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Leveraging market-based assets to de-risk the firm's operations

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Leveraging market-based assets

TO DE-RISK THE FIRM'S OPERATIONS

In times of uncertainty and volatility, the active management of market-based assets, such as brands and channel relationships, take on a new significance in managing risk.

By Rajendra Srivastava

Today's dynamic and ultra-competitive environments require managers to deal with volatile markets and minimise vulnerability to competitor inroads. Volatility has been defined as an indication of how much and how quickly a value, such as the price of a product, changes over time. It is governed by both variability and uncertainty, with variability describing the overall movement, and uncertainty referring to the unpredictability of the movement. The levels of volatility vary widely across countries, and it is essentially on account of these two elements—variability and uncertainty—that there is far more scope for volatility in the growing, emerging markets of Asia, as compared to say the developed markets of the West.

For example, when the U.S. began tapering off its quantitative easing programme, many emerging markets in Asia were at major risk. With interest rates remaining low, domestic private debt in the region had surged, as there had been an increase in foreign currency denominated external borrowing.[i] With the appeal of relatively high interest rates waning, these countries were no longer flush with foreign direct investment, and their fortunes changed dramatically, creating havoc in their currency and equity markets.

Secondly, many sectors of developing Asian markets are not as well known as those in the developed markets. When there is no previous comparison point, it becomes far more difficult to predict demand, thereby increasing uncertainty. This is particularly true for firms operating in sectors such as technology. BlackBerry, for example, was a market leader that did not heed the threat of rapidly emerging low-cost competition coming out of Asia, and went on to witness its product become steadily irrelevant within a decade.

> Volatility varies widely across all countries, and it is essentially on account of two elements—variability and uncertainty.

A third reason for demand uncertainty is because income growth in the middle class has fuelled increased consumption of consumer goods. Growth in consumer goods can therefore be twice as much or more than overall GDP growth. Even when these economies slow down, growth in consumer goods–though decreased–is still quite high by developed market standards. However, capacity development spurred by previously higher growth has resulted in short-term excess capacity. This puts considerable downward pressure on price trends that further erodes revenues and profits at the product category level.

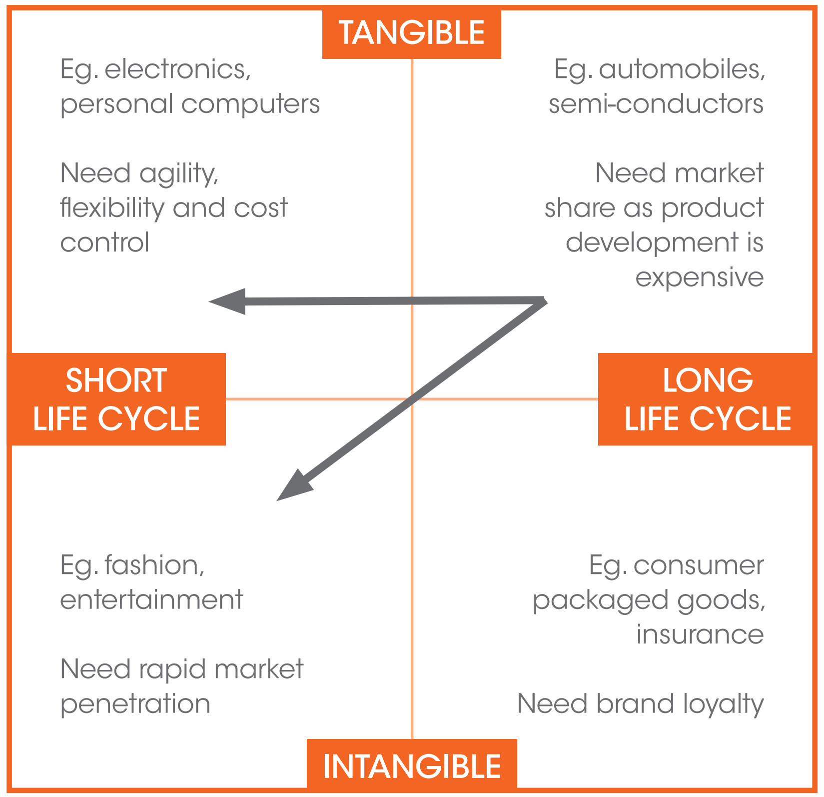
Finally, many companies in Asia are further back in the value chain. Typically, they have far fewer customers than those that are 'customer facing', such as in retail businesses. In such oligopsonic markets, the slowing down of purchases by even one customer can cause a huge setback to the business. This was seen earlier this year when Samsung lost the monopoly it held as the producer of Apple's microprocessor, to the Taiwanese firm, TSMC, which began supplying chips for iOS devices like the iPhone and iPad. The further back we go in the channel, the greater is this problem. In Asian markets, this in an important factor to consider as many Asian companies are involved in business-to-business (B2B) manufacturing–relying on big contracts from oligopsonic buyers–and thus intrinsically carry a far greater risk of volatility.

