

# THINK ACT

BEYOND MAINSTREAM



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## SIMPLY THE BEST

**Frugal products are not just for emerging markets:  
How to profit from servicing new customer needs**

JUNE 2015

**Roland Berger**  
Strategy Consultants

# THE BIG 3

 **4.8**

**billion people will belong to the global middle class in 2030. The race is on to target these new consumers – a vast source of market potential for European companies.**

**p. 5**

 **4**

**different market and competitive positions lay the cornerstones for successful product strategies. Roland Berger's four-quadrant matrix helps companies quickly make the right decisions.**

**p. 6**

 **70%**

**of Germany's top managers are focusing their plans for 2015 on product portfolios. It is high time to talk about new market strategies – and to consciously embrace frugal products.**

**p. 9**



**Slim down  
or start from  
scratch?  
p. 13**

# Two birds with one stone. Emerging markets write the most exciting growth stories – causing many to overlook the rise of completely new customer segments in mature Western economies. Frugal products empower companies to address new needs and demands on both fronts.

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How can companies continue to grow in both youthful markets and mature, apparently saturated ones? By further sharpening their strategic focus on what customers really need. For those that want a piece of the action in the low-end to mid-range market segments, the concept of frugal innovation **A** – developing simple products to meet basic needs – has lost none of its attraction, none of its powers of persuasion. Interest among our clients in industry remains unbroken, despite the fact that not all high-flying expectations have yet been realized: The hundred-dollar laptop for developing countries with inadequate infrastructures is still waiting to make its breakthrough. Designed as a car for the masses, the strikingly simple Tata Nano has not even gained a foothold on its home market in India, let alone in Europe or the USA. Yet nothing undermines the status of frugal innovation as a front-line source of growth stimulus today.

Our previous studies show that businesses have room to improve both strategies and operations as they carve out market positions and define their product portfolios. It is fair to say that, up to now, some of them have not understood their customers' needs as well as

they might have. Frugal innovation does not mean innovation at the lowest possible cost. The most common mistake seems to be simply removing certain functions from mature and sophisticated products in an attempt to target new customers. Yet the mere promise of driving "the cheapest car in the world" is clearly not attractive enough. A different approach is needed: Products must be rethought and redeveloped from the ground up.

One of the most popular and successful examples is the Dacia Logan. In his then capacity as CEO of Renault, Louis Schweitzer once drew far-reaching conclusions for his model policy from observations made in Russia. His strategic shift toward a new simplicity sparked off a complete cultural volte-face. More than ten years on, industrial growth strategies and product portfolios are still learning lessons from this groundbreaking development.

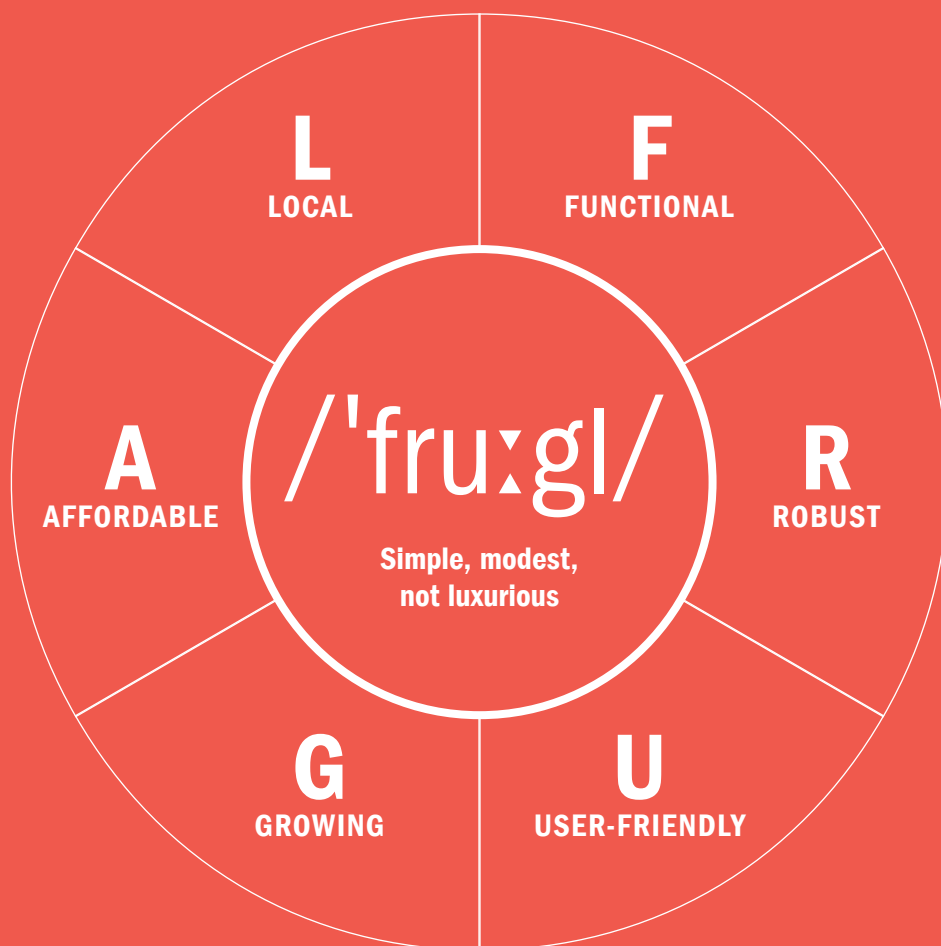
Accompanying President Jacques Chirac on a trip to Russia, the Frenchman noted that car dealers in this emerging market were selling antiquated Ladas for a good 6,000 euros, but couldn't shift Renaults with price tags of 12,000 euros. Why, he asked himself, should technological progress keep Renault from building a

