

Mark L. Frigo, Editor

Overcome the Dangers of Commoditization

BY ARNOLDO C. HAX

There is something paradoxical going on with strategy in most organizations—at least the ones that I have run into. On one hand, the need for strategy is real and intense. Companies are facing adverse conditions aggravated by increased competition, lack of growth oppor-

tunities, and an erratic capital market. They also need to make significant investments in hardware and software technologies whose returns seem to be elusive. Despite these realities, there's a lack of proper strategic thinking that seems to significantly impair the development of an organization's potential. Executives seldom know how to get started, particularly because of "vision." How can we capture the essence of how we want to position ourselves in the marketplace, and how can we communicate that enthusiastically inside and outside the organization?

Also, the new technologies, particularly those around the Internet, have allowed us to achieve a degree of interconnection that had never been possible. This means that the *network* has become the relevant focus of strategic scope. A company has to be perceived as part of a coherent system formed by suppliers, customers, and,

most critically, complementors—firms that deliver products and services that enhance our own product and service portfolio. This constitutes the *extended enterprise*. No company can afford to play the game alone. Therefore, a smart vision should be expansive and outwardly oriented so that we can leverage our extensive set of resources.

At the same time, the technology is allowing us to treat our customers in a singularly individualized way, if we choose to do so. We can seek a close proximity to the customer and deliver a value proposition designed to satisfy a customer's specific needs. This simply means that the customer is placed at the center of strategy and that the primary objective is *customer bonding*: establishing a constructive and enduring relationship based on mutual trust, collaboration, and joint benefits.

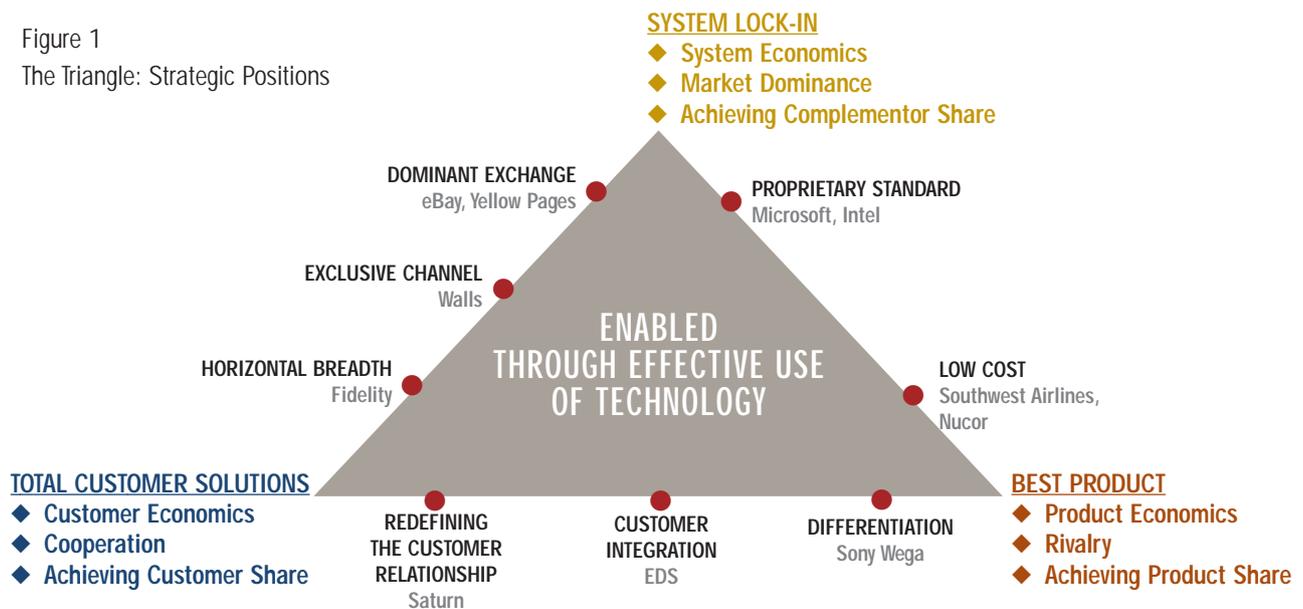
Under these new conditions, I am

dismissing the old paradigm of perceiving the ultimate goal of strategy as achieving *competitive advantage*. It is a dangerous fallacy that asserts, either explicitly or implicitly, that strategy is war and that the way to win it is to beat our competitors, usually by offering superior products.

This kind of behavior often leads to the commoditization of the product offering. By being obsessed about competitors, we tend to imitate them, and this leads to the convergence of an industry where all of the key players begin to respond by following in each other's footsteps. Imitation leads to sameness, and sameness will never lead to greatness, which is the required characteristic of an outstanding company.

