THE ROAD TO "TWELVE FULL OUNCES"

In 1931, the Pepsi-Cola Company was purchased by Charles G. Guth in a complex financial transaction worked out in association with, and at the instigation of, Roy Megargel. Guth was born in the mid-1870s and apparently had spent most of his life prior to the Depression as a fairly successful entrepreneur in the soft drink and confectionary industries. He joined Loft, Inc., a chain of confectionary stores, in 1929; and the following year he became president.

Loft's performance had been mediocre for years. In 1921, its net after-tax profits were $0.73 million, and in 1925 its sales had reached $8.2 million. In 1928, on the threshold of what was to prove a decade of management tumult, sales were only $7.3 million, and net profit after taxes had dropped to $0.19 million. One year later sales dropped again, by almost $30,000, and Loft lost over $150,000. On 1 April 1929, a new management team took control of the company and found itself, as they reported, "confronted with financial and operating conditions of a most unsatisfactory nature requiring the immediate development of ways and means for placing the finances of the Company on a sound basis and for increasing sales to such a volume that the business would again be placed on a profitable basis." The new managers raised money in the capital markets, closed stores, and developed new manufacturing processes for the candies Loft sold.

Whether or not this program would have proven successful we will never know, for Guth took over the company in a proxy fight on 18 March 1930. Pepsi executive Milward W. Martin's later description of the organizational arrangements Guth instituted at that time speaks volumes about the new CEO. Guth's board members were all handpicked, and at least one was required to tender a signed resignation in advance. Guth's salary was fixed at $25,000 plus 1 percent of increased sales, with no requirement for increased profits. He had the power to name the salaries of all other officers and employees and to change them without notice. He delegated as little authority as possible, dealing directly with everyone from board members to clerks.

Guth had every intention of using his new power to enrich himself. He had much need of enrichment. He was almost continuously in financial difficulty during the first half of the 1930s. Banks were calling in his loans; he was borrowing on his insurance; he was substituting Loft for the banks as his creditor. Though he did not have much money, Guth did have Loft. And even though it was not doing very well, Loft did have assets of over $13 million in 1931. The company's sales that year exceeded $14 million, although profits came to only $0.37 million (one remembers the terms of Guth's employ).

The Delaware Court of Chancery, before which the question of the ownership of Pepsi-Cola was litigated in 1938, described Loft in 1931 as a "substantial company." It operated 115 stores in major cities in the Middle Atlantic states; and its subsidiaries, the Happiness and Mirror chains, operated approximately 85 additional stores. These stores sold candy, ice cream, soft drinks, and light lunches. Loft also had a large manufacturing plant across the river from Manhattan in Long Island City that turned out many of the products sold in the stores and did a wholesale business with other retailers as well.

The Pepsi-Cola Company had first come to Guth's attention in 1928, when Megargel tried, unsuccessfully, to interest him in it. As chief executive of Loft in 1931, Guth
renewed his interest in Pepsi from a different perspective, as a memorandum that he wrote to one of his vice-presidents attests: "Mr. Robertson: Why are we paying the full price for coca-cola? Can you handle this, or would you suggest our buying Pepsico [Pepsi-Cola] at about $1.00 per gallon? C.G.G."

Guth felt that Loft had a right to a discount on Coca-Cola. In 1929, 1930, and the first eight and a half months of 1931, Loft was moving an annualized average of 31,584 gallons of Coca-Cola syrup, or more than 1 percent of Coca-Cola's sales. Robertson replied: "We are not paying quite full price for Coca-Cola, We pay $1.38 instead of $1.50, but we pay too much. I am investigating as to pepsi-cola. V.O.R." Although Robertson was correct in saying that Loft received a discount, his numbers were incorrect. Loft was paying $1.48 for the syrup, the standard whole-sale price of which for the big buyer was $1.60. (As the volume purchased declined, the per-gallon price of Coca-Cola rose as high as $2.00.) Guth's point remained, however. If Loft kept its retail fountain prices constant, purchased Pepsi instead of Coke, and suffered no decline in sales as a result, a substantial additional sum would fall to the bottom line. The week after Guth's memorandum to Robertson, Pepsi-Cola was declared bankrupt. Megargel quickly contacted Guth to suggest that the two combine to buy Pepsi out of bankruptcy. Guth agreed, using $7,000 of Loft's money as part of the $12,000 purchase price. Having expressed a mild interest in Pepsi syrup, Guth suddenly found himself owning the entire company.

