Marketing
Practical Marketing Strategy

Instructor:
Craig Shoemaker, Ph.D.
International Business School

McGraw-Hill/Irwin
A Division of The McGraw-Hill Companies

McGraw-Hill Primis

Text:
Harvard Business School Marketing Cases
Walker et al.
# Contents

*Harvard Business School Marketing Cases*

<table>
<thead>
<tr>
<th>Case Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advanced Visual Systems</td>
<td>1</td>
</tr>
<tr>
<td>Case</td>
<td>1</td>
</tr>
<tr>
<td>Compaq Computer: Intel Inside?</td>
<td>13</td>
</tr>
<tr>
<td>Case</td>
<td>13</td>
</tr>
<tr>
<td>Goodyear: The Aquatred Launch (Condensed)</td>
<td>21</td>
</tr>
<tr>
<td>Case</td>
<td>21</td>
</tr>
<tr>
<td>MD Motors</td>
<td>34</td>
</tr>
<tr>
<td>Case</td>
<td>34</td>
</tr>
<tr>
<td>Oscar Mayer: Strategic Marketing Planning</td>
<td>48</td>
</tr>
<tr>
<td>Case</td>
<td>48</td>
</tr>
<tr>
<td>Pizza Hut, Inc.</td>
<td>62</td>
</tr>
<tr>
<td>Case</td>
<td>62</td>
</tr>
<tr>
<td>Black &amp; Decker Corp.: Household Products Group, Brand Transition</td>
<td>78</td>
</tr>
<tr>
<td>Case</td>
<td>78</td>
</tr>
<tr>
<td>Eastman Kodak Co.: Funtime Film</td>
<td>92</td>
</tr>
<tr>
<td>Case</td>
<td>92</td>
</tr>
</tbody>
</table>

Walker et al. • *Marketing Strategy: A Decision–Focused Approach, Fourth Edition*

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Introduction to Strategy</td>
<td>97</td>
</tr>
<tr>
<td>2. Corporate Strategy Decisions and Their Marketing Implications</td>
<td>97</td>
</tr>
<tr>
<td>3. Business Strategies and Their Marketing Implications</td>
<td>122</td>
</tr>
<tr>
<td>II. Opportunity Analysis</td>
<td>147</td>
</tr>
<tr>
<td>4. Identifying Attractive Markets</td>
<td>147</td>
</tr>
<tr>
<td>5. Industry Analysis and Competitive Advantage</td>
<td>167</td>
</tr>
<tr>
<td>6. Measuring Market Opportunities</td>
<td>190</td>
</tr>
<tr>
<td>7. Targeting Attractive Market Segments</td>
<td>209</td>
</tr>
<tr>
<td>8. Differentiation and Positioning</td>
<td>231</td>
</tr>
</tbody>
</table>
### III. Formulating Market Strategies

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>9. Marketing Strategies for New Market Entries</td>
<td>251</td>
</tr>
<tr>
<td>10. Strategies for Growth Markets</td>
<td>274</td>
</tr>
<tr>
<td>11. Strategies for Mature and Declining Markets</td>
<td>298</td>
</tr>
<tr>
<td>12. Marketing Strategies for the New Economy</td>
<td>329</td>
</tr>
</tbody>
</table>

### IV. Implementation and Control

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>14. Measuring and Delivering Marketing Performance</td>
<td>359</td>
</tr>
</tbody>
</table>
Advanced Visual Systems

By March of 1997, Harry Cochran had just completed his first two months as the new president and CEO of Advanced Visual Systems, Inc. (AVS), based in Waltham, Massachusetts. AVS developed and sold high-end data visualization software that allowed massive quantities of data to be transformed into informative two- and three-dimensional (2D and 3D) graphical representations.

The heritage of AVS hearkened back to 1988 in the software development laboratories of Stardent Computer, Inc. as an effort to understand and capitalize on the emerging market for 3D visualization software. With a focus on computer hardware, however, the management of Stardent did not want to be distracted with the intricacies and risks of software development and marketing. It therefore allowed the software development team to spin out the 3D software division. In January of 1992, this new enterprise was spawned as AVS.

The company initially enjoyed tremendous growth. By 1994, sales were over $17 million, but after only modest growth in 1995, sales in 1996 had dropped back to 1994 levels. (See Exhibit 1, Financial Statements and Exhibit 2, Revenue Analysis). AVS seemed to have hit a ceiling in spite of the high esteem it had earned in the marketplace. It was up to Cochran to put the company back on track.

Graphic Visualization Software

Visualization software was used by technical and business professionals who recognized that if they could transform large data sets into useful information, they would accelerate the understanding of complex problems, and that whoever made the most effective use of this asset would have an enormous competitive advantage. In 1992, most of these end-users were engineers using expensive and sophisticated systems in large government and industry computer laboratories.

Accordingly, the first product developed by AVS was AVS (Application Visualization
Advanced Visual Systems, Inc.

**System**, designed to facilitate scientific research that was sold directly to these large laboratory users. Since often these users relied on either internal or external software developers to create applications customized to their needs, AVS also created an application development product called AVS/Expresos: a multi-platform, component-based software environment for building applications with interactive visualization and graphics features. AVS/Expresoso employed an innovative object-oriented visual programming interface to create, modify, and connect application components. It provided object kits that contained numerous building blocks for constructing visualization applications and application components such as graphics display, image processing, and geographic rendering. AVS engineers also developed a version of AVS/Expresoso called VIZ Expresoso for end-users.

The landscape, however, was changing in the mid-1990s. With the cost of 3D-capable computers falling below $3,000 and the proliferation of 3D-enabled web browsers and interactive visualization software, the available market for high-performance 3D solutions was expanding exponentially and influencing the way in which businesses and technical professionals viewed and analyzed data. Increasingly complex and voluminous data were overwhelming traditional analysis techniques such as spreadsheets, simple charts and graphs, and two-dimensional static pictorial representations. In a rapidly expanding set of disciplines, these conventional methods were being supplemented with, and in many cases supplanted by, more sophisticated visualization techniques that permitted more sophisticated data analysis such as that offered by AVS.

Visualization was thus becoming an increasingly important tool in a number of industries. An oil exploration company, for example, interpreted 3D seismic surveys to pinpoint more effectively the location of promising oil deposits. A telecommunications company used multi-dimensional relationships to determine the best location for cellular telephone receivers. A defense contractor took data from multiple sources (e.g., satellite imagery, aircraft telemetry, etc.) and built an integrated visual command-and-control system. The same telecommunications company used customer-related multi-dimensional relationships to analyze how to retain customers. An engineering company visually analyzed the data collected from simulations to improve design efficiencies of circuit boards. A medical imaging company viewed gamma camera data more effectively to provide radiologists with a more accurate diagnostic tool. A financial services company used advanced visualization techniques to uncover new customers from large prospect databases.

The end-users of AVS software were a diverse group. In 1996, the geospatial, engineering, and medical imaging markets represented approximately 77% of the company's overall business, although the customers who bought AVS products were still mostly software developers who customized visualization packages and bundled AVS software into final

<table>
<thead>
<tr>
<th>End-users of AVS Software</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Geospatial</td>
<td>5%</td>
</tr>
<tr>
<td>Defense/intelligence</td>
<td>15%</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>10%</td>
</tr>
<tr>
<td>Environmental</td>
<td>7%</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>20%</td>
</tr>
<tr>
<td>Other Markets</td>
<td>3%</td>
</tr>
<tr>
<td>Engineering</td>
<td>10%</td>
</tr>
<tr>
<td>Medical Imaging</td>
<td>30%</td>
</tr>
</tbody>
</table>
deliverables. AVS's developer customers included independent software vendors (ISV's) who sold their applications to third party end-users, system integrators who built application solutions for their customers, and internal software development groups who created applications for deployment to users within their organizations. In all of these cases, application developers understood end-user requirements and built applications designed to solve their particular needs. They used either AVS development tools such as AVS/Expresoso as a development framework to create their own software or end-user products such as AVS to imbed sophisticated visualization capabilities as components in their software. The most common alternative to using AVS products was to use traditional development approaches. The primary source of competition for AVS/Expresoso, therefore, was in-house development.

AVS/Expresoso pre-built graphics and visualization modules thus saved both time and effort for the developer, which translated to faster time-to-market and thus faster time-to-revenue. The AVS/Expresoso Developer's Package was sold to developers for $25,000 (UNIX) or $18,000 (PC). Usually developers also purchased one or two additional developer seats at $6,000 (UNIX) or $4,000 (PC) per seat. From 1994 to 1996, about 200 developer packages had been sold at an average of, including additional seats, just over $25,000.

Once a developer completed an application using AVS/Expresoso as the development environment, it would purchase application seats for each customer who purchased their software ($2,950 UNIX, $1,450 PC quantity at list, lessoso discounts) to deploy the application with AVS/Expresoso objects embedded. These were known as “run-time licenses.” The expectation was that this scenario would produce a recurring revenue stream for four to five years.

The run-time license revenue that AVS could garner was thus potentially more important than the revenue generated from the initial product/developer tool sale. AVS, however, had failed to reap the full potential of this revenue source. Only about 10% of development projects actually generated any run-time licenses. Those that did sold from 5 to 50 application seats, or an average of 20 seats. The price paid for each of these seats netted out to just under $1,000, on average, after quantity discounts were applied.

**Distribution of AVS Products**

AVS sold its product through several channels. It sold directly to customers (developers and end-users), through independent distributors, or through its own subsidiaries. Other software companies also purchased AVS products to imbed into their own products.

In 1993, AVS had expanded internationally with the acquisition of Uniras, a Denmark-based supplier of computer graphics products with sales of $11 million. Since its parent company had gone bankrupt, AVS was able to acquire Uniras at the “fire sale” price of under $1 million. Uniras offered a complementary product line of charting and graphing products, Toolmaster and Gsharp, and immediate accessoso to the growing European market supported by established sales and product support teams. Following the acquisition, Uniras’ European offices became AVS subsidiaries but continued to operate as autonomous divisions of AVS.

By the end of 1996, AVS had established distribution channels throughout the world,
Advanced Visual Systems, Inc.  

serving its products primarily through a direct sales force in the United States and through subsidiaries in Denmark, France, Germany, Italy, and the United Kingdom, and through distributors in certain other countries. Kubota Graphics Technologies, Inc., which had exclusive distribution rights in Japan and other Asian countries, had been very successful in selling AVS products there.

The AVS sales organization in the United States consisted of seven direct sales field representatives and two telesales representatives. The direct sales people met face to face with prospective customers, and the telesales representatives telephoned prospective customers, followed up and qualified leads for the direct sales organization, accelerated order processing and receipt at the end of the sales pipeline, and contacted existing customers to make follow-on sales.

**AVS Operations**

Users of AVS software demanded very little support. Indeed, AVS only had two customer support engineers on staff in the United States. When developer customers asked questions these individuals could not answer, they were usually referred directly to one of the twenty software design engineers. Uniras offered support in Europe and Kubota in Japan. While customers could get their questions answered by highly qualified engineers, the engineers often complained that the questions distracted them from the focused attention required of writing code for new programs.

AVS did offer some consulting services, but since customers were more in touch with the unique requirements of each vertical market¹, AVS had chosen not to have any specialized end-user industry expertise *a priori*. Since the gross margin on professional services were quite high (40%), if a customer wanted some support in their development efforts, typically AVS would hire a consultant for a specific project. Finding and training a consultant might, however, take as much as four months before he or she could be productive. For smaller projects, AVS couldn’t keep up with demand. In 1996, AVS had four full-time consultants who were paid between $70,000 and $100,000 per year depending on their level of expertise. Consulting services only contributed about 5% of total revenue (or just under $1 million) in 1996.

The real focus of AVS was to develop continually enhanced tools. Its engineers therefore focused on making marginal improvements to AVS software. When new versions were completed, they were turned over to the marketing and sales department so that they could be used in their sales pitch to potential customers.

AVS had invested over 200 staff-years in development of its products. The company’s core technology and knowledge base in graphic visualization therefore presented a significant barrier to entry to new competitors.

¹ A vertical market refers to a segment of end-user market defined by common industrial technology needs.
Vertical Markets

Medical Imaging

In 1995, AVS had embarked on a program to target sales directly to end-users in certain vertical markets. The first such market targeted was that of medical imaging.

In medical imaging the main application areas for visualization included computer-aided medical diagnostics, image-guided surgery, and radiation treatment planning. Medical researchers and physicians using imaging applications were able to visualize non-invasive computer models of the human body. These models helped better detect, measure, and operate on patients with serious health conditions like cancerous tumors, Alzheimer's disease, epilepsy, and Parkinson's disease. AVS products were used by a significant percentage of the research hospitals and the emerging treatment planning segments where 3D imaging was important. The company had also been quite successful in the medical OEM segment of this market. To date, the company had over twenty OEM customers.

During 1995 and 1996, AVS had invested over $2 million in marketing, sales, and application development in medical imaging. It became apparent, however, that the current medical imaging market potential for visualization software and services was relatively small, estimated to be $50 million. The biggest competitor in the market sold about $12.5 million, while in-house development accounted for about $30 million. The remaining $7.5 million was spread among another six players including AVS. By 1996, this market accounted for only 10% of AVS’s sales, and the effort to market directly into this market were dropped. AVS’s annual sales in the medical market were about $1.8 million.

Alternative Vertical Markets

The strategy of entering certain vertical markets, however, was not dropped. With the experience of the medical imaging initiative behind them, criteria for entering new markets were developed which included the potential to dominate an application area by achieving a 40% market share. The other markets under consideration were the geospatial and engineering markets where a number of AVS products were already being used. Meanwhile, some consideration was being given to the fledgling, but potentially even greater, market for visual data mining/data warehouse visualization.

Management estimated that an investment of $2 million would be required to target either the geospatial or the engineering market. This included about 10 employees at $150,000 apiece in sales, management, customer support, consulting, and product development, and an additional $500,000 for marketing. Any consultants who might be added to help new users customize applications to their specific uses, however, would pay for themselves after a month of training.

Geospatial

The geospatial market consisted of several different vertical markets, some technical and some commercial, which had in common a compelling need to use sophisticated visualization techniques to analyze massive amounts of data involving relationships below, on, or above the
surface of the Earth. In all of these applications, geographically dependent data was analyzed spatially to provide greater insight about complex interdependencies among the data. Some examples of these types of visualization applications included remote sensing satellite imaging, earth resources management, radio frequency propagation modeling, and customer retention analysis.

By 1996, AVS had already made some inroads in a number of technical geospatial vertical markets, including defense/intelligence (accounted for 5% of AVS end-user base), oil and gas (15%), environmental (10%), and telecommunications (7%). More recently, it had begun to penetrate segments of the high-end business visualization market, initially with applications delivered into telecommunications and financial services vertical markets. Opportunities were also arising in companies that needed visualization applications in other business markets as they began to recognize the value visualization offered. Typical of these new opportunities were data mining/data warehouse visualization applications for customer retention and database marketing programs. As had been the case in the technical markets, providing the business user with a visual framework within which to analyze many variables of transactional, demographic, and customer purchase data provided a deeper level of insight than was available with traditional analysis techniques.

Two independent software vendors (ISVs), ESRI and Intergraph, controlled over half of the geospatial software tools market. The remaining market share was split between eight other vendors.

New high-resolution satellite data sources were scheduled to emerge into the commercial market in 1998. The availability of relatively low-cost, high-resolution, ortho-rectified imagery (geometrically correct) from these new satellites could fundamentally change the nature of the geospatial market. Intelligent "image maps" could become the standard data set for manipulation and analysis within a geospatial system. Two-dimensional satellite images that were texture-mapped and draped over three-dimensional terrain data could become the new geographic framework.

AVS management estimated that the current market for geospatial visualization software and services exceeded $100 million. In addition, classified projects from the Department of Defense/Intelligence community could be at least that amount. AVS sales in the geospatial market were about $7 million in 1996, although only a fraction of these sales were directly to end-users.

Choosing the geospatial market seemed attractive. Since there appeared to be some commonality between the various geospatial applications, the incremental cost to enter each segment of the market would only be about another $1 million over the $2 million required to make the initial thrust into a single segment of the market. However, it was uncertain whether the existence of the commonality was substantive enough. Although $1 million was a relatively absorbable investment size, AVS management wondered about how to go about verifying the significance of the commonality.
Advanced Visual Systems, Inc.

Engineering

The engineering market accounted for 30% of AVS end-user sales in 1996. It was segmented into multiple markets that included major industries such as aerospace, automotive, and semiconductor. Within engineering, visualization was used in computed-aided engineering (CAE) and electronic design automation (EDA). Ninety percent of all software sales in this market were directly to end-users.

In the CAE market, AVS had two types of customers. The first type was comprised of developers of CAE applications that built post-processors for resale to end-user customers. The second type of customer were end-users and included major industrial companies, such as Boeing and Ford, which built in-house post-processors to visualize results from multiple analysis applications. Integrating all aspects of the design processes was a major trend within engineering markets and this ability to use AVS products to integrate and view results from multiple applications had tremendous value to these companies. The worldwide market for CAE tools was estimated to be about $5 billion and growing at 10% per year.

While AVS had no significant share of the $1.6 billion worldwide EDA market (1995), it counted four major end-users as customers with sales of almost $200,000 in the first two quarters of 1996. There were several major competitors in this market, the largest of which had tens of thousands of seats around the world. The EDA market was, however, projected to grow at almost 17% per year.

The potential for visualization software and services in these engineering markets was thought to be approximately $50 million, but there were no major competitors. Ninety percent of all applications were developed in-house by users. AVS currently sold about $2 million in this market, a four percent market share. The AVS management thought that it could substantially increase the presence if AVS could offer an application that can be seamlessly integrated with others already in use by end-users. One marketing manager was arguing for this engineering vertical market by saying, “this is an opportunity to become a star in a niche market that is too small for strong competitors to get in but good enough for a company like ours.”

Harry Cochran and the Future of AVS

Harry Cochran had been hired in early 1997 and was given broad latitude to engineer the revival of AVS. He was a veteran entrepreneur in the software industry. Prior to joining AVS, he had been chairman of TRUE Software, Inc. and founder, president, and CEO of Expressosoway Technologies Corporation Technologies, a pioneer in interactive decision support systems. Cochran had overseen Expressosoway’s growth from initial start-up to its ultimate sale to Sybase. At Sybase, he served as vice president of Advanced Indexing Products before deciding that new opportunities beckoned.

When he first arrived at AVS, Harry interviewed nearly all 105 employees in the company and asked each of them to share their thoughts on what was right or wrong with the company and where opportunities lay. He discovered a disillusioned group sailing what he termed a “rudderlessoso ship” with little pro-active decision-making, inter-divisional strife, and no
dominant market position in any of the vertical markets in which AVS sold its products. Almost everyone had been “burned” so often that they were pessimistic about the future of the company and taking any sort of risk. The unspoken but prevalent corporate credo was “don’t lose” rather than “win”.

Product development engineers felt burned because of lack of follow-through from the sales and marketing team. From the perspective of the sales and marketing team, however, those in product development were too focused on adding bells and whistles to existing software without the benefit of any end-user input. They often were left frustrated in their efforts to sell directly to large end-users or to developers who were trying to customize products to those end-users. Indeed, AVS had been technology-driven to the point where the people in marketing and sales were only brought in to figure out how to sell new products after they were completed.

Often development engineers were distracted from their work by requests for quality assurance, to produce documentation, or to offer customer support. They thus avoided such distractions whenever possible, often leaving these activities incomplete.

With increasing pressure to increase profitability and sales, everyone either retreated to backbiting or discovered the security of monastic seclusion.

Harry did, however, find a number of strengths that offered the foundation for opportunity. The balance sheet was healthy. AVS had over $7 million in cash, no debt, a history of at least marginal profitability, a good reputation, and a core of good technicians. The company had a large net operating loss carry-forward from Stardent that would, management thought, provide shelter for a significant portion of future profits.

After then studying the dynamics of both the software industry and those of AVS’s primary customers, Cochran was considering what changes might be required to bring AVS out of the doldrums. He thought that AVS had been trapped in an outdated perception of the marketplace. While the developer market was still strong and sophisticated users in specialized laboratories still relied on AVS software, the market was essentially flat. He saw that the increased usage of data visualization within the specialized vertical markets represented a viable opportunity. AVS would never be able to compete in this market, however, if it just kept making its existing software more complex, and, if less sophisticated users were courted, AVS would have to develop its consulting and service capabilities to offer adequate support and customization.

Cochran knew that he would have to answer several key questions before proceeding: what vertical markets should be targeted and what resources would be required to realize the opportunity of those markets? In addition, he wondered what changes should be made to the current operations better to meet the needs of existing customers.
Exhibit 1
Financial Statements

AVS Balance Sheet
1994 – 1996

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CURRENT ASSETS:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and Cash Equivalents</td>
<td>6,476</td>
<td>6,969</td>
<td>6,574</td>
</tr>
<tr>
<td>Accounts Receivable Trade - Net</td>
<td>4,151</td>
<td>4,871</td>
<td>3,890</td>
</tr>
<tr>
<td>Inventories</td>
<td>133</td>
<td>110</td>
<td>82</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>326</td>
<td>332</td>
<td>323</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>11,086</td>
<td>12,282</td>
<td>10,869</td>
</tr>
<tr>
<td>PROPERTY AND EQUIPMENT - NET</td>
<td>906</td>
<td>1,169</td>
<td>852</td>
</tr>
<tr>
<td>OTHER ASSETS</td>
<td>122</td>
<td>129</td>
<td>92</td>
</tr>
<tr>
<td>SOFTWARE DEVELOPMENT</td>
<td>651</td>
<td>581</td>
<td>404</td>
</tr>
<tr>
<td>Total Assets</td>
<td>12,764</td>
<td>14,161</td>
<td>12,216</td>
</tr>
</tbody>
</table>

LIABILITIES AND STOCKHOLDERS' EQUITY

| CURRENT LIABILITIES:                |       |       |       |
| Short-term Senior Debt             |       |       |       |
| Accounts Payable                   | 1,146 | 1,354 | 697   |
| Accrued Expenses                   | 3,636 | 3,592 | 3,715 |
| Deferred Support Revenue           | 3,292 | 3,907 | 3,349 |
| Total Current Liabilities          | 8,074 | 8,853 | 7,761 |

| LONG-TERM DEBT                     |       |       |       |
| Capital Equipment Financing        |       |       |       |
| Subordinated Debt                  |       |       |       |
| Obligation Under Capital Lease     | 186   | 86    | -     |
| Total Long-term Debt               | 186   | 86    | -     |

| STOCKHOLDERS' EQUITY               |       |       |       |
| Total Liabilities and Stockholders' Equity | 4,505 | 5,222 | 4,456 |

| Total                                      | 12,764| 14,161| 12,217|
### AVS Income Statement
**1994 – 1996**

<table>
<thead>
<tr>
<th>Product</th>
<th>1994 % of Revenue</th>
<th>1995 % of Revenue</th>
<th>1996 % of Revenue</th>
<th>1996 % of Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVS</td>
<td>6.272 35.3%</td>
<td>4.777 24.6%</td>
<td>3.575 20.0%</td>
<td></td>
</tr>
<tr>
<td>Toolmaster</td>
<td>4.718 27.3%</td>
<td>3.412 17.0%</td>
<td>2.245 12.5%</td>
<td></td>
</tr>
<tr>
<td>AVS/Express</td>
<td>3.66 2.1%</td>
<td>3.103 16.0%</td>
<td>3.956 22.1%</td>
<td></td>
</tr>
<tr>
<td>Gharp</td>
<td></td>
<td></td>
<td>804 4.5%</td>
<td></td>
</tr>
<tr>
<td>VIS/Express</td>
<td></td>
<td>0.0%</td>
<td>0.0%</td>
<td>128 0.7%</td>
</tr>
<tr>
<td><strong>TOTAL PRODUCT</strong></td>
<td>11.356 66.8%</td>
<td>12.097 62.3%</td>
<td>10.993 61.4%</td>
<td></td>
</tr>
<tr>
<td>Support</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AVS</td>
<td>1.831 10.6%</td>
<td>2.410 12.4%</td>
<td>2.089 11.7%</td>
<td></td>
</tr>
<tr>
<td>Toolmaster</td>
<td>4.667 27.2%</td>
<td>4.657 24.0%</td>
<td>2.451 23.7%</td>
<td></td>
</tr>
<tr>
<td>AVS/Express</td>
<td>21 0.1%</td>
<td>234 1.2%</td>
<td>751 4.2%</td>
<td></td>
</tr>
<tr>
<td>Gharp</td>
<td></td>
<td>128 0.7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>VIS/Express</td>
<td></td>
<td>12 0.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL SUPPORT</strong></td>
<td>6.599 37.9%</td>
<td>7.301 37.0%</td>
<td>7.231 40.4%</td>
<td></td>
</tr>
<tr>
<td>Consulting</td>
<td>722 4.2%</td>
<td>984 5.1%</td>
<td>984 5.6%</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>358 2.1%</td>
<td>882 4.5%</td>
<td>349 1.8%</td>
<td></td>
</tr>
<tr>
<td>Bundled Support</td>
<td>(1.717) (9.9%)</td>
<td>(1.857) (9.6%)</td>
<td>(1.541) (8.6%)</td>
<td></td>
</tr>
<tr>
<td><strong>REVENUE</strong></td>
<td>17.258 100.0%</td>
<td>19.407 100.0%</td>
<td>17.916 100.0%</td>
<td></td>
</tr>
<tr>
<td>Cost of Sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td>1.472 8.5%</td>
<td>1.353 7.0%</td>
<td>1.582 8.8%</td>
<td></td>
</tr>
<tr>
<td>Consulting</td>
<td>350 2.0%</td>
<td>799 4.1%</td>
<td>745 4.2%</td>
<td></td>
</tr>
<tr>
<td>Support</td>
<td>1.093 5.9%</td>
<td>1.746 9.0%</td>
<td>1.363 7.4%</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL COST OF SALES</strong></td>
<td>2.915 16.4%</td>
<td>3.998 20.1%</td>
<td>3.683 21.4%</td>
<td></td>
</tr>
<tr>
<td><strong>GROSS MARGIN</strong></td>
<td>14.433 83.6%</td>
<td>15.509 79.9%</td>
<td>14.236 78.6%</td>
<td></td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Engineering</td>
<td>2.859 16.0%</td>
<td>3.300 17.3%</td>
<td>3.481 19.4%</td>
<td></td>
</tr>
<tr>
<td>Sales-Domestic</td>
<td>2.241 13.0%</td>
<td>2.707 13.9%</td>
<td>2.795 15.6%</td>
<td></td>
</tr>
<tr>
<td>Sales-International</td>
<td>6.310 30.8%</td>
<td>6.066 29.4%</td>
<td>5.182 28.9%</td>
<td></td>
</tr>
<tr>
<td>Marketing</td>
<td>1.462 8.5%</td>
<td>1.737 9.0%</td>
<td>1.706 9.0%</td>
<td></td>
</tr>
<tr>
<td>F&amp;A</td>
<td>1.532 8.9%</td>
<td>1.596 8.2%</td>
<td>2.108 11.9%</td>
<td></td>
</tr>
<tr>
<td>FAS 86 Deferred</td>
<td>(281) -1.6%</td>
<td>(342) -1.8%</td>
<td>(357) -2.0%</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL OPERATING EXPENSE</strong></td>
<td>13.123 76.0%</td>
<td>14.756 76.0%</td>
<td>14.915 83.2%</td>
<td></td>
</tr>
<tr>
<td><strong>NET OPERATING INCOME</strong></td>
<td>1.310 7.6%</td>
<td>7.53 3.9%</td>
<td>(829) -4.4%</td>
<td></td>
</tr>
<tr>
<td>Interest Income / Exh G/L</td>
<td>206 1.2%</td>
<td>286 1.5%</td>
<td>240 1.3%</td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td></td>
</tr>
<tr>
<td><strong>NET INCOME BEFORE TAX</strong></td>
<td>1.516 8.8%</td>
<td>1.039 5.4%</td>
<td>(569) -3.3%</td>
<td></td>
</tr>
<tr>
<td><strong>INCOME TAX</strong></td>
<td>420 2.4%</td>
<td>400 2.1%</td>
<td>236 1.3%</td>
<td></td>
</tr>
<tr>
<td><strong>NET INCOME (LOSS)</strong></td>
<td>1.096 6.4%</td>
<td>639 3.3%</td>
<td>(925) -4.0%</td>
<td></td>
</tr>
</tbody>
</table>
Advanced Visual Systems, Inc.  

Exhibit 1 (Continued)  
Financial Statements

**AVS Cash Flow Statement**  
**1994 – 1996**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income (loss)</td>
<td>1,094</td>
<td>639</td>
<td>(825)</td>
</tr>
<tr>
<td>Depreciation and Amortization</td>
<td>889</td>
<td>1,038</td>
<td>1,290</td>
</tr>
<tr>
<td>Changes in Assets and Liabilities</td>
<td>578</td>
<td>45</td>
<td>(37)</td>
</tr>
<tr>
<td><strong>Cash Provided by Operating Activities</strong></td>
<td>2,561</td>
<td>1,722</td>
<td>428</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Flows From Investing Activities</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases of Property and Equipment</td>
<td>(761)</td>
<td>(866)</td>
<td>(440)</td>
</tr>
<tr>
<td>Investment in Computer SW Dev. costs</td>
<td>(286)</td>
<td>(340)</td>
<td>(357)</td>
</tr>
<tr>
<td><strong>Cash used by Investing Activities</strong></td>
<td>(1,047)</td>
<td>(1,206)</td>
<td>(797)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Flows From Financing Activities</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of Common Stock</td>
<td>16</td>
<td>48</td>
<td>30</td>
</tr>
<tr>
<td>Exercise Stardent Options</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retirement of Common Stock</td>
<td>(1)</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>ST Senior Debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LT Capital Equipment Debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LT Subordinated Debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payments on Capital Lease Obligations</td>
<td>(69)</td>
<td>(101)</td>
<td>(86)</td>
</tr>
<tr>
<td><strong>Cash used by Financing Activities</strong></td>
<td>(54)</td>
<td>(53)</td>
<td>(56)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Effect of Exchange Rate Changes on Cash</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[Equation]</td>
<td>(221)</td>
<td>30</td>
<td>30</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Increase (Decrease) In Cash and Equivalents</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[Equation]</td>
<td>1,239</td>
<td>493</td>
<td>(395)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash and Cash Equivalents Beg of Year</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[Equation]</td>
<td>5,237</td>
<td>6,476</td>
<td>6,969</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash and Cash Equivalents End of Year</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[Equation]</td>
<td>6,476</td>
<td>6,969</td>
<td>6,574</td>
</tr>
</tbody>
</table>
### Exhibit 2

#### Revenue Analysis

<table>
<thead>
<tr>
<th>(x 1,000)</th>
<th>Total</th>
<th>US</th>
<th>Europe</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AVS5</td>
<td>6,272</td>
<td>4,777</td>
<td>3,575</td>
<td>2,795</td>
</tr>
<tr>
<td>Toolmaster</td>
<td>4,718</td>
<td>3,412</td>
<td>2,245</td>
<td>321</td>
</tr>
<tr>
<td>AVS/Express</td>
<td>366</td>
<td>3,103</td>
<td>3,956</td>
<td>326</td>
</tr>
<tr>
<td>Gsharp</td>
<td>805</td>
<td>804</td>
<td>21</td>
<td>49</td>
</tr>
<tr>
<td>VIS/Express</td>
<td>43</td>
<td>80</td>
<td>302</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total Product</strong></td>
<td>11,356</td>
<td>12,097</td>
<td>10,993</td>
<td>3,442</td>
</tr>
<tr>
<td><strong>Support</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AVS5</td>
<td>1,831</td>
<td>2,410</td>
<td>2,089</td>
<td>1,272</td>
</tr>
<tr>
<td>Toolmaster</td>
<td>4,687</td>
<td>4,657</td>
<td>4,251</td>
<td>714</td>
</tr>
<tr>
<td>AVS/Express</td>
<td>21</td>
<td>234</td>
<td>751</td>
<td>20</td>
</tr>
<tr>
<td>Gsharp</td>
<td>128</td>
<td>5</td>
<td>5</td>
<td>122</td>
</tr>
<tr>
<td>VIS/Express</td>
<td>12</td>
<td>3</td>
<td>8</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total Support</strong></td>
<td>6,539</td>
<td>7,301</td>
<td>7,231</td>
<td>2,006</td>
</tr>
<tr>
<td><strong>Consulting</strong></td>
<td>722</td>
<td>984</td>
<td>984</td>
<td>422</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>358</td>
<td>882</td>
<td>249</td>
<td>81</td>
</tr>
<tr>
<td><strong>Bundled Support</strong></td>
<td>-1,717</td>
<td>-1,857</td>
<td>-1,541</td>
<td>-510</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>17,258</td>
<td>19,407</td>
<td>17,916</td>
<td>5,441</td>
</tr>
<tr>
<td><strong>Direct Expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td>1,472</td>
<td>1,353</td>
<td>1,582</td>
<td></td>
</tr>
<tr>
<td>Consulting</td>
<td>350</td>
<td>799</td>
<td>745</td>
<td></td>
</tr>
<tr>
<td>Support</td>
<td>1,003</td>
<td>1,746</td>
<td>1,503</td>
<td></td>
</tr>
<tr>
<td><strong>Contribution</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td>9,884</td>
<td>10,744</td>
<td>9,411</td>
<td></td>
</tr>
<tr>
<td>Consulting</td>
<td>372</td>
<td>185</td>
<td>239</td>
<td></td>
</tr>
<tr>
<td>Support</td>
<td>5,536</td>
<td>5,555</td>
<td>5,728</td>
<td></td>
</tr>
<tr>
<td><strong>Contribution Margins</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td>87.0%</td>
<td>88.8%</td>
<td>85.6%</td>
<td></td>
</tr>
<tr>
<td>Consulting</td>
<td>51.5%</td>
<td>18.9%</td>
<td>24.3%</td>
<td></td>
</tr>
<tr>
<td>Support</td>
<td>84.7%</td>
<td>76.1%</td>
<td>79.2%</td>
<td></td>
</tr>
<tr>
<td><strong>Product as % of Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product</td>
<td>65.8%</td>
<td>62.3%</td>
<td>61.4%</td>
<td>63.3%</td>
</tr>
<tr>
<td>Support</td>
<td>37.9%</td>
<td>37.6%</td>
<td>40.4%</td>
<td>36.9%</td>
</tr>
<tr>
<td><strong>Support as % of Total</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product</td>
<td>29.2%</td>
<td>50.5%</td>
<td>58.4%</td>
<td>45.5%</td>
</tr>
<tr>
<td>Support</td>
<td>37.9%</td>
<td>37.6%</td>
<td>40.4%</td>
<td>36.9%</td>
</tr>
<tr>
<td><strong>Support as % of Product</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AVS5</td>
<td>99.3%</td>
<td>136.5%</td>
<td>189.4%</td>
<td>222.4%</td>
</tr>
<tr>
<td>Toolmaster</td>
<td>5.7%</td>
<td>7.5%</td>
<td>19.0%</td>
<td>6.1%</td>
</tr>
<tr>
<td>AVS/Express</td>
<td>0.0%</td>
<td>15.9%</td>
<td>0.0%</td>
<td>10.2%</td>
</tr>
<tr>
<td>Gsharp</td>
<td>0.0%</td>
<td>0.0%</td>
<td>15.9%</td>
<td>0.0%</td>
</tr>
<tr>
<td>VIS/Express</td>
<td>2.9%</td>
<td>3.8%</td>
<td>2.6%</td>
<td>3.2%</td>
</tr>
<tr>
<td><strong>End user sales</strong></td>
<td>$8,103</td>
<td>$7,992</td>
<td>$7,021</td>
<td>$4,067</td>
</tr>
<tr>
<td><strong>Developer Sales</strong></td>
<td>$9,792</td>
<td>$11,406</td>
<td>$11,203</td>
<td>$1,381</td>
</tr>
<tr>
<td><strong>Total Sales by Product</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AVS5</td>
<td>$8,103</td>
<td>$7,187</td>
<td>$5,664</td>
<td>$4,067</td>
</tr>
<tr>
<td>Toolmaster</td>
<td>$9,405</td>
<td>$8,069</td>
<td>$6,496</td>
<td>$1,035</td>
</tr>
<tr>
<td>AVS/Express</td>
<td>$387</td>
<td>$3,337</td>
<td>$4,707</td>
<td>$346</td>
</tr>
<tr>
<td>Gsharp</td>
<td>$0</td>
<td>$805</td>
<td>$932</td>
<td>$0</td>
</tr>
<tr>
<td>VIS/Express</td>
<td>$0</td>
<td>$0</td>
<td>$425</td>
<td>$0</td>
</tr>
</tbody>
</table>
Compaq Computer: Intel Inside?

Compaq Computer’s Presario line of notebooks for the consumer market had broken all conceivable sales goals by fall 1997. In the year since its launch, Compaq had catapulted from a 3% market share to its current level of 46%, passing the previous market leader, Toshiba, whose share had fallen from 60% to 40%.

Market research had played a crucial role in developing the Presario line. “We ran our consumer notebook concept past some focus groups,” said Greg Memo, vice president of the Mobile Products Division for the Consumer Products group, “and we couldn’t believe the results. But it was great, and we ended up with a runaway success. We sold 40,000 machines—our entire initial production run—in the first few months. We could have sold twice that many, but we did really well, we got in, we got out, and no one got hurt.”

Despite the success of the current line, threats loomed as the market shifted. In order to maintain its market share, Compaq needed to develop a low-priced machine. Using a processor that was not made by Intel offered the easiest way to cut costs. But Intel held 82% of the processor market and had established itself as a brand name with its “Intel Inside™” campaign. Compaq had emblazoned the Intel Inside™ sticker on its own machines in order to take advantage of Intel’s cooperative advertising payments. Would consumers buy a notebook with a non-Intel processor? Or would they stay with the Intel name brand and cost Compaq its leadership in a market it had defined and filled?

Compaq’s Consumer Notebook

Compaq’s Consumer Division, in an effort to design a true consumer notebook computer, had conducted a series of focus groups with consumers to determine their desires in a machine. Previously, most consumer notebooks had been underpowered, undersized, high-priced leftovers from the corporate channel. The Presarios that had debuted in Fall 1996 had 16 MB RAM across all products (twice the amount commonly available at the time), multi-media capabilities, and a lower price.

---

1 A processor, also known as CPU (central processing unit), is the brain of a computer.

2 Consumer sales are distinguished from corporate sales by the entity providing the funds. A computer purchased with personal funds is considered a consumer sale, even if it is used for work at home.
Retailers loved the line as well, along with Compaq’s new attention to their needs. Rather than timing launches to coincide with new technological developments, Compaq targeted new lines for prime retailing seasons, such as back-to-school and holidays. In a market where product shortages were routine, Compaq did its best to provide dependable supply so that retailers could buy advertising in advance. The company priced its machines to hit standard retail price points. In addition, Compaq’s executives listened to the retailers. It was the retail channel that delivered the news in 1997 that the market was moving to lower price points. Compaq had to come up with a profitable sub-$2,000 notebook or risk losing the low end of the market altogether.

By January 1997, four months after the Presario introduction, Compaq’s share of the consumer notebook market had increased to 27%, from 3%. A year later, Compaq led the market, with a 46% share of units, 33% of dollars. It had defined the consumer laptop market and was busily filling it. Even as it took market share from competitors, the entire market grew. (See Table A.)

### Table A  Market Size and Share

<table>
<thead>
<tr>
<th></th>
<th>June ’96</th>
<th>Sept. ’97</th>
</tr>
</thead>
<tbody>
<tr>
<td>Toshiba</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IBM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NEC</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apple</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Texas Inst.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compaq</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fujitsu</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


### Pricing Issues

In part, Compaq could only blame itself for the steady price erosion. In early 1997, it had introduced the first fully functional desktop PC from a major brand priced at less than $1,000. Some of the cost savings had come from using a processor made by Cyrix, one of Intel’s competitors. The machine appealed to consumers who had previously balked at PCs’ high prices. Spurred by this, Intel worked with Compaq to develop a new sub-$1,000 machine using its own processor. This machine, with the same performance and features as the Cyrix model, was forecasted to outsell the Cyrix version significantly.

Falling prices for desktops depressed those for notebooks. Table B shows the shift in notebook prices between January and July of 1997.
Compaq Computer: Intel Inside?

Table B  Distribution of Consumer Notebooks by Price, January and July 1997

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $1,000</td>
<td>1.0%</td>
<td>2.4%</td>
</tr>
<tr>
<td>$1,000-$1,500</td>
<td>15.5%</td>
<td>20.9%</td>
</tr>
<tr>
<td>$1,500-$2,000</td>
<td>18.8%</td>
<td>29.3%</td>
</tr>
<tr>
<td>$2,000-$3,000</td>
<td>50.0%</td>
<td>32.2%</td>
</tr>
<tr>
<td>$3,000+</td>
<td>15.0%</td>
<td>15.2%</td>
</tr>
</tbody>
</table>


Competition

Compaq faced price pressures from Toshiba, its archrival and the recently deposed market leader. Toshiba generally charged $100 to $200 less than Compaq on comparably equipped machines. As a vertically integrated subsidiary of a big Japanese conglomerate, it had cost advantages that Compaq could not rival. Toshiba made all the major notebook components aside from the processors, which were exclusively purchased from Intel. Toshiba also maintained a much larger engineering design team than did Compaq's Consumer Division, allowing it to react quickly to any design or technological changes in the industry.

Other competitors included IBM and Fujitsu. IBM's machines, Compaq executives admitted, "are technically superior to ours. But we beat them on price for performance." Fujitsu had the low end of the market.

By fall 1997, Compaq had a 45% share of the consumer notebook market, due to the debut of the Presario 1210, its first sub-$2,000 notebook. This machine, with an Intel processor, was popular with both first-time notebook buyers and repeat purchasers who needed a bare-bones machine to augment their primary computers. Margins, however, were unsustainably slim.

The retail market for notebooks in fall 1997 is shown in Table C.

Table C  Mobile computers' retail market share

![Graph showing market share of mobile computers from November 96 to September 97. Toshiba, Compaq, Fujitsu, and IBM are marked on the graph.]

Source: adapted from company information.
The Alternatives

Compaq started work on three versions of a new low-cost notebook, shown in Table D. Two of these used non-Intel processors from AMD and Cyrix, who held 3.4% and 1.6%, respectively, of the U.S. processor market. These producers had been plagued with design flaws and availability problems in the past—Compaq had stumbled badly when AMD was unable to produce its version of Intel's Pentium fast enough to get a new line of desktop machines to market—but both finally had the technology and productive capacity to be competitive with Intel.

Table D  Strategic Notebook Options

<table>
<thead>
<tr>
<th>Code Name</th>
<th>Processor</th>
<th>Cost</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elvis</td>
<td>Cyrix Media GX with MMX</td>
<td>Least</td>
<td>Fewer parts, less upgradeable, new manufacturing technology, needed new BIOS</td>
</tr>
<tr>
<td>Road Warrior IIA</td>
<td>AMD K6 with MMX</td>
<td>+$150</td>
<td>Needed new BIOS, new manufacturing technology</td>
</tr>
<tr>
<td>Road Warrior IIB</td>
<td>Intel Pentium with MMX</td>
<td>+$300</td>
<td>Existing BIOS and manufacturing technology.</td>
</tr>
</tbody>
</table>

Source: Company information.

"Elvis," with the Cyrix processor, had the lowest cost structure of the three. Although it looked similar to the "Road Warrior II (RWII)" products, it had fewer parts and a simpler structure. With equal system configurations, processor performance, hard drive, RAM, and CD-ROM, the "Elvis" design was approximately $100 to $200 less expensive than a "RW II" with an AMD K6 processor.

The "RW II" was designed with two system boards—one using the AMD K6 processor (AMD's Pentium II equivalent) and the second using the Intel Pentium MMX processor. The AMD version would retail for approximately $100 to $200 less than an Intel machine, due to the cost savings in processor price.

Developing three system designs imposed significant costs and risks. Engineering requirements were substantial for the two non-Intel machines, especially given the extreme conditions that notebooks imposed on components. Intel processors posed fewer engineering challenges because they were already used so extensively throughout the industry.

Second, AMD and Cyrix were relying on unproven technology to manufacture their new high-performance processors. Failure to meet the specifications for notebooks would delay the product's launch. AMD and Cyrix both had aggressive timetables for implementing this process, which had challenged even Intel.

Just manufacturing and procurement for the three different models was a logistical nightmare. Each model would require a stock of unique components, which would prohibit easy switching of resources among designs in order to meet unexpected demand. “It’s clear,” said Greg Memo, vice president of the Consumer Mobile Division, “that we have to reduce the options.” He knew that market research had helped to design the Presario line. He hoped it could help create the next generation as well.


4 Basic Input Output System (BIOS) was the set of instructions that told the computer how to do its work. Notebooks placed special demands on BIOS because system heat had to be regulated. Because AMD and Cyrix processors had not been used in notebooks before, suitable BIOS did not yet exist for them.
The Study

“Traci, we need a couple of focus groups, fast,” said Memo, entering the office of Traci Cox, director of market research. “We have to test how willing customers are to pay more for Intel.”

“We can certainly do some focus groups for you, Greg,” said Cox. “But for the sort of tradeoff analysis you’re talking about, you may also want a quantitative study. They’re fairly expensive,” she warned, “and they take a little time. But that’s the best way to handle something like this, where you just don’t know how people will respond.” Cox suggested a set of focus groups in conjunction with a discrete choice study to gauge the willingness of consumers to pay varying amounts for various attributes, including branded or unbranded processors. (See Exhibit 1 for the study design.) “It’s like a typical purchase situation,” she said. “A respondent can have this or that, or pay a certain amount more for both, and are they willing to do so?”

Unlike a focus group, which used a fairly small number of people, the discrete choice study would involve hundreds of participants and cost between $100,000 and $150,000. “It can be worth it though,” Cox added. “One of the benefits of a discrete choice study is that you can interpolate between different pairs of options. For instance, if 30% would pay $45 and 10% would pay $60, you can guess that 20% would pay $52.50.” Some of the people recruited for the quantitative study would also participate in focus groups to gauge their reactions to Intel as opposed to alternative processors.

A few weeks later, Memo answered the telephone. “Greg, the executives need an update on that alternative processor project. Are we going with all three or not?” asked Rod Schrock, senior vice president of the Consumer Division. As he hung up the phone, Memo saw the report of the most recent study on the top of his inbox. (See Exhibit 2.)
Exhibit 1  Notebook Alternative Processor Research Design

Objectives

The main objectives of this research are to

• Test the impact of non-Intel processors on consumer purchase preferences for mid- to high-priced notebook PCs. This includes testing the impact of brand on consumer reaction to non-Intel processors.
• Understand the impact of a non-Intel processor on sales and customer acceptance of mid- to high-priced Compaq notebook PCs.

Methodology

• 12 one-hour quantitative research sessions,\(^5\) with 3 sessions followed by a one-hour focus group.
• 257 notebook PC consumers (own or intend to purchase within 6 months) in Chicago, San Francisco, and Irvine in September 1997.
• All respondents screened to ensure they meet the target market profile:
  • Actively shopping for notebook PCs.
  • Fit attitude, behavior, and ownership questions.
  • Are key decision makers for technology purchases for the home.
  • Have purchased a notebook PC within the past 12 months or intended to do so within the next 6 months.
• Note: for the purposes of this research, “value-priced PC brands” are brands which, holding all else equal (features, performance, design) have less than a $100 brand premium. The “premium-priced PC brands” have a brand premium above $100, all else equal.

\(^5\) Participants made choices between pairs of options, or indicated their willingness to pay more to have both.
Exhibit 2  

Alternative Processor Research Results

- Despite the length of time Intel has owned the processor market without any viable competitors, Intel’s equity with consumers appears to be largely based on time rather than on preference.
  - Consumers do not demand Intel so much as they are unfamiliar with any acceptable alternatives.
  - Approximately two-thirds of consumers say that they are willing to consider alternative processors.
- The primary interest in alternative processors comes from consumers who are purchasing less-expensive PCs.
- A previous study projected that over a quarter of Compaq’s notebook volume could be accounted for by a sub-$2,000 PC equipped with a Cyrix processor.
- In this research, consumers who are spending less than $2,500 on their notebooks have a significantly greater overall likelihood of purchasing an AMD processor than those consumers who are planning to spend $2,500 or more.
- Consumers who are interested in purchasing Compaq have significantly lower consideration of AMD processors than other consumers and the highest proportion of consumers who say that there is absolutely no likelihood of purchasing an AMD processor.
- Consumers have no inherent perceptions of problems with Intel’s quality, so they have no compelling motivation to switch brands other than gaining price discounts or performance benefits.
- Alternative processors are not entirely compatible with consumers’ perceptions of premium-priced products.
- Consumers interested in alternative processors tend to be more price-sensitive and less tolerant of brand premiums.
- Low-priced competitors with alternate processors could underprice Compaq considerably, stealing its share. If Compaq moves pre-emptively and adopts alternate processors first, the combination of reduced price and brand recognition could shut out these competitors and preserve or enhance its market share.
- Even with price discounts and performance benefits, over one-third of the notebook PC market will effectively not even consider a product with an alternative processor.
- If Intel offers sweetheart deals to competitors or begins a heavy negative-marketing campaign, consumer interest in alternative processors could quickly dissipate.
- The large majority of consumers indicate that they will be willing to give alternative processors even more consideration after they have seen the products on the market for a while and they have established a track record.
  - Consumers want to see the alternative processors in the workplace, read magazine reviews, and talk to friends. More value is placed on extrinsic attributes such as market share and use by large corporations than on intrinsic ones like value or performance.
These findings indicate that the success of alternative processors may increase over time, with limited adoption upon their introduction but increasing acceptance with use.

Overall consumers are relatively indifferent to the processor brand, focusing their attention primarily on processor speed, display size and type, and the amount of RAM.

Although consumers assume a quality PC brand will use only quality components, there is no greater acceptance for alternative processors when offered by premium-priced PC brands than when offered by value-priced brands.

The important driver of consumer acceptance of alternative processors does not appear to be opinion of the PC brand but simply having awareness of the PC brand.

In discussions, consumers have a much higher opinion of Compaq than they do of Acer. However, they are more likely to purchase an Acer with an AMD processor than a Compaq so equipped.

In fact, alternative processors may be inconsistent with premium-priced PC brands.

Acceptance of AMD increases as the PC brand premium decreases.

Consumers accept a brand premium for Compaq of between $50 and $150 depending on the competitive brand.

PC brand seems to be slightly more important to consumers than processor brand.

If there are problems with the PC, consumers do not call or blame the processor company.

Switching customers to AMD

Many people are willing to switch to AMD once the discount exceeds 10% of the system price.

Some segments of consumers display a very strong preference for AMD, but even segments which tend to prefer Intel will give AMD serious consideration.

Quantitative Research Results

If AMD cannot offer a discount near $100, a large majority of consumers will stay with Intel and will be almost impossible to win.

The bulk of consumers who will buy AMD expect to save $100 compared to the same computer with Intel. Additional discounts will not win enough new purchasers to offset the revenue loss.

Results of Tradeoff Analysis, All Else Equal

<table>
<thead>
<tr>
<th>Model</th>
<th>Chosen by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compaq 266 MHZ AMD CPU</td>
<td>34%</td>
</tr>
<tr>
<td>Toshiba 233 MHZ Intel CPU</td>
<td>25%</td>
</tr>
<tr>
<td>Acer 233 MHZ Intel CPU</td>
<td>28%</td>
</tr>
</tbody>
</table>

Source: company information.
In January 1992, Barry Robbins, Goodyear’s vice president of marketing for North American Tires, was contemplating the upcoming launch of the Aquatred, a new tire providing improved driving traction under wet conditions. The Aquatred would be positioned in the U.S. market as a replacement tire for passenger cars. Over recent years, the replacement tire market had matured and new channels had gained share, so Robbins needed to make sure Goodyear had the right product and the right timing to generate support from the company’s traditional base of independent dealers. Despite a long and close relationship with those independent dealers, Goodyear was also weighing the risks and benefits of expanding the company’s distribution channels. If new outlets were added, Robbins would also have to assess whether the new channel would sell the Aquatred.

Background

In 1991, Goodyear operated 41 plants in the United States, 43 plants in 25 other countries, six rubber plantations, and more than 2,000 distribution outlets worldwide. In fiscal year 1991, Goodyear earned net income of less than one percent on total revenues of $10.91 billion; the company had approximately 105,000 employees. Goodyear ranked third in worldwide sales of new tires behind Michelin and Bridgestone, respectively.

Low growth, declining prices and over-capacity in an environment of corporate consolidation characterized the U.S. tire industry. Exhibit 1 lists the brand shares of U.S. retail sales for the largest tire manufacturers from 1975 to 1990. During this period, Michelin achieved large share gains in both the replacement and original equipment manufacturer (OEM) markets. Unlike other U.S. tire manufacturers, Goodyear had made large investments (over $1.5 billion) during the late 1970s to produce radials. The company also had a strong track record in launching innovative new products. For example, in 1981 Goodyear successfully launched the Eagle, the first radial tire offering high-speed traction for sports cars. On a typical radial, the cost of goods sold was 60% of the manufacturer’s selling price, but the Eagle provided Goodyear and its dealers with higher percentage profit margins than standard radials.

In the early and mid-1980s, Goodyear made large investments in pipelines for natural gas and oil transmission. In 1986, Sir James Goldsmith attempted to take over Goodyear and was bought out by management after a highly emotional takeover battle, which greatly increased Goodyear’s
debt. Although 13% of the company’s work force was furloughed between 1987 and 1991, in 1991 Goodyear was still spending $1 million per day on interest payments, and earnings were sluggish.

In June of 1991, Stanley G. Gault, retired chairman of Rubbermaid, became chairman of Goodyear. Gault had been a member of Goodyear’s board of directors, and many hoped that he would bring the same marketing flair and new product skills that he had shown at Rubbermaid. Gault stated his goal at Goodyear:

. . . to create a market-driven organization. That means to serve the customer and the ultimate user. People are wrong to think of tires as a commodity—that a tire is a tire is a tire. . . . Customers want safety—they want that car to stop. They want reliability.¹

Gault installed his own management team, sold off assets that were not directly related to the tire business, and placed an increased priority on new product development.

The Market for Passenger Tires

The market for passenger tires could be segmented in three ways. One segmentation was based on the distinction between performance and broad-line tires. Performance tires were wider than broad-line tires, were more expensive, and provided better traction. Although performance tires could be replaced with broad-line tires, consumers rarely made this substitution because of the resulting decrease in handling and performance. Performance tires represented 25% of Goodyear’s domestic unit sales, 30% of dollar sales, and an even higher percentage of profits.

The market could also be segmented based on replacement and OEM tires. Replacement tires were sold to individual consumers, while OEM tires were sold to car manufacturers. Car makers used volume purchases to negotiate substantial discounts on tires. In 1991, U.S. replacement tire sales were estimated at $8.6 billion (137 million units sold). In the United States, Goodyear’s passenger tire division derived 65% of its revenues from replacement tires and 35% from OEM tires. Division revenues were $1.98 billion on sales of 39.1 million tires.

A third segmentation scheme was along brand classifications, which included major brands, minor brands, and private label. Major brands, which carried the name of a major tire manufacturer, accounted for 36% of unit sales in the replacement passenger tire market. Major brands had the highest recognition among consumers and included Goodyear, Firestone, Michelin, Bridgestone, Pirelli, and Goodrich. Minor brands represented 24% of unit sales and included tires made by smaller manufacturers as well as tires made by major manufacturers but sold under a different name. Minor brands included Sears, Dunlop, General, Kelly (a Goodyear subsidiary), Uniroyal, Cooper, Yokohama, and Toyo. Although minor, these brands were often well-recognized by consumers and included high-priced niche brands.

Sales of private label tires constituted the remaining 40% of the market. Many small manufacturers specialized in private label tires, while some larger manufacturers used excess capacity to service the private label market. Most private label tires carried names exclusive to a particular retailer, but others were available to any retailer. Private label manufacturers typically had only one distributor per territory, which gave the distributor some flexibility in pricing. In 1991, private label tires constituted 80% of the sales of Goodyear’s wholly owned Kelly-Springfield subsidiary; the remaining 20% were sold under the Kelly brand. The average retail selling price of a

private label tire was 18% lower than the price of a comparable branded tire. Although sales of
dealer, the average life remained slightly lower than the life of a branded tire.

Many of the attributes important to consumers when purchasing a tire were not apparent
upon visual inspection. To certify product quality, some retailers added warranties to their tires.
These warranties were paid for by the retailer and would typically guarantee the tire for 60,000 miles,
with the value of the guarantee decreasing on a pro-rata basis over the life of the tire. Retailer
warranties were particularly common on sales of private label tires.

In past years, Goodyear had produced two lines of private label tires: the All American and
the Concorde. The Goodyear brand was not placed on these tires, providing Goodyear’s independent
dealers with low-priced lines to compete with other types of outlets. In 1991, Robbins replaced the All
American and the Concorde with Goodyear-branded tires at comparable prices because market
research showed that the non-branded lines cannibalized sales of branded tires. Although the sales of
these two lines were relatively small, some analysts felt that discontinuing the All American and
Concorde increased incentives for Goodyear’s independent dealers to sell tires made by other
manufacturers. Some independent dealers believed that consumers wanted to choose from a range of
tires, and favored offering private brands to provide consumers with a reference point, which they
argued would increase the sales of Goodyear tires.

Consumers in the Replacement Passenger Tire Market

Most consumers viewed tires as a “grudge purchase”—an expensive necessity to keep a
vehicle in driving condition. The average time between purchases of tires was 2.5 years, but over half
of all tire-buying consumers made their purchase the same day they became aware of their need for
tires. Most tires were bought in pairs: 42% of consumer purchases involved two tires, 40% involved
four tires, 16% involved one tire, and only 2% involved three tires. Purchases of sets of four tires
accounted for 60% of all units sold. The percentage of consumers who did not know what brand of
tire they planned to buy next rose to 53% in 1992 from 36% in 1982.

Generally, tire consumers could be broken down into quality-conscious buyers (18%), value-
conscious buyers (23%) and price-focused buyers (59%). Whereas price-focused buyers treated tires
as a commodity purchase, quality and value-conscious buyers placed greater weight on tire quality
and performance attributes obtainable at a given price. Goodyear regularly surveyed car owners,
asking about performance attributes considered when purchasing tires. The five most important tire
attributes, in order from higher to lesser importance, were tread life, wet traction, handling, snow
traction, and dry traction.

Across the segments, all consumers placed great importance on price when shopping for
tires. A 1989 Goodyear survey had shown that with no other information available, consumers
expected Goodyear’s broad-line tires to be priced within a six-dollar range from the most expensive
to the least expensive. The research also demonstrated that Goodyear’s point-of-sale displays did
little to alter consumers’ expectations of retail prices.

It was estimated that three-fourths of all Goodyear tires sold in independent or company-
owned outlets were sold on promotion, at an average discount of 25%. This discount was offered to
the consumer in a number of ways, such as one free tire with the purchase of three tires, one tire for
half price with the purchase of another tire at full price, or 25% off the price of selected tires.
Experiments with everyday low pricing in the tire industry had been unsuccessful because price
competition among dealers undermined attempts to set consistently low but fair prices. As one dealer
explained, “Consumers expect to buy their tires on sale. We have created a price-conscious monster.”
Wholesale Channels for Replacement Tires

Goodyear directly sold passenger tires to large chains and wholesalers, with no retail operations who resold their tires to car dealers, service stations, small independent dealers, and other secondary outlets. This accounted for 10% of Goodyear’s factory sales. Another 40% went to large chains that both sold tires at retail and resold tires to other dealers or to secondary outlets. The remaining 50% went to small independent dealers who bought tires to resell in their own retail outlets and did not resell to other outlets. This breakdown was typical of the industry.

Retail Channels for Replacement Tires

Six major retail channels competed for market share in the U.S. replacement passenger tire market. (Exhibit 2 shows each channel’s market share, relative prices, and reliance on private label tires.) The six channels can be described as follows:

1. Garages/service stations: These were typically small, neighborhood outlets offering gasoline, tires, and auto services. Their share of the tire market had declined in recent years in favor of lower-cost, higher-volume outlets. Garages and service stations sold private label tires as well as branded tires to combat price pressure from larger outlets.

2. Small independent tire dealers: Small independent tire dealers operated one or two outlets, where they sold and installed tires and also offered auto services. Many small independent tire dealers started as single-brand outlets but over time added additional brands. Both small dealers and large independent tire chains derived an increasing portion of their revenues from private label tires.

3. Manufacturer-owned outlets: These outlets, owned and operated by the tire manufacturers, typically sold only one brand of tires and offered a range of auto services.

4. Warehouse clubs: Warehouse clubs operated large stores carrying categories as diverse as food, clothing, electronics, tires, and hardware. Warehouse clubs offered a limited brand selection, with the selection changing according to the deals their buyers could strike with vendors. Also, warehouse clubs offered minimal in-store service other than installation. Although warehouse clubs were a relatively new retail format, they were growing quickly due to their low prices.

5. Mass merchandisers: Mass merchandisers were retail chains that sold tires, performed auto services, and carried other types of merchandise. Mass merchandisers typically maintained a very wide brand selection. For example, Sears sold Michelin, Goodrich, Pirelli, Bridgestone, Yokohama, and its own Roadhandler brand.

6. Large tire chains: Also known as “multi-brand discounters,” large tire chains typically had 30-100 outlets concentrated within a geographic region. These chains carried major brands of tires as well as private label, and tended to be low-priced, high-volume operations. In recent years, large tire chains gained share, often by acquiring smaller independent dealers.

In most markets, consumers could choose among these types of channels. As one independent dealer noted, “The tire manufacturer is not only our supplier but also our competitor through manufacturer-owned outlets. On top of that, we compete with the warehouse clubs, mass merchandisers, corner station, and who knows who else.”
Goodyear: The Aquatred Launch (Condensed)

Goodyear’s Distribution Structure

Goodyear did not sell tires in garages/service stations, warehouse clubs, or mass merchandisers; instead, the company relied on three types of outlets. Goodyear’s 4,400 small independent dealers accounted for 50% of sales revenues, while the 1,047 manufacturer-owned outlets generated 30% of sales (the remainder of sales occurred primarily through franchised dealers and directly to government agencies). Goodyear was also testing a new retail format, Just Tires. Modeled after “quick lube” stores that offered fast oil changes without an appointment, Just Tires stores sold and installed tires but did not offer any other products or services. Just Tires stores provided consumers with guarantees covering speed and quality of installation.

Manufacturer-owned outlets could be opened or closed at the discretion of the manufacturer. During the 1970s, Goodyear opened as many as 200 outlets per year. By 1983, the company owned 1,300 outlets in the United States, but became concerned about the associated demands for capital and management attention. Despite Goodyear’s efforts to site company-owned outlets in locations that would minimize competition with its independent dealers, complaints were common. Over time, Goodyear placed increasing emphasis on franchising new outlets and also converted some company-owned outlets into franchised and independent dealerships.

Only about 2,500 of Goodyear’s small independent dealers were considered active in that they generated a consistent level of sales, maintained the major Goodyear retail displays, and offered the full line of Goodyear tires. A typical dealership required an owner investment of $100,000 and generated annual revenues of $1,000,000. Goodyear’s independent outlets sold an average of 15.5 tires/day, including both Goodyear and other brands of tires, although most Goodyear dealers derived the majority of their sales from Goodyear tires. The average selling price of all tires sold by Goodyear’s independent dealers was $75 per tire. Retail margins for independent dealers averaged 28% on Goodyear tires, 25% for dealers carrying other major brands, and 20% for private label tires. Average wholesale margins were 18% for private label tires and 14% for Goodyear tires.

Monthly auto service sales for independent tire dealers averaged $38,100 per outlet. Most tire dealers changed oil, performed alignments, replaced shocks, fixed exhaust systems, and did minor engine work. Independent dealers derived, on average, 48% of their revenues from auto services in 1991, up from 26% in 1980. On average, 20% of service revenues came from tire-related work. Margins for independent dealers were 50% on service labor and 20%-25% on parts installed; 70% of service revenues were earned from labor, with the remaining 30% earned from parts.

The average number of tires installed per day at a typical independent dealer increased 13% from 1983 to 1991, but the average service dollars per outlet grew 92% during the same period. Not all dealers were pleased with their reliance on service revenues. As one dealer said, “To me it’s an indictment of the industry that we cannot support ourselves on tire sales. We have to have that service to survive.” Tires were an expensive purchase for most consumers, and independent dealers worried about the “sticker shock” resulting from service charges increasing the bill to the consumer.

Goodyear serviced independent dealers through the area sales manager, who made sure that dealer orders were placed properly, provided information about market trends, offered advice on operations, and handled complaints. Visits from area sales managers were very important to dealers. As one area sales manager noted, “You never get to the dealer enough. You could spend all day there and then the next day the guy would say, ‘Gee, I have this problem today. Too bad you weren’t around.’”

---

2These margins are estimated from several sources and may vary by region or time period.
Most complaints from independent dealers involved relatively minor billing problems, although complaints about competition from other channels or the location of company-owned outlets were also common. Issues that could not be handled by the area sales manager were referred to the district manager. The dealer council took up complaints common to many dealers. Goodyear had established ten regional councils to represent the views of Goodyear’s independent dealers. Each regional council elected one dealer to Goodyear’s national dealer council for passenger tires. Goodyear’s top marketing and sales executives attended council meetings to answer questions, address complaints, or hear suggestions.

Independent dealers also set their own inventory policies. For many years Goodyear had protected its dealers by not selling Goodyear-branded tires in other outlets; in exchange, Goodyear dealers did not carry other brands. In 1989, 70% of Goodyear’s independent dealers carried only Goodyear tires, while 30% stocked other brands. Typically, the other brands were not aggressively merchandised but used only as lower-priced alternatives to Goodyear. By 1991, estimates suggested that 50% of Goodyear’s independent dealers sold only Goodyear tires, while the other 50% stocked at least one other brand. Among the latter, some aggressively merchandised other brands but Goodyear tires still generated 90% of the revenues for most independent dealers.

Independent dealers’ concern for protecting their interests led the National Tire Dealers and Retreaders Association (NTDRA) to pass a bill of rights in 1992 (see Exhibit 3). NTDRA president Robert Gatzke said, “[T]his bill of rights clearly identifies certain rights which independent tire dealers have a right to expect from their tire suppliers.” The bill demanded that manufacturers respect the independent dealers’ importance, consult independent dealers on key decisions, avoid placing company-owned outlets in competition with independent dealers, supply tires to independent dealers in a timely manner, and grant dealers the same pricing and programs given to high-volume outlets such as wholesale clubs and multi-brand discounters.

Although Goodyear claimed not to want its tires sold in low-priced outlets such as warehouse clubs, mass merchandisers, and auto supply stores, those outlets sporadically obtained Goodyear tires. The price-based ads and frequent discounting from those outlets angered Goodyear’s independent dealers. One owner of two independent tire outlets said, “The mass merchandisers are eating up the distribution of our product. It could drive me out of the tire business.” Industry observers felt that the large tire chains that acted solely as wholesalers diverted tires to those outlets. As one analyst said, “There’s a lot of big wholesalers who will sell to anybody.”

Goodyear’s options to stop the diversion were limited by legal restrictions that prohibited manufacturers from dictating either retail selling prices or to whom their tires could be resold. However, in December 1990, Goodyear sued two automotive chains: Tire America and Western Auto Supply. Sears owned both, and neither was an authorized Goodyear dealer. The suits charged that the Sears units were advertising Goodyear tires without maintaining enough inventory to meet demand. Consumers drawn to the store were allegedly switched to other brands in a “bait and switch” tactic. Goodyear also maintained that the chains were not authorized to use the Goodyear trademark in their advertising.

**Competition**

Goodyear regularly surveyed car owners to monitor their image of the major tire brands. In terms of brand perceptions Goodyear and Michelin were virtually even, but Michelin’s image was

---

stronger among quality-conscious and value-conscious consumer segments, while Goodyear had a stronger image among the price-focused consumer segment (Exhibit 4).

In 1992, Michelin had fewer than 125 company-owned outlets, but Michelin tires were available through 7,000 dealers. Most of these were multi-brand large tire chains and sold Michelin as the prestige line in their product offerings. Michelin tires were also available in 95% of the 600 warehouse clubs in the United States, mass merchandisers such as Montgomery Ward and Sears, and a variety of gas and service stations. Michelin, Uniroyal, and Goodrich had recently combined their sales forces to allow their salespeople to sell all three brands.

Exhibit 5 presents a brand-switching matrix, showing loyalty by brand among consumers replacing passenger tires. Michelin owners were the most loyal, followed by Goodyear owners, but significant proportions of consumers who owned major brands replaced their tires with private label brands. Goodyear typically spent 9%-11% of sales on advertising and promotion, with 60% being spent on promotion. Among U.S. tire marketers, Goodyear’s share of voice in television and magazine advertising was about 60%.

Goodyear’s competitors were planning a wide range of campaigns for 1992. Both Bridgestone and Michelin were planning to introduce new tires with 80,000-mile warranties, while Uniroyal was introducing a new tire for light trucks. Under Michelin’s ownership, BF Goodrich was focusing on the high performance market, while Goodyear’s Kelly-Springfield subsidiary used advertising primarily to announce the low price of its tires.

The Aquatred Tire

In 1989, Goodyear began developing a new and exciting replacement market tire that would have a tangible, perceptible difference over existing models. Howard MacDonald, marketing manager for Passenger Tires, said, “We were looking for something that appearance-wise was different—something that a customer would walk into a showroom and tell from a distance that it was different.” The Aquatred was developed after comparing 10 different designs on performance and consumer preference. The deep groove down the center of the tire was dubbed the “Aquachannel.” According to Goodyear, the Aquatred’s tread design channeled water out from under the tire, reducing hydroplaning and improving traction in wet conditions. Performance tests showed that in wet conditions, cars equipped with Aquatreds traveling at 55 miles per hour stopped in as much as two-car-lengths-less distance than similar cars equipped with conventional all-season radials. When 50% worn, the Aquatred maintained the same wet traction as a new all-season tire.

Goodyear planned to sell the Aquatred with a 60,000-mile warranty and to position the tire at the top of the broad-line segment. The last tire to promise increased wet traction to the broad-line segment was the Uniroyal Rain Tire in the early 1970s. The Aquatred was patented, but patent protection on tread designs was difficult to enforce. Continental Tire was known to be working on its own anti-hydroplaning tire, to be called the Aqua Contact, which could be launched in early 1993.

The Aquatred was test-marketed in a large metropolitan area. A Goodyear survey from the test market compared purchase behavior for Aquatred buyers with purchase behavior for buyers of the Invicta GS, Goodyear’s most expensive broad-line tire. Compared with buyers of the Invicta GS, Aquatred buyers were more likely to replace competitors’ tires, searched more extensively for

---

6Hydroplaning occurs in wet conditions due to a layer of water forming between the tire and road, causing a momentary loss of traction.
information prior to purchase, were more likely to drive imported cars, and more often came to Goodyear outlets specifically for the Aquatred. Exhibit 6 presents data gathered by a “mystery shopper,” a Goodyear employee who shopped for tires at independent dealers without identifying his or her affiliation with Goodyear. Despite the uniformity of the company’s literature and policies, there was variation in the presentation and pricing of the Aquatred by dealers in the test market.

Due to the long buying cycles of auto manufacturers, the Aquatred would not be available as original equipment, so all sales of the Aquatred would come through the replacement market. It was estimated that a full-scale launch would cost Goodyear about $21 million.

Managers at Goodyear still had two concerns about the launch. First, would Goodyear’s dealers be receptive to a high-priced tire when the industry seemed to be turning toward long-life warranties and low-cost private labels? One dealer had said,

I would be much more interested in a tire that went 80,000 miles than one that channels the rain out of the way. Even a 35,000-mile tire at a decent price point would be better. The Aquatred is a boutique tire, but where do we make our money as a dealer? Middle-of-the-road products.

Second was the channel itself. Goodyear management debated whether distribution should be expanded, and if so, what specific channels or retailers should be added. Expanding distribution could boost sales and prevent Goodyear OEM tires from being replaced by other brands in the replacement market. However, selling tires in lower-service outlets could erode the value of the Goodyear brand, cannibalize sales of existing outlets, and might cause dealers to take on additional lines of tires. Stanley Gault, Goodyear’s new chairman, had expanded distribution at Rubbermaid, and many Goodyear dealers were concerned that he would do the same at Goodyear. As one dealer said, “Today, you can go to any store and get a Rubbermaid product, and the prices on Rubbermaid have dropped accordingly. We feel that Goodyear tires should not be that way.”

If the decision was made to launch the Aquatred, there would be a variety of launch-related issues to settle. For example, given the wide range of tires sold by Goodyear, dealers would need advice regarding which customers would be likely to switch to Aquatreds. In the test markets, some dealers had tried to sell Aquatreds only to customers who drove newer cars or looked affluent. And if distribution was expanded, Goodyear would need to decide whether the new channel would receive the Aquatred.

In addition, Goodyear had to finalize pricing and promotional policies for the Aquatred. Goodyear hoped to price the Aquatred at a 10% premium over the Invicta GS, but the successful launch of the Tiempo in 1977 was partly attributed to a low retail price. Independent dealers in test markets had consistently asked for price promotions on the Aquatred. Robbins had turned down all such requests, but given the growing problem of tires diverted to unauthorized dealers, it was not clear that the tire could be kept out of channels that were prone to discounting and promotions.

Plans for the national launch were proceeding during an important period in Goodyear’s history. Any change in distribution strategy would affect the launch, but the launch and the associated marketing programs would affect Goodyear’s dealers. Stanley Gault was upbeat and saw the Aquatred as a product to revitalize Goodyear. Robbins, armed with consumer research, wanted to be sure that the consumer and the channel would agree.
Exhibit 1  Brand Shares of Unit Sales in the U.S. Passenger Tire Market

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Replacement Market</strong> (includes larger brands only)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodyear</td>
<td>14.0%</td>
<td>14.0%</td>
<td>15.5%</td>
<td>15.0%</td>
<td>15.0%</td>
</tr>
<tr>
<td>Michelin</td>
<td>2.5</td>
<td>7.0</td>
<td>8.0</td>
<td>8.5</td>
<td>8.5</td>
</tr>
<tr>
<td>Firestone</td>
<td>10.5</td>
<td>10.0</td>
<td>9.5</td>
<td>8.0</td>
<td>7.5</td>
</tr>
<tr>
<td>Sears</td>
<td>10.0</td>
<td>10.0</td>
<td>9.0</td>
<td>6.5</td>
<td>5.5</td>
</tr>
<tr>
<td>General</td>
<td>2.0</td>
<td>3.0</td>
<td>2.5</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>BF Goodrich</td>
<td>4.0</td>
<td>5.0</td>
<td>4.5</td>
<td>4.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Bridgestone</td>
<td>0.0</td>
<td>2.0</td>
<td>2.0</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Cooper</td>
<td>1.0</td>
<td>1.5</td>
<td>2.5</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Kelly</td>
<td>3.0a</td>
<td>4.0</td>
<td>3.0</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Uniroyal</td>
<td>3.5</td>
<td>3.5</td>
<td>3.0</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Dunlop</td>
<td>2.5</td>
<td>2.5</td>
<td>2.5</td>
<td>2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Pirelli</td>
<td>0.0</td>
<td>0.0</td>
<td>1.0</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Montgomery Ward</td>
<td>4.5</td>
<td>3.5</td>
<td>2.0</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Otherb</td>
<td>42.5</td>
<td>34.0</td>
<td>35.0</td>
<td>35.5</td>
<td>37.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OEM Market</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodyear</td>
<td>35%</td>
<td>28%</td>
<td>32%</td>
<td>36%</td>
<td>38%</td>
</tr>
<tr>
<td>Michelin</td>
<td>2</td>
<td>5</td>
<td>11</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Firestone</td>
<td>24</td>
<td>22</td>
<td>22</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td>General</td>
<td>11</td>
<td>11</td>
<td>13</td>
<td>12</td>
<td>11</td>
</tr>
<tr>
<td>Uniroyal</td>
<td>20</td>
<td>24</td>
<td>22</td>
<td>17</td>
<td>13</td>
</tr>
<tr>
<td>BF Goodrichc</td>
<td>8</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Dunlop</td>
<td>0</td>
<td>10</td>
<td>0</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Bridgestone</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: *Modern Tire Dealer*

*Estimates
*Other included a variety of smaller brands, some of which were exclusively private label.
*BF Goodrich was sold to Uniroyal, and eventually to Michelin.
## Exhibit 2  Share of Retail Sales of Replacement Passenger Tires by Channel (U.S. market only)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Garages/service stations</td>
<td>18%</td>
<td>11%</td>
<td>8%</td>
<td>6%</td>
</tr>
<tr>
<td>Small independent tire dealers</td>
<td>36</td>
<td>47</td>
<td>46</td>
<td>40</td>
</tr>
<tr>
<td>Manufacturer-owned outlets</td>
<td>11</td>
<td>10</td>
<td>11</td>
<td>4</td>
</tr>
<tr>
<td>Warehouse clubs</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>Mass merchandisers</td>
<td>28</td>
<td>24</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Large tire chains</td>
<td>4</td>
<td>2</td>
<td>12</td>
<td>23</td>
</tr>
<tr>
<td>Other</td>
<td>3</td>
<td>6</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Relative Price Index, 1991</th>
<th>Sales of Private Label Tires as a Percent of Retail Sales Dollars, 1991</th>
</tr>
</thead>
<tbody>
<tr>
<td>Garages/service stations</td>
<td>110%</td>
</tr>
<tr>
<td>Small independent tire dealers</td>
<td>100</td>
</tr>
<tr>
<td>Manufacturer-owned outlets</td>
<td>107</td>
</tr>
<tr>
<td>Warehouse clubs</td>
<td>80</td>
</tr>
<tr>
<td>Mass merchandisers</td>
<td>97</td>
</tr>
<tr>
<td>Large tire chains</td>
<td>90</td>
</tr>
<tr>
<td>Other</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: Company records  
Note: Relative price index indicates typical retail prices for the same tire in each channel. Retail prices in “other” category varied according to the specific outlet.
Exhibit 3  Tire Dealers’ Bill of Rights

“Tire dealers as independent business people have earned the right to the respect of all other facets of the tire, retreading, and auto service industries since it has long been established that they fulfill the role as the most important channel of tire distribution. . . .

Tire dealers expect to give loyalty to, and receive loyalty from their manufacturers; to be treated like valued customers; and to be encouraged to sell to end users without direct competition from their manufacturers. Independent tire dealers have a right to the uninhibited exercise of their ability to increase their market share with the cooperation of their manufacturers. . . .

Tire dealers have a right to expect reasonable and timely communications from, and where appropriate, consultation with their manufacturers on actions taken by the manufacturers which directly affect independent tire dealers and their customers. . . .

Independent tire dealers have the right to expect their manufacturers to pay careful attention to supply and demand, pursuing neither to excess, and to keep the dealer supplied in a timely fashion with high quality products which will allow the dealer to sell and serve the customer properly. . . .

Independent dealers have a right to a level playing field including the availability of tire lines, pricing, terms, and programs equal to those offered to wholesale clubs, discounters, company-owned stores, mass merchandisers, chains, and other forms of competition. . . .

Tire manufacturers should recognize the need for profits, not only for themselves, but also for the independent tire dealer who performs the major distribution function for them. . . .

Independent tire dealers have a right to the timely, proper, and uniform issuance of credits for advertising, national account sales, return goods, adjustments, and any other money due. . . .

Independent tire dealers . . . have a right to expect that the manufacturer will use the network of independent tire dealers as the first step for expansion, increasing the dealers’ market share; and that commitments made are commitments kept.”

Source: Adapted from Tire Business.
Exhibit 4  Brand Image of Major Tire Manufacturers, 1991

A survey of broad-line tire owners asked what brand of tires the owners intended to buy the next time they needed tires. Results are reported below for the five major brands and for the four major consumer segments.

Intent to Buy for Major Consumer Segments

<table>
<thead>
<tr>
<th></th>
<th>All Buyers</th>
<th>Value-Conscious Buyers</th>
<th>Quality-Conscious Buyers</th>
<th>Price-Focused Buyers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodyear</td>
<td>15%</td>
<td>17%</td>
<td>15%</td>
<td>14%</td>
</tr>
<tr>
<td>Michelin</td>
<td>15%</td>
<td>25%</td>
<td>26%</td>
<td>7%</td>
</tr>
<tr>
<td>Other</td>
<td>19%</td>
<td>19%</td>
<td>24%</td>
<td>17%</td>
</tr>
<tr>
<td>Uncommitted</td>
<td>51%</td>
<td>39%</td>
<td>35%</td>
<td>62%</td>
</tr>
</tbody>
</table>

Source: Company records

Exhibit 5  Switching Among Tire Brands, 1991

<table>
<thead>
<tr>
<th>Brand Replaced</th>
<th>Bridgestone</th>
<th>Firestone</th>
<th>Goodyear</th>
<th>Michelin</th>
<th>Minor Brands</th>
<th>Private Label</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bridgestone</td>
<td>29%</td>
<td>4%</td>
<td>8%</td>
<td>8%</td>
<td>7%</td>
<td>43%</td>
<td>100%</td>
</tr>
<tr>
<td>Firestone</td>
<td>2</td>
<td>27%</td>
<td>11%</td>
<td>6%</td>
<td>7%</td>
<td>45%</td>
<td>100%</td>
</tr>
<tr>
<td>Goodyear</td>
<td>2</td>
<td>5%</td>
<td>39%</td>
<td>5%</td>
<td>9%</td>
<td>38%</td>
<td>100%</td>
</tr>
<tr>
<td>Michelin</td>
<td>3</td>
<td>3%</td>
<td>7%</td>
<td>44%</td>
<td>6%</td>
<td>36%</td>
<td>100%</td>
</tr>
<tr>
<td>Minor brands</td>
<td>2</td>
<td>4%</td>
<td>10%</td>
<td>7%</td>
<td>32%</td>
<td>42%</td>
<td>100%</td>
</tr>
<tr>
<td>Private label</td>
<td>2</td>
<td>5%</td>
<td>8%</td>
<td>5%</td>
<td>7%</td>
<td>70%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Company records

Note: The above chart can be read as follows: Four percent of car owners with Bridgestone tires bought Firestone tires to replace the Bridgestone.
Exhibit 6  Results of Mystery Shopping in Aquatred Test Market

A male mystery shopper visited nine independent Goodyear outlets in the Aquatred test market during October 1991. The mystery shopper told the staff in each outlet that his wife needed tires for her Plymouth Voyager. In the sales presentations that followed:

Eight of the nine salespersons mentioned the Aquatred during their presentations. Of those eight, five began their presentation with the Aquatred and three finished with the Aquatred.

Three salespeople made specific claims concerning the Aquatred’s superior performance in wet traction. One claimed the Aquatred was 15% better than other tires; another claimed 20%-25%; and a third claimed up to 35% better traction with the Aquatred.

Goodyear’s suggested retail prices for the Aquatred were $89.95 with a black sidewall, and $93.95 with a white sidewall. Prices quoted by six outlets were as follows:

<table>
<thead>
<tr>
<th>Store Number</th>
<th>Price with Black Sidewall</th>
<th>Price with White Sidewall</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$79.95</td>
<td>$79.95</td>
</tr>
<tr>
<td>2</td>
<td>81.95</td>
<td>81.95</td>
</tr>
<tr>
<td>3</td>
<td>80.00</td>
<td>83.00</td>
</tr>
<tr>
<td>4</td>
<td>85.00</td>
<td>85.00</td>
</tr>
<tr>
<td>5</td>
<td>85.00</td>
<td>88.00</td>
</tr>
<tr>
<td>6</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Company records
MD Motors

In late July 1998, Mr. Holger Gossmann, Managing Director of MD Motors, was both surprised and concerned. He had just learned that although Volkswagen AG had recently bought Rolls-Royce Motor Cars Limited in the United Kingdom, Bayerische Motoren Werke AG in Germany had acquired exclusive rights to the Rolls-Royce brand name. In the future, MD Motors, the exclusive agent in Hong Kong for Rolls-Royce and Bentley motor cars, faced the possibility that it would no longer be able to market the Rolls-Royce brand, with its imposing radiator grille and elegant Flying Lady hood ornament. Mr. Gossmann knew he would have to carefully develop a new strategic marketing plan to reposition MD Motors.

The Luxury Car Market

The market for luxury and so-called near-luxury cars peaked in 1986, when 1.6 million units were sold worldwide. Although the market underwent a downward adjustment in subsequent years, sales began to rebound in the late 1990s. The resurgence was attributed to baby boomers who were entering their affluent years. “They love to spend their money on luxury goods … the strongest-selling vehicles are the higher-priced models”, said the Managing Director of one automotive marketing consultancy firm. The strength of the North American and European economies also helped. The US alone was the largest luxury car market in the world.

The near-luxury segment of the industry was classified as cars with price tags of between US$25,000 and US$35,000, while cars in the high-end luxury segment were priced above US$35,000. Players in the latter category included Ferrari, Jaguar, Lamborghini, Mercedes-Benz, Porsche, Rolls-Royce and Bentley.

Overall, sales of the near-luxury segment fared better than those of the high-end segment. Apart from being cheaper, cars at the lower end of the market were considered less ostentatious in countries such as the US. Nevertheless, cars in both segments of the market offered consumers a

3 US$1=HK$7.74.
quiet ride, immense power, subtle shifting, maximum comfort, reliability and increasingly sophisticated gadgetry.

In response to the boom in the luxury car market, many players wanted to participate in the action by introducing new models. In 1998, Jaguar introduced its first mid-sized luxury car in 30 years, the S-type saloon. It planned to launch another smaller model in the year 2001, called the X400, in order to achieve an overall annual sales target of 200,000 units. Mercedes-Benz also had plans to introduce an all-new line of super-luxury products, called the Maybach. The Maybach was tentatively priced at above US$150,000, making it the most expensive Mercedes to date.

Hong Kong

Luxury cars had always been popular in Hong Kong. This was exemplified by the fact that the city had the second highest Mercedes-Benz market share in the world. At the beginning of 1998, there were more than 30,000 Mercedes on Hong Kong’s roads. Percentage-wise they formed a larger proportion of the private car market than in Germany, the car-maker’s home country.4

Passenger Car Market

Unlike some Asian countries such as Korea, Hong Kong had no assembly plants or car manufacturers of its own. All the cars on the streets of the city were imported, mainly from Japan and Europe. European cars tended to be targeted at the higher end of the market, whereas most Japanese cars were aimed at the lower end. US cars were not very popular among the local population. All motor cars were represented by sole agents or local distributors, with no major capital investment from car manufacturers.

By the end of 1997, out of a total population of more than six million, there were 1,142,226 licensed drivers. The total number of licensed private cars was 314,833.5 In 1997, a total of 53,584 vehicles were sold in Hong Kong, 38,899 of which were private cars (excluding taxis). Luxury automobiles (including near-luxury and high-end segments) made up 7% of the private market figure.6

Government Regulation

Due to the Government’s long-standing non-interventionist policy, the passenger car market in Hong Kong was relatively free. The measures that the Government did take were primarily aimed at limiting the number of vehicles on the road. In 1994, for example, the authorities changed the first registration tax policy from one based on factory costs to one based on published retail prices. The tax rate on new vehicles ranged from 40% for the lower end of the market to 60% for cars with a taxable value exceeding HK$300,000.

The Economy

But Government regulations did not affect car sales as much as did the state of Hong Kong’s economy, since the local population bought vehicles more for pleasure than for convenience or necessity. Hong Kong had one of the world’s most comprehensive and efficient mass transportation systems, thus owning a private car was not essential to the general public. To many, car ownership served mainly as a reflection of their social status.

Throughout much of the 1980s and early 1990s, the economy had been robust. For the six years prior to 1998, Hong Kong’s GDP growth rate had ranged between 3.9 per cent and 6.3 per cent.\(^7\) Per capita GDP had risen steadily and in 1997 stood at US$26,614.\(^8\) This gave Hong Kong one of the highest per capita GDP levels in Asia, after Japan. It also surpassed that of a number of industrialised economies such as the UK, Canada and Australia. A growing economy meant that consumers had higher disposable income levels and were more willing to spend. Consequently, sales of big-ticket items such as cars benefitted from Hong Kong’s financial health.

But the Asian financial crisis caused the economy to enter a slump in 1998. For the first time in over two decades, the city was forecast to record negative GDP growth. As a result of this, while car sales in Europe and the US rose, those in Hong Kong fell. Total vehicle sales dropped from 24,358 in the first six months of 1997 to 21,574 in the first six months of 1998. Only 15,692 passenger cars were sold, compared with 18,092 in the first half of the previous year, a decline of about 13 per cent. Luxury cars fared worse. Unit sales in that segment fell some 30 per cent, from 1,349 to 950.\(^9\) As a percentage of the overall passenger car market, however, the sales of luxury cars remained relatively stable.

Even though Hong Kong had one of the lowest private car ownership ratios among developed countries, it boasted the highest per capita ownership of Rolls-Royce motor cars in the world. One of Hong Kong’s most prestigious hotels, The Peninsula, was the world’s largest operator of a Rolls-Royce fleet. It had nine of them, including the classic antique Silver Dawn model. In September 1991, Hong Kong was chosen as the venue for the world’s longest parade of Rolls-Royce motor cars, with 114 cars in a charity fund-raising procession.

**MD Motors**

As the sole agent for Rolls-Royce and Bentley motor cars in Hong Kong, MD Motors was a division of Inchcape plc, a UK-based international service and marketing group. In Hong Kong, Inchcape Motors International distributed a wide range of brands, from budget Japanese sedans to high-end luxury cars, through five sister companies. On a worldwide scale, Inchcape was the largest independent importer/distributor and retailer of motor vehicles, with sales of over 350,000 cars a year in over 33 countries. Within this network, only MD Motors distributed Rolls-Royce and Bentley motor cars.

As part of the giant Inchcape group, MD Motors was one of the oldest motor trading companies in Hong Kong. The dealership was originally called Metro Dodwell Motors, but changes in the corporate structure led the Company to be simply known as MD Motors. Throughout its history, the dealership had handled a number of luxury British brands, including Jaguar, Rover and Land Rover. Once these cars reached critical mass, however, separate subsidiaries were set up for them within the Inchcape group, such as Jaguar Hong Kong and Rover Hong Kong. As of July 1998, the Company also had the rights to distribute Aston Martins, but the car was generally not well received in the Hong Kong market. There were plans to drop the brand and rely primarily on the Rolls-Royce and Bentley motor cars, which formed the bulk of the Company’s revenue.

MD Motors was located in Wan Chai, a fifteen-minute walk from Central – Hong Kong’s business centre. A giant version of the Flying Lady mascot adorned the window of the showroom, which faced onto the busy Gloucester Road. Surrounded by mirrors and with soft

music playing in the background, the 1,486 square foot showroom proudly displayed the latest Rolls-Royce and Bentley models. The area also housed a number of other car dealers, including Jaguar, Toyota and Peugeot.

Since 1996, Rolls-Royce Motor Cars Limited had been urging its dealers around the world to redecorate their showrooms in order to achieve a standardised global retail environment. This standardised look involved two distinct spheres, one for Rolls-Royce and another for Bentley. The showroom environment was meant to create an unforgettable experience for the customer where Rolls-Royce and Bentley would be clearly differentiated through design, textures and heritage references.

Although Rolls-Royce Motor Cars Limited expected the new corporate look to be installed by all its dealers, it was not prepared to extend any financial assistance. For the comparatively small Hong Kong showroom, the renovation exercise was expected to cost approximately HK$3 million. To make matters worse, because the new design was so elaborate and because of the confined space of the Hong Kong outlet, after the proposed renovation, Mr. Gossmann could only expect to display two cars. This, coupled with other technicalities such as the upcoming expiry of the showroom lease agreement, led MD Motors to postpone the plans for renovation.

With the renewal of the two-year lease in July 1998 and after extensive discussions with the officially appointed architect to make the remodelled showroom less cramped, Mr. Gossmann decided to follow the lead of key worldwide dealers, and signed a GB£35,000 contract, committing his Company to the refurbishment.¹⁰

MD Motors remained a very profitable Company throughout the 1990s, even though sales did drop off from a record set in 1993. As of the end of 1997, MD Motors controlled a small but highly profitable 2.4% of the luxury car market in Hong Kong, behind other luxury brands such as Mercedes, BMW and Lexus.¹¹

Much of its profit was attributable to Rolls-Royce motor cars, which had achieved significant brand recognition in Hong Kong. Although Mr. Gossmann had the foresight to build up Bentley’s market share in Hong Kong, Rolls-Royce remained the dealership’s star attraction. The breakdown of Rolls-Royce to Bentley sales had gradually shifted from about 90:10 in 1993 to 50:50 in 1997. A year later, however, the trend reverted back to 65:35 in favour of Rolls-Royce.

**Rolls-Royce and Bentley**

Both Rolls-Royce and Bentley were manufactured by Rolls-Royce Motor Cars Limited. The company evolved from a partnership established between Henry Royce and the Hon. Charles Rolls in the beginning of the 1900s. Engineer Royce strongly believed in the need for quality.

> Small things make perfection, but perfection is no small thing … the quality remains long after the price is forgotten.
> - Henry Royce, Rolls-Royce co-founder¹²

With the outbreak of World War I, the company branched out to design and manufacture aero-engines as well. Its success allowed it to acquire Bentley Motors in 1931. Bentley had an

---

¹⁰ GB£1=US$1.644; GB£1=HK$12.74.
established reputation for speed and endurance, and the marque was inextricably linked to the 24-hour races at Le Mans, where it picked up numerous awards. Since 1931, both Rolls-Royce and Bentley motor cars had been manufactured side-by-side.

In the 1960s, the Rolls-Royce firm encountered financial difficulties associated with the development of a new jet engine, and was subsequently taken over by the UK Government in 1971. The motor car division was separated from the jet engine division and refloated as a distinct entity. Following the injection of hundreds of millions of pound sterling of state aid and the success of several engine models, the aerospace manufacturer returned to the private sector in 1987 and was known as Rolls-Royce plc. The separated automobile company, Rolls-Royce Motor Cars Limited, was subsequently acquired by Vickers plc. Vickers was an engineering company with a wide variety of interests, including marine propulsion, turbine components, medical systems and defence systems.

Over the years, the Rolls-Royce brand of cars became synonymous with quality, attention to detail, prestige and exclusivity. The cars were instantly distinguishable by their two interlocking “R” logo, imposing radiator grille and Flying Lady mascot. The mascot, also known as the Spirit of Ecstasy, had adorned the cars since 1911. The figurine was termed “a romantic representation of elegance and craftsmanship” and was one of the world’s most recognised car mascots.  

Rolls-Royce motor cars were manufactured at Crewe, in northwest England, by a group of engineers and craftsmen who endeavoured to produce cars that met the needs and tastes of individual owners. Each Rolls-Royce was a combination of precision, technology and traditional craftsmanship.

Over the years a number of different models had been produced, including the Phantom series, Silver Dawn, Silver Cloud, Silver Shadow, Silver Spirit, Silver Spur and Park Ward. As a testament to their durability and reliability, about 75 per cent of all cars ever manufactured were still on the road.

Unlike the Rolls-Royce, which was a symbol of grace and stature, the Bentley was designed to inspire enthusiasm. The car was not only to be admired, but to be driven with passion. From its racing car heritage, Bentley was known for its speed and dynamism. The Bentley wings that adorned each car embodied the marque’s sporting past and the power associated with it.

In 1952, the Bentley R-Type Continental was introduced, and became the world’s fastest four-seater motor car of its time. Subsequent improvements throughout the years came with the launch of the S and T series. In the 1980s and 1990s, the Turbo R, Continental R, Azure, Continental T and Brooklands saloon enlarged Bentley’s repertoire. The Bentley Continental T accelerated from zero to 60 mph in 5.7 seconds and had a top speed of 170 mph – the highest recorded figure for a production motor car.

**Merger Mania**

The 1990s was known as the decade for mergers, and the car industry was no exception to this trend. The grapevine was saturated with news of actual or expected tie-ups. It made sense for car manufacturers to join forces in order to spread the research and development, manufacturing and marketing costs. The largest transnational industrial deal in history occurred in May 1998, when Daimler-Benz AG announced it would merge with Chrysler Corporation for US$39 billion. The

---

combination of two of the most profitable automobile companies effectively made the new entity
the world’s fifth-largest automobile maker.

Volkswagen AG (VW) was another player with a number of makes under its umbrella, including
Bugatti and Lamborghini. It had plans to substantially increase production of the latter and
develop the brand into an alternative to Ferrari. A smaller Lamborghini, powered by an Audi
engine, was reputed to be on the drawing boards. Rumours circulated that VW would enlarge its
repertoire by moving into the heavy goods market by acquiring Renault or Scania.

Saab, another European manufacturer, had for years been under the effective control of General
Motors, while Ford owned Jaguar and Aston Martin as well as a substantial stake in Mazda. It
was reported that Volvo would soon be added to Ford’s collection of brands. Bayerische Motoren
Werke AG (BMW) had Rover under its wing, and speculation abounded that it would tie-up with
Fiat, although the rumour was subsequently denied.\(^\text{14}\) The giant Fiat group controlled Alfa
Romeo, Ferrari and Maserati.

Every major car manufacturer was said to be engaged in talks with other industry players
regarding a merger, acquisition or partnership. Being big was obviously the order of the day, or –
as was the case – the decade. Size facilitated competition on a global level and enabled
corporations to benefit from higher economies of scale that would not normally be possible for an
independent company.

Competition in the luxury market was growing increasingly intense; manufacturers no longer
intended to politely share the market, but were aggressively moving into each other’s traditional
territories. The bottom line fuelled this push. Provided a manufacturer was successful, the
margins to be gained in this market were significantly higher than in other segments. In this
respect, the merger mania that had gripped the industry helped because, by nature of their
exclusive image, luxury cars usually only sold on a small scale but building them involved high
fixed costs. Typically, these costs were drastically reduced when a small niche brand was taken
over by a big company.

*Rolls-Royce Motor Cars Limited’s Response*

Not to be left behind by the trend of introducing new models in the luxury car market, Rolls-
Royce launched the Silver Seraph in early 1998 – its first all-new Rolls-Royce motor car in nearly
two decades. The new car had a V12 engine and was the most technically advanced car built by
the company. It was, however, relatively smaller than the spacious Silver Spur it replaced and
had less torque than the traditional Rolls-Royce.

Similarly, in the same year, Bentley introduced a new model called the Arnage. The new car was
powered by a twin turbocharged V8 engine, and replaced the Brooklands and Turbo R models,
which had ceased production at the end of 1997.

Apart from ushering in new makes of both brands, Rolls-Royce Motor Cars Limited also
upgraded its factory in Crewe, with the inclusion of its first moving assembly line, advanced paint
and wood facilities, as well as new technology. The main objective of the revamp was to increase
manufacturing flexibility in accordance with the modern “lean” philosophy and yet integrate it
with the traditional levels of craftsmanship and attention to detail expected from both brands.

Production time was expected to be cut from 800 to 400 man-hours per car, which was still very high compared with a European mass-production standard of 25.\footnote{Reed, S., and Woodruff, D., “A Gamble as Big as a Rolls”, \textit{Business Week}, 19 January, 1998.}

\textbf{Difficulties}

Despite the innovation, the cut-throat automotive industry made it very difficult for low-volume luxury car makers to survive. The takeover of niche producers such as Ferrari, Maserati and Jaguar by mass producers provided proof. Rolls-Royce Motor Cars Limited was not immune to this phenomenon. The company faced severe financial problems in the early 1990s when a sharp recession hit the UK, one of its primary markets. While costs ballooned, turnover slumped. From a high of 3,333 units in 1990, only 1,350 cars were sold in 1993.\footnote{Rose, M., “Rolls-Royce Goes on the Block; Analysts Bet on a BMW Purchase”, \textit{The Asian Wall Street Journal}, 28 October, 1997.} The estimated loss to Vickers, its parent company, for 1991 and 1992 combined was GB£100 million. Since then, the luxury car maker witnessed a gradual recovery, with sales of 1,414, 1,556 and 1,744 units for 1994, 1995 and 1996, respectively.\footnote{Ibid.}

The company, whose earnings fluctuated widely, was estimated to have only made US$45 million in profit in 1996. On sales of approximately US$400 million that was a good margin, but it was still not enough for Vickers. The near US$320 million that Rolls-Royce Motor Cars Limited had spent on modernising its plant and developing new models was almost triple Vickers’ group profit of US$135 million.\footnote{Reed, S., and Woodruff, D., “A Gamble as Big as a Rolls”, \textit{Business Week}, 19 January, 1998.}

As one commentator put it, the car maker formed a “drain on what was an otherwise profitable engineering group”.\footnote{Anonymous, “Spirit of Agony”, \textit{The Economist}, 14 December, 1991.} Vickers plc seemed to concur. A spokesperson announced that the group could not devote the necessary research and development costs that Rolls-Royce Motor Cars Limited required, as it would dilute the resources of the rest of its core businesses. In October 1997, in a move that surprised many analysts by its timing – ahead of the launch of the Silver Seraph – Vickers announced its intention to sell the company. This was in accordance with its plans to streamline its range of operations. The previous month, the group had announced measures to divest itself of its medical products division.

\textbf{Bidding for Rolls-Royce Motor Cars Limited}

Some of the world’s biggest automobile makers were said to be interested in making the elite company their own, including Daimler-Benz and Ford, but ultimately the contest was fought between BMW and VW. BMW was heavily favoured, as it had a long-standing relationship with the company and was the supplier of the engines for the new Rolls-Royce Silver Seraph and Bentley Arnage.

\textbf{The Players}

\textbf{BMW}

Although BMW did not share the same cachet as Mercedes-Benz, the automobile maker produced luxury cars that were very well accepted in the US, Europe and Asia. In order to strengthen and broaden its position in the luxury car niche, BMW’s Chief Executive Bernd Pischetsrieder wanted to boost the company’s image. Mr. Pischetsrieder was an engineer who
had worked his way up through the manufacturing ranks. He had previously been criticised for not being aggressive enough. Although BMW had resisted merging with other car manufacturers, in 1995 it acquired the Rover Group, which had been struggling for nearly two decades. Mr. Pischetsrieder envisioned Rover as a second line of upscale cars, which would add the British traditional sense of styling to BMW’s high-tech repertoire. The acquisition was a disappointment, however, and although losses were narrowing, a profit contribution was not expected until 2003.20 Mr. Pischetsrieder hoped the tentative Rolls-Royce purchase would prove more auspicious. BMW bid GBR340 million for the British company.

**VW**

VW was Europe’s biggest car maker. It produced more than four million cars a year, compared to BMW’s one million. Chief Executive Ferdinand Piëch, the grandson of the company’s founder, had plans to turn VW into the world’s largest and most successful car company. His long-term aim was to move VW into the upscale ranks of the automotive industry, achieve across-the-board worldwide brand recognition, as well as make inroads into the heavy trucks and light vehicles markets. It already had a number of brands under its control, including Seat, a Spanish firm that VW took over in the 1980s, and Skoda, a Czech car maker it bought in 1991. In the higher end of the market it had Audi, Lamborghini and Bugatti. In June 1998, VW also announced a deal to develop a luxury sports utility vehicle with Porsche. However, the pragmatic iron-willed Mr. Piëch wanted more. He wanted to distance VW from its image as “the people’s car” and develop it into a brand with “a Mercedes-like reputation and Mercedes-like margins”.21 VW maintained a fierce rivalry with Daimler-Benz, which had moved into VW’s traditional territory – the production of moderately priced cars – by merging with Chrysler. To this end, Mr. Piëch set his sights on acquiring Rolls-Royce Motor Cars Limited and offered GBR430 million, significantly higher than BMW’s bid, for the company.

**The Sale**

Even though a number of small shareholders were against the sale, on 5 June, 1998, the majority of Vickers’ owners, principally institutional investors, voted overwhelmingly in favour of a VW takeover. Even though the price VW paid for Rolls-Royce Motor Cars Limited was nearly three times the latter’s net tangible asset value of GBR149 million, it was still considered a cheaper alternative than developing a new line. VW Chief Executive Piëch was said to have been delighted with the deal.

The same could not be said for Mr. Pischetsrieder. He proclaimed that the whole auction process was “distasteful” and said Vickers had sold Rolls-Royce Motor Cars Limited “like fake Persian carpets manufactured in India”.22 BMW threatened to stop supplying engines for the Rolls-Royce Silver Seraph and Bentley Arnage when its contract ran out in July 1999. In order to neutralise this threat, VW agreed to purchase UK engine maker Cosworth for nearly GBR120 million. Cosworth was part of the Vickers group and had an international reputation for advanced automotive engine technology. It was involved in racing, engineering, casting and manufacturing. But as it turned out, BMW was not to be outdone. The story was not yet over.

---

The Fine Print

Despite the GB£430 million that changed hands, VW still did not control the Rolls-Royce brand name. The agreement governing Rolls-Royce’s split in the 1970s gave Rolls-Royce Motor Cars Limited full rights to everything that was not directly related to the Rolls-Royce name and aero-engine business. This included the Flying Lady mascot, the distinctive Rolls-Royce radiator grille, the Bentley brand name and the winged Bentley “B” radiator badge. Rolls-Royce plc, however, retained control over the Rolls-Royce brand name and logo, even though it had no holding in the automobile maker. The aerospace company also had the right to veto the purchase of the car manufacturer by parties of which it did not approve.

We attach the greatest importance to the preservation and protection of the Rolls-Royce name and trademark as key assets of our business, and we'll take whatever action is necessary and appropriate.

- Rolls-Royce plc spokesman Martin Brodie

VW thus faced a situation where Rolls-Royce plc could theoretically refuse to allow an automobile that came out of the Crewe factory to be called a Rolls-Royce despite its readily distinguishable features. To complicate matters further, Rolls-Royce plc, headed by Chairman Sir Ralph Robins, had a long-standing relationship with BMW. The two were partners in an aero-engine joint venture. Sir Ralph had also played a large role in ensuring the Rolls-Royce Silver Seraph would be powered by a BMW, instead of a Mercedes, engine.

The Final Outcome

Approximately one month after the VW deal with Vickers, Rolls-Royce plc struck an agreement with BMW. In what was termed the coup of the decade by Automotive News, BMW acquired the brand name rights to the prestigious luxury car that epitomised British craftsmanship for GB£40 million. On 28 July, 1998, in order to avoid a potentially disastrous protracted legal wrangle, the two nemeses – BMW and VW – reached a compromise.

BMW agreed to license the rights to the Rolls-Royce brand free-of-charge to VW until 31 December, 2002, and resolved to continue supplying engines and other components for the Silver Seraph and Arnage models in the meantime. As of 2003, BMW would take control of the production of Rolls-Royce and establish a separate factory in England, while VW would continue to produce Bentley in Crewe. Both companies said they would jointly use the existing dealer network at least through the year 2003. They also maintained that both brands would retain their British image despite their German ownership.

The final outcome seemed to have pleased all the parties involved. Although considerably less cheerful than BMW’s Pischetsrieder, VW Chief Executive Piëch said he was content with just the Bentley name, even though he would have liked to own the Rolls-Royce name as well.

