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WHEN MARKETING *IS* STRATEGY

Why you must shift your strategy downstream,
from products to customers *by Niraj Dawar*

It's no secret that in many industries today, upstream activities—such as sourcing, production, and logistics—are being commoditized or outsourced, while downstream activities aimed at reducing customers' costs and risks are emerging as the drivers of value creation and sources of competitive advantage. Consider a consumer's purchase of a can of Coca-Cola. In a supermarket or warehouse club the consumer buys the drink as part of a 24-pack. The price is about 25 cents a can. The same

consumer, finding herself in a park on a hot summer day, gladly pays two dollars for a chilled can of Coke sold at the point-of-thirst through a vending machine. That 700% price premium is attributable not to a better or different product but to a more convenient means of obtaining it. What the customer values is this: not having to remember to buy the 24-pack in advance, break out one can and find a place to store the rest, lug the can around all day, and figure out how to keep it chilled until she's thirsty.

Downstream activities—such as delivering a product for specific consumption circumstances—are increasingly the reason customers choose one brand over another and provide the basis for customer loyalty. They also now account for a large share of companies' costs. To put it simply, the center of gravity for most companies has tilted downstream.

Yet business strategy continues to be driven by the ghost of the Industrial Revolution, long after the factories that used to be the primary sources of competitive advantage have been shuttered and offshored. Companies are still organized around their production and their products, success is measured in terms of units moved, and organizational hopes are pinned on product pipelines. Production-related activities are honed to maximize throughput, and managers who worship efficiency are promoted. Businesses know what it takes to make and move stuff. The problem is, so does everybody else.

The strategic question that drives business today is not "What else can we make?" but "What else can we do for our customers?" Customers and the market—not the factory or the product—now stand at the core of the business. This new center of gravity

demands a rethink of some long-standing pillars of strategy: First, the sources and locus of competitive advantage now lie outside the firm, and advantage is accumulative—rather than eroding over time as competitors catch up, it grows with experience and knowledge. Second, the way you compete changes over time. Downstream, it's no longer about having the better product: Your focus is on the needs of customers and your position relative to their purchase criteria. You have a say in how the market perceives your offering and whom you compete with. Third, the pace and evolution of markets are now driven by customers' shifting purchase criteria rather than by improvements in products or technology.

Let's consider more closely how companies can use downstream activities to upend traditional strategy.

Must Competitive Advantage Be Internal to the Firm?

In their quest for upstream competitive advantage, companies scramble to build unique assets or capabilities and then construct a wall to prevent them from leaking out to competitors. You can tell which of its activities a firm considers to be a source of competitive advantage by how well protected they are: If the company believes its edge lies in its production processes, then plant visits are strictly controlled. If it believes that R&D sets it apart, security around its research labs is airtight and armies of lawyers protect its patents. And if it prizes its talent, you'll find hip work spaces for employees, gourmet lunches, yoga studios, nap nooks, sabbaticals, and flexible work hours.

Downstream competitive advantage, in contrast, resides outside the company—in the external linkages with customers, channel partners, and complementors. It is most often embedded in the processes for interacting with customers, in marketplace information, and in customer behavior.

A classic thought experiment in the world of branding is to ask what would happen to Coca-Cola's ability to raise financing and launch operations anew if all its physical assets around the world were to mysteriously go up in flames one night. The answer, most reasonable businesspeople conclude, is that the setback would cost the company time, effort, and money—but Coca-Cola would have little difficulty raising the funds to get back on its feet. The brand would easily attract investors looking for future returns.



On a hot day, consumers gladly pay a 700% price premium for the convenience of buying a cold can of soda from a vending machine.

Idea in Brief

THE OPPORTUNITY

Companies' upstream activities—such as sourcing, production, and logistics—are being commoditized or outsourced, while downstream activities aimed at shaping customers' perception and reducing their costs and risks are emerging as the main sources of competitive advantage.