Saying that Guth owned the whole company was, however, not saying much. Pepsi in 1931 was, in the words of the Delaware Chancery Court, "a corporation which in point of actual fact was a mere shell of a corporation with practically nothing in the way of assets except a formula and trademark and the franchise as a corporation to engage in the work of erecting a business thereon." The company, furthermore, "completely acked any executive force of its own to direct its affairs." As if all this were not enough, when Guth finally sampled a drink compounded from the formula he had purchased, he declared it "unsatisfactory." Pepsi, however, did have an asset in Guth—an owner who was the chief executive of another company whose resources he was happy to exploit for Pepsi's benefit. Loft supplied Pepsi with personnel from common laborers to skilled workers to white-collar employees to executive talent. Loft's laboratory was at Pepsi's disposal. Indeed, it was in Loft's laboratory that a Loft's chemist, Richard Ritchie, experiment[ed] with the formula with the view of producing a drink which would have a competitive resemblance to Coca-Cola. Ritchie spent about two or three weeks . . . trying out different changes in the formula. When he thought he had a result which was satisfactory, he notified Guth who said it was about right.

Pepsi also had in Loft a customer. From 1931 through 1933, Loft purchased $50,300 worth of Pepsi syrup, almost half of Pepsi's sales. The results at the fountain were predictable. Coca-Cola was well known, whereas Pepsi was not. Precisely how much Loft lost by selling Pepsi instead of Coke is not known, but one account estimates that the soft drink volume of Loft slipped from an annual average of over 31,000 gallons to 21,000 gallons. The complainants against Guth in the 1938 Delaware Chancery Court case calculated that from 1931 to 1935, Loft's total loss in profits came to $322,631. As late as 1933, Loft's Pepsi-Cola experiment was considered a "com- plete failure." Pepsi-Cola, in the judgment of the Delaware Chancery Court in 1938, "was in a condition of undoubted insolvency"; it was "confessedly an un adjudicated bankrupt." Guth made an unsuccessful attempt to sell the company to Coca-Cola that year.
Sometime late in 1933, however, Guth made a product policy decision that reversed the failing company's fortunes decisively. He decided to price 12-ounce bottles to the trade in such a way that they could be retailed at the same price as the standard 6- or 7-ounce bottle. The Pepsi customer would thus receive twice as much product for the same price as the Coke customer—and this in the middle of the Depression.

Although Pepsi was primarily a fountain product when Guth bought it, soon thereafter he began bottling operations, both company-owned and franchised. By 1932, he was experimenting with a 12-ounce bottle for 10 cents, but "the sales volume was so totally unimpressive as to be discouraging." Perhaps a 6-ounce bottle for 3 cents compared to the competition's 5-cent bottle was the answer, an idea that was considered but rejected. Finally, out of a series of conferences in late 1933, the concept emerged, apparently inspired by the presence of the bottle itself, of selling the 12-ounce bottle for 5 cents. Bottles were to be sold to candy jobbers for 50 cents per 24-bottle case. The jobbers were to resell them to their retailers for 75 cents per case, and the retail price was to be 5 cents per bottle or $1.20 per case. Credit for the idea and for the pricing structure must go primarily to the chief Loft candy salesman, Frank Burns.

The product took off. By 30 June 1934, Pepsi-Cola had, in the words of the Delaware Chancery Court, "turned the corner." Guth was not the type to hesitate when there was money to be made, and so he moved with vigor to ensure that Pepsi would not be merely a local brand. Enfranchising bottlers as quickly as possible was the key, because Pepsi did not have access to the capital necessary to develop a fully company-owned bottling operation. Fortunately, there were enough bottlers looking for additional brands to carry to make rapid franchising possible.

One of the first to be called, in November 1933, was Joseph LaPides, whom Guth had known through previous business dealings in Baltimore. LaPides did not at first believe that a 12-ounce bottle could be retailed profitably for a nickel. Guth persisted and promised to cover any losses LaPides might incur. By April 1934, LaPides was selling a thousand cases of Pepsi-Cola in one day. Soon thereafter he became a Pepsi representative, with responsibility for enfranchising bottlers in one of four huge territories. Territorial representatives received a royalty of 2 cents per case of Pepsi sold in their area. For at least two of those contracts, the remuneration quickly soared above a half million dollars a year.

In 1936, Pepsi posted net after-tax profits of nearly $2.1 million. In 1937, profits reached $3.2 million, and the company had a network of 313 domestic franchised bottlers, five company-owned bottling plants, and the beginnings of a foreign business.

