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Cost Innovation: Preparing for a 'Value-for-Money' Revolution

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Some of established businesses' most ubiquitous and profitable business models are increasingly being challenged by a new breed of emerging market players. Rather than simply focusing on cut-priced, undifferentiated offerings, emerging country multinationals are deploying their cost advantages in creative ways to deliver high technology, variety and customisation at minimal price premiums, and to redirect niche offerings towards volume segments. This amounts to the emergence of a new type of generic strategy: 'cost innovation'. Meanwhile, fundamental changes in global market structures are afoot which favour these new business models, and the confluence of these forces is creating a global 'value-for-money' revolution. Incumbents will require new types of responses to survive and prosper – but the pre-requisite for any effective response is a shift in mindset about the new business models required to succeed in the future.

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A new era of global competition

Imagine a world where high technology, variety and customisation - along with specialist products - are available to customers at dramatically lower prices, and where the value-for-money equation offered to global consumers has been transformed by the appearance of new players with new kinds of business models. Could even the best entrenched incumbents ignore this kind of dramatic change in the competitive climate? This new era of global competition is not far-fetched: it is precisely the disruption to existing business models that the new multinationals from emerging markets, led by the Chinese dragons, are even now starting to unleash. And it means we must all learn to cope with a world that is beginning to see a cost revolution, whether we are prepared for it or not.

This article begins by explaining how new global competitors are now successfully challenging some of our most ubiquitous and profitable business models, and goes on to argue that a number of long-term, fundamental trends in the global economy - the increasing share of global demand accounted for

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by developing markets, the emergence of large, value-driven segments among consumers in developed economies, and global consolidation in retailing - are favouring these new business models. Finally, it explores the possible ways in which established companies might respond successfully.

Established business models under threat

Two of the classic generic strategies (as recommended by Porter) for dealing with a competitive challenge from a low-cost competitor involve business models based on 'differentiation' and 'focus'. Differentiation, in turn, is frequently based on the introduction of improved technology, or on offering more choice of varieties and customisation, supported by marketing and brand-building investments.[1]

The goal of differentiators is to bring their distinctiveness to the mainstream market. But when pursuing technological differentiation, innovators often begin by first applying the latest high technology to those applications targeted at the most demanding users or towards early adopters. What these users have in common is the ability to pay, so it makes sense for established global suppliers to restrict the latest high technology to leading specialist segments, and only gradually transfer it over to mainstream products. In this way, their business models capture the maximum value (or what economists call 'consumer surplus') throughout the life cycle of any new technology, allowing them to enhance the return on their R&D investment. Likewise, differentiation on the basis of offering more variety and customer choice usually involves customers paying a substantial price premium to make the business model profitable. This compensates for the increased costs of time lost in the set-up and changeover of production lines, along with the un-recouped costs and write-offs on obsolete inventory involved in delivering wider product lines or customised offerings.

Strategies based on focus, meanwhile, usually involve targeting a niche market with a specialised offering that appeals to those customers who are willing to pay a price premium for a non-standard specification. These business models rely on the idea that the cost penalty from the loss of economies of scale associated with specialisation will be more than offset by price realisation from what is, inevitably, a limited number of prospective customers.

Each of these standard business models is now coming under threat from *cost innovation*: the strategy of deploying the cost advantages that are enjoyed by players based in emerging economies (especially China) which are finding radical new ways to offer customers around the world dramatically more utility for less expenditure.

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standard business models of differentiation and focus are coming threatened by emerging economy players employing cost innovation to offer [global] customers dramatically more utility for less expenditure.