THE STRATEGY

To compete effectively, companies must shift their focus from upstream to downstream activities, emphasizing how they define their competitive set, influence customers' purchase criteria, innovate to solve customer problems, and build advantage by accumulating customer data and harnessing network effect.

THE LESSON

The downstream tilt is most relevant to three types of companies: those in product-based industries such as pharma, those in maturing industries, and those seeking to move up the value chain. Mastering downstream activities can allow these firms to build new forms of customer value and lasting differentiation.

The second part of the experiment is to ask what might happen if, instead, 7 billion consumers around the world were to wake up one morning with partial amnesia, such that they could not remember the brand name Coca-Cola or any of its associations. Long-standing habits would be broken, and customers would no longer reach for a Coke when thirsty. In this scenario, most businesspeople agree that even though Coca-Cola's physical assets remained intact, the company would find it difficult to scare up the funds to restart operations. It turns out that the loss of downstream competitive advantage—that is, consumers' connection with the brand—would be a more severe blow than the loss of all upstream assets.

Establishing and nurturing linkages in the marketplace creates stickiness—that is, customers' (or complementors') unwillingness or inability to switch to a competitor when it offers equivalent or better value. Millions or billions of individual choices to remain loyal to a brand or a company add up to real competitive advantage.

Must You Listen to Your Customers?

A company is market-oriented, according to the technical definition, if it has mastered the art of listening to customers, understanding their needs, and developing products and services that meet those needs. Believing that this process yields competitive advantage, companies spend billions of dollars on focus groups, surveys, and social media. The “voice of the customer” reigns supreme, driving decisions related to products, prices, packaging, store placement, promotions, and positioning.

But the reality is that companies are increasingly finding success not by being responsive to customers' stated preferences but by defining what customers are looking for and shaping their “criteria of purchase.” When asked about the market research that went into the development of the iPad, Steve Jobs famously replied, “None. It's not the consumers' job to know what they want.” And even when consumers do know what they want, asking them may not be the best way to find out. Zara, the fast-fashion

The Shifting Source of Competitive Advantage

WHAT ELSE CAN WE MAKE AND SELL?

WHAT ELSE CAN WE DO FOR OUR CUSTOMERS?

UPSTREAM ACTIVITIES				DOWNSTREAM ACTIVITIES		
Sourcing	Production	Logistics	Innovation	Shaping Customer Perception	Innovation	Building Accumulative Advantage
Contract with lowest-cost suppliers	Reduce costs/ maximize scale and throughput	Optimize supply-chain and distribution efficiency	Build better products	Define competitive set Change purchase criteria Build trust	Tailor offering to consumption circumstances Reduce customer costs and risks	Harness network effects Accrue and deploy customer data
FIXED COSTS, CUSTOMER VALUE, AND COMPETITIVE ADVANTAGE ARE MOVING DOWNSTREAM						

retailer, places only a small number of products on the shelf for relatively short periods of time—hundreds of units per month compared with a typical retailer's thousands per season. The company is set up to respond to actual customer purchase behavior, rapidly making thousands more of the products that fly off the shelf and culling those that don't.

Indeed, market leaders today are those that define what performance means in their respective categories: Volvo sets the bar on safety, shaping customers' expectations for features from seat belts to airbags to side-impact protection systems and active pedestrian detection; Febreze redefined the way customers perceive a clean house; Nike made customers believe in themselves. Buyers increasingly use company-defined criteria not just to choose a brand but to make sense of and connect with the marketplace. (See the sidebar "How Cialis Beat Viagra.")

Those criteria are also becoming the basis on which companies segment markets, target and position their brands, and develop strategic market positions as sources of competitive advantage. The strategic objective for the downstream business, therefore, is to influence how consumers perceive the relative importance of various purchase criteria and to introduce new, favorable criteria.

Must Competitive Advantage Erode over Time?

