

## SECTION ONE

# DEVELOPING A MARKETING STRATEGY

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## CHAPTER 1

# CREATING CUSTOMERS AND SHAPING THE COMPETITIVE GAME

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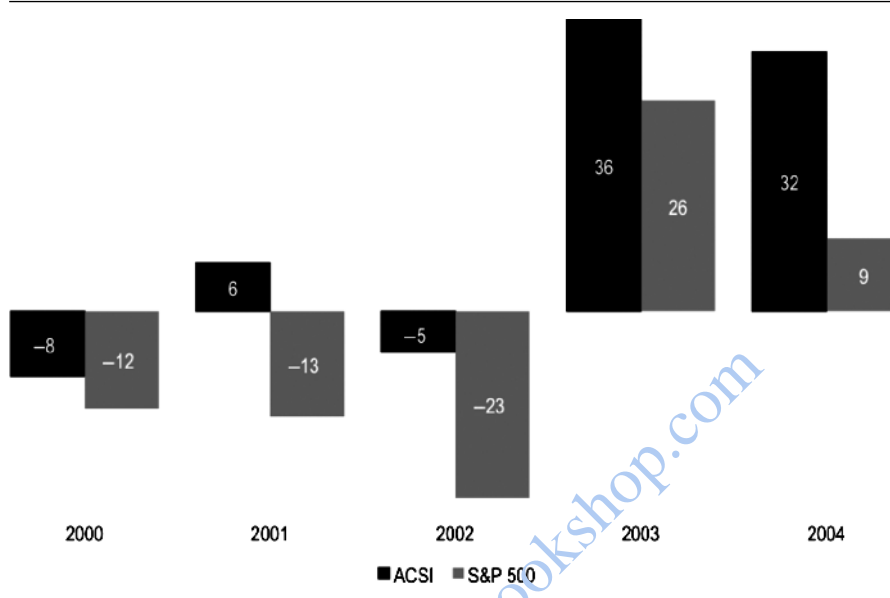
### INTRODUCTION

In his landmark, *Management*, Peter Drucker wrote about the purpose of business—not *a* business, but *business*. Contrary to the commonly held view that the only meaningful purpose of business is profit, Drucker articulated what we recognize today as the marketing concept: “There is only one valid definition of business purpose: *to create a customer*. . . . The customer is the foundation of a business.”<sup>1</sup> According to this view, products, technology, or brands do not, per se, produce profits. Products, technology, and brands are all devices through which an organization creates value for its customers. Profit and success are *outcomes* of creating customers and of successfully managing that process, which is not simply the responsibility of a marketing function. “Marketing is so basic that it cannot be considered a separate function,” Drucker continues. . . . “It is the whole business seen from the point of view of its final result, that is, from the customer’s point of view. Concern and responsibility for marketing must, therefore, permeate all areas of the enterprise.”<sup>2</sup> In Drucker’s view, only marketing and innovation generate revenue; all other activities are simply costs.

The concept Drucker advanced has become *the* central concept of marketing and, as originally envisioned, it has moved beyond its functional limits to become increasingly important as a central concept of management.<sup>3</sup> The diffusion of the marketing concept has been fueled by mounting evidence of its value. Leading scholars and consultants have written for years about how a market orientation is central to organizational success.<sup>4</sup> But much of

## KELLOGG ON MARKETING

**Figure 1.1**  
**Customer Satisfaction and Return on Investment**



the evidence they cited was anecdotal. More recently, however, empirical evidence is demonstrating what others suspected but were unable to state with more conviction. Some of that evidence appears in Figure 1.1, which shows the return on investment of the S&P 500 over five years compared to the return on investment of the top 25 percent of firms with respect to customer satisfaction, as measured by the American Customer Satisfaction Index. The data show that firms with more satisfied customers have higher returns—beating market averages over five years—with lower variability over time.<sup>5</sup> Mounting evidence suggests that creating satisfied customers appears associated with higher return on investment and reduced risk.<sup>6</sup>

As the power of the marketing concept has been recognized, a growing number of organizations have begun to transform their businesses to become more market-oriented. Procter & Gamble, Unilever, and others that have long embraced the marketing concept have worked to continually transform their organizations to remain at the forefront. But other firms in industries where marketing has played a less central role—usually as a distinct function rather than as a guiding principle—have begun to embrace the concept more fully. These firms can be found in every corner of the economy, from rapidly growing, high-technology companies to mature, established industrial businesses.

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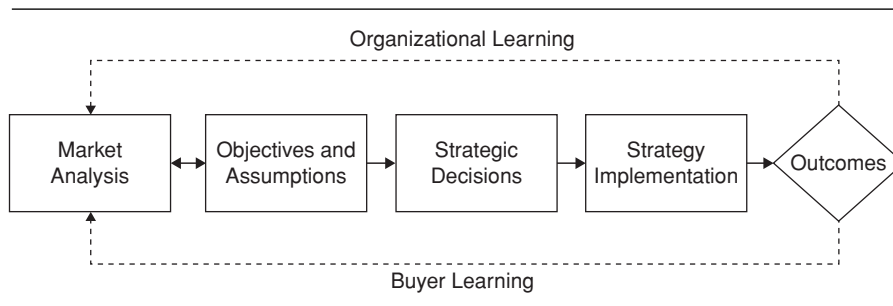
For example, in the mid-2000s, Intel's CEO announced plans to transform the company so that "every idea and technical solution should be focused on meeting customers' need from the outset."<sup>7</sup>

Although the concept of marketing appears straightforward—focus the organization on creating a customer—two challenges are central to implementing it. First, customers are complex, fascinating, and not always easy to understand. Customers often seek value they can articulate, but they are unaware of what they don't know, and they are largely blind to their subconscious desires. Therefore, understanding customers *holistically* is necessary to be an excellent marketing organization. Second, creating competitive advantage by creating customers requires a deep understanding of the role of consumers in the process of competition. The traditional view is that marketing is essentially about responding to buyer needs, and doing so will create competitive advantage. Mounting evidence, however, suggests that marketing does much more. It educates buyers and significantly shapes the nature of competition. Successful competitive strategy helps define and redefine the competitive game. Understanding that role is important to understand more fully the role of marketing strategy in creating competitive advantage.

