Tool #6:

Avoiding the Commodity Trap

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The Commodity Trap—and Finding Ways to Differentiate

A prevalent reason many ventures started by the poor fail to become sustainable or profitable concerns what we might call **"the commodity trap"** (see Figure 1). It starts with having a business that is by and large selling something that is not meaningfully different from what many others in the same market are selling. When customers see no difference among competitors, they buy from whomever has the lowest price or is the most convenient to buy from. They have no loyalties, and effectively see the purchase as a commodity. Firms are forced to compete on price rather than on some other basis. Competing on price is almost always a losing proposition.

However, things get worse. Profit margins are squeezed as firms operating in markets with low entry barriers and intense competition attempt to undercut one another in order to retain or gain customers. Meanwhile, operating costs keep rising, further cutting into margins. High unit costs are tied to the fact that the business tends to be labor-intensive, with the entrepreneur doing much of the work in producing a product or delivering a service. Further, the entrepreneur does not have the money to acquire machinery or incorporate technologies that could reduce unit costs.

Costs are further inflated because the entrepreneur has limited capacity to produce to sell, and keeps relatively low inventories, meaning he or she does not realize economies in production. Small inventories or production quantities translate into (and are the result of) the purchasing materials or supplies in small quantities from suppliers. He or she cannot afford to buy in the larger lot sizes that would qualify the entrepreneur for discounts or lower prices from suppliers. As a result, the entrepreneur has no bargaining power with suppliers. In many cases, the entrepreneur is not able to purchase at the wholesale level, and so must acquire materials, ingredients or supplies at the retail level—and paying retail prices further eliminates any potential profit margins.

The squeeze on margins is exacerbated when operating in more mature or saturated markets, where there is little to no growth in the size or spending levels of the overall customer base. With smaller margins, the entrepreneur has less to reinvest in the business or take home. Lack of reinvestment means the business only becomes more of a **commodity**, especially if other firms are trying new and different things.

Consider the kinds of ventures often started by those living in poverty conditions. Painting contractors, child care providers, equipment repair businesses, cleaning services, moving or delivery companies, small restaurants, convenience stores and other small shops, among others, all have one thing in common. They can easily be perceived as commodity businesses by customers, and the entrepreneur is forced to keep prices low no matter what happens to operating costs. Of course, the entrepreneur generally believes their business is different in some way, but this is meaningless if the customer does not see or value the difference.

