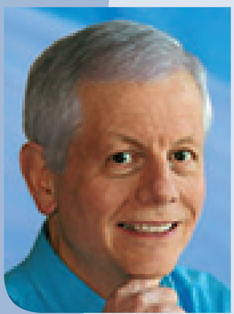
IMD
No. 133, May 2006
Perspectives for Managers
www.imd.ch

Pay Less, Get More – The Growing Challenge of Value Competitors



Adrian Ryans
IMD Professor
of Marketing and Strategy

Value competition is a growing phenomenon in many industries that managers simply can't ignore. Value competitors offer "good enough" products and services at very attractive prices, and their value propositions are often very appealing to some market segments, often rapidly growing ones.

In North America and Europe value competitors are capturing growing shares of many product and service markets. Companies such as Ryanair, easyJet and fifty other low-cost carriers in Europe have captured over 25% of the intra-Europe airline trip market. In the UK domestic market their share is approaching 50%. Low-cost carriers are now leading players in almost every major regional airline market in the world. In financial services, value competitors also prosper, such as ING Direct. In 2005 ING Direct delivered over € 600 million of pre-tax profit to its parent company, a 40% increase over the previous year. In food retailing, hard discounters are capturing a growing share of the market in many countries. Aldi and Lidl have captured over 40% of the German retail grocery market. Wal-Mart is increasingly dominant in the United States. In many business-to-business markets, local value competitors are capturing significant market shares in countries like China and India. Some are now rapidly moving out of their low-cost niches to challenge Western companies both in Asian and in Western markets. Huawei, a Chinese telecommunications and networking company, has been doubling its international sales in recent years, albeit from a small base, and is now a supplier to some major European carriers.

Managers need to pay attention to value competitors for two major reasons: they can often learn from them, and in some cases they need to move quickly against them, if they are to take advantage of new market opportunities and to respond to what may well be their biggest long-term competitive threat.

Why Have Value Competitors Become Such a Major Threat?

The threat from value competitors seems more pervasive and serious than it was a few years ago. In the past, many companies were able to dismiss value products and services as having poor quality and unacceptable service. And sometimes they were right. But today, for certain customer segments the "quality" of some of these products and services not only matches, but may actually exceed that of the traditional players. Some customers prefer to order products or services, or conduct transactions over the Internet, at a time convenient to them, rather than waste time dealing with a poorly trained sales or service representative in person or at a call center.

It is easier than ever before for companies to be able to offer "good enough" quality products or services. For example, with the growth of design houses and electronic-manufacturing-service (EMS) companies it is very easy for a wide range of companies, such as retailers, to brand and sell consumer electronic products, which are often positioned as value offerings. Companies like Li and Fung play the same role in a variety of consumer hard and soft goods. ING Direct can put together an attractive mortgage offering

by outsourcing most of the activity to a third party. In industry after industry the barriers to entry, particularly in the value segments of the market, have come tumbling down, increasing the degree of competition from value players.
Many companies, particularly in Asia, have built strong value offerings in meeting the needs of many customers in their local markets. In the case of Chinese and Indian companies, some of them have built tremendous scale and scope based on the size and diversity of their domestic markets. When they finally emerge on the world stage, some have unbeatable value propositions, not only for the value segments of the markets, but also for some customers that want more complete and sophisticated solutions. If Western companies don't challenge them in the core value segments in their domestic markets and allow them to build scale and sophistication, they may be unstoppable when they do emerge in global markets.

What Can We Learn from Value Players?

Successful value players are very good at understanding the needs of their target segments and tailoring a "good enough" solution for them. They are absolutely ruthless in eliminating features that their target customers don't value, or can be convinced that they don't value. They do not necessarily take customer input at face value! When Ryanair became the first major airline to eliminate "free" checked luggage to drive down its costs, some observers were less than happy. But Ryanair combined the move with lower fares, and web check-in that gave passengers who use it priority boarding, to make the move palatable. In a few months its target customers did adjust to the new regime, and Ryanair had extended its competitive advantage and attracted even more passengers with its new lower prices. The best of the value players have very clear value propositions, and adhere to them closely. As Michael O'Leary has said, "We guarantee to give you the lowest airfare. You get a safe flight. You get a normally on-time flight. That's the package. We don't and won't give you anything more on top of that." Some value players are adept at identifying complementary products and services that some of their customers might be interested in. They offer these optional features at attractive prices, often by working with complementors or suppliers. This can be an important source of revenue, and, more importantly, profits. Again, Ryanair is a leader in the airline industry in this regard, generating ancillary revenues of about € 250 million in Fiscal 2006, much of this going directly to the bottom line.