VW planned to launch a new range of smaller lower-priced Bentley models in 2002 or 2003 to compete against top-of-the-range Mercedes and BMW models. The projected production figure for the new car alone was reported to be 7,000. BMW also said it hoped to triple the yearly Rolls-Royce sales figure to 6,000 cars by expanding the number of models and including a smaller version of the vehicle, based on an existing BMW. But most observers agreed that of

---

the two, Bentley represented greater growth potential. The brand had been easily outselling the Rolls-Royce marque in the worldwide market for years. In 1997, Bentley accounted for about 60 per cent of the 1,918 cars sold by Rolls-Royce Motor Cars Limited.26

**MD’s Marketing Strategy**

Most of Rolls-Royce’s dealers around the world were reportedly pleased that the two luxury brands had been sold to leading German companies whose primary business was building and selling cars. But in places such as Hong Kong, where the Rolls-Royce brand was such a popular one, the implications for the Dealership’s business were more troubling.

MD Motors, as the local importer/distributor and retailer of Rolls-Royce, could potentially be losing the bread and butter of its business.

- MD Motors Managing Director Holger Gossmann27

Mr Holger Gossmann was at the helm of a 48-member team [see Exhibit 1]. As a self-described motor enthusiast, Mr. Gossmann had nearly 30 years’ experience in the luxury car market. After completing his studies in Germany, he began his career as a sales representative for 3M Corporation and was transferred to Hawaii in 1969. Once there, he decided to explore new opportunities and joined a BMW dealership. In the 1970s and 1980s he made a name for himself by building up the sales team until it achieved the best per capita sales in the US. In 1989, Mr. Gossmann moved to Hong Kong, and in the following year joined Inchcape’s Jaguar division. His success in establishing a new sales office for the luxury brand and in boosting sales soon led Mr. Gossmann to be promoted to General Manager of MD Motors and subsequently to Managing Director.

**Positioning**

Selling a car as prestigious as Rolls-Royce and Bentley is vastly different from selling any other make. We have to respond to our customers’ needs and desires far more than we would in any other franchise. Our customers expect a different level of service; they demand special attention, which I believe is unique to MD Motors.

- MD Motors Managing Director Holger Gossmann28

This “special attention” was translated in a variety of ways. First, each Rolls-Royce and Bentley could be specially commissioned to fit an owner’s specifications. Mr. Gossmann recalled one customer who wanted a fully functional office in the back of his Rolls-Royce, complete with telephone, facsimile and photocopier. The time-honoured skills and state-of-the-art technology available at the Crewe factory meant that nothing in the manufacture of a Rolls-Royce or Bentley was routine.

Second, Mr. Gossmann believed in maintaining strong personal relationships with existing and potential customers. The factory’s motto, “Made for me, by people I know, and who know me”, was the message each MD Motors’ customer was meant to receive. In practice this strategy was vital because a Rolls-Royce was very durable – and, not to mention, expensive – hence the actual number of units sold was relatively low. Having close contacts with his existing clientele meant that the latter could be more easily persuaded to upgrade their cars to newer models or persuade

---

26 Ibid.
27 Interview with Mr. Gossmann on 5 March, 1999.
their friends to do the same. The Company had two trade-in programmes: the “Recycling” Campaign, in which an old Rolls-Royce or Bentley could be exchanged for a newer model, and the “Conquest” Campaign, whereby any brand could be traded in for these luxury cars. If customers perceived the personal touch Mr. Gossmann tried to convey, they were also more likely to service and repair their cars with MD Motors.

**Excellent After-Sales Service**

Most companies in the automotive industry were traditionally structured into three distinct divisions, i.e., sales, service and parts, but at MD Motors there were only two. The service and parts departments, which served as customers for each other, were merged together to form the after-sales division, which complemented the sales operations.

> After-sales service make up the meat and potatoes or, in Hong Kong, the rice – the substance of daily needs – while sales is the gravy.

- MD Motors Managing Director Holger Gossmann

Mr. Gossmann was a strong believer in providing excellent after-sales service (maintaining, repairing and reconditioning cars). Located at the Rolls-Royce and Bentley service facility in Aberdeen, Hong Kong’s redeveloped ancient fishing port, was a team of dedicated and professional technicians who were specially trained to service the two prestigious brands to the highest possible standards using only genuine Rolls-Royce parts. Every car sold by MD Motors carried a three-year unlimited mileage warranty, as well as a three-year exclusive maintenance package.

Never one to be complacent, Mr. Gossmann kept close track of customer satisfaction through quarterly surveys. Customers were asked to rate the Company’s sales and after-sales service. The results were then monitored to see where improvements could be made. This was an extension of MD Motors’ corporate motto: “We know what drives you”.

Mr. Gossmann’s strategy was an apparent success and customers seemed to be very pleased with what they were driving. In 1993, the dealership won the Rolls-Royce Largest Single Point Dealer worldwide award. MD Motors sold no fewer than 94 Rolls-Royce and Bentley motor cars that year, more than other dealers in places such as New York and London. In recognition of this achievement, Mr. Gossmann was presented with a commemorative plaque by the Director of Overseas Operations for Rolls-Royce, Nigel Cornelius, who said the record was “a quite outstanding achievement for any dealer, but especially in a place the size of Hong Kong”.

MD Motors received another distinction on 9 July, 1998, when it became the first luxury car distributor in Hong Kong to receive the coveted ISO9002 award. The certification was awarded following a rigorous evaluation of the operation of all departments, management procedures/practices and the maintenance of certain provisions, all of which were designed to ensure that a high degree of efficiency existed throughout the Company.

**The Cars**

As of July 1998, MD Motors had six products to offer to its customers: two Rolls-Royce models – Silver Seraph and Park Ward limousine; and four Bentley models – Arnage, Azure, Continental R and Continental T. The retail price for the Silver Seraph was HK$3.2 million while the low-

---

29 Interview with Mr. Gossmann on 5 March, 1999.
end Bentley, the Arnage, was priced at HK$2.98 million and the high-end Continental T, HK$4.2 million. These prices were inclusive of the 60% government registration tax.

The cars were sold by a team of three sales executives headed by Spanser Lam, who had been with the Inchcape group for more than 10 years. The executives usually followed up on enquiries by arranging off-site meetings where they would take with them a briefcase featuring the different wood, carpet and leather interior samples for the commissioning of each luxury car sold by MD Motors. Unlike most Western consumers, the majority of Rolls-Royce and Bentley buyers in Hong Kong rarely visited the retail outlet and were not influenced by the showroom environment. The majority of deposits were taken in customers’ offices and/or homes.

**The Drivers**

The marketing plan that MD Motors had in place to attract the buyers of both car brands reflected their respective marque identities and the people who drove them. Rolls-Royce models were perceived as enduring, reliable cars to be admired and respected. Most Rolls-Royce owners in Hong Kong were either business tycoons, patriarchal figures in their 50s or younger self-made millionaires who wanted a symbol of their success. Ninety per cent of Rolls-Royce motor cars were chauffeur-driven.

In order to build strong relationships with Rolls-Royce owners and would-be owners, MD Motors sponsored events such as the Rolls-Royce Master Series of concerts, held twice a year. Soloists or ensembles were invited to perform before customers and prospects alike. The event served to provide a classy atmosphere where Rolls-Royce owners would mingle, and where the Company could give exposure to their latest products.

Because Rolls-Royce motor cars were mostly chauffeur-driven, MD Motors organised yearly training programmes for the drivers. Two-day instruction courses on how to handle the luxury car were held in the Repulse Bay Hotel, and attendance levels were typically high. Catering to drivers’ needs was important to MD Motors as drivers often influenced owners’ decision-making processes – i.e. the selection of car brands, models, accessories and service/repair outlets.

The Bentley, on the other hand, appealed more to the emotions rather than the intellect. It was a much sportier car than Rolls-Royce, and appealed to a spirit of daring and adventure. Local Bentley owners were typically business professionals and entrepreneurs aged between 35 and 45, who preferred to drive the cars themselves. They tended to be well travelled and had a preference for being less ostentatious.

Since 1994, Mr. Gossmann had been trying to move the sales of Bentley into the fast lane. He had always believed that Bentley was a great product which should be sold with feeling. The problem, as he saw it, was that Asians were “not so much in touch with their feelings”. Bentley did not enjoy the same level of prestige in the local market as did Rolls-Royce.

In order to cultivate an enthusiasts’ culture, a Hong Kong branch of the Bentley Drivers Club was established. The Club, originally established in the UK by founder W.O. Bentley, had a history of over 60 years and had about 2,900 members worldwide. Another event that was held to convey Bentley’s exciting image was a high-speed race held on an airfield in Shek Kong. Local journalists were invited to participate in the function and join in the fun.

---

31 Interview with Mr. Gossmann on 5 March, 1999.
Due to the exclusive nature of the two brands, advertising was primarily done in print and carried in lifestyle magazines such as *Tatler* and *Racing World*, as well as business papers such as the *Financial Times*. The marque values of Rolls-Royce were enduring, grace, wisdom, endeavour and celebration. The message conveyed in the ads was one of calmness, relaxation and insight. This was exemplified in one print ad that prominently featured the Flying Lady against a backdrop of a calm blue sky with the copy: “In front of every great man there’s a woman”. Bentley’s marque values were certainty, passion, daring, glorious and thoroughbred. The message in the Bentley ads conveyed enthusiasm, character, power and dynamism. Publicity and media events for both brands were handled by Bentley Porter Novelli Limited. 

Rolls-Royce and Bentley owners also received free quarterly issues of the in-house magazine, *Queste*, which not only featured updates on the two brands but also articles on entertainment and leisure. For Internet-savvy Rolls-Royce and Bentley enthusiasts, MD Motors had its own website where the latest news and promotional packages could be accessed.

**The Economy**

Following the slump in the local economy, Mr. Gossmann knew that the sales of his luxury cars would suffer. MD Motors had previously pursued a fixed pricing policy, which was not negotiable. With the introduction of the new models, Mr. Gossmann had to decide whether to continue this pricing system, and had to develop new ideas to boost revenue.

In order to lower the overall cost of purchasing a car, some car buyers had turned to the “grey” market. The price of cars in this market was much lower than for comparable ones sold through the authorised distributors. “Grey” importers also offered some models and specifications that were not available through the traditional channels. The drawback was that consumers obtained no warranties with such purchases, but for some consumers the price differential was worth the risk. To avoid erosion of MD Motors’ bottom line, methods to combat this trend had to be found.

According to the latest statistics in Mr. Gossmann’s possession, MD Motors’ total sales figure had fallen by 43 per cent, from 65 cars in March 1997 to 37 a year later. Rolls-Royce once again proved to be the more popular brand; 24 Rolls-Royce motor cars were sold compared to 13 for Bentley.

**Conclusion**

The shift in the sales pattern was not an encouraging development, given that MD Motors might soon lose the right to distribute Rolls-Royce. MD Motors had a long history of re-inventing itself and adapting to changes, both in its internal and external environments. Mr. Gossmann was aware, however, that past success was no guarantee of future success, and 1998 marked a critical point in MD Motors’ history. The Company was faced with a number of challenges, and its survival depended on how well they were handled.

---

32 No relation to the Bentley car brand name.
EXHIBIT 1

MD MOTORS ORGANISATIONAL CHART

Managing Director
Holger Gossmann

Administrator
Gloria Cheung

General Sales & Marketing Manager
Spanser Lam

After-Sales Manager
Daniel Choi

Service Department

Parts Department

Source: MD Motors, 8 July, 1998
Oscar Mayer: Strategic Marketing Planning

Marcus McGraw leaned back in his leather chair and gazed out his office window at the ice skaters on Lake Mendota. He loosened his tie, slipped off his loafers, and sighed deeply. It had been a long week, and he was still struggling with what direction to take in his upcoming Strategic Plan presentation to his boss at Kraft Foods. In McGraw’s 22-year career with Oscar Mayer Foods—including the last four as president of the Division—he had never encountered such a complex business challenge. First there was the alarming market research report prepared by McTiernan Corp., a consulting firm the division had relied on for planning advice over many years. Then, in the middle of his desk, lay a series of memos from four of his most trusted managers, all responding to the McTiernan report with their ideas on what action was “clearly best for the company.” The problem was that at first glance no two recommendations seemed even remotely alike in regard to what was “so clearly best.” “Oh well,” McGraw thought out loud, “this is why they pay me the big bucks.” And with that he hauled out the note from Mike McTiernan that had started the controversy.

October 14

Dear Marcus,

It was good talking with you last week, and I hope you enjoyed the Green Bay thrashing of the Cowboys. What a great game!

In regard to the enclosed Oscar Mayer Annual Report, please note our belief that the marketplace for processed meats is undergoing some fundamental changes that will threaten your profit growth over the next 3-5 years.

The most critical threat we see is that the Division’s current product portfolio is slowly shifting out of alignment with consumer trends. Specifically, your traditional red meat products like bologna, hot dogs and bacon, all branded Oscar Mayer, are under attack for being too high in fat content. You can see the results in your softening sales trends.

In the short-run you’ve been able to offset these losses through your recent acquisition of Louis Rich, Inc., and their turkey-based line of products that are both lower in fat and also lower priced. Your ability to use your business and distribution system strengths to make Louis Rich the leader of the white meat segment has really paid off—and
has kept the “total Division scorecard” looking favorable.

But the investment costs to build this “second brand” have been high, and we fear that some of the steam may be running out on Louis Rich, as evidenced by the slowing growth rate, and the entry of competitive copy-cat brands of turkey and chicken lunch meat and hot dogs.

If Oscar Mayer branded red meat products remain sluggish and the Louis Rich white meat lines begin to slow, your goal of +3-4% annual lb. volume growth could be in jeopardy.

Finally, I have to again mention the other consumer trend that may threaten both your current Oscar Mayer and Louis Rich products. This involves the increasingly fast-forward pace of our lives, especially for moms in the workforce. They represent a large part of your target audience and they are constantly looking for new products that are faster and easier to use. I know that your latest attempt, Oscar Mayer Stuff ‘n Burgers, wasn’t the answer, but I recommend that you keep searching for any and all ways to “boost convenience.”

By now I’m sure you’re muttering “There goes McTiernan again with the sky is falling routine.” But I guess that’s a part of my job as an outside observer. To shout before the sky actually falls.

Which brings me to what you might consider doing about all of this. Here’s a possible direction:

“The Division should continue to focus on broadening and contemporizing its product lines against emerging health and convenience trends, while carefully allocating its investment monies (e.g. advertising and promotion budgets) to deliver both short-run and longer-run profits.”

As I see it from a distance, your present laundry list of possible “investment bets” includes the following:

1. Adding new benefits to the current OM/LR products.
2. Strengthening/diversifying your lines via another acquisition.
3. Internally developing new products that tap the new needs.

But, as always, the devil is in the details . . . and the details will need to come from your Business Managers and their teams. Knowing them as I do, I’m sure you’ll be getting plenty of advice! Let me know if I can help.

Best regards,

Mike

McGraw nodded at the closing lines and replaced the report in his desk. Mike McTiernan was right again. The Division was probably in decent shape for another year, but then what? One thing was for sure: McGraw had no intention of surrendering Oscar Mayer’s track record as the fastest growing profit-maker across all of the Kraft divisions. In fact, prior to the McTiernan Report, he was planning to make two very bold promises about annual growth over the next three years: +4% per year on volume and +15% on operating income. “I’m going to stick with that call unless all of the
‘details’ really prove that it can’t be done,” McGraw thought to himself, as he pulled the complete McTiernan Report (see Exhibit 1) out of his file, and began to read.

Upon finishing Mattson’s report, McGraw got out of his chair and walked across the room to the bulls-eye putter resting against the far wall. As he stroked the first golf ball toward the imaginary cup in his mind, he thought about all of the times he had been here before. “When was the last year that the sky wasn’t falling?” he wondered. “Of course it’s getting harder and of course some of the wheels are coming off. And of course we’ll find a way to get it right. Bring on the Cowboys.” With the first of the four internal memos in hand, he began a serious read as he paced the room.

To: Marcus McGraw
From: Rob Goodman–Louis Rich Category Mgr.
Subject: McTiernan Report

I read the report and agree that we need to reconsider our investment strategy—with an emphasis on backing the winner in our stable, Louis Rich.

Better-for-you white meat products are on-trend, and we were smart enough to see it before the others. The recent slow-down in the rate of growth simply says that competitors are catching on. Which means that we need to pump more money in to stay in the lead.

I really believe that white meat lines can capture 50% of the market over time, and my folks have put together an aggressive plan centered on two initiatives:

1. Boosting our brand awareness and trial by heavying up our advertising behind the new “Switch to Rich” campaign. We’re still in the early growth stage of the life cycle with LR and this copy really demonstrates the advantages of white meat over red. It’s tested well and should add share, if we run enough weight behind it to really break through the clutter.

2. Introducing the string of new products that R&D has developed, including LR Turkey Bacon and the great Roast Turkey and Gravy dinner line you saw last week.

To get this done, I figure we’ll need to up our Advertising & Promotion budget by about $22 million. In the short-run, this will reduce our profits slightly, but provide another big jump in volume and set us up for long-term growth. Given the clear upside potential for white meat lines, this “L-T growth over next year profits” strategy seems right.

<table>
<thead>
<tr>
<th>Estimated Profit &amp; Loss: Louis Rich</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Year</td>
</tr>
<tr>
<td>Pound volume</td>
</tr>
<tr>
<td>% change versus last year</td>
</tr>
<tr>
<td>Advertising and promotion</td>
</tr>
<tr>
<td>Operating income</td>
</tr>
</tbody>
</table>

*Figures in millions.

Let’s discuss further when you’re ready.
“That’s exactly what I would argue if I were in Rob’s shoes,” thought McGraw. “He’s riding a fast horse and knows that those don’t come around all that often. But I wonder what his new advertising will do to our Oscar Mayer lines. And what’s a bacon made from turkey going to taste like? Let’s see what Jane has to say.”

To: Marcus McGraw  
From: Jane Morely–Director of Finance & Planning  
Subject: McTiernan–Acquisitions

This report prompted me to dig into the possibility of going after some small companies that offer both healthier and more convenient products. Three caught my attention:

1. Chicken Rite Inc. Located in Savannah, with sales of roughly $15 MM across 4-5 states, their star is a line of low cal chicken salad in single serve tubs.

2. Turkey Time Ltd. They’re on the West coast, doing $10-20MM, with a line that’s similar to Louis Rich, except for some ready-made frozen sandwiches. They also have a new plant with excess capacity.

3. Crabbies, Inc. Their HQ is in Maine and they make a string of simulated shellfish products (e.g. crabs, lobster) out of low cost raw materials such as halibut. Sales estimated at $15MM.

Turkey Time is closest to our know-how, and the plant might support further LR expansion. The other two might let us tip-toe into some new protein sources and convenience products at relatively low risk.

A complete guess at price tags might be $15-25MM apiece. If we borrowed this at 12%, annual debt service would run about $3MM. The impact on operating income would obviously depend on how they’d perform.

Let me know if you want a deeper search. And on the rest of McTiernan, we’ll need to acknowledge our weak Oscar Mayer trends and new products history when we do the presentation. The good news is that we’ve been delivering the numbers, which is ultimately the bottom line, isn’t it?

McGraw pondered the thought of another acquisition on the heels of the Louis Rich deal. As always, Jane’s instincts were to never sit still in the presence of good results. In fact she always argued that good results gave you the “right” to take risk, and reach out for new investments. The key question, of course, was how to balance all of this stuff. McGraw looked at the remaining two memos on his desk, and grabbed the one from Jim Longstreet, who was the newest member of his direct management team, brought in to improve the new product hit rate.

To: Marcus McGraw  
From: Jim Longstreet  
Subject: My Thoughts on the McTiernan Report

I felt that McTiernan got it exactly right when he said that the Division’s long-term health lies in “broadening and contemporizing our product lines against emerging consumer needs.” Yes, we have to stay profitable in the interim, but 85% of our
current volume lies in lines we’ve sold for almost 100 years! And the data shows that lunch meat, hot dogs and bacon are all very mature categories with no built-in growth.

To get the 4% annual volume gain we want, I believe we need to invent a 4th major category within processed meats that can address changing consumer lifestyles and give us a “growth engine” that will carry us for a decade.

And now is the time to do this, while results are strong and we are able to both make our short-run goals and invest in the future.

I have two ideas to offer here which have come out of work by our new cross-functional “Invention Teams.” The first cleared our concept test hurdle and is entering the “value engineering and economic evaluation stage.” The other is just taking shape as an early concept.

1. “Zappetites.” This is a line of miniaturized family favorites (pizza slice, burger on a bun, tacos, etc.) that go from freezer to microwave to your mouth in 60 seconds. They come two per 4 oz. pack at a retail price of $1.39, and take advantage of two hot consumer trends:
   * The move from sit-down meals to on-the-go hand-held portable grazing meals; and
   * The explosive growth of the microwave oven, with the associated search for products that fit.

   We see this as “fast foods at home,” with no prep convenience and sure-fire tastes that both kids and adults will enjoy. The fit here with our Oscar Mayer Brand equity also seems high.

   R&D remains hopeful about formulating these lines, although the cost structure is up in the air and we will probably need to add 2-4 food tech people. But the Stuff ‘n Burgers experience taught us many valuable lessons about the “frozen food channel” which should help this time out.

   If we give this priority, we should be able to complete our development work in the next 6-8 months and be ready to sell-in early next year—assuming we clear the remaining consumer and financial checkpoints.

2. “Lunchables.” This is the idea that came from listening to working moms describe what they think and feel about making carried lunches for themselves and for their kids five days a week: “painful to pack, boring to eat, and zero appreciation for the effort.”

   If our “important problem-superior solution model” for new product success is right, we’ve got the first half of the puzzle in hand. The solution-side we have in mind involves a plastic tray that we would fill up with some new carried lunch recipes. Almost like a “TV Dinner” tray, but in a more compact size that could fit in a brown bag.

   The recipes we’re considering would involve our sliced lunch meats, together with some cheese, crackers (since bread shelf life is too short),
condiments, and possibly a little chocolate treat. We’d try to make this filling enough to be a credible lunch, with pricing probably in the $1.25–1.50 range.

While our thinking is still early, this pre-packaged RTE lunch concept seems like a logical next step toward being more convenient and contemporary for a company like ours that wants to “own carried lunches.”

I believe that both of the above ideas fit McTiernan’s vision, and both feel like they have “sufficient scale” to become a 4th major category for us.

In regard to the appropriate level of investment, the following would allow us to complete development on one or both of these initiatives next year, and then take them national the following year.

<table>
<thead>
<tr>
<th>Estimated Profit &amp; Loss: New Products</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Pound volume (SnB)</td>
</tr>
<tr>
<td>Investment</td>
</tr>
<tr>
<td>Operating income</td>
</tr>
</tbody>
</table>

*Figures in millions. Current year volume is Stuff’n Burgers.*

Sorry about the length of this note, but I wanted to get my full shot in before Rob and Eric pocket every cent of my budget!

McGraw tossed the memo back on his desk, and thought about all of the new products he’d lived through over two decades. What was the batting average? One in ten? And every time another one went down, there was absolute hell to pay. A thousand questions on Stuff ‘n Burgers. All sorts of “free help” from the consultants. Guys left and right promising a new magic solution to get it right next time. “If only the basic categories had more intrinsic growth we wouldn’t need another flight into the unknown,” he mused.

But Longstreet did have some good points to go along with another two years of projected losses. And both ideas passed McTiernan’s wish for improved convenience. The trick will be to manage the risk along the way so that I don’t get another big dose of red ink. “Well, I’ve put it off long enough,” McGraw thought, as he looked at the last remaining memo. He knew it would be a heat-seeking missile from his long-time friend Eric Stanger.

To: Marcus McGraw
From: Eric Stanger—VP of OM Brand
Subject: McTiernan/Back To Basics

Marcus, this is probably a memo I’ll wish I hadn’t written and you’ll wish you hadn’t received.

On McTiernan . . . first off, he’s right to ring the alarm bell! The foundation of our building—the Oscar Mayer Brand, which accounts for $110MM or 82% of our total profit—is eroding rapidly, and if we don’t act soon it may be too late to fix it. This is, of course, a topic that you and I have debated over the last three years, and you know the headlines as well as I do:
In order to underwrite the growth of the new Louis Rich trademark and experiment with more new products, we have in effect been milking the Oscar Mayer lines. Our price increases on several of our most critical items have outpaced those of the key competitors, in order to always deliver more bottom line profits. Simultaneously we have shaved our A&P budgets for the same purpose. The result has been a slippage in “value” and trust among our consumer franchise that has now manifested itself in two year’s worth of declining sales and share.

I know that I signed on for this strategy for the greater good of the Division. And I know that it’s paid off in big growth, at least for the Louis Rich business. But as we old Southern boys say, “the chickens are now coming home to roost in our P&L.”

Hence my theme: “it’s time to get back to basics on the Oscar Mayer business.” And here are the six actions that I think are urgent:

1. Take a 10 cent per package price cut on the top three OM branded items in each category to begin to get back in line with the competition.
2. Increase the A&P budget by $25MM to restore fair share support for the brand.
3. Reinstitute the Wienermobile promotional program to play off the general nostalgia craze that is sweeping the nation.
4. Get enough R&D resources going to formulate a low fat and salt line of OM products.
5. Update the analyses on capacity utilization in our OM plants and rationalize what’s required to cover additional price reductions.
6. Most importantly, announce to the sales force and the entire organization that the Division’s number one goal for the year lies in reinvigorating Oscar Mayer brand growth.

I think that if we do the above and get somewhat lucky on the cost of commodities, I can begin to turn around the volumes while holding the line on operating income.

<table>
<thead>
<tr>
<th></th>
<th>Estimated Profit &amp; Loss: Oscar Mayer Brand</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Last Year</td>
</tr>
<tr>
<td>Pound volume</td>
<td>662(^a)</td>
</tr>
<tr>
<td>% change vs. last year</td>
<td>(1.3%)</td>
</tr>
<tr>
<td>Advertising &amp; promotion</td>
<td>$245</td>
</tr>
<tr>
<td>Operating income</td>
<td>107</td>
</tr>
</tbody>
</table>

\(^a\)Figures in millions.

You know, you and I worked together over fifteen years ago to make Oscar Mayer into the leading national brand in the processed meats industry. Building those damn displays in the boonies at 1AM in the morning. And it paid off.

What a bitter pill it would be if, together, we watched while it all slipped away.
Out on the lake, the last of the skaters were heading for home and a warm cup of hot chocolate to soothe away the chill. McGraw thought about those displays. And Eric Stanger. And all the other people that made the company go around by caring this much. “Just as I expected. Nothing here but a bunch of terrific ideas to choose from and the same folks who always get them done. And I thought this was going to be a hard one.” McGraw picked up the phone and called home. Guess who. Late again. Be there when I get there. Gotta get this one down on paper so I can sleep on it. The shorthand of a lasting marriage between two busy people.

The clock on the wall read 11:00 PM when McGraw next looked up from his yellow pad. He was sure that McTiernan was cuddled up in bed by now. He was also dead tired, but still pumped. He loved putting together the pieces. “So, when I add it all up, here’s what I want to promise against what I’m being promised.”

<table>
<thead>
<tr>
<th>Current Year</th>
<th>Next Year (My Wish)</th>
<th>Next Year From My Managers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Pound volume$^a$</td>
<td>934</td>
<td>971</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>2.6%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Advertising &amp; promotion</td>
<td>$385</td>
<td>TBD</td>
</tr>
<tr>
<td>Operating income</td>
<td>134</td>
<td>154</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>14.0%</td>
<td>15.0%</td>
</tr>
</tbody>
</table>

$^a$All figures in millions.

“The volumes are close; the spending is too high; and everyone’s sandbagging the bottom line. Or are they?”

McGraw’s final act for the day was his traditional “do list.”

How to Balance the Options

- Volume vs. profit
- OM brand value/quality of initiatives/pricing
- LR steam/ads/NP’s
- Flat categories/off trend
- Health and convenience
- Acquire vs. develop
- Chicken/fish/another LR
- Zap/Lunchpacks
- Problem-solution
- 4th category
- Learning vs. speed
- What we do well
- Competition
- Cost structure/benchmarks
- Risk profile
- Equitable distribution
- What else???
Questions

(1) In the beginning of the case McGraw thinks he has "never encountered such a complex business challenge" as the one he currently faces. By the end of the case, after he has read the ideas listed in the four memos, McGraw can’t believe he ever thought the investment issue was "going to be a hard one." What changed the president’s perspective? What strategic decision-making process does McGraw pursue?

(2) If McGraw chooses a strategic direction that favors only one department, what negative effects could this have on other departments? How can McGraw mitigate the damage?

(3) What effects is the change in the strengths and weaknesses of competition having on the Oscar Mayer Division? How does this impact the investment decision?

(4) Absent any resource constraints, which of the four departmental directions do you think is the most viable? Which is the second best strategy? Which is the least viable?

(5) Given the information in the case, what strategic course do you think the Division should pursue?

(6) Which of Jim Longstreet’s new product ideas is less likely to succeed? Why?
Exhibit 1  McTiernan Report: Processed Meat Industry

The following is our assessment of key trends affecting the market and implications for Oscar Mayer’s strategic plan.

1. What’s Happening to Meat Consumption in the United States

Over the past five years total meat consumption (fresh and processed) has been sluggish—with gains in white meat offset by losses in red.

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Five Years Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Meat</td>
<td>170.1</td>
<td>168.5</td>
</tr>
<tr>
<td>Red</td>
<td>124.9</td>
<td>134.7</td>
</tr>
<tr>
<td>White</td>
<td>45.2</td>
<td>33.8</td>
</tr>
</tbody>
</table>

Within the Division’s core categories, this same pattern is evident in retail sales data provided by Nielsen’s scanning panel.

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Prior Year</th>
<th>Two Years Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>All lunch meat:</td>
<td>1,427</td>
<td>1,393</td>
<td>1,363</td>
</tr>
<tr>
<td>Red</td>
<td>1,103</td>
<td>1,108</td>
<td>1,112</td>
</tr>
<tr>
<td>White</td>
<td>324</td>
<td>285</td>
<td>251</td>
</tr>
<tr>
<td>All hot dogs:</td>
<td>859</td>
<td>851</td>
<td>843</td>
</tr>
<tr>
<td>Red</td>
<td>661</td>
<td>685</td>
<td>699</td>
</tr>
<tr>
<td>White</td>
<td>198</td>
<td>166</td>
<td>144</td>
</tr>
<tr>
<td>All bacon (red)</td>
<td>677</td>
<td>698</td>
<td>709</td>
</tr>
</tbody>
</table>

*Figures in millions.

McTiernan feels that two important consumer trends are driving these sales results:

- The growing emphasis on nutrition. What began with a move toward lower calorie products, has now broadened into flight from products thought to be high in fat or salt. In processed meats, this has clearly helped lines made from turkey or chicken and hurt those made from red meat.

- The need for products offering greater convenience. With 55% of women now working outside the home, time to prepare meals has continued to erode. This has produced both anxiety and feelings of guilt—especially among “working moms”—and, in turn, a search for low/no prep, ready-to-eat foods such as frozen dinners. Its impact on processed meats is evident in the low ratings on “convenience” seen in our recent national telephone survey.
Unfortunately for the Division, neither of these important consumer trends favor our current portfolio of products. And, unless we can find solutions, long-term sales will likely suffer—especially on the Oscar Mayer red meat lines.

2. **Competition—Adding Fuel to the Fire**

   In addition to the consumer changes, the Division is also facing a much more challenging set of competitors than in the past. This is the result of a “shake-out” in the industry over 5-10 years, as profits vanished for many old-time “meat-packers” who depended on sales of unbranded, fresh red meat products. As shopping preferences began to shift from hamburgers and steaks to chicken, the thin profit margins for these companies disappeared and they were forced to close down or sell out to new ownership.

   The result of these closures and acquisitions is a more consolidated meat industry, comprising companies with sophisticated manufacturing and marketing skills, stronger financial positions, and a focus on building value-added brands and market share.

   As the Division faces these multi-billion dollar competitors (e.g., ConAgra, Sara Lee, Hormel, etc.), the race will be on for new ideas and promotional support to achieve industry leadership.

3. **Slowed Growth in Divisional Sales**

   While profits have continued to grow nicely in recent years (see **Exhibit 2**), gains in pound sales have slowed, particularly on the Oscar Mayer branded product lines.

<table>
<thead>
<tr>
<th>Division Shipments</th>
<th>Current</th>
<th>Prior Year</th>
<th>Two Years Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>All products&lt;sup&gt;A&lt;/sup&gt;</td>
<td>934</td>
<td>916</td>
<td>886</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>2.6%</td>
<td>3.0%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Oscar Mayer brand</td>
<td>650</td>
<td>662</td>
<td>671</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>(1.8%)</td>
<td>(1.3%)</td>
<td>0.3%</td>
</tr>
<tr>
<td>Louis Rich brand</td>
<td>272</td>
<td>244</td>
<td>215</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>10.9%</td>
<td>13.4%</td>
<td>14.2%</td>
</tr>
<tr>
<td>Stuff'n Burgers</td>
<td>12</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

<sup>A</sup>Figures in millions.
Likewise, market shares reflect this same pattern of strength for Louis Rich offsetting weakness for Oscar Mayer.

<table>
<thead>
<tr>
<th>Lunch Meat</th>
<th>Current</th>
<th>Prior Year</th>
<th>Two Years Ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oscar Mayer Brand</td>
<td>22.3%</td>
<td>22.8%</td>
<td>23.4%</td>
</tr>
<tr>
<td>Louis Rich Brand</td>
<td>8.6</td>
<td>7.9</td>
<td>7.0</td>
</tr>
<tr>
<td></td>
<td>30.9</td>
<td>30.7</td>
<td>30.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Hot Dogs</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Oscar Mayer Brand</td>
<td>12.5</td>
<td>12.9</td>
<td>13.2</td>
</tr>
<tr>
<td>Louis Rich Brand</td>
<td>2.9</td>
<td>2.2</td>
<td>1.4</td>
</tr>
<tr>
<td></td>
<td>15.4</td>
<td>15.1</td>
<td>14.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bacon</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Oscar Mayer Brand</td>
<td>11.3</td>
<td>11.2</td>
<td>11.5</td>
</tr>
</tbody>
</table>

4. Recent New Product Activity

Aside from the acquisition and roll-out of the Louis Rich lines, the Division’s track record on new products has mirrored that of most food companies—with many more failures than successes. Thus, while “close-in line extensions” such as Oscar Mayer Jumbo Hot Dogs or Lean ‘n Tasty Bacon have added modest share gains (0.5-1.0 percentage points of share), attempts at launching “really new lines” have been unsuccessful.

The most recent failure was Oscar Mayer Stuff ‘n Burgers, a precooked and frozen hamburger patty “with cheese and condiments inside,” intended to give busy moms a more convenient way to serve this popular dinner. A post-mortem analysis indicated that while the product gained reasonably good trial, its flavor and texture disappointed many consumers, especially those who prepared it in the microwave.

Profit margins were also narrowed by the need to invest in new business systems, processes, and technology to compete in the “frozen foods channel,” as opposed to the Division’s traditional “refrigerated distribution channel.”

5. Overall Conclusions and Implications

Given the above, we feel that the Division must make some very hard investment choices now to maintain the excellent growth record it has enjoyed over the past several years.

Your core red meat brand, Oscar Mayer, is suffering share losses; your white meat “solution,” Louis Rich, is slowing a bit; your new product attempts haven’t delivered on the “greater convenience” that consumers are demanding; and the competitive environment is much tougher than before.

To counter this, the Division must call on its traditional sources of strength: your powerful brand reputation with retailers and consumers alike; the technology skills in R&D; your unmatched sales force; and, of course, your history as a “get-it-done” organization (see Exhibit 3).

But, in our judgment, you must act quickly and decisively in order to win.

Doug Mattson
Partner-McTiernan Corp.
Exhibit 2  Oscar Mayer Division Performance (MM)

<table>
<thead>
<tr>
<th></th>
<th>Current Year</th>
<th>Last Year</th>
<th>Two Years</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Division:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pound volume(^a)</td>
<td>934</td>
<td>916</td>
<td>886</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>2.6%</td>
<td>3.0%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Revenue</td>
<td>$1924</td>
<td>$1883</td>
<td>$1693</td>
</tr>
<tr>
<td>Variable margin</td>
<td>904</td>
<td>847</td>
<td>762</td>
</tr>
<tr>
<td>Advertising &amp; promotion</td>
<td>385</td>
<td>358</td>
<td>330</td>
</tr>
<tr>
<td>Operating income</td>
<td>134</td>
<td>118</td>
<td>105</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>14%</td>
<td>12%</td>
<td>11%</td>
</tr>
<tr>
<td><strong>Oscar Mayer Brand:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pound volume</td>
<td>650</td>
<td>662</td>
<td>671</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>(1.8%)</td>
<td>(1.3%)</td>
<td>0.3%</td>
</tr>
<tr>
<td>Revenue</td>
<td>$1378</td>
<td>$1428</td>
<td>$1443</td>
</tr>
<tr>
<td>Variable margin</td>
<td>661</td>
<td>671</td>
<td>679</td>
</tr>
<tr>
<td>Advertising &amp; promotion</td>
<td>236</td>
<td>245</td>
<td>254</td>
</tr>
<tr>
<td>Operating income</td>
<td>110</td>
<td>107</td>
<td>105</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>2.8%</td>
<td>1.9%</td>
<td>2.1%</td>
</tr>
<tr>
<td><strong>Louis Rich Brand:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pound volume</td>
<td>272</td>
<td>244</td>
<td>215</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>10.9%</td>
<td>13.4%</td>
<td>14.2%</td>
</tr>
<tr>
<td>Revenue</td>
<td>$511</td>
<td>$455</td>
<td>$412</td>
</tr>
<tr>
<td>Variable margin</td>
<td>232</td>
<td>176</td>
<td>123</td>
</tr>
<tr>
<td>Advertising &amp; promotion</td>
<td>133</td>
<td>113</td>
<td>106</td>
</tr>
<tr>
<td>Operating income</td>
<td>29</td>
<td>14</td>
<td>7</td>
</tr>
<tr>
<td>% change versus last year</td>
<td>++</td>
<td>++</td>
<td>++</td>
</tr>
<tr>
<td><strong>New Products (SnB):</strong></td>
<td>12</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Revenue</td>
<td>$35</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Variable margin</td>
<td>11</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Advertising &amp; promotion</td>
<td>15</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Operating income</td>
<td>(5)</td>
<td>(6)</td>
<td></td>
</tr>
</tbody>
</table>

\(^a\)Figures in millions.
Exhibit 3  Company Background

In 1883, Oscar F. Mayer, a Bavarian immigrant, founded a retail market in Chicago specializing in “Old World” sausages and Westphalian hams. Placing quality first and price second, Oscar Mayer & Co. soon became a well-known producer of meats in and around Chicago. By 1900 the company employed 43 people, including five salespeople who traveled throughout the Chicago area, distributing meats by horse-drawn wagons.

After graduating from Harvard in 1909, Oscar G. Mayer, the founder’s son, joined the business. In 1919, while visiting his fiancee in Madison, Wisconsin, the younger Mayer heard a co-operative meat packing plant was up for auction. Recognizing its usefulness as a valuable source of raw materials, Oscar G. Mayer purchased the plant.

Through the following years, Oscar Mayer expanded the distribution of its products, pioneered several marketing programs (e.g. TV jingles, the Wienermobile, whistle premiums) increased sales, added plants and grew to be the nation’s leading manufacturer of processed meats. Creation and acquisitions of subsidiaries helped to diversify and enlarge an otherwise one dimensional firm. For instance, in 1970 Oscar Mayer purchased C. F. Claussen & Sons, Inc. which packs and distributes refrigerated fresh pickles, pickled tomatoes, sauerkraut, and relish. Also, in 1979, Louis Rich, Inc., the nation’s largest manufacturer of processed turkey products, was acquired.

Pizza Hut, Inc.

In May 1986, Steve Reinemund, the newly appointed president of Pizza Hut, Inc., announced that he intended to pursue vigorously the “exciting opportunities afforded by our new segment, delivery.” Seven months later, the home delivery units had produced mixed results, and Reinemund met with his senior managers to decide how to respond.

Entry into the home delivery market had been a major strategic decision at Pizza Hut, and Reinemund was well aware of the difficulties it presented. Half of the 5,025 Pizza Hut system restaurants were owned by large, powerful franchisees with exclusive rights to the territories they controlled. While some franchisees saw the benefits of home delivery in their markets, others were strongly opposed. Moreover, many franchisees did not agree with the manner in which Pizza Hut would implement delivery. Nevertheless, to be successful, the delivery strategy needed the franchisees’ cooperation. Attaining this cooperation in the Pizza Hut franchise system would be, in the words of Jim Baxter, vice president of franchising, “a matter of sell, not tell.”

The Pizza Market

The rapid growth in home delivery in the mid-1980s revitalized the pizza market and was responsible for pizza’s position as the fastest-growing part of the $53 billion fast food market. Three main segments comprised the pizza restaurant market: eat-in, carryout, and delivery. The sales for each segment are shown below:

<table>
<thead>
<tr>
<th></th>
<th>Eat-In</th>
<th>Carryout</th>
<th>Delivery</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$4.3 billion (57%)</td>
<td>$3.1 billion (41%)</td>
<td>$0.1 billion (1%)</td>
<td>$ 7.5 billion</td>
</tr>
<tr>
<td>1984</td>
<td>$4.7 billion (48%)</td>
<td>$4.0 billion (41%)</td>
<td>$1.0 billion (10%)</td>
<td>$ 9.7 billion</td>
</tr>
<tr>
<td>1986a</td>
<td>$5.1 billion (40%)</td>
<td>$5.0 billion (39%)</td>
<td>$2.6 billion (20%)</td>
<td>$12.7 billion</td>
</tr>
<tr>
<td>1990a</td>
<td>$5.9 billion (27%)</td>
<td>$9.0 billion (41%)</td>
<td>$7.0 billion (32%)</td>
<td>$21.9 billion</td>
</tr>
</tbody>
</table>

Source: GDR/Crest Enterprises, Inc.
aProjections based on limited Pizza Hut entry into delivery segment as of third-quarter 1986

Many companies competed in more than one segment; for example, carryout was a significant percentage of most eat-in restaurants’ business. At Pizza Hut, carryout accounted for 40% of the dollar volume in 1986, compared with 37% in 1982.
In 1986, while the overall pizza market expanded rapidly (because of home delivery), in-restaurant consumption of pizza was not increasing significantly. Industry observers believed that the restaurant industry was seriously overbuilt; pizza parlors seemed to be on every corner in some towns. They believed that the already intense local competition in the pizza eat-in and carryout segments would soon approach all-out warfare, as evidenced by increased use of couponing, deals, and price competition.

The Pizza Consumer

Pizza was a very popular restaurant food item, second only to hamburgers in frequency of purchase. Pizza was predominantly a dinner food, although many consumers also viewed it as an evening snack. Consumers did not react casually to pizza, unlike their feelings for hamburgers, chicken, and fish. Consumer research had shown that pizza was a personal, almost sensual, experience for many people. Moreover, consumers generally did not believe that great pizza could be made by a fast-food chain.

While pizza consumption was strongest in the northern and eastern parts of the United States, pizza’s appeal was broad based, with no areas exhibiting major rejection. However, tastes in pizza varied significantly by region. This presented a challenge for chains attempting to maintain product continuity while expanding into different regions.

By the early 1980s, convenience was crucial to many consumers. Two-career families often found cooking at home or eating in restaurants too time consuming, thereby increasing carryout and home delivery business. In both 1985 and 1986, consumer surveys undertaken by the National Restaurant Association identified pizza home delivery as the most important new fast food concept. Another study had shown that consumers generally viewed pizza as eat-at-home food. Many analysts believed that the rapid growth of the in-home video rental market, together with the increasing number of baby-boomers with small children, would further fuel the pizza delivery segment.

Competition in the Pizza Market

Although faced with intense competition from aggressive regional chains and single-unit owner-operated local competitors, Pizza Hut had dominated the eat-in pizza segment nationwide for years (Exhibit 1). Godfather’s Pizza, another eat-in/carryout chain, which competed in many of the same local markets as Pizza Hut, traditionally was perceived as Pizza Hut’s most significant national competitor.

Before 1984, neither Pizza Hut nor its franchisees thought that Domino’s Pizza posed a serious competitive threat to Pizza Hut’s leadership position in the overall pizza market. Domino’s, however, had grown from sales of $626 million in 1984 to $1.085 billion in 1985, and to $1.55 billion by the end of 1986. In 1985 the chain opened 954 new outlets (bringing the total to 2,839)—the highest one-year total ever recorded by a food service company. Two-thirds of Domino’s outlets were franchised; the company used its company-owned stores as sites for required franchisee training. Although there were several large franchisees operating many units all over the United States, most of the 600 franchisees in early 1986 owned only one or two stores. While some of its outlets had carryout windows, Domino’s was essentially a delivery-only chain. Domino’s management believed the large percentage of carryout business in the industry was especially vulnerable to Domino’s delivery strategy.

Pizza Hut first experienced the effects of Domino’s expansion in its company-owned stores. While Pizza Hut’s franchisees had exclusive rights to most of the smaller markets, Pizza Hut’s company-owned stores controlled most of the large, densely populated metropolitan markets. By late...
1985, Pizza Hut senior management was convinced that Domino’s dominance of the fast-growing delivery segment was the major threat to Pizza Hut’s continued leadership of the overall pizza market. By 1986, Domino’s had begun to extend its expansion into the smaller towns generally controlled by Pizza Hut franchisees. Domino’s clearly intended to gain total market leadership while maintaining its dominance of the delivery segment.

Pizza Hut, Incorporated

On June 15, 1958, Dan and Frank Carney, two college students from Wichita, Kansas, opened the first Pizza Hut restaurant. It was a startling success. By the following February, the Carney brothers had opened two more restaurants and had begun to develop plans for the first franchised outlet. The chain grew rapidly, with 43 restaurants opened by 1963 and 296 by 1968. Pizza Hut went public in 1969, and in 1977 was acquired by PepsiCo, Inc. In 1981 Pizza Hut became the largest pizza restaurant chain in the world in both sales and number of restaurants. Sales reached $1 billion in 1981; by December 1986, Pizza Hut, still headquartered in Wichita, had a total of 5,025 domestic units and annual sales of almost $2 billion (Exhibit 2).

Since the 1960s, Pizza Hut restaurants were characterized by a distinctive freestanding design and familiar red roof (Exhibit 3). All Pizza Hut restaurants were full-service, eat-in/carryout family-style operations seating about 60 to 90 customers and normally open from 11 a.m. to midnight.

Although the menu had changed over the years, pizza was always the main product in Pizza Hut restaurants. The company paid careful attention to operational efficiency, and continued to offer a high-quality product at a premium price. A constant stream of new product introductions served to invigorate consumer interest, but many franchisees were concerned by the increased cost of operations caused by the expanding menu.

For more than 20 years, the Pizza Hut franchisees had taken the lead in marketing. In the early 1980s, however, the company further strengthened its corporate marketing department and began developing comprehensive national and local market strategies. By 1986, the company was developing and implementing systemwide corporate marketing programs and realizing leverage from national TV advertising.

The Franchise System at Pizza Hut

Franchising was an integral part of the Pizza Hut strategy since the corporation’s founding. In 1968, there were 293 franchised restaurants and only seven company-owned restaurants. Over the next seven years, the company built new stores and acquired many more (including the acquisition of the 225 units of a large Pizza Hut franchisee). By the mid-1970s, there were almost as many company-owned as franchised units. In December 1986, 135 individuals, partnerships, and/or corporations operated 2,395 Pizza Hut system restaurants and 96 delivery-only units as franchisees. Meanwhile, the company itself operated 2,173 restaurants and 361 delivery-only units.

Many of the original franchisees, whose holdings had grown with the company, were still part of the system in 1986. Sixty percent of all franchised units were controlled by franchisees whose main offices were still in Wichita. In the Pizza Hut system, exclusive franchises were granted for specified market areas. Unlike franchise systems characterized by single-unit owner/operators, most Pizza Hut franchisees were large companies with diversified holdings, sometimes including other food service franchisor units like Kentucky Fried Chicken and Long John Silver. Of the 135 franchisees, almost two-thirds operated 10 or more Pizza Hut system restaurants in 1986. Except for minority opportunity programs, no new franchise areas had been offered to the public since 1971. When a franchisee chose to sell its holdings, they were purchased by the company or another franchise holder.
Franchisee rights and obligations were specified in formal franchise agreements. Under the agreements, each franchisee was obligated to develop its exclusive market area in accordance with a five-year development schedule. Essentially, the agreement required the franchisee to open an agreed-upon number of new restaurants during the first year of the agreement, an agreed-upon number during the second year, and so on, up to year five. The development schedule represented franchisee commitment to significant continuing investment in the business. After the five-year period expired, the company could negotiate a secondary development schedule with the franchisee to open additional restaurants in the area, if the company deemed it practicable. Although franchisee failure to comply with either development schedule entitled the company to franchise others or to open company-owned restaurants in the previously exclusive area, this had never been necessary. In no case could there be a restaurant established within two miles of an existing franchisee restaurant.

Franchisees paid Pizza Hut an initial fee of $15,000 for each system restaurant they opened. Franchisees also paid the company an ongoing franchise fee of 4% of monthly gross sales. The company or franchisee invested about $466,000–$816,000 to open each eat-in/carryout restaurant. By contrast, delivery-only units required an estimated $128,500–$198,500 investment. However, by the time one included delivery vehicles, training, additional advertising, and the company’s central order-taking computer system, the company’s investment in a company-owned delivery unit was about equal to that of a traditional restaurant. Franchisees investing in delivery-only units typically did not buy vehicles and did not always adopt the company’s computer-ordering system (see Exhibit 4 for expenses of company-owned delivery units).

The International Pizza Hut Franchise Holders Association

The International Pizza Hut Franchise Holders Association (IPHFHA) was formed in 1967 to “solidify the national image of Pizza Hut and to further product loyalty,” and to “devise the most appropriate use of the funds available for national advertising.” By 1986, its role had been extended to render many other services to franchisees (e.g., accounting services, group life insurance, workman’s compensation insurance, credit union).

Franchisees were required to become members of the IPHFHA. The IPHFHA communicated with the company regularly through the IPHFHA board of directors. The IPHFHA employed a professional staff headed by Gerald Aaron, president, who acted as intermediary between the board and the company. He directed for the association the broad policy areas of marketing, finance, and administration. Joint advisory committees (with franchisee and company members) were formed in 1985 to further enhance communication between the company and the franchisees on the issues of human resources, delivery, products, and buildings and equipment.

The IPHFHA was reorganized in 1975, and the Advertising Committee was formed to “determine and control the amount, kind, and quality of national advertising and sales promotion to be provided . . . for Pizza Hut and its franchisees.” (In 1981 the role of the Advertising Committee was continued under the new franchise agreement.) Four marketing professionals made up the Advertising Committee, two representing the company and two representing the franchisees. IPHFHA Members voted on funding for national advertising and other IPHFHA programs. The company, although not a member of IPHFHA, was contractually bound by the franchise agreement to contribute at the same rate as the franchisees. In 1986, the current assessment was 2% of the first $28,000 of monthly sales for each restaurant and 1% of all monthly sales above $28,000. The Advertising Committee controlled the entire advertising budget, and was also responsible for hiring and firing the national advertising agency.

Market area advertising was managed by local co-ops comprising all of those franchisees (and the company if applicable) operating restaurants within a particular market area. All co-op members, franchisees and company alike, were required to make contributions to the co-op for advertising in their area in the amount of 2% of monthly gross sales (in addition to the contributions
to the national advertising fund). All disputes arising within co-ops were arbitrated by the Advertising Committee.

In addition to ad hoc interaction between the company and its franchisees at regional store manager meetings, there were two general systemwide meetings each year. Franchisees set the summer meeting agenda and the company set the winter meeting agenda. Company management also regularly met with the board of IPHFFHA and with the franchisees on the advisory committees.

**Delivery at Pizza Hut, Inc.**

For many years, the prospect of entering the delivery market worried Pizza Hut senior managers; delivery units might cannibalize the traditional restaurant business, causing reduced profit margins. In the summer of 1984, however, Pizza Hut began exploring the possibility of such an entry. Because it was believed that the addition of delivery service to traditional eat-in restaurants would create unmanageable operational bottlenecks, the solution for Pizza Hut management was to enter the delivery market with separate delivery-only units (i.e., with no eat-in or carryout facilities). These units would be considerably smaller than the traditional restaurant facilities and would not require parking space or highly visible locations (Exhibit 3); occupancy costs therefore would be about 2.1% of sales rather than 6% for the standard eat-in restaurants.

In 1985 a small delivery task group was formed at Pizza Hut and began opening company-owned delivery units in several markets. Their idea was to open a cluster of delivery-only units in each market and keep their costs as low as possible because of the small expected margins (Exhibit 4). There was considerable resistance to the delivery concept at all levels within the company, and company restaurant managers and supervisors in the markets where delivery units had been opened complained bitterly about the adverse effect on their sales. Nevertheless, Pizza Hut management was becoming increasingly concerned about Domino’s rapid expansion, and deemed entry into the delivery segment necessary if the company was to maintain its market leadership position.

By August 1985, eight markets had been opened with a total of 51 company-owned delivery-only units. In the well-developed markets—Atlanta, Georgia, and Norfolk, Virginia—customers called a single phone number. Orders were then sent by facsimile machine to the appropriate delivery unit. Although the system was relatively cheap, as the number of units grew, it became more and more unmanageable, and the “fax” machines presented a significant bottleneck. In late summer 1985, senior Pizza Hut managers visited the Norfolk market and became convinced that, with a number of operational adjustments, the delivery concept was workable, offered tremendous potential growth, and should be pursued. The company postponed further expansion into new markets while it contracted for the development of a computerized central ordering system and perfected other aspects of the delivery concept.

The computerized central ordering system, called the Customer Service Center (CSC), allowed customers in a particular market to call a single number to place an order. The caller first was asked his or her phone number and the system ascertained whether the caller had ordered before. If so, the operator would verify the caller’s name and address and ask if the customer would like the same type of pizza previously ordered. The order would then be forwarded automatically to the appropriate delivery unit where a terminal would receive the order information.

The CSC system, although expensive to develop, was designed to be capable of handling the vast number of calls generated in a large market with a large number of delivery units. It was necessary, however, that the system work perfectly. Customers in an eat-in restaurant understood and tolerated waiting a few minutes to be seated. Delivery customers expected their phone call to be answered within seconds, even though 60% of the daily calls for an entire market area might come in during a one-hour period. While there were substantial marketing benefits to having only one phone number for an entire market, there were significant risks in operating such a complex system. In
Norfolk, Virginia, initial problems with the installation of the CSC had created serious losses in a once-profitable delivery market.

Although there had been some difficulties during its installation, Pizza Hut management was convinced that the CSC would be a significant competitive advantage. About 70% of Domino's franchisees owned only one store, and Pizza Hut believed that the costs of coordination and management of such a centralized ordering system at Domino's would be prohibitive. In the Pizza Hut system, the concentration of restaurant ownership in the hands of the company and relatively few franchisees would allow for much easier coordination and substantial cost savings. Under the company's delivery concept, the company would invest in the CSC for each market and manage it, coordinating the ordering process and providing service on a fee-per-call basis to participating franchisees and company stores (currently $ .65 per call). Pizza Hut's investment in the CSCs was expected to be large, but management believed that such systems were essential to the delivery strategy. It was expected that eventually the franchisees would purchase the necessary equipment and manage the Customer Service Centers themselves in their own markets.

Another major issue presented in developing a profitable delivery concept was whether there would be a charge for service. Pizza Hut management was convinced that for competitive reasons the company could not charge for delivery (Domino’s delivered free with a 30-minute guarantee). The additional cost of providing free delivery was the same, regardless of order size. This meant that, to the extent the average check price could be increased, margins would increase. To help maintain margins when offering free delivery, therefore, it was decided that the size and price of delivered pizzas would be slightly increased over pizza in traditional restaurants (i.e., delivery sizes would be 10-14-16" versus the 9-13-15" sizes in the traditional restaurants and Domino’s 12-16" sizes). Customers would pay approximately 10% more for a small, medium, or large pizza, but would get more as well. This “upsizing” would increase the average check price and gross margin, thereby helping to defray the cost of free delivery and the Customer Service Centers.

In early 1986, Pizza Hut was reorganized to reflect the increasing importance and autonomy of the delivery segment (Exhibit 4). A senior vice president of operations managed all traditional restaurant operations, while Senior Vice President Allan Huston was general manager of delivery. Still another senior vice president led the marketing function for the traditional restaurants. Delivery had its own separate marketing department that reported directly to Allan Huston. Even the regions into which the country was divided were different for delivery and the traditional restaurant business.

Although there was some experimentation with alternative delivery concepts (e.g., no upsizing in some markets) during the spring and summer of 1986, the marketing function for the delivery group was not fully operational until July. Huston concentrated primarily on the operational details surrounding the opening of new delivery units rather than on refining the Pizza Hut delivery concept. In the first half of 1986, Pizza Hut doubled the number of markets where it operated delivery units and had almost quadrupled the total number of units (Exhibit 6). Those delivery units were predominately in metropolitan areas—where most of the company’s markets were. The initial units opened were in markets with high levels of traditional restaurant penetration and high “per-store-average” (PSA) sales. A second group, opened later in 1986, were in low penetration and low per-store-average sales markets.

Throughout 1986, Pizza Hut managers on the traditional restaurant side of the business continued to be concerned about competition from the Pizza Hut delivery operation, as well as from Domino’s. Huston and other managers in the delivery operation, however, believed that delivery was expanding the market by including people who would not go to a restaurant for pizza. They argued that consumers who ate pizza in restaurants and those who had pizza delivered sought very different benefits, and that delivery did not compete directly with traditional restaurants. Moreover, the adverse effects of Pizza Hut delivery units on traditional restaurant sales growth appeared to be most pronounced in markets where there was weak sales growth already; in strong markets the effect
was short lived. As Reinemund noted in early 1986, “We do not yet know how great a factor this overlap will be. But what we do know is that in many cases our restaurant business has actually grown after our delivery units have entered the market.” In the words of another senior Pizza Hut manager:

While it is true that we often are serving the same customers, we are serving them on totally separate dining occasions. When we introduce delivery to a market, we get the business of customers who probably were ordering a competitor’s pizza simply for the convenience of home delivery.

As for personnel, it was clear that needs of the delivery business were significantly different from those of the traditional restaurant business. Pizza Hut restaurant managers were trained to manage the “total customer experience” and, because of the isolation from customers, some restaurant managers did not think they would enjoy running a delivery-only unit. While many production and operation functions would overlap, store managers found it hard to see how career paths could cross over from traditional full-service restaurants to delivery units or vice versa. Moreover, moving as quickly as it had into new markets, Pizza Hut found it difficult to manage at the store level. Ninety percent of the people working in the delivery business were new, and delivery presented unfamiliar operational demands in the areas of driver management, trade area definition, and order taking.

The Franchisees’ Experience with Delivery

A few Pizza Hut franchisees had been offering delivery unofficially for 20 years. In the early 1980s, the company consistently attempted to dissuade franchisees from offering delivery. Nevertheless, the number of small-town franchisees delivering pizza to college dormitories and military bases from their traditional restaurants had begun to increase. In some isolated cases franchisees faced local competitive environments that they believed necessitated offering delivery. By 1982, about 25 franchisees operated delivery services from a total of about 75 standard eat-in restaurants.

Most franchisees that entered the delivery segment did so by retrofitting existing eat-in restaurants to allow for delivery “out the back door” (Exhibit 6 shows the number of franchisees owning retrofit and delivery-only units from 1984 to 1986). They found, however, that retrofitting significantly increased demands on the restaurant manager and required much greater local management skills. Because of operational bottlenecks, some franchisees lost money on the delivery business and ceased delivery operations. The company believed this supported its concept of opening separate delivery-only units.

Through 1985, the majority of Pizza Hut franchisees saw no reason for delivery. They faced little or no competition in their market from the major chains offering delivery, and were less interested in overall market share battles than the company seemed to be. Sixty-five percent of all franchised restaurants were in towns with populations under 50,000 people, and delivery in those rural areas was not as easy to justify economically as in more densely populated markets. In late 1985, when the company changed its position completely and began to encourage franchisees to open delivery-only units, most franchisees were not interested in doing so.

In November 1985, the company announced to franchisees that it interpreted franchise agreement development schedules to include delivery and, therefore, the company had the right to require franchisee development of delivery units in their markets. The company announced that it would not exercise that right for one-and-a-half years while it perfected the concept, but urged franchisees to begin developing delivery-only units immediately.
The franchise community’s response was quick and clear. Most franchisees saw no reason to risk business in their eat-in restaurants by expanding into the delivery market. They denied that the development schedules allowed Pizza Hut to require them to open delivery units. They openly expressed their disagreement with the company’s delivery concept, especially regarding upsizing (referred to by one franchisee as “up-pricing”). They also questioned the necessity of the computerized Customer Service Centers and the delivery-only units (some franchisees wanted to retrofit existing restaurants, and others wanted carryout allowed in the delivery units). Significant tension arose between the company and its franchisees. At a heated IPHFHA board meeting in December 1985, board members and Pizza Hut senior management recognized that they had been concentrating too much on each other and not enough on Domino’s. They agreed to operate temporarily under a “yellow flag” plan (an automobile racing term referring to the period when each side continues to operate as before without either side trying to improve its relative position).

The company’s upsizing concept continued to be a focal point of disagreement. Although Pizza Hut suggested prices, the franchisees were free to price their products as they pleased. The franchisees argued that, even though they had not increased prices as frequently as the company-owned restaurants had in past years, they were still at a price disadvantage when compared to the competition. This disadvantage was especially acute in the delivery business; franchisees believed that upsizing would exacerbate the problem because customers were conscious only of the absolute price of a small, medium, or large pizza and did not calculate price per square inch of the product.

The franchisees also wanted to know why Pizza Hut needed an expensive CSC system, if Domino’s didn’t have one. They felt that if delivery was necessary, the costs should be kept as low as possible. This meant simple phone ordering to each local restaurant, and delivery out of existing restaurants where feasible. It was important to franchisees that the system be as flexible as possible so that they could find local solutions to local problems.

The reorganization of Pizza Hut in early 1986, which provided for the delivery business to operate autonomously from the traditional restaurant business, raised another issue in the franchise community. Franchisees were concerned that while the company could afford to run the delivery and eat-in businesses separately, the franchisees did not have the resources for separate marketing and operations departments for the traditional restaurant and delivery business. The mismatch of organizational forms between company and franchisees was expected to create significant management difficulties. To make matters worse, the Pizza Hut national advertising account had been split in two within the advertising agency so that a separate group could begin working only on delivery. Many franchisees viewed the two businesses as one and were concerned that their separation would make coordination between delivery and eat-in even more difficult.

There was little consensus of opinion among the franchisees regarding the various elements of the company’s delivery concept. There was, however, virtual unanimous franchisee concurrence that the existing franchise agreement did not cover delivery. In February 1986 Jim Baxter, who had been with Pizza Hut for almost 10 years, was appointed vice president of restaurant franchising and assumed the role of liaison between the company and franchisees. In May, newly appointed president Steve Reinemund accompanied Baxter to a series of regional meetings with the franchisees where Reinemund announced that the company no longer contended that the existing development agreement covered delivery. He also announced the company’s intention to negotiate with the board of the IPHFHA to produce an amendment to the franchise agreement that would provide for systemwide entry into the delivery market. Reinemund suggested that the amendment would include incentives (e.g., reduced or no royalties for a certain time period on new delivery-only units) designed to make franchisee participation in the delivery segment more attractive. These incentives would be retroactive for any franchisee delivery-only units opened in the meantime. The amendment would take effect if franchisees representing 85% of the units approved it within a specified time period.
The August Franchisee Meeting

As the August 1986 franchisee meeting drew near, Pizza Hut management decided it was time to press again for the full involvement of all franchisees in systemwide entry into the delivery market. Pizza Hut operated delivery units in 16 markets, with a total of 284 company-owned units. The company had hired and trained over 10,000 people. The flagship Norfolk market, which had experienced difficulties, was now profitable. The first half-year results from the operating units were impressive, and Delivery General Manager Huston was confident that the company could make a good business case for delivery.

Huston and the delivery group gave an extremely upbeat presentation of the delivery data to franchisees at the August meeting. Their purposes included (1) to convince franchisees that the time had come to give total support to the delivery effort, (2) to “sell” the company’s delivery concept to the franchisees, and (3) to successfully launch the amendment negotiation process that was to begin in earnest after the meeting. While many franchisees remained adamantly opposed to delivery, others were becoming convinced that they could, in fact, increase their overall income with delivery even if they would face decreased average margins. While the idea of delivery became more acceptable, however, there was still little support for the particulars of the company’s delivery concept.

The Current Situation

As the negotiations for an amendment to the Franchise Agreement continued into the fall of 1986, competition in the delivery market intensified tremendously. Systemwide, Domino’s increased advertising 100% over the previous year. Moreover, much of its advertising was specifically focused on the markets Pizza Hut was attempting to open for delivery. Domino’s spent an average of 68% more on advertising in those markets than in its other markets. Moreover, Domino’s had proven to be an able competitor with satisfied customers and an inexperienced but highly enthusiastic franchise system. It met Pizza Hut head-on in each market Pizza Hut entered by focusing on execution, quality, advertising, and price.

Discounting became even more prevalent in late 1986. Fifty percent of Domino’s pizzas were sold on deal. Pantera’s joined Little Caesar in offering two-for-one deals; Godfather’s and Pizza Inn launched their own delivery services also with deep price discounts. Delivery proved to be much more price, coupon, and deal sensitive than the traditional restaurant business.

Of the 19 Pizza Hut company-controlled markets open in December 1986, three were profitable. At the unit level, of the 361 company-owned operating delivery units, 194 were profitable. Company-owned delivery units that had opened early that year performed well from both a sales and profit perspective. The fierce competitive environment in markets opened later that year, however, led to slower sales growth and greater operating losses than expected for those units. For example, in one market, per-store average weekly sales rose to $6,600 after three weeks. Domino’s had responded with two-for-one deals for three months, and the per-store average weekly sales dropped to around $4,850. Moreover, in markets with greater than $8,000 per-store average weekly sales in traditional restaurants, Pizza Hut delivery units averaged $7,300; in markets where traditional per-store average was less than $8,000, delivery units averaged only $4,225. Overall, the average weekly sales per delivery unit in December was $6,000.

Huston believed that some of the markets were overbuilt with delivery units and that Pizza Hut was getting all the sales that could be expected from those units. The ratio of traditional restaurants to potential customers averaged 1 restaurant to 70,000 people, while the delivery units averaged 1 unit to 40,000 people.

Consumer research had shown that the standard Pizza Hut pizza served in the traditional restaurants was not as well-suited to the delivery environment, causing quality to suffer. Pizza Hut
research and development managers were confident that they could solve that problem by developing a new product designed especially for delivery. This would involve an entirely different production process than that used currently in the traditional restaurants.

Meanwhile, the number of franchisees who had introduced delivery was growing rapidly. Franchisees who in August had told Aaron that delivery would be “over their dead bodies” were inviting him to visit their delivery operations. Moreover, many franchisees who had introduced delivery were doing significantly better than the company-owned stores. Eighteen franchisees opened a total of 65 delivery-only units in 1986, bringing the overall total to 96. All but two units with over seven months’ experience were profitable. In addition, by December 1986, 292 traditional restaurants had been retrofitted by franchisees to provide delivery service. Because the delivery operations were co-mingled with the eat-in and carryout operation in the retrofitted restaurants, it was difficult to estimate their profitability; however, the franchisees were reported to be pleased with the results so far. The franchisees’ success with delivery was attributed to the fact that they had developed markets where they were already strong and had carefully picked the trade areas with the highest potential. They had also priced more competitively, and only 20% had upsized. Most kept costs low by having phone orders go direct to each separate unit instead of using Customer Service Centers.

The winter franchisee meeting was scheduled for January, and Reinemund, Huston, and Baxter had less than a month to decide how to proceed. Before deciding what to do at that meeting, they wanted to review the overall strategy and likely profit impact on Pizza Hut of delivery.
Pizza Hut, Inc.

**Exhibit 1**  Top Pizza Chains, 1986

<table>
<thead>
<tr>
<th></th>
<th>Systemwide Sales ($ millions)</th>
<th>Units</th>
<th>Average Check/Person</th>
<th>Delivery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pizza Hut</td>
<td>1,934</td>
<td>5,025</td>
<td>$9.99</td>
<td>Separate delivery units plus franchisee add-on delivery out of restaurant</td>
</tr>
<tr>
<td>Domino’s</td>
<td>1,550</td>
<td>3,696</td>
<td>$9.50</td>
<td>Delivery only</td>
</tr>
<tr>
<td>Little Caesar</td>
<td>520</td>
<td>1,308</td>
<td>$2.75</td>
<td>No delivery</td>
</tr>
<tr>
<td>Pizza Inn</td>
<td>278.7</td>
<td>748</td>
<td>$4.30</td>
<td>Separate delivery units</td>
</tr>
<tr>
<td>Godfather’s</td>
<td>275</td>
<td>650</td>
<td>$9.75</td>
<td>Add-on delivery out of restaurant</td>
</tr>
<tr>
<td>Round Table Pizza</td>
<td>250</td>
<td>535</td>
<td>$5.00</td>
<td>Add-on delivery out of restaurant</td>
</tr>
<tr>
<td>Showbiz/Chuck E. Cheese</td>
<td>249</td>
<td>268</td>
<td>$5.20</td>
<td>No delivery</td>
</tr>
<tr>
<td>Shakey’s</td>
<td>197</td>
<td>386</td>
<td>$4.25</td>
<td>Add-on delivery out of restaurant</td>
</tr>
<tr>
<td>Mr. Gatti’s</td>
<td>139.2</td>
<td>319</td>
<td>$7.81</td>
<td>Add-on delivery out of restaurant</td>
</tr>
</tbody>
</table>

Adapted from *Nation’s Restaurant News*
## Exhibit 2  Pizza Hut Historical Data (U.S. domestic only)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>System net sales ($MM)</td>
<td>732</td>
<td>832</td>
<td>1,007</td>
<td>1,170</td>
<td>1,394</td>
<td>1,566</td>
<td>1,743</td>
<td>1,934</td>
</tr>
<tr>
<td>Market share&lt;sup&gt;a&lt;/sup&gt;</td>
<td>14.9</td>
<td>15.7</td>
<td>17.0</td>
<td>17.2</td>
<td>18.0</td>
<td>17.3</td>
<td>16.0</td>
<td>15.4</td>
</tr>
<tr>
<td>Units&lt;sup&gt;b&lt;/sup&gt;:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>1,940</td>
<td>1,888</td>
<td>1,843</td>
<td>1,845</td>
<td>1,911</td>
<td>2,051</td>
<td>2,224</td>
<td>2,534</td>
</tr>
<tr>
<td>Franchise</td>
<td>1,801</td>
<td>1,873</td>
<td>1,922</td>
<td>1,975</td>
<td>2,095</td>
<td>2,157</td>
<td>2,309</td>
<td>2,491</td>
</tr>
<tr>
<td>Total</td>
<td>3,741</td>
<td>3,761</td>
<td>3,765</td>
<td>3,820</td>
<td>4,006</td>
<td>4,208</td>
<td>4,533</td>
<td>5,025</td>
</tr>
<tr>
<td>Company</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PSA&lt;sup&gt;c&lt;/sup&gt; sales ($M)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Traditional)</td>
<td>196</td>
<td>221</td>
<td>267</td>
<td>306</td>
<td>348</td>
<td>372</td>
<td>395</td>
<td>400</td>
</tr>
<tr>
<td>(Delivery)</td>
<td>395</td>
<td>400</td>
<td>282</td>
<td>289</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PSA sales growth</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real</td>
<td>(3.1)</td>
<td>4.7</td>
<td>11.8</td>
<td>8.0</td>
<td>9.8</td>
<td>1.8</td>
<td>2.0</td>
<td>(2.0)</td>
</tr>
<tr>
<td>Price</td>
<td>6.4</td>
<td>8.1</td>
<td>9.0</td>
<td>6.6</td>
<td>3.9</td>
<td>5.1</td>
<td>3.4</td>
<td>8.0</td>
</tr>
<tr>
<td>Total</td>
<td>3.3</td>
<td>12.8</td>
<td>20.8</td>
<td>14.6</td>
<td>13.7</td>
<td>6.9</td>
<td>5.4</td>
<td>1.2</td>
</tr>
<tr>
<td>Net sales ($MM)</td>
<td>354</td>
<td>399</td>
<td>476</td>
<td>556</td>
<td>678</td>
<td>766</td>
<td>835</td>
<td>929</td>
</tr>
<tr>
<td>Net sales growth(%)</td>
<td>--</td>
<td>12.7</td>
<td>19.3</td>
<td>16.8</td>
<td>21.9</td>
<td>13.0</td>
<td>9.0</td>
<td>11.3</td>
</tr>
<tr>
<td>Total revenues ($MM)</td>
<td>495</td>
<td>556</td>
<td>489</td>
<td>569</td>
<td>699</td>
<td>795</td>
<td>867</td>
<td>967</td>
</tr>
<tr>
<td>ROAE (%)&lt;sup&gt;d&lt;/sup&gt;</td>
<td>3.5</td>
<td>6.1</td>
<td>8.9</td>
<td>16.4</td>
<td>21.7</td>
<td>16.9</td>
<td>15.0</td>
<td>12.4</td>
</tr>
</tbody>
</table>

<sup>a</sup>Based on data from GDR/Crest Enterprises, Inc.

<sup>b</sup>Total number of U.S. domestic units of all kinds: restaurant, delivery, and mobile open that year

<sup>c</sup>PSA—Per Store Average: annual average computed by dividing total sales for each four-week store period by number of stores open during that period and then aggregating across all 13 store periods

<sup>d</sup>Return on Assets Employed: calculated as earnings divided by year’s average net asset base
Exhibit 3  Traditional Red-Roof Pizza Hut Restaurant

Delivery Unit
**Exhibit 4** Pro Forma Profit and Loss Statement (based on $8,000/week sales)\(^a\)

<table>
<thead>
<tr>
<th></th>
<th>Company-owned Traditional Restaurant</th>
<th>Company-owned Delivery Unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross sales</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Advertising, discounts,</td>
<td>16.5%</td>
<td>18.5%</td>
</tr>
<tr>
<td>promotions, and allowances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales(^b) &amp; labor</td>
<td>48.5%</td>
<td>46.2%</td>
</tr>
<tr>
<td>Semivariables &amp; premiums(^c)</td>
<td>8.7%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Vehicles(^d)</td>
<td>--</td>
<td>6.1%</td>
</tr>
<tr>
<td>Occupancy costs</td>
<td>6.0%</td>
<td>2.1%</td>
</tr>
<tr>
<td>General and administrative</td>
<td>7.2%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Customer service center costs</td>
<td>--</td>
<td>5.9%</td>
</tr>
<tr>
<td>Net field contribution</td>
<td>13.1%</td>
<td>8.8%</td>
</tr>
</tbody>
</table>

\(^a\)Percentages reflect an assumed $8,000/week store. As weekly sales decreased below $8,000, expenses as percent of sales increased significantly. At approximately $7,000/week, Delivery Unit net field contribution was 0.

\(^b\)Cost of sales tended to be lower in the Delivery Units due to a combination of upsizing and higher prices per order. Labor costs for Delivery Units did not include order-taking expenses that were reflected in the Customer Service Center costs.

\(^c\)Semivariables refers to utilities, uniforms, and other operating supplies. Premiums refers to items such as special glassware or toys that were given away or sold below cost to promote the sale of a particular menu item.

\(^d\)Vehicle expenses reflect a mix of driver- and company-owned vehicles. Eighty percent of the delivery vehicles were owned by the drivers, who were reimbursed for their use per trip.
Exhibit 5  Organization Chart

Pizza Hut, Inc.

President/CEO
Steve Reinemund

Vice President, Research and Engineering
Allan Huston

Vice President, Delivery Marketing

Vice President, Delivery Operations

Regional Vice President West
Regional Vice President North Atlantic
Regional Vice President Southeast
Director, Fleet Directory
Director, Planning and Development
Regional Vice President North Central
Regional Vice President South Central
Regional Vice President East Central
Regional Vice President Southeast
Regional Vice President Cumberland
Regional Vice President North Atlantic

Vice President, Restaurant Development
Senior Vice President, Personnel
Senior Vice President, Operations
Vice President Franchising, Jim Baxter

Senior VP and General Mgr. Delivery

Senior Vice President, Finance

Senior Vice President, Marketing

Vice President, Field Operations
Senior Director, Operations Services
Regional Vice President Pacific Region

Vice President, Franchise Developments

Vice President, Law
### Exhibit 6  Open Pizza Hut System Traditional Restaurants and Delivery Units

<table>
<thead>
<tr>
<th></th>
<th>Company-Owned</th>
<th>Franchisee-Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Traditional Restaurants</td>
<td>Delivery-only Units</td>
</tr>
<tr>
<td>August 1984</td>
<td>2,011</td>
<td>11</td>
</tr>
<tr>
<td>December 1984</td>
<td>2,025</td>
<td>16</td>
</tr>
<tr>
<td>August 1985</td>
<td>2,046</td>
<td>51</td>
</tr>
<tr>
<td>December 1985</td>
<td>2,004</td>
<td>78</td>
</tr>
<tr>
<td>August 1986</td>
<td>2,208</td>
<td>284</td>
</tr>
<tr>
<td>December 1986</td>
<td>2,173</td>
<td>361</td>
</tr>
</tbody>
</table>

*Domestic U.S. restaurants and delivery units only*

*Totals for franchisee-owned traditional restaurants include those restaurants retrofitted to provide delivery service.*
The Black & Decker Corporation
Household Products Group: Brand Transition

In April 1984, Black & Decker Corp. (B&D) acquired the Housewares Division of General Electric Co. (GE), combining the GE small-appliance product line with its own household product line to form the Household Products Group. The terms of the acquisition set the stage for a unique marketing challenge. B&D was permitted to manufacture and market appliances carrying the GE name, but only until April 1987. During the intervening three years, B&D would have to replace the GE name on all the acquired models with its own brand name.

Immediately after the acquisition, Kenneth Homa, B&D’s vice president of marketing, was assigned responsibility for the brand transition. Homa had to design a marketing program to transfer the B&D name to the GE small-appliance lines without losing market share. Specifically, he had to determine the timing for the transition of the various GE product lines and the roles that advertising and promotion should play in the transition. Homa had been asked to have the proposal for the brand transition completed by June 1—only a week away. Before he began to formulate the proposal, Homa reviewed the acquisition and the challenges it presented.

The Acquisition

With 1983 sales of $1,167 million, B&D was the leading worldwide manufacturer of professional and consumer hand-held power tools. Over 100 products were produced in 21 factories around the world. By the late 1970s, B&D was confronting two important problems—a slower growth rate for the power tool market worldwide together with increasing foreign competition. At the same time, management realized that the American housewares market presented a significant opportunity. Capitalizing on its expertise in small-motor production and cordless appliance technology, B&D introduced the Dustbuster® in 1979, a rechargeable hand-held vacuum cleaner. The Dustbuster Vac “moved B&D from the garage into the house”; 60% of Dustbuster purchases were made by women. The Dustbuster’s success prompted the launch of two other rechargeable products, the Spotliter® rechargeable flashlight and the Scrub Brusher™ cordless scrubber. In 1983, these three products generated revenues of over $100 million, almost one-third of B&D’s U.S. consumer product

1In 1983, B&D produced 20 million small motors, four times as many as its closest competitor.
sales. Pretax profit margins on these products were estimated at a healthy 10%. Sales of the three products were expected to increase by 30% annually between 1983 and 1985.

Consumer demand for these three innovative products led B&D executives to conclude that further penetration of the housewares market could generate substantial sales and profits for the company. They resolved to develop a family of products that could address consumer needs “everywhere in the house, not just in the basement or garage.” However, a significant impediment to growth was B&D’s limited access to housewares buyers in the major retail chains. B&D’s three housewares products were sold along with B&D’s power tools through hardware distributors to hardware buyers and were typically stocked in the hardware sections of retail stores. B&D sought to gain access to housewares buyers through the acquisition of a competitor, the GE Housewares Division.

With 1983 sales of $500 million (GE’s total sales in 1983 were $26.79 billion), GE’s Housewares Division was the largest competitor in the U.S. electric housewares or small-appliance market. (GE sales of small appliances outside the United States were limited. By contrast, 40% of B&D’s total sales were made in Europe.) GE sold almost 150 models of products in 14 categories covering food preparation, ovening, garment care, personal care, and home security. (The categories were food processors, portable mixers, electric knives, can openers, drip coffee makers, toaster ovens, toasters, electric skillets, grills and griddles, irons, hair dryers, curling brushes/irons, scales, and security alarms.) In all the appliance categories in which it competed—except food processors, hair care products, and toasters—GE ranked first or second in market share. GE’s success largely resulted from continuing attention to product innovation. For example, the GE product line included the recently introduced Spacemaker™ series of premium-priced under-the-cabinet kitchen appliances. The division’s 150-person sales force called on housewares buyers in all channels of distribution.

Discussions between GE and B&D culminated in an agreement, announced in February 1984, whereby B&D would acquire the GE Housewares Division for $300 million, comprising $110 million in cash, a $32 million three-year note, and 6% of B&D stock. In return, B&D acquired seven plants in the United States, Mexico, Brazil, and Singapore; five distribution centers; sixteen service centers; and the Housewares Division’s sales and management team. GE retained rights to the accounts receivable at the time of the transfer. Finally, B&D negotiated the right to continue to use the GE name on appliances in the Housewares Division product line for three years from the signing of the acquisition papers in April 1984. However, B&D could not use the GE name on any new appliances introduced after the acquisition. At a stroke, the acquisition transformed B&D from a specialist housewares manufacturer into the dominant full-line player in the housewares market.

The Housewares Market

Product Lines and Pricing

After acquiring the GE division, B&D participated in five more broad housewares categories with aggregate industry sales of $1.4 billion divided as follows:

<table>
<thead>
<tr>
<th>Product Line</th>
<th>Industry Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food preparation</td>
<td>$275 million</td>
</tr>
<tr>
<td>Beverage makers</td>
<td>$325 million</td>
</tr>
<tr>
<td>Ovening</td>
<td>$250 million</td>
</tr>
<tr>
<td>Garment care</td>
<td>$200 million</td>
</tr>
<tr>
<td>Personal care</td>
<td>$350 million</td>
</tr>
</tbody>
</table>
The housewares market was mature and fragmented. Industry growth depended primarily on the rate of household formation and the pace of new product development. About one-tenth of all small appliances in use were replaced each year. The timing of replacement purchases could be accelerated if manufacturers could persuade consumers to trade up to more highly featured, higher-priced, higher-margin models of a particular appliance.

The new B&D offered one of the broadest lines of any manufacturer, competing in 17 product groups. Market performance data for the principal product lines are summarized in Exhibit 1. In all these groups, B&D marketed multiple models that covered almost all price points and product feature configurations. For example, the B&D line included 18 different irons with suggested retail prices from $14.76 to $25.89. The range included promotional, step-up, and premium models. Proctor-Silex, B&D’s closest competitor in this category, offered 12 models.

B&D’s models were priced competitively within each price/feature segment but, overall, B&D’s share tended to be stronger in the medium and upper rather than the lower price ranges. In the fall of 1984, the average retail price of a B&D small appliance was 16% higher than the average retail price of its competitors’ appliances. The B&D retail price premium varied across product categories as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Price Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food preparation</td>
<td>8%</td>
</tr>
<tr>
<td>Cleaning</td>
<td>10%</td>
</tr>
<tr>
<td>Ovening</td>
<td>26</td>
</tr>
<tr>
<td>Garment care</td>
<td>5</td>
</tr>
<tr>
<td>Personal care</td>
<td>16</td>
</tr>
</tbody>
</table>

Some B&D executives were concerned that the price premium in certain categories left B&D vulnerable to lower-priced competition. They advocated price decreases on some models for 1985. Other executives, noting that B&D/GE housewares prices had increased on average by only 10% between 1980 and 1984, believed that price increases were necessary to maintain margins. (The contribution margin on B&D small appliances, after variable costs, averaged 40%. The percentage margin was higher on premium models such as the Spacemaker products.) However, all agreed that, despite B&D’s share leadership position, competitive brands did not appear to set their prices in relation to B&D’s prices.

B&D’s price premium in the food preparation category was largely due to the premium-priced Spacemaker line of under-the-cabinet kitchen appliances. Launched in 1982 with a can opener, the Spacemaker line was expanded in 1983 to include a toaster oven, drip coffee maker, mixer, and electric knife. The Spacemaker line attracted some first-time purchasers into these five categories but, more important, persuaded current owners to trade up. Although the Spacemaker line at first reversed GE’s share erosion in these categories, lower-priced imitations soon appeared. GE’s standard countertop version of the Spacemaker appliances lost share as GE’s competitors slashed prices to maintain their sales volumes in countertop models. Nevertheless, Spacemaker models were expected to account for about 40% of B&D’s 1984 unit sales in the five product categories in which they competed.

Competition

B&D’s principal competitors in the housewares market were Sunbeam (a subsidiary of Allegheny International), Proctor-Silex (Westray), Hamilton Beach (Scovill), and Norelco (Philips). Few offered as broad a line as B&D, but all four competed with B&D in at least six categories. In addition, B&D had to contend with specialist competitors in each product category. For example, Cuisinart was the market share leader in food processors as was Mr. Coffee in drip coffee makers. European manufacturers, such as Krups, were increasingly penetrating and helping to expand the premium price segment in some categories. Their higher-margin products were welcomed by
department stores that sought to continue to compete with mass merchandisers in housewares. Japanese manufacturers were not a factor in the U.S. small-appliance market except for dual-voltage travel irons.

Following the acquisition announcement, B&D’s housewares competitors saw the imminent demise of the strongest brand name in the housewares market (i.e., GE) as an opportunity to increase their market shares. Hence, prices on some existing models were reduced; price increases announced for 1985 were minimal, and promotional and merchandising allowances escalated. The timing of new product introductions accelerated and, in some instances, manufacturers decided to enter new product categories. Norelco and West Bend, for example, both announced that they would launch a line of irons.

Sunbeam was especially aggressive and heavily advertised two new products in the fall of 1984: the Monitor automatic shut-off iron and the Oskar compact food processor. Both were introduced at premium rather than penetration price levels. In addition, Sunbeam announced a $43 million marketing budget for 1985, including $25 million for national advertising, $10 million for cooperative advertising, and $8 million for sales promotion. The 1985 budget was more than Sunbeam had spent in the previous five years combined. Some analysts doubted that Sunbeam would follow through with this level of spending, however.

Besides GE’s long-standing competitors, B&D also had to contend with imitators of its cordless vacuums and lights. Believing that the newly acquired product lines would divert B&D’s management attention and resources, these imitators redoubled their efforts to capture more market share.

**Distribution**

Small electric appliances were distributed through various channels. **Table A** shows the percentages of industry dollar sales accounted for by each of seven channels.

Mass merchandisers, such as Montgomery Ward, and discount stores, such as K Mart, had gained share in recent years, mainly at the expense of department stores. Catalog showrooms, such as Service Merchandise, carried the broadest line of small appliances, whereas other channels tended to cherry-pick the faster-moving items. GE had built a disproportionately strong share position with volume retailers, notably catalog showrooms and mass merchandisers. B&D was traditionally strong in hardware stores. In the fall of 1984, B&D accounts carried, on average, 30 B&D stockkeeping units (SKUs). (An SKU is an individual model or item in the product line.)

**Table A** Breakdown of Industry Dollar Sales by Channel (%)

<table>
<thead>
<tr>
<th>Channel</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Catalog showrooms</td>
<td>15%</td>
</tr>
<tr>
<td>Mass merchandisers</td>
<td>28%</td>
</tr>
<tr>
<td>Department stores</td>
<td>9%</td>
</tr>
<tr>
<td>Drug Stores</td>
<td>6%</td>
</tr>
<tr>
<td>Hardware stores</td>
<td>5%</td>
</tr>
<tr>
<td>Discount stores</td>
<td>8%</td>
</tr>
<tr>
<td>Othera</td>
<td>29%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100%</td>
</tr>
</tbody>
</table>

*a*Includes sales through stamp and incentive programs, premiums, and military sales.
Most retailers did not view small appliances as especially profitable. Retail margins averaged 15% to 20%, though promotional merchandise was typically sold near cost. Hence, the space allocated to housewares by most chains remained stable, despite an increasing proliferation of new products. As a result, manufacturers were under more pressure than ever to secure shelf space through merchandising and promotion incentives.

Housewares and hardware buyers at B&D’s major accounts determined twice a year which models they would specify as “basics.” These selected models were carried in distribution for the following six months, usually in all the stores of a chain. Other models not specified as basics might occasionally be stocked but only in response to temporary promotion offers.

Basics were typically specified in January and May. Retail sales of small appliances peaked before Mother’s Day and Christmas. Twenty-one percent of retail sales occurred in the first calendar quarter, 21% in the second, 17% in the third, and 41% in the fourth. Manufacturers and retailers scheduled their advertising and promotion efforts accordingly.

**Consumer Behavior**

Consumers shopping for small appliances were often characterized as having low information needs, low perceived interbrand differentiation, and high price sensitivity. A 1984 B&D survey drew the following conclusions:

- Two out of three consumers bought their last housewares appliance on sale and/or with a rebate. The highest percentages bought on sale were the countertop drip coffee makers, mixers, and can openers.

- Two out of three consumers compared the prices of different brands and checked to see which brands were on sale.

- Fewer than one out of three consumers would wait until a specific brand went on sale.

- Almost three out of four consumers were willing to switch from their current brands when they purchased replacements. However, fewer than one out of four consumers were indifferent to brand names.

A follow-up study of buying behavior for irons found that most consumers, when they needed a replacement, would not wait for a sale but would check to see if a store was having a sale. Fifty percent bought a replacement within seven days. Only 10% of the irons were bought as gifts. Forty-two percent of the purchasers had a specific brand in mind when they set off for the store, and 85% ended up buying that brand. Thirty-eight percent were attracted to a particular store by its advertisement, and most bought at the first store in which they shopped. Half of all purchasers bought their irons on sale and/or with a rebate.

**Planning the Brand Transition**

**Consumer Research**

To aid transition planning, B&D surveyed 600 men and women 18 to 49 years old in four geographically representative cities during July 1984. The survey first probed consumers’ awareness of 10 housewares manufacturers, their ownership of small appliances by each manufacturer, and the
degree to which their overall image ratings of each manufacturer were favorable or unfavorable. These results are summarized in Exhibit 2.

Next, respondents were asked to rate each manufacturer on various attributes using a 100-point scale. Averaging all responses, the researchers identified B&D's strengths and weaknesses compared with its main housewares competitors (GE excluded) and then with GE (see Table B).

Table B  B&D’s Strengths and Weaknesses

<table>
<thead>
<tr>
<th>B&amp;D Strengths</th>
<th>B&amp;D Advantage vs. Closest Competitor</th>
<th>B&amp;D (Dis)Advantage vs. GE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Has high-quality workmanship</td>
<td>+24</td>
<td>+5</td>
</tr>
<tr>
<td>Makes durable products</td>
<td>+23</td>
<td>+4</td>
</tr>
<tr>
<td>Makes reliable products</td>
<td>+20</td>
<td>+1</td>
</tr>
<tr>
<td>Leader in making innovative products</td>
<td>+18</td>
<td>(7)</td>
</tr>
</tbody>
</table>

*B&D Vulnerabilities

| Makes products that can be easily serviced         | +7                                  | (17)                      |
| Makes products most people would consider buying  | +7                                  | (12)                      |
| Makes attractive, good-looking products            | +6                                  | (8)                       |
| Makes products that are generally priced lower    | +5                                  | (9)                       |
| Makes products that are easily found              | +2                                  | (9)                       |

*Other than GE.

The survey asked respondents whether they currently perceived B&D favorably or unfavorably as a manufacturer of each of 16 products. The percentages answering “very favorably” on a four-point scale were as follows:

<table>
<thead>
<tr>
<th>Product</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smoke alarms</td>
<td>62%</td>
</tr>
<tr>
<td>Flashlights</td>
<td>60%</td>
</tr>
<tr>
<td>Vacuums</td>
<td>48%</td>
</tr>
<tr>
<td>Grills/griddles</td>
<td>29%</td>
</tr>
<tr>
<td>Electric knives</td>
<td>25%</td>
</tr>
<tr>
<td>Can openers</td>
<td>24%</td>
</tr>
<tr>
<td>Scales</td>
<td>22%</td>
</tr>
<tr>
<td>Toaster ovens</td>
<td>21%</td>
</tr>
<tr>
<td>Irons</td>
<td>18%</td>
</tr>
<tr>
<td>Portable mixers</td>
<td>17%</td>
</tr>
<tr>
<td>Toasters</td>
<td>17%</td>
</tr>
<tr>
<td>Food processors</td>
<td>16%</td>
</tr>
<tr>
<td>Coffee makers</td>
<td>13%</td>
</tr>
<tr>
<td>Skillets</td>
<td>12%</td>
</tr>
<tr>
<td>Curling irons</td>
<td>11%</td>
</tr>
<tr>
<td>Hair dryers</td>
<td>9%</td>
</tr>
</tbody>
</table>

Qualitative research indicated that consumers considered B&D a suitable manufacturer of these products but were largely unaware that B&D already made them.
Product Plans

Homa knew that B&D executives disagreed concerning both the timing and the manner in which the B&D name should be transferred to the GE small-appliance line. In talking with other executives, he had identified five points of view.

One group of executives argued that the name change should be executed across the entire product line as soon as possible to demonstrate B&D’s commitment to the trade. At the other extreme, a second group, skeptical about the likely pulling power of the B&D brand in housewares, proposed that B&D delay the name transfer until the end of the three-year period.

A third group of executives supported a gradual transition whereby all the items in one or two product categories would be reintroduced under the B&D name in successive six-month periods. A fourth group wanted to execute the name change first on the premium quality items in several product categories to be followed later by the remaining lower-priced items in each product line. A fifth group argued that the transition schedule should be linked to a new product development program. Through such a program, the name change would be implemented in a product category only after the product line and packaging had been redesigned and/or when B&D could offer a new product with enhanced features.

As he planned the transition program, Homa also had to consider proposals for new or revised products that B&D product managers had submitted. The proposals included the following:

- The Spacemaker line of under-the-cabinet appliances, which had been acquired from GE, could be redesigned by B&D to look sturdier and more compact. The edges could be rounded for additional safety.

- B&D could develop Black Tie™, a line of “men’s grooming tools,” which would be priced at a 15% premium over the hair care line acquired from GE.

- Plans had been developed for the Stowaway line of dual-voltage travel appliances. The line would include a folding iron, hair dryer, and curling irons.

- The Handymixer cordless beater, the first extension of B&D’s cordless technology into the kitchen, had been proposed.

- An automatic shut-off iron had been designed by B&D. Unlike the Sunbeam model, the B&D iron would beep to let the consumer know that it had been left on.

Communications

An effective communications plan would be integral to the brand transition. Historically, B&D and GE had implemented communications programs with fundamental differences. Specifically, GE had emphasized push programs (e.g., volume rebates, purchase allowances), which were aimed at the trade, while B&D had emphasized pull programs (e.g., advertising, consumer rebates), which targeted consumers. These differences are reflected in Exhibits 3 and 4, which summarize the advertising and promotion expenditures for GE and B&D before the acquisition. Homa’s tentative recommendations for 1985 communications expenditures also are included in Exhibits 3 and 4.
Advertising

Increased advertising expenditures would be necessary to bolster consumer brand loyalties in the face of more aggressive competition. Homa estimated that media expenditures of $100 million would be needed for the brand transition.

The issue of how to handle the brand transition in advertising was much debated. Some executives believed that explicit references to GE in B&D’s advertising were necessary to maintain market share during the transition, especially in categories where GE’s brand name equity was strong. These executives wanted a transition statement such as “designed by GE, built by B&D” to be included in advertising. They also wanted hang tags on B&D products at the point of sale to indicate that the products had formerly been made by GE. Critics of this dual-branding approach, which included B&D’s advertising agency, argued that it would confuse consumers and simply sustain the GE franchise. Exhibits 5 and 6 present television advertisements proposed by B&D’s advertising agency.

Promotional Programs

Homa had to determine whether or not to maintain GE’s more generous support of promotional programs. Some trade accounts already had expressed concern about potential cutbacks that B&D might implement. Competitive housewares manufacturers did all they could to cultivate this concern in an effort to secure additional basics listings and shelf space for their own products.

At the time of the acquisition, GE’s promotional programs for the trade included purchase allowances, volume rebates, dating discounts, and cooperative advertising. Promotional programs for consumers focused on consumer rebates.

Purchase allowances During the 1970s, GE initiated purchase allowances (PAs) on selected models against orders paid for during the first two months after Christmas and Mother’s Day, the peak retail selling periods. Over time, PAs came to be offered on orders placed beyond these two-month periods. By 1983, 90% of shipments included an off-invoice PA.

Volume rebates GE operated a volume rebate program that offered trade accounts a year-end refund of up to 4% of their net purchases during the year. Accounts qualified for various percentage rebates according to the degree to which their purchases increased over those of the previous year. There were two other features of the program. First, the rebates were computed on an account’s total purchases rather than separately for each shipping point. Second, the program attempted to maintain the total number of SKUs by requiring a dealer to have incremental sales in four of six defined product categories to earn the minimum rebate.

Dating discounts Dating allowed customers to pay for goods after they were shipped and received. Dating encouraged trade accounts to place early orders for goods that they did not have to pay for immediately. The seasonality of retail sales and the desire of trade accounts to avoid holding high bulk-to-value small appliances in their own warehouses made dating programs a necessity in the small-appliance industry. Production planning and scheduling could become more efficient if a trade account placed early orders at the same time that it decided which SKUs to specify for its basics lineup.

GE Housewares Division’s standard terms required full payment by the tenth of the month following an order, plus 45 days. The dating program permitted an account to place an order in May and June for shipment before September 1 and payment by December 10. A second dating program required payment by May 10 on orders placed in December and January. A schedule of early-payment allowances rewarded accounts for payment of invoices before the dating program due date. GE’s purchase allowance and dating programs together permitted accounts to pay less and pay later.
Cooperative advertising  GE’s Housewares Division had long offered trade accounts a cooperative advertising program. Accounts accrued 3% of their net purchases in a rolling 12-month cooperative advertising fund. (Allowances accrued more than 12 months previously that had not been spent were forfeited.) Accounts could draw on these accruals to subsidize the cost of retail advertising that featured GE products. GE paid the full cost of qualifying advertising but sometimes only partially charged accounts’ accrual funds if they featured particularly profitable premium-priced products such as items in the Spacemaker line, if they ran advertisements featuring multiple GE items, or if they timed their advertising to coincide with flights of GE national advertising.

Consumer rebates  Initiated in the 1970s to help sell slower-moving models, consumer rebates had become endemic to the housewares category by the early 1980s. By 1983, almost all list price increases were cushioned with rebates, and three-quarters of all feature advertisements for GE housewares included references to manufacturer rebate offers. The average value of housewares manufacturers’ consumer rebates escalated as each tried to outdo the other. In an effort to lead the industry toward more realistic list pricing, GE in 1983 curtailed rebates on irons and toaster ovens, two categories in which it was the market share leader. Far from following GE’s lead, competitors increased their rebate offers. As a result, GE’s share declined six points in both categories within six months.

Conclusion

Homa had two main concerns. How could the B&D brand name be transferred most effectively to the GE small-appliance line? What kind of communications program would facilitate the transfer?
Exhibit 1  Market Performance Summary for Selected Product Lines

<table>
<thead>
<tr>
<th>Product</th>
<th>Year</th>
<th>GE/B&amp;D Unit Share (%)</th>
<th>Feature Ad Share (%)</th>
<th>Average Retail Price ($)</th>
<th>GE/B&amp;D Share Rank in 1984</th>
<th>Major Competitors (Share and Rank)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food processors</td>
<td>1983</td>
<td>16%</td>
<td>9%</td>
<td>$55.00</td>
<td>3</td>
<td>Cuisinart 25% (1)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>13</td>
<td>7</td>
<td>72.00</td>
<td>2</td>
<td>Hamilton Beach 21% (2)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>15</td>
<td>8</td>
<td>NA</td>
<td>11</td>
<td>Moulinex 11% (4)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Sunbeam 7% (5)</td>
</tr>
<tr>
<td>Mixers</td>
<td>1983</td>
<td>31</td>
<td>22</td>
<td>16.00</td>
<td>2</td>
<td>Sunbeam 28% (1)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>26</td>
<td>20</td>
<td>15.40</td>
<td>3</td>
<td>Hamilton Beach 21% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>35</td>
<td>16</td>
<td>NA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Can openers</td>
<td>1983</td>
<td>28</td>
<td>25</td>
<td>17.65</td>
<td>1</td>
<td>Rival 30% (2)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>34</td>
<td>23</td>
<td>20.52</td>
<td>3</td>
<td>Sunbeam 8% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>30</td>
<td>26</td>
<td>NA</td>
<td>4</td>
<td>Hamilton Beach 6% (4)</td>
</tr>
<tr>
<td>Toasters</td>
<td>1983</td>
<td>13</td>
<td>16</td>
<td>16.63</td>
<td>3</td>
<td>Toastmaster 32% (1)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>12</td>
<td>10</td>
<td>21.01</td>
<td>3</td>
<td>Proctor-Silex 30% (2)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>11</td>
<td>10</td>
<td>NA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Toaster ovens</td>
<td>1983</td>
<td>56</td>
<td>49</td>
<td>45.51</td>
<td>1</td>
<td>Toastmaster 25% (2)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>52</td>
<td>39</td>
<td>47.85</td>
<td>3</td>
<td>Proctor-Silex 8% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>50</td>
<td>40</td>
<td>NA</td>
<td>5</td>
<td>Norelco 4% (4)</td>
</tr>
<tr>
<td>Drip coffee makers</td>
<td>1983</td>
<td>17</td>
<td>13</td>
<td>34.48</td>
<td>2</td>
<td>Mr. Coffee 19% (1)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>18</td>
<td>15</td>
<td>37.63</td>
<td>3</td>
<td>Norelco 17% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>17</td>
<td>16</td>
<td>NA</td>
<td>4</td>
<td>Hamilton Beach 9% (4)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Proctor-Silex 8% (5)</td>
</tr>
<tr>
<td>Electric knives</td>
<td>1983</td>
<td>39</td>
<td>NA</td>
<td>13.54</td>
<td>2</td>
<td>Hamilton Beach 47% (1)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>39</td>
<td>NA</td>
<td>17.28</td>
<td></td>
<td>Moulinex 6% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>39</td>
<td>NA</td>
<td>17.65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Irons</td>
<td>1983</td>
<td>52</td>
<td>39</td>
<td>20.44</td>
<td>1</td>
<td>Proctor-Silex 18% (2)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>46</td>
<td>29</td>
<td>21.83</td>
<td>2</td>
<td>Sunbeam 13% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>45</td>
<td>29</td>
<td>NA</td>
<td>3</td>
<td>Hamilton Beach 11% (4)</td>
</tr>
<tr>
<td>Hair care</td>
<td>1983</td>
<td>8</td>
<td>8</td>
<td>17.74</td>
<td>4</td>
<td>Conair 22% (1)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>6</td>
<td>4</td>
<td>15.37</td>
<td></td>
<td>Clairol 12% (2)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>5</td>
<td>3</td>
<td>NA</td>
<td></td>
<td>Sassoon 8% (3)</td>
</tr>
<tr>
<td>Cordless vacuums</td>
<td>1983</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td></td>
<td>Douglas 8% (2)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td></td>
<td>Sears 8% (2)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>NA</td>
<td>NA</td>
<td>25.70</td>
<td></td>
<td>Norelco 7% (4)</td>
</tr>
<tr>
<td>Lighting products</td>
<td>1983</td>
<td>65</td>
<td>NA</td>
<td>NA</td>
<td></td>
<td>First Alert 25% (2)</td>
</tr>
<tr>
<td></td>
<td>1984</td>
<td>57</td>
<td>44</td>
<td>NA</td>
<td></td>
<td>Sunspot 5% (3)</td>
</tr>
<tr>
<td></td>
<td>1985a</td>
<td>38</td>
<td>36</td>
<td>21.10</td>
<td></td>
<td>Norelco 4% (4)</td>
</tr>
</tbody>
</table>

Note: NA means not available.