A

# FRUGAL INNOVATION

ACTIVATING THE RIGHT STRATEGIC AND OPERATIONAL LEVERS

Primarily in emerging countries, frugal products are associated with six key attributes



Related concepts can be found in Asia and South America

**\gambiarra\  
BRAZIL**

*Solving problems by improvising the use of methods and all available materials.*

**\zizhu chuangxin\  
CHINA**

*"Endogenous innovation": The Chinese leadership uses this term to denote scientific and technological transformation.*

**\Jugaad\  
INDIA**

*A colloquial term for creative improvisation that achieves more with fewer resources. "Keep everything as simple as possible."*

good car for 6,000 euros? Modern, reliable, and affordable: These three criteria together laid the foundation on which he would build a completely new model series.

In 2004, Renault unveiled the unspectacular family car Logan, a coproduction with Romanian subsidiary Dacia. Since then, the vehicle – made with 50% less parts than a Renault – has been a sweeping success for the French auto group, even in Western Europe. Today, the Dacia brand is a strong and established pillar of the group's business. These basic cars accounted for 20% of global sales as early as 2008, and for 40% by 2013. In its financial reporting on the third quarter of fiscal 2014, Renault cited Dacia as "still the fastest-growing automotive brand in Europe".

The company's annual results for 2014 were accordingly positive, with the Dacia brand occupying three of the top five slots for Renault's best-selling models: The Duster SUV came top, with the Logan in third place (after the Renault Clio) and the compact Sandero fourth. While global sales of Renault cars were down 1.4% year on year to 1.81 million units, Dacia sales climbed 18.8% to nearly 475,000 vehicles. Renault remains committed to launching an extremely low-cost auto on the Indian market in 2015. It is also preparing to build cars in China as of 2016. In the latter market, Volkswagen too is striving to shore up its market share with a very attractively priced car. The consensus is clearly that this is one way forward.

Frugal vehicles evidently scratch where their target group itches. At the same time, they are opening up whole swathes of new buyers – far beyond the emerging markets for which these cars were originally designed, fitted, and priced. Success has come on two fronts, then. From now on, managers can look forward to similar market responses as they map out their product strategies. Not just in the auto industry.

There are several ways in which companies can potentially gain strategic competitive advantages: **B**

#### **> GROWING IN EMERGING MARKETS**

lets them benefit from significant expansion in these economies in the short and medium term and, in the longer term, encourage new customers to gradually trade up to higher market segments.

#### **> GROWING IN ADVANCED MARKETS**

lets them exploit untapped medium-term potential in the low-end to mid-range segments.

#### **> FIGHTING OFF COMPETITORS**

helps them keep indigenous companies from emerging markets out of their own home/established markets in the long run.

