Mastering Marketing Part eight Sector marketing

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New marketing media
Escaping the commodity trap in business markets

In many business markets, customers are perceiv- ing fewer and fewer differences among competitors' offerings. The major reasons for this are the quality management movement in production and the greater availability of comparable alternatives from international sources. As a result, customers are making an increasing number of purchase decisions on the basis of price. They are pressuring suppliers to reduce their prices and provide additional price discounts. In many markets, suppliers are finding that although their sales revenues are growing, it is often at the expense of profitability.

The present article will explain how suppliers can forestall or reverse this trend. Suppliers either fall into one of two categories. They are in a commodity business simply because they think narrowly about the core product or service. The personal computer, for example, is often viewed as a commodity. Alternatively, they may estimate that the customer purchases may be near or exactly the same across suppliers. In these markets, offerings that companies purchase are typically more than just the core product or service. They contain components and systems that enhance the value of the core product or service and that provide additional value to customers.

Before concluding that they are in a commodity business, suppliers need to look more closely at market and industrial trends to determine if the differences between their offerings and their competitors' offerings are significant. Typically, they should estimate the value that customers receive, validate their pricing, and estimate their share of customers' business.

Estimate the value that customers receive.
Value is the worth of the product or service to the customer. It is always assessed on a per-unit level; typically it is a comparison of an offering's value with what the customer is currently using or what the next best supplier's offering.

To estimate the value that a customer receives, the supplier gathers comprehensive data on how its offering adds value or reduces costs in the customer's application. At the same time, suppliers should investigate how much change in their market offerings would be worth to customers. They should also measure service and social benefits, which can be significant sources of value.

Consider, for example, safety glasses. These provide the technician with a clear view of the working area. Workers' eyes are protected from infrared and ultraviolet light and foreign substances. They provide the economic benefit of fewer lost days due to injuries and lower insurance premiums. To obtain these benefits, workers must wear the glasses, however, some workers feel that the glasses make their vision worse or do not wear them when they should.

Taking a more comprehensive view of value, Dallas Safety Products has designed a line of safe- ty glasses that look like designer sunglasses. They have contoured frames that come in a variety of colors, with lenses in a selection of tints. Since workers actually enjoy wearing such stylish protective glasses, workplace compliance is no longer a problem.

Validate market pricing.
Understanding competitors' prices is often difficult in business markets because of problems in determining comparability. A supplier should investigate what supplementary services are included in a competitor's price. Unfortunately, it may be in the competitor's interest to present a false picture of pricing and offering. An additional difficulty in the increasing use of overtime and discounts is that customers may perceive as a commodity. It may be extremely difficult to differentiate if customers perceive it in a way that makes it difficult to differentiate. In some cases, customers are purchasing more than the competitor's offerings without customers' view of value, and suppliers can identify significant sources of differentiation. Some valuable strategies are described below.

Create knowledge banks.
A supplier can search for knowledge that would be valuable for customers to have. Yet it is difficult for customers to acquire by themselves. An example is how the customer's ways of doing things compare with the best competitors' practices. Allegiance Healthcare, a leading distributor of hospital supplies, has built a best-practice database from the experiences of 100 leading hospitals. The database details the activities performed and resources consumed in each of the procedures that together account for 90 percent of the hospitals' surgical operations. Armed with the information in the database, Allegiance's clinical consultants can work with customers to identify deviations from best practice in order to reduce costs and improve productivity.

Build leveraging expertise.
A supplier can search for problems that a number of customers experience, with a view to in- venting expertise in that area that customers to regulatory changes and reminding them of existing standards. It supplies a regulatory compliance manual, audits compliance at customers' sites and helps smaller customers to prepare their annual toxic chemical release inventories and air emissions statements.

Without GLS's assistance, these customers would find it difficult and costly to keep up with regulatory changes. Senior managers welcome GLS's support, because failure to comply with regulations can lead to criminal prosecution.

When corporate customers buy personal computers (PCs), they often want to install software that is specific to their companies, in addition to software from companies such as Microsoft. To do this typically takes six months. To overcome this problem, Dell Computer recognized that it could build expertise that would enable it to end this costly nuisance. It created a high-speed, 100-megabit Ethernet at its factory that can instantly download a tailor-made mix of software onto major customers' computers.

Change the customer's frame of reference.
Customers that focus on the core product or service...
tend to see price reductions rather than total cost as the way that suppliers set themselves apart from one another. Suppliers that can change the customer’s frame of reference to total cost have greater opportunities to add value, reduce costs and differentiate themselves. As an example, Boeing has chosen Dell PCs. Dell has 30 employees on site at Boeing, who work closely with Boeing managers in configuring their network. The Dell personnel are reported to be “the Boeing PC department than as a PC vendor. In exchange for all of the customer’s business, suppliers sometimes are able to change how they do business with the customer. For example, a coating supplier will put a technician on site to oversee the painting process and to quote a price per coated object rather than the customary price per litre of paint.

**Selective work together in ways that align business interests and goals**

Often the customer and supplier have to work together to produce superior outcomes. Collaborative risk- and gain-sharing agreements are possible arrangements. In these, the supplier works with the customer to improve both its own performance and, while exposing itself to potential losses, receives a greater share of any profit.