## DEVELOPING MARKETING STRATEGY TO CREATE CUSTOMERS

The process of developing marketing strategy to create customers is shown in Figure 1.2. It shows that, based on an understanding of the markets (customers and competitors), organizations establish objectives. These are the outcomes they hope to achieve through the application of resources and typically include market outcomes (e.g., sales), financial metrics (return on investments), and

**Figure 1.2**  
**Developing Marketing Strategy**



measures of customer knowledge (e.g., brand awareness or perception). Based on these objectives, organizations make key strategic decisions, implement strategy, and observe results. Buyers learn as a result of their experience in the market, and organizations learn about how to produce the outcomes they desire. And so it continues. Here, we focus on the overall process, with emphasis on market analysis and the process of creating customer value.

### **Market Analysis**

The foundation of a successful competitive marketing strategy is a deep and holistic understanding of buyers, their motivation, what they value, and how they choose. Many times, individuals and organizations lack sufficient knowledge about buyers to create a solid foundation for a competitive marketing strategy. Lacking that information, they substitute plausible assumptions. Those assumptions are often widely shared views about buyers and individuals more generally. We often assume, for instance, that buyers know what they want, that they are rational about seeking it, that offering more options is preferable to fewer, that a lower price is preferred to a higher price, and that more information improves choice. In some cases, these assumptions are accurate summaries of buyer behavior. In other cases, as mounting research shows, they are seriously misleading, despite their intuitive appeal. Buyers are much more complex than we might imagine; they are much more sophisticated in some ways and much simpler in others.

For example, we do not always know what we want, nor do we choose rationally. Knowing what we want in any product category—motor oil, a family physician, or life insurance—requires data, time, expertise, and experience. We often lack one or more of these in making choices. Moreover, humans are emotional beings, driven by forces that we do not always understand or even recognize. As a result, we are unable or unwilling to articulate the full range of our needs or wants. Crafting a solid foundation for competitive strategy requires deeper understanding of buyers to capture the essence of behavior when buyers make choices without time, data, or expertise, and when buyers are driven by forces they do not recognize.

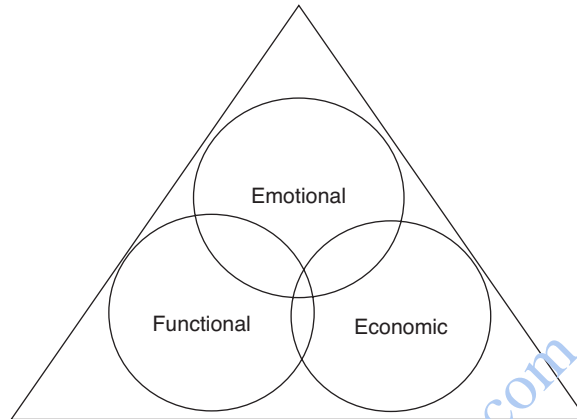
### **Buyer Goals**

An enduring principle of human behavior is that individuals and groups are motivated by the goals they seek. A goal is simply a desired state of being. Simple as that sounds, desired human states of being can be complex. Goals reflect the full richness of the future we desire—our aspirations, our dreams,

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**Figure 1.3**  
**Buyer Goal Hierarchy**



our hopes, and our economic ambitions. Simply put, goals are our hopes and dreams. Individuals seek a vast range of goals—to be good parents, to be successful professionally, to be at peace, to make a positive contribution to the world, and to have fun. The range and number of goals an individual seeks over a lifetime is virtually unlimited and evolves over time.

The existence of such a vast number and range of goals, each with multiple dimensions, creates a fundamental dilemma for individuals. Time is too limited to pursue them all, so we must prioritize. One buyer's goal hierarchy, shown in Figure 1.3, suggests that as buyers we seek value on at least three dimensions: emotional, functional, and economic. Emotional goals are higher-order goals such as self-image, power, control, and affiliation. We pursue these over a long period of time; they are complex and important to us. These goals change slowly, are limited in number, and are pursued consciously but also subconsciously—the concept of our self-image, for instance, in a multidimensional goal. Lower in the hierarchy are functional and economic goals. These do not exist independently of higher-order goals. Selecting a vehicle with four-wheel drive and rugged features serves obvious functional goals but also conveys a particular image to others. Functional and economic goals tend to be less complex than emotional goals, are pursued over a shorter time horizon, and are less important than emotional goals.<sup>8</sup>

The full range of goals—emotional, functional, and economic—are sought in both business-to-consumer and business-to-business settings, although the mix of goals can differ. For consumers, self-image and affiliation can be

important in the categories such as beer, athletic shoes, or automobiles. In business settings, buyers are thought to be more “rational,” focusing on functional and economic to the exclusion of emotion. Humans are, however, fundamentally emotional beings. Our emotions are a part of a system of reasoning—our subconscious—produced over thousands of years of evolution. Our emotional systems are impossible to switch off, even for the most expert buyer. When American Airlines buys aircraft engines, when Google goes public, or when a university invests its endowment, these organizations bring much expertise to bear on the decisions, but the risk associated with each is high, making sure that emotions are central to each decision.