Volatility is contextual

In the last few years, there has been a shift from manufacturing to information- and knowledge-driven services, where the world is moving in a direction of progressively more value coming from intangibles. Product life cycles are getting shorter, and as they develop, economies are becoming more service oriented (refer to Figure 1).

Nonetheless, many Asian businesses are becoming further embedded in the top left quadrant, that is, of tangible, short cycle industries–which goes against the trend and adds to the risk– because for firms to succeed in the manufacture of tangibles, new product development is critical. However, new product development is itself becoming a riskier proposition with product development cycles becoming shorter, parallel development taking place (resulting in fewer go/no-go gates) and many low-cost global competitors quickly replicating new products. But while continuous innovation and differentiation is a must to reduce volatility in the West, in Asia, countries such as China, India and Indonesia are fortunately big markets, and so firms can operate more on scale rather than margins. And that may require product simplification as well as process improvement, rather than product innovation.

FIGURE 1: SHIFT TOWARD INTANGIBLES AND SHORTER PRODUCT LIFE CYCLES



Risk and management controls

Risk can be of several types, from a systematic risk that affects the macro-environment, to idiosyncratic firm-specific risk (refer to Figure 2). Systematic risk relates to where you compete, and consequently, the strategy to manage this risk is largely in the selection of the right product markets. Even then, as the 2008 global financial crisis has shown, sometimes it does not matter how well behaved the organisation is, a meltdown in the environment results in mayhem in all firms' markets.

Moreover, what might be considered a safe position today may well change in the future, because external factors such as technology can bring about industry evolution. For example, in the space of five years, Li & Fung has gone from a position of a dominant global supply chain manager and the darling of this part of the world to witnessing troubled times. This is partly on account of disintermediation, which has resulted in supply chain shrinkage and firms bypassing Li & Fung's intermediary role.

But while it may be harder to manage the systematic risk, firms can indeed manage the idiosyncratic risks at the industry as well as at the firm level. Asian emerging markets are especially prone to industry level risks due to competitive zeal: all too often, there is an abundance of companies rushing to enter a limited space. Hence while the Chinese automotive market has increased manyfold–China is now the world's second largest automotive market–so too have the number of competitors. This constant tussle for market share greatly increases uncertainty at the firm level.

