

# Herbalife Nutrition Achieves Success by Managing Risks

## INTRODUCTION

Herbalife Nutrition is a leading nutritional health company that has had a successful and sustainable business model over the last 40 years. In 2018, Herbalife Ltd. changed its name to Herbalife Nutrition Ltd. (“Herbalife”). The name change was a strategic decision that represented Herbalife’s commitment to making the world a healthier place and its strategic transformation into a leader in the nutrition industry. However, despite Herbalife’s long-term success, there have been concerns over the company’s direct selling business model. The objective of this case is to provide insight into the opportunities for success and to examine the need to manage risks associated with direct selling using a multilevel compensation system. The involvement of the regulatory and political system in addressing charges of misconduct and the efficacy of the direct selling business model is examined in the context of William Ackman and Pershing Square Capital Management’s attack on Herbalife. How Herbalife managed this conflict, including the negative publicity by news media, demonstrates the importance of understanding, documenting, and successfully defending the operations of a business. The investigation into the operations of Herbalife opens the door to an improved understanding of how direct selling can be an effective business model that provides benefits to all stakeholders.

Before presenting the Herbalife story, we first explore the direct selling business model that the firm uses to distribute its products. This business model is often misunderstood and questioned as being unsustainable. While there is misconduct in all business models, direct selling

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misconduct is often associated with the entire industry rather than the firm that perpetrated the misconduct.

## **THE DIRECT SELLING BUSINESS MODEL**

Before discussing the direct sales model, it is important to note that all products are “sold” to consumers. Beyond direct selling, many products are sold at retail stores or through online sources. Some are sold via salespeople, either at a retail location or directly to the consumer. Specific to this case, “direct selling” is defined as the marketing of products to end consumers through person-to-person sales presentations at non-retail locations such as consumer homes, the workplace, or online. The practice of direct selling should not be confused with more traditional on-site selling, such as at car dealerships, where customers come to the salesperson. In a direct selling model, salespeople seek out the consumer (at their home, work, socially, or online), to sell the product, rather than the consumer coming to them. Direct selling is not a new business model; in fact, it is one of the oldest ways to distribute products. In the nineteenth century, it was a widespread method because many consumers did not have access to retail stores. In addition, direct sellers are generally not employees of the companies they represent but rather autonomous individuals who enter into independent contractor agreements with a company to sell their products. In return, companies do the research and development (also known as R&D), manufacturing, packaging, shipping, quality control, servicing of customers, website development, social media promotions, making for low-risk, low-cost of entry and exit for the direct sellers. Thus, for the remainder of this case, think of companies such as Avon, Juice Plus+, and Herbalife Nutrition as examples of direct sellers.

# Single and Multilevel Direct Selling

Direct selling has two compensation methods. There are single- and multilevel compensation models of direct selling. Single-level compensation occurs when direct sellers only earn commissions for sales they make themselves. Multilevel compensation is when direct sellers earn income from their own sales of products as well as commissions from sales made by those they have recruited to sell the product. Forms of multilevel direct selling operate in nearly all countries, but the practice is often strictly regulated and/or closely scrutinized because pyramid schemes have given this form of selling a negative connotation. In most cases, multilevel marketing companies are legitimate because they sell products to consumers and do not require direct sellers to recruit others in order to earn a profit. Thus, properly monitored and managed multilevel direct selling models are not pyramid schemes, as they offer companies a sustainable way to directly sell their products through a hardworking salesforce of individuals who believe in the products they sell. In fact, most direct selling representatives are champions for the products and often become independent contractors to get discounts and provide the products to friends and neighbors. The vast majority of representatives are involved part-time and are not trying to earn a living. Many well-established companies operate using a multilevel direct sales model (see Table 1 for the top ten global direct selling companies based on 2019 sales revenue).

