



STRATEGIC MARKETING

ninth
edition

David W. Cravens
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Strategic Marketing

Ninth Edition

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STRATEGIC MARKETING

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To Sue and Karen

DWC

To the memory of Helena G. Piercy
(1911–2001)

NFP

Preface

Strategic marketing in companies around the world is confronted with unprecedented challenges and exciting opportunities in the twenty-first century. Driven by demanding customers with complex value requirements, aggressive global competition, turbulent markets, rapid emergence of disruptive new technologies, and global expansion initiatives, marketing strategy has become an enterprise-spanning responsibility with major bottom-line implications. Central to the opportunities generated by these challenges is a critical need to improve executives' understanding of markets and competitive space, customer value delivery, innovation culture and processes, and effective organizational design.

Strategic marketing's demanding role in business performance is demonstrated in the market-driven strategies of successful organizations competing in a wide array of market and competitive situations. Providing superior customer value, leveraging distinctive capabilities, responding rapidly to diversity and change in the marketplace, developing innovation cultures, and recognizing global business challenges are demanding initiatives which require effective marketing strategies for gaining and sustaining a competitive edge. *Strategic Marketing* examines the underlying logic and processes for designing and implementing market-driven strategies.

Market-Driven Strategy

Providing superior value to customers is the core objective of market-driven strategy. Several initiatives are necessary in achieving this objective.

- Marketing strategy provides the guidelines for action that are essential in delivering superior customer value.
- Marketing is a major stakeholder in the essential organizational core processes—new product development, customer relationship management, value/supply-chain management, and business strategy implementation.
- Essential relationship initiatives place new priorities on collaborating with customers, suppliers, value-chain members, and even competitors.
- Understanding customers, competitors, and the market environment requires the active involvement of the entire organization to gain and manage market knowledge decisively.
- Developing methods that enable the organization to continually learn from customers, competitors, and other relevant sources is vital to sustaining a competitive edge.
- The powerful technologies provided by the Internet and the World Wide Web, corporate intranets, and advanced communication and collaboration systems for customer and supplier relationship management underpin effective strategy processes.
- The environmental, ethical, and corporate responsibility aspects of business practice are critical concerns for individual executives as well as their companies, requiring management direction and active involvement by the entire organization.

Customer diversity and new forms of competition create impressive growth and performance opportunities for those firms that successfully apply strategic marketing concepts and analyses in business strategy development and implementation. The challenge to become market-driven is apparent in a wide array of industries around the world. Analyzing market

behavior and matching strategies to changing conditions require a hands-on approach to marketing strategy development and implementation. Penetrating financial analysis is an important strategic marketing requirement.

Strategic Marketing examines marketing strategy using a combination of concepts, application processes, and cases to develop managers' and professionals' decision making processes and apply them to business situations. The book is intended for use in undergraduate capstone marketing strategy courses and the MBA marketing core and advanced strategy courses.

New and Expanded Scope

Regardless of business size and scope, competing in any market today requires a global perspective. The ninth edition accentuates this global perspective. The author team provides an extensive range of global involvement. The shrinking time-and-access boundaries of global markets establish new competitive requirements. The global dimensions of marketing strategy are integrated throughout the chapters of the book and also considered in several cases. The rapid emergence of powerful new competitive forces throughout the world, often facilitated by new business models, mandates an international viewpoint for executives in most organizations.

Strategic customer relationship management (CRM) is examined in a new chapter, recognizing the escalating importance of this topic in business firms and its essential role in guiding marketing strategy. Customer equity and customer lifetime value are examined along with other relevant aspects of CRM.

Innovation and new product planning and strategic brand management are given increased coverage in this edition. Enhancing brand equity has become a top priority challenge in companies around the world.

Internet initiatives comprise a vital part of the marketing strategies of all companies. Internet strategies are rapidly expanding on a global basis. Because of the nature and scope of the various uses of the Internet, we have integrated this important topic into several chapters rather than developing a separate chapter. Internet Features are included in all chapters.

Special attention and emphasis are given to marketing metrics throughout the book. Improving the measurement of marketing effectiveness is a high priority issue in many companies.

New current applications of business marketing initiatives are included in every chapter. New features examine strategy, innovations, relationship, global ethics and corporate responsibility, Internet, and metrics aspects of business practice.

Teaching and Learning Design

Strategic Marketing uses a decision-making perspective to examine the key concepts and issues involved in analyzing and selecting strategies. It is apparent that many instructors want to examine marketing strategy beyond the traditional emphasis on marketing functions. Marketing strategy is considered from a total business perspective. The length and design of the book offer flexibility in the use of the text material and cases. The feature applications included in each chapter can be used for class discussion and assignments.

The book is designed around the marketing strategy process with a clear emphasis on analysis, planning, and implementation. Part I provides an overview of market-driven strategy and business and marketing strategies. Part II considers markets, segments, and

customer value. Part III provides the basis for designing market-driven strategies. Part IV considers market-driven program development. Finally, Part V examines implementing and managing market-driven strategies. Decision process guidelines and applications are provided throughout the book to assist the reader in applying the analysis and strategy development approaches discussed in the text.

The Cases

There are 21 new cases out of a total of 44. Many are well-known companies that students should find both interesting and challenging. Shorter application-focused cases are placed at the end of each part of the book. These cases are useful in applying the concepts and methods discussed in the chapters, and they can be used for class discussion, hand-in assignments, and/or class presentations. The cases consider a wide variety of business environments, both domestic and international. They include goods and services; organizations at different value-chain levels; and small, medium, and large enterprises. The Features in every chapter provide additional illustrations and material for consideration and discussion.

Most of the cases examine the marketing and business strategies of well-known companies. The cases are very timely, offering an interesting and challenging look at contemporary business practice. Importantly, these companies have available extensive financial, product, and corporate information on the Internet, which expands analysis opportunities.

Part VI includes comprehensive cases that offer students a variety of opportunities to apply marketing strategy concepts. Each case considers several important strategy issues. The cases represent different competitive situations for consumer and business goods and services as well as domestic and international markets.

Changes in the Ninth Edition

The ninth edition of *Strategic Marketing* follows the basic design of previous editions. Nevertheless, the revision incorporates many significant changes, topic additions, and updated examples. Every chapter includes new material and expanded treatment of important topics.

Each chapter has been revised to incorporate new concepts and examples, improve readability and flow, and encourage reader interest and involvement. Topical coverage has been expanded (or reduced) where appropriate, to better position the book for teaching and learning in today's rapidly changing business environment. An expanded set of Internet and Feature applications is included at the end of each chapter. Marketing planning guidelines are provided in the Chapter 1 Appendix, financial analysis suggestions are included in the Chapter 2 Appendix, and marketing metrics are discussed in the Chapter 15 Appendix.

Teaching/Learning Resources

A complete and expanded teaching-learning portfolio is available on the Online Learning Center, at www.mhhe.com/cravens9e. It includes an Instructor's Manual with course-planning suggestions, answers to end-of-chapter questions, Internet application guidelines, Feature application guidelines, and extensive instructor's notes for each of the 44 cases. A multiple-choice question test bank and a PowerPoint® presentation for each chapter are also included online. The PowerPoints provide a complete and organized coverage of the chapter topics and application examples.

This edition of the manual has been substantially revised and expanded to improve its effectiveness in supporting course planning, class discussion, and examination preparation. Detailed instructor's notes concerning the use of the cases are provided, including epilogues when available. The text, cases, and Instructor's Manual offer considerable flexibility in course design, depending on the instructor's objectives and the course for which the book is used.

Acknowledgments

The ninth edition has benefited from the contributions and experiences of many people and organizations. Business executives and colleagues at universities in many countries have influenced the development of *Strategic Marketing*. While space does not permit thanking each person, a sincere note of appreciation is extended to all. We shall identify several individuals whose assistance was particularly important.

A special thank you is extended to the reviewers of this and prior editions and to many colleagues who have offered numerous suggestions and ideas. Throughout the development of the ninth edition, several individuals made important suggestions for improving the book.

We are also indebted to the case authors who gave us permission to use their cases. We appreciate the opportunity to include them in the book. Each author or authors are specifically identified with each case.

A special note of thanks is due to the management and professional team of McGraw-Hill/Irwin for their support and encouragement on this and prior editions of *Strategic Marketing*: Paul Ducham, as publisher, has provided an important editorial leadership role; Editor Laura Spell and Editorial Assistant Sara Hunter have been a constant source of valuable assistance and encouragement; Dean Karampelas provided important marketing direction for the project; James Labeots guided the book through the various stages of production while Matthew Baldwin polished the design.

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Brief Contents

PART ONE

Strategic Marketing 1

- 1** Imperatives for Market-Driven Strategy 2

1A Appendix Strategic Marketing Planning 27

Cases for Part One 30

PART TWO

Markets, Segments, and Customer Value 47

- 2** Markets and Competitive Space 48

2A Appendix Financial Analysis for Marketing Planning and Control 74

- 3** Strategic Marketing Segmentation 83

- 4** Strategic Customer Relationship Management 113

- 5** Capabilities for Learning About Customers and Markets 129

Cases for Part Two 156

PART THREE

Designing Market-Driven Strategies 183

- 6** Market Targeting and Strategic Positioning 184

- 7** Strategic Relationships 206

- 8** Innovation and New Product Strategy 236

Cases for Part Three 269

PART FOUR

Market-Driven Program Development 289

- 9** Strategic Brand Management 290

- 10** Value Chain Strategy 318

- 11** Pricing Strategy 347

- 12** Promotion, Advertising, and Sales Promotion Strategies 372

- 13** Sales Force, Internet, and Direct Marketing Strategies 396

Cases for Part Four 418

PART FIVE

Implementing and Managing Market-Driven Strategies 443

- 14** Designing Market-Driven Organizations 444

- 15** Marketing Strategy Implementation and Control 473

15A Appendix Marketing Metrics 499

Cases for Part Five 502

PART SIX

Comprehensive Cases 525

INDEXES

Name Index 765

Subject Index 772

Table of Contents

PART ONE

STRATEGIC MARKETING 1

Chapter 1

Imperatives for Market-Driven Strategy 2

Market-Driven Strategy 3

Characteristics of Market-Driven Strategies 4

Determining Distinctive Capabilities 5

Classifying Capabilities 6

Creating Value for Customers 7

Becoming Market Driven 7

Corporate, Business, and Marketing Strategy 8

Corporate, Business, and Marketing Strategy 10

Components of Corporate Strategy 10

Corporate Strategy Framework 10

Business and Marketing Strategy 12

The Marketing Strategy Process 13

Challenges of a New Era for Strategic Marketing 18

Escalating Globalization 18

Technology Diversity and Uncertainty 19

The Web 2.0 20

Ethical Behavior and Corporate Social

Responsiveness 20

Summary 23

Appendix 1A

Strategic Marketing Planning 27

Cases for Part One 30

Case 1-1 Audi 30

Case 1-2 The New York Times 34

Case 1-3 Coca-Cola Co. (A) 40

PART TWO

MARKETS, SEGMENTS, AND CUSTOMER VALUE 47

Chapter 2

Markets and Competitive Space 48

Markets and Strategies 49

Markets and Strategies Are Interlinked 49

Thinking Outside the Competitive Box 50

An Array of Challenges 50

Matching Needs with Product Benefits 52

Defining and Analyzing Product-Markets 53

Forming Product-Markets 55

Illustrative Product-Market Structure 57

Describing and Analyzing End-Users 57

Identifying and Describing Buyers 58

How Buyers Make Choices 59

Environmental Influences 60

Building Customer Profiles 60

Analyzing Competition 61

Defining the Competitive Arena 61

Key Competitor Analysis 64

Anticipating Competitors' Actions 66

Market Size Estimation 67

Market Potential 67

Sales Forecast 68

Market Share 68

Evaluating Market Opportunity 68

Developing a Strategic Vision About the Future 70

Phases of Competition 70

Anticipating the Future 70

Summary 71

Appendix 2A

Financial Analysis for Marketing

Planning and Control 74

Chapter 3

Strategic Marketing Segmentation 83

Levels and Types of Market Segmentation 84

Market-Driven Strategy and Segmentation 86

Market Segmentation, Value Opportunities, and

New-Market Space 86

Market Targeting and Strategic Positioning 87

Activities and Decisions in Market

Segmentation 89

Defining the Market to Be Segmented 89

Identifying Market Segments 90

Segmentation Variables 90

Characteristics of People and Organizations 90

Product Use Situation Segmentation 91

Buyers' Needs and Preferences 93

Purchase Behavior 94

Forming Market Segments 96

Requirements for Segmentation 96

Approaches to Segment Identification 98

<i>Customer Group Identification</i>	99
<i>Forming Groups Based on Response Differences</i>	102
Finer Segmentation Strategies	104
<i>Logic of Finer Segments</i>	104
<i>Finer Segmentation Strategies</i>	105
Selecting the Segmentation Strategy	106
<i>Deciding How to Segment</i>	106
<i>Strategic Analysis of Market Segments</i>	106
Summary	109

Chapter 4

Strategic Customer Relationship Management 113

Pivotal Role of Customer Relationship Management	114
<i>CRM in Perspective</i>	114
<i>CRM and Database Marketing</i>	114
<i>Customer Lifetime Value</i>	115
Developing a CRM Strategy	116
<i>CRM Levels</i>	116
<i>CRM Strategy Development</i>	118
<i>CRM Implementation</i>	119
Value Creation Process	121
<i>Customer Value</i>	121
<i>Value Received by the Organization</i>	122
<i>CRM and Value Chain Strategy</i>	123
CRM and Strategic Marketing	123
<i>Implementation</i>	123
<i>Performance Metrics</i>	124
<i>Short-Term Versus Long-Term Value</i>	124
<i>Competitive Differentiation</i>	124
Summary	126

Chapter 5

Capabilities for Learning About Customers and Markets 129

Market-Driven Strategy, Market Sensing, and Learning Processes	130
<i>Market Sensing Processes</i>	131
<i>Learning Organization</i>	131
Marketing Information and Knowledge Resources	134
<i>Scanning Processes</i>	136
<i>Specific Market Research Studies</i>	138
<i>Internal and External Marketing Information Resources</i>	138
<i>Existing Marketing Information Sources</i>	141
<i>Creating New Marketing Information</i>	143
<i>Marketing and Management Information Systems</i>	146

Marketing Intelligence and Knowledge Management 147

<i>Marketing Intelligence</i>	147
<i>Knowledge Management</i>	148
<i>Role of the Chief Knowledge Officer</i>	148
<i>Leveraging Customer Knowledge</i>	148
Ethical Issues in Collecting and Using Information	149
<i>Invasion of Customer Privacy</i>	149
<i>Information and Ethics</i>	150
Summary	151

Cases for Part Two 156

Case 2-1 Pfizer, Inc.	156
Case 2-2 Ikea	162
Case 2-3 China and India: Opportunities and Challenges	168
Case 2-4 Johnson & Johnson	177

PART THREE

DESIGNING MARKET-DRIVEN STRATEGIES 183

Chapter 6

Market Targeting and Strategic Positioning 184

Market Targeting Strategy	185
<i>Targeting Alternatives</i>	185
<i>Factors Influencing Targeting Decisions</i>	186
Targeting in Different Marketing Environments	187
<i>Emerging Markets</i>	188
<i>Growth Markets</i>	189
<i>Mature Markets</i>	190
<i>Global Markets</i>	192
Positioning Strategy	193
<i>Selecting the Positioning Concept</i>	195
Developing the Positioning Strategy	196
<i>Scope of Positioning Strategy</i>	197
<i>Marketing Program Decisions</i>	197
Determining Positioning Effectiveness	199
<i>Customer and Competitor Research</i>	200
<i>Test Marketing</i>	200
<i>Analytical Positioning Techniques</i>	201
<i>Determining Positioning Effectiveness</i>	201
<i>Positioning and Targeting Strategies</i>	202
Summary	202

Chapter 7

Strategic Relationships 206

The Rationale for Interorganizational Relationships 207

- Opportunities to Enhance Value* 208
- Environmental Complexity* 209
- Competitive Strategy* 209
- Skills and Resource Gaps* 209
- Evaluating the Potential for Collaboration* 213

Forms of Organizational Relationships 214

- Supplier Relationships* 215
- Intermediate Customer Relationships* 216
- End-User Customer Relationships* 217
- Strategic Customers* 217
- Strategic Alliances* 219
- Joint Ventures* 221
- Internal Partnering* 221

Managing Interorganizational Relationships 223

- Objective of the Relationship* 223
- Relationship Management* 224
- Partnering Capabilities* 225
- Control and Evaluation* 226
- Exiting from Alliance* 226

Global Relationships Among Organizations 227

- The Strategic Role of Government* 228

Summary 231

Chapter 8

Innovation and New Product Strategy 236

Innovation as a Customer-Driven Process 238

- Types of Innovations* 239
- Finding Customer Value Opportunities* 239
- Finding New Product Opportunities* 239
- Initiatives of Successful Innovators* 242
- Recognizing the Realities of Product Cannibalization* 244

New-Product Planning 244

- Developing a Culture and Strategy for Innovation* 245
- Developing Effective New-Product Planning Processes* 247
- Responsibility for New-Product Planning* 248

Idea Generation 249

- Sources of Ideas* 249
- Methods of Generating Ideas* 251

Screening, Evaluating, and Business Analysis 253

- Screening* 253
- Concept Evaluation* 254
- Business Analysis* 255

Product and Process Development 257

- Product Development Process* 257

Marketing Strategy and Market Testing 260

- Market Strategy Decisions* 260
- Market Testing* 260

Commercialization 263

- The Marketing Plan* 263
- Monitoring and Control* 263

Variations in the Generic New Product

Planning Process 264

Summary 265

Cases for Part Three 269

- Case 3-1 Walt Disney Co. 269
- Case 3-2 Intel Corp. 274
- Case 3-3 McDonald's Corp. 281
- Case 3-4 Tesco Plc. 285

PART FOUR

MARKET-DRIVEN PROGRAM DEVELOPMENT 289

Chapter 9

Strategic Brand Management 290

Strategic Brand Management 291

- The Strategic Role of Brands* 291
- Brand Management Challenges* 292
- Brand Management Responsibility* 296
- Strategic Brand Management* 296

Strategic Brand Analysis 298

- Tracking Brand Performance* 299
- Product Life Cycle Analysis* 300
- Product Performance Analysis* 300
- Brand Positioning Analysis* 301

Brand Equity Measurement and Management 301

- Measuring Brand Equity* 301
- Brand Health Reports* 301

Brand Identity Strategy 302

- Alternatives for Brand Identification* 302
- Brand Focus* 303
- Identity Implementation* 304

Managing Brand Strategy 304

- Strategies for Improving Product Performance* 304

Managing the Brand Portfolio 306

- Determining Roles of Brands* 307
- Strategies for Brand Strength* 307
- Strategic Brand Vulnerabilities* 308

Brand Leveraging Strategy 310

- Line Extension 310*
- Stretching the Brand Vertically 310*
- Brand Extension 311*
- Co-Branding 311*
- Licensing 311*
- Global Branding 311*
- Internet Brands 312*
- Brand Theft 313*

Summary 314**Chapter 10****Value Chain Strategy 318****Strategic Role of Value Chain 319**

- Distribution Functions 319*
- Channels for Services 321*
- Direct Distribution by Manufacturers 321*

Channel Strategy 323

- Types of Channels 324*
- Distribution Intensity 327*
- Channel Configuration 328*
- Channel Maps 329*
- Selecting the Channel Strategy 330*
- Changing Channel Strategy 331*

Managing the Channel 333

- Channel Leadership 334*
- Management Structure and Systems 334*
- Physical Distribution Management 334*
- Channel Relationships 336*
- Channel Globalization 336*
- Multichanneling 337*
- Conflict Resolution 337*
- Channel Performance 338*
- Legal and Ethical Considerations 338*

International Channels 340

- Examining International Distribution Patterns 341*
- Factors Affecting Global Channel Selection 342*
- Global Issues Regarding Multichannel Strategies 342*

Summary 343**Chapter 11****Pricing Strategy 347****Strategic Role of Price 348**

- Price in the Positioning Strategy 349*
- Pricing Situations 350*
- Roles of Pricing 350*
- Pricing Strategy 351*
- Pricing Objectives 352*

Analyzing the Pricing Situation 353

- Customer Price Sensitivity 353*
- Cost Analysis 356*
- Competitor Analysis 357*
- Pricing Objectives 359*

Selecting the Pricing Strategy 360

- How Much Flexibility Exists? 360*
- Price Positioning and Visibility 362*
- Illustrative Pricing Strategies 362*
- Legal and Ethical Considerations 363*

Determining Specific Prices and Policies 365

- Determining Specific Prices 365*
- Establishing Pricing Policy and Structure 367*
- Pricing Management 367*

Summary 369**Chapter 12****Promotion, Advertising, and Sales****Promotion Strategies 372****Promotion Strategy 373**

- The Composition of Promotion Strategy 373*
- Designing Promotion Strategy 375*
- Communication Objectives 376*
- Deciding the Role of the Promotion Components 378*
- Determining the Promotion Budget 378*
- Promotion Component Strategies 380*
- Integrating and Implementing the Promotion Strategy 380*
- Effectiveness of Promotion Strategy 381*

Advertising Strategy 381

- Setting Advertising Objectives and Budgeting 382*
- Creative Strategy 384*
- Media/Scheduling Decisions 384*
- Role of the Advertising Agency 386*
- Implementing the Advertising Strategy and Measuring Its Effectiveness 388*

Sales Promotion Strategy 389

- Nature and Scope of Sales Promotion 389*
- Sales Promotion Activities 390*
- Advantages and Limitations of Sales Promotion 392*
- Sales Promotion Strategy 393*

Summary 393**Chapter 13****Sales Force, Internet, and Direct Marketing Strategies 396****Sales Force Strategy 397**

- The Role of Selling in Promotion Strategy 398*
- Types of Sales Jobs 399*

<i>Defining the Selling Process</i>	400
<i>Sales Channels</i>	401
<i>Designing the Sales Organization</i>	402
<i>Sales Force Evaluation and Control</i>	407

Internet Strategy 408

<i>Strategy Development</i>	409
<i>Deciding Internet Objectives</i>	409
<i>E-Commerce Strategy</i>	410
<i>Value Opportunities and Risks</i>	410
<i>Measuring Internet Effectiveness</i>	411
<i>The Future of the Internet</i>	411

Direct Marketing Strategies 412

<i>Reasons for Using Direct Marketing</i>	412
<i>Direct Marketing Methods</i>	413
<i>Advantages of Direct Marketing</i>	414
<i>Direct Marketing Strategy</i>	415

Summary 415

Cases for Part Four 418

Case 4-1 Microsoft Corp.	418
Case 4-2 Nike Inc.	425
Case 4-3 Dell Inc.	433
Case 4-4 Hewlett-Packard Co.	439

PART FIVE IMPLEMENTING AND MANAGING MARKET-DRIVEN STRATEGIES 443

Chapter 14

Designing Market-Driven Organizations 444

Trends in Organization Design 445

<i>The New Organization</i>	445
<i>Managing Organizational Process</i>	449
<i>Organizational Agility and Flexibility</i>	451
<i>Employee Motivation</i>	451

Organizing for Market-Driven Strategy 452

<i>Strategic Marketing and Organization Structure</i>	452
<i>Aligning the Organization with the Market</i>	452
<i>Marketing Functions Versus Marketing Processes</i>	453
<i>Marketing as a Cross-Functional Process</i>	454

Marketing Departments 456

<i>Centralization Versus Decentralization</i>	456
<i>Integration or Diffusion</i>	456
<i>Contingencies for Organizing</i>	457
<i>Evaluating Organization Designs</i>	457

Structuring Marketing Resources 459

<i>Structuring Issues</i>	459
<i>Functional Organizational Design</i>	459

<i>Product-Focused Design</i>	459
-------------------------------	-----

<i>Market-Focused Design</i>	461
------------------------------	-----

<i>Matrix Design</i>	461
----------------------	-----

<i>New Marketing Roles</i>	462
----------------------------	-----

Organizing for Global Marketing and Global Customers 465

<i>Organizing for Global Marketing Strategies</i>	466
<i>Organizing for Global Customers</i>	467

Summary 469

Chapter 15

Marketing Strategy Implementation and Control 473

The Strategy Marketing Planning Process 474

<i>The Marketing Plan Guides Implementation</i>	474
<i>Contents of the Marketing Plan</i>	475
<i>Managing the Planning Process</i>	475

Implementing the Strategic Marketing Plan 477

<i>Implementation Process</i>	477
<i>Building Implementation Effectiveness</i>	478
<i>Internal Marketing</i>	479
<i>A Comprehensive Approach to Improving Implementation</i>	481
<i>Internal Strategy-Organization Fit</i>	481

Strategic Marketing Evaluation and Control 482

<i>Customer Relationship Management</i>	483
<i>Overview of Control and Evaluation Activities</i>	483
<i>The Strategic Marketing Audit</i>	483

Marketing Performance Measurement 486

<i>The Importance of Marketing Metrics</i>	487
<i>The Use of Marketing Metrics</i>	487
<i>Types of Marketing Metrics</i>	488
<i>Selecting Relevant Metrics</i>	488
<i>Designing a Management Dashboard</i>	489
<i>Interpreting Performance Measurement Results</i>	490

Global Issues for Planning, Implementation, and Control 493

<i>Global Marketing Planning</i>	493
<i>Implementation Globally</i>	494
<i>Performance Measurement and Control Globally</i>	494

Summary 495

Appendix 15A

Marketing Metrics 499

Cases for Part Five 502

Case 5-1 Verizon Communications Inc.	502
Case 5-2 Home Depot Inc.	507
Case 5-3 Yahoo! Inc.	514
Case 5-4 Nissan Motor Co.	519

PART SIX

COMPREHENSIVE CASES

Cases for Part Six 525

Case 6-1 Microsoft Corp. (B)	525
Case 6-2 Samsung Electronics Co.	533
Case 6-3 General Electric Appliances	539
Case 6-4 Slendertone	548
Case 6-5 Toyota	559
Case 6-6 Coca-Cola Co. (B)	566
Case 6-7 Keurig Inc.	571
Case 6-8 Dura-plast, Inc.	584
Case 6-9 Wal-Mart	595
Case 6-10 Blair Water Purifiers India	600
Case 6-11 Murphy Brewery Ireland, Limited	612
Case 6-12 Dairyland Seed Company	623
Case 6-13 International Business Machines	633

Case 6-14 L'Oréal Nederland B.V.	644
Case 6-15 ESPN	652
Case 6-16 Cowgirl Chocolates	659
Case 6-17 Procter & Gamble Co.	671
Case 6-18 Amazon.com Inc.	679
Case 6-19 Nanophase Technologies Corporation	684
Case 6-20 Cola Wars in China	698
Case 6-21 Smith & Nephew—Innovex	711
Case 6-22 Sun Microsystems	724
Case 6-23 Telus Mobility—What to Do with Mike	730
Case 6-24 Tri-Cities Community Bank	744
Case 6-25 Cima Mountaineering, Inc.	750

Indexes

Name Index	765
Subject Index	772

Part

1

Strategic Marketing

Imperatives for Market-Driven Strategy

Radical market changes, new demands for superior performance, and ever-fiercer competition are rapidly escalating, and pose great challenges to executives around the world. Even market and industry boundaries are no longer easy to define because of the entry of new and disruptive forms of competition. Customers' demands for superior value from the goods and services (products) they purchase are unprecedented, as they become yet more knowledgeable and more perceptive in the judgments they make. New phases of Internet business models—Web 2.0 (the second generation of Internet enterprises after the Web 1.0 dot.com crashes of the early 2000s)—provide wholly new forms of competition.

External influences from diverse pressure groups and lobbyists have escalated dramatically in country after country. The level of searching scrutiny of the ethical standards and corporate responsibility initiatives has never been so high and exerts compelling influence on decision makers in companies. In the face of this turbulence and complexity, companies adopt market-driven strategies guided by the logic that all business strategy decisions should start with a clear understanding of markets, customers, and competitors.¹ Increasingly, it is clear that enhancements in customer value provide a primary route to delivering superior shareholder value.²

Nonetheless, while it is important to recognize that the challenges are extreme, there is huge scope for achieving business success. The risks and uncertainties have escalated, and in many ways so have the rewards for developing strategies that deliver superior value. Innovative Web-based businesses like Google and eBay may be prototypes, but in more conventional industries a company like Arcelor Mittal Steel is illustrative.

From acquiring his first steel mill in Indonesia in 1976, Lakshmi Mittal has grown Arcelor Mittal to a dominant force in the global steel business. Mittal supplies more than 30 percent of the steel used by U.S. car companies and is responsible for 10 percent of world steel output—2006 sales were \$88.5 billion. Between 1989 and 2004, Mittal made 17 deals across the globe, buying the unwanted assets of bigger steel groups or down-at-heel state-owned plant. Acquisitions have spanned Asia, the Caribbean, the former Eastern Europe, the U.S. (International Steel Group and Ispat Inland), and Europe. Mittal's business turns around failing steel plants through a program of replacing existing management, fixing liquidity by reestablishing credit with suppliers, improving operations, shifting production to higher-value output, forming regional groups to boost purchasing power, and selling off non-core subsidiaries. Importantly, Mittal's long-term strategy was to challenge the

existing business model prevalent in the steel industry—conventional industry thinking was dominated by tonnages of steel produced, not profits, and regional supply chains. Mittal's view was that only large steel companies could negotiate advantageously with suppliers of iron ore and coal, and major customers such as automakers. Through a strategy of consolidation, a rigorous program of continuous improvement, and the deployment of a superior knowledge-sharing network across the global business, Mittal has reinvented the steel sector and created new ways to achieve superiority in customer value and competitive strength.³

This chapter examines three important market-driven strategy topics:

- *First*, we develop the theme of market-driven strategy and its pivotal role in designing and implementing effective business and marketing strategies. To achieve this, we review the characteristics of market oriented organizations, the development of distinctive capabilities, and the creation of value for customers.
- *Second*, we look at the links between business and marketing strategy and corporate strategy to clarify the scope of strategy and the marketing strategy process. The Appendix discusses Strategic Marketing Planning.
- *Lastly*, to emphasize the turbulent context in which executives make strategic choices, we explore some of the most important challenges in the modern marketplace—escalating globalization, technological change, the Web 2.0, and the imperatives of ethical behavior and corporate social responsibility.

Market-Driven Strategy

The underlying logic of market-driven strategy is that the market and the customers that form the market should be the starting point in business strategy. Importantly, market-driven strategy provides a company-wide perspective, which mandates more effective integration of activities and processes that impact customer value. The development of a market-driven strategy is not a short-term endeavor. A considerable amount of effort is necessary to build a market-driven organizational culture and processes. Also, the methods of measuring progress extend beyond short-term financial performance measures. Certainly, it is important that we recognize that short-term cost savings and profit enhancements may undermine the achievement of strategic goals and the building of superior customer value. Exhibit 1.1 summarizes the characteristics of market-driven strategies.

EXHIBIT 1.1
Characteristics
of Market-Driven
Strategies



Characteristics of Market-Driven Strategies

Becoming Market Oriented

Market orientation is a business perspective that makes the customer the focal point of a company's total operations. "A business is market-oriented when its culture is systematically and entirely committed to the continuous creation of superior customer value."⁴ Importantly, achieving a market orientation involves the use of superior organizational skills in understanding and satisfying customers.⁵ Becoming market-oriented requires the involvement and support of the entire workforce. The organization must monitor rapidly changing customer needs and wants, determine the impact of these changes on customer behavior, increase the rate of product innovation, and implement strategies that build the organization's competitive advantage.

A market-oriented organization continuously gathers information about customers, competitors, and markets; views the information from a total business perspective; decides how to deliver superior customer value; and takes actions to provide value to customers.⁶ Importantly, these initiatives involve cross-functional participation. Market orientation requires participation by everyone in the organization. An organization that is market oriented has both a culture committed to providing superior customer value and processes for creating value for buyers. Market orientation requires a customer focus, competitor intelligence, and cross-functional cooperation and involvement. This initiative extends beyond the marketing function in an organization.

Customer Focus

The marketing concept has proposed customer focus for half a century, yet until the 1990s this emphasis had limited impact on managers as a basis for managing a business.⁷ There are many similarities between the marketing concept and market orientation, although the former implies a functional (marketing) emphasis. The important difference is that market orientation is more than a philosophy since it consists of a process for delivering customer value. The market-oriented organization understands customers' preferences and requirements and effectively deploys the skills and resources of the entire organization to satisfy customers. Becoming customer-oriented requires finding out what values buyers want to help them satisfy their purchasing objectives.

Competitor Intelligence

A market-oriented organization recognizes the importance of understanding its competition as well as the customer:

The key questions are which competitors, and what technologies, and whether target customers perceive them as alternate satisfiers. Superior value requires that the seller identify and understand the principal competitors' short-term strengths and weaknesses and long-term capabilities and strategies.⁸

Failure to identify and respond to competitive threats can create serious consequences for a company. For example, Polaroid's management did not define its competitive area as all forms of photography, concentrating instead on its instant photo monopoly position, and eventually the company was outflanked by digital photography. Had Polaroid been market oriented its management might have better understood the changes taking place, recognized the competitive threat, and developed strategies to counter the threat. Instead, the company filed for bankruptcy.

Cross-Functional Coordination

Market-oriented companies are effective in getting all business functions working together to provide superior customer value. These organizations are successful in removing the

walls between business functions—marketing talks with research and development and finance. Cross-functional teamwork guides the entire organization toward providing superior customer value.

Performance Implications

Companies that are market oriented begin strategic analysis with a penetrating view of the market and competition. Moreover, an expanding body of research findings points to a positive relationship between market orientation and superior performance.⁹ Companies that are market oriented display favorable organizational performance, compared to companies that are not market oriented. The positive market orientation/performance relationship has been found in several United States, European, and Asian studies.

Determining Distinctive Capabilities

Identifying an organization's distinctive capabilities (competencies) is a vital part of market-driven strategy. "Capabilities are complex bundles of skills and accumulated knowledge, exercised through organizational processes, that enables firms to coordinate activities and make use of their assets."¹⁰ The major components of distinctive capabilities are shown in Exhibit 1.2, using Southwest Airlines' business model to illustrate each component. The airline's growth and financial performance are impressive. In 2007, Southwest reported its

EXHIBIT 1.2 **Distinctive** **Capabilities at** **Southwest Airlines**

Sources: Wendy Zellner, "Dressed to Kill," *BusinessWeek*, February 21, 2005, 58–59. Doug Cameron, "Southwest Seeks New Sources of Passenger Revenue," *Financial Times*, Friday, April 20, 2007, 24.

Organizational Processes

Southwest pioneered a point-to-point route system contrasting with the hub-and-spoke design used by many conventional airlines.

The value proposition consists of low fares and limited services (e.g., no in-flight meals).

Major emphasis throughout the organization is on building a loyal customer base.

Operating costs are kept low by using a single aircraft type, minimizing the time between a plane landing and taking off, no assigned seating, and developing strong customer loyalty (lower selling costs).

The business model is characterized by "keeping it simple."

Skills and Accumulated Knowledge

Southwest has developed impressive skills in operating its business model at very low cost.

Accumulated knowledge has guided management in improving its business design over time.

The business model is being leveraged to drive more non-flying revenue, such as hotel booking from its web site and charging for a broader array of services.

Additional directions identified include carrying more cargo, international flights and alliances with other carriers, and in-flight Internet services.

Coordination of Activities

Coordination of activities is facilitated by the point-to-point business model.

High aircraft utilization, simplification of functions, and limited passenger services enable management efficiency, and the provision of on-time, point-to-point services offered on a frequent basis.

Assets

Very low operating costs.

Loyal customer base.

High employee esprit de corps.

64th straight quarter of profitability, a record unmatched in the airline sector. The pioneer of “no frills” flying, the airline now carries more domestic passengers than any other U.S. airline.

An organization’s capabilities are not a particular business function, asset, or individual, and instead, consist of core processes of the organization. Michael Porter indicates that “the essence of strategy is in the activities—choosing to perform activities differently or to perform different activities than rivals.”¹¹ His concept of activity networks is consistent with viewing distinctive capabilities as groupings of skills and accumulated knowledge, applied through organizational processes. Mittal Steel’s ability to turn around outdated steel mills and to globalize sales is illustrative.

Organizational capabilities and organizational processes are closely related:

... it is the capability that enables the activities in a business process to be carried out. The business will have as many processes as are necessary to carry out the natural business activities defined by the stage in the value chain and the key success factors in the market.¹²

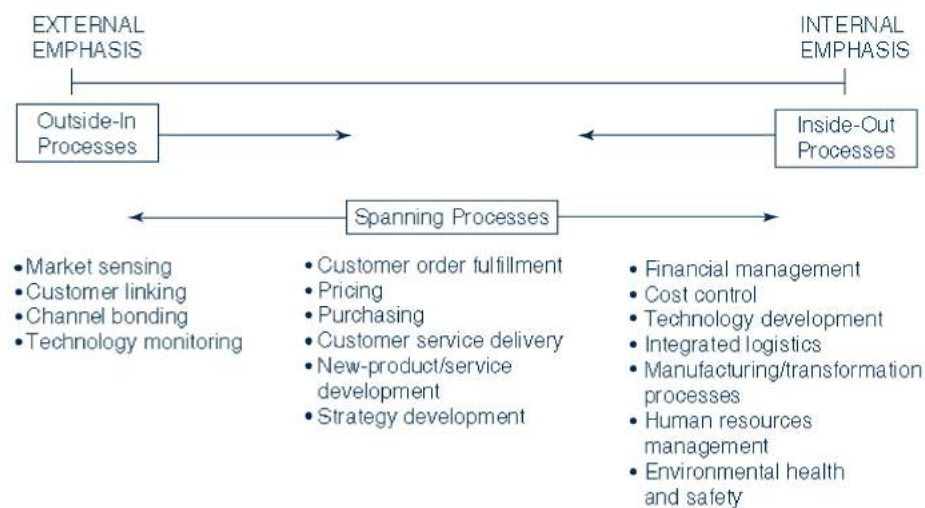
Classifying the organization’s capabilities is useful in identifying distinctive capabilities. As shown in Exhibit 1.3, one way of classification is to determine whether processes operate from outside the business to inside, inside out, or spanning processes. The processes shown are illustrative rather than a complete enumeration of processes. Moreover, since a company may have unique capabilities, the intent is not to identify a generic inventory of processes.

Classifying Capabilities

The process capabilities shown in Exhibit 1.3 differ in purpose and focus.¹³ The outside-in processes connect the organization to the external environment, providing market feedback and forging external relationships. The inside-out processes are the activities necessary to satisfy customer value requirements (e.g., manufacturing/operations). The outside-in processes play a key role in offering direction for the spanning and inside-out capabilities, which respond to the customer needs and requirements identified by the outside-in processes. Market sensing, customer linking, channel bonding (e.g., producer/retailer relationships), and technology monitoring provide vital information for new product opportunities, service requirements, and competitive threats.

EXHIBIT 1.3 Classifying Capabilities

Source: Chart from George S. Day, “The Capabilities of Market-Driven Organizations,” *Journal of Marketing*, October 1994, 41. Reprinted with permission of the American Marketing Association.



The organizational process view of distinctive capabilities requires shifting away from the traditional specialization of business functions (e.g., operations, marketing, research and development) toward a cross-functional process perspective.¹⁴

Capabilities and Customer Value

Value for buyers consists of the benefits and costs resulting from the purchase and use of products. Value is perceived by the buyer. Superior value occurs when there are positive net benefits. A company needs to pursue value opportunities that match its distinctive capabilities. A market-oriented company uses its market sensing processes, shared diagnosis, and cross-functional decision making to identify and take advantage of superior value opportunities. Management must determine where and how it can offer superior value, directing these capabilities to customer groups (market segments) that result in a favorable competency/value match.

Creating Value for Customers

Intense global competition and the increasing demands of ever-more sophisticated customers make the creation of customer value an important challenge for managers. We take a closer look at the concept of customer value, and consider how value is generated.

Customer Value

Offering superior customer value is at the core of business design at companies as diverse as Google, Mittal Steel, and Southwest Airlines. Buyers form value expectations and decide to purchase goods and services based on their perceptions of products' benefits less the total costs incurred.¹⁵ Customer satisfaction indicates how well the product use experience compares to the buyer's value expectations. Superior customer value results from a very favorable use experience compared to expectations and the value offerings of competitors.

Providing Value to Customers

As discussed earlier, the organization's distinctive capabilities are used to deliver value by differentiating the product offer, offering lower prices relative to competing brands, or a combination of lower cost and differentiation.¹⁶ Deciding which avenue to follow requires matching capabilities to the best value opportunities. Kodak's innovative approach to pricing the ink cartridges for its latest printers challenges industry conventions. Competitors price printers low, but charge high prices for ink cartridges (in some cases as much for the cartridge as the printer it fits). Kodak EasyShare printers cost more, but the ink cartridges are substantially cheaper than competitors'. Kodak's gamble is to attract high-volume users by offering them better value, leaving low-volume users to the competition.¹⁷

Nonetheless, there is an important distinction between value and innovation. An *Economist Intelligence Unit Report* included interviews with executives from many leading companies throughout the world: "What counts, conclude the participants, is value innovation. This is defined as creating new value propositions . . . that lead to increased customer satisfaction, loyalty, and—ultimately—sustainable, profitable growth. Market leaders are just that—pioneers."¹⁸

Becoming Market Driven

The discussion so far points to the importance of becoming market oriented, leveraging distinctive capabilities, and finding a good match between customers' value requirements and the organization's capabilities. The supporting logic for these actions is that they are expected to lead to superior customer value and organizational performance. Research evidence indicates that these characteristics are present in market-driven organizations,

which display higher performance than their counterparts that are not market driven. A market-driven organization must identify which capabilities to develop and which investment commitments to make. Market orientation research and evolving business strategy paradigms point to the importance of market sensing and customer linking capabilities in achieving successful market-driven strategies.¹⁹

Market Sensing Capabilities

Market-driven companies have effective processes for learning about their markets. Sensing involves more than collecting information. It must be shared across functions and interpreted to determine what actions need to be initiated. Mittal's global intranet links managers and generates valuable information for diagnosis and action in performance improvement. Developing an effective market sensing capability is not a simple task. Various information sources must be identified and processes developed to collect and analyze the information. Information technology plays a vital role in market sensing activities. Different business functions have access to useful information and need to be involved in market sensing activities.

Customer Linking Capabilities

There is substantial evidence that creating and maintaining close relationships with customers is important in market-driven strategies.²⁰ These relationships offer advantages to both buyer and seller through information sharing and collaboration. Customer linking also reduces the possibility of a customer shifting to another supplier. Customers are valuable assets.

Quintiles Transnational has very effective customer linking capabilities.²¹ Its drug testing and sales services are available in more than 50 countries. The company has extensive experience in clinical trials and marketing. Quintiles' customers are drug companies located in many countries around the world. Ongoing collaborative relationships are essential to Quintiles' success. It offers specialized expertise, assisting drug producers to reduce the time necessary in developing and testing new drugs. Quintiles helped develop or commercialize every one of the world's top 30 best-selling drugs.

Aligning Structure and Processes

Becoming market driven may require changing the design of the organization, placing more emphasis on cross-functional processes. Market orientation and process capabilities require cross-functional coordination and involvement. Many companies have made changes in organization structures and processes as a part of their customer value initiatives. The changes include improving existing processes as well as redesigning processes. Primary targets for reengineering are sales and marketing, customer relationship management, order fulfillment, and distribution. The objectives of the business process changes are to improve the overall level of product quality, reduce costs, and improve service delivery. Underpinning such changes and initiatives is the importance of what has been called "implementation capabilities," or the ability of an organization to execute and sustain market-driven strategy, and do so on a global basis.²² In addition to formulating the strategies essential to delivering superior customer value, it is vital to adopt a thorough and detailed approach to strategy implementation.

Corporate, Business, and Marketing Strategy

Business and marketing strategies are being renewed by executives in a wide range of companies, in their efforts to survive and prosper in an increasingly complex and demanding business environment. Choosing high performance strategies in this



Some conventional wisdom suggests that the era of the Personal Computer (PC) is over—it is yesterday's computing platform. Nonetheless, PC sales have grown from 50 million a year to 200 million in the past decade and are still rising.

The real change occupying executives in this sector is more subtle. It is a shift in the "eco-system" of the PC business. The days of the established purchase process of picking your PC from the Dell website, as the one with the most powerful Intel processor you can afford, and then loading Microsoft's Windows XP and Office package may be over.

