Escaping the commodity trap –

How to regain a competitive edge in commodity markets

Study results

Stuttgart, April 2014
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Management summary

Study results:

> A "commodity trap" describes a situation where even complex products and services are downgraded to "commodities", with limited differentiation and where competition is primarily price-based – this is due to a combination of developments experienced by customers, competitors and in products/technologies.

> The commodity trap is a phenomenon found in all industries – over 60% of the study participants have been affected, 54% have yet to take sufficient action to escape (and among affected companies even 65%). At many companies, there is a significant gap between recognizing the commodity trap and reacting accordingly.

> In most industries, commoditization already started some 5 years ago – almost all industries report their low-end market segments as being affected, more than half of the participants also see their middle segments being hit and about 20% face commoditization even in their premium segments.

> Key levers used to escape the commodity trap include innovation, quality and business model actions – the biggest gaps between a lever's effectiveness and its application are seen in the levers business model alignment and target costing/design-to-cost.

Consequences from the Roland Berger perspective:

> Actions designed to escape the commodity trap depend on whether the commodity trap is pending or whether a company has already fallen into it – thus, actions can be for the short, medium or long term, and taking preventive rather than reactive action provides much greater leeway.

> Successful short-term actions include tactical marketing/sales activities, whereas medium-term actions include changes in product or market positioning as well as quality and cost actions – long-term activities include portfolio realignment and changes to the business model.

Source: Roland Berger
A. Study results – Commoditization is threatening many industries
A commodity trap is a situation where products and services have slipped into purely price-based competition.

**Definition of "commodities" and a "commodity trap"**

> **"Commodities"** are **products** and **services** that
>   - Have a high level of **standardization** (quality, technical features, etc.)
>   - Face intense competition with **comparable, substitutable** products/services
>   - Are subject to major **price transparency** for customers, usually in a buyers' market

> **The "commodity trap"** is a situation where providers of "commodity" products or services find themselves facing
>   - Increasing **price** and **margin pressure**
>   - New **market players**, often followed by production over-capacities
>   - A **downward spiral** of purely **price-based competition** and no escape by **traditional** means of **standing out from the competition**

Source: Roland Berger
The majority of companies are facing the commodity trap but have yet to take sufficient counteraction

Roland Berger survey: "Escaping the commodity trap" – Overview of results

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>63%</td>
<td>Of all companies are facing the commoditization of their products and services</td>
</tr>
<tr>
<td>61%</td>
<td>Of all companies see their products and services already caught in the commodity trap</td>
</tr>
<tr>
<td>54%</td>
<td>Of all companies realize that they have not yet taken sufficient action to escape the commodity trap</td>
</tr>
</tbody>
</table>

Source: Roland Berger
65% of the companies that see their products and services caught in the commodity trap fail to take sufficient action to escape.

Roland Berger survey: "Escaping the commodity trap" – Overview of results

- 61% of all companies see their products and services already caught in the commodity trap.
- 35% believe they are taking sufficient action to escape.
- 65% realize they have not yet taken sufficient action to escape.

Source: Roland Berger
Several industries are facing a significant gap between recognizing the commodity trap and reacting accordingly.

Perception of a commodity trap and reaction per industry:

- **Transportation**
- **Utilities**
- **Financial services**
- **IT/telecommunications**
- **Other**
- **Consumer goods**
- **Healthcare, medtech and pharma**
- **Automotive**
- **Chemicals/oil**
- **Engineered products and high tech**
- **Construction**

"Yes, our company's products or services are caught in the commodity trap"

Industries with a significant gap between perceiving the commodity trap and reacting accordingly.

Industries responding largely appropriately to the perceived commodity trap.

"Yes, we are currently taking sufficient action to escape the commodity trap"

Source: Roland Berger
Most companies started seeing the commoditization of their products and services already some 5 years ago

Experience with commoditization of products and services

Companies' experience with commoditization...

- Started approx. 5 years ago: 71%
- Just started: 14%
- Will possibly start in about 5 years: 15%

1) Share of answers that described the level of agreement with the statement as (5) very high or (4) high; on a scale of (1) very low to (5) very high

Source: Roland Berger
Most industries already started seeing commoditization about 5 years ago – By now, basically all industries have been affected.

