

# Business Model Design

## NESPRESSO—EVOLUTION OF A \$4 BILLION BUSINESS MODEL FOR COFFEE

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MANAGEMENT ACCOUNTING GUIDELINE

CASE STUDY

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### Acknowledgements

The description of the Nespresso business model was developed by the Strategyzer core team for use by certified trainers and consultants. It has been modified by the author for the development of this case study and used with permission.

The business model canvas and other tools are available for free download at [www.Strategyzer.com/canvas](http://www.Strategyzer.com/canvas)

## Introduction

Nespresso, a subsidiary of Nestlé, is one of the most successful and powerful commercial product businesses of the 21<sup>st</sup> century. Based on a new technology for delivering espresso coffee, the company's remarkable business model rewrote the conventional wisdom on profitability in the coffee industry. As with most companies though, success did not come overnight—certainly not on the first try. In this case study, we will examine the three phases of the evolution of Nespresso's business model. We will also take an in-depth look at the building blocks and key elements that have made its current business model successful.

## Company Background

In 1979, Nespresso introduced “portioned” coffee to the world. Nespresso began as a revolutionary idea: to allow anyone to create a barista style coffee consistently and easily. Following some early stumbles selling the coffee machine and pods as one product system through third parties, the company created a business model that revolutionized the coffee industry worldwide. According to Nielsen statistics (2015), the portioned coffee segment is the fastest growing segment of the global coffee industry.

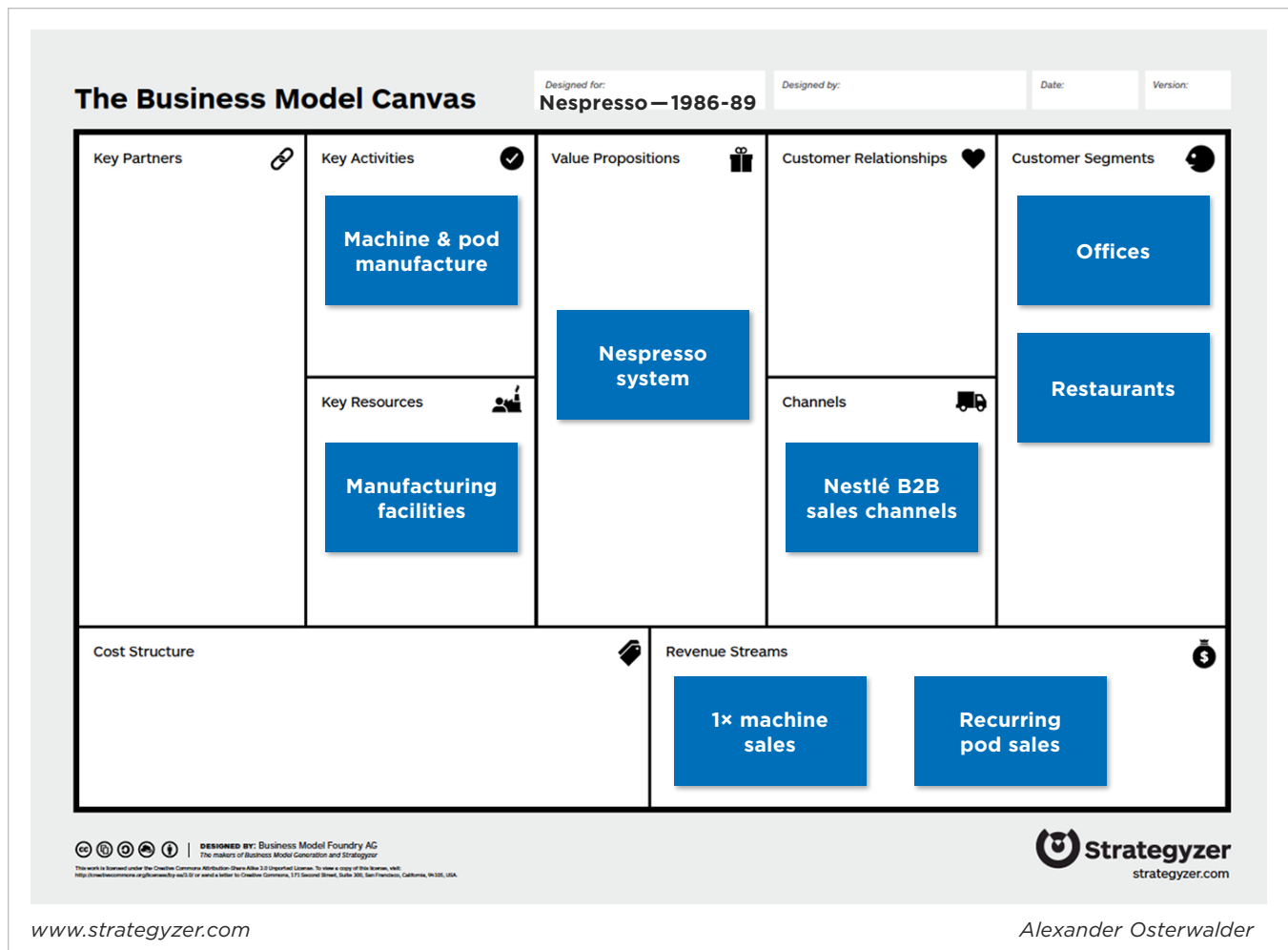
Nespresso is headquartered in Lausanne, Switzerland and sells its products in 64 countries and operates three production centres, all in Switzerland. In 2015, there were 450 Nespresso-owned boutiques spread across 58 countries. The company has grown from 331 employees in 2000 to more than 12,000 in 2015. According to Bloomberg reporting, revenues in 2015 were estimated at \$4.5 billion USD.