### **Creating Value, Focusing Resources, and Competitive Positioning**

Goals create a problem for an individual or organization to solve. How can we achieve greater social status? How can we have more financial security? How can we have a relaxing and exciting vacation? Each of these is a problem reflecting an important individual goal. Organizations have goals as well. Corporations seek faster growth, recognition among peers, and, of course, financial success. Each of these goals creates a *problem* for the organization to solve. Individuals and organizations create value by solving such problems.

The value we attach to the solutions varies greatly by the importance of the problem being solved. Although many factors influence a goal's importance, the position in the hierarchy is the single most important factor. Higher-order, emotional goals are difficult to achieve, are sought over a long time period, are complex and multidimensional, and require considerable personal or organizational commitment. Achieving a higher-order goal requires a greater personal commitment, making it more important than a more easily achieved goal. Emotional goals are often pursued subconsciously. Instead, buyers focus on a more concrete or *focal* goal, such as *losing weight* versus the more abstract *live a healthier life*. Although buyers are more aware of focal goals, they are less important than higher-order goals because they fall in the middle of the goal hierarchy. Subgoals in each of these categories are specific and considered over a short time period. These lower-order goals are subordinate to the focal goals they serve and ultimately to the smaller number of higher-order goals.

Competitive marketing strategies propose solutions to buyer problems—they propose means for buyers to achieve their goals. Successful marketing strategies, however, must do more than simply create value for buyers. Successful strategies create *unique* solutions for *the most important problems* buyers confront. Doing so requires focusing resources. Although all buyers have goals, different buyers seek solutions to different problems. These differences create

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market segments, which create a fundamental challenge for competitive strategy. With limited resources, a firm simply cannot solve all customers' problems, and it certainly cannot create unique solutions for the full range of customer problems. Choices must be made. All strategies reflect decisions about where resources will be deployed and, therefore, where they will not. By focusing resources, the firm magnifies their impact. This concept, derived from the military roots of strategy, can be traced back to Roman military commanders who grouped legions of troops to overwhelm their opponents' smaller numbers. Focus is the essence of guerilla warfare. One of the most effective guerilla strategists, Mao Zedong, wrote, "Although I fight one against 10, I engage 10 against one." Concentration of resources multiplies the impact of limited resources for advantage.

Once a firm has decided where it will focus its resources to solve a consumer problem, the next key decision is selecting the competitive positioning. The positioning is simply a statement of the unique value the firm will offer to selected customers. From the buyers' perspectives, the competitive positioning is a *value proposition*, an articulation of the unique solution the firm will offer to solve the target buyers' problems. As such, it describes the value the firm offers and what it will not offer. Crafting a value proposition requires identifying the various alternatives that buyers consider as solutions to their problems. Each of these solutions shares aspects in common, called *points of parity*, and they offer unique aspects of value, called *points of difference*. For example, if the goal is an indulgent treat, all may be high in calories but only some may include chocolate. The goal of positioning is to craft a unique, compelling solution to customers' problems that takes into account the competitive options available and the strengths and weaknesses of the organization. Some classic value propositions appear in Table 1.1.<sup>9</sup>

### Implementation

From within the firm, the competitive positioning provides a focus for aligning organizational resources and incentives to deliver the solution buyers anticipate. Thus, beyond focusing resources on particular segments in particular markets, competitive marketing strategy further focuses the firm's activities on those that uniquely create value for buyers. By focusing resources, firms multiply the impact of those resources. Focus, however, creates internal conflict. Each function has its own view of important tasks that need to be accomplished. Competitive positioning provides a means to align functions and reduce functional conflict. As such, the value proposition acts like a score for a symphony, focusing the efforts of the firm to the selected markets, target segments, and a unique competitive position.

**Table 1.1**  
**Classic Value Propositions**

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*Superior satisfaction of a common goal.* A powerful point of difference arises when a brand delivers superior satisfaction on the core functional benefit of the product category. Although appealing to buyers and logical to firms, such a position often invites competitive imitation and escalation, which can render such a position less valuable.

*Uniquely satisfy a neglected goal.* A potentially more enduring advantage is created by a brand distinguishing itself from rivals based on satisfying a neglected buyer goal. The changing lives of buyers have made this rich territory. The time pressure many buyers face means that individuals pursue some urgent goals such as financial security, social responsibility, and social acceptance, at the expense of more internal (perhaps more important) self-oriented goals.

*Satisfy a unique combination of common goals.* Even without the ability to deliver superior value on any one goal, a compelling point of difference is possible by satisfying a unique combination of goals. By delivering value on a unique combination of dimensions, firms can create a competitively distinct value proposition and make simple comparisons difficult for buyers.

*Resolve goal conflict.* Many times goals conflict. Being a better parent, gaining greater professional acceptance, and devoting more time to community service are wonderful goals but fundamentally in conflict. Associating a brand with a unique and effective resolution to this dilemma can produce a powerful point of difference.

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### **Consumer Learning and Competition**

Once strategies are developed and implemented, firms compete to create customers. Buyers in the target segment are confronted with a range of value propositions, each proposing a solution to a certain problem. Based on the options, buyers act. They either choose or not, and their objectives are realized or not. In the process, organizations and customers learn from the experience.

