With the economy sagging last summer, Kimberly-Clark Corp., the nation's leading diaper manufacturer, turned to an old tactic for pumping up profits: It tried to sneak in a 5% price increase by cutting the number of diapers in each pack of its Huggies.

Instead of more profit, though, the company got a hard lesson in how its archrival, Procter & Gamble Co., is aggressively exploiting economic hard times and pummeling its competitors.

Kimberly-Clark's chief executive officer, Thomas J. Falk, expected U.S. No. 2 P&G to follow up with a similar price increase with its Pampers, as it had in the past. But as smaller packs of Huggies hit store shelves, P&G dug into its own deep pockets. It splurged on promotional dollars to prod retailers into slashing prices on its bigger Pampers packs or putting up special displays. And it dramatically boosted the value of its discount coupons.

P&G sought to highlight the greater number of diapers in its diaper packs by stamping the word "Compare" on them. In some stores, Huggies buyers even received coupons on their receipts offering $5 off their next diaper purchase -- of Pampers.

To Mr. Falk, the surprising blitzkrieg was "unprecedented and unthinkable." He lamented, "We didn't expect them to take a 15% price reduction on Pampers for five months." Kimberly-Clark was forced to cancel its price increase before it got off the ground and race to match some of P&G's promotions, narrowing its profit margins. It ended up falling short of third-quarter earnings expectations, an announcement that caused its stock to plunge 12% in a day.

Months later, Kimberly-Clark's prospects for sales growth are so sluggish that it recently cut its long-term targets, essentially admitting it has lost pricing power in the diaper market.

At P&G, CEO A.G. Lafley is unapologetic. "We have a philosophy and a strategy," he says. "When times are tough, you build share."
P&G raised estimates for the seventh time in eight quarters Thursday when it upped its fiscal first-quarter earnings projections. The company's shares rose 3%, or $2.63, to $91.43, in 4 p.m. New York Stock Exchange composite trading. P&G said broad-based volume and market-share progress led growth.

P&G is just one of many big companies following this harsh playbook. They spent the record boom years restructuring operations, piling up cash and making acquisitions. Entering the tougher economic times larger and leaner than they had been before, these companies now are using their new muscle to try to grab business away from their competition.

Consider the auto industry. In past recessions, the Big Three auto companies tended to act in lockstep, offering some generous rebates but for the most part holding prices steady and simply absorbing drops in volume. They assumed that debt-laden consumers would cut their spending in a downturn, and that companies just needed to ride it out.

No more. Pressured by imports, General Motors Corp. has relentlessly courted consumers throughout the economy's recent doldrums with generous rebates and cheap financing, in a brash effort to grab share from Ford Motor Co. and DaimlerChrysler AG.

While those weaker rivals have been forced to follow suit, they have seen their sales and profit margins erode badly. Ford's net income fell 27% in the second quarter, as escalating consumer incentives failed to stoke auto sales. DaimlerChrysler, hurt by its embattled U.S. arm, said net income fell 90% in the second quarter. GM has taken some hits too, though it's market share has held up better than its smaller U.S. rivals.

GM has also come under fire for hurting the profitability of the entire sector. But at an industry conference this year, GM CEO Rick Wagoner brushed off such criticism. "I say it is time to stop whining and play the game," he said.

In prior recessions, grocery stores grew accustomed to raising prices to preserve some of their profits. But this time they have faced an enormous competitive threat from Wal-Mart Stores Inc., which is seeking to expand its grocery operations, a category in which it barely competed five years ago.

Leaning on its efficient logistics and lower cost structure, Wal-Mart has kept grocery prices low throughout the recession and its aftermath. Other chains are struggling to differentiate themselves in other ways, but at a heavy cost. Kroger Co. recently issued a profit warning, blaming "competitive conditions." Albertson's Inc. Thursday reported a 37% drop in second-quarter net profit. Safeway Inc. reported a 48% slide in profits for its fiscal second quarter, due mostly to shutting down weakly performing stores.

PC Battle

A similar battle is raging in personal computers, where Dell Inc., relying on its lean cost structure, has been steadily slashing prices on its PCs in an effort to gain more market share from archrival Hewlett-Packard Co. The latest cut came days after H-P reported that its PC unit slipped into the red in its fiscal third quarter because of steep price-cutting.

An earlier price cut by Dell in late 2000, as an Internet-fueled boom in PC sales faltered, helped push Compaq Computer Corp. into a merger with H-P, and drove home-computer maker Gateway
Inc. toward a new business in consumer electronics.

