Managing Marketing Risks-II

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Efficient production can only partially explain the success of a product. Often, it is marketing which holds the key. Marketing, however, involves several uncertainties. This article explains the risks involved in product development, pricing and distribution, and how they can be mitigated.

In this second and concluding part of the series on marketing risks, we examine product development risks, pricing risks and supply chain risks.

Product Development Risks

New product launches are expensive and risky. New products may fail due to several reasons.

- Overestimation of market size.
- Poor product design.
- Wrong positioning.
- Over-pric ing.
- Uninspiring advertisements.
- Higher than expected costs of product development.
- Aggressive competitor response.

Strong new-product planning is required to improve the probability of success. The top management must define the markets and product categories that the company wants to target. It must set specific criteria for new-product idea acceptance, based on the specific *strategic role* the product is expected to play. A new product can help the company to remain an innovator, to defend its marketshare position, to get a foothold in a new market to take advantage of its special strengths or to exploit technology in a new way.

The amount of investment is a major decision in product development. Outcomes are so uncertain that it is difficult to use normal investment criteria for budgeting. Some companies encourage as many projects as possible, hoping that a few will click. Others set their R&D budgets as a percentage of sales or by looking at how much the competition spends. Alternately, companies can decide how many successful new products they need and work backwards to estimate the required R&D investment.

LVMH, the highly innovative French company, understands the risks involved in product development. As Chairman Bernard Arnault points out[1], "We don't like failures. We try to avoid them. That is why with many of our products, we make a limited number. We do not put the entire company at risk by introducing all new products all the time. In any given year in fact, only 15 percent of our business comes from the new; the rest comes from traditional, proven products—the classics."

Successful product development requires cross-functional coordination and involves a consistent commitment of resources. It also implies the establishment of suitable organizational arrangements that facilitate the integration of the product development process into the strategic planning process.

Many companies are revamping their organizational mechanisms and processes to improve the chances

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[1] *Havard Business Review, October, 2001.*

of success in product development. The use of cross-functional teams is now a standard practice. By having executives from marketing, production and design together, right from the start, the product development cycle time can be cut down, leading to major cost savings. When several product development efforts are going on simultaneously, the costs incurred can be significantly reduced, if there is a constant transfer of knowledge across projects. This eliminates redundancies and cuts the time taken to complete the project. For a company like Microsoft, which develops products like MS Office, this is extremely important. Microsoft has to constantly transfer knowledge across software like Word, Excel, and Power Point, which are part of MS Office.

Pricing Risks

Pricing strategies and tactics form an important element of a company's marketing mix. Companies must carefully evaluate the various internal and external factors involved before choosing a price that will give them the greatest competitive advantage in the target markets.

As Niall Fitz Gerald[2] puts it, "When the price value equation of a brand gets out of line, sooner or later, people will notice. And when they do, they will act. There of course, lies the real lesson of Marlboro Friday. It was another case of creeping greed. Bit by bit, hoping to go unnoticed, they got their price/ value equation out of line."

Most products tend to have a pricing indifference band[3]. Within this band, pricing changes do not have much impact on a customer's willingness to buy. A product's specific location within this band will have a significant impact on profitability. Delineating the band is more expensive in the brick and mortar world. On the Web, cost effective means of determining the band are available by changing prices and measuring the elasticity of demand.

A price-cut or hike will affect customers, competitors, distributors, and suppliers. A price-cut can be risky as customers may view it negatively. Is the product faulty and not selling well? Has quality been reduced? Will price come down further? Similarly, a price increase can also create a negative customer perception. The company is greedy and charging what the market will bear.

How can the firm figure out the likely reactions of its competitors? Just like the customer, the competitor can interpret a price cut in many ways—the company is trying to grab a larger market share, it is doing poorly and trying to boost its sales, or it wants others to join in cutting prices to increase the market size. Competitors are most likely to react when the number of firms involved is small, when the scope to differentiate is less and when the buyers are well informed. Uncertainty is less when there is one large competitor, who tends to react in a predictable way to price changes. When there are several competitors, the company must guess each competitor's likely reaction. If all competitors behave alike, there is no problem. But if competitors do not behave alike—perhaps because of differences in size, market share, or strategy—separate analyses are necessary. Also, if competitors treat each price change as a fresh challenge and react according to their self-interest, the company will have to figure out their game plan each time.

How does a company deal with price cuts by competitors? If the company feels price reduction is likely to erode profits, it might simply decide to hold its current price and protect its profit margin. Similarly, if it thinks it will not lose too much market share, it may maintain its price and wait till it is clear about the impact of the competitor's price change. Or, the company may decide that effective action should be taken immediately. It can reduce its price to match the competitor's price. It may undercut the competitor if it feels that recapturing lost market share later would be too hard. Or, the company might improve quality and increase price, moving its brand upmarket.

In general, responding to competitive pressures by cutting prices is a strategy which clever marketers avoid. This is a game, which does not stop with one round of price cuts. Each cut leads to more cuts typically, leaving everyone worse off. Moreover, repeated price reduction may lead to cost cutting, a deterioration in quality or a perceived dilution of brand image. In the long run, price-cutting is a self defeating strategy and is unsustainable as some competitor can always quote a lower price.

