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Commodity-Price Trap

BY GRAHAM KENNY

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I'm often asked by clients in such industries as electricity, food, concrete mixers, reinforcing steel, and professional services, how to get a decent price for their products or services. Their products and services are rapidly becoming "commoditised", they complain, and "everything comes down to price".

It's a good question and one that doesn't have easy answers. Before I make some suggestions, let's see if we can come to a precise definition of what makes a product or service a commodity.

What's a Commodity?

We might start off by noting that a commodity exists where a product or service has become standardised. Primary products like iron ore, wheat, wool and coal are classic examples. But manufactured products such as electricity and products for which detailed specifications and designs are laid down can also move into the commodity class – concrete and reinforcing steel, for instance.

Services, too, can become commodities. An article in the Sydney Morning Herald dated November 22, 2002, announced a "Sombre Mood in Julia Ross". Julia Ross Recruitment is a public company providing recruitment services to organisations. The accompanying picture showed three glum-faced directors at their annual general meeting, with the Chairman announcing that "this market is becoming increasingly competitive and commoditised, with resultant pressure on margins". Julia Ross faced fierce competition for contracts from global recruitment firms such as Adecco, TMP and Manpower. The result was a profit downgrade, and their shares tumbled 25 per cent from a week earlier.

Commoditisation has also occurred in the legal profession with the conveyancing of property. Once thought to be tricky and complex, now conveyancing is carried out by specialists for a fixed fee and at "low cost".

It appears few industries are free from this phenomenon of commoditisation.

Characteristics of Commoditised Industries

When a product of service drifts towards the commodity category, strategic factors such as product or service features become standardised. As a result, customer focus gravitates towards price, and the opportunities a business has to differentiate itself from its competitors appear to narrow.

A look at a few different industries will show us how strategic opportunities vary according to the extent to

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which a product or service has become a commodity.

In the case of a manufacturer purchasing electricity from Energy Australia, the strategic factors in its relationship with the supplier include price, service quality (supply reliability) and customer service. Since there are no types of electricity, one of the strategic factors, product range, isn't relevant. As the manufacturer rarely needs service and takes the quality for granted, the focus goes onto price.

This is different from a consumer of canned fruit and vegetables produced by organisations such as SPC, Heinz and Golden Circle. Here the strategic factors relevant to consumer choice are more numerous and include price, image/brand, product quality, packaging, product range, availability and consumer service. Not only is the range of strategic factors wider than in the case of electricity (and other commodities), but so is the variation in product quality between brands. And image/brand is very important to consumer choice. It plays a larger and larger part as we move away from classic commodities.

If we look further afield, at professional services, we see even greater opportunities for differentiation and price variation. Take a large law firm like Minter Ellison. Its clients and non-clients make their choices based on strategic factors such as price, image/brand (perceived expertise), service quality, service range and client service. A key difference here is that, unlike electricity and canned food, product/service quality is difficult for a client to assess. The service is administered by lawyers whose expertise clients can't evaluate. As a result, value, the weighing up of strategic factors, including price, becomes tough to appraise. Image/brand becomes a signal for service quality and value. Thus, if they get their image and reputation right, lawyers can charge premium prices.

Can product or service providers in commodities learn from food manufacturers, law firms and others? I think they can. Here are a few suggestions for avoiding the commodity-price trap:

- ***Identify the Strategic Factors for Your Customers.*** If you don't, you can't do anything effective in competitive strategy. Strategic factors are the decision criteria used by both your customers and non-customers to choose or not choose you over your competition. In the case of a provider of public seminars to managers, for example, these include location of seminar, image/reputation of company and presenter, learning outcomes, seminar duration, timing, customer service and price. Understand the importance of all of these, and you're on your way to developing effective strategy and moving the emphasis away from price alone. Otherwise, price will tend to dominate.