To establish dominance in the PC world, the Big Three—Dell, Intel, and Microsoft—relied on mutually supportive business models. Microsoft added features to software to encourage upgrades. Intel made faster chips to handle the new software, and Dell used its direct sales model to sell cheaper boxes. This has become a recipe for bloated software, inefficient chips, and poor service.

The result is that Microsoft is being outpaced by Google software, AMD has come up with better chips than Intel, forcing Intel to change course, and Dell is trying to look more like Apple by opening stores and selling Dell computers in Wal-Mart. Dell has ended an exclusive deal with Intel to use AMD chips in some products and to load Google software on Dell PCs. Dell is looking to use acquisitions and partnerships to develop into a computer services business with less dependence on hardware sales.

It is new competitors who have found ways of making more money from the PC platform that was thought to be securely in the hands of the Big Three.

Sources: Adapted from Richard Waters, "Computer Pack Top Dogs Lose Their Bite," *Financial Times*, Monday June 5, 2006, p.19. Kevin Allison and Chris Nuttall, "Dell To Sell Its Computers At Wal-Mart," *Financial Times*, Friday May 25, 2007. Kevin Allison, "Dell To Target Indirect Sales," *Financial Times*, May 17, 2007, p.17. Maija Palmer and Kevin Allison, "Dell Plans More Emphasis on Services," *Financial Times*, Wednesday June 6, 2007, 26.

environment of constant change requires vision, sound strategic logic, and commitment. Market-driven organizations develop closely coordinated business and marketing strategies. Executives in many companies are reinventing their business models with the objective of improving their competitive advantage. These changes include altering market focus, expanding product scope, partnering with other organizations, outsourcing manufacturing, and modifying internal structure. The capacity for continuous reconstruction requires innovation with respect to the organizational values, processes, and behaviors that systematically favor perpetuating the past rather than innovation for renewal.²³

The transformation of the personal computer marketplace from the dominance of Dell, Intel, and Microsoft by the superior value offered by competitors like AMD in chips and Google in software, and the radical strategic changes required of the established competitors, are illustrative of competitive revolution. This competitive turmoil is described in the STRATEGY FEATURE.

Conventionally, we distinguish between corporate, business, and marketing strategy as shown in Exhibit 1.4. Corporate strategy consists of deciding the scope and purpose of the business, its objectives, and the initiatives and resources necessary to achieve the objectives. Business and marketing strategy is guided by the decisions top management makes about how, when, and where to compete. This should be a two-way relationship—while corporate strategy defines strategic direction, allocates resources, and defines constraints on what cannot be done, executives responsible for marketing strategy have a responsibility to inform corporate strategists about external change in the market that identifies opportunities and threats. We will examine each level or approach to strategy in turn, before describing and illustrating the marketing strategy process in more detail.

EXHIBIT 1.4
Corporate, Business,
and Marketing
Strategy



Corporate, Business, and Marketing Strategy

Corporate strategy consists of the decisions made by top management and the resulting actions taken to achieve the objectives set for the business. The major corporate strategy components are shown in Exhibit 1.5. *Scope* is concerned with resolving questions about the business the firm should be in, where it should focus, and its enduring strategic purpose. *Corporate objectives* indicate the dimensions of performance upon which to focus and the levels of achievement required. *Corporate strategies* are concerned with how the company can achieve its growth objectives in current or new business areas. *Resource allocation* addresses the division of limited resources across businesses and opportunities. *Synergies* highlight competencies, resources, and capabilities that drive efficiency and effectiveness in the business. Essential to corporate success is matching the capabilities of the organization with opportunities to provide long-term superior customer value.

Components of Corporate Strategy

It is apparent that in the 21st century marketing environments, companies are drastically altering their business and marketing strategies to get closer to their customers, counter competitive threats, and strengthen competitive advantages. Challenges to management include escalating international competition, new types and sources of competition, political and economic upheaval, dominance of the customer, and increasing marketing complexity. These challenges create imperatives for organizational change, which may sometimes be radical.

Corporate Strategy Framework

A useful basis for examining corporate strategy consists of (1) management's long-term vision for the corporation; (2) objectives which serve as milestones toward the vision; (3) resources; (4) businesses in which the corporation competes; (5) structure, systems, and processes; and (6) gaining corporate advantage through multimarket activity.²⁴

EXHIBIT 1.5
Components of
Corporate Strategy



Deciding Corporate Vision

Management's vision defines what the corporation is and what it does and provides important guidelines for managing and improving the corporation. Strategic choices about where the firm is going in the future—choices that take into account company capabilities, resources, opportunities, and problems—establish the vision of the enterprise. Developing strategies for sustainable competitive advantage, implementing them, and adjusting the strategies to respond to new environmental requirements is a continuing process. Managers monitor the market and competitive environment. Early in the strategy-development process management needs to define the vision of the corporation. It is reviewed and updated as shifts in the strategic direction of the enterprise occur over time.

Top management vision may be radical and sometimes involves risks. While Amazon.com initially promised to revolutionize retailing with its online operations, founder Jeff Bezos wants to transform Amazon into a digital utility—running customers' business logistics and processes using the same state-of-the-art technologies and operations that power Amazon's own online retailing. Amazon is renting out resources it uses to run its own business and has even allowed outside programmers access to its pricing and product data.²⁵

Objectives

Objectives need to be set so that the performance of the enterprise can be gauged. Corporate objectives may be established in the following areas: *marketing, innovation, resources, productivity, social responsibility, and finance*.²⁶ Examples include growth and market-share expectations, product quality improvement, employee training and development, new-product targets, return on invested capital, earnings growth rates, debt limits, energy reduction objectives, and pollution standards. Objectives are set at several levels in an organization beginning with those indicating the enterprise's overall objectives. The time frame necessary for strategic change often goes beyond short-term financial reporting requirements. Companies are using more than financial measures to evaluate longer-term strategic objectives, and non-financial measures for short-term budgets.

Resources

It is important to place a company's strategic focus on its resources—assets, skills, and capabilities.²⁷ These resources may offer the organization the potential to compete in different markets, provide significant value to end-user customers, and create barriers to competitor duplication. We know that distinctive capabilities are important in shaping the organization's strategy. A key strategy issue is matching capabilities to market opportunities. Capabilities that can be leveraged into different markets and applications are particularly valuable. For example, the GoreTex high performance fabric is used in many applications from apparel to dental floss.

Business Composition

Defining the composition of the business provides direction for both corporate and marketing strategy design. In single-product firms that serve one market, it is easy to determine the composition of the business. In many other firms it is necessary to separate the business into parts to facilitate strategic analyses and planning. When firms are serving multiple markets with different products, grouping similar business areas together aids decision-making.

Business segment, group, or division designations are used to identify the major areas of business of a diversified corporation. Each segment, group, or division often contains a mix of related products (or services), though a single product can be assigned such a designation. Some firms may establish subgroups of related products within a business segment that are targeted to different customer groups.

A business segment, group, or division is often too large in terms of product and market composition to use in strategic analysis and planning, so it is divided into more specific strategic units. A popular name for these units is the *Strategic Business Unit* (SBU). Typically SBUs display product and customer group similarities. A strategic business unit is a single product or brand, a line of products, or a mix of related products that meets a common market need or a group of related needs, and the unit's management is responsible for all (or most) of the basic business functions. Typically, the SBU has a specific strategy rather than a shared strategy with another business area. It is a cohesive organizational unit that is separately managed and produces sales and profit results.

For example, part of the remarkable strategic turnaround at Hewlett-Packard involved restructuring choices made in 2005 by incoming CEO Mark Hurd. He reversed his predecessor's merge of the computer and printer divisions, on the grounds that smaller, more focused business units would perform better than larger, more diffused alternatives, and separated the computer and printer units.²⁸

In a business that has two or more strategic business units, decisions must be made at two levels. Corporate management must first decide what business areas to pursue and set priorities for allocating resources to each SBU. The decision makers for each SBU must select the strategies for implementing the corporate strategy and producing the results that corporate management expects. Corporate-level management is often involved in assisting SBUs to achieve their objectives.

Structure, Systems, and Processes

This aspect of strategy considers how the organization controls and coordinates the activities of its various business units and staff functions.²⁹ Structure determines the composition of the corporation. Systems are the formal policies and procedures that enable the organization to operate. Processes consider the informal aspects of the organization's activities. Strategic choices provide the logic for different structure, systems, and process configurations.

The logic of how the business is designed is receiving considerable attention. "A business design is the totality of how a company selects its customers, defines and differentiates its offerings, defines the tasks it will perform itself and those it will outsource, configures its resources, goes to market, creates utility for customers, and captures profit."³⁰ The business design (or business model) provides a focus on more than the product and/or technology, instead looking at the processes and relationships that comprise the design.

Business and Marketing Strategy

Many strategy guidelines are offered by consultants, executives, and academics to guide business strategy formulation. These strategy paradigms propose a range of actions including re-engineering the corporation, total quality management, building distinctive competencies, reinventing the organization, supply chain strategy, and strategic partnering. It is not feasible to review the various strategy concepts and methods that are available in many books, seminars, and consulting services. The corporate strategy framework presented here offers a basis for incorporating relevant strategy perspectives and guidelines.

An important issue is whether selecting a successful strategy has a favorable impact on results. Does the uncontrollable environment largely determine business performance or instead, will the organization's strategy have a major impact on its performance? The evidence suggests that strategic choices matter.³¹ While environmental factors such as market demand, intensity of competition, government, and social change influence corporate performance, the strategic choices made by specific companies also have a significant impact on their performance. Importantly, the impact may be positive or negative. For example,

Kmart held the leading market position over Wal-Mart in 1980, yet Wal-Mart overtook Kmart by investing heavily in information systems and distribution to develop a powerful customer-driven, low-cost retail network. Kmart declared bankruptcy in early 2002, and was sold for less than \$1 billion.

Business and Marketing Strategy Relationships

An understanding of business purpose, scope, objectives, resources, and strategy is essential in designing and implementing marketing strategies that are consistent with the corporate and business unit plan of action. The chief marketing executive's business strategy responsibilities include (1) participating in strategy formulation and (2) developing marketing strategies that are consistent with business strategy priorities and integrated with other functional strategies. Since these two responsibilities are closely interrelated, it is important to examine marketing's role and functions in both areas to gain more insight into marketing's responsibilities and contributions. Peter F. Drucker described this role:

Marketing is so basic that it cannot be considered a separate function (i.e., a separate skill or work) within the business, on a par with others such as manufacturing or personnel. Marketing requires separate work and a distinct group of activities. But it is, first, a central dimension of the entire business. It is the whole business seen from the point of view of its final result, that is, from the customer's point of view.³²

Frederick E. Webster describes the role of the marketing manager: "At the corporate level, marketing managers have a critical role to play as advocates for the customer and for a set of values and beliefs that put the customer first in the firm's decision making, and to communicate the value proposition as part of that culture throughout the organization, both internally and in its multiple relationships and alliances."³³ This role includes assessing market attractiveness in the markets available to the firm, providing a customer orientation, and communicating the firm's specific value advantages.

Strategic Marketing

Marketing strategy consists of the analysis, strategy development, and implementation of activities in: developing a vision about the market(s) of interest to the organization, selecting market target strategies, setting objectives, and developing, implementing, and managing the marketing program positioning strategies designed to meet the value requirements of the customers in each market target.

Strategic marketing is a market-driven process of strategy development, taking into account a constantly changing business environment and the need to deliver superior customer value. The focus of strategic marketing is on organizational performance rather than a primary concern about increasing sales. Marketing strategy seeks to deliver superior customer value by combining the customer-influencing strategies of the business into a coordinated set of market-driven actions. Strategic marketing links the organization with the environment and views marketing as a responsibility of the entire business rather than a specialized function.

The Marketing Strategy Process

The marketing strategy analysis, planning, implementation, and management process that we follow is described in Exhibit 1.6. The strategy stages shown are examined and applied through the later parts of this book. *Markets, segments and customer value* consider market and competitor analysis, market segmentation, strategic customer relationship management, and continuous learning about markets. *Designing market-driven strategy* examines customer targeting and positioning strategies, marketing relationship strategies,

EXHIBIT 1.6 Marketing Strategy Process



and innovation and new product strategy. *Market-driven program development* consists of brand, value-chain, pricing, and promotion and selling strategies designed and implemented to meet the value requirements of targeted buyers. *Implementing and managing market-driven strategies* considers organizational design and marketing strategy implementation and control.

Markets, Segments, and Customer Value

Marketing management evaluates markets and customers to guide the design of a new strategy or to change an existing strategy. Analysis is conducted on a regular basis after the strategy is underway to evaluate strategy performance and identify needed strategy changes. Activities include:

- **Markets and Competitive Space.** Markets need to be defined so that buyers and competition can be analyzed. A product-market consists of a specific product (or line of related products) that can satisfy a set of needs and wants for the people (or organizations) willing and able to purchase it. The objective is to identify and describe the buyers, understand their preferences for products, estimate the size and rate of growth of the market, and find out what companies and products are competing in the market. Evaluation of competitors' strategies, strengths, limitations, and plans is a key aspect of this analysis.
- **Strategic Market Segmentation.** Market segmentation offers an opportunity for an organization to focus its business capabilities on the requirements of one or more groups of buyers. The objective of segmentation is to examine differences in needs and wants and to identify the segments (subgroups) within the product-market of interest. The segments are described using the various characteristics of people, the reasons that they buy or use certain products, and their preferences for certain brands of products. Likewise, segments of industrial product-markets may be formed according to the type of industry, the uses for the product, frequency of product purchase, and various other factors. The similarities of buyers' needs within a segment enable better targeting of the organization's capabilities to buyers with corresponding value requirements.
- **Strategic Customer Relationship Management.** A strategic perspective on Customer Relationship Management (CRM) emphasizes delivering superior customer value by personalizing the interaction between the customer and the company and achieving the

coordination of complex organizational capabilities around the customer. CRM aims to increase the value of a company's customer base by developing better relationships with customers and retaining their business. CRM can play a vital role in market targeting and positioning strategies. Since CRM is an enterprise-spanning initiative, it needs to be carefully integrated with marketing strategy.

- **Capabilities for Continuous Learning About Markets.** Understanding markets and competition has become a necessity in modern business. Sensing what is happening and is likely to occur in the future is complicated by competitive threats that may exist beyond traditional industry boundaries. Managers and professionals in market-driven firms are able to sense what is happening in their markets, develop business and marketing strategies to seize opportunities and counter threats, and anticipate what the market will be like in the future. Several market sensing methods are available to guide the collection and analysis of information.

Designing Market-Driven Strategies

Evaluating markets, segments, and customer value drivers at the outset of the marketing strategy process identifies market opportunities, defines market segments, evaluates competition, and assesses the organization's strengths and weaknesses. Market sensing information plays a key role in designing marketing strategy, which includes market targeting and positioning strategies, building marketing relationships, and developing and introducing new products (goods and services).

- **Market Targeting and Strategic Positioning.** A core issue is deciding how, when, and where to compete, given a firm's market and competitive environment. The purpose of **market targeting strategy** is to select the people (or organizations) that management wishes to serve in the product-market. When buyers' needs and wants vary, the market target is usually one or more segments of the product-market. Once the segments are identified and their relative importance to the firm determined, the targeting strategy is selected. The objective is to find the best match between the value requirements of each segment and the organization's distinctive capabilities. The targeting decision is the focal point of marketing strategy since targeting guides the setting of objectives and developing a positioning strategy. Examples of market target objectives are desired levels of sales, market share, customer retention, profit contribution, and customer satisfaction. **Positioning strategy** is the combination of the product, value chain, price, and promotion strategies a firm uses to position itself against its key competitors in meeting the needs and wants of the market target. The strategies and tactics used to gain a favorable position are called the marketing mix or the marketing program. The positioning strategy seeks to position the brand in the eyes and mind of the buyer and distinguish the product from the competition. The product, distribution, price, and promotion strategy components make up a bundle of actions that are used to influence buyers' positioning of a brand.
- **Strategic Relationships.** Marketing relationship partners may include end-user customers, marketing channel members, suppliers, competitor alliances, and internal teams. The driving force underlying these relationships is that a company may enhance its ability to satisfy customers and cope with a rapidly changing business environment through collaboration of the parties involved. Building long-term relationships with customers and value chain partners offers companies a way to provide superior customer value. Strategic partnering has become an important strategic initiative for many well-known companies and brands. Many firms outsource the manufacturing of their products. Strong relationships with outsourcing partners are vital to the success of these powerful brands.



The Canadian company, Research in Motion Ltd. (RIM), achieved remarkable success with the BlackBerry product range—cell phones with wireless e-mail capabilities. It took RIM from 1997 to early 2004 to sign up the first million users, but by 2007 BlackBerry had 12 millions users worldwide. However, the potential market is estimated at 400–800 million users.

The design and functionality of BlackBerry made RIM the market leader in personal digital assistants (PDAs), overtaking more established players like Palm, Hewlett-Packard and Dell. BlackBerry software has been licensed to most of the world's largest cell phone handset makers, including Nokia.



RIM achieved an important first-mover advantage with BlackBerry. The brand has become an icon—with its own nickname “The CrackBerry” because of its addictive nature, and its own malady “BlackBerry Thumb” referring to the penalty for over-use of the small keyboard.

While further designs have been launched—the BlackBerry Pearl, for example—the challenge is to stay ahead of aggressive competitors from across the tech industry, including Nokia, Dell, Hewlett-Packard, Good Technology, and Microsoft. There is a danger that e-mail may become standard on all cell phones.

RIM's strategy is to accept that the vast majority of handhelds for e-mail and other services will be made by competitors, and to stake out leadership in software and services:

- Licensing software to phone and handheld manufacturers
- Working with the carriers to push its devices and others using its software
- Offering software and services to allow companies to offer their own services or software applications on a BlackBerry device.

Sources: Heather Green and Cliff Edwards, “The Squeeze on BlackBerry,” *BusinessWeek*, December 6, 2004, 74–75. Paul Taylor and Bernard Simon, “RIM Sees Fine BlackBerry Harvest,” *Financial Times*, April 12, 2005, 11. Ben Hunt and Stephen Pritchard, “BlackBerries Are Not the Only Fruit,” *Financial Times IT Report*, Wednesday June 29, 2005, 1. Jessica E. Vascellaro, “Research in Motion Net, Revenue More Than Double,” *The Wall Street Journal*, October 5, 2007, B3.

- **Innovation and New Product Strategy.** New products are needed to replace old products when sales and profit growth decline. Closely coordinated new product planning is essential to satisfy customer requirements and produce products with high quality at competitive prices. New product decisions include finding and evaluating ideas, selecting the most promising for development, designing the products, developing marketing programs, market testing the products, and introducing them to the market. The differences between existing product attributes and those desired by customers offer opportunities for new and improved products. Successful innovation is a major business challenge. An interesting example of a new product achieving remarkable results is the Blackberry handheld device, as described in the INNOVATION FEATURE.

Market-Driven Program Development

Market targeting and positioning strategies for new and existing products guide the choice of strategies for the marketing program components. Product, distribution, price, and promotion strategies are combined to form the positioning strategy selected for each market target. The marketing program (mix) strategies implement the positioning strategy.

- **Strategic Brand Management.** Products (goods and services) often are the focal point of positioning strategy, particularly when companies or business units adopt organizational approaches emphasizing product or brand management. Product strategy includes: (1) developing plans for new products; (2) managing programs for successful products; and (3) deciding what to do about problem products (e.g., reduce costs or improve the product). Strategic brand management consists of building brand value (equity) and managing the organization's system of brands for overall performance.
- **Value-Chain Strategy.** Market target buyers may be contacted on a direct basis using the firm's salesforce or by direct marketing contact (e.g., Internet), or, instead, through a value-added chain (distribution channel) of marketing intermediaries (e.g., wholesalers, retailers, or dealers). Distribution channels are often used in linking producers with end-user household and business markets. Decisions that need to be made include the type of channel organizations to use, the extent of channel management performed by the firm, and the intensity of distribution appropriate for the product or service.
- **Pricing Strategy.** Price also plays an important role in positioning a product or service. Customer reaction to alternative prices, the cost of the product, the prices of the competition, and various legal and ethical factors establish the extent of flexibility management has in setting prices. Price strategy involves choosing the role of price in the positioning strategy, including the desired positioning of the product or brand as well as the margins necessary to satisfy and motivate distribution channel participants.
- **Promotion Strategy.** Advertising, sales promotion, the salesforce, direct marketing, and public relations help the organization to communicate with its customers, value-chain partners, the public, and other target audiences. These activities make up the promotion strategy, which performs an essential role in communicating the positioning strategy to buyers and other relevant influences. Promotion informs, reminds, and persuades buyers and others who influence the purchasing process.

Implementing and Managing Market-Driven Strategy

Selecting the customers to target and the positioning strategy for each target moves marketing strategy development to the action stage (Exhibit 1.6). This stage considers designing the marketing organization and implementing and managing the strategy.

- **Designing Market-Driven Organizations.** An effective organization design matches people and work responsibilities in a way that is best for accomplishing the firm's marketing strategy. Deciding how to assemble people into organizational units and assign responsibility to the various mix components that make up the marketing strategy are important influences on performance. Organizational structures and processes must be matched to the business and marketing strategies that are developed and implemented. Organizational design needs to be evaluated on a regular basis to assess its adequacy and to identify necessary changes. Restructuring and reengineering of organizations has led to many changes in the structures of marketing units.
- **Marketing Strategy Implementation and Control.** Marketing strategy implementation and control consists of: (1) preparing the marketing plan and budget; (2) implementing the plan; and (3) using the plan in managing and controlling the strategy on an ongoing basis. The marketing plan includes details concerning targeting, positioning, and marketing mix activities. The plan spells out what is going to happen over the planning period, who is responsible, how much it will cost, and the expected results (e.g., sales forecasts). The preparation of the marketing plan is discussed in the Appendix to this chapter.

Marketing strategy is an ongoing process of making decisions, implementing them, and tracking their effectiveness over time. In time requirements, strategic evaluation is far more demanding than planning. Evaluation and control are concerned with tracking performance and, when necessary, altering plans to keep performance on track. Evaluation also includes looking for new opportunities and potential threats in the future. It is the connecting link in the strategic marketing planning process shown in Exhibit 1.6. By serving as both the last stage and the first stage (evaluation before taking action) in the planning process, strategic evaluation ensures that strategy is an ongoing activity.

Challenges of a New Era for Strategic Marketing

Nearing the end of the first decade of the 21st century, it is apparent that executives face unprecedented challenges in strategic marketing to cope with turbulent markets, competitive revolution, and escalating customer demands for value superiority. In this chapter we describe the rationale for market-driven strategy and its components, as a business approach relevant to the new challenges of the present and future. Importantly, the personal demands for incisiveness and ingenuity in creating and implementing innovative and robust marketing strategies should not be ignored. In addition to the technical skills of analysis and planning required to implement market-driven strategy, capabilities for understanding new market and competitor phenomena will be at a premium. Societal and global change also mandates high levels of personal integrity in managers and leaders, and the reflection of these qualities in the social responsiveness of organizations.

Escalating Globalization

The internationalization of business is well-recognized in terms of the importance of export/import trade and the growth of international corporations, particularly in the Triad, comprising North America, Europe, and Japan. However, for strategic marketing in the 21st century, such a view of the international marketing issue may be short-sighted. The most intriguing and surprising challenges are likely to come from outside the mature Triad economies. It is important to understand the degree and extent of difference between the developed economies and the new world beyond. The effects may be dramatic. Recall our earlier discussion of the impact of Mittal on the global steel business.

The ability of competitors in emerging countries like China and Korea to produce goods at very low costs and prices was well-documented in the 1990s and early 2000s, and many markets like apparel have been severely affected. It is clear that some major customers may source from countries with massive cost advantages in labor costs. In 2004, Wal-Mart was the world's largest purchaser of Chinese goods, spending \$15 billion in China in 2003, making the company China's fifth largest trading partner, ahead of countries like Russia and Britain. Indeed, U.S. consumers are reacting to price differences for medical treatments by traveling abroad. While a heart bypass may cost \$25-35,000 in the U.S., the operation is available in Thailand and India for \$8-15,000.³⁴

The corollary is that emerging markets offer huge opportunities for exporters because of the population size and growing wealth. For example, one of the driving forces in the huge merger of consumer products companies Procter and Gamble and Gillette was to pool expertise in emerging markets—the goal of the combined enterprise is to serve the world's six billion consumers, not just the one billion most affluent. The focus is on the “lower income consumer” in markets like India and China, through the development of affordable products.³⁵



India. In 2006, for the first time, the value of India's acquisitions of overseas companies (\$22.4 billion) exceeded the value of foreign companies buying into the country (\$11.3 billion). The attraction is gaining access to lucrative developed country markets while maintaining the high productivity of the low-cost base in India. High profile deals include:

- Suzlon Energy, manufacturer of wind turbines, pays \$521 million for Hansen Transmissions, a gearbox producer in Belgium.
- Tata Steel pays \$13.1 billion for Corus, the Anglo-Dutch steelmaker.
- Ranbaxy Laboratories makes acquisitions in Europe and the U.S.A. and targets Germany's Merck in pharmaceuticals.

China. China has foreign exchange reserves exceeding \$1000 billion. In 2007, a survey by the Economist Intelligence Unit showed record numbers of Chinese companies are looking to make overseas acquisitions, targeting Asia, Europe and the U.S.A. The highest profile deal is the acquisition by Lenovo of IBM's personal computer business. Other purchases have failed—the attempted acquisition of the U.S. oil group Unocal by the China National Offshore Oil Corporation in 2005 failed. The approach to Maytag, known for its Hoover vacuum cleaners, by Haier, was rejected. Chinese companies want to acquire Western brands and market access. Chinese overseas acquisitions are expected to escalate.

Russia. The value of Russian overseas merger and acquisition deals in 2006 reached \$13 billion, compared to \$1 billion in 2002. Russia is cash rich on the basis of its exports of oil, gas and metals. Many big Russian companies see expansion into international markets as essential. Energy and metals groups want to move beyond raw materials into higher profit areas such as refining and manufacturing. In 2006, \$50 billion of Russian international deals failed. Gas giant Gazprom's interest in Centrica in Britain was rejected for political reasons. Steelmaker Exraz is rumored to be looking at Ipsco Inc, a pipemaker in Illinois. The success rate of international deals is expected to grow rapidly.

Sources: Dan Roberts, Richard McGregor and Stephanie Kirchgaessner, "A New Asian Invasion: China's Champions Bid High for American Brands and Resources," *Financial Times*, Friday June 24, 2005, 17. Joe Leahy, "Unleashed: Why Indian Companies Are Setting Their Sights on Western Rivals," *Financial Times*, Wednesday February 7, 2007, 13. Jason Bush, "Rubles Across the Sea," *BusinessWeek*, April 30, 2007, 43. Sundeep Tucker, "Reluctant Player Prepares to Step On to World Stage," *Financial Times*, May 31, 2007, 7.

Furthermore, the most important exports from countries like India and China may not just be goods and services but new business models, which will impact established ways of doing business in the developed world. For example the GLOBAL FEATURE describes the aggressive expansion and acquisition strategies of companies in several emerging markets.

It is clear that the new breed of multinational company will be from developing nations, like Brazil, China, India, Russia, and even Egypt and South Africa. They are mostly companies that have prevailed in brutally competitive home markets, against local competitors and Western multinationals. They have business models that can generate profits from extremely low prices and survive in very tough environments.³⁶

The global marketplace is dynamic and changing in complex ways with fundamental effects on the competitiveness and viability of companies in many sectors. Those who underestimate the rate of change and important shifts in international relationships run the risk of being outmaneuvered.

Technology Diversity and Uncertainty

The skills and vision required to decide which radical innovation opportunities can be successfully commercialized will be extremely demanding, and the risks of failure will be high. Innovations have the potential to revolutionize a range of different industries.

They demand a strategic perspective that accepts the potential for revolution but balances this with commercial imperatives. The danger is that conventional approaches and short-sighted management may miss out on the most important opportunities.

Much innovation will reflect increased globalization. Chinese innovators are on the cutting edge in fields as diverse as autos, energy, semiconductors, and telecommunications.³⁷ China manufactures the bulk of the world's DVD players, cell phones, shoes, and certain other products. In the past these products have been designed elsewhere and produced in China. Now, some of the most innovative designs are developed in China, for both Chinese and foreign companies.³⁸ Major organizations like Microsoft and IBM are investing in worldwide innovation networks spanning countries like India, China, Russia, Israel, Singapore, Taiwan, and South Korea to speed development cycles and bring new technologies to market sooner.³⁹

The Web 2.0

As the impact of the Web on business became apparent in the 1990s, some authorities argued that the Internet would make conventional strategies obsolete. However, this phase of Internet business (Web 1.0) led to the failure of many Web-based businesses in the early 2000s. A more compelling logic is that the Internet is a powerful complement to traditional business and marketing strategies.⁴⁰ Nonetheless, competitive boundaries are likely to be altered and competition will become more intense.

However, discussions of Web 2.0 are dominated by emerging phenomena like social networking sites, such as MySpace—purchased for \$580 million by News Corporation in 2005—and video-sharing sites, such as YouTube—purchased by Google for \$1.65 billion in 2006. While such sites are highly popular among users—particularly younger consumers—the commercial implications are becoming apparent. It is possible, for example, that a social networking site like MySpace may be a highly effective advertising medium because it can achieve high engagement between individual brands and consumers, displacing traditional advertising spending from some advertisers' budgets.⁴¹

An interesting example of Web innovations with important marketing opportunities is the virtual reality site Second Life. The site and some of the marketing applications are described in the INTERNET FEATURE.

More generally, file-sharing, blogs, and social networking services have spawned many new services, including the online encyclopedia, Wikipedia, and the free Internet telephone network, Skype. The Web is providing a collaboration mechanism allowing companies to tap into the collective intelligence of employees, customers, and outsiders to solve problems and identify new opportunities. Outcomes range from the new retail marketplace found at eBay to consumer-generated content for advertising.⁴² Internet strategy is considered throughout the book as an integral part of thinking about strategic marketing, not as a separate topic.

Ethical Behavior and Corporate Social Responsiveness

The demands on individuals to display high levels of personal integrity will likely increase in the future. Increasing levels of transparency mandate that manager behavior should meet the highest standards. The penalties for failing to meet the highest standards are likely to be severe. Growing emphasis is placed on corporate citizenship and the establishment and protection of secure corporate reputation as an asset with a financial return associated.⁴³

While in the past corporate ethics and social responsibility may not have been center-stage in corporate and business strategy, this situation has changed dramatically. Major concerns about fairness and justice, and the impact of business activities on the physical



Virtual reality sites like Second Life provide users with access to an alternative or parallel world, where they can live imaginary lives, and take on the identity of their avatar (the online representation of the person, with the characteristics they choose). Second Life encompasses some 50 virtual square miles, which it would take days to cross (though flying or teleporting are options). There are thousands of eye-catching structures, physical landmarks and interactive objects, as well as virtual businesses, internet-based social groups, and scheduled events ranging from dance parties to yard sales. Residents spend local currency—Linden dollars—available at in-world ATMs. Second Life had 100,000 residents in 2006, but 2.7 million by 2007.

There is already considerable real company involvement in virtual reality worlds:

- Sun Microsystems uses its Second Life presence to develop a better understanding of new communications modes. Sun hosted the first Fortune 500 press conference in the “Sun Pavillion” in Second Life in 2006, attended by 60 avatars including journalists, software developers and Sun customers. Sun can create new products—such as computer hardware—and test it to destruction in Second Life.
- American Apparel Inc became the first real-world clothing retailer to set up shop in Second Life in June 2006. The store sells virtual T-shirts for residents to wear. Adidas has sold 21,000 pairs of virtual shoes in its store.
- Starwood Hotels has built a huge model of its new Aloft hotel on an island, with deluxe pool and designer lounge.
- IBM has bought a large space used for company and industry meetings of IBMers’ avatars.
- Crompco Corp., an underground gas tank testing company, has built a virtual gas station for training employees.
- Other businesses have created their own virtual worlds as marketing tools to reach young people who prefer logging on to watching television. Coca-Cola’s MyCoke.com envelops fans in everything Coke, with games, music and chat in virtual space. Wells Fargo’s Stagecoach Island is a virtual world where people can play games to learn about finance.

Online virtual worlds offer untapped marketing potential for real-world products and services, because they sustain consumer engagement with a brand. Companies may have to think about directing marketing efforts to their customers’ online alter egos, as well as their real customers.

Sources: Paul Hemp, “Avatar-Based Marketing,” *Harvard Business Review*, June 2006. Allison Enright, “How The Second Half Lives,” *Marketing News*, February 15, 2007, 12–14. Robert D. Hof, “My Virtual Life,” *BusinessWeek*, May 1, 2006, 72–82.

environment are high on the management agenda. For example, a research study by McKinsey suggests that as many as 70 percent of company managers believe there is room for improvement in the way large companies anticipate social pressure and respond to it. Managers see risks for their businesses in some social challenges—such as, climate change, data privacy, and healthcare—but opportunities in other challenges—such as the growing demand for more ethical, healthier, and safer products.⁴⁴ Further indications of the importance of ethical and social responsibility issues are shown in studies of the perceptions of business school students—who will provide the next generations of managers. Business students appear to believe that companies should work more aggressively toward the betterment of society and want to find socially responsible employment in their careers.⁴⁵

However, concern for Corporate Social Responsibility (CSR) extends beyond altruism or corporate philanthropy to a shift in the way that firms develop their business models. Customer pressures on suppliers to evidence higher standards of corporate behavior are considerable. In business-to-business marketing, suppliers unable or unwilling to meet the social responsibilities defined by major customers stand the considerable risk of losing those customers.⁴⁶

In consumer marketing, a recent five-country survey, conducted by market research group GfK NOP, suggests that consumers in five of the world's leading economies believe that business ethics have worsened in the past five years, and they are turning to "ethical consumerism" to make companies more accountable.⁴⁷ Respondents believe that brands with "ethical" claims—of environmental policies or treatment of staff or suppliers—would make business more answerable to the public, and that companies should "promote ethical credentials more strongly."⁴⁸ The impact of "ethical consumerism" is of escalating significance.

However, while compliance with social demands for more ethical and responsible behavior is an important issue in strategic marketing, exciting new opportunities are being identified by companies in combining social initiatives with their business models and value propositions, to seek new types of competitive advantage. Recently, Porter and Kramer have argued that many prevailing approaches to CSR are fragmented and disconnected from business and strategy, while in fact the real challenge is for companies to analyze their social responsibility prospects using the same frameworks that guide their core business choices. The goal is to establish CSR not simply as corporate altruism, but as a source of opportunity, innovation, and competitive advantage.⁴⁹ The most strategic CSR adds a dimension to a company's value proposition, so that social impact is central to strategy. They note that the number of industries and companies whose competitive advantage can involve social value propositions is rapidly growing:

Organizations that make the right choices and build focused, proactive, and integrated social initiatives in concert with their core strategies will increasingly distance themselves from the pack. . . . Perceiving social responsibility as building shared value rather than as damage control or as a PR campaign will require dramatically different thinking in business. We are convinced, however, that CSR will become increasingly important to competitive success.⁵⁰

Prototypes for the pursuit of social initiatives as a key part of the business model and to achieve competitive strength are illustrated in the ETHICS FEATURE, describing the One Laptop Per Child program and recent high-profile developments at Dell Inc. and Microsoft.

Indeed, environmental initiatives that make business sense are not restricted to high technology business. Remanufacturing at Caterpillar Inc. is one of the company's fastest growing divisions, with sales in excess of \$1 billion a year—remanufacturing takes used diesel engines and uses the reclaimed parts to produce "like new" engines that sell for half the cost of a new engine. Similarly, at Xerox reclaimed photocopier parts go straight onto the new-build assembly line.⁵¹ A major interest in the financial services field is the creation of new sustainable financial products, which enable companies like banks to achieve competitive differentiation.⁵²

The challenges to executives to develop and implement business models which achieve the goals of both business and society are considerable and span all sectors of industry. While these forces of change describe a challenging yet exciting environment for strategic marketing, across the world marketing professionals are finding new and better ways to respond to the new realities, to deliver superior customer value to their markets, and to enhance shareholder value. Underpinning processes of reinvention and radical innovation are principles of robust marketing strategy. The goal of this book is to identify and illustrate these principles, and provide processes for responding to the challenges.



One Laptop Per Child. In 2004 an MIT team said they were going to overcome the digital divide between the rich and poor by making a \$100 laptop for the poor children of the world—the One Laptop Per Child (OLPC) project. Initially dismissed as a charitable project, the MIT team's vision has underlined to the commercial IT sector the market power of the poor. The effects on hardware and software companies have been dramatic: Intel has developed low-cost computers aimed at students in third-world countries; AMD has pledged to get half the world's population online by 2015 with its Personal Internet Communicator; Microsoft is supporting the establishment of computer kiosks in villages in developing countries to allow shared online access; Quanta Computer, the world's largest contract manufacturer of notebook computers, is making OLPC laptops selling for \$200. The OLPC project underlines the social benefits and the commercial opportunities of a cheap laptop, which was relatively easy to make using newer technologies, open source software, by stripping out unneeded functions.

Dell Inc. Leading computer supplier, Dell Inc, is leveraging its distinctive competitive competences in initiatives with both business and social benefits—using the strengths of its direct business model to generate collective efforts to reduce energy consumption and protect the environment. The initiative centers on improving the efficiency of IT products, reducing the harmful materials used in them, and cooperating with customers to dispose of old products. Michael Dell's environmental strategy focuses on three areas: creating easy, low-cost ways for businesses to do better in protecting the environment—providing, for example, global recycling and product recovery programs for customers, with participation requiring little effort on their part; taking creative approaches to lessen the environmental impact of products from design to disposal—helping customers to take full advantage of new, energy-saving technology and processes, and advising on upgrades of legacy systems to reduce electricity usage; and looking to partnership with governments to promote environmental stewardship PC. The link between this CSR initiative and the company's business model and value proposition is clear.

Microsoft. In 2007 Microsoft was partnering with governments in less developed countries to offer Microsoft Windows and Office software packages for \$3 to governments that subsidize the cost of computers for schoolchildren. The potential business benefit for Microsoft is to double the number of PC users worldwide, and reinforce the company's market growth. The social benefit is the greater investment in technology in some of the poorest countries in the world, with the goal of improving living standards and reducing global inequality.

Sources: Michael Dell, "Everyone Has a Choice," *Financial Times Digital Business—Special Report*, Wednesday April 18, 2007, 1. "Footing the Bill: Gates Offers \$3 Software to Poor," *Financial Times*, Friday April 20, 2007, 1.

Summary

The challenges facing business executives are framed by turbulence in the business and competitive environment challenging the resilience of companies to prosper. This chapter aims, first, to examine the nature of market-driven strategy and the market oriented company; second, to explain the links between corporate strategy and business and marketing strategy; and, third, to underline some of the major challenges of the current marketing era, including globalization, technology change, and ethics and corporate social responsibility.

A market-driven strategy requires that the market and customers should be the starting point in business strategy formulation. Market orientation provides the appropriate business perspective that makes the customer the focal point of the company's operations.

A company's distinctive capabilities provide the skills and knowledge that are deployed to create value for customers. Becoming market-driven relies on market sensing and customer linking capabilities, and the alignment of structure and process with market-driven priorities.

Corporate strategy involves management in deciding the long-term vision for the company, setting objectives, focusing on capabilities, choosing the businesses in which the corporation competes, and defining the business design and how it will create value. Business strategy focuses on the strategic plan for each unit. The marketing strategy process involves evaluating markets, segments, and value drivers, designing market-driven strategies, developing market-driven programs, and implementing and managing strategies.

The modern era for market-driven strategy involves many complex and challenging issues for executives. We underline the importance of escalating globalization, emerging Web 2.0 phenomena, technology diversity and uncertainty, and strategic mandates for ethical behavior and corporate social responsibility initiatives linked not simply to compliance but to new sources of competitive advantage.

Questions for Review and Discussion

1. Top management of companies probably devotes more time to reviewing (and sometimes changing) their corporate vision (mission) now than in the past. Discuss the major reasons for this increased concern with the vision for the corporation.
2. Discuss the role of organizational capabilities in corporate strategy.
3. What is the relationship between the corporate strategy and the strategies for the businesses that comprise the corporate portfolio?
4. Discuss the major issues that top management should consider when deciding whether or not to expand business operations into new business areas.
5. Develop an outline of how you would explain the marketing strategy process to an inventor who is forming a new business to develop, produce, and market a new product.
6. Discuss the role of market targeting and positioning in an organization's marketing strategy.
7. Explain the logic of pursuing a market-driven strategy.
8. Examine the relevance of market orientation as a guiding philosophy for a social service organization, giving particular attention to user needs and wants.
9. How do the organization's distinctive capabilities contribute to developing market-driven strategy?
10. How would you explain the concept of superior customer value to a new finance manager?
11. Suppose you have been appointed to the top marketing post of a corporation and the president has asked you to explain market-driven strategy to the board of directors. What will you include in your presentation?
12. Develop a list of the personal challenges confronting the marketing executive, and consider the qualities and capabilities which may be most relevant to meeting these challenges.

Internet Applications

- A. Visit the websites of fashion clothing companies Zara (www.zara.com) and H&M (www.hm.com). What do these sites tell you about the targeting and positioning strategies being pursued by these companies?
- B. What does Google's website (www.Google.com) tell us about the company's ability to collect information about individuals and businesses? What privacy issues arise, and how can they be resolved?
- C. Review the McKinsey & Co. website. Are there indications that the consulting company is market oriented?

Feature Applications

- A. Read the ETHICS FEATURE—Corporate Social Responsibility for Competitive Advantage. Summarize the reasons why companies are adopting corporate social responsibility initiatives. What arguments support the pursuit of social initiatives by business organizations, and what arguments suggest that the role of business is primarily to make profits?
- B. Review the INTERNET FEATURE—Second Life. What are the marketing opportunities emerging from Web innovations such as virtual reality and social networking sites? How can these opportunities be pursued for gains in competitive strength and position in particular market segments?

Notes

1. George S. Day, "The Capabilities of Market-Driven Organizations," *Journal of Marketing*, October 1994, 37–52.
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3. Stanley Reed, "Mittal & Son," *BusinessWeek*, April 16, 2007, 44–50. Stanley Reed, "The Raja of Steel," *BusinessWeek*, December 20, 2004, 18–22.
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5. George S. Day, *Market-Driven Strategy: Processes for Creating Value* (New York: Free Press, 1990).
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Appendix 1A

Strategic Marketing Planning Developing the Strategic Plan for Each Business

Strategic analysis is conducted to: (1) diagnose business units' strengths and limitations, and (2) select strategies for maintaining or improving performance. Management decides what priority to place on each business regarding resource allocation and implements a strategy to meet the objectives for the SBU. The strategic plan indicates the action agenda for the business.

The strategic analysis guides establishing the SBU's mission, setting objectives, and determining the strategy to use to meet these objectives. The SBU's strategy indicates market target priorities, available resources, financial constraints, and other strategic guidelines needed to develop marketing plans. Depending on the size and diversity of the SBU, marketing plans may either be included in the SBU plan or developed separately. If combined, the marketing portion of the business plan will represent half or more of the business plan. In a small business (e.g., retail store, restaurant, etc.), the marketing portion of the plan may account for most of the plan. Plans may be developed to obtain financial support for a new venture, or to spell out internal business and marketing strategies.

Preparing the Marketing Plan

Marketing plans vary widely in scope and detail. Nevertheless, all plans need to be based on analyses of the product-market and segments, industry and competitive structure, and the organization's value proposition. We look at several important planning issues that provide a checklist for plan preparation.

Planning Relationships and Frequency

Marketing plans are developed, implemented, evaluated, and adjusted to keep the strategy on target. Since the marketing strategy normally extends beyond one year, it is useful to develop a three-year strategic plan and an annual plan to manage marketing activities during the year. Budgets for marketing activities (e.g., advertising) are set annually. Planning is really a series of annual plans guided by the marketing strategic plan.

The frequency of planning activities varies by company and marketing activity. Market targeting and positioning strategies are not changed significantly during the year. Tactical changes in product, distribution, price, and promotion strategies may be included in the annual plan. For example, the aggressive response of competitors to Healthy Choice's successful market entry required changes in Con Agra's pricing and promotion tactics for the frozen food line.

Planning Considerations

Suppose that you need to develop a plan for a new product to be introduced into the national market next year. The plan for the introduction should include the expected results (objectives), market targets, actions, responsibilities, schedules, and dates. The plan indicates details and deadlines, product plans, a market introduction program, advertising and sales promotion actions, employee training, and other information necessary to launching the product. The plan needs to answer a series of questions—what, when, where, who, how, and why—for each action targeted for completion during the planning period.