The traditional upstream view is that as rival companies catch up, competitive advantage erodes. But for companies competing downstream, advantage grows over time or with the number of customers served—in other words, it is accumulative.

For example, you won't find Facebook's competitive advantage locked up somewhere in its sparkling offices in Menlo Park, or even roaming free on the premises. The employees are smart and very productive, but they're not the key to the company's success. Rather, it's the one billion people who have accounts on the website that represent the most valuable downstream asset. For Facebook, it's all about network effects: People who want to connect want to be where everybody else is hanging out. Facebook does everything possible to keep its position as the preeminent village square on the internet: The data that users post on Facebook is not portable to any other site; the time lines, events, games, and apps all create stickiness. The more users stay on Facebook, the more likely their friends are to stay.

Network effects constitute a classic downstream competitive advantage: They reside in the marketplace, they are distributed (you can't point to them, paint them, or lock them up), and they are hard to replicate. Brands, too, carry network effects. BMW and Mercedes advertise on television and other mass media, even though fewer than 10% of viewers may be in their target market, because the more people are awed by these brands, the more those in the target market are willing to pay for them.

Indeed, the very nature of network effects is that they are accumulative. But other downstream advantages—particularly those related to amassing and deploying data—are accumulative as well. Consider Orica, an explosives company mired in a commodity business in Australia. The primary concern of its customers—quarries that blast rock for use in landscaping and construction—was to meet well-defined specifications while minimizing costs. Because the products on the market were virtually indistinguishable, the quarries saw no reason to pay a premium for Orica's or any other company's explosives. At the same time, Orica knew that blasting rock is not as straightforward as it may appear. Many factors affect the performance of a blast: the profile of the rock face; the location, depth, and diameter of the bored holes; even the weather. Mess up the complex formula for laying the explosives often enough and your profits crumble into dust and get blown away by the wind.

Orica realized that customers harbored much unspoken anxiety about handling the explosives without accidents, not to mention transporting and storing them safely. If it could systematically reduce even some of those costs and risks, it would be providing significant new value for the quarries—far in excess of any price reduction that competitors could offer. So Orica's engineers set to work gathering data on hundreds of blasts across a wide range of quarries and found surprising patterns that led them to understand the factors that determine blast outcomes. Using empirical models and experimentation, Orica developed strategies and procedures that greatly reduced the uncertainty that, until then, had gone hand in hand with blasting rock. It could now predict and control the size of the rock that would result from a blast and could offer customers something its competitors could not: guaranteed outcomes within specified tolerances for blasts. Quarries soon shifted to Orica, despite lower prices from competitors. Not only had the company developed an edge over rivals,

How Cialis Beat Viagra

Redefining customers' purchase criteria is one of the most powerful ways companies can wrest market leadership from competitors.

The strategy serves incumbents and challengers alike. Consider, for example, the \$5 billion market for erectile dysfunction drugs. Pfizer launched the first such drug, Viagra, in April 1998, with a record 600,000 prescriptions filled that month alone. At a price of \$10 per dose and a gross margin of 90%, Pfizer could afford to splurge on marketing and sales. It rolled out a \$100 million advertising campaign, and sales reps made a whopping 700,000 physician visits that year. In the process, Pfizer created an entirely new market on the basis of one key criterion of purchase: efficacy. The drug got the job done.

By 2001 annual sales had reached \$1.5 billion, and other pharmaceutical companies had taken note of the size, growth, and profitability of the market. In 2003, Bayer introduced Levitra, the first competitor to Viagra. The drug had a profile very similar to Viagra's and a slightly lower price—classic “me too” positioning.

Soon after, Lilly Icos, a joint venture between Eli Lilly and the biotech firm ICOS, entered the market with a new product—Cialis—that was different from its competitors in two ways. First, whereas Viagra

and Levitra were effective for four to five hours, Cialis lasted up to 36 hours, making it potentially much more convenient for customers to use. Second, product trials showed fewer of the vision-related side effects associated with Viagra and Levitra.