- ***Avoid Tendering Situations.*** One of our clients, who manufactures concrete mixers that go on the back of trucks, and whose customers and non-customers are Pioneer, CSR Readymix and Boral, among others, complains that the person who decides on the successful tenderer in these organisations is a "bean counter". Such a person, our client says, isn't able to assess the differences in the labour-saving, maintenance-saving and efficiency features of his mixers. As a result, the decision can come down to nothing but the difference of a few dollars on price. The decision-maker may be shortchanging his or her organisation in the long term, but it never gets to know. If possible, don't go there!

- ***Sell to Senior Management.*** When products or services become commodities, the decision on who gets the work is frequently delegated to lower organisational levels – as in our concrete mixer example above. The more junior person probably doesn't appreciate the true value of the product or service to the organisation. Senior management, by contrast, is in a far better position to look beyond mere price and to appreciate value – value based on price and performance. This means evaluating achievements on strategic factors such as product or service quality, product or service features and ongoing customer service.

- ***Sell Value, Not Price.*** Think of products or services that are expensive in their categories: Rolls Royce in cars, TAG-Heuer in watches, Mont Blanc in pens and Sofitel in hotels, to take but a few examples. None of these compete on price – they couldn't, since a potential customer has the option of paying just $25,000 for a car, $15 for a watch and so on. What these companies do compete on is value. Price is balanced against other strategic factors such as product features, service range, image and customer service. To avoid the commodity-price trap, always bring the buyer back to value – in all promotional material, project proposals, etc. But to be able to do this, you have to look at value from the customer's point of view. And this is quite a challenge for many inward-looking, production-oriented businesses.

- ***Include Additional Products or Services.*** One way for a business to differentiate itself from its competitors is to provide something extra at no charge. In the case of an engineering consultancy such as the CSIRO, this could be the provision of software to ensure that the assistance already provided is successfully implemented. In the case of a car manufacturer such as Toyota, this could be an extended warranty on parts or free roadside support for a limited period. For a supplier of reinforcing steel such as One Steel, it could be the provision of free technical advice. In each of these cases, the extras wouldn't cost the business a great deal, yet could be powerful differentiators. Explore ways of providing something extra to your customers at no charge.

- ***If an Exporter, Consolidate Supply.*** The Australian Wheat Board (AWB) operates as a "single desk". This means that Australian wheat is sold overseas through one seller only, and buyers are unable to pit one Australian wheat producer against another, thereby forcing Australian wheat prices down. There have been many attempts from overseas to break up the AWB, but so far they have been unsuccessful. The lesson for other commodity producers in products and services is, where possible, to consolidate your offering and avoid competition on price alone. But don't try this within the country – it might be labelled collusion.

- ***Build Your Brand.*** A brand communicates many things. First off is the image of your organisation, and here Mercedes Benz, IBM and Coca Cola come to mind. Your reputation – for good or bad service, for instance – also gets wrapped up in your

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brand. Creating brand awareness among customers can generate brand loyalty, provided you deliver value consistently. The message, then, is to differentiate yourself from your other "commodity producers" so as to promote your brand and what it stands for: quality, professionalism, integrity, thoroughness, expertise. Remember Australian wool's promotion around its brand and the image it wished to create with "pure new wool"?

- ***Build Relationships.*** A further way to take the emphasis off price is to place it on people – your organisational team and your customers. Such an emphasis involves developing a rapport between a member or members of your organisation and the decision-makers in your customer's organisation. There are numerous ways to do this: Christmas parties, corporate gifts, etc. One that is prominent at sporting and other entertainment events is the corporate box. A range of companies, in fact, make it a point to entertain their clients in order to develop personal relationships with them, as distinct from the more formal business relationships.

  Mention of "relationship" brings to mind another and less expensive form of rapport-building: relationship marketing. Via newsletters, articles and emails, a company keeps in touch with its client base. For example, it may decide to provide clients with free updates on an important topic.

  All these methods are subtle ways of building customer confidence in your company. It's a way of proclaiming: "There's more to us than price; we're not just commodity producers".