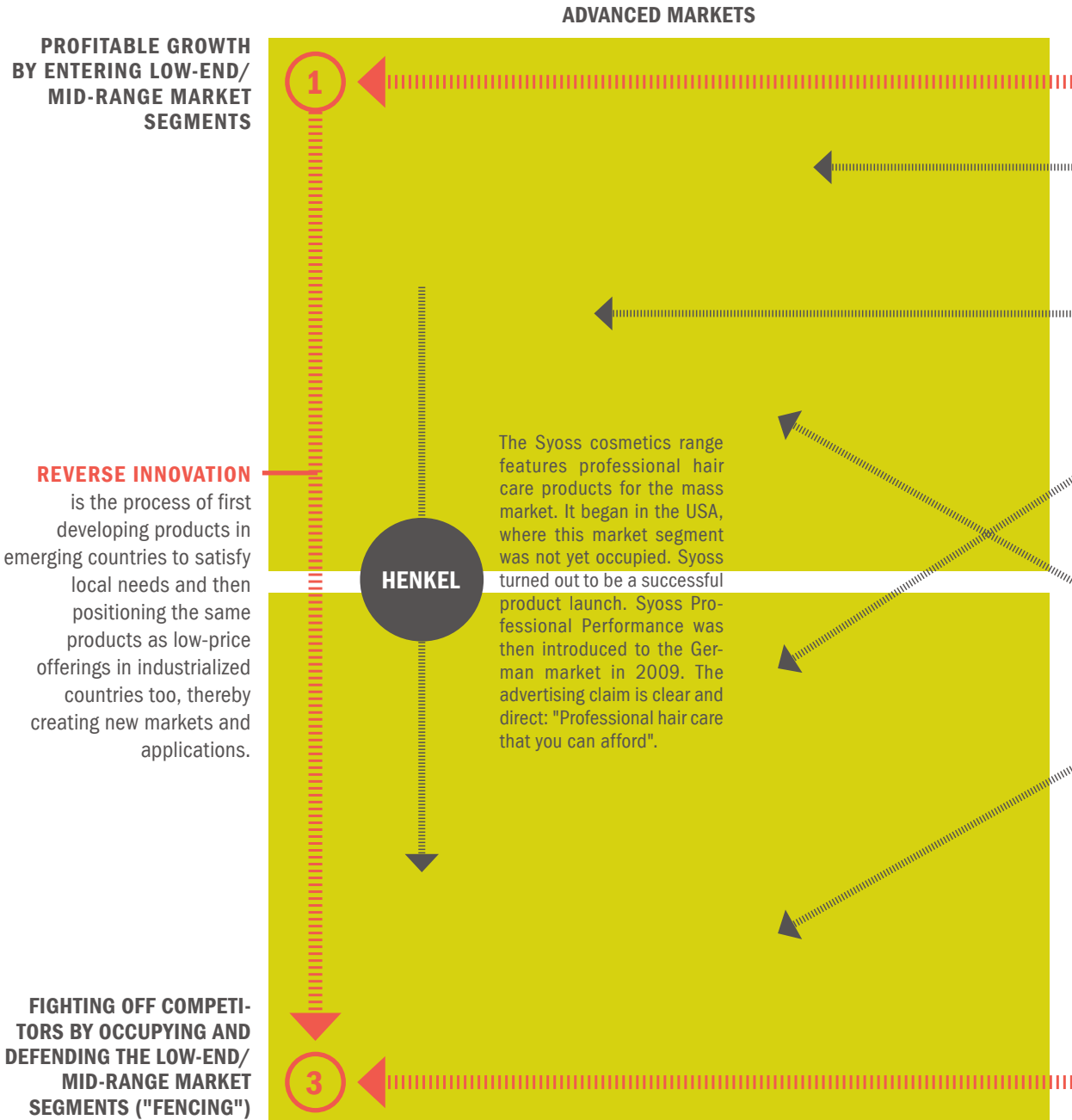
However businesses choose to position themselves, stable demographic and economic factors play into the hands of their frugal product strategies. In their Trend Compendium and other publications, the experts at Roland Berger have repeatedly studied the power shifts that are taking place in the global economy. We believe that, by 2030, 95% of population growth and 70% of real GDP growth will be taking place in emerging countries. Three quarters of growth will be divided up between 20 countries, including Mexico, Peru, Colombia, Argentina, Nigeria, South Africa, Iran, Iraq, Turkey, Indonesia, Malaysia, and Vietnam. In 2030, only just over a quarter of exports will originate in industrialized countries, while nearly three quarters come from today's emerging markets. Four out of five middle-class consumers will live outside Europe and the USA, and their average age will be far below that of Western countries. Moreover, their consumption spending will increase about three times as fast as in the "old world". Five years ago, the OECD reckoned that only 1.8 billion people belonged to the global middle class. Five years from today, the figure will be 3.2 billion, rising as high as 4.8 billion  by 2030. **C** All of which adds up to higher incomes, growing demand, millions of consumer wishes, and the need for millions of machines to manufacture entirely new products: vast market potential for European companies too, in other words.

The BRIC countries in particular look set to continue to grow in the medium term. In purely economic terms, the Russian economy has suffered from low raw material prices in 2015. On the other hand, growth is returning to other regions for precisely the same reason. Emerging markets such as India, Thailand, and the Philippines, for example, are benefiting from the world's current economic climate. China – already the second-biggest economy and trading nation and home to the world's largest for-

B

# WATCH AND GROW

OPTIMAL MARKET STRATEGIES FOR FRUGAL PRODUCTS:  
REAL-WORLD EXAMPLES AND DEVELOPMENT TRAJECTORIES IN  
ROLAND BERGER'S FOUR-QUADRANT MATRIX



**Frugal products** pass through development trajectories. Very few of them can be unambiguously assigned a priori to this or that management strategy. Nor do they tend to stay in the same quadrant throughout their life cycle. Frugal innovation can be an attractive option both for emerging and advanced markets, and can be used to win new market positions or defend existing ones. Some products are initially developed for emerging markets, but then also become established at low prices in the low-end segment of developed economies.