The company has a constant focus on research and development, widening its coffee selection and offering new or enhanced machines. The Nespresso system is subject to 1,700 patents. In 2014, Nespresso launched its VertuoLine machines and pods in Canada and the US to cater to North American preferences for large cups of coffee. Nespresso does not manufacture coffee machines, they buy machines through eight separate manufacturing partners (including Krups, Miele, Siemens, and DeLonghi) so it can maintain its focus on design.

Nespresso's direct-to-consumer model is the only one in the Nestlé portfolio. Since 2016, Nestlé has been experimenting with B2C e-commerce in China for other product lines using Nespresso's success as an example. Nespresso's key to leveraging the customer relationship is its Nespresso Club, which provides special offers and personalized service and engages customers in product-service development.

## BUSINESS PHASE 1 Nespresso

In 1979, Nespresso technology creator Eric Favre pitched his approach to Nestlé for its coffee business line, which at the time was driven mostly by instant coffee. The new concept was based on packaged, single servings of high quality coffee served via a simplified espresso machine. In the first version of the business line, the machine and pods were manufactured by Nestlé and sold as a “system,” primarily targeting the office market, but also selling to restaurants, where the value proposition was based on a more efficient way to prepare espresso drinks for customers.

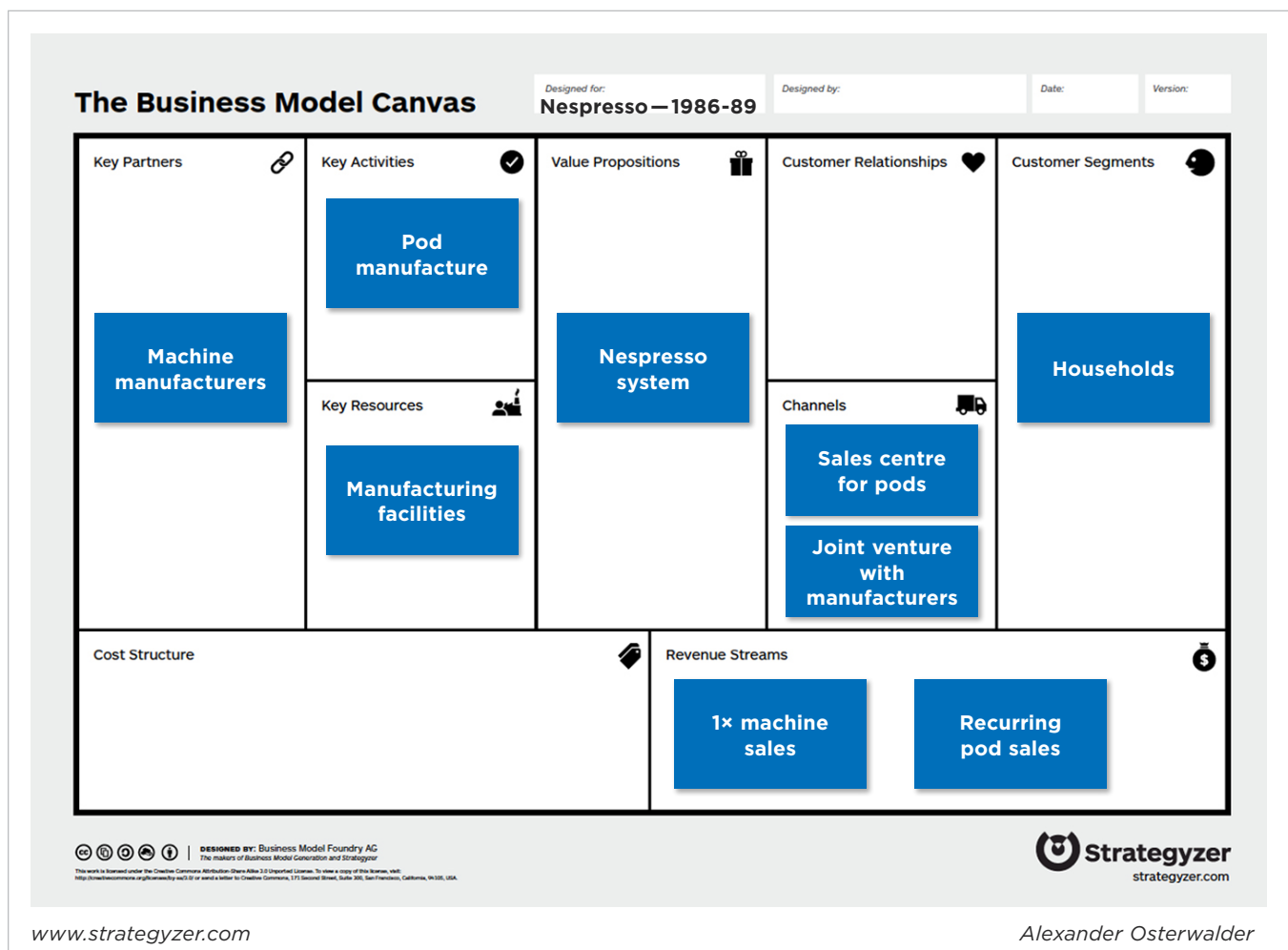


Nestlé launched the new product line in Switzerland and Japan but failed on a number of fronts. Early machines suffered from problems in performance and service as Nestlé struggled with quality control over manufacturing. Nestlé also misjudged the market. The office market found the capsule costs too expensive while restaurants didn't buy in because their customers associated the sound, look, and technique of traditional espresso machines with quality coffee.

