Profit Patterns

by Adrian J. Slywotzky and David J. Morrison

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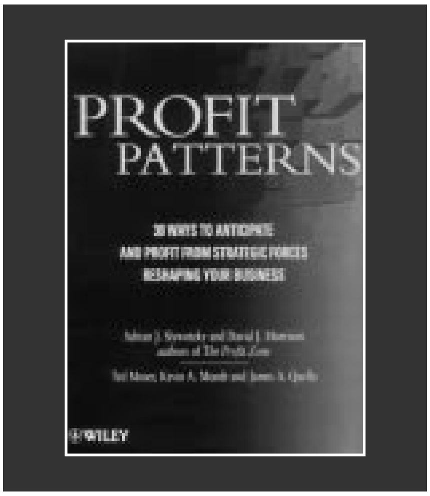

THE AUTHORS

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THE KEY IDEAS

Increasing the value of a company depends on its capacity to predict

Value migration from one economic sector to another or from one company to another has unimaginable proportions, in particular because of the new phenomena that mass investment and venture capital represent. The public is looking for companies that will succeed in the future and bet on the winner.

Major managers have a talent for recognizing development market trends

There are some changing and development trends in all business sectors. They can be erected into models, thereby making it possible to acquire a technique for predicting them. This consists of recognizing them in the actual economic context. This book proposes thirty strategic prediction models divided into seven families.

Predicting is not enough: one still has to act in time!

Managers analyze development trends in the environment in order to identify opportunities. They then have to determine a strategic plan for their company, and set up a system aligning the internal and external organizational structure as a function of their objectives.

THE SUMMARY

Migration of value and polarisation

Market value migrates towards new business concepts. The polarisation phenomenon multiplies the importance of detecting tendencies as soon as possible.

For most of the 20th century, mastering strategic evolution models was not a determining factor, and formulas for success were fixed and relatively simple. In industry, the basic model stated that profit was a function of relative market share. Today, this rule is confronted with more and more contradictions: among car manufacturers for example, where small companies like Toyota are more profitable than General Motors and Ford. The highest rises in value have become the exclusive right of the companies with the most efficient business designs. These upstart companies have placed themselves in the profit zone of their sectors thanks, in part, to their size, but also to their new way of doing business - exploiting new rules which are sources of value creation. Among the new rules which define a good strategic plan are:

➜ strong orientation towards the customer

➜ internal decisions which are coherent with the overall activity, concerning the products and services as well as the involvement in the different activities of the value chain

➜ an efficient mechanism for value–capture.

➜ a powerful source of differentiation and of strategic control, inspiring investor confidence in future cash-flow.

➜ an internal organisation carefully designed to support and reinforce the company's strategic plan.

Why does value migrate? The explanation lies largely in the explosion of risk-capital activities in the USA. Since the 40's, of the many companies that have been created, about a thousand have allowed talented employees, the "brains", to work without the heavy structures of very big companies. The risk–capital factor is now entering a new phase in the USA, in that the recipes for innovation and value-creation are spreading from just the risk-capital companies to all big companies. A growing number of the 500 richest companies have an internal structure for getting into the game of investing in companies with high levels of value-creation. Where does this leave Europe? According to recent research, innovation in strategic thinking is under way in Europe, albeit with a slight time-lag. Globalisation is making the acceptation of these value-creation rules a condition of global competitivity.

There is a second phenomenon that has an even more radical influence on value-creation - polarisation : The combination of a convincing and innovative strategic plan, strategic control and a dominant market share creates a terrific increase in investor confidence. The investors believe that the company has established its position of strength not only for the current, but also for the next strategic cycle. The result is an exponential growth in value, and especially a spectacular out-distancing of the direct rivals. The polarisation process typically has two stages. In phase 1, the competitors seem to be level. In fact, one of them has understood, has "got it", before the others and is investing in a new strategic action plan to take into account the pattern which is starting to redefine the sector. Phase 2 begins when the conditions are right for the pattern to take over: at this moment, the competitor who "got it", attracts the attention of customers, investors and potential recruits (the brains). The intense public attention snowballs, the market value explodes to leave the nearest competitor way behind. Examples are numerous in various sectors: Microsoft against Apple and Lotus, Coca-Cola against Pepsi, Nike against Reebok and so on. Polarisation of value raises the stakes and adds a sense of urgency: The first company to anticipate market change and to take appropriate invest-

