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How you can build more profitable markets

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Most executives are aware of the importance of understanding and managing the market forces that drive profitability: customers, competitors, complementors, substitutes, suppliers and potential entrants. However, very few companies fully exploit both the obvious, and less obvious, ways of managing these market forces in order to build more profitable markets for their businesses. In this *Perspectives*, we will present some of the more innovative ways that certain companies are using to manage and exploit some of these six market forces. Complementors, in particular, are often crucial but ignored.

The six market forces that can impact a company's profitability in a given market are shown in Figure 1 with, in each case, the major factors that have a negative impact on market profitability. If the market forces are negative, then it is highly unlikely that a given market will generate good profits for the company. In some cases, even if only one major force is negative, it can make the market relatively unattractive and unprofitable. The challenge that management faces is to shape the factors that could make a market force negative in order to make the overall market environment as positive and profitable as possible. In part, by obsessively managing each of the six market forces, often in very creative ways, Intel's Architecture Group, for example, has built an extraordinarily profitable business in microprocessors. In 2004, it earned an impressive $12 billion in operating income on revenues of $29 billion.

Since most companies pay attention to direct competitors and managing the power of suppliers, our focus here will be on the other four market forces: customers, complementors, substitutes and potential entrants, which either receive less attention, or are frequently not fully exploited.