The cost innovation challenge

'Cost innovation' might sound like an oxymoron - most of us in the commercial world have got used to associating innovation with the business of providing more functionality and greater sophistication. But the fact that it breaks conventional wisdom is precisely why it has the potential to rewrite the existing rules of global competition. Cost innovation has three faces:

- First, challengers are starting to offer customers *high technology at low cost*. Chinese computer maker Dawning, for example, has put supercomputer technology into the low-cost servers that are the everyday workhorses of the world's IT networks. This novel strategy is demolishing the conventional wisdom that high technology should be restricted to high-end products and segments, and is interrupting the conventional game in which established global competitors maximize their profits along the product life cycle by only slowly migrating new technology from high-priced segments toward the mass market;

- Second, these new global competitors from emerging economies are presenting customers with *variety at low cost*, proffering an unmatched choice of products into what used be considered standardized, mass-market segments. Thus the harbour machinery maker Shanghai Zhenhua Port Machinery Company (ZPMC) hired 800 design engineers – between 20 and 40 times the number of design staff employed by their German and Italian competitors. This massive engineering resource allows ZPMC to offer a far wider product range than its European rivals, and to be able to customise its equipment to the particular requirements of any port operator's site - all at the same price as standardised machinery. Again, this challenges the accepted wisdom that customers who want variety and customisation will have to pay a hefty price premium;
- Third, the emerging competitors are *moving niche products into the mass market*, challenging the conventional wisdom of focus strategies. Using their low costs to reduce their break-even points, they can offer specialty products at dramatically lower prices, attempting to unlock latent demand and turn former niche markets into volume businesses. If they succeed, the bases of competition will shift towards volume and cost – a game which incumbents are often ill equipped to play. For example, consumer appliance maker Haier has transformed the market for wine-storage refrigerators from the preserve of a few wine connoisseurs into a mainstream category sold through America's Sam's Club (a subsidiary of Wal-Mart) at less than half the previously prevailing price. The end result: Haier has grabbed a 60 percent market share, leaving yesterday's niche players floundering. Competition from this new business model is challenging the notion that specialty products must forever remain low-volume and high-priced.[2]

These are just a few examples of how Chinese companies across a wide spectrum of industries, and with varying heritages, have begun to deploy cost innovation to push into the global market. Dozens of others include: Galanz, which now supplies more than half the world's microwave ovens; BYD, the world's second-largest maker of rechargeable batteries; China International Marine Containers (CIMC) that now sells 55% of the shipping containers used in world trade (from the most basic to the highest technology temperature-controlled and foldable containers); and Pearl River Piano, which is now the global volume leader, producing around a hundred thousand pianos every year.

Cost innovation is also employed in the strategies of some of the leading companies that are globalising from non-Chinese bases. Examples from India include: Suzlon – which has become the world's fourth largest supplier of wind power generators by bringing high technology to global customers at lower prices; Tata - whose 'Nano' car retails at just 1 Lakh Indian Rupees (100,000 rupees = around $2,100); and the software services companies such as Infosys and Wipro, which now offer a wide range of sophisticated IT services using a 'global delivery model' in which costs are cut dramatically by dividing projects optimally between offshore capacity in India and third countries as well as on-site staff local to the customer to tailor implementation and provide maintenance support. Brazil's Embraer, meanwhile, has carved out a major share of the world regional jet market by combining its core technology and system integration capabilities with 11 risk-sharing partnerships spanning the world, enabling it to bring leading-edge global technology into its products at unmatched value for money.

making fundamental changes to business models is risky, expensive and slow. New capabilities take time to build, entrenched mindsets can be devilishly hard to change and existing customers, revenues and brand equity may be at risk: such moves cannot be taken lightly.

Just as with other forms of disruptive competition, these novel strategies create a particular problem for managers of established firms, in that the tried and tested approaches that have previously proved successful in dealing with traditional rivals are unlikely to address these new challenges effectively. However, making fundamental changes to a company's business model is potentially risky, expensive and slow. New capabilities can take a considerable time to build, entrenched mindsets can be devilishly hard to change and existing customers, revenues from the installed base and brand equity may all be put at risk as a result: such moves cannot be taken lightly. So - is it really necessary to retool our future business models just because some new competitors are starting to use cost innovation to win share in pockets of the global market?