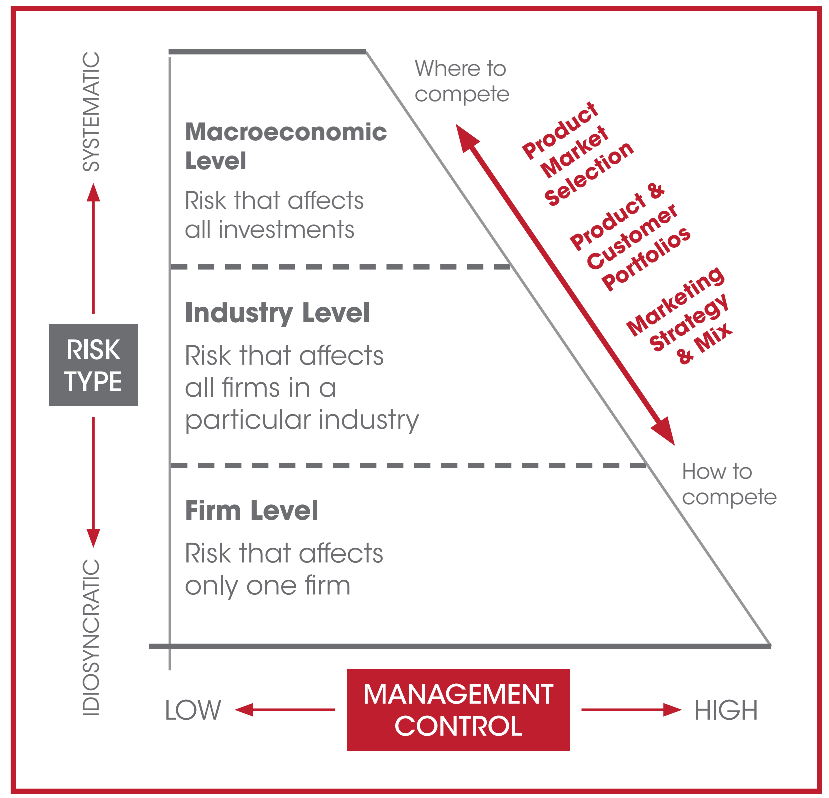
In other cases, uncertainty and risk may be self-inflicted. So while risk in financial markets may be higher than that for say, consumer goods (people do have to eat, before they invest), some financial institutions may elevate their risk further by serving 'sub-prime' credit customers in the pursuit of higher revenues and margins.

Similarly, many companies which operate in relatively stable consumer markets such as food and beverage rely on price-promotion to elevate demand. But this simultaneously increases demand variance, which might be mitigated by other companies using every-day-low-price (EDLP) strategies.

THE OPTIONS APPROACH TO MANAGING RISK AND UNCERTAINTY

There are many approaches to managing uncertainty and risk. Firstly, uncertain

FIGURE 2: TYPES OF RISK MANAGEMENT CONTROL



times demand insight. Anticipation of change enables the potential for an appropriate response. For example, it can be safely predicted that with ageing becoming an issue in many Asian countries, there will be an increase in demand for healthcare. So adding capacity and growing the business would be a safe bet for companies operating in this industry. Secondly, exploration of ways to reduce uncertainty and volatility, such as the EDLP strategies mentioned above. Thirdly, preparation for volatility by perhaps holding enough inventory to manage demand uncertainty. Hence, by and large, uncertainty demands flexibility and actions contingent on information. This is termed the options approach.

Put simply, the options approach suggests that, depending on the level of uncertainties, a firm may choose to either defer or exit from an investment (and the option captures the value of postponing the investment decision relative to investing today), or then exercise a growth option by making initial investments in an asset such that follow-up investments could be made at a later date.

In my view, under options thinking, uncertainty is an opportunity rather than a threat. For any outcome, there is an upside potential (performance above expectations) and downside risk (performance below expectations). The trick is to avail of the upside potential and sidestep downside risk–and while uncertainty clearly adds to the risk, it is also undoubtedly the best time for a firm to gain competitive advantage by managing that risk better than its competitors.

Using market-based assets to manage risk in volatile times

Amongst other strategies, such as improving agility and becoming a better sensing organisation, one of the most effective ways for marketers to manage risk is by actively developing 'market-based assets'.

