

Opportunities for Action

Razors and Blades: New Models for Durables

Gillette's introduction in 1903 of a safety razor with a disposable blade turned out to be brilliant. So was Hewlett-Packard's decision to keep the price of its inkjet printer low, in order to capture the market for its high-margin cartridges. In fact, many companies in the consumer industry, particularly in the durables sector, could benefit from similar strategies. Challenged by faster innovation cycles, aggressive Asian entrants, consolidating retailers, and the growth of private-label products, manufacturers of home appliances, electronics, and other durables could find new opportunities with their own versions of razors and blades.

Of course, some companies are wise to stay with their traditional business models. They may lack the appropriate capabilities, economies of scale, or necessary intellectual property. Or they may face entrenched global competitors. But more often, the reason most companies continue to sell products the way they've always sold them is that they are stuck in old ways of thinking. "Our core competency is bending metal," they may say, or "There's no money in services." Those beliefs need to be challenged. Companies that shy away from taking a fresh look at their business models risk having their competitors do it for them.

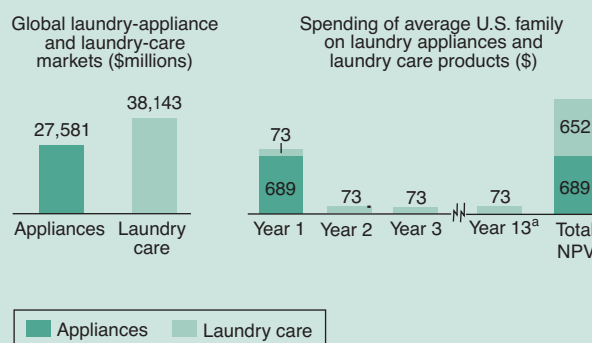
New Ways of Thinking

One way of redefining a business is to redefine the customer. Take household appliances. Some manufacturers still consider their core customer—the one they have an ongoing relationship with—to be the retailer that sells their products rather than the consumer who buys them. That's because consumers tend to purchase a

major appliance only once every three years, so a manufacturer's relationship with them is transitory. Service, if it is required, is usually provided by the retailer or by networks of approved independents. Yet, as many packaged-goods companies have discovered, the stream of revenues that consumers generate by using and upgrading their purchases can produce significant growth and profits.

Washers and dryers, for example, bring in annual revenues of nearly \$28 billion worldwide, but the consumable laundry products that the appliances use generate more than \$38 billion. (See Exhibit 1.) What's more, the consumables are often sold at much higher profit levels than the appliances. In 2004, for example, Procter & Gamble had \$2.2 billion in net earnings from fabric- and home-care products alone—products that are used in the machines made by Bosch, Electrolux, General Electric, Kenmore, LG Electronics, Maytag, Samsung, and Whirlpool, among others. Yet none of those appliance brands has managed to tap the profit potential from the stream of consumable products. Hewlett-Packard, in contrast, ensures that it benefits from downstream profits by patenting its printer's cartridge technology and making the use of its cartridges a requirement for

Exhibit 1. Laundry Care Products Offer Recurring Downstream Revenues for Appliance Makers



Sources: Datamonitor and Euromonitor; BCG analysis.

^aEstimated average life of washers and dryers.

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honoring its warranty. The printer itself accounts for only one-third of the profit pool over its life, whereas cartridges account for two-thirds. (See Exhibit 2.)

Companies such as Procter & Gamble aren't content with the profits that come from consumables. Increasingly, packaged goods manufacturers, as well as the big retailers, are going after the durables market itself. Procter & Gamble, for example, captured 25 percent of the mop and broom business in just four months with Swiffer, its alternative to the ordinary broom. Three years later, Swiffer and its accessory products had accumulated \$315 million in sales. Meanwhile, Rubbermaid reported a 20 percent drop in sales of conventional mops and brooms. On the retail front, The Home Depot now car-

ries its own Ridgid and Ryobi brands, produced exclusively for the company by Techtronic Industries and positioned directly against the Black & Decker and DeWalt lines.

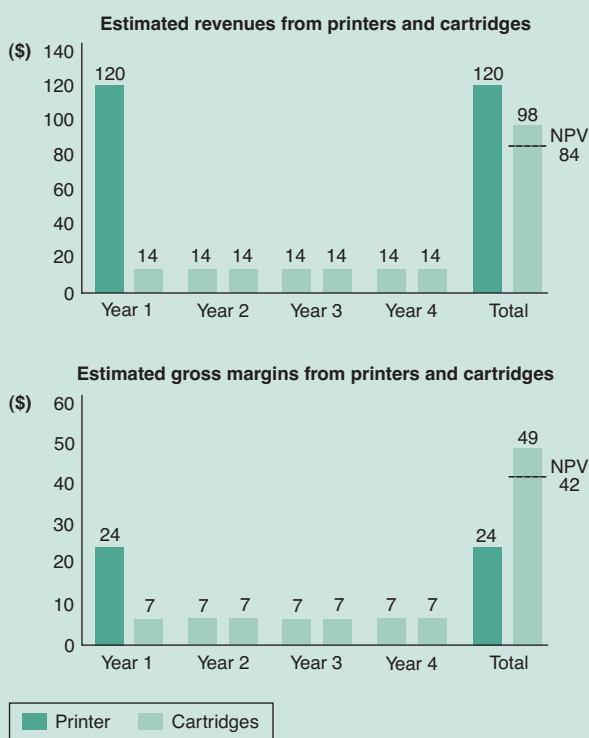
Four Alternative Models

But durables companies are fighting back. Here are four alternative business models, including the Gillette approach, that innovative companies are using to bring new life to their growth and returns.