On its own, the rise of multinationals from emerging countries would probably not be enough to justify a radical business model rethink (although it should not be forgotten how just a few 'upstart' Japanese firms such as Toyota and Honda wrecked havoc with business models that had prevailed for over sixty years in the global automobile industry). However, parallel changes in the structure of the global competitive environment are moving the future goal posts decisively in favour of the new, cost innovation business models.

Three parallel global competitive environment changes are moving the goal posts decisively in favour of cost innovation business models.

Global pressures for a value-for-money revolution

Three different long-term forces are creating important changes in the requirements for global competitive success. First and foremost, *emerging markets,* especially in the BRIC (i.e., Brazil, Russia, India and China) and VISTA (i.e., Vietnam, Indonesia, South Africa, Turkey and Argentina) countries are becoming increasingly important as drivers of demand. The *Economist* magazine recently pointed out how, by 2005, the combined GDP of emerging and developing economies had risen to over half of global GDP when measured at purchasing-power parity.[3] On average, developing country markets are also growing two to three times faster than those in the developed world. Business models capable of succeeding in emerging markets, therefore, are likely to be decisive in the next round of global competition.

Yet the requirements of these future business models are often substantially at variance with those associated with success in a world where global demand has been (up to now) defined largely by developed-world consumers.[4] Unlocking the mass market in these developing countries will require a step-change in the price/performance ratio and value for money. Successful suppliers are likely to have to possess the capabilities to deal with inadequate infrastructures, both hard (such as transportation and IT infrastructure) and soft (such as legal and regulatory processes), as well as being able to find routes to market and communication strategies that can be effective in appealing to inexperienced (often first-time) buyers, despite under-resourced and unreliable distributors. This vector of requirements is potentially a much better fit with the emerging cost innovation business models that deliver a step-change in value for money, rather than the traditional strategies of (even the most experienced) multinationals that have historically dominated global markets.

A second important shift in the global market stems from the fact that China's 1.3 billion people (including a potentially active labour force of 800 million) and equivalent potential workforce in India can't move from their position of economic isolation to become an integrated part of the world economy without a *downward pressure on global labour rates.* And that process - which arguably began in 1978 when China started to open up to the world and continued via India's process of deregulation and reform since the early 1990s - still has a long way to go. For example, there are still at least 500 million Chinese who could move from low-productivity agriculture to be efficiently employed in manufacturing and services, and probably another 1 billion that might make this transition in India and other developing countries over the next decades. While these macro level shifts continue - and there is little reason to suppose they will stop - downward pressure on global wages will continue.

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These forces have led real income levels of a significant segment of the working population in the developed world to stall or even to decline (especially among less-skilled workers in North America and Europe), and many also feel their job security is threatened. As a result, a substantial - and growing- market segment of consumers in the developed world has become acutely focused on seeking out the lowest prices and the best 'value for money'. A recent study by Broda and Romalis, for example, found that between 1994 and 2005 lower-income consumers in the US were able to consume a substantially wider variety of goods despite stagnating incomes.[5] In other words, they have demanded — and been able to do so successfully - that their suppliers deliver more utility for the same amount of spending. Cost innovation business models will be required to prosper from this growing segment of consumers that demands 'every day low prices' and increased value for money.

Third, global retailers become ever more powerful in determining the success or failure of their supplier companies, even the most established ones. Companies such as Wal-mart, Carrefour and Tesco have used their global distribution networks to gain unprecedented market influence, and have increasingly become the 'gatekeepers' who decide what products are available to their end customers. With the aim of strengthening their bargaining position against their existing, dominant MNC suppliers, and delivering improved value for money to their customers, it may be in these large retailers' interests to foster the emergence of cost-innovation business models.

to strengthen their bargaining position against suppliers and deliver value for money to customers, large retailers [will likely] foster cost-innovation business models.