Market-based assets are essentially the firm's connections in the value chain ecosystem. These assets are predominantly of two types: intellectual and relational. Intellectual market-based assets reflect the knowledge the firm possesses about its external environment, such as facts, perceptions and projections. The greater the knowledge, the better would be the firm's speed and accuracy of response.

Relational market-based assets refer to the interface of the firm with its key external stakeholders, and include both–customer relationships such as brands and installed customer base; and partner relationships including channels, co-brands and networks. By entering into such relationships, a firm would have greater knowledge of market conditions, lower inventories and several other advantages that can enable it to better manage its activities and ensure that the cash flows become more stable and less unpredictable.

Below are some of the key strategies suggested to reduce risk, specifically in the Asian context, by actively managing market-based assets.

INVEST IN CREATING A STRONG BRAND

In times of volatility, market cycles get shorter and more pronounced, and under such conditions, trust and strong customer relationships are important factors for survival. But in Asia, while customers may have awareness, preferences are not as well-developed as say, in the U.S. Still, a great brand addresses that challenge by creating strong market imperfections, providing opportunities for pricing flexibility, and

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generating a powerful attachment for the product. By creating differentiation, the brand ensures that commoditisation is overcome, which leads to a period of competitive advantage. High equity brands witness higher customer loyalty, and a lower churn. And in times of volatility, this is an invaluable asset.

CREATE A LOYAL CUSTOMER BASE

One of the best ways to deal with uncertainty is to create customer inertia, which slows market churn, and along with creating a well-established installed customer base, not only protects the firm's market, but also prevents competitors from attacking it. Back in the early 1970s, research showed that the churn rate of customers that had only a bank checking account was substantially higher than those who had a checking and savings account. And if the customers had three or more accounts, they could be considered to be effectively locked in. Similarly, free online bill payment services was another way that banks have retained retail customers.

Marketers have invested in a variety of programmes aimed at enhancing customer loyalty and switching costs by increasing benefits (e.g., Singapore Airlines' loyalty programme) and reducing risks (e.g., through unconditional money-back guarantees) to more loyal customers. Larger retailers often offer programmes where consumers collect stamps or points which are redeemable throughout a network. This provides a significant advantage compared to the single store retailer and enhances both desired loyalty and inertia. In addition, cross-selling and up-selling are two key market strategies that have been used by firms to retain customers—as has been seen in the case of Apple, which has migrated and moved its customer base from the iPod to the iPhone and on to the iPad.

Finally, as many of these companies are in the B2B space, there should be a strong value attached to long-term contracts—even if these are offered at a price concession. After all, the experience curve states that the more experience a firm has in producing a particular product, the lower are its costs. Hence, given that long term contracts are expected to lock in customers, they would provide a hedge against volatile demand, and reduce production costs.

BUILD CUSTOMER AND PRODUCT PLATFORMS

One of the most valuable ways for a firm to deal with multiple uncertainties is by creating shared product and customer platforms. Modular designs can enable this strategy, as the firm can design its products in such a way that they can be used in multiple end-use products. Honda, for example, deploys a small engine technology that supports multiple products such as cars, motorcycles, generators and lawn mowers. By doing so, Honda can better manage its risks and costs, by spreading it across several items in its product range. It can also help increase sales and enable quicker adoption of new innovations. Moreover, by using the same technology, it can out-spend competition even if it is a late entrant. This is particularly important for Asian companies that operate in the B2B space.

Firms can also take advantage of multiple product lines by creating unique product/service bundles, such as Microsoft's Office Suite, that others cannot easily duplicate.[ii]

SHIFT TO CUSTOMER SOLUTIONS AND BUSINESS OPTIONS

In the manufacturing space, offering services helps reduce volatility and vulnerability. This is one of the key reasons that the Finnish company, Konecranes, which had traditionally focused on manufacturing cranes, is now progressively moving to grow its revenue from services. This is also why a company like General Electric chooses to install its MRI machine at no upfront cost to the radiologist, and instead charges for maintenance based on its use—because it recognises that this results in a much longer term relationship with the customer than what would have been achieved by merely selling the product along with a warranty.