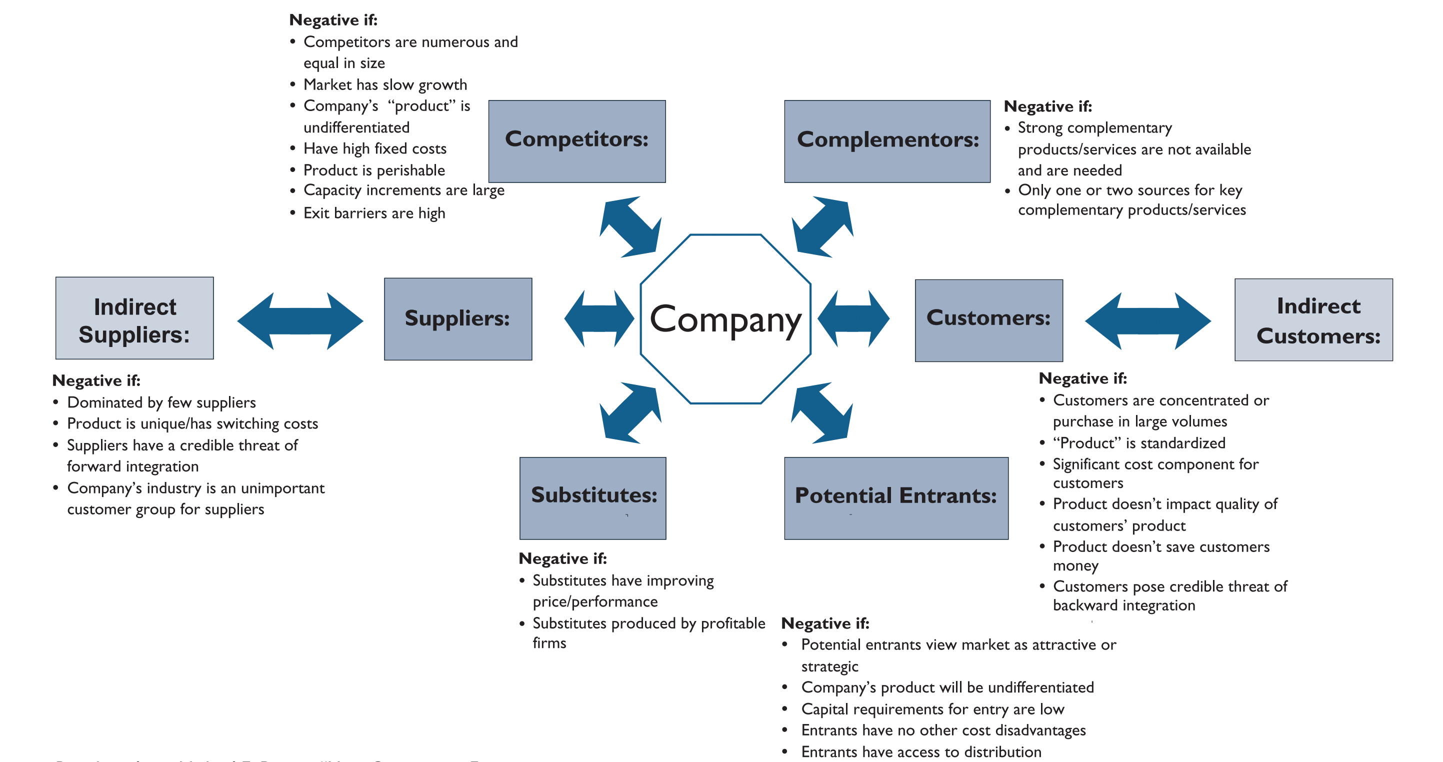
Customer

Powerful customers have become a major threat to profitability in many markets. Strong brands and differentiated solutions are important, if often inadequate, tools for dealing with customer power in today's markets. Some of the most effective ways of reducing customer power are to deliberately focus on customers and segments that have less power, or are less likely to wield the power they have, to actively encourage the emergence and growth of new customers, and to make sure not to inadvertently encourage customer concentration or enhance their bargaining power. If appropriate, bypassing direct, powerful customers, who demand low prices, to serve a less powerful group of indirect customers may be the preferred route to profitability.

By focusing on small and medium-sized accounts, UPS is believed to have achieved significantly higher margins in the air express market in the United States than Federal Express, which tends to serve larger and more powerful customers who demand and receive bigger discounts.

Companies as diverse as Intel and Procter & Gamble have programs to help new, or smaller, customers compete more effectively with their larger customers. Intel certifies that the "packages" of server components that it sells to small assemblers will work with the hardware and software from other companies. This allows these small Intel customers, who may be new

Shaping the six market forces



Based partly on Michael E. Porter, "How Competitive Forces Shope Strategy" *Harvard Business Review*, March-April 1979

entrants, to more effectively compete with Hewlett-Packard, IBM and Dell, thus diluting the power of these big customers. Procter & Gamble produces special, smaller sizes of many of its popular products that hit the price points of the fast-growing, so-called "dollar stores," helping them to compete with retail giants like Wal-Mart.

Some markets are quite fragmented, for historical and cultural reasons. Under these circumstances, suppliers operating in the market are often tempted by production, inventory and distribution cost pressures to rationalize the product range and to encourage customers to move to globally standardized products. However, the move to globally standardized products may enhance the power of their customers and reduce the company's freedom in pricing. Additionally, it may help competitors to penetrate the market. One extreme example of this almost occurred in a segment of the animal care industry. This craft-oriented market has existed for hundreds of years and has developed in different ways in different countries and even in regions within countries. In the late 20th century, there was a gradual consolidation in the industry with one company ultimately becoming the dominant player with over 80% of the market in some product segments. The Chinese market for the product was one of the largest in the world, and an increasing threat to the dominant player was low-cost Chinese competition. The first reaction of top management was that they needed to rationalize the company's product range and encourage customers to move to globally standardized products. This would allow the company to dramatically lower its costs. However, after thinking more deeply about the issue, management realized that perhaps a more effective strategy to maintain profitability and deal with the Chinese competitive threat might be to reinforce the fragmentation of the market. A highly fragmented global market would result in less powerful customers and would be less attractive to a volume-oriented competitor, who would need to invest heavily to understand all the nuances of the different geographic markets, and to develop the marketing and sales tools to wean the industry away from its traditional products and practices.

Smart players are careful not to offer large volume discounts to their biggest customers unless competitive conditions absolutely demand it, particularly if this will have a big impact on the customers' competitiveness in his market. Yet some companies continue to do so in order to gain short-term volumes, and they are surprised, a couple of years later when they find that they are highly dependent on a few, now very powerful, customers, who try to wring even more concessions out of them.

Finally, if faced with very tough and powerful customers who are destroying the profitability of a market, a company should look for innovative ways to bypass these customers and serve at least a segment of the market more directly. Nestlé has been quite successful doing this with its Nespresso coffee business. By selling the coffee capsules for the Nespresso machines at very attractive margins directly to consumers, it has managed to bypass the powerful retailers that control most of the traditional retail coffee business.

Complementors

For many products and services, complementors are critical. Rather than waiting for the complementary products and services to become available spontaneously, some companies actively and aggressively try to ensure that a complete solution is available to potential customers. This involves having a clear vision of what the complete solution will look like, while aggressively communicating this vision to potential complementors and supporting them.

