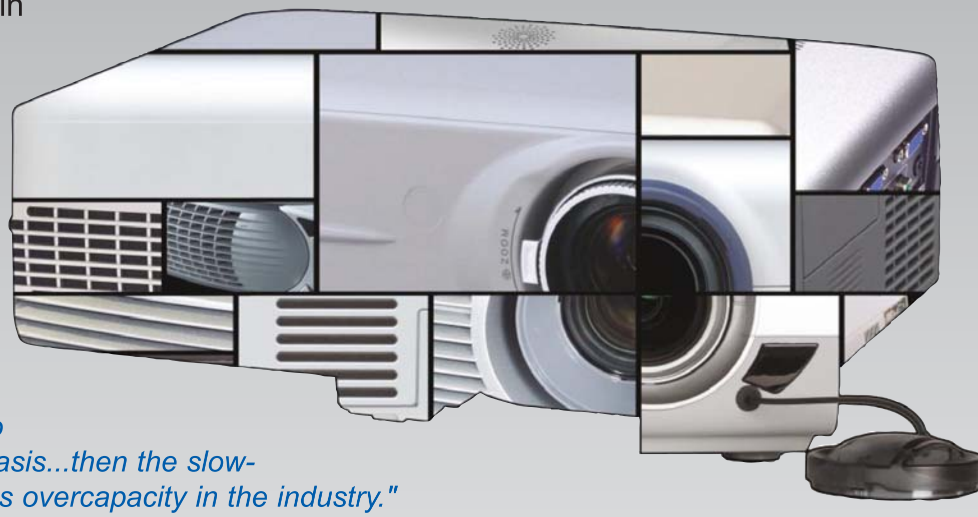
SURVIVING COMMODITIZATION

Manufacturers, distributors, and dealers all feel the heat when previously high-margin products become commodities. Yet with hard work it's possible to survive - even prosper - in spite of the profit squeeze.

by Don Kreski



"At some point, a product's rate of sales growth will slow down and the product will enter a stage of relative maturity...the sales growth rate starts to decline...sales flatten on a per capita basis...then the slow-down in the rate of sales growth creates overcapacity in the industry."

- Phil Kotler, author of Marketing Management

"If you're talking about deteriorating profit margins, it's the most efficient companies and the most efficient manufacturers that remain at the end. That's the case with every product line. There's no reason to believe that our industry will buck that trend."

- Mark Pickard, Toshiba America

Every product eventually follows the same lifecycle. First, there's the introductory stage, followed by a growth stage, maturity, and then decline. As products move through this lifecycle and become more accepted in the marketplace, quality, volume, and competition all increase as prices drop. At some point, manufacturing costs bottom out and price competition erodes profitability for the manufacturer and, consequently, everyone else in the supply chain. At this point, products become commodities with little margin for profitability.

"It's classic economics," says Alan Brawn, national product marketing manager for Samsung Digital Information Technology. "Three or four years ago you and I would walk into a Best Buy or a Fry's and we would see all these CRT monitors for $500 or $600. Now they sell for less than $200. These are very mature, very accepted products today, but they're not very profitable."

Indeed, many products in the pro AV market - CRT monitors and, some would argue, projectors - are reaching a state of maturity that greatly inhibits profitability. Even on the pro audio side, where technology typically moves much slower and product lifecycles are much longer, there are signs of maturity.

"There's significant excess capacity in the pro audio business," says Davis Merrey, president of Altec Lansing Professional. "By that I mean there are more manufacturers than needed to serve the market, and more people involved on the distribution end of it than are really required." As a result, the pro audio industry has contracted about 10 percent in the last two years, Merrey estimates.

Despite these telltale signs of market maturity, some people suggest that the pro AV industry is actually on the verge of a large expansion. Candace Petersen, worldwide marketing director for InFocus Systems, argues strenuously against the maturity or commoditization of the projection end of the business. Products are not commodities, she says, until 80 or 90 percent of them are purchased as replacement units. "By definition, commoditization only occurs when there's little value in a channel," she says. In other words, if there's a large segment of the market that will not buy because there's nothing in the category that meets their needs, it's not commoditization.

Petersen says that when InFocus introduced its first $999 projector in May, the company was targeting a large, untapped portion of the potential projector market, not creating a commodity. "If you look at the opportunity base for projectors, then the average life of a projector, you'll see that we're not penetrated yet," she says. "We have a growth opportunity in our industry at the lower end."

Fred Krazeise, director of strategic marketing for Sharp Electronics' LCD products group, echoes Petersen's sentiments. "The market for projectors hasn't begun to be made yet," Krazeise says. "With the breakthrough of the $999 projector, with Dell and HP and those mass marketers now involved in projection and display technology, we're really going to see the market grow. They're the ones that are going to be taking it to the broadest base of customers, because they have a tremendous installed customer base."

While market expansion on the low end is clearly underway, the consequences are not as clear. At issue is whether pro AV manufacturers and dealers ride the wave, or whether it's the computer industry and brick and mortar retailers that benefit most from this expansion. "On the one hand, these changes are frightening. But on the other hand, one of the immutable laws of marketing is that you want to expand the category, and the $999 projector certainly does that," Krazeise says. "The fact is that everyday we hear people asking, 'When's the fallout going to occur?' But I don't know that it is, really, because the penetration rate for projection technology is still relatively low."

