
Building Business Profitability: The Value Connection

Out of the Commodity Swamp

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Introduction

Prices for a wide variety of materials supplied by the process industries are declining as economic growth slows. Customers increasingly pressure their suppliers to lower price, claiming their suppliers provide “commodities.” And, often these customers suggest competing suppliers are more than willing to cut prices in order to get an order.

How can managers in the process industries deal with the pressure to constantly lower prices? What defense do managers have against the charge they sell a commodity? The answer lies in creating and positioning value delivering offerings targeted at specific segments of customers. In addition, managers must develop a set of selling tactics that convince customers to pay for these value delivering offerings. Value based marketing is a process designed to help managers understand their markets, create products and services that provide value for specific target customers, and sell these products/services in a way that allows the firm to be rewarded with price for the value it delivers.

The objective of value based marketing processes is to optimize the profitability of the business. The operating environment for firms in the process industries makes the development and implementation of value based approaches a necessity. Process industries are characterized by high capital investments; the desire to “sell out” this capital investment results in challenging competitive environments and customers who actively encourage price competition. Further, many firms in the process industries operate in markets well removed from ultimate customers; if they want to be rewarded for the full value of their products, managers of process industry firms must understand how their products and services create value beyond their direct customers. Finally, in many cases the core product supplied by many process industry firms is a commodity; in order to avoid the price competition common with commodity products, managers must find ways to deliver value beyond the core chemical product.

This is the first installment of a three part series dealing with value based marketing processes. In this part, we will develop the concept of value and describe tools and processes for the creation of value delivering products and services. In the second installment, tactics for selling these value delivering offerings will be developed. In the third installment, we will explore how to define competitive strategies that allow the firm to manage more profitability in intensely competitive arenas.

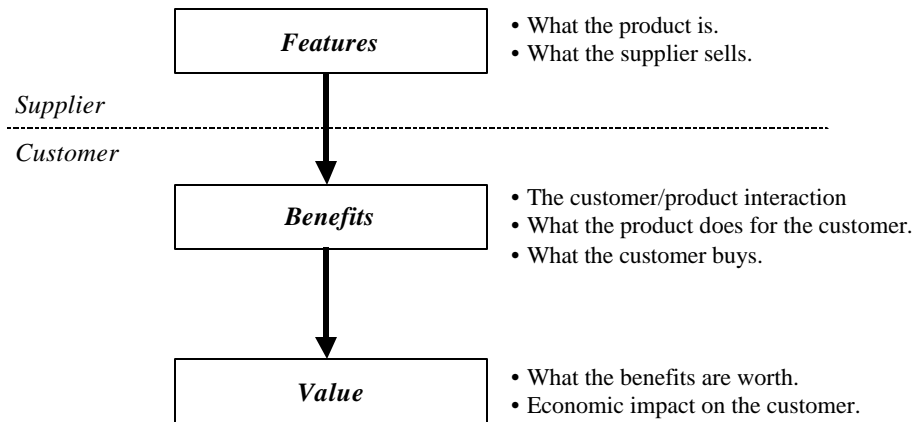
What is Value?

There are many definitions of value. For the purpose of building effective pricing policy, however, the best definition of value is:

Value is the economic impact of the supplier's offering on the customer's business.

In order to understand economic impact, it is useful to start by defining the “value hierarchy” (Figure 1).

Figure 1: The Value Hierarchy



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The value hierarchy gives us insight into a very important point: customers do not buy what suppliers sell. Suppliers sell features, while customers buy benefits. Customers do not want what suppliers sell; instead, customers want what happens when they use what suppliers sell. To illustrate, when a business person takes an airline flight, they do not want to take the flight – they want to be able to meet other business people at their destination. It is not the flight they are buying, it is the ability to personally communicate with other business people after they have taken the flight.