### **The Evolution of Buyer Learning**

To understand competition, it's important to understand how buyers *learn*. Buyers learn over time in a systematic way; their problem solving evolves. Early in the life of a market, buyers are inexperienced. Buying a new home robot is difficult because we know so little. In such *extensive problem solving*, buyers actively seek and process such information, constructing the basic knowledge necessary to be a buyer. As buyers become more experienced, making a choice in the category is no longer an entirely novel task. It is familiar but not routine. Buyers have basic awareness of options, perceptions of the alternatives,

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preferences for the perceived differences and similarities, and logic for choosing among them. Information is processed less actively, and buyers use less complicated strategies for brand choice. Buyer behavior in such a situation can be described as *limited problem solving*. Finally, buyers become very experienced. They become aware of the relevant brands and competitors and knowledgeable about differences between alternatives. They have clear preferences for those differences and established strategies for choosing among options. Buying becomes more practiced—it becomes *routine problem solving*.<sup>10</sup> Learning slows and a period of stability emerges that depends fundamentally on the knowledge that buyers have acquired. Based on that learning a social consensus emerges that defines the competitive game.

### **Market Stability: Types of Buyer Knowledge**

Competition during the period of stability is defined as what buyers have learned through this process of evolution. Buyer learning, however, is an imprecise process. We learn as buyers differently than as students learning calculus or art history. As buyers, we learn casually, sometimes without conscious recognition and sometimes by fleeting observation or more careful consideration. We have limited experiences and observations, and we devote finite attention to interpreting what we experience or observe. Nevertheless, we draw conclusions that guide our actions as buyers. Those actions are based on at least four types of knowledge we acquire through the learning process: *categories, perceptions, preferences, and choice*.

**Categories** A fundamental element of our routines is the set of potential solutions we discover. For those seeking a college education, the United States offers more than 3,000 choices; many grocery stores have 20,000 different items for sale; Apple offers more than 100,000 applications for the iPhone. Knowing all these alternatives is impossible. Customers simplify the number of alternatives to make a decision. To do so, they construct a set of alternatives based on the alternatives of which they are aware and, from that set, a smaller set to consider more carefully. Consumers typically consider three to five alternatives. For example, buyers consider on average three brands of antacids, eight brands of automobiles, and four brands of shampoo in making purchases in these categories.<sup>11</sup> Therefore, a primary task of buying is to learn how to eliminate most alternatives from further consideration.

Buyers construct small consideration sets for a number of reasons. The process of learning about brands is costly in terms of time and effort. Searching, whether electronically or physically, requires the individual to incur certain

so-called *search* costs. If the cost of learning about another brand remains constant but the benefit declines with the number of brands considered, buyers will search over some optimal number of brands. Other brands will simply remain unknown to the buyer. Moreover, cognitive capacity is limited, so individuals are willing to allocate only so much memory to various brands of shampoo, for example. Buyers add or drop brands from consideration based on the perceived cost and benefit of doing so, all the while maintaining a set of better-known, frequently considered brands.

**Perceptions** Buyers learn perceptions of the alternatives in the consideration set. Perceptions are the thoughts, feelings, and images we attach to otherwise complex entities. Buyer perceptions are useful simplifications of reality. Even for a small set of alternatives, making full and complete comparisons across all meaningful attributes and features would be a daunting, burdensome, and complex task for most consumers. Buying a first computer is a difficult task, in part because our perceptions are not yet well formed. We do not know how to process the massive amount of information we confront. With experience, we structure those thoughts using perceptions. We simplify alternatives on a set of common and unique dimensions, highlighting similarities and differences, making comparisons easier. In that process, we discard much relevant information that is simply too costly or too difficult to process or organize. As such, perceptions are sufficiently complete, but always incomplete.

**Preferences** Based on perceptions, buyers form judgments about the value of perceived similarities and differences among alternatives. Those judgments are based on experience. Buyers have no preferences prior to their first experience. With the exception of some foods, for which humans have an innate taste preference (such as sweetness), it is impossible to have preferences for something about which consumers have no knowledge. Without knowledge of the product, buyers have no means to create perceptions of it, and without perceptions they are forced to value the individual attributes of the product. Even if buyers have objective information on brand attributes, the value of an individual attribute of the superiority of one attribute combination over another may not be obvious. Through trial and experience, consumers develop a naive theory relating perceptions to value or outcomes.<sup>12</sup> For example, we learn that we prefer blue shirts over white, white wine over red, and warm-climate vacations over cold. With a small number of exceptions, the preferences we have are learned.

**Choice** Finally, buyers develop logic for choosing among the alternatives they consider based on their goals, the perceptions of the alternatives, and

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their preferences. We construct a logic for choosing. Although we sometimes choose carefully, thoughtfully, and deliberately, more often than not (even for important decisions) we devise a shortcut to minimize the effort of making a choice. Simplification is necessary for mundane and important choices. Entering a grocery store with 20,000 items requires a repertoire of shortcuts. If we send a friend or neighbor to the store, we may unknowingly reveal our shortcut when providing such hints as “look at these two brands and choose the cheaper,” or “buy only one brand.” Even in the most important decisions, we create simplifications. When choosing a personal physician, rather than doing an exhaustive search, comparing patient outcomes, and weighing the risks and benefits, we often simply ask a friend or colleague for a recommendation. Some of the shortcuts consumers use are shown in Table 1.2.

**Table 1.2**  
**Strategies for Decision Making**

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*Compensatory.* In a compensatory strategy, consumers weigh all the perceived characteristics of all the alternatives and reach an overall judgment about choice. A strength on one perceived dimension can offset, or compensate for, a weakness on another.

