The New "Low Cost"
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The New “Low Cost”

Low-cost offerings are not new, but there is a new wave of low-cost business models. They are taking share from traditional players in many industry sectors and locations.

This new wave first appeared in rapidly developing economies (RDEs) where both local and multinational companies have had to design new models to serve a large segment of customers with limited financial means. These new models also have important strategic implications for the developed world. RDE-based market leaders are leveraging their home-market success to pursue global ambitions. And multinationals are disrupting competitors and pioneering new price points and applications in the developed world with low-cost offerings created for RDEs.

Although some traditional firms are already riding this wave, too many are at risk of missing it.

History and the Golden Rules of Low Cost

In 1436, Johann Gutenberg invented the printing press. Until then, books had been laboriously and exquisitely hand produced by monks. Gutenberg’s invention dramatically reduced production costs, and by 1500, nearly 20 million books had been printed—more than had been produced in the whole of human history before Gutenberg’s invention.

In 1869, John Sainsbury opened his first self-service supermarket in London. Until then, grocers had competed on the basis of location and sales staff. Sainsbury decided to locate his stores outside city centers and also to let customers help themselves. Some of the money he saved by reducing staff and choosing less expensive locations was returned to customers in lower prices. Success came quickly. Sainsbury’s supermarket was not cheap; it was different.

A low-cost approach is more than merely an opportunity for current customers to buy the same goods for less. Most important, it is a truly new value proposition that addresses both existing and new customers and is supported by a novel operating model. Consider this: 55 percent of the first-time flyers on Ryanair, a low-cost airline, have never before traveled by plane.

In 1948, Dick and Mac McDonald reinvented the restaurant: No more printed menus—only a limited set of choices. No waiters—customers would place orders directly at a counter separating the dining room from the kitchen. No more forks and knives—customers would eat with
their hands. Perhaps they would even wipe their table before leaving. What a revolution. There would be no compromise on the quality of the food. Cost savings were achieved by range simplification and, as in a supermarket, by having customers perform part of the work traditionally done by employees.

These examples illustrate the four golden rules of low-cost business models:

- Low cost is not low margin. It can be highly profitable. Ryanair and McDonald’s, for example, are among the most profitable companies in their industries.
- Low cost is not low quality. It is, usually, narrower range.
- Low cost is not cheap imitation. It is true innovation.
- Low cost is not unbranded. It is frequently supported by potent brands.

Although not all successful low-cost business models are alike, many have characteristics in common and rely on a carefully selected set of radical and mutually supportive choices across all dimensions of the business model. (See the exhibit “Low-Cost Business Models Are Based on an Integrated Model with Radical Choices.”)

### The New Wave of Low-Cost Business Models

By the beginning of the twenty-first century, most multinationals had realized that to achieve their growth

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### Low-Cost Business Models Are Based on an Integrated Model with Radical Choices

<table>
<thead>
<tr>
<th>Target segments</th>
<th>Product or service offering</th>
<th>Revenue model</th>
</tr>
</thead>
<tbody>
<tr>
<td>◦ Focus on a limited number of price-sensitive customer segments</td>
<td>◦ Design a provocative new offer with strong appeal to the target segments</td>
<td>◦ Price for basic core value</td>
</tr>
<tr>
<td>◦ Define segment borders clearly</td>
<td>◦ Keep it simple, uniform, and focused on basics and on eliminating other attributes</td>
<td>◦ Eliminate frills</td>
</tr>
<tr>
<td>◦ Understand their priorities and business economics</td>
<td>◦ Establish high core-service standards to support the value proposition</td>
<td>◦ Charge for options</td>
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### Low-cost business models

<table>
<thead>
<tr>
<th>Value chain</th>
<th>Cost model</th>
</tr>
</thead>
<tbody>
<tr>
<td>◦ Align and optimize the asset base</td>
<td>◦ Achieve low cost along the whole value chain</td>
</tr>
<tr>
<td>◦ Define core versus noncore activities</td>
<td>◦ Apply the model from sourcing through distribution</td>
</tr>
<tr>
<td>◦ Determine what should be in-house and what outsourced</td>
<td>◦ Design to the cost target consistent with the profitable delivery of the value proposition</td>
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<tr>
<td>◦ Rely, wherever possible, on up-to-date, standardized assets</td>
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### Operating model