At the time, the key criteria that physicians considered in prescribing a drug for erectile dysfunction were efficacy and safety. Those two criteria accounted for a

relative importance of 70%. Duration had a relative importance of less than 10%.

The strategic question for Lilly Icos was whether it could influence how physicians perceived the importance of the criteria. The positioning was hotly debated prior to launch: Should the company center its marketing strategy on Cialis's lack of side effects, given that safety was already one of the two key criteria? Or should it attempt to establish duration as a new criterion?

The marketing team decided to emphasize the benefits of duration—being able to choose a time for intimacy in a 36-hour window—in its launch campaign, and it set the price for Cialis higher than that for Viagra to underscore the product's superiority.

The new criterion of purchase—marketed as romance and intimacy rather than sex—caught on. A *BusinessWeek* article reporting on an early positioning study stated, “Viagra users who had been informed of the attributes of both drugs were given a stack of objects and asked to sort them into two groups, one for Viagra and the other for Cialis. Red lace teddies, stiletto-heeled shoes, and champagne glasses were assigned to Viagra, while fluffy bathrobes and down pillows belonged to Cialis.”

In 2012 Cialis passed Viagra's \$1.9 billion in annual sales, with duration supplanting efficacy as the key criterion of purchase in the erectile dysfunction market.



but the advantage was accumulative: As Orica amassed more data, it further improved the accuracy of its blast predictions and increased its advantage relative to its competitors.

Can You Choose Your Competitors?

Conventional wisdom holds that firms are largely stuck with the competitors they have or that emerge independent of their efforts. But when advantage moves downstream, three critical decisions can determine, or at least influence, whom you play against: how you position your offering in the mind of the customer, how you place yourself vis-à-vis

your competitive set within the distribution channel, and your pricing.

If you're in the beverage business and you've developed a rehydrating drink, you have a choice of how to position it: as a convalescence drink for digestive ailments, as a half-time drink for athletes, or as a hangover reliever, for example. In each instance, the customer perceives the benefits differently, and is likely to compare the product to a different set of competing products.

In choosing how to position products, managers have tended to pay attention to the size and growth of the market and overlook the intensity and identity

Brita changes its competitive set when it is placed in the bottled water aisle at the supermarket instead of with kitchen appliances at a big-box store.



of the competition. Downstream, you can actively place yourself within a competitive set or away from it. Brita filters compete against other filters when they are placed in the kitchen appliances section at big-box stores, for instance. But Brita changes both its comparison set and the economics of the consumer decision when the filters are placed in the bottled-water aisle at supermarkets. Here Brita filters have a competitive cost advantage, delivering several more gallons of clean water per dollar than bottled water. Of course, not all buyers of bottled water are buying solely for the criterion of cost (some are buying for portability, for example), but for those who are, Brita is an attractive choice.

If you would prefer not to be compared with any other brands, then you're better off marketing, distributing, and packaging your products in ways that avoid familiar cues to customers. A trip to the grocery store or a glance at online catalogs shows how similar many products' packaging is: Most yogurts are sold in exactly the same pack size and format, and their communications are often so indistinguishable that consumers cannot recall the brand after having seen an advertisement. The lack of differentiation encourages competition, when many of these brands would be better off avoiding it.

Finally, pricing has a strong influence on whom you compete with. When Infiniti launched its comeback car, the G35, in 2002, it was hailed as a BMW-beater. The car, loosely based on the legendary

Nissan Skyline, rivaled the BMW 5 series in terms of interior space and engine power, but it would have struggled to compete for a couple of reasons: The 5 series is aimed at experienced BMW buyers—or at least buyers who have previously owned a luxury automobile. Also, the 5 series is very expensive, and when customers are shelling out that kind of money, they're not looking for value—they're looking for an established brand and value proposition. Infiniti chose to position the G35 against the BMW 3 series instead. The right pricing accomplished that objective: Many consumers, especially car buyers, use price as a key criterion in forming their consideration set.