Responsibility for Preparing Plans

A marketing executive or team is responsible for preparing the marketing plan. Some companies combine the business plan and the marketing plan into a single planning activity. Regardless of the format used, the marketing plan is developed in close coordination with the strategic plan for the business. There is also much greater emphasis today to involve all business functions in the marketing planning process. A product or marketing manager may draft the formal plan for his/her area of responsibility, coordinating and receiving inputs from advertising, marketing research, sales, and other marketing specialists. Coordination and involvement with other business functions (R&D, finance, operations) is also essential.

Planning Unit

The choice of the planning unit may vary due to the product-market portfolio of the organization. Some firms plan and manage by individual products or brands. Others work with product lines, markets, or specific customers. The planning unit may reflect how marketing activities and responsibilities are organized.

The market target is a useful focus for planning regardless of how the plan is aggregated. Using the target as the basis for planning helps to place the customer in the center of the planning process and keeps the positioning strategy linked to the market target.

Preparing the Marketing Plan

Format and content depend on the size of the organization, managerial responsibility for planning, product and market scope, and other situational factors. An outline for a typical marketing plan is shown in Exhibit 1A-1. We take a brief look at the major parts of the planning outline to illustrate the nature and scope of the planning process. In this discussion the market target serves as the planning unit.

Outline for Preparing an Annual Marketing Plan

The Situation Summary

This part of the plan describes the market and its important characteristics, size estimates, and growth projections. Market segment analysis indicates the segments to be targeted and their relative importance. The competitor analysis indicates the key competitors (actual and potential), their strengths and weaknesses, probable future actions, and the organization's competitive advantage(s) in each segment of interest. The summary should be very brief. Supporting detailed information for the summary can be placed in an appendix or in a separate analysis.

EXHIBIT 1A-1 Outline for Preparing an Annual Marketing Plan

Strategic Situation Summary

A summary of the strategic situation for the planning unit (business unit, market segment, product line, etc.).

Market Target(s) Description

Define and describe each market target, including customer profiles, customer preferences and buying habits, size and growth estimates, distribution channels, analysis of key competitors, and guidelines for positioning strategy.

Objectives for the Market Target(s)

Set objectives for the market target (such as market position, sales, and profits). Also state objectives for each component of the marketing program. Indicate how each objective will be measured.

Marketing Program Positioning Strategy

State how management wants the firm to be positioned relative to the competition in the eyes and mind of the buyer.

A. Product Strategy

Set strategy for new products, product improvements, and product deletions.

B. Distribution Strategy

Indicate the strategy to be used for each distribution channel, including the role of channel members, assistance and support provided, and specific activities planned.

C. Price Strategy

Specify the role of price in the marketing strategy and the planned actions regarding price.

D. Promotion Strategy

Indicate the planned strategy and actions for advertising, publicity, Internet, personal selling, and sales promotion.

E. Marketing Research

Identify information needs and planned projects, objectives, estimated costs, and timetable.

F. Coordination with Other Business Functions

Specify the responsibilities and activities of other departments that have an important influence on the planned marketing strategy.

Forecasts and Budgets

Forecast sales and profit for the marketing plan and prepare the budget for accomplishing the forecast.

Describe the Market Target

A description of each market target, size and growth rate, end-users' characteristics, positioning strategy guidelines, and other available information useful in planning and implementation are essential parts of the plan. When two or more targets are involved, it is helpful to indicate priorities for guiding resource allocation.

Objectives for the Market Target(s)

Here we spell out what the marketing strategy is expected to accomplish during the planning period. Objectives are needed for each market target, indicating financial performance, sales, market position, customer satisfaction, and other desired results. Objectives are also usually included for each marketing program component.

Marketing Program Positioning Strategy

The positioning statement indicates how management wants the targeted customers and prospects to perceive the brand. Specific strategies and tactics for product, distribution, price, and promotion are explained in this part of the plan. Actions to be taken, responsibilities, time schedules, and other implementation information are included at this point in the plan.

Planning and implementation responsibilities often involve more than one person or department. One approach is to assign a planning team the responsibility for each market target and marketing mix component. Product and geographical responsibilities are sometimes allocated to individuals or teams. The responsibilities and coordination requirements need to be indicated for marketing units and other business functions. Importantly, the planning process should encourage participation from all of the areas responsible for implementing the plan. Contingency plans may be included in the plan. The contingencies consider possible actions if the anticipated planning environment is different from what actually occurs.

Forecasting and Budgeting

Financial planning includes forecasting revenues and profits and estimating the costs necessary to carry out the marketing plan (see the Appendix to Chapter 2 for financial analysis details). The people responsible for market target, product, geographical area, or other units should prepare the forecasts and budgets. Comparative data on sales, profits, and expenses for prior years is useful to link the plan to previous results.

Cases for Part 1

Case 1-1

Audi

Chef *sache*. That's German for "the boss's business." And when it's the boss's business at Audi, watch out. Each month, Audi's compulsive chief executive, Martin Winterkorn, rolls up his sleeves and leads a trouble-shooting session with engineers at the company's electronics center, zeroing in on faulty systems and problem parts. Winterkorn's rules: no shifting the blame to anyone else, such as suppliers. No phone calls to subordinates—the brains to remedy the defects better be in the room. And no one leaves until a fix is found.

The boss's business extends way beyond that monthly session. Not even the smallest buttons on the dashboard escape Winterkorn's attention. At the first auto show under his watch, he summarily ordered a gorgeous Audi sedan removed just hours before the opening: The stitching on the upholstery wasn't right. (Audi staffers now bring two of each model to every show.) The 57-year-old PhD in metal physics is obsessed with creating perfect cars. "We want to be the No. 1 premium brand," says Winterkorn.

There's a lot riding on his precision mania. Audi, the \$32 billion high-end car unit of Volkswagen, has been striving for two decades to move its cars upmarket. The effort has cost billions in investments in technology, design, and performance. The goal: to match the exclusive image of mighty Mercedes-Benz and BMW. Individual Audi models have been making a splash for years. The 1994 aluminum frame A8 sedan was an industry first. The iconic Audi TT sports roadster and coupe, introduced in 1998, polished Audi's image as a design leader. The A4's cool, minimalist styling and powerful four-cylinder motor created a new generation of popular Audis, including the sizzling Cabriolet. The A4 line accounts for nearly half of all Audi sales.

Now, Winterkorn is presiding over the arrival of Audi into the front ranks. On Feb. 16, Detroit-based *AutoWeek* voted the \$41,000 A6 sedan its Car of the Year. Late last year the magazine heralded Audi's flagship luxury model, the A8, as America's best luxury car. In car-crazed Germany, *Auto Motor & Sport* on Feb. 15 elevated Audi to No. 1 in its four key model segments,

from the A3 compact to its flagship A8 sedan. "Audi is on the cusp of its full first turn as an international luxury brand," says James N. Hall, vice-president for industry analysis at researcher Auto-Pacific Inc. in Southfield, Mich.

Avant-Garde Styling

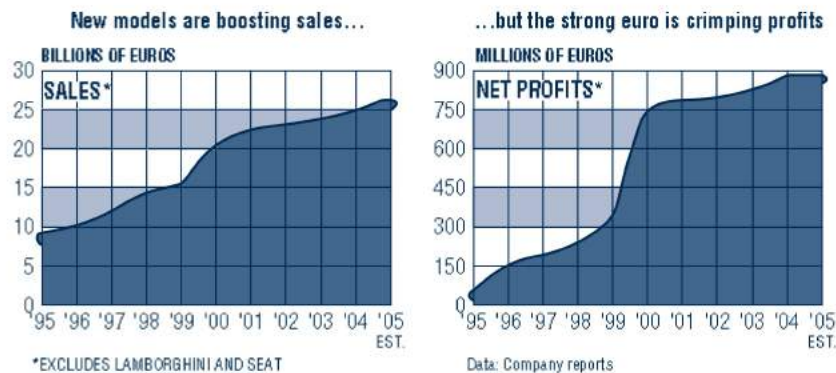
Audi is building up a roster of famous customers, from Spain's King Juan Carlos to musician k.d. lang. It's also luring buyers from rival German auto makers. Bernd Pooch, chief executive of a Berlin machine-tool maker, was a diehard BMW fan. But last November, turned off by the avant-garde styling of the latest 7 Series, the 64-year-old test-drove a \$100,000, 275-horsepower Audi Quattro A8. Smitten by the smooth handling and finely crafted interior, he quickly signed a lease. "People just don't know how good Audi really is," he says.

That's especially true in the U.S., where Audi sells less than half the volume of BMW, Mercedes, or Toyota Motor Corp.'s luxury brand Lexus. Audi suffers in the U.S. from an outdated sales and marketing network and a reputation for buggy electronic systems. Reliability "has been our Achilles' heel," admits Marc Trahan, Audi of America's quality director. To ratchet up its global standing, Audi has to smooth out its U.S. kinks.

Still, the numbers track Audi's upward march. Revenue per vehicle is \$41,389, up from \$25,125 in 1994. Sales have nearly tripled, to more than \$32 billion in the same period (Exhibit 1). Profits in 2004 rose 7.4%, to hit a record \$1.15 billion. The share price (a small tranche of Audi shares still trade, despite VW's ownership) has soared to \$347 from \$79 in 2000. In Europe, Audi nearly matched BMW's sales last year, with 559,428 vehicles to BMW's 579,632. Its most powerful versions of the A8 outsell Mercedes and BMW models with comparable engines. "In the last 15 years, Audi has made an incredible advance," says BMW CEO Helmut Panke. "They wanted to be fully accepted as a premium brand, and they made it."

EXHIBIT 1

Audi's Upmarket Drive



Audi, though, is just finishing the first lap of a long race. It now must strengthen global sales outside Europe and add new models to match the depth of BMW and Mercedes offerings. Audi also has a long way to go to match the revenue and profit horsepower of Mercedes and BMW. Last year, Audi clocked sales of 779,000 cars, but Mercedes and BMW sold more than 1.2 million each. By revenues, Audi is still only 55% the size of BMW and 48% that of Mercedes-Benz. Audi's profits are a fraction of its rivals' income, too, since it has fewer expensive models on the market. To remedy that, Winterkorn aims to spend some \$15 billion over the next four years, 80% of it on new products.

The son of Hungarian emigrants who moved to Germany in 1945, Winterkorn admits his weakness is impatience. To get workers charged up, he exhorts his troops to take risks and own up to failure quickly. "What he hates is when people cover up mistakes or problems, or shift the blame to someone else," says one manager. The trim and demanding "big boss," as Audi workers refer to Winterkorn, prowls the production line and software labs seeking intelligence from line workers and technicians. A favorite Winterkorn saying: "Don't bore me with the good news. Give me the worst."

In Winterkorn's race to bulk up Audi's size, 2005 is a crucial year. The new models launched in 2004 in Europe have given Audi momentum. It has one of the newest fleets on the market, including the elegant new A6 sedan, redesigned A4 sedan, and the A3 hatchback. A keenly awaited product is the Q7 SUV, costing roughly \$40,000, which will hit European showrooms in early 2006, followed by a baby SUV, the Q5, one year later. Under wraps is a sports car in the \$100,000 to \$200,000 range, dubbed the Le Mans, which is expected to have a 610 hp engine that can accelerate from 0 to 60 mph in just 3.7 seconds. "It would show that anything BMW

and Mercedes can do, Audi can do better," says Garel Rhys, professor of automotive economics at Cardiff Business School in Wales.

But the Audi chief's biggest priority for 2005 is clinching quality gains. Winterkorn is betting his three-year crusade to stamp out glitches, especially in electronics, will boost Audi's rankings above its German rivals in J.D. Power & Associates Inc.'s 2005 quality and reliability rankings, due out in June. "If they make sure they get quality right, they could pick up a lot of dropped straws," says Auto-Pacific's Hall.

Moving Up in the Rankings

Like its German rivals, Audi's cars have been plagued since the late 1990s with electronic snafus as auto makers stuffed more and more microchips into their vehicles. But years of hard work are starting to pay off. In J.D. Power's 2004 ranking of initial quality, Audi moved up three places to rank 11th out of 37 auto brands, one place above BMW and one notch below Mercedes. Chance Parker, Power's quality guru, says Audi still needs to improve its reliability over the long haul—an area where Winterkorn hopes Audi will excel this year. "Some of Audi's [last-generation] launches have been very buggy," Parker says. That's why Audi is 22nd in Power's 2004 ranking of long-term dependability. The good news for Audi is that Mercedes sank to 28th. Audi's ratings should trend upward thanks to the quality of the new models hitting the market.

Audi's other tough goal will be boosting visibility in the U.S. Of Audi's 263 dealerships, 127 share floor space with other brands, and 115 also sell Volkswagen. Johan de Nysschen, Audi of America's boss, is in the middle of a major push to upgrade dealerships. "The

cornerstone for brand building is making Audi more successful in the U.S.," says Albrecht Denninghof, senior auto analyst at Hypo-und Vereinsbank in Munich.

Winterkorn, who took control in March, 2002, is just starting to put his stamp on the company. He started at Audi in 1981, moved in 1993 to VW as chief of quality, and then became head of product development. He is close to VW Chairman and former Audi boss Ferdinand Piëch, the architect of Audi's upmarket strategy. Ironically, it was Winterkorn, at Piëch's bidding, who developed VW's ill-fated luxury sedan, the Phaeton. A rival to the A8, it flopped in the market despite strong praise for its engineering.

Now, Audi's growth and profits are increasingly vital to Volkswagen, where high costs and missteps with key models have clouded prospects. Although internal tussles with VW over shared platforms and competing model launches have cost Audi precious time in getting cars to market, the division accounted for nearly 100% of VW Group's net earnings last year. In 2004 the average operating profit per car at Audi was \$1,374, while Volkswagen brand cars, suffering from high costs, model mistakes, and an aging fleet, lost an average \$13 per vehicle, according to Paris brokerage Exane.

The wholesale parts-sharing of the early 1990s between Audi and VW has given way to a more sophisticated sharing of modules that still saves money but allows Audi cars to look and behave differently. And VW's plummeting profits have dashed Piëch's ill-fated drive to push Volkswagen upmarket. A recent report by Morgan Stanley puts Audi's value at \$14 billion—80% of VW Group.

Winterkorn is reaping the payoff of billions of dollars in investments since 1980 when Audi kicked off its upmarket bid with the "Quattro" four-wheel-drive system. To earn its stripes, Audi had to outengineer its rivals, setting industry benchmarks in everything from lightweight aluminum frames, drive systems, and engine performance to the "soft skin" materials covering plastic parts that give Audi's interiors a richer feel. The auto maker's navigation and information system wins high marks as user-friendly and intuitive. "Audi is like the iPod of cars. It's more intelligently designed," says Bill Joy, partner at venture-capital firm Kleiner Perkins Caufield & Byers in Menlo Park, Calif., and former chief scientist at Sun Microsystems Inc.

Audi's 53,000 workers—fiercely proud of the company's engineering heritage, which goes back to

founder August Horch—are as obsessed as Winterkorn with building cars that outshine BMW and Mercedes. Production Chief Frank Dreves pauses in the lobby of headquarters to make a point about the latest A3 Sportback. "Feel this," says Dreves, running his fingers over a nearly invisible laser-welded seam between the roof of the tomato red car and the side panel. "This is normally a gutter in every car. We invented a new laser welding process to eliminate the gutter to reduce interior noise. None of our competitors bothers to do this."

Forging a luxury brand has also required stand-out design. In 2002, Piëch lured Italian designer Walter Maria de Silva to Audi from Alfa Romeo. A year later, De Silva unveiled a bold, more sculptured look for the A6 and A8 sedans that started hitting the market last year. The deep front grille, now being extended through most of the model line, gives Audi an edgier look.

But closing the revenue gap with BMW and Mercedes will take another generation of cars at least. Audi has six basic models, compared with 10 at BMW—soon to be 12—and 13 at Mercedes. By selling more top-end cars, BMW and Mercedes generate much greater revenues and higher margins. In 2004, Audi earned an operating margin of 5.5%. "Our goal is to achieve an operating profit margin of 8% within this decade," says Audi Chief Financial Officer Rupert Stadler.

One risk along the way is that a struggling VW shaves capital expenditure, crimping Audi's investments. Winterkorn insists his \$15 billion investment plan is secure, but VW Chief Executive Bernd Pischetsrieder has announced he aims to cut spending 6%, or nearly \$1 billion, over the next two years.

Audi also needs to invest heavily in marketing and distribution outside Europe to match BMW's and Mercedes' global reach. Although Audi is already a premium-car market leader in China, with a 65% share, rivals are coming on strong, and the market for luxury vehicles has slowed. In Japan, where Audi trails BMW and Mercedes, Winterkorn has canceled a dealership-sharing agreement with Toyota and set up a network of 100 exclusive dealerships. He's also planning to spend \$130 million on building a dealer network in Russia over the next five years.

For Winterkorn, the final heat to catch BMW and Mercedes is the challenge of a lifetime. For Piëch, likewise, a victory would crown his life's work as engineer and manager. But getting there will require perfect execution—and a steady hand on the wheel.

Still a Long Way To Go In America

It would be hard to find a more devoted Audi fan than Mark Fullerton. The CEO of a Cincinnati tech-services company and his wife have owned 27 Audis. Fullerton, 53, has toured Audi's factory in Ingolstadt, Germany, six times, and attended its driving school four times. "I believed no one could seduce us away from Audi," he says. So why has Fullerton recently been test-driving cars made by Japanese and other German auto makers?

He fears Audi has lost its edge. Not long ago, he says, "Audi was the only game in town" if you wanted a premium performance car with all-wheel drive at lower prices than its rivals. Now nearly every luxury carmaker offers AWD. And thanks to generous lease terms, Fullerton can lease a \$57,620 BMW for \$736 a month, about \$100 a month less than what he'd pay on a comparable \$54,770 Audi. "It pains me," he says.

It pains Audi dealers, too, since leasing accounts for 43% of their sales. Last year, Audi's U.S. sales fell 10%—their first decline in a decade. Management shake-ups rattled dealers. And even as the new A6 sedan was drawing rave reviews, sales got off to a slow start, with little promotion when it hit showrooms last fall. "The good news is that the A8, A6, and new A4 have exceptionally good quality, but in the short term, we're not playing with the full quiver of arrows that the other guys have," says Bill Hoehn, owner of a Carlsbad, Calif., Audi dealership.

Despite a decade on the comeback trail, Audi is still running behind archrivals BMW and Mercedes Benz in the minds of American consumers. The carmaker is hampered by a weak dollar, a shaky U.S. dealer network, and a narrow lineup that includes no sport-utility vehicles. And it still needs to improve its long-term reliability.

That doesn't mean Audi isn't on the upswing. Its U.S. sales jumped 16% in February. Its American executives and engineers are working closely with their German counterparts to eliminate glitches. They're convinced Audi will crack the Top 10 when the latest J.D. Power & Associates' Initial Quality Study is issued this spring. And they are counting on those new models. Says Johan de Nysschen, Audi of America chief: "We will have the newest product lineup in the luxury sector." But de Nysschen is also dead set against raising incentives—and that includes more generous lease deals. Piling on big incentives

effectively lowers a car's pricing, which would hurt both Audi's image and the resale value of its cars. Says de Nysschen: "I don't want to undo all the good that has been done."

Audi Needs an SUV

Its rivals depend on them for a big percentage of U.S. sales

*U.S. sales in 2004
Data: Ward's AutoInfoBank

SUV sales as percentage of total*

PORSCHE
58%

LEXUS
53%

BMW
24%

MERCEDES
12%

AUDI
0%

The problem is the new model that Audi dealers want most—the \$40,000 seven-seater Q7 SUV—won't be available until spring 2006, eight years after Mercedes launched the M-Class. With no SUVs, Audi's unit sales in the U.S. are 25% to 30% of rivals. "You only address half the market in the U.S. if you only have cars to sell," de Nysschen admits. Analysts fear that by the time Audi delivers the Q7 and the smaller Q5 in 2007, the trend could be losing momentum. De Nysschen says Audi can sell 50,000 Q7s a year.

It will take more than new models to vault Audi into the top luxury tier in the U.S. Still haunted by memories of the "sudden acceleration" scare of the 1980s, Audi needs to turn out near-perfect cars to build its quality reputation. Audi "has to overcompensate," says Marc Trahan, the company's U.S. quality director. Still, he had to work to convince the Germans to listen to American consumers and move cup holders from the instrument panel, where coffee sloshed onto the stereo controls, to the center console. De Nysschen hopes the efforts will turn customers into goodwill "ambassadors" for the brand. That's essential if Audi doesn't want to lose loyalists like Fullerton.

Source: "Hot Audi," *BusinessWeek*, March 14, 2005, 64–68.

—By Gail Edmondson in Ingolstadt, Germany, with Kathleen Kerwin in Detroit and Karen Nickel Anhalt in Berlin

Case 1-2

The New York Times

Since 1896, four generations of the Ochs-Sulzberger family have guided *The New York Times* through wars, recessions, strikes, and innumerable family crises. In 2003, though, Arthur Ochs Sulzberger Jr., the current proprietor, faced what seemed to be a publisher's ultimate test after a loosely supervised young reporter named Jayson Blair was found to have fabricated dozens of stories. The revelations sparked a newsroom rebellion that humiliated Sulzberger into firing Executive Editor Howell Raines. "My heart is breaking," Sulzberger admitted to his staff on the day he showed Raines the door.

It turns out, though, that fate was not finished with Arthur Sulzberger, who also is chairman of the newspaper's corporate parent, New York Times Co. The strife that convulsed *The New York Times's* newsroom under the tyrannical Raines has faded under the measured leadership of his successor, Bill Keller, but now its financial performance is lagging. NYT Co.'s stock is trading at about 40, down 25% from its high of 53.80 in mid-2002 and has trailed the shares of many other newspaper companies for a good year and a half. "Their numbers in this recovery are bordering on the abysmal," says Douglas Arthur, Morgan Stanley's senior publishing analyst.

Meanwhile, the once-Olympian authority of the *Times* is being eroded not only by its own journalistic screw-ups—from the Blair scandal to erroneous reports of weapons of mass destruction in Iraq—but also by profound changes in communications technology and in the U.S. political climate. There are those who contend that the paper has been permanently diminished, along with the rest of what now is dismissively known in some circles as "MSM," mainstream media. "The Roman Empire that was mass media is breaking up, and we are entering an almost-feudal period where there will be many more centers of power and influence," says Orville Schell, dean of the University of California at Berkeley's journalism school. "It's a kind of disaggregation of the molecular structure of the media."

The pride that Sulzberger takes in his journalistic legacy is palpable, his knowledge of the *Times's* august history encyclopedic. Yet "Young Arthur," as he is still known to some at age 53, exudes a wisecracking,

live-wire vitality more typical of a founding entrepreneur than of an heir. He began an interview for this article by picking up a big hunk of metal from a conference room table and brandishing it menacingly. "Ask any question you'd like," he growled and then deposited the object in a less obtrusive spot. "It's an award," he added softly.

Sulzberger, who succeeded his father as publisher in 1992 and as chairman in 1997, already rescued *The New York Times* from decline once. With the help of then-CEO Russell T. Lewis, he reinvented the "Gray Lady" by devising a radical solution to the threat of eroding circulation that had imperiled the *Times* and other big-city dailies for years. Sulzberger changed the paper itself by spending big money to add new sections and a profusion of color illustration. At the same time, he made the *Times* the first—and still the only—metro newspaper in America to broaden its distribution beyond its home city to encompass the entire country. Today, nearly 50% of all subscribers to the weekday *Times* live somewhere other than Gotham.

The Sulzbergers who preceded him were newspapermen; Arthur Jr., by his own description, is a "platform-agnostic" multimedia man. In the mid-1990s, NYT Co. became one of the first Old Media companies to move into cyberspace. *Times* reporters also began experimenting with adapting their newspaper stories to another medium new to them—television. Today, *NYTimes.com* consistently ranks among the 10 most popular Internet news sites, and New York Times Television is one of the largest independent producers of documentary programming in the U.S. "Within our lifetimes, the distribution of news and information is going to shift to broadband," Sulzberger says. "We must enter the broadband world having mastered the three key skill sets—print, Internet, and video—because that's what's going to ensure the future of this news organization in the years ahead."

Sulzberger acknowledges that he and his company are embattled in the present. "These are tough times, and they've been tough times for a while." But he and new CEO Janet L. Robinson (Lewis retired at the end of 2004) are sticking with the long-term plan set nearly a decade ago: enhancing the content of the *Times* and extending its reach into virgin territories west of the Hudson while also building its multimedia capacity. In 2002, NYT Co. added a global dimension to its growth strategy by acquiring full control of the *International Herald Tribune*, which is now being upgraded and expanded.

In essence, Sulzberger is doing what his forebears have always done: sink money into the *Times* in the belief that quality journalism pays in the long run. "The challenge is to remember that our history is to invest during tough times," he says. "And when those times turn—and they do, inevitably—we will be well-positioned for recovery."

Will it work this time? Will toughing it out Sulzberger-style revitalize the *Times* or consign it to creeping irrelevance? "Despite all that has happened, I still think that *The New York Times* has a stature and a position of journalistic authority that is greater than any news organization in the world. Could that be destroyed? I believe that it could be," says Alex S. Jones, a former *Times* media critic who is co-author of *The Trust*, a history of the Sulzbergers and their newspaper. Jones, who now runs the Joan Shorenstein Center on the Press, Politics & Public Policy at Harvard University, hastens to add that he hopes that the paper will thrive again. "I tell you, I hate to think of it not succeeding," he says.

The constancy of their commitment to high-cost journalism has put the Sulzbergers in an increasingly contrarian position. Many of the country's surviving big-city dailies once were owned by similarly high-minded dynastic families that long ago surrendered control to big public corporations that prize earnings per share above all else. Editorial budgets at most newspapers, as well as TV and radio stations, have been squeezed so hard for so long that asphyxiation is a mounting risk. The proliferation of Web sites and cable-TV stations has produced an abundance of commentary and analysis, but the kind of thorough, original reporting in which the *Times* specializes is, if anything, increasingly scarce.

In effect, the Sulzbergers have subsidized the *Times* in valuing good journalism and the prestige it confers over profits and the wealth it creates. In fact, for much of its history, the *Times* barely broke even. Recasting the paper into a publicly held corporation capable of pursuing profit as determinedly as *Times* editors chase Pulitzers was the signal achievement of Arthur Jr.'s father, Arthur O. "Punch" Sulzberger Sr. Still, NYT Co. consistently fails to post the 25% profit margins of such big newspaper combines as Gannett Co. and Knight-Ridder Inc. mainly because of the *Times*'s outsize editorial spending, which the paper does not disclose but which is thought to exceed \$300 million a year.

For a time, Arthur Jr. enthralled Wall Street by adding double-digit growth to the Sulzbergian formula. The

value of NYT Co. shares soared 295% from their 1996 low to their 2002 high, boosting the value of the family's 19% holding to \$1.5 billion. Like other Old Media families, the Sulzbergers have been able to maintain unquestioned control of their company by creating a new class of voting stock and reserving most of it for themselves. Among them, the various branches of the Sulzberger family control 91% of the Class B voting shares.

The Bancrofts of Dow Jones & Co. and the Grahams of Washington Post Co. share the Sulzbergers' journalism-first philosophy. However the Washington Post has moved beyond newspapering to a greater extent than has NYT Co., which in addition to the *Herald Tribune* owns *The Boston Globe*, 15 small daily newspapers, and eight television stations. Actually, Arthur Jr. has increased his company's financial reliance on the *Times* by selling off magazines and other peripheral properties acquired under his father. In short, NYT Co. is quality journalism's purest traditional play.

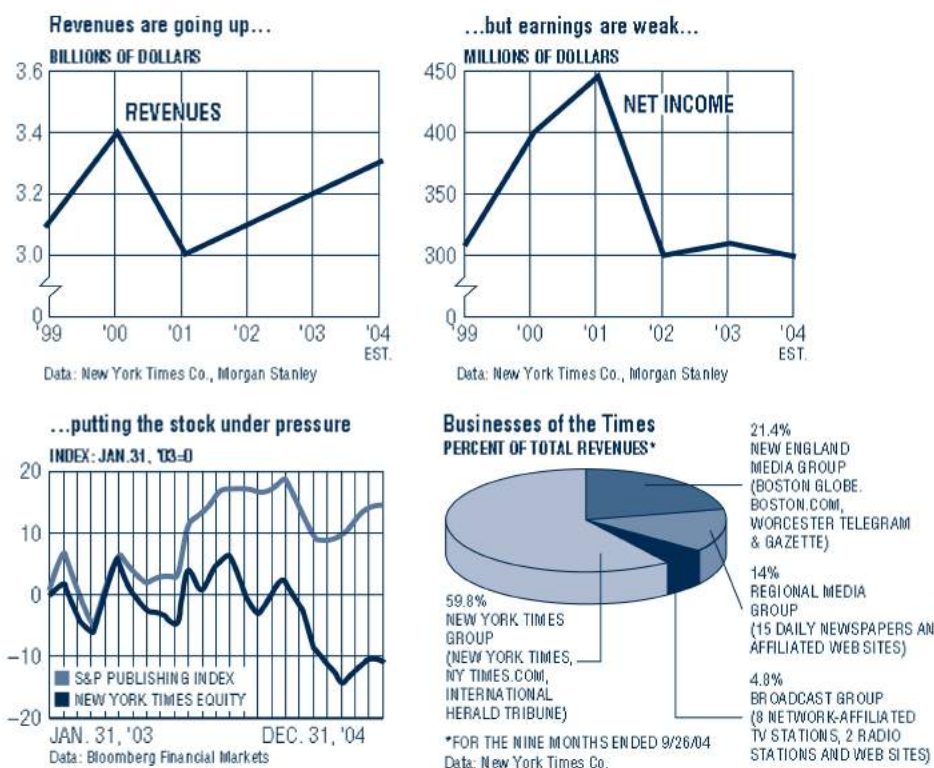
In 2004, the company clearly failed to parlay quality into the growth it will need to continue supporting the *Times* franchise. The Wall Street consensus is that the company will report net income of \$290 million for 2004, down 4% from the preceding year and a good 35% below the \$445 million it netted in the media industry boom year of 2001 (Exhibit 1). Revenues have plateaued at \$3 billion, give or take a few hundred million, for five years running.

It wasn't that long ago—Apr. 8, 2002, to be precise—that all seemed right in Arthur Sulzberger Jr.'s rarified world. On that day, most of the *Times*'s 1,200 reporters and editors gathered in its newsroom just off Times Square to celebrate the paper's record haul of Pulitzer Prizes. No newspaper had ever before won more than four Pulitzers in a year; the *Times* won seven in 2002—six of which recognized its Herculean coverage of the September 11 terrorist attacks and their aftermath. Sulzberger was ecstatic, not realizing that he already had made the biggest blunder of his tenure as publisher: naming Howell Raines as executive editor.

Raines, who had joined the paper in 1978 as a national correspondent, had deeply impressed Sulzberger by shaking the stodginess out of the editorial page as its editor during the Clinton years. Raines campaigned hard for the promotion in 2001, vowing to root out complacency and do whatever was needed to raise the staff's "competitive metabolism." By most accounts, Sulzberger saw Raines, then 58, as his journalistic alter ego and collaborator in transforming the *Times* into a fully national, multimedia franchise.

EXHIBIT 1

A Halting Recovery



Just 18 months after self-proclaimed “change agent” Raines had taken charge, the *Times* ran a devastatingly self-critical article recounting how Jayson Blair had plagiarized or made up at least 36 stories. Sulzberger, who has often been accused of lacking gravitas, will be a long time living down his flip initial reaction to Blair’s transgressions: “It sucks.” Worse, Sulzberger had no feel for how Raines was perceived in the newsroom, where resentment of his arbitrary, self-aggrandizing ways had reached the flash point. Three weeks after Sulzberger had unequivocally affirmed his support for Raines, the publisher fired him and Managing Editor Gerald Boyd.

The Blair-Raines fiasco devastated Sulzberger. But after a long period of introspection, he appears to have regained his confidence if not quite his swagger. “There’s no question that the experience changed him,” says Steven L. Rattner, a prominent private equity investor who has been one of Sulzberger’s closest confidants ever since they worked together as young *Times* reporters in the late 1970s. “It’s made him more open to other views and more careful to have a better sense of what’s going on,” he says. “I think it has been an eye-opening experience for Arthur, and that’s never bad for any of us.”

Sulzberger swallowed a heaping helping of humble pie in replacing Raines with Keller, a former managing editor whom he had passed over in promoting Raines. Appointed in July, 2003, Keller, 54, has been editor for only as long as Raines was but already has made a number of changes as fundamental as those that his predecessor promulgated yet never implemented. “I cringed every time I read that people thought my job was to come in and calm the place down because it made me sound like the official dispenser of Zolof,” says Keller, whose gracious manner has often been mistaken for passivity. “I saw myself instead as being, in some sense, a change agent without having to wave a revolutionary banner.”

Keller has made so many high-level personnel changes that two-thirds of all newsroom workers now report to a new boss. He has also put into practice a string of reforms suggested by several internal committees formed in the wake of the Blair affair. These include the appointment of a standards editor and a public editor, or ombudsman. By most accounts, the *Times* now is much more responsive to outside complaints and criticism than it was.

At considerable expense, the paper also has redesigned a half-dozen of its sections and upgraded its global culture coverage with the addition of 20 writing and editing jobs. "In the last year, there has been more change in a packed period of time than I've seen at this paper ever," says Sulzberger, who also credits Keller with "steadying our culture and lowering the temperature here." It is no mean feat to simultaneously improve morale and shake things up, but Keller is going to have to make certain that a happier newsroom does not again make for a more complacent newsroom. What Raines derided as "the *Times*'s defining myth of effortless superiority" might now be in remission—but has it been eradicated?

While the *Times* appears to be regaining its stride journalistically, it has not been rewarded with circulation gains (see Exhibit 2). In 2004, the paper posted an infinitesimal 0.2% increase in the circulation of both the daily edition, which now stands at about 1.1 million, and the Sunday paper, which is just under 1.7 million. Since the national expansion began in 1998, the *Times* has added 150,000 daily subscribers outside New York but is thought to have lost about 96,000 subscribers in its home market. The net increase of 54,000 represents a 5.1% uptick, which compares with the 3.5% decline in U.S. daily newspaper circulation over this period. What's more, the *Times* posted its gains despite boosting the price of a subscription by more than 25% on average.

New subscribers are increasingly hard to come by for all newspapers as advances in digital communications spur the proliferation of alternative sources of

news and information. For the under-30 set in particular, digital accessibility and interactivity tend to trump the familiarity of long-established names like *The New York Times*, CBS, or CNN.

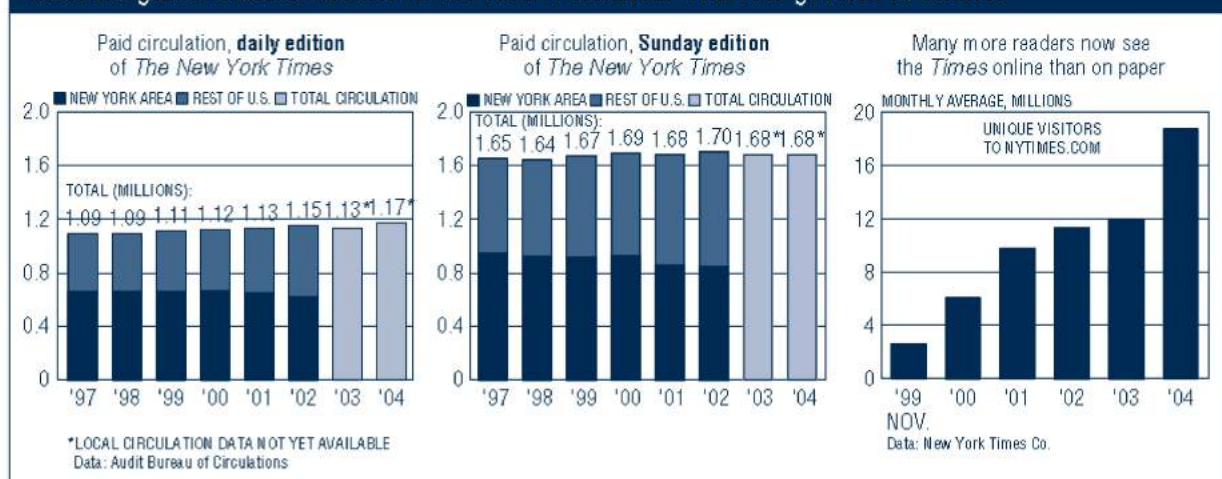
The growing polarization of the body politic along ideological lines also is hurting the *Times* and its big-media brethren. One of the few things on which Bush and Kerry supporters agreed during the Presidential campaign was that the press was unfair in its coverage of their candidate. Keller says the *Times* was deluged with "ferocious letters berating us for either being stooges of the Bush Administration or agents of Michael Moore." Complaints from the Right were far more numerous, even before the newspaper painted a bull's-eye on itself in running a column by public editor Daniel Okrent headlined "Is *The New York Times* a Liberal Newspaper?" Okrent's short answer: "Of course it is."

What a growing, or at least increasingly strident, segment of the population seems to want is not journalism untainted by the personal views of journalists but coverage that affirms their partisan beliefs—in the way that many Fox News shows cater to a conservative constituency. For years, major news organizations have been accused of falling short of the ideal of impartiality that they espouse. Now, the very notion of impartiality is under assault, blurring the line between journalism and propaganda.

For its part, the Bush White House has succeeded to a degree in marginalizing the national or "elite" press by walling off public access to much of the workings of the government and by treating the Fourth Estate

EXHIBIT 2 Circulation by the Numbers

National gains mask a decline in the New York area. The real growth is online.



as merely another special interest group that can be safely ignored when it isn't being exploited. The Bushies particularly dislike the *Times*, which, in their view, epitomizes the Eastern liberal Establishment. In his acceptance speech at the Republican convention, George W. Bush mocked the *Times* for what he considered its overly pessimistic coverage of post-World War II Germany. "Maybe that same person is still around, writing editorials," he joked.

The *Times* also is under attack from another branch of the federal government—the judiciary. The paper figures centrally in most of a half-dozen pending court cases that collectively pose a dire threat to the traditional journalistic practice of assuring confidentiality to whistle-blowers and other informants. In October, a federal judge ordered Judith Miller of the *Times* imprisoned for up to 18 months for refusing to testify before a grand jury investigating the leaking of the identity of CIA operative Valerie Plame to conservative columnist Robert Novak. Miller, who researched the Plame affair but never wrote about it, remains free pending a review by the federal Court of Appeals in Washington.

Sulzberger, who spent six years as a reporter, is outraged that journalists are being slapped with contempt charges for refusing to yield confidential sources to prosecutors. "Reporters are going to jail for doing their jobs, and that's just wrong," he says. The publisher has been less outspoken in responding to the paper's political assailants. In an interview with *BusinessWeek*, though, he denied his paper is biased in its coverage of national politics or the war in Iraq or even that it is liberal. The term he prefers is "urban," says Sulzberger. "What we saw play out in this election was urban vs. suburban-rural, not red state vs. blue state," he says. "We are from an urban environment; it comes with the territory. We recognize that, and we can't walk away from it, but neither can we play it politically. I don't think we do."

For the first time since he became publisher 12 years ago, Sulzberger must carry on without Russ Lewis at his side. Lewis, a loquacious lawyer who got his start as a *Times* copy boy in 1966, stepped down on Dec. 26 after seven years as president and CEO of NYT Co. His replacement is the 54-year-old Janet Robinson, a former schoolteacher who joined the company in 1983 and worked her way up through advertising sales. She played an important role in the national expansion of the *Times* as its president and general manager from 1996 into 2004. On the Street, Robinson is known as a formidable manager who relentlessly puts NYT Co.'s

best foot forward. "She's never met a number she couldn't spin positively," one analyst says.

The most pressing business problem the new CEO faces is a paucity of advertising. Through November, the *Times*'s ad revenues were just 2.3% ahead of the previous year—a surprisingly weak performance, considering that the newspaper industry as a whole reported a 9.7% gain in national advertising revenues during the first nine months, according to TNS Media Intelligence/CMR. Expenditures on local newspaper advertising in the industry rose 6.6%.

A strengthening U.S. economy would help the *Times* in 2005 but wouldn't necessarily restore it to competitive parity. The huge runup in advertising rates over the last decade is forcing more U.S. companies to economize, either by shifting into lower-cost media or by homing in more precisely on their target markets. Neither trend bodes well for the *Times*, whose unique status as America's only metro daily with national reach appears to be putting it at a tactical disadvantage in some ways.

The *Times* has many fewer readers outside of New York City than do the two largest national newspapers—*USA Today* and *The Wall Street Journal*—both of which have circulations far in excess of 2 million. "Those two papers tend to be a more cost-effective buy than the *Times* just because their circulation across the country is so much larger," says Jeff Piper, vice-president and general manager of Carat Press, a big media buyer. Even in the New York region, where the *Times* reaches only 14% of all adult readers, the paper's circulation is too diffuse to allow for effective targeting by ZIP Code—a technique that has enriched many other metro dailies with revenue from inserts.

Robinson maintains that there is nothing wrong with the *Times*' market position that a growing national and New York economy can't fix. Underscoring her confidence, the paper just imposed what is now an annual Jan. 1 ad rate increase, layering a 5% hike atop a cumulative 38% increase since 2000. "We feel that premium quality equals premium price," Robinson says.

At the same time, the *Times* continues to move out from the 312 markets in which the paper is available into adjacent precincts. In October, it began printing the national edition in Dayton, Ohio, in a plant owned by the local daily. That enabled it to sell papers in 100 new ZIP Codes while raising its presence in existing markets as far afield as Louisville. It plans to add seven new contract sites to its network of 20 printing plants by the end of 2006.

The reinvention of the *Times* as a national paper has been accompanied by a steady loss of subscribers in the New York metro area. Its dwindling presence at home has been caused in part by forces beyond its control, including a big influx of non-English-speaking immigrants. However, taking the paper further upscale in pursuit of an elite nationwide readership priced it out of some New Yorkers' reach (a seven-day subscription goes for about \$480 a year) and constrained its spending on local marketing and promotion. In addition, the *Times* has declined to join in the trend of introducing foreign-language editions or free editions for young adult readers. (It may be rethinking its free-paper aversion, as evidenced by *The Boston Globe's* recent purchase of a 49% stake in *Metro Boston*, a give-away tabloid.)

The substitution of national for local subscribers benefited the *Times* financially even beyond the sizable premium it earns on national advertising. On average it costs the *Times* about one-third more to produce and deliver a newspaper in its home market (the only place where it owns its printing plants) than in the rest of America. But Sulzberger bristles at the notion that the *Times* is writing off its hometown readers or that a declining New York circulation is the inevitable result of national expansion. "We are not walking away from New York," he says. "But we are growing elsewhere."

The sphere of NYT Co.'s ambitions widened to encompass the globe when it muscled Washington Post Co. aside to gain full control of the *International Herald Tribune*, America's broadsheet voice abroad since 1887. The Post reluctantly agreed to relinquish its 50% interest for \$65 million after NYT Co. threatened to start a new paper to drive the IHT out of business. "The thing was going sideways and sooner or later was going to die," says Sulzberger, who was harshly criticized by some for lacking the gentlemanliness of his father.

The company considered making the *Tribune* over into a foreign edition of the *Times*, but decided in the end to maintain IHT's separate, international identity. "This needs to be a European paper for Europeans," says Michael Golden, a NYT Co. vice-chairman who was named publisher of IHT in 2003. Actually, the *Trib's* 240,000 subscribers are concentrated in Europe but spread among 180 countries.

Under Golden, a slightly older first cousin of Sulzberger's, the *Trib* has adopted the *Times's* playbook, if not its name. The transatlantic flow of copy from the *Times* has increased, but the *Trib* has enlarged its own news staff, too. It has also added

pages, color photos, and new printing sites in Sydney, São Paulo, and Kuwait City. The *Trib* scored impressively in recent reader surveys in Europe and Asia and ad sales are rising, but they still amount to less than \$100 million a year. Golden and his cousin yearn to turn the *Trib's* operating losses into profits, but the general track record of English-language newspapers and magazines abroad is discouraging. Even if the IHT flourishes, it will be a long time before it contributes significantly to its parent company's top or bottom lines.

The same is true of NYT Co.'s investment in television news. The *Times* has built a cadre of television professionals who, in collaboration with a revolving cast of print reporters, have produced much fine work for *Frontline*, *Nova*, and other programs. In 2003, the *Times* moved beyond production into distribution, laying out \$100 million for half-ownership of a digital cable channel, Discovery Times, operated in partnership with Discovery Communications Inc. Discovery Times reaches 35 million homes—an impressive total for a fledgling channel—but its ratings are minuscule: In October, just 27,000 people tuned in during prime time, according to Nielsen/NetRatings.