Our experience with commoditization …

### Started 5 years ago

- Financial services: 87%
- Transportation: 85%
- Other: 77%
- Construction: 76%
- Consumer goods: 75%
- IT/telecommunications: 70%
- Chemicals/oil: 69%
- Engineered products and high tech: 64%
- Healthcare, medtech and pharma: 57%
- Automotive: 56%
- Utilities: 56%

### Has just started

- Financial services: 7%
- Transportation: 5%
- Other: 9%
- Construction: 6%
- Consumer goods: 12%
- IT/telecommunications: 15%
- Chemicals/oil: 25%
- Engineered products and high tech: 14%
- Healthcare, medtech and pharma: 29%
- Automotive: 22%
- Utilities: 27%

### Will possibly start in approx. 5 years

- Financial services: 6%
- Transportation: 10%
- Other: 14%
- Construction: 18%
- Consumer goods: 13%
- IT/telecommunications: 15%
- Chemicals/oil: 6%
- Engineered products and high tech: 22%
- Healthcare, medtech and pharma: 14%
- Automotive: 22%
- Utilities: 17%

1) Publishing, media, professional services, etc.

Source: Roland Berger
Commoditization widespread in low-end and mid-market segments – Some 20% of companies facing this even in the high-end segment

Market segments affected by commoditization

Companies are experiencing commoditization in the ...

- **Budget/low-end segment**: 84%
- **Intermediate segment**: 60%
- **Premium/high-end segment**: 20%

1) Share of answers that described the level of agreement with the statement as (5) very high and (4) high; on a scale of (1) very low to (5) very high

Source: Roland Berger
In most industries, commoditization affects mainly the budget market segments – But some struggle even in the premium segment

Market segments affected by commoditization broken down by industry

<table>
<thead>
<tr>
<th>Utilities</th>
<th>Very low</th>
<th>Mid-market</th>
<th>Very high</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT/telecommunications</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer goods</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Engineered products &amp; high tech</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Healthcare, medtech and pharma</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other(^1)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Automotive</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Chemicals/oil</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Construction</td>
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<td></td>
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</tr>
</tbody>
</table>

\(^1\) Publishing, media, professional services, etc.

> The **budget/low-end** market segments in all industries are being affected by commoditization

> In some industries, the **mid-market segment** is already being affected similar to the budget/low-end market segment

> By and large, the **premium/high-end segment** seems less affected by commoditization and the commodity trap

Source: Roland Berger
Price-related aspects are viewed as the most significant indicators of a commodity trap across industries

Indicators of a commodity trap across industries

<table>
<thead>
<tr>
<th>Customer</th>
<th>Technology/product-related</th>
<th>Competition</th>
<th>General</th>
</tr>
</thead>
<tbody>
<tr>
<td>Only price-based customer decisions</td>
<td>Limited opportunities to differentiate products</td>
<td>Low level of innovation</td>
<td>New competitors</td>
</tr>
<tr>
<td>68%</td>
<td>52%</td>
<td>43%</td>
<td>53%</td>
</tr>
</tbody>
</table>

1) Share of answers that described the level of agreement with the statement as (5) very high and (4) high; on a scale of (1) very low to (5) very high

Source: Roland Berger
Almost all levers used to escape the commodity trap exhibit a gap between their level of application and their perceived effectiveness.

Effectiveness and current application level of levers to escape the commodity trap

<table>
<thead>
<tr>
<th>Use innovation to differentiate products</th>
<th>Very low</th>
<th>Level of effectiveness/application</th>
<th>Very high</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upgrade/bundle products with services</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Improve product and delivery quality</td>
<td></td>
<td></td>
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<tr>
<td>Strategically align the business model</td>
<td></td>
<td></td>
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<tr>
<td>Strengthen target costing/design-to-cost</td>
<td></td>
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<tr>
<td>Create a suitable organizational basis to react flexibly to strategic challenges</td>
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<td></td>
<td></td>
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<tr>
<td>Apply marketing and sales tools</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shift toward specific market segments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategically align portfolio</td>
<td></td>
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</tbody>
</table>

> For almost all levers, the current level of application does not correspond to their perceived effectiveness.

> Innovation and quality-related levers are viewed as the best way to escape the commodity trap.

> The largest gap between effectiveness and level of application is seen for the business model alignment lever.