Microsoft versus Apple and Lotus

In 1989, Microsoft, Apple and Lotus had solid client bases, excellent products and equivalent market-values. Subsequently, Microsoft's ambitious and forward-thinking strategic market plan captured the energy of several economic and strategic developments, and thanks to polarisation, Microsoft quickly dominated the market. Today, Microsoft is worth (in billions) $220, Apple $4 and Lotus $3.

ment decisions can gain a considerable lead thanks to recognition by the market.

Mindsharing

Companies which manage to use models to recognise key changes in their sector can gain value by polarisation. ê The way to do this is mindsharing with the main customers, investors and potential recruits.

In a growing number of sectors today, competition is concentrated on the race towards mindshare. The company which leads this race attracts customers who attract others in an upwards spiral. At the transition from phase 1 to phase 2, the managing team's top priority is to win the mindshare battle. There are three stages in this strategy: mindsharing with customers gives an immediate competitive advantage in terms of sales; mindsharing with investors provides the resources to maintain this advantage, and mindsharing with potential recruits increases the chances of maintaining the lead in the short and the long term. This triple capture sets off a chain reaction releasing an enormous amount of economic energy. Markets today are characterised by a staggering degree of transparency. Successes and failures are instantaneously visible to the whole world. The extraordinary success of some investors encourages professional and amateurs to look for the next hen to lay a golden egg. This investment mentality has spread to the employment market, where compensations (such as stock-options) are increasingly linked to results. From these three components - customers, investors and new talent – is created the accelerating phenomenon, polarisation: thousands of investors look towards the leader at the beginning of the race. The share value goes up at the same time as the rise in customer numbers and the public perception that the current leader will be the winner. The rise in share-price gets more attention from the media, and so on.

" Markets today are characterised by a staggering degree of transparency. "

How to get the knowledge before the others, in order to launch the company into leadership? There are several attitudes, forms of behaviour and knowledge that can be used: being paranoiac, thinking from day to day that the current market conditions are going to change; talking to people with different points of view; being in the field, looking for signs of change. And above all, building a research network to find the patterns of strategic change, not only in one's particular sector, but in the whole economy, so as always to understand the patterns a bit better and a bit sooner than the competitors.

Thirty patterns of strategic evolution

Experienced managers can detect similarities between movements of value in different circumstances. 30 of these patterns can be divided into 7 categories.

Some managers understand migrations of value before other managers, allowing them to continually improvise their business plan in order to find and exploit value. Experience is an obvious advantage: situations can repeat themselves or be similar to others, so that experienced managers recognise and assimilate them quickly.

Amazon.com

CONVENTIONAL TO DIGITAL BUSINESS DESIGN:

Amazon combines Internet technology and customer analysis so as to overcome the inefficiencies of traditional booksellers and:

➜ offers 2 million titles, a greater choice than that of any "superstore",
➜ aims as much at the ordinary reader who wants a wide choice as the specialist,
➜ can have a virtual stock ten times as great as the physical stock of its rivals,
➜ has a negative working capital requirement,
➜ has a stock rotation 50 times greater than that of a traditional bookshop.

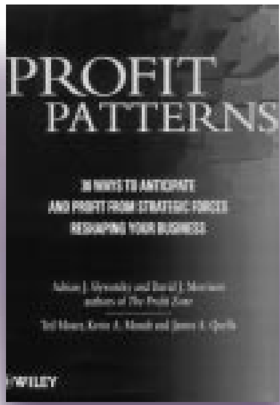
Thanks to these factors, Amazon can sell 20 to 30% cheaper than its competitors.

MICRO-SEGMENTATION:

Amazon gathers information on clients each time they buy, and gradually personalises the customers' visits according to that information and to that of other customers with similar tastes. The customisation is refined each time the customer orders or just browses

THE CORNERSTONE:

Book sales are the cornerstone of Amazon's activities. Now that the stone is well-established, Amazon are seeking to diversify into CD's and into internet portals giving price-comparison information.