Online, the *Times* already is making serious money. New York Times Digital (which includes Boston.com as well as NYTimes.com) netted an enviable \$17.3 million on revenues of \$53.1 million during the first half of 2004, the last period for which its financials have been disclosed. All indications are that the digital unit is continuing to grow at 30% to 40% a year, making it NYT Co.'s fastest-revving growth engine.

Advertising accounts for almost all of the digital operation's revenues, but disagreement rages within the company over whether NYTimes.com should emulate *The Wall Street Journal* and begin charging a subscription fee. Undoubtedly, many of the site's 18 million unique monthly visitors would flee if hit with a \$39.95 or even a \$9.95 monthly charge. One camp within the NYT Co. argues that such a massive loss of Web traffic would cost the *Times* dearly in the long run, both by shrinking the audience for its journalism and by depriving it of untold millions in ad revenue. The counterargument is that the *Times* would more than make up for lost ad dollars by boosting circulation revenue—both from online fees and new print subscriptions paid for by people who now read for free on the Web.

Sulzberger declines to take a side in this debate, but sounds as if he is leaning toward a pay site. "It gets to

EXHIBIT 3
Strategy Report Card**New York Times Co. aims to deliver top-notch journalism in any form, anyplace.**

PRINT Instituted a radical plan to take the flagship paper national. For years, it looked like a masterful stroke as new ads and subscribers poured in. In an effort to build a presence in all markets, the *Times* prints at 20 plants across the nation. Lately, though, circulation growth has hit a wall.

GRADE: B+ (was A last semester)

TELEVISION Has pursued several ventures for translating *Times* stories into documentaries. Two years ago the *Times* spent \$100 million for a one-half interest in Discovery Times, a cable channel. Efforts so far have been good for the brand, but not much of a moneymaker.

GRADE: C+

DIGITAL the *Times* was early to see the potential of the Web. Today the *Times* Web site is attracting nearly 18 million visitors each month, and ad sales are growing 30% to 40% a year. The result: a \$100 million business in NYT.com with healthy margins and robust growth.

GRADE: A-

INTERNATIONAL

Squeezed out *The Washington Post* in 2002 to gain full ownership of the *International Herald Tribune*. The *IHT* has more cachet overseas than the *Times*, so it won't carry the flagship brand for now. But it's getting a *Times*-style makeover. Growth prospects are uncertain.

GRADE: INCOMPLETE

the issue of how comfortable are we training a generation of readers to get quality information for free," he says. "That is troubling."

What's a platform agnostic to do? *The New York Times*, like all print publications, faces a quandary. A majority of the paper's readership now views the paper online, but the company still derives 90% of its revenues from newspapering. "The business model that seems to justify the expense of producing quality journalism is the one that isn't growing, and the one that is growing—the Internet—isn't producing enough revenue to produce journalism of the same quality," says John Battelle, a co-founder of *Wired* and other magazines and Web sites.

Today, Sulzberger faces an even bigger challenge than when he took charge of the *Times* in the mid-1990s (Exhibit 3). Can he find a way to rekindle growth while preserving the primacy of the *Times*'s journalism? The answer will go a long way toward determining not only the fate of America's most important newspaper but also whether traditional, reporting-intensive journalism has a central place in the Digital Age.

—With John Rossant in Paris and Lauren Gard in New York

Source: Anthony Bianco, "The Future of the New York Times," *BusinessWeek*, January 17, 2005, 64–72.

Case 1-3**Coca-Cola Co. (A)**

When former Coca-Cola co. executive E. Neville Isdell agreed last May to come out of retirement and become chief executive of the beleaguered soda giant, he brimmed with confidence. No Coke newcomer, Isdell had spent 35 years inside the vast Coke system as the Atlanta company built itself into the world's most recognized global brand, retiring in 2001 after a three-year

stint as head of a large European Coke bottler. "The system isn't broken," Isdell told a *BusinessWeek* reporter at the time. "There's still opportunity for both Coca-Cola and the other brands."

All it took was a tour of Coke's operations in India, China, and 14 other key markets this summer for Isdell to see a different reality: Coca-Cola was a troubled company. Things looked so bad that just 100 days into his new job the 61-year-old Irishman interrupted his fact-finding mission to deliver a surprise warning to Wall Street. Coke, which had been struggling since the

death in 1997 of its revered CEO, Roberto C. Goizueta, had made little progress in its efforts to meet the rising challenges of noncarbonated drinks. The soda giant would fall short of the meager 3% growth in earnings that analysts were resigned to for the third and fourth quarters. Moreover, Isdell was clearly prepping Wall Street for perhaps another year—or longer—of underperformance. “We’ve got a long way to go,” a chastened Isdell told analysts. “The last time I checked, there was no silver bullet. That’s not the way this business works.” Coke later announced that third-quarter earnings had fallen 24%, the worst quarterly drop at Coke in recent history.

As late as the 1990s, Coca-Cola Co. was one of the most respected companies in America, a master of brand-building and management in the dawning global era. Now the Coke machine is badly out of order. The spectacle of Coke’s struggles has become almost painful to watch: the battles with its own bottlers; the aged, overbearing board; the failed CEOs and failed attempts to recruit a successor; the dearth of new products; the lackluster marketing. “They’ve been their own worst enemy, a casualty of their own success,” says Emanuel Goldman, who has followed Coke as an analyst since the 1970s (see Exhibit 1).

Yet as grave as those problems are, they only hint at the real dimensions of Coke’s woes. The Coca-Cola organization is stuck in a mind-set formed during its heyday in the 1980s and ’90s, when Goizueta made Coke into a growth story that captivated the world. An unwillingness to tamper with the structures and beliefs formed during those glory years has left the company unable to adapt to consumer demands for new kinds of beverages, from New Age teas to gourmet coffees, that have eaten into the cola king’s market share. “The whole Coke model needs to be rethought,” says Tom Pirko, president of BevMark LLC, a Santa Barbara (Calif.) consulting firm. “The carbonated soft-drink model is 30 years old and out of date.”

Of all the problems that can beset a corporation, a dysfunctional culture has to be one of the toughest to fix. How do you get thousands of employees suddenly to change their most basic assumptions about their company? After all, the beliefs and attitudes that make up a culture filter into everything else: decisions on basic strategy, management style, staffing, performance expectations, product development. That’s why the problems at Coke have proven so intractable. A succession of managers has focused on trying to do what Coke has always done, only better. Meanwhile, rival

EXHIBIT 1 Coke’s Challenges

Break-Down

Coke today struggles to do the things that once made it great

MEDDLING BOARD

Coke’s star-studded group of directors, many of whom date back to the Goizueta era, has built a reputation for meddling. Some insiders believe the last CEO, Doug Daft, never recovered after the board unexpectedly vetoed his 2000 deal for Quaker Oats.

MORIBUND MARKETING

Once world-class, critics say that today the soda giant has become too conservative, with Norman Rockwell-like ads that don’t resonate with the teenagers and young adults that make up its most important audience.

LACK OF INNOVATION

In the U.S. market, Coke hasn’t created a best-selling new soda since Diet Coke in 1982. In recent years, Coke has been outbid by rival PepsiCo for faster growing noncarb beverages like SoBe and Gatorade.

FRICTION WITH BOTTLERS

Over the past decade Coke has often made its profit at the expense of bottlers, pushing aggressive price hikes on the concentrate it sells them. But key bottlers are now fighting back with sharp increases in the price of Coke at retail.

INTERNATIONAL WORRIES

Coke desperately needs more international growth to offset its flagging U.S. business, but while some markets like Japan remain lucrative, in the large German market Coke’s had so many problems it’s rebidding all bottling contracts in 2007.

PepsiCo Inc. has a much different view of its mission (hint: it's not just about soda pop)—one that has helped it adapt far more successfully to a changing marketplace. Until Coke can lay the ghost of Goizueta to rest and let go of some long-cherished beliefs, it's unlikely to fix its problems.

Frozen in Time

Is the latest Coke CEO capable of leading Coke out of the valley? It's too early in Isdell's tenure to say for sure, but the early signs are not promising. Although he earned a reputation for bold decision-making as a young executive, Isdell seems to have fallen into lock-step with the reigning Coke orthodoxy. He says the company's salvation lies in simply tuning up the soda operations and capitalizing on existing brands. "We are not talking about radical change in strategy," he told Wall Street analysts in November. "We are talking about a dramatic change in execution."

That was more or less the playbook used by Roberto Goizueta, a charismatic CEO. The Cuban-born executive sold off ancillary businesses and refocused the company on what it did best: selling carbonated soft drinks. At the same time he engaged in some sophisticated reengineering of the company's financial structures. In 1986, Coke spun off a 51% stake in its U.S. bottling operations, a shrewd bit of financial alchemy that let it dump billions of dollars of bottling-related debt off its balance sheet while allowing it to continue pulling the strings at the spin-off. Thanks to near-constant buying and selling of small bottling operations, the deal also helped Coke achieve consistent profit gains, turning the once-stodgy company into—shazam!—a growth stock.

Meanwhile, Coke was able to ride the global boom like few other companies, rushing into once-closed economies such as China, East Germany, and the Soviet Union and sating their pent-up demand for a taste of America. The result: Coke stock soared 3,500% during Goizueta's 16-year reign, helping to make him one of the first supercompensated CEOs and the first professional manager to break the \$1 billion pay barrier. After his death from lung cancer in October, 1997, Goizueta was all but deified, his financial structures, his cola-centric philosophy, and even his board of directors frozen in place ever since.

The ensuing years have seen a long and painful descent. After generating average annual earnings growth of 18% between 1990 and 1997, Coke's net income in recent years has grown an average of just

4%. Shares have fallen hard, currently trading at less than half their 1998 peak as more and more investors conclude that Coke's best days may be behind it. "At Coke," says Brian Holland, research director at Boyd Watterson Asset Management LLC, a Cleveland money manager that has cut its Coke holdings by 84% since last December, "there's a lot to fix, and there's no short-term solution."

In the absence of a clear vision, Coke's desire to cling to its past is not hard to understand. After all, in Coke Classic, the company is blessed with a flagship product that remains, for all of the management missteps of the past decade, one of the most powerful brands in the world. And despite the company's problems, it is still a cash cow. Helped by the dollar's decline against other major currencies, Coke is expected to generate roughly \$5 billion in operating profits this year, far beyond such companies as Nike, Colgate-Palmolive, and McDonald's that have similar global ambitions. Indeed, part of Coke's paralysis is a fear that nothing else the company enters will ever match the extraordinary margins of soda concentrate.

"Smoke and Mirrors"

Goizueta's most ingenious contribution to Coke, the ingredient that added rocket fuel to the stock price, was a bit of creative though perfectly legal balance-sheet rejiggering that in some ways prefigured the Enron Corp. machinations. Known inside the company as the "49% solution," it was the brainchild of then-Chief Financial Officer M. Douglas Ivester. It worked like this: Coke spun off its U.S. bottling operations in late 1986 into a new company known as Coca-Cola Enterprises Inc., retaining a 49% stake for itself. That was enough to exert de facto control but a hair below the 50% threshold that requires companies to consolidate results of subsidiaries in their financials. At a stroke, Coke erased \$2.4 billion of debt from its balance sheet. Just as important, it was able to command six board seats at CCE, which it packed with current or former Coke executives, including then-Coke President Donald R. Keough. With effective control, Coke for years could ensure that CCE was run to Coke's benefit. "Coke was creating a special-purpose entity, like Chewbacca from Enron," marvels one Wall Street analyst, referring to Enron's Chewco Investments limited partnership. Coke disputes any comparison to Enron and says the spin-off was simply a way "to leverage substantial efficiencies and adapt more rapidly to the changing trade landscape in the U.S."

Its behind-the-scenes control of CCE allowed Coke to extract a series of advantages, from pricing to deciding how many vending machines CCE purchased. Coke had tacit control over how much its largest customer—CCE—paid for the concentrate Coke sold it, as well as how much CCE charged retailers for the actual soda. Thus the escalating price wars between Coke and Pepsi came much more out of CCE's margins than Coke's, especially since Coke also required CCE to shoulder a growing portion of its brands' marketing costs.

But that was just one aspect of this unusual relationship. In the '80s and '90s a generation that ran small, family-owned bottlers was looking to retire. Coke had been snapping up these operations as a way to assure quality and to keep them from falling into the hands of leveraged-buyout artists, who would likely bleed them for their cash flow. In CCE it had another so-called anchor bottler, one of roughly a dozen around the world, from which it could exact ever-higher profits as it resold these smaller bottlers to the anchors. There were so many such deals that Coke was able to convince analysts the resulting profits should be considered part of normal operations and not extraordinary income.

For a time, this flurry of dealmaking masked the problems building in Coke's international business. But by the end of the '90s, Coke simply ran out of assets to resell, and its largest bottlers began to sink fast under all the debt-financed acquisitions they had made at Coke's behest. The result: Coke's profits stalled, with operating income falling from \$5 billion in 1997 to as low as \$3.69 billion in 2000. "In hindsight, a lot of what Coke was doing was smoke and mirrors, stuff that wouldn't pass the accounting standards of today," notes Douglas C. Lane, a private fund manager who now holds 400,000 Coke shares. "And at the time it created expectations of growth that weren't real." Coke notes that all such transactions were fully disclosed at the time.

The next move was inevitable: Coke imposed a crushing 7.6% price hike on its bottlers in the late '90s as Ivester, now CEO, desperately tried to sustain Goizueta's profit streak. Coke's U.S. bottlers, livid over the price increase, burned up the phone lines to some key Coke board members and succeeded in pushing the already embattled Ivester over the ledge. In late 1999, he resigned.

Ivester's successor, Douglas N. Daft, tried to work with bottlers, but relations have steadily deteriorated since. (Daft serves on the board of The McGraw-Hill

Cos., which publishes *BusinessWeek*.) In a sign of disunity that would have been unthinkable in the Goizueta era, some bottlers are beginning to push back with price hikes that could boost their own profits—at Coke's expense.

While those hikes could dampen sales—and thus reduce the amount of concentrate bottlers need to purchase from Coke—the bottlers are clearly banking on the belief that they will come out ahead, even if Coke doesn't. At the same time, many bottlers have refused to carry some of the company's new noncarbonated niche offerings that Coke acquired, such as Mad River teas and Planet Java coffee, forcing the company to bury both products last year. While CCE executives maintain that relations have improved under Isdell, Trevor Messinger, a Coke bottler in Rapid City, S.D., readily admits relations between Coke and some bottlers are contentious. "I don't think everybody is on the same page of the playbook," he says.

If the friction between Coke and its bottlers worsens, some analysts believe that Isdell will have no choice but to resort to radical measures to defend Coke's interests—such as reacquiring the 62% of CCE it doesn't own. (Coke's stake has declined to 38% because of dilution.) If CCE continues to raise prices, then reabsorbing the bottler could be the only means left for Coke to ensure that it maintains its share of the pie, reasons Morgan Stanley analyst William P. Pecoriello.

Another scenario swirling inside the Coke system would have Isdell reacquiring CCE and then breaking up its assets and territories for resale to smaller bottlers or even major U.S. beer distributors—which as private companies may be content to work on lower margins than publicly traded CCE. But for now, Coke shows little willingness to tamper with this vestige of the Goizueta era. "I think that there are a number of things that we can do together without having to consider changing the model," Isdell said in an interview.

Nowhere is the Goizueta orthodoxy more apparent than in the company's unwavering focus on its aging group of soda-pop brands, especially the hallowed four: Coca-Cola, Diet Coke, Sprite, and Fanta. Goizueta was fond of discussing Coke's market share in terms of "share of stomach," as though, with the right marketing, people could be induced to give up coffee, milk, and even water in favor of Coke. Seven years after his death, the company remains fixated on making its flagship Coke brand the universal beverage from Stockholm to Sydney. Coke's sodas constitute 82% of its worldwide beverage sales, far more than at Pepsi,

which is gaining on Coke's lead in the U.S. beverage market and numbers Tropicana juice, Gatorade sports drinks, and Aquafina water among its billion-dollar beverage brands.

Coke loyalists still believe in the the mantra first coined by legendary Coke Chairman Robert W. Woodruff and often repeated by Goizueta, of putting a Coke within an "arm's reach of desire" of consumers around the globe. But increasingly, consumers are reaching for anything but a soda. The mass market that Coke was so adept at exploiting has splintered. Consumer tastes have shifted from sodas to an array of sports drinks, vitamin-fortified waters, energy drinks, herbal teas, coffee, and other noncarbonated products, some of which are growing as much as nine times faster than cola. After rising steadily during the '80s and '90s, per capita soda consumption in the U.S. has declined every year since 1998. Yet when Daft tried to push Coke to become a "total beverage company," he met with resistance from Coke's board.

In an interview early in the Daft years, investment banker and director Herbert A. Allen dismissed Daft's efforts, declaring: "That's all fine and good, but I still believe that getting the four core [soda] brands right is 85% of the equation." That attitude still seems to dominate. One director, speaking on the condition he not be named, recently dismissed bottled water as "something I guess we have to carry. But the fact is we're still the kings of carbonation—always have been, always will be."

Coke's cultural resistance to diversification has become an enormous liability. South Beach Beverage Co., for example, negotiated with Coke for two years before the soda giant decided against acquiring the New Age juice company. It took Pepsi just two weeks to make an offer. Is SoBe a huge brand? No, but it gives Pepsi access and insight into a market that its soda pop completely bypasses. If you think of yourself as a beverage-and-snack company, as Pepsi does, that's valuable. If you think of yourself as a soda company, as Coke does, it's not.

Pepsi Generation

Its portfolio of beverages and its faster-growing snack foods give Pepsi enormous clout with retailers (see Exhibit 2). Pepsi boasts that it has become the second-largest generator of revenues, after Kraft Foods Inc., for its largest grocer customers. Pepsi isn't shy about using that clout to try to wrest shelf space from Coke and other rivals. "If we were only playing in carbonated soft

EXHIBIT 2 Coke vs. Pepsi

Pepsi never quite caught Coke in the cola wars, but its portfolio strategy has made it the long-term winner	
COKE	PEPSI
Sales \$21 BILLION	Sales \$27 BILLION
Sales Growth* 2%	Sales Growth* 4%
Earnings \$4.3 BILLION	Earnings \$3.6 BILLION
Earnings Growth* 4%	Earnings Growth* 12%
Stock** -40%	Stock** 38%
Business Breakdown 100% BEVERAGE	Business Breakdown 37% BEVERAGE 58% FRITO-LAY SNACKS 5% QUAKER CEREAL
* Five-year average ** Five-years ended 12/3/04	Data: Bloomberg Financial Markets

drinks, competitively we would be disadvantaged in many ways," says PepsiCo CEO Steven S. Reinemund. "Being outside carbonated [soft drinks] makes sure we're growing in the areas where there is growth."

Isdell has said he'll explore new beverage categories. If so, he'll be starting well behind Pepsi. Pepsi got a two-year jump on Coke in bottled water and later outmaneuvered Big Red to acquire both SoBe and Gatorade. As a result, Coke's Powerade has just a 17% share of the fast-growing sports-drink segment in the U.S., vs. 81% for PepsiCo's Gatorade brand. And after garnering just a 2.8% share of the popular energy-drink category—vs. 58.5% for independent rival Red Bull—Coke plans to try again with a second energy drink, Full Throttle, in January.

But in reaching into new categories, Coke may have to figure out how to get these beverages to market using food brokers, since its dedicated bottlers have been loath to handle new products that don't approach the high volumes of soda. Here, too, Pepsi has a head start. Gatorade is already distributed through a well-established system of brokers. Coke also may have to reduce its profit expectations, since the margins on noncarbonated drinks are generally lower. "Even with premium price, they cannot achieve those [soda] margins in the New Age category," warns Lance Collins, founder of New Jersey-based Fuze Beverage LLC, whose products include a diet pomegranate white tea.

The one area at Coke where the thinking has changed since the height of the Goizueta era, though not necessarily for the better, is marketing. At his Atlanta funeral, Goizueta was eulogized to the strains of *I'd Like To Teach the World To Sing* from Coke's syrupy but unforgettable commercials of the '70s. At the height of its powers, the Coke marketing machine could turn even disaster into triumph, as it did when Coke tampered with its historic concentrate formula in 1985. The sweeter new concoction backfired, but Coke seized the opportunity to build intense loyalty for Coca-Cola Classic.

The marketing magic at Coke had begun to fade even before Goizueta's death. In the late '90s, Ivester began shifting resources away from advertising and into blanketing the world with as many vending machines, refrigerated coolers, and delivery trucks as Coke and its bottlers could muster. The goal was simple ubiquity, while the niceties of brand-building were ignored. "There was no vision, no marketing," recalls one former executive. "It was all growth through distribution."

This proved to be a costly shift. For one, vending machines that were put into unconventional locations such as auto-parts stores didn't always pay off. Coke's lackluster advertising didn't help, either. Ivester, who had a deep distrust of Madison Avenue, tended to starve the ad budget, believing that the iconic Coke brand was powerful enough to sell itself. That began to change under Daft, who hired Steven J. Heyer, a former ad exec, and promoted him to president. Then, to evade the stifling Atlanta bureaucracy, he and Heyer pushed decision-making out into the field. But the move went wrong when Coke's local marketers, suddenly unshackled, began producing racy ads, including an Italian spot featuring a couple skinny-dipping. That prompted Coke headquarters to reclaim control and revert to bland Norman Rockwell-type ads. The

result, says one former marketing executive, is an erosion of Coke's perceived value as a brand: "Starbucks can charge \$2 for a cup of coffee, and they can barely sell a 12-pack of Cokes for \$2."

In recent years, Coke showed signs of regaining its footing on the marketing front, thanks in large part to Heyer. But Heyer's departure in June after he was passed over for the top job was viewed as a big loss and is likely to lead to an exodus of the talent he brought to Coke during his three-year tenure. His successor, longtime Coke exec Charles B. "Chuck" Fruit, contends that Coke is producing good ads but has been hurt by a propensity to careen from campaign to campaign. "We've suffered from an impatience that we're going to have to overcome," he says. "When we change campaigns and have 11 different looks to a brand at any one time, we're swimming upstream."

"Simple Little Things"

To really break out, Coke could make a transformative acquisition, as Pepsi did in the 1970s when it bought Frito-Lay Inc. But Isdell is downplaying the notion of a big, audacious fix for Coke's troubles. In fact, he readily admits that during one of his European tours he passed on the chance to acquire Red Bull—the independently owned, market-leading energy drink. Rather than a gaudy acquisition, Isdell maintains that Coke's redemption will come from its ability to better perform the "millions of simple little things" that Coke employees do around the globe each day. And Isdell is adamant that there's still growth in carbonated soft drinks. The reason goes back to the bottom line: He says there just aren't many businesses for sale that produce the lush margins—around 30%, some analysts estimate—that Coke makes from selling its proprietary concentrate to bottlers. In the end, Isdell has come around to the view that there's plenty of growth left in soda pop. "Regardless of what the skeptics may think, I know that carbonated soft drinks can grow," he told analysts in mid-September.

That's a remarkably conservative strategy for a man who made his name as a change agent at the soda giant. During his years of helping Coke crack emerging markets in Africa, Asia, and Eastern Europe—assignments that earned him the reputation as the "Indiana Jones of Coke"—the gregarious former rugby player made his mark as the revolutionary who was always willing to challenge the corporate dogma. As a European executive in the late 1980s, Isdell pushed the company

into bottled water—a full decade before the cola-centric managers did the same back in the U.S. “He got an awful lot of grief from headquarters,” recalls Gavin Darby, a former Coke executive.

And when Coke was poised to reenter India in 1993 after a 17-year absence, Isdell allowed his local managers to establish a beachhead by purchasing the leading India soda maker, Parle, even though Coke had long frowned on acquiring rival soda makers. Coke’s former India chief, Jay Raja, recalls Isdell telling him to go for it: “We agreed that we would ask for forgiveness instead of permission.” Isdell’s instincts were proven right: At a later board meeting, Goizueta hailed Isdell’s move, which gave Coke 60% of the Indian soda market almost overnight, as “the deal of the decade,” recalls Raja.

Notorious Board

Perhaps the biggest impediment Isdell faces, outsiders say, is Coke’s board. More than anyone else, the directors, especially the powerful triumvirate of Warren E. Buffett, Herbert A. Allen, and Donald Keough, are the keepers of the flame at Coke. Over the years they have strictly enforced obedience to the Goizueta Way. This politburo of the Goizueta era (of 14 directors, 10 date back to the late CEO) has chewed through two CEOs in the past five years. Three directors are over the age of 70, but don’t look for any departures soon. Earlier this year the board waived Coke’s mandatory retirement age, 74, to allow Buffett to remain and Keough to rejoin.

This is a group that believes in getting involved—very involved—in company affairs. Many Coke insiders feel that Daft, Isdell’s predecessor who abruptly announced his retirement last February, never recovered from Buffett’s 11th-hour veto of his attempt to steal Quaker Oats Co. from Pepsi in November, 2000. The deal was quashed when the legendary financier declared at a special board meeting that Quaker and its powerful Gatorade brand weren’t worth giving up 10.5% of the Coca-Cola Co. Daft declined to speak for this article except to say he retired for health reasons. “The board has to challenge management’s plan but should not challenge its authority. The Coke board was micro-managing,” says John M. Nash, a board consultant and former president of the National Association of Corporate Directors.

So notorious is the Coke board that many blame it for the humiliating rejections Coke received from a string of CEO candidates the board courted before anointing Isdell. Even Buffett’s prestige were not enough to persuade James M. “Jim” Kilts, head of Gillette Co., where Buffett was a director for years. Like Robert A. Eckert of Mattel Inc. and Carlos M. Gutierrez of Kellogg Co., Kilts passed on the opportunity to head the world’s most powerful brand. (Indeed, one executive that Coke approached for the job was rankled by the way Coke’s board leaked the names of people it was pursuing. “It was like the search was playing out on CNN,” he says. “One of the greatest legacies that [Isdell] can leave behind is a reshaped board.”)

Board members have made clear their opposition to product diversification, as well as their belief that mergers aren’t what’s needed. At times they’ve even involved themselves in operations. Keough rankled some marketing staffers when earlier this year he personally killed an edgy TV ad—in which a teen wipes a Coke can under his armpit before handing it to an unwitting friend—that he deemed in poor taste. Isdell maintains that he’ll be able to stand his ground with Coke’s board. Sonya H. Soutus, a Coke spokeswoman, says it is “presumptuous and unfair” to criticize Coke’s board members, who she says have substantial stockholdings, bring a wealth of experience, and have taken steps to address Coke’s problems.

Can Isdell return Coke to greatness? In some ways, the clock is working against him. At 61, he may be only a transitional CEO. Still, long-timers can sometimes bring special skills to rejuvenating a tired corporate culture. “A.G. Lafley was a product of Procter & Gamble, and William Johnson was a product of [H.J.] Heinz,” notes Gary M. Stibel, a management guru at Westport (Conn.)-based New England Consulting Group. “They remembered what it was like when their companies were great, and they returned them to that greatness.” There are plenty of other examples, though, such as Eastman Kodak Co., where a succession of CEOs was unable to break from the past and continued to ride outdated models and product lineups nearly into oblivion. As two CEOs have already discovered at Coke, it isn’t easy following in the footsteps of a legend.

Source: Dean Foust, “Gone Flat,” *BusinessWeek*, December 20, 2004, 76–82.

Part
Markets,
Segments, and
Customer Value **2**

Chapter 2

Markets and Competitive Space

Markets are increasingly complex, turbulent, and interrelated, creating challenges for managers in understanding market structure and identifying opportunities for growth. The traditional view assumes that the market and competitive space are stable and changes are predictable. Importantly, this perspective may be misleading and even dangerous when market boundaries reconfigure because of new technologies and competition and the emergence of new business designs (such as Google, Inc., the world's leading Internet search engine). Sustaining and building competitive advantage increasingly requires altered strategic thinking about market boundaries and structure. Rapid technological change, market convergence, Internet access, global competition, and the diversity of buyers' preferences in many markets require continuous monitoring to identify promising business opportunities, assess the shifting requirements of buyers, evaluate changes in competitive positioning, and guide managers' decisions about which buyers to target and how to position brands to appeal to targeted buyers. A complete view of the market is important, even when management's interest centers on one or a few market segments within a particular market. Understanding the scope and structure of the entire market is necessary to develop strategy and anticipate market changes and competitive threats. Understanding markets and how they are likely to change in the future are vital inputs to market-driven strategies.

Illustrative of the challenges of transformation in markets and competitive space are Eastman Kodak's delayed responses to the potential disruptive impact of digital photography on traditional film and camera markets. The pervasive impact of digital imaging technology demanded a rapid change in Kodak's business design and understanding of the market.¹ Kodak's revenues from its traditional products and services declined from \$10 billion in 2001 to an estimated \$5 billion in 2007, when total revenues were expected to exceed \$10 billion. The consequences of Kodak's delayed responses to the changing markets include major financial losses, extensive layoffs, expensive plant closures, and escalating debt. Kodak's prior management (new CEO in June 2005) had underestimated the speed and rate of decline of purchases in film markets around the world. The 25 percent annual declines in Kodak's film sales were more than three times greater than estimated by management. While Kodak holds a strong position in the U.S. digital camera market, adding to the firm's financial problems are the very small margins on digital cameras. Management decided to stop building digital market share in late 2006 at the expense

of profitability and halted production of digital cameras, outsourcing manufacturing to a Singapore-based supplier. The company was expected to reach breakeven on digital camera sales at the end of 2006.

Kodak's competitive threats are not unique. Leica, the luxury traditional camera producer, was close to collapse in 2005 but management forecast better performance in 2006 with the introduction of its M8 digital rangefinder model. Many companies and industries are experiencing major changes in their core markets. Strategic thinking in changing markets confronts executives with complex challenges but also exciting opportunities. These new challenges are driven by demanding customers with changing value requirements, aggressive global competition, market turbulence, rapid emergence of new and increasingly turbulent technologies, and the escalating globalization initiatives of many companies.

The Kodak illustration highlights several important issues concerning markets and competitive space. The changes described show how competitive threats may develop from new competition (electronics firms). Importantly, the rapid growth of digital photography points to the importance of market sensing and strategic vision in assessing the nature and scope of new competitive threats and guiding strategic initiatives to counter the threats.

The chapter begins with a discussion of how markets and strategies are interrelated, followed by an approach to determining product-market scope and structure. Next, we look at how buyers are described and analyzed, and examine the important process of competitor analysis. Guidelines follow for developing a strategic vision about the scope and composition of markets in the future. Finally, we consider how to estimate market size. Financial Analysis guidelines are included in the Appendix.

Markets and Strategies

Knowledge about markets and competitive space is essential in guiding business and marketing strategies. First, we look at how markets impact strategy and discuss the importance of thinking outside the competitive box. Next, we examine several forces that are creating changes in market boundaries and structure, and consider the need to define markets in terms of buyers' needs and product benefits.

Markets and Strategies Are Interlinked

Market changes often require altering business and marketing strategies. Managers who do not understand their markets and how they will change in the future may find their strategies inadequate as buyers' value requirements change and new products become available which better satisfy buyers' requirements. Many forces are causing the transformation of industries and are changing the structure of markets and nature of competition. These influences create both market opportunities and threats by altering the nature and scope of products, markets, and competitive space. Market-driven companies proactively alter their strategies to deliver superior value to existing and new customers. For example, PepsiCo shows impressive performance in understanding and catering to changing tastes in the beverage and snacks market, rather than trying to change them.² The company faces the facts about market change and adapts products to them. To capitalize on the growing market for New Age herbally enhanced beverages, PepsiCo acquired SoBe Beverages in 2001, and extended the brand into an energy drink for the school age market—SoBe No Fear—and SoBe Fuerte, aimed at the Hispanic market. Sabritas chips were brought in from PepsiCo's Mexican subsidiary targeting the foreign-born segment of the large and escalating U.S. Hispanic market. PepsiCo defines its mission as serving the consumer, not protecting its existing brands.

Thinking Outside the Competitive Box³

Not surprisingly there is a tendency for executives to think in terms of a stable “competitive box” around their businesses—defined by technology, geography, competitors, and the existing customer base. This frame of reference enables analytical tools to be successfully applied, research to be carried out, and plans to be made. This traditional perspective is logical in stable markets but fails to address the reality that the real threats as well as exciting opportunities may be present outside the conventional competitive box shown in Exhibit 2.1. Increasingly, new markets, new types of competition, and new business designs are emerging which fuel market growth and cannibalize the existing customer base of incumbents’ markets. Importantly, effective processes for understanding markets and competitive space and guiding the strategic initiatives appropriate for the markets require strategic thinking outside the competitive box.

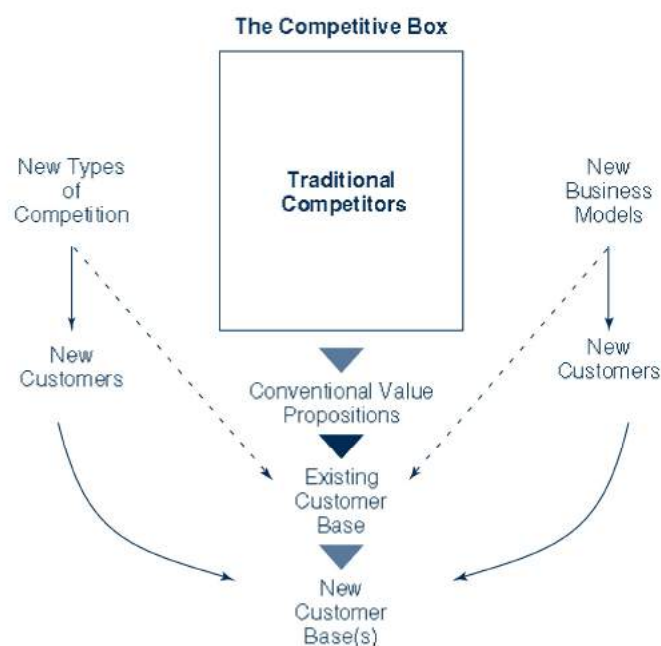
An Array of Challenges

Changes in markets are drastically altering opportunities and competitive space and increasing the importance of strategic thinking in these changing markets. Disruptive innovation, commoditization of product designs, creation of new market space, and fast changing markets are challenges that underline the need to identify changes in the market(s) and diagnose the strategic implications of the changes.

Disruptive Innovation

These innovations provide simpler and less costly ways to match the value requirements offered by the products (goods and services) of incumbent firms serving the market.⁴ Examples of disruptive innovations and new business models are illustrated by Amazon.com on traditional bookstores, digital photography on cameras and film, and steel mini-mills on integrated mills. The opportunity for market access by disruptive innovations is created by the products of incumbent firms in the market which are exceeding the value requirements of buyers. Disruptive innovations may meet the needs of new segments or entire markets.

EXHIBIT 2.1
Opportunities
Outside the
Competitive Box





Google is renowned as the leading Internet search engine. Established in 1998, Google was valued at \$23 billion when it was floated on the stock market in 2004, and made annual profits of nearly \$3 billion in 2006. The company's strategy initiatives reveal ambitions beyond search:



- Initial income was from search-related advertising—Google had online advertising income of \$11 billion in 2007.
- The company's strategy is expressed as "100 percent relevant beyond search," indicating its intention to leverage capabilities in areas other than simply Web searching.
- Google is targeting the global advertising industry—online and off-line. Recent developments include a move into video (through the purchase of YouTube as an outlet for video advertising); audio (by the acquisition of dMarc, an automated network selling radio advertising, and a deal with ClearChannel, the world's largest radio company); and print (with an agreement to sell advertising on behalf of 66 U.S. newspapers).
- Google is partnering with media companies to supply video content to affiliated websites—including MTV. It has formed an alliance with News Corporation's MySpace to access social networking.

- Google is now positioning itself as a rival to Microsoft—Google Apps allows users to off-load their e-mail systems to Google, while keeping their own e-mail addresses, as well as providing an online office productivity suite to compete directly with Microsoft's Office package. Google offers a free e-mail service—Gmail—challenging Microsoft's Hotmail; Picasa to allow online photo storage; Google Earth and Google Maps; free Web publishing; and is working on computer security products.
- Plans for e-book digitization—scanning books and making them online searchable—aims to do the same for books as the iPod did for music.
- Google's mission is to "organize the world's information" and not simply to personalize advertising, but to organize people's daily lives.

Sources: Tony Allen-Mills, "Search Me?," *The Sunday Times*, May 27, 2007, 1–13; Robert D. Hof, "Google Steps Into Microsoft's Office," *BusinessWeek*, February 12, 2007, 62–64; Richard Waters, "Act Two: How Google Is Muscling Its Way Into the Advertising Mainstream," *Financial Times*, January 19, 2007, 13; Richard Waters, "All Eyes on Google Advertising," *Financial Times*, April 17, 2007, 22.

Disruptive innovations may impact various technologies and industries. Indications of these new threats to existing firms can often be identified through perceptive market sensing outside the competitive box. Complacency and management's hesitancy to consider options beyond the core business focus are potential problems. When indications are found that markets are changing, strategic thinking initiatives need to be pursued. The strategic development of Google is illustrative of the disruptive changes that can be created by an able competitor. This is described in the STRATEGY FEATURE.

Commoditization Threats

When modularization (products comprised of standardized components) occurs products become commodities, making it difficult to earn anything more than subsistence returns.⁵ For example, when the personal computer (PC) market became commoditized the

opportunity for profits shifted to microprocessors (Intel) and operating system software (Microsoft). Commoditization was a key factor for IBM's management in deciding to move out of the PC market. The business was sold to Lenovo, the leading Chinese PC company.

The potential effect of commoditization in markets highlights the importance of developing a vision about how the market is likely to change in the future, and deciding what business strategy initiatives to pursue. Strategies to overcome commoditization threats may involve competing at a different stage in the value chain or moving into a different product category that provides attractive growth and profit opportunities.

Creating New Market Space

Kim and Mauborgne offer an interesting and relevant perspective on how companies can create new market space.⁶ These actions require finding and pursuing opportunities to offer potential buyers value in markets and segments that are not being served. The purpose is to target new opportunities where buyers' value requirements are not being satisfied by existing products. For example, unit sales of camera phones were estimated to exceed 400 million units in 2006, over four times digital camera sales.⁷ Cell phone users have access to digital photography because the camera is subsidized by wireless carriers. This creates new market space and new uses by digital camera users. Creating new market space requires changing management's traditional strategic perspective of looking for market opportunities inside the Competitive Box.

Fast Changing Markets

Increasingly, fewer markets are stable, and instead, many are changing rapidly. Fast changing markets require modifications in management's strategic thinking. Indications of changes are signaled by shifting customer value requirements, new technologies, changes in competitive space, and new business models. Fast changing markets may sometimes be difficult to predict and strategy initiatives may necessitate trial and error adjustments guided by market responses. Not acknowledging or responding to the threats and requirements of fast changing markets is the real danger. Importantly, even in markets assumed to be comparatively stable, innovation can quickly alter market space.

Matching Needs with Product Benefits

The term *product-market* recognizes that a market exists only when there are buyers with needs who have the ability to purchase goods and services and products are available to satisfy the needs. There is a compelling logic that competitive strength comes from putting customer needs at the center of a company's operations; that this perspective should guide strategic thinking for markets. For example, Progressive Insurance shows remarkable sales growth and shareholder value creation by its focus on the most important needs of its customers. The INNOVATION FEATURE describes how the company has adapted its operations to effectively meet customer needs.

Markets are comprised of groups of people who have the *ability* and *willingness* to buy something because they have a need (value requirement) for it.⁸ The ability to buy and willingness to buy indicate that there is demand for a particular product. People with needs and wants buy the benefits provided by a good or service to satisfy either a household or organizational use situation. A product-market matches people with needs—needs that lead to a demand for a good or service—to the product benefits that satisfy those needs. Thus, a product-market combines the benefits of a product with the needs that motivate people to express a demand for that product.

Accordingly, markets are defined in terms of needs substitutability among different products and brands and by the different ways in which people choose to satisfy their

Innovation Feature *Progressive Insurance: Customer Needs at the Center of Strategy*



- In the period 1994 to 2004, Progressive Insurance increased sales from \$1.3 billion to \$9.5 billion, and ranks high in the *BusinessWeek* Top 50 U.S. companies for shareholder value creation.
- The company invents new ways of providing services to save customers time, money, and irritation, while often lowering costs at the same time.
- Loss adjusters are sent to the road accidents rather than working at the head office, and they have the power to write checks on the spot.
- Progressive reduced the time needed to see a damaged automobile from seven days to nine hours.
- Policyholders' cars are repaired quicker, and the focus on this central customer need has won much auto insurance business for Progressive.
- These initiatives also enable Progressive to reduce its own costs—the cost of storing a damaged automobile for a day is \$28, about the same as the profit from a six-month policy.

Source: Adapted from Adrian Mitchell, "Heart of the Matter," *The Marketer*, June 12, 2004, 14.

needs. "A product-market is the set of products judged to be substitutes within those usage situations in which similar patterns of benefits are sought by groups of customers."⁹ The influence of competing brands becomes stronger the closer the substitutability and the more direct the competition. The Ford Taurus competes directly with the Toyota Camry, whereas in a less direct yet relevant way, other major purchases (e.g., vacation travel) compete with automobile expenditures due to the buyer's budget constraints.

As an example, a financial services product-market for short-term investments may include money market accounts, mutual funds, U.S. Treasury bills, bank certificates of deposit, and other short-term investment alternatives. If one type of product is a substitute for another, then both should be included in the product-market.

By determining how a firm's specific product or brand is positioned within the product-market, management can monitor and evaluate changes in the product-market to decide whether alternate targeting and positioning strategies and product offerings are needed. When defining a product-market, it is essential to establish boundaries that are broad enough to contain all of the relevant product categories which are competing for the same buyer needs.

Defining and Analyzing Product-Markets

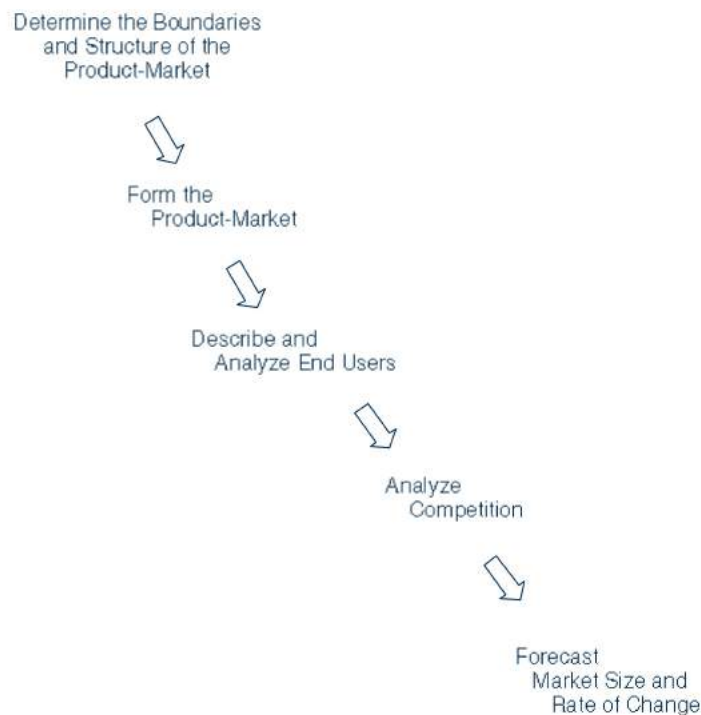
In the remainder of the chapter we discuss the activities involved in defining and analyzing product-markets. The steps are shown in Exhibit 2.2, beginning with determining product-market boundaries and structure.

Determining Product-Market Boundaries and Structure

Product-market boundaries and structure provide managers with important information for developing business and marketing strategies, and alert management to new competition. Considering only a company's brands and the direct competitors may mask potential competitive threats or opportunities.

Product-Market Structure

A company's brand competes with other companies' brands in generic, product-type, and product-variant product-markets. The **generic product-market** includes a broad group of

EXHIBIT 2.2
Defining and
Analyzing
Product-Markets


products that satisfy a general, yet similar, need. For example, several classes or types of products can be combined to form the generic product-market for kitchen appliances. The starting point in determining product-market boundaries is to identify the particular need or want that a group of products satisfies, such as performing kitchen functions. Since people with a similar need may not satisfy the need in the same manner, generic product-markets are often heterogeneous, containing different end-user groups and several types of related products (e.g., kitchen appliances).