### EMERGING MARKETS

**PROFITABLE GROWTH BY ENTERING LOW-END/MID-RANGE MARKET SEGMENTS**

2

#### DACIA

The Renault subsidiary is meeting the needs of more and more new customers. Rivals still have virtually no answer.

#### DANNON

The US subsidiary of French dairy product manufacturer Danone enriches yoghurts with vitamin A, iron, and zinc. Placed on the South African market in 2005, the Danimal brand helped combat malnutrition and create jobs. 10% of sales revenues go to the "Daniladies" who sell yoghurt in the townships under the supervision of "Danigrandmas" (women with superior education).

#### UNILEVER

For people on low incomes, standard-sized packages of coffee, toothpaste, lotions, and washing powder can be too expensive. Unilever thus introduced single-portion packages of simple products with prices in the cent range. After the 2008 financial crisis, the strategy scored with hard-hit consumer groups in Southern Europe and the USA.

#### GENERAL ELECTRIC

A lightweight, portable ECG device originally intended for medics in India and China is now selling well in the USA too - at 20% below the market price for comparable products.

#### SAME DEUTZ-FAHR (SDF)

The Italian agricultural machinery producer plans to begin selling tractors in the 35-42 hp segment in India in 2015. Agrolux and Agromax are the two brands manufactured locally for the world's biggest tractor market. Their pricing follows the pattern set by Indian market leader Mahindra, although SDF sees itself as competing with higher-priced models from New Holland and John Deere.

#### TRUMPF

The German engineering company acquired a 72% stake in Chinese rival Jiangsu Jinfangyuan (JFY), a maker of punching machines, in 2013. Its express aim was to position itself in the low-end price segment. The Chinese firm's machines cost less than 100,000 euros, while Trumpf's lowest-priced product went for 250,000 euros.

4

**FIGHTING OFF COMPETITORS BY OCCUPYING AND DEFENDING THE LOW-END/MID-RANGE MARKET SEGMENTS ("FENCING")**

eign exchange reserves – is seeing the balance tip away from an investment- and export-oriented economy and lean more strongly toward a domestic, consumer-oriented market. Structural reforms are beginning to bite, and the new China is opening up. The country's growth will slow down in 2015, but will remain on a high level.

## Serious rivals in the battle for new customers

The changes sweeping China and other emerging markets are opening up all kinds of new perspectives. Indigenous companies are no longer merely extended workbenches. In many cases, they have become serious rivals in the battle for new customers in both developing and advanced markets. The competitive fight has long since moved out of the price arena: Product USPs are now the order of the day. Firms who want to play the market successfully must learn to develop frugal products that are perfectly tailored to the low-end and mid-range segments – the low-income strata in mature economies and the upwardly mobile middle classes in emerging markets. The key, as ever, is to understand what customers want and demand. Also, speed takes precedence over perfection. Products become established if they get to market early, if their quality is "good enough" and if they accurately target relevant customer needs.