By 1935, Guth was clearly getting bored with Loft, where things continued to deteriorate. Profits were $65,340 in 1933 and $21,280 in 1934; the following year the company lost $229,551. In October 1935, Guth tried to lower wages and salaries in an economy move. In response, angry employees surrounded his office, and Guth was able to leave only with the assistance of a police escort. Guth asked himself why, owning 91 percent of the Pepsi-Cola Company (now worth a fortune), he needed this kind of aggravation. He couldn't come up with an answer, so he resigned from Loft to devote himself full-time to Pepsi.

Guth departed from Loft under a complicated agreement that he hoped would soon allow him to oust his successor, James W. Carkner, and to replace him with an executive to
whom he could give orders. Carkner declined to play the assigned role. He knew that the only chance for Loft to reverse its deteriorating position and for him to survive professionally was to obtain financing for Loft, to keep Guth's influence and appointees out of the company, and, most important, to obtain control for Loft of Guth's 237,500 shares of Pepsi-Cola stock.

Although the chances of achieving even one of these goals seemed very slim in November 1935, Carkner achieved all three. The developments leading to this result are complex, but we can focus here on those elements most important to our story. Carkner contracted with two New York law firms to develop Loft's case for Guth's Pepsi stock in return for $10,000 to cover expenses and a contingency fee of one-quarter of everything recovered. Financing came from the Marine Midland Trust Company and also from a Wall Street investment firm, the Phoenix Securities Corporation. With Phoenix came the remarkable Walter S. Mack, Jr., who was to serve as Pepsi-Cola's CEO for more than a decade.

But before we proceed to Walter Mack's years at Pepsi's helm, we should first analyze Pepsi-Cola's transformation. How did Pepsi move from unadjudicated bankruptcy to a valuable prize, able to command the time and effort of talented lawyers and the capital of banks on the chance that they might obtain a share of it?

The first piece of the Pepsi puzzle is Charles G. Guth himself. Pepsi did not simply survive and grow by itself in response to the needs of an impersonal market. It was envisioned and energized by Guth. It was Guth's refusal to do business on Coca-Cola's terms in the first place that saved Pepsi from the dustbin of business history. Negotiation expert Chester Karrass has written about people who are "simply less willing to be dominated than others and would rather do without than be exploited" even if an agreement is in their best interest. Judging from how Pepsi-Cola performed for Loft from 1931 at least through 1933 (and probably well beyond—remember that it was Pepsi in bottles that took off, not Pepsi at the fountain), both Loft and Coca-Cola would have been better off if Loft had purchased Coke at the asking price. It was a so-called win-win situation. Yet Guth did not give Coke what was best for both of them because he refused to be dominated by an unyielding negotiating opponent. Moreover, Guth had the fundamental insight that Pepsi would never succeed as a me-too product. Coke was simply too strong. A dramatic gesture was needed, and what more dramatic gesture could there be than offering twice the product for the same price? That idea had originated with Frank Burns, not Guth; but Guth saw its value.

Indeed, the supposedly impregnable wall of the "brand beyond competition" was breached with remarkable ease. The battering ram was neither a magical taste nor a mystical advertising appeal; it was value, an especially attractive attribute in the middle of the Depression.

Guth immediately recognized that once a hole was poked in the enemy's battlements, he had to move quickly to consolidate Pepsi's position. He, like Candler long before him, had a nationwide vision. He was determined to make his brand grow, even at the price of royalty agreements that in hindsight appear overgenerous. Guth had been around long enough in the confection and soft drink industries to know some of the young, aggressive, bold distributors-like Joseph LaPides. Guth also moved to develop a system that would bring active distributors into his camp in areas where he did not know them personally.
Quick expansion was important. Competing on price—unlike, for example, pouring a fortune into an advertising campaign—was a strategy that Coke did not want to copy. As market leader, it did not want to educate the public to expect twice as much for the same price. New entrants could copy the Pepsi strategy because they had nothing to lose. That was why it was important for Pepsi to expand aggressively.

Another key to Pepsi’s success was Loft or, more precisely, Guth’s willingness to exploit Loft for Pepsi’s benefit. He not only used Loft’s property and executive personnel, but he also viewed Loft as a captive market of considerable size for Pepsi. Pepsi at this time was more a retailer’s than a manufacturer’s brand. And it was probably also helpful that Loft was so prominent in New York City, where a large market could be reached without the daunting problems of transporting soft drinks over long distances.

