MKT 455
Marketing Strategy and Analytics

Industry or Product Category Analysis

The marketing concept states that we should find out what our customers want and then give it to them. When we find out that what customers want is moving away from what a firm does, then the firm must start thinking about new directions for its business or businesses. As an example, consider American tobacco giant RJ Reynolds. Beginning in the 1960s, the government, insurance companies, and the healthcare industry began campaigns to reduce the number of Americans who smoked by pointing out the dangers of tobacco and by regulating tobacco products. While the U.S. tobacco industry fiercely fought the movement against tobacco regulation, RJ Reynolds took steps to insulate itself from what it saw as a long term threat to the viability of tobacco as a consumer product. In 1986, the company purchased Nabisco Brands, a maker of crackers and other snack foods figuring that as tobacco sales waned, they could eventually reinvent the company and protect their shareholders. Ultimately, that's not what happened. RJ Reynolds was purchased by private equity investors in a leveraged buyout, the new owners divested the food holdings and the tobacco industry continues to thrive overseas, even though U.S. sales have declined. However, the story gives one example of how firms look to their own and other industries as opportunities for growth or for survival. A few minutes on the internet could give you a thousand of other examples.

The point to the story is simple. Businesses large and small should regularly monitor and evaluate their own industries and other industries to see how the industries are changing and whether the long term prospects remain positive. Moving or expanding industries may be the only viable route to continued growth or even survival. These web notes discuss some common metrics for evaluating the attractiveness of industries.

For our purposes, we're going to replace the word "industry" with the term "product category," or just "category" for short. The term category is more commonly used in contemporary marketing than industry. To many, they mean roughly the same thing. Importantly, product categories are more focused on sets of competitors, irrespective of their industry. However, as we will learn later, not all firms in an industry compete with one another, and not all competition comes from the same industry. Nonetheless, the term category is more tuned to today's professional vernacular, so it will be ours.

THE MEANING OF PRODUCT CATEGORIES

The product category is an important concept because product categories help marketers do many useful things. As we will learn later, product categories provide a starting point for market segmentation. Product categories help marketers identify potential sources of competition, and by extension, opportunity. Product categories help marketers position their products and promote them more effectively. In this section, we'll look at the meaning of product categories with the goal of introducing some metrics and tools useful for analyzing a firm's current category or other categories that may be attractive to the firm.

The Meaning of Products

To appreciate the meaning of product categories, a good place to start would be to consider what a product is. To many people, products are defined by their attributes – what the product does, what it looks like, its features, etc. However, marketers should see products differently. Products should be defined not be their attributes, but by the benefits they provide. In other words, products should be thought of as "benefit delivery systems." We'll revisit this perspective when we discuss product strategy later this term. For now, the point to emphasize is that products should be thought of as ways to satisfy customer needs through the delivery of benefits and not by what the product is made of or how it looks. Let me give an example from a friend and former colleague. In his consumer behavior course, he liked to come to class with a cordless drill. He would show it to students and ask what students got it they bought the product. Invariably, they responded by shouting out things like, "a plastic case," "an electric motor," "a handle," "a trigger," "a battery," and so on. After students offered their thoughts, my friend would smile as he put a bit into the drill and drilled a hole into the classroom podium. Then he would say, "No, what you get is the ability to make holes." The point to his somewhat destructive example (which the dean's office later banned) was that the physical attributes of the product may change over time, but the benefit desired by consumers did not. Drills may one day have no motors or bits and may use laser beams to make holes. But the benefit the product satisfies does not change.

Now think about what people get when they buy other types of products. Consider a Rolex watch. What does the buyer get for their several thousand dollars? Does the Rolex keep time so much better than a Timex to justify the cost difference? How about the differences in styling? What buyers of Rolex watches get is probably better captured by how the watch makes them feel inside. The Rolex name and reputation evoke feelings of success, indulgence, and pleasure. Accurately telling time is probably pretty low on the list of benefits people desire when they buy one of these watches. Most people may think of Rolexes as watches. Marketers may think of them in terms of luxury, status, and reward.

The preceding raises another important point: benefits need not be practical or utilitarian in nature. A useful way to categorize benefits is to think of them as resource benefits, sensory benefits, or psychological benefits. *Resource benefits* are benefits of products that save the user some valuable resource, usually time or money. *Sensory benefits* are those that are experienced through one or more of the five senses. *Psychological benefits* are felt through emotional or mental processes. Products usually offer many benefits at once, though some are obviously more important to purchase than others. Marketers should think of products as "bundles of benefits" in order remain consistent with how their customers think. Customers buy benefits.

Benefits and Product Categories

With the preceding discussion in mind, we can now define product categories as *groups of products that offer similar benefits*. The idea is to consider your products part of a group or groups of products that do the same things for customers. The advantage of incorporating benefits into your thinking about product categories is you define the benefits that make up the product category. And because, in all likelihood, the other firms included in your product category will be pursuing the same customers as you, thinking about the product category in terms of benefits also helps identify current and potential competitors, which will be the subject of much discussion later.