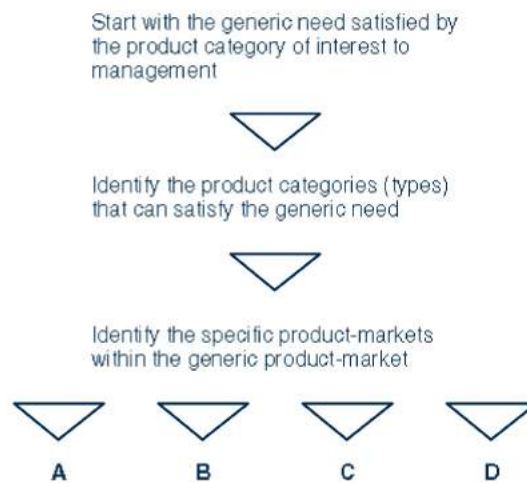
The **product-type product-market** includes all brands of a particular product type, such as ovens for use in food preparation by consumers. The product type is a product category or product classification that offers a specific set of benefits intended to satisfy a customer's need or want in a specific way. Differences in the products within a product-type product-market may exist, creating **product-variants**.¹⁰ For example, electric, gas, and microwave ovens all provide heating functions but employ different technologies.

Guidelines for Definition

In defining the product-market, it is helpful to indicate (1) the basis for identifying buyers in the product-market of interest (geographical area, consumer/business, etc.); (2) the market size and characteristics; and (3) the brand and/or product categories competing for the needs and wants of the buyers included in the product-market.

The composition of a product-market can be determined by following the steps shown in Exhibit 2.3. We illustrate how this process can be used to determine the composition of the kitchen appliance product-market. Suppose top management of a kitchen appliance firm is considering expanding its mix of products. The company's present line of laundry and dishwashing products meets a generic need for the kitchen functions of cleaning. Other kitchen use situations include heating and cooling of foods. In this example the generic need is performing various kitchen functions. The products that provide kitchen functions are ways of satisfying the generic need. The break out of products into specific product-markets (e.g., A, B, C, and D) would include equipment for washing and drying

EXHIBIT 2.3
Determining the
Composition of a
Product-Market



clothing, appliances for cooling food, cooking appliances, and dishwashers. The buyers in various specific product-markets and the different brands competing in these product-markets can be identified and analyzed. The process of mapping the product-market structure begins by identifying the generic need (function) satisfied by the product of interest to management. Need identification is the basis for selecting the products that fit into the product market.

An example of the product-market structure to meet people's needs for food is shown in Exhibit 2.4. A fast-food restaurant chain such as McDonald's should consider more than its regular customers and direct competitors in its market opportunity analysis. The consumption need being satisfied is fast and convenient preparation of food. The buyer has several ways of meeting the need such as purchasing fast foods, preparing food in the microwave in the home, patronizing supermarket delis, buying prepared foods in convenience stores, and ordering take outs from traditional restaurants. The relevant competitive space includes all of these fast-food sources. It is essential to analyze market behavior and trends in the product-markets shown in Exhibit 2.4, since competition may come from any of the alternative services.

Forming Product-Markets

The factors that influence how product-market boundaries should be determined include the purpose for analyzing the product-market, the rate of changes in market composition over time, and the extent of market complexity.

Purpose of Analysis

If management is deciding whether or not to exit from a business, primary emphasis may be on financial performance and competitive position. Detailed analysis of the product-market may not be necessary. In contrast, if the objective is finding one or more attractive

EXHIBIT 2.4
Illustrative Fast-Food
Product-Market
Structure



market segments to target in the product-market, a much more penetrating analysis is necessary. When different products satisfy the same need, the product-market boundaries should contain all relevant products and brands. For example, the photography product-market should include digital cameras, related equipment and services, and conventional cameras, film, and services. Product-market boundaries should be determined in a manner that will facilitate strategic thinking, enabling management to capitalize on existing and potential opportunities and to avoid possible threats.

Changing Composition of Markets

As discussed earlier product-markets may change as new technologies become available and new competition emerges. New technologies offer buyers different ways of meeting their needs. For example, fax technology gave people in need of overnight letter delivery an alternative way to transmit the information. The entry into the market by new competitors also alters competitive space.

Industry classifications often do not clearly define product-market boundaries. For example, people may meet their needs for food with products from several industries as shown in Exhibit 2.4. Industry-based definitions do not consider alternative ways of meeting needs. Industry classifications typically have a product supply rather than a customer demand orientation. Of course, since industry associations, trade publications, and government agencies generate a lot of information about products and markets, information from these sources should be included in market analysis. However, market analysis activities should not be constrained by industry boundaries.

Extent of Market Complexity

Three characteristics of markets capture a large portion of the variation in their complexity: (1) the *functions* or uses of the product needed by the customer, (2) the *technology* used in the product to provide the desired function, and (3) the different *customer segments* using the product to perform a particular function.¹¹

Customer function considers the role or purpose of the good or service. It is the value provided to the customer. Thus, the function provides the capability to satisfy the value requirements of the customer. In the case of the personal computer, the function performed may be entertainment for the household, information search, Internet purchasing, or the performance of various business functions.

Different *technologies* may satisfy the use situation of the customer. Steel and aluminum materials meet a similar need in various use situations. The technology consists of the materials and designs incorporated into products. In the case of a service, technology relates to how the service is rendered. For example, voice calls can be sent via the Internet, traditional phone lines, and wireless phones.

Customer segment recognizes the diversity of the needs of customers in a particular product-market such as automobiles. A specific brand and model won't satisfy all buyers' needs and wants. Two broad market segments for automobile use are households and organizations. These classifications can be further divided into more specific customer segments, such as preferences for European-style luxury sedans, sport utility vehicles, and sports cars.

It is important to focus on the consumer (or organizational) end-user of the product when defining the market, since the end-user drives demand for the product. When the end-users' needs and wants change, the market changes. Even though a producer considers the distributor to which its products are sold to be the customer, the market is really defined by the consumer and organizational end-users who purchase the product for consumption.

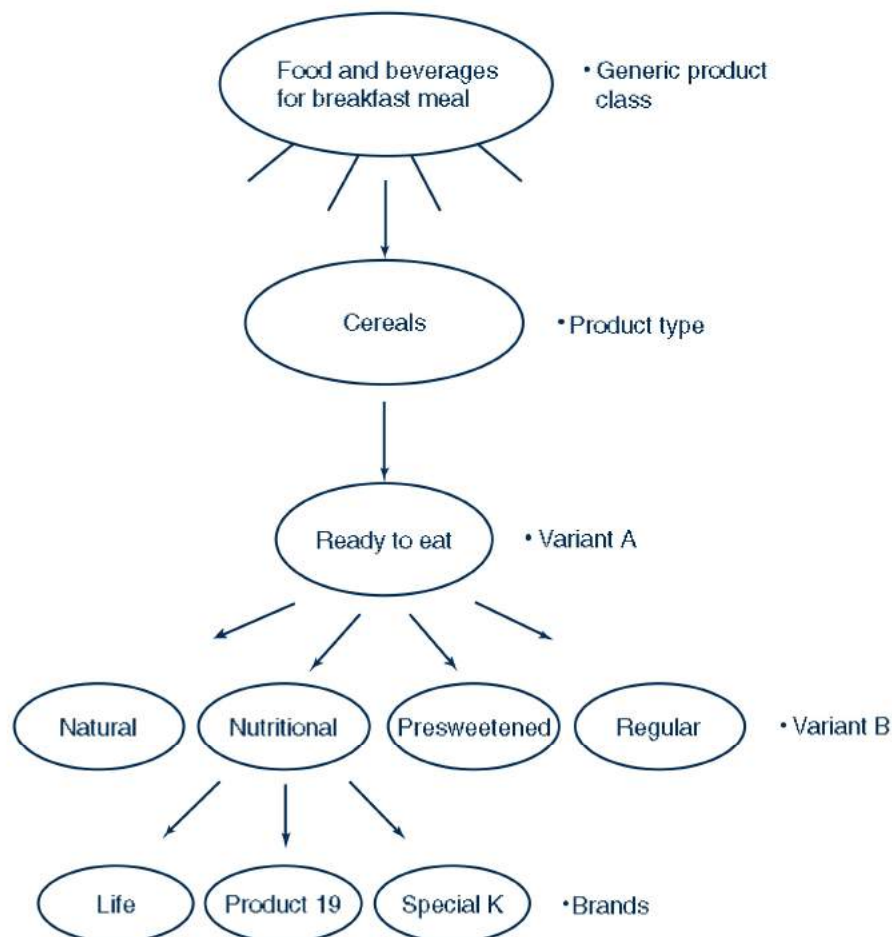
Illustrative Product-Market Structure

Suppose you are a brand manager for a cereal producer. You know that brands like Life, Product 19, and Special K compete for sales to people that want nutritional benefits from cereal. Nonetheless, our earlier discussion highlights the value of considering a more complete picture of how competing brands like Life, Product 19, and Special K also may experience competition from other ways of meeting the needs satisfied by these brands. For example, a person may decide to eat a Kellogg's Nutri-Grain cereal bar instead of a bowl of cereal, and the consumer may want to vary the type of cereal, eating a natural or regular type of cereal. Because of the different product types and variants competing for the same needs and wants, the cereal brand manager should develop a picture of the product-market structure within which her/his brand is positioned. Exhibit 2.5 provides an illustrative product-market structure for cereals. The diagram can be expanded to portray other relevant product types (e.g., breakfast bars) in the generic product-market for food and beverages.

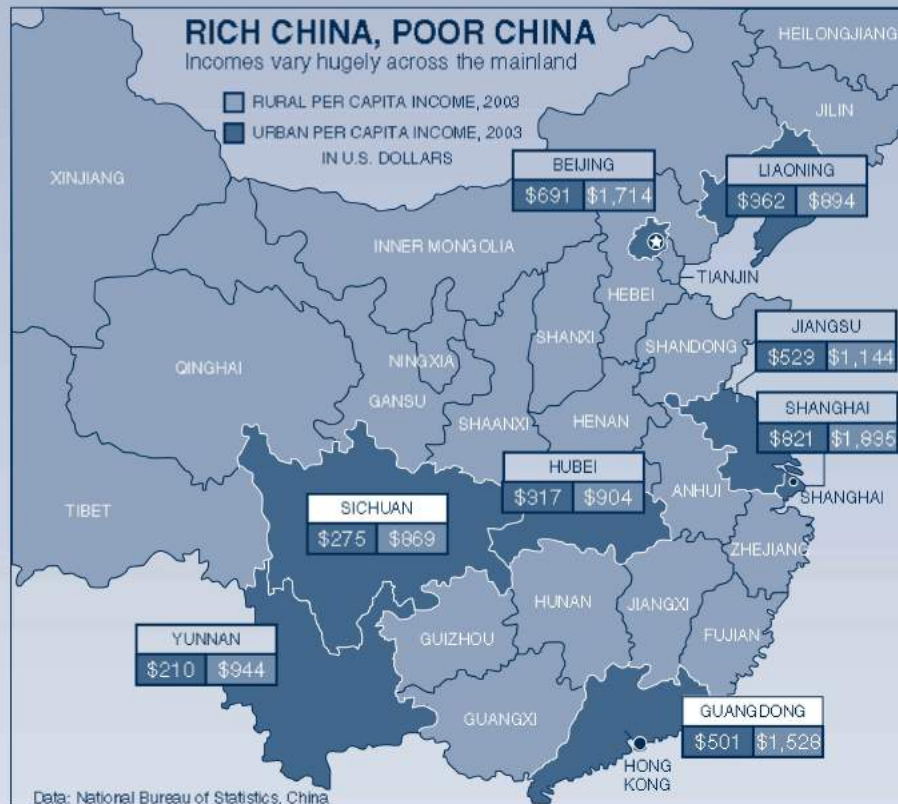
Describing and Analyzing End-Users

After determining the product-market structure it is useful to develop profiles of end-user buyers for the generic, product-type, and product-variant levels of the product-market

EXHIBIT 2.5
Illustrative Product-
Market Structure



Global Feature *Per Capita Income Variations in China*



Source: "Let a Thousand Brands Bloom," *BusinessWeek*, October, 17, 2005, 58.

(Exhibit 2.2). Buyers are identified, described, value requirements are indicated, and environmental influences (e.g., interest rate trends) determined. Analysis of the buyers in the market segments within a product-market is considered in Chapter 3.

Identifying and Describing Buyers

Characteristics, such as family size, age, income, geographical location, sex, and occupation are often useful in identifying buyers in consumer markets. Illustrative factors used to identify end-users in organizational markets include type of industry, company size, location, and types of products. Many published sources of information are available for use in identifying and describing customers. Examples include U.S. Census data, trade association publications, and studies by advertising media (TV, radio, magazines). When experience and existing information are not adequate in determining buyers, research studies may be necessary to identify and describe customers and prospects.

An interesting profile of per capita income variations across China is shown in the GLOBAL FEATURE.¹² Note the huge differences between Rural and Urban income. Recognizing these income variations, Haier, the leading appliance producer in China, designs its larger washing machines for Chinese cities, but offers a very small model at \$37 for poorer areas. The Chinese population information is useful in identifying and describing buyers where income is a relevant predictor of purchases of goods and services such as automobiles and kitchen appliances.

How Buyers Make Choices

Often, simply describing buyers does not provide enough information to guide market targeting and positioning decisions. We also need to try to find out *why* people buy products and specific product brands. In considering how customers decide what to buy, it is useful to analyze how they move through the sequence of steps leading to a decision to purchase a particular brand. Buyers normally follow a decision process. They begin by recognizing a need (problem recognition); next, they seek information; then, they identify and evaluate alternative products; and finally, they purchase a brand. Of course, the length and complexity of this process varies by product and purchasing situation. Decisions for frequently purchased products with which a buyer has past experience tend to be routine. One part of studying buyer decision processes is finding out what criteria people use in making decisions. For example, how important is the brand name of a product in the purchase decision?

Illustrations of the buying decision process stages for a consumer purchase and an organizational purchase are shown in Exhibit 2.6. The consumer purchase involves a portable CD player purchased by a student, whereas the organizational purchase is for a portable CD player component from an outside supplier. Both processes move through the major stages in the buying decision process, but the issues and activities are quite different.

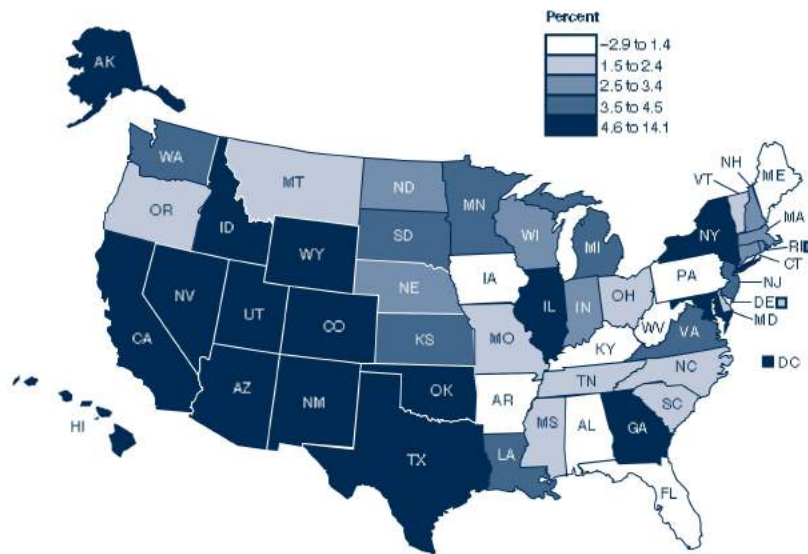
EXHIBIT 2.6 Comparing the Stages in Consumer and Organizational Purchases

Source: Roger A. Kerin, Steve W. Hartley, and William Rudelius, *Marketing The Core* (Burr Ridge, IL: McGraw-Hill/Irwin, 2004), 129.

STAGE IN THE BUYING DECISION PROCESS	CONSUMER PURCHASE: PORTABLE CD PLAYER FOR A STUDENT	ORGANIZATIONAL PURCHASE: EARPHONES FOR A PORTABLE CD PLAYER
Problem recognition	Student doesn't like the features of the portable CD player now owned and desires a new portable CD player.	Marketing research and sales departments observe that competitors are improving the earphones on their portable CD models. The firm decides to improve the earphones on their own new models, which will be purchased from an outside supplier.
Information search	Student uses past experience, that of friends, ads, the Internet, and <i>Consumer Reports</i> to collect information and uncover alternatives.	Design and production engineers draft specifications for earphones. The purchasing department identifies suppliers of portable CD player earphones.
Alternative evaluation	Alternative portable CD players are evaluated on the basis of important attributes desired in a portable CD player, and several stores are visited.	Purchasing and engineering personnel visit with suppliers and assess (1) facilities, (2) capacity, (3) quality control, and (4) financial status. They drop any suppliers not satisfactory on these factors.
Purchase decision	A specific brand of portable CD player is selected, the price is paid, and the student leaves the store.	They use (1) quality, (2) price, (3) delivery, and (4) technical capability as key buying criteria to select a supplier. Then they negotiate terms and award a contract.
Postpurchase behavior	Student reevaluates the purchase decision, may return the portable CD player to the store if it is unsatisfactory.	They evaluate suppliers using a formal vendor rating system and notify a supplier if earphones do not meet their quality standard. If the problem is not corrected, they drop the firm as a future supplier.

EXHIBIT 2.7 Population Trends for the 50 States in the United States: 1995 to 2025

Source: U.S. Bureau of the
Census, Population Division,
PPL-47.



Environmental Influences

The final step in building customer profiles is to identify the external environmental factors that influence buyers and thus impact the size and composition of the market over time. These influences include government actions (e.g., tax cuts), social change, economic shifts, technology, and other factors that may alter buyers' needs and wants. Typically, these factors are not controlled by the buyer or the firms that market the product, and substantial changes in environmental influences can have a major impact on customers' purchasing activities. Therefore, it is important to identify the relevant external influences on a product-market and to estimate their future impact. During the past decade various changes in market opportunities occurred as a result of uncontrollable environmental factors. Illustrations include the shifts in population age-group composition, changes in tax laws affecting investments, and variations in interest rates. Consider, for example, the population trends for the 50 states in the United States from 1995 to 2025. Note that some states (Exhibit 2.7) display high growth rates while others are declining in size. Residential construction rates and various other product-markets will be impacted by differences in population growth across regions and states in the U.S.

Building Customer Profiles

Describing customers begins with the generic product-market. At this level customer profiles are likely to describe the size and general composition of the customer base. For example, the commercial air travel customer profile for a specified geographical area (e.g., South America) would include market size, growth rates, mix of business and pleasure travelers, and other general characteristics. The product-type and variant profiles are more specific about customer characteristics such as needs and wants, use situations, activities and interests, opinions, purchase processes and choice criteria, and environmental influences on buying decisions. Normally, product-type analysis considers the organization's product and closely related product types.

In developing marketing strategy, management is concerned with deciding which buyers to target within the product-market of interest and how to position to each target. The customer profiles help to guide these decisions. The profile information is also useful in deciding how to segment the market. More comprehensive customer analyses are necessary in market segmentation analysis, which we discuss in Chapter 3.

Analyzing Competition

Competitor analysis considers the companies and brands that compete in the product-market of interest. Analyzing the competition follows the five steps shown in Exhibit 2.8. In Step 1 we determine the competitive arena in which an organization competes and describe the characteristics of the competitive space. Steps 2 and 3 identify, describe, and evaluate the organization's key competitors. Steps 4 and 5 anticipate competitors' future actions and identify potential competitors that may enter the market.

Defining the Competitive Arena

Competition often includes more than the firms that are direct competitors, like Coke and Pepsi. For example, the different levels of competition for diet colas are shown in Exhibit 2.9. The product variant is the most direct type of competition. Nevertheless, other product categories of soft drinks also compete for buyers, as do other beverages. A complete understanding of the competitive arena helps to guide strategy design and implementation. Since competition often occurs within specific industries, study of the industry structure is useful in defining the competitive arena, recognizing that more than one industry may be competing in the same product-market, depending on the complexity of the product-market structure. For example, the digital photography product-market includes traditional camera and film competitors and electronics industry competitors.

Industry Analysis

Competitor analysis is conducted from the point of view of a particular firm. For example, a soft drink firm such as Coca-Cola should include other beverage brands in its industry analysis. Two kinds of information are needed: (1) a descriptive profile of the industry; and (2) an analysis of the value chain (distribution) channels that link together the various organizations in the value-added system from suppliers to end-users. Thus, the industry analysis is horizontal and covers similar types of firms (e.g., soft drink producers), whereas the value chain analysis considers the vertical network of firms that supply materials and/or parts, produce products (and services), and distribute the products to end-users.

The industry analysis includes: (1) industry characteristics and trends, such as sales, number of firms, and growth rates; and (2) operating practices of the firms in the industry, including product mix, service provided, barriers to entry, and geographical scope. Many industries provide information in publications and websites that is useful in the analysis. Industry associations also publish research reports which typically include growth forecasts.

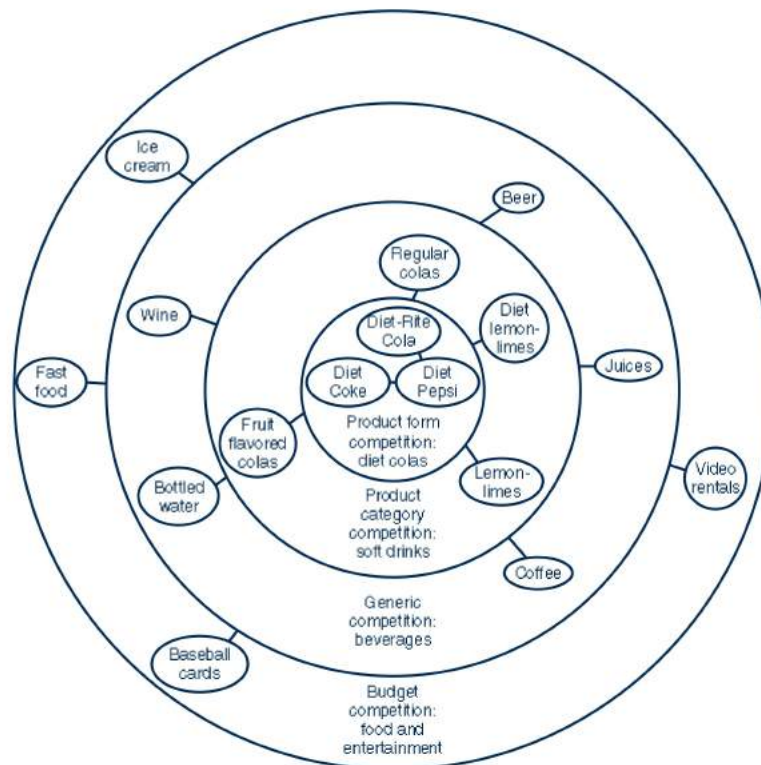
EXHIBIT 2.8 Analyzing the Competition

- 1 Define the competitive arena for the generic, specific, and variant product-markets.
- 2 Identify key competitors.
- 3 Evaluate key competitors.
- 4 Anticipate actions by competitors.
- 5 Identify and evaluate potential competitors.

EXHIBIT 2.9

Examples of Levels of Competition

Source: Donald R. Lehmann and Russell S. Winer, *Analysis for Marketing Planning*, 4th ed. (Burr Ridge, IL: Richard D. Irwin, 1997), 22. Copyright © The McGraw-Hill Companies. Used with permission.



First, we need to identify the companies that comprise the industry and develop descriptive information on the industry and its members. It is important to examine industry structure beyond domestic market boundaries, since international industry developments often affect regional, national, and international markets. It is also necessary to include all relevant industries in the analysis. For example, as shown in Exhibit 2.10, including only the firms providing traditional long distance phone services would provide an incomplete assessment of the industries and firms that provide services. The traditional boundaries between phone companies, cable providers, and other tech firms are changing rapidly. Note the large differences in revenue growth.

The industry identification is based on product similarity, location at the same level in the value chain (e.g., manufacturer, distributor, retailer) and geographical scope. The industry analysis considers:

- Industry size, growth, and composition.
- Typical marketing practices.
- Industry changes that are anticipated (e.g., consolidation trends).
- Industry strengths and weaknesses.
- Strategic alliances and potential mergers/acquisitions among competitors.

Analysis of the Value-Added Chain

The study of supplier and distribution channels is important in understanding and serving product-markets. While some producers may go directly to their end-users, many work with other organizations through distribution channels. The extent of vertical integration by competitor backward (supply) and forward toward end-users is also useful information.

EXHIBIT 2.10 The Shifting Telecom LandscapeSource: "The Shifting Telecom Landscape," *BusinessWeek*, February 28, 2005, 36.

	Revenue in Billions						Compound Annual Growth Rate
	2003	2004	2005	2006	2007	2008	
• Video	\$ 0.2	\$ 0.3	\$ 0.5	\$ 1.0	\$ 1.6	\$ 2.5	65.7%
• Consumer broadband	2.8	3.5	4.0	4.2	4.6	4.8	11.4
• Consumer long distance	20.7	18.2	16.0	13.6	11.3	9.2	-15.0
• Business local	26.3	26.7	26.4	26.1	25.8	25.5	-0.6
• Business long distance	26.1	24.5	23.0	21.3	19.7	18.2	-7.0
• Business data*	44.8	45.6	46.6	47.1	46.8	45.4	0.3
• Consumer local	46.9	42.2	39.0	36.2	34.0	32.3	-7.25
• Wireless	91.5	108.7	119.2	132.8	144.5	153.6	10.9
Total	\$260.7	\$271.5	\$277.0	\$285.0	\$291.3	\$294.9	2.5%

*Includes Internet access, private data lines, ATM traffic, and frame relay data: In-Stat/MDR.

The types of relationships (collaborative or transactional) in the distribution channel should be identified and evaluated. The extent of outsourcing activities in the value chain is also of interest. Different channels that access end-user customers should be included in the channel analysis. By looking at the distribution approaches of industry members, we can identify important patterns and trends in serving end-users. Value chain analysis may also uncover new market opportunities that are not served by present channels of distribution. Finally, information from various value chain levels can help in forecasting end-user sales.

The use of outsourcing manufacturing and other business functions expanded rapidly in the United States and Europe during the last decade. By outsourcing an organization may gain strategic advantage by focusing on its core competencies, while outsourcing other necessary business functions to independent partners. Thus, analysis of outsourcing activities may be an important aspect of competitor analysis.

Competitive Forces

Different competitive forces are present in the value-added chain. The traditional view of competition is expanded by recognizing Michael Porter's five competitive forces that impact industry performance:

1. Rivalry among existing firms.
2. Threat of new entrants.
3. Threat of substitute products.
4. Bargaining power of suppliers.
5. Bargaining power of buyers.¹³

The first force recognizes that active competition among industry members helps determine industry performance, and it is the most direct and intense form of competition. The aggressive competition between General Motors and Toyota is illustrative. Rivalry may occur within a market segment or across an entire product-market. The nature and scope of competition may vary according to the maturity of the industry.

The second force highlights the possibility of new competitors entering the market. Existing firms may try to discourage new competition by aggressive expansion and other types of market entry barriers. The entry of Wal-Mart into the supermarket business has substantially expanded and intensified the competitive arena in this market.

The third force considers the potential impact of substitutes. New technologies that satisfy the same customer value requirement are important sources of competition. Including alternative technologies (e.g., disruptive innovations) in the definition of product-market structure identifies substitute forms of competition.

The fourth force is the power that suppliers may be able to exert on the producers in an industry. For example, the high costs of labor exert major pressures on the commercial airline industry. Coke and Pepsi exert important influences on their independent bottlers and encourage collaboration. Companies may pursue vertical integration strategies to reduce the bargaining power of suppliers. Collaborative relationships are useful to respond to the needs of both partners.

Finally, buyers may use their purchasing power to influence their suppliers. Wal-Mart, for example, has a strong influence on the suppliers of its many products. Understanding which organizations have power and influence in the value chain provides important insights into the structure of competition.

Key Competitor Analysis

Competitor analysis is conducted for the firms directly competing with each other (e.g., Nike and Reebok) and other companies that management may consider important in strategy analysis (for example, potential market entrants). The rapid expansion of competitor intelligence activities by many companies in the last decade highlights the high priority executives place on monitoring competitors' activities. Many companies around the world have developed very effective intelligence units. Nonetheless, there are important ethical and legal issues to consider in competitive intelligence gathering. These issues are illustrated in the ETHICS FEATURE.

We now look at two major aspects of competitor analysis: (1) preparing a descriptive profile for each competitor; and (2) evaluating the competitor's strengths and weaknesses (Steps 2 and 3 of Exhibit 2.8).

Describing and Evaluating the Competitor

A *key competitor* is any organization going after the same market target as the firm conducting the analysis. American and Southwest Airlines are key competitors on many U.S. routes. Key competitors are brands that compete in the same product-market or segment(s) within the market (Motorola, Nokia, and Samsung cell phones). Different product types that satisfy the same need or want may also actively compete against each other. Thus, microwave dinners may compete with fast-food operators.

Information which is typically included in the competitor profile is shown in Exhibit 2.11. Sources of information include annual reports, industry studies by government and private organizations, business magazines and newspapers, industry trade publications and websites, reports by financial analysts (e.g., *Value Line Investment Survey*), government reports, standardized data services (e.g., Information Resources, Inc. and Nielsen), databases, suppliers, customers, company personnel, and salespeople. Direct contact with the research directors of trade publications is often a useful source of information about the industry and key competitors.

It is important to gain as much knowledge as possible about the background, experience, qualifications, and tenure of key executives for each major competitor. This information



Most competitive intelligence gathering relies on publicly available information and the views of distributors and customers. However, there are important limits to the behavior of intelligence gatherers. The Society of Competitive Intelligence Professionals outlaws misrepresentation by intelligence gatherers in its code of ethics. Nonetheless, there are grey areas, which raise serious ethical dilemmas:

- What if intelligence researchers pose as something else—conference organizers, headhunters, students, or journalists to tease information out of intelligence targets?
- Is it acceptable if competitor staff members are interviewed for phantom jobs which do not exist, to see what they reveal when questioned?
- Is it reasonable for researchers to pose as customers to collect competitor information?

Unethical intelligence gathering practices carry substantial risks if discovered, and are completely unacceptable to reputable companies. Many organizations now operate ethics compliance systems, and report corporate citizenship actions to shareholders and investors.

Direct contact with competitors to gather intelligence may be interpreted as “inappropriate conversations” associated with anti-competitive behavior, and attract investigation and punishment by regulatory bodies.

Source: Stephen Overell, “Agents Who Shed Light on Hidden Corporate Life,” *Financial Times*, Monday, March 19, 2001, p. 14; Joseph Weber, “The New Ethics Enforcers,” *BusinessWeek*, February 13, 2006, 76–77.

EXHIBIT 2.11 Describing and Evaluating Key Competitors

- Business scope and objectives
- Management experience, capabilities, and weaknesses
- Market position and trends
- Market target(s) and customer base
- Positioning strategy for each target
- Distinctive capabilities
- Financial performance (current and historical)

includes the executives’ performance records, their particular areas of expertise, and the firms where they were previously employed. These analyses may suggest the future strategic initiatives of a key competitor.

Market targets and customer base analyses center on the market segments targeted by the competitor and the competitor’s actual and relative market-share position. Relative market position is measured by comparing the share of the firm against the competitor with the highest market share in the segment. All segments in the product-market that could be targeted by the firm should be included in the competitor evaluation.

The competitor’s past performance offers a useful basis for comparing competitors. The customer value proposition offered by the competitor for each segment is important information. This may indicate competitive opportunities as well as a possible threat. The competitor’s distinctive capabilities need to be identified and evaluated.

An analysis of each competitor’s past sales and financial performance indicates how well the competitor has performed on a historical basis. Competitor ratings are also useful in the comparisons (e.g., *Consumer Reports*). A typical period of analysis is three to five years or longer depending on the rate of change in the market. Performance information may include sales, market share, net profit, net profit margin, cash flow, and debt.

Additionally, for specific types of businesses other performance information may be useful. For example, sales-per-square-foot is often used to compare the performance of retail stores. Operating cost per passenger mile is a relevant measure for airline performance comparisons.

Assessing how well competitors meet customer value requirements requires finding out what criteria buyers use to rate each supplier. Customer-focused assessments are more useful than relying only on management judgments of value delivery. Measurement methods include customer comparisons of value attributes of the firm versus its competitors, customer surveys, loyalty measures, and the relative market share of end-use segments.¹⁴ Customer value assessment is further considered in Chapter 4.

Using the competitor information, we can develop an overall evaluation of the key competitor's current strengths and weaknesses. Additionally, the summary assessment of distinctive capabilities includes information on the competitor's management capabilities and limitations, technical and operating advantages and weaknesses, marketing strategy, and other key strengths and limitations. Since competitors often display different capabilities, it is important to highlight these differences.

Anticipating Competitors' Actions

Steps 4 and 5 in competitor analysis (Exhibit 2.8) consider what each key competitor may do in the future, and identify potential new competitors. The information obtained in the previous steps of the analysis should be helpful in estimating future trends, although possible strategy shifts by competitors may occur.

Estimating Competitors' Future Strategies

Competitors' future strategies may continue the directions that they have established in the past, particularly if no major external influences require changing their strategies. Nevertheless, assuming an existing strategy will continue is not wise. Competitors' current actions may signal probable strategy shifts that may create future threats.

An interesting development in the telecommunication market is the growth in the use of Internet calling. First introduced in 1995, Voice-Over Internet Protocol (VOIP) experienced start-up problems but by 2003, the technology was a rapidly growing share of home and business markets.¹⁵ Industry authorities expect the technology to become a significant competitive threat. VOIP subscribers are estimated to increase to over five times the 2003 level by 2006.

Relatedly, the acquisition strategy at eBay is a strong indicator of the company's goal to move from being an online auction site to an e-commerce engine that sells Web tools to small businesses. Current developments at eBay are illustrated in the INTERNET FEATURE, and are indicative of the areas in which eBay will be a competitor in the future.

Identifying New Competitors

New competitors may come from four major sources: (1) companies competing in a related product-market; (2) companies with related technologies; (3) companies already targeting similar customer groups with other products; and/or (4) companies competing in other geographical regions with similar products. Market entry by a new competitor is likely under one or more of these conditions:

- High profit margins are being achieved by market incumbents.
- Future growth opportunities in the market are attractive.
- No major market-entry barriers are present.



The online auction site eBay.com has become one of the Web's most successful sites with 233 million registered users. The impact on many areas of conventional retailing has been substantial.

EBay executives believe future growth depends on evolving the company beyond a destination site into a provider of tools and services that power e-commerce across the Web. The company is making considerable efforts to break out of its current business model, and has spent \$6 billion in five years. Key acquisitions include:

- PayPal—payment processor for eBay and other websites - \$1.5 billion (July 2002).
- Rent.com provides property rental and roommate search services—\$415 million (December 2004).
- Kuran/Pro—helps sellers set up online storefronts separate from eBay (January 2005).
- Shopping.com runs a comparison-shopping website—\$620 million (June 2005).
- Skype—its Internet telephone service can connect sellers with shoppers—\$2.5 billion (September 2005).
- Stubhub—a ticket reselling site that is promoted on eBay—\$310 million (January 2007).
- Stumbleupon—recommends websites based on user interests - \$75 million (May 2007).

Source: Catherine Holahan, "Going, Going . . . Everywhere," *BusinessWeek*, June 18, 2007, 62–64.

- Competition is limited to one or a few competitors.
- Gaining an equivalent (or better) competitive advantage over the existing firm(s) serving the market is feasible.

If one or more of these conditions are present in a competitive situation, new competition will probably appear.

Market Size Estimation

An important part of market opportunity analysis is estimating the present and potential size of the market. Market size is usually measured by dollar sales and/or unit sales for a defined product-market and specified time period. Other size measures include the number of buyers, average purchase quantity, and frequency of purchase. Three key measures of market size are: *market potential*, *sales forecast*, and *market share*.

Market Potential

Market potential is the maximum amount of product sales that can be obtained from a defined product-market during a specified time period. It includes the total opportunity for sales by all firms serving the product-market. Market potential is the upper limit of sales that can be achieved by all firms for a specified product-market over an indicated time period. Often, actual industry sales in a specified year fall somewhat below market potential because the production and distribution systems are unable to completely meet the needs of all buyers who are both *willing* and *able* to purchase the product during the period of interest.

Useful information for considering market potential and growth rates for various product categories in Russia is shown in Exhibit 2.12. The share of household ownership percentages and share increases provide an indication of where the market potential appears promising. Not surprisingly, cell phone and computer penetration is expanding rapidly. Household income is increasing fast and 70 percent of all income is disposable in Russia compared to 40 percent in Western countries.¹⁶ Market potential is exploding for many product categories including tourism and financial services.

EXHIBIT 2.12
Market Penetration
and Growth Rates for
Selected Consumer
Product Categories
in Russia

Source: Jason Bush, "Shoppers
 Gone Wild," *BusinessWeek*,
 February 20, 2006, 46.

Ownership by Share of Households		
	2001	2005
Mobile phone	6%	50%
Computer	5	20
Washing machine	16	35
Stereo	15	31
Video recorder	39	50
Car	25	31
Imported TV	58	71
Apartment or house	71	82
August 2001 vs. August 2005		Data: GfK Rus.

Sales Forecast

The sales forecast indicates the expected sales for a defined product-market during a specified time period. The industry sales forecast is the total volume of sales expected by all firms serving the product market. The sales forecast can be no greater than market potential and typically falls short of potential as discussed above. A forecast can be made for total sales at any product-market level (generic, product type, variant) and for specific subsets of the product-market (e.g., market segments). A company sales forecast can also be made for sales expected by a particular firm.

Several sales forecasting methods are described in Exhibit 2.13. The advantages of each technique are indicated. Time-series analysis is popular for projecting future sales but is very dependent on the stability of historical trends.

Market Share

Company sales divided by the total sales of all firms for a specified product-market determines the market share of a particular firm. Market share may be calculated on the basis of actual sales or forecasted sales. Market share can be used to forecast future company sales and to compare actual market position among competing brands of a product. Market share may vary depending on the use of dollar sales or unit sales due to price differences across competitors.

It is essential in preparing forecasts to specify exactly what is being forecast (defined product-market), the time period involved, and the geographical area. Otherwise, comparisons of sales and market share with those of competing firms will not be meaningful.

Evaluating Market Opportunity

Since a company's sales depend, in part, on its marketing plans, management's forecasts and marketing strategy are closely interrelated. Forecasting involves "what if" analyses. Alternative positioning strategies (product, distribution, price, and promotion) need to be evaluated for their estimated effects on sales. Because of the marketing effort/sales relationship, it is important to consider both market potential (opportunity) and planned marketing expenditures in determining the forecast. The impact of different sales forecasts must be evaluated from a total business perspective, since these forecasts affect production planning, human resource needs, and financial requirements.

Sales forecasts of target markets are needed so that management can estimate the financial attractiveness of both new and existing market opportunities. The market potential and growth estimates gauge the overall attractiveness of the market. The sales forecast for the company's brand in combination with cost estimates provide a basis for profit projections. The decision to enter a new market or to exit from an existing market depends heavily on

EXHIBIT 2.13 Summary of Advantages and Disadvantages of Various Forecasting Techniques

Source: Mark W. Johnston and Greg W. Marshall, *Sales Force Management*, 7th ed. (New York: McGraw-Hill/Irwin, 2003), 131.

Sales Forecasting Method	Advantages	Disadvantages
User expectations	1. Forecast estimates obtained directly from buyers 2. Projected product usage information can be highly detailed 3. Insightful method aids planning marketing strategy 4. Useful for new product forecasting	1. Potential customers must be few and well defined 2. Does not work well for consumer goods 3. Depends on the accuracy of user's estimates 4. Expensive, time-consuming, labor-intensive
Sales force composite	1. Involves the people (sales personnel) who will be held responsible for the results 2. Is fairly accurate 3. Aids in controlling and directing sales effort 4. Forecast is available for individual sales territories	1. Estimators (sales personnel) have a vested interest and therefore may be biased 2. Elaborate schemes sometimes are necessary to counteract bias 3. If estimates are biased, process to correct the data can be expensive
Jury of executive opinion	1. Easily done, very quick 2. Does not require elaborate statistics 3. Utilizes "collected wisdom" of the top people 4. Useful for new or innovative products	1. Produces aggregate forecasts 2. Expensive 3. Disperses responsibility for the forecast 4. Group dynamics operate
Delphi technique	1. Minimizes effects of group dynamics	1. Can be expensive and time-consuming
Market test	1. Provides ultimate test of consumers' reactions to the product 2. Allows assessment of the effectiveness of the total marketing program 3. Useful for new and innovative products	1. Lets competitors know what firm is doing 2. Invites competitive reaction 3. Expensive and time-consuming to set up 4. Often takes a long time to accurately assess level of initial and repeat demand
Time-series analysis	1. Utilizes historical data 2. Objective, inexpensive	1. Not useful for new or innovative products 2. Factors for trend, cyclical, seasonal, or product life-cycle phase must be accurately assessed and included 3. Technical skill and good judgment required
Statistical demand analysis	1. Great intuitive appeal 2. Requires quantification of assumptions underlying the estimates 3. Allows management to check results 4. Uncovers hidden factors affecting sales 5. Method is objective	1. Factors affecting sales must remain constant and be identified accurately to produce an accurate estimate 2. Requires technical skill and expertise 3. Some managers reluctant to use method due to the sophistication

financial analyses and projections. Alternate market targets under consideration can be compared using sales and profit projections. Similar projections of key competitors are also useful in evaluating market opportunities.

Developing a Strategic Vision About the Future

Market development and competitive space may not follow clearly defined and predictable paths. Nonetheless, signals can be identified that are useful in pointing to possible market changes. Answers to the questions shown in Exhibit 2.14 are needed in Developing a Strategic Vision concerning the firm's market(s). These issues need to be addressed for each product-market.

Phases of Competition

It is useful to distinguish between different phases in the development of competition. In the initial stage, companies compete in identifying product concepts, technology choices, and building competencies.¹⁷ This phase involves experimentation with ideas, and the path to market leadership is not clearly defined. Phase 2 may involve partnering of companies with the objective of controlling industry standards, though these firms eventually become competitors. Finally, as the market becomes clearly defined and the competitive space established, the competitors concentrate on market share for end products and profits. The personal computer market is currently in this stage.

Anticipating the Future

Increasingly, we find that change and turbulence, rather than stability, characterize many product-markets. Moreover, as discussed above, it is often possible to determine the forces underway that will alter product-market structure. Though these influences are not easily identified and analyzed, the organizations that choose to invest substantial time and effort in anticipating the future create an opportunity for competitive advantage. Fuji appears to have done a better job of anticipating the future of digital photography than did Kodak. Executives in market-driven companies recognize the importance of developing these capabilities.

Hamel and Prahalad offer a compelling blueprint for analyzing the forces of change. While the details of their process cannot be captured in a few pages of discussion, the following questions are examples of the information needed to anticipate the future:¹⁸

- What are the influences (discontinuities) present in the product-market that have the potential to profoundly transform market/competitor structure?
- Investigate each discontinuity in substantial depth.

EXHIBIT 2.14 Developing a Strategic Vision

- Are product-market boundaries and composition of the product-market undergoing transformation?
- How and to what extent is the end-user customer base changing?
- Are the scope and structure of competitor space changing due to market and industry transformation and entry/exit of competitors?
- Are there potential threats from disruptive technologies and/or commoditization?
- Are the composition and structure of the value chain(s) serving the end-user market(s) changing?
- Do other influences operating in the product-market have the potential to significantly transform the product?
- At what life-cycle stage is the product-market (new, growth, maturity, decline), and how fast is the life cycle advancing?

- How will the trend impact customers?
- What is the likely economic impact?
- How fast is the trend developing?
- Who is exploiting this trend?
- Who has the most to gain/lose?
- What new product opportunities will be created by this discontinuity?
- How can we learn more about this trend?

Following the blueprint requires looking in depth at the relevant forces of change in a product-market and other markets that are interrelated. Anticipating the future requires searching beyond the existing competitive arena for influences that promise to impact product-market boundaries. The process requires the involvement of the entire organization and it demands a substantial amount of time. A company with a market orientation and cross-functional processes should be able to utilize these processes for anticipating the future. Importantly, developing a vision about the future needs to be an ongoing process.

Summary

Analyzing markets and competition is essential to making sound business and marketing decisions. The uses of product-market analyses are many and varied. An important aspect of market definition and analysis is moving beyond a product or industry focus by incorporating market needs into the analysts' viewpoint.