## BUSINESS PHASE 2 Nespresso

By 1986, Nestlé was prepared to give up on the Nespresso business line, but instead shifted its strategy for the business. Nestlé established Nespresso as a separate company wholly owned by Nestlé. Nestlé removed Favre, the inventor, as CEO and installed Yannick Lang, a marketing expert from Philip Morris, to head up the new company. Lang's influence was felt immediately as the company shifted its target market to affluent households. The manufacturing issues were resolved by outsourcing machine manufacturing to Eugster/Frismag, an established coffee machine company.

Critically, Nestlé, a B2B company, lacked the B2C sales channels, so the Nespresso system was sold as a joint venture with coffee manufacturers, distributed through the manufacturers' sales and distribution system. Nespresso concentrated on manufacturing and selling the pods. Pod sales were carried out through mail order and telephone-based sales centres.



The problem with this approach was the sales channel. The manufacturer's sales force made smaller commissions from selling Nespresso machines and there was no corporate commitment to the sales support from the machine manufacturer. There were also errors and delays in the pod ordering and fulfillment process.

## BUSINESS PHASE 3 Nespresso

In 1988, Nestlé brought in Jean-Paul Gillard, a consumer product specialist, to head up the Nespresso business. Under Gillard's leadership the company made the strategic moves that made Nespresso the phenomenally successful business we know today. Manufacturing of machines was shared among multiple companies, reducing risk and lowering costs as companies compete to keep their share of the business. Nespresso produced wider varieties of coffee, tightened relationships with coffee growers, and expanded pod distribution channels. A retention strategy involving the Nespresso Club supported sales.

## Keys to a Successful Business Model

The brilliance of Nespresso's business model was how it applied a long-standing successful business model pattern, Bait and Hook, that divides an offer into two elements: the machine and the consumables. This model is alternately known as the razor and blades model: the purchase of a technology (protected by patents) locks customers into using consumables specifically designed for that technology.

The next key to the success was to recognize the importance of building separate distribution channels for the two elements of the offer and to optimize operations for each of these channels.

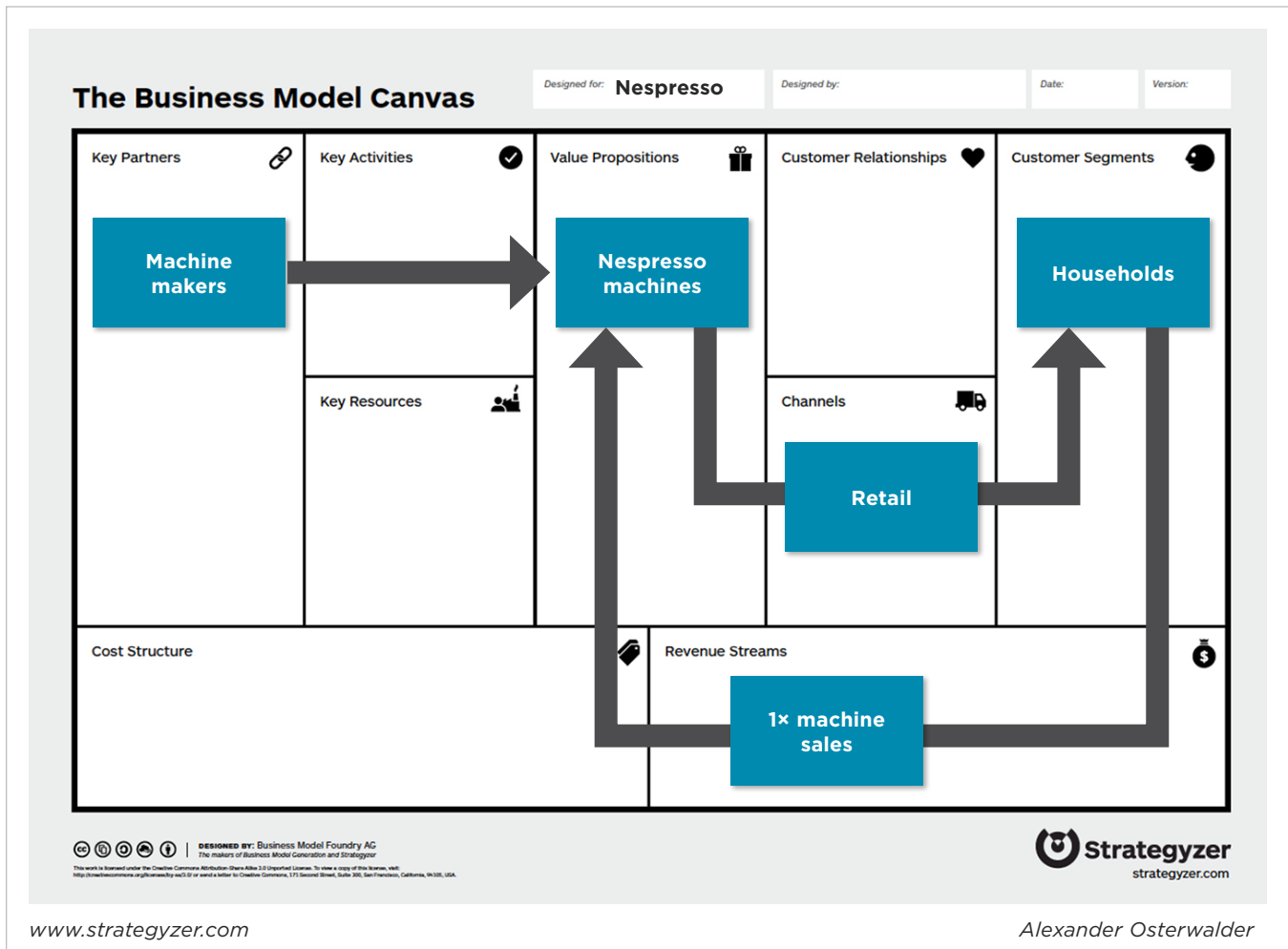
Other keys to the model were in infrastructure. Nespresso created two great partnerships: selection process for coffee suppliers and the outsourcing of machine manufacturing. The latter partnership left Nespresso to concentrate on design and patents for its coffee machines.