The story of how Haier broke into the mass market in the United States market is a good example. Haier's CEO Zhang Riu Min recalled:

> *I set my U.S. general manager the target of half of the top ten retail chains in the United States. He said it was impossible - it took famous brands like General Electric, Whirlpool and Maytag decades to do that. Eventually we came up with a way forward: we erected a huge billboard displaying the Haier brand and some of our products on the road outside Wal-Mart's headquarters in Arkansas. Seeing the advertisement from his office window, Wal-Mart's head of purchasing began to enquire into Haier and its capabilities.*

This led to Haier working closely with Wal-Mart to fine-tune its product designs and marketing. As well as getting its product onto U.S. shelves, the relationship with Wal-Mart helped the Chinese company overcome its lack of in-depth understanding of local market and trading conditions, and learn to tailor its products better to fit local consumer needs. In exchange, Wal-Mart reaped benefits by gaining a new supplier capable of offering products with outstanding value for money. Today a large proportion of Haier's U.S. sales come from the top ten retailers, including Wal-Mart, Lowe's, Best Buy, Home Depot, Office Depot, Target, Sam's Club, Costco and Sears. The pattern is the same in Europe and Japan, where Haier's sales are concentrated in the top five retailers. From a standing start twenty-five years ago, Haier is already global number four in white-goods, just behind the leaders from the United States, Europe and Japan - each of which have more than a hundred years of history in the market.

Looked at together, these considerations suggest the changing demands of the global market will, in the future, reward companies with business models designed to succeed in an environment where: developing markets comprise the largest and fastest growing part of world demand; acutely price- and value-for-money-conscious consumers make up a significant and rising segment of developed markets; and global concentration in retailing places ever-greater cost pressures on suppliers.

New business models for winning in the new global game

Dealing with the disruptive potential of cost innovation in the context of changing requirements for global market success will call for some radical re-thinking about future business models. One way or another, the objective for established players must be to incorporate cost innovation capabilities into their future business models. Three kinds of responses look promising as indicating ways forward:

- Using cost innovation to beat the challengers at their own game;
- Giving a global mandate for certain products to subsidiaries in countries such as China and India;
- Allying with the companies that have mastered cost innovation to strengthen incumbents' global competitiveness.

Learning the tricks of cost innovation

The key here is to create a new business model by combining cost innovation advantages with your existing strengths as an established player. But can you do this at home? Or is cost innovation only possible via accessing advantages uniquely available in low-cost, low-price environments such as China? Delivering high technology at low cost, for example, might depend on being able to tap into sources of technology that are available more cheaply in emerging economies than elsewhere, leveraging the low-cost pool of qualified engineers available in these developing countries.

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cost innovation may demand managers look at their existing business models' cost structures to seek new ways to do more with less.

Other sources of cost innovation, however, do not require a company to shift more operations to the developing world: rather, they demand that managers take a fresh look at the cost structures imposed by their existing business models and seek new ways to do more with less. This might include searching for opportunities to substitute cheaper materials, and/or abandoning dogma about existing production processes. Thus the leading shipping containers supplier CIMC, for example, found a way to substitute synthetic materials for expensive hardwood panelling in most of its products, while the battery champion, BYD, learned to produce rechargeable, lithium-ion units at ambient temperature and humidity, making the expensive 'dry rooms' their competitors had long believed were essential to the manufacturing process unnecessary: this cost innovation has enabled BYD to reduce its unit manufacturing costs from $40 to just $12.

Looking for ways to unlock the latent potential of existing (or even discarded) technologies by re-combining them in new ways is another route to achieving cost innovation. A classic example is Haier's approach to the launch of its new line of high-performance washing machines. It noted that washing machine technology and design in Asia, Europe and North America had historically followed independent development paths, each of which had different advantages and drawbacks. European machines, for example, used less water but American ones were usually faster, while Asian models generally made better use of electronic sensors. Lacking the baggage of decades of industry experience - meant that companies from different parts of the world vehemently disagreed on the relative merits of these different approaches - Haier decided to make a machine that combined the best of all three. This new model harnessed a single engine to create two separate washing actions - both emulating the American-style washing action and mimicking the European approach to removing dirt - and then completed the product by adding the kind of electronic sensing and control circuitry typical of a Japanese machine. The resultant machine used only half the water of conventional machines but achieved close to 50 percent improvement in cleaning power at twice the speed — and had the added benefit of reducing the wear and tear on garments by 60 percent. Although none of the underlying technology was really new, the machine won the only white-goods gold medal awarded at the International Invention Expo in its launch year.

