9-810-091
REV: JUNE 23, 2011

MUKTI KHAIRE
STEFAN AICHINGER
MONIKA HOFFMANN
MAXIMILIAN SCHNOEDL

Zotter—Living by Chocolate

I spend all day working on chocolate; that's where I focus all my energy. I don't think anyone—including the customer—has the judgment to tell me what to do.

— Josef Zotter, chocolatier and founder of Zotter GmbH

Looking out the small airplane window, Josef Zotter admired the lush green hills and farms of Styria, Austria, below him (for maps and information on Austria, see **Exhibit 1**). He took another bite of his newest creation, a peanut and ketchup chocolate, letting it slowly melt in his mouth. Zotter was on his way home to Austria from his new flagship store in Essen, Germany, and he was excited about the potential for further store openings in the months to come. He had so many ideas for growing his company. Zotter chuckled when he thought about his latest project, a flavor-filled syringe[a] called CHOCOshot oral. Finally, consumers would be able to taste the soft fillings of Zotter chocolates, "without distraction, like licking jam from bread." He wondered how the media would react to the unconventional idea of using syringes. Provoking people with innovations had been his key to success so far. Tomorrow he was going to Milan to present his latest book at a gourmet festival. As Zotter thought about his various ideas, he wondered what would be the right way to grow his company.

Zotter History

Early Entrepreneurial Years

Zotter, confectioner and cook by training, had initially worked as head chef in the restaurant at the Hotel Imperial in Vienna, the capital of Austria. Although the Imperial was arguably one of the city's finest hotels, Zotter left in 1987 to open his first pastry shop in Graz (Austria's second-biggest city). "My head was full of ideas that I wanted to realize quickly and without ifs and buts," the entrepreneur said, explaining his motivations. In order to maximize the capacity of the company-owned pastry shop and increase sales, Zotter launched a total of four affiliated cafés in the following years. Tied up in day-to-day activities and focused on product quality rather than financial management, he soon experienced difficulties in operating the cafés profitably. This ultimately forced the company to declare bankruptcy in 1997.

[a] Given Zotter's commitment to sustainability, the syringe was made of environmentally friendly plastic.

Professor Mukti Khaire, and Stefan Aichinger, Monika Hoffmann, and Maximilian Schnoedl (all MBAs 2010) prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

Over the course of the debt-restructuring negotiations, Zotter closed three of his four cafés. In the remaining café, he began experimenting with made-to-order confectionery. Increasing consumer demand and high margins stirred his interest in comfit[b] for special occasions (e.g., anniversaries and weddings). To reduce high packaging expenditures (driven by a small SKU size of 1" x 1"), Zotter tried to find ways to increase product size. In his trials, he piled layers of different flavors on top of each other; inspired by the traditional comfit technique, he then wrapped his products in chocolate. These first chocolate confectionery creations, initially distributed by Zotter's shop and a handful of regional partners, proved to be so successful that he managed to convince banks to extend credit lines.

Fast-increasing demand for Zotter's comfit-style chocolates soon outstripped the manufacturing capacity of the pastry shop. However, the company's limited working capital made it impossible to get a lease for additional production space. Faced with this challenging situation, Zotter again decided to improvise. He initially set up operations in the barn adjacent to his parents' house in the countryside in Bergl. "Welcome back! Now at least somebody will look after the barnyard, and we don't have to get old all by ourselves," said Zotter's mother when he moved back in. He then split his time between chocolate production on Mondays and Tuesdays and sales activity in the pastry shop for the rest of the week. In July 1999, the remaining sales outlet was eventually closed, and plant and equipment were transferred to the new company headquarters in Bergl. The pastry shop and café business became, instead, a chocolate venture.

Founding Zotter GmbH

While only Zotter's wife and another confectioner had worked for the chocolatier in the summer of 1999, the firm employed 12 full-time workers by Christmas of the same year. "Since production was running almost 24/7, we had to transform our bedroom into a sales center and use other parts of my parents' house as office space," explained Zotter. By December 2001, the company eventually generated enough cash flow to pay back 100% of its remaining debt. Zotter's firm subsequently used its earnings to invest an aggregate amount of 18.5 million euros (€)[c] in new property, plant, and equipment (PPE) from 1999 to 2009. Zotter commented, "Having just emerged from bankruptcy, my wife and I decided to take a more conservative financing approach this time. As opposed to our prior decision to use debt for the pastry shop expansions, we consciously chose to take an all-equity financing approach in order to grow the chocolate business."

Innovating Chocolate and Educating Customers

During the following years, the Zotter brand became synonymous with a variety of innovations. The company provoked consumers and differentiated itself by challenging chocolate industry conventions. Zotter believed that educating consumers about his innovations would help them understand product-quality differentials better. He hoped customers would develop individual chocolate preferences, similar to the way they did with wine.

Bean to bar Against the prevailing industry trend, Zotter moved more and more production steps in-house, thus integrating vertically upstream. He believed that this would allow him to both fairly compensate cocoa farmers and optimize product quality by working closely with his entire supply chain. In 2007, the entrepreneur's new chocolate manufacturing plant in Bergl was completed,

[b] Comfit is confectionery consisting of dried fruits, nuts, or spices, coated with sugar candy.

[c] 1 € = 1.51 US$ as of December 4, 2009; http://www.xe.com.

right next to his parents' home (see Exhibit 2 for photos). Zotter designed his new factory not only to maximize production efficiency, but also to give visitors an opportunity to watch every production step closely. Visitors could taste a wide selection in the so-called Chocolate Theater, ranging from liquid cocoa mass to finished products. He explained, "Too many of my competitors today use preprocessed cocoa mass instead of raw cocoa beans to produce chocolate, thereby sacrificing quality for marginal pricing advantages."

Handgeschöpft Zotter's *handgeschöpfte Schokolade* (hand-created or hand-scooped chocolate), which he manufactured in a fundamentally different way from the rest of the industry, was perhaps his best-known invention. The German term *handgeschöpft* was derived from paper production and traditionally defined the process through which different layers of paper were compressed in order to produce higher-quality sheets.[d] Applying this technique to chocolate manufacturing, Zotter piled up individual layers of flavors (e.g., white poppy, cinnamon, and apricot) before coating them with chocolate. Rather than producing chocolate "outside-in" (pouring chocolate into a mold and then adding a single flavor), as was industry tradition, Zotter produced *handgeschöpfte* chocolate "inside-out." Even though consumers did not fully understand how Zotter's manufacturing process was different from that of other producers, they valued the unique tasting experience as the different layers melted in their mouths over time.