There about 30 patterns which can be put into 7 groups according to their key factors. It is important to understand that the patterns have three general characteristics: multiplicity, variants and cycles. The principle of multiplicity indicates that while a sector or a company may be affected by just one simple strategic pattern, most situations are more complicated and involve several simultaneously evolving patterns. The variants to the known models are developed in different circumstances and according to the creativity of the users of the models. Studying the variants gives more finesse in model-analysis. Finally, each model depends on economic cycles which are more or less long. The time a pattern takes to develop depends on its nature and also on the nature of the customers and sector in question.

1) The first family of strategic evolution patterns consists of the six “Mega patterns”: these models do not address any particular dimension of the activity (customer, channels of distribution and value chain), but have an overall and transversal influence. They owe their name “Mega” to their range and impact (as much from the point of view of the different economic sectors as from the duration). The six Mega models are: No profit, Back to profit, Convergence, Collapse in the middle, De facto standard and Technology shifts the board.

• *The No profit pattern* is characterised by a zero or negative result over several years in a company or economic sector. The first factor which favours this pattern is the existence of a single strategic plan in several competitors: they all apply differentiation by price to capture market-share. The second factor is the loss of the “crutch” of the sector, that is the end of a system of help, such as artificially maintained interest levels, or state subsidies. Among the best examples of this in the USA are in agriculture and the railway industry in the 50’s and 60’s, and in the aeronautical industry in the 80’s and 90’s.

• *The Back to profit pattern* is characterised by the emergence of innovative strategic plans or projects which permit the return of profits. In the 80’s, the watch industry was stagnating in a no profits zone. The vision of Nicolas Hayek allowed Swatch and other brands to get back into a profit-making situation thanks to a products pyramid built around the new brand.

Thirty profit patterns

Les principales tendances d'évolution stratégique et de migration de la valeur peuvent être schématisées à l'aide de 30 modèles de profit, eux-mêmes regroupés en sept grandes familles. Chaque modèle reprend un schéma classique de perte de valeur pour un secteur ou une entreprise, et donne des indices quant aux remèdes à apporter.

MEGA PATTERNS
- No profit
- Back to profit
- Convergence
- Collapse of the middle
- de facto standard
- Technology shifts the board

KNOWLEDGE PATTERNS
- product to customer knowledge
- Operations to knowledge
- Knowledge to product

Product patterns
- Product to brand
- Product to blockbuster Product
- Profit multiplier
- Product to pyramid
- product to solution

VALUE CHAIN MODELS
- Deintegration
- Value Chain squeeze
- Strengthening the weak link
- Reintegration

CHANNEL PATTERNS
- Multiplication
- Concentration
- Compression
- Disintermediation

CUSTOMER PATTERNS
- Profit shift
- Microsegmentation
- Power shift
- Redefinition

ORGANISATION PATTERNS
- Skill shift
- Pyramid to network
- Cornerstoning
- Conventional to digital business design

• *Convergence* implies the grouping together of several economic sectors or elements of the value chain (suppliers, products, complementarity) so that all previous known limits are broken. An example is the sector of materials, particularly that of the intrusion of plastic and aluminium into the previously closed domain of steel. The consumers' interest in light, economic materials made aluminium and plastic the winners in the convergence, and steel the loser.

• *Collapse of the middle pattern* involves the passage from an average, uniform offer to a new and extreme differentiated offer. The danger comes from an offer which does not reach its objectives, with no differentiation, neither by price nor by product. This model is best illustrated by traditional computer constructors (or original equipment manufacturers) whose value was transferred to Dell (an economical and highly personalised product) or to IBM and Hewlett-Packard (personal computer constructors who became also suppliers of integrated solutions).

“ For fifteen years, value has been emigrating from products to brand names, integrated solutions and blockbusters. ”

• *De facto standard model* concerns sectors where customers or consumers demand product compatibility (usually technical), and one competitor creates value, through an innovation, by managing to impose a standard for the whole sector. There are numerous well-known examples of standards: certificates of quality (ISO 9000), capacity to function universally (VHS video recorders)... Standards create a real need in the consumer, and allows the company who exploits them to profit in two ways: through sales of products conforming to the standard, and also through contracts with partners who are interested in the standard. The counter-example of Apple is interesting here: until the 90's Apple's graphic interface system (Macintosh) was considerably superior to Microsoft's system. Apple decided to use this advantage to make more highly-priced computers, instead of working on a coalition of competitors/partners which would have made their interface the de facto standard. The result of this strategy is sadly famous; $100 billion of value transferred to Microsoft, who then imposed Windows as the PC standard.

