

Chapter 5

CREATE VALUE FOR YOUR CUSTOMERS: THREE APPROACHES

Once your company has defined its customer chains and aligned itself properly with the winning participants, the real work of creating and capturing value begins. Each business along the customer chain looks back at its suppliers and forward at its markets to determine which decisions will result in continued growth and the strongest possible rewards for its own shareholders.

The economics of business markets builds upon this simple proposition, which defines our approach to value creation. For a supplier to command a higher price or to win a customer's business over its competition, the business customer must perceive that it will be better off buying from that supplier—and that it in fact prefers the supplier's higher-priced product. This matter-of-fact statement defines how business customers make decisions, and it creates a framework for identifying the ways in which a firm can create value for its customers.

What emerges from this framework is a powerful insight. It's actually saying that there are three ways—and only three ways—for a

supplier to create value from the perspective of a potential business customer: *increase market share*, *increase prices*, or *cut costs*.

An organization can *increase market share* for a business customer if the customer believes it can increase its market share only by choosing the supplier's product—even at a higher price. Perhaps customers further along the customer chain favor the supplier's ingredient, motivating them to purchase products that incorporate that ingredient. Or maybe a distributor believes it can use a particular supplier's product as a magnet for customers who may go on to purchase additional products from the catalog. We've also seen situations where share gains have been linked to products that incorporate sustainable technology.

An organization can help *increase prices* for a business customer if the customer believes it can turn around and achieve a price premium for its own products—by passing along the higher price of the supplier's product to its own customers. The most obvious examples are firms that provide a spectrum of products with different ingredients, at different price points. Many commercial truck manufacturers offer additional options above and beyond the standard equipment, and, for components such as engines, transmissions, and axles, the higher-priced option often is the most popular. Customers are willing to pay for pricier products because they believe these purchases will save them money in the long term.

In both of these approaches to value creation, the supplier's direct customer must believe that its own customers will reward it—with either a share premium or a price premium (or both)—for incorporating the supplier's products or for offering the supplier's higher-priced products.

A supplier organization can *cut costs* for a business customer if that customer believes it can save money elsewhere in its business by

selecting that supplier's product over the competition's or by trading up to the supplier's higher-priced product. This decision can be made entirely within the business customer's firm as part of its efforts to optimize its manufacturing processes, reduce the cost of warranty claims, lower the cost of providing any services that are linked to its products, or otherwise remove costs from the equation and thus improve its bottom line. In some cases, these savings might be passed along to shareholders in the form of higher profits. In other instances, they might be passed along to the firm's own customers via lower prices, strengthening the firm's own competitive position and increasing its market share.

Take note: We are not advocating that the supplier lower its prices. Price-based competition arises only when suppliers fail to introduce unique ways to create value for their customers. When competing suppliers haven't invested in some type of value that distinguishes their products, the business customer—forced to cut costs when it cannot pass on premium prices to the end customer—will demand lower prices in return for doing business with the supplier. In other words, this approach to creating value is a last resort. The supplier is saying to its customer, "There is nothing of value I can do for you, other than cutting my price."

Great opportunities for growth can emerge when a firm steps into its customers' shoes in order to understand what contributions it can make to strengthen its customers' own business performance. Successful business strategy can be built upon a detailed understanding of the customers' plans, pains, and priorities.

These win-win outcomes—where the supplier wins business and/or realizes higher prices while also giving the customer some sort of advantage—are at the economic heart of business-to-business

relationships. Those suppliers who create value with a proposal that makes their customers better off in some way will be rewarded with higher margins, a stronger customer relationship, and profitable growth.

This model for value creation holds true for companies in any market. At a recent meeting with one of our clients, we gave the executive team a pop quiz. The instructions were to read the following success stories of three customers—about a supplier in a different industry—and characterize Supplier A.

Customer 1 said:

“We’re in an industry defined by short product life cycles. If the customer looks at our offering and doesn’t see anything new, that customer looks at our competitors instead. Supplier A came to us with an idea that would allow us to update the product as often as we wanted—the typical time required by our other suppliers to adjust to a new release would be reduced to next to nothing. We are always cited in surveys for new product innovation, and now our engineers can implement a modest upgrade without the organization having to jump through hoops. At this point, Supplier A is getting all our business.”