Products and Consumables. Gillette takes in about \$4 billion a year from its razor-and-blades portfolio, with a global market share that is more than six times greater than that of its nearest competitor. Its recurring-revenue model is highly profitable, accounting for 42 percent of the company's total sales and 68 percent of its total profits. Makers of inkjet printers aren't the only durables companies that can benefit from this model. Consider a \$1,000 side-by-side refrigerator that features a built-in ice and water dispenser with an embedded water filter. Over the life of the refrigerator, the manufacturer could earn about the same gross margin from the filter replacements (roughly \$70, in discounted future cash flows) as from the sale of the refrigerator itself. Because most manufacturers focus their time and effort on the core product, however, they often overlook the lifetime annuity that can be derived from consumable product extensions.

Disposables and Beyond. Many high-priced products that were expected to last for years are being replaced by disposables. Given the advent of new technologies, sometimes the disposables are then threatened by new durables—which invite their own replacement by still another generation of disposables. All this change opens up the potential for new revenue streams flowing not only from the disposables but also from the durables that remain.

Exhibit 2. Revenues from HP's Printers and Cartridges Are Similar, but Margins on Cartridges Are Much Higher



SOURCE: BCG analysis.

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The twists and turns of the camera and film business are a case in point. In 2004, single-use film cameras accounted for 38 percent of the total U.S. film-camera market. But in 2005, sales of digital cameras grew 23 percent over the previous year and were purchased by nearly 30 percent of U.S. households. The owners of all these digital cameras, however, printed less than 19 percent of their pictures.

To capture recurring revenues in a declining disposable-camera market, a number of companies have developed digital cameras for one-time use. Ritz Camera Centers, for example, the largest retail camera and photo chain in the United States, launched the Ritz/Wolf Camera Dakota. At \$11, this disposable digital model costs only slightly more than a disposable film camera from Kodak or Fuji, and Ritz/Wolf charges \$3 less for processing prints.

For its part, Kodak is offering a host of new services that help customers who have either durable or disposable digital cameras manage, print, and share pictures more easily. One result is a digital camera service, called EasyShare, for convenient capture and uploading of pictures to the computer and the Internet. Kodak acquired EasyShare Gallery (formerly Ofoto) in 2001. Kodak EasyShare Gallery added 2 million customers in the first two years and has grown to 28 million members today. Kodak also is the market leader in home snapshot prints, and its Picture Maker self-serve kiosks are in retail locations around the world.

Products and Accessories. New technology often changes where and how a company profits from a sale. When Apple developed the iPod, it diverged from the traditional razor-and-blades model and made the iTunes Music Store (the recurring revenue) the “loss leader” that strengthens the overall product offering and locks in the customer. When Apple unveiled the iTunes Music Store in April 2003, iTunes sold

more than a million songs in the first week. It went on to sell more than 14 million in the first six months and more than 600 million to date. At 99 cents per song and \$9.99 for most albums, the record labels capture most of the profit (65 cents per song). Yet iPod sales have increased more than 30 times since the introduction of iTunes, and that growth has driven significant sales and profits from peripheral products and accessories.

Multiple Revenue Streams. Some new products are blurring the lines between product and service, durable and consumable. Consider the game console business. Sony and Microsoft would like to sell more than just the console. But unlike a printer manufacturer, which can restrict its customers to its own cartridges, Sony and Microsoft can't insist that their customers buy only the games and accessories they produce. Instead, they license the rights to game producers and then take a share of the profit through the fees. And online gaming offers the potential to capture monthly revenues from the games themselves.

General Motors is expanding its relationship with its automobile customers by offering additional products and services through its subsidiary companies, such as GMAC, its financial and insurance arm, and OnStar, its in-vehicle communications and assistance service. Launched in 1997, OnStar now has nearly 4 million customers. Initially focused on concierge services, emergency assistance, air-bag-deployment notification, and roadside assistance, OnStar has added such features as monthly e-mail to subscribers, which includes vehicle diagnostic information and hands-free calling. GM considers OnStar a critical product differentiator and a major element of its customers' overall vehicle experience.

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As successful as these and other business models have been, there is a caveat: no model will last forever. Sooner or later, good ideas will be displaced by even better ideas and new technologies. For instance, after years of having to replenish their vacuum-cleaner bags regularly, consumers can now choose from among a number of bagless vacuum cleaners.

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Pressure on durables' margins will only get stronger. Some of that pressure will come from traditional competitors, but much of it will come from new global entrants, retail customers, packaged goods companies, and technology shifts. Clinging to yesterday's definition of the business will become increasingly risky.

To see if your company could benefit from fresh thinking about its business model, consider passing around the following questions at your next strategy session:

- What is the total profit pool across the value chain from the products we sell over their lifetime? Who is capturing that value today and how successfully?
- Would our brand, core capabilities, and channel strength allow us to capture a larger piece of the total profit pool?
- Are we at risk from new business models or technology changes that may redefine the profit pools for our products?

- Should we explore opportunities for products that are purchased more frequently? Should we develop products with manufacturers of packaged goods?
- What is the right path for broadening our model—direct involvement, partnerships, or joint ventures?

There's no standard answer to these questions. Each company will need to develop its own formula for the future. For some companies, staying focused on the core business will make sense. But for many others, it's time to take a fresh look at where the profits come from.

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