One company that has done a superlative job of managing its complementors is Intel, particularly with respect to its core microprocessor business. As the company introduced more and more powerful processors with increasing capabilities, it was very successful in communicating its vision of the future for the PC. It identified the next "hot" application for the PC, and the hardware and software that was going to be needed to make the vision a reality. The broad vision was presented at major industry conferences. In parallel, it held Intel Developer Forums with the companies that would be needed to provide their parts of the overall solution, both for Intel's customers and for PC end users. In many cases Intel's venture capital arm, Intel Capital, would help fund innovative new technologies and services that supported the vision and which would fuel the demand for Intel microprocessors. In some cases, it also invested heavily in marketing activities to support critical new applications. In the case of Wi-Fi wireless networks, Intel spent some $300 million on a global marketing campaign that included advertising, conferences and support for developers making their applications work smoothly for mobile workers.

Another way to accelerate the growth of a business is to encourage competition between complementors in order to drive down the cost of the complementary products and services. Hughes Space and Communication, a leading producer of satellites prior to its acquisition by Boeing, was one company that used this approach. It recognized that one barrier to selling more commercial satellites was the total cost of the satellite plus its launching. Being naturally reluctant to reduce the price of its satellites, managers at Hughes decided to focus on driving down the cost of launch services. Since there are a limited number of suitable equatorial sites for launching satellites into geosynchronous orbits, Hughes encouraged Boeing to get into the sea launch business, hoping that an additional, geographically well-positioned player would lead to increased price competition between the various launch site operators driving down the total cost for customers. Boeing did enter the satellite launch business, and the first commercial launch by Boeing's Sea Launch took place in 1999.

Substitutes

Substitutes are products or services that for some customers and some applications meet the customer's needs to a greater or lesser extent. Hewlett-Packard (HP) is facing a major substitute challenge to its highly profitable home digital photo printing business. This business faces cheaper substitute services provided by online photography sites that print and mail photos, and the in-store photo printing services provided by some retail giants, such as Wal-Mart. HP is trying to meet this challenge by dramatically improving the price/performance of its home digital printing solutions, by speeding up its printers, and by making them easier to use. HP is also reducing the prices of its paper and ink. This is a traditional way to fight substitutes, even if it means some sacrifice of margins.

Another powerful way to fend off substitutes is to build switching barriers or leverage existing behavioral patterns, so that it becomes more difficult for customers to move to the substitute. In the battle for the digital photo printing business, retailers are trying to take advantage of many customers' continuing practice of bringing rolls of film into the store for printing, by providing the same service for digital image memory cards. Some retailers are suggesting that customers should only print digital images on expensive home printers when they need a print quickly, otherwise they should take advantage of the less expensive and more convenient services at retail stores or by mail. This latter tactic of "pigeon holing" a substitute into a narrow range of applications has been used effectively by companies in various industries to reduce

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the impact of substitutes. A final approach for trying to control the effect on the attractiveness and profitability of a market by substitutes is for a company to enter the substitute market itself, and then try to influence it and control it from the inside.

Potential Entrants

While many companies pay a lot of attention to competitive analysis and managing competitors, there is often not a similar focus on managing potential entrants, who could become a major future threat to profitability.

The most obvious way to discourage potential entrants is to build and reinforce barriers to entry. However, it may be more effective to lower potential entrants' interest in a market, so that they either delay or do not seriously consider entry, thus allowing the incumbent to strengthen its position. Some companies do this by managing the potential entrants' expectations about the profitability or strategic importance of a market. Apple appears to have used this tactic with its iTunes music download business. In November 2003, Steve Jobs, the CEO of Apple, told analysts that iTunes was not a moneymaker, even though it was the largest player in this business. This might have discouraged some potential entrants and Apple could, of course, make money, because by having an aggressively priced iTunes product, profitable iPod sales would be enhanced.

Companies have used a variety of other ways to successfully slow down or block the entry of new players. In some situations, intellectual property can be an effective tool, but it usually does not provide an insurmountable barrier. Depending on the nature of the business, effectively locking up the key channels for reaching customers, or controlling the supply of a key component, may be more effective. Minnetonka, which pioneered the idea of selling liquid soap conveniently dispensed by a small pump, used the latter tactic. With the initial success of Softsoap, the challenge became how to delay or prevent new entrants that would likely include such powerful companies as Procter & Gamble and Unilever. Minnetonka realized that the best way to slow down the entry of new players was to buy up the global supply of the little pumps, delaying the entry of the giants by more than a year. This gave it a chance to build its own brand equity and market position.

Conclusions

The framework proposed in this *Perspectives* could lead to intensive and creative discussions among the members of the management team, both before deciding to enter a market and as an ongoing analysis tool as strategies and tactics are refined over time. Complementors, in particular, are often ignored or not leveraged to maximum advantage. A diligent application of the six market forces model can ensure that the company focuses its scarce resources on potentially profitable markets, and that it then generates as much profit as possible from the markets it does compete in.

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