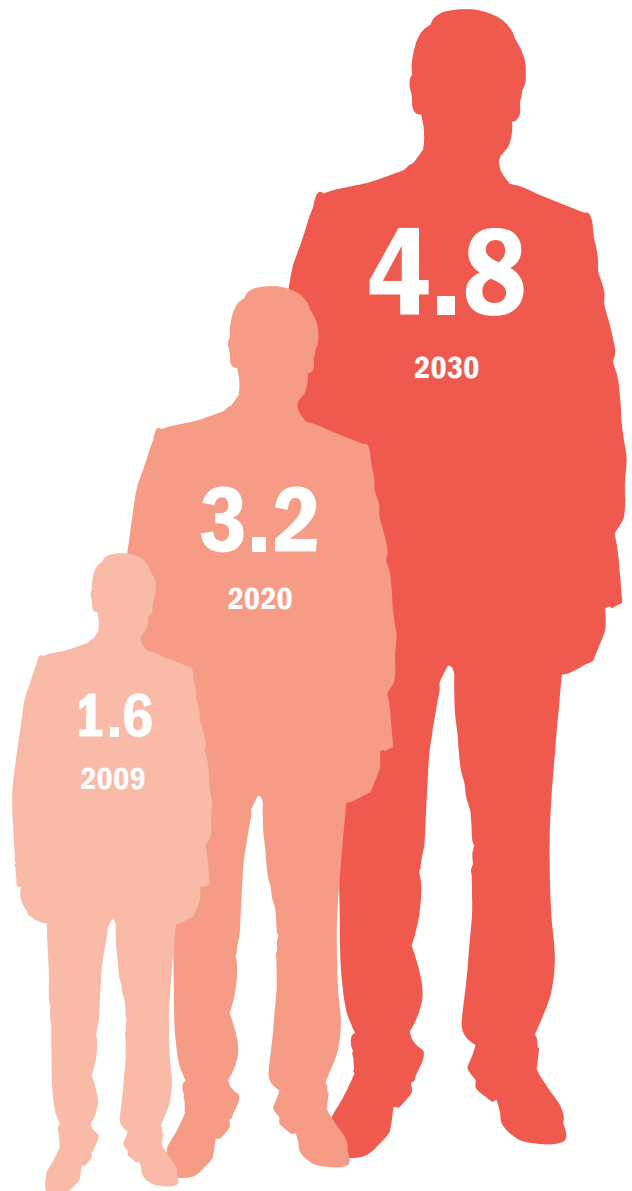
Frugal innovation is continuing to advance in emerging markets and has every chance of making the breakthrough in industrialized countries as well. The financial crisis, recession, stagnating household incomes, and high unemployment have opened the doors wide in a number of European countries, for example. In the USA, Pew Research has found that only 44% of Americans still see themselves as middle class – 9% fewer than in 2008. In their own perception, 40% of the American population have slipped into lower income brackets, while "only" 25% saw themselves on the losing side in 2008. This is another way in which consumers' needs are changing.

That is the situation today: many causes, but a single, clear trend. By 2018, frugal products will almost double in importance – as a share of both sales and profits – at the companies we surveyed.

C

### THE WORLD'S GROWING MIDDLE CLASS

Figures of hope: More and more people on middle incomes equate to growing demand for frugal products [world population in billions]



Source: OECD



# Frugal additions to product portfolios.

Most companies are now turning their attention to product portfolios. One practical approach helps with the systematic evaluation of frugal products and their markets.

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What products and services should we deliver? Which ones should we drop? How can we cut product and service costs across our functions? How can we align our product and service attributes with what customers want? According to 70% of the top managers we surveyed, these are exactly the questions to which management teams urgently need answers. This was the central finding of our sixth Operations Efficiency Radar, in which more than 120 representatives of medium-sized enterprises in Germany (with revenues of up to approx. five billion euros) took part at the end of 2014. According to the survey, product portfolios currently occupy more boardroom attention than controlling and financial processes, working capital management, logistics, purchasing and administration. What is more, managers manifestly share the same view across practically all industries, from automotive and high-tech to mechanical and plant engineering to chemicals, pharmaceuticals, and construction. The fact that technology-driven firms in particular are currently concentrating on product and service portfolios for the long haul suggests that the time is now ripe for European companies to discuss new market strategies that explicitly embrace frugal products.

Companies generally anticipate strong market growth for their frugal products, especially in high-tech

sectors. **D** To make the most of this growth in practice, it is imperative that customers' needs be moved center stage. Unambiguous answers are needed to two pivotal questions: Which functions does the product need (and which ones doesn't it need!)? And how exactly will the product be used? As a rule, it is not enough merely to slim down an existing product. One reason is that this approach usually fails to satisfy customers' specific requirements (which often involves accepting compromises in any case). Another is that it doesn't normally deliver the targeted product costs. To express that in positive terms: You need to rethink solutions from the ground up, shaking off past restrictions and compromises, if you want to fully satisfy customers' needs and meet your product cost targets. Only frugal products that are redeveloped from scratch will succeed.