Customer 2 said:

“We all had a lot at stake with this new product, and we were surprised when a performance issue surfaced. We had two suppliers at this point, and we expected Supplier B to say, “What can we do to help?” Instead they said, “We recommend that you go back to the drawing

board.” This was communicated at upper management levels first, which really wreaked havoc with our technical team. Money was on the table and careers were at stake—the supplier just didn’t understand the seriousness of the situation. One of our engineers talked to Supplier A. It turned out that they had faced a very similar problem with a customer in Europe. They flew in two engineers who spent a month with us and got the problem resolved.”

Customer 3 said:

“Supplier A brought a team to our organization, demonstrated a new approach, and showed us how we could eliminate a significant amount of materials—which we were buying from them, by the way—and eliminate two steps in the manufacturing process. It has saved us a lot of money.”

The executives at this meeting concluded that the supplier being described was a high-technology firm, probably supplying the cell phone or computer market.

In fact, the company was a packaging supplier. Its products were, by the company’s own description, “pretty darn basic”; its costs were measured in cents and fractions of cents. It did own a few patents, but by and large, its business was a commodity business. Nonetheless, its customers considered it to be a company that could bring substantial value into their relationships. The packaging supplier created value for its customer by increasing market share, increasing revenue, and cutting cost.

Innovation in packaging turned out to be a significant contributor

to Customer 1's merchandising strategy; the supplier helped the customer establish its position as an innovator by constantly enhancing its product line. The packaging firm was able to eliminate a barrier to the customer's success; its near-instant ability to evolve the packaging in concert with the products' evolution led to faster product introduction. This type of contribution created value from Customer 1's perspective: The customer is selling a branded, differentiated product—and either getting a premium price or enjoying a substantial market share.

Many brands compete within customer chains involving tough end customers who demand the best. When end customers can choose from among many competing options, they'll always look for innovation, something new, a stand-out offering from the manufacturers and (further back along the customer chain) their suppliers. While the firm's product innovations were behind this success story, the packaging supplier's ability to keep pace with its customer's innovations was critical to marketplace success. Because its innovation created value, end customers were eager to pay more for a product that delivered more. The customer was able to increase its market share and its revenue, and the supplier reaped the rewards of the customer's continued business.

Customer 2 was able to resolve certain performance issues when its supplier sought to bring value to the relationship. Every business customer in every industry faces important technical challenges. Often, the end customer's purchase decisions depend upon the manufacturer's success in meeting these technical challenges, whether with product safety, performance, reliability, shelf life, or any other area that matters to the end customers. This is one of the ways the manufacturer can differentiate itself from its competition.

The problem faced by Customer 2 was one of product leakage,

with a host of bad implications, including significant returns, wastage, and overall dissatisfaction among its end customers. The cause of the problem was a change in the product's chemistry from the previous generation; the solution required only a modest change in the packaging materials and the filling process. The firm was able to launch its new product on time and, after a few tweaks to the process, at the targeted price point. Like Supplier A in this case, any firm in any industry can increase profitability if it can recognize the technical challenges facing its customers and provide solutions that create value in at least one of the three ways: by yielding improved market successes (reflected in either market share or prices) or by affecting operations in some way that translates into gains for the bottom line.

Bottom-line gains were the game changer for Customer 3. In this case, Supplier A created value for its customer by improving its processes and competitiveness, thus taking costs out of the system. These types of value contributions are often invisible to customers further along the customer chain, since they involve process changes, material substitutions, or shifts in the roles of the supplier and its direct customer as well as the boundaries between them. The supplier in this case study, understanding how its customer used its packaging to protect the product, reengineered its offering to achieve the same level of protection with a simpler packaging solution. As the example noted, this reduced the materials used, which created a short-term reduction in the supplier's sales to this customer—a route that many businesses might shy away from. But in our discussions, both this supplier and this customer noted that the contribution was “a great long-term business decision.” This supplier's approach to its customer relationship was focused on helping its customer succeed, which would eventually

result in future business awards and growth; there was never any question about whether it was appropriate to surface this innovation.

Now we've seen how any company can create value for its customers in three ways. An important part of that value creation process, however, involves matching opportunities to the right market segments. The next chapter describes an approach to market segmentation that your business can use to create value and capture these opportunities.