**TABLE 1 Top Ten Direct Selling Companies**

	<b>Company Name</b>	<b>Product Types</b>	<b>2019 Revenue (USD Billions)</b>
1	Amway	Nutrition, Beauty, Bath and Body, Home, Jewelry, Food and Beverage, Fragrances	\$8.40
2	Herbalife	Nutrition, Weight Loss Management, Personal Care	\$4.90
3	Avon	Cosmetics, Skin Care, Fragrance, Personal Care, Hair Care, Jewelry, Gifts	\$4.76
4	Vorwerk	Household Appliances and Cosmetics	\$4.23
5	Natura	Cosmetics	\$3.66
6	Coway	Air Filtration Systems	\$2.58
7	Nu Skin	Cosmetics	\$2.40
8	Tupperware	Food Storage and Preparation, Cookware, Serving Items, Cosmetics, Beauty Products	\$1.80
9	Oriflame	Cosmetics, Personal Care, Wellness	\$1.47
10	Ambit Energy	Electricity and Natural Gas Services	\$1.31

*Source:* “DSN Announces 2020 Global 100 List,” *Direct Selling News*, April 1, 2020,  
<https://www.directsellingnews.com/dsn-announces-2020-global-100-list/> (accessed June 4, 2020).

## **Pyramid Schemes**

Any business model can be used to conduct fraud. Some store retailers can engage in consumer fraud through pricing, promotion, or inferior products. A major concern that has plagued multilevel direct selling is that it can be used by unethical actors to develop fraudulent pyramid schemes. A pyramid scheme is a fraudulent business model that eventually collapses, with the vast majority of participants losing their investments. Pyramid schemes can develop from multilevel sales models as well as other schemes that take money with the promise of large gains. However,

in reality, there is no legitimate product. The only way to keep the scheme going is to find new investors. The four defining characteristics of a pyramid scheme are laid out by the Koscot Test, which is used to determine whether a business is a pyramid scheme. These characteristics are: (1) people pay the company to participate; (2) in return, they gain the right to sell a product or service; (3) they are compensated for recruiting others; and (4) this compensation is unrelated to whether or not any of the product or service is actually sold. In other words, participants in pyramid schemes have little or no incentive to sell products, but rather have a much greater incentive to aggressively recruit others into the scheme. Each person recruited pays an up-front fee (usually expensive), and these fees trickle up the pyramid to be collected by leaders at the top. These schemes become problematic because newcomers are promised large profits for buying in and continuing to recruit others. As the network grows, the ability to deliver payment for recruitment becomes impossible and the scheme fails, leaving most in the network in a position where they lose their initial investment. The Federal Bureau of Investigation (FBI) warns of pyramid schemes that come in the form of marketing and investment opportunities where the individual is offered a contractorship or franchise to market a product. The key is where the real profit is earned; if it is not earned by the actual sale of a legitimate product but by the sales of new contractorships, it is likely a pyramid scheme. Therefore, a pyramid scheme is not sustainable in the long run. Multilevel direct selling companies that sell quality products to consumers and have existed for decades are not pyramid schemes.

Pyramid schemes can be hard to identify clearly, but the FTC has warned consumers about two red flags. The first is inventory loading, which is when a new participant purchases a large amount of nonrefundable inventory that they are unlikely to use or consume within a reasonable period of time; this is a requirement and not a choice like with internal consumption (sellers using

the products). If the product is of low quality, it is clear how this requirement invites fraud. As such, inventory loading is prohibited by the Direct Selling Association's (DSA) Code of Ethics (see Table 2). Legitimate firms follow the DSA's code by offering a refund policy and buyback process for a contractor who no longer wants to sell. The second warning sign of a pyramid scheme is a lack of sales external to the selling network. If the only people buying the product are the ones selling it, there is a clear problem with the business. Businesses that require inventory loading and don't rely on external sales are likely to be pyramid schemes. There are approximately 1,000 direct selling firms operating in the United States in a given year. Over the past 40 years, the FTC has only filed 30 cases alleging firms were pyramid schemes, which accounts for less than 3 percent of all direct selling firms.

## **Self-Regulation of Direct Selling**

To overcome the concerns of multilevel marketing, some direct selling firms choose to self-regulate their multilevel direct sales practices through membership in self-regulatory organizations. For example, many firms follow the principles of the World Federation of Direct Selling Association (WFDSA) and national-level direct selling associations such as the United States Direct Selling Association (DSA) in the United States. The WFDSA promotes ethical practices in direct selling globally through advocacy and strong relationships with governments, consumers, and academia. The U.S. DSA also emphasizes ethical business practices and consumer protection measures and requires that members adhere to the DSA's Code of Ethics (See Table 2). This Code of Ethics recognizes the importance of a fair and responsible approach to direct selling since direct selling requires sensitive and personal one-on-one interaction that can lead to undue pressure placed upon consumers. The Code (1) prohibits deceptive or unlawful practices regarding recruits and customers; (2) requires that direct sellers provide accurate and truthful information

about the price, quality, and promotion of the products; (3) illuminates and enforces the need for a clear record of the sales made by contractors; (4) necessitates that warranties be fully explained; (5) requires direct sellers to clearly identify themselves to customers and maintain the confidential information of their customers; (6) prohibits pyramid scheme practices; and (7) provides guidelines on inventory purchases, earnings reporting, inventory loading, start-up fee payments, and training practices.