In the last few years, Nespresso has expanded its "owned" distribution channels to include physical stores. It is reasonable to suspect the company learned good lessons from another high quality brand, Apple, and its success launching branded stores.

All such keys were instrumental in delivering a resilient, adaptive, innovative and sustainable edge.

NOTE: Nespresso has separate business models for sales to businesses and sales to households. For the purposes of this case study, we will focus on the business model for households.

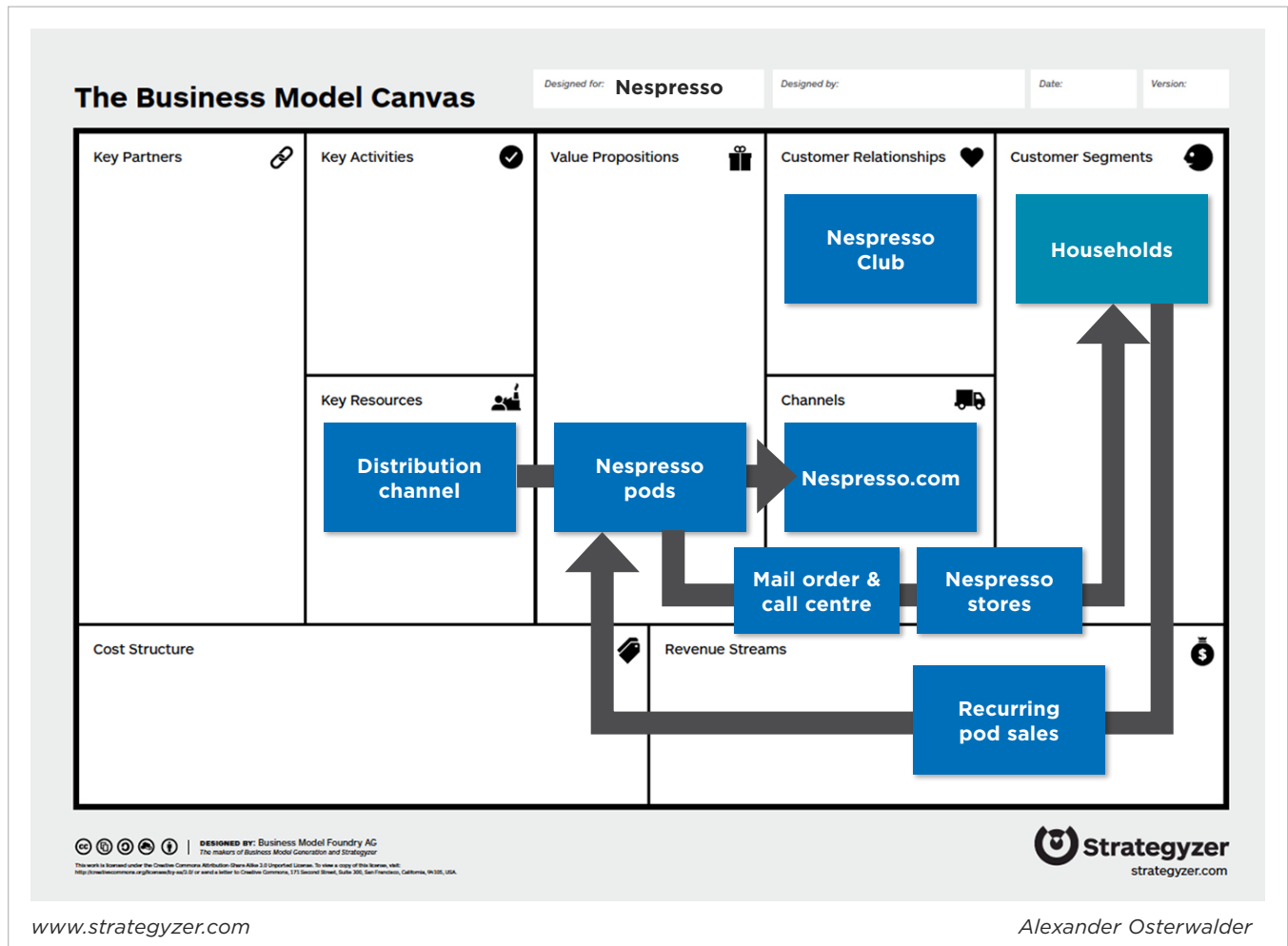
## STEP 1 Coffee Machines



Nespresso removes coffee machine manufacturing from its key activities by outsourcing to key partners. Nespresso coffee machines are sold through a general retail channel (e.g., home appliance stores, general retailers, and coffee specialty stores) to households. This is a standard intermediated channel where sales are one-time transactions and revenues are shared with each step in the chain. Additionally, the machines may be bought through Nespresso's own branded stores.