"Managers may need to move quickly against value competitors in seizing new market opportunities."

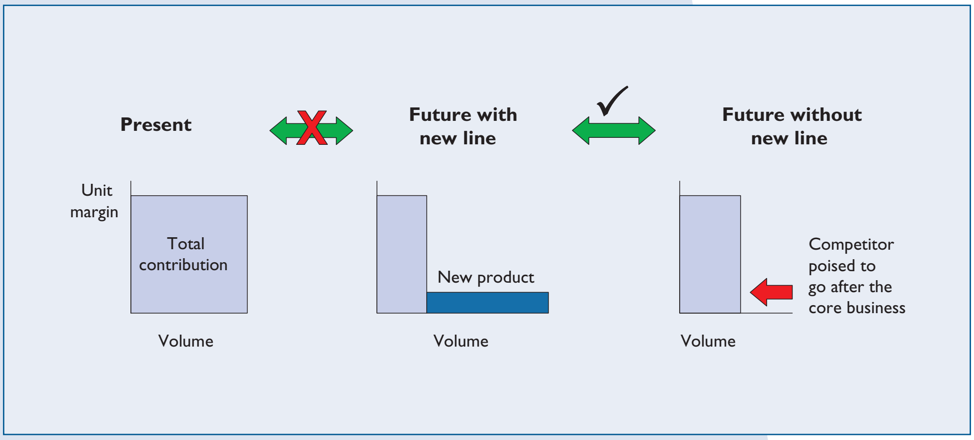
Many established "high-end" companies can learn a lot from their value competitors, both in terms of eliminating costly features that may not be valued by segments of their customers, as well as in developing innovative ways to reduce costs that may even create customer value. Recently Lufthansa began "over-nighting" seven of its planes and the associated flight crews in Hambourg, rather than having them spend the night at different airports around Europe. This is something Ryanair does routinely to reduce costs. However, Lufthansa found that having the same attendants on some of the same flights day after day resulted in them getting to know the regular customers on these flights, thus increasing satisfaction for both groups.

Responding to the Threat of Value Competitors

While in almost every case we can learn from our value competitors, in some cases we must respond to the threat they pose to our core business. In certain situations there may be real barriers that prevent value competitors from capturing an ever larger share of the overall market, as they move upward both to escape the intense price competition at the bottom of the market and to take advantage of what they see as the "easy, juicy" profits in the "up market" segments. Unfortunately, in many situations the barriers are more imaginary than real, and there is little to prevent them from attacking the traditional players in their core businesses. The most effective barriers are the ones which result from the required business models in the different parts of the market being fundamentally different. This makes it very difficult for a competitor to compete effectively in different segments of the market at the same time, even with the effective use of partners.

If a company must confront and fight value competitors, the sooner it takes the initiative the more likely it is to be successful – companies must be paranoid about every potential threat. But meeting the threat is never as easy as one might hope.

One of the major barriers to effective response is in the heads of the executives that must make the fundamental decision whether to respond. For the sake of simplicity, let us assume that the way to respond to the value competition is to introduce a new product that will compete directly with the value competitors' offerings, and at a competitive price. As the diagram below suggests, there are three financial perspectives that must be considered: the present situation, the future with the new product, and the future without the new product. In the "present" the company often has good volumes at attractive margins, and is making good profits in the business. The "future with the new product", while often adding some incremental volume albeit at significantly lower margins, often results in the company cannibalizing some of the sales of its existing high-margin business. At first glance, this does not look like an attractive proposition for the shareholders. However, the third perspective is usually even less appealing. Here the value competitors have eroded some of the existing business and are now well established. And they are often well positioned to go after the company's core, high-margin business. The relevant comparison should always be between two futures: the future where we take on the value competitors with truly competitive offerings versus the future where we ignore them and jeopardize our future prospects. However, too often we see management teams debating the merits of the present versus the future with the new product. The present is wonderful right now, but it is gone forever, and the real issue now is which of the two "future" perspectives leaves us better positioned.