I believe in three tenets of strategy: first, the achievement of superior economic performance; second, the establishment of customer bonding through a unique and differentiated value proposition; and third, the creation of a spirit of success established by attracting and retaining superior talent. Commoditization goes against each one of these tenets and should be avoided at all cost. With a commodity business you will never enjoy outstand-

Figure 1
The Triangle: Strategic Positions



The Triangle is part of a new management framework that we have developed under the title The Delta Model. For a comprehensive exposure, please refer to A. Hax and D. Wilde, *The Delta Project*, Palgrave Macmillan, 2001.

ing economic performance, you will never provide unique offerings to your customers, and, most importantly, you will never be able to attract and retain the most valuable talent.

I view strategy as the pursuit of a strong collaboration between the firm and its logical partners that leads to customer bonding. The task isn't easy, but it could be immensely rewarding. (I'll describe how to accomplish it and share with you the lessons and experiences I have collected along the way).

The Alternative Strategic Positionings—the Triangle

The three options represented in the Triangle (Figure 1) are the starting point for developing a strong vision. I have found it helpful to present managers three ways to accomplish the desired customer bonding. Although, in practice, most organizations find themselves in a hybrid situation, it's useful to reflect on these options as if they were mutually exclusive, representing very different approaches to

managing the business.

At the right-hand side of the triangle is the Best Product positioning. The way to attract, satisfy, and retain the customer is through the inherent characteristics of the product. This position is rather inward and narrow, based on the prevailing product economics. The major strategic driving forces are the development of an efficient supply chain, which guarantees a low-cost infrastructure; a proven internal capability for new product development, which assures the proper renewal of the existing product line; and the securing of distribution channels, which massively transfer the products to the targeted market segments. The yardsticks for this strategy are relevant competitors that we are trying to equal or surpass. Frequently the products are standardized, and the customers are faceless and generic. Commodization is a real threat and often an unavoidable outcome as imitation becomes a preferred pattern of competition. The measure of success here is product share, which ultimately can fragment

the business activities in a disconnected set of product offerings.

At the left-hand side of the Triangle sits the option called Total Customer Solutions, which represents a 180-degree departure from the Best Product position. Rather than selling standardized, isolated products to depersonalized customers, we are providing solutions consisting of a portfolio of customized products and services that represent a unique value proposition to individual customers. Instead of acting alone, we engage the relevant set of partners that constitute our extended enterprise. Instead of engaging in a war of attrition against our competitors, we seek cooperation that establishes the desired customer bonding. The relevant overall measure of performance becomes the total customer share, whose needs we are attempting to satisfy in as comprehensive a way as possible. Our supply chain isn't relevant—what's relevant is the combined chain that includes us, the customer, and our key suppliers. The joint development efforts with our customers are central to our success.

Customer economics, not our product economics, guide us since we are trying to help the customer enhance his or her financial performance.

At the top of the Triangle stands the most demanding strategic option, System Lock-In. Here we are addressing the full network as the relevant scope, the gaining of complementors' share as the ultimate objective, and the system economics as the driving force. Those who are successful in reaching this position gain a de facto dominance in the market that assures them a customer lock-in and a competitor lock-out.

Complementors play a key role because they are the basis for the consolidation of this power. Bill Gates is the richest man in the world, not necessarily because he has developed the best product or excels at customer attention but because he has an army of people working for him who aren't on his payroll—all of the application software developers who are writing for the Windows-compatible operating systems. Once you reach lock-in, it's hard for someone to take it away from you because of the so-called network effect, which creates the proverbial virtuous circle: Customers want to buy the computer with access to the largest set of applications, and software developers want to write applications for the computers with the largest installed base.

Not every organization has the capacity or the ability to reach a System Lock-In position. Nevertheless, the need to consider the full network as the relevant business stage and the pursuit of close linkages with complementors are relevant for developing an effective strategy, no matter what your ultimate goal might be. Moreover, the transformation that a company should undertake to move away from a commoditized product-

centric mentality into a Total Customer Solutions position is, in my opinion, a mandatory challenge for all executives. In my work with different companies, I have found the Triangle to be an extremely effective tool to open the minds of executives to different strategic alternatives.

Options for Each Strategic Positioning

The Triangle also illustrates the basic options that are usually available to capture the desired strategic position.

The Best Product strategy rests on the classical form of competition that dictates that there are only two ways to win: through low cost or differentiation. The problem is that differentiation is seldom a source of sustainable advantage since, once the strategy is revealed and becomes public, technology often allows a quick imitation that neutralizes the competitive advantage sought. If that's the case, the only viable option available to the Best Product strategy is low cost, which explains why commoditization is such a prevailing outcome in this corner of the Triangle. The low-cost position doesn't provide much room for success. After all, how many players can enjoy a low-cost advantage simultaneously? This gives rise to undesirable effects, including excessive rivalry, imitators, and the adverse impact on margins and profitability for all the players.

Yet there are obviously successful companies in this corner of the Triangle. The figure shows Sony Wega as offering a differentiated product in TV sets, although the durability of its differentiation is debatable. In the low-cost position are two very successful companies in rather mediocre industries: Southwest in the commercial airline industry and Nucor in steel. The fact that these are excep-

tions to the rule underscores the difficulties of achieving successful competition in this corner.