The value hierarchy helps us keep a perspective on what customers buy. The hierarchy has three levels:

- **Features** – This is what the product or service is, and it is what the supplier sells. Features include the physical product and service attributes, packaging, quality, delivery terms, financing, branding, etc.
- **Benefits** – Benefits emerge from the interaction of the customer with the product or service. While features are what the product is, benefits are what the product/service does for the customer. Customers buy benefits.
- **Value** – Value is the economic consequences the customer receives from the benefits. In turn, there are two types of benefits:
 1. **Cost Reduction** – The customer's costs are lower when they use a specific supplier's offerings. This might come from lower material costs, reduced labor inputs, easier handling, etc.
 2. **Revenue Enhancement** – The customer is able to generate higher levels of revenue from the use of a specific supplier's products. This might occur because the customer

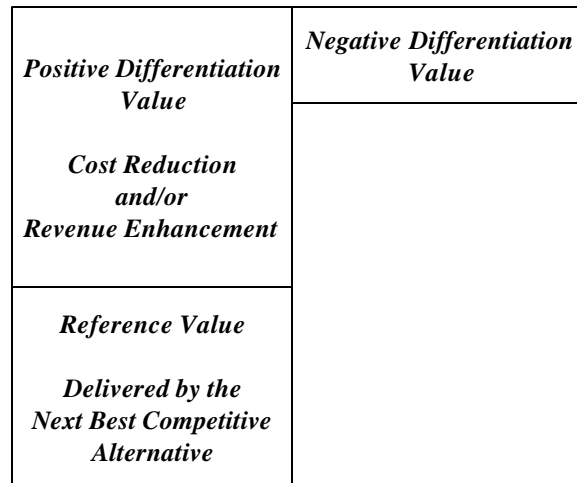
is able to charge higher prices, or because the customer is able to sell to customers they can not reach when they use another supplier's products/services.

Our experience is that managers are often aware of their impact on customers' costs, but they are less familiar with their impact on customers' revenue generating capabilities. While cost reduction is certainly important, it is often much lower than a supplier's impact on customers' revenue generation potential. In order to price for all the value customers realize, suppliers must understand both cost reduction and revenue enhancement impacts.

We've introduced the term differentiation, but have not yet developed the differentiation concept. Differentiation does not mean different offering features. Instead, differentiation means the unique benefits and value that customers can only get when they use a specific supplier. The important distinction is that differentiation implies customers receive unique *benefits* from using a specific supplier's offerings. Suppliers may have very different offering features, but unless these create unique benefits for customers, the offering is not differentiated.

A very useful tool for capturing differentiation is what we call the Economic Value Estimation®, or EVE® for short. Figure 2 shows the layout of a typical EVE®, utilizing three components:

Figure 2: Economic Value Estimation®



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- **Reference Value** – Reference value is the value customers receive from the next best competitive alternative. Reference value is included to recognize the appropriate competition, and to establish differentiation (see the discussion in the following section).
- **Positive Differentiation Value** – This is the value customers receive uniquely from the specific customer. Positive differentiation value is based in the benefits customers can only get in using the specific supplier's offerings.

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- **Negative Differentiation Value** – Negative differentiation value represents unique costs customers incur doing business with the specific supplier’s offerings. These costs would disappear if the customer purchased from the next best competitive offerings.

The EVE® forms the foundation for a value based pricing scheme by capturing the net value delivery (Reference Value + Positive Differentiation Value – Negative Differentiation Value) to the customer. A portion of this net value delivery is captured by the supplier in the form of price. The portion of net value delivery not captured by the supplier (through price) is “distributed” to the customer, and is an incentive for the customer to buy from the supplier.

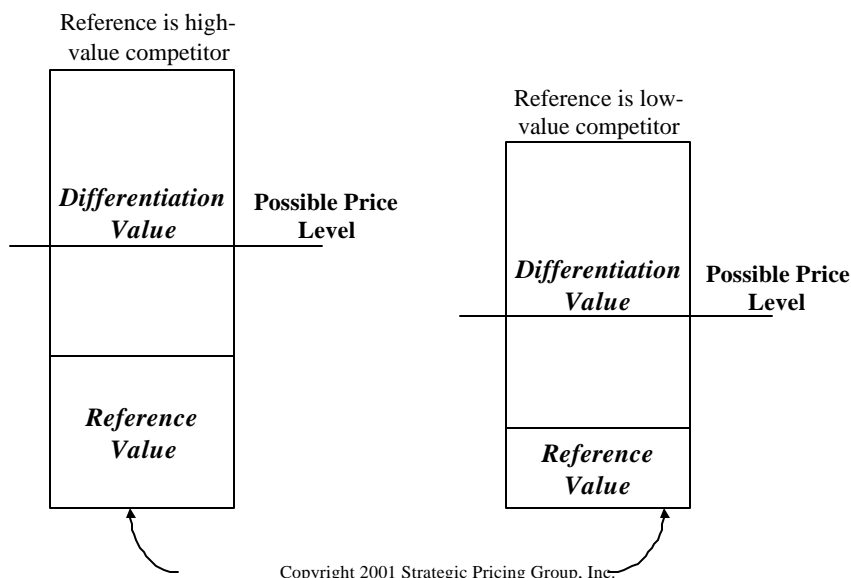
The Competitor Impact

In order to build value based pricing policy, managers must acknowledge the presence of competition. The reason for this is that customers do not think about any supplier without also thinking about competitors – other possible solutions for the customer’s needs.

