

# P&G: Teaching An Old Dog New Tricks

Reprinted from FORTUNE  
May 31, 2004 Vol. 149 No. 11

CEO A.G. Lafley has kicked up the good ideas at the stodgy Midwestern giant--and the company's growth too. Here's an inside look at how he's doing it.

By: Patricia Sellers

When Procter & Gamble purchased Iams five years ago, many people worried that the rule-bound behemoth would muck up the growth of the savvy pet-food marketer. Iams was one of those companies (think Starbucks) that had an almost magical bond with its consumers, selling \$13 bags of cat food and other high-priced products exclusively in pet stores and through veterinarians. P&G, being P&G, flexed its marketplace muscle immediately: Using 3,000 trucks to move Iams into 25,000 mass retail outlets, it increased distribution nearly 50% overnight. Then, armed with research indicating that pet owners fear that their four-footed family members will die before they do, Iams's R&D folks began collaborating with Procter's scientists who study human hearts, bones, muscles, teeth, and gums. Iams unleashed a stream of new foods aimed at lengthening pets' lives--weight-control formulas, antioxidant blends, tartar-fighting "dental defense" ingredients.

It paid off: Iams has moved from the nation's No. 5 pet-food brand to No. 1. Worldwide sales have doubled to \$1.6 billion; profits have tripled. Now, to woo vets, P&G is expanding Iams into the business of magnetic-resonance imaging--yes, Iams-branded MRIs for dogs and cats--and Iams-branded insurance to help pay for the \$1,200 scans. "We're offering consumers peace of mind," says P&G CEO A.G. Lafley, who owns a Cavalier King Charles spaniel and two Maine coon cats.

Iams is just one example of how P&G is reemerging as master brand-builder and model growth company. P&G a growth company? Yes--thanks largely to the innovations that Lafley has sparked at the company. When he took over in the summer of 2000, things were grim. His predecessor, Dirk Jager, a brusque, hard-charging Dutchman who ran P&G for 17 months, grew one thing: costs. Volumes flattened and profit margins shrank on P&G's biggest brands, which include Pampers, Tide, and Crest. The stock fell 43%.

A low-key guy with a Mister Rogers demeanor who had run P&G's Asia and beauty-care operations, Lafley focused spending on the core brands even as he commenced a restructuring that involved \$1.7 billion in cost cuts. He also trimmed prices on many P&G products. As a result, over the past three years, core volume (units sold in P&G's existing businesses) is up an average 7% annually. Operating income, adjusted for extraordinary gains and charges, is up an average 17%. The stock price has nearly doubled. And this is a 167-year-old company with its roots in businesses so slow-growing as to make the average executive weep.

Lafley brought a whole lot of creativity and rigor to P&G's innovation process, a tough thing to do in the notoriously rule-bound culture. During the past two years, P&G has raised its new-product hit rate (the percentage of new entries that deliver a return above the cost of capital)

from 70% to 90%. That's terrific in an industry where half of new products fail within 12 months, according to market-research firm Information Resources. "In the 18 years that I've followed Procter," says Deutsche Bank analyst Andrew Shore, "I have never seen the company this good."

The latest quarter's results are even better: 19 of P&G's 20 largest brands improved their market shares. Overall core volume rose 12%, fueled by new products such as Olay Regenerist anti-aging creams, Prilosec heartburn pills, Swiffer dusters, and Mr. Clean AutoDry, a power gun that sprays your car sparkling clean (and dry) and has helped triple sales of 46-year-old Mr. Clean in one year. "What other \$50 billion companies are growing core volume more than 10%?" asks Shore. (Very few; see box.) "The company's growth is astounding us all," says Intuit founder Scott Cook, a onetime Procter brand manager, referring to his fellow P&G board members.