*Lexicographic.* Buyers using a lexicographic choice rule identify the most important goal and then select the alternative that delivers most on that one goal, ignoring all other goals. A lexicographic strategy has the benefit of being very simple, easy to apply, and thus not very demanding of cognitive resources. In deriving such economy, however, the buyer ignores considerable information.

*Satisficing.* A buyer using this strategy develops a set of minimum levels on each perceived dimension and then considers each alternative sequentially. Looking at each dimension of the first brand, the buyer decides if it meets a preset minimum level. If it fails on any one dimension, it is rejected, and the next alternative is considered. The buyer selects the first option that meets all the minimum requirements. If no alternative meets the established standards, then the cut-off levels are revised and the process is repeated.

*Elimination by aspect.* In the first stage of this multi-stage choice rule, the buyer selects the most important dimension, determines a cut-off, and eliminates all alternatives that do not meet the cut-off on that dimension. With a reduced set of alternatives, the buyer then identifies the second most important dimension, sets a cut-off level for that dimension, and eliminates the alternatives that fail to satisfy the second cut-off. This process continues until only one alternative remains.

*Phased decision rules.* In some cases, buyers combine strategies in a sequence throughout the process. Early in the process, buyers use one process to screen alternatives and reduce the set; in the next stage, they rely on a more elaborate strategy to choose among the screened alternatives.

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**The Market Paradigm: The Rules of the Competitive Game**

The knowledge that consumers acquire, and the social consensus that emerges from it, defines a *market paradigm*. This is a well-developed understanding on the part of buyers about how to achieve their goals and includes the set of brands buyers consider, the dimensions on which they are judged, the value they attach to perceived similarities and differences, and the logics they develop for choosing among them given their goals. This knowledge, incomplete as it may be, creates the *rules of the competitive game*. For example, if your goal is to send a package overnight, a small set of alternatives pop to mind (including possibly FedEx, UPS, and the U.S. Postal Service); all share certain similarities and differ on established dimensions (reliability, image, price, convenience). You may have already assigned weights to those perceived differences, establishing your willingness to pay for each, and you may have constructed a logic for choosing among the alternatives depending on the urgency and importance of your shipment.

This paradigm rests on buyers' mutual experiences and observations, as well as the consensus that has emerged from that experience. It does not, however, rest on exhaustive knowledge on the part of buyers. Buyers develop the knowledge that forms the basis for the paradigm through casual learning. Buyers learn just enough to solve the problem at hand and then have no incentive to learn more. Although the paradigm is effective, it is based on a limited (although sufficiently correct) view of reality from the perspective of buyers. For example, although we may not know much about shipping packages overnight, we know enough to get our packages where they need to be, and we have no desire to learn much more.

**UNDERSTANDING COMPETITIVE DYNAMICS**

Once established, a paradigm can remain stable for many years. Eventually, however, all market paradigms are redefined as the social consensus on which the market rests changes. Three forces operate to undermine any established social consensus and establish a new consensus and a new competitive paradigm: *technological innovation*, *strategic innovation*, and *buyer change*.

**Technological Innovation**

Changes in technology create the opportunity for existing players or new entrants to redefine the competitive game through a new approach to solving buyer problems. The implicit foundation of the paradigm is a technology that

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defines the economics of the industry, which has a powerful if implicit effect on the paradigm that emerges. Innovation can occur at any level in one of three ways.<sup>13</sup> *Incremental innovation* is perhaps the most common. It is the further refinement of existing technologies in an established direction of improvement. The microprocessor gets faster and uses less electricity, just as the mobile phone becomes more sophisticated and smaller. Incremental innovations are usually not disruptive. *Architectural innovations* are rare and have a greater impact. These are innovations in a subsystem or some mechanism linking subsystems.<sup>14</sup> Architectural innovations alter the way in which subsystems relate to one another, creating fundamental change. Canon's introduction of smaller printers is an example of one such innovation. *Discontinuous innovation*, perhaps what we most often associate with the term innovation, is a fundamental change in a crucial subsystem of the technology. The invention of digital imaging is a discontinuous innovation. Architectural and discontinuous innovations create the opportunity to redefine the competitive game through the creation of new solutions to existing buyer problems.

### Strategic Innovation

The inequities of an established game create incentives for those who are disadvantaged (or entirely excluded from the game) to redefine it, even without the benefit of new technology. Although strategic innovation is conceptually possible by crafting a new strategy that is unorthodox on any dimension of the received paradigm, in practice many innovative strategies begin with either a novel scope of the market or the competitive strategy. A novel *scope of the market* enables an innovative firm to address ignored buyers or to focus on a specific, overlooked, or underserved niche of buyers. Southwest Airlines, one of the most profitable airlines in the United States, has achieved a powerful position in its market by drawing new customers to air travel through extremely low fares. Southwest has been able to create a low-cost model that has been emulated and refined by others such as Ryan Air in Ireland and JetBlue. India's Tata Nano, an inexpensive car offered at about \$2,500, offers a similar example. The target is the massive number of Indian consumers who currently own no car. The concept of basic, low-cost transportation, though hardly new, is innovative given the strategies currently being pursued in the global auto business.

One powerful source of strategic innovation is devising an entirely new set of activities to achieve the same or even superior organizational outcomes. Such an innovation redefines the *scope of competitive strategy*. Over time, in any competitive game, organizations learn what actions produce desired results.