Business strategies and markets are interrelated and companies which do not understand their markets and how they are likely to change in the future are at a competitive disadvantage. Effective market sensing is essential in guiding business and marketing strategies. Disruptive innovation, the process of customers shifting their purchases to new products that better meet their needs, should be anticipated and counterstrategies developed. An essential part of becoming market-oriented is identifying future directions of market change.

This chapter examines the nature and scope of defining and analyzing product-market structure. By using different levels of aggregation (generic, product-type, and product-variant), products and brands are positioned within more aggregate categories, thus helping to better understand customers, product interrelationships, industry structure, distribution approaches, and key competitors. This approach to product-market analysis offers a consistent guide to needed information, regardless of the type of product-market being analyzed. Analyzing market opportunity includes (1) determining product-market boundaries and structure; (2) forming the product-market; (3) describing and analyzing end-users; (4) analyzing competition; and (5) estimating market size and growth rates.

After determining the product-market boundaries and structure, information on various aspects of the market is collected and examined. First, it is useful to study the people or organizations who are the end-users in the product-market at each level (generic, product type, and variant). These market profiles of customers help to evaluate opportunities and guide market targeting and positioning strategies. Next, we identify and analyze the firms that market products and services at each product-market level to aid strategy development. Industry and key competitor analysis considers the firms that compete with the company performing the market opportunity analysis. Thus, industry analysis for a personal computer producer would include the producers that make up the industry. The analysis should also include firms operating at all stages (levels) in the value-added chain, such as suppliers, manufacturers, distributors, and retailers.

The next step is a comprehensive assessment of the major competitors. The competitor analysis should include both actual and potential competitors that management considers important. Competitor analysis includes: (1) describing the company; (2) evaluating the

competitor; and (3) anticipating the future actions of competitors. It is also important to identify possible new competitors. Competitor analysis is an ongoing activity and requires coordinated information collection and analysis.

An important part of product-market analysis is estimating potential and forecasting sales. The forecasts often used in product-market analysis include estimates of market potential, sales forecasts of total sales by firms competing in the product-market, and the sales forecast for the firm of interest. This information is needed for various purposes and is prepared for different units of analysis, such as product category, brands, and geographical areas. The forecasting approach and techniques should be matched to the organization's needs.

The mounting evidence about markets points to the critical importance of understanding and anticipating changes in markets by developing a strategic vision about the future. In gaining these insights, it is useful to view competition as a three-stage process of experimentation, partnering to set industry standards, and then pursuing market share and profits. Analyzing the forces of change provides a basis for anticipating how product-markets will change in the future.

Questions for Review and Discussion

1. Discuss the important issues that should be considered in defining the product-market for a totally new product.
2. Under what product and market conditions is the end-user customer more likely to make an important contribution to product-market definition?
3. What recommendations can you make to the management of a company competing in a rapid growth market to help it identify new competitive threats early enough so that counterstrategies can be developed?
4. There are some dangers in concentrating product-market analysis only on a firm's specific brand and those brands that compete directly with a firm's brand. Discuss.
5. Using the approach to product-market definition and analysis discussed in the chapter, select a brand and describe the generic, product type, and brand product-markets of which the brand is a part.
6. For the brand you selected in Question 5, indicate the kinds of information needed to conduct a complete product-market analysis. Also suggest sources for obtaining each type of information.
7. Select an industry and describe its characteristics, participants, and structure.
8. A competitor analysis of the 7UP soft drink brand is being conducted. Management plans to position the brand against its key competitors. Should the competitors consist of only other non-cola drinks?
9. Outline an approach to competitor evaluation, assuming you are preparing the analysis for a regional bank holding company.
10. Discuss how a small company (less than \$1 million in sales) should analyze its competition.
11. Many popular forecasting techniques draw from past experience and historical data. Discuss some of the more important problems that may occur in using these methods.
12. What are the relevant issues a cross-functional team should consider in developing a strategic vision about the future for the organization's product-market(s)?

Internet Applications

- A. Visit the website of Project 2000 (www.2000.ogsm.vanderbilt.edu), founded at the Owen Graduate School of Vanderbilt University to determine if the Web provides useful information for market and competitor analysis. Describe the various types of market information available on the Web.
- B. Visit Hoover's website (www.hoovers.com). Investigate the different options for competitive and market analysis provided. How can these online tools best be utilized? What limitations apply?

- C. Johnson & Johnson is currently competitive in the surgical stent market (a device inserted surgically in an artery to enable blood flow). Perform an Internet analysis of the stent market indicating past and current unit sales levels and forecasts for 2006–2010.
- D. Samsung Electronics is one of the top producers of cell phones. Draw from Internet sources to prepare an analysis of the global cell phone market.

Feature Applications

- A. Select a product-market where new types of competition and/or new business models are developing. Discuss how and to what extent “opportunities outside the competitive box are developing.”
- B. Review the GLOBAL FEATURE concerning China’s geographical income distributions. Discuss how this information could be useful to a company planning to enter the Chinese market with water purification treatment units for use in residences.

Notes

1. This illustration is based on William M. Bulkeley, “Kodak’s Loss Widens as Revenue Declines 8.8%,” *The Wall Street Journal*, August 2, 2006, B10; “A Tense Kodak Moment,” *BusinessWeek*, October 17, 2005, 84–85; “Another Kodak Moment,” *The Economist*, May 14, 2005, 69.
2. Diane Brady, “A Thousand and One Noshes,” *BusinessWeek*, June 14, 2004, 44.
3. This discussion is based on David W. Cravens, Nigel F. Piercy, and Artur Baldauf, “Strategic Thinking for Changing Markets,” Working Paper, October 15, 2007.
4. Clayton M. Christensen and Michael E. Raynor, *The Innovator’s Solution* (Boston: Harvard Business School Press, 2003), Chapter 1.
5. *Ibid.*, Chapter 6.
6. W.C. Kim and R. Mauborgne, *Blue Ocean Strategy* (Boston: Harvard Business School Press, 2005).
7. Pui-Wing Tam, “Entreaty to Camera-Phone Photographers: Please Print,” *The Wall Street Journal*, December 28, 2004, B1 and B3.
8. This discussion is based upon suggestions provided by Professor Robert B. Woodruff of the University of Tennessee, Knoxville.
9. Rajendra K. Srivastava, Mark I. Alpert, and Allan D. Shocker, “A Customer-Oriented Approach for Determining Market Structures,” *Journal of Marketing*, Spring 1984, 32.
10. George S. Day, *Strategic Marketing Planning: The Pursuit of Competitive Advantage* (St. Paul, MN: West Publishing, 1984), 72.
11. Derek F. Abell, *Defining the Business: The Starting Point of Strategic Planning* (Englewood Cliffs, NY: Prentice Hall, 1980).
12. “Let a Thousand Brands Bloom,” *BusinessWeek*, October 17, 2005, 58 and 60.
13. Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), 5.
14. George S. Day and Robin Wensley, “Assessing Advantage: A Framework for Diagnosing Competitive Superiority,” *Journal of Marketing*, April, 1988, 12–16.
15. Peter Grant and Almar Latour, “Circuit Breaker,” *The Wall Street Journal*, October 9, 2003, A1 and A9; “Net Phones Start Ringing Up Customers,” *BusinessWeek*, December 29, 2003, 45–46.
16. Jason Bush, “Shoppers Gone Wild,” *BusinessWeek*, February 20, 2006, 46.
17. C. K. Prahalad, “Weak Signals Versus Strong Paradigms,” *Journal of Marketing Research*, August 1995, iii–vi.
18. Gary Hamel and C. K. Prahalad, *Competing for the Future* (Boston: Harvard Business School Press, 1994), 101.

Appendix 2A

Financial Analysis for Marketing Planning and Control

Several kinds of financial analyses are needed for marketing analysis, planning, and control activities. Such analyses represent an important part of case preparation activities. In some instances it will be necessary to review and interpret the financial information provided in the cases. In other instances, analyses may be prepared to support specific recommendations. The methods covered in this appendix represent a group of tools and techniques for use in marketing financial analysis. Throughout the discussion, it is assumed that accounting and finance fundamentals are understood.

Unit of Financial Analysis

Various units of analysis that can be used in marketing financial analysis are shown in Exhibit 2A.1. Two factors often influence the choice of a unit of analysis: (1) the purpose of the analysis and (2) the costs and availability of the information needed to perform the analysis.

Financial Situation Analysis

Financial measures can be used to help assess the present situation. One of the most common and best ways to quantify the financial situation of a firm is through ratio analysis. These ratios should be analyzed over a period of at least three years to discern trends.

Key Financial Ratios

Financial information will be more useful to management if it is prepared so that comparisons can be made. James Van Horne comments upon this need.

To evaluate a firm's financial condition and performance, the financial analyst needs certain yardsticks. The yardstick frequently used is a ratio or index, relating two pieces of financial data to each other. Analysis and interpretation of various ratios should give an experienced and skilled analyst a better understanding of the financial condition and performance of the firm than he would obtain from analysis of the financial data alone.¹

As we examine the financial analysis model in the next section, note how the ratio or index provides a useful frame of reference. Typically, ratios are used to compare historical and/or future trends within the firm or to compare a firm or business unit with an industry or other firms.

Several financial ratios often used to measure business performance are shown in Exhibit 2A.2. Note that these ratios are primarily useful as a means of comparing:

1. Ratio values for several time periods for a particular business.
2. A firm to its key competitors.
3. A firm to an industry or business standard.

There are several sources of ratio data. These include data services such as Dun & Bradstreet, *The Value Line Investment Survey*, industry and trade associations, government agencies, and investment advisory services.

Other ways to gauge the productivity of marketing activities include sales per square feet of retail floor space, occupancy rates of hotels and office buildings, and sales per salesperson.

¹James C. Van Horne, *Fundamentals of Financial Management*, 4th ed. (Englewood Cliffs, NJ: Prentice-Hall, 1980), 103–4.

EXHIBIT 2A.1
Alternative Units for
Financial Analysis

Market	Product/Service	Organization
Market	Industry	Company
Market niche(s)	Product mix	Segment/division/unit
Geographic area(s)	Product line	Marketing department
Customer groups	Specific product	Sales unit:
Individual customers	Brand	Region
	Model	District branch
		Office/store

EXHIBIT 2A.2 Summary of Key Financial Ratios

Source: Adapted from Arthur A. Thompson, Jr., and A. J. Strickland III, *Strategy and Policy*, 4th ed. (Homewood, IL: Richard D. Irwin, 1987), 270-1.

Ratio	How Calculated	What It Shows
Profitability ratios:		
1. Gross profit margin	$\frac{\text{Sales} - \text{Cost of goods sold}}{\text{Sales}}$	An indication of the total margin available to cover operating expenses and yield a profit.
2. Operating profit margin	$\frac{\text{Profits before taxes and before interest}}{\text{Sales}}$	An indication of the firm's profitability from current operations without regard to the interest charges accruing from the capital structure.
3. Net profit margin (or return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales}}$	Shows after-tax profits per dollar of sales. Subpar profit margins indicate that the firm's relatively low, its costs are relatively high, or both.
4. Return on total assets	$\frac{\text{Profits after taxes}}{\text{Total assets}} \quad \text{or} \quad \frac{\text{Profits after taxes} + \text{Interest}}{\text{Total assets}}$	A measure of the return on total investment in the enterprise. It is sometimes desirable to add interest to after-tax profits to form the numerator of the ratio, since total assets are financed by creditors as well as by stockholders; hence, it is accurate to measure the productivity of assets by the returns provided to both classes of investors.
5. Return on stockholders' equity (or return on net worth)	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	A measure of the rate on stockholders' investment in the enterprise.
6. Return on common equity	$\frac{\text{Profits after taxes} - \text{Preferred stock dividends}}{\text{Total stockholders' equity} - \text{Par value of preferred stock}}$	A measure of the rate of return on the investment which the owners of common stock have made in the enterprise.
7. Earnings per share	$\frac{\text{Profits after taxes} - \text{Preferred stock dividends}}{\text{Number of shares of common stock outstanding}}$	Shows the earnings available to the owners of common stock.
Liquidity ratios:		
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Indicates the extent to which the claims of short-term creditors are covered by assets that are expected to be converted to cash in a period roughly corresponding to the maturity of the liabilities.
2. Quick ratio (or acid-test ratio)	$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$	A measure of the firm's ability to pay off short-term obligations without relying on the sale of its inventories.
3. Cash ratio	$\frac{\text{Cash \& Marketable securities}}{\text{Current liabilities}}$	An indicator of how long the company can go without further inflow of funds.

(continued)

EXHIBIT 2A.2—(concluded)

4. Inventory to net working capital	Inventory Current assets – Current liabilities	A measure of the extent to which the firm's working capital is tied up in inventory.
Leverage ratios:		
1. Debt to assets ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Measures the extent to which borrowed funds have been used to finance the firm's operations.
2. Debt to equity ratio	$\frac{\text{Total debt}}{\text{Total stockholders' equity}}$	Provides another measure of the funds provided the creditors versus the funds provided by owners.
3. Long-term debt to equity ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	A widely used measure of the balance between debt and equity in the firm's overall capital structure.
4. Times-interest-earned (or coverage ratios)	$\frac{\text{Profits before interest and taxes}}{\text{Total interest charges}}$	Measures the extent to which earnings can decline without the firm's becoming unable to meet its annual interest costs.
5. Fixed-charge coverage	$\frac{\text{Profits before taxes and interest} + \text{Lease obligations}}{\text{Total interest charges} + \text{Lease obligations}}$	A more inclusive indication of the firm's ability to meet all of its fixed-charge obligations.
Activity ratios:		
1. Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$	When compared to industry averages, it provides an indication of whether a company has excessive inventory or perhaps inadequate inventory.
2. Fixed-assets turnover*	$\frac{\text{Sales}}{\text{Fixed assets}}$	A measure of the sales productivity and utilization of plant and equipment.
3. Total-assets turnover	$\frac{\text{Sales}}{\text{Total assets}}$	A measure of the utilization of all the firm's assets; a ratio below the industry average indicates the company is not generating a sufficient volume of business given the size of its asset investment.
4. Accounts receivable turnover	$\frac{\text{Annual credit sales}}{\text{Accounts receivable}}$	A measure of the average length of time it takes the firm to collect on the sales made on credit.
5. Average collection period	$\frac{\text{Accounts receivable}}{\text{Total sales} \div 365}$ or $\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	Indicates the average length of time the firm must wait after making a sale before it receives payment.

*The manager should also keep in mind the fixed charges associated with noncapitalized lease obligations.

EXHIBIT 2A.3 Illustrative Contribution Margin Analysis for Product X (\$000)

Sales	\$300
Less: Variable manufacturing costs	100
Other variable costs traceable to product X	50
Equals: Contribution margin	150
Less: Fixed costs directly traceable to product X	100
Equals: Product net income	\$ 50

Contribution Analysis

When the performance of products, market segments, and other marketing units is being analyzed, management should examine the unit's profit contribution. Contribution margin is equal to sales (revenue) less variable costs. Thus, contribution margin represents the amount of money available to cover fixed costs, and contribution margin less fixed costs is net income. An illustration of contribution margin analysis is given in Exhibit 2A.3. In this example, product X is generating a positive contribution margin. If product X were eliminated, \$50,000 of product net income would be lost, and the remaining products would have to cover fixed costs not directly traceable to them. If the product is retained, the \$50,000 can be used to contribute to other fixed costs and/or net income.

Financial Analysis Model

The model shown in Exhibit 2A.4 provides a useful guide for examining financial performance and identifying possible problem areas. The model combines several important financial ratios into one equation. Let's examine the model, moving from left to right. Profit margin multiplied by asset turnover yields return on assets. Moreover, assuming that the performance target is return on net worth (or return on equity), the product of return on assets and financial leverage determines

performance. Increasing either ratio will increase net worth. The values of these ratios will vary considerably from one industry to another. For example, in grocery wholesaling, profit margins are typically very low, whereas asset turnover is very high. Through efficient management and high turnover, a wholesaler can stack up impressive returns on net worth. Furthermore, space productivity measures are obtained for individual departments in retail stores that offer more than one line, such as department stores. The measures selected depend on the particular characteristics of the business.

Evaluating Alternatives

As we move through the discussion of financial analysis, it is important to recognize the type of costs being used in the analysis. Using accounting terminology, costs can be designated as fixed or variable. A cost is *fixed* if it remains constant over the observation period, even though the volume of activity varies. In contrast, a *variable* cost is an expense that varies with sales over the observation period. Costs are designated as mixed or semivariable in instances when they contain both fixed and variable components.

Break-Even Analysis

This technique is used to examine the relationship between sales and costs. An illustration is given in Exhibit 2A.5. Using sales and cost information, it is easy to determine from a break-even analysis how many units of a product must be sold in order to break even, or cover total costs. In this example 65,000 units at sales of \$120,000 are equal to total costs of \$120,000. Any additional units sold will produce a profit. The break-even point can be calculated in this manner:

$$\text{Break-even units} = \frac{\text{Fixed costs}}{\text{Price per unit} - \text{Variable cost per unit}}$$

EXHIBIT 2A.4 Financial Analysis Model

Profit margin ↓		Asset turnover ↓		Return on assets ↓		Financial leverage ↓		Return on net worth ↓
Net profits (after taxes) Net sales	×	Net sales Total assets	→	Net profits (after taxes) Total assets	×	Total assets Net worth	=	Net profits (after taxes) Net worth

Price in the illustration shown in Exhibit 2A.5 is \$1.846 per unit, and variable cost is \$0.769 per unit. With fixed costs of \$70,000, this results in the break-even calculation:

$$\text{BE units} = \frac{\$70,000}{\$1.846 - \$0.769} = 65,000 \text{ units}$$

To determine how many units must be sold to achieve a target profit (expressed in before-tax dollars), the formula is amended as follows:

$$\text{Target profit units} = \frac{\text{Fixed costs} + \text{Target profit (before tax)}}{\text{Price per unit} - \text{Variable cost per unit}}$$

Using the same illustration as above and including a target before-tax profit of \$37,700, the target profit calculation becomes:

$$\begin{aligned} \text{Target profit units} &= \frac{\$70,000 + \$37,700}{\$1.846 - \$0.769} \\ &= 100,000 \text{ units} \end{aligned}$$

Break-even analysis is not a forecast. It indicates how many units of a product at a given price and cost

must be sold in order to break even or achieve a target profit. Some important assumptions that underlie the above break-even analysis include the use of constant fixed and variable costs, a constant price, and a single product.

In addition to break-even analysis, several other financial tools are used to evaluate alternatives. Net present value of cash flow analysis and return on investment are among the most useful. For example, assume there are two projects with the cash flows shown in Exhibit 2A.6.

Though return on investment is widely used, it is limited by its inability to consider the time value of money. This is shown in Exhibit 2A.7. Return on investment for *both* projects X and Y is 10 percent. However, a dollar today is worth more than a dollar given in three years. Therefore, in assessing cash flows of a project or investment, future cash flows must be discounted back to the present at a rate comparable to the risk of the project.

EXHIBIT 2A.6 Cash Flow Comparison (\$000s)

	Project X	Project Y
Start-Up Costs	<1,000 >	<1,000 >
Year 1	500	300
Year 2	500	400
Year 3	300	600

EXHIBIT 2A.5
Illustrative Break-Even Analysis

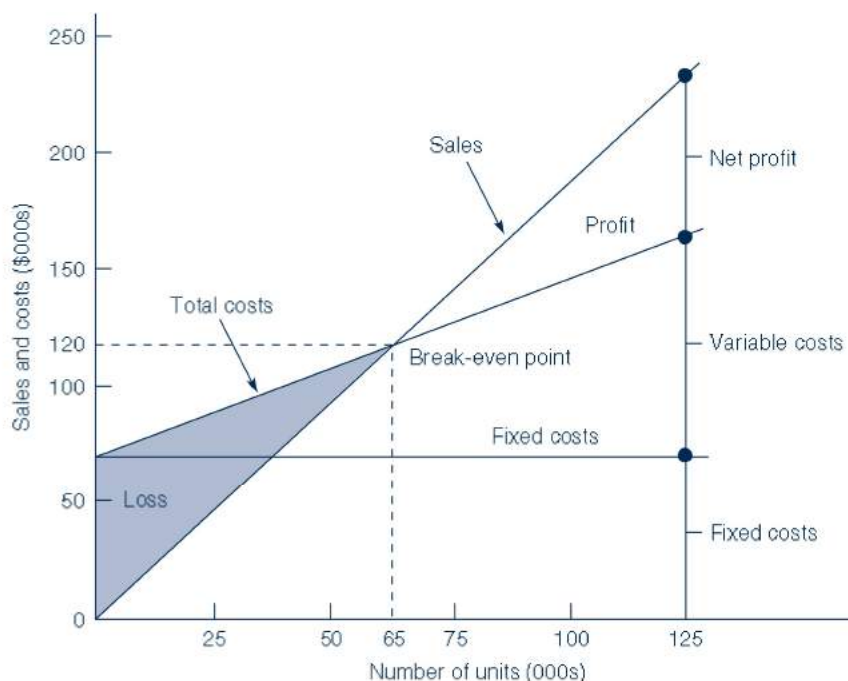


EXHIBIT 2A.7
Present Value of Cash
Flows

	Time	Cash Flow	PV Factor	NPV of Cash Flow
<i>Project X</i>				
	0	<1,000>	$1/(1 + .12)^0 = 1$	<1,000>
	1	500	$1/(1 + .12)^1 = 0.8929$	= 446.45
	2	500	$1/(1 + .12)^2 = 0.7972$	= 398.60
	3	300	$1/(1 + .12)^3 = 0.7118$	= 213.54
			Present value	+ 58.59
<i>Project Y</i>				
	0	<1,000>	$1/(1 + .12)^0 = 1$	<1,000>
	1	300	$1/(1 + .12)^1 = 0.8929$	= 267.87
	2	400	$1/(1 + .12)^2 = 0.7972$	= 318.88
	3	600	$1/(1 + .12)^3 = 0.7118$	= 427.08
			Net present value	+ 13.83

Discounting cash flows is a simple process. Assume that the firm is considering projects X and Y and that its cost of capital is 12 percent. Additionally, assume that both projects carry risk comparable to the normal business risk. Under these circumstances, the analyst should discount the cash flows back to the present at the cost of capital, 12 percent. Present value factors can be looked up or computed using the formula $1/(1 + i)^n$, where i equals our discounting rate per time period and n equals the number of compounding periods. In this example, the present value of cash flows would be as shown in Exhibit 2A.7.

Because both projects have a positive net present value, both are good. However, if they are mutually exclusive, the project with the highest net present value should be selected.

Financial Planning

Financial planning involves two major activities: (1) forecasting revenues and (2) budgeting (estimating future expenses). The actual financial analyses and forecasts included in the strategic marketing plan vary considerably from firm to firm. In addition, internal financial reporting and budgeting procedures vary widely among companies. Therefore, consider this approach as one example rather than the norm.

The choice of the financial information to be used for marketing planning and control will depend on its relationship with the corporate or business unit strategic plan. Another important consideration is the

selection of performance measures to be used in gauging marketing performance. The objective is to indicate the range of possibilities and suggest some of the more frequently used financial analysis.

Pro forma income statements can be very useful when one is projecting performance and budgeting. Usually, this is done on a spreadsheet so that assumptions can be altered rapidly. Usually, only a few assumptions need be made. For example, sales growth rates can be projected from past trends and adjusted for new information. From this starting point, cost of goods can be determined as a percentage of sales. Operating expenses can also be determined as a percentage of sales based on past relationships, and the effective tax rate as a percentage of earnings before taxes. However, past relationships may not hold in the future. It may be necessary to analyze possible divergence from past relationships.

In addition, pro forma income statements can be used to generate pro forma cash flow statements. It is then possible to compare alternative courses of action by employing a uniformly comparable standard cash flow.

Supplemental Financial Analyses

The preceding sections of this appendix detailed the various forms of traditional financial analysis useful in marketing decision making. There are supplemental forms of analysis that can also be helpful in different types of marketing decisions. These supplemental techniques

draw mainly from the management accounting discipline and rely on data that are available only to internal decision makers. Many of the financial analyses in the earlier sections employed data from published financial statements.

Only recently have marketing decision makers been able to look to management accounting to provide an additional set of quantitative tools to aid in the decision process.² These tools may be referred to collectively as strategic management accounting practices. Simmonds is generally credited with originating the term *strategic management accounting*, which he defines as “the provision and analysis of management accounting data about a business and its competitors for use in developing and monitoring the business strategy.”³ Although academic researchers may disagree about the specific techniques which constitute strategic management accounting, a wide selection of management accounting practices available for use in marketing decision making. These practices are described in Exhibit 2A.8

and include activity-based costing, attribute costing, benchmarking, brand valuation budgeting and monitoring, competitor cost assessment, competitive position monitoring, competitor performance appraisal, integrated performance measurement, life cycle costing, quality costing, strategic costing, strategic pricing, target costing, and value-chain costing.⁴

Exhibit 2A.8 also provides a description of the various marketing applications of strategic management accounting practices in terms of specific decision-making situations. Most of these practices require the marketing decision maker to gather information additional to that normally used for the preparation of external financial statements. In most cases, this information is already available in the accounting information system of the firm. However, it may be necessary to compile data from outside the firm in a more formalized manner to perform analysis using some of these strategic management accounting practices.

²George Foster and Mahendra Gupta, “Marketing, Cost Management and Management Accounting,” *Journal of Management Accounting Research* 6 (1994), 43–77.

³K. Simmonds, “Strategic Management Accounting,” *Management Accounting* (UK) 59, no. 4 (1981), 26–29.

⁴For a comprehensive description of strategic management accounting techniques and differences in attitudes toward the use of these techniques between accounting and marketing managers, see Karen S. Cravens and Chris Guilding, “An Empirical Study of the Application of Strategic Management Accounting Techniques,” *Advances in Management Accounting* 10 (2001), 95–124.

EXHIBIT 2A.8 Supplemental Financial Analyses Using Management Accounting Practices

Strategic Management Accounting Practice	Description of the Practice	Description of Marketing Application
Activity-based costing	Indirect costs are assigned to a product or service in relation to the activities used to produce the product or provide the service. Decision making focuses on the collection of activities necessary to produce the product or service rather than the costs in a specific category.	This technique is particularly useful in determining the costs of customization or the provision of additional services to customers. Since the activities are the central focus for costing, decision makers can evaluate customers and markets in terms of the activities required to serve their needs.
Attribute costing	Products or services are costed in terms of attributes that appeal to customers. Thus, the cost object is not the entire product but a collection of features that respond to customer needs.	The nature of the cost object can be modified to support different strategic decision-making situations. As customers modify their preferences, decision makers can consider how particular product attributes satisfy their needs relative to marketing positioning strategies.
Benchmarking	Benchmarking is improving existing processes by looking to an ideal standard. The standard may be established from an external source such as a competitor, a partner, or an unrelated industry or company or by another area of the same firm.	Benchmarking provides an opportunity to assess processes for improvement and strategic advantage in terms of operational effectiveness. Critical lapses in customer service or customer contact situations can be remedied.
Brand valuation—budgeting and monitoring	Brand valuation assesses the current and future potential of a brand in quantitative terms. A “capitalized” value for internally developed brands can be created even though in the United States this value may not be included on a balance sheet.	Current spending on brand promotion activities can be evaluated in terms of future benefits. This can assist with budgeting decisions relative to a portfolio of brands or products and in monitoring the mix and potential of existing products.
Competitive position monitoring	This type of analysis is used in evaluating the market strategy of a competitor. Overall competitor positions in the market and industry are assessed, including sales and trend information, along with market share and cost estimates.	Since this technique requires an external focus, it allows decision makers to assess the position of a product in terms of existing and future strategy relative to competitors. Situations allowing a firm to improve competitive position can be identified and acted upon.
Competitor performance appraisal	This form of analysis is a detailed part of competitive position monitoring and focuses on preparing a quantitative analysis of the competitor’s external financial statements.	Decision makers can identify the key areas of a competitor’s market advantage and relate areas of advantage to strategic decisions.

(continued)

EXHIBIT 2A.8—(concluded)

Integrated performance measurement	This form of analysis uses performance appraisal based on measures that are developed in terms of a customer focus. Integrated measures may be linked to customer satisfaction and may include nonfinancial measures monitored at the individual and departmental levels.	Measures focusing on the customer can be linked to overall strategic objectives throughout the organization. Decision makers can get a clear picture of how their decisions (and performance) affect overall corporate performance.
Life cycle costing	A product or service is costed based on stages in the life of a product rather than financial reporting periods.	Decision makers can adopt a longer-term perspective to evaluate the performance of a product without the constraints of annual reporting periods.
Quality costing	Accounting measures support determining the cost of quality and the cost of a quality failure.	Decision makers can evaluate the impact on customers and market position when choices are made regarding quality issues.
Strategic costing	Strategic costing involves recognizing that the ultimate objective of expenditures related to a product or service may be more long-term in perspective. Thus, cost minimization is not the prime objective. Choices involving costs are evaluated in terms of long-term issues and the future potential of strategies.	Long-term strategy and strategic objectives considering product positioning and market penetration can be evaluated more completely. The long-term implications of a decision receive precedence over the short-term effect.
Strategic pricing	Strategic pricing adopts a more long-term and demand-focused approach to pricing rather than considering a cost-based and historical foundation.	Pricing decisions can be evaluated more in terms of competitive and market choices.
Target costing	A market-based approach is used to determine the target cost for a future product. The target cost is the remainder after a desired profit margin is subtracted from the estimated market price of a new product.	Since the product is designed to meet the target cost, decision makers know that the product will be able to enter the market at a price that allows an adequate level of profits. External rather than internal factors determine the price.
Value-chain costing	The cost of a product is evaluated over the entire value chain of production from research and development to customer service. This value chain may include multiple functional areas within the organization and cover different financial accounting reporting periods.	Operational efficiencies and competitive positioning can be evaluated at all stages of the value chain, not merely from the costs incurred during production. Links to suppliers, customers, and competitors can be considered at all points of the value chain.

Chapter 3

Strategic Market Segmentation

Segmenting markets is a foundation for superior performance. Understanding how buyers' needs and wants vary is essential in designing effective marketing strategies. Effective approaches to segmenting markets may be one of the most critical factors in developing and implementing market-driven strategy. The need to improve an organization's understanding of buyers is escalating because of buyers' demands for uniqueness and an array of technologies available to generate products to satisfy these demands. Companies are responding to the opportunities to provide unique customer value with products ranging from customized phone pagers for business users to self-designed greeting cards for consumers, and even postage stamps with customers' own photographs incorporated.

Best Buy provides an interesting illustration of strategic market segmentation. While accounting for around 17 percent of the U.S. and Canada consumer electronics market, nonetheless 2003 saw the piloting of Best Buy's "customer-centricity" strategy, radically shifting the company's strategic emphasis from products and technology to customers. The goal is to focus on the most attractive customers based on the important differences between them in their purchasing and preferences in consumer electronics. The customer base has been segmented into basic lifestyle groups. High priority target groups are described as:

- **Jill**—the "soccer mom," who is the main shopper for the family, but often avoids electronics stores, she is well-educated and confident, and wants to enrich her children's lives with technology, yet she is intimidated by technology and jargon.
- **Barry**—the wealthy professional man, who demands the latest technology and best service.
- **Buzz**—the young "tech enthusiast," who wants technology and entertainment.
- **Ray**—the family man, who wants technology that improves his and his family's life.
- **Mr Storefront**—the small business customer who can use Best Buy's product solutions and services.

Other interesting segments are the **Carrie's** (young, single females) and the **Helen and Charlie's** (older couples whose children have left home). Stores are being adapted to serve at least one dominant customer segment shopping at each store—though Jill and Barry stores are a frequent combination of segments in the same store. At the store level,

employees are trained to recognize and focus on the needs and preferences of the target segments for that store. Indications are that stores converted to focus on the target segments perform substantially better than other stores.¹

Buyers vary according to how they use products, the needs and preferences that the products satisfy, and their consumption patterns. These differences create market segments. Market segmentation is the process of identifying and analyzing subgroups of buyers in a product-market with similar response characteristics (e.g., frequency of purchases). Recognizing differences between market segments, and how they change better and faster than competitors is an increasingly important source of competitive advantage.

Indeed, even for companies producing consumer products, the concept of a “one-size-fits-all mass market” is increasingly less relevant. Many consumer markets show signs of fragmentation into “microsegments” driven by diverse product preferences and media usage and demanding “right for me” in products purchased.² This is why Nike offers more than 300 varieties of sport shoe, not just one.

The most specific form of market segmentation is to consider each buyer as a market segment. This is the basis for “one-to-one marketing.”³ Such fine-tuned segmentation is possible for an expanding array of products due to mass customization techniques. It offers an exciting new approach to serving the unique needs and wants of individual buyers. Custom designed products satisfy the individual buyer’s needs and wants at prices comparable to mass produced products. The growing adoption of Customer Relationship Management systems that integrate all information about each individual customer into a single location provides unprecedented opportunities to learn about customer needs from their actual behavior. This is discussed in Chapter 4.

The worldwide apparel industry is increasingly adopting mass customization technologies to allow clothing to be designed and produced for the individual consumer. Pioneered by Levi Strauss & Co with Personal Pair jeans (later Original Spin), stores as diverse as Brooks Brothers, Harrods in London, Bon Marché in Paris, and many other retailers use body scanning to measure dimensions and produce clothes customized for the individual consumer. For Levi’s the goal is to reduce the traditional struggle to locate jeans that fit well, into a ten-second shopping experience—when the consumer steps out of the “measure me up” kiosk, personal stylists are available to help choose the best styles. At Harrods, customized apparel by designers like Vivienne Westwood and Nick Holland is produced based on body scanning information. Internet-based companies offer mass-customized clothing, including IC3D (Interactive Custom Clothes Company Designs), American Fit, and Beyond Fleece.⁴

We begin the chapter with a discussion of the different purposes that segmentation models can fulfill and the role of market segmentation in marketing strategy, followed by a discussion of the variables used to identify segments. Next, we look at the methods for forming segments followed by a review of high-variety strategies. Finally, we consider the issues and guidelines involved in selecting the segmentation strategy and in its implementation.

Levels and Types of Market Segmentation

Segmentation is an important capability in strategic marketing, which is linked to choosing market targets and positioning against alternatives to build competitive advantage. Importantly, we recognize that segmentation may serve several purposes at levels which range from the strategic to the operational. The Best Buy analysis of its customer base and realignment of its stores and employee behaviors around segments illustrates an interesting

approach to strategic market segmentation. Many traditional views emphasize segmentation as an operational tool—for example, to aim advertising effectively at different types of customers.

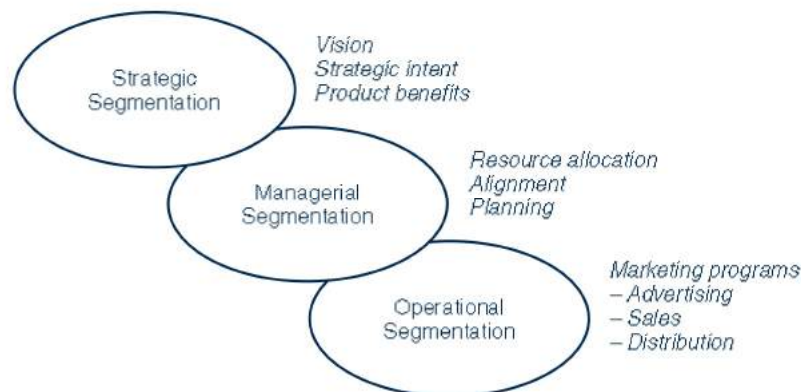
However, segmentation models appropriate to developing advertising programs may be quite different from those used to develop marketing strategy. While advertising-oriented segmentation aims to identify targets that differ in their responses to a given message, strategic segmentation has the goal of identifying market segments that differ in their purchasing power, goals, aspirations and behavior, in ways relevant to identifying new product and value opportunities.⁵

It is useful to examine segmentation as operating at several decision making levels in the way suggested by Exhibit 3.1. Strategic segmentation links to the management vision and strategic intent of corporate strategy and emphasizes product benefits that different types of buyers seek. Managerial segmentation is concerned with allocating resources around segment targets, including them in marketing plans and aligning organizational processes around them. Operational segmentation issues are concerned with the marketing program changes needed to reach segment targets with advertising and promotions, and with distribution systems. The Best Buy example illustrates these levels of segmentation approach: the strategic issues are concerned with consumer lifestyles and the benefits that different types of consumers seek in choosing and purchasing consumer electronics. The managerial issues are concerned with identifying target segment members, redesigning stores to serve chosen segments, and providing employees with the training and power to focus on the segment targets. Operational segmentation issues are concerned with delivering relevant messages to targets and supporting the segmentation strategy at the store level.

In considering the role of segmentation, the deepest decisions are whether to revise the business model in response to how social forces are changing the lives of different types of customer, how to position a brand, which segments to pursue, and whether to make fundamental changes to the product or to develop an entirely new product. The shallowest decisions are concerned with issues like whether to make small improvements in existing products, how to select targets of a media campaign, or whether to adjust prices.⁶

It is important to effective market-driven strategy that these different aspects of segmentation should be aligned and integrated. The goal of strategic marketing segmentation is to support the processes whereby products are designed and developed around the needs of different types of purchasers to offer superior customer value, and then to identify the mechanisms by which that value can be delivered. This requires segmenting markets in ways that reflect how customers actually live their lives and the jobs that they need to get done.⁷

EXHIBIT 3.1
Levels of Market
Segmentation



Market-Driven Strategy and Segmentation

Market segmentation needs to be considered early in the development of market-driven strategy. Segments are identified, customer value opportunities and new market spaces are explored in each segment, organizational capabilities are matched to promising segment opportunities, market target(s) are selected from the segment(s) of interest, and a positioning strategy is developed and implemented for each market target (Exhibit 3.2). We examine each of these activities to indicate the role of segmentation in the marketing strategy process.

Market Segmentation, Value Opportunities, and New Market Space

Market segmentation is the process of placing the buyers in a product-market into subgroups so that the members of each segment display similar responsiveness to a particular positioning strategy. Buyer similarities are indicated by the amount and frequency of purchase, loyalty to a particular brand, how the product is used, and other measures of responsiveness. So, segmentation is an identification process aimed at finding subgroups of buyers within a total market. The opportunity for segmentation occurs when differences in buyers' demand (response) functions allow market demand to be divided into segments, each with a distinct demand function.⁸ The term "market niche" is sometimes used to refer to a market segment that represents a relatively small portion of the buyers in the total market. We consider a niche and a segment to be the same.

Segmentation identifies customer groups within a product-market, each containing buyers with similar value requirements concerning specific product/brand attributes. A segment is a possible market target for an organization competing in the market. Segmentation offers a company an opportunity to better match its products and capabilities

EXHIBIT 3.2
Segmentation in
the Market-Driven
Strategy Process





The airline sector is a mature marketplace, which has been dominated by the financial difficulties of the large, full-service carriers, and the moves towards industry consolidation. Major successes have been achieved by the “no frills” budget carriers—Southwest in the U.S., Ryanair in Europe, AirAsia in Malaysia, Air Deccan in India, Gol in Brazil—with very low fares.

However, the newest niche strategy is the all-business-class airline, aimed at the premium cabin traveler on a budget. The new carriers offer gourmet food, beds that are bed-like and cashmere blankets, but at transatlantic fares in the \$1,000–\$3,500 range, compared to as much as \$8,000 at the established airlines. The target is business travelers, corporate customers, and leisure travelers prepared to upgrade.

Eos, the first all-business-class start-up, started flying between the U.S. and the U.K. in 2005. Maxjet and Silverjet (U.K.-based) were in operation by 2007. They threaten the business class services of the major transatlantic carriers—British Airways, Virgin Atlantic, American Airlines and United Airlines. By 2007, the three all-business-class carriers accounted for more than 20 percent of the premium seat capacity in the London/New York market.

British Airways and Virgin Atlantic are rushing to launch their own transatlantic all-business-class services, to defend the premium traveler segment.

Sources: Kerry Capell, “Business Class at Bargain Prices,” *BusinessWeek*, February 5, 2007, 46. Chris Bryant and Maggie Urry, “Virgin Atlantic Set to Launch Business-Only Service,” *Financial Times*, June 5, 2007, 24. Kevin Done, “Maxjet in £ 50.5 Million AIM Listing,” *Financial Times*, June 14, 2007, 21.

to buyers’ value requirements. Customer satisfaction can be improved by providing a value offering that matches the value proposition considered important by the buyer in a segment.

Importantly, market analysis may identify segments not recognized or served effectively by competitors. There may be opportunities to tap into new areas of value and create a unique space in the market. For example, while the global airline business is highly competitive, low-cost airlines like Southwest have been able to develop profitable opportunities. Interestingly, the newest entrants to the sector are all-business-class airlines, providing premium air travel at fares very competitive against the conventional airlines. This development is described in the INNOVATION FEATURE.

While broad competitive comparisons can be made for an entire product-market, more penetrating insights about competitive advantage and market opportunity result from market segment analyses. Examining specific market segments helps to identify how to (1) attain a closer match between buyers’ value preferences and the organization’s capabilities, and (2) compare the organization’s strengths (and weaknesses) to the key competitors in each segment.

Market Targeting and Strategic Positioning

Market targeting consists of evaluating and selecting one or more segments whose value requirements provide a good match with the organization’s capabilities. Companies typically appeal to only a portion of the people or organizations in a product-market, regardless of how many segments are targeted. Management may decide to target one, a few, or several segments to gain the strength and advantage of specialization. Alternatively, while a specific segment strategy is not used, the marketing program selected by management is likely to appeal to a particular subgroup of buyers within the market. Segment identification and targeting are obviously preferred. Finding a segment by chance does not give management the opportunity of evaluating different segments in terms of the financial and competitive advantage implications of each segment. When segmentation is employed, it should be by design, and the underlying analyses should lead to the selection of one or more promising segments to target.



- Notwithstanding depressed car markets in the U.S. and Europe, BMW's remake of the 1959 classic is one of the most successful model overhauls ever. Sales of 176,000 cars in 2003 were up 22.4 percent from 2002, and the Oxford, England factory is running at capacity. In 2007, the plant produced the millionth Mini.
- The new Mini look is a cute snout and bull-dog like stance offering an appealing contrast to boxy sports utility vehicles. While based on the original Mini, this is a premium priced vehicle, packed with technology.
- The car is positioned to be "quintessentially cool." Its biggest selling point is its individualistic appeal.
- Budget for the U.S. launch was only \$13 million, so BMW used event-focused "guerrilla tactics," unconventional stunts, and irreverent humor to spark an infectious buzz.
- One of the first Mini-sightings in the U.S. was a Mini strapped to the roof of a sports utility vehicle with the sign "What are you doing for fun this weekend?" The Mini also appeared seated in football stadiums like a fan watching the game.
- The cool status of the Mini was cemented in place when it was used in the 2003 remake of the movie *The Italian Job*. The 2006 launch of the Mini-Cooper used an internet-only campaign in homage to *The Matrix*.
- When the Mini convertible came to the U.S. and European markets in 2004, the cars were delivered with the top down and a seal to be broken when the roof was raised for the first time. Buyers were asked to sign a mock contract committing them to keep the roof down as long as they could—to stay true to the Mini convertible's open-minded spirit.
- BMW nurtured Mini mania by keeping supply just short of demand. More than half of buyers custom-order the Mini and wait three months for delivery.

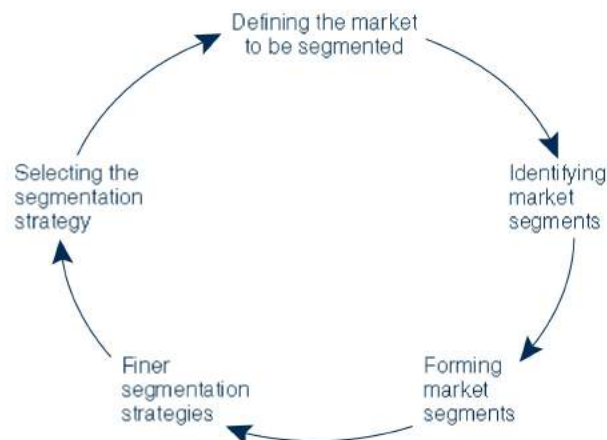
Source: Gail Edmondson and Michael Eldam, "The Mini Just Keeps Getting Mightier," *BusinessWeek*, April 5, 2004, 26; John Reed, "Millionth Mini Marks Milestone for BMW," *Financial Times*, April 16, 2007, 4.