*aFigures for 1985 are estimated.
The Black & Decker Corporation Household Products Group: Brand Transition

Exhibit 2  Consumer Research on Major Housewares Manufacturers

<table>
<thead>
<tr>
<th></th>
<th>Aided Corporate Awareness (%)</th>
<th>Product Ownership (%)</th>
<th>Corporate Image Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Men</td>
</tr>
<tr>
<td>General Electric</td>
<td>100%</td>
<td>91%</td>
<td>2</td>
</tr>
<tr>
<td>Black &amp; Decker</td>
<td>99</td>
<td>67</td>
<td>1</td>
</tr>
<tr>
<td>Mr. Coffee</td>
<td>99</td>
<td>51</td>
<td>4</td>
</tr>
<tr>
<td>Conair</td>
<td>79</td>
<td>43</td>
<td>9</td>
</tr>
<tr>
<td>Hamilton Beach</td>
<td>93</td>
<td>43</td>
<td>5</td>
</tr>
<tr>
<td>Norelco</td>
<td>98</td>
<td>54</td>
<td>3</td>
</tr>
<tr>
<td>Proctor-Silex</td>
<td>80</td>
<td>28</td>
<td>8</td>
</tr>
<tr>
<td>Rival</td>
<td>56</td>
<td>19</td>
<td>10</td>
</tr>
<tr>
<td>Sunbeam</td>
<td>96</td>
<td>48</td>
<td>6</td>
</tr>
<tr>
<td>Toastmaster</td>
<td>92</td>
<td>41</td>
<td>7</td>
</tr>
</tbody>
</table>

Exhibit 3  Advertising and Merchandising Expenditures for GE Housewares (in millions of dollars and percentage of net sales billed)

<table>
<thead>
<tr>
<th></th>
<th>1983 $</th>
<th>% of Sales</th>
<th>1984 $</th>
<th>% of Sales</th>
<th>1985a $</th>
<th>% of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Push Programs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase allowances</td>
<td>$17.5</td>
<td>3.5%</td>
<td>$22.5</td>
<td>4.5%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Volume rebates</td>
<td>14.0</td>
<td>2.8%</td>
<td>14.5</td>
<td>2.9%</td>
<td>$12.5</td>
<td>2.5%</td>
</tr>
<tr>
<td>Cash discounts</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Subtotal</td>
<td>31.5</td>
<td>6.3%</td>
<td>37.0</td>
<td>7.4%</td>
<td>12.5</td>
<td>2.5%</td>
</tr>
<tr>
<td><strong>Pull Programs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National advertising</td>
<td>$8.5</td>
<td>1.7%</td>
<td>$16.5</td>
<td>3.3%</td>
<td>$34.0</td>
<td>6.8%</td>
</tr>
<tr>
<td>Co-op advertising</td>
<td>26.0</td>
<td>5.2%</td>
<td>25.5</td>
<td>5.1%</td>
<td>32.0</td>
<td>6.4%</td>
</tr>
<tr>
<td>Consumer rebates</td>
<td>13.0</td>
<td>2.6%</td>
<td>9.5</td>
<td>1.9%</td>
<td>15.0</td>
<td>3.0%</td>
</tr>
<tr>
<td>Consumer promotions</td>
<td>1.5</td>
<td>0.3%</td>
<td>1.0</td>
<td>0.2%</td>
<td>0.5</td>
<td>0.1%</td>
</tr>
<tr>
<td>Sales promotion materials</td>
<td>3.0</td>
<td>0.6%</td>
<td>1.5</td>
<td>0.3%</td>
<td>3.5</td>
<td>0.7%</td>
</tr>
<tr>
<td>Press relations</td>
<td>1.0</td>
<td>0.2%</td>
<td>1.0</td>
<td>0.2%</td>
<td>1.0</td>
<td>0.2%</td>
</tr>
<tr>
<td>Exhibits</td>
<td>1.0</td>
<td>0.2%</td>
<td>1.0</td>
<td>0.2%</td>
<td>1.0</td>
<td>0.2%</td>
</tr>
<tr>
<td>Functional support expenses</td>
<td>1.5</td>
<td>0.3%</td>
<td>1.5</td>
<td>0.3%</td>
<td>2.0</td>
<td>0.4%</td>
</tr>
<tr>
<td>Corporate promotion assessment</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>In-store merchandising</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.5</td>
<td>0.7%</td>
</tr>
<tr>
<td>Subtotal</td>
<td>55.5</td>
<td>11.1%</td>
<td>57.5</td>
<td>11.5%</td>
<td>92.5</td>
<td>18.5%</td>
</tr>
<tr>
<td>Total merchandising expenditures</td>
<td>$87.0</td>
<td>17.4%</td>
<td>$94.5</td>
<td>18.9%</td>
<td>$105.0</td>
<td>21.0%</td>
</tr>
</tbody>
</table>

Note: 1984 and 1985 figures continue to separate the former GE housewares line from the former B&D household products line for ease of comparison. Total 1985 B&D Household Products Group expenditures can be calculated by summing the last columns in Exhibits 3 and 4.

aEstimated
Exhibit 4  Advertising and Merchandising Expenditures for Black & Decker Household Products (in millions of dollars and percentage of net sales billed)

<table>
<thead>
<tr>
<th></th>
<th>1983 $</th>
<th>1983 % of Sales</th>
<th>1984 $</th>
<th>1984 % of Sales</th>
<th>1985$</th>
<th>1985 % of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Push Programs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flexible funds (off-invoice)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Retail incentive plan</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$1.0</td>
<td>0.6%</td>
</tr>
<tr>
<td>Cash discounts</td>
<td>$0.9</td>
<td>0.9%</td>
<td>$1.2</td>
<td>0.9%</td>
<td>1.5</td>
<td>0.9%</td>
</tr>
<tr>
<td></td>
<td>0.9</td>
<td>0.9%</td>
<td>1.2</td>
<td>0.9%</td>
<td>2.5</td>
<td>1.5%</td>
</tr>
<tr>
<td>Pull Programs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National advertising</td>
<td>$8.9</td>
<td>8.9%</td>
<td>$12.0</td>
<td>9.2%</td>
<td>$18.6</td>
<td>11.0%</td>
</tr>
<tr>
<td>Co-op advertising</td>
<td>2.0</td>
<td>2.0%</td>
<td>3.1</td>
<td>2.4%</td>
<td>7.3</td>
<td>4.3%</td>
</tr>
<tr>
<td>Consumer rebates</td>
<td>-</td>
<td>-</td>
<td>2.2</td>
<td>1.7%</td>
<td>11.7</td>
<td>7.1%</td>
</tr>
<tr>
<td>Consumer promotions</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sales promotion materials</td>
<td>0.5</td>
<td>0.5%</td>
<td>1.6</td>
<td>1.2%</td>
<td>1.4</td>
<td>0.8%</td>
</tr>
<tr>
<td>Press relations</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Exhibits</td>
<td>-</td>
<td>-</td>
<td>0.1</td>
<td>0.1%</td>
<td>0.3</td>
<td>0.2%</td>
</tr>
<tr>
<td>Functional support expenses</td>
<td>-</td>
<td>-</td>
<td>0.1</td>
<td>0.1%</td>
<td>0.3</td>
<td>0.2%</td>
</tr>
<tr>
<td>Corporate promotion assessment</td>
<td>-</td>
<td>-</td>
<td>1.0</td>
<td>0.8%</td>
<td>2.0</td>
<td>1.2%</td>
</tr>
<tr>
<td>In-store merchandising</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>11.4</td>
<td>11.4%</td>
<td>20.1</td>
<td>15.5%</td>
<td>41.6</td>
<td>24.6%</td>
</tr>
<tr>
<td>Total merchandising expenditures</td>
<td>$12.3</td>
<td>12.3%</td>
<td>$21.3</td>
<td>16.4%</td>
<td>$44.1</td>
<td>26.1%</td>
</tr>
</tbody>
</table>

Note: B&D household products: Dustbuster Vac, Spotliter, and Scrub Brusher.

aEstimated
Exhibit 5 Proposed 1985 Spacemaker Advertisement

(SFX: TRAFFIC)
ANNCR: (VO) One of the most densely populated places on earth

Coffeemaker, mixer, toaster oven,

electric knife

and can opener. The only completely coordinated line of under-the-cabinet appliances.

(SFX: BIRDS CHIRPING)
They return your counter to a more natural state.

The Spacemaker line from Black & Decker: Ideas at work.
Exhibit 5  Proposed 1985 Spacemaker Advertisement

(SFX: Electronic High Tension)
ANNCR: (VO) It splits the dark with a powerful beam.

It can survive a drop of 6 feet.

Spotlite rechargeable light from Black & Decker.

Spotlite stores all the power you need in its own recharging base.

So on a moment's notice

It gives you light.

Light for your safety...and peace of mind.

It's one utility light that does more than just shine.

Spotlite.

One of the many lights in the lighting series. From Black & Decker: Ideas at work.
Eastman Kodak Company: Funtime Film

On January 25, 1994, George Fisher, Kodak’s recently appointed chief executive officer, met with analysts and investors to set out Kodak’s new strategy for film products. During the past week (between January 17 and January 24), Kodak stock had lost 8% in value on rumors of a price cut on film.

While Kodak continued its overwhelming domination of the photo film market, its market share in the United States had eased from about 76% to 70% over the past five years “as competitors like Fuji Photo Film Co. and Konica Corp. wooed consumers with lower-priced versions.”¹ Previously, Kodak had attempted to blunt share-gaining attempts by such rivals and private label products by introducing a superpremium brand, Ektar. Now Kodak proposed to introduce a brand at Fuji and Konica’s price level, 20% below the price of Kodak’s flagship Gold Plus brand. The new brand, Funtime, was to be available only in limited quantities during two off-peak selling seasons. While some viewed the move favorably, others were more skeptical. One analyst termed the strategy “seemingly a long step down the slippery slope that ends in private label trial.”

The U.S. Photo Film Market

In 1993, approximately 16 billion color exposures were made—the equivalent of 670 million 24-exposure rolls. Typically, a consumer paid between $2.50 and $3.50 for a 24 exposure roll. Over the past five years, the market’s annual unit growth rate averaged only 2%. Major suppliers were Kodak, Fuji of Japan, Agfa of Germany, and 3M. Kodak and Fuji sold only branded products. Because of a 1921 consent decree still in force, Kodak could not sell film on a private label basis. Both Agfa and 3M sold their film to consumers as branded product and to other firms for sale under a private label. Polaroid entered the market in 1989 with its branded product, which it sourced from 3M. Film was intensively distributed through discount and department stores (32% of sales), drug stores (24%), camera shops (14%), supermarkets and convenience stores (13%), wholesale clubs (9%) and mail order (2%).

Analysts’ estimates of unit market shares by manufacturer are shown in Table A.

Fuji and Kodak were locked in a global battle for dominance of the worldwide photographic market. Both sold cameras and other imaging products as well as film. Fuji’s worldwide sales of $10 billion made it half Kodak’s size. Fuji started its serious incursion into Kodak territory in 1984, when it captured consumers’ attention, particularly in the United States, by becoming the official film of the 1984 Summer Olympics in Los Angeles.

Both Fuji’s and Polaroid’s U.S. dollar sales grew at over 15% in the past year, compared with Kodak’s 3% growth rate. An industry expert opined, “Fuji’s gains can be largely attributed to the marketer’s ability to keep the line on price, an area where Kodak has suffered.” Fuji’s and Polaroid’s U.S. dollar sales grew at over 15% in the past year, compared with Kodak’s 3% growth rate. An industry expert opined, “Fuji’s gains can be largely attributed to the marketer’s ability to keep the line on price, an area where Kodak has suffered.”

Private labels as a group grew about 10%.

### Category Pricing

Kodak’s Gold Plus brand was the standard of the industry. Exhibit 1 shows the average retail prices for a single 24-exposure roll of ISO 100 film. (ISO refers to the “speed” or light sensitivity of the film. Amateurs typically use 100, 200, or 400, with 100 being the most popular. Higher-ISO films performed in lower light conditions, but were more expensive.)

As shown in Exhibit 1, there were four price tiers in the market. Kodak Gold Plus, the largest-selling brand by far, set the Premium Brand price at $3.49. Kodak’s gross margins were believed to be about 70%. Both Kodak and Fuji offered superpremium brands targeted very narrowly at advanced amateurs and professionals. These products were distributed mainly through camera shops and were not major sellers.

Fuji’s key brand, Fujicolor Super G, anchored the Economy Brand tier at 17% below the Premium tier. Fuji’s gross margin was believed to be about 55%. Konica and 3M’s ScotchColor brand were other competitors in this tier. Finally, film procured from either Agfa or 3M and sold under another name made up the Price Brand tier. Representative products are shown in Exhibit 1. While most of the film in this group was “branded” with the name of the retail outlet selling it (e.g., Kmart, a major mass merchant, and Walgreen’s, a major drug chain), Polaroid, the dominant firm in instant cameras and film, marketed conventional film it sourced from 3M in this tier. On average, these “Price Brands” were priced about 30% less than Kodak Gold Plus. Dealer percentage margins were typically higher for private label products.

---


3Casewriter Note: For purposes of calculations in the case analysis, a good approximation is that dealer margins on Kodak film averaged 20%; other suppliers’ film yielded a 25% dealer margin.
Consumer Behavior

Film usage rates varied widely across households with a mean of 15 rolls per year. The Wolfman Report estimated that 20% of households bought less than 5 rolls per year, 22% bought between 5 and 9 rolls, 28% bought 10 to 15 rolls, 16% bought 16 to 25 rolls, and 13% bought more than 25 rolls. Often, these rolls were purchased in “multipacs” containing 2-3 rolls of film. Kodak advertised heavily, e.g., spending approximately $50 million on camera and film supply advertising in the United States in 1993. (This was about 4 times Fuji’s U.S. advertising spending.) Kodak advertising was typified by presentation developed for use on the 1994 Olympic Winter Games television broadcast. Contrasting against the Olympic competition from Norway broadcast around the world, the ad portrayed a young boy in his own competition in his backyard falling into a snowbank to make a “snow angel.” The voice-over noted, “Some of the best events happen in your own backyard . . . why trust them to less than Kodak film.”

Actual quality differences among films were unclear. Both Kodak and Fuji tried to position themselves as providing superior quality film through their advanced technology. However, Consumer Reports conducted a test of films and reported, “We found most films to be no better or worse than their competitors of the same speed. The top six ISO 100 films scored so similarly that we think all will yield prints of comparable quality.” In order of overall quality score (score out of 100 in parenthesis), these top six films were:

1. Polaroid High Definition (95)
2. Fujicolor Super G (94)
3. Kodak Gold Plus (93)
4. Konica Super SR (93)
5. Kodak Ektar (92)
6. ScotchColor (92)

ScotchColor was also sold as private label from Kmart, Kroeger, Target, and York, among others as shown in Exhibit 1. Fuji Superpremium brand Reala had a score of 90, and Agfacolor XRG scored 88. Consumer Reports regarded score differences of less than 5 points as “not significant.”

According to a 1991 survey cited in Discount Merchandiser, more than half of the picture takers in the United States claim to know “little or nothing about photography.” As a result the article claimed, “Consumers tend to view film as a commodity, often buying on price alone.” The article also quoted Jim Van Senus, Kodak’s manager of general merchandise marketing: “The importance of brand name in consumer decision making is still strong. On the other hand, there is a growing body of price-sensitive consumers there. We are seeing growth in private label film activity.” Kodak research had shown that 50% of buyers were “Kodak-loyal,” 40% were “samplers” relying heavily on Kodak, and 10% shopped on price.

The Funtime Strategy

For 1994, Kodak planned a major repositioning of its film product line. A new emulsion technology would increase exposure latitude. Three films would be offered:

---

5Consumer Reports, November 1993, p. 712.
1. Gold Plus—to remain the flagship brand at a price unchanged from 1993 levels. Gold Plus would receive 60% of the dollar advertising support.

2. Royal Gold—to replace Ektar in the Superpremium segment. Whereas Ektar had been targeted to professionals and serious amateurs, Royal Gold would be targeted to a broader audience for “very special” occasions. Offering richer color saturation and sharper pictures, it would be positioned as especially appropriate for those occasions when the consumer may wish to make enlargements. Royal Gold would be heavily supported by advertising (40% of the total film budget) and by promotion and would be priced lower than Ektar was selling to the trade at a 9% premium over Gold Plus. Cooperative advertising allowances were to be offered to the trade to provide the incentive to maintain Royal Gold retail prices at 20% above Gold Plus, thereby offering superior trade margins.

3. Funtime—to give Kodak a presence in the Economy Brand Tier at a price 20% below Gold Plus on a per roll basis.

Key aspects of the Funtime marketing plan:

- No advertising support
- Offer only twice a year at off-peak film use times, viz. for 2-3 months beginning in April, and again for 2-3 months beginning in September.
- Available in limited quantities.
- Offer in only the two most popular speeds, ISO 100 and 200. (In contrast, Royal Gold would be eventually offered in five speeds.)
- Available to all classes of trade.
- Packaged only in “value packs,” specifically in two forms:
  1. 2 rolls of 24 exposures
  2. 4-roll package
     (3 rolls of 24 exposures, 1 roll of 36 exposures)

Alexander Wasilov, vice president and general manager of Kodak Consumer Imaging in the U.S. and Canada, explained the strategy:

This repositioning is intelligent risk taking that will drive both our market share and earnings . . . [It] will allow us to be more selective in targeting certain customer segments. We now have Royal Gold film for those very special memories—the birth of a baby, the graduation. We continue to offer Gold film, for capturing those unexpected moments—the baby smiling, the father and son playing catch in the backyard. And now we will offer a special promotion twice a year, featuring a modified version of Gold film at a slightly lower price than our other films.8

Commenting on the strategy, Konica’s director of marketing said, “There will be an opportunity for us at Konica. It seems like a desperate move to regain market share. Not a way to make the industry more profitable.”9

---

9Ibid.
Eastman Kodak Company: Funtime Film

Exhibit 1  Price Tiers in Film Market Defined by Average Retail Price Paid

<table>
<thead>
<tr>
<th>Price Tiers</th>
<th>Brand</th>
<th>Price ($)</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Superpremium Brands</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fujicolor Reala</td>
<td>$4.69</td>
<td>134</td>
</tr>
<tr>
<td></td>
<td>Kodak Ektar</td>
<td>$4.27</td>
<td>122</td>
</tr>
<tr>
<td><strong>Premium Brands</strong></td>
<td>Kodak Gold Plus</td>
<td>$3.49</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Agfacolor XRG</td>
<td>$3.49</td>
<td>100</td>
</tr>
<tr>
<td><strong>Economy Brands</strong></td>
<td>Fujicolor Super G</td>
<td>$2.91</td>
<td>83</td>
</tr>
<tr>
<td></td>
<td>Konica Super SR</td>
<td>$2.91</td>
<td>83</td>
</tr>
<tr>
<td></td>
<td>ScotchColor</td>
<td>$2.69</td>
<td>77</td>
</tr>
<tr>
<td><strong>Price Brands</strong></td>
<td>(S) Polaroid High Definition</td>
<td>$2.49</td>
<td>71</td>
</tr>
<tr>
<td></td>
<td>(S) Kroeger</td>
<td>$2.49</td>
<td>71</td>
</tr>
<tr>
<td></td>
<td>(A) Walgreen’s</td>
<td>$2.49</td>
<td>71</td>
</tr>
<tr>
<td></td>
<td>(S) York</td>
<td>$2.40</td>
<td>69</td>
</tr>
<tr>
<td></td>
<td>(A) Clark Color</td>
<td>$2.35</td>
<td>67</td>
</tr>
<tr>
<td></td>
<td>(S) Kmart Focal</td>
<td>$2.29</td>
<td>66</td>
</tr>
<tr>
<td></td>
<td>(S) Target</td>
<td>$2.19</td>
<td>63</td>
</tr>
</tbody>
</table>

Source: National Survey reported in *Consumer Reports*, November 1993, pp. 711-715.

Note: Numbers in ( ) are indices indicating price relative to Kodak Gold Plus.

(S) designates the film was procured from 3M and was equivalent to ScotchColor.

(A) designates the film was procured from Bayer’s Agfa and was equivalent to AgfaColor XRG.
Chapter Two

Corporate Strategy Decisions and Their Marketing Implications

RedEnvelope—Marketing Upscale Gifts Online

In 1997 two graduates of the University of California's Haas Business School started a company called 911Gifts. The firm combined a website and a toll-free customer service center with gifts provided by two established merchants to cater to last-minute crisis shoppers. Although the new company attracted gift-givers, it also had some weaknesses: The company name, with its connotation of wailing ambulances, turned off many potential customers; the firm's suppliers provided an uninspired assortment of gifts; and a lack of capital inhibited the company's ability to grow. As a result, by early 1999 the firm was treading water. The site had managed only about $1 million in sales the previous year. Consequently, the owners decided to reinvent the company.

A New Mission and Corporate Strategy

The owners' first move was to hire a marketing-savvy chief executive officer. They attracted Hilary Billings, a 36-year-old manager, away from Williams-Sonoma where she had successfully developed the firm's Pottery Barn catalog operation.

After analyzing 911Gifts' strengths and weaknesses, she crafted a new mission and competitive strategy for the company. Instead of positioning itself as a center for emergency gifts, the firm would aim for upscale elegance. Further, it would try to broaden the definition of gift-giving opportunities. “Most online retailers are inherently self-purchase,” Ms. Billings says. They “repurpose themselves just before Christmas as gift companies. There's a big difference between that and a company that thinks only about gifts.”

Within six weeks of becoming CEO, Ms. Billings had developed marketing and business plans detailing how the firm would accomplish its new strategic mission and had hired the core of a new management team. She then made the rounds of Silicon Valley's venture capitalists with a slide show detailing the company's new plans and subsequently obtained $21 million in new financing from Sequoia Capital and $10 million from Weston Presidio in exchange for approximately a one-third ownership of the company.
**The New Marketing Plan**

**The Target Market** Consistent with the firm's new strategic mission, it targeted its marketing efforts at a more selective segment of potential customers. The new target market was similar to the one Ms. Billings knew from her days at Williams-Sonoma: high income (over $85,000 per year), well-educated professionals, including both men and women. The focus was also on people who were connected to the Internet and had a history of buying online.

To understand the needs and preferences of the firm's target customers, managers did a little qualitative marketing research, informally interviewing some prospective customers and analyzing past sales patterns. But initially the firm relied more heavily on the customer knowledge its managers had gained through past experience. "We talked about our [target] customer in a very intimate way," one manager recalls. "What kind of clothes they wore, what kind of car they drove. We put up a poster labeled 'him' and 'her' and we'd put Post-it Notes under each with products we thought they'd want to buy."

**The New Product Line and Company Brand**

Armed with information and intuition concerning the desires of the target market, company managers set about upgrading the product line. A variety of suppliers were contracted to provide products that reflected a high-quality, upscale point of view: things such as amber heart necklaces, old-fashioned thermometers, and boxes of pistachios and carmellos (10 ounces of each for $40). The firm also partnered with suppliers to develop its first wave of exclusive merchandise: a series of gift baskets that might be described as "lifestyle kits." For instance, for fishing fanatics they developed a fishing creel filled with 12 hand-cut fish-shaped cookies for $48.

Another criterion the firm used to reorganize its product offerings was a high gross margin. Most of the firm's products carry margins of 50 percent or more, a necessary offset for lavish spending on customer service, which Ms. Billings says is unavoidable in view of the company's strategy of pursuing future growth, in part, by building customer loyalty and repeat purchases. "You have to own your customer's experience—and that comes at a price." About half of the 450 stockkeeping units (SKUs) that 911Gifts had been selling were dropped, and more than 300 items were added.

To simplify a customer's search for the perfect gift, the company also redesigned its website. The new website allowed customers to navigate through the offerings by type of recipient, by gift-giving occasion, or by product category.

Finally, to more clearly reflect the firm's new upscale positioning, the company name was changed to RedEnvelope Gifts Online. The name derives from an Asian custom of marking special occasions by giving cash or small presents enclosed in a red envelope. It also suggested a distinctive packaging approach: all RedEnvelope gifts are delivered in a red gift box with a hand-tied bow.

**Advertising and Promotion**

With only a few weeks to go before the peak holiday selling season, RedEnvelope decided to devote a third of its new capital to advertising aimed at building customer awareness of the site. Rather than costly TV ads, the firm concentrated its money on a series of print ads to be run in newspapers and magazines, such as the New York Times, with readerships similar to RedEnvelope Gifts Online. The name derives from an Asian custom of marking special occasions by giving cash or small presents enclosed in a red envelope. It also suggested a distinctive packaging approach: all RedEnvelope gifts are delivered in a red gift box with a hand-tied bow.

**Distribution and Order Fulfillment**

RedEnvelope owns its own inventory, marketing, systems management, and customer service operations. But
it does not yet have sufficient capital to develop its own physical logistics and order fulfillment operation. Consequently, the company contracted with ComAlliance, a fulfillment firm in Ohio, to provide warehouse space and everything that goes with it, including the workers expected to produce scads of smartly wrapped packages. The ComAlliance facility is located at the end of an Airborne Express runway. Thus, merchandise that leaves the warehouse by 2 A.M. can be in the air by 4:30 and to its destination by noon. This setup allowed RedEnvelope to make a promise that was the core of its early brand-building efforts: Christmas Eve delivery of gifts ordered by midnight on December 23.

Customer Feedback Once the site was up and running, managers were able to track purchases hourly and quickly reformulate the product mix. For example, a line of wines was not selling as quickly as expected, generating only six purchases an hour. It was replaced with a Zen fountain that sold reliably at a rate of one every five minutes.

The Results

RedEnvelope's new management team brought the new operation online 60 days before Christmas in 1999. In two months the company shipped 20,000 packages and generated more revenue than the firm had managed in the preceding two years. Its Web alliances and ads were particularly effective. According to Nielsen NetRatings, 17.4 percent of those who saw the firm's banner clicked on it; the typical click-through rate for banner ads is about 2 percent. And nearly 6 percent of those who visited the site made purchases, compared to an industry average conversion rate of about 2 percent. Most important, the firm lived up to its promises. It filled 98 percent of its orders accurately, shipped 99 percent of its packages on time, and only 2 percent of recipients wanted to return their gifts.

On the minus side, during the first months of its existence the company shelled out nearly $4 in marketing for every $1 in gross sales. Thus, the future profitability of RedEnvelope—just as with many other new Internet retailers—will depend on the firm's ability to build a loyal customer base and reap repeat purchases to recoup its marketing investments. The good news is that the high margins the firm earns on its products may make future profitability a more attainable goal than it has been for some low-margin Internet marketers. And as of this writing, at least, RedEnvelope has managed to dodge the dot.com debacle of 2001 and continues to pursue its revenue growth and profitability goals.

Strategic Challenges Addressed in Chapter 2

The corporate strategy crafted by Hillary Billings after joining RedEnvelope provides a clear sense of direction and useful guidance for the firm's managers when developing competitive, marketing, and other functional strategies because it speaks to the dimensions of strategy we discussed in Chapter 1. First, it defines the overall mission and scope of the firm by clearly focusing on marketing elegant and unique gifts for all occasions to an upscale segment of on-line consumers. It also lays out goals and objectives for the company—particularly concerning revenue growth and the rapid attainment of profitability—and specifies a corporate development strategy for achieving those objectives. Specifically, RedEnvelope seeks growth primarily through increased penetration of its target customer segment, and profitability by focusing on high-margin merchandise and lowering customer acquisition costs by improving their loyalty and repeat purchases.

RedEnvelope's objectives and development strategy, in turn, influence the way it allocates its resources and leverages its core competencies in order to build and maintain a competitive advantage. The firm hired experienced managers with extensive knowledge of the target segment, allocated substantial resources to tracking customers' purchase patterns and preferences, formed alliances with suppliers to develop exclusive and unique products
that fit those preferences, and invested heavily in the people and systems necessary to provide excellent service and build customer loyalty. Finally, the firm seeks synergy across the various products it offers by investing in advertising and promotion activities aimed at building a strong corporate identity and awareness of the RedEnvelope brand, and by developing the necessary capabilities—both internally or through alliances—to provide superior service and timely order fulfillment regardless of what the customer buys.

The successful reformulation of RedEnvelope’s corporate strategy illustrates the importance of a detailed understanding of target customers, potential competitors, and the market environment when developing strategies at any level. Indeed, Hillary Billings was hired as the firm’s CEO partly because of her extensive experience in marketing high-margin merchandise to a similar target segment at Williams-Sonoma. As we pointed out in Chapter 1, marketers’ close contact with customers and the external environment often means they play a crucial role in influencing strategies formulated at higher levels in the firm, even when they’re not appointed CEO.

On the other hand, a well-defined corporate strategy also influences and constrains the strategic decisions that marketers and other functional managers can make at lower organizational levels. RedEnvelope’s mission of offering elegant and unique gifts for all occasions clearly influences the kinds of items the firm’s marketers can—and cannot—add to the product line. And its objective of achieving profitability by maintaining high margins rules out aggressive pricing policies and frequent sales promotions.

In view of the interactions and interdependences between corporate-level strategy decisions and strategic marketing programs for individual product-market entries, this chapter examines the five components of a well-defined corporate strategy in more detail: (1) the overall scope and mission of the organization, (2) company goals and objectives, (3) a development strategy for future growth, (4) the allocation of corporate resources across the firm’s various businesses, and (5) the search for synergy via the sharing of corporate resources, competencies, or programs across businesses or product lines. Exhibit 2.1 summarizes some of the crucial questions that need to be addressed by each of these five components.

While a market orientation—and the analytical tools that marketing managers use to examine customer desires and competitors’ strengths and weaknesses—can provide useful insights to guide decisions concerning all five elements of corporate strategy, they are particularly germane for revealing the most attractive avenues for future growth and for determining which businesses or product-markets are likely to produce the greatest returns on the company’s resources. In turn, all five components of corporate strategy have major implications for the strategic marketing plans of the firm’s various products or services. Together, they define the general strategic direction, objectives, and resource constraints within which those marketing plans must operate. We examine the marketing implications involved in both formulating and implementing the five components of corporate strategy in the following sections.

**Corporate Scope—Defining the Firm’s Mission**

A well-thought-out mission statement guides an organization’s managers as to which market opportunities to pursue and which fall outside the firm’s strategic domain. A clearly stated mission can help instill a shared sense of direction, relevance, and achievement among employees, as well as a positive image of the firm among customers, investors, and other stakeholders.
To provide a useful sense of direction, a corporate mission statement should clearly define the organization’s strategic scope. It should answer such fundamental questions as the following: What is our business? Who are our customers? What kinds of value can we provide to these customers? and What should our business be in the future? For example, several years ago PepsiCo, the manufacturer of Pepsi-Cola, broadened its mission to focus on “marketing superior quality food and beverage products for households and consumers dining out.” That clearly defined mission guided the firm’s managers toward the acquisition of several related companies, such as Frito-Lay, Taco Bell, and Pizza Hut, and the divestiture of operations that no longer fit the company’s primary thrust.

More recently, in response to a changing global competitive environment, PepsiCo narrowed its scope to focus primarily on package foods (particularly salty snacks) and beverages distributed through supermarket and convenience store channels. This new, narrower mission led the firm to (1) divest all of its fast-food restaurant chains; (2) acquire complementary beverage businesses, such as Tropicana juices and Lipton’s iced teas; and (3) develop new brands targeted at rapidly growing beverage segments, such as Aquafina bottled water.²

### Market Influences on the Corporate Mission

Like any other strategy component, an organization’s mission should fit both its internal characteristics and the opportunities and threats in its external environment. Obviously, the firm’s mission should be compatible with its established values, resources, and distinctive competencies. But it also should focus the firm’s efforts on markets where those resources and competencies will generate value for customers, an advantage over competitors, and synergy across its products. Thus, PepsiCo’s new mission reflects the firm’s package goods marketing, sales, and distribution competencies and its perception that substantial
synergies can be realized across snack foods and beverages within supermarket channels via shared logistics, joint displays and sales promotions, cross-couponing, and the like.

**Criteria for Defining the Corporate Mission**

Several criteria can be used to define an organization’s strategic mission. Many firms specify their domain in *physical* terms, focusing on *products* or *services* or the *technology* used. The problem is that such statements can lead to slow reactions to technological or customer-demand changes. For example, Theodore Levitt argues that Penn Central’s view of its mission as being “the railroad business” helped cause the firm’s failure. Penn Central did not respond to major changes in transportation technology, such as the rapid growth of air travel and the increased efficiency of long-haul trucking. Nor did it respond to consumers’ growing willingness to pay higher prices for the increased speed and convenience of air travel. Levitt argues that it is better to define a firm’s mission as *what customer needs are to be satisfied and the functions the firm must perform to satisfy them.* Products and technologies change over time, but basic customer needs tend to endure. Thus, if Penn Central had defined its mission as satisfying the transportation needs of its customers rather than simply being a railroad, it might have been more willing to expand its domain to incorporate newer technologies.

One problem with Levitt’s advice, though, is that a mission statement focusing only on basic customer needs can be too broad to provide clear guidance and can fail to take into account the firm’s specific competencies. If Penn Central had defined itself as a transportation company, should it have diversified into the trucking business? Started an airline? As the upper-right quadrant of Exhibit 2.2 suggests, the most useful mission statements focus on the customer need to be satisfied and the functions that must be performed to satisfy that need, and they are *specific* as to the customer groups and the products or technologies on which to concentrate. Thus, instead of seeing itself as being in the railroad business or as satisfying the transportation needs of all potential customers, Burlington Northern Santa Fe Railroad’s mission is to provide long-distance transportation for large-volume producers of low-value, low-density products, such as coal and grain.

**Social Values and Ethical Principles**

An increasing number of organizations are developing mission statements that also attempt to define the social and ethical boundaries of their strategic domain. The annual reports of firms such as Borden and 3M, for example, often include sections on “Social Responsibility,”

**Exhibit 2.2**

**Characteristics of Effective Corporate Mission Statements**

<table>
<thead>
<tr>
<th>Functional Based on customer needs</th>
<th>Physical Based on existing products or technology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transportation business</td>
<td>Railroad business</td>
</tr>
<tr>
<td>Long-distance transportation for large-volume producers of low-value, low-density products</td>
<td>Long-haul, coal-carrying railroad</td>
</tr>
</tbody>
</table>

which outline the ethical principles the firm tries to follow in dealings with customers, suppliers, and employees, and its policies concerning such social issues as charitable contributions and environmental protection. Roughly two-thirds of U.S. firms have formal codes of ethics, and one in five large firms has formal departments dedicated to encouraging compliance with company ethical standards. At United Technologies, a global defense contractor and engineering firm, 160 business ethics officers monitor the firm’s activities and relations with customers, suppliers, and governments around the world.4

Outside America, fewer firms have formal ethics bureaucracies. To some extent, this reflects the fact that in other countries governments and organized labor both play a bigger role in corporate life. In Germany, for instance, workers’ councils often deal with issues such as sexual equality, race relations, and workers’ rights.5

**Ethics** is concerned with the development of moral standards by which actions and situations can be judged. It focuses on those actions that may result in actual or potential harm of some kind (e.g., economic, mental, physical) to an individual, group, or organization.

Particular actions may be legal but not ethical. For instance, extreme and unsubstantiated advertising claims, such as “Our product is far superior to Brand X,” might be viewed as simply legal puffery engaged in to make a sale, but many marketers (and their customers) view such little white lies as unethical. Thus, ethics is more proactive than the law. Ethical standards attempt to anticipate and avoid social problems, whereas most laws and regulations emerge only after the negative consequences of an action become apparent.6

**Why Are Ethics Important? The Marketing Implications of Ethical Standards**

One might ask why a corporation should take responsibility for providing moral guidance to its managers and employees. While such a question may be a good topic for philosophical debate, there is a compelling, practical reason for a firm to impose ethical standards to guide employees. Unethical practices can damage the trust between a firm and its suppliers or customers, thereby disrupting the development of long-term exchange relationships and resulting in the likely loss of sales and profits over time. For example, one survey of 135 purchasing managers from a variety of industries found that the more unethical a supplier’s sales and marketing practices were perceived to be, the less eager were the purchasing managers to buy from that supplier.7

Unfortunately, not all customers or competing suppliers adhere to the same ethical standards. As a result, marketers sometimes feel pressure to engage in actions that are inconsistent with what they believe to be right—either in terms of personal values or formal company standards—in order to close a sale or stay even with the competition. This point was illustrated by a survey of 59 top marketing and sales executives concerning commercial bribery—attempts to influence a potential customer by giving gifts or kickbacks. While nearly two-thirds of the executives considered bribes unethical and did not want to pay them, 88 percent also felt that *not* paying bribes might put their firms at a competitive disadvantage.8 Such dilemmas are particularly likely to arise as a company moves into global markets involving different cultures and levels of economic development where economic exigencies and ethical standards may be quite different.

Such inconsistencies in external expectations and demands across countries and markets can lead to job stress and inconsistent behavior among marketing and sales personnel, which in turn can risk damaging long-term relationships with suppliers, channel partners, and customers. A company can reduce such problems by spelling out formal social policies and ethical standards in its corporate mission statement and communicating and enforcing those
standards. Unfortunately, it is not always easy to decide what those policies and standards should be. There are multiple philosophical traditions or frameworks that managers might use to evaluate the ethics of a given action. Consequently, different firms or managers can pursue somewhat different ethical standards, particularly across national cultures. Exhibit 2.3 displays a comparison (across three geographic regions) of the proportion of company ethical statements that address a set of specific issues. Note that a larger number of companies in the United States and Europe appear to be more concerned with the ethics of their purchasing practices than those of their marketing activities. Comparing firms across regions, U.S. companies are more concerned about proprietary information. Canadian firms are more likely to have explicit guidelines concerning environmental responsibility, and European companies more frequently have standards focused on workplace safety. Since many ethical issues in marketing are open to interpretation and debate, we will examine such issues and their implications individually as they arise throughout the remainder of this book.

**Corporate Objectives**

Confucius said, “For one who has no objective, nothing is relevant.” Formal objectives provide decision criteria that guide an organization’s business units and employees toward specific dimensions and performance levels. Those same objectives provide the benchmarks against which actual performance can be evaluated.
To be useful as decision criteria and evaluative benchmarks, corporate objectives must be specific and measurable. Therefore, each objective contains four components:

- A performance dimension or attribute sought.
- A measure or index for evaluating progress.
- A target or hurdle level to be achieved.
- A time frame within which the target is to be accomplished.

Exhibit 2.4 lists some common performance dimensions and measures used in specifying corporate as well as business-unit and marketing objectives.

**Exhibit 2.4**

**Common Performance Criteria and Measures That Specify Corporate, Business-Unit, and Marketing Objectives**

<table>
<thead>
<tr>
<th>Performance criteria</th>
<th>Possible measures or indexes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>$ sales</td>
</tr>
<tr>
<td></td>
<td>Unit sales</td>
</tr>
<tr>
<td></td>
<td>Percent change in sales</td>
</tr>
<tr>
<td>Competitive strength</td>
<td>Market share</td>
</tr>
<tr>
<td></td>
<td>Brand awareness</td>
</tr>
<tr>
<td></td>
<td>Brand preference</td>
</tr>
<tr>
<td>Innovativeness</td>
<td>$ sales from new products</td>
</tr>
<tr>
<td></td>
<td>Percentage of sales from product-market entries introduced within past five years</td>
</tr>
<tr>
<td></td>
<td>Percentage cost savings from new processes</td>
</tr>
<tr>
<td>Profitability</td>
<td>$ profits</td>
</tr>
<tr>
<td></td>
<td>Profit as percentage of sales</td>
</tr>
<tr>
<td></td>
<td>Contribution margin*</td>
</tr>
<tr>
<td></td>
<td>Return on investment (ROI)</td>
</tr>
<tr>
<td></td>
<td>Return on net assets (RONA)</td>
</tr>
<tr>
<td></td>
<td>Return on equity (ROE)</td>
</tr>
<tr>
<td>Utilization of resources</td>
<td>Percent capacity utilization</td>
</tr>
<tr>
<td></td>
<td>Fixed assets as percentage of sales</td>
</tr>
<tr>
<td>Contribution to owners</td>
<td>Earnings per share</td>
</tr>
<tr>
<td></td>
<td>Price/earnings ratio</td>
</tr>
<tr>
<td>Contribution to customers</td>
<td>Price relative to competitors</td>
</tr>
<tr>
<td></td>
<td>Product quality</td>
</tr>
<tr>
<td></td>
<td>Customer satisfaction</td>
</tr>
<tr>
<td></td>
<td>Customer retention</td>
</tr>
<tr>
<td></td>
<td>Customer loyalty</td>
</tr>
<tr>
<td></td>
<td>Customer lifetime value</td>
</tr>
<tr>
<td>Contribution to employees</td>
<td>Wage rates, benefits</td>
</tr>
<tr>
<td></td>
<td>Personnel development, promotions</td>
</tr>
<tr>
<td></td>
<td>Employment stability, turnover</td>
</tr>
<tr>
<td>Contribution to society</td>
<td>$ contributions to charities or community institutions</td>
</tr>
<tr>
<td></td>
<td>Growth in employment</td>
</tr>
</tbody>
</table>

*Business-unit managers and marketing managers responsible for a product-market entry often have little control over costs associated with corporate overhead, such as the costs of corporate staff or R&D. It can be difficult to allocate those costs to specific strategic business units (SBUs) or products. Consequently, profit objectives at the SBU and product-market level are often stated as a desired contribution margin (the gross profit prior to allocating such overhead costs).*
Enhancing Shareholder Value: The Ultimate Objective

In recent years a growing number of executives of publicly held corporations have concluded that the organization’s ultimate objective should be to increase its shareholders’ economic returns as measured by dividends plus appreciation in the company’s stock price. To do so management must balance the interests of various corporate constituencies, including employees, customers, suppliers, debtholders, and stockholders. The firm’s continued existence depends on a financial relationship with each of these parties. Employees want competitive wages. Customers want high quality at a competitive price. Suppliers and debtholders have financial claims that must be satisfied with cash when they fall due. And shareholders, as residual claimants, look for cash dividends and the prospect of future dividends reflected in the stock’s market price.

If a company does not satisfy its constituents’ financial claims, it ceases to be viable. Thus, a going concern must strive to enhance its ability to generate cash from the operation of its businesses and to obtain any additional funds needed from debt or equity financing.

The firm’s ability to attain debt financing (its ability to borrow) depends in turn on projections of how much cash it can generate in the future. Similarly, the market value of its shares, and therefore its ability to attain equity financing, depends on investors’ expectations of the firm’s future cash-generating abilities. People willingly invest in a firm only when they expect a better return on their funds than they could get from other sources without exposing themselves to any greater risks. Thus, management’s primary objective should be to pursue capital investments, acquisitions, and business strategies that will produce sufficient future cash flows to return positive value to shareholders. Failure to do so not only will depress the firm’s stock price and inhibit the firm’s ability to finance future operations and growth, but also it could make the organization more vulnerable to a takeover by outsiders who promise to increase its value to shareholders.

Given this rationale, many firms set explicit objectives targeted at increasing shareholder value. These are usually stated in terms of a target return on shareholder equity, increase in the stock price, or earnings per share. Recently, though, some executives have begun expressing such corporate objectives in terms of economic value added or market value added (MVA). A firm’s MVA is calculated by combining its debt and the market value of its stock, then subtracting the capital that has been invested in the company. The result, if positive, shows how much wealth the company has created.

Unfortunately, such broad shareholder-value objectives do not always provide adequate guidance for a firm’s lower-level managers or benchmarks for evaluating performance. For one thing, standard accounting measures, such as earnings per share or return on investment, are not always reliably linked to the true value of a company’s stock. And as we shall see later in this chapter, tools are available to evaluate the future impact of alternative strategic actions on shareholder value, but those valuation methods have inherent pitfalls and can be difficult to apply at lower levels of strategy such as trying to choose the best marketing strategy for a particular product-market entry.

Finally, there is a danger that a narrow focus on short-term financial, shareholder-value objectives may lead managers to pay too little attention to actions necessary to provide value to the firm’s customers and sustain a competitive advantage. In the long term, customer value and shareholder value converge; a firm can continue to provide attractive returns to shareholders only so long as it satisfies and retains its customers. But some managers may overlook this in the face of pressures to achieve aggressive short-term financial objectives, as illustrated by the experience of Schlitz Brewing discussed in Exhibit 2.5.
The Marketing Implications of Corporate Objectives

Most organizations pursue multiple objectives. This is clearly demonstrated by a study of the stated objectives of 82 large corporations. The largest percentage of respondents (89 percent) had explicit profitability objectives: 82 percent reported growth objectives; 66 percent had specific market-share goals. More than 60 percent mentioned social responsibility, employee welfare, and customer service objectives, and 54 percent of the companies had R&D/new product development goals.14 These percentages add up to more than 100 percent because most firms had several objectives.

Trying to achieve many objectives at once leads to conflicts and trade-offs. For example, the investment and expenditure necessary to pursue growth in the long term is likely to reduce profitability and ROI in the short term.15 Managers can reconcile conflicting goals by prioritizing them. Another approach is to state one of the conflicting goals as a constraint or hurdle. Thus, a firm attempts to maximize growth subject to meeting some minimum ROI hurdle.

In firms with multiple business units or product lines, however, the most common way to pursue a set of conflicting objectives is to first break them down into subobjectives, then assign subobjectives to different business units or products. Thus, subobjectives often vary across business units and product offerings depending on the attractiveness and potential of their industries, the strength of their competitive positions, and the resource allocation decisions made by corporate managers. For example, PepsiCo’s managers likely set relatively high volume and share-growth objectives but lower ROI goals for the firm’s Aquafina brand, which is battling for prominence in the rapidly growing bottled water category, than for Lay’s potato chips, which hold a commanding 40 percent share of a mature product category. Therefore, two marketing managers responsible for different products may face very different goals and expectations—requiring different marketing strategies to accomplish—even though they work for the same organization.

As firms emphasize developing and maintaining long-term customer relationships, customer-focused objectives—such as satisfaction, retention, and loyalty—are being given greater importance. Such market-oriented objectives are more likely to be consistently pursued across business units and product offerings. There are several reasons for this. First,
given the huge profit implications of a customer’s lifetime value, maximizing satisfaction and loyalty tends to make good sense no matter what other financial objectives are being pursued in the short term. Second, satisfied, loyal customers of one product can be leveraged to provide synergies for other company products or services. For instance, IBM hopes that satisfied customers of its website development services for small businesses will eventually become customers for the company’s servers and software products as they grow. Finally, customer satisfaction and loyalty are determined by factors other than the product itself or the activities of the marketing department. A study of one industrial paper company, for example, found that about 80 percent of customers’ satisfaction scores were accounted for by nonproduct factors, such as order processing, delivery, and postsale services. Since such factors are influenced by many functional departments within the corporation, they are likely to have a similar impact across a firm’s various businesses and products.

**Corporate Growth Strategies**

Often, the projected combined future sales and profits of a corporation’s business units and product-markets fall short of the firm’s long-run growth and profitability objectives. There is a gap between what the firm expects to become if it continues on its present course and what it would like to become. This is not surprising because some of its high-growth markets are likely to slip into maturity over time and some of its high-profit mature businesses may decline to insignificance as they get older. Thus, to determine where future growth is coming from, management must decide on a strategy to guide corporate development.

Essentially, a firm can go in two major directions in seeking future growth: expansion of its current businesses and activities or diversification into new businesses. Exhibit 2.6 outlines some specific options a firm might pursue while seeking growth in either of these directions.

**Expansion by Increasing Penetration of Current Product-Markets**

One way for a company to expand is by increasing its share of existing markets. This typically requires actions such as making product or service improvements, cutting costs and prices, or outspending competitors on advertising or promotions. Amazon.com pursued a combination of all these actions—as well as forming alliances with Web portals, affinity groups, and the like—to expand its share of Web shoppers, even though the expense of such activities postponed the firm’s ability to become profitable.

Even when a firm holds a commanding share of an existing product-market, additional growth may be possible by encouraging current customers to become more loyal and concentrate their purchases, use more of the product or service, use it more often, or use it in new ways. In addition to its promotional efforts, Amazon.com spent hundreds of millions of dollars on warehouses and order fulfillment activities, investments that earned the loyalty of its customers. As a result, by the year 2000 more than three-quarters of the firm’s sales were coming from repeat customers. Other examples include museums that sponsor special exhibitions to encourage patrons to make repeat visits and the recipes that Quaker Oats includes on the package to tempt buyers to include oatmeal as an ingredient in other foods, such as cookies and desserts.
Expansion by Developing New Products for Current Customers

A second avenue to future growth is through a product-development strategy emphasizing the introduction of product-line extensions or new product or service offerings aimed at existing customers. For example, Arm & Hammer successfully introduced a laundry detergent, an oven cleaner, and a carpet cleaner. Each capitalized on baking soda’s image as an effective deodorizer and on a high level of recognition of the Arm & Hammer brand. Similarly, RedEnvelope’s managers are constantly searching for unique new items to add to its line of gifts.

Expansion by Selling Existing Products to New Segments or Countries

Perhaps the growth strategy with the greatest potential for many companies is the development of new markets for their existing goods or services. This may involve the creation of marketing programs aimed at nonuser or occasional-user segments of existing markets. Thus, theaters, orchestras, and other performing arts organizations often sponsor touring companies to reach audiences outside major metropolitan areas and promote matinee performances with lower prices and free public transportation to attract senior citizens and students.
Expansion into new geographic markets, particularly new countries, is also a primary growth strategy for many firms. For example, General Electric announced a growth strategy that shifts the firm’s strategic center of gravity from the industrialized West to Asia and Latin America. While developing nations represent attractive growth markets for basic industrial and infrastructure goods and services, growing personal incomes and falling trade barriers are making them attractive potential markets for many consumer goods and services as well. Even developed nations can represent growth opportunities for products or services based on newly emerging technologies or business models. For instance, while the rapid growth of e-retailers such as Amazon.com is likely to slow in the United States over the next few years, growth in the number of online shoppers is expected to expand rapidly in Europe, as shown in Exhibit 2.7.

**Expansion by Diversifying**

Firms also seek growth by diversifying their operations. This is typically riskier than the various expansion strategies because it often involves learning new operations and dealing with unfamiliar customer groups. Nevertheless, the majority of large U.S., European, and Asian firms are diversified to one degree or another.

**Vertical integration** is one way for companies to diversify. **Forward vertical integration** occurs when a firm moves downstream in terms of the product flow, as when a manufacturer integrates by acquiring or launching a wholesale distributor or retail outlet. For example, IBM recently withdrew its Aptiva desktop PCs from independent computer retailers such as CompUSA and made them available only over the company’s own retail website in order to improve customer service and reduce costs. **Backward integration** occurs when a firm moves upstream by acquiring a supplier.

Integration can give a firm access to scarce or volatile sources of supply or tighter control over the marketing, distribution, or servicing of its products. But it increases the risks inherent in committing substantial resources to a single industry. Also, the investment required to vertically integrate often offsets the additional profitability generated by the integrated operations, resulting in little improvement in return on investment.

**Related (or concentric) diversification** occurs when a firm internally develops or acquires another business that does not have products or customers in common with its current businesses but that might contribute to internal synergy through the sharing of production...
facilities, brand names, R&D know-how, or marketing and distribution skills. Thus, PepsiCo acquired Cracker Jack to complement its salty snack brands and leverage its distribution strengths in grocery stores.

The motivations for unrelated (or conglomerate) diversification are primarily financial rather than operational. By definition, an unrelated diversification involves two businesses that have no commonalities in products, customers, production facilities, or functional areas of expertise. Such diversification mostly occurs when a disproportionate number of a firm’s current businesses face decline because of decreasing demand, increased competition, or product obsolescence. The firm must seek new avenues of growth. Other, more fortunate, firms may move into unrelated businesses because they have more cash than they need in order to expand their current businesses, or because they wish to discourage takeover attempts.

Unrelated diversification tends to be the riskiest growth strategy in terms of financial outcomes. Most empirical studies report that related diversification is more conducive to capital productivity and other dimensions of performance than is unrelated diversification. This suggests that the ultimate goal of a corporation’s strategy for growth should be to develop a compatible portfolio of businesses to which the firm can add value through the application of its unique core competencies. The corporation’s marketing competencies can be particularly important in this regard, as evidenced by the success of firms like PepsiCo.

Expansion by Diversifying through Organizational Relationships or Networks

Recently, firms have attempted to gain some benefits of market expansion or diversification while simultaneously focusing more intensely on a few core competencies. They try to accomplish this feat by forming relationships or organizational networks with other firms instead of acquiring ownership.

Perhaps the best models of such organizational networks are the Japanese keiretsu and the Korean chaebol—coalitions of financial institutions, distributors, and manufacturing firms in a variety of industries that are often grouped around a large trading company that helps coordinate the activities of the various coalition members and markets their goods and services around the world. Compaq is a Western firm that is attempting to develop a similar network of organizational alliances. While Compaq concentrates on its core competencies in marketing and servicing computer hardware and software, it depends increasingly on partnerships with other firms for other functions and for expertise in new markets and product lines. For instance, Compaq relies heavily on Accenture for assistance in designing computer networks for its largest customers and on a number of Asian suppliers and assemblers for the manufacture of its products. Such relationships allow Compaq to concentrate on its core competencies while simultaneously expanding its product and service offerings and reducing its costs and assets employed.

Allocating Corporate Resources

Diversified organizations have several advantages over more narrowly focused firms. They have a broader range of areas in which they can knowledgeably invest, and their growth and profitability rates may be more stable because they can offset declines in one business with gains in another. To exploit the advantages of diversification, though, corporate managers must make intelligent decisions about how to allocate financial and human resources
Portfolio Models

One of the most significant developments in strategic management during the 1970s and 1980s was the widespread adoption of portfolio models to help managers allocate corporate resources across multiple businesses. These models enable managers to classify and review their current and prospective businesses by viewing them as portfolios of investment opportunities and then evaluating each business’s competitive strength and the attractiveness of the markets it serves.

The Boston Consulting Group’s (BCG) Growth-Share Matrix

One of the first—and best known—of the portfolio models is the growth-share matrix developed by the Boston Consulting Group in the late 1960s. It analyzes the impact of investing resources in different businesses on the corporation’s future earnings and cash flows. Each business is positioned within a matrix, as shown in Exhibit 2.8. The vertical axis indicates the industry’s growth rate and the horizontal axis shows the business’s relative market share.

The growth-share matrix assumes that a firm must generate cash from businesses with strong competitive positions in mature markets. Then it can fund investments and expenditures in industries that represent attractive future opportunities. Thus, the market growth rate on the vertical axis is a proxy measure for the maturity and attractiveness of an industry. This model represents businesses in rapidly growing industries as more attractive investment opportunities for future growth and profitability.

Exhibit 2.8

BCG’s Market Growth Relative Share Matrix

Similarly, a business’s relative market share is a proxy for its competitive strength within its industry. It is computed by dividing the business’s absolute market share in dollars or units by that of the leading competitor in the industry. Thus, in Exhibit 2.8 a business is in a strong competitive position if its share is equal to, or larger than, that of the next leading competitor (i.e., a relative share of 1.0 or larger). Finally, in the exhibit, the size of the circle representing each business is proportional to that unit’s sales volume. Thus, businesses 7 and 9 are the largest-volume businesses in this hypothetical company, while business 11 is the smallest.

**Resource Allocation and Strategy Implications** Each of the four cells in the growth-share matrix represents a different type of business with different strategy and resource requirements. The implications of each are discussed below and summarized in Exhibit 2.9.

- **Question marks.** Businesses in high-growth industries with low relative market shares (those in the upper-right quadrant of Exhibit 2.9) are called question marks or problem children. Such businesses require large amounts of cash, not only for expansion to keep up with the rapidly growing market, but also for marketing activities (or reduced margins) to build market share and catch the industry leader. If management can successfully increase the share of a question mark business, it becomes a star. But if managers fail, it eventually turns into a dog as the industry matures and the market growth rate slows.

- **Stars.** A star is the market leader in a high-growth industry. Stars are critical to the continued success of the firm. As their industries mature, they move into the bottom-left quadrant and become cash cows. Paradoxically, while stars are critically important, they often are net users rather than suppliers of cash in the short run (as indicated by the possibility of a negative cash flow shown in Exhibit 2.9). This is because the firm must continue to invest in such businesses to keep up with rapid market growth and to support the R&D and marketing activities necessary to maintain a leading market share.

- **Cash cows.** Businesses with a high relative share of low-growth markets are called cash cows because they are the primary generators of profits and cash in a corporation. Such businesses

**Exhibit 2.9**

**Cash Flows across Businesses in the BCG Portfolio Model**
do not require much additional capital investment. Their markets are stable, and their share leadership position usually means they enjoy economies of scale and relatively high profit margins. Consequently, the corporation can use the cash from these businesses to support its question marks and stars (as shown in Exhibit 2.9). However, this does not mean the firm should necessarily maximize the business’s short-term cash flow by cutting R&D and marketing expenditures to the bone—particularly not in industries where the business might continue to generate substantial future sales.

- **Dogs.** Low-share businesses in low-growth markets are called dogs because although they may throw off some cash, they typically generate low profits, or losses. Divestiture is one option for such businesses, although it can be difficult to find an interested buyer. Another common strategy is to harvest dog businesses. This involves maximizing short-term cash flow by paring investments and expenditures until the business is gradually phased out.

**Limitations of the Growth-Share Matrix** Because the growth-share matrix uses only two variables as a basis for categorizing and analyzing a firm’s businesses, it is relatively easy to understand. But while this simplicity helps explain its popularity, it also means the model has limitations:

- **Market growth rate is an inadequate descriptor of overall industry attractiveness.** Market growth is not always directly related to profitability or cash flow. Some high-growth industries have never been very profitable because low entry barriers and capital intensity have enabled supply to grow even faster, resulting in intense price competition. Also, rapid growth in one year is no guarantee that growth will continue in the following year.

- **Relative market share is inadequate as a description of overall competitive strength.** Market share is more properly viewed as an outcome of past efforts to formulate and implement effective business-level and marketing strategies than as an indicator of enduring competitive strength.24 If the external environment changes, or the SBU’s managers change their strategy, the business’s relative market share can shift dramatically.

- **The outcomes of a growth-share analysis are highly sensitive to variations in how growth and share are measured.** Defining the relevant industry and served market (i.e., the target-market segments being pursued) also can present problems. For example, does Pepsi Cola compete only for a share of the cola market, or for a share of the much larger market for non-alcoholic beverages, such as iced tea, bottled water, and fruit juices?

- **While the matrix specifies appropriate investment strategies for each business, it provides little guidance on how best to implement those strategies.** While the model suggests that a firm should invest cash in its question mark businesses, for instance, it does not consider whether there are any potential sources of competitive advantage that the business can exploit to successfully increase its share. Simply providing a business with more money does not guarantee that it will be able to improve its position within the matrix.

- **The model implicitly assumes that all business units are independent of one another except for the flow of cash.** If this assumption is inaccurate, the model can suggest some inappropriate resource allocation decisions. For instance, if other SBUs depend on a dog business as a source of supply—or if they share functional activities, such as a common plant or salesforce, with that business—harvesting the dog might increase the costs or reduce the effectiveness of the other SBUs.

**Alternative Portfolio Models** In view of the above limitations, a number of firms have attempted to improve the basic portfolio model. Such improvements have focused primarily on developing more detailed, multifactor measures of industry attractiveness and a business’s competitive strength and on making the analysis more future-oriented. Exhibit 2.10 shows some factors managers might use to evaluate industry attractiveness and a business’s competitive position. Corporate managers must first select factors most appropriate for their firm and weight them according to their relative importance. They then rate each business and its industry on the two sets of factors. Next, they combine the weighted evaluations into summary measures
used to place each business within one of the nine boxes in the matrix. Businesses falling into boxes numbered 1 (where both industry attractiveness and the business’s ability to compete are relatively high) are good candidates for further investment for future growth. Businesses in the 2 boxes should receive only selective investment with an objective of maintaining current position. Finally, businesses in the 3 boxes are candidates for harvesting or divestiture.

These multifactor models are more detailed than the simple growth-share model and consequently provide more strategic guidance concerning the appropriate allocation of resources across businesses. They are also more useful for evaluating potential new product-markets. However, the multifactor measures in these models can be subjective and ambiguous, especially when managers must evaluate different industries on the same set of factors. Also, the conclusions drawn from these models still depend on the way industries and product-markets are defined.  

**Value-Based Planning**

As mentioned, one limitation of portfolio analysis is that it specifies how firms should allocate financial resources across their businesses without considering the competitive strategies those businesses are, or should be, pursuing. Portfolio analysis provides little guidance, for instance, in deciding which of two question mark businesses—each in attractive markets but following different strategies—is worthy of the greater investment or in choosing which of several competitive strategies a particular business unit should pursue.

**Value-based planning** is a resource allocation tool that attempts to address such questions by assessing the shareholder value a given strategy is likely to create. Thus, value-
based planning provides a basis for comparing the economic returns to be gained from
investing in different businesses pursuing different strategies or from alternative strategies
that might be adopted by a given business unit.

A number of value-based planning methods are currently in use, but all share three basic
features. First, they assess the economic value a strategy is likely to produce by examin-
ing the cash flows it will generate, rather than relying on distorted accounting measures,
such as return on investment. Second, they estimate the shareholder value that a strategy
will produce by discounting its forecasted cash flows by the business’s risk-adjusted cost of
capital. Finally, they evaluate strategies based on the likelihood that the investments
required by a strategy will deliver returns greater than the cost of capital. The amount of
return a strategy or operating program generates in excess of the cost of capital is commonly
referred to as its economic value added, or EVA. This approach to evaluating alternative
strategies is particularly appropriate for use in allocating resources across business units
because most capital investments are made at the business-unit level, and different business
units typically face different risks and therefore have different costs of capital.

**Discounted Cash Flow Model** Perhaps the best-known and most widely used approach
to value-based planning is the discounted cash flow model proposed by Alfred Rappaport and
the Alcar Group, Inc. In this model, as Exhibit 2.11 indicates, shareholder value created by a
strategy is determined by the cash flow it generates, the business’s cost of capital (which is
used to discount future cash flows back to their present value), and the market value of the
debt assigned to the business. The future cash flows generated by the strategy are, in turn,
affected by six “value drivers”: the rate of sales growth the strategy will produce, the operating profit margin, the income tax rate, investment in working capital, fixed capital investment required by the strategy, and the duration of value growth.

The first five value drivers are self-explanatory, but the sixth requires some elaboration. The duration of value growth represents management’s estimate of the number of years over which the strategy can be expected to produce rates of return that exceed the cost of capital. This estimate, in turn, is tied to two other management judgments. First, the manager must decide on the length of the planning period (typically three to five years); he or she must then estimate the residual value the strategy will continue to produce after the planning period is over. Such decisions are tricky, for they involve predictions of what will happen in the relatively distant future.30

Some Limitations of Value-Based Planning

Value-based planning is not a substitute for strategic planning; it is only one tool for evaluating strategy alternatives identified and developed through managers’ judgments. It does so by relying on forecasts of many kinds to put a financial value on the hopes, fears, and expectations managers associate with each alternative. Projections of cash inflows rest on forecasts of sales volume, product mix, unit prices, and competitors’ actions. Expected cash outflows depend on projections of various cost elements, working capital, and investment requirements.

While good forecasts are notoriously difficult to make, they are critical to the validity of value-based planning. Once someone attaches numbers to judgments about what is likely to happen, people tend to endow those numbers with the concreteness of hard facts. Therefore, the numbers derived from value-based planning can sometimes take on a life of their own, and managers can lose sight of the assumptions underlying them.

Consequently, inaccurate forecasts can create problems in implementing value-based planning. For one thing, there are natural human tendencies to overvalue the financial projections associated with some strategy alternatives and to undervalue others. For instance, managers are likely to overestimate the future returns from a currently successful strategy. Evidence of past success tends to carry more weight than qualitative assessments of future threats. Managers may pay too little attention to how competitive behavior, prices, and returns might change if, for example, the industry were suddenly beset by a slowdown in market growth and the appearance of excess capacity.

On the other hand, some kinds of strategy alternatives are consistently undervalued. Particularly worrisome from a marketing viewpoint is the tendency to underestimate the value of keeping current customers. Putting a figure on the damage to a firm’s competitive advantage from not making a strategic investment necessary to maintain the status quo is harder than documenting potential cost savings or profit improvements that an investment might generate. For example, a few years ago Cone Drive Operations, a small manufacturer of heavy-duty gears, faced a number of related problems. Profits were declining, inventory costs were climbing, and customers were unhappy because deliveries were often late. Cone’s management thought that a $2 million computer-integrated manufacturing system might help solve these problems; but a discounted cash flow analysis indicated the system would be an unwise investment. Because the company had only $26 million in sales, it was hard to justify the $2 million investment in terms of cost savings. However, the financial analysis underestimated intangibles such as improved product quality, faster order processing, and improved customer satisfaction. Management decided to install the new system anyway, and new business and nonlabor savings paid back the investment in just one year. More important, Cone retained nearly all of its old customers, many of whom had been seriously considering switching to other suppliers.
Finally, another kind of problem involved in implementing value-based planning occurs when management fails to consider all the appropriate strategy alternatives. Since it is only an analytical tool, value-based planning can evaluate alternatives, but it cannot create them. The best strategy will never emerge from the evaluation process if management fails to identify it. To realize its full benefits, then, management must link value-based planning to sound strategic analysis that is rigorous enough to avoid the problems associated with undervaluing certain strategies, overvaluing others, and failing to consider all the options.

**Sources of Synergy**

A final strategic concern at the corporate level is to increase synergy across the firm’s various businesses and product-markets. As mentioned, synergy exists when two or more businesses or product-markets, and their resources and competencies, complement and reinforce one another so that the total performance of the related businesses is greater than it would be otherwise.

**Knowledge-Based Synergies**

Some potential synergies at the corporate level are knowledge-based. The performance of one business can be enhanced by the transfer of competencies, knowledge, or customer-related intangibles—such as brand-name recognition and reputation—from other units within the firm. For instance, the technical knowledge concerning image processing and the quality reputation that Canon developed in the camera business helped ease the firm’s entry into the office copier business.

In part, such knowledge-based synergies are a function of the corporation’s scope and mission—or how its managers answer the question, What businesses should we be in? When a firm’s portfolio of businesses and product-markets reflects a common mission based on well-defined customer needs, market segments, or technologies, the company is more likely to develop core competencies, customer knowledge, and strong brand franchises that can be shared across businesses. However, the firm’s organization structure and allocation of resources also may enhance knowledge-based synergy. A centralized corporate R&D department, for example, is often more efficient and effective at discovering new technologies with potential applications across multiple businesses than if each business unit bore the burden of funding its own R&D efforts. Similarly, some argue that strong corporate-level coordination and support are necessary to maximize the strength of a firm’s brand franchise, and to glean full benefit from accumulated market knowledge, when the firm is competing in global markets.

**Corporate Identity and the Corporate Brand as a Source of Synergy**

Corporate identity—together with a strong corporate brand that embodies that identity—can help a firm stand out from its competitors and give it a sustainable advantage in the market. Corporate identity flows from the communications, impressions, and personality projected by an organization. It is shaped by the firm’s mission and values, its functional competencies, the quality and design of its goods and services, its marketing communications, the actions of its personnel, the image generated by various corporate activities, and other factors.32

In order to project a positive, strong, and consistent identity, firms as diverse as Caterpillar, Walt Disney, and The Body Shop have established formal policies, criteria, and
guidelines to help ensure that all the messages and sensory images they communicate reflect their unique values, personality, and competencies. One rationale for such corporate identity programs is that they can generate synergies that enhance the effectiveness and efficiency of the firm’s marketing efforts for its individual product offerings. By focusing on a common core of corporate values and competencies, every impression generated by each product’s design, packaging, advertising, and promotional materials can help reinforce and strengthen the impact of all the other impressions the firm communicates to its customers, employees, shareholders, and other audiences, and thereby generate a bigger bang for its limited marketing bucks. For example, by consistently focusing on values and competencies associated with providing high-quality family entertainment, Disney has created an identity that helps stimulate customer demand across a wide range of product offerings—from movies to TV programs to licensed merchandise to theme parks and cruise ships.

**Corporate Branding Strategy—When Does a Strong Corporate Brand Make Sense?**

Before a company’s reputation and corporate image can have any impact—either positive or negative—on customers’ purchase decisions, those customers must be aware of which specific product or service offerings are sponsored by the company. This is where the firm’s corporate branding strategy enters the picture. Essentially, a firm might pursue one of three options concerning the corporate brand:33

1. The corporate brand (typically the company’s own name and logo) might serve as the brand name of all or most of the firm’s products in markets around the world, as is the case with many high-tech (e.g., Cisco Systems, Siemens, IBM, Caterpillar) and service (e.g., British Airways, Amazon.com, McDonald’s, Hilton hotels) companies.

2. The firm might adopt a dual branding strategy in which each offering carries both a corporate identifier and an individual product brand. Examples include Microsoft software products (e.g., Microsoft Windows, Microsoft Word, etc.) and Ford automobiles (Ford Taurus, Ford Explorer, etc.)

3. Finally, each product offering might be given a unique brand and identity—perhaps even different brands across different global markets—while the identity of the source company is de-emphasized or hidden. This is the strategy pursued by Procter and Gamble and many other consumer package goods firms.

The question is, When does it make sense to emphasize—and seek to gain synergy from—a strong corporate identity and brand name in a company’s branding strategy? Surprisingly, this question has not been subjected to much empirical research. However, some of the conditions favoring a dominant corporate brand are rather obvious. For instance, the corporate brand will not add much value to the firm’s offerings unless the company has a strong and favorable image and reputation among potential customers in at least most of its target markets. Thus, the 3M Company features the 3M logo prominently on virtually all of its 70,000 products because the firm’s reputation for innovativeness and reliability is perceived positively by many of its potential customers regardless of what they are buying.

A related point is that a strong corporate brand makes most sense when company-level competencies or resources are primarily responsible for generating the benefits and value customers receive from its various individual offerings. For example, many service organizations (e.g., McDonald’s, Disney, Marriott, etc.) emphasize their corporate brands. This is due, in part, to the fact that services are relatively intangible and much of their value is directly generated by the actions of company personnel and facilitated by other firm-specific resources, such as its physical facilities, employee training and reward programs, quality control systems, and the like.
Finally, a recent exploratory study based on interviews with managers in 11 Fortune 500 companies suggests that a firm is more likely to emphasize a strong corporate brand when its various product offerings are closely interrelated, either in terms of having similar positionings in the market or cross-product elasticities that might be leveraged to encourage customers to buy multiple products from the firm. The study also found that firms with strong corporate brands tended to have more centralized decision-making structures where top management made more of the marketing strategy decisions. The obvious question, of course, is whether a firm’s decision-making structure influences brand strategy, or vice versa. We will explore such organization design issues and their marketing strategy implications in more detail later in Chapter 13.

Synergy from Shared Resources

A second potential source of corporate synergy is inherent in sharing operational resources, facilities, and functions across business units. For instance, two or more businesses might produce products in a common plant or use a single salesforce to contact common customers. When such sharing helps increase economies of scale or experience-curve effects, it can improve the efficiency of each of the businesses involved. However, the sharing of operational facilities and functions may not produce positive synergies for all business units. Such sharing can limit a business’s flexibility and reduce its ability to adapt quickly to changing market conditions and opportunities. Thus, a business whose competitive strategy is focused on new-product development and the pursuit of rapidly changing markets may be hindered more than helped when it is forced to share operating resources with other units. For instance, when Frito-Lay attempted to enter the packaged cookie market with its Grandma’s line of soft cookies, the company relied on its 10,000 salty-snack route salespeople to distribute the new line to grocery stores. The firm thought its huge and well-established snack salesforce would give its cookies a competitive advantage in gaining shelf space and retailer support. But because those salespeople were paid a commission on their total sales revenue, they were reluctant to take time from their salty-snack products to push the new cookies. The resulting lack of a strong sales effort contributed to Grandma’s failure to achieve a sustainable market share.

As we shall see in the next chapter, the type of competitive strategy a business unit chooses to pursue can have a number of implications for corporate-level decisions concerning organizational structure and resource allocation as well as for the marketing strategies and programs employed within the business.

**Take Aways**

- A clearly defined corporate mission answers the question “What business(es) should we be in?” It provides guidance to a firm’s managers concerning what alternative product categories and market segments fit best with the firm’s competencies, resources, and objectives. Mission statements are most useful, therefore, when they are relatively specific concerning both the customer groups and the products or technologies on which the firm will concentrate.

- Unethical behavior by a firm’s employees can damage the trust between a firm and its suppliers and customers, thereby disrupting the development of long-term relationships and reducing sales and profits over time.

- In the long term, the value a firm generates for its shareholders and the value it delivers to its customers converge. A firm can continue to provide attractive returns to shareholders only so long as it satisfies and retains its customers.

- The four major paths to corporate growth—market penetration, market development, product development, and diversification strategies—imply differences in a firm’s strategic scope, require different competencies and marketing actions, and involve different types
and amounts of risk. Decisions about which path(s) to pursue should consider all of these factors.

- A strong corporate brand can create synergy across a firm’s various product offerings, but only if potential customers are aware that the company possesses competencies or values that (1) are likely to enhance the value they receive from the firm’s goods and services and (2) differentiate the company from its competitors.

- Self-diagnostic questions to test your ability to apply the concepts in this chapter can be found at this book’s website at www.mhhe.com/walker.

## Endnotes


18. “GE’s Brave New World,” Business Week, November 8, 1993, pp. 64–70.


21. For a more comprehensive review of the evidence concerning the effects of diversification, see Roger A. Kerin, Vijay Mahajan, and P. Rajan Varadarajan, Contemporary Perspectives on Strategic Market Planning (Boston: Allyn and Bacon, 1990), chap. 6.

22. For example, see Ravi S. Achrol and Philip Kotler, “Marketing in the Network Economy,” Journal of Marketing 63 (Special Issue 1999), pp. 146–63.


24. Robert Jacobson argues that market share and profitability are joint outcomes from successful strategies and, further, that management skills likely have the greatest impact on profitability. See “Distinguishing Among Competing Theories of the Market Share Effect,” Journal of Marketing 52 (October 1988), pp. 68–80.


26. For a more detailed discussion of the uses and limitations of multifactor portfolio models, see Kerin, Mahajan, and Varadarajan, Contemporary Perspectives on Strategic Market Planning, chap. 3.

27. The discounted cash flow model is the approach focused on in this chapter. It is detailed in Alfred Rappaport, Creating Shareholder Value: A New Standard for Business Performance (New York: Free Press, 1986).

28. For a detailed discussion of the shortcomings of accounting data for determining the value created by a strategy, see Rappaport, Creating Shareholder Value, chap. 2.


30. A more in-depth discussion of the forecasts and other procedures used in value-based planning can be found in Rappaport, Creating Shareholder Value, or Kerin, Mahajan, and Varadarajan, Contemporary Perspectives on Strategic Market Planning, chap. 9.


CHAPTER THREE

BUSINESS STRATEGIES AND THEIR MARKETING IMPLICATIONS

Business Strategies and Marketing Programs at 3M

The Minnesota Mining and Manufacturing Company, better known as 3M, began manufacturing sandpaper nearly a century ago. Today it is the leader in dozens of technical areas from fluorochemistry to fiber optics. The firm makes more than 60,000 different products, which generated $16.7 billion in global sales in 2000. The company produced $3.1 billion in operating income, for more than a 19 percent return on invested capital.

As you might expect of a firm with so many products, 3M is organized into a large number of strategic business units (SBUs). The company contains more than 40 such SBUs or product divisions organized into six market sectors:

- The Industrial Sector makes a variety of tapes, abrasives, and adhesives for industrial applications ranging from electronics to the auto industry.
- The Transportation, Graphics, and Safety Sector produces such things as reflective materials for traffic signs, respirators for worker safety, and materials for commercial graphics.
- The Health Care Sector markets a variety of medical, surgical, pharmaceutical, and dental products and services.
- The Consumer and Office Sector offers products for homes and offices, such as Post-it brand repositionable notes and Scotch brand tapes.
- The Electro and Communications Sector supplies connecting, splicing, and protective products for electronics and telecommunications markets.
- The Specialty Materials Sector provides fluoro thermoplastics and fluorothermopolymers for a variety of applications from packaging to electronics.

While 3M has acquired many smaller firms over the years, its growth strategy has focused primarily on internal new product development, emphasizing both improved products for existing customers and new products for new markets. One formal objective assigned to every business unit is to obtain at least 30 percent of annual sales from products introduced within the past four years. The company supports its growth strategy with an
R&D budget of more than $1 billion, almost 7 percent of total revenues.

The company also pursues growth through the aggressive development of foreign markets for its many products. A seventh organizational sector is responsible for coordinating the firm’s marketing efforts across countries. In 2000, 3M attained $9 billion in sales—53 percent of its total revenue—from outside the United States.

Differences in customer needs and life-cycle stages across industries, however, lead 3M’s various business units to pursue their growth objectives in different ways. The Industrial Tape Division within the Industrial Sector, for example, operates in an industry where both the product technologies and the customer segments are relatively mature and stable. Growth in this group results from extending the scope of adhesive technology (for instance, attaching weather-stripping to auto doors), product improvements and line extensions targeted at existing customers, and expansion into global markets.

In contrast, the firm’s Drug Delivery Systems Division within the Health Care Sector develops new medical applications for emerging technologies developed in 3M’s many R&D labs. It sells a variety of technologies for the delivery of medications that are inhaled or absorbed through the skin. Most of the unit’s growth comes from developing new products, often through alliances with other pharmaceutical firms, aimed at new markets.

The competitive strategies of 3M’s various business units also differ. For instance, the industrial tape unit is primarily concerned with maintaining its commanding market share in existing markets while preserving or even improving its profitability. Its competitive strategy is to differentiate itself from competitors on the basis of product quality and excellent customer service.

But the drug delivery systems unit’s strategy is to avoid head-to-head competitive battles by being the technological leader and introducing a stream of unique new products. To be successful, though, the unit must devote substantial resources to R&D and to the stimulation of primary demand. Thus, its main objective is volume growth; and it must sometimes sacrifice short-run profitability to fund the product development and marketing efforts needed to accomplish that goal.

These differences in competitive strategy, in turn, influence the strategic marketing programs within the various business units. For instance, the firm spends little on advertising or sales promotion for its mature industrial tape products. However, it does maintain a large, well-trained technical salesforce that provides valuable problem-solving assistance and other services to customers and informed feedback to the firm’s R&D personnel about potential new applications and product improvements.

In contrast, the pioneering nature of the drug delivery unit’s technologies calls for more extensive promotion to attract potential alliance partners, develop awareness among prescribing physicians, and stimulate primary demand. Consequently, the unit devotes a relatively large portion of its revenues to advertising in technical journals aimed at the pharmaceutical industry, physicians, and other medical professionals. It also supports a well-trained salesforce, but those salespeople spend much of their time demonstrating new technologies and building relationships with drug manufacturers who are prospective customers and partners.

**Strategic Challenges Addressed in Chapter 3**

The situation at 3M illustrates that large firms with multiple businesses usually have a hierarchy of strategies extending from the corporate level down to the individual product-market entry. As we saw in Chapter 2, corporate strategy addresses such issues as the
firm’s mission and scope and the directions it will pursue for future growth. Thus, 3M’s corporate growth strategy focuses primarily on developing new products and new applications for emerging technologies.

The major strategic question addressed at the business-unit level is, How should we compete in this business? For instance, 3M’s industrial tape unit attempts to maintain its commanding market share and high profitability by differentiating itself on the basis of high product quality and good customer service. The drug delivery unit, on the other hand, seeks high growth via aggressive new product and market development.

Finally, the strategic marketing program for each product-market entry within a business unit attempts to allocate marketing resources and activities in a manner appropriate for accomplishing the business unit’s objectives. Thus, most of the strategic marketing programs within 3M’s drug delivery unit involve relatively large expenditures for marketing research and introductory advertising and promotion campaigns aimed at achieving sales growth.

One key reason for 3M’s continuing success is that all three levels of strategy within the company have usually been characterized by good internal and external consistency, or strategic fit. The company’s managers have done a good job of monitoring and adapting their strategies to the market opportunities, technological advances, and competitive threats in the company’s external environment. The firm’s marketing and sales managers play critical roles both in developing market-oriented strategies for individual products and in influencing and helping to formulate corporate and business-level strategies that are responsive to environmental conditions. At the same time, those strategies are usually internally compatible. Each strategy fits with those at other levels as well as with the unique competitive strengths and competencies of the relevant business unit and the company as a whole.²

Recent empirical evidence shows that when there is a good fit between a business’s competitive strategy and the strategic marketing programs of its various product or service offerings, the business will achieve better results in terms of sales growth, market share, and profitability than when the two levels of strategy are inconsistent with one another.³ Therefore, this chapter focuses on what marketing decision makers can and should do to help ensure that the strategic marketing plans they develop are appropriate in light of the available resources and competitive thrust of the business that is their organizational home.

First, we briefly examine the strategic decisions that must be made at the business level, including how business units should be designed. We’ll pay particular attention to the question of how a business might choose to compete. What generic competitive strategies might a business pursue, and in what environmental circumstances is each strategy most appropriate? We’ll also explore whether the same kinds of competitive strategies are relevant for small, single-business organizations and entrepreneurial start-ups as for large multi-SBU firms such as 3M and whether technological shifts, such as the growth of e-commerce, are likely to give birth to new competitive strategies or make some old ones obsolete.

Next, we examine the interrelationships between different business competitive strategies and elements of the strategic marketing programs for the various products within the business. How does—or should—a particular competitive strategy influence or constrain marketing programs for the business’s product offerings? And what happens if the market positioning or specific marketing actions that would be most effective for appealing to a product’s target customers do not fit very well with the competitive strategy of the larger business unit? For example, as some of the products made by the drug delivery unit at 3M—such as the inhalers they make for delivering asthma medications—become
well-established and mature, they may require marketing actions (e.g., more competitive pricing) that are not consistent with the aggressive product development strategy of the business unit. What should 3M and the marketing manager responsible for inhalers do under such circumstances?

**Strategic Decisions at the Business-Unit Level**

The components of a firm engaged in multiple industries or businesses are typically called **strategic business units**, or **SBUs**. Managers within each of these business units decide which objectives, markets, and competitive strategies to pursue. Top-level corporate managers typically reserve the right to review and approve such decisions to ensure their overall consistency with the company’s mission, objectives, and the allocation of resources across SBUs in its portfolio. However, SBU-level managers, particularly those in marketing and sales, bear the primary responsibility for collecting and analyzing relevant information and generating appropriate strategies for their businesses. Those managers are more familiar with a given SBU’s products, customers, and competitors and are responsible for successfully implementing the strategy. The rationale for breaking larger firms into semi-autonomous SBUs usually stems from a market-oriented desire to move strategic decision making closer to the customers the business is trying to reach.

The first step in developing business-level strategies, then, is for the firm to decide how to divide itself into SBUs. The managers in each SBU must then make recommendations about (a) the unit’s objectives, (b) the scope of its target customers and offerings, (c) which broad competitive strategy to pursue to build a competitive advantage in its product-markets, and (d) how resources should be allocated across its product-market entries and functional departments.

**How Should Strategic Business Units Be Designed?**

Ideally, strategic business units have the following characteristics:

- A **homogeneous set of markets to serve with a limited number of related technologies.** Minimizing diversity across an SBU’s product-market entries enables the unit’s manager to better formulate and implement a coherent and internally consistent business strategy.

- A **unique set of product-markets**, in the sense that no other SBU within the firm competes for the same customers with similar products. Thus, the firm avoids duplication of effort and maximizes economies of scale within its SBUs.

- **Control over those factors necessary for successful performance**, such as production, R&D and engineering, marketing, and distribution. This does not mean an SBU should not share resources, such as a manufacturing plant or a salesforce, with one or more other business units. But the SBU should determine how its share of the joint resource is used to effectively carry out its strategy.

- **Responsibility for their own profitability.**

As you might expect, firms do not always meet all of these ideals when designing business units. There are usually trade-offs between having many small homogeneous SBUs versus large but fewer SBUs that managers can more easily supervise.

What criteria should managers use to decide how product-markets should be clustered into a business unit? The three dimensions that define the scope and mission of the entire corporation also define individual SBUs:
1. **Technical compatibility**, particularly with respect to product technologies and operational requirements, such as the use of similar production facilities and engineering skills.

2. Similarity in the **customer needs** or the product benefits sought by customers in the target markets.

3. Similarity in the **personal characteristics** or behavior patterns of customers in the target markets.

In practice, the choice is often between technical/operational compatibility on the one hand and customer homogeneity on the other. Frequently management defines SBUs by product-markets requiring similar technologies, production facilities, and employee skills. This minimizes the coordination problems involved in administering the unit and increases its ability to focus on one or a few critical competencies.

In some firms, however, the marketing synergies gained from coordinating technically different products aimed at the same customer need or market segment outweigh operational considerations. In these firms, managers group product-market entries into SBUs based on similarities across customers or distribution systems. For instance, 3M’s Medical Products unit includes a wide range of products involving very different technologies and production processes. They are grouped within the same business unit, though, because all address health needs, are marketed to physicians and other health professionals, and can be sold through a common salesforce and distribution system.

### Business-Unit Objectives

Companies break down corporate objectives into subobjectives for each SBU. In most cases, those subobjectives vary across SBUs according to the attractiveness of their industries, the strength of their competitive positions within those industries, and resource allocation decisions by corporate management. For example, managers may assign an SBU in a rapidly growing industry relatively high volume and share-growth objectives but lower ROI objectives than an SBU with a large share in a mature industry.

A similar process of breaking down overall SBU objectives into a set of subobjectives should occur for each product-market entry within the unit. Those subobjectives obviously must reflect the SBU’s overall objectives; but once again they may vary across product-market entries according to the attractiveness and growth potential of individual market segments and the competitive strengths of the company’s product in each market. For example, when 3M’s consumer products group first introduced its Scotch-Brite Never Rust soap pads—a new form of scouring pad that will never rust or splinter because it is made from recycled plastic beverage bottles—its objective was to capture a major share of the $100 million soap pad market from well-entrenched competitive brands such as SOS and Brillo. 3M wanted to maximize Never Rust’s volume growth and market share even if the new line did not break even for several years. Consequently, the firm’s top managers approved a major investment in a new plant and a substantial introductory advertising budget. At the same time, though, the consumer group maintained high profitability goals for its other established products—such as Scotch brand Magic Transparent Tape and Post-it brand notes—to provide the cash required for Never Rust’s introduction and preserve the group’s overall profit level.

### Allocating Resources within the Business Unit

Once an SBU’s objectives and budget have been approved at the corporate level, its managers must decide how the available resources should be allocated across the unit’s various product-market entries. Because this allocation process is quite similar to allocating corporate
resources across SBUs, many firms use similar economic value, value-based planning, or portfolio analysis tools for both. Of course, at the SBU level managers must determine the attractiveness of individual target markets, the competitive position of their products within those markets, and the cash flows each product entry will likely generate rather than analyzing industry attractiveness and the overall competitive strengths of the firm.

Unfortunately, value-based planning is not as useful a tool for evaluating alternative resource allocations across product-market entries as it is for evaluating allocations across SBUs. This is because the product-market entries within a business unit often share the benefits of common investments and the costs of functional activities, as when multiple products are produced in the same plant or sold by the same salesforce. The difficulty of deciding what portion of such common investments and shared costs should be assigned to specific products increases the difficulty of applying a discounted cash flow analysis at the product-market level. As we shall see in Chapter 14, some firms have adopted activity-based costing systems in an attempt to resolve such problems, but many difficulties remain.

**How Do Businesses Compete?**

As mentioned, the essential strategic question at the SBU level is, How are we going to compete in this business? Thus, business strategies are primarily concerned with allocating resources across functional activities and product-markets to give the unit a sustainable advantage over its competitors. Of course, the unit’s core competencies and resources, together with the customer and competitive characteristics of its industry, determine the viability of any particular competitive strategy. The 3M drug delivery unit’s strategy of gaining revenue growth via technological leadership and aggressive new product and market development, for instance, will continue to work only if the firm’s R&D, engineering, and marketing competencies and resources continue to outweigh those of its competitors. Consequently, most SBUs pursue a single competitive strategy—one that best fits their market environments and competitive strengths—across all or most of the product-markets in which they compete. The question is, What alternative strategies are available to a business unit? What are the basic, or generic, competitive strategies most SBUs choose to pursue?

**Generic Business-Level Competitive Strategies**

Researchers have identified general categories of business-level competitive strategies based on overall patterns of purpose, practice, and performance in different businesses. Michael Porter distinguishes three strategies—or competitive positions—that businesses pursue to gain and maintain competitive advantages in their various product-markets: (1) overall cost leadership; (2) differentiation—building customer perceptions of superior product quality, design, or service; and (3) focus, in which the business avoids direct confrontation with its major competitors by concentrating on narrowly defined market niches. Porter describes firms that lack a distinctive strategy as being “stuck in the middle” and predicts that they will perform poorly.

Robert Miles and Charles Snow identified another set of business strategies based on a business’s intended rate of product-market development (new product development, penetration of new markets). They classify business units into four strategic types: prospectors, defenders, analyzers, and reactors. Exhibit 3.1 describes each of these business strategies briefly. As you can see, businesses pursuing a prospector strategy focus on growth through the development of new products and markets. 3M’s drug delivery business unit illustrates this. Defender businesses concentrate on maintaining their positions in
established product-markets while paying less attention to new product development, as is the case with 3M’s industrial tape business unit. The analyzer strategy falls in between these two. An analyzer business attempts to maintain a strong position in its core product-market(s) but also seeks to expand into new—usually closely related—product-markets. Finally, reactors are businesses with no clearly defined strategy.

Even though both the Porter and Miles and Snow typologies have received popular acceptance and research support, neither is complete by itself. For example, a defender business unit could pursue a variety of competitive approaches to protect its market position, such as offering the lowest cost or differentiating itself on quality or service. Thus, we have combined the two typologies in Exhibit 3.2 to provide a more comprehensive overview of business strategies. Exhibit 3.2 classifies business strategies on two primary dimensions: the unit’s desired rate of product-market development (expansion) and the unit’s intended method of competing in its established product-markets.

Each of our strategic categories could be further subdivided according to whether a business applies the strategy across a broadly defined product-market domain or concentrates...
on a narrowly defined segment where it hopes to avoid direct confrontation with major competitors (the focus strategy of Porter). Although this distinction is useful, it is more germane to a discussion of the business’s target market strategy (as discussed in Chapter 7) than to its competitive strategy. Most businesses compete in a reasonably consistent way across all of their product-markets, whether their domain is broad or narrow.

Exhibit 3.2 describes only six business strategies, rather than the eight that one might expect. We view reactor and prospector business units as two homogeneous categories. Evidence suggests that a substantial portion of businesses fall into the reactor category. One study, for instance, found that 50 out of 232 businesses examined could be classified as reactors. By definition, however, such businesses do not have well-defined or consistent approaches either to new product development or to ways of competing in existing product-markets. In other words, reactors have no clear competitive strategy. Therefore, we will largely ignore them during the rest of this discussion.

Prospectors are also shown as a single strategic category in Exhibit 3.2 because the desire for rapid new product or market development is the overriding aspect of their strategy. There is little need for a prospector business to consider how it will compete in the new product-markets it develops because it will face little or no competition—at least not until those markets become established and other firms begin to enter.

**Do the Same Competitive Strategies Work for Single-Business Firms and Start-ups?**

Even small firms with a single business and only a few related product offerings or start-ups with a single product must decide how they will compete. And just like an SBU in a major corporation such as 3M, their competitive strategies should be tailored to their unique resources and competencies and aimed at securing a sustainable advantage over
existing or potential competitors. Therefore, the same set of generic competitive strategies is just as appropriate for small firms as for business units within larger ones. For example, Jack Daniels defends its commanding share of the prestige segment of the very mature North American whiskey market by stressing the long tradition of its production process and the superior quality of its Kentucky bourbon: in other words, by pursuing a very effective differentiated defender strategy.

However, there is one important difference between single-business and multi-SBU organizations. In smaller single-business firms the distinction between business-level competitive strategy and marketing strategy tends to blur and the two strategies blend into one. Jack Daniels’ competitive strategy, for instance, is essentially the same as the market positioning for its primary product: a product that offers higher quality than competing brands because it is made with old-fashioned methods and ingredients that have not changed for more than a century. And the elements of its marketing strategy all flow from that competitive/market positioning: a premium price, advertising that stresses the product’s long history and traditional production practices, old-fashioned packaging, and the like.

Another difference applies to entrepreneurial start-ups. Most start-ups do not have the resources to succeed by competing as a “me-too” competitor in a well-established and highly competitive product market. By definition they do not have an established market position to defend. Therefore, while the taxonomy of competitive strategies is still relevant to entrepreneurial firms, in reality most of them—at least those that stand a reasonable chance of success—begin life as prospectors. They compete primarily by developing a unique product or service that meets the needs and preferences of a customer segment that is not being well served by established competitors.

The critical question for a start-up firm, though, is, What happens when the new product matures and competitors arrive on the scene? Should the firm continue to focus on developing a stream of new products to stay a step ahead of the competition, even though such a strategy would mean paying less attention to its successful first entry? Should the firm switch to a defender strategy to leverage its initial success, even though that would mean competing head to head with other, probably bigger, competitors? Should the firm create two separate SBUs with different competitive strategies, even though it is small and resources are limited? These are the kinds of questions that arise when the market and competitive conditions facing a product entry change. The entry’s marketing strategy should be adjusted in response to such changes, but that may make it less compatible with the overall competitive strategy of the business, which is typically harder to change in the short term. These and similar issues related to strategic change are examined in more detail later in this chapter.

**Do the Same Competitive Strategies Work for Service Businesses?**

What is a service? Basically, services can be thought of as intangibles and goods as tangibles. The former can rarely be experienced in advance of the sale, while the latter can be experienced, even tested, before purchase. Using this distinction, a service can be defined as “any activity or benefit that one party can offer to another that is essentially intangible and that does not result in the ownership of anything. Its production may or may not be tied to a physical product.”

We typically associate services with nonmanufacturing businesses, even though service is often an indispensable part of a goods producer’s offering. Services such as applications engineering, system design, delivery, installation, training, and maintenance can be crucial for building long-term relationships between manufacturers and their customers, particularly...
in consumer durable and industrial products businesses. Thus, almost all businesses are engaged in service to some extent.

Many organizations are concerned with producing and marketing a service as their primary offering rather than as an adjunct to a physical product. These organizations include public-sector and not-for-profit service organizations, such as churches, hospitals, universities, and arts organizations. The crucial question is this: To be successful, must service organizations employ different competitive strategies than goods manufacturers?

The framework we used to classify business-level competitive strategies in Exhibit 3.2 is equally valid for service businesses. Some service firms, such as Super 8 or Days Inn in the lodging industry, attempt to minimize costs and compete largely with low prices. Other firms, like Marriott, differentiate their offerings on the basis of high service quality or unique benefits. Similarly, some service businesses adopt prospector strategies and aggressively pursue the development of new offerings or markets. For instance, American Express’s Travel Related Services Division has developed a variety of new services tailored to specific segments of the firm’s credit-card holders. Other service businesses focus narrowly on defending established positions in current markets. Still others can best be described as analyzers pursuing both established and new markets. For instance, Cable & Wireless Communications, a long-distance carrier whose competitive strategy is discussed in Exhibit 3.3, might best be described as a differentiated analyzer.

A study of the banking industry provides empirical evidence that service businesses actually do pursue the same types of competitive strategies as goods producers. The 329 bank CEOs who responded to the survey had little trouble categorizing their institution’s competitive strategies into one of Miles and Snow’s four types. Fifty-four of the executives reported that their banks were prospectors, 87 identified their firms as analyzers, 157 as defenders, and 31 as reactors.¹²

Cable & Wireless Communications, the U.S. subsidiary of a British telecommunications firm, competes in the relatively mature and highly competitive business of providing long-distance services to business customers. Company executives knew long ago that their operation could not compete on price with larger competitors like AT&T or MCI. So they sought to differentiate themselves—and to defend their established customer base—by providing the best customer support in the industry. As a result, Cable & Wireless turned itself from a mundane commodity business into a sophisticated telemarketer and partner with its customers.

Part of Cable & Wireless’s success was the result of good target market selection. The firm focused on winning and holding on to small or medium-sized business clients with monthly billings of $500 to $15,000. For such small businesses, the company’s 500 U.S. salespeople, working out of 36 regional offices, acted like telecommunications managers. Corporations too small to hire their own telecom specialists valued the advice and expertise Cable & Wireless people could offer, and top management gave those salespeople substantial autonomy to tailor their offerings and advice to each customer’s needs.

Within its target small-business segment, however, Cable & Wireless was not content to merely maintain relationships with established customers. The firm pursued a differentiated analyzer strategy by also devoting substantial effort and resources to developing and pitching specialized services aimed at attracting new customers from new industry segments. For example, the company gained substantial business from smaller firms within the legal profession by developing functions that appealed specifically to lawyers, such as innovative ways to track and bill calls linked to specific client accounts.

Do the Same Competitive Strategies Work for Global Competitors?

In terms of the strategies described in Exhibit 3.2, businesses that compete in multiple global markets almost always pursue one of the two types of analyzer strategy. They must continue to strengthen and defend their competitive position in their home country—and perhaps in other countries where they are well established—while simultaneously pursuing expansion and growth in new international markets.

When examined on a country-by-country basis, however, the same business unit might be viewed as pursuing different competitive strategies in different countries. For instance, while 3M’s industrial tape group competes like a differentiated defender in the United States, Canada, and some European countries where it has established large market shares, it competes more like a prospector when attempting to open and develop new markets in emerging economies such as China and Mexico. This suggests that a single SBU may need to engage in different functional activities (including different strategic marketing programs)—and perhaps even adopt different organizational structures to implement those activities—across the various countries in which it competes. McDonald’s faces this kind of situation across the 94 countries in which it operates, as discussed in Exhibit 3.4.

Will the Internet Change Everything?

Some analysts argue that the Internet will change the way firms compete. The Internet makes it easier for buyers and sellers to compare prices, reduces the number of middlemen necessary between manufacturers and end users, cuts transaction costs, improves the functioning of the price mechanism, and thereby increases competition. One possible outcome of all these changes is that it will be harder for firms to differentiate themselves on any basis other than low price. All the business-level competitive strategies focused on differentiation will become less viable, while firms pursuing low-cost strategies will be more successful.

While we agree that the Internet has increased both efficiency and competitiveness in many product-markets, we doubt that competition will focus exclusively on price. For one thing, innovation is likely to continue—and probably accelerate—in the future. Unique new products and services will continue to emerge and provide a way for the innovator to gain a competitive advantage, at least in the short term. Thus, firms with the resources and competencies necessary to produce a continuing stream of new product or service offerings that appeal to one or more customer segments—that is, to effectively implement a prospector strategy—should be successful regardless of whether they are the lowest-cost producers in their industries. Amazon.com, the largest e-tailer as of early 2001, is generally not the lowest priced.

In addition, the Internet is primarily a communications channel. While it facilitates the dissemination of information, including price information, the goods and services themselves will continue to offer different features and benefits. As customers gather more information from the Internet and become better informed, they are less likely to be swayed by superficial distinctions between brands. But if a firm offers unique benefits that a segment of customers perceive as meaningful, it should still be able to differentiate its offering and command a premium price, at least until its competitors offer something similar.

Finally, the Internet will make it easier for firms to customize their offerings and personalize their relationships with their customers. Such personalization should differentiate the firm from its competitors in the
McDonald’s now has nearly 29,000 retail outlets serving customers around the world. As you can see from the chart, in 1985 more than three-quarters of all McDonald’s restaurants were inside the United States, but by 1999 more than half were outside America.

McDonald’s is growing faster overseas in part because the fast-food market is more mature and much more competitive in the United States than in most other nations. Consequently, the firm’s competitive strategies—and therefore its prices, marketing costs, and operating margins—tend to be different in other countries than in the United States.

McDonald’s holds a commanding 42 percent share of the domestic burger market. The firm’s competitive strategy in the United States, then, is that of a differentiated defender intent on preserving its market share position and profitability in the face of slowing demand and increasing competition. Among other things, the company has begun an aggressive campaign to reduce its operating costs by simplifying its restaurant designs, reducing the number of items on the menu, and so on. Some of those cost savings will be reflected in lower prices, while the rest will be plowed back into aggressive advertising and promotion programs. Finally, the firm is attempting to gain more sales and profits from older adults—a segment where McDonald’s has not been very strong—by improving product quality via a new “made for you” food preparation system.

Outside the United States, on the other hand, McDonald’s faces less organized competition (Pizza Hut is its nearest rival), but the demand for fast food is just beginning to grow. Consequently, the firm must often pursue a prospector strategy focused on building demand among new customers. This helps explain the rapid rate of new restaurant construction outside of the United States. The firm built about 1,800 new outlets in 1999, but only 150 were in the United States. Unfortunately, infrastructure problems in developing markets such as China and Eastern Europe mean that, on average, new restaurants cost much more to build. And to attract new customers in such markets, McDonald’s initially has to price its burgers very low. While demand growth and economies of scale usually help individual units turn a profit relatively soon after opening, at the national level McDonald’s is often making a rather long-term bet—a bet with the risk of political or economic upheaval.

To help managers in each country adjust to local market and environmental differences, McDonald’s gives them great flexibility and autonomy. In every country the pace of expansion—and the strategy for achieving it—is decided locally. And so far those locally developed strategies have been quite successful.

HOW DO COMPETITIVE STRATEGIES DIFFER FROM ONE ANOTHER?

In Chapter 1 we said that all strategies consist of five components or underlying dimensions: scope (or breadth of strategic domain), goals and objectives, resource deployments, a basis for achieving a sustainable competitive advantage, and synergy. But the generic strategies summarized in Exhibit 3.2 are defined largely by their differences on only one dimension: the nature of the competitive advantage sought. Each strategy also involves some important differences on the other four dimensions—differences that are outlined in Exhibit 3.5 and discussed below. Those differences provide insights concerning the conditions under which each strategy is most appropriate and about the relative importance of different marketing actions in implementing them effectively.

Differences in Scope

Both the breadth and stability of a business’s domain are likely to vary with different strategies. This, in turn, can affect the variables the corporation uses to define its various businesses. At one extreme, defender businesses, whether low-cost or differentiated, tend
to operate in relatively well-defined, narrow, and stable domains where both the product technology and the customer segments are mature.

At the other extreme, prospector businesses usually operate in broad and rapidly changing domains where neither the technology nor customer segments are well established. The scope of such businesses often undergoes periodic redefinition. Thus, prospector businesses are typically organized around either a core technology that might lead to the development of products aimed at a broad range of customer segments or a basic customer need that might be met with products based on different technologies. The latter is the approach taken by 3M’s drug delivery systems business. Its mission is to satisfy the health needs of a broad range of patients with new products developed from technologies drawn from other business units within the firm.

Analyzer businesses, whether low-cost or differentiated, fall somewhere in between the two extremes. They usually have a well-established core business to defend, and often their domain is primarily focused on that business. However, businesses pursuing this intermediate strategy are often in industries that are still growing or experiencing technological changes. Consequently, they must pay attention to the emergence of new customer segments and/or new product types. As a result, managers must review and adjust the domain of such businesses from time to time.

Differences in Goals and Objectives

Another important difference across generic business-level strategies with particular relevance for the design and implementation of appropriate marketing programs is that different strategies often focus on different objectives. SBU and product-market objectives might be specified on a variety of criteria, but to keep things simple, we focus on only three performance dimensions of major importance to both business-unit and marketing managers:

1. **Effectiveness.** The success of a business’s products and programs relative to those of its competitors in the market. Effectiveness is commonly measured by such items as sales growth relative to competitors or changes in market share.

2. **Efficiency.** The outcomes of a business’s programs relative to the resources used in implementing them. Common measures of efficiency are profitability as a percent of sales and return on investment.

3. **Adaptability.** The business’s success in responding over time to changing conditions and opportunities in the environment. Adaptability can be measured in a variety of ways, but the most common ones are the number of successful new products introduced relative to those competitors or the percentage of sales accounted for by products introduced within the last five years.

However, it is very difficult for any SBU, regardless of its competitive strategy, to simultaneously achieve outstanding performance on even this limited number of dimensions, because they involve substantial trade-offs. Good performance on one dimension often means sacrificing performance on another. For example, developing successful new products or attaining share growth often involves large marketing budgets, substantial up-front investment, high operating costs, and a shaving of profit margins—all of which reduce ROI. This suggests that managers should choose a competitive strategy with a view toward maximizing performance on one or two dimensions, while expecting to sacrifice some level of performance on the others, at least in the short term. Over the longer term, of course, the chosen strategy should promise discounted cash flows that exceed the business’s cost of capital and thereby increase shareholder value.

As Exhibit 3.5 indicates, prospector businesses are expected to outperform defenders on both new product development and market-share growth. On the other hand, both
defender strategies should lead to better returns on investment. Differentiated defenders likely produce higher returns than low-cost defenders, assuming that the greater expenses involved in maintaining their differentiated positions can be more than offset by the higher margins gained by avoiding the intense price competition low-cost competitors often face. Once again, both low-cost and differentiated analyzer strategies are likely to fall between the two extremes.16

Differences in Resource Deployment

Businesses following different strategies also tend to allocate their financial resources differently across product-markets, functional departments, and activities within each functional area. Prospector—and to a lesser degree, analyzer—businesses devote a relatively large proportion of resources to the development of new product-markets. Because such product-markets usually require more cash to develop than they produce short term, businesses pursuing these strategies often need infusions of financial resources from other parts of the corporation. In portfolio terms, they are “question marks” or “stars.”

Defenders, on the other hand, focus the bulk of their resources on preserving existing positions in established product-markets. These product-markets are usually profitable; therefore, defender businesses typically generate excess cash to support product and market development efforts in other business units within the firm. They are the “cash cows.”

Resource allocations among functional departments and activities within the SBU also vary across businesses pursuing different strategies. For instance, marketing budgets tend to be the largest as a percentage of an SBU’s revenues when the business is pursuing a prospector strategy; they tend to be the smallest as a percentage of sales under a low-cost defender strategy. We discuss this in more detail later in this chapter.

Differences in Sources of Synergy

Because different strategies emphasize different methods of competition and different functional activities, a given source of synergy may be more appropriate for some strategies than for others.

At one extreme, the sharing of operating facilities and programs may be an inappropriate approach to gaining synergy for businesses following a prospector strategy. And to a lesser extent, this also may be true for both types of analyzer strategies. Such sharing can reduce an SBU’s ability to adapt quickly to changing market demands or competitive threats. Commitments to internally negotiated price structures and materials, as well as the use of joint resources, facilities, and programs, increase interdependence among SBUs and limit their flexibility. It is more appropriate for such businesses to seek synergy through the sharing of a technology, engineering skills, or market knowledge—expertise that can help improve the success rate of their product development efforts. Thus, 3M’s drug delivery systems business attempts to find medical applications for new technologies developed in many of the firm’s other business units.

At the other extreme, however, low-cost defenders should seek operating synergies that will make them more efficient. Synergies that enable such businesses to increase economies of scale and experience curve effects are particularly desirable. They help reduce unit costs and strengthen the strategy’s basis of competitive advantage. The primary means of gaining such operating synergies is through the sharing of resources, facilities, and functional activities across product-market entries within the business unit or across related business units. Emerson Electric, for instance, formed an “operating group” of several otherwise
autonomous business units that make different types of electrical motors and tools. By sharing production facilities, marketing activities, and a common salesforce, the group was able to reduce the costs of both per-unit production and marketing.

Deciding When a Strategy Is Appropriate: The Fit between Business Strategies and the Environment

Because different strategies pursue different objectives in different domains with different competitive approaches, they do not all work equally well under the same environmental circumstances. The question is, Which environmental situations are most amenable to the successful pursuit of each type of strategy? Exhibit 3.6 outlines some major market, technological, and competitive conditions—plus a business unit’s strengths relative to its competitors—that are most favorable for the successful implementation of each generic business strategy. We next discuss the reasons each strategy fits best with a particular set of environmental conditions.

Appropriate Conditions for a Prospector Strategy

A prospector strategy is particularly well suited to unstable, rapidly changing environments resulting from new technology, shifting customer needs, or both. In either case, such industries, like many involving e-commerce, tend to be at an early stage in their life cycles and offer many opportunities for new product-market entries. Industry structure is often unstable because few competitors are present and their relative market shares can shift rapidly as new products are introduced and new markets develop.

Because they emphasize the development of new products and/or new markets, the most successful prospectors are usually strong in, and devote substantial resources to, two broad areas of competence: first, R&D, product engineering, and other functional areas that identify new technology and convert it into innovative products; second, marketing research, marketing, and sales—functions necessary for the identification and development of new market opportunities.

In some cases, however, even though a prospector business has strong product development and marketing skills, it may lack the resources to maintain its early lead as product-markets grow and attract new competitors. For example, Minnetonka was the pioneer in several health and beauty-aid product categories with brands such as Softsoap liquid soap and Check-Up plaque-fighting toothpaste. However, because competitors such as Procter & Gamble and Colgate-Palmolive introduced competing brands with advertising and promotion budgets much larger than Minnetonka could match, the firm was eventually forced to change its strategy and concentrate on manufacturing products under licenses from larger firms.