The DSA and the Council for Better Business Bureaus (CBBB), the network hub for BBBs in the United States, Canada, and Mexico, have created a third-party, self-regulatory program, the Direct Selling Self-Regulatory Council (DSSRC), for the direct selling industry, which was launched in January 2019. The DSSRC monitors the entire direct selling channel—including DSA member and non-member companies. The new, third-party, self-regulatory organization monitors the entire U.S. direct selling industry and embodies the following principles:

- Clear industry standards on issues such as product and earning representations;
- Identification of relevant best practices from other self-regulatory models;
- Creation of a process that both monitors and enforces strict business principles;
- Enacts measures to raise the bar of excellence for DSA members and the entire direct selling channel

Herbalife is a leading supporter of the DSSRC. This demonstrates the company's commitment and leadership in supporting ethical conduct in the direct selling industry.

## **TABLE 2 Direct Selling Association Code of Ethics**

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### **As a consumer, you should expect salespeople to:**

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Tell you who they are, why they're approaching you, and what products they are selling.

Promptly end a demonstration or presentation at your request.

Provide a receipt with a clearly stated cooling off period permitting the consumer to withdraw from a purchase order within a minimum of three days from the date of the purchase transaction and receive a full refund of the purchase price.

Explain how to return a product or cancel an order.

Provide you with promotional materials that contain the address and telephone number of the direct selling company.

Provide a written receipt that identifies the company and salesperson, including contact information for either.

Respect your privacy by calling at a time that is convenient for you.

Safeguard your private information.

Provide accurate and truthful information regarding the price, quality, quantity, performance, and availability of their product or service.

Offer a written receipt in language you can understand.

Offer a complete description of any warranty or guarantee.

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### **As a salesperson, you should expect a DSA member company to:**

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Provide you with accurate information about the company's compensation plan, products, and sales methods.

Describe the relationship between you and the company in writing.

Be accurate in any comparisons about products, services, or opportunities.

Refrain from any unlawful or unethical recruiting practice and exorbitant entrance or training fees.

Ensure that you are not just buying products solely to qualify for downline commissions.

Ensure that any materials marketed to you by others in the salesforce are consistent with the company's policies, are reasonably priced, and have the same return policy as the company's.

Require you to abide by the requirements of the Code of Ethics.

Safeguard your private information.



Provide adequate training to help you operate ethically.

Base all actual and potential sales and earning claims on documented facts.

Encourage you to purchase only the inventory you can sell in a reasonable amount of time.

Repurchase marketable inventory and sales aids you have purchased within the past 12 months at 90 percent or more of your original cost if you decide to leave the business.

Explain the repurchase option in writing.

Have reasonable startup fees and costs.

Source: Direct Selling Association, *Consumer Protection Toolkit*,

<http://www.dsef.org/wp-content/uploads/2015/03/DSEF-Consumer-Protection-Toolkit.pdf> (accessed May 25, 2017).

## **HERBALIFE NUTRITION**

Herbalife Nutrition, Ltd. is the second-largest multilevel marketing company in the world. The story of Herbalife includes direct selling, but the company's success has come through the acceptance of its products by consumers, much like any other company. One difference between Herbalife and most companies is that their products are not sold in retail stores; rather, consumers interact with independent sellers to order products. Herbalife is a publicly traded company headquartered in Los Angeles, California, that has loyal customers around the world.