Although choosing to avoid competitors may minimize head-on competition, there is no guarantee that you won't still have to contend with competitors you didn't want or ask for. But if you've done your homework and established dominance on your criterion of purchase, me-too competitors will be putting themselves in an unfavorable position if they choose to follow you.

Surprisingly, you have more say in determining who your competitors are if you're a later entrant in a marketplace than if you break new ground. A later entrant can choose to compete directly with an incumbent or to differentiate, whereas an incumbent is subject to the decisions of later entrants. But an incumbent is not helpless: It can stay ahead of competitors by continually redefining the market and introducing new criteria of purchase.

Does Innovation Always Mean Better Products or Technology?

Like prime real estate in a crowded city, customers' mindspace is increasingly scarce and valuable as brands proliferate in every category and existing ones are sliced wafer-thin. Companies compete ferociously against one another not to prove superiority but to establish uniqueness. Volvo does not claim to make a better car than BMW does, nor the other way around—just a different one. In customers' minds, Volvo is associated with safety, while BMW emphasizes the joy and excitement of driving. Because the two automakers emphasize different criteria of purchase, they appeal to very different customers. In a global study aimed at finding out what "excitement" meant to customers, respondents were asked to "describe the most exciting day of your life." When the results were tallied, it turned out that BMW owners described exciting things they had done—white-water rafting in Colorado, attending a Rolling Stones concert. In contrast, the most exciting day by far in the lives of Volvo owners was the birth of their first child. Brands compete by convincing customers of the relative importance of their criterion of purchase.

That is not to say that the upstream activities associated with building safer or faster cars don't matter. The product remains an essential ingredient in demonstrating the brand's positioning on its chosen criterion. The product and its features turn the abstract, intangible promises of the brand into real benefits. Volvo's product innovations really do make its cars safer, reinforcing a lasting brand association with its customers. But the product itself does not occupy a more privileged position in the marketing mix than, say, the right communication or distribution.

Where Else Does Innovation Reside?

The persistent belief that innovation is primarily about building better products and technologies leads managers to an overreliance on upstream activities and tools. But downstream reasoning suggests that managers should focus on marketplace activities and tools. Competitive battles are won by offering innovations that reduce customers' costs and risks over the entire purchase, consumption, and disposal cycle.

Consider the case of Hyundai in the depths of the Great Recession of 2008–2009. As the economy faltered, American job prospects looked painfully uncertain, and consumers delayed purchases of durable goods. Automobile sales crashed through

the floor. GM's and Chrysler's long-term financial problems resurfaced with a vengeance, and both companies sought government bailouts. Hyundai, which primarily targeted lower-income customers, was particularly hard hit. The company's U.S. sales dropped 37%.

As overall demand plunged, the immediate response of most car companies was to slash prices and roll out discounts in the form of cash-back offers and other dealer incentives. Hyundai considered these options, but it eventually took a different approach: It asked potential customers, "Why are you not buying?" The resounding answer was "The risk of buying during the financial crisis—when I could lose my job at any time—is simply too high."

So instead of offering a price reduction, Hyundai devised a risk-reduction guarantee to target that concern directly: "If you lose your job or income within a year of buying the car, you can return it with no penalty to your credit rating." Called the Hyundai Assurance, the guarantee acted like a put option, addressing the buyer's primary reason for holding back on the purchase of a new vehicle. The program was launched in January 2009. Hyundai sales that month nearly doubled, while the industry's sales declined 37%, the biggest January drop since 1963. Hyundai sold more vehicles that month than Chrysler, which had four times as many dealerships. Competitors could easily have matched Hyundai's guarantee—yet they didn't. They continued to slash prices and offer cash incentives. The Hyundai Assurance was a downstream innovation. Hyundai didn't innovate to sell better cars—it innovated by selling cars better.