<table>
<thead>
<tr>
<th>Organization</th>
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<tbody>
<tr>
<td>◦ Design for operational efficiency</td>
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<tr>
<td>◦ Limit overhead</td>
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<tr>
<td>◦ Adopt radical human-resources policies</td>
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<tr>
<td>◦ Match new employees with the right job profiles</td>
</tr>
<tr>
<td>◦ Foster an entrepreneurial, visionary culture</td>
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Source: BCG analysis.
ambitions they would need to win in the so-called BRIC markets: Brazil, Russia, India, and China.

Most companies simply transplanted their traditional developed-world business models to these markets. Serving higher-income customers in the major urban centers, these companies achieved double-digit growth with only a small revenue base. This kind of growth is nice, but it’s unlikely to have a material impact on a company’s global results or long-term leadership. In most sectors, achieving strategically significant revenues in RDEs requires going beyond the top of the pyramid and developing business models and offerings that address the broader market. A low-cost business model is a critical element of any RDE strategy.

Nokia offers one of the best examples of such a strategy made real. To win in the developing world, it adapted its business model: it leveraged local R&D centers to create low-cost products with features specifically designed to meet the needs of mainstream customers, and it built a novel system to get those phones to market. Nokia’s approximately 100,000 points of distribution give it four times the reach of its nearest competitor. Nokia’s intimacy with the Indian market—which, in the time that Nokia has been there, has grown from next to nothing to the world’s second-largest mobile-phone market after China—has fueled meteoric growth.

Today, with $3 billion in revenue from India, Nokia is one of the largest multinationals there. But the game is not over. Nokia faces escalating challenges from nimble local handset manufacturers. Tianyu, for example, has risen to the number three position in the market, employing a business model that focuses on fast innovation cycles and unique features such as ultraviolet lights that detect counterfeit currency.

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Low cost is a necessity in emerging markets and often also a source of inspiration in mature markets. In 2002, General Electric was having only limited success selling ultrasound devices priced at $100,000 and higher to sophisticated Chinese hospitals. It was clear that capturing the heart of the market would require a dramatically different business model. GE chose to pursue a value proposition focused on low cost and portability. It made significant changes to its operating model—in R&D as well as sales and service—to rapidly develop and launch a portable product. At an initial selling price of $30,000 (the price is now down to $15,000), the product was a success.

Sales took off in China. Moreover, GE discovered that this new product opened numerous new applications for ultrasound in the developed world where its traditional products were either too large or too expensive to be considered. By 2008, revenues from portable ultrasound equipment had grown to nearly $300 million. GE has reaped similar “two way” benefits not only in other health-care lines but also in other businesses such as aircraft engines.

Jeff Immelt, GE’s chairman and CEO, refers to this phenomenon as “reverse innovation.”

Low-cost business-model innovators are not all from the developed world. Taiwan’s AsusTeK Computer pioneered the low-cost market for netbooks with a profitable Linux-based machine priced only slightly higher than the computers from the nonprofit One Laptop per Child initiative. The product, the Eee PC, was voted the most desired gift for Christmas 2007 on Amazon.com.

India’s Tata Motors saw a huge untapped opportunity in families who needed motorized transportation but could not afford a traditional car. Until Tata introduced the $2,500 Nano in 2009, the only options for these families were three-wheelers.

Tata rethought the automotive business model from the ground up in order to design, produce, and deliver a $2,500 car. The company of course eliminated many frills and limited available options, but—more important—it also leveraged an open-development model that relied heavily on suppliers. Like GE, Tata sees opportunities to bring this innovation to the developed world. Tata has announced the Nano Europa, which will meet all European regulatory standards and is likely to be on the market by 2012, priced at less than $10,000.

How Should Traditional Companies React?