In the $19 billion global diaper industry, the recession has intensified a longstanding battle between P&G and Kimberly-Clark. P&G commercialized the disposable diaper when it rolled out Pampers in 1961, but it has tended to lag in innovation and focus most of its efforts on marketing. It has been the No. 2 player in the U.S. in sales and market share since the mid-1980s. Still, Pampers is P&G's largest global brand, with $5 billion in annual global sales that account for nearly 12% of P&G's total.

Though it came to the industry later, Kimberly-Clark, which is less than a third the size of P&G, passed P&G in the U.S. and opened up a lead by consistently investing in technical innovations such as elastic leg openings to help diapers fit better. With $3 billion in global sales, much of that from the U.S., Huggies accounts for roughly 22% of Kimberly-Clark's annual revenue.

In recent years, competition has stiffened between the two as pricing pressures intensify, generic brands grow in popularity and prospects for new growth stall. The disposable-diaper industry grew along with the tail end of the baby boom. But these days, with the U.S. birth rate essentially flat and disposable diapers widely accepted here, prospects for domestic growth are limited.

Mr. Lafley, 56 years old, made Pampers a top priority when he became P&G's CEO in 2000 with a promise to focus on the company's biggest brands, biggest customers and biggest markets. "For about 15 years, Kimberly-Clark had been having their way with the Procter & Gamble Co.," he concedes.

To take on Kimberly-Clark, P&G installed Deb Henretta, a 42-year-old mother of three, as president of global baby care and started a wholesale revision of the Pampers brand. P&G invested heavily in upgrading its products, adding features such as stretchy sides and overlapping fasteners that could adjust the size of diapers. It also moved to develop premium pull-up diapers, or training pants, for toilet-training toddlers. Kimberly-Clark had dominated that segment, which carries higher prices and profit margins.

Then P&G took its revamped products to a new battleground: the store shelf. As it rolled out its revamped line of Pampers in early 2002, P&G twice lowered the cost per diaper by increasing the number of diapers in a pack. Kimberly-Clark followed the first price move but balked at the second. Price reductions already were cutting into its profit margins, and the company was worried that the price gap between high-end diapers and regular diapers was shrinking too much, according to Dudley Lehman, president of infant and child care for Kimberly-Clark.

Instead, Kimberly-Clark responded with last summer's attempt to raise prices by cutting the number of diapers in each package and trimming the price per pack by a bit less. That presented P&G with a challenge of its own. Kimberly-Clark's move had pushed the price of a pack of Huggies below $10, which marketers view as a key psychological threshold in the minds of consumers.

Since P&G couldn't immediately cut the number of diapers in its packages, Mr. Lafley says the company faced a "prisoner's dilemma": leave its per-pack price higher than Huggies and risk losing customers, or drop its price and eat the difference. "The economy wasn't very good, budgets were pinched, and diapers are oftentimes one of, if not the most, expensive items in the basket," he says.
But such a moment was what Mr. Lafley had been preparing for. Since taking over P&G, he had been cutting costs, shedding failing units and buying higher-margin businesses such as the Clairol beauty business in part to allow P&G greater flexibility in competitive fights in low-growth businesses such as diapers. P&G decided not just to match the price drop, but to keep the same number of diapers in each package for several months. P&G eventually did cut the number in its packs of Pampers to match what Kimberly-Clark offered, but not until February.

In the face of P&G's countermoves, Kimberly-Clark never got the 5% price increase it wanted in the first place.

P&G also went after a new feature that Kimberly-Clark had added to its Pull-Up diapers: "easy open" sides. They had fine, Velcro-like strips on the sides, making the training pants easier to remove. Kimberly-Clark unveiled the innovation in mid-October, just as its smaller packages were hitting shelves, boasting that it was "the most heavily researched innovation in 14 years of Pull-Ups history." The implication was that Huggies had once again bested Pampers with a technical innovation.

Marketing Assault

But P&G fired back with an unprecedented marketing assault. The company blanketed TV with ads claiming that the new Huggies' Pull-Ups were too easy to open and kids could pull them off. "You are 2 years old, and it's not that you're a show-off," an announcer said in the ad, as an on-screen toddler ran through a dinner party waving his training pants around. "It's just those Pull-Ups pull apart like diapers."