## STEP 2 Coffee



The coffee, sold in 'Grand Crus', are sold exclusively through Nespresso-owned channels. These sales are direct, recurring, and long term.

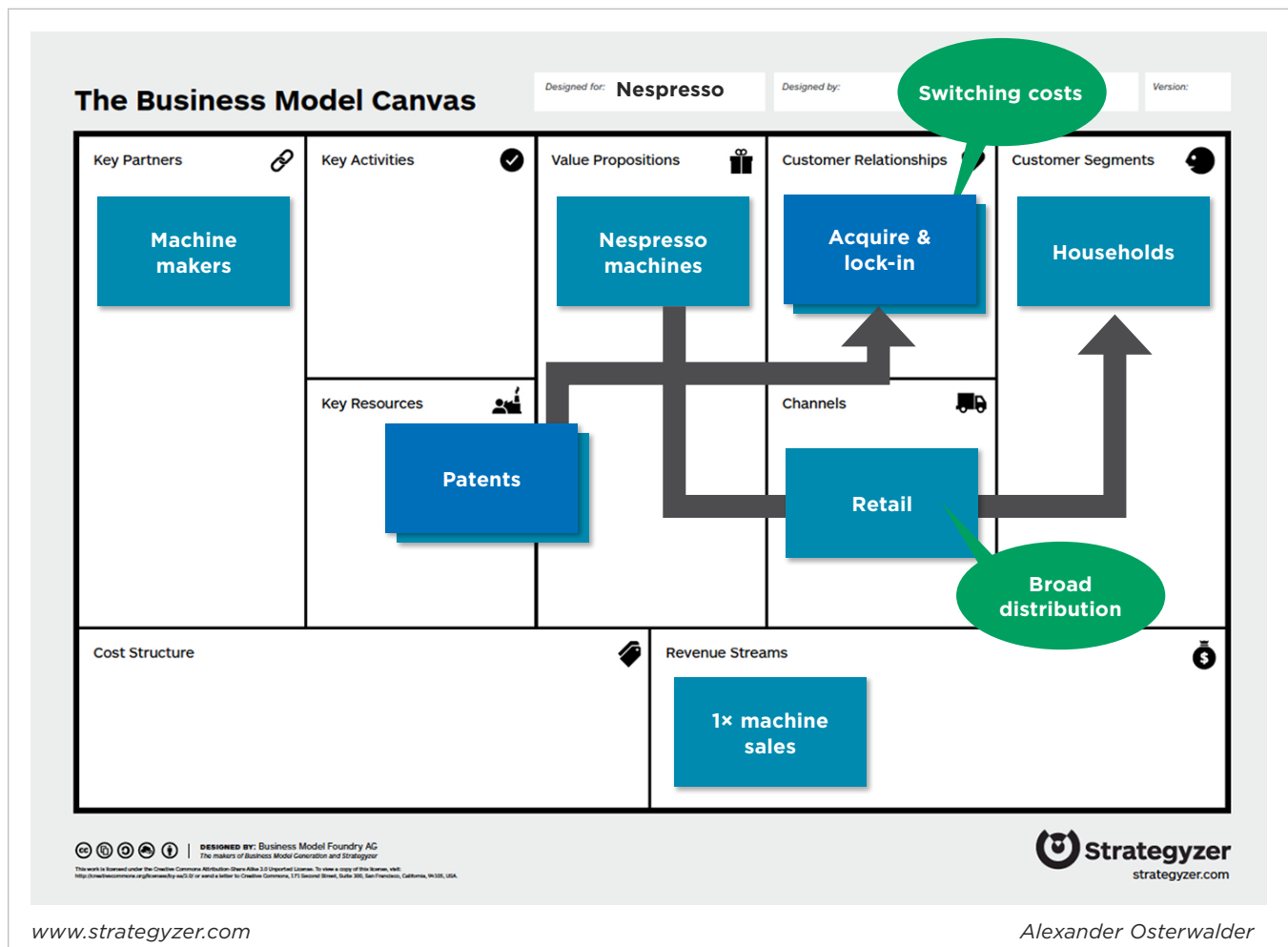
Initially the pods were sold through mail and call centres. Nespresso then expanded to email and [Nespresso.com](https://www.nespresso.com). In recent years, Nespresso has expanded its bricks and mortar presence with branded stores emphasizing the high quality of its products, and in the case of large centres very high-end quality stores. In Canada, Nespresso has branded “boutique” stores in 11 cities in Quebec, Ontario, Alberta and British Columbia. Additionally, Nespresso has “store-in-store” locations (e.g., Bay stores). Nespresso owns all these channels that are key resources to its business. Taken together, the objectives fulfilled both the resilient and adaptive drivers in RAISE as the overall objectives were meant to be strategic and long-lasting, able to withstand and adapt to the ever-evolving demands of both customers and the changing dynamic of the market.

The Nespresso Club is a core component of managing and personalizing customers' interaction with Nespresso. Members can track their purchases and history. The club allows Nespresso to promote products and services directly to consumers. It also provides a mechanism for research and development.