Too often, when it comes to low cost, companies get caught in two traps: a denial trap and an innovation trap.
We all know the denial trap. Business leaders underestimate the power of low-cost models to affect their business. They think that low-cost options are not serious rivals. They presume that their customers value their company’s service and brand too much to defect. When they start to see movement toward a low-cost player, they make some minor adjustments or efforts at imitation. When that approach eventually fails, they retreat to the premium segment.

This was exactly how traditional pharmaceutical companies reacted to the growth of generic drugs in the mid-1990s. Having considered generics to be negligible, they tried to cover the low-end market with older, off-patent products. Some launched generics divisions but closed them down because volumes were low and margins thin. But now Teva Pharmaceutical Industries, a leader in generics, is enjoying top-quartile profitability while growing at a rate that is three times that of the pharmaceutical market overall—and increasingly diversifying into...patent-protected drugs.

The innovation trap is familiar too. Development teams typically think that new products should always be better, more sophisticated, and, thus, more expensive than the models they replace. When new high-end products are launched, the previous generations are discounted, becoming the midrange and bottom-of-the-line products.

Meanwhile, smart low-cost players invest in true innovation targeted at the bottom of the pyramid. Leveraging new technologies and frequently new business models, these low-cost players compete and win against yesterday’s technologies. In fact, a leading manufacturer of medical devices, recognizing this syndrome, recently decided to refocus some of its R&D activities to renew its low-end range.

For those that have avoided the denial and innovation traps and have decided to participate in the low-cost game, there are still hard choices:

- Should the low-cost business model be operated within the core business?
- Should it share the same brand as the parent?
- Should it try to maximize synergies with the parent or favor autonomy?
- Should the low-cost business grow organically or by acquisition?

There are no one-size-fits-all answers to these questions, but experience suggests some general rules:

- Low-cost offerings cannot flourish within a traditional “high cost” environment.
- Brands can stretch only so far. Thus, a secondary brand is often advisable.
- The first priority for a low-cost model is that it must win on its own merits. Synergies should be a secondary concern.
- There are some brilliant organic-development successes in low cost. But, if good options exist, there is no shame in acquiring leading low-cost players in their infancy—and then giving them autonomy.

Jetstar Airways, the low-cost airline launched by the Qantas Group in 2004, is a great example of organic development. Jetstar was given a great deal of autonomy. It could buy its own planes, recruit staff under its own contract, and operate under its own brand. Jetstar became profitable in its first year of operation, and in 2009, Qantas announced that its own solid financial performance was principally due to Jetstar’s strong profitability. Most other traditional airlines that launched low-cost offerings chose to maximize synergies, leading to disappointing results because of the mismatch between their low-cost value proposition and a hybrid operating model that combined some low-cost elements with largely major-carrier economics.

Essilor International, the world leader in ophthalmic lenses, illustrates the role of acquisitions. The company has made several attempts to counter the increasing share of Asian imports in its core Western markets. Throughout the past decade, Essilor conducted a systematic acquisition program of low-cost players on all continents. To date, the company has purchased a leading Korean manufacturer, Indian laboratories, and leading stock houses in countries including Italy, the United Kingdom, and the United States. Given that
these companies were quite profitable, Essilor has let them run fairly independently with a focus on top-line success. The company calls this approach “organic acquisition.”

A Call for Action

Multinational companies cannot avoid having a robust low-cost strategy. Without one, it will be impossible to compete in emerging markets and to prevail over innovative low-cost challengers in developed ones. Low-cost attackers often hit where it hurts, rapidly crippling the economics of more traditional business models.

So take a moment to dream: get your management team together and imagine your worst nightmare. Then ask yourselves what it would take for your company to be the initiator rather than the victim. This might cannibalize some of your current profit, but, most likely, it will also expand your market scope in a significant way.

Are you like the monks of the fifteenth century, trying to illuminate manuscripts faster and better, or are you envisioning and creating the new printing press that will vault you to the top of your industry—and deliver a true revolution for the benefit of mankind?
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Acknowledgments

The authors would like to thank Charlotte Polderman for her valuable research contributions. They would also like to thank Katherine Andrews, Gary Callahan, Matthew Clark, Angela DiBattista, Elyse Friedman, Sara Strassenreiter, and Simon Targett for their editorial and production assistance.

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