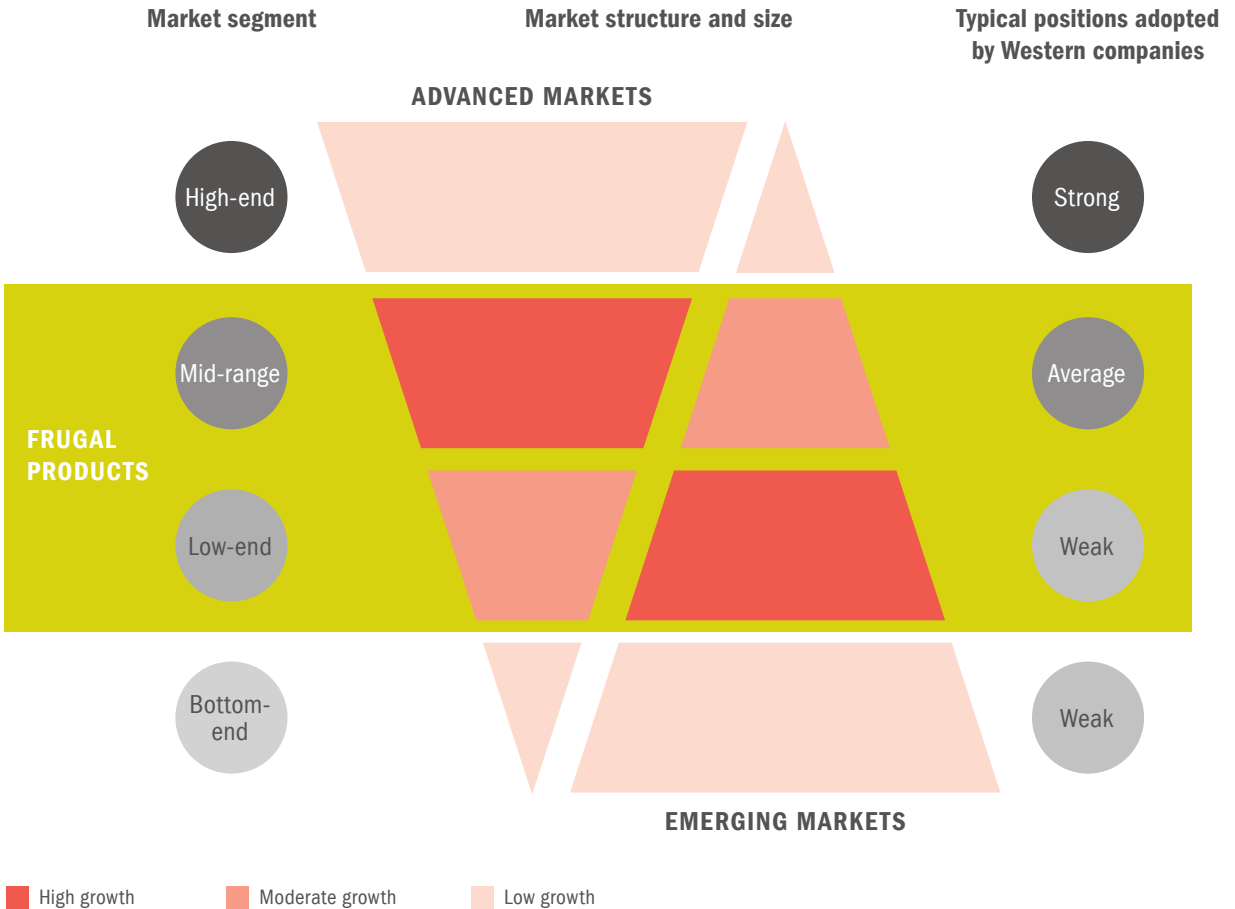
Drawing on their extensive experience of collaborating with practitioners in industry, the experts at Roland Berger have developed an approach that enables companies to work systematically and strategically through every frugal project, step-by-step.

**Market analysis:** Analyze target markets and customers' needs, select customer segments, assess market and growth volumes, set up the business model, identify product pricing corridors, and define margin targets.

D

**KEY GROWTH AREAS**

How Western industrial companies can successfully position themselves



Source: Roland Berger

**Product design:** Systematically realize the concept for the technical solution, define the specific product functions, explore alternatives for different functions, and evaluate product costs.

**Value chain:** Decide what to make and what to buy in development, procurement, production, and logistics, focus on a local footprint and collaborate closely with local distribution partners on marketing and sales.

**Change management:** Plot a road map, develop a risk management system, and factor in implementation and monitoring considerations.

Taken together, these points give management useful guidance that helps them seamlessly and systematically implement new product portfolios and business models.

# Rigorous implementation is key. Frugal product launches repeatedly encounter the same obstacles – and the same success factors. Lessons are there to be learned.

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**Typical obstacles:** Countless consulting projects have shown us that, when new product launches do not go according to plan, the producers mostly lack a knowledge of the markets and/or competitive prices. Internal acceptance and resolve are missing, as are specific local engineering skills. Ultimately, this leads to problems with the planning of product costs and the design of the value chain.

To acquire an in-depth knowledge of new markets, it is not enough to simply apply proven doctrines to new situations. Many high-tech companies are in danger of getting stuck in the rut of a risk-averse quality culture that focuses on the supply side. Their protracted development cycles and standard processes are incapable of handling fast, flexible, local development and production. They lack the openness they would need to develop new frugal products – even with regard to financing, in many cases: In our experience, banks tend to be rather more reluctant to splash the cash when it comes to frugal products. Inadequate coordination with local regulatory bodies is another obstacle, as are friction in the relationships between central and local developers, differences of opinion about quality requirements, and discrepancies in matters such as discipline and the working culture.

