Interview

Beating the Commodity Trap: an interview with Richard D'Aveni

Interview by Alistair Craven

Professor Richard D'Aveni is a keynote speaker, consultant, CEO coach, informal interim CEO, strategic advisor, and off-site strategic decision process facilitator for companies in the US and Europe at the divisional and CEO-level.

His clients have included AGFA, Delphi, GM, GE, Merrill Lynch, Motorola and PepsiCo. He has also been a keynote speaker at The Conference Board CEO Forum, The World Economic Forum, Young President's Organization, Society of Competitive Intelligence Professionals, CIO Forum, and the Management Centre Europe, as well as numerous other professional societies and corporate events throughout the world. Professor D'Aveni is recognized in the Thinkers 50 as one of the world's most influential business thinkers.

Commoditization – a virulent form of hypercompetition – is destroying markets, disrupting industries, and shuttering long-successful firms. Conventional wisdom says the best way to combat commoditization is differentiation. But differentiation is difficult and expensive to implement, and keeps you ahead of the pack only temporarily. In Beating the Commodity Trap, D'Aveni provides a radical new framework for fighting back, drawing on an in-depth study of more than 30 industries.

AC: Can you tell us about the purpose of your new book?

Richard A. D'Aveni:

Over the last 30 years I have been looking at strategy and competition from a variety of different angles. Time and time again in my research and consulting work I came across companies which were afflicted by commoditization in their markets. The more I thought about it, the more I realized that commoditization is really a fact of business life. Everything becomes a commodity over time. The trouble is most managers don't realize this or choose to ignore this. So, Beating the Commodity Trap is a wake-up call for managers. This is an issue they need to pay attention to and develop strategies to counter.

My research shows commoditization is usually the result of a failure to act early enough. Managers are often in denial about commoditization; and fail to respond in a timely manner. Typically, they continue to fight against low-end competition by discounting even when they know they are fighting a losing battle. This has the unfortunate and unintended effect of increasing the depth and severity of the problem. In a hole, executives often grab the nearest spade and carry on digging.

AC: Why is commoditization such a danger for organizations today?

Richard A. D'Aveni:

Technology, hypercompetition and the rise of low cost competitors in virtually every industry makes commoditization an omnipresent danger. The temptation is to put the blame on cheap producers in China or some other external factor, but most commodity traps are very much related to how managers act or do not act.
Commoditization has the potential to destroy entire markets, disrupt whole industries, and drive previously successful firms out of business. What is needed is a new way of recognizing and responding to the threat of commoditization, and that is what I provide in my book.

What I call a commodity trap is where a company sees its competitive position being eroded so that it can no longer command a premium price in its market. Whether caused by a new low-cost competitor (such as fashion's Zara), new product innovation (think of enhanced customer experiences in restaurants), or the introduction of multiple substitutes and imitators (such as Honda, Suzuki, Victory, and Big Dog in motorcycles), this sort of competition is always costly and sometimes even deadly.

AC: You note that most managers can feel when there is something wrong, but cannot articulate why they are trapped. Can you elaborate?

Richard A. D'Aveni:

The reality is that commoditization doesn't usually simply happen to a firm. Most commoditization results from managers failing to innovate, issuing bad products, or denying trends already in motion. After this continues for a while the firms are then caught in the trap, unable to get out due to the dilemmas they create. Commoditization traps are set by firms themselves as well as by their competitors.

The conventional wisdom for fighting commoditization advises either cost and capacity reduction or increased differentiation. But there is little advice on how to identify the root cause of commoditization, so that the very source can be avoided, eliminated, or in some cases even used to your advantage. Managers have to be vigilant and think whether there is any evidence of the three traps I describe emerging. If there is, they need to act fast.

AC: The book features many interesting case study examples. Which impresses you the most, and why?