- ***Invest in Negotiation Skills.*** A client that supplies equipment to the mining industry is heavily dependent on the contracts it's able to negotiate with its customers, suppliers and contractors. Dollars saved with suppliers and contractors and made with customers go straight to the client's bottom line. But this client of ours has recognised that the deals it strikes are negotiated by a wide range of its managers. Geographically dispersed, they are often left to their own devices and vary enormously in their negotiation capabilities. Senior management has acknowledged that these managers may have had their prices bargained down and may have fallen into the commodity-price trap. The decision? To improve managers' negotiation skills. We would add: as part of this improvement, have managers understand the strategic factors for customers, suppliers and contractors.

- ***Test the Profitability of Your Customers.*** Before you fall into the commodity-price trap and are pushed around by your customers, assess how profitable they are to you. Most businesses know their own profitability as a whole; many know what it is for the various units within the business; some are even aware of which specific products make a profit. These are numbers that flow from the accounting system and a series of breakdowns. But assessing the profitability of customers requires a form of aggregation, across product lines, and most businesses don't have this knowledge. When you do the assessment, allocate all costs, including capital costs, such as office, store or factory space, and overhead costs, such as office staff's time. You may be surprised to discover that the very customers which see you as a commodity producer, those who are your biggest pains in the neck, are actually making you lose money.

  To cite an example: a client of ours, a manufacturer of trusses and frames for houses, mills timber to size and sells mouldings and other builders' requirements. On analysing its customers, it found that some bought products mainly from its mill. An analysis of mill activities showed that they weren't bringing in any profit, after full costs were taken into account. The manufacturer weighed up the implications of losing certain customers if the milling operation was closed. After due consideration, the decision was made to proceed with the closure and, as a consequence, jettison the unprofitable customers. Lose the losers.

- ***Change the Industry Business Model.*** A business model is the way an organisation generates revenue and makes a profit. In most industries there tends to be a standard way of doing this and, as a result, products or services can become commodities. In the childcare industry, the business model takes the form of selling the service to parents and charging them for the care. What if the customer were re-defined: not parents, but the employers of parents – organisations? This way the childcare facility could be established at or near the workplace and subsidised by the employer, provided a case could be made that such a system reduces employee absenteeism and improves employee morale and productivity – which it can. And it's actually been done – by a US company called Bright Horizons. Following their example, you might figure out how you can do this in your industry, to escape the commodity-price trap.

- ***Exit the Industry.*** If all the previous suggestions do not appear feasible or seem just too hard, the last resort might be to get out of the industry or industry segment altogether. You might sell the business entirely and move to greener pastures, or change your emphasis. As an example of the last option, take the concrete mixer manufacturer previously discussed. Companies in that industry also make concrete silos, weighbins for sand and gravel, and other similar products. These products are customised to client needs, and money can be made from them. Some manufacturers are exiting concrete mixers in order to concentrate on these industry segments where money can be made.

The Need to Re-focus

Many managers who get caught up in the commodity-price trap become tunneled in their thinking, sucked in by a mind-set. This phenomenon can overtake a whole industry – remember the recruitment field and Julia Ross Recruitment. The result is that organisations can become purely price-driven.

The suggestions I've made here to avoid this trap should assist you to re-focus your business.

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A commodity trap is where a company sees its competitive position being eroded so that it can no longer command a premium price in its market. In a commodity trap, consumers receive more product benefits for their money or pay lower prices for the same or lower levels of benefits. The result is that companies find that they can hold their prices and lose market share, or they can hold market share only by lowering prices. In either case, they have lost their pricing power. This book takes a fresh look at pricing, product differentiation and the need for decommoditisation in market sectors where products and services are standardised and interchangeable. In the first cha.Â Introduction. This book takes a fresh look at pricing, product differentiation and the need for decommoditisation in market sectors where products and services are standardised and interchangeable.