CHAPTER 4

Formulation, Evaluation and Selection of Marketing Strategies

Contents

Learning Objectives

In this chapter you will become familiar with:

- the different aspects to be taken into consideration when formulating a marketing strategy
- the basic design options within the various aspects of a marketing strategy
- the most important portfolio models for supporting the formulation of marketing strategies
- the key criteria that should be applied in the evaluation of marketing strategies
- the options for applying formal decision-making models when selecting marketing strategies.

In accordance with the strategic planning process discussed in Chapter 2, and following the situation analysis presented in Chapter 3, this chapter describes the steps for formulating and evaluating strategies, and selecting suitable strategy alternatives. **Strategy formulation** takes into account aspects such as the objectives that are being pursued, the targeted customer group(s), the intended customer benefits to be offered and the basic design of the marketing mix. In Section 4.1, we will first define the concept of marketing strategy by outlining central questions that a marketing strategy is supposed to provide answers for. Subsequently, in Section 4.2, we will present concepts that can support and facilitate the formulation of marketing strategies. In Section 4.3, we will close this chapter with some concluding remarks.

4.1 Central Questions for the Formulation of Marketing Strategies

In order to structure the discussion of marketing strategy, we introduce a set of key questions that need to be addressed in the course of formulating a marketing strategy. Figure 4-1 provides an overview of these key questions. The following sections will discuss each of these questions in more detail.

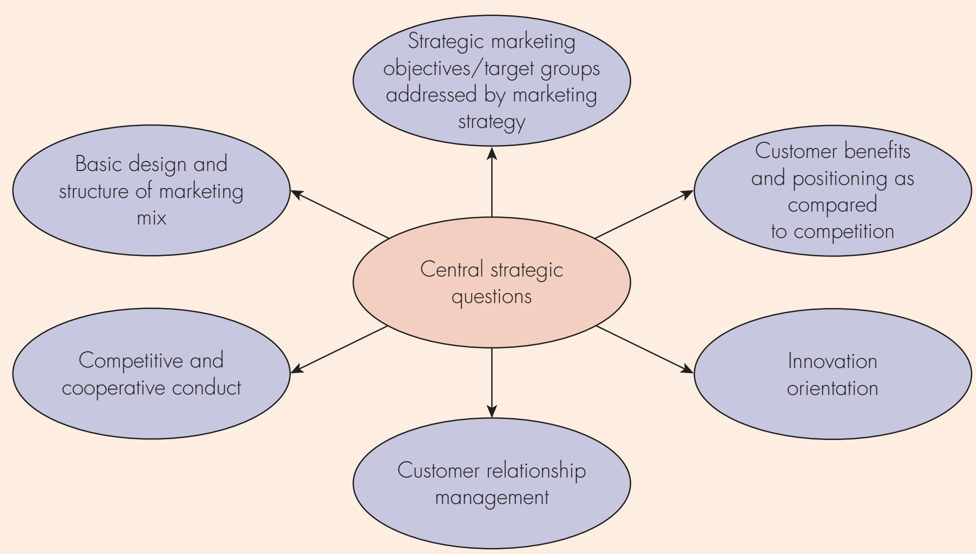

Figure 4-1 Central questions for formulating marketing strategies

4.1.1 Where do we go from Here? Questions Regarding Strategic Marketing Objectives and Target Groups

These central questions deal with the issue of **what** should be achieved (strategic marketing objectives) and **which** customers should be reached (target groups of the marketing strategy). Table 4-1 provides a list of the most important questions in this respect.

Table 4-1 Central questions concerning strategic marketing objectives and the target groups of the marketing strategy

- Which market segments should be developed by the company and what priorities should be set for the individual segments?
- How should the marketing resources be allocated with regard to developing existing customers and acquiring new ones?
- What marketing objectives related to potential should be achieved for all market segments/ for the individual segments and by what particular point in time?
- What marketing objectives related to market success should be achieved for all market segments/for the individual segments and by what particular point in time?
- What marketing objectives related to financial success should be achieved for all market segments/for the individual segments and by what particular point in time?

The first question concerns the issue of **which market segments should be developed** (see Section 3.1 for how to identify market segments). To this end, we have to distinguish different coverage strategies (i.e. the company needs to choose between complete or partial market coverage). In the case of partial market coverage, the company restricts itself to the development of selected segments. Complete coverage implies the targeting of all identified segments.

Once the company has identified the segments it intends to target, it has to tackle the question of the **priority with which the individual market segments should be developed**. This is necessary as companies have limited resources and some segments are more attractive than others. Portfolio methods (see Section 4.2) can explore this question.

A second question related to the target group(s) addresses the distribution of the marketing resources with respect to the **development of existing customers** and the **acquisition of new customers**. According to the concept of customer relationship management (see Chapter 9), optimizing business relationships with existing customers should be the focus of market development. Research shows that the acquisition of new customers is considerably more costly than maintaining existing ones (for an overview of this approach, see Reichheld and Sasser 1990).

The recommendation to focus on existing customers is plausible, and studies have proven that this marketing strategy can be successful (see e.g. Blattberg and Deighton 1996; Capon *et al*. 1990; Reichheld and Sasser 1990). However, a company needs to spend a certain portion of its marketing resources to acquire new customers. This is especially important in the early phases of the market life cycle (see Section 2.2.3). It is also possible that the sales potential of existing customers has essentially been saturated so that significant growth potential can be explored only by acquiring new customers. In pursuing both – the development of existing customers and the acquisition of new customers – the most attractive customers should be treated as a priority. The customer portfolio and the customer lifetime value (CLV), for example, can assist in prioritizing individual customers and customer segments (see Chapter 9).

Subsequent to these considerations, the *specific marketing objectives* need to be determined. Here, the differentiation between marketing objectives related to potential, market success and financial success (see Section 2.1, Figure 2-2) can be applied. As Table 4-1 shows, these objectives should be defined for both the market segments as a whole as well as for the individual segments. The more dissimilar the individual segments and the more differentiated the company's approach to developing the segments, the more important is this differentiation by market segment.

4.1.2 In the Catbird Seat? Questions Regarding Customer Benefits and Positioning Relative to the Competition

A second category of key strategic questions is related to the general decision of what customer benefits should be created and to the company's basic strategic positioning relative to the competition (see Table 4-2). These two questions reflect the relationships in the 'strategic triangle' (see Figure 4-2).

With regard to the question of **what customer benefits the company should create**, it should first be emphasized that, in principle, customer benefits arise when **customer needs are satisfied** (for a discussion regarding 'customer needs', refer to the Appendix). Here it is crucial that the benefits sought from a particular product or service are based on genuine and actual customer needs, and that the company is able to (at least partially) satisfy these needs. In this context, different customer benefits can be offered for different segments (especially when segments vary greatly in terms of customer needs).

It can be helpful to categorize **benefits** with respect to the question of which benefits to offer. In this context, we differentiate two types of benefit: core benefits and additional benefits.

Core benefits relate to fundamental aspects of the company's products and services. They result from satisfying the basic customer needs with regard to a specific product or service offer (see Anderson and Narus 2003). **Additional benefits**, in contrast, arise from the offer of additional services and features extending beyond the basic needs of customers. Here, a need on the part of the customer exists as well, but the customer does not necessarily expect that need to be met by the company. For example, a customer of a car repair shop expects the car to be repaired and to run smoothly (core benefit). An additional benefit can arise if, say, the car repair shop provides the customer with a rental car for the duration of the repair job.

In order to compete effectively in the market, companies must provide core benefits. This can be regarded as the minimum prerequisite for serving a market. Even though additional benefits are 'add-ons', providing these can be an important basis for a differentiation strategy.

Table 4-2 Central strategic questions concerning customer benefits and positioning as compared to the competition

- What benefits should the company offer its customers?
- What competitive advantages is the company striving for?

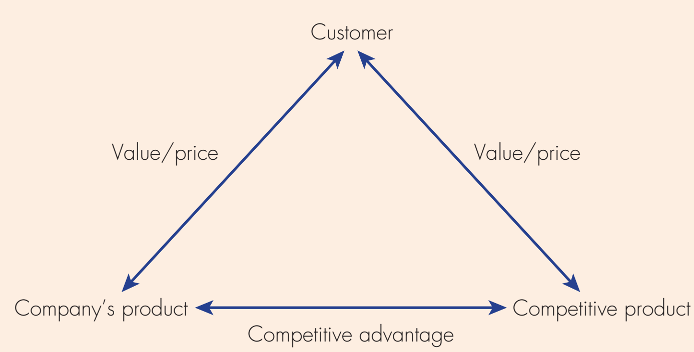

Figure 4-2 Positioning of customer benefits and competitive advantage in the strategic triangle (Simon 1989)

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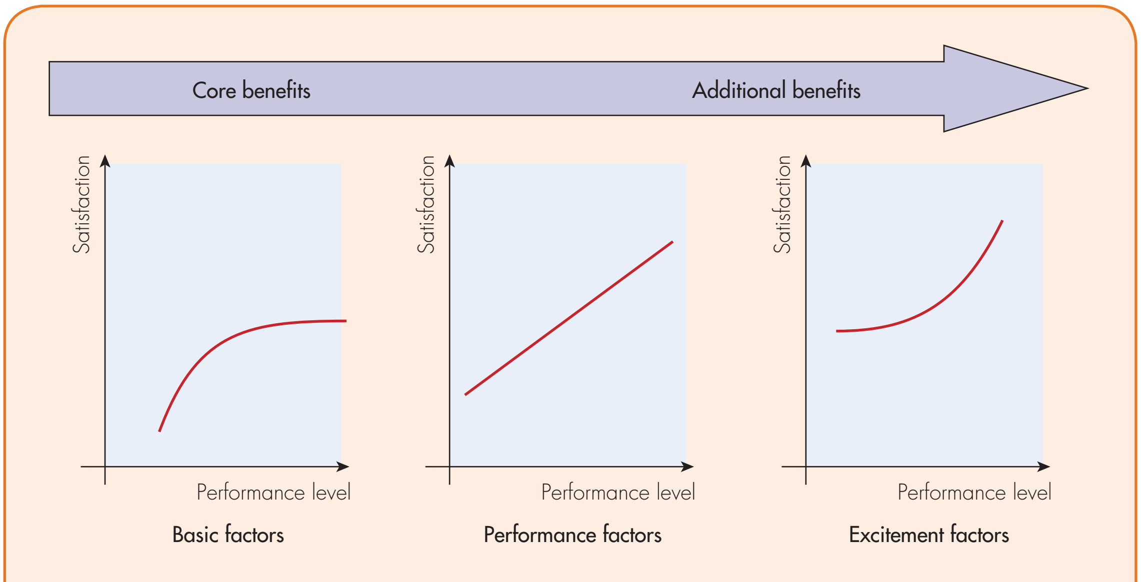

Figure 4-3 Customer satisfaction effects in relation to various performance factors (adapted from Oliver 1997, p. 152)

Depending on whether a core benefit or an additional benefit is achieved, company services and products are differentiated into **basic factors, performance factors and excitement factors**. These factors are characterized by a different impact of the performance level on the overall satisfaction of the customer (see Figure 4-3). Accordingly, with basic factors, a low performance level leads to dissatisfaction, while a high performance level does not result in a high degree of satisfaction since customers expect a high performance level. However, in the case of excitement factors, a high performance level leads to high customer satisfaction (for more on 'customer satisfaction', see Appendix), while a low performance level does not lead to dissatisfaction, since the customer does not have any strong expectations with regard to this performance level. When formulating the marketing strategy it is therefore of importance to assess which of the additional services and features constitute excitement factors for customers.