And so we stand at a critical juncture in the pro AV market. At first glance, commodity pricing suggests that there's no future in projector box sales. But on closer inspection, the lack of penetration in the projector market would seem to suggest ample opportunity for manufacturers, distributors, and dealers alike. So which is it?

The manufacturer's perspective

One way manufacturers compete in a maturing market is to strive for greater efficiency. The largest manufacturers look for the low-cost labor markets to build their factories. This is particularly true in the most competitive product categories. Greater efficiency leads to lower costs, which can translate to better profitability.

Another possible strategy is differentiation. Altec Lansing's Merrey says many manufacturers are currently trying to take some of the labor cost out of installing their products. "We do this by packaging," he says. "For example, we sell ceiling speakers in a pre-assembled form, where the speaker comes with the proper transformer and grill already mounted on it."

The problem is that competitors are quick to imitate, making differentiation a tricky strategy. Mark Pickard, vice president of product marketing for Toshiba America, says his company is careful not to build too many features into its commodity-level projectors. "It can be unwise to add too much differentiation for that price band, because now you're reducing the value of your differentiation of the chain," he says. In other words, adding features to com-

modity products can simply commoditize those features. "You have to walk that tightrope," Pickard says.

The goal is to differentiate in ways that others either cannot, or will not, imitate. For Altec Lansing, that means moving a little outside of the mainstream markets. "There are two areas that we focus on. One is speech intelligibility. The other is efficiency," Merrey says.

A niche strategy may be the only option for smaller companies. However, larger manufacturers can strive for cost efficiencies with their low-end products and differentiation in the higher end. Brawn says Samsung uses the revenue from its more mature, lower-margin products to finance new product development. "The winners are going to be the ones who have figured out that they're not going to be able to fight the fact that a 15-inch display - and pretty soon a 17-inch display - is going to be a commodity, and at the same time say, 'What's the next big thing?' The profit in any company is what's next, though the commodities are what keep the lights on, keep the factories moving," he says.

Pickard believes that the manufacturer's channel strategy is the key to success. In the low-end SVGA projector market, Toshiba competes not so much on product, but on availability. "We have the good fortune of having terrific relationships with retailers, so we have better placement than most of our competitors," he says. "For low-end XGA, the effects are a little different because now you're primarily talking about the domain of the pro AV dealers...but there again, your differentiation is non-product. 'How good is your dealer incentive program? What kind of sales incentives do you offer?'"

The distributor's perspective

Like manufacturers, distributors have been affected by commoditization and the profit squeeze. ActiveLight, for example, has grown rapidly by focusing on the plasma display market, but CEO Brad Gleeson says the company's profits haven't kept pace with its overall unit and revenue growth. "There are more distributors carrying the product. There are more dealers sub-distributing products, and as more manufacturers look for distribution, smaller players step up to the plate and take advantage of that opportunity," he says.

How should a distributor react? "Short of buying all of our competitors," Gleeson says, "the only strategy that you can accept is one of increased operational efficiency. You have to make money on the buy, not on the sell. You have to reduce your cost of moving each box, and your profit has to come from customer retention, not spending money to acquire new ones."

Bill Mullin, sales manager for Starin Distributing, a Chesterton, IN-based AV products distributor, says he feels the same margin pressures as other distributors because there are so many offerings and points of delivery. He also has to deal with manufacturers in various states of anxiety and panic who are consequently expanding their distribution. The result, Mullin says, is that prices come down to their buoyancy level.

IN DEFENSE OF THE $999 PROJECTOR

When the subject of product commoditization is discussed in the pro AV market, it's not long before someone raises the issue of the $999 projector. For many, it symbolizes the issue. But not for InFocus, which reduced the price of its X1 projector below $1,000 in May.

To analyze the impact of the $999 projector, Candace Petersen, worldwide marketing director of InFocus says the first thing you need to do is look at the opportunity number, or the total number of projector units that could be sold. In the United States, Petersen estimates there are about 3.5 million classrooms, 3 million corporate meeting or conference rooms, and perhaps another million meeting rooms in hotels, conference centers and resorts. The opportunity number, then, is 7 or 8 million potential projector sales, "because you're basically replacing the installed base of overhead projectors," she says. Petersen estimates that about 1.8 million projectors were sold last year to professional users in the U.S., with perhaps 2.2 million more expected this year.

Once the opportunity is identified, the issue becomes how to prompt large numbers of new buyers to purchase projectors. Even though Epson was the first to launch a sub-$1,000 projector, Petersen says InFocus had been planning to make the move for nealy three years because she felt the $999 price point was of great significance in the marketplace. "I believed that this industry would follow the same model as Dell for PCs and even laserjets," she says. "Once you make them affordable at a good-enough spec, people will buy them. Sales should shift to first time users...and that begs the question, 'Do we want to make the pie bigger or do we want to just sit and have price wars and all argue over the smaller pie?'"