Unconventional flavors Starting in the early 2000s, Zotter pioneered and marketed chocolates with previously untried ingredients. His creations—for example, chocolate that contained chili,[e] cheese, or beer—stood in marked contrast to the prevailing traditional flavors his competitors relied on, such as pure chocolate bars, or milk chocolate filled with almonds. Leveraging his *handgeschöpft* production technique, Zotter combined different, seemingly incompatible flavors (e.g., pink coconut and fish gum). Because he introduced as many as 70 new flavors every season, journalists became interested in Zotter as an unconventional player in the chocolate industry. Zotter remarked, "My company has never needed a marketing budget, since we fortunately always received so much media coverage and positive PR from product launches. I also haven't spent a single euro to find out what consumers think or what they want. If you need market research or product development, it's already too late—you need to constantly innovate and stay ahead of the curve."

Organic and fair production

As a cocoa processing company, we carry the responsibility for the living and working conditions of cocoa farmers in the Third World. Fair trade creates opportunities for small farmers and plantation workers in the producing countries. They are able to emancipate themselves from fluctuating world market prices and establish their own self-determined existence.

– Josef Zotter

In 2003, Zotter decided to use only organic and fair-trade ingredients for his chocolate creations,[f] becoming the only major chocolate producer in Austria to pursue this strategy.[g] In addition to his

---

[d] In addition to process innovation, the term *handgeschöpft* was highly recognizable and became part of Zotter's brand in the minds of consumers; in German, the word alludes both to an action performed by hand (*hand*) and to divine creation (*geschöpft*).

[e] Although combining chili with chocolate was part of Mexican tradition, Zotter claimed to be the first Western chocolate manufacturer to bring this combination to market.

[f] Even before 2003, the majority of ingredients used in Zotter chocolates were organic.

organic production focus, Zotter also wanted his employees to share his vision of organic food. Thus, he hired a cook who prepared free meals from organic ingredients for all his workers on a daily basis. Zotter said, "It was important to not merely produce a niche product with an organic label, but to shift the entire thinking and product range to organic cultivation. Since we have built on quality and regional culture right from the start and refrained from the use of preservatives or artificial flavors, it was just a matter of consistency to pursue an organic philosophy in general."

Each year in his manufacturing plant, Zotter processed approximately 250 tons of cocoa from Nicaragua, the Dominican Republic, Ecuador, Costa Rica, Panama, and Brazil, as well as 160 tons of sugar from Paraguay. To educate consumers about his supply chain, he subsequently equipped the Chocolate Theater with a cinema that showed documentaries on cocoa-bean–producing countries. Even though Zotter initially intended to purchase cocoa plantations overseas in order to directly ensure a fair working environment for suppliers, red tape and corruption prevented him from pursuing this approach. Instead, he became part of the Fairtrade[h] Austria initiative in 2004, which guaranteed fair wages for farmers and transporters. In Nicaragua, Zotter specifically launched a project to encourage farmers to adhere to superior agricultural practices and in turn remunerated them with substantial price premiums over and above those for Fairtrade and organic production (for details, see **Exhibit 3**).

Chocolate and art Having produced comfit for special occasions, Zotter wanted his chocolates to be wrapped in festive designs. In 1994, he began working with the Austrian artist Andreas Gratze, who designed distinctive packaging for Zotter's chocolates. Over the years, the artistic packaging of Zotter chocolates won a series of awards, including the popular iF-packaging award[i] in 2008. In 2009, Gratze was nominated for the Design Award of the Federal Republic of Germany for his Zotter graphics (see Exhibit 4 for sample packaging designs). Zotter packaging was a key component in the company's success and ability to differentiate itself from traditional chocolate manufacturers. According to Professor Schnedlitz of the Vienna University of Economics and Business, "chocolate is an impulse purchase product. The design of Zotter's packaging is a key component of the brand's success. Its packaging clearly sets Zotter apart from all other chocolate bars the customer can choose from."

Challenges

> *To me, resistance against conventional chocolate wisdom and creation of new forms of chocolate is more than a professional challenge; it is my life.*
>
> – Josef Zotter

Production challenges From early on, Zotter had to innovate in order to overcome challenges he faced when entering the chocolate industry. After the initial setup in his parents' house, the

---

[g] As a result of Zotter's commitment to fair trade, sales from fair-trade chocolate products increased from approximately €2 million in 2003 to €16 million in 2008; http://downloads.fairtrade.at/infomaterial/FT_Jahresbericht_08_web.pdf.

[h] Fairtrade International was a trading partnership, based on dialogue, transparency, and respect, that sought greater equity in international trade. It guaranteed that producers were paid a fair price for their goods. In addition, they received a so-called Fairtrade Premium to improve working and living conditions. Hartwig Kirner, Fairtrade Austria, interview, November 3, 2009; and http://www.fairtrade.net.

[i] The packaging award of the Hanover-based iF International Forum Design focused on packaging, packaging graphics, packing materials, and packaging machines of all kinds. The jury gave an award to Gratze based on his creative and funny graphical representations of the Zotter chocolate compositions.

company's aggressive growth often spurred Zotter to implement previously untried ideas. For instance, he first used simple curtain rails to define batch sizes for the production process, since no comparable machinery existed for the scale of Zotter's operations. When he decided to in-source production steps several years later, he had to purchase expensive machinery from other, unrelated industries (like centrifuges from the wastewater treatment industry in order to separate cocoa butter from cocoa mass), which only operated at ~30% capacity utilization levels in Zotter's plant. Zotter remarked, "These machines are my Ferraris and Maseratis. Running them at low capacity—in fact, having them at all—is a luxury. However, they give me the freedom to tweak every step in the production process, which is critical to maintaining our high product quality." On the other hand, contrary to conventional production management principles, Zotter shut down production every year during the hottest summer months because the temperatures affected the quality of the chocolate, particularly during transport and in the small stores (with no air-conditioning) where he sold his chocolates.

