globally in 2005 (29% increase on 2004)
- 1 million coffee machines sold in 2005 (619,000 in 2004)
- 2.2 million club members in 2005 (1.6 million in 2004)
- 16.6% market share in 2005 (European market leader in espresso machines)
- Estimated Sfr1 billion (\$818 billion) revenue in 2006 and Sfr2 billion by 2010

Having the 'nes' in Nespresso guarantees you the brand name. And Nestlé didn't have to spin it off, otherwise it could have lost control of its brand."

Entrepreneurship also offers people alternative career routes within an organisation. Berssenbrügge says that part of the appeal of the CEO position at Nespresso was that it was international and had the advantages of working for a start-up within a large group.

Nespresso has also worked hard on its brand and quality. It offers four ranges of machines, which have been designed in conjunction with manufacturers such as Krups, Miele, Siemens and Magimix, and it teamed up early on with Swiss designer Antoine Cahen, who has designed every machine bar one. Cahen says that his design agency, Les Ateliers du Nord, and Nespresso have grown together over the past 18 years.

"It's been an interesting ride, from disagreements with senior management to roaring successes with machines such as the Concept and Essenza," he says. "It is a designer's responsibility to disobey when it's justified. The first CEO was very traditional, but time proved us right. And Nespresso ended up making some courageous decisions on products, which, at the time, were very daring. A designer appreciates this."

The company buys only 'gourmet' or specialty coffee (which makes up 10%-20% of world production), of which only 10% meets its standards. Most of it (95% Arabica) comes from Latin America and grows at between 1,500m and 2,500m; the remainder (Robusta) comes from small plantations in Asia and Africa.

The coffee is processed into capsules at the Nespresso facto-

ry in Orbe, Switzerland, 25km from the company's headquarters near Lausanne. Given the volume produced (1.7 billion capsules were sold in 2005), Nespresso is thinking about a second plant. "We could take it to Eastern Europe for cheaper labour costs, but it's not just a question of cost," says Berssenbrügge. "Our current factory looks like a watch factory, very high-tech, clean, and involves a lot of knowledge and skills."

What matters most to Berssenbrügge is the quality of the coffee, especially its crema (the thin layer of foam that retains the coffee's aroma until the first sip), and he has gone to considerable lengths to secure the long-term availability of the coffee. Nespresso started its AAA Sustainable Quality Programme initiative in 2003 with a view to securing long-term supplies of the right grade of coffee.

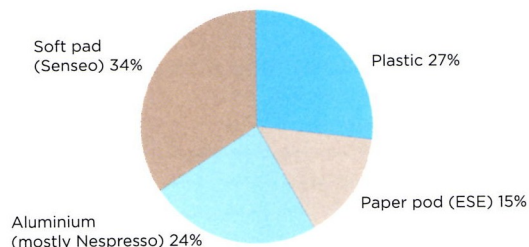
Since it buys only from a tiny proportion of world production, it encourages those farmers who produce gourmet coffee to improve the sustainability (environmentally, socially and economically) of their farm in order to ensure that the quality of their coffee will be the same in five years' time. In return, Nespresso guarantees a premium rate and long-term custom for farmers who meet its AAA criteria.

Nespresso teamed up with the Rainforest Alliance, a leading environmental NGO promoting biodiversity and sustainability, for the programme. The charity helped it set the criteria and

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STATE OF THE POD MARKET

Total volume worldwide, 2004



Source: ESE Consortium



Nespresso buys only 'gourmet' coffee in its search for quality

devise the tools for assessment. Farms are then audited independently with the help of the Rainforest Alliance's network of NGOs and partners. The coffee, however, is not Rainforest Alliance-accredited.

Chris Wille, head of sustainable agriculture at Rainforest, says that Nespresso's decision not to go for an accreditation label is right for the company. "It's not a marketing tool, it's a business strategy," he explains. "Nespresso has gone for quality rather than price. It started with the question: what can we do to change things? And it's got to where it is now."

Berssenbrügge concurs. "I've got nothing against Fair Trade [a similar accreditation to that of Rainforest], but this would not be good enough for us. Fair Trade guarantees a price, but it doesn't guarantee the quality," he says. "We have to do things differently to fulfil our requirements. We are looking for the best and we are willing to pay even more than Fair Trade." Volluto is currently its only blend made solely from AAA-quality coffee. Nespresso hopes that 50% of its coffee will be AAA-sustainable by 2010.

The real question, however, is what coffee connoisseurs think. Berssenbrügge says that Nespresso has featured in 18 blind tests and came first in all of them. One might assume that the real litmus test would be whether Nespresso sells well in Italy, but the market there is fraught with social complications. Drinking coffee in Italy is like having a pint at the pub in

the UK, and market penetration of home espresso machines is therefore quite low.