We can identify various other types of benefits (see Anderson *et al.* 1993; Anderson and Thomas 1997; Anderson and Narus 1998; Ulaga 1999), including those listed below:

- **Functional benefits** originate from the basic functions of the product and are associated with its benefit. Mobility is the functional benefit of a car.
- **Economic benefits** also result from the product features. A car provides an economic benefit if it is fuel-efficient.
- **Process-related benefits** arise from easy procurement or business processes that facilitate company–customer interactions. For example, many car dealers will offer to pick up the customer's car if it needs to be repaired.
- **Emotional benefits** emerge from the positive feelings and emotions evoked by a product, for example, the pride owners take in their luxury cars.
- Like emotional benefits, **social benefits** are also associated with positive feelings. A social benefit results when other people admire the owner of a prestigious car.

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The question of **competitive advantages being pursued** relates to how the company wants to differentiate itself relative to its competitors. As already discussed in Section 3.4.1, a competitive advantage refers to the company's performance relative to competitors and to its ability to outperform competitors. In view of the relationship between customer benefits and competitive advantage, it is important to note that a performance feature can serve as a basis for a competitive advantage only if it generates a corresponding customer benefit. A widespread phenomenon is that performance features generate a significant customer benefit, but do not represent a competitive advantage for the company.

How a company intends to achieve its competitive advantage is at the core of the **competitive strategy** of the company or individual SBU. Figure 4-4 shows a typology of the basic (generic) competitive strategies.

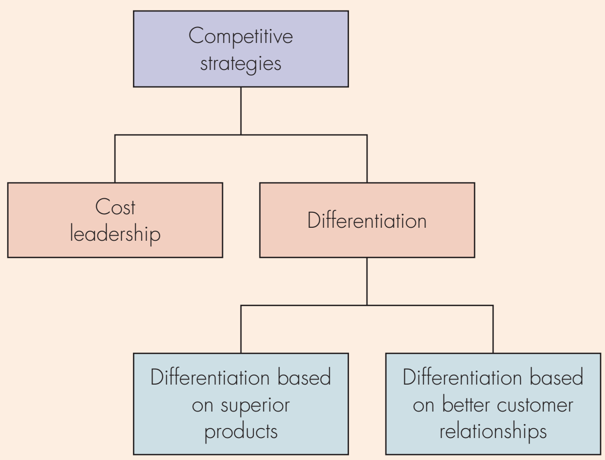

Figure 4-4 Basic competitive strategies

The **cost leadership** strategy aims at efficiency of operations in order to achieve the most favorable cost position within an industry (see Porter 1980; Treacy and Wiersema 2003; see also Focus on Marketing 4-1 for an illustration). Such a position allows the company greater flexibility in terms of pricing (i.e. the company can offer its products at prices lower than its competitors and win market share in doing so). In addition to a low price, extensive standardization of products and utilization of efficient sales channels are typical characteristics of cost leadership.

In contrast, a **differentiation** strategy aims to achieve superiority for the company based on the performance of its product offer (see Hagel and Singer 1999; Porter 1980; Treacy and Wiersema 2003). A differentiation strategy offers a broader range of strategic options as compared to the cost leadership strategy. In general, there are two types of differentiation strategy:

1 differentiation on the basis of superior products

2 differentiation on the basis of superior customer relationships.

Differentiation on the basis of superior products (Hagel and Singer (1999) term it 'product leadership') aims to design the company's products so that they are perceived by customers as being unique and superior in comparison to those of the competition (for an illustration of this type of strategy, see Focus on Marketing 4-2). The perception of superiority does not necessarily

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have to be grounded on objective performance features (e.g. product reliability), but can be based on subjectively perceived performance advantages (e.g. brand image). Typical characteristics of a market development based on this strategy include intensive brand management and unremitting innovation.

In contrast, **differentiation on the basis of superior customer relationships** focuses on the company's customer relationships. The basic concept of this strategy is to establish and maintain long-term, stable customer relationships. Typical characteristics of a market development based on this strategy include thorough analyzes of individual customer needs, a high degree of customization in sales and customer relationship management, as well as training initiatives geared towards securing and improving the customer orientation of employees.

Focus on Marketing 4-1 Example of a cost leadership strategy

When Theo and Karl Albrecht founded supermarket chain Aldi in 1962, they invented the concept of discount stores and made Aldi one of the prime examples of how to successfully implement a low-cost strategy. It has thrived not only in the competitive German market but also in the U.S., all over Europe, and in Australia. It has about 4,700 stores in Germany and 7,500 worldwide, and is further expanding.

According to an article in the *Harvard Business Review*, the blueprint for a low-cost strategy is to 'stay ahead of bigger rivals by delivering the basic product or providing one benefit better than rivals do; and [backing] everyday low prices with superefficient operations to keep costs down.' How does that work for Aldi?

The simple concept of Aldi starts with the limited product range. 'A typical Aldi outlet carries about 700 products – 95% of which are store brands – compared with the 25,000-plus products in traditional supermarkets.' The prices of these store brands are about 30% cheaper than in traditional supermarkets. Due to the proven quality, shoppers snatch at the offer. Consequently, Aldi achieves a higher sales volume and therefore has more leverage in price negotiations with suppliers. By choosing store locations wisely in side streets and suburban areas, Aldi keeps real estate costs down.

Products are displayed on pallets to cut restocking time. Customers are required to pay a refundable deposit for grocery carts so that they return the carts themselves. Consequently, no personnel are necessary to collect carts. But then, Aldi offers customers a fast and efficient shopping trip as several checkout lines reduce waiting times.

Overall, Aldi average markup is 13% compared to 30% of other European retailers. Lower prices for quality products are quite appealing: 'Consumers are more than ever looking for ways to cut their expenses for food', says Jason Hart, president of Aldi US, 'Aldi is the answer'.

Sources: Boldt, Jensen, Schwarzer 2009; Kumar 2006.

Empirical studies in the field of strategy research have shown that combined competitive strategies aiming at a balance of differentiation and cost aspects can be more profitable than 'pure' competitive strategies. In view of this, the **ability to combine the different strategy types** becomes important. Here the idea is that it is possible to simultaneously realize cost leadership and differentiation (see Sheth and Sisodia 1999). Such combined strategies are called **hybrid competitive strategies**.

Focus on Marketing 4-2 Differentiation strategy on the basis of superior products

Procter & Gamble to launch SK-II in USA

SK-II launched 20 years ago in Japan, and was developed, according to a legend propagated by P&G, by a monk who discovered skin-rejuvenating 'pitera' after noticing workers at a sake factory had unusually soft hands from the yeast used for fermentation. P&G acquired SK-II as part of Max Factor in 1991 and it caught the fancy both of former Chairman-CEO Durk Jager and current Chairman-CEO A.G. Lafley, who formerly headed P&G's Asian business.

In the past decade, SK-II has grown at compound double-digit rates as it expanded into Taiwan, Korea and Hong Kong. Since its UK launch, the brand has grown globally at a 16% annual clip to $400 million, Mr Lafley said at a recent investor conference.

Price is almost no object to 'age-defying' SK-II consumers, said Patrick Hansson, Geneva-based brand manager for SK-II in Western Europe.

The most avid spend as much as $10,000 a year on their twice-daily ritual of creams, lotions, cosmetics, masks and cleansing cloths. Average SK-II consumers in the UK may spend $2,000 a year – more than 10 times what an average US family spends on all P&G brands combined.

In the UK, where the brand was introduced in 2000, SK-II launched solely in two Selfridges stores; three years later it is in only about a dozen more stores in that chain, along with Harrods and Fraser.

In contrast to the typical big-budget mass-market P&G launch, SK-II marketing is a low-risk, low-budget, high-service affair that really does build the brand one consumer at a time. First purchases come only through a 'consultant' who performs an individualized skin analysis in one of SK-II's elaborate stores within stores and follows up with a handwritten note. Database-customized mailings drive most new SK-II product launches in the UK, Mr Hansson said.

Source: Neff 2003.

Mass customization is such a hybrid competitive strategy combining both the differentiation and cost leadership strategy. Mass customization refers to the cost-efficient production and marketing of products tailored to the individual requirements of a few customers (in extreme cases, this may be a single customer). The term 'customization' reflects the strategy of differentiation, while 'mass' and the associated large-volume production reflect the cost leadership strategy (for more on mass customization, see Focus on Marketing 4-3).

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Focus on Marketing 4-3 Example of mass customization

Customized chocolate

An article in *Business Week* from 2012 illustrates how Nestlé, the world's largest food and nutrition company, applies mass customization to tap new sources of revenues.

Traditionally well-reputed for making affordable chocolates such as KitKat or Crunch bars, Nestlé recognized that the demand for pricier premium chocolates rises faster than for normal everyday candies. To capitalize on this development, the Swiss company has figured out 'customized confections' and offer them online under its premium Maison Cailler line. Shoppers, so far only from Switzerland and Lichtenstein, can order a taster package with different kinds of chocolate and find out what they like best. An online questionnaire helps determine the respective 'chocolate personality'. Subsequently, consumers 'can order larger boxes of the candies, marrying their favored chocolate with preferred fillings ranging from peppercorn and vanilla to raspberry and verbena.' For such a premium product, Nestlé demands a premium price: a single box of 16 pieces weighing 128 grams in total comes at a cost of $28.30 – a price of 'more than $100 a pound'. Laurent Freixe, head of Nestlé's European business, however, believes that consumers do not only value cheap prices but also look for 'products that overtake their expectations'.