## Business Model Key #1: Why Two Channels?

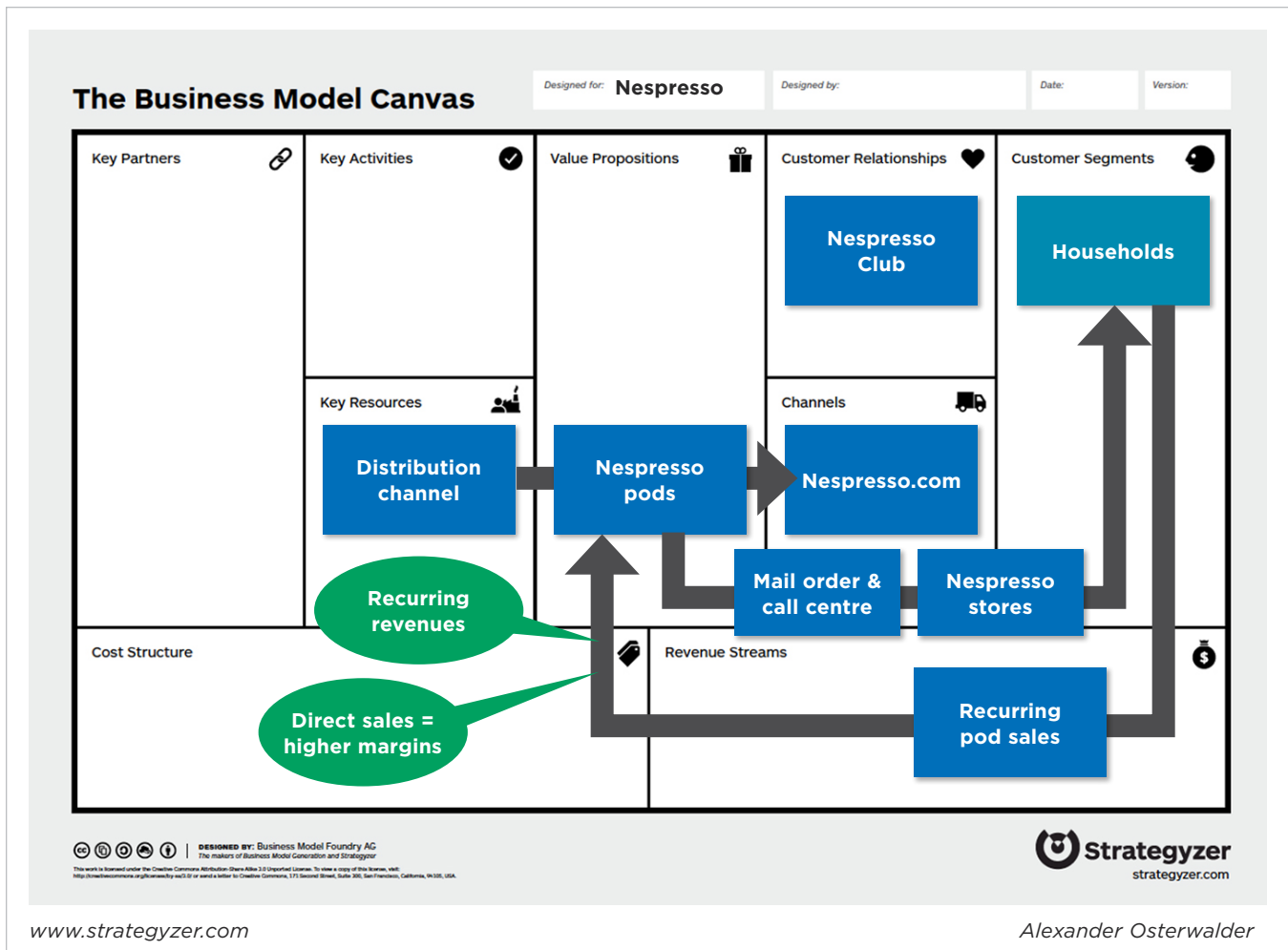
The two-channel approach, retail and direct, aims to optimize the specific purpose of each channel.

The retail channel serves two purposes. First, the nature of retail provides consumers with broad-based, open-ended access to products. The broad reach is paired with marketing a high-end brand, which makes product placement and presentation within the retail stores very important. The second purpose of the channel, given the product patents, locks customers into Nespresso's pods. After investing in a Nespresso machine, the high cost of investing in a different machine discourages customers from switching brands.



The direct distribution approach for the coffee pods is very important to the enormous revenue generation of Nespresso's business model. By controlling the distribution channel, Nespresso has direct control over the customer experience of purchasing coffee, enhanced through the Nespresso Club, with ongoing purchases generating recurring revenues. By having total control over distribution and fulfillment, Nespresso has increased its margins by disintermediating the sales channel. The revenues from pod sales do not have to be shared.