Worse still, strict cost controlling is often absent from the word go. When that happens, costs cannot be regarded as equal design parameters on a par with

technical requirements and prescribed timing milestones (although they should be). And if there is no clear link between technical features and commercial implications, it will always be difficult to realize a competitively priced solution. Every technical decision is, ultimately, also a cost decision.

**Typical success factors:** The development and establishment of a frugal product hinges critically on an understanding of what is not required of the product, and that can be determined by means of conjoint analysis, for example. Another vital factor is the firm's resolve and commitment to set aside sufficient personnel and other resources. We believe it is exceptionally important to set up a local development unit. Our experience also attests to the value of professional change management, the full backing of top management, open communication with the workforce – and the patience to wait for all these success factors to come to fruition.

Lastly, a distinct branding strategy is imperative. To avoid jeopardizing established brands, it may make sense to operate a dual-brand strategy that clearly communicates the origins of the frugal product ("powered by") without negatively affecting the placement (and pricing) of the established brands. Dacia, a sub-brand of Renault, is a good example. Another one is the Horki brand operated by Korean auto manufacturer Kia and destined solely for the Chinese market. The name Horki is a made-up compound that combines

the Chinese word "hor" ("China") and "ki" ("driving a car"). It derives from Kia's joint venture with a Chinese manufacturer, Dongfeng Kia Yueda.

The gratifying finding of our case studies is this: Companies that have carefully weighed the risks and opportunities and thoroughly discussed the typical obstacles and success factors usually realize very satisfactory results. Technology firms frequently exceed their own expectations with regard to the cost, quality, performance, and profitability of their products. Not all industries can say the same thing, however.

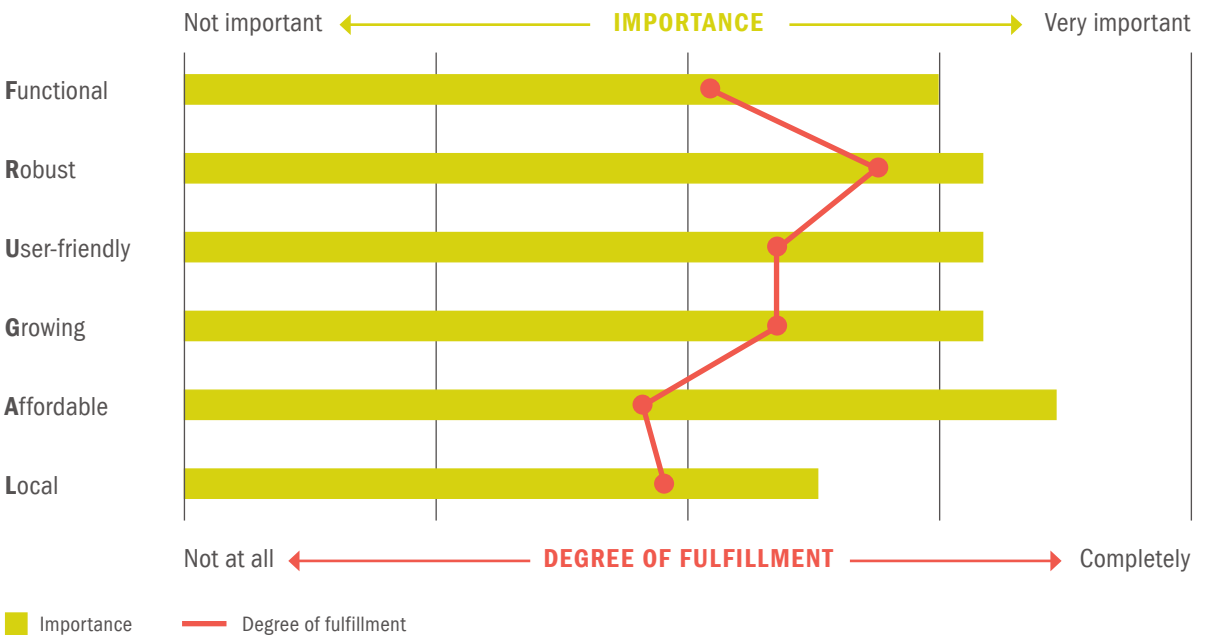
Several studies show that a number of generalizations can nevertheless be made. For example, we asked customers to assess the importance of the individual aspects subsumed under the word FRUGAL as an acronym. **E** This proved to be a revealing exercise. Products have to be robust and user-friendly, and must also service growing markets. While engineers are evi-

dently good at the robust bit, functionality commands rather less importance among representatives of industry. Least important of all is the aspect of local production, even though this is comparatively easy to implement. All of which leaves us with affordability as the most important characteristic feature of a frugal product. As it happens, this is also where companies must overcome the biggest obstacles if they want to realize their goals. Once price points have been set, the link between product costs, customers' requirements and targeted margins becomes clearly visible.