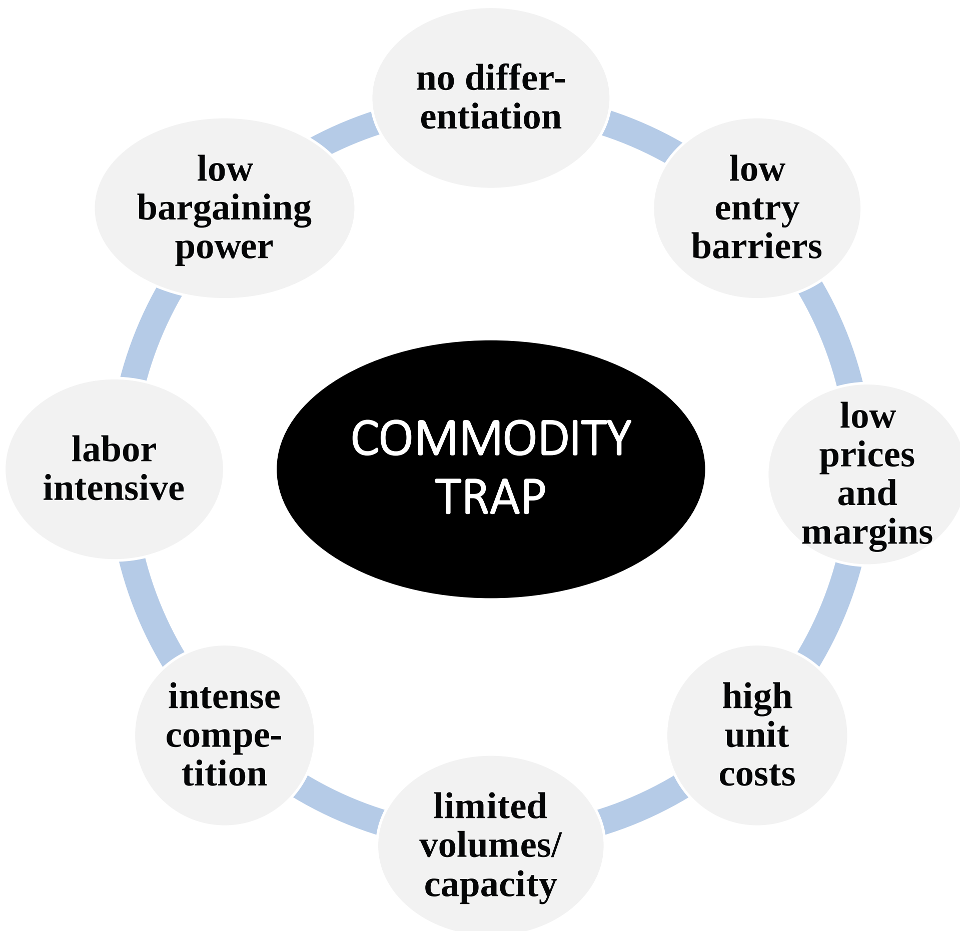
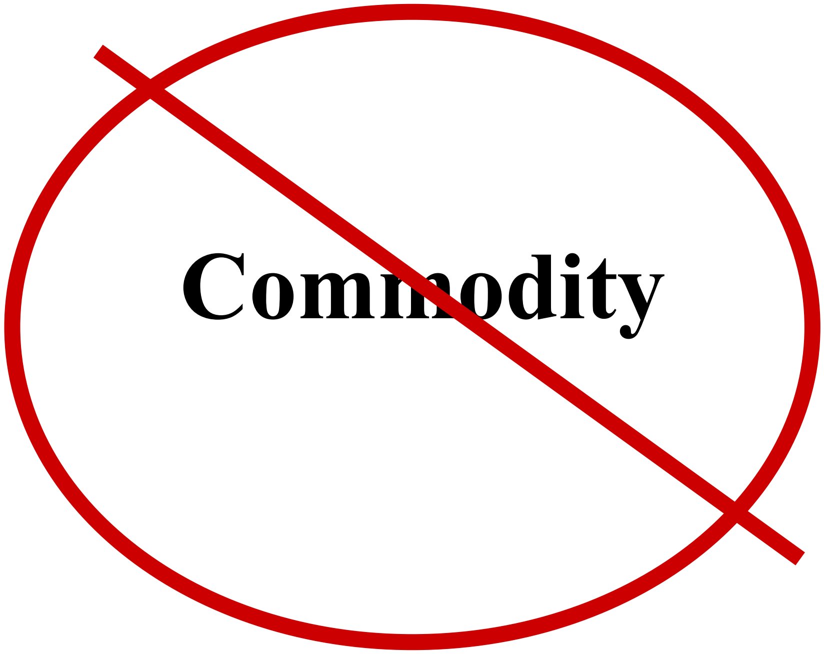


Figure 1: The Commodity Trap Facing Poverty Entrepreneurs

The goal must be to create meaningful and sustainable differentiation. This means offering something unique that creates real value for enough customers. This can represent a unique challenge for someone who is poor. They first must recognize potential sources of meaningful differentiation, which can require an in-depth understanding of customers, competitors, supplier capabilities, and available technologies. From a more general perspective, new businesses differentiate themselves from others in many ways, including the quality of their offerings, the kinds of experiences they create for customers, their ability to customize, support after the sale, and value for the money, among others.



A more specific approach to uncovering sources of differentiation can be found in Figure 2. This framework encourages the entrepreneur to look at what they are selling at four levels. The core level involves translating what is being sold into the primary benefit being delivered to customers. An entrepreneur that makes uniforms for local companies is not really selling uniforms, they are selling professionalism or image benefits. The tangible level refers to aspects of the basic product or service itself, such as the quality level or the selection available. The augmented level concerns ways in which the basic product or service might be augmented, such as by providing delivery, a warranty, or easy return policy. Lastly, the communicated level has to do with a unique identity or image the company is trying to convey to customers. A cleaning company might try to project itself as environmentally conscious based on the types of cleaning products and disposal practices it uses, or as a socially-concerned business based on employing the disabled or relying on equitable labor practices, or as patriotic based on hiring vets, the colors on it vehicles, and the community events it sponsors.

Using the framework in Figure 2 (and additional variables can be added at each level depending on the venture in question), the low income entrepreneur is able to identify variables or combinations of variables that can enable differentiation. This applies to even the most basic of business types. Of particular importance is the need to find sources of difference that are not as easy for competitors to copy given their resource configurations.

Once one or more sources of differentiation are identified, the entrepreneur must build their value offering around this difference. Doing so is not easy for the low income entrepreneur. Like segmentation and targeting particular customer groups, differentiation requires discipline. The entrepreneur is worried that differentiating in a particular way might alienate other potential customers who are not attracted to this difference. But attracting a lot of people who value the source of differentiation will pay off far more than the returns from going after anyone and everyone with a generic approach that is not unlike what a number of competitors are doing. Further, where customers perceive a difference and it is a difference they value, they are often **willing to pay more and demonstrate more loyalty** to the business.