But Nestlé itself requires new competencies. Past endeavors to offer premium sweets were not successful. For instance, an attempted brand repositioning of Maison Cailler failed. 'Nestlé is a strong player in the mass market, but in the premium segment, it doesn't have a strong reputation,' says Patrick Hasenboehler, an analyst at Bank Sarasin in Zurich. Moreover, selling chocolate via the Internet means essentially entering uncharted territory for Nestlé. Competitors like Lindt & Sprüngli have already set up online shops – so far, however, only for standard products. Although the online store is intended to account for most of the sales, a boutique in Broc, Switzerland, home to the traditional Maison Callier brand, will also carry the 'customized confections.'

Nestlé is confident about the potential of its premium candy and plans to enter neighboring markets beginning next year. 'The big objective is to make it sustainable, make it something which will enter into consumption habits and which will not be just a one-off,' says Mr. Freixe.

Source: Doherty, D. (2012) Nestlé's Bespoke Chocolate, *Business Week*, 4267, 27–28.

4.1.3 What's the News? Questions Regarding Innovation Orientation

Another category of key strategic questions concerns the innovation orientation of a company or strategic business unit. Table 4-3 lists the key questions.

Table 4-3 Central strategic questions concerning innovation orientation

- How should the company set priorities for the development of new products and markets?
- Which technologies should be used and further developed, and to what extent?

The key question is concerned with the company's **innovation orientation**. In principle, a company can **innovate in products** and also **innovate in markets**. Four alternative strategies emerge from combining these two options, which can be integrated into Ansoff's (1965) Product-Market Growth Matrix (see Table 4-4).

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Table 4-4 The Product-Market Growth Matrix (adapted from Ansoff 1965, p. 109)

	Existing markets	New markets
Existing products	Market penetration	Market development
New products	Product development	Diversification

1 With the **market penetration** strategy (existing products, existing markets), the company concentrates on markets already served and products currently being offered. This strategy thus exhibits the lowest degree of innovation.

2 The **product development** strategy (new products, existing markets) focuses on developing products in the same markets the company is already catering to (for a detailed discussion of new product development, Section 5.2).

3 With the **market development** strategy (existing products, new markets), the company's established products are marketed in new geographic markets (internationalization), in new market segments or by establishing new sales channels.

4 With the **diversification** strategy (new products, new markets), new products are offered in markets where the company had no presence before. This strategy exhibits a high degree of innovation.

The Product-Market Growth Matrix has important strategic implications. First, it formulates different growth strategies along the line of an innovation orientation. Second, the concept illustrates the risks inherent in the different strategies. Market penetration has a low risk, product development and market development have an intermediate level of risk, and diversification is a risky strategy. Third, the matrix can also be regarded as a portfolio of strategies and, in line with the basic idea of a portfolio, the notion of a balanced Product-Market Growth Matrix should be emphasized. No company can survive by pursuing only market penetration as the Product Life Cycle Model indicates that products will eventually reach maturity (see Section 2.2.3). Companies need to innovate in products and markets and – consequently – in both to survive in the long run. In order to do so, companies need a strong focus on innovation orientation, as is the case described in Focus on Marketing 4-4. Focus on Marketing 4-5 highlights a market development strategy.

Focus on Marketing 4-4 Example of innovation orientation

Innovate with Kraft

In recent years many companies turned to sources outside the company for new creative ideas. For example, Kraft Foods, one of the world's largest food and beverage companies, implemented open innovation activities to complement the internal capabilities of more than 2,000 scientists and technologists across R&D. Besides collaborations with suppliers and partners, Kraft generates new ideas through its 'Innovate with Kraft' website, where anyone can submit ideas ranging from new products, technology, ingredients, packaging to processes.

Source: http://www.kraftbrands.com/innovatewithkraft/

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Focus on Marketing 4-5 Market development strategy at KFC

Kentucky Fried Chicken in China

When multinational companies enter foreign markets, they have to pose a key question: 'How far should they go to localize their offerings?' An article in *Harvard Business Review* deals with this difficulty by citing Kentucky Fried Chicken's (KFC) impressive success story in China as an example.

KFC, which is operated by the fast food company Yum!, is expanding fast and opening new outlets daily. Largely to KFC's account, Yum! is nowadays China's leading restaurant company with an overall fast food market share of 40%. According to the article 'the company has achieved this success by abandoning the dominant logic behind its growth in the United States'.

When KFC entered China in 1987, it brought along a 'taste of America'. KFC's executives quickly understood that maintaining the established US business model would not lead to the intended success. Consequently, expansion was mainly focused on smaller cities where KFC as a pioneer could choose the most attractive locations. KFC set up its own distribution network including its own truck fleet to ensure efficient logistics. Moreover, the traditionally used franchising system was abandoned as not enough qualified entrepreneurs were available.

KFC's executives saw that food was at the 'very heart of society' and that a huge variety of both national and regional dishes would be essential to lure customers. The food choice includes 'spicy chicken, rice dishes, egg tarts, fried dough sticks, wraps with local sauces, and fish and shrimp.' Recipes, e.g. the level of spiciness are adjusted to regional preferences to make KFC part of the local community. While in the U.S. KFC restaurants are primarily designed for take-out food, in China outlets offer space for patrons to eat on the spot. By implementing all these changes, KFC achieved to not be seen as 'a fast-food chain selling inexpensive Western-style items' but a part of Chinese food culture.

And what is the outlook? 'The third quarter of 2010 marked the first time that China revenue (more than $1.1 billion) had surpassed U.S. revenue, and many analysts expect that Yum!'s China business will be twice as large as its US business within five years.'

Source: adapted from Bell and Shelman 2011.

4.1.4 All Strings Attached? Questions on Customer Relationship Management

A fourth category of central strategic questions is concerned with the aspects of customer relationship management. A primary element here is the management of existing customers to optimize customer satisfaction – a key prerequisite for customer loyalty (for a discussion of 'customer satisfaction', please refer to the Appendix). As far as company objectives are concerned, customer relationship management (we will also use the term 'relationship marketing') aims at the optimal design of the customer relationships of a company. Of special relevance are the establishment and maintenance of **long-term business relationships**, which can be associated with numerous potential advantages for the company, such as:

- sales-related advantages
- cost-related advantages.

In terms of **sales-related advantages**, sales volumes generated with a customer can increase over the course of a business relationship. If a company gains an increasingly better understanding of the customer's needs in the course of a relationship, it can use this information to create an improved offer for the customer. Furthermore, the customer may increase their share-of-wallet with the company. Cross-selling and reduced price sensitivity of customers are additional advantages of successful customer relationship management (see also Chapter 9).

Cost-related advantages can arise from a decrease in information and coordination expenses required for maintaining the business relationship (i.e. transaction costs are reduced – for more on 'transaction cost theory', see Appendix). In light of the fact that the acquisition of new customers is generally very costly (see Hart *et al.* 1990; Reichheld and Sasser 1990), a potential cost-related benefit of long-term business relationships is that they can reduce the necessity of costly new customer acquisition activities.

Accordingly, the objective of customer relationship management is the establishment of **customer loyalty**. As a rule, an essential prerequisite for customer loyalty is a sufficient level of customer satisfaction. The strategic orientation of these customer relationship management activities can be derived from the answers to the central questions shown in Table 4-5.

Table 4-5 Central strategic questions concerning customer relationship management

- For what should customer loyalty be established? The company, company employees, products or brands?
- Which customers/customer groups should be targeted in loyalty-building programs?
- How (i.e. via which reasons for loyalty) should customer loyalty be ensured?
- Which instruments can be used to secure customer loyalty?

The first central question regarding customer relationship management refers to which object the customer loyalty should refer to. In principle, customers can be loyal to companies, persons, products or brands.

With respect to the second central question, concerning which **customers/customer groups** should be targeted in terms of developing loyalty, it should be pointed out that prioritizing the individual market segments (already discussed in the first central question in Chapter 3) is particularly important when defining customer relationship management activities.

A further central question in customer relationship management addresses how to ensure customer loyalty. At the core of this question are the fundamental factors driving customer loyalty. When formulating the marketing strategy, a company has to determine which **reasons for loyalty** should

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be promoted and to what extent. Four basic reasons for customer loyalty are especially relevant (see Meyer and Oevermann 1995):

1 **psychological reasons for loyalty** comprise customer satisfaction, personal relationships and customer habits (psychological reasons for loyalty also include, e.g., loyalty to a specific brand, see Fournier 1998)
2 **economic reasons for loyalty** arise if the business relationship is designed so that it is economically disadvantageous for the customer to switch to another company due to high switching costs
3 **technical/functional reasons for loyalty** exist if there are technical dependencies, and switching to another company is associated with difficulties of availability or problems of compatibility
4 **contractual reasons for loyalty** exist if the customer is bound to the company for a certain period of time due to a contractual agreement and thus, for legal reasons, cannot switch to a different company (e.g. a contractual tie with a provider in the telecommunications market).

A fourth question inquires about the instruments that should be used to secure customer loyalty. A detailed description of the available tools and instruments will not be presented here. For more information, please refer to Section 9.2 in Part 3 of this book, which discusses the marketing instruments of customer relationship management.

4.1.5 In Good Company? Questions Regarding Competitive and Cooperative Conduct

A fifth category of central strategic questions regarding the formulation of marketing strategies tackles a company's conduct towards other companies (see Table 4-6). The focal point here is on strategic considerations concerning the competitive and cooperative conduct of a company.

Table 4-6 Central strategic questions concerning competitive and cooperative conduct

- How should the company generally interact with its competitors?
- With which companies, and with what objectives, should the company cooperate within the scope of the market development, and how should the cooperation be structured and designed?

The first question relates to how the company should generally interact with its **competitors**. In the course of their market development, companies are frequently confronted with competitor actions that go beyond the normal 'day-to-day business'. A differentiation between cooperative actions and threatening behavior can be made in this context. Cooperative actions on the part of a competitor do not have a negative impact on the company's achievement of objectives. For instance, price increases by a competitor can be interpreted as cooperative since they can enable the company to increase its own prices. Threatening behavior, on the other hand, can negatively affect the company's ability to achieve its objectives. For example, the launch of a new product or price reductions on the part of the competition can diminish the company's profit.

The best way to respond to the competitive activities has to be decided on a case-by-case basis. The marketing strategy can provide only general response patterns. For example, a strategic guideline can define how aggressively a company tends to react. The extent to which a company can forecast probable competitor activities and respond to them proactively before they are actually implemented (e.g. price reductions prior to an expected new product launch by a competitor) is also decisive.

Of particular relevance are threatening actions on the part of competitors. If a company is threatened by another competitor, four basic **competitive reactions** have been observed (see Kuester *et al.* 1999, 2001):

1 ignoring the activity
2 cooperating with the competitor
3 counterattacking
4 switching to different markets.