Appropriate Conditions for an Analyzer Strategy

The analyzer strategy is a hybrid. On one hand, analyzers are concerned with defending—via low costs or differentiation in quality or service—a strong share position in one or more established product-markets. At the same time, the business must pay attention to new product development to avoid being leapfrogged by competitors with more technologically
### Exhibit 3.6

**Environmental Factors Favorable to Different Business Strategies**

<table>
<thead>
<tr>
<th>External factors</th>
<th>Prospector</th>
<th>Analyzer</th>
<th>Differentiated defender</th>
<th>Low-cost defender</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry and market</td>
<td>Industry in introductory or early growth stage of life cycle; many potential customer segments as yet unidentified and/or undeveloped.</td>
<td>Industry in late growth or early maturity stage of life cycle; one or more product offerings currently targeted at major customer segments, but some potential segments may still be undeveloped.</td>
<td>Industry in maturity or decline stage of life cycle; current offerings targeted at all major segments; sales primarily due to repeat purchases/replacement demand.</td>
<td>Industry in maturity or decline stage of life cycle; current offerings targeted at all major segments; sales primarily due to repeat purchases/replacement demand.</td>
</tr>
<tr>
<td>Technology</td>
<td>Newly emerging technology; many applications as yet undeveloped.</td>
<td>Basic technology well developed but still evolving; product modifications and improvements—as well as emergence of new competing technologies—still likely.</td>
<td>Basic technology fully developed and stable; few major modifications or improvements likely.</td>
<td>Basic technology fully developed and stable; few major modifications or improvements likely.</td>
</tr>
<tr>
<td>Competition</td>
<td>Few established competitors; industry structure still emerging; single competitor holds commanding share of major market segments.</td>
<td>Large number of competitors, but future shakeout likely; industry structure still evolving; one or more competitors hold large shares in major segments but continuing growth may allow rapid changes in relative shares.</td>
<td>Small to moderate number of well-established competitors; industry structure stable, though acquisitions and consolidation possible; maturity of markets means relative shares of competitors tend to be reasonably stable over time.</td>
<td>Small to moderate number of well-established competitors; industry structure stable, though acquisitions and consolidation possible; maturity of markets means relative shares of competitors tend to be reasonably stable over time.</td>
</tr>
<tr>
<td>Business's relative strengths</td>
<td>SBU (or parent) has strong R&amp;D, product engineering, and marketing research and marketing capabilities.</td>
<td>SBU (or parent) has good R&amp;D, product engineering, and marketing research capabilities, but not as strong as some competitors; has either low-cost position or strong sales, marketing, distribution, or service capabilities in one or more segments.</td>
<td>SBU has no outstanding strengths in R&amp;D or product engineering; costs are higher than at least some competitors; SBU’s outstanding strengths are in process engineering and quality control and/or in marketing, sales, distribution, or customer services.</td>
<td>SBU (or parent) has superior sources of supply and/or process engineering and production capabilities that enable it to be low-cost producer; R&amp;D, product engineering, marketing, sales, or service capabilities may not be as strong as some competitors.</td>
</tr>
</tbody>
</table>
advanced products or being left behind in newly developing application segments within the market. This dual focus makes the analyzer strategy appropriate for well-developed industries that are still experiencing some growth and change as a consequence of evolving customer needs and desires or continuing technological improvements.

Commercial aircraft manufacturing is an example of such an industry. Both competitors and potential customers are few and well established. But technology continues to improve, the increased competition among airlines since deregulation has changed the attributes those firms look for when buying new planes, and mergers have increased the buying power of some customers. Thus, Boeing’s commercial aircraft division has had to work harder to maintain a nearly 50 percent share of worldwide commercial plane sales. Although the firm continues to enjoy a reputation for producing high-quality and reliable planes, it had to make price concessions and increase customer services during the late 1980s and early 1990s to stave off threats from competitor European Airbus. At the same time, Boeing’s commercial aircraft division had to engage in a major development effort aimed at producing the next generation of aircraft, including its 757, 767, and 777 models. Unfortunately, the proliferation of new models contributed to substantial production and delivery problems in the late 1990s, which produced some customer dissatisfaction.

Boeing’s experience illustrates one problem with an analyzer strategy. Few businesses have the resources and competencies needed to successfully defend an established core business while generating new products at the same time. Success on both dimensions requires strengths across virtually every functional area, and few businesses (or their parent companies) have such universal strengths relative to competitors. Therefore, analyzers are often not as innovative in new product development as prospectors. And they may not be as profitable in defending their core businesses as defenders.

**Appropriate Conditions for a Defender Strategy**

A defender strategy makes sense only when a business has something worth defending. It is most appropriate for units with a profitable share of one or more major segments in a relatively mature, stable industry. Consistent with the “constant improvement” principles of total quality management, most successful defenders initiate process improvements, product improvements, or line extensions to help protect and strengthen their established positions. But they devote relatively few resources to basic R&D or the development of innovative new products. Thus, a defender strategy works best in industries where the basic technology is not very complex or where it is well developed and unlikely to change dramatically over the short term. For instance, Pillsbury’s prepared-dough products SBU has pursued a differentiated defender strategy for years. The unit generates substantial profits from well-established refrigerated dough products such as Pillsbury Crescent rolls and Hungry Jack biscuits. But while it has introduced a number of line extensions over the years, most have been reconfigurations of the same basic dough-in-a-can technology, such as Soft Breadsticks.

**Differentiated Defenders** To effectively defend its position by differentiation, a business must be strong in those functional areas critical for maintaining its particular competitive advantages over time. If a business’s differentiation is based on superior product quality, those key functional areas include production, process engineering, quality control, and perhaps product engineering to develop product improvements. The effort to develop and maintain a quality differentiation can be worthwhile, though, because evidence suggests that superior product quality has a strong impact on a business’s return on investment—an important performance objective for defenders.17
Regardless of the basis for differentiation, marketing is also important for the effective implementation of a differentiated defender strategy. Marketing activities that track changing customer needs and competitive actions and communicate the product offering’s unique advantages through promotional and sales efforts to maintain customer awareness and loyalty are particularly important.

**Low-Cost Defenders** Successful implementation of a low-cost defender strategy requires the business to be more efficient than its competitors. Thus, the business must establish the groundwork for such a strategy early in the growth stage of the industry. Achieving and maintaining the lowest per-unit cost usually means that the business has to seek large volume from the beginning—through some combination of low prices and promotional efforts—to gain economies of scale and experience. At the same time, such businesses must also invest in more plant capacity in anticipation of future growth and in state-of-the-art equipment to minimize production costs. This combination of low margins and heavy investment can be prohibitive unless the parent corporation can commit substantial resources to the business or unless extensive sharing of facilities, technologies, and programs with other business units is possible.

The low-cost defender’s need for efficiency also forces the standardization of product offerings and marketing programs across customer segments to achieve scale effects. Thus, such a strategy is usually not so effective in fragmented markets desiring customized offerings as it is in commodity industries such as basic chemicals, steel, or flour, or in industries producing low-technology components such as electric motors or valves.

While low-cost defenders emphasize efficiency and low price as the primary focus of their competitive strategy, it is important to keep in mind that businesses pursuing other strategies should also operate as efficiently as possible given the functional activities necessary to implement those strategies. Some of the most effective businesses are those that work *simultaneously* to lower costs and improve quality and service. And operating efficiency is likely to become even more critical as the Internet makes it easier for customers to compare prices across alternative suppliers or to obtain low-price bids via “buyers’ auction” sites, such as [www.FreeMarkets.com](http://www.FreeMarkets.com) or [www.MetalSite.com](http://www.MetalSite.com).

**How Different Business Strategies Influence Marketing Decisions**

Business units typically incorporate a number of distinct product-markets. A given entry’s marketing manager monitors and evaluates the product’s environmental situation and develops a marketing program suited to it. However, the manager’s freedom to design such a program may be constrained by the business unit’s competitive strategy. This is because different strategies focus on different objectives and seek to gain and maintain a competitive advantage in different ways. As a result, different functions within the SBU—and different activities within a given functional area, such as marketing—are critical for the success of different strategies.

There are, therefore, different functional key factors for success inherent in the various generic business strategies. This constrains the individual marketing manager’s freedom of action in two basic ways. First, because varying functions within the business unit are more important under different strategies, they receive different proportions of the SBU’s total resources. Thus, the SBU’s strategy influences the amount of resources committed to marketing and ultimately the budget available to an individual marketing manager within the business unit. Second, the SBU’s choice of strategy influences both the kind of...
Chapter Three  Business Strategies and Their Marketing Implications

market and competitive situation that individual product-market entries are likely to face and the objectives they are asked to attain. Both constraints have implications for the design of marketing programs for individual products within an SBU.

It is risky to draw broad generalizations about how specific marketing policies and program elements might fit within different business strategies. While a business strategy is a general statement about how an SBU chooses to compete in an industry, that unit may comprise a number of product-market entries facing different competitive situations in various markets. Thus, there is likely to be a good deal of variation in marketing programs, and in the freedom individual marketing managers have in designing them, across products within a given SBU. Still, a business’s strategy does set a general direction for the types of target markets it will pursue and how the unit will compete in those markets. And it does have some influence on marketing policies that cut across product-markets. Exhibit 3.7 outlines differences in marketing policies and program elements that occur across businesses pursuing different strategies, and those differences are discussed below.

Product Policies

One set of marketing policies defines the nature of the products the business will concentrate on offering to its target markets. These policies concern the breadth or diversity of product lines, their level of technical sophistication, and the target level of product quality relative to competitors.

Exhibit 3.7

Differences in Marketing Policies and Program Components across Businesses Pursuing Different Strategies

<table>
<thead>
<tr>
<th>Marketing policies and program components</th>
<th>Prospector</th>
<th>Differentiated defender</th>
<th>Low-cost defender</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product policies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Product-line breadth relative to competitors</td>
<td>+</td>
<td>+</td>
<td>–</td>
</tr>
<tr>
<td>• Technical sophistication of products relative to competitors</td>
<td>+</td>
<td>+</td>
<td>–</td>
</tr>
<tr>
<td>• Product quality relative to competitors</td>
<td>?</td>
<td>+</td>
<td>–</td>
</tr>
<tr>
<td>• Service quality relative to competitors</td>
<td>?</td>
<td>+</td>
<td>–</td>
</tr>
<tr>
<td>Price policies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Price levels relative to competitors</td>
<td>+</td>
<td>+</td>
<td>–</td>
</tr>
<tr>
<td>Distribution policies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Degree of forward vertical integration relative to competitors</td>
<td>–</td>
<td>+</td>
<td>?</td>
</tr>
<tr>
<td>• Trade promotion expenses as percent of sales relative to competitors</td>
<td>+</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Promotion policies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Advertising expenses as percent of sales relative to competitors</td>
<td>+</td>
<td>?</td>
<td>–</td>
</tr>
<tr>
<td>• Sales promotions expenses as percent of sales relative to competitors</td>
<td>+</td>
<td>?</td>
<td>–</td>
</tr>
<tr>
<td>• Salesforce expenses as percent of sales relative to competitors</td>
<td>?</td>
<td>+</td>
<td>–</td>
</tr>
</tbody>
</table>

Key:  Plus sign (+) = greater than the average competitor.
Minus sign (−) = smaller than the average competitor.
Question mark (?) = uncertain relationship between strategy and marketing policy or program component.
Because prospector businesses rely heavily on the continuing development of unique new products and the penetration of new markets as their primary competitive strategy, policies encouraging broader and more technically advanced product lines than those of competitors should be positively related to performance on the critical dimension of share growth. The diverse and technically advanced product offerings of 3M’s drug delivery systems SBU are a good example of this.

Whether a prospector’s products should be of higher quality than competitors’ products is open to question. Quality is hard to define; it can mean different things to different customers. Even so, it is an important determinant of business profitability. Thus, Hambrick suggests that in product-markets where technical features or up-to-the-minute styling are key attributes in customers’ definitions of quality, high-quality products may play a positive role in determining the success of a prospector strategy. In markets where the critical determinants of quality are reliability or brand familiarity, the maintenance of relatively high product quality is likely to be more strongly related to the successful performance of defender businesses, particularly differentiated defenders.

Differentiated defenders compete by offering more or better choices to customers than do their competitors. For example, 3M’s commercial graphics business, a major supplier of sign material for truck fleets, has strengthened its competitive position in that market by developing products appropriate for custom-designed signs. Until recently, the use of film for individual signs was not economical. But the use of computer-controlled knives and a new Scotch-brand marking film produce signs of higher quality and at lower cost than those that are hand-painted. This kind of success in developing relatively broad and technically sophisticated product lines should be positively related to the long-term ROI performance of most differentiated defender businesses.

However, broad and sophisticated product lines are less consistent with the efficiency requirements of the low-cost defender strategy. For one thing, maintaining technical sophistication in a business’s products requires continuing investments in product and process R&D. For another, broad, complex lines can lead to short production runs and larger inventories. Some of the efficiency problems associated with broader, more-customized product lines may disappear, however, with continuing improvements in computer-assisted design and manufacturing, process reengineering, and the like.

Instead of, or in addition to, competing on the basis of product characteristics, businesses can distinguish themselves relative to competitors on the quality of service they offer. Such service might take many forms, including engineering and design services, alterations, installation, training of customer personnel, or maintenance and repair services. A policy of high service quality is particularly appropriate for differentiated defenders because it offers a way to maintain a competitive advantage in well-established markets.

The appropriateness of an extensive service policy for low-cost defenders, though, is more questionable if higher operating and administrative costs offset customer satisfaction benefits. Those higher costs may detract from the business’s ability to maintain the low prices critical to its strategy, as well as lowering ROI—at least in the short term. On the other hand, even low-cost defenders may have difficulty holding their position over the long term without maintaining at least competitive parity with respect to critical service attributes.

**Pricing Policies**

Success in offering low prices relative to those of competitors should be positively related to the performance of low-cost defender businesses—for low price is the primary competitive weapon of such a strategy. However, such a policy is inconsistent with both differentiated
defender and prospector strategies. The higher costs involved in differentiating a business’s products on either a quality or service basis require higher prices to maintain profitability. Differentiation also provides customers with additional value for which higher prices can be charged. Similarly, the costs and benefits of new product and market development by prospector businesses require and justify relatively high prices. Thus, differentiated defenders and prospectors seldom adhere to a policy of low competitive prices.

**Distribution Policies**

Some observers argue that prospector businesses should show a greater degree of forward *vertical integration* than defender businesses. The rationale for this view is that the prospector’s focus on new product and market development requires superior market intelligence and frequent reeducation and motivation of distribution channel members. This can best be accomplished through tight control of company-owned channels. However, these arguments seem inconsistent with the prospector’s need for flexibility in constructing new channels to distribute new products and reach new markets.

Attempting to maintain tight control over the behavior of channel members is a more appropriate policy for defenders who are trying to maintain strong positions in established markets. This is particularly true for defenders who rely on good customer service to differentiate themselves from competitors. Thus, it seems more likely that a relatively high degree of forward vertical integration is found among defender businesses, particularly differentiated defenders, while prospectors rely more heavily on independent channel members—such as manufacturer’s representatives or wholesale distributors—to distribute their products.

Because prospectors focus on new products where success is uncertain and sales volumes are small in the short run, they are likely to devote a larger percentage of sales to *trade promotions* than are defender businesses. Prospectors rely on trade promotion tools such as quantity discounts, liberal credit terms, and other incentives to induce cooperation and support from their independent channel members.

**Promotion Policies**

Extensive marketing communications also play an important role in the successful implementation of both prospector and differentiated defender strategies. The form of that communication, however, may differ under the two strategies. Because prospectors must constantly work to generate awareness, stimulate trial, and build primary demand for new and unfamiliar products, high advertising and sales promotion expenditures are likely to bear a positive relationship to the new product and share-growth success of such businesses. The drug delivery SBU at 3M, for instance, devotes substantial resources to advertising in professional journals and distributing samples of new products, as well as to maintaining an extensive salesforce.

Differentiated defenders, on the other hand, are primarily concerned with maintaining the loyalty of established customers by adapting to their needs and providing good service. These tasks can best be accomplished—particularly in industrial goods and services industries—by an extensive, well-trained, well-supported salesforce. Therefore, differentiated defenders are likely to have higher salesforce expenditures than are competitors.

Finally, low-cost defenders appeal to their customers primarily on price. Thus, high expenditures on advertising, sales promotion, or the salesforce would detract from their basic strategy and may have a negative impact on their ROI. Consequently, such businesses are likely to make relatively low expenditures as a percentage of sales on those promotional activities.
What should a marketing manager do if the market environment facing a particular product or service demands marketing actions that are not consistent with the overall competitive strategy of the business to which it belongs? What if, for example, the product’s target market is rapidly becoming more mature and competitive, but it is housed in a prospector business unit that does not have the cost structure or the personnel to allow the aggressive pricing or excellent customer service that may be needed for the product to compete successfully? Or what if newly emerging technology demands that a mature product category undergo an innovative redesign even though the defender SBU does not have extensive R&D and product development capabilities?

If a business unit is focused on a single product category or technological domain—as is the case with 3M’s industrial tape unit—the ideal solution might be for the whole SBU to change its strategy in response to shifting industry circumstances. As the product category matures, for instance, the SBU might switch from a prospector to an analyzer strategy, and ultimately to one of the defender strategies.

The problem is that—as we shall see in Chapter 13—effective implementation of different business strategies requires not only different functional competencies and resources but also different organizational structures, decision-making and coordination processes, reward systems, and even personnel. Because such internal structures and processes are hard to change quickly, it can be very difficult for an entire SBU to make a successful transition from one basic strategy to another.26 For example, many of Emerson Electric’s SBUs historically were successful low-cost defenders, but accelerating technological change in their industries caused the corporation to try to convert them to low-cost analyzers that would focus more attention on new product and market development. Initially, however, this attempted shift in strategy resulted in some culture shock, conflict, and mixed performance outcomes within those units.

In view of the implementation problems involved, some firms do not try to make major changes in the basic competitive strategies of their existing business units. Instead, they might form new prospector SBUs to pursue emerging technologies and industries rather than expecting established units to handle extensive new product development efforts.

Similarly, as individual product-market entries gain successful positions in growing markets, some firms move them from the prospector unit that developed them into an existing analyzer or defender unit, or even into a newly formed SBU, better suited to reaping profits from them as their markets mature. For example, a number of innovative products developed at 3M, such as Post-it repositionable notes, have enjoyed sufficient success that new divisions were formed to concentrate on defending them as their markets matured. Many successful entrepreneurial start-ups eventually reorganize into two or more business units, one to continue prospecting new products and markets and another to defend the firm’s initial product offering as its market matures.

Finally, some firms that are technological leaders in their industries may divest or license individual product-market entries as they mature rather than defend them in the face of increasing competition and eroding margins. This approach is relatively common at firms such as 3M and DuPont.

Because the marketing manager responsible for a given product-market entry is usually most closely tuned-in to changes in the market environment, he or she bears the responsibility...
for pointing out any mismatches between what is best for the product and the capabilities of the organizational unit to which it belongs. The marketer should develop a marketing strategy that makes the most sense in light of a detailed analysis of the available customer and competitive information and present a strong case for the resources necessary to implement the plan. If those resources are not available within the business unit, or if the marketing strategy is inconsistent with the SBU’s objectives or competitive strategy, top management faces a choice of moving the product to a more benign unit of the firm or rejecting the recommended strategy. If the strategy is rejected, the marketer will likely have to make compromises to the strategy to make it fit better with the competitive thrust of the SBU, even though an attractive opportunity may be lost. But if the marketer has great confidence in the recommended strategy, he or she might opt to quit the firm and pursue the opportunity elsewhere, as was the case with Jim Watkins, as discussed in Exhibit 3.8.

**Exhibit 3.8  Jim Watkins Takes a Hike**

When he was a product manager at the Pillsbury Company in the early 1970s, James D. Watkins became convinced that microwave technology represented a major opportunity for the packaged food industry. Consequently, he developed a marketing plan that proposed the pioneering development and aggressive introduction of a line of microwavable food products, starting with microwave popcorn. However, the business unit he worked for—and the entire Pillsbury Company at that time—was focused on defending strong positions in established markets, largely through incremental line extensions and product improvements. In other words, it was pursuing more of an analyzer strategy. As a result, top management rejected Watkins’s proposal as being too risky and requiring resources and capabilities that were in short supply.

Watkins subsequently quit Pillsbury, founded a new firm called Golden Valley Microwave, attracted venture capital, hired some food scientists to do the necessary R&D, and began to market ActII microwave popcorn through large mass merchandisers such as Wal-Mart. As Watkins had predicted in his original marketing plan, the availability of microwavable foods spurred a rapid increase in consumer demand for microwave ovens, which in turn increased demand for more microwavable foods. His new company grew rapidly, and a few years later he sold it to Conagra for many millions of dollars.

But don’t be too critical of Pillsbury. Like a good analyzer, the company avoided playing the risky role of the pioneer, but it eventually responded to the growing potential of microwave technology and successfully launched its own line of microwavable foods, including popcorn.

**Take Aways**

- Research suggests that a business is likely to achieve superior revenue growth, market share, and profitability when there is a good fit between its competitive strategy and the strategic marketing programs of its various product or service offerings.
- Business-level competitive strategies can be usefully categorized into (1) prospector strategies focused on growth via the development of new products and markets, (2) defender strategies primarily concerned with defending strong positions in established markets through either low prices or offering customers superior value in terms of product quality or service, and (3) analyzer strategies, which are hybrids of the other two strategies.
- The generic competitive strategies described in the previous point apply equally well to services and physical products, single-product start-ups and multi-divisional corporations, and global and domestic operations, and they are unlikely to change dramatically due to the rise of e-commerce.
- Because the various business-level strategies focus on different objectives and seek to gain a competitive advantage in different ways, marketing may play a different role under each of the strategies, and varying marketing actions may be called for.
- The marketing decision-maker’s job is to develop a sound, evidence-based marketing strategy for his or
her offering and to make a persuasive case for its support. If that strategy does not fit the objectives or available resources and competencies of the business unit in which the product is housed, top management may choose to move the product to a more amenable unit or require adjustments to the strategy.

**Endnotes**

1. Material for this example was obtained from The 3M Company 2000 Annual Report and other information found on the company’s website, www.3m.com; and Shawn Tully, “Why to Go for Stretch Targets,” Fortune, November 14, 1994, pp. 145–58.


13. For example, see “Internet Economics: A Thinker’s Guide,” The Economist, April 1, 2000, pp. 64–66.


18. For example, see Ronald Henkoff, “Cost Cutting: How to Do It Right,” Fortune, April 9, 1990, pp. 40–49.


22. For additional arguments in the debate about the relative costs and competitive benefits of superior customer service, see Rahul Jacob, “Beyond Quality and Value,” Fortune, Special Issue, Autumn–Winter 1993, pp. 8–11; and Valerie A. Zeithaml and Mary Jo Bitner, Services Marketing (New York: McGraw-Hill, 1996), chap. 2.


24. Although Hambrick argues for the reverse relationship, data from his study of 850 SBUs actually support our contention that defenders have more vertically integrated channels than do prospectors. See Hambrick, “Some Tests of Effectiveness.”


Chapter Four

Identifying Attractive Markets

The Changing American Menswear Market

From jeans to khakis, from tailored suits to “business casual,” clothing preferences among American men have been changing. A trend toward casual dress in the workplace that got its start during the 1980s in high-tech firms in Silicon Valley in California became pervasive throughout the business world during the dot-com boom of the late 1990s. One day in early 2000, some 350 lawyers and staffers from the old-line New York law firm of Cadwalader, Wickersham, and Taft crowded into the Polo mansion on New York's posh upper east side to get some advice on how to enter the “business casual” era.

The Impact of Unfavorable Macroenvironmental Trends

For companies serving the men's tailored clothing market, the challenges brought about by the business casual trend have been daunting. Manufacturers of tailored men's clothing have stumbled, and some have attempted to reposition themselves as purveyors of more casual attire. Retailers of men's suits also have struggled, and some, like the Kuppenheimer chain, a unit of Hartmarx, the leading manufacturer of tailored menswear in the United States, have closed their doors entirely.

What happens when unexpected unfavorable trends, like that toward more casual dress in the workplace, cause demand for a category of goods or services to shrink, as has happened with tailored men's clothing? First, providers of such goods feel a softening in their sales. As sales grow softer, firms find themselves having excess capacity and expense levels that cannot be supported by reduced levels of revenue. Often, the performance figures that result paint a picture that is anything but pretty. By 1999, Hartmarx, which had struggled with the changing menswear market for a decade, found its pretax profit margins in its men's apparel group languishing at 2 percent of sales, while its stock had fallen to less than $4 per share, from an already depressed $10 in 1997. Hartmarx was far from the only menswear firm to feel the heat. In 1999 the bankrupt retailer Edison Brothers liquidated its 295 Riggings stores because not a single buyer out of 250 interested parties was willing to buy the ailing chain. Today's Man, a 25-store menswear chain in the eastern United States, was forced to reorganize under bankruptcy protection in 1998. Numerous other chains and independent men's clothiers suffered similar fates.

The widespread troubles experienced by menswear retailers and manufacturers in the 1990s are
typical of what can happen when unforeseen trends—whether social trends, as in this case, or others—cause consumer demand to drop rapidly. Simply put, the market for tailored men's apparel shrank like a cheap suit and the ensuing competitive pressures in the menswear manufacturing and retailing industries made this market and these industries far less attractive than they had once been.

**IS SUCCESS IMPOSSIBLE IN THE FACE OF UNFAVORABLE TRENDS?**

Most observers of the men's apparel market in the 1990s would have concluded that success would have been difficult to achieve for any player serving that market. At least one tailored clothing retailer, however, continued to prosper in spite of adverse market conditions. The Men's Wearhouse, whose first store opened in Houston, Texas, in 1973, went public in 1992 and grew consistently throughout the 1990s, opening as many as 50 stores per year in the late 1990s. The chain's same-store sales grew as well, including a 10.4 percent same-store sales increase in 1998. How did Men's Wearhouse thrive where others failed? It offered a mix of branded and private-label merchandise in low-cost but nicely appointed strip center locations. It spent heavily on employee training to build a customer-oriented, team-selling culture. It spent its marketing money largely in broadcast media, instead of the more traditional print advertising used by other menswear retailers, making founder George Zimmer, its radio spokesman, a celebrity in the process. As President David Edwab noted in 1999, “If you look at this company, we've taken the most difficult part of the apparel business, added marketing, training, the right real estate, and store strategies to sell men what they like the least. As a result, we've gained market share in a consolidating industry.”

**WHAT’S NEXT? WILL SUITS COME BACK?**

When the dot-com bubble burst in 2000, the time seemed right for a return to more formal business attire. The logic was that laid-off dot-com workers would be interviewing again, and those who had kept their jobs would begin dressing better out of fear. So far, however, according to Neal Fox, vice chairman of Today's Man, the menswear retailer, "Right now there's more spin out there, but not a massive upsurge in suit sales." Will suits come back, or will they simply be one option, to be worn when appropriate, for client meetings or to make one's employer think you have a job interview? Time will tell. For marketing strategists in the menswear industry, it's a question not to be ignored.

**STRATEGIC CHALLENGES ADDRESSED IN CHAPTER 4**

As the story of the changing menswear market shows, unfavorable sociocultural or other trends that negatively influence market demand can have a devastating effect on the performance of firms serving that market. Similarly, favorable trends exert positive forces that make it easier for firms to perform well. As discussed in Exhibit 4.1, retailers and manufacturers of casual clothing suitable for today's workplace have fared well in the late 1990s. Entrepreneurs seeking to start new firms, investors in search of favorable returns, and managers in existing firms are therefore well advised to consider the presence and strength of such trends in deciding where to place their bets.

In this chapter, we address the second of the 4 Cs—the **environmental context** in which the business operates—that were identified in Chapter 1 as the analytical foundation
II. Opportunity Analysis

4. Identifying Attractive Markets

Section Two Opportunity Analysis

88

With suits passé, what are up-and-coming young professionals wearing to work? For many, the answer is khakis and sportshirts. In the young men's sportswear category in 1999, the khaki business more than doubled over 1998, as, in traditional department stores, khakis' share of the young men's apparel business grew from 6 percent in 1998 to 15 percent in 1999. Levi's, a leading brand in the khaki category, increased its young men's market share to 25 percent and maintained its number one position in the young men's category.

Casual clothing retailers happily rode the wave, as well. Gap, Inc., and its family of stores enjoyed increased demand for its casual clothing in 1999, resulting in a 29 percent increase in worldwide sales and a 38 percent increase in earnings per share. An important part of Gap's growth was its broadened focus on Internet retailing. "We also reached new customers and expanded market share by opening more than 500 stores worldwide and broadening our brands online. Our passion for serving customers better every day will continue to drive quality growth for Gap, Banana Republic, and Old Navy," said Millard S. Drexler, president and CEO.

Gap's ability to stay in tune with fashion trends proved less than infallible, however. From late 1999 into 2002, Gap struggled to find the right mix of merchandise for its stores, and same-store sales and company profits tumbled. Will Gap successfully tune in to what its customers want in the new millennium? Time will tell.


Exhibit 4.1 Khakis Conquer the Workplace

Swimming Upstream or Downstream: An Important Strategic Choice

Casual dress in the workplace is a social trend. The graying of America is a demographic one. Global warming is a trend in our physical environment. All these trends influence the fortunes of some companies, but not others. As we have seen, the influence of macro-environmental trends—or macro trends, for short—like these can be pervasive and powerful. In general, life is better swimming downstream, accompanied by favorable trends, than upstream, running counter to such trends.

Like mosquitoes or cooling breezes on a humid summer evening, trends will always be present, whether marketing managers like them or not. The question is what managers can do about them. For some trends, marketers and other managers can do little but react and adapt. In the 1990s, manufacturers of products sold in spray containers were required to find new propellants less harmful to the ozone layer. Governments concerned about global warming mandated this change. For other trends, like the shift toward casual dress in the workplace for Gap, favorable moves can be reinforced through effective marketing. Similarly, sometimes, unfavorable ones can be mitigated. But doing these things requires that important trends be noticed and understood. The sociocultural, demographic, and physical environments are but three of six major
components of the macroenvironment. The other three are the political/legal, economic, and technological components. We deal with the competitive environment in Chapter 5.

**MACRO TREND ANALYSIS: A FRAMEWORK FOR ASSESSING MARKET ATTRACTIVENESS**

Each of the six macroenvironmental components will be examined in terms of how the dynamics of change affect the attractiveness of particular markets and influence marketing strategies and programs.

**The Demographic Environment**

The world’s population in 1994 was 5.63 billion persons versus 2.52 billion in 1950. It is expected to grow to 7.47 billion by 2015. Some 80 percent of the world’s population lives in the less-developed countries, where 95 percent of the increase in population takes place. Africa and Asia represent nearly 90 percent of the increase. Africa’s population is expected to double by 2025—from 728 million to 1.49 billion—while that of Asia is expected to grow by 40 percent—from 3.46 billion to 4.96 billion. China and India will account for most of this increase. Europe over the next 20 years is expected to have a declining population. The United States is the only major developed country projected to show a population increase—from 263 million (current) to 331 million by 2025.

A major trend is the aging of the world’s population caused primarily by declining mortality rates. The developing nations are experiencing dramatic changes in their over-65 age group—a severalfold increase over the next 20 years is expected. Another important global trend is the rapid shift in the populations of the less-developed countries from rural to urban. By 2025 nearly 60 percent of the population of the less-developed countries is expected to be urban versus 37 percent currently. In contrast 75 percent of the population of developed countries is currently urban, but is expected to grow very slowly in the future. By the year 2015, seven cities will have populations in excess of 20 million (see Exhibit 4.2).

**Exhibit 4.2**

<table>
<thead>
<tr>
<th>Urban area</th>
<th>1994</th>
<th>Urban area</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Tokyo</td>
<td>26.5</td>
<td>1. Tokyo</td>
<td>28.4</td>
</tr>
<tr>
<td>2. New York</td>
<td>16.3</td>
<td>2. Bombay</td>
<td>27.4</td>
</tr>
<tr>
<td>4. Mexico City</td>
<td>15.5</td>
<td>4. Shanghai</td>
<td>23.4</td>
</tr>
<tr>
<td>5. Shanghai</td>
<td>14.7</td>
<td>5. Jakarta</td>
<td>21.2</td>
</tr>
<tr>
<td>8. Beijing</td>
<td>12.0</td>
<td>8. Beijing</td>
<td>19.4</td>
</tr>
<tr>
<td>10. Seoul</td>
<td>11.5</td>
<td>10. Mexico City</td>
<td>18.8</td>
</tr>
</tbody>
</table>

U.S. Demographics The U.S. population grew by 20 million persons during the 1990s—the largest increase of any developed country—and is expected to grow by about 2 million a year well into the 21st century. Four major shifts are occurring in the U.S. population: the changing family structure, aging, geographic distribution, and ethnic composition. Each of these trends is discussed briefly below.

Family Structure The traditional husband-dominated, closely structured family is less and less typical of American society. Today’s households because of divorce (about half of all marriages end in divorce) and remarriage have evolved into a number of different kinds of households populated by single individuals; adults of the same sex or both sexes (married or not) living together; unmarried adults living with children, both related and unrelated; single-parent families; and married couples with children. The situation is further complicated because a substantial number of these households have two or more wage earners. These different types of households vary in their income and in their purchases of various products and services. For example, households with two wage earners are apt to have more than one car and spend more money on eating out.

Aging Baby boomers (those born between 1946 and 1964) who now constitute nearly 80 million persons continue to dominate growth in the age groups they pass through en route to old age. And the number of people over 65 has increased by 13 percent since 1990 to nearly 35 million. Those over 85 have increased 40 percent to over 4.2 million during this timespan. In the years ahead we can expect the over-65 age group to increase substantially. As boomers age, they increasingly affect the purchase of goods and services. Households age 45 to 54 are the single most affluent U.S. consumer segment. For a description of what these households are buying, see Exhibit 4.3.

Geographic Distribution Immigrants account for nearly one-third of U.S. annual growth and end up residing mostly in the large metropolitan areas in California, New York, Texas, Florida, New Jersey, and Illinois. The South and West continue to gain population at the expense of the Midwest and Northeast. California, Texas, and Florida accounted for over half the U.S. growth in the 1980s, and the latter two states continued to have strong growth during the 90s. Yet another trend is the migration of jobs and people to suburban cities—farther and farther from central cities.

Ethnic Composition Another major trend is that the United States is becoming more diverse ethnically. At present, more than 25 percent of the population is composed of racial minorities. The Hispanic population is the fastest-growing segment and is expected to increase from 22.5 million in 1990 to nearly 90 million, rising from 9 percent to a 22 percent share of the total population by 2050. The African-American population is forecasted to double by 2050—from 30.6 to 62 million—while Asians will increase from 7.6 million

Exhibit 4.3 What Boomers Age 50–64 Buy

As boomers fight aging, they consume large quantities of skin creams, suntan lotions, hair coloring, cosmetics, vitamins, and nutritional supplements. This segment spends more than any other on books, women’s clothing, home computers, entertainment, new cars and trucks, and restaurant meals. By 2000 they accounted for the largest share of purchasing a majority of most categories of goods and services.

to 41 million. The three groups, over the next 50 or so years, will account for nearly 50 percent of the total U.S. population. Such growth will further internationalize the United States—especially in such major cities as Los Angeles, Miami, and New York. Products with high ethnic appeal, in such areas as food and clothing, should be in high demand in such cities.

**Implications of Demographic Trends for Market Attractiveness** The demographic trends discussed in this section have resulted in rapidly growing markets for a diverse array of products and services. Rapid economic development and a growing middle class in Asia have been a boon for capital goods manufacturers in the United States and Europe, as they export capital equipment to the Asian factories seeking to satisfy Asia’s growing demand for manufactured goods for local as well as export markets. Aging populations in developed countries have created growing demand for senior housing of many types and for in-home, home repair, and home modification services to enable older persons to stay in their homes. Demographic trends also have led marketers to develop products and special marketing programs targeted at minority and other demographic groups whose numbers are growing.

On the downside, demographic trends have made other markets less attractive than they once were. Migration of jobs and people from some Northeast and Midwest cities to suburbs or cities elsewhere in the United States has led to stagnant real estate and employment markets there, while cities in the West and South thrive.

**The Sociocultural Environment**

This environment represents the values, attributes, and general behavior of the individuals in a given society. Compared with economic, political, and technological changes, the sociocultural environment evolves slowly. People grow up in a system of values they tend to carry throughout their lifetimes. Transformation in the structure of society, in its institutions, and in the distribution of wealth occurs gradually in democratic countries. Even so, we have in recent years seen a substantial change in individual values, family structure, minority rights, leisure-time activities, and conservation.

**The Evolution of Individual Values** North American society has been characterized by the traditional values of hard work, thriftiness, and faith in others and in institutions. In the 60s, however, new social values emerged. Instead of leaving the destiny of their country in the hands of their elders and institutions, the young—particularly college students—collectively fought for what they perceived to be good causes, such as civil rights, the end of the Vietnam war, and nonconformism. The young emerged as a new social force—sharing and defending a common set of new values even across national borders. This era is often referred to as the “Age of Us.”

More recently, individual values have shifted again, particularly in the younger generation (20–29 years of age), often referred to as Generation X. During their formative years they have been exposed to dire predictions about the economic health of America, many public scandals, the advent of the knowledge society, the electronic/computer revolution, the changing structure of the American family, and the growing influence of minority groups.

Because of these experiences, members of this generation are greatly concerned with simplifying their lives, with obtaining a college education, with their relations with their families and the opposite sex, and with economic security. Their coping includes living at home (particularly men), postponing marriage, and delaying having children. They are

II. Opportunity Analysis

4. Identifying Attractive Markets

realistic and pragmatic about surviving yet do not define success solely in terms of money. They place considerable emphasis on the family life they missed as children. While generally turned off by big government, they care a great deal about such issues as AIDS, abortion, and the environment. For one professional’s list of the shifting values in Western societies, see Exhibit 4.4.

The Evolution of Family Structure The traditional husband-dominated, closely structured family is less and less typical of our North American society. Children are becoming more autonomous and participate at an earlier age in many family decisions. A more balanced allocation of power between husband and wife also has emerged. In part this has resulted from the fact that many women are more independent economically. Working parents’ absence from the home has substantially reduced the interactions among family members and family cohesiveness. The increasing divorce rate has made one-parent households more common. All these factors have considerably changed the buying process for many goods, including which family members are involved in the purchase of certain goods.

Implications of Sociocultural Trends for Market Attractiveness Along with broader sociocultural trends come changes in consumer tastes and behavior. Natural foods are in. Exercise for both genders is in. Fat and cholesterol are out. Thus, sociocultural changes, such as those described in this section and at the beginning of the chapter, influence the markets for a broad array of consumer products such as natural foods, exercise equipment and sports beverages, low-fat food products, and men’s apparel. Sociocultural trends also have influenced how marketing activities are carried out in some markets. For example, advertising programs now accommodate more joint decision making in households.

Exhibit 4.4
Shifting Values in Western Societies

<table>
<thead>
<tr>
<th>Traditional values</th>
<th>New values</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-denial ethic</td>
<td>Self-fulfillment ethic</td>
</tr>
<tr>
<td>Higher standard of living</td>
<td>Better quality of life</td>
</tr>
<tr>
<td>Traditional sex roles</td>
<td>Blurring of sex roles</td>
</tr>
<tr>
<td>Accepted definition of success</td>
<td>Individualized definition of success</td>
</tr>
<tr>
<td>Traditional family life</td>
<td>Alternative families</td>
</tr>
<tr>
<td>Faith in industry, institutions</td>
<td>Self-reliance</td>
</tr>
<tr>
<td>Live to work</td>
<td>Work to live</td>
</tr>
<tr>
<td>Hero worship</td>
<td>Love of ideas</td>
</tr>
<tr>
<td>Expansionism</td>
<td>Pluralism</td>
</tr>
<tr>
<td>Patriotism</td>
<td>Less nationalistic</td>
</tr>
<tr>
<td>Unparalleled growth</td>
<td>Growing sense of limits</td>
</tr>
<tr>
<td>Industrial growth</td>
<td>Information/service growth</td>
</tr>
<tr>
<td>Receptivity to technology</td>
<td>Technology orientation</td>
</tr>
</tbody>
</table>

Developed Western societies are gradually moving away from traditional values and toward the emerging new values being embraced on an ever-widening scale, says author Joseph Plummer.

The Economic Environment

The economic performance of a country is measured by gross domestic product (GDP)—usually on a per-capita basis after accounting for inflation. To realistically compare incomes across countries, it is necessary to use a purchasing power parity (PPP) approach that considers the cost of a standard basket of products (expressed in U.S. dollars) for each country. Thus, using a PPP analysis helps to compare the relative purchasing power of a given country for goods with what these same goods would cost in the United States. If GDP per capita is calculated on the basis of exchange rates, then Japan has the world’s highest average. But America has the highest if purchasing power parity is used to calculate per capita GDP.8

Using PPP values typically produces lower GDP per capita income for the wealthier countries and higher ones for the poorer nations. Despite this “leveling,” the gap in real GDP (less inflation) has increased between rich and poor countries—mainly because of higher population growth.9 But PPP does not take into account the subsidies provided by many countries for such essentials as food, utilities, shelter, transportation, education, and medical care, which account for about half of the average household expenditures in developed countries.

The world’s economic growth continues to increase as measured by total gross national product (GDP). In the years ahead, the developing countries are expected to have substantially higher rates of economic growth than the developed ones. Asia has experienced the strongest growth—over 8 percent (primarily because of China’s explosive growth)—and is expected to continue at a 7 percent rate near-term. In South America, Argentina and Brazil are forecasted to continue their strong growth rates while Ecuador is still suffering from economic difficulties. Some countries in Central Europe will have difficulty avoiding negative growth.10

America seems to have regained its competitiveness because of a powerful surge in productivity triggered by low interest rates, flat unit labor costs, low inflation, and heavy capital investments, especially in high-tech equipment. The more-open U.S. market has made its companies more competitive as compared with Europe and, to some extent, Japan.11

In the United States, growth will come largely from the large number of baby boomers moving into their peak earning years (age 44–54). Overall, the forecast calls for increased spending on personal insurance and pensions, owned homes, appliances, home furnishings, food at home, utilities, health insurance, entertainment, and education. Expected to decline are expenditures for food away from home, alcoholic beverages, rental units, apparel, vehicles, gasoline, reading, and tobacco products.12 Of considerable concern is the growing gap between the classes. An average American middle-class household experienced a 4.6 percent decline in its inflation-adjusted annual income over a 15-year period versus a 7.9 percent increase for the top one-third group. The richest 5 percent of American families had an increase of 29.1 percent in their annual income.13

International Trade Increasingly countries have become more economically interdependent as have many of their industries. Free-trade agreements in various stages of completion embrace a high percentage of the industrialized nations, including a single European market (EC); a merging of the European Community (EC) with the European Free Trade Area (EFTA) to form the European Economic Area (EEA); and the North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico, which will eventually embrace most Latin American countries.

The United States is by far the largest national market, representing about 25 percent of the total world market for goods and services (Japan is second with 10 percent). As
such, the U.S. market is a high priority target for the business firms of most countries, especially those of Japan and Europe. Inevitably, the United States is a highly competitive market for many goods and services. It is not only the biggest importer of goods and services, but also the biggest exporter, with Germany a close second. Even small companies are now significant players in the export game.14

Today nearly one-third of all automobiles sold in the United States are of Japanese origin. A large percentage of all TVs, radios, calculators, motorcycles, binoculars, robots, cameras, VCRs, tape players, and digital watches sold in the United States are foreign-made. Many U.S. companies are foreign-owned—for example, Pillsbury (English), Carnation (Swiss), Firestone (Japanese), and CBS Records (Japanese).

Fluctuating exchange rates can significantly change the relative price competitiveness of firms manufacturing in different countries. For example, the devaluation of the yen versus the U.S. dollar (from 108.95 in June 1996 to 122.78 in February 1997) enabled Japanese automakers to offer better deals in selling and leasing their cars in the United States, especially those made in Japan. The big three U.S. automakers (General Motors, Ford, and DaimlerChrysler) complained about the U.S. policy of strengthening the value of the dollar against the yen and the German mark and forecast lower profits—even a decline in market share.

**Implications of Economic Trends for Market Attractiveness** Economic trends influence the level of demand in most markets, but they are particularly important in capital goods markets, real estate, and other markets where sensitivity to interest rates and the level of household or corporate income can be extreme. Economic trends often combine with other macro trend categories, with powerful effects. For example, the growth of the baby boomers, a demographic trend, together with the strong American economy and low interest rates in the late 1990s, both economic trends, resulted in rapidly growing demand for condominiums and second homes in resort areas. Some who foresaw these trends made a killing during this period. If these trends continue, rising resort real estate prices are likely also to continue, unless the supply of resort properties outpaces demand.

**The Political/Legal Environment**

In every country there is a legislative or regulatory environment within which both local and foreign firms must operate. As with any other external force, the political/legal environment presents a firm with strategic opportunities as well as threats. The business regulations in a country reflect its economic maturity and political philosophy. At the extreme, political risk for the firm includes confiscation (seizure without compensation as happened in Iran several years ago), expropriation (seizure with some compensation), and domestication (requiring transfer of ownership to the host country and local management and sourcing).

Other risks include changes in exchange control (which can take a variety of forms), local content laws, import restrictions, taxes, and price controls—all of which usually operate to the advantage of local industry. Clearly, many third world countries present an array of political risks to companies seeking to do business in them. (See Exhibit 4.5 for a discussion of the risks of investing in China.) On the other hand, governments can encourage foreign investment through policies such as tax concessions and tariff protection. Indeed, countries commonly encourage certain kinds of investments while simultaneously restricting others. For example, governments may encourage local firms to export to countries that have considerable political risk by providing insurance against losses from such risk (for instance, the U.S. Export-Import Bank).
In but a few years China has emerged as a powerful economic force with the world’s largest potential market. Because of its longer-term attractiveness, it has attracted substantial investments by a diverse group of multinational firms despite high inflation rates, widespread corruption, the growing power of the military, and the possible turmoil following the death of its aging leader. Examples of the poor treatment accorded foreign investors include the eviction of McDonald’s from a prime location in Beijing, even though its lease had 17 years to run; Lehman Brothers’ having to sue two state corporations to pay $100 million for losses in foreign exchange trading; and a group of Japanese, German, and Italian banks begging Beijing to reimburse them for $400 million of defaulted loans made to state enterprises.


Controversies over copyright infringement involve the highest stakes. In China, pirate factories often under the protection of senior politicians and high-ranking military officials engage in counterfeiting such items as videos, compact disks, computer software, prescription drugs, herbicides, and Rolex watches. Such counterfeiting costs U.S. companies an estimated $1 to $2 billion a year.\(^\text{15}\)

**Government Regulation** The number and intricacy of laws and regulations make it difficult to understand regulatory elements affecting marketing. Most countries have regulations concerning food and drugs, as well as price, products, promotion, and distribution, but these vary considerably in their applicability to marketing. For example, the European Community (EC) is phasing in thousands of rules to provide uniform safety, health, and environmental standards for its member countries. These rules now favor companies producing a variety of products for several countries, but in the future some exporters will be required to make costly design changes, to substantially retool, and to add new quality control systems.

It has long been argued that regulations cripple the economy and stifle innovation. This is often true, but effects are frequently overstated since business will strive to find innovative ways to adhere to regulations at less than the anticipated costs. For example, when the U.S. Occupational Safety and Health Administration issued a higher standard for avoiding worker exposure to the toxic chemical formaldehyde, industry costs were expected to be $10 million yearly. But by modifying the resins and reducing the amount of formaldehyde, costs were negligible. Further, the changes enhanced the global competitiveness of the U.S. foundry supply and equipment industry.\(^\text{16}\)

**Government Deregulation** Government, business, and the general public throughout much of the world have become increasingly aware that overregulation protects inefficiencies, restricts entry by new competitors, and creates inflationary pressures. In the United States, airlines, trucking, railroads, telecommunications, and banking have been deregulated. Markets also are being liberated in Western and Eastern Europe, Asia, and many of the developing countries. Trade barriers are crumbling due to political unrest and technological innovation.

Deregulation has typically changed the structure of the affected industries as well as lowered prices. For example, in the decade following deregulation of the U.S. airline industry (1978–1985), over 200 new air carriers entered the market, and prices were estimated to be 40 percent cheaper than they would have been under regulation. Also, some 900 monopoly routes were made more competitive.\(^\text{17}\) The early actions of firms following
deregulation include improving pricing capabilities, finding new ways to differentiate their services, increasing their marketing skills, and conserving capital to maintain flexibility. Later, the strategies of the surviving companies center on fine-tuning their pricing capabilities, preempting competitors via strategic alliances, and developing their marketing skills.18

Implications of Regulation and Deregulation for Market Attractiveness
As regulatory practices wax and wane, the attractiveness of markets often follows suit. For example, the deregulation of telecommunications in Europe, following earlier deregulation in the United States, is opening markets to firms seeking to offer new services and take market share from the established monopolies. The rise of Internet retailing and Internet telephony has policy makers arguing over the degree to which these Internet activities should be subject to state and federal tax in the United States. The outcome of these arguments may have considerable effect on consumers’ interest in buying and calling on the Web. Further, the U.S. government’s effort to force a breakup of Microsoft has left high-tech firms wondering about the extent to which their successful innovations will cause them to run afoul of government antitrusters.19

The Technological Environment
Technology can have a substantial impact on an industry’s performance. Consider the effect of genetic engineering on pharmaceuticals, of transistors on telecommunications, and of plastics on metals. Identification of the commercial potential of technological developments has dramatically accelerated, and the lag between ideas, invention, and commercialization has decreased.

In the past three decades, an amazing number of new technologies have brought forth such products as video recorders, compact disks, ever-more-powerful and ever-smaller computers, fax machines, new lightweight materials, and highly effective genetically engineered drugs. Technological progress over the next 10 years is predicted to be several times that experienced during the past 10 years; much of it will be spurred by the need to find solutions to our environmental problems. Major technological innovations can be expected in a variety of fields, especially in biology and electronics/telecommunications.20

Trends in Biology
The biological revolution is of fairly recent origin, especially gene therapy. There are some 60,000 to 80,000 genes in each human cell, which, by instructing cells to make proteins, can dictate not only our physical characteristics (the color of our eyes), but also our susceptibility to certain diseases. A single gene can trigger creation of a protein that, if it works like a drug, can lead to the development of a drug worth $500 million annually, such as Amgen’s anemia-fighting Epogen. Research to discover faulty genes, if successful, may lead to the development of therapeutic treatments for such diseases as cystic fibrosis and colon cancer, which would be worth billions of dollars.21

Drug companies around the world are investing vast sums in R&D in their continued search for new problem-solving agents. Anticipated results in the pharmaceutical and agricultural areas include such exciting prospects as these:22

- Pharmaceuticals: production of human growth hormones to cure dwarfism and prevent muscle wasting, the introduction of powerful genetically engineered vaccines to treat certain kinds of cancers, and replacing defective genes that cause a variety of diseases (such as cystic fibrosis). A gene has been discovered that holds the promise of successfully treating obesity.23 Scientists are also making good progress in the development of mass-produced tissue cultures for growing skin (for treating severe burn patients) and other organs (livers). This technology could reduce the need for donated transplants and plastic implants.24
II. Opportunity Analysis
4. Identifying Attractive Markets

Chapter Four Identifying Attractive Markets

- **Agriculture**: production of more disease-resistant livestock and plants, nonpolluting biological pesticides and insecticides, and a solution to the crop losses from salty soil. Farmers are beginning to plant commercial crops of engineered corn, cotton, soybeans, and potatoes. The biotech seeds are targeted at making crops resistant to popular weed killers as well as viruses and fungal diseases. The danger is that cotton-munching boll worms and other pests will develop resistance to the toxins produced by the engineered plants.

**Trends in Electronics/Telecommunications**

Electronics have played an important role in our society since the 1950s. They were first used primarily in radio and television and lately in digital watches, automatic cameras, video games, and microcomputers. Probably nothing has changed the workplace more in recent years than the personal computer, now numbering nearly 200 million worldwide. See Exhibit 4.6 for a description of Intel’s new supercomputer on a chip.

Technology is also changing the nature and scope of the telecommunications industry. The changes are revolutionizing how businesses operate (banks, airlines, retail stores, and marketing research firms), how goods and services as well as ideas are exchanged, and how individuals learn and earn as well as interact with one another. Consumers today enjoy check-free banking, the death of the invoice, and ticketless air travel.

These innovations are the result not only of changes in computing systems but also of reduced costs in communicating (voice or data). For example, the cost of processing an additional telephone call is so small it might as well be free. And distance is no longer a factor—it costs about the same to make a trans-Atlantic call as one to your next-door neighbor. The major events responsible for fueling the information revolution are:

- The development of fiber-optic cables in which a single fiber can carry 30,000 messages simultaneously. Such cables can be used by both telephone and cable operators, and they cost less to develop and maintain than copper wire systems.
- Storage devices developed to handle the increasing volume of data required to make the modern corporation competitive. Information about a firm’s customers accounts for much of the increase. Over the next several years the storage market is expected to grow an average of 98 percent a year.
- Breakthroughs leading to the use of flexible low-cost wireless transmissions, which provide mobility to the user and can provide inexpensive access to homes, versus the use of fixed systems.
- Development of low-cost multimedia chips (microprocessors).

At the dawn of the new millennium, developments in telecommunications and computing have led to the rapid convergence of the telecommunications, computing, and entertainment industries. Music-hungry college students with personal computers now download music from legal sites, such as mp3.com, and perhaps illegal ones. For them,
brick-and-mortar music stores may soon be a thing of the past. Cell phone users in Europe check sports scores, breaking news, stock quotes, and more using wireless application protocol, or WAP. Savvy marketers and entrepreneurs who follow technological trends are able to foresee new and previously unheard of applications such as these and thereby place themselves and their firms at the forefront of the innovation curve, sometimes earning entrepreneurial fortunes in the process.

Implications of Technological Trends for Market Attractiveness

Changes in technology have always created attractive new markets. Think of all the markets created or made more attractive by Henry Ford’s invention of the automobile. Such changes also have swept away old ones, such as the market for buggy whips. Today’s venture capital investors monitor such changes, and many seek to invest their funds to serve markets that are growing exponentially as a result of technological developments, such as providing services for e-commerce firms. Some would say that choosing attractive markets or industries for investment is one of the most important criteria for venture capital success.

In addition to creating attractive new markets, technological developments are having a profound impact on all aspects of marketing practice, including marketing communication (ads on the Web or via e-mail), distribution (books and other consumer and industrial goods bought and sold via the Web), packaging (use of new materials), and marketing research (monitoring supermarket purchases with scanners or Internet activity with digital “cookies”). We explore the most important of these changes in later chapters in this book.

The Physical Environment

Beyond the depletion of many of the earth’s valuable resources, there are indications that the earth’s overall health is declining. Deserts are growing while forests are shrinking, lakes are dying, the quality and quantity of groundwater are declining, and the planet may be experiencing a rising temperature.

One of the more frightening environmental scenarios concerns the buildup of carbon dioxide in the atmosphere that has resulted from heavy use of fossil fuels. This carbon dioxide “blanket” traps the sun’s radiation, which leads to an increase in the earth’s average temperature. One computer model of the climate predicts a cooling of Europe; Africa, East Asia, and South America warming a lot; and less rain in East Asia, Southern Africa, most of South America, Mexico, and parts of the United States. While the evidence is increasing that greenhouse gases are changing the climate, there is considerable disagreement over the details of the warming effects. Still, various concerned groups (including insurance companies) are demanding that governments take strong remedial action. Among other undesirable eventualities, the greenhouse effect might trigger the infection of nontropical populations with such diseases as malaria, hepatitis, yellow fever, cholera, and meningitis.

Worldwide, there are inadequate supplies of municipal water, which has forced European cities to use tertiary sewage treatments to purify water for household use. California has recently begun to use reclaimed sewage water for parks, golf courses, and roadside landscaping, but not for drinking. Poor water quality causes Americans to spend $7 billion annually for bottled water and for tap-water purification. Americans drink three times as much bottled water as they did a decade ago.

Pollution problems exist throughout the world, especially in Eastern Europe, China, and the developing countries. Germany is spending tens of billions of dollars to clean up eastern Germany, where under communist rule forests were blighted, drinking water badly polluted, and the air fouled such that motorists were forced to use their headlights during
China is the world’s worst polluter, dumping billions of tons of industrial pollutants into waterways and hundreds of millions of tons of carbon emissions into the atmosphere. It is encouraging to note that pollution regulations are becoming stricter throughout the world, including China, where authorities are considering making serious pollution punishable by death. And recycling programs are increasing in popularity throughout the world.

Development of Green Products as a Response to Environmental Problems

In general, discussion of the problems in the physical environment has stressed the threats and penalties facing business throughout the world. But business can do a number of things to turn problems into opportunities. One is to invest in research to find ways to save energy in heating and lighting. Another is to find new energy sources such as low-cost wind farms and hydroelectric projects. Businesses also have seen opportunities in developing hundreds of green products (those that are environmentally friendly) such as phosphate-free detergents, recycled motor oil, tuna caught without netting dolphins, organic fertilizers, high-efficiency light bulbs, recycled paper, and men’s and women’s casual clothes made from 100 percent organic cotton and colored with nontoxic dyes. Other innovations include using smaller packages for many consumer goods (such as compact containers for superconcentrated soaps and collapsible pouches for cleaners once packed in plastic jugs), discontinuing the use of cardboard packages for deodorants, and selling teabags without tags and strings. For the public, prices of eco (green) products are in line with ordinary products, especially when the quantity offered (tissues per roll of toilet tissue and loads of laundry per liter of concentrated detergent) is considered.

Implications of Trends in the Physical Environment for Market Attractiveness

Global warming can create attractive opportunities for green products that are earth-friendly. On the other hand, if global warming continues, it may play havoc with markets for winter vacationers, snowmobiles, and other products and services whose demand depends on the reliable coming of Old Man Winter. Other physical trends such as the depletion of natural resources and fresh groundwater may significantly impact firms in many industries serving a vast array of markets. Tracking such trends and understanding their effects are important tasks.

Environmental Analysis Guides Marketing Decision Making

Macro trends can have powerful influence on the attractiveness of markets, as well as on marketing practice. What should managers charged with strategic responsibilities do to take advantage of or cope with such trends? First, they need to prioritize trend categories, so they know what to watch for. Second, they need to identify, and then monitor, sources of relevant information about macro trends. Third, as key developments are noted, they need to anticipate impacts and be prepared to change strategies if necessary.

Prioritizing Trend Categories

Apparel marketers closely watch sociocultural trends so as to provide garments in tune with today’s changing lifestyles. For example, specialized undergarments for female athletes have become a growing market, as more and more women participate in athletic pursuits. To the delight of sports apparel marketers like Nike, Brandi Chastain’s shirtless torso and sports bra won front-page and front-cover positions in numerous publications following her
successful penalty kick that won for the United States the coveted World Cup women’s soccer title in 1999.

Real estate investors closely monitor economic trends, because changes in interest rates or income can dramatically impact demand for both commercial and residential properties. Venture capitalists and high-tech entrepreneurs watch technological trends. Food marketers study demographic and sociocultural trends to provide new food products that fit modern lifestyles and satisfy rapidly growing demand for ethnic foods. The list goes on and on. What’s important is for businesspeople to understand which macro trend categories are likely to have the most impact on their fortunes and monitor those categories accordingly. Similarly, managers need to monitor changes in ethical standards and expectations, so they do not run afoul of their customers’ expectations. Ethical Perspective 4.1 discusses ethical issues that have arisen in this arena.

### Information Sources and Outputs of Macro Trend Analysis

There is an endless supply of information about macro trends, including the popular and business press, the Internet, supplier and customer contacts, and so on. Thus, gathering relevant data is not difficult, but it does take time and effort. A good place to start is with trade associations and trade magazines, both of which typically track and report on trends relevant to the industries they serve. Most local, state, and federal governments provide demographic data easily accessible at their websites, such as www.census.gov in the United States. Government sources and the business press are good places to look for economic

---

**Ethical Perspective 4.1 Ethical Issues in Macro Trend Analysis**

Because there are myriad ways in which business and the environment interact, it is not surprising that firms find it difficult to cope with environmental issues. More and more companies, however, are taking an active role in dealing with the environmental issues that face society today, not only making sure they are in compliance with environmental regulations, but also taking a strong proenvironmental stance that includes abandoning products that are environmentally harmful.

Most companies make an effort to develop a proenvironment attitude among their employees, customers, and the general public—a substantial majority have ethical codes of behavior to guide their employees regarding the environment. Many support green organizations such as the National Wildlife Federation, the Sierra Club, and the Environmental Defense Fund. Since the public demands it, more and more resource conservation and recycling receive considerable support from many members of the business community. McDonald’s, for example, has switched from plastic and styrofoam packaging to cardboard and paper.

Another ethical problem area lies in treatment of third world countries. Concern for such countries has a long history; witness the campaigns against South Africa’s apartheid and, more recently, for civil rights in China. U.S. companies have come under severe criticism for contracting with suppliers that use child labor or that provide unhealthy working environments and for charging high prices in third world countries for goods such as pharmaceutical drugs.

Dealing with environmental problems can seem intractable because of difficulty in defining their severity (e.g., the greenhouse effect), let alone knowing how to solve them (replenishing underground water supplies). When we think we have found a solution, we are not sure of its long-term versus short-term effects and the extent to which the solution may be dysfunctional. In some areas, however, the picture is clearer, and a positive response may even be good business.
trend data. Various books, such as one called Find It Fast, provide guidance on where to look online and offline for various kinds of such information.42

The key outputs of a competent macro trend analysis for any market should include both quantitative and qualitative data. Quantitative data should provide evidence of the market’s size and growth rate, for the overall market as well as for key segments. Qualitative data should include factors that will likely influence these figures in the future, whether favorably or unfavorably.

**Anticipating and Responding to Environmental Change**

Critical changes in macroenvironmental conditions often call for changes in the firm’s strategy. Such changes can be proactive or reactive, or both. To the extent that a firm identifies and effectively deals with key trends before its competitors do, it is more likely to win and retain competitive advantage. In any case, management needs systems to help identify, evaluate, and respond to environmental events that may affect the firm’s longer-term profitability and position. One such approach uses an opportunity/threat matrix to better assess the impact and the timing of an event, followed by the development of an appropriate response strategy. This approach is discussed below.

**Impact and Timing of Event** In any given period, many environmental events that could have an impact on the firm—either positively or negatively—may be detected. Somehow, management must determine the probability of their occurrence and the degree of impact (profitability and/or market share) of each event. One relatively simple way to accomplish these tasks is to use a $2 \times 2$ dimensional opportunity/threat matrix such as that shown in Exhibit 4.7. This example contains four potential environmental events that a large U.S. telecommunications company might have identified as worthy of concern in the early 2000s. The probability of each occurring by the year 2010 was rated as was the impact on the company in terms of profitability or market share. The event likely both to occur by 2010 and to have the greatest impact appears in the upper left-hand box. At the

---

**Exhibit 4.7**

**Opportunity/Threat Matrix for a Telecommunications Company**

<table>
<thead>
<tr>
<th>Probability of Occurrence (2010)</th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Low</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

1. Wireless communications technology will make networks based on fiber and copper wires redundant.
2. Technology will provide for the storage and accessing of vast quantities of data at affordable costs.
3. The prices of large-screen (over 36-inch) digitalized TV sets will be reduced by 50 percent (constant dollars).
4. Telephone companies will emerge as the dominant force in the telecommunications industry as well as the operators of telecommunications systems.

*Profits or market share or both.
very least, such an event should be examined closely, including estimating with as much precision as possible its impact on profitability and market share.

The opportunity/threat matrix enables the examination of a large number of events in such a way that management can focus on the most important ones. Thus, events such as number 4 in the exhibit with a high probability of occurring and having a high impact should be closely monitored. Those with a low probability of occurrence and low impact, such as number 3 in the exhibit, should probably be dropped, at least for the moment. Events with a low probability/high impact (number 1) should be reexamined less frequently to determine whether the impact rating remains basically sound.

### Take Aways

- Trends can and often will profoundly influence the success of any business. Serving attractive markets, where trends are favorable—swimming with the current—is likely to yield more success than serving those where trends are unfavorable—swimming against the current. Thus, context, the second of the 4 Cs, matters and is central to the assessment of any opportunity.
- Taken together, the six macro trend categories constitute a useful analytical framework to ensure that all bases are covered when scanning environmental conditions.
- Paying regular and systematic attention to the highest priority macro trend categories permits timely decision making, perhaps ahead of competitors.
- Gathering hard data on macro trends is not difficult. Trade associations and trade magazines provide a good place to start.
- Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at www.mhhe.com/walker.

### Endnotes


3. Ibid.


6. Early research on this group reported their behavior as being strange and unexplained and hence the name “Generation X,” which derived from a novel of that name written by Douglas Copeland (New York: St. Martin’s Press, 1991). Subsequent research reveals this stereotype to be highly inaccurate in describing this generation’s values and beliefs.


9. Ibid.


16. John Carey and Mary Beth Regan, “Are Regs Bleeding the Economy,” Business Week, June 17, 1995, p. 75. Also, see Michael E. Porter and Clas Van…
Chapter Four  Identifying Attractive Markets

der Linde, “Green and Competitive,” Harvard Business Review, September–October 1995, p. 123. American companies have long insisted they were overregulated. For a discussion of why this may not be true—at least as far as Germany and Japan are concerned—see “To All U.S. Managers Upset by Regulations: Try Germany or Japan,” The Wall Street Journal, December 14, 1995, p. A5.


20. These were among the top technologies in importance ranked by scientists at a leading research institute. Others include those concerned with high-density energy sources (fuel cells), miniaturization (supercomputer that fits in a pocket), antiaging products (making the process less traumatic), and sensors that can detect diseases at an early stage (lung cancer from breath measurements). See Douglas E. Olesen, “The Top Technologies for the Next 10 Years,” The Futurist, September–October 1995, p. 9.


22. For a discussion of the validity of the hype that surrounds gene therapy, see “A Triumph of Hype over Experience,” The Economist, December 16, 1995, p. 77.


28. “Death of Distance”; and Gates, Road Ahead.


33. “Science and Technology: Reading the Patterns,” The Economist, April 1, 1995, p. 65.


38. In some countries, voluntary recycling programs have been so successful that systems cannot keep up with the supply. See “Austria Has Recycling Problems,” Business Europe, March 7, 1994, p. 6.


Chapter Five

Industry Analysis and Competitive Advantage

The Cellular Telephone Business: Increasing Competition in a Growing Market

FROM LONDON TO TOKYO TO CHICAGO, cell phones have become a “Can’t do without it” tool of time-pressed businesspeople, hip teenagers, and just about anyone else who wants to stay in touch. There is little doubt that the market for mobile telephone service is growing rapidly. In 1983, when the first cellular phone system began operations, it was projected that by 2000, less than one million people would subscribe. As a result of dramatic growth among both business and household users, however, the number of cell phone users has reached more than 100 million worldwide! In Finland, the world’s most cell-phone-crazy country, cell phone penetration has passed 70 percent; in South Korea and Hong Kong, 60 percent.

The market for mobile telephony is served by two principal industries: cell phone manufacturers and cell phone service providers. How attractive are these apparently booming industries?

Cell Phone Manufacturing

Rapid-fire technological advances from Qualcomm, Ericsson, Nokia, and others have brought countless new features to the market, including software to access the World Wide Web. In Europe, new phones enable mobile users to check the weather forecast, their e-mail, stock quotes, and more. Finland’s Nokia has rocketed to world leadership in cell phones, leaving early and longtime leader Motorola in the dust. From year to year, though, market share figures for leading cell phone manufacturers can double or be halved, depending on whose latest technology catches the fancy of users. To investors’ joy or dismay, stock prices follow suit. Qualcomm’s shares soared 2,600 percent in 1999, only to fall back by more than 60 percent by mid 2000. Nokia, too, saw its share price tumble in 2001.

This recent history in the hotly competitive cell phone manufacturing industry suggests that a rapidly growing market does not necessarily provide a smooth path to success. Growing markets are one thing, but turbulent industries serving those markets are quite another.

Cell Phone Service Providers

Industry conditions for service providers have run wild as well. The race to win global coverage has led to mergers of large players, such as Europe’s
Vodafone with America’s AirTouch, in 1999. Vodafone did not stop there, however, going on to acquire Germany’s Mannesmann in 2000. Other marketers with well-known brands also have jumped into the fray. Richard Branson’s Virgin Group bought idle capacity from a British also-ran and launched Virgin Telecom, picking up 150,000 customers in his first six weeks. All over Europe, where cell phone penetration is far higher than in the United States, market-by-market battles for market share are raging. Prices for cell phone service have slid, given the competitive pressures. To make matters worse, the cost of obtaining new government licenses to support new third-generation (3G) services has skyrocketed. Britain’s auction in early 2000 of 3G licenses wound up raising some $35 billion in license fees, roughly 10 times what was expected. Other European governments have taken notice. Thus, the rapidly growing market for cell phone service has attracted so much interest from competing firms and some governments eager to get their hands on a share of the money that the long-term future profitability of the industry has been put into question. By 2001, the result was a severely depressed market for the shares of wireless providers and other telecom companies as well.

Strategic Challenges Addressed in Chapter 5

As the examples of the cellular phone manufacturing and service industries show, serving a growing market hardly guarantees smooth sailing. Equally or more important are industry conditions and the degree to which specific players in the industry can establish and sustain competitive advantage. Thus, as entrepreneurs and marketing decision makers ponder an opportunity to enter or attempt to increase their share of a growing market like that for mobile phones, they also must carefully examine a host of other issues, including the conditions that are currently prevailing in the industry in which they would compete and the likelihood that favorable conditions will prevail in the future.

In this chapter, we provide analytical frameworks to enable prospective entrepreneurs and marketing strategists in established firms to address four critical questions pertinent to such an examination: How can we assess the attractiveness of an industry? If we aim to compete on the basis of innovation, how can we determine how quickly our innovation is likely to win market acceptance? What does the overall attractiveness of the market and industry context imply for chances for future success? Finally, how can we establish and then sustain competitive advantage over the duration of our product’s life cycle? First, however, we clarify the difference between two oft-confused terms: market and industry.

Markets and Industries: What’s the Difference?

In Chapter 1, we defined a market as being comprised of individuals and organizations who are interested and willing to buy a good or service to obtain benefits that will satisfy a particular need or want and who have the resources to engage in such a transaction. One such market consists of college students who get hungry in the middle of the afternoon and have a few minutes and enough spare change to buy a snack between classes.
An industry is a group of firms that offer a product or class of products that are similar and are close substitutes for one another. What industries serve the student snack market? At the producer level, there are the salty snack industry (makers of potato and corn chips and similar products); the candy industry; the fresh produce industry (growers of apples, oranges, bananas, and other easy-to-eat fruits); and others too numerous to mention. Distribution channels for these products include the supermarket industry, the food service industry, the coin-operated vending industry, and so on. Clearly, these industries are different and offer varying bundles of benefits to hungry students.

The distinction between markets and industries is an important one. Sellers who look only to others in their own industry as competitors are likely to overlook other very real rivals and risk having their markets undercut by innovators from other industries. Should Kodak be more concerned with Fuji, Agfa, and other longtime players in the film and photoprocessing industries, or should it be worrying about Hewlett-Packard, Sony, and others whose digital technologies may make photography’s century-old silver halide chemistry go the way of the buggy whip? Only time will tell.

Defining Markets and Industries: Levels of Analysis

Assessing the attractiveness of markets and industries requires clarity about which consumers and which of their needs or which sellers of which products are to be included in the assessment. Confusion between market and industry can result since consumer needs are often thought of in product terms—“I’m hungry. I need a candy bar”—in the same way that industries are typically described by the products they sell. Thus, markets are often defined both in demographic and/or geographic terms (who and/or where the customers are) and in terms of a particular good or service demanded by the consumer, expressed at the industry, product class, or product type level.

Challenges in Market and Industry Definition

Markets and industries can be defined at several levels of analysis: industry, product class, and product type are most common. The level chosen for a particular analysis can have important implications for strategic and marketing planning. Defining a market or industry at too broad a level can cause the analyst to overlook important market–industry interactions in a particular market segment or for a particular product class or type. But defining the market or industry too narrowly can cause the analyst to miss potentially important competitive developments.

The problem with using the industry level is that it typically includes an array of non-competing products. For example, within the automotive market, is a Toyota Echo in competition with a BMW or a Mack truck? Within chemical markets, do polymers that substitute for natural materials compete with gasoline additives, dyestuffs, and industrial coatings? Probably not. For an entrepreneur seeking to market a new chemical compound that enhances the depth of color when cotton yarns are dyed, understanding the state of the overall chemical industry is probably less important than understanding dyestuffs competitors.

Using product class as one’s level of analysis suffers from this same type of problem since the products involved may serve diverse markets or market segments. The more generic the definition of a product class, the higher the aggregation level of products (for instance, all cars versus sport utility vehicles) and the more stable is market demand,
as well as the product life cycle curve, a concept we explore later in this chapter. Thus, basic needs for automobiles (at least, in developed countries) typically change slowly, though demand patterns for SUVs or pickup trucks or compact cars may be more volatile. The more generically the product class is defined, the less useful it is for strategic planning, which seeks to identify opportunities and threats for specific product-market relationships.

**Product types** are subsets of a product class and contain items that are technically similar, although they may vary in such aspects as appearance and price. In the case of cereals, for example, the product types could be defined as hot or cold cereals. Hot cereals would include at least two subtypes: regular and instant. Cold cereals would include regular, presweetened, natural, and fortified. Regular could be broken down into such categories as corn flakes, raisin brans, and shredded wheat. Other examples of product hierarchies abound, especially when different processing technologies are involved—frozen, canned, fresh, dehydrated, and freeze-dried fruits and vegetables, for example. Most marketers select product type as their level of analysis for marketing planning because, while products within a product type may serve different subsets of needs, they are typically close substitutes for one another. The product-type level of aggregation is considerably more sensitive than the other levels to environmental changes—such as those driven by macro trends, as discussed in Chapter 4—that create opportunities or threats for individual product-market entries. The danger in restricting one’s market and competitive analysis to a particular product type is that other product types, such as bagels or a trip through the drive-through at McDonald’s in the breakfast market, may be overlooked. Focusing on the true **consumer need** (i.e., a fast breakfast, rather than cereal, a product) can help avoid this problem.

Doing so appears to be uncommon, however. A recent study found that managers tended to rely on supply-based attributes (i.e., what companies sell) in identifying competitors, rather than demand- or customer need-based attributes (i.e., what customers need). Further, managers tend to identify too few firms as competitors and are especially likely to omit new firms or potential competitors. Stories of experienced managers who “know their business” and are surprised by the sudden emergence of a new competitor that operates in a different way are legion. For an example of how firms create new market space not bound by old industry definitions, see Exhibit 5.1.

---

**Exhibit 5.1 Creating New Market Space**

W. Chan Kim and Renée Mauborgne argue that one way to avoid cutthroat, head-to-head competition, in rapidly growing markets as well as those that are flat or growing slowly, is to find new “market space,” as they call it, that defies conventional boundaries of industry competition. By looking across substitute industries or to complementary product and service offerings that go beyond what an industry has traditionally offered, companies can rethink the functional and emotional orientation of their industry and help shape industry trends to their own advantage. Cisco Systems created new market space in this way when it recognized that the doubling of the number of Internet users every 100 days was creating demand for high-speed data exchange that was not being adequately served by existing industries. Today, more than 80 percent of all traffic on the Internet flows through Cisco’s routers, switches, and other network devices, on which Cisco earns margins in the 60 percent range. Creating new market space can be attractive, indeed!

As consumers and businesspeople have become hooked on cell phones, the market for mobile communication has grown rapidly. By most measures, this is a large, growing, and attractive market. But are cell phone manufacturing and cellular services attractive industries? An industry’s attractiveness at a point in time can best be judged by analyzing its driving forces, its critical success factors and the degree to which a management team can perform on these factors, and especially the five major competitive forces: rivalry among present competitors, potential competitors, the bargaining power of suppliers, the bargaining power of buyers, and the threat of substitute products.

Driving Forces

Just as macroenvironmental trends are important in shaping market attractiveness, so, too, are they important in shaping the attractiveness of industries. Michael Porter calls these trends driving forces. These include (1) changes in the industry’s long-term growth rate, which directly affect investment decisions and intensity of competition; (2) changes in key buyer segments, which affect demand and strategic marketing programs; (3) diffusion of proprietary knowledge, which controls both the rate at which products become more alike and the entry of new firms; (4) changes in cost and efficiency, derived from scale and learning effects, which have the potential of making entry more difficult; and (5) changes in government regulations, which can affect entry, costs, bases of competition, and profitability. Collecting and examining trend data in each of these areas helps an entrepreneur or marketer determine whether an industry is sufficiently attractive to enter or remain in and helps shape strategic marketing decisions that enable the firm to compete effectively. The profusion of data now available on the Internet has made the gathering of these data much easier than was true several years ago.

Porter’s Five Competitive Forces

Five interactive competitive forces collectively determine an industry’s long-term attractiveness: present competitors, potential competitors, the bargaining power of suppliers, the bargaining power of buyers, and the threat of substitute products. This mix of forces explains why some industries are consistently more profitable than others and provides further insights into which resources are required and which strategies should be adopted to be successful.

The strength of the individual forces varies from industry to industry and, over time, within the same industry. In the fast-food industry, the key forces are present competitors (for example, Wendy’s versus Burger King versus McDonald’s), substitute products (neighborhood delis, salad bars, all-you-can-eat buffet restaurants, and frozen meals), and buyers who are concerned about health and nutrition and who see fast foods as a symbol of a throw-away society.

Rivalry among Present Competitors Rivalry occurs among firms that produce products that are close substitutes for each other, especially when one competitor acts to improve its standing or protect its position. Thus, firms are mutually dependent: What one firm does affects others, and vice versa. Ordinarily, profitability decreases as rivalry increases. Rivalry is greater under the following conditions:
There is high investment intensity; that is, the amount of fixed and working capital required to produce a dollar of sales is large. High intensity requires firms to operate at or near capacity as much as possible, thereby putting strong downward pressure on prices when demand slackens. Thus, high investment-intensity businesses are, on average, much less profitable than those with a lower level of investment. Bob Crandall, the CEO of American Airlines, once described the airline business as being “intensely, vigorously, bitterly, savagely competitive.”

There are many small firms in an industry or no dominant firms exist. In recent years, hundreds of pharmaceutical companies have started up, all hoping to produce new wonder drugs. In such crowded segments as neurosciences, inflammatory diseases, and drug delivery, competition is keen, and some companies are considering preemptive steps in an effort to dominate their niches.

There is little product differentiation—for example, major appliances, TV sets, and passenger-car tires.

There is a high cost to changing suppliers (switching costs) as would be the case in changing a major computer software system.

The greater the competitive rivalry in an industry, the less attractive it is to current players or would-be entrants. Though the cellular service industry is capital intensive, there are several dominant firms whose products are differentiated through rapid technological change, and switching costs to change cell phone suppliers are low. Thus, rivalry in this industry might be judged as moderately favorable.

Threat of New Entrants A second force affecting industry attractiveness is the threat of new entrants. New competitors add capacity to the industry and bring with them the need to gain market share, thereby making competition more intense. The threat of new entrants, such as firms using new packet-switching technology that allows the user to always be connected, is a very real concern to present cellular industry players. The greater the threat of new entrants, the less will be an industry’s attractiveness. Entry is more difficult under the following conditions:

When strong economies of scale and learning effects are present, since it takes time to obtain the volume and learning required to yield a low relative cost per unit. If firms already present are vertically integrated, entry becomes even more expensive. Also, if the existing firms share their output with their related businesses, the problem of overcoming the cost disadvantage is made even more difficult.

Exhibit 5.2
The Major Forces That Determine Industry Attractiveness

If the industry has strong capital requirements at the outset.

When strong product differentiation exists.

If gaining distribution is particularly difficult.

If a buyer incurs switching costs in moving from one supplier to another.

**Bargaining Power of Suppliers** The bargaining power of suppliers over firms in an industry is the third major determinant of industry attractiveness. It is exercised largely through increased prices. Its impact can be significant, particularly when a limited number of suppliers service several different industries. Their power is increased if switching costs and prices of substitutes are high and they can realistically threaten forward integration. Suppliers are especially important when their product is a large part of the buyer’s value added—as is the case with metal cans, where the cost of tin plate is over 60 percent of the value added. In recent years, the bargaining power of suppliers in many industries has changed dramatically as more companies seek a partnership (just-in-time) relationship with their suppliers. What was once an arm’s-length adversarial relationship has turned into a cooperative one resulting in lower transaction costs, improved quality derived primarily from using a supplier’s technological skills to design and manufacture parts, and decreased transaction time in terms of inventory replenishments.

The greater the bargaining power of the key suppliers to an industry, the less will be the overall attractiveness of the industry. The newly discovered power that European governments have begun to exert by auctioning bandwidth for new cellular services has raised the bargaining power of the suppliers of bandwidth to the cellular industry. This change has reduced the attractiveness of this industry.

**Bargaining Power of Buyers** An industry’s customers constantly look for reduced prices, improved product quality, and added services and thus can affect competition within an industry. Buyers play individual suppliers against one another in their efforts to obtain these and other concessions. This is certainly the case with some large retailers in their dealings with many of their suppliers.

The extent to which buyers succeed in their bargaining efforts depends on (1) the extent of buyer concentration, as when a few large buyers that account for a large portion of industry sales can gain concessions; (2) switching costs that reduce the buyer’s bargaining power; (3) the threat of backward integration, thereby alleviating the need for the supplier; (4) the product’s importance to the performance of the buyer’s product—the greater the importance, the lower their bargaining power; and (5) buyer profitability—if buyers earn low profits and the product involved is an important part of their costs, then bargaining will be more aggressive.

The greater the power of the high-volume customers served by an industry, the less attractive will be that industry. One attractive dimension of the cellular phone service industry is that its customers have relatively little power to set terms and conditions for cellular phone service. Buyers are numerous and not very concentrated and their cell phone costs are typically not of great importance or expense, relatively speaking.

**Threat of Substitute Products** Substitutes are alternative product types (not brands) that perform essentially the same functions, as tin versus aluminum cans, oleomargarine versus butter, and the faxing of documents versus overnight express delivery. Substitute products put a ceiling on the profitability of an industry by limiting the price that can be charged, especially when supply exceeds demand. Thus, in the metal container industry, aluminum is a substitute for tinplate and constrains the prices charged by tinplate producers (see Exhibit 5.3). For cellular phone service providers, possible substitutes include personal digital assistants (PDAs) such as 3Com’s Palm Pilot, possible new multimedia devices from the likes of Sony, Matsushita, and Samsung, or new mobile digital products not yet imagined.
A Five Forces Analysis of the Cellular Phone Service Industry

A useful way to summarize a five forces industry analysis is to construct a chart like that shown in Exhibit 5.4. There, we summarize one analyst’s judgment of the favorability of the five forces for the cellular phone service industry in the year 2001. This analysis indicates that, compared to earlier in the industry’s history when there were fewer players (thus, less rivalry), no threatening substitutes on the horizon, and a cozier relationship with governments to provide bandwidth, the industry today is probably less attractive than some industries, for which four or five of the forces might be favorable. Thus, strategists who must decide whether to enter or continue to invest in this industry must make a judgment as to whether the rapid growth of the market—a favorable environmental context—is sufficient to offset the deteriorating attractiveness of the industry—the not-so-favorable competitive situation. Given this mixed outlook, strategists will no doubt consider other factors, including the degree to which they believe they are likely to be able to establish and sustain competitive advantage. We further develop this theme later in this chapter.

Changing Competition and Industry Evolution

As we shall see later in this chapter, most products and product categories pass through a series of stages in their life cycles: introduction, growth, shakeout, maturity, and decline. All five competitive forces just discussed are affected by the passage of time; therefore, their strength varies as the industry passes from its introductory stage to its growth stage and on to maturity, followed by decline. Competitive forces are apt to be weakest during the fast-growth period; thus, there are substantial opportunities for gaining market share. During the shakeout period, competitive forces are at their strongest, and many competitors are forced to exit the industry. During maturity, competition typically slackens, but only if the industry leader holds a strong relative share position. An industry will experience more price competition during maturity if the leader holds a weak relative share position. Kellogg and General Mills hold two-thirds of the U.S. domestic cereal market, but because Kellogg does not hold a dominant relative share, the industry experiences considerable price competition. A declining industry usually witnesses considerable rivalry, the extent of which depends on the strength of the exit barriers and the rate of decline.
Critical Success Factors

The critical success factors that differentiate between the success and failure of firms within an industry differ from industry to industry. These factors often are concerned with one or more of the elements in the marketing mix—product (e.g., the capability to generate successful new products), price (be a low-cost producer), place (obtain widespread product distribution), and promotion (strong relationships with large customers). As the old saying goes in the retailing industry, only three things are critical to success: location, location, and location. Thus, location, a potentially powerful source of competitive advantage, often makes the difference between which retailers are successful and which are not.

Assessing the fit between an industry’s critical success factors and the presence of those factors in a firm or a proposed management team is a good way to assess whether an industry is attractive to that particular firm or management team and to determine whether that firm or team is likely to be attractive to investors or other suppliers of resources. Thus, before deciding whether or not to invest in a start-up, most venture capitalists want to know whether the start-up team has the necessary competencies to be successful in the industry it proposes to enter.

### Industry Analysis Locally: How Intense Is the Immediate Competition?

As we have seen, assessing an industry’s driving forces and Porter’s five forces and understanding its critical success factors are important to industry analysis. These are macro-level issues, similar to the macro trends we examined in Chapter 4. To most firms, immediate and local competitive conditions are equally if not more important. Such conditions are particularly

---

**Exhibit 5.4**

**Five Forces Analysis of the Worldwide Cell Phone Service Industry in Late 2001**

<table>
<thead>
<tr>
<th>Five forces</th>
<th>Score</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rivalry among present competitors</td>
<td>Rivalry is low to moderate: moderately favorable</td>
<td>Products are differentiated through new features and services; customer switching costs are low.</td>
</tr>
<tr>
<td>Threat of new entrants</td>
<td>Threat of new entrants is high: moderately unfavorable</td>
<td>Rapid pace of technological change may bring new entrants based on new technologies: packet switching, satellites.</td>
</tr>
<tr>
<td>Supplier power</td>
<td>Supplier power is high: moderately unfavorable</td>
<td>Governments have raised the price of additional bandwidth through auctions.</td>
</tr>
<tr>
<td>Buyer power</td>
<td>Buyer power is low: very favorable</td>
<td>Even large customers have little power to set terms and conditions in this oligopolistic industry.</td>
</tr>
<tr>
<td>Threat of substitutes</td>
<td>Threat of substitutes is high: moderately unfavorable</td>
<td>PDAs or new multimedia devices could replace cell phones.</td>
</tr>
</tbody>
</table>

Overall conclusion: Only two of the five forces are favorable, while three are unfavorable. Thus, the cellular phone service industry is not particularly attractive at this time.
salient for firms, such as retailers, that operate on a local basis. If an entrepreneur wants to open a fly-fishing shop near a blue-ribbon trout stream in Montana, he or she will be pleased that fly-fishing is on the rise, that consumers have adequate income to pursue such a sport, and that leisure activities are becoming more important to many people. But it also matters if there are already a couple of fly-fishing shops serving the local market, and whether those shops serve their customers effectively. If so, the overall trends and industry conditions probably do not matter much, for the local fly-fishing pie can be sliced only so many ways! Thus, assessing an industry must typically be done locally, as well as more globally, and relevant information about specific competitors must be obtained.

In Chapter 6, we address the market knowledge systems that many firms use to gather competitive information, as well as other relevant market and industry data. As we shall see, gathering this information is important, and ethical issues having to do with how competitive information is obtained are likely to arise. For a discussion of ethical issues in gathering information to perform competitive analyses, see Ethical Perspective 5.1.

**Rate of Diffusion of Innovations:**

**ANOTHER FACTOR IN ASSESSING OPPORTUNITY ATTRACTIVENESS**

Before entrepreneurs or established marketers invest in the development and introduction of an innovation, they should evaluate how rapidly the innovation is likely to be adopted by the target market. The faster the adoption rate, the more attractive an innovative good or service is to the marketer, as competitors are caught short while consumers build loyalty to the new product. Diffusion of innovation theory seeks to explain the adoption of a product or service over time among a group of potential buyers. Lack of awareness typically limits early adoption. As positive word
about the product spreads, the product is adopted by additional consumers. Diffusion theory is useful to managers in predicting the likely adoption rate for new and innovative goods or services.

**The Adoption Process**

The adoption process involves the attitudinal changes experienced by individuals from the time they first hear about a new product, service, or idea until they adopt it. Not all individuals respond alike; some tend to adopt early, some late, and some never. Thus, the market for a new product tends to be segmented over time.

The five stages in the adoption process are awareness, interest, evaluation, trial, and adoption:

1. **Awareness.** In this stage, the person is only aware of the existence of the new product and is insufficiently motivated to seek information about it.
2. **Interest.** Here the individual becomes sufficiently interested in the new product but is not yet involved.
3. **Evaluation.** This is sometimes referred to as the mental rehearsal stage. At this point, the individual is mentally applying the new product to his or her own use requirements and anticipating the results.
4. **Trial.** Here the individual actually uses the product, but, if possible, on a limited basis to minimize risk. Trial is not tantamount to adoption; only if the use experience is satisfactory will the product stand a chance of being adopted.
5. **Adoption.** In this stage, the individual not only continues to use the new product but also adopts it in lieu of substitutes.

**The Rate of Adoption**

If plotted on a cumulative basis, the percentage of people adopting a new product over time resembles an S curve. Although the curve tends to have the same shape regardless of the product involved, the length of time required differs among products—often substantially.

The time dimension is a function of the rate at which people in the target group (those ultimately adopting) move through the five stages in the adoption process. Generally, the speed of the adoption process depends on the following factors: (1) the risk (cost of product failure or dissatisfaction), (2) the relative advantage over other products, (3) the relative simplicity of the new product, (4) its compatibility with previously adopted ideas, (5) the extent to which its trial can be accomplished on a small-scale basis, and (6) the ease with which the central idea of the new product can be communicated. Some new products move quickly through the adoption process (a new breakfast cereal), while others take years. Risk minimization via guarantees and reliable and prompt service is critical as is the ability to demonstrate the product’s uniqueness in meeting the customer’s needs. Source credibility is also important.

The rate at which a product passes through the adoption process is also a function of the actions taken by the product’s supplier. Thus, the diffusion process is faster when there is strong competition among members of the supplier group, when they have favorable reputations, and when they allocate substantial sums to R&D (to improve performance) and marketing (to build awareness). The cellular phone industry should score high on these adoption factors.

**Adopter Categories**

Early adopters differ from later adopters. Using time of adoption as a basis for classifying individuals, five major groups can be distinguished: innovators, early adopters, early majority, late majority, and laggards. (Note that these are different from the five stages of adoption for a given individual just discussed.) See Exhibit 5.5 for the approximate size
and characteristics of each group. Because each category comprises individuals who have similar characteristics and because individuals differ substantially across categories, these adopter groups can be considered market segments. Thus, one would use a different set of strategies to market a new product to the early adopter group than to market it to the late majority group. For a discussion of the challenges in transitioning marketing efforts from group to group, see Exhibit 5.6.

The differences cited in Exhibits 5.5 and 5.6 are important because they help in the development of strategic marketing programs. In organizational markets, suppliers can identify innovative firms by reputation, profitability, size, and the suppliers’ experiences in dealing with them. As evident from earlier discussion, information alone about the product or service is not usually a sufficient reason to adopt. Commercial sources of information (such as salespeople and mass media advertising) are important at the outset, but less-commercial and more-professional sources are sought to validate the proclaimed merits of the new product, especially during the evaluation stage. Advice from opinion leaders is more critical as a legitimizing agent than as a source of information. A classic study of how doctors reacted to the introduction of a new “miracle drug” found that only 10 percent adopted on the basis of data provided by their initial source of information, indicating that data alone will not cause adoption.

Thus, commercial sources are most important at the awareness stage in the adoption process, while personal influence is most important at the evaluation stage. In the interest stage, both are important. In the trial stage, marketers should attempt to make it relatively easy for a prospect to try a product under conditions that minimize risk. Therefore, strategic marketing programs should accommodate the various stages in the adoption process as well as the different adoption audiences.

**Implications of Diffusion of Innovation Theory for Forecasting Sales of New Products and New Firms**

Optimistic entrepreneurs or new product managers sometimes wax euphoric about the prospects for the innovations they plan to bring to market. They naively forecast that their innovations will capture 10 percent or 20 percent of the market in its first year. How likely...
Section Two  Opportunity Analysis

II. Opportunity Analysis  5. Industry Analysis and Competitive Advantage

is it that a truly innovative new product, even a compellingly attractive one, will win all of the innovators plus most of the early adopters in its first year on the market? History suggests that such penetration levels are rare at the outset. More typically, first-year penetration levels include some but not all of the innovators, well under 2 1/2 percent of those who, it is hoped, will ultimately adopt!

A good way to estimate how quickly an innovation is likely to move through the diffusion process is to construct a chart that rates the adoption on the six key factors influencing adoption speed, as shown in Exhibit 5.7. An innovation that is risky for the prospective user to try or buy, has little competitive advantage, is complex or incompatible with current user behavior, and is difficult or expensive to try or to understand its benefits is likely to face tough sledding, regardless of the attractiveness of the industry. Personal robots, introduced in the early 1980s with great fanfare following the introduction of personal computers, were such an innovation. Thus, introducing a new product that delivers no real benefits or lacks competitive advantage into any industry, regardless of its high-tech profile, is likely to be an unpleasant experience!

**Exhibit 5.6 Crossing the Chasm: A Difficult Transition in the Diffusion Process**

In his classic book on the marketing of high-technology products, Geoffrey Moore explores the challenges of crossing the “chasm,” as he calls it, in the diffusion process between the early adopters and the early majority. For many high-tech products, innovators and early adopters have quite different needs from early majority customers. Innovators and early adopters are often willing to adopt a revolutionary new product that is not yet very user-friendly or whose product features have not yet been fully developed. Their own technical skill enables them to adapt such a product to their needs and resolve some of the uncertainties inherent in the product’s perhaps still-unclear potential. Their self-perception as an innovator gives them comfort in trying new products before others do. Early majority buyers, on the other hand, typically require easier-to-use products, whose benefits are clearly defined, and for which there is proof that the product will perform. Taking a product from the first group of buyers to the second is a difficult challenge, one that is compounded by the fact that buyers in the innovator and early adopter groups are not likely to associate or talk with buyers in the early majority group.


Sustaining Competitive Advantage over the Product Life Cycle

The product life cycle is concerned with the sales history of a product or product class. The concept holds that a product’s sales change over time in a predictable way and that products go through a series of five distinct stages: introduction, growth, shakeout, maturity, and decline (see Exhibit 5.8). Each of these stages provides distinct opportunities and threats, thereby affecting the firm’s strategy as well as its marketing programs. Despite the fact that many new products do not follow such a prescribed route because of failure, the concept is extremely valuable in helping management look into the future and better anticipate what changes will need to be made in strategic marketing programs.

At the beginning (the introductory stage), a new product’s purchase is limited because members of the target market are insufficiently aware of its existence; also, the product often lacks easy availability. As more people learn about the product and it becomes more
readily available, sales increase at a progressively faster rate (the growth stage). Growth slows as the number of buyers nears the maximum and repeat sales become increasingly more important than trial sales. As the number of both buyers and their purchases stabilizes, growth becomes largely a function of population growth in the target market. At the end of the growth period—just before the advent of maturity—the shakeout or competitive turbulence stage occurs. This is characterized by a decreasing growth rate that results in strong price competition, forcing many firms to exit the industry or sell out. The mature stage is reached when the net adoption rate holds steady—that is, when adopters approximate dropouts. When the latter begin to exceed new first-time users, the sales rate declines and the product is said to have reached its final or decline stage.17

Life Cycle Curves

Many products do not go through the product life cycle curve shown in Exhibit 5.8 because a high percentage are aborted after an unsatisfactory introductory period. Other products seemingly never die (Scotch whiskey, TVs, automobiles). The shape of the life cycle curve varies considerably between and within industries but is typically described as “S”-shaped. One study identified 12 different types of curves.18

In general, however, only one or a very few curves typify an industry (see Exhibit 5.9 for the common types). The growth-decline plateau is probably the most common since a majority of products are in their mature stage (color TVs and most household appliances). This is followed by the cycle/recycle type, which is characteristic of many pharmaceutical products that receive heavy promotions at the outset and again when sales begin to falter. The innovative-maturity curve goes through several life cycles because new innovative characteristics as well as new uses are discovered. A classic illustration is 3M’s Scotch
tape, which initially expanded to a line of colored and patterned items for gift wrapping. Next, a low-price commercial line was added, and finally 3M developed a coated type to compete with reflective tape. All of these tapes are still doing very well. The classic S-shaped curve occurs only when the product passes through all stages to its death (steam engines and many prescription drugs). Where is the Web in its life cycle?

Fads, such as Beanie Babies, pet rocks, and hula hoops, enter suddenly, experience strong and quick enthusiasm, peak early, and enter the decline stage shortly thereafter. Thus, even when successful, their life cycle is unusually short and is typically depicted in the form of an inverted V.

**Market and Competitive Implications of Product Life Cycle Stages**

The various stages of the product life cycle present different opportunities and threats to the firm. By understanding the characteristics of the major stages, a firm can do a better job of setting forth its objectives and formulating its strategies as well as developing its action plans (see Exhibit 5.10). Our discussion here is generalized; in Chapters 10, 11, and 12 we present a comprehensive examination of specific marketing-strategy programs and do so for both leaders and followers.

**Introductory Stage**  There is a vast difference between pioneering a product class and a product type. The former is more difficult, time-consuming, expensive, and risky, as must have been the case when the telephone was introduced versus the introduction of the cellular phone. The introductory period, in particular, is apt to be long, even for relatively simple product classes such as packaged food products. Because product type and subtype
entries usually emerge during the late-growth and maturity stages of the product class, they have shorter introductory and growth periods. Once the product is launched, the firm’s goal should be to move it through the introductory stage as quickly as possible. Research, engineering, and manufacturing capacity are critical to ensure the availability of quality products. Where service is important, the firm must be able to provide it promptly (as in postpurchase service and spare-parts availability). The length of the product line should be relatively short to reduce production costs and hold down inventories.

For sophisticated industrial products, the initial market consists mainly of large companies with enough resources to risk adoption, the technical capabilities to objectively evaluate the merits of the new product, and the most to gain if it works out well. To encourage trial and repeat buying, marketers of consumer products use a combination of methods, including heavy demonstration-oriented TV advertising, in-store displays, free samples, coupons, and special introductory prices. The firm also must obtain distribution and ample shelf space to provide product availability—particularly in self-service outlets such as supermarkets.

**Marketing Mix in the Introductory Stage** The length of the product line typically should be relatively short to reduce production costs and hold down inventories. Efforts to establish competitive advantage are typically focused on differentiating the new product or product line from solutions customers previously employed to satisfy the targeted want or need. Many early PCs were purchased to perform spreadsheet analyses on the computer, instead of running the calculations by hand, with all the potential for error and difficulty

---

**Exhibit 5.9**

**COMMON PRODUCT LIFE CYCLE CURVES**

I. Growth-Decline-Plateau

II. Cycle-Recycle

III. Innovative-Maturity

IV. Classical

Section Two  Opportunity Analysis

### Exhibit 5.10
**Expected Characteristics and Responses by Major Life Cycle Stages**

<table>
<thead>
<tr>
<th>Stages in Product Life Cycle</th>
<th>Stage characteristics</th>
<th>Introduction</th>
<th>Growth</th>
<th>Shakeout</th>
<th>Mature</th>
<th>Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market growth rate</td>
<td>Moderate</td>
<td>High</td>
<td>Leveling off</td>
<td>Insignificant</td>
<td>Negative</td>
<td></td>
</tr>
<tr>
<td>(constant dollars)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical change</td>
<td>High</td>
<td>Moderate</td>
<td>Limited</td>
<td>Limited</td>
<td>Limited</td>
<td></td>
</tr>
<tr>
<td>in product design</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Segments</td>
<td>Few</td>
<td>Few to many</td>
<td>Few to many</td>
<td>Few to many</td>
<td>Few</td>
<td></td>
</tr>
<tr>
<td>Competitors</td>
<td>Few</td>
<td>Many</td>
<td>Decreasing</td>
<td>Limited</td>
<td>Few</td>
<td></td>
</tr>
<tr>
<td>Profitability</td>
<td>Negative</td>
<td>High</td>
<td>Low</td>
<td>High for</td>
<td>Low</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>market-share leaders</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Firm’s normative responses**

<table>
<thead>
<tr>
<th>Strategic marketing objectives</th>
<th>Stimulate primary demand</th>
<th>Build share</th>
<th>Build share</th>
<th>Hold share</th>
<th>Harvest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product</td>
<td>Quality</td>
<td>Continue quality improvements</td>
<td>Rationalize</td>
<td>Concentrate on features</td>
<td>No change</td>
</tr>
<tr>
<td>Product line</td>
<td>Narrow</td>
<td>Broad</td>
<td>Rationalize</td>
<td>Hold length of line</td>
<td>Reduce length of line</td>
</tr>
<tr>
<td>Price</td>
<td>Skimming or penetration</td>
<td>Reduce</td>
<td>Reduce</td>
<td>Hold or reduce selectively</td>
<td>Reduce</td>
</tr>
<tr>
<td>Channels</td>
<td>Selective</td>
<td>Intensive</td>
<td>Intensive</td>
<td>Intensive</td>
<td>Selective</td>
</tr>
<tr>
<td>Communications</td>
<td>High</td>
<td>High</td>
<td>High</td>
<td>High to declining</td>
<td>Reduce</td>
</tr>
</tbody>
</table>

in making changes that the previous manual procedures entailed. Where service is important, the firm must be able to provide it promptly (as in postpurchase service and spare-parts availability).

The firm’s pricing is strongly affected by a variety of factors: the product’s value to the end user; how quickly it can be imitated by competitors; the presence of close substitutes; and the effect of price on volume (elasticity) and, in turn, on costs. Basic strategy choices involve skimming and penetration. **Skimming** is designed to obtain as much margin per unit as possible. This enables the company to recover its new product investments more quickly. Such a strategy is particularly appropriate in niche markets and where consumers are relatively insensitive to price, as was the case in the sale of cellular phones to business executives early in the product life cycle. **Penetration pricing** enables the firm to strive for quick market development and makes sense when there is a steep experience curve, which lowers costs; a large market; and strong potential competition.

The importance of **distribution** and channel intermediaries varies substantially from consumer to industrial goods. The latter are often sold direct, but with few exceptions consumer goods use one or more channel intermediaries. Product availability is particularly
important with consumer goods because of the large amounts spent on promotion to make consumers aware of the product and to induce usage. Distribution is easier if the company uses the same channels for its other products and has a successful track record with new product introductions.

During the introductory period, **promotion expenditures** involving advertising and salesforce are a high percentage of sales, especially for a mass-market, small-value product. Some dot-coms spent themselves to failure for promotional purposes. For industrial goods, personal selling costs are apt to be much higher than advertising costs.

The communications task at the outset is to build awareness of the new product’s uniqueness, which is typically an expensive undertaking. Further, the promotional expenditures (such as in-store displays, premiums, coupons, samples, and off-list pricing) required to obtain product availability and trial are substantial. For industrial products, the time required to develop awareness of the product’s uniqueness is often extensive due to the number of people in the buying center and the complexity of the buying systems.

**Growth Stage** This stage starts with a sharp increase in sales. Important product improvements continue in the growth stage, but at a slower rate. Increased brand differentiation occurs primarily in product features. The product line expands to attract new segments. It does so by offering an array of prices and different product features. During the latter part of the growth stage, the firm—especially the dominant one—makes every effort to extend the growth stage by adding new segments, lowering costs, improving product quality, adding new features, and trying to increase product usage among present users.

**Marketing Mix Changes** The **product line** expands to attract new market segments. It does so by offering an array of prices and different product features. The quest for competitive advantage now shifts to differentiation from other entrants in the product class. **Prices** tend to decline during the growth period (the average cost of servicing cellular subscribers has been dropping by about 20 percent annually), and price differences between brands decrease. The extent of the decline depends on cost—volume relationships, industry concentration, and the volatility of raw material costs. If growth is so strong it outpaces supply, there is little or no pressure on price; indeed, it may enable sellers to charge premium prices.

During this period sellers of both industrial and consumer goods strive to build a channel or a direct-sales system that provides maximum product availability and service at the lowest cost. If this can be accomplished, rivals are placed at a disadvantage, even to the extent of being excluded from some markets. This is particularly the case with some industrial goods for which the number of intermediaries in any one market is limited. A brand must attain some degree of distribution success in advance of the mature stage, because channel members then tend to disinvest in less-successful brands.

**Promotion costs** (advertising and personal selling) become more concerned with building demand for a company’s brand (selective demand) than demand for the product class or type (primary demand). Firms strive to build favorable attitudes toward their brand on the basis of its unique features. Communications are also used to cultivate new segments. Even though promotion costs remain high, they typically decline as a percentage of sales.

**Shakeout Stage** The advent of this period is signaled by a drop in the overall growth rate and is typically marked by substantial price cuts. As weaker competitors exit the market, the stronger firms gain shares. Thus, major changes in the industry’s competitive structure occur. During shakeout the firm must **rationalize** its product line by eliminating weaker items, emphasize creative promotional pricing, and strengthen its channel relationships. The personal computer industry is now mired in a global price war in its efforts...
II. Opportunity Analysis

5. Industry Analysis and Competitive Advantage

Section Two  Opportunity Analysis

to adjust to a slowing market. The entire industry is experiencing higher inventories and simultaneously intensifying competitive environment. Several firms have dropped out of the retail computer market. And Apple has gone through serious financial problems. To a considerable extent, what happens during the shakeout has been predetermined by how well each brand has been positioned in relation to its targeted segments, its distribution system, and its relative costs per unit.

Marketing Mix Changes In addition to entering into more direct price competition, firms make every effort to maintain and enhance their distribution system. Channel intermediaries use this downturn in industry sales to reduce the number of products carried and, hence, their inventories. Weaker competitors often have to offer their intermediaries substantial inducements to continue stocking all or even part of their line. Promotion costs may increase, particularly for low-share firms, as companies attempt to maintain their distribution by offering consumers buying incentives. This is particularly the case for sellers of consumer goods.

Mature Stage When sales plateau, the product enters the mature stage, which typically lasts for some time. Most products now on the market are in the mature stage. Stability in terms of demand, technology, and competition characterizes maturity. Strong market leaders, because of lower per-unit costs and the lack of any need to expand their facilities, should enjoy strong profits and high positive cash flows. But there is always the possibility of changes in the marketplace, the product, the channels of distribution, the production processes, and the nature and scope of competition. The longer the mature stage lasts, the greater the possibility of change. If the firm does not respond successfully to a change but its competitors do, then a change in industry structure may occur.