• *Conventional to digital business design* is the last "Mega Model". An important technological innovation suddenly moves the board on which all the strategies and battles take place and the power structure is quite changed. There are few inventions or technological innovations which can really have such influence on the economy: the car, television, the personal computer, Internet . . . Each time, the cards are dealt out again, in a way which is sometimes unforeseeable, but always profound. At the beginning of the television era, for example, the number of manufacturers multiplied, while only a handful remain today; the advertising landscape changed entirely, as did the entertainment sector, which moved, practically overnight, from Hollywood to New York.

The six other groups of strategic patterns do not have such a general impact on the economy as a whole, but each group is relatively homogeneous.

In the 80's watches industy were in a no profits zone. The vision of Nicolas Hayek allowed Swatch and other brands to get back into a profit-making situation thanks to a products pyramid built around the new brand.

Draw your own strategic landscape

Establish a complete picture of your own area of action:

➜ **Factors of influence:** :
media, investors, financial advisors, State/Regulators and Lobbies.

➜ **Sources of talent:**
employees, recruits – potential "brains"

➜ **Sources of innovation:**
research and development, risk-capital, universities

➜ **Partnerships with other sectors**

List also your customers, channels of distribution, suppliers and value-chains in competition.

You will be able to identify malfunctions, incompatibilities, contradictions and discontinuities, and so you will more easily anticipate the emergence of new patterns.

2) Value-chain patterns consist of the evolution of relations a company has with the different levels of its value-chain: customers, distribution channels, products and raw materials. Should certain tasks be sub-contracted out or brought back in to the company.? Change the supplier or strengthen links with him.

3) Customer patterns concern the risks brought about by changes in customer attitudes, in terms of the loss or creation of value. Are all customers profitable? What are the limits of segmentation? What is the ideal customer?

4) Channel patterns : how distribution tendencies influence value creation. Distribution channels multiply in line with consumer segmentation. They can also reduce in number, as in the case of French supermarkets, where baker, dairyman, butcher and fishmonger are all found in the same shop. The intermediaries in these channels can similarly appear or disappear.

5) Product patterns show how value has migrated, over the past 15 years, from the product to other elements, such as the brand, integrated solutions and blockbusters.

6) Knowledge patterns: as the economy passes from the fabrication of physical goods to the application of useful ideas, these patterns will multiply in the years to come. Knowledge gained through the activity permits the redefinition of this activity, using information on consumers, products and internal organisation.

7) Organisation patterns illustrate the new business paradigm, value-creation, and the future paradigm, the balance of attention given to products, customers and internal and external organisation of the company. A company's share in value-creation will depend on two main imperatives: the system must be perfectly tuned to the company's strategic plan, and sufficient energy must be expended to execute the plan brilliantly. The common factor in these models is the close link between the talent of the company and its customers.

Applying the method.

The manager can employ methods to detect other patterns and tendencies in his sector, and establish response mechanisms in the company

The list of patterns noted here is obviously not exhaustive. The manger needs methods of identifying other, unknown tendencies, especially in complex environments. He also needs specific tools for taking specific action decisions, as well as spotting tendencies, if possible, before his competitors. Three tools are of help here:

➜ Visualise your strategic landscape: With the help of the diagram (page 15) construct a global picture of your playing-field. Begin with your customers and your prospects, adding all the distribution channels, the representatives who have an influence on the sale of your products or services, the sources of inspiration and talent, your competitors and the suppliers and other agents who orbit in your sphere.

Then ask yourself if the management team is capable of: identifying potential customers; analysing profit variations in the value chain; finding the weak link and identifying zones of emerging profits. With this approach you will be able to detect tendencies which change the strategic landscape of your sector.

