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The Perils of Product Differentiation

The story of **product differentiation** is usually told as a tale of great financial gain to the firms that do it, inflicted at sizable cost on consumers, who don't really "need" the new products. Whether it is fast food, soft drinks, clothing styles, or automobile models, the reasoning seems to be this: Develop a catchy name or theme, design a slick advertising campaign to clearly differentiate your product from others on the market, and presto—instant wealth.

At first blush, the story seems eminently plausible. After all, are "Tommy Jeans" really any better than Levi's? Is a Whopper fundamentally different from a Big Mac? And does anybody believe the Gateway cows make the company's computers any faster? In each case, the firms that differentiated their product from those of their rivals profited handsomely. And in each case, it is remarkably difficult to come up with any objective evidence that one product is much different from another—much less any *better*. Product differentiation, it seems, is the sure road to financial success: Gullible consumers will buy almost anything if it is just "positioned"—packaged and advertised—properly.

In fact, a careful look at the record suggests that product differentiation is neither so easy nor so profitable as it might seem at first glance. Instead, it appears that consumers are considerably more discriminating than they are usually given credit for. Moreover, if they are not interested in what is being offered, they'll reject it—at great cost to the firm that tries to inflict it upon them. Because of this, product differentiation is a risky business, fraught with potential losses and likely to succeed only if the firms doing it have something that is truly of value to consumers. The fact is that most

new products fail—often spectacularly. Thus, product differentiation seems to be much like any other business venture in that it is likely to be successful only if the product is valued by the consumer, and on average it is an activity that can be expected to yield only the competitive rate of return. A look back at history will suggest why this is so.

Our first episode takes us back half a century and involves an icon of American industry, the Ford Motor Company. On September 2, 1957, amid pronouncements that “this product will raise the industry standard to a new level,” Ford introduced a new automobile; its name was the Edsel. The car’s unveiling culminated nearly 10 years of research and development costing roughly \$1.5 billion in today’s terms. The company’s official goal for first-year sales of the Edsel was 200,000 vehicles. Little more than *half* this number were actually sold in the first *two* years of the model’s existence. After several attempts to save the floundering wonder car (including a major reorganization of the Edsel division, and a complete redesign of the car) Edsel production was discontinued in November of 1959—just two years, two months, and 15 days after its much heralded introduction. The failure was so spectacular that the car became an object of derisive humor on a host of television shows, and one historian of the episode remarked that “compared with the Edsel, Custer’s Last Stand was a victory.” Overall, it appears that Ford lost more than \$5 billion in today’s terms—some 40 percent of the entire value of the company. The product that was supposed to restore it to industry leadership very nearly brought the company to its knees.

What went wrong? It certainly wasn’t a lack of promotional efforts. By the time the Edsel was launched, Ford had recruited almost 1200 Edsel dealers to market and distribute the car. The advertising company handling the Edsel added 60 new employees to service the account and even opened a branch in Detroit, headquarters of Ford. The advertising campaign began in the fall of 1955, some two years before the Edsel hit the market. And the promotional effort was so intensive that shortly before the car’s 1957 unveiling one Ford executive remarked, “When [consumers] find out it’s got four wheels and one engine, just like the next car, they’re liable to be disappointed.”

And disappointed they were. Styling was one feature that Ford hoped would differentiate the Edsel from other cars, for it

included a host of new features, including a vertically oriented grill with rounded corners. The problem, according to consumers, was that the car looked like "a Ford sucking a lemon." Perhaps the lemon analogy was appropriate, for within weeks of the Edsel's introduction, reports of manufacturing defects in the car became rampant—oil leaks, trunks that wouldn't open, inferior paint jobs, sagging springs, and incorrect rear axle ratios all became facts of life for Edsel buyers. The Edsel was different all right, and consumers quickly rejected it.