Marketing Mix Changes Because of technical maturity, the various brands in the marketplace become more similar; therefore, any significant breakthroughs by R&D or engineering that help to differentiate the product or redirect its cost can have a substantial payout (see Exhibit 5.11). One option is to add value to the product that benefits the customer by improving the ease of use (voice-activated dialing with cellular phones), by incorporating labor-saving features, or by selling systems rather than single products (adding extended service contracts). Increasingly, service becomes a way of differentiating the offering. Promotion expenditures and prices tend to remain stable during the mature stage. But the nature of the former is apt to change; media advertising for consumer goods declines and in-store promotions, including price deals, increase. The price premium attainable by the high-quality producer tends to erode. The effect of experience on costs and prices becomes smaller and smaller. Competition may force prices down, especially when the two leading competitors hold similar shares. For consumer goods, distribution and in-store displays (shelf facings) become increasingly important, as does effective cost management.

Exhibit 5.11 What the Bicycle Industry Needs Is Innovation

I n the early 80s mountain bikes gave the bicycle industry a much-needed boost in sales. But the demand for such bikes has peaked and most firms in the industry are experiencing flat or declining sales. Clearly what the industry needs, and is attempting, to do is reinvent the bike. An attempt to do so via the use of a battery-powered motor to propel the bike failed, but one entrepreneur is working on a foldable bike that weighs less than 3.5 pounds.

Source: “Reinventing the Bicycle,” The Economist, November 18, 1995, p. 76.
Decline Stage Eventually most products enter the decline stage, which may be gradual (canned vegetables/hot cereals) or extremely fast (some prescription drugs). The sales pattern may be one of decline and then petrification as a small residual segment still clings to the use of the product (tooth powder versus toothpaste). Products enter this stage primarily because of technologically superior substitutes (jet engines over piston engines) and a shift in consumer tastes, values, and beliefs (cholesterol-free margarine over butter).

As sales decline, costs increase, and radical efforts are needed to reduce costs and the asset base. Even so, if exit barriers are low, many firms vacate the market, which increases the sales of remaining firms, thereby delaying their exit (see Exhibit 5.12). Stronger firms may even prosper for a time. If the curve is a steep decline followed by a plateau, then some firms can adjust. If the firm is strong in some segments vacated by its competitors, then it may experience a sufficient increase in market share to compensate for loss of sales elsewhere.

Marketing Mix Changes Marketing expenditures, especially those associated with promotion, usually decrease as a percentage of sales in the decline stage. Prices tend to remain stable if the rate of decline is slow, there are some enduring profitable segments and low exit barriers, customers are weak and fragmented, and there are few single-product competitors. Conversely, aggressive pricing is apt to occur when decline is fast and erratic, there are no strong unique segments, there are high exit barriers, a number of large single-product competitors are present, and customers have strong bargaining power. For consumer goods, marketing activity centers on distribution—persuading intermediaries to continue to stock the item even though they may not promote it. For industrial products the problem may center around maintaining the interest of the salesforce in selling the item.

Harvesting or withdrawal has as its objective an increase in cash flow that can be accomplished by milking (making only the essential investments), internal transfer of assets, and sales of the business or its assets. In any milking operation, management looks for ways to reduce assets, costs, and the number of items in the product line.

Strategic Implications of the Product Life Cycle

The product life cycle model is a framework that signals the occurrence of opportunities and threats in the marketplace and the industry, thereby helping the business better anticipate change in the product’s strategic market objective, its strategy, and its marketing program. By matching the entry’s market position objective with the investment level required and the profits and cash flows associated with each stage in the product life cycle, we can better visualize the interrelationships (see Exhibit 5.13). As would be expected, there is a
high correlation between the market and industry characteristics of each stage, the market share objectives, and the level of investment, which, in turn, strongly affect cash flow.

**Introductory and Growth Stages** Because the introduction of a new product requires large investments, most firms sustain a rather sizable short-term loss. For many dot-coms, these losses have been especially sizable! As the product moves into the growth stage, sales increase rapidly; hence, substantial investments continue. Profitability is depressed because facilities have to be built in advance to ensure supply. The firm with the largest share during this period should have the lowest per-unit costs due to scale and learning effects. If it chooses to decrease its real price proportionate to the decline in its costs, it dries up the investment incentives of would-be entrants and lower-share competitors. The innovating firm’s share is likely to erode substantially during the growth stage. Nevertheless, it must still make large investments, for even though it is losing share, its sales are increasing. New entrants and low-share sellers are at a substantial disadvantage here. They must not only invest to accommodate market growth, but also to gain market share.

**Mature and Declining Stages** As the product enters the mature stage, the larger-share sellers should be able to reap the benefits of their earlier investments. Given that the price is sufficient to keep the higher-cost sellers in business, that growth investments are no longer needed, and that most competitors may no longer be striving to gain share, the leader’s profitability and positive cash flow can be substantial. But the leader needs to continue making investments to improve its product and to make its manufacturing, marketing, and physical logistics more efficient. The generalized product life cycle model portrays a profitability peak during the latter part of the growth stage. But one study of over 1,000 industrial businesses found that despite declining margins, overall profitability did not decline during maturity mainly because less money was spent on marketing and R&D.\(^{21}\)

**Limitations of the Product Life Cycle Framework**

The product life cycle model’s major weakness lies in its normative approach to prescribing strategies based on assumptions about the features or characteristics of each stage. It fails to take into account that the product life cycle is, in reality, driven by market forces
expressing the evolution of consumer preferences (the market), technology (the product), and competition (the supply side). Mary Lambkin and George Day argue strongly that greater emphasis on competitive issues helps to better understand the evolution of a product-market. This is especially the case in understanding the dynamics of competitive behavior in evolving market structures.

Strategic Value of Product-Market Evolution

As illustrated by the cellular phone industry, products and markets are constantly evolving. On the product side, the growing commonality of technology increases the difficulty of maintaining strong product differentiation. Over time, costs per unit tend to decline because of scale and learning effects leading to lower prices. On the market side, demand eventually slows, and consumers become more knowledgeable about the product, forming attitudes about the attractiveness of competing brands. And over time, industry structure and rivalry among established companies change.

These evolutionary forces interact to affect not only a market’s or an industry’s attractiveness but also the success requirements for a firm’s various product-market entries. The management implications of this evolutionary process are as follows:

At the corporate and business-unit levels, the firm must generate new products or enter new markets to sustain its profitability. This has been the case in the American beer industry, where overall demand is down, but the sales of microbrews have experienced rapid growth over the past 10 years. The younger generation finds such beers particularly attractive.

At the product level, objectives and strategy change as the product passes through various evolutionary stages. For example, PC sales to the American home market—the fastest-growing segment of the PC market—have slowed substantially. Firms once serving this segment such as Packard Bell, IBM, and Digital have suffered substantial losses or exited the market. Low-cost machines designed to service consumers who want to use only the Internet are now available. In an effort to accommodate change, industry players are dropping prices, downsizing, accelerating their R&D, and even selling parts of their companies.

At the marketing program level, the evolutionary process typically generates significant changes. For example, when the sales of camcorders (lightweight video cameras) plateaued, the industry realized it had to find new markets beyond young parents. In an effort to reach new customers, camcorder firms downplayed the high-tech nature of their product by simplifying its design, cutting prices, and changing advertising appeals and media vehicles.

Anticipating change is a very difficult undertaking and requires a systematic framework to help managers better understand the product-market evolutionary process. This is especially the case as more and more markets become international. Chapters 4 and 5 have provided a series of tools and analytical frameworks to guide managers in addressing the critical decisions that these changes bring about.

Take Aways

- Companies are more likely to be successful in generating sales and profits if the opportunities they pursue are blessed with the following conditions:
  - Driving forces for the industry are favorable.
  - The industry’s five forces are, on balance, favorable.

- The capabilities of the firm and/or the management team are sufficient to perform with respect to the industry’s critical success factors.

- Local competitive conditions are favorable.

- In other words, choosing an attractive industry, as well as a growing market, is important!
An innovation is more likely to be successful if it will diffuse at a rate rapid enough to quickly establish customer loyalty and advantage over competitors. This chapter provides a framework for assessing this likelihood.

Regardless of the nature of the playing field, developing and regularly updating winning marketing strategies are important, too! In developing strategies to build and sustain competitive advantage, marketing decision makers are more likely to win the competitive war by adjusting their strategies as the markets and industries in which they compete evolve through the stages of the product life cycle. Specific tools and frameworks for managing this task are provided in the balance of this book.

Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at www.mhhe.com/walker.

Endnotes


5. Ibid., chap. 3.


12. Ibid.


15. Rogers, Diffusion of Innovations.


17. For an interesting discussion of the application of the life cycle concept to almost anything besides products (e.g., the fall of the Berlin Wall, the unification of Europe, and the demise of communism), see Theodore Modes, “Life Cycles,” The Futurist, September–October 1994, p. 20.


Chapter Six

MEASURING MARKET OPPORTUNITIES

African Communications Group: Bringing Modern Telecommunications to Tanzania

In Tanzania in the early 1990s, many towns and villages had no access whatsoever to telecommunications services. Even in the capital, Dar es Salaam, a city of almost two million people, on average only one telephone line had been installed per hundred residents. The waiting list to obtain service from the Tanzania Telecommunications Company Limited (TTCL) was 7 to 10 years. Monique Maddy and Côme Laguë, two recent MBA graduates from a leading U.S. business school, saw in these and other market and industry data an opportunity not only to bring telecommunications services to Tanzania, but long term to bring a variety of telecommunications services—including pay phones, paging, voice-mail, and other voice and data communications services—to sub-Saharan Africa. After three months of on-site research in late 1993, Maddy and Laguë decided that building a pay phone network in Tanzania was the most promising opportunity for entering this market. They knew that, in order to obtain financing as well as the necessary licenses to operate in Tanzania, they would have to prepare a credible business plan. They also knew that among the most critical elements of any business plan was the sales forecast. Not only would the sales number be the starting point from which all the other numbers in the plan would be developed, but it would be a key litmus test for prospective investors. If the sales forecast were well supported and credible, Maddy and Laguë believed the rest of the pieces would fall into place. But how could such a forecast be prepared with any confidence for a largely new and underdeveloped market?

Market Analysis

As a result of their research, Maddy and Laguë had concluded that the market for building a pay phone system in Tanzania was extremely attractive. Beyond those on the waiting list for phone service, there was huge “unofficial” demand from individuals who had not bothered to apply for service. Maddy and Laguë estimated that, by 1996, there would be 500,000 potential subscribers for telephone service, and that even with a planned doubling of its capacity, TTCL could satisfy only perhaps half this demand. Moreover, on most Tanzanian phones, it took several minutes to receive a dial tone. Once dial tone was received it could...
take 40 minutes to connect with cities in Africa, or 20 minutes with Europe. Of the 300 coin-operated pay phones in Tanzania, many were inoperative, and some only took coins that no longer were in circulation and were virtually worthless due to Tanzania's high rate of inflation. The market for phone service looked promising, indeed.

**INDUSTRY ANALYSIS**

TTCL, Tanzania's central telephone company, was state-owned, though it was expected that TTCL would be privatized at some point. TTCL offered neither paging, fax, cellular, nor data services. There were several small private telecommunications companies, including one radio-calling service with 105 subscribers, and two high-end cellular phone companies. New licenses were likely to be issued in the next couple of years for cellular services, paging, and pay phones; and Maddy and Laguë hoped to be among those who would win these licenses.

Maddy and Laguë's analysis told them that industry conditions overall were attractive. Though new competitors would likely enter the market, Maddy and Laguë's head start would put them in good position; there were numerous suppliers eager to expand in the African market, and buyers currently had few options to obtain phone service of any kind. There were no substitutes other than cellular service, which was extremely expensive, due to the high cost of building the infrastructure, and the bureaucratic TTCL did not seem likely to be a very vigorous competitor.

**CONSUMER NEEDS AND BEHAVIOR**

Not only was Tanzania's telecommunications infrastructure poorly developed, but the same was true for its electricity and water services and its roads. It took three days to travel from Dar es Salaam to Mwanza, Tanzania's second-largest city, only 751 miles away. Most telephone calls in cities were made by businesspeople, who accounted for 70 percent of telecommunications revenue. Since most residences had no phones, misuse of business phones was common. Employees were generally required to use pay phones for all types of long-distance calls. Most retail shops—known as dukas, which were makeshift open-air stalls made of wood and tin—had no phones. Maddy and Laguë believed their pay phone network, together with the voice-mail and paging services they planned to offer, would provide more efficient ways of doing business to these small merchants who constituted the backbone of the Tanzanian economy. The biggest challenge they would face would probably be to educate Tanzanians on how to use their proposed system. Since the literacy rate in Tanzania was 90 percent, they felt optimistic about their ability to do so.

**THE BUSINESS IDEA**

The idea for African Communications Group (ACG), their proposed venture, was innovative but simple. Maddy and Laguë would build a network of pay phones based on wireless radio technology, with a central platform for routing calls and connecting with the TTCL network. The phones would be card-operated, with prepaid cards sold in retail establishments located near the phone booths. The retailers would get a margin on the sale of the phone cards, and might help watch over the phones to discourage vandalism. Paging and voice-mail would soon be added to the system at low incremental cost. These features would provide quick communication to parties that did not have regular phone service. Subscribers could receive voice-mail messages and leave messages for other voice-mail subscribers. The pagers could be used to signal the subscriber that a message had been received.
MEASURING THE OPPORTUNITY: DETERMINING MARKET POTENTIAL AND PREPARING A SALES FORECAST

Maddy and Laguë liked the opportunity that lay before them, and they felt their business skills and contacts made them a good team to pursue it. But how could they translate all the market and industry data they had gathered into a credible estimate of market potential and an evidence-based sales forecast? Proving that the market and industry were attractive and that consumers would see benefits from using their network was one thing. Coming up with hard numbers for market potential and sales revenue was quite another.

STRATEGIC CHALLENGES ADDRESSED IN CHAPTER 6

Entrepreneurs like Maddy and Laguë and managers in established firms need to develop knowledge about their market and industry and synthesize that knowledge into tangible plans that their organizations can act on. These plans can take many forms. For Maddy and Laguë, a business plan was needed to raise the necessary capital and obtain the operating licenses to start the venture. For new product managers in established firms, marketing plans must be developed to win support and resources to permit the product’s launch. Elsewhere in organizations of all kinds, annual budgets are prepared to guide decision making for the coming year.² These decisions determine staffing, investments in productive capacity, levels of operating expense, and so on. In almost every case, these planning and budgeting activities begin with a sales forecast. Once a sales figure is agreed to, the various activities and investments needed to support the planned sales level are budgeted.

In Chapter 6, we deal with two key issues that enable managers and entrepreneurs to bring life to their dreams. First, we address the challenges in estimating market potential and forecasting sales, for both new and existing products or businesses. We provide a menu of evidence-based forecasting methods, each of which is useful in some situations, but not others, and we discuss their limitations. Second, we briefly address the informational needs of the forecasting task—as well as the tasks addressed in the earlier chapters of this book that enable managers and entrepreneurs to understand their market and competitive contexts—to provide guidance on where to gather, collect, and report data relevant to strategic marketing decision making, that is, marketing research. In this second portion of the chapter, we assume the reader already has learned the basics of planning and conducting marketing research. Such research is essential in strategic decision making—to provide evidence on which to base the various corporate-level and business-level decisions discussed in Chapter 2. Depending solely on hunches—instead of more carefully thought-out research inquiries, even modest ones done quickly—can be a risky proposition indeed.

EVERY FORECAST IS WRONG!

We know of no manager who has ever seen a forecast that came in exactly on the money. Some forecasts turn out too high; others too low. Forecasting is an inherently difficult task, because no one has a perfect crystal ball. The future is inherently uncertain, especially in today’s rapidly changing markets. Consumer wants and needs shift, buffeted by the winds of ever-changing macro trends. Competitors come and go. New technologies sweep away
old ones. Some forecasts are based on extensive and expensive research, others on small-scale inquiries, still others on uninformed hunches. As we have seen, however, forecasting plays a central role in all kinds of planning and budgeting in all kinds of businesses and other organizations. Given the stakes and the risks entailed in being very wrong with a forecast, some effort to prepare an evidence-based forecast, instead of a wild guess, is almost always called for, even if time and money are scarce. So forecast we must, but how?

**A Forecaster’s Toolkit: A Tool for Every Forecasting Setting**

Before choosing a method to prepare a forecast, one first must know what is to be estimated or forecasted. First, there’s the size of the potential market, that is, the likely demand from all actual and potential buyers of a product or product class. An estimate of market potential often serves as a starting point for preparing a sales forecast, which we explore in more detail later in this chapter. For Maddy and Laguë’s venture in Tanzania, prospective investors will want to know how large the potential market for telephone services will be in the coming years, measured perhaps in several ways: in numbers of telephone users, in numbers and/or minutes of calls, and in dollars or Tanzanian shillings. This market is comprised of those consumers who are likely to have both the willingness and ability to buy and use a phone card or one of ACG’s other services at one of ACG’s pay phones. There’s also the size of the currently penetrated market, those who are actually using pay phones in Tanzania at the time of the forecast. Investors also will want to know these figures—the size of the potential and penetrated markets for the market segments Maddy and Laguë intend to serve, their target market. They also will need a sales forecast, in which they predict sales revenues for ACG, for five years or so. How might they do these things?

Established organizations employ two broad approaches for preparing a sales forecast: top-down and bottom-up. Under the top-down approach, a central person or persons take the responsibility for forecasting and prepare an overall forecast, perhaps using aggregate economic data, current sales trends, or other methods we describe shortly. Under the bottom-up approach, common in decentralized firms, each part of the firm prepares its own sales forecast, and the parts are aggregated to create the forecast for the firm as a whole. For an example of how managers at Gap Inc. retailing divisions combine both methods to forecast next-year sales, see Exhibit 6.1.

The bottom-up logic also applies to Maddy and Laguë’s task. They can break their anticipated demand into pieces and sum the components to create the summary forecast. These pieces could be market segments, such as small retailers, mobile businesspeople, consumers, and so on, or product lines, such as revenue from phone cards or individual pay phones, voice-mail fees, pager fees, and the like. Using the bottom-up approach presents numerous advantages. First, this approach will force them to think clearly about the drivers of demand for each market segment or product line, and thus better understand the real potential of their business and its parts. Second, they will be forced to make explicit assumptions about the drivers of demand in each category, assumptions they can debate—and support with evidence gathered from their research—with prospective investors and they can later verify as the business unfolds. Third, such an approach facilitates “what if” planning. Various combinations of market segments and/or product lines can be combined to build a business plan that looks viable.
From what forecasting methods, or tools, can Maddy and Laguë choose? There are six major evidence-based methods for estimating market potential and forecasting sales: statistical methods, observation, surveys, analogy, judgment, and market tests. A seventh method, not evidenced-based—the SWAG method (Silly Wild-@*# Guess)—is not condoned here, though there is little else to support some forecasts!

**Statistical and Other Quantitative Methods**

**Statistical methods** use past history and various statistical techniques, such as multiple regression or time series analysis, to forecast the future based on an extrapolation of the past. This method is typically not useful for ACG or other entrepreneurs or new product managers charged with forecasting sales for a really new product or new business. There is no history in their venture on which to base a statistical forecast.

In established firms, for established products, statistical methods are extremely useful. When Michelin, the tire maker, wants to forecast demand for the replacement automobile tire market in Asia for the next year, it can build a statistical model using such factors as the number and age of vehicles currently on the road in Asia, predictions of GDP for the region, the last few years’ demand, and other relevant factors to forecast market potential as well as Michelin’s own replacement tire sales for the coming year. Such a procedure is likely to result in a more accurate forecast than other methods, especially if Michelin has years of experience with which to calibrate its statistical model.

As with all forecasting methods, statistical methods have important limitations. Most important of these is that statistical methods generally assume that the future will look very much like the past. Sometimes this is not the case. US WEST, the regional Bell telephone company serving the Rocky Mountain and Northwest regions of the United States, ran into trouble in the 1990s when its statistical models used to predict needs for telephone capacity failed to allow for rapidly increasing use of computer modems, faxes, and second lines for teenagers in American homes. Suddenly, the average number of lines per home skyrocketed, and there was not enough physical plant—cable in the ground, switches, and so on—to accommodate the growing demand. Consumers had to wait, sometimes for months, to get additional lines, and they were not happy about it! Similarly, if product or market
characteristics change, statistical models used without adequate judgment may not keep pace. When tire makers produce automobile tires that last 80,000 miles instead of 30,000 to 50,000 miles, the annual demand for replacement tires is reduced. If automobile manufacturers were to change the number of wheels on the typical car from four, the old statistical models also would be in trouble.

Other quantitative forecasting methods, especially for new product forecasting, also have been developed. These include methods to mathematically model the diffusion of innovation process for consumer durables (discussed in Chapter 5) and conjoint analysis, a method to forecast the impact on consumer demand of different combinations of attributes that might be included in a new product.

Observation

Another method for preparing an evidence-based forecast is to directly observe or gather existing data about what real consumers do in the product-market of interest. Maddy and Laguë conducted a study of pay phone use in Tanzania to find out how many minutes per day the typical pay phone was used. Their study showed that an average of 150 three-minute calls were made per day at the 60 working pay phones then provided by other companies in Dar es Salaam. Revenue for most pay phones fell into the US$100 to $150 range.

Like statistical methods, observation-based forecasting is attractive because it is based on what people actually do. If behavioral or usage data can be found from existing secondary sources—in company files, at the library, or on the Internet—data collection is both faster and cheaper than if a new study like the one Maddy and Laguë conducted must be designed and carried out. For new-to-the-world products, however, observation is typically not possible and secondary data are not available, since the product often does not yet exist, except in concept form. Had there been no pay phones in Tanzania or a similar country, observation would not have been possible. Market tests, which we discuss later in this section, are one way to get real purchase data about new-to-the-world products.

Surveys

Another common way to forecast sales or estimate market potential is to conduct surveys. These surveys can be done with different groups of respondents. Consumers, after being shown a statement of the product concept or a prototype or sample of the product, can be asked how likely they are to buy, creating a survey of buyers’ intentions. Buyers also can be asked about their current buying behavior: what they currently buy, how often, or how much they use. The salespeople can be asked how much they are likely to sell, completing a survey of salesforce opinion. Experts of various kinds—members of the distribution channel, suppliers, consultants, trade association executives, and so on—also can be surveyed.

As part of their research in Dar es Salaam, Maddy and Laguë surveyed pay phone customers to find out more about them. A whopping 65 percent were using a pay phone because they lacked access to another working phone—good news for the ACG concept! Sixty-three percent were business customers, 20 percent were students or teachers, and 17 percent were other nonbusiness customers. Business customers spent an average of US$10 per week for 14 pay phone calls, and nonbusiness customers spent US$6 per week for 12 calls. By combining these data with demographic data on the Tanzanian population, Maddy and Laguë now had what they needed to prepare an evidence-based, bottom-up forecast of market potential, market segment by market segment.
Surveys possess important limitations, however. For one, what people say is not always what people do. Consumer surveys of buyer intention are always heavily discounted to allow for this fact. For one common approach to doing so, see Exhibit 6.2. Second, the persons who are surveyed may not be knowledgeable, but if asked for their opinion, they will probably provide it! Third, what people imagine about a product concept in a survey may not be what is actually delivered once the product is launched. If consumers are asked if they will buy an “old world spaghetti sauce with homemade flavor,” they will surely provide a response. Whether they will actually like the taste and texture of the sauce that the lab develops is another story! In general, statistical and observational methods, where adequate data or settings are available in which to apply them, are superior to survey methods of forecasting, because such methods are based, at least in part, on what people have actually done or bought (e.g., the number of old cars actually on the road, or the length of pay phone calls in Tanzania), while survey methods (Are you likely to buy replacement tires this year? How often are you likely to use a pay phone?) are based on what people say, a less reliable indicator of their future behavior.

**Analogy**

An approach often used for new product forecasting where neither statistical methods nor observations are possible is to forecast the sales or market potential for a new product or product class by analogy. Under this method, the product is compared with similar products for which historical data are available. When Yoplait, the leading marketer of yogurt in the United States, plans to introduce a new flavor, its managers likely will look at the sales history of earlier introductions to forecast the sales for the newest flavor. This method...
also is used for new-to-the-world high-technology products, for which product prototypes are often either not available or extremely expensive to produce. Rather than conduct surveys to ask consumers about their likelihood to buy a product they can hardly imagine (What would someone have said in 1978 about his or her likelihood to buy a personal computer?), forecasters consider related product introductions with which the new product may be compared. Early forecasts for high-definition television (HDTV) were done this way, comparing HDTV with historical penetration patterns for color TV, videocassette recorders (VCRs), camcorders, and other consumer electronic products.13

As always, there are limitations. First, the new product is never exactly like that to which the analogy is drawn. Early VCRs penetrated American households at a much faster rate than did color TV. Which analogy should be used for HDTV? Why? Second, market and competitive conditions may differ considerably from when the analogous product was launched. Such conditions need to be taken into account.

**Judgment**

While we hesitate to call this a forecasting method of its own, since capable and informed judgment is required for all methods, sometimes forecasts are made solely on the basis of experienced judgment, or intuition. Some decision makers are intuitive in their decision processes and cannot always articulate the basis for their judgments. Said a footwear buyer at Nine West Group, “Trend forecasting is a visceral thing that cannot be trained. I rely on my sense of color and texture, but at times I cannot explain why I feel a certain way . . . I just know.”14 Those with sufficient forecasting experience in a market they know well may be quite accurate in their intuitive forecasts. Unfortunately, it is often difficult for them to defend their forecasts against those prepared by evidence-based methods when the two differ. Nonetheless, the importance of experienced judgment in forecasting, whether it is used solely and intuitively or in concert with evidence-based methods, cannot be discounted.

**Market Tests**

Market tests of various kinds are the last of our most commonly used methods. Used largely for new products, market tests such as experimental test markets may be done under controlled experimental conditions in research laboratories, or in live test markets with real advertising and promotion and distribution in stores. Use of test markets has declined over the past two decades for two reasons. First, they are expensive to conduct because significant quantities of the new product must be produced and marketing activities of various kinds must be paid for. More importantly, in today’s data-intensive environment, especially for consumer products sold through supermarkets and mass merchants, competitors can buy the data collected through scanners at the checkout and learn the results of the test market without bearing the expense. More diabolically, competitors can engage in marketing tactics to mislead the company conducting the test, by increasing sampling programs, offering deep discounts or buy-one-get-one-free promotions, or otherwise distorting normal purchasing patterns in the category. Experimental test markets, on the other hand, are still commonly used.

The coming of the Internet has made possible a new kind of market test: an offer directly to consumers on the Web. Offers to chat rooms, interest groups, or e-mail lists of current customers are approaches that have been tried. Use of such techniques likely will increase, due to companies’ ability to carry out such tests quickly and at low cost. We explore these and other Internet marketing strategies in greater detail in Chapter 9.
Mathematics Entailed in Forecasting

Regardless of the method used, the ultimate purpose of the forecasting exercise is to end up with numbers that reflect what the forecaster believes is the most likely outcome, or sometimes a range of outcomes under different assumptions, in terms of future market potential or for the sales of a product or product line. The combination of judgment and other methods often leads to the use of either of two mathematical approaches to determine the ultimate numbers: the chain ratio calculation or the use of indices. See Exhibits 6.3 and 6.4 for examples applying these mathematical calculations to arrive at sales forecasts. Both mathematical approaches begin with an estimate of market potential (the number of households in the target market in Exhibit 6.3; the national market potential for a product category in Exhibit 6.4). The market potential is then multiplied by various fractional factors that, taken together, predict the portion of the overall market potential that one firm or product can expect to obtain. In Exhibit 6.3, which shows the more detailed of the two approaches, the factors reflect the appeal of the product to consumers, as measured by marketing research data, and the company’s planned marketing program.

Cautions and Caveats in Forecasting

Keys to Good Forecasting

There are two important keys to improve the credibility and accuracy of forecasts of sales and market potential. The first of these is to make explicit the assumptions on which the forecast is based. This way, if there is debate or doubt about the forecast, the assumptions can be

Exhibit 6.3
Chain Ratio Forecast: Trial of Fresh Pasta

Once Nestlé’s research on fresh pasta had been completed (see Exhibit 6.2), it used the chain ratio method to calculate the total number of households who would try their fresh pasta. The chain ratio calculation went like this:

<table>
<thead>
<tr>
<th>Research results for</th>
<th>Data from research</th>
<th>Chain ratio calculation</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of households in target market</td>
<td>77.4 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Concept purchase intent: adjusted figure from Exhibit 6.2</td>
<td>34.5% will try the product</td>
<td>77.4 million × 34.5%</td>
<td>26.7 million households will try if aware</td>
</tr>
<tr>
<td>Awareness adjustment: based on planned advertising level</td>
<td>48% will be aware of the product</td>
<td>26.7 million × 48%</td>
<td>12.8 million households will try if they find product at their store</td>
</tr>
<tr>
<td>Distribution adjustment: based on likely extent of distribution in supermarkets, given the introductory trade promotion plan</td>
<td>The product will obtain distribution reaching 70% of U.S. households</td>
<td>12.8 million × 70%</td>
<td>9.0 million will try the product</td>
</tr>
</tbody>
</table>

Similar chain ratio logic is useful in a variety of forecasting settings.

debated, and data to support the assumptions can be obtained. The resulting conversation is far more useful than stating mere opinions about whether the forecast is too high or too low.

For ACG, the combination of observational and survey forecasting methods enabled Maddy and Laguë to articulate the assumptions on which their revenue forecasts were based, and to support those assumptions with data. Their evidence-based forecast was instrumental in their obtaining US$3.5 million in start-up capital to get their venture off the ground.15

The second key to effective forecasting is to use multiple methods. When forecasts obtained by different methods converge near a common figure, greater confidence can be placed in that figure. The procedure used at Gap Inc. to forecast next-year sales (see Exhibit 6.1) is an example of such an approach. Where forecasts obtained by multiple methods diverge, the assumptions inherent in each can be examined to determine which set of assumptions can best be trusted. Ultimately, however, any forecast is almost certainly wrong. Contingency plans should be developed to cope with the reality that ultimately unfolds.16

Biases in Forecasting

Several sources of potential bias in forecasts should be recognized. First, forecasters are subject to anchoring bias, where forecasts are perhaps inappropriately “anchored” in recent historical figures, even though market conditions have markedly changed, for better or worse.17 Second, capacity constraints are sometimes misinterpreted as forecasts. Someone planning to open a car wash that can process one car every seven minutes would probably be amiss in assuming sufficient demand to actually run at that rate all the time. A restaurant chain that is able to turn its tables 2.5 times each night, on average, must still do local market research to ascertain how much volume a new restaurant will really produce. Putting similar 80-table restaurants in two trade areas with different population makeup and density, with different levels of competition, will result in varying sales levels.
Another source of bias in forecasting is incentive pay. Bonus plans can cause managers to artificially inflate or deflate forecasts, whether intentionally or otherwise. “Sandbagging”—setting the forecast or target at an easily achievable figure in order to earn bonuses when that figure is beaten—is common.

Finally, unstated but implicit assumptions can overstate a well-intentioned forecast. While 34.5 percent of those surveyed (after adjustments, as shown in Exhibit 6.2) may indicate their willingness to buy a new grocery product, such as fresh pasta, for such a forecast to pan out requires that consumers actually are made aware of the new product when it is introduced, and that the product can actually be found on supermarket shelves. Assumptions of awareness and distribution coverage at levels less than 100 percent, depending on the nature of the planned marketing program for the product, should be applied to such a forecast, using the chain ratio method (see Exhibit 6.3).

**Why Data? Why Marketing Research?**

In the first portion of this chapter, we provided several approaches to forecasting, each of which requires that data be collected. Similarly, the first five chapters of this book provided frameworks for gaining a better understanding of market and competitive conditions and of what buyers in a given market want and need—what we call market knowledge. Obtaining market knowledge also requires data, and so far we’ve provided little discussion of exactly how one might best find the necessary data. Without relevant and timely data, market knowledge is generally incomplete and often ill-informed, based perhaps on hunches or intuition that may or may not be correct.

Without adequate market knowledge, strategic marketing decisions are likely to be misguided. Products for which there is little demand may be introduced, only to subsequently fail. New markets may be entered, despite market or industry conditions that make success unlikely. Attractive product-markets may be overlooked. Products may be marketed to the wrong target market, when consumers in another market segment would like the product better. Pricing may be too high, reducing sales, or too low, leaving money on the table. Advertising and promotion monies may be poorly spent. Second-best distribution channels may be chosen. These outcomes are all too common. Most often, they result from ill- or under-informed marketing decisions. Thoughtfully designed, competently executed marketing research can mitigate the chances of such unpleasant outcomes.

Thus, in the remainder of this chapter we address the challenge of obtaining market knowledge, including the development of systems to track pertinent market information inside and outside the firm, as well as the design and implementation of more targeted studies intended to collect information about a particular marketing problem. We begin by discussing the principal kinds of market knowledge systems used in companies large and small, and we show how such systems can improve the timeliness and quality of marketing decisions.

**Market Knowledge Systems: Charting a Path toward Competitive Advantage**

Marketing is rapidly becoming a game where information, rather than raw marketing muscle, wins the race for competitive advantage. There are four commonly used market knowledge systems on which companies rely to keep pace with daily developments: internal
records regarding marketing performance in terms of sales and the effectiveness and efficiency of marketing programs, marketing databases, competitive intelligence systems, and systems to organize client contact. Effective use of such systems is likely to result in happier, higher-volume, more loyal customers. Few of these systems existed in their current form until developments in data processing and data transmission made them cost effective.

Internal Records Systems

Every Monday morning, each retail director at the headquarters of Nine West Retail Stores, a leading operator of shoe specialty stores, receives the “Godzilla Report,” a tabulation of detailed sales and inventory information about the fastest-selling items in Nine West stores from the prior week. By style and color, each director learns which items in his or her stores are selling fast and need to be reordered. A similar report provides information about all other styles currently in Nine West’s stores, so that slow sellers can be marked down or transferred to stores where those styles are in higher demand. Additional reports aggregate sales information by style and color; by merchandise category (e.g., dress or casual); by store, area, or region; and for various time periods. The information provided by these reports constitutes the backbone of Nine West’s decision making about which shoes to offer in which of its stores. Imagine how much more difficult the retail director’s job would be without today’s point-of-sale systems to collect and report such data! Imagine the potential advantage Nine West has over shoe retailers who lack such information.

Every marketer, not just retailers, needs information about “what's hot, what’s not.” Unfortunately, accounting systems generally do not collect such data. Typically, such systems just track dollars of revenue, with no information about which goods or services were sold. Thus, marketers need internal records systems to track what is selling, how fast, in which locations, to which customers, and so on. Providing input on the design of such systems so that the right data are provided to the right people at the right time is a critical marketing responsibility in any company. In some cases, such systems constitute a significant competitive advantage.

But what constitutes critical marketing information varies from company to company and industry to industry. Nine West retail directors need to know which styles and colors are selling, in which stores, at what rate. Wal-Mart believes its key suppliers need to know its store-by-store item and category sales data, so it provides password-protected online access to such data to those suppliers. Telemarketers need to know which callers are producing sales, at what times of day, for which products. Marketers of kitchen gadgets through infomercials on late-night television need to know which ads on which stations in which cities are performing, in order to place media dollars where they will be most productive. Companies selling their wares to industrial markets through outside salesforces need to know not only which products are selling to which customers but also which salespeople are selling how much, at what margins and expense rates, to whom. The salesforce, too, needs information about status of current orders, customer purchasing history, and so on. For an example of how salesforce automation software is helping modern salespeople to be more productive and more able to satisfy customer needs, see Exhibit 6.5. For those charged with developing or updating internal record systems in their companies, we provide, in Exhibit 6.6, a series of questions to help marketing decision makers specify what internally generated sales data are needed, when, for whom, in what sequence, at what level of aggregation.
Marketing Databases

Many companies have become quite sophisticated about keeping track of their customers’ purchases using marketing databases. Catalog marketers such as Lands’ End and L.L. Bean know who are their best customers and what categories they tend to buy. Online marketers like Amazon.com use “cookies,” electronic signatures placed at a customer’s personal computer, so they not only keep track of what each customer has bought, but they also recognize the customer when he or she logs on to their site. Airlines track members of their frequent flyer programs and target some with special promotions. Supermarket chains such as Safeway encourage their customers to obtain cards that give the user “clipless coupon” savings when they shop, and that permit Safeway to better understand the purchasing patterns of its customers.

Designing marketing databases that take effective advantage of customer data that companies are in a position to collect requires that several major issues be considered: the cost of collecting the data, the economic benefits of using the data, the ability of the company to keep the data current in today’s mobile society, and the rapid advances in technology that permit the data to be used to maximum advantage.

Collecting information, then storing and maintaining it, always costs money. If a company wants to know more about the demographics and lifestyles of its best customers, in addition to their purchasing histories, it must obtain demographic and lifestyle data about them. Doing so is more difficult than it sounds; most people are unwilling to spend much time filling out forms that ask nosy questions about education, income, whether they play tennis, and what kind of car they drive. The cost of collecting such information must be weighed against its value. What will be done with the information once it is in hand?

Various commercial marketing databases are available, with varying depth and quality of information. For example, the Polk Company (www.polk.com) sells data compiled from state driver’s license records in the United States, as well as a demographic and lifestyle database compiled from questionnaires returned with warranty cards for consumer durables such as toasters, stereos, and the like. Donnelley’s DQI database (www.donnelley.com) covers more than 150 million individual U.S. consumers and 90 million U.S. households and includes more than 1,600 demographic, lifestyle, purchasing power, and creditworthiness variables, among others. Claritas’s PRIZM service (Potential Rating Index for Zip Markets, www.claritas.com) classifies U.S. consumers into one of 62 distinct demographic and behavioral clusters according to the Zip code and postal carrier route where they live. Claritas and others offer a range of database marketing products.
and services in Europe and other developed regions. Virtually every credit-card issuer, magazine publisher, affinity group (e.g., United Airlines Mileage Plus members), and others who sell to or deal directly with consumers sell their customer databases. Marketers who consider buying lists or other services from any of these commercial database providers need to inquire exactly how and where the data are collected and when (Have 20 percent of the people on the list moved?). They also should compare the costs of databases containing names about which more is known (higher cost, but of higher value to targeted marketers, since response rates will be higher for names chosen on the basis of more relevant information) to the extra value, compared to simpler compiled databases, such as those taken from telephone directories or automobile registrations. Marketers planning to build their own databases need also to consider several increasingly important ethical issues, as discussed in Ethical Perspective 6.1.

For firms with deep pockets, advances in computing power and database technology, including new data-mining technology, are permitting firms to combine databases from different sources to permit a more complete understanding of any member of the database. Keeping current with what is possible in database technology is important, as technological advances often make possible that which was only a dream a short time ago.

**Competitive Intelligence Systems**

In today’s fast-paced business climate, keeping up with competitors and the changing macroenvironment is no easy task. Competitive intelligence (CI) is a systematic and ethical approach for gathering and analyzing information about competitors’ activities and related business trends. It is based on the idea that more than 80 percent of all information...
Section Two  Opportunity Analysis

142

is public knowledge. The most important sources of CI information include companies’ annual and other financial reports, speeches by company executives, government documents, online databases, trade organizations, as well as the popular and business press. The challenge is to find the relevant knowledge, analyze it, and share it with the decision makers in the organization, so they can use it. The critical questions that managers setting up a CI system should ask are

- How rapidly does the competitive climate in our industry change? How important is it that we keep abreast of such changes?
- What are the objectives for CI in our company?

New technologies relating to the gathering and use of information about consumers and their behavior, interests, and intentions raise a host of legal and ethical questions. These new technologies have the potential to harm individuals when such information “is used without their knowledge and/or consent, leading them to be excluded from or included in activities in such a way that they are harmed economically, psychologically, or physically. Examples include the improper disclosure of a person’s credit rating, denying medical insurance to an individual based on confidential information, and a person’s being placed on target lists for direct mail and telemarketing. The depth of privacy concerns varies from country to country, a critical issue for Internet marketers, given their global reach.

Ethical issues in marketing research stem, in large part, from the interaction between the researcher and respondents, clients, and the general public. For instance, respondents should not be pressured to participate, should have the right to remain anonymous, and should not be deceived by fake sponsorship.

Client issues involve the confidentiality of the research findings and the obligation to strive to provide unbiased and honest results regardless of client expectations. The public is very much involved when they are exposed to a sales solicitation disguised as a marketing research study or issuing from data obtained from “volunteer surveys” using write-ins or call-ins.

In discussing the reliability of, and ethical issues involved with, marketing research studies, a Wall Street Journal article noted that many studies “are little more than vehicles for pitching a product or opinion.” An examination of hundreds of recent studies indicated that the business of research has become pervaded by bias and distortion. More studies are being sponsored by companies or groups with a financial interest in the results. This too often leads to a bias in the way questions are asked.

Because of shortages in time and money, sample sizes are being reduced to the point that, when groups are further broken into subgroups, the margin of error becomes unacceptable—assuming a probability sample was used. In addition to sample size, the way the sampling universe is defined can bias the results. Thus, in a Chrysler study showing that people preferred Chrysler’s cars to Toyota’s, a sample of only 100 respondents was used in each of two tests, and none owned a foreign car. Thus, the respondents may well have been biased in favor of U.S. cars.

In addition to the problems noted above, subjective sampling procedures often are used, data analysis may be flawed, or only the best conclusions are reported. Frequently researchers are hired whose views on the subject area being researched are known to be similar to those of the client. In an attempt to regulate the marketing research industry, several codes of conduct and ethics have been developed. These include published codes by the American Marketing Association, the American Association for Public Opinion Research, the Marketing Research Association, and the Council of American Survey Research Organizations.

Who are the best internal clients for CI? To whom should the CI effort report?
What budget should be allocated to CI? Will it be staffed full- or part-time?

In companies that operate in industries with dynamic competitive contexts, the use of full-time CI staff is growing.

**Client Contact Management Systems**

Several low-cost software applications that run on PCs are available to keep track of client lists and the various kinds of contacts that are made with each client. ACT and Goldmine are two of the best-known programs in this arena. These programs keep track of clients’ names, addresses, phone and fax numbers, and so on—along with all kinds of personal tidbits, such as their spouse’s and children’s names and the kind of wine the client likes to drink—and they also provide an organized way to make notes about each contact with the customer. They also can remind the user when it is time to follow up with the customer on a topic left pending. Most whose livelihood depends on face-to-face selling now use such systems to keep themselves organized.

**Other Kinds of Market Knowledge Systems**

We have covered but a few of the most common market knowledge systems, most of which are computer applications in today’s increasingly sophisticated data-driven age. These tools make marketers better informed about their customers, potential customers, and competitors and help them be more productive, both of which help establish and sustain competitive advantage. New applications are being developed every day. Ultimately, the potential that many of these systems share is to enable marketers to serve target markets of one; that is, to know enough about any given customer and the competitive context that an offering can be tailored to fit each customer so well that the customer’s needs are met perfectly. Doing so is many a marketer’s dream!

**Marketing Research: A Foundation for Strategic Decision Making**

We now turn briefly to the *marketing research* task: the design, collection, analysis, and reporting of research intended to gather data pertinent to a *particular* marketing challenge or situation. The word *particular* is very important. Marketing research is intended to address carefully defined marketing problems or opportunities. Research carried out without carefully thought-out objectives usually means time and money down the tubes! Some marketing problems commonly addressed through marketing research include tracking customer satisfaction from unit to unit or year to year (*tracking studies*); testing consumer responses to elements of marketing programs, such as prices or proposed advertising campaigns; and assessing the likelihood that consumers will buy proposed new products.

The steps in the marketing research process are shown in Exhibit 6.7. As this exhibit shows, the marketing research process is fraught with numerous opportunities for error. That’s why it’s so important that all who play influential roles in setting strategy for their firms or who use marketing research results for decision making be well-informed and critical users of the information that results from market research studies.

It is beyond the scope of this book, however, to instruct the reader in how to design
marketing research studies. For those wishing to read more on this topic, numerous textbooks on marketing research are available. In Exhibit 6.8, we do suggest a variety of sources where secondary data may be obtained to assess the attractiveness of markets and industries, two important tasks for any strategic marketing decision maker.

**WHAT USERS OF MARKETING RESEARCH SHOULD ASK**

The research process described in Exhibit 6.7 makes clear where many of the potential stumbling blocks are in designing and conducting marketing research. The informed and critical user of marketing research should ask the following questions, ideally before implementing the research or, if necessary, subsequent to its completion, to ensure that the research is unbiased and the results are reliable.

1. **What are the objectives of the research?** Will the data to be collected be sufficient to meet those objectives?

2. **Are the data sources appropriate?** Are cheaper, faster secondary data used where possible? Is qualitative research planned to ensure that quantitative research, if any, is on target?

3. **Are the planned qualitative and/or quantitative research approaches suited to the objectives of the research?** Qualitative research is better for deep insights into consumer behavior, while quantitative research is better for measurement of a population’s attitudes and likely responses to products or marketing programs.

4. **Is the research designed well?** Will questionnaire scales permit the measurement necessary to meet the research objectives? Are the questions on a survey or in an interview or focus group unbiased? (“Isn’t this a great new product? Do you like it?”) Do the contact method and sampling plan entail any known bias? Is the sample size large enough to meet the research objectives?

5. **Are the planned analyses appropriate?** They should be specified before the research is conducted.
Chapter Six  Measuring Market Opportunities

Exhibit 6.8
Some Information Sources for Market and Industry Analysis

<table>
<thead>
<tr>
<th>Type of information</th>
<th>Library sources</th>
<th>Internet sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>To find trade associations and trade magazines</td>
<td>Gale Directory of Publications; Encyclopedia of Associations</td>
<td><a href="http://www.gale.com">www.gale.com</a></td>
</tr>
<tr>
<td>Information on specific companies</td>
<td>Hoover’s Handbook of American Business; Ward’s Business Directory; Dun and Bradstreet Million Dollar Directory; Moody’s Industrial Manual</td>
<td><a href="http://www.hoovers.com">www.hoovers.com</a></td>
</tr>
<tr>
<td>U.S. demographic and lifestyle data</td>
<td>Lifestyle Market Analyst</td>
<td><a href="http://www.census.gov">www.census.gov</a></td>
</tr>
<tr>
<td>International demographics and world trade</td>
<td>Predicasts F&amp;S Index United States, Europe and International</td>
<td></td>
</tr>
<tr>
<td>Macrotrends</td>
<td>Statistical Abstract of the United States; Business Periodicals Index</td>
<td><a href="http://www.stat-usa.gov">www.stat-usa.gov</a></td>
</tr>
<tr>
<td>E-commerce</td>
<td>Red Herring magazine</td>
<td><a href="http://www.cyberatlas.com">www.cyberatlas.com</a></td>
</tr>
<tr>
<td>Proprietary providers of research reports</td>
<td></td>
<td><a href="http://www.emarketer.com">www.emarketer.com</a></td>
</tr>
<tr>
<td>Market share information</td>
<td>Market Share Reporter</td>
<td><a href="http://www.dis.strath.ac.uk/business">www.dis.strath.ac.uk/business</a></td>
</tr>
<tr>
<td>Clearinghouse of business information sites</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average financial statements by industry</td>
<td>Annual Statement Studies, Risk Management Association, formerly Robert Morris and Associates</td>
<td><a href="http://www.rmahq.org/ann_studies/asstudies.html">www.rmahq.org/ann_studies/asstudies.html</a></td>
</tr>
</tbody>
</table>

Given the rate of change on the Web, some Internet addresses may change, and some print sources may add websites.

Source: Robert I. Berkman, Find It Fast: How to Uncover Expert Information on Any Subject in Print or Online (New York: HarperCollins, 1997); various Web addresses as listed above.

**Take Aways**

- Every forecast and estimate of market potential is wrong! Evidence-based forecasts and estimates, prepared using the tools provided in this chapter, are far more credible—and generally more accurate—than hunches or wild guesses. A menu of evidence-based forecasting approaches is provided in this chapter.
Forecasts have powerful influence on what companies do, through budgets and other planning procedures. Thus, forecasting merits significant management attention and commitment.

Superior market knowledge is not only an important source of competitive advantage, but it also results in happier, higher-volume, and more loyal customers. Thus, the systematic development of market knowledge is a critically important activity in any organization.

Endnotes


3. Ibid.


16. A key challenge for manufacturers is to be able to quickly adjust production schedules to adapt to demand that differs from the forecast. To read more about how to enable production to respond quickly in the face of unforeseen changes in demand, see Marshall L. Fisher, Janice H. Hammond, Walter R. Obermeyer, and Ananth Raman, “Making Supply Meet Demand in an Uncertain World,” Harvard Business Review, May–June 1994.


19. Welch and Raman, Merchandising at Nine West Retail Stores.


22. For more on marketing research, see any business school marketing research text, such as Dillon, Madden, and Firtle, Marketing Research in a Marketing Environment (Burr Ridge, IL: Irwin/McGraw-Hill, 1993). Also see Pamela L. Akrebeck and Robert B. Settle, The Survey Research Process (Burr Ridge, IL: Irwin/McGraw-Hill, 1994). The survey research methods section of the American Statistical Association offers useful guides to conducting focus groups and surveys. Downloadable PDF files may be found at www.stat.ncsu.edu/info/srms/srms.html.
Michael Budowski likes living on the edge. In September 1999, it occurred to him that the Super Bowl offered an opportunity to “Put a turbocharger in this company,” as he put it. In early 1999, Budowski had convinced his wife Susan, who ran a small business as a wedding consultant out of their home, to expand into cyberspace. They soon launched the OurBeginning website, where customers could order wedding announcements, thank you notes, and other printed matter. Now, in September, with the Super Bowl looming, Budowski saw an opportunity to put his company on the map and quickly establish his brand. The Super Bowl was the top-rated TV show of the year, with an expected viewing audience of 135 million people.

A Significant Investment

A successful entrepreneur with interests in the restaurant industry and the exterminating business, CEO Budowski and investor and COO Michael Brandenburg spent three weeks obtaining loans and selling equity to fund their $5 million gamble. They would need $1 million to beef up the site so it could handle an anticipated two million users a day, far beyond its average of only 10,000 per day. They would pay Disney i.d.e.a.s., a unit of the Walt Disney Company, another $1 million to create a series of funny ads out of the seemingly staid topic of stationery and wedding invitations. And they would spend $3 million to run three pregame ads and a fourth spot during the game. For his $5 million, Budowski hoped to create a database of five million customers (many of whom would have heard about the site while watching the big game), establish brand recognition, and jumpstart his sales.

Budowski was not the only dot-com entrepreneur who saw the Super Bowl as a path to riches. Two dot-com companies, Monster.com and HotJobs.com, had made big splashes the year before with clever Super Bowl ads, and HotJobs had, in August, successfully completed a successful initial public offering of its stock. After a month of trading, the stock had tripled. For the upcoming game on January 30, 2000, more than a dozen dot-com companies had made plans similar to Budowski’s, notwithstanding the $2.2 million average cost to run a single 30-second TV commercial.
**Measuring the Results**

So, what happened? Did the flurry of Super Bowl ads take these companies where they wanted to go? According to a study by Nielsen/NetRatings, the dot-com Super Bowl ads did not necessarily translate into sustained increases in Web traffic. For established Web brands, the ads seemed to have helped hold and increase their Web traffic. Comparing traffic in January and March, Monster.com traffic was up 6 percent, to 2.6 million unique visitors in March; E-Trade.com was up 18 percent; and Pets.com was up 7 percent (see Exhibit 7.1). For Britannica, an established offline brand still new to the Web, traffic was up 68 percent to just over one million unique visitors in March. For unknown newcomers like OurBeginnings, however, the story was mostly dismal. While AutoTrader.com had done well, with a traffic increase of 45 percent to almost 1.6 million unique visitors, most newcomers, as a lot, had generated small numbers of new visitors, especially in light of the spending it took to generate them. For most of them, including OurBeginning.com, the Super Bowl–generated spike in February traffic had fallen off sharply in March.

**Exhibit 7.1**

**Traffic at Websites of Dot-com Advertisers: Super Bowl 2000**

<table>
<thead>
<tr>
<th>Site</th>
<th>Unique Audience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Site</td>
<td>January</td>
</tr>
<tr>
<td>Monster.com</td>
<td>2,465,104</td>
</tr>
<tr>
<td>E-Trade.com</td>
<td>1,877,011</td>
</tr>
<tr>
<td>AutoTrader.com</td>
<td>1,099,489</td>
</tr>
<tr>
<td>WebMD.com</td>
<td>1,041,583</td>
</tr>
<tr>
<td>LifeMinders.com</td>
<td>1,207,055</td>
</tr>
<tr>
<td>Britannica.com</td>
<td>594,468</td>
</tr>
<tr>
<td>Pets.com</td>
<td>592,029</td>
</tr>
<tr>
<td>HotJobs.com</td>
<td>794,933</td>
</tr>
<tr>
<td>OnMoney.com</td>
<td>NA</td>
</tr>
<tr>
<td>Kforce.com</td>
<td>167,355</td>
</tr>
<tr>
<td>Netpliance.com</td>
<td>38,395*</td>
</tr>
<tr>
<td>OurBeginning.com</td>
<td>284,049</td>
</tr>
<tr>
<td>LastMinuteTravel.com</td>
<td>50,474*</td>
</tr>
<tr>
<td>Computer.com</td>
<td>68,468*</td>
</tr>
<tr>
<td>Epidemic.com</td>
<td>77,131*</td>
</tr>
<tr>
<td>Agillion.com</td>
<td>NA</td>
</tr>
</tbody>
</table>

NA—Fewer than 10 visitors.

* Below statistically stable total. From: Nielsen/NetRatings survey of 50,000 Web surfers.

Of course, some would argue that traffic counts only tell part of the story. Huge media coverage of the dot-com phenomena placed many of these companies’ names in the popular and business press, in both print and broadcast media. OurBeginning.com received more than 450 print mentions and 100 broadcast hits. Others would say that the Super Bowl exposure would make it easier for them to raise venture capital, a task growing more difficult by the day in 2000, as the dot-com financing window nearly slammed shut. These advertisers and their agencies used these explanations to put a brave face on the results.

But those who would assess the effectiveness of these Super Bowl ads in consumer marketing terms would prefer to use as metrics either the relationships between ad spending and the revenue dollars they generated—never mind margin dollars—or the per-customer cost of acquiring new customers. Let’s look at OurBeginning.com’s results. First, traffic. In the first quarter, January through March, their site had, according to their own reports, one million unique visitors, a figure not dramatically dissimilar to the Nielsen figure of 882,000 visitors (see Exhibit 7.1). At two million total hits, this traffic represented an average of just over 20,000 hits per day, up from 10,000 per day in the fall of 1999. While traffic was indeed up, the Super Bowl effort seemed to have fallen well short of Budowski’s goal of building a five-million-customer database. What about sales, you ask? The one million visitors spent a total of $510,000 in the first quarter, a figure equal to approximately one-tenth of the marketing expense it took to generate these sales. If a typical customer spent $50 to $100—an educated guess—OurBeginning.com acquired perhaps 5,000 to 10,000 customers, at a cost of $5 million. These figures translate into a customer acquisition cost of $500 to $1,000 per customer.

Was it worth it? Are new customers worth this cost? Did Budowski’s $5 million bet pay off? Time will tell whether those who learned of his site from the Super Bowl ads and the attendant publicity will buy enough wedding invitations, birth announcements, and other things OurBeginning.com sells to make the effort worthwhile. What if they don’t? “It doesn’t fold the company,” he says. “I like living on the edge, but not that close to the edge.”

**STRATEGIC CHALLENGES ADDRESSED IN CHAPTER 7**

OurBeginning.com’s Super Bowl advertising is but one example of the many cases where naïve marketers fail to clearly identify the target market most likely to purchase their goods or services. In doing so, they risk wasting enormous resources by paying to deliver promotional messages to customers who are unlikely to buy what they have to sell. While some Super Bowl viewers undoubtedly fell into the demographic group most likely to need wedding invitations, birth announcements, and related products, most in that very broad audience did not. The problem for Budowski was that each set of eyeballs had to be paid for, whether they fell into the target market or not.

In Chapter 7, we draw on the foundation of market knowledge and customer understanding that the reader of the first six chapters is now able to assemble to introduce what are probably the most important and fundamental tools in the marketer’s toolkit: market segmentation and target marketing. Together with product positioning, which we address in Chapter 8, these tools provide the platform upon which most effective marketing programs are built. Learning to apply these tools effectively, however, requires that several important questions be addressed. Why do market segmentation and target marketing make sense; why not pitch our wares to the widest possible audience, as did Michael Budowski during Super Bowl 2000? Second, how can potentially attractive market segments be identified and defined? Finally, how can these segments be prioritized so that the most attractive ones are pursued? Answering these questions should enable any
entrepreneur, a venture capital investor in Silicon Valley, or a marketing manager in an established firm to decide which market segments should be targeted and which investments should be made.

**WHY DO MARKET SEGMENTATION AND TARGET MARKETING MAKE SENSE?**

Market segmentation is the process by which a market is divided into distinct subsets of customers with similar needs and characteristics that lead them to respond in similar ways to a particular product offering and marketing program. Target marketing requires evaluating the relative attractiveness of various segments (in terms of market potential, growth rate, competitive intensity, and other factors) and the firm’s mission and capabilities to deliver what each segment wants, in order to choose which segments it will serve. Product positioning entails designing product offerings and marketing programs that collectively establish an enduring competitive advantage in the target market by creating a unique image, or position, in the customer’s mind. Arguably, OurBeginning.com would have been better served by examining its early customer base, or other customers it sought to serve, to determine who comprised its target market and how that market could best be reached—in terms of effectiveness and efficiency—with promotional strategies intended to win new customers.

These three decision processes—market segmentation, target marketing, and positioning—are closely linked and have strong interdependence. All must be well considered and implemented if the firm is to be successful in managing a given product-market relationship. More often than not, successful companies have been able to manage this relationship and, in so doing, distance themselves from their competitors. Consider the following international example.2

In England, Japanese companies have outperformed their British rivals across a range of industries. A major reason for this was that the Japanese were better at managing the segmentation, targeting, and positioning relationships. Thus, only 13 percent of the Japanese firms versus 47 percent of the British were unclear about their target segment of customers and their special needs.

All too often the marketing directors of the British companies remarked that they see their target market as being the whole market and since their products had wide appeal, there was no need to segment the market. As a consequence, the Japanese concentrated their resources in specific high-potential segments while the British tended to spread theirs thinly across the entire market. When British companies did segment, they did so at the lower, cheaper end of the market. This resulted in customers increasingly perceiving the Japanese, in contrast to the British, as offering quality and status.

However large the firm, its resources are usually limited compared with the number of alternative market segments available for investment. Thus, a firm must make choices. Even in the unusual case where a firm can afford to serve all market segments, it must determine the most appropriate allocation of its marketing effort across segments. But are all these analyses and conscious choices about which segments to serve really necessary?

**Most Markets Are Heterogeneous**

Because markets are rarely homogeneous in benefits wanted, purchase rates, and price and promotion elasticities, their response rates to products and marketing programs differ. Variation among markets in product preferences, size and growth in demand, media habits,
and competitive structures further affect the differences and response rates. Thus, markets are complex entities that can be defined (segmented) in a variety of ways. The critical issue is to find an appropriate segmentation scheme that will facilitate target marketing, product positioning, and the formulation of successful marketing strategies and programs. Many dot-com advertisers who invested considerable sums in Super Bowl ads in 2000, only to win minimal consumer response, now recognize that broadly targeted advertising that fails to identify and reach a properly focused target market is a roadmap to bankruptcy. Of course, some of these advertisers would say that their real purpose was to reach venture capital investors or others who might eventually buy their stock in a hoped-for IPO. Was the Super Bowl a cost-effective way to reach these target markets with their message? History—not to mention sound marketing practice—suggests otherwise.

Today’s Market Realities Often Make Segmentation Imperative

Market segmentation has become increasingly important in the development of marketing strategies for several reasons. First, population growth has slowed, and more product-markets are maturing. This sparks more intense competition as firms seek growth via gains in market share (the situation in the automobile industry) as well as in an increase in brand extensions (Starbucks coffee ice cream, Colgate toothbrushes, Visa traveler’s checks).

Second, such social and economic forces as expanding disposable incomes, higher educational levels, and more awareness of the world have produced customers with more varied and sophisticated needs, tastes, and lifestyles than ever before. This has led to an outpouring of goods and services that compete with one another for the opportunity of satisfying some group of consumers.

Third, there is an increasingly important trend toward microsegmentation in which extremely small market segments are targeted. This trend has been accelerated in some industries by new technology such as computer-aided design, which has enabled firms to mass-customize many products as diverse as designer jeans and cars. For example, many automobile companies are using a flexible production system that can produce different models on the same production line. This enables the company to produce cars made to order and soon, perhaps, sell them on the Internet.

Finally, many marketing organizations have made it easier to implement sharply focused marketing programs by more sharply targeting their own services. For example, many new media have sprung up to appeal to narrow interest groups. These include special interest magazines, such as Backpacker and Working Mother; radio stations with formats targeted to different demographic groups, such as classical music, rock, country, and jazz, not to mention talk shows of various kinds; and cable TV channels, such as Nickelodeon and the Filipino Channel. Also, more broad-based magazines such as Newsweek, Sports Illustrated, and People offer advertisers the opportunity to target specific groups of people within their subscription base. An advertiser can target specific regions, cities, or Zip codes, or even selected income groups.

In addition to forcing firms to face the realities of the marketplace, market segmentation offers the following benefits:

- It identifies opportunities for new product development. Often a careful analysis of various segments of potential customers reveals one or more groups whose specific needs and concerns are not being well-satisfied by existing competitive offerings. Such uncovered segments may represent attractive opportunities for development of new products or innovative marketing approaches: for example, the laptop computer.
It helps in the design of marketing programs that are most effective for reaching homogeneous groups of customers.

It improves the strategic allocation of marketing resources. The strategic benefits of segmentation are sometimes overlooked. Well-defined segments, when coupled with specific products, serve as potential investment centers for a business. Most successful business strategies are based on market segmentation and a concentration of resources in the more attractive segments. Segmentation should focus on subdividing markets into areas in which investments can gain a long-term competitive advantage.

### How Are Market Segments Best Defined?

There are several important objectives entailed in the market segmentation process:

- The process should identify one or more relatively homogeneous groups of prospective buyers with regard to their wants and needs and/or their likely responses to differences in the elements of the marketing mix—the 4 Ps (product, price, promotion, and place). For marketers of athletic shoes, such as Nike and Adidas, for example, high-performance distance runners is such a segment.

- Differences within one market segment should be small compared to differences across various segments (most high-performance distance runners probably have athletic footwear needs that are quite similar to one another, but quite different from, say, the needs of basketball players).

- The segmentation criteria should measure or describe the segments clearly enough so that members can be readily identified and accessed, in order for the marketer to know whether a given prospective customer is or is not in the target market and in order to reach the prospective customer with advertising or other marketing communication messages. Nike or Adidas might have defined their initial target market as being comprised of members of running clubs or distance runners on collegiate track and cross-country teams.

- Finally, the segmentation process should determine the size and market potential of each segment for use in prioritizing which segments to pursue, a topic we address in more detail later in this chapter. Nike, for example, could easily ascertain how many such runners there were in the United States, and they probably knew how many pairs of shoes per year the typical distance runner bought, at what average price.

Given these objectives, what kinds of segmentation criteria, or descriptors, are most useful? Marketers divide segmentation descriptors into three major categories for both consumer and organizational markets: **demographic descriptors** (which reflect who the target customers are), **geographic descriptors** (where they are), and **behavioral descriptors** of various kinds (how they behave with regard to their use and/or purchases of a given category of goods or services). We examine each of these categories next.

### Demographic Descriptors

While firm demographics (age of firm, size of firm, industry, etc.) are useful in segmenting organizational markets, we usually think of demographics in terms of attributes of individual consumers, as shown in Exhibit 7.2. Some examples of demographic descriptors used to segment consumer markets are as follows:

*Age*: “Thanks to a demographic trend that is being called ‘invasion of the stroller people,’ babies are hot, both as consumers and marketing tools.” There are nearly 24 million children under five in the United States—20 percent more than in 1980. Aside from medical costs, new parents spend on average $7,000 on a baby’s first year. Nike has announced a new line of toddler clothes.\(^5\)
**Exhibit 7.2**

**Some of the More Commonly Used Demographic Descriptors***

<table>
<thead>
<tr>
<th>Demographic descriptors</th>
<th>Examples of categories</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td>Under 2, 2–5, 6–11, 12–17, 18–24, 25–34, 35–49, 50–64, 65 and over</td>
</tr>
<tr>
<td>Sex</td>
<td>Male, female</td>
</tr>
<tr>
<td>Household life cycle</td>
<td>Young, single; newly married, no children; youngest child under 6; youngest child 6 or over; older couples with dependent children; older couples without dependent children; older couples retired; older, single</td>
</tr>
<tr>
<td>Income</td>
<td>Under $15,000, $15,000–24,999; $25,000–74,999, etc.</td>
</tr>
<tr>
<td>Occupation</td>
<td>Professional, manager, clerical, sales, supervisor, blue collar, homemaker, student, unemployed</td>
</tr>
<tr>
<td>Education</td>
<td>Some high school, graduated high school, some college, graduated college</td>
</tr>
<tr>
<td>Events</td>
<td>Birthdays, graduations, anniversaries, national holidays, sporting events</td>
</tr>
<tr>
<td>Race and ethnic origin</td>
<td>Anglo-Saxon, African-American, Italian, Jewish, Scandinavian, Hispanic, Asian</td>
</tr>
</tbody>
</table>

*Others include marital status, home ownership, and presence and age of children.

**Sex:** Recently General Motors’ Chevrolet division spent considerable funds on advertising and events to convince women that its cars are made with them in mind. Chevrolet’s efforts recognize that women spend $85 billion annually in buying half of all the new cars purchased in the United States.6

**Household life cycle:** Formerly known as family life cycle, this concept has been “modernized” by incorporating nontraditional households such as single-parent and never-married singles households. Essentially it describes the stages in the formation, growth, and decline in a household unit. Each stage differs in its expenditure patterns. Thus, young marrieds are heavy buyers of small appliances, furniture, and linens. With the arrival of children, purchases include insurance, washers and dryers, medical care, and an assortment of child-oriented products. A recent study confirmed that transitions in household situations are related to meaningful changes in spending behavior, but that it is often difficult to relate these changes to the purchase of specific products.7

**Income:** Higher-income households purchase a disproportionate number of cellular phones, expensive cars, and theater tickets. The circulation and advertising of magazines targeting the rich have increased dramatically in recent years—for example, *The Robb Report*, a monthly magazine whose readers have an average income of $755,000.8

**Occupation:** The sales of certain kinds of products (e.g., work shoes, automobiles, uniforms, and trade magazines) are tied closely to occupational type. The increase in the number of working women has created needs for specialized goods and services including financial services, business wardrobes, convenience foods, automobiles, and special-interest magazines.

**Education:** There is a strong positive correlation between the level of education and the purchase of travel, books, magazines, insurance, theater tickets, and photographic equipment.

**Events:** These include a varied set of activities ranging from national holidays, sports, and back-to-school week, to personal events such as birthdays, anniversaries, and weddings. Each requires a specific marketing program.

**Race and ethnic origin:** More and more companies are targeting these segments via specialized marketing programs. Motorola has run separate advertising campaigns for its pagers and cellular phones to African-Americans, Asian-Americans, and Hispanics. Spiegel and *Ebony* magazine have combined to produce a direct-mail catalog designed to provide apparel that meets the style, color, and fit needs of African-Americans. Efforts, so far, have been successful.9

Demographic descriptors are also important in the segmentation of industrial markets, which are segmented in two stages. The first, macrosegmentation, divides the market according to the characteristics of the buying organization using such descriptors as age of
firm, firm size, and industry affiliation (SIC code). The international counterpart of SIC is the trade-category code.

The second stage, microsegmentation, groups customers by the characteristics of the individuals who influence the purchasing decision—for instance, age, sex, and position within the organization. International markets are segmented in a similar hierarchical fashion, starting with countries, followed by groups of individuals or buying organizations.

Geographic Descriptors

Different locations vary in their sales potential, growth rates, customer needs, cultures, climates, service needs, and competitive structures, as well as purchase rates for a variety of goods. For example, more pickup trucks are sold in the southwest United States, more vans in the Northeast, and more high-priced imports in the West. Uni-Marts, Inc., a convenience store operator of over 400 stores, focuses on small towns and rural areas, thereby avoiding big competitors. In its 23-year history, it has yet to record a loss.10

Geographic segmentation is used in both consumer and organizational markets and is particularly important in retailing and many services businesses, where customers are unwilling to travel very far to obtain the goods or services they require. Thus, one way to segment retail markets is by distance or driving time from a particular location. The area included within such a geographically defined region is called a trade area.

In the brave new world of electronic commerce, geographic segmentation issues can be very important, given the global reach of the Internet. For an example of how one online auction site is segmenting and targeting the European market country by country, see Exhibit 7.3.

From Jim Rose’s office in London, more than 5,000 miles from Silicon Valley, eBay doesn’t look so invincible. Rose, chief executive officer of QXL.com, believes that thinking global means thinking local. Unlike eBay, QXL lets established retailers as well as ordinary consumers pitch their wares, to make relatively inexperienced European net surfers more comfortable with the online auction game.

Rather than fielding a single website for the European continent, QXL moved from its 1997 start in the United Kingdom to a dozen countries by 2000. In some, it launched a new site; in others it bought an already established player. Says Rose, “We’re operating in 12 different languages. That means 12 different currencies, too.” Though the QXL logo looks identical on each country’s site, the merchandise featured on the sites’ front pages varies substantially. On its German site, for example, a travel agency might be auctioning a vacation package to Majorca, a destination popular with German travelers. “You would never find that on the list for a U.K. promotion,” says Stanislaus Laurent, a 31-year-old Frenchman and QXL’s senior vice president of sales and marketing. “In the U.K. it would be Madrid, or maybe St. Lucia.” To ensure that each site effectively targets local preferences and needs, each one has its own office and staff that customizes what QXL offers and oversees local marketing efforts.

Is QXL’s segmented, targeted approach working? “QXL is painfully slow and antiquated compared with eBay,” says Heather Gardner, a British bank clerk who sells antiques and collectibles online. But she points out that her merchandise sells better on QXL than it does on eBay’s U.K. site. “For some reason, I get the sales there,” she says. Whether QXL’s targeted, segmented approach will win the war against eBay has yet to be determined. As Jim Rose says, “The issue is how you execute.”

Geodemographic Descriptors

Many segmentation schemes involve both demographic and geographic factors. Thus, retailers usually want to know something about the people who live within, say, a two-mile or five-mile radius of their proposed new store. Neiman Marcus, the upscale department store, might target one demographic group within a given trade area, and Wal-Mart, a discounter, might target another. National Decision Systems (www.ends.com) and other sources offer low-cost reports based on census data that show the demographic profile of the population residing within any given radius of a particular street corner or shopping center location. These reports are useful in assessing the size and market potential of a market segment defined by a particular trade area. Geodemographics also attempts to predict consumer behavior by making demographic, psychographic, and consumer information available at the block and Zip code levels. Claritas’s PRIZM service classifies all U.S. households into 62 demographically and behaviorally distinct clusters, each of which, in turn, is assigned to one of 15 social groups.11

Behavioral Descriptors

There is no limit to the number of insightful ways successful marketers have segmented markets in behavioral terms. Nike originally targeted high-performance distance runners. Specialized and Gary Fisher target bicyclists who wish to ride on single-track trails or back-country terrain. Europe’s EasyJet airline targets leisure travelers. Gatorade’s original target market consisted of athletes who needed to replenish water and salts lost through perspiration. This simple segmentation scheme created a whole new category of “sports beverages,” which now includes entries from Coke (Powerade) and Pepsi (All Sport), though Gatorade still dominates the category with an 80 percent market share. This one-time niche market has grown into a $2.2 billion market in the United States alone.12 These examples all demonstrate the power of highly specific behavioral descriptors in defining sharply focused market segments, based not on who the target consumers are or where they live, but based on what they do. In virtually every consumer and organizational market there are probably segments like these just waiting to be identified and targeted by insightful marketers. Behavioral descriptors can take many forms, including those based on consumer needs; on more general behavioral patterns, including lifestyle or social class; and, in organizational markets, on the structure of firms’ purchasing activities and the types of buying situations they encounter.

Consumer Needs Customer needs are expressed in benefits sought from a particular product or service. Individual customers do not have identical needs and thus attach different degrees of importance to the benefits offered by different products. In the end, the product that provides the best bundle of benefits—given the customer’s particular needs—is most likely to be purchased.

Since purchasing is a problem-solving process, consumers evaluate product or brand alternatives on the basis of desired characteristics and how valuable each characteristic is to the consumer—choice criteria. Marketers can define segments according to these different choice criteria in terms of the presence or absence of certain characteristics and the importance attached to each. Firms typically single out a limited number of benefit segments to target. Thus, for example, different automobile manufacturers have emphasized different benefits over the years, such as safety (presence of side door airbags), reliability, and high mileage versus styling, quickness, and status.

In organizational markets, customers consider relevant benefits that include product performance in different use situations. For example, some super computers are bought
because they meet the high-speed computational requirements of a small group of customers such as governments, universities, and research labs. Other considerations in the purchase of industrial products/services include on-time delivery, credit terms, economy, spare parts availability, and training.

**Product-Related Behavioral Descriptors** In addition to highly specific behavioral descriptors such as those just discussed, there are more general product-related descriptors as well. They include product usage, loyalty, purchase predisposition, and purchase influence, all of which can be used to segment both consumer and industrial markets. **Product usage** is important because in many markets a small proportion of potential customers makes a high percentage of all purchases. In organizational markets, the customers are better known, and heavy users (often called *key accounts*) are easier to identify.

With respect to **loyalty**—as reflected by the numbers of successive purchases made over time—current users can vary considerably in their purchases of a given brand or patronage of a particular supplier. In organizational markets, sellers can often observe this directly; in consumer markets, identifying loyal customers requires marketing research. Consumers hold different predispositions toward the purchase of a product. A market segmentation scheme based on product knowledge (are they aware of it?) and **purchase predisposition** can identify the nonusers who are most likely to become future buyers. For example, knowledgeable nonusers who state intentions to buy, say, a high-fiber cereal are the most likely to become future users. Knowledgeable nonusers who do not intend to buy, on the other hand, would probably represent a low potential.

Market segmentation based on sources of **purchase influence** is relevant for both consumer and organizational markets. Many products used by various family members are purchased by the wife, but joint husband–wife decisions are becoming more common. Children’s products, prescription drugs, and gifts are clearly influenced by a variety of individuals. In organizational markets, several individuals or units with varying degrees of influence participate in the buying center.

**General Behavioral Descriptors** More general behavioral descriptors, including lifestyle and social class, are also commonly used in consumer markets. In organizational markets, prospective customers differ in how they structure their purchasing activities and in the nature of the buying situations they are engaged in.

**Lifestyle** Segmentation by lifestyle, or psychographics, groups consumers on the basis of their activities, interest, and opinions. From such information it is possible to infer what types of products and services appeal to a particular group, as well as how best to communicate with individuals in the group.

Various segmentation approaches based on lifestyle have been developed, either by companies seeking to segment their own markets or by service providers whose tools are available to anyone. For example, Goodyear Tire and Rubber and Ogilvy and Mather (an advertising agency), working separately, have developed several classifications for global lifestyle segments. The Goodyear effort consists of six groups: the prestige buyer, the comfortable conservative, the value shopper, the pretender, the trusting patron, and the bargain hunter. Ogilvy and Mather proposes 10 global segments based on lifestyle characteristics: basic needs, fairer deal, traditional family life, conventional family life, look-at-me, somebody better, real conservatism, young optimist, visible achiever, and socially aware.

Stanford Research Institute (SRI) has created an improved U.S. segmentation service (called VALS 2), which builds on the concept of self-orientation and resources for the individual. **Self-orientation** is based on how consumers pursue and acquire products and services that provide satisfaction and shape their identities. In doing so, they are motivated by...
the orientations of principle, status, and action. Principle-oriented consumers are motivated by abstract and idealized criteria, while status-oriented consumers shop for products that demonstrate the consumer’s success. Action-oriented consumers are guided by the need for social or physical activity, variety, and risk taking.

Resources include all of the psychological, physical, demographic, and material means consumers have to draw on. They include education, income, self-confidence, health, eagerness to buy, intelligence, and energy level—on a continuum from minimal to abundant.

Based on these two dimensions, VALS 2 defines eight segments that exhibit distinctive behavior and decision making: actualizers, fulfillers, achievers, experiencers, believers, strivers, makers, and strugglers. The segments are approximately the same size so as to represent viable market targets. Claritas and similar commercial organizations identify each of the respondents as to their VALS type, thereby permitting a cross-classification of VALS type with the product usage and personal information collected by such companies. Thus, users can determine what each VALS segment bought, what their media habits are, and similar data. The VALS system has been further developed in Europe and Asia. Those interested in the VALS segmentation scheme can complete a short survey on the VALS website (log onto http://future.sri.com/VALS/VALSindex.shtml) and discover the VALS segment to which they belong.

Social Class Every society has its status groupings based largely on similarities in income, education, and occupation. Because researchers have long documented the values of the various classes, it is possible to infer certain behavior concerning a given product. For example, the middle classes tend to place more value on education, family activities, cleanliness, and being up-to-date than do lower-class families. In the international field, one has to be careful in using social class as a segmentation variable since the differences among classes can become blurred, as they do in the Scandinavian countries. In America many of the criteria used to define class status seem to be no longer applicable as the nation becomes increasingly fragmented into dozens of distinct subcultures, each with its own unique tastes and ambitions. As noted earlier, Claritas, Inc., has identified 62 distinct classes in the United States, each with its own set of beliefs and aspirations.

Organizational or Firm Behavioral Descriptors Purchasing structure and buying situation segmentation descriptors are unique to organizational markets. Purchasing structure is the degree to which the purchasing activity is centralized. In such a structure the buyer is likely to consider all transactions with a given supplier on a global basis, to emphasize cost savings, and to minimize risk. In a decentralized situation, the buyer is apt to be more sensitive to the user’s need, to emphasize product quality and fast delivery, and to be less cost-conscious.

The buying situation descriptor includes three distinct types of situations: straight rebuy, a recurring situation handled on a routine basis; modified rebuy, which occurs when some element, such as price or delivery schedules, has changed in a client–supplier relationship; and a new buying situation, which may require the gathering of considerable information and an evaluation of alternative suppliers.

Global Market Segmentation

The traditional approach to global market segmentation has been to view a country or a group of countries as a single segment comprising all consumers. This approach is seriously flawed because it relies on country variables rather than consumer behavior, assumes homogeneity within the country segment, and ignores the possibility of the existence of homogeneous groups of consumers across country segments.
More and more companies are approaching global market segmentation by attempting to identify consumers with similar needs and wants reflected in their behavior in the marketplace in a range of countries. This intercountry segmentation enables a company to develop reasonably standardized programs requiring little change across local markets, thereby resulting in scale economies. Star TV’s launch of a Pan-Asian satellite television service broadcasting throughout Asia in English and Chinese is an example of such a strategy.20

Theodore Levitt has long been a proponent of globalization of a homogeneous marketplace for certain goods (for instance, consumer durables) based on price and high quality. He argues that similar segments have emerged in different countries at the same time because of technological developments affecting communications, transportation, and travel.21 Others, using the same reasoning, believe there are two emerging intercountry global segments: the global elite consumer and the global teenage segment. The former is targeted by producers of products and services with an image of exclusivity (cellular phones, personal computers, luxury cars, expensive perfumes). The growing number of reasonably affluent groups in Latin America offer considerable potential for a variety of goods including automobiles, compact disc players, children’s clothing, and health and beauty aids.22

The global teenage segment assumes a minimum of differences in cultural norms and lifestyles for teenagers across countries. Empirical evidence exists for this view for certain kinds of products, such as Swatch watches, Sony’s line of audio products for children, and Benetton’s colorful knitwear. Even in Japan, typed as a homogeneous culture featuring the “Japan First” sentiment, there is considerable evidence that younger generations are becoming more positive about U.S. and European products.23

Clearly, many global trends are influencing the behavior of consumers, including increased per-capita GNP, increased literacy and education, growth in urbanization, greater availability of TV and the Internet, and more travel. Many consumer products are becoming more common (automobiles, major home appliances, TVs). Thus, the global market for many products can be thought of as in transition. This development will require global marketers to continuously monitor their markets to identify emerging segments.

**Innovative Segmentation: A Key to Marketing Breakthroughs**

At the beginning of this section (see How Are Market Segments Best Defined? on page 153), we identified four objectives of the market segmentation process. Effective marketers, such as the creators of Nike athletic shoes, Gatorade, and other highly successful products, know that meeting these objectives through insightful and innovative market segmentation schemes is often the key to marketing breakthroughs. Often, combinations of different descriptors are used to more precisely target an attractive segment: perhaps some behavioral dimension together with a carefully defined demographic profile within some geographic region. Generally, it is useful to know the demographic profile of the target market to be pursued, even if the driving force behind the segmentation scheme is geographical and/or behavioral in nature. Understanding the demographic profile of a target market enables the marketer to better choose targeted advertising media or other marketing communication vehicles, unlike many Super Bowl advertisers in January 2000.

As is the case for many kinds of marketing decision making, computer-based decision support systems have been developed to aid marketers as they wrestle with market segmentation decisions. Some widely used systems are identified in Exhibit 7.4.

As several examples in this section have shown, at the foundation of many marketing breakthroughs one often finds an insightful segmentation scheme that is sharply focused in a behavioral way. Marketers with superior market knowledge are probably more likely
Section Two  Opportunity Analysis

II. Opportunity Analysis

7. Targeting Attractive Market Segments

Choosing Attractive Market Segments: A Five-Step Process

Most firms no longer aim a single product and marketing program at the mass market. Instead, they break that market into homogeneous segments on the basis of meaningful differences in the benefits sought by different groups of customers. Then they tailor products and marketing programs to the particular desires and idiosyncrasies of each segment. But not all segments represent equally attractive opportunities for the firm. To prioritize target segments by their potential, marketers must evaluate their future attractiveness and their firm’s strengths and capabilities relative to the segments’ needs and competitive situations.

Within an established firm, rather than allowing each business unit or product manager to develop an approach to evaluate the potential of alternative market segments, it is often better to apply a common analytical framework across segments. With this approach, managers can compare the future potential of different segments using the same set of criteria and then prioritize them to decide which segments to target and how resources and marketing efforts should be allocated. One useful analytical framework managers or entrepreneurs can use for this purpose is the market-attractiveness/competitive-position matrix. As we saw in Chapter 2, managers use such models at the corporate level to allocate resources across businesses, or at the business-unit level to assign resources across product-markets. We are concerned with the second application here.

Exhibit 7.5 outlines the steps involved in developing a market-attractiveness/competitive-position matrix for analyzing current and potential target markets. Underlying such a matrix is the notion that managers can judge the attractiveness of a market (its profit potential) by examining market, competitive, and environmental factors that may influence profitability. Similarly, they can estimate the strength of the firm’s competitive position by

Strategic Issue

Choosing Attractive Market Segments: A Five-Step Process

Most firms no longer aim a single product and marketing program at the mass market.

Strategic Issue

Choosing Attractive Market Segments: A Five-Step Process

Two broad kinds of software applications are used in segmenting markets. Data mining applications enable the marketer to examine a customer database to identify patterns of variables that predict which customers buy or don’t buy, as well as how much they buy. CART® and MARS™ from Salford Systems, Inc. (www.salford-systems.com) are two such applications. Various tools for analyzing the demographic makeup of a proposed target market are also available. National Decision Systems (www.ends.com) is one such supplier. Various analytical procedures in SPSS MR or other statistical software packages also are useful for market segmentation.


Exhibit 7.4 Software Tools for Market Segmentation

Strategic Issue

Choosing Attractive Market Segments: A Five-Step Process

At the foundation of many marketing breakthroughs one often finds an insightful segmentation scheme that is sharply focused in a behavioral way.

Strategic Issue

Choosing Attractive Market Segments: A Five-Step Process

To generate the insights necessary to define market segments in these innovative and meaningful ways. Phil Knight and Bill Bowerman, the founders of Nike, as runners themselves, had the necessary market knowledge to see how distance runners, as a market segment, were underserved. Their insight, together with the development of innovative products and the creation of effective marketing programs, led the growth of the athletic footwear market, as consumers purchased different shoes for their different athletic pursuits, and ultimately revolutionized the athletic footwear industry.
looking at the firm’s capabilities or shortcomings relative to the needs of the market and the competencies of likely competitors. By combining the results of these analyses with other considerations, including risk, the mission of the firm, and ethical issues (see Ethical Perspective 7.1), conclusions about which markets and market segments should be pursued can be reached.

The first steps in developing a market-attractiveness/competitive-position matrix, then, are to identify the most relevant variables for evaluating alternative market segments and the firm’s competitive position regarding them and to weight each variable in importance. Note, too, that Exhibit 7.5 suggests conducting a forecast of future changes in market attractiveness or competitive position in addition to, but separately from, an assessment of the current situation. This reflects the fact that a decision to target a particular segment is a strategic choice that the firm will have to live with for some time.

Step 1: Select Market-Attractiveness and Competitive-Position Factors

An evaluation of the attractiveness of a particular market or market segment and of the strength of the firm’s current or potential competitive position in it builds naturally on the kind of opportunity analysis developed in Chapters 4 through 6. Managers can assess both
Dimensions on the basis of information obtained from analyses of the environment, industry and competitive situation, market potential estimates, and customer needs. To make these assessments, they need to establish criteria, such as those shown in Exhibit 7.6, against which prospective markets or market segments can be evaluated. Both market and competitive perspectives are necessary.

Market-Attractiveness Factors As we showed in Chapter 4, assessing the attractiveness of markets or market segments involves determining the market’s size and growth rate and assessing various trends—demographic, sociocultural, economic, political/legal, technological, and physical—that influence demand in that market. An even more critical factor in determining whether to enter a new market or market segment, however, is the degree to which unmet customer needs, or needs that are currently not being well served, can be identified. In the absence of unmet or underserved needs, it is likely to be difficult to win customer loyalty, regardless of how large the market or how fast it is growing. “Me-too” products often face difficult going in today’s highly competitive markets.

Competitive-Position Factors As we showed in Chapter 5, understanding the attractiveness of the industry in which one competes is also important. Entering a segment...
Step 2: Weight Each Factor

Next, a numerical weight is assigned to each factor to indicate its relative importance in the overall assessment. Let’s imagine that we are Phil Knight or Bill Bowerman in 1964, before Nike even existed, and we are considering starting a venture to market new and better athletic shoes specifically designed for distance runners. Weights that Knight and Bowerman might have assigned to the major factors in Exhibit 7.6 are shown in Exhibit 7.7. Some users would rate each bullet point in Exhibit 7.6 independently, assigning a weight to each one.

Exhibit 7.6
Factors Underlying Market Attractiveness and Competitive Position

<table>
<thead>
<tr>
<th>Market-attractiveness factors</th>
<th>Competitive-position factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer needs and behavior</td>
<td>Opportunity for competitive advantage</td>
</tr>
<tr>
<td>• Are there unmet or underserved needs we can satisfy?</td>
<td>• Can we differentiate?</td>
</tr>
<tr>
<td>Market or market segment size and growth rate</td>
<td>• Can we perform against critical success factors?</td>
</tr>
<tr>
<td>• Market potential in units, dollars, number of prospective customers</td>
<td>• Stage of competing products in product life cycle: Is the timing right?</td>
</tr>
<tr>
<td>• Growth rate in units, dollars, number of prospective customers</td>
<td>Firm and competitor capabilities and resources</td>
</tr>
<tr>
<td>• Might the target segment constitute a platform for later expansion into related segments in the market as a whole?</td>
<td>• Management strength and depth</td>
</tr>
<tr>
<td>Macro trends: Are they favorable, on balance?</td>
<td>• Financial and functional resources: marketing, distribution, manufacturing, R&amp;D, etc.</td>
</tr>
<tr>
<td>• Demographic</td>
<td>• Brand image</td>
</tr>
<tr>
<td>• Sociocultural</td>
<td>• Relative market share</td>
</tr>
<tr>
<td>• Economic</td>
<td>Attractiveness of industry in which we would compete</td>
</tr>
<tr>
<td>• Political/legal</td>
<td>• Threat of new entrants</td>
</tr>
<tr>
<td>• Technological</td>
<td>• Threat of substitutes</td>
</tr>
<tr>
<td>• Physical</td>
<td>• Buyer power</td>
</tr>
<tr>
<td></td>
<td>• Supplier power</td>
</tr>
<tr>
<td></td>
<td>• Competitive rivalry</td>
</tr>
<tr>
<td></td>
<td>• Industry capacity</td>
</tr>
<tr>
<td></td>
<td>• Driving forces: are they favorable, on balance?</td>
</tr>
</tbody>
</table>
Step 3: Rate Segments on Each Factor; Plot Results on Matrices

This step requires that evidence—typically both qualitative and quantitative data—be collected to objectively assess each of the criteria identified in Step 1. For Knight and Bowerman in 1964, the assessment of the various factors might have looked such as those shown in Exhibit 7.7. While more detailed evidence than we discuss here should have been, and no doubt was, gathered, Knight and Bowerman might have reached the following conclusions:

**Market-attractiveness factors**
- Unmet customer needs for lateral stability, cushioning, and lightweight shoe have been identified. Score: 10.
- The distance runner segment is quite small, though growing, but it might lead to other segments in the future. Score: 7.
- Macro trends are largely favorable: fitness is “in,” number of people in demographic groups likely to run is growing, global trade is increasing. Score 8.

**Competitive-position factors**
- Opportunity for competitive advantage is somewhat favorable; proposed shoes will be differentiated, but shoe category seems mature, and their new firm has no track record. Score: 7.
- Resources are extremely limited, though management knows runners and distance running; Bowerman has strong reputation. Score: 5.
- Five forces are largely favorable (low buyer and supplier power, little threat of substitutes, low rivalry among existing firms), driving forces attractive. Score: 7.

Mere armchair judgments about each criterion are not very credible and run the risk of taking the manager or entrepreneur into a market segment that may turn out not to be viable. It is especially important to undertake a detailed analysis of key competitors, especially with regard to their objectives, strategy, resources, and marketing programs, as was discussed in Chapter 5. Similarly, compelling evidence that a proposed entry into a new
Step 4: Project Future Position for Each Segment

Forecasting a market’s future is more difficult than assessing its current state. Managers or entrepreneurs should first determine how the market’s attractiveness is likely to change over the next three to five years. The starting point for this assessment is to consider possible shifts in customer needs and behavior, the entry or exit of competitors, and changes in their strategies. Managers also must address several broader issues, such as possible changes in product or process technology, shifts in the economic climate, the impact of social or political trends, and shifts in the bargaining power or vertical integration of customers.

Managers next must determine how the business’s competitive position in the market is likely to change, assuming that it responds effectively to projected environmental changes but the firm does not undertake any initiatives requiring a change in basic strategy. The expected changes in both market attractiveness and competitive position can then be plotted on the matrix in the form of a vector (arrow) that reflects the direction and magnitude of the expected changes. Anticipating such changes may be critically important in today’s Internet age.

Step 5: Choose Segments to Target; Allocate Resources

Managers should consider a market to be a desirable target only if it is strongly positive on at least one of the two dimensions of market attractiveness and potential competitive position and at least moderately positive on the other. In Exhibit 7.8 this includes markets positioned in any of the three cells in the upper right-hand corner of the matrix. However, a business may decide to enter a market that currently falls into one of the middle cells under...
these conditions: (1) managers believe that the market’s attractiveness or their competitive strength is likely to improve over the next few years; (2) they see such markets as stepping-stones to entering larger, more attractive markets in the future; or (3) shared costs are present, thereby benefiting another entry.

The market-attractiveness/competitive position matrix offers general guidance for strategic objectives and allocation of resources for segments currently targeted and suggests which new segments to enter. Thus, it also can be useful, especially under changing market conditions, for assessing markets or market segments from which to withdraw or to which allocations of resources, financial and otherwise, might be reduced. Exhibit 7.9 summarizes generic guidelines for strategic objectives and resource allocations for markets in each of the matrix cells. The general thrust of these guidelines is that managers should concentrate resources in attractive markets where the business is securely positioned, use them to improve a weak competitive position in attractive markets, and disengage from unattractive markets where the firm enjoys no competitive advantage.

**DIFFERENT TARGETING STRATEGIES SUIT DIFFERENT OPPORTUNITIES**

Most successful entrepreneurial ventures target narrowly defined market segments at the outset, as OurBeginning.com might have done, and as Phil Knight and Bill Bowerman did.

---

**Exhibit 7.9**

**Implications of Alternative Positions within the Market-Attractiveness/Competitive-Position Matrix for Target Market Selection, Strategic Objectives, and Resource Allocation**

<table>
<thead>
<tr>
<th>Competitive Position</th>
<th>Weak</th>
<th>Medium</th>
<th>Strong</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Build selectively:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Specialize around limited strengths</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Seek ways to overcome weaknesses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Withdraw if indications of sustainable growth are lacking</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DESIRABLE POTENTIAL TARGET</td>
<td>Invest to build:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Challenge for leadership</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Build selectively on strengths</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Reinforce vulnerable areas</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>DESIRABLE POTENTIAL TARGET</td>
<td>Protect position:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Invest to grow at maximum digestible rate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Concentrate on maintaining strength</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Medium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited expansion or harvest:</td>
</tr>
<tr>
<td>• Look for ways to expand without high risk; otherwise, minimize investment and focus operations</td>
</tr>
<tr>
<td>Manage for earnings:</td>
</tr>
<tr>
<td>• Protect existing strengths</td>
</tr>
<tr>
<td>• Invest to improve position only in areas where risk is low</td>
</tr>
<tr>
<td>DESIRABLE POTENTIAL TARGET</td>
</tr>
<tr>
<td>• Emphasize profitability by increasing productivity</td>
</tr>
<tr>
<td>• Build up ability to counter competition</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Divest:</td>
</tr>
<tr>
<td>• Sell when possible to maximize cash value</td>
</tr>
<tr>
<td>• Meantime, cut fixed costs and avoid further investment</td>
</tr>
<tr>
<td>Manage for earnings:</td>
</tr>
<tr>
<td>• Protect position</td>
</tr>
<tr>
<td>• Minimize investment</td>
</tr>
<tr>
<td>Protect and refocus:</td>
</tr>
<tr>
<td>• Defend strengths</td>
</tr>
<tr>
<td>• Seek ways to increase current earnings without speeding market’s decline</td>
</tr>
</tbody>
</table>

for two reasons. One, doing so puts the nascent firm in a position to achieve early success in a market segment that it understands particularly well. Second, such a strategy conserves precious resources, both financial and otherwise. But segmenting the market into narrow niches and then choosing one niche to target is not always the best strategy, particularly for established firms having substantial resources. Three common targeting strategies are **niche-market**, **mass-market**, and **growth-market** strategies.

### Niche-Market Strategy

This strategy involves serving one or more segments that, while not the largest, consist of substantial numbers of customers seeking somewhat-specialized benefits from a product or service. Such a strategy is designed to avoid direct competition with larger firms that are pursuing the bigger segments. For example, overall coffee consumption is down substantially, but the sales of gourmet coffees have boomed in recent years.

### Mass-Market Strategy

A business can pursue a mass-market strategy in two ways. First, it can ignore any segment differences and design a single product-and-marketing program that will appeal to the largest number of consumers. The primary object of this strategy is to capture sufficient volume to gain economies of scale and a cost advantage. This strategy requires substantial resources, including production capacity, and good mass-marketing capabilities. Consequently, it is favored by larger business units or by those whose parent corporation provides substantial support. For example, when Honda first entered the American and European motorcycle markets, it targeted the high-volume segment consisting of buyers of low-displacement, low-priced cycles. Honda subsequently used the sales volume and scale economies it achieved in that mass-market segment to help it expand into smaller, more-specialized segments of the market.

A second approach to the mass market is to design separate products and marketing programs for the differing segments. This often is called **differentiated marketing**. For example, Marriott does this with its various hotel chains. Although such a strategy can generate more sales than an undifferentiated strategy, it also increases costs in product design, manufacturing, inventory, and marketing, especially promotion.

### Growth-Market Strategy

Businesses pursuing a growth-market strategy often target one or more fast-growth segments, even though they may not currently be very large. It is a strategy often favored by smaller competitors to avoid direct confrontations with larger firms while building volume and share. Most venture capital firms invest only in firms pursuing growth-market strategies, because doing so is the only way they can earn the 30 percent to 60 percent annual rates of return on investment that they seek for portfolio companies. Such a strategy usually requires strong R&D and marketing capabilities to identify and develop products appealing to newly emerging user segments, plus the resources to finance rapid growth. The problem, however, is that fast growth, if sustained, attracts large competitors. This happened to DEC when IBM entered the minicomputer business. The goal of the early entrant is to have developed an enduring competitive position via its products, service, distribution, and costs by the time competitors enter.
SELECTING TARGET MARKETS IN THE INTERNATIONAL ARENA

Some companies go international to defend their home position against global competitors who are constantly looking for vulnerability. This forces the firm to target major developed countries (the United States, Japan, and Western European countries). A global competitor can attack the home market by reducing price, the cost of which is subsidized by profits generated elsewhere in the world. If the defending company is solely a domestic player, it has to respond by cutting price on its entire volume, while the aggressor has to do so on only part of its total sales.

To prevent such attacks, or minimize their impact, a firm must have the capacity to strike back in markets where the aggressor is vulnerable. For example, Caterpillar, through a joint venture with Mitsubishi Heavy Industries, has for the past 30 years made a substantial investment in Japan to deny its Japanese competitor, Komatsu, strength at home, thereby taking away its profit sanctuary. Had Cat not been successful in doing so, Komatsu would have been able to compete more aggressively with Cat, not only in the United States but also in other major world markets.26

Another reason a firm may go overseas and target a specific country is to service customers who also are engaging in global expansion. In recent years Japanese automobile companies that have created U.S. manufacturing facilities have encouraged some of their parts suppliers to do the same. Firms also enter overseas markets to earn foreign exchange and, in some cases, are subsidized by their governments to do so.

The selection of one or more target countries may be dictated by the availability of an appropriate partner. For example, Kellogg has had a European presence since the 1920s and controls about half the market. General Mills, which is Kellogg’s major U.S. competitor, has long wanted to enter the European market, but to do so on its own would have been an extremely expensive undertaking, given Kellogg’s high market share. The solution was to enter into a joint venture (Cereal Partners Worldwide) with Nestlé, which has no cereals but does have a powerful distribution system.27 France, Spain, and Portugal constituted the initial target markets for General Mills’ Honey Nut Cheerios and Golden Grahams.

In general, with the exception of these strategic special circumstances, the selection of overseas target markets follows essentially the same patterns as for domestic markets, although given the magnitude of economic, social, and political change in the world today, companies are paying considerably more attention to political risk.

TAKE AWAYS

- Marketers and entrepreneurs who find new and insightful ways to segment mature markets often uncover opportunities for uncontested market entry and rapid growth.
- Sharply focused target marketing enables marketers to differentiate from mass-market leaders by giving consumers in a narrowly defined market segment what they want.
- Focused market entry strategies conserve resources and facilitate early success.
- The five-step procedure provided in this chapter identifies segments having the highest potential.
- The market-attractiveness/competitive-position matrix is a useful analytical framework for deciding which markets or market segments to enter and from which to withdraw.
- Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at www.mhhe.com/walker.
CHAPTER SEVEN  
TARGETING ATTRACTIVE MARKET SEGMENTS

ENDNOTES


15. From information provided by Stanford Research Institute.

16. The relative weight of these vary across countries. In China, for example, more weight is given to occupation and education, whereas Western countries emphasize residence, income, and family background. See John D. Daniels and Lee H. Radebaugh, International Dimensions of Contemporary International Business (Boston: PWS-Kent, 1993), p. 136.


25. Ibid.


Chapter Eight

Differentiation and Positioning

Dell’s Direct Business Model Wins Customers and Competitive Advantage

From 1994 to 1998, Dell Computer Corporation grew from $3.5 to $18.2 billion in revenue and from $149 million to $1.5 billion in profits. During this period, Dell grew more than twice as fast as its major rivals and tripled its market share. Michael Dell, its founder, ranked as the fourth richest American, with an estimated worth of $13 billion. Clearly, Dell Computer was doing something right.

Giving Customers What They Want

From its origins in Michael Dell’s dorm room at the University of Texas, Dell Computer sold personal computers directly to end users, in contrast to most other leading manufacturers, who sold through distributors, resellers, and retailers. By differentiating from other computer makers—selling direct, first over the telephone, and later via the Internet—Dell enabled customers, especially corporate customers, to specify exactly the features they wanted. Dell then quickly assembled computers to meet these specifications and shipped them directly to its customers.

What was it about Dell’s concept that customers found so attractive? First, they could specify precisely what they wanted—hard drive size, memory, modem or network card, and so on. Second, Dell’s price/value offering was unbeatable—customers got more computer for their money. And, because Dell shipped quickly and offered strong service and support, albeit without local face-to-face handholding, these two major benefits—get exactly what you want, for less money—came without any significant drawbacks to its key target market, corporations.

Sustainable Competitive Advantage

Not only did Dell’s direct business model offer tangible benefits to its target customers, it also brought Dell important advantages that gave it a real and—so far—sustainable edge over its competitors. Dell worked closely with its suppliers to arrange just-in-time delivery of parts for its custom-assembled PCs, communicating replenishment needs to key vendors on an hourly basis. By carrying, in 1996 for example, only 15 days of inventory on average, instead of 65 days for competitor Compaq, Dell not only saved carrying cost for its inventory, but it bought parts later, thereby benefiting from the fact that prices of
components used to make PCs typically declined 25 to 20 percent per year. Additional savings from eliminating intermediaries in its distribution channel made Dell's cost advantage over its competitors a substantial one.

Given its lower cost structure than its competitors, Dell's custom-built, low-cost positioning in the marketplace allowed it to make an attractive strategic choice. Should it choose to reap higher margins than others in its industry, or should it keep prices low to gain market share? For much of its history, Dell made the latter choice, gaining share at the expense of its rivals.

**The High-Tech Recession of 2001**

In 2001, a sharp recession in the high-tech economy caused computer sales to fall off a cliff. Earnings fell across most high-tech industry sectors, and PCs were no exception. Archrival Compaq lost $279 million on a 17 percent decline in sales in the second quarter of 2001. Dell's earnings slid too, falling 12 percent from second quarter 2000, though its sales were still up 10 percent over the prior year. Chipmaker AMD's earnings fell 92 percent from the prior year on a 16 percent decline in sales. How did Dell's positioning serve it in this challenging environment? Michael Dell didn't blink, announcing that Dell would seek to triple its share of the computer business to 40 percent, in spite of the slimmer profit margins it would endure. He figured his strong value positioning with customers would enable his company to grab market share from weaker rivals and his low-cost business model would give Dell the opportunity to tough it out profit-wise until conditions improved.

**Strategic Challenges Addressed in Chapter 8**

As Dell’s story illustrates, the success of a product offered to a given target market depends on how well it is positioned within that market segment—that is, how well it performs relative to competitive offerings and to the needs of the target audience. **Positioning** refers to both the place a product or brand occupies in customers’ minds relative to their needs and competing products or brands and to the marketer’s decision making intended to create such a position. Thus, the positioning notion comprises both competitive and customer need considerations.

Positioning is basically concerned with differentiation. Ries and Trout, who popularized the concept of positioning, view it as a creative undertaking whereby an existing brand in an overcrowded marketplace of similar brands can be given a distinctive position in the minds of targeted prospects. While their concept was concerned with an existing brand, it is equally applicable for new products. While typically thought of in relation to the marketing of consumer goods, it has equal value for industrial goods and for services, which require essentially the same procedure as consumer goods. Because services are characterized by their intangibility, perishability, consumer participation in their delivery, and the simultaneous nature of their production and consumption, they are—when compared with products—more difficult for consumers to understand, to compare with competing products, to predict in terms of their performance, and, therefore, more difficult for marketers to position successfully.
In this chapter we take the final step in preparing the foundation on which effective marketing programs are based. Drawing on decisions made about target markets, as discussed in Chapter 7, we address the critical question, How should a business position its product offering—whether goods or services—so customers in the target market perceive the offering as providing the benefits they seek, thereby giving the product an advantage over current and potential future competitors? As marketing managers know, the positioning decision is a strategic one, with implications not only for how the firm’s goods or services should be designed, but also for developing the other elements of the marketing strategy. Pricing decisions, promotion decisions, and decisions about how the product is to be distributed all follow from, and contribute to the effectiveness of, the positioning of the product in its competitive space.

Differentiation: The Key to Customer Preference and Competitive Advantage

Why do customers prefer one product over another? In today’s highly competitive markets, consumers have numerous options. They can buy a personal computer from Dell, Apple, Compaq, or a host of other PC makers. They can choose from dozens of best-selling novels to take along on an upcoming vacation. They can buy the novel they choose from an online merchant such as Amazon.com, from large chain booksellers such as Barnes and Noble or their online counterparts, from book clubs, from a local bookstore, or in some cases from their nearby supermarket or mass merchant. They even can borrow the book at their local library and not buy it at all! Whether for goods such as computers or books, or services such as libraries, consumers make choices such as these nearly every day. In most cases, consumers or organizational customers choose what they buy for one of two reasons: what they choose is better, in some sense, or cheaper. In either case, the good or service they choose is, in some way, almost always different from others they could have chosen.

Differentiation is a powerful theme in developing business strategies, as well as in marketing. As Michael Porter points out, “A company can outperform its rivals only if it can establish a difference that it can preserve. It must deliver greater value to customers or create comparable value at a lower cost, or both.” Most of the time, differentiation is why people buy. They buy the latest John Grisham novel because they know it will be a page-turner, different from the last Grisham they read, and hard to put down. They buy it from Amazon.com because they know Amazon’s selection is enormous, and its one-click ordering system takes only a minute. Or they buy it from the megastore because it’s fun to browse there or from their local bookseller because they feel good about supporting their local merchants. They buy it at the supermarket because it’s convenient. All these book-selling strategies are different, and they appeal to different consumers (i.e., different market segments) at different points in time, for different book-buying purposes. If these strategies did not vary, consumers would have no reason to use some of them, and they would buy their books where they were cheapest or most convenient, though even in such a case, the cheaper pricing or greater convenience would still constitute differences.

Differentiation in Business Strategies

Michael Porter’s classic book on competitive advantage identified three generic strategies: cost leadership, differentiation, and focus, as shown in Exhibit 8.1. These strategies,
which differ in the scope of the target market and market needs they serve (broad or narrow competitive scope) and on whether they base their competitive advantage on low cost (lower prices to the customer for equivalent products) or differentiation (products that are superior on some important dimensions), represent distinctly different ways in which companies can compete for the minds and wallets of customers in their target markets. Porter argues that the worst strategy is to be “stuck in the middle,” to be neither different nor lower in cost than one’s competitors. Companies in such a position offer customers little reason not to take their business elsewhere. But customers don’t really buy strategies. They buy specific goods and services and effective execution: on-time delivery, proper installation, responsive customer service, and so on. Thus, strategy is implemented at the product-market level, where differentiation lies at the heart of positioning.