The final key to the rise of Pepsi, ironically enough, was Coca-Cola. The leader was so profitable—its price umbrella was so high—that a competitor could afford to sell twice as much cola for the same price and still make a considerable profit. Further, Coca-Cola was already confronting a problem that would bedevil it in later years. The company’s extensive distribution system had developed incrementally over many years, and the network was composed of firms that operated with varying degrees of efficiency. Coca-Cola wanted to protect all the players, including the inefficient, and thus its system was becoming inflexible.

The company was, moreover, attempting to maintain prices during the greatest depression in American history. Prices of so many commodities dropped so sharply that the cola market was being invaded by intertype competition. Decreases in citrus and milk prices, for example, were leading to greater sales of orange juice, orange drinks, and milk shakes. Soda fountains were changing as well; they were turning into luncheonettes. A survey of luncheonettes toward the end of the 1930s indicated that many were devoting less display space to Coca-Cola and were instead using that space to advertise their own daily food specials.

Coca-Cola was making some adjustments, such as developing new methods of distribution like the automatic vending machine, which was installed in the territory of the Coca-Cola Bottling Company of New York in 1937. And, of course, it advertised vigorously. Price competition, however, was another matter. Because of its success, because of its profitability, and because of its rigidity, Coca-Cola unwittingly helped call Pepsi-Cola into being.

FROM BUCCANEER TO ENTREPRENEUR

Walter Staunton Mack, Jr., who was to succeed Guth as chief executive of Pepsi-Cola in 1939, was born in his parents’ brownstone in New York City on 19 October 1895. Mack’s father, who was in the woolen business in New York, made a good living, though the family was not wealthy. Mack was raised in New York City, attending Public School 87 and DeWitt Clinton High School. He graduated from Harvard in 1917, and from there took an officer candidate’s course at Annapolis, where he graduated third in a class of three hundred. After active duty in World War I, Mack returned to New York. He worked for a time in his father’s company, became involved in politics and community affairs, and married a wealthy woman. Toward the end of the 1920s, he took a position with a small investment trust called Chain and General Equities, which invested in such chains as Safeway and Kroger.
Mack caught the eye of financier Wallace Groves, who made him chief operating officer of Groves's Phoenix Securities Corporation in 1932 or 1933. Mack told Groves that he "was really only interested in reorganizing and rebuilding companies" rather than in buying and selling securities. Groves said that his interest also lay in that area, which was why he had chosen for his company the name Phoenix, "the legendary bird that grows out of its own ashes."

Mack was visited at Phoenix in 1936 by James W. Carkner. The new CEO of Loft needed money to stave off bankruptcy. Phoenix agreed to provide funds in exchange for options to purchase Loft stock at an attractive price. Loft's situation was becoming critical, as sales continued to drop and losses to mount. But the suit against Guth for control of Pepsi made Loft attractive to a gambling man.

Loft's suit against Guth came to trial in November 1937, and the judge issued his opinion the following September. That opinion was an unmitigated victory for the Loft forces. Guth elected to appeal, precipitating a managerial morass in which three directors represented the Guth forces, three the Loft forces, and a seventh served as a disinterested mediator.

Mack, one of the directors, became president, but Guth stayed on in the position of general manager. Here is Mack's description of how that arrangement worked out:

"I remember my first day in the office at Pepsi's plant in Long Island City. It was a chilly day in October, but I was far from chilly. The general manager, Mr. Guth, had assigned the president, me, an office which was a cubbyhole directly above the boiler room. I looked around the space, which didn't take very long, there was nothing there. No paper, no pencils, no nothing. I called my secretary and said I wanted some office tools so that I could start working, and she said she was sorry but that Pepsi employees had been instructed by the general manager not to supply us with anything, since there wasn't anything in the court order requiring them to give me a pencil. A little later in the day I wanted to go to the men's room but it was locked, and I was told that only Mr. Guth had the key, which he handed out personally to whomever he saw fit. Well, I knew that was hopeless, so I found a little restaurant around the corner and used their john for the next six months."

Mack let neither this rather dispiriting situation nor the constant uproar at directors' meetings bother him; he concentrated instead on "straightening out the company."

Guth was finally forced out of both Pepsi and Loft in 1939, when it was discovered that he had purchased another cola company (Noxie-Cola) and had started spiriting away people in the Pepsi organization to run it. Soon thereafter, the Delaware Chancery Court's decision against him in Loft v. Guth was upheld in the Delaware Supreme Court. Charles Guth thus passed into history, last seen trying to get Guth Cola—a 12-ounce bottle selling for 3 cents—off the ground in Pittsburgh. He did not leave Pepsi empty-handed, however. He took with him an estimated $3 million—an impressive accomplishment in Depression values for someone who had begun the 1930s flirting with bankruptcy.