Allegiance is a company that uses such agreements. Its managers believe that Allegiance’s clinical consultants can help the typical hospital to reduce operating costs by about 30 per cent. Often these savings come in the form of improved supply management, product standardisation and increased product utilisation. But the more efficient a hospital becomes in its use of supplies, the fewer the products and services it purchases from Allegiance. Rather than promoting the wasteful use of supplies, Allegiance is willing to train hospital personnel and consultants in the use of an adequate amount of supply, thus increasing the savings.

Once an agreement is signed, Allegiance puts its consultants on site to work on improving the customer’s supply management processes. At the end of the first year, cost savings are audited. The hospital and Allegiance split the savings 50-50. Each year thereafter the hospital gains a greater portion of the savings. On the risk side, Allegiance must not only keep the hospital’s costs from rising above the baseline established from the previous year, it also needs to discover cost savings great enough to cover the expense of participation, which is substantial.

**Construct flexible market offerings**

No matter how precisely a supplier segments a market, some suppliers will be included in the segments of segment members will remain. Even though customers within a segment may be essentially the same in their requirements, each remain different in others.

In the past, suppliers have either ignored or been unable to deal with these differences. They have merely chosen to provide offerings consisting of “standard” bundles of products and services designed to meet the needs of the “averages” customer within each segment. Worse, in many instances suppliers have provided the same “vanilla” offerings across all segments. As a result, some customers have paid for services they did not need, while others have not had the depth of service they required, even if willing to pay extra.

Rather than ignore residual variation, perception suppliers that attribute it by building flexibility into their market offering. They do so by first constructing “naked solutions,” for each market segment — the bare minimum of products and services that all segment members uniformly value. Importantly, they are sold at the lowest possible price. In turn, naked solutions are wrapped with options that are offered separately for segment members to value them.

**The return on differential value**

Rebuilding differentiation in a commodity offering does suppliers no good if they cannot obtain an equitable return on the value provided. However, this does not necessarily mean that they have to change more. Gaining a greater share of customers’ business and “cooperative pricing” provide greater profitability by lowering a supplier’s costs. Small price premiums or “cooperative pricing” improvements and value-adding services offered for a fee allow suppliers to realise a significant return.

**A greater share of customers’ business**

Suppliers might seek to have customers give them a greater share of their business as a reward for providing superior value. As all customers must buy their requirements from someone, so why not from a few suppliers or even just one? This is especially effective when the supplier can offer a compelling benefit in return — as in the previous coating example — and can alliterate concerns about continuity of supply and single sourcing.

**Co-operative pricing**

When customers simply demand lower prices, a supplier that wants to do business with them needs to work with them to find ways to reduce it. With “co-operative pricing”, the supplier and customer work together to detect “minimum” performance expectations that are unnecessarily restrictive in the customer’s application and that can be reduced in exchange for a lower price. Thus two companies might trade longer lead times, fewer product variations, fewer delivery locations or less technical support for reduced prices. In each case, the supplier may retain part of the cost savings as incremental profit and pass the remainder on to the customer as an incentive to change.

Small price premiums or “cooperative pricing” improvements on occasion, suppliers can realise small price premiums for differentiation initiatives. A pigment supplier, for example, was able to get a premium of half a cent per pound for providing its pigment in slurry form rather than in fifty-pound dry bags. This change made it easier for customers to handle the pigment, since it was already liquid and there were no dust hazards for workers or bags to dispose of.

Suppliers can also improve profitability by monitoring transaction pricing, which involves realising the greatest net price for each individual order. To monitor transaction prices, the supplier first constructs a "pocket price matrix", which refers to all levels, discounts, rebates, incentives and bonuses that a customer receives for a given transaction. These "trading elements" are then subtracted off the list price to produce a "pocket price", which refers to the revenue the supplier actually realises from the transaction.

Analysis of pocket prices reveals which customers segments receive the greatest discounts, how willing customers are to pay, and whether salespeople are exercising their pricing authority appropriately. Reducing the number of pricing exceptions can dramatically improve profitability. McKinsey consultants Mora and Roselli contend that a 1 per cent improvement in prices, assuming no volume loss, increases a supplier’s first operating profits by 11 per cent.

**Value-adding services, for a fee**

Many supplier managers believe that to differentiate themselves from competitors, they must give away value-adding services for free. This is not necessarily the case, provided that they can persuasively demonstrate that their service offers substantially greater value than competitors’ services. For example, although Dell estimates that loading a tailored mix of customer software at the factory saves the customer $250 to $500 per PC, it charges only $15 to $30 for the service.

**A gradual process**

Just as diversified offerings did not become commodities overnight, suppliers cannot rebuild commodity offerings into differentiated offerings overnight. Our emphasis has been on changes that, over time, will reduce the number of their business done solely on the basis of price. We recognise that price will be likely to remain important to customers but the changes we have discussed should decrease the emphasis that customers place on it.

Value assessment provides a deep understanding of customer requirements and preferences, and it is what is worth for suppliers to fulfil them. Superior knowledge of value also provides suppliers with a means to get an equitable return for their efforts and to judge to what extent they are getting such a return.

One senior manager we spoke to during our research suggested that a good strategy for rebalancing differentiation is that there is no fun to be had in selling only on price. When there is market pressure on price, his business unit tried to respond creatively by demonstrating that it has something different to offer, something that provides better value than competitors’ offerings.

So why not have some profitable fun?

**Further reading**


Gleckman, H. with McWilliams, G. (1999) *Ask and it shall be given*, *Business Week* (October 6 116, 118). On the way that customers are pressuring suppliers to reduce prices and provide additional price discounts.
