L.E.K.

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Reaching for Value: Grow your business by offering less – and more

Most business leaders buy into the logic of differentiating their products from those of competitors, and offering more complete solutions to customer needs. But what if you find that other competitors with stripped-down offerings are gaining share? Does that mean you should abandon efforts at differentiation and switch to a simplified, low-cost product? If so, what should you do about customers who say they like the more complete, higher-value offering?

There are plenty of companies that put bare-bones offerings in front of their customers, and compete by offering an acceptable product at the lowest possible price. Think Southwest Airlines, most big box stores and e-commerce retailers, Motel 6 in lodging, and many retail banks today.

At the other end of the spectrum are the "deluxe editions." These are the companies that offer the most complete product or service solutions possible, and charge their customers accordingly. Originally, I wanted to cite Eos Airlines here – the airline that started offering the ultimate luxury flights between New York and London back in October 2005, putting 48 "Sky Suite" seats in a Boeing 757 designed to hold 220 – but Eos filed for bankruptcy and suspended operations in April. OK, scratch Eos. Think about successful international airlines like British Airways and Quantas. Consider high-service retailers such as Nordstrom, premium hotels such as Marriott, and the personal service of private banks, such as J.P. Morgan.

Now the question becomes, *How do you decide which way to go?* What factors, inside and outside your company, might push you toward either the "stripped-down" or "deluxe edition" approaches? Or, can you avoid this decision altogether by offering multiple tiers of service that attempt to meet the needs of customers from both ends of the spectrum?

Increasingly, companies are looking at ways to disaggregate service offerings that were previously sold as a packaged offering, with added features designed to provide differentiation against lower priced competitors. As an illustration, let's look at two pacesetting companies (PetSmart and PETCO) in an interesting industry: the pet trade. If you're an animal lover in the U.S., you most likely already know all about these two companies, and you may even have a sense of their respective strengths and weaknesses. For the benefit of the other half of the world, I'll summarize them briefly.

PetSmart, headquartered in Phoenix, is the world's biggest retailer of pet foods and supplies, with more than 1,000 stores in the U.S. and Canada, $4.7 billion in annual sales, and more than 38,000 employees. On the other hand, PETCO, headquartered in San Diego, whose sales, through its 850 U.S. stores – staffed by around 18,000 employees – add up to something north of $1 billion. PetSmart is publicly traded, whereas PETCO was taken private in 2006 by two buyout firms. Although PetSmart is substantially bigger than its rival, it doesn't perform

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significantly better along key retail dimensions like inventory turns, sales per square foot, or operating income per square foot.

Historically, PETCO tended to be the higher-priced, higher-service player, priced about 15% higher than PetSmart. In the middle of this decade, PETCO cut its prices somewhat to compete more effectively with its larger rival. But this move was obscured and offset by a bigger and somewhat contradictory trend: Both PetSmart and PETCO were moving toward offering a broader range of services to their customers. Strategists at both companies understood that pet lovers are, well, a breed apart. They want nothing but the best for their dog, cat, parakeet, or gerbil. With that in mind, both companies began offering a wide range of services, including grooming, obedience schools, vaccination clinics, photography, and "pet hotels" – a gentle euphemism for boarding kennels.

Even though the pricing for boarding services was comprehensive and relatively high, the initial response from pet lovers was enthusiastic. As PetSmart CEO, Philip L. Francis, told a researcher from Indiana University's Kelley School of Business in 2005:

> *About half of our hotel guests have never been publicly boarded or kenneled before When that statistic was shared with me, I was very skeptical, because I just couldn't believe people had stayed home the last ten years and were now suddenly travelling because they had a pet-hotel option. Focus groups indicated, however, that people didn't have boarding or kennelling options with which they felt comfortable . . . Now that our pet hotels are available, for the first time these people have access to a place they're comfortable with . . . We're really growing and creating a scalable business that didn't exist before.*

This success encouraged the strategists to think in even grander terms: Why not make our customers even more "comfortable" with the notion of public boarding? Why not even bigger kennels, with even bigger runs? Why not even more services built in, at an even higher price? Gradually, both companies upgraded their comprehensive pet-hotel services, nudging themselves even further toward the deluxe end of the scale.

But then something unexpected happened: Pet owners – formerly perceived as unrestrained spenders, when it came to their pets – decided that there were indeed limits. The pet hotels' "vacancy" signs started lighting up on a more and more regular basis. At least in this particular realm, both PetSmart and PETCO were becoming uncompetitive with the available alternatives – for example, paying the neighbor's kid to make sure Fido got food, water, and exercise while you were out of town.

In response, the two pet-care giants backed off. They recognized that the premium offering they had developed was out of reach for many of their customers. They trimmed their prix fixes services, and began pushing an a la carte menu. You want the longer run? You want Fido to participate in Doggie Playgroup? You want grooming? Fine. Each is available at an additional cost. In other words, PetSmart and PETCO decided to go with a low "headline" price, and then price extras at profitable levels. Through a disaggregation of services, the two companies gave their customers the chance to assign a value to each of those services – to say how much they would be willing to pay for each.

Another recent industry example of disaggregration of previously bundled products and services is the airline business. Not only have the U.S. legacy carriers been forced to reduce ticket prices for leisure travelers, but (as many of us have already discovered) they now charge extra for food, an exit-row seat, or even a checked suitcase.

Software companies as well, often incur extra costs once they have completed development of a new program. The extra spending is not to make the product better, but to make it worse. By figuring out ways to take out features while still retaining a core level of functionality, they can put a lower-end product within reach of price-sensitive customers without destroying premium pricing for those willing to pay full freight, Think, for example, of the home, education, and professional versions of Microsoft products.

How do you know whether offering this kind of disaggregated service offering is right for you? After all, there are plenty of examples where a one price, no-extras offering has been shown to have great customer appeal and good economics for providers. Here are four key questions that will help you decide:

1. How do customers measure value and compare different competitive offerings? What do customers look for as a headline price? How much do they value different features or built-in services? Early e-commerce companies figured out that search engines compared product costs, so they priced their goods accordingly, and made their shipping department the profit center. While it is possible to educate customers to focus on different price measures, it may be easier to talk in the language and benchmarks they are used to.

2. Are there large segments of customers with very different service needs? BMW was one of the first companies to include four years of scheduled maintenance in the price of all new cars. It works because almost all purchasers of a car costing $40,000 or more will want to have it professionally serviced. But if there are large segments of potential customers who would not value one or more features, then it makes sense to question whether those features should always be included, even if they can be provided at no incremental cost to the supplier (think of the software example).

3. Do our high fixed costs make it highly advantageous for us to attract incremental customers? Packaging a set of features that may not appeal to everyone, but is valued by some subset of consumers, often makes sense for companies selling manufactured products with high variable costs. But what about for fixed-cost businesses like hotels, airlines, software, and pharmaceuticals? For these types of businesses, it usually makes sense to broaden your appeal and maximize value from your fixed-cost investments.

4. Do we risk diluting our brand? Does American Airlines reduce the value of its brand by "nickel and dime-ing" its customers, reinforcing the idea that the world's biggest airline is no better than – and is perhaps worse than! – the so-called discount airlines? True, travelers who lack elite status, are forced to get on last, and sit at the back next to the lavatory, may have little loyalty left to any airline brand. But there are circumstances in which taking away an important service component can destroy the fundamental brand proposition. Wouldn't Home Depot suffer if – like Sears over the years – it unloaded all those knowledgeable sales people in the name of economy?

In the end, "less is more," Modernist architect Mies van der Rohe liked to say. But you can find 195,000 entries on Google for *more is more* – and 4.2 million entries for *enough is enough!*

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