Thus, along with loyalty programmes, services are another valuable way to foster customer loyalty. It enhances customer 'stickiness' by taking advantage of synergies in providing a complete customer solution. This is why it is preferable to be an Original Design Manufacturer (ODM) rather than an Original Equipment Manufacturer (OEM)—as the latter simply manufactures to specifications provided—while the ODM has consciously moved up the value chain, and made the customer reliant for design capability too.

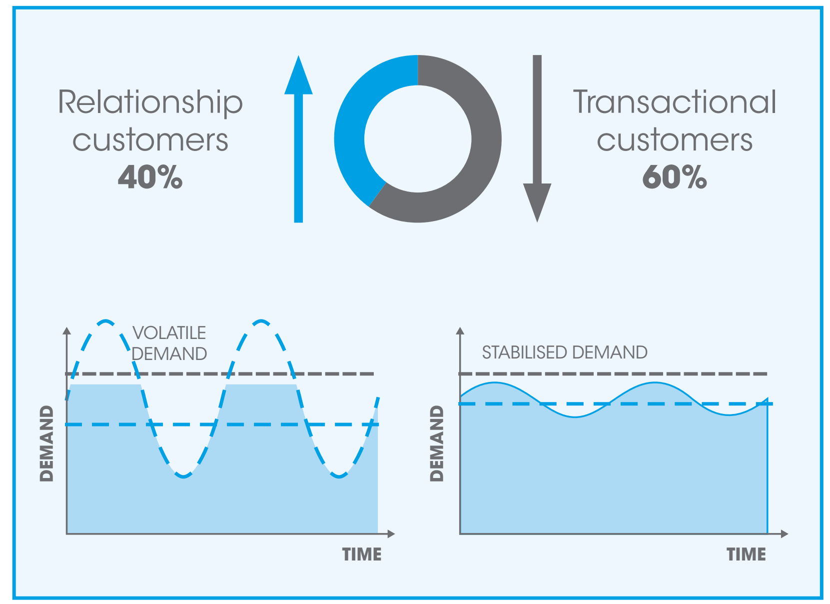
GET THE RIGHT CUSTOMER MIX

Firms should focus on not just the 'largest' customers, but those who would have the most to gain from their products. And typically, it is those firms that are not the largest that are hungry for differentiation. The other significant issue with focusing on very large customers is that it can result in very high dependency on that customer's fortunes, and whims.

Getting the right customer mix also means that firms need to move towards replacing transaction-based exchanges with relationship-based customer intimacy—and this is a great tool for the firm to de-risk.

For instance, suppose a steel mill, which is subject to customer cycles, supplies to an automotive OEM. Because it is very difficult for it to halt production and restart; even when there is a slowdown in the automotive industry, it has to continue with its operations. This results in excess inventory, which it sells to the distributor. And when the economy improves, the distributors start competing. In this example, the distributors are what we would call transactional customers, and the OEM would be a relationship customer. If the steel mill can consciously work toward increasing the proportion of its relationship customers, say from 40 percent to 60 percent, it would find that it has far more steady and strategic customer relationships to manage, as compared to dealing with the distributors who are transactional customers and more opportunistic in nature. The relationship customers thus tend to have a more stable demand, and are also far more loyal to the firm. Stabilisation of demand enables more efficient capacity utilisation (refer to Figure 3).

FIGURE 3: RELATIONSHIP CUSTOMERS VERSUS TRANSACTIONAL CUSTOMERS



However, it must be noted that transactional customers may have low loyalty, even if they are satisfied with the product. This anomaly tends to typically be found in commodity markets, or where there is low differentiation among the products and many substitutes have lowered the switching cost. An example would be the PC market, where despite being satisfied with one brand, the customer may not hesitate to replace with another brand. Hence, firms operating in such markets need to recognise that even though they have a strong product, they may not be in a position to retain a large proportion of customers. Thus creating differentiated products are a key means to reduce volatility. But referring back to the earlier discussion, sometimes it is a differentiated solution (such as the billing method, collections, delivery, service warranties, etc.) rather than the simple product that offers a tremendous opportunity to erect a competitive barrier to entry.