Richard A. D'Aveni:

Many companies actually manage to defeat commoditization or use it to their advantage. These are the companies I admire. Think of Wal-Mart in retailing and Ryanair or Southwest in the airline industry. Other firms, faced with commodity traps, use any of three responses: to take advantage, escape or undermine that trap. My favourite response is – rather than succumbing to the market power of that low-end discounter – seeking to undermine it. Several different strategies came to light in my research about how to undermine the strategy of a low-end discounter. One was to find a way to make its power obsolete. Another was to apply another of the commodity traps – proliferation – to the low-end discounter to basically take it out of the market by nibbling at it from multiple directions. So, it can be done.

AC: To quote you from the book, “a sharp economic downturn sometimes causes the perfect storm.” What do you mean by this statement?

Richard A. D'Aveni:

There's a particular problem which rears its head during recession: demand evaporation. That's when people simply stop buying, so all products have to lower their prices to sell anything at all. Here the solutions are to recognize that you're in a tremendous storm, to batten down the hatches, and to also learn how to float with the changes so you can be very flexible as things unfold. Then finally you need to be able to pre-position yourself for landing on your feet when the storm subsides.
AC: You say that is ironic that extreme differentiation results in commoditization. Why is this so?

Richard A. D'Aveni:

The fact is product-based advantages are narrowing and fleeting, making it harder for companies to extract a price premium in most markets. Just about every manager I talk to is engaged in differentiation, but very few of them feel that continuous differentiation is a solution. They simply don't get the results they expect because everyone else is doing it too. In the end they feel like the Red Queen in Alice in Wonderland, who noted that: "Here you must run faster and faster to get nowhere at all!" Managers are no strangers to running on the same spot. Many conclude they need to get better at continuous differentiation by infusing greater customer orientation into their organizations. But, once again, everyone else is doing this as well.

This race for differentiation becomes like the old joke about two friends confronted by a bear in the woods. One friend puts on his running shoes. The other points out that he can't hope to outrun the bear. But the first friend responds: "I know, but all I have to do is outrun you!" The problem is that the bear wins in the end – or both race right into a commodity trap. The race not only goes to the swiftest but to the person running in the right direction. Differentiation can be a powerful way to change positioning, but it is only part of the solution to the commodity trap. To run in the right direction – in ways that avoid, moot or eliminate a commodity trap – you have to understand how commoditization occurs. You have to be able to recognize the different traps and know how to escape them. Identifying these traps and showing how to get out of them is the focus of my book.

AC: What do you mean by “white space”?

Richard A. D'Aveni:

I use a tool called a price-benefit map to gauge how a company performs along some of the issues we have talked about. White space is the place on the price-benefit map where no competitors have positioned themselves. In other words, it is untapped markets ready to be discovered by those bold enough to go where no man has gone before.

AC: You say that "re-seizing the momentum" is one way to escape the escalation trap. Can you briefly describe the escalation trap and why companies should re-seize the momentum?

Richard A. D'Aveni:

Escalation is what happens when companies become locked into a form of one-upmanship – each trying to outdo its rivals by offering the customer more benefits at the same or a lower price. Customers get more and more for their money as cut-throat competition sees prices plummet. This is what I call the escalation trap. The dilemma is that no one can be the first to blink. Managers facing escalation can’t stand still or they will lose market share to rivals. Meanwhile if companies engage in escalation, it leads to price and benefit wars that cause declining margins and profitability.

There are many variations of this escalation trap and the strategies for beating it, but all involve managing the momentum of escalation – by reversing, harnessing, or re-seizing the momentum.

Escalation can ultimately give way to a more radical change: the momentum it creates can cause the market to metamorphose to a completely different primary benefit or product offering. GE turbines morphed into service providers; military night vision goggles into integrated battlefield command and control systems, and so on. When re-seizing the momentum, it is often best to pace and prepare for the shifts because it is not easy to build new know-how and core competencies on a just-in-time basis. Waiting until competitors have shifted may be too late, forcing laggards into a losing game of constant
catch-up. So the ability to periodically restart the momentum necessitates a set of new capabilities.

Successful pace setters are good at managing transitions, so that they can move quickly and smoothly to each new primary benefit offered by their product. They develop the capabilities for future primary benefits before the previous one runs out of steam and erodes.