Herbalife focuses on the sale of products related to nutrition, weight management, and personal care, with independent contractors selling in more than 90 countries. Mark Hughes founded the company in 1980 out of a desire to create a safe alternative to other weight loss products. Herbalife's first sales were conducted from the trunk of Hughes's car in Los Angeles. Two years later, the company reached \$2 million in sales. Herbalife became a publicly traded company in 1986 when it joined the NASDAQ stock exchange. Since then, Herbalife has become

a sustainable multi-billion-dollar global company. Throughout its growth, Herbalife has experienced many changes to leadership and ownership structure.

## **Foundational Products**

Herbalife sells products for weight management, nutrition, energy, fitness, and personal care that support a healthy lifestyle. The weight management line consists of Formula 1 protein shakes, supplements, weight loss enhancers, protein bars, and snacks, all serving the purpose of helping customers to attain their weight goals. For instance, the Personalized Protein Powder and the Protein Drink Mix offerings provide an alternative to traditional meals while supplying energy and curbing hunger cravings, whether consumers want to lose or maintain their weight or build muscle mass. Targeted nutrition products include dietary and nutritional supplements that contain herbs, vitamins, minerals, and other natural ingredients to strengthen specific areas of the body that tend to be problematic for many people. For example, Tri-Shield helps the heart stay healthy by maintaining good cholesterol levels and providing antioxidants, and Ocular Defense Formula and Joint Support Advanced offer nutritional aid for the eyes and joints of aging adults. The energy and fitness product options are designed for those engaged in sports and fitness activities. Customers can choose from drink mix-ins such as the H<sup>3</sup>O Fitness Drink, which enhances clarity and rehydrates the body, or utilize supplements such as N-R-G (Nature's Raw Guarana Tablets), which also promote mental clarity. Herbalife's personal care products include skin cleansers, moisturizers, lotions, shampoos, and conditioners. In this product line, Herbalife offers program sets called Herbalife SKIN, containing groups of cleansers, moisturizers, and creams customized for different types of skin, from dry to oily. Overall, Herbalife follows a strategy of producing high-quality products that enhance customer health and well-being.

# **Herbalife's Implementation of the Direct Selling Model**

People are attracted to becoming direct sellers for many reasons. Some are passionate about a product and want to promote the company. Others want to receive a discount on their personal orders, a common benefit of being a direct seller. Many find working as a direct seller to be a flexible, part-time opportunity for extra income. There are 2.3 million independent contractor direct sellers of Herbalife products. Most, if not all, of them personally use these products.

Direct sellers are attracted to the low startup cost of selling Herbalife. For about \$94 a kit, new sellers receive a Herbalife Member Pack, which includes forms, applications, a tote bag, and samples of various Herbalife products. The pack includes informational and training materials that educate the new seller on using and retailing the products, business basics, and how to build a sales and marketing plan. The member kit is the only purchase required to become an Herbalife network member and seller. Herbalife does not require its distributors to pay a “fee” to join, and the only up-front money spent represents the true value of the kit.

As soon as a seller joins Herbalife, they receive benefits. Sellers enjoy discounts on products ranging from 25 to 50 percent depending on the level of contractorship (contractors move up levels by achieving certain sales goals). Contractors can sell products at any price they set and make decisions on how they want to position and sell the Herbalife products (within legal and company guidelines). The more successful an Herbalife seller, the greater the discounts and commissions on product sales.

In the event that a contractor no longer wants to sell Herbalife products, the company will buy back any remaining inventory of the seller. In fact, Herbalife goes beyond the Direct Selling Association's ethical guidelines for buying back products by reimbursing the distributor for everything he or she initially purchased (100 percent buyback policy). The company also limits the

amount of inventory a seller can initially purchase. Herbalife's membership structure is designed to clearly differentiate their legitimate multilevel marketing model from fraudulent schemes.

The Herbalife business model has succeeded due to the company's products and support. Most Herbalife distributors do not have a physical store location, as they practice direct selling from home. However, there are strict company policies and legal requirements that regulate product information, sales techniques, advertising, lead generation, social media, and related issues. Herbalife also created a centralized e-commerce section for contractors on its GoHerbalife website that also controls branding and product claims. Distributors each have their own page on the platform, which they can use to attract customers. Customers are only randomly connected through the platform if they don't have a Distributor who can provide them service. Thus, direct sellers are independent, yet are required to represent Herbalife through ethical business practices.

