
Building Business Profitability: The Value Connection

Out of the Commodity Swamp

Part 3

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Introduction

The previous installments of this series introduced value based strategy development and implementation as a route to profitable pricing. Part 1 focused on developing value based strategy. In that discussion, value was defined as a supplier's economic impact on the customer's business. This economic impact is created through developing products and services that impact the customer's business through:

- Reducing the customer's costs.
- Increasing the customer's revenue.

Part 2 of this series focused on processes for implementing value based pricing strategies. That second article proposed the "5Cs" process for strategy implementation:

- *Comprehend* what drives value for target customers.
- *Create* products and services that deliver value to target customers.
- *Communicate* the presence of value to target customers.
- *Convince* customers to pay for delivered value.
- *Capture* value with consistent pricing policies.

Managing these 5Cs instills value based strategy principles widely across the organization.

While building and implementing value based strategies is essential to improving organizational profitability, this alone does not ensure profitability. In addition to managing value based strategies, business teams must also manage competitive strategies in order to ensure profitability.

A good example of "profitless" pricing practice occurred recently. Eurodiol, a subsidiary of the Sisas Group entered the market for butanediol (BDO)¹ in 1998 when they commissioned a plant with 110 million pounds/year capacity. According to one competitor, Sisas intended to force other BDO suppliers out of the market, and then move prices up.²

Sisas had actually succeeded with this strategy in another chemical (maleic anhydride). When Sisas began manufacturing maleic anhydride, there were many small suppliers. These smaller suppliers could not match the low cost position Sisas established, nor did they have the financial staying power of Sisas.

¹ BDO is an intermediate used for the production of spandex fibers, a number of plastics and some pharmaceuticals.

² Information extracted from *Chemical Marketing Reporter*, June 26, 2000, p. 2.

The BDO arena was very different, however. BDO is dominated by a few very large, global firms. Most of these large firms have a captive market for BDO; they also manufacture downstream products and participate in the merchant market opportunistically. Sisas had no downstream production, and sold only in the merchant market.

Sisas entered the market with very low prices. Over the two years Sisas participated in the market, prices moved from a historical average of \$1.00 per pound to prices of \$0.50 to \$0.60 per pound. A price increase of 10% was established July 1, 2000, and prices are forecast to gradually increase.

Based on the author's estimates, the Sisas strategy had a negative net present value in the range of \$200 Million. The strategy did not succeed in displacing any of the incumbent manufacturers, and may well have contributed to the bankruptcy of Sisas.

Without thinking through the competitive implications of a proposed pricing strategy, the management team may not benefit from the development and implementation of a value based pricing strategy. This article addresses the components of a value based approach, and provides guidelines for managing competitive dynamics.

Market Share Wars

For many capital intense firms, market share is a dominant concern of the management team. Their perspective is rooted in an element of truth. Capital intense firms often have higher levels of fixed costs; for high fixed cost firms, increasing market share leads to lower fixed cost per unit (the concept of "economies of scale"). Managers operating in these higher fixed cost businesses argue that profitability increases as share increases.

Does profitability increase as share increases? Two components contribute to profitability: sales revenue (price times volume) and costs. As share increases, higher fixed costs are spread over more volume and unit cost does indeed decline. But what about sales revenue? To determine if more share will generate more profit, we must examine what happens to price as share – sales volume – increases. Two factors impact price as share increases:

- As sales volume increases, demand curves typically slope downward. That is, as volume goes up, price goes down.
- Share gains come at someone's expense. If a firm is increasing share, some other firm must lose share. Often the share losing firm resists the loss, responding with price. In order to grow share – particularly in more mature markets – managers must move price down.

This can create significant impact: price moves down following the demand curve, and competitors respond with price moving price points even lower. The consequence is that as share increases, price frequently moves lower, sometimes substantially lower.

Many managers seem to implicitly examine only the cost consequences of a share move, i.e., see only the lower unit cost arising from increased share. In order for a share gain to be profitable, the demand curve (price versus volume) must have a shallower slope than the unit cost decline available through economies of scale. Our experience is this occurs very rarely.

This problem is particularly severe in mature industries. In mature industries, volume grows only at general economic growth rates. In this environment, share gains are the result of stealing share from some other competitor. The competitor losing share sees the result quickly; their unit costs go up immediately as they lose volume. The easiest and fastest response in this environment is for the competitor to immediately cut price in order to try to regain lost share. The result is predictable: competitors battle for share using price, eventually terminating when the firms “agree” to end the mutual damage. But by then prices have declined, and competitors typically wind up with the share they had at the start of the battle.