Experience, of course, is limited. Organizations cannot experiment with every possible combination of actions. Based on this limited experience, organizations develop an imperfect but useful understanding of how actions produce outcomes. More experience reinforces that other sets of strategic decisions are not viable by the absence of evidence demonstrating their viability. Strategic innovation that goes beyond the limits of currently pursued strategies remains a viable option in virtually all markets. The popular Blue Ocean Strategy concept, as exemplified by Cirque de Soleil, demonstrates the potential power of strategic innovation.<sup>15</sup> Toyota's entry into the luxury car market with Lexus and Apple's launch of the iPod both represent classic examples of strategic innovation. Neither depends on fundamentally new technology. Indeed, in the case of the iPod, a central aspect of the innovation is in the novel distribution of music through iTunes. Lexus distinguished itself from Mercedes-Benz and other luxury carmakers through excellent service that was made possible through product changes.

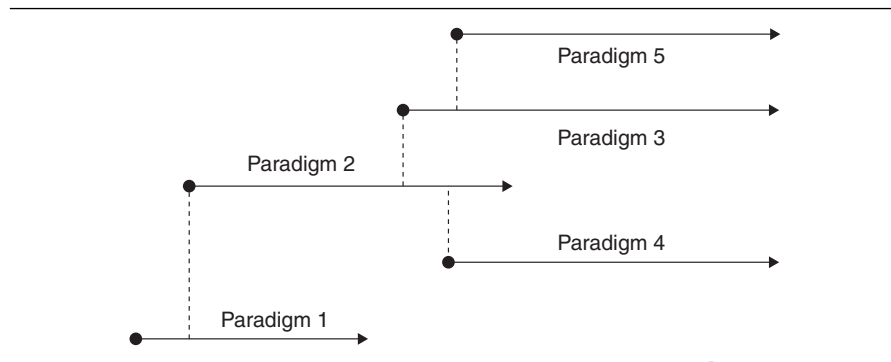
### **Buyer Change**

Absent technological or strategic innovation, change remains inevitable. Existing buyers, both individuals and organizations, evolve. As buyers evolve, their goals change. Our goals at age 15 are certainly different from our goals at age 55. These changes are created by aging and the different challenges it brings (first job, new home, changing careers, etc.) but also by external pressures (social change, economic opportunities and concerns, etc.). Change is one constant in our lives. Beyond that, new buyers are entering established markets every day. These new buyers may have different goals than existing buyers, different perceptions, and fundamentally different preferences compared to existing buyers. Over time, of course, existing buyers will slowly exit the market. This slow but inevitable process of buyer entry and exit creates the opportunity to create a new game with new buyers. These changes in buyers are so important because buyer changes threaten the social consensus on which every market rests.<sup>16</sup>

### **Sequential Paradigms**

Through the development of marketing strategy, competition produces a series of competitive paradigms. Initially, firms develop strategies to solve buyer problems, then buyers learn based on the observations and experiences those strategies create. As buyers learn, a consensus emerges and the game evolves, reaching a relative stability. The resulting paradigm benefits some firms and

**Figure 1.4**  
**Sequential Competitive Paradigms**



disadvantages others. Technology may change, those who are disadvantaged will seek a more advantageous order, and buyers will evolve. Eventually the established paradigm fades away as buyers evolve or collapses as a result of innovation. From that change a new paradigm arises, and the process continues, as illustrated in Figure 1.4.

This process of competition is well illustrated by the automobile industry. Invented by Karl Benz, the first automobiles were individually manufactured luxuries. Henry Ford created the low-cost, no-variety concept that brought the car to the masses. Shortly after his success, Alfred P. Sloan created the mass-variety idea with the founding of General Motors, imitated by Ford, Chrysler, and others. Toyota developed the current dominant concept associated with limited variety, high quality, and low price. This, too, has been imitated by others. In each paradigm, the competitive game differed significantly from the previous paradigm. Some changes were enabled by technological innovation, such as mass production, while others were the result of strategic innovation, such as General Motors. Each paradigm clearly produced competitive advantage for some and competitive disadvantage for others. For example, Ford dominated the low-cost concept, but General Motors clearly dominated Ford by using the mass-variety paradigm.

## UNDERSTANDING COMPETITIVE ADVANTAGE

The goal of competitive strategy is to create competitive advantage. Traditional concepts of competitive advantage have focused on industry analysis, unique resources, and customer focus. Some industries are surely more attractive than

others due to economic structure that limits entry, reduces competition, and increases profits. Furthermore, within an industry, some firms possess unique, valuable skills that improve their performance. Some firms more effectively meet customers' needs, creating value that translates directly into higher profits. Beyond these sources, the competitive process illustrated in Figure 1.4 reveals new avenues for creating competitive advantage. Gaining those insights requires a deeper understanding of the competitive process it reflects.

### **Social Rivalry**

The process of competition in Figure 1.4 is a *social* process. Social processes differ in at least four fundamental ways from a biological process (survival of the fittest) that is typically associated with competition: First, the rules of the game are created by consensus among buyers and sellers, in other words, those who play the game define the rules. Second, changing the rules of the game requires only achieving a new consensus. Third, the paradigm creates winners and losers among competitors. Those disadvantaged have an incentive to replace the paradigm with a new one; those advantaged by the paradigm have the incentive to preserve it, creating a tension between winners and losers. Fourth, elimination from the game—death in the biological world—is not inevitable, unambiguous, or permanent in social rivalry. Unlike living beings, corporations are social creations and have the possibility of infinite life. Bankruptcy may signal the end of one form of a corporation but it is by no means *the end*. So long as investors have confidence in an organization it can rise from death, unlike mere mortals.