## **Herbalife Customer Base**

Herbalife serves a broad external customer base. To illustrate, an independent survey conducted by Nielsen, a global information and measurement company, sampled 10,525 consumers and indicated that 3.3 percent of the general U.S. population made an Herbalife purchase sometime within a three-month period (approximately 7.9 million customers). The external sales volume is a good indicator of the strength and legitimacy of the company's business. Additionally, the study showed that those who had made a purchase in the last three months were loyal and tended to make purchases approximately every two months. A strength of Herbalife over its long history as a company is a sustained customer base that uses and repurchases Herbalife products based on the quality, usefulness, and value they provide.

# CHALLENGES TO HERBALIFE'S MULTILEVEL MODEL

Herbalife, like many multilevel marketing companies, has been accused of being a pyramid scheme. However, considering the firm's long and successful history, these claims were not taken seriously until 2012 when prominent hedge fund manager and billionaire investor William Ackman announced that he and his company, Pershing Square Capital Management, had spent a year studying Herbalife and concluded the firm was, in fact, an elaborate pyramid scheme.

Ackman is known as an "activist investor" and claimed it was his civic duty to expose Herbalife as fraudulent. Of note, Ackman's company also stood to profit heavily, having invested \$1 billion in a short sale of Herbalife's stock (a complex investment strategy that earns money if the stock price falls, rather than rises). Ackman's target stock price for Herbalife was \$0. In other words, he believed the company should and would fail. Ackman continued to campaign and advocate against Herbalife, which plunged Herbalife into a controversy over the potential legitimacy of its business. The problem was, the investment community and mass media did not understand a sustainable direct selling business model. The investigation led by Ackman focused on the low earnings of independent contractors and was the result of months of research and analysis by his team. The accusations against Herbalife included the following: (1) the majority of contractors for Herbalife lose money, (2) Herbalife pays more to recruit new contractors than sell actual products, and (3) only the top one percent of contractors earn most of the money. Ackman argued that Herbalife recruits contractors under false pretenses by unrealistically suggesting they can earn a large income. Furthermore, he alleged that the real money in Herbalife comes not from selling products but from recruiting other contractors, as all the top earners make the vast majority of their income through downline commissions from the sales of those in their recruiting chain. Although

Herbalife has published results showing that the majority of its profit is made through product sales, Ackman believed this information to be false and misleading, as he estimated sales to be only 3 percent of Herbalife's revenue, with the rest made via recruiting. In reality, Herbalife does not charge a fee for becoming an independent contractor and earns its profits from selling products.

Herbalife has also been accused of issuing false accounting statements, although there has never been any official legal claim brought about its accounting records. According to allegations, all products sold to contractors are shown as retail sales, without tracking whether the contractor consumes the products (internal consumption) or to whom the contractor sold the products. Critics believe the company should not record sales revenue for internal consumption but only from sales made to end users. This argument falls into the larger backdrop of the defense and legitimacy of internal consumption. Ackman and other critics have used these arguments to emphasize that the majority of Herbalife contractors are not successful in selling their products (other than to themselves). Herbalife's records show that only one percent of its registered contractors will make \$100,000 or more from the business in their lifetime. This statistic shows that many who try direct selling are either not willing or lack the business knowledge to put in sufficient effort to make a living. In most cases, those who sell Herbalife do so as a side job and only work part-time, depending on how much extra money they want to make.

Ackman's allegations launched an unprecedented storm of controversy for Herbalife. Four days after Ackman's initial presentation, the company's stock fell 43 percent. Ackman launched a well-financed mass media and publicity campaign and engaged in political lobbying to drive down the price of the stock. The debate over the company became polarized, with prominent investors, analysts, public interest groups, and loyalists presenting heated arguments both for and against

Herbalife's legitimacy. Recognizing the seriousness of the situation, Herbalife responded in force, including hiring a lobbying team and launching one of the largest marketing campaigns in the company's history to bolster and strengthen the Herbalife brand. Over the length of the dispute, both Ackman and Herbalife spent multiple millions of dollars supporting their positions and attacking each other. The media showcased the Ackman and Herbalife conflict.