Meanwhile, the potential of today's niche markets and specialty products must be re-examined to look for ways to transform them into volume segments. This means adopting a single-minded focus on reducing break-even by reverse engineering existing products to maintain core functionality while cutting out features that customers rarely use, simplifying designs, and finding greater opportunities to share development and launch costs across different product lines.

Marketing strategies also need to be looked at afresh. Established players, for example, often think of TV advertising as a primary brand-building vehicle. But managers must find alternative ways to get the message out - which in many parts of the world cannot include the Internet. The Taiwanese computer-maker Acer provides a good example of cost innovation in marketing: for over a decade, it has put its name on the heavy-luggage trolleys and small carts in Asia's airports. Business fliers and vacationers who can afford to travel by air are both potential laptop buyers: they can read Acer's message for between five and ten minutes as they walk from cars to gates or from baggage claims to exits. This tactic displays Acer's name and tagline to potential customers for the equivalent of between ten and twenty 30-second TV ads, representing a high impact/cost ratio.

The gateway to these cost-innovation strategies is a change in mind-set.

Adopting a strategy to vigorously defend low-end segments or third-world markets currently seen as peripheral can, for example, focus an organization on building its capability to deliver cost innovation and stimulate it to learn these strategies from competitors who are globalising an emerging market base. The gateway to these strategies is a change in mind-set. Gilbert Cloyd, Procter and Gamble (P&G)'s chief technology officer, explained the shift in thinking thus:

> *Prior to 2000 we were always going to deliver the absolute best, then 'cost save'. We have changed that to 'cheaper and better'. That's the innovation standard, so that for the target consumer in a segment we provide them with an experience that they find better than any other competitive product in that category and price tier and at a cost structure that the competition can't match.*[6]

He concedes that in the past there were some at P&G who '*saw those objectives as contradictory*', but says the game is now about '*accepting up front that the true innovation goal is being both better and lower cost. And that has caused us to rethink a lot of things*'. The new cost innovation mind-set is the key to creating a business model that will allow firms to continue to thrive as the global step-change in market demands for value for money takes place.

Giving an emerging market subsidiary a global mandate

A powerful way to accelerate learning about cost innovation is to transfer the global mandate for running certain businesses, products or global customer segments - including the associated strategic decision-making - to a market where a cost innovation business model is already well established.

A few companies, for example, have already taken the step of giving their Chinese subsidiaries global responsibilities. One such pioneer is Intel, which announced in August 2005 that global responsibility for its Channel Platforms Group (CPG) would be shifted to Shanghai. This was the first time Intel had ever transferred global leadership of one of its five major strategic business units (SBUs) outside the United States. Intel's rationale for giving the global mandate for its CPG (whose charter is to expand Intel's worldwide presence by accelerating global channel growth through innovative business models and platform solutions tailored to meet local market needs) is instructive. In addition to China's huge market potential, Intel vice president William Siu noted that it was giving its Shanghai centre global responsibility to because '*Shanghai is becoming increasingly important as a commercial and technology centre, not only for China, but for the worldwide IT industry*'.[7] Intel went on to say that running the SBU from China would be particularly important in allowing it to unlock potential demand in emerging markets and in the cost-competitive segments of the developed world that required advanced technology at demanding price points. The Chinese head of the unit added: '*While CPG will be based out of China, we are an international organization whose charter is to serve the needs of the channel worldwide*'. Put another way, Intel has given China a global mandate to help it bring cost innovation to world markets - a strategy its headquarters was less well equipped to pull off.

emerging market subsidiaries [taking on] global responsibilities need autonomy to experiment with cost-innovative methods and product designs, authority to make decisions quickly, and beefed up staffing

To execute this strategy, however, requires giving the emerging market subsidiary the autonomy necessary to experiment and develop new and cost-innovative ways of doing things and new product designs, together with the authority to make decisions quickly, rather than working through a tortuous chain of command involving reference back to HQ. Some companies, such as Samsung Electronics have found that this necessitates new reporting lines: to make its global mandate work, their former Chinese head became one of the three executive directors on Samsung's main board holding global responsibilities. Effective execution of a global mandate also requires lower-level capabilities to be beefed up so that the subsidiary is staffed by people with the qualities required to lead a multinational business, rather than simply implementing a local manufacturing, sourcing or market sales brief.