Recall the Chapter 1 description of positioning strategy as the combination of the actions management takes to meet the needs and wants of each market target. The strategy consists of product(s) and supporting services, distribution, pricing, and promotion components. Management's choices about how to influence target buyers by favorably positioning the product in their eyes and minds help in designing the positioning strategy.

The GLOBAL FEATURE describes the positioning strategy chosen by BMW for the new Mini, as a lifestyle vehicle, and the innovative marketing program choices that fit with buyer characteristics in this niche of the automobile market.

Market segmentation lays the groundwork for market targeting and positioning strategies. The skills and insights used in segmenting a product-market may give a company

EXHIBIT 3.3
Activities and
Decisions in Market
Segmentation



important competitive advantages by identifying buyer groups that will respond favorably to the firm's marketing efforts. The previous Best Buy example is illustrative. Faulty segmentation reduces the effectiveness of targeting and positioning decisions. For example, in 2000 General Motors made the decision to axe the Oldsmobile brand—the oldest auto brand in the U.S. Although sometimes a symbol of innovation and style, Oldsmobile failed to establish a strong position in a long-term market niche or segment—it did not deliver the “class” of Cadillac and Buick, nor the wider market appeal of Chevrolet.⁹

Activities and Decisions in Market Segmentation

The process of segmenting a market involves several interrelated activities and decisions beginning with defining the market to be segmented (Exhibit 3.3). It is necessary to decide how to segment the market, identifying segments, which involves selecting the variable(s) to use as the basis for identifying segments. For example, frequency of use of a product (e.g., frequent, moderate, and occasional) may be a possible basis for segmentation. Next, the method of forming market segments is decided. This may consist of managers using judgment and experience to divide the market into segments. Alternatively, segments may be formed using statistical analysis. The availability of customer purchase behavior information in CRM systems, for example, provides a growing base for this analysis. Part of forming segments is deciding whether finer (smaller) segments should be used. Finally, strategic analysis is conducted on each segment to assist management in deciding which segment(s) to target.

Defining the Market to Be Segmented

Market segmentation may occur at any of the product-market levels shown in Exhibit 3.4. Generic-level segmentation is illustrated by segmenting supermarket buyers based on shopper types (e.g., on the basis of available shopping time). Product-type segmentation is shown by the differences in price, quality, and features of shaving equipment. Product variant-segmentation considers the segments within a category such as electric razors.

An important consideration in defining the market to be segmented is estimating the variation in buyers' needs and requirements at the different product-market levels and identifying the types of buyers included in the market. The all-business-class airline discussed in the earlier INNOVATION FEATURE illustrates a strategy focused on a specific

EXHIBIT 3.4
Segmentation in the
Health and Beauty
Supplies Market

Level of Competition	Product Definition	Illustrative Competitors	Need/Want Satisfied
Generic	Health and beauty aids	Consumer products companies	Enhancement of health and beauty
Product type	Shaving equipment	Gillette, Remington, Bic	Shaving
Product variant	Electric razors	Braun, Norelco, Remington, Panasonic	Electric shaving

passenger segment. Nonetheless, in contemporary markets, boundaries and definitions can change rapidly, underlining the strategic importance of market definition and selection, and the need for frequent re-evaluation.

Identifying Market Segments

After the market to be segmented is defined, one or more variables are selected to identify segments. For example, the United States Automobile Association (USAA) segments by type of employment. Although unknown to many people, USAA has built a successful business serving the financial services needs of U.S. military personnel located throughout the world. USAA has close relationships with its 5.6 million members using powerful information technology. The USAA service representative has immediate access to the client's consolidated file, the one-to-one service encounter is highly personalized, and USAA achieves a 98 percent retention rate in its chosen market segment.¹⁰ In 2007, USAA was "#1 Customer Service Champ" in a BusinessWeek survey.¹¹

First, we discuss segmentation variables, followed by a review of the variables that are used in segmentation analyses.

Segmentation Variables

One or more variables (e.g., frequency of use) may be used to divide the product-market into segments. *Demographic* and *psychographic* (lifestyle and personality) characteristics of buyers are of interest, since this information is available from the U.S. Census reports and many other sources including electronic databases. The *use situation* variables consider how the buyer uses the product, such as purchasing a meal away from home for the purpose of entertainment. Variables measuring buyers' *needs* and *preferences* include attitudes, brand awareness, and brand preference. *Purchase-behavior* variables describe brand-use and consumption (e.g., size and frequency of purchase). We examine these variables to highlight their uses, features, and other considerations important in segmenting markets.

Characteristics of People and Organizations

Consumer Markets

The characteristics of people fall into two major categories: (1) geographic and demographic, and (2) psychographic (lifestyle and personality). Demographics are often more useful to describe consumer segments after they have been formed rather than to identify them. Nonetheless, these variables are popular because available data often relate demographics to the other segmentation variables. Geographic location maybe useful for segmenting product-markets. For example, there are regional differences in the popularity of transportation vehicles. In several U.S. states the most popular vehicle is a pickup truck. The "truck belt" runs from the upper Midwest south through Texas and the Gulf coast states. The Ford brand is dominant in the northern half of the truck belt while Chevrolet leads in the southern half.

Demographic variables describe buyers according to their age, income, education, occupation, and many other characteristics. Demographic information helps to describe groups of buyers such as heavy users of a product or brand. Demographics used in combination with buyer behavior information are useful in segmenting markets, selecting distribution channels, designing promotion strategies, and other decisions on marketing strategy.

Lifestyle variables indicate what people do (activities), their interests, their opinions, and their buying behavior. Lifestyle characteristics extend beyond demographics and offer a more penetrating description of the consumer.¹² Profiles can be developed using lifestyle characteristics. This information is used to segment markets, help position products, and guide the design of advertising messages.

For example, consumer goods companies in many personal care and beauty product areas are looking for sales growth with male purchasers, rather than females. The male shopper is conventionally not well understood by companies in these product fields. Lifestyle and product choice differences between different types of males are shown in the STRATEGY FEATURE. While crude, this model provides an initial basis for examining product development opportunities for different segments of the male personal care product market.

Organizational Markets

Several characteristics help in segmenting business markets. The type of industry (sometimes called a vertical market) is related to purchase behavior for certain types of products. For example, automobile producers purchase steel, paint, and other raw materials. Since automobile firms' needs may vary from companies in other industries, this form of segmentation enables suppliers to specialize their efforts and satisfy customer needs. Other variables for segmenting organizational markets include size of the company, the stage of industry development, and the stage of the value-added system (e.g., producer, distribution, retailer).

Organizational segmentation is aided by first examining (1) the extent of market concentration, and (2) the degree of product customization.¹³ Concentration considers the number of customers and their relative buying power. Product customization determines the extent to which the supplier must tailor the product to each organizational buyer. If one or both of these factors indicate quite a bit of diversity, segmentation opportunities may exist.

For example, Boeing caters to the specific needs of each air carrier purchasing commercial aircraft, adapting designs to meet customer priorities. Nonetheless, the costs of customization are high and Boeing has had to evaluate the value/cost relationships of its attempts to satisfy the needs of single airline segments.

Product Use Situation Segmentation

Markets can be segmented based on how the product is used. As an illustration, Nikon, the Japanese camera company, offers a line of high performance sunglasses designed for activities and light conditions when skiing, snowboarding, skating, and driving. Nikon competes in the premium portion of the market with prices somewhat higher than Ray-Ban, the market leader. Timex uses a use situation basis of segmentation for its watches.

Needs and preferences vary according to different use situations. Consider, for example, segmenting the market for prescription drugs. Astra/Merck identifies the following segments based on the type of physician/patient drug use situation:

- **Health care as a business**—customers such as managed care administrators who consider economic factors of drug use foremost.
- **Traditional**—physicians with standard patient needs centered around the treatment of disease.



Consumer products companies in fields like personal care and cosmetics are focusing more attention on the male consumer. They are having to re-think the characteristics of the male purchaser. Male shopper stereotypes or segments include:

The Metrosexual

- The affluent, urban sophisticate, who adds deeper meaning, quality and beauty to consumption. Thinks of loafers as objets d'art.
- P&G, Beiersdorf and Polo Ralph Lauren do good business with the metro.

The Maturiteen

- More savvy, responsible, mature and pragmatic than previous cohorts, with poise attributed to baby boomer parents who treat kids as equals.
- A technology master, adept at online research, often acting as an inhouse shopping consultant. Never knew a time without the Web, and its interactivity has nurtured in them a radical view of brands—they own them.
- Adidas, Sony and Unilever are skillful at playing along with them.

The Modern Man

- Neither retro nor metro, he's something in the middle. A sophisticated consumer in his 20s and 30s—a bigger shopper than his Dad, but still a sports fan.
- Comfortable with women but doesn't like shopping with them. Moisturizer and hair gel are perfectly ordinary to him.
- Philips Norelco used locker room humor to get the modern man comfortable with the below-the-neck shaver, Bodygroom.

The Dad

- Largely ignored, but in their peak earning years.
- Smart companies like Dyson and Patek Philippe are reaching out to them.

The Retrosexual

- If the metrosexual champions the female ethos with a "go Girl," the retrosexual is screaming "Stop!" Has lived through the same cultural turmoil and consumerism, but rejects feminism and happily wallows in traditional male behavior. Nostalgic for the good old days before moisturizers for men.
- Burger King and P&G's Old Spice have this dude nailed.

Source: Nanette Byrnes, "Secrets of the Male Shopper," *BusinessWeek*, September 4, 2006, 45–54.

- **Cost sensitive**—physicians for whom cost is paramount, such as those with a sizable number of indigent patients.
- **Medical thought leaders**—people on the leading edge, often at teaching hospitals, who champion the newest therapies.¹⁴

A sales representative provides the medical thought leader with cutting-edge clinical studies, whereas the cost-sensitive doctor is provided information related to costs of treatments.

Mass customization offers a promising means of responding to different use situations at competitive prices. Recall the earlier clothing industry example.

Buyers' Needs and Preferences

Needs and preferences that are specific to products and brands can be used as segmentation bases and segment descriptors. Examples include brand loyalty status, benefits sought, and proneness to make a deal. Buyers may be attracted to different brands because of the benefits they offer. For example, the "fair trade" branding of products as diverse as coffee and clothing, with goals of benefiting producers in developing countries, has shown remarkable growth in the 2000s. The segment consists of consumers who are prepared to pay a higher price for staple products, if their actions benefit people in poorer countries. This is an example of "ethical branding" aimed at a new and growing segment of ethically-motivated consumers.¹⁵

Consumer Needs

Needs motivate people to act. Understanding how buyers satisfy their needs provides guidelines for marketing actions. Consumers attempt to match their needs with the products that satisfy their needs. People have a variety of needs, including basic physiological needs (food, rest, and sex); the need for safety; the need for relationships with other people (friendship); and personal satisfaction needs.¹⁶ Understanding the nature and intensity of these needs is important in (1) determining how well a particular brand may satisfy the need; and/or (2) indicating what change(s) in the brand may be necessary to provide a better solution to the buyer's needs.

Attitudes

Buyers' attitudes toward brands are important because experience and research findings indicate that attitudes influence behavior. Attitudes are enduring systems of favorable or unfavorable evaluations about brands.¹⁷ They reflect the buyer's overall liking or preference for a brand. Attitudes may develop from personal experience, interactions with other buyers, or by marketing efforts, such as advertising and personal selling.

Attitude information is useful in marketing strategy development. A strategy may be designed either to respond to established attitudes or, instead, to attempt to change an attitude. In a given situation, relevant attitudes should be identified and measured to indicate how brands compare. If important attitude influences on buyer behavior are identified and a firm's brand is measured against these attitudes, management may be able to improve the brand's position by using this information. Attitudes are often difficult to change, but firms may be able to do so if buyers' perceptions about the brand are incorrect. For example, if the trade-in value of an automobile is important to buyers in a targeted segment and a company learns through market research that its brand (which actually has a high trade-in value) is perceived as having a low trade-in value, advertising can communicate this information to buyers.

Perceptions

Perception is defined as "the process by which an individual selects, organizes, and interprets information inputs to create a meaningful picture of the world."¹⁸ Perceptions are how buyers select, organize, and interpret marketing stimuli, such as advertising, personal selling, price, and the product. Perceptions form attitudes. Buyers are selective in the information they process. As an illustration of selective perception, some advertising messages may not be received by viewers because of the large number of messages vying for their attention. For example, Exhibit 3.5 lists products where substantial proportions of TV advertisements are actively ignored or skipped using a personal video recorder. Negative attitudes and perceptions may be a major barrier to communicating with consumers.

EXHIBIT 3.5

Television Viewers Watch Fewer Ads

Source: Survey of the 151 largest U.S. television markets in 2003 by CNW Marketing Research Inc. reported in Anthony Bianco, "The Vanishing Mass Market," *BusinessWeek*, July 12, 2004, 65.

	Ads Actively Ignored on Television	Ads Skipped Using Personal Video Recorder
Beer	4.8%	31.9%
Movie trailers	11.6	44.1
Soft drinks	21.6	82.7
Drug	32.3	45.6
Specialty clothing	33.4	62.4
Home products	41.6	90.3
Fast food	45.1	95.7
Cars (national)	52.8	68.8
Pet-related	55.5	81.5
Credit cards	62.7	94.2
Mortgage financing	74.1	94.7
Upcoming program	75.3	94.4
Unweighted average	43.1	71.6

Or, more simply, for example, a salesperson's conversation may be misunderstood or not understood because the buyer is trying to decide if the purchase is necessary while the salesperson is talking.

People often perceive things differently. Business executives are interested in how their products, salespeople, stores, and companies are perceived. Perception is important strategically in helping management to evaluate the current positioning strategy and in making changes in this positioning strategy. Perception mapping is a useful research technique for showing how brands are perceived by buyers according to various criteria. We discuss how preference mapping is used to form segments later in the chapter.

Purchase Behavior

Consumption variables such as the size and frequency of purchases are useful in segmenting consumer and business markets. Marketers of industrial products often classify customers and prospects into categories on the basis of the volume of the purchase. For example, a specialty chemical producer concentrates its marketing efforts on chemical users that purchase at least \$100,000 of chemicals each year. The firm further segments the market on the basis of how the customer uses the chemical. The development of CRM systems offers fast access to records of actual customer purchase behavior and characteristics. CRM and loyalty programs are generating insights into customer behavior and segment differences, and providing the ability to respond more precisely to the needs of customers in different segments. We discuss the impact of CRM on analyzing customer characteristics in Chapter 4.

Since buying decisions vary in importance and complexity, it is useful to classify them to better understand their characteristics, the products to which they apply, and the marketing strategy implications of each type of purchase behavior. Buyer decisions can be classified according to the extent to which the buyer is involved in the decision.¹⁹ A high-involvement decision may be an expensive purchase, have important personal consequences, and impact the consumer's ego and social needs. The decision situation

EXHIBIT 3.6

Consumer Involvement in Purchase Decisions

Source: Eric N. Berkowitz, Roger A. Kerin, Steven W. Hartley, and William Rudelius, *Marketing*, 5th ed. (Chicago: Richard D. Irwin, 1997), 156. Copyright © The McGraw-Hill Companies. Used with permission.

	Consumer Involvement		
	High	Low	
Characteristics of Purchase Decision Process	Extended Problem Solving	Limited Problem Solving	Routine Problem Solving
Number of brands examined	Many	Several	One
Number of sellers considered	Many	Several	Few
Number of product attributes evaluated	Many	Moderate	One
Number of external information sources used	Many	Few	None
Time spent searching	Considerable	Little	Minimal

may consist of extended problem solving (high involvement), limited problem solving, or routine problem solving (low involvement). The characteristics of these situations are illustrated in Exhibit 3.6.

These categories are very broad since the range of involvement covers various buying situations. Even so, the classifications provide a useful way to compare and contrast buying situations. Also, involvement may vary from individual to individual. For example, a high-involvement purchase for one person may not be such for another person, since perceptions of expense, personal consequences, and social impact may vary across individuals. Exhibit 3.7 summarizes the various segmentation variables and shows examples of segmentation bases and descriptors for consumer and organizational markets. As we examine the methods used to form segments, the role of these variables in segment determination and analysis is illustrated.

EXHIBIT 3.7

Illustrative Segmentation Variables

Source: Eric N. Berkowitz, Steven W. Hartley, William Rudelius, and Roger A. Kerin, *Marketing*, 7th ed. (Burr Ridge, IL: McGraw-Hill/Irwin, 2003).

	Consumer Markets	Industrial/Organizational Markets
Characteristics of people/organizations	Age, gender, race Income Family size Lifecycle stage Geographic location Lifestyle	Type of industry Size Geographic location Corporate culture Stage of development Producer/intermediary
Use situation	Occasion Importance of purchase Prior experience with product User status	Application Purchasing procedure New task, modified rebuy, straight rebuy
Buyers' needs/preferences	Brand loyalty status Brand preference Benefits sought Quality Proneness to make a deal	Performance requirements Brand preferences Desired features Service requirements
Purchase behavior	Size of purchase Frequency of purchase	Volume Frequency of purchase

Forming Market Segments

Turning around the performance of Miller Brewing's business was in part based on developing new segment targets for Miller's beer brands. Targets for some of the biggest brands are:

- **Miller Genuine Draft**—aiming at “mainstream sophisticates,” males aged 25–35 attracted by the tag line “Beer. Grown Up.”
- **Milwaukee's Best Light**—targeting “hardworking men” with a beer to be picked up after a long day at work, sponsors the World Series of Poker on ESPN to get the attention of these poker-playing consumers.
- **Pilsner Urquell**—for “beer aficionados,” or more discerning drinkers. Select salespeople—“beer merchants”—educate bar staff and retailers on the special character of the Czech beer, the original golden pilsner.
- **Miller Icehouse**—for “drinking buddies,” hanging out, playing Xbox, or getting ready to go out, targeting the modern young male.²⁰

The requirements for segmentation are discussed first, and then the methods of segment formation are described and illustrated.

Requirements for Segmentation

An important question is deciding if it is worthwhile to segment a product-market. For example, for many years Gillette successfully adopted a “one product for all” strategy in the razor market. While in many instances segmentation is a sound strategy, its feasibility and value need to be evaluated. Nonetheless, the growing fragmentation of mature mass markets into segments with different needs and responsiveness to marketing actions may mandate segmentation strategy. Correspondingly, the growth of narrowcast media—cable-television and radio; specialized magazines; cell-phone and personal digital assistant screens; and the Internet—has made major changes in the costs of reaching market segments. Segment targets which could not traditionally be reached with communications and product variants to match their needs at reasonable costs to the seller may now be accessible targets.²¹ For example, the INTERNET FEATURE illustrates some of the ways in which the Web is changing the ability of companies both to identify segments in the marketplace, but as importantly to reach them more precisely with targeted communications.

It is important to decide if it is worthwhile to segment a product market. Five criteria are useful for evaluating a potential segmentation strategy.

Response Differences

Determining differences in the responsiveness of the buyers in the product-market to positioning strategies is a key segment identification requirement. Suppose the customers in a product-market are placed into four groups, each a potential segment, using a variable such as income (affluent, high, medium, and low). If each group responds (e.g., amount of purchase) in the same way as all other groups to a marketing mix strategy, then the four groups are not market segments. If segments actually exist in this illustration, there must be differences in the responsiveness of the groups to marketing actions, such as pricing, product features, and promotion. The presence of real segments requires actual response differences. Simply finding differences in buyers' characteristics such as income is not enough.

For example, income is useful in finding response differences in emerging markets. In Russia, average income per person in 2006 was just \$300 a month. Nonetheless, a surprising number of Russians live as well or better than their Western counterparts—in



The attractiveness of market segments is influenced by the ability to reach targets with marketing communications. The Internet is rapidly changing the ability of companies to reach both narrow and broad target segments:

- Young adults are low users of print media and television, making them difficult to target using conventional methods. However, of American teens (12–17 years old), 87 percent use the Internet, 65 percent use instant messaging, and 44 percent go online everyday. The “MySpace generation” is found in social networking websites like MySpace and Facebook.com and blogging sites like Xanga.com.
- One of the strengths for Google as the Internet’s most used search engine is the ability to analyze individuals’ search patterns to identify interests and behaviors, allowing personalized advertising to be developed and delivered around those interests.
- Dogster.com is a social networking site for dog owners. Users can create free Web pages to share photos and tell stories about their pets. After two years in operation, in 2006 Dogster.com was attracting 10 million paid advertisements a month.
- Jaman is an Internet start-up online art house for movie downloads—such as Bollywood and martial arts movies. Its target is individuals interested in world movies and the works of independent filmmakers, and includes a social networking element. Users are likely to be sophisticated consumers with international interests, and the site provides access to this otherwise difficult to locate consumer.

Sources: Kevin Allinson, “Web Brings New Breed of Ads,” *Financial Times*, Wednesday, August 30, 2006, 21. Jessi Hempel, “The MySpace Generation,” *BusinessWeek*, December 12/19, 2005, 64–72. Richard Waters, “Google’s Buried Treasure,” *Financial Times*, Wednesday, July 23, 2003, 11. Stephen H. Wildstrom, “At Last, An Online Art House,” *BusinessWeek*, April 30, 2007, 22.

fact, the richest tenth of Russia’s population earns around fifteen times as much as the poorest tenth. In 2006, Russia was home to 88,000 millionaires. Importantly, some 70 percent of Russians’ income is disposable, compared to around 40 percent for the typical Western consumer—the result of low flat-rate income tax and subsidized housing and utilities. The emergence of a Russian middle class with substantial spending power provides a promising target for luxury goods brands like Mercedes-Benz, Cartier, and Christian Dior.²²

Identifiable Segments

It must be possible to identify the customer groups that exhibit response differences, and sometimes finding the correct groups may be difficult. For example, even though variations in the amount of purchase by customers occur in a market, it may not be possible to identify which people correspond to the different response groups in the market. While it is usually feasible to find descriptive differences among the buyers in a product-market, these variations must be matched to response differences. The impact of the Internet is important to identifying segments (INTERNET FEATURE).

Actionable Segments

A business must be able to aim a marketing program strategy at each segment selected as a market target. As discussed earlier, specialty magazines offer one means of selective targeting. Ideally, the marketing effort should focus on the segment of interest and not be wasted on non-segment buyers. Cable television, magazine, and radio media are able to provide coverage of narrowly defined market segments. The Internet offers great potential for direct marketing channels to reach specialized segments. Similarly, databases offer very focused access to buyers.

Cost/Benefits of Segmentation

Segmentation must be financially attractive in terms of revenues generated and costs incurred. It is important to evaluate the benefits of segmentation. While segmentation may cost more in terms of research and added marketing expenses, it should also generate more sales and higher margins. The objective is to use a segmentation approach that offers a favorable revenue and cost combination. Interestingly, Bain & Co research suggests that in their studies over a five-year period, companies that successfully tailor product offerings to desirable customer segments show annual profit growth of around 15 percent—compared to only 5 percent annual growth in other companies in their sectors.²³

Stability over Time

Finally, the segments must show adequate stability over time so that the firm's marketing efforts will have enough time to produce favorable results. If buyers' needs change too fast, a group with similar response patterns at one point may display quite different patterns several months later. The time period may be too short to justify using a segmentation strategy. However, this question is also one where the impact of narrowcast media and advanced production technology may drastically reduce the time over which a segment targets needs to be stable for it to be an attractive target.

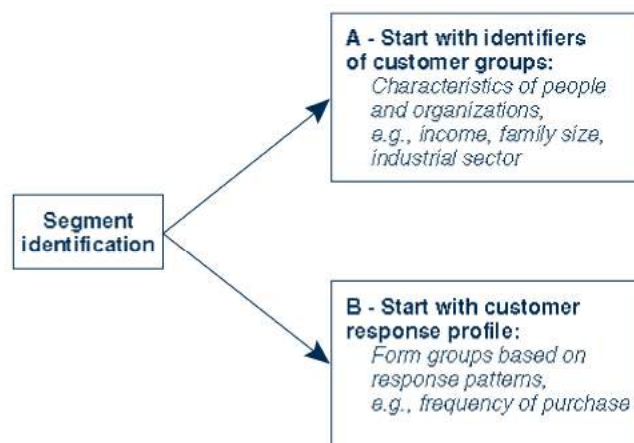
Product Differentiation and Market Segmentation

The distinction between product differentiation and market segmentation is not always clear. *Product differentiation* occurs when a product offering is perceived by the buyer as different from the competition on any physical or nonphysical product characteristic, including price.²⁴ Using a product differentiation strategy, a firm may target an entire market or one (or more) segments. Competing firms may differentiate their product offerings in trying to gain competitive advantage with the same group of targeted buyers. Market targeting using a differentiation strategy is considered further in Chapter 6.

Approaches to Segment Identification

Segments are formed by: (A) grouping customers using descriptive characteristics and then comparing response differences across the groups; or (B) forming groups based on response differences (e.g., frequency of purchase) and determining if the groups can be identified based on differences in their characteristics. Exhibit 3.8 illustrates the two approaches. Approach A uses a characteristic such as income or family size believed to be

EXHIBIT 3.8
Approaches
to Segment
Identification



related to buyer response. After forming the groups, they are examined to see if response varies across groups. Approach B places buyers with similar response patterns into groups and then develops buyer profiles using buyer characteristics. We describe each approach to show how it is used to identify segments.

Customer Group Identification

After the product-market of interest is defined, promising segments may be identified, using management judgment in combination with analysis of available information and/or marketing research studies. Consider, for example, hotel lodging services. Exhibit 3.9 illustrates ways to segment the hotel lodging product-market. An additional breakdown can be made according to business and leisure travelers. These categories may be further refined by individual customer and group customer segments. Groups may include conventions, corporate meetings, and tour groups. Several possible segments can be distinguished. Consider, for example, Marriott's Courtyard hotel chain. These hotels fall into the midpriced category and are targeted primarily to frequent business travelers who fly to destinations, are in the 40-plus age range, and have relatively high incomes.

When using the customer group identification approach, it is necessary to select one or more of the characteristics of people or organizations as the basis of segmentation. Using these variables, segments are formed by (1) management judgment and experience; or (2) supporting statistical analyses. The objective is to find differences in responsiveness among the customer groups. We look at some of the customer grouping methods to show how segments are formed.

Management Insight and Available Information

Management's knowledge of customer needs is often a useful guide to segmentation. For example, both experience and analysis of published information are often helpful in segmenting business markets. Business segment variables include type of industry, size of purchase, and product application. Company records often contain information for analyzing the existing customer base. Published data such as industry mailing lists can be used to identify potential market segments. These groups are then analyzed to determine if they

EXHIBIT 3.9
Product-Market
Segmentation
Dimensions for Hotel
Lodging Services



display different levels of response. Effective segmentation may sometimes be achieved through insight and creativity, but it is important to avoid stereotyped thinking based on industry norms. A distinctive segmentation strategy which does not mirror those of competitors may be an important source of advantage.

Segmenting using management judgment and experience underpins the success of Coach in serving both fashion-conscious consumers and factory outlet customers. The luxury positioning of the Coach brand places it on a par with Gucci, Versace, and Dior, although Coach prices are much lower. Flagship Coach stores are located on Beverley Hills' Rodeo Drive and New York's Madison Avenue. Nonetheless, the fastest-growing part of Coach's business is the factory outlets where the previous season's products are sold at discounted prices. Although an unconventional approach to segmentation in the luxury goods market, Coach carefully manages its brand position with upscale shoppers, but also builds sales with older bargain-hunters in factory outlets.²⁵

Cross Classification Analyses

Another method of forming segments is to identify customer groups using descriptive characteristics and compare response rates (e.g., sales) by placing the information in a table. Customer groups form the rows and response categories form the columns. Review of industry publications and other published information may identify ways to break up a product-market into segments. Standardized information services such as Information Resources Inc. collect and publish consumer panel data on a regular basis. These data provide a wide range of consumer characteristics, advertising media usage, and other information which is analyzed by product and brand sales and market share. The data are obtained from a large sample of households through the United States. Similar statistical data are available in many overseas countries.

Information is available for use in forming population subgroups within product-markets. The analyst can use many sources, as well as management's insights and hunches regarding the market. The essential concern is whether a segmentation scheme identifies customer groups that display different product and brand responsiveness. The more evidence of meaningful differences, the better chance that useful segments exist. Cross-classification has some real advantages in terms of cost and ease of use. There may be a strong basis for choosing a segmenting scheme that uses this approach. This occurs more often in business and organizational markets, where management has a good knowledge of user needs, because there are fewer users than there are in consumer product-markets. Alternatively, this approach may be a first step leading to a more comprehensive type of analysis.

Data Mining for Segmentation

The availability of computerized databases offers a wide range of segmentation analysis capabilities. This type of analysis is particularly useful in consumer market segmentation. Databases are organized by geography and buyers' descriptive characteristics. Databases can be used to identify customer groups, design effective marketing programs, and improve the effectiveness of existing programs. The number of available databases is rapidly expanding, the costs are declining, and the information systems are becoming user friendly. Several marketing research and direct mail firms offer database services. Further discussion on data mining is provided in Chapter 4.

By identifying customer groups using descriptive characteristics and comparing them to a measure of customer responsiveness to a marketing mix such as product usage rate (e.g., number of fax ink cartridges per year), potential segments can be identified. If the response rates are similar within a segment, and differences in response exist between segments, then

promising segments are identified. Segments do not always emerge from these analyses, because in some product-markets distinct segments may not exist, or the segment interrelationships may be so complex that an analysis of these predetermined groupings will not identify useful segments. Product differentiation strategies may be used in these situations.

Segmentation Illustrations

A now-classic study for Mobil examines buyers in the gasoline market to identify segments. The findings, including information obtained from over 2,000 motorists, are summarized in Exhibit 3.10. The research identified five primary purchasing groups.²⁶ Interestingly, the study found that the Price Shopper spent an average of \$700 annually, compared to \$1,200 for the Road Warriors and True Blues. Mobil's marketing strategy was to offer gasoline buyers a quality buying experience, including upgraded facilities, more lighting for safety, responsive attendants, and quality convenience products. The target segments are Road Warriors and Generation F3, involving a major effort on convenience stores and reduced time at the gas pump based on the Mobil *Speed Pass*. The test results from the new strategy raised revenues by 25 percent over previous sales for the same retail sites.

As shown by the profiles described in Exhibit 3.10, needs and preferences vary quite a bit within a market. Trying to satisfy all of the buyers in the market with the same marketing approach is difficult. Analyzing both the customer and the competition is important. Specific competitors may be better (or worse) at meeting the needs of specific customer groups (e.g., Mobil's Road Warriors). Finding gaps between buyers' needs and competitors' offerings provides opportunities for improving customer satisfaction. Also, companies study competitors' products to identify ways to improve their own.

In a different sector, one European bank employed a psychologist to examine customers' monthly statements to search for clues to lifestyle and personality profiles. The study identified three customer groups:

- **Hedonistic Grazers**—impulsive and spontaneous people, with a tendency to live for the moment; Bridget Jones characters who are instant pleasure seekers and do not like to postpone fun and extravagance any longer than is absolutely necessary.

EXHIBIT 3.10 Diversity of Gasoline Buyers

Source: Alanna Sullivan, "Mobil Bets Drivers Pick Cappuccino over Low Prices," *The Wall Street Journal*, January 30, 1995, B1. Wall Street Journal. Central Edition [Staff Produced Copy Only] by Alanna Sullivan. Copyright 1995 by Dow Jones & Co Inc. Reproduced with permission of Dow Jones & Co Inc. in the format Textbook via Copyright Clearance Center.

Road Warriors:	True Blues:	Generation F3:	Homebodies:	Price Shoppers:
Generally higher-income, middle-aged men, who drive 25,000 to 50,000 miles a year . . . buy premium with a credit card . . . purchase sandwiches and drinks from the convenience store . . . will sometimes wash their cars at the carwash.	Usually men and women with moderate to high incomes who are loyal to a brand and sometimes to a particular station . . . frequently buy premium gasoline and pay in cash.	(for fuel, food, and fast): Upwardly mobile men and women—half under 25 years of age—who are constantly on the go . . . drive a lot and snack heavily from the convenience store.	Usually housewives who shuttle their children around during the day and use whatever gasoline station is based in town or along their route of travel.	Generally aren't loyal to either brand or a particular station; and rarely buy the premium line . . . frequently on tight budgets . . . efforts to woo them have been the basis of marketing strategies for years.
16% of buyers	16% of buyers	27% of buyers	21% of buyers	20% of buyers

- **Material Martyrs**—masters of time management and efficiency; control freaks who plan their weekly meals in advance and prefer to buy furniture than to go out; introverted and home loving; careful and frugal.
- **Steady Builders**—mature, settled, stable people, with a strong sense of responsibility, who debate a big expense rather than spend spontaneously.²⁷

Understanding lifestyle differences is critical to providing financial services tailored to the differences between these groups, since there is a link between lifestyle and the needs for financial services, as well as responsiveness to different offers.

In an era of increased globalization, it is also important to recognize that segmentation has an international dimension in many markets. At the simplest level, country differences will dictate the need for variations in the sizes of products like apparel and household furniture based on ethnic identity in overseas countries. However, a strategic approach to segmentation internationally requires deeper analysis. For example, global brands may be judged on quality, global and social responsibility characteristics by consumers. An international research study suggests segments relating to how consumers relate to global brands are:

- **Global Citizens** (55%)—rely on the global success of a company to indicate quality and innovation, but concerned about social responsibility issues. The U.S. and U.K. have relatively few global citizens, but they are more common in Brazil, China, and Indonesia.
- **Global Dreamers** (23%)—less discerning about and more fervent in their admiration of transnational companies. They see global brands as quality products and accept the cultural symbols they provide, and are less concerned with social responsibility issues.
- **Antiglobals** (13%)—skeptical that transnational companies deliver higher quality goods, and dislike brands that preach American values. Do not trust global companies to behave responsibly, and their brand preferences indicate they try to avoid doing business with transnational firms.
- **Global Agnostics** (9%)—do not base purchase decisions on a brand's global attributes, and judge them on the same criteria they use for local brands. Higher numbers in the US, but lower in Japan, Indonesia, and China.²⁸

Forming Groups Based on Response Differences

The alternative to selecting customer groups based on descriptive characteristics is to identify groups of buyers by using response differences to form the segments. A look at a segmentation analysis for the packaging division of Signode Corporation illustrates how this method is used.²⁹ The products consist of steel strappings for various packaging applications. An analysis of the customer base identified the following segments: programmed buyers (limited service needs), relationship buyers, transaction buyers, and bargain hunters (low price, high service). Statistical (cluster) analysis formed the segments using twelve variables concerning price and service trade-offs and buying power. The study included 161 of Signode's national accounts. Measures of the variables were obtained from sales records, sales managers, and sales representatives. The segments vary in responsiveness based on relative price and relative service.

The widespread adoption of CRM systems offers greater opportunity for timely and detailed analysis of response differences between customers. The "data warehouse," by integrating transactional data around customer types, makes possible complex analyses to understand differences in the behavior of different customer groups, to observe customer lifecycles, and to predict behavior.³⁰ We discuss CRM in Chapter 4. Response difference approaches draw more extensively from buyer behavior information than the customer

group identification methods discussed earlier. Note, for example, the information on Signode's customer responsiveness to price and service. We now look at additional applications to more fully explore the potential of the customer response approaches.

Cluster Analysis

Cluster analysis (a statistical technique) groups people according to the similarity of their answers to questions such as brand preferences or product attributes. This method was used to form segments for Signode Corporation. The objective of cluster analysis is to identify groupings in which the similarity within a group is high and the variation among groups is as great as possible. Each cluster is a potential segment.

Perceptual Maps

Another segmentation method uses consumer research data to construct perceptual maps of buyers' perceptions of products and brands. The information helps select market-target strategies, and decide how to position a product for a market target.

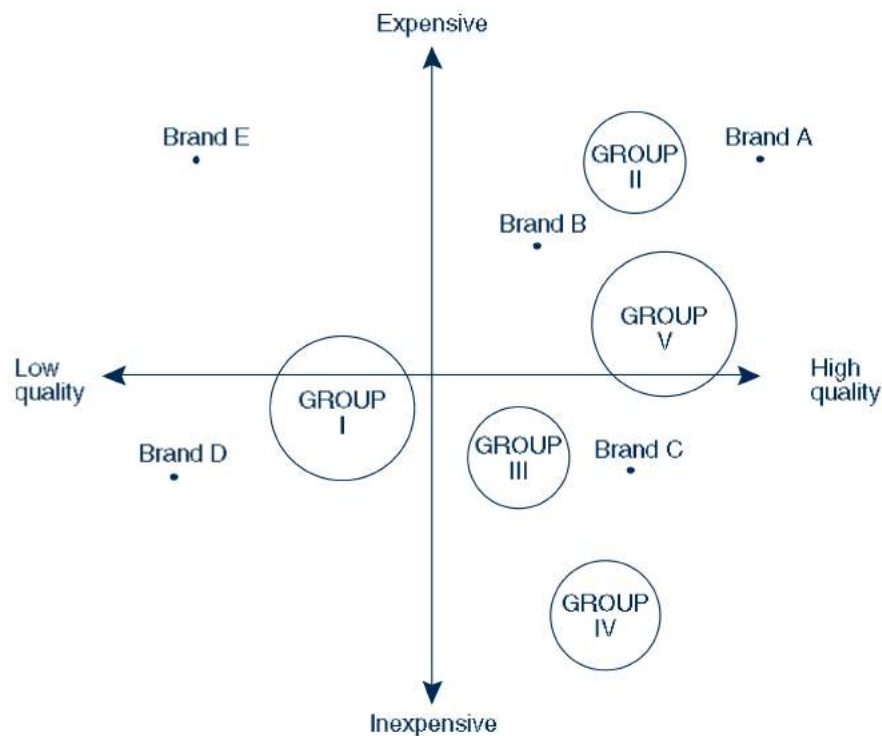
While the end result of perceptual mapping is simple to understand, its execution is demanding in terms of research skills. Although there are variations in approach, the following steps are illustrative:

1. Select the product-market area to be segmented.
2. Decide which brands compete in the product-market.
3. Collect buyers' perceptions about attributes for the available brands (and an ideal brand) obtained from a sample of people.
4. Analyze the data to form one, two, or more composite attribute dimensions, each independent of the other.
5. Prepare a map (two-dimensional X and Y grid) of attributes on which are positioned consumer perceptions of competing brands.
6. Plot consumers with similar ideal preferences to see if subgroups (potential segments) will form.
7. Evaluate how well the solution corresponds to the data that are analyzed.
8. Interpret the results as to market-target and product-positioning strategies.

An example of a perception map is shown in Exhibit 3.11. Each Group (I–V) contains people from a survey sample with similar preferences concerning expensiveness and quality for the product category. The Brands (A–E) are positioned using the preference data obtained from the survey participants. Assuming you are product manager for Brand C, what does the information indicate concerning possible targeting? Group V is a logical market target and III may represent a secondary market target. To appeal most effectively to Group V, we will probably need to change somewhat Group V consumers' price perceptions of Brand C. Offering a second brand less expensive than C to appeal to Group IV is another possible action. Of course, it is necessary to study the research results in much greater depth than this brief examination of Exhibit 3.11. Our intent is to illustrate the method of segmenting and show how the results might be used.

Perceptual mapping, like many of the research methods used for segment identification, is expensive and represents a technical challenge. When used and interpreted properly, these methods are useful tools for analyzing product-market structure to identify possible market targets and positioning concepts. Of course, there are many issues to be considered in specific applications such as choosing the attributes, identifying relevant products and brands, selecting the sample, and evaluating the strength of results.

EXHIBIT 3.11
Consumer Perception
Mapping Illustration



Finer Segmentation Strategies

A combination of factors may help a company utilize finer segmentation strategies. Technology may be available to produce customized product offerings. Furthermore, highly sophisticated databases for accessing buyers can be used, and buyers' escalating preferences for unique products encourage consideration of increasingly smaller segments. In some situations, an individual buyer may comprise a market segment. Thus, an important segmentation issue is deciding how small segments should be. We consider the logic of finer segments followed by a discussion of the available finer segmentation strategies.

Logic of Finer Segments

Several factors working together point to the benefits of considering very small segments—in some cases, segments of one. These include (1) the capabilities of companies to offer cost effective, customized offerings; (2) the desires of buyers for highly customized products; and (3) the organizational advantages of close customer relationships.

Customized Offerings

The capabilities of organizations to offer customized products is feasible because of extensive information flow and comprehensive data bases, computerized manufacturing systems, and integrated value chains.³¹ Database knowledge, computer-aided product design and manufacturing, and distribution technology (e.g., just-in-time inventory) offer promising opportunities for serving the needs and preferences of very small market segments. This technology combined with the Internet has led to the emergence of “sliver” companies or “micro-multinationals”—small, flexible organizations selling highly-specialized products across the world. For example, with products which can be

digitized and delivered online, such as computer software, music collections, financial services like travel and auto insurance, and e-books, there is already capacity for almost infinite customization.

Diverse Customer Base

The requirements of an increasingly diverse customer base for many products are apparent. For example, the international automobile industry is facing the challenge of the Three Day Car Program—allowing the buyer to specify the detail and design choices of a vehicle online, the order stimulates production, with delivery three days later. This Program has been designed because of the diversity in customer preferences in autos, and the sheer number of variants included in modern vehicles.

Close Customer Relationships

Companies recognize the benefits of close relationships with their customers. By identifying customer value opportunities and developing cost effective customized offerings, relationships can be profitable and effective in creating competitive barriers.

Finer Segmentation Strategies

We examine three approaches for finer segmentation opportunities: micro-segmentation, mass customization, and variety seeking.³²

Micro-segmentation

This form of segmentation seeks to identify narrowly defined segments using one or more of the previously discussed segmentation variables (Exhibit 3.7). It differs from more aggregate segment formation in that micro-segmentation results in a large number of very small segments. Each segment of interest to the organization receives a marketing mix designed to meet the value requirements of the segment.

Mass Customization

Providing customized products at prices not much higher than mass produced items is feasible using mass customization concepts and methods. Achieving mass customization objectives is possible through computer-aided design and manufacturing software, flexible manufacturing techniques, and flexible supply systems.

Variety-Seeking Strategy

This product strategy is intended to offer buyers opportunities to vary their choices in contrast to making unique choices.³³ The logic is that buyers who are offered alternatives may increase their total purchases of a brand. Mass customization methods also enable companies to offer an extensive variety at relatively low prices, thus gaining the advantages of customized and variety offerings.

Finer Segmentation Issues

While the benefits of customization are apparent, there are several issues that need to be examined when considering finer segmentation strategies:³⁴

1. How much variety should be offered to buyers? What attributes are important in buyers choices and to what extent do they need to be varied?
2. Will too much variety have negative effects on buyers? It is possible that buyers will become confused and frustrated when offered too many choices?
3. Is it possible to increase buyers' desire for variety, creating a competitive advantage?
4. What processes should be used to learn about customer preferences? This may involve indirect methods (e.g., database analysis), or involving buyers in the process.

High variety strategies, properly conceived and executed, offer powerful opportunities for competitive advantage by providing superior value to customers. As highlighted by the above issues, pursuing these finer segmentation strategies involves major decisions including which strategy to pursue and how to implement the strategy. Estimating the value and cost tradeoffs of the relevant alternatives is important in deciding how fine the segmentation should be.

Selecting the Segmentation Strategy

We have considered several approaches to market segmentation, ranging from forming segments via experience and judgment to finer segmentation strategies. We now discuss deciding how to segment the market and strategic analysis of the segments that have been identified.

Deciding How to Segment

The choice of a segmentation method depends on such factors as the maturity of market, the competitive structure, and the organization's experience in the market. The more comprehensive the segmentation process, the higher the costs of segment identification will be, reaching the highest level when field research studies are involved and finer segmentation strategies are considered. It is important to maximize the available knowledge about the product-market. An essential first step in segmentation is analyzing the existing customer base to identify groups of buyers with different response behavior (e.g., frequent purchase versus occasional purchase). Developing a view of how to segment the market by managers may be helpful. In some instances this information will provide a sufficient basis for segment formation. If not, experience and existing information are often helpful in guiding the design of customer research studies.

The five segmentation criteria discussed earlier help to evaluate potential segments. Deciding if the criteria are satisfied rests with management after examining response differences among the segments. The segmentation plan should satisfy the responsiveness criterion plus the other criteria (end users are identifiable, they are accessible via a marketing program, the segment(s) is economically viable, and the segment is stable over time). The latter criterion may be less of an issue with mass customization since changes can be accommodated. Segmentation strategy should not be static. The competitive advantage gained by finding (or developing) a new market segment can be very important.

Strategic Analysis of Market Segments

Each market segment of interest needs to be studied to determine its potential attractiveness as a market target. The major areas of analysis include customers, competitors, positioning strategy, and financial and market attractiveness.