[2] *The Economic Times, October 24, 2001*
[3] *McKinsey Quarterly, 2001 Number 2*

The Web has created the possibility of adjusting prices flexibly and fast in response to market forces. Indeed, when demand fluctuates sharply, flexible pricing can be an effective risk-mitigation mechanism. A mix of offline and online selling strategies can be very effective. For example, if products have little demand and prices have to be cut drastically, the Internet can come in handy because a large number of customers can be tapped quickly online.

Some consumers are prepared to pay more than others as they attach greater value to the benefits. In the brick-and-mortar world, segmenting customers on this basis is difficult if not impossible. However, the Internet offers exciting opportunities to understand and segment customers by collecting and processing a variety of information. Thus, loyal customers can be charged a lower price while a premium can be collected from occasional buyers, who approach the company only during a crisis.

Charging different prices for different customers is however, not entirely risk free. When Amazon.com offered DVD buyers three different discount structures, 30 percent, 40 percent and 50 percent, customers getting the lower discount complained. If consistency and trustworthiness are a product's core values, changing prices from segment to segment can be a very risky strategy. In October 1999, Coke sparked off a major controversy when it announced that it was seriously looking at using a technology that would enable vending machines to change prices according to atmospheric temperature. The move backfired and Coke had to cancel the initiative.

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Supply Chain Risks

The ability to manage the supply chain is undoubtedly one of the key requirements for staying ahead of competitors. It does not matter whether a company is vertically integrated or operates in a small segment of the value chain. The need for coordination with supply chain partners and ensuring that orders are efficiently executed is important in both the cases. Supply chain risks arise because one or more of the company's partners may fail to deliver, leading to delayed delivery or cancelled orders or lost customers. Such risks have become more potent because of the dramatic transformation of supply chains in recent times. (See Figure). In the past, the supply chain was more or less linear, collecting raw materials at one end, passing it through the processing stages and finally sending out finished products to the customers. Due to developments in communication and information technology, the shape of the supply chain has not only become non-linear but in some cases even indeterminate. Materials can flow in all directions. So, understanding and coordination have become much more difficult.

In the evolving supply chain the information flow is facilitated through an Intelligent Information Processor (IIP). The IIP interacts with the channel members and ensures the smooth flow of goods and information across the chain. Physical goods and information flows take place in a non-linear manner, unlike the traditional supply chain, as shown in the following figure.

The evolving supply chain has been referred to in the literature as amorphous, since structures are difficult to map and keep changing depending on the strategies of the company and its partners. The same company may directly market its products to customers through its website and also execute some orders through its traditional channels consisting of distributors, wholesalers and retailers. For some activities, the company may reduce the number of partners to improve integration and give them the volumes needed for generating economies of scale. In the process, the company's vulnerability may increase. Two types of expertise, Information Technology and Relationship Management are absolutely vital in mitigating supply chain risks. Information has to flow in a seamless manner across partners and must be made available to them online. The type of dedicated investments, which today's supply chains demand, imply that a relationship of trust and reciprocity must exist among the different entities. Indeed, without good relations, the effectiveness of the supply chain will fall drastically.

The importance of a well-oiled distribution system cannot be overemphasized. Often, companies spend heavily on advertising and promotion without paying adequate attention to distribution. According to the famous advertising guru, Regis McKenna, "Branding isn't awareness. You can only build awareness if you have first built a distribution infrastructure. Awareness doesn't change behavior, though it may lead people to take another look. The actual experience they have with the product is what changes behavior…The key point is persistent presence. For example, Coca-Cola is probably the world's most recognized brand. Everyday, one billion Cokes are bought. If I were to take away their bottlers and distributors, no matter how big the ad budget, would you buy a Coke? No because you couldn't access it."

The importance of supply chain risk management has been highlighted by the difficulties faced by dotcoms in order fulfilment, a critical success factor in online businesses. In the US, during the 2000 Christmas season, in spite of booking orders at least a week before December 25, 8 percent of the packages failed to arrive on time.

For most e-business operations, the key decision involved in order fulfilment is whether to build or outsource distribution infrastructure. eToys started off by outsourcing but later invested heavily in modern warehousing facilities. It went bankrupt in the process. Webvan, the online grocer has invested heavily in 26 high tech warehouses to facilitate same day delivery. Webvan hopes that this investment will pay off if business expands and it can widen its product range. Some analysts however estimate that Webvan will have to attract five percent of the US households to break even. Faced with this Herculean task, the company's stock price has crashed while losses have mounted. Webvan will quite likely, run out of cash in the near future. In contrast, UK grocer, Tesco has pursued a low tech strategy involving order pickers at local stores who fill a customer's basket manually. This approach, though clumsy at first sight, has enabled Tesco to go online without making heavy upfront investments. Similarly, Wal-Mart, in spite of its huge resources decided to start off by outsourcing order fulfilment. Wal-Mart wanted to get to the market fast and learn the intricacies of online order execution. Now, it has decided to handle delivery inhouse.