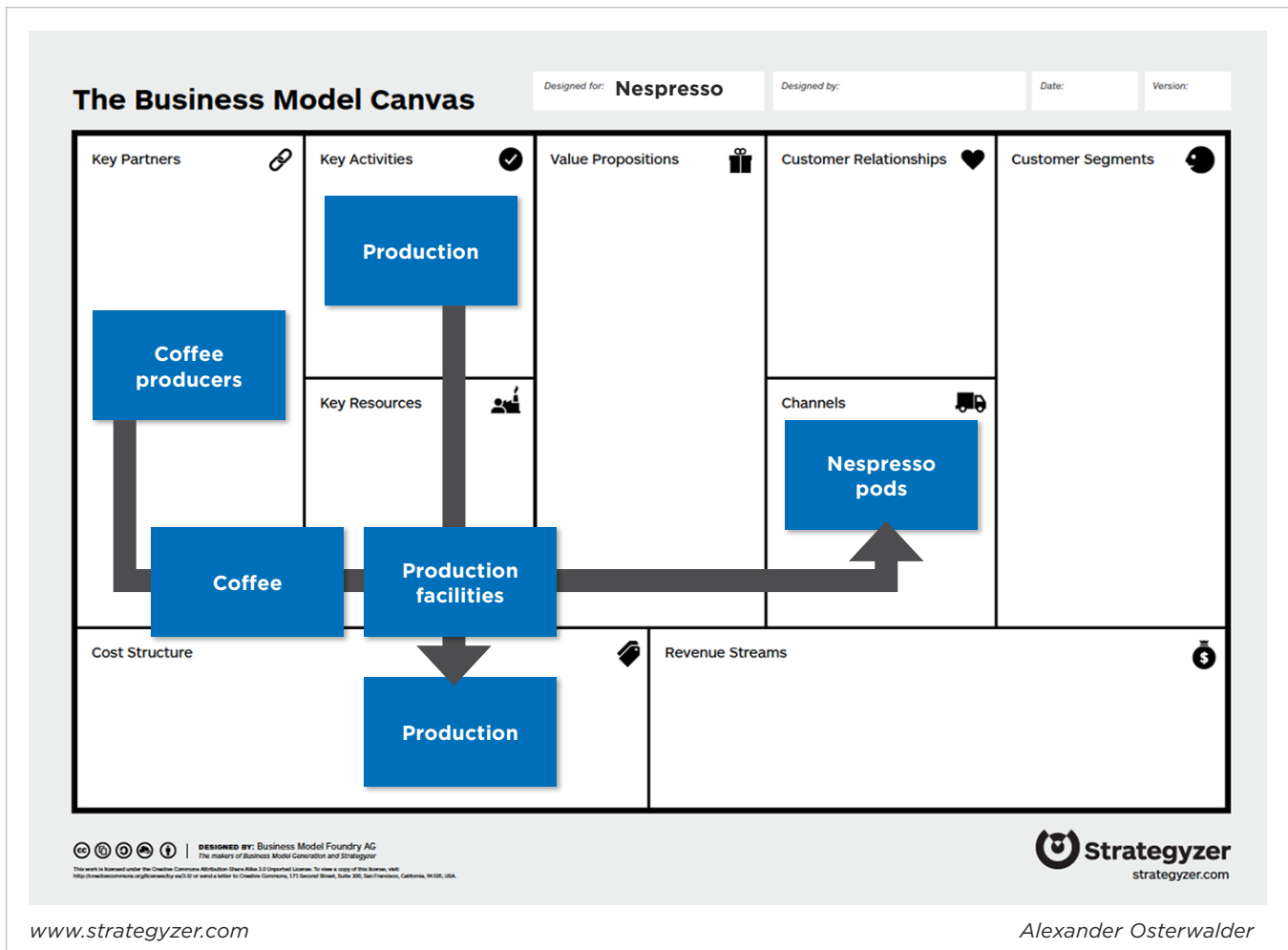
### STEP 3 Infrastructure: Pod Production

Nespresso is first and foremost a coffee company. It markets its high-end, luxury brand and coffee quality and selection are critical to success.

According to Nespresso, gourmet coffee represents 10 percent of the world's coffee crop. And of that gourmet coffee, only 10–20 percent meets Nespresso's selection requirements. It has strict selection and sourcing processes worldwide with great concern for the terroir (i.e., the characteristics of particular coffees based on geography, climate, and elevation). The company produces 24 "Grand Crus" for home consumption, and 16 crus for the VertuoLine product line targeted for North American tastes.

In 2014, Nespresso launched its sustainability strategy, "The Positive Cup," with three focusses: sourcing and social welfare, aluminium sourcing, and use and disposal resilience for climate change. Nespresso has a separate program for coffee growers, the AAA Sustainable Quality Program, to ensure the continued supply of the highest quality coffee as well as the protection of the environment and growers. In 2015, more than 80 percent of coffee suppliers were registered in the program.

Specialists in Nespresso's production centres craft and blend single origin coffees. This is also where new machines are designed. Nespresso has three production centres, all located in Switzerland.