Distribution challenges From the company's early days, Zotter faced significant distribution challenges. For instance, the chocolates' six-month shelf-life required timely distribution. As the company grew, Zotter needed to rethink the regionally focused distribution model. Instead of distributing through supermarket chains and other mass-market channels, Zotter decided to target gourmet stores exclusively. While this decision slowed diffusion, it allowed Zotter to preserve the high-quality brand image and a correspondingly high price tag.

Competitive challenges With rapid sales growth and the positive PR generated in newspapers and magazines, three types of competitors quickly emerged. Regional producers from Austria and Germany used the term *handgeschöpft* to label their products. Some competitors went even further, copying Zotter's innovative manufacturing techniques. Also, Zotter gradually experienced more competition in the organic and Fairtrade market segment. And multinational confectionary producers also began to pay more attention to Zotter chocolates. Zotter recalled, "I still remember two events in the company history that proved to me that we were on the right track. After we had created and successfully sold our first chili-chocolate product line in 2003, Lindt launched a chili-flavored chocolate. In the following year, I received an online order from Ritter Sport for our Marc de Champagne chocolate, only to find Ritter Sport's Marc de Champagne chocolate in a nearby retailer a few months later."

Legislative challenges Because Zotter initially developed chocolate bars as large-scale versions of comfit, he saw no compelling reason to follow the conventional packaging sizes in the industry. As he recalled, "I did not want to go down the route of standardized packaging. Rather, I played around with a few different size options and found that I liked the look and feel of a 70 gram bar."

However, by Austrian law, only SKU sizes of 50 gram or 100 gram (or multiples thereof) were permitted when Zotter first launched production. So he decided to quote the price for 1 kilogram on each SKU,[j] which became a legally enacted industry standard a few years later. Zotter said, "We were always borderline illegal, but in a good way—even today, our manufacturing processes yield a comparatively low precision output, which means that we are actually selling 68 grams to 80 grams per bar rather than 70 grams. Of course, our 70-gram packaging, taken together with the introduction of the euro in 2002, also gave us a competitive edge in pricing. If you sell 70 grams as opposed to 100 grams, your price tag suddenly does not look that expensive."

[j] 1 kilogram (kg) equals 1,000 grams (g), approximately 35 ounces or 2.2 pounds.

In early 2009, Zotter again found himself testing the boundaries of the law. He started to produce chocolate from fruit powder, using a new dry-freezing technique. For example, going beyond traditional strawberry-filled or strawberry-flavored milk chocolate, Zotter's strawberry "in&out" product not only contained strawberry filling, but also was wrapped in strawberry "chocolate" that was made with fruit powder. Therefore, the in&out products (i.e., fruit "chocolate") could no longer be classified as one of the three official chocolate categories in European Union legislation (namely, milk, dark, and white chocolate). Disregarding the legislation, Zotter continued selling these products as "chocolate."

Communication challenges Zotter rarely used traditional marketing channels or advertising. Instead, he relied on word-of-mouth and public relations, limiting himself primarily to packaging design, the Chocolate Theater, and communication through his home page, http://www.zotter.at. Consequently, the company had few possibilities to interact with consumers. Even though a majority of Zotter's sales were of *handgeschöpft* chocolates, Zotter estimated that only 20% of interested customers understood what that term meant. Nevertheless, surveys indicated that consumers associated the term with high quality and were willing to pay a price premium.[1] In order to increase product knowledge, Zotter included an explication of *handgeschöpft* on his website as well as inside each chocolate's packaging. He also hired a lawyer to seek trademark protection for the term.

In communicating with consumers, Zotter argued that "we live in a time of overproduction. I believe products that evoke emotions are important nowadays, which is why I like to personalize my messages and push the boundaries to challenge customers." Consequently, he changed the packaging of some of his most well-established cash-cow products from time to time, against conventional marketing wisdom.

Chocolate Industry Overview

The History of Chocolate

Chocolate was first consumed by the Mayas and Aztecs in Mexico and Central America over 2,000 years ago. By mixing cocoa beans and seasoning, these ancient cultures created a spicy, foam-covered drink, called *xocoatl*. Spanish conquistadores first brought the Aztec recipe to Europe around 1500. Initially received unenthusiastically, chocolate drinks became popular in Europe after the original recipe was changed, notably by adding sugar and cinnamon.[2] Chocolate finally gained widespread popularity after the first solid chocolate was developed in Europe in the mid-1800s.[3] Since then, chocolate became an immensely popular snack and dessert in many parts of the world. In 2008, global sales for chocolate were approximately €41 billion,[4] growing at 4% to 5% per annum.[5]

International Chocolate Production

A global value chain The main ingredients for chocolate were derived from the seeds of the cocoa tree. The largest producing countries were Côte d'Ivoire, Ghana, and Indonesia, accounting for 39%, 21%, and 13% of world production, respectively.

The fermented and dried beans of the cocoa tree were delivered to chocolate manufacturers that cleaned and roasted them to bring out flavor and color. After the manufacturers removed the shells from the beans, they milled the cocoa nibs to create cocoa liquor. Next, they pressed the cocoa liquor to extract cocoa butter. They added other ingredients, such as sugar, milk, and emulsifying agents, before the mixture passed the refining and conching processes.[k] Finally, the mixture was tempered, put in molds, and cooled before being packaged for distribution.[6]

Cocoa bean exportation could involve two or more middlemen (small traders and wholesalers), although some farmers' cooperatives also exported cocoa beans directly. To facilitate trading, organizations such as the Federation of Cocoa Commerce Ltd. established standardized grading to determine the quality of cocoa. Cocoa was affected by a range of pests and diseases, with some estimates putting losses as high as 30% to 40% of global production.[7]

Main chocolate producers In 2007, about 40% of cocoa beans globally were processed by three major cocoa-producing companies, Archer Daniels Midland (ADM), Barry Callebaut, and Cargill Incorporated.[8] Meanwhile, chocolate manufacturers themselves reduced their cocoa-processing activities to focus on final chocolate production steps and marketing activities for their chocolate. Consequently, the cocoa-processing share of the seven largest chocolate producers (e.g., Mars, Inc.; Cadbury Schweppes PLC; Hershey Foods Corporation) fell from 23% 2001 to 15% in 2007.[9] Since chocolate tastes varied by region, these companies owned a number of different regional and local brands.[10]

By 2009, many chocolate manufacturers did not actually select, source, roast, or grind their own beans. Instead, they bought either processed raw materials (i.e., cocoa butter) or premixed chocolate mixes (i.e., combinations of cocoa butter, sugar, and other ingredients) from global suppliers.