Differentiation among Goods and Services

As we saw in the previous chapter, customers in one market segment have wants and needs that differ in some way from those of customers in other segments. Positioning allows the marketer to take advantage of and be responsive to such differences and position particular goods and services so as to better meet the needs of consumers in one or more of these segments. These differences are often physical. Dell’s computers have exactly the features the customer wants, not a compromise based on what’s available in the computer store. Nike’s original waffle sole was a physical difference. But differences also can be perceptual, as with Nike’s later products that benefited from endorsements by John McEnroe, Michael Jordan, and other famous athletes. Creating both physical and perceptual differences, using all the elements of the marketing mix—product, pricing, promotion, and distribution decisions—is what effective positioning seeks to accomplish.

Physical Positioning

One way to assess the current position of a product offering relative to competitors is on the basis of how the various offerings compare on some set of objective physical characteristics. For example, an article in The Wall Street Journal discussed the pending battle in the 1996 season between the various brands of behemoth sport utility vehicles. It compared Ford’s Expedition versus GM’s Suburban on seating capacity, engine, city mileage, highway mileage, length, and price (see Exhibit 8.2). In many cases a physical positioning
Section Two  Opportunity Analysis

174

**Exhibit 8.2**

1996 Ford Expedition versus GM Suburban on a Selected Number of Physical Dimensions

<table>
<thead>
<tr>
<th>Feature</th>
<th>Expedition</th>
<th>Suburban</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seating capacity</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Cargo capacity</td>
<td>115 cu. ft.</td>
<td>149.5 cu. ft.</td>
</tr>
<tr>
<td>Engine</td>
<td>4.6 liter, V-8</td>
<td>5.7 liter, V-8</td>
</tr>
<tr>
<td>City mileage</td>
<td>14 mpg</td>
<td>13 mpg</td>
</tr>
<tr>
<td>Highway mileage</td>
<td>18 mpg</td>
<td>17 mpg</td>
</tr>
<tr>
<td>Length</td>
<td>204.6 inches</td>
<td>220 inches</td>
</tr>
<tr>
<td>Price</td>
<td>$24–36,000</td>
<td>$24,682–38,000</td>
</tr>
</tbody>
</table>


analysis can provide useful information to a marketing manager, particularly in the early stages of identifying and designing new product offerings.

Despite being based primarily on technical rather than on market data, physical comparisons can be an essential step in undertaking a positioning analysis. This is especially true with the competitive offerings of many industrial goods and services, which buyers typically evaluate largely on the basis of such characteristics. In addition, it contributes to a better marketing/R&D interface by determining key physical product characteristics; helps define the structure of competition by revealing the degree to which the various brands compete with one another; and may indicate the presence of meaningful product gaps (the lack of products having certain desired physical characteristics), which, in turn, may reveal opportunities for a new product entry.

**Limitations of Physical Positioning**

A simple comparison of only the physical dimensions of alternative offerings usually does not provide a complete picture of relative positions because, as we noted earlier, positioning ultimately occurs in customers’ minds. Even though a product’s physical characteristics, package, brand name, price, and ancillary services can be designed to achieve a particular position in the market, customers may attach less importance to some of these characteristics than, or perceive them differently from, what the firm expects. Also, customers’ attitudes toward a product are often based on social or psychological attributes not amenable to objective comparison, such as perceptions of the product’s aesthetic appeal, sportiness, or status image. Consequently, perceptual positioning analysis—whether aimed at discovering opportunities for new product entries or evaluating and adjusting the position of a current offering—is critically important.

**Perceptual Positioning**

Consumers often know very little about the essential physical attributes of many products, especially household products, and even if they did, they would not understand the physical attributes well enough to use them as a basis for choosing between competitive offerings. (For the major differences between physical and perceptual product positioning analyses, see Exhibit 8.3.) Many consumers do not want to be bothered about a product’s
physical characteristics because they are not buying these physical properties but rather the benefits they provide. While the physical properties of a product certainly influence the benefits provided, a consumer typically can evaluate a product better on the basis of what it does than what it is. Thus, for example, a headache remedy is judged on how quickly it brings relief, a toothpaste on the freshness of breath provided, a beer on its taste, and a vehicle on how comfortably it rides.

The evaluation of many products is subjective because it is influenced by factors other than physical properties, including the way products are presented, our past experiences with them, and the opinions of others. Thus, physically similar products may be perceived as being different because of different histories, names, and advertising campaigns. For example, some people will pay considerably more for Bayer aspirin than for an unadvertised private label even though they are essentially the same product.

**Exhibit 8.3**

<table>
<thead>
<tr>
<th>Physical positioning</th>
<th>Perceptual positioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical orientation</td>
<td>Consumer orientation</td>
</tr>
<tr>
<td>Physical characteristics</td>
<td>Perceptual attributes</td>
</tr>
<tr>
<td>Objective measures</td>
<td>Perceptual measures</td>
</tr>
<tr>
<td>Data readily available</td>
<td>Need for marketing research</td>
</tr>
<tr>
<td>Physical brand properties</td>
<td>Perceptual brand positions and positioning intensities</td>
</tr>
<tr>
<td>Large number of dimensions</td>
<td>Limited number of dimensions</td>
</tr>
<tr>
<td>Represents impact of product specs and price</td>
<td>Represents impact of product specs and communication</td>
</tr>
<tr>
<td>Direct R&amp;D implications</td>
<td>R&amp;D implications need to be interpreted</td>
</tr>
</tbody>
</table>

**Customers or prospective customers perceive physical as well as other differences between goods or services within a product category, of course. Marketing decision makers seeking to win a particular position in customers’ minds will seek to endow their product with various kinds of attributes, which may be categorized as follows:**

- **Simple physically based attributes.** These are directly related to a single physical dimension such as price, quality, power, or size. While there is a direct correspondence between a physical dimension and a perceptual attribute, an analysis of consumers’ perception of products on these attributes may unveil phenomena of interest to a marketing strategy. For instance, two cars with estimated gasoline mileage of 23.2 and 25.8 miles per gallon may be perceived as having similar gasoline consumption.

- **Complex physically based attributes.** Because of the presence of a large number of physical characteristics, consumers may use composite attributes to evaluate competitive offerings. The development of such summary indicators is usually subjective because of the relative importance attached to different cues. Examples of composite attributes are the speed of a Dell computer, roominess of a car, and a product’s or service’s being user friendly.

- **Essentially abstract attributes.** Although these perceptual attributes are influenced by physical characteristics, they are not related to them in any direct way. Examples include bodiness...
of a beer, sexiness of a perfume, quality of a French wine, and prestige of a car. All of these attributes are highly subjective and difficult to relate to physical characteristics other than by experience.

The importance of perceptual attributes with their subjective component varies across consumers and product classes. Thus, it can be argued that consumers familiar with a given product class are apt to rely more on physical characteristics and less on perceptual attributes than consumers who are less familiar with that product class. It also can be argued that while perceptual product positioning is essential for nondurable consumer goods, such is not the case for consumer durables (such as sport utility vehicles) and many industrial goods.

Even though there is considerable truth in these statements, perceptual attributes must be considered in positioning most products. One reason is the growing similarity of the physical characteristics of more and more products. This increases the importance of other, largely subjective dimensions. Consider, for example, whether Nike’s Air Jordan basketball shoes would have sold as well without Michael Jordan’s endorsement and his presence in their ads.

Preparation for Marketing Strategies: The Positioning Process

Positioning a new product in customers’ minds or repositioning a current product involves a series of steps, as outlined in Exhibit 8.4. These steps are applicable to goods and services, in domestic or international markets, and to new or existing products. This is not to suggest that the determinant product attributes and the perceptions of consumers of the various competitive offerings will remain constant across countries or other market segments; rather, they are likely to vary with most products. After managers have selected a relevant set of competing offerings serving a target market (Step 1), they must identify a set of critical or determinant product attributes important to customers in that target market (Step 2).

Step 3 involves collecting information from a sample of customers about their perceptions of the various offerings, and in Step 4 researchers analyze this information to determine the product’s current position in customers’ minds and the intensity thereof (Does it occupy a dominant position?), as well as those of competitors.

Managers then ascertain the customers’ most preferred combinations of determinant attributes, which requires the collection of further data (Step 5). This allows an examination of the fit between the preferences of a given target segment of customers and the current positions of competitive offerings (Step 6). And finally, in Step 7, managers write a concise statement that communicates the positioning decision they have reached.

A discussion of these steps in the positioning process takes up the remainder of this chapter.

Step 1: Identify a Relevant Set of Competitive Products

Positioning analyses are useful at many levels: company, business unit, product category, and specific product line or brand. At the company or business-unit level, such analyses are useful to determine how an entire company or business unit is positioned relative to its competitors. The results of such analyses are sometimes displayed graphically by plotting
competing companies or businesses in their respective quadrants of the generic strategies grid shown in Exhibit 8.1. Larger or smaller dots or circles are used to indicate relative sizes of competing firms.

At the product category level, the analysis examines customers’ perceptions about types of products they might consider as substitutes to satisfy the same basic need. Suppose, for example, a company is considering introducing a new instant breakfast drink. The new product would have to compete with other breakfast foods, such as bacon and eggs, breakfast cereals, and even fast-food drive-throughs. To understand the new product’s position in the market, a marketer could obtain customer perceptions of the new product concept relative to likely substitute products on various critical determinant attributes, as we describe in Steps 3 and 4 of the positioning process (see Exhibit 8.4).

Once competitors introduce several brands into the category, a positioning analysis at the product or brand level can be helpful to better understand how various brands appeal to customers, to position proposed new products or brands or reposition current ones, and to identify where new competitive opportunities might be found.
Section Two  Opportunity Analysis

At whichever level the positioning analysis is to be done, the analyst’s choice of competing products (or product categories or firms) is critical. Marketers who omit important substitute products or potential competitors risk being blindsided by unforeseen competition.

Step 2: Identify Determinant Attributes

Positioning can be based on a variety of attributes—some in the form of surrogates that imply desirable features or benefits as a positioning base. The common types of bases are the following.

- **Features** are often used in physical product positioning and, hence, with industrial products. An example of its use with a consumer good is Jenn-Air’s claim, “This is the quietest dishwasher made in America.” Amazon.com has a unique “1-click®” ordering system.

- **Benefits**, like features, are directly related to a product. Examples here include Volvo’s emphasis on safety and durability and Norelco’s promising a “close and comfortable shave.”

- **Usage** includes end use (“If you’ve got it in the kitchen, it probably goes with pork”—a versatility claim); demographic (“Just because kids will be kids doesn’t mean you can’t have knock-down, gorgeous floors”—Congoleum); psychographic or behavioral (Ellesse positioning itself as producing a fashionable upscale active-wear line); and popularity (Hertz as the biggest rental car company in the world).

- **Parentage** includes who makes it (bottled by a French vintner; “At Fidelity, you’re not just buying a fund, a stock, or a bond—you’re buying a better way to manage it”) and prior products (“Buying a car is like getting married. It’s a good idea to know the family first,” followed by a picture of the ancestors of the Mercedes-Benz S class model).

- **Manufacturing process** is often the subject of a firm’s positioning efforts. An example is Jaeger-LeCoultre’s statement about its watches: “We know it’s perfect, but we take another 1,000 hours just to be sure.”

- **Ingredients** as a positioning concept is illustrated by some clothing manufacturers saying their sports shirts are made only of pure cotton.

- **Endorsements** are of two types: those by experts (“Discover why over 5,000 American doctors and medical professionals prescribe this Swedish mattress”—Tempor-Pedic) and those via emulation as with Michael Jordan using Nike shoes.

- **Comparison** with a competitor’s product is common (“Tests prove Pedigree is more nutritious than IAMS, costs less than IAMS, and tastes great, too”—Pedigree Mealtime).

- **Proenvironment** positioning seeks to portray a company as a good citizen (“Because we recycle over 100 million plastic bottles a year, landfills can be filled with other things, like land, for instance”—Phillips Petroleum).

- **Product class** as when freeze-dried coffee was introduced as a new and different product type versus regular or instant coffees.

- **Price/quality** is used in cases such as Wal-Mart successfully positioning itself as the lowest-price seller of quality household products.

- **Country or geographic area** (French wines, Russian vodka).

Theoretically, consumers can use many attributes to evaluate products or brands, but the number actually influencing a consumer’s choice is typically small, partly because consumers can consider only attributes of which they are aware. The more variables used in positioning a given product, the greater the chance of confusion and even disbelief on the part of the consumer. The positioning effort must be kept as simple as possible and complexity should be avoided at all costs.

In using one or more attributes as the basis of a brand’s positioning effort, it is important to recognize that the importance attached to these attributes often varies. For example, while the brands of soap or shampoo provided by a hotel may be an attribute that some
consumers use in evaluating hotels, most are unlikely to attach much importance to it when deciding which hotel chain to patronize. Even an important attribute may not greatly influence a consumer’s preference if all the alternative brands are perceived to be about equal on that dimension. Deposit safety is an important attribute to consider when choosing a bank, but most consumers perceive all banks to be about equally safe. Consequently, deposit safety is not a determinant attribute: It does not play a major role in helping customers to differentiate among the alternatives and to determine which bank they prefer.

Marketers should rely primarily on determinant attributes in defining the product space in a positioning analysis. The question is, How can a marketer find out which product dimensions are determinant attributes? Doing so typically requires conducting some kind of marketing research, using the marketing research process described in a previous chapter. This brings us to Step 3.

**Step 3: Collect Data about Customers’ Perceptions for Products in the Competitive Set**

Having identified a set of competing products, the marketer needs to know what attributes are determinant for the target market and the product category under consideration. He or she also needs to know how different products in the competitive set are viewed on these attributes. Typically this market knowledge is developed by first conducting qualitative research, perhaps interviews or focus groups, to learn which attributes are determinant. Then quantitative research follows, perhaps a survey of consumers about their perceptions, to gather data on how competing products score on these attributes. Later in this chapter, we discuss several statistical and analytical tools that are useful in this portion of the positioning process.

**Step 4: Analyze the Current Positions of Products in the Competitive Set**

Whether the positioning process is directed at a new product not yet introduced or repositioning one that already exists, it is important to develop a clear understanding of the positioning of the products that have been determined to be in the competitive set (see Step 1). A useful tool for doing so is the positioning grid, also called a perceptual map. The positioning grid provides a visual representation of the positions of various products or brands in the competitive set in terms of (typically) two determinant attributes. Where more than two attributes are to be considered in a positioning analysis, multidimensional grids, or multiple grids, are produced. But not all products or brands exist in the minds of most consumers.

A brand that is not known by a consumer cannot, by definition, occupy a position in that consumer’s mind. Often the awareness set for a given product class is 3 or fewer brands even though the number of available brands is greater than 20. Thus, many if not most brands have little or no position in the minds of many consumers. For example, in the last 10 or so years, more than 200 new soft drinks have been introduced, most of which were not noticed or remembered by consumers. Thus, the first step in acquiring a distinct position for a brand is to build brand awareness. In doing so, the brand needs to be strongly associated with one or more concepts relating to the purchase decision. A distinct position is best obtained by developing a strong relationship between a brand and a limited number of attributes. Determining the attributes on which the product’s positioning will be based is a key outcome of the positioning process and a driver of the marketing communication strategy, as well as the marketing strategy overall, that will ultimately be developed. Without
clear guidance about the intended position of the product, advertising agencies, salesforces, and others charged with building the awareness and recognition of the product in the marketplace will be ill-equipped to do this important job.

**Building a Positioning Grid** An example of what can be done with data gathered in Step 3 is found in Exhibit 8.5, which shows the results obtained from a study done by Babson College that portrays how a sample of consumers positioned a number of women’s clothing retailers in the Washington, D.C., area. Respondents rated the various stores on the two determinant attributes of value and fashionability. Some stores, such as Nordstrom and Kmart, occupy relatively distant positions from one another, indicating that consumers see them as very different. Other stores occupy positions comparable to one another (Neiman Marcus, Saks) and thus are considered relatively alike, meaning the intensity of competition between these stores is likely to be considerably greater than for those that occupy widely divergent positions.

**Exhibit 8.5**
**Perceptual Map of Women’s Clothing Retailers in Washington, D.C.**

The store positioning shown in Exhibit 8.5 also provides useful information about possible opportunities for the launching of a new store or the repositioning of an existing one. Positioning for a new store could be done by examining the positioning map for empty spaces (competitive gaps) where no existing store is currently located. There is such a gap in the upper right quadrant of the “value/fashionability” map in Exhibit 8.5. This gap may represent an opportunity for developing a new entry or repositioning an old one that is perceived to offer greater fashionability than Nordstrom at a lower price. Of course, such gaps may exist simply because a particular position is either (1) impossible for any brand to attain because of technical constraints or (2) undesirable since there are few prospective customers for a brand with that set of attributes.

Marketing Opportunities to Gain a Distinct Position In situations where one or a limited number of brands dominate a product class (or type) in the minds of consumers, the main opportunity for competitors generally lies in obtaining a profitable position within a market segment not dominated by a leading brand. Competing head-on against the leaders on the basis of attributes appropriated by larger competitors is not likely to be effective. A better option is to concentrate on an attribute prized by members of a given market segment. Thus, Dell offers its customers a custom-built computer that has exactly the desired features, something its corporate customers value.

Constraints Imposed by an Intense Position Although marketers should seek a distinctive and intense position for their brands, attaining such a position imposes constraints on future strategies. If shifts in the market environment cause customers to reduce the importance they attach to a current determinant attribute, marketers may have difficulty repositioning a brand with an intensely perceived position on that attribute. Repositioning carries with it the threat of alienating part or all of the product’s current users regardless of success with its newly targeted group. Success in its repositioning efforts may well ensure losing its current group of users.

Another concern is the dilution of an existing intense position as a result of consolidation. For example, British Leyland was formed through a series of mergers involving a number of British car manufacturers. For years, the company did not have a clear identity because it was new and distributed a variety of brands, including Rover, Triumph, and Austin-Morris. Most Europeans had difficulty recalling spontaneously any British car manufacturer since once-strong brand names such as Austin and Morris had lost their identity and meaning.

Another danger associated with an intensely positioned brand is the temptation to over-exploit that position by using the brand name on line extensions and new products. The danger here is that the new products may not fit the original positioning and the brand’s strong image is diluted. For example, how many travelers know the difference between Holiday Inn, Holiday Inn Express, Holiday Inn Select, and Holiday Inn Garden Court?

Limitations of Product Positioning Analysis The analysis depicted in Exhibit 8.5 is usually referred to as product positioning because it indicates how alternative products or brands are positioned relative to one another in customers’ minds. The problem with this analysis, though, is that it does not tell the marketer which positions are most appealing to customers. Thus, there is no way to determine if there is a market for a new brand or store that might locate in an “open” position or whether the customers in other market segments prefer brands or stores with different attributes and positions. To solve such problems it is necessary to measure customers’ preferences and locate them in the product space along with their perceptions of the positions of existing brands. This is called a market positioning analysis. We deal with this issue in Step 5.
Step 5: Determine Customers’ Most Preferred Combination of Attributes

There are several ways analysts can measure customer preferences and include them in a positioning analysis. For instance, survey respondents can be asked to think of the ideal product or brand within a product category—a hypothetical brand possessing the perfect combination of attributes (from the customer’s viewpoint). Respondents then could rate their ideal product and existing products on a number of attributes. An alternative approach is to ask respondents not only to judge the degree of similarity among pairs of existing brands but also to indicate their degree of preference for each. In either case, the analyst, using the appropriate statistical techniques, can locate the respondents’ ideal points relative to the positions of the various existing brands on the product space map.

Another method of assessing customers’ preferences and trade-offs among them is a statistical technique called conjoint analysis. Customers are surveyed and asked their preferences among various real or hypothetical product configurations, each with attributes that are systematically varied. By analyzing the resulting data, the marketer can learn which of several attributes are more important than the others. These results then can be used in positioning analyses such as those described here.

Whichever approach is used, the results will look something like Exhibit 8.6, which shows a hypothetical cluster of ideal points for one segment of women’s-clothing consumers. As a group, this segment would seem to prefer Nordstrom over any other women’s clothing retailer on the map.

There are, however, several reasons not all customers in this segment are likely to prefer Nordstrom. First, the ideal points of some customers are actually closer to Macy’s than Nordstrom. Second, customers whose ideal point is equidistant between the two stores may be relatively indifferent in their choice of which store to patronize. And finally, customers sometimes may patronize stores somewhat further away from their ideal—particularly when buying low-involvement, nondurable goods or services—to assess the qualities of new stores, to reassess older stores from time to time, or just for the sake of variety.

Using price as one dimension of a positioning grid, or as a key dimension on which a product is positioned, is typically not very useful unless price is a key driver of the marketing strategy. This is the case for two reasons. First, price is easily imitable by competitors. Unless the firm has a clear cost advantage over its competitors, by virtue of its processes or other sources of efficiency, using low price as a basis for positioning can be a fast road to a price war that no one (except consumers) will win. Second, claims that one’s product—whether a good or a service—is low-priced are sometimes not very credible, because so many marketers make such claims. It is often better to position around more enduring differentiators, and let price speak more subtly for itself. Wal-Mart, an exception, has been able to sustain its low-price positioning in the United States because its costs, compared to those of its chief competitors, actually are lower. The same is true for Dell.

Step 6: Consider Fit of Possible Positions with Customer Needs and Segment Attractiveness

An important criterion for defining market segments is the difference in the benefits sought by different customers. Because differences between customers’ ideal points reflect variations in the benefits they seek, a market positioning analysis can simultaneously identify distinct market segments as well as the perceived positions of different brands. When customers’ ideal
points cluster in two or more locations on the product space map, the analyst can consider each cluster a distinct market segment. For analytical purposes, each cluster is represented by a circle that encloses most of the ideal points for that segment; the size of the circle reflects the relative proportion of customers within a particular segment.

Exhibit 8.7 groups the sample of Washington, D.C., respondents into five distinct segments on the basis of clusters of ideal points. Segment 5 contains the largest proportion of customers; segment 1, the smallest. By examining the preferences of customers in different segments along with their perceptions of the positions of existing brands, analysts can learn much about (1) the competitive strength of different brands in different segments, (2) the intensity of the rivalry between brands in a given segment, and (3) the opportunities for gaining a differentiated position within a specific target segment.

Step 6 not only concludes the analysis portion of the positioning process and crystalizes the decision about the positioning a product should hold, but it also can uncover locations in the product space where additional new products could be positioned to serve
customer needs not well served by current competitors. Thus, Exhibit 8.4 shows that a possible side benefit of the positioning process is recognition of underserved positions where additional new products might be placed.

Step 7: Write Positioning Statement or Value Proposition to Guide Development of Marketing Strategy

The final decision about where to position a new brand or reposition an existing one should be based on both the market targeting analysis discussed in Chapter 7 and the results of a market positioning analysis. The position chosen should match the preferences of a particular market segment and should take into account the current positions of competing brands.
It also should reflect the current and future attractiveness of the target market (its size, expected growth, and environmental constraints) and the relative strengths and weaknesses of competitors. Such information, together with an analysis of the costs required to acquire and maintain these positions, allows an assessment of the economic implications of different market-positioning strategies. Dell’s belief that corporate customers, its principal target market, would value its custom-built, low-cost positioning and that competitors would have difficulty emulating its model has served it well through the ups and downs of the PC market.

Most successful products, like Dell computers, are positioned based on one or, at most, two determinant attributes, whether physical or perceptual. Using more simply confuses customers. Domino’s Pizza, in its early days, focused its positioning solely on its fast delivery, since that was the principal dimension on which it established its competitive advantage. While there are many things Domino’s could have said about the pizza itself, for example, it chose to focus its positioning on its key point of differentiation: fast delivery. Recently, when fast delivery became common in the pizza industry, Domino’s added a heat retention device to its delivery containers and added a second positioning attribute: hot. Papa John’s, a more recent entrant in the pizza business, positions its offering around a single attribute, the quality of its pizza, with its promotional phrase, “Better ingredients. Better pizza.”

Where there are no real product differences, as in so-called me-too products, or no differential benefits to the user, not only is success hard to achieve, but also ethical issues may arise. For an example of ethical issues involving positioning in the pharmaceutical industry, see Ethical Perspective 8.1.

Once the desired positioning for the product has been determined, it’s a good idea to write it down so those charged with developing and implementing the marketing strategy have a clear understanding of what is intended for the product and where it will fit in its competitive set. Two approaches are commonly used for doing so. In the classical approach, a positioning statement is written. A more recent approach, one being adopted in a growing number of firms, involves writing a value proposition for the product.

**Writing a Positioning Statement or a Value Proposition** A positioning statement is a succinct statement that identifies the target market for which the product is...
intended and the product category in which it competes and states the unique benefit the product offers. An example of a positioning statement that reflects Volvo’s marketing strategy in the United States is shown in Exhibit 8.8.

A value proposition is similarly explicit about what the product does for the customer (and sometimes, what it does not do) and typically also includes information about pricing relative to competitors. Both positioning statements and value propositions should reflect a unique selling proposition that the product embodies. In this sense, they reflect the basis on which the marketer intends to win sustainable competitive advantage by differentiating the product from others in its competitive space. In its shortest form, a value proposition typically looks like this:

- Target market
- Benefits offered (and not offered)
- Price range (relative to competitors)

Exhibit 8.8 also provides a value proposition for Volvo. More fully developed value propositions sometimes identify the best competing alternatives available to the customer and specify the benefits, in measurable terms, that the customer can expect to receive by using the proposed product. Detailed value propositions such as these are particularly helpful in positioning industrial goods and services, where quantifiable customer benefits are often essential to make the sale.

It is important that the positioning statement or value proposition states benefits that the user of the product will obtain, rather than features or attributes of the product itself, or vague or ambiguous platitudes about high quality or excellent service. By benefits, we mean the resulting end-use measurable consequences that the user will experience through the use of the product, in comparison to others.

The marketer writes positioning statements and value propositions for use internally and by others, such as advertising agencies, engaged to develop the marketing strategy. They are short and succinct, and are typically not written in catchy consumer language, though catchy slogans and tag lines for communication with customers often follow. They are commonly written for a product line or a brand, as is the case in our Volvo example, but sometimes for a single product or for a business as a whole. For products or brands, they play several important roles. They provide direction for R&D and product development about what kind of attributes should be built into the product (side door airbags, for example, in Volvo’s case). They provide direction for those who create advertising campaigns about what the focus of those campaigns should be (for example, Volvo’s ads almost always focus on safety or durability, even though Volvo could say other things about its cars). The value proposition provides direction for pricing decisions. Thus, in a very real sense, the positioning statement or value proposition constitutes the foundation upon which the
marketing strategy is built. More broadly, when used at the business level, as they sometimes are, these statements articulate the strategic direction toward which the company’s activities in all arenas should be directed. Promising a certain sort of positioning, or value, to the target market is one thing. Delivering it is another. Clear and concise positioning statements and value propositions can play important roles in effectively executing the intended strategy.

**Exhibit 8.9 Software Tools for Positioning Decision Making**

Software tools useful for making positioning decisions include applications that identify important determinant attributes, as well as statistical applications that can plot positioning grids from market research data.

**Conjoint analysis:** As was mentioned in Step 5 of the positioning process, it is important to learn which key attributes are important to consumers. Conjoint analysis is one tool for doing so. Conjoint analysis determines which combination of a limited number of attributes consumers most prefer. The technique is helpful for identifying appealing new product designs and important points that might be included in a product’s advertising. Although it can provide some insights about consumer preferences, it cannot provide information about how consumers perceive the positioning of existing products in relation to product dimensions. Conjoint analysis is one way to narrow down a set of product attributes to those most important to consider in product design and positioning decisions. Most often, it is used with physical attributes, not perceptual ones. Several widely used conjoint analysis applications are available from Sawtooth Software, Inc. ([www.sawtoothsoftware.com](http://www.sawtoothsoftware.com)).

**Factor analysis and discriminant analysis:** Factor analysis and discriminant analysis are two statistical techniques useful in constructing positioning grids based on actual marketing research data. They are included in most broad-based statistical packages, such as SPSS MR ([www.spss.com/spssmr](http://www.spss.com/spssmr)). To employ factor analysis, the analyst first must identify the salient attributes consumers use to evaluate products in the category under study. The analyst then collects data from a sample of consumers concerning their ratings of each product or brand on all attributes. The factor analysis program next determines which attributes are related to the same underlying construct (“load” on the same factor). The analyst then uses those underlying constructs or factors as the dimensions for a product space map, and the program indicates where each product or brand is perceived to be located on each factor.

Discriminant analysis requires the same input data as factor analysis. The discriminant analysis program then determines consumers’ perceptual dimensions on the basis of which attributes best differentiate, or discriminate, among brands. Once again, those underlying dimensions can be used to construct a product space map, but they are usually not so easily interpretable as the factors identified through factor analysis. Also, as with factor analysis, the underlying dimensions may be more a function of the attributes used to collect consumer ratings than of the product characteristics that consumers actually consider to be most important.

**Multidimensional scaling:** Unlike the other techniques in which the underlying dimensions identified depend on the attributes supplied by the researcher when collecting data, multidimensional scaling produces dimensions based on consumer judgments about the similarity of, or their preferences for, the actual brands. These underlying dimensions are thought to be the basic attractive dimensions that consumers actually use to evaluate alternative brands in the product class. Multidimensional scaling programs that use data on similarities construct geometrically spaced maps on which the brands perceived to be most similar are placed close together. Those that use consumer preferences produce joint space maps that show consumer ideal points and then position the most-preferred brands close to those ideal points.

Unfortunately, the underlying dimensions of the maps produced by multidimensional scaling can be difficult to interpret. Also, the dimensions identified are only those that already exist for currently available brands. This makes the technique less useful for investigating new product concepts that might involve new characteristics. Finally, the technique is subject to statistical limitations, when the number of alternative brands being investigated is small. As a rule, such techniques should be applied only when at least eight or more different products or brands are being examined.
Throughout the positioning process, we have advocated collecting marketing research data so positioning decisions are anchored in solid evidence, not mere supposition or naive opinion. Advances in computing power and statistical techniques have made possible a broad range of tools to help the marketing decision maker make the best use of marketing research. We briefly outline a few of these tools in Exhibit 8.9. It is beyond the scope of this book to provide detailed instruction in the use of these and other statistical techniques. Texts on marketing research and new product development are good sources for additional depth in this area.18

ENDNOTES


8. For a description of a perceptual mapping procedure that allows consumers to describe and rate the brands involved in their own terminology, see Jan-Benedict E. M. Steenkamp, Hans C. M. Van Tripp, and Jos M. F. Ten Berge, “Perceptual Mapping Based on Idiosyncratic Sets of Attributes,” Journal of Marketing Research, February 1994, p. 15.


12. Existing brands’ attractiveness can be inferred from current sales volumes and market shares. The position occupied by the share leader is obviously more appealing to a greater number of customers than are the positions occupied by lesser brands.


14. When using preference data to define market segments, however, the analyst also should collect information about customers’ demographic characteristics, lifestyle, product usage, and other potential segmentation variables. This enables the analyst to develop a more complete picture of the differences among benefit segments. Such information can be useful for developing advertising appeals, selecting media, focusing personal selling efforts, and designing many of the other elements of a marketing program that can be effective in appealing to a particular segment.

15. The sizes of the individual circles in Exhibit 8.7 are fictitious and designed for illustrative purposes only.

16. The map in Exhibit 8.7 shows five distinct preference segments but only one set of perceived product positions. The implication is that consumers in this sample were similar in the way they perceived existing brands but different in the product attributes they preferred. This is the most common situation; customers tend to vary more in the benefits they seek than in how they perceive available products or brands. Sometimes, however, various segments may perceive the positions of existing brands quite differently. They even may use different determinant attributes in assessing these positions. Under
such circumstances, a marketer should construct a separate market-positioning map for each segment.


SECTION THREE

FORMULATING MARKETING STRATEGIES

CHAPTER 9  Marketing Strategies for New Market Entries

CHAPTER 10  Strategies for Growth Markets

CHAPTER 11  Strategies for Mature and Declining Markets

CHAPTER 12  Marketing Strategies for the New Economy
III. Formulating Market Strategies

9. Marketing Strategies for New Market Entries
CHAPTER NINE

MARKETING STRATEGIES FOR NEW MARKET ENTRIES

Illinois Tool Works—New Nuts & Bolts to Fill Many Niches

Un glamorous and low-profile, Illinois Tool Works makes a diverse array of products that typically are attached to, embedded in, or wrapped around somebody else’s goods. It manufactures nails, screws, bolts, strapping, wrapping, valves, capacitors, filters, and adhesives—as well as the tools and machines to apply them.

Long known for superior engineering—and premium prices—in recent years the Chicago conglomerate has managed to develop and implement more cost-efficient manufacturing methods, become more price-competitive, and aggressively expand its global presence. More important, the firm has been extraordinarily innovative in a variety of mundane product areas. It is the inventor and world’s largest producer of plastic safety buckles, a leading supplier of fasteners to General Motors, the inventor of the plastic loops that hold six-packs together, the maker of ZipPak resealable food packages, and the producer of painting equipment for Toyota’s auto plants. ITW holds nearly 3,000 active U.S. patents, but the firm is so decentralized and has been so prolific that nobody at corporate headquarters can come up with an exact tally of how many products it makes.

How can a $10 billion company manage such diversity, reduce costs, and generate a constant stream of new products all at the same time? As we shall see in Chapter 13, the firm’s organization structure and management policies have a lot to do with it. For one thing, the company is highly decentralized. Lower-level managers are given a great deal of authority to identify and pursue new products or new markets. This helps the firm maintain close contact and relationships with its many customers. And when engineers and marketers in one division develop and commercialize a successful new product, the company often spins off the product and the personnel as a new division. Consequently, the firm now has more than 500 separate divisions or business units operating in 40 different countries—each with its own marketing, R&D, and manufacturing operations—most of which are quite small and nimble, usually accounting for less than $50 million in annual sales.

While the company’s divisions develop tons of new products every year, many are variations of existing products that are redesigned for new applications in new market segments. For instance, in the mid-1980s, an ITW researcher invented a durable safety-rated plastic buckle for a customer who makes life jackets. Now, the firm sells millions of dollars of buckles designed for packs, bicycle helmets, pet collars, and many other applications.
ITW is often the pioneer in developing new product-markets, but it does not always end up as the market share leader as those product categories mature. Instead, it tends to focus on, and often dominates, smaller market niches where competition is less intense and profit margins are higher. As one ITW manager says, “We try to sell where our competitors aren’t.” Although the company is not the market share leader in all of its many businesses, its revenue growth and profitability over the past decade have been among the best in the United States. The firm has consistently been first or second among the most admired firms in the metal products industry on Fortune’s annual survey, and it achieved 14 percent growth in net income in 2000 despite a sagging U.S. economy.

**Strategic Challenges Addressed in Chapter 9**

Illinois Tool Works’ success illustrates several important points about new product and market development. First, both sales growth and cost cutting can help improve profits. But while it is often easier to cut costs in the short term, revenue growth—particularly growth generated by the development of innovative new products—can have a bigger impact on a firm’s profitability and shareholder value over the long haul. This point is confirmed by a study of 847 large corporations conducted by Mercer Management Consulting. The authors found that the compound annual growth rate in the market value of companies that achieved higher-than-average profit growth but lower revenue growth than their industry’s average—companies that increased profits mostly by cutting costs, in other words—was 11.6 percent from 1989 to 1992. By contrast, companies that achieved higher-than-average profits as the result of higher-than-average revenue growth saw their market value jump at an annual rate double that—23.5 percent.2

Illinois Tool Works’ history also illustrates that new product introductions can involve products that differ in their degree of newness from the perspective of the company and its customers. Some of the products developed by the firm, such as the first plastic safety-rated buckle, were new innovations in the eyes of both the company and its customers. But while many of the products ITW develops for new applications, such as buckles designed especially for bicycle helmets or pet collars, are new to the customers in those target niches, they are old hat to the company.

This chapter examines marketing strategies and programs appropriate for developing markets for offerings that are new to the target customers. Our primary focus is on programs used by the pioneer firm, or first entrant—into a particular product-market. Being the pioneer gains a firm a number of potential competitive advantages, but it also involves some major risks. Some pioneers capitalize on their early advantage and maintain a leading market share of the product category, earning substantial revenues and profits, well into the later stages of the product’s life cycle.

Other pioneers are less successful. While ITW has pioneered many new product categories, for instance, it has not always ended up as the share leader in those categories as they grew and matured. In some cases this was a consequence of ITW’s strategy of avoiding
competition by focusing on specialized niche markets. But in other cases, followers have overtaken the pioneer by offering better products, superior customer service, or lower prices. This leads to an interesting strategic question: Is it usually better for a firm to bear the high costs and risks of being the pioneer in hopes of maintaining a profitable position as the market grows or to be a follower that watches for possible design or marketing mistakes by the pioneer before joining the fray with its own entry? We examine this question in the next section.

Not all pioneers are intent on remaining the overall share leader as the market grows. Some, like ITW, adopt a niche market strategy geared to making substantial profits from specialized market segments where they will face fewer large competitors. Others try to stay one jump ahead of the competition by introducing a constant stream of new products and withdrawing from older markets as they become more competitive. Which strategy is best? It depends on the firm’s resources and competencies, the strength of likely future competitors, and characteristics of the product and its target market. Therefore, we will examine some alternative strategies that might be adopted by a pioneer and the situations where each makes most sense.

**How New Is New?**

A survey of the new product development practices of 700 U.S. corporations conducted by the consulting firm of Booz, Allen & Hamilton found that the products introduced by those firms over a five-year period were not all equally “new.” The study identified six categories of new products based on their degree of newness as perceived by both the company and the target customers. These categories are discussed below and diagrammed in Exhibit 9.1, which also indicates the percentage of new entries falling in each category during the five-year study period. Notice that only 10 percent of all new product introductions fell into the new-to-the-world category.3

- **New-to-the-world products**—True innovations that are new to the firm and create an entirely new market (10 percent).
- **New product lines**—A product category that is new for the company introducing it, but not new to customers in the target market because of the existence of one or more competitive brands (20 percent).
- **Additions to existing product lines**—New items that supplement a firm’s established product line. These items may be moderately new to both the firm and the customers in its established product-markets. They also may serve to expand the market segments appealed to by the line (26 percent).
- **Improvements in or revisions of existing products**—Items providing improved performance or greater perceived value brought out to replace existing products. These items may present moderately new marketing and production challenges to the firm, but unless they represent a technologically new generation of products, customers are likely to perceive them as similar to the products they replace (26 percent).
- **Repositionings**—Existing products that are targeted at new applications and new market segments (7 percent).
- **Cost reductions**—Product modifications providing similar performance at lower cost (11 percent).

A product’s degree of newness—to the company, its target customers, or both—helps determine the amount of complexity and uncertainty involved in the engineering, operations, and marketing tasks necessary to make it a successful new entry. It also contributes to the amount of risk inherent in those tasks.
Introducing a product that is new to both the firm and target customers requires the greatest expenditure of effort and resources. It also involves the greatest amount of uncertainty and risk of failure because of the lack of information and experience with the technology and the target customers.

Products new to target customers but not new to the firm (such as line extensions or modifications aimed at new customer segments or repositionings of existing products) are often not very innovative in design or operations, but they may present a great deal of marketing uncertainty. The marketing challenge here—as with new-to-the-world products—is to build primary demand, making target customers aware of the product and convincing them to adopt it. We investigate this marketing problem in this chapter.

Finally, products new to the company but not to the market (such as new product lines, line extensions, product modifications, and cost reductions) often present fewer challenges for R&D and product engineering. The company can study and learn from earlier designs or competitors’ products. However, these products can present major challenges for process engineering, production scheduling, quality control, and inventory management. Once the company introduces such a product into the market, its primary marketing objective is to build selective demand and capture market share, convincing customers the new offering is better than existing competitive products. We discuss marketing programs a firm might use to accomplish these objectives later in Chapter 10.

---

### Exhibit 9.1

**Categories of New Products Defined According to Their Degree of Newness to the Company and Customers in the Target Market**

<table>
<thead>
<tr>
<th>Newness to the Market</th>
<th>Newness to the Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>New product lines (20%)</td>
</tr>
<tr>
<td></td>
<td>New-to-the-world products (10%)</td>
</tr>
<tr>
<td>Low</td>
<td>Cost reductions (11%)</td>
</tr>
<tr>
<td></td>
<td>Additions to existing product lines (26%)</td>
</tr>
<tr>
<td></td>
<td>Revisions/improvements to existing products (26%)</td>
</tr>
<tr>
<td></td>
<td>Repositionings (7%)</td>
</tr>
</tbody>
</table>

Objectives of New Product and Market Development

The primary objective of most new product and market development efforts is to secure future volume and profit growth. This objective has become even more crucial in recent years due to rapidly advancing technology and more intense global competition. A steady flow of new products and the development of new markets, including those in foreign countries, are essential for the continued growth of most firms.

The ITW case illustrates, however, that individual development projects also may accomplish a variety of other strategic objectives. When asked what strategic role was served by their most successful recent new entry, the respondents in the Booz, Allen & Hamilton survey mentioned eight different strategic objectives. Exhibit 9.2 lists these objectives and the percentage of respondents that mentioned each one. The exhibit also indicates which objectives focused on external concerns (e.g., defending market share) and which were driven by a desire to improve or build upon the firm’s internal strengths. Most respondents indicated their new entry helped accomplish more than one objective.

Exhibit 9.3 shows that different types of new entries are appropriate for achieving different strategic objectives. For example, if the objective is to establish a foothold in or preempt a new market segment, the firm must introduce a product that is new to that market,

Exhibit 9.2
Strategic Objectives Attained by Successful New Market Entries

although it may not be entirely new to the company. On the other hand, if the objective is to improve cash flow by adding another cash generator, simple line extensions or product modifications—particularly those that reduce unit costs—may do the trick.

A business’s objectives for its new entries influence the kind of entry strategy it should pursue and the marketing and other functional programs needed to implement that strategy. For instance, if a business is pursuing a prospector strategy and its objectives are to maintain a position as a product innovator and to establish footholds in a variety of new product-markets, it should attempt to be the pioneer in as many of those markets as possible. As we saw in Chapter 3, successful implementation of such a strategy requires the business to be competent in and devote substantial resources to R&D, product engineering, marketing, and marketing research.

On the other hand, if the business is concerned primarily with defending an already strong market share position in its industry, it may prefer to be a follower. Usually entering new product-markets only after an innovator, a follower relies on superior quality, better customer service, or lower prices to offset the pioneer’s early lead. This strategy usually requires fewer investments in R&D and product development, but marketing and sales still are critical in implementing it effectively. A more detailed comparison of these alternative new market entry strategies is the focus of the next section of this chapter.

### Market Entry Strategies: Is It Better to Be a Pioneer or a Follower?

With products such as Word, Excel, and Powerpoint, Microsoft holds a leading share of most office application software categories. But in most of those categories, the firm was not the pioneer. Lotus 1-2-3 was the leading spreadsheet for many years, and WordPerfect and other programs led the word processing category. But as a follower, Microsoft developed improved product designs offering better performance, and it had superior financial
resources to aggressively promote its products. Microsoft’s Windows also held a commanding share of the operating systems market, a position the firm could leverage to convince personal computer manufacturers to bundle its applications software with their machines.

On the other hand, some of the software industry’s pioneers have not fared so well in the marketplace. Lotus, for example, experienced financial difficulties and was ultimately acquired by IBM. While we have stressed the competitive importance of growth via the introduction of new products, the important strategic question is whether it always makes sense to go first. Or do both pioneer and follower market entry strategies have some particular advantages under different conditions?

**Pioneer Strategy**

Conventional wisdom holds that although they take the greatest risks and probably experience more failures than their more conservative competitors, successful pioneers are handsomely rewarded. It is assumed competitive advantages inherent in being the first to enter a new product-market can be sustained through the growth stage and into the maturity stage of the product life cycle, resulting in a strong share position and substantial returns.

Some of the potential sources of competitive advantage available to pioneers are briefly summarized in Exhibit 9.4 and discussed below.4

1. **First choice of market segments and positions.** The pioneer has the opportunity to develop a product offering with attributes most important to the largest segment of customers or to promote the importance of attributes that favor its brand. Thus, the pioneer’s brand can become the standard of reference customers use to evaluate other brands. This can make it more difficult for followers with me-too products to convince existing customers that their new brands are superior to the older and more familiar pioneer. If the pioneer has successfully tied its offering to the choice criteria of the largest group of customers, it also becomes more difficult for followers to differentiate their offerings in ways that are attractive to the mass-market segment. They may have to target a smaller peripheral segment or niche instead.

2. **The pioneer defines the rules of the game.** The pioneer’s actions on such variables as product quality, price, distribution, warranties, postsale service, and promotional appeals and budgets set standards that subsequent competitors must meet or beat. If the pioneer sets those standards high enough, it can raise the costs of entry and perhaps preempt some potential competitors.5

---

**Exhibit 9.4**

<table>
<thead>
<tr>
<th>Potential Advantages of Pioneer and Follower Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pioneer</strong></td>
</tr>
<tr>
<td>• Economies of scale and experience</td>
</tr>
<tr>
<td>• High switching costs for early adopters</td>
</tr>
<tr>
<td>• Pioneer defines the rules of the game</td>
</tr>
<tr>
<td>• Possibility of positive network effects</td>
</tr>
<tr>
<td>• Distribution advantage</td>
</tr>
<tr>
<td>• Influence on consumer choice criteria and attitudes</td>
</tr>
<tr>
<td>• Possibility of preempting scarce resources</td>
</tr>
</tbody>
</table>
3. **Distribution advantages.** The pioneer has the most options in designing a distribution channel to bring the new product to market. This is particularly important for industrial goods where, if the pioneer exercises its options well and with dispatch, it should end up with a network of the best distributors. This can exclude later entrants from some markets. Distributors are often reluctant to take on second or third brands. This is especially true when the product is technically complex and the distributor must carry large inventories of the product and spare parts and invest in specialized training and service.

For consumer package goods, it is more difficult to slow the entry of later competitors by preempting distribution alternatives. Nevertheless, the pioneer still has the advantage of attaining more shelf-facings at the outset of the growth stage. By quickly expanding its product line following an initial success, the pioneer can appropriate still more shelf space, thereby making the challenge faced by followers even more difficult. And as many retailers are reducing the number of brands they carry in a given product category to speed inventory turnover and reduce costs, it is becoming more difficult for followers with unfamiliar brands and small market shares to gain extensive distribution.

4. **Economies of scale and experience.** Being first means the pioneer can gain accumulated volume and experience and thereby lower per unit costs at a faster rate than followers. This advantage is particularly pronounced when the product is technically sophisticated and involves high development costs or when its life cycle is likely to be short with sales increasing rapidly during the introduction and early growth stages.

As we shall see later, the pioneer can deploy these cost advantages in a number of ways to protect its early lead against followers. One strategy is to lower price, which can discourage followers from entering the market because it raises the volume necessary for them to break even. Or the pioneer might invest its savings in additional marketing efforts to expand its penetration of the market, such as heavier advertising, a larger salesforce, or continuing product improvements or line extensions.

5. **High switching costs for early adopters.** Customers who are early to adopt a pioneer’s new product may be reluctant to change suppliers when competitive products appear. This is particularly true for industrial goods where the costs of switching suppliers can be high. Compatible equipment and spare parts, investments in employee training, and the risks of lower product quality or customer service make it easier for the pioneer to retain its early customers over time.

In some cases, however, switching costs can work against the pioneer and in favor of followers. A pioneer may have trouble converting customers to a new technology if they must bear high switching costs to abandon their old way of doing things. Pioneers in the development of music CDs, for instance, faced the formidable task of convincing potential buyers to abandon their substantial investments in turntables and LP record libraries and to start all over again with the new technology. Once the pioneers had begun to convince consumers that the superior convenience, sound quality, and durability of CDs justified those high switching costs, however, demand for CDs and CD players began to grow rapidly and it was easier for followers to attract customers.

6. **Possibility of positive network effects.** The value of some kinds of goods and services to an individual customer increases as greater numbers of other people adopt the product and the network of users grows larger. Economists say that such products exhibit network externalities or positive network effects. Information and communications technologies, such as wireless phones, fax machines, computer software, e-mail, and many Internet sites, are particularly likely to benefit from network effects. For instance, the value of eBay as an auction site increases as the number of potential buyers and sellers who visit and trade on the site increase. If the pioneer in such a product or service category can gain and maintain a substantial customer base before competing technologies or providers appear on the market, the positive network effects generated by that customer base will enhance the benefits of the pioneer’s offering and make it more difficult for followers to match its perceived value.

7. **Possibility of preempting scarce resources and suppliers.** The pioneer may be able to negotiate favorable deals with suppliers who are eager for new business or who do not appreciate...
the size of the opportunity for their raw materials or component parts. If later entrants subsequently find those materials and components in short supply, they may be constrained from expanding as fast as they might like or be forced to pay premium prices.

Not All Pioneers Capitalize on Their Potential Advantages

There is some evidence to suggest that the above advantages can help pioneers gain and maintain a competitive edge in new markets. For instance, some research has found that surviving pioneers hold a significantly larger average market share when their industries reach maturity than firms that were either fast followers or late entrants in the product category.7

On the other hand, some pioneers fail. They either abandon the product category, go out of business, or get acquired before their industry matures. One study, which took these failed pioneers into account and averaged their performance together with that of the more successful survivors, found that pioneers overall did not perform as well over the long haul as followers.8

Of course, volume and market share are not the only dimensions on which success can be measured. Unfortunately, there is little evidence concerning the effect of the timing of a firm’s entry into a new market on its ultimate profitability in that market or the value generated for shareholders.9

In view of the mixed research evidence, then, it seems reasonable to conclude that while a pioneer may have some potential competitive advantages, not all pioneers are successful at capitalizing on them. Some fail during the introductory or shakeout stages of their industries’ life cycles. And those that survive may lack the resources to keep up with rapid growth or the competencies needed to maintain their early lead in the face of onsloughts by strong followers.10

Follower Strategy

In many cases a firm becomes a follower by default. It is simply beaten to a new product-market by a quicker competitor. But even when a company has the capability of being the first mover, the above observations suggest there may be some advantages to letting other firms go first into a product-market. Let the pioneer shoulder the initial risks while the followers observe their shortcomings and mistakes. Possible advantages of such a follower strategy are briefly summarized in Exhibit 9.4 and discussed below.

1. **Ability to take advantage of the pioneer’s positioning mistakes.** If the pioneer misjudges the preferences and purchase criteria of the mass-market segment or attempts to satisfy two or more segments at once, it is vulnerable to the introduction of more precisely positioned products by a follower. By tailoring its offerings to each distinct segment, the follower(s) can successfully encircle the pioneer.

2. **Ability to take advantage of the pioneer’s product mistakes.** If the pioneer’s initial product has technical limitations or design flaws, the follower can benefit by overcoming these weaknesses. Even when the pioneering product is technically satisfactory, a follower may gain an advantage through product enhancements. For example, Compaq captured a substantial share of the commercial PC market by developing faster and more portable versions of IBM’s original machine.

3. **Ability to take advantage of the pioneer’s marketing mistakes.** If the pioneer makes any marketing mistakes in introducing a new entry, it opens opportunities for later entrants. This observation is closely related to the first two points, yet goes beyond product positioning...
and design to the actual execution of the pioneer’s marketing program. For example, the pioneer may fail to attain adequate distribution, spend too little on introductory advertising, or use ineffective promotional appeals to communicate the product’s benefits. A follower can observe these mistakes, design a marketing program to overcome them, and successfully compete head-to-head with the pioneer.

Marketing mistakes can leave a pioneer vulnerable to challenges from later entrants even in product categories with substantial positive network effects. For example, Microsoft’s Windows operating system was not the first user-friendly system on the market. However, Microsoft promoted and priced Windows very aggressively, it formed alliances with original equipment manufacturers (OEMs) in the personal computer industry to encourage them to install Windows on their machines, and it engaged in extensive licensing and cooperative agreements with other software developers. All these actions helped Windows capture a commanding share of the operating systems market, which in turn generated tremendous positive network effects for Windows and made it difficult for alternative systems to compete (perhaps too difficult, from the U.S. Justice Department’s perspective).

4. Ability to take advantage of the latest technology. In industries characterized by rapid technological advances, followers can possibly introduce products based on a superior, second-generation technology and thereby gain an advantage over the pioneer. And the pioneer may have difficulty reacting quickly to such advances if it is heavily committed to an earlier technology. Consumer popularity of the newer VHS format, for instance, gave followers in the videocassette recorder market an advantage over pioneer Sony, which was locked in to the less-popular Beta format.

5. Ability to take advantage of pioneer’s limited resources. If the pioneer has limited resources for production facilities or marketing programs, or fails to commit sufficient resources to its new entry, followers willing and able to outspend the pioneer experience few enduring constraints.

Determinants of Success for Pioneers and Followers

Our discussion suggests that a pioneering firm stands the best chance for long-term success in market-share leadership and profitability when (1) the new product-market is insulated from the entry of competitors, at least for a while, by strong patent protection, proprietary technology (such as a unique production process), substantial investment requirements, or positive network effects, or (2) the firm has sufficient size, resources, and competencies to take full advantage of its pioneering position and preserve it in the face of later competitive entries. Evidence suggests that organizational competencies, such as R&D and marketing skills, not only affect a firm’s success as a pioneer, but also may influence the company’s decision about whether or not to be a pioneer in the first place. Firms that perceive they lack the competencies necessary to sustain a first-mover advantage may be more likely to wait for another company to take the lead and to enter the market later.11

McDonald’s is an example of a pioneer that has succeeded by aggressively building on the foundations of its early advantage. Although the firm started small as a single hamburger restaurant, it used the franchise system of distribution to rapidly expand the number of McDonald’s outlets with a minimum cash investment. That expansion plus stringent quality and cost controls, relatively low prices made possible by experience-curve effects, heavy advertising expenditures, and product line expansion aimed at specific market segments (such as Egg McMuffin for the breakfast crowd) have all enabled the firm to maintain a commanding share of the fast-food hamburger industry.

On the other hand, a follower will most likely succeed when there are few legal, technological, or financial barriers to inhibit entry and when it has sufficient resources or competencies to overwhelm the pioneer’s early advantage. For example, given Procter &
Gamble’s well-established brand name and superior advertising and promotional resources, the company was able to quickly take the market share lead away from pioneer Minnetonka, Inc., in the plaque-fighting toothpaste market with a reformulated version of Crest. A study conducted across a broad range of industries in the PIMS database supports these observations. The author’s findings are briefly summarized in Exhibit 9.5 and discussed below. The author found that, regardless of the industry involved, pioneers able to maintain their preeminent position well into the market’s growth stage had supported their early entry with the following marketing strategy elements:

- **Large entry scale**—Successful pioneers had sufficient capacity, or could expand quickly enough, to pursue a mass-market targeting strategy, usually on a national rather than a local or regional basis. Thus, they could expand their volume quickly and achieve the benefits of experience-curve effects before major competitors could confront them.

- **Broad product line**—Successful pioneers also quickly add line extensions or modifications to their initial product to tailor their offerings to specific market segments. This helps reduce their vulnerability to later entrants who might differentiate themselves by targeting one or more peripheral markets.

- **High product quality**—Successful pioneers also offer a high-quality, well-designed product from the beginning, thus removing one potential differential advantage for later followers. Competent engineering, thorough product and market testing before commercialization, and good quality control during the production process are all important to the continued success of pioneers.

- **Heavy promotional expenditures**—Successful pioneers had marketing programs characterized by relatively high advertising and promotional expenditures as a percentage of sales. Initially the promotion helps to stimulate awareness and primary demand for the new product category, build volume, and reduce unit costs. Later, this promotion focuses on building selective demand for the pioneer’s brand and reinforcing loyalty as new competitors enter.

The same study found that the most successful fast followers had the resources to enter the new market on a larger scale than the pioneer. Consequently, they could quickly reduce their unit costs, offer lower prices than incumbent competitors, and enjoy any positive network effects. Some fast followers achieved success, however, by leapfrogging earlier entrants. These followers won customers away from the pioneer by offering a product with more sophisticated technology, better quality, or superior service.

**Exhibit 9.5**

**Marketing Strategy Elements Pursued by Successful Pioneers, Fast Followers, and Late Entrants**

**These marketers . . .** are characterized by one or more of these strategy elements:

**Successful pioneers**
- Large entry scale
- Broad product line
- High product quality
- Heavy promotional expenditures

**Successful fast followers**
- Larger entry scale than the pioneer
- Leapfrogging the pioneer with superior:
  - product technology
  - product quality
  - customer service

**Successful late entrants**
- Focus on peripheral target markets or niches

Finally, the author found that some late entrants also achieved substantial profits by avoiding direct confrontations with more established competitors and by pursuing peripheral target markets. They often offer tailor-made products to smaller market niches and support them with high levels of service.

Followers typically enter a market after it is in the growth phase of its life cycle, and they start with low market shares relative to the established pioneer. Consequently, our discussion in the next chapter of marketing strategies for low-share competitors in growth markets is germane to both fast followers and later entrants. Before focusing on strategies for followers, however, we should first examine strategies that might be successfully employed by the first entrant in a new product-market.

**Strategic Marketing Programs for Pioneers**

The preceding discussion suggests that the ultimate success of a pioneering strategy depends on the nature of the demand and competitive situation the pioneer encounters in the market and on the pioneer’s ability to design and support an effective marketing program. It also depends on how the pioneer defines success—in other words, the objectives it seeks to achieve. Thus, a pioneer might choose from one of three different types of marketing strategies: mass-market penetration, niche penetration, or skimming and early withdrawal. Exhibit 9.6 summarizes the primary objectives of each strategy and the circumstances favoring their use. While specific conditions may favor a given strategy, they do not guarantee its success. Much still depends on how effectively a firm implements the strategy. Also, it is highly unlikely that all the listed conditions will exist simultaneously in any single product-market.

**Mass-Market Penetration**

The ultimate objective of a mass-market penetration strategy is to capture and maintain a commanding share of the total market for the new product. Thus, the critical marketing task is to convince as many potential customers as possible to adopt the pioneer’s product quickly to drive down unit costs and build a large contingent of loyal customers before competitors enter the market.

Mass-market penetration tends to be most successful when entry barriers inhibit or delay the appearance of competitors, thus allowing the pioneer more time to build volume, lower costs, and create loyal customers, or when the pioneer has competencies or resources that most potential competitors cannot match. Relevant competencies include product engineering, promotional and channel management skills, and the financial and organizational resources necessary to expand capacity in advance of demand. In some cases, though, a smaller firm with limited resources can successfully employ a mass-market penetration strategy if the market has a protracted adoption process and slow initial growth. Slow growth can delay competitive entry because fewer competitors are attracted to a market with questionable future growth. This allows the pioneer more time to expand capacity.

Mass-market penetration is also an appropriate strategy when the product category is likely to experience positive network effects. Since the value of such products increases as the number of users grows, it makes sense for the pioneer to quickly capture and maintain as large a customer base as possible.
### Exhibit 9.6

**Marketing Objectives and Strategies for New Product Pioneers**

<table>
<thead>
<tr>
<th>Situational variables</th>
<th>Mass-market penetration</th>
<th>Niche penetration</th>
<th>Skimming: early withdrawal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary objective</strong></td>
<td>• Maximize number of triers and adopters in total market.</td>
<td>• Maximize number of triers and adopters in target segment.</td>
<td>• Recoup development and commercialization costs as soon as possible.</td>
</tr>
<tr>
<td></td>
<td>• Maintain leading share position in total market.</td>
<td>• Maintain leading share position in target segment.</td>
<td>• Withdraw from market when increasing competition puts pressure on margins.</td>
</tr>
<tr>
<td><strong>Market characteristics</strong></td>
<td>• Large potential demand.</td>
<td>• Large potential demand.</td>
<td>• Limited potential demand.</td>
</tr>
<tr>
<td></td>
<td>• Relatively homogeneous customer needs.</td>
<td>• Fragmented market; many different applications and benefit segments.</td>
<td>• Customers likely to adopt product relatively slowly; long adoption process.</td>
</tr>
<tr>
<td></td>
<td>• Customers likely to adopt product relatively quickly; short diffusion process.</td>
<td>• Customers likely to adopt product relatively quickly; short adoption process.</td>
<td>• Early adopters willing to pay high price; demand is price inelastic.</td>
</tr>
<tr>
<td><strong>Product characteristics</strong></td>
<td>• Product technology patentable or difficult to copy.</td>
<td>• Product technology offers little patent protection; easily copied or adapted.</td>
<td>• Product technology offers little patent protection; easily copied or adapted.</td>
</tr>
<tr>
<td></td>
<td>• Substantial network effects; value increases with growth of installed customer base.</td>
<td>• Limited or no network effects.</td>
<td>• Limited or no network effects.</td>
</tr>
<tr>
<td></td>
<td>• Components or materials difficult to obtain; limited sources of supply.</td>
<td>• Components or materials easy to obtain; many sources of supply.</td>
<td>• Components or materials easy to obtain; many sources of supply.</td>
</tr>
<tr>
<td></td>
<td>• Complex production process; substantial development and/or investment required.</td>
<td>• Relatively simple production process; little development or additional investment required.</td>
<td>• Relatively simple production process; little development or additional investment required.</td>
</tr>
<tr>
<td><strong>Competitor characteristics</strong></td>
<td>• Few potential competitors.</td>
<td>• Many potential competitors.</td>
<td>• Many potential competitors.</td>
</tr>
<tr>
<td></td>
<td>• Most potential competitors have limited resources and competencies; few sources of differential advantage.</td>
<td>• Some potential competitors have substantial resources and competencies; possible sources of differential advantage.</td>
<td>• Some potential competitors have substantial resources and competencies; possible sources of differential advantage.</td>
</tr>
<tr>
<td><strong>Firm characteristics</strong></td>
<td>• Strong product engineering skills; able to quickly develop product modifications and line extensions for multiple market segments.</td>
<td>• Limited product engineering skills and resources.</td>
<td>• Strong basic R&amp;D and new product development skills; a prospector with good capability for continued new product innovation.</td>
</tr>
<tr>
<td></td>
<td>• Strong marketing skills and resources; ability to identify and develop marketing programs for multiple segments; ability to shift from stimulation of primary demand to stimulation of selective demand as competitors enter.</td>
<td>• Limited marketing skills and resources.</td>
<td>• Good sales and promotional skills; able to quickly build primary demand in target market; perhaps has limited marketing resources for long-term market maintenance.</td>
</tr>
<tr>
<td></td>
<td>• Sufficient financial and organizational resources to build capacity in advance of growth in demand.</td>
<td>• Insufficient financial or organizational resources to build capacity in advance of growing demand.</td>
<td>• Limited financial or organizational resources to commit to building capacity in advance of growth in demand.</td>
</tr>
</tbody>
</table>

Niche Penetration

Even when a new product-market expands quickly, however, it still may be possible for a small firm with limited resources to be a successful pioneer. In such cases, though, the firm must define success in a more limited way. Instead of pursuing the objective of capturing and sustaining a leading share of the entire market, it may make more sense for such firms to focus their efforts on a single market segment. This kind of niche penetration strategy can help the smaller pioneer gain the biggest bang for its limited bucks and avoid direct confrontations with bigger competitors.

A niche penetration strategy is most appropriate when the new market is expected to grow quickly and there are a number of different benefit or applications segments to appeal to. It is particularly attractive when there are few barriers to the entry of major competitors and when the pioneer has only limited resources and competencies to defend any advantage it gains through early entry. For example, the fact that the applications for many of Illinois Tool Works’ products are highly specialized, its markets are fragmented, and it prefers to avoid direct confrontations with large competitors all help explain why the firm favors a niche penetration strategy.

Some pioneers may intend to pursue a mass-market penetration strategy when introducing a new product or service, but they end up implementing a niche penetration strategy instead. This is particularly likely when the new market grows faster or is more fragmented than the pioneer expects. Facing such a situation, a pioneer with limited resources may decide to concentrate on holding its leading position in one or a few segments, rather than spreading itself too thin developing unique line extensions and marketing programs for many different markets or going deep into debt to finance rapid expansion.

Skimming and Early Withdrawal

Even when a firm has the resources to sustain a leading position in a new product-market, it may choose not to. Competition is usually inevitable, and prices and margins tend to drop dramatically after followers enter the market. Therefore, some pioneers opt to pursue a skimming strategy while planning an early withdrawal from the market. This involves setting a high price and engaging in only limited advertising and promotion to maximize per-unit profits and recover the product’s development costs as quickly as possible. At the same time, the firm may work to develop new applications for its technology or the next generation of more advanced technology. Then when competitors enter the market and margins fall, the firm is ready to cannibalize its own product with one based on new technology or to move into new segments of the market.

The 3M Company is a master of the skimming strategy. According to one 3M manager, “We hit fast, price high (full economic value of the product to the user), and get the heck out when the me-too products pour in.” The new markets pioneered by the company are often smaller ones of $10 million to $50 million, and the firm may dominate them for only about five years or so. By then, it is ready to launch the next generation of new technology or to move the old technology into new applications. An example of 3M’s approach is described in Exhibit 9.7.

As Exhibit 9.6 indicates, either small or large firms can use strategies of skimming and early withdrawal. But it is critical that the company have good R&D and product development skills so it can produce a constant stream of new products or new applications to replace older ones as they attract heavy competition. Also, since a firm pursuing this kind of strategy plans to remain in a market only short term, it is most appropriate when there...
are few barriers to entry, the product is expected to diffuse rapidly, and the pioneer lacks the capacity or other resources necessary to defend a leading share position over the long haul.

**Marketing Program Components for a Mass-Market Penetration Strategy**

As mentioned, the crucial marketing task in a mass-market penetration strategy is to maximize the number of customers adopting the firm’s new product as quickly as possible. This requires a marketing program focused on (1) aggressively building product awareness and motivation to buy among a broad cross-section of potential customers and (2) making it as easy as possible for those customers to try the new product, on the assumption that they will try it, like it, develop loyalty, and make repeat purchases.

Exhibit 9.8 outlines a number of marketing activities that might help increase customers’ awareness and willingness to buy or improve their ability to try the product. This is by no means an exhaustive list; nor do we mean to imply that a successful pioneer must necessarily engage in all of the listed activities. Marketing managers must develop programs combining activities that fit both the objectives of a mass-market penetration strategy and the specific market and potential competitive conditions the new product faces.

**Increasing Customers’ Awareness and Willingness to Buy**

Obviously, heavy expenditures on advertising, introductory promotions such as sampling and couponing, and personal selling efforts all can increase awareness of a new product or service among potential customers. This is the critical first step in the adoption process for a new entry. The relative importance of these promotional tools varies, however, depending on the nature of the product and the number of potential customers. For instance, personal selling efforts are often the most critical component of the promotional mix for highly technical industrial products with a limited potential customer base. Media advertising and sales promotion are usually more useful for building awareness and primary demand for a new consumer good among customers in the mass market. In either case, when designing a mass-market penetration marketing program, firms should broadly focus promotional efforts to expose and attract as many potential customers as possible before competitors show up.

Firms might also attempt to increase customers’ willingness to buy their products by reducing the risk associated with buying something new. This can be done by letting customers try the product without obligation, as when car dealers allow potential customers to test-drive a new model, or when software developers allow customers to download a trial version and use it free for 30 days. Liberal return policies and extended warranties can serve the same purpose.
### Exhibit 9.8

**Components of Strategic Marketing Programs for Pioneers**

<table>
<thead>
<tr>
<th>Strategic objectives and tasks</th>
<th>Mass-market penetration</th>
<th>Niche penetration</th>
<th>Skimming: early withdrawal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase customers' awareness and willingness to buy</td>
<td>- Heavy advertising to generate awareness among customers in mass market; broad use of mass media.</td>
<td>- Heavy advertising directed at target segment to generate awareness; use selective media relevant to target.</td>
<td>- Limited advertising to generate awareness; particularly among least price-sensitive early adopters.</td>
</tr>
<tr>
<td></td>
<td>- Extensive salesforce efforts to win new adopters; possible use of incentives to encourage new product sales.</td>
<td>- Extensive salesforce efforts focused on potential customers in target segment; possible use of incentives to encourage new product sales to target accounts.</td>
<td>- Extensive salesforce efforts, particularly focused on largest potential adopters; possible use of volume-based incentives to encourage new product sales.</td>
</tr>
<tr>
<td></td>
<td>- Extensive introductory sales promotions to induce trial (sampling, couponing, quantity discounts).</td>
<td>- Extensive introductory sales promotions to induce trial, but focused on target segment.</td>
<td>- Limited use, if any, of introductory sales promotions; if used, they should be volume-based quantity discounts.</td>
</tr>
<tr>
<td></td>
<td>- Move relatively quickly to expand offerings (line extensions, multiple package sizes) to appeal to multiple segments.</td>
<td>- Additional product development limited to improvements or modifications to increase appeal to target segment.</td>
<td>- Little, if any, additional development within the product category.</td>
</tr>
<tr>
<td></td>
<td>- Offer free trial, liberal return, or extended warranty policies to reduce customers' perceived risk of adopting the new product.</td>
<td>- Offer free trial, liberal return, or extended warranty policies to reduce target customers' perceived risk of adopting the new product.</td>
<td>- Offer free trial, liberal return, or extended warranty policies to reduce target customers' perceived risk of adopting the new product.</td>
</tr>
<tr>
<td></td>
<td>- Penetration pricing; or start with high price but bring out lower-priced versions in anticipation of competitive entries.</td>
<td>- Penetration pricing; or start with high price but bring out lower-priced versions in anticipation of competitive entries.</td>
<td>- Skimming pricing; attempt to maintain margins at level consistent with value of product to early adopters.</td>
</tr>
<tr>
<td></td>
<td>- Extended credit terms to encourage initial purchases.</td>
<td>- Extended credit terms to encourage initial purchases.</td>
<td>- Extended credit terms to encourage initial purchases.</td>
</tr>
<tr>
<td></td>
<td>- Heavy use of trade promotions aimed at gaining extensive distribution.</td>
<td>- Trade promotions aimed at gaining solid distribution among retailers or distributors pertinent for reaching target segment.</td>
<td>- Limited use of trade promotions; only as necessary to gain adequate distribution.</td>
</tr>
<tr>
<td></td>
<td>- Offer engineering, installation, and training services to increase new product's compatibility with customers' current operations to reduce switching costs.</td>
<td>- Offer engineering, installation, and training services to increase new product's compatibility with customers' current operations to reduce switching costs.</td>
<td>- Offer limited engineering, installation, and training services as necessary to overcome customers' objections.</td>
</tr>
</tbody>
</table>
Finally, a firm committed to mass-market penetration might also broaden its product offerings to increase its appeal to as many market segments as possible. This helps reduce its vulnerability to later entrants who could focus on specific market niches. Firms can accomplish such market expansion through the rapid introduction of line extensions, additional package sizes, or product modifications targeted at new applications and market segments. Illinois Tool Works, for example, rapidly increased sales of its plastic safety buckle by modifying it for use with a variety of products, such as bicycle helmets, backpacks, and pet collars.

**Increasing Customers’ Ability to Buy** For customers to adopt a new product and develop loyalty toward it, they must be aware of the item and be motivated to buy. But they also must have the wherewithal to purchase it. Thus, to capture as many customers in as short a time as possible, it usually makes sense for a firm pursuing mass-market penetration to keep prices low (penetration pricing) and perhaps offer liberal financing arrangements or easy credit terms during the introductory period.

Pioneers introducing new information or communications technologies tend to be particularly aggressive in pricing their offerings for two reasons. First, as we have seen, such products often can benefit from positive network effects if enough customers can be induced to adopt them quickly. Second, the variable costs of producing and distributing additional units of such products are usually very low, perhaps even approaching zero. For instance, the costs of developing a new software product are high, but once it is developed, copies can be made and distributed over the Internet for next to nothing. These two factors mean that it often makes sense for pioneers in such product categories to set their price very low to initial customers—perhaps even to give away trial copies—in hopes of quickly building a large installed base, capturing more value from later customers with higher prices, and maximizing the lifetime value of their customers by selling them upgrades and enhanced versions of the product in the future.14

Another factor that can inhibit customers’ ability to buy is a lack of product availability. Thus, extensive personal selling and trade promotions aimed at gaining adequate distribution are usually a critical part of a mass-market penetration marketing program. Such efforts should take place before the start of promotional campaigns to ensure that the product is available as soon as customers are motivated to buy it.

A highly technical new product’s incompatibility with other related products or systems currently used also can inhibit customers’ purchases. It can result in high switching costs for a potential adopter. The pioneer might reduce those costs by designing the product to be as compatible as possible with related equipment. It also might offer engineering services to help make the new product more compatible with existing operations, provide free installation assistance, and conduct training programs for the customer’s employees.

The above actions are suited not just to the marketing of products; most are essential elements of mass-market penetration strategies for new service, retail, and even e-commerce websites as well. The marketing actions of an e-tailer such as Amazon.com, discussed in Exhibit 9.9, provide a textbook example of the elements of, as well as some of the risks inherent in, a mass-market penetration strategy.

**Additional Considerations When Pioneering Global Markets** Whether the product-market a pioneer is trying to penetrate is domestic or foreign, many of the marketing tasks appropriate for increasing potential customers’ awareness, willingness, and ability to buy the new product or service are largely the same. Of course, some of the tactical aspects of the pioneer’s strategic marketing program—such as specific product features, promotional appeals, or distribution channels—may have to be adjusted to fit different cultural, legal, or economic circumstances across national borders. For Bausch &
Lomb to develop the Chinese market for contact lenses, for instance, it first had to develop an extensive training program for the country’s opticians and build a network of retail outlets, actions that were unnecessary in more developed markets.

Unless the firm already has an economic presence in a country via the manufacture or marketing of other products or services, however, a potential global pioneer faces at least one additional question: What mode of entry is most appropriate? There are three basic mechanisms for entering a foreign market: exporting through agents (e.g., using local manufacturers’ representatives or distributors), contractual agreements (e.g., licensing or franchise arrangements with local firms), and direct investment.

Exporting is the simplest way to enter a foreign market because it involves the least commitment and risk. It can be direct or indirect. The latter relies on the expertise of domestic international middlemen: export merchants, who buy the product and sell it...
overseas for their own account; export agents, who sell on a commission basis; and cooperative organizations, which export for several producers—especially those selling farm products. Direct exporting uses foreign-based distributors and agents or operating units (i.e., branches or subsidiaries) set up in the foreign country.

**Contractual entry modes** are nonequity arrangements that involve the transfer of technology or skills to an entity in a foreign country. In **licensing**, a firm offers the right to use its intangible assets (e.g., technology, know-how, patents, company name, trademarks) in exchange for royalties or some other form of payment. Licensing is less flexible and provides less control than exporting. Further, if the contract is terminated, the licensor may have developed a competitor. It is appropriate, however, when the market is unstable or difficult to penetrate.

**Franchising** grants the right to use the company’s name, trademarks, and technology. Also, the franchisee typically receives help in setting up the franchise. It is an especially attractive way for service firms to penetrate foreign markets at low cost and to couple their skills with local knowledge and entrepreneurial spirit. Host countries are reasonably receptive to this type of exporting since it involves local ownership. U.S. companies have largely pioneered franchising—especially such fast-food companies as McDonald’s, Pizza Hut, Burger King, and Kentucky Fried Chicken. In recent years foreign franchisers have entered the United States—largely from Canada, Great Britain, and Japan—in a variety of fields, including food, shoe repair, leather furniture, and wall cleaning.

Other contractual entry modes include **contract manufacturing**, which involves sourcing a product from a manufacturer located in a foreign country for sale there or elsewhere (e.g., auto parts, clothes, and furniture). Contract manufacturing is most attractive when the local market is too small to warrant making an investment, export entry is blocked, and a quality licensee is not available. A **turnkey construction contract** requires the contractor to have the project up and operating before releasing it to the owner. **Coproduct** involves a company’s providing technical know-how and components in return for a share of the output that it must sell. **Countertrade** transactions include barter (direct exchange of goods—hams for aircraft), compensation packages (cash and local goods), counterpurchase (delayed sale of bartered goods to enable the local buyer to sell the goods), and a buyback arrangement in which the products being sold are used to produce other goods.

**Overseas direct investment** can be implemented in two ways: joint ventures or sole ownership. **Joint ventures** involve a joint ownership arrangement (e.g., one between a U.S. firm and one in the host country) to produce or market goods in a foreign country. Today, joint ventures are commonplace because they avoid quotas and import taxes and satisfy government demands to produce locally. They also have the advantage of sharing investment costs and gaining local marketing expertise. For example, Motorola had difficulty penetrating the Japanese market until it formed an alliance with Toshiba to set up a joint chip-making venture. In addition, Toshiba provided Motorola with marketing help.

A **sole ownership** investment entry strategy involves setting up a production facility in a foreign country. Direct investment usually allows the parent organization to retain total control of the overseas operation and avoids the problems of shared management and loss of flexibility. This strategy is particularly appropriate when the politics of the situation require a dedicated local facility. Firms using a direct investment strategy extensively include General Motors, Procter & Gamble, General Foods, Hewlett-Packard, and General Electric.

Exporting has the advantage of lowering the financial risk for a pioneer entering an unfamiliar foreign market. Unfortunately, such arrangements also afford a pioneer relatively little control over the marketing and distribution of its product or service—activities that are critical for winning customer awareness and loyalty in a new market. At the other extreme, investing in a wholly owned subsidiary typically makes little sense until it
becomes clear that the pioneering product will win customer acceptance. Consequently, intermediate modes of entry, such as licensing or forming a joint venture with a local firm in the host country, tend to be the preferred means of developing global markets for new products. Joint ventures are particularly appropriate in this regard because they avoid quotas and import restrictions or taxes, and they allow a pioneer to share financial risks while gaining local marketing expertise. Thus Bausch & Lomb established a joint venture with Beijing Optical as a basis for building contact lens factories in China and for gaining access to Chinese opticians. Consequently, the firm has been able to develop and maintain a leading market share in the world’s most heavily populated country with a modest investment of only about $20 million.

Marketing Program Components for a Niche Penetration Strategy

Because the objectives of a niche penetration strategy are similar to but more narrowly focused than those of a mass-market strategy, the marketing program elements are also likely to be similar under the two strategies. Obviously, however, the niche penetrator should keep its marketing efforts clearly focused on the target segment to gain as much impact as possible from its limited resources. This point is evident in the outline of program components in Exhibit 9.8. For example, while a niche strategy calls for the same advertising, sales promotion, personal selling, and trade promotion activities as a mass-market program, the former should use more selective media, call schedules, and channel designs to precisely direct those activities toward the target segment.

Marketing Program Components for a Skimming Strategy

As Exhibit 9.8 suggests, one major difference between a skimming strategy and a mass-market penetration strategy involves pricing policies. A relatively high price is appropriate for a skimming strategy to increase margins and revenues, even though some price-sensitive customers may be reluctant to adopt the product at that price. This also suggests that introductory promotional programs might best focus on customer groups who are least sensitive to price and most likely to be early adopters of the new product. This can help hold down promotion costs and avoid wasting marketing efforts on less profitable market segments. Thus, in many consumer goods businesses, skimming strategies focus on relatively upscale customers, since they are often more likely to be early adopters and less sensitive to price.

Another critical element of a skimming strategy is the nature of the firm’s continuing product-development efforts. A pioneer that plans to leave a market when competitors enter should not devote much effort to expanding its product line through line extensions or multiple package sizes. Instead, it should concentrate on the next generation of technology or on identifying new application segments, in other words, preparing its avenue of escape from the market.

Now that we have examined some strategies a pioneer might follow in entering a new market, we are left with two important strategic questions. The pioneer is by definition the early share leader in the new market; hence the first question is, What adjustments in strategy might be necessary for the pioneer to maintain its leading share position after competitors arrive on the scene? The second is, What strategies might followers adopt to take business away from the early leader and increase their relative share position as the market grows? These two strategic issues are the focus of the next chapter.
Take Aways

- Being the pioneer in a new product or service category gains the firm a number of potential advantages. But not all pioneers are able to sustain a leading position in the market as it grows. A pioneering firm stands the best chance for long-term share leadership and profitability when the market can be insulated from the rapid entry of competitors by patent protection or other means and when the firm has the necessary resources and competencies to capitalize on its first-mover advantages.

- Evidence suggests that pioneers who successfully capitalize on their first-mover advantage and sustain a leading competitive position (a) introduce a quality product and pay careful attention to quality control, (b) have the capacity to enter on a large scale or the resources to expand rapidly as the market grows, (c) back the introduction with substantial promotion to build awareness and trial, and (d) rapidly expand the product line to satisfy multiple customer segments.

- Followers can trump the pioneer in a new product category if they can enter with more capacity backed by substantially larger marketing expenditures, or by leapfrogging the first mover with superior technology, product quality, or customer service.

- Not all pioneers attempt to penetrate the mass market and remain the share leader as that market grows. Some adopt a strategy geared to making profits from specialized niche markets where they will face fewer direct competitors. Still others try to stay one jump ahead of competitors by introducing a stream of new products and withdrawing from older markets as they become more competitive. The appropriate strategy to adopt depends on the firm’s resources and competencies, the strength of likely competitors, and the characteristics of the product and its target market.

- Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at www.mhhe.com/walker.

Endnotes


2. These results are reported in Myron Magnet, “Let’s Go for Growth,” *Fortune*, March 7, 1994, pp. 60–72.


16. This assumes that demand is relatively price inelastic. In markets where price elasticity is high, a skimming price strategy may lead to lower total revenues due to its dampening effect on total demand.
Nike versus Vans: The Battle for Jocks’ Hearts and Soles

NIKE ATHLETIC SHOES began life in 1964—albeit under a different name—as a specialty product targeted at long-distance runners, a very narrow niche of the athletic footwear market. Phil Knight, a former distance runner at the University of Oregon, and his former coach Bill Bowerman believed that distance runners needed better shoes. With his wife's waffle iron and some latex, Bowerman developed the waffle outsole that would revolutionize the running shoe. Nike's new shoes were lighter and more flexible than competing shoes, with better lateral stability to protect against ankle sprains and more cushioning to help runners' bodies cope with miles and miles of repetitive impact.

The company struggled for years to strengthen its foothold in an industry dominated by much larger global competitors like Adidas. But in 1972 Nike finally gained the sporting world's attention when four of the top seven finishers in the Olympic marathon wore the firm's shoes. By 1974 Nike was America's best selling brand of training shoe, and the Nike brand was on the way to stardom.

Having become number one in training shoes, Nike set its sights on achieving share leadership in the entire industry. As a first step toward accomplishing that goal, the company invested heavily in new product R&D and design efforts to expand its product line with offerings tailored to the needs and preferences of participants in a wide variety of other sports. It held down costs by outsourcing production of the new lines to a number of offshore manufacturers. However, the firm maintained tight control over, and was much less frugal with, its marketing efforts. Nike spent heavily on endorsement deals with sport celebrities and on a series of stylish but edgy mass media ad campaigns to capture attention and build a strong brand image in its new target segments. It also constructed an extensive distribution network consisting largely of independent mass retailers and specialty chains like Footlocker.

In 1978, tennis great John McEnroe signed with the company and tennis shoes became a prominent part of the product line. In 1985, a promising Chicago Bulls rookie named Michael Jordan endorsed a line of Air Jordan shoes and apparel. By 1986, Nike's worldwide sales passed the billion-dollar mark and Nike had become the acknowledged technological leader in the footwear industry. Today, Nike offers a full line of shoes for virtually every athletic activity, it's the global leader in industry market share, and it dominates most segments of the market—with a few notable exceptions.
Boarders Are Bored with Nike

In 1995 Nike made a concerted run at capturing a dominant share of the shoe and apparel purchases of skateboarders, but stubbed its toe. These days, the brand of choice among boarders is tiny Vans Inc. The Santa Fe Springs, California, company pioneered thick-soled slip-on sneakers able to absorb the shock of a five-foot leap on wheels. The firm nurtures its cool image with an offbeat marketing program that forgoes media advertising and focuses instead on sponsorships, events, and other “experience” activities that fit the skateboard culture. The centerpiece of these marketing efforts is the elaborate skateboard parks Vans is building at malls around the country. The company also gets some broader media exposure by sponsoring events such as the Vans Triple Crown, a showcase for alternative sports ranging from skateboarding to BMX biking that is broadcast by NBC Sports. As Vans’ CEO Gary Schoenfeld points out, “Our vision is not to hit our target audience over the head with ads, but to integrate ourselves into the places they are most likely to be.”

Because the skateboarding craze was hot during the first years of the 21st century, Vans enjoyed heady growth. The company earned $15.5 million on sales of $336 million in its 2000 fiscal year, a 23 percent increase over the year before. True, that gives Vans less than 2 percent of an overall athletic shoe market that is half-owned by Nike, but the firm’s focus on alternative sports fanatics has built an intensely loyal—and profitable—customer base.

While Vans would like to pursue growth by developing new products, it also wants to avoid offending loyal customers who love its maverick roots and outsider image. The company would rather preserve its dominance in a small but lucrative market niche than launch a risky and expensive battle for a bigger share of the entire market. Thus, the firm is experimenting with hiking boots, snowboard boots, and an expanded clothing line, but has steered clear of inline skates because skateboarders tend to see them as a wimpy offshoot.

Strategic Challenges Addressed in Chapter 10

While Nike was clearly not the pioneer of the athletic shoe industry, the firm’s technical innovations, stylish designs, and savvy market segmentation strategy spurred a sustained period of market growth. Both conventional wisdom and the various portfolio models suggest there are advantages to be gained from a strategy of investing heavily to build and sustain a commanding share of a growing market, a strategy similar to Nike’s. But a market is neither inherently attractive nor unattractive simply because it promises rapid future growth. And not all competitors have the resources and capabilities necessary to dominate an entire market, as Vans—with its limited marketing budget—seems well aware. Consequently, managers must consider how customer desires and the competitive situation are likely to evolve as a market grows, and determine whether their firms can exploit market growth to establish a sustainable advantage. Therefore, the next section of this chapter examines both the opportunities and competitive risks often found in growing product-markets.

The primary objective of the early share leader, usually the market pioneer, in a growth market is share maintenance. From a marketing perspective the firm must accomplish two important tasks: (1) retain repeat or replacement business from its existing customers...
and (2) continue to capture the major portion of sales to the growing number of new customers entering the market for the first time. The leader might use any of several marketing strategies to accomplish these objectives. It might try to build on its early scale and experience advantages to achieve low-cost production and reduce its prices. Alternatively, the leader might focus on rapid product improvements, expand its product line to appeal to newly emerging segments, or increase its marketing and sales efforts, all of which Nike employed in building global leadership in the athletic footwear market.

The second section of this chapter explores marketing strategies—both defensive and offensive—that leaders might use to maintain a dominant market share in the face of continuing growth and increasing competition.

A challenger’s strategic objective in a growth market is usually to build its share by expanding its sales faster than the overall market growth rate. Firms do this by stealing existing customers away from the leader or other competitors, capturing a larger share of new customers than the market leader, or both. Once again, challengers might use a number of strategies to accomplish these objectives. These include developing a superior product technology; differentiating through rapid product innovations, line extensions, or customer service; offering lower prices; or focusing on market niches where the leader is not well established, as Van’s has done in the skateboarding segment. The fourth section details these and other share-growth strategies that market challengers use under different conditions.

The success of a firm’s strategy during the growth stage is a critical determinant of its ability to reap profits, or even survive, as a product-market moves toward maturity. Unfortunately, the growth stage is often short; and increasingly rapid technological change and market fragmentation are causing it to become even shorter in many industries. This shortening of the growth stage concerns many firms—particularly late entrants or those who fail to acquire a substantial market share—because as growth slows during the transition to maturity, there is often a shakeout of marginal competitors. Thus, when choosing marketing strategies for competing in a growing product-market, managers should keep one eye on building a competitive advantage that the business can sustain as growth slows and the market matures.

Opportunities and Risks in Growth Markets

Why are followers attracted to rapidly growing markets? Conventional wisdom suggests such markets present attractive opportunities for future profits because

- It is easier to gain share when a market is growing.
- Share gains are worth more in a growth market than in a mature market.
- Price competition is likely to be less intense.
- Early participation in a growth market is necessary to make sure that the firm keeps pace with the technology.

While generally valid, each of these premises may be seriously misleading for a particular business in a specific situation. Many followers attracted to a market by its rapid growth rate are likely to be shaken out later when growth slows because either the preceding premises did not hold or they could not exploit growth advantages sufficiently to build a sustainable competitive position. By understanding the limitations of the assumptions about growth markets and the conditions under which they are most likely to hold, a manager can make better decisions about entering a market and the kind of marketing strategy likely to be most effective in doing so.
Gaining Share Is Easier

The premise that it is easier for a business to increase its share in a growing market is based on two arguments. First, there may be many potential new users who have no established brand loyalties or supplier commitments and who may have different needs or preferences than earlier adopters. Thus there may be gaps or undeveloped segments in the market. It is easier, then, for a new competitor to attract those potential new users than to convert customers in a mature market. Second, established competitors are less likely to react aggressively to market-share erosion as long as their sales continue to grow at a satisfactory rate.

There is some truth to the first argument. It usually is easier for a new entrant to attract first-time users than to take business away from entrenched competitors. To take full advantage of the situation, however, the new entrant must be able to develop a product offering that new customers perceive as more attractive than other alternatives, and it must have the marketing resources and competence to effectively persuade them of that fact. This can be difficult, especially when the pioneer has had months or years to influence potential customers’ decision criteria and preferences.4

The notion that established competitors are less likely to react to share losses so long as their revenues are growing at an acceptable rate is more tenuous. It overlooks the fact that those competitors may have higher expectations for increased revenues when the market itself is growing. Capital investments and annual operating budgets are usually tied to those sales expectations; therefore, competitors are likely to react aggressively when sales fall below expected levels whether or not their absolute volumes continue to grow. This is particularly true given that increased competition will likely erode the leader’s relative market share even though its volume may continue to increase. As illustrated by the hypothetical example in Exhibit 10.1, the leader’s market share might drop from a high of 100

percent at the beginning of the growth stage to 50 percent by the maturity stage, even though the firm’s absolute volume shows steady growth.

Industry leaders often react forcefully when their sales growth falls below industry levels, or when the industry’s growth rate slows. For example, when growth in the personal computer market slumped in 2000 due to the dot-com crash and other factors, Dell Computer did not adjust its aggressive sales growth objective. Instead, it launched a brutal price war aimed at taking more business away from competitors in order to achieve its goal. Because Dell’s focus on direct selling over the Internet, its build-to-order manufacturing system, and its tightly integrated supply chain made it the undisputed low-cost producer in the industry, Dell was able to slash gross margins from 21.3 percent in mid-2000 to 17.5 percent in mid-2001 and still make money. As a result, Dell’s leading share of the global PC market increased from 10 percent to 13 percent by July of 2001. And while the firm earned $360 million in profits through the first half of 2001, its competitors suffered a total of $1.1 billion in losses.5

Share Gains Are Worth More

The premise that share gains are more valuable when the market is growing stems from the expectation that the earnings produced by each share point continue to expand as the market expands. The implicit assumption in this argument, of course, is that the business can hold its relative share as the market grows. The validity of such an assumption depends on a number of factors, including the following:

- **The existence of positive network effects.** As we saw in the previous chapter, pioneers in new product-markets enjoy several potential competitive advantages that they can—but don’t always manage to—leverage as the market grows. For information-based products, such as computer software or Internet auction sites, one of the most important such advantage is the existence of positive network effects, the tendency for the product to become more valuable to users as the number of adopters grows. Such network effects increase the likelihood that an early share leader can sustain, and even increase, its relative share as the market grows. As Microsoft was able to license its Windows operating system to a growing number of computer manufacturers, for example, software developers created more and more applications to run on Windows, which made Windows even more attractive to later computer buyers and helped Microsoft expand its already commanding market share.

- **Future changes in technology or other key success factors.** On the other hand, if the rules of the game change, the competencies a firm relied on to capture share may no longer be adequate to maintain that share. For instance, Sony was the pioneer and early share leader in the videocassette recorder industry with its Betamax technology. But Matsushita’s longer-playing and lower-priced VHS format equipment ultimately proved much more popular with consumers, captured a commanding portion of the market, and dethroned Sony as industry leader.

- **Future competitive structure of the industry.** The number of firms that ultimately decide to compete for a share of the market may turn out to be larger than the early entrants anticipate, particularly if there are few barriers to entry. The sheer weight of numbers can make it difficult for any single competitor to maintain a substantial relative share of the total market.

- **Future fragmentation of the market.** As the market expands, it may fragment into numerous small segments, particularly if potential customers have relatively heterogeneous functional, distribution, or service needs. When such fragmentation occurs, the market in which a given competitor competes may shrink as segments splinter away.

In addition to these possible changes in future market conditions, a firm’s ability to hold its early gains in market share also depends on how it obtained them. If a firm captures share through short-term promotions or price cuts that competitors can easily match and that may tarnish its image among customers, its gains may be short-lived.
Price Competition Is Likely to Be Less Intense

In many rapidly growing markets demand exceeds supply. The market exerts little pressure on prices initially; the excess demand may even support a price premium. Thus, early entry provides a good opportunity for a firm to recover its initial product development and commercialization investment relatively quickly. New customers also may be willing to pay a premium for technical service as they learn how to make full use of the new product. In contrast, as the market matures and customers gain more experience, the premium a firm can charge without losing market share slowly shrinks; it eventually may disappear entirely.6

However, this scenario does not hold true in every developing product-market. If there are few barriers to entry or if the adoption process is protracted and new customers enter the market slowly, demand may not exceed supply—at least not for very long. Also, the pioneer, or one of the earliest followers, might adopt a penetration strategy and set its initial prices relatively low to move quickly down the experience curve and discourage other potential competitors from entering the market.

Early Entry Is Necessary to Maintain Technical Expertise

In high-tech industries early involvement in new product categories may be critical for staying abreast of technology. The early experience gained in developing the first generation of products and in helping customers apply the new technology can put the firm in a strong position for developing the next generation of superior products. Later entrants, lacking such customer contact and production and R&D experience, are likely to be at a disadvantage.

There is substantial wisdom in these arguments. Sometimes, however, an early commitment to a specific technology can turn out to be a liability. This is particularly true when multiple unrelated technologies might serve a market or when a newly emerging technology might replace the current one. Once a firm is committed to one technology, adopting a new one can be difficult. Management is often reluctant to abandon a technology in which it has made substantial investments, and it might worry that a rapid shift to a new technology will upset present customers. As a result, early commitment to a technology has become increasingly problematic because of more rapid rates of technological change. This problem is dramatically illustrated by the experience of Medtronic, Inc., as described in Exhibit 10.2.

Exhibit 10.2 Medtronic’s Commitment to an Old Technology Cost It Sales and Market Share

The dangers inherent in being overly committed to an early technology are demonstrated by Medtronic, Inc., the pioneer in the cardiac pacemaker industry. Medtronic was reluctant to switch to a new lithium-based technology that enabled pacemakers to work much longer before being replaced. As a result, several Medtronic employees left the company and founded Cardiac Pacemakers Inc. to produce and market the new lithium-based product. They quickly captured nearly 20 percent of the total market. And Medtronic saw its share of the cardiac pacemaker market fall rapidly from nearly 70 percent to 40 percent.

Growth-Market Strategies for Market Leaders

For the share leader in a growing market, of course, the question of the relative advantages versus risks of market entry is moot. The leader is typically the pioneer, or at least one of the first entrants, who developed the product-market in the first place. Often, that firm’s strategic objective is to maintain its leading share position in the face of increasing competition as the market expands. Share maintenance may not seem like a very aggressive objective, because it implies the business is merely trying to stay even rather than forge ahead. But two important facts must be kept in mind.

First, the dynamics of a growth market—including the increasing number of competitors, the fragmentation of market segments, and the threat of product innovation from within and outside the industry—make maintaining an early lead in relative market share very difficult. The continuing need for investment to finance growth, the likely negative cash flows that result, and the threat of governmental antitrust action can make it even more difficult. For example, 31 percent of the 877 market-share leaders in the PIMS database experienced losses in relative share, and leaders were especially likely to suffer this fate when their market shares were very large.7

Second, a firm can maintain its current share position in a growth market only if its sales volume continues to grow at a rate equal to that of the overall market, enabling the firm to stay even in absolute market share. However, it may be able to maintain a relative share lead even if its volume growth is less than the industry’s.

Marketing Objectives for Share Leaders

Share maintenance for a market leader involves two important marketing objectives. First, the firm must retain its current customers, ensuring that those customers remain brand loyal when making repeat or replacement purchases. This is particularly critical for firms in consumer nondurable, service, and industrial materials and components industries where a substantial portion of total sales volume consists of repeat purchases. Second, the firm must stimulate selective demand among later adopters to ensure that it captures a large share of the continuing growth in industry sales.

In some cases the market leader might pursue a third objective: stimulating primary demand to help speed up overall market growth. This can be particularly important in product-markets where the adoption process is protracted because of the technical sophistication of the new product, high switching costs for potential customers, or positive network effects.

The market leader is the logical one to stimulate market growth in such situations; it has the most to gain from increased volume, assuming it can maintain its relative share of that volume. However, expanding total demand—by promoting new uses for the product or stimulating existing customers’ usage and repeat purchase rates—is often more critical near the end of the growth stage and early in the maturity stage of a product’s life cycle. Consequently, we discuss marketing actions appropriate to this objective in the next chapter.

Marketing Actions and Strategies to Achieve Share-Maintenance Objectives

A business might take a variety of marketing actions to maintain a leading share position in a growing market. Exhibit 10.3 outlines a lengthy, though not exhaustive, list of such actions and their specific marketing objectives. Because share maintenance involves multiple objectives,
### Exhibit 10.3

**Marketing Actions to Achieve Share-Maintenance Objectives**

<table>
<thead>
<tr>
<th>Marketing objectives</th>
<th>Possible marketing actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retain current customers by</td>
<td>• Increase attention to quality control as output expands.</td>
</tr>
<tr>
<td>• Maintaining/improving satisfaction and loyalty.</td>
<td>• Continue product modification and improvement efforts to increase customer benefits and/or reduce costs.</td>
</tr>
<tr>
<td></td>
<td>• Focus advertising on stimulation of selective demand; stress product's superior features and benefits; reminder advertising.</td>
</tr>
<tr>
<td></td>
<td>• Increase salesforce’s servicing of current accounts; consider formation of national or key account representatives to major customers; consider replacing independent manufacturer’s reps with company salespeople where appropriate.</td>
</tr>
<tr>
<td></td>
<td>• Expand postsale service capabilities; develop or expand company’s own service force, or develop training programs for distributors’ and dealers’ service people; expand parts inventory; develop customer service hotline or website.</td>
</tr>
<tr>
<td></td>
<td>• Encouraging/simplifying repeat purchase.</td>
</tr>
<tr>
<td></td>
<td>• Expand production capacity in advance of increasing demand to avoid stockouts.</td>
</tr>
<tr>
<td></td>
<td>• Improve inventory control and logistics systems to reduce delivery times.</td>
</tr>
<tr>
<td></td>
<td>• Continue to build distribution channels; use periodic trade promotions to gain more extensive retail coverage and maintain shelf-facings; strengthen relationships with strongest distributors/dealers.</td>
</tr>
<tr>
<td></td>
<td>• Consider negotiating long-term requirements contracts with major customers.</td>
</tr>
<tr>
<td></td>
<td>• Consider developing automatic reorder systems or logistical alliances.</td>
</tr>
<tr>
<td></td>
<td>• Reducing attractiveness of switching.</td>
</tr>
<tr>
<td></td>
<td>• Develop a second brand or product line with features or price more appealing to a specific segment of current customers (flanker strategy—see Exhibits 10.4 and 10.5).</td>
</tr>
<tr>
<td></td>
<td>• Develop multiple-line extensions or brand offerings targeted to the needs of several user segments within the market (market expansion).</td>
</tr>
<tr>
<td></td>
<td>• Meet or beat lower prices or heavier promotional efforts by competitors—or try to preempt such efforts by potential competitors—when necessary to retain customers and when lower unit costs allow (confrontation strategy).</td>
</tr>
<tr>
<td>Stimulate selective demand among later adopters by</td>
<td>• Head-to-head positioning against competitive offerings or potential offerings.</td>
</tr>
<tr>
<td>• Differentiated positioning against competitive offerings or potential offerings.</td>
<td>• Develop a second brand or product line with features or price more appealing to a specific segment of potential customers (flanker strategy).</td>
</tr>
<tr>
<td></td>
<td>• Make product modifications or improvements to match or beat superior competitive offerings (confrontation strategy).</td>
</tr>
<tr>
<td></td>
<td>• Meet or beat lower prices or heavier promotional efforts by competitors when necessary to retain customers and when lower unit costs allow (confrontation strategy).</td>
</tr>
<tr>
<td></td>
<td>• When resources are limited relative to a competitor’s, consider withdrawing from smaller or slower growing segments to focus product development and promotional efforts on higher potential segments threatened by competitor (contraction or strategic withdrawal strategy).</td>
</tr>
<tr>
<td></td>
<td>• Develop multiple-line extensions or brand offerings targeted to the needs of various potential user applications or geographical segments within the market (market expansion strategy).</td>
</tr>
<tr>
<td></td>
<td>• Build unique distribution channels to more effectively reach specific segments of potential customers (market expansion strategy).</td>
</tr>
<tr>
<td></td>
<td>• Design multiple advertising and/or sales promotion campaigns targeted at specific segments of potential customers (market expansion strategy).</td>
</tr>
</tbody>
</table>
and different marketing actions may be needed to achieve each one, a strategic marketing program usually integrates a mix of the actions outlined in the exhibit.

Not all the actions summarized in Exhibit 10.3 are consistent with one another. It would be unusual, for instance, for a business to invest heavily in new product improvements and promotion to enhance its product’s high-quality image and simultaneously slash prices, unless it was trying to drive out weaker competitors in the short run with an eye on higher profits in the future. Thus, the activities outlined in Exhibit 10.3 cluster into five internally consistent strategies that a market leader might employ, singly or in combination, to maintain its leading share position: a fortress, or position defense, strategy; a flanker strategy; a confrontation strategy; a market expansion strategy; and a contraction, or strategic withdrawal, strategy.

Exhibit 10.4 diagrams this set of strategies. It is consistent with what a number of military strategists and some marketing authorities have identified as common defensive strategies. To think of them as strictly defensive, though, can be misleading. Companies can use some of these strategies offensively to preempt expected future actions by potential competitors. Or they can use them to capture an even larger share of future new customers.

Which, or what combination, of these five strategies is most appropriate for a particular product-market depends on (1) the market’s size and its customers’ characteristics, (2) the number and relative strengths of the competitors or potential competitors in that market, and (3) the leader’s own resources and competencies. Exhibit 10.5 outlines the situations in

---

**Exhibit 10.4**

**Strategic Choices for Share Leaders in Growth Markets**

### Chapter Ten  
**Strategies for Growth Markets**

**Exhibit 10.5**  
**Marketing Objectives and Strategies for Share Leaders in Growth Markets**

<table>
<thead>
<tr>
<th>Situational variables</th>
<th>Fortress or position defense</th>
<th>Flanker</th>
<th>Confrontation</th>
<th>Market expansion</th>
<th>Contraction or strategic withdrawal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary objective</strong></td>
<td>Increase satisfaction, loyalty, and repeat purchase among current customers by building on existing strengths; appeal to late adopters with same attributes and benefits offered to early adopters.</td>
<td>Protect against loss of specific segments of current customers by developing a second entry that covers a weakness in original offering; improve ability to attract new customers with specific needs or purchase criteria different from those of early adopters.</td>
<td>Protect against loss of share among current customers by meeting or beating a head-to-head competitive offering; improve ability to win new customers who might otherwise be attracted to competitor's offering.</td>
<td>Increase ability to attract new customers by developing new product offerings or line extensions aimed at a variety of new applications and user segments; improve ability to retain current customers as market fragments.</td>
<td>Increase ability to attract new customers in selected high-growth segments by focusing offerings and resources on those segments; withdraw from smaller or slower-growing segments to conserve resources.</td>
</tr>
<tr>
<td><strong>Market characteristics</strong></td>
<td>Relatively homogeneous market with respect to customer needs and purchase criteria; strong preference for leader's product among largest segment of customers.</td>
<td>Two or more major market segments with distinct needs or purchase criteria.</td>
<td>Relatively homogeneous market with respect to customers' needs and purchase criteria; little preference for, or loyalty toward, leader's product among largest segment of customers.</td>
<td>Relatively heterogeneous market with respect to customers' needs and purchase criteria; multiple product uses requiring different product or service attributes.</td>
<td>Relatively heterogeneous market with respect to customers' needs, purchase criteria, and growth potential; multiple product uses requiring different product or service attributes.</td>
</tr>
<tr>
<td><strong>Competitors' characteristics</strong></td>
<td>Current and potential competitors have relatively limited resources and competencies.</td>
<td>One or more current or potential competitors with sufficient resources and competencies to effectively implement a differentiation strategy.</td>
<td>One or more current or potential competitors with sufficient resources and competencies to effectively implement a head-to-head strategy.</td>
<td>Current and potential competitors have relatively limited resources and competencies, particularly with respect to R&amp;D and marketing.</td>
<td>One or more current or potential competitors with sufficient resources and competencies to present a strong challenge in one or more growth segments.</td>
</tr>
<tr>
<td><strong>Firm's characteristics</strong></td>
<td>Current product offering enjoys high awareness and preference among major segment of current and potential customers; firm has marketing and R&amp;D resources and competencies equal to or greater than any current or potential competitor.</td>
<td>Current product offering perceived as weak on at least one attribute by a major segment of current or potential customers; firm has sufficient R&amp;D and marketing resources to introduce and support a second offering aimed at the disaffected segment.</td>
<td>Current product offering suffers low awareness, preference, and/or loyalty among major segment of current or potential customers; firm has R&amp;D and marketing resources and competencies equal to or greater than any current or potential competitor.</td>
<td>No current offerings in one or more potential applications segments; firm has marketing and R&amp;D resources and competencies equal to or greater than any current or potential competitor.</td>
<td>Current product offering suffers low awareness, preference, and/or loyalty among current or potential customers in one or more major growth segments; firm's R&amp;D and marketing resources and competencies are limited relative to those of one or more competitors.</td>
</tr>
</tbody>
</table>
which each strategy is most appropriate and the primary objectives for which they are best suited.

**Fortress, or Position Defense, Strategy**

The most basic defensive strategy is to continually strengthen a strongly held current position—to build an impregnable fortress capable of repelling attacks by current or future competitors. This strategy is nearly always part of a leader’s share-maintenance efforts. By shoring up an already strong position, the firm can improve the satisfaction of current customers while increasing the attractiveness of its offering to new customers with needs and characteristics similar to those of earlier adopters.

Strengthening the firm’s position makes particularly good sense when current and potential customers have relatively homogeneous needs and desires and the firm’s offering already enjoys a high level of awareness and preference in the mass market. In some homogeneous markets, a well-implemented position defense strategy may be all that is needed for share maintenance.

Most of the marketing actions listed in Exhibit 10.3 as being relevant for retaining current customers might be incorporated into a position defense strategy. Anything the business can do to improve customer satisfaction and loyalty and encourage and simplify repeat purchasing should help the firm protect its current customer base and make its offering more attractive to new customers. Some of the specific actions appropriate for accomplishing these two objectives are discussed in more detail below.