Part of the InFocus strategy was to force dealers and retailers to sell the product at $999, no matter what their markup might be. Petersen said she provided co-op funds to major electronics discounters so they could run the $999 price in newspaper inserts. The idea was that the end users would ask for the projector without a need for the dealers to push it to them.

InFocus measured its foray into this lower-price market very carefully. "When we launched the X1 at $999, we did a free, three-year additional warranty if customers registered on the Web," Petersen says. "Then I went back and surveyed them and asked were they a first time user and where they use the projector. If all I did was sell projectors to people who already had them, then I was playing a commodity game."

The results of Petersen's survey? "I will tell you that 75 percent of them were first-time users. We reached a new group of people who would not have purchased if the price point would have stayed at $2000," she says. Petersen adds that about two-thirds of the X1 projectors went into people's homes, with small- to medium-sized businesses making up most of the remaining third, together with a few small school districts and nonprofits.

"To me," she says, "it was a great experience. The survey proves that we didn't set out to learn how fast we can create a commodity and help everybody lose money. We have a growth opportunity in our industry at the lower end, because now the ROI makes sense to a whole new group of people."

Starin's survival strategy has been to add services - consultation, design assistance, and product training. Unlike some distributors, Starin has outside sales reps. "If you base your life on price, price is what you get," Mullin says. "If you base it on serving people in some way, you have something to build on."

Mark Wilkins, president of Stampede Presentation Products, a Williamsville, NY-based electronic display products distributor, has responded by attempting to expand the company's customer base by working with dealers in four areas: pro AV, PC, direct response, and home theater. Wilkins says much of Stampede's recent growth has come out of the home theater boom and consequently the company has focused much of its resources on developing home theater dealers.

Another growth area for Stampede has been installation. "A lot of pro AV dealers have a cost structure where they need to charge a high hourly price. But for a hang and bang, you don't need a $100-an-hour engineer," Wilkins says. "What we've done is offered a service where dealers can still take the simple jobs and make a guaranteed profit margin." As a result, Stampede has kept its margins steady while growing 30 to 40 percent a year.

The dealer's perspective

With the commoditization of low-end products and even low-end installations, one of the most common strategies for pro AV dealers is to focus on high-end products and services. To that end, many dealers have been working hard to transform their business strategy to systems integration. Dave Ferlino, president of Allentown, PA-based Vistacom, says his company does a lot of systems where the client is very dependent on technology. As dependence increases, he says, the client's need to focus on the price becomes less.

Yet some dealers continue to focus on commodity products. Joe Dowdell, Jr., vice president of Fox River Graphics in Carpentersville, IL, has engaged in an aggressive growth plan, hiring new sales people and beginning work on an e-commerce website. "It's the integration side that we're focusing on," Dowdell says, "but we still think there's some money to be made in the box-moving business."

At least two relatively new companies are trying to build nationwide organizations to compete more efficiently in both the box and systems markets. Ron Ellington, CEO of Denver-based USAV, a buying and marketing organization with 10 member dealers, says the dealers he's talked to are looking to carry fewer lines and concentrate on making good decisions about which manufacturers they want to work with in the long term.

John Godbout has turned his Scottsdale, AZ-based CCS Presentation Systems into a multi-office partnership similar to many franchise operations. He buys centrally for 10 dealerships with 24 office locations. As a result, Godbout buys better than most and probably has less overhead. While this strategy may not be for everyone, he says there are a number of areas where any dealer can add value. "When we sell to a school, we either sell an installation or we'll sell them on a cart, and we make more money on the cart than we will on the projector," Godbout says. "You can wrap services and other high-margin or reasonable-margin products around the projector."

That's not to say things are going to be easy. Sharp's Krazeise says that dealers should expect a lot of competition from the various channels. "The manufacturers have to allow their products to be sold in ways in which consumers want to buy them. That is obviously hard for our pro AV dealers to take. But it's a reality and it will continue."

The way for dealers to compete, Krazeise adds, is to add value in ways that discounters can't imitate. Networking is one area where dealers can differentiate their services. In the next two years, every projector above entry level will be able to access a network, he says. "Dealers really need to come up to speed on networking issues, and that can be one tremendously important value that they can add," he says.

Samsung's Brawn says services and programs are the keys to success for anyone in the pro AV industry. "The truth is that product is not going to be the differentiation anymore, because product in a very real sense has become a commodity at almost all levels."

Brawn also suggests that pro AV dealers learn to market their unique skills. "When somebody says, 'I can buy that plasma display for $2,799,' I'll say, 'Excuse me sir, but you can't afford to pay $2,799.' If they ask what I mean, I'll ask what happens when you've got a board meeting tomorrow and you need a product replaced?'"

While all of these strategies are likely to work for some, Godbout suggests that, in a tough market, it's the hardest working and most enthusiastic people who are going to succeed. "You've just got to get up in morning and go to work. It's amazing that so many people don't understand that," he says. "And it's top-end loaded. If the guy who's running the company is doom and gloom, then your company will be doom and gloom. If the guy who's running it walks around energized, your company will be energized."

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