In the UK, the praise has also been less effusive. Consumer organisation Which? rated the Krups Nespresso espresso as average in taste, while an internet coffee pod retailer called it "Nescafé in a capsule". Alison Eastwood, researcher at Which?, says that where Nespresso scores high is on convenience. "If you're a serious coffee-drinker, you will go for a traditional espresso machine," she says. "Making a mess is part of the fun. But if you're after a reasonable coffee, and you want something quick and practical that looks good, pod machines are great."

Nespresso capsules also don't come cheap. They are the most expensive on the market (see box) and, in classic 'razor and blade' business model fashion, consumers are tied to using the Nespresso capsules in their machines. Some of the competing systems are more fluid: ESE (Easy Serving Espresso) is a consortium of several leading coffee roasters and espresso machine manufacturers – including illycaffè and Lavazza – that have adopted a standard size for their coffee 'pods' (the equivalent of the capsule, but made in a paper sachet). Started in 1998, the consortium now boasts 24 members and offers a large choice of coffee and machines.

Senseo, the other big player on the market, is a joint venture between Philips and Sara Lee. Unlike ESE, however, Senseo hasn't marketed itself as espresso but as café crema. "It's a mass-market proposition," says Paul Hobden, senior marketing manager at Philips DAP. "One of our targets is people who drink instant coffee."

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THE QUEST FOR THE PERFECT ESPRESSO

- 1800s** Engineers start work on a new preparation method, percolation, where boiling water is forced through ground coffee by gravity or light pressure created by steam. The foundations for espresso are laid.
- 1855** Edward Loysel de Santais wows the crowd at the Paris Exposition with the first coffee machine using a variation of the percolation method.
- 1901** Italian entrepreneur Luigi Bezzera starts commercial manufacture. His system, which uses the pressure of trapped steam to force water through the coffee, is still the heart of modern espresso machines.
- 1935** Francesco Illy, founder of illycaffè, invents the 'Illetta'. His machine automatically measures the quantity of water and is the first to use compressed air rather than steam to create pressure.

- 1945** A breakthrough design by Italian manufacturer Gaggia is simpler and easier to use: steam is replaced by a pump, which compresses the water. Some of these machines are still in use today, especially in southern Italy.
- 1961** Ernesto Valente comes up with the idea of compressing cold water and passing it through a heat exchanger, so that it reaches the coffee at the optimum 90°C temperature. His Faema E61 machine is revolutionary and defines modern espresso machines.



Senseo promises the quality of ground roast with the convenience of instant and the formula has worked. It has sold 4 billion pods since the launch in 2001 and 10 million machines. Unlike Nespresso, generics are available for Senseo machines, but Senseo has been involved in lawsuits to defend its brand and the revenues from its coffee pods.

Nespresso potentially faces similar problems. Its capsule system is patented, along with elements of its machines, but the patent for the capsules runs out in 2011. Berssenbrügge says that the company has contingency plans for this particular hurdle; however, it wouldn't be surprising to see Nespresso come up with a new machine and a new system by then.

Until now, Nespresso has considered itself in a league of its own. "The market share of other competitors is negligible," says a Nestlé spokesman. "We're not competing in the same market as Tassimo [whose pods of tea, coffee and chocolate also work exclusively with its machines]. We're not on the same level."

The success of companies such as Senseo and Tassimo suggests that the practical and fun element of the machine is just as important as what comes out of it, be it espresso, hot chocolate or tea. Both Berssenbrügge and Hobden say that they can't afford to become complacent and will have to keep innovating, particularly with blends of coffee.

Improving market penetration rates will be the next target. Both Senseo and Nespresso have done very well in their home markets – the Netherlands and Switzerland, with rates of 50% and 68% respectively – and in France. But the penetration rate for espresso machines is only about 4%-5% across

Europe as a whole and close to zero in other markets. Nespresso is planning to expand in Asia, where it is already doing well in Japan, and Latin America.

Nespresso doesn't make any money from its machines; revenues are tied to capsules and accessories (cups, display boxes, etc). To this end, the company has expanded its network of Nespresso boutiques and boutique bars in cities across the world to improve its high-street visibility. The company has also launched its first celebrity campaign, featuring George Clooney, in a bid to promote the image of Nespresso as a luxury concept.

But whether George will be able to smooth over the challenges ahead remains to be seen. Competition is increasing, generics will probably get on their case, and who knows whether espresso machines will still be as popular in 10 years' time. "There is a trend towards good espresso and better coffee as a whole everywhere in the world," says Berssenbrügge. "Also, all the macchiatos and lattes need a good espresso as their base, so I can see a long-term market."

Cox also points out: "Nestlé has built this segment of the market, so it has first-mover advantage."

Berssenbrügge is convinced that the force that put it on the market in the first place will keep it in the race. "In real estate, it's location, location, location; here, it's innovation, innovation, innovation, on all fronts." ■

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