

Commoditisation

How to deal with the downward pressure on price and profitability

Commoditisation ... In today's "business speak" the word commoditisation is never far from any chief executive's lips or business correspondents pen. But like many buzz words it is much used and little understood. The impact of commoditisation across a wide range of businesses is to drive down growth and profitability and to weaken relationships between customers and suppliers, making customer loyalty and retention difficult. Hence commoditisation is one of the biggest challenges facing business today.

This article seeks to explain the What and Why of commoditisation but more importantly looks at the HOW, i.e. What are the strategies and approaches that businesses can adopt in dealing with this.

What is commoditisation?

A commodity used to refer to something traded on the financial markets like oil or gold. Often it referred to basic agricultural or natural products such as wheat or pork bellies. So how come you see people talking about the commoditisation of branded consumer products, computers and software?

In the original and simplified sense, commodities were things of value, of uniform quality, that were produced in quantity by many different producers that were in effect interchangeable ... we're back to pork bellies! So from that we come to appreciate that a commodity is something that consumers perceive to be of uniform quality and value. If consumers don't see any difference in value in competing offerings then what other criteria are left on which to base their purchasing decision? The Price, the whole price and nothing but the price! A commodity then is something where the purchase decision is based purely or largely on price.

So commoditisation is when:

- consumers see little differentiation between competing products
- they have plenty of choice
- therefore they make their purchase decision based on price

Why does it happen?

The giants of the consumer goods industries like P&G or Masterfoods spend literally billions on building brands that seek to differentiate themselves from their competitors. Yet still people regularly talk of commoditisation in the grocery market



place in branded goods and in hi tech industries such as computers and even software. Why has commoditisation become such a powerful force?

Since 1989 the world has become “Flat”, it has become a level playing field, where commerce and competition has become truly global. The collapse of the communist block and the opening up of free trade there and in countries like India and China, the technology revolution in the spread of fibre optics, broadband technology, computer penetration, internet usage and the rise of the search engines such as Google have created this “flat” world that presents every business with both opportunity and threat.

The key here is consumer perception. A brand may not change its features and benefits but consumer perception of value may change, if for example they perceive it to be dated. This particular issue in fashion related industries (this doesn't just mean clothes it includes for example cosmetics and personal care products) Consumer perception is increasingly difficult to manage. Today's consumers are well informed and have high and growing expectations.

The key factors that cause commoditisation are the availability of alternatives, customer awareness and knowledge of those alternatives, and their perception of the differentiation between products. The advent of the internet and its associated technologies has created a revolution in these areas. Customers (be they individuals or businesses) can, at the click of a mouse check out dozens of alternatives from across the world. This review of alternatives is made easier by various cost comparison websites such as priceguide.co.uk and pricegrabber.com. In retailing the on line auctioning processes for tenders/ contracts for products reflects this trend at a commercial level. Examples of these online auction organisations (or Retail Exchanges) are Worldwide Retail Exchange or GlobalNetXchange (GNX) GNX members are conducting auctions for in excess of \$1 billion a month. All this has made the customer a far better informed, more discerning and demanding than ever before.

In the world of computers, logically you might think hi-tech products were immune to commoditisation wouldn't you? Developing new technology, continual advances in computing power... Moore's law; surely that's all added value? And yet all the talk in the computer industry is of commoditisation. The UK's leading electrical retailer latest results (11/05) reported its computing sales down 7% across the group. All retailers in the PC industry report the consumer emphasis has been on price, and hence prices and margins on PC's and laptops have fallen in the whole industry, for manufacturers and retailers. Why is this? From the consumer's point of view, one pc or notebook does much the same as the next, the finer distinctions of who makes the chips, what the graphics card is, how many RAM of memory or GHz of processing power have become of little or no importance. The capabilities of all machines have long outstripped the needs of the majority of consumers and added power and functionality has little real value for them now. No differentiation, plentiful supply of alternatives leads clearly to a purchase on price commodity market.