In most cases, products in the same product category will be highly physically similar to each other. Thus, Rolex competes with exotic watches such as Zenith, Cartier, and Breitling. However, what about watch brands such as Timex? Although physically similar to Rolex, Timex does not compete because

they share none of the benefits that count to buyers. No consider this from another angle. What about Mercedes Benz as a competitor for Rolex? When you think about it, this actually makes some sense. Certainly, Mercedes is a closer competitor to Rolex watches than Timex watches. Therefore, it may under some circumstances be sensible to place Mercedes into the same product category as Rolex. Doing so may open Rolex's thinking to new opportunities. In all likelihood, there is a significant number of people who could afford a Rolex or a Mercedes, but not both. If so, these people may represent an opportunity for Rolex – or Mercedes if they're thinking the same way.

ANALYZING PRODUCT CATEGORIES

Whatever the reason for examining product categories, and as noted earlier, there are many, several metrics and analytical approaches are useful for understanding them. In this section, we're going to examine categories from an attractiveness perspective. A firm currently in a product category may wish to consider whether they should remain in the category, or example. Similarly, a firm seeking new opportunities may wish to evaluate other product categories.

Category Size

An obvious place to start is to consider the size of the product category. While this may seem relatively straightforward, it can become somewhat more complicated. Given the previous discussion about benefits and product categories, bear in mind that some firms would need to consider category size from potentially unusual perspectives. For example, if Rolex decided to try conceptualizing its product category as "engineered precision luxury items," then the category would be much broader than its traditional competitors. Getting a handle on a useful measure of size may be difficult and would require some judgment calls.

Product Sales. The most commonly used measure of category size would be how much product was sold in the category. Product sales may be measured in units or in dollars. The decision on which to use may rest in part with the role of price in sales. If prices among competitors in the category are relatively similar or if price does not vary much due to negotiation or discounts, then either unit sales or dollar sales are appropriate measures of category size. However, if prices fluctuate or cover a broad range among legitimate competitors, then unit sales may be a better measure of category size.

By either measure, large category size does not automatically equate to an attractive category. Large categories may have attracted large competitors, which may require large resources to get in or stay in. If so, companies eyeing these opportunities must have something compelling to offer customers and they must have the resources to promote and distribute it. If the category is crowed, they must also have the ability to cut price, because large crowded categories compete with discounts until some weaker competitors are shaken out.

Number of Customers. A more unusual take on category size is the number of customers who actually purchase in the category. This take on category size intersects with the notions of market and sales potential, as customer valuation, all of which we will cover later. However, the simple truth that not all customers are equally valuable to companies. The question from a category size perspective is whether less valuable customers can be made into more valuable customers. If the overall number of customers and the proportion of them that are not particularly valuable are both relatively high, then this measure of category size may be useful. Consider the diagram on the following page (Exhibit 1), which was adapted from Lehmann and Winer (2008).

Exhibit 1. Analysis of Category Size Measured by Number of Customers

The exhibit above shows how estimates of numbers of customers can be used to evaluate category size. Obviously, number of customers alone gives little in the way of information. However, when combined with total purchases, the information becomes insightful. Obtaining information about total purchases of all brands in a category may seem difficult, but chances are, enough data on purchases by amount or frequency can be purchased to make accurate inferences about the entire category.

The customers shown at the relatively flat part of the top of the curve represent loyal customer bases for the respective companies in the category. These are likely brand loyal customers for whom convincing to switch brands may be difficult or expensive. If many of my customers are brand loyal frequent purchasers, I can rely on the revenue from their purchases to grow or expand my brand. High potential customers purchase less frequently than the loyal bases, so while they have familiarity with one or more brands, their behavior suggests that they are not as invested in their purchases. Depending on the type of product an the ordinary purchase cycle, such customers may be grown into member of the loyal base. For companies considering expanding into a new category, the low or infrequent purchasers who make up the long term prospects may represent their best opportunities for getting a foothold and expanding. The customers are numerous, they are at least passingly familiar with the category, and their level of purchases suggests that they are unlikely to be brand loyal.

Bear in mind that the shape of the curve in Exhibit 1 need not be as it is shown. Data from different categories may well produce different shapes, which in turn would have different implications for whether the market size represents an attractive opportunity. For example, consider a curve with a large share of loyal customers and a smaller tail with fewer long term prospects. No matter what the raw numbers indicate about category size, a large share of brand loyal customers with few long term prospects would not bode well for a new category entrant.

Category Growth

If a firm currently operates in a slow growing category or is evaluating new categories for expansion, category growth will be key for evaluating long term prospects. Here we view category growth from two perspectives. First is growth itself, which is a relatively simple matter. Second is the growth rate in light of the category's stage in the product life cycle.

Calculating Category Growth. The formula for calculating a growth rate is straightforward enough and is given by the simple formula below where *t* represents the current time period.

$$Growth\ in\ Sales = \frac{Sales_t - Sales_{(t-1)}}{Sales_{(t-1)}} \times 100$$

The formula calculates what percentage category sales have grown from the previous to the current period. Importantly, the unit chosen for *t* depends on the circumstances. Usually with category growth, managers rely on years, however, quarterly or even monthly sales data may also be useful. Whatever unit is chosen, a single growth calculation will not paint a good picture of what's happening in the category. At least three period of growth calculations are necessary to even imagine a trend and even this is not much data. Ten years would be closer to a satisfactory amount. This way growth can viewed over a longer period to see whether any observed trends are likely to be transitory.