If the competitor has not yet carried out its threatening actions, but is expected to, the company can try to defend itself (see Bowman and Gatignon 1995; Gatignon *et al.* 1997; Kuester *et al.* 1999, 2001). A range of **defence mechanisms** can be taken into consideration when formulating the marketing strategy (also see Bain 1956; Gruca and Sudharshan 1995). The company can use product, price, communication and sales, as well as customer relationship management instruments, to fend off threatening competitor behavior.

Another key question concerns **cooperative conduct** and thus the issue of which companies should be cooperating in the market development process. In this context, a **strategic alliance** refers to a formal business relationship between two or more companies that established a cooperation with common objectives (e.g. development of technologies or markets). The cooperating companies remain legally independent and regulate the cooperation in the specified areas through more or less formal contracts. By contrast, the legal independence of the participating companies changes in the case of a **merger** or **acquisition**. In a merger, two or more companies build one entity by giving up their previous legal existence. With an acquisition, a company buys out one or more other companies or parts of companies and the acquired companies lose their legal independence. Acquisitions can be voluntary (with the consent of the target company) or involuntary (referred to in this case as hostile takeovers).

When discussing cooperative conduct it is important to focus on the intended objectives of the companies involved. The following potential objectives exist in this context (see Barney 2001; Gulati 1998; Varadarajan and Cunningham 1995):

- joint creation of market entry barriers for other competitors
- reciprocal access to knowhow and other resources
- easier market access and sales synergies
- expansion of the service range and/or filling gaps in the product range
- leveraging cost-cutting potential in the form of economies of scale and experience curve effects (see Section 2.2.2)
- risk management.

There are three possible forms of cross-company cooperation.

1 In **vertical cooperations**, companies positioned at different levels of the value chain work together. An example here is the strategic alliance between an insurance firm (as product supplier) and a company in the financial services sector.
2 **Horizontal cooperations** refer to collaborations between companies positioned at the same level of the value chain within the same industry. In this case, the cooperating companies are thus (potential) competitors. An example here would be an alliance between airlines.
3 In **lateral cooperations** (also called diagonal cooperations), companies in different industries work together. Such cooperations are created, for instance, between companies whose markets are merging due to technological developments (e.g. acquisition of a software company by a telecommunications provider).

In addition to this general description of potential forms of cooperation, strategic alliances can also be categorized in terms of marketing aspects. Table 4-7 shows a classification of strategic alliances categorized by the most dominant marketing instrument.

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Table 4-7 Differentiation of strategic alliances categorized by the dominant marketing mix instrument

Form of alliance	Possible focus of cooperations	Examples
Product alliance	■ Granting of a manufacturing license for another company ■ Bundled marketing of complementary products of both partners ■ Joint new product development or market launches	Joint development of new medications by pharmaceutical companies
Communication alliance	■ Joint usage of communication tools, possibly with a common advertising message	Joint sponsorship of a sports event
Distribution alliance	■ Joint utilization of sales channels, field or customer service organizations ■ Joint activities in logistics	Inventory of a trade company is managed by a manufacturer
Price alliance	■ Joint pricing activities on the part of several companies	Joint discount systems, cross-company price bundling
Customer loyalty alliance	■ Joint customer loyalty activities by companies	Joint bonus systems of airline, car rental and hotel companies

4.1.6 All Well Mixed? Questions Regarding the Marketing Mix Design and Structure

The final category of central strategic questions deals with the basic design and structure of the marketing mix (see Table 4-8). There are two different categories of question in this context: those that relate to the general design and structure of the marketing mix, and those that concern the basic alignment of the individual components of the marketing mix.

A key question addressing the general design and structure concerns the degree to which the **market development is differentiated** for individual market segments. In other words, this question addresses the positioning of a company between the two extreme points of a completely standardized market development across all segments and a completely customized development of each individual market segment. In fact, if the market development is strongly differentiated for the different segments, the key questions related to the design and structure of the marketing mix should be answered on a segment-specific basis.

As noted above, the question regarding the company's **product–price positioning** is related to the general design and structure of the marketing mix. The basic options for design and structure related to the decision about the positioning are shown in Figure 4-5. Price and performance are the two attributes that help to construct this two-dimensional matrix. The attribute 'performance' relates to non-price marketing instruments. Both price and performance are assessed qualitatively or quantitatively relative to the competition (for 'multi-dimensional scaling' as a general technique for positioning analysis please refer to the Appendix). In the diagonal depicted in Figure 4-5, a consistent positioning can be achieved, with relative price and relative performance at corresponding levels. In company practice, strategic positioning in this diagonal area is frequently applied. Moreover, companies that want to increase their market share or penetrate a new market often choose a positioning with a particularly favorable price–performance ratio.

Table 4-8 Selected central strategic questions concerning the design and structure of the marketing mix

Central questions regarding marketing mix design and structure

- To what extent should the market development between the individual customer segments be differentiated during the course of market development?
- How should the company's product–price positioning be designed?
- How large should the marketing budget be and how should it be allocated to the various marketing instruments?
- What interaction effects between the various marketing instruments or various products have to be taken into consideration?

Selected questions regarding product decisions

- How broad and detailed should the company's product range be?
- What quality level does the company want to achieve with its products?
- What types of product innovations are the focus of the company's innovation activities?
- How should the company's brand(s) be structured and positioned?

Selected questions regarding pricing decisions

- What price positioning should the company strive for in relation to the competition?
- When setting prices, how should costs, competitor prices and customer benefits be prioritized?
- To what extent and by means of which criteria should the company pursue price differentiation?
- To what extent and by means of which criteria should the company grant discounts, rebates and bonuses?

Selected questions regarding communication decisions

- What communication objectives and target groups should the company focus on?
- How large should the communication budget be and how should it be allocated to the individual communication instruments?
- What communication messages should be particularly emphasized?
- How should the success of the communication be monitored?

Selected questions regarding sales decisions

- Should the products be directly or indirectly sold?
- Should just one sales channel or several sales channels be used?
- How should the various sales channels be defined?
- What criteria should be used to select the sales partners?
- How should the activities be distributed between the company and its sales partners?

'Premium' positioning is based on high-quality products and services, while 'economy' positioning is based on low prices. This process is essentially similar to the cost leadership strategy (see Section 4.1.2) and is often associated with high volume (thus, also referred to as 'price–volume strategy').

Another question is concerned with the overall **marketing budget**. In connection with budget decisions, a relevant issue is how to allocate the budget to the individual marketing mix instruments.

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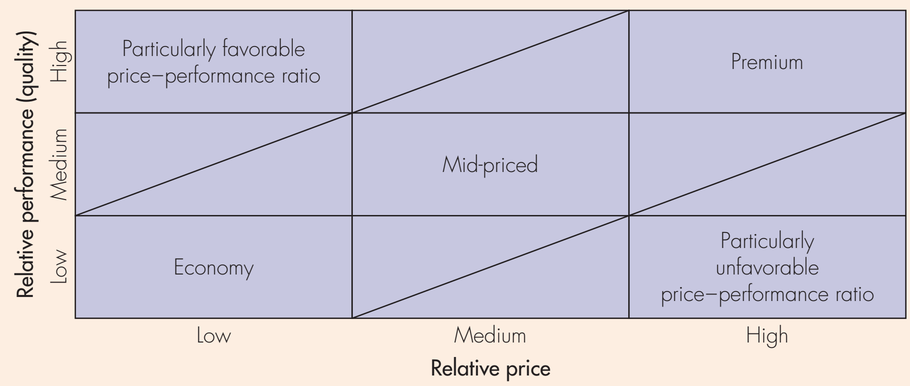

Figure 4-5 Basic design of product–price positioning strategies (see Simon 1992, p. 64)

4.2 Supporting Concepts for the Formulation of Marketing Strategies

After describing the different facets of a marketing strategy, this section will discuss a number of concepts that can play a supporting role in the formulation of marketing strategies. It should be mentioned in this context that some of the concepts presented within the scope of strategic analysis (see Chapter 3) can also be relevant here. This applies, for example, to SWOT analysis (see Section 3.4.2). However, the models discussed in Chapter 3 focus more on analytical aspects, whereas the concepts in this section explicitly aim at generating **recommendations for marketing management**.

We will introduce the following concepts:

- the strategic gameboard
- portfolio techniques.

The **strategic gameboard** is a qualitatively oriented creativity technique that describes the nature of competition in an industry. To this end, two fundamental questions are asked: 'Where does competition take place?' (referring to market segmentation) and 'How is competition shaped?' (referring to the business system). With regard to the first question, the development of a niche or, alternatively, the entire market can be considered. The second question takes into account competition according to old rules vs competition according to new rules as strategic options. These dimensions result in a matrix that identifies four basic strategies (see Figure 4-6).

The analysis focuses on finding ways that allow for radical realignments of the competitive landscape (see Kerin *et al*. 1990). New rules can be realized through innovation or by reconfiguring the rules of competition in the entire market. Striving to rewrite the rules of competition is called a **new game strategy** (see also 'blue ocean strategy' in Section 3.4.1). An example of this strategy is the approach of a mechanical engineering company to provide customers with the option of leasing machines instead of buying them. This offer, when first introduced, led to a reconfiguration of competition. Competitors were no longer primarily focused on product performance and price, but to a great extent on financing and service concepts.

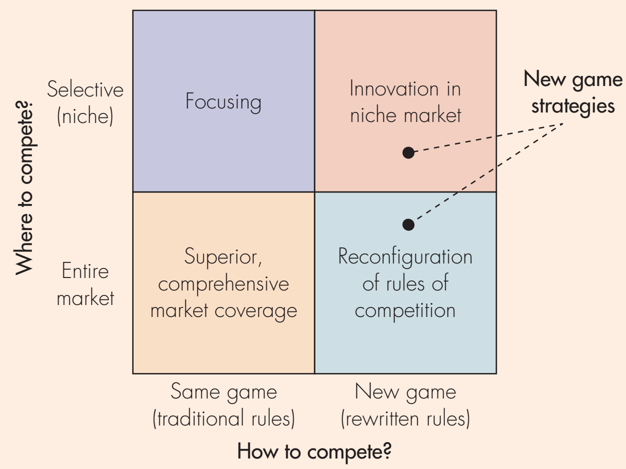

Figure 4-6 The strategic gameboard

We can distinguish new game strategies according to the following characteristics:

- New game strategies are more effective and successful the more competitors are taken by surprise.
- New game strategies aim at shaping competitive conditions in a way that favors the particular strengths of the company.
- New game strategies can lead to high profits, but also pose significant risks.

Focus on Marketing 4-6 illustrates an example of a new game strategy.

Focus on Marketing 4-6 The Starbucks customer experience

Fortune magazine describes Starbucks as 'possibly the most dynamic new brand and retailer to be conceived over the past two decades'. The company has a huge global reach, and as of 2008, has over 7,500 locations in more than 40 countries worldwide.

