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Commoditization—The "Dirty Word" of Business

Few CEOs want to see their business become commoditized, but most believe that this is an inevitable result of market forces and there is little they can do to stop or delay this undesirable and unsatisfactory end position.

Are they right or wrong about the inevitability of commoditization?

They are right that over time customers and competitors can drive the commoditization of even the most specialized businesses. However, they are **wrong** in that **commoditization is not inevitable**. Most CEOs do not realize that their own organization's actions often cause or accelerate the evolution toward commoditization. Fortunately, they can use an understanding of the causes of commoditization to develop strategies and tactics which can prevent, delay, or potentially reverse this profit draining evolution and create more satisfied customers, a better long-term economic structure and higher return to shareholders.

Many industrial and consumer products contain and utilize an extraordinary amount of technology, but have gone through the painful evolution from specialty to commodity. Too often, this transition has been accelerated not only by customers seeking greater choice and buying power and competitors seeking a larger portion of industry profits, but by the suppliers themselves through strategies that focus on cost reducing their offering and the administration of their business. This leads to simplified product offerings and highly simplified pricing approaches, resulting in an averaged offering and averaged and transparent pricing. The potential negative impact of these strategies combined with the instinctive organizational drive and incentives to maximize volume at all costs, tend to accelerate rather than slow down the natural forces of commoditization of a business.

Moving away from averaging in offering design and pricing can be a powerful mechanism to increase perceived value and limit competitive intensity, resulting in improved value capture. If these changes are supported by an aligned organization mind set and pricing capability, the slide toward commoditization can be slowed, or at times reversed.

Unfortunately, expanding or customizing offerings to more closely fit customers' needs or changing the communication of price and cost will not by itself slow commoditization. Pricing strategy, tactics, and process must also be upgraded and customized to halt the slide and improve profits.

The use of new and powerful pricing tools can create meaningful and sustainable profit gains. However, they can lose much of the impact if they are not designed or implemented with insight about how customers perceive value and make their buying decisions. For example, rebates are a commonly used price communication tool in industrial products to customize pricing and limit competitive intensity. However, a mistake many businesses make is to design rebates to customers based on specific volume tiers. If they are participating in a growing market, this approach creates rebates for customers when their volume grows even if the supplier's market share for that customer declines. A better price communication approach that can limit this type of commoditization is the use of market share-based rebates. With this approach, the customer is rewarded (and a switching cost is created) for buying a larger share from a single supplier independent of total actual volume, effectively limiting competitive intensity and maintaining the position of the offering as a specialty.

Some examples of mistakes and changes in offering or pricing that have improved value capture:

- In the past, cell phone manufacturers commoditized their products by encouraging their distributors to "give the phone away" to get over switching costs and create new switching costs. Most consumers, as a result, had no concept of the value and cost of the technology in their cell phones. However, there is now a strong move toward broadening the product line and showing, if not always collecting, an appropriate full price for a new phone.
- Thermal transfer printing ribbon suppliers historically passed power to their distributors and customers by simplifying the pricing of their products. They priced all roll sizes and configurations on a common cents-per-square-inch basis, even though the product was used and purchased by the roll. Shifting to a dollars per roll pricing approach more tightly linked benefits to price and made it difficult for distributors and customers to easily apply pressure across the entire product line. As a result, power shifted back to the manufacturer and margins increased with no volume loss.
- Many specialty chemical companies left volume and price "on the table" when internally-driven cost reductions drove them to reduce their product offerings and limit their services. As a result, they nearly always under- or over-served customers, making it difficult to collect full price for the value delivered or hold share when customers' expectations were not met. A shift back to a broader product offering with increased services selectively provided to customers who recognized the value and were willing to pay, and reduced offering and price for those unwilling to pay, resulted in significant gains in both share and margin.
- A Tier 1 component supplier stopped "opening their books" to their customer and proudly communicating the details of every hard fought cost reduction they achieved. As a result, they stopped "automatically" passing on price reductions that completely negated the profit gain of their efforts – even when lower price was not needed to retain the business in either the short- or long-term.