**Actions to Improve Customer Satisfaction and Loyalty**

The rapid expansion of output necessary to keep up with a growth market often can lead to quality control problems for the market leader. As new plants, equipment, and personnel are quickly brought on line, bugs can suddenly appear in the production process. Thus, the leader must pay particular attention to quality control during this phase. Most customers have only limited, if any, positive past experiences with the new brand to offset their disappointment when a purchase does not live up to expectations.

Perhaps the most obvious way a leader can strengthen its position is to continue to modify and improve its product. This can reduce the opportunities for competitors to differentiate their products by designing in features or performance levels the leader does not offer. The leader might also try to reduce unit costs to discourage low-price competition.

The leader should take steps to improve not only the physical product but customers’ perceptions of it as well. As competitors enter or prepare to enter the market, the leader’s advertising and sales promotion emphasis should shift from stimulating primary demand to building selective demand for the company’s brand. This usually involves creating appeals that emphasize the brand’s superior features and benefits. While the leader may continue sales promotion efforts aimed at stimulating trial among later adopters, some of those efforts might be shifted toward encouraging repeat purchases among existing customers. For instance, it might include cents-off coupons inside the package to give customers a price break on their next purchases of the brand.

For industrial goods, some salesforce efforts should shift from prospecting for new accounts to servicing existing customers. Firms that relied on independent manufacturer’s reps to introduce their new product might consider replacing them with company salespeople to increase the customer service orientation of their sales efforts. Firms whose own salespeople introduced the product might reorganize their salesforces into specialized groups focused on major industries or user segments. Or they might assign key account representatives, or cross-functional account teams, to service their largest customers.
Finally, a leader can strengthen its position as the market grows by giving increased attention to postsale service. Rapid growth in demand not only can outstrip a firm’s ability to produce a high-quality product, but it also can overload the firm’s ability to service customers. This can lead to a loss of existing customers as well as negative word of mouth that might inhibit the firm’s ability to attract new users. Thus, the growth phase often requires increased investments to expand the firm’s parts inventory, hire and train service personnel and dealers, and improve the information content on the firm’s website.

**Actions to Encourage and Simplify Repeat Purchasing**  One of the most critical actions a leader must take to ensure that customers continue buying its product is to maximize its availability. It must reduce stockouts on retail store shelves or shorten delivery times for industrial goods. To do this, the firm must invest in plant and equipment to expand capacity in advance of demand, and it must implement adequate inventory control and logistics systems to provide a steady flow of goods through the distribution system. The firm also should continue to build its distribution channels. In some cases, a firm might even vertically integrate parts of its distribution system—such as building its own warehouses, as Amazon.com and several other e-tailers have done recently—to gain better control over order fulfillment activities and ensure quick and reliable deliveries.

Some market leaders, particularly in industrial goods markets, can take more proactive steps to turn their major customers into captives and help guarantee future purchases. For example, a firm might negotiate requirements contracts or guaranteed price agreements with its customers to ensure future purchases, or it might tie them into a computerized reorder system or a tightly integrated supply-chain relationship. Such actions are all aimed at increasing customers’ repeat purchases and loyalty in order to maximize their lifetime value. While it makes good sense to begin building strong customer relationships right from the beginning, they become even more crucial as the market matures and competition to win over established customers becomes more intense. Consequently, we’ll have more to say about building and managing customer relationships in the next chapter.

**Flanker Strategy**

One shortcoming of a fortress strategy is that a challenger might simply choose to bypass the leader’s fortress and try to capture territory where the leader has not yet established a strong presence. This can represent a particular threat when the market is fragmented into major segments with different needs and preferences and the leader’s current brand does not meet the needs of one or more of those segments. A competitor with sufficient resources and competencies can develop a differentiated product offering to appeal to the segment where the leader is weak and thereby capture a substantial share of the overall market.

To defend against an attack directed at a weakness in its current offering (its exposed flank), a leader might develop a second brand (a **flanker** or **fighting brand**) to compete directly against the challenger’s offering. This might involve trading up, where the leader develops a high-quality brand offered at a higher price to appeal to the prestige segment of the market. This was Toyota’s rationale for introducing its Lexus brand of luxury automobiles, for instance.

More commonly, though, a flanker brand is a lower-quality product designed to appeal to a low-price segment to protect the leader’s primary brand from direct price competition. Pillsbury’s premium-quality Hungry Jack brand holds the major share of the refrigerated biscuit dough market; however, a substantial number of consumers prefer to pay less for a somewhat lower-quality biscuit. Rather than conceding that low-price segment to competitors, or reducing Hungry Jack prices and margins in an attempt to attract price-sensitive consumers, Pillsbury introduced Ballard, a low-priced flanker brand.
A flanker strategy is always used in conjunction with a position defense strategy. The leader simultaneously strengthens its primary brand while introducing a flanker to compete in segments where the primary brand is vulnerable. This suggests that a flanker strategy is appropriate only when the firm has sufficient resources to develop and fully support two or more entries. After all, a flanker is of little value if it is so lightly supported that a competitor can easily wipe it out.

**Confrontation Strategy**

Suppose a competitor chooses to attack the leader head to head and attempts to steal customers in the leader’s main target market. If the leader has established a strong position and attained a high level of preference and loyalty among customers and the trade, it may be able to sit back and wait for the competitor to fail. In many cases, though, the leader’s brand is not strong enough to withstand a frontal assault from a well-funded, competent competitor. Even mighty IBM, for instance, lost 20 market-share points in the commercial PC market during the mid-1980s to competitors such as Compaq, whose machines cost about the same but offered features or performance levels that were better, and to the clones who offered IBM-compatible machines at much lower prices. Later, the firm’s share of the PC market eroded further as companies such as Dell and Gateway introduced more convenient and efficient Internet ordering and direct distribution systems and cut prices even more.

In such situations, the leader may have no choice but to confront the competitive threat directly. If the leader’s competitive intelligence is good, it may decide to move proactively and change its marketing program before a suspected competitive challenge occurs. A confrontational strategy, though, is more commonly reactive. The leader usually decides to meet or beat the attractive features of a competitor’s offering—by making product improvements, increasing promotional efforts, or lowering prices—only after the challenger’s success has become obvious.

Simply meeting the improved features or lower price of a challenger, however, does nothing to reestablish a sustainable competitive advantage for the leader. And a confrontation based largely on lowering prices creates an additional problem of shrinking margins for all concerned. Unless decreased prices generate substantial new industry volume and the leader’s production costs fall with that increasing volume, the leader may be better off responding to price threats with increased promotion or product improvements while trying to maintain its profit margins. Evidence also suggests that in product-markets with high repeat-purchase rates or a protracted diffusion process, the leader may be wise to adopt a penetration pricing policy in the first place. This would strengthen its share position and might preempt low-price competitors from entering.

The leader can avoid the problems of a confrontation strategy by reestablishing the competitive advantage eroded by challengers’ frontal attacks. But this typically requires additional investments in process improvements aimed at reducing unit costs, improvements in product quality or customer service, or even the development of the next generation of improved products to offer customers greater value for their dollars.

**Market Expansion Strategy**

A market expansion strategy is a more aggressive and proactive version of the flanker strategy. Here the leader defends its relative market share by expanding into a number of market segments. This strategy’s primary objective is to capture a large share of new customer groups who may prefer something different from the firm’s initial offering, protecting the
firm from future competitive threats from a number of directions. Such a strategy is particularly appropriate in fragmented markets if the leader has the resources to undertake multiple product development and marketing efforts.

The most obvious way a leader can implement a market expansion strategy is to develop line extensions, new brands, or even alternative product forms utilizing similar technologies to appeal to multiple market segments. For instance, although Pillsbury holds a strong position in the refrigerated biscuit dough category, biscuit consumption is concentrated among older, more traditional consumers in the South. To expand its total market, gain increased experience-curve effects, and protect its overall technological lead, Pillsbury developed a variety of other product forms that use the same refrigerated dough technology and production facilities but appeal to different customer segments. The expanded line includes crescent rolls, Danish rolls, and soft breadsticks. Similarly, Nike captured and has sustained a leading share of the athletic shoe market by developing a series of line extensions offering technical, design, and style features tailored to the preferences of enthusiasts in nearly every sport.

A less-expensive way to appeal to a variety of customer segments is to retain the basic product but vary other elements of the marketing program to make it relatively more attractive to specific users. Thus, a leader might create specialized salesforces to deal with the unique concerns of different user groups. Or it might offer different ancillary services to different types of customers or tailor sales promotion efforts to different segments. Thus, performing arts groups often promote reduced ticket prices, transportation services, and other inducements to attract senior citizens and students to matinee performances.

Contraction, or Strategic Withdrawal, Strategy

In some highly fragmented markets, a leader may be unable to defend itself adequately in all segments. This is particularly likely when newly emerging competitors have more resources than the leader. The firm may then have to reduce or abandon its efforts in some segments to focus on areas where it enjoys the greatest relative advantages or that have the greatest potential for future growth. Even some very large firms may decide that certain segments are not profitable enough to continue pursuing. For example, IBM made an early attempt to capture the low end of the home hobbyist market for personal computers with the introduction of the PC Jr. But the firm eventually abandoned that effort to concentrate on the more lucrative commercial and education segments.

Share-Growth Strategies for Followers

Marketing Objectives for Followers

Not all late entrants to a growing product-market have illusions about eventually surpassing the leader and capturing a dominant market share. Some competitors, particularly those with limited resources and competencies, may simply seek to build a small but profitable business within a specialized segment of the larger market that earlier entrants have overlooked, as Vans has done with great success in the skateboarder segment of the athletic shoe market. As we have seen, this kind of niche strategy is one of the few entry options that small, late entrants can pursue with a reasonable degree of success. If a firm can successfully build a profitable business in a small segment while avoiding direct competition with larger competitors, it often can survive the shakeout period near the end of the growth stage and remain profitable throughout the maturity stage.
Exhibit 10.6
MARKETING ACTIONS TO ACHIEVE SHARE-GROWTH OBJECTIVES

**Marketing objectives** | **Possible marketing actions**
---|---
Capture repeat/replacement purchases from current customers of the leader or other target competitor by
- Head-to-head positioning against competitor's offering in primary target market.
  - Develop products with features and/or performance levels superior to those of the target competitor.
  - Draw on superior product design, process engineering, and supplier relationships to achieve lower unit costs.
  - Set prices below target competitor's for comparable level of quality or performance, but only if low-cost position is achieved.
  - Outspend the target competitor on promotion aimed at stimulating selective demand:
    - Comparative advertising appeals directed at gaining a more favorable positioning than the target competitor's brand enjoys among customers in the mass market.
    - Sales promotions to encourage trial if offering's quality or performance is perceptively better than target competitor's, or induce brand switching.
    - More extensive and/or better-trained salesforce than target competitor's.
  - Outspend the target competitor on trade promotion to attain more extensive retail coverage, better shelf space, and/or representation by the best distributors/dealers.
  - Outperform the target competitor on customer service:
    - Develop superior production scheduling, inventory control, and logistics systems to minimize delivery times and stockouts.
    - Develop superior postsale service capabilities. Build a more extensive company service force, or provide better training programs for distributor/dealer service people than those of target competitor.
- Technological differentiation from target competitor's offering in its primary target market.
  - Develop a new generation of products based on different technology that offers superior performance or additional benefits desired by current and potential customers in the mass market (*leapfrog strategy*).
  - Build awareness, preference, and replacement demand through heavy introductory promotion:
    - Comparative advertising stressing product's superiority.
    - Sales promotions to stimulate trial or encourage switching.
    - Extensive, well-trained salesforce; heavy use of product demonstrations in sales presentations.
  - Build adequate distribution through trade promotions and dealer training programs.

Stimulate selective demand among later adopters by
- Head-to-head positioning against target competitor's offering in established market segments.
  - See preceding actions.
- Differentiated positioning focused on untapped or underdeveloped segments.
  - Develop a differentiated brand or product line with unique features or prices that is more appealing to a major segment of potential customers whose needs are not met by existing offerings (*flanking strategy*).
  - Develop multiple line extensions or brand offerings with features or prices targeted to the unique needs and preferences of several smaller potential applications or regional segments (*encirclement strategy*).
  - Design advertising, personal selling, and/or sales promotion campaigns that address specific interests and concerns of potential customers in one or multiple underdeveloped segments to stimulate selective demand.
  - Build unique distribution channels to more effectively reach potential customers in one or multiple underdeveloped segments.
  - Design service programs to reduce the perceived risks of trial and/or solve the unique problems faced by potential customers in one or multiple underdeveloped segments (e.g., systems engineering, installation, operator training, extended warranties, service hotline, or website).
Many followers, particularly larger firms entering a product-market shortly after the pioneer, have more grandiose objectives. They often seek to displace the leader or at least to become a powerful competitor within the total market. Thus, their major marketing objective is to attain share growth, and the size of the increased relative share such challengers seek is usually substantial. For instance, while Cisco Systems holds a dominant 80 percent share of the market for the routers that direct data to the right places on the Internet, it was a late entrant into the market for switching systems used by telephone companies to direct voice traffic. In 1999, Cisco held less than a 1 percent share of the $225 billion market for telephone equipment. Nevertheless, it announced its intention to become the global share leader in that market.11

Marketing Actions and Strategies to Achieve Share Growth

A challenger with visions of taking over the leading share position in an industry has two basic strategic options, each involving somewhat different marketing objectives and actions. Where the share leader and perhaps some other early followers have already penetrated a large portion of the potential market, a challenger may have no choice but to steal away some of the repeat purchase or replacement demand from the competitors’ current customers. As Exhibit 10.6 indicates, the challenger can attempt this through marketing activities that give it an advantage in a head-to-head confrontation with a target competitor. Or it can attempt to leapfrog over the leader by developing a new generation of products with enough benefits to induce customers to trade in their existing brand for a new one. Secondarily, such actions also may help the challenger attract a larger share of late adopters in the mass market.

If the market is relatively early in the growth phase and no previous entrant has captured a commanding share of potential customers, the challenger can focus on attracting a larger share of potential new customers who enter the market for the first time. This also may be a viable option when the overall market is heterogeneous and fragmented and the current share leader has established a strong position in only one or a few segments. In either case, the primary marketing activities for increasing share via this approach should aim at differentiating the challenger’s offering from those of existing competitors by making it more appealing to new customers in untapped or underdeveloped market segments.

Once again, Exhibit 10.6’s list of possible marketing actions for challengers is not exhaustive, and it contains actions that do not always fit well together. The activities that do fit tend to cluster into five major strategies that a challenger might use singly or in combination to secure growth in its relative market share. As Exhibit 10.7 indicates, these five share-growth strategies are frontal attack, leapfrog strategy, flanking attack, encirclement, and guerrilla attack. Most of these strategies are basically mirror images of the share-maintenance strategies discussed earlier.

Which, or what combination, of these five strategies is best for a particular challenger depends on market characteristics, the existing competitors’ current positions and strengths, and the challenger’s own resources and competencies. The situations in which each strategy is likely to work best are briefly outlined in Exhibit 10.8 and discussed in the following sections.

Deciding Whom to Attack

When more than one competitor is already established in the market, a challenger must decide which competitor, if any, to target. There are several options:
Attack the market-share leader within its primary target market. As we shall see, this typically involves either a frontal assault or an attempt to leapfrog the leader through the development of superior technology or product design. It may seem logical to try to win customers away from the competitor with the most customers to lose, but this can be a dangerous strategy unless the challenger has superior resources and competencies that can be converted into a sustainable advantage. In some cases, however, a smaller challenger may be able to avoid disastrous retaliation by confronting the leader only occasionally in limited geographic territories through a series of guerrilla attacks.

- Attack another follower who has an established position within a major market segment. This also usually involves a frontal assault, but it may be easier for the challenger to gain a sustainable advantage if the target competitor is not as well established as the market leader in the minds and buying habits of customers.

- Attack one or more smaller competitors who have only limited resources. Because smaller competitors usually hold only a small share of the total market, this may seem like an inefficient way to attain substantial share increases. But by focusing on several small regional competitors one at a time, a challenger can sometimes achieve major gains without inviting retaliation from stronger firms. For example, by first challenging and ultimately acquiring a series of smaller regional manufacturers, Borden managed to capture the leading share of the fragmented domestic pasta market.
### Exhibit 10.8
**Marketing Objectives and Strategies for Challengers in Growth Markets**

#### Share-Growth Strategies

<table>
<thead>
<tr>
<th>Situational variables</th>
<th>Frontal attack</th>
<th>Leapfrog</th>
<th>Flank attack</th>
<th>Encirclement</th>
<th>Guerrilla attack</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary objective</strong></td>
<td>Capture substantial repeat/replacement purchases from target competitor’s current customers; attract new customers among later adopters by offering lower price or more attractive features.</td>
<td>Induce current customers in mass market to replace their current brand with superior new offering; attract new customers by providing enhanced benefits.</td>
<td>Attract substantial share of new customers in one or more major segments where customers’ needs are different from those of early adopters in the mass market.</td>
<td>Attract a substantial share of new customers in a variety of smaller, specialized segments where customers’ needs or preferences differ from those of early adopters in the mass market.</td>
<td>Capture a modest share of repeat/replacement purchases in several market segments or territories; attract a share of new customers in a number of existing segments.</td>
</tr>
<tr>
<td><strong>Market characteristics</strong></td>
<td>Relatively homogeneous market with respect to customers’ needs and purchase criteria; relatively little preference or loyalty for existing brands; no positive network effects.</td>
<td>Relatively homogeneous market with respect to customers’ needs and purchase criteria, but some needs or criteria not currently met by existing brands.</td>
<td>Two or more major segments with distinct needs and purchase criteria; needs of customers in at least one segment not currently met by existing brands.</td>
<td>Relatively heterogeneous market with a number of small, specialized segments; needs and preferences of customers in some segments not currently satisfied by competing brands.</td>
<td>Relatively heterogeneous market with a number of larger segments; needs and preferences of customers in most segments currently satisfied by competing brands.</td>
</tr>
<tr>
<td><strong>Competitor’s characteristics</strong></td>
<td>Target competitor has relatively limited resources and competencies, particularly in marketing and R&amp;D; would probably be vulnerable to direct attack.</td>
<td>One or more current competitors have relatively strong resources and competencies in marketing, but relatively unsophisticated technology and limited R&amp;D competencies.</td>
<td>Target competitor has relatively strong resources and competencies, particularly in marketing and R&amp;D; would probably be able to withstand direct attack.</td>
<td>One or more competitors have relatively strong marketing, R&amp;D resources and competencies, and/or lower costs; could probably withstand a direct attack.</td>
<td>A number of competitors have relatively strong marketing, R&amp;D resources and competencies, and/or lower costs; could probably withstand a direct attack.</td>
</tr>
<tr>
<td><strong>Firm’s characteristics</strong></td>
<td>Firm has stronger resources and competencies in R&amp;D and marketing and/or lower operating costs than target competitor.</td>
<td>Firm has proprietary technology superior to that of competitors; firm has necessary marketing and production resources to stimulate and meet primary demand for new generation of products.</td>
<td>Firm’s resources and competencies are limited, but sufficient to effectively penetrate and serve at least one major market segment.</td>
<td>Firm has marketing, R&amp;D, and production resources and competencies necessary to serve multiple smaller segments; firm has decentralized and adaptable management structure.</td>
<td>Firm has relatively limited marketing, R&amp;D, and/or production resources and competencies; firm has decentralized and adaptable management structure.</td>
</tr>
</tbody>
</table>
Avoid direct attacks on any established competitor. In fragmented markets in which the leader or other major competitors are not currently satisfying one or more segments, a challenger is often best advised to “hit ‘em where they ain’t.” This usually involves either a flanking or an encirclement strategy, with the challenger developing differentiated product offerings targeted at one large or several smaller segments in which no competitor currently holds a strong position. Thus, Vans has profited in the athletic shoe market by focusing on small alternative sports whose adherents do not find the “mainstream” image of Nike and other major brands very appealing.

Deciding which competitor to attack necessitates a comparison of relative strengths and weaknesses, a critical first step in developing an effective share-growth strategy. It also can help limit the scope of the battlefield, a particularly important consideration for challengers with limited resources.

Frontal Attack Strategy

Where the market for a product category is relatively homogeneous, with few untapped segments and at least one well-established competitor, a follower wanting to capture an increased market share may have little choice but to tackle a major competitor head-on. Such an approach is most likely to succeed when most existing customers do not have strong brand preferences or loyalties, the target competitor’s product does not benefit from positive network effects, and the challenger’s resources and competencies—particularly in marketing—are greater than the target competitor’s. But even superior resources are no guarantee of success if the challenger’s assault merely imitates the target competitor’s offering.

To successfully implement a frontal attack, a challenger should seek one or more ways to achieve a sustainable advantage over the target competitor. As discussed earlier, such an advantage is usually based on attaining lower costs or a differentiated position in the market. If the challenger has a cost advantage, it can cut prices to lure away the target competitor’s customers, or it can maintain a similar price but engage in more extensive promotion.

Challenging a leader solely on the basis of low price is a highway to disaster, however, unless the challenger really does have a sustainable cost advantage. Otherwise, the leader might simply match the lower prices until the challenger is driven from the market. The problem is that initially a challenger is often at a cost disadvantage because of the experience-curve effects established competitors have accumulated. The challenger must have offsetting advantages such as superior production technology, established relations with low-cost suppliers, the ability to share production facilities or marketing efforts across multiple SBUs, or other sources of synergy before a low-price assault makes sense.

A similar caveat applies to frontal assaults based solely on heftier promotional budgets. Unless the target competitor’s resources are substantially more limited than the challenger’s, it can retaliate against any attempt to win away customers through more extensive advertising or attractive sales and trade promotions.

One possible exception to this limitation of greater promotional effort is the use of a more extensive and better-trained salesforce to gain a competitive advantage. A knowledgeable salesperson’s technical advice and problem-solving abilities can give additional value to a firm’s product offering, particularly in newly developing high-tech industries.

In general, the best way for a challenger to effectively implement a frontal attack is to differentiate its product or associated services in ways that better meet the needs and preferences of many customers in the mass market. If the challenger can support those meaningful
product differences with strong promotion or an attractive price, so much the better, but usually the unique features or services offered are the foundation for a sustainable advantage. For example, Dell has been successful as a follower in the PC market by offering both superior customer service and low prices. Customers can design their own computers on the company’s website, get exactly the features they want, and have the equipment delivered to their doors in two or three days. Such excellent service is possible, in large part, due to the close coordination between Dell and its suppliers, coordination that minimizes inventories of parts and finished computers, thereby lowering costs and prices, and maximizes manufacturing flexibility and delivery speed. Dell’s competitive advantage has proven to be sustainable, too, because its alliances with suppliers took years to develop and are hard for its competitors to match.

Variables that might limit the competitor’s willingness or ability to retaliate can also improve the chances for successful frontal attack. For instance, a target competitor with a reputation for high product quality may be loath to cut prices in response to a lower-priced challenger for fear of cheapening its brand’s image. And a competitor pursuing high ROI or cash flow objectives may be reluctant to increase its promotion or R&D expenditures in the short run to fend off an attack.12

Leapfrog Strategy

A challenger stands the best chance of attracting repeat or replacement purchases from a competitor’s current customers when it can offer a product that is attractively differentiated from the competitor’s offerings. The odds of success might be even greater if the challenger can offer a far superior product based on advanced technology or a more sophisticated design. This is the essence of a leapfrog strategy. It is an attempt to gain a significant advantage over the existing competition by introducing a new generation of products that significantly outperform or offer more desirable customer benefits than do existing brands. For example, the introduction of reasonably priced video cameras by Sony and other Japanese electronics manufacturers largely took over the market for home movie equipment and a large share of the market for Polaroid’s self-developing photography equipment as well. And now digital cameras are doing the same thing to the video market.

In addition, such a strategy often inhibits quick retaliation by established competitors. Firms that have achieved some success with one technology—or that have committed substantial resources to plant and equipment dedicated to a current product—often are reluctant to switch to a new one because of the large investments involved or a fear of disrupting current customers.

A leapfrog strategy is not viable for all challengers. To be successful, the challenger must have technology superior to that of established competitors as well as the product and process engineering capabilities to turn that technology into an appealing product. Also, the challenger must have the marketing resources to effectively promote its new products and convince customers already committed to an earlier technology that the new product offers sufficient benefits to justify the costs of switching.

Flanking and Encirclement Strategies

The military historian B. H. Liddell-Hart, after analyzing battles ranging from the Greek Wars to World War I, determined that only 6 out of 280 victories were the result of a frontal attack.13 He concluded that it is usually wiser to avoid attacking an established adversary’s point of strength and to focus instead on an area of weakness in his defenses. This is the
basic premise behind flanking and encirclement strategies. They both seek to avoid direct confrontations by focusing on market segments whose needs are not being satisfied by existing brands and where no current competitor has a strongly held position.

**Flank Attack**  A flank attack is appropriate when the market can be broken into two or more large segments, when the leader and/or other major competitors hold a strong position in the primary segment, and when no existing brand fully satisfies the needs of customers in at least one other segment. A challenger may be able to capture a significant share of the total market by concentrating primarily on one large untapped segment. This usually involves developing product features or services tailored to the needs and preferences of the targeted customers, together with appropriate promotional and pricing policies to quickly build selective demand. Japanese auto companies, for instance, penetrated the U.S. car market by focusing on the low-price segment, where domestic manufacturers’ offerings were limited. Domestic car manufacturers were relatively unconcerned by this flanking action at first. They failed to retaliate very aggressively because the Japanese were pursuing a segment they considered to be small and unprofitable. History proved them wrong.

In some cases, a successful flank attack need not involve unique product features. Instead, a challenger can sometimes meet the special needs of an untapped segment by providing specially designed customer services or distribution channels. One major reason for the success of L’eggs pantyhose, for instance, was that it was the first brand to be distributed through an extensive channel of convenience goods retailers, such as grocery and drug stores, instead of more fashionable department and clothing stores. The greater shopping convenience provided by this new distribution channel appealed strongly to the growing segment of working women. More recently, as Exhibit 10.9 recounts, a small citrus farmers’ cooperative has stolen substantial market share from much bigger competitors by delivering a high-quality product and emphasizing its folksy, common-man image.

**Encirclement**  An encirclement strategy involves targeting several smaller untapped or underdeveloped segments in the market simultaneously. The idea is to surround the leader’s brand with a variety of offerings aimed at several peripheral segments. This strategy makes most sense when the market is fragmented into many different applications segments or geographical regions with somewhat unique needs or tastes.

---

**Exhibit 10.9 A Small Citrus Juice Co-op Squeezes Big Rivals**

When a little-known farmers’ cooperative called Citrus World Inc. started to market its own brand of pasteurized orange juice, it looked like an improbable player in the $3 billion juice market. Citrus World, an 800-employee operation in rural Florida, was up against a couple of established giants: Seagram Co., owner of the Tropicana brand, and Coca-Cola Co., with its Minute Maid line.

But Citrus World knew exactly what to do: Squeeze that folksy image for all it was worth. To sell its Florida’s Natural brand, it ordered TV commercials featuring sunburned farmers gulping down juice. In one ad, growers holding boxes of oranges hold a “stockholders’ meeting” in the back of a truck. Other workers cut “overhead” by chopping a branch from an orange tree.

Thanks to catchy ads, a quality product, and aggressive pricing, Citrus World made a splash. In 1995 Florida’s Natural knocked Minute Maid out of the number 2 spot in the rapidly growing market for “premium,” or pasteurized, not-from-concentrate orange juice, and the brand experienced a larger percentage sales increase than Tropicana. While Citrus World attacked its larger rivals’ exposed flanks, in part, by offering lower prices, its success also demonstrates that a substantial segment of consumers prefers to deal with what they perceive to be small, “underdog” companies.

Once again, this strategy usually involves developing a varied line of products with features tailored to the needs of different segments. Rather than try to compete with Coke and Pepsi in the soft drink market, for example, Cadbury-Schweppes offers a wide variety of flavors such as cream soda, root beer, and ginger ale—almost anything but cola—to appeal to small groups of customers with unique tastes. Similarly, Vans is trying to expand its foothold in the athletic shoe industry by targeting several niche segments of enthusiasts in other alternative sports—such as snowboarding—where the brand’s youthful “outsider” image might be appealing and where the firm’s larger competitors are not well established.

**Guerrilla Attack**

When well-established competitors already cover all major segments of the market and the challenger’s resources are relatively limited, flanking, encirclement, or all-out frontal attacks may be impossible. In such cases, the challenger may be reduced to making a series of surprise raids against its more established competitors. To avoid massive retaliation, the challenger should use guerrilla attacks sporadically, perhaps in limited geographic areas where the target competitor is not particularly well entrenched.

A challenger can choose from a variety of means for carrying out guerrilla attacks. These include sales promotion efforts (e.g., coupon drops and merchandising deals), local advertising blitzes, and even legal action. Short-term price reductions through sales promotion campaigns are a particularly favored guerrilla tactic in consumer goods markets. They can target specific customer groups in limited geographic areas; they can be implemented quickly; and they are often difficult for a larger competitor to respond to because that firm’s higher share level means that a given discount will cost it more in absolute dollars. For similar reasons, carefully targeted direct mail or Internet marketing campaigns also can be an effective guerrilla tactic, as illustrated by the dial-around companies described in Exhibit 10.10.

---

**Exhibit 10.10 The Guerrilla Attack on AT&T**

In the 1990s, kitchen phones across the United States sprouted little stickers with official-looking five-digit codes and slogans like “Dial & Save.” They were evidence of a sneakily successful marketing campaign that took a $900 million bite out of AT&T and its major long-distance rivals. The stickers arrived in direct mail promotions by resellers of phone service known as **dial-around companies**. A customer could punch in the five-digit code when making a long-distance call and save from 10 to 50 percent over the undiscounted rates of the major long-distance companies.

Dial-around companies were mostly small, privately held firms that bought long-distance capacity in bulk from telephone giants and resold it at cut rates, routing calls through the switching equipment of other companies or their own. Their services were marketed under a variety of different brand names and promoted largely through direct mail campaigns. The mailings were usually targeted at customers whom AT&T and its rivals tended to neglect, such as older people. These consumers were often bargain hunters, yet typically they didn’t use the phone enough to qualify for most long-distance savings plans.

How did dial-arounds gain so much ground without provoking a counterattack from AT&T? First, they focused on customers that the bigger firms did not deem very important or profitable. Second, many small companies were involved so it was hard for AT&T to retaliate against them individually. But as the volume of business of the dial-around companies continued to increase, the firm was eventually forced to react against them as a group. The firm instituted its One Rate plan, promising residential customers calls anywhere, anytime for 15 cents a minute.

In some cases the ultimate objective of a series of guerrilla attacks is not so much for the challenger to build its own share as it is to prevent a powerful leader from further expanding its share or engaging in aggressive actions to which it would be costly for the followers to respond. Lawsuits brought against the leader by several smaller competitors over a range of activities can effectively slow down the leader’s expansionist tendencies by diverting some of its resources and attention.

### Supporting Evidence

Several studies conducted with the PIMS database provide empirical support for many of the managerial prescriptions we have discussed. These studies compare businesses that achieved high market shares during the growth stage of the product life cycle, or that increased their market shares over time, with low-share businesses. As shown in Exhibit 10.11, the marketing programs and activities of businesses that successfully achieved increased market share differed from their less-successful counterparts in the following ways:

- Businesses that increased the quality of their products relative to those of competitors achieved greater share increases than businesses whose product quality remained constant or declined.
- Share-gaining businesses typically developed and added more new products, line extensions, or product modifications to their line than share-losing businesses.
- Share-gaining businesses tended to increase their marketing expenditures faster than the rate of market growth. Increases in both salesforce and sales promotion expenditures were effective for producing share gains in both consumer and industrial goods businesses. Increased advertising expenditures were effective for producing share gains primarily in consumer goods businesses.
- Surprisingly, there was little difference in the relative prices charged between firms that gained and those that lost market share.

These findings are consistent with many of our earlier observations. For instance, they underline the folly of launching a frontal attack solely on the basis of lower price. Unless

---

### Exhibit 10.11

<table>
<thead>
<tr>
<th>Strategic changes</th>
<th>Share-gaining challengers</th>
<th>Share-losing challengers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative product quality scores</td>
<td>+1.8</td>
<td>–0.6</td>
</tr>
<tr>
<td>New products as a percent of sales</td>
<td>+0.1</td>
<td>–0.5</td>
</tr>
<tr>
<td>Relative price</td>
<td>+0.3</td>
<td>+0.2</td>
</tr>
<tr>
<td>Marketing expenditures (adjusted for market growth):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salesforce</td>
<td>+9.0%</td>
<td>–8.0%</td>
</tr>
<tr>
<td>Advertising:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer products</td>
<td>+13.0%</td>
<td>–9.0%</td>
</tr>
<tr>
<td>Industrial products</td>
<td>–1.0</td>
<td>–14.0</td>
</tr>
<tr>
<td>Promotion:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer products</td>
<td>+13.0%</td>
<td>–5.0%</td>
</tr>
<tr>
<td>Industrial products</td>
<td>+7.0</td>
<td>–10.0</td>
</tr>
</tbody>
</table>

Source: Adapted with the permission of The Free Press, a Division of Simon & Schuster, Inc., from The PIMS Principles: Linking Strategy to Performance by Robert D. Buzzell and Bradley T. Gale. Copyright © 1987 by The Free Press.
the challenger has substantially lower unit costs or the leader is inhibited from cutting its own prices for some reason, the challenger’s price cuts are likely to be retaliated against and will generate few new customers. On the other hand, frontal, leapfrog, flanking, or encirclement attacks based on product improvements tailored to specific segments are more likely to succeed, particularly when the challenger supports those attacks with substantial promotional efforts.

Regardless of the strategies pursued by market leaders and challengers during a product-market’s growth stage, the competitive situation often changes as the market matures and its growth rate slows. In the next chapter, we examine the environmental changes that occur as a market matures and the marketing strategies that firms might use to adapt to those changes.

**Take Aways**

- If the market leader wants to maintain its number-one share position as the product category moves through rapid growth, it must focus on two important objectives: (1) retaining its current customers and (2) stimulating selective demand among later adopters.
- Marketing strategies a leader might adopt to defend its relative share as the product category grows include position defense, flanker, confrontation, market expansion, and contraction. The best one to choose depends on the homogeneity of the market and the firm’s resources and competencies relative to potential competitors.
- For a challenger to increase its market share relative to the established leader, it must differentiate its offering by delivering superior product benefits, better service, or a lower price. Challenging the leader solely on the basis of price, however, is a good way to start a price war and can be a highway to disaster unless the challenger has a sustainable cost advantage.
- Smaller challengers often try to avoid direct confrontations with the share leader by pursuing flanker, encirclement, or guerrilla attack strategies that focus on market segments where the leader is not well established.
- Self-diagnostic questions to test your ability to apply the concepts in this chapter to marketing decision making may be found at this book’s website at www.mhhe.com/walker.

**Endnotes**

6. In some rapidly evolving high-tech markets, price premiums can disappear very quickly, as pointed out in Gross, Coy, and Port, “Technology Paradox.”
12. For a more extensive discussion of factors that can limit a leader’s willingness or ability to retaliate against a direct attack, see Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), chap. 15.
Chapter Eleven

Strategies for Mature and Declining Markets

Johnson Controls: Making Money in Mature Markets

At first glance, Johnson Controls Inc. in Glendale, Wisconsin, appears to be the epitome of a staid, slow-growing, “old-economy” company. After all, the firm’s success and future survival depend on several product and service categories that have not experienced very much growth in the domestic market in recent years. Johnson’s major businesses include batteries, seats, and other internal components for automobiles; heating and cooling equipment for large commercial buildings and schools; and facilities management services.

But first glances can be deceiving. The firm’s managers have developed a four-pronged strategy for making money in such mature markets. First, Johnson has acquired a number of weaker competitors in each of its product categories over the years in order to gain market share and remove excess capacity. Second, the firm has expanded sales volume by moving aggressively into global markets. The firm now operates in 500 different locations around the world.

Most important, the firm has nurtured close relationships with established customers such as General Motors, Ford, Daimler-Chrysler, BMW, and Toyota. Those relationships, in turn, have enabled Johnson to maintain solid profit margins by improving customer retention and gaining operating efficiencies via logistical alliances, just-in-time delivery systems, and other process improvements. Finally, the firm’s close customer relationships have provided it with market intelligence and facilitated joint development projects, both of which have helped the firm gain additional revenue from the introduction of new product and service offerings targeted at those customers.

A strong balance sheet and a long-term perspective have helped Johnson build market share—and expand into foreign countries—through the acquisition of competitors. In some cases, the firm has snapped up firms with product or service offerings that complement and extend Johnson’s own product line in one of its established target markets. For instance, the firm spent $167 million to acquire Pan Am’s World Services division, a facility management operation that does everything from mow the lawn to run the cafeteria. That acquisition, when combined with Johnson’s existing heating and cooling systems business and some new products and services developed internally, turned the company into a full-service facilities operator. Johnson can now manage a client’s entire building while offering highly customized heating and cooling systems and controls that minimize energy use.
This combination of customized products and full service has both expanded the company’s share of the commercial real estate market and enabled it to maintain relatively high margins in a highly competitive business.

In other businesses, Johnson has combined the economies of scale generated through savvy acquisitions with the knowledge gained from close customer relationships to both develop new products and drive down operating costs. For example, Johnson has become the leading worldwide supplier of automotive seating and interior systems, such as floor consoles and instrument panels, by assisting manufacturers with the design and development, as well as the manufacture, of such components. As one engineer at Daimler-Chrysler pointed out, “Johnson is able to completely integrate the design, development, and manufacture of [our] seats,” and do it for less than the auto companies could. And by closely coordinating inventories and production schedules, Johnson has reduced costs even further for both its customers and itself. For instance, by locating its plants close to a customer’s production facility, Johnson is able to assemble seats to order, load them on a truck in a sequence that matches the cars coming down the assembly line, and deliver them to the customer all in as little as 90 minutes.

Despite the maturity of its markets, Johnson’s strategy is paying off, in terms of both revenue growth and profits. In recent years the firm has averaged nearly 30 percent annual growth, with sales increasing from about $10 billion in 1996 to more than $17 billion in 2000. At the same time, the firm has increased dividends paid to shareholders for 25 straight years, and in 2000 it earned a 20 percent return on shareholder equity.

Strategic Challenges Addressed in Chapter 11

Many managers, particularly those in marketing, seem obsessed with growth. Their objectives tend to emphasize annual increases in sales volume, market share, or both. But the biggest challenge for many managers in developed nations in future years will be making money in markets that grow slowly, if at all. The majority of product-markets in those nations are in the mature or decline stages of their life cycles. And as accelerating rates of technological and social change continue to shorten such life cycles, today’s innovations will move from growth to maturity—and ultimately to decline—ever faster.

A period of competitive turbulence almost always accompanies the transition from market growth to maturity in an industry. This period often begins after approximately half the potential customers have adopted the product and the rate of sales growth starts to decline. As the growth rate slows, many competitors tend to overestimate future sales volume and consequently end up developing too much production capacity. Competition becomes more intense as firms battle to increase sales volume to cover their high fixed costs and maintain profitability. As a result, such transition periods are commonly accompanied by a shakeout during which weaker businesses fail, withdraw from the industry, or are acquired by other firms, as has happened to some of Johnson Controls’ competitors in the United States and European automotive seat and battery industries. In the next section of this chapter we examine some strategic traps that can threaten a firm’s survival during an industry shakeout.
Challenges in Mature Markets

Businesses that survive the shakeout face new challenges as market growth stagnates. As a market matures, total volume stabilizes; replacement purchases rather than first-time buyers account for the vast majority of that volume. A primary marketing objective of all competitors in mature markets, therefore, is simply to hold their existing customers—to sustain a meaningful competitive advantage that will help ensure the continued satisfaction and loyalty of those customers. Thus, a product’s financial success during the mature life cycle stage depends heavily on the firm’s ability to achieve and sustain a lower delivered cost or some perceived product quality or customer-service superiority.

Some firms tend to passively defend mature products while using the bulk of the revenues produced by those items to develop and aggressively market new products with more growth potential. This can be shortsighted, however. All segments of a market and all brands in an industry do not necessarily reach maturity at the same time. Aging brands such as Jell-O, Johnson’s baby shampoo, and Arm & Hammer baking soda experienced sales revivals in recent years because of creative marketing strategies. Thus, a share leader in a mature industry might build on a cost or product differentiation advantage and pursue a marketing strategy aimed at increasing volume by promoting new uses for an old product or by encouraging current customers to buy and use the product more often. Therefore, in this chapter we examine basic business strategies necessary for survival in mature markets and marketing strategies a firm might use to extend a brand’s sales and profits, including the strategies that have been so successful for Johnson Controls.

Challenges in Declining Markets

Eventually, technological advances; changing customer demographics, tastes, or lifestyles; and development of substitutes result in declining demand for most product forms and brands. As a product starts to decline, managers face the critical question of whether to divest or liquidate the business. Unfortunately, firms sometimes support dying products too long at the expense of current profitability and the aggressive pursuit of future breadwinners.

An appropriate marketing strategy, however, can produce substantial sales and profits even in a declining market. If few exit barriers exist, an industry leader might attempt to increase market share via aggressive pricing or promotion policies aimed at driving out weaker competitors. Or it might try to consolidate the industry, as Johnson Controls has done in its automotive components businesses, by acquiring weaker brands and reducing overhead by eliminating both excess capacity and duplicate marketing programs. Alternatively, a firm might decide to harvest a mature product by maximizing cash flow and profit over the product’s remaining life. The last section of this chapter examines specific marketing strategies for gaining the greatest possible returns from products approaching the end of their life cycle.

Shakeout: The Transition from Market Growth to Maturity

Characteristics of the Transition Period

The transition from market growth to maturity typically begins when the market is still growing but the rate of growth starts to decline. This slackening of the growth rate either sparks or occurs simultaneously with other changes in the market and competitive environment. As
mentioned earlier, such changes typically include the appearance of excess capacity, increased difficulty of maintaining product differentiation, increased intensity of competition, and growing pressures on costs and profits. Consequently, weaker members of the industry often fail or are acquired by larger competitors during this shakeout stage.

**Strategic Traps during the Transition**

A business’s ability to survive the transition from market growth to maturity depends to a great extent on whether it can avoid some common strategic traps. Four such traps are summarized in Exhibit 11.1.

The most obvious trap is simply the failure to recognize the events signaling the beginning of the shakeout period. The best way to minimize the impact of slowing growth is to accurately forecast the slowdown in sales and hold the firm’s production capacity to a sustainable level. For both industrial and consumer durable goods markets, models can forecast when replacement sales will begin to outweigh first-time purchases, a common signal that a market is beginning to mature. But in consumer nondurable markets—particularly those where growth slows because of shifting consumer preferences or the emergence of substitute products—the start of the transition period can be nearly impossible to predict.

A second strategic trap is for a business to get caught in the middle during the transition period without a clear strategic advantage. A business may survive and prosper during the growth stage even though it has neither differentiated its offering from competitors nor attained the lowest-cost position in its industry. But during the transition period, such is not the case.

A third trap is the failure to recognize the declining importance of product differentiation and the increasing importance of price or service. Businesses that have built their

---

**Exhibit 11.1**

**Common Strategic Traps Firms Can Fall into during the Shakeout Period**

1. **Failure to anticipate transition from growth to maturity.**
   - Firms may make overly optimistic forecasts of future sales volume.
   - As a result, they expand too rapidly and production capacity overshoots demand as growth slows.
   - Their excess capacity leads to higher costs per unit.
   - Consequently, they must cut prices or increase promotion in an attempt to increase their volume.

2. **No clear competitive advantage as growth slows.**
   - Many firms can succeed without a strong competitive advantage during periods of rapid growth.
   - However, firms that do not have the lowest costs or a superior offering in terms of product quality or service can have difficulty sustaining their market share and volume as growth slows and competition intensifies.

3. **Assumption that an early advantage will insulate the firm from price or service competition.**
   - In many cases, technological differentials become smaller as more competitors enter and initiate product improvements as an industry approaches maturity.
   - If customers perceive that the quality of competing brands has become more equal, they are likely to attach greater importance to price or service differences.
   - Failure to detect such trends can cause an early leader to be complacent and slow to respond to competitive threats.

4. **Sacrificing market share in favor of short-run profit.**
   - A firm may cut marketing or R&D budgets or forgo other expenditures in order to maintain its historical level of profitability even though industry profits tend to fall during the transition period.
   - This can cause long-run erosion of market share and further increases in unit costs as the industry matures.
success on technological superiority or other forms of product differentiation often disdain aggressive pricing or marketing practices even though such differentiation typically erodes as markets mature. As a result, such firms may delay meeting their more aggressive competitors head-on and end up losing market share, as Hewlett-Packard and Compaq both discovered in the wake of Dell’s aggressive pricing policies as the personal computer market slumped in 2000.

Why should a firm not put off responding to the more aggressive pricing or marketing actions of its competitors? Because doing so may lead to a fourth trap—giving up market share too easily in favor of short-run profit. Many businesses try to maintain the profitability of the recent past as markets enter the transition period. They usually do this at the expense of market share or by forgoing marketing, R&D, and other investments crucial for maintaining future market position. While some smaller firms with limited resources may have no choice, this tendency can be seriously shortsighted, particularly if economies of scale are crucial for the business’s continued success during market maturity.

**Strategic Choices in Mature Markets**

The maturity phase of an industry’s life cycle is often depicted as one of stability characterized by few changes in the market shares of leading competitors and steady prices. The industry leaders, because of their low per-unit costs and little need to make any further investments, enjoy high profits and positive cash flows. These cash flows are harvested and diverted to other SBUs or products in the firm’s portfolio that promise greater future growth.

Unfortunately, this conventional scenario provides an overly simplistic description of the situation businesses face in most mature markets. For one thing, it is not always easy to tell when a market has reached maturity. Variations in brands, marketing programs, and customer groups can mean that different brands and market segments reach maturity at different times.

Further, as the maturity stage progresses, a variety of threats and opportunities can disrupt an industry’s stability. Shifts in customer needs or preferences, product substitutes, increased raw material costs, changes in government regulations, or factors such as the entry of low-cost foreign producers or mergers and acquisitions can threaten individual competitors and even throw the entire industry into early decline. Consider, for example, the competitive position of Timex, a brand that dominated the low-price segment of the American watch market in the 1970s. First the appearance of imported digital watches and later a shift in consumer preferences toward more fashionable and prestigious brands buffeted the firm and eroded its market share.

On the positive side, such changes also can open new growth opportunities in mature industries. Product improvements (such as the development of high-fiber nutritional cereals), advances in process technology (the creation of minimills for steel production), falling raw materials costs, increased prices for close substitutes, or environmental changes all can provide opportunities for a firm to dramatically increase its sales and profits. An entire industry can even experience a period of renewed growth.

Discontinuities during industry maturity suggest that it is dangerously shortsighted for a firm to simply milk its cash cows. Even industry followers can substantially improve volume, share, and profitability during industry maturity if they can adjust their marketing objectives and programs to fit the new opportunities that arise. Thus, success in mature markets requires two sets of strategic actions: (1) the development of a well-implemented
business strategy to sustain a competitive advantage, customer satisfaction, and loyalty and (2) flexible and creative marketing programs geared to pursue growth or profit opportunities as conditions change in specific product-markets.

**Strategies for Maintaining Competitive Advantage**

As discussed in Chapter 3, both analyzer and defender strategies may be appropriate for units with a leading, or at least a profitable, share of one or more major segments in a mature industry. Analyzers and defenders are both concerned with maintaining a strong share position in established product-markets. But analyzers also do some product and market development to avoid being leapfrogged by competitors with more advanced products or being left behind in new applications segments. On the other hand, defenders may initiate some product improvements or line extensions to protect and strengthen their position in existing markets, but they spend relatively little on new product R&D. Thus, an analyzer strategy is most appropriate for developed industries that are still experiencing some technological change and may have opportunities for continued growth, such as the computer and commercial aircraft industries. The defender strategy works best in industries where the basic technology is not very complex or is unlikely to change dramatically in the short run, as in the food industry.

Both analyzers and defenders can attempt to sustain a competitive advantage in established product-markets through differentiation of their product offering (either on the basis of superior quality or service) or by maintaining a low-cost position. Evidence suggests the ability to maintain either a strongly differentiated or a low-cost position continues to be a critical determinant of success throughout both the transition and the maturity stage. One study examined the competitive strategies pursued by the two leading firms (in terms of return on investment) in eight mature industries characterized by slow growth and intense competition. In each industry, the two leading firms offered either the lowest relative delivered cost or high relative product differentiation. Similarly, more recent observations by Treacy and Wiersema found that market leaders tend to pursue one of three strategic disciplines. They either stress operational excellence, which typically translates into lower costs, or differentiate themselves through product leadership or customer intimacy and superior service.

Generally, it is difficult for a single business to pursue both low-cost and differentiation strategies at the same time. For instance, businesses taking the low-cost approach typically compete primarily by offering the lowest prices in the industry. Such prices allow little room for the firm to make the investments or cover the costs inherent in maintaining superior product quality, performance, or service over time.

It is important to keep in mind, however, that pursuit of a low-cost strategy does not mean that a business can ignore the delivery of desirable benefits to the customer. Similarly, customers will not pay an unlimited price premium for superior quality or service, no matter how superior it is. In both consumer and commercial markets customers seek good value for the money, either a solid, no-frills product or service at an outstanding price or an offering whose higher price is justified by the superior benefits it delivers on one or more dimensions. Thus, even low-cost producers should continually seek ways to improve the quality and performance of their offerings within the financial constraints of their competitive strategy. And even differentiated defenders should continually work to improve efficiency without sacrificing product quality or performance. This point is clearly illustrated in the diagram of the customer value management process in Exhibit 11.2, which shows that actions to improve customers’ perceptions of quality (whether of goods
or service) and to reduce costs both impact customer value. The critical strategic questions facing the marketing manager, then, are: How can a business continue to differentiate its offerings and justify a premium price as its market matures and becomes more competitive? and How can businesses, particularly those pursuing low-cost strategies, continue to reduce their costs and improve their efficiency as their markets mature?

**Methods of Differentiation**

At the most basic level, a business can attempt to differentiate its offering from competitors’ by offering either superior product quality, superior service, or both. The problem is that *quality* and *service* may be defined in a variety of different ways by customers.

**Dimensions of Product Quality** To maintain a competitive advantage in product quality, a firm must understand what *dimensions customers perceive to underlie differences across products* within a given category. One authority has identified eight such dimensions of product quality. These are summarized in Exhibit 11.3 and discussed next.
European manufacturers of prestige automobiles, such as Mercedes-Benz and Porsche, have emphasized the first dimension of product quality—functional performance. These automakers have designed cars that provide excellent performance on such attributes as handling, acceleration, and comfort. Volvo, on the other hand, has emphasized and aggressively promoted a different quality dimension—durability (and the related attribute of safety). A third quality dimension, conformance to specifications, or the absence of defects, has been a major focus of the Japanese automakers. Until recent years, American carmakers relied heavily on broad product lines and a wide variety of features, both standard and optional, to offset their shortcomings on some of the other quality dimensions.

The reliability quality dimension can refer to the consistency of performance from purchase to purchase or to a product’s uptime, the percentage of time that it can perform satisfactorily over its life. Tandem Computers has maintained a competitive advantage based on reliability by designing computers with several processors that work in tandem, so that if one fails, the only impact is the slowing of low-priority tasks. IBM had difficulty matching Tandem’s reliability because its operating system was not easily adapted to the multiple-processor concept. Consequently, Tandem has maintained a strong position in market segments consisting of large-scale computer users, such as financial institutions and large retailers, for whom system downtime is particularly undesirable.

The quality dimension of serviceability refers to a customer’s ability to obtain prompt and competent service when the product does break down. For example, Caterpillar has long differentiated itself with a parts and service organization dedicated to providing “24-hour parts service anywhere in the world.”

Many of these quality dimensions can be difficult for customers to evaluate, particularly for consumer products. As a result, consumers often generalize from quality dimensions that are more visual or qualitative. Thus, the fit and finish dimension can help convince consumers that a product is of high quality. They tend to perceive attractive and well-designed products as generally high in quality, as witnessed by the success of the Krups line of small appliances. Similarly, the quality reputation of the brand name, and the promotional activities that sustain that reputation, can strongly influence consumers’
perceptions of a product’s quality. A brand’s quality reputation together with psychological factors such as name recognition and loyalty substantially determine a brand’s equity—the perceived value customers associate with a particular brand name and its logo or symbol. To successfully pursue a differentiation strategy based on quality, then, a business must understand what dimensions or cues its potential customers use to judge quality, and it should pay particular attention to some of the less-concrete but more visible and symbolic attributes of the product.

### Dimensions of Service Quality

Customers also judge the quality of the service they receive on multiple dimensions. A number of such dimensions of perceived service quality have been identified by a series of studies conducted across diverse industries such as retail banking and appliance repair, and five of those dimensions are listed and briefly defined in Exhibit 11.4.

The quality dimensions listed in Exhibit 11.4 apply specifically to service businesses, but most of them are also relevant for judging the service component of a product offering. This pertains to both the objective performance dimensions of the service delivery system, such as its reliability and responsiveness, as well as to elements of the performance of service personnel, such as their empathy and level of assurance.

The results of a number of surveys suggest that customers perceive all five dimensions of service quality to be very important regardless of the kind of service being evaluated. As Exhibit 11.5 indicates, customers of four different kinds of services gave reliability, responsiveness, assurance, and empathy mean importance ratings of more than 9 on a 10-point rating scale. And though the mean ratings for tangibles were somewhat lower in comparison, they still fell toward the upper end of the scale, ranging from 7.14 to 8.56.

The same respondents also were asked which of the five dimensions they would choose as being the most critical in their assessment of service quality. Their responses, which are shown in Exhibit 11.5, suggest that reliability is the most important aspect of service quality to the greatest number of customers. Both service reliability and responsiveness are proving to be particularly important for, and the Achilles’ heel of, many e-commerce sites. This point is dramatically illustrated by the experiences of Petopia.com Inc., described in Exhibit 11.6.

The key to a differentiation strategy based on providing superior service is to meet or exceed target customers’ service quality expectations and to do it more consistently than competitors. The problem is that sometimes managers underestimate the level of those customer expectations, and sometimes those expectations can be unrealistically high. Therefore, a firm needs to clearly identify target customers’ desires with respect to service quality and to clearly define and communicate what level of service they intend to deliver.

### Exhibit 11.4

**Dimensions of Service Quality**

- **Tangibles**: Appearance of physical facilities, equipment, personnel, and communications materials.
- **Reliability**: Ability to perform the promised service dependably and accurately.
- **Responsiveness**: Willingness to help customers and provide prompt service.
- **Assurance**: Knowledge and courtesy of employees and their ability to convey trust and confidence.
- **Empathy**: Caring, individualized attention the firm provides its customers.

When this is done, customers have a more realistic idea of what to expect and are less likely to be disappointed with the service they receive.

**Improving Customer Perceptions of Service Quality** The major factors that determine a customer’s expectations and perceptions concerning service quality—and five gaps that can lead to dissatisfaction with service delivery—are outlined in Exhibit 11.7 and discussed next.

1. **Gap between the customer’s expectations and the marketer’s perceptions.** Managers do not always have an accurate understanding of what customers want or how they will evaluate a firm’s service efforts. The first step in providing good service is to collect information—through customer surveys, evaluations of customer complaints, or other methods—to determine what service attributes customers consider important.

2. **Gap between management perceptions and service quality specifications.** Even when management has a clear understanding of what customers want, that understanding might not get translated into effective operating standards. A firm’s policies concerning customer service may be unclear, poorly communicated to employees, or haphazardly enforced. Unless a firm’s employees know what the company’s service policies are and believe that management is seriously committed to those standards, their performance is likely to fall short of desired levels.

3. **Gap between service quality specifications and service delivery.** Lip service by management is not enough to produce high-quality service. High standards must be backed by the programs, resources, and rewards necessary to enable and encourage employees to deliver good service. Employees must be provided with the training, equipment, and time necessary to deliver good service. Their service performance must be measured and evaluated. And good performance must be rewarded by making it part of the criteria for pay raises or promotions, or by other more direct inducements, in order to motivate the additional effort good service requires.

4. **Gap between service delivery and external communications.** Even good service performance may disappoint some customers if the firm’s marketing communications cause them to have unrealistically high expectations. If the photographs in a vacation resort’s advertising and brochures make the rooms look more spacious and luxurious than they really are, for instance, first-time customers are likely to be disappointed no matter how clean or well-tended those rooms are kept by the resort’s staff.

5. **Gap between perceived service and expected service.** This results when management fails to close one or more of the other four gaps. It is this difference between a customer’s expectations and his or her actual experience with the firm that leads to dissatisfaction.

The above discussion suggests a number of actions management can take to close the possible gaps and improve customer satisfaction with a company’s service. Some of those actions are nicely illustrated by the response of Petopia.com’s managers to the firm’s service problems,
as described earlier in Exhibit 11.6. Achieving and sustaining high levels of service quality can present difficult implementation problems, however, because it usually involves the coordination of efforts of many employees from different functional departments and organizational levels. Some of these coordination problems are examined in Chapter 13.

**Methods of Maintaining a Low-Cost Position**

Moving down the experience curve is the most commonly discussed method of achieving and sustaining a low-cost position in an industry. But a firm does not necessarily need a large relative market share to implement a low-cost strategy. For instance, Johnson
Controls relies on close alliances with customers, as well as economies of scale, to hold down its inventory and distribution costs. And Michael Dell, as a small follower in the personal computer industry, managed to achieve costs below those of much larger competitors by developing logistical alliances with suppliers and an innovative, Internet-based direct distribution channel.

Some other means for obtaining a sustainable cost advantage include producing a no-frills product, creating an innovative product design, automating or outsourcing production, developing low-cost distribution channels, and reducing overhead.\textsuperscript{12}

**A No-Frills Product** A direct approach to obtaining a low-cost position involves simply removing all frills and extras from the basic product or service. Thus, Suzuki cars, warehouse furniture stores, legal services clinics, and grocery stores selling canned goods out of crates all offer lower costs and prices than their competitors. This lower production cost is often sustainable because established differentiated competitors find it difficult to stop offering features and services their customers have come to expect. However, those established firms may lower their own prices in the short run—even to the point of suffering losses—in an attempt to drive out a no-frills competitor that poses a serious threat. Thus, a firm considering a no-frills strategy needs the resources to withstand a possible price war.\textsuperscript{13}

**Innovative Product Design** A simplified product design and standardized component parts also can lead to cost advantages. In the office copier industry, for instance, Japanese firms overcame substantial entry barriers by designing extremely simple copiers, with a fraction of the number of parts in the design used by market-leading Xerox.

**Cheaper Raw Materials** A firm with the foresight to acquire or the creativity to find a way to use relatively cheap raw materials also can gain a sustainable cost advantage. For example, Fort Howard Paper achieved an advantage by being the first major papermaker to rely exclusively on recycled pulp. While the finished product was not so high in quality as paper from virgin wood, Fort Howard’s lower cost gave it a competitive edge in the price-sensitive commercial market for toilet paper and other such products used in hotels, restaurants, and office buildings.

**Innovative Production Processes** Although low-cost defender businesses typically spend little on product R\&D, they often continue to devote substantial sums to process R\&D. Innovations in the production process, including the development of automated or computer-controlled processes, can help them sustain cost advantages over competitors.

In some labor-intensive industries, a business can achieve a cost advantage, at least in the short term, by gaining access to inexpensive labor. This is usually achieved by moving all or part of the production process to countries with low wage rates, such as Taiwan, Korea, or Mexico. Unfortunately, because such moves are relatively easy to emulate, this kind of cost advantage may not be sustainable.

**Low-Cost Distribution** When distribution accounts for a relatively high proportion of a product’s total delivered cost, a firm might gain a substantial advantage by developing lower-cost alternative channels. Typically, this involves eliminating, or shifting to the customer, some of the functions performed by traditional channels in return for a lower price. In the consumer banking industry, for example, automated teller machines have helped reduce labor costs and investment in bricks-and-mortar branch banks. But they also have reduced the amount of personalized service banks provide to their customers, which may help explain why average customer satisfaction with banks fell by more than 8 percent from 1994 to 2000.\textsuperscript{14}
Reductions in Overhead Successfully sustaining a low-cost strategy requires that the firm pare and control its major overhead costs as quickly as possible as its industry matures. Many U.S. companies learned this lesson the hard way during the 1980s when high costs of old plants, labor, and large inventories left them vulnerable to more efficient foreign competitors and to corporate raiders.

Customers’ Satisfaction and Loyalty Are Crucial for Maximizing Their Lifetime Value

Analyzer, and particularly defender, businesses are mostly concerned with protecting their existing positions in one or more mature market segments and maximizing profitability over the remaining life of those product-markets. Thus, financial dimensions of performance, such as return on investment and cash flow, are usually of greater interest to such businesses than are more growth-oriented dimensions, such as volume increases or new product success. Businesses can achieve such financial objectives by either successfully differentiating their offerings or maintaining a low-cost position.

While the primary emphasis in many businesses during the early 1990s was on improving efficiency through downsizing and reengineering, there is substantial evidence that firms with superior quality goods and services also obtain higher returns on investment than do businesses with average or below average offerings. The lesson to be learned, then, is that the choice between a differentiation or a low-cost strategy is probably not the critical determinant of success in mature markets. What is critical is that a business continually work to improve the value of its offerings—by either improving product or service quality, reducing costs, or some combination—as a basis for maintaining its customer base as its markets mature and become increasingly competitive.

Measuring Customer Satisfaction To gain the knowledge necessary to continually improve the value of their offerings to customers, firms must understand how satisfied existing and potential customers are with their current offerings. This focus on customer satisfaction has become increasingly important as more firms question whether all attempts to improve absolute quality of their products and services generate sufficient additional sales and profits to justify their cost. This growing concern with the economic “return on quality” has motivated firms to ask which dimensions of product or service quality are most important to customers and which dimensions customers might be willing to sacrifice for lower prices. For instance, United Parcel Service recently discovered that many of its customers wanted more time to interact with the company’s drivers in order to seek advice on their shipping problems, and they were willing to put up with slightly slower delivery times in return. Consequently, UPS now allows its drivers an additional 30 minutes a day to spend at their discretion to strengthen ties with customers and perhaps bring in new sales.

Useful measures of customer satisfaction, then, should examine both (1) customers’ expectations and preferences concerning the various dimensions of product and service quality (such as product performance, features, reliability, on-time delivery, competence of service personnel, and so on) and (2) their perceptions concerning how well the firm is meeting those expectations. Any gaps where customer expectations exceed their recent experiences may indicate fruitful areas for the firm to work at improving customer value and satisfaction. Of course, such measurements must be made periodically to determine whether the actions taken have been effective.

Improving Customer Retention and Loyalty Maintaining the loyalty of existing customers is crucial for a business’s profitability. This is especially true as markets mature
because loyal customers become more profitable over time. The firm not only avoids the high costs associated with trying to acquire replacement customers in an increasingly competitive market, but it also benefits because loyal customers (1) tend to concentrate their purchases, thus leading to larger volumes and lower selling and distribution costs; (2) provide positive word-of-mouth and customer referrals; and (3) may be willing to pay premium prices for the value they receive.19

Periodic measurement of customer satisfaction is important because a dissatisfied customer is unlikely to remain loyal over time. Unfortunately, the reverse is not always true: Customers who describe themselves as satisfied are not necessarily loyal. Indeed, one author estimates that 60 to 80 percent of customer defectors in most businesses said they were “satisfied” or “very satisfied” on the last customer survey before their defection.20 In the interim, perhaps competitors improved their offerings, the customer’s requirements changed, or other environmental factors shifted. Companies that measure customer satisfaction should be commended—but urged not to stop there. Satisfaction measures need to be supplemented with examinations of customer behavior, such as measures of the annual retention rate, frequency of purchases, and the percentage of a customer’s total purchases captured by the firm.

Most important, defecting customers should be studied in detail to discover why the firm failed to provide sufficient value to retain their loyalty. Such failures often provide more valuable information than satisfaction measures because they stand out as a clear, understandable message telling the organization exactly where improvements are needed. The actions of MicroScan, as detailed in Exhibit 11.8, provide a good example of the intelligent use of such defector analysis.

Are All Customers Equally Valuable?21 While improving customer loyalty is crucial for maintaining market share and profitability as markets mature, an increasing number of companies are asking whether every customer’s loyalty is worthy of the same level of effort and expense. In these firms, technology is creating a new business model that alters the level of service and benefits provided to a customer based on projections of that customer’s value to the firm. With the development of extensive customer databases, it is possible for companies to measure what different levels of customer service cost on an individual level. They also can know how much business a particular customer has generated in the past, estimate what she or he is likely to buy in the future, and calculate a rate of return for that individual for different levels of service.

Strategic Issue
An increasing number of companies are asking whether every customer’s loyalty is worthy of the same level of effort and expense.

Exhibit 11.8 MicroScan Examines Defectors to Improve Customer Loyalty

The MicroScan division of Baxter Diagnostics, Inc., makes instruments used by medical laboratories to identify microbes in patient cultures. In 1990 MicroScan was neck-and-neck with Vitek Systems, Inc., for market leadership, but its management knew it would have to do better to win the race. The firm analyzed its customer base, highlighting accounts that had been lost as well as those that remained active but showed a declining volume of testing. MicroScan interviewed all the lost customers and a large portion of the “decliners,” probing deeply for the causes underlying their change in behavior. They found that such customers had concerns about the company’s instrument features, reliability, and responsiveness to their problems.

In response, MicroScan’s management shifted R&D priorities to address specific shortcomings its lost customers had identified, such as test accuracy and time-to-result. It also redesigned customer service protocols to ensure that immediate attention was given to equipment faults and delivery problems. As a result, MicroScan’s sales began to improve and it established a clear market-share lead within two years.

From a purely economic viewpoint, tailoring different levels of service and benefits to different customer segments depending on their profitability makes sense, at least in the short run. In an era when labor costs are increasing while many markets, especially mature ones, are getting more competitive, many firms argue they cannot afford to provide extensive hands-on service to everyone. Companies also point out that they're often delivering a wider range of products and services than ever before, including more ways for customers to handle transactions. Thanks to the Internet, for example, consumers have better tools to conveniently serve themselves. And finally, service segmentation may actually produce some positive benefits for customers—more personalized service for the best customers and, in many cases, lower overall costs and prices for everyone else. For instance, Fidelity Investments now gets about 550,000 website visits each day and more than 700,000 daily phone calls, three-quarters of which go to automated systems that cost the company less than a dollar each, including research and development costs. The rest are handled by human operators, at a cost of about $13 per call.

From an ethical standpoint, however, many people question the inherent fairness and potential invasion of privacy involved in using a wealth of personal information about individual consumers as a basis for withholding services or benefits from some of them, especially when such practices are largely invisible to the customer. You don't know when you're being shuttled to a different telephone queue or sales promotion. You don't know what benefits you're missing or what additional fees you're being charged. Some argue that this lack of transparency is unfair because it deprives consumers of the opportunity to take actions, such as concentrating their purchases with a single supplier, switching companies, or paying a service fee, that would enable them to acquire the additional services and benefits they are currently denied.

From a strategic view, there are also some potential dangers in cutting services and benefits to customers who have not generated profits in the past. For one thing, past behavior is not necessarily an accurate indicator of a customer's future lifetime value. The life situations and spending habits of some customer groups—college students, for instance—can change dramatically over time. In addition, looking only at a customer's purchases may overlook some indirect ways that customer affects the firm's revenues, such as positive word-of-mouth recommendations and referrals to other potential buyers. And some customers may not be spending much with a company precisely because of the lousy service they have received as a result of not spending very much with that company. Instead of simply writing off low-volume customers, it may make more strategic sense to first attempt to convert them into high-volume customers by targeting them for additional promotions, by trying to sell complementary goods and services, or by instituting loyalty programs (e.g., the airlines' frequent-flier programs).

Finally, by debasing the satisfaction and loyalty of low-volume customers, firms risk losing those customers to competitors. In a mature industry, particularly one with substantial economies of scale, such a loss of market share can increase unit costs and reduce the profitability of those high-volume customers that do remain loyal. And a creative competitor may find ways to make other firms' cast-off customers very profitable after all.


The ability of firms to tailor different levels of service and benefits to different customers based on each person's potential to produce a profit has been facilitated by the growing popularity of the Internet. The Web has made it easier to track and measure individual transactions across businesses. It also has provided firms with new, low-cost service options; people can now serve themselves at their own convenience, but they have to accept little or no human contact in return.

The end result of this trend toward individually tailored service levels could be an increased stratification of consumer society. The top tier may enjoy unprecedented levels of personal attention. But those who fall below a certain level of profitability for too long may face increased service fees or receive reduced levels of service and benefits. For example, some credit-card companies now charge higher annual fees to customers who do not rack
up some minimum level of interest charges during the year. In other firms, call center personnel route customers to different queues. Big spenders are turned over to high-level problem solvers while less profitable customers may never speak to a live person. Finally, choice customers may get fees waived or receive promotional discounts based on the value of their business, while less valuable customers may never know the promotions exist.

The segmentation of customers based on projections of their value and the tailoring of different service levels and benefits to those segments raise both ethical and strategic questions, some of which are explored in Exhibit 11.9. One possible way for a firm to resolve some of the dilemmas involved in dealing with less profitable customers is to find ways to increase their lifetime value by increasing the frequency and/or volume of their purchases. This is one strategy examined in detail in the following section.

### Marketing Strategies for Mature Markets

#### Strategies for Maintaining Current Market Share

Since markets can remain in the maturity stage for decades, milking or harvesting mature product-markets by maximizing short-run profits makes little sense. Pursuing such an objective typically involves substantial cuts in marketing and R&D expenses, which can lead to premature losses of volume and market share and lower profits in the longer term. The business should strive during the early years of market maturity to maximize the flow of profits over the remaining life of the product-market. Thus, the most critical marketing objective is to maintain and protect the business’s market share. In a mature market where few new customers buy the product for the first time, the business must continue to win its share of repeat purchases from existing customers.

In Chapter 10 we discussed a number of marketing strategies that businesses might use to maintain their market share in growth markets. Many of those same strategies continue to be relevant for holding on to customers as markets mature, particularly for those firms that survived the shakeout period with a relatively strong share position. The most obvious strategy for such share leaders is simply to continue strengthening their position through a fortress defense. Recall that such a strategy involves two sets of marketing actions: those aimed at improving customer satisfaction and loyalty and those intended to encourage and simplify repeat purchasing. Actions like those discussed earlier for improving the quality of a firm’s offering and for reducing costs suggest ways to increase customer satisfaction and loyalty. Similarly, improvements to service quality, such as just-in-time delivery arrangements or computerized reordering systems, can help encourage repeat purchases.

Since markets often become more fragmented as they grow and mature, share leaders also may have to expand their product lines, or add one or more flanker brands, to protect their position against competitive inroads. Thus, Johnson Controls has strengthened its position in the commercial facilities management arena by expanding its array of services through a combination of acquisitions and continued internal development.

Small-share competitors also can earn substantial profits in a mature market. To do so, however, it is often wise for them to focus on strategies that avoid prolonged direct confrontations with larger share leaders. A niche strategy can be particularly effective when the target segment is too small to appeal to larger competitors or when the smaller firm can establish a strong differential advantage or brand preference in the segment. For instance, with only 36 hotels worldwide, the Four Seasons chain is a small player in the lodging industry. But by focusing on the high end of the business travel market, the chain has grown and prospered. The chain’s hotels differentiate themselves by offering a wide range
of amenities, such as free overnight shoe shines, that are important to business travelers. Thus, while they charge relatively high prices, they also are seen as delivering good value.

**Strategies for Extending Volume Growth**

Market maturity is defined by a flattening of the growth rate. In some instances growth slows for structural reasons, such as the emergence of substitute products or a shift in customer preferences. Marketers can do little to revitalize the market under such conditions. But in some cases a market only *appears* to be mature because of the limitations of current marketing programs, such as target segments that are too narrowly defined or limited product offerings. Here, more innovative or aggressive marketing strategies might successfully extend the market’s life cycle into a period of renewed growth. Thus, *stimulating additional volume* growth can be an important secondary objective under such circumstances, particularly for industry share leaders because they often can capture a relatively large share of any additional volume generated.

A firm might pursue several different marketing strategies—either singly or in combination—to squeeze additional volume from a mature market. These include an *increased penetration strategy*, an *extended use strategy*, and a *market expansion strategy*. Exhibit 11.10

**Exhibit 11.10**

**Situational Determinants of Appropriate Marketing Objectives and Strategies for Extending Growth in Mature Markets**

<table>
<thead>
<tr>
<th>Situation variables</th>
<th>Increased penetration</th>
<th>Extended use</th>
<th>Market expansion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary objective</strong></td>
<td>Increase the proportion of users by converting current nonusers in one or more major market segments.</td>
<td>Increase the amount of product used by the average customer by increasing frequency of use or developing new and more varied ways to use the product.</td>
<td>Expand the number of potential customers by targeting underdeveloped geographic areas or applications segments.</td>
</tr>
<tr>
<td><strong>Market characteristics</strong></td>
<td>Relatively low penetration in one or more segments (i.e., low percentage of potential users have adopted the product); relatively homogeneous market with only a few large segments.</td>
<td>Relatively high penetration but low frequency of use in one or more major segments; product used in only limited ways or for special occasions; relatively homogeneous market with only a few large segments.</td>
<td>Relatively heterogeneous market with a variety of segments; some geographic areas, including foreign countries, with low penetration; some product applications underdeveloped.</td>
</tr>
<tr>
<td><strong>Competitors’ characteristics</strong></td>
<td>Competitors hold relatively small market shares; comparatively limited resources or competencies make it unlikely they will steal a significant portion of converted nonusers.</td>
<td>Competitors hold relatively small market shares; comparatively limited resources or competencies make it unlikely their brands will be purchased for newly developed uses.</td>
<td>Competitors hold relatively small market shares; have insufficient resources or competencies to preempt underdeveloped geographic areas or applications segments.</td>
</tr>
<tr>
<td><strong>Firm’s characteristics</strong></td>
<td>A market share leader in the industry; has R&amp;D and marketing competencies to produce product modifications or line extensions; has promotional resources to stimulate primary demand among current nonusers.</td>
<td>A market share leader in the industry; has marketing competencies and resources to develop and promote new uses.</td>
<td>A market share leader in the industry; has marketing and distribution competencies and resources to develop new global markets or applications segments.</td>
</tr>
</tbody>
</table>
## Exhibit 11.11

**Possible Marketing Actions for Accomplishing Growth Extension Objectives**

<table>
<thead>
<tr>
<th>Marketing strategy and objectives</th>
<th>Possible marketing actions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Increased penetration</strong></td>
<td></td>
</tr>
</tbody>
</table>
| Convert current nonusers in target segment into users | • Enhance product's value by adding features, benefits, or services.  
• Enhance product's value by including it in the design of integrated systems.  
• Stimulate additional primary demand through promotional efforts stressing new features or benefits:  
  Advertising through selective media aimed at the target segment.  
  Sales promotions directed at stimulating trial among current nonusers (e.g., tie-ins with other products).  
  Some sales efforts redirected toward new account generation, perhaps by assigning some sales personnel as account development reps or by offering incentives for new account sales.  
  Improve product's availability by developing innovative distribution systems. |
| **Extended use**                 |                             |
| Increase frequency of use among current users | • Move storage of the product closer to the point of end use by offering additional package sizes or designs.  
• Encourage larger volume purchases (for nonperishable products):  
  Offer quantity discounts.  
  Offer consumer promotions to stimulate volume purchases or more frequent use (e.g., multipack deals, frequent-flier programs).  
• Reminder advertising stressing basic product benefits for a variety of usage occasions.  
• Develop line extensions suitable for additional uses or applications.  
• Develop and promote new uses, applications, or recipes for the basic product.  
  Include information about new applications/recipes on package.  
  Develop extended use advertising campaign, particularly with print media.  
  Communicate new application ideas through sales presentations to current customers.  
• Encourage new uses through sales promotions (e.g., tie-ins with complementary products). |
| Encourage a wider variety of uses among current users |                             |
| **Market expansion**             |                             |
| Develop differentiated positioning focused on untapped or underdeveloped segments | • Develop a differentiated flanker brand or product line with unique features or price that is more appealing to a segment of potential customers whose needs are not met by existing offerings.  
  Or  
  • Develop multiple line extensions or brand offerings with features or prices targeted to the unique needs and preferences of several smaller potential applications or regional segments.  
  • Consider producing for private labels.  
  • Design advertising, personal selling, and/or sales promotion campaigns that address specific interests and concerns of potential customers in one or multiple underdeveloped segments to stimulate selective demand.  
  • Build unique distribution channels to more effectively reach potential customers in one or multiple underdeveloped segments.  
  • Design service programs to reduce the perceived risks of trial and/or solve the unique problems faced by potential customers in one or multiple underdeveloped segments (e.g., systems engineering, installation, operator training, extended warranties).  
  • Enter global markets where product category is in an earlier stage of its life cycle. |
summarizes the environmental situations where each of these strategies is most appropriate and the objectives each is best suited for accomplishing. Exhibit 11.11 then outlines specific marketing actions a firm might employ to implement each of the strategies, as discussed in more detail in the following paragraphs.

**Increased Penetration Strategy** The total sales volume produced by a target segment of customers is a function of (1) the number of potential customers in the segment; (2) the product’s penetration of that segment, that is, the proportion of potential customers who actually use the product; and (3) the average frequency with which customers consume the product and make another purchase. Where usage frequency is quite high among current customers but only a relatively small portion of all potential users actually buy the product, a firm might aim at increasing market penetration. It is an appropriate strategy for an industry’s share leader because such firms can more likely gain and retain a substantial share of new customers than smaller firms with less-well-known brands.

The secret to a successful increased penetration strategy lies in discovering why nonusers are uninterested in the product. Very often the product does not offer sufficient value from the potential customer’s view to justify the effort or expense involved in buying and using it. One obvious solution to such a problem is to enhance the product’s value to potential customers by adding features or benefits, usually via line extensions.

Another way to add value to a product is to develop and sell integrated systems that help improve the basic product’s performance or ease of use. For instance, instead of simply selling control mechanisms for heating and cooling systems, Johnson Controls offers integrated facilities management programs designed to lower the total costs of operating a commercial building.

A firm also may enhance a product’s value by offering services that improve its performance or ease of use for the potential customer. Since it is unlikely that people who do not know how to knit will ever buy yarn or knitting needles, for example, most yarn shops offer free knitting lessons.

Product modifications or line extensions, however, will not attract nonusers unless the enhanced benefits are effectively promoted. For industrial goods, this may mean redirecting some sales efforts toward nonusers. The firm may offer additional incentives for new account sales or assign specific salespeople to call on targeted nonusers and convert them into new customers. For consumer goods, some combination of advertising to stimulate primary demand in the target segment and sales promotions to encourage trial, such as free samples or tie-in promotions with complementary products that nonusers currently buy, can be effective.

Finally, some potential customers may be having trouble finding the product due to limited distribution, or the product’s benefits may simply be too modest to justify much purchasing effort. In such cases, expanding distribution or developing more convenient and accessible channels may help expand market penetration. For example, few travelers are so leery of flying that they would go through the effort of calling an insurance agent to buy an accident policy for a single flight. But the sales of such policies are greatly increased by making them conveniently available through vending machines in airport terminals.

**Extended Use Strategy** Some years ago, the manager of General Foods’ Cool Whip frozen dessert topping discovered through marketing research that nearly three-fourths of all households used the product, but the average consumer used it only four times per year and served it on only 7 percent of all toppable desserts. In situations of good market penetration but low frequency of use, an extended use strategy may increase volume. This was particularly true in the Cool Whip case; the relatively large and homogeneous target market consisted for the most part of a single mass-market segment. Also, General Foods held nearly a two-thirds share of the frozen topping market, and it had the marketing resources...
and competencies to capture most of the additional volume that an extended use strategy might generate.

One effective approach for stimulating increased frequency of use is to move product inventories closer to the point of use. This approach works particularly well with low-involvement consumer goods. Marketers know that most consumers are unlikely to expend any additional time or effort to obtain such products when they are ready to use them. If there is no Cool Whip in the refrigerator when the consumer is preparing dessert, for instance, he or she is unlikely to run to the store immediately and probably will serve the dessert without topping.

One obvious way to move inventory closer to the point of consumption is to offer larger package sizes. The more customers buy at one time, the less likely they are to be out of stock when a usage opportunity arises. This approach can backfire, though, for a perishable product or one that consumers perceive to be an impulse indulgence. Thus, most superpremium ice creams, such as Häagen-Dazs, are sold in small pint containers; most consumers want to avoid the temptation of having large quantities of such a high-calorie indulgence too readily available.

The design of a package also can help increase use frequency by making the product more convenient or easy to use. Examples include single-serving packages of Jell-O pudding to pack in lunches, packages of paper cups that include a convenient dispenser, and frozen-food packages that can go directly into a microwave oven.

Various sales promotion programs also help move inventories of a product closer to the point of use by encouraging larger volume purchases. Marketers commonly offer quantity discounts for this purpose in selling industrial goods. For consumer products, multi-item discounts or two-for-one deals serve the same purpose. Promotional programs also encourage greater frequency of use and increase customer loyalty in many service industries. Consider, for instance, the frequent-flier programs offered by major airlines.

Sometimes the product’s characteristics inhibit customers from using it more frequently. If marketers can change those characteristics, such as difficulty of preparation or high calories, a new line extension might encourage customers to use more of the product or to use it more often. Microwave waffles and low-calorie salad dressings are examples of such line extensions. For industrial goods, however, firms may have to develop new technology to overcome a product’s limitations for some applications. For instance, Johnson Controls recently acquired Prince Automotive to gain the expertise necessary to develop instrument panels and consoles incorporating the sophisticated electronics desired by top-end manufacturers such as BMW and Mercedes-Benz.

Finally, advertising can sometimes effectively increase use frequency by simply reminding customers to use the product more often. For instance, General Foods conducted a reminder campaign for Jell-O pudding that featured Bill Cosby asking, “When was the last time you served pudding, Mom?”

Another approach for extending use among current customers involves finding and promoting new functional uses for the product. Jell-O gelatin is a classic example, having generated substantial new sales volume over the years by promoting the use of Jell-O as an ingredient in salads, pie fillings, and other dishes.

Firms promote new ways to use a product through a variety of methods. For industrial products, firms send technical advisories about new applications to the salesforce to present to their customers during regular sales calls. For consumer products, new use suggestions or recipes may be included on the package, in an advertising campaign, or on the firm’s website. Sales promotions, such as including cents-off coupons in ads featuring a new recipe, encourage customers to try a new application. To reduce costs, two or more manufacturers of complementary products sometimes cooperate in running such promotions. A
recent ad promoting a simple Italian dinner, for instance, featured coupons for Kraft’s Parmesan cheese, Pillsbury’s Soft Breadsticks, and Campbell’s Prego spaghetti sauce. In some cases, slightly modified line extensions might encourage customers to use the product in different ways. Thus, Kraft introduced a jalapeño-flavored Cheese-Whiz in a microwavable container and promoted the product as an easy-to-prepare topping for nachos.

**Market Expansion Strategy** In a mature industry with a fragmented and heterogeneous market where some segments are less well developed than others, a market expansion strategy may generate substantial additional volume growth. Such a strategy aims at gaining new customers by targeting new or underdeveloped geographic markets (either regional or foreign) or new customer segments. Once again, share leaders tend to be best suited for implementing this strategy. But even smaller competitors can employ such a strategy successfully if they focus on relatively small or specialized market niches.

Pursuing market expansion by strengthening a firm’s position in new or underdeveloped **domestic geographic markets** can lead to experience-curve benefits and operating synergies. The firm can rely on largely the same expertise and technology, and perhaps even the same production and distribution facilities, it has already developed. Unfortunately, domestic geographic expansion is often not viable in a mature industry because the share leaders usually have attained national market coverage. Smaller regional competitors, on the other hand, might consider domestic geographic expansion a means for improving their volume and share position. However, such a move risks retaliation from the large national brands as well as from entrenched regional competitors in the prospective new territory.

To get around the retaliation problem, a regional producer might try to expand through the acquisition of small producers in other regions. This can be a viable option when (1) the low profitability of some regional producers enables the acquiring firm to buy their assets for less than the replacement cost of the capacity involved and (2) synergies gained by combining regional operations and the infusion of resources from the acquiring firm can improve the effectiveness and profitability of the acquired producers. For example, Heileman Brewing Company grew from the 31st largest brewer of beer in the mid-1960s to the 4th largest by the mid-1980s through the acquisition of nearly 30 regional brands. Heileman took control of strong regional brands such as Old Style, Carling, and Rainier, but because it had no dominant national brand it avoided antitrust opposition to its acquisition program. After acquisition, Heileman maintained the identity of each brand, increased its advertising budget, and expanded its distribution by incorporating it into the firm’s distribution system in other regions. As a result, Heileman achieved a strong earnings record for two decades, until the firm was itself acquired by an Australian brewer.

In a different approach to domestic market expansion, the firm identifies and develops entirely **new customer or application segments**. Sometimes the firm can effectively reach new customer segments by simply expanding the distribution system without changing the product’s characteristics or the other marketing-mix elements. A sporting goods manufacturer that sells its products to consumers through retail stores, for instance, might expand into the commercial market consisting of schools and amateur and professional sports teams by establishing a direct salesforce. In most instances, though, developing new market segments requires modifying the product to make it more suitable for the application or to provide more of the benefits desired by customers in the new segment.

One final possibility for domestic market expansion is to produce **private-label brands** for large retailers such as Sears or Safeway. Firms whose own brands hold relatively weak positions and who have excess production capacity find this a particularly attractive option. Private labeling allows such firms to gain access to established customer segments without
making substantial marketing expenditures, thus increasing the firm’s volume and lowering its per-unit costs. However, since private labels typically compete with low prices and their sponsors usually have strong bargaining power, producing private labels is often not a very profitable option unless a manufacturer already has a relatively low-cost position in the industry. It also can be a risky strategy, particularly for the smaller firm, because reliance on one or a few large private-label customers can result in drastic volume reductions and unit-cost increases should those customers decide to switch suppliers.

Global Market Expansion—Sequential Strategies  For firms with leading positions in mature domestic markets, less-developed markets in foreign countries often present the most viable opportunities for geographic expansion. As discussed in previous chapters, firms can enter foreign markets in a variety of ways, from simply relying on import agents to developing joint ventures to establishing wholly owned subsidiaries—as Johnson Controls has done by acquiring an automotive seat manufacturer in Europe.

Regardless of which mode of entry a firm chooses, it can follow a number of different routes when pursuing global expansion. 22 By route we mean the sequence or order in which the firm enters global markets. Japanese companies provide illustrations of different global expansion paths. The most common expansion route involves moving from Japan to developing countries to developed countries. They used this path, for example, with automobiles (Toyota), consumer electronics (National), watches (Seiko), cameras (Minolta), and home appliances, steel, and petrochemicals. This routing reduced manufacturing costs and enabled them to gain marketing experience. In penetrating the U.S. market, the Japanese obtained further economies of scale and gained recognition for their products, which would make penetration of European markets easier.

This sequential strategy succeeded: by the early 1970s, 60 percent of Japanese exports went to developed countries—more than half to the United States. Japanese motorcycles dominate Europe, as do its watches and cameras. Its cars have been able to gain a respectable share in most European countries.

A second type of expansion path has been used primarily for high-tech products such as computers and semiconductors. For the Japanese it consists of first securing their home market and then targeting developed countries. Japan largely ignored developing countries in this strategy because of their small demand for high-tech products. When demand increased to a point where developing countries became “interesting,” Japanese producers quickly entered and established strong market positions using price cuts of up to 50 percent.

A home market—developed markets—developing markets sequence is also usually appropriate for discretionary goods such as soft drinks, convenience foods, or cosmetics. Coca-Cola, for instance, believes that as disposable incomes and discretionary expenditures grow in the countries of South America, Asia, and Africa those markets will drive much of the company’s future growth. Similarly, firms such as the French cosmetics giant L’Oreal have positioned a number of different “world brands”—including Ralph Lauren perfumes, L’Oreal hair products, and Maybelline and Helena Rubinstein cosmetics—to convey the allure of different cultures to developing markets around the world. 23

Strategies for Declining Markets

Strategic Issue

The relative attractiveness of the declining product-market and the business’s competitive position within it should dictate the appropriate strategy.

Most products eventually enter a decline phase in their life cycles. As sales decline, excess capacity once again develops. As the remaining competitors fight to hold volume in the face of falling sales, industry profits erode. Consequently, conventional wisdom suggests that firms should either divest declining products quickly or harvest them to maximize short-term
Chapter Eleven Strategies for Mature and Declining Markets

261

profits. Not all markets decline in the same way or at the same speed, however; nor do all firms have the same competitive strengths and weaknesses within those markets. Therefore, as in most other situations, the relative attractiveness of the declining product-market and the business’s competitive position within it should dictate the appropriate strategy.

Relative Attractiveness of Declining Markets

Although U.S. high school enrollment declined by about 2 million students from its peak in 1976 through the end of the 1980s, Jostens, Inc., the leading manufacturer of class rings and other school merchandise, achieved annual increases in revenues and profits every year during that period. One reason for the firm’s success was that it saw the market decline coming and prepared for it by improving the efficiency of its operations and developing marketing programs that were effective at persuading a larger proportion of students to buy class rings.24

Jostens’ experience shows that some declining product-markets can offer attractive opportunities well into the future, at least for one or a few strong competitors. In other product-markets, particularly those where decline is the result of customers switching to a new technology (e.g., more students buying personal computers instead of portable typewriters), the potential for continued profits during the decline stage is more bleak.

Three sets of factors help determine the strategic attractiveness of declining product-markets: conditions of demand, including the rate and certainty of future declines in volume; exit barriers, or the ease with which weaker competitors can leave the market; and factors affecting the intensity of future competitive rivalry within the market.25 The impact of these variables on the attractiveness of declining market environments is summarized in Exhibit 11.12 and discussed below.

Conditions of Demand Demand in a product-market declines for a number of reasons. Technological advances produce substitute products (such as electronic calculators for slide rules), often with higher quality or lower cost. Demographic shifts lead to a shrinking target market (baby foods). Customers' needs, tastes, or lifestyles change (the falling consumption of beef). Finally, the cost of inputs or complementary products rises and shrinks demand (the effects of rising gasoline prices on sales of recreational vehicles).

The cause of a decline in demand can affect both the rate and the predictability of that decline. A fall in sales due to a demographic shift, for instance, is likely to be gradual, whereas the switch to a technically superior substitute can be abrupt. Similarly, the fall in demand as customers switch to a better substitute is predictable, while a decline in sales due to a change in tastes is not.

As Exhibit 11.12 indicates, both the rate and certainty of sales decline are demand characteristics that affect a market’s attractiveness. A slow and gradual decline allows an orderly withdrawal of weaker competitors. Overcapacity does not become excessive and lead to predatory competitive behavior, and the competitors who remain are more likely to make profits than in a quick or erratic decline. Also, when most industry managers believe market decline is predictable and certain, reduction of capacity is more likely to be orderly than when they feel substantial uncertainty about whether demand might level off or even become revitalized.

Not all segments of a market decline at the same time or at the same rate. The number and size of enduring niches or pockets of demand and the customer purchase behavior within them also influence the continuing attractiveness of the market. When the demand pockets are large or numerous and the customers in those niches are brand loyal and relatively insensitive to price, competitors with large shares and differentiated products can continue to make substantial profits. For example, even though the market for cigars...
shrank for years, there continued to be a sizable number of smokers who bought premium-quality cigars. Those firms with well-established positions at the premium end of the cigar industry have continued to earn above-average returns. And recently, the cigar market has been growing again.

**Exit Barriers**  The higher the exit barriers, the less hospitable a product-market will be during the decline phase of its life cycle. When weaker competitors find it hard to leave a product-market as demand falls, excess capacity develops and firms engage in aggressive pricing or promotional efforts to try to prop up their volume and hold down unit costs. Thus, exit barriers lead to competitive volatility.

Once again, Exhibit 11.12 indicates that a variety of factors influence the ease with which businesses can exit an industry. One critical consideration involves the amount of highly specialized assets. Assets unique to a given business are difficult to divest because of their low liquidation value. The only potential buyers for such assets are other firms who would use them for a similar purpose, which is unlikely in a declining industry. Thus, the firm may have little choice but to remain in the business or to sell the assets for their scrap value.
value. This option is particularly unattractive when the assets are relatively new and not fully depreciated.

Another major exit barrier occurs when the assets or resources of the declining business intertwine with the firm’s other business units, either through shared facilities and programs or through vertical integration. Exit from the declining business might shut down shared production facilities, lower salesforce commissions, damage customer relations, and increase unit costs in the firm’s other businesses to a point that damages their profitability. Emotional factors also can act as exit barriers. Managers often feel reluctant to admit failure by divesting a business even though it no longer produces acceptable returns. This is especially true when the business played an important role in the firm’s history and it houses a large number of senior managers.

**Intensity of Future Competitive Rivalry** Even when substantial pockets of continuing demand remain within a declining business, it may not be wise for a firm to pursue them in the face of future intense competitive rivalry. In addition to exit barriers, other factors also affect the ability of the remaining firms to avoid intense price competition and maintain reasonable margins: size and bargaining power of the customers who continue to buy the product; customers’ ability to switch to substitute products or to alternative suppliers; and any potential diseconomies of scale involved in capturing an increased share of the remaining volume.

**Divestment or Liquidation**

When the market environment in a declining industry is unattractive or a business has a relatively weak competitive position, the firm may recover more of its investment by selling the business in the early stages of decline rather than later. The earlier the business is sold, the more uncertain potential buyers are likely to be about the future direction of demand in the industry and thus the more likely that a willing buyer can be found. Thus, Raytheon sold its vacuum-tube business in the early 1960s even though transistors had just begun replacing tubes in radios and TV sets and there was still a strong replacement demand for tubes. By moving early, the firm achieved a much higher liquidation value than companies that tried to unload their tube-making facilities in the 70s when the industry was clearly in its twilight years.26

Of course, the firm that divests early runs the risk that its forecast of the industry’s future may be wrong. Also, quick divestment may not be possible if the firm faces high exit barriers, such as interdependencies across business units or customer expectations of continued product availability. By planning early for departure, however, the firm may be able to reduce some of those barriers before the liquidation is necessary.

**Marketing Strategies for Remaining Competitors**

Conventional wisdom suggests that a business remaining in a declining product-market should pursue a harvesting strategy aimed at maximizing its cash flow in the short run. But such businesses also have other strategic options. They might attempt to maintain their position as the market declines, improve their position to become the profitable survivor, or focus efforts on one or more remaining demand pockets or market niches. Once again, the appropriateness of these strategies depends on factors affecting the attractiveness of the declining market and on the business’s competitive strengths and weaknesses. Exhibit 11.13 summarizes the situational determinants of the appropriateness of each strategy. Some of the marketing actions a firm might take to implement them are discussed next and listed in Exhibit 11.14.
Harvesting Strategy

The objective of a harvesting or milking strategy is to generate cash quickly by maximizing cash flow over a relatively short term. This typically involves avoiding any additional investment in the business, greatly reducing operating (including marketing) expenses, and perhaps raising prices. Since the firm usually expects to ultimately divest or abandon the business, some loss of sales and market share during the pursuit of this strategy is likely. The trick is to hold the business’s volume and share declines to a relatively slow and steady rate. A precipitous and premature loss of share would limit the total amount of cash the business could generate during the market’s decline.

A harvesting strategy is most appropriate for a firm holding a relatively strong competitive position in the market at the start of the decline and a cadre of current customers likely to continue buying the brand even after marketing support is reduced. Such a strategy also works best when the market’s decline is inevitable but likely to occur at a relatively slow and steady rate and when rivalry among remaining competitors is not likely to be very intense. Such conditions enable the business to maintain adequate price levels and profit margins as volume gradually falls.
### Chapter Eleven  
**Strategies for Mature and Declining Markets**

#### Exhibit 11.14  
**Possible Marketing Actions Appropriate for Different Strategies in Declining Markets**

<table>
<thead>
<tr>
<th>Marketing strategy and objectives</th>
<th>Possible marketing actions</th>
</tr>
</thead>
</table>
| **Harvesting strategy** | • Eliminate R&D expenditures and capital investments related to the business.  
• Reduce marketing and sales budgets.  
Greatly reduce or eliminate advertising and sales promotion expenditures, with the possible exception of periodic reminder advertising targeted at current customers.  
Reduce trade promotions to minimum level necessary to prevent rapid loss of distribution coverage.  
Focus salesforce efforts on attaining repeat purchases from current customers.  
• Seek ways to reduce production costs, even at the expense of slow erosion in product quality.  
• Raise price if necessary to maintain margins. |
| **Maintenance strategy** | • Continue product and process R&D expenditures in short term aimed at maintaining or improving product quality.  
• Continue maintenance levels of advertising and sales promotion targeted at current users.  
• Continue trade promotion at levels sufficient to avoid any reduction in distribution coverage.  
• Focus salesforce efforts on attaining repeat purchases from current users.  
• Lower prices if necessary to maintain share, even at the expense of reduced margins. |
| **Profitable survivor strategy** | • Signal competitors that firm intends to remain in industry and pursue an increased share.  
Maintain or increase advertising and sales promotion budgets.  
Maintain or increase distribution coverage through aggressive trade promotion.  
Focus some salesforce effort on winning away competitors’ customers.  
Continue product and process R&D to seek product improvements or cost reductions.  
• Consider introducing line extensions to appeal to remaining demand segments.  
• Lower prices if necessary to increase share, even at the expense of short-term margins.  
• Consider agreements to produce replacement parts or private labels for smaller competitors considering getting out of production. |
| **Niche strategy** | • Continued product and process R&D aimed at product improvements or modifications that will appeal to target segment(s).  
• Consider producing for private labels in order to maintain volume and hold down unit costs.  
• Focus advertising, sales promotion, and personal selling campaigns on customers in target segment(s); stress appeals of greatest importance to those customers.  
• Maintain distribution channels appropriate for reaching target segment; seek unique channel arrangements to more effectively reach customers in target segment(s).  
• Design service programs that address unique concerns/problems of customers in the target segment(s). |
Implementing a harvesting strategy means avoiding any additional long-term investments in plant, equipment, or R&D. It also necessitates substantial cuts in operating expenditures for marketing activities. This often means that the firm should greatly reduce the number of models or package sizes in its product line to reduce inventory and manufacturing costs.

The business should improve the efficiency of sales and distribution. For instance, an industrial goods manufacturer might service its smaller accounts through telemarketing or a website rather than a field salesforce or assign its smaller customers to agent middlemen.

For consumer goods, the business might move to more selective distribution by concentrating its efforts on the larger retail chains.

The firm would likely reduce advertising and promotion expenditures, usually to the minimum level necessary to retain adequate distribution. Finally, the business should attempt to maintain or perhaps even increase its price levels to increase margins.

**Maintenance Strategy** In markets where future volume trends are highly uncertain, a business with a leading share position might consider pursuing a strategy aimed at maintaining its market share, at least until the market’s future becomes more predictable. In such a maintenance strategy, the business continues to pursue the same strategy that brought it success during the market’s mature stage. This approach often results in reduced margins and profits in the short term, though, because firms usually must reduce prices or increase marketing expenditures to hold share in the face of declining industry volume. Thus, a firm should consider share maintenance an interim strategy. Once it becomes clear that the market will continue to decline, the business should switch to a different strategy that will provide better cash flows and return on investment over the market’s remaining life.

**Profitable Survivor Strategy** An aggressive alternative for a business with a strong share position and a sustainable competitive advantage in a declining product-market is to invest enough to increase its share position and establish itself as the industry leader for the remainder of the market’s decline. This kind of strategy makes most sense when the firm expects a gradual decline in market demand or when substantial pockets of continuing demand are likely well into the future. It is also an attractive strategy when a firm’s declining business is closely intertwined with other SBUs through shared facilities and programs or common customer segments.

A strong competitor often can improve its share position in a declining market at relatively low cost because other competitors may be harvesting their businesses or preparing to exit. The key to the success of such a strategy is to encourage other competitors to leave the market early. Once the firm has achieved a strong and unchallenged position, it can switch to a harvesting strategy and reap substantial profits over the remaining life of the product-market.

A firm might encourage smaller competitors to abandon the industry by being visible and explicit about its commitment to become the leading survivor. It should aggressively seek increased market share, either by cutting prices or by increasing advertising and promotion expenditures. It also might introduce line extensions aimed at remaining pockets of demand to make it more difficult for smaller competitors to find profitable niches. Finally, the firm might act to reduce its competitors’ exit barriers, making it easier for them to leave the industry. This could involve taking over competitors’ long-term contracts, agreeing to supply spare parts or to service their products in the field, or providing them with components or private-label products. For instance, large regional bakeries have encouraged grocery chains to abandon their own bakery operations by supplying them with private-label baked goods.

The ultimate way to remove competitors’ exit barriers is to purchase their operations and either improve their efficiency or remove them from the industry to avoid excess capacity. With continued decline in industry sales a certainty, smaller competitors may be forced to sell their assets at a book value price low enough for the survivor to reap high
CHAPTER ELEVEN

STRAATEGIES FOR MATURE AND DECLINING MARKETS

returns on its investment, as Heileman Brewing Company did on its acquisitions of smaller regional brewers during the 1970s and 80s.

Niche Strategy Even when most segments of an industry are expected to decline rapidly, a niche strategy may still be viable if one or more substantial segments will either remain as stable pockets of demand or decay slowly. The business pursuing such a strategy should have a strong competitive position in the target segment or be able to build a sustainable competitive advantage relatively quickly to preempt competitors. This is one strategy that even smaller competitors can sometimes successfully pursue, because they can focus the required assets and resources on a limited portion of the total market. The marketing actions a business might take to strengthen and preserve its position in a target niche are similar to those discussed earlier concerning niche strategies in mature markets.

Take Aways

- Strategic choices in mature, or even declining, markets are by no means always bleak. Many of the world’s most profitable companies operate largely in such markets.
- A critical marketing objective for all competitors in a mature market is to maintain the loyalty of existing customers. To accomplish that goal, firms must pursue improvements in the perceived value those customers receive from their offerings—either by differentiating themselves on the basis of superior quality or service, by lowering costs and prices, or both.
- An important secondary objective for some firms, particularly share leaders, in mature markets is to stimulate further volume growth by taking actions to convert nonusers into users, to increase use frequency among current users, or to expand into untapped or underdeveloped markets.
- Declining markets can still offer attractive opportunities for sales revenues and profits. Their attractiveness—and the appropriate marketing strategy to follow—depends on, among other things, the pace and certainty of market decline, the presence of exit barriers, the firm’s competitive strengths, and the likely intensity of future competition.
- Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at www.mhhe.com/walker.

Endnotes

1. This example is based on material found in Rick Tetzeli, “Mining Money in Mature Markets,” Fortune, March 22, 1993, pp. 77–80; and in the Johnson Controls Inc. 2000 Annual Report, which can be found at the company’s website at www.jci.com.
2. For a more detailed discussion of these traps, see Michael E. Porter, Competitive Strategy (New York: Free Press, 1980), pp. 247–49.
12. For a more detailed discussion of these and other approaches for lowering costs, see Aaker, Strategic Market Management, chap. 10.
14. This percentage decline is based on the University of Michigan’s annual poll of customer satisfaction among a sample of 50,000 consumers, as reported in Diane Brady, “Why Service Stinks,” Business Week, October 23, 2000, p. 120.
MARKETING STRATEGIES FOR THE NEW ECONOMY

When Something Clicks: An Old-Economy Camera Retailer Gets Web-Savvy

KOREAN-BORN JACK SHIN opened Camera World in a musty downtown location in Portland, Oregon, in 1977. By refusing to sell cheap “gray-market” goods (such goods are not meant by their overseas manufacturers to be sold in the United States and are generally not covered by manufacturers’ warranties) that many dealers were pushing, Shin built close relationships with Fuji, Canon, Nikon, and other leaders in the photography world and parlayed those relationships into a thriving family business. By providing expert advice and first-rate customer service to retail and mail-order customers, Shin and his family made sure that customers who shopped at Camera World became repeat customers. In 1996, though, after struggling through several years of a flat camera market and worn out from the daily challenges every entrepreneur faces, Shin decided to sell his business.

Word of the availability of Camera World reached Alessandro Mina, a native Swede who, with two fellow European students in the MBA program at Stanford, had founded Sverica International, an investment vehicle designed to acquire and transform old-economy businesses into aggressive growth companies by taking advantage of new-economy technologies. Camera World “fit all our criteria,” Mina recalls. “It was profitable. Sales were stagnant, but there was a growth opportunity. The owner was retiring, and there was a successful mail-order business in place. It had a huge database of happy customers who came to Camera World in the same way people go to Amazon.com for books or Dell Computer for computers—they go there pretty much knowing what they want. I held the view that Internet and mail-order sales are basically the same that way, so I thought it had all the ingredients for a great Web business.” The company even had a website, though visitors could not use it to make purchases.

TRANSFORMING THE BUSINESS

Mina bought the company and named its online arm Cameraworld.com. Fortunately, many of the key ingredients to build a new-economy business were already in place. The company already had figured out how to take orders, process and ship them, and process returns where necessary. It enjoyed long-established relationships with top-tier suppliers and had built innovative systems to provide customer service. Its phone lines were staffed by professional photographers (or photographers with day jobs) who knew their stuff. The
key challenges that remained involved transforming the Web pages from simple brochures into a genuine transaction site and marrying the company’s back-end systems to whatever happened on the Web. The toughest challenge, though, was time. Mina wanted his new company to become the leading online camera retailer before a competitor could.

Mina moved the company’s distribution facility into a new and better-organized warehouse four times the size of its previous home, but with lower rent and reduced labor costs. “Because the warehouse was larger and better organized, we made more shipments on time”—within 24 hours instead of five days—“with fewer errors.” Mina hired Web Northwest, the designer of the original Camera World website, to transform its 300-visitors-a-day site into a visually appealing, highly interactive one. He spent $20,000 on new servers to crank up the site’s capacity. By early 2000, the Cameraworld.com site, which costs roughly $10,000 per month to maintain, was handling 15,000 visitors and 400 transactions per day. The site, now a full-fledged community for photo enthusiasts, offers a selection wizard to help customers choose the right camera, online chats with noted photographers, and an Internet telephony feature that lets customers talk online with the sales and support staff.

**Growing the Business**

Among Camera World’s happy customers was an amateur wildlife photographer named Aneel Bhusri, whose real job was as a partner in Greylock, a Boston-based venture capital firm. In 1999, Greylock and five other venture capitalists invested $60 million to help Mina scale up the business. More online and offline ads, more sales and support staff, and a new CEO whom Mina helped find, Terry Strom, former CEO of Egghead Software, will take the company from an Internet start-up to an established e-commerce player, if all goes well. Mina, now living in Boston, is happy to let others grow the company. “I can go back to what I do best—finding good companies to invest in,” Mina says. Investor Bhusri is thrilled at having an opportunity to play a leading role in an Internet company that, as he says, “gets it. If you look at what makes a website successful, most of it is logistics. Camera World had this figured out a long time ago. Why don’t others? I honestly don’t know the answer. These guys are rare. I think they can be the Dell of the camera business.”