Market segmentation Chocolate markets could be segmented along multiple dimensions. Consumers often thought of chocolate in terms of dark, milk, white, and filled chocolate. Chocolate was further categorized into premium and mass-market products. Although there was no standardized definition of premium chocolate, industry experts generally considered ingredients, manufacturing methods, taste, and pricing as the primary categorization criteria.[11] The organic and Fairtrade chocolate segments, which consumers mostly perceived as premium segments, experienced high growth. New organic players entered the market, and existing companies such as Cadbury began certifying some of their products as Fairtrade or organic.[12]

International Consumption Patterns and Market Trends

Consumption patterns Chocolate consumption varied widely across countries, largely due to cultural factors. Generally, however, consumption grew in many regions of the world due to economic development, falling chocolate prices, new product development, and marketing efforts (see Exhibit 5 for total chocolate confectionery consumption). Per capita chocolate consumption was traditionally the highest in many parts of Western Europe, especially in Germany and Switzerland (about 10 kg per capita in 2006). Mediterranean Europeans tended to eat less chocolate (about 3 kg per capita). Other parts of the world traditionally consumed much less chocolate. While, on average, Americans consumed only about half as much chocolate as their German counterparts, U.S. consumption was high compared to countries in Asia or Latin America (for example, Brazilians consumed about 2.2 kg per capita; in China, consumption was less than 0.2 kg per capita).[13]

Recent trends A number of trends affected chocolate production and consumption behavior. First, the global trend to healthier living led to increased marketing and consumption of darker chocolate, which was generally considered healthier than milk chocolate due to its lower fat and sugar content. Moreover, dark chocolate was shown to lower blood pressure and have antioxidant

[k] Conching was a kneading or smoothing process. The speed, duration, and temperature of the kneading affected the flavor.

properties, although these benefits were to be weighed against calorie consumption. Increased dark chocolate sales drove most of the growth in the overall chocolate industry.

A second trend was the growth of the premium chocolate segment. Premium chocolate sales benefited not only from the health trend (premium chocolate was largely of the dark variety), but also from an increasing interest in more exotic flavors.

Lastly, growing consumer concerns about food safety and environmental issues increased consumption of ethical organic and Fairtrade chocolate. Although global organic chocolate sales were estimated at approximately €214 million in 2005, this segment grew at over 20% year-on-year.[14]

Austrian Chocolate Market

Market overview The overall size of the Austrian chocolate market in 2008 was approximately €314 million.[15] Growth had been slow, at 1% year-on-year since 2006.[16] While prices remained largely stable at approximately €9.80 per kilogram, growth was driven by an increasing volume of sales, particularly in dark chocolate bars (tablets).[17]

Zotter primarily competed in the chocolate-bar market segment, which accounted for approximately half of the overall chocolate market.[18] Like chocolate snacks, which were consumed on the go, bars were among the fastest-growing segments in the Austrian market. Slower-growing segments included countlines,[l] bagged assortments, and seasonal chocolates.[19] Filled chocolates represented nearly half of chocolate bar sales.[20] In 2008, both plain milk and plain dark chocolate each represented approximately 25% of the market. However, from 2004 to 2008, there was a clear shift from milk toward dark chocolate (see **Exhibit 6** for the segmentation of the Austrian market).[21]

Fairtrade chocolate accounted for approximately 5% of the overall chocolate market in 2008—a 400% increase compared to 2003, which could mainly be attributed to Zotter's success, according to the head of Fairtrade Austria.[22] Fairtrade-branded products were associated with high quality and ethical sourcing. However, consumers did not perceive Fairtrade products as particularly expensive.[23]

The Austrian market experienced trends that were similar to those of the global market. Dark chocolate and premium segments grew, and chocolate companies introduced a wide array of exotic flavors. Although Austrians had a long tradition of chocolate consumption and snacking after meals, the chocolate segment came under increasing pressure for healthier snacks, such as fruit or cereal bars.[24]

Distribution Two channels dominated food retailing in Austria: smaller mom-and-pop stores (about 40% of stores had a sales area of less than 400 sqm[m]) and grocery retail chains.[25] While the smaller stores were generally independently run and operated, the retail chains were heavily consolidated. In 2008, three groups (REWE Group, Spar, and Aldi/Hofer) had a combined food retailing market share of 78.5%.[26] Consolidation had increased since 2006, with nearly all players

[l] A countline was a consumer product (especially confectionary) that was supplied to retailers in packages of multiple items and sold individually to customers.

[m] 400 sqm (square meters) is the equivalent 4,305 square feet.

outside the top three losing market share. Discount supermarkets had invested in the Austrian market, and by 2008, they held 23.3% of the market and were among the fastest-growing players.[n27]

Grocery retail chains were the largest channel for chocolate, accounting for approximately 30% of chocolate sales. Discounters (16%) and mom-and-pop stores (9%) accounted for a further quarter of sales. Because chocolate was an impulse purchase, nontraditional food channels, including kiosks, confectioners, convenience stores, and gas stations, accounted for approximately 45% of sales.[28]

Competitive landscape In 2009, the main chocolate producers in Austria were Kraft Foods, Ferrero, Lindt & Sprüngli, and Mars.[29] Other market participants included Nestlé, Manner, Ritter Sport, and private-label brands (especially discount retailers). Finally, the growing niche of organic and Fairtrade manufacturers included Zotter and its much smaller rival, EZA chocolates (see Exhibit 7 for their Austrian market shares).[30]

Kraft Foods was the clear market leader, holding a 38.5% market share in 2007. Kraft sales were heavily weighted toward the local Milka brand, accounting for over 75% of its Austrian sales. Milka, which had traditionally dominated the mass-market chocolate bar segment, had recently attempted to shift toward a more premium product mix, notably through the introduction of its Amavel chocolate-mousse bars. Milka was also taking first steps toward addressing the health trend by introducing Milka Diät, a light version of its popular chocolate bars. Further innovation at Milka focused on adding a number of new flavors to its substantial variety of flavors, especially in the form of seasonal specials.[31]

Ferrero was the number-two player in the Austrian market, with a share of approximately 11% in 2007.[32] Ferrero sales were split among its Kinder Schokolade brand, as well as the more premium Ferrero Rocher, Mon Chéri, and Raffaello brands. Ferrero was known in the industry for its thorough and scientific approach to innovation. Its innovation efforts were aimed at perfecting its most popular brands.