Customers stream into Starbucks to buy coffee at far higher prices than they used to before the advent of the chain. They go to their local Starbucks to read on plush sofas, or to use the wi-fi connections available in over 400 UK branches, to read e-mail on their laptops and hold meetings. In the US and Canada, customers can load money onto the company's stored-value cards. The cards can be personalized to a design of their choice, and they entitle the customer to special offers such as free refills. Since October 2006, Starbucks has fostered a partnership with Apple's iTunes to offer complimentary digital music downloads to their US customers.

'Starbucks has become what I call the third place,' says Howard Schultz, the man who built the coffee company that has become an American institution. 'The first place is home. The second place is work. We are the place in between. It's a place to feel comfort. A place to feel safe. A place to feel like you belong.' The Starbucks website describes the atmosphere as:

Focus on Marketing 4-6 (Continued)

'specifically designed to be cosy and intimate, while at the same time providing people with their own personal space to use as they wish. . . . Those looking for peace and quiet away from home or the office can relax and linger in an armchair and escape into a book, whilst those looking for an intimate place to meet friends can huddle on a sofa and chat over a mug of coffee, as they would in their own home.'

These features are now familiar in many city center coffee shops around the world, but it was Starbucks who pioneered this new and unusual customer experience from the company's origins in Seattle. Schultz's aim was to try to create something that never really existed in the US: cafe life, for centuries a hallmark of Continental society.

Sources: Bonamici 2004; company information from www.starbucks.com and www.starbucks.co.uk, 14 April 2008.

Quantitatively oriented concepts can also be applied for the design of the marketing strategy. The most prominent quantitative concept is the **portfolio technique**.

The portfolio method is intended to support the process of **resource allocation** in markets – in other words, the question addresses to what extent a company should invest resources into developing a particular market or market segment. The term 'portfolio' originated in finance to address the problem of spreading investments across a securities portfolio. The original concept emphasizes the idea of balancing investments according to specific criteria (e.g. risk). This problem is akin to one of the resource allocation decisions firms face, particularly when they are operating in multiple markets. The portfolio technique as applied in marketing may recommend that firms invest heavily in markets to strengthen their competitive position, to maintain their position, to limit investment or to even discontinue activities in certain markets.

The markets/market segments that are analyzed during the course of a portfolio analysis can be defined according to various criteria (see Section 3.3 on market segmentation). In international marketing, for example, portfolios can be used to analyze local and national markets, and to set appropriate priorities for these markets (for more information on this topic see Chapter 12). If a company is divided into strategic business units (SBUs), portfolio analysis is usually conducted at the SBU level.

Most portfolio models share the common objective to support decisions related to resource allocation in markets, and they also share a common logic: within the course of a portfolio analysis, markets are positioned in a two-dimensional matrix, with one axis referring to market attractiveness in the broadest sense and the other axis, generally speaking, indicating the strength of the company's position in the markets being analyzed. A subsequent evaluation of these two dimensions results in basic recommendations with regard to resource allocation. In the following, we will examine the most important portfolio models:

- the market growth/market share portfolio
- the life cycle portfolio.

The **market growth/market share portfolio** (also referred to as the BCG Model, as it was developed by Bruce Henderson at the Boston Consulting Group in 1970) is a well-known application of the portfolio technique and was the first to be discussed systematically (see Abell and Hammond 1979; Hedley 1977). With this technique, the company's SBUs are evaluated by the relative market share (defined as the ratio of the company's own market share as compared to the market share of the strongest competitor). Obviously, this approach is shaped by the results of the PIMS project (see Section 2.2.1) as well as the theory of the experience curve model (see Section 2.2.2). Furthermore, the market attractiveness of SBUs is assessed based on market growth, an approach that is rooted in the logic of the Life Cycle Model (see Section 2.2.3).

Figure 4-7 illustrates the formal structure of this portfolio. The horizontal axis refers to relative market share and the vertical axis captures the market growth. For each axis, a cut-off point is determined so that the resulting matrix consists of four cells. As a rule, the vertical cut-off point is located at a relative market share of 1, which is exceeded only by the market leader. An additional line highlights market shares between 1 and 1.5. When formulating a marketing strategy, special attention should be paid to SBUs that fall into this area since the comparatively weak market leadership of the company is especially at risk here. There are no general criteria for determining the cut-off point for the horizontal dimension. Determining the cut-off point has important implications as above this threshold point growth is deemed to be significant (the selected 5% value in Figure 4-7 is used for illustrative purposes). Possible criteria for determining this point include, for example:

- average industry growth (if all examined markets belong to the same industry)
- general macroeconomic growth data (if the examined markets belong to different industries), or
- company-internal growth targets.

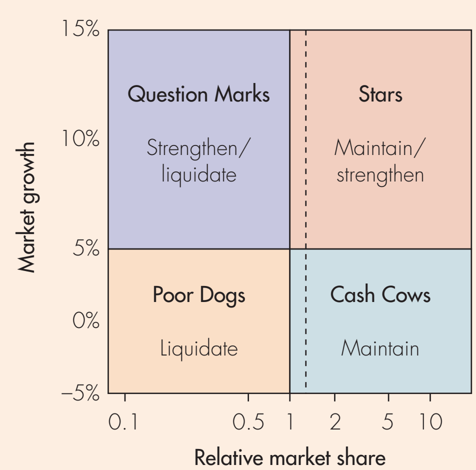

Figure 4-7 Market growth/market share portfolio

In general, the individual markets/SBUs are represented by circles whose size proportionally corresponds to the respective sales volume of the company. The affiliation of an SBU with one of the four cells in Figure 4-7 leads to basic recommendations (standard strategies) with regard to resource allocation, as described below.

- **Stars** (SBUs characterized by a high market share and a high market growth rate) often are highly profitable, however they require a significant allocation of resources if the objective is to maintain or strengthen the market position in a fast-growing market. The basic recommendation for these business units is to deploy extensive resources (e.g. with a view to developing new products/ acquiring new customers).

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- **Question Marks** (SBUs characterized by a low market share and a high market growth rate) generally require the utilization of significant marketing resources relative to their sales in order to be able to sustain them in a fast-growing market. Accordingly, they are frequently unprofitable. The strategic key question here is whether major investments (e.g. for developing new products or establishing new sales channels) should be made in order to turn this SBU into a Star.
- **Poor Dogs** (SBUs characterized by a low market share and a weak or even negative market growth rate) should be managed in such a way that does not put any financial burden on the company. Options for action include a gradual retreat or limiting activities to individual market niches.
- **Cash Cows** (SBUs characterized by high market share and low market growth), with their strong position in a market that at best displays a weak growth performance, yield more cash flow than would be feasible to reinvest. Here, marketing resources (e.g. customer loyalty schemes) should be deployed only to the extent required to maintain the market position. In markets where SBUs are in such a position, the cash flow generated should be invested in growing markets (Stars or Question Marks).

A significant weakness of this basic portfolio lies in the very limited data basis: far-reaching recommendations for resource allocation are based on just three indicators (market growth, own market share, market share of the strongest competitor). Subsequently, other similar portfolio models have been conceptualized that are more comprehensive in nature (e.g. the GE product portfolio matrix).

Another model of the portfolio approach is the **life cycle portfolio**, which analyzes markets based on the life cycle phase that they are experiencing. This approach is therefore very strongly rooted in the logic of the Life Cycle Model (see Section 2.2.3).

The two dimensions applied in this model are the life cycle phase and the competitive position. With regard to the competitive position of the company, five positions can be distinguished (see Laukamm and Steinthal 1986):

1. dominant (quasi-monopoly)
2. strong (as a rule, large degree of independence from the strategies of the competition)
3. favorable (e.g. one of several market leaders in a fragmented market without any outstanding competitor)
4. tenable (e.g. specialization in a market niche)
5. weak (e.g. companies that are too small for the competitive dynamics in their sector, or companies that have made severe mistakes in the past).

This model displays a distinct conceptual similarity to the market growth/market share portfolio; however, the dimensions addressed here are more comprehensive than in the classic approach. From the evaluation of a market/SBU based on these two criteria, this portfolio derives recommendations for one of four strategic directions (see Figure 4-8):

1. progressive development (wide range of strategic options)
2. selective development (focus on particular segments or niches)
3. revitalization/proof of viability (significant improvement of competitive position or retreat to niches)
4. retreat (minimization of investments or exit).

At its core, the model states that the more advanced the life cycle, the fewer situations exist where a progressive development with a correspondingly high resource deployment would be feasible. Thus,

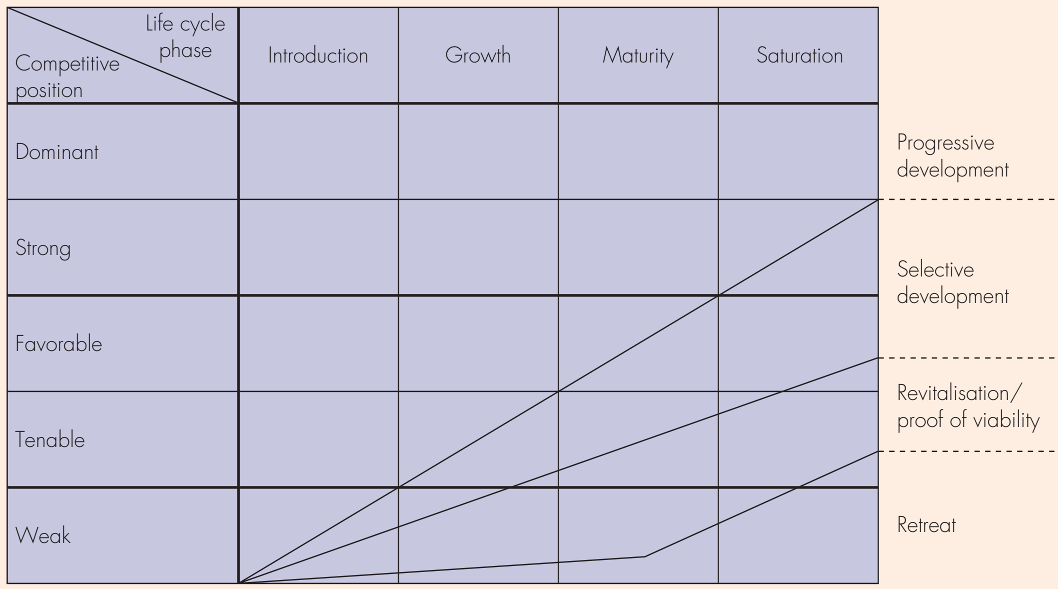

Figure 4-8 Strategic directions in the life cycle portfolio

such progressive development is considered to be more feasible in the introductory phase, virtually regardless of the competitive position, whereas in later life cycle phases, progressive development is recommended only in the case of a dominant or strong competitive position. In other words, this model discourages a costly rush to catch up in late life cycle phases. For more information on this portfolio, please refer to Jain (2004).