A study by consulting firm, Bain, reveals that warehouses become scale efficient only at 15,000 transactions per day or about 250,000 square feet. Even a large online company like Amazon is now only approaching the volumes needed to recover the investments it has made in warehousing. Joseph Sklesinger, *et al*[4] , has explained the importance of striking a balance between outsourced and inhouse order fulfilment infrastructure, "The urgent task is to keep up with changing expectations, and to avoid disappointing customers or making expensive investments that become obsolete before they show a return. Managers, who continue to short-change order fulfilment will eventually surrender their customers and revenues to those with superior infrastructures. They will cede business to competitors who assemble profit-effective capabilities that build customer loyalty and to those who correctly determine which capabilities should be owned and which outsourced."

Channel Conflicts

Channel management is a key issue driving Supply Chain Management. Ideally, individual channel members, whose success depends on overall channel success, should understand and accept their roles, coordinate their goals and activities, and co-operate to attain overall channel goals. But this implies giving up individual goals. Channel members rarely take such a broad view and are usually more concerned with their own short-term goals and their dealings with firms closest to them in the channel. Channel members typically act alone and often disagree on the roles each should play and the rewards. Such disagreements over goals and roles generate channel conflict. *Horizontal conflict* occurs among firms at the same level of the channel. A dispute between two dealers in a city over the territory they should handle is a good example. *Vertical Conflict* refers to conflicts between different levels of the same channel. A dispute between a distributor and a retailer would fall in this category.

[4] *Ivey Business Journal, July-August, 2001.*

Channel conflict is not a new phenomenon but has gained importance in recent times, with the growth of e-business. Many consumer goods manufacturers cite channel conflict as the main obstacle to selling goods online. Channel conflict was an important issue when Toys R us set up its website Toysrus.com for doing business online. Bob Moog, who joined as CEO of Toys R us, e-Business operations, resigned after he found that there was confusion over the role of the Internet and the traditional distribution channels. When Levi Strauss launched its websites Levi.com and Dockers.com, it resulted in friction with dealers. Levi later decided not to sell through its website and instead decided to direct site visitors to the online retailing arms of JC Penny and Macy's. Even for higher involvement products like cars, channel conflicts may arise. When General Motors announced that it would buy back some dealer franchises and start direct selling through the Internet, it faced strong protests from dealers.

The web has eliminated layers of traditional intermediaries, while encouraging new intermediaries with specialized capabilities in the movement and handling of small parcels. Managers may sometimes placate existing channel members, knowing fully well that these traditional relationships will have to be severed one day. Resolution of channel conflicts by pampering the traditional dealer network may not always be the right strategy. Customers decide how to buy and may well shift their loyalty to competitors if channel members do not respect their decision. So, a clear and transparent communication to channel members about changes in channel strategy is in order.

Sometimes, channel conflicts can seriously impair customer relationships. Consider a customer who logs onto a website to procure a PC of a particular configuration. If the site does not accept the order due to a bug, the customer may contact the call center to report the problem. Instead of dealing with the customer's concern, the call centre staff may book the order to earn commission and not even bother to report the bug to the concerned department. Consequently, the customer concern would remain unattended and lead to a marked deterioration in relationship with customers over time.

The main challenge for both established companies and start-ups is to integrate web initiatives with the traditional channels. Accordingly, sales order fulfilment and service processes have to be re-engineered to create a seamless customer experience that allows customers to choose the method of interaction depending on the situation. If companies are unable to identify the channels their customers prefer and do not gear up to facilitate these seamless transactions, they run the risk of losing customers.

Many companies are dealing with channel conflicts intelligently. Banana Republic sells apparel over the internet but dissatisfied customers can visit the nearby store for an exchange or a refund. CUS, the largest drug store chain in the US, allows customers to place online orders and choose between a same day pick up at the nearest CUS store or home delivery the next day.

Sourcing

Sourcing activities along the supply chain need to be managed carefully. Fluctuations in raw material prices pose an important risk for marketers, especially in industries where the inputs used are commodities and the amount of value addition in the manufacturing process is not very significant. To protect itself from this risk, a company can use a variety of techniques: hedging through forward or futures contracts, technological advancements, commodity substitution and just-in-time sourcing.

Technological advancement can cut the consumption of an input, facilitate substitution of one commodity by another and in some cases, even enable complete switch over from one commodity to another depending on the prevailing prices. By releasing requisition orders just before the raw materials inventory gets depleted, the time period during which volatility occurs can be reduced. This will ensure that suppliers do not pad up their price. Dell is a good example of the build to order model.

Concluding Notes

In today's customer driven environment, marketing risks need to be managed effectively. The marketing mix has to be carefully analyzed to examine the scope for providing a better value proposition to customers. Product launch, promotion, pricing and distribution are all activities which need to be managed carefully after considering the various risks involved. In the online world, marketers face special challenges. ■

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