Accessing cost innovation capabilities through alliances or acquisitions

Another way to create a new business model for a future that will demand 'value for money on steroids' is to use alliances or acquisitions to combine the strengths of an established multinational - its technology, systems, brands, and the experience and reach of its existing subsidiaries - with the cost innovation advantages being built by emerging market challengers.

Joint ventures between (for example) developed country and Chinese companies have historically been aimed either at breaking into the Chinese market or at securing an effective, high-quality supply chain through equity involvement in operations inside China. Today we are seeing the beginnings of alliances between European and Chinese companies aimed at strengthening the position of both partners in the global market. The 50:50 joint venture between Fiat and China's Chery Automobile to assemble both companies' cars starting in 2009, for example, is aimed at a range of markets well beyond China - in fact Chery already produces engines for Fiat cars sold across the developing world.

Acquisitions are an alternative route to combining Western and Chinese skills in the quest for greater global competitiveness. Access to unique knowledge and experience accumulated by Chinese companies over the past two decades of reform - especially about delivering unsurpassed value for money and cost innovation - is becoming an increasingly important motivator in such acquisitions. A good example was the 2001 acquisition of Avansys, one of the world's leading producers of power supply equipment for telecommunication equipment providers and data centres, by Emerson Electric. At the time, experts felt the $750 million price tag was too high, but Emerson argued that Avansys was an outstanding company that brought complementary products, a young and talented workforce, and capabilities it could leverage to enhance its business worldwide. And the move has paid off handsomely: Emerson Network Power has become a global leader, generating sales of $3.6 billion in 2008 (an 11% increase over 2007) and earning margins of 12.6%.

Such acquisitions seem to be growing in popularity - 2007 saw 400 acquisitions by foreign companies in China, with a value exceeding $30 billion. Even some established global players like Coca-Cola have been on the Chinese acquisition trail: in October 2008 it offered $2.5 billion for the Huiyan Juice Group, a Chinese company with a strong track record in developing and launching a wide variety of healthy soft drinks into the mass market. This deal was ultimately thwarted by a Chinese anti-trust ruling — but Japan's Itochu were more successful in buying a 20 per cent stake in Ting Hsin, a major Chinese food processing group, for $710m in November 2008. Similar alliances and acquisitions - designed to add the benefits of cost innovation to the existing armoury of business models by involving partners or targets who have mastered a step-change in value for money - should also be possible with firms in other emerging economies such as India, Brazil or South-East Asia.

integrating cost innovating acquisitions successfully involves headquarters staff becoming learners as well as teachers.

Of course successfully negotiating and then integrating such acquisitions often involves overcoming numerous hurdles, including a tortuous due diligence process (which can often take up to six months), preservation of the acquired company's cost innovation capabilities as it is integrated, and the receptivity of the headquarters staff to becoming learners as well as teachers. A key ingredient will be the ability to assemble a team with both local and foreign experience and a full breadth of capabilities.

Meeting the challenge of cost innovation

Whether you are an established multinational, a national champion or a entrepreneurial start-up, positioning yourself for success in the coming global competitive environment - illustrated in Figure 1 - involves some clear choices: you can take on board the notion of cost innovation and deploy it to complement your own distinctive capabilities and experience; you can restructure your own organization to fully leverage the potential advantages of the unique environment emerging economies offer across the full spectrum from R&D and design to operations and marketing; or you can seek to access these advantages from experienced practitioners by partnering or acquiring aimed at improving your global (as well as your local) advantage. But doing nothing is not an option.