Lindt was the third-largest player in the Austrian market. The firm had benefited from the recent trend toward premium chocolates and exotic flavors, making it the only large player to materially increase its market share.[33] Lindt benefited from its premium reputation and experience in launching nontraditional flavors (e.g., it followed Zotter's introduction of chili-flavored chocolate[34]).

Other significant players in the Austrian chocolate market included global players with international brands, such as Masterfoods/Mars (e.g., Milky Way, Mars, M&Ms), Nestlé (e.g., After Eight, Smarties) as well as players with a regional focus, such as Ritter Sport (square bars) and Manner (nougat waffles). Private labels dominated the discount retail channel, giving them an overall market share of ~11%.[35]

As Fairtrade accounted for about 5% of chocolate sales,[36] with Zotter holding a 4.6% market share, there were few other significant Fairtrade/organic players. Zotter's most notable direct competitor within this niche was EZA. EZA was a diversified business, with the majority of revenues coming from coffee (€4.3 million), arts and crafts (€3.6 million), chocolates (€2.3 million), and other food products (€2.5 million). EZA chocolate was primarily sold through Weltläden, a Fairtrade-specific distribution channel, food retailers, and other nontraditional channels (e.g., cafés, institutions). Compared to Zotter, EZA chocolates were less expensive (approximately €2 to €2.5 per 100 g).

[n] One of the top-three supermarkets was actually a discounter with approximately 20% market share; 20% of the 23.3% market share of the discounters was part of the 78.5%.

Branding focused more on their origin, rather than provocative flavors. Although EZA packaging featured unique designs, again, the emphasis was on country of origin.[37]

Zotter in 2009

Brand Strategy and Innovation

You need to innovate to stay relevant.

— Josef Zotter

Since its inception, Zotter had focused on developing new forms and flavors of chocolate, thereby building up a brand image of "being different than the rest." Although *handgeschöpfte Schokolade* still constituted almost three-quarters of Zotter sales in 2009, its revenue share had gradually been replaced by newer Zotter inventions. Labooko Chocolate (a chocolate booklet that enabled consumers to compare two pure chocolate bars from different regions, introduced in 2008) and Drinking Chocolate (a mini chocolate bar to insert into hot milk and disperse by either shaking or stirring) made up almost 20% of turnover (for a breakdown of Zotter sales per product category, channel, and region, see **Exhibit 8**). In 2009, Zotter introduced 70 new flavors, the largest number of new SKUs developed and sold in a single year in the company's history. Zotter commented, "Usually, the innovation process in most companies goes from product development through a number of departments until innovation is killed by the finance department. We don't do it that way. We want to interact with and challenge our customers, but also let them make the final call on what they want to purchase."

Typically, 40% to 45% of newly developed flavors were sold for only one year and then taken off the shelves; comparatively few cash-cow products (less than one-third) remained in circulation three years or longer. Zotter believed that trial-and-error-type innovation was his key to success.

Distribution Model

Stemming from the company's early ties to small-scale, regionally active mom-and-pop stores and the *Weltläden*, Zotter's distribution model was still centered on selling to a dispersed network of sales outlets in 2009. Apart from its relationships with gourmet shops, the company selectively entered into cooperation with bigger retail chains, the prevailing distribution channel, in order to avoid a mass-market image and price cuts. According to Zotter, "we rely on a variety of retailers to support small and medium-sized businesses." And, even though Zotter had never imagined selling sizable amounts of chocolate at his factory store, his Chocolate Theater attracted 150,000 visitors at a basic tour price of €7.90 and accounted for 10% of overall sales in 2009 (including sales in the company shop).

In October 2009, Zotter launched Mitzi Blue, a disk-shaped, high-end, pure chocolate for mass-market distribution. Marketed with advertisements in newspapers and on billboards as "rounded, but with edges" (see **Exhibit 9** for sample packaging), the product was planned to bring "a little bit of Zotter to everyone." After negotiations with supermarkets resulted in increased costs and tougher-than-expected terms, Zotter pulled back: "I felt uncomfortable pushing the pressure I received through to our suppliers or modifying our own production process. I couldn't pretend to be someone I was not." Consequently, Zotter largely abandoned the supermarket channel and distributed Mitzi Blue in his traditional channels along with his existing product lines.

Financial Performance

In 2008, Zotter GmbH generated over €14 million in revenues, 10 times more than only six years earlier. The company also sustained healthy profit margins at a high of 32% of sales, although margins had declined lately (see **Exhibit 10** for Zotter's P&L statement). Zotter summed up his philosophy: "I don't define my success based on my revenue figures. I am creating trends and great taste. If I manufactured shoes, for example, I would commit myself to making the best shoes in the world. You don't do that because of money."

Decision Facing Zotter

As the plane was landing in Austria, Zotter contemplated how he should prepare his company for the future. Zotter's ambition was to keep innovating and growing his company, but he wondered what path he should choose. How could he further exploit the brand he had built in Austria and Germany? Should he look for alternative distribution channels? Was it time to expand the brand beyond chocolate? Should he introduce his brand to new geographic markets? Zotter was also wondering whether he should focus on one option or pursue multiple expansion strategies simultaneously.

Exploit the Brand in Austria/Germany

The Zotter brand enjoyed high popularity in Austria. Zotter wondered how he could leverage the value of his brand to accelerate growth. He saw two basic ways to increase sales: he could attract new customers or he could increase his share of wallet with existing customers. On the one hand, his opportunity to grow was limited by his current distribution model. Zotter might therefore need to explore new channels. On the other hand, he could expand into new products in addition to leveraging his existing product portfolio.