Given the adverse structural characteristics of the Best Product positioning in many situations, I wonder why so many companies fall into the trap of accepting this option as the only one available. The transformation toward a Total Customer Solutions position requires a very different way to capture the customer and a very different mind-set.

There are three options that you should pursue simultaneously. First, redefine the customer engagement process. Segment your customers carefully, arrange them into proper tiers that reflect distinct priorities, and provide a differentiated treatment to each tier. Saturn did this when they redefined the experience of buying and owning a car in the U.S. Second, think hard about how to use your capabilities to perform some activities for customers that they used to do themselves because you can execute much more effectively. This is customer integration, and it's the signature business of EDS, a company that redefined IT outsourcing in the U.S. Third, consider expanding the breadth of products and services you are providing to the customer as much as possible. Paramount example of that positioning is Fidelity, a firm that provides full coverage of financial services to their customers. These three options should be carried out simultaneously for a Total Customer Solutions strategy with the most impact.

Now for System Lock-In. One powerful way to achieve it is through the development and ownership of industry standards. Microsoft and Intel—two magic complementors—have done this with the Wintel operating system and chip business in the

PC market. Another way to reach System Lock-In is to have the exclusivity of the channels of distribution that customers use to avail themselves of the product. Limited shelf space is a usual trick. This has happened in Europe and Asia with Walls ice cream, which provides small merchants a refrigerated cabinet that can only be used for that product. The final option is dominant exchange, where you have a dominant position, such as eBay and Yellow Pages, in serving as a unique link between sellers and buyers.

Change Your Mind-Set

The perception that emerges from the Triangle is quite straightforward. The competencies required for a successful positioning in the Best Product strategy are a strong product base, a solid supply chain infrastructure, and internal innovation capabilities to match. Yet often they aren't enough for your business to excel. You need to push the organization closer to Total Customer Solutions and to seek and seize—whenever possible—opportunities for a System Lock-In. The rewards for pursuing these strategies could be significant.

But there also are many obstacles to avoid and overcome, so you'll have to change your mind-set from a product-centric to a customer- and complementor-centric disposition. In doing this, challenge conventional wisdom. Here are some thoughts that might help you get started.

Commodities exist only in the minds of the inept. The trap that you could fall into is to concentrate your attention strictly on the product. Some products can't be differentiated in terms of their internal properties, so it seems like they are a commodity—copper, for instance.

Who could say that Chilean copper is superior to American or Zambian copper? What is relevant is that customers aren't commodities—they are distinct and unique in the way they use the product, and that is central. The way in which Carrier, the world's leader in air conditioner manufacturing, uses copper is completely different from the way General Motors does. If you ignore that and don't reflect those differences in your product offering, you are commoditizing and short-changing your potential.

Select your customer—don't let the customer select you. If the customer is at the center of strategy, customer selection is a critical managerial decision. Yet many companies let a customer come to them without any careful targeting or screening. It isn't surprising, therefore, that they often end up with the customers left over by their competitors and who might not be on their preferred list.

The customer isn't always right. The proper interaction with customers goes beyond just listening to their needs—it's to jointly develop a mutually acceptable proposition where you uncover how your capabilities, complemented with those of external parties, can generate products, services, and solutions that weren't apparent.

The customer doesn't have power over you. Some people want you to believe that the most serious antagonistic player is the customer! The idea is that the customer has become more sophisticated and informed and thus able to transform this knowledge into power to use against you. The relationship with the customer should be based on mutual trust, fairness, and win-win opportunities. This is the most intelligent and the only reasonable way to conduct business.

Sales are too important to be left to the sales force. In an extreme form of

Best Product organization, the sales force of one organization deals with the purchasing department of the other one. This clearly prevents both companies from generating the greatest rewards. For Tier 1 customers, top executives of both firms must meet to decide on the mutually agreeable value proposition. Direct contact of multifunctional teams is at the heart of proper strategy execution.

Technology is too important to be left to the technical staff. Often companies limit the use of their technological know-how to imbed it into their products and processes. This works fine if you are deploying a Best Product strategy, but not in the other corners of the Triangle. Technical knowledge should be a key component of the design of the customer value proposition and should be performed through joint multifunctional teams, not in the solitude of the laboratories.

Achieving Your Potential

The way to win isn't to beat your competitor but to bond with your customer. If you follow this advice, it will change the way you do business in a more constructive way. ■

Arnoldo C. Hax is the Alfred P. Sloan Professor of Management at M.I.T. You can reach him at ahax@mit.edu.

Mark L. Frigo, Ph.D., CPA, CMA, is director of The Center for Strategy, Execution and Valuation and Eichenbaum Foundation Distinguished Professor of Strategy and Leadership in the Kellstadt Graduate School of Business at DePaul University. He is a leading expert in strategy design and execution and co-developer of the Return Driven Strategy framework with Joel Litman. You can reach Mark at mfrigo@depaul.edu.