THE INNOVATION MISSTEP

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Abstract. *The author makes the case that cause of innovation to battle commoditization is far too often lost even before it starts. The dysfunctional distribution system has been turned on its head as distributors have wrested control of the strategic prerogatives of manufacturers in order to capture a disproportionate share of the value of the supplying company's products. Mega distributors like Wal-Mart Stores Inc. and Home Depot Inc. end up profiting at the expense of their vendors, and manufacturers earn little or nothing on the sale of their own innovated products. The mega distributors not only control the delivery of their products to consumers but also wield tremendous power over their internal processes, further reducing the value of the innovation. There is some hope: if done right, manufacturers still possess the ability to directly influence what happens to their innovations products once they enter the distribution chain, but, this window is rapidly closing.*

Keywords: innovation management; sales and distribution strategy; direct marketing; channel control.

The conventional wisdom states that innovation is essential if companies want to stay in business because global competition is turning many products into commodities. Innovation is pushed as the best way to stay ahead of the competition and deliver high value in a global marketplace.

Dishearteningly, however, the practice of innovation has often come up short. The problem is not that companies are falling behind in their ability to innovate. Rather, the issue is that innovation is simply the first step in a two-step process, and if the second step is missed, all of the blood, sweat, tears and money that poured into the product in the first place are likely to be wasted. Many firms simply do not demonstrate an interest in capturing the real value of their innovations. Instead of reaping rewards from their efforts, these companies have allowed third parties to take over their products and processes. With the hope of huge sales, large market shares and above-average profitability, innovators have repeatedly missed the all-important „second step" in the innovation process: controlling their innovation as it moves out of the factory and into the hands of the customer. Such a misstep can actually accelerate the path to commoditization for an innovated product.

1. The Dysfunctional Distribution System

Many companies that at one time built innovative products that could command high prices have long since abandoned this corporate strategy, settling instead for higher sales volumes, lower profits, loss of control and ultimately commoditized products. This has occurred through a systematic process in which huge mass-marketing retailers have used disproportional buying power to disable the strategic goals and imperatives of their suppliers.

The origins of the current arrangement began several decades ago when producers lost interest in managing sales and distribution, in favor of a new managerial paradigm that emphasized core competencies, innovation, technology and operational effectiveness. By identifying and exploiting their internal capabilities, businesses would be able to manufacture products for new markets, create significant benefits for end users and make imitation difficult. New products produced at a lower cost would be the ultimate result for companies that pursued this course.

Capitalizing on this emerging dependency relationship, the newly empowered large retail chains and mass discounters quickly evolved into what are called the Mega-distributors. By the beginning of the 21st century, these mega-distributors (the Megas) were the dominant players in the American and much of the global economy.

By catering to the mass market, innovators are allowing mega-distributors to capture the value of their products, even as the Megas impose costs and changes in strategic direction and operational control. Too often, the innovations of producers pass from their ownership and control into a form of property held, for all practical purposes, in de facto with the mass marketers. The innovation is enjoyed by numerous customers, the Megas profit handsomely by selling the innovation while insisting upon ever greater price reductions, and the innovators work like dogs to keep up with the demands of their „partners," all the while watching their innovation get treated more and more like a commodity.

2. How Distributors Cherry Pick Innovation

The dysfunctional distribution system has created conditions in which the Megas can literally pick and choose the innovations that they wish to dominate. Many promising new products are now identified and controlled by the mass marketers almost at will. Until the 1980s, auto retailing consisted largely of independent dealerships that relied mainly on selling one Detroit or import brand for their livelihoods. These dealers, who could not match the economic power of Ford or GM or Toyota, had to follow the dictates of managers in Detroit and Japan. The large auto makers had the power to make life very easy or very hard for automotive distributors.

Beginning the late 1970's, In order to boost fledgling sales manufacturers originally permitted their dealers to sell other brands if those brands did not constitute direct competition. As a result, Ford car dealers could sell GMC trucks and Chrysler dealers could now sell Pontiacs. Over time, the ability of manufacturers to exert control over their dealers began to erode. Because everyone was eventually selling everything, manufacturers were did not intervene because they were afraid of losing short-term sales and alienating long-term customers. The shift of power away from the innovator to the distributor was now underway.

The inevitable outcome was that instead of the exclusive, dedicated dealer who sold only one line of vehicles, dealerships now were able to evolve into super stores selling multiple brands (Mercer, 1994).

For Detroit, only two options were left when control over the dealer network was compromised: drop the dealers and create a completely new sales and distribution network, or learn to get along with the new power structure.

Not wanting to start over, Detroit chose to stay with the existing dealer network. Logically, the evolution of multi-brand dealers continued as national, mega retailers like Auto Nation were able to sell an array of models from different manufacturers. For firms like Auto Nation, who represent multiple manufacturers in many states, the only brand that matters is the one serving its purpose at a particular moment in time. Because these firms manage a portfolio of brands, they are able to quickly adapt and respond to changes in the marketplace. If there is a new model change at Ford that the buying public does not like, or if Ford's innovations are good, but not as good as their competitors, Auto Nation can seamlessly shift to selling „better" Chevrolets, or Dodges or Hyundais. Customers will still buy, revenue will continue to come in, and the dealership will continue to grow.