Distribution Zotter's decision not to distribute his products through supermarkets limited his growth potential significantly. Three large supermarket chains dominated the retail market in Austria and continued to grow.[38] How much did customers value the convenience of buying chocolate in supermarkets? Should Zotter take a completely new approach to distribution?

Part of his philosophy was giving his customers a "chocolate experience," which was evidently well received by the 150,000 visitors who came every year to his factory in the Austrian countryside. Could he not bring this experience to more of his customers by building a network of Zotter-branded stores? These stores could both serve as revenue generators for the company and bring the "Zotter experience" to customers who had never visited the production facility in Bergl.

Zotter had already begun experimenting with this format. In late November 2009, he opened a 100-sqm[o] store in Essen, Germany, which featured his Chocolate Theater concept. The store was equipped with well-known features from his main store in Bergl, like a chocolate fountain and small gondolas transporting Drinking Chocolates. Zotter felt the opening had been a big success. The store had made around €3,500 in sales on each of its first three days.[p] Zotter planned further store openings in Germany and Austria for 2010. For a 100-sqm store, the investment costs would be €400,000 (depreciated over eight years). Zotter calculated additional annual costs of €310,000 (€180,000 for

[o] 100 sqm (square meters) is the equivalent 1,076 square feet.

[p] For comparison, in the factory in Bergl on a peak Saturday, Zotter made €20,000 in revenues from entry fees and chocolate sales.

labor, €80,000 for rent, €30,000 for maintenance costs, and €20,000 for other variable costs). One Zotter chocolate bar currently sold at €3.2 in a store (the factory sold one chocolate bar for €1.5 to the store).

However, questions about the implementation still remained. Would the shops generate enough revenues to pay off the investment? Another question was ownership; Zotter thought about operating smaller stores under a franchise concept. What level of autonomy should the franchise owners have? What would be the implications on the company's culture and quality standards?

Product In order to increase sales, Zotter contemplated expanding his brand beyond chocolate to chocolate-related products. CHOCOshot oral was already the first step away from the traditional chocolate bar. Zotter also toyed with the idea of expanding into a beauty product line based on chocolate—creamy chocolate soap bars, relaxing chocolate massages, and soothing cocoa butter creams.

In addition, Zotter also had projects related to the company's culture and philosophy in mind. He wanted to take his efforts to educate consumers about sustainability to the next level. His idea was to create a farm with cows, goats, ducks, and chicken next to his Chocolate Theater in Bergl. He contemplated selling organic high-quality meats and exotic spices. With a provocative name, "edible animal farm," Zotter hoped to get people to question the origins of meat products and then show them how to relate that to chocolate sourcing. According to him, "when consumers eat chocolate, they don't think about the cocoa bean farmer sweating in the sun. It is the same with meat—no one thinks about where it comes from."

This new project could also be a marketing tool for his chocolate business. As an expansion of the Chocolate Theater tour around his factory, the farm could attract even more visitors to Bergl and create media attention for his core business.

Introduce the Brand to New Markets

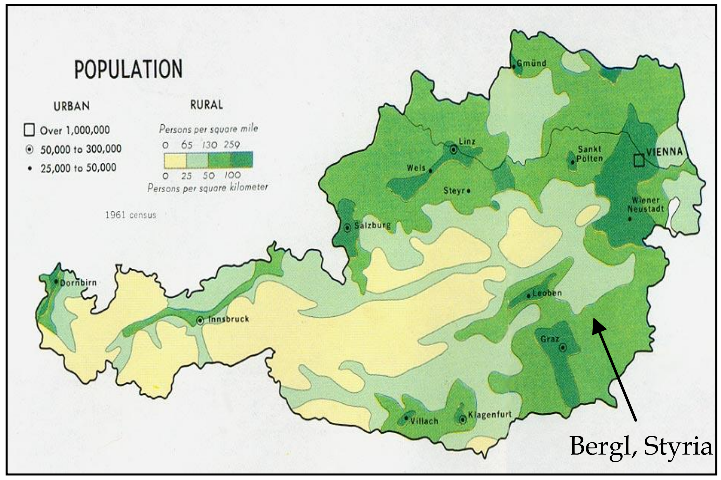
Although Zotter had achieved remarkable growth in Austria, he became increasingly aware that a greater share of his growth came from Germany and other international markets. Had he outgrown his niche in Austria? Was it time to introduce his brand to new markets? The success of organic chocolates in the U.K.,[q] for example, suggested demand for Zotter's value proposition in other markets. Learning from previous exporting experiences, Zotter preferred to enter one region at a time. By focusing all his energy on one region, he could benefit from media attention and quickly gain market share. However, questions remained: How should he enter new markets and what distribution strategy should he employ? What would be the implications for the current organization and production process?

Conclusion

As Zotter contemplated these plans, he questioned where to focus his energy and capital. He still had to run the day-to-day business and drive innovation of new chocolate flavors. What should he pursue first? Or should he perhaps pursue all options at once? What were the benefits and the risks?

[q] By focusing on organic products, Green & Black became the fastest-growing chocolate brand in the U.K. between 2004 and 2007. Euromonitor, Chocolate Confectionery—United Kingdom, November 2008.

Exhibit 1 Information on Austria



Source: Courtesy of the University of Texas Libraries, The University of Texas at Austin.

Exhibit 2 Zotter's House in Bergl, 1999 (left) and Zotter's Plant Adjacent to It, 2007 (right)

Source: Company materials.