On a related note, some firms may choose to cement their relationships with particular customers by granting price concessions in exchange for longer-term purchase contracts. While this may work in the short-run, it must be noted that both the vulnerability and volatility of cash flows are undervalued when a short-term transaction perspective displaces a longer-term relationship mentality.[iii]

DEVELOP STRONG CHANNEL MARKET-BASED ASSETS

Managing relationships well in the distribution network goes a long way in reducing risk. Firms can increase switching costs with 'entanglement programmes', such as incentives or offering services.

The volatility of cash flows is also reduced when manufacturers reduce cash flow uncertainty by demand-driven flexible manufacturing. The logic is that the firm uses internal capacity to meet steady, repeatable demand; and outsources production to cover uncertain demand. Firms can also shift the risk to their partners where appropriate, and Li & Fung has done that very well with vendor-managed inventories. It has kept its core business model asset-light and flexible, by not owning any part of its production facilities. Moreover, the company decided that they would contribute between only 30 percent and 70 percent of a factory's production. This ensured that, while at 30 percent, the factories appreciated the importance of a contract with Li & Fung, by not taking on 100 percent of the production, Li & Fung did not become responsible for having the suppliers completely dependent on its order.[iv] Similarly, in April 2013, e-commerce player Flipkart operating in India launched Flipkart Marketplace, where buyers could deal with sellers directly. This way, Flipkart would be responsible for delivering the product but would no longer have its own inventory.[v]

It also helps when a firm is vertically integrated, particularly in adverse economic times. This gives it more control, flexibility and greater ability to absorb external shocks. However, it must be noted that this is a double-edged sword, as it may also increase the concentration of risk.

Firms in Asia must work towards bringing the consumer to the channel partner. This sends a strong statement that "not only will we give you the product to sell, but also give you the customer to buy it". The second half of this statement is very powerful, because it is only when customers start asking for the product that strong branding and customer loyalty takes place. And while most Asian companies manage the 'pull' side well, they are not very good at 'pushing' the consumer side (with the notable exceptions of some like Lenovo and Haier, which are getting better at managing the overall channel relationship).

RETIRE CAPACITY

Yet another way to reduce volatility is to retire capacity. The PC market, for example, was shrinking as low-end users migrated to tablets, resulting in unused manufacturing capacity. PC manufacturers began to heavily discount their products, which led to further price cutting. In this case, it would have been better if the capacity had been altogether closed out, or at least shifted to some other category. Of course, in some industries this cannot be done. For instance, in the hotel business, if a property is not profitable and is sold, chances are that it would be bought and used for the same purpose. It would be the same in the shipping and airlines industries. Hence, in some industries, capacity never disappears, and it is these industries that are far more risky whenever over-supply becomes a huge issue.

And in Asia, there is clearly excess capacity in a number of industries. For instance, the steel sector is straining under the pressure caused by years of excess steelmaking capacity, despite the Chinese government mandating that 80 million tonnes of capacity should be removed by 2018.[vi] Thus firms would need to take a close look at how they can close out or re-deploy their excess manufacturing capacity.

Learn how to defend your position in the marketplace

While the strategies prescribed for Asian companies to hedge against volatility and uncertainty are much the same as in western countries, the context is different. Asia is growing at a much faster rate. It is also subject to greater fluctuations, with large amounts of money moving in and out. Meanwhile many Asian companies are lower down in the value chain and engaged in B2B marketing. For these reasons, flexibility and market knowledge become critical. Effective management of the firm's market-based assets would be great enablers to achieving this.

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