Reducing costs and risks for customers is central to any downstream tilt—indeed, it is the primary means of creating downstream value. Not surprisingly, many of the cases we've examined illustrate this: Facebook reduces its customers' costs of interacting with friends; Orica reduces quarries' blast risks; Coca-Cola reduces the customer's costs of finding a cool, refreshing drink the moment she's thirsty.

Is the Pace of Innovation Set in the R&D Lab?

The product innovation treadmill is an upstream imperative. In fact, technology innovations are sometimes thought to be the greatest threat to competitive advantage. But such changes in the market are relevant only if they upend downstream competitive advantage. You don't need to sweat every product launch and every new feature introduction by

High failure rates for new products suggest that companies are continuing to invest heavily in product innovation but are unable to move customers' purchase criteria.

a competitor—just those that attempt to wrest control of the customers' criteria of purchase. After all, it was not the advent of digital photography that ultimately doomed Kodak—it was the company's failure to steer consumers' shifting purchase criteria.

By contrast, after more than a century of shaving technology innovation, Gillette still controls when the market moves on to the next generation of razor and blade. Even though for the past three decades competitors have known that the next-generation product from Gillette will carry one additional cutting edge on the blade and some added swivel or vibration to the razor, they've never preempted that third, fourth, or fifth blade. Why? Because they have little to gain from preemption. Gillette owns the customers' criterion—and trust—so the additional blade becomes credible and viable only when Gillette decides to introduce it with a billion-dollar launch campaign. Four blades are better than three, but only if Gillette says so. In other words, technological improvements don't drive the pace of change in the industry—marketing clout does.

Market change can be evolutionary, generational, or revolutionary, and each type can be understood in terms of consumer psychology. Evolutionary changes push the boundaries of existing criteria of purchase: higher horsepower or better fuel efficiency for cars, faster processing speeds for semiconductor chips, more-potent pills. Generational changes introduce new criteria that complement old ones, often opening up new market segments: sugar-free soft drinks, hybrid vehicles, pull-up diapers, once-a-day medications where multiple pills were previously required. Revolutionary changes don't just introduce new criteria, they render the old ones obsolete: The new video-game controllers from Nintendo Wii changed how people interact with their games; touch screens

and multitouch interfaces changed what customers expect from a smartphone; a vaccine for tuberculosis, AIDS, or malaria would make current treatments almost redundant within a couple of decades.

The power required to push a revolutionary change through the market is greater than that required to move a market through a generational change, and that power in turn is greater than the market muscle required to introduce an evolutionary change. In each case, the quality of the product innovation—the increased benefits relative to current products—helps move the market, but it does not guarantee a shift. High failure rates for new products in many industries suggest that companies are continuing to invest heavily in product innovation but are unable to move customer purchase criteria. Technology is a necessary but insufficient condition in the evolution of markets. It's the downstream activities that move customers through evolutionary, generational, and revolutionary changes.

Tilt

An ongoing downstream tilt in industry after industry calls into question many ingrained assumptions about business—in particular, those about competitive advantage, competition, and innovation.

The downstream tilt has particular resonance for three kinds of companies: The first is companies that operate in product-obsessed industries, such as technology and pharmaceuticals. The possibilities of downstream value creation and the potential for building competitive advantage in the marketplace tend to be eye-opening for such firms. The second is companies operating in maturing industries whose products are increasingly commoditized. These firms are keen to find sources of differentiation that do not rely on easily replicated products or production advantages. The third is companies seeking to move up the value chain. Downstream activities provide a way to build new forms of customer value and lasting differentiation.

The critical locus of both value and competitive advantage increasingly resides in the marketplace rather than within a company. Activities that attract customers by reducing their costs and risks and repel rivals by building unassailable sources of differentiation represent the key to competing downstream. The downstream playing field has its own set of rules, and managers who learn to play the game achieve an early advantage. ▾

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