➜ Measuring Mindshare:

In addition to your strategic landscape diagram, ask yourself some fundamental questions about the company's mindsharing. Today, in your sector, who is mindsharing with the customers? To whom are the customers, or the most profitable segment of customers, giving their money today? Which companies are attracting venture-capital investors? Which companies are going, or are about to go, public? As for talent recruitment, what is your analysis of the turnover of the ten stars of your sector? Which companies are attracting talent? Finally, who is winning the battle for mindshare with the media and other important actors on the scene? And then find out how the winners have managed to acquire this mindshare for their company.

➜ Decode the conditions and the detonators:

The principle tendency-indicators can be put into three categories: first, there is the variability in the extent of customer priorities and in the relative performances of competitors. Then, the speed and direction of change: an acceleration or a change of direction in customers' priorities, in technology or in current strategic plans. Finally, malfunctions in the value-chain, in the organisation or in customer groups (friction, inefficiency etc.).

The manager wishing to anticipate the great strategic developments in his sector in order to get ahead of his competitors must dominate the current patterns, knowing their vocabulary, how they work and what their variants are. He must also be well acquainted with the strategic landscape of the whole economy. He must be able to decode the main indicators of his sector – their relative importance and amplitude. He can then take action: identify and evaluate potential strategies to choose the one which will give him a decisive advantage over the competition.

From
Profit Patterns
by Adrian J. Slywotzky
And David J. Morrison
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FOR FURTER INFORMATIONS

The human equation : building profits by putting people first,
by Jeffrey Pfeffer, Harvard Business School Press, January 1998.

Value migration : how to think several moves ahead of the competition,
by Adrian J. Slywotzky, Harvard Business School Press, January 1996.

L'EXPERT

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The most important objective of companies is to create, develop and maintain one or more competitive advantages in order to generate dividends for the shareholders. For a long time, it was simply a question of dominating the market, either by costs or by a policy of differentiation. As Michael Porter advised, it was essential to avoid being "stuck in the middle". This way of thinking set up competitive rivalry in a closed world, and tended towards stability.

This model is less and less relevant today for whole sectors of the economy. We see a multitude of strategic movements which defy the logic of the old system. "Profit Patterns" lists numerous strategies which have joined the small number that we knew before. These patterns often combine to give rise to strategic models which are better adapted to the new and changing needs of the consumer. The game is also complicated by the rapidity, even suddenness, with which the patterns impose themselves on their markets.

Competitive advantages thus become more difficult to maintain and so the relative positions on the market become more fluid. The game is open the those who can anticipate. "Profit Patterns" explains how to analyse these tendencies and identify the holes in the market which are paths of opportunity for companies in the know, threats for the others. Nothing can be taken for granted in the New Economy. The Internet sector shows us that companies must learn to regularly adapt their business design. For it to work properly, the analysis plan proposed by the authors must be taken on board by the managers so that it can be conducted permanently throughout the whole organisation.

This business culture revolution must go further: speed, flexibility and experimentation are the keys to success today. Imagination, vision, and the capacity for strategic executive action are essential qualities. Even more than analysis, it is intuition and action which have replaced strategic planning. Fortune wrote recently that the leaders of the new economy "don't stop to think; they just take action, at high speed."

The instability inherent in this new strategic reality has its counterpoint in the sudden developments seen in the financial world. The authors rightly underline the importance of the "polarisation" effect which is more and more frequent in certain sectors: companies suddenly experience an exponential growth of their share-value which leaves their main competitors standing. A virtuous circle is set up: rising value gives them the financial resources to accelerate their development and to recruit the best talent thanks to remuneration based on share-performance.

The authors rightly attribute this phenomenon to investors' recognition of the superiority of these new business designs. However this interpretation merits refinement: the superiority resides less in the companies' current capacity to identify the first indications of strategic discontinuity than in their future capacity to develop a portfolio of strategic options and to choose the right one at the right time. The value of such companies as Amazon and AOL, which benefit from financial polarisation, can only be explained in this way.

To be competitive in the long-term, a company must not only excel in its "real" market, but also in its financial market. Competition in both is very fierce, and one can not neglect either of these fields of battle without suffering the consequences. This share-market will assume its own importance alongside the commercial market, and in the future, its successful exploitation will be a key to the strategic superiority of publicly-quoted companies.

JEAN-FLORENT RÉROLLE