The prerequisite for all these types of initiatives is to recognise that the changes now underway in the global competitive environment will demand a revolution in the value-for-money delivered by future business models. Cost innovation — the strategy of deploying the cost advantage enjoyed by players based in emerging economies in radically new ways to offer customers around the world dramatically more utility for less expenditure - will be key to making this step-change.

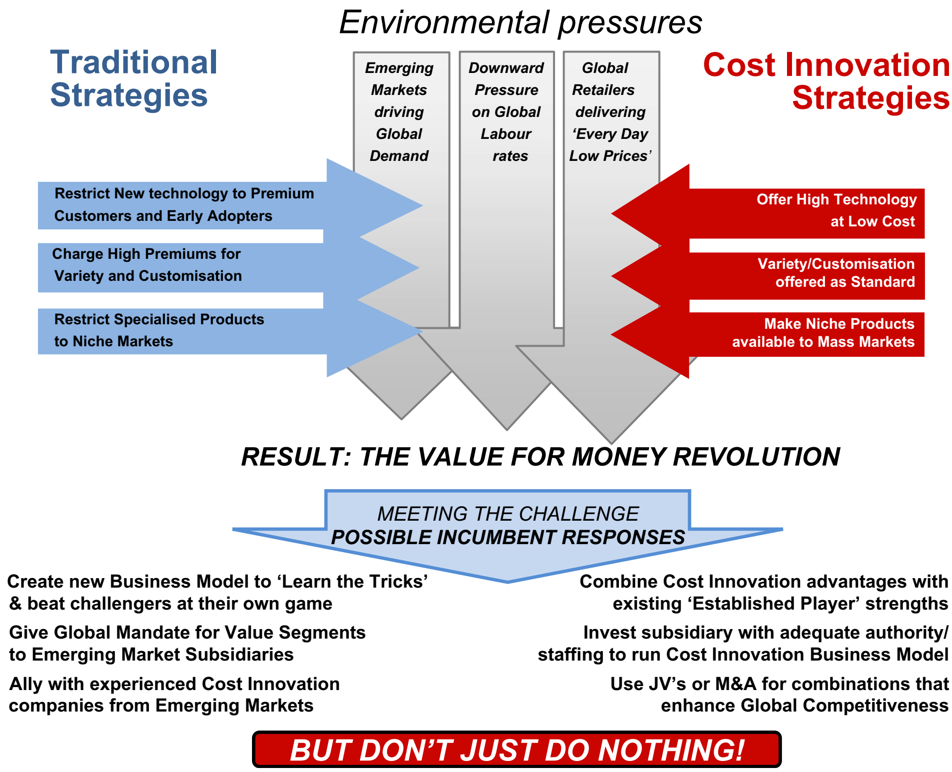

Figure 1. The value for money revolution: causes and response

To achieve it managers will need to go beyond merely equating innovation with providing more functionality and greater sophistication, and start creating business models aimed to deliver high technology at low cost, and variety and customisation without a hefty price premium, and to unlock latent demand by offering the kind of value for money that turns today's cosy niche segments into tomorrow's mass markets. Executing these strategies will require a rethink of the supply chain to find where expensive capital-intensive processes can be streamlined, how products might be re-engineered to improve value for money, technological solutions that enable the substitution of cheaper materials, and a hard look at how to improve the impact/cost ratio of marketing expenditure. It may involve transferring the global mandate for value-for-money products or services to subsidiaries located in emerging economies that have the necessary cost-innovation experience - with the consequent need to restructure reporting lines and upgrade the capabilities of local staff for their new, global role. It might also necessitate acquisitions and alliances with emerging market champions aimed explicitly at accessing cost innovation capabilities for use in the acquirers' broader global market. Whatever mix of these specific initiatives a company chooses, however, the goal is the same: to make sure its business model is re-equipped to succeed as the value-for-money revolution gathers strength.

recognising global competitive environment changes is key to making the step-change … business models must be re-equipped to face the gathering value-for-money revolution. Doing nothing is not an option.

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