The picture may be patchy, but the conclusion to be drawn is obvious: Every part of a company needs far-reaching management decisions that are well-thought-through and rigorously implemented. More so than in the past, it is vital to formulate a strategy which ensures that frugal innovation is tackled and realized systematically from the ground up.

**E**  
**ATTRIBUTES OF FRUGAL PRODUCTS**

Customers' perspective: "Affordability" is where the greatest potential for improvement lies



Source: Roland Berger

F

# **+** FRUGAL STRATEGY

FRUGAL PRODUCTS ONLY ROLL UP THE MARKET  
IF THEY ARE REDEVELOPED FROM SCRATCH

Of course it is possible to simplify an established product. Especially in emerging markets, however, the result seldom meets either customers' needs or the producer's pricing requirements. That is why products targeting the low-end to mid-range segments of these markets should be completely redeveloped.



# **Best practice.** Affordability is a must. The frugal development of new products means alternately seeing them from the customer's and the manufacturer's perspective.

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Our analysis of numerous best-practice examples enabled us to make certain generalizations that each company can use for its own ends. Companies that want to successfully launch frugal products have to learn to see both sides of the coin: what customers expect of a product, and how producers can cost-efficiently give them what they want. Ultimately, it all boils down to finding the right product configuration that best satisfies customers while still giving the producer a competitive edge. If a suitable product strategy is to be mapped out, pivotal questions that come up again and again demand unequivocal answers. **F**

What price can the product fetch on the market? Making a product less expensive is not the only issue at stake. Ideally, the new product will be accompanied by an innovative pricing model that allows for subscriptions or lease-and-buy-back options, say. Just as important is the question: How can we find out exactly what customers are not willing to pay for? The answer here provides a necessary indication of how rigorously the functionality of frugal products must be defined – irrespective of whether a product is redeveloped from the ground up or adapted from a more complex existing product. The design must be aligned with clear-cut cost targets. Affordability is the most essential attribute of a frugal product; and the best way to achieve this goal is to utilize local resources – for research and development, for procurement and production. Co-

operating with local sales organizations is likewise an integral part of this decentralized strategy. For this reason, the whole company must be kept fully and regularly informed and involved in the development and launch of a frugal product.

In most industries, frugal products are of great importance to profitable growth – especially in emerging markets. Adopting a systematic, tailor-made approach right from the outset enables industrial companies to avoid disappointing sales and profit outcomes. It also leaves them ideally placed to avoid being left behind by home-grown players in emerging countries. Having said that, companies that swiftly align their strategies and processes with this segment will find themselves able to sell frugal products successfully in more than just emerging markets. Some growing customer segments are taking shape right in the heart of mature Western economies. There are many reasons why frugal products are the solution to allow industrial companies to profit – in the most literal sense of the word – from this growth. **◆**

# ABOUT US

## Roland Berger Strategy Consultants

Roland Berger Strategy Consultants, founded in 1967, is the only leading global consultancy of German heritage and European origin. With 2,400 employees working from 36 countries, we have successful operations in all major international markets. Our 50 offices are located in the key global business hubs. The consultancy is an independent partnership owned exclusively by 220 Partners. [WWW.ROLANDBERGER.COM](http://WWW.ROLANDBERGER.COM)

## Further reading



### COO INSIGHTS INDUSTRY 4.0

Our research across Europe shows that digital production has already begun to revolutionize value chains at many companies. BMW CEO Harald Krüger is clearly optimistic about what human-machine interaction will bring to automobile production. Our publication also highlights where the really lucrative 3D printing niches are springing up, and draws on insights from Airbus to look at how companies can defend themselves against cyber attacks. What factors help companies successfully realize Industry 4.0 models is a question to which we have found more than one key answer.



### COO INSIGHTS FRUGAL INNOVATION

How can companies switch from a "Big is beautiful" mind-set to one of "Good enough" or "Best fit"? The answer is "frugal innovation" – the art of making more out of less, when the "less" is already on hand. This issue reproduces an interview with Siemens Healthcare and explores three assumptions. First, emerging markets are no longer markets that simply scoop up whatever they get from high-end Western producers. Second, scarce resources are forcing companies to be more efficient in how they use raw materials and more careful with costs. And third, what's good for the emerging markets can also be good for the entire world. It all sounds so simple – but deceptively so. A whole edition of COO Insights looks at the reasons why.



### STUDIE FRUGAL PRODUCTS

The "Frugal products" study lays the foundation for our strategic considerations. More than 60 top managers from a variety of industries took part, helping us identify the most important attributes of frugal products at each link in the value chain. Fewer than half of our study participants were satisfied with sales of and profits on their products, many of which are presented pars pro toto. Our consulting strategy and experience show that a clear understanding of customers' needs is key.

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