But what about Ford, the company that spent the billions to „innovate" new model changes and has now realized that the marketplace is not overly excited about the improved product? What can it do? Ford only produces and sells Fords. Still, the company has borne the risk, dealt with the lawyers and government safety inspectors, spent tens of millions on engineering tests and designs, conducted thousands of hours of costly market research, sourced new parts from suppliers, and retooled its manufacturing processes. All of this was done in order to bring new innovations to the marketplace. But because Ford cannot influence customers like Auto Nation in a meaningful way, it is always under pressure to cut costs, pressure suppliers and offshore jobs.

3. Doing It the Right Way

Some producers are able to capture the value of their innovations and avoid the commoditization trap. These manufacturers recognize the critical importance of controlling what happens to their innovated products throughout the sales and distribution chain. Notwithstanding the challenge presented by the Megas, it is possible to ensure that firms protect the created value that they have placed in their products and processes. It is proposed that innovative firms consider the following four suggestions – what might be referred to collectively as the „second step" in the innovation process.

3.1. Monitor and Control Your Distribution

In order to capitalize on your innovation, you must control distribution. This does not mean that you should (necessarily) sell your product in your own retail stores. But it does mean that you must be determined to monitor and control distribution, regardless of the channels used to bring your product to market.

In some situations, this may mean striking strong deals with distributors and holding the line. In others, it may mean avoiding certain distributors all together.

Sometimes this may involve owning the distribution channel. Strategic innovation is necessarily paired with the ability to sacrifice sales, market share and short-term profits, in order to retain the value of your innovated product.

3.2. Create the Channel Yourself

The determination to control distribution may mean that you must create your own direct channels in the marketplace.

Channel creation can be costly both in terms of resources and determination, but can be an effective way to bypass the demands and limitations placed on producing firms by the Megas.

When Mars created an ice-cream treat based on its popular candy bar, it had every reason to expect a hefty payoff from its first-mover advantage status. However, when it introduced its major innovation (and new product category) into the U.K. market, the American firm's initial efforts failed because Unilever had tied up all of the appropriate distribution channels in Britain. Unilever owns the Walls brand of ice-cream products, including the best-selling Magnum ice-cream bar. The marketing power of this large multinational corporation kept Mars out of the freezers that accounted for 50% of in-country sales. The other large distributor, Lyons Maid, allowed Mars to stock only one of Mars' five ice-cream products its freezers (Liesner, 1994). Mars responded by spending (pound)5 million on installing 26,000 freezers in retail outlets throughout the U.K. By 2005, Mars had the best-selling ice cream bar in Britain. Mars, like Nike, was able to bring its innovation to the marketplace by investing in a channel that it could control. This was an expensive proposition, but one that gave its product a chance among consumers.

3.3. Don't Make the Same Mistake Twice

If you have already made the innovation misstep and are in the process of losing control over distribution, chart a new course with your next product innovation. Perhaps no other company in America more readily epitomizes innovation than does Apple. The firm serves as the archetype of core competency based innovation. Once viewed as a computer business, Apple has leveraged its capabilities in order to create previously unimagined new markets through a succession of amazing products.

The initial arrival of the iPod revolutionized the personal music industry. For the first few years of its existence, the iPod dominated the MP3 category. Not surprisingly, however, few customers today view the iPod as anything other than a commodity(Is that really the case? The price of the iPod hasn't fallen and it has tremendous cachet, much more so than any competing product. Plus, it commands a huge share of the market.) The iPod's dominance of the category and the value of the innovation has been usurped by the tens of millions of music phones and stand-alone MP3 players. Although estimates are hard to glean, the iPod is at best a niche in an increasingly commoditized market. When Steve Jobs announced the creation of the iPhone in January of 2007, he said that Apple itself views MP3 players and music phones as part of the same market (Jobs, 2007). If that is the case, then iPods enjoy only about a 10% market share – which is getting smaller every year – as music phones and other MP3 players proliferate. The iPod has been sold at Target, Amazon.com and Best Buy stores for years. Each of these outlets, which also sell directly competing products, provide no after-sales support and customer training on how to fully use the device. In such scenarios, commoditization is much more likely to occur.

This may help to explain why Apple's new iPhone is tightly controlled with regard to its sales and distribution. The only other non-Apple „bricks and mortar" place to buy an iPhone is at one of the 2,100 AT&T stores across North America.(The iPhone is also available at Apple's proprietary stores and via Apple.com). Each buyer will interact with a customer service specialist who has been exclusively trained on the benefits and use of the iPhone. Apple (the manufacturer) and AT& T (the distributor) will be in alignment as to their long-term interest in the iPhone's success. The Megas will not get their commodity-driven hooks into the iPhone – at least not in the beginning.

3.4. Direct Marketing Can Be the Best Option

The best way fully exploit your innovation may be to sell it directly to customers via the Internet, in-bound call centers, or direct mail. As tools like CRM software, database-management programs, and Web-based customer-service aids (each commoditized already) become more affordable to businesses of all sizes, the possibility of directly targeting a company's micro-market comes well within reach. The benefits of customer intimacy, loyalty and word-of-mouth advertising that are achievable with effective direct marketing should make it a top consideration in efforts to avoid the trap of losing control over innovated products.

4. Conclusion

Innovative companies are often focused on invention, research and product development, even as they neglect the process of bringing their products to the marketplace in a way that is advantageous over the long haul. At the same time that innovators invest resources into making a better mousetrap, other firms specializing in sales and distribution invest resources into strategies designed to shift profit from the producing company to themselves. While producing firms use their energies to create amazing new products, the mega distributors use their energies to successfully leverage bargaining power in order to capture the value created by both process and product innovations. Over the past 30 years, the ability of the mega-distributors to do this has perhaps proven to be the greatest innovation of them all.

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