Differentiation also requires an investment of time, effort, and money, and has to be continually reinforced in the minds of customers. For someone in poverty, identifying the source of differentiation early on is critical. Once resources are configured in a particularly way, it can be quite costly to change the configuration in ways that create a meaningful difference in terms of how the venture is perceived. The entrepreneur caught in the commodity trap can find themselves in a downward cycle without the additional resources and available time needed to break out of this cycle.

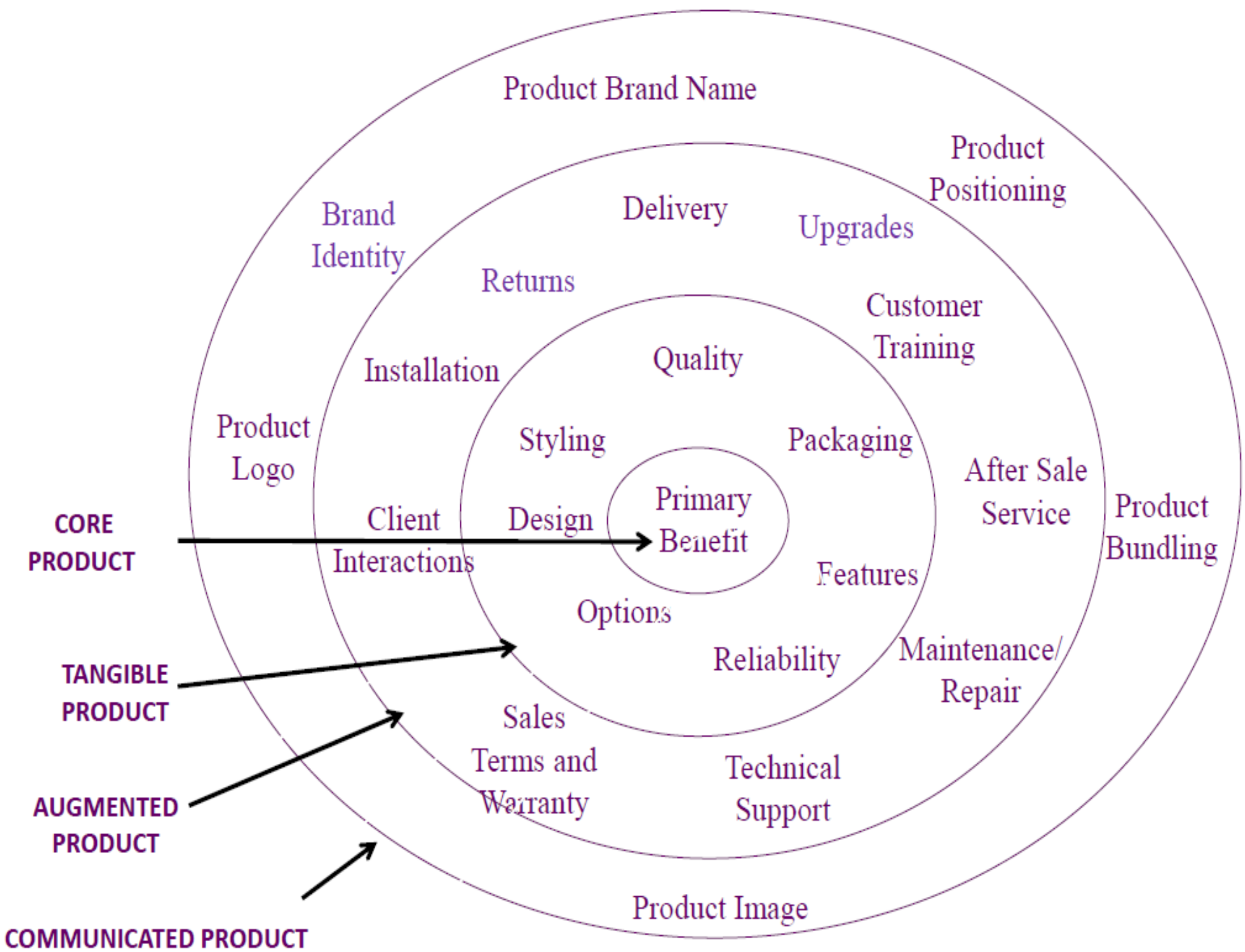


Figure 2: Finding Sources of Differentiation at Four Levels