**AC:** Why do you think that standard models of strategy which advise not to escalate rivalry within an industry are wrong?

**Richard A. D'Aveni:**

The classic modern view of strategy goes back to Michael Porter's model of the five forces from his 1980 book. Essentially, this is about the creation of an oligopolistic industry, one in which all the players cooperate, and build barriers to entry so that they keep out companies that are unfriendly. And then inside the barriers they build friendly companies that divide up the marketplace and collude on price – though, of course, they do that all through signals rather than explicitly. Porter talks about the de-escalation of rivalry in an industry to increase margins.

What I like to talk about is the use of even price wars to create growth. So you change your margins by lowering them, create shareholder value by creating more rapid growth, and rather than living in peace with each other you actively disrupt each other's core competency. You attempt to obsolete the leader's core competency, and when you do that you become the new leader.

In Porter, thanks to barriers to entry, there are a few industry leaders and they're unchallengeable so that you are left with a peripheral market. If we followed Porter's model, all we would have is a world of people pre-described in a cast system, a world of corporations stuck in their cast. And the greatest companies don't see the barriers there. I'll give you a very simple example, Toyota versus General Motors. General Motors spent years and years building up a service dealer network. Eventually, it had between 6,000 and 7,000 service dealers and spent billions on supporting those franchisees or dealerships. Then Toyota shows up and simply makes a car that needs much less service. And all of those billions are sunk costs and wasted, and actually work against you.

**AC:** You describe Apple as a great "momentum generator" and innovator. What is your opinion on the mixed reactions to its latest product the iPad?

**Richard A. D'Aveni:**

Apple has continually re-seized the momentum. The music-oriented iPod morphed into the iPhone and video game players, for example. Its antennae have proved accurate time and time again. I suspect the initial reaction to the iPod was somewhat quizzical. It does not provide what people think they want, but it makes them think again about how they consume, say, music. The jury is still out on whether the iPad can continue this winning streak.

**AC:** You say that companies that don't have sufficient innovativeness need to build their innovation capability to drive escalation. Can you give any practical tips on this subject?

**Richard A. D'Aveni:**

My inspiration is always real people making real decisions. Steve Loranger, CEO of ITT Industries, told me how his company has harnessed commoditization by lowering prices, improving performance, and expanding the market.

"We offer 1,000 times the power with less than half the weight and size for half of the price, and have stimulated an explosion in demand, making night vision standard issue for the
US military. As we get more innovative and leverage our scale, we are able to offer even lower prices and our operating margins are going up," he told me.

Think of it: A thousand times the power at half the price, yet margins are going up! It is perhaps counter intuitive, and flies in the face of conventional wisdom, but harnessing escalation is a powerful way to use the momentum of price-benefit warfare. This is especially shocking when you consider that some of the most popular and standard models of strategy advise that you should not escalate rivalry, but actively work to reduce the rivalry within the industry.

If harnessed, the decline in pricing grows the market. As the technology moves from use by military specialists to standard issue for almost every GI, it means the market can profitably support higher quality at a lower price. The secret to making escalation work is to relentlessly reduce your own costs before reducing your prices, while forcing rivals to lower price and then catch up on cost reductions.

But there is a limit to how far this can go. At a certain point when all soldiers have its technology, ITT will need to redefine the primary benefit offered by its product in order to restart the escalation all over again. For example, ITT's next move is to tie its night vision systems into its GPS, mapping, and communications systems so that commanders and soldiers have a full, real-time picture of the battlefield and where the "friendlies" and enemies are. Eventually, the primary benefit of night vision systems might not be night vision, but a new type of vision that only an integrated battlefield communications system can provide. Harnessing the momentum generally gives way to re-seizing the momentum. In the meantime (and this may last for years), ITT has led the market and built its business by harnessing the momentum of escalation based on the current primary benefit of better sight in the dark.

AC: Finally, are there any closing comments you wish to make?

Richard A. D'Aveni:

Remember that battles are never won permanently, just transformed. You are always jockeying for better positions. And, as former British Prime Minister Margaret Thatcher once said, "You may have to fight a battle more than once to win it."

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