Source: Roland Berger
We designed the commodity trap survey as a joint study by ICV and Roland Berger – All key industries are represented

Survey focus and responses

**Target industries**
- Participants from **10** different **industries**
- **All key industries** covered

**Target functions**
- Designed as a **cross-functional** study
- Focus on **C-level** executives

**Procedure**
- Online survey with e-mail notification and web-based questionnaire
- **Pre-selected options for answers** to be checked off
- **Levers** based on ICV and Roland Berger experience

**Timeframe**
- **February 2014**

**Response**
- Approx. 420 participants with a sound response rate of approx. **16%**

**Participants’ industries**

**Sales of participating companies [EUR m]**

- > 5,000: 15%
- 500-5,000: 29%
- 50-500: 33%
- < 50: 23%

Source: Roland Berger
B. The commodity trap – Root causes, elements and symptoms from the Roland Berger perspective
Root causes of the commodity trap are driven by global megatrends – Three interlinked elements and three ways of falling into the trap

Three global megatrends are pushing companies into the commodity trap

### Root causes
- Changing demographics
- Globalization and future markets
- Scarcity of resources
- The challenge of climate change
- Dynamic technology and innovation
- Global knowledge society
- Sharing global responsibility

- **Three out of seven global megatrends** contribute to the *root causes* of commoditization
- Their *impact on the global economy* triggers the commodity trap

### Elements of a commodity trap
- There are **three interlinked elements** of a commodity trap
- Various indicators per element signify the existence or emergence of a commodity trap

### Ways to fall into the trap
- The slide into the commodity trap can start at *any* of the three elements
- These elements reinforce each other
- **Result:** significant price and margin pressure

Source: Roland Berger
Root causes of commodity traps lie in global megatrends that cannot be influenced by a single company.

Global megatrends and selected symptoms of commoditization:

**Changing demographics**
- New market players
- Emerging competitors from developing countries

**Globalization and future markets**
- Globally accessible supply market
- Technological diffusion (to developing countries)

**Scarcity of resources**
- Technological maturity with limited progress
- New substitute products/services

**The challenge of climate change**
- Mass customization through modular products
- Changing customer perceptions of value

**Dynamic technology and innovation**
- Newly established price transparency

**Global knowledge society**

**Sharing global responsibility**

Source: Roland Berger
Commodity traps have three interlinked aspects – Various indicators signify the emergence of a trap

Elements and indicators of the commodity trap – Selected aspects

1. Transparency of product/service features, pricing and cost
   - Globally accessible supply markets
   - Changed customer perception of value – away from differentiation
   - Decreasing customer loyalty
   - Price-based buying decision – Purchasing decides on supplier

2. Technological maturity, i.e. low rate of further development
   - Standardization of technologies, interfaces, components, etc.
   - Modularization of products – emerging mass customization
   - Transfer of experts to emerging market competitors
   - Know-how/technology diffusion (e.g. to developing countries)

3. Established technical standards – officially or de facto
   - New competitors previously unable or unwilling to compete
   - New market players from lower-cost/developing countries
   - Excess production capacity, i.e. supply greater than demand
   - Substitute products, e.g. at the lower end of the (previous) market

Source: Roland Berger
The fall into a commodity trap can start with any of the three elements – Price and margin pressure is the ultimate outcome

Ways into the commodity trap

> Commoditization can start at any of the three elements of the trap
> Elements reinforce each other, e.g.
  – Technological progress leads to standardized, easy-to-manufacture products or components
  – New players, also from developing countries, enter the market
  – Customers rarely differentiate products based on their features – price remains the only differentiator
> This ultimately results in significant price and margin pressure and, thus, in a commodity trap

Source: Roland Berger
C. Escaping the commodity trap – Actions and key success factors from the Roland Berger perspective
There are two ways to react to the commodity trap – Only "changing the rules" promises sustainable competitiveness.

Commodity trap and consequences

Option I: "Play by the rules"

- Compete within the commodity trap, i.e. through price
- Increase size and realize economies of scale
- Restructure and cut costs

Option II: "Change the rules"

- Escape the commodity trap by changing the rules of the game
- Tackle all three elements of the commodity trap and their indicators
- Select and implement an appropriate set of counteractions, including changing the business model

Source: Roland Berger
"Changing the rules" requires three steps: Analyze the commodity trap, select lever(s) and define company-specific counteractions.

The way out of the commodity trap – Overview

Step I: Analyze the commodity trap

- Establish transparency regarding status, elements and mechanisms of commoditization
- This requires carefully evaluating the triggers that have caused the trap

Step II: Select lever(s)

- Select an appropriate set of levers depending on which have already been applied, what impact should be achieved, and what resources are available
- Consider and analyze similar examples from competitors or other industries

Step III: Define specific actions

- Specific counteractions are to be defined and detailed based on the commodity trap characteristics and selected levers
- The way out of a commodity trap will be different for each company, as it depends on the company's core competencies and characteristics

Source: Roland Berger
The first step out of the commodity trap is to establish transparency regarding the triggers and mechanisms of commoditization.