## **FTC Investigation and Settlement of Claims**

In March of 2014, the Federal Trade Commission (FTC) opened a civil investigation of Herbalife. The investigation was prompted by Ackman's reports to the public and lobbying efforts that brought the "pyramid scheme" message to Congress. Ackman made political contributions to legislators who advocated for his position. Ackman believed the FTC would rule against the company and force the firm to cease operations. However, Herbalife welcomed the investigation and was very cooperative with the FTC. At the onset of the investigation, Herbalife stated it was confident in its compliance with laws, its financial stability, and its success as a company over the past 34 years. In 2016, the FTC settled its case with Herbalife, dismissing the accusation of Herbalife being a pyramid scheme.

Nevertheless, the settlement did result in major changes for Herbalife. The FTC mandated a restructuring of Herbalife's business practices, affecting how the company reports sales of members (consumers) and independent contractors selling to retail consumers. Changes were made to the level of involvement participants were allowed to have in selling products. An aspect of the settlement is a mandate that Herbalife must derive 80 percent of sales from legitimate end-user purchases to maintain its distributor compensation program. In addition, Herbalife must now prohibit participants from leasing or purchasing physical business locations to sell Herbalife products until they have completed a year as a distributor and completed a business training

program.

The FTC also required Herbalife to pay \$200 million to individuals who had lost money through involvement in selling Herbalife products. It was deemed that Herbalife's use of advertising through testimonials had misled potential participants about the realities of financial success through involvement with Herbalife. The settlement requires Herbalife to make truthful claims about how much people are likely to make and ensure the claims are backed by facts.

The company was able to comply with the FTC order. In 2017, Herbalife exceeded the settlement guidelines, proving 90 percent of sales were documented sales by consumers outside the distribution network. Additionally, Herbalife proved 400,000 discount buyers or "preferred" members were not pursuing the business opportunity and thus were simply customers of Herbalife through retail sales. These successes counteract Ackman's claims of Herbalife having no "real" consumers. Investor Carl Icahn, a supporter of Herbalife throughout the controversy, stated, "I think it's ironic, but factual, that as a result of the propaganda against the company that it now has a much better idea of who their customers are and it opens the door for Herbalife to greatly benefit." By 2019, Herbalife fully emerged from the FTC investigation. The company achieved a stock price of \$59 in January 2019, from a low of \$15 in 2015. Overall, Herbalife learned several lessons throughout the investigation and has improved business practices as a result of the FTC settlement. The investigation confirmed that Herbalife has maintained a 40-year sustainable business model.

## **Impact of FTC Settlement on Pershing Capital**

The end of Pershing Capital's crusade against Herbalife came to a "bruising defeat" as described by *The Wall Street Journal*. Ackman's hedge fund management company Pershing Square Capital lost hundreds of millions of dollars over his five-year bet against Herbalife. While disappointed



that the pyramid scheme accusation was found to be false, Ackman contended that several of his claims were confirmed in the FTC case. Since the settlement, Pershing Capital reported losses for four years in a row. As such, a large number of Pershing Capital's largest investors have left the fund and Ackman has reduced staff to return the firm to its roots as a smaller organization.

Ackman has publicly admitted to making mistakes in his bets with Herbalife but states confidence in his portfolio and the future of Pershing Capital.

## **NEW OPPORTUNITIES: CONSUMER MEGATRENDS**

Herbalife has overcome many challenges throughout its history. In addition to the FTC settlement and general societal misconceptions about multilevel marketing, Herbalife has always had to adapt to changes in consumer preferences. It is no secret that today's consumers spend more time shopping for and researching products online and less time shopping in stores or interacting with salespeople than in the past. In addition, the digitization of society has led consumers to have greater demands that infringe upon their personal life. Fortunately, for Herbalife, solutions that address many societal changes- termed megatrends- are well aligned with the company's products. According to a recent investor's presentation, Herbalife leadership views the trends of (1) increasing obesity of the population, (2) aging of the population, (3) increasing healthcare costs, and (4) expanding interest in entrepreneurship as opportunities that position the company for long-term success. In addition, as consumers become more dependent on social recommendations, Herbalife expects their model of individual and social exchange (i.e., direct selling consultation) to help consumers looking for coaching and experience that helps them in making decisions related to personal well-being.