Despite the relevance of portfolio techniques for the design of the marketing strategy, a number of **weaknesses of portfolio analysis** have to be mentioned. When discussing the general deficits of portfolio analysis, a number of methodological problems should first be noted, including the dependency of the results on market definition, the issue of determining the cut-off points, and the sensitivity of the resultant strategy recommendations towards minor changes in data input. More severe than these methodological aspects, however, is the problem that the portfolio analysis neglects potential market, cost or technology-related synergies between the individual SBUs. For example, if synergies are significant, a market exit can be extremely problematic since other SBUs are likely to be affected by this.

In summary, the portfolio concept significantly contributes to systematic decision making pertaining to the central issue of resource allocation for markets. In view of this, it is not surprising that this method continues to play an important role in today's company practice for the design of corporate strategy and marketing strategy. In our opinion, an essential didactic benefit of the concept is that it clearly demonstrates to companies the importance of a well-balanced portfolio structure (especially when it concerns markets with different growth rates). The aforementioned problems do not pose a fundamental challenge to the portfolio approach, but rather illustrate that it should not be applied without reflection. In particular, portfolio analyzes should be accompanied by additional, and ideally complementary, analyzes (see, e.g., the methods described in Chapter 2).

4.3 Evaluating Marketing Strategy

Strategy formulation, as described here, frequently results in several alternative marketing strategies that can differ significantly or only gradually. It is therefore the company's task to evaluate the alternative strategies with regard to suitable criteria and select an alternative on the basis of this evaluation.

Marketing strategies can be evaluated based on both qualitative and quantitative aspects. During the course of a **qualitative evaluation** of the various alternative strategies, several aspects have to be considered. The **consistency** of the marketing strategy is the first issue in this consideration, which concerns maintaining consistency to the company objectives as well as to other strategies that are deployed by the company (e.g. business unit strategies). A second aspect when evaluating a marketing strategy is its **information basis**. The core question here is whether the marketing strategy has a sufficient information basis or if parts of the strategy were formulated based on managerial 'gut feeling'. An essential key aspect when evaluating a marketing strategy is an assessment of the **strategy content**. In this, the most important aspect is the extent to which the central strategic questions raised in Section 2.1 have been addressed adequately and to what degree those answers are feasible and useful. Furthermore, a marketing strategy should also be evaluated with regard to the feasibility of **strategy implementation** (see also Part 4 of this book).

Summary

In this chapter, we focused on the formulation, evaluation and selection of marketing strategies. First of all, a company has to define the strategic marketing objectives and the customer groups to be targeted in the marketing strategy. Then, a set of closely intertwined questions has to be addressed. Among them, the decision as to whether the company focuses mainly on providing core benefits to its customers or also offers additional benefits is of central importance as it influences the company's competitive strategy. Focusing solely on core benefits often goes hand in hand with a cost leadership strategy, whereas providing additional benefits can be the basis for a differentiation strategy. Another question concerns the innovation strategy to be pursued. The decision here is whether the company focuses on new products, new markets, or both. The Product-Market Growth Matrix has important strategic implications for this consideration. The next set of questions deals with aspects of customer relationship management (e.g. whether customer loyalty should be established with regard to the company or rather with regard to certain representatives of the company). Furthermore, it has to be decided what customer groups should be targeted and how customer loyalty should be ensured. As outlined in the previous chapters, strategy also has to consider the competitive environment. Key questions here are whether the company adopts a cooperative or hostile stance towards competitors. At the instrumental level, questions arise regarding product decisions, pricing, communication and sales. The key decision is to what extent the marketing mix should be standardized across different market segments or whether a customized development of different segments is more suitable. Finally, we presented two methods that can be used to support the process of strategy formulation. The strategic gameboard combines the market where competition takes place (entire market vs niche) and the business system (old rules vs new rules) in order to deduce appropriate strategies. The more quantitatively oriented portfolio technique helps to classify the attractiveness of different market segments or SBUs in order to derive optimal resource allocation decisions.

Case Study: Achieving Service Excellence Cost-effectively

An article in Harvard Business Review describes what is special about Singapore Airlines' (SIA) corporate strategy: 'Over the past four decades, it has earned a stellar reputation in the fiercely competitive commercial aviation business by providing customers with high-quality service [. . .] What's not so well known is that despite the quality of its services, SIA is also one of the industry's most cost-effective operators.'

SIA pursues a dual strategy which materializes through a combination of cost-consciousness and a desire to provide superior customer service. For instance, the company's plane fleet is regularly replaced by younger planes. Consequently, mechanical problems occur less frequently resulting in fewer flight delays and cancellations. Moreover, fuel efficiency of new planes is higher and the

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Case Study (Continued)

need for maintenance is lower. While overall servicing costs are held down, customers are also pleased by flying in new and modern planes.

As providing excellent service necessitates qualified people, SIA does not refrain from investing heavily: the company-owned school trains recruits in 'deportment, etiquette, wine appreciation, and cultural sensitivity'. Each of SIA's employees undergoes annual retraining of 110 hours. That all comes at a cost of $70 million annually. But the outcome of superior service quality not only pleases customers but also holds down cost as customer turnover is reduced.

SIA is famous for its innovations like on-demand entertainment systems in all classes. In addition to a highly structured company-wide innovation process, single employees, especially those with direct customer contact, are encouraged to contribute: 'Not only is this approach cost-effective, but the process ensures that innovations are developed in accordance with operational realities, making it easy to implement them.' Innovation at SIA is goal-oriented and mostly incremental. Only when the potential for differentiation is identifiable does SIA engage in technology leadership. On the contrary, in back office functions SIA is willing to deploy cheaper off-the-shelf systems.

The article concludes: 'Executing dual strategies is difficult – that's what makes the approach so valuable. By being different in ways that customers like, companies that do so rise from the pits of commoditization and make profits even in highly competitive industries.'

Source: Heracleous and Wirtz 2010.

Discussion Questions

1. Describe which basic competitive strategy SIA pursues.
2. What is the advantage of SIA's basic competitive strategy?
3. What could be problems and potential negative consequences of SIA's basic competitive strategy?
4. Assessing the design of SIA's product-price positioning strategy, how would you describe their positioning in the market?

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Key Terms

Acquisition of new customers *69*
Basic factors, performance factors and excitement factors *71*
Benefits *70*
Cash Cows *87*
Competitive advantages being pursued *72*
Competitive reactions *79*
Competitive strategy *72*
Competitors *79*
Contractual reasons for loyalty *79*
Cooperative conduct *80*
Core benefits *70*
Cost leadership *72*
Cost-related advantages *78*
Customer loyalty *78*
Customers/customer groups *78*
Defence mechanisms *80*
Development of existing customers *69*
Differentiation on the basis of superior customer relationships *73*
Differentiation on the basis of superior products *72*
Differentiation *72*
Diversification *76*
Economic benefits *71*
Economic reasons for loyalty *79*
Emotional benefits *71*
Functional benefits *71*
Horizontal cooperations *80*
Hybrid competitive strategies *73*
Innovate in markets *75*
Innovate in products *75*
Innovation orientation *75*
Lateral cooperations *80*
Life cycle portfolio *87*
Long-term business relationships *78*
Market development *76*
Market growth/market share portfolio *85*
Market penetration *76*
Marketing budget *82*
Mass customization *74*
Merger *80*
New game strategy *83*
Poor Dogs *87*
Portfolio technique *85*
Process-related benefits *71*
Product development *76*
Product–price positioning *81*
Psychological reasons for loyalty *79*
Quantitatively oriented concepts *85*
Question Marks *87*
Reasons for loyalty *78*
Recommendations for marketing management *83*
Resource allocation *85*
Sales-related advantages *78*
Social benefits *71*
Stars *86*
Strategic alliance *80*
Strategic gameboard *83*
Strategy formulation *68*
Strategy implementation *89*
Technical/functional reasons for loyalty *79*
Vertical cooperations *80*
Weaknesses of portfolio analysis *88*
What customer benefits the company should create *70*
Which market segments should be developed *69*

9780077146047_4_C04a.indd 92 11/6/12 4:36 PM

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End of Part 1 Case Study – Tesla Motors, Inc.: Silicon Valley is Getting Started to E-nable Mobility for the Masses

What to do with Internet Millions?

At the beginning of the 21st century Elon Musk must have thought to himself: “I know how to make quite some money with the internet. Now I want to make a real impact for mankind. I want to make the world a better place, a place worth living. And if that doesn’t work – I’ll better prepare for life on Mars!” For one of his major entrepreneurial endeavors he has borrowed the name of a remarkable man named Tesla. The name was chosen carefully.

Nikola Tesla, born 1856, was a mechanical and electrical engineer with exceptional creativity. However, when he worked for Thomas A. Edison, he would not pay him more than $14 a week. Blessed with a photographic mind, he spent a life inventing and discovering – and became one of the most famous inventors in the early days of electrical engineering. He paved the way for technologies which today are taken for granted by millions of people – such as alternating current (AC) or the radio. At the time of his death, he held more than 700 patents – just another reason why he is referred to as ‘The Man Who Invented the 20th Century’ (Schwartz 2012).

Groundbreaking inventions like Tesla’s require innovators who can take the heat of the market. A very special kind of today’s innovators can be found in Silicon Valley. They are well-educated and have made a fortune with internet companies. They bring in a lot of inspiration and they share the ambitious vision to make the world a better place. Just like Elon Musk. He could well follow the tracks of Tesla and become the man for the 21st century – and maybe make electric vehicles a worldwide success.

Elon Musk – A Man on a Mission

Elon Musk was born in 1971 in Pretoria, South Africa. At the age of 10 he got his first computer. He taught himself programming and roughly two years later, he designed a computer game which he later sold to a computer magazine for $500. Because he wanted to avoid mandatory military service under the apartheid regime in South Africa, he left home together with his brother at the age of 17 his destination Canada. In Canada he enrolled in Queen’s University in Kingston, Ontario, and took on smaller jobs – as an intern at Microsoft and as a programmer for a videogame company – before he was granted a scholarship from the University of Pennsylvania to study physics and economics (Chafkin 2007). Having earned undergraduate degrees in economics and physics from the University of Pennsylvania, he moved to California in 1995 to enroll in a graduate program in physics at Stanford University. He stayed for just two days (Crunchbase 2012). He quickly realized that he rather wanted to deal with things he believed would deeply impact humanity for the following decades: the Internet, sustainable energy (both in production and consumption), and space exploration (Milo 2010). And he somehow felt that he would miss a unique chance to be part of the internet revolution. That was when he and his brother founded Zip2 together, a company providing software for online publishing. Four years later Zip2 was bought by Compaq in a transaction worth $341 million (Crunchbase 2012) of which Elon Musk was pocketing $22 million (Chafkin 2007). His next venture aimed at revolutionizing worldwide online payments. For this reason, he founded X.com in 1999. After an acquisition, Musk was fired from the board in 2000 and the company's name was changed to PayPal (Chafkin 2007). However, the company was bought by eBay in 2002 for $1.5 billion in shares. At that time Elon Musk owned 11.7% of PayPal's shares (Crunchbase 2012).