Sure, Lafley has made a few targeted acquisitions like Clairol and Wella, which he bought to gain the top spot in the global hair-care market. But organic growth--meaning growth from core businesses, excluding gains from acquisitions--is at the root of P&G's transformation. "It's the most precious kind of growth," Lafley says. "I talk to Jim McNerney [3M's CEO, who is on P&G's board] and Jeff Immelt [on whose GE board Lafley sits] about it all the time. Organic growth is more valuable because it comes from your core competencies." He adds: "Organic growth exercises your innovation muscle. It is a muscle. If you use it, it gets stronger."

In this respect, a lot of great companies are painfully out of shape. Coke, Kraft, and Unilever are just a few of the giants that are struggling to innovate and build the brands they already have. According to a recent Boston Consulting Group survey of senior executives, more than two-thirds cite innovation as a priority, but 57% are dissatisfied with the returns on their innovation investments. Lafley can relate: "We've had the most problems innovating in two of our biggest brands," he says. Pampers and Crest lost their No. 1 market positions in the U.S. to Kimberly-Clark and Colgate-Palmolive, respectively, several years ago because those companies innovated more aggressively than P&G did. Colgate grabbed the market for teeth-whitening and breath-freshening toothpastes, and Kimberly-Clark for toddlers' training pants.

Warning: When Lafley talks about what he's done to make P&G more innovative, you need a weed-whacker to cut through the clichés. "The consumer is boss," Lafley says constantly--that is, when he's not talking about "reframing the brands" (defining P&G's brands more broadly); "connect and develop" (reaching outside for ideas); and "360-degree innovation" (differentiating products not just by formulation but also by design). "There is a lot of jargon," Lafley admits, smiling. "But we have to find things that are simple for 100,000 people to understand. And more than half my organization doesn't have English as a first language. So it's intentional." And apparently it works. Here's the Lafley model for innovating in a big, stodgy company.

Crank up one-on-one consumer research. Jim Stengel, Procter's chief marketing officer, has cut his reliance on focus groups--the conventional method for studying consumers. "You don't really learn anything insightful," he says, contending that P&G and its rivals have already met consumers' obvious needs and that today's opportunities lie in meeting needs that consumers may not articulate. "I'm a big observational guy," says Stengel. So he has urged the marketers to spend lots of time with consumers in their homes, watching the ways they wash their clothes,

clean their floors, and diaper their babies, and asking them about their habits and frustrations. Back in 2000, the typical brand marketer spent less than four hours a month with consumers. Says Stengel: "It's at least triple that now."

Lafley, meanwhile, prods everybody he meets to view the brands not as scientists (who focus on technical perfection) but as consumers. So does Deb Henretta. The president of P&G's baby-care division, she opened a diaper-testing center right down the hall from her office. There dozens of young moms watch their tots get undressed, diapered, and measured every which way by P&G technicians in brightly colored smocks. One thing the lab experience has taught P&G is that parents are frustrated by how long it takes their youngsters to be toilet trained. So this August, Henretta is launching a new line, Pampers Feel 'n Learn Advanced Trainers, designed to stay wet for two minutes, alerting toddlers to try tinkling in the toilet.

Expand what each brand does. Pampers' mission changed from "we want the driest diapers" to "helping moms with baby's development." Such rethinking and the spate of new products that went with it, from Easy Ups training pants to Kandoo baby wipes, have helped Pampers--P&G's biggest brand--gain share against Kimberly-Clark's Huggies for the first time in nearly a decade.

The Crest brand, which had lost share to Colgate for seven years straight, is another example. Its new strategy: "A healthy, beautiful smile for life." P&G created a new category, teeth-whitening systems, with Crest Whitestrips, peroxide-coated strips that adhere to your choppers, and Crest Night Effects paint-on gel. With \$300 million in annual retail sales, these products dominate the market with a 70% share. Crest SpinBrush, a toothbrush with a battery-powered rotating head, brings in \$160 million in sales, making it the nation's bestselling toothbrush. And new high-intensity toothpaste flavors like citrus and cinnamon, which appeal to young and ethnic consumers, have helped Crest catch up to Colgate in the U.S. toothpaste wars. Though still No. 2 globally, Crest has doubled in sales in three years, and profits are up even more.