Specifically, societal megatrends largely relate to a need for better nutrition, well-being, and fulfillment across society. Concerns over obesity and healthcare costs affect both older consumers and younger ones. In both cases, recovery and prevention are an important ingredient to enjoying a fulfilling life. Older adults need options to help offset health problems, and younger adults are increasingly interested in preventing the problems that they see in older generations. Thus, Herbalife’s strategy to rebrand themselves as a nutrition company that develops, manufactures, and delivers products of unquestioning quality fits closely to consumer segments responding to alarming societal trends. These consumers are also well informed and willing to invest time and energy to make sure they are purchasing products that will actually deliver on claims. Herbalife is embracing these trends by building upon its direct sales model through social media and new initiatives that position direct sellers as trusted consultants that connect people who learn from and support each other. In addition, Herbalife’s well-established direct selling model fits well with consumer interest in entrepreneurship. Similar to Uber, Lyft, and other “gig” opportunities, direct selling allows an individual to work at their own schedule and with the intensity they desire. Pairing high-quality products with flexible, self-driven earning opportunities positions Herbalife well to respond to changing consumer markets. The following sections outline selected specifics of Herbalife’s (1) product quality strategy, (2) engagement strategy termed “nutrition clubs,” which started in Mexico in 2004, and (3) commitment to social responsibility through its mission to encourage nutrition and well-being to external and internal communities.

## **Product Quality Strategy**

To ensure quality, Herbalife invests in continuous research and development of its product lines. For example, recent use of genetic technology advances allows Herbalife to confirm quality raw materials for the manufacture of its products. Steven Newmaster, Ph.D. and trained ethnobotanist,

speaks on behalf of the DNA testing Herbalife uses to ensure the quality of plants they use. Newmaster states the natural supply chain they use has been tested from the producer to the manufacturer. Through DNA barcode technology, Herbalife can confirm the ingredients used in its products are authentic, healing, and nutritious. DNA testing is conducted by raw ingredients being matched to a comprehensive library of thousands of botanical species around the globe to determine high DNA-level quality. Herbalife is undertaking these changes in its product development because consumers desire transparency of product origins prior to purchase.

To support consistent product quality through technology, Herbalife has six research and development facilities and seven labs that test for quality. The company also has a global operations team of almost 2,000 people including more than 300 research scientists that support their products. This team sets the uniform global standard for quality and oversees all elements of product development and production. Herbalife's ISO 17025 accreditation indicates adherence to strict standards in technical competency of laboratory personnel, accuracy of testing methods, use of proper equipment, and it assures consumers that the tests are trustworthy.

To further ensure product quality, Herbalife closely controls its supply chain through its "Seed to Feed" strategy. Since 2009, Herbalife has invested \$250 million in vertical manufacturing and infrastructure to increase the in-house production of key product units from less than 5 to 70 percent, in essence, managing products from raw seed to feed the manufacturing process. COO, David Pezzullo, elaborates on the strategy: "We use a stage-gate product development process with hundreds of steps and more than 60 sign-offs along the way to ensure that every aspect of the product, from quality assurance, safety, science and regulatory to sensory and label design, conforms to our specifications." This process can take up to 18 months to complete and involves the work of more than 300 technical employees. All manufacturing facilities, whether in the

United States or abroad, must comply with FDA regulations for manufacturing practices, which specify how production facilities in food, dietary supplements, and acidified foods must operate. Herbalife undertakes all of these steps as they strive for “best in class” regarding product excellence.

## **Engagement Strategy**

Herbalife has achieved success through direct and personal attention to consumer needs; nutrition clubs build on this through support communities. The first Herbalife Nutrition Club opened in Mexico in 2004. The Nutrition Club was formed to bring together people interested in nutrition and the support of a like-minded community. Originally, the club served as a physical location where the community could meet and purchase the products they needed in cost-effective portions that were more convenient than bulk purchasing. In addition to convenience, the club also provides a connection to enjoy and learn about the products in the company of other people with similar goals in their weight loss journey. Over time, Nutrition Clubs have also incorporated fitness classes to address a healthy lifestyle. Herbalife has embraced the Nutrition Club concept as an answer to societal megatrends and to further differentiate the company from others in its industry. Nutrition Clubs allow independent distributors to provide personalized nutrition plans, motivation, and accountability to customers. Since 2004, the concept has thrived, with Herbalife supporting over 17,500 Nutrition Clubs in the United States and nearly 118,000 worldwide.

