There is an emerging competitive crisis. Multinationals are disrupting competitors, and pioneering new price points and applications in the developed world with low-cost offerings created for rapidly developing economies.

We explain how smart low-cost players are investing in true innovation targeted at the large, low-income segments of the population.

A new wave

A new world-wide wave of low-cost business models innovators are taking share from traditional players in many industry sectors and locations. This new wave has had a significant impact in rapidly developing economies where both local and multinational companies have designed new models to serve a large segment of customers with limited financial means. These new models also have important strategic implications for the developed world. Market leaders in rapidly developing economies are building on their home-market success to pursue global ambitions.

Although some traditional firms are already riding this wave, many are at risk of missing it. The current recessionary environment in some developed countries provides an opportunity to establish a low-cost alternative offering in many markets. However, a low-cost approach involves a great deal more than merely offering current customers an opportunity to buy the same goods for less. Most important, it is a truly new value proposition that addresses both existing and new customers and is supported by a novel operating model. For example, offering a limited range of products without compromising on quality is a key element of many low-cost business models.

Common characteristics of low-cost business models

Low-cost business models share a strong coherence between the value proposition and the asset bases, organizations, and brands that support them – and this coherence delivers high operational efficiency. Although not all successful low-cost business models are alike, many have characteristics in common and rely on a carefully selected set of radical and mutually supportive choices across all dimensions of the business model:

- **Target segments** – Not surprisingly low-cost innovators typically focus on price-sensitive customer segments. Moreover, they often enable an organization to profitably serve new customers who are out of the reach of more traditional business models.
- **Product or service offering** – Low-cost innovators focus on radical rather than incremental offerings – and they design them precisely to delight the chosen customers. The goal is to keep it simple, focused on key basics, and to eliminate any other attributes that add either complexity or cost.
- **Revenue model** – Pricing should be clear and reflect the basic core value of the product or service. While frills should be avoided, a well-designed menu of incremental options can be a real source of enhanced profit.
- **Value chain** – Low-cost models depend on a lean value chain aligned to deliver the value proposition and no more. Innovators commonly perform only core activities in-house and outsource the rest.
- **Cost model** – The cost model begins with a cost target consistent with profitably delivering on the value proposition and then works backward to achieve it.
• **Organization** – While it is of course important to limit overhead in low-cost models, it’s also crucial to have talented people who viscerally understand the value proposition and organizational mission. An entrepreneurial, aligned, and visionary culture can ensure that every customer contact is consistent with the brand and value proposition.

### Low-cost business models from rapidly developing economies

One driver of the search for low-cost innovation is the battle for market share in the rapidly developing economies of the world. By the beginning of the twenty-first century, most multinationals had realized that to achieve their growth ambitions they would need to win in the so-called BRIC markets: Brazil, Russia, India, and China. Most companies simply transplanted their traditional developed-world business models to these markets. Serving higher-income customers in the major urban centres, these companies achieved double-digit growth with only a small revenue base. This kind of growth is nice, but it’s unlikely to have a material impact on a company’s global results or long-term leadership. In most sectors, achieving strategically significant revenues in rapidly developing economies requires developing business models and offerings that address the broader market.

Nokia offers one of the best examples of such a strategy. To win in the developing world, it adapted its business model: it tasked local R&D centres to create low-cost products with features specifically designed to meet the needs of mainstream customers, and it built a novel system to get those phones to market. Nokia’s approximately 100,000 points of distribution give it four times the reach of its nearest competitor. Nokia’s intimate knowledge of the Indian market – which, in the time that Nokia has been there, has grown from next to nothing to the world’s second-largest mobile-phone market after China – has enabled meteoric growth.

Today, with $3 billion in revenue from India, Nokia is one of the largest multinationals there. However, the game is not over. Nokia faces escalating challenges from nimble local handset manufacturers that focus on fast innovation cycles and unique features.

Value chain innovation is a necessity in emerging markets (to enable low prices) and a source of increased profits in mature markets. In 2002, General Electric was having only limited success selling ultrasound devices priced at $100,000 and higher to sophisticated Chinese hospitals. It was clear that capturing the heart of the market would require a dramatically different business model. GE chose to pursue a value proposition focused on low cost and portability. It made significant changes to its operating model – in R&D as well as sales and service – to rapidly develop and launch a portable product. After introducing the ultrasound machine at $30,000, GE was able to cut its costs further and reduce the price down to just $15,000.