The pressure of commoditisation is a significant threat and businesses are now going to have to work much harder to differentiate themselves and add value to their customers

Commoditisation indicators

You know your market is commoditised when ...

- price falls
- profitability falls
- competition increases
- own label / ODM product share grows
- brand index declines

So here are some indicators that commoditisation is critically affecting markets from all industries: ~

- The IGD's (Institute of Grocery Distribution) conference in 2005 had Flair, creativity and innovation as its central theme, as it argued that in order to achieve continued growth in a mature market the grocery industry had to be come much more tailored and creative in meeting customer needs.
- The pricing/ cost pressure on manufacturers in the consumer goods industry is illustrated by the Grocer's survey of the top 150 manufacturer's for 2005 that showed an overall 0.2% decline in operating profit.
- Penetration of Own label product is increasing and now stands at 40% of all packaged grocery sales making it an industry worth £39 billion in the UK alone. The main driver for this huge and growing part of the market is, according to IGD research value for money and low prices.
- Prices in the food industry are falling in relative terms. In the last 10 years the average price of non seasonal foods has risen by 15% vs. background prices which have risen by 27%. (ONS data) This clearly indicates a commoditised market place where consumers have benefited from more choice and perceive less difference between competing offers.
- Feedback from Miller Heiman's Q1 2006 sales confidence index (based on research with a database of sales leaders) suggested that pressure to discount is intense and that 90% of businesses believing they have to cut prices to win business. One third said they cut between 10-20% and almost half saying they discount to 10%
- The UK's leading electrical retailer (Dixon's Store Group) latest results (11/05) reported its computing sales down 7% across the group.
- In 2005 Computacentre, a leading computer distributor and service provider, published interim results that showed a 9.3% drop in revenue and a 72% fall in profit before tax, which they attributed to " a steep fall in product margins in the UK and intense price competition"

Help! What do we do?

Well one option using the “if you can’t beat them join them” strategy is to recognise that there is no perceived customer value and look to become a low cost producer, stripping out all possible costs and competing at the lowest common denominator end of the market.

For the producers of branded goods and complex products and services this is not an option so the solution has to be finding ways to increase the customer’s perception of value. At a marketing level this is what brands seek to do. They seek to give a product an aura of quality/ reliability/ cool/ chic whatever will appeal to the target market, thereby creating the value in the consumer’s eyes

In terms of business to business the same rules apply but the added value must come from how you add value to the business customer, the retailer, the distributor, or client.

1. The first step is to have a clear and unbiased understanding of where you are currently. What is your customer’s perception of the value you and your company bring? Do they perceive you as a provider of basic commodity level products? (i.e. products for which there are a large number of alternatives and little perceived value differences) Or conversely do they see you as a truly strategic partner who adds value well over and above just providing product? Are you seen as an important contributor to their business success? The question that lies behind this of course is do you know how you are perceived? Or do you just guess or feel you understand their view?



2. The next step is to understand what’s in your kit bag. What are the key strategic strengths that set your business apart from its competitors? What are you really good at? What is your value proposition? How can you add value to your customers? How can you help them achieve their goals and objectives? This needs to be understood across the organisation, not just at the senior levels but through out the whole organisation and very specifically in the sales team. If the sales team don’t have a clear focus and positive belief in what added value the

organisation can bring to its customers then they will not be able to differentiate you from the rest. The next consideration is to ensure that this is understood in a holistic way, not just in an individual brand-centric way. The whole should be greater than the sum of the parts.