These developments gave him the opportunity to dedicate himself to his other areas of interest. He founded Space Exploration Technologies Corp. (SpaceX) to build rockets and spacecraft to be sent into orbit and beyond. The objective was to commercialize space transport vehicles (SpaceX 2012). The company, for which he serves as the CEO and chief designer, has developed the 'Dragon' spacecraft which is reusable and therefore dramatically reduces costs of missions into space. The company has just recently completed a mission to the International Space Station (ISS) and has won a NASA contract of over $1.6 billion to operate further missions to the ISS (Schectman 2010).

Additionally, he is engaged as chairman and controlling shareholder of SolarCity. The company was founded by two of his cousins after Musk had the idea of a business model in clean energy services in order to build a retail brand for solar panel installation. The company not only handles the actual installations on customers' rooftops but also rebate applications with the state government, remote monitoring of the panels, and any maintenance (Chafkin 2007). SolarCity's mission is to make clean energy available at lower prices compared to fossil fuels and making the switch easy for customers (SolarCity 2012). The company has won contracts by homeowners and government agencies as well as companies like eBay, Intel and Walmart (SolarCity 2012) and it seems to prepare its IPO valuing the company at $1.5 billion (Levy 2012).

Finally, Elon Musk co-founded Tesla Motors, Inc. and is the company's chairman, product architect and CEO. Heading three companies, each with ambitious goals, leaves Elon Musk with 100 hours work per week – and the weekends with his 5 children in Disneyland (Oliver 2010). Having three fulltime jobs raised concern from some of Tesla's key investors. They even made Elon Musk's presence on the board a condition for further cooperation (Tesla Motors, Inc. 2010). It truly seems like Elon Musk warrants Tesla's success but poses a major risk for the company at the same time.

Tesla Motors, Inc.: Breaking the Mold in Car Manufacturing

Company overview & strategy

Tesla Motors, Inc. develops, designs, manufactures and sells electric vehicles and electric vehicle powertrain components. It was founded in 2003 and is headquartered in Palo Alto, California – right in the middle of Silicon Valley (GlobalData 2012). Its first CEO was co-founder Martin Eberhard. Elon Musk was the lead investor from the very beginning with an initial investment of $6.3 million. In 2007, after Elon Musk had invested several more millions in Tesla and overall investments were $100 million, the company suffered from huge cost and manufacturing problems – without having produced a single car. However, the production and quality problems got under control one after another and the first vehicles were delivered, resulting in very positive media response. Nonetheless, the company kept losing money and Elon Musk poured more and more money into the business and convinced other investors to do the same. In October 2008, Musk also took over as CEO of Tesla. In early 2009, Daimler decided to buy battery packs for the e-Smart worth $40 million and later that year bought a 10% stake in the company for $50 million (Davis 2010). This marked a strategic turning point providing Tesla with resources to further develop its product portfolio.

Musk thinks big with Tesla. He states that 'the overarching purpose of Tesla [. . .] is to expedite the move from a mine-and-burn hydrocarbon economy towards a sustainable, solar electric economy' (Tesla Motors, Inc. 2012a). In order to do so, three strategic phases were set up. The first objective was to demonstrate that electric vehicles are desirable and feasible – and can even be fun. That's what the first product, the 'Roadster', was designed for, targeted at affluent, technology addicted first adopters of the new technology (see Exhibit 1). Second, produce a luxury sedan on eye-level with BMW's 5 series or Mercedes's E-class. In the last phase, the objective is to 'produce hundreds of thousands of low-cost electric vehicles for the masses' (Davis 2010). According to Musk, he intends to finally sell electric vehicles for just $30,000, which represents the average price of a new combustion engine car today (White 2012). By 2012, phase one is completed – the Roadster sold nearly 2,500 times and is virtually sold out. To support the launch of phase two, Tesla received a $465 million government loan from an alternative vehicle fund in 2009 (Davis 2010).

Exhibit 1 Model 5 Signature
Source: www.teslamotors.com

Starting in a niche segment to subsequently explore the mass market is not a new strategy in other industries. It is, though, for the automotive industry. Electronic gadgets like MP3 players, smartphones, and 3D TVs, for example, are often introduced into a niche segment first before the skimming prices come down to a level where they become attractive for the majority of the market. This is how Tesla launched its Roadster. With time and accumulation of volume the cars are planned to be less expensive and the financial support for further developing the product portfolio comes from the first customers. Musk's mission will only be accomplished when the cars become less expensive for masses to be able to buy and drive them (White 2012; Oliver 2010).

The sales and service organizations of Tesla, Inc. differ from established car manufacturers. Instead of having numerous independent dealers, Tesla operates only company owned stores. George Blankenship, Tesla's vice president of worldwide sales and ownership experience, highlights that 'opening our own stores allows us to ensure customers interested in learning more about Tesla will receive an amazing customer experience from the moment they walk through the door' (Tesla 2012). Additionally, the stores are located in high-traffic locations, such as shopping centers, where people can walk by and inform themselves about electric vehicles. Musk says: 'We need to introduce people to electric cars, not expect them to come to us. The problem with car dealerships is that you've already decided what you want to buy before you even go there' (Bellini 2012). By 2012, Tesla owned 22 stores worldwide with main locations in the US, Europe but also in Asia. Four additional stores were planned to open by mid-2012. For service checks, Tesla owners can visit regional service centers. Moreover, Tesla has established mobile service teams which are based in service hubs. These teams can perform annual inspections, upgrades and other maintenance at customers' homes or offices (Tesla Motors, Inc. 2012b).

It is, of course, a giant step from a tiny garage, handcrafting some hundred Roadsters per year, to get to producing cars on a large scale. It is highly capital-intensive, especially building up production capacity. However, one day in early 2010 Toyota offered Musk to buy the NUMMI (New United Motor Manufacturing, Inc.) plant located in Fremont, California. The plant was equipped with two paint shops and a 50 megawatt power plant. It had a production capacity of up to 450,000 cars per year and a book value of close to $1 billion. Toyota and General Motors had closed the plant just before. Musk knew that the factory was more than perfect in order to grow Tesla's output and he also knew that potential buyers were rare as the crisis in the automotive industry was at its peak. So he offered everything he had: $42 million. In April 2010, Musk invited Akio Toyoda, the president of Toyota, to his house for breakfast to talk about cooperation possibilities. A Tesla Roadster that was parked in front of Musk's house caught Toyoda's attention and after the two took a ride Toyoda cancelled all meetings for the day. Whether it was Musk or the Roadster, Toyoda was thrilled. Four weeks later, it was announced that Toyoda had accepted Musk's bid for the NUMMI plant. Additionally, Toyota announced an investment of $50 million in Tesla and that Tesla would develop a prototype electric vehicle for Toyota (Davis 2010).

By the end of 2011, Tesla, Inc. had 1,417 employees. With regard to financial performance, revenues continued to grow. In 2011, revenue was $204 million as compared to $117 million in 2010 representing an increase of 74%. 27% of the revenue came from the development of services (2010: 17%). While gross margin was positive and was growing over the recent years, operating margin remained weak and below industry average. The same was true for return on equity. For the year 2012, significant revenue growth was expected due to new product introductions planned to be launched in the second half of the year. Revenues for 2012 were expected to be in the range of $550 to 600 million (GlobalData 2012; Tesla Motors, Inc. 2012c; see Exhibit 2 for details).

Exhibit 2 Tesla, Inc. selected financial data 2008–11

	2008	2009	2010	2011
Revenue	14,742	111,943	116,744	204,242
Gross margin	–3.67	9.77	27.18	31.04
Operating margin	–532.52	–46.36	–125.78	–123.13
Net profit margin	–561.54	–49.79	–132.19	–124.56
Return on Equity	–	–84.84	–74.54	–113.55

Sources: GlobalData 2012; Tesla Motors, Inc. 2012c; Tesla Motors, Inc. 2010.

Desirable products as the basis for success

Tesla, Inc. has built up enormous expertise for electric vehicles. The product range therefore comprises not only vehicles but also electric vehicle powertrain components and development services. For example, Daimler has purchased battery systems for the electric Smart and the A-class from Tesla. Daimler has also placed an order to develop a full powertrain including batteries, chargers, motor, gearbox as well as software. Additionally, Tesla develops powertrain components for Toyota's RAV4 EV.

The first vehicle which was developed, designed, manufactured and sold by Tesla is the high-end, high-performance ‘Roadster’ sports car. It is based on the chassis of the Lotus Elise because of its lightweight construction. Elon Musk was strongly engaged in the Roadster’s design. He included design elements of Formula 1 cars, a touchpad door latch as well as a lower door sill. All electric powertrain components were developed by Tesla, resulting in an uncompromising sports car which accelerates from 0 to 60 mph in just under 4 seconds and runs 245 miles (395 km) per charge (Tesla Motors, Inc. 2012d; Reed 2009). The Roadster was first delivered in early 2008, selling for $109,000, and it soon caught attention by affluent people as well as celebrities (Reed 2009). The car is assembled in a garage behind a Tesla showroom in Menlo Park, California (Davis 2010). Due to the licensing agreement with Lotus, the production is limited to 2,500 vehicles only. It is therefore expected that production of the Roadster will be stopped in the course of 2012 once this output has been achieved.

In March 2009, Tesla announced a luxury sedan named Model S (Reed 2009). The announcement represented the start of Tesla’s second strategic phase – competing with other premium brands like BMW or Mercedes. Prices start from $49,900 and the range is up to 300 miles (483 km). Deliveries were planned to start in mid-2012. Tesla has more than 10,000 reservations for Model S worldwide basically representing an interest free loan of $105 million due to customer down-payments (Tesla, Inc. 2012b). Tesla plans to produce up to 20,000 units of the Model S from 2013 onwards. The car represents a major milestone for the company as it is supposed to ensure Tesla’s long-term profitability and to prove Tesla’s capability of making electric vehicle mass compatible (Fehrenbacher 2012).