Sales took off in China. Moreover, GE discovered that this new product opened numerous new applications for ultrasound in the developed world where its traditional products were either too large or too expensive to be considered. By 2008, revenues from portable ultrasound equipment had grown to nearly $300 million. GE has reaped similar “two way” benefits not only in other healthcare lines but also in other businesses such as aircraft engines. Jeff Immelt, GE’s chairman and CEO, refers to this phenomenon as “reverse innovation.”

India’s Tata Motors saw a huge untapped opportunity in families that needed motorized transportation but could not afford a traditional car. Tata rethought the automotive business model from the ground up in order to design, produce, and deliver a $2,500 car. The company of course eliminated many frills and limited available options, but – more importantly – employed an open-development model that relied heavily on suppliers.

### How should traditional companies react?

Too often, when it comes to reacting to low-cost competitors, companies get caught in one of two traps – a denial trap and an innovation trap.
The denial trap

Most managers have become all too familiar with the denial trap. This is because corporate leaders too often underestimate the power of low-cost models to affect their business. They think that low-cost options are not serious rivals. They presume that their customers value their company's service and brand too much to defect. When they start to see customers deserting them for a low-cost player, they make some minor adjustments or efforts at imitation. When that approach eventually fails, they retreat to serve only the premium segment of their market. It is important to realize, however, that the advent of low-cost players can alter customer behaviour permanently.

The innovation trap

Development teams typically think that new products should always be better, more sophisticated, and, thus, more expensive than the models they replace. When new high-end products launch, the previous generations are discounted, becoming the midrange and bottom-of-the-line products.

Meanwhile, smart low-cost players invest in true innovation targeted at the large, low-income segments of the population. Leveraging new technologies and frequently new business models, these low-cost players compete and win against yesterday's technologies. For incumbents threatened by low-cost upstarts, the best approach is not to start a price war or to make a half-hearted attempt to offer a low-cost alternative, but instead to both sharpen the competitiveness of their high-end model while also exploring their own approach to low-cost business model innovation. Don't just make a defensive move to hurt an upstart, but take an offensive move to open up a new source of profits.

Organic development versus acquisition

There are successful examples on both side of the debate over whether low-cost innovation should be do-it-yourself operation or whether it can be achieved by acquisition. There are some brilliant organic-development successes based on low cost innovation. However, if good candidates exist, another viable strategic option is to acquire leading low-cost players in their infancy – and then give them autonomy.

Jetstar Airways, the low-cost airline launched by the Qantas Group in 2004, is a great example of organic development. Jetstar was given a great deal of autonomy. It could buy its own planes, recruit staff under its own contract, and operate under its own brand. Jetstar became profitable in its first year of operation, and in 2009, Qantas announced that its own solid financial performance was principally due to Jetstar's strong profitability. Most other traditional airlines that launched low-cost offerings chose to maximize synergies, leading to disappointing results because of the mismatch between their low-cost value proposition and a hybrid operating model that combined some low-cost elements with largely major-carrier economics.

Essilor International, the world leader in ophthalmic lenses, illustrates the role of acquisitions. The company has made several attempts to counter the increasing share of Asian imports in its core Western markets. Throughout the past decade, Essilor conducted a systematic acquisition programme of low-cost players on all continents. The company purchased a leading Korean manufacturer and Indian laboratories. Essilor has let them run fairly independently with a focus on rapid revenue growth.

A call for action

Most multinational companies need a robust low-cost offering strategy that will enable them to achieve or maintain a leadership position. Without one, it will be impossible to compete in emerging markets and to prevail over innovative low-cost challengers in developed ones. Low-cost attackers often hit where it hurts, rapidly crippling the cost structure of more traditional business models.
Get your management team together and imagine your worst nightmare – a low-cost competitive product or service that was able to satisfy 90 per cent of your customers. Then ask yourselves, what it would take for your company to be the initiator rather than the victim? What new markets could such a product or service conquer? A low-cost innovation might cannibalize some of your current profit, but, most likely, it will also expand your market scope in a significant way.

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