In some cases, the business model that is required to challenge the low cost competition is so fundamentally different that it is very difficult for a busines unit, or even two separate focused business units, to compete effectively with the value competitors. This is why to date no full service airline has been able to compete successfully over an extended period of time with a sophisticated regional low cost career. Many of the world's leading full-service airline carriers have tried - and failed. The good news in this is that these same low cost carriers may not be a threat to the full service airlines core long haul business. However, new value competitors with business models more attuned to the long haul opportunity may still pose a significant threat, and this is already in evidence in some key long haul markets.

Another significant barrier to effective response to value competitors is the corporate culture, particularly the product development or engineering culture and the sales culture. The CEO of Danfoss, a leading Danish industrial controls company, recently stated that it would be difficult for his Western engineers to design a truly low cost product for the Chinese and global markets, because their engineering culture is so ingrained with delivering high quality that they do this for every aspect of their products, and this naturally drives up costs. Danfoss is planning to use acquisitions of Chinese companies to close this gap.

At least as important in many Western companies is the sales culture. Even in developing countries they are often so used to selling high-end products against the value offerings of their competitors

“ In industry after industry, the barriers to entry, particularly in the value segments of the market, have come tumbling down. ”

that they are unable to change, even when they have genuine value-oriented products in their own product lines. They often lack access to, and relationships with, the potential customers for the value offerings. And even if they do overcome these problems, they may use the value offering as a "foot-in-the-door" product to give them an opportunity to sell their higher-priced, higher-margin traditional offerings. If the value offering is not effectively distributed and effectively sold to the target customers, then it will be of very limited value in challenging the value competitors. In some cases, this requires the company to totally re-think its distribution and sales strategy to take advantage of the value opportunity and to effectively challenge the value competitors. Companies such as Unilever and Cummins have done this in order to take full advantage of the value opportunities facing some of their businesses in the Indian market.

Value Competition – Threat and Opportunity

Value competition is the new reality in industry after industry. Established players can view it as a threat or an opportunity. For most companies value competition represents an important stimulus and opportunity for learning. It almost always causes companies to rethink the segmentation of their markets and to develop a deeper understanding of needs by market segment.
Many companies, despite evidence to the contrary from numerous industries, are complacent and think that they are immune to the threat of value competition. In 2005, the CEO of an Italian company, one of the world leaders in high–tech fitness equipment, was quoted as saying, "If you have innovative products... the Asians are not a problem." He, like many before him, was probably underestimating how attractive some customers might find more basic value products. Undoubtedly, as the health and fitness craze takes a stronger hold in China and other developing markets, more local competitors will emerge, and some will move up to more sophisticated products that will be attractive to customers all over the world. The Italian company may have been better off moving quickly and competitively to counter the threat, even if it did cannibalize its high end products. If it were successful, it could build barriers to competition by denying its emerging competitors high profits, big volumes, and the resultant experience-curve effects. It might also be able to lock them out of some potential channels of distribution, particularly in the developed world.
GE Medical Systems has been quite successful in developing a series of products designed and built in China for value conscious Chinese customers. These products typically have perhaps 80% of the functionality of products designed in the West, but might sell at 50% of the price. Although initially designed for the Chinese market, they have also gained acceptance in value-oriented segments of the market all over the world. As GE and others have demonstrated, there can be real profit opportunities in the value-oriented segments of markets.

Conclusion

Value competition is a growing reality in most industries. Management teams ignore it at their risk and peril, and it should be a priority issue on the top management teams' agenda. Often the team can get good ideas for improving its own business from studying value competitors, not only from its own industry, but also from other industries. Companies should regularly re-visit their value proposition to make sure that it is still relevant for for their target segments. They should ensure that the business system designed to deliver the value proposition is still the best one, and that it is not in need of a re-tuning or more radical change.
If a company decides that it should move against emerging value competitors, it is almost always better to move quickly and more aggressively than it thinks it needs to. Even then it will probably not be moving fast enough!

IMD
P. O. Box 915, CH-1001 Lausanne,
Switzerland
Tel.: +41 21 618 0111
Fax: +41 21 618 0707
info@imd.ch
http://www.imd.ch

Editor: Roger Whittle

IMD INTERNATIONAL
Real World. Real Learning®