For firms who choose to build customer preference through differentiating their offerings (the desirable strategy for most firms in the market), competition is beneficial. Competition is necessary in order to establish differentiation – a supplier needs competitive offerings in order to demonstrate differentiation.

The challenge for value based pricing strategy is to assure the customer places them in the right competitive context. If the customer compares a supplier against a vastly inferior competitor, they will be more price sensitive even though the supplier delivers substantial differentiated value. Using the EVE, the problem in being compared to the wrong competitor is obvious; Figure 3 illustrates this problem. Even when the supplier provides high levels of value, if a low-value competitor is the reference, the supplier will be under more pressure to lower price.

Figure 3: Problems in Comparisons to the Wrong Competitor



Successful implementation of a value based pricing approach includes identification of the appropriate competition. Suppliers should always communicate the appropriate competitive frame to customers; we'll discuss how this is done in the second part of this series.

Delivering Value in Mature Markets

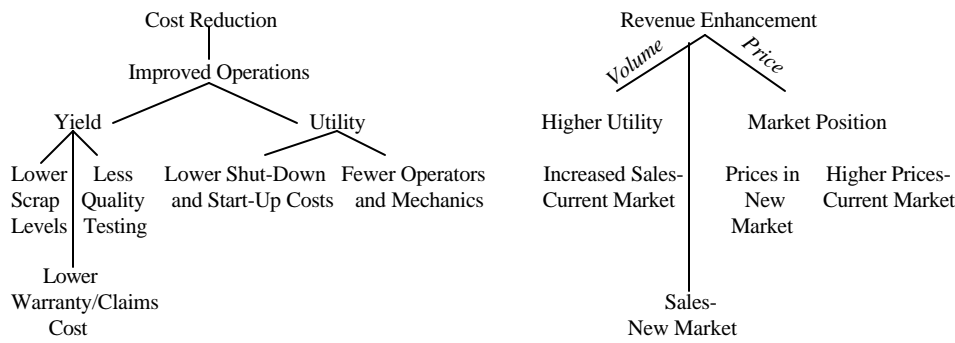
So far, we've discussed value delivery through differentiation. Many managers easily understand the notion of differentiation when their products have unique properties that are highly valued by customers and the ability to supply these products is protected. In cases where products are unique, and cannot be easily be matched by competition (either because of regulatory protection or proprietary technology), the ability to command premium prices is more apparent.

But what about markets where products are readily matched by competitors, as is the case in many chemical markets today? How can managers achieve differentiation with these "commodity" products? The answer lies in looking beyond the product to the total offering and the benefits customers derive from this total offering.

As markets mature, often the core product is readily matched by competitors. Customers frequently point to the commonality of the core product (the "commodity") and insist suppliers price compete for their business. Value based suppliers, however, look for ways to deliver value beyond the core product. They do this through augmenting the core with services and other products that uniquely provide benefits for target customers. These value based suppliers must gain a deep and thorough understanding of their target customers' businesses in order to create packages of products and services differentiated for target customers. There are two challenges in the augmentation process:

1. Augmenting to create differentiation, not difference: Suppliers sometimes create packages of products and services that are different than competitive offerings, but these are not necessarily differentiated. In order to be differentiated, the augmentation must create customer benefits that are unique. If the augmentation does not create unique customer benefits, it will either increase price competition (through mere matching of competitive offerings) or increase costs without the potential for higher prices (if the customer receives no benefit from the augmented products/services, they will not pay for the augmentation).

Figure 4: Suggested Benefits Arising From Process Industries' Offerings



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2. Getting paid for the differentiation: In order to profitably provide augmentation, a supplier must get paid for the resources used to create the augmentation. This requires the supplier position the value delivered to the target customer and negotiate in a way that compels the customer to pay for the value created. This positioning and negotiation process is briefly described in the following section, and is more deeply explored in the next installment of this series.