Step I: Commodity trap analysis

Selected assessment criteria for analysis

1. Customer
   - Changing customer perceptions of value
   - Transparency on pricing and features
   - Rational, price-based decision making
   - etc.

2. Technology, products, know-how
   - Technological maturity
   - Customization through modular products
   - Standardization
   - Technological diffusion (e.g. to developing countries)
   - Substitute products
   - etc.

3. Competition
   - Globally accessible supply market
   - Excess capacity
   - Emerging competitors from developing countries
   - New market players
   - Established quality standards, e.g. legislative
   - etc.

Key questions to be answered

- Which elements of the commodity trap are affected? Which indicators can be measured or observed?
- Are all competitors affected by the commodity trap?
- Have competitors already escaped the trap? If so, how?
- Which product and market segments are affected?
- etc.

Source: Roland Berger
A wide range of levers is available to pave the way out of the commodity trap

### Step II: Overview of selected levers

<table>
<thead>
<tr>
<th>Levers</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Short-term levers</strong></td>
<td></td>
</tr>
<tr>
<td>1. Apply marketing and sales actions</td>
<td>Advertising, advanced pricing strategies, CRM, strategic product positioning</td>
</tr>
<tr>
<td>2. Upgrade/bundle products with services for differentiation</td>
<td>Extend warranties, ensure guaranteed availability, provide maintenance packages</td>
</tr>
<tr>
<td><strong>Med.-term levers</strong></td>
<td></td>
</tr>
<tr>
<td>3. Shift toward specific market segments</td>
<td>Specific products for developing countries, high-end customers, etc.</td>
</tr>
<tr>
<td>4. Use innovation to differentiate products</td>
<td>Focus on R&amp;D activities to gain/maintain technology leadership</td>
</tr>
<tr>
<td>5. Improve product and delivery quality</td>
<td>Guarantee limited failure rates/downtime, on-time in-full (OTIF)</td>
</tr>
<tr>
<td>6. Strengthen target cost/design-to-cost</td>
<td>Focus R&amp;D activities on design-to-cost based on derived cost targets</td>
</tr>
<tr>
<td><strong>Long-term levers</strong></td>
<td></td>
</tr>
<tr>
<td>7. Strategically align portfolio</td>
<td>Buy/sell business units</td>
</tr>
<tr>
<td>8. Strategically align the business model</td>
<td>Introduce new revenue model, switch to higher step in value chain</td>
</tr>
<tr>
<td>9. Create a suitable organizational basis to react flexibly to strategic challenges</td>
<td>Set up small independent business units with P&amp;L responsibility</td>
</tr>
</tbody>
</table>

Source: Roland Berger
A set of levers has to be selected based on the desired impact and the available resources

Step II: Overview of selected levers and prioritization

Lever prioritization

Impact

High

Medium

Low

Implementation effort

1. Apply marketing and sales actions
2. Upgrade/bundle products with services for differentiation
3. Shift toward specific market segments
4. Use innovation to differentiate products
5. Improve product and delivery quality
6. Strengthen target cost/design-to-cost
7. Strategically align portfolio
8. Strategically align the business model
9. Create a suitable organizational basis to react flexibly to strategic challenges

Source: Roland Berger
The specific actions for escaping the trap need to be developed based on the company's situation and prioritized set of levers.

Step III: Company-specific action definition (example)

Define actions

- Conduct cross-functional working sessions
- Derive a set of actions

Develop action plans

- Prepare implementation plan
- Define results, milestones and responsibilities

Result: Escape the trap

- Monitor implementation and action effectiveness
- Ensure sustainability

Source: Roland Berger
There are five key success factors for escaping a commodity trap

1. **Core competencies** – Leverage core competencies to develop new know-how or business opportunities

2. **Thinking outside the box** – Look beyond the current business model for ways out of the commodity trap

3. **Change management** – Be aware that successful implementation, especially for business model innovations, requires comprehensive change management actions

4. **Value chain & market segments** – Analyze all directions along the value chain and potential market segments in order to find the "white spot" for your future business

5. **Sustainability** – Think of long-term, sustainable ways to escape a commodity trap – short-term actions usually only postpone the problem

Source: Roland Berger
It's character that creates impact!