## STEP 4 Infrastructure: Brand

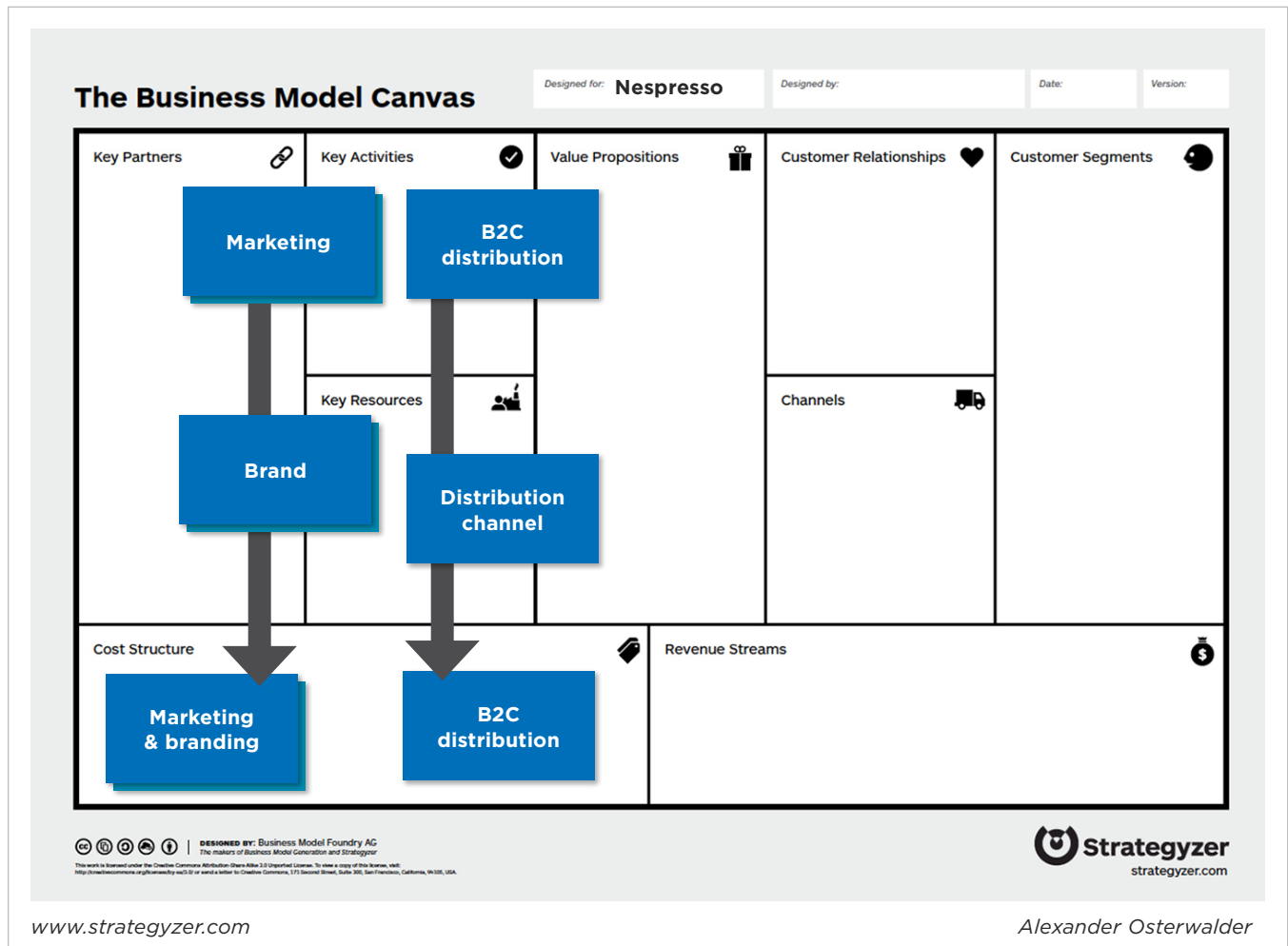
The marketing face of Nespresso is George Clooney. Nespresso is a brand based on perceived class, exclusivity, and luxury quality. The company has carefully staged and managed its marketing and branding over the years. This quality image carries over to its branded stores and its customer relations (managed through the Nespresso Club).

The cost of branding, marketing, and promotion is high. Nespresso's stores are carefully staged and positioned to reflect the company's high-end luxury brand image and service quality. The stores locations are carefully selected and positioned for the geographic market (similar to the Apple Store).

## STEP 5 Infrastructure: Fulfillment

Nespresso pioneered a new type of business for Nestlé (the innovation driver in RAISE): business to consumer (B2C). This meant Nespresso had to build distribution channels and solve fulfillment challenges (e.g., logistics, scale, technology) without the support of its parent company. Using a retail channel to sell the coffee machines was familiar, but the sales and delivery of pods directly to consumers required building and maintaining shipping and fulfillment channels. This is a very large and critical part of the Nespresso business model as it connects with the disintermediation of the pod sales

channel to maximize margins. Generating such a cutting-edge idea and translating them into reality provided a potential source of ongoing sustainable value.



## Business Model Key #2: Authenticity

According to Joseph Pine, author on customer experience and advisor to Fortune 500 companies, there are two rules about authenticity: don't say you are authentic unless you are authentic, and if you say you are authentic, you had better be authentic.

Nespresso markets a luxury brand image. With a value proposition built on perceived value, it is critical for the company to be authentic in the products and services it offers. This requires Nespresso to emphasize the consumption experience and ritual, focussing innovation efforts on cutting edge design for its machines that are easy to use and offering renowned coffees. They do an admirable job of being authentic to that brand.

## Business Model Key #3: B2C

Nespresso redefined the coffee business when it created its highly successful business model. Traditionally coffee is a commodity business. Coffee producers and distributors sell through a retail or

B2B channel and do not deal directly with consumers. The coffee industry had its first real innovative change when companies like Starbucks took the coffee service and wrapped a distinctive experience around it. However, the experience approach remains an extension of a service industry. Nespresso changed that dynamic by engaging consumers directly and providing a quality barista experience with an easy and convenient method in the home or in the office.

## Summary

Having survived early errors in judging the market, manufacturing quality control, and distribution channels, Nespresso's success stems from two key shifts in strategy. The first was to redefine its target market and shift from a B2B business to B2C. The second has to do with splitting its single "system" offer into two separate offers: the machine and the pods. This alone didn't trigger growth until Nespresso optimized the sales channels for each offer. Nespresso expanded to deliver its machines through as many retail channels as possible, which built a broad-based lock-in for the company's pods. The sales of the pods benefited from expanding into multiple owned channels, which leveraged electronic communications, and from the creation and expansion of the Nespresso Club, which helped customers manage their buying and enhanced data gathering.

After years of striving to withstand both the internal and external market challenges, while still ensuring their consumers remained their number one priority, Nespresso had established a solid and enduring foundation with the implementation of the business model design. Having factored in and combined the three drivers of success (i.e., be resilient, adaptive and innovative), the outcome has been one of a sustainable enterprise that maximizes its ability to respond to these changes. The business model has effectively demonstrated how leveraging such philosophy drivers ensures resiliency in the face of competitive customer environments, adaptability from sudden and shifting market changes, and innovating in the face of the ever-evolving market needs.



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