From September 2002 to March 2003, P&G spent $25 million advertising its own Easy Ups, according to Competitive Media Reporting, more than three times the $8 million Kimberly-Clark spent advertising Pull-Ups in the same period.

Kimberly-Clark sued P&G for false advertising and got the ad enjoined for two weeks, but Pampers came back on the air with only a slightly altered message. Kimberly-Clark says it plans to go back to court this fall to try to get P&G's ads off the air permanently. Meantime, P&G has seen market share for its new pull-up diapers grow to nearly 20% from zero in February 2002.

Kimberly-Clark's share of the overall diaper market has fallen a point over the past year to 43.7%, while P&G has gained nearly three points to 38.3%, according to Information Resources Inc. That figure doesn't include sales to Wal-Mart or club stores, where more than half of diapers are purchased, but industry officials believe the market-shares follow similar trends.

Sales data suggest that since P&G decreased its package size in February, Kimberly-Clark has regained some ground in recent months, but P&G argues that its momentum is still strong.

P&G hasn't limited its aggressiveness to diapers. When Mr. Lafley was promoted to CEO, the company was often relying on price increases to make its quarterly earnings targets. But the price gap between its Ivory soap, Tide laundry detergent and Charmin toilet paper and generic versions of the same products was widening. The growing gap was slowly eroding P&G's market share.

Shortly after he took office in the fall of 2000, Mr. Lafley told worried P&G directors that he planned to evaluate the pricing on P&G's products. Three years later, he has systematically lowered prices on a host of P&G products, from stalwarts such as Pampers and Bounty to new
entries, including Crest Whitestrips and Swiffer mops.

The company has been able to absorb those cuts, including the damage from the diaper battle, thanks to its diverse portfolio of more-profitable businesses, such as Olay skin care. Though the spending that helped pump up diaper shares can't continue indefinitely, P&G is betting that by gaining share it can win more shelf space and support from retailers, inflicting long-term damage on its rivals.

At Kimberly-Clark, Mr. Falk can't afford such measures. His smaller company has many fewer products and no high-end business to match the beauty-care unit at P&G. While in the quarter ended June 30, P&G reported a 5% rise in profit even after all its spending, Kimberly-Clark's profit fell 1.7% in the same period.

In another fractious market, P&G watched for years as the smaller Playtex Products Inc. stole share in the tampon market from its own Tampax business, which it had acquired in 1997 for $1.7 billion. The lack of growth at Tampax had long been an embarrassment for P&G managers.

After taking office, Mr. Lafley urged Tampax managers, who were working on a new Tampax product code-named "Mulan," to punch up the advertising for the product. After losing share for years, he told them, it was crucial that Tampax reverse its fortunes. "This advertising must be well above normal -- and high-recalling -- let's get it done now so we're ready to go next spring," Mr. Lafley scribbled in the margins of an April 10, 2001, memo on the project.

The resulting product, dubbed Tampax Pearl, arrived in stores a year ago. It has a shimmery-plastic applicator with a contoured grip and comes in a shiny box. As part of the company's $50 million marketing campaign, P&G shipped 75,000 displays for retailers to plunk in store aisles. Pearl was designed specifically to "reclaim share lost to Playtex," according to advertising strategy documents from P&G's advertising agency, Leo Burnett.

Like Kimberly-Clark, Playtex's results have suffered. It reported a 72% decline in profit for the second quarter. Sales of P&G's Tampax brand grew 9.4% in the 52 weeks ended July 13, while sales of Playtex tampons fell 7.4%, according to IRI.

In Playtex's case, P&G's attack is even more painful because the company put itself up for sale last year and is staggering under a heavy debt load. "Consumers must be in the position of trusting manufacturers claims," says Martin Petersen, a Playtex spokesman. "Violation of this trust, especially by such a prestigious company as P&G, makes their claims of winning in the marketplace hollow indeed."

As with Kimberly-Clark, P&G took an aggressive advertising approach, claiming its Pearl tampons were simply better than Playtex, until Playtex won a permanent injunction against the campaign earlier this year. A federal jury awarded $2.96 million in damages to Playtex, but Playtex's lawyers argued that the sales it lost due to P&G's false-advertising claims amounted to $13.3 million.

P&G executives insist they had a good case and are appealing the decision. But they also say that winning a lawsuit is of secondary importance. Pointing to the increased Tampax sales, Mr. Lafley says, "I'd rather win in the store. I don't really care about the rest of it."

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