The social view suggests that competition may be viewed as a series of card games, rather than a process of natural selection. Each player starts with certain resources, and all players are subject to the natural laws of probability. The cards fall as they may. The rules of the game, however, are not left to natural selection. The rules are established by agreement among all players. For example, all players must agree on the number of cards, the process for drawing cards, the way they are played (face up, face down), and the ordering of the resulting hands. Without such an agreement, there simply is no game. Subject to agreed-upon rules, players will use different strategies; some will win and others will lose. Some players may be forced from the game if their funds are depleted; they are free to compete again, and possibly win, if they can secure additional funds. Eventually, one player will emerge as winner. Winning in such a context is much more than skill or good fortune. Winning depends on designing the game wisely so that it exploits your advantages and opponents' weaknesses, and then exercising those advantages (and hopefully

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receiving some good fortune along the way). Having confident investors never hurts, of course.

In markets, competition is much more complex than a simple game of cards, and the stakes can be much greater. But there are important similarities. In all markets, the nature of the game, at least initially, is completely undefined. Buyers lack the knowledge to create a meaningful game. It awaits definition. Before Motorola created the technology to make cellular phones, buyers did not have enough understanding of the impact of cellular technology on their lives to make meaningful judgments about it. Similarly, at any point in a market, the future is undefined. It awaits definition. Once defined, the game begins.

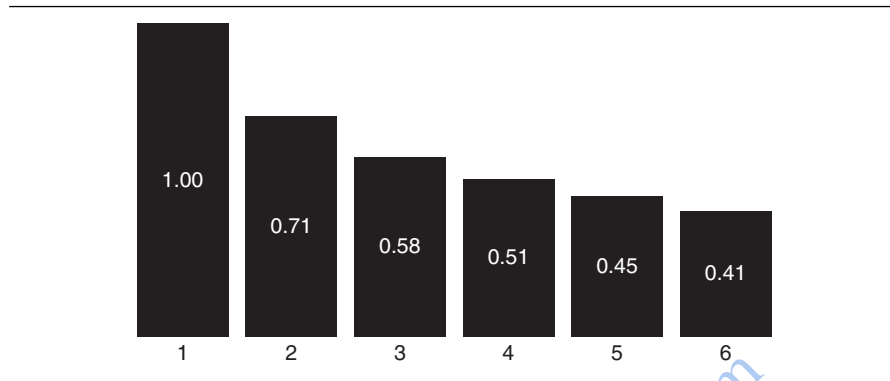
### **Defining the Game: Market Pioneering**

The battle to define the future (and set the rules of the game) begins with the definition of the market. Wrigley's chewing gum, Coca-Cola drinks, Levi's blue jeans, Gerber baby food, and Kleenex tissues all created the markets that they continue to lead. Although pioneers such as these are indeed overtaken by later entrants, many pioneers continue to outsell their rivals for years, sometimes decades. In some cases, the length of time in which these brands have led their markets is nothing short of remarkable. Levi Strauss & Company, founded in 1853, remains the best-selling blue jean company in the world more than 150 years later, as does Coca-Cola, which was founded in 1886.

Pioneering a market produces many significant competitive advantages. Pioneers are often better known, more easily recalled, and, therefore, chosen more frequently, even if they are perceived as identical to others in all important respects. Human memory is not at all like a computer memory, where all encoded information is recalled with equal ease and precision. A pioneer is more easily recalled and, therefore, considered more frequently. The pioneer can set the standard for later entrants, becoming strongly associated and even synonymous with the category (think of Kleenex or Coca-Cola). As the standard, the pioneer can influence the perceptions that buyers develop and the value buyers attach to perceived similarities and differences among brands. Coca-Cola or Levi's have had a huge, enduring impact on how buyers think about colas and jeans. Experience with the pioneer affects consumers' choice strategy. Being better known the pioneer is lower risk, which affects consumers' price sensitivity. Combined, these differences in awareness, perception, preferences, and choices create a significant competitive advantage.<sup>17</sup>

The empirical evidence on the benefits associated with pioneering are substantial. Figure 1.5 shows a study of market share relative to the pioneer, adjusted for differences in marketing strategy based on brands' orders of entry

**Figure 1.5**  
**Relative Market Share Based on Order of Entry**



into the market.<sup>18</sup> Across all brands and all categories, Figure 1.5 suggests that the second entrant typically earns about 70 percent of the market share of the pioneer, the third entrant earns 60 percent, and so on until the sixth entrant earns less than half the market share of the pioneer. This contradicts expectations. It is reasonable to suspect that if two brands pursue the same marketing strategy, both should achieve the same results, dividing the market. Figure 1.5 shows that expectation is contradicted. To achieve the same sales, later entrants need to spend more on advertising, select a lower price, and offer a superior product. This creates a burden that the pioneer does not share. This effect, dubbed *pioneering advantage*, has been reported in a wide range of markets.

### **Fast Following**

Observation suggests that some firms have achieved success not through pioneering but through fast following. Fast followers typically enter the market soon after its emergence, on a large scale, but without dramatic innovation. Such imitation has proven to be a successful strategy in many markets. For example, Yahoo pioneered Internet search engines only to be overtaken by Google; the de Havilland Comet created the commercial aircraft market that Boeing soon led; Raytheon was overtaken in microwave ovens; and IBM eclipsed Sperry-Univac in mainframe computers.<sup>19</sup>

What advantages arise from fast following? One study offers some potential insight. The study examines the impact of marketing activity, order of entry, sales diffusion, and the timing of entry (pioneer, growth-stage, or late-stage

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entry) on the sales of 29 pharmaceutical brands in six markets. In these markets, fast followers grow faster than the pioneers because buyers are more responsive to their product quality, and fast followers are less vulnerable to the success of competitors.<sup>20</sup> These findings suggest that entry at the right moment in the evolution of a market can facilitate growth and provide significant insulation from competitors. By entering soon after the emergence of a market, the fast follower can become the brand with which many consumers first gain experience. As a result, fast followers can be seen as lower risk, better known, and distinctively positioned. They can establish the standard in a market and enjoy many of the advantages associated with pioneering. Fast following, however, requires scale, resources, and nimbleness, characteristics that are not found in all organizations.