Get employees from different divisions to exchange ideas. North American oral-care boss Diane Dietz got help on Crest's new flavors from her colleagues who work on Millstone coffee and Herbal Essences shampoos. Aroma experts, they helped her develop a scratch-and-sniff feature on Crest packages. She also looks for marketing advice when she goes to the "top-15 meetings" that CMO Stengel convenes every quarter for the key people who work on P&G's 15 biggest brands. "We don't exist in silos anymore," says Susan Arnold, P&G's beauty-care and feminine-care boss, who picks up ideas when she roams the "poster shows"--internal trade shows in which each business unit displays a storyboard listing recent successes and best ideas.

P&G's 7,500 R&D people, located in 20 technical facilities in nine countries, post problems ("How can you clean without rinsing?") on an internal website and also meet in "communities of practice" dedicated to areas of expertise. (Need to know about whiteners? Come to the Bleach COP meeting on Monday!) Lafley evaluates the scientists' and marketers' idea sharing when he conducts half-day "innovation reviews" in each business unit annually. "People get just as much credit for giving good ideas as for receiving," he says. It works (see table for products that resulted from intracompany collaboration). Just one example: To develop Mr. Clean AutoDry, home-care R&D boss Karl Ronn turned to scientists in P&G's Pur water purification unit and to the folks who work on Cascade and know how to dry dishes without spotting. When necessary,

business units borrow or acquire talent from others to make those products happen.

Reach outside for ideas. Lafley says that his goal is to derive half of P&G's invention from external sources, up from 20% four years ago and about 35% today. "Inventors are evenly distributed in the population, and we're as likely to find invention in a garage as in our labs," he explains. Given that invention is, as Lafley puts it, "such a difficult business," and that the pace of innovation is, by P&G's estimates, twice as great as a decade ago, why not seek ideas and technologies from the full talent pool? That clashes with a long-held P&G tenet: We have all the answers. The R&D people worried that it was the beginning of outsourcing. But Lafley insists he doesn't intend to cut the R&D workforce, which has cooked up such products as the first all-vegetable shortening (Crisco) and the first heavy-duty laundry detergent (Tide). The big idea is to bring in technology from entrepreneurs, as P&G did when it bought SpinBrush from an inventor named John Osher in 2001.

Getting ideas from outside also means working with other companies. For example, two years ago some P&G managers spotted in Japanese retail outlets an eraser that takes marks off walls; to create their own product, called Mr. Clean Magic Eraser, they hired German chemical giant BASF to make the key foam ingredient. And while P&G's health-care division is dreaming up plenty of its own inventions (such as Intrinsa, a testosterone patch for women with low sexual desire), its biggest success lately has been in selling somebody else's product: Prilosec. Launched last September, the over-the-counter version of AstraZeneca's prescription heartburn medicine has been one of the most successful Rx-to-OTC conversions ever, with first-year sales expected to total \$300 million.

Lafley is even pushing P&G to form alliances with outright competitors. Two years ago he held an auction to find a company that could market patented adhesive-film technology that P&G uses in its packaging and in Crest Whitestrips. The winner: Clorox, which owns the Glad brand (and competes with P&G in floor mops and water purification, since Clorox owns Brita). The joint venture and the product that has come out of it, Glad Press 'n Seal, have been successful for both parties: Glad Press 'n Seal has overtaken S.C. Johnson's Saran as the top-selling food wrap in the U.S., and more products are on the way.

Stop testing so much. It's not the P&G way to put out a product without test-marketing it. But consumer testing takes time--a luxury that P&G execs increasingly don't have. Says Susan Arnold, P&G's beauty queen: "We don't have time to cross all the T's and dot all the I's. This business is trend-based and fashion-based. You have to be intuitive, instinctual, and gut-driven." Last year, when baby-boomers were wild for Botox, she quickly launched Olay Regenerist, a line of skin-care products based on wound-healing technology that P&G had been developing with Sederma Laboratories in France. Regenerist is now No. 1 in the intensely competitive anti-aging category in the U.S. By cutting down on test-marketing (but not, mind you, on science), P&G has reduced product launch time from lab to roll-out from three years to 18 months companywide. Meg Whitman, eBay's CEO and a P&G board member, believes that P&G should move even faster. "Perfection is the enemy of good enough," she says. "I think that's right," says Lafley.