Growth and the Product Life Cycle (PLC). Many people erroneously believe that product life cycles are evaluated for individual brands. This is not the case. The PLC is intended to be a tool for evaluating product categories. That's because much of the changes in PLCs over time come from the introduction and removal of competition, which by definition requires more than one firm.

Exhibit 2. The Product Life Cycle

Exhibit 2 on the previous page illustrates the PLC. Note that no curves represent individual brand sales. Everything is shown in terms of the category. In the development stage, the product is not yet available for sales so to the market, the category does not yet exist. To the developing firm (or firms) it does exist and it is already losing money in the absence of any sales. Once the product is introduced, sales begin. At this stage, there may be only one brand in the category (called the *category pioneer*) but that usually does not last long. Before the end of the introduction stage, competitive brands may already be entering the category. Note that across all brands, the category still loses money. Launching new products requires significant investment and sales will be awhile catching up.

In the growth stage, category sales start to increase at an increasing rate. This is because, if the product is catching on with consumers, many competitive brands may jump in. Their combined sales pushes the category sales curve up rapidly. Losses reach their low point at the start of the growth stage. Early entrants are starting to recoup their investments and so losses moderate. The category usually becomes profitable at some point in the growth stage.

Category growth remains positive but begins to slow during the maturity stage. Profits also begin to rise. During this stage, brands that did not really catch on begin to close. Customers of these firms switch to surviving brands, making them more profitable. Both category sales and category profits reach their high points in the maturity stage. In a well established category, the cost of selling should be relatively low, meaning that firms milk their brands for cash during this stage.

Eventually category sales begin to drop. More firms begin to leave the category or close as they cut their losses. Perhaps they are turning to whatever product or technology that will replace the current category. Overall category profits may begin to fall, but for strong surviving firms, this stage may remain profitable for some time. Thus, for the overall category, sales and profits may be declining, but for the category leader or leaders, the category may still be producing solid results. Of course, at some point this will begin to fall off, even for the leaders. With good planning, that eventuality need not be traumatic to these firms.

The point to the PLC is to illustrate that categories experience periods of rapid growth, slow growth, and similar periods of decline. For firms seeking to enter categories, the category's position along the PLC will do much to predict future growth opportunities.

Category Capacity

Category capacity is a fancy word for the concept of supply. We recall from economics that when demand exceeds supply, prices rise and surpluses drop; when supply exceeds demand, prices drop and surpluses rise. When it comes to entering or remaining in product categories, the amount of supply or capacity in the category is critical as is the timing. As economic theory describes, over time supply and demand try to match each other in what economists refer to as equilibrium. Equilibrium occurs when supply just matches demand at a price that just clears the market with no surplus and no unmet demand. In the real world, of course, this does not happen except when considered in the long term.

In the context of category capacity, we think of this as attempting to match sales with capacity. The issue is frequently that capacity takes time to create. For example, consider cruise line cabins. If cruise lines are selling out at prices that meet or exceed profit goals, they or new entrants have an incentive to add capacity. The problem is that, this case, capacity may take several years to add, and conditions may change in the interim. Generally speaking, manufacturing capacity takes time to add while retailing or distribution strategy may be added more quickly.

Competitive Intensity

Category attractiveness can also be evaluated in the context of Harvard University professor Michael Porter's (2008) famous "Five Forces Model." Porter's model predicts the conditions that increase competitive intensity in a product category. The more intense the competition in a category, the less attractive the category is. Porter demonstrates that intensely competitive categories are less profitable, which makes sense. Competition may save consumers money, but it costs firms money.

Exhibit 3. Porter's Five Forces Model

While the specifics of Porter's model, which are beyond the scope of this discussion, can get complicated, the basics are straightforward. Firms facing the potential of new competition, either from new category entrants or from substitutes, must prepare for increased competition, which is expensive and reduces profitability. Categories with lower threats from new entrants or substitutes are those where economies of scale are rewarded, capital requirements for entry are high, and where customers significant costs to switch brands.

Powerful customers mean lower prices for the goods they purchase. Wal-Mart is now the classic example of this; the discount chain has a reputation for beating up suppliers to save every penny possible. Large buyers or categories where there are few buyers typically increase buyer power. Also, when buyers can easily switch to other suppliers tends to increase their power. Powerful buyers tend to pit their suppliers against each other, increasing competitive intensity in the category. An analogous set of circumstances increase supplier power in a category. When suppliers are few or suppliers have high market share, they tend to have high bargaining power. Suppliers selling highly differentiated products tend to have more bargaining power because the differentiation makes their products relatively unique.

References

Lehmann, Donald R. and Russell S. Winer (2008), *Analysis for Marketing Planning* (7th ed.). New York: McGraw Hill.

Porter, Michael E. (2008), "The Five Competitive Forces that Shape Strategy," *Harvard Business Review*, 86 (January), 78-93.