### Differentiation

Differentiation is a classic competitive strategy. The goal of differentiation is to create a meaningful difference between one alternative and its rivals within an established paradigm, in order to shape rather than redefine the competitive game. Any aspect of buyer knowledge can be the basis for differentiation. A brand can be distinguished by a unique image, thus providing an advantage of being recalled more easily and more often. For example, for years Morton Salt has been strongly associated with an advertising campaign claiming that “When it rains it pours.” Salt is sodium chloride and has no meaningful product differentiation, but as a result of more effective advertising, it is better known and chosen more often. Similarly, Perrier is more sophisticated than La Croix water and Volvos are safe (if unexciting) compared to BMWs.

Some brands are distinguished by offering more value than competitors on a common dimension of value. Toyotas may be more dependable than their rival cars, for example. Brands can be differentiated by being easier to choose; they are a powerful device for helping consumers make choices among many otherwise similar alternatives. Brands can even be differentiated through the use of an irrelevant but distinguishing attribute to simplify brand choice.<sup>21</sup> These differences become meaningful if they become part of the social consensus. Volvo need not be the safest car, but it needs to be strongly associated with safety in the minds of buyers. Important differences are, therefore, *created* rather than *discovered*.

Differentiation has many advantages. With a strong brand, a company’s products are more easily recognized, more easily recalled, more competitively distinct. That uniqueness is the basis for competitive advantage and the value of the brand itself. If a brand loses its uniqueness, it loses its effectiveness as a

brand. As such, brands are intangible assets. The value of brands in the minds of consumers translates into value for the owners of those brands. Changes in key intangible factors, such as brand assets, have a significant effect on the stock market valuation of the firm. This link between brand and market value has been documented across a wide variety of markets and environments. These analyses show a significant positive link between changes in brand strength and stock return, suggesting that a brand is an asset with the ability to generate a stream of future cash flows.<sup>22</sup>

### **Redefining Markets**

Another avenue for creating competitive advantage is redefining an established market. This amounts to defining the next-generation paradigm. As discussed earlier, technological innovation, strategic innovation, and capitalizing on buyer change are effective at creating a new paradigm within an established market. In personal computing, IBM pioneered the market, Microsoft overtook IBM with a shift in value from hardware to software, and Google appears poised to take the lead from Microsoft as the technology shifts to cloud-based computing. Each new generation of technology brings the opportunity to redefine the market. Even without technological change, strategic innovation can create new paradigms, as illustrated by the automobile industry. As new buyers enter a market without established concepts, brands can use that point of entry to redefine the market, as Pepsi has done in its rivalry with Coca-Cola or as Toyota has done following its entry into the United States.

Research suggests that these innovative late movers enjoy enduring competitive advantage through the same mechanisms that produce pioneering advantage. In one study of two prescription drug markets, researchers examined the success of the pioneers, innovative late entrants, and imitative later entrants. Analyzing brand sales over time as a function of marketing activities, the success of competitors, and other factors, the study shows that pioneers enjoy clear advantages: Buyers are less responsive to the marketing spending of imitators compared to pioneers, while imitators grow more slowly, have lower potential sales and lower rates of repeat purchase, and have no effect on pioneers' sales as a result of their marketing activities. Innovative late movers, however, enjoy important competitive advantages relative to the pioneer. Innovative later entrants create larger potential markets, grow faster, and have higher rates of repeat purchase. As innovative late entrants become more successful, their sales momentum slows the growth of the pioneer and reduces the effectiveness of the pioneer's marketing efforts. The success of an innovative

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late mover, in other words, creates a clear *disadvantage* for the pioneer. To achieve the same level of sales, the pioneer now must spend more, price lower, or offer a more appealing product. Innovation thus produces a late-mover *advantage*, which is ironically based on the same processes that create pioneering advantage.<sup>23</sup>

### SUMMARY

Drucker's call to create customers leads marketers down an interesting path. By creating customers—segmenting markets, selecting target markets, developing value propositions, and delivering value to solve problems—buyers learn, and as buyers learn, markets become established. Marketing strategy simultaneously creates value for buyers and creates markets and the competitive game. Rather than a race to meet some prespecified consumer objective, competition becomes a struggle to influence what buyers know and, as a result, how they behave. This ultimately influences the rules of the game. Organizations compete over every aspect of buyer knowledge: how to define the category, how brands within that category are perceived, how valuable differences should be, and how consumers should choose among the alternatives in the category. Defining the game, even if for a brief interval, can create enormous benefits. Those who are disadvantaged will eventually create a new paradigm, or the prevailing one will fall victim to changes in buyers. This creative destruction produces another period of strategic turmoil, from which a new stability will emerge, and so the process continues. Rather than being a race to make the better mouse trap, or to identify the optimal competitive strategy, competition produces a sequence of paradigms. Each produces winners and losers, victors and victims, and each falls victim to change. Competition becomes a battle to define the future of the market, to create tomorrow's customers. In such a world, competitive advantage is, as Drucker might agree, the fruit of marketing and innovation.

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