Give designers more power. Lafley believes that P&G needs to market not just the product itself

but the consumer's experience of the product--how it looks, smells, and feels. Three years ago he added a head of design at P&G, a company veteran named Claudia Kotchka, who reports directly to him. Her designers used to labor in anonymity on logos and packaging. But they are now deeply involved in all aspects of product development. For Olay Regenerist, they helped with the formulation and the fragrance too. For the recent launch of SK-II, designers worked on marketing materials and in-store kiosks at Saks, where it is sold exclusively. SK-II, P&G's entry into prestige cosmetics, is its priciest product line ever: a jar of Facial Treatment Concentrate, due this fall, will cost \$300. It's too early to tell how the line will do in the U.S., but since P&G acquired the brand through its Max Factor purchase in 1991, it has risen from obscurity to become the top-selling prestige skin-care line in Asia, with \$500 million in sales.

Cater to developing markets. P&G generates 20% of its revenues in developing countries, vs. 45% for Colgate and 35% for Unilever. The problem: P&G's cost structure has always been so bloated that it could not sell its products at affordable prices and still earn an adequate profit. So the company began coming up with smarter, cheaper ways to make products for those markets. While P&G used to use only world-class proprietary equipment, for instance, it now has contract manufacturers produce Safeguard soap and Always feminine pads. In China it uses a "Coca-Cola model" to manufacture Tide: P&G-owned factories produce the "concentrate" of secret cleaning ingredients, then contractors add standard stuff, like sulfates and phosphates, and package it.

As in the U.S., the company is asking more consumers what they want. In Russia, P&G started talking to ordinary Russian women and learned that most dislike the technologically advanced thin Always pads for feminine protection; turns out that a thick pad makes them feel more secure. By designing one, P&G has recently gained eight share points in Russia. P&G's sales in emerging markets are up 19% this year, and margins are on par with the corporate average.

Know what not to do. In an attempt to spur growth, some companies reflexively offer fat bonuses for innovation or hire stars from outside. Lafley hasn't done either of those things. He doesn't need to revamp pay schemes, he says, noting that managers who fail to share ideas simply do not get promoted. (He does motivate the rank and file by giving out modest rewards--50 stock options--for creative ideas and by celebrating innovators on P&G's internal website.) Also, Lafley refuses to import top talent. A true promote-from-within company, P&G recruits outsiders at mid-level and above only for positions requiring specialized skills. (The typical vice president has been at P&G for a remarkable 22 years--five years less than Lafley has.) Some see his refusal to hire from outside as a contradiction, given that he's so eager to get ideas from outside. But Lafley contends that P&G's family-like culture is a competitive advantage.

For many reasons, it won't be easy for Lafley to keep the growth going. P&G now faces very tough comparisons, given the strong results of the past couple of years. Says Lafley: "The laws of mathematics dictate that it's getting tougher to do better." Indeed, Deutsche Bank's Shore predicts that volume growth will be 6% in 2005, vs. 9% this year. Wall Street's biggest question is whether P&G can successfully integrate a couple of its acquired businesses: Wella, where a squabble with minority shareholders has been a distraction, and Clairol, which P&G bought in 2001. P&G has just started to turn Clairol around after it lost enormous market share in hair care because its previous owner, Bristol-Myers Squibb, didn't spend enough on marketing and failed to innovate.

What's more, P&G must fight its own history. Lafley worries about what he calls a "cycle of inconsistency." Terrific runs have yielded to bad ones three times in the past two decades. Lafley is keenly aware of that. And it only stokes his determination to keep his innovation machine running strong.