Slowing, preventing, or reversing the drive to commoditization is neither instinctive nor easy. However, a solid approach is to parallel the problem solving concepts used in operations – identify the root cause of the problem and develop and implement a lasting corrective action. Some common mindsets and lack of customer focus within organizations are often the root causes of the averaging of their offerings and pricing that result in the accelerated commoditization of their business.

Common Commoditization Mindsets

1. Continually simplify and standardize the product/service offering despite different value realized by different customers.
2. Simplify pricing communications, to make it very easy and inexpensive to administer and to set prices and make price changes in ways that sever the direct link between perceived value and price.
3. Describe price in a way that commoditizes all elements of the offering and transfers power to customers and even competitors e.g., Use of a single multiplier applied equally to all list prices.
4. Change prices to all customers for all products in the same way and at the same time despite widely varying impact on different customers, e.g., across the board price changes.
5. Seek new and repeat sales orders strictly based on providing the lowest price, ignoring the excess value provided to some customers and their switching costs.
6. Support industry-wide standardization of product specifications and pricing approaches, limiting ability to differentiate from competition and encouraging customers to focus solely on price.
7. Limit all communications with customers to a single sales-purchasing channel, preventing vertical sales relationships and communications to all people within a customer who receive benefits.
8. Make it easy for competitors to understand the exact offering and price through easily tracked published price lists and pricing policies.
9. Establish internal measures and informal as well as formal incentives that reward gains in unit volume and gross sales dollars rather than meeting specific pricing objectives and targeted gains and losses in specific segments of the market.
10. Ignore customers switching costs, but then:
    - Overcome one-time switching costs with permanent price changes when "getting in"
    - Fail to recognize and build switching costs when "staying in."

What can a CEO do? There are no easy or quick fixes, but the mindsets that drive organizations to commoditize their business can be changed by creating, executing, and rewarding a "**value capture" mindset.**

- **Developing an in-depth understanding across all functions of how customers make money and how our offering helps them increase their profits.**
- **Understanding and measuring the real price received for every transaction (know your "pocket price").**
- **Segmenting the market by grouping buying decisions (not necessarily customers or products) based on perceived value of the offering and buying process.**
- **Creating an ability to offer customized product/service offerings (for target customers willing to pay for them at costs-near or the same as simplified offerings.**
- **Managing price level, timing, and communications as an integrated package.**
- **Ensuring that incentives and organization motivations support delivering the right value and collecting our fair share – even if unattractive volume needs to be sacrificed.**
- **Operating a pricing process that is fact based and judgment driven, but is clearly a learning process with objective and timely feedback to all participants.**

Visible leadership from the top and participation by managers at multiple levels from all functions can create the desired mindset shift across the organization in as little as one year. However, the change effort must be fact based, objective, driven from the market-in, not from the company-out, and measured on sales and profit gains, not the quantity, size or weight of reports.

If it is not easy or quick, is it really worth the significant effort and potential distraction from the current "full plate" of activities to create and sustain the capability and "Value Capture" mindset needed to prevent the commoditization of your business? In our experience, it is. But only if **sustainably improving your margins by at least two full points** justifies the time, effort, distraction and risk of the effort.

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MFL's consulting practice focuses on helping our clients build margins and volume by capturing their fair share of the value they deliver to their customers. We focus first on helping our clients view their business from the "market-in" as a way to clearly understand where and how to compete most successfully. We then focus on improving pricing because, while often under managed or managed in isolation, pricing is a powerful and integrating lever that can drive a profitable shift in mindset and capability across all functions of a business. The end products for our clients are enhanced abilities to develop winning and sustainable strategies and pricing approaches and capabilities resulting in significant top and bottom line growth.

Our extensive consulting experience at McKinsey & Company and MFL, combined with our line general management experience, has enabled us to help our clients sustainably improve profits and growth by building their organization's capabilities to increase and capture a larger share of the value they deliver.

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