Finally, in February 2012 Tesla announced its third vehicle, the Model X, a premium SUV. One day after its presentation, Tesla had already received 500 reservations worth at least $5,000 and

Exhibit 3 The Tesla Roadster

Source: www.teslamotors.com

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representing potential sales of $40 million. It is based on the Model S platform, which allows Tesla to use, for example, tools and machines from Model S and significantly save costs. Prices are similar to the Model S and production will start in late 2013 with a planned annual volume of 10,000 to 15,000 units (Tesla Motors, Inc. 2012c).

Electric vehicles in general do not require space for exhaust pipes, thermal protection of the engine, or large catalytic converters (Davis 2010). That means, the design of electric vehicles offers the possibility to create something completely new – to redefine what cars can be. For example, the new Model S has an optional third row of seats – in a sedan which competes with BMW's 5 series or the Mercedes E-class. Additionally, combustion engines require a tunnel for the driveshaft and exhaust pipes. These make cars less stiff and create noise. In an electric vehicle, this is not required plus the battery pack sits on the floor of the car which brings the center of gravity down and makes the underbody perfectly flat. This results in higher stiffness of the chassis, less vibration, less noise, better aerodynamics, and optimized road handling characteristics (Davis 2010). Additionally, unlike combustion engines, electric machines provide torque and total power right from the start – fast acceleration and driving pleasure are guaranteed. These facts can indeed make a difference when competing with combustion engine vehicles.

Strategic Outlook

Now, what can Tesla, Inc. expect from the future? Will Elon Musk sell enough cars to make the world a better place? One issue for Tesla to solve will be to make electric vehicles a real alternative to combustion engine vehicles. Today, battery technology does not allow large capacities and therefore the range of electric vehicles is rather limited. Yet, there is a weak charging infrastructure and it takes hours for a full charge. Additionally, the battery is the most expensive component of electric vehicles and customers are not very confident about battery safety, recoverability and durability. Tesla seems to have identified some of these problems. The company is working on leasing and financing programs to make their vehicles easier to own. Additionally, Tesla plans to install fast chargers along major highways (White 2012). To do so, Tesla announced that it will unveil a new fast charging technology before mid-2013. This technology will enable a 300 mile/483 km range car to charge within one hour (Rechtin 2012).

However, input costs tend to increase, such as costs for rolled steel, aluminum, glass, and plastic. Over the last decade, producer price indexes for these products have increased by more than 85%. Additionally, there is a worldwide shortage of computer chips which are important components for battery managements systems and other components of electric vehicles. Tesla, Inc. has had major problems with operational costs in its history and together with increased input costs this could affect future margins (GlobalData 2012).

With regard to the operation of electric vehicles, car owners will require close service partners so that maintenance and repair works can be done quickly. It cannot be expected that customers will cut back their service expectations, which are based upon the extensive service networks they know from established car manufacturers. Therefore, it may pose a major challenge for Tesla to provide a widespread network of service partners.

On the other hand, there is increasing demand for fuel efficient, hybrid and electric vehicles as can be seen from Model S reservations. Tesla has built up enormous know-how in the area of electric powertrain components which opens up further cooperation possibilities and new markets. For many automotive companies, Tesla may be the partner of choice because it has a strong brand name as well as a global and unique market presence in the market for electric vehicles. This may, in part, be the result of Elon Musk's management capabilities. He has a successful track record of entrepreneurial endeavors and, among others, was awarded *Inc Magazine*'s entrepreneur of the year 2007 (Chafkin 2007), *Time Magazine*'s 100 people who most affect the world in 2010, and *Forbes* listed him as one of 'America's 20 Most Powerful CEOs 40 And Under' (Smith 2012). Musk was also able to hire other senior managers with a wide experience in technology, automotive and electric vehicle industries. The current management team brings in a track record in vehicle development, manufacturing, sales as well as service. Finally, the huge capital resources and the government loan can help Tesla to further strengthen their market position. As at December 31, 2011, available capital was $493 million (Tesla, Inc. 2012c; GlobalData 2012).

In the last years, however, Tesla, Inc. has reported a declining or constantly low operating margin. The –125.78% in 2010 was below the industry average in the clean technology sector of 1.35%. In 2011, operating margin was –123.13%, indicating inefficient cost management or weak pricing. Return on equity has equally declined in recent years. Figures for 2010 (–74.5%) were below the industry average of –2.0%. The return on equity for 2011 was –113.55% which indicated that other companies in the sector seem to use shareholders' money more effectively (GlobalData 2012).

The Automobile Market and the Market for Electric Vehicles

The automotive industry involves the production and sales of automobiles as well as retail activities such as gas stations and after sales activities such as spare parts and service. The industry is expected to grow at an annual rate of at least 5.5% in the years ahead until 2015. Total volume of the market is expected to be more than $5,132 billion by 2015. Regarding volume, Scotiabank estimates that car sales would total 58.89 million in 2011 and 62.18 in 2012, representing a growth of 5.6%. Particularly, rapid sales growth is expected from emerging markets, such as India (where sales figures have doubled since 2006), Brazil (which may become the third largest car market by 2016), Russia and especially China (Gomes 2012; Plunkett Research, Inc. 2012). The sales growth in China is stimulated by growing household incomes, low level of interest rates as well as subsidies for the purchase of energy efficient cars (Gomes 2012). The industry is strongly competitive and concentrated. It is mostly in the hands of major players like Toyota, General Motors, Volkswagen, Hyundai, and Ford. The biggest five companies together hold roughly two thirds of the global market (see Exhibit 4).

Exhibit 4 Approximate Global Unit Sales by Top Auto Manufacturers 2010

Manufacturer	Volume (million units)	Market share (%)
Toyota	8.4	15.6
General Motors	8.3	15.4
Volkswagen	7.1	13.1
Hyundai	5.7	10.6
Ford	5.3	9.8
Nissan	4.0	7.4
Peugeot	3.6	6.7
Honda	3.5	6.5
Others	8.06	14.9
Overall	53.96	

Source: Plunkett Research, Inc. 2012.

According to a study of the German consultancy Roland Berger, major trends of the industry until 2025 will be a shift of sales and production capacity to Asia, a decreasing motorization rate due to changing emotional preferences towards other products than cars, new business models such as car sharing – and powertrain electrification. Roland Berger estimates that by 2025, 10% of new car sales worldwide will be electric vehicles, 40% will be hybrids while 50% are combustion engine vehicles (see Exhibit 5; Roland Berger 2011). However, rapid growth for electric vehicles is only expected when more advanced batteries with enhanced capacity will become available at lower prices (Plunkett Research, Inc. 2012). Additionally, sales of electric vehicles continue to depend on governmental incentives, such as tax credits (Roland Berger 2012).

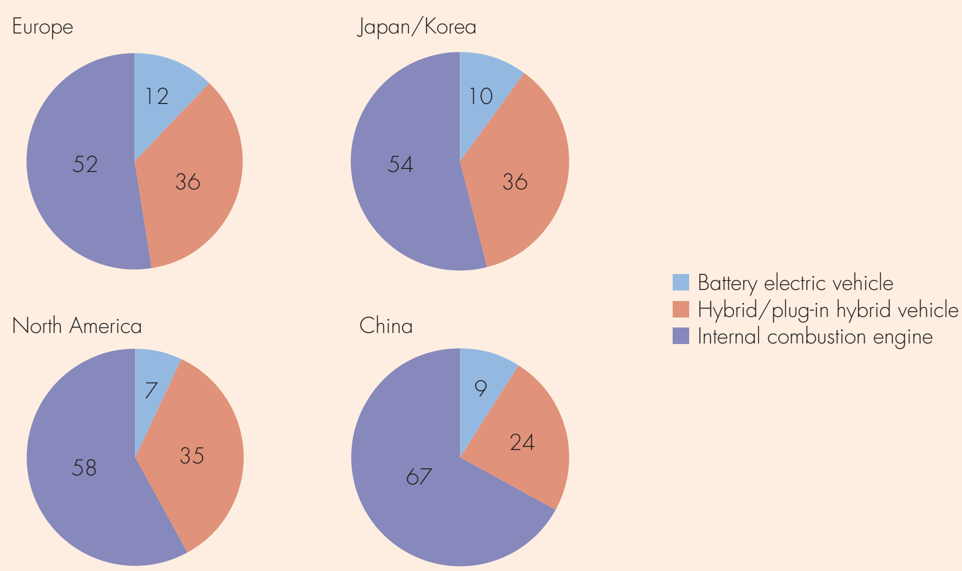

Exhibit 5 Powertrain hybridization/electrification in 2025 (market shares in %)
Source: Roland Berger 2011.

Saving the World may not be Easy – Challenges Ahead of Elon Musk and Tesla

So far, Elon Musk is well on his way to turn Tesla into his next success story. Yet, there are a number of challenges he has to master. It will not be an easy task when considering where Tesla started and how many cars they have actually produced to-date. Also, there are other companies that have a stake in this market. Tesla faces a marketplace 'crowded with electric car competition from big-league manufacturers like GM and Nissan' (Davis 2010). For Tesla's growth to take-off, it also needs to find a qualified workforce, deal with unions and suppliers for which 20,000 cars are not the most attractive proposal (Davis 2010).

And who ever said that a brilliant Internet entrepreneur will be a successful manager in the automotive business? Elon Musk should be well aware that making cars can be quite unrewarding: Too many players are chasing too few profits. The whole industry is forced to innovate, resulting in 'cars of ever greater

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sophistication, but which customers resist paying more for. [. . .] Scale is essential and earnings are modest, even for the industry's top players' (Davis 2010). Cars are also considered emotional products, making media scrutiny omnipresent. This puts car brands at risk – particularly an electric vehicle brand.

However, the biggest question is whether Tesla will be able to convince customers beyond first adopters. If you want to move the masses, it all comes down to the question whether the higher price of an electric vehicle will pay off due to the lower running costs of petrol-free driving (Reed 2009). It seems that the world cannot be saved easily.

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Discussion Questions

1. How can electric vehicles be a success? What are the main customer segments? Which of these are the most relevant for Tesla, Inc.?
2. Are electric vehicles a niche product? Estimate the potential global market size of the electric vehicle industry in 2012, 2020, and 2050.
3. Conduct a SWOT analysis and consider different ways of growth for Tesla Motors, Inc. How can Elon Musk accomplish his mission and make electric vehicles a product for the masses? Which factors may prevent rapid growth?
4. Who are Tesla, Inc.'s major competitors and how are they strategically positioned in the market in relation to Tesla? Who could pose a major threat and how should Tesla protect itself from this threat?
5. Discuss the market attractiveness of the electric vehicle market. Is it an attractive market for an investment? Could market entrance be worthwhile, both for niche players and for the established auto companies?

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