The Ford Motor Company is not the only corporate giant to have suffered at the hands of the consumers whom it supposedly controls. Consider the Coca-Cola Company, which on April 23, 1985, held a heavily publicized news conference to announce "the most significant soft drink marketing development in the company's history." Coca-Cola, the soft drink that had been the company's leading brand for nearly 100 years, was to be replaced with a formula (soon to be dubbed "New Coke") expected to be a more vigorous competitor for its chief rival, Pepsi. The announcement electrified millions across the country and became the lead story on the evening's national news broadcasts. According to *Time* magazine, 81 percent of the U.S. population knew of the change in formula within 48 hours, more people than were aware in July 1969 that Neil Armstrong had walked on the moon. By June, fully 96 percent of Americans knew of New Coke. Indeed, Coca-Cola executives estimated that the news stories generated by the decision to change the formula were worth the equivalent of \$150 million in advertising expenditures. It is difficult to find another product in history that has been launched with anything like the attention received by New Coke. Success—and profits—it seemed, were assured.

There was just one problem: the company's customers didn't like the new formula. Within a month, the company was getting 5000 letters every week objecting to the change in formula, as well as that many complaining telephone calls *every day*. Perhaps more importantly, consumers backed up their complaints in the grocery stores and fast food restaurants, staying away from New Coke in droves. Company officials became increasingly concerned that their April decision had been a disastrous mistake, and on July 9 the board of directors decided to reverse that mistake.

Two days later, the original formula—newly dubbed “Coca-Cola Classic”—was back. By some estimates, the financial damage to the company was \$1 billion in today’s dollars.

It is tempting to think that mistakes such as those made by Ford and Coca-Cola are matters of history, unlikely to be repeated in the modern world of marketing focus groups and sophisticated computer-modeling of consumer behavior. The great Burger King french-fry fiasco suggests otherwise. Although Burger King has long led the nation in taste tests of hamburgers, its larger rival, McDonald’s, has remained top dog in the french-fry department. This is a matter of some importance to all concerned, because with a profit margin as high as 80 cents on the dollar, fries are the most lucrative item on the fast food menu. Thus, after two years of intensive research and development, and armed with a \$70 million marketing budget, Burger King launched a new line of french fries on January 2, 1998.

Burger King was determined to differentiate its product from McDonald’s popular fry, hoping to do so with a special preparation that guaranteed extra crispiness. So exacting was the company that the specifications for preparing the new fries ran to 19 pages. And although the process was complicated, franchisees were excited. Said one, an owner of 41 Burger Kings, “This fry was supposed to be our salvation.” For a while, it looked like it was. Intrigued by expensive Super Bowl advertising and a give-away of 15 million orders of fries on “Free Fryday,” consumers swarmed into Burger Kings to try it out. By the middle of 1998, the company had sold 150 million more orders of fries than the same period the year before. But soon enough, consumers had enough: some said it was too salty, others too crispy. Some complained the fries clumped together, and others thought they were bitter. But whatever their words, their behavior said it all: they stayed away in droves, and by 1999 Burger King french-fry sales were down 14 percent. Soon thereafter, the company pulled the plug: the fry that was to be salvation is no more. And although the company is tight-lipped on how much the fry fiasco cost, the president of Burger King’s National Franchise Association made it clear how the franchisees felt: “The g— d— fry was bad—horrendous.” Consumers, it seems, agreed.

Of course, not all cases of product differentiation are like the disasters we have examined here. Indeed, if they were, no sensible

business would seek to differentiate its goods from competitors'. The point instead is that product differentiation, for all of its oft-told stories of success, is far from being a road to riches. Like all economic endeavors, there are revenues, costs, and risks involved. There is no guarantee the profits will be positive, much less enough to warrant the risks. To hope to achieve even a competitive rate of return on differentiated products, companies must deliver to their customers a quality product at a reasonable price. This was a lesson that certainly made an impression on Donald Keogh, president of Coca-Cola in 1985. In announcing the return of the original formula to the shelves, Keogh apologized to consumers for the decision to launch New Coke. The episode, he said, had convinced him that "Our boss is the consumer." One guesses that Ford and Burger King would agree.

DISCUSSION QUESTIONS

1. If a firm can either devote resources to selling or improving an existing product, or to developing and differentiating a new product, what must be true about the profit rate on both activities in equilibrium?
2. Suppose that a large fraction of differentiated products fail. What will be true about the profit rate observed on differentiated products that happen to succeed? (Hint: Keep in mind your answer to Question 1.)
3. Suppose that product-differentiation activity is much riskier than most other business ventures. What would you expect the profit rate for product differentiation to be, compared to the average profit rate on other business activities?