Economics of Adding Value through Product Differentiation

Bruce A. Babcock
Center for Agricultural and Rural Development
Iowa State University

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Overview

• What is a differentiated product?
• Why can product differentiation create value?
• What attributes are consumers willing to pay for?
• How can profits be increased?
• How can profits be sustained?
What is a Differentiated Product?

• What happens to sales if a product’s price is increased?
  – If sales fall to zero, then no product differentiation.
  – If sales do not fall to zero, then there is some perceived difference in the product.

Examples of Commodity Products

• Number 2 yellow corn
• 185 pound hog carcass grown in confinement
• Gasoline sold on a corner with two other stations
Weisengold eggs are not a commodity product

News Release from Frito-Lay

• Tostitos Is First Frito-Lay Package To Call Out "0 Grams Trans Fat" On Front

Plano, TX (September 9, 2004) - Frito-Lay announced today it will feature a "0 grams trans fat" message on the front of some of America's favorite snack chips. The Tostitos line of tortilla chips will be the first Frito-Lay product to carry the message on the front of the packaging as part of the brand's new look.
Many ways to differentiate a product

Napa Valley Wine Appellations
Oakville vs Rutherford

- Oakville is mildly affected by fog and wind from the San Pablo Bay that manages to slip past the Yountville Mounts. At the same time, Oakville enjoys the abundant sunshine and warmer temperatures that are characteristic of the Northern Napa Valley.
- Oakville is slightly cooler than Rutherford to the north. Cabernet Sauvignon dominates Rutherford a bit more than Oakville, but the varietal is the undisputed king in both AVAs. Opus One produces what is probably the most famous wine based on Oakville Cab.
- Rutherford Cabs are grown in slightly warmer temperatures and tend to have earthier, less fruity flavors. On average, they are a little less approachable in their youth, but age longer. Keep in mind that these are very slight and generalized distinctions. Great Oakville Cabs will age for many years and grow more complex and balanced over time as well.

Why can product differentiation increase profits?

- Commodity producers are price takers
  – If Price > Cost, profits are positive
  – If Price < Cost, lose money

- With a differentiated product price can be raised without losing all sales

- Or firms that differentiate can gain a competitive advantage by entering a new market that has differentiated standards
  – Dairy, meat and egg suppliers for fast food chains
The Home Depot’s Environmental Commitment to Sell FSC-Certified Products

- Royal Mahogany Doors from a certified forest in Costa Rica.
- Premwood Doors, an alternative to lauan interior doors.
- Hardwood plywoods by Roseburg F.P. and Columbia F.P.
- FSC-certified dimensional lumber from a large Canadian supplier.
- Flooring underlayment made from recycled newspapers and gypsum sold as a replacement to lauan flooring underlayment.

“Rest assured, as more “green” products become available, The Home Depot will carry them.”
What attributes can induce consumers to part with a bit extra?

- Superior taste
- Unique taste
- Superior appearance
- Good for you
- Good for the environment
- Locally raised
- Authentic
- Humanely raised

Which attributes can be “discovered” by consumers?

- Taste and appearance (experience goods)

- Other attributes may or may not exist in a product that claims to have them (credence goods)
How to increase profits from experience goods

- Create a better product
- Invest in appropriate level of marketing
- Control production costs
- Make sure supply is matched with commitments
- Maintain consistent quality

How to Make Profits from a Credence Good

- Find an attribute that consumers will actually pay money to obtain
- Source a supply that offers the attribute
- Set up a convincing enough certification system.
- Invest in appropriate level of marketing
- Control production costs
- Make sure supply is matched with commitments
Valuing Product Attributes – Bruce Babcock

How Can Value Creation Be Sustained?

• Imitators will soon flood the market and drive profits to zero unless a significant barrier to entry exists
  – High oil, white corn, waxy corn
  – Organic produce
  – non-GMO soybeans

Types of Barriers to Entry

• Regulatory
• Technological (e.g., fully traceable)
• Geographic
• Capital costs
• Marketing/brand identity
Geographic Barriers

- American AVA system for wines
- European GI system (PDOs and PGI*s)

Example GIs in the EU

- Parmigiano Reggiano
- Mozarella di bufala campana
- White Stilton and Blue Stilton
- Welsh beef
- Newcastle brown ale
- Camembert de Normandie
- Roquefort
- Dortmuder bier
- Feta cheese
- Kalamata olives
GI Restrictions

- Only cheese produced in the three counties of Derbyshire, Leicestershire and Nottinghamshire and made according to a strict code may be called Stilton. There are just six dairies licensed to make Stilton. They are subject to regular audit by an independent inspection agency accredited to European Standard EN 45011.

To be called Stilton, each cheese must:
- be made only in the three counties from local milk which is pasteurized before use
- be made only in a traditional cylindrical shape
- be allowed to form its own crust or coat
- be un-pressed
- have delicate blue veins radiating from the center
- have a taste profile typical of Stilton.

Brand Loyalty

- Branding a product is the traditional way of creating a barrier to entry
  - Sun-Maid
  - Sunkist
  - Ocean Spray
  - Mondavi
- Creation of a successful brand is expensive
- Maintenance of a brand is expensive
Summary

• Growers can make money being low-cost producers and selling for a profit at the commodity price, or

• Growers can create a differentiated product, have some control over quality and quantity, and try to behave like consumer-oriented firms worldwide.