3. The third stage is to ensure you are structured and operating in a customer centric way. How can you add value unless you truly understand your customers and what they are trying to achieve and align your efforts around supporting that? How can you add value unless you understand them and their challenges well enough to know what they need, hence what they perceive as value. Of course all companies say they put their customer's first but in reality they do not. Their thinking, their planning, their financial structures, cost centres are all geared to internal factors, usually around "products" or brands. The start point then is not how can we add value to the customer, how we can contribute to solving their business and organisational issues but how can we make our numbers? And from then onwards its all about us, our numbers, our brands, our products our targets and how we can foist these upon the customer almost regardless of whether that meets their need or not. With all the choice and alternatives available, customers can make money from numerous sources so why should they work with you? What needs/ objectives over and above basic revenue generation can you help achieve?
4. Step 4 is to ensure you create or implement robust process and enshrine the customer centric thinking at the centre of the strategy, planning, and action at all levels of your commercial interactions; be they at a macro relationship management level or at a micro meeting management level and everything in between. How can you add value unless you act on your thinking? Using a strong process will ensure that you translate that information/ understanding of how to add value to your customers into strategic plans. It will then help you execute with discipline against those plans so it systematically and rigorously drives actions and behaviours of the organisation
5. Step 5 is to be innovative in new value creation. As part of the overall strategy, specific initiative needs to be put in place to be truly creative in creating new value propositions for your customers. By which we mean creative beyond the standard responses of new products, brand extensions and category management. One approach is to utilise methods more commonly found at the upstream end of the value chain (new business and new product innovation) and reflecting influences of recent trends towards fusion of brand equities to create new markets and new consumer propositions. This effectively creates a new space that can offer breakthrough as well as incremental solutions .This challenges businesses to be truly creative in their thought and approach to adding value to the customer.

Tackling commoditisation is one of the most critical issues facing business today and to do it successfully requires commitment, time, focus and investment. It is not a quick fix. The good news however that is the forces of commoditisation and the

downward spiral of price and profitability is not inevitable. There are ways to combat it effectively and partners to help organisations do just that. The key is to recognise the issue and start dealing with it proactively before it's too late!

Appendix 1; Real world examples of businesses that succeeded despite commoditisation pressures and trends

- **Starbucks**

- How has Starbucks taken the humble commodity of coffee beans and made a global empire from it?
- How have they been so successful that they've seen their stock go from \$2.50 to \$40 in the space of 10 years?
- They have done it by a total commitment to a differentiated coffee solution, allowing each consumer to customise their own coffee and hence meet individual requirement. They have added value to consumers
 - By creating tailored solutions
 - By making the ambience relaxing so that it's a whole experience not just a cup of coffee
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Water Market

You would think that water is the ultimate commodity wouldn't you? Water is a uniform product with little differentiation from the free stuff that comes out of the taps? And yet, the market for mineral water in the UK is worth £269.6m and is growing at 4% a year (TNS data). The Earth Policy institute based in Washington DC states that 154 billion litres of mineral are drunk worldwide an increase of more than half in the last decade. How has this industry beaten the commoditisation pressures?

It has done it by creating value that appeals to:

- Consumer concerns with tap water safety and purity
- Consumer health concerns and priorities, so many waters are marketed as part of a healthy lifestyle rather than just a drink
- Stylish consumers that see it as chic and contemporary
- Different consumer groups by differentiating and creating new areas of value such as enhanced sports waters and flavoured waters
- Retailers by creating a profitable and growing segment for them to benefit from. The product Coke was due to launch in 2004 (Dasani) was made from "purified Thames water" at 95p a bottle it would have had a 300,000 percent mark up available for manufacturer and retailer to share

Dell:

Some would argue that Dell's business model causes commoditisation in the market. It focused on providing low cost products which it achieves by having a direct model and a produce to order strategy that capitalises on using standardised components and reducing inventory.

While it is a low cost producer, the key to Dell's success has not been in merely providing cheap machines but in finding innovative ways to add value to their consumers and customers. It satisfies the needs of the consumers by giving them a highly customised product that meets the individual needs and specification. Dell has led the business market for PC's/ laptops also because it adds value to its business customers in a similar way. Dells Chief Executive Kevin Rollins has said recently that Dell's future remained with sales to businesses, which accounted for about 85 percent of last year's \$55.9 billion in sales

Bibliography

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