Exhibit 3 Price Components for Zotter Nicaragua-Sourced Cocoa

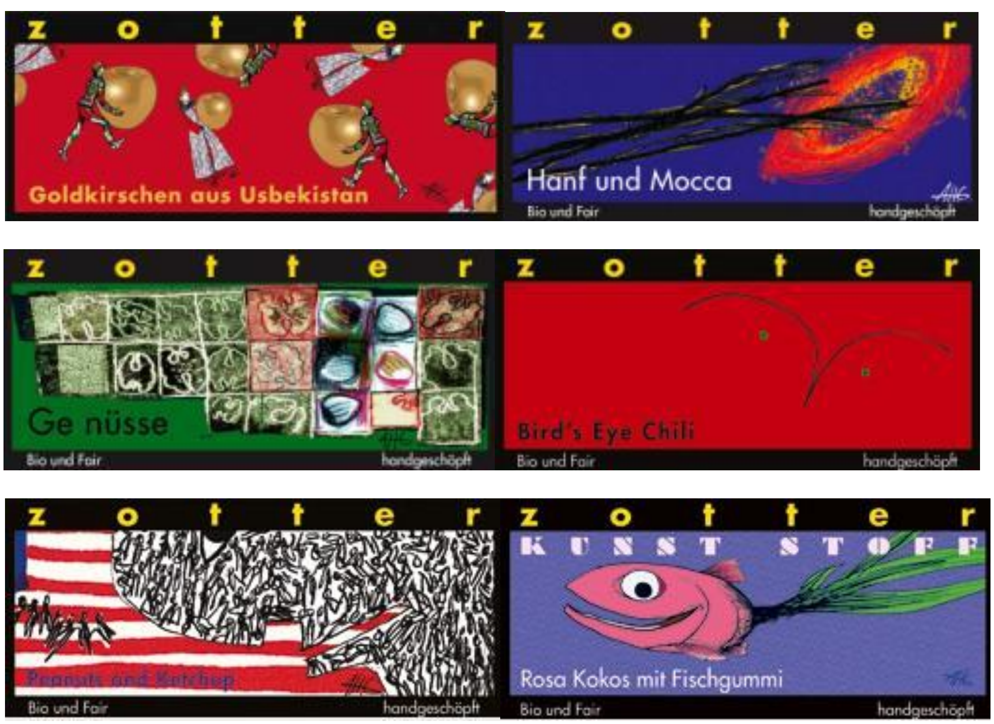
Cost Item	Cost Factor
Average Cocoa Price received by Farmers*	$900-$1,100**
Organic Premium	$300
Fairtrade Premium	$300
Organic & Fairtrade Price	$1,600
Zotter Nicaragua Price	**$4,200**
Multiple of Farmer Price	*4.2*
Multiple of Organic & Fairtrade Price	*2.6*

** Farmers receive on average ~50% of world market price ($2000) (Jan 2003 - Jan 2009)*
*** All prices in $ per metric ton (1,000 kg)*

Source: Company materials.

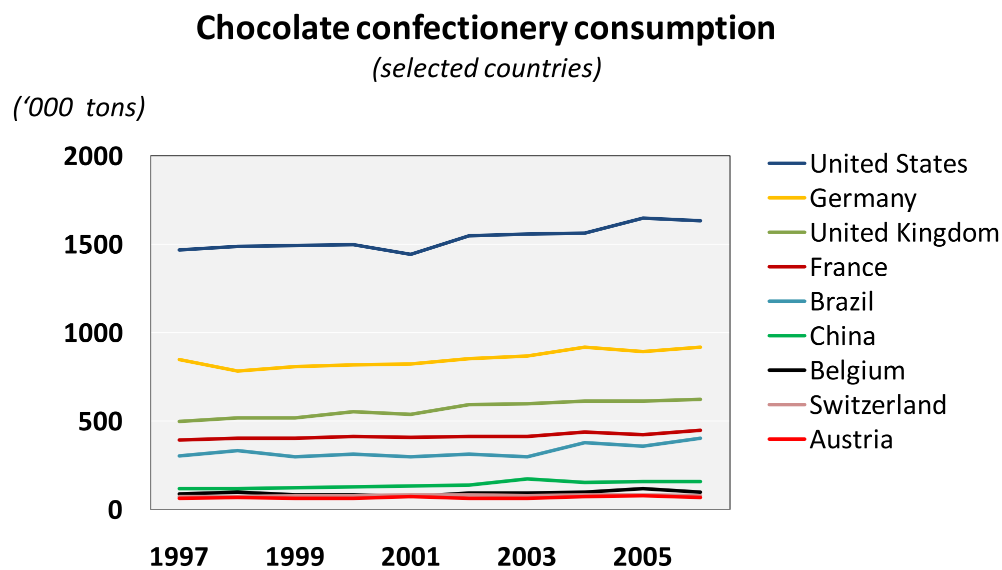
Note: Average monthly cocoa prices fluctuated widely from 2003 to 2009, between US$ 1,500 and US$ 3,000, according to the International Cocoa Organization.

Exhibit 4 Sample Designs for Handgeschöpfte Schokolade



Source: Company materials.

Exhibit 5 Total Chocolate Confectionery Consumption in Selected Countries (thousands of tons)



Source: Casewriter analysis of data from ICCO.

Exhibit 6 Austrian Market Segmentation (% of retail value)

Flavor	2004	2005	2006	2007	2008
Plain dark	20.0	21.0	23.0	24.0	25.0
Plain milk	30.0	28.0	26.0	25.0	24.0
Plain white	4.0	3.5	3.2	3.0	2.9
Filled	46.0	47.5	47.8	48.0	48.1
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Euromonitor International, Chocolate Confectionary: Austria, January 2009.

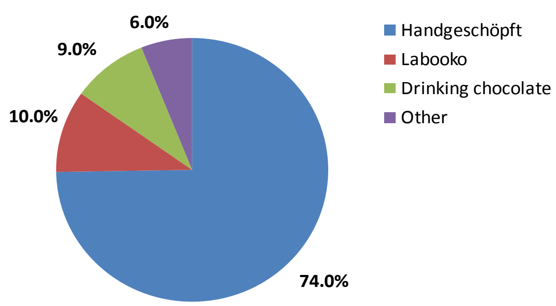
Exhibit 7 Austrian Market Shares and Market Size

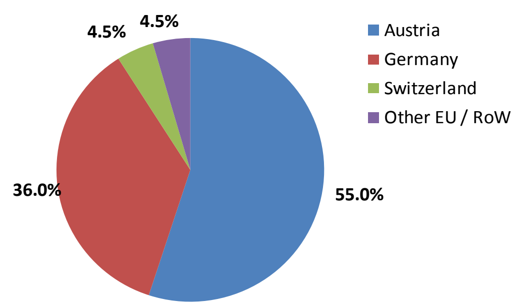
Brand	2003	2004	2005	2006	2007
Kraft	39.3%	39.4%	39.5%	39.0%	38.5%
Ferrero	11.6%	11.3%	11.2%	11.0%	10.9%
Lindt	7.4%	7.5%	7.9%	8.6%	9.3%
Masterfoods	7.7%	8.4%	8.5%	8.5%	8.5%
Nestlé	4.5%	4.3%	4.2%	4.1%	4.1%
Ritter Sport	3.2%	3.2%	3.3%	3.3%	3.3%
Manner	2.3%	2.2%	2.1%	2.0%	1.9%
Private label	10.6%	10.8%	10.9%	11.0%	11.0%
Zotter	**0.9%**	**1.4%**	**2.0%**	**3.3%**	**4.1%**
EZA	0.4%	0.5%	1.2%	0.7%	0.6%
Others	12.1%	11.1%	9.2%	8.5%	7.8%
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Market size (€ mn)	291	308	305	307	311