Managing competitive dynamics starts with understanding what share of the market each firm can legitimately claim. The key to legitimate share is providing value for target customers at competitive advantage. All sources of competitive advantage are market segment specific: no source of competitive advantage can be applied across all customer segments. An essential component of profitable management of competitive dynamics is understanding where the firm fits in the market (where value can be delivered at competitive advantage) and not extending into market segments where the firm has no competitive advantage.

A good question to start this process is: “What share of the market can we profitably serve.” The answer to this question is based in how the management team creates, sustains and renews competitive advantage.

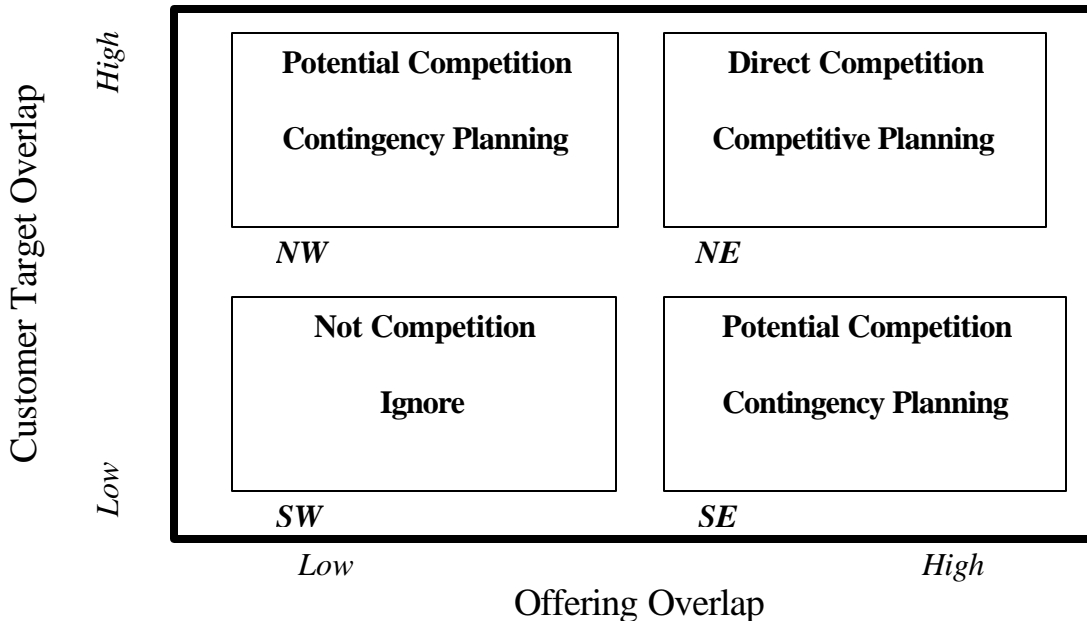
The strategy implication is that if the management team wants to grow share, it must create, sustain and renew sources of competitive advantage for each target market segment. Trying to capture share where the firm has no competitive advantage will result in price wars and lowered profitability.

Identifying Competitors

Assessing the segments the firm can profitably serve facilitates the identification of competitors. Figure 1 is a framework for identifying competition. Figure 1 identifies firms on the basis of:

- The extent they are targeting the same customers as your firm. The greater the target customer overlap is, the more intense competition will be.

Figure 1: A Framework for Identifying Competition



- The extent they are serving target customers similar offerings. The greater the offering similarity, the more intense competition will be.

Four groups of competitors are apparent:

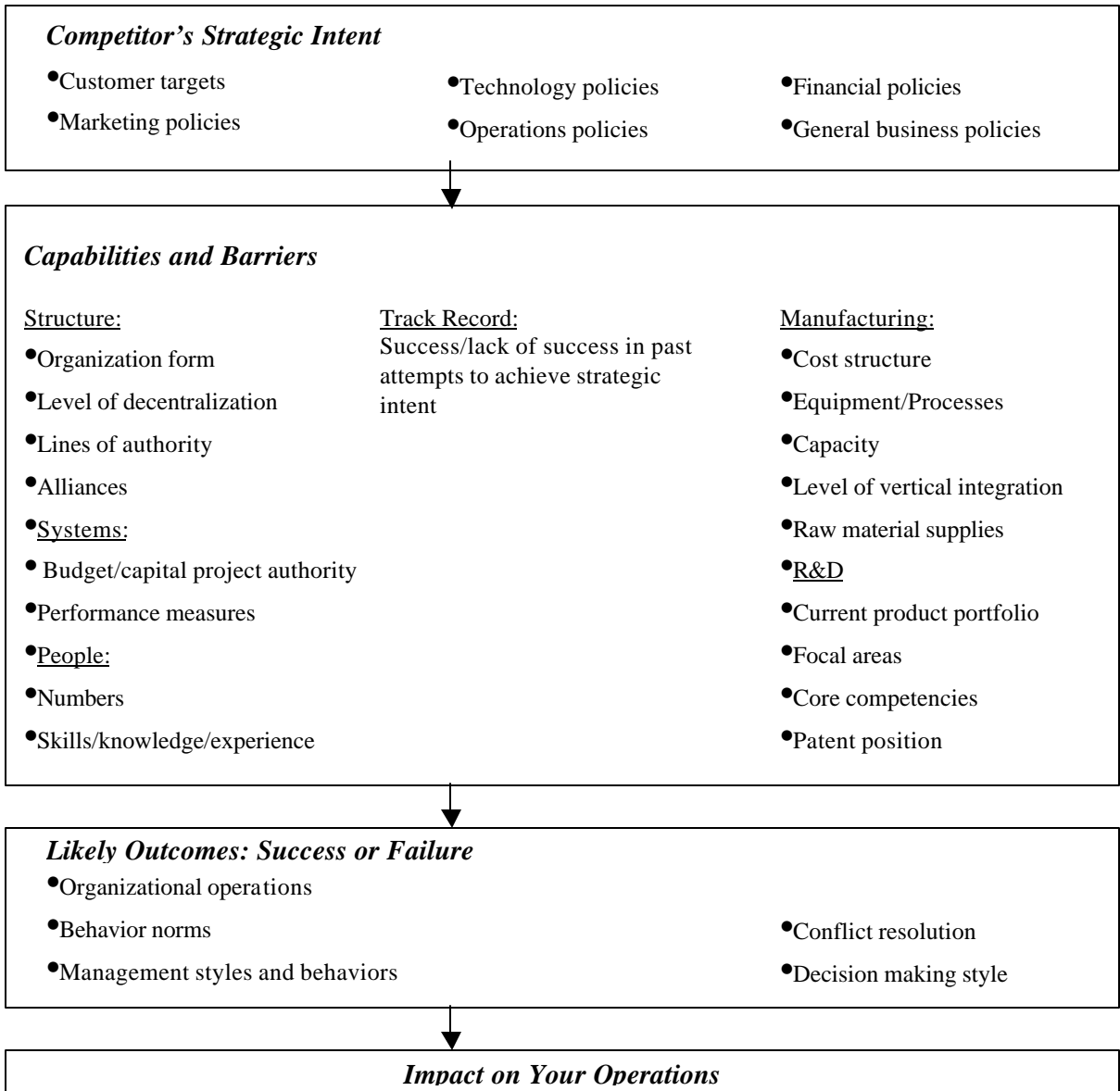
1. SW – Low customer target overlap and low offering overlap: these firms are taking a different approach to the market. They are not competitors, and their market maneuvers should not precipitate a response.
2. NE – High customer target overlap and high offering overlap: these firms are direct competitors. A competitive plan should be developed for each firm in this quadrant.
3. NW – High customer target overlap and low offering overlap: firms who are targeting the same customers but offering something different. These firms could potentially become direct customers if they develop similar offerings. Scenario planning is useful in identifying how and when they might become direct competitors. Contingency planning is required to determine how to discourage entry and how to deal with entry if it can not be discouraged.
4. SE – High offering overlap and low customer target overlap: firms who market a similar offering but target different customers. These firms could potentially become direct customers if they begin targeting the same customers. Scenario planning is useful here also in identifying how and when they might become direct competitors. Contingency planning is required to determine how to discourage entry and how to deal with entry if it cannot be discouraged.

Analyzing the view presented through the Figure 1 is the next critical step in developing profitable pricing strategy. Incorrect identification of the competition may result in initiating actions that are not aimed at managing direct competitors or reacting to market place actions from firms who are not real competitors. Either case can result in lowered profitability.