Customer Analysis

When forming segments, it is useful to find out as much as possible about the customers in each segment. Variables such as those used in dividing product-markets into segments are also helpful in describing the people in the same segments. The objective is to find descriptive characteristics that are highly correlated to the variables used to form the segments. Standardized information services are available for some product-markets including foods, health and beauty aids, and pharmaceuticals. Large markets involving many competitors make it profitable for research firms to collect and analyze data that are useful to the firms serving the market. We discuss marketing information resources in Chapter 5.

An essential part of customer analysis is determining how well the buyers in the segment are satisfied. Customer satisfaction depends on the perceived performance of a product and supporting services and the standards that customers use to evaluate that performance.³⁵ The customer's standards complicate the relationship between organizational product specifications (e.g., product attribute tolerances) and satisfaction. Standards may involve something other than prepurchase expectations such as the perceived performance of competing products. Importantly, the standards are likely to vary across market segments.

Competitor Analysis

Market segment analysis considers the set of key competitors currently active in the market in which the segment is located plus any potential segment entrants. In complex market structures, mapping the competitive arena requires detailed analysis. The competing firms are described and evaluated to highlight their strengths and weaknesses. Information useful in the competitor analysis includes business scope and objectives; market position; market target(s) and customer base; positioning strategy; financial, technical, and operating strengths; management experience and capabilities, and special competitive advantages (e.g., patents). It is also important to anticipate the future strategies of key competitors.

Value chain analysis can be used to examine competitive advantage at the segment level. A complete assessment of the nature and intensity of competition in the segment is important in determining whether to enter (or exit from) the segment and how to compete in the segment. Competitor and value chain analysis are discussed in Chapter 2.

Positioning Analysis

We consider positioning strategy in Chapter 6. Segment analysis involves some preliminary choices about positioning strategy. One objective of segment analysis is to obtain guidelines for developing a positioning strategy. Flexibility exists in selecting how to position the firm (or brand) with its customers and against its competition in a segment. Positioning analysis shows how to combine product, distribution, pricing, and promotion strategies to favorably position the brand with buyers in the segment. Information from positioning maps like Exhibit 3.11 is useful in guiding positioning strategy. The positioning strategy should meet the needs and requirements of the targeted buyers at a cost that yields a profitable margin for the organization.

Estimating Segment Attractiveness

The financial and market attractiveness of each segment needs to be evaluated. Included are specific estimates of revenue, cost, and segment profit contribution over the planning horizon. Market attractiveness can be measured by market growth rate projections and attractiveness assessments made by management.

Financial analysis obtains sales, cost, and profit contribution estimates for each segment of interest. Since accurate forecasting is difficult if the projections are too far into the future, detailed projections typically extend two to five years ahead. Both the segment's competitive position evaluation and the financial forecasts are used in comparing segments. In all instances the risks and returns associated with serving a particular segment need to be considered. Flows of revenues and costs can be weighted to take into account risks and the time value of revenues and expenditures.

It should be recognized that as information availability grows, for example through the data warehouses associated with CRM systems, the evaluation of segment attractiveness also has the potential for identifying unattractive market segments, and even individual customers which may be candidates for deletion. There may also be ethical considerations which limit the attractiveness of certain segments. The ETHICS FEATURE describes some



Segmentation studies for many markets identify children as a high value opportunity. Confectionery, fast food, music, and toys are examples. Children exhibit great “pester power” influencing their own consumption and that of the family.

Parents and health advisors across the world warn of the dangers of childhood obesity. For food firms, an ethical dilemma targeting this segment concerns the impact of their marketing actions on the young.

If they are accepted as proper market targets, ethical questions surround the ways in which advertisers reach young consumers with promotional messages, in ways which get around parental controls and conventional media:

- Reports in Europe suggest some advertising agencies use Internet chatrooms to place commercial messages to reach young consumers, getting around strict rules concerning advertising to children.
- Food companies have been accused of using text messaging (SMS), websites and viral marketing campaigns to sell products to children.
- Some advertising agencies run focus group research with consumers as young as three years old, to establish ways to channel “pester power” onto family purchasing.

Sources: Glen Owen, “Scandal of the Advertisers Who Pose as Young Girls on Internet Chatrooms,” *Daily Mail*, April 2, 2006, 27. Jenny Wiggins, “Food Industry Criticised over Tactics to Tempt Children,” *Financial Times*, January 31, 2006, 5. Gill Swain, “Pester Power,” *The Sunday Times*, December 29, 2002, 1–16.

of the issues surrounding targeting children (or some groups of children), and some of the undesirable practices that have emerged. The potential for damage to brand and corporate reputation in such situations is considerable.

Segmentation “Fit” and Implementation

One important aspect of evaluating segment attractiveness is how well the segments match company capabilities and the ability to implement marketing strategies around those segments.³⁶ There are many organizational barriers to the effective use of segmentation strategies. New segment targets which do not fit into conventional information reporting, planning processes, and budget systems in the company may be ignored or not adequately resourced. Innovative models of customer segments and market opportunities may be rejected by managers or the culture of the organization.

There are dangers that managers may prefer to retain traditional views of the market and structure information in that way, or that segmentation strategy will be driven by existing organizational structures and competitive norms.³⁷ It is important to be realistic in balancing the attractiveness of segments against the ability of the organization to implement appropriate marketing strategies to take advantage of the opportunities identified. Building effective marketing strategy around market segmentation mandates an emphasis on actionability as well as technique and analysis.³⁸

Many of the issues we consider in later chapters impact on the operational capabilities of a company to implement segmentation strategies, for example, strength in cross-functional relationships may be a prerequisite to delivering value to new segments; the ability to work with partners may be needed to develop new products to build a strong position in a key market segment. The existence of these capabilities, or the ability to develop them, should be considered in making segmentation decisions.

Segment Attractiveness Analysis

An illustrative market segment analysis is shown in Exhibit 3.12. A two-year period is used for estimating sales, costs, contribution margin, and market share. Depending on the

EXHIBIT 3.12**Segment
Attractiveness
Analysis**

Estimated (\$ millions)	Segment		
	X	Y	Z
Sales*	10	16	5
Variable costs*	4	9	3
Contribution margin*	6	7	2
Market share†	60%	30%	10%
Total segment sales	17	53	50
Segment position:			
Business strength	High	Medium	Low
Attractiveness‡	Medium	Low	High

*For a two-year period.

†Percent of total sales in the segment.

‡Based on a five-year projection.

forecasting difficulty, estimates for a longer time period can be used. When appropriate, estimates can be expressed as present values of future revenues and costs. Business strength in Exhibit 3.12 refers to the present position of the firm relative to the competition in the segment. Alternatively, it can be expressed as the present position and an estimated future position, based upon plans for increasing business strength. Attractiveness is typically evaluated for some future time period. In the illustration a five-year projection is used.

The example shows how segment opportunities are ranked according to their overall attractiveness. The analysis can be expanded to include additional information such as profiles of key competitors. The rankings are admittedly subjective since decision makers will vary in their weighting of estimated financial position, business strength, and segment attractiveness. Place yourself in the role of a manager evaluating the segments. Using the information in Exhibit 3.12, rank segments X, Y, and Z as to their overall importance as market targets. Unless management is ready to allocate a major portion of resources to segment Z to build business strength, it is a candidate for the last-place position. Yet Z has some attractive characteristics. The segment has the most favorable market attractiveness of the three, and its estimated total sales are nearly equal to Y's for the next two years. The big problem with Z is its business strength. The key question is whether Z's market share can be increased. If not, X looks like a good prospect for top rating, followed by Y, and by Z. Of course, management may decide to go after all three segments.

Summary

Because buyers differ in their preferences for products, finding out what these preferences are and grouping buyers with similar needs is an essential part of business and marketing strategy development. Effective segmentation is key to market-driven strategy, linking strategic issues with the management of resources and operations around segment targets. Segmentation links value opportunities in the market and new market spaces to a company's capabilities to achieve a strong strategic positioning.

Segmentation demands close attention to market definition, identifying market segments and forming segment targets, which are described, analyzed, and evaluated. Segmentation of a product-market requires that response differences exist between segments and that the segments are identifiable and stable over time. Also, the benefits of segmentation should exceed the costs. The variables useful as bases for forming and describing segments include the characteristics of people and organizations, use situation, buyers' needs and preferences, and purchase behavior.

Segments can be formed by identifying customer groups using the characteristics of people or organizations. The groups are analyzed to determine if the response profiles are different across the candidate segments. Alternatively, customer response information can be used to form customer groupings and then the descriptive characteristics of the groups analyzed to find out if segments can be identified. Several examples of segment formation are discussed to illustrate the methods that are available for this purpose.

Finer segmenting strategies present attractive options for moving toward small segments and responding to buyers' unique value requirements. Technology, buyer diversity, and relationship opportunities are the drivers of finer segmentation strategies. These strategies include microsegmentation, mass customization, and variety seeking. While potentially attractive, finer segmentation strategies are more complex than other forms of segmentation and require comprehensive benefit and cost evaluations.

Segment analysis and evaluation consider the strengths and limitations of each segment as a potential market target for the organization. Segment analysis includes customer descriptions and satisfaction analysis, evaluating existing and potential competitors and competitive advantage, marketing program positioning analysis, and financial and market attractiveness. Segment analysis is important in evaluating customer satisfaction, finding new-product opportunities, selecting market targets, and designing positioning strategies. Nonetheless, it is also important to understand the organizational barriers to implementing segmentation strategy which may exist in a company, and to evaluate the "fit" of segmentation with company capabilities. Effectively implemented, a good segmentation strategy creates an important competitive edge for an organization.

Questions for Review and Discussion

1. Competing in the single European market raises some interesting market segment questions. Discuss the segmentation issues regarding this multiple-country market.
2. Why are there marketing strategy advantages in using demographic characteristics to break out product-markets into segments?
3. The real test of a segment formation scheme occurs after it has been tried and the results evaluated. Are there ways to evaluate alternative segmenting schemes without actually trying them?
4. Suggest ways of obtaining the information needed to conduct a market segment analysis.
5. Why may it become necessary for companies to change their market segmentation identification over time?
6. Is considering segments of one buyer a reality or a myth? Discuss.
7. Is it necessary to use a unique positioning strategy for each market segment targeted by an organization?
8. Under what circumstances may it not be possible to break up a product-market into segments? What are the dangers of using an incorrect segment formation scheme?
9. What are some of the advantages in using mass customization technology to satisfy the needs of buyers?
10. Does the use of mass customization eliminate the need to segment a market?

Internet Applications

- A. Explore several of the following websites:
www.adquest.com
www.americanet.com
www.autosite.com
www.mlm2000.com

www.sidewalk.com

www.monster.com

www.realtor.com

How does the information from these sites affect our traditional concept of market segmentation? How is the segmentation process altered by such Internet providers?

- B. Evaluate the following site for additional ideas and material concerned with market segmentation and the types of support that can be provided for companies:
www.marketsegmentation.co.uk

Feature Applications

- A. Review the material in the INNOVATION FEATURE “All-Business-Class Airlines.” Do these new ventures represent a robust segmentation strategy? What other segment opportunities can be identified in the airline business? How could these be exploited?
- B. Review the BMW Mini case in the GLOBAL FEATURE “The BMW Mini.” Do you believe that BMW has built a robust niche or segment strategy, or is the car a fashion item with limited lasting appeal to car buyers, like other “retro” attempts?

Notes

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Strategic Customer Relationship Management

Building effective customer relationships is widely recognized by executives as a high priority business initiative.¹ A study of 960 international executives rated customer relationship management (CRM) and strategic planning highest among ten priority strategic initiatives for improving organizational performance.² CRM is a cross-functional core business process concerned with achieving improved shareholder value through the development of effective relationships with key customers and customer segments.³

Forming and sustaining valuable customer relationships is the most prized strategic outcome of correctly visualized and implemented CRM programs.⁴ A Mercer consultant survey of top executives found developing and sustaining customer relationships to be the most important source of competitive advantage in the twenty-first century. One of the primary conclusions of research concerning CRM failures is that achieving desired customer outcomes requires the alignment of the entire organization, while avoiding the narrow and incomplete perspective of viewing CRM as a technology initiative. Moreover, a fragmented or functional focus is not sufficient.

Successful CRM initiatives are guided by a carefully formulated and implemented organizational strategy. CRM offers sellers the opportunity to gather customer information rapidly, identify the most valuable customers over the relevant time horizon, and increase customer loyalty by providing customized products and services. This is described as “tying in an asset” when the asset is the customer. CRM supports a customer-responsive strategy, which gains competitive advantage when it:

- Delivers superior customer value by personalizing the interaction between the customer and the company.
- Demonstrates the company’s trustworthiness and reliability to the customer.
- Tightens connections with the customer.
- Achieves the coordination of complex organizational capabilities around the customer.⁵

CRM encourages a focus on customer loyalty and retention, with the goal of winning a larger share of the total lifetime value of each profitable customer.

We begin by taking a more detailed look at CRM and its pivotal role in contributing to bottom-line enterprise performance. Next, developing a CRM strategy and building customer lifetime value are examined. Finally, we discuss the value creation process and consider the relationship between CRM and market segmentation, targeting, and strategic positioning.

Pivotal Role of Customer Relationship Management

The term CRM means very different things in different circumstances, a consequence of the rapid evolution and development of this approach to managing customer relationships. CRM may be used to identify an array of initiatives including automated customer contact systems, salesforce productivity, customer service and automated call centers, and enterprise-wide systems designed to integrate information about customers into a single access point.

CRM in Perspective

CRM may refer to little more than building relationships with customers to match a company's product and service offer better with customer needs. Others see CRM as developing a unified and cohesive view of the customer, without regard to how the customer chooses to communicate with the organization (in person, by mail, Internet, or telephone). Emphasis is placed on enhanced customer service and the use of call centers to provide consistency in how the company interacts with customers. Alternatively, CRM may focus only on the creation and use of a customer database to support decision makers.

It is important to shift attention from the technology and hardware of CRM to the continuing process of "making managerial decisions with the end goal of increasing the value of the customer base through better relationships with customers, usually on an individual basis."⁶ The emphasis on strategy built around profitable customers as the primary concern of CRM is emphasized by Bain & Co. Bain's view is that CRM must combine business processes with customer strategies to develop customer loyalty and enhance financial performance.⁷ Another useful viewpoint suggests that CRM consists of three main elements:

- Identifying, satisfying, retaining, and maximizing the value of a firm's best customers.
- Wrapping the firm around the customer to ensure that each contact with the customer is appropriate and based upon extensive knowledge of both the customer's needs and profitability.
- Creating a full picture of the customer.⁸

Advances in technology are highly supportive to the implementation of CRM at all levels of the business. One interesting development is described in the INNOVATION FEATURE.

CRM and Database Marketing

Information technology has enabled companies to develop extensive databases concerning existing and potential customers. This information is useful in segmentation, account management, and many other marketing applications. Technology can be used by companies to interact with the customer and develop flexible customer-level responses. Databases are an important part of CRM. "However, the overarching framework of CRM includes much more than just databases and IT systems."⁹ CRM enables the use of database applications at very disaggregated levels including individual customers.



Pay by Touch is a rapidly growing company operating a biometric network. To pay, customers press a finger on a scanner and enter a personal number to have the goods charged to a credit card or bank account. From a pilot scheme at Piggly Wiggly supermarkets in South Carolina, Pay By Touch has expanded to more than 3,000 locations in the U.S. Supervalu, the second largest traditional U.S. grocer, is the largest user. Aside from payment efficiency, purchases can be tied to the biometric identity of the customer.

Beyond simplifying payments, Pay By Touch can use its SmartShop technology to direct weekly incentives and special price cuts to an individual customer based on shopping habits and preferences. For retailers, this system offers a way to direct offers effectively to their most loyal customers, rather than supporting the “cherry picking” on bargains by customers who only buy the offers.

Source: Adapted from Jonathan Birchall, “Pay By Touch Puts Its Finger on Loyalty,” *Financial Times*, Friday, June 22, 2007, 19.

A database created through CRM technology should contain information about the following:

- *Transactions*—should include a complete purchase history for each customer with accompanying details (date, price paid, products purchased).
- *Customer Contacts*—with multiple channels of distribution and communication the database should record all customer contacts with the company and its distributors, including sales calls, service requests, complaints, inquiries, and loyalty program participation.
- *Descriptive Information*—for each individual customer, relevant descriptive data that provide the basis for market segmentation and targeted marketing communications.
- *Response to Marketing Stimuli*—whether the customer responded to specific advertising, a price offer, a direct marketing initiative, or a sales call, or any other direct contact.¹⁰

Increasingly sophisticated software is available to undertake data mining and model data from the CRM database.

Customer Lifetime Value

While traditional approaches to market segmentation identify groups of customers by their purchase behavior and/or descriptive data, CRM offers the opportunity to examine individual customers or narrowly defined groups, and to calculate what each customer offers the company in profits. The metric *customer lifetime value* (CLV) calculates past profit produced by the customer for the firm—the sum of all the margins of all the products purchased over time, less the cost of reaching that customer. To this is added a forecast of margins on future purchases (under different assumptions for different customers), discounted back to their present value. This process provides an estimate of the profitability of a customer during the time span of the relationship. The CLV calculation is a powerful tool for focusing marketing and promotional efforts where they will be most productive.

Thus, CLV provides the estimated profitability of a customer (business or consumer) during the time span of the relationship. A study conducted by Deloitte Consulting found that companies which recognize the importance of understanding CLV are 60 percent more profitable than firms that do not consider CLV.¹¹ The familiar Pareto Rule



In 1998, Joe Simpson, a British mountain climber, wrote a book called *Touching the Void*, an account of his near-death climbing experience in the Andes. It sold only modestly. Ten years later, Jon Krakauer wrote *Into Thin Air*, another book about a mountain climbing tragedy, which became a best-seller. Suddenly, *Touching the Void* began to sell again. Random House rushed out a new edition to meet demand. Booksellers promoted *Touching the Void* in their *Into Thin Air* displays. A paperback of the older book spent fourteen weeks on the New York Times best-seller list. *Touching the Void* now outsells *Into Thin Air* more than two to one. The decisive factor was Amazon.com recommendations, suggesting that readers who liked *Into Thin Air* would also like *Touching the Void*.

The theory of "The Long Tail" reflects Internet economics. Selling products like music or film downloads can be done with extremely low inventory and distribution costs, which means that a company can capture the entire market, including the long tail of non-hits, which is often where the real value is. The biggest money may be in the smallest sales. The basis of a long tail strategy is to make everything available and to assist buyers in the search.

Non-hits may be a bigger market than hits. In 2004 in the U.S. books selling more than 250,000 copies sold 53 million copies in total. Books selling under 1,000 copies totaled 84 million. Hits are only what appeals to the largest available middle ground of the population. Music companies and publishers are actively repackaging products from their back catalogs to exploit the "long tail."

"Long Tail" strategies have become attractive because of enhanced customer knowledge and insight into the existence of very small niches in markets, driven by CRM and Internet technology.

Sources: Chris Anderson, *The Long Tail: How Endless Choice Is Creating Unlimited Demand* (London: Random House Business Books, 2007). Dominic Rushe, "Retailers Start to Climb the Long Tail Tail," *The Sunday Times*, October 29, 2006, 3–13. Tony Jackson, "The Freedom in Selection," *Financial Times*, Wednesday, July 12, 2006, 11.

suggests that 20 percent of customers yield 80 percent of the profits, so it is very important to find the high value customers, which are typically a small part of the total customer base.

Nonetheless, the power of CRM to enhance a company's depth of customer knowledge and to allow access to individuals and small groups of customers is having profound effects on strategic thinking. The STRATEGY FEATURE discusses the "Long Tail" issue as an example of new strategies being driven by the combination of CRM and Internet technology.

Developing a CRM Strategy

We discuss alternative levels of an organization's focus toward CRM, followed by strategy development guidelines and the CRM implementation process.

CRM Levels

CRM can be viewed from companywide, customer-facing, and functional levels.¹² Each level has important but different implications for strategic marketing. All three perspectives are important, although the companywide or strategic level provides the most complete view of CRM. The functional perspective considers the processes that are needed to fulfill required marketing functions. The customer-facing level offers a single view of the customer across all of the organization's access channels to the customer. This level of CRM is concerned with coordinating information across all contact channels on a continuing basis. The RELATIONSHIP FEATURE describes hotel group Accor's customer-facing activities.

Relationship Feature

How Accor Accomplishes Customer-Facing Activities



OVER 180 LOCATIONS WORLDWIDE

SOFITEL
HOTEL INTERCONTINENTAL

MAKE ANOTHER CITY FEEL LIKE ANOTHER WORLD. On your next getaway, don't leave your senses behind. Pamper them all as only Sofitel can. From fresh flowers to luxurious appointments to delicious food, Sofitel designs every detail to stimulate all of your senses. You don't stay at Sofitel; you immerse yourself in it. Come experience our distinctive art of living.

1-800-SOFITEL SOFITEL.COM ACCORHOTELS.COM

ACCOR ▶ A new perspective on our Hotels and Services

The France-based hotel group Accor links CRM data to guest survey information in its U.S. Sofitel and Novatel hotels, to anticipate the preferences of frequent users. The VP for sales and marketing for Accor North America notes "It takes us back to the time when there were small inns and the owner knew every customer and treated them as an individual. It should help streamline check-in and accommodate preferences for guests who, for example, request the same room every time. The group will be able to market with a microscope instead of a telescope."

Source: Marian Edmunds, "Your Wish Is on My Database," *Financial Times*, February 28, 2000, 16.

The company-wide level provides a strategic focus for CRM.¹³ It considers the implications of knowledge about customers and their preferences across the entire company. The intent is to guide the interactions between the organization and its customers in seeking to maximize the lifetime value of customers for the firm. Importantly, the strategic perspective acknowledges that: (1) customers vary in their economic value to the company; and (2) customers differ in their expectations toward the firm.

The strategic use of CRM resources reflects the shift in focus by marketing executives to the customer who delivers long-term profits, that is, an emphasis on customer retention rather than acquisition. Well-known metrics suggest that as little as a 5 percent increase

in customer retention can have an impact as high as 95 percent on the net present value delivered by the customer.¹⁴ Other studies by McKinsey consultants find that repeat customers generate over twice as much gross income as new customers.¹⁵ CRM emphasizes that executives should focus the organization's strategy on customer profitability and the gains from reducing customer "churn."

Interestingly, as CRM evolves and offers executives deeper insights into their customer base, the new information may challenge strategic assumptions in important ways. For example, the points made above suggest a powerful linkage between enhanced customer loyalty and higher customer profitability. However, companies are discovering through CRM database analysis that this is not always true. Some groups of customers may not justify the costs required to retain them, because the real fit between their needs and the company's products is weak. Just because a group of customers was profitable in the past, it may be dangerous to assume this will always be true. For example, many non-loyal customers are initially profitable, causing the company to chase them for further profits—but once these customers have ceased buying they become increasingly unprofitable if the company continues to invest in them. CRM data provides executives with a unique basis to address such issues as loyalty and profitability on the basis of fact instead of assumption, and to focus on individual customers, rather than groups containing many dissimilar buyers.¹⁶

CRM Strategy Development

The major steps in developing a CRM strategy are shown in Exhibit 4.1. We provide an overview of each step.

Organizational Commitment to CRM

Everyone in the firm needs to be supportive of the CRM initiative, beginning with top management. This commitment is consistent with the characteristics of a market-oriented culture. All functions in the firm are likely to have an involvement with certain of the CRM processes and activities. These parts of the business need to be involved at the beginning of strategy development. Ongoing cooperation and acceptance are essential to success. The customer is the unifying basis for employee and functional involvement.

The Project Team

The cross-functional team is the center of decision analysis and action for the CRM process. The team will need to become familiar with the CRM process before pursuing analysis and action initiatives. All relevant functions and departments should be involved. Initially, external consulting capabilities may be needed. Major financial commitments will be required as well as management and professional time commitments. Value chain representation may also be needed depending on the firm's position in the value chain (supplier, producer, or marketing intermediary). For example, a CRM strategy by PepsiCo would need to include independent bottler representation.

EXHIBIT 4.1 The Steps in Developing a CRM Strategy

Source: V. Kumar and Werner J. Reinartz, *Customer Relationship Management* (Hoboken, NJ: John Wiley & Sons, Inc.), 2006, 39.

1. Gain an organization-wide commitment to CRM strategy.
2. Form a cross-functional CRM project team for decision analysis and actions.
3. Conduct a business needs analysis concerning customer relationships.
4. Develop and define the CRM strategy to guide management process.

Business Needs Analysis

Each company's requirements concerning customer relationships need to be examined. These analyses are critical in providing direction to CRM initiatives, which must be integrated into the business strategy. The departments and individuals unitizing the CRM system (e.g., managers from sales, marketing, customer service and value chain) should clearly indicate what is needed from the strategy and agreement must be reached concerning CRM expectations and performance metrics.

The CRM Strategy

The components of the CRM strategy are shown in Exhibit 4.2.¹⁷ The value proposition spells out what the organization must provide in order to satisfy customer expectations. Understanding customers' value requirements is essential. The business case is an assessment which indicates the shareholder value and financial return of delivery of the required customer value. CRM initiatives require substantial resources and return needs to be carefully evaluated. The customer strategy indicates how different customer segments will be formed and managed. In business-to-business markets, firms may need to target individual customers. The enterprise transformation plan indicates the necessary initiatives to launch the CRM strategy—the changes which are required throughout the enterprise. Finally, all relevant stakeholders must be familiar with the plan, to assure that the necessary value propositions are determined and provided to the targeted customer segments.

CRM Implementation

Gartner Inc. estimated worldwide CRM expenditures at \$76 billion in 2005 and expanding at rapid growth rates.¹⁸ Other estimates place expenditures at much higher levels. However, the evidence of the performance of CRM systems has been disappointing for many companies. The Gartner Group concluded that 55 percent of all CRM projects do not produce results. A Bain & Co. 2001 survey of management tools ranked CRM at the bottom for satisfaction—indeed, one in five users in the Bain survey reported their CRM initiatives had not only failed to deliver profitable growth, but had also damaged long-term customer relationships.¹⁹

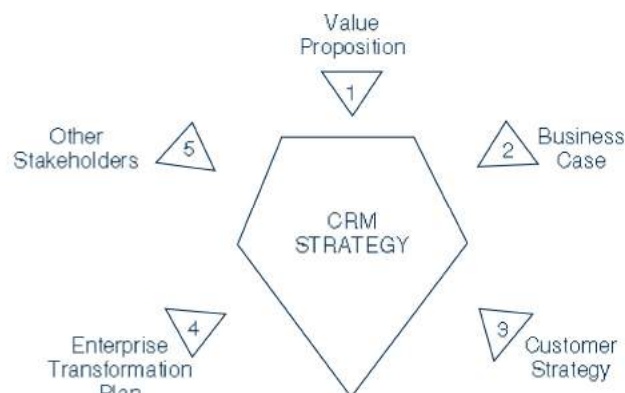
Successful Implementation

One recommendation proposes that the major components of the successful implementation of CRM are:

- A front office that integrates sales, marketing, and service functions across all media (call centers, people, retail outlets, value chain members, Internet).

EXHIBIT 4.2 **Develop and Define** **the CRM Strategy** **to Guide the** **Management Process**

Source: V. Kumar and Werner J. Reinartz, *Customer Relationship Management* (Hoboken, NJ: John Wiley & Sons, Inc., 2006), 42.





Call centers provide support and service to customers, though some sell as well. They are used predominantly in mass-market consumer industries. The centers exist to improve the quality of customer service.

There are many attractions in outsourcing call center operations to low-pay countries like India and Taiwan—an in-house call center agent in the U.S. is likely to be paid around \$29,000, while the agent in India receives \$2,667. The majority of call centers in India use college-educated employees. The better Indian call center operators train staff in the accent and dialect of their customers' regions, and staff adapt sleeping patterns to align with working hours in the customers' country. The intent is that consumers contacting the call center will not even be aware that they are speaking to someone in a foreign country.

Nonetheless, some major companies are pulling back from overseas call center operations for several reasons:

- Customer complaints about service received and language difficulties.
- Survey data suggest 60 percent of Americans say they are less likely to do business with a company after a bad call center experience, and 62 percent say their most recent experience with an overseas call center was disappointing. The dissatisfaction level is twice that shown by calls to centers that they believe are in the U.S.
- Technology difficulties leave call center agents with no information about customers, giving the impression they do not know what the customer is talking about.
- Media coverage has become increasingly critical of companies off-shoring call center jobs.

While sometimes attractive economically, there is a risk that overseas call centers may undermine the quality of customer relationships and pose a threat to corporate and brand reputation for those who employ them.

Sources: Kerry Miller, "Hello India? Er, Des Moines," *BusinessWeek*, June 25, 2007, 14. Pete Encardio, "Making Bangalore Sound Like Boston," *BusinessWeek*, April 10, 2006, 48.

- A data warehouse that stores customer information and the appropriate analytical tools with which to analyze that data and learn about customer behavior.
- Business rules developed from the data analysis to ensure the front office benefits from the firm's learning about its customers.
- Measures of performance that enable customer relationships to continually improve.
- Integration into the firm's operational support (or "back office") systems, ensuring the front office's promises are delivered.²⁰

Causes of Failure

There have been several suggestions that high failure rates associated with CRM are caused by managers underestimating the necessary organizational changes required for effective implementation that obtains the benefits of CRM. While the front end of CRM systems is concerned with building databases, integrating customer data, providing better customer service, and establishing systems like automated call centers for enhanced responsiveness, achieving the full potential of CRM requires change in company-wide processes, organization structure, and corporate culture.

Some of the early lessons learned about CRM implementation relate to the call centers and surrounding technology. The call center may be the most important point of contact with the customer. The GLOBAL FEATURE examines the situation with international call centers, which have caused some controversy.

EXHIBIT 4.3

**Useful Websites for
Additional CRM
Material**

www.dbmarketing.com

The website of the Database Marketing Institute, with a number of articles and speeches concerning recent developments in database marketing, available to be downloaded.

www.theearling.com

A site with extensive information about developments in data mining, and articles and papers on this topic for download.

www.1to1.com

The website of the Peppers & Rogers Group features the work and consultancy of Don Peppers and Martha Rogers. White Papers are available for download. A free subscription to the inside 1 to 1 newsletter is also available.

www.teradata.com

The website of the Teradata Division of NCR. It contains an interesting technical library on data warehousing and data mining as well as customer case studies.

www.crmdaily.com

This website provides new headline material on a daily basis concerning various CRM applications and management issues on a free subscription basis.

Bain & Co. research suggests that there are four significant pitfalls to avoid in CRM initiatives:

1. Implementing CRM before creating a customer strategy—success relies on making strategic customer and positioning choices, and this outweighs the importance of the computer systems, software, call centers, and other technologies.
2. Putting CRM in place before changing the organization to match—CRM affects more than customer-facing processes: it impacts internal structures and systems that may have to change.
3. Assuming that more CRM technology is necessarily better, rather than matching the technology to the customer strategy.
4. Investing in building relationships with disinterested customers, instead of those customers who value them.²¹

Websites giving additional information on various aspects of CRM are shown in Exhibit 4.3. There is also extensive literature on the topic and several recent books have been published.

Value Creation Process

Payne and Frow define the value creation process in CRM as (1) the value the customer receives; and (2) the value the organization receives.²² Successfully managing the value exchange between the customer and the firm is essential in effective CRM.

Customer Value

The benefits the customer receives are expressed by the value proposition. The objective of the organization is to provide a superior customer experience. The value proposition “explains the relationship among the performance of the product, the fulfillment of the customer’s needs, and the total cost to the customer over the customer relationship life cycle.”²³

Metrics Feature *How General Electric Co. Measures Customers' Experience*



HAPPY (AND NOT-SO-HAPPY) CUSTOMERS

General Electric is a big user of the "Net Promoter" concept of customer satisfaction, popularized by Fred Reichheld of Bain & Co. Below are questions similar to those on which GE's Capital Solutions unit asks customers to rate the unit's performance on a 0–10 scale.

- How willing are you to recommend us to a friend or associate?
- How would you rate our ability to meet your needs?
- How would you rate our people?
- How would you rate our processes?
- What is your impression of our market reputation?
- How would you rate the cost of doing business with us?
- How would you rate the overall value of our product or service as being worth what you paid?

Source: Kathryn Kranhold, "Client-Satisfaction Tool Takes Root," *The Wall Street Journal*, July 10, 2006, B3.

Assessing whether a superior customer experience is accomplished requires determining the relative importance placed by customers on different attributes of the product. Market segmentation may be useful in analyses to find the extent of correspondence between customer value requirements and value provided by the firm. Conjoint analysis and other techniques can be used in these assessments. An interesting approach to measuring customers' experience used by General Electric Co. is described in the METRICS FEATURE.

Value Received by the Organization

Determining value received from CRM requires the following information:

First, it is necessary to determine how existing and potential customer profitability varies across different customers and customer segments. Second, the economics of customer acquisition and customer retention and opportunity for selling, up-selling, and building customer advocacy must be understood.²⁴

As discussed earlier a key concept associated with the value received by the organization via CRM is customer lifetime value (CLV). CLV is the expected profitability of a customer over the time-span of the relationship with the customer. The sum of CLV for all of a firm's customers is termed customer equity. CLV provides useful information in selecting valuable customers for targeting.

Value received by the customer is also relevant. It is important to recognize the potential negative impact of issues regarding consumer trust on CRM activities.²⁵ If buyers believe that the information collected by their suppliers may be used to exploit them, their trust in the relationship may be jeopardized. Accordingly, executives need to recognize trust and privacy implications of CRM initiatives.

CRM approaches may also be valuable in identifying less attractive customers and developing effective ways to handle this issue—what Larry Selden calls separating the "angel customers" and the "demon customers."²⁵ For example, the INTERNET FEATURE describes an approach adopted by retailers to manage the problem of excessive product returns by some customers.



Some consumers cost retailers a lot of money because of such practices as: “wardrobing”—buying expensive clothes, wearing them once, and then returning them; “pack attacks”—damaging a package on display to buy it later at a discount; and excessive returning. Excessive or fraudulent returning is estimated to cost U.S. retailers \$16 billion annually. Some consumers buy hundreds of items and return them all (or all but one).

The Return Exchange is a California-based data warehouse which can analyze customers return behavior from retail companies. When products are returned to stores, customer ID and product details are sent to The Return Exchange. If analysis suggests the individual is an excessive returner, the customer’s pattern of returns—the number, frequency, and value—are displayed at the store when returns are made. The retailer can decide whether the customer should be given a warning or refused a return.

Source: Adapted from Paul Rubens, “How to Get Rid of ‘Devil Customers,’” *ft.com*, June 13, 2007.

CRM and Value Chain Strategy

It is important that CRM be integrated with the different channels that access end-user customers. “The multi-channel integration process is arguably one of the most important processes in CRM because it takes the outputs of the business strategy and value creation processes and translates them into value-adding activities with customers.”²⁶ Many companies interact with customers using multiple channels including salespeople, value chain partners, email and Internet, telephoning, and direct marketing. The concept of the “perfect customer experience,” an example of integrated channel management, is described in Exhibit 4.4.

CRM and Strategic Marketing

From the perspective of strategic marketing, there are several reasons why CRM is important and why there should be extensive marketing involvement in decisions about CRM. Importantly, an organizational perspective is needed in guiding the CRM strategy.

Implementation

It is critical that the adoption and implementation of CRM be seen as more than technology focused on efficiency. There are significant implications for the strategic positioning of a company and its customer relationships, where the voice of marketing should be heard. Our earlier discussion of CRM implementation highlights several relevant issues.

EXHIBIT 4.4 The Perfect Customer Experience

Source: Adrian Payne and Penne Frow, “A Strategic Framework for Customer Relationship Management,” *Journal of Marketing* (October 2005), 173.

“The perfect customer experience,” which must be affordable for the company in the context of the segments in which it operates and its competition, is a relatively new concept. This concept is now being embraced in industry by companies such as TNT, Toyota’s Lexus, Océ, and Guinness Breweries. Therefore, multi-channel integration is a critical process in CRM because it represents the point of cocreation of customer value. However, a company’s ability to execute multi-channel integration successfully is heavily dependent on the organization’s ability to gather and deploy customer information from all channels and to integrate it with other relevant information.

Operationally it is important not to assume that the drivers of value for all customers are the same, or that CRM is the key to all important customer relationships. For example, there are signs that many customers are weary of call centers and automated responses.

Performance Metrics

The availability of CRM data provides the opportunity to update the measures used by managers to assess the success of their brands in the marketplace. Traditional financial and market-based indicators like sales, profitability, and market share will continue to be important. However, CRM allows the development of measures that are customer-centric and more insightful concerning marketing strategy effectiveness. CRM-based measures of performance (both online and offline) may include: customer acquisition cost, conversion rates (from lookers to buyers), retention/churn rates, same customer sales rates, loyalty measures, and customer “share of wallet.”²⁷

The client-satisfaction measure discussed in the earlier METRICS FEATURE is used in all of GE’s business units from homeowners to hospitals. The CEO highlights the net-promoter score as a key part of GE’s growth formula.²⁸ Respondents are categorized as promoters, passives, and detractors relative to how likely they are to recommend GE to a friend. Perhaps most important, the metric indicates the firm’s commitment to CRM.

Short-Term Versus Long-Term Value

It is important that when decisions are made about a company’s customer priorities using historical customer profitability, long-term issues should be considered. Customers who are currently unprofitable may be attractive long-term prospects for suppliers who maintain loyalty through the hard times until the customers become profitable, and customers who are currently profitable may not be the best prospects for the future. The simple availability of CRM information should not be allowed to override strategic choices of customers to be retained where a long-term relationship may be highly attractive. This is why the active participation of marketing executives in CRM initiatives is important.

Customer lifetime value is an attractive measure to use to examine long-term customer attractiveness. For example, in many countries retail banks aggressively recruit young people as customers when they are undergraduate and graduate students (and likely to be unprofitable to the bank) with the goal of retaining the customer with a better than average chance of becoming a high-net-worth individual (and offering profitable opportunities to the bank).

Competitive Differentiation

If certain customers are unprofitable, then rather than “firing” the customer, the competitive issue may be how to change the route to market to make them profitable to the company. For example, when British Airways made the decision to focus only on its profitable business-class passengers at the expense of economy travelers, Virgin Airways gained the economy-class passengers by offering a better value proposition than BA. CRM data may provide one of the most powerful tools for identifying different customers on the basis of their behavior and other characteristics, to locate those whose needs have good fit with a company’s capabilities. As one-to-one marketing expert Don Peppers has noted: “For every credit card company that wants to concentrate on higher income customers, there’s another credit card company that wants to concentrate on lower income customers, and they do it by streamlining their service and making it more cost-efficient.”²⁹ It is important that decisions about customer choices reflect strategic priorities.



The logic of CRM as a source of customer knowledge suggests that some customers will be more attractive than others—they are more profitable, they buy more, or they are better prospects. In retailing, the “devil customers” who cost retailers money may be as much as 20 percent of the customer base. The dilemma is the stance to take with less profitable customers.

With unattractive customers we can . . .

Stop doing business with them, or do less business with them . . .

- Turn their business away.
- Less attractive customers can be charged for services that are free to others.
- More attractive customers are offered better deals if they threaten to defect, but these offers are not available to less attractive customers.

Offer them a lower level of service or added value . . .

- Call center technology can “recognize” customers and direct calls to different sales and service teams, based on the prospects with that customer. The most attractive prospects can be dealt with quicker and offered special deals and discounts.

Work to make them more attractive and profitable . . .

- More attractive customers can be offered special deals through loyalty or frequent user programs.
- Focus on factors that can make the less profitable customer more attractive—a higher share of their spending spent, cross-selling, promoting higher margin products.

However, there may be a moral dilemma regarding the fairness of treating some customers differently than others. When Express clothing stores stopped accepting returns from “serial returners” and Filene’s Basement banned a few customers from its stores because of excessive returns and complaints, both received much adverse publicity. European banks which have tried to restrict access of poorer customers to bank branches and services have been similarly criticized. The logic of favoring some customers over others may be weakened by potential damage to the brand.

Sources: Ariana Eunjung Cha, “In Retail, Profiling for Profit,” *Washington Post*, August 17, 2005, A01; Paul Rubens, How to Get Rid of ‘Devil Customers,’ *ft.com*, June 13, 2007.

Nonetheless, there are issues of social responsibility and ethics which surround the ways in which CRM technology can be used to differentiate between attractive and less attractive customers. If handled insensitively this differentiation may be damaging to corporate and brand reputation. The ETHICS FEATURE highlights some of these dilemmas.

Lack of Competitive Advantage

Investment in CRM to build competitive advantage may be an illusion if a company focuses only on automated call centers and customer complaint systems. The level of expenditure on CRM suggests that most competitors in most markets will have similar resources, and may be quicker to get to the real competitive strengths in aligning resources and capabilities around customers. Competitive advantage requires more than just investment in CRM technology, particularly if it is poorly implemented. Our earlier discussion indicated the danger of allowing technology to drive the CRM strategy. Similar CRM technology is available to most companies in most markets, and the issue for competitive advantage enhancement is not having the technology but how it is used.

Information-Based Competitive Advantage

One of the most important aspects of CRM from a strategic marketing perspective is the creation of a major new source of knowledge about customers. Used appropriately the databases and information resources and capabilities created through CRM technology may be one of the most valuable resources a company has for uncovering new value-creating opportunities for customers and for developing market understanding and insights ahead of the competition. As a further resource for developing and exploiting market sensing capabilities, CRM systems have enormous potential, which many organizations are beginning to exploit to build competitive advantage.

Summary

To some, CRM means little more than building relationships with customers to match the product offer better with customer needs. Others see CRM as concerned with developing a unified and cohesive view of the customer, no matter how the customer chooses to communicate with the organization (in person, by mail, Internet, or telephone), and emphasizing enhanced customer service and the use of call centers to provide consistency in how the company interacts with customers. To others, CRM focuses on the creation and use of a customer database to support decision makers.

Understanding customer relationship management begins with recognizing that CRM seeks to increase the value of an organization's customer base by developing and retaining better relationships with customers. CRM may involve the use of databases but includes much more than technology. CRM makes it possible to examine individual customers or narrowly defined groups (micro segments) and calculate what each offers the company in potential profits. The resulting customer lifetime value (CLV) can be used to focus marketing and promotional efforts.

CRM strategy can be viewed from companywide, customer-facing, and functional perspectives. The companywide or strategic perspective provides the most complete view of CRM. Designing the CRM strategy follows a sequence of initiatives: gaining organizational commitment to CRM, forming the project team, analyzing business needs, and determining the CRM strategy to be pursued by the organization.

CRM strategy includes the value proposition to be offered, the business case, the customer strategy, the enterprise transformation plan, and responsibilities to other stakeholders. CRM strategy implementation involves integration of sales, marketing, and service functions across all media and value chain members, creation of a data warehouse, decision guidelines for use of CRM analyses, determination of performance benchmarks, and integration of cross-functional operations.

Several hurdles to successful CRM implementation include implementing before creating a customer strategy, launching CRM before making essential organizational

changes, assuming that more CRM technology is necessarily better, and investing time and resources with disinterested customers. CRM is a major undertaking that is complex and demanding.

CRM is a value creation process consisting of the value the customer receives and the value the organization receives. The benefits the customer receives are expressed in the value proposition. The value the organization receives is determined by a penetrating analysis of the profitability of the customer base. Customer lifetime value is the basis of the assessment.

CRM is an important aspect of strategic marketing, recognizing that CRM is an enterprise spanning initiative. It is essential that CRM be carefully integrated with marketing strategy. CRM has a vital role to play in market targeting and marketing program positioning strategies.

Questions for Review and Discussion

1. How should CRM be defined to provide a complete strategy perspective?
2. Discuss the value of considering CRM at different organizational levels.
3. What is involved in estimating customer lifetime value (CLV)?
4. Discuss the process of developing a CRM strategy.
5. What are the important issues in CRM implementation?
6. Discuss how CRM creates value for the firm's stakeholders.
7. What is the relationship between CRM and market segmentation?
8. Discuss the role of the cross-functional CRM team.

Internet Applications

- A. Visit the website of SalesForce.com. Based on the information provided discuss how SalesForce.com can contribute to a company's CRM.
- B. Visit one of the websites discussed in Exhibit 4.3. Discuss how the website may be useful to a company in its CRM activities.

Feature Applications

- A. Critically evaluate the "Net Promoter" concept of customer satisfaction used by the General Electric Co. What role does customer experience information play in GE's CRM?

Notes

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