Research shows that healthy habits are best formed in a social setting that offers support, advice, and reinforcement of the habits. Members who attend the clubs can receive nutrition and fitness tips and encouragement from the independent distributors running the establishments. Herbalife Executive Vice President explains, “The Nutrition Club owners typically charge an attendance fee on a daily, weekly or monthly basis. Invited members can enjoy shakes, teas, and

aloe and participate in activities like group workouts, fitness walks, and weight-loss challenges.” Nutrition Clubs are the perfect solution to those seeking influence in their nutrition lifestyle while also giving them community support in a positive environment. To ensure quality and consistency, Nutrition Club operators (independent Herbalife distributors) must undergo extensive training before commencing operations. Herbalife’s training for operators provides them with the resources and education to create a budget and business plan and learn the local laws. Additionally, Herbalife compliance staff monitors and performs site visits regularly to ensure regulations are upheld. Overall, the Nutrition Club strategy has enhanced Herbalife’s direct selling model and has been instrumental in gaining consumer trust in the company’s product line and its informed and helpful resellers.

## **Social Responsibility**

Herbalife takes its responsibility as a corporation seriously. The company summarizes its values through a commitment to doing “the right, honest, and ethical thing.” More specifically, CEO Michael Johnson stated that the “company’s reputation is its greatest asset,” so much emphasis is placed on ethical business conduct. According to Herbalife’s Corporate Code of Business Conduct and Ethics, employees must engage in fair interaction with everyone associated with the company, including external stakeholders. The code has guidelines in place as to how contractors and employees of Herbalife should interact with suppliers, competitors, business partners, and regulatory authorities. The company discourages conflicts of interest and offers three methods of reporting unethical behavior: through the company hotline, through the company website, or by contacting the general counsel. Those who violate these standards are disciplined, suspended, or terminated, which demonstrates Herbalife’s commitment to its ethics code and ethical conduct.

Herbalife is committed to its external and internal community. To the external community, the Herbalife Family Foundation (HFF) and the Casa Herbalife program provide funds and volunteerism to charities committed to supporting at-risk children. Herbalife Nutrition Foundation also provides support to nutrition initiatives and disaster relief. For instance, Herbalife's partnership with the Global Alliance for Improved Nutrition (GAIN) focuses on providing essential nutrients to improve the health of women and children worldwide. To its internal community, Herbalife proactively embraces employee wellness and eco-friendly initiatives. The company incentivizes employees to be healthy and participate in fitness activities. Such incentives include providing complementary products and reduction of individual health insurance costs. As such, the company has been recognized by *Men's Fitness* magazine as "One of the 15 Fittest Companies in America." In terms of being environmentally conscious, Herbalife's headquarters have received accolades for its LEED certification and environmentally friendly design. The firm also encourages distributors to increase their own sustainability activities.

## **CONCLUSION**

Herbalife Nutrition has navigated many challenges and capitalized on many opportunities since its formation in 1980. Important to this case is Herbalife's direct sales, multilevel compensation model. This model is responsible for Herbalife's exceptional growth and success, as committed and engaged sellers have delivered value through products and expertise to the company's large customer base. However, the same model has led to concerns over the stability and sustainability of the company, as some have assumed their operations to be a pyramid scheme destined to fail. Despite Herbalife's investigation and resulting restructuring, the company has emerged well positioned to continue its success by aligning the core competencies of its products and business model with changing consumer preferences and needs. This case illustrates that referring to direct

selling firms as pyramid schemes is a misrepresentation of a highly effective sustainable business model that has existed for hundreds of years.

Herbalife will face the same challenges other members of the retail industry must address in the future. Internet sales are now 10 percent of retail sales and Amazon has more than 50 percent of the online retail market. Herbalife may be better positioned to face this competition because they do not have the overhead of expensive retail stores. The need for assistance and consultation in buying nutritional products provides the opportunity for person-to-person interaction. Maintaining a strong ethical culture and building trust with consumers is the glue that holds relationships together. The multilevel compensation method in the direct selling business model will continue to be debated and scrutinized, but Herbalife provides a strong example of how this system can benefit all stakeholders.

## QUESTIONS FOR DISCUSSION

1. Describe the differences between a legitimate direct selling business model and a pyramid scheme.
2. Evaluate how Herbalife managed their regulation and public relations risks.
3. Why has Herbalife continued to be successful after the attack by Ackman and an FTC investigation?

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