Understanding Competitive Moves

The starting point for understanding direct and potential competition lies in assessing their strategic intent, the ability of the competitor to achieve its strategic intent, and the implications of the pursuit of strategic intent. Figure 2 summarizes the elements important to competitor analysis³:

Figure 2: Assessing Competition



³ A good way to use this analysis is to begin by analyzing both direct and potential competitors, and then applying the framework to your own operations. Often inconsistencies between strategic intent and capabilities/barriers become apparent as you analyze your own business.

Strategic Intent: What does the competitor intend to make happen? What are its market targets and policies (marketing, technology, operations, finance and general business)?

- Customer targets – You should already have an indication of competitive intent from identifying who the real competitors are. In addition, you should identify the priority of customer customers for the competitor, i.e., the importance of each target in the competitor's portfolio of customers. Pursuing business with customers who are critically important to the competitor is likely to precipitate immediate and severe response: you should pursue these customers only when you have a position competitors cannot overcome.
- Marketing policies – Often these policies must be inferred from the competitor's market place behavior. In particular, develop insights into the competitor's product and service portfolio renewal policy, i.e., how frequently the competitor renews its offering line and whether the competitor leads or reacts to industry wide renewal. The product/service portfolio indicates what customers and what customer needs the competitor is/can address. In addition, identify how the competitor deals with distribution (width, breadth and depth of distribution coverage). Next detail how the competitor manages pricing: is it pricing policy clearly defined and adhered to? Finally, look at the competitor's marketing action "tendencies:" How does the competitor typically behave when it brings new offerings to market? When it is managing distribution channels? When it is threatened by competitive actions?
- Technology Policy – Does the competitor lead or follow technology evolution. What is the competitor's portfolio of patents? Are patents focused on process (implying cost reduction efforts) or product/service (implying differentiation efforts)? Based on patent filings, technical paper publication, and your own personnel's assessments, what is the focus area of the competitor's R&D efforts?
- Operations Policy – What is the competitor's manufacturing capability? What is its capacity? What is the competitor's capital investment cycle (at what level of capacity utilization does it typically start capacity expansions)? What is the state of the competitor's current manufacturing facilities? What is the competitor's utility and capacity utilization?
- Financial Policy – How is the competitor capitalized? Different levels of debt and equity lead to different behaviors in expanding and contracting economies.
- General Business Policy – How does the competitor deal with globalization issues? To what extent does the competitor operate domestically, multi-nationally or globally? What are management's training (often indicating focus of the business) and functional orientations? What are management's tendencies: How does the competitor typically behave when it brings new offerings to market? When it is managing distribution channels? When it is threatened by competitive actions?

Capabilities/Barriers – Here we are looking at whether the competitor can achieve its strategic intent. In a sense, capabilities are the opposite of barriers: what a competitor has that will support achieving its strategic intent is a capability. What prevents a competitor from achieving its strategic intent is a barrier.

- Structure – How is the competitor structured? Will this help or hinder achieving strategic intent? Does the competitor have any alliances that will help it achieve its

strategic intent? Or alternatively, will any alliances prevent the competitor from achieving its strategic intent? Are lines of authority set up to facilitate pursuit of strategic intent?

- Systems – Does the competitor have the appropriate budgeting and control processes to support achieving its strategic intent.
- People – Does the competitor have critical mass of people to support pursuit of strategic intent. Do these people have the appropriate skills, knowledge, and experience to support the strategic intent? Are any critical skills, knowledge, or experience base components missing?
- Manufacturing – What is the competitor's cost structure? Does the cost structure support the level of pricing necessary for the target customer segments? Does the competitor have the necessary manufacturing equipment and processes for the target segments? Does the competitor have access to all the raw materials necessary for its manufacturing processes?
- R&D – Does the competitor have the necessary technology base to support its strategic intent? Are any critical technology components missing?
- Track Record – Does the competitor's track record indicate potential success or failure in pursuing its strategic intent?

Likely Outcomes: Success or Failure – Comparing strategic intent with capabilities and barriers, what will happen? Will the competitor succeed? Fail? When the competitor succeeds/fails, how will they behave?

Impact on Your Operations – Given the likely behavior of the competitor, how will your business be impacted? In some cases it may be better to let a competitor succeed (e.g., in opening a new market if you can quickly follow and the competitor has the cost burden of starting the market). In other cases, it may be better to prevent a competitor from failing (e.g., a failing competitor may drive prices so low no firm can profitably compete).