**Strategic Challenges Addressed in Chapter 12**

As the Camera World example shows, the opportunities presented by the Internet and other sectors of the new economy can transform old-economy companies and provide compelling opportunities for growth. Leaders of virtually every company today are, at a minimum, wondering what they should do about the Internet, the development of new communications media and technologies from broadband cable to mobile telephony, and other such developments. Some are committing significant resources in hopes of taking advantage of these new developments. But the optimal path through the new-economy maze is far from clear for most companies.

Thus, in Chapter 12, we address several timely and important questions that marketing strategists in today’s companies and entrepreneurs must ask. Does the company need a new-economy strategy? Do the technological advances of the new economy represent...
Section Three  Formulating Marketing Strategies

Strategic Issue
What marketing roles can the Internet and other recent and future technological developments play, and which of these should be pursued?

We begin by reviewing several trends that highlight the growing importance of the Internet and other new-economy technological developments. We then identify the key advantages and disadvantages inherent in new-economy phenomena, all of which every company must clearly understand. Next, we identify the marketing roles that new-economy technologies can plausibly play in marketing strategies, and we articulate a decision framework for managers to use to decide which of the growing array of new-economy tools their firms should employ—from Web-based marketing research to advertising on mobile phones to the delivery of digitized information, goods, and services over the Web. Finally, we examine what has gone wrong in the dot-com world to date, and we identify some key success factors in developing market offerings to successfully serve new-economy markets.

Does Every Company Need a New-Economy Strategy?

Like it or not, the new economy is here to stay. But exactly what do people mean by this ubiquitous phrase? By new economy, we mean the industries that fuel the development of or participate significantly in electronic commerce and the Internet, develop and market computer hardware and software, and develop or provide any of the growing array of telecommunications services. The obvious players are dot-com retailers such as Amazon.com, Web portals such as Yahoo! and America Online, companies such as Cisco and 3Com that make much of the hardware on which the Internet runs, software firms such as Netscape and Microsoft, and telecom companies such as AT&T, EchoStar, and Qwest whose communications networks permit the transmission of voice or data over various kinds of wire-line, wireless, and satellite networks. However, many formerly old-economy companies are making increasingly significant commitments to new-economy technologies. Longtime bricks-and-mortar retailers such as Gap and Wal-Mart, century-old manufacturing companies large and small whose electronic data interchange (EDI) systems are critical to their sourcing and/or selling, and service businesses such as Kinko’s are all committed to the new economy in one way or another. These days, every company is asking itself, “Do we need an Internet (or other new-economy-based) strategy?”

The growing adoption in both consumer and commercial sectors of the Internet, wireless telephony, and other new-economy technologies is making this question an imperative one. The Gartner Group forecasts that by 2004 75 percent of U.S. households will have Internet access, of which 29 million households will be broadband-enabled.2 Broadband, or high-speed, connections that permit data transmission dramatically faster than today’s 56K modems will, according to Gartner, account for three-quarters of the $10,000 worth of goods and services that Gartner says will be bought online on average by each U.S. household in 2006. And the new economy is not just an American phenomenon. In 2000, nearly 400 million people worldwide had online access, of which only one-third were in the United States (see Exhibit 12.1).3 Mobile telephones, more prevalent in Europe than in the United States, will soon surpass 100 percent penetration in some countries. New technologies will make many of these phones able to receive advertisements and will provide mobile access to the Web. Adding GPS (global positioning satellite) technology to the mix makes the possibilities even more intriguing, since marketers will know both who and where we are!
Jupiter Research reports that online consumer spending in 1999 accounted for more than $1 billion in sales in at least four categories: air travel, hotels, personal computers, and books. Jupiter estimates that consumer spending online will grow from $17.3 billion in 1999 to $86.3 billion in 2003. The same sort of growth is also happening in business-to-business e-commerce. While B2B (business-to-business) e-commerce accounted for only $215 million in 1999 (not counting business done via EDI channels), according to AMR Research Inc., or just 1.4 percent of all commercial transactions, it is expected to explode to $5.7 trillion by 2004.

What should marketers conclude from these trends? Notwithstanding the ups and downs of stock market valuations of new-economy companies, notwithstanding the difficulties many B2B and B2C (business-to-consumer) companies are having in developing business models that actually make money, and notwithstanding the so-called digital divide, in which some segments of the population are dramatically underrepresented in the Internet population, the long-term prospects for doing business in the new economy are still enormous. Americans’ love affair with entrepreneurs and the huge supply of available venture capital money (notwithstanding the industry downturn in 2000 and 2001), combined with the growing market acceptance of and the inherent advantages brought by the Internet and other new-economy technologies, suggest that nearly every American company needs to examine how it will be affected by and can take advantage of these new technologies (see Exhibit 12.2). The rapid pace of Internet adoption outside the United States suggests that the same can be said in most other developed and developing countries.

The outcome of such an examination should be the development of one’s own new-economy strategy in most companies of significant size or scope. The fact that one’s competitors will surely develop and deploy such strategies is a further argument for doing so. But marketers should take heart, for the good news is this. “In the end, e-consumers and e-businesses aren’t so different from traditional buyers and sellers after all. Customers are,
by and large, pragmatists—whether they are individuals looking for a new shirt, or a big automaker looking for a new source of steel. When the e-way is easier, faster, and cheaper, it can win.” The promise of easier, faster, and cheaper is exactly what Alessandro Mina saw when he bought Camera World. Today’s well-educated business students can bring the same insights—as well as new-economy expertise—to the companies they join.

**Threats or Opportunities? The Inherent Advantages and Disadvantages of the New Economy for Marketers**

What advantages do new-economy technologies provide to marketers and their customers? Seven potentially attractive elements characterize many new-economy technologies: the syndication of information, the increasing returns to scale of network products, the ability
to efficiently personalize and customize market offerings, the ability to disintermediate distribution, global reach, round-the-clock access, and the possibility of instantaneous delivery.

The Syndication of Information

Syndication involves the sale of the same good—typically an informational good—to many customers, who then combine it with information from other sources and distribute it. The entertainment and publishing worlds have long employed syndication, producing comic strips, newspaper columns, and TV shows that appear in many places at once. Without syndication, today’s mass media would not exist as we know it. Though Internet marketers rarely use the word syndication to describe what they do, it lies at the heart of many e-commerce business models. Inktomi, an originator of syndicated content, provides its search engine technology to many branded search engine sites. Screaming Media, a syndicator, collects articles in electronic form and delivers relevant portions of this content to more than 500 sites, each of which appeals to a different target audience. E*Trade, a distributor of syndicated information, brings together from many sources content relevant to its investor clientele and packages it in ways useful to these clients. Camera-world.com plays all these syndication roles, too, in different ways.

Why is syndication important? First, because syndication deals with informational goods (digitized text, music, photos, CAD/CAM files, and so on) rather than tangible goods, a company can syndicate the same informational goods or services to an almost infinite number of customers with little incremental cost. Variable costs approach zero. Producers of tangible goods and most services (candy bars, for example, or haircuts) must spend money on sugar and chocolate or labor for each additional candy bar or haircut sold. Not so for information producers, where sending a digital copy of a photo or an Internet news feature to one more recipient is essentially free. Second, the syndication process can be automated and digitized, enabling syndicated networks to be created, expanded, and flexibly adapted far more quickly than would be possible in the physical world.

Syndication via the Internet—and soon, perhaps, via mobile phones or other mobile devices—opens up endless opportunities for marketers. It replaces scarcity with abundance. Information can be replicated an infinite number of times and combined and recombined in an infinite number of ways. It can be distributed everywhere, all at once, and be available all the time. Taking advantage of this potential, however, requires new thinking. Companies need to identify and occupy the most important niches in syndication networks. These are the ones that maximize the number and strength of links to other companies and customers, though shifting market conditions inevitably mean that these links must change as markets evolve. Bloomberg, the provider of syndicated information to stock traders and analysts, is an example of a company that has positioned itself well; many of its clients now regard their Bloomberg terminals as indispensable. Thus, almost any company can think of itself as part of a larger, interconnected world and seek ways to occupy originator, syndicator, or distributor roles in an appropriate syndication network.

Increasing Returns to Scale of Network Products

Any undergraduate economics student knows that an increased supply of a good leads to lower value, hence lower prices. But that was before fax machines, operating systems, and other products used in networks, where the second fax machine, for example, makes the first one more valuable, and so on. This characteristic of informational networks—a product
becomes more valuable as the number of users increases—is often called a **positive network effect** or **network externality**. When combined with the syndication of informational products, this characteristic has led to the seemingly crazy strategy of giving one’s Internet product away for free, often a strategy of choice for new-economy marketers! Hotmail, whose e-mail software costs users nothing, creates value for advertisers and others in the large network that it has created.

Companies that can identify and exploit opportunities where they can benefit from the **increasing returns to scale** that result from positive network effects can sometimes grow very quickly on relatively modest capital investment. If Cameraworld.com is successful in building a community of photo enthusiasts who share insights with one another—in chat rooms or other formats—via the Camera World website, the increasing returns of this growing community will benefit Camera World as well as its customers.

### The Ability to Efficiently Personalize and Customize Market Offerings

Amazon.com tracks the books I buy and, using a technology known as **collaborative filtering**, is able to compare my purchases with those of others and thereby recommend to me books they think I would like, personalized to my taste and reading habits, as Amazon understands them (see Exhibit 12.3). If they do this well, my purchases go up, and I

---

**Exhibit 12.3**

**Personalization through Collaborative Filtering**

become a happier customer, because Amazon helps me find books I want to read. While collaborative filtering technology has a long way to go (the book I bought for my daughter when she was leaving for a semester in Ecuador does not make me a Latin American culture buff!), the potential of this and other new-economy technologies offers the promise of creating sharply targeted market segments—ultimately, market segments of one.

Collaborative filtering is but one way of personalizing a market offering to each customer. When formal decision rules can be identified in the way customers behave (for example, reminding customers of, or making special offers for, upcoming birthdays or offering supplementary items based on past purchases), **rules-based personalization** can be done. The most predictive rules, however, may require customers to divulge information that they do not want to take the time, or are not willing, to divulge.

**Customization** techniques, which are user-driven instead of marketer-driven (as we have seen for personalization approaches), allow users to specify the nature of what is offered to them. Several office supply firms, for example, now offer corporate users the ability to create customized office supply catalogs tailored to their company. Such catalogs simplify ordering procedures, save time and money in the purchasing department, and help control expense by offering to perhaps far-flung employees only what the purchasing department has approved in advance. Similarly, CDNow offers consumers the opportunity to order customized CDs consisting of only the songs the customer chooses. In today’s highly competitive markets, personalization and customization can help build customer loyalty and make it less likely for customers to switch to other suppliers.

### Disintermediation and Restructuring of Distribution Channels

Many goods and services are sold through distribution channels. The Internet makes it possible for marketers to reach customers directly, without the expense or complication of distribution channels, a phenomenon known as **disintermediation**. Best-selling author Stephen King sold his recent novel, *The Plant*, via the Web (see Exhibit 12.4), one installment at a time. King benefited by not having to share revenues with publishers and other distribution intermediaries, and King’s fans benefited by paying only a dollar or two for each installment of the book and by getting instant delivery at any time, virtually anywhere in the world. More than 150,000 readers ponied up for the first chapter upon its release in July 2000 though interest in subsequent chapters dwindled. Random House Inc. has announced plans to offer electronic versions of 100 classic works in its literary library, such as James Joyce’s *Ulysses*, for as little as $4.95 online. Rather than selling direct, however, Random House will sell through specialty sites, such as Shakespeare.com, as well as through some established online book retailers. Thus, rather than disintermediating its channel for these books, Random House is simply restructuring it to take advantage of the Web’s increasing reach.

Deciding to disintermediate or restructure one’s channel, however, should not be done lightly. Levi Strauss, the jeans maker, angered its existing retailers by offering custom-fit jeans direct to consumers via the Web. Ultimately, the company withdrew the offering due in part to the howls of protest it heard from its regular retail channel members. Similar concerns have arisen in the travel industry, as airlines and others have disintermediated travel agents by selling airline tickets and other travel services directly to consumers via the Web. Someone must perform the functions normally performed by channel members—taking orders, delivering products, collecting payment, and so on—so those who consider disintermediating their channels and selling direct must determine how they will perform these
functions and must evaluate whether doing so is more effective and efficient than using intermediaries.

**Global Reach, 24×7 Access, and Instantaneous Delivery**

With the Internet and other new-economy technologies, typically there is no extra cost entailed in making information, digital goods, or services available anywhere one can gain access to the Web—literally, **global reach**; making them available 24 hours per day, seven days per week, 52 weeks per year; and, in some cases, providing instantaneous delivery. In our increasingly time-pressed world, access and service like this can be of great value to customers. Camera World’s online store, for example, is always open. Easy-Jet, a rapidly growing low-priced airline in Europe, sells a large proportion of its tickets on its own website, many of them to international travelers who reserve flights from afar, even from another continent. Flight confirmations are delivered instantly. Software vendors whose products may be purchased and instantaneously downloaded from the Web provide similar responsiveness. As mobile telephony and GPS technologies develop, similar benefits will be available to customers and marketers whose products are well suited to mobile media. Is anyone up for portable music downloaded to one’s cell phone from the Internet?12 How about a free salad with a pizza, today only, at the restaurant just around the corner?
Are These New-Economy Attributes Opportunities or Threats?

Most marketers can choose to take advantage of one or more of the benefits offered by new-economy technologies, including those we have outlined above. To that extent, these technologies constitute opportunities available to marketers who employ them. Viewed differently, however, they raise complex ethical issues (see Ethical Perspectives 12.1 and 12.2) and they also present potentially significant threats.

First, the fact that the variable cost for syndicated goods approaches zero sounds like a good thing, until one realizes that for most products, price, over the long run, usually is not far from variable cost. If variable cost is zero, will prices drop to near zero, too? If so, such an outcome would represent disaster for information producers. Several companies once thought that providing lists of telephone numbers on CD-ROMs might be a good business. After all, it costs less than a dollar to produce a CD-ROM once the content is ready, and lists of phone numbers had already been compiled by the telephone companies. Alas for these marketers (but happily for consumers), numerous competitors rushed into the market, and with undifferentiated products they were soon forced to compete on price alone. Prices plunged. CD phone books, originally priced in 1986 at $10,000 per copy, soon sold for a few dollars in discount software bins.13

Selling music on the Internet also seemed like a good idea to music publishers and even to artists. Imagine getting $12 to $15 for the music on a CD, with no retailers or distributors to take cuts of the revenue, and no costs to pay for fancy packaging! Disintermediation sounds good, if you are a music publisher, but it’s a threat if you’re a music retailer, even a Web-based one like CDNow! But Napster, Gnutella, and others developed ways to enable consumers to share and download music—and other kinds of files—for free.14 The music labels and artists, of course, were less than excited about Napster’s delivery of their music to consumers for free, fearing that such delivery would eliminate the need for consumers to
Another threat to new-economy technologies is that there are few barriers to entry, and most Internet strategies are easily imitated. Numerous book retailers are challenging Amazon.com. Half a dozen e-tailers initially crowded the pet supplies business, though their numbers thinned fast. Unless one can patent one’s method of doing business on the Web, as has Amazon with its 1-Click® ordering system or Priceline.com with its approach to selling cut-rate airline tickets online, it is likely that one’s competitive advantage in the online space will not be sustainable. Even for Amazon and Priceline, long-term success is by no means assured.

Other threats include privacy and security issues, which can drive away customers rather than attract them if they are not handled with care. In Exhibit 12.5, we discuss the impact of the Internet’s global reach on privacy issues. The most restrictive jurisdictions’ privacy rules may eventually apply to Internet marketers anywhere. Privacy laws in Europe, compared to the United States, are substantially more strict, as is discussed in Exhibit 12.5.

Similarly for security, customers are wary of providing too much information to online marketers, even though that information might help the marketer tailor its offerings to the customer’s benefit. Potential misuse of credit-card numbers and other personal information still concerns many users. The use of so-called cookies, electronic markers that enable websites to track whose computer visits them, for how long, and in what sequence, provides a wealth of consumer behavior data that marketers hope to use to personalize their offerings to customers. But how many customers want their click-streams tracked by an electronic Sherlock Holmes? Would a candidate for public office want the press to examine and make public his or her online shopping behavior?

Ultimately, a marketer’s best defenses against these disadvantages are likely to take either of two forms. One defense is through the patent and copyright system, though as the Napster example shows, such protection may not be effective as new technologies are developed that make the protection of intellectual property problematic. A second defense is through what Carl Shapiro and Hal Varian call versioning.¹⁵ Shapiro and Varian argue...
that, even for information products whose variable cost approaches zero, the value of information to different kinds of customers is likely to vary substantially. Marketers who have the insight to determine which features will be valuable to some customers, but of little value to others, can package and repackage information differently and serve market segments with margins that need not fall to zero. Versioning can be done on many dimensions: time (which users value getting the information sooner than others?); convenience (can we restrict the place or degree of access to some users?); comprehensiveness (which users need detail? Which only need the big picture?); manipulation (which users want to be able to manipulate, duplicate, process, store, or print the information?); community (which users want to discuss information with others?); and support (who needs, and will pay for, support?). Other dimensions on which versioning can be based include freedom from annoyance, speed, user interfaces, image resolution (for visual images, such as stock photos), and more not yet imagined. By tailoring the same core information to the varied needs of different buyers, the unusual economics of information can work to the advantage of the seller, while providing excellent value to the buyer. Skills in market segmentation and targeting, differentiation, and positioning—skills developed earlier in this book—are needed to enable marketers to best take advantage of new-economy technologies and mitigate their disadvantages.

**Strategic Issue**

Skills in market segmentation and targeting, differentiation, and positioning—skills developed earlier in this book—are needed to enable marketers to best take advantage of new-economy technologies and mitigate their disadvantages.

**First-Mover Advantage: Fact or Fiction?**

In the Internet gold rush in the late 1990s, the key to Internet success was said to be first-mover advantage. The first firm to establish a significant presence in each market niche would be the one that succeeded. Thus, Amazon would win in books. EBay would win in auctions. Autobytel would win in the automotive sector, and so on. Later followers need not bother. As we saw at the beginning of this chapter, Alessandro Mina of Camera World appeared to hold this view. But is first-mover advantage real?

As we saw in Chapter 9, being the first mover does bring some potential advantages, but not all first movers are able to capitalize on those advantages. Thus, many are surpassed...
over time by later entrants. One thing a pioneer must do to hold on to its early leadership position is to continue to innovate in order to maintain a differential advantage over the many imitators likely to arrive late to the party but eager to get in.

Jim Collins, co-author of the best-sellers *Good to Great* and *Built to Last: Successful Habits of Visionary Companies*, is more blunt about the supposed rule that nothing is as important as being first to reach scale. “It’s wrong,” he says. “Best beats first.”17 As Collins points out, VisiCalc was the first major personal computer spreadsheet. Where is VisiCalc today? It lost the battle to Lotus 1-2-3, which in turn lost to Excel. What about the now-ubiquitous Palm Pilot? It came to market years after early leader Sharp and the Apple Newton. Palm Pilot’s designers found a better way to design personal digital assistants—using one reliable script, instead of everyone’s own script—and have sold 6 million units.18 But its current advantage may not last, as Handspring and Blackbird are now nipping at Palm Pilot’s heels. America Online, another new-economy star, got to its leading position by being better, not first. In the old economy, Wal-Mart didn’t pioneer discount retailing. Nucor didn’t pioneer the minimill for making steel from scrap. Starbucks didn’t pioneer the high-end coffee shop. Yet all were winners, while the early leaders fell behind or disappeared. None of these entrants were first—they were better. Being first may help attract investors and may make some founders and venture capitalists rich, but it’s hardly a recipe for building a great company. In his book *Digital Darwinism*, Evan Schwartz identifies seven strategies for surviving in the digital economy. Being the first mover is not among them.19 Fortunately, with the dot-com crash in early 2000, investors seem to be catching on to the game.

**Developing a New-Economy Strategy: A Decision Framework**

Most companies of substantial size or scope will need to develop strategies to take advantage of new-economy technologies, but doing so is easier said than done. This is new ground in most companies. In several earlier chapters, we identified recent software applications with the potential for helping marketers be more effective and efficient in their marketing decision making and marketing activities. To some observers, such applications fall within the scope of the new economy. In this section, we examine areas in which even newer new-economy technologies have widespread marketing applications. While we recognize that other non-marketing applications also may be compelling for many companies, our focus remains on marketing, for which, as Peter Sealey points out, productivity gains have been hard to come by.20 Sealey argues that major advances in marketing productivity will depend on the broader use of information. That will happen only when companies fully leverage the power of the Internet, he says. Thus, in this section we focus on how the Internet—and, for some applications, mobile telephony—can fruitfully be employed for marketing purposes.21

**Marketing Applications for New-Economy Tools**

In the first chapter of this book we pointed out that a number of activities have to be performed by somebody for an exchange transaction to occur between a selling firm and a potential customer. Retaining that customer for future transactions adds additional activities, such as providing effective and responsive customer service after the sale. From the customer’s point of view, these necessary activities can be summarized in a six-stage consumer experience process that begins with communicating one’s wants and needs to
Chapter Twelve  Marketing Strategies for the New Economy

prospective sellers; moving through the awareness, purchase, and delivery processes; obtaining any necessary service or support after the purchase to support its use or consumption; and ultimately sometimes returning or disposing of the product (we identify the six stages from the marketer’s perspective in Exhibit 12.6). Customers first provide information about their needs to sellers, whose customer insight permits them to develop goods or services intended to meet the customers’ needs. This stage in the process requires that information flow from customer to seller, as shown in Exhibit 12.6. While there may be several back-and-forth iterations in the insight stage, as new product developers invent and refine their product ideas, ultimately some good or service is developed, and information about the new product—promotion and brand building—then flows to customers, to inform and encourage them to buy. If the customer likes what is offered, a transaction ensues, requiring that information about pricing, terms, delivery, and so on flow both ways. With a transaction consummated, delivery of the good or service is made, with the product flowing to the customer and money or other compensation flowing to the seller. But the seller’s job is not yet done, for the customer may need some kind of customer support or service during use, in which case additional information may flow in either direction or additional goods or services may flow to the customer, possibly in exchange for additional revenue. Finally, the customer may need to return, dispose of, or discontinue use of the good or service, at which point the product may be returned to the seller, cash may flow back to the customer (as a result of the product’s return or some kind of trade-in, perhaps), and another transaction—with this or another seller—may ensue, thereby repeating much of the process. The Internet and, to a more limited extent, mobile telephony offer applications at some or all of these stages. We now explore some of these applications, though in this fast-moving arena, new ones will undoubtedly arise before the ink is dry on this book. Then, in the next section, we set forth a decision framework to assist marketers in deciding for which of these stages, and with which applications, new-economy tools should become part of their strategies.

Internet Applications for Customer Insight  In Chapter 6, we discussed the role of marketing research in understanding customers and developing products—whether

Exhibit 12.6  A Customer Experience Model for New-Economy Marketing Decision Making

<table>
<thead>
<tr>
<th>Stage in customer experience process from marketer’s perspective</th>
<th>Direction of information flows</th>
<th>Direction of product flows (goods or services)</th>
<th>Direction of cash flows (revenue opportunities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer insight</td>
<td>P → C</td>
<td>P → C</td>
<td>P → C</td>
</tr>
<tr>
<td>Product promotion and brand building</td>
<td>P → C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transaction</td>
<td>P → C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product delivery</td>
<td>P → C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Customer support and service</td>
<td>P → C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product return or disposal</td>
<td>P → C</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

P = Producer
C = Customer
goods or services—to meet their needs. Marketers rely on a flow of information from customers or prospective customers about their wants and needs, however latent these may sometimes be, to generate the insight essential to the development of compelling new products (see Exhibit 12.6). How might the Internet facilitate this process?

Pollsters and other marketing researchers are increasingly turning to the Internet to conduct marketing research. Why? Just as Alessandro Mina saw the potential for “easier, faster, and cheaper” in Camera World, so too do researchers when they consider the Internet. For example, in years past, when Hewlett-Packard wanted to know what customers thought about its printers, it sent thousands of surveys through the mail, either on paper or on a computer diskette. It was a cumbersome process and “very expensive,” says H-P market analyst Anita Hughes. Now, H-P sends customers to a website to gather feedback. The new approach saves time and money and allows greater depth in the research—targeting specific respondents with instant follow-ups, for instance, or showing product prototypes online. “The possibilities are just huge,” says Hughes. H-P uses Greenfield Online, one of a growing number of firms that specialize in Web-based marketing research. In fact, some observers now view Internet-based quantitative research as the wave of the future, due to its cost-cutting, time-saving advantages over traditional telephone, mail, and mall-intercept surveys.

Nonetheless, using the Web for research is not without controversy. Traditional researchers debate the Web’s merits on a number of dimensions: in terms of representativeness of the current makeup of the Web audience, largely whiter, richer, younger, and more educated than the population as a whole; in terms of self-selection biases, where people volunteer to participate in Web-based polls; and in terms of the randomness, or lack thereof, of Web samples. But many of these problems are present in other forms of research, too, especially as more people refuse to answer mail or telephone surveys. Where random sampling is not an issue, such as for small-scale qualitative research such as focus groups, the Web may be particularly attractive. Greenfield Online recently ran an online focus group for Ford Motor Company in which 17 people who drive sport utility vehicles participated in three live chat sessions. Juli Caltrider, the Ford Expedition brand manager, followed the discussion from her own computer and occasionally interjected questions herself. Was the effort successful for Ford? “I got information faster, [and] I got additional depth in the information that I don’t believe I would have gotten otherwise,” Caltrider says. The downside was her inability to see facial expressions or read the participants’ body language. Using Web-based research, for both qualitative studies like Ford’s and for large-scale quantitative studies, is here to stay. The portion of total qualitative research done online could grow “to as high as 25 percent to 30 percent (of all money spent on qualitative research) in the future,” says Bill McElroy, president of the New York-based Internet Marketing Research Organization (IMRO). For demos of one provider’s online research tools, see Interactive Tracking Systems Inc.’s website at www.iTracks.com.

New-Economy Applications for Product Promotion and Brand Building

There are three broad approaches for using the Internet to promote one’s product or services, that is, to provide information about one’s product to the intended target market and build brand awareness and equity (see Exhibit 12.6). One is to engage in viral marketing, whereby consumers are encouraged to spread the word about a Web-based marketer. Another is to place promotional content—brochureware, as it is sometimes called—on one’s website and encourage customers to peruse it as they wish. A third approach is to place ads in various places on the Web.

Viral marketing was the way Hotmail.com, the largest free e-mail provider, won its success. It attached a message at the end of every e-mail sent by its users announcing its
availability as a free provider. The more users sent e-mail, the faster the word about Hotmail spread. Viral marketing is a low-cost and potentially powerful technique for building brand awareness.25

Placing brochureware about a company’s products, news development, and press releases, or about other things, on the Web is an easy and inexpensive first step toward a new-economy strategy. It provides answers to customer or prospective customer questions with global 24×7 access. It avoids looking technologically clueless: What company lacks a fax line or a website today? But it is not very proactive, and if a company doesn’t otherwise promote the website where the information is placed, either on Web portals, on search engines, or in offline media, no one will know it is there. “The Web cliché, ‘if you build it, they will come,’ has lulled many online marketers into a false sense of security,” says Charles Sayers, an Internet marketing consultant.26 Unfortunately, brochureware also helps your competitors keep up with what you are doing.

To help customers find their websites, companies can use businesses such as Search Engine Watch to find software applications that help them appear among the first links the search engines return. Intelliquis is another such company. It is also a good idea to create so-called hook pages or doorway pages. These pages offer information on specialized subjects that consumers are likely to search for. E*Trade, for example, offers a hook page with free online stock advice and links the page to its own home page.27 Another way to attract customers to one’s website is to put together affiliate deals, in which owners of other websites are paid—in flat fees or commissions on whatever the referred customers buy—to send customers your way. The largest portals, such as America Online and Yahoo!, earn a substantial portion of their revenues this way.

Internet (and, perhaps soon, mobile telephony) advertising is a more proactive strategy, but deciding whether and how to use it is not easy. A simple way to advertise on the Internet is to take advantage of the shift in power from marketers to consumers brought about by easy access to comparative information by making available information for comparison purposes. The Web-based luggage retailer eBags.com, for example, provides charts to make it easier for customers to compare different garment bags and other products to find the one that’s right for them. Automakers and other automotive sites provide similar comparative information to help consumers choose makes and models of cars that best suit their needs. Comparative sites are likely to turn up in virtually every product category over time, and having one’s goods or services included among those described by such sites will likely turn out to be increasingly important. Of course, if one’s goods or services do not pass competitive muster, being included on such sites can work the other way!

A more proactive advertising strategy is to place ads on the Web. In the early days, 4 percent to 5 percent of viewers of banner ads, the colorful strips of ad content splashed across the top of a Web page, would click on the banner to read the additional information that followed (see Exhibit 12.7). Today, as Web audiences widen beyond the early ’netheads who frequented the Web and such ads become more pervasive, the click-through rate has plummeted to 0.3 percent to 0.5 percent, according to Jupiter Research, far below
response rates for traditional direct mail, where about 2 percent of recipients respond.\(^{28}\) Once touted as a way to build brands on the Internet, whether for online or offline companies, there’s growing concern that banner ads may simply not work. By late 2001, amid an overall drop in ad spending across most media, online ad revenue had slid (see Exhibit 12.8) and the cost per thousand viewers for banner ads had dropped to about $10, about half the cost one year earlier.\(^{29}\) By the first half of 2001, banner ads accounted for just 36 percent of online ad spending, down from 53 percent in the fourth quarter of 1999.\(^{30}\)

Is advertising on the Internet dead? Probably not, as advertisers experiment with emerging formats for using this new medium (see Exhibit 12.8). Century 21, a real estate firm, has run humorous superstitials to promote its services that help homebuyers find new homes. Travelocity.com, the Internet travel agency, uses Internet ads for promoting specific travel offers. Consumer response is measured several times a day, and the message is changed if the ad isn’t boosting sales.\(^{31}\)

**Exhibit 12.8**

**The Online Pitch**

---

The Century 21 and Travelocity ads reflect trends toward more compelling and, in some cases, more measurable ad vehicles. New techniques include rich media (short ads with video and sound), cliffhangers (rich media ads that leave the viewers “hanging” and direct them to a website to view the end of the ad); superstitials (rich media ads that show up unexpectedly on a viewer’s screen); streaming audio (like a radio commercial); and vFlash (consumers can choose to place a vFlash icon on their screen from, say Blockbuster Video, which flashes when Blockbuster has an offer it wants to make. Clicking on a pop-up box then takes the viewer to the Blockbuster website, where the offer is presented.). All these techniques, and new ones sure to be developed, hope to take advantage of growing Web penetration to reach consumers in new ways. If these approaches are not made more measurable, however, some observers say that big ad dollars are unlikely to flow their way.

There are several ways to use Internet advertising in a measurable manner. One way is to use opt-in e-mail, where consumers allow companies they are interested in to send them e-mail with new promotions. According to Seth Godin, such permission marketing (as opposed to interruption marketing, as Godin calls the current methods) offers the potential for companies to create trust, build long-term relationships with customers, and greatly improve their chances for making a sale. By 2001, the average number of permission-based e-mails received by Internet users had increased to 36 per week, double the prior year figure. For an example of how Harrah’s, the resort casino operator, used e-mail marketing to fill its hotel rooms after the September 11, 2001, attacks on New York and Washington, see Exhibit 12.9.

Another way to make Web advertising more measurable is to have advertisers pay for performance, rather than for placement, regardless of the type of ad employed. The advertiser might pay for click-throughs, for leads generated, even commissions for actual orders placed. Doing so, however, would require that extensive traffic data that follow a customer’s click-stream be captured and analyzed. Jeff Forslund’s job is to do just that for credit-card issuer NextCard, a major Web advertiser. For example, Forslund knows that a particular banner ad that appeared on Yahoo! on August 25, 2000, attracted 1,915 visits, 104 credit-card applications, and 22 approvals. He also knows that those 22 new customers transferred preexisting credit-card balances averaging $1,729 each. With such data in hand, NextCard can determine the value of that banner ad and negotiate how much and on what basis—placement or performance—it is willing to pay Yahoo! to place another similar ad. Dan Springer, NextCard’s chief marketing officer, believes that the Internet is better suited to getting measurable results than for branding efforts. He says current results indicate, however, that today’s Web ad prices are too high.

In the wake of the September 11, 2001, attack on America, Harrah’s Entertainment Inc. felt an immediate 25 percent downturn in its business in Las Vegas. Few people were in the mood to party, and fewer wanted to fly. By having already linked its 24 million-strong customer database with its website and e-mail marketing system, Harrah’s was well positioned to counterattack. It targeted e-mails to customers it thought might want to take a trip to its tables and slot machines and, by the end of September, the hotel was back near 100 percent occupancy, filling almost 4,000 rooms that would otherwise have gone empty.

Additional factors, besides the high price for placing Web ads and the current lack of measurement capability for many of them are holding back development of the Web as a successful advertising medium. Two are privacy and security concerns, as mentioned earlier in this chapter. Consumer rights advocates are not certain that consumers want Jeff Forslund and others like him to have the click-stream data he needs to measure ad performance. What if someone’s click-stream as he or she explores data about AIDS is gathered? Could such data be misused? Another deterrent is the glacial pace at which more interesting video and audio ads can download, given today’s 56K modems. Many people won’t wait for such ads to load. As faster broadband connections become more common, this problem will fade, but it’s hard to tell just how quickly broadband will penetrate the market.

While Internet advertising now seems almost “old hat,” advertising on mobile phones is about to emerge as a significant new vehicle for promotion, especially in Europe and Japan, where mobile phone usage and technological development are far ahead of the United States. As DoCoMo’s iMode and other high-speed mobile phone technologies penetrate various markets, the installed base of web-enabled mobile phones will grow large enough that ads will begin to make sense. The issues surrounding the use and effectiveness of this medium will parallel those for the Internet, and the pace at which applications become user-friendly enough to be valued by customers will determine how quickly this medium develops. In Europe and Japan, and subsequently elsewhere, these developments bear watching.

**New-Economy Applications for Conducting Transactions** If promotional activities do their jobs, the hoped-for consequence is that some customers will decide to buy. Can the Internet or mobile telephony help transactions occur? Several Web-based companies are in the business of enabling client websites to handle transactions. Making the transition to a transaction-capable website was among the first tasks Camera World’s new owners had to do after they bought the business. BroadVision Inc. (broadvision.com), for example, offers a wide range of software products that enable clients to conduct B2B or B2C commerce on their websites or via kiosks or mobile telephones. Such products from BroadVision and others typically provide back-end systems and inventory control, prepare warehouse and ship documents, and bill the customer for the sale. Some such systems now allow companies to engage in **dynamic pricing**, a controversial system that gauges a customer’s desire to buy, measures his means, and sets the price accordingly. In this respect, target markets of one are now here, to the chagrin of some consumers!

Recent legislation in the United States has cleared the way for the use of **digital signatures** over the Web, and other countries may soon follow. Such digital authentication will pave the way for more efficient sale of insurance, mortgages, and other goods and services via the Web or mobile telephones. Imagine removing your car from your collision insurance policy when it’s parked in the driveway for an extended period, and reinstating coverage with the click of a mouse. It also will lower the costs companies incur due to Internet fraud, which has been common, and thereby save consumers money. Brooks Fisher of Intuit Inc., a provider of a wide range of online financial services, says, “Less fraud means better pricing.”

More broadly, the Internet and wireless telephony are quickly removing constraints that limit sellers in terms of what they sell and how they sell it. Banks are moving all the transactions they can onto the Web, where a typical banking transaction costs just two cents, compared with 36 cents for an ATM transaction and $1.15 for a teller-assisted transaction. In Scandinavia, 700,000 Finns use Sonera, the leading Finnish wireless carrier, to
do everything from ordering chocolates from the back seat of a taxicab to getting a date. The 1999 mobile commerce and information revenues of Zed, a Finnish Internet site serving mobile phone users, totaled $126 million—in a country one-fourtieth the size of the United States.\textsuperscript{39} Elsewhere, the Internet now offers buyers and sellers choices ranging from fixed-price online catalogs, to customer-tailored catalogs, to auctions, to negotiated prices, to Priceline.com’s demand collection system, to barter and more.\textsuperscript{40}

By enabling virtually frictionless movement among ways of doing business, these so-called all-in-one markets benefit both buyers and sellers. The trend toward multiple ways of transacting business on the Web runs counter to the conventional wisdom about e-commerce. Many observers had predicted that easy access to pricing information on the Internet would push all transactions toward a single mechanism—wide-open price competition in which the lowest-priced offer wins the order. For some commodity-like products that are easily compared—several Web shopping bots can tell a customer who has the lowest price on the latest Tom Clancy novel, for example—this may yet turn out to be the case. So far, however, this prediction has not come to pass.

**New-Economy Applications for Delivering Digital Products** Many companies probably don’t give much thought to it, but an increasing array of goods and services can be digitized and thereby delivered to customers via any digital medium, including the Internet, satellites, and digital telephones. Fifty years ago, the then-current technological miracle was the analog delivery of sounds and images to consumers via the newfangled invention called television. Today, as we have seen earlier in this chapter, books, music, and more can be delivered digitally any time, at any digitally connected place. In 2, 5, or 10 years, what else will be digitally deliverable? Psychotherapy, with or without a live therapist, and legal advice are now available online from numerous providers.\textsuperscript{41} Online postage is available at several websites, including that of the United States Postal Service. Unfortunately for their investors, e-postage pioneers Stamps.com and E-stamp.com squandered millions in start-up capital to pursue this market, with little so far to show for their efforts.\textsuperscript{42} One new company is even rumored to be developing technology for delivering scents online. Who knows what’s next? Beam me up, Scotty!\textsuperscript{43}

**New-Economy Applications for Customer Service and Support** An increasingly important application on the Internet is for various sorts of customer service, replacing more costly—and sometimes more inconsistent and error prone—human support. Companies from Dell to the Denver Zoo use the Web to provide answers to frequently asked questions, from technical ones in Dell’s case to how to arrange a children’s birthday party at the zoo. Savvy marketers know that, for all the hoopla about acquiring new customers, the real driver of the bottom line is the ability to profitably retain existing ones and that effective, responsive customer service is a key ingredient in doing so. They also know that customer retention is a competitive necessity. In nearly every industry, some company will soon figure out new ways to exploit the potential of the Internet to create value for customers. Without the ability to retain those customers, however, even the best-conceived business model on the Web will collapse.\textsuperscript{44}

There are numerous examples of how Web-based customer service programs are providing customers with better service at lower costs, surely a win–win proposition. Michael Climo, purchasing director for e-tailer SmartHome.com, was seeking a supplier to provide fast delivery of its shipments to customers. United Parcel Service won the business not only by delivering SmartHome’s parcels quickly, but also by cutting SmartHome’s customer service costs while improving service. UPS helped redesign the SmartHome website so customers could track their shipments with a click of a mouse. SmartHome’s call center now gets virtually no calls to check order status, down from 60 per day before the
change, freeing its staff to make more sales calls. The Web-smart capabilities of UPS have made it the clear leader in delivering the $40 billion in merchandise bought online in 2000, with an estimated 55 percent of the business, compared to 10 percent for FedEx. Attracting and retaining its business customers is what the UPS Web-based services are all about.

Benefits of an array of Web-based customer service applications are available to old- and new-economy companies alike, in both B2B and B2C contexts. Tracking shipments or answering other frequently asked questions is but one application. Building communities among users—using bulletin boards, chat rooms, or other e-techniques—is another one that can build customer loyalty and provide an important source of feedback on new product ideas, product problems, and other issues. Tom Lowe, founder of Playing Mantis, a maker of die-cast cars, plastic model kits, and action figures, credits his company’s Web-based bulletin boards for feeding customer relationships that would be the envy of any company. As one customer posted to one of the Playing Mantis boards, “Polar Lights is very special to me. . . . You’ve rekindled the joy I once felt when buying these kits. . . . You’re the ONLY company I feel a part of.”

The growing number of Web-based customer service applications offers the tantalizing combination of better service and significant cost savings. The trick is to focus on the customer service benefits first, rather than mere cost cutting. Customers are quick to discern when cost cutting takes precedence over genuine service responsiveness. Does anyone like the way call center software has changed the way consumers obtain phone numbers from directory assistance, or the fact that some banks won’t provide bank-by-mail envelopes to those who prefer to do their banking the old-fashioned way?

One myth some companies have bought into is that the Internet is a self-service medium. They assume that they can let customers do all the work, but most customers really don’t want to do more. One solution is coproduction, in which companies carefully consider which burdens they can remove from the customer, using new-economy technologies, and which customers can perform, assessing costs and benefits to both parties. Doing so can provide insights into new ways to serve customers better, as Charles Schwab now does when it e-mails customers to alert them to big moves in their stocks.

New-Economy Applications for Product Return and Disposal Customers’ experiences with goods and some services do not end until the products are consumed, returned, or disposed of. Some companies have found ways to use new-economy technologies to facilitate these processes. Dell, for example, provides an Internet space where Dell customers can sell their old computers when they upgrade to a new one. Both old- and new-economy companies can avail themselves of similar applications. In retailing, many retailers with both online and offline stores accept returns at any location. Concerns related to returning online purchases (the inability to see and touch the goods before purchase and the inability to return goods easily) rank second and third on the list of factors that deter consumers from shopping online (see Exhibit 12.10).

Developing New-Economy Marketing Strategies: The Critical Questions

Knowing what marketing arrows are available in one’s new-economy quiver is one thing. Deciding which of these applications will deliver the most bang for the buck is quite another. Our flow model of the customer experience process (see Exhibit 12.6) facilitates such decision making by raising six important questions that should be asked about whether to employ new-economy tools at any or all stages of the process. These
diagnostic questions are shown in Exhibit 12.11. We address each of these questions in this section.

**Can We Digitize Any or All of the Necessary Flows at Each Stage in the Consumer Experience Process?** At the heart of the new economy is the reliance on digital means of transmitting information, some of which is recomposed into goods—CDs, books, and more. In considering whether to employ new-economy technologies at any stage of the consumer experience process, a company should ask whether any of the flows—information, goods or services, or cash—can be digitized.

For cash, the answer is an automatic yes, via credit cards or other forms of electronic payment, except where currency issues pose problems, such as in some international settings. And new forms of electronic payment will soon enhance the security of cash flows over the Web.

For goods and services, the question is more difficult. Text, audio, and visual images (moving or still) can be digitized, as can books, music, photos, and, given enough bandwidth, movies and other videos. But at present, most tangible goods and many services cannot easily be transmitted digitally. For others, however, such as legal advice, therapy
for mental health patients, and other goods or services that can adequately be represented in words, sounds, or images, the possibilities are endless. Will technology soon make possible the digital transmission of physical goods? Who knows? When it happens, the many sci-fi buffs around the world will not be surprised!

For information, text, audio, and images can be digitized. But what about the soft hand of a cashmere sweater? The heft and balance of a carpenter’s hammer? The taste of fine European chocolate? The fragrance of a new cologne? Today, these important informational attributes of goods cannot be readily digitized. Tomorrow? Time will tell.

When any of the flows at any stage of the consumer experience process can, given sufficient information and ingenuity, be digitized, the remaining questions in Exhibit 12.11 should then be considered to decide whether or not new-economy applications for a particular flow should be implemented.

**Exhibit 12.11**

**Diagnostic Questions for New-Economy Marketing Decisions**

- Can we digitize this stage or flow?
- Can we do so first, and/or be proprietary?
- How valuable and time-critical is what kind of information?
- Can we reach and build relationships with our target market?
- Measurably effective?
- Measurably efficient?

**Can We Do So First, and/or in a Proprietary Way**

As we have seen, barriers to entry on the Web are low, and most good ideas can be quickly imitated. A key question in deciding whether or not to employ a new-economy application is whether one can do so in a proprietary way, thereby deterring imitation, or do so with a sufficient head start so that competitive advantage can be established before others follow. Amazon.com was early in the Internet retailing game and enjoyed a helpful head start. E-tailers of pet supplies, however, were not so fortunate, as half a dozen venture-capital-backed online pet stores battled for survival in 2000. Without anything proprietary, and without a head start, most of these companies will likely fail and fail early, as some already have.
For old-economy companies, using the Internet for applications that do not reinvent the heart of the business as Camera World’s new owners decided to do—for brochureware or customer service, for example—speed to market may or may not be critical, depending on how quickly others in their industry are likely to move into similar applications. As always, competitor intelligence, some of which can be gleaned from competitors’ websites, is essential.

**How Valuable and How Time-Critical Are What Kinds of Information to the Recipient?** For the informational flows in Exhibit 12.6, a key question in making resource deployments is the importance of various kinds of information to the recipient, either the company or the customer, depending on the direction of the flow. The more valuable and time-critical the information, the more sensible it may be to invest in new-economy applications to provide easy, timely, and 24×7 access to those who can benefit from the information. Wal-Mart, arguably an old-economy company that has long been an industry leader in its use of information technology, now posts on the Web password-protected, up-to-the-minute, store-by-store, SKU-by-SKU sales information that its key suppliers can access, thereby enabling them to better ensure that Wal-Mart’s stores remain in stock on their merchandise.

**Can New-Economy Tools Reach and Build Relationships with Customers in the Target Market?** Making information, goods, or services available on the Web is of little use if the people to whom those flows are directed lack Web access. As we have seen, some demographic groups are underrepresented on the Internet. Web-based services targeted at senior citizens may have difficulty, given the current paucity of seniors who have easy Web access, though the number of seniors on the Web is now growing rapidly. Similarly, people and businesses in the third world are also underrepresented. New-economy applications that make the most business sense will be those targeting groups for whom use of the Web is relatively widespread.

Simply reaching customers with new-economy tools may not be enough, however, especially for marketers of commodity-like products. Going beyond reach to build mutually beneficial relationships may be what is needed. Amazon.com has begun to build loyal relationships with its growing customer base by focusing its efforts on exceptional customer service. While book lovers often can find books for lower prices elsewhere on the Web, many of them simply return to Amazon’s site, with its easy 1-Click® ordering, customer reviews, and other customer-friendly features. Using new-economy tools for building customer relationships may be their most important application in the long run.

**Are New-Economy Tools Measurably Effective and Efficient Compared to Other Solutions?** Ultimately, given favorable answers to the first four questions in this section, deciding to invest in a particular new-economy marketing strategy or application comes down to two final questions. Is the new-economy solution effective, and is it more efficient than other solutions? As we have seen, UPS was able to sell SmartHome on its shipping because it was not only effective in getting SmartHome’s parcels to their destinations on time, but also because SmartHome was able to improve on and save money on customer service at the same time. Another example of using the Web for effectiveness and efficiency gains is the new Kinko’s Internet order-taking system, Print to Kinko’s. Customers can upload digital versions of documents to kinkos.com and have them delivered on paper at any Kinko’s location within a few hours. Kinko’s hopes the new system will capture some of the large market for corporate printing, thereby boosting sales, while enhancing productivity by reducing the error rate on printing orders from 10 percent to 1 percent, by cutting order handling costs, and by keeping Kinko’s’ copiers humming. Other
dot-com printing players, such as iPrint and mimeo.com, were first to market, but Kinko’s has the brand name and more than 1,000 stores. Will the digital strategy accelerate Kinko’s growth and increase earnings? CEO Joseph Hardin likes its potential. “We may be late to the market,” he says, “but at the end of the day, he who executes wins.”

Marketers’ concerns over the effectiveness and efficiency of their websites have led to the development of web analytics, software solutions that monitor and summarize website usage patterns. Web analytics is the equivalent of having a team of marketing researchers follow customers through a bricks-and-mortar retail store. The technology can uncover a variety of problems that can plague websites: cumbersome navigation, content that can’t be easily found, underperforming search engine strategies, and unprofitable online marketing partnerships. The results of these analyses can improve customer satisfaction and response to the website, strengthen the marketer’s hand in negotiating terms of partnership deals, and even identify new market segments that might be best served with tailored sites. “We’re looking at the (Web analytics) every day, just like the guys on Wall Street look at daily stock quotes,” says Jonathan Kapplow, corporate Internet marketing manager at Hanover Direct, a catalog and Web retailer of gifts and apparel.

In the final analysis, setting clear SMART objectives that new-economy tools or activities are intended to meet—specific, measurable, attainable, relevant, timebound—and running cost–benefit analyses to assess their likely performance are necessary for making go/no-go decisions and for prioritizing which initiatives should be pursued first. Fortunately, the inherent measurability of many new-economy tools often provides clear and compelling feedback on whether they are meeting the objectives. In addition, attention must be given to a variety of business process issues that can get in the way of effective execution of even the best intentions for a new-economy strategy in an old-economy company. Recent research by Rosabeth Moss Kanter identified 10 common mistakes such companies commonly make (see Exhibit 12.12). Avoiding these errors is easier said than done, of course, but web analytics can help catch any errors that are made.

Developing Strategies to Serve New-Economy Markets

This chapter has, for the most part, addressed how companies of any kind, size, industry, or age can use new-economy tools and technologies for marketing purposes. No doubt, however, there are readers who see bigger fish to fry in the new-economy skillet. They see the new economy as offering the prospect for starting an entrepreneurial venture, in a new firm or within an existing one, to serve a market created by the advent of the Internet, wireless telephony, or other new or still-emerging technologies. Thus, in this final section, we address some lessons learned from the dot-com crash of 2000, we provide a framework for thinking about where and how revenues might be generated in the new-economy marketspace, and we examine what it is likely to take to create enduring success in the new-economy ventures of tomorrow.

What Lessons Can We Learn from the Dot-com Crash?

In April 2000 and the months that followed, the dot-com party ended. Many ventures with lofty market capitalizations stumbled and fell, in some cases losing more than 90 percent of their value by the end of 2000. Others shut their doors or were acquired, often on unfavorable terms. Venture capitalists slammed the funding window shut in some categories,
such as e-tailing and e-hubs. With their coffers laden with money to invest, their focus moved to other more promising—or so they hoped—sectors. What went wrong?

In a lengthy cover story in October 2000, *Fortune* magazine identified a dozen lessons to be learned from the dot-com crash. The 12 lessons, shown in Exhibit 12.13, indicate collectively that many fundamental strategic marketing principles were ignored in the mad rush to what looked to be dot-com nirvana. Markets and market segments were not clearly identified and targeted. Low barriers to entry that made industries unattractive were ignored. First-to-market mania ruled, and the ability to sustain competitive advantage by offering better goods and services and better value often was overlooked. (Web latecomers such as Kinko’s now appear to have an edge over their upstart net printing rivals.) The basic economics of some businesses were ignored. (It can

---

**Exhibit 12.12**

**THE 10 DEADLY MISTAKES OF WANNA-DOTS**

1. Sprinkle Internet responsibilities throughout the company—a little Web site here, a little brochure-ware there. Let them all go forward, as long as they stay small and innocuous. If any look like they have potential, raise skeptical questions at executive meetings and repeat frequently that the Internet is overhyped.

2. Form a committee to create a new corporate Internet offering, staff it with people from unrelated areas who are already doing five other things, and don’t release them from their regular jobs. Give the leadership role to a bored executive as a reward for his years of loyal service. (Never mind that he has no Internet experience; he surfs the Web, doesn’t he?)

3. Find the simplest, least-demanding thing you can do on the Web. Go for copyware that looks like what everyone else is doing. Instead of a killer app, create a “yawner app.” (That will save time and money. And that way, you can cross the Internet off your to-do list quickly.)

4. To build the site, choose the vendors that are the most dismissive of your traditional business (they think you’re dinosaurs) but whose abilities you’re least capable of assessing. Then hand over the technical work to them (that way, nobody inside has to learn anything new) but refuse to take their advice about how the site should look (after all, you’re the industry experts). Use more than one vendor—so you can have the fun of watching them slug it out.

5. Make sure what you do on the Web is exactly the same as what you do off-line: duplicate your traditional business assumptions on-line. (After all, the Internet is just a tool, isn’t it?)

6. Insist that an Internet venture meet every corporate standard: cost controls, quarterly earnings, recruitment sources, compensation policies, purchasing procedures. Allocate just enough resources to keep it alive but not enough to risk its becoming an innovator—because that would require more investment.

7. Under the banner of decentralization and business unit autonomy, reward each unit for its own performance, and offer no extra incentives to cooperate in cyberspace. (Maintain your belief that conflict is a healthy spur to higher performance; let the victor get the spoils.) Keep reminding divisions that they are separate businesses because they are different, and that’s that.

8. Compare your performance with your traditional industry competitors in the physical world. (That way you will always have someone to whom you can feel superior.) Dismiss on-line competitors as ephemeral fads. And don’t even consider whether companies from unrelated industries could steal across the borders and poach your customers by using the Net. (Why worry about the hypothetical?)

9. Celebrate your conversion to e-business by giving people in the rest of the organization tools they are unable to use, requiring changes they are confused about making. Tell people this will help them do their work better. Schedule training classes at a distant location. Watch as the new tools take too much time and make it harder to get work done; then punish people for their resistance to make change.

10. And, last but not least, never forget that the company, not the customer, is in the driver’s seat. The Internet is an opportunity for us to communicate with them.

cost more to ship a bag of pet food than consumers typically pay for it. Acquiring (at reasonable cost) and retaining satisfied customers matter. Profitability and positive cash flow matter (sooner rather than later revenues should exceed expenses, including marketing expenses). Despite the carnage, however, *Fortune* concludes that, while the dot-com era is over, the Internet era is just getting started.

What Are the Key Success Factors in Serving the Dot-com Markets of Tomorrow?

What might tomorrow’s entrepreneurs do to craft marketing strategies to serve these still enticing new-economy markets? For one, would-be Internet entrepreneurs should consider the various ways in which revenue can be generated on the Web or in other new-economy settings. Unless someone, a business or a consumer, is willing to fork over money for what a new business offers, its chances for success lie somewhere between slim and none. Exhibit 12.14 shows a number of ways in which revenue can be generated by Web-based businesses—from commerce, by selling content, by organizing communities, or from building the new-economy infrastructure. Understanding one’s business model and being willing to change it as market and technological conditions warrant are essential.
Second, such entrepreneurs must ask not, What can I sell? but What do new-economy customers and markets need, whether through business-to-business (Grainger.com), business-to-consumer (Amazon.com or LandsEnd.com), consumer-to-consumer (eBay.com), or consumer-to-business (Priceline.com) business models, that my new company can provide better, easier, faster, or cheaper using new-economy tools and technologies? If a particular business idea does not fill some real, though perhaps currently latent, need identified by this question, there is no viable business.

Third, would-be entrepreneurs must now realize that barriers to entry are incredibly low in the new economy. For everyone who has the next latest and greatest Web-based idea, there are dozens of other prospective entrepreneurs likely to be exploring similar ideas concurrently. It’s not really the ideas that count. As Bob Zider, president of the Beta Group, a Silicon Valley firm that develops and commercializes new technology, says,
“Many entrepreneurs make the mistake of thinking that venture capitalists are looking for good ideas when, in fact, they are looking for good managers in good industry segments.”57 What matters is the team that will execute an idea to deliver the performance and value that customers, whether businesses or consumers, want and will pay for. Only then will investors make money. Thus, execution is key, a truism we explore in greater depth in Chapters 13 and 14. As Intel’s Andy Grove says about building the next wave of (it is hoped successful) Internet businesses, “It’s work. Very unglamorous work . . . The heavy lifting is still ahead of us.”58 Much of this work is of the kind set forth in the first 12 chapters of this book: understanding customers and the markets they comprise; understanding industries and the competitors that do daily battle in them; and developing strategic marketing programs that can establish and maintain sustainable competitive advantage.

But there’s also the work of strategy execution. In this chapter, we’ve explored the new economy and how both existing and new firms can find ways—measured in terms of effectiveness and efficiency—to take advantage of the promise it offers. In the two chapters that remain, we examine how best to organize for the effective implementation of, and control the results generated by, marketing strategies. “Give me ‘A’ execution of a ‘B’ plan over ‘B’ execution of an ‘A’ plan” is a common refrain heard from venture capitalists and other investors. Planning is important. But effective execution delivers the results, and results are what count.

**Take Aways**

- Seven potentially attractive elements characterize many new-economy technologies: the syndication of information, the increasing returns to scale of network products, the ability to efficiently personalize and customize market offerings, the ability to disintermediate distribution, global reach, 24×7 access, and the possibility of instantaneous delivery.
- First-mover advantage is simply wrong. Best beats first.
- Most observers now believe that the Internet is better suited for delivering measurable marketing results—as is direct marketing—than for brand building.
- Web-based customer service applications offer the tantalizing combination of better service and significant cost savings. The trick, of course, is to focus on the customer service benefits first, rather than mere cost cutting, since customers are quick to discern when cost cutting takes precedence over genuine service responsiveness.
- Keys to success in tomorrow’s new-economy ventures include clearly understanding one’s business model (Exactly where will revenue come from: commerce, content, community, or infrastructure?), filling real (though perhaps latent) customer needs, and putting together the right management team that can deliver the performance and value that customers want and will pay for. Only then will investors make money.
- Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at [www.mhhe.com/walker](http://www.mhhe.com/walker).

**Endnotes**

Chapter Twelve  Marketing Strategies for the New Economy

17. Ibid., p. 48.
18. Ibid., p. 49.
21. For a broader look at Internet marketing, see Ward Hanson, Principles of Internet Marketing (Cincinnati: South-Western College Publishing, 2000).
27. Ibid.
35. Ibid.
43. From the science fiction movie Star Trek, in which it was routine to digitally transmit objects, including people, from place to place.
49. Haddad, “Big Brown’s Coup.”
52. Warner, “Fallen Idols.”
54. Warner, “Fallen Idols.”
55. Weintraub, “Late to the Party.”
56. Ibid.
58. Useem, “What Have We Learned?”
Controls Pay for Wal-Mart

Wal-Mart is a discount general merchandise retailer with sales of over $165 billion and net income of over $5.5 billion in fiscal 1999. Founded less than 40 years ago, it is America's largest, most-profitable, and one of its most-admired companies. Over the past decade it has continuously ranked as one of the best companies in its return on stockholders' equity.

As of November 2000, the company operated over 4,000 stores, of which more than 1,000 were outside the United States (in Mexico, Canada, Europe, and Asia). Of these stores, 866 were supercenters (a combination supermarket and general merchandise store) and 469 were Sam's Clubs. Management had an aggressive plan for store growth in fiscal 2000—40 Wal-Mart stores, 170 to 180 supercenters, and 40 to 50 Sam's Clubs. Internationally, the plan calls for 100 to 110 new stores. Wal-Mart stores serve more than 100 million customers per week, and the company employs more than 1 million people.

A major reason for Wal-Mart's success is its ability to control costs. In 1999 it was able to hold its operating, selling, and general administrative costs to 16.4 percent of sales. This was substantially below that of its closest competitor, Kmart, and explains, in part, the company's excellent profitability record.

In the 1960s when he had only 10 stores, Sam Walton realized he couldn't expand successfully unless he could capture the information needed to control his operations. He became, according to one competitor, the best utilization of control information in the industry. By the late 1970s Wal-Mart was using a storewide computer-driven information system that linked stores, distribution centers, and suppliers. Kmart started using a similar system only in the early 1990s.

In the late 1980s Sam Walton tapped David Glass to take over as CEO. Now the company's chairman, Glass, more than anyone, successfully engineered the development of Wal-Mart's advanced distribution and merchandise-tracking system, which were needed to handle the enormous sales increases as the company's stores spread throughout the United States. “Wal-Mart's incomparable systems are a secret of its success—the unadvertised contributor to the stock's 46.8 percent average annual return during the decade before Sam's death.”

Today, the company can convert information into action almost immediately. To do so required a massive investment (over $700 million) in computer and satellite systems, which collectively generate the largest civilian database of its kind in the world. In addition to automated replenishment, the system provides up-to-the-minute sales.
of any item by region, district, and store. By looking at the computer screens in the satellite room, a manager can see systemwide data of the day’s sales as they happen, the number of stolen bank cards retrieved that day, whether the seven-second credit card approval system is working properly, and the number of customer transactions completed that day.

Wal-Mart’s philosophy has always been that its executives should spend part of their time in the field visiting with associates (employees) and customers. Thus, they board the company’s prop planes in Bentonville on Monday each week, returning to share their findings with headquarters personnel and to prepare for a series of merchandise meetings Friday and Saturday. These are no-holds-barred sessions concerned with moving merchandise. For example, in one meeting it was suggested that Wal-Mart was missing a great business opportunity in street-hockey gear because of the in-line skate craze. Others agreed, and within a few minutes appropriate action had been taken, including the development of an eight-foot-long display section. This was, and similar decisions will be, communicated to all store managers by the following morning at the latest using Wal-Mart’s computer-driven communications system.

By merging state-of-the-art computer communications technology with hands-on management, Wal-Mart has developed a distribution system to the point stores should never be out of stock. Doing this better than its rivals has resulted in substantially more sales per square foot than competitors and, hence, a faster stock turn. This means less borrowing to carry fewer inventories and hence lower interest payments—several hundred million dollars lower than its nearest competitor. And lost sales because of stockouts are minimized.

### Strategic Challenges Addressed in Chapter 14

In Chapter 13, we said that planning is important, and that effective implementation is crucial. The Wal-Mart example demonstrates how effective planning and implementation can play out in the performance of a company. Together, these two activities constitute the heart of most business endeavors. In the end, however, it is neither planning nor implementation that really counts. Results are what counts. Results are what managers and entrepreneurs are paid to deliver. Results are what attract investment capital to permit a company—whether a large public company such as Wal-Mart or an emerging dot-com start-up—to grow. Just watch what happens to a public company’s stock price when the results are not what Wall Street expects. The share price plummets and, sometimes, heads roll. Weak sales and profit performance at Gap Inc. in late 1999 and 2000 cut Gap’s stock price by half and led to a series of middle and upper management changes at the once high-flying retailer. The focus on results is not restricted to for-profit organizations either. Exhibit 14.1 shows how some nonprofit organizations are measuring their success and winning increased funding from donors as a result.

In Chapter 14, we address several critical questions that provide the link between a company’s efforts to plan and implement marketing strategies and the actual results that those strategies produce. How can we design strategic control systems to make sure the strategies we are pursuing remain in sync with the changing market and competitive environment in which we operate? How can we design systems of marketing metrics to ensure that the marketing results we plan for are the results we deliver? In other words, if the ship
gets off course during the journey, either strategically or in terms of execution of the marketing strategy, how can we make sure that we know quickly of the deviation so that mid-course corrections can be made in a timely manner? In today’s rapidly changing markets, even the best-laid plans are likely to require changes as their implementation unfolds.

We begin by developing a five-step process for evaluating and controlling marketing performance on a continuous basis. We then apply the process to the issue of strategic control: How can we monitor and evaluate our overall marketing strategy to ensure that it remains viable in the face of changing market and competitive realities? Next, we apply the process to tracking the performance of a particular product-market entry and to the marketing actions taken to implement its marketing plan, or marketing performance measurement. Are we meeting sales targets, in the aggregate and for various products and market segments? Is each element of the marketing mix doing its job: Which items in the product line are selling best, are the ads producing enough sales leads, is the salesforce generating enough new accounts, and so on? Finally, we show how marketing audits can be used periodically to link the control process—for both strategic control and for measuring current marketing performance—with marketing planning.

Designing Control Systems Step by Step

As the Wal-Mart example demonstrates, a well-functioning control and reappraisal system is critical to the success of a business. To be successful, it should be well integrated with the other steps in the marketing management process: setting objectives, formulating strategies, and implementing a plan of action. The control system monitors the extent to which the firm is achieving its objectives. When it is not, the firm determines whether the
reason lies in the environment, the strategies employed, the action plans, the way the plans were being implemented, or some combination thereof. Thus, the control and reappraisal step is diagnostic, serving to start the marketing management process anew.

Control processes differ at each organization level. Thus, in a large diversified company, corporate management is concerned with how well its various SBUs are performing relative to the opportunities and threats each faces and the resources given them. Control here would be strategic. At the SBU level, or in smaller companies, concern is primarily with the unit’s own strategy, especially as it pertains to its individual product-market entries. We will concentrate mainly on this latter organizational level since it constitutes the bulk of any control system.

Regardless of the organization level involved, the control process is essentially the same. It consists of five steps: setting performance standards, specifying feedback, obtaining data, evaluating it, and taking corrective action (see Exhibit 14.2). Although the staff organization is typically responsible for generating the control data, the line organization administers the control process. Certainly, this is the case with Wal-Mart, as seen in the involvement of regional vice president, district managers, store managers, and department heads in obtaining and processing control data as well as taking corrective action. More importantly, line managers need to be closely involved with the development of the control system, so that they can be assured of getting the performance data they need, on a timely basis, and in a format they can easily use to support their long-term and day-to-day decision making.

### Setting Standards of Performance

These standards derive largely from the objectives and strategies set forth at the SBU and individual product-market entry level. They generate a series of performance expectations for profitability (return on equity or return on assets managed), market share, and sales. At the product-market level, standards of performance also include sales and market-share
determinants such as percent effective distribution, relative shelf-facings, awareness, consumers’ attitude change toward a given product attribute, customer satisfaction, and the extent of price parity.

Similarly, for every line item in a marketing budget—product development costs, advertising and promotional expenses, costs for salespeople, and so on—specific and measurable standards of performance must be set so that each of these elements of marketing performance can be evaluated. We address the development of these standards later in this chapter. Without a reasonable set of performance standards, managers cannot know what results are being obtained, the extent to which they are satisfactory, or why they are or are not satisfactory. Performance-based control measures are often tied to the compensation of those individuals responsible for attaining the specified goals. Such a system can cause actions to be taken that in the short term may help attain the desired goals but in the longer term may be detrimental to the firm (see Exhibit 14.3).

Recent years have witnessed a shift from using primarily financially based performance measures to treating them as simply part of a broader array of measures. While the use of nonfinancial measures is not new, giving them equal or greater status is. Thus, more and more companies are turning to measures they feel better reflect how their managers think about what decision areas drive the firm’s success, such as customer satisfaction, product quality, market share, and new product development. If the firm has set enhanced shareholder value as its ultimate objective, then it needs to change from the traditional ROI concept to one using a valuation model that focuses on the future cash flow trend, which is discounted at an appropriate discount rate adjusted for risk.

The increasing use of cross-functional teams empowered to manage such processes as order fulfillment, major accounts, and new product introductions has required the development of a new set of imaginative control measures. In a similar vein, Robert Simmons believes that more managers are facing the problem of how to exercise control in organizational settings that require flexibility, innovation, and creativity. Employees are being asked to use initiative in servicing customer needs and seizing opportunities, and yet, in so doing, they may expose the company to substantial risk.

To be of any value, performance standards must be measurable; further, they must be tied to specific time periods, particularly when they concern a management compensation system. The SMART acronym (specific, measurable, attainable, relevant, and timebound),

<table>
<thead>
<tr>
<th>Strategic Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>For every line item in a marketing budget—product development costs, advertising and promotional expenses, costs for salespeople, and so on—specific and measurable standards of performance must be set so that each of these elements of marketing performance can be evaluated.</td>
</tr>
</tbody>
</table>

Exhibit 14.3 Blind Ambition at Bausch & Lomb

Bausch & Lomb, a large international firm known for its Ray-Ban sunglasses, contact lenses, and a wide array of eyewear products, has experienced serious financial problems. The emphasis on achieving double-digit annual profit growth caused managers to use short-term tactics that in the longer term would wound the company seriously. Favorite tactics were to give customers unusually long payment terms and threaten to fire distributors unless they took on large quantities of unwanted merchandise. They also shipped goods before they were ordered and booked them as sales.

According to some executives, division heads might receive a small bonus even if they fell 10 percent short of yearly earning targets, while an overage was handsomely rewarded. A small weight was assigned to such assets as receivables and inventories, but apparently one could miss the assigned asset objectives substantially and still get a big bonus. Customer satisfaction was given a small importance rating.

to which we have referred when discussing the setting of objectives in earlier chapters, is a useful framework for setting performance standards. Generally, control systems at the product-market level operate on a monthly, quarterly, and annual basis, with the monthly and quarterly data cumulated to present a current picture and to facilitate comparisons with prior years. In recent years, the trend has been for control systems to operate over shorter periods (weekly and even daily) and for control data to be more readily available. Wal-Mart’s inventory control system, for example, provides instantaneous up-to-date data. Strategic control tends to operate over longer periods.

Of particular importance is whether the business unit as a whole and its individual product-market entries have set forth milestone achievement measures. For example, in a three-year strategic plan, a given SBU might have 12-month milestones such as annual sales of $100 million, profits of $20 million, and a return on assets managed of 14.5 percent. At the product-market entry level, milestones include such measures as product sales by market segments, marginal contributions, and operating margins. At the marketing functional area level, examples of milestone measures for a consumer good are level of awareness, trial, repeat purchases (brand loyalty) among members of the target audience, reduction in marketing costs as a percent of sales, and percent of stores stocking (weighted by sales).

In recent years, major U.S. companies such as AT&T, DuPont, Ford, GM, IBM, and Motorola have used a new performance type of measure—benchmarking. What this means is that the firm’s performance in a given area is compared against the performance of other companies. Thus, Wal-Mart regularly compares itself with its competitors on merchandise assortments, service quality, and out of stocks. The comparison does not, however, have to be with companies in the same industry. For example, Xerox benchmarked its order filling/shipping performance against L. L. Bean (a mail-order retailer catering to the outdoor set), which has a well-deserved reputation for fulfilling orders both quickly and accurately. A visit to Bean’s warehouse revealed that workers could “pick and pack” items three times as fast as Xerox.8

**Profitability Analysis** Regardless of the organizational level, control involves some form of profitability analysis. In brief, *profitability analysis* requires that analysts determine the costs associated with specific marketing activities to find out the profitability of such units as different market segments, products, customer accounts, and distribution channels (intermediaries). Wal-Mart does this at the department and individual store levels as well as for individual lines of goods within a department. More and more managers are attempting to obtain profitability measures for individual products by market segments.

Profitability is probably the single most important measure of performance, but it has limitations. These are that (1) many objectives can best be measured in nonfinancial terms (maintaining market share); (2) profit is a short-term measure and can be manipulated by taking actions that may prove dysfunctional in the longer term (reducing R&D expenses); and (3) profits can be affected by factors over which management has no control (the weather). For a discussion of the newly discovered profitability religion in the dot-com world, see Exhibit 14.4.

Analysts can use direct or full costing in determining the profitability of a product or market segment. In **full costing**, analysts assign both direct, or variable, and indirect costs to the unit of analysis. **Indirect costs** involve certain fixed joint costs that cannot be linked directly to a single unit of analysis. For example, the costs of occupancy, general management, and the management of the salesforce are all indirect costs for a multiproduct company. Those who use full costing argue that only by allocating all costs to a product or a market can they obtain an accurate picture of its value.

**Direct costing** involves the use of **contribution accounting**. Those favoring the **contribution margin** approach argue there is really no accurate way to assign indirect costs.
Further, because indirect costs are mostly fixed, a product or market may make a contribution to profits even if it shows a loss. Thus, even though the company must eventually absorb its overhead costs, the contribution method clearly indicates what is gained by adding or dropping a product or a customer. Exhibit 14.5 shows an example of full and direct costing. The difference in the results obtained is substantial—$370,000 using full costing versus $650,000 with the contribution method.

Contribution analysis is helpful in determining the yield derived from the application of additional resources (for instance, to certain sales territories). Using the data in Exhibit 14.6 we can answer the question, “How much additional profit would result from a marginal increase in sales of $300,000—assuming the gross margin remains at 19.62 percent and the only cost is $35,000 more in sales commissions and expenses?” As Exhibit 14.6 shows, the answer is a profit increase before taxes of $53,000.

Companies are increasingly turning from traditional accounting methods, which identify costs according to various expense categories, to activity-based costing (ABC), which bases costs on the different tasks involved in performing a given activity. ABC advocates have used it to improve product costing, thereby improving pricing parameters, providing better service, trimming waste, and evaluating quality initiative.9

**Customer Satisfaction** So far, we have been discussing performance measures in essentially financial terms. But financial terms are insufficient since they fail to recognize the importance of customer satisfaction, which is an important driving force of the firm’s future market share and profitability. As products and services become more alike in an already highly competitive marketplace, the ability to satisfy the customer across a variety of activities (of which the product is only one) will become an even greater success determinant. Thus, measures relating to customer preferences and satisfaction are essential as an early warning of impending problems and opportunities.

A multiproduct firm will need customer satisfaction measures for each of its different products even if they are sold to the same customer. This would especially be the case if...
the choice criteria varied substantially between products, especially in terms of expectations regarding service (delivery, repairs, and availability of spare parts). Also, a firm needs to develop its own satisfaction measures with its various intermediaries (channel members) and major suppliers (advertising agencies).

Developing a meaningful measure of customer satisfaction requires the merging of two kinds of measures. The first has to do with an understanding and measurement of the criteria used by customers to evaluate the quality of the firm’s relationship with them. Knowing the product/service attributes that constitute the customer’s choice criteria as well as the relative importance of each should facilitate this task. These were developed in the process by which the firm identifies the target market for its product-market entries. Once these attributes are identified, they serve as the basis for developing expectation measures.

The second type of measurement is concerned with how well the firm is meeting the customer’s expectations on an individual attribute as well as an overall basis. Thus, if the choice criteria of a cruiseline’s target market included such attributes as food, exercise facilities, and entertainment, then a performance measure would be developed for each. By weighting these by the relative importance of each, an overall performance measure can be obtained. These two measures collectively serve as the basis for evaluating the company’s performance on customer satisfaction.
In recent years more top-level executives are visiting their major accounts (whether they be end-use customers or intermediaries) to learn firsthand how to better serve them. Such visits frequently result in joint projects designed to reduce the costs incurred by both parties in the sale of a given set of products.10

### Specifying and Obtaining Feedback Data

Once a company has established its performance standards, its next step is to develop a system that provides usable and timely feedback data on actual performance. In most cases someone must gather and process considerable data to obtain the performance measures, especially at the product-market level. Analysts obtain feedback data from a variety of sources, including company accounting records and syndicated marketing information services such as Nielsen. The sales invoice or other transaction records, such as those produced by retailers’ point-of-sale systems, are the basic internal source of data because they provide a detailed record of each transaction. Invoices are the basis for measuring profitability, sales, and various budget items. They also provide data for the analysis of the geographic distribution of sales and customer accounts by type and size.

Another source, and typically the most expensive and time-consuming, involves undertaking one or more marketing research projects to obtain needed information. In-house research projects are apt to take longer and be more expensive than using an outside syndicated service. But there may be no alternative, as, for example, in determining awareness and attitude changes and obtaining data on customer service. Exhibit 14.7 gives an example of how Wal-Mart uses marketing research to help maintain its low-price image. A third source, and one we discussed above, involves the use of executives to gather information from their personal visits with customers.

### Evaluating Feedback Data

Management evaluates feedback data to find out whether there is any deviation from the plan, and if so why. Wal-Mart does this in a variety of ways, including sending its regional vice presidents into the field on a regular basis to learn what’s going on and why.
Chapter Fourteen  Measuring and Delivering Marketing Performance

Typically, managers use a variety of information to determine what the company’s performance should have been under the actual market conditions that existed when the plan was executed. In some cases this information can be obtained in measured form; examples include a shift in personal disposable income (available from government sources), a change in the demand for a given product type (obtained when measuring market share), the impact of a new brand on market share (reported by a commercial source), or a change in price by a major competitor. Often, however, the explanation rests on inferences drawn from generalized data, as would be the case in attributing poor sales performance to an improvement in a competitor’s salesforce.

At the line-item level, whether for revenue or expenses, results are compared with the standards set in step one of the control process. A merchandise manager or buyer at an apparel retailer such as Gap, for example, would track sales results of each style or merchandise category in terms of its selling rate (how many weeks’ supply is on hand overall and in which stores?) and its gross margin performance. For a district sales team of an industrial goods manufacturer, salespeople might be measured on the number of sales calls they make per week, the number of new accounts they generate, their sales volume in dollars and units, their travel expenses, and a variety of other metrics. A stylist in a beauty salon might be measured in terms of the number or sales dollars of haircuts she produces per day or per hour.

Taking Corrective Action

The last step in the control process concerns prescribing the needed action to correct the situation. At Wal-Mart, this is partly accomplished at its various congresses held every Friday and Saturday when managers decide what actions to take to solve selected problems. Success here depends on how well managers carry out the evaluation step. When linkages between inputs and outputs are clear, managers can presume a causal relationship and specify appropriate action. For example, assume that inputs consisted of an advertising schedule that specified the frequency of a given TV message. The objective was to change attitudes about a given product attribute (the output). If the attitude change did not occur, remedial action would start with an evaluation of the firm’s advertising effort, particularly the advertising message and how frequently it ran.

But in most cases it is difficult to identify the cause of the problem. Almost always, an interactive effect exists among the input variables as well as the environment. There is also the problem of delayed responses and carry-over effects. For example, advertisers can rarely separate the effects of the message, media, frequency of exposure, and competitive responses in an attempt to determine advertising effects. Even if the company could determine the cause of a problem, it faces the difficulty of prescribing the appropriate action to take. Most control systems are “based on the assumption that corrective action is known should significant variations arise. Unfortunately, marketing is not at a stage where performance deviations can be corrected with certainty.”

Exhibit 14.7  Wal-Mart Uses Marketing Research to Maintain Price Image

Wal-Mart makes every effort to keep its regular everyday prices lower than competitors’ on a set of critical products. These “image items” are thought to be the basis of a customer’s perception of how expensive a store is. Every few weeks Wal-Mart undertakes research to determine the prices charged by its major competitors for these same items. The company then makes sure that Wal-Mart has the lowest price. Even top management, including Sam Walton when he was alive, has been known to do comparison shopping.
Sometimes the situation is so serious (shipping time lags competition by 30 percent) that radical change is needed. To more and more business managers this means “reengineering” or starting all over. This involves rethinking and redesigning the relevant business processes “to achieve dramatic improvements in critical contemporary measures of performance such as cost, quality, service, and speed.”12 A business process uses a variety of activities to create an output that is of value to a customer. For example, the order-filling process exists only to deliver the right goods to a customer in good shape and in the time promised.

Sometimes the outcome is greater or better than management had planned; for example, when sales and market share exceed the schedule. In such cases, the marketers still need an evaluation to find out why such a variance occurred. Perhaps a more favorable environment evolved because demand was greater than expected and a major competitor failed to take advantage of it. Or perhaps the advertising message was more effective than expected. These different reasons would call for different marketing responses to hold what had been obtained and to further exploit the favorable situation.

### Design Decisions for Strategic Control Systems

Strategic control is concerned with monitoring and evaluating a firm’s SBU-level strategies (see Exhibit 14.8 for the kinds of questions this type of control system is designed to answer). Such a system is difficult to implement because there is usually a substantial amount of time between strategy formulation and when a strategy takes hold and results are evident. Since both the external and internal environments are constantly evolving, strategic control must provide some way of changing the firm’s thrust if new information about the environment and/or the firm’s performance so dictates. Inevitably, much of this intermediate assessment is based on information about the marketplace and the results obtained from the firm’s marketing plan.

#### Identifying Key Variables

To implement strategic control, a company must identify the key variables to monitor, which are the major assumptions (planning premises) made in formulating the strategy. The key variables to monitor are the two types: those concerned with external forces and those concerned with the effects of certain actions taken by the firm to implement the

### Exhibit 14.8

**Examples of Questions a Strategic Control System Should Be Able to Answer**

1. What changes in the environment have negatively affected the current strategy (e.g., interest rates, government controls, or price changes in substitute products)?
2. What changes have major competitors made in their objectives and strategies?
3. What changes have occurred in the industry in such attributes as capacity, entry barriers, and substitute products?
4. What new opportunities or threats have derived from changes in the environment, competitors’ strategies, or the nature of the industry?
5. What changes have occurred in the industry’s key success factors?
6. To what extent is the firm’s current strategy consistent with the preceding changes?
strategy. Examples of the former include changes in the external environment such as changes in long-term demand, the advent of new technology, a change in governmental legislation, and actions by a competitor. Examples of the latter types (actions by the firm) include the firm’s advertising efforts to change attitudes and in-store merchandising activities designed to improve product availability.

The frameworks and analytical tools for market and competitive analysis that we discussed in Chapters 4 and 5 are useful in determining what variables to monitor in a strategic control system. Deciding exactly which variables to monitor is a company-specific decision; in general, it should focus on those variables most likely to affect the company’s future position within its industry group.

**Tracking and Monitoring**

The next step is to specify what information or measures are needed on each of the key variables to determine whether the implementation of the strategic plan is on schedule—and if not, why not. The firm can use the control plan as an early-warning system as well as a diagnostic tool. If, for example, the firm has made certain assumptions about the rate at which market demand will increase, it should monitor industry sales regularly. If it has made assumptions about advertising and its effect on attitudes, it would be likely to use measures of awareness, trial, and repeat buying. In any event, the firm must closely examine the relevancy, accuracy, and cost of obtaining the needed measures.

The advent of e-mail, intranets, and other digital tools for disseminating information has made it easier for sometimes far-flung managers to monitor strategic developments. Critical strategic control information can now be monitored on a real-time basis anywhere in the world.

**Strategy Reassessment**

This can take place at periodic intervals—for example, quarterly or annually, when the firm evaluates its performance to date along with major changes in the external environment. It also can use the control system to alert management of a significant change in either or both its external/internal environments. This involves setting triggers to signal the need to reassess the viability of the firm’s strategy. It requires a specification of both the level at which an alert will be called and the combination of events that must occur before the firm reacts. For example, total industry sales of 10 percent less than expected for a single month would not be likely to trigger a response, whereas a 25 percent drop would. Or a firm might decide that triggering will occur only after three successive months in which a difference of 10 percent occurred in each.

In the fast-changing dot-com world, strategy reassessment may happen much more quickly, as competitive and technological developments cause firms to quickly change their entire strategies and business models. Reasonware.com, an e-tailer of wireless telephone products and services, began in late 2000 to develop a new strategy focused on business services when it realized how difficult it was for most e-tailers to reach profitability.13

**Design Decisions for Marketing Performance Measurement**

Designing control systems to measure marketing performance at the product-market and line-item levels involves answering four essential questions:
Who needs what information?
When and how often is the information needed?
In what media and in what format(s) or levels of aggregation should the information be provided?
What contingencies should be planned for?

In essence, designing a marketing performance measurement system is like designing the dashboard of a car. Such a system needs to include the most critical metrics to assess whether the car or the business is progressing toward its objectives. Thus, for a car, the dashboard includes a speed gauge and odometer to measure progress toward the destination, a fuel gauge, warning lights for engine and braking system malfunction, and so on, but it typically does not indicate how much windshield wiper fluid remains, how much weight the car is carrying, or other relatively nonessential indicators. The same holds true for a business: The “drivers” who are managing the business need to know certain essential information while the “car”—or strategy—is running, while other less crucial indicators can be omitted or provided only when requested. We now address the four key questions, or design parameters, of marketing performance measurement systems.

**Who Needs What Information?**

Marketing performance measurement systems are designed to ensure that the company achieves the sales, profits, and other objectives set forth in its marketing and strategic plans. In the aggregate, these plans reflect the outcomes of the company’s or the SBU’s planning efforts, which have specified how resources are to be allocated across markets, products, and marketing-mix activities. These plans, as we noted in Chapter 13, include line-item budgets and typically specify the actions expected of each organizational unit—whether inside or outside the marketing function or department—and deemed necessary to attain the company’s financial and competitive positioning objectives. The first and foremost objective for marketing is the level of sales the company or the product-market entry achieves.

Who needs sales information? Top management needs it. Functional managers in other parts of the organization—manufacturing, procurement, finance, and so on—need it. Marketing managers responsible for the various marketing-mix activities, from product design to pricing to channel management to selling and other promotional activities, need it.

**Sales Analysis**  A sales analysis involves breaking down aggregate sales data into such categories as products, end-user customers, channel intermediaries, sales territories, and order size. The objective of an analysis is to find areas of strength and weakness; for example, products producing the greatest and least volume, customers accounting for the bulk of the revenues, and salespersons and territories performing the best and the worst.

Sales analysis recognizes that aggregate sales and cost data often mask the real situation. Sales analysis not only helps to evaluate and control marketing efforts, but also helps management to better formulate objectives and strategies and administer such nonmarketing activities as production planning, inventory management, and facilities planning.

An important decision in designing the firm’s sales analysis system concerns which units of analysis to use. Most companies assemble data in the following groupings:

- Geographical areas—regions, counties, and sales territories.
- Product, package size, and grade.
- Customer—by type and size.
• Channel intermediary—such as type and/or size of retailer.
• Method of sale—mail, phone, channel, Internet, or direct.
• Size of order—less than $10, $10–25, and so on.

These breakdowns are not mutually exclusive. Most firms perform sales analyses hierarchically; for example, by county within a sales territory within a sales region. Further, they usually combine product and account breakdowns with a geographical one: say, the purchase of product X by large accounts located in sales territory Y, which is part of region A. Only by conducting sales analysis on a hierarchical basis using a combination of breakdowns can analysts be at all sure that they have made every reasonable attempt to locate the opportunities and problems facing their firms.

Sales Analysis by Territory The first step in a sales territory analysis is to decide which geographical control unit to use. The county is the typical choice since it can be combined into larger units such as sales territories and it is also a geographical area for which many data items are available, such as population, employment, income, and retail sales. Analysts can compare actual sales (derived from company invoices) by county against a standard such as a sales quota that takes into account such factors as market potential and last year’s sales adjusted for inflation. They can then single out territories that fall below standard for special attention. Is competition unusually strong? Has less selling effort been expended here? Is the salesforce weak? Studies dealing with such questions as these help a company improve its weak products and exploit its stronger ones. Category and brand development indices, such as those described in Chapter 6, are often used in assessing sales performance by territory.

Exhibit 14.9 illustrates a sales territory analysis. It shows that only one territory out of seven shown exceeded its 1999 quota, or standard of performance, and by just $18,112. The other six territories accounted for a total of $394,685 under quota. Territory 3 alone accounted for 55 percent of the total loss. The sales and the size of the quota in this territory suggest the need for further breakdowns, especially by accounts and products. Such breakdowns may reveal that the firm needs to allocate more selling resources to this territory. The company needs to improve its sales primarily in territories 3 and 5. If it can reach its potential in these two territories, overall sales would increase by $301,911, assuming that the quotas set are valid.

### Exhibit 14.9

<table>
<thead>
<tr>
<th>Sales Territory</th>
<th>Salesperson</th>
<th>Company sales 1999</th>
<th>Sales quota 1999</th>
<th>Overage, UNDERAGE</th>
<th>Percent of potential performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Barlow</td>
<td>$552,630</td>
<td>$585,206</td>
<td>-32,576</td>
<td>94%</td>
</tr>
<tr>
<td>2</td>
<td>Burrows</td>
<td>470,912</td>
<td>452,800</td>
<td>+18,112</td>
<td>104</td>
</tr>
<tr>
<td>3</td>
<td>White</td>
<td>763,215</td>
<td>981,441</td>
<td>-218,226</td>
<td>77</td>
</tr>
<tr>
<td>4</td>
<td>Finch</td>
<td>287,184</td>
<td>297,000</td>
<td>-9,816</td>
<td>96</td>
</tr>
<tr>
<td>5</td>
<td>Brown</td>
<td>380,747</td>
<td>464,432</td>
<td>-83,685</td>
<td>82</td>
</tr>
<tr>
<td>6</td>
<td>Roberts</td>
<td>494,120</td>
<td>531,311</td>
<td>-37,191</td>
<td>93</td>
</tr>
<tr>
<td>7</td>
<td>Macini</td>
<td>316,592</td>
<td>329,783</td>
<td>-13,191</td>
<td>96</td>
</tr>
</tbody>
</table>
Without a standard against which to compare results, the conclusions would be much different. Thus, if only company sales were considered (column 1), White would be the best salesperson and Finch the worst. By using sales quotas as a performance standard, White was not the best but the worst salesperson, with a 77 percent rating.

**Sales Analysis by Product** Over time, a company’s product line tends to become overcrowded and less profitable unless management takes strong and continuous action to eliminate no-longer-profitable items. By eliminating weak products and concentrating on strong ones, a company can increase its profits substantially. Before deciding which products to abandon, management must study such variables as market-share trends, contribution margins, scale effects, and the extent to which a product is complementary with other items in the line.¹⁴

A product sales analysis is particularly helpful when combined with account size and sales territory data. Using such an analysis, managers often can pinpoint substantial opportunities and develop specific tactics to take advantage of them. For example, one firm’s analysis revealed that sales of one of its highest-margin products were down in all the Asian sales territories. Further investigation showed that a regional producer was aggressively promoting a recently modified product with reduced prices. An analysis of the competing product revealed questionable reliability under certain operating conditions. The salesforce used this information to turn around the sales problem.

**Sales Analysis by Order Size** Sales analysis by order size may identify which dollar-size orders are not profitable. For example, if some customers frequently place small orders that require salesforce attention and need to be processed, ordered picked, and shipped, a problem of some importance exists.

Analysis by order size locates products, sales territories, and customer types and sizes where small orders prevail. Such an analysis may lead to setting a minimum order size, charging extra for small orders, training sales reps to develop larger orders, and dropping some accounts. An example of such an analysis involved a nationwide needlework product distributor, which found that 28 percent of all its orders were $10 and under. A study revealed that the average cost of servicing such orders was $12.82. The analysis also showed that the company did not break even until the order size reached $20. Based on these findings, the company installed a $35 minimum order, charged a special handling fee of $7.50 on all orders below $35, and alerted its field sales reps and telephone salespeople to the problem. As a result, the company increased its profits substantially.

**Sales Analysis by Customer** Analysts use procedures similar to those described earlier to analyze sales by customers. Such analyses typically show that a relatively small percentage of customers accounts for a large percentage of sales. For example, the needlework products distributor cited above found that 13 percent of its accounts represented 67 percent of its total sales. Frequently, a study of sales calls shows that the salesforce spends a disproportionate amount of its time with the small accounts as compared with the larger ones. Shifting some of this effort to the larger accounts may well increase sales.

**Sales/Share Determinants** Sales and market share are a function of a number of primary determinants. For a consumer product these include effective distribution, relative price, attitude maintenance or change toward one or more salient product characteristics relative to competition, and shelf-facings. These, in turn, are a function of secondary determinants such as number and frequency of sales calls, trade deals, and the effectiveness of the advertising message with a given reach and frequency schedule. An analysis of the share determinants should provide insights into presumed linkages between the firm’s inputs and outputs: for example, number and frequency of sales calls and effective distribution. This,
in turn, leads to a better understanding of the firm’s marketing efficiency. Is the salesforce making as many calls per day as expected—and the right number of calls on target accounts to obtain a certain level of distribution?

Marketing research is usually required to ascertain the extent to which determinants are being attained. For example, consistently having a lower price on the same product relative to major competitors is an important determinant of sales. As in the case of Wal-Mart, interviewers would need to shop the targeted stores to obtain the desired price data.

**Line-Item Margin and Expense Analysis** Sales data are not the only marketing performance information needed, of course. Gross and net margins must be tracked, and the effectiveness and efficiency of all line-item marketing expenses must be measured. The designers of marketing performance measurement systems must develop appropriate metrics to track the critical performance indicators for margins and expenses so that timely mid-course corrections can be made. Thus, the weeks-on-hand metric that tells a Gap sweater buyer how quickly each style is selling tells him or her whether to buy more of a particular style if it is selling well, or mark it down if it is not moving. Making such decisions on a timely basis can have a profound effect on gross margins. A not-so-pretty sweater may be more salable at 25 percent off before Christmas than at 60 percent off December 26.

Because budgets project revenues and expenses for a given time period, they are a vital part of the firm’s planning and control activities. They provide the basis for a continuous evaluation and comparison of what was planned with what actually happened. In this sense, budgeted revenues and profits serve as objectives against which to measure performance in sales, profits, and actual costs.

Budget analysis requires that managers continuously monitor marketing–expense ratios to make certain the company does not overspend in its effort to reach its objectives. Managers also evaluate the magnitude and pattern of deviations from the target ratios. Managers of the various marketing units have their own control measures. For example, advertising managers track advertising costs per 1,000 target audience, buyers per media vehicle, print ad readership, size and composition of TV audiences, and attitude change. Sales managers typically track number of calls per salesperson, costs per call, sales per call, and new accounts. The major marketing expenses are those associated with marketing research, brand management, sales salaries, sales expenses, media advertising, consumer promotions, trade promotions, and publicity. Before taking corrective action on any of these expenses that are out of line, managers may need to disaggregate the data to help isolate the problem. For example, if total commissions as a percent of sales are out of line, analysts need to study them by each sales territory and product to determine exactly where the problem lies.

**When and How Often Is the Information Needed?**

Timeliness is a key criterion for the development of a marketing performance measurement system. As we have seen, Wal-Mart’s systems provide sales information at the store and item level on an up-to-the-minute basis. More commonly, though, managers attend to performance information—whether for sales, margins, or expenses—on a periodic basis, since they don’t have time or the need to assess the performance of every item at every minute of every day. Buyers and merchandise managers in retailing firms typically assess item and category sales performance on a weekly basis. In fashion categories, such as women’s apparel, where timeliness is especially important, having sales information a couple of days, or even hours, ahead of competitors can make the difference between
obtaining more of a hot-selling item or being left in a faster-moving competitor’s dust. Store payroll expense, another key performance criterion for retailers that impacts both customer service and profitability, is typically measured on a weekly basis, though store managers may be encouraged to send employees home if business is unexpectedly slow on a given day or call in extra help when more is needed. The performance of industrial salespeople—in terms of number of sales calls, sales volume, expense control, and other indicators—is typically done on a monthly basis, though some firms may do so more or less frequently as they see fit. Strategic control indicators, such as changes in market share, macro trends, and so on, are likely to be measured and reported less frequently because these kinds of longer-term issues may not be readily apparent or may give false alarms at more frequent intervals.

In What Media and in What Format(s) or Levels of Aggregation Should the Information Be Provided?

Advances in information technology have made possible the measurement and reporting of marketing performance information with previously unheard-of ease of access and timeliness, without even printing the data! As we have seen, Wal-Mart’s sales information is available on computer screens on an up-to-the-minute basis. In other companies, salespeople around the world now log on to company intranets to see the latest order status of a customer before they walk in the door on a sales call. But having good and timely information and reporting it in such a manner that it is easy and quick to use are different things. Imagine a Gap buyer having to manually add up the performance of various styles to determine how the category is performing. Reports should provide such aggregation, of course, but someone must decide what sort of aggregation is most useful for each information user.

Even the format or medium in which performance information is presented can make a big difference to the manager using the data. Weekly weeks-on-hand sales reports that retail buyers and merchandise managers depend on are most usefully reported in order of how fast the styles are selling, rather than alphabetically or some other way. The styles at the top of the report (those with little stock on hand, as measured by their weeks-on-hand sales rate) are candidates for reorders. Styles at the bottom of the report (the ugly sweater in mid-November with 25 weeks of inventory on hand) are candidates for markdowns. The ones in between may need little attention. Once a season ends, a different report, aggregating styles by vendor, perhaps, might be useful to determine which suppliers have performed well and which have performed poorly across the assortment of styles they provide. Thoughtful attention to the format in which marketing performance information is reported, to the levels at which it is aggregated, for different kinds of decision purposes, and for different users, can provide a company with a significant competitive advantage.

As we noted earlier in this chapter, it took Kmart many years to come close to Wal-Mart’s system of tracking and reporting store and item sales performance.

What Contingencies Should Be Planned for?

Because all strategies and the action plans designed to implement them are based on assumptions about the future, they are subject to considerable risk. Too often, assumptions are regarded as facts; and little attention is paid to what action or actions can be taken if any or all of the assumptions turn out to be wrong.
Managers, therefore, often follow a contingency planning process that includes the elements shown in Exhibit 14.10 identifying critical assumptions; assigning probabilities of being right about the assumptions; ranking the importance of the assumption; tracking and monitoring the action plan; setting the “triggers” that will activate the contingency plan; and specifying alternative response options. We discuss these steps briefly next.

**Identifying Critical Assumptions** Because there are simply too many assumptions to track them all, contingency plans must cover only the more important ones. Assumptions about events beyond the control of the individual firm but that strongly affect the entry’s strategic objectives are particularly important. For example, assumptions about the rate of market growth coupled with the entry’s market share will strongly affect the entry’s profitability objectives. The effect of a wrong assumption here can be either good or bad, and the contingency plan must be prepared to handle both. If the market grows at a rate faster than expected, then the question of how to respond needs to be considered. Too often contingency plans focus only on the downside.

Another type of uncontrollable event that can strongly affect sales and profits is competitive actions. This is particularly true with a new entry (when a competitor responds with its own new product), although it can apply with more mature products (competitor’s advertising is increased). Assumptions about industry price levels must be examined in depth because any price deterioration can quickly erode margins and profits.

Assumptions about the effects of certain actions taken by the firm to attain its strategic objectives also need to be considered in depth. Examples include the firm’s advertising...
objectives, which are based on assumptions about an improvement or maintenance of consumer attitudes toward the product’s characteristics compared with competing brands, or the monies allocated to merchandising to improve the product’s availability. Further, once the targeted levels of the various primary objectives are reached, there are assumptions about what will happen to sales and share.

**Assigning Probabilities**  
This step consists of assigning to the critical assumptions probabilities of being right. These probabilities must be considered in terms of the consequences of being wrong. Thus, assumptions that have a low probability of being wrong but could affect the firm strongly need to be considered in depth (for instance, gas shortages or high prices or the demand for large luxury automobiles).

**Rank Ordering the Critical Assumptions**  
If assumptions are categorized on the basis of their importance, the extent to which they are controllable, and the confidence management has in them, then the basis for rank ordering the assumptions and drafting the contingency plan has been set forth. Ordinarily, these criteria will have screened out those assumptions that need not be included—those with a low impact on objectives and those about which there is a high confidence they will not occur. Assumptions that relate to uncontrollable events should, however, be monitored if they strongly affect the entry’s strategic objectives since the firm can react to them. For example, if the assumption about the rate of market growth is wrong, then the firm can either slow or increase its investments in plant construction.

**Tracking and Monitoring**  
The next step is to specify what information (or measures) are needed to determine whether the implementation of the action plan is on schedule—and if not, why not. The contingency plan is, therefore, an early warning system as well as a diagnostic tool. If, for example, the firm has made certain assumptions about the rate of market demand increase, then it would monitor industry sales on a regular basis. If assumptions were made about advertising and its effect on attitudes, then measures of awareness, trial, and repeat buying would be likely to be used. Relevancy, accuracy, and cost of obtaining the needed measures must be examined in depth. Some of the information needed in the contingency plan might have been specified in the control plan, in which case it is already available.

**Activating the Contingency Plan**  
This involves setting the “triggers” to activate the contingency plan. It requires a specification of both the level at which an alert will be called and the combination of events that must occur before the firm reacts. If, for example, total industry sales were 10 percent less than expected for a single month, this would not be likely to trigger a response, whereas a 25 percent drop would. Or a firm may decide the triggering would occur only after three successive months in which a difference of 10 percent occurred. Triggers must be defined precisely and responsibility assigned for putting the contingency plan into operation.

**Specifying Response Options**  
Actually, the term *contingency plan* is somewhat misleading. It implies that the firm can know in advance exactly how it will respond if one or more of its assumptions go awry. This implication is unrealistic because there are a great many ways for critical assumptions to turn out wrong. To compound the problem, the firm’s preplanned specific responses can be difficult to implement, depending on the situation and how it develops. This can lead to a set of responses that build in intensity. Thus, most firms develop a set of optional responses that are not detailed to any great extent in an effort to provide flexibility and ensure further study of the forces that caused the alert.
Global Marketing Control

Maintaining control over global marketing activities is more difficult than with domestic marketing, primarily because of the number of countries involved, each presenting a unique set of opportunities and threats. This makes it difficult to monitor simultaneously a variety of environments and to prescribe corrective action on an individual-country basis where appropriate. Differences in language and customs, accentuated by distance, further compound the control problem.

Keegan recommends that global companies use essentially the same control system format for both their domestic and foreign operations. Report frequency and extent of detail would vary by the subsidiary’s size and environmental uncertainties. The great advantage of using a single system is that it facilitates comparisons between operating units and communications between home office and local managers. On the surface, the use of electronic data interchange should simplify performance evaluation across countries. While this is true in terms of budget control, it leaves much to be desired in terms of understanding the reasons for any deviations.

The extent of control exercised over an overseas subsidiary is largely a function of its size, differences in the environment (including its stability), and the extent to which the company employs a standardized rather than a localized strategy. The larger a company’s international operation, the greater the likelihood that staff personnel specializing in control activities will be on-site, making the control system more elaborate and precise in its operation. Small overseas operations tend to involve fewer specialists and a less-intensive control system.

Another factor affecting the control system is the extent to which environmental differences exist. Ordinarily, the greater the differences between the home country and the foreign subsidiary, the more decision-making authority is delegated. Large multinationals compensate for these differences by clustering countries with similar environments into regions that have sufficient revenues to permit the use of a headquarters staff. When considerable environmental instability is present, it is difficult to employ a formal control system; the tendency is to delegate to local management the authority to make certain kinds of decisions without review and approval by the home office.

A third major factor affecting the international control system is the extent to which standardized strategy is used. The more standardized the strategy, especially with respect to the product, the greater the degree of control exercised over many activities, including purchasing raw materials and determining components, manufacturing, and quality specifications. Ordinarily, control over marketing activities is less stringent than with manufacturing. Other factors also affect control: the success of the subsidiary (the greater the success, the less the home office interference) and the physical distance separating the home office and the subsidiary (the greater the distance, the less frequently the subsidiary will be visited). Rapidly improving voice and data communication systems throughout the world have greatly improved the effectiveness of global managers, but many managers feel strongly that the personal touch is still important not only for control purposes but also to improve customer satisfaction.

A Tool for Periodic Assessment of Marketing Performance: The Marketing Audit

While marketing performance measurement systems are essential for tracking day-to-day, week-to-week, and month-to-month performance to see that planned results are actually delivered, it is sometimes useful to step back and take a longer view of the marketing...
performance of an SBU or of the entire company. Marketing audits are growing in popularity, especially for firms with a variety of SBUs that differ in their market orientation. They are both a control and planning activity that involves a comprehensive review of the firm’s or SBU’s total marketing efforts cutting across all products and business units. Thus, they are broader in scope and cover longer time horizons than sales and profitability analyses.

Our concern here is at the individual SBU level or the entire company, for smaller or single-business firms. Such an audit covers both the SBU’s objectives and strategy and its plan of action for each product-market entry. It provides an assessment of each SBU’s current overall competitive position as well as that of its individual product-market entries. It requires an analysis of each of the marketing-mix elements and how well they are being implemented in support of each entry. The audit must take into account the environmental changes that can affect the SBU’s strategy and product-market action programs.17

**Types of Audits**

Audits are normally conducted for such areas as the SBU’s marketing environment, objectives and strategy, planning and control systems, organization, productivity, and individual marketing activities such as sales and advertising. These areas are shown in Exhibit 14.11 with examples of the kinds of data needed and serve as the basis for the discussion that follows.

- The **marketing environment audit** requires an analysis of the firm’s present and future environment with respect to its macro components, as discussed in Chapter 4. The intent is to identify the more significant trends to see how they affect the firm’s customers, competitors, channel intermediaries, and suppliers.

- The **objectives and strategy area audit** calls for an assessment of how appropriate these internal factors are, given current major environmental trends and any changes in the firm’s resources.

- The unit’s **planning and control system area audit** evaluates the adequacy of the systems that develop the firm’s product-market entry action plans and the control and reappraisal process. The audit also evaluates the firm’s new product development procedures.

- The **organization area audit** deals with the firm’s overall structure (can it meet the changing needs of the marketplace?); how the marketing department is organized (can it accommodate the planning requirements of the firm’s assortment of brands?); and the extent of synergy between the various marketing units (are there good relations between sales and merchandising?).

- The **marketing productivity area audit** evaluates the profitability of the company’s individual products, markets (including sales territories), and key accounts. It also studies the cost-effectiveness of the various marketing activities.

- The **marketing functions area audit** examines, in depth, how adequate the firm handles each of the marketing-mix elements. Questions relating to the **product** concern the attainability of the present product-line objective, the extent to which individual products fit the needs of the target markets, and whether the product line should be expanded or contracted. **Price** questions have to do with price elasticity; experience effects, relative costs, and the actions of major competitors; and consumers’ perceptions of the relationship between a product’s price and its value. **Distribution** questions center on coverage, functions performed, and cost-effectiveness. Questions about **advertising** focus on advertising objectives and strategies, media schedules, and the procedures used to develop advertising objectives and strategies, media schedules, and the procedures used to develop advertising messages. The audit of the salesforce covers its objectives, role, size, coverage, organization, and duties plus the
quality of its selection, training, motivation, compensation, and control activities. In some companies marketing audits cover additional areas including the two that follow.

- The company’s ethical audit evaluates the extent to which the company engages in ethical and socially responsible marketing. Clearly this audit goes well beyond monitoring to make sure the firm is well within the law in its market behavior. If the company has a written code of ethics, then the main purpose of this audit is to make certain that it is disseminated, understood, and practiced.

- The product manager audit, especially in consumer goods companies, seeks to determine whether product managers are channeling their efforts in the best ways possible. They are queried on what they’re doing versus what they ought to be doing. They also are asked to rate the extent to which various support units were helpful.18

### Take Aways

- Most managers and entrepreneurs are evaluated primarily on the results they deliver. Effective design of control systems, whether for strategic control or for marketing performance measurement, helps ensure the delivery of planned results. A step-by-step process for doing so is provided in this chapter.

- Control systems that deliver the right information—in a timely manner and in media, formats, and levels of aggregation that users need and can easily use—can be important elements for establishing competitive advantage. Four key questions that designers of such systems should address are discussed in this chapter.

- From time to time, it is useful to step back from day-to-day results and take a longer view of marketing performance for a company or an SBU. A marketing audit, as outlined in this chapter, is a useful tool for conducting such an assessment.

- Self-diagnostic questions to test your ability to apply the analytical tools and concepts in this chapter to marketing decision making may be found at this book’s website at [www.mhhe.com/walker](http://www.mhhe.com/walker).
SECTION FOUR  IMPLEMENTATION AND CONTROL

ENDNOTES


2. For a discussion of Kmart’s new centralized replenishment system, see “Remote Control,” The Economist, May 29, 1993, p. 90.


13. See the company’s website at www.reasonware.com.

14. Activity-based accounting is particularly helpful to managers in determining product profitability since it allocates costs to products more accurately than traditional methods by breaking down overhead costs more precisely. See Paré, “A New Tool,” p. 125.


16. Ibid.


18. John A. Quelch, Paul W. Farris, and James M. Oliver, “The Product Manager Audit,” Harvard Business Review, March–April 1987, p. 30. Based on their research, these authors conclude that product managers spend too much time on routine matters such as those relating to promotion execution and too little on product design and development.