The clear implication for value based firms is that as markets mature, the basis for competition and value delivery evolves beyond the core product. The key to achieving price premiums is the ability to differentially create benefits customers highly value. In more mature markets, firms that fail to create unique benefits and value are forced to sell commodities, and cope with the price competition commodity markets demand. In these more mature markets, as the core product is supplied by competition, unique benefits and value often emerges from the augmentation of the offering. Value based suppliers must invest in renewal of offerings to continue positioning for premium prices.

Earlier we introduced the concept of value delivery through both cost reduction and revenue enhancement. Figure 4 highlights some typical ways process industry offerings impact customers economics through value delivery. Value based suppliers

look to augment their offerings by creating benefits fitting these kinds of customer impacts.

Figure 5: The “5Cs” of Value Based Marketing

1. **Comprehend**: Understand the customer’s business and their business economics
2. **Create** : Develop products/services that deliver value to target customers
3. **Communicate**: How products and services are valuable to target customers
4. **Convince**: Target customers to pay for the delivered value
5. **Capture**: A portion of the delivered value with consistent pricing and competitive management policies

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Selling Value – The “5Cs” Approach

How can managers build a differentiated strategy that provides unique benefits and value? Figure 5 illustrates the process steps. This process flow – from comprehension to capturing value – becomes the framework for establishing value based approaches.

- **Comprehend** – The process starts with a thorough analysis of target customers’ businesses. Note that this requires the management team carefully define appropriate target customers. Understanding a customer’s business includes determining their business model and their economics. Further, understanding a customer’s business necessitates defining how the supplier can impact the customer’s economics through providing unique benefits. Critical to profitably providing unique benefits is the establishment of sources of competitive advantage; this will be discussed in the third installment of this series.
- **Create** – As the management understands target customers’ businesses, the next process step involves developing products and services (offerings) that provide tangible benefits and value. Management should focus product/service development on the creation of significant differentiation – providing unique benefits that are critically important to target customers. Any other product/service features that do not drive differentiated benefit should not be included in offerings to customers.
- **Communicate** – As differentiated offerings are created, the next task is to communicate to customers the presence of these offerings. Communication includes

mass forms of communication (for example, advertising), and personal forms of communication (sales scripts). The focus of the communication should always be the benefits and value customers receive, not the features of the offerings. Communication to target customers will be more fully explored in the second installment of this series.

- ***Convince*** – In the communication process value based firms promote an important shift: negotiations with target customers move from price negotiation to value negotiation. Economic Value Estimation® becomes the primary tool to convince the customer the price is fair given the value created in the customer's use of the offering. When customers resist price levels, elements of the EVE® are removed from the offering, forcing the customer to acknowledge to give up important value delivery in order to achieve lower prices. This technique equalizes power in customer negotiations; we will explore this more thoroughly in installment two of this series.
- ***Capture*** – In the last process step, the management team establishes a consistent set of pricing and competitive management policies. Perhaps most important of the pricing policies is the institution of a "fixed price" policy: the price for each element of value delivery is clearly defined and "non-negotiable." Only the elements of value delivery are negotiable. From a competitive view, management must establish policies that pick competitive engagements carefully; the wrong competitive engagements destroy the ability to capture rewards for value delivery. Selection of competitive engagements will be more fully developed in the third installment of this series.

Summary

Customers are increasingly forcing their suppliers into "commodity chains" by aggressively denying any uniqueness in the supplier base. If suppliers cannot escape these commodity chains, they will be forced to price compete, and find themselves powerless, at the mercy of these aggressive customers.

Escaping from commodity chains involves:

- Building differentiation based on value delivery to target customers.
- Communicating the value delivery to target customers in a way that is meaningful to the customer, that is, in a way that allows the target customer to see the economic impact of doing business with the supplier.
- Capturing a portion of the delivered value through consistent pricing and competitive management policies.

Next Steps

In following installments, we will first develop insights into how to diagnose and then deal with different customer buying behaviors. In the second part of this series, we will define tools to communicate value and use these tools to deal with aggressive customer negotiations.

In the third part of this series we will develop a view of competitive strategy that will allow suppliers to manage competitive interactions so they become more profitable. In that note, we will explore competitive policy tools, and provide guidelines for more successful competitive interactions.