The context of this analysis is to create options for managing competitors. The objective of this analysis will indicate when managers should fight competition, and when competitive moves should be tolerated.

Potential Competition: Scenarios and Contingency Planning

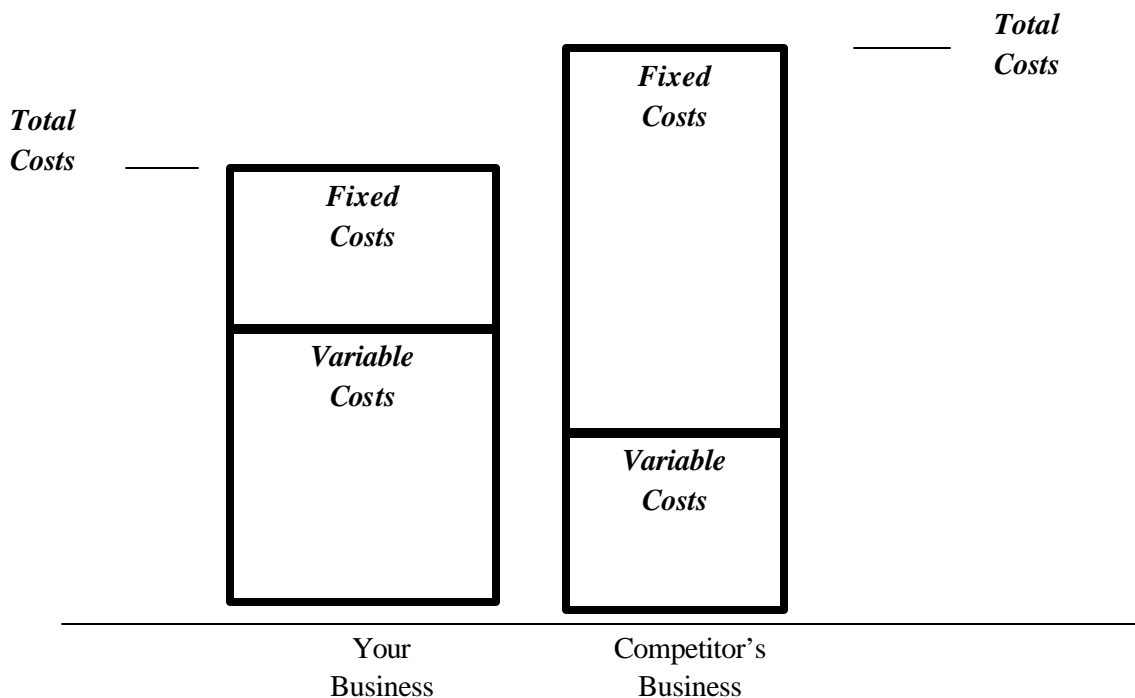
Adding the Cost Component

To properly set price levels, managers must know their costs. Costs are important not to determine price (i.e., price should not be determined by adding costs and a desired profit margin), but instead are critical for understanding if the business will be profitable at the set price point.

Cost structure is the critical component for appropriate profit driven price analysis. By cost structure, I mean the split between fixed and variable costs. For pricing purposes, variable costs are the key issue.

Not only must managers understand their own cost structure, but they must also know their competitors' cost structures – the competitors' fixed/variable cost splits. Figure 3 illustrates why this is important.

Figure 3: Competitive Cost Structures



In Figure 3, a competitor has higher total costs, but lower variable costs. In a price war, the competitor has greater price flexibility even though it has higher total costs. This arises from the fact that the competitor can price down to its lower variable costs (as long as prices are above variable costs, there is a positive contribution to covering fixed costs). Variable cost is in effect a floor price, and the competitor has a lower price floor. It is exceedingly dangerous to engage in a price war with a competitor that has lower variable costs.

Competitive Signalling

Achieving Price Transparency

Building Profitable Action

Critical to profitable management of competitive strategy is engaging in appropriate competitive management. Two guidelines apply:

- Never engage in actions you cannot win. If your business does not have a source of strength, don't engage in the action. Always initiate actions or reactions based on your sources of competitive advantage. Often managers who enter actions with no real source of strength wind up in price wars, decreasing their profitability.

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- When the rules of competition don't favor you, change the rules. Refuse to engage in actions where a competitor defines the rules of competition. Invest in shifting the rules of competition so they more closely fit your sources of competitive advantage.