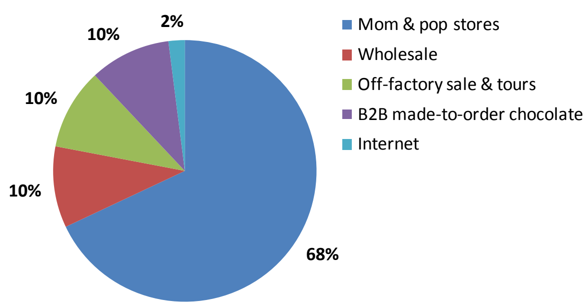
Source: Casewriter analysis of data from Euromonitor estimates, A.C. Nielsen estimates, Zotter internal data, and EZA company reports.

Note: Zotter market share for 2008: 4.6%

Exhibit 8 Zotter Sales per Channel, Region, and Product Category (2009 company estimates)







Source: Company materials.

Exhibit 9 Mitzi Blue Sample Package Designs

Source: Company materials.

Source: Company materials.

Exhibit 10 Zotter GmbH P&L (in thousands of euros)

Country	2002	2003	2004	2005	2006	2007	2008	*CAGR*
Revenues	**1,337**	**2,724**	**4,318**	**6,234**	**10,417**	**12,772**	**14,322**	***48%***
Cost	**1,097**	**2,114**	**3,224**	**4,178**	**7,132**	**10,425**	**11,911**	***49%***
Materials	308	673	958	1,521	3,733	5,335	5,270	*61%*
Labor	189	501	589	434	949	1,351	2,035	*49%*
SG&A / Packaging / Transport	362	471	989	1,096	1,195	1,519	2,007	*33%*
Other	92	157	135	352	143	1,438	1,787	*64%*
Tax	147	312	554	776	1,113	782	813	*33%*
Net income	**240**	**610**	**1,094**	**2,055**	**3,286**	**2,347**	**2,411**	***47%***
Net income margin (%)	*18%*	*22%*	*25%*	*33%*	*32%*	*18%*	*17%*	

Source: Company materials.
Note: Based on Austrian GAAP, which does not seperately disclose gross profit and COGS

Endnotes

[1] According to *Cash* magazine's brand index, September 2007, p. 79.

[2] International Cocoa Organization, http://www.icco.org, accessed October 29, 2009.

[3] International Confectionery Association, http://www.international-confectionery.com.

[4] "The Global Confectionery Market Grew By 2.4% in 2008 to Reach a Volume of 12.8 Billion Kilograms," Business Wire, Research and Markets, November 17, 2009, via Factiva, November 20, 2009.

[5] "Chocolate sales follow suppliers to Eastern Europe, says report," Confectionery News, November 20, 2009, http://www.confectionerynews.com/On-your-radar/Recession-effects/Chocolate-sales-follow-suppliers-to-Eastern-Europe-says-report, accessed November 20, 2009.

[6] International Cocoa Organization.

[7] International Cocoa Organization.

[8] International Cocoa Organization.

[9] International Cocoa Organization.

[10] Professor Schnedlitz, WU Wien, interview, November 3, 2009.

[11] Daniel C. Snow, Steven C. Wheelwright, and Alison Berkley Wagonfeld, "Scharffen Berger Chocolate Maker (A)," HBS No. 606-043 (Boston: Harvard Business School Publishing, 2005), pp. 2–4.

[12] Hartwig Kirner, Fairtrade Austria, interview, November 3, 2009.

[13] International Cocoa Organization.

[14] International Cocoa Organization.

[15] Estimate based on Euromonitor Chocolate Confectionery Austria, January 2009; and A.C. Nielsen.

[16] Euromonitor, Chocolate Confectionery Austria.

[17] Euromonitor, Chocolate Confectionery Austria.

[18] Euromonitor, Chocolate Confectionery Austria.

[19] Euromonitor, Chocolate Confectionery Austria.

[20] Euromonitor, Chocolate Confectionery Austria.

[21] Euromonitor, Chocolate Confectionery Austria.

[22] Kirner, interview.

[23] Kirner, interview; and A.C. Nielsen, "Handel in Österreich Basisdaten 2008," p. 65. Ninety-seven percent of Austrians don't perceive Fairtrade products as more expensive than similar non-Fairtrade products, compared to European average of 58%.

[24] Based largely on Euromonitor, Chocolate Confectionery Austria Report, January 2009; and Datamonitor, Austria—Chocolate Confectionery Report, January 2002.

[25] A.C. Nielsen, Handel in Österreich Basisdaten 2008, Konsumententrends 2008.

[26] A.C. Nielsen, Handel in Österreich Basisdaten 2008, Konsumententrends 2008, p. 7 and p. 13.

[27] A.C. Nielsen, Handel in Österreich Basisdaten 2008, Konsumententrends 2008, p. 12.

[28] Datamonitor, Austria—Chocolate Confectionery Report, January 2002; and Schnedlitz, interview.

[29] Euromonitor, Chocolate Confectionery Austria.

[30] Euromonitor, Chocolate Confectionery Austria.

[31] Euromonitor, Chocolate Confectionery Austria.

[32] Euromonitor, Chocolate Confectionery Austria.

[33] Euromonitor, Chocolate Confectionery Austria.

[34] Schnedlitz, interview; and Josef Zotter, interview, October 12, 2009.

[35] Euromonitor, Chocolate Confectionery Austria.

[36] Kirner, interview.

[37] http://